Topical Thoughts
October 2023

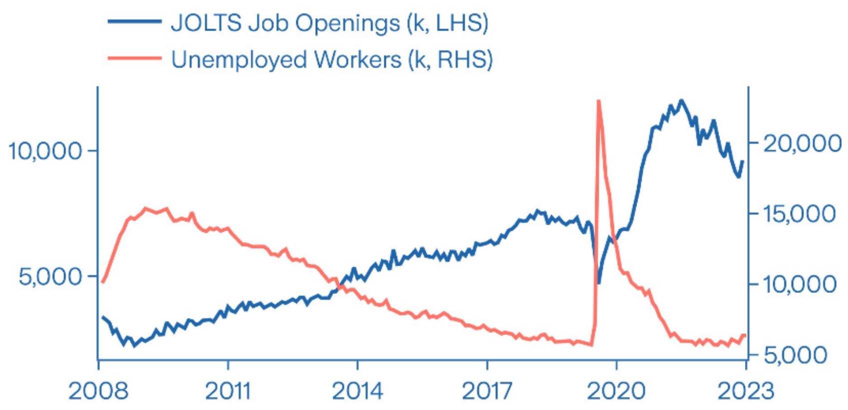
US Labour Market

Where have all the workers gone - exodus of the baby boomers

In the aftermath of the pandemic-induced recession US workers have been reluctant to come back to the labour market. The slow rise in the participation rate has disguised the underlying trend of a falling participation in an ageing society. The labour market may therefore have been even tighter than perceived over the past two years, triggering an increasingly hawkish reaction by the Fed. Now cracks are appearing and the labour market is losing momentum, increasing the risk that the Fed has tightened too much.

The US economy has shown remarkable resilience this year and the labour market is holding up well so far despite the Fed's most aggressive monetary tightening cycle in decades. At 3.8%, the unemployment rate remains very low, vacancies are far below their peak levels but are still elevated, and although they have risen above their recent lows, jobless claims have not picked up markedly.

The gap between open jobs and unemployment is closing



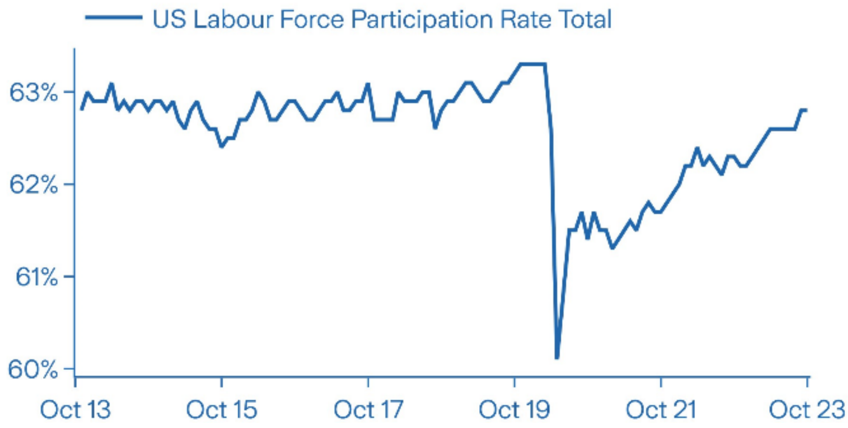
Source: Bloomberg

Demographic trends weigh on labour market participation

In fact, the labour market may have been even tighter than it looked over the past two years. In April 2020, when COVID hit, the labour force participation rate collapsed to the lowest level since 1973 as the pandemic pushed the economy into a deep recession. However, while massive fiscal and monetary stimulus led to a sharp rebound in economic activity, the participation rate did not follow suit. Fear of infection, changed work attitudes and generous fiscal support resulted in a large number of workers not returning to the labour market during the first phase of the recovery.

With worries around COVID fading and excess savings being run down, workers eventually returned, releasing pressure from an overheating labour market. Accordingly, the participation rate continuously picked up to reach 62.8% in September 2023, a post-pandemic high, though still half a percentage point below its pre-pandemic level in February 2020.

The participation rate is almost back at its pre-COVID level



Source: Bloomberg

However, the recent recovery disguises the fact that the long-term trend of labour market participation is falling due to the demographic shift. As the population ages, the overall participation rate is expected to fall as older workers, who make up an increasing share of the total workforce, partially or fully retire. The interaction of a falling trend rate and a strong rebound of the more volatile cyclical part has blurred the underlying development in the labour market in recent years.

Because older workers felt particularly at risk from COVID, the pandemic triggered an acceleration in retirement. This resulted in a significant drop of the overall participation rate as a disproportionately high number of older workers dropped out of the labour force in a short period of time. Most of these workers would have left the workforce over the past few years anyway and are therefore unlikely to come back. Hopes that the participation rate will soon rise back to pre-pandemic levels or even above are thus likely to be disappointed as they ignore the fact that the falling trend rate will continue to weigh on the labour market. Policies to keep older workers active for longer would help to mitigate the impact, particularly given that participation of the prime age group of 25 to 54 year-old workers has soared to the highest in more than two decades and is unlikely to rise much further from here.

The participation rate of prime age workers has soared to multi-year highs

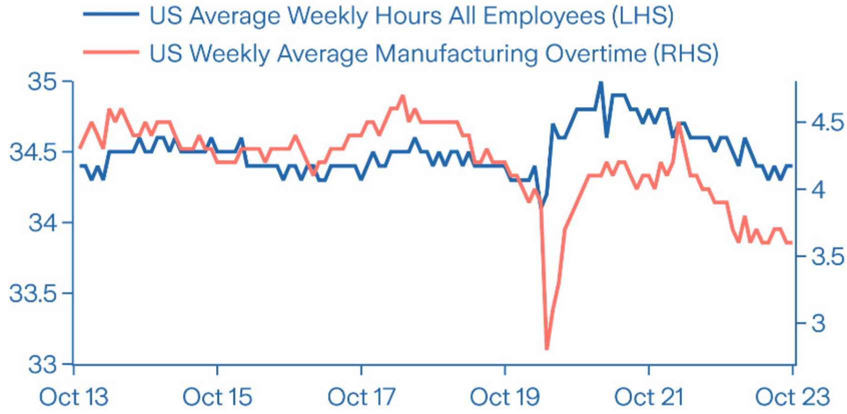
Source: Bloomberg

In a recent paper, the Federal Reserve Bank of San Francisco estimates that the actual participation rate is now above its longer-term trend, meaning that the falling trend in participation is currently more than compensated by a cyclical upswing in employment. The overall participation rate therefore misrepresents how tight the labour market has been in the aftermath of the pandemic. This also helps to explain why the Fed had to tighten its policy significantly more than initially projected. Nevertheless, the risk now is that the Fed tightens too much or for too long as the labour market is losing momentum.

The economic outlook is deteriorating

With tighter financial conditions becoming an increasingly severe drag for the economy, more and more cracks are appearing in the labour market. While unemployment is only rising slowly the number of vacancies is rapidly falling and although the number of new payrolls has been growing at a solid pace in recent months, total hours worked by all employees are now back in line with pre-pandemic levels. In addition, overtime in manufacturing has recently fallen to multi-year lows, a potential sign of a weakening employment situation more generally.

More jobs, fewer hours worked



Source: Bloomberg

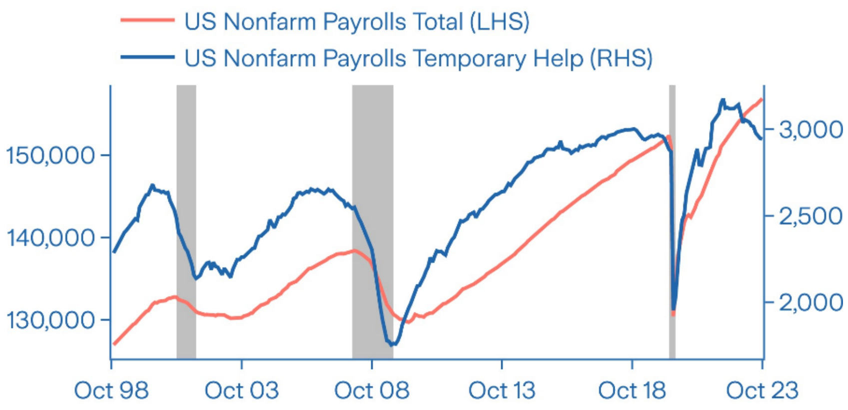
Weaker employment conditions are also reflected in the lowest quits rate since January 2021 and workers are finding it more difficult to find a job. Companies' hiring intentions have fallen back to pre-COVID levels.

Hiring has normalised to pre-pandemic levels

Source: Bloomberg

Finally, although the total number of payrolls keeps rising, the demand for temporary workers has been falling continuously since its peak in March last year. Historically, this has been a reliable indicator of slowing growth and a looming recession.

Falling demand for temporary workers points at weaker growth ahead



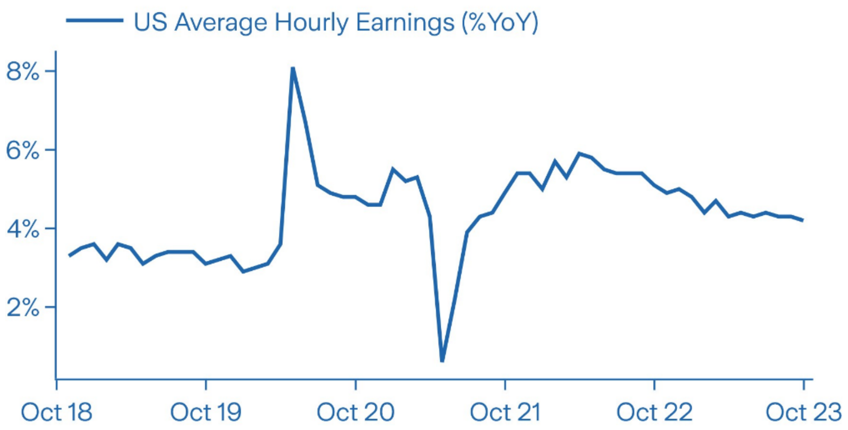
Note: Grey bars represent recession periods

Source: Bloomberg

Wage pressure is fading as the employment situation normalises

The slowdown in the labour market is welcome from an inflation perspective as it mitigates wage pressure and would allow the Fed to take a less hawkish stance. Growth in average hourly earnings slowed to 4.15% in September 2023, down from almost 6% in March 2022. Encouragingly, on an annualised basis, average hourly earnings were roughly in line with the Fed's inflation target in August and September.

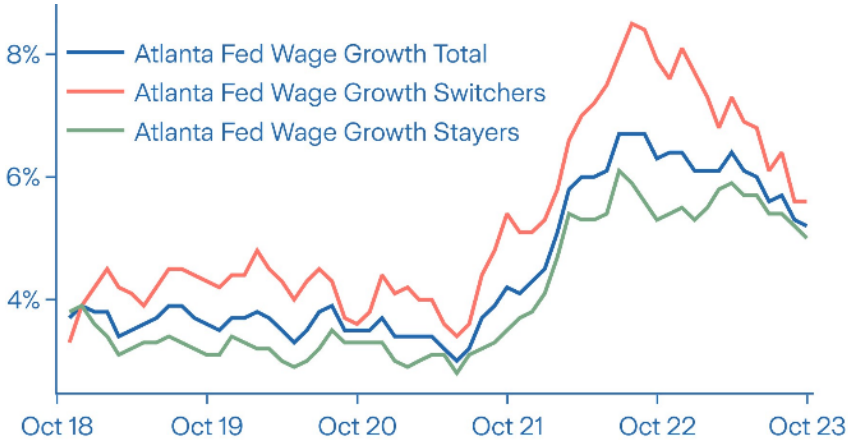
Fading wage pressure



Source: Bloomberg

The Atlanta Fed wage tracker showed overall wage growth at 5.2% YoY in September, down from 6.7% a year ago. Interestingly, however, wage growth for workers who switched jobs and for those who stayed has now basically converged again. In other words, despite a still elevated number of vacancies relative to the number of employed workers, switching jobs does not bring a significant pickup in wages on average anymore. Firms' willingness to pay higher wages to lure away workers seems to have faded substantially.

Not much to gain from switching jobs



Source: Bloomberg

In the aftermath of the COVID-induced recession companies struggled to keep up with rebounding consumer demand and had difficulties to fill open positions. With most of the pent-up demand satisfied and excess savings spent, the labour market has moved to a more normal situation.

The Fed risks overtightening as labour market momentum has turned

Most of the economic data published recently reflect a normalisation in the labour market and rising headwinds for employment and growth. Consequently, while the US job market looks to be in robust health on the surface, cracks are widening and we expect unemployment to move meaningfully higher in the quarters ahead. The longer the Fed keeps up its hawkish stance, however, the higher the risk of damaging the labour market and the economy more than needed to bring inflation down in trying to compensate for the initial lack of tightening. History tells us that it will be difficult to quickly turn negative developments in the labour market around once momentum deteriorates, particularly if it exacerbates a long-term trend.

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