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MARCH 2024

## A rule of thumb for the US labour market

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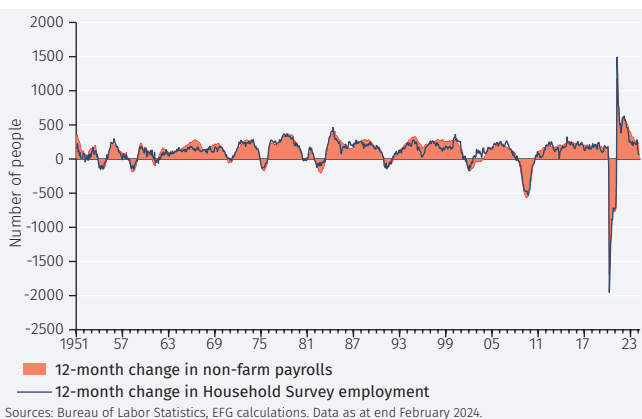
## A RULE OF THUMB FOR THE US LABOUR MARKET

The latest US labour market report released on 8 March contained mixed messages. While the headline change in non-farm payrolls was much stronger than expected, the previous month's data was revised significantly lower and there was an increase in the unemployment rate. With so much information contained within the report, it can be difficult to interpret. Daniel Murray reviews the data in this edition of *Infocus* and suggests a rule of thumb for thinking about the state of the US labour market.

The monthly US labour market report (*The Employment Situation*) is one of the most closely-watched statistical releases and markets can experience dramatic shifts dependent on the data that are published. However, there is a vast amount of information contained in the report so it can be difficult to know which data to focus on. Furthermore, the numbers can be volatile from month-to-month. It is therefore useful to think about the longer-term characteristics and to view each release in that context.

The most heavily-watched data point within the monthly report is the headline change in non-farm payrolls. This is derived from the *Establishment Survey*, which asks companies how many people they employ. Separately, there is the *Household Survey*, which asks individuals whether they are employed and from which the unemployment rate is derived. The two can deliver starkly different messages in an individual month. For example, in the latest report non-farm payroll employment increased by 275,000 while household employment declined by 184,000. However, as one would expect, they line up well when the comparison is over 12 months, as shown in Figure 1.

### 1. Change in non-farm payrolls vs. change in household employment



The change in non-farm payrolls is important in terms of its influence on monetary policy decisions. The Fed has indicated that it thinks the labour market is tight although in better balance than it was. In conjunction with elevated inflation, this

has been a decisive factor in the Fed tightening policy. A critical question therefore relates to what change in non-farm payrolls is consistent with stability in the labour market.

If the change in non-farm payrolls is less than this threshold then the labour market will be getting looser, something that may encourage the Fed to consider easing policy. If the change in non-farm payrolls is above the critical threshold, this will give the Fed greater cause for concern that labour market conditions are getting tighter. Thinking about the labour market in relation to that threshold also provides valuable information on the state of the economy. If the change in non-farm payrolls is consistently below the critical level then this is a strong indication that economic growth is slowing.

Firstly, note that the US working age population has been growing at a compounded annual rate of around 0.7% per annum over the last five years. The US working age population is currently around 267.9 million. If the population of working age grows at the same rate over the next year as it has over the previous few years, it would grow by an additional 2.0m people.

Next, it is necessary to make an assumption about the participation rate. That is, what proportion of the working age population are either in work or unemployed and actively looking for a job. The latest *Employment Situation* report for February shows the participation rate at 62.5%. Moreover, this has been surprisingly stable over the past few years. If this remains broadly unchanged over the next year then the labour force would grow by 1.2m people.

The final step in the calculation estimates how many jobs would need to be created for the unemployment rate to remain unchanged. The unemployment rate is currently 3.9%, which implies that an additional 1.2m people would need to be employed over the course of the next year for the unemployment rate to neither increase nor decrease. This equates to a monthly increase in employment of 98,000 people, which is the all-important threshold level.

Figure 2 illustrates the calculation:

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## 2. Threshold calculation

Threshold calculation ('000 people and %)		
Population of working age end Feb-24 [A]	267,882	267,882
Assumed growth rate [B]	0.7%	1.0%
Population of working age end Feb-25 [C = A x (1+B)]	269,836	270,560
Change in population of working age [D = C - A]	1,955	2,679
Participation rate [E]	62.5%	62.5%
Implied change in labour force [F = D x E]	1,222	1,674
Unemployment rate [G]	3.9%	3.9%
Implied change in employment to keep unemployment rate unchanged [H = F x (1 - G)]	1,175	1,610
Monthly equivalent [I = H/12] = THRESHOLD	98	134

Source: Bureau of Labor Statistics, EFG calculations. Data as at end February 2024

There are a number of moving parts to this calculation that could change the threshold level. For example, if the working age population grows faster or slower than assumed or if the participation rate changes. For reference, for every 0.1% increase in the growth rate of working age population, the monthly threshold level increases by 13,000. The five-year compound annual growth rate (CAGR) of the US labour force prior to the covid crisis was around 1.0%. If that is used instead of 0.7% it would suggest a current threshold level of around 134,000 (also shown in the table). Trivially, every 1% increase in the participation rate increases the monthly threshold level by just 2,000.

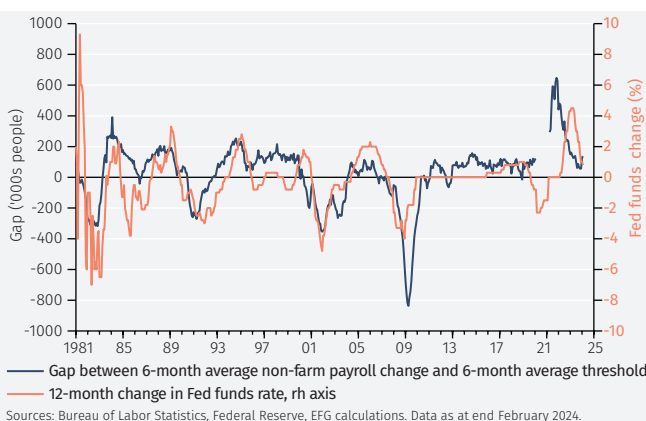
Figure 3 shows the close relationship with Fed policy. The chart highlights how the Fed funds rate has tended to increase when non-farm payrolls are increasing by more than the threshold and decrease when non-farm payrolls are below the threshold.<sup>1</sup> Because the data can jump around from month to month, six

month moving averages of the change in non-farm payrolls and the estimated threshold level are used – this gives a better indication of the underlying state of the US labour market whilst eliminating some of the noise. The correlation coefficient between the 12-month change in the Fed funds rate and the non-farm payrolls-threshold gap is 53.0%.<sup>2</sup>

### Conclusion

The US labour market is complicated and these numbers should not be taken as being overly precise. Furthermore, the Fed looks at a range of factors – not least inflation, measures of labour demand and labour market trends - when considering whether or not to change its policy. And we should not obsess too much over a single month's data. However, if over a period of a few months we see the change in non-farm payrolls consistently higher or lower than the threshold level identified in this report – currently around 100,000 to 130,000 per month – then it will be a good indication of a change in labour market conditions. That, in turn, may be a significant factor in influencing Fed policy and market sentiment.

### 3. 12-month change in Fed funds and the threshold gap



<sup>1</sup> The analysis assumes 0.7% growth in the working age population. It is notable that rates were at the zero lower bound for a prolonged period of time following the Global Financial Crisis in 2008/09. Furthermore, the covid crisis in 2020/21 also contributed to an unusual economic and policy environment.  
<sup>2</sup> To avoid the distorting impact of covid on the analysis, the 12-month period between March 2020 and March 2021 is excluded from the sample.

