US Labour Market : the Plot Thickens

- The market is unconvinced by the strong payroll. We can see reasons why job creation might be overstated at the moment, but the pace probably remains too quick for the Fed to deliver the pivot the market is after.
- We are prudent on the lower inflation print in the Euro area.
- We explore Olivier Blanchard's piece in the FT about revising up the central banks' inflation target Key point.

The market chose last Friday to look through another strong headline payroll for November, probably considering there was too much ambiguity in the details of the release. Yet, while we can see why the Establishment survey might be overstating job creation at the moment – we explore the adjustment for disappearing/emerging firms as a potential source - it's also likely that the "true" pace is still too slow to bring about a quick disinflation.

The fact that the "quits ratio" is still almost 2 standard deviations above its long-term average is testament to the lingering tension on the labour market and the re-acceleration in wages, even a "statistically fragile" one, comes right in time to justify Jay Powell's line. His mixture of caution – "going at it" more slowly – and determination – making it plain the Fed is not on the brink of a pause – is probably exactly what's needed in the current environment, which is indeed uncertain, but still inconsistent with a swift return to 2% inflation. The market continues to price rate cuts for the second half of 2023 (we expect them for 2024), but we see this as inconsistent with the current pricing of the terminal rate – slightly - below 5% (5% is our baseline but with a balance risk tilted to the upside). Indeed, rate cuts could be easily envisaged as a response to policy overshooting, but a terminal rate below 5% would not necessarily qualify as "over-restrictive" given the current resilience in the data.

The Euro area finally had its lower-than-expected inflation print as well, although the lack of details at this stage makes it difficult to ascertain whether this is more "signal" than "noise. Still, as fragile as it is the November inflation print may help the ECB to move its pace of tightening to 50 basis points "only" in December.

Finally, we discuss Olivier Blanchard's column in the FT arguing for an upside revision in the central banks' inflation target. This may be more fruitful in the US than in the Euro area.

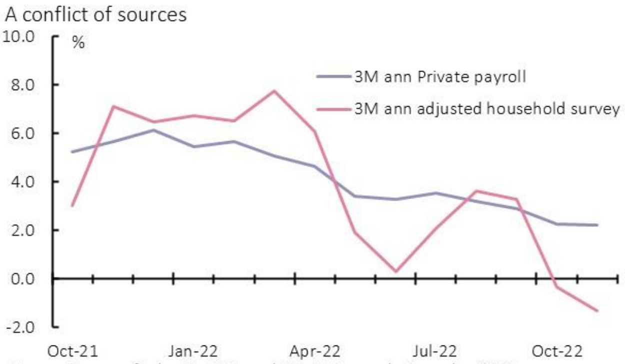
Ignoring potholes on the road

We wrote last week that the market rally of the last few weeks was overly dependent on a small number of data prints, that it could easily flip and that there are only so many strong United States (US) payrolls that it can take on the chin. Markets were however quite resilient after the release of the higher-than-expected payroll last Friday. After initially giving ground, the S&P500 index ended up only 0.12% down on the day, barely denting the nearly 10% rebound on the month. 10-year Treasury yields also fell on the day, ending below 3.5% after a brief spike to 3.65%. It may well be that **investors chose to look through the headline number and considered there were too many surprising details in the release to dispose of their belief in a "dovish pivot" by the Federal Reserve (Fed).**

Rather than obsessing over the monthly figure, we continue to prefer looking at the short-term trend, here the 3-month annualized change in employment, and even with this precaution the numbers for the most common gauge of job creation in the US remain very robust. Indeed, the deceleration in job creation as per the establishment survey has become almost impossible to see (2.2% in November from 2.3% in October in the private sector) and remains far too high to qualify as a proper landing, even a super soft one. **The message from all data sources remains ambiguous though (see Exhibit 1), and this probably explains the market equanimity**. Indeed, the household survey reported a net destruction of jobs for the second month in a row. As we noted a month ago, short-term divergences between the two surveys are not uncommon, but the correlation on the 3-month annualized change has historically been very high (R2=0.89) which makes the persistent divergence intriguing.

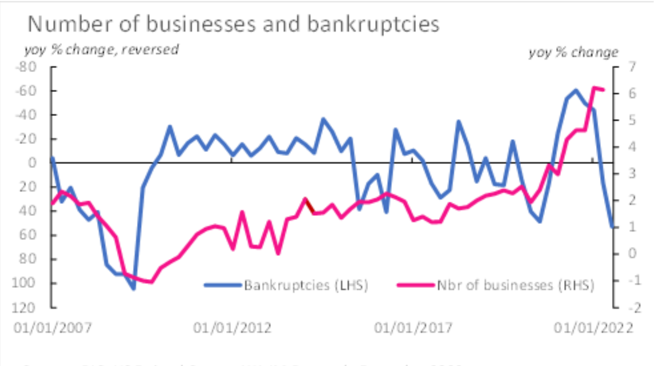
Any attempt at explaining the wedge is highly conjectural, given the high propensity of the payroll data to be revised, which might be made more acute by the particularly high proportion of firms in the Establishment survey sample which did not provide data for November (50.6%, the highest rate since 2002). **There is however a possibility that the Establishment survey currently overstates job creation because of the way it deals with the net flow of disappearing and emerging businesses**.

Exhibit 1 – The divergence continues



Source: Bureau of Labor Statistics and AXA IM Research, December 2022

Exhibit 2 – Something in the net flow of firms



Sources: BLS, US Federal Courts, AXA IM Research, December 2022

Indeed, it can take several months for new firms to start declaring jobs and make it to the sample, which would then constantly understate job creation. To correct for this bias, the Bureau of Labor Statistics (BLS) chose to be symmetric and ignores "on the other side" the job losses triggered by firms going out of business. It then adds a "residual effect" on employment from business birth/death dynamics based on an econometric model estimated on the actual number of existing firms according to the Quarterly Census of Employment and Wages. The BLS has to use this estimated approach rather than the actual net number because of a one-quarter lag in the availability of the data (the latest we have for now from the census date back to Q2). We can try – tentatively – to fill that gap by comparing the quarterly census data with the number of bankruptcies filed in federal courts for which we have fresher data (see Exhibit 2). The steep rise in bankruptcies during the Great Financial Crisis of 2008-2009 coincided with the swift decline in the number of existing businesses. After bankruptcies stabilized, the number of existing businesses predictably increased regularly between 2010 and 2019. Then, the pandemic triggered a massive decline in bankruptcies, reflecting the magnitude of the monetary and fiscal support, and the number of firms duly accelerated. The decline in bankruptcies continued into

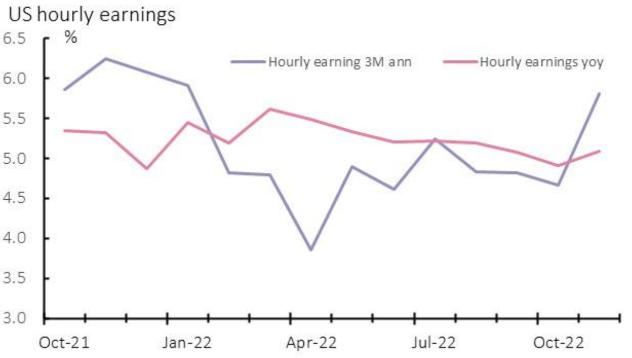
Q2 2022, before shooting up in Q3, which makes it likely that the number of firms will decline or at least stabilize in the quarterly census when it becomes available for Q3 as well, but this is not yet impacting the establishment survey. This means there might be a good reason to take the latest headline payroll with a pinch of salt. This, combined with the message from other sources – such as the rise in continuing jobless claims and the job openings and quits ratio (see Exhibit 3) – suggests **the labour market is actually softening probably faster than what the establishment survey suggests.**

Yet, it's also likely that the "true" pace is still too slow to bring about a quick disinflation. The fact that the "quits ratio" is still almost 2 standard deviations above its long-term average is testament to the lingering tension. The "great resignation wave" is not yet over, and this is likely to continue fostering strong wage gains. The November payroll batch also came up with an acceleration in earnings, far exceeding consensus. The 3-month annualized growth rate for wages is now back to its early-year level (see Exhibit 4). Again, prudence is needed, since the wage data suffer from some of the same flaws as those on job numbers – in particular the very high "no response ratio". Yet, as disappointing as it is for those who were expecting a swift Fed pivot, **the re-acceleration in wages, even a "statistically fragile" one, comes right in time to justify Jay Powell's line at his speech and interview with the Brookings institution last week**. His mixture of caution – "going at it" more slowly – and determination – making it plain the Fed is not on the brink of a pause – is probably exactly what the doctor would prescribe in the current environment, which is indeed uncertain, but still inconsistent with a swift return to 2% inflation.

Exhibit 3 – In the right direction, but slowly

Source: Bureau of Labor Statistics and AXA IM Research, December 2022

Exhibit 4 – Data may be fragile, but wage growth is up



Source: Bureau of Labor Statistics and AXA IM Research, December 2022

What's new in the Brooking interview?

There was no real innovation on the policy stance message: Powell expanded on the three points he has been making for several months, which for some reason the market refuses to fully hear. First, the pace of tightening is about to slow down – although he gave himself some wiggle room, he telegraphed quite clearly that on 14 December, the Federal Open Market Committee (FOMC) would converge around a 50-basis points hike. That message had been already fully bought by the market. Second, he repeated that the Fed still has some ground to cover before getting to the terminal rate. Third, they may have to stay there quite some time to make sure the inflation beast has been properly killed. Despite the clarity of the message *("History cautions strongly against prematurely loosening policy. We will stay the course until the job is done")* there is still "noise on the line" between the Fed and the market on these last two points, especially the last one. The market currently expects a terminal rate of 4.9% and the beginning of rate cuts – 50 bps – before the end of 2023.

The Fed boss is not engaging in a direct debate with investors on market pricing – unlike the Bank of England which has explicitly stated that it considers that the current market pricing is too low – but **in our view the probability of rate cuts in H2 2023 in the US is a positive function of the terminal rate**. Indeed, a quick return to accommodation would probably be the product of some overshooting in the first half the year generating a faster-than-expected disinflation. Would stopping below 5% be consistent with an over-restrictive territory given the likely macro configuration by the spring of 2023? True, this would still be nearly twice the Fed's own estimate of the neutral rate, but 4.9% is only a stone throw from what was the terminal rate in the September "dot plot" already (4.6%) while the Fed's communication since then has pointed to a higher median terminal rate in the next batch of FOMC forecasts in December. **Given the resilience in the data flow so far, it's now difficult to argue that the Fed's preferred trajectory is definitely an overshooting one**. There is always the possibility of "non -linearities" – that the real economy and especially the labour market "snap" past a certain threshold of monetary restriction, but these are notoriously difficult to forecast. We continue to be conservative on this one and don't expect the Fed to cut before 2024.

Beyond the already well-trodden presentation of the likely policy stance Powell got into a discussion of the sources of inflation and offered that so far wages had not been the main cause of the acceleration in consumer prices but may well become crucial ahead. Our interpretation, looking at how service prices had accelerated recently, was that it had already started in earnest, but Powell's willingness to see this as the next big thing may be a strong indication that from now on, it's the labour market rather than "excess demand" in general, or the observed inflation rate which will be the Fed's main compass. This gets us back to a point we made several months ago. Central banks are dealing with two major uncertainties on the domestic front. One, the speed at which aggregate demand will respond to the monetary policy tightening. Second, the speed at which employment and then wages will react to the slowdown in aggregate demand. It may well be that labour supply scarcity is pushing businesses to engage in labour hoarding: they maintain an excessive level of employment relative to demand because they don't want to take the risk of being unable to fill positions when the recovery kicks in. **Even if the labour market data is getting more difficult to read, the Fed is likely to err on the side of caution and tolerate a very significant deterioration in demand if this is what it takes to finally obtain the desired landing of employment and wages.**

Some slowdown in Euro area inflation

The Euro area finally had its lower-than-expected inflation print as well, although the lack of details at this stage makes it difficult to ascertain whether this is more "signal" than "noise". Headline inflation hit a still spectacular 10.0% year-on-year in November, while the market consensus stood at 10.4%, a visible deceleration (10.6% in October). Most of the decline came from energy, but the pass-through from wholesale to retail prices can be quite erratic in this sector, in part because of government action, and the European Central Bank (ECB) is likely to focus on the fact that core inflation was unchanged at 5% year-on-year, and on that indicator, there was no misalignment from consensus. **After four months of impressive rise on core, a stabilization is of course good news, but prudence is de rigueur**. The deceleration in services inflation at the Euro area level (4.2% after 4.3%) may have been overly impacted by the German data (where it declined from 4% to 3.7%yoy) with the usual risk the proverbially volatile "package holidays" did a lot of the move.

Still, as fragile as it is the November inflation print may help a majority of the Governing Council to move its pace of tightening to 50 basis points "only" in December. The central bank has been communicating on its willingness to be data dependent for the calibration of the next hikes, and upside surprises on inflation in the last few months had been explicitly mentioned as an input in the decision to resort to 75 bps hikes. The ECB should be symmetric in its data dependency: a downside surprise on inflation, however patchy, should count towards being more prudent on the desired pace of policy tightening.

What then once inflation lands?

Given all the qualifiers we have added to the tentative disinflation which is currently emerging in the Euro area, and the news on the US labour market, it may sound strange to be already thinking about the central banks' reaction function when inflation hits 3%. We have ample time. Still, this is what Olivier Blanchard is inviting us to do in his Op Ed in the Financial Times (FT) last week, and we could not resist taking the bait.

Blanchard already proposed in 2010 to revise up the central banks' inflation target to 4%. He is now putting a more modest move to 3% on the table, but he seems to be more confident that this time he will be heard. He has a point. Indeed, one of the key elements in his Op Ed is that unlike in the previous decade when inflation was stubbornly refusing to exit from a pitiful 0 to 1% range, in the current configuration, central banks will be landing back towards their target "from the upside". **Once inflation is back to 3%, will central banks consider that doing "whatever it takes"**

to push it down further to 2% is really worth it given the additional pain it would be forced to inflict in terms of growth and employment to get there, especially if we have already had to go through a recession in 2023, and fiscal policy is becoming restrictive, partly in reaction to the higher level of interest rates?

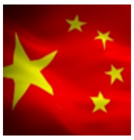
The honest answer to this is "it depends", in our view. A central bank would have to balance the immediate macro cost of taking the real economy further down with the medium to long-term cost of allowing inflation expectations to de-anchor – which a shift in the central bank's target could trigger – resulting in the need to engage in properly crippling rate hikes down the road. Blanchard argues that new evidence suggests that an observed inflation rate at 3% rather than 2% has little impact on households' expectations. In any case, our understanding is that **what he proposes is an upward shift in the inflation target "by stealth"** (his point at the end on "*I would be surprised if central banks officially moved the target, but they might decide to stay higher than it for some time and maybe, eventually, revise it*"). We don't want to put words in his mouth, but we understand this as a configuration in which, rather than publicly announcing that it will pursue 3% rather than 2%, the central bank would simply stop engaging in additional restriction once inflation is on track to 3%. This would give them cover to check "how things are going". If the central bank were to determine that allowing inflation to stay at 3% is too much of a risk, it could always reverse course and resume hiking after the observation pause without losing credibility.

This is a quite tempting approach. It would force some "interesting gymnastics" though. Technically central banks could not wait until inflation is observed at 3% to stop adding restriction since, given the transmission lags, they would probably get inflation below their new, implicit target. As long as they refuse to *explicitly* change the target, they would also need to "pretend", especially in their forecasts. They would basically still have inflation back to 2% at the end of their forecasting horizon, rationalizing it by arguing that the lagged effect of the cumulative rate hikes would be sufficient to get there without additional restriction. Would it feel "iffy"? Possibly in principle, but **in practice, the ECB for years published forecasts which invariably had inflation getting back to 2% although failing year after year to reach this "from the downside". The symmetric pattern may not be more costly to their credibility.**

Such an approach "by stealth" would however, in our opinion, be more readily implemented by the Fed than by the ECB, and probably even in an "unconscious manner". Given the Fed's traditional attention to its "twin mission" – fostering full employment and price stability - even if the latter has taken the ascendency for decades, it may not be difficult to find a majority of FOMC members who will genuinely think that enough has been done on restriction, at great cost for the real economy, and who will get increasingly worried of overshooting and will hence produce low inflation forecasts. Since the public focuses on the forecast of the Fed's FOMC "median member", getting a majority on board would be enough to send those messages. The ECB's forecasting exercise is in practice more centralized, even when national central banks contribute. But the main difference may be more "cultural". Indeed, the inclusion of an explicit, quantified inflation target at 2% is still relatively new at the Fed (January 2012), while it has been an article of faith at the ECB since inception in 1999, even if the wording has changed to make it more symmetric. True, the European Treaty mentions "price stability" as the ECB's mission while allowing the central bank to define it in practice, but **the intra-Euro area tension which would result from an explicit or implicit abandonment of the 2% target could be quite significant.**

Note finally than in Blanchard's Op Ed, shifting the inflation target from 2% to 3% would not be a "free lunch". The main advantage he sees in this move is that it would reduce the probability to see the central bank facing the zero limit in bad times, since the *average* nominal interest rate would also gradually rise to be commensurate with the new inflation target. There would thus be in principle less need to resort to unconventional policy. Contrary to a popular view, shifting the inflation target moderately up would not necessarily result in the sort of "ultra-lax" monetary policy which financial investors are often yearning for.

While this is very speculative, a situation in which the Fed would move its inflation target up and not the ECB would be interesting. True, the US would over time lose competitiveness relative to Europe, but this has rarely driven the euro-dollar exchange rate movements. European investors – who care about returns compared to their *domestic* inflation – would be incentivized to invest in US securities given the further widening in the average interest rate differential – which could actually push the dollar up.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Labour market. Payrolls rose by 263k, unemployment was at 3.7% while earnings rose by 0.6% on the month. JOLTs dipped and Challenger job cuts soared • Saving rate (Oct) 2.3% - h'holds unwind excess saving • GDP (Q3) revised up to 2.9% (saar) from 2.6% • Chic PMI (Nov) hit recessionary 37.2, ISM firmer 49.0 • Congress moves to impose deal and avert rail strike	• PPI inflation (Nov) further falls expected contributing to easier outlook for CPI inflation, particularly goods • Continuing claims – on a rising trend and highest since February 2022 • Michigan 5-10y inflation expectations (Dec, p) – stabilising around 3%? • Non-mfg ISM index - slowdown beyond manufacturing?
	• EMU headline inflation fell to 10%yoy, mostly driven by important energy prices decline in the Netherlands Spain and Belgium. Core is unchanged at 5% • EMU Producer price down to 30.8%yoy from 41.9% • EC surveys slightly improved in services; consumer confidence was flat but industrial sentiment fell again • Labour market is resilient (Urate down to 6.5% (-0.1pp)	• Final PMIs across countries and at EMU level • EMU October retail sales expected to fall by 1.7%mom • Watch last speeches of ECB members before December meeting (15th). Both hawks and doves can pick up what they want in last HICP print but we believe probability of a 75bp hike has lowered • EMU employment and GDP details for Q3
	• Housing market slows following fallout post mini-Budget Nationwide house prices (Nov) fall 1.4%mom • CBI survey (Nov) rising number of retailers reported a fall in sales in the year to Nov • Sunak signals end of "golden era" in UK-China relations in speech at Lord Mayor's Banquet	• Final PMIs (Nov) • Halifax house prices (Nov) expect to mirror recent nationwide decline in house prices • RICS housing survey (Nov) • BRC retail sales (Nov)
	• u/rate (Oct) remained flat in Oct • Retail sales (Oct) continues to recover 0.2%mom • Weakening tech output dragged IP (Oct) falling 2.6% • MoF corporate survey showed strong increase in capex 11.5%qoq saar	• Tankan manufacturing index (Dec) • Current account balance (Oct) • Final GDP (Q3) • Households spending data (Oct)
	• COVID cases moderate from record highs • Beijing responds to social unrest by pledging to ease excessive tightening • Local governments in Guangzhou, Beijing and Shanghai relax social restrictions, reduce PCR testing and loosen quarantine arrangement • Beijing reportedly aims to lift elderly vaccination rate to over 90% by end-January	• Trade activity (Nov) to reflect softening global and domestic demand • Price pressure (Nov) eases particularly at consumer level • Credit growth (Nov) to reflect increased policy support • Markets to stay focused on Beijing's COVID policy changes
	• CB: Thailand hiked +25bp to 1.25% • Q3 GDP growth (yoy) lost steam in Brazil (3.6%), India (6.3%) & Turkey (3.9%) • Annual inflation (Oct) fell in Korea (5.0%), Indonesia (5.4%). It picked up in Peru (8.5%) • Peru's Congress launched a third impeachment attempt against President Castillo	• CB: India is expected to hike +35bp to 6.25% & Peru +50bp to 7.50%. Brazil (13.75%), Chile (11.25%) & Poland (6.75%) to stay on hold • Annual inflation (Nov) data in Chile, Colombia, Hungary, Mexico, Taiwan, Thailand, Turkey, Philippines, Poland & Russia • Q3 GDP in Romania & South Africa

Upcoming events		
	US:	Mon: PMIs (Nov,f), ISM non-mfg index (Nov), Factory orders (Oct); Tue: Trade (Oct); Wed: Non-farm productivity (Q3,f), Unit labour costs (Q3,f); Thu: Weekly jobless claims (3 Dec); Fri: PPI (Nov), Michigan consumer sentiment (Dec, p), Michigan inflation expectations (Dec, p).
	Euro Area:	Mon: EU19, GE, FR, IT, SP services PMI (Nov, f), EU19 Composite PMI (Nov, f), EU19 Retail sales (Oct); Tue: GE new manufacturing orders (Oct); Wed: EU19 GDP (Q3,f), GE industrial production (Oct); Fri: SP industrial production (Oct).
	UK:	Mon: Services PMI (Nov); Tue: BRC retail sales (Nov), Construction PMI (Nov); Thu: RICS Housing survey (Nov); Fri: Fitch Rating review .
	Japan:	Wed: prelim Leading index (Oct), Final GDP (Q3), Trade & current account balance (Oct); Thu: Economy Watchers Survey (Nov)
	China:	Mon: Caixin services PMI (Nov), Wed: Trade data (Nov), Foreign exchange reserves (Nov); Fri: CPI inflation (Nov)

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