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ECONOMIC TALKING POINTS

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Focus on Real Pay Increases and the Plethora of Other Solid Economic Reports

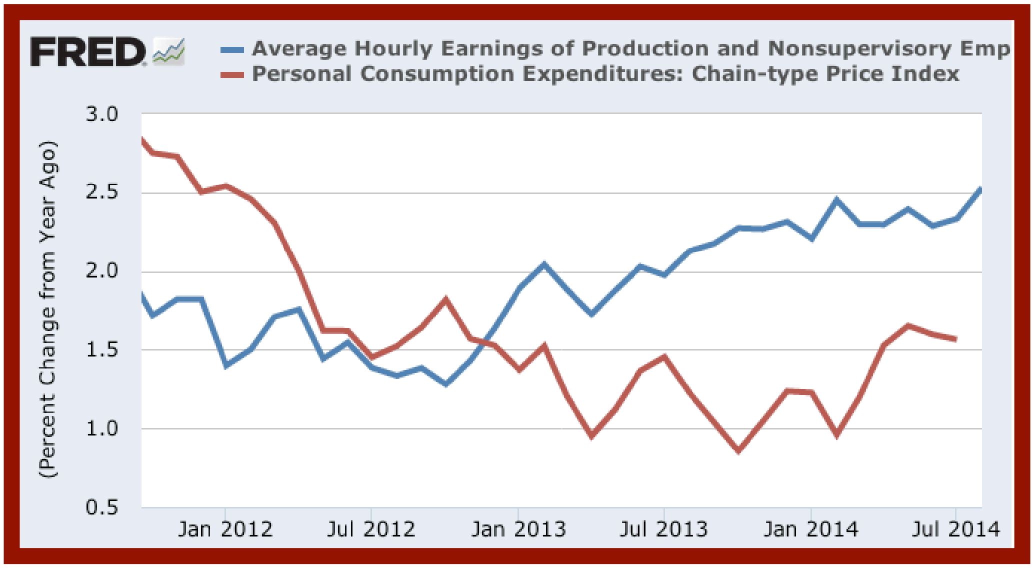
The soft August payroll numbers were clearly unexpected, disappointing, and certainly inconsistent with other recent gauges on labor market conditions.

So, yes, we were caught off guard by the relatively anemic 142,000 increase in total hiring (and an even weaker 134,000 in the private sector) last month.

However, let's not ignore a simple fact. Summer months have always posed a challenge for the BLS to get accurate numbers for the preliminary release.

Look back at just the last four years and you see the BLS had to revise upwards the August payroll numbers each year by an average of more than 80,000 jobs. They will likely do so again as more data is collected for August. I expect the final tally will be considerably higher and thus put it closer in line with the preponderance of other, more upbeat employment figures by ADP, ISM, Job openings (JOLTS), claims for unemployment benefits, and the Conference Board's Help Wanted OnLine data, to name a few.

Frankly, from the start our focus in this report has been elsewhere. The very fulcrum of US economic activity going forward will be real wage growth. The key determinant of a sustainable expansion is whether working Americans will earn enough to achieve real purchasing power. That's the dynamic that will influence consumer spending, business capital investments, and ultimately monetary policy. Here, we did spot an important trend in the August report. Average hourly earnings for production and nonsupervisory workers in the private sector (a measure that is quite sensitive to shifts in the business cycle) rose 2.5% last month from its ago level. This is the biggest annual increase since May 2010. At the same time, inflation as measured by the PCE price index, which the Federal Reserves relies on, eased back to 1.6% in July (latest available)! This translates into real income growth, an important prerequisite for healthier economic activity.



True, the 2.5% increase in nominal pay is still no reason to uncork champaign bottles. The bigger point here is that the upward trend in average hourly earnings suggests that the balance of power is gradually shifting from employers to employees. Additional evidence to support this conclusion comes from the short term unemployment rate, or those out work less than 27 weeks. It has now dropped to below 4.2%, less than the 4.8% average since 1948. There is considerable research (by Robert Gordon and Alan Krueger) suggesting the short-term unemployment rate, not the headline unemployment rate, is a better measure of the tightness in the labor market and a more accurate predictor of employee pay trends.

Further evidence that the job market is brighter than the headline payroll numbers is that the number of nonfarm employees forced to work part time because employers had less work for them, has been plunging. August's level for this category dropped to 4.23 million workers, the second lowest since 2008.

On a related note, the more comprehensive measure of joblessness, which combines total unemployed, plus the marginally attached workers and those stuck in P/T jobs, (U-6 measure) has fallen to12%, the lowest since October 2008.

Total unemployed, plus all marginally attached workers plus total employed part time for economic reasons

To me, these are the essential job metrics to monitor at this time, in part because they are consistent with most other recent macroeconomic data that point to real improvement in economic fundamentals. We have seen August auto sales soar to 17.5 million, best since 2006. In addition, industrial production (up 5% year-over-year), construction spending (rose 8% YOY) housing starts (up 21.7%), consumer and business confidence levels, corporate profits, a resumption in business capital spending, record exports, --- all point to an economy gaining more traction. Last but certainly not least, the composition of economic activity now is the healthiest we have seen in more than a decade as the private sector's contribution to growth gets larger, while the government's profile is much smaller.

What does all this mean for Fed policy? I believe the odds have now increased the Janet Yellen Fed will raise the fed funds rate in the first half, and then continue to tighten in a very gradual manner. The upward slope will be so shallow that we should still see negative real interest rates well into 2016.

The ending of QE this fall and the abandonment of a zero-bound rate policy next year would be the clearest sign yet that the shadow of the last recession is at long last receding into history. And that! --- not the preliminary soft payroll numbers for August --- should be the underlying theme of this economy.
