MACRO STRATEGY

Economic Monthly

Are Rising State-Level Unemployment Rates Trying To Tell Us Something?

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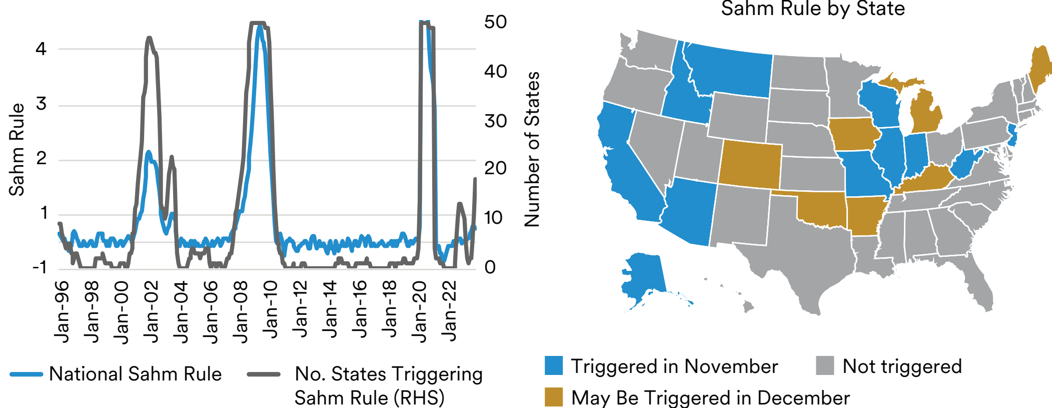
Although economic data are appearing more benign, we remain cautious around economic fundamentals. Unemployment at the state level is rising despite rosy-seeming national levels. We continue to watch the general health of the consumer and are worried about how much longer they can continue to carry the economy. Our base forecast—including a recession and rate cuts beginning toward the end of the second quarter—remains unchanged.

State-Level Unemployment on the Rise

Although national level unemployment is still at a tight 3.7%, state-level unemployment shows a growing number of states under pressure. When looking at state-level unemployment using the Sahm rule, we see a significant number of states triggering the rule, suggesting weakness, if not an increasing likelihood of recession.[1]

In the November edition of our Economic Monthly, we applied the Sahm rule at the national level and showed that it may be triggered soon. Applying the Sahm rule at the state level shows a similar concern.

Chart 1 | State Sahm Rule Triggers Tend To Lead National Sahm Rule Triggers



Source: BLS, Bloomberg, MIM

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MetLife Investment Management

Authors

DREW T. MATUS
Chief Market Strategist

TANI FUKUI
Director, Global Economic & Market Strategy

SHAN AHMED
Associate, Global Economic & Market Strategy

Historically, triggers to state-level Sahm rules have tended to be leading indicators to a triggering of the Sahm rule at the national level. Localized strength can obscure creeping labor market softness.

In November, despite the national unemployment rate declining, 11 states triggered the Sahm rule, together comprising some 30% of U.S. GDP. The national level of unemployment stayed at 3.7% in December, unchanged from November. While the BLS has not yet released December data at the state level yet, if we assume that state-level unemployment also remains unchanged in December, an additional seven states comprising 8% of U.S. GDP would also trigger the Sahm rule. Setting aside the pandemic era, that would result in the largest number of states under the Sahm rule since June 2010. More instructively, a rapid increase in the number of states triggering the Sahm rule started in August 2007, foreshadowing the increase in the national unemployment rate and the 2008 recession.

Although this isn't a smoking gun for a recession—indeed the Sahm rule pulled back at the national level in December—its triggering remains a distinct possibility over the next several months.

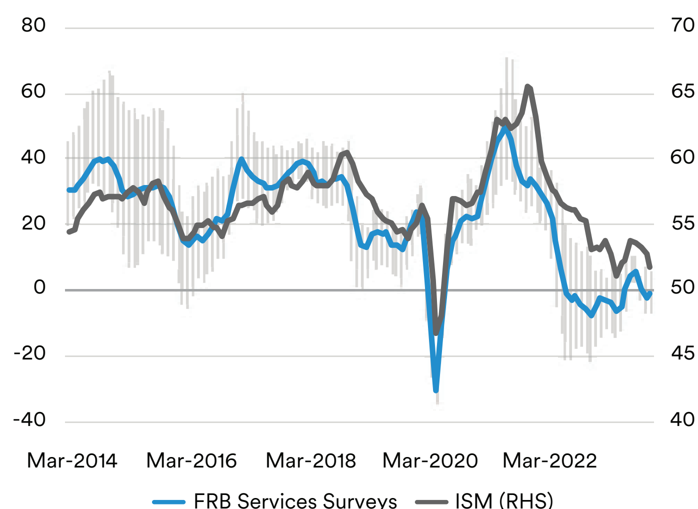
No Cruel Summer for Services?

Much has been made of the summer of services spending by fans of Taylor Swift and Beyonce and by anyone else itching to be part of a crowd. And it looks like there were concerns that the summer of 2023 would be a high-water mark—six-month expectations from services firms surveyed by various Federal Reserve Banks largely expected a deterioration in conditions.

But those concerns seem to have dissipated. Most recently—in the last few months of 2023—the surveys appear to show firms more optimistic about the next six months.

The ISM services index—which is national but only asks for current opinion rather than expectations—shows a slowing of activity from 2022, which most recently has plateaued. Negative growth in services generally indicates a recession, as it is a much larger part of consumer spending, although it moves more gradually. If services spending stabilizes at its current pace—as has been happening in recent months, and as services firms appear to be expecting—it will do a great deal to help the U.S. avoid a recession.

Chart 2 | Services Slide Coming to an End?



Grey shading represents the min and max regional survey in the month.

Note: For the Federal Reserve Bank Surveys, a reading of zero denotes no growth, while positive denotes positive growth. For the Services ISM Index, a reading of 50 denotes no growth, while above 50 denotes positive growth.

Source: Dallas Fed, Philadelphia Fed, Kansas City Fed, Richmond Fed, ISM, Haver, MIM

Businesses Haven't Been Pulling Their Weight.

The consumer did well in 2023. But GDP growth in the first three quarters of 2023 revealed a strange composition that relied less on consumption than on government spending, weak import demand and the construction of manufacturing facilities. Avoiding a recession in 2024 may rely less on the consumer and more on business investment.

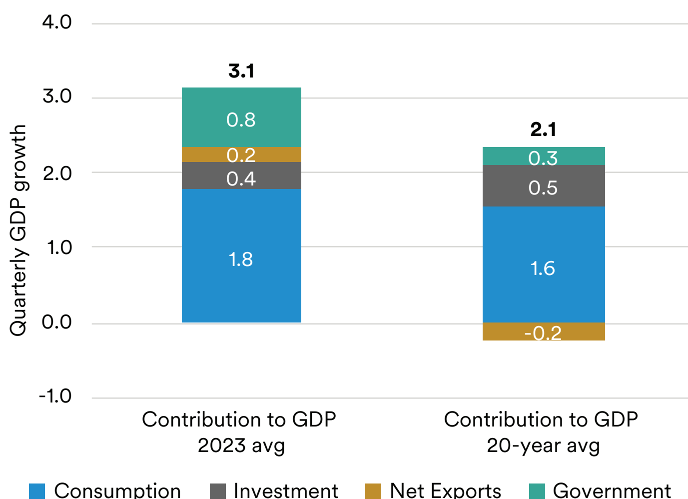
Historically, personal consumption contributes around 1.6 percentage points to GDP growth, with business investment adding another 0.5 percentage points. Government and net exports more or less cancel each other out, contributing small positive and negative amounts respectively.

Consumers did well, contributing 1.77 percentage points. But it was government that truly outperformed, providing 0.8 percentage points. Net exports also contributed positively, due to weak import demand. By contrast, investment contributed less than usual—and most of this came from a surge in building manufacturing facilities for computer, electronic and electrical equipment, supported in part by the three industrial policy acts passed by Congress at the urging of the Biden Administration.[2]

What does this mean for growth in 2024? While government spending is likely to remain robust due to the industrial policy acts, consumers are likely facing

constraints on further spending and cannot be counted on to carry growth the way they did in 2024.

Chart 3 | Looking For an Investment Pickup in 2024



Source: BEA, Haver, MIM

A non-recessionary scenario would likely rely on businesses to increase investment. A few clear opportunities exist. Residential investment is likely to improve in 2024, given stronger demand and moderating rates. Investment in equipment could see improvement as manufacturing facilities are finalized and come online. The biggest question mark remains investment capacity, given tighter corporate margins, tighter lending standards and persistently high interest rates.

U.S. Outlook Summary

We continue to expect a recession in 2024. Several concerns factor into this view, including the following.

First, credit conditions continue to tighten, with lending contracting on a real basis. This tightening is part of the fallout from tighter monetary policy. Second, delinquency rates are rising—particularly for consumer loans and commercial real estate. Third, the labor market is loosening, with the increase in payrolls approaching "replacement rates" (i.e., the rate at which labor force participation remains stable). As for healthcare, government and food and accommodation services—together, these sectors comprised 72% of payroll additions in 2023—reaching satiation. As a result, much of the drive to hire is likely to dissipate through 2024.

We believe the Fed has finished hiking rates this cycle, given that core PCE moderated to 3.2 percent by year-end. We expect 150 basis points worth of fed funds rate cuts beginning around midyear 2024. Whether or not there is a recession, the Fed is likely to cut as it eases from the current tight conditions.

We expect a particularly mild increase in unemployment, given that prior recessions have seen unemployment increase by at least two percentage points, reflecting the unusually tight labor market conditions.

After a wild fourth quarter, the 10-year Treasury fell to 3.88% in the last few trading days of the year. Yields have historically peaked ahead of cuts to the fed funds rate; with cuts on the horizon and inflation on a downward path, we expect yields to have peaked for the cycle. We expect yields to remain flat for the year, especially if our expectation of a struggle to get inflation to 2% holds.

MIM Forecast

U.S.	2023	2024	2025
GDP	*2.1*	0.0	1.1
CPI	*3.2*	2.8	2.8
10 Year	*3.88*	4.00	3.50
Policy rates (upper bound)	*5.50*	4.00	2.00
Unemployment	*3.7*	4.6	4.5

Note: GDP is annual average growth rate, CPI is Q4 year/year, 10 year is year-end, policy rate is the upper bound year-end rate. Italics denotes actual data; the rest are forecasts.
Source: Metlife Investment Management

Risks to the Outlook

We continue to recognize mitigating factors that work against our call for a recession in the first part of 2024. First, labor market robustness could continue to support consumer spending. Consumer confidence improved in December, and goods and services spending were strong in December. Second, the manufacturing sector has shown some signs of recovery and may continue to boost GDP in 2024, as industrial policy spending ramps up. Finally, single-family home starts picked up gradually in 2023, giving some hope to a moderation of housing and rent inflation.

Endnotes

[1] As a reminder, the Sahm rule examines the most recent three-month moving average unemployment rate less the lowest three-month moving average over the past year. Triggering the Sahm rule means the difference is 0.5 or greater, meaning there has been a 50-basis-point spike in unemployment relative to its recent history. Triggering the Sahm rule has also historically been associated with the onset of a recession.

[2] These coincided with the trio of industrial policy Acts passed by the Biden Administration, the Infrastructure Investment and Jobs Act, the Inflation Reduction Act, and the CHIPS Act, and likely were in part fueled by these.

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