Economics from Washington

SECOND THOUGHTS

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- *Labor markets tightened in April. This will continue throughout 2016, even though monthly job growth is likely to slow substantially.*

- *The quality of job growth during the current expansion has been high, despite what politicians may claim.*

- *The rate of wage increase has moved up about ½ percentage point, but this is not creating inflation pressure. Instead, it is squeezing profit margins. It may be some time before higher wages are translated into higher prices.*

- *The April job report provided no justification for higher interest rates. Officials will continue to monitor incoming data.*

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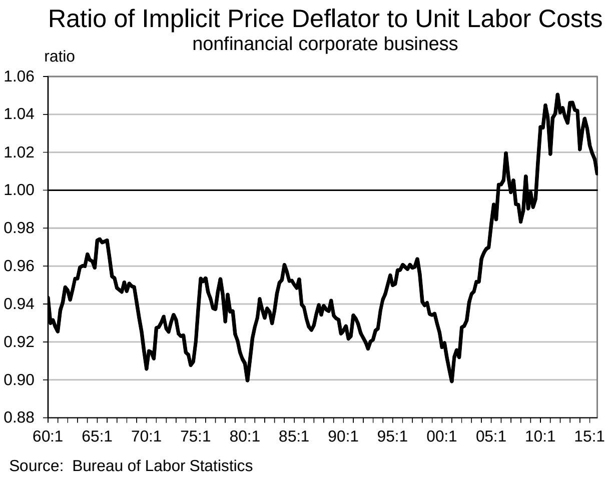
Although many thought the April employment report was disappointing, it showed another solid rise in jobs. Since the economy requires less than 100,000 jobs per month to sustain a steady unemployment rate, an increase of 160,000 means labor markets are still tightening. With unemployment now at 5%, we have expected the rate of tightening to slow materially this year. By the end of the year, we expect monthly job growth to be near 100,000 and the unemployment rate to be about 4 ½ %. However, there is more to the story than simply running out of available workers – profits also play a role.

There was also some disappointment that the labor force participation rate declined slightly in April. As we discussed several weeks ago, the recent increase was due more to fewer people dropping out of the labor force than anything else – there has been no surge of reentrants. In April, more dropped out, pushing the rate back up. Monthly flows in and out of the labor market are very erratic, so it is best to focus on the trends. The most powerful trend comes from the aging labor force. Against this downward pressure is the positive pressure provided by cyclical tightening in labor markets. The net effect is a slight downward drift in the participation rate and this is what we expect to see. This is not especially good or bad news, it simply reflects the changing demographic structure of the labor market.

One of the positive aspects of this report is the quality of new jobs. Some noted a strong increase in business and professional services, but this is not just a recent development. This sector has produced the largest share of job growth during the entire expansion and the second largest share in the past six months. Health care has produced the second largest share during the expansion and the largest in the past six months. Together, these two sectors account for about 50% of the job growth during the expansion, and these are relatively high paying jobs. While the expansion has been less robust than most hoped, the high quality of job growth seems to be generally under appreciated.

At present, the most important information in the monthly employment report is the hourly wage data. While there is always some variation, wages were rising close to a 2% rate through mid-2015. They showed a



little acceleration in the second half of the year, and have now increased at a rate near 2 ½ % for the past five months. Wages rose this fast in early 2014, but could not be sustained because labor markets had substantially more slack. Now the increase looks sustainable. Many analysts have been watching for a sustainable rise in wages as a sign inflation pressure is increasing, but this is not what the data show is happening.

The combination of accelerating wage rates and very poor productivity growth has caused a sharp rise in unit labor costs – they increased at a rather spectacular 4% annual rate in 1Q and are up 2.3% over the past year. This rise in costs can show up either in higher inflation or lower profit margins. The data point to a margin squeeze. Although 1Q profit estimates are not yet available for the national accounts, this is not something that just began recently. Rising costs have been gently squeezing margins for over a year. From 2010 to 2013, the business sector was able to increase prices about 4% per year faster than labor costs. This allowed margins to remain very high. The differential began to shrink in 2014 and by the end of 2015 stood at about 1% as shown in this week's chart. Based on what we can tell from earnings reports, it may have vanished in early 2016. How much margins will shrink is not clear, since margins have varied over a wide range in the past – there is no 'normal' to use as a standard for comparisons. Suffice it to say, margins are still very high on a historical basis.

Until business is able to defend margins by increasing prices as fast or faster than costs, the squeeze will continue. One bit of evidence comes from the monthly small business survey where we can compare planned price increases with actual price increases. While the number planning to increase prices exceeds those planning to cut by 15 - 20% on a routine basis, the actual data now shows more price reductions than increases. Apparently, 'pricing power' remains very weak. This will change if wage and employment growth keep income rising at a solid pace, but as noted above, employment growth will likely slow, so change may take some time. In addition, smaller profit margins feed back into business investment and hiring decisions, producing a negative feedback loop. The bottom line is it is not clear when rising labor costs will put upward pressure on inflation; the squeeze on profit margins, however, is very clear.

For a central bank looking to increase interest rates, the April employment report was not helpful. Job growth was not far from most officials' expectations so there was no particular disappointment, but the squeeze on margins points to continued weak investment. It also suggests wage related inflation pressure is not yet important. While officials believe they have largely achieved their maximum employment mandate, rising inflation does not stand in the way of allowing labor markets to tighten a bit more. Until there is something they can point to as a reason for raising rates, the FOMC will simply continue to monitor incoming data.

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