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The labor market for goods industries is starting to cool

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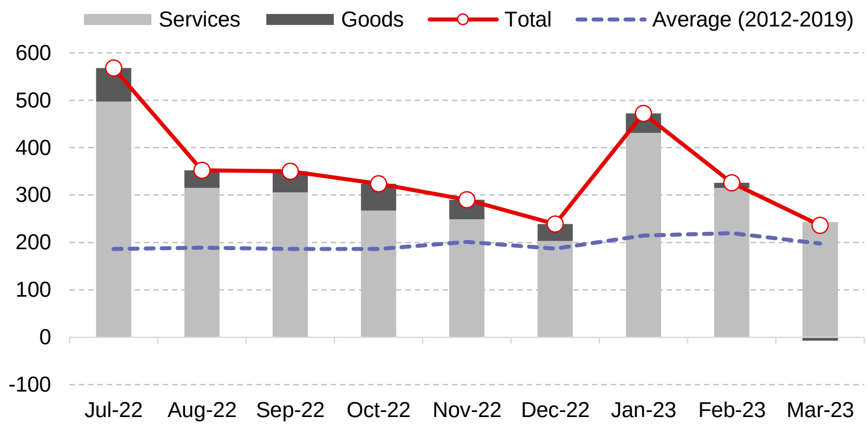
- Several indicators from production to consumption have signalled a slowdown in goods industries for months, and the labor market is finally beginning to reflect that. Employment in goods industries did not grow in March for the first time since April 2021, and we may begin to see job losses in the coming months.
- Overall, the labor market is still tight and the unemployment rate remains historically low. The strongest signs of cooling are present in job openings, where the vacancy to unemployed ratio fell to 1.67. Though trending in the right direction, labor demand is still well above the pre-pandemic level.
- Based purely on the labor market, the Fed will certainly consider another 25 bps hike in May. However, the fallout from the banking situation has yet to fully materialize. Banks are likely to tighten credit conditions in the coming weeks and months and the Fed may view this as a replacement for more interest rate increases. Right now, the odds of no change vs another hike in May are 50/50.

The beginning of the slowdown in goods industries

Overall employment expanded by 236,000 in March, closely in line with most expectations. Leisure and hospitality again led the expansion, adding 72,000 jobs in March. Employment in the industry is still 2.2% below its pre-pandemic level, and growth is likely to continue as long as consumption in food services and accommodation remains elevated. Employment growth in government was second in March, adding 47,000 jobs. There are still 314,000 fewer jobs in the industry compared to February 2020.

Health care also continued to expand, adding 34,000 jobs in March. Even though employment has exceeded its pre-pandemic level, the industry is still by many measures understaffed. Consumption in health care is less dependent on economic conditions, compared to leisure and hospitality. Demographic forces have a big impact, and the aging population will ensure demand stays relatively high even in the event of a recession.

Employment growth in goods has finally stopped
Nonfarm payroll employment change, thousands



Source: BLS, MUFG Bank Economic Research

The story is different for goods employment. In March, good producing industries lost 7,000 jobs in total, virtually equivalent to no change. This is the first month where these industries have collectively not expanded since April 2021. Employment change in manufacturing, construction, and mining have all been essentially flat in March.

While one month of no growth isn't indicative of a trend on its own, other economic indicators have pointed to slowdown in goods for a few months. Real personal consumption has been flat since the start of 2022 for both durable goods and non-durable goods excluding gasoline. Additionally, the ISM Manufacturing index has been pointing to a slowdown for months, and construction of single-family residential properties has dropped drastically since the Fed started raising interest rates.

This broad slowdown in goods industries is just now beginning to be reflected in the labor market. We are likely to experience job losses in industries such as manufacturing and construction sometime in Q3, and perhaps even in the later months of Q2.

The labor market is beginning to loosen

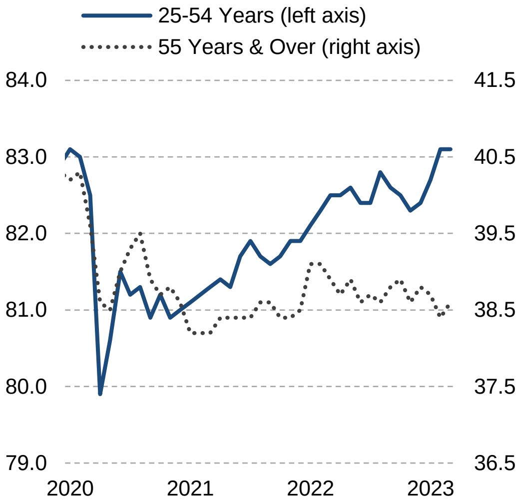
The labor force participation rate stayed at 83.1% in March for prime-age workers (25-54 years old). Further acceleration is unlikely for this age group since it has already reached the pre-pandemic rate from January 2020. There continues to be no progress in the participation rate of older workers (55 and older). Early retirements since the pandemic appear to have permanently shifted participation rates down. At this point, only a recession is likely to bring older workers back to the labor force. But even then, we may not see them return the rate seen immediately before the pandemic.

The good news is, while the labor supply isn't substantially growing, labor demand is finally showing signs of cooling. Job openings fell in February by 632,000, bringing the vacancy to unemployed ratio down to 1.67. These figures still indicate a historically tight labor market, but the trend is finally beginning to move in the right direction.

Hiring fell in February from 5.92 million to 5.77 million. This, along with the drop in vacancies and flat employment growth in goods industries, are the strongest signals of a cooling labor market. However, quits and layoff have not changed by much and the unemployment rate still stands near historic lows at 3.5% as of March. Demand still exceeds supply in the US labor market.

Participation rates have recovered for prime-age workers

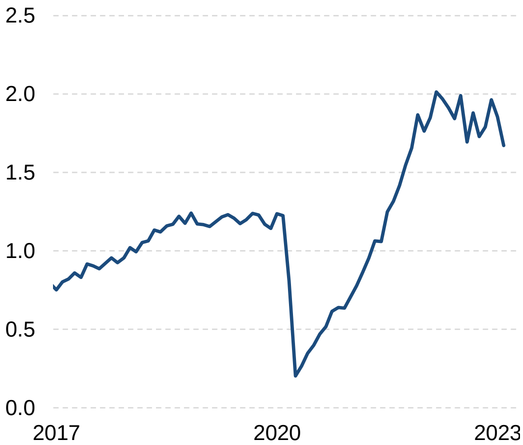
Labor force participation rates, %



Source: BLS, MUFG Bank Economic Research

The labor market is beginning to loosen a bit

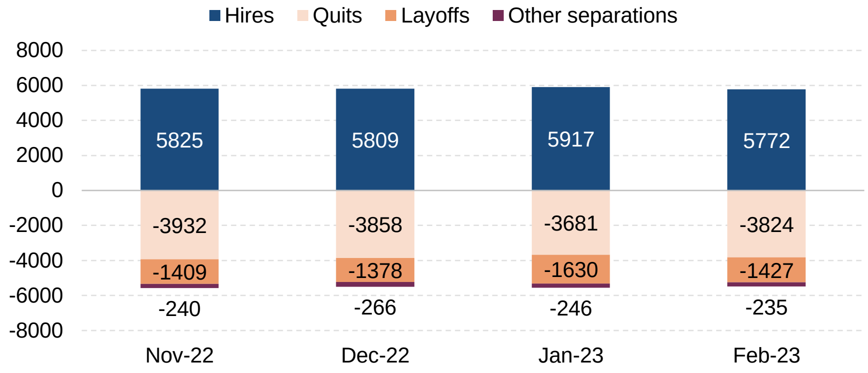
Vacancy to unemployed ratio, %



Source: BLS, MUFG Bank Economic Research

Hiring has decreased while layoffs and quits remain steady

Hires and separations, private industries, thousands



Source: BLS, MUFG Bank Economic Research

The Fed is in a difficult position

From the Fed's perspective, March's labor market data may not be enough to warrant a pause on interest rate hikes. While yes, demand is finally showing signs of trending downward, the level is still far too high to be consistent with a 2% inflation target. On this labor market data alone, the Fed would likely be leaning toward more hikes.

However, the latest banking situation is sure to further tighten credit conditions in the US. The full effect likely won't materialize for another few weeks or months, so balancing the impact of raising the Federal Funds Rate with additional credit restrictions from the banking sector is going to be the Fed's biggest challenge. Given this reality, the odds of another hike are 50/50.

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