MACRO STRATEGY

Economic Monthly

Labor Market: On the Precipice?

November 20, 2023

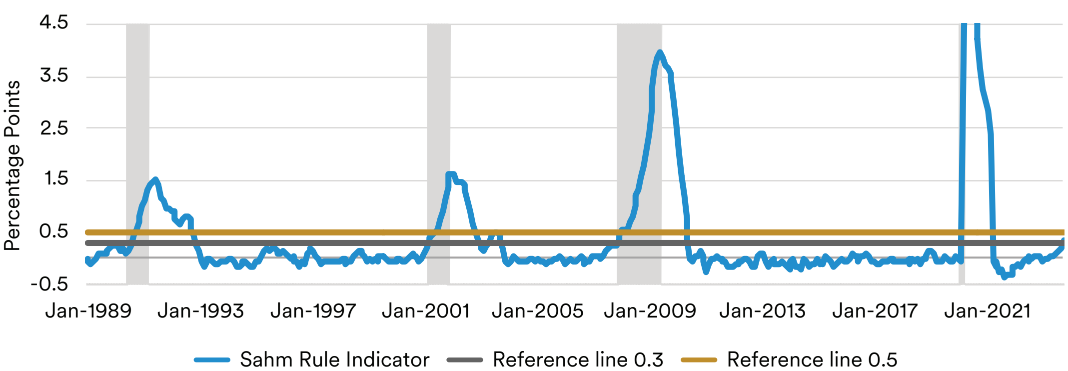
Monthly Themes

- The Sahm Rule of unemployment surpassed 0.3% in October, potentially foreshadowing a recession.
- Default rates are expected to worsen in the first half of 2024.
- Is consumer spending as strong as it looks?

Is the Labor Market Signaling a Recession?

The unemployment rate has been creeping up gradually since July, reaching 3.9% this past October according to the BLS. The Sahm Rule indicator measures the difference between the 3-month moving average of the unemployment rate and the minimum of that average over the last 12 months. Traditionally, this difference surpassing a threshold of 0.5% is considered indicative of a recession, but looking backwards gives many historical examples where a recession (as later determined by the NBER) has already started by the time the Sahm Rule passes 0.5%. In October, the Sahm Rule indicator broke 0.3%, which is a "yellow flag" that indicates potential momentum in unemployment increases and a possible recession. The indicator has been rising steadily since April 2023.

The Sahm Rule Indicator has been Rising Steadily Since April



Source: BLS, Haver, MIM

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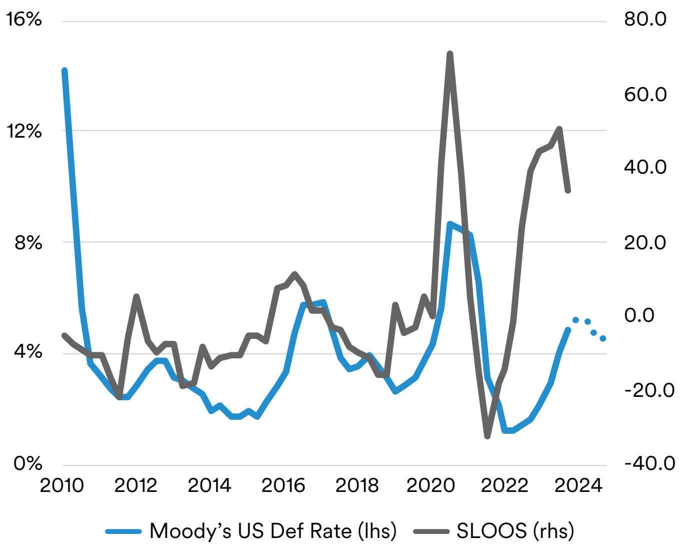
While it's true that unemployment is still at historically low levels, the magnitude of increase is more relevant to consumers who may cut spending in the face of job losses than the low starting point.

Default Rates Expected to Worsen Before They Get Better

October 2023's Senior Loan Officer Opinion Survey (SLOOS) showed stabilizing lending standards over the third quarter, with the majority of credit standards unchanged from the prior quarter. At the same time, in absolute terms standards remain tight at recessionary levels, and banks are concerned about a less favorable or more uncertain economic outlook and have a reduced tolerance for risk.

The survey also reveals differences between small banks and large banks. Larger banks report less tightening of C&I lending standards compared to small banks, which are more concerned about deposit outflows, lack of liquidity, and the falling market value of fixed-income assets.

SLOOS Predicts Higher Default Rates



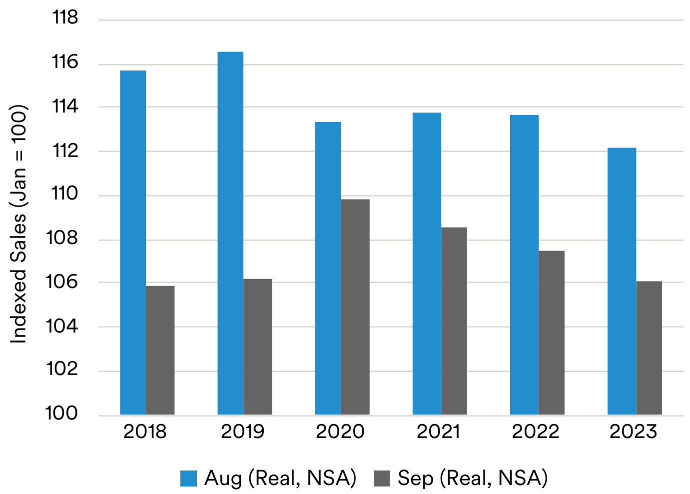
Source: Moody's, Federal Reserve, MIM

Most importantly, the SLOOS is an important leading indicators for default rates (see Figure 1). We use the SLOOS in our credit cycle default model, and the latest survey suggests that default rates may increase into the first half of 2024 but then start to improve by the second half of the year. The SLOOS alone implies a 1-year forward default rate of about 7%, but we do not believe that default rates will rise that much as 2024 maturities are at a very manageable level.

Seasonality and Inflation Blurring the Retail Sales Picture

The U.S. retail sales headline estimate, which is adjusted for seasonality but not inflation, rose 0.7% in September from the prior month, marking the sixth-straight month of growth, according to the U.S. Census. Sales gains were broad-based in September, with the largest expansion of 3% in miscellaneous store retailers.

Consumers Not As Strong?



Source: Census, MIM

The seemingly positive picture flips when examining real, non-seasonally adjusted retail sales (see Figure 2). The year to date growth for August and September 2023 show a decelerating growth trend since its peak in 2021.

The picture overall suggested that the U.S. consumer is not quite as strong as thought. Looking forward, future retail sales reports may continue to show signs of weakening as consumers face high credit card balances, higher-for-longer interest rates, and tightening lending standards.

Risks to the Outlook

Similar to last month, we continue to see at least two mitigating factors that work against our call for a recession in the first part of 2024. First, even though consumer spending may not be as strong as it looks on the surface (as we discussed in this Monthly), consumers continue to spend in absolute terms and the holiday season is likely to cushion near term spending pullbacks. Second, President Biden's industrial policy bills boosted GDP in 2023, and these have the potential for a further stimulus effect given that spending is expected to ramp up further next year.

U.S. Outlook Summary

Our overall outlook remains roughly similar to last month's. We continue to expect that a recession will occur in 2024, and we do not expect another interest rate hike from the Fed in the December meeting.

However, we have revised our 10-year forecast for 2024 upwards to 4.00%. Currently, rates are higher than supported by economic fundamentals, and under the assumption of a 2024 recession, we expect rates to drift down from their current high levels.

MIM Forecast

U.S.	2023	2024
GDP	2.1	0.0
CPI	3.0	2.8
10 Year	4.00	4.00
Policy rates (upper bound)	5.50	4.00
Unemployment	4.0	4.6

Note: GDP is annual average growth rate, CPI is Q4 year/year, 10 year is year-end, policy rate is the upper bound year-end rate.
Source: Metlife Investment Management

Additionally, we expect 150bps of cuts next year, to bring the upper bound of the policy rate to 4.00% by the end of the year. As inflation comes down, the real rate is expected to increase and the Fed would need to cut just to keep real rates stable. Then, additional cuts can be attributed to the assumption of a recession.

Lastly, we revised downward our unemployment rate for the end of 2024 to 4.6. Given our call for a recession in the first half of the year, we expect unemployment to peak (potentially at a level higher than 4.6%) and then start to recover by year-end.

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