Where are the First Labor Market Cracks Likely to Appear?

Monetary policymakers will continue to strike a hawkish hue due to low unemployment. Thus, until the unemployment rate rises meaningfully from its current 3.5% rate, the Fed will reinforce the “higher for longer” mantra with respect to the level of interest rates. However, the labor market may be closer to an inflection point than many investors think.

According to consensus estimates, nonfarm payrolls rose 190k last month, continuing a trend of moderating employment. This estimate is potentially too high. One area of potential weakness is construction, where job gains have been robust. As we can see from the left-hand side chart below, the level of construction employment is at an all-time high. However, this does not jibe with the level of construction activity shown by the accompanying right-hand figure.

Over the past four quarters, inflation-adjusted construction spending both commercial and residential is down a whopping 13.7%. This is the largest decline since the deep housing-induced 2008-2009 downturn and the third largest cyclical drop on record. Yet, construction payrolls have been immune. Why?

One, lingering supply-chain issues may be hampering the completion of various projects. If so, employees will remain on the payroll even though the backlog of projects has meaningfully fallen. In other words, there will be a delay before construction firings begin.

Two, builders may be hesitant to shed labor because of pandemic-related difficulty in finding workers. If so, employees will remain on the payroll if firms absorb weaker demand in their margins. What scenario do we envision going forward?

The significant decline in construction spending combined with little evidence we are at a bottom means that construction layoffs may have been delayed but are still coming. A similar situation arose in 2006-07 before the sharp downturn that began in 2008. Based on the current level of activity, the level of construction employment should be over 700k lower. This alone would push the unemployment rate up nearly half a percentage point. We will see if this Friday’s employment report marks the beginning of this inflexion. Stay tuned.
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. © 2022 SMBC Group. All rights reserved.