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ECONOMIC TALKING POINTS

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Higher Worker Pay and Consumer Confidence Suggest The Fed's Job Is Done

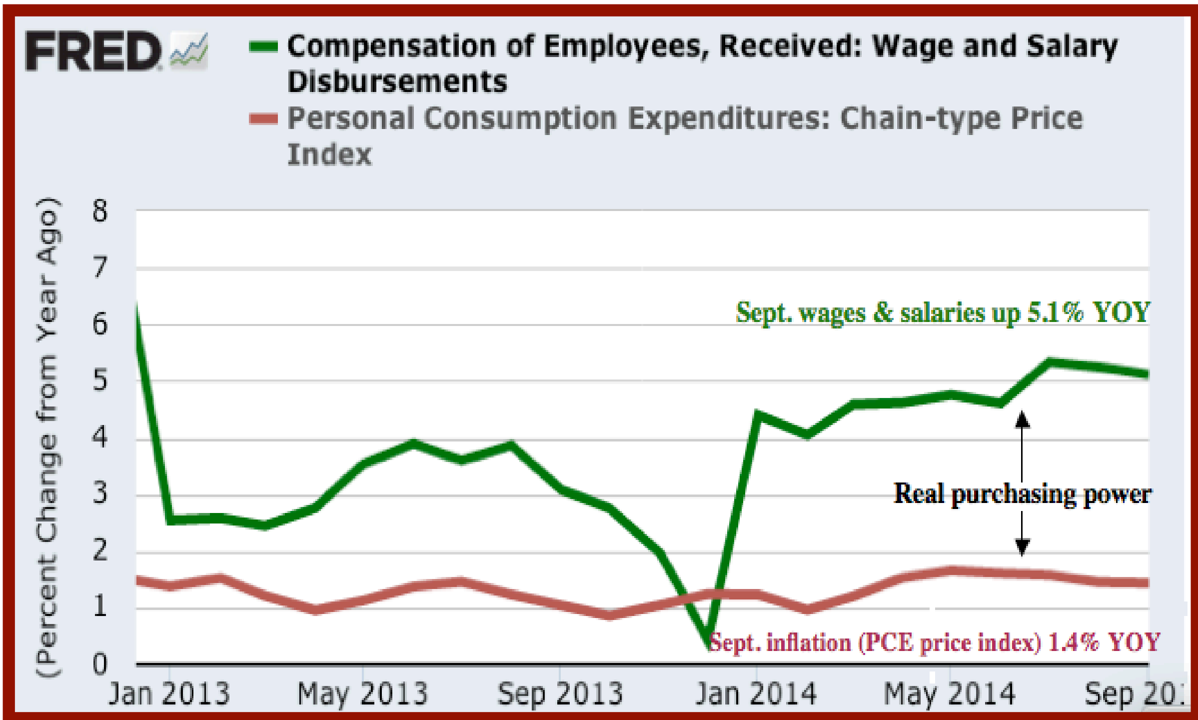
For most of the year, forecasters were baffled by a persistent dichotomy in economy. Business activity was strong with output expanding at a 3% pace or better in four of the past five quarters. Employers were also hiring in 2014 at the fastest clip in 15 years, a factor that helped boost consumer confidence to 7 year highs!

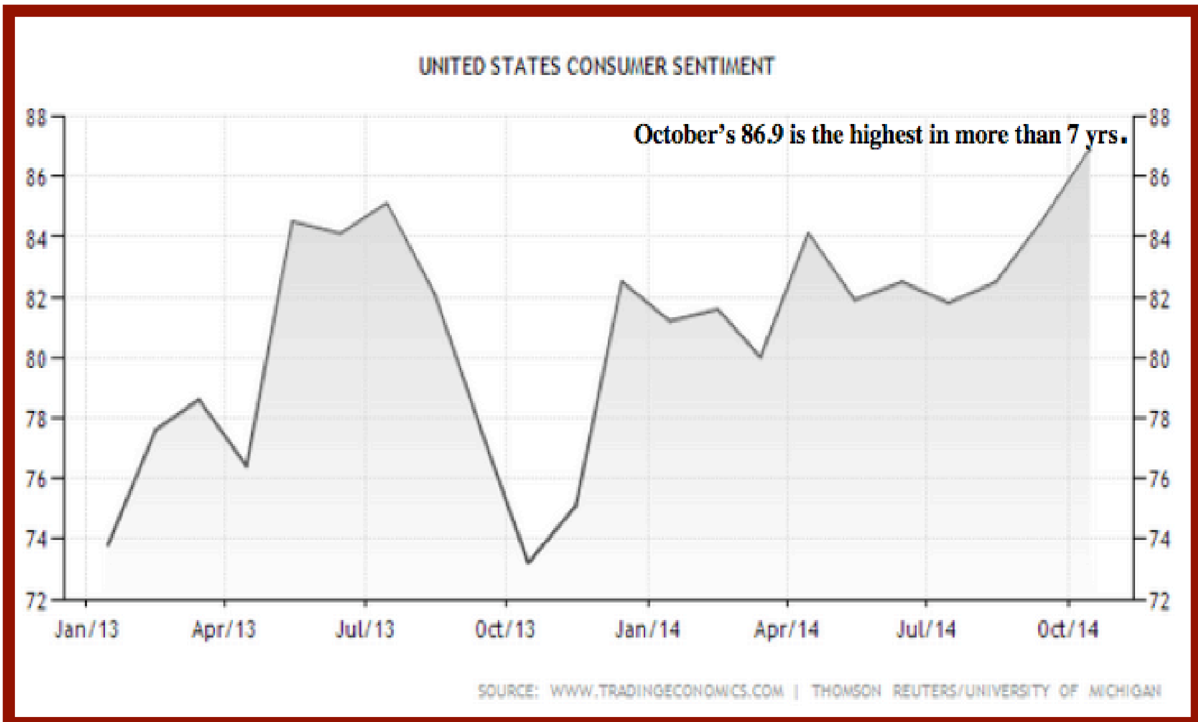
Yet, despite all this good news, one critical statistic stubbornly lagged behind the improvement in the economy; Wages and salaries had remained lackluster. Numerous explanations were given for this: The U.S. still suffered from significant cyclical unemployment and so employers had little incentive to raise pay. Another argument given was that most of the hiring occurred in low wage jobs. Whatever the explanation, many worried that without healthier gains in pay, household spending would stay anemic and stunt future economic growth.

Well, worry no more. **While late in coming, the long missing piece of the puzzle --- employee compensation --- has finally made the critical upturn.** Moreover, we expect this trend of rising wages to continue and provide the fuel for an economic expansion that could well last several more years.

The first such evidence today was September's personal income and spending release. Some analysts may wring their hands over the fact that consumer outlays fell 0.2% last month. **But that is hardly the main story.** After all, even shoppers occasionally take a breather, especially after ramping up spending every other month since last January.

The much bigger takeaway from this report is that Americans are now seeing real gains in purchasing power and that this, in combination with a more vibrant labor market, is what will drive consumption considerably higher in the coming months and quarters.





September wages and salaries component was up 5.1% over the past 12 months, that is more than triple the pace inflation!! (PCE price index was up only 1.4% during this period.) If you want to adjust for both inflation and taxes and thus compute take home pay, real disposable personal income was up 2.5% year-over-year.

The combination of higher pay and less spending last month did push up the savings rate to 5.6%, from 5.4% from August. But this increase in savings was not motivated by households nervousness over jobs and finances. In fact, October readings on confidence show that consumers are the most optimistic they have been in at least seven years. Today's release on consumer sentiment by Thomson Reuters/University of Michigan's reported October's final reading was the best since July 2007. The Conference Board's consumer confidence showed similar results for this month. **Higher savings under these circumstances means Americans are building up their financial firepower for future spending and hints of a much better than expected holiday shopping season.** (Our forecast for holiday spending is an increase of 4.8% from 2013.)

Another release out today that relates to pay was the employment cost index. Here, too, we see a clear upturn in worker incomes. The ECI looks at changes in wages and salaries from the perspective of employers. That is, how much did labor costs increase in the latest quarter? The result: wages and salaries jumped 0.8% in the July – September quarter, the biggest leap since the second quarter of 2008.

So what are we to take away from these numbers?

First, the decline in cyclical unemployment and the difficulty in finding skilled workers are forcing employers to lift pay as a way to both retain existing workers and lure in qualified applicants.

Two, it also tells us the Fed has now gone about as far as it can using the levers of monetary policy to reduce cyclical unemployment. Today's reports on higher compensation raises the probability the Federal Reserve will *finally* remove the "considerable time" phrase in its December FOMC statement.

Third, the responsibility to solve the near 10 million who are structurally unemployed now rests with the White House and Congress, and NOT with the Federal Reserve. The Fed's job is essentially done in bringing the expansion back on line. It's now time for interest rates to normalize again. Our expectation is that the fed funds rate will rise gradually to about 1% by the end of 2015, with yields on 10 yr. Treasuries reaching to 3.25%.

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