NFP Preview – A shrinking labor market

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CITI'S TAKE

We expect another overall soft jobs report in August, with a modest 20k increase in nonfarm payrolls and the unemployment rate rising to 4.2%. Wage growth should continue to slow, evidence that recent declines in the unemployment rate do not reflect a retightening labor market. Indeed, slowing job growth, falling labor force participation, and a lower unemployment rate have been partly a result of demographic changes, which all else equal could imply lower NAIRU, lower potential growth and lower neutral rates. While inflation data will be most important this month, another soft jobs report could be especially important in the decision making for Fed officials who are less concerned than others that the economy is reheating and leading to sticky inflation.

Inflation data for August will be the most important factor determining the outcome (hike or hold) of the September FOMC meeting in a few weeks. But August jobs data will likely still be an important input for some Fed officials' decision making, especially those who are not as convinced as others that a reheating economy is creating sticky inflation.

We expect an overall soft jobs report again in August, with a modest 20k increase in nonfarm payrolls, the unemployment rate rising to 4.2%, and more slowing in wage growth. Unlike Chair Warsh in his Jackson Hole speech, we do think the softening in wage growth is a positive sign for slowing inflation. Slowing wage growth means both slowing input costs, especially in various services sectors, and less ability for consumers to pay higher prices.

Still, the unemployment rate will be the most important part of monthly jobs data, and we would not be surprised to see the unemployment rate remain unchanged or even fall again alongside labor force participation, as has been the case for most of this year. But as demographic changes have led participation to fall 0.6pp since the start of the year, the unemployment rate falling by only 0.2pp does suggest that demand has weakened alongside (but not quite as much as) supply. And importantly, a lower unemployment rate has not been putting upward pressure on wages. An overall smaller labor force due to demographic changes, all else equal, would be associated with lower NAIRU, lower potential growth (GDP has averaged below 2% for three quarters), and lower neutral rates.

Nonfarm Payrolls – More seasonal weakness to come

We expect a modest 20k increase in nonfarm payrolls in August, implying job growth flat on average over the last two months following a 23k decline in employment in July. This would largely reflect usual seasonal summer weakness, which could continue for a few months. Hiring plans, such as in the NFIB survey data, seem to exhibit the same pattern as payrolls, but a few months earlier (plans to hire will be made before someone actually starts working). Previously very weak hiring plans suggest a period where payroll job growth could average a bit below zero, before employment rises again in the usually seasonally strong winter months.

We think this volatility in monthly jobs data throughout the year reflects a combination of usual seasonality due to the low-hiring environment (weak data in months where hiring should be strong) coupled with large changes in the immigrant work force which can skew annual employment patterns in abnormal ways. Throughout this year and into next, we still expect job growth to average around a low ~30k breakeven rate or possibly a bit softer.

Still, some recent weakness in employment in certain sectors may not repeat in August. There was a large decline in local education employment in July which may reflect some issues with seasonal adjustment around the end of the school year. We expect a modest bounce-back in government employment in August. But given consistent declines in local education employment since April, we do not think all of the recent weakness reflects seasonal adjustment issues. Leisure/hospitality employment may rebound after two softer months, but we would not be surprised by some further slowing in sectors like health care.

Lastly, there is some chance of a mechanical drag on August payrolls from the late-July expiration of temporary protected status work permits for some immigrant workers. It is not clear if these workers may have found other means of maintaining jobs, and we do not incorporate a large effect from this issue in our forecasts. If payroll employment in August is a bit weaker than we expect, we would not necessarily dismiss weakness as only a result of the TPS expiration, as other data like hiring plans have been soft. A surprisingly large decline in payrolls (more than -50k) could suggest a TPS issue.

Average Hourly Earnings – Soft wage growth

We expect a 0.3%MoM increase in average hourly earnings in August and for the year-on-year rate to remain modest at 3.1%. Given very soft wage growth in July, there could be a larger mechanical rebound in earnings in August. But given substantial slowing already, average hourly earnings are likely to remain in line with, and even a bit softer than, a typical pre-pandemic pace.

However, we would not be surprised to see wage growth even softer in August. While factors like the ratio of job openings to unemployed workers have ticked up slightly and could signal some future modest pick-up in wage growth, mechanical factors suggest downside risks to August. We have been surprised the last two months to see large declines in production and non-supervisory employment, which represent over 80% of total private employment. These workers have lower average wages, implying recent weakness in average hourly earnings occurred despite job gains being led by higher-paid managerial workers. Some normalization towards stronger production employment and softer managerial employment could suggest further slowing in average earnings.

Unemployment Rate – Still all about participation

After two months of declines, we expect the unemployment rate to rise again in August to 4.2% but with substantial uncertainty and two-sided risks.

The key downside risk to the unemployment rate remains the labor force participation rate, which has declined 0.6pp since January while the unemployment rate has declined 0.2pp over the same period. Much of this decline in participation is structural, reflecting factors like an aging population and slowing immigration that have implied an overall smaller labor force. We think an overall lower level of initial jobless this year is also a consequence of a smaller labor force, and we will be watching claims for possible signs of when downward pressure from demographics may stabilize. But as labor supply has fallen substantially, the unemployment rate falling by less suggests that demand has also continued to weaken.

We also see some familiar patterns in recent declines in the labor force participation rate in June and July. One is that participation of young workers tends to fall early in the summer. This year, the unemployment rate among this cohort has been following a very similar trend to last year, when unemployment jumped in August. There has also been some pattern of falling participation among prime age women through mid-summer, which may reflect dynamics unique to the summer months. For example, if child-care issues during summer break create difficulties for people searching for work, some workers may be temporarily considered out of the labor force rather than unemployed. We think some of these seasonal dynamics will reverse in the next few months, sending the unemployment rate closer to 4.5% again.