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May's jobs report was a downer, so why are the markets so upbeat?

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BOTTOM LINE

The labor market laid a colossal egg this week, capped off by a much weaker-than-expected gain of only 75,000 nonfarm payroll jobs in May. That was exacerbated by a sizable downward revision of 75,000 jobs combined in March and April.

Moreover, the Challenger job-cut report announced an 86% year-over-year (y/y) increase in cuts during May, and Wednesday's ADP private payroll survey for May showed a disastrous gain of only 27,000 jobs (versus consensus expectations of 185,000). Finally, Monday's ISM manufacturing survey for May posted its weakest reading in nearly three years at 52.1.

So how did the financial markets respond to this spate of bad economic news? Stocks have ripped higher by almost 6% over the past four days, nearly reversing the S&P 500's 7.6% decline from its May Day record high to this past Monday's bottom. Benchmark 10-year Treasuries are on a roll, too, with prices soaring and yields plunging to a nearly 2-year low of 2.05%.

Thanks to the Federal Reserve, this bad news became good news. Investors now believe the Fed, in light of this weak economic data, will soon begin to end its recent "on-hold" posture and cut interest rates, perhaps as soon as its policy-setting meeting on June 19.

It's all about the Fed Markets are now pricing in a 25% probability of a quarter-point rate cut at the June meeting, a 75% chance of a cut at the July 31 meeting and a 99% chance of a rate cut by year-end. In our view, the market is overestimating the odds of a June move for two reasons. First, we think Presidents Trump and Xi will meet at the G20 summit in Osaka, Japan (June 28-29) and agree to get trade and tariff discussions back on track. In our view, May's labor-market weakness is related to trade and global economic growth concerns. Second, we believe the Fed would much prefer to base a policy change on a trend rather than an aberrant data point, and the June jobs report released on July 5 could show or refute one. So it would be prudent for the Fed to stay put at the June meeting and regroup in late July after seeing June's employment data and the status of the U.S.-China trade negotiations.

What hurt May's weak payroll results? First, ADP's private-sector hiring was much weaker-than-expected in May, with a gain of only 27,000 jobs (versus consensus expectations of 185,000)—far below April′s addition of a robust 271,000. Small-business hiring actually shed 52,000 jobs in May, compared with the addition of 71,000 jobs in April. Also, the Challenger survey reported nearly 59,000 job cuts in May, a 46% month-over-month (m/m) increase and an 86% y/y surge. Finally, the survey week for initial weekly unemployment claims, a critically important leading employment indicator, rose to 212,000 for the week ended May 18. That's 10% higher than the 49-year cycle low (matching September 1969) of 193,000 for the week ended April 13—the survey week for the April payroll report.

Shocking nonfarm payroll reversal Although Federated's in-house model forecasted a modest gain of 82,000 jobs, the consensus missed badly with its estimate of 175,000. Moreover, the actual print of 75,000 was neutralized by the sharp downward revision of 75,000 combined jobs in March and April—final gains of 153,000 and to 224,000, respectively. In May, government hiring fell by 15,000 jobs (paced by state and local declines of 10,000 and 9,000, respectively), which means that the private sector hired 90,000.

Household survey bounces The admittedly volatile household survey (a leading employment indicator) added 113,000 jobs last month, compared with losses of

103,000 jobs in April and 201,000 jobs in March.

Construction and manufacturing weak The construction industry added a paltry 4,000 jobs in May versus 30,000 jobs in April and 15,000 in March. The manufacturing sector added an in-line 3,000 jobs, after a gain of 5,000 in April and a loss of 3,000 in March.

Labor impairment falls; unemployment and participation rates flat The unemployment rate (U-3) was unchanged in May at a 49-year low of 3.6%, and the labor force participation rate remained at 62.8% in May, down from a 5-year high of 63.2% in February. The labor impairment rate (U-6) declined to 7.1% in May, a new 18-year low.

Wage growth declines, hours worked flat Average hourly earnings rose a modest 0.2% m/m in May, was flat from March and April, and still down from a robust 0.4% gain in February. The y/y gain slipped a tick to 3.1% in May, down from February's 3.4% increase, which was a 10-year high. For the third time in the past four months, the average private work week for all employees in May remained at 34.4 hours worked. A change of 0.1 hour worked theoretically adds or subtracts 350,000 jobs from the economy.

Retail hiring remains soft The sector shed jobs for the fourth consecutive month, losing 8,000 jobs in May, versus losses of 14,000 jobs in April, 15,000 jobs in March and 14,000 in February.

Temps modestly higher Temporary help (a leading economic indicator) added 5,000 jobs in May, after a gain of 10,000 jobs in April, a loss of 11,000 jobs in March, a gain of 7,000 jobs in February and a loss of 26,000 jobs in January.

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