US EMPLOYMENT, CONSUMER SPENDING, AND THE EQUITY MARKET

by **Robert F. DeLucia, CFA**
Consulting Economist

The equity market is at an important crossroads: Stock prices are at all-time highs at a time when employment is weakening and public health risks for the fall are escalating. While it is always difficult to discern equity market sentiment, it appears that an increasing number of investors who had been on the sidelines are becoming fearful of missing out on the upside. Pure momentum investing has pushed both the S&P 500 and the NASDAQ to all-time highs, although equal-weighted indexes are well below their previous peaks.

Summary and Major Conclusions:

- Consumer spending has been sluggish and the savings rate has spiked to record levels. It seems plausible to assume that private consumption is unlikely to embark on a healthy and sustained recovery phase without a strong labor market.

- Although the labor market is gradually healing, the rehabilitation process is likely to be painfully slow, implying an unusually long period of high unemployment. The employment report for July showed only modest improvement.

- Net job creation has derived mainly from workers who were temporarily laid off and have been recalled back to work. The number of workers who were permanently laid off has not recovered, suggesting that very few new jobs have been created, a reflection of the slump in business confidence.

- The labor participation rate plunged to 60% in April, the lowest level in more than 45 years. A staggering five million of unemployed workers have exited the workforce since February. If these individuals were counted as unemployed, the jobless rate would be 14% rather than 10.2%.

- Current data on worker compensation paint a weak picture. Wage growth slowed abruptly in the second quarter to only 2% from a rate of 3.2% in the previous quarter, the slowest quarter-to-quarter rise in wages since 2017.

- The inability of schools to hold in-person classes is another potential obstacle for employment. Bloomberg Economics estimates that as many as 18 million parents could put job seeking on hold until their children have returned to the classroom.

- The outlook for employment is unfavorable through yearend: Net job creation is likely to weaken in coming months, the unemployment rate could remain near 10%, and wages will likely remain under downward pressure.

- Continued high levels of daily coronavirus cases will weigh on business confidence and discourage firms from expanding operations. The biggest risk is that the jump in temporary unemployment morphs into permanent job losses as rising infections trigger a further leg down in business confidence.

- The pace of hiring is likely to stall in coming months; if Congress fails to pass another spending bill, unemployment could increase sharply. Availability of a vaccine for COVID-19 — expected early next year — should mark an inflection point in hiring trends and trigger a steady increase in hiring as 2021 unfolds.

- The other wild card in the outlook is fiscal policy, as powerful partisan politics have prevented Congress from delivering another spending package. The absence of further fiscal relief would almost certainly result in a renewed economic downturn.

- The equity market is at an important crossroads: Stock prices are at all-time highs at a time when employment is weakening and public health prospects for the fall are deteriorating.

- While it is always difficult to discern equity market sentiment, it appears that an increasing number of investors who have been on the sidelines are becoming fearful of missing out on the upside.

- Investors continue to plow into a handful of stocks perceived as safe, namely, the largest ten stocks within the S&P 500, resulting in the most highly concentrated market advance since the 1960s. These technology and internet stocks have benefitted enormously from the pandemic and economic lockdown.

- For passive investors in S&P 500 index funds, the equity market is overvalued and vulnerable to a setback at any time. For value managers, the risk/reward ratio is favorable at current depressed levels, although a shift in market leadership is not likely until 2021 and beyond.

Unlike all previous business cycles, *job creation* will likely prove to be the critical economic variable in the outlook because of its direct impact on consumer spending. In all prior economic cycles, *credit expansion* has been the crucial driver of household spending. However, despite the extraordinary policy actions by the Federal Reserve, private credit creation has slumped: *Households are reluctant to borrow and bank lending standards have tightened since the onset of the pandemic*.

Consequently, consumer spending has been sluggish and the personal savings rate has spiked to record levels. It seems plausible to assume that personal consumption expenditures are unlikely to embark on a healthy and sustained recovery phase without a strong labor market. Moreover, the labor market is at risk to a new surge in COVID-19 infections and/or failure of Congress to pass legislation for a new spending package. This week's *Economic Perspective* analyzes labor market trends in the context of the current business cycle and government policy initiatives (see chart 1).

Chart 1: Household Savings Surge to an All-Time High
The Personal Savings Rate (%)
Savings as a Percent of Disposable Personal Income
Source: Bureau of Economic Analysis

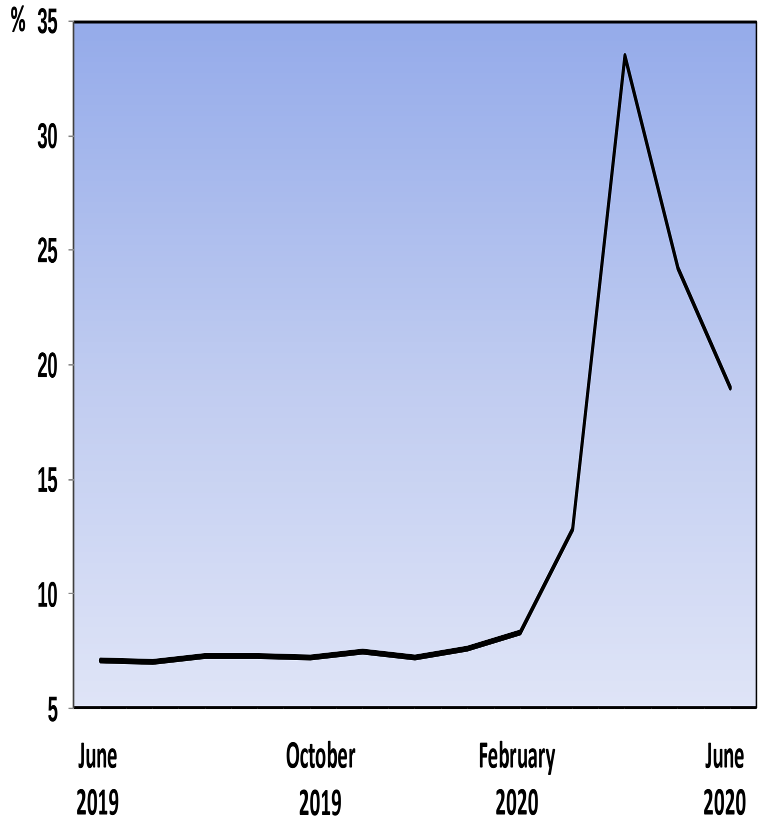
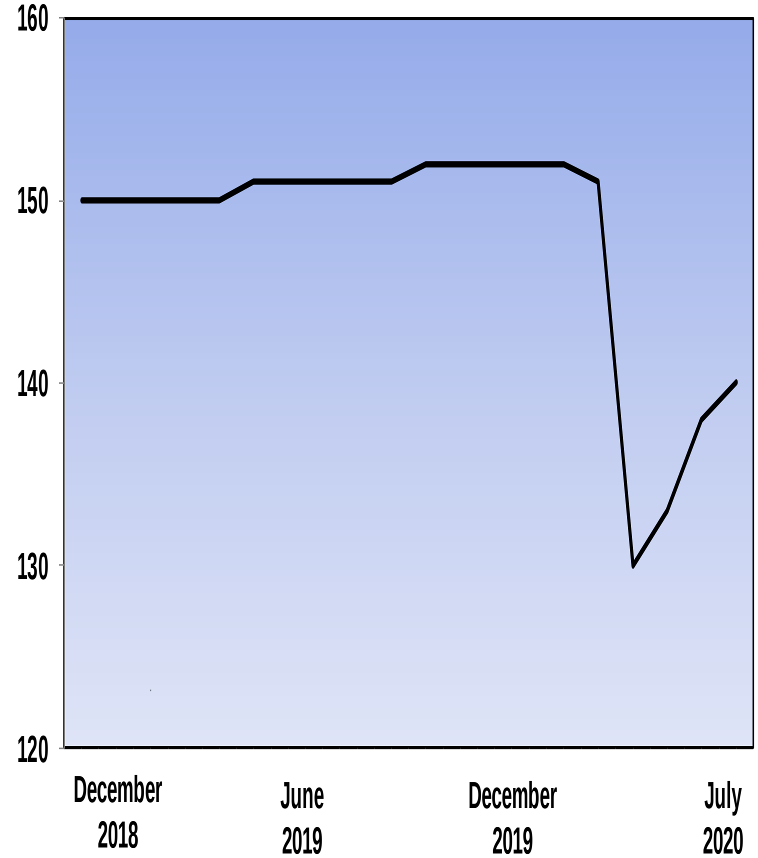


Chart 2: A Sluggish Recovery in Employment
Workers on Nonfarm Payrolls (Millions)
Source: US Labor Department

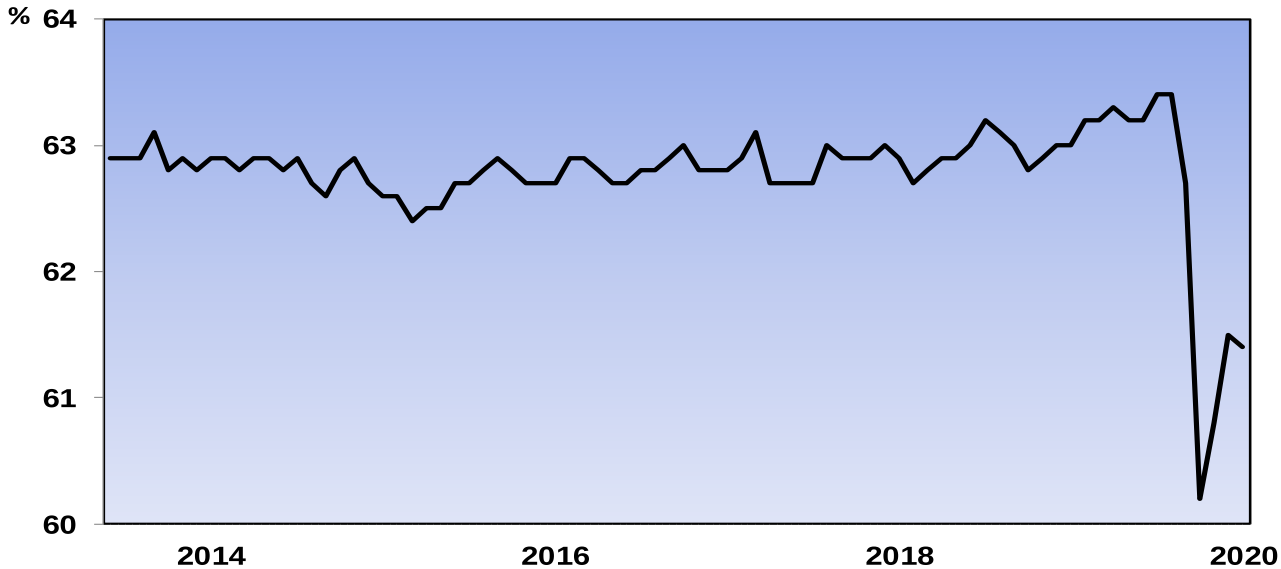


LABOR MARKET TRENDS

Although the labor market is gradually healing, the rehabilitation process is likely to be painfully slow, implying an unusually long period of high unemployment. The labor market improved only modestly in July: Net job creation increased by 1.8 million, down from growth of 4.8 million in June, while the unemployment rate fell only slightly to 10.2%. Only 45% of the 22 million jobs lost in March and April have been restored (see chart 2).

Furloughed Workers: Net job creation has derived mainly from workers who were temporarily laid off and have been recalled back to work — especially in the hard-hit restaurant, retail, and healthcare sectors. *The number of workers who were permanently laid off has not recovered, suggesting that very few new jobs have been created, a reflection of the slump in business confidence*. Long-term unemployment is becoming a big problem. A stunning 6.5 million workers have been without a job for between 15 and 26 weeks, more than 40% of total unemployed workers of 16 million.

Chart 3: The Labor Force Participation Rate Sinks to a 45-Year Low
Percentage of Workers in the Labor Force,
Either Employed or Looking for a Job
Source: US Labor Department

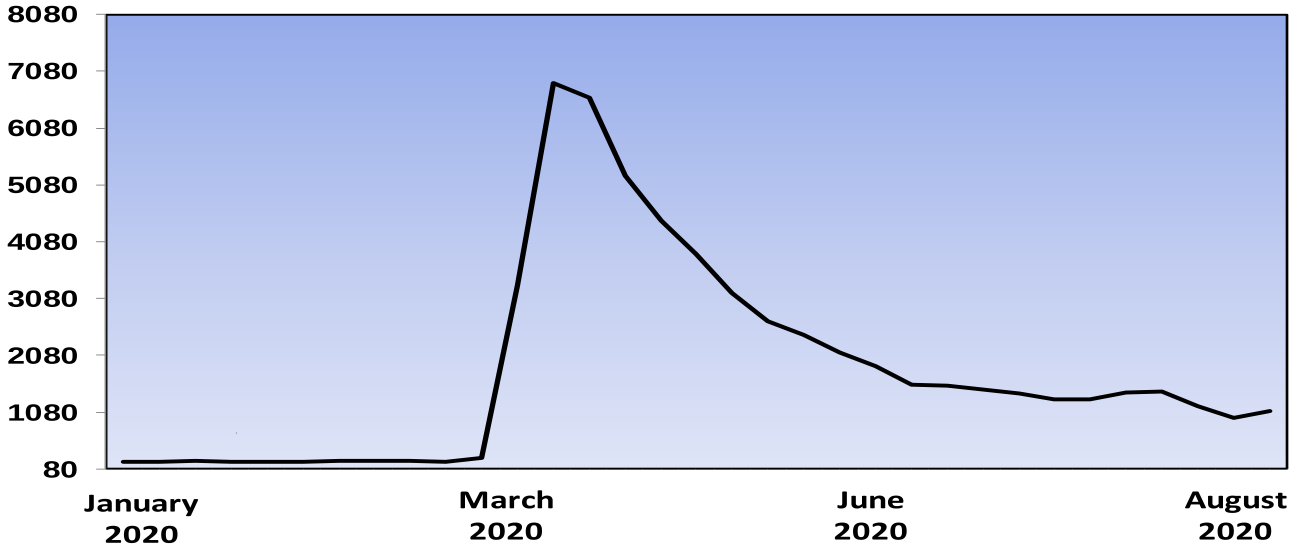


Labor Participation Rate: The labor participation rate plunged to 60% in April, the lowest level in more than 45 years, and has recovered to only 61.5%. This indicator measures the percentage of workers in the labor force who are either employed or actively seeking employment. A staggering five million unemployed workers have exited the workforce since February. If these individuals were counted as unemployed, the jobless rate would be 14% rather than 10.2% (see chart 3).

Employee Wages: Unsurprisingly, current data on worker compensation paint a weak picture. Wage growth slowed abruptly in the second quarter to only 2% from a rate of 3.2% in the previous quarter, the slowest quarter-to-quarter rise in wages since 2017. Businesses have clearly usurped bargaining power from labor, and this trend could persist for an extended period in an environment of record-high unemployment.

Small Business Failures: The potential risk of large-scale business failures is well known, with the small business sector especially at risk. The failure rate for small businesses — firms with fewer than 500 employees — is ***triple*** that of large companies. Shrinkage within the small business sector is a direct threat to employment: *Even though larger competitors will assume the customers of these failing firms, the **net effect** will be fewer jobs*. The explanation is simple: *Large companies will find ways to increase production without proportionately increasing staff, through economies of scale and with the use of various productivity-enhancing programs*.

Chart 4: Rise in Initial Jobless Claims Signals Labor Market Weakness
Initial Claims for Unemployment Insurance (Thousands)
Source: US Labor Department



Protecting Profit Margins: Faced with weak sales demand and an absence of pricing power, large companies will continue to aggressively cut costs over the next year. Labor compensation is the largest expense for businesses, accounting for nearly two-thirds of total operating costs. As such, firms will be slow to add to payrolls in an attempt to protect profit margins in the challenging business environment that lies ahead.

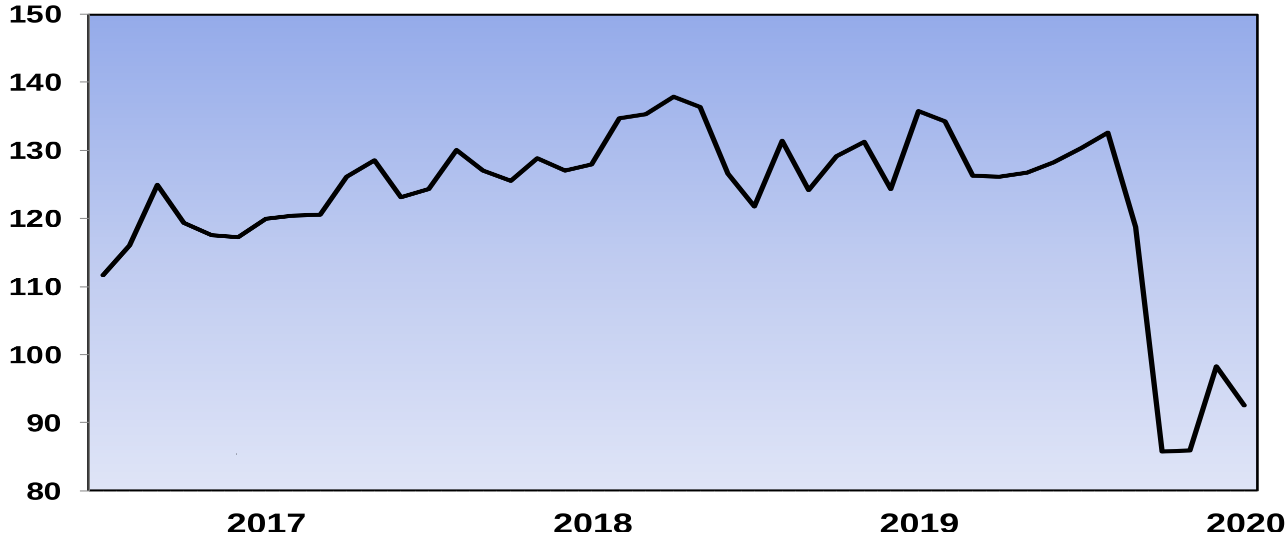
School Closures: The challenges facing schools in conducting in-person classes is another potential obstacle for employment. A heavy reliance on at-home virtual learning along with childcare restrictions means that many parents will be challenged to be simultaneously employed while supervising their children at home. Bloomberg Economics estimates that as many as 18 million parents could put job seeking on hold until their children return to the classroom.

EMPLOYMENT OUTLOOK

The US labor market outlook is filled with ambiguity. Although monthly job data have improved and the unemployment rate is falling, other labor market data paint a gloomy picture. Initial jobless claims increased during the week ending August 15, following many weeks of improvement. The outlook for employment is unfavorable through yearend: Net job creation is likely to weaken in coming months, and wages will likely remain under downward pressure (see chart 4).

Business Confidence: Moreover, continued high levels of daily infections will weigh on business confidence and discourage firms from expanding operations, which means that hiring will remain weak. *<u>The biggest risk is that the jump in furloughed workers that began in March will morph into permanent job losses</u>*.

Chart 5: Consumer Confidence Remains Depressed
Index of Consumer Sentiment
Source: The Conference Board



- The pace of hiring is almost certain to stall in coming months, implying minimal net growth in payrolls through yearend. If Congress fails to pass another spending bill, unemployment could increase sharply.
- Distribution of a vaccine for COVID-19 during 2021 should mark a major inflection point in hiring trends and trigger a steady increase in job growth as the year unfolds.
- Assuming a sustained improvement in public health conditions during the course of 2021, job creation could increase significantly in 2022.
- Following a cumulative loss of ten million jobs this year, employment could increase by two million next year and by close to five million in 2022. However, nonfarm payrolls will not return to pre-pandemic peaks until 2023.
- The unemployment rate could end this year at roughly 10% or slightly lower, declining to 7.5% by the end of next year and 5.5% at yearend 2022, a level still higher than the official rate of 4.5% considered to be full employment.

LABOR MARKET WEAKNESS: IMPLICATIONS

The US labor market has struggled in recent weeks, and is likely to remain challenged for a prolonged period. The key implications are as follows:

- **Household Savings**: A combination of slow wage growth, weak job creation, and widespread job insecurity will dampen consumer confidence and cause households to save more and spend less (see chart 5).

- **Inflation**: A prolonged period of labor market slack will exert downward pressure on wages in particular and consumer inflation in general.

- **Monetary Policy**: A weak labor market will compel the Federal Reserve to persevere with a hyper-accommodative monetary policy for longer than normal.

- **Profit Margins**: The combination of stagnant employment and slow wage growth could result in a widening of profit margins, as businesses benefit from a reduction in total labor compensation. *In the long term, businesses will increasingly rely on achieving labor market efficiencies through automation*.

- **Equity Market**: A combination of highly accommodative monetary conditions and widening profit margins should support the equity market, as asset values benefit from both a larger stream of future earnings and a lower discount rate.

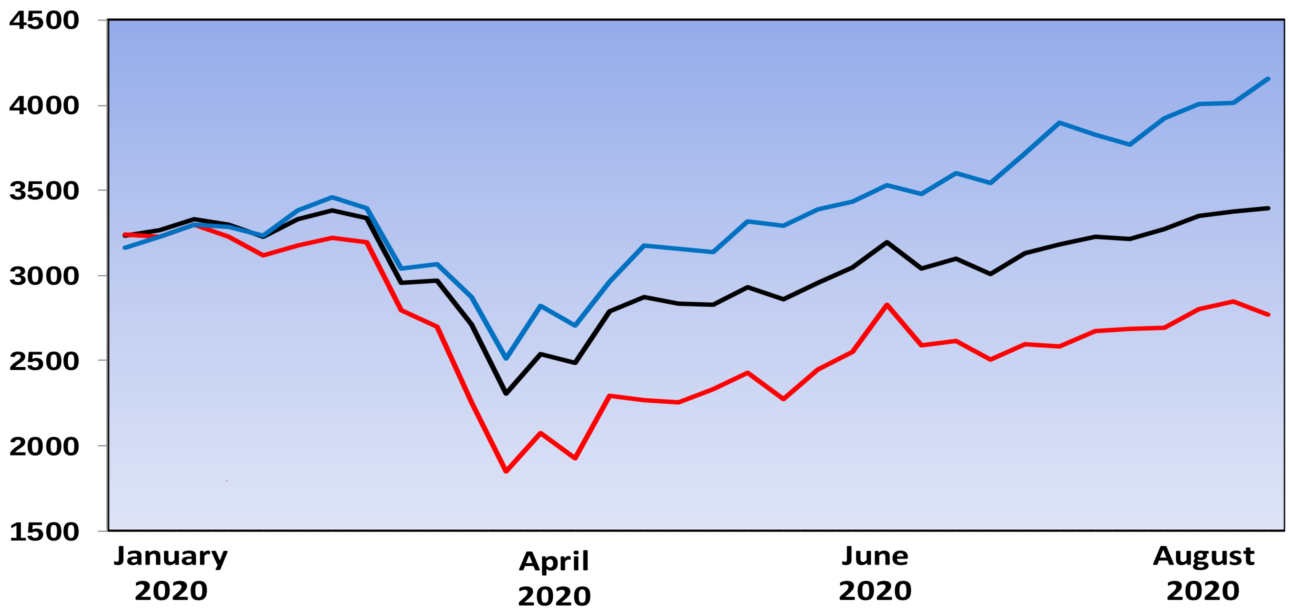
- **Populist Politics**: A jobless recovery is consistent with a further rise in populist politics within the US. A combination of persistently high unemployment and widening income inequality could create an even more fertile environment for populist sentiment, a negative for investor confidence.

GOVERNMENT POLICY

The US economy is currently in a holding pattern and would be susceptible to further weakness in the event of another surge in coronavirus cases, hospitalizations, and fatalities. *The obvious implication is that the economy is desperately in need of continued economic stimulus*. The Federal Reserve has created a formidable firewall between the slumping economy and the financial system, and has made it clear that it will provide whatever stimulus is necessary to support the real economy for as long as necessary.

Fiscal Policy: The wild card in the outlook is fiscal policy, as fierce partisan politics have prevented Congress from delivering another spending package. Fiscal policymakers responded quickly and forcefully to the economic collapse in March, but must now follow through with additional support. The combination of a second wave of COVID-19 infections and failure of Congress to agree to an additional spending package could result in a more severe economic downturn prior to yearend.

Chart 6: Wide Equity Market Divergences Across Indexes
Resulting from Capitalization Weighting
S&P 500 Index
NASDAQ 100 Index
Value Line Index
Source: Bloomberg



INVESTMENT CONCLUSIONS

The equity market is at an important crossroads: Stock prices are at all-time highs at a time when employment is weakening and public health prospects for the fall are deteriorating. While it is always difficult to discern equity market sentiment, it appears that an increasing number of investors who had been on the sidelines are becoming fearful of missing out on the upside. Pure momentum investing has pushed both the S&P 500 and the NASDAQ to all-time highs, although equal-weighted indexes are well below their peaks from earlier in the year.

Apparently disregarding the growing economic risks, investors appear to have adopted a "hedging" strategy of plowing into a handful of stocks perceived as safe — namely, the five largest stocks within the S&P 500, and eschewing economically sensitive stocks. These leading technology and internet stocks have benefitted massively from the pandemic and economic lockdown and have enjoyed an acceleration in earnings growth. The NASDAQ 100 has appreciated by 33% through the middle of August, compared with a 15% decline in the equal-weighted Value Line Index of 1700 stocks (see chart 6).

Momentum investors continue to pile into these stock market darlings, resulting in the most highly concentrated market advance since the 1960s. This market spike has been led by Apple, the first stock in market history to reach a market capitalization of $2 trillion, or fully 7% of the S&P 500 Index. Other stocks in the top five include Microsoft (5.9%), Amazon (5.9%), Alphabet (3.8%), and Facebook (2.7%), *a cumulative total market cap of 25% in just these five stocks*. *As a group, these five stocks have appreciated by **49%** this year while the remaining 495 stocks in the S&P 500 are **down** by 5%*.

For passive investors in S&P 500 index funds, the equity market appears to be overvalued and vulnerable to a setback at any time. For value fund managers, the risk/reward ratio is favorable at current depressed valuation levels, although a shift in market leadership in favor of value over growth is unlikely to occur until the economic skies begin to brighten in 2021 and beyond.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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The NASDAQ-100: is a stock market index made up of equity securities issued by 100 of the largest non-financial companies listed on the Nasdaq stock market. It is a modified capitalization-weighted index.

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.

The Value Line Geometric Composite Index: The original index released, and launched on June 30, 1961. It is an equally weighted index using a geometric average. Because it is based on a geometric average the daily change is closest to the median stock price change.

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