

U.S. Economics Weekly: Market and Policy Comments

No Pressure From Wages

- Wage inflation has been extremely mild during this expansion, and although there are signs that wage growth may pick up, we do not believe that it will pose an inflationary threat. Corporate profit margins have soared, reflecting cost cutting during the recession and a slow pace of labor cost increases since then. At this point, any wage cost increases will likely be absorbed by the elevated margins, rather than kindle inflation.
- Margin compression is not a threat to the expansion either. In fact, a shift in income from capital to labor would represent a shift to a new phase of expansion. Labor's share of income has fallen to levels not seen in the post-war period, possibly reflecting globalization and technological change. From such low levels, we expect that a rise in labor income would bolster demand.
- The April employment report featured a huge decline in the unemployment rate, but confusing details in the household survey led people to discount the drop. We believe that the declines in the labor force and employment were moves back to trend after huge gains at the start of the year. Therefore, we do not look for major reversals in these statistics or in the jobless rate in May. In addition, we look for payrolls to return to a more subdued trend-like 185K increase.

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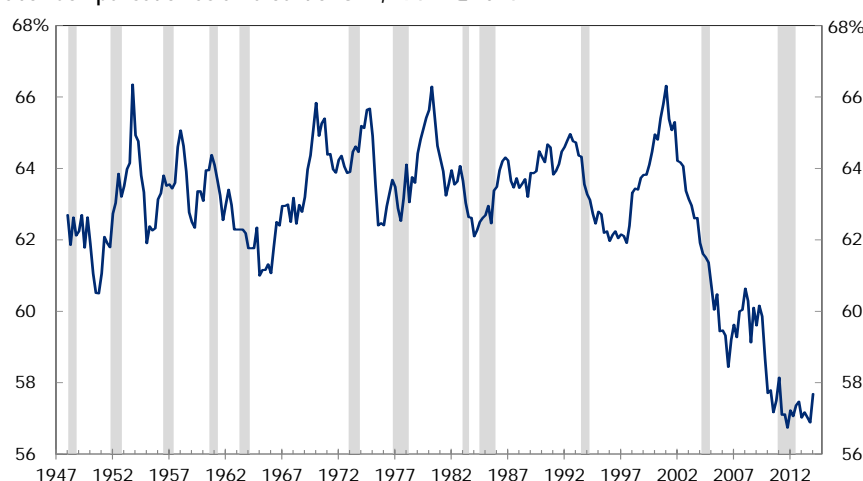
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Labor Compensation as a Percent of GDP, 1947-1Q 2014



Note: Shaded regions denote recessions.

Sources: Bureau of Economic Analysis and Citi Research.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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No Pressure From Wages

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Wages have been relatively tame thus far in this expansion.

Lower short-term unemployment is beginning to drive up labor costs.

Long-term unemployment may limit wage pressures.

We lowered our unemployment call.

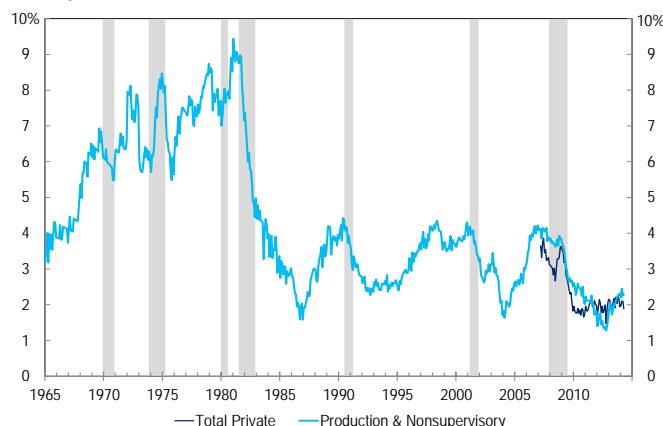
Fed Chair Yellen has stressed the importance of wages as a source of price inflation pressures in monetary policy deliberations. Her view has been that, as long as wage pressures remain tame, the Fed can maintain easier policy than implied by other labor market indicators (including the unemployment rate). On that score, wages have been extremely quiescent throughout this expansion and probably can accelerate somewhat without adding much to inflation pressures. Average hourly earnings have been rising at about a 2 percent rate for the past five years, which is lower than during any other expansion in the past 50 years (Figure 1). Real earnings actually have been unchanged for the entire expansion.

We look to the unemployment rate for an indication of slack, especially short-term unemployment (less than six months). There has been some evidence that the downswing in short-term unemployed is beginning to drive up unit labor costs (Figure 2). But the rise is at the early stages and unit cost inflation remains low by historical standards. We doubt that the decline in short-term unemployment will cause a major rise in wage inflation in the next year or two, but there may be some lift, especially in some in-demand sectors.

We showed last week that even long-term unemployed workers should not be counted out of the labor market, as they seem to have many of the same characteristics as the short-term unemployed.¹ We recognize that people out of work for long durations can lose skills and motivation, and can be harder to employ because employers stigmatize such applicants. Nevertheless, we find this group continues to find jobs along with their short-term counterparts. This suggests that there may be somewhat more slack than implied by the short-term rate alone, which actually could allow firms to satisfy some demand for labor without exerting pressure on wages.

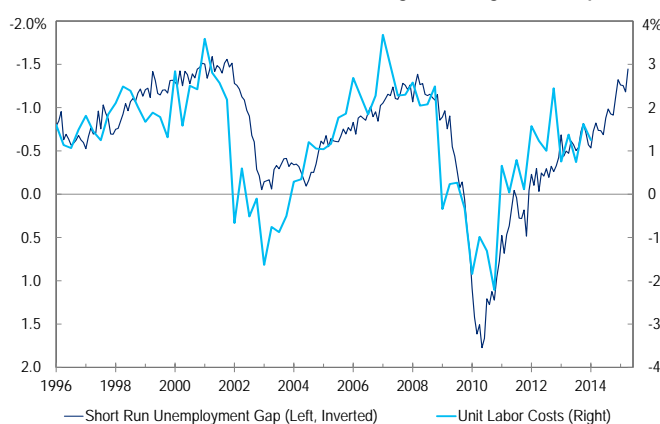
After the April jobs report, we lowered our forecast for the overall unemployment rate, and we suspect that the FOMC will have to do the same in the June Statement of Economic Projections. Our detailed forecasts are presented in Figure 3 below. The unemployment rate should continue to decline, hitting 6 percent by the end of this year and dipping toward 5½ percent by year-end 2015. So wage pressures may begin to emerge sometime late this year or early next.

Figure 1. Hourly Earnings (Year-to-Year Percent Change), 1965-April 2014



Note: Shaded regions denote recessions.
Source: Bureau of Labor Statistics.

Figure 2. Short Run Unemployment Rate Gap (Lagged 12-Months) and Unit Labor Costs (Annualized Two-Year Avg. Pct. Chg.), 1992-April 2014



Note: The short-term unemployment rate gap is NAIRU minus the less than 27 week unemployment rate.
Sources: Bureau of Labor Statistics, Congressional Budget Office and Citi Research.

¹See "[Unlucky Job Searches](#)," [Market and Policy Comments](#), Citi, May 23, 2014. Also note that we showed it may require much more GDP growth to lower long-term unemployment than short term.

Figure 3. Labor Market Indicators (Changes in Thousands and Ratios), 2012-16

	2012	2013	2014	2015	2016
Population	2,446	2,468	2,492	2,516	2,540
Labor Force	1,556	1,549	1,565	1,579	1,593
Participation Rate (%)	63.6	62.8	62.8	62.8	62.7
Employment	1,433	1,459	1,471	1,491	1,511
Employment/Population (%)	58.6	58.6	59.0	59.3	59.5
Unemployment	1,228	1,035	945	885	825
Unemployment Rate (%)	7.9	6.7	6.0	5.6	5.2
Not in Labor Force	8,898	9,186	9,266	9,366	9,466

Note: The population figures represent the number of working age people.

Sources: Bureau of Labor Statistics and Citi Research.

Corporate profits are extremely high.

The owners of capital have received the lion's share of the benefits from increasing production and productivity during this cycle. Domestic corporate profits have soared, largely due to cost cutting during the recession and the extremely slow pace of labor cost increases. In fact, throughout the expansion, domestic corporate profits have hovered in a range rarely seen since the 1970s (Figure 4). While this rise may reflect globalization and labor-saving technology, it also is an indication that the economy still has plenty of room to grow.

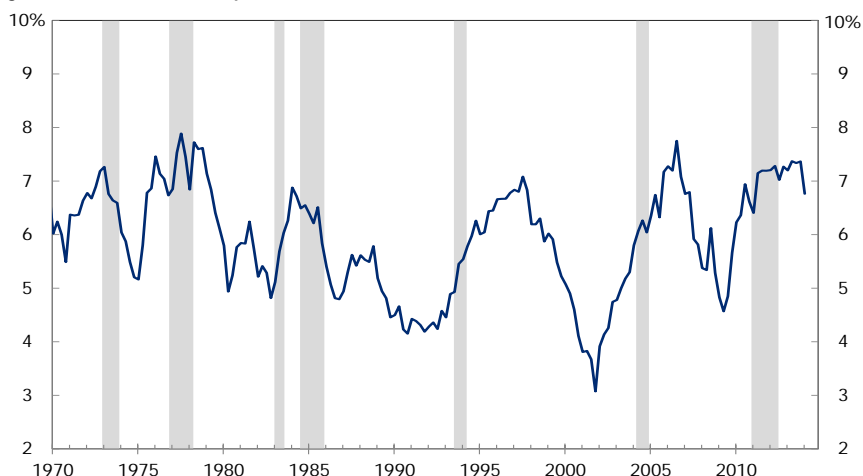
A pickup in wages probably would be absorbed in margins.

Firms continue to hold down labor costs, but their ability to do so will wane over time as the economy moves into the next phase of the expansion. Output can only rise so much through productivity gains. Eventually, firms will have to hire more workers (and bid more aggressively for those workers) to keep up with demand, meaning bigger wage gains. However, we don't see a pickup in wages as inflationary, because competitive firms probably would absorb the higher labor costs and accept lower profit margins.

Rising compensation could signal a new phase of expansion.

A pullback in profit margins from rising labor share shouldn't pose a threat to the recovery. This kind of shift typically happens mid-expansion, which is why margins tend to peak several years before a cyclical peak. In fact, a pickup in hiring and wages probably would boost aggregate demand and usher in a new leg of the expansion. Profit margins may shrink as labor's share of output expands later in the cycle, but the prospects of maintaining mark-ups will continue to spur investment. Also, the pickup in hiring and wages provides more income to consumers, which fuels demand further.

Figure 4. Nonfinancial Corporate Profits as a Share of GDP, 1970-1Q 2014

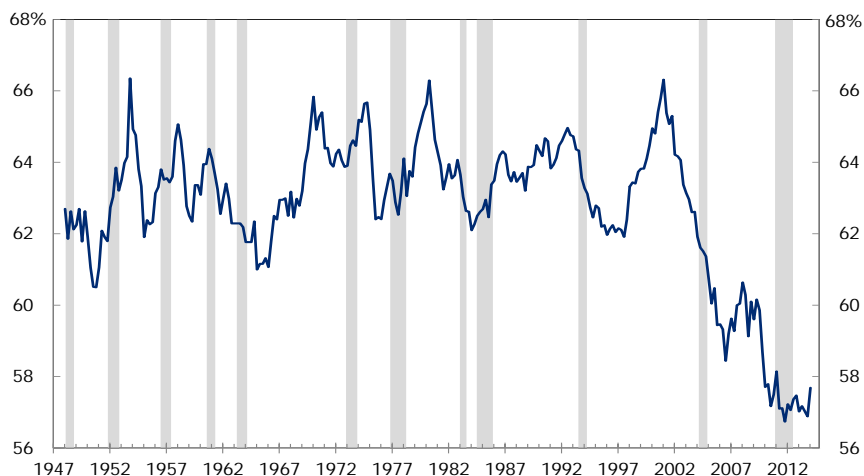


Note: Shaded regions denote recessions. Source: Bureau of Economic Analysis and Citi Research.

Labor's share of output has collapsed.

Labor's share of output has made a dramatic downward shift since the start of the new millennium. For 55 years, compensation of employees as a share of output hovered in a band between 61 percent and 66 percent, but then declined to 57 percent in 2013, which is well below any other point since World War II (Figure 5). The sharp decline was not offset by a commensurate rise in domestic profit margins, but rather by rising non-labor costs, including other returns to capital such as proprietors income, interest expense, and depreciation. Nevertheless, we think labor's share has shrunk so much that any shift in income from capital to labor would have to be seen as a positive development from a demand growth standpoint.

Figure 5. Compensation as a Percent of GDP, 1947-1Q 2014



Note: Shaded regions denote recessions. Sources: Bureau of Economic Analysis and Citi Research.

All Eyes on the Employment Report

The April household survey was confusing...

There was a lot of confusion surrounding the April employment report, especially the household survey, which has caused some uncertainty leading up to the May report. For instance, the unemployment rate fell by 0.4 percentage point in April to 6.3 percent, but this good news was not mirrored in other aspects of the household survey. Specifically, the labor force fell by 806K and employment fell by 73K. These declines led many observers to discount the drop in the unemployment rate and some even to anticipate a reversal in May along with a bounce back in the labor force.

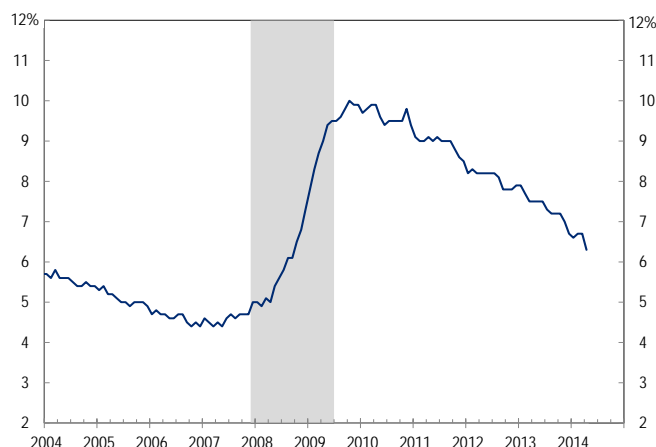
...but we don't think the drop in the unemployment rate will be reversed.

We disagree with this assessment. We do not anticipate a major reversal of the declines in either the labor force or the unemployment rate. Such a sharp drop in the unemployment rate is a rare event, only occurring three other times in the past 30 years. In each of those instances, the drop was confirmed for the most part in the following month. The unemployment rate either edged up slightly (maintaining most of the decline) or continued to fall. We expect the same this time.

Declines in the labor force and employment may represent a move back to trend.

We actually see the declines in the labor force and the unemployment rate in April as moves back to trend. The labor force surged by 1.29 million in the first quarter. As a point of comparison, it increased by only 700K between when the expansion started in mid-2009 and now. Clearly, the early 2014 increase went way beyond the trend, so a correction should not be a surprise. In fact, including the huge decline in April, the labor force still is up nearly 500K thus far this year. Likewise, employment soared in the beginning of the year, rising 1.16 million through March. Even with the decline in April, employment gains in the household survey are averaging 270K per month this year. As a result, we do not expect the recent declines in the labor force and employment to be reversed in May.

Figure 6. Unemployment Rate, 2004-April 2014



Note: Shaded region denotes recession.
Source: Bureau of Labor Statistics.

Figure 7. Employment Statistics (Thousands Unless Indicated),
Feb 14-May 14E

	May E	Apr	Mar	Feb
Total Employment	185	288	203	222
Private Payrolls	185	273	202	201
Goods Producing	25	53	29	48
Construction	15	32	17	24
Manufacturing	5	12	7	20
Service Producing	160	220	173	153
Retail Trade	20	35	25	-6
Business Services	55	75	52	82
Government	0	15	1	21
Unemployment Rate (Percent)	6.3	6.3	6.7	6.7
Average Workweek (Hours)	34.4	34.5	34.5	34.3
Hours Worked Index (Percent)	-0.1	0.3	0.7	-0.1
Hourly Earnings (Percent)	0.3	0.0	0.1	0.3

Sources: Bureau of Labor Statistics and Citi Research.

The jobless rate is falling steadily, despite some big monthly swings.

The April unemployment rate decline may have been a catch-up as well. The jobless rate has been falling at a fairly steady pace of 0.2 percentage point per quarter for the past four years (Figure 6). But the move down has been erratic on a month-to-month basis. Quarters in which there was little or no decline in the unemployment rate typically were followed by large declines. Since the unemployment rate was unchanged between December and March, the steep April decline merely reestablished the trend.

The household survey is not robust enough to estimate level changes.

The bottom line is that labor force and employment are extremely volatile in the household survey, especially month-to-month changes. Even the Bureau of Labor Statistics does not put much faith in monthly changes in the labor force or employment levels. The sample is too small (less than one half of one tenth of one percent of the labor force) to have much confidence in those figures. Specifically, the small sample size of 60K is extrapolated up to 155 million. The errors can be extremely large, and those errors are compounded by taking the difference between two surveyed levels.

The Fed Chair advocates looking at a wide array of labor market indicators.

The unemployment rate is a different matter. Chair Yellen has said that the unemployment rate is the most important gauge of labor market health, but she stresses that policymakers need to look at a wide array of measures. We would add other variables to the list of important labor market indicators: the trend pace of payroll gains (from the establishment survey), job openings and gross hires (from JOLTS) as well as some outside indicators, including surveys and initial and continuing unemployment claims). Notably, continuing claims have fallen by more than 200K since the beginning of the year, which indicates improvement in the labor market and points to continued declines in the unemployment rate.

We look for a payroll rise of 185K.

Payroll increases averaged a solid 238K over the past three months, but those outsize gains largely reflected payback after the harsh winter hindered new hiring. That bounce back seems to have run its course and the May reading likely settled back closer to the former trend near 185K (Figure 7). We still anticipate that the trend in net hiring will be gradually picking up steam toward 200K, as underlying economic activity accelerates toward 3 percent in the coming year.

May-June 2014

Monday	Tuesday	Wednesday	Thursday	Friday
<p>26</p> <p>Memorial Day NYSE Holiday Federal Gov't Holiday</p>	<p>27</p> <p>Durable Goods Orders <u>Total</u> <u>ExTrans</u> Mar 3.6% 2.9% Apr 0.8% 0.1% S&P/CaseShiller (Mar) FHFA (Mar) Consumer Confidence Apr 81.7 May 83.0</p> <p>Auction 2-Yr. Note: \$31.0B Auction 3 & 6 Mth. Bills: \$48.0B</p>	<p>28</p> <p>Mortgage Applications</p> <p>Auction 2-Yr. FRN: \$13.0B Auction 5-Yr. Note: \$35.0B Auction 1 Mth. Bill: \$45.0B</p>	<p>29</p> <p>Jobless Claims 5/24 300 Thous GDP & Chain Price Index 1Q14A 0.1% 1.3% 1Q14P -1.0% 1.3%</p> <p>Corporate Profits (1QP)</p> <p>Pending Home Sales (Apr)</p> <p>Auction 7-Yr. Note: \$29.0B</p>	<p>30</p> <p>Personal Income & Consumption Mar 0.5% 1.0% Apr 0.3% -0.1%</p> <p>Chicago Barometer <u>PMI</u> <u>Prices</u> Apr 63.0 55.2 May 65.5</p> <p>Reuters/Michigan Sentiment MayP 81.8 MayF 81.9</p> <p>Farm Prices (May)</p>
<p>June 2</p> <p>ISM Manufacturing PMI Prices Apr 54.9 56.5 May(E) 55.0</p> <p>Construction PIP Mar 0.2% Apr(E) 0.2%</p> <p>Auction 3 & 6 Mth. Bills: \$48.0B(E)</p>	<p>3</p> <p>Factory Orders <u>Ord.</u> <u>Inv.</u> Mar 1.3% 0.1% Apr(E) 0.5%</p> <p>Total Vehicle Sales Apr 16.0M May(E) 16.1M</p> <p>Auction 1 Mth. Bill: \$45.0B(E)</p>	<p>4</p> <p>Mortgage Applications ADP Employment Nonfarm Productivity <u>Prod</u> <u>ULC</u> 1QP -1.7% 4.2% 1QR(E) -3.1% 5.6%</p> <p>International Trade Balance Mar -\$40.4B Apr(E) -\$38.0B</p> <p>ISM Non-Manufacturing <u>PMI</u> <u>Prices</u> Apr 55.2 60.8 May(E) 55.5</p> <p>Beige Book</p>	<p>5</p> <p>Jobless Claims 5/31 300 Thous(E)</p> <p>Ann. 3-Yr. Note: \$28.0B(E) Ann. 10-Yr. Note: \$21.0B(E) Ann. 30-Yr. Bond(r): \$13.0B(E)</p>	<p>6</p> <p>Employment <u>Apr</u> <u>May(E)</u> Payrolls 288K 185k Unemp. Rate 6.3% 6.3% Avg. Hrly. Earn. 0.0% 0.3% Priv. Wrkwk 34.5H 34.4H</p> <p>Consumer Credit Mar \$17.5B Apr</p>
<p>9</p> <p>Flow of Fund (1Q)</p> <p>Auction 3 & 6 Mth. Bills: \$48.0B(E)</p>	<p>10</p> <p>Small Business (May)</p> <p>Wholesale Inventories Mar 1.1% Apr</p> <p>Auction 3-Yr. Note: \$28.0B(E) Auction 1 Mth. Bill: \$35.0B(E)</p>	<p>11</p> <p>Mortgage Applications</p> <p>Federal Budget Balance May 13 -\$138.7B May 14(E)</p> <p>Auction 10-Yr. Note: \$21.0B(E)</p>	<p>12</p> <p>Jobless Claims 6/7</p> <p>Import Price Index <u>Total</u> <u>ExPetro</u> Apr -0.4% -0.2% May(E)</p> <p>Retail Sales <u>Total</u> <u>ExAuto</u> Apr 0.1% 0.0% May(E)</p> <p>Business Inventories Mar 0.4% Apr(E)</p> <p>Ann. 30-Yr. TIPS(r): \$7.0B(E) Auction 30-Yr. Bond(r): \$13.0B(E)</p>	<p>13</p> <p>Producer Price Index <u>Final Demand</u> <u>ExF&E</u> Apr 0.6% 0.5% May(E)</p> <p>Reuters/Michigan Sentiment MayF 81.9 JunP(E)</p>
<p>16</p> <p>Empire State Manufacturing May 19.0 Jun(E)</p> <p>Industrial Prod. & Cap. Util. Apr -0.6% 78.6% May(E)</p> <p>Housing Market Index May 45 Jun(E)</p> <p>Auction 3 & 6 Mth. Bills: \$48.0B(E)</p>	<p>17</p> <p>Consumer Price Index <u>Total</u> <u>ExF&E</u> Apr 0.3% 0.2% May(E)</p> <p>Real Earnings (May) Housing Starts and Permits May 1,072K 1,080K Jun(E)</p> <p>FOMC Meeting</p> <p>Auction 1 Mth. Bill: \$30.0B(E)</p>	<p>18</p> <p>Mortgage Applications</p> <p>Current Account 4Q 13 -\$81.1B 1Q 14(E)</p> <p>FOMC Meeting</p>	<p>19</p> <p>Jobless Claims 6/14</p> <p>Philly Outlook Survey May 15.4% Jun(E)</p> <p>Leading Indicators Apr 0.4% May(E)</p> <p>Ann. 2-Yr. FRN(r): \$13.0B(E) Ann. 2-Yr. Note: \$30.0B(E) Ann. 5-Yr. Note: \$35.0B(E) Ann. 7-Yr. Note: \$29.0B(E) Auction 30-Yr. TIPS(r): \$7.0B(E)</p>	<p>20</p>

(E) Indicates Citigroup estimates. (A) Advance. (P) Preliminary. (F) Final. (UNCH) Unchanged. (R) Revised. Contributors: Martha Berasain and Cathy Gaeta.

Appendix A-1

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