February 10, 2025

Morning Briefing

Anatomy Of Full Employment

Check out the accompanying chart collection.

Executive Summary: When others saw labor market weakening last summer, we saw normalization from the settling down of pandemic-period churn. Our labor market outlook remains constructive. The growth of the labor force should continue to slow, but demand for workers will remain strong, keeping the labor market needle at full employment. Strong productivity gains from widespread AI adoption and a full-employment labor market should spur robust real wage growth. Strong wage growth should keep consumer spending growth and GDP growth strong. All this should keep our Roaring 2020s economic scenario on track. Indeed, January's labor market data confirm every aspect of our outlook. ... Also: Dr Ed reviews "Mothers' Instinct" (++).

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Labor Market I: Finding Full Employment. Friday's January employment report confirms every part of our optimistic outlook on the labor market. The unemployment rate fell to 4.0%, its lowest since last May, even though more Americans decided to participate in the labor force (*Fig. 1*). Before we discuss the January data, let's review our labor market outlook.

As we've argued since last summer, the post-pandemic period was historically anomalous and led many to misread an apparent slowdown in the jobs market as harbingering a looming recession. In fact, the largest wave of immigration on record helped raise the unemployment rate without any material layoffs. Also, labor market indicators such as hiring and quits fell. Such cooling has preceded recessions in the past, but this time it was simply the natural result of the pandemic's massive labor market churn settling down. Normalization was to be expected, but it was widely misinterpreted as a sign that the "long and variable lags" of a Federal Reserve tightening cycle finally had clamped down on the economy.

The labor market is likely to chart a slightly different path going forward than it did over 2023 and 2024. Greatly reduced immigration and mostly topped-out labor force participation and employment metrics from native-born workers mean that the labor force will grow at a slower pace. However, we believe demand for workers is stronger than most do. Thus, we think it is likely that the unemployment rate will remain at full employment around 3.7% to 4.3%.

Barring unexpected events, we're expecting monthly payroll growth to average around 150,000-175,000 workers over the coming quarters and years, below the roughly 175,000-180,000 average pace just before the pandemic. Despite the slowdown of employment growth, strong productivity gains and a full-employment labor market should spur robust real wage growth.

This should maintain the solid pace of consumer spending growth and real GDP growth. Furthermore, consumer spending should continue to get a boost from rising nonlabor income, including interest and dividends. In addition, retiring Baby Boomers will continue to spend their retirement funds, which may very well cause the personal saving rate to turn negative.

Now let's assess the implications of the January data for the remainder of this year—and consider the outlook for the rest of President Trump's second term:

(1) *Payroll growth*. Despite January's lower-than-expected payroll gain of 143,000, the three-month average monthly increase in payrolls reached 237,000, as November's and December's initial figures were revised up by a collective 100,000 (*Fig. 2*). At the end of last year, we had an above-consensus forecast that the three-month average would be at least 200,000 after the January report. In fact, were it not for the Los Angeles fires, it might even have topped 250,000.

Roughly 591,000 workers weren't at work in January due to bad weather, the highest monthly total since February 2021 (when winter storms blanketed the country and led to the Texas freeze and power crisis) (*Fig. 3*). Based on the increase in California's jobless claims over the past few weeks, this was likely due to the multiple weeks of LA fires—despite the Bureau of Labor Statistics' (BLS) specious declaration that the fires had no impact on employment. That seems to be the BLS' go-to response to seemingly all extreme weather events whether it's the case or not. But we suspect the fires had at least some impact on payroll growth because of the significant drop in average weekly hours worked to the lowest since the pandemic (*Fig. 4*). This series should rebound sharply in February.

(2) *Labor market reacceleration*. The labor market may be picking up, as it has been doing since last November's Election Day. Exhibit A is that the birth/death adjustment provided a boost to January's payrolls gains, and we expect it will continue to so, as business applications are rising due to Trump 2.0 business optimism, a.k.a. Animal Spirits (*Fig. 5*). Exhibit B is that the percentage of private industries reporting high payrolls over the past three months (a.k.a. the payroll diffusion index) surged to 64.8%, the highest since January 2023 (*Fig. 6*).

(3) *Goods gaining ground*? Dragging on payroll employment have been the goods-producing sectors, i.e., mining, lodging, construction, and manufacturing. Even as construction employment has climbed to new highs, overall goods employment has stagnated and even fallen over the past few years (*Fig. 7*). However, we're expecting a turnaround as manufacturing enters a rolling recovery.

The ISM M-PMI rose above 50.0 in January after 26 months in contraction, propelled by strong new orders, expanding employment, and higher production (*Fig. 8*). The payroll diffusion index for manufacturing industries also surged to a multiyear high, of 57.6% (*Fig. 9*).

Demand for labor in goods industries ostensibly is increasing. But the growth in labor supply is undoubtedly starting to wane. New unskilled immigrants find much of their work in goods-producing sectors. Southern border crossings have plummeted since last summer and are very likely to remain low under the current administration (*Fig. 10*). So over-the-table hiring (that is recorded by government statistics) is likely to accelerate. Over a longer-term horizon, if Trump 2.0 succeeds in its goals of rebalancing global trade, domestic manufacturing employment should increase as well. A lower US corporate tax rate plus tariffed foreign goods should make producing in the US more cost-competitive despite the higher cost of employing American workers.

(4) *Leaving, not losing*. The number of workers who were unemployed due to layoffs fell in January, while the number of job leavers rose (*Fig. 11*). Workers reentering the labor market, currently the largest source of unemployment, also increased. On balance, these conditions helped to boost the employment-population ratio for prime-age (25-54 years) workers to a historically high 80.7% (*Fig. 12*).

If you want a job, you can find one: While it started taking longer for unemployed workers to find jobs, January's duration of unemployment fell for those seeking jobs for the longest time periods (*Fig. 13*).

And if you have a job, you're in good shape: The number of employed workers losing their job remained at one of the lowest rates on record in January (*Fig. 14*).

(5) *Not so bad for natives.* The fact that foreign-born workers have made up most of the employment gains since the pandemic has roused some concerns about the state of the labor market (*Fig. 15*). We believe that to be misleading without proper context. While native-born employment has remained relatively steady post-pandemic, plenty of native-born workers have entered the labor market and/or found news jobs. However, these additions have largely been offset on a net basis by the wave of retirements, masking the actual increase, which is evident from the boom in payroll growth. Moreover, foreign-born workers account for only about a fifth of US employment, so a small absolute increase in their ranks (from around 27,000 to 31,000) represents a large percentage change, which can sound alarming.

(6) *Revisions are a non-event.* The final revision of the BLS's *Quarterly Census of Employment and Wages* (QQCEW) reduced the initial downward revision for the period from April 2023 to March 2024 from -818,000 payrolls to -598,000. Also included in the January data were the Census Bureau's update, which found that several million more immigrants came into the US over the past two years than initially estimated. Even after the big update to the size of the labor force, demand for labor continues to outstrip supply (*Fig. 16*).

The large upward revision in the labor force and household employment, to 170.7 million and 163.9 million Americans respectively, will likely correlate with upward revisions to real GDP growth, business output, and therefore productivity growth.

(7) *Average hourly earnings*. Wage growth beat expectations in January. Average hourly earnings increased 0.5% m/m and 4.1% y/y, and it increased 4.2% y/y for production and nonsupervisory workers. While we believe nominal wages growth will continue to outpace inflation, we think annual raises boosted the data. We're expecting a gradual slowing in the y/y figure as it converges toward the Employment Cost Index, which is currently up 3.6% y/y (*Fig. 17*).

The jump in wage growth was offset by the drop in the average workweek in our Earned Income Proxy (EIP). Combined with the added 143,000 payrolls, our EIP rose 0.27% m/m in January. Typically, this would lead to an increase in retail sales by around the same amount, or less than 0.1% m/m in real terms. However, we wouldn't be surprised if consumer spending was a bit higher than that last month, as the fires in California may have

boosted demand for services in the short run. In any case, we expect a rebound in consumer spending this month.

Labor Market II: Counting on Productivity. We believe productivity growth is on its way up from the cyclical lows of just 0.5% in 2015 to 3.5%-4.0% annually by the end of the decade. And that's on an annualized 20-quarter moving average basis, meaning that productivity growth is accelerating now since this figure rose to 1.8% during Q4-2024 (*Fig. 18*).

As population and labor force growth wanes, productivity will be the source of real economic growth. Indeed, productivity is highly correlated with real wage growth because in a competitive labor market, workers are paid their fair wage in real terms. So with the economy potentially settling in at full employment, more productive and better paid workers will drive rising consumer spending going forward. Here's more:

(1) *Not more labor, but more productive labor*. Productivity increases when workers produce more output for every hour they work. That productivity rate times the total number of hours worked equals real GDP growth. However, the rate of growth for aggregate weekly hours has slowed, and we wouldn't be surprised if it slows even further through the end of the decade (*Fig. 19*). Fewer new employees and shorter workweeks will become the norm.

(2) *Productivity and labor costs*. Productivity growth declined from 2.1% to 1.6% y/y in Q4, while unit labor costs (ULC) increased from 2.2% to 2.7% y/y. Both represent changes in direction due to a big decline in durable manufacturing output amid higher hourly compensation.

We expect the trends in both (i.e., higher productivity growth, lower ULC inflation) to resume this quarter. Falling auto inventories and stalled auto production dragged down real GDP growth last quarter. As the latest labor force revisions are factored into growth data, we expect an upward revision to output to raise productivity growth and lower ULC inflation. Nonetheless, manufacturing productivity appears to be growing for the first time since the Great Financial Crisis (*Fig. 20*).

(3) *Investing in capital*. An economy at full employment means it is difficult and costly to hire new workers, so businesses are encouraged to invest in technologies to augment their workforce. Entrepreneurship also encourages productivity, and we've seen a boon in new business creation since the pandemic (*Fig. 21*). In our opinion, the normalized-interest-rate environment makes it difficult for so-called zombie companies to stick around and artificially

boost capacity, instead inspiring actual innovation. Federal Reserve Governor Adriana Kugler highlighted both of these as factors driving the productivity boom in a *speech* on Friday.

The latest technological innovation is artificial intelligence. AI is much more likely to creatively disrupt services-providing and white-collar employment than production and supervisory workers, in our opinion. But because there is a shortage of highly skilled labor, this innovation will do more to alleviate labor cost pressures for employers and to benefit employees by making them more productive than it will to eliminate jobs and create an oversupply of workers. Indeed, we're optimistic that AI will create more jobs than it displaces, or at least not raise the unemployment rate. In our base-case productivity-led Roaring 2020s scenario, American workers and consumers will prosper to a degree they haven't in decades.

Movie. "Mothers' Instinct" (2024, ++) stars Anne Hathaway and Jessica Chastain as neighborly mothers with sons who are the same age and best friends. When one of the boys dies in a terrible accident, the friendship of the two mothers is strained. More deaths are ahead as the plot thickens and suspicions mount. One of the mothers is a psycho, but which one? The film (and its musical score) is an homage to the directing style of Alfred Hitchcock. The two leading ladies deliver superlative performances. (See our movie reviews *archive*.)

Calendars

US: Mon: Consumer Inflation Expectations. **Tues:** NFIB Business Optimism Index 104.6; WASDE Report; Powell Testimony; Williams; Bowman; Hammack. (FXStreet estimates)

Global: Mon: UK BRC Retail Sales Monitor 0.2%; China M2 7.2%y/y; Lagarde; Australia Westpac Consumer Confidence. **Tues:** France Unemployment Rate 7.5%; Schnabel; Bailey; Mann. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): Last week saw the US MSCI index fall 0.2% w/w and underperform the 0.6% gain of the AC World ex-US index. The US MSCI

closed on Friday 1.4% below its January 23 record high (its first record high since December 6). The AC World ex-US improved to 5.3% below its June 15, 2021 record high, but it had been just 0.7% below at the end of September. EM Latin America was the best performing region last week, with a gain of 1.5%, followed by EM Asia (1.4%), EM (1.4), EMEA (1.2), and the AC World ex-US. EMU (0.0) was the worst regional performer, followed by Europe (0.2) and EAFE (0.2). The China MSCI index performed the best among country indexes last week, with a gain of 4.8%, followed by South Africa (3.7), Mexico (3.3), Spain (2.6), and Sweden (2.2). Taiwan was the week's worst country performer, falling 0.6%, followed by India (-0.5), Switzerland (-0.4), and Hong Kong (-0.3). On a ytd basis, the US MSCI index is up 2.7%, but lost more ground last week against the AC World ex-US (4.6). Among regional indexes, EM Latin America is ahead of the pack ytd, leading with a gain of 11.0%, followed by EMU (7.6), Europe (7.0), EMEA (5.8), EAFE (5.5), and the AC World ex-US. The worst performing regions so far in 2025: EM Asia (2.0) and EM (3.1). Looking at the major selected country markets that we follow, Brazil is the best ytd performer with a gain of 12.7%, followed by Sweden (12.2), Spain (10.5), Germany (9.2), and South Africa (9.1). The worst performing countries ytd: India (-4.2), Hong Kong (-2.6), Japan (1.9), Taiwan (2.0), and the US (2.7).

US Stock Indexes (*link*): Just six of the 48 major US stock indexes that we follow rose for the week. That's up from four rising a week earlier, but down from all 48 rising in the two weeks before that. The Russell MidCap Growth index was the best performer, with a gain of 2.1%, ahead of S&P 500 LargeCap Pure Growth (1.8%), S&P 500 Transportation (1.5), S&P 500 LargeCap Growth (0.5), and S&P 400 MidCap Pure Growth (0.2). The S&P 600 SmallCap Pure Value index, with a decline of 3.1%, was the worst performer, followed by S&P 400 MidCap Pure Value (-2.9), S&P 500 LargeCap Pure Value (-2.3), Nasdaq Industrials (-2.1), and S&P 600 SmallCap Value (-1.9). All but one of the 48 indexes are still positive so far in 2025, down from all 48 rising a week earlier and 46 rising in 2024. The Russell MidCap Growth index is now in the top spot as the best performer so far in 2025, with a gain of 7.9%, ahead of S&P 500 LargeCap Pure Growth (7.7), S&P 500 Transportation (5.3), Russell 1000 Value (4.5), Russell 3000 Value (4.3), and S&P 600 SmallCap Pure Growth (4.3). The worst performing major US stock indexes ytd: S&P 600 SmallCap Pure Value (-2.1), S&P 600 SmallCap Value (0.2), S&P 600 SmallCap Equal Weighted (0.7), Russell 1000 Growth (0.7), and S&P 500 LargeCap Pure Value (0.7).

S&P 500 Sectors Performance (*link*): Six of the 11 S&P 500 sectors rose last week, and the same six beat the S&P 500's 0.2% decline. That compares to six S&P 500 sectors rising a week earlier, when seven were ahead of the S&P 500's 1.0% decline. The outperformers last week: Consumer Staples (1.6%), Real Estate (1.3), Energy (1.0), Information

Technology (0.8), Financials (0.6), and Utilities (0.2). The underperformers last week: Consumer Discretionary (-3.6), Communication Services (-2.1), Industrials (-0.8), Materials (-0.6), and Health Care (-0.3). The S&P 500 is up 2.5% ytd, with 10 sectors in positive territory and nine sectors ahead of the index. Financials now wears the crown as the best ytd performer, with a gain of 7.0%, ahead of Communication Services (6.7), Health Care (6.3), Materials (4.9), Industrials (4.2), Consumer Staples (3.5), Utilities (3.1), Real Estate (3.0), and Energy (3.0). These two sectors are lagging the S&P 500 so far in 2025: Information Technology (-2.1) and Consumer Discretionary (0.7).

US Economic Indicators

Employment (*link*): Employment was below expectations in January, likely restrained by wildfires in California and wintery weather in other parts of the country. *Payroll employment* advanced 143,000 in January (vs 170,000 expected), while both December (to 307,000 from 256,000) and November (261,000 from 212,000) payrolls were revised higher for a net gain of 100,000. *Private payroll* employment climbed 111,000 in January, with *service providing* accounting for the gain; *goods-producing* jobs were flat, as a decline in *mining & logging* payrolls (-7,000) during the month offset the small gains in *construction* (4,000) and *manufacturing* (3,000). *Within service-providing* industries, *health care* added 44,000 jobs, slightly below the average 57,000 per month during 2024. Within healthcare, there were widespread gains in January, with hospitals (14,000), nursing & residential facilities (11,000), and home health care services (11,000) all contributing to the gain. *Retail trade* employment climbed 34,000 in January, led by general merchandise (31,000) retailers. Retail trade employment showed little change during calendar year 2024. *Social assistance* jobs added 22,000—primarily for individual and family services (20,000)—virtually matching its average monthly increase of 20,000 last year. *Government employment* remained on an uptrend, adding 32,000 to payrolls in January—close to last year's 38,000 average monthly gain.

Wages (*link*): Average hourly earnings (AHE) for *all workers on private payrolls* increased 0.5% in January, while the three-month rate increased 4.4% (saar), exceeding the yearly rate of 4.1%. The yearly rate is up from 3.6% in July, which was the lowest since May 2021; the yearly rate peaked at 5.9% in March 2022. *Service-providing industries showing three-month rates above their yearly rates*: financial services (6.2% & 4.5% y/y), professional & business services (5.7 & 5.1), other services (5.0 & 4.6), education & health services (4.7 & 4.4), retail trade (4.0 & 3.1), transportation & warehousing (3.0 & 2.5), and wholesale trade (2.5 & 2.1). *Service-providing industries showing three-month rates below their yearly rates*:

information services (1.8 & 5.2) and utilities (1.7 & 3.3). *Service-providing industries with three-month and yearly rates nearly identical:* leisure & hospitality (3.8 & 3.7). Within *goods-producing* industries, the annualized three-month rates were below the yearly rates for both *durable goods* manufacturing (3.6% & 4.4% y/y) and *nondurable goods* manufacturing (2.6 & 3.0) industries.

Earned Income Proxy (*link*): Our Earned Income Proxy (EIP), which tracks consumer incomes and spending closely, climbed to yet another a new record high in January, increasing 0.3%. *Average hourly earnings* in January advanced 0.5%, while *aggregate weekly hours* fell 0.2%—with private payroll employment ticking up 0.1% and the average workweek falling 0.3%. Over the past 12 months, our EIP advanced 5.0%—with aggregate weekly hours up 0.9% and average hourly earnings up 4.1%.

Unemployment (*link*): The *number of unemployed* fell 37,000 in January to 6.8 million, down from a recent peak of 7.2 million in July. The unemployment rate fell for the second month, from 4.2% in November to 4.0% in January—the lowest level since last May. The rate was below 4.0% from February 2022 through April 2024 before reaching 4.0% last May. The *participation rate* ticked up to 62.6% last month from 62.5% the prior three months, remaining in a volatile flat trend over the past year. *By race:* The unemployment rates in January ticked up for African Americans (to 6.2% from 6.1%) and Asians (3.7 from 3.5) but fell for Hispanics (4.8 from 5.1) and Whites (3.5 from 3.6). *By education:* Unemployment rates fell in January for those with less than a high school diploma (to 5.2 from 5.6) and those with a bachelor's degree or higher (2.3 from 2.4), while rates for those with a high school degree (4.5 from 4.3) moved higher and the rate for those with some college or an associate's degree was unchanged at 3.5%.

Consumer Sentiment Index (*link*): Consumer sentiment dropped in February to its lowest reading since last July, according to preliminary estimates, on concerns that the threat of tariffs will cause a spike in inflation. The *consumer sentiment index* dropped for the second month, from an eight-month high of 74.0 in December to 67.8 in February, with all five components of the index deteriorating this month. The report notes that the decrease was widespread over all political parties and all age and wealth groups. *Looking at the components*, the *current conditions* gauge declined from 75.1 in December to 68.7 this month, while the *expectations* component to sank from 76.9 in November to 67.3 this month. *Turning to inflation*, *year-ahead* inflation expectations jumped from 3.3% in January to 4.3% this month—the highest rate since November 2023—and this is only the fifth time in 14 years that there has been such a large one-month rise (one percentage point or more). February's reading is well above the 2.3%-3.0% range seen in the two years prior to the

pandemic. Long-run inflation expectations also remained elevated relative to the 2.2%-2.6% range seen in the two years pre-pandemic, ticking up from 3.2% to 3.3% this month.

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales weakened during the final quarter of 2024. *Headline retail sales* fell 0.2% in December (vs -0.1% expected) after remaining unchanged in November and falling 0.3% in October. The *components of retail sales* show spending on *food, drinks, and tobacco* fell for the third time in four months, slumping 0.7% in December and 1.2% over the period. Meanwhile, *non-food products ex auto fuels* rose 0.3% in December after falling 1.0% over the two months through November, while sales of *automotive fuels* rose 0.9% over the two months through December after falling 0.9% over the two months ending October. December data are available for the *Eurozone's four largest economies*, with Spain (1.4% m/m & 4.3% y/y) posting the strongest growth on both a monthly and yearly basis, while Italy (0.3 & 1.4) also posted gains over both periods. Meanwhile, sales in Germany (-1.6 & 1.9) and France (-0.2% & 1.8) fell in December but were above year-ago levels.

Germany Factory Orders (*link*): Germany *factory orders* soared in December, beating expectations. *Manufacturing orders* jumped 6.9%, bouncing back from November's 5.2% drop and more than double the consensus estimate of 2.0%. It was the first gain in three months and the best pace since September. December's gain was boosted by a 55.5% surge in orders for aircraft, ships, and trains. *Excluding large orders*, the gain was still a solid 2.2%. *Domestic orders* jumped 14.6%, while foreign orders advanced 1.4% during the month—led by a 6.2% jump in billings from *within the Eurozone*; billings from *outside the Eurozone* contracted 1.5%. *By sector*, capital (10.9%) and consumer (7.7) goods orders posted strong gains, while intermediate (0.2) goods orders barely budged.

Germany Industrial Production (*link*): German industrial production in December was a surprise on the downside, posting its steepest decline since July. Germany's *industrial production*, which includes construction, sank 2.4% (vs -0.6% consensus forecast), more than reversing November's 1.3% gain. Production was down 3.1% versus a year ago, accelerating from November's 2.8% decline. December output was dragged down by double-digit declines in both autos (-10.0%) and machine maintenance & assembly (-10.5), while pharmaceuticals (11.6) posted a double-digit gain. *By sector*, both capital (-4.7%) and intermediate (-3.3) goods production contracted, while consumer (0.9) goods production posted a modest gain.

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