July 29, 2024

Labor Stress Elusive Despite Growth Strains

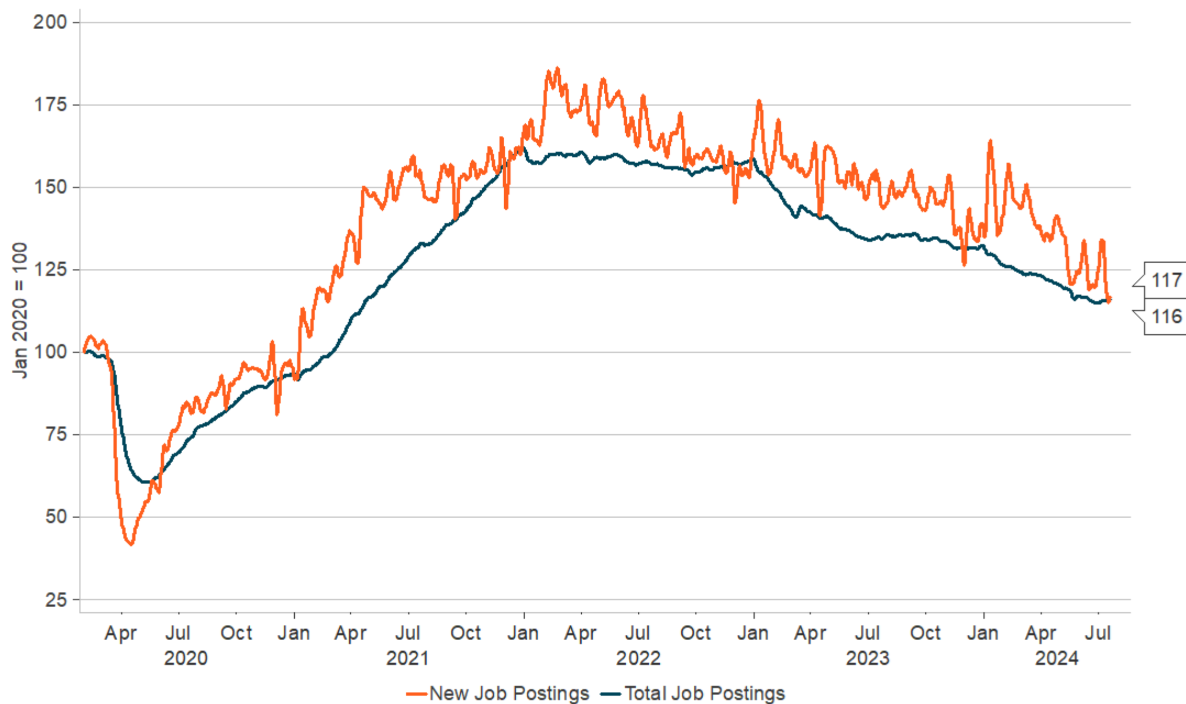
Central banks look to labor markets as growth woes mount

- Corporate earnings point to material demand softness
- Monetary policy transmission aimed at generating weaker labor markets remains difficult
- EM central banks to stay cautious even with a looser Fed

Labor markets the missing link for broad-based policy repricing

The Fed decision this week will dominate proceedings. As exogenous shocks from politics and growth collide with lofty valuations, repricing was always going to be on the cards and the market is now expecting a far more dovish outcome, though a cut is not the base case. So far, the volatility is manageable, but the Fed will be keen to ensure that their messaging doesn’t exacerbate the sentiment shift, which risks financial conditions beyond their current intent. Globally, even though central banks are increasingly confident about attaining price stability, there is an increasing sense of disconnect between clear demand weakness but the lack of transmission into softer labor markets. Regardless of the underlying reason, be it supply problems or productivity growth, elusive wage growth will likely keep services inflation high and limit central banks’ room for maneuver. Using high-frequency data, we construct a combined labor market openings index for the US, UK, Germany, France and Canada, weighted by nominal GDP. Notwithstanding summer volatility in labor market openings, there is a clear downtrend in openings, which have fallen to only 17% of pre-pandemic levels, down from close to 80% above during the height of reopening labor market shortages. Total openings have also fallen commensurately.

Exhibit #1: G5 countries' real-time job openings



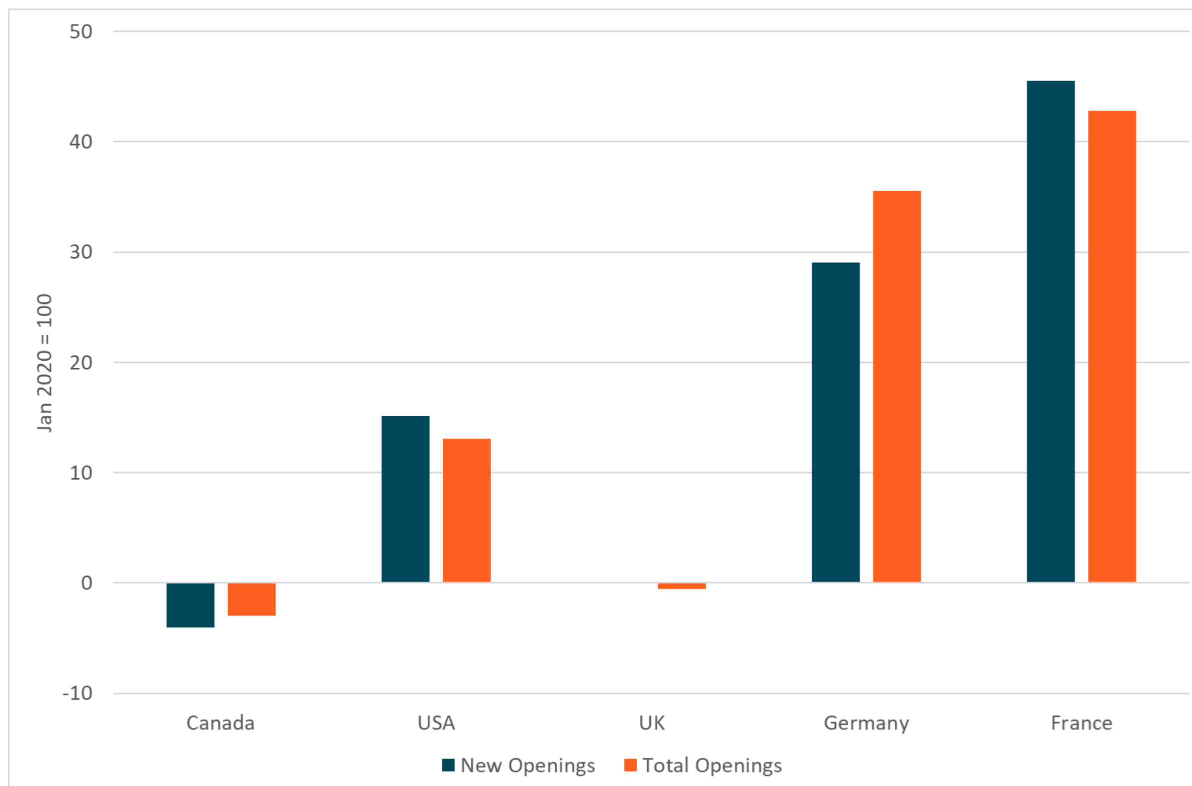
Source: Macrobond, Indeed, BNY

Due to the size of the US economy, this index itself is heavily skewed toward developments in the US and masks intra-G5 dispersion. For example, in Canada and the UK, current new openings and total openings are now just at or below pre-pandemic levels (Exhibit #2). Even so, there is no sign of any comfort among developed market central banks of softer wages accompanying weaker labor demand. Last week, even after cutting rates the Bank of Canada warned that while “moderating,” “wage growth…remains elevated,” and that “inflation is also elevated in services that are closely affected by wages.” The ECB is now only looking for moderation in 2025, while the Bank of England will have to also wait until then for viable labor market data, though headline inflation may prove low enough for them to act this week as well. Even if central banks are correct in assessing that wage inflation remains too high and is driving services inflation, hawkish policy stances keep financial conditions tight through all sectors of the economy.

Last week’s manufacturing surveys and earnings reports should give policymakers additional food for thought, as it is becoming evident that other sectors could be weakening aggressively. Although idiosyncrasies matter, major automotive producers across three different continents saw their earnings reports disappoint materially. Meanwhile, investors are becoming cautious about the semiconductor industry – an area where demand is supposed to be inelastic due to geopolitical and strategic reasons – and tightened financial conditions in one of the few areas of manufacturing expansion and resilience. The bottom line is that for central banks without an employment mandate, keeping financial conditions tight could

inadvertently hollow out non-service sectors of the economy. Even when services inflation falls back to target, it would only represent a pyrrhic victory.

Exhibit #2: Change in G5 job openings



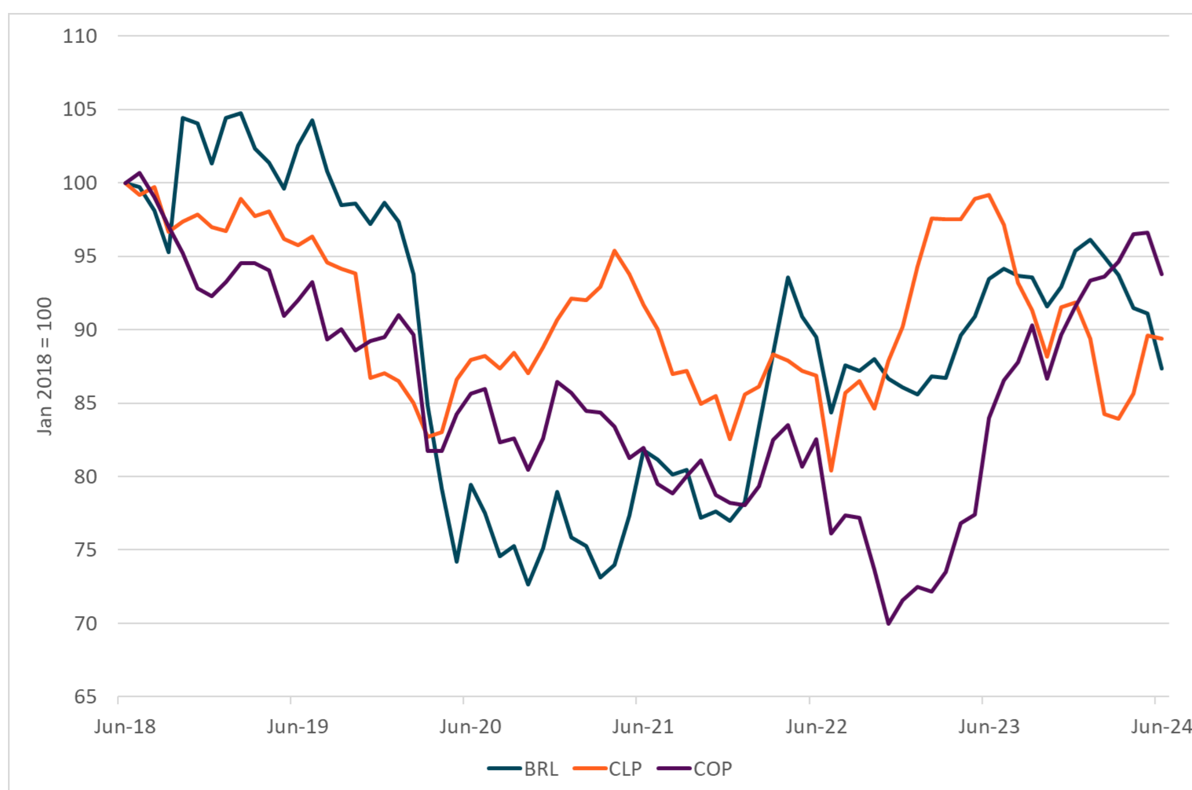
Source: Macrobond, Indeed, BNY

Elsewhere this week, Latin American central banks certainly would welcome a dovish surprise from the Fed. Having kept a material buffer between themselves and the Fed throughout the last two years, at the expense of domestic public and private sector demand, this was supposed to be the year when aggressive Fed easing provided strong relief. However, this was not to be and the pressure from governments in the region for central banks to act is palpable. This week sees decisions in Brazil, Colombia and Chile – all of which remain exposed to dollar resilience and terms of trade deterioration this year due to the commodity price slump. As global risk aversion starts to pick up, their currencies and underlying bond markets will be even more at risk from hedging interest, even if yield differentials hold up relatively well if the Fed signals a more conservative path. There are no exogenous shocks either, such as a material Chinese investment boom or large supply and demand imbalances, which sustained these currencies through much of 2022 and 2023. Political risk is a more recent phenomenon, but neither local nor external conditions will prove supportive.

Given the headwinds in place, it is quite striking that valuations are not attractive at all for

BRL, CLP and COP. Their respective real effective exchange rate (REER, Exhibit #3) indices from the Bank for International Settlements point to very limited adjustment since the highs seen last year for COP, while BOP and CLP remain comfortably above cycle lows. Given that their nominal effective exchange rates (NEER) have been under pressure since the carry trade started to unwind globally, inflation differentials are starting to assert themselves, especially with US price growth starting to wane. This is not how such central banks expected their currencies' valuations to adjust and explains why easing expectations for the entire region has stalled materially, with BRL forward rates especially notable. Fiscal expansion – although much desired by governments in the region after showing restraint during the pandemic – would only exacerbate risk aversion at a time when sentiment has turned fragile.

Exhibit #3: Latin America currency valuations

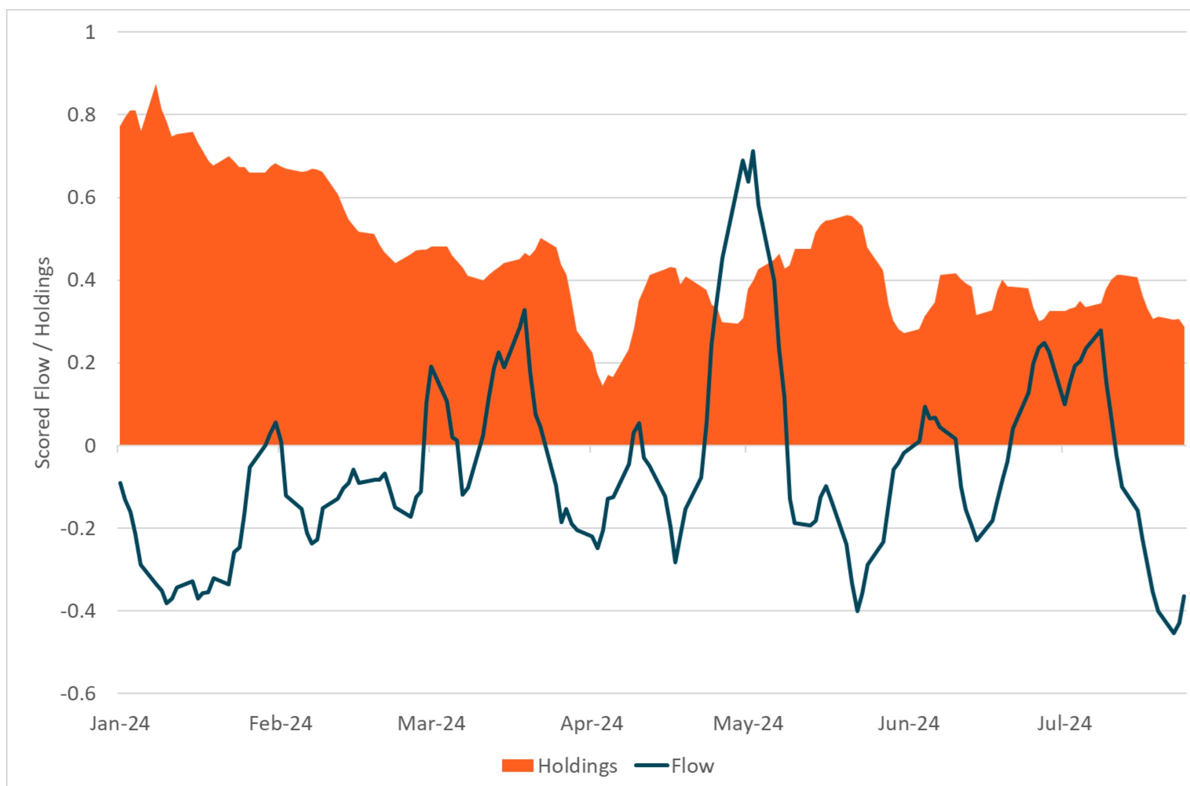


Source: BNY

Several weeks ago, when carry interest appeared to be in a better position, we expressed doubts that high-yielding currencies could sustain interest for long, even with a 'higher-for-longer' central bank policy. Based on iFlow's holdings indices (Exhibit #4), holding levels in high-yielding currencies remain positive and statistically significant, indicating the best-held currencies remain the highest yielders. Latin American currencies continue to populate the higher ranks, though they have been overtaken by EMEA currencies such as PLN and TRY. Last week saw Latin American currency flow reach the weakest point of the year, but overall holdings remain stable, indicating that volumes have not expanded aggressively. Given the

mean-reversion nature of flows, if the Fed does lean toward a dovish interpretation and this is subsequently complemented by resilient monetary policy postures across Latin America, there is scope for Latin American currency flows to recover and keep holdings favorable. However, we fear that the growth and political environment warrants weaker valuations across Latin America up ahead and given the stubbornness of global inflation amid holdings support, the balance of risks remains tilted toward sustained outflows and the neutralization of holdings in the region.

Exhibit #4: Latin American currency flow vs. holdings



Source: BNY

We remain of the view that there will be a more concerted push for growth in China for H2 as the country seeks to hit growth targets. Having confirmed that a meaningful fiscal push is coming, key trading partners should still be prepared for improvement in Chinese demand, but markets looking for opportunities need to be extremely mindful of specialization.

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