Labor Market Watch

The labor market continues to cool, but has a long way to go

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Labor market conditions cooled in February

Labor market conditions continue to cool gradually. Our proprietary BofA Indicator of US Labor Market Conditions fell by 0.13pts in February, to 0.91, well below the expansion high of 1.62 observed in March 2020. Although labor market conditions are softening, the labor market remains tight overall with current readings in line with prior cycle highs.

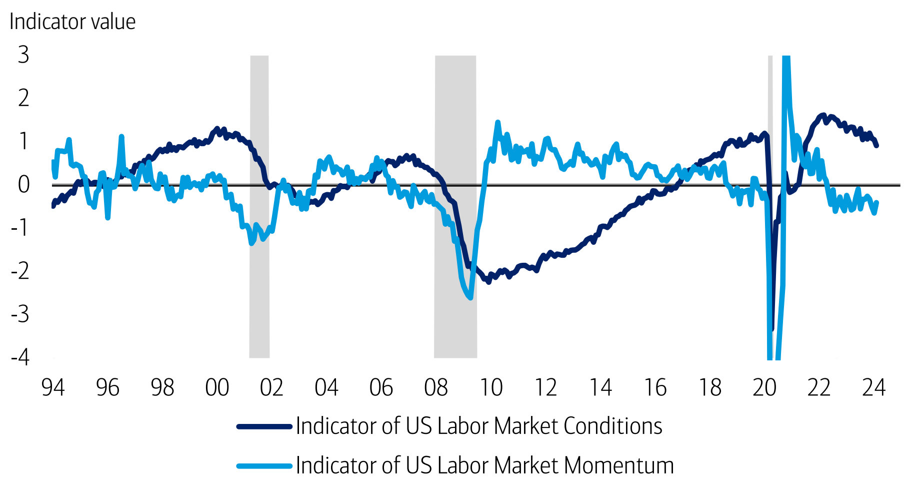
Labor market momentum remains soft

Labor market momentum improved in February but remains soft on balance. Our proprietary BofA Indicator of US Labor Market Momentum rose 0.24pts to -0.40 on the month. Momentum, which we interpret as the marginal rate of change in labor market conditions, has been negative for 22 consecutive months. Hence, despite this month's improvement, momentum points to further cooling in labor market conditions ahead.

Resilience, not re-acceleration, and gradual easing

Like our take on the February employment report (see report: February US employment: Resilience, but not overheating), our proprietary indicators on the labor market do not point to a re-acceleration in the economy. That said, labor market conditions remain tight and any Fed cutting cycle will need to maintain a restrictive policy stance to bring the labor market into better balance. In other words, rate cuts should be gradual, and the real policy rate should remain positive.

Exhibit 1: Labor market conditions are cooling and momentum remains soft
BofA Indicators of labor market conditions and momentum



Source: BofA Global Research. Shaded areas represent recession periods as defined by the National Bureau of Economic Research (NBER). The indicators identified as Indicator of US Labor Market Conditions and Indicator of US Labor Market Momentum above are intended to be indicative metrics only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise relied upon by third parties for any other purpose, without the prior written consent of BofA Global Research. These indicators were not created to act as a benchmark.

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The labor market has cooled, but remains near cycle highs

To distill the signal from various labor market inputs, we turn to our BofA Indicator of US Labor Market Conditions and BofA Indicator of US Labor Market Momentum. As we detailed in our report (see report: [Assessments of labor market conditions], 3 August 2022), we apply principal components analysis to a set of underlying labor market data from January 1994 to the present in order to extract a signal about labor conditions and momentum. The indicators are normalized to have a mean of zero and standard deviation equal to one, with positive readings indicating above-average conditions or momentum, and negative readings implying weaker-than-average outcomes.

Labor market conditions have softened, but remain near three-decade highs

The BofA Indicator of US Labor Market Conditions fell by 0.14pts in February to 0.92pts (Exhibits 2 and 3). This brings our indicator further below the cycle high of 1.62 observed in March 2022, suggesting the US labor market is gradually coming into better balance.

There is still work to be done to restore balance in the US labor market. Although the labor market continues to cool, our indicator of labor market conditions suggests they remain tight overall. At 0.92 standard deviations above average, readings on labor market conditions are near prior cycle highs and are broadly at their highest readings in the last three decades. At the current pace, it would take another two years to bring labor market conditions back to their average level since 1994.

The evolution in the unemployment rate, weekly hours, average hourly earnings, job flows from unemployment to employment, the labor market differential, and small-business sentiment toward hiring and hard-to-fill positions all decreased labor market conditions in February (Exhibit 4). These declines were partially offset elsewhere by the evolution of underemployment (U6 less U3), and less long-term unemployment.

Exhibit 2: Labor market conditions are cooling but remain near prior cycle highs

BofA Indicators of labor market conditions and momentum (standard deviations above/below period average. Shading indicates recessions.

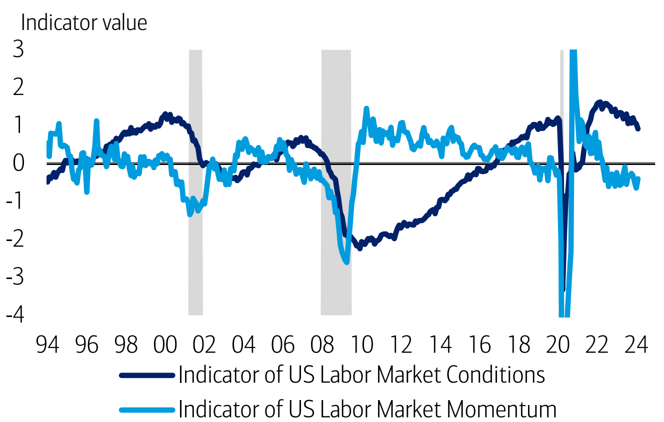

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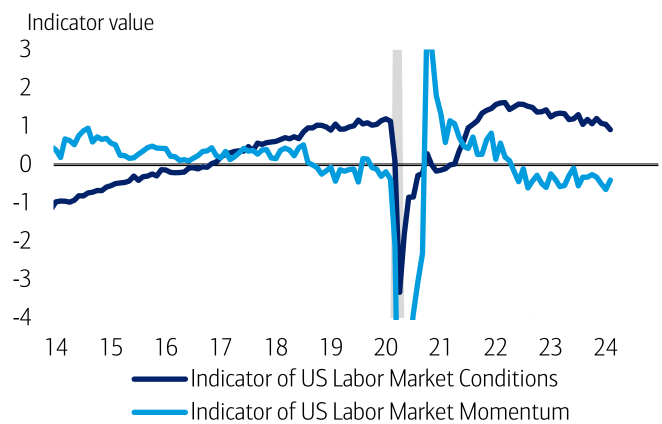
Exhibit 3: Labor market momentum has been in negative territory for 22 consecutive months

BofA Indicators of labor market conditions and momentum (standard deviations above/below period average. Shading indicates recessions.



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Labor market momentum rebounded in February

Labor market momentum rebounded in February, with our indicator rising by 0.24pts to -0.40pts. The sharp improvement in momentum was driven almost entirely by the improvement in average weekly hours for production and nonsupervisory employees over the past six months. In this case, improvement meant that growth in average weekly hours over the past six months in February (0.0%) was an improvement over last month's 0.1% decline. Our indicator of momentum is heavily influenced by hours worked since it sends an important signal about cyclical forces in the labor market.

That said, our BofA Indicator of US Labor Market Momentum, which we interpret as the marginal rate of change in US labor market conditions, has been in negative territory for 22 consecutive months dating to early 2022. Hence, even though momentum improved in February, our indicator remains in negative territory and points to further softening in labor conditions in the months ahead.

A gradual easing cycle

Altogether, our BofA Indicator of US Labor Market Conditions suggests that Fed tightening has produced some softening in labor market conditions. According to our BofA Indicator of US Labor Market Momentum, it has also weakened momentum and suggests the current stance of policy is likely to weaken conditions further.

Since our readings of labor market conditions remain above average, our indicators suggest that monetary policy needs to remain restrictive to continue to bring labor markets into balance. Put differently, our indicators suggest any easing cycle should be gradual and the policy rate should remain positive in real terms. We continue to expect the first 25bp-rate cut in June and 75bp in cuts for the year. In addition, we expect another 100bp of rate cuts in 2024. Against our outlook for core PCE inflation of 2.6% this year (4Q/4Q) and 2.3% next, this would still result in positive values for the real funds rate over our forecast horizon.

Exhibit 5: Job flows from unemployment to employment led to a decline in labor market conditions while the rebound in weekly hours boosted momentum

Contribution to the change in the BofA Indicators of US Labor Market Conditions and Momentum in February 2024 (change in standard deviations)

Contribution to the change in the indicator

	Indicator of US labor market conditions		Indicator of US labor market momentum	
variable	1m chg	12m chg	1m chg	12m chg
Total change	-0.14	-0.41	0.24	-0.01
U3 unemployment rate	-0.01	-0.02	-0.01	-0.01
Cyclical portion of the LFPR (actual LFPR less trend)	0.00	0.00	0.00	0.00
U6 less U3	0.01	-0.02	0.00	0.00
Employed part time for economic reasons (in % of total employment)	0.00	-0.02	0.00	0.00
Initial claims (in % of total employment)	0.00	0.00	0.00	0.01
Unemployed 27 weeks or more (in % of total unemployment)	0.02	-0.01	-0.04	0.02
6m % chg in private payroll employment	0.00	-0.01	0.01	-0.05
6m % chg in temporary help services employment	0.00	0.00	0.00	0.02
6m % chg in avg weekly hours, Prod & nonsupervisory (goods industries)	-0.01	0.01	0.24	-0.12
12m% chg in avg. hourly earnings, total private industries	-0.01	-0.06	0.02	0.10
Job flows from unemployment to employment (in % of total unemployment)	-0.07	-0.07	0.02	0.02
Labor market differential (jobs plentiful less jobs hard to get)	-0.02	-0.07	0.00	0.01
NFIB firms planning to increase employment (3mma)	-0.04	-0.07	-0.01	-0.02
NFIB positions hard to fill (3mma)	-0.01	-0.07	0.00	0.01

Source: BofA Global Research

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