



MORNING BRIEFING

September 12, 2018

All About Wages

See the [collection](#) of the individual charts linked below.

(1) Labor market tight enough to revive Phillips curve finally? (2) Wage inflation still below Yellen's "normal." (3) Labor costs don't automatically get marked up into prices. (4) Record profit margin implies more productivity growth than official data show. (5) Lots of industries with above-average wage inflation don't have much pricing power. (6) Real wage and other compensation measures show rising trends, not stagnation. (7) The Council of Economic Advisers posts a useful primer on wages, which confirms upbeat trend. (8) Gene Epstein explains why labor's share of national income isn't as bad as shown by official data, and widely reported.

US Labor Compensation I: Can Companies Mark up Labor Costs? There's no debate about the US labor market: It is tight. There is some evidence that it is finally tight enough to boost wage inflation. The inverse Phillips curve relationship between wage inflation and the unemployment rate has been missing in action for a very long time during the current economic expansion.

Has Godot finally arrived? Maybe, but Melissa and I aren't totally convinced. Recall that during her first [press conference](#) as Fed chair on March 19, 2014, Janet Yellen, who is one of the country's leading labor economists, said that 3%-4% wage inflation would be "normal." It was running around 2% at the time, and the jobless rate was 6.7%. Last month, the jobless rate was down to 3.9%. However, the wage inflation rate was 2.9% ([Fig. 1](#)). That was the highest since June 2009, but still shy of 3.0%. Nevertheless, it is getting easier to see an inverse correlation between the jobless rate and the wage inflation rate ([Fig. 2](#)).

The same cannot be said for the relationship between the unemployment rate and the core PCED measure of consumer price inflation ([Fig. 3](#)). As the former fell from a cyclical peak of 10.0% during October 2009 to 3.9% last month, the latter has been eerily range bound between 0.9% and 2.1%.

While there is now a more discernable uptrend in wage inflation since late 2012, the same cannot be said for price inflation ([Fig. 4](#)). Rising labor costs don't automatically get passed through to prices. They can be offset by productivity and also can be absorbed by lowering profit margins. The puzzle is that productivity growth has been running around an annual rate of barely 1.0% for the past five years ([Fig. 5](#)). Furthermore, the S&P 500 profit margin rose to record highs in recent quarters ([Fig. 6](#)). This suggests that productivity growth may be higher than the official data show.

On Monday, we highlighted the following derby for wage inflation in the Bureau of Labor Statistics' (BLS) major industry groupings: utilities (4.8% y/y), financial activities (4.7), information services (3.4), construction (3.3), retail trade (3.2), leisure & hospitality (3.2), professional & business services (3.0), all industries (2.9), education & health services (2.6), durable goods manufacturing (2.3), transportation & warehousing (2.3), wholesale trade (2.0), mining & logging (1.5), and consumer nondurable manufacturing (0.9).

Most of the industries with wage inflation rates above the average don't have much pricing power to pass through labor costs, either because they are regulated or because they are highly competitive. The former applies to utilities. Financial activities, information services, retail trade, leisure & hospitality all are competitive.

Remarkably, notwithstanding widespread reports of a trucker shortage, average hourly earnings in the truck transportation industry rose just 3.1% y/y during July ([Fig. 7](#)). Thanks to the IT logistic revolution, there has been a remarkable increase in the industry's productivity, as evidenced by the record high in the ratio of the ATA truck tonnage index to truck transportation payroll employment ([Fig. 8](#)). Also of note is that wage inflation is well below average in both durable and nondurable goods manufacturing.

US Labor Compensation II: Primer on Wage Measurement. The widespread mythical contention that wages have stagnated over the past couple of decades irks us because the comprehensive data show otherwise. One of the most widely cited statistics to support this claim is the Census Bureau's median money income per household, which is more or less just workers' earned income and social security ([Fig. 9](#)). It has been relatively flat since 2000. However, that data series was never intended to be a measure of the standard of living but rather a baseline for determining the poverty line and to whom government transfers should go. Other measures of mean household income and consumption per household haven't stagnated at all since 2000.

We have shown on a regular basis that the real wage rate (based on average hourly earnings of production and nonsupervisory workers divided by the PCED) has been on a solid uptrend since the mid-1990s ([Fig. 10](#))! But this measure never makes headlines.

So it's refreshing to see the topic of wage measurement attracting wider attention, including from the White House. Recently, the Council of Economic Advisers (CEA) released a [paper](#) supporting the conclusion that compensation growth has been much better than widely believed with points that make sense to us (notwithstanding the CEA's inherent possible bias toward making the administration look good).

The paper's three basic parts cover the three main flaws with traditional wage metrics: the failure to incorporate additional employment benefits, the failure to account for compositional changes in the workforce, and the failure to use more accurate measures of inflation to deflate nominal wage growth. Accounting for these issues, the CEA calculates that real average hourly after-tax compensation has risen by a solid 1.4% over the past year (Q2-2017 to Q2-2018) instead of the near-zero growth reported in the headlines. Let's take a closer look:

(1) *Benefits*. Specifically, the CEA focuses on debunking the myth of wage stagnation demonstrated by the BLS's Current Employment Statistics (CES) survey. Benefits—such as employer-paid health insurance premiums, paid leave, and retirement plans—are important compensation components that the CES measure leaves out. Nonwage benefits, including bonus payments, represented nearly one-third of total compensation in 2018, according to the CEA (see Figure 2 in the White House report).

(2) *Composition*. Changes in labor force composition are important for assessing aggregate real wage growth. Shifts in the mix of age and demographic profiles influence aggregate wage changes. Most prominently, the Baby Boomers, who started to turn 65 during 2011, are retiring and being replaced by younger, less experienced workers. With this, the downward bias of aggregate wage changes is “extraordinary,” according to the CEA.

By the way, the CEA didn't point it out, but we have previously observed that many Baby Boomers are retiring later in life and likely experiencing slower wage growth than during their prime working years—

another depressor of aggregate wage growth.

Demographics aside, entry and exit into the workforce also strongly influence workforce composition over the course of a business cycle. According to the CEA report: “During a recession, the entry of inexperienced workers slows, and those losing their jobs also tend to have less work experience than average, which artificially (relative to what individual workers experience) increases the national average wage. ... The reverse tends to occur during an expansion.”

From 2013 to 2018, when the fraction of the population that works significantly increased and the workforce’s share of younger workers rose, “the potential for composition changes to mask wage growth is particularly high,” according to the CEA.

(3) *Inflation*. Using the PCED to deflate nominal wages, the CEA observes faster real wage growth than yielded with the more commonly used CPI for Urban Consumers, which often shows “systematically more inflation” than the PCED (see the CEA report’s Figure 8).

Many economists, including Fed members, prefer the PCED as a more accurate measure of consumer price inflation for four main reasons. These relate to accounting for the substitution of goods and services, the relative weights placed on categories of goods and services, the scope of goods and services covered, and seasonal adjustment factors.

US Labor Compensation III: Declining Labor Share Is a Myth. Gene Epstein, *Barron’s* crackerjack economics editor from 1993-2017, recently shared an [article](#) with us that he wrote for *Reason*, the monthly print magazine of “free minds and free markets.” The article counters a widely accepted media narrative that labor’s share of economic output is on the decline. Setting up the strawman, Gene writes: “Greedy capitalists have been helping themselves to an ever-growing share of our economic output. The decline of labor unions and factory jobs, our dependence on cheap foreign labor, and businesses’ growing ‘monopsony’ power are shafting American workers.”

Making that same point in a 7/13 [article](#), the *NYT* ran a simple chart of Bureau Economic Analysis’ (BEA) data. It shows that “paychecks account for much less of the nation’s total income since the last recession, and the profits of businesses account for more.” The problem, according to Gene, is that these data need tweaking before accurate conclusions can be drawn. After having former BEA Chief Statistician Robert Parker vet his approach, here’s what Gene presents:

(1) *Annualizing the trend*. To “smooth out intra-year volatility,” Gene took Parker’s suggestion to express the data annually rather than quarterly, as a quarterly representation masks the cyclicity of the data and makes it appear to be on a sustained long-term downtrend. Gene observes that the “entire historical range” is “pretty well captured from 1947’s high of 70.4 percent to 1965’s low of 65.9 percent.” He adds: “Labor’s current share, at 67.1 percent, is on the low side of that range, but it is equal to or greater than the years from 1994 to 1997.”

(2) *Excluding government, including self-employed*. Further, Gene calls into question the *NYT*’s use of national income in the denominator for two reasons. For one, the government is included, but should be excluded, since the story “concerns the capitalist private sector.” Second, “by starting with national rather than domestic income, it includes the distorting effects of inflows and outflows from foreign countries.” Additionally, the numerator is flawed not only because it includes compensation of government workers but also because it excludes self-employment income, an important component of private-sector income.

(3) *Revised ratio*. Gene’s newly calculated denominator starts with the BEA’s “net domestic product”

and “net domestic income,” then “takes out the portion attributed to all levels of government.” Next, the revised denominator “takes an average for each year of private sector net domestic income and net domestic product, since each is using different sources to measure the same concept.” Finally, the numerator of the new ratio deducts compensation of government employees from total compensation and includes “proprietor’s income.” See the outcome in chart form [here](#).

CALENDARS

US. Wed: PPI-FD Total, Core, and Core Ex Trade Services 0.2%/0.2%/0.2%, Atlanta Fed Business Inflation Expectations, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book. **Thurs:** Headline & Core CPI 2.8%/2.3% y/y, Jobless Claims 210k, Treasury Budget -\$164.0b, EIA Natural Gas Report, Quarles, Bostic. (Econoday estimates)

Global. Wed: Eurozone Industrial Production -0.5%/m/1.0%/y/y, Japan Machine Orders 5.7%/m/4.5%/y/y. **Thurs:** Germany CPI 0.1%/m/2.0%/y/y, Australia Employment Change & Unemployment Rate 18k/5.3%, BOE Rate Decision & Asset Purchase Target 0.75%/ £435b, ECB Rate Decision 0.00%, ECB Marginal Facility & Deposit Facility Rates 0.25%/-0.40%, ECB Publishes Macroeconomic Projections, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): All these indexes were at record highs at the end of August for the first time since January, but the SmallCaps were outperforming LargeCaps and MidCaps on a ytd basis. Here’s how they rank ytd through Monday’s close, along with their 2017 performance and their percentage changes since their record highs in late August: S&P SmallCap 600 (15.6% ytd, 11.7% in 2017, -1.4% from record high), Russell SmallCap 2000 (11.9, 13.1, -1.3), Russell LargeCap 1000 (7.8, 19.3, -1.3), S&P LargeCap 500 (7.6, 19.4, -1.3), and S&P MidCap 400 (6.9, 14.5, -0.9). Forward revenues and earnings are at record highs now for all the S&P and Russell indexes. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap’s forward earnings was steady at a seven-year high of 22.7% y/y, which compares to a six-year low of -1.8% in October 2015; MidCap’s rose to a seven-year high of 24.0% from 23.8%, which compares to a six-year low of -1.3% in December 2015; and SmallCap’s edged up w/w to 34.1% from 34.0%, which compares to an eight-year high of 34.8% in mid-August and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.9% and 10.3%, MidCap 21.6% and 12.5%, and SmallCap 28.3% and 15.7%.

S&P 500 Growth vs Value ([link](#)): The S&P 500 Growth index is up 13.6% ytd, well ahead of the 1.3% gain for its Value counterpart. Value is 4.5% below its January 26 record high and no longer in a correction, while Growth is 1.7% below its record high on August 29. During 2017, Growth’s 25.4% gain was double the 12.6% rise for Value. Growth had trailed Value in the four months following the election. Now Growth’s 45.1% gain since the election is double the 22.6% increase logged by Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value’s 14.3% gain. Growth is expected to deliver more than double the rate of revenue growth (STRG) that Value does over the next 12 months, but forward earnings growth (STEG) is only slightly higher for Growth; specifically, 8.7% STRG and 14.2% STEG are projected for Growth, respectively, vs 4.5% and 12.6% for Value. Prior to February’s selloff, Growth’s P/E of 21.8 on January 26 was its highest since May 2002, while Value’s 16.6 on January 3 was its highest since April 2002. Through Monday, Growth’s P/E was back up to 20.0 from its 15-month low of 18.8 on April 2, and Value’s 14.2 remains close to its 25-month low of 13.9 on March 23. Regarding NERI, Growth’s was positive in August for a 16th straight month, but edged down to a still-impressive 8.8% from 8.9% in

July; that compares to a record high of 22.3% in March and a five-year low of -16.2% in April 2015. Value's NERI was also positive in August for a 16th month (following 33 months of negative readings), but eased to 5.1% from 5.8%; that compares to a record high of 21.2% in March and five-year low of -20.3% in April 2015. The TCJA has boosted the consensus 2018 earnings estimate and the forward profit margin for both Growth and Value. Growth's 2018 estimate has risen 10.0% vs Value's 8.9% gain. Growth's forward profit margin has jumped to 16.7% from 14.4% prior to the TCJA's passage, and is down slightly from its record high of 16.5% during mid-June. Value's forward profit margin of 10.1% now matches its pre-Financial-crisis record high during August 2007 and is up from 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): Small business optimism in August hit a new record high! "At the beginning of this historic run, Index gains were dominated by expectations: good time to expand, expected real sales, inventory satisfaction, expected credit conditions, and expected business conditions," said NFIB Chief Economist Bill Dunkelberg. "Now the Index is dominated by real business activity that makes GDP grow: job creation plans, job openings, strong capital spending plans, record inventory investment plans, and earnings. Small business is clearly helping to drive that four percent growth in the domestic economy." August's Small Business Optimism Index (SBOI) jumped to a new record high of 108.8, up 13.9 points since just before the November 2016 election. The report issued with the data noted that the SBOI turned up sharply in late November 2016, heading to readings in the top 5% of its history by that December; it hasn't looked back ever since. Last month, of the 10 components of the SBOI, six increased and four declined. Of the components contributing positively, hiring plans (to 26% in August from 23% in July) and job openings (38 from 37) reached new record highs, while now is a good time to expand (34 from 32) matched its May 2018 record high. Plans to increase inventories (10 from 4) and earnings trends (1 from -1) were within 1 point and 2 points, respectively, of their record highs; capital spending plans (33 from 30) climbed to a new cyclical high. Finding qualified workers easily held onto the top spot for survey respondents' single most important business problem, while the percentages of respondents citing taxes, government regulation, and poor sales continued to head south.

JOLTS ([link](#)): Job openings in July reached a new record high. Openings rebounded 280,000 during the two months through July, to 6.939 million, after falling -181,000 in May. Meanwhile, hirings were little changed at 5.679 million, a 2,000 uptick following June's -70,000 decline. Total separations rose for the second month, by a total of 115,000, to 5.534 million—the highest since April 2001. The latest hiring and separations data yielded an employment advance of 145,000 for July, nearly matching July's payroll increase of 147,000. Those quitting their jobs jumped 106,000 to a new record high of 3.583 million. July's private industry job-opening rate remained at its record high of 4.7%, while the quit (2.7%) rate rose to its highest percentage since April 2001; the total hire (4.2) rate was a tick below May's cyclical high of 4.3%. July's ratio of unemployed workers per job opening was below 1.00 for the fourth month, falling to a new record low of 0.90 in July.

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