US Macroeconomics

January 17, 2023

Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

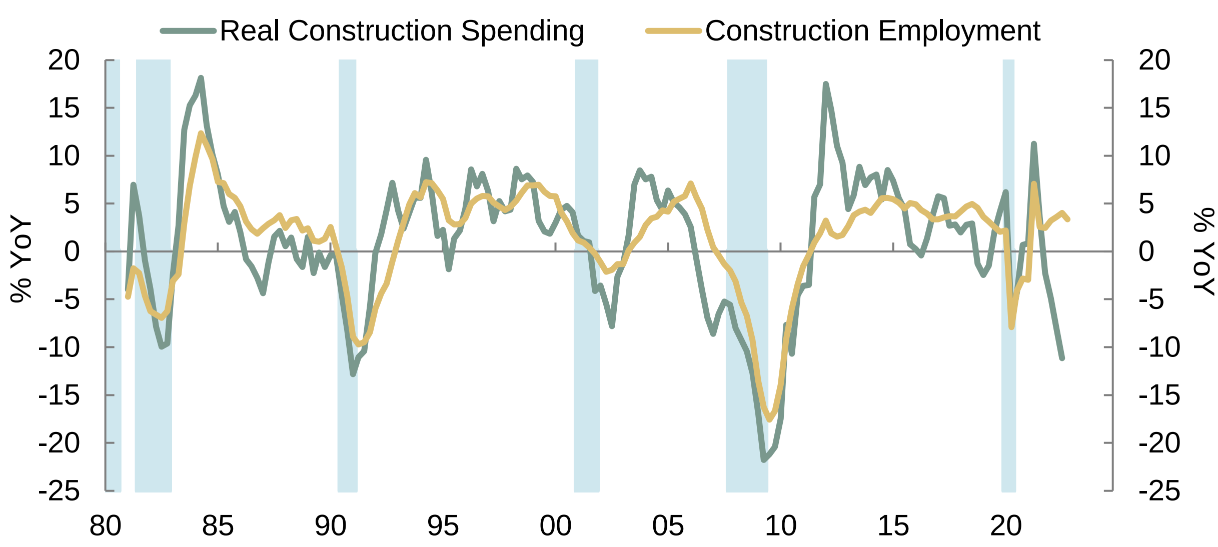
Nearing A Tipping Point

Some Fed policymakers and market participants view a tight labor market as a sign that recession risk is still relatively low. After all, the unemployment rate fell a tenth last month to 3.5%, matching its cyclical low. Historically the unemployment rate is a leading indicator ahead of a downturn. Every time in the past when the unemployment rate had increased 60 basis points (bps) from its trough, the economy was either in recession or about ready to enter one. This time is unlikely to be different because **the labor market is on the cusp of a substantial pullback in construction employment**. A downturn in construction alone may be enough to tip over the economy.

The chart below shows the year-over-year growth rate in real total construction spending versus total construction employment. Both series capture activity in both the commercial and residential sectors. **Over the last four quarters, construction spending is down a sizeable 11%**, which is the weakest pace since Q1 2010 (-17.5%) when the economy was slowly emerging from the 2008-09 housing crash. At present, construction employment remains robust despite the large decline in construction spending. Can this continue? No.

Through Q3 2022, the latest quarter for which inflation-adjusted construction spending is available, there is a massive 15 percent point gap between spending and employment. This is the largest difference since Q4 1951 (-18.1%). When spending has been negative and a large divergence in the two series ensued, ultimately it was employment that collapsed. This is what we expect in the months immediately ahead, and it should significantly push up the unemployment rate.

According to our calculations, **construction employment should be 741k lower in Q3 2022 than what the jobs data show**. This alone would push up the unemployment rate by 45 bps. Further declines in construction spending are likely to be seen both last quarter and in the current quarter. In fact, construction specific job losses should approach 1 million. **This is easily enough to push the unemployment rate well above 4%**. Of course, there would be additional negative knock-on effects from construction-related job declines. Consequently, the fact that the labor market more generally and the construction sector in particular look healthy should not brighten the near-term economic outlook.



Source: BEA, BLS, Haver, SMBC Nikko

Disclaimer

This presentation is for discussion purposes only and is not intended to be an offer to sell or the solicitation of an offer to buy any securities, or any commitment to underwrite, subscribe for or place any securities, is not an offer or commitment to provide any financing or extension of credit or service, and does not contain any tax or legal advice. This presentation has been prepared by SMBC Group (which may include, collectively or individually, any of the following entities in the Americas Division: Sumitomo Mitsui Banking Corporation ("SMBC"), SMBC Nikko Securities America, Inc. ("SMBC Nikko"), SMBC Nikko Securities Canada, Ltd. ("Nikko Canada"), SMBC Capital Markets, Inc. ("SMBC-CM"), SMBC Leasing and Finance, Inc., JRI America, Inc., and SMBC Rail Services LLC) and is being furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. This presentation is confidential and is the property of SMBC Group subject to copyright. Any reproduction of this presentation, in whole or in part, is prohibited, and you may not release these materials to any person, except to your advisors and professionals to assist you in evaluating these materials, provided that they are obligated, by law or agreement, to keep the presentation confidential. These materials do not constitute research, a recommendation or an offer or solicitation to any person to enter into any transaction or adopt any hedging, trading, or investment strategy. Prior to participating in any such transaction, you should consult your own independent, competent, legal, tax, accounting, and other professional advisors.

In preparing this presentation, SMBC Group has relied upon information available from third parties, including public sources, and we have assumed, without independent verification, the accuracy and completeness of such information. Specific prices, indices, or measures, including ranges, listed in this document were prepared at the time the document was prepared, and are subject to change without notice. SMBC Group makes no representations to and does not warrant this presentation's accuracy or completeness. SMBC Group expressly disclaims any liability for any use of the information set forth herein, including, without limitation, any use of the information set forth herein in the preparation of financial statements or accounting material.

These materials may contain forward-looking statements, which may include projections, forecasts, income estimates, yield or return, future performance targets or similar analysis. These forward-looking statements are based upon certain assumptions. All forward-looking statements are based upon currently available information and SMBC Group is not obligated to provide an update. Actual events may differ from those assumptions. Opinions, projections, price/yield information and estimates are subject to change without notice. There can be no assurance that estimated returns or projections will be realized, that forward-looking statements will materialize or that actual results will not be materially lower than those presented. Past performance is not necessarily indicative of future results. Any transactions or strategies addressed may not be suitable for all parties. The value, price or income from transactions or strategies may fall as well as rise. SMBC Group or an affiliate may have a position in any of the underlying instruments, assets, indices, or rates mentioned in this document. You should make your own independent judgment or seek independent financial and tax advice with respect to any matter contained herein.

SMBC is subject to Japanese firewall regulations and therefore absent client consent, non-public client information may not be shared with SMBC Nikko Securities Inc.

SMBC Nikko is a U.S. registered broker-dealer of SMBC Group. Nikko Canada is a U.S. and Canadian registered broker-dealer of SMBC Group. SMBC-CM is provisionally registered as a U.S. swap dealer with the CFTC. Capital markets and other investment banking activities for SMBC Group are performed by a combination of SMBC Nikko, Nikko Canada, SMBC Nikko Securities Inc. and SMBC-CM. Lending and other commercial banking activities are performed by SMBC and its banking affiliates. Derivative activities may be performed by SMBC-CM or SMBC. SMBC Group deal team members may also be employees of any of the foregoing entities. SMBC Group does not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with SMBC Group or for the purpose of avoiding U.S. tax-related penalties.