

How healthy is the U.S. labor market?



From the Field
September 2024

Key Insights

- The Federal Reserve appears ready to start cutting interest rates. But investors need to understand that not all rate cut cycles are the same.
- If higher rates have cooled inflation but ultimately lead to a spike in unemployment, investor enthusiasm over Fed cuts is likely to be short-lived.



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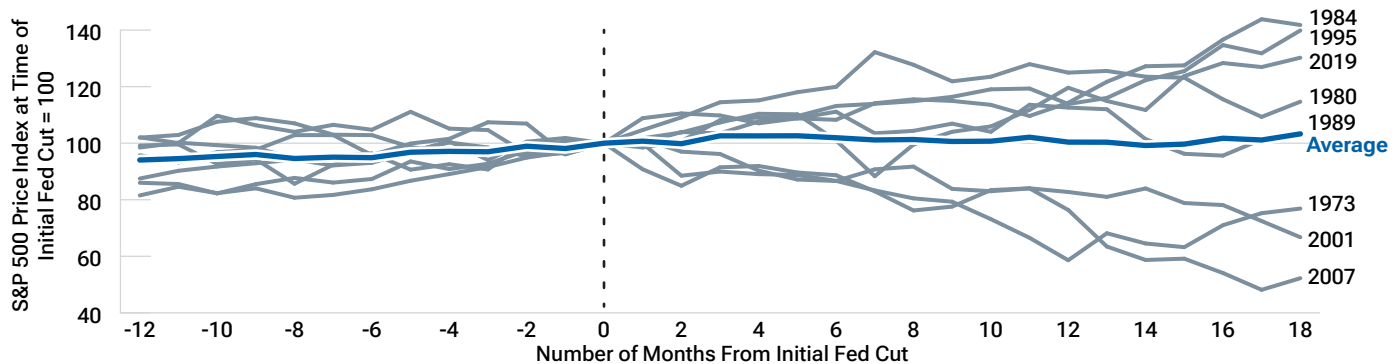
The U.S. Federal Reserve now appears almost certain to begin a rate-cutting cycle in September. Not surprisingly, global stock markets have responded positively to this news. However, investors should understand that rate-cutting cycles are not all the same.

Historically, cutting cycles accompanied by “soft landings” for the U.S. economy have tended to be very good for stock markets. But cycles with recessions have tended to be bad for them (Figure 1).

This is why the health of the U.S. labor market is so important right now. If higher interest rates have cooled inflation but ultimately lead to a spike in unemployment, investor enthusiasm over Fed cuts is likely to be short-lived.

Not all Fed cutting cycles are the same

(Fig. 1) S&P 500 Index performance around initial cuts in the federal funds rate



Past performance is not a reliable indicator of future performance.

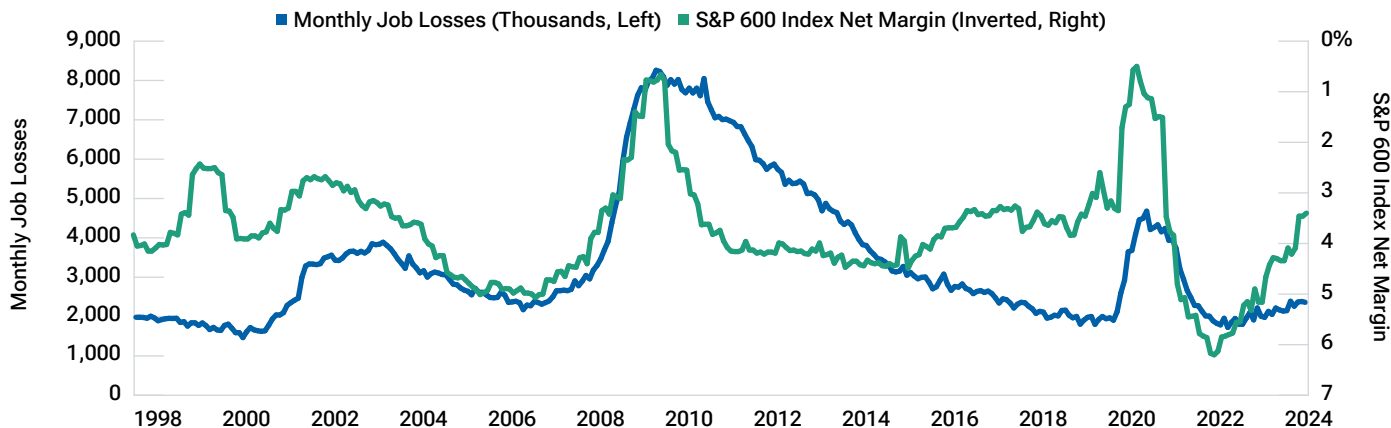
September 1972 to July 2024.

Years shown on right indicate year of initial federal funds rate cut.

Sources: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. Standard & Poor’s (see Additional Disclosure).

Profit margins for smaller companies are a reason for concern

(Fig. 2) S&P 600 Index profit margin (inverted) versus U.S. monthly job losses



Past performance is not a reliable indicator of future performance.

January 1998 to July 2024.

Source: Bloomberg Finance L.P.

U.S. labor markets appear to be normalizing

The July report on non-farm payrolls, released on August 2, proved weaker than expected, triggering a sharp, but brief, sell-off in the stock market.

However, a closer examination of the July data actually revealed a relatively benign picture. Job creation has slowed over the past three years, but only toward a growth rate that is more in line with the longer-term average. The pace of this slowdown also appears to be flattening out.

Weekly unemployment claims paint a similar picture. Claims have increased steadily so far in 2024 but are still low relative to longer-term history. This supports the case that U.S. labor markets are simply normalizing, rather than flashing a recession warning.

Profit margins are a reason for concern

However, there are still reasons to be concerned. One area that bears watching are profit margins for smaller companies. Small companies typically carry higher

debt burdens than larger firms, so higher interest rates have taken a proportionally larger bite out of their profits. When profit margins shrink to low or even negative levels, companies are often forced to lay off workers.

Overall, profit margins for U.S. publicly listed companies appear healthy and stable. But profit margins for smaller companies, as measured by the S&P 600 Index, have been deteriorating for more than two years and are reaching the danger zone (Figure 2).

This is potentially bad news for the labor market because small businesses account for the majority of U.S. jobs. It is also why there is an urgent need for Fed policymakers to cut rates even though inflation hasn't yet returned to their 2% target.

Conclusion

As of late August, U.S. labor market data were not flashing warning signs of a recession. But it will be important to keep an eye on the data going forward. As a result, our Asset Allocation Committee is maintaining a broadly neutral risk profile.

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