ECONOMIC OUTLOOK

REGIONS

March 2018

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Labor Costs: It's The Sum Of The Parts, Not One Part, That Matters

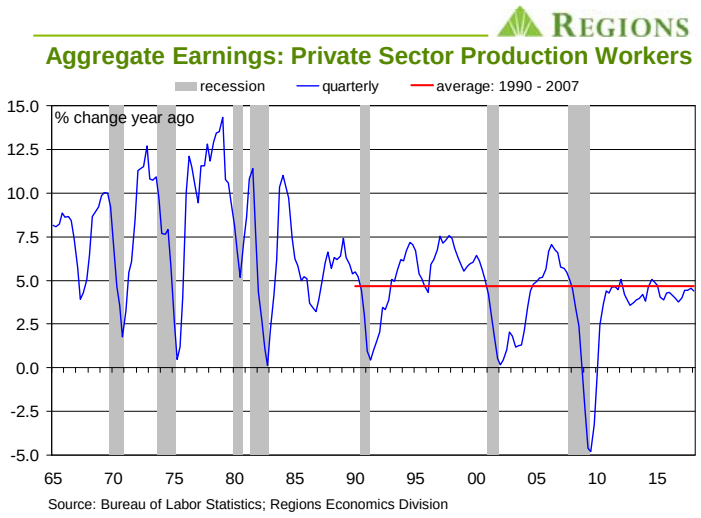
Sure, we get that whole "the whole is greater than the sum of its parts" thing. We're fairly sure, however, that Aristotle didn't moonlight as a labor economist. If he had, he would no doubt have concluded that when it comes to labor costs, it's the sum of the parts that matters. Then again, were he living in modern times and forced to rely on the cursory accounts and instant reactions that masquerade as actual analysis of the monthly employment reports, Aristotle may have concluded that neither the whole nor the sum of the parts matters, but a single part can tell you all you need to know. Which, aside from not being the case, at least where the labor market is concerned, just doesn't sound all that profound when printed on a coffee mug.

In any event, it never ceases to amaze (let alone annoy) us that, out of roughly 40 pages of data in each monthly employment report, many analysts and market participants focus on one single number – average hourly earnings – and on this basis draw broad conclusions on the health of the labor market, the outlook for inflation, and what it all means for monetary policy. In all fairness, one reason many analysts and market participants do so is that many central bankers seem to rely on wage pressures as a proxy of inflation pressures in the broader economy.

This is why the January employment report caused such a stir in the financial markets – the January data (since revised) showed average hourly earnings to have risen 2.9 percent year-on-year, the largest such increase since April 2009. In conjunction with an unemployment rate of 4.1 percent, below many estimates of "full employment," this set off the inflation alarm bells, the premise being that with wage growth heating up, faster inflation in the broader economy was surely at hand. And, as if on cue, the January CPI report showed, to quote one of many such headlines, an "inflation surge," with the headline CPI rising 0.5 percent and the core CPI rising 0.3 percent in January. That this left the headline CPI up 2.1 percent and the core CPI up 1.8 percent year-on-year did nothing to assuage fears of an inflation surge.

We devoted a portion of our February *Outlook* to a discussion of why there was far less to the reported growth in average hourly earnings in January than meets the eye, as the reasons for this seem to have been lost in the *deeply analytical* (sarcasm font alert!) instant reactions to the January employment report. We devoted a good portion of our September 2017 *Outlook* to a discussion of wage growth and why the seemingly slow pace of wage growth seen to date during the current cycle really shouldn't be surprising. We also spent some time discussing the lack of any empirical foundation for the premise that wage growth leads inflation – indeed, what causality there is runs in the other direction, which explains much of what we've seen in the current cycle.

As these are by no means the only instances in which we've made many of the same points, we won't revisit them here. Not to worry, though, because we still have a bone to pick with those who see growth in average hourly earnings as an indicator of inflation pressures in the broader economy. To wit, we've yet to come across a single firm that manages average hourly wages rather than managing total labor costs, which are a function of the number of people working, the number of hours they work, and how much they earn for each hour worked. And, from our end, forecasts of consumer spending rely on aggregate earnings, not hourly earnings, as an input. As seen in the following chart, relying solely on growth in average hourly earnings as a gauge of labor market tightness can lead one to a much different conclusion than a conclusion based on growth in total labor costs.

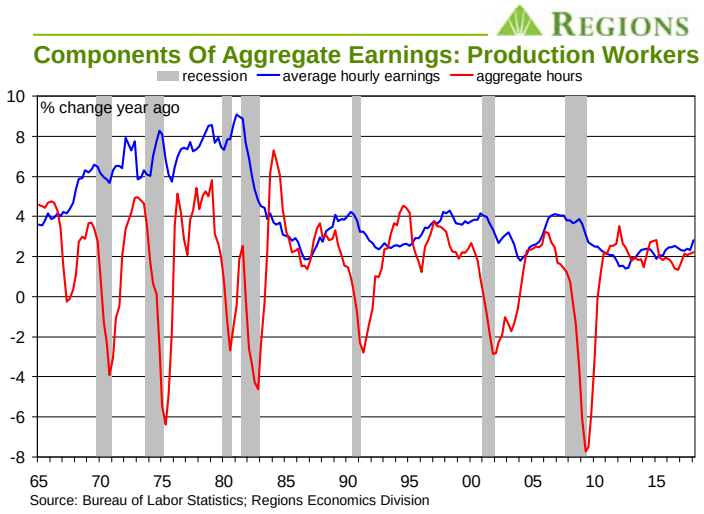


The chart above shows aggregate wage and salary earnings for production workers, who account for roughly 82 percent of all private sector workers (a share that hasn't changed much since the 1960s), with those in supervisory or management positions accounting for the remainder. While the data (employment, hours, earnings) on production workers go back to the 1960s, data for the private sector as a whole go back to only 2006, and while we've constructed a comparable historical series for our internal use, we simply use the data on production workers here, noting that our chart for the total private sector shows basically the same patterns. We've also included a bar showing the average growth rate for aggregate earnings of production workers for the 1990-2007 period, which we think a more relevant guidepost than the much faster growth that prevailed over earlier time periods. As we discussed in our September 2017 *Outlook*, inflation and productivity growth were also faster in earlier time periods and any assessment of wage growth has to account for these factors.

More to our immediate point, despite some acceleration in the growth of average hourly earnings and steady growth in the level

of employment, growth in aggregate earnings has pretty much been range bound for some time now. This is a somewhat different version of the state of the labor market than the shopworn but soundbite friendly "wage growth has picked up so faster inflation is sure to follow" narrative we've been treated to over the past few months, especially since the release of the January employment report. Sure, inflation is picking up, but faster growth in labor costs is not the primary driver of this.

To help account for growth in aggregate wage and salary earnings remaining somewhat range bound, it helps to break the broader series out into its components. In the chart below, we show year-on-year growth in average hourly earnings and aggregate hours worked, again using data for private sector production workers. Note that the sum of these two components yields the growth in aggregate earnings shown in our first chart.



As is clear from the above chart, growth in aggregate hours worked exhibits significantly stronger cyclical behavior than does growth in hourly earnings. The data show that during expansions wage growth ultimately responds to tightening labor market conditions – again, though, in the context of prevailing rates of inflation and productivity growth. During downturns, however, wage growth may slow but average hourly earnings themselves basically never fall – looking at the data on a quarterly frequency, there has never once been either a quarter/quarter or a year/year decline in average hourly earnings of production workers (there are a few such instances in the monthly data but these mainly reflect quirks in the data, such as short survey periods).

Movements in aggregate hours worked, however, are much more pronounced, as firms adjust both hours worked and the number of workers – in that order – in response to changing business conditions. Indeed, as seen in the above chart, the series on aggregate hours worked has historically been a reliable indicator of turns in the business cycle. Managing the number of hours worked by current workers is far less disruptive, and costly, than altering head counts in response to changing business conditions. But, when those changes in business conditions seem likely to not only persist but become more pronounced, such as when what at first looks like a slowdown in growth morphs in to a recession, firms will begin to adjust head counts, often aggressively.

So, not only is the distinction between hourly wages and hours worked important in thinking about total labor costs, so too is the distinction between average hours worked and the number of people working. This is why we pay so much attention to not only the level of but also changes in average weekly hours. In a broader sense, changes in average weekly hours have historically tended to be early warning indicators of cyclical changes in labor market conditions and, in turn, the broader economy. As we often note, even seemingly small changes in the average length of the workweek can, if they are sustained, tell us big things about underlying conditions in the broader economy, as each one-tenth of an hour change in the average length of the workweek is equivalent to over 300,000 jobs in terms of aggregate labor input.

In turn, these seemingly small changes in average hours worked have a powerful impact on aggregate wage and salary earnings. For instance, when transitory factors pushed average weekly hours down to 34.4 hours in January from 34.5 in December, aggregate wage and salary earnings barely budged despite the addition of 238,000 private sector jobs and a 0.3 percent increase in average hourly earnings; had weekly hours held at 34.5 hours, aggregate earnings would have risen by 0.5 percent. We saw this reverse in February; hours worked went back to 34.5 hours and aggregate wage and salary earnings rose by 0.7 percent even as average hourly earnings rose by only a puny 0.1 percent

This gets us back to where this discussion started. In other words, despite steady growth in employment and firming growth in hourly earnings, growth in total labor costs has been somewhat range bound and, despite a headline unemployment rate of 4.1 percent, firms still have a powerful lever to pull in terms of aggregate labor input. Though off cyclical lows, the length of the average workweek is still well short of where it would be were the labor market being stretched to capacity. For instance, at present the length of the average workweek for production workers is roughly seven-tenths of an hour below the average that prevailed over the expansion of the 1990s, and is also below the average that prevailed in the years ahead of the 2007-09 recession.

Obviously average hours worked vary, in some cases sharply, across industry groups, but those relative relationships are no different now than has always been the case. In the aggregate, there is considerable capacity for firms to add to labor input by adding hours for current workers, and this is the one change that would be most impactful in terms of total labor costs. Indeed, one can argue that firms have responded to mandates such as higher minimum wages and (though here in only a few industries) ACA requirements by holding down hours worked for at least parts of their workforces as a means of managing total labor costs.

Our point here is that those relying on growth in average hourly earnings as a guide to the degree of tightness in the labor market or, more egregiously, the main driver of changes in inflation, are missing the mark. To be sure, at some point growth in total labor costs may accelerate to a degree sufficient to lead firms to try to push for higher output prices, but we're not close to that point just yet and it is changes in hours worked, not changes in hourly wages, that will get us there faster. We have often stated our view that a shorter average workweek is an underappreciated form of labor market slack. This applies not only to the utilization of labor

input, but also to the growth of total labor costs which, after all, is what firms manage to.

Perhaps Not A Crisis, But At Least Cause For Concern

At year-end 2017 the personal saving rate fell to its lowest point in a decade, which touched off talk that the U.S. was facing a "saving crisis." Many who made this assertion did so on the basis that the last time the saving rate was this low was late-2007, and we all know what happened next. As if what we all know happened next stemmed directly from the saving rate being so low, which most of us, but apparently not all of us, know was not the case.

This does not mean the low saving rate is not cause for concern. It is, but only when we focus our concerns on the more relevant measure of saving in the U.S. economy, i.e., the domestic saving rate. The personal saving rate measures saving in the household sector, but total domestic saving also flows from the corporate sector and the government sector. Or not – any single sector of the economy can engage in dissaving (i.e., run a negative saving rate), as has long been the case in the government sector of the U.S. economy. In a closed economy, negative saving in one or more sectors must be offset by saving in the remaining sector(s) while in an open economy foreign saving can compensate for a lack of or low level of domestic saving. In any economy, closed or open, the aggregate level of investment equals the aggregate level of saving, which of course matters because investment is the key fuel of any economy's growth over time.

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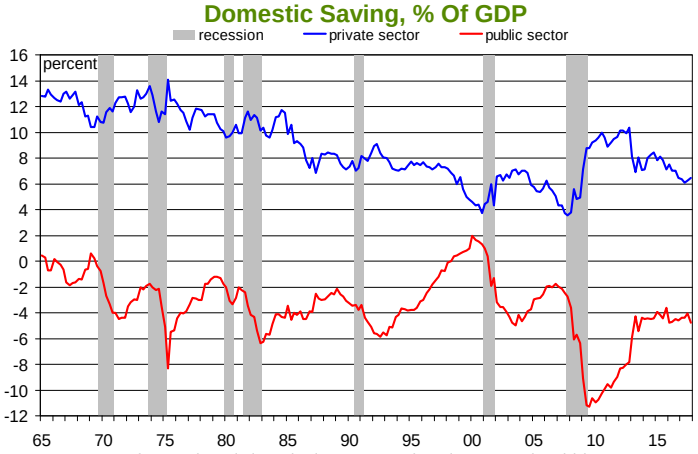
Domestic Saving, % Of GDP



Source: Bureau of Economic Analysis; Federal Reserve Board; Regions Economics Division

As of Q4 2017, the domestic saving rate, or, domestic saving as a percentage of nominal GDP, stood at only 1.74 percent, well below historical averages but in line with the average rate of 1.9 percent seen since mid-2016. In the chart above we break domestic saving down on the basis of the private sector (or, combined household and corporate saving) and the public sector. As of Q4, the household saving rate stood at 1.97 percent, the corporate saving rate (which is measured on the basis of net saving, i.e., excluding depreciation) stood at 4.52 percent, and the public sector (all levels of government combined) saving rate stood at negative 4.75 percent. Adding across the three sectors yields the net domestic saving rate of 1.74 percent.

As seen in the prior chart, the private sector saving rate has trended lower over recent decades, as has the government sector saving rate, though in the latter case this has meant the degree of dissaving in the government sector has risen. The secular decline in the private sector saving rate mainly reflects a significant and sustained decline in the saving rate in the household sector. As we have discussed in prior editions of our *Outlook*, this to a large extent reflects traditional saving having been displaced by rising household net worth. An increased incidence of ownership of assets such as houses and equities, rising prices for those assets, and the expanded ability to liquidate some/all of the value of these assets have combined to displace traditional saving in the household sector. The following chart shows average saving rates by decade for each of the three sectors of the domestic economy.

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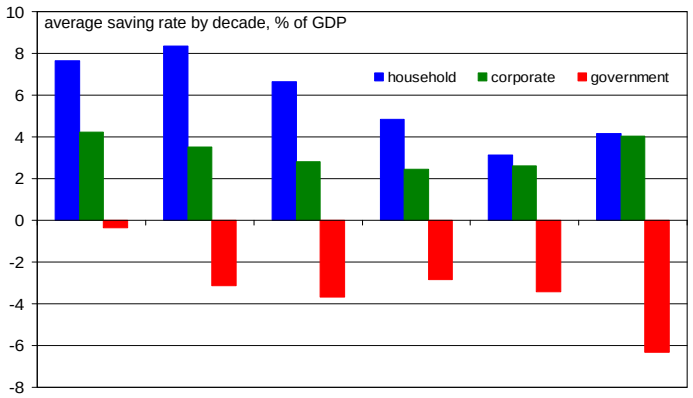
Government Sector An Increasing Drag On Domestic Saving



Source: Bureau of Economic Analysis; Federal Reserve Board; Regions Economics Division

In the aftermath of the 2007-09 recession, the household saving rate rose at a fairly steady pace, which helps account for the average saving rate since 2010 being higher than the rate that prevailed over the prior decade even though the household saving rate fell sharply in mid-2016. The higher corporate saving rate since 2010 largely reflects the robust growth in corporate profits seen over much of the current expansion. To be sure, the striking decline in the average government saving rate since 2010 in part reflects the lasting effects of the 2007-09 recession, but what is concerning is that the government saving rate has flattened out at a rate considerably below historical norms, particularly for an economy in the latter phases of an expansion.

Why this is worth thinking about is that the negative saving rate in the government sector at year-end 2017 reflects none of the impacts of either the tax bill enacted in late-December 2017 or the spending bill enacted in early-2018, both of which are likely to add to the size of the federal government budget deficit. In other words, the government saving rate is likely to fall even further over the next few years as a result of the degree of fiscal stimulus set to be injected into the economy. To be sure, to the extent the tax bill adds to the economy's sustainable growth rate, that would mitigate the impact on the deficit but, even in the most optimistic case, i.e., the tax cuts pay for themselves, the added government spending this year and next (if not longer) will add to the size of the deficits, i.e., increase the degree of dissaving in the government sector.

Even though we look for the saving rate in the household sector to increase off of current values, which we see as unsustainably low, any such increase is unlikely to offset what will be a greater degree of dissaving in the government sector over coming years. In other words, the overall domestic saving rate will likely fall over coming years. To the extent this is the case, that leaves the U.S. with two options. One is to embark on a path of steadily lower levels of investment spending, which implies a lower "speed limit" (our term for the economy's sustainable rate of noninflationary growth). The other option is to attract more foreign saving, which over recent decades has bridged the gap between domestic saving and investment.

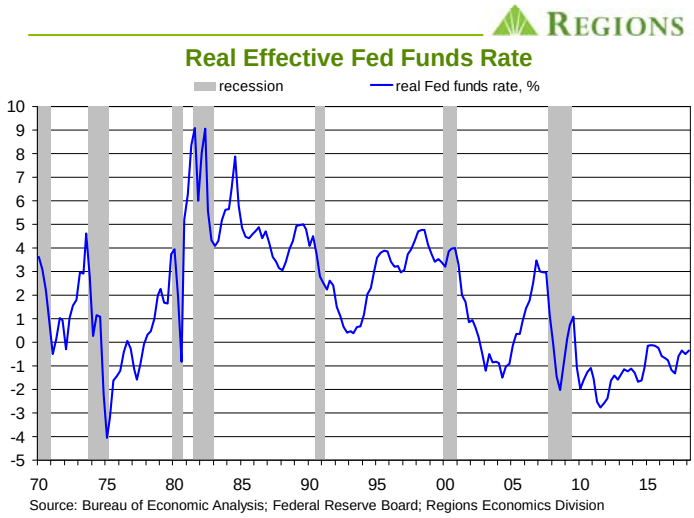
Though not typically thought of or discussed in these terms, the U.S. has consistently run trade deficits over recent decades, the flip side of which has been a persistent capital inflow, which simply reflects the realities of balance of payments accounting. In other words, the U.S. has basically been able to consistently consume above its means thanks to foreign capital financing the difference. One key reason the U.S. has been able to sustain this dynamic is that the U.S. dollar is effectively the world's reserve currency, and dollars accumulated by foreigners in trade transactions (i.e., trade in goods and services) have been "recycled" into demand for assets denominated in U.S. dollars.

That federal government budget deficits figure to become even larger over coming years means, barring an offsetting increase in private sector saving, the U.S. will need to attract even greater sums of foreign savings, and the cost of doing so will no doubt increase, i.e., it will take higher U.S. interest rates to attract foreign savings. At the same time, moves to restrict flows of trade in goods and services will restrict inflows of foreign capital. And, while any such movement is not yet on the horizon, there could come a time when there is a viable alternative to the U.S. dollar as the world's main reserve currency, which would make attracting foreign saving into the U.S. even more difficult, i.e., costly. This is not by any means intended as an alarmist rant, but it is intended as a reminder that the U.S. has been, and remains, highly dependent on foreign capital to finance not only current consumption but also future growth. This can go on, but only until it can't, and that time can come abruptly and without advance notice.

Should The FOMC Pick Up The Pace Even If Inflation Doesn't?

Thus far we've touched on two factors – wage growth and fiscal stimulus – that many worry will contribute to inflation accelerating at a faster pace than the FOMC is now anticipating. As such, many market participants and private sector analysts have come to expect four, if not more, 25-basis point hikes in the Fed funds rate target range in 2018 as opposed to the three such hikes most anticipated at the beginning of this year. The FOMC may, at their March 20-21 meeting, take a similar step in their revised economic and financial projections, as the "dot plot" released as part of these projections could imply four such rate hikes in 2018 rather than the three hikes implied by the December 2017 edition.

At this point, our baseline forecast continues to anticipate three funds rate hikes in 2018, though our degree of conviction is not all that high and we could easily see a case for four hikes. But, the grounds on which such a case can be made are for us not so much centered on inflation, barring of course an episode of runaway inflation that we simply do not see developing, but instead on a more fundamental point, which we illustrate in the following chart.



The chart shows the real (or, inflation adjusted) value of the effective Fed funds rate which, as seen in the chart, has been negative since 2009. Allowing for some further pickup in inflation over coming months, we are almost three full 25-basis point funds rate hikes away from the real Fed funds rate being positive. In other words, with the expansion now in its ninth year and poised for a late-cycle acceleration, the real Fed funds rate is still negative, indicating monetary policy remains accommodative. Just how accommodative, however, is open for debate.

It must be noted that there is not any one "appropriate" value of the real Fed funds rate, as this varies over time along with factors such as the rates of productivity growth and labor force growth, i.e., the economy's "speed limit" (isn't it amazing how many of our discussions take us back to this same place). At present, this implies the "equilibrium" real funds rate is much lower than historical norms. That said, it is valid to question whether a negative real Fed funds rate is still warranted, particularly if we are indeed on the verge of a late-cycle acceleration in growth. Though being circumspect as central bankers tend to be they won't come out and say so, it could be that at least some FOMC members are concerned that the real funds rate is too low and, as such, worry about the potential consequences for inflation.

One argument (which, by the way, drives us absolutely nuts) is that the FOMC should lift the Fed funds rate at a faster pace to give them more room to cut it during the next downturn. While the "logic" in this argument is hard to spot, it does nonetheless raise a point recently made by Boston Fed President Rosengren, who noted that given current low rates of labor productivity growth and labor force growth, the Fed funds rate will likely rise by much less during the current cycle than has been the case during past rate hike cycles. As such, when the next downturn comes, the FOMC may once again have to resort to unconventional policy measures (like General MacArthur, QE may indeed return) because there won't be much room to cut the Fed funds rate. So, while a negative value may be too low, it could be that there simply isn't much room to the upside for the real Fed funds rate.

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Q3 '17 (a)	Q4 '17 (p)	Q1 '18 (f)	Q2 '18 (f)	Q3 '18 (f)	Q4 '18 (f)	Q1 '19 (f)	Q2 '19 (f)		2016 (a)	2017 (p)	2018 (f)	2019 (f)
3.2	2.5	2.5	3.7	3.3	3.2	2.4	2.0	Real GDP[1]	1.5	2.3	3.0	2.5
2.2	3.8	1.8	2.5	2.6	2.7	2.1	1.9	Real Personal Consumption[1]	2.7	2.7	2.6	2.2
								Business Fixed Investment:				
8.5	7.9	6.0	6.3	5.5	4.1	4.4	4.1	Equipment, Software, & IP[1]	0.3	4.5	6.6	4.3
-7.0	2.5	3.2	5.0	4.2	3.6	3.6	2.4	Structures[1]	-4.1	5.4	2.4	3.2
-4.7	13.0	4.0	6.6	4.8	6.8	7.2	6.0	Residential Fixed Investment[1]	5.5	1.8	4.5	6.0
0.7	2.9	2.8	3.0	3.0	2.6	1.1	0.0	Government Expenditures[1]	0.8	0.1	2.4	1.3
-597.5	-652.2	-677.6	-670.3	-661.6	-656.4	-656.1	-660.4	Net Exports[2]	-586.3	-621.4	-666.5	-665.2
1.172	1.256	1.260	1.286	1.311	1.344	1.366	1.378	Housing Starts, millions of units[3]	1.177	1.208	1.300	1.381
17.1	17.7	17.0	16.8	16.7	16.7	16.6	16.4	Vehicle Sales, millions of units[3]	17.5	17.2	16.8	16.4
4.3	4.1	4.1	4.0	3.9	3.8	3.8	3.7	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7
1.5	1.5	1.6	1.6	1.5	1.4	1.2	1.1	Non-Farm Employment[5]	1.8	1.6	1.5	1.1
0.7	1.1	4.4	3.0	2.7	2.9	2.7	2.2	Real Disposable Personal Income[1]	1.4	1.2	2.6	2.6
1.8	1.9	1.8	2.1	2.0	1.9	1.9	2.0	GDP Price Index[5]	1.3	1.8	1.9	2.0
1.5	1.7	1.8	2.2	2.4	2.1	2.0	2.0	PCE Deflator[5]	1.2	1.7	2.1	2.0
2.0	2.1	2.3	2.9	2.9	2.6	2.3	2.2	Consumer Price Index[5]	1.3	2.1	2.7	2.2
1.4	1.5	1.6	1.9	2.1	2.2	2.1	2.1	Core PCE Deflator[5]	1.8	1.5	2.0	2.1
1.7	1.7	1.9	2.4	2.5	2.6	2.4	2.4	Core Consumer Price Index[5]	2.2	1.8	2.3	2.4
1.13	1.18	1.42	1.67	1.90	2.13	2.17	2.38	Fed Funds Target Rate, %[4]	0.39	0.98	1.78	2.40
2.24	2.37	2.77	2.90	3.00	3.05	3.10	3.15	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.93	3.18
3.89	3.92	4.26	4.49	4.61	4.67	4.73	4.76	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.51	4.81
-2.1	-2.3	-2.5	-2.5	-2.6	-2.8	-2.7	-2.8	Current Account, % of GDP	-2.4	-2.3	-2.6	-2.8

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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