SPECIAL REPORT

October 18, 2024

Labor Markets, The Fed And Profits

- The Fed has one eye on the labor market and the other on inflation. Both should give the central bank room to gradually lower interest rates, roughly in line with the 140bps of cuts currently reflected in money markets over the next twelve months.

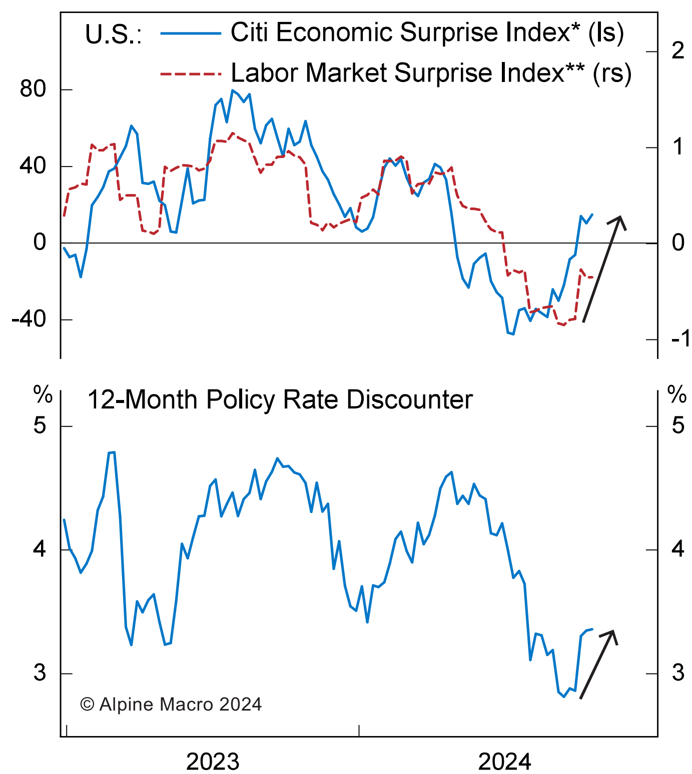
- Leading employment indicators are less encouraging than September nonfarm payrolls data, but still point to continued economic expansion. Corporate profit margins are well-supported.

- A perfect macro landing remains by far our highest-odds scenario. Stay bullish on equities and overweight *vis-à-vis* bonds. Macro risks are balanced between recession and rebound. Other than that, hard-to-handicap geopolitical tensions allow for an oil spike and economic stagflation.

"... we have seen upward revisions to GDI, an increase in job vacancies, high GDP growth forecasts, a strong jobs report and a hotter than expected CPI report... I view the totality of the data as saying monetary policy should proceed with more caution on the pace of rate cuts than was needed at the September meeting."

- Federal Reserve Governor Christopher Waller, October 14, 2024.

Chart 1 More Nails In The Recession Coffin



*Source: Citi
**Source: Bloomberg Finance L.P.

Monday's *U.S. Themes & Strategy* reviewed recent data supporting our outlook for "macro calm", albeit with the possibility of a geopolitically induced oil spike lurking in the background that would "change everything" for a time.[1] This *Special Report* takes a deep dive into labor market trends. Ultimately, we find further support for our baseline outlook scenario, but also examine scenarios that would make life tougher for the Fed and corporate profits.

1 Alpine Macro *U.S. Themes & Strategy* "Macro Calm And Energy Tail Risks" (October 14, 2024).

Constructive Labor Backdrop For Businesses And The Fed

The Fed is becoming less nervous about recession and more nervous about the lack of an economic slowdown (see **Waller quote**). This is appropriate given the recent bounce in economic and labor market data surprises, and both Atlanta and NY Fed Q3 GDP growth Nowcasts are above 3% (**Chart 1**).

However, there are also signs that the growth-inflation tradeoff has improved, which would give the Fed room to cut interest rates. Labor productivity is increasing at a faster rate than the average of the pre-pandemic/post-GFC period. Prime-age workers continue to enter the labor force, boosting the unemployment rate from extremely low levels (**Chart 2**).

The result is a bullish combination of rising real wages, falling price inflation and flat unit labor costs. Note that the ideal labor market environment for businesses and the Fed is not the same as for workers. The current backdrop is more in line with the former, even though wage growth exceeds core price inflation.

First, job prospects are less rosy than the robust September nonfarm payrolls report suggests. Our favourite leading employment indicators all are falling, though most are losing downward momentum, consistent with a subpar economic expansion rather than recession (**Chart 3**). These include the labor market churn rate,[2] job quits and openings, temporary services payrolls and NFIB hiring plans. Moreover, the diffusion index of private employment has declined close to the boom/bust 50 level.

2 Alpine Macro *U.S. Bond Strategy Special Report* “Lower Wage Growth Ahead” (February 16, 2023).

Chart 2 Rising Real Wages, Flat ULC

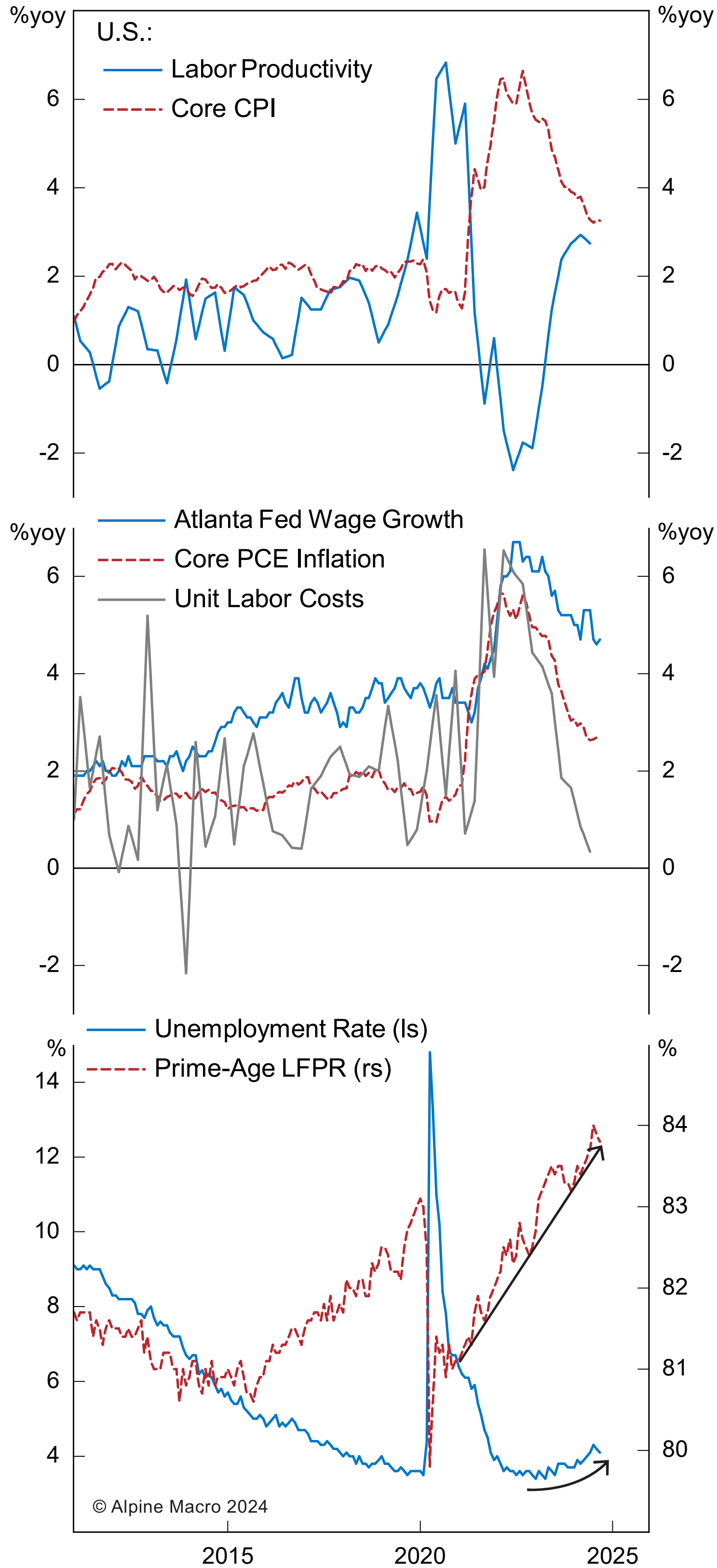
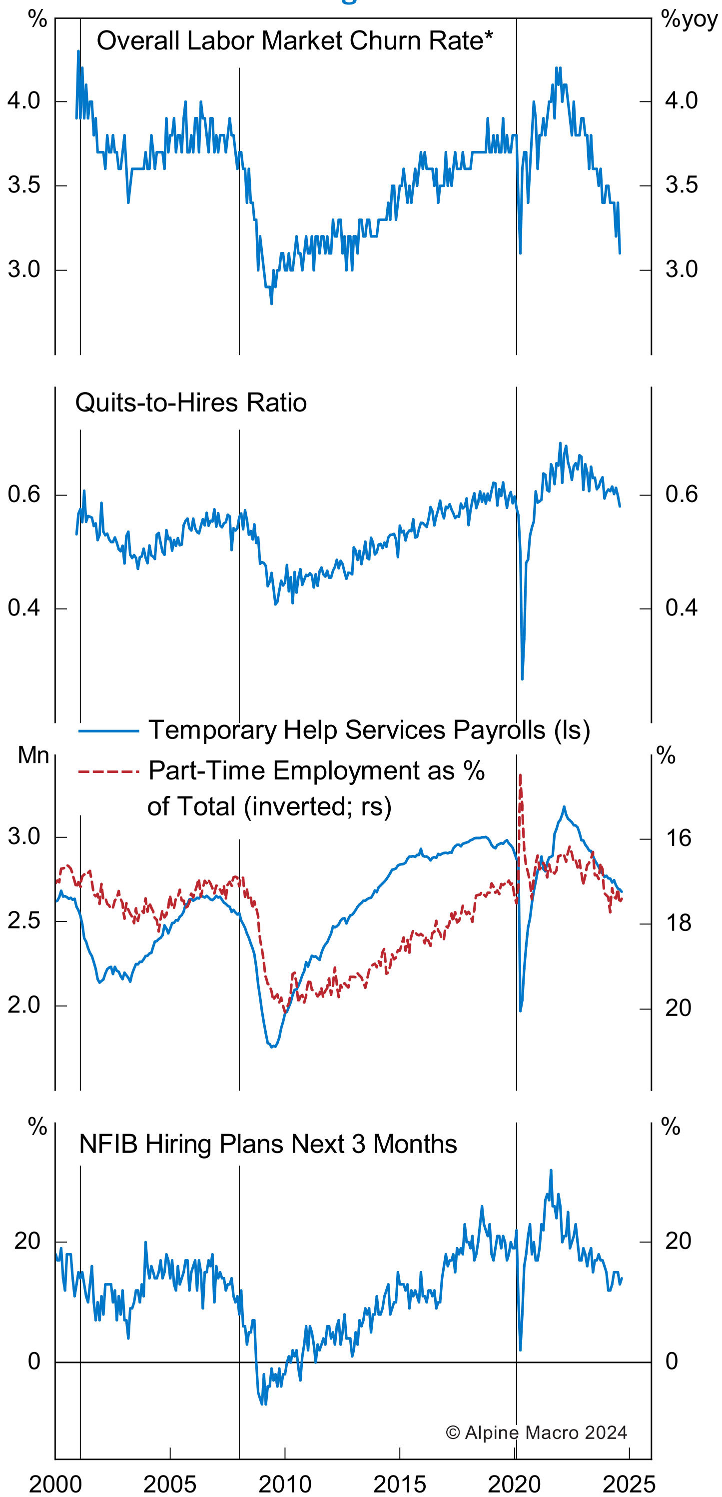
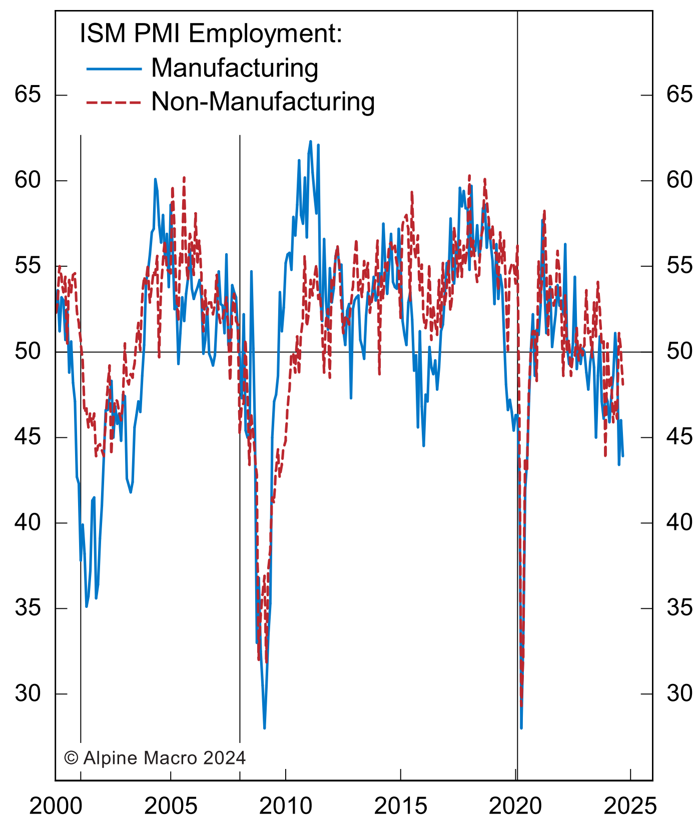


Chart 3 Leading Job Indicator Decline Is Moderating



*Calculated as the minimum of hiring rate and separation rate, both of which include layoffs and quits
Note: Vertical lines denote when payrolls peaked

Chart 4 Both Subindexes Below 50

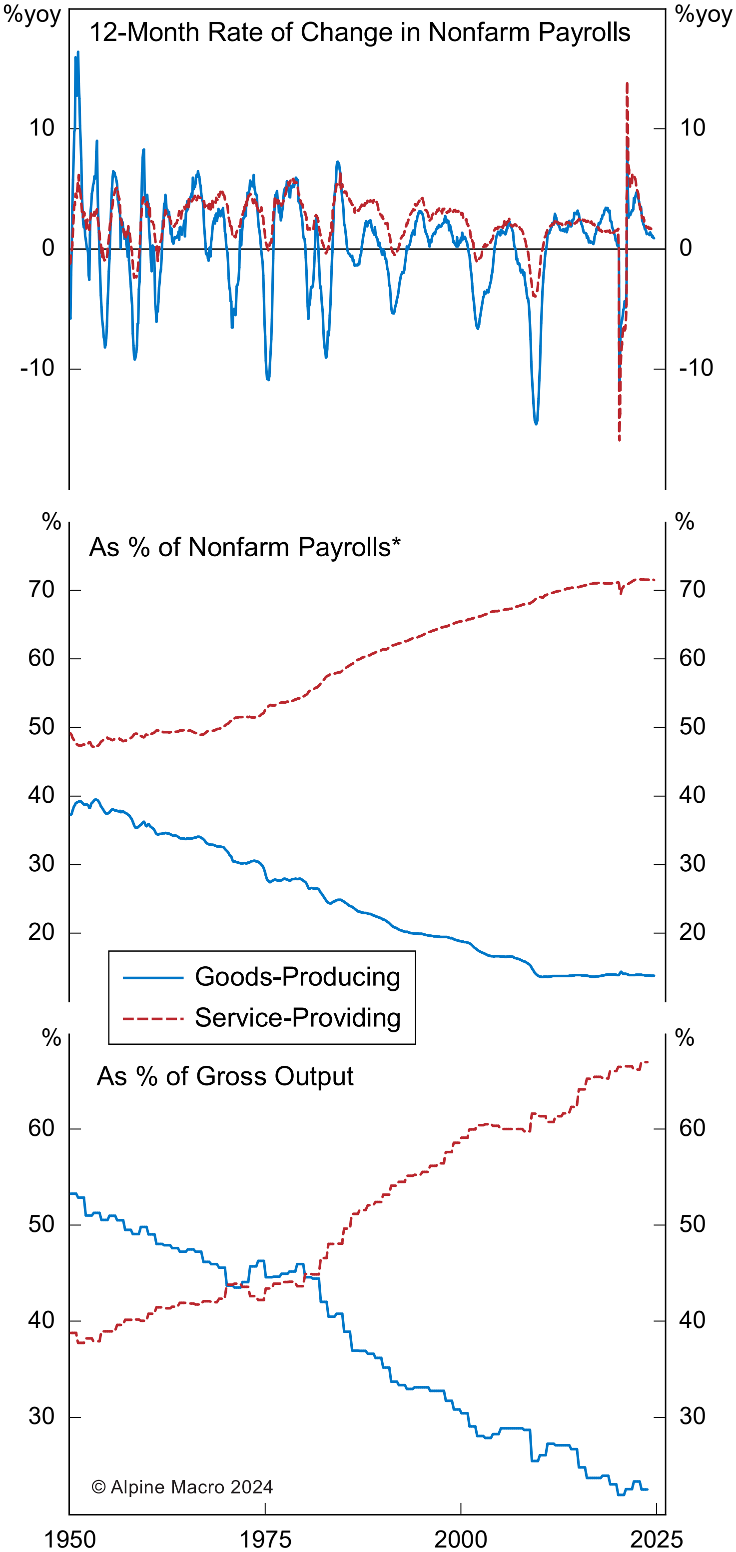


Note: Vertical lines denote when payrolls peaked

Second, both services and manufacturing sector ISM employment survey readings are below the neutral 50 level (**Chart 4**). It is usually the case that the service sector is not important for the business cycle, even though the sector accounts for 72% of employment and 78% of GDP, because it has much smaller oscillations than manufacturing (**Chart 5**). However, the unusual nature of the post-pandemic recovery led to "revenge spending" and surging job demand in "Covid epicenter services" like hotels, restaurants, movie theaters, airlines and cruise lines. That surge appears to have run its course.

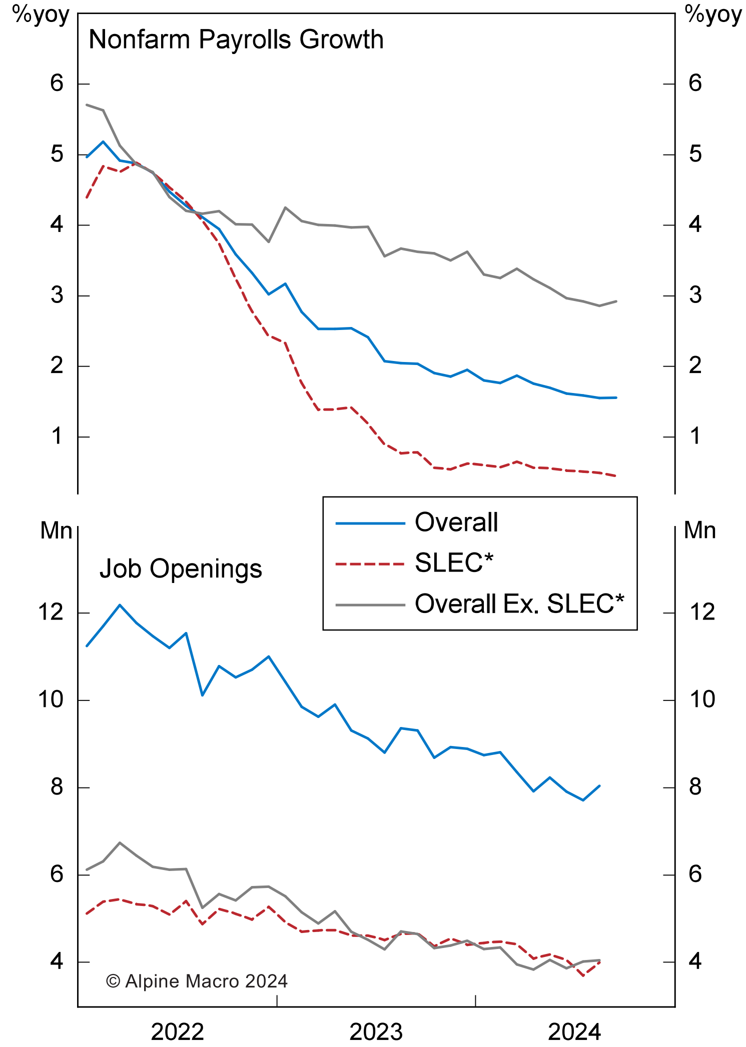
Third, sectors of the economy that had significant worker shortages as the pandemic abated have

Chart 5 This Service Employment Cycle Is Unusually Important



*Shown as 3-month moving average

Chart 6 SLEC: From Tailwind To Slight Headwind

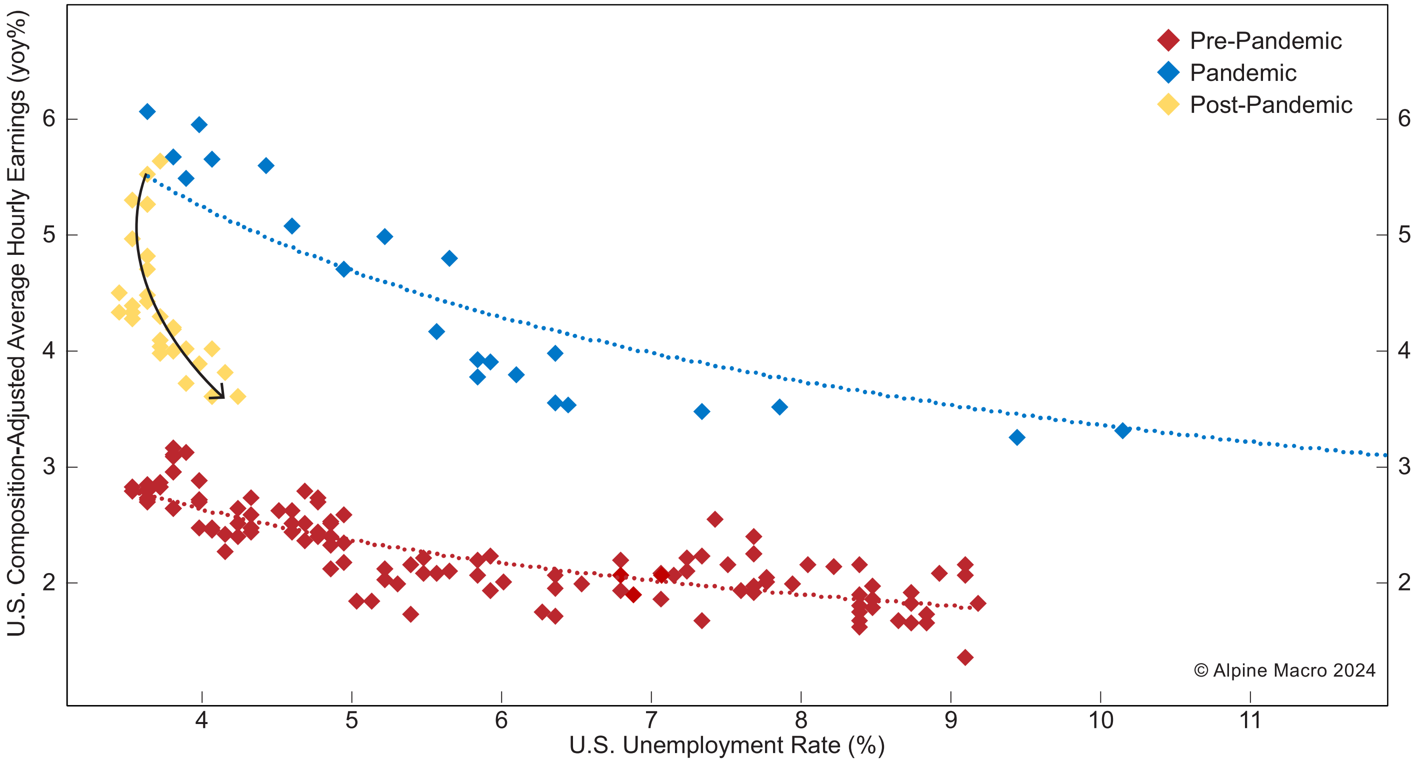


*State & Local Government, Leisure & Hospitality, Education & Health Services, and Construction

begun to slow. SLEC sectors (see **Chart 6** footnote for breakdown) account for 45% of employment and about half of openings. SLEC payrolls growth of 4-5% two years ago has downshifted to below 1% this year.

Bottom line: Job creation is slowing, but there are no signs that a sustained contraction lies ahead. Most likely, this will further weaken wage growth, boost unemployment and lead to a subpar economic expansion.

Chart 7 Phillips Curve Reverting To Normal



Note: Red data = Jan 2010 - March 2020, Blue data = April 2020 - March 2022, Yellow data = April 2022 - Present

Phillips And Beveridge Curve Mean Reversion

Another important development in labor markets is the renormalization of the relationship between wages, employment and job openings. More specifically, the Phillips and Beveridge Curves appear to be returning to the correlations that held before the pandemic:

- **Phillips Curve:** A surge in employment costs as the pandemic abated spurred concerns that the Phillips Curve wage-unemployment tradeoff had either worsened or "shifted upward" (Chart 7). These concerns will be allayed by recent developments. Employment cost increases have fallen to 4% without much increase in unemployment
- **Beveridge Curve:** Related to the above concern, job openings rose far above historic norms in 2021/22, both in absolute terms and *vis-à-vis* unemployment. This raised the possibility of chronic, long-lasting labor shortages arising from pandemic-specific factors, such as "long Covid" and early retirement by the boomer age cohort. Chart 8 shows that the ratio of job openings-to-unemployment has plunged, albeit still above pre-pandemic norms, and this closely correlates with wage growth.

The biggest takeaway for investors from this mean reversion of the two curves is that wage disinflation will likely persist, but there will not be a waterfall decline. That fits with the message from both wage

Chart 8 Beveridge Curve Reverting To Normal

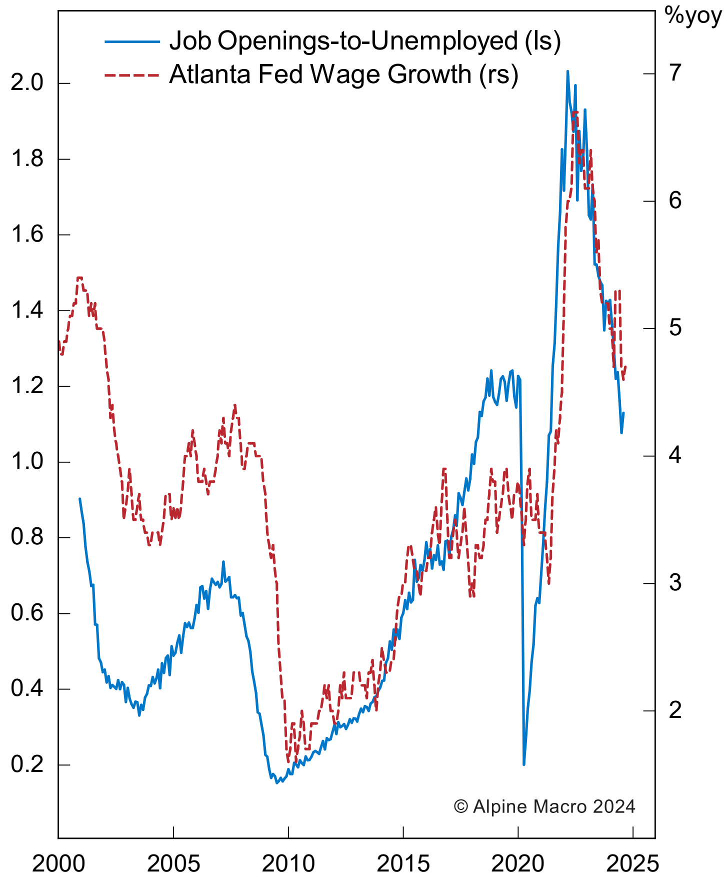
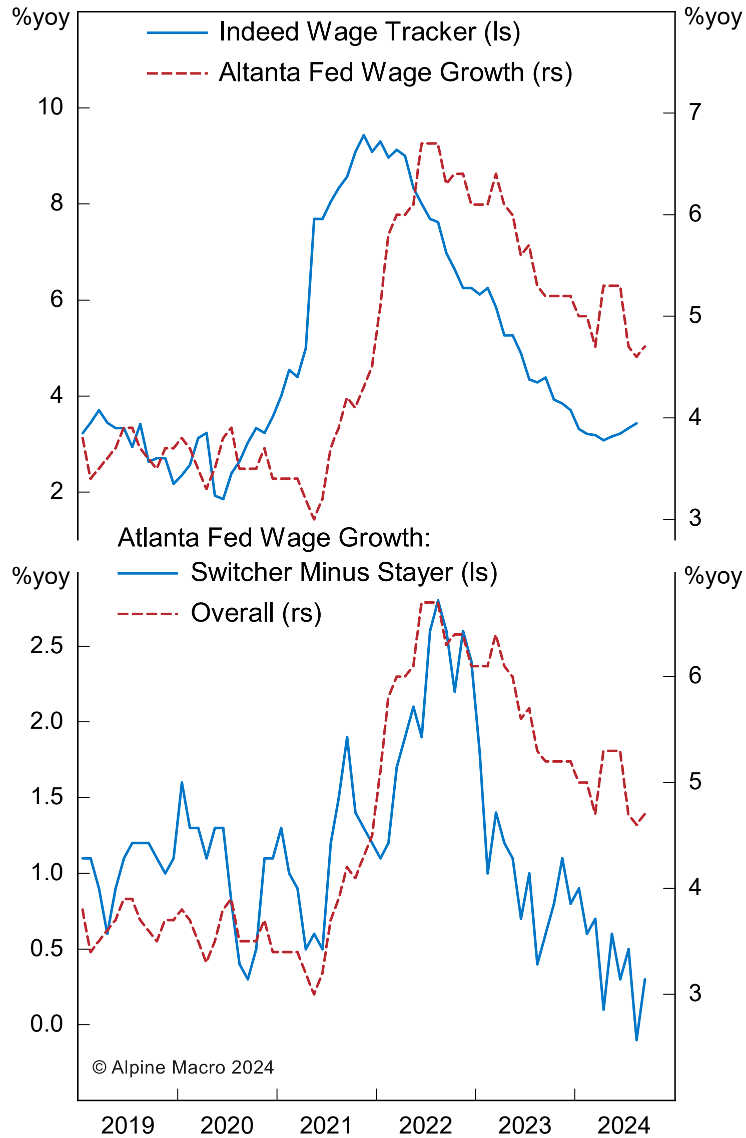


Chart 9 Wage Growth Should Soften Moderately



trackers and the disappearing gap between wage increases awarded to job switchers versus job stayers (**Chart 9**).

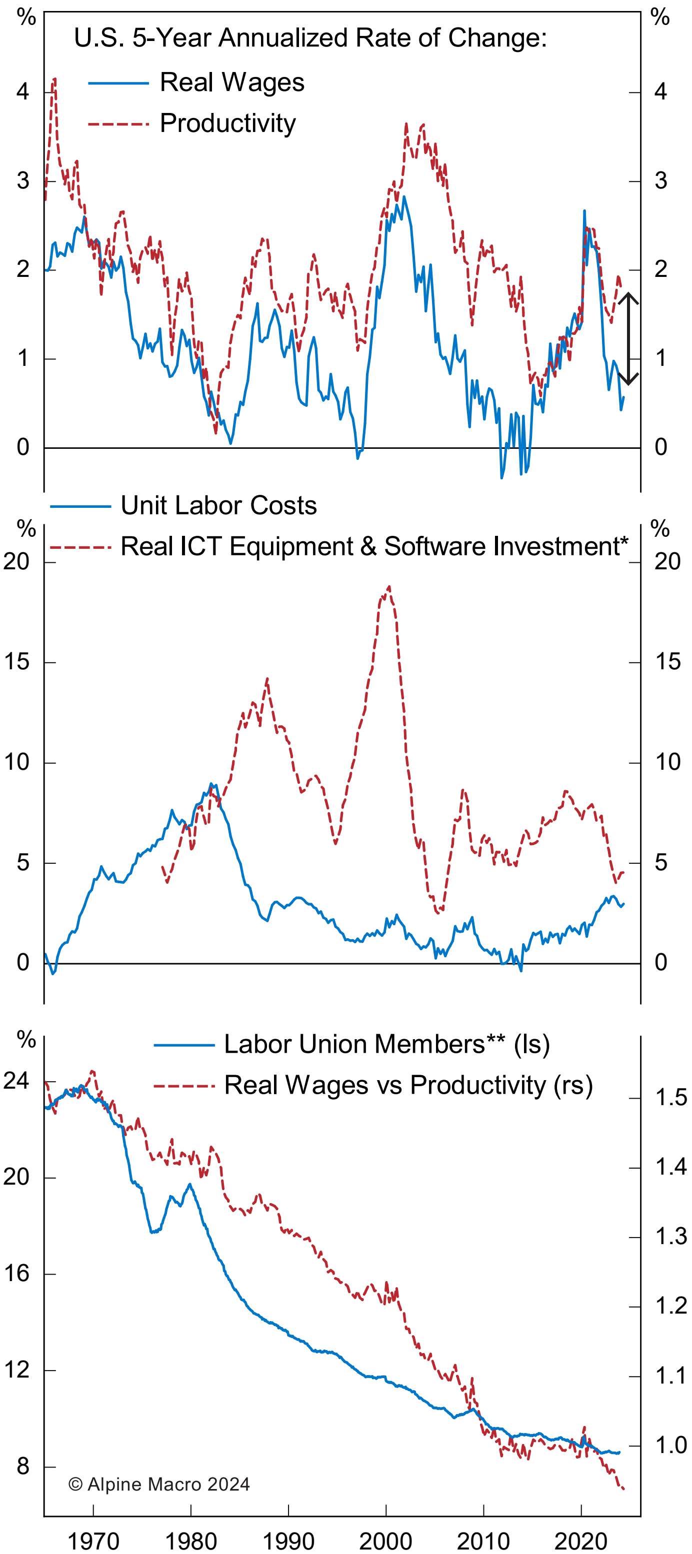
Bottom line: Relationships between wages, employment and job openings are returning to normal. Good news for disinflation and profits, as discussed in the next section.

Profits Should Hold Up

The combination of rising real wages and flat unit labor costs should lend support to the corporate sector. If so, the Q3 earnings season should bring positive surprises to both corporate bottom and toplines.

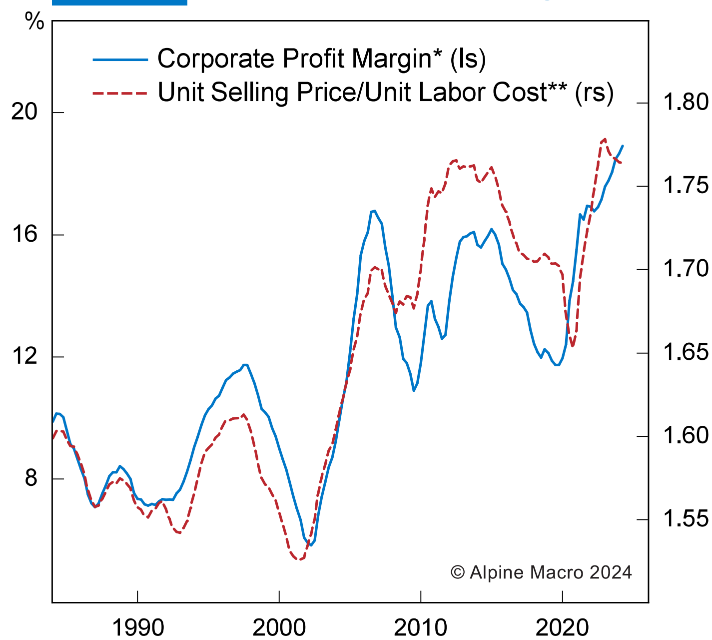
Consistent with this, **Chart 10** shows that real wages are lagging productivity gains. This is nothing new, driven by falling union membership, rising globalization and increasing robot density. More recently, however, the negative divergence between productivity and real wage growth has increased after converging in the runup to the pandemic. The likelihood of an AI-driven tech boom increases the odds of capital-labor substitution that further undermines worker bargaining power.

Chart 10 Real Wage/Productivity Divergence Favors Profits



*Gross fixed capital formation deflated by CPI; source: OECD
**Union members as % of labor force

Chart 11 Support For Corporate Margins



*Corporate profits of domestic non-financial industries, with an inventory valuation adjustment, as a proportion of gross domestic non-financial income; shown as a 4-quarter moving average
**For domestic non-financial corporate sector; shown as a 4-quarter moving average

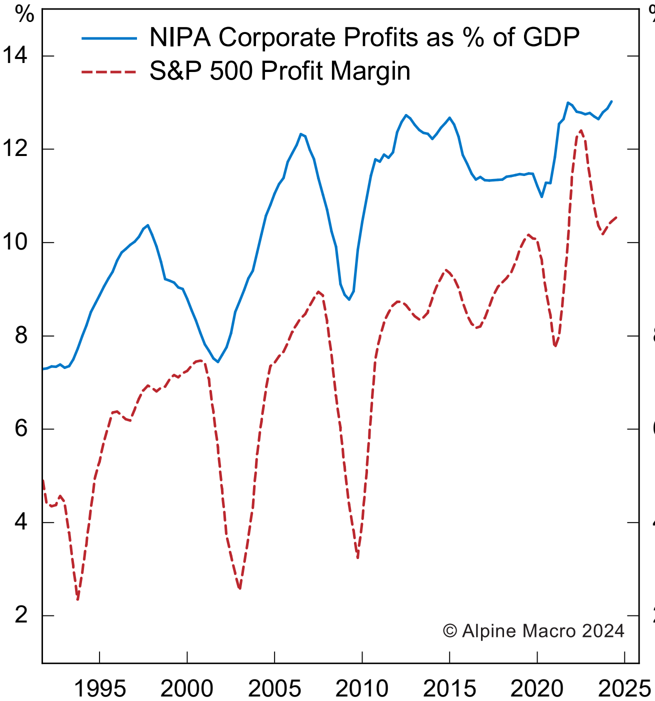
In addition, (smoothed) corporate margins have an underlying tailwind in the form of buoyant selling prices relative to unit labor costs (Chart 11). That suggests the underlying uptrend in NIPA corporate profits share of GDP and the S&P 500 profit margin are intact (Chart 12).

Bottom line: Margins should benefit from flat unit labor costs. Odds are on the side of larger positive surprises for Q3 earnings season.

Business Cycle Risks Are Balanced, Geopolitics Are A Wild Card

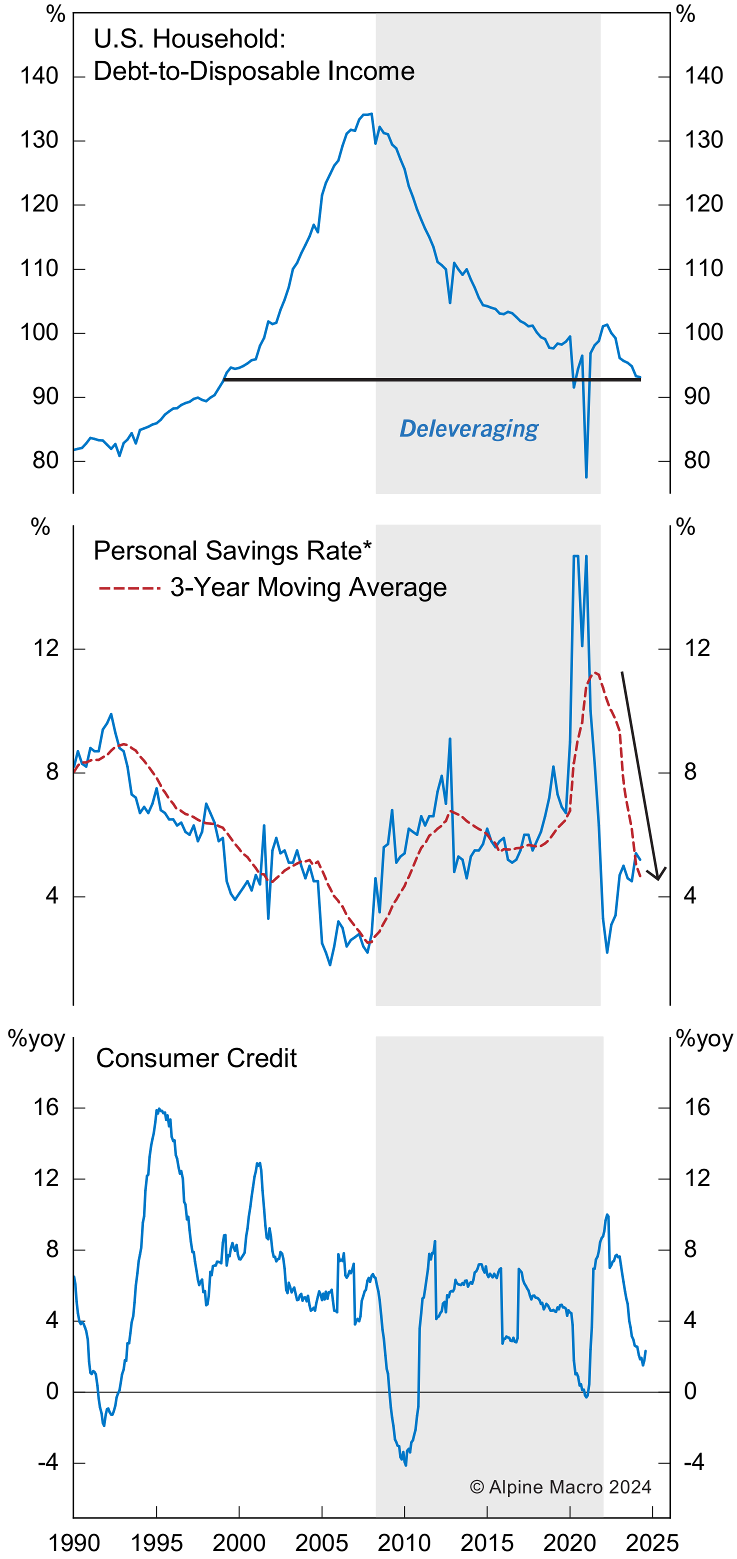
Recent data has increased our confidence that a period of "macro calm" lies ahead. But baseline scenarios should never be assigned anywhere close to 100% odds. What we can say is that the upside risk of growth at or above trend has gone up, while the downside risk of mild recession persists.

Chart 12 Profit Share And Margins: Underlying Uptrend



Note: Both series are shown as 4-quarter moving average

Chart 13 Upside Risk: Consumer Releveraging

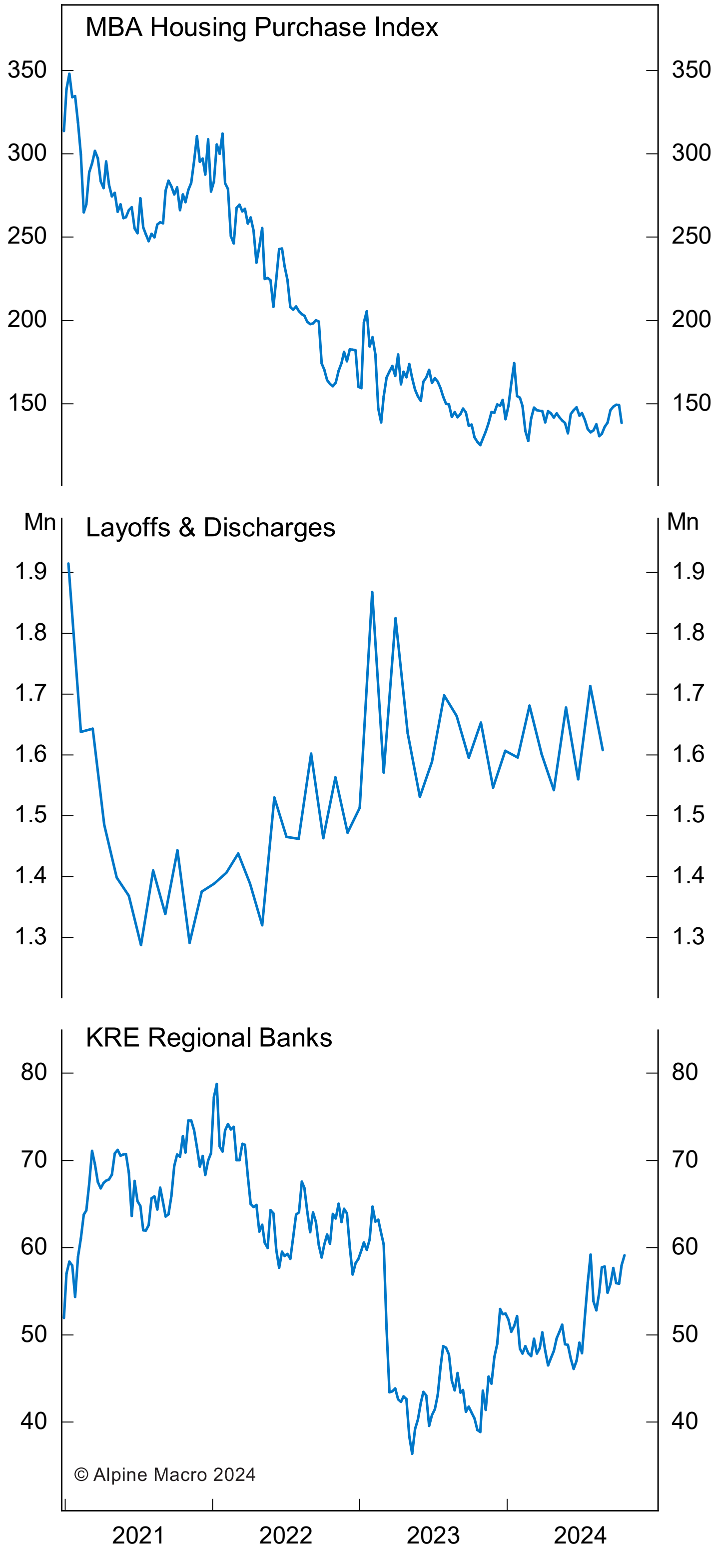


*Truncated at 15

Charts 13 and **14** show barometers that we are monitoring to determine whether to adjust the odds of either upside or downside risks. Consumer releveraging would give the economy a tailwind that has not been present since before the 2007/08 subprime crisis and GFC. Next Monday's *Global Strategy* report will discuss the end of household deleveraging that has left debt-to-income ratios close to 25-year lows.[3] However, that is very different from outright consumer willingness to increase debt burdens, and renewed financial institutions willingness to lend to them. For now, the savings rate is at 5.2%, above the 3.8% average of the 2002-2007 consumer borrowing binge that accompanied the housing boom. Moreover, consumer credit is barely expanding.

3 Alpine Macro *Global Strategy Special Report* "Why R* May Have Risen" (October 21, 2024).

Chart 14 Downside Risk Barometers



On the other side, barometers for reacceleration and/or above-trend growth are in a holding pattern. The MBA housing purchase index is flat, generally fluctuating with 30-year mortgage rates. Worker layoffs and discharges are going sideways around the midpoint of their range of the past three years. Regional bank stocks continue to hit new 2024 highs but are still below the index level that prevailed before the failure of Silicon Valley Bank in March 2023.

Finally, the potential for an oil spike has not gone away, which would constitute a negative aggregate supply shock for the U.S. and, even worse, net energy importers Europe and Asia. There are rumors that Israeli PM Benjamin Netanyahu has promised the Biden Administration that they will not attack Iranian oil facilities. Alpine Macro *Chief Geopolitical Strategist* Dan Alamariu believes that this would delay, rather than eliminate, the potential for an escalating confrontation between Israel and Iran. The risk of a major escalation in the Middle East will remain as long as Israel is engaged in high intensity fighting against Hamas and/or Hezbollah.

Bottom line: Odds of severe recession remain low. However, downside and upside risks are balanced relative to our "perfect macro landing" baseline scenario. Apart from these risks, by far the biggest wild card is an oil shock emanating from the Middle East.

David Abramson
Chief U.S. Strategist & Director of Research

A Unique Mind On The Markets