Economic Indicator — August 5, 2022

Employment Report: Fireworks in July

Summary

If the U.S. economy is in a recession, no one seems to have told employers. Nonfarm payroll growth in July was more than double the Bloomberg consensus, registering a 528K monthly gain. This marked the second fastest pace of job growth in 2022. Employment growth was broad-based with nearly all major sectors adding jobs in the month. Average hourly earnings data added further fuel to the fire, increasing 0.5% in the month and 5.2% over the past year. The unemployment rate fell a tenth of a percentage point to 3.5%, which matches the 50-year low reached in 2019.

Broadly speaking, the economic data are sending mixed messages at present, and the white-hot payroll numbers look increasingly out-of-line with other data points. That said, employment growth of more than half a million jobs per month and a falling unemployment rate are hard to ignore, and we suspect this data will give the FOMC the confidence it needs to push ahead aggressively with its fight against inflation. At least a 50 bps rate hike at the September 20-21 FOMC meeting seems likely at this point in time, and yet another 75 bps hike could be in store if inflation over the next two CPI reports shows no signs of trending lower.

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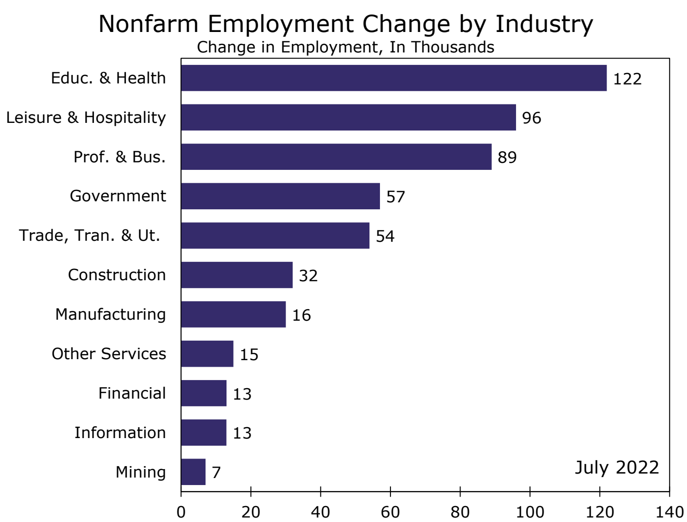
Payroll, Wage Growth Surge Past Expectations

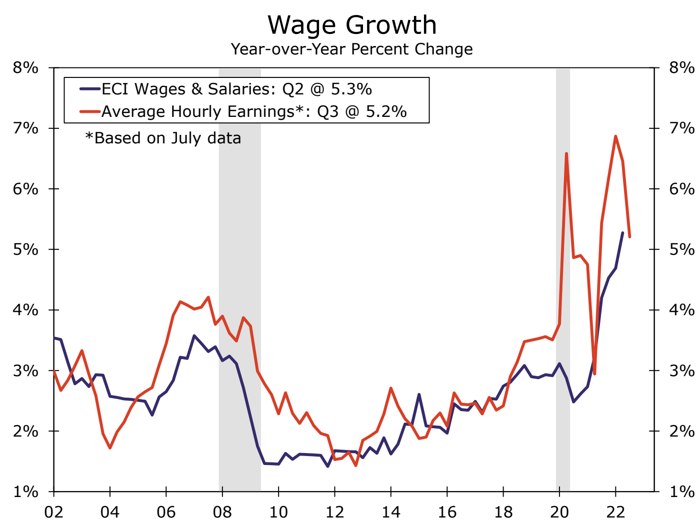
Nonfarm payroll growth surged past consensus expectations in July, posting a 528K monthly increase despite the consensus forecast looking for "just" a 250K gain. This marked the fastest pace of job growth since February. Net revisions to the prior two months added another 28K to total employment.

Employment growth was remarkably broad-based with nearly all major industries adding jobs in the month. Leisure & hospitality hiring continued to lead the way as it recovers from the pandemic with payrolls up 96K. Construction employment increased 32K despite other data releases showing a slowdown in the real estate sector, while professional and business services (+89K), health care (+70K) and manufacturing (+30K) also saw strong job gains in July. Summer seasonal factors related to the education sector, which typically see substantial cuts to payrolls in July, flattered the headline gain somewhat as employment in state and local education rose 31K after seasonal adjustment. A larger adjustment for new firms "birthed" this July also appears to have contributed to the upward surprise. The BLS forecasts a 309K boost to un-seasonally adjusted payrolls this July, 45K more than last July.

The data on wage growth were just as hot as the payroll numbers. Average hourly earnings posted an increase of 0.5% month-over-month, pushing the year-ago change up from 5.1% in June to 5.2% in July. Relative to the ECI or other measures such as the Atlanta Fed's Wage Growth Tracker, average hourly earnings recently has been one of the more benign wage growth indicators. But even the hourly earnings data are starting to look sticky: the 5.2% year-over-year change matches the 5.2% annualized rate registered over the past three months.

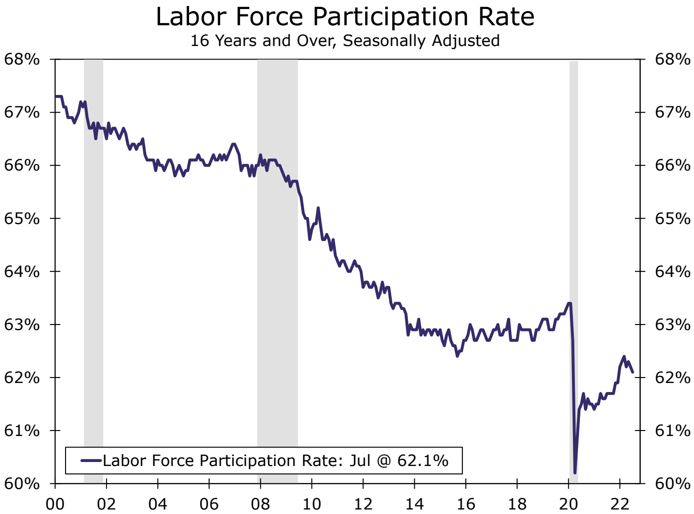


Source: U.S. Department of Labor and Wells Fargo Economics



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

The preferable way to tamp down wage pressures would be for labor supply to increase rather than having to squash demand for workers as the former portends better for growth. Yet the benign escape route from the inflation pressures currently emanating from the labor market looks increasingly closed off. Despite extraordinary demand for workers, the labor force participation rate fell a tick, continuing a slide that began this spring. A second straight decline in the labor force helped push the unemployment rate to 3.5%—matching its 53-year low. The drop in the unemployment rate was also helped along by a rise in the household measure of employment, albeit a notably smaller increase (179K) than the payroll measure of employment gains. While we give more weight to monthly job growth as reported by the establishment survey given its significantly larger sample size, the 179K rise in household employment adds to the list of labor market indicators suggesting hiring conditions are in fact cooling.



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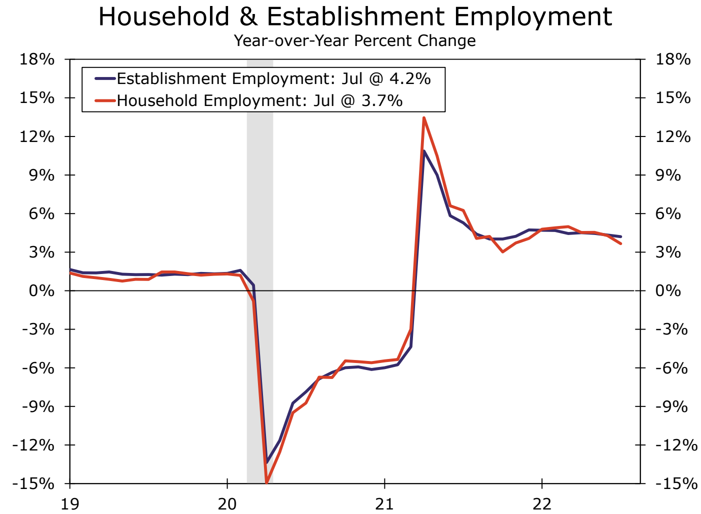

Source: U.S. Department of Labor and Wells Fargo Economics

Fed Tightening Likely to Remain in Overdrive

The July employment report increasingly stands apart from a wide range of indicators that show labor market conditions weakening. Yet it is arguably the most integral in forming Fed officials' assessment of the labor market.

In the 2010s expansion, a blowout nonfarm payrolls report typically would have been a welcome development for monetary policymakers at the Federal Reserve. The current situation facing the FOMC is much more nuanced. Chair Powell and company need job growth to slow *enough* that the "extremely tight" labor market cools but not *so much* that unemployment rises materially and the economy is pushed into a painful recession. Employment growth of more than half a million new jobs per month is clearly not a sustainable pace of job creation at this point in the cycle. Perhaps even more concerning for the Federal Reserve is that wage growth looks to be increasingly sticky around 5.0%-5.5% on an annualized basis, which is roughly a percentage point or two above what would be consistent with the Fed's 2% inflation mandate.

Threading this needle will be difficult, and we suspect the FOMC will be inclined to put more weight on the price stability half of its mandate if push comes to shove. At least a 50 bps rate hike at the September 20-21 FOMC meeting seems likely at this point in time, and yet another 75 bps hike could be in store if inflation over the next two CPI reports shows no signs of trending lower. Additional monetary policy tightening should eventually slow nonfarm payroll growth in the months ahead, and our base case still includes a mild recession that begins early in 2023.

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