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JOB GROWTH STABILIZING, WAGES RISING

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KEY TAKEAWAYS

The May jobs data were generally positive, and job growth may be accelerating after slowing since 2015.

Wage growth topped consensus and is increasing, but is not yet at levels that would alarm the Fed.

The unemployment rate is near an almost 50-year low, a significant accomplishment but one that provides little guidance for markets or the economy.

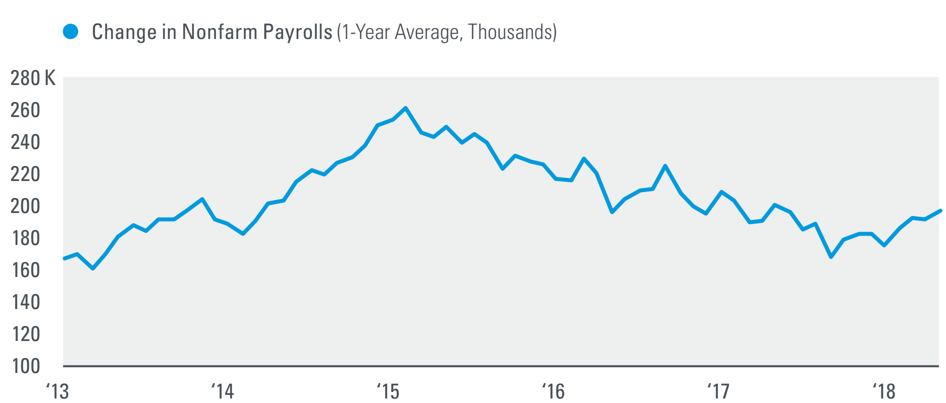
The May employment report confirmed that the job market remains healthy, with job creation showing signs of stabilizing after steadily slowing over the last several years. A healthy labor market should continue to provide support for the economy and consumer spending, and we may even see some acceleration as fiscal stimulus provides incentives that may draw more people into the labor force and encourage businesses to hire.

We are encouraged by stabilizing job growth; few economic indicators so strongly represent quality-of-life improvement for the people behind the numbers. However, labor activity tends to send late signals for markets, and the most important element of the report was the absence of any real sign that the economy is in danger of overheating. Despite building evidence of potential wage pressure, the small upside surprise in wages was not enough to alarm markets, but it was likely enough to keep the Federal Reserve (Fed) on track to hike rates at its next policy meeting on June 12–13.

JOB GROWTH HAS BEEN STABILIZING

It's natural for job growth to slow as we move later into the economic cycle, when businesses are already running closer to target employment levels and labor is becoming more scarce. That pattern has held true so far in this cycle as well: Average yearly job growth peaked at 261,000 in February 2015, and has gone through a natural slowing process since [Figure 1]. Nevertheless, job growth

1 JOB GROWTH MAY BE ACCELERATING AGAIN



Sources: LPL Research, U.S. Bureau of Labor Statistics 06/01/18

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remains at very healthy levels for this point in the cycle, and the most recent report provided growing evidence that the trend may be ramping up.

It's unlikely that we will see job growth climb to the 250,000+ mark we saw in 2015, but it doesn't need to. Even with slower growth, the unemployment rate continues to fall, indicating that a shrinking percentage of those looking for jobs are unable to find employment. In fact, at the current rate of unemployment, a rising proportion of those looking would be considered "frictional" unemployment, a result of the natural lag between starting to look for a job and being hired.

The one-year average of monthly job growth has clearly stabilized and has even accelerated in the short term, rising 29,000 over the last eight months. The job numbers are much noisier (more statistically uncertain) than they are usually given credit for, so we wouldn't make too much of that eight-month change yet, but at the very least we've seen improvement. During shorter economic cycles, job growth tends to peak and reverse. But during longer cycles, even though peak growth tends to come early to mid-cycle, it's been normal to have extended periods of steady job growth.

2 LOW UNEMPLOYMENT A THREAT ONLY IF ECONOMY IS OVERHEATING

Recession (Beginning Year)	Unemployment Low	Months to Recession
1953	2.5%	3
1957	3.7%	6
1960	4.8%	3
1970	3.4%	16
1973	4.6%	2
1980	5.6%	9
1981	7.2%	4
1990	5.0%	17
2001	3.8%	12
2008	4.4%	15
Average		**8.7**

Source: LPL Research, U.S. Bureau of Labor Statistics 06/01/18

Illustration is historical and no guarantee of future results.

UNEMPLOYMENT RATE HEADED FOR A NEAR 50-YEAR LOW

The unemployment rate dropped from 3.9% to 3.8% in May, a surprise given we are only a month away from the move from 4.0% to 3.9%. We haven't been at 3.8% unemployment since April 2000 and were only a fraction of a percent away from hitting 3.7%, which we haven't seen December 1969 when the unemployment rate was at 3.5%. (The 1970s welcomed the economy into a new decade the following month with the start of a recession and a jump in the unemployment rate to 3.9%.) Given current economic momentum, we appear likely to hit 3.7% over the next several months, which would be a noteworthy accomplishment.

Nevertheless, low unemployment does not provide a meaningful signal of recession risk. In the 10 post-1950 recessions, unemployment has been at its cycle low an average of nine months before the onset of recession [Figure 2]. Given that you don't know whether the current rate is the cycle low in real time (it could go lower) and that equity markets peak an average of six months before a recession starts, watching the unemployment rate in isolation does not provide a useful signal of market tops or recession risks. We can take some solace in the fact that the gap between the unemployment rate low and recession has been an average of 15 months over the last three economic cycles, which may be more applicable to the current expansion given its length. Since cycles typically end due to excesses rather than old age, low unemployment is usually only a threat when excesses have built up in the economy. For now, low unemployment remains a positive for the economy, in our view.

WAGES STILL FAVOR GROWTH

Historically, it takes average hourly earnings of production and nonsupervisory workers growing at about 3% year over year to get inflation to the Fed's 2% target. Wages rose 2.8% year over year in May, a modest and welcome upside surprise from expectations of 2.7% and still ahead of inflation, but not yet at that 3% threshold. Nevertheless, this was still the fastest pace of wage growth since June 2009, when wages were still early in their post-recession decline (they would bottom in October 2012 at 1.2%). It's also the fourth consecutive month of year-over-year wage growth accelerating, a streak we haven't seen since 2013. Given the Fed's emphasis that its inflation target is symmetrical, indicating comfort with letting inflation run a little hot, we would not consider wages an immediate threat. At the same time, we know any sudden acceleration could change that view quickly, as we saw in the market's reaction to the upside surprise in January's wage data.

While wage pressure remains modest, there are continued signs that it might be building. The summary of employment conditions in the Fed's Beige Book, a summary of anecdotal reports gathered in each of the Fed's 12 districts, highlighted that "contacts continue to report difficulty filling positions across skill levels," and that "many firms responded to talent shortages by increasing wages as well as the generosity of their compensation packages." We also see continuing bargaining power by labor in an increase in the number of quits as a percentage of total separations in the Bureau of Labor Statistics' Job Openings and Labor Turnover Survey (JOLTS). The data are delayed, but as of March, quits as a percent of separations matched its highest level since data first became available in December 2000.

While wage growth remains in a "neutral" zone and has some cushion to the upside, we continue to monitor wages closely for inflation threats. Every cycle is different, but in the last three cycles it took wage growth over 4% to signal an economy that was overheating. And given the potential added inflation push from new tariffs, the cushion may be smaller than it now appears. The cost of tariffs is not only the increase in import costs but the ability of domestic producers to raise prices while remaining competitive, creating an implicit tax on consumers and businesses to compensate for increased trade friction.

UPBEAT GROWTH PICTURE, BUT TRAJECTORY UNCHANGED

With expectations already in place for the economy to accelerate after a slow first quarter, the jobs report confirmed but did little to change the U.S. economic outlook. The Atlanta Fed's GDPNow model for second-quarter gross domestic product (GDP) edged up only 0.1% after the jobs report, although to a robust 4.8%. The New York Fed's model did not move at all in response to the jobs report, and sits at a lower but still strong 3.3% for the second quarter. Bloomberg consensus economist estimates sit at 3.1% for the second quarter and 2.8% for all of 2018.

CONCLUSION

The May jobs report was reassuring after a slight deceleration in job growth in April. Trailing-year job creation has even accelerated over the last eight months. While likely past peak, job creation continues to look robust for this point in the economic cycle, especially with the unemployment rate approaching a near 50-year low. Wage pressure is not worrisome yet, but it has been accelerating over the last four months and bears watching, especially given anecdotal evidence of tightening labor markets. Overall, the jobs report signaled a healthy labor market and keeps the economy on track to meet our forecast of 2.75–3.0% GDP growth in 2018.* ■

*As noted in *Outlook 2018: Return of the Business Cycle*, LPL Research projects real gross domestic product (GDP) growth of around 2.75-3% in 2018. This is in line with historical mid-cycle growth of the last 50 years. Economic growth is affected by changes to inputs such as business and consumer spending, housing, net exports, capital investments, and government spending.

IMPORTANT DISCLOSURES

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The presidents of regional Federal Reserve Banks are commonly classified as hawks or doves. Hawks generally favor tighter monetary policy, with less monetary support from the Federal Reserve. Doves are the opposite, generally favoring easing of monetary policy.

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