MORNING BRIEFING
November 8, 2022

On Labor, Productivity & Wages

Check out the accompanying chart collection.

Executive Summary: For a variety of reasons, there's a severe mismatch between the demand for and supply of labor in the US. That's created a maelstrom in the market, with extraordinary levels of turnover: One third of payroll employees have quit their jobs over the past 12 months, most for higher-paying ones. That's driving up wage inflation and driving down productivity. … But we still expect productivity to recover this decade as businesses react by investing in productivity-boosting technologies—our "Roaring 2020s" scenario. … While the latest data show some moderation in wage inflation, it probably won't continue to moderate sustainably until turnover subsides.

YRI Monday Webcast. Replays of the Monday webcasts are available *here*.

US Labor Market I: Pandemonium. Everything has been topsy-turvy since the pandemic. There was a terrible recession during 2020 that lasted only two months. There was a V-shaped recovery from Q2-2020 through Q4-2021 (*Fig. 1*). Real GDP soared 15.1% over that period. It fully recovered by Q1-2021, just three quarters after it troughed. The headline PCED inflation rate soared from just under 2.0% y/y during February 2021 to a peak of 7.0% during June 2022, the highest reading since December 1981 (*Fig. 2*). The 2-year US Treasury yield soared from around 0.25% during H1-2021 to 4.66% currently (*Fig. 3*). The 30-year mortgage rate soared from 3.32% at the start of this year to 7.33% on Friday (*Fig. 4*).

Just as tumultuous has been the US labor market, which took longer to recover than did GDP but now it remains surprisingly strong. The Fed's main goal during the pandemic was to lower the unemployment rate. It succeeded all too well, as the jobless rate fell to a recent low of 3.5% during July and September of this year, but inflation soared (*Fig. 5*). The jobless rate edged up to 3.7% during October.

Now, according to September's *FOMC Summary of Economic Projections*, the Fed's goal is to increase the jobless rate to 4.4% during 2023 and 2024 in order to lower the headline PCED inflation rate to 2.8% next year and 2.3% in 2024. During his November 2 *press conference*, Fed Chair Jerome Powell warned that it might take higher interest rates than the FOMC had previously expected to achieve all that. If so, then we will see that reflected in December's SEP.

Consider the following recent strong developments in the labor market that are challenging the Fed's goal:

(1) *Coincident indicators.* Payroll employment is one of the four components of the Index of Coincident Economic Indicators (CEI), which rose to a new record high during September. It probably did so again during October, as payroll employment rose to a new record high that month.

Another one of the four components of the CEI is industrial production. Friday's employment report showed that aggregate weekly hours in manufacturing rose 0.2% m/m during October, suggesting that industrial production continued to expand in October (*Fig. 6*).

We've found that payroll employment in truck transportation and in temporary help services are highly correlated with the Index of Leading Economic Indicators (*Fig. 7* and *Fig. 8*). Both measures rose to new record highs during October. By the way, payroll employment in information industries rose last month to the highest level since April 2006 despite recent layoff announcements among technology companies.

(2) *Divergent trends.* Payroll employment rose 4.1 million during the first 10 months of this year to a new record high (*Fig. 9*). Over the same period, the gains in household employment (2.6 million) and the labor force (2.4 million) have slowed, and both remain just below their pre-pandemic record high levels. The payroll measure tallies the number of jobs, while the household measure counts the number of workers. The latter shows that the number of workers with full-time positions increased by 2.0 million since the start of this year, while the number with part-time jobs has increased by 713,000 so far this year (*Fig. 10*).

(3) *JOLTS turnover.* The pandemonium in the labor market is easiest to see in the JOLTS data. During September, there were still 10.7 million job openings, or 1.8 open positions for every unemployed worker. This series is highly correlated with the percent of small business owners with job openings and with the jobs-plentiful series that is included in the consumer confidence survey (*Fig. 11* and *Fig. 12*). Both are available through October and suggest that the JOLTS series fell in October but remains very high.

There are numerous reasons for the imbalance between the demand and the supply of labor. The labor force is growing more slowly along with the working-age population. Older

Baby Boom workers are retiring. The younger workers who've been entering the labor force in recent years seem to have less allegiance to their employers and are more easily persuaded to quit for greener pastures than are older workers. Some might prefer a couple of part-time jobs to the commitment of full-time employment.

Whatever might be the explanation, a near record 33.5% of all payroll employees quit their jobs over the past 12 months through September (*Fig. 13*). Over this same period, total separations and total hires accounted for 47.0% and 50.7% of payrolls (*Fig. 14*). That's an extraordinary amount of turnover!

(4) *Productivity.* All the post-pandemic turnover in the labor force has weighed heavily on productivity, especially during the first three quarters of 2022. It's hard to maintain productivity growth when lots of employees are quitting and being replaced with new workers who must be trained to do their jobs.

Nonfarm business productivity rose just 0.3% (saar) during Q3 after falling 4.1% during Q2 and 5.9% during Q1 (*Fig. 15*). Hourly compensation moderated a bit to 3.8%, so unit labor costs rose 3.5%. However, those are annualized quarterly increases. On a y/y basis, unit labor costs still rose 6.1%, which boosted the CPI inflation rate to 8.2% through September (*Fig. 16*).

So what about our Roaring 2020s productivity-boom scenario? We still have seven years for this to happen. We still believe that a major productivity growth cycle started during Q4-2015, when the annualized 20-quarter percent change in productivity bottomed at 0.4% (*Fig. 17*). It recently peaked at 2.5% during Q2-2021 and fell to 1.6% during Q3-2022.

We expect that businesses increasingly will respond to the shortage of labor by using productivity-enhancing technologies like robotics and artificial intelligence. We expect to see the productivity cycle peak around 4.0% during the second half of this decade.

US Labor Market II: Wage Inflation Moderating or Not? Now let's focus on the wage component of the wage-price-rent spiral. Friday's employment report did show some moderation in the pace of wage inflation as measured by average hourly earnings (AHE) for all workers. However, the rapid pace of quitting to get better pay by switching jobs probably must subside for wage inflation to continue moderating. Consider the following:

(1) AHE rose 4.7% y/y during October, while its annualized 3-month inflation rate fell to 3.8% (*Fig. 18*). That suggests that inflationary wage pressures are easing.

(2) The Atlanta Fed's median wage growth tracker shows that pay rose 6.4% through September, with job switchers seeing pay increases of 7.9% and job stayers receiving 5.3% increases (*Fig. 19*).

ADP has started to post similar data, which show that the median percent change in annual pay through October rose 15.2% for job changers and 7.7% for job stayers.

Calendars

US: **Tues:** NFIB Small Business Optimism 91.3; EIA Short-Term Energy Outlook. **Wed:** MBA Mortgage Applications; Wholesale Trade & Inventories 0.4%/0.8%; Crude Oil Inventories & Gasoline Production; WASDE Report; Williams. (Bloomberg estimates)

Global: **Tues:** Eurozone Retail Sales 0.3%m/m/-1.3%y/y; France Non-farm Payrolls 0.4%q/q; Italy Retail Sales; Japan Leading & Coincident Indicators; Japan Current Account; China CPI 0.4%m/m/2.5%y/y; China PPI -1.4%y/y; Nagel; Wuermeling; Enria; Pill; Lowe. **Wed:** UK RICS House Price Balance 20%; ECB Economic Bulletin; Bullock; Elderson; Haskel; Beerman; Wuermeling. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for all three of these indexes for a fifth straight week. LargeCap's forward earnings has fallen in 12 of the 19 weeks since it peaked at a record high in late June. Over the same time period, MidCap's has dropped 13 times, and SmallCap's has moved lower 12 times. For a 19th straight week, none of these three indexes had forward earnings at a record high. LargeCap's is at a 34-week low and 3.6% below its record high at the end of June. MidCap's is at a 30-week low and 4.5% below its record high in early June; and SmallCap's is at a 27-week low and 3.9% below its record high in mid-June. Forward earnings momentum continues to fade. The yearly rate of change in LargeCap's forward earnings was down to a 19-month low of 6.0% y/y from 7.4% a week earlier; that's down from a record-high 42.2% at the end of July 2021 and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings tumbled w/w to a 19-month low of 12.1% y/y from 16.4%. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's was down sharply w/w to a 21-month low of 8.0% y/y from 12.9%. That's down from a record high of 124.2% in June 2021. It had been at a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2022 to 2023 to improve instead of decline as is typical, but their forecasts have been heading lower lately for both years. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (6.1%, 5.6%), MidCap (14.0, -0.7), and SmallCap (11.2, 4.9).

S&P 500/400/600 Valuation (*link*): Valuations moved lower last week for the first time in three weeks and have dropped in seven of the past 11 weeks. LargeCap's forward P/E fell 0.4pt to 16.4 from 16.8, but remains 1.3pt above its 30-month low of 15.1 at the end of September. That compares to a 16-week high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E edged down 0.1pt w/w to 12.5 from 12.6, up from a 30-month low of 11.1 at the end of September. That compares to a 16-week high of 13.2 in early August, a record high of 22.9 in June 2020, and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E fell 0.2pt w/w to 11.9 from 12.1, up from a 14-year low of 10.6 at the end of September. That's down from a 16-week high of 12.8 in early August and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 23% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 116th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 27% reading is near its biggest discount since February 2001. SmallCap's P/E has been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 73rd straight week; the current 6% discount is an improvement from its 9% discount in December but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022, and the declines have accelerated considerably for Q3-2022. In the latest week, the Q3-2022 S&P

500 earnings-per-share forecast rose 119 cents w/w to $55.97 due to positive earnings surprises, and is now 5.9% below its $59.49 forecast at the start of the quarter. Analysts expect S&P 500 Q3 earnings growth to weaken to 3.9% y/y on a frozen actual basis and 4.3% on a pro forma basis. That's down from Q2-2022's 9.9% y/y gain on a frozen actual basis and 8.4% y/y on a pro forma basis. Double- and triple-digit percentage growth is expected for just four sectors in Q3-2022, and y/y declines are expected for five. That compares to Q2-2022's count of four sectors with triple- and double-digit growth, three with a single-digit gain, and four with a y/y decline. Here are the S&P 500 sectors' latest blended earnings growth rates for Q3-2022 versus their Q2-2022 growth rates: Energy (140.6% in Q3-2022 versus 295.5% in Q2-2022), Industrials (19.1, 31.6), Real Estate (14.8, 13.1), Consumer Discretionary (12.8, -12.1), S&P 500 (4.3, 8.4), Health Care (1.4, 8.7), Consumer Staples (0.1, 2.2), Information Technology (-0.7, 1.5), Utilities (-5.5, -3.7), Materials (-8.4, 17.5), Financials (-16.1, -19.3), and Communication Services (-25.4, -20.3).

S&P 500 Q3 Earnings Season Monitor (*link*): As the Q3-2022 earnings season approaches the finish line, the results to date indicate that it's the poorest quarterly reporting season since Q1-2020 as assessed by the four surprise metrics we measure for both earnings and revenues. With nearly 86% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 2.2%, and earnings have exceeded estimates by only 3.8%. At the same point during the Q2 season, revenues were 2.7% above forecast and earnings had beaten estimates by 6.1%. For the 429 companies that have reported Q3 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed from their readings from Q2-2021 to Q2-2022. The 429 reporters so far collectively has a y/y revenue gain of 11.9% but an earnings gain of only 5.0%, as higher costs are pressuring profit margins. Excluding Energy, S&P 500 revenue growth falls to 8.7% y/y from 11.9% and earnings growth drops to -3.3% from 5.0%. Just 70% of the Q3 reporters so far has reported a positive revenue surprise, and 72% has beaten earnings forecasts. However, significantly fewer companies have reported positive y/y earnings growth in Q3 (59%) than positive y/y revenue growth (80%). These figures aren't likely to change markedly as more Q3-2022 results are reported in the coming weeks, but what change there is should have a downward bias as retailers are more likely to miss forecasts and guide lower in this difficult economic environment.

Global Economic Indicators

Germany Factory Orders (*link*): Recession fears are growing in Germany after factory orders in September contracted for the seventh time in eight months, sinking an alarming

4.0% m/m and 12.3% over the period, after starting the year with a 2.9% gain. *Domestic orders* ticked up 0.5% after falling three of the prior four months by 6.5%, while foreign orders tumbled 7.0% in September and 8.5% during the two months ending September; orders had rebounded 5.0% in July. *Foreign orders from within the Eurozone* fell sharply for the second month, by 8.0% in September and 10.9% over the period, while *orders from outside the Eurozone* plunged 6.3% after a 0.8% downtick in August. Here's a look at the ytd movements in domestic orders, along with the breakdown from both inside and outside the Eurozone for the main industry groupings, respectively: consumer nondurable goods (+6.3%, +6.1%, -0.8%), consumer durable goods (-5.4, -11.6, +0.6), intermediate goods (-8.3, -13.3, -12.6), and capital goods (-20.0, -6.3, -4.1).

Germany Industrial Production (*link*): Production was a surprise on the upside in September despite ongoing supply bottlenecks and a decline in output in energy-intensive industries. Germany's *headline production*, which includes construction, rose 0.6% in September after a 1.2% decline in August and no change in July. Production is down 1.4% ytd. Production excluding construction (which the overall Eurozone uses) rose 0.8% after falling 1.2% during the two months through August; it's down 1.4% ytd. *Manufacturing production* advanced 0.8% in September, following a two-month decline of 1.1%; it's down 1.2% ytd. Looking at the *main industrial groupings*, capital goods output climbed in September for the fifth time in six months, by 1.1% m/m and 10.3% over the period, more than recovering from the 9.5% plunge during the two months through March—with output flat ytd. Consumer durable goods production remains on a volatile flat trend, dropping 3.4% in September after climbing 3.3% during the two months through August. Meanwhile, consumer nondurable goods production has rebounded 4.4% during the two months through September after falling 7.3% during the five months through July; it's down 3.3% from its recent peak during February. Output of intermediate goods sank to its lowest level since September 2020, contracting 3.7% ytd.

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