SMITH AFFILIATED CAPITAL

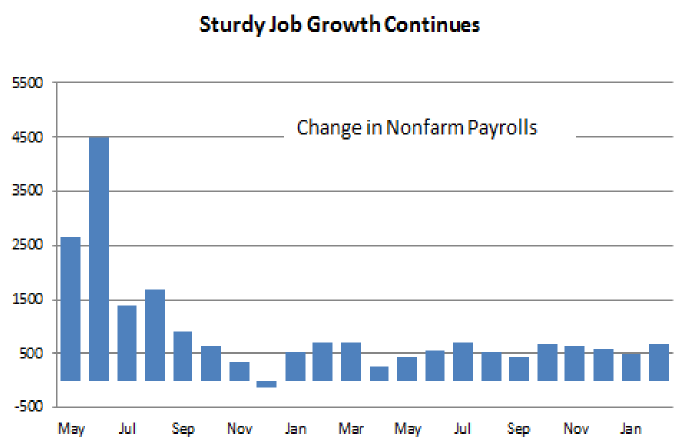
WEEK OF MARCH 4, 2022

# WEEKLY ECONOMIC COMMENTARY

Amid the darkness on the Russian/Ukraine front, a ray of sunshine brightened the U.S. economic landscape this week. On Friday, the Labor Department reported that the economy generated another blockbuster jobs increase in February and, once again, revised up the employment gains previously reported for December and January. It's always a fun – but hapless – practice in sports to second-guess a manager's decision made during the heat of a game. We wonder, however, if the Federal Reserve would have been so patient about withdrawing monetary stimulus back in November and December if it had the jobs data in hand that it has now.

Recall that job growth appeared to be slowing markedly in the fall, as original estimates showed nonfarm payrolls slid from 531 thousand in October to 199 thousand in November and 210 thousand in December. The Fed had every reason to be cautious about prematurely withdrawing stimulus, particularly as Omicron had just replaced the fading Delta variant of Covid-19, and its alarmingly rapid spread threatened to put the kibosh on activity. In hindsight, those fears turned out to be not only unfounded but were also nurtured by false signals. True, there has been a slowdown from the upwardly revised job growth of 677 thousand in October. But the revisions for November and December were even more striking, putting the job gains for those months at 647 thousand and 588 thousand, respectively. So what seemed to be a sharp drop-off turned out to be a barely perceptible slowdown from a breakneck pace.

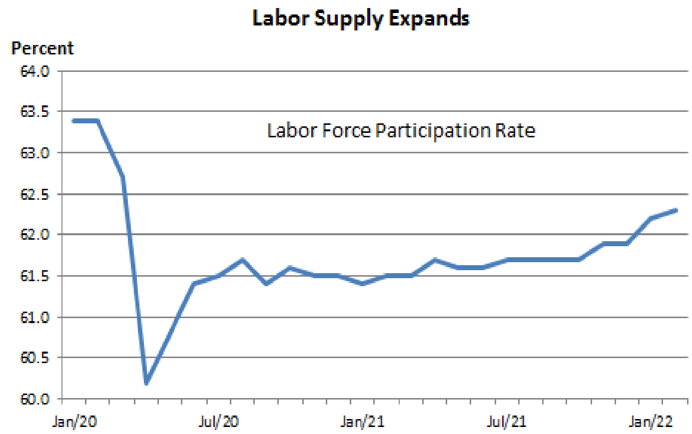
More to the point, Friday's jobs report revealed that the economy's job-creating engine is still running on all cylinders. In February, nonfarm payrolls increased by a muscular 678 thousand, more than 200 thousand above the consensus forecast and the most substantial gain since last March. At the risk of being repetitive, the previous estimate for January was also revised up by 18 thousand jobs, putting the three-month average for job growth at a robust 582 thousand. Over the twelve months through January, job growth averaged 559 thousand, so there are no signs yet that the red-hot labor market is cooling. Indeed, the ongoing break-neck pace of job creation would seem to belie the widespread labor shortages that are the primary complaint in so many industries.




Which, in turn, raises the question, where are the jobs coming from? The answer is – just about everywhere. Fully 76.6 percent of private industries added staff last month; except for a slightly higher 76.8 percent last March, that's the broadest swath of industries expanding payrolls since December 1997. Not surprisingly, with the rapid decline in Omicron case counts, employment in services is pacing the gains. People are more comfortable coming out of their homes and engaging in in-person activities, and the hospitality sector is responding by beefing up staff. Hence, jobs in leisure and hospitality increased by a sturdy 179 thousand in February, building on the substantial gains in recent months as health fears steadily fade. Builders are also responding to the ever-strengthening demand for new homes, spurring a robust 50 thousand increase in construction jobs—the strongest in a year.

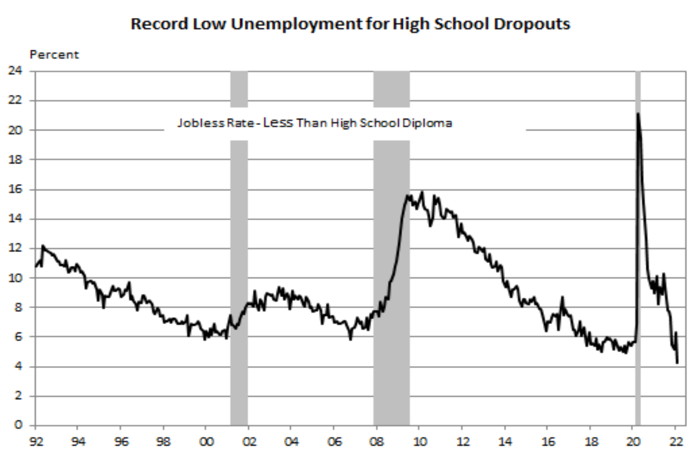
Most encouragingly, health care workers are returning. This critical sector has experienced acute labor shortages because health concerns have pushed these front-line workers to the sidelines. With the improved health situation, they are now coming back. The economy added a robust 94 thousand healthcare jobs last month, more than triple the three-month average pace of 30 thousand. Barring a resurgence of the pandemic, this trend should continue in the months ahead and help a much-needed expansion in the labor force, further easing the labor shortage as well as upward pressure on wages. There is still a ways to go before the labor force participation rate returns to its prepandemic level of 63.4 percent. But the rate increased to 62.3 percent in February, which is the highest since the onset of Covid-19 in February 2020.

To be sure, demographic trends and early retirements indicate that the participation rate will not return to its previous peak. But the rate among the prime-age segment of the population, the 25-54 age range, has been steadily climbing and, at 82.2 percent in February, is closing in on the 83.3 percent prepandemic level. What's more, the surge in early retirements is abating. After a long and steep decline, the participation rate among workers 55 and over increased to 39.1 percent in February from 38.4 percent in November. We suspect that many early retirees are being lured back to the workforce by attractive pay packages, reduced health fears, and a diminished financial cushion, as accumulated savings from pandemic-era benefits are running out.




But while the labor force participation rate is grinding slowly upwards, workers are rapidly reclaiming their massive job losses during the worst of the pandemic in 2020. Of the 22 million jobs purged in March and April of that year, only 2.1 million remain unclaimed. At the current pace of job growth, that shortfall would be made up by June. And depending on how fast the labor supply expands, the number of unemployed job seekers should also dwindle. The unemployment rate fell to 3.8 percent in February, only a tad above the 3.5 percent prepandemic low. And the tightening job market is benefiting all racial, ethnic, and less-educated groups. The unemployment rate for Black, Hispanic and Asian American workers all fell. What's more, the jobless rate for workers with less than a high-school diploma fell to 4.3 percent in February, the lowest since records started for this group in 1992.

The strong demand for workers amid a labor supply that is only grudgingly expanding puts upward pressure on wages. However, in one of the only downbeat aspects of the February jobs report, earnings for all private-sector workers failed to increase for the first time in over a year following a robust 0.6 percent advance in January. This setback may reflect artificial strength in January rather than weakness in February, as some 28 states raised the minimum wage in the first month of the year. Many companies in the private sector, flush with record profits, handed out big bonuses, particularly for higher-wage earners. Indeed, nonmanagement workers, who generally do not partake in generous bonus pools, did see their average hourly earnings increase by 0.3 percent last month. However, that too was the weakest gain in a year.




Importantly, with earnings unchanged last month, workers have a more challenging time keeping up with inflation. Over the year through February, average hourly earnings increased 5.1 percent, down from 5.5 percent in January. We will be getting the consumer price report for February next week. Still, it is expected to show an annual rate of inflation close to 8 percent, which indicates that worker purchasing power would shrink by about 3 percent. That said, nonmanagement workers would fare somewhat better, as their 0.3 percent earnings increase last month kept the annual gain at 6.1 percent, the same as January. What's more, the workweek ticked up by 0.1/hr, which, combined with the muscular gain in employment, more than offset the weak earnings change, imparting a sizeable 0.8 percent boost to overall labor income.

No doubt, the Federal Reserve welcomed the cooling-off of worker earnings last month, as it suggests some easing on price pressures from rising labor costs. But any relief is likely to be short-lived as long as the demand for workers remains as strong as it is and labor supply fails to catch up. There was still a record 3.8 million more job openings than applicants in January, so the incentive to offer higher pay to attract workers is still strong. And even as labor shortages have given workers more bargaining power, unionization efforts are also gaining traction, which could add muscle to that trend. From our lens, the latest jobs report, notwithstanding the weak earnings change, strengthens the Fed's commitment to start raising rates at its next meeting on March 15-16.

What's more, the heightened military conflict in Ukraine adds to the supply disruptions that are exacerbating inflation, particularly as it affects such critical commodities as oil, food, and industrial materials, as manifested by the skyrocketing price of aluminum. At the same time, the war has injected an unwelcome dose of uncertainty into the economic landscape that Fed Chair Powell duly acknowledged in his congressional testimony this week. While Powell noted that the conflict would not deter the Fed from its expected initial rate hike of 25 basis points at the upcoming meeting, he also recognized the need to be cautious and nimble given the uncertainty created by the Russian invasion. That uncertain feeling is clearly roiling the financial markets as stock prices have tumbled since the onset of the war, and a flight to quality has taken hold. The bellwether 10-year Treasury yield fell by about 25 basis points this week to 1.73 percent on Friday, erasing some of the tightening of financial conditions that the Fed is striving to achieve. If nothing else, the escalating war in Ukraine will make it even harder for the Fed to bring about a soft landing for the economy.

| | FINANCIAL INDICATORS | | | |
|---|---|---|---|---|
| INTEREST RATES | March 4 | Week Ago | Month Ago | Year Ago |
| 3-month Treasury bill | 0.33% | 0.32% | 0.23% | 0.04% |
| 6-month Treasury bill | 0.64 | 0.69 | 0.55 | 0.07 |
| 3-month LIBOR | 0.58 | 0.51 | 0.32 | 0.19 |
| 2-year Treasury note | 1.49 | 1.58 | 1.32 | 0.14 |
| 5-year Treasury note | 1.64 | 1.87 | 1.77 | 0.79 |
| 10-year Treasury note | 1.73 | 1.97 | 1.92 | 1.56 |
| 30-year Treasury bond | 2.16 | 2.28 | 2.21 | 2.28 |
| | | | | |
| 30-year fixed mortgage rate | 3.76 | 3.89 | 3.55 | 3.02 |
| 15-year fixed mortgage rate | 3.01 | 3.14 | 2.77 | 2.34 |
| 5/1-year adjustable rate | 2.91 | 2.98 | 2.71 | 2.73 |
| | | | | |
| STOCK MARKET | | | | |
| Dow Jones Industrial Index | 33614.80 | 34058.75 | 35089.74 | 32778.64 |
| S&P 500 | 4328.87 | 4384.65 | 4500.53 | 3943.34 |
| NASDAQ | 13313.84 | 13694.62 | 14098.01 | 12920.15 |
| | | | | |
| Commodities | | | | |
| Gold ($ per troy ounce) | 1974.90 | 1890.10 | 1808.30 | 1696.25 |
| Oil ($ per barrel) - Crude Futures (WTI) | 115.00 | 91.94 | 91.94 | 62.29 |
| | | | | |
| ECONOMIC INDICATOR | Latest Month/Quarter | Previous Month/ Quarter | Two-Months/ Qtrs Ago | Average-Past Six Months or Quarters |
| ISM Manufacturing Index (February) | 58.6 | 57.6 | 58.8 | 59.5 |
| ISM Services Index (February) | 56.5 | 59.9 | 62.3 | 62.7 |
| Nonfarm Payrolls (February) - 000s | 678 | 481 | 588 | 583 |
| Unemployment Rate (February) - Percent | 3.8 | 4.0 | 3.9 | 4.2 |
| Average Hourly Earnings (Feb) - % change | 0.0 | 0.6 | 0.5 | 0.4 |