LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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JULY EMPLOYMENT REPORT
HEALTHY JOB GAINS DESPITE MISSING EXPECTATIONS

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KEY TAKEAWAYS

July nonfarm payroll growth was softer than expected, but strong upward revisions for May and June paint an overall picture of a healthy job market.

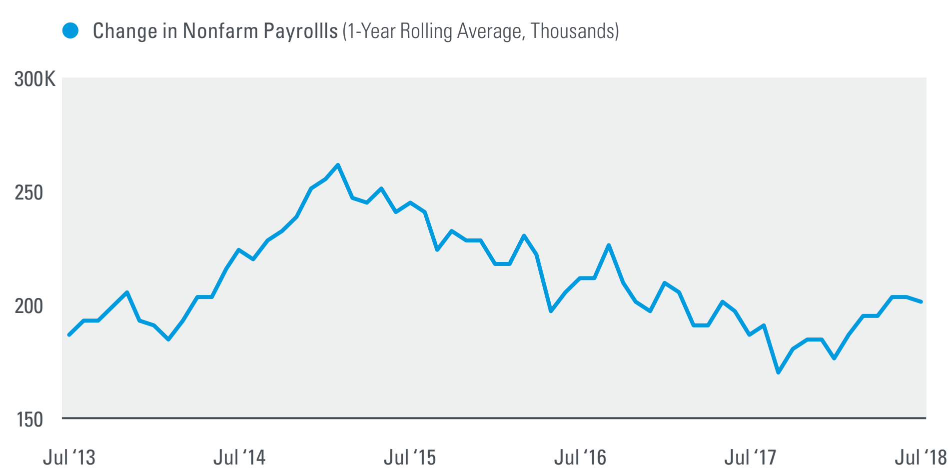
Accelerating manufacturing employment helped fuel overall payroll growth.

Wage growth remains subdued, but wage pressure may be building.

The Labor Department's July jobs report, released on Friday, August 3, confirmed that the labor market remains healthy. Nonfarm payrolls rose 157,000 in July, below consensus expectations for a 193,000 increase; however, an upward revision of 59,000 jobs for May and June more than offset the July miss and helped paint an overall picture of a healthy job market. With the revisions, job growth for May and June averaged 258,000, the strongest two-month period since July 2016. These strong summer months lifted 3-month average payroll growth to 224,333 and 1-year average payroll growth to 200,000 [Figure 1].

Slowing job growth is expected in this stage of the economic cycle, with the economy near what is considered full employment. Late-summer job growth is also seasonally weaker as temporary summer jobs are terminated. Given those upward payroll revisions, seasonality, and the late-stage economic cycle, cooler growth in July makes sense, and the long-term trend of payroll growth looks steady.

1 PAYROLL GROWTH STILL STRONG AFTER MAY AND JUNE REVISIONS



Source: LPL Research, U.S. Department of Labor 08/03/18

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MANUFACTURING JOBS SUPPORT GROWTH

Job growth in the manufacturing sector was one of the highlights in July's jobs report. Manufacturing jobs increased 37,000, close to a high for the cycle [Figure 2]. The jobs data support the strength we've seen in the manufacturing sector over the past few months, with the Institute for Supply Management's (ISM) and Markit's U.S. manufacturing activity gauges near economic cycle highs in June.

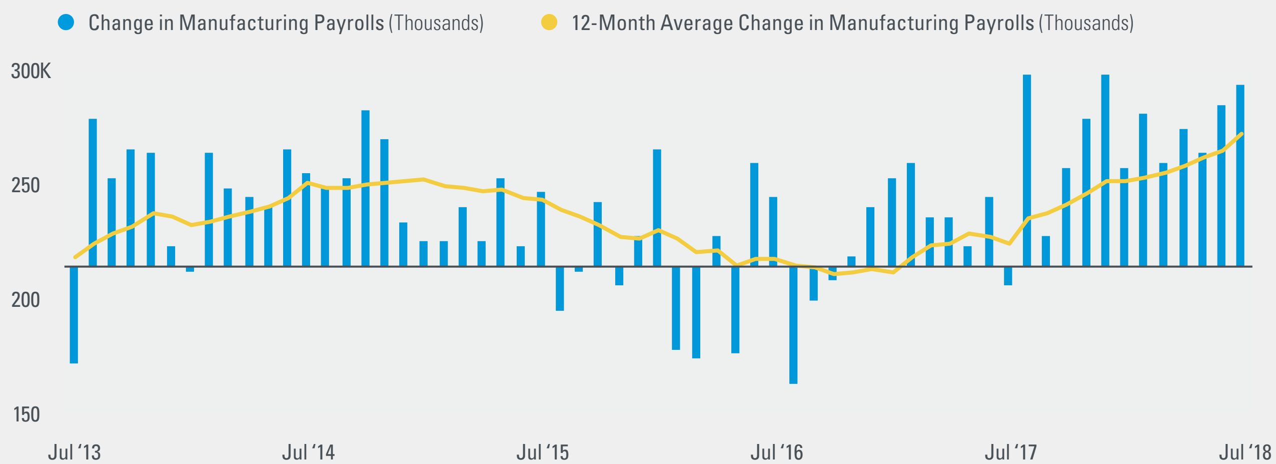
As the manufacturing sector continues to improve, we expect manufacturing payrolls to expand accordingly and lift overall job growth. The impact from tariffs, however, remains a risk, with some effects already starting to appear in the manufacturing reports. July's ISM Manufacturing Index came in at 58.1, below expectations of 59.4. While 58.1 is still historically strong, it was the largest month-over-month dip in the gauge since August 2016—evidence that uncertainty around trade is impacting U.S. manufacturers.

UNDEREMPLOYMENT AT A 17-YEAR LOW

Unemployment fell slightly in July, but underemployment—which includes discouraged workers, workers marginally attached to the workforce, and those working part time for economic reasons—fell more dramatically. The headline unemployment rate fell to 3.9% in July after unexpectedly ticking up to 4.0% in June and continues to hover near its lowest level since April 2000. Given our current economic momentum, we expect the unemployment rate to continually grind down to 3.6% over the next several months.

The more interesting number to us is the underemployment rate, which fell to a 17-year low of 7.5% in July. The underemployment rate has dropped precipitously since the beginning of 2017, which is significant considering the high underemployment rate has been heralded as a source of slack in an otherwise tight labor market. The decrease in the underemployment rate is a positive sign for the U.S. economy, as it shows that companies generally expect growth to pick up enough to justify higher headcounts.

2 MANUFACTURING HAS PROPELLED RECENT NONFARM PAYROLLS GROWTH



Source: LPL Research, U.S. Department of Labor 08/03/18

However, wage pressure should intensify as the underemployment rate continues to decline and competition for labor intensifies.

WAGE GROWTH SUBDUED, BUT CATALYSTS FOR GROWTH EMERGING

One of the most important figures from the jobs report was average hourly earnings, a component that investors scrutinize for clues on the pace of inflation. Average hourly earnings rose 2.7% year over year, matching consensus expectations. While still manageable, the three-month average for year-over-year average hourly wage growth is 2.73%, the highest since July 2009 (when the U.S. economy was rebounding from the depths of the financial crisis).

While wage growth is accelerating, it remains at manageable levels and shouldn't force the Federal Reserve (Fed) to reconsider its approach to gradually raising interest rates. Historically, wage growth over 4% is a signal to the Fed that the economy may be overheating, a level that wages haven't come close to yet in this economic cycle. Markets agreed that the jobs report wouldn't change the Fed's policy path significantly. Fed funds futures are pricing in about a 60% chance of two additional rate hikes by the end of this year, a probability that has remained stable over the past few weeks.

However, underlying forces in the labor market could be setting the stage for a jump in wage growth. The number of people who quit jobs, which often occurs when workers are lured away by more attractive opportunities, jumped to 3.56 million in May, the highest point in Labor Department data going back to 2000 and the biggest month-over-month increase since 2014. That surge in quits boosted the quit rate (voluntary quits as a percent of separations) to 2.4%, a 17-year high.

Employers are also challenged in hiring workers, another force that could lift wages substantially. In the Fed's latest Beige Book (released in July), most districts reported that firms were having difficulty finding skilled labor, and some districts stated that labor shortages were constraining growth. Among other efforts, firms are raising compensation to attract and retain employees, according to the Beige Book.

While we don't expect wages to rise anywhere near the Fed's historical watermark for wage growth soon, we will continue to monitor wage growth along with prices.

CONCLUSION

The July jobs report was a continuation of labor market tightening we've seen as the economic cycle has matured. Payroll growth remains strong, especially in the context of May and June revisions. While wage pressure isn't strong enough to warrant changes in the pace of monetary policy, the argument for pay increases is growing stronger. Overall, we maintain our view that U.S. gross domestic product will grow near 3% in 2018* amid a continually strengthening labor market. ■

*As noted in our *Midyear Outlook 2018: The Plot Thickens*, LPL Research projects real gross domestic product (GDP) growth of up to 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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Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.