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RISING WAGES AND THE U.S. ECONOMY

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KEY TAKEAWAYS

Wage pressure has been well contained in the current economic cycle, but recent reports show wage growth is accelerating.

Growth in wage costs, however, is far below the level seen in the Fed's last tightening cycle.

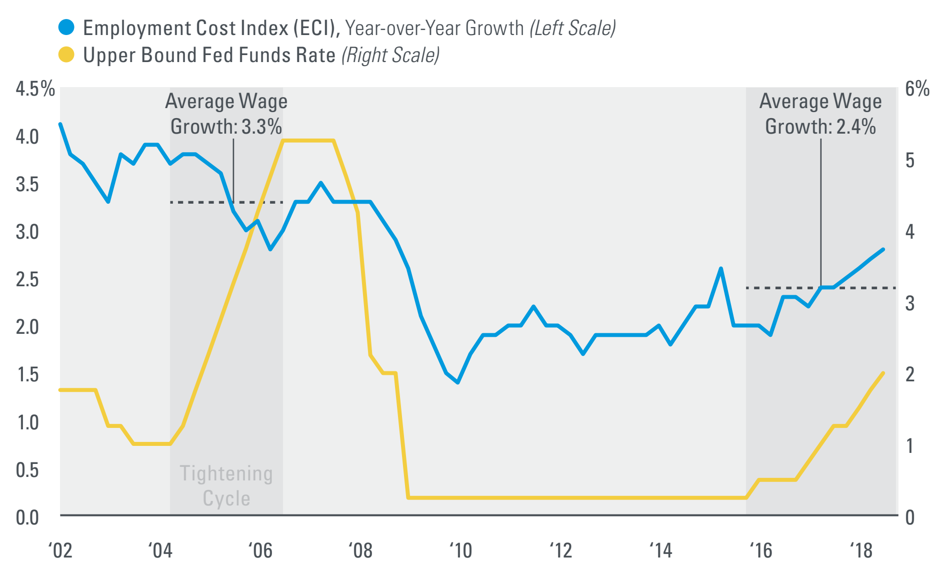
We believe wage growth (and labor costs) will remain manageable amid the Fed's gradual approach and changing labor market dynamics.

U.S. wage growth has been one of the most highly scrutinized economic trends recently. Investors watch average hourly earnings and employment cost data to gauge inflationary pressures, as wages represent up to 70% of business costs, and the Federal Reserve's (Fed) dual mandate includes achieving stable prices.

So far, wage growth has been contained, but recent reports show wage pressures are rising. The October jobs report showed average hourly earnings grew at a 3.1% pace year over year, the first time annual growth has eclipsed 3% since April 2009. Employment Cost Index (ECI) data for the third quarter confirmed that compensation costs are growing at their fastest pace of the cycle [Figure 1].

While wages are picking up amid a historically tight labor market, we think the current pace of wage growth is sustainable and healthy for the economy, instead of a warning sign of a substantial pick-up in inflation.

1 CURRENT PACE OF WAGE GROWTH SUPPORTS GRADUAL RATE INCREASES



Source: LPL Research, Bloomberg 10/31/18

Tightening cycles are periods when the Federal Reserve raises interest rates.

Employment Cost Index: This is a quarterly report from the U.S. Department of Labor that measures the growth of employee compensation (wages and benefits). The index is based on a survey of employer payrolls in the final month of each quarter.

Illustration is historical and no guarantee of future results.

THE HISTORY

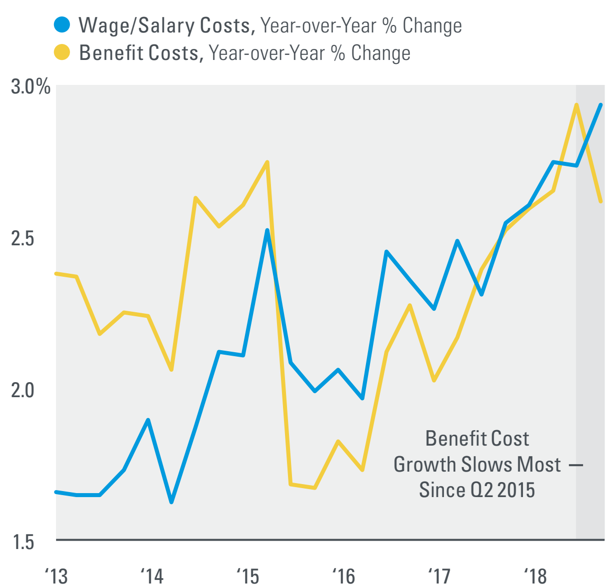
We believe data on wages should be viewed in a historical context to understand how the Fed might respond to increasing wage pressures. For this, we use the ECI as a historical indicator of where wages have been during past tightening cycles. ECI growth has averaged 2.4% in the current tightening cycle, far below the 3.3% average rise during the Fed's last tightening cycle (as shown in Figure 1).

Compensation costs climbed as fast as 3.9% in the year before the Fed first hiked rates in April 2004, significantly above the 2.8% year-over-year increase last quarter. Each of the past five economic recessions started with wage growth around 4%, so wages have room to grow before the pace reaches alarming levels.

CURRENT DRIVERS

The undercurrents of current wage growth paint a picture of evolving domestic and global economies. Wage growth was broad-based across jobs sectors last quarter, as wages accelerated for both private industry and government jobs. Wage costs in service jobs grew the most in a quarter since 2007, boosting year-over-year wage increases to a cycle-high 2.9%, as employers adjusted to the U.S. economy's shift to a more service-based labor force. Wages in goods-producing jobs grew 2.7% year over year. On an industry level, salary-cost increases in sales, office, production, and transportation jobs have led gains, and year-over-year increases for these groups have either met or exceeded cycle highs. On the other hand, wage growth in natural resources jobs, which include construction, farming, extraction, and forestry, has declined for three straight quarters as trade tensions have weighed on the agriculture industry. As the U.S.-China trade dispute continues, wage costs for natural resources jobs may stagnate further as firms seek to reduce expenses to compensate for lost revenue.

2 WAGE COST GROWTH ACCELERATES WHILE BENEFIT COST GROWTH COOLS



Source: LPL Research, Bloomberg 10/31/18

The balance of salary and benefit costs could also signal changing dynamics in employee pay as the job market tightens further. In the last several Beige Books, employers noted they were resorting to non-salary benefits over pay increases to attract and retain workers. As wage costs rose at their fastest pace of the cycle last quarter, benefit costs grew at the slowest pace since the second quarter of 2015 [Figure 2].

While benefit costs are heavily influenced by bonuses, slowing growth in benefit costs combined with accelerating salary costs may show companies' pivot from improving non-salary incentives to increasing pay. We will continue to monitor economic data for shifts in these trends.

CURIOUS LABOR MARKET

The absence of substantial wage growth is one facet of a curious, but solid U.S. labor market. The unemployment rate sits near a 48-year low and non-farm payrolls growth is solid, but evidence of a mismatch between employers and workers persists. The number of U.S. jobs openings has exceeded the number of unemployed labor force participants for five straight months through August, a dynamic that hasn't occurred in data going back to 2001. The quit rate is also at its highest point in 17 years, indicating workers feel empowered enough by opportunities to voluntarily leave their jobs. Since the labor market is tight, significant wage growth could appear quickly. However, we believe the combination of low labor force participation, globalization, and millennials replacing baby boomers in the workforce will continue to keep a lid on wage costs. A rise in the "prime age" (25–54) participation rate may also signal more slack in the labor market than there appears to be, as fiscal stimulus through lower taxes makes entering the workforce a more attractive option.

While wage growth has been considered a negative development for financial markets because the Fed is in tightening mode, steady wage growth has been a boon to economic activity. Personal incomes have grown near the quickest pace in three years recently, lifting consumer spending and aiding consumer confidence.

Unit labor costs, or employers' compensation expenses per unit of output, have remained contained, so the pace of compensation cost growth hasn't meaningfully weighed on profit margins yet. Low unit labor costs reflect improvements in productivity, which helps offset some of the negative impact of higher wages.

Manageable wage growth is also a testament to the effectiveness of the Fed's gradual interest rate hikes in this macroeconomic environment. The U.S. economy is humming along with contained inflationary pressures, primarily due to the Fed's careful policy approach.

CONCLUSION

Financial markets may still be sensitive to wage data, but we encourage investors to view inflation reports compared to historical trends. To us, current wage growth is in a sweet spot. We view the pace of wage growth as a net benefit to the U.S. economy, as modestly accelerating wages boost personal incomes. However, we don't expect wages to accelerate so quickly that the Fed would shift to a more aggressive path for rate hikes. ■

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