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The Quarterly Perspective

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ABOUT

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At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to insightful, objective solutions, and always working solely for the best interest of our clients.

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Cooling Labor Markets Are Welcome News to the Fed, But More is Needed

Recent metrics reveal last year's "way-too-hot" labor market finally returning to balance.

While markets are busy hand-wringing over the Fed's willingness to increase rates one more time, positive developments in the labor markets are deserving attention. Recent trends have shifted in the right direction and are addressing one of the Fed's biggest fears regarding the inflation fight.

In its efforts to rein in decades-high inflation, the Fed was confident it could slow demand for goods and services by raising interest rates. By late 2022, evidence materialized that rate hikes were working. The labor markets, however, were a bit more confounding.

As things slowed in housing and consumer goods, the aggregate metrics on jobs were still astoundingly hot. For all of 2022, new jobs grew at double the rate compared to the average year pre-pandemic.[1] Noting his concern, Federal Reserve Chair Jerome Powell repeatedly cited the imbalance in labor markets as a chief obstacle to bringing down inflation.[2] Even if suppliers catch up enough to stabilize prices on goods and services, the Fed still risks having a major problem on its hands if wage inflation proves hard to break.

Slowing = Normalizing

After pandemic policies, rapid retirements, and a shutdown in legal immigration devastated workforce dynamics in 2020 and 2021, a gaping hole was left in the labor force. Initially, the rapid rate of returning employment was welcome as the unemployment rate dropped in 2021 from 6.9% to a pre-pandemic "full employment" level of 3.9%.[3] But, inexplicably, job growth just kept coming. In the face of rate hikes and high inflation, employers kept wanting more employees. By the end of 2022, the number of job openings exceeded the number of people who were unemployed by 5.5 million openings.[4]

So, what's the good news now? Over the last six months, progress, defined by slower job growth and less demand for workers, has seen notable improvement. Three key areas tell the story:

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- Job openings are clearly declining. Total openings have fallen by 37% since March of 2022.[5]
- Quit rates, a sign of how competitive labor conditions are, have come down 21% from 2022 highs.[6]
- Monthly job growth looks closer to normal. Over the last six months, the monthly average for new jobs has dropped to 233,000 per month, -40% less of where it stood a year ago.[7]

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Bad News = Good News and Vice Versa?

Ordinarily, a slowdown in labor trends would be disheartening news, but in the context of an inflation fight, the downshift is being well received. Even more surprising, with labor loosening a bit, there has been no damaging spillover effect on the unemployment rate. As highlighted by Powell in May, interest rates have increased 5.25% over 18 months, yet the unemployment rate is still fractionally off of where it started.[8]

Clearly, encouraging trends show progress is happening, but the Fed still acknowledges the goal hasn’t been reached yet. Last week's September employment report showed 336,000 new jobs created, a number uncomfortably high for the Fed’s satisfaction.

What Does it Mean for Investors?

“In sum, it’s hard to fathom that the Fed’s official policy is to slow the pace of job demand; but in reality, it is necessary for bringing inflation down to a sustainable 2%.”

In sum, it’s hard to fathom that the Fed’s official policy is to slow the pace of job demand; but in perspective, it is necessary for bringing inflation down to a sustainable 2%. As with all good things in life, what is perceived as a social “good” can also be overdone with unwelcome consequences.

Investors looking for an end to the Fed’s tight monetary policy stance should hope for a full and complete fight to bring inflation down. At this point, a modest level of labor slack is needed. If unattained, the Fed risks arriving at only a partial resolution in the inflation fight, while still stuck in a prolonged battle with wage inflation.

Sources:
1 Bureau of Labor Statistics (BLS)
Institute for Supply Management
2 federalreserve.gov FOMC Meeting Press Conference Transcripts
3 BLS
4 Ibid
5 Ibid
6 Ibid
7 Ibid
8 Ibid

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Past Performance is No Guarantee of Future Results

Keeping Up with Interest Rates and Why the Fed is Still Wrestling with One More Rate Hike

Inflation numbers have improved substantially, but still have further to go.

"But the recent bump up to 3.7% after the August CPI report may have shaken the confidence of some members at the Federal Reserve."

After reaching 9.0% in June of 2022, headline inflation made notable progress over the course of a year, falling to 3.0% by mid-summer. But the recent bump up to 3.7% after the August CPI report may have shaken the confidence of some members at the Federal Reserve.[1]

In their latest FOMC meeting, reports showed 12 of the 19 members still holding on to the notion of raising rates one more time in 2023, while the remaining seven members believe the current level of rates is sufficient.[2]

In the follow-up press conference, Fed Chairman Jerome Powell reassured listeners the hike was not already pre-decided, but that the committee still needs time to assess its position.[3] As with many complex matters, the Fed is wrestling over several aspects of current inflation metrics.

"Fed Chairman Jerome Powell reassured listeners the hike was not already pre-decided, but that the committee still needs time to assess its position."

Here are a few of the issues:

The latest move in headline CPI was driven by rising energy prices. After June, oil prices increased from $68 per barrel to $92. That increase affected both gasoline and utility costs. At this point, the direction of oil prices could end up being the key factor in whether the Fed hikes one more time in December.[4]

The Fed's preferred measure of inflation, the PCE index excluding Food and Energy, actually fell over the last two months.[5] This is an example of where excluding fuel prices makes sense. The Fed seemingly can modify demand on the whole, but they can't always control when power players in the oil markets (i.e. Saudi Arabia) decide to change production levels.

Ultimately, when it comes to interest rate policy, it is more than just the landing spot for the Federal Reserve that is important. Also critical is the planned duration for how long the Fed will keep interest rates elevated. While markets would love to see the Fed go into interest rate-cutting mode, the Fed is projecting only modest cuts in 2024.[6]

Fast Facts On Rates

Current Fed Funds Rate

5.3%

Highest Since 2007.[7]

The Fed's Preferred Inflation Metric

PCE Index minus Food and Energy fell from 4.3% to 3.9% in August.[8]

Rate Cuts

Markets expect the first interest rate cut in July of 2024.[9]

The FOMC projects two rate cuts next year.[10]

Sources:
1 Bureau of Labor Statistics (BLS)
2 Federal Reserve.gov, Summary of Economic Projections, Sept. 20, 2023
3 Federal Reserve.gov, Press Conference Transcript, Sept 20, 2023
4 BLS
5 Bureau of Economic Analysis (BEA)
6 Federal Reserve.gov, Summary of Economic Projections, Sept. 20, 2023
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8 BEA
9 CME FedWatch Tool, CME Group
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“Real GDP for the 2nd quarter reported at +2.1%. Expectations from the Federal Reserve of Atlanta are suggesting 3rd quarter GDP reports above 4.0%.”

Business Cycle Risk Profile

- The latest index value reflects the pre-existing recession risk that has been acknowledged since the spring of 2022.
- Five of the nine underlying inputs are flagging.
- Assuming the economy has experienced a rolling recession, it looks like the worst of the economic slowdown has already been seen in housing, technology, transportation, and manufacturing.
- A rebound in housing appears ready as homebuilders increase permits, but rising mortgage rates are still a problem.
- The Fed is haggling over one more rate hike, potentially before the end of 2023. Already, the Fed is expected to decrease rates modestly in 2024.
- Real GDP for the 2nd quarter reported at +2.1%. Expectations from the Federal Reserve of Atlanta are suggesting 3rd quarter GDP reports above 4.0%.

Alphalytics Research Economic Systemic Risk Index
Three Month Average, Weighted Diffusion Index

Recession Threat Level

Elevated

Several factors are scoring consistent with past recessions.

45 Present Score

Shaded areas represent U.S. recessions.
Signal line represents historical mark where economic factors signaled imminent risk of recession.
Source: NBER, Federal Reserve Bank of St. Louis.

Interpreting the Index Score:

- The index score measures nine economic factors that have demonstrated co-movement with the deteriorating conditions of the past seven recessions dating back to 1970.
- When the index score is at 100, it means all nine of the factors are measuring at levels consistent with past economic expansion.
- When the index score is below 100, it means that one or more of the weighted factors has moved to a level consistent with past economic contractions.
- In aggregate a score of 70 or higher is interpreted as a composite profile consistent with past economic expansion. A score lower than 70 is interpreted as a composite profile consistent with past economic contraction.
- Markets can, and sometimes do, demonstrate volatility even though the economic factors are measuring consistent with expansion.

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Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

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That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing we invest consistent with business cycle forces, aligning investments with the conditions driving returns in the present, rather than chasing what worked in the past.

About Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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