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Labor Market Watch

US December employment preview: The "catch-up" effect has legs

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Solid job growth to end the year

For December, we forecast nonfarm payroll (NFP) employment increased by 175k following gains of 199k in November and 150k in October (Exhibit 1). Should our forecast prove correct, it would mean the US economy added 2.727mn jobs in 2023 (Dec/Dec) before accounting for any revisions to the prior two months. This would be a meaningful deceleration from the 4.793mn jobs added in 2022, but stronger than the 2.5mn average from 2015 to 2019. In short, job growth was strong in 2023.

Government hiring spree

We expect total nonfarm payroll growth to be driven in part by ongoing strength in the government sector. Over the last six months, government employment has increased by an average of 56k/month (Exhibit 2). We expect this trend persisted in December as we look for the government sector to have added 50k jobs, owing in large part to growth in state and local education jobs which remain below pre-pandemic levels by about 75k (Exhibit 3).

Private employment: a few good sectors

Meanwhile, we expect private employment rose by 125k, roughly in line with the six-month trailing average. Job growth in the private sector should continue to be driven by growth in "high-touch" services sectors—education and health, leisure and hospitality, and other services—as demand for these services continues to improve. Excluding these sectors, private employment growth fell by 48k over the last six months (Exhibit 4). Therefore, while net job growth remains impressive, it is thanks in large part to a few sectors. At the state and local, and private sector level, the "catch-up" effect has room to run.

Wage growth to dip below 4.0%

Average hourly earnings (AHE) likely advanced by 0.3% m/m in December, decelerating slightly from the 0.4% m/m print in November. As a result, we expect y/y growth in AHE to edge down a tenth to 3.9%. This would be directionally in line with the downward trend posted wage growth series from Indeed, which does lead average hourly earnings though the sample is short (Exhibit 5). Importantly, our forecast for AHE growth would also point to further cooling of wage inflation and improvement in the balance between labor demand and supply.

Income growth to remain supportive of consumption

While we look for employment and average hourly earnings to increase, we expect average weekly hours to tick down a tenth to 34.3 owing to a reversal in hours worked in retail and wholesale trade. As a result, we expect total weekly payrolls—the product of hours worked, employment and wages—increased by 0.1% m/m in December and 3.5% annualized in 4Q, which would be supportive of healthy consumption in 4Q.

(Continued on next page)

Participation rate and unemployment rates to hold steady

On the household survey, we expect the labor force participation rate will hold at 62.8% as positive cyclical forces continue to help offset negative demographics. While the participation rate remains below its pre-pandemic level of 63.3%, the recovery exceeds its structural trend by about 0.6-0.7pp by our estimate (Exhibit 6). This is due in large part to greater cyclical participation for prime age working women and a sharp rebound in immigration. Indeed, net migration topped 1mn in each of the last two years based on the latest population estimates from the Census Bureau. Given our forecasts for the participation rate and payroll employment growth, we expect the unemployment rate to remain at 3.7%.

Implications for fed funds pricing

An employment report in line with our forecast would likely keep the Fed thinking the labor market is gradually coming into better balance. Heading into the December employment situation report, the three-month average change in nonfarm payrolls was 204k down from 221k in September and 321k from a year ago. A reading of 175k at the headline would point to gradually cooling labor market conditions, but the bulk of incoming data on labor market activity points to still-healthy labor market conditions. We think a report in line with our forecast keeps the Fed on track for 100bp of cuts this year beginning in March. An early start, but a gradual pace.

In our view, a print on nonfarm payrolls of 200k or better, along with beats on average hourly earnings, participation, or average weekly hours, is likely to reduce market expectations for rate cuts beginning in March or, equivalently, fewer cuts over the course of 2024. Much of the upside to the US outlook has been driven by stronger-than-expected growth in total hours, which has helped support consumer spending through growth in disposable income. Anything that points to a stronger labor market on the margin is likely to keep the Fed nervous about re-igniting inflationary pressures, though we would argue positive supply shocks, including those from labor supply, have helped pull inflation lower. Nevertheless, a strong report could keep the Fed thinking it needs more information before it is confident to ease policy.

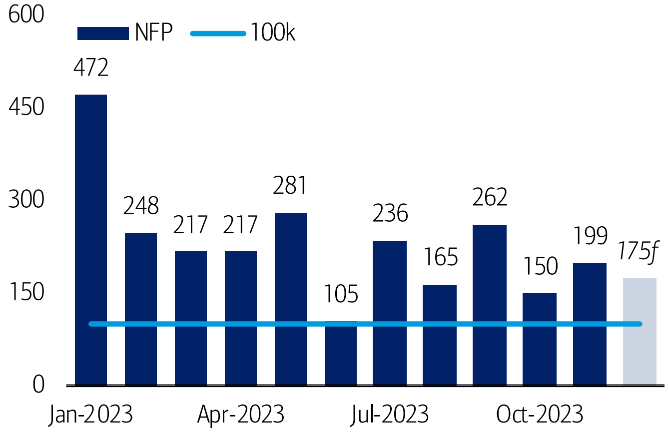
In the other direction, a print below 150, with softening payroll gains from services-producing sectors like leisure and hospitality and education and health, could fuel concerns that COVID-reopening forces are running out of steam and catch-up employment is fading more rapidly than expected. In our view, this would increase the odds of a cutting cycle beginning in March given that the Fed's reaction function is now more balanced in terms of the dual mandate. An even softer print could also open the door for a faster pace of rate cuts – 25bp rate cuts at successive meetings – or larger up-front cuts of 50-75bp should it look like a hard landing or job losses are imminent.

Either way, we think the committee is more invested than ever in achieving a soft landing and it would likely react to weaker economic data as readily as it would to evidence that inflation is converging to the 2% target. This means the Fed has multiple routes to cuts – weaker activity and softer inflation – and a downside surprise to employment would be bullish for the rates market.

To watch: household revisions

The December employment report will also include revisions to the household survey. Each year, the Bureau of Labor Statistics updates seasonal factors for the household data and revises the most recent five years. The update typically does not affect the participation rate or the unemployment rate. Then the January employment report (released on February 2) incorporates revisions to the establishment survey, including the benchmark to the Quarterly Census of Employment and Wages data, and updated population estimates are incorporated in the household survey.

Exhibit 1: Nonfarm payroll (NFP) employment (m/m ch. thous. SA)
We forecast NFP employment rose by 175k in December 2023.



Source: BLS, Haver Analytics, BofA Global Research
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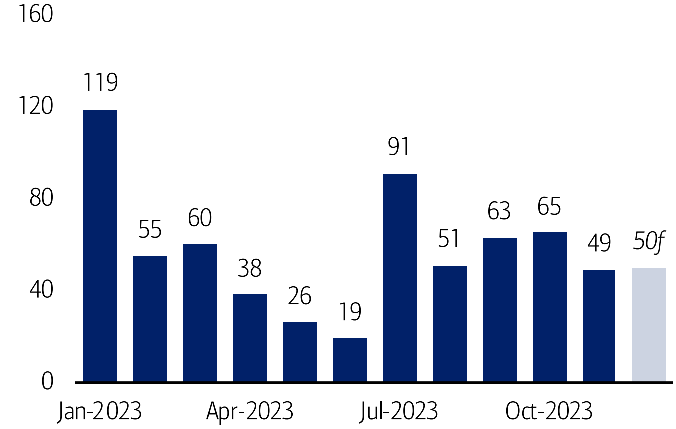
Exhibit 2: Government payroll employment (m/m ch. thous. SA)
Government employment should remain a key driver of job growth in Dec.



Source: BLS, Haver Analytics, BofA Global Research
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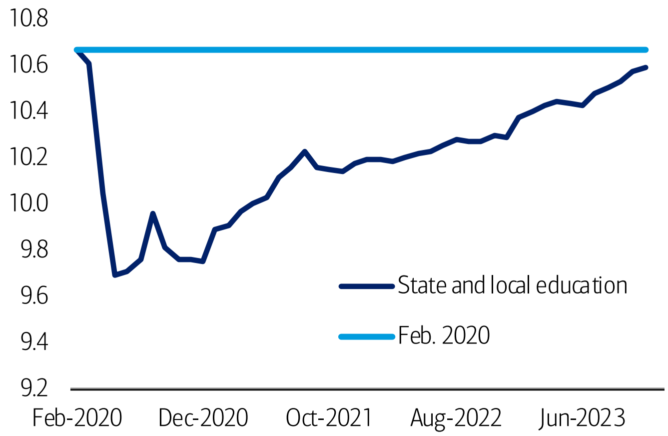
Exhibit 3: State and local education employment (Mn. SA)
State and local education employment remains below February 2020 levels



Source: BLS, Haver Analytics, BofA Global Research
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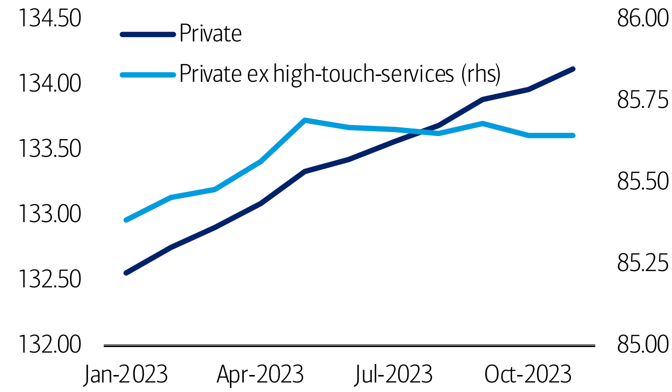
Exhibit 4: Private employment (Mn. SA)
Private employment growth has been narrowly driven



Source: BLS, Haver Analytics, BofA Global Research
Note: High-touch services includes education and health, leisure and hospitality, and other services
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Exhibit 5: Wage growth (% y/y)
Posted wages and average hourly earnings inflation are easing

Source: BLS, Indeed Hiring Lab, Haver Analytics, BofA Global Research
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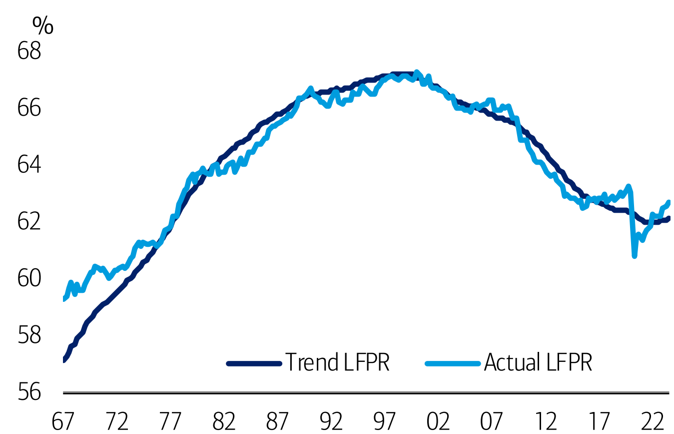
Exhibit 6: Labor force participation rate vs. a trend estimate (%)
The Labor Force participation rate is well above its trend



Source: BLS, Haver Analytics, BofA Global Research
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