THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

July 3, 2014

A most important caveat to the June jobs report

The solid June job numbers were certainly a pleasant way to begin the July 4th holiday weekend. In the past three months companies and government agencies have ramped up hiring to the fastest pace since the first quarter of 2012. Both total and private employment once again smashed into record territory (with 138.8 million in aggregate and 116.8 million on business payrolls). The jobless rate has now fallen to 6.1%, the lowest since September 2008. No doubt many people will cheer all this news.

But here's the thing---and we do not mean to be holiday spoilers. Of the hundreds of individual data points in this jobs report, there are really only a few that take on special importance at this stage of the business cycle. These are the gauges that ought to be on everyone's radar at this point because they provide fresh clues on where this expansion is headed in the coming months.

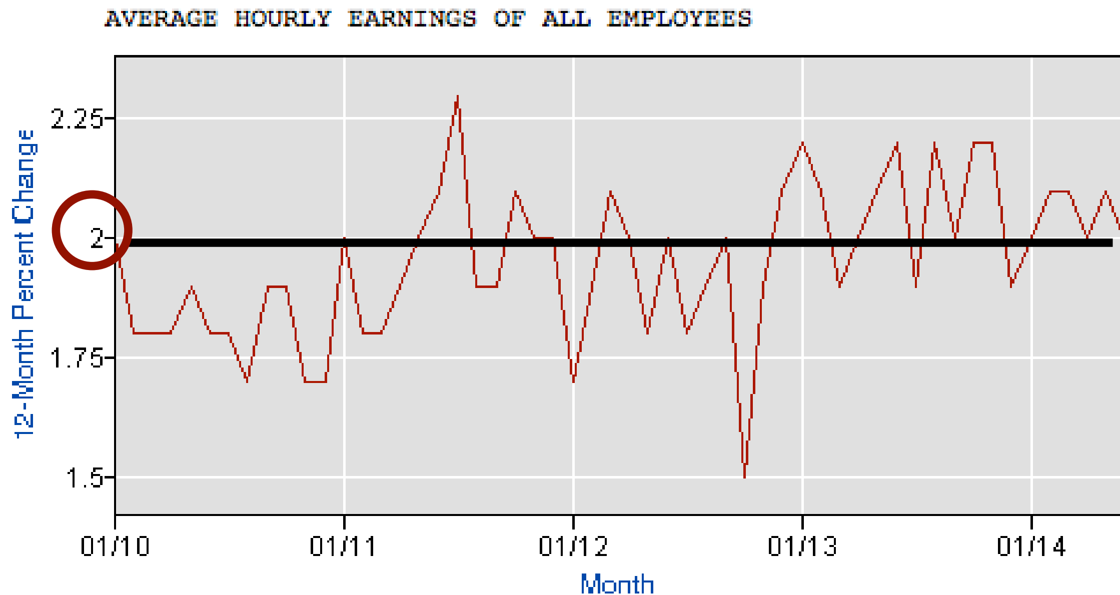
First, what does the June employment release tell us about gains in employee paychecks now that inflation is on the rise? Second, are private firms asking workers to put in longer hours? Let's take them individually.

No sustained expansion is possible if Americans see their pay month after month merely match or fall short of the cost of living. The June report tells us most Americans are still making no progress on this front. In fact, average hourly earnings actually slipped to a yearly rate of 2.0% last month, down from 2.1% in

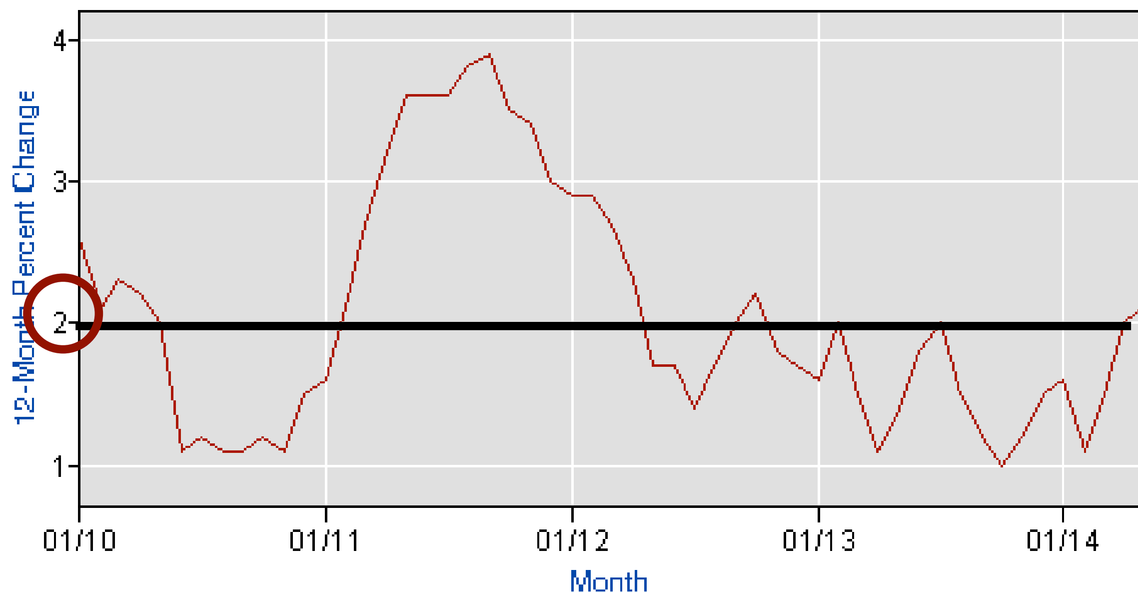
May. More worrisome is the average weekly pay over the year; it has now retreated two consecutive months and slid to 2% in June. What is so troubling about these numbers is that inflation keeps wiping out any gain in real pay.

Inflation is on the move

CPI has accelerated for three straight months on an annual basis. The 2.1% pace in May was the biggest since October 2012. The PCE price index, which the Fed follows more closely, climbed 1.8% and that too was the fastest increase since the fall of 2012. And these figures haven't fully taken into account the latest jump in oil price prices. Both Brent and WTI prices are up about $10 in the past 8 weeks.



Consumer price inflation



Driving energy costs higher have been the geopolitical crises in the Ukraine and Iraq--- and neither appears even close to being resolved. Indeed, from our analysis, both conflicts are likely to get much worse this summer. The end of the cease-fire in Ukraine this week has been followed by a sharp escalation in fighting. In Iraq, the Sunni – Shia schism has exploded into a paroxysm of violence. The savagery of ISIS has led to a wave of Islamic fratricide that promises to engulf Syria, Lebanon, Iran, Saudi Arabia, Jordan and perhaps even Israel. Throw into that cauldron too the likelihood that negotiators will fail to come to an agreement over Iran's nuclear program by the July 20th deadline.

Should anyone really expect the price of crude --- and thus inflation --- to remain stable given that the fighting in the Middle East is likely to intensify? Of course not.

Let's bring this back to the current jobs report and raise the second important metric to watch: hours worked. It stands to reason that if the economy is improving, we would see employees put in more time on the job. Indeed, this is usually a leading indicator of both future hiring and pay increases. However, average weekly hours remained unchanged for the fourth straight month at 34.5.

What does it all come down to?

So far this year, Americans have been spending more than their income and much of this can be attributed to the sense of well being from the rise in stock and real estate values. But we are approaching a critical juncture where the lack of real income growth plus the burden of higher gasoline prices will force consumers to make some hard choices. The persistent erosion of purchasing power means many Americans will shortly have to choose from one of three unpleasant options:

Option one. The combined burden of higher gas prices and lack of real income could force consumers to bite the bullet and scale back discretionary expenditures. In effect, they would grudgingly accept a lower standard of living until their earnings improve. Such a step, of course, would act as a brake on economic growth.

Option two. Shoppers can continue to spend in the months ahead, but they will dig deeper into personal savings to help pay for these outlays. So far we have not seen any evidence of this. In fact, the savings rate rose in May to 4.8%, the highest in 8 months!

Option three. Consumers who struggle because of poor gains in real pay turn to debt as a way to finance purchases. *It appears this that is precisely what is happening.* The growth in consumer credit debt has been on the rise this year and spiked by $26.8 billion April, according to the Federal Reserve. That 12.3% jump from the previous month was biggest monthly increase in more than 12 years, and included hefty pick-ups in both revolving and non-evolving debt. The growing dependence on debt could prolong consumer spending a few more months. But in the absence higher real wages, this type of consumption cannot last much longer, certainly not if we see both gas prices and inflation-driven interest rates edge higher later this year.

Why have nominal wages been so sluggish?

A real intriguing question at this point is why have we not seen greater increases in nominal pay five years after the end of the recession? Remember, one of Yellen's justifications to keep rates low is it will permit moderate economic growth, which should boost wages as US firms compete for fewer workers. Conceptually this makes perfect sense. The Fed Chair must be pleased that both measures of the unemployment rate (U-3 and U-6) have been on the decline. Moreover, the number of long term unemployed (those jobless 27 weeks or longer) has dropped to 3.1 million and now account for 32.8% of all those jobless, the lowest proportion since June 2009. Still, the growth in nominal pay appears to be stuck at 2% --- even as inflation marches higher. Why is this happening?

There are a few possible explanations. One is that US companies are holding back because they are still not convinced of the sustainability of the current expansion. They may want to wait until after the midterm elections, or perhaps even the 2016 presidential election for a better sense of future tax and spending policies out of Washington.

Or, much more problematic, it could be that the relationships that links economic growth, employment and higher nominal wages are not as neat as they once were. After all US firms have never been more integrated in global economy and have never faced more pressure to be price competitive. Nearly 30% of our GDP is now linked to international trade, up from 20% in just two decades ago. It is not a coincidence that US companies have slowed the pace of hiring to slash costs during this time period. When faced with such intense global competition for markets, the hurdle rate to hire additional workers and boost compensation can be much higher.

Bottom line:

Just as one should discount the sharp 2.9% GDP contraction of the first quarter due to inclement weather, we also need to temper any exuberance about the stronger 3% to 3.5% rebound in the spring quarter. Yes, the economy did end the second quarter on a strong note, with a fairly good employment report. But the stark reality remains that Americans are still not seeing much purchasing power, and unless we see a more meaningful acceleration in incomes the next few months to offset higher inflation, a slowdown in consumer spending (and thus economic activity) is inevitable in the second half that could well spill into 2015.

==============================

© Copyright 2014 ALL RIGHTS RESERVED
THE ECONOMIC OUTLOOK GROUP, LLC