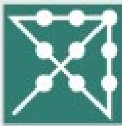

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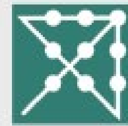

August 5, 2024

Morning Briefing

Rolling Into A Recession?

Check out the accompanying chart collection.

Executive Summary: A weak July employment report does not a recession make. The financial markets reacted on Friday as though it does, but we believe that report was a weather-impacted anomaly and not representative of the strength of the US labor market. Eric & Ed makes that case today, explaining what was going on behind the scenes to make Friday's stock market unusually volatile, why we expect employment data to snap back in August, and why we don't expect a hard landing of the economy. … Furthermore, the latest productivity data are consistent with our Roaring 2020s outlook.

YRI Weekly Webcast. Join Dr. Ed's live webcast with Q&A on Mondays at 11 a.m. EST. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

US Stock & Labor Markets I: Accentuating the Positives. Friday's employment report for July was shockingly weak. So much so that the financial markets immediately priced in an imminent recession and a much more aggressive response by the Fed to end it as soon as possible.

Since early 2022, Debbie, Eric, and I have been promoting the notion that no economy-wide recession is imminent; instead, what the economy has been going through is a sequence of rolling recessions depressing different sectors at different times, allowing the overall economy to continue to grow. However, Friday's employment report clearly raises the question of whether the overall economy is now rolling into an employment-led recession.

The diehard hard-landers are back and whooping it up. Yes, they told us so: We are in a recession …whoopee! We hate to spoil their party, but we will do our best to do so in today's *Morning Briefing*.

Yes, they are right that the 114,000 and 97,000 increases in July's total and private-industry payrolls were weak. However, they *were* increases, not decreases, and there's no reason to

think they will be followed up by decreases. In fact, we expect to see bigger increases in the August employment report early next month.

The three-month average increase in total payrolls through July was 170,000 (*Fig. 1*). That compares to the pre-pandemic monthly average of 178,000 from 2018 through 2019. Sorry, we don't see a recession in that comparison.

Also, payroll employment rose to a record high in July (*Fig. 2*). It is highly correlated with S&P 500 companies' collective forward earnings since companies tend to hire when they are profitable and fire when they are unprofitable. S&P 500 forward earnings rose to a record high in July.

Payroll employment is one of the four components of the Index of Coincident Economic Indicators (CEI). So this one at least doesn't confirm that a recession might have started in July. However, we acknowledge that the other three components, when they are reported later this month, might do so. We know from Friday's report that aggregate hours worked in manufacturing fell 0.6% m/m following a solid gain of 0.8% over the previous two months (*Fig. 3*). That means that industrial production, another CEI component, probably fell last month.

There is also a hint of a recession in private-industry average workweek, which fell 0.2% during July (*Fig. 4*). It is a component of the Index of Leading Economic Indicators. It offset the 0.1% increase in private-industry payrolls. So aggregate hours worked edged down 0.1% during July (*Fig. 5*). Conceivably, that's a sign that a recession has started, but it's not a clear one at all since this series, which rose to a record high in June, can be volatile from month to month.

Our bet is that aggregate hours worked will be back at a record high in August as the average workweek, which is also volatile m/m, rebounds and payroll increases accelerate. That's because we blame the weather for the weakness in July's payrolls.

US Stock & Labor Markets II: Blaming the Weather. We did see that the Bureau of Labor Statistics (BLS) noted in Friday's employment report that Hurricane Beryl had no impact on the report. However, the BLS didn't say that the weather had no impact. Consider the following:

(1) *Weathering the storm*. We think the rise in the July unemployment rate from 4.1% in June to 4.3% in July had to do with inclement weather including Beryl's impact on Texas.

According to the BLS household employment survey, 1.54 million workers were either not working or working only part-time due to weather in July (*Fig. 6*). That was up from 280,000 in June and one of the top five monthly readings for workers impacted by weather since 2018!

(2) *Everything's bigger in Texas.* Some of these layoffs showed up in the initial unemployment claims in Texas, which rose to 31,685 in the week ended July 20 and remained elevated at 25,453 in the week ended July 27 (*Fig. 7*). Texas claims also put significantly boosted pressure on national figures: 87% of the not seasonally adjusted increase in continuing claims for the week ended July 20—which rose to a near-three-year-high of 1.88 million—came from Texas.

Given the above, we are hard-pressed to fathom why the BLS included the following warning label on its latest employment report: "Hurricane Beryl made landfall on the central coast of Texas on July 8, 2024, during the reference periods for both the household and establishment surveys. Hurricane Beryl had no discernible effect on the national employment and unemployment data for July, and the response rates for the two surveys were within normal ranges." Go figure!

(3) *Transitory layoffs.* There's evidence that many of July's layoffs were temporary and should be reversed in the August report. Workers on temporary layoff jumped to more than 0.6% of the total labor force in July, the highest since late 2021. Workers reentering the labor force are actually the primary driver of rising unemployment right now, rising to 1.3% in July, another post-2021 high. Meanwhile, permanent job losers are still around 1.0% of the total labor force (*Fig. 8*).

As workers impacted by July's inclement weather return to their jobs in August, we expect to see lower national unemployment claims and higher national payroll employment. Fed officials have plenty of time between now and their speeches at the Jackson Hole symposium in a few weeks to digest the report and see what we're seeing. Chicago Fed President Austan Goolsbee (a noted dove) joined *Bloomberg TV* shortly after the employment report was released and cautioned against reading too much into a single report.

(4) *Earned Income Proxy.* Nominal average hourly earnings increased by 0.2% m/m in July to the highest level since May 2020 (*Fig. 9*). However, that was offset by a 0.2% m/m fall in aggregate hours worked. So our Earned Income Proxy (EIP) for private-industry wages and salaries in personal income was flat in July.

The *Cleveland Fed's Inflation Nowcast* currently forecasts the CPI and the PCED measures of consumer prices rose 0.24% and 0.20% m/m during July. That means that our real EIP probably fell slightly in July after rising 0.5% in June (*Fig. 10*). The decline in real incomes is likely to weigh on retail sales for the month. So there might be some more weakness in July's batch of retail sales, personal income, and the CEI reports to be released over the rest of this month. We attribute this to the month's inclement weather.

(5) *More job seekers*. Our view is that the labor market continues to normalize as supply comes into better balance with demand (*Fig. 11*). Fed Chair Jerome Powell agreed with our position in his *press conference* last Wednesday. Indeed, he mentioned that the labor market is normalizing 12 times, as in: "We think what the data broadly show in the labor market is an ongoing, gradual normalization of labor market conditions."

Powell also observed: "Strong job creation over the past couple of years has been accompanied by an increase in the supply of workers, reflecting increases in participation among individuals aged 25 to 54 years and a strong pace of immigration."

Labor force participation among prime-age (25-54 years old) workers rose to a 24-year high of 84% in July (*Fig. 12*). And they've been successful in finding work—the share of prime-age Americans with a job (the employment-population ratio) rose to 80.9% in July, also the highest in more than two decades (*Fig. 13*).

US Stock & Labor Markets III: Blaming the Sahm Rule, Carry Trades & Too Many Bulls. The stock markets' adverse reaction to Friday's jobs report apparently was to price in a hard landing and to expect a series of federal funds rate (FFR) cuts by the Fed, including a 50-basis-point cut in September. Helping to unnerve investors was that the increase in the unemployment rate might have triggered the Sahm Rule, implying that the jobless rate is about to soar, as it has in the past once the rule was triggered.

In his presser, Powell dismissed the Sahm Rule as a "statistical regularity." We agree. We acknowledge that the tightening of monetary policy in the past led to gradually rising unemployment followed by big spikes in the unemployment rates. But those spikes were attributable to financial crises that morphed into credit crunches that forced employers to cut payrolls and consumers to retrench (*Fig. 14*). There was a credit crisis last year, but the Fed averted an economy-wide credit crunch and recession.

Show us a credit crunch, and we'll agree that the unemployment rate is about to soar as the economy falls into a recession.

We also believe that Friday's market selloff was exacerbated by a mad scramble by speculators to cover their carry trades in the Magnificent-7 stocks (Alphabet, Amazon, Apple, Meta, Microsoft, and Nvidia) and other financial assets around the world. The one exception was US Treasury securities, which rallied strongly in reaction to the global financial turmoil. In addition, sentiment was overly bullish in the stock market, making it vulnerable to the tumultuous selloff that occurred on Friday.

The rapid unwind of carry trades injected another dose of volatility into the financial markets. Carry traders borrowing at ultralow rates in Japan effectively short the yen, borrowing and selling it to then buy other currencies of countries with higher interest rates so they can invest in those countries' assets.

Carry trades have worked out well since global central banks (except for the Bank of Japan) began raising interest rates in 2022, and especially last year as the weakening yen gave the trade extra juice. (The preponderance of carry trades also helped push the yen to weaker than 161.00 to the dollar thanks to all the selling pressure.)

Carry trades are great, until they're not. This one started to unravel in the past few weeks after Japan's Ministry of Finance defended the currency and the BOJ subsequently started to tighten monetary policy. The rising yen forced carry traders to cover their shorts in the yen rapidly and to liquidate their assets that were financed by their carry trades. Many had piled into momentum stocks, including the Magnificent-7 and those in the Nasdaq 100 (*Fig. 15*).

The yen is now trading at 146.50 to the dollar versus more than 161.00 a few weeks ago. The carry trade unwind likely spurred much of the spike in the CBOE Volatility Index (VIX) to above 29 midday Friday, as seen by increased volatility in bonds and currencies (*Fig. 16*).

Finally, the Investor Intelligence Bull/Bear Ratio has been around 4.00 for several weeks (*Fig. 17*). The percentage of bears has been hovering around lows only seen a few times since the survey started in 1987, which is a contrarian indicator.

US Stock & Labor Markets IV: Productivity & Unit Labor Costs. Financial markets tend to grasp onto incremental data points and over-extrapolate them, but viewing the forest rather than fixating on the trees can often serve investors better. Last week's labor market data was a case in point: Where the markets saw growing risk of a recession in Friday's

employment report, we saw confirmation that US economic growth remains solid based on Thursday's productivity report. Here's why:

(1) *Productivity boom*. In our Roaring 2020s scenario, we expect productivity growth to boost real GDP growth above market expectations. This year is off to a good start: Productivity rose 2.7% y/y through Q2-2024 after rising 2.9% in Q1, exceeding its 2.1% average since the late 1940s (*Fig. 18*).

(2) *Fairy dust*. We often say that productivity is like "fairy dust" for an economy. Higher productivity reduces unit labor costs (ULC), which is the yearly percent change in the ratio of hourly compensation divided by productivity. We see this as the core inflation rate of the economy that drives the CPI over time (*Fig. 19*). The ULC inflation rate was down to just 0.5% y/y during Q2-2024, its slowest pace since 2019 (*Fig. 20*). In other words, we've fully traversed the pandemic-period inflationary shock.

Productivity is often spurred by tight labor markets that encourage companies to invest in technologies that augment the skills of their workers. In this cycle, those are AI, automation, and robotics. Higher productivity expands corporate profit margins by weighing on ULC but also boosts workers' real wage gains (*Fig. 21*). Real wage gains fuel real consumption, which leads to rising corporate profits ... it's a virtuous cycle.

(3) *Demographics*. After the pandemic pulled forward a lot of early retirements, a thrust of new workers entered the labor force to fill the gap. Many of the new entrants were illegal immigrants looking to perform unskilled labor (*Fig. 22*). As the 2020s progress, these workers will become more productive as they get better at their jobs.

Calendars

US: Mon: ISM NM-PMI 51.4; S&P Global C-PMI & NM-PMI 55.0/56.0; Loan Officer Survey; Daly. **Tues:** Trade Balance -$72.5b; Atlanta Fed GDPNow 2.5%; Weekly Crude Oil Inventories. (FXStreet estimates)

Global: Mon: Eurozone PPI 0.1%m/m/-3.3%y/y; Eurozone, Germany, and France C-PMIs 50.1/48.7/49.5; Eurozone, Germany, and France NM-PMIs 51.9/52.0/50.7; UK C-PMI & NM-PMI 52.7/52.4; Japan Household Spending 0.2%m/m/-09%y/y. **Tues:** Eurozone Retail Sales -0.2%; Germany Factory Orders 0.7%; RBA Interest Rate Decision 4.35%. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index took it on the chin last week, falling 2.2% to a two-month low and 5.8% below its record high on July 16. The AC World ex-US index fared better, but still dropped 1.8% w/w to its lowest level since the beginning of May and is now nearly back in a correction at 9.6% below its June 15, 2021 record high. Not one of the major regions or selected country markets that we follow moved higher for the week. EMEA was the best performing region last week, albeit with a decline of 0.4%, followed by EM Asia (-0.9%), EM (-1.0), and the AC World ex-US. EMU was the worst regional performer with a decline of 3.6% to 17.5% below its October 2007 record high, followed by EM Latin America (-3.2), Europe (-2.3), and EAFE (-2.0). Among the major selected country markets that we follow, Switzerland performed the best last week, albeit with a decline of a hair less than 0.1%, followed by South Africa (-0.1), India (-0.5), Australia (-0.5), and China (-0.6). Spain fell 4.4% for the worst country performance last week, followed by Mexico (-3.9), Germany (-3.7), Brazil (-2.9), and Canada (-2.9). The US MSCI's 11.6% ytd gain remains well ahead of the AC World ex-US index's (2.7). EM Asia is still ahead of the pack as the leading region ytd with a gain of 6.8%, which puts it ahead of EM (3.7), Europe (2.7), and the AC World ex-US. The worst performing regions so far in 2024: EM Latin America (-20.2), EMU (0.5), EMEA (2.0), and EAFE (2.5). Looking at the major selected country markets that we follow, India is now the best ytd performer with its gain of 19.4% ahead of Taiwan (18.7%), but that country is down 14.2% from its July 11 record high. Taiwan is followed by the United States (11.6), the United Kingdom (6.0), and South Africa (4.5). The worst performing countries so far in 2024: Brazil (-23.2), Mexico (-19.6), Hong Kong (-13.8), Korea (-4.6), and France (-4.4).

US Stock Indexes (*link*): Just one of the 48 major US stock indexes that we follow rose w/w, down from 30 rising a week earlier. The Dow Jones 15 Utilities index was the best performer with a gain of 4.8%, ahead of S&P 500 LargeCap Value (-1.4), Dow Jones 65 Composite (-1.6), S&P 500 LargeCap Equal Weighted (-1.7), and S&P 100 MegaCap Equal Weighted (-1.8). The Russell 2000 Growth index was the worst performer with a decline of 6.7%, followed by Russell 2000 (-6.7), Russell 2000 Value (-6.5), and S&P 400 MidCap Pure Growth (-5.9). Looking at their ytd performances, 43 of the 48 indexes are higher so far. That's down from 47 indexes a week earlier, which was the highest count so far this year. The S&P 500 LargeCap Growth index moved back into the top spot as the best performer so far in 2024, with a gain of 16.7%, ahead of Dow Jones 15 Utilities (15.5), S&P 100 MegaCap (15.0), Russell 1000 Growth (13.6), and Russell 3000 Growth (13.1). The worst performing major US stock indexes ytd: S&P 500 Transportation (-4.2), S&P 400

MidCap Pure Value (-3.7), Dow Jones 20 Transports (-3.3), S&P 600 SmallCap Pure Value (-2.8), and S&P 600 SmallCap Value (-1.1).

S&P 500 Sectors Performance (*link*): Five of the 11 S&P 500 sectors rose last week, and six were ahead of the S&P 500's 2.1% decline. That compares to seven sectors rising a week earlier when eight were ahead of the composite index's 0.8% decline. The outperformers last week: Utilities (4.3%), Real Estate (2.8), Communication Services (1.3), Consumer Staples (1.2), Health Care (0.7), and Materials (-1.4). The underperformers last week: Consumer Discretionary (-4.3), Information Technology (-4.0), Energy (-3.7), Financials (-3.0), and Industrials (-2.8). The S&P 500 is up 12.1% ytd, with 10 sectors in positive territory, but only three are ahead of the index. That's down from five sectors ahead of the index during mid-May. Communication Services is now the best ytd performer, with a gain of 19.6%, ahead of Information Technology (18.5) and Utilities (17.1). These sectors are lagging the S&P 500 so far in 2024: Consumer Discretionary (-0.3), Real Estate (4.4), Materials (5.2), Energy (6.0), Industrials (7.7), Health Care (10.5), Consumer Staples (11.6), and Financials (11.8).

US Economic Indicators

Employment (*link*): Employment was weaker than expected in July, while there were downward revisions to both June and May payrolls. *Payroll employment* advanced 114,000 (vs 175,000 expected) in July—the least since December 2020—and slowing from 179,000 in June and 216,000 in May. Revisions show both June (to 179,000 from 206,000) and May (216,000 from 218,000) payroll increases were lower than previously reported, for a net loss of 29,000 over the two-month period. *Private payroll* increased 97,000, below the 148,000 expected, and slower than June and May gains of 136,000 and 206,000, respectively. *Private service-providing* industries increased 72,000 in June, led by *health care*, which added 55,000 jobs—comparable to the average monthly gain of 63,000 over the prior 12 months, led by home health care services (22,000) and hospitals (20,000). *Social assistance* (9,000) continued its uptrend, but at half the pace of the prior 12 months. *Leisure & hospitality* employment increased 23,000 after gains of 1,000 and 18,000 the prior two months, while *information services* jobs saw a 20,000 cut in jobs in July, after no gain the prior two months. *Government* added only 17,000 jobs last month, slowing recently, following large gains during 2023 and Q1-2024. *Goods-producing* jobs rose 25,000 in July, led by construction (25,000), with manufacturing adding 1,000 jobs and mining & logging cutting 1,000 jobs.

Wages (*link*): Average hourly earnings (AHE) for *all workers on private payrolls* increased 0.2% in July, while the yearly rate eased for the second month, from 4.0% in May to 3.6% in July—which was the lowest rate since May 2021. It peaked at 5.9% in March 2022. *Private industry* wages rose 3.7% (saar) over the three months through July, an uptick from June's 3.5% and a tick below the 3.6% yearly rate. *Service-providing industries showing three-month rates above their yearly rates*: information services (6.4% & 3.4% y/y), other services (5.4 & 3.8), professional & business services (4.6 & 3.9), and education & health services (4.0 & 3.1). *Service-providing industries showing three-month rates below their yearly rates:* utilities (-0.5 & 1.2), transportation & warehousing (1.8 & 4.3), financial services (3.0 & 4.7), and leisure & hospitality (3.6 & 3.9). *Service-providing industries with three-month and yearly rates identical:* retail trade (2.0 & 2.0) and wholesale trade (2.7 & 2.7). Within *goods-producing* industries, the annualized three-month rates were slightly above the yearly rates for both *durable goods* manufacturing (6.1 & 5.7) and *nondurable goods* manufacturing (2.6 & 2.1) industries.

Earned Income Proxy (*link*): Our Earned Income Proxy (EIP), which tracks consumer incomes and spending closely, was unchanged at its record high in July. *Average hourly earnings* in July advanced 0.2%, while *aggregate weekly hours* fell 0.2%—with private payroll employment increasing 0.1% and the average workweek falling 0.3%. Over the past 12 months, our EIP advanced 4.7%—with aggregate weekly hours up 1.1% and average hourly earnings up 3.6%.

Unemployment (*link*): The number of unemployed rose 352,000 to 7.2 million in July, with the unemployment rate climbing for the fourth successive month, from 3.8% in March to 4.3% in July—the highest since October 2021. The rate was below 4.0% from February 2022 through April 2024, before reaching 4.0% this May. Household employment rose 67,000 in July, while the labor force was 420,000 higher than in June. The participation rate ticked up to 62.7% last month after slipping from 62.7% in April to 62.5% in May. *By race*: The unemployment rates for African Americans was unchanged at 6.3% in July, while the rates for Hispanics (5.3 from 4.9) and Whites (3.8 from 3.5) both moved higher, while the rate for Asians (3.7 from 4.1) moved lower. *By education*: The unemployment rate dipped in July for those with a bachelor's degree or higher (to 2.3% from 2.4%), while rates rose for those with some college or an associate degree (3.5 from 3.4), a high school degree (4.6 from 4.2), and less than a high school diploma (6.7 from 5.9) moved higher.

Construction Spending (*link*): Construction spending fell short of expectations again in June, though spending remains in record territory. *Total construction spending* slipped 0.3% in June (vs an expected 0.2% gain) and 0.7% over the two months through June from

April's record high. Spending through the first half of this year was 8.6% above the comparable period a year ago. Private residential investment declined 0.3% in June, with *new single-family homes* falling 1.2% and *new multi family* units little changed, ticking down 0.1%. Versus a year ago, however, the former increased 9.9%, while the latter sank 7.4%. *Private nonresidential* construction slipped 0.1% in June, led by declines in commercial (-0.8%), health care (-0.8), religious (-0.6), and power (-0.6). and office (-1.7) buildings, though private nonresidential building was up 4.2% y/y, led by double-digit gains in manufacturing (19.1) and power (11.7) structures. It remains stalled at record highs. *Total public construction* spending fell 0.4% in June from May's record high; it's up 7.3% y/y.

Auto Sales (*link*): Motor vehicle sales in July remained in a volatile flat trend around recent highs. *Total* sales rose to 15.8mu (saar) in July, up from its recent bottom of 14.9mu in January and not far from its recent high of 16.1mu during December and June of last year. Total sales bottomed at 12.3mu in September 2021. *Domestic light truck* sales have hovered in a flat trend around 10.0mu (saar) since mid-2023, increasing from 9.8mu this June to 10.0mu in July. These sales bottomed at 7.3mu in September 2021. *Domestic car* sales edged up to 2.1mu (saar) in July, hovering in a flat trend around 2.0mu since September 2021. Turning to *imports*, they had been on an uptrend since May 2022, climbing from 2.6mu in May 2022 to 3.8mu this April before leveling out in recent months.

Global Economic Indicators

Global Manufacturing PMIs (*link*): The global manufacturing sector in July experienced a growth setback, with activity expanding at the weakest rate in seven months. The *JP Morgan Global M-PMI* fell below the breakeven point between contraction and expansion for the first time this year, slipping to 49.7 in July from 50.8 in June. It was at a 22-month high of 51.0 in May. Two out of the five *PMI sub-indices*, new orders and stocks of purchase, were a drag on the overall index, while employment was flat; the trend in output was much less positive than in recent months. Meanwhile, vendor lead times lengthened, mainly due to supply-chain disruptions rather than strong demand. *By country*, only 15 of the 32 countries for which data are available posted expansions in manufacturing output. India led the leaderboard, while growth was also recorded in China, the US, the UK, and Brazil. The euro area remained the main source of weakness, with output falling for the sixteenth successive month, though there were sharp growth slowdowns in both China and the US manufacturing activity and a contraction in Japan's manufacturing output. *Turning to prices*, average input costs and selling prices continued to rise in July, though the rate of increase slowed for both. The rates of increase were still stronger in developed nations than

emerging markets.

US Manufacturing PMI (*link*): Manufacturing activity in July contracted again, posting its weakest performance in eight months. The *M-PMI* fell for the fourth month, to 46.8 in July, after climbing from 47.8 in February to 50.3 in March. It was below the breakeven point between contraction and expansion for the 20th time in the past 21 months. According to ISM, the *overall economy* continued its expansion for the 51st month after a one-month contraction in April 2020. (A Manufacturing PMI above 42.5% over a period of time generally indicates an expansion of the overall economy.) The *production* (to 45.9 from 48.5) and new orders (47.4 from 49.3) measures fell deeper into contractionary territory in July, as did employment (43.4 from 49.3). The backlog-of-orders gauge was unchanged at 41.7. Meanwhile, the *supplier deliveries* (52.6 from 49.8) measure moved into "slowing" territory—rising above 50.0—for the first time in five months after four straight months of faster deliveries. (The supplier deliveries component is the only measure that is inversed—a reading above 50.0 indicates slower deliveries, which is typical as the economy improves and customer demand strengthens.) The price pressures measure picked up slightly in July, to 52.9 from June's six-month low of 52.1; it was at 60.9 in April—which was the highest since mid-2022.

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