Good May Job Gains, But a Long Road to Recovery

Key takeaways
- The June 5 employment report was unexpectedly strong in jobs created and an unemployment rate that saw a decline (instead of a rise).
- Some caution is in order, however, as many features of the report suggest that the road to recovery is likely to have many twists and turns along the way.

What it may mean for investors
- We continue to expect equity market volatility and recommend that investors use the recent rally to reallocate towards quality asset classes and sectors.

Surprisingly strong employment report for May has implications for the second half of 2020

Last Friday’s employment report was unexpectedly strong in jobs created and an unemployment rate that saw a decline (instead of a rise). The trend in continuing unemployment claims has improved somewhat recently, and it is in line with the May employment report showing that some workers have been called back. However, the decline was more than we expected to see this soon as businesses start to re-open.

Most encouraging, hiring strength was most notable in many of the industries that suffered the most during the nationwide lockdown. The Leisure and Hospitality sector has been a focus of the lockdown. Restaurants and bars shed 5.4 million jobs in April but added 1.37 million jobs in May. Meanwhile, construction payrolls rose by 464,000 in May, erasing nearly half of the 995,000 jobs that April took away. Construction jobs returned in both homebuilding and nonresidential construction.
Other measures, particularly the increase in the average workweek, imply that the economic recovery probably began in May—at least a month earlier and likely stronger than we had been expecting. The economy may well have a stronger second half in 2020 than we had anticipated, even if fourth-quarter growth moderates from a powerful third-quarter pace.

Fallout from May’s blockbuster employment report extends beyond the timing and strength of the economy’s recovery to the monetary and fiscal policy debate and, arguably, the stock market’s rally and the November elections. Encouraging economic data likely will add to investor interest in the June 10 FOMC (Federal Open Market Committee) policy announcement—specifically the Federal Reserve’s plans for added monetary stimulus. The economy’s more upbeat tone also could influence the debate in Congress and with the White House over another fiscal-support package expected later this month. Economic optimism also could provide a shot in the arm to the president’s poll numbers. Lastly, signs of strength help validate the stock market’s latest rally and, perhaps, provide a base for further gains despite rich market valuations.

The long and winding road to recovery is just beginning

We expected employment to rise as businesses reopened in the spring. In fact, nearly 75% of last month’s employment gain came from a 2.7 million decline in furloughed workers. That contributed to a decline in the unemployment rate to 13.3% from 14.7% in April (or to 16.3% from 19.7% the previous month if millions of temporarily laid off workers had not been classified as employed). By contrast, an increase in permanent layoffs actually added to the jobless rolls. That increase may reverse if, as expected, growth from the reopening ripples across the economy.

Nevertheless, several points argue for continued patience with the economic recovery:

1. At least some of the furloughed workers and recent increases in what the Labor Department describes as “permanently” unemployed may not be called back as quickly—or maybe not even at all—if the recovery is disrupted or growth remains too weak to rehire them.

2. Unemployment, at 21 million, remains far above anything experienced in the past 70 years, pointing to a long road ahead for a full labor-market recovery in the absence of an unlikely economic boom.

3. Also, consider that other parts of the Leisure and Hospitality industry were not as fortunate as restaurants and bars. Jobs at hotels declined by a further 148,200 jobs in May, leaving employment in this sector a little less than half of what it was one year ago.

4. In total, restaurants have hired back roughly 23% of the workers they let go in March and April. While we expect some follow through in June, some large chains have already warned that business has not come back as quickly as they brought back workers, and they are now reducing hours and asking workers to take unpaid leave.

5. Future job growth could face headwinds from further cuts by businesses unable to hang on until a recovery is fully on track, along with local and, particularly, state layoffs responding to cuts to balance budgets. Most of May’s decline in public-sector employment was in education and other local-government jobs, leaving jobs at the state level particularly vulnerable. In the corporate sector, May’s announced layoffs of 400,000 workers, though down from April, still were more than five times higher than the long-term average.
We conclude that the economic recovery may begin sooner than we had thought, but the road to recovery is likely to have many twists and turns along the way. We expect the economy to be tested by a staggered reopening and a potentially cautious response by consumers to the reopening in the absence of a vaccine, immunotherapy, or adequate testing safety net. Moreover, there’s the risk of renewed increases in the COVID-19 infection rate, plus increased bankruptcies and fresh layoffs in some sectors of the economy even as others are slowly improving.

**Investment implications**

We continue to expect some range trading in the S&P 500 Index in the coming weeks and months. It’s good to see the economy starting to rebound now, and that does suggest a stronger third-quarter rebound than we had expected. But that and a lot of positive expectations (for example, COVID-19 infection rates in the months ahead) have been priced in. It’s still early to confirm these positive trends in the economy, and we still foresee volatility without support from improving earnings.

Our guidance to investors since early March has been to be overweight U.S. Large Cap and U.S. Mid Cap equities, but to stick with quality sectors—those where firms have good cash flow, good cash/debt ratios, and good earnings prospects. Those sectors are Information Technology, Communication Services, Consumer Discretionary, and Health Care. We also favor Financials, but more from a valuation perspective. We favor rotating funds out of Industrials, Energy, Materials, U.S. Small Caps, and international markets.
Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks.

Sector Risks

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio’s vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **Communication** services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Investing in the **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio’s performance. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

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