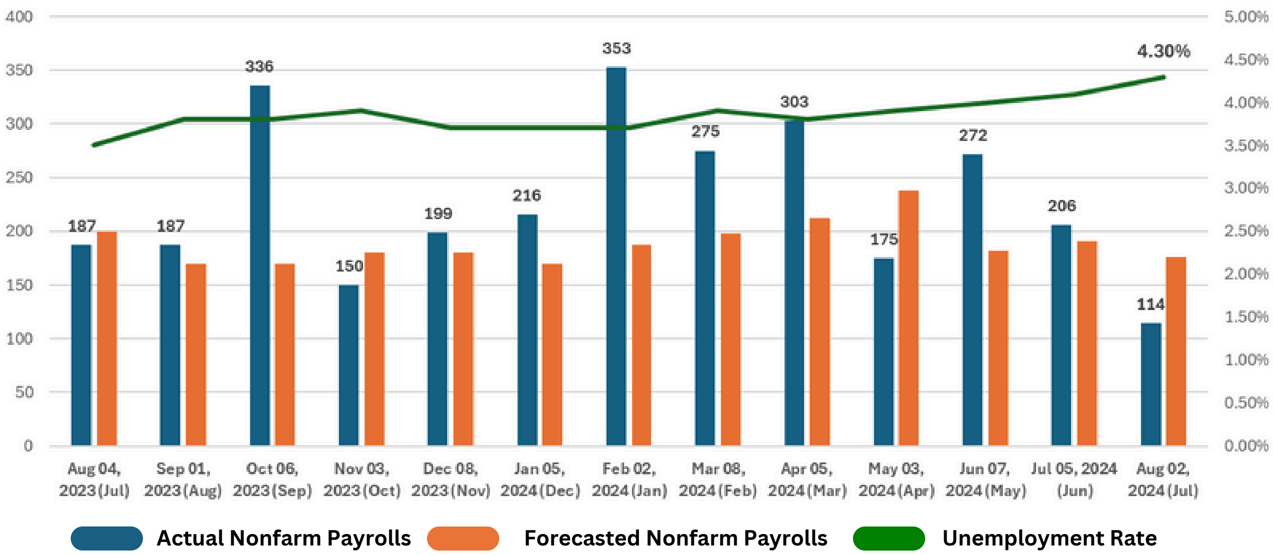
Taking Stock - The Power of Payrolls

Recent weeks have highlighted how Central Banks, and indeed wider financial markets have shifted their attention from inflation rates, which continue to fall in all major Western economies, and towards the labour market. Taking the US as an example, the current rate of inflation in the US is 2.9%, within touching distance of the Fed's targeted rate of 2%. However, this data is no longer driving the Fed's decision making when it comes to cutting interest rates. Their focus now lies on a few key metrics, with two of these being monthly Nonfarm Payrolls data and the US unemployment rate. While the unemployment rate is self explanatory, nonfarm payrolls are more unique, with the US being one of a few select countries that report this exact type of data. The metric records the number of job additions made in the US on a monthly basis, excluding the farming sector and other seasonal industries, and focusing on non seasonal labour. The data accounts for close to 80% of the US' monthly job additions, making it one of the most important labour statistics available to both the Federal Reserve and wider financial markets. In early August, non farm payrolls data was released for July, with the actual job additions missing forecasted additions by over 60,000. This caused distress in financial markets, and led to the Sahm Rule jumping to over 0.50, which has historically been a sign of an impending downturn. However, for the past 12 months nonfarm payrolls have only missed estimates four times, despite the fact that for the past 12 months interest rates have been steady at 5.50%. Meanwhile, unemployment has slowly ticked up in the US to over 4%, currently sitting at 4.3%. For the Federal Reserve, both metrics are now of paramount importance, as further increases in the unemployment rate or further misses in non farm payroll additions could cause the US labour market to finally crack, having endured one of the most intense rate hike cycles in US history. However, with a rate cut now all but confirmed for September, pressure will begin to subside on the labour market, with renewed hope that growth can continue in the world's largest economy.

US Nonfarm Payrolls and Unemployment Data - July 23-24



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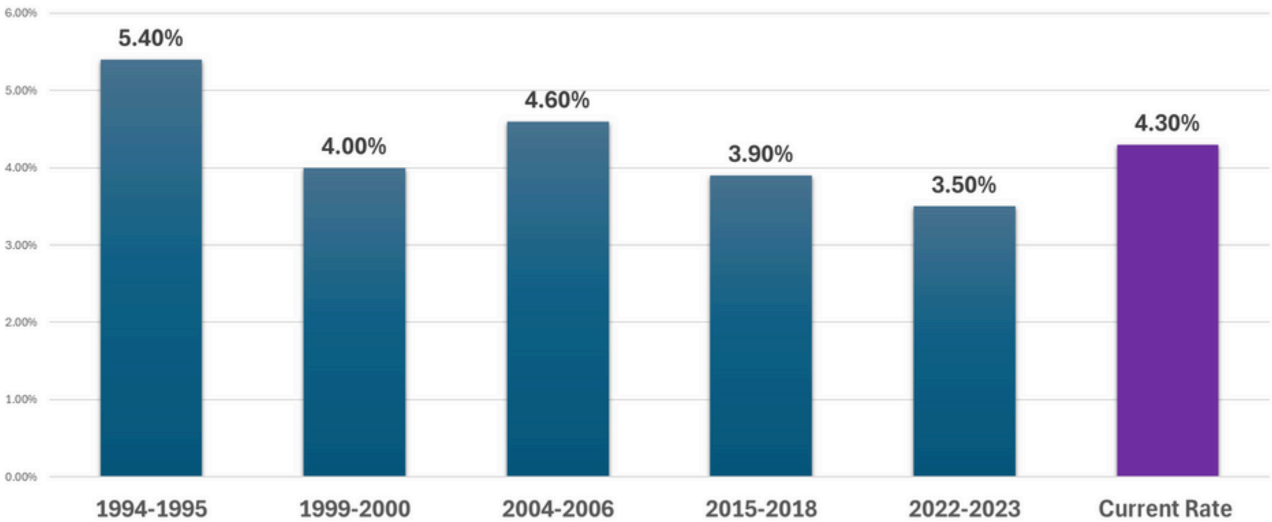
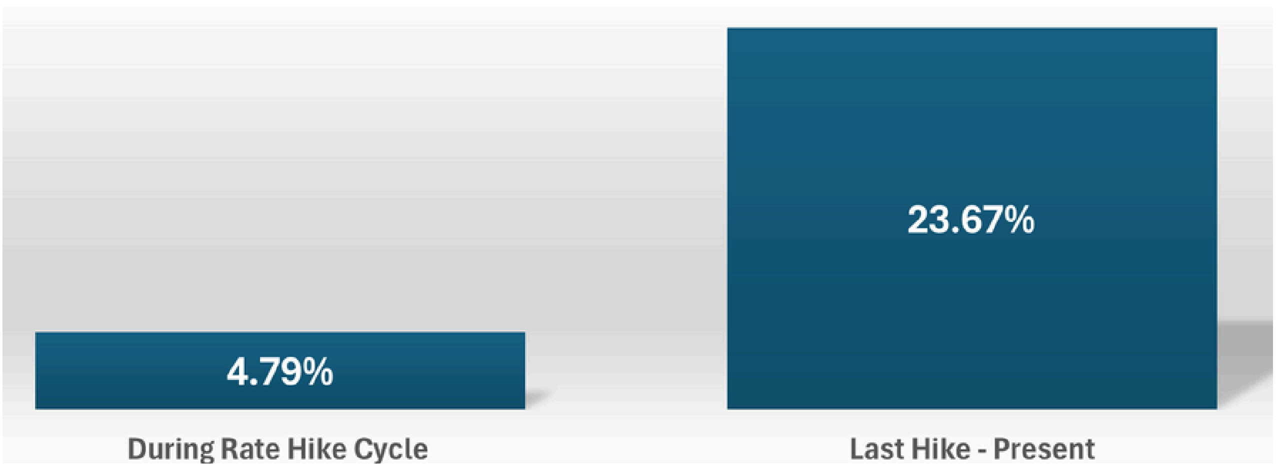
While the current data is not overtly positive, there is some solace to take from historical data and performances of equities. Whilst the US unemployment rate is now 4.3%, that is still relatively low considering the length of time interest rates have been elevated. The Federal Reserve ended their current hiking cycle in July 2023, at which point the US unemployment rate was 3.5%, which is the lowest level of unemployment recorded at the end of any rate hike cycle over the past 30 years. For the rate to be only 4.3% after a year of high rates is a testament to the overall strength of the US economy and its labour market.

Unemployment Rate at the end of US rate hike cycles (1995-2023)



Finally, whilst the labour market is beginning to show signs of fatigue after a prolonged rate cycle, the US equity market has shrugged off the higher interest rates and has delivered extremely well considering the market conditions. Even during the most difficult period between 2022 and 2023 when the Fed hiked rates, the S&P 500 returned nearly 5%, and since July 2023 when rates reached 5.50%, the index has returned over 23%. Couple this with inflation which remained elevated up to the start of 2024, and constant geopolitical and market risk, the return is quite remarkable.

S&P500 Performance during and after Rate Hike Cycle



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