BNY
iFlow
MACRO MORNING BRIEFING

August 5, 2024

No Longer a Mere "Gradual Normalization" of the Labor Market?

- A weaker than expected labor market report stokes concern
- The “Sahm rule” has been triggered but we don’t think a recession is at hand
- We’re not ready to call for a jumbo rate cut in September

Well Below Expectations

On the heels of last Wednesday’s FOMC meeting – at which a September rate cut was indicated as likely, the disappointing labor market data released the following Friday virtually assures it. Indeed, markets are now pricing a greater than 100% chance of a cut of 25bps, implying a nontrivial chance of a “jumbo” 50bp reduction. It also puts at risk our view of a soft landing for the economy, in which inflation returns to target without policy tipping the economy into recession.

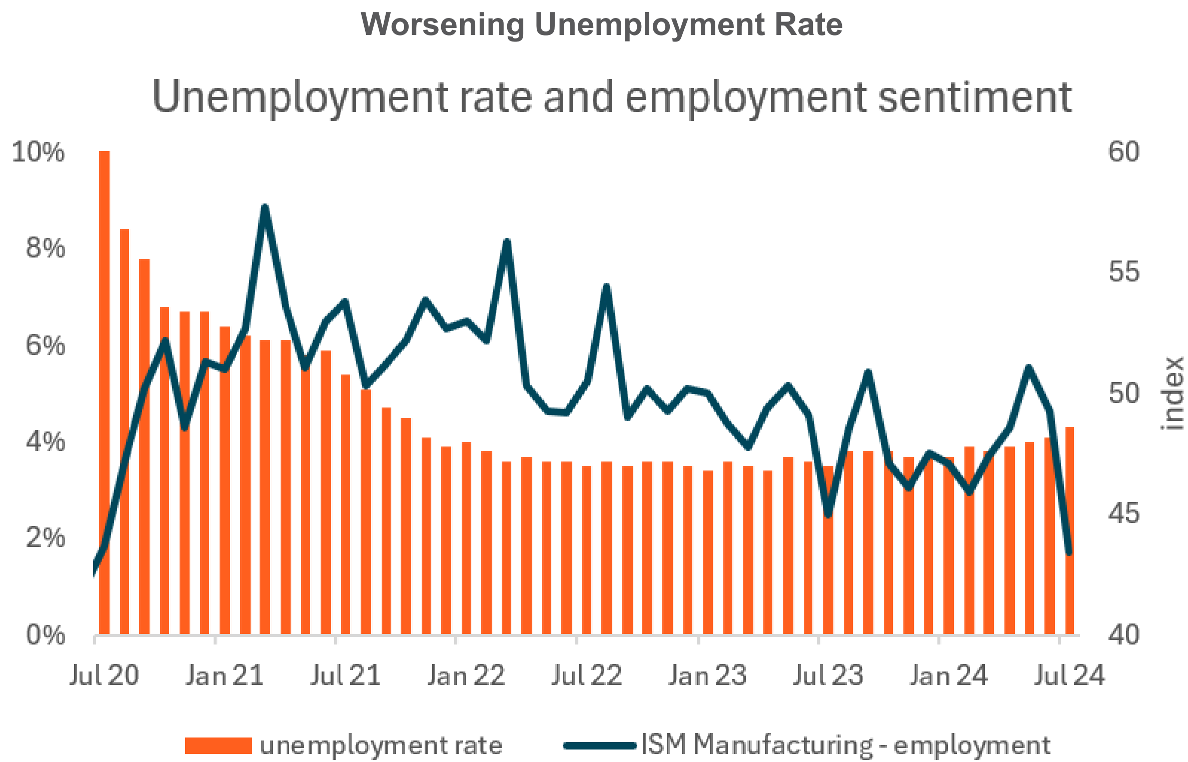
We won’t go as far as to expect a jumbo cut in September, nor will we call for a recession – yet. But the labor market deterioration is concerning. The unemployment rate increased from 4.1% to 4.3%, crossing the threshold of the suddenly widely watched and commented-upon Sahm rule (see below). Headline nonfarm payrolls increased by just 114,000, compared to 175,000 expected by consensus and 179,000 (revised) in June.

Furthermore, the report was generally weak across the board and under the hood. From the household survey, the number of unemployed workers increased by 352,000, while employed increased by just 67,000. Within the establishment survey, we continued to see significant contributions to NFP growth from just two sectors. Health Care and Government combined for 72,000 of the 114,000 jobs produced, both of which are noncyclical industries, indicating that

labor demand on a cyclical level is modest at best.

Combined with the ISM manufacturing survey posting the lowest employment subcomponent since the dark days of the pandemic, these labor market data have sent stocks, yields and the dollar lower to end last week. The 2y10y yield curve is close to uninverting, closing Friday at about -9bp of slope, with the yield on the 2y note having fallen by 21bp (as of this writing), while the 10y yield was down 11bp. This kind of bull steepening is often thought of as a recession signal.

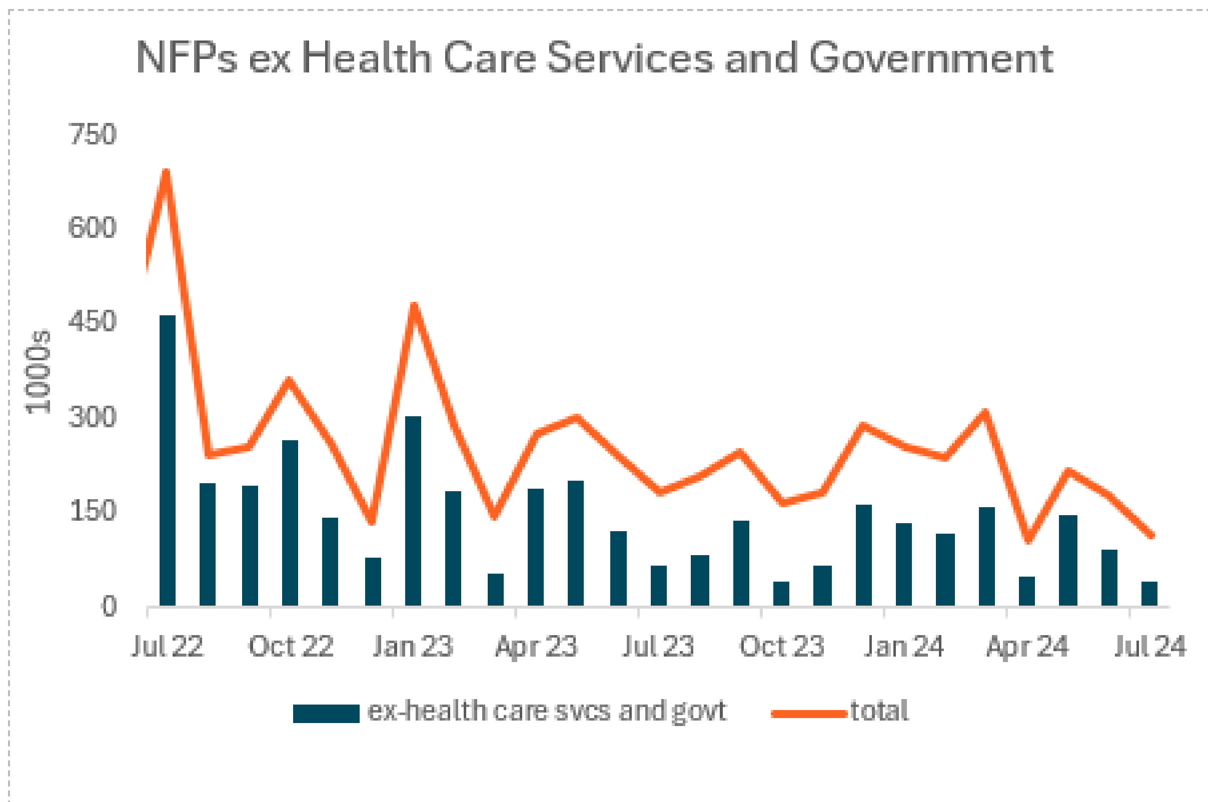
Worsening Unemployment Rate



Source: BNY Markets, Bureau of Labor Statistics, Institute for Supply Management

---

Narrow Leadership



Source: BNY, Bureau of Labor Statistics

Sahm Old Story?

As mentioned in passing above, much has been discussed in the financial ether recently about the Sahm rule, a heuristic (or in Fed Chair Powell's words, a "statistical regularity") for identifying recessions. Developed while Claudia Sahm was an economist at the Fed's Board of Governors, it first appeared in print in 2019 (see here). This year, as the labor market began slowing, it has gained widespread interest.

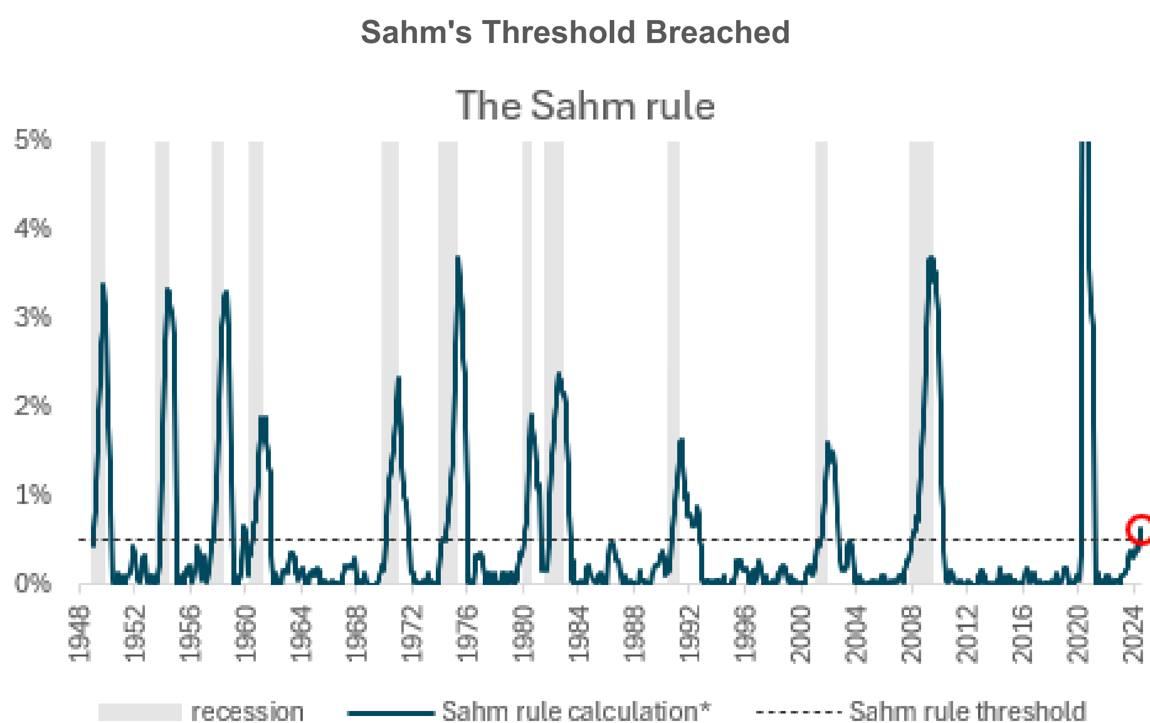
The rule states that when the most recent three-month average of the unemployment rate (UE) rises to be 0.5% higher than the lowest observed UE over the last 12 months, a recession is at hand. To be specific, the average UE between May and July this year is 4.13%. The lowest UE we've seen over a sample of the previous 12 months was 3.5% in July of 2023. The difference between these two observations is 0.613%, well above the trigger of 0.5%.

Now, even Claudia Sahm herself has argued in December 2022 that she "created a monster" and that it is merely "an empirical regularity, it's not a proposition; it's not a law of nature." One – including Sahm herself – could argue that the Covid recession was an anomaly, as has been the recovery from it. Chair Powell, when asked about the Sahm rule argued that "this pandemic era has been one in which so many apparent rules have been flaunted" and "…the whole situation is not the same as many of the other…business cycles that we've seen."

Furthermore, if we look to just two weeks ago, when Q2 GDP was released, it came in at 2.8%, and real final sales to domestic purchasers (domestic demand) grew at 2.6% – and has averaged 2.8% over the past six quarters – we feel we can safely assert that at least through June, the economy was hardly on the verge of a recession.

We would be willing to consider the strong possibility of a mild labor market recession, in which unemployment reaches somewhere in the high 4% range, but that doesn't mean that overall growth will fall for two consecutive quarters in a row, the textbook definition of a recession. Nevertheless, while our "no recession" call remains in place, we do acknowledge that it is a risk. Much of what happens from here depends on monetary policy, which we discuss below.

Sahm's Threshold Breached



Source: BNY, Bureau of Labor Statistics

*Comparison of rolling 3m average of unemployment rate and lowest unemployment over preceding 12 months

---

Fed Outlook: Not Ready to Call for a Jumbo Cut

On the heels of the FOMC and the troublesome labor data, the market has priced in some very aggressive policy moves from the Fed as we head toward autumn. The chart below (top panel) shows how much and how quickly the swaps curve has moved lower. We compare the curve from the July 31 close (the afternoon of the FOMC last Wednesday) to the curve on

Friday afternoon. In just two days, the outlook has become much more dovish.

To be precise, as of this writing, fed funds futures are pricing in 44bp of cuts at the next policy-setting meeting on September 18, well above the typically presumed 25bp cut. Furthermore, by the following meeting, on November 7, the market is priced for 84bp in rate cuts, or almost two consecutive jumbo reductions in the policy rate in just two meetings. In the second panel below, we show the implied rate cut probabilities from the swaps market for the next four months. A probability of over 100% signifies more than 25bps, as we see for September and November. Note how these have jumped in recent days.

Powell and others had begun to emphasis the presence of and concern over risks to both sides of the Fed's dual mandate – stable prices (i.e., the 2% core PCE target) and maximum employment. This emphasis was abundantly present in both the July 31 policy statement and the press conference that afternoon. To quote from the transcript of the latter, "If the labor market were to weaken unexpectedly or inflation were to fall more quickly than anticipated, we are prepared to respond." The Chair further asserted that "we think what the data broadly show in the labor market is an ongoing, gradual normalization of labor market conditions." Last week's data might call that last assertion into question – this could be the beginning of an "unexpected" weakening of the labor market, rather than an "ongoing" and "gradual" one, meaning the Fed could indeed act as forcefully as the markets are currently pricing – i.e., a 50bp cut.

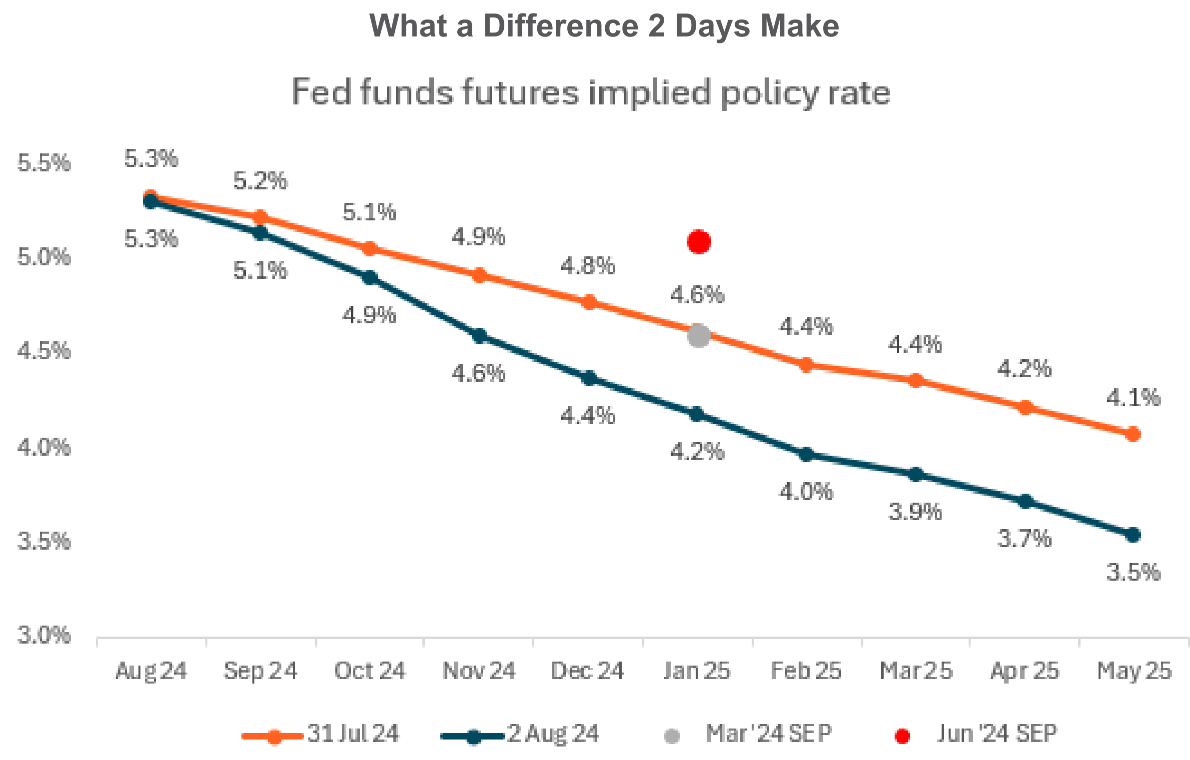
As we said above, we're not there yet, but we see the argument. Our inclination is to maintain the view for a 25bp cut in September, explicitly telegraphed in Chair Powell's August 23 appearance at the Jackson Hole Symposium. As for a 50bp cut, jumbo rate moves are rare, and usually only in response to outright emergencies.

The July data could also have been affected by Hurricane Beryl, which hit Texas on June 8, right before the two labor surveys' (establishment and household) collection period. The household survey itself showed that 436,000 people were unable to work due to bad weather, for example. A bounce back in the August data might be observed. The problem, however, is that those data will not be published until September 6, less than two weeks before the next FOMC. This could render a volatile August in markets, with each data release treated as a referendum on the 25bp vs. 50bp debate.

To avoid sounding like boilerplate Fedspeak, we will assess the data as they come in and are prepared to amend our call. Between now and Jackson Hole we have a CPI print, three

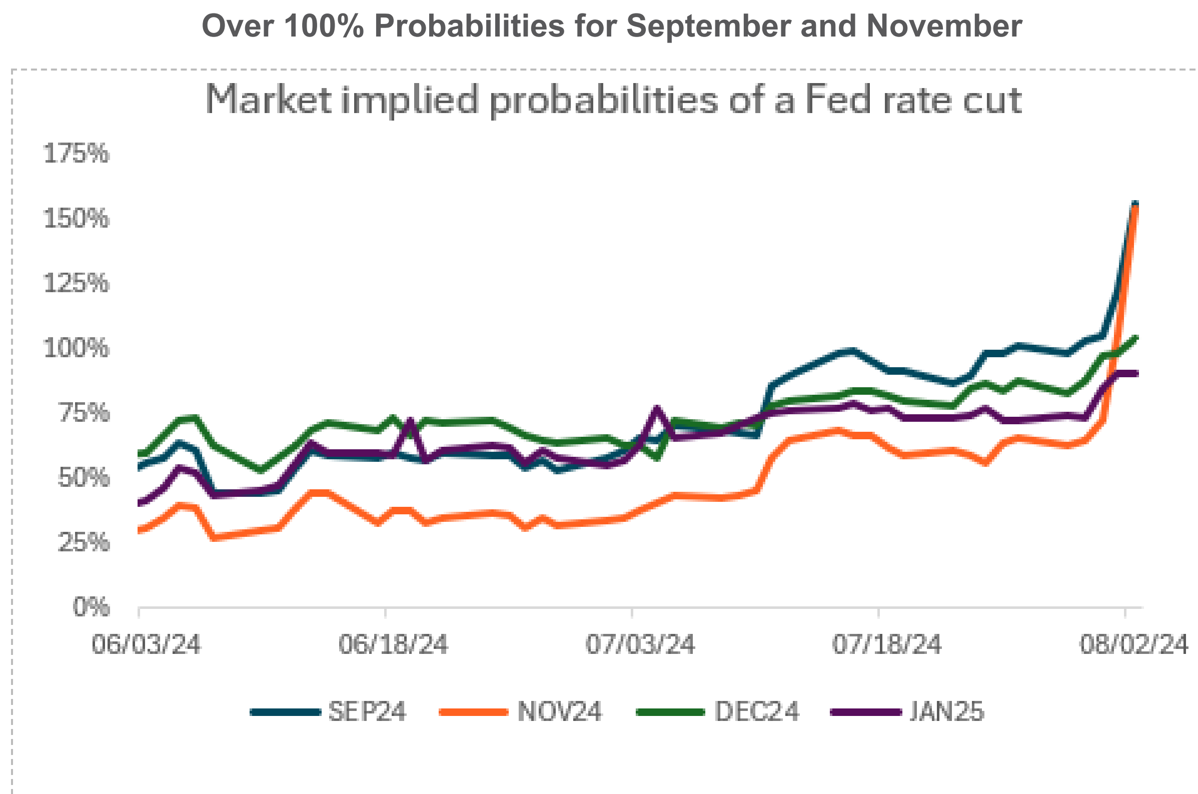
jobless claims releases and the July ISM services release, from which the employment subcomponent will be scrutinized. The chances for a jumbo cut are poised on a knife's edge, and so are our data watching antennae.

What a Difference 2 Days Make



Source: BNY, Bloomberg

Over 100% Probabilities for September and November



Source: BNY, Bloomberg

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNY.com

John Velis
AMERICAS MACRO STRATEGIST

CONTACT JOHN

Can't see the email? View online

We take our data protection and privacy responsibilities seriously and our privacy notice explains how we collect, use, and share personal information in the course of our business activities. It can be accessed here.

This email was sent to email address, and was sent by The Bank of New York Mellon 240 Greenwich Street, New York NY 10286.

Your privacy is important to us. You can opt out from receiving future Newsletters by unsubscribing via this link at any time. You can also select the topics that you want to receive by managing your preferences.

This message was sent from an unmonitored email box. Please do not reply to this message.

Contact Us | iflow@bnymellon.com

© 2024 The Bank of New York Mellon Corporation. All rights reserved.

This message was sent from an unmonitored email box. Please do not reply to this message.

.