Yardeni Research

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Morning Briefing

Labor Market Remains In Good Shape

Check out the accompanying chart collection.

Executive Summary: Our conviction in the labor market's continued health wasn't shaken by the increase in unemployment that triggered the Sahm Rule a few months ago. Today, Eric explains why we dismissed this signal and why we expect revised BLS data next month to show payroll employment at another record high. A greater influx of immigrants than the Census Bureau initially realized has boosted labor market participation, which boosted unemployment. … High rates of immigration have supported GDP growth by increasing aggregate hours worked along with the productivity growth boom now underway. We expect the productivity boom to continue, playing a big role in our Roaring 2020s scenario, with its main driver being the widespread adoption of new technologies as immigration slows.

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

Economy I: Positive Labor Market Revisions Coming. We've remained positive on the labor market throughout last year and now into the new year, even as it has concerned many strategists and some participants on the Federal Open Market Committee (FOMC). There are, of course, the usual pessimists who continue to warn about a looming recession. But plenty of sober minded economists also feel that the labor market is skating on thin ice. These worries began in July when the so-called Sahm Rule recession indicator triggered. They were exacerbated in August when the Bureau of Labor Statistics (BLS) revised payroll growth down by 818,000 to 2.08 million net new jobs created for the 12 months ended March 2024. This was a result of the BLS's preliminary Quarterly Census of Employment and Wages (QCEW) revision. The final revision is due this February—more on what to expect below.

Since then, hiring has moderated, and it has taken a bit longer for unemployed workers to find a new job. To us, this has not signaled cracks in the labor market's foundation that presage a wave of layoffs. We believe it represents a healthy normalization of the labor market after having just experienced one of the tightest job markets on record. Recent data support our optimistic interpretation. Consider the latest from the Census Bureau, as well as the state of the labor force heading into 2025:

(1) *Quarterly Census of Employment and Wages*. In data released last month, the Census Bureau incorporated new techniques to count immigrants. It found that several million more immigrants came into the US than initially estimated over the past few years, in turn driving the fastest population growth in decades. The Census Bureau initially estimated that 2.14 million new migrants came into the US during the years ended June 2022 and June 2023. The latest data show 3.98 million over 2022 and 2023, representing 85% of total population growth (*Fig. 1*). And in the year ended June 2024, another 2.79 million international immigrants came into the US, or 84% of the year's total population growth.

These updated immigration estimates will affect certain metrics in the BLS's household survey of employment, including the labor force participation rate and unemployment rate. However, the BLS refrains from revising historical household data. Nonetheless, the large upward revision from the Census Bureau should ultimately filter into household employment and labor force growth this year. This could close the puzzling gap between household and payroll employment growth, as the former has plateaued while the latter has risen to new record highs (*Fig. 2*).

We suspect the updated data may feed into the final revision of the BLS's Quarterly Census of Employment and Wages (QCEW) next month, potentially reversing the bulk of the preliminary downward revision. The labor force may very well already constitute a record 170 million Americans, and payroll employment could be revised to a record 160 million.

On the heels of the first QCEW revision, we wrote in our August 22 *Morning Briefing*: "Many illegal immigrants aren't counted in the BLS's Quarterly Census of Employment and Wages (QCEW). That's because employers don't always pay state unemployment insurance (UI) taxes on those undocumented workers: Studies indicate that only about half (or optimistically up to 75%) of these workers are captured by UI. Using the Congressional Budget Office's (CBO) estimated net immigration of 3.3 million in fiscal 2023 (and its estimate that 65% of that figure represents illegal immigrants), we can assume that between 283,140 and 566,280 of workers weren't counted by the QCEW. That's based on 80% employment, two-thirds labor force participation, and between 50%-75% of workers captured by state UI. That takes monthly payroll growth to a range of 197,000 to 221,000. Not bad."

The Census Bureau's estimates of 2.29 million immigrants in 2023 and 2.79 million in 2024 still undershoot the Congressional Budget Office's estimate of 3.3 million for each year, so there's a chance that the updated QCEW and household data will still be on the soft side. Regardless, the story is that jobs growth continues to be strong despite higher interest rates.

(2) *Labor force.* The wave of early retirements by Baby Boomers during the pandemic left a gap in the US labor force. A falling birthrate and increasing death rate are also symptoms of an aging population. The native-born labor force shrank in November for the first time since 2021, which may be the start of a trend (*Fig. 3*). Foreign-born workers now account for 19.2% of the labor force, up from around 17.1% before the pandemic (*Fig. 4*). The actual figure likely already exceeds 20.0%.

(3) *Unemployment*. The unemployment rate has risen from 3.4% in April 2023 to 4.2% as of November (*Fig. 5*). We wouldn't be worried about a marginally higher rate, as the rapid growth of the labor force has been behind much of the increase. Increasing native-born labor force participation and new immigrants looking for work naturally cause higher unemployment. This was missed by many adherents to the Sahm Rule recession indicator.

We've referred to the Sahm Rule as "technical analysis of macroeconomic data" ("TAMED" for short) because it says little beyond the fact that unemployment tends to spike rather than gradually rise when the economy is hit by a credit crunch that causes a recession. In fact, that's partly why we dismissed the Sahm Rule's triggering back in July when the unemployment rate gradually rose from a historical low to 4.3%, which was 0.5% higher than the lowest three-month average over the previous 12 months (*Fig. 6*). It since has un-triggered, sending a false positive.

Workers reentering the labor force accounted for 30.7% of total unemployment in November, outpacing permanent job losers (26.5%), as it has since late 2021(*Fig. 7*). Not only are new immigrants looking for jobs, but more and more Americans are encouraged enough by their job prospects to look as well. These positive labor force contributions helped trigger the Sahm Rule rather than layoffs.

(4) *Payroll growth*. Another source of pessimists' angst is the Birth/Death adjustment. The BLS uses this model to account for payrolls added by new businesses that may not be captured in its survey. Some argue that these additional jobs have been overstated. In our opinion, the Birth/Death model accurately accounts for the surge in business innovation and entrepreneurship since the pandemic. Indeed, new business applications jumped from 425,000 in October to 449,000 (sa) in November, the most since December 2023 and well above pre-pandemic levels (*Fig. 8*). We expect applications to continue rising thanks to

optimism over a lower corporate tax rate and deregulation under Trump 2.0.

While some of these applications may be for single-person businesses, applications for businesses that the Census Bureau deems to have a high propensity to hire paid employees surged to a near-record high in November (*Fig. 9*). The Birth/Death adjustment could very well support our expectation for the three-month gain in payroll employment to increase to 200,000 by January's employment report.

Economy II: From Labor Force Boom to Productivity Boom? We are betting on a productivity boom. Not one in the future, but the current one. It started from the cyclical lows of just 0.5% productivity growth in 2015, per the 20-quarter moving average (*Fig. 10*). While productivity growth rose to around a 2.0% annualized rate as of last year, we believe the boom is in the early innings and could reach 3.5%- 4.0% by the end of the decade.

In light of the incoming deceleration in population and labor force growth, this is especially important for understanding the overall economic trajectory. Here’s what’s driving our expectations:

(1) *Productivity versus labor force.* Productivity increases when workers produce more output for every hour they work. That productivity rate times the number of hours worked equals real GDP growth. Increasing hours worked was a major contributor to strong real GDP growth over the past two years (*Fig. 11*).

However, average weekly hours have been relatively flat around 34.3, slightly below pre-pandemic levels (*Fig. 12*). So the increase in hours worked was due entirely to more people working. Therefore, immigration drove aggregate hours worked higher and accounted for a large chunk of economic growth in 2023 and 2024. Even higher-than-thought immigration suggests that hours worked was larger than believed, and therefore productivity may have been lower. We don't think this will affect productivity growth much, however. That's because even after the initial QCEW release depressed hours worked, productivity growth was revised a bit lower after GDP growth was also revised lower.

Data revisions tend to happen in the same direction, i.e., negative (positive) revisions in one area of the economy tend to presage negative (positive) revisions in another. We're expecting these upward population revisions to make a positive impact on the data.

(2) *Immigration cessation*. The record immigration across the southern border dramatically slowed last July as President Biden clamped down on the border during the election

campaign (*Fig. 13*). This likely will fall further with President Trump back in office beefing up border security and making deals with Latin American countries to prevent migration at its source.

Much lower immigration will lower payroll employment growth, though it will likely keep the unemployment rate subdued, as fewer workers will be looking for jobs.

(3) *Productivity doubling*. Widespread adoption of technologies like AI, automation, robotics, and perhaps quantum computing should continue to make workers more productive and offset the much slower labor force growth. Why do we expect companies to invest heavily in new tech? The shortage of skilled workers creates an investment imperative to augment current staff. It's one of the positive symptoms of a full-employment economy.

Improving the capital stock has been a primary driver of the productivity growth boom thus far. Now, labor composition will also help. Immigration has been a relative drag on productivity in recent years. As experienced Baby Boomers exited the labor force, new immigrants entered, many facing myriad barriers to job success (e.g., related to language, housing, work-status stability, and work experience). This improved GDP growth by growing the labor force but did not enhance productivity. Those workers will grow more experienced as they spend time in the US, therefore helping to support real wage growth rather than suppressing it (*Fig. 14*).

We also think total factor productivity, or how well workers use high-tech capital, will improve. Workers are becoming better at using AI and other automations each day. Moreover, hybrid work environments that enhance productivity are becoming the norm. Workers can collaborate and create new innovations in the office 2-3 times per week, while minimizing commute time and increasing remote capabilities. Skilled workers, such as parents with children, can also remain in the workforce for longer. The gig economy is another fallback for workers to stay employed even when personal issues prevent full-time employment.

(4) *The Roaring 2020s*. Our expectations for possibly 4.0% annual productivity growth this decade may seem extreme in the context of the post-Great Financial Crisis malaise. But historically and in context of the current tech boom, it’s reasonable to expect. Indeed, it is the basis of our Roaring 2020s base-case outlook.

Of course, we allow for the possibility that certain prospects could derail our Roaring 2020s scenario—such as stickier inflation, high stock-market valuations, trade wars, and a number of other bearish concerns. It's because we acknowledge these possibilities that we don't attribute higher than a 55% probability to the Roaring 2020s scenario.

However, rising productivity growth can drive corporate profit margins to new highs, support workers' real wages, and depress inflation. Productivity is the best formula for economic growth and can maximize per-capita prosperity. We're counting on it to drive the S&P 500 to 10,000 by 2029.

Calendars

US: Tues: JOLTS Job Openings 7.65m; ISM NM-PMI 53.5; Trade Balance -$77.5b; Weekly Crude Oil Inventories; Barkin. **Wed:** ADP Employment Change 143,000; Consumer Credit Change $12.5b; MBA Mortgage Applications; 30-Year Bond Auction; FOMC Minutes; Waller. (FXStreet estimates)

Global: Tues: Eurozone Headline & Core Flash CPI 2.4%/2.7%y/y; France CPI 0.3%m/m/1.5%y/y; Italy CPI 0.3%m/m/1.5%y/y; Italy Unemployment Rate 6.0%. **Wed:** Eurozone Economic Sentiment 95.8; Eurozone PPI 1.6%m/m/-1.2%y/y; Germany Factory Orders 0.4%; Germany Retail Sales 0.4%; France Consumer Confidence 89. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the January 3 week, forward earnings moved simultaneously higher for all three of these indexes for the sixth time in seven weeks after mostly stalling since late July for the SMidCaps. After doing so for nearly all of 2024, LargeCap's forward earnings started the year off at a record high. MidCap's improved to a 27-month high and is just 1.2% below its record high in early June 2022. SmallCap's rose to a 12-week high and is now 11.1% below its June 2022 record. LargeCap's forward earnings has soared 21.5% from its 54-week low during the week of February 1, 2023; MidCap's is 7.8% above its 55-week low during the week of March 10, 2023; and SmallCap's is just 2.8% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2025:

LargeCap (9.9%, 12.5%, 13.2%), MidCap (-0.7, 13.3, 15.8), and SmallCap (-12.3, 17.5, 18.2).

S&P 500/400/600 Valuation (*link*): Valuations were mostly a hair lower w/w for these three indexes during the January 3 week. LargeCap's forward P/E ticked down 0.1pt w/w to 21.7 and is now 0.6pt below its 43-month high of 22.3 during the December 6 week. It's up 4.7pts from a seven-month low of 17.0 during the October 27, 2023 week and 6.6pts 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 was steady w/w at 15.9 and is now 1.2pts below its 40-month high of 17.1 during the November 29 week. It's up 3.6pts from a 12-month low of 12.3 at the end of October last year and compares 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 0.1pt w/w to 15.6 and is 1.5pts below its 41-month high of 17.1, also during the November 29 week. It's up 5.0pts 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 compares to 22% during the November 29 week, which was the lowest since the March 9, 2023 week and up from a 25-year-high 29% discount during the July 5, 2024 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 28% discount compares to 23% during the November 29 week, which was the lowest since the March 9, 2023 week and up from a 24-year-low 34% discount during the July 5, 2024 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. SmallCap's 2% discount to MidCap's is among the smallest since July 2021. Prior to that from 2003 to 2018, SmallCap's P/E had been mostly above MidCap's, and both were above LargeCap's.

Global Economic Indicators

Global Composite PMIs (*link*): Global economic growth in December accelerated to a four-month high, led by the service sector. The Global *C-PMI* Output Index rose from 51.9 in September to 52.6 in December, remaining in expansionary territory for the 14th straight month, with the *Services Business Activity* index rising from 52.9 to 53.8 over the comparable period. Meanwhile, the *Manufacturing Output Index*, remained lackluster, falling back into contractionary territory to 49.6 after rising to 50.0 in November following four months below. *By industry*, production fell in the intermediate and capital goods sectors, though rose in consumer goods industries. *Geographically*, growth in economic activity was recorded in ten of the 14 countries for which December data were available. Growth was driven by India, Spain, and the US, with China and Japan also contributing. The three largest Eurozone countries—Germany, France, and Italy—were major drags on growth, with Canada the only country to record a weaker performance. *Business optimism* slipped to a three-month low, as an improvement in the service sector helped to offset weaker confidence among manufacturers. According to the report, *average input costs* rose for the fifty-fifth straight month in December, explaining a further increase in output charges, with both accelerating December.

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