Economic commentary from the Investment Advisory Group

Job growth surprised to the upside in June, validating the Fed's rate hikes to battle inflation

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Executive summary: U.S. payrolls in June increased by 372,000, handily beating the consensus of 265,000. Meanwhile, the unemployment rate held steady at 3.6% for a fourth straight month. We reiterate that these are not the hallmarks of a weak economy.

The June job gains were widespread. Yet, some of the internal components are signaling that the overheating conditions within the labor market continue to cool from the hard boil during 2021. For instance, average hourly earnings haven't increased year-over-year in four months, and hours worked have steadily fallen since peaking in the spring of 2021. But these point to a gradual cooling rather than a dramatic slowdown.

The overall labor market strength validates the Federal Reserve's (Fed) laser focus on inflation in the near term and front-end loading rate hikes. Accordingly, we expect the Fed to follow through with another three-quarter point (0.75%) rate hike when it meets late this month. Looking ahead, while that's good news for inflation, maintaining that gradual cooling pace in the broader economy will be tougher to achieve in our view.

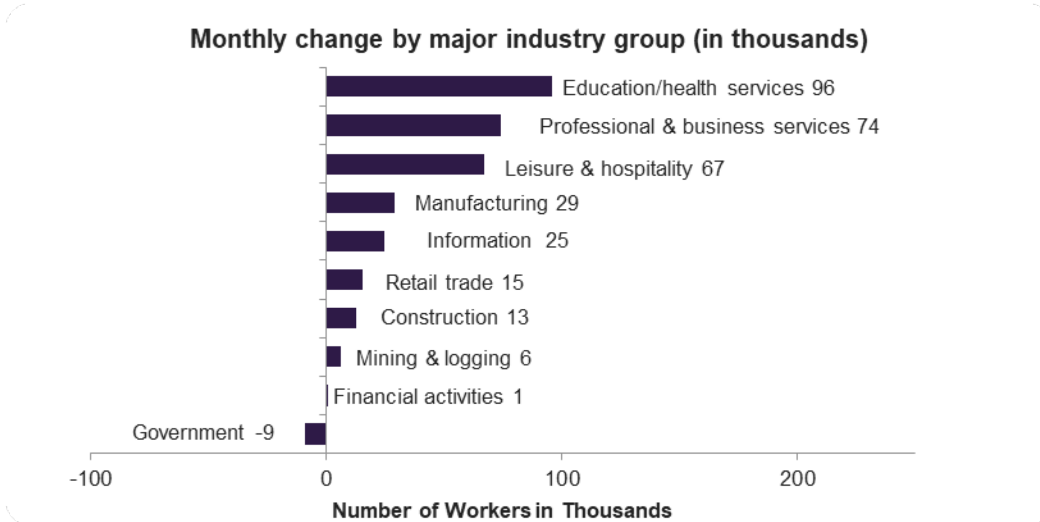
Component	May	Prior month	Six-month average	Comment
Change in payrolls	372,000	384,000	486,000	Downward revisions of 74K for April and May, though still strong job growth. Pre-pandemic 3-year average was 181K/mo.
Unemployment rate (U-3)	3.6%	3.6%	3.8%	The labor force shrank by 353K, the second drop in three months. The leisure & hospitality industry still needs 1.3 million workers to get back to its pre-pandemic level.
Labor force participation rate	62.2%	62.3%	62.3%	Older workers remain the biggest drag on the labor force participation rate due to retirements and COVID-19 concerns.
Average hourly earnings (YoY)	5.1%	5.2%	5.4%	Non-supervisory slipped to 6.4% YoY from 6.7% in March. Still, it remains well above the average of 3.3% during 2019.
Average weekly hours worked	34.5	34.6	34.6	Manufacturing hours ticked down to 40.3. This is likely due to the Russia-Ukraine conflict, which is pinching some global supply chains, especially for autos.

Sources: Truist IAG, Bloomberg, Bureau of Labor Statistics

A review of the major industry trends

Private payrolls increased by 381,000 workers, which is a three-month high. However, government payrolls shrank by 9,000. Service-providing industries added 333,000 positions, while goods producers hired 48,000 workers.

Government payrolls shrank for the first time in eight months.



Sources: Truist IAG, Bloomberg, Bureau of Labor Statistics

Hiring within retail trade rebounded in June after shedding 43,700 jobs in May. Still, general merchandise stores, which accounted for more than three-quarters of the May job losses and includes the likes of Walmart and Target, clipped another 7,200 workers in June.

Payrolls in the leisure & hospitality industry remained steady, hiring 67,000 in June compared to 68,000 in May. Still, the leisure & hospitality industry remains 580,000 workers below pre-pandemic levels and the pace of hiring has slowed from this spring and winter.

Otherwise, employment showed little change over the month in other major industries, including education/health services and professional & business services. We're keeping a close eye on construction to watch for signs of further weakness, particularly after roughly four months of declining residential housing activity.

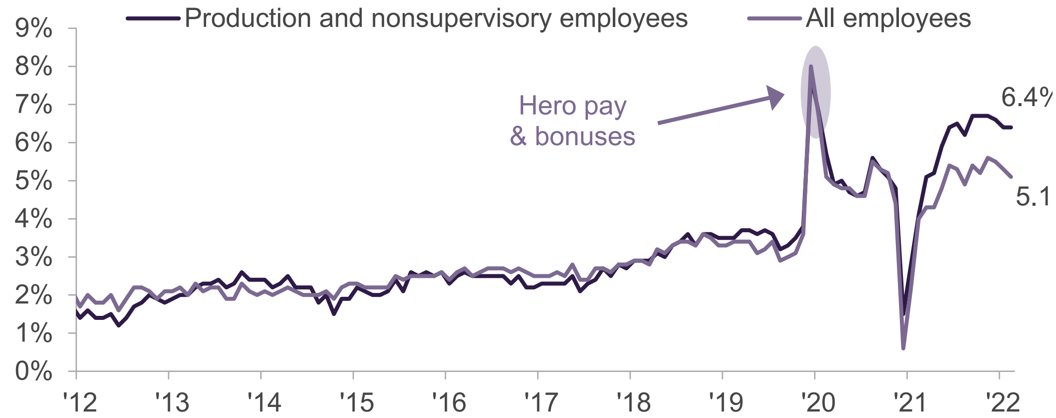
Wage growth and hours worked gradually slipping from very high levels in 2021

Wage growth increased as average hourly earnings rose 5.1% from a year ago, more than double the 2.4% average for the decade before the pandemic (2009 through 2019). But it hasn't increased in four months, down from 5.6% in March.

Similarly, average hourly earnings for rank & file workers (officially known as production & nonsupervisory employees) haven't increased in six months. It, too, remains significantly above its pre-pandemic 10-year average of 2.4%. This is important since production & nonsupervisory employees are the bulk of all employees and where most of the dramatic recent wage gains have been concentrated.

Average hourly earnings haven't increased in 6 months for production & nonsupervisory employees.

Average hourly earnings (change year-over-year)

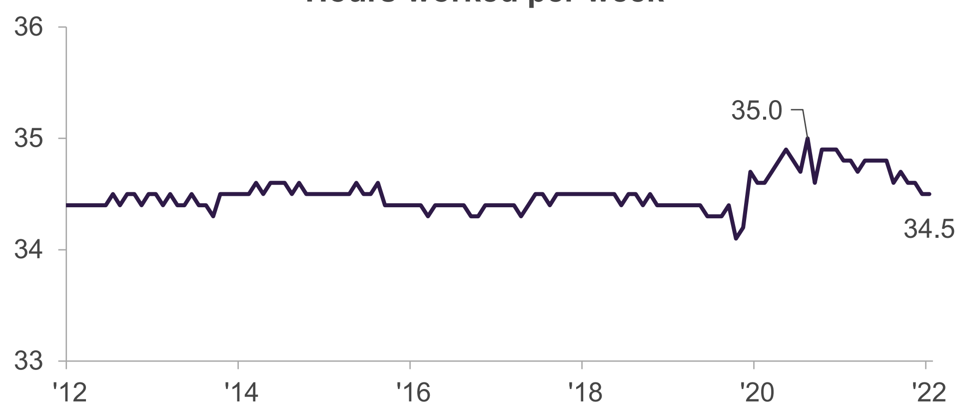


Sources: Truist IAG, Bloomberg, Bureau of Labor Statistics

Hours worked—officially known as average weekly hours worked for all employees—have also gradually declined since 2021. It peaked at 35.0 hours in January 2021 and appears to be heading back towards the pre-pandemic 10-year average of 34.4. Within manufacturing, hours worked and overtime hours have already returned to their respective long-term averages.

Hours worked have gradually declined since peaking in 2021.

Hours worked per week



Sources: Truist IAG, Bloomberg, Bureau of Labor Statistics

Our take

The labor market remains firmly in the "strong" camp, underscored by another strong jobs report in June. It is corroborated by a nearly 50-year low in initial jobless claims, and job openings and quit rates hovering near record levels. It is also confirmed by wage growth running well above the long-term averages.

There have been 2.74 million jobs created in 2022 alone, or an average of 457,000 per month. That's more than 3.5 times the long-term monthly average of 125,000. These are not the hallmarks of a weak economy and has the U.S. has never had a recession while maintaining such strong job growth.

That said, most of the labor market data are lagging or coincident indicators, except for initial jobless claims, which are considered a leading indicator. In other words, the strong labor market dynamics today don't tell us much about the future.

Furthermore, there are plenty of cross currents within the rest of the economic data, whereby some data are soft, such as nearly everything associated with housing. Additionally, several manufacturing gauges, including the ISM Manufacturing survey, are flickering. Meanwhile, other data are strong, such as travel and service-related metrics.

Alas, inflationary pressures persist, not just within the labor market but elsewhere. The Russian invasion has aggravated inflationary pressures, forcing global energy prices higher and seeping into food prices. We don't expect higher food and energy prices to correct anytime soon. Case in point, U.S. crude oil prices have pushed above $100 per barrel as we write this piece.

This presents the Fed with a very challenging task – cool inflation but don't interrupt the strong recovery. We think that the current labor market strength validates the Federal Reserve's (Fed) laser focus on inflation in the near term and front-end loading rate hikes. We expect the Fed to follow through with another three-quarter point (0.75%) rate hike when it meets late this month.

But there is a difficult macro backdrop globally as uncertainty abounds. For example, disrupted supply chains are much improved today compared to 2021 but are still not fully recovered. Autos are the poster child for this, and production is still well-below pre-pandemic levels. There is also abnormal spending, marked by the outsized spending on goods and continued pent-up demand for services, the aforementioned stretched labor market, tightening financial conditions, and higher inflation. Meanwhile, global central banks, especially the Fed, have dramatically hiked artificially low interest rates and governments have reduced fiscal stimulus. The latter two are appropriate and couldn't/shouldn't continue. Still, on net, these are less supportive for economic growth.

The twenty-billion dollar question is: can the U.S. economy withstand all of these crosscurrents? Indeed, it will be a slower growth path forward. Yet, there are positive offsets. For example, the majority of U.S. consumers and small businesses have ample cash buffers, which was bolstered by stimulus initially but is supported by higher wages going forward. Accordingly, debt ratios are low and credit quality remains solid. These factors have sustained strong balance sheets.

Looking ahead, the Fed is addressing inflation, which is important for the long term. However, maintaining that gradual cooling pace in the broader economy will be tougher to achieve in our view. On balance, we think it's possible that the U.S. can power through much of the crosscurrents, but not all of them. That points toward a slowing U.S. economy or prolonged sluggishness until these crosscurrents abate. Whether that's officially labeled a recession remains to be seen.

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