THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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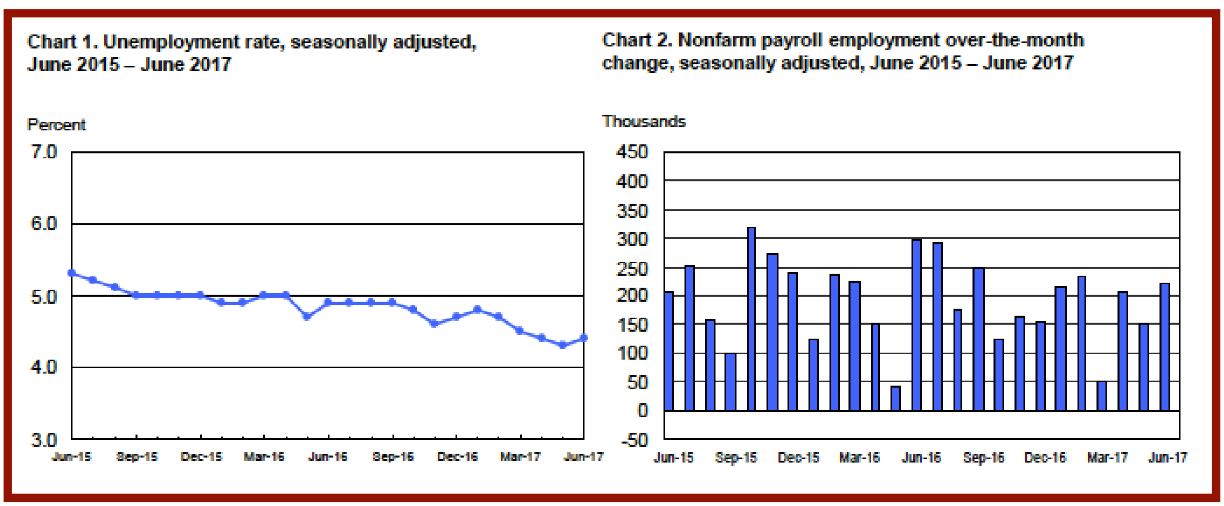
Great Jobs Report! But Will Wage Growth Soon Accelerate? Not Likely!

Job creation is the ultimate report card on the state of the economy. If business leaders are upbeat about the prospects for economic growth, they'll hire more people to increase output. So, with June's solid 222,000 increase in nonfarm payrolls and the upward revisions for April and May, we're inclined to grade economic activity an A minus.



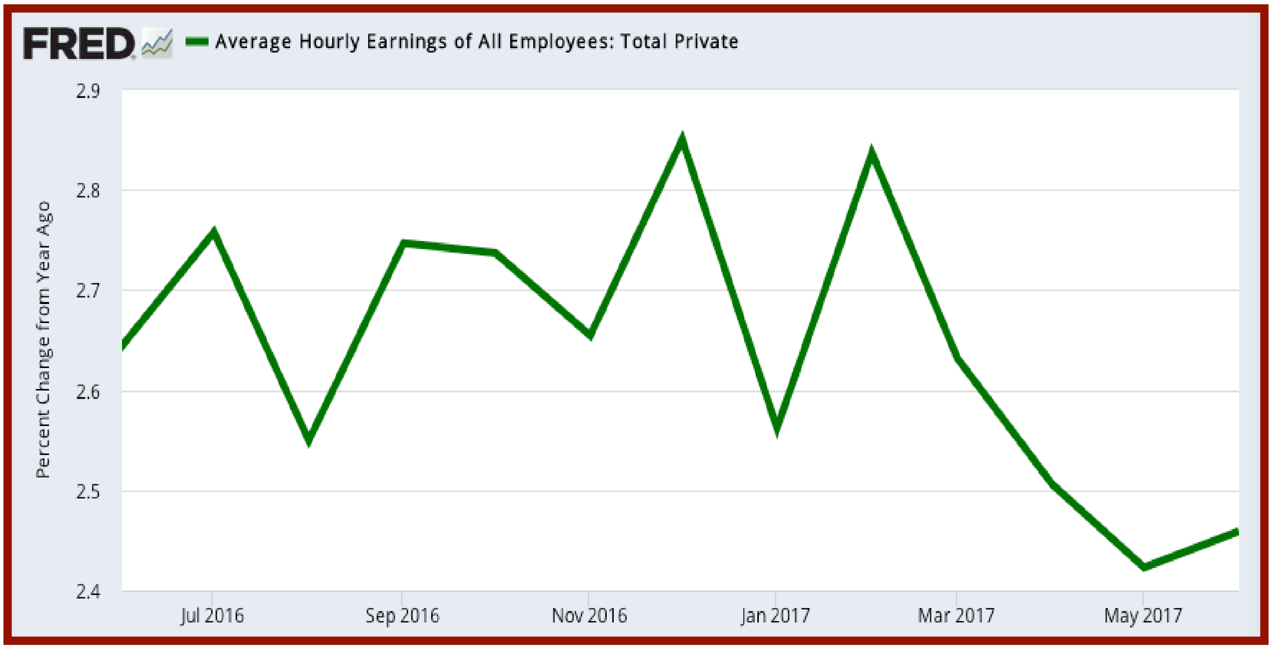
Even American workers see better job opportunities in this market. Both the labor force participation rate and its distant cousin, the employment-population ratio, have increased a tenth of a point, to 62.8% and 60.1%, respectively.

The strong job numbers are all the more remarkable given we're now in the ninth year of this economic cycle. Remember, the average length of a post-WW II recovery

--- that is from the moment an economy emerges from recession to the time it trips up and suffers another downturn --- is less than five years! Nor is there any evidence the current business cycle, mature as it is, is even close to peaking. None of the usual precursors that warn of a pending recession are present--- not high inflation, crippling interest rates and surging oil prices. That suggests this cycle upturn, which began in June 2009, could last beyond the record 10-year long expansion of the 1990s.

So why did we attach a minus to the grade of A? It's because there remains one baffling aspect to this otherwise uplifting story. Why is it that growth in wages remains stuck at the very same pace as when the unemployment rate stood at 10%?

Let me repeat that point. The jobless rate has now been hovering close to a 16-year low of 4.4% in June. Yet average hourly earnings is up 2.5% for the year, the same as when the jobless rate last hit double digits! The absence of wage inflation so late in this business cycle has perplexed the Federal Reserve and complicated monetary policy.



So why aren't we seeing wages accelerate to reflect the growing demand for workers? Does the Phillips Curve have any relevance when labor has become a global resource?

These questions cannot be ignored any longer. So here are a couple of reasons why we believe wage growth will remain lackluster:

1. Companies simply do not have sufficient pricing power to afford boosting employee pay. If we use the CPI to gauge how much firms can raise prices on goods and services, then inflation has risen about 1.9%. If you add 0.5% for productivity growth, then companies can theoretically increase pay around 2.5%. Anything more could eat into profit margins.

2. The prevalence of E-Commerce has also fundamentally altered retail pricing strategies. Online competition and discounts have limited the ability of firms to substantially boost wages.

3. There are demographic factors at work here too. We are experiencing a secular shift in the composition of the workers, with older, higher paid baby boomers now retiring. Replacing them are younger workers who earn less and may see smaller wage increases.

4. The number of Americans who *prefer* part time work has been increasing every year since 2011, and this too could dampen wage growth.

5. Union membership has also been in long-term decline. The proportion of workers who are represented by unions has now fallen to just 10.7% from a peak of 34.8% in the mid 1950s. That has scaled back collective bargaining agreements and thus prevented more aggressive pay increases.

6. Another perspective is that labor has become a global resource. Companies have for years taken advantage of labor cost arbitrage opportunities and outsourced work on a worldwide scale. But that process has effectively reduced the differential in pay over the years. Wages in emerging countries, which had been relatively low, are now edging higher, while pay increases in the industrial countries are becoming more modest. Keep in mind this combination of low unemployment rates and anemic wage growth is not limited to just the US. Japan and Germany also have very tight labor markets and workers there have also experienced minimal increases in pay.

What does this all mean for the economy and future monetary policy?

Here we need to go back to the basics. Employers want to know they can get a return on the investment of hiring each worker. But that calls for firms to either see greater demand for their products --- and/or to achieve much higher rates of productivity.

Well, one that first point it's unlikely we'll see a major rebound in consumer purchases after more than 8 consecutive years of economic growth and consumption. Consumer demand appears to be largely satiated at this point. Just look at auto sales the last few months; they have clearly plateaued after seven straight years of growth.

Nor can we expect much on productivity growth in the near future. Corporate managers are unlikely to ramp up capital spending projects to improve productivity when there is still so much uncertainty over fiscal policy, infrastructure spending and health care. Indeed, the entire economic, political and geopolitical landscape appears deeply unstable.

**Will the investigations in Washington lead to a constitutional crisis?
What are the prospects of a war on the Korean Peninsula, which will consume three major regional economies --- Japan, South Korea and China?
Is China close to suffering its own financial crisis?
Could a confrontation in the South China Sea cripple one of the world's most important supply chain routes.**

For all these reasons, I see little chance of a break out in wage inflation, at least with this business cycle. That means it will be much more difficult for inflation (PCE price index) to reach the Fed's 2% target this year or surpass it on a sustained basis the next two years. It also suggests the Fed will forgo another rate increase this year and instead shift focus on gradually shrinking its $4.5 trillion balance sheet.

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Key Economic Forecasts

- Actual
- Forecast

United States

	I 2016	II 2016	III 2016	IV 2016	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018
Real Gross Domestic Product (GDP):												
%	0.8	1.4	3.5	2.1	1.4	2.5	2.3	2.4	2.5	2.7	3.0	2.7
Personal Consumption Expenditures:												
PCE	1.6	4.3	3.0	3.5	1.1	3.0	2.5	2.8	2.6	3.5	3.3	2.5
Inflation, end of period, year-over-year:												
CPI %	0.9	1.0	1.5	2.1	2.4	2.5	2.6	2.5	2.5	2.7	2.7	2.8
Unemployment Rate (end of period):												
%	5.0	4.9	4.9	4.7	4.5	4.4	4.3	4.5	4.5	4.6	4.6	4.8
Non-farm Payrolls, monthly avg. thousand:												
	196	164	239	148	166	194	135	135	145	130	115	125
Treasury 10-yr Note Yield % (end of period)												
	1.78	1.49	1.60	2.45	2.39	2.30	2.39	2.35	2.90	3.15	3.15	3.20
Federal funds rate % (end of period)												
	0.38	0.38	0.38	0.63	0.88	1.13	1.13	1.38	1.63	1.88	2.13	2.13

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
US	1.8	-0.3	-2.8	2.5	1.6	2.2	1.7	2.4	2.6	1.6	2.1	2.6
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	1.9	1.8
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.8	1.4	0.9
Japan	2.1	-0.7	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.3	1.0
Canada	2.7	0.7	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	2.9	2.5
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	7.0	7.5
China	14.2	9.6	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.5	6.5
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.6	0.3	1.5
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.0	1.8	2.4
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.6	2.4	2.4	2.6	2.7
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.4	0.9	1.7
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.7	3.3