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Making Sense

Labor Market Report | August 2, 2024

Loud Market Reaction to Weakening Employment Data

The July employment report was very disappointing and raises the risk that the Federal Reserve is behind the curve. Monthly job growth was weak, and the unemployment rate rose substantially. Markets reacted forcefully as Treasury yields plunged, equity futures fell, and the dollar weakened.

The loudest signal from this morning's report is 0.2 percentage point rise in the unemployment rate, which at 4.3% now stands at its highest level since 2021. For several months, markets mostly brushed aside weaker labor market data because some softening was welcomed given the elevated inflation and highly distorted labor markets of 2021-2022. **But the unemployment rate has now risen by almost a full 1.0%, raising questions of whether employment is merely cooling off or weakening materially.**

CONTACT

Phillip Neuhart | SVP, Director of Market and Economic Research
phillip.neuhart@firstcitizens.com
919-716-2403

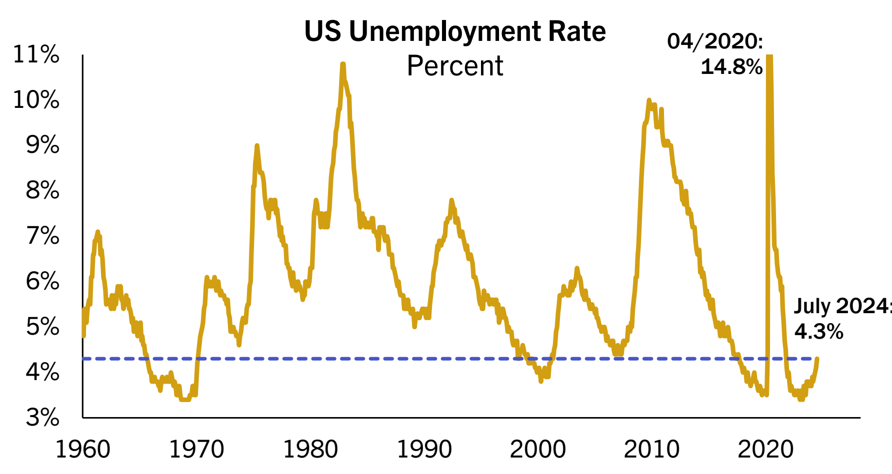
Brent Ciliano, CFA | SVP, Chief Investment Officer
brent.ciliano@firstcitizens.com
919-716-2650

Blake Taylor | VP, Market and Economic Research Analyst
blake.taylor@firstcitizens.com
919-716-7964

Counterarguments abound for why the cooling labor market this year is still of little concern for the economic outlook. For example, some of the recorded gain in joblessness is likely due to a fast-growing labor force owing to recent surges in immigration. In addition, layoffs have been fairly muted. But these views must reckon with the realities that **significant rises in unemployment rarely level off on their own** and deteriorating labor markets can turn into a vicious cycle as firms trim or suspend hiring plans.

Thirty minutes after the report, the interest-rate sensitive 2-year Treasury yield plunged by 20 basis points to 3.93%, the lowest level in over a year, and the 10-year yield fell by 10bp to 3.85%. The spread between the two – often analyzed to assess how markets view the growth outlook – narrowed to its least-inverted spread since July 2022, when the Federal Reserve was in its early days of tightening policy to address surging inflation. Equity prices fell following the report, and the dollar weakened.

This morning's data paints an awkward picture for policymakers, who just this week maintained interest rates at 5.25-5.5%, the same level for the past year and generally viewed as fairly restrictive. The Fed has telegraphed that interest rate cuts over the next few months are likely modest and not guaranteed. But markets disagree and expect the Fed to cut interest rates at least at every meeting and view the possibility of a 50 basis point rate cut in September as a material possibility. **It is our view that the Fed is likely behind the curve, and interest-rate cuts in the near future are warranted.**



Source: BLS, Bloomberg

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