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ECONOMIC TALKING POINTS

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Pandemic Fallout: As Wages Climb, Companies Are Exploring Other Options

The year ends with a curious jobs report. Once again its two principal data series --- the establishment and household surveys --- took different paths in tallying up employment for December.

Was this just another statistical fluke? Or is something more significant unfolding in the labor market? We believe it's the latter.

For the last several months, the establishment survey has made a mockery of monthly guesstimates by market professionals. Hate to be this blunt, but billions of dollars of investment capital are riding on consensus predictions of payrolls.

The forecast for December in the establishment survey was that net new hiring increased by 422,000; instead it came in at a more modest 199,000. True, it's not an earth-shattering miss, but we have seen these large statistical quirks all too often and the result is it causes more confusion than clarity. That's because a whole different story is being told in the household survey. Total employment shot up 651,000 last month--- and that hefty increase followed a stunning 1,090,000 jump in November. (Incidentally, the establishment survey in November reported less than one-fourth of that figure, 249,000!)

So let's try to make some sense of this persistent divergence between these two main gauges of employment.

Some historical context is needed here. Prior to the pandemic, the household and establishment surveys generally moved in tandem, both in direction and in magnitude. That's clearly no longer the case.

To get a better grasp of what's happening in the labor market, we begin this probe with a dose of humility. The pandemic is changing the entire economic landscape in ways we do not yet fully understand. Companies and workers have jettisoned old practices about hiring and work and are experimenting with new ideas.

For example, imbedded in these surveys we believe is a growing shift away from permanent hires (receiving W2s) to a preference for more full-time contract workers (1099s). Such a change would favor the household survey.

Why would firms prefer contract workers at this point?

One instinctive guess would be that retailers heavily staffed up for the holiday shopping season. The only problem with that explanation is it's not supported by facts. Retailers actually shed 2,100 workers last month --- and laid off 13,300 in November! So there are deeper issues at work here.

Let's run through a few:

First, companies are turning more cautious about permanent hires. Yes, there is an urgency to fill millions of vacant position, but there is also lingering uncertainty about the path of the economy this year and next. Just what is the outlook for the pandemic and inflation? Will the Federal Reserve raise interest rates too much or too fast and inadvertently choke off demand for goods services. Just how high will energy prices climb in the coming months?

Second, corporate HR departments are more preoccupied now with cauterizing the hemorrhaging of workers within their own firms, let alone actually adding to payrolls. Professional recruiters say they are spending more than half their time just finding replacements for executives that have departed.

Third, we're seeing a commitment by large companies to substitute capital for labor. Core capital outlays (that is, capital expenditures ex-defense and transportation) took off in 2021 after many years of flatlining. The rationale? Companies want to increase output and boost productivity. But if labor costs are getting prohibitively expensive, or if one can't find qualified people to hire, then it makes more sense to increase the productive capacity of a company by investing in new machinery, equipment, software, robotics and AI. (Needless to say, such investments also address the issue of future virus-related absenteeism.) So long as the cost of capital is cheaper relative to labor, firms are content to make such outlays.

And there is a corollary to consider as well.

Note that average weekly *hours* worked has held steady at 34.7 hours the last three months --- and is down from 35 hours the start of last year. Yet, average hourly *earnings* in the private sector has been on a tear since last April. This trend has to be concerning to employers. In the years before the pandemic, multi-year employment contracts could be set with annual increases in wages of 3%. That would be sufficient to provide workers with an income above the rate of inflation. Recall that in the prior two decades, CPI inflation averaged less than 2% a year.

But the cost of living has now jumped to a rate in excess of 6%, a pace that has already eroded the purchasing power of households. To make up for this loss in real income, consumers have been digging deeper into savings. So much so that the personal savings rate plummeted in November (latest available) to 6.9%, the lowest in four years!

You might see where I'm going with this. Any upcoming negotiations on wage contracts will see both existing employees and new hires demand future pay increases exceed inflation. These workers now have the leverage to insist on such terms given the labor shortage.

However, any firm that grudgingly signs off on such lucrative multi-year wage contracts has placed its profit margins in jeopardy. For as the supply chains get untangled and more goods flow through the economy, market forces take over again and that will diminish corporate pricing power. The last thing employers want is to box themselves into a corner with years of pay hikes when they can't fully offset such expense with higher prices to customers. Historically, wages have been notoriously sticky on the downside. And any attempt to keep prices high relative to one's competitor could result in an even costlier loss in market share.

So the challenge for employers is to find a way to fill job openings--- yet avoid the risk of a collapse in margins. The solution? Lure in contract workers with exceptionally high pay but for a much shorter duration. That option may explain the growing preference to hiring 1099-tax workers --- and why we have seen a growing gap between the household and establishment surveys.

Implications for the Federal Reserve

The December employment report will not alter the Fed's current thinking on monetary policy. They have, by most metrics, satisfied their full employment mandate. When the economy has 10.6 million positions to fill but only 6.9 million unemployed looking for work, there's little more the Fed can do. They don't have the means to increase the size of the labor force. That falls more on the laps of Congress and the White House (through increases in immigration and the current Build Back Better plan).

At this juncture, the Fed will focus on forces that shape inflation. We continue to believe that price pressures will soon crest as improvements in supply chain flows begin to ease the chronic scarcity of goods. That's why we are sticking with our previous forecast of a maximum of two hikes this year and three in 2023.

United States

	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023	I 2024	II 2024	III 2024	IV 2024
Real Gross Domestic Product (GDP):																
%	6.3	6.7	2.3	6.2	2.2	3.6	4.1	3.3	1.8	2.7	2.5	2.6	2.2	2.7	3.0	2.2
Personal Consumption Expenditures:																
PCE %	11.4	12.0	2.0	6.8	2.4	4.2	3.7	2.9	1.5	2.9	2.8	2.7	2.0	2.7	2.5	2.8
Inflation, end of period, year-over-year:																
CPI %	2.6	5.3	5.4	6.9	6.8	6.1	5.5	3.8	3.3	2.8	2.6	2.3	2.2	2.3	2.3	2.4
Unemployment Rate (end of period):																
%	6.0	5.9	4.7	3.9	4.1	3.9	3.8	3.9	3.7	3.6	3.5	3.7	3.6	3.6	3.6	3.5
Non-farm Payrolls, monthly avg. thousand:																
	513	615	651	365	455	625	665	640	385	510	495	410	275	310	315	325
Treasury 10-yr Note Yield % (end of period):																
	1.75	1.44	1.52	1.51	1.60	1.65	1.75	2.05	2.10	2.10	2.26	2.35	2.35	2.45	2.53	2.45
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.63	0.88	1.13	1.38	1.63	1.63	1.63	1.88	1.88

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
US	2.6	1.6	2.2	1.8	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	5.4	3.3	2.4	2.5
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.7	4.9	3.9	2.4	1.7
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.8	5.7	4.6	2.5	2.0
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	1.7	0.6	-0.2	-4.5	2.0	2.8	2.2	1.4
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.0	1.6	-5.3	5.0	4.2	2.7	2.2
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-7.5	7.8	7.0	6.4	5.7
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.1	2.3	6.6	5.9	5.6	5.1
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-4.4	4.4	2.3	3.3	2.7
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	-8.4	5.9	2.9	2.7	2.4
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	4.3	3.1	2.6	2.7
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	-2.9	4.1	2.9	2.4	2.1
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.7	–3.4	5.4	4.8	3.6	3.2

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