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Markets & Economies

Labor Market Will Be Key to Size of Fed Cut

The pace of the moderation in U.S. employment data could influence whether the U.S. Federal Reserve delivers an expected rate cut of either 25 or 50 basis points at its September policy meeting.

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In a speech on August 23, U.S. Federal Reserve (Fed) Chair Jerome Powell affirmed his increasing confidence that a "soft landing" for the U.S. economy has been achieved by stating that the time for rate cuts has arrived, effectively declaring victory over the great inflation surge of 2021-2022.

Powell's remarks, delivered at the conclusion of the U.S. Federal Reserve Bank of Kansas City's annual economic symposium in Jackson Hole, Wyo., were more optimistic (i.e., dovish) than we had expected. He also made it clear that the balance of risks has shifted to the labor market by declaring that Fed policymakers would not welcome a further cooling of conditions, citing the increase in the unemployment rate from 3.4% in April 2023 to 4.3% in July 2024.

Two Views of the Labor Market

The health of the U.S. labor market labor market looms large as the September 17–18 meeting of the Fed's policy-setting arm, the Federal Open Market Committee (FOMC), approaches—especially since the release of a preliminary estimate of annual revisions to U.S. employment data by the U.S. Bureau of Labor Statistics (BLS) on August 21. The BLS revisions resulted in a downward adjustment to March 2024 total U.S. nonfarm employment of 818,000 (0.5%).

Applying the revisions to employment data smoothly from March 2023 through March 2024—the changes won't be incorporated into the monthly data released by the BLS until next February—shows that private sector employment growth slowed very sharply in early 2023 and has remained consistently below the 2017-2019 average of 177,000 per month ever since. Inasmuch as the slowdown happened after a period of inordinately strong employment growth when firms were, in effect, hoarding workers for precautionary reasons amid the COVID-19 pandemic, the recent data are consistent with multiple interpretations, especially since it is likely that the information used to revise the employment data lower is likely to undercount undocumented workers, a subgroup that has increased sharply since 2022, based on data from the U.S. Bureau of Labor Statistics.

The interpretation taken by the FOMC appears to be that the slowdown in employment growth—and parallel increase in the unemployment rate—could be the prelude to a downward spiral that feeds on itself. In that scenario, weaker job growth hurts consumer confidence, causing a slowdown in consumer spending. That, in turn, causes job growth to moderate even further, triggering a "non-linear" break that results in a recession.

An alternative view of the data is that the slowdown represents a "bullwhip" effect—a payback for the period of extremely strong employment growth that preceded it. That would make a self-sustaining downward spiral much less likely as companies adjust employment down to desired levels gradually, due to differing workforce needs across industries and companies.

That narrative is supported by a slowdown in gross hiring accompanied by very low layoffs, implying that the adjustment is not a threat to incumbent workers, and thus shouldn't result in a negative impact on confidence and spending. Employment growth should pick up again gradually over time as the excess from 2021-2022 is absorbed. Under these conditions, no rate cuts are needed, as the economy is experiencing an orderly adjustment that will rectify itself in time. The risk under this scenario is that the neutral rate may be much higher than the FOMC believes it is, and that cutting rates ends up providing stimulus instead of removing accommodation. That would result in employment and gross domestic product (GDP) growth picking up sooner, risking the central bank's 2% inflation target and suggesting that the Fed is willing to provide a "put" to the economy and the markets too cheaply.

25 or 50?

In any case, the current state of the labor market is thought to be such that it does not pose an inflationary threat. The issue is whether the Fed cuts rate gradually in line with a risk management orientation or aggressively as it would to offset a cyclical downturn. The notion that the Fed has plenty of room to cut rates from current levels suggests to some observers that a 50-basis point (bp) cut in the fed funds rate is likely at the September meeting, rather than the typical 25-bp cut. The ultimate size of the reduction is likely to be influenced by the August employment report (scheduled for release September 7). If the jobs data are relatively strong—a real possibility considering the weather-related quirks that appear to have depressed results in July—it seems more likely that the Fed's next rate-cut cycle will get underway with a 25-bp move.

The U.S. economy has proven time and time again that it is extremely resilient and able to sustain GDP growth above 2%, even despite a sharp rise in rates to a very high level. If that continues, and we believe it will, we think the Fed may deliver less in rate cuts, and at a more gradual pace, than what the market is pricing.

Investment Implications

As the Fed moves toward a more accommodative policy stance, how might investors respond? As we have previously noted, one approach we favor in fixed income is to diversify across duration exposures, including short-term bonds and credit-oriented instruments to balance the rate risk inherent in longer-term bonds. For equity investors, we think quality stocks, along with shares of rapidly growing, innovative companies, are also well positioned for the current environment.

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Glossary & Index Definitions

A **basis point** is equal to one one-hundredth of a percentage point.

The **Federal Reserve (Fed)** is the central bank of the United States. The **Federal Open Market Committee** (FOMC) is the branch of the Fed that determines the direction of monetary policy in the United States.

The federal funds rate is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight on an uncollateralized basis. **Fed funds futures** are financial futures contracts based on the federal funds rate and traded on the Chicago Mercantile Exchange. These futures are considered a direct reflection of collective marketplace insight regarding the future course of the Federal Reserve's monetary policy.

"Fed put" is a term used to describe the market belief that the Fed would step in and implement policies to limit the stock market's decline beyond a certain threshold.

Those with a **hawkish** view of monetary policy are focused on inflation. They favor raising interest rates to restrict the supply of money. **Dovish** monetary policy supports economic growth and aims to achieve maximum employment. It seeks to lower interest rates or keep them low, because loose monetary policy increases the money supply.

The **neutral rate of interest**, also known as **r-star**, is the real short-term interest rate expected to prevail when an economy is at full strength and inflation is stable.

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