ECONOMIC UPDATE

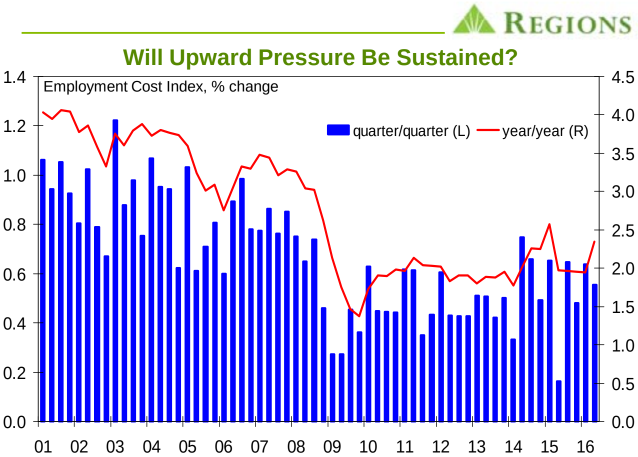
REGIONS

July 29, 2016

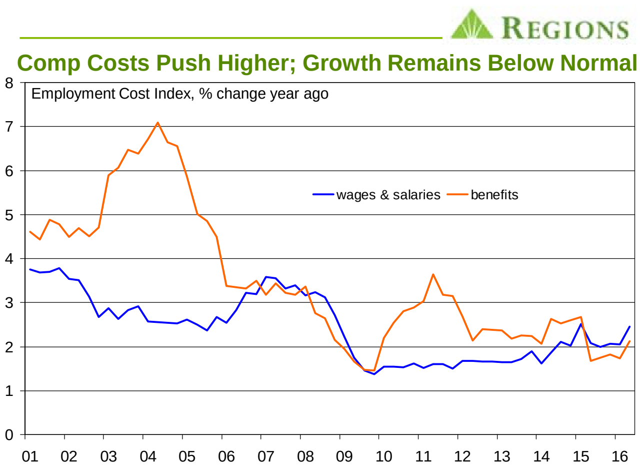
Q2 2016 Employment Cost Index: Some Upward Pressure, But Will It Be Sustained?

- The total ECI was up 0.6 percent in Q2 2016, with the wages/salaries component up 0.6 percent and the benefits component up 0.5 percent.
- On a year-over-year basis, the total ECI was up by 2.3 percent in Q2 with wage costs up 2.5 percent and benefit costs up 2.1 percent.

Total compensation costs, as measured by the Employment Cost Index (ECI), rose by 0.6 percent in Q2 2016, in line with expectations. The wage component of the ECI was up 0.6 percent in Q2 while the benefits component rose 0.5 percent. On an over-the-year basis, the total ECI was up 2.3 percent, with the wage component up 2.5 percent and the benefits component up 2.1 percent.



The ECI is one of the three main data series – the others being average hourly earnings from the monthly employment report and unit labor costs from the quarterly labor productivity and costs report – showing trends in labor costs. The ECI tends to get less attention than its two counterparts but nonetheless is perhaps the most meaningful of the three series. The ECI is designed to measure changes in total labor costs, for both money wages and salaries and noncash fringe benefits (such as health insurance and pensions). One distinction between the wage component of the ECI and the more widely followed average hourly earnings metric is the ECI is not affected by shifts in the composition of employment across industry groups. Instead, the wage component of the ECI effectively measures wage costs for the same jobs over time and the total ECI measures labor costs (i.e., wages and benefits) for the same jobs over time. One drawback of the average hourly earnings metric is that it is skewed by changes in the composition of employment and hence will mask differentials in earnings across industry groups.



These differences aside, the alternative series are at present all singing from the same hymnal. Each shows some acceleration in wage growth but at the same time shows growth remains well below what we would expect to see in a fully healthy labor market, or, if you prefer, at full employment. The question, at least for us, is the extent to which the upward pressure on wage growth will persist. While we do see labor market conditions as having tightened, we still see more slack in the labor market than many other analysts see, with this slack still acting as a drag on wage growth in our view. We'd caution that the over-the-year comparison for Q2 2016 is an easy one, as the ECI came in somewhat weak in Q2 2015 (as seen in our top chart). More fundamentally, we think wage growth is being upwardly biased, at least in certain segments of the economy, by recently implemented increases in minimum wages across many parts of the U.S. as well as by increases in entry level wages being voluntarily paid by many large national retailers and firms in a few other industries. These higher entry level wages in most cases filter up through the ranks of more experienced workers. We will note that the ECI measure of wage growth in retail trade shows year-on-year growth of better than 3.0 percent in recent quarters. The point is that any such one-off increases will have but a transitory impact on measured wage growth, ultimately washing from the data. It is too soon to tell, then, to what extent genuinely tighter labor market conditions are pushing wage growth higher, which is the form of upward pressure that would be sustained.

The bottom chart shows the cumulative percentage change in wage costs across industry groups between Q1 2012 and Q2 2016. As always there is a good deal of variance across industry groups but a few things stand out. First, the relatively slow growth in wages in construction seems at odds with what has been a steady homebuilder refrain of labor shortages inhibiting single family construction. As noted above, retail trade has been one of the high achievers in terms of wage growth. Also, while the ECI is not impacted by the mix of jobs, the rankings shown here coupled with the data on job growth by industry from the monthly employment report helps account for what remains sluggish growth in average hourly earnings, which is sensitive to the industry mix.

We have argued it will not be until some point in 2017 that wage growth approaches what would be considered normal. Until then, firms will face fairly steady growth in total comp costs with low inflation helping workers stretch nominal earnings further. Not ideal, but nonetheless what to us still seems the most likely scenario between now and then.

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