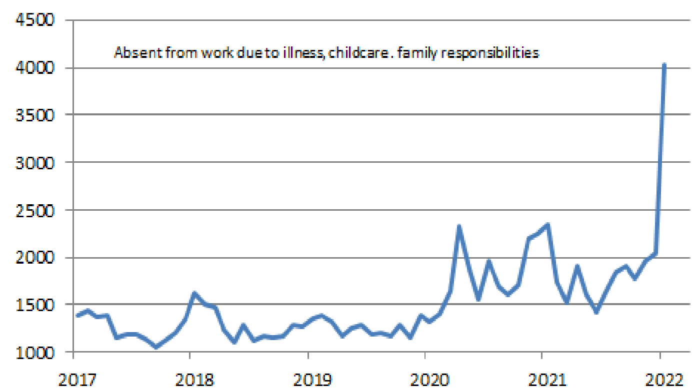
WEEKLY ECONOMIC COMMENTARY

Friday's jobs report was something to behold, featuring one of the biggest misses relative to expectations on record. To be sure, the widespread view throughout the week was that the report should be taken with a grain of salt. Most economists were prepared for an exceptionally weak reading for job growth in January, as the Omicron case count peaked at over 800 thousand a day during the mid-month reference week the payroll survey was taken, up from an average of 200 thousand in December. Hence, many economists thought that workers would be temporarily sidelined due to illness, child care, and/or family responsibilities which would exacerbate staffing shortages and temporarily curtail business activity, resulting in an exceptionally weak jobs report. Indeed, the giant payroll processing company, ADP, reported on Wednesday that private companies shed a massive 301 thousand jobs in January.

The consensus on Wall Street was for a relatively mild jobs gain of 150 thousand last month, but not to worry because Omicron's disruptive effects were waning (case counts have fallen sharply since mid-January), and hiring would rebound along with reviving activity in coming months. Nor, for that matter, would a weak reading on jobs in January deter the Federal Reserve from its planned course of raising interest rates this year, beginning most likely in March. Well, the consensus was correct in at least one respect. The Omicron surge in January did ignite a spike in absentee workers, as the number of people reporting sick jumped from 1.7 million to 3.6 million in January. Add in those staying home due to childcare or family responsibilities, and the number climbs to 4 million in January, double the December count.

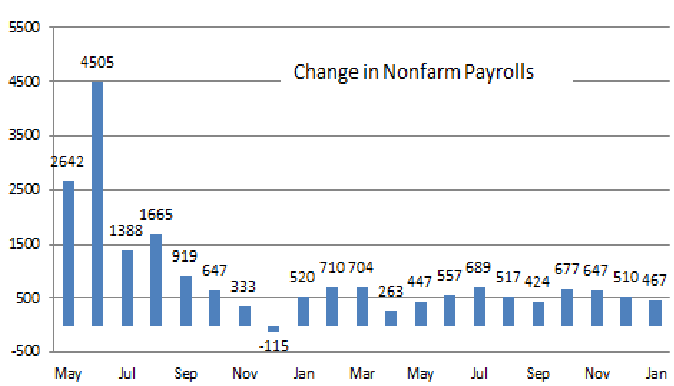
Covid-Related Work Absences



However, the key point to consider is that those absent workers were still employed and, hence, did not detract from the payroll count during the month. In earlier days, companies may well have cut ties with employees who needed extended days off due to illness or other reasons. Not so in the red-hot job market of today, when workers are quitting at a record pace, and there are 3.7 million more job openings than unemployed workers. In this environment of staffing shortages, companies are not only cutting their absentee workers more slack, hoping to retain their services after they recover, but they are also hiring new ones at a breakneck pace. This brings us to Friday's jobs report and the astonishing miss by forecasters of the job gains registered in January.

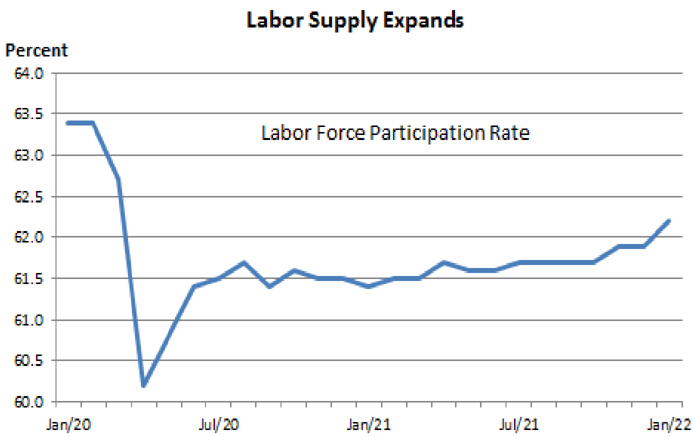
The headline increase was itself mind-boggling. Nonfarm payrolls increased by 467 thousand during the month, outpacing the 150 thousand-consensus forecast by a considerable margin. What's more, the statisticians at the Labor Department added a whopping 709 thousand workers to the earlier estimates of payrolls for November and December. Hence, what was thought to be a soft ending to 2021, with only 199 thousand jobs added in December, now looks significantly more muscular, with the revised count coming in at 510 thousand new jobs. That's not to say Omicron failed to have an impact. With so many absentee workers, companies had to curtail output or limit operations; the average workweek fell by a sharp 0.6 percent to the lowest level since April 2020.

Sturdy Job Growth Continues



But surprisingly, the sectors that are the most vulnerable to the effects of the virus were the biggest drivers of job growth last month. Leisure and hospitality, where worker shortages are particularly acute, added a whopping 151 thousand jobs, accounting for a third of the overall gain. Waiters and bartenders who come in contact with customers more than most workers joined the ranks of employed in huge numbers. Foodservice and drinking places added a sturdy 108 thousand jobs in January. Meanwhile, retailers added 61 thousand positions, the second most substantial increase in a year. That belies the weak pace of retail sales seen in recent months. But given the severe labor shortages in this sector, retailers likely decided to look through the temporary lull in activity from Omicron and hold onto their holiday hires rather than lay them off as usual in January. That weaker than usual post-holiday layoffs translated into a strong seasonally adjusted increase last month.

Where did all these workers come from? Since the onset of the pandemic in the spring of 2020, employers struggled to get people off the sidelines, which remained stubbornly bloated for several reasons. Health fears and childcare responsibilities topped the list, of course. Still, generous government payments and surging asset values also allowed individuals to either forgo a paycheck for extended periods or take early retirement. The labor force participation rate fell from 63.4 percent to 60.2 percent during the worst of the pandemic and only grudgingly moved higher over the ensuing two years. But last month saw a significant uptick, as the rate climbed from 61.9 percent to 62.2 percent, a post-pandemic high. The rise caught us, as well as most economists, by surprise. We had expected the spread of the Omicron variant to delay the recovery in the labor supply.



However, it appears that an increasingly tight labor market that is lifting wages at an accelerated pace combined with vanishing government support and a diminishing financial cushion are enticing workers to rejoin the labor force. Indeed, the influx of entrants to the workforce outpaced the increase in employment, resulting in a slight uptick in the unemployment rate, from 3.9 percent to 4.0 percent. But economists like to describe such an increase as occurring for the "right" reasons, i.e., people are rejoining the labor force because they are more confident in getting the job they want. In the current environment, not only are jobs easier to get they are also more lucrative.

Average hourly earnings increased by a hefty 0.7 percent in January, lifting the gain to an eye-opening 5.7 percent over the past year. Except for May 2020, when the onset of the pandemic threw low-wage workers out of jobs and skewed average wages higher, the January year-over-year increase was the strongest since figures for all private-sector workers began in 1997. However, the wage data for non-management workers goes back longer – to 1965, and the picture here is even more encouraging. Average hourly earnings for blue-collar workers increased by 6.9 percent over the past year. Except for the aforementioned compositional distortions to the workforce that occurred in the spring of 2020, you would have to go back 40 years to find a more robust increase in worker wages.

That said, while workers in the lowest paying sectors, such as leisure and hospitality and retail, had been getting the most substantial wage increases, that changed in January as wage gains for this cohort slowed. In contrast, professional and business services, education and health services, financial activities, and information saw more buoyant monthly wage gains, signifying that wage growth is spreading more broadly. With the focus resting squarely on inflation and wage dynamics, the pop in wage growth will no doubt catch the attention of Federal Reserve officials and provide them with more ammunition to raise rates in March. That's also captured the attention of bond investors, who are driving up long-term yields. The 10-year Treasury note closed on Friday, yielding 1.92 percent, the highest since late 2019.

Needless to say, following the jobs report on Friday, the discussion in the markets immediately shifted to the Federal Reserve. The key question was whether the blockbuster increase in jobs and elevated wage increases would spur the Fed to accelerate the move towards a tighter policy stance. After all, the 0.7 percent increase in average hourly earnings in January translates into an 8 ½ percent annual gain. With productivity growth estimated at 1 ½ - 2.0 percent this year, that means companies would need to raise prices by close to 7 percent to cover the increase in labor costs. Whether they could make such increases stick is another question, but the Fed would clearly not tolerate the prospect of a 7 percent inflation rate this year.

At its last policy meeting, the Fed signaled that it would raise rates four times this year in quarter-point increments after it stops its bond-buying program in March and that it would start reducing its balance sheet shortly after that. Some considered that an aggressive plan earlier last month, but the jobs report quelled that concern. Now the concern is that the Fed has fallen too far behind the inflation curve, and steeper rate increases are needed to bring it under control. More market participants now expect a 50 basis point increase in March and six or seven increases over the course of 2022. While the heightened risk of a more hawkish policy certainly makes sense after the jobs report – particularly if next week's consumer price report also blows through expectations – we doubt that the Fed would hike by 50 points at the March meeting. For one, it would only have one month of additional data to digest. For another, a rate increase that size might actually spook the market into thinking the Fed is panicking that it lost control of inflation. That said, if inflation and job growth continue to exceed expectations beyond March, the odds of a 50-point hike in June would undoubtedly increase, as would the pace of increases over the second half of the year, including the possibility of monthly hikes instead of the quarterly increases currently projected by the Fed.

FINANCIAL INDICATORS				
INTEREST RATES	February 4	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.23%	0.20%	0.10%	0.03%
6-month Treasury bill	0.55	0.43	0.12	0.05
3-month LIBOR	0.32	0.30	0.23	0.19
2-year Treasury note	1.32	1.16	0.84	0.09
5-year Treasury note	1.77	1.62	1.50	0.47
10-year Treasury note	1.92	1.77	1.77	1.19
30-year Treasury bond	2.21	2.08	2.12	1.97
30-year fixed mortgage rate	3.55	3.55	3.23	2.73
15-year fixed mortgage rate	2.77	2.80	2.43	2.21
5/1-year adjustable rate	2.71	2.70	2.41	2.78
STOCK MARKET				
Dow Jones Industrial Index	35089.74	34725.47	36231.66	31458.4
S&P 500	4500.53	4431.85	4677.03	3934.83
NASDAQ	14098.01	13770.57	14935.90	13856.30
Commodities				
Gold ($ per troy ounce)	1808.30	1792.90	1796.70	1802.95
Oil ($ per barrel) - Crude Futures (WTI)	91.94	87.31	78.95	55.39
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (January)	57.6	58.8	60.6	59.7
ISM Services Index (January)	59.9	62.3	68.4	63.7
Nonfarm Payrolls (January) - 000s	467.0	510.0	647.0	541.0
Unemployment Rate (January) - Percent	4.0	3.9	4.2	4.4
Average Hourly Earnings (Jan.) - % change	0.7	0.5	0.4	0.5