August employment report: Labor market softness leaves door open for more Fed cuts

The nonfarm payrolls came in below consensus at 130k in August. Increasing the three-month average 16k to 156k. Temporary hiring for the 2020 Census (+25k jobs) masks some softness in job gains. We add the possibility of another 25bp cut in December (four cuts total in 2019), particularly if trade talks remain unsuccessful or data continues weakening. The BCI forecasts a 30.1% probability of recession in one year (up from 28.5%), back above the warning threshold for leaning out of risky assets.

Implications for Fed: We expect 25bp cuts in September and October, and now the possibility of another cut in December if trade talks are unsuccessful or if data continues to weaken. With the 10-year U.S. Treasury yield hovering at the recent range of 1.45-1.6%, the Fed may need three additional cuts to un-invert the yield curve. The Fed wants to be accommodative and they don't have enough confidence in the outlook to challenge the bond market's pricing. Additionally, manufacturing softness, global growth, and trade tensions remain headwinds for the US economy.

Implications for growth: The U.S. BCI's 12-month recession probability is back above the warning threshold, given softer August job gains and larger yield inversion. Recession probabilities may lower back under the warning threshold if the Fed cuts interest rates enough to un-invert the yield curve over the next couple months, and macro/financial data doesn't deteriorate in the meantime.

EXHIBIT 1: BUSINESS CYCLE INDEX (BCI)

Source: Recession dates from National Bureau of Economic Research. Out of sample forecasts were calculated by simulating the time-series model into the future. The value shown is the median of the simulated value for the month.
EXHIBIT 2: EMPLOYMENT FORECAST

Forecasts of nonfarm payroll employment changes
as of August 2019

Source: Actual employment data from St. Louis FRED database. Out of sample forecasts were calculated by simulating the time-series model into the future. The value shown is the median of the simulated value for the month.

FREQUENTLY ASKED QUESTIONS

What is the Business Cycle Index?

- The Business Cycle Index (BCI) forecasts the strength of economic expansion or recession in the coming months, along with forecasts for other prominent economic measures.
- The two outputs featured here are the Business Cycle Index and the Employment Forecast.
- Inputs to the model include non-farm payroll, core inflation (without food and energy), the slope of the yield curve, and the yield spreads between Aaa and Baa corporate bonds and between commercial paper and Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts.

Why is it important?

- The BCI forecasts the future direction of the business cycle.
- Historically, the stock market responds to investor perceptions of the future direction of the business cycle.

Can I use the BCI as a market-timing tool?

- No. The BCI is not meant to serve as a direct prediction regarding the future performance of any financial market. It is not intended to predict or guarantee future investment performance of any sort.
How do we interpret it?

- An increase in the BCI indicates that the business cycle conditions are improving — either moving closer to exiting a recession or to stronger expansion.

- A decrease in the BCI indicates that business cycle conditions are worsening — either moving closer to entering a recession or to a deeper recession.

How often is it updated?

- The Business Cycle Index is updated monthly after payroll employment numbers are released and will be published around the 15th calendar day of the month.
These macroeconomic forecasts do not constitute a projection of the stock market or of any specific investment.

Historical employment data displayed in the Business Cycle Index are reflective of current data as provided by the data sources including any revisions to previous data. These revisions may change historic data points and historic ranges for some or all indicators. These changes are usually due to seasonal adjustments to previously supplied data.

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Standard Deviation is a statistical measure of the degree to which an individual value in a probability distribution tends to vary from the mean of the distribution.

No investment strategy can guarantee a profit or protect against a loss in a declining market.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

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