Disappointing May jobs report ups the uncertainty around US interest rate hikes

A June hike is likely a no-go for the Federal Reserve, while a July move may depend on the data

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James Ong
Senior Macro Strategist, Derivative Portfolio Manager

Jay Raol
Senior Macro Analyst

Friday's nonfarm payroll report was a large disappointment, with just 38,000 new jobs added in May versus Invesco Fixed Income's expectation of 200,000. Although the weakness was likely exacerbated by some special factors (for example, we estimate that striking Verizon workers subtracted around 35,000 jobs), it was broad-based. Overall, we see three reasons for the weakness:

1. Lower demand for jobs (due to a fall in labor force participation)
2. Lower supply of jobs (as shown by very few hires and an increase in part-time versus full time work)
3. One-off shocks in a few service categories (Verizon, temporary employment and the arts). It is likely that the May jobs report also reflected some lagged effects from the first-quarter financial shock (it was never clear why payrolls held up so well in the first quarter.

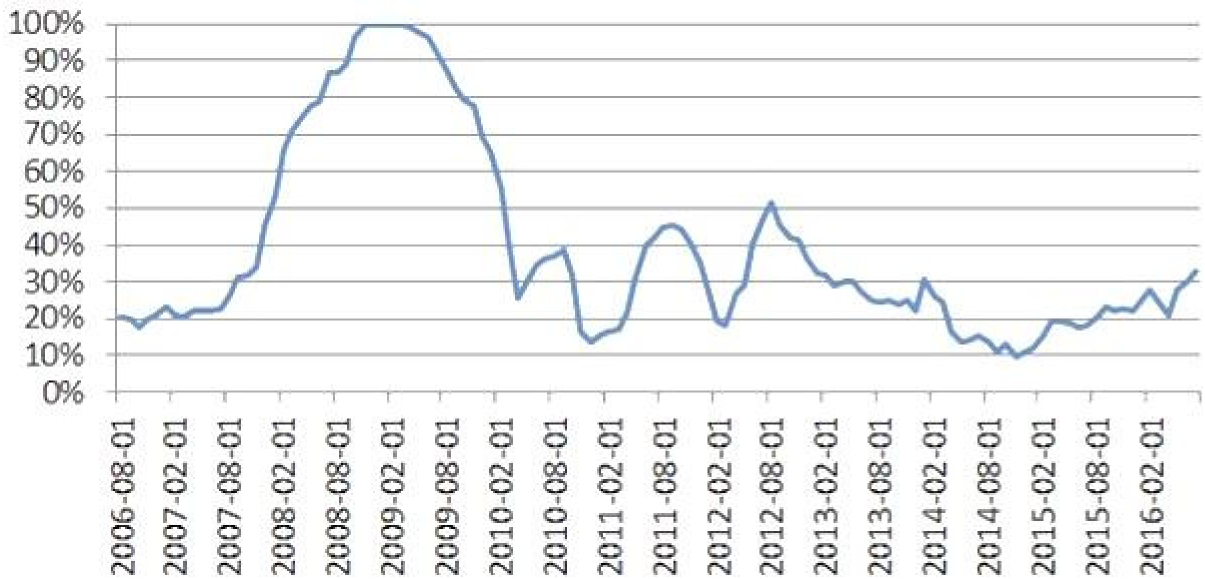
Interpreting the numbers

This month's weakness was sufficient to drag down the longer-term moving averages to which we give considerable weight in our economic model. The three-month moving average of monthly payroll growth has now dropped to 116,000 (127,000, adjusting for the Verizon strike). Three-month moving averages of about this level have been measured two other times in the current expansion, and each time the job market bounced back. Today, however, we believe a similar bounce back to about 200,000 is less likely due to the length of the cycle and a reduced pool of workers available.

At the same time, we do believe that the actual trend in employment is above what the May jobs reports suggests. For example, other indicators of employment – such as the May ADP report (which measures private-sector hiring) and jobless claims – did not indicate a picture nearly as negative as May's nonfarm payroll growth.

Invesco Fixed Income has updated our growth model to reflect the uncertainty around our quarter-over-quarter and trend growth estimates. The May payroll number points to lower-trend growth and pulls down our second-quarter growth estimates significantly. While other recent consumption indicators, such as auto sales and consumer confidence, are softer, they have held up much better. Also, housing activity, credit creation and certain discretionary spending data continue to hold up. However, when combined with May's low payroll number, the combined data point to lower-trend growth, and that is helping to drive up the probability of recession, according to our estimates. Our economic model now suggests the probability of recession is up from 20% in January to 30% currently.

Recession Probability



Source: Invesco estimates, June 6, 2016.

How might the Fed react?

The May jobs report will likely raise the level of uncertainty at the Federal Reserve (Fed), in our view. Although we believed a June interest rate hike was very unlikely, it now seems impossible. In our view, a hike in July will be dependent on improvement in the labor data as shown by the June payroll report. The increased uncertainty of the jobs outlook makes it difficult to estimate the number of additional hikes the Fed will likely make this year.

Fed Chair Janet Yellen's remarks on June 6 provided some insights into the Fed's interpretation of the growth outlook. Ms. Yellen said she believes that the "positive forces supporting employment growth and higher inflation will continue to outweigh the negative ones," but that, going forward, she and other Fed officials would be grappling with whether the decreased pace of hiring is temporary or a sign of a more persistent economic slowdown. [1] As the Fed addresses this question, we expect less of a focus on rate hikes and a renewed focus on "data dependence." Treasury futures markets now put a 4% probability on a rate increase in June, 31% on a move in July and 48% on a move by September, according to the Chicago Mercantile Exchange.[1]

[1] Source: Wall Street Journal, June 6, 2016.

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