IS THE US EMPLOYMENT BOOM NEARING AN END?

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Summary and Major Conclusions:

The future direction of the US labor market may be the most important variable in the outlook for economic growth. Weakness in hiring would greatly increase the odds of recession, while continued strength in job creation would form a durable foundation for solid growth in consumer spending and housing. In an environment of healthy employment and wage growth, US GDP could accelerate to an annual rate of 2.5% in 2020, up from an estimated 2.1% this year. Company earnings should also strengthen sequentially throughout next year, following another two quarters of interim weakness.

- Along with trade policy, the future direction of the US labor market may be the most important variable in the outlook for economic growth. Weakness in hiring would greatly increase the risk of recession, while continued strong job creation would support vigorous growth in consumer spending and housing.

- The US labor market remains in good condition, with continued solid growth in hiring and wages, along with a slow pace of layoffs. The unemployment rate has declined to 3.5%, a 50-year low. In my judgment, job creation should continue at a healthy pace through most of 2020.

- A more pessimistic view of employment is based upon the government's monthly report on nonfarm payrolls, which have been in a weakening trend since early this year. Compared to a monthly average of 220,000 in 2018, net additions to nonfarm payrolls have averaged only 167,000 this year.

- There are several reasons why investors should not overreact to the monthly employment report. An escalation in trade tensions over the past year has clearly reduced business confidence, and therefore plans to expand both capital investment and hiring.

- There is also a strong likelihood that the slowdown in job creation is the result of an ongoing shortage of skilled workers and difficulty of businesses in finding qualified workers. An analysis of other employment data reveals a healthy labor market.

- In my judgment, the weekly report on initial claims for unemployment insurance is the most reliable indicator of labor market strength. This measure is currently stable at the lowest level in 50 years.

- The most recent Manpower survey of 11,500 companies points to strong hiring intentions for the fourth quarter, led by transportation, retail and wholesale trade, leisure and hospitality, and business and professional services.

- The monthly hiring rate averaged 5.5 million new workers in the third quarter, the highest on record. Hiring is not keeping pace with job openings, suggesting a pent-up demand for workers. Surveys reveal that the number one challenge for business firms is an inability to find qualified workers.

- Wages have been in a steady uptrend since 2015. The current annual growth rate of nearly 3% is the highest since 2009 — up from only 2.5% two years ago — with continued acceleration expected in 2020.

- My forecast assumes stabilization of job creation within a monthly range of 125,000 to 150,000 through yearend, and strengthen modestly in 2020. Nonfarm payrolls should rise by an average 150,000 per month over the course of next year.

- The major risk to employment is confidence. Business retrenchment is most frequently triggered by uncertainty and falling confidence regarding the economic future. The trade war between China and the US has greatly undermined confidence, most evident in a sharp reduction in capital spending plans.
- Continued escalation in the tariff war could lead to a sharp pullback in hiring, which would trigger a rise in the unemployment rate. Deterioration in labor market conditions could undermine household sector confidence and spending, thereby raising the risk of recession.
- Continued robust growth in nonfarm payrolls would sharply reduce the odds of a recession. In an environment of healthy employment and wage growth, US GDP should continue to grow at an annual rate in excess of 2.5% in 2020, up from 2.2% for all of 2019.
- My assumption regarding accelerating growth in job creation in 2020 is consistent with an ongoing uptrend in both stock prices and bond yields. The equity market should significantly outperform fixed-income markets in 2020.
- Both government and high-grade corporate bonds are vulnerable to negative rates of return in 2020, while speculative-grade corporate bonds could generate low-single-digit returns.
- Of greatest importance for equity investors is economic sector leadership. In an environment of strong job creation — and therefore accelerating GDP and profit growth — economically sensitive (cyclical) stocks should outperform defensive stocks and bond proxies for the first time since 2016. Value stocks should also outperform growth stocks.

Along with US trade policy, the future direction of the US labor market may be the most important variable in the outlook for economic growth, which in turn is the critical determinant of future investment returns. This week's *Economic Perspective* provides an update of current employment trends, along with a forecast for 2020.

WHAT IS YOUR ASSESSMENT OF CURRENT LABOR MARKET CONDITIONS?

The US labor market remains in good condition, with continued solid growth in hiring and wages along with a slow pace of layoffs. The unemployment rate is stable at a 50-year low of 3.5%. In my judgment, job creation should continue at a healthy pace through most of 2020. However, there is a growing divergence among economists regarding the strength of employment and the outlook for hiring over the next year.

WHAT IS THE BASIS FOR THIS DIVERGENCE?

A more pessimistic view of employment is based on the government's monthly report of nonfarm payrolls, which has been in a weakening trend since the middle of this year. Compared with a monthly average of 220,000 in 2018, net additions to nonfarm payrolls have averaged only 167,000 this year. By comparison, the net increase in jobs averaged 185,000 and 200,000 in 2018 and 2017, respectively (see chart 1).

Chart 1: Steady Slowdown in Monthly Net Job Creation
Monthly Change in US Nonfarm Payrolls, Thousands, Quarterly Average
Source: Department of Labor

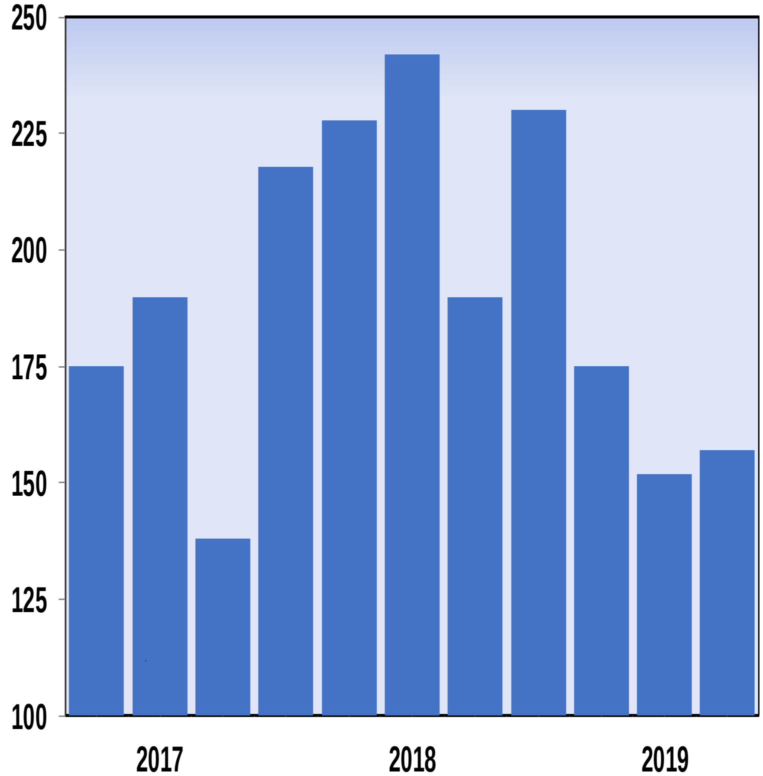
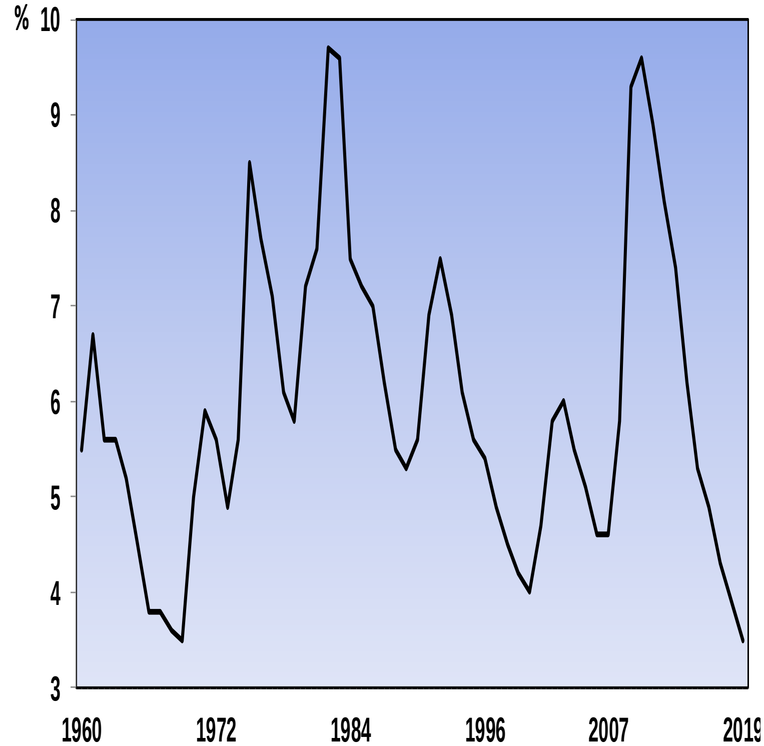


Chart 2: US Unemployment Rate at a 50-Year Low
The Number of Workers Unemployed
As a Percentage of the Labor Force
Source: Department of Labor



Recent monthly trends are even more striking: Payrolls have increased at an average pace of only 155,000 over the past three months ending in September. In short, additions to nonfarm payrolls have been in a steady downtrend that began in March of this year. For most economists and investors, the monthly nonfarm payroll report is the most popular gauge of labor market strength.

ARE YOU CONCERNED ABOUT THE APPARENT SLOWDOWN IN JOB GROWTH?

There are three reasons why investors should not overreact to this volatile monthly series. First, an escalation in trade tensions over the past year has clearly reduced ***business confidence***, thereby affecting decisions regarding capital investment and hiring. *An analysis of previous business cycles reveals a very high correlation between capital spending and hiring*. ***My assumption is that an end to the trade war will spark a revival in business confidence and a strengthening in both job creation and capital formation***.

Second, *there is a strong likelihood that the slowdown in job creation could be the result of the ongoing shortage of skilled workers and the growing difficulty of businesses in finding qualified workers*. With an unemployment rate at a 50-year low of 3.5%, the number of job openings nationwide (7.1 million) exceeds the number of unemployed workers (5.8 million) by the widest margin on record (see chart 2).

Chart 3: Weekly Jobless Claims at a 50-Year Low
Initial Claims for Unemployment Insurance
Source: Department of Labor

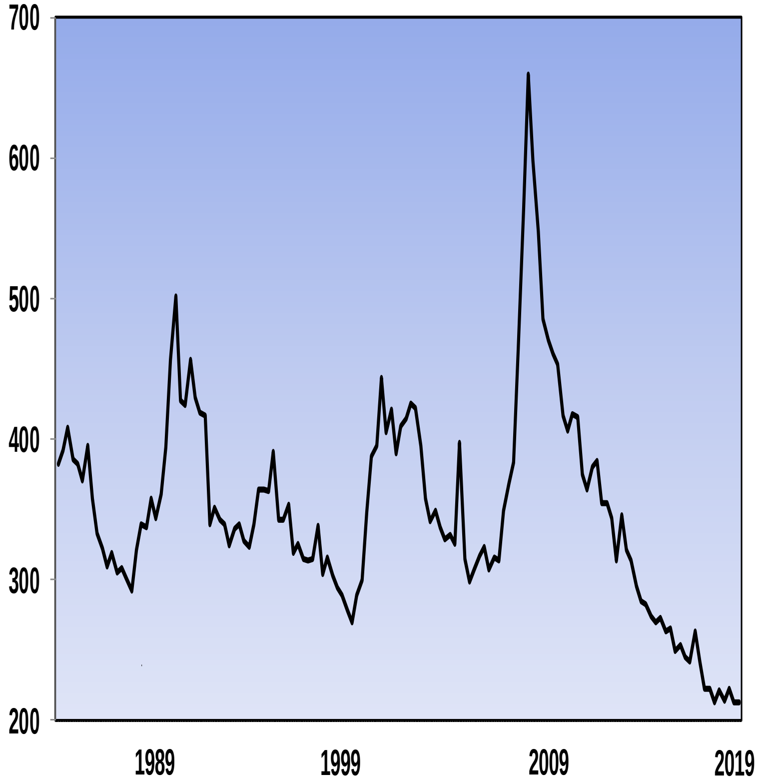
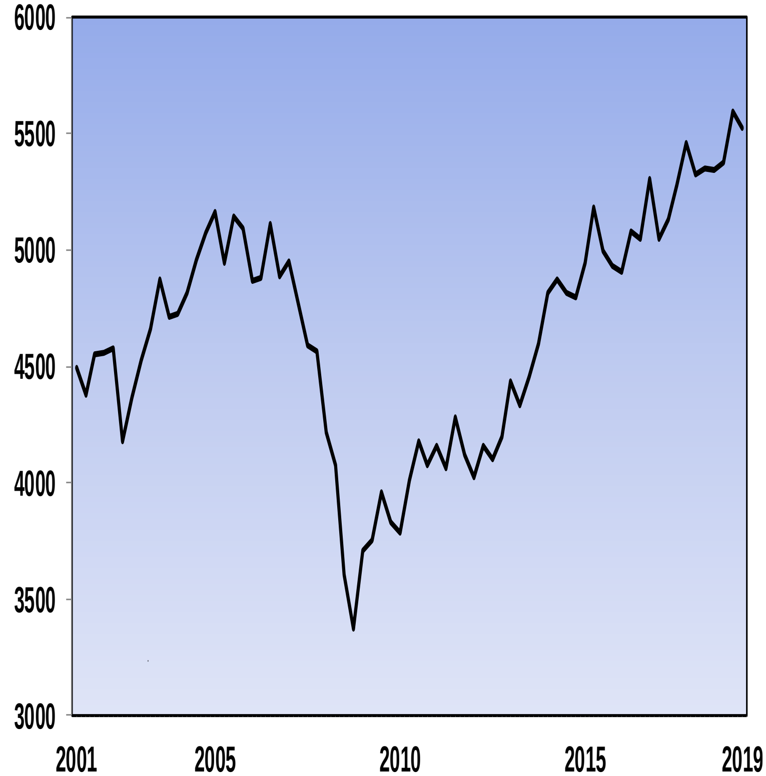


Chart 4: Gross Hiring Near an All-Time High
Number of Workers Hired Monthly, Hundreds
Source: Department of Labor



Finally, most other key data on employment point to a continued healthy labor market. Turning the argument around, _one can only imagine how much stronger employment would be in the absence of the profound uncertainty associated with the trade war_.

COULD YOU SUMMARIZE OTHER LABOR MARKET INDICATORS?

Most other labor market indicators reflect a robust labor market, with very few exceptions:

- **Initial Jobless Claims**: Weekly claims for unemployment insurance are the single most reliable indicator of the strength of the labor market. This measure is currently stable at the lowest level in 50 years (see chart 3).

- **Manpower Survey**: This survey of 11,500 companies points to strong hiring intentions for the fourth quarter, led by transportation, retail and wholesale trade, leisure and hospitality, and business and professional services.

- **New Hires**: Gross hiring has averaged 5.5 million over the past three months, an all-time high. Hiring is not keeping pace with job openings, implying considerable pent-up demand for workers (see chart 4).

Chart 5: Workers Very Optimistic Regarding Employment Prospects
Consumer Confidence Survey
Percentage of Consumers Reporting That Jobs Are Plentiful
Source: The Conference Board

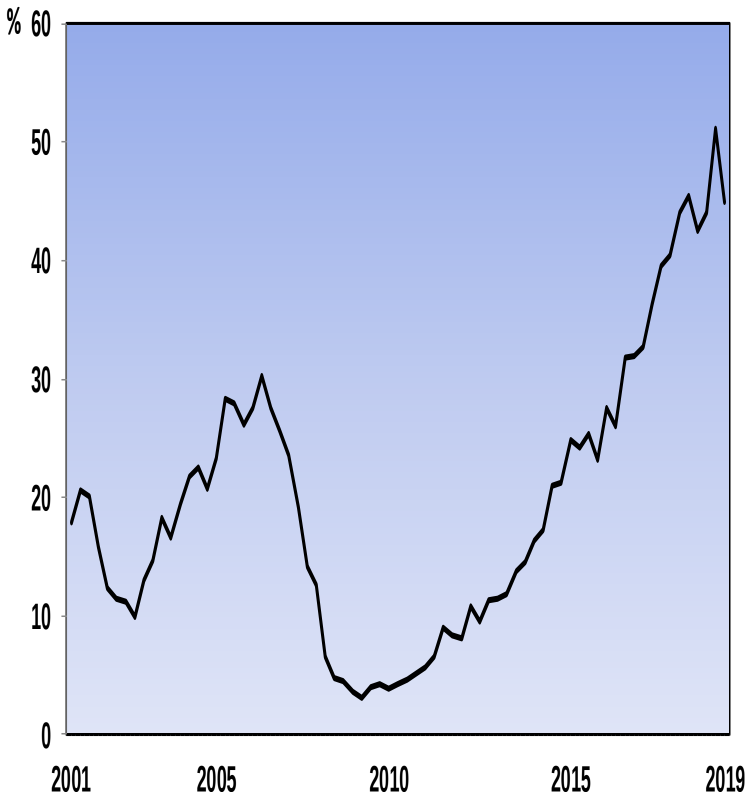
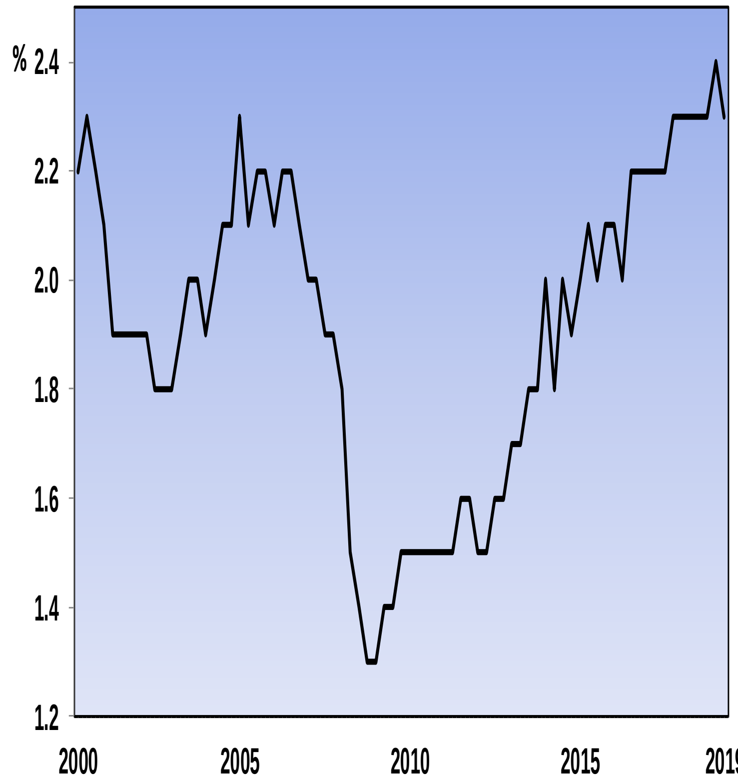


Chart 6: Workers Leaving Their Jobs at a Record Pace
The Quit Rate: Percentage of Workers
Voluntarily Quitting Their Jobs
Source: Bureau of Labor Statistics



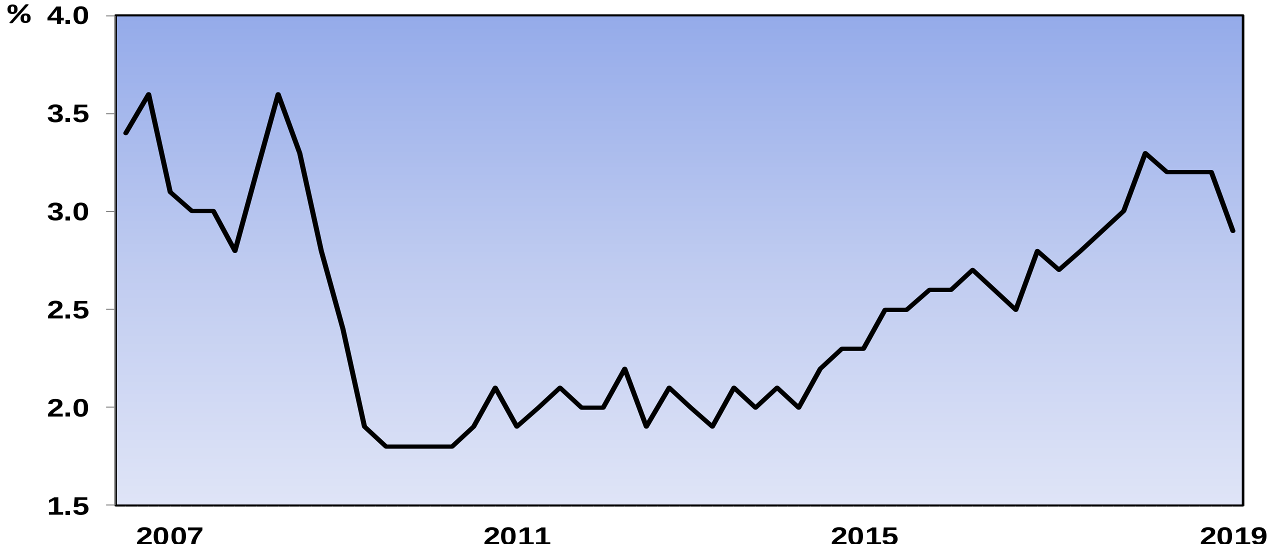
- **Worker Shortages**: Surveys reveal that the number one challenge of business firms is an inability to find qualified workers.

- **Survey of Job Openings**: The Conference Board's monthly survey of consumer confidence asks survey participants this question: "Are job openings plentiful or scarce?" Roughly 50% of respondents reported that jobs are plentiful, the highest percentage in nearly two decades (see chart 5).

- **The Quit Rate**: The Labor Department tracks the number of workers who voluntarily leave their jobs — a proxy for worker confidence and assurance in seeking a new job. The number of "quits" rose to 3.5 million, by far the highest on record. The quit rate measures the number of quits as a percentage of employment; the current rate of 2.3% is near the highest since 2001 (see chart 6).

- **Labor Participation Rate**: The labor participation rate has been in a steady uptrend since 2015 and is at the highest level in nearly a decade. Rising participation reflects growing confidence in labor markets among previously unemployed workers. It also helps to maintain an optimal balance between the supply of and demand for workers.

Chart 7: Wages In a Generally Accelerating Growth Trend
Average Hourly Wages, Annual % Growth Rate
Source: Bureau of Labor Statistics



- **Wage Growth**: As measured by average hourly earnings, wages have been in a steady uptrend since 2015. Wage growth has averaged 3% in recent months, the fastest pace since 2009 (see chart 7).

The bottom line is that numerous indicators suggest that labor market conditions are healthy and that solid job creation is likely to persist over the next year.

WHAT IS YOUR FORECAST FOR EMPLOYMENT IN 2020?

My forecast assumes that net job creation will stabilize within a monthly range of 125,000 to 150,000 through yearend, and strengthen modestly in 2020. Nonfarm payrolls should rise by an average 150,000 per month over the course of next year. *This pace would be the slowest in several years, but still very impressive for the eleventh year of an economic expansion*.

At this pace, additions to payrolls comfortably exceed the number of new entrants into the labor force — estimated at 110,000 workers per month — implying downward pressure on the unemployment rate. Currently at 3.5%, the unemployment rate could decline to 3.3% or lower in 2020. If so, this would be the lowest unemployment rate since the 1960s.

My forecast also assumes some further acceleration in wage growth. Compared with a current growth rate of 3%, average hourly earnings could strengthen during 2020 and 2021, rising to an annual rate of 3.5%. *A combination of moderate but sustained job growth and higher wages per worker implies a growth rate in personal income of nearly 5% in 2020*.

WHAT IS THE MAJOR RISK TO THE OUTLOOK?

In a word, the major risk to employment is ***confidence***. In principle, a retrenchment in business expansion plans is most frequently triggered by uncertainty and declining confidence in the future. The trade war between China and the US has resulted in widespread uncertainty, most evident in a sharp reduction in capital spending plans.

Continued escalation of the tariff war could lead to a retrenchment in hiring, triggering a rise in the unemployment rate. Consumer spending has been the locomotive of the US economy in 2019. A deterioration in labor market conditions could undermine household sentiment and spending, thereby raising the risk of recession.

WHAT ARE THE MOST SIGNIFICANT ECONOMIC IMPLICATIONS OF THE OUTLOOK?

The future direction of the US labor market may be the most important variable in the outlook for economic growth. Weakness in hiring would greatly increase the risk of recession, while continued strength in job creation would form a durable foundation for solid growth in consumer spending and housing.

Continued steady growth in nonfarm payrolls would sharply reduce the odds of a recession. In an environment of healthy employment and wage growth, US GDP should continue to grow at an annual rate in excess of 2.5% throughout 2020, up from an estimated 2.2% this year. Company earnings would also embark on a solid recovery path, following another two quarters of weakness.

WHAT ARE THE INVESTMENT IMPLICATIONS?

Employment is the key to the direction of world financial markets over the next year. A healthy labor market would be consistent with sustained economic growth throughout 2020 and into 2021, accompanied by faster growth in company earnings. My assumption of accelerating growth in job creation next year is also consistent with an uptrend in both stock prices and bond yields. The equity market should significantly outperform fixed-income markets over the next 12 months.

In an environment of solid job creation — and therefore accelerating real GDP and earnings growth — ***cyclical stocks should outperform defensive stocks for the first time since 2016***. Specifically, economic sector leadership should shift from consumer staples, utilities, real estate and healthcare — the leaders of the past two years — to industrials, materials, transportation, energy, and financials. Both government and high-grade corporate bonds are vulnerable to negative rates of return in 2020, while returns on higher-yielding speculative-grade bonds could be modestly in the black.

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CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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