US Macroeconomics

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Something Has to Give

The labor market has been immune to higher interest rates thus far in the rate hiking cycle. Even though the unemployment rate jumped an unexpected three-tenths to 3.7% last month, it is only a tenth higher than where it was when the Fed began its tightening cycle in March 2022. It is fair to wonder when the labor market will crack. The construction sector is likely to hold early clues.

Construction spending is highly sensitive to interest rates, which is evident from its sharp fall over the past year. As to be expected, construction hiring is highly positively correlated with construction spending. When the latter surges so, too, does employment and vice versa.

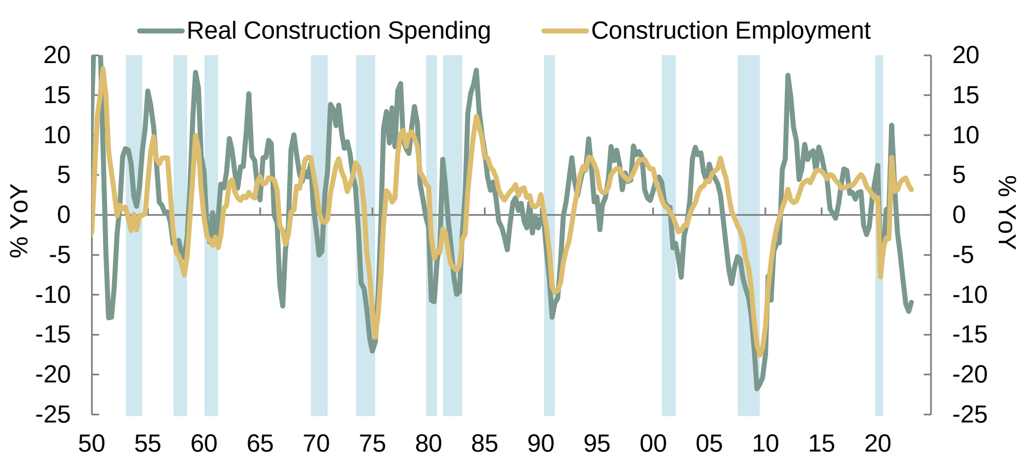
Since the Fed began tightening monetary policy, total real inflation-adjusted construction spending, which includes both commercial and residential structures, is down 11% over the past year. Notably, this is one of the weakest periods on record. However, over the last year, construction payrolls are up about 3%. **Construction employment has not pulled back**, at least not yet. In the process, there is a yawning gap between to the two series, as illustrated in the chart below.

There is currently a massive 14 percentage point gap between the growth rates in construction spending and employment. This is slightly smaller than the near 16 percentage point difference seen during Q3 and Q4 2022, which was the biggest since Q3 1951 (21%). So, the recent divergence remains significant. The key question is how does this gap close? Does spending rise to employment? Does employment fall to spending? Or is it some combination of the two — spending up, employment down?

Given the fact that borrowing rates are restrictive and may stay that way if the Fed gets its druthers, it is doubtful there will be a substantial improvement in spending. While we may experience a slower rate of decline in spending, the heavy lifting is likely to come from much weaker hiring because this is what happened in the past. Employment eventually falls to the rate of spending.

It is possible it will take longer to play out because of labor hoarding. For many businesses, the pandemic posed a host of unique and difficult challenges. Finding skilled labor was one of them. Consequently, **construction firms may be hesitant to let go of previously hard-to-get workers as quickly as in the past when demand faltered**. But eventually the laws of supply and demand will win out.

At some point, builders will either need to cut payrolls to bring supply in line with demand, or the Fed will need to cut rates to bring demand in line with supply. There has never been a persistent divergence between spending and hiring.



Sources: BEA, BLS, NBER, Haver, SMBC Nikko

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