Economics

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The Sahm Rule Signal: On the Blink or Flashing Red?

To What Extent Are Labor Force Entrants Interfering with the Sahm Rule Signal?

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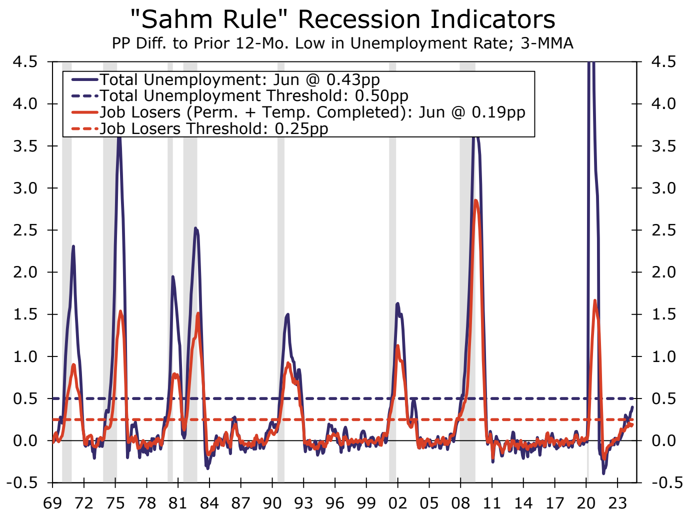
Summary

Rising unemployment over the past year has sent the clearest signal yet that the labor market is weakening. While the Sahm Rule indicator—which highlights the historical pattern that the unemployment rate has never risen 0.5 points above its prior 12-month low without a recession—has not crossed its recession threshold, the current rise would nonetheless be unique if a downturn in the labor market were to be avoided. Of course, this *has* been a unique labor market, with the pandemic initially delivering a massive shock to labor supply. Is the recovery in labor supply now interfering with the Sahm Rule signal?

At 0.43, the Sahm Rule indicator has already risen more than at the onset of any recession in the past 50 years. Yet entrants into the labor force, particularly re-entrants, have been an unprecedented driver of the increase. This should assuage some concern over the current rise as it comes in larger part for the "right" reason of more workers entering the jobs market, which ultimately makes it easier for businesses to grow.

Yet the increase in the unemployment rate for the "wrong" reasons is troubling in its own right. Looking at the rise in unemployment due to job loss on the same basis as the traditional Sahm Rule shows an increase similarly reminiscent of periods when the labor market was on the brink of a downturn.

Could this be the cycle where the Sahm Rule breaks? The larger lift from labor force entrants and more gradual ascent compared to the starting point of prior recessions raises the likelihood. That said, the negative feedback loop between rising unemployment and declining spending means that neither the current increase in the traditional Sahm Rule indicator nor the job loser version should be brushed aside. Recession thresholds crossed or not, the increase in both values shows an unequivocal deterioration in the labor market. With momentum in the jobs market difficult to shift, we see the risk of recession remaining unusually high at the moment.



Source: U.S. Department of Labor and Wells Fargo Economics

Sahm Rule Reignites Recession Watch

Softening in the labor market is perhaps most evident by the recent rise in the unemployment rate. Unemployment rose to 4.1% in June, up from 3.7% as recently as January and a cycle-low of 3.4% in April 2023. As we discussed in a report earlier this year, the unemployment rate vacillates little throughout the business cycle (Figure 1). Falling unemployment helps create a virtuous circle of stronger income and spending growth that supports additional employment, while, in contrast, rising unemployment can set off a negative feedback loop between income, spending and hiring. The importance of this dynamic has made the unemployment rate a closely watched indicator of recession, with its recent rise putting a spotlight on the "Sahm Rule" to gauge whether the economy may be on the brink of—or already in—a downturn.

The Sahm Rule, conceived by economist Claudia Sahm in 2019, has gained popularity as a recession gauge due to its timely availability, straightforward calculation and consistent track record. The Sahm Rule states that, when looking at the unemployment rate on a three-month moving average basis, if the current value rises above its prior 12-month low by 0.5 percentage points, the economy is in a recession.[1] It was initially designed as an automatic trigger for fiscal stimulus (specifically, direct payments to individuals), with its aim to be a clear indication that the economy was already in a downturn while avoiding false positives. Thus, since 1960, the threshold has always been crossed only *after* the economy was in a recession, by an average of three to four months. As shown in Figure 2, the recent increase in the Sahm Rule indicator has yet to reach the 0.5 point threshold, but it stands out in that it would be unique if not ultimately associated with a recession.

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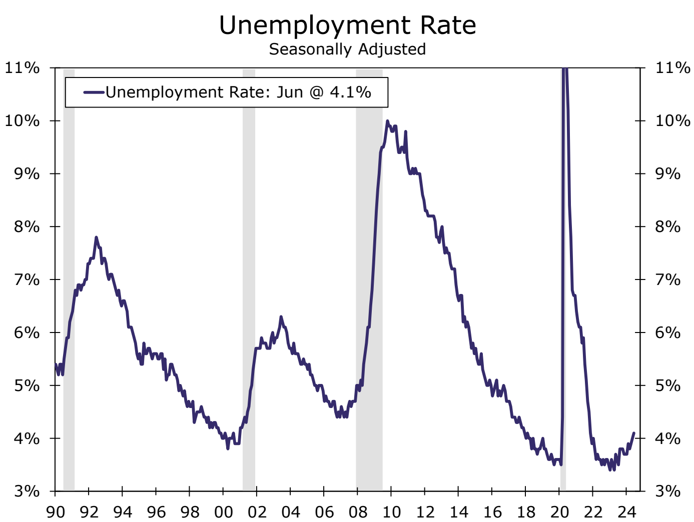
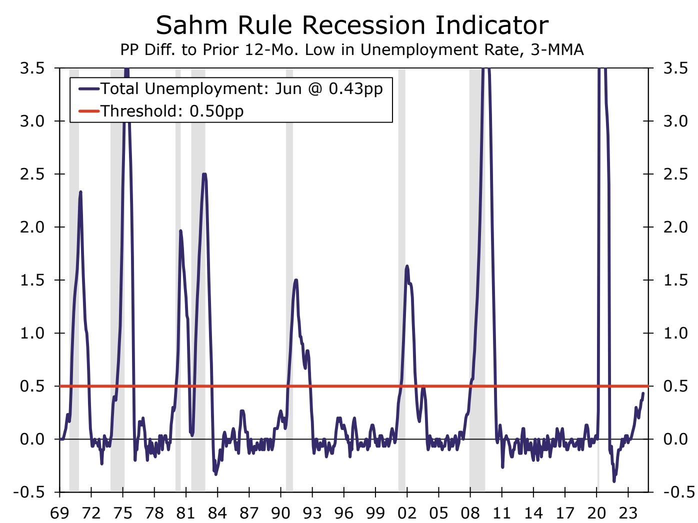
Figure 1



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 2



Source: U.S. Department of Labor and Wells Fargo Economics

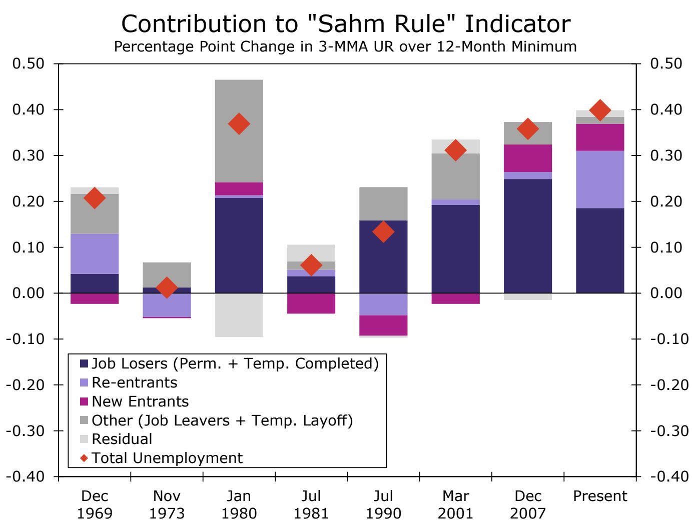
The Sahm Rule, however, does not distinguish between the different reasons the unemployment rate can increase. Unemployment can rise for "good" reasons, such as more workers entering the labor force which ultimately makes it easier for businesses to grow. But it can also rise for "bad" reasons, such as individuals losing jobs. While this distinction has not impacted the reliability of the Sahm Rule in the past, could the unique labor supply dynamics still rippling from the pandemic be interfering with its current signal?

Not Quite as Bad as It Looks: Labor Force Entrants Sizable Driver

There are different reasons why workers may be "unemployed," a state the Bureau of Labor Statistics (BLS) defines as not currently having a job, having actively looked for employment in the past four weeks and being available to work now. Young workers or new immigrants may be entering the jobs market for the first time, while more seasoned workers may be re-joining the labor force after stepping away for a period. Some unemployed persons may be in between work, having quit their prior job or been temporarily laid off due to seasonal fluctuations at their workplace. And of course, workers can be become unemployed due to the loss of a job.

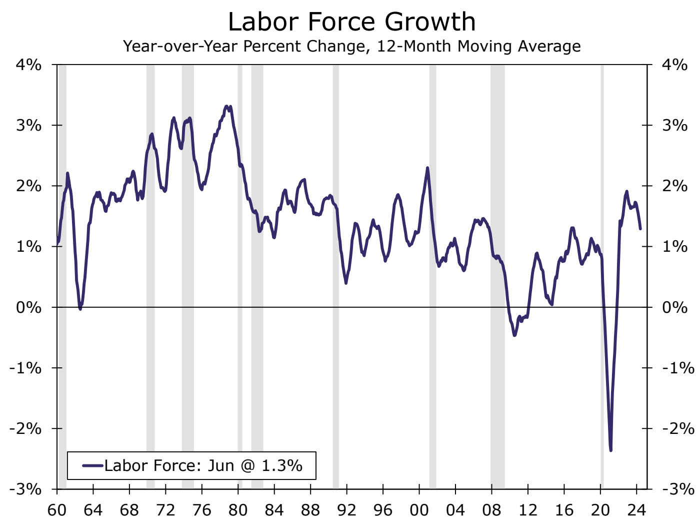
The BLS tracks the reasons workers are unemployed, which we use to decompose the recent rise in the Sahm Rule indicator. Already the increase in the total unemployment rate relative to its prior 12-month low is larger than in the initial month of each recession over the past 50 years (Figure 3, red diamonds). This marked rise in total unemployment has contributed to the growing angst about the recent weakening in the overall labor market. However, as also shown in Figure 3, entrants into the labor force have been an unprecedented driver of the increase compared to prior periods when a downturn was unfolding in the jobs market. Re-entrants to the labor force in particular have accounted for an unusually large share (0.12 points, or 31%) of the current value of the Sahm Rule indicator.[2]

Figure 3



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 4



Source: U.S. Department of Labor and Wells Fargo Economics

This significant contribution to the Sahm Rule indicator from more workers joining the labor force should assuage some concern over the recent increase in the unemployment rate. The influx suggests workers still see sufficient job opportunities to put their hats into the hiring ring, and it gives a better chance for businesses to find suitable employees to expand their operations.

That said, the boost from the relatively "good" reason of more labor force entrants is not enough to brush off the recent rise in the unemployment rate. The growing ranks of workers unemployed after having entered the labor market underscores how job opportunities, after having steadily dwindled the past two years, are now insufficient to fully absorb workers entering the labor force. What's more, the increase in unemployed labor force entrants comes not as the pace of workers funneling into the jobs market has accelerated, but instead as the post-pandemic surge in labor force growth has started to trail off (Figure 4). After expanding 1.7% or more in 2022 and 2023, the labor force has grown by just 0.6% over the past 12 months.

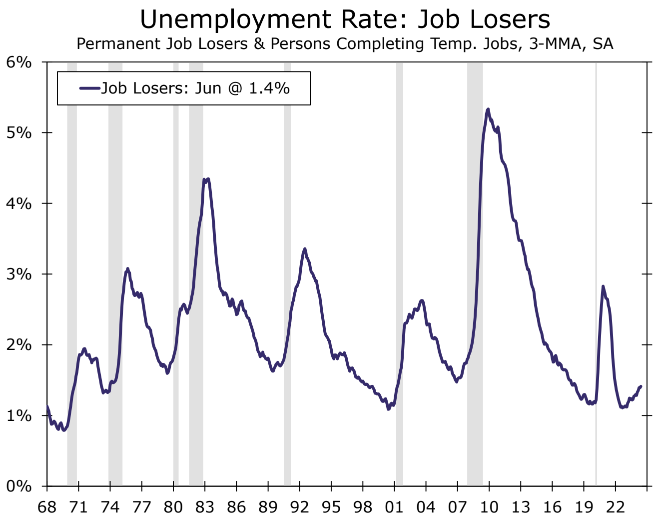
The increase in unemployed labor force entrants comes despite the post-pandemic surge in labor force growth having started to trail off.

Don't Breathe Easy Yet: Sharp Rise in Job Losers Still Worrisome

Furthermore, the rise in unemployment for the "wrong" reasons looks troubling in its own right. Entrants at least may offer a boost to labor supply and signal some optimism about overall hiring conditions, but increases in unemployment due to the loss of a permanent job or completion of a temporary job more directly point to a deterioration in underlying economic conditions. While individuals who are unemployed due to a job loss (whether a permanent job or the end of a temporary job) account for a smaller *share* of the increase in the Sahm Rule indicator than prior periods when the labor market was on the cusp of a downturn, the *absolute* increase looks worryingly similar (refer back to Figure 3).[3] Over the past year, the rate of unemployment for these job losers has climbed steadily from a low of 1.1% in the late summer of 2022 to 1.4% at present (Figure 5). Like the total unemployment rate, it is unusual to see such a directional shift without a much larger deterioration closely following.

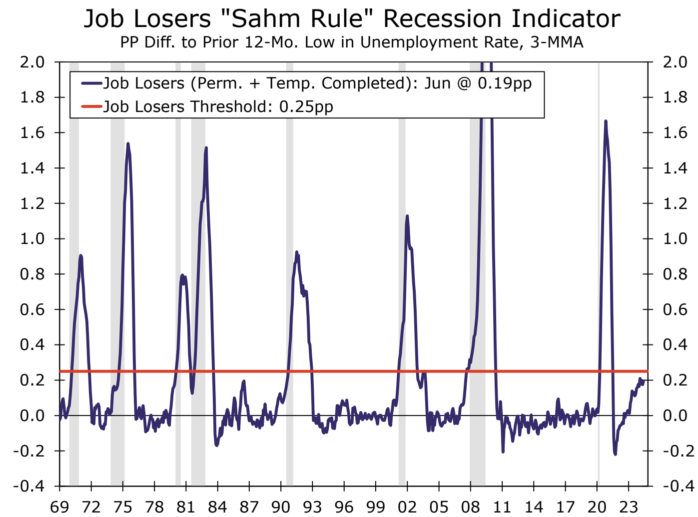
To better gauge the level of concern this development warrants, we look at the rise in the unemployment rate for permanent job losers and persons completing temporary jobs on the same basis as the traditional Sahm Rule. The unemployment rate for this subset of unemployed workers has risen more than 0.25 points above its prior 12-month low (on a three-month average basis) only during or closely following recessions. Like the overall Sahm Rule measure, the rise in the unemployment rate for job losers has yet to pass its recession threshold. In addition, while elevated, the job losers version of the indicator has moved sideways in a narrow range (0.17-0.21) in the past five months, instead of continuing to rocket higher as in prior periods when a recession was imminent.

Figure 5



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 6



Source: U.S. Department of Labor and Wells Fargo Economics

That said, the current rise in the job loser version of the Sahm Rule is sufficiently steep to signal a heightened risk of recession. The warning sign it currently flashes is likely to persist at least through the fall. The 12-month low from which the current unemployment rate for job losers and persons completing temporary jobs is compared will remain within a basis point of its current value until October, risking any further rise in this group's current unemployment rate pushes it over the 0.25 that has historically been associated with a recession. The 12-month low of the *total* unemployment rate, however, is set to drift a bit higher in the next few months, giving a bit more space for the traditional Sahm Rule to avoid being triggered.

Thresholds Crossed or Not, Clear Deterioration in the Jobs Market

The historically large contribution of labor force entrants to the recent increase generates scope for the Sahm Rule to break this cycle. As Sahm herself has pointed out, "The Sahm Rule is a historical pattern, not a law of nature."[4] Thus far the increase in the Sahm Rule indicator, while large, has not occurred as swiftly as in prior periods when recession was setting in. If the recent rise in the unemployment rate proves to be more a matter of normalization from its exceptionally low level generated by the unique circumstances of the post-pandemic economy, rather than the early signs of a downturn, it would not be the first recession signal to misfire this cycle. After all, the yield curve has been inverted since 2022, GDP contracted for two straight quarters in 2023 and the Leading Economic Index continues to plumb lower.

Yet we remain wary to wave away the recent rise in unemployment. Setting labor force entrants aside and focusing on the rise in unemployment due to job loss on its own paints a worrying picture of the labor market. Taking a similar approach to the Sahm Rule and applying it to the unemployment rate for permanent job losers and persons completing temporary job shows an increase dangerously close to prior recession periods.

Setting labor force entrants aside and focusing on the rise in unemployment due to job loss on its own paints a worrying picture of the labor market.

Notably, neither the traditional Sahm Rule indicator nor the job loser version have surpassed their respective historical recession thresholds. But recession thresholds crossed or not, the recent increase in both values shows a clear deterioration in labor market conditions. With momentum in the jobs market difficult to shift, we see the risk of a recession remaining unusually high at the moment. As a result, the weakening in the labor market, and not just the improving picture of inflation, is likely to drive the FOMC to begin reducing the fed funds rate by its September 18 meeting.

Endnotes

1 – Sahm, Claudia. "Direct Stimulus Payments to Individuals." The Hamilton Project at Brookings. May 16, 2019. (Return)

2 – The Sahm Rule uses real-time data available to policymakers at the time. Unfortunately, due to data availability issues with the vintages of seasonally adjusted unemployment levels by reason, we do not use a real-time data series as is the design of Claudia Sahm's original rule. It would be best to analyze the 12 months prior to historical recessions using the data that policymakers had available on the eve of recession; however, vintages for series such as the seasonally adjusted level of unemployed job leavers and new entrants are not readily available prior to 2011. Accordingly, our comparisons use currently published data, but any deviations would be due to revised seasonal factors, as historical data from the Current Population Survey is otherwise unrevised with annul updates to the survey's population controls. (Return)

3 – We exclude workers on temporary layoff from this category due to unemployment due to the expectation that individuals will soon be called back to work. (Return)

4 – Claudia Sahm. "The Sahm rule: I created a monster." Stay-At-Home Macro (SAHM). December 30, 2022. (Return)

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