VSWA Flash

US labor market

MARKET PERFORMANCES (as of October 21, 2022 – 14:25 CET)

	CURRENT	CHANGE 1 WEEK	CHANGE YTD		CURRENT	CHANGE 1 WEEK	CHANGE YTD
S&P 500 Index	**3'665.78**	**-0.11%**	**-23.09%**	**Gold**	**1'620.07**	**-1.48%**	**-11.43%**
S&P/Toronto Stock	**18'579.29**	**1.38%**	**-12.46%**	**Silver**	**18.33**	**0.28%**	**-21.36%**
EuroStoxx 50	**3'434.95**	**1.57%**	**-20.09%**	**Oil WTI**	**84.73**	**-1.03%**	**12.66%**
SMI Index	**10'350.48**	**0.20%**	**-19.61%**	**EUR/USD**	**0.9716**	**-0.06%**	**-14.55%**
DAX Index	**12'594.02**	**1.26%**	**-20.72%**	**EUR/CHF**	**0.9853**	**-0.79%**	**5.30%**
Nikkei Index	**26'890.58**	**-0.74%**	**-6.60%**	**USD/CHF**	**1.0141**	**-0.86%**	**9.98%**
Emerging Market Index	**53'705.56**	**0.29%**	**-23.34%**	**USD/JPY**	**151.78**	**-2.05%**	**24.18%**
Yield 10Y US Treasuries	**4.312**	**0.2926**	**2.8022**	**CAD/USD**	**0.7222**	**-0.28%**	**9.55%**
Yield 10Y German Bund	**2.507**	**0.1680**	**3.0815**	**USD/CNY**	**7.2468**	**-0.75%**	**12.29%**

[Source: Bloomberg]

The “last man standing” will give in

Over the past months, one economic indicator after another lost momentum. The much-cited purchasing managers' indices (PMI) plummeted and fell below the critical 50-point line, various business surveys painted a gloomy picture and consumer confidence suffered a severe setback. The only remaining bastion of strength was the US labor market. Companies were eager to advertise new jobs and hired several hundred thousand new employees each month. The unemployment rate also fell steadily – this summer, it even dropped to a 50-year low. Meeting by meeting, Federal Reserve Chairman Jerome Powell pointed out that the “very, very strong” labor market allowed for aggressive tightening. According to recently published US labor market data, the central bank's rate hikes are now starting to be felt on the labor market. The number of job openings fell by more than one million in August, the sharpest drop since the start of the pandemic. The quits rate, considered an indicator of labor market confidence, peaked in early 2022. Other indicators, such as the Conference Board's consumer survey, show that consumers have become more cautious when it comes to their employment prospects. Lastly, also initial jobless claims have ticked up. The cooling of the labor market however, is not yet translating into a higher unemployment rate – the latter in fact dropped from 3.7% to 3.5% in September.
We believe that this will change in the months ahead. Given the combination of poor macroeconomic data, high inflation, and tight monetary policy a recession at a later stage cannot be excluded. During a recession, unemployment typically rises by at least 1% (on average 2%). As a rule of thumb, this happens as soon as companies' costs approach revenues and costs have been rising as of late while gross domestic product growth has slowed down.

Implication for wages, consumption and monetary policy

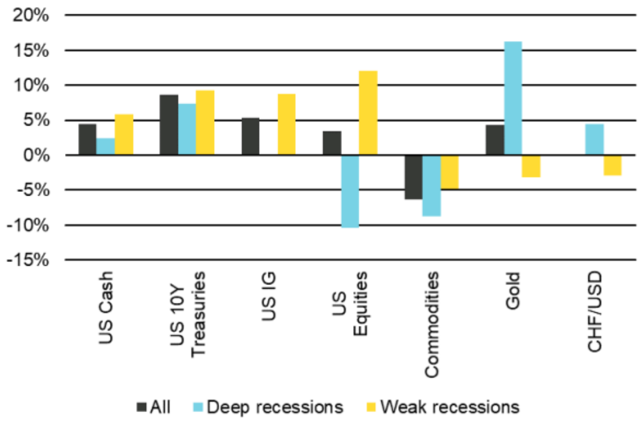
What does this mean for wage growth? If we believe commonly used leading indicators, for example those of the Atlanta Federal Reserve Wage Growth Tracker or the Dallas Federal Reserve (report October 4, 2022: “More Workers Find Their Wages Falling Even Further Behind Inflation”), then wage pressure should decline. This should also be reflected in a change in consumer behavior – but bear in mind that consumption is already under pressure due to high inflation.
In our view, all this makes a so-called wage-price spiral of the kind that occurred in the 1970s rather unlikely. Sooner or later, rising unemployment will then result in monetary policy support. Looking at the past, the US Federal Reserve always lowered interest rates at the latest when there was a significant increase in the unemployment rate. To sum it up: with higher unemployment, consumption suffers, and so does economic growth, wages and inflation come down, and the central bank changes its monetary policy.

Implications for investors

Historically, significantly higher unemployment rates have always been accompanied by a recession. As a rule of thumbs, two consecutive quarters of negative GDP growth are typically used as a shorthand definition for a recession. The National Bureau of Economic Research (NBER) however, determines the peaks and troughs in the economy that define recessions and expansions. Talk about a possible recession has been high for quite some time now. But the NBER prefers measures such as real income and unemployment rates, which still have some good readings. We therefore think it makes sense to look at how asset classes have performed during such periods.
Vontobel conducted a study in which the average performance of individual asset classes twelve months after the start of a recession where analyzed. The sample starts with the recession of 1937, which occurred during the Great Depression, and ends with the global financial crisis of 2008. The pandemic-related recession of 2020 was excluded because it was an “atypical” recession, i.e., a very sharp contraction followed by an unusually strong and rapid recovery.

One can conclude that such a scenario is positive for bonds and negative for risk assets such as equities – at least in the beginning. Later, when things really turn south, central banks generally come rushing to the rescue and deploy stimulus, which is supportive for risk assets. Looking at the chart below, it also becomes evident that the "depth" of the recession matters. "Deep" recessions (a deep recession is defined during which real gross domestic product (GDP) plunged **more** than 3%) argued for exposure to gold, US government bonds, and cash.

Chart: Twelve months forward returns after the start of a recession (average since the 1930s – excluding 2020)



Source: Global Financial Data, US Bureau of Labor Statistics, Vontobel, VSWA
Past performance is no reliable indicator of future performance.

The situation was different in "weak" recessions (recessions during which real GDP shrank by **less** than 3%). In such periods, riskier assets such as US equities were also worthwhile. Investment-grade bonds (IG), US government bonds, and the US dollar also posted positive returns 12 months after the start of a recession. The analysis also showed that commodities should have been avoided altogether, no matter if it was a deep or a weak contraction. It typically took them more than twelve months to recoup their losses.

As mentioned above, the NBER calls a recession. It typically waits, however, to get revised data and have a more complete picture of economic conditions before deciding on the peak and troughs of the business cycle. Having said this, despite the positive returns after 12 months according to the chart, it is still premature to interpret that we have seen the trough in financial markets. As stated in our last Investment Outlook, in the bond space we remain overweight corporates and underweight government bonds on a relative basis. In terms of duration, we prefer to stay below benchmark. Considering the pros and cons, we keep the equity weight at the long-term strategic weight. Despite the high volatility, oversold situation and the negative sentiment we think it is not the right moment to reduce the equity allocation. On the other hand, we believe it is too early to add more risk to the portfolio. Central banks remain still very hawkish, and it looks like macro data may worsen before we see a turning point.