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Is the Labor Market Tossing a Fair Coin?

How important is tomorrow's June employment report? In isolation, the answer would surely be not much. The month-to-month swings in job gains can be quite large, and one month does not a trend make.

And yet, there seemed to be a pretty significant reaction to the May employment number, a reaction that did not escape the attention of MarketWatch's Caroline Baum:

> So yes, the Fed does seem to be altering its macro view on potential growth (slower) and the neutral funds rate (close to zero) as a hangover from the Great Recession becomes an increasingly inadequate explanation for persistent 2% growth.
>
> What comes across to the observer is a bad case of one-number-itis. The monthly jobs report does contain a lot of important information, including hiring, wages and a proxy for output (aggregate hours index). But the Fed talks out of both sides of its mouth, cautioning against putting too much weight on a single economic report, and then doing just that.

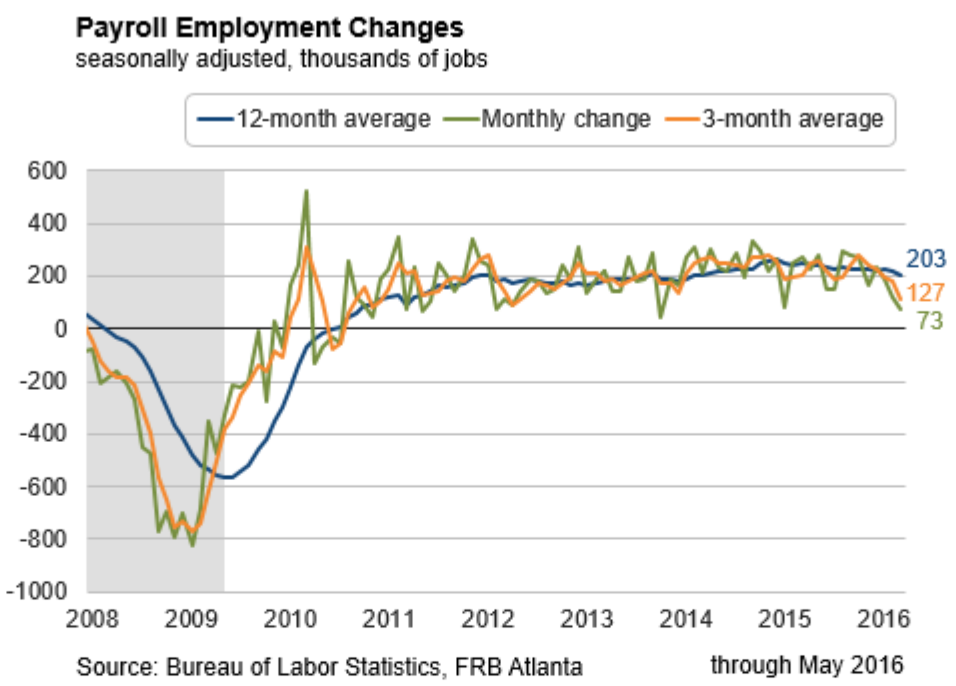
I get it. I don't speak for the Fed, of course—above my rank—but I am in fact one of those who regularly cautions against putting excessive weight on one number. And I am also one of those taken aback by the May employment report, so much so that my view of the economy changed materially as a result of that report.

Let me check that. My view of the *risks* to the economy, or more specifically the risks to my assessment of the strength of the economy, changed materially.

Here's an analogy that I find useful. Flip what you assume to be a fair coin. The probability of getting a heads, as we all know, is 50 percent. And if you weren't too traumatized by the statistics courses in your past, you will recall that the probability of two heads in a row is 25 percent, dropping to just about 13 percent of the coin coming up heads three times in a row.

Now, 13 percent is not zero, but it may be getting low enough for you to begin to wonder about your assumption that the coin is actually fair. If you have some stake in whether it is or isn't, you might want to take one more toss to get a little more evidence (since the odds of getting four heads in a row is, while not impossible, pretty improbable).

The point is that it wasn't just the May statistic that was striking in last month's report, but also the fact that the March and April numbers were revised downward to the tune of nearly 60,000 jobs. And if you step back a bit, you will see that the rolling three-month average of monthly job gains has been declining through the first half of the year (as the chart shows), even adjusting the May number for the Verizon strike:



Strike-adjusted, the May job gains were the lowest since December 2013. The three-month average (again strike-adjusted) was the lowest since the middle of 2012. In other words, although the year-over-year pace of jobs gains has been holding up, momentum in the labor market is decidedly softer—at least when measured by payroll employment gains.

I have been assuming that the U.S. economy will, for a while yet, continue to create jobs at a pace greater than necessary to maintain the unemployment rate at a more or less constant level. That pace is generally believed to be about 80,000 to 140,000 jobs per month, depending on your assumptions about the labor force participation rate. Another jobs report (including revisions to past months) that counters that assumption would, I think, cause a reasonable person to reassess his or her position.

Based on today's ADP report, the odds look good for some decent news tomorrow. On the other hand, if the June employment number does tick up, some observers will no doubt note that it is a pre-Brexit statistic. It may take a few more flips of the coin to determine if that consideration matters.

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