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Strong demand or the calm before the storm?

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Employment growth was strong in January as the labor market continues to defy expectations. Jobs were added across the board, even in interest rate sensitive industries. So far, Fed policy has been successful at slowing inflation and wage growth, and even economic output is showing signs of a future contraction. But the labor market has not responded. This suggests that the economy still has excess demand and waves of inflation may present themselves soon or there is a looming crash in the US economy.

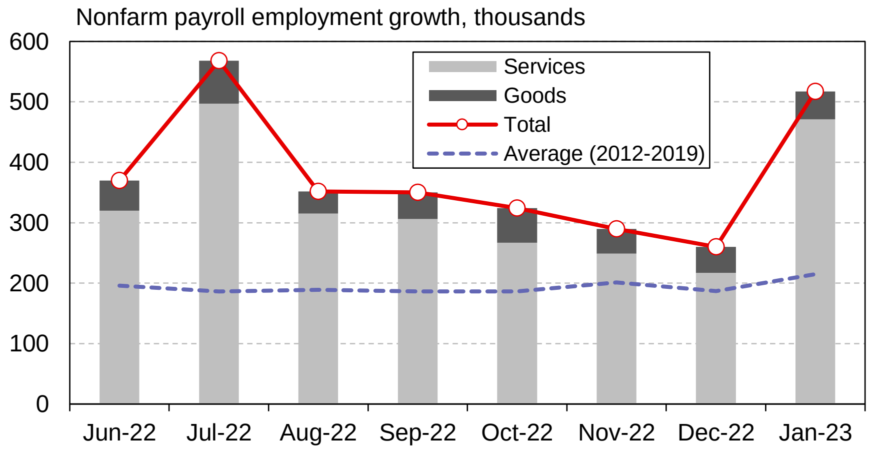
Shortages are driving some industries

In January 2023, the US labor market added 517,000 jobs, beating most forecasts by at least 100 percent. The labor market expanded by much more than the average for January in the years before the pandemic (+215,000). Growth occurred across several industries including leisure and hospitality, professional and business services, health care, retail trade, construction, and manufacturing.

Perhaps not surprisingly, leisure and hospitality experienced the largest growth as the industry has yet to fully recover jobs lost since the pandemic. Food services and drinking places added 99,000 jobs in January and will likely continue to "normalize." It's likely that only a recession would be able to stop the leisure and hospitality industry from eventually reaching pre-pandemic levels of employment.

The picture becomes less clear when looking at growth in other industries. For construction, market optimism and shortages are potential drivers. The 10-year treasury yield and 30-year fixed rate mortgage average have been falling since they peaked in late October 2022, helping keep housing demand and construction high. Shortages for both single- and multi-family homes continue to plague the industry and they will keep prices elevated despite the high-cost environment. Another round of accelerating prices may not occur, but don't expect housing prices to fall like used cars.

MONTHLY JOBS GROWTH CONTINUES TO BE HISTORICALLY STRONG



Source: BLS, MUFG Bank Economic Research

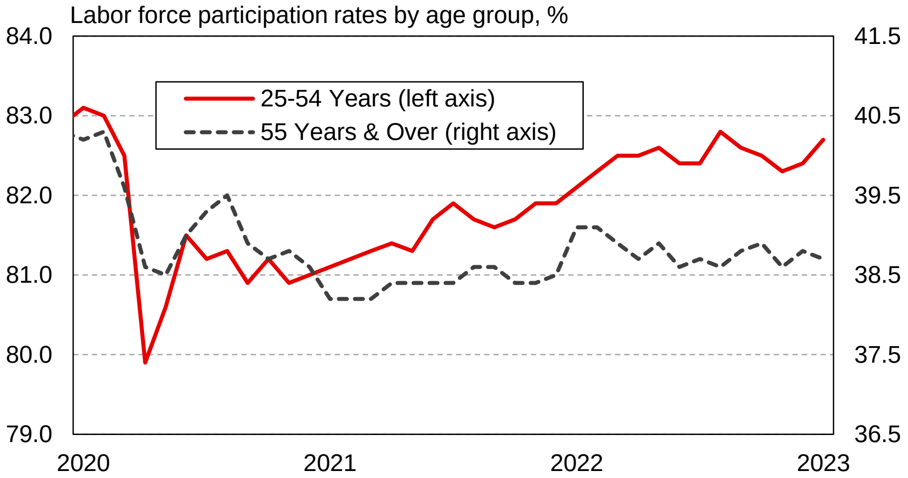
Manufacturing employment has been steadily slowing but is still expanding, adding 19,000 jobs in January compared to a monthly average of 33,000 in 2022. Continued jobs growth with slower demand can mean the industry is not expecting profit margins to fall markedly. New orders for durable goods, excluding transportation, has entered negative territory in December 2022, a strong signal of anticipated weak growth. The inventory to sales ratio for autos (a major industry within durable goods) remains near historic lows (0.56), significantly below the pre-pandemic level (around 2.0). Shrinking, or not improving, inventories can keep prices elevated and help manufacturers maintain markups despite expected reductions in sales. In the case of autos, rebounding inflation is possible.

The case for inflation waves can be made for several industries, but a looming crash may be more likely. Much of 2023 will come down to corporate profit margins. Labor costs comprise the largest share of company expenses and a continued expansion of the labor market can mean that profits have not been hit, yet. Employment is a lagging indicator and reductions in the workforce at a company level are often not gradual. Expected reductions in profits don't necessarily lead to layoffs, as is the case now with most companies, but realized losses often do. Corporate profits have been strong so far, but most signs point to weak demand in 2023. And once profits take a hit, there could be a sudden crash in the labor market.

Labor market remains tight

The labor force participation rate has increased slightly for prime-age workers (25-54 years old) in January, slowly approaching the rate seen pre-pandemic. Older workers (55 and older) are still not re-joining the labor force and as of now, there is no indication that will change. Labor supply issues are not disappearing, and it's likely that only a recession will bring about a large number of re-entrants to the labor force. As of now, the labor market remains tight with the unemployment rate falling slightly to 3.4 percent, reflecting an increase in the civilian labor force and a decrease in the number of unemployed persons.

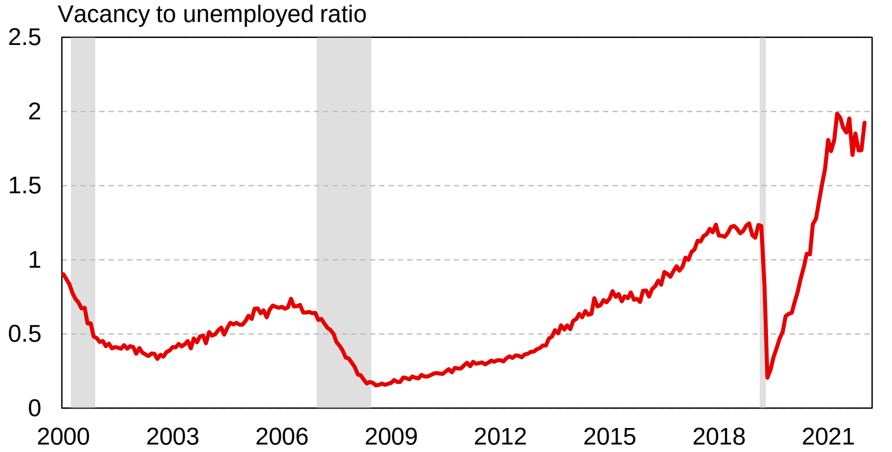
OLDER WORKERS CONTINUE TO STAY OUT OF THE LABOR FORCE



Source: BLS, MUFG Bank Economic Research

Demand for workers remains high as company finances stayed strong in 2022. The vacancy to unemployed ratio jumped in December to 1.9, with most of the increase being driven by the leisure and hospitality industry. As noted earlier, that industry is poised for continued growth. But even excluding leisure and hospitality, the number of job openings remained high, ensuring the ongoing imbalance between labor demand and supply.

JOB OPENINGS GROW AS UNEMPLOYMENT LEVEL FALLS



Source: BLS, MUFG Bank Economic Research

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