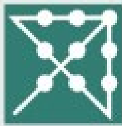
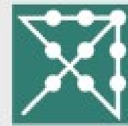
 Yardeni Research 

October 8, 2024

Morning Briefing

On Jobs, Bonds & Liquidity

Check out the accompanying chart collection.

Executive Summary: Hard-landers who thought a recession was taking root in the labor market were mistaken, Eric explains. He and Ed interpreted the recent rise in unemployment as signifying a normalizing labor market—not one that was weakening in an alarming fashion. … Also: Stronger-than-expected economic indicators have dramatically curtailed expectations for further Fed rate cuts. … And: The September 30 tapping of the Fed's standing repo facility is nothing to worry about.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Economy: Long Live the Labor Market. After two years of higher interest rates and Fed balance-sheet tightening, the lack of cracks in the labor market has caught nearly everyone off guard. In disbelief that their economic models could be wrong, some claimed that this could not be true! The diehard hard-landers vocally grasped onto any sign that suggested that the "long and variable lags" sown by tightened monetary policy had come to roost in the labor market.

Among those signposts: The Bureau of Labor Statistics' (BLS) downward revision to annual payroll employment by 818,000. The summer slowdown in hiring. The rise in weather-related unemployment during July. These were heralded as inescapable facts that the long-awaited recession had arrived. Champagne glasses were clinked.

September's gangbusters payroll employment data allayed fears (or perversely, hopes) that the labor market was coming unhinged. We have been saying all along that those concerns were misplaced. There is no endogenous force that causes unemployment to spike once it starts rising, as some Fed officials and pundits have speculated. Financial crises cause the massive increase in unemployment associated with a recession, per our Credit Crisis Cycle theory (*Fig. 1*).

It was highly unlikely that the unemployment rate would remain at a historical low forever.

That wouldn't be consistent with moderating inflation... or reality.

While the hiring environment has cooled, we continue to believe that the labor market is simply normalizing after a period of record tightness. That's partly why we think there wasn't much need for the Fed's 50bps rate cut in September—and certainly no need for an emergency 75bps rate cut in July, as some CNBC guests at the time asserted was necessary.

Here are our additional takes on the latest labor market data:

(1) *Sahm Rule reversal.* The so-called Sahm Rule, a recession indicator based on the moving average of the headline unemployment rate, was triggered in July when the unemployment rate rose to 4.3% (*Fig. 2*). Then, we dismissed this as yet another false recession signal. The creator of the eponymous rule did so too in the weeks following. That proved to be the right call.

The unemployment rate ticked down from 4.2% in August to 4.1% in September. Unrounded, the unemployment rate actually fell to 4.051%. The thinnest margin prevented the headline unemployment rate from declining 0.3ppts in just two months. That would have put the unemployment rate 0.2ppts below Fed officials' latest projection of the long-term rate.

(2) *Hiring head fake.* Job vacancies typically fall when confidence in the economic outlook deteriorates. Feeling less optimistic about external job opportunities, fewer workers quit their jobs. As businesses are less confident about future profits, they are less likely to expand operations and therefore hire less workers.

The numbers of hires and quits measured by JOLTS have fallen recently (*Fig. 3*). Rather than fewer workers quitting their jobs because they aren't confident about their job market prospects, staff retention may be improving, as wages and benefits now match what workers feel they are worth. As consumer inflation falls, there's less pressure to job-hop in search of higher wages.

One curiosity is that the number of job openings relative to both the number of hires and the number of quits has stabilized above pre-pandemic levels (*Fig. 4*). That suggests employers still have an unmet demand for labor.

(3) *Skills mismatch.* As job openings fall, unemployment tends to rise. And vice-versa.

That's the foundation of the Beveridge curve model (*Fig. 5*). However, labor demand is retaining its post-pandemic surge and even turned higher last month (*Fig. 6*). Perhaps businesses are eager to hire, but the current (growing) labor pool does not possess the skills employers are looking for.

According to the NFIB survey of small businesses, 52% of small business owners said there were no qualified applicants to fill their openings in September (*Fig. 7*).

(4) *Employment gains.* We've highlighted that much of the upward pressure on the unemployment rate has come from workers entering the labor force. This is obviously preferable to layoffs causing a rise. Employed workers transitioning into unemployment fell from 1.06% of the labor force to 0.93% in September (*Fig. 8*). Even as more Americans previously out of the labor force started searching for jobs and became newly unemployed, the unemployment rate fell.

(5) *Unions.* Strikes have made headlines, and clearly workers have a lot of bargaining power. The longshoremen's 62% raise over six years equates to roughly 8.4% annualized increases—better than expected equity returns! More than 30,000 Boeing employees continue to strike after refusing a 30% raise, plus additional bonuses and benefits. These pay raises are representative of a broader trend. Lower-wage workers (production and nonsupervisory workers account for roughly 80% of US employment) have seen their real wages rise for the past several years (*Fig. 9*). Union wages simply lag non-union wage gains because contracts lock in a set path of wage increases for several years (*Fig. 10*). It can take quite a while to negotiate new contracts.

Unions also represent a shrinking percent of total private sector employment, now just 6%, nearly half the representation in 1992 (*Fig. 11*). Union membership fell to less than one-third of government employees in 2023 for the first time on record. So while union members are seeing big wage increases, these figures may not make a big impact on national figures.

(6) *Goods versus services.* Union membership in the private sector has shrunk in part because the US economy is now driven much more by services providers than goods producers. Economic output and consumption favor services to goods at a roughly 2:1 ratio.

For instance, manufacturing jobs fell 7,000 last month (*Fig. 12*). But goods-producing jobs (i.e., manufacturing, construction, and mining) now represent just 10% of total nonfarm employment (*Fig. 13*). Employment in the leisure and hospitality industry, meanwhile, rose 78,000, boosted by consumer spending on services. Across services industries, the three-

month moving average of job openings is increasing (*Fig. 14*).

Some hard-landers say there's no way that September's payroll gains make sense given that the employment series in ISM's national Purchasing Manager Indexes (PMIs) has been depressed. While M-PMI employment is somewhat correlated with the monthly change in manufacturing payrolls, the relationship between the NM-PMI series and services employment broke down several years ago (*Fig. 15* and *Fig. 16*). We'll stick with the hard data.

Bonds: Re-Inversion? Fed officials' decision to cut the federal funds rate (FFR) by 50bps was predicated on the fact that they were behind the curve on fighting rising unemployment. We note that many who continue to beat that drum were also calling for rate cuts back in July. In any case, the market has pared its expectations for future FFR cuts, as the most recent economic data have been much stronger than expected.

Here's more:

(1) *FFR futures.* After the Fed's rate cut on September 18, futures tied to the FFR priced in the Fed cutting all the way to the terminal rate (the ultimate endpoint of an easing cycle) of 2.8% over the next 12 months (*Fig. 17*). Now, the market expects the Fed to take the FFR to 3.5% in that period, a dramatic shift in expectations. The number of FFR cuts priced in over the next year has fallen from nearly 10 to about 5.5 (*Fig. 18*).

We aren't worried about the Fed not "meeting" the market expectations for cuts. Recall, the market priced in seven cuts coming into this year, and the stock market did just fine without any until September. Leading up to the September Fed meeting, a number of pundits said that if the Fed didn't cut as much as the market had priced in, the Fed effectively would tighten financial conditions. This was a big risk, according to them. No word from this group whenever financial conditions are loose and could risk higher inflation, of course. Nonetheless, long-term bond yields have risen meaningfully since the Fed's too-big rate cut, putting a damper on their suggestion.

It makes sense that short-term-rates markets price in a slew of cuts at any sign of potential weakness in the economy. Investors who are long the Magnificent-7 and broader S&P 500—particularly with leveraged positions—know that the Fed's reaction function is to cut first, ask questions later. Even if it is "expensive" to hedge recession risk in rates markets, why not do so to protect your downside? That's likely why investors are so quick to pile in, especially considering that stock valuations are relatively stretched. Those recession

hedges do provide a fade-able opportunity to those who trade rates futures and agree with our Roaring 2020s outlook, however.

(2) *Yield curve.* The US Treasury yield-curve spread (i.e., between the 2-year and the 10-year Treasury bond yields) has reverted from a local high of +23bps to now just +1bps, flirting with re-inversion (*Fig. 19*). Perhaps the bond market thinks the Fed will hold the FFR too high for too long and cause a credit crisis. Or rather, the bond market thinks the FFR will end up around 4.0% over the long run. That sounds about right to us.

The yield curve has bear flattened meaningfully since the payroll employment data on Friday, as both the 2-year and 10-year Treasury yields have risen. The 10-year has now breached 4.00% and is nearly 40bps higher than its recent low of 3.63% (*Fig. 20*). In the weeks following the Fed meeting, the curve had steepened, with the 2-year yield falling as the 10-year yield rose (pricing in over-easy monetary policy causing higher long-term growth and inflation). Such a reversal is rare, reflecting the fact that the strength of the employment report caught the consensus off guard.

(3) *Credit spreads.* The spread between high-yield corporate bond yields and comparable US Treasury yields has compressed further to just above 300bps (*Fig. 21*). The bond market continues to doubt the likelihood of a recession and defaults from the junk bond universe.

Rates & Repo: Liquidity Shortage? The Fed's standing repo facility (SRF) was tapped for $2.35 billion on Monday, September 30. This facility was put up five years ago to alleviate pressures in the financial plumbing during the Fed's previous go at quantitative tightening (QT). There were several causes for the increase in usage, but it's not likely to ruffle too many feathers at the Fed. We expect QT to continue its tempered pace for several months. However, further pressure in repo markets could lead to a quicker ending.

Here's more:

(1) *Quarter-end.* Funding markets always see pressure on quarter-end dates. This is when foreign banks pull back from these markets to window-dress their balance sheets for quarterly reporting. The SRF was designed to absorb these pressures, and $2 billion is chump change relative to past usage of the facility (*Fig. 22*). As a reminder, banks pledge Treasuries (or other high-quality collateral) to the SRF in exchange for overnight cash.

(2) *Quantitative tightening.* By reducing the amount of liquidity in the financial system, QT

reduces the supply of cash to financing collateral (i.e., new Treasury supply). This can put upward pressure on repo rates and force banks to hit the Fed for financing. As the Treasury issues more and more debt, that also increases the amount of Treasuries that Wall Street needs to finance (*Fig. 23*).

(3) *Should you worry?* No. Bank reserves are still very high, above $3.0 trillion (*Fig. 24*). There are few signs of worry in funding markets. The rising Treasury supply and asset managers' preference for Treasury futures have led to more trading activity at higher repo rates, but that's not an immediate cause for concern. The bigger story is that M2 money supply is now increasing again on a y/y basis (*Fig. 25*). The Fed has plenty of shock absorbers, and they are more likely to end QT too soon than too late.

Calendars

US: Tues: NFIB Small Business Optimism Index 92.0; Trade Balance -$70.6b; Atlanta Fed GDPNow 2.5%; API Weekly Crude Oil Inventories; Collins; Bostic; Jefferson. **Wed:** MBA Mortgage Applications; Wholesale Inventories 0.2%; Crude Oil Inventories & Gasoline Production; 10-Year Note Auction; FOMC Minutes; Williams; Daly; Bostic; Barkin; Collins; Goolsbee; Logan. (FXStreet estimates)

Global: Tues: Germany Industrial Production 0.8%; Eurogroup Meetings; Nagel; Balz; Mauderer; Kent. **Wed:** Japan PPI -0.3%m/m/2.3%y/y; Elderson. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings move higher during the October 4 week. LargeCap's forward earnings rose a hair w/w after falling for two straight weeks for the first time since December, when it fell for three straight weeks. It's now 0.2% below its record high during the September 13 week. Several weeks earlier, LargeCap snapped its 37-week streak of record-high forward earnings, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's fell 0.5% w/w, but is just 2.1% below its record high in early June 2022. SmallCap's rose 0.3% w/w to 10.9% below its mid-June 2022 record. Through the week ending October 4, LargeCap's forward earnings has soared 18.8% from its 54-week low

during the week of February 1, 2023; MidCap's is 6.6% above its 55-week low during the week of March 10, 2023; and SmallCap's is 3.2% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.0%, 14.6%), MidCap (-0.9, 16.3), and SmallCap (-9.1, 18.3).

S&P 500/400/600 Valuation (*link*): Valuations were mixed during the October 4 week for these three indexes, but all remain at or close to their recent multi-year highs. LargeCap's forward P/E was steady w/w at a 32-month high of 21.4 and is 1.3pts above its 14-week low of 20.1 during the August 9 week. It's also up 4.4pts from a seven-month low of 17.0 during the October 27 week and 6.3pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.1pt w/w to 15.9, and is now just 0.1pt below its 27-month high of 16.0 at the end of March and up 3.6pts from a 12-month low of 12.3 at the end of October. These compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E fell 0.2pt w/w to 15.4 from a 34-month high of 15.6. It's up 4.8 pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 26% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 29% discount is up from a 24-year-low 34% discount during the July 5 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales showed a modest recovery in August, on widespread strength. Headline retail sales edged up 0.2% in August, following flat sales in July and a 0.4% decline in June. The *components of retail sales* show spending on *food, drinks & tobacco* posted the third increase in four months, rising 0.2% in August and 0.6% over the period, as a 0.7% decline in June sales partially offset the 1.0% gain in May sales.

Non-food products ex fuel ticked up 0.3% in August, after a three-month decline of 0.4%--which followed a 0.7% jump in April. Meanwhile, sales of *automotive fuels* rebounded 1.1% in August after falling three of the prior four months, by 1.3% over the period. *Over the past year*, overall retail sales rose 0.8%, led by increases in automotive fuels (2.5% y/y) and non-food products ex fuel (1.4), which was partially offset by a small decline in foods, drinks & tobacco (-0.2). August data are available for *three of the Eurozone's four largest economies*, with Spain (+0.4% m/m & +2.4 y/y) showing the strongest performance of the three, while sales in France (+0.5 & +0.3) and Italy (0.0 & -0.1) showed little change versus a year ago.

Germany Factory Orders (*link*): Germany factory orders declined at a sharper-than-expected rate in August, posting its biggest decline since the start of the year, led by a large drop in transportation equipment orders following July's big gain. *Orders* contracted 5.8% (vs an expected 1.9% drop), following an upwardly revised 3.9% (from 2.9%) increase in July. Excluding large-scale orders, new orders dropped 3.4%. Domestic orders plunged 10.9% in August, while foreign orders showed a 2.2% shortfall, with billings from within the Eurozone tumbling 10.5% while orders from outside the Eurozone climbed 3.4%. *By sector*, there were widespread declines, capital (-8.6%) goods orders posting the largest decline in August, followed by intermediate (-2.2) and consumer (-0.9) goods orders. *Looking ahead*, Ifo's business expectations measure dropped to 86.3 in September, the lowest level since February, while Germany's M-PMI sank further into contractionary territory to 40.6 in September, the lowest in a year.

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