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U.S. Labor Markets—Signals of Strength and Struggle

What could labor markets be signaling for the U.S. economy ahead? We explore indicators to assess when a turn in the economy may come.

DEEPER ANALYSIS OF INVESTMENT TRENDS AND TOPICS

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Key Insights

- *In recent quarters, employment reports have been consistent with robust labor market conditions—reflecting an extended period of U.S. economic strength.*
- *Historically, these employment trends have preceded business cycle turns that eventually gave way to recession. We do not believe that a U.S. recession is imminent, but we expect some labor market measures to soften later in 2019 as economic growth slows.*
- *This likely will contribute to renewed growth concerns and heightened market volatility. In this month's report, we analyze leading, coincident, and lagging labor-market indicators to offer insight on the timing of U.S. economic and market changes.*

In recent quarters, employment reports have reflected some of the strongest U.S. labor market conditions in decades. For example, the number of surveyed individuals noting that they were unemployed, and those filing for first-time unemployment insurance benefits, fell to a 50-year low in April. And by some measures, there currently are more job vacancies than there are unemployed individuals to fill them. This positive data have emerged at a time of heightened investor concern about a U.S. economic recession.

While employment trends generally have been encouraging, we believe that the latest labor market releases reflect both strength and some signs of struggle in the U.S. economy. Low unemployment, steady hiring activity, and high job vacancies suggest the economy has passed through a period of strength. Historically, such labor market strength also has preceded business cycle turns that eventually gave way to struggle as the economy slipped into recession. We do not believe that a U.S. recession is imminent. Yet, we do expect some measures of labor market activity to soften later this year as growth slows. This is likely to contribute to heightened levels of market volatility in 2019 as investors contend with renewed growth concerns.

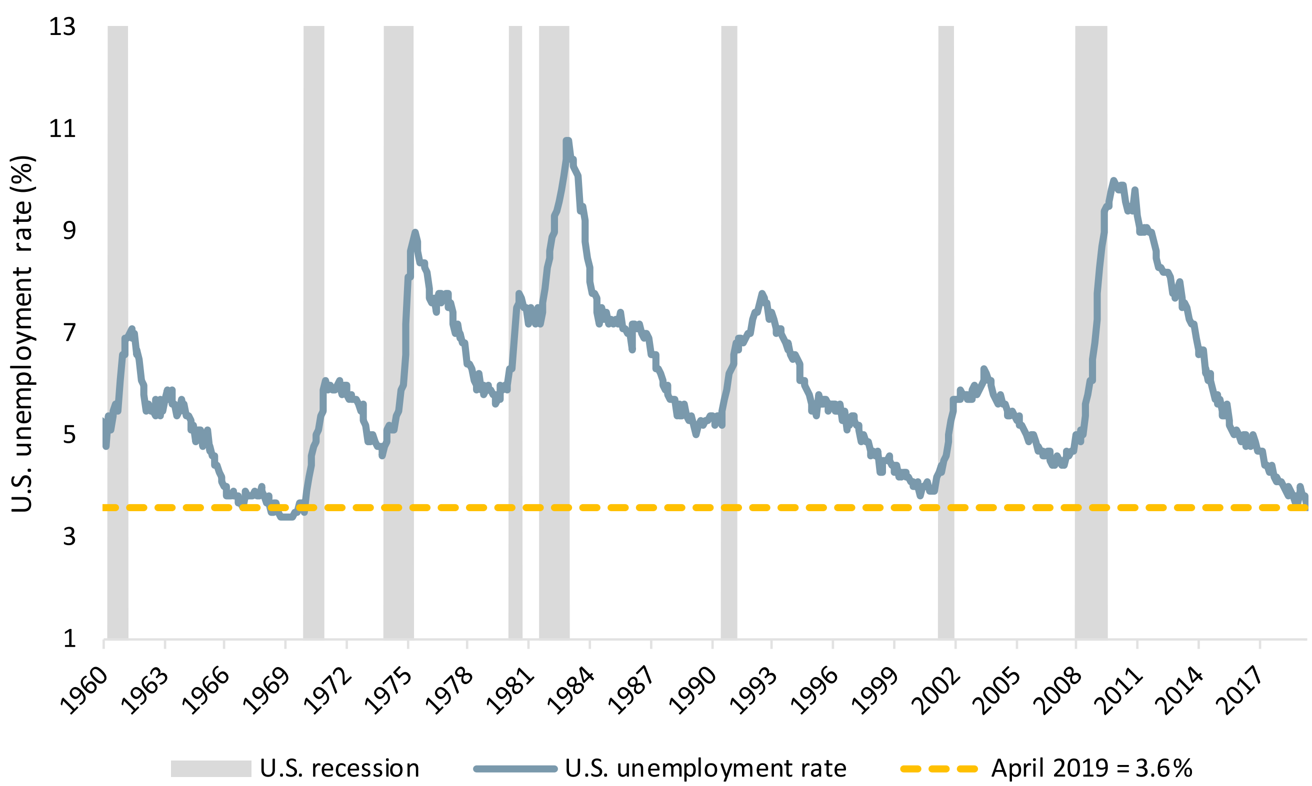
The U.S. unemployment rate and economic growth

In April, the U.S. unemployment rate fell to 3.6%, which was its lowest reading since October 1969 (Chart 1). This came on the heels of a better-than-expected first quarter gross domestic product (GDP) print. The release had sparked optimism among some investors that U.S. economic growth still could reaccelerate this year. Nevertheless, statistical analyses of the data tell us that falling unemployment typically occurs as a result of improving GDP growth—and often with a time delay. In other words, the unemployment rate is a lagging indicator that tells investors where the economy already has been, rather than where it is going.

What should investors make of April's unemployment print? While the April unemployment rate was notably low, it was by no means a record. April's unemployment rate ranks 57th lowest out of all monthly releases since 1948. In fact, the record for the lowest U.S. unemployment rate actually was in May 1953, when this key figure fell to an impressively low 2.5%. Back then, GDP, labor productivity, and wage growth were expanding at average annual clips of 6%, 4%, and 7%, respectively. These are enviable statistics compared to today's low-growth environment in which similar measures have more or less averaged about half of those historical rates.

Further, following the 2.5% unemployment rate low in May 1953, the U.S. economy subsequently slipped into a recession (in July 1953). This was only two months after the unemployment rate hit its remarkable low. Further statistical analysis suggests that U.S. recessions historically have been preceded by unemployment rate intracycle lows at an average of 7 months before the recession (and by as long as 16 months prior to recession). What do unemployment data suggest about the economy today? Indicators underpinning our current economic forecasts suggest that U.S. unemployment is likely to continue along its downward trajectory through the course of this year, which does not suggest an imminent recession.

Chart 1. U.S. unemployment was at a 50-year low in April 2019



Sources: Bureau of Labor Statistics, Bloomberg, Wells Fargo Investment Institute; data as of April 30, 2019.

Chart 2. Nonfarm payrolls can be a useful measure of real GDP growth

Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Bloomberg, Wells Fargo Investment Institute; May 17, 2019. Real U.S. GDP measures total U.S. economic output that is adjusted for price changes. Unlike nominal GDP, real GDP accounts for inflation, and it often can offer a more accurate view of economic growth than nominal GDP can. Quarterly data, and monthly nonfarm payroll data, reflect three-month average values for each quarterly period. A Granger causality test was performed to determine the statistical relationship between GDP and nonfarm payrolls more precisely. The analyses were conducted between March 1990 and December 2018 to assess the long-term relationship and between March 2010 and December 2018 in order to assess the short-term relationship. They showed a coincident, and sometimes one-quarter lead, relationship between nonfarm payrolls and U.S. GDP.

Payroll trends can be a useful measure of real-time economic growth

In recent months, investors also have been presented with better-than-expected private nonfarm payroll data (the "jobs report"). Whereas the unemployment rate is based on a U.S. Bureau of Labor Statistics household survey of respondents' indication of joblessness (the Current Population Survey), nonfarm payrolls reflect hiring activity as reported from a business perspective (Current Employment Survey).

Statistically speaking, changes in nonfarm payrolls tend to coincide with (and in some cases, lead) developments in the broader economy (Chart 2). This makes the nonfarm payroll indicator a useful real-time gauge of U.S. economic activity. While an advance look at quarterly GDP figures is typically published in the first month following quarter-end, monthly nonfarm payroll data are released on the first Friday of *every* month. This higher frequency data can give some investors a better sense of how the economy is doing—even before the lower frequency, quarterly GDP data are released.

For example, our analysis shows that GDP growth, adjusted for the effects of trade and inventories, actually decelerated in the first quarter of 2019. In other words, growth in the U.S. economy slowed even as headline GDP growth beat expectations. What did the higher frequency monthly nonfarm payroll (jobs) data tell us about first-quarter economic activity? While the year-over-year measure of nonfarm payrolls initially rose in January, by March, payroll growth slowed to a nine-month low, consistent with softer U.S. first-quarter GDP growth.

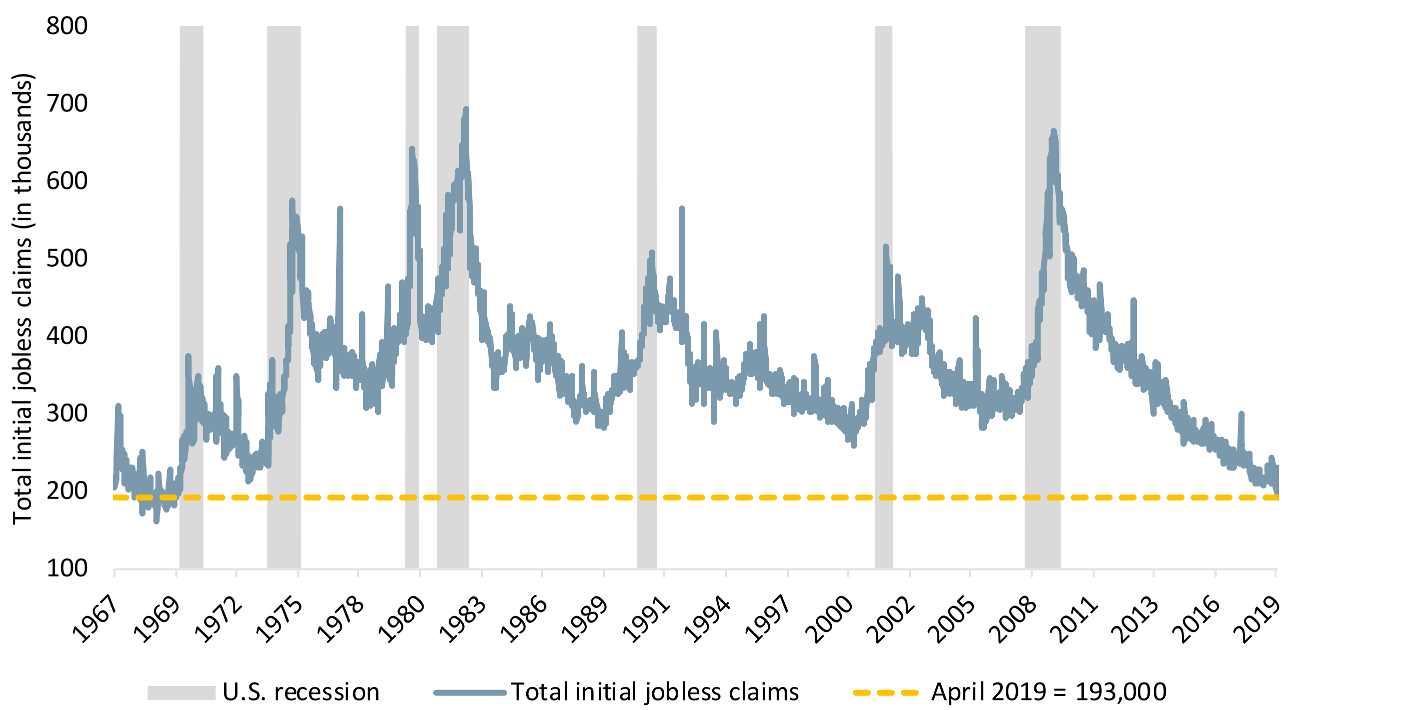
A leading employment indicator for economic activity

If the unemployment rate tells us where the U.S. economy has been and nonfarm payrolls are a measure of current conditions, what labor market indicator can investors look to as a guide for whether the economy is facing continued strength or future struggle? Jobless claims are one such useful data point. Technically speaking, there are two types of jobless claims: initial jobless claims, and continuing claims for unemployment insurance—with a key difference being whether unemployment insurance claims are filed by those workers just displaced from their jobs or those presently jobless but still seeking work.

In April, the initial jobless claims measure fell to 193,000, a multi-decade low—as fewer employers chose to displace workers. To put this into context, during the height of the Great Recession, 650,000 displaced workers were filing initial unemployment insurance claims per week (Chart 3). One explanation for today's low jobless claims is that employers are more reluctant to displace workers when economic conditions remain somewhat favorable and the ability to hire a new employee has become more challenging (based on the Job Openings and Labor Turnover Survey data for March 2019).

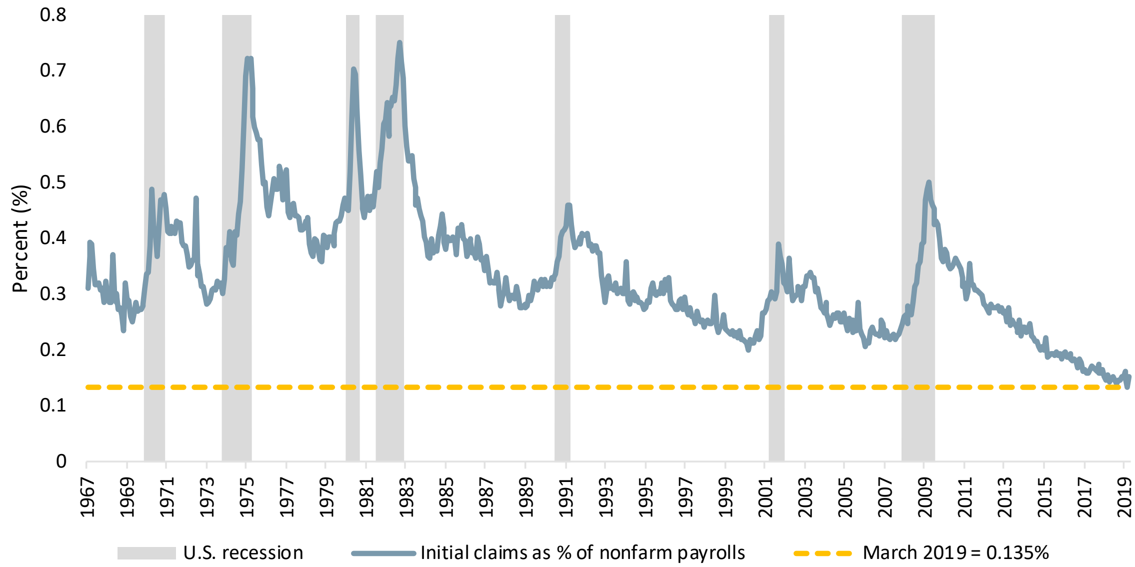
Markets initially rallied on the April jobless claims data. Market participants cited the latest release as more evidence that the economy was exhibiting signs of a rebound. In fact, the last time initial unemployment claims were this low, the size of the U.S. labor force was half the size that it is today. Put differently, Chart 4 shows that the number of initial jobless claims filed, as a percentage of employed workers, fell to a rate not seen in recent history. This suggests that employers are holding on tightly to their workers as good help is increasingly more difficult to come by.

Chart 3. Initial jobless claims fell to a 50-year low in April 2019



Sources: Bureau of Labor Statistics, Bloomberg, Wells Fargo Investment Institute; April 30, 2019.

Chart 4: April ratio of initial jobless claims to nonfarm payrolls was the lowest in recent history



Sources: Wells Fargo Investment Institute, Bureau of Labor Statistics, Bloomberg; May 20, 2019.

Another reason that initial jobless claims are important to investors is because of their foretelling nature. Changes in unemployment claims have been statistically shown to lead changes in some key components of the U.S. economy, such as consumer spending. While the latest jobless claims data have been consistent with a rise in economic activity, this release's sensitivity to (ebbs and flows in) business confidence suggests that jobless claims could rise this year. One reason that we expect this is that business confidence likely will weaken in the months ahead as geopolitical concerns and other policy uncertainties make the future less certain. This could lead employers to become less hesitant about displacing workers as economic activity slows.

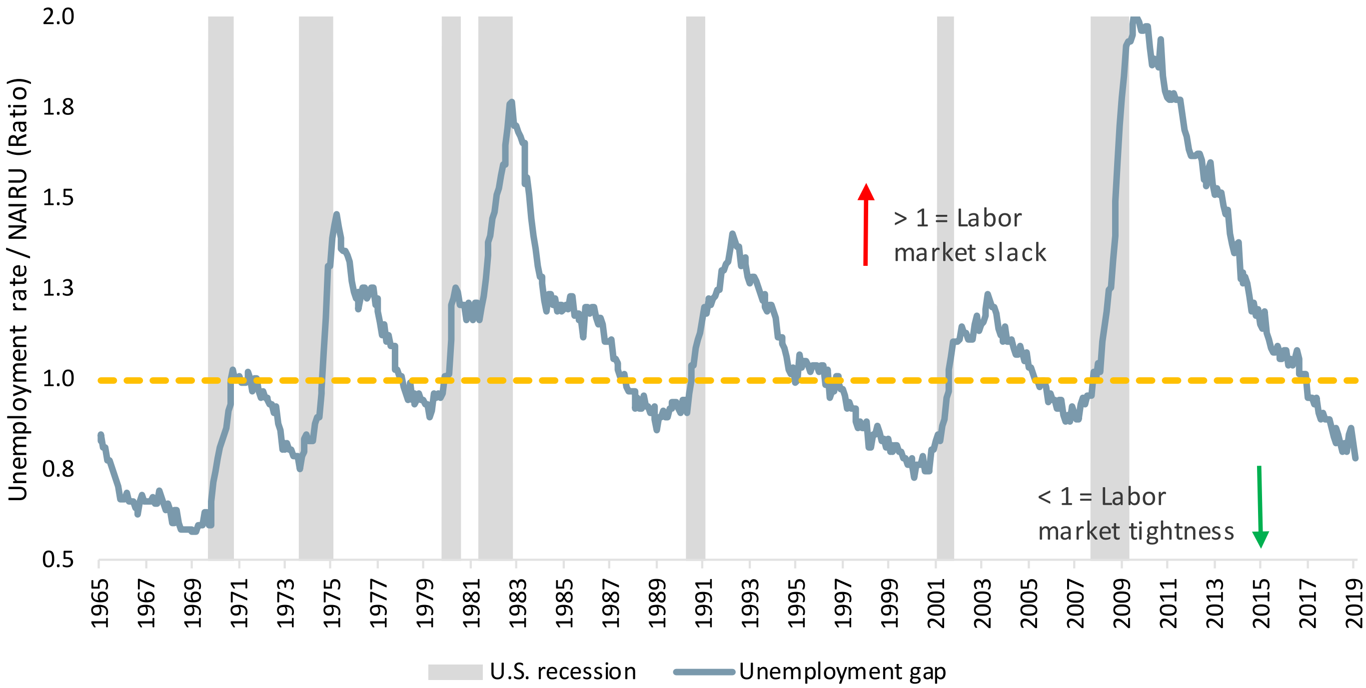
Labor market tightness or slack

Terms like "slack" and "tightness" often are used to connote the relative health of labor market activity. Some investors are particularly interested in whether there is more room for employers to hire workers (slack)—as this often is associated with a stronger economic outlook (and less inflationary pressure). Our review of the unemployment rate, nonfarm payrolls, and jobless claims suggests that there is less slack in the U.S. labor markets than there was in the recent past. This, in turn, reflects more labor market tightness and potentially could leave only slightly more room for additional U.S. job gains this year.

Another gauge of this labor market "slack versus tightness" profile is the unemployment gap. This measure compares the nonaccelerating inflation rate of unemployment (NAIRU) or "natural unemployment rate" to the actual unemployment rate we discussed earlier. Natural unemployment simply refers to the concept that unemployment cannot be entirely eliminated in an economy, given a structural mismatch between jobs available and skilled labor (among other factors).

An unemployment rate that is above the NAIRU, or "natural unemployment rate," suggests that there is "slack" in the U.S. labor market. A negative value, which occurs when actual unemployment falls below the natural unemployment rate, suggests "tight" labor market conditions. The latest reading in the unemployment gap plotted in Chart 5 reflects tight labor market conditions (when considered along with other labor market indicators that we have reviewed).

Chart 5: Unemployment gap reflects tightness in the U.S. labor market



Sources: Wells Fargo Investment Institute, Bureau of Labor Statistics, Congressional Budget Office, Bloomberg; May 20, 2019.

Connecting the dots on the U.S. labor market, economy, and markets

When the metrics we have reviewed are taken together, labor market data have exhibited signs of strength and signals of some employer struggle (unfilled jobs) and future challenges. To be sure, April's labor market report suggested that the U.S. economy has passed through a period of solid growth, which we believe has contributed to tighter labor market conditions. Further, we see the modest rise in the labor force participation rate, particularly among a younger cohort, as a positive longer-term driver of economic activity (along with its implications for a potential rise in household formation and higher consumer spending).

As we move through the latter stages of the business cycle, labor market data are likely to exhibit some added signs of struggle. Job vacancies outpacing unemployed workers reflects a mismatch between skills and workers (and also, potentially, the desire for work in certain industries). And while employers are expected to grow payrolls this year, they are likely to do so at a slower pace than in recent years—as economic confidence is increasingly constrained by elevated policy uncertainties. This could encourage a rise in jobless claims as activity in the U.S. economy softens later this year.

We expect slower year-over-year GDP growth this year than in 2018, despite the fact that the first quarter GDP growth figure beat expectations. Therefore, we anticipate greater market volatility as economic data (particularly coincident and leading labor market indicators) soften through year-end. As markets have appreciated during one of the longest economic expansions in U.S. history, we favor rebalancing portfolio exposure today to align with an investor's specific goals (and to ensure that investments match an investor's risk/reward profile). That is, we would reduce exposure to asset classes where allocations have exceeded long-term target allocations, and raise exposure to those asset classes where holdings fall short of long-term target exposure.

We also believe that it is important to ensure portfolios are well diversified across geographies and asset classes, including exposure to fixed income, equities, real assets, and other classes. In the equity space, several markets are facing increasing volatility, stemming from trade and geopolitical challenges. We favor a balanced (neutral) approach to investing in most equity classes, but we would avoid overexposure to U.S. small-cap equities (we have an unfavorable view), and we believe that investors should maintain healthy exposure to emerging market equities (we are most favorable on this equity class).

In the fixed income space, we prefer higher quality issuers and aligning portfolio duration with an investor's individually selected benchmark. (Duration is a measure of a bond's or fixed-income portfolio's sensitivity to interest-rate risk.)

We expect ongoing economic uncertainty to increasingly impact many facets of the financial markets as we look to the future. Certainly, U.S. labor market data in April were notable for evidence of economic strength. Yet, the data appear to be signaling some increased economic struggles in the months ahead.

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Mr. Donisanu follows global trends in economics and politics and writes about their implications for international financial markets. His work has been quoted in print media, including outlets such as the Wall Street Journal, the Financial Times, Barron's, and Reuters. He also has been featured in television and radio interviews on Bloomberg, CNBC, and the Canadian Business News Network. Mr. Donisanu also presents his views via speaking engagements to investment professionals. He has worked in the financial services industry since 2001.

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Ms. Woodhams is responsible for providing economic, market, and investment research support. Her work contributes to Wells Fargo Investment Institute investment strategy publications and presentations. Prior to her current role, she was a Wells Fargo Wealth and Investment Management Intern at Wells Fargo Advisors. Charlotte earned a bachelor's degree in Political Science from Davidson College in North Carolina. She is located in San Francisco.

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