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# Easing labor market and slow burning inflation

**September 1, 2023**


- The August jobs report showed another solid month of job gains and core PCE inflation was mostly flat in July. Despite this, the Fed will likely pause interest rate hikes at the next FOMC meeting. Employment growth was mostly in the health care industry, a segment of the economy least affected by monetary policy, and inflation still looks to be trending downward. An easing labor market and slow burning inflation may be just what the Fed wants.
- The unemployment rate jumped to 3.8%, but that may reflect less dynamism in the labor market as opposed to a sign of upcoming job losses. Monthly growth in those that were previously unemployed and remained unemployed reached its highest level in August since May 2020. And while labor market flows from employed to unemployed also increased, the impact was much smaller.

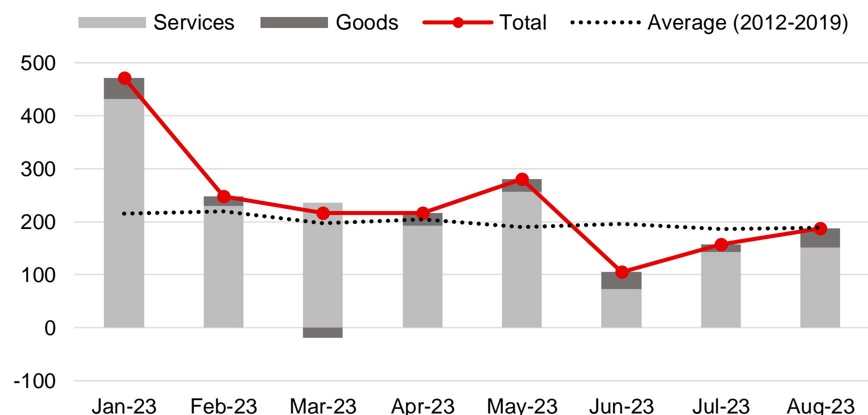

## Revisions adds to uncertainty

August was another solid month for jobs gains, but there are some signs that the labor market may be responding to the Fed. The largest job gains occurred in health care industries, which added 71,000 jobs and in leisure and hospitality, which added 40,000 jobs. Both industries exhibited historically strong growth, but from the Fed's perspective, it is largely inconsequential.

The health care industry has more inelastic demand, where consumption responds less to prices. Demand is largely driven by demographic forces, making the health care industry a poor gauge of aggregate demand, the means through which monetary policy works to slow inflation. What happens in the health care industry will have little impact on the Fed's interest rate policy, at least in this tightening cycle.

As for the leisure and hospitality industry, employment is still 290,000 jobs below its pre-pandemic level. Given how tight the labor market is in this segment of the economy, a significant slowdown in hiring would likely be a recession signal, something the Fed is actively trying to avoid. We can expect more jobs to be added in this industry in 2023.

**June's large revision overshadows August's strength**
*Nonfarm payroll employment growth, thousands*




Source: BLS, MUFG Bank Economic Research



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The rest of the labor market is showing much more easing, especially in services industries. Employment in professional and business services has been virtually flat since May, information services continues to tick down, and financial services was little changed in August. The biggest drop in employment was in transportation and warehousing services (-34,200), but that largely reflects the bankruptcy of Yellow, the freight-trucking company.

There is, however, some indication of growing demand in goods industries. Manufacturing employment added 16,000 jobs in August, small growth in comparison to the size of the industry but also the largest monthly job gain since October of last year. The construction industry also added 22,000 jobs, but fiscal policy aimed at reshoring semiconductor chips manufacturing is likely supporting this jobs growth.

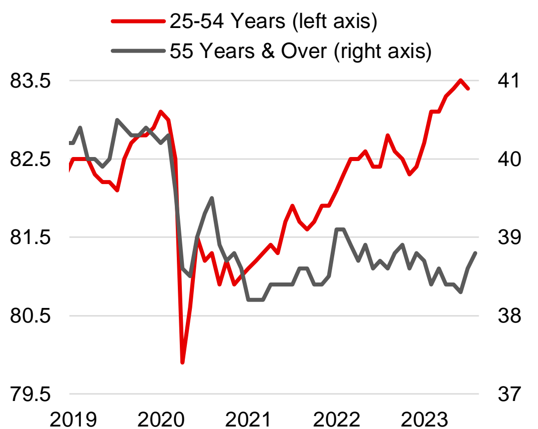
At this point, it is difficult to distinguish between jobs growth "normalizing" to pre-pandemic levels and "easing" in response to contractionary monetary policy. The downward revision in June's employment growth (in part from retail services) was surprisingly large and more in support of an "easing" labor market. At the very least, this increases scepticism as to the strength of the labor market, especially if historically large revisions become the norm. But even with this uncertainty (or perhaps because of it), there is little justification for a more aggressive Fed.

**Some easing in tightness**

The labor force participation rate increased by 0.2 percentage points to 62.8%, mostly from an increase in the size of the labor force for those aged 16-24 years and from older workers (55 & over). Prime-age workers (25-54) comprise the largest portion of the labor market and have led most of the increases in labor supply since the pandemic began. However, it's not clear how long this can continue for. There are already 2.3 million more prime-age workers in the labor force today than there were in February 2020, and this rate of increase may not be sustainable for much longer.

**Uptick in older worker participation**

*Labor force participation rates, %*




Source: BLS, MUFG Bank Economic Research

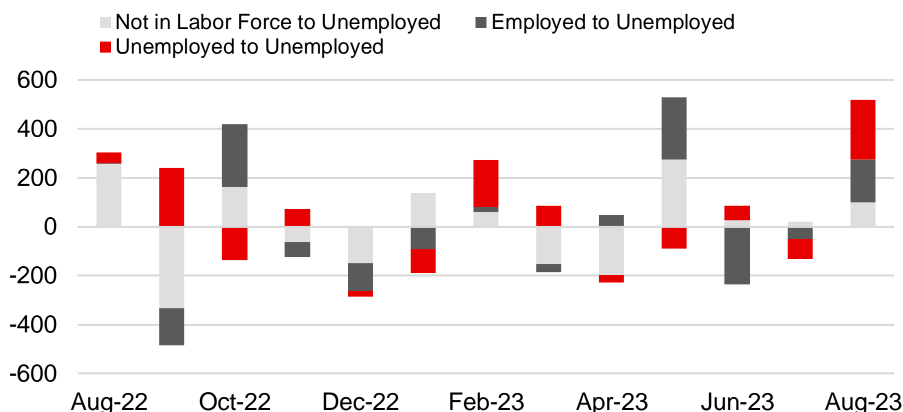
Given this constraint on labor supply in the short-run, labor demand will need to slow for the tight labor market to loosen in any considerable way. There are some signs that this is underway with job openings gradually falling but the evidence is stronger with the drop in hires. Total private hires fell to 5.4 million in July, the lowest level since June 2019.

In addition to fewer hires from the JOLTS survey, the CPS survey from the BLS is also showing evidence of a less dynamic labor market. Calculated from the CPS, the unemployment rate jumped to 3.8% in August from 3.5% in July. This increase is more substantial than in previous months, but it was largely driven by those that remain unemployed as opposed to those that lost their job.

The unemployment level increased by 8.8% in August, and 47% of that increase was from persons that were previously unemployed and remained unemployed. This is the largest increase in labor market flow from unemployed to unemployed since May 2020. The flow from employed to unemployed (i.e., lost job) comprised nearly 34% of the increase in the unemployment level and the flow from not in the labor force to unemployed comprised around 19% of the increase. If this trend continues, it will likely be a strong signal that the labor market is indeed coming down from historical tightness.

**More people remained unemployed than lost their job**

*Labor market flows, unemployment level, thousands*



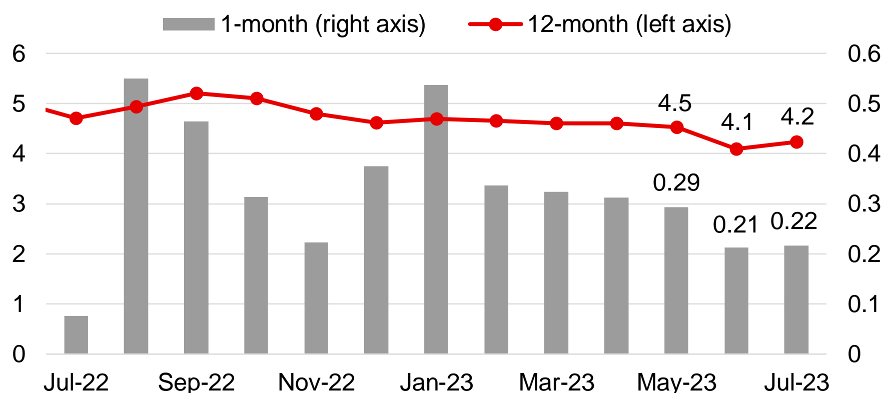

Source: BLS, MUFG Bank Economic Research

**Slow burning inflation**

Core PCE, the Fed's preferred inflation measure, showed much less disinflation than core CPI. Monthly growth in core PCE was 0.22%, up very slightly from 0.21% in June. Annual growth in core CPI ticked up to 4.2% in July, but much of that can be attributed to base effects since on a 6-month annualized basis, core PCE fell to 3.4% in July, down from 4.1% in June. On a 6-month annualized basis, new autos inflation fell to 0.2% but used autos rose to 6.7%. Inflation in many other durable goods including furnishings, recreational goods, and other durables is clearly trending downward.

**Core price growth was largely flat in July**

*Core PCE Price Index, %*




Source: BEA, MUFG Bank Economic Research

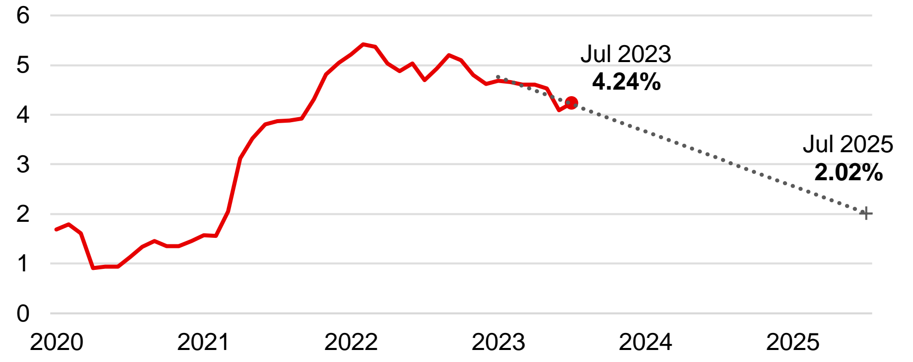
July's PCE will likely not convince the Fed to hike interest rates at the next FOMC meeting, despite showing less disinflation momentum. Given that the labor market remains strong, though easing, and economic growth is above trend, it would be puzzling for inflation to fall at a rapid pace. This slow burn may actually be comforting in knowing that the inflation dynamics are not as distorted as previously thought, and it may give the Fed confidence that they can engineer a soft landing.

There are, however, downsides to such a slow burn. At the current rate of disinflation, annual growth in core PCE won't fall to the Fed's 2% target until July 2025. And while this may be the price to pay for avoiding a recession, it risks de-anchoring inflation expectations. If price growth remains above target for too long and consumers begin to expect higher inflation in the short and medium-term, it could drive further consumption and economic growth, consequentially leading to more demand-driven inflation.

As of now, there is not enough evidence to suggest that expectations have de-anchored, so even a flat July inflation reading will likely not convince the Fed to hike again.

**At the current trajectory, inflation won't fall to 2% until 2025**

*Core PCE Price Index, 12-month growth rate, %*




Note: Dotted line reflects 2023 trend
Source: BEA, MUFG Bank Economic Research



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