# MyStratWeekly
Market views and strategy

Ostrum
ASSET MANAGEMENT

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N° 031 // **July 12, 2021**

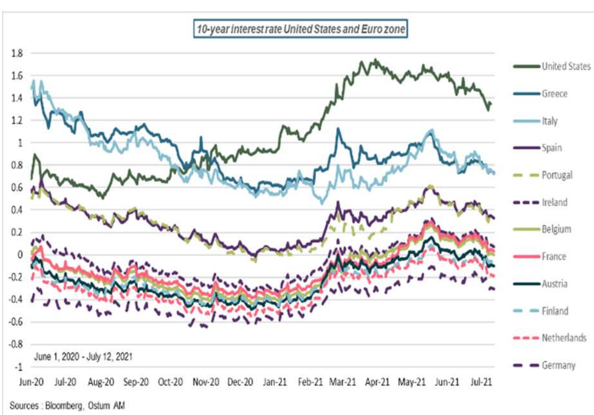

## Topic of the week: A peek at US labor markets

- **Despite a strong recovery, the US economy is showing a 7 million job deficit compared to February 2020 level;**
- **The pandemic has exacerbated matching problems in the labor market, leading to high unemployment despite the creation of record jobs;**
- **Transfers to households and an acceleration of permanent exits from the labor market are delaying the pickup in the participation rate.**

## Market review: Delta scare

- **The ECB presents its strategic revue;**
- **Climate risks will guide monetary policy;**
- **US yields tumble through 1.30% after the ISM services report;**
- **Equities briefly lower before bouncing to new highs.**

## Chart of the week




The week was marked by a sharp easing in US long term interest rates, dragging European long term rates in its wake. The catalyst was a weaker than expected ISM services index followed by fears related to the strong rise in the number of contaminations with the Delta variant, raising concerns about activity. To this were added a few technical factors.

The American 10-year rate thus fell during the week below the level of 1.30%, for the first time since February, and the German 10-year rate below -0.30%, for the first time since the beginning of April.

## Figure of the week

**14**

Source: Ostrum AM

That's the number of Chinese companies that were added to the US blacklist on Friday for alleged human rights violations in the Xinjiang Uyghur Autonomous Regions.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## Topic of the week

# A peek at US labor markets

**The Fed's employment narrative is that there is still ample slack in the US labor market. The US economy is allegedly short 7mn jobs from the pre-pandemic period. The Fed's highly politicized view of the US job market fails to capture the idiosyncrasies of the current situation. In this piece, we look at the determining factors of employment looking at both the labor demand and the supply sides.**

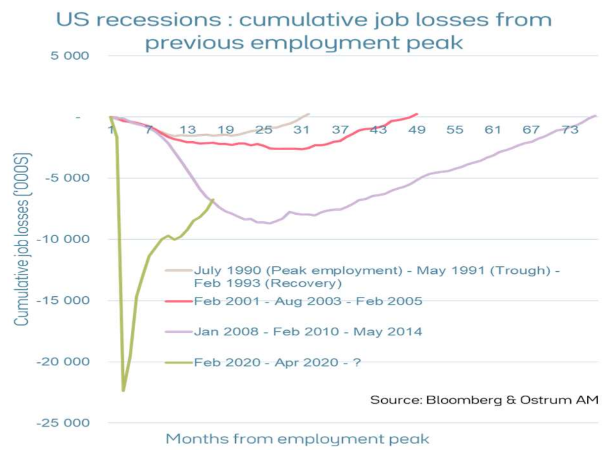
### 7 million jobs short… but an unusual job contraction

The Federal Reserve has long been of the view that a job recovery can only be called once all employment losses from the pandemic have been recouped. The pandemic outbreak resulted in business shutdowns and unheard-of job losses totaling 21mn at some point. Total employment, measured by the Bureau of Labor Statistics' non-farm payroll estimate, declined from a record high at 152.5 million in February 2020 to a low at 130.2 million, just two months hence. Despite furlough schemes and payroll protection loans, joblessness rose. That said, as of June 2021, non-farm payrolls had bounced to 145.7 million. Thus, about two-thirds of total job losses during the pandemic have already been recouped.

*The pattern of pandemic job losses is very different from that of past recessions.*

The pandemic hit is very different from previous employment contractions. The 1990s recession was followed by the so-called jobless recovery. The recession of the early 2000s was mild but the employment response was weak so that the ensuing economic upswing was deemed the job *loss* recovery. The 2008 great financial crisis was characterized by a collapse in aggregate demand and a prolonged period of employment shortfall. In contrast, the pandemic stands out as an unprecedented uneconomic collapse in employment followed by a swift upturn as the economy reopened.

Measuring the hit to employment by thousands of jobs lost or as a percent of peak employment does not materially change the analysis. Now, US employment still stands 4.4% or 6.7 million jobs below the previous high. Understandably, the Fed expresses concerns about the apparent shortfall in jobs and the associated economic hardship for American families. The Fed's dual mandate defined by Congress is to pursue maximum sustainable employment and price stability. Many Fed policymakers now talk of maximum employment apparently dropping the reference to 'sustainability' and hence the concept of a natural level of unemployment. With hindsight, the average inflation targeting framework only serves one purpose: put greater emphasis on the chosen employment objective.




### Idiosyncrasies of the pandemic, structural changes and permanent job losses

The 2020 recession is not a typical aggregate demand shock. This is because the rapid fiscal response in the US and elsewhere and the swift development of vaccines enabled a recovery in US household spending on durable goods, residential investment and corporate business investment. Beneath the surface of massive job destruction, it thus appears that the pandemic only had a lasting impact on a few industries. Client-facing positions were cut sharply whilst work-from-home swiftly became the norm for many high-end service industry workers (including finance, engineering, information technology...).

The unevenness in job losses is clear at the sector level. The 4.4% shortfall in aggregate employment is largely traceable to the leisure and hospitality sector. Covid restrictions obviously led to activity losses and mandatory shutdowns of many leisure businesses. Despite a sharp recovery, employment losses in the leisure sector still account for about a 40% of the US total. This is huge for an industry that represented just about 8% of all US workers before the pandemic. Within the leisure and hospitality group, accommodation and food services make up the bulk of job destruction. As an example, employment at cafeterias, grills and buffets is still down 56% (or 61k on May non-farm payroll data) from February 2020. Likewise, the arts, entertainment and recreation industry has shed more than 500k compared with the pre-pandemic peak level. Travel arrangement and reservation services were also hit hard. Employment at travel agencies is down by a third or 67k. In the same vein, transport shed jobs to the tune of 250k and lower transport obviously rippled through aircraft manufacturing, parts and equipment (for another 57k jobs lost from February 2020).

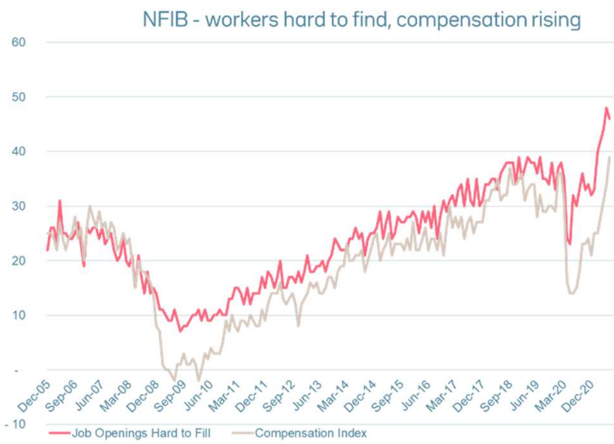
In addition, brick-and-mortar retailing lost a lot of business, especially clothing retail. This is an unmistakable feature of the K-shaped recovery from Covid. Online retailers and logistics companies gained considerably adding significant jobs. The pandemic hence accelerated underlying trends towards online commerce at the expense of traditional retail. The same is true of office suppliers hit hard by the development of work from home.

Therefore, it is of the essence for policymakers to get a sense of how many of jobs lost due to the pandemic are actually recoverable. The shortfall is unlikely to be fixed by monetary stimulus spurring aggregate demand. This simply is not about demand. Instead, there is considerable pent-up demand for vacation and leisure activities given large household savings. However, healthcare safety measures, if maintained, may prevent profitable business development in the years to come. Would airliners or restaurant chains survive if they have to operate at subpar capacity for several years? Strong demand does not guarantee a recovery in employment. The synchronous global upturn as tentative signs of reopening emerge last year put pressure on global supply chains and caused a rise in inflation. One example is the automobile industry where sales bounced early on in the recovery but higher commodity prices and shortages of components limited production output so that employment is still some 60k below peak. The same is true of parts of the metals industries as reopening clashes with demand for investment linked to the energy transition.

In sum, the pandemic accelerated long-term shifts in demand to which supply and employment have a hard time adjusting for the time being.

## The labor supply shortage

The K-shaped economic recovery resulted in mismatches between supply and demand for goods and services, which in turn contributed to higher inflation, supply-chain pressures and increased trade imbalances. At the micro level, mismatches in the labor market have become the norm. Most businesses of all sizes report difficulties to hire. To be fair, skilled labor had been in short supply for some time. The low level of initial jobless claims prior to the pandemic already reflected labor hoarding by firms. Weekly jobless claims hovered about 220k, well below cyclical lows looking back 30 years. Labor hoarding was arguably one important factor behind relatively modest productivity gains in the past decade. What is new is that unskilled labor has become harder to find too during the recovery from the pandemic. In the National Federation of Independent Businesses survey, the chief concern of business heads at present is finding workers, even before evaluating the impact on compensation plans. It is also clear from the service ISM survey that hiring difficulties do restrict business.



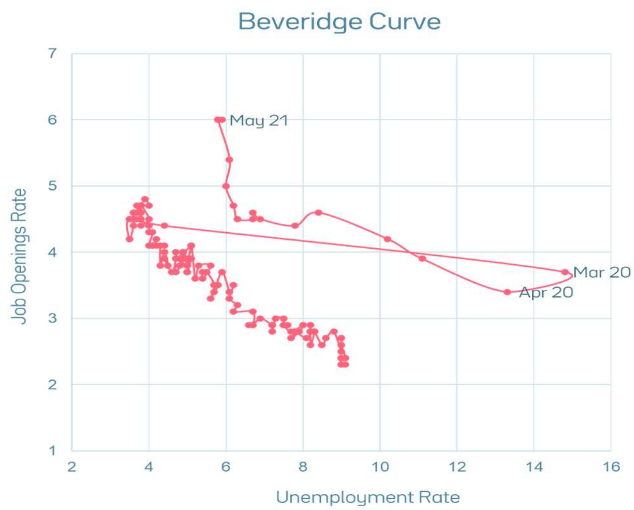
Source: Bloomberg, Ostrum AM

The Bureau of Labor Statistics produces a survey of job openings and labor turnover. Job openings are a straightforward gauge of demand for labor. The JOLTS survey thus sheds some light on the extent of labor mismatches at present. The job openings tally adds up to more than 9.2 million positions in May 2021. That is about 3 million more than the current historically high pace of gross hiring. The current gap is unprecedented although job openings had outpaced hiring since 2017.

Source: Bloomberg, Ostrum AM

Combining the job openings rate (i.e. the number of positions for which firms are actively seeking to hire workers divided by employment plus job openings) with the current rate of unemployment entails a direct measure of labor mismatches, a concept also known as the Beveridge curve. There is usually a stable downward-sloping relationship between the job openings rate and the unemployment rate.

When economic growth is elevated, business investment is upbeat, job opportunities abound and the rate of unemployment tends to fall. There is some room for optimism though as the quits rate keeps climbing. It suggests that a greater number of workers are quitting their jobs to pursue better job opportunities and income prospects.




Source: Bloomberg, Ostrum AM

In the past year however, there were a notable outward shift in the relationship, which has even become vertical early on in 2021. Available positions now represent about 6% (April 2021) of the employment demand (employment plus available jobs) but the unemployment rate no longer declines. In other words, there is unprecedented excess demand for labor but not enough workers willing and able to take the job. In the leisure sector, the job openings rate is up to 10.1%, incidentally the same level as the unemployment rate in the industry.

## Labor participation, government transfers and reservation wages

One of the most notable labor market developments in the past year is the sharp increase in the share of the population outside the labor force. There are 100 million Americans, aged 16 and up, that do not participate to the labor market (i.e. nor employed or looking for a job). What is more, inactive population is up 5 million from a year ago.

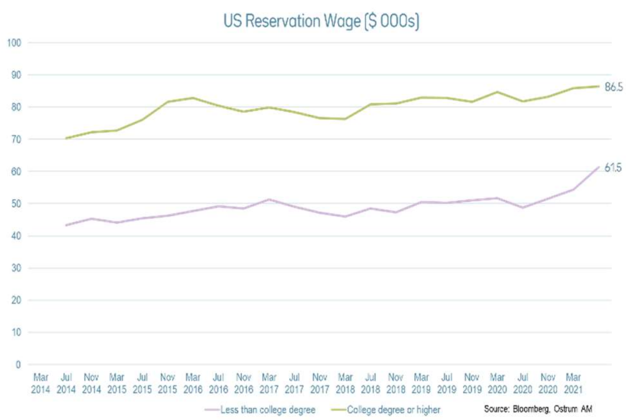
Within the inactive population of up to 100 million, 7 million claim to be willing to work. This is down from over 9.4 million a year ago. The 2.4 million decline hence suggests a loss of potential output. The early retirement of workers hesitant to go back amid Covid restrictions has been an important factor. Make no mistakes. Most people who declare that they are available and willing to work but have not looked for a job in the past month have a low probability of getting a job.

In other words, discouraged workers and workers marginally attached to the labor force have a structural unemployment problem, adding 0.7pp on average to the official U-3 unemployment rate measure (5.9% in June).

There may be several reasons for the declining labor force. Population aging is undoubtedly a dominant factor but there seems to be an acceleration to the downside in the wake of recessions. The decision to participate is quite complex for many households. Many individuals struggle to access the labor market due to a lack of skills/training, inadequate fiscal incentives, insufficient public transport infrastructure or unavailability of childcare for single mothers for instance.

The 'human infrastructure' deal brokered by Joe Biden aims at tackling such impediments to a higher participation rate. We will see if the Administration is able to pull out a deal in the context of razor-thin senate majority. Furthermore, the impact of government handouts on household participation rate is a hot topic. Republicans argue that stimulus checks (up to $1400 per individual in March) and supplementary unemployment benefits at both Federal and state levels have lowered participation. Some Republican states have already decided to cut back unemployment benefits in June. Federal aid of $300 per week is set to expire next September. We will soon find out whether income transfers have played a role in US households' decision to participate. Childcare checks will be made monthly from this summer which may encourage back to work from persons that left their occupation to assist children as school were closed.

In addition to with the level of income transfers, reservation wages inform the decision to participate to the labor market. According to the New York Fed's consumer expectations survey, the reservation wage – i.e the average lowest wage respondents would be willing to accept for a new job – has been on the rise in the past year. The steepest rise pertains to the lesser educated. In March 2021, individuals with less than a college degree responded that they would be willing to accept a new job if wages were on average $ 61.5k. This is a 26% increase from $ 48k in June 2020. The revised wage expectation probably explains part of the labor market drop-out rate. In contrast, college graduates demand $ 86k per annum to start a new job, or just about 5.7% than in June 2020. The skill premium is shrinking. Service workers with client-facing occupations may indeed be hesitant to return to their workplace, especially if they have to use public transportation. They demand a risk premium so to speak. The extra wage premium must be made up by faster productivity for employment to resume rising. Yet Unit labor costs were up 4.1% from a year ago in the first quarter, which is highly unusual in a recession.




Excess demand for labor should be conducive of higher compensation packages. A broad range of business surveys indeed report upward pressure on compensation. Anecdotes abound about firms in labor-intensive service industries (retailers, restaurants…) offering extra benefits, perks or one-time bonus payments of $1,000 and up to attract workers… and avoid locking in higher wage costs.


The Atlanta Fed's median wage however paints a similar picture. The data reflects annual wage growth from subsequent cohorts of households. In contrast to the two previous recessions, wage growth has barely decelerated from its cyclical peak. The annual median wage growth stood at 3% in May. Young workers (16 to 24 years old) enjoyed 7%+ annual wage increases in May as lower-paid occupations recovered from disproportionate job losses during the pandemic. Higher reservation wages have played a role. Likewise, wage growth in the bottom quartile is higher than at the top (4.2% vs. 2.9%). The skill premium is nonexistent as wage growth is 3.4% across the low, medium and high skill worker groups. Job switchers capture higher wage growth than job stayers broadly in line with historical averages (+0.6pp).

# Conclusion

**When you have a hammer, everything looks like a nail. The Fed has framed the debate on employment as an aggregate demand issue, requiring further monetary easing.**

**The study of current labor market dynamics suggests otherwise. The pandemic left scars in the US labor market. Record job openings coexist with still elevated high unemployment rate and apparent labor supply and demand mismatches. The participation rate is low and pressures arise from higher reservation wages among low-skill workers in particular. Labor supply constraints may thus persist potentially adding to current inflation risks.**

**Axel Botte**

## Market review

# Delta scare

### US yields plunge as equities dip before bouncing to new highs

Financial markets sometimes form erratic expectations about the economic cycle. The publication of a lower than expected ISM services index (60.1 in June) was enough to rekindle fears of a slowdown in activity, as the spread of the delta variant entails potential downside risks. Faced with the resurgence of Covid cases, several countries in southern Europe have taken measures to limit tourist flows. However, the violence of the US rate move stems mainly from technical factors, and the mid-week equity market breather proved ultimately limited. The S&P 500, which rebounded sharply on Friday, marked a new historic high during the session. The dollar fell again at the end of the week, while the yen seemed for a time to regain its safe haven status. The euro hesitated before rebounding towards $ 1.19. In the euro area, the Bund rally to -0.34% on Thursday, driven by purchases of futures contracts initially contributed to wider sovereign spreads before final investors and banks intervened buying back back peripheral debts. Credit traded weaker, as iTraxx indices reacted to a bounce in implied volatility. Spreads also show profit taking on high yield, and even emerging debt.

Economic indicators still foreshadow very strong growth in the second quarter in the United States. Activity probably grew at an annualized rate of between 8 and 10% in the three months to June, thanks to the rebound in spending on services taking over from the consumption of durable goods and residential investment, which now appear constrained by pressure on prices. The unprecedented $ 35 billion increase in consumer credit in May portends upward revisions to retail sales. Against this backdrop, the 4-point drop in ISM services gauge will remain anecdotal. The survey only highlights the constant pressures on supply chains and prices paid as well as the difficulties of recruitment. The service employment index fell below 50 despite some 850k jobs created in June.

In the euro zone, the ECB has released its strategic review. The Central Bank’s inflation target is now symmetrical around 2% and housing prices will be taken into account in policy setting. However, the ECB will not have the same degree of tolerance as the Fed around its inflation target. Climate risks will be increasingly important in the conduct of monetary policy through the development of new models estimating the resilience of the economy, the financial sector and therefore the transmission of monetary policy. Monitoring indicators for "green" assets will make it possible to estimate the financial sector's exposure to these risks. The criteria for accepting collateral and eligibility to the CSPP will also be reviewed according to climate risks.

The US 10-year plunge below 1.30% caught most market participants by surprise. The acceleration to the downside appears to come from algorithmic trading buying futures contracts and hence forcing a reduction in the quite consensus short positions among final investors. The low liquidity after the long weekend in the United States, a primary market at a standstill this week also contributed to this sharp fall in bond yields. In addition to these positioning aspects, there appears to be a considerable lack of collateral in the system. T-bill maturities in July will amount to more than $ 1.1 trillion, and auctions of short titles herald a further contraction in the amount outstanding. In addition, for the first time since February, bond flows in the United States are recovering with nearly $ 18.5 billion invested this week. The rise in oil towards $ 75 a barrel, made possible by the absence of an agreement for an increase in production within OPEC +, helped to support breakeven inflation rates amid a sharp flattening in the yield curve. Most reflation trades suffered, including commodity-related currencies. In the euro area, the Bund was dragged down by the T-note futures and traded below -0.30% for the first time since April. The newly-issued 30-year OAT bond (€ 5 billion from May 2053 at 0.84%) has met solid demand despite the relative lack of interest from insurers seeking yield levels above 1%. Italian bonds were initially affected by selling pressure on BTP futures before final interest helped to tighten Italian spreads (106bp at 10 years). Iberian bonds also widened by about 4bp this week.

The sense of caution across credit markets did not translate into a material widening in spreads. The support from the CSPP, although reduced to less than € 1bn in the last two weeks, is enough to ensure a slight outperformance vis-à-vis dollar credit. The primary market still totaled € 10 billion in issues, including € 2 billion eligible for the CSPP, which found good demand even without a premium compared to the secondary market levels. The high yield market ignores both the volatility of the iTraxx XO and still buoyant primary market activity with 7 transactions this week. The asset class spread widened this week, however. The spread curves remain very flat on the BB-rated bond group.

The equity markets therefore experienced an episode of volatility in the middle of the week, reacting late to the downtrend in Treasury yields. Friday's session erased this temporary weakness so that the Nasdaq is up about 1% in four sessions. In the euro area, flows to equity funds seem to be slowing down. The fall in yields weighs on bank stocks. Oil companies are down more than 3% despite a barrel of Brent at $ 75, as sectors linked to tourism underperform again. Europe is outperforming Asian markets subject to weakening Chinese indicators.

**Axel Botte**
Global strategist

## Main market indicators

| G4 Government Bonds | 09-Jul-21 | -1wk (bp) | -1m (bp) | YTD (bp) |
|---|---|---|---|---|
| EUR Bunds 2y | -0.68 % | -1 | +0 | +2 |
| EUR Bunds 10y | -0.29% | -6 | -5 | +28 |
| EUR Bunds 2s10s | 38 bp | -5 | -5 | +25 |
| USD Treasuries 2y | 0.21 % | -2 | +6 | +9 |
| USD Treasuries 10y | 1.35 % | -7 | -14 | +44 |
| USD Treasuries 2s10s | 114 bp | -5 | -19 | +35 |
| GBP Gilt 10y | 0.66 % | -5 | -8 | +46 |
| JPY JGB 10y | 0.03 % | -1 | -4 | +1 |
| **€ Sovereign Spreads (10y)** | 09-Jul-21 | -1wk (bp) | -1m (bp) | YTD (bp) |
| France | 35 bp | +2 | -2 | +12 |
| Italy | 106 bp | +5 | -2 | -6 |
| Spain | 65 bp | +4 | +0 | +3 |
| **Inflation Break-evens (10y)** | 09-Jul-21 | -1wk (bp) | -1m (bp) | YTD (bp) |
| EUR OATi (9y) | 132 bp | -5 | -5 | - |
| USD TIPS | 228 bp | -6 | -4 | +29 |
| GBP Gilt Index-Linked | 343 bp | -5 | -13 | +43 |
| **EUR Credit Indices** | 09-Jul-21 | -1wk (bp) | -1m (bp) | YTD (bp) |
| EUR Corporate Credit OAS | 83 bp | +0 | -1 | -9 |
| EUR Agencies OAS | 42 bp | +1 | +2 | +1 |
| EUR Securitized - Covered OAS | 34 bp | +1 | +2 | +1 |
| EUR Pan-European High Yield OAS | 299 bp | +7 | +9 | -59 |
| **EUR/USD CDS Indices 5y** | 09-Jul-21 | -1wk (bp) | -1m (bp) | YTD (bp) |
| iTraxx IG | 47 bp | +1 | -2 | -1 |
| iTraxx Crossover | 234 bp | +5 | -7 | -8 |
| CDX IG | 48 bp | +1 | -2 | -2 |
| CDX High Yield | 276 bp | +6 | -6 | -17 |
| **Emerging Markets** | 09-Jul-21 | -1wk (bp) | -1m (bp) | YTD (bp) |
| JPM EMBI Global Div. Spread | 354 bp | +14 | +21 | +2 |
| **Currencies** | 09-Jul-21 | -1wk (%) | -1m (%) | YTD (%) |
| EUR/USD | $1.187 | +0.06 | -2.5 | -2.89 |
| GBP/USD | $1.388 | +0.4 | -1.67 | +1.67 |
| USD/JPY | ¥110.19 | +0.78 | -0.49 | -6.25 |
| **Commodity Futures** | 09-Jul-21 | -1wk ($) | -1m ($) | YTD ($) |
| Crude Brent | $75.5 | -$0.6 | $3.8 | $24.3 |
| Gold | $1 810.7 | $23.4 | -$80.5 | -$83.7 |
| **Equity Market Indices** | 09-Jul-21 | -1wk (%) | -1m (%) | YTD (%) |
| S&P 500 | 4 362 | 0.97 | 3.38 | 16.13 |
| EuroStoxx 50 | 4 068 | -0.40 | -0.70 | 14.51 |
| CAC 40 | 6 529 | -0.36 | -0.52 | 17.62 |
| Nikkei 225 | 27 940 | -2.93 | -3.48 | 1.81 |
| Shanghai Composite | 3 524 | 0.15 | -1.83 | 1.47 |
| VIX - Implied Volatility Index | 16.21 | 4.72 | -9.39 | -28.75 |

Source: Bloomberg, Ostrum Asset Management

# Additional notes

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