AOR Update: Labor Market Cracks Emerging

2 June 2023

Key Takeaways

- We believe an upward trend in initial jobless claims signals weakness ahead, despite continued strong headline jobs numbers. Higher income cohorts have increasingly been filing claims, an atypical shift that could portend a bigger than expected drop in consumption in the back half of the year.
- Other cracks beneath the surface are apparent across a wide array of labor market data, including a declining quits rate, weakening Conference Board job sentiment and a negative trend in hours worked. Historically, these data sets deteriorate ahead of the broader labor market.
- With only modest progress toward loosening labor pressures, the Fed is likely to maintain interest rates at a higher level for longer than financial markets are currently pricing in.

Headline Jobs Strength Obscures Underlying Weakness

U.S. equity markets stayed rangebound in May and leadership remains concentrated among the largest components of the S&P 500 Index. Specifically, the five largest members of the benchmark have delivered 85% of its total return this year, meaning the remaining 495 companies contributed just 15%. Deteriorating breadth is typically associated with a bull market on its last legs and not a solid foundation for a rally to build upon. Similar to equities, the U.S. labor market is also seeing deterioration beneath the surface while the headline figures remain resilient.

The labor market has proved the most solid pillar of the U.S. economy over the past several quarters, with an average of 314,000 jobs created each month in 2023, even as other areas of the economy have slowed substantially. In fact, initial prints for the last 14 monthly non-farm payroll (jobs) releases have surpassed consensus expectations, the longest run of consecutive beats in at least 25 years. Despite labor market resilience, we continue to believe initial jobless claims are the canary in the coalmine. Importantly, they have begun trending higher in recent months, consistent with their yellow or cautionary reading on the ClearBridge Recession Risk Dashboard.

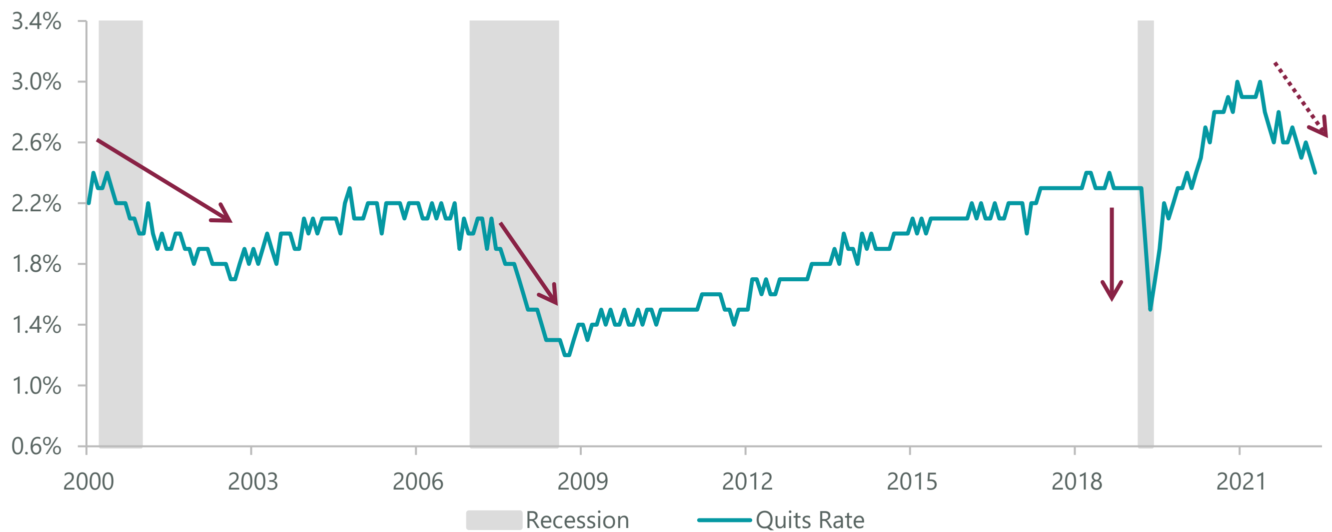
Initial jobless claims tend to be volatile in any given week, which is why we evaluate them on a four-week moving average basis. While the trend in claims over the past three months appears to support a shift toward a higher level, a substantial shift in who is filing these claims is more telling. An increasing share of claims has been coming from the middle- and upper-income cohorts, while those filed by the lower-income cohorts have declined. This dynamic is atypical but not out of sync with headline job losses concentrated in the typically higher-paying technology and financial sectors. Given this unique shift toward higher earners losing their jobs, consumption may witness a bigger drop than expected later in 2023, given the current pickup in jobless claims.

Exhibit 1: Canary in the Coalmine

Data as of 26 May 2023. Source: Bloomberg, Bureau of Labor Statistics (BLS).

Other cracks beneath the surface are apparent in a wide array of labor market data. The Job Openings and Labor Turnover or JOLTs survey, for example, showed an improvement in the headline job openings figure in its most recent release, indicating improving labor demand. However, the quits rate within the survey — which measures how many workers are leaving their jobs and is another way of viewing the health of the labor market as most workers only quit to leave for a new job — fell back from the very high end of the pre-pandemic range, suggesting the labor market may actually be cooling to more normal levels.

Exhibit 2: Declining Quits Rate Signals Weakening Job Sentiment



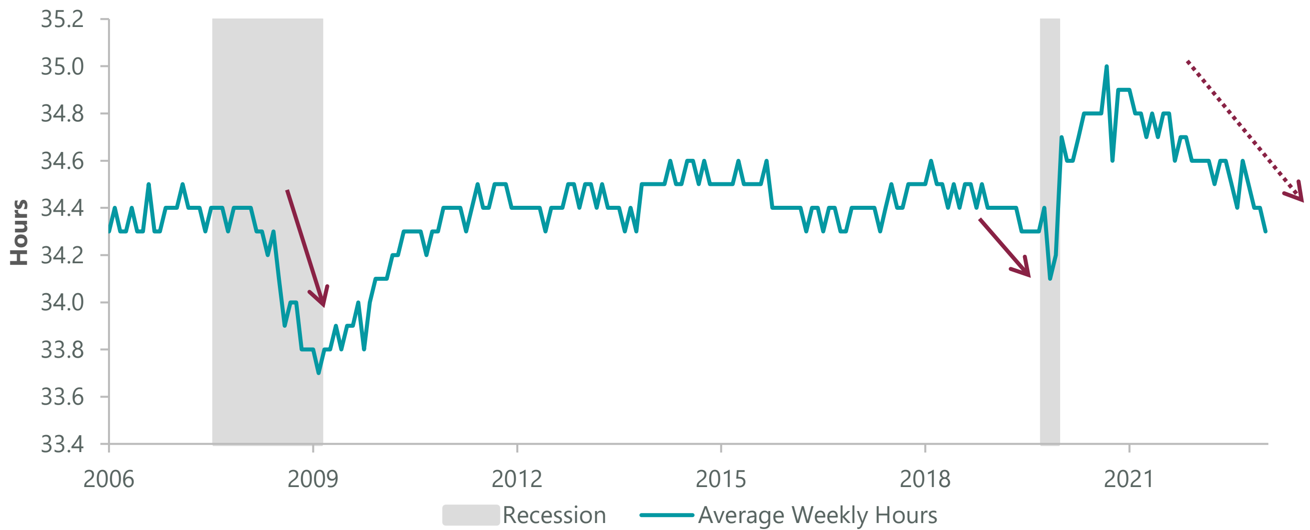
Data as of 30 April 2023. Source: BLS, National Bureau of Economic Research (NBER) and Bloomberg.

Fewer workers quitting in favor of new jobs is consistent with deteriorating job sentiment in the Conference Board's Consumer Confidence survey, one of the labor market indicators on the ClearBridge Recession Risk Dashboard. This indicator worsened to a red or recessionary level last month as the share of workers reporting jobs were plentiful had fallen, while those reporting jobs were hard to get had modestly risen, a trend that continues.

The jobs report itself also reveals multiple fractures not immediately evident. Although overall payroll gains remain strong, hours worked have been steadily falling since peaking in early 2021. Hours worked typically fall as the economy enters a recession, with employers cutting shifts in the face of declining demand. This measure has now slipped below the average level seen during the last expansion and shows no sign of stabilising. The cut to hours worked coupled with the surge in hiring could be indicative of labor hoarding as businesses may be reluctant to reduce headcount after the hiring difficulties experienced in recent years. While labor hoarding

can continue, we believe it's only a matter of time before profitability pressures lead to cost-cutting measures, including layoffs.

Exhibit 3: Hours Worked Has Likely Peaked



Data as of 31 May 2023. Source: BLS, NBER and Bloomberg.

In summary, headline labor market strength is obscuring weakening trends for overall employment and consumption. The headline numbers have slowed, but remain at too-high levels for inflation to drop back to the Fed's 2% target. Wages in particular stand out, with average hourly earnings running above 4% for all workers and at 5% for production and non-supervisory workers, which account for about 80% of overall U.S. employment. Alternate wage measures like the Fed's preferred Employment Cost Index and the Atlanta Fed's Wage Growth Tracker are at similarly elevated levels inconsistent with 2% inflation. The wage problem is nothing new. In fact, wage growth was the first signal on the dashboard to turn both yellow and then red back in 2021. There are no changes to the dashboard this month.

Exhibit 4: ClearBridge Recession Risk Dashboard

		Current	Deepening Red Signal		
		May 31, 2023	**Mar. 31, 2023**	**Dec. 31, 2022**	**Sept. 30, 2022**
Consumer	Housing Permits	✖	✖	●	●
	Job Sentiment	✖	●	●	⬆
	Jobless Claims	●	⬆	⬆	⬆
	Retail Sales	✖	✖	✖	✖
	Wage Growth	✖	✖	✖	✖
Business Activity	Commodities	✖	✖	✖	✖
	ISM New Orders	✖	✖	✖	✖
	Profit Margins	✖	✖	✖	●
	Truck Shipments	●	⬆	⬆	⬆
Financial	Credit Spreads	✖	✖	✖	✖
	Money Supply	✖	✖	✖	✖
	Yield Curve	✖	✖	✖	●
	Overall Signal	✖	✖	✖	✖

⬆ Expansion ● Caution ✖ Recession

Source: ClearBridge Investments.

Against this backdrop, the Federal Reserve is likely to maintain interest rates at a higher level for longer than investors appreciate. While inflation has slowed, it remains far too high for comfort. Slowing the labor market to reduce wage gains and thus consumption will take time but should ultimately help bring inflation back down to target. Progress is being made, but more work is needed to tame price pressures. For equity investors, discount rates may shift higher or not drop as rapidly as the market is expecting, potentially pressuring valuations. Market pricing for monetary policy in the coming months appears to be converging toward the Fed's expectations, which are for higher interest rates, however a divergence still exists. This lends us to continue to favor tilts toward stocks with defensive characteristics.

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