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ECONOMIC TALKING POINTS

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Wage inflation is no longer MIA. What will the Fed do now?

Month after month, the one glaring absence in the jobs report has been rising wages. Well, it's no longer MIA.

With the supply of unemployed and underemployed workers just about fully depleted, the pressure to fill nearly 6 million job openings every month and retain current employees finally forced companies to offer higher compensation. It was in fact inevitable. Technology and the globalization of labor never repealed the Philips Curve, just delayed it.

American workers in the private sector saw their average hourly pay increase 2.9% over the last 12 months in January. The last time we saw such a pace was in June 2009. More significantly is that wages have now been climbing steadily since October of last year and we expect it will cross the 3% threshold by the second quarter, if not sooner. The key takeaway: The law of supply and demand and its impact on pricing remains immutable.

Rarely have employers had so much difficulty finding workers.

• A recent report by the US Chamber of Commerce and the USG Corporation (a major manufacturer of building products) reported that 95% of their contractors complained about the difficulty of locating workers for their projects. Reuters noted the shortage of workers in the construction field alone is the worst since 2007. The building industry has nevertheless scrambled to hire another 36,000 workers in January, for a total of 226,000 over the past year.

Chart 1. Unemployment rate, seasonally adjusted, January 2016 – January 2018

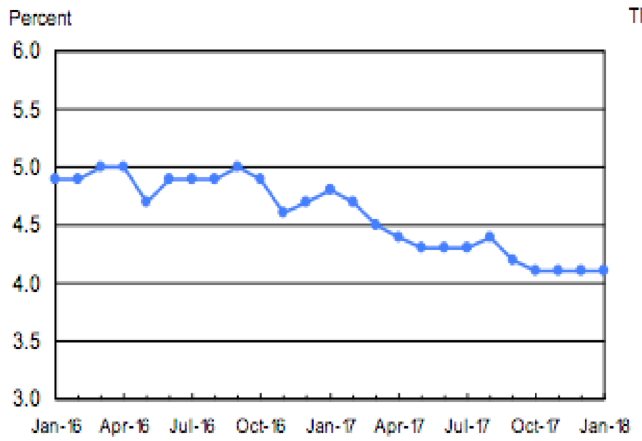
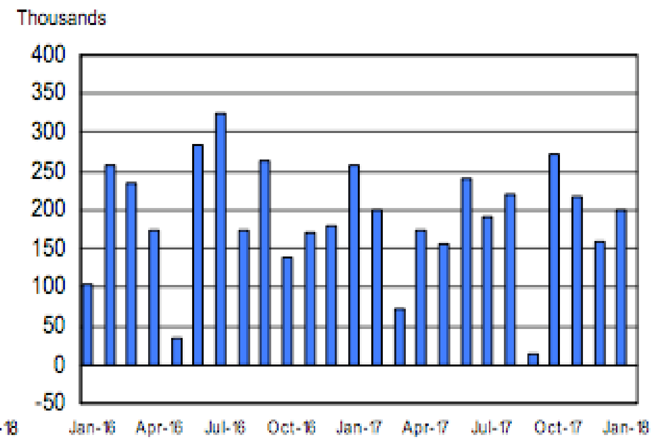


Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, January 2016 – January 2018



- The service sector, which makes up nearly 90% of the economy, finds itself in the same difficult predicament. For example, firms in leisure and hospitality have been on a hiring tear since 2010, and they added another 35,000 to payrolls last month for a total of 342,000 in the last 12 months.

- Trucking and warehouse employment, key barometers that reflect consumer and business demand for goods, rose another 2,200 in January, double the pace the month before. That accelerated the 12-month hiring pace to 13,800, the fastest in more than two years.

- Even Employment agencies had to beef up their staff to work at meeting the needs of their clients. Hiring in this field increased by 5,700 last month, which swelled payroll in this industry by another 122,000 since January of 2017, again the biggest 12-month rise in more than 2 years. The 3.68 million people now working in the employment services field is the highest since November 2006, more than a year before the financial crisis hit.

All told, payrolls increased by 200,000 the first month of the year, with the private sector accounting for all but 4,000 of that figure. That's more than double what is needed to keep the unemployment rate from rising. The reason the jobless rate did not drop below 4.1% was because 518,000 more people entered the workforce in January, the biggest monthly increase in more than two years. Jumping into the labor market were midterm semester graduates along with those chronically unemployed who were resolved to resume looking in the New Year.

What about the Federal Reserve and Monetary Policy?

The question that now looms large is what impact will the healthy jobs report ---and specifically the jump in wages ---have on future monetary policy? We have already seen market rates soar in response. For fixed income investors, the employment release brought fresh worries that inflation may now accelerate and cross the Fed's 2% threshold sooner, and thus pressure the central bank to raise short-term rates more aggressively. The bond market certainly got walloped after the jobs report was released. The yield on 10 yr. Treasury notes quickly jumped to 2.85%, a four year high!

The fear of higher rates also pounded the stock market as equity investors assessed the impact it would have on future consumer spending, business capital spending, and on the overall valuation of stocks.

But the Fed also has to be careful about the fallout from rising market rates. Households may begin to pull back expenditures now that the cost of borrowing (for auto loans and mortgages) climbs. While the tax cut will leave Americans with slightly more take home pay, one shouldn't assume that extra income will spur more spending. After all, consumers have supported this expansion for more than eight years, which raises the question of whether demand is close to being satiated. How many more cell phones, autos, home electronic gadgets do households need after nearly a decade of shopping?

Moreover, shoppers have financed much of these purchases by taking on more debt and saving less. Total household debt now stands at a record high $12.96 trillion. Debt service in the latest quarter (3rd 2017) climbed to 10.29% of disposable personal income, the most in six years. That may be manageable when interest rates were historically low, but it could be more problematic now that we're in a rising rate environment. Americans have also dug deep into their savings, and in the process slashed their personal savings rate down to the lowest in a decade. Finally, there is more If households chose to use more of their take home pay to replenish their savings and/or reduce indebtedness, we will see less discretionary spending in 2018

We are not forecasting an abrupt pull back by consumers this year, but neither do we see Americans significantly ramping up outlays in the coming quarters.

A wholly different picture emerges regarding business capital spending. Given the (1) scarcity and higher cost of labor, (2) the reality that major US companies have to operate in a tough global competitive environment, (3) and contend with online shopping which limits pricing power --- we expect to see corporate investment take off this year as firms move quickly to increase their increase operating efficiency and productivity. The accelerated write-off provisions in the latest tax cut serve as an additional catalyst to boost capital outlays.

The rush to increase corporate investments, a process that actually began early last year, should permit wages to increase without immediately leading to a pick up in retail prices. In other words, we expect to see a longer than usual lag in cost-push side of inflation. Productivity is already recovering. Output per hour increased by 1.2% in 2017, its best performance since 2015.

The drop in equity prices can also work to keep inflation in check. If Americans suddenly see the market undergo a correction as stock prices get revalued to reflect higher interest rates, it can also impact consumer behavior through the wealth effect. Should the growth in household net worth markedly slows or contracts, shoppers will turn more cautious. (One more intangible factor that may depress both stock prices and future consumer spending is simply the political chaos and policy paralysis in Washington. We're a few days away from another possible government shutdown.)

The bottom line:
One should never extract too much from just one month's data. We do believe that wage pressures are finally bubbling up and that this will lift inflation in the near future. But precisely how much and when is still very unclear. So we are still sticking with our view that the Fed will continue to pursue its cautious and deliberate pace to normalize short term interest rates. Our forecast calls for just three increases this year, with another two in 2019. A lot more data is scheduled to come out between now and March 20th when the FOMC next meets under Jay Powell's leadership. The Fed also knows January's data can also be subject to distortions due to seasonal factors. As strong as this latest employment report was, it is still not enough for us to project a fourth ---or even fifth rate hike this year.

United States

	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019
Real Gross Domestic Product (GDP):												
%	1.2	3.1	3.2	2.6	2.4	3.2	2.5	2.5	1.9	2.2	2.0	2.4
Personal Consumption Expenditures:												
PCE %	1.9	3.3	2.2	3.8	2.4	2.8	2.4	2.4	2.2	2.1	2.3	2.7
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	2.1	2.2	2.2	2.3	2.3	2.4	2.4	2.5	2.7
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.1	4.0	3.7	3.7	3.9	4.2	4.4	4.4	4.5
Non-farm Payrolls, monthly avg. thousand:												
	166	187	128	204	190	185	160	160	150	145	140	140
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.80	2.88	2.90	3.10	3.35	3.38	3.40	3.40
Federal funds rate % (end of period):												
	0.88	1.13	1.13	1.38	1.63	1.63	1.88	2.13	2.38	2.63	2.63	2.63

GDP Growth - Global Economy

Country	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.1
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	2.4	1.7
United Kingdom	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.0	1.4
Japan	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.9	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.2	2.7	2.5
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.8	7.5	7.5
China	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.9	6.6	6.3
Brazil	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.6	0.9	2.3	2.8
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	2.5
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.4	2.4	2.7	2.8	3.0
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.4	2.1	2.0
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.3	3.4	3.5

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017	End 2018	End 2019
USD/Yen	91	93	81	77	87	105	119	120	117	113	111	114
Euro/USD	1.40	1.43	1.34	1.29	1.32	1.37	1.21	1.09	1.05	1.20	1.25	1.24

Oil (Brent spot) & Gasoline (Average retail unleaded, $)

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017	End 2018	End 2019
Crude oil per barrel	46	78	95	107	111	111	58	38	49	67	54	45
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	2.26	2.00	2.31	2.47	2.45	2.30

Major Stock Indexes

	End 2015	End 2016	End 2017	% Change '17	End 2018	% Change '18
DJIA	17,425	19,763	24,719	25.1	26,400	6.8
S&P 500	2,044	2,239	2,674	19.4	2,824	5.6
NASDAQ	5,007	5,383	6,903	28.2	7,393	7.1
RUSSELL 2000	1,136	1,357	1,536	13.1	1,708	11.2

Economic & Geopolitical Events That Can Disrupt U.S. GDP Growth: Their Probability of Occurrence

Any scenario above 50% will be incorporated in our baseline economic forecasts for 2018 and 2019.

PROBABILITY (%)	U.S.
45	President Trump departs before his first term expires
30	NAFTA talks fail and cause a trade war
20	Federal Reserve raises interest rates too rapidly; Yield curve inverts
30	Bitcoin price crashes; sell-off spreads to broader equity markets
40	U.S. inflation accelerates faster than expected
	FOREIGN
45	War on the Korean Peninsula
40	China mismanages efforts to deleverage; debt bubble bursts
25	U.S. - Chinese confrontation in the South China Sea
35	Iran's domestic turmoil boils over to civil war: cost of crude climbs
30	Saudi - Iran tensions escalate to direct military conflict: Oil prices surge
25	War erupts between Israel & Lebanon's Hezbollah
15	Brexit talks collapse and imperils global trade
30	Catastrophic act of terrorism involving WMDs