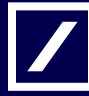
Deutsche Morgan Grenfell 

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BACKLASH: WORKERS VS. BONDS

May 8, 1996

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Chief Economist

I. Wall Street's Agitators

Is there any hope left that bond yields can fall back to 6% by year-end and to 5% by the end of 1997? I think so. I expect that the recent jump in bond yields will slow economic growth, which in turn will help to keep a lid on inflation over the rest of the year. This should set the stage for another big bond rally (Exhibits 1 and 2).

On the other hand, the thoughtful and thought-provoking economists and strategists at Morgan Stanley expect a worker backlash against:

1) corporate restructuring and downsizing,
2) small wage gains, and
3) astronomical CEO compensation packages.

They predict that cost-push inflation is imminent, pushed up by bigger increases in labor costs (Exhibit 3). They believe that bond yields will remain over 7% this year and probably rise to 8% next year. They foresee a 1000-point drop in the Dow Jones Industrials. The Morgan Stanley scenario is almost revolutionary:

> Workers of America, unite! You are not getting your fair share of the economic pie. You are getting ripped off by your bosses. They are paying themselves too much, while you get too little. Corporate profits are soaring, while wages are stagnating.

Personally, I find it very ironic and even slightly amusing that the promoters of this "Worker Backlash" scenario are employed at a premier investment banking house and leading advisor to America's corporate restructurers. (By the way, the views expressed here are solely mine and don't necessarily represent those of Deutsche Morgan Grenfell or its management.)

II. Backlash Of The Bond Vigilantes

I don't subscribe to the Worker Backlash Theory. However, the amazing jump in bond yields so far this year from just under 6% to over 7% suggests that many bond investors and traders are signing up. Regardless of whether the backlash theory is right or wrong, the Morgan Stanley bearish forecast for the bond market has been on track so far this year.

My bond forecast has been way off track so far this year. The same thing happened to me in 1994. Bond yields soared because of widespread fears that inflation was about to move higher. I argued that inflation would remain low and that the back-up in bond yields was unwarranted and presented a huge buying opportunity. Inflation did remain low in 1994 and again in 1995. Also real GDP growth slowed dramatically from 3.5% in 1994 to 1.3% in 1995. Consequently, bond yields plummeted last year by 200 basis points.

Will it be déjà vu all over again? Is the latest back-up in bond yields again unwarranted? Is this yet another great buying opportunity? Not if the Worker Backlash Theory is correct. In this case, inflation will be higher in 1997 than in 1996 and bond yields won't be heading down again for the next 18 to 24 months.

If my Bond Vigilante Backlash Theory is correct, then economic growth and inflation won't be high enough to trigger a worker backlash. I first started to write about the bond "vigilantes" in the July 27, 1983 issue of my weekly analysis: "Bond Investors Are The Economy's Vigilantes." *In effect, the bond market has become more powerful than the Federal Reserve.* The bond market regulates the cost of long-term credit. The bond market responds much more rapidly and with less restraint than the Fed to perceived changes in the business and inflation outlooks. Yields soared recently because bond investors and traders fear that wage inflation is likely to move higher. So the bond vigilantes are in effect launching a preemptive attack against labor (Exhibit 1).

III. Power To The People?

Economic power has shifted increasingly away from US workers, especially those organized in unions. It has shifted to the bond vigilantes (as discussed above) and to company managements. Domestic industrial deregulation coupled with intense global competition as a result of the end of the Cold War means that companies must cut costs to survive. Could it be that workers prefer to work for tough, cost-cutting managements than for lax ones? I think they would rather work for a successful company where the pay isn't top dollar than for a poorly managed company where wages are relatively high, but the risk of business failure is great.

I don't believe that the corporate downsizing trend is over. Until this year, companies publicly announced their job cutbacks because stock investors bid up their share prices. There has been a political and media backlash against these announcements this year. *Odds are that managements will continue to reduce their payrolls if they see fit, but there won't be any news releases.*

IV. No Sign Of Backlash In Wages

The Morgan Stanley scenario is widely feared by bond and stock investors and is wildly opposite to my view of the world. In other words, if my outlook for the economy and financial markets is wrong, it will be because the competition's story is the right one.

The latest data on wages have many investors convinced that unit labor costs are picking up. I disagree:

1) Wages in the Employment Cost Index (ECI) rose 1% during the first quarter (Exhibit 4). They are up 3.2% from a year ago, the fastest pace since the first quarter of 1992. The biggest gain in wages was in retailing, where pay increased at an annual rate exceeding 8% during the quarter and 3.5% from a year ago. I find these numbers hard to believe. However, if they are accurate, I doubt that store and restaurant retailers can pass these increased costs through to their customers, because competition is very intense in retailing (Exhibits 5 and 6).

2) The rebound in ECI wage inflation was partially offset by a 0.1% decline in benefits during the first quarter, the first drop in this series since the data were first collected during 1979 (Exhibit 7). As a result, total ECI compensation–including wages, salaries, and benefits–rose 0.7% during the first quarter and 3.0% from a year ago (Exhibit 8).

3) The unemployment rate is relatively low at 5.4%. If labor market conditions are as tight as feared by the bond bears, then why are factory jobs down by 269,000 since May of last year? They even fell during April by 17,000, though 30,000 workers returned to General Motors after the strike. To smooth out the effects of the strike, let's compare average factory wages during the latest three months through April to a year ago: They are up only 2.7%. A similar calculation shows wages up only 1.8% in construction (Exhibit 9). Other than the rise in retail and wholesale wage inflation, there is little evidence of a cyclical rebound in other service-producing industries (Exhibit 10).

V. The NAIRU Jacket

Might wage inflation rise even if the Worker Backlash Theory is wrong? It's possible. Instead of workers demanding more, employers might have to pay them more if labor becomes scarce. Even I will agree that at some unemployment rate between today's 5.4% level and zero, wage inflation will rise. However, I believe that the unemployment rate could fall to 4% by the end of the decade and yet wage inflation will remain low.

During the 1970s and early 1980s, the unemployment rate had an upward trend because Baby Boomers poured into the labor market. The youngest Baby Boomers first turned old enough to work during 1980. Since younger workers tend to have higher unemployment rates than older ones, the aggregate unemployment rate shifted upwards (Exhibit 11). Monetary and fiscal policies had an inflationary bias because policymakers were more concerned about the uptrend in unemployment. Perversely, therefore, high inflation coincided with high unemployment.

In the 1990s, the reverse is happening. As the labor force matures along with the Baby Boomers, the national unemployment rate is likely to trend still lower. Yet–again perversely–the inflation rate has also been heading down and could move even closer to zero. In other words, the so-called Non-Accelerating Inflation Rate of Unemployment (NAIRU) is shifting downward. In addition to the demographic explanation for this phenomenon, here are five more:

1) Competition is intense from cheap labor amply available worldwide following the end of the Cold War.
2) Corporate downsizing in response to intense global competition following the end of the Cold War means job losses, since labor is the largest component of costs for most businesses.
3) Outsourcing is an important trend among businesses seeking to cut costs by using outside vendors that can supply certain goods and services more cheaply.
4) Job insecurity is a consequence of downsizing and outsourcing.
5) The decline of union power is another consequence of the more competitive New World Economic Order.

VI. Political-Push Inflation?

Buchanan Populism. The worker backlash scenario became very credible when Pat Buchanan won the Republican primary in New Hampshire on February 20. The press immediately concluded that this proved that workers were mad as hell. However, Pat flamed out quickly.

Even in states with many working-class voters, Pat found no meaningful support. That's because his basic message is a lie: Americans are not worse off today than in the past. Americans have never been better off than they are today. Both real personal income and real consumption per capita–i.e., purchasing power and the standard of living–are at record highs! (See The Federalist Paper No. 89, The Populist Myth, March 25, 1996.)

Minimum Wage. Of course, some workers are worse off than in the past, particularly those earning the minimum wage. However, only 5% of all workers earn this minimum. The recent move by President Bill Clinton and some Congressional representatives to raise the minimum wage by 21% to $5.15 was inspired by election year campaigning, not pressure from newly empowered, or newly emboldened, workers.

VII. Clinton Study Discredits Backlash Theory

The front cover story of the February 26, 1996 issue of *Newsweek* was titled "Corporate Killers." The article bashed CEOs of major corporations for firing workers. Interestingly, President Bill Clinton didn't join the CEO bashers. He did not revive the campaign theme he used so effectively when he first ran for the big leather chair in the Oval Office, namely, "Putting People First."

Perhaps he read a preliminary draft of a very upbeat study of the wonderful performance of the labor market from 1993 to 1996. The report by the Council of Economic Advisors (CEA) with the Office of the Chief Economist of the US Department of Labor was released to the public on April 23. Here are the major findings:

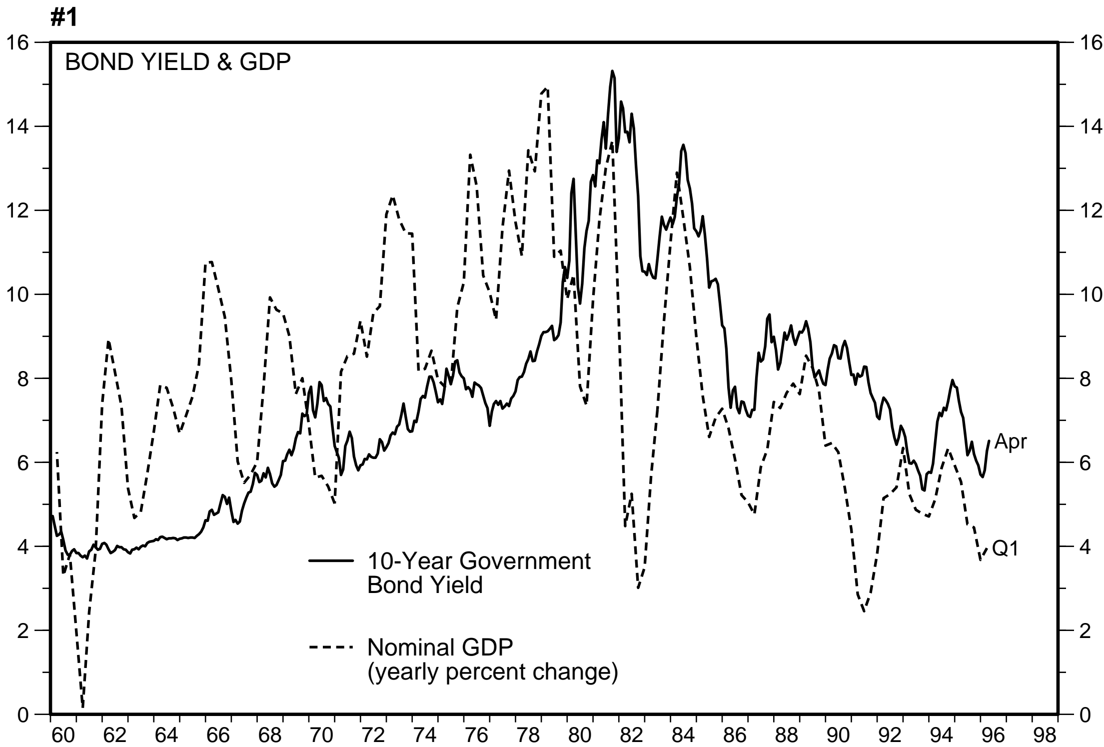
1. Since January 1993, the US economy has created 8.5 million net new jobs despite all the corporate restructurings. Over this same period, net job creation in Europe and Japan has been virtually zero.
2. The new job opportunities are not for hamburger flippers: Two-thirds of the net growth in full-time employment between February 1994 and February 1996 occurred in businesses paying above-median wages.
3. The vast majority of the net new jobs are full-time.
4. The share of multiple job holders has remained roughly constant since the late 1980s.
5. Displacement rates for older, white-collar and better educated workers have risen, although they remain low relative to those for younger, blue-collar, and less educated workers.

VIII. Happiness Is 120,000 Jobs Per Month

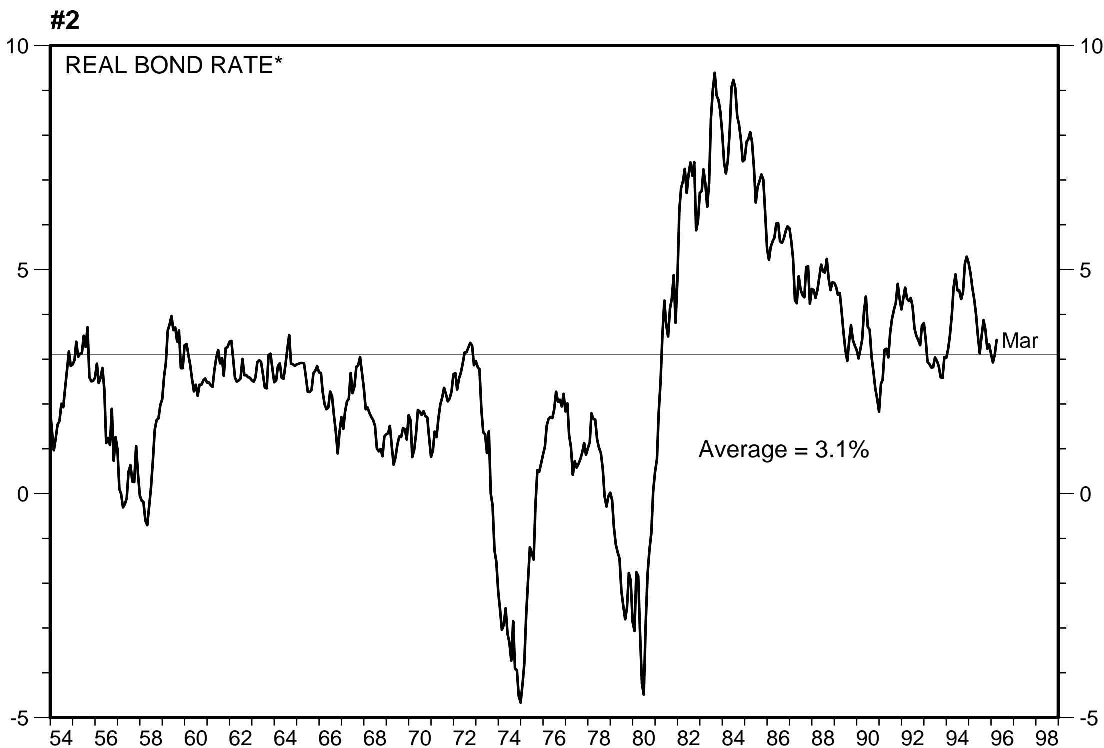
The CEA report also observes that given current demographic trends, the Bureau of Labor Statistics projects that the labor force will continue to grow by approximately 1.1% annually between 1994 and 2005. This is well below the growth rates of the 1970s and 1980s (Exhibit 12). "Therefore, to keep unemployment low, the economy needs to average a net increase of about 120,000 new jobs per month."

No wonder consumer and worker confidence is so high despite all the talk of job insecurity. We only need to create 120,000 jobs per month to keep the unemployment rate down. That's all! People may be insecure about their own jobs, but they are secure knowing that the American economy is secure. Our economy is flourishing precisely because workers have accepted the fact that they must adapt to very competitive domestic and global markets. American workers are moving forward, not lashing back.

- Bond Yield -



Prior to 1980s, bond yield traded below growth of nominal GDP and was relatively uncorrelated with business cycle. Since 1980, bond yield exceeds nominal GDP and moves quickly to dampen the business cycle.

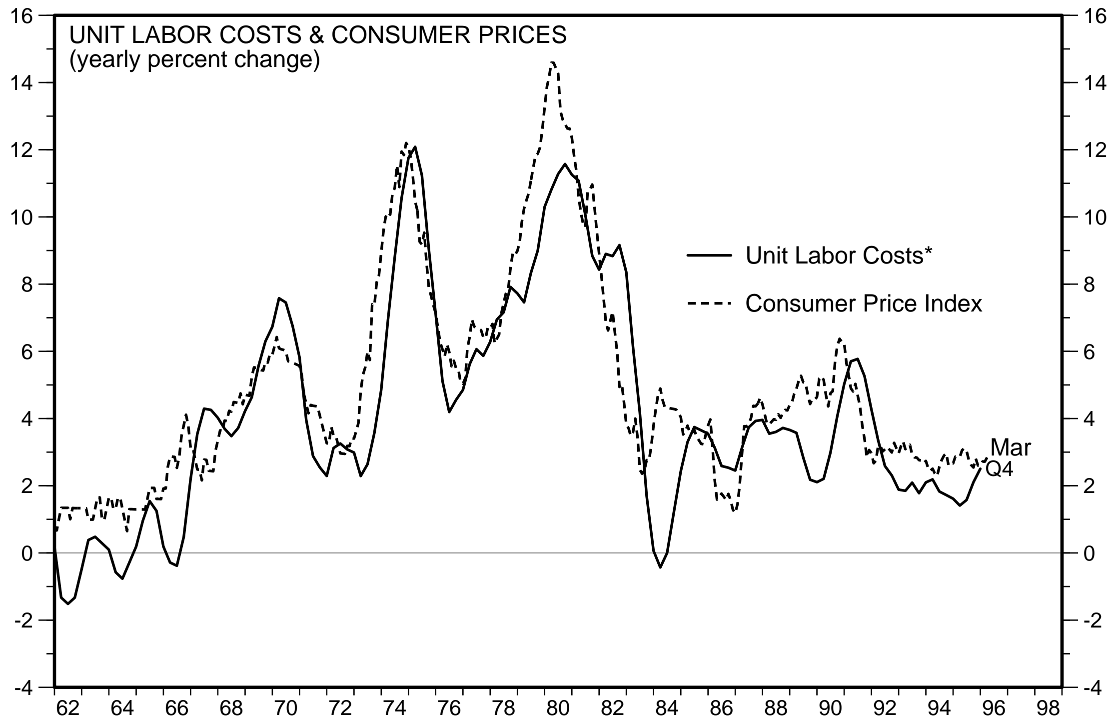


* 10-year government bond yield minus yearly percent change in the CPI.

Real bond yield has been hovering close to its historical average during the 1990s. So the recent jump in nominal yield should be limited if inflation remains low. So far, in the 1990s, a 5% real return has been a good buying opportunity.

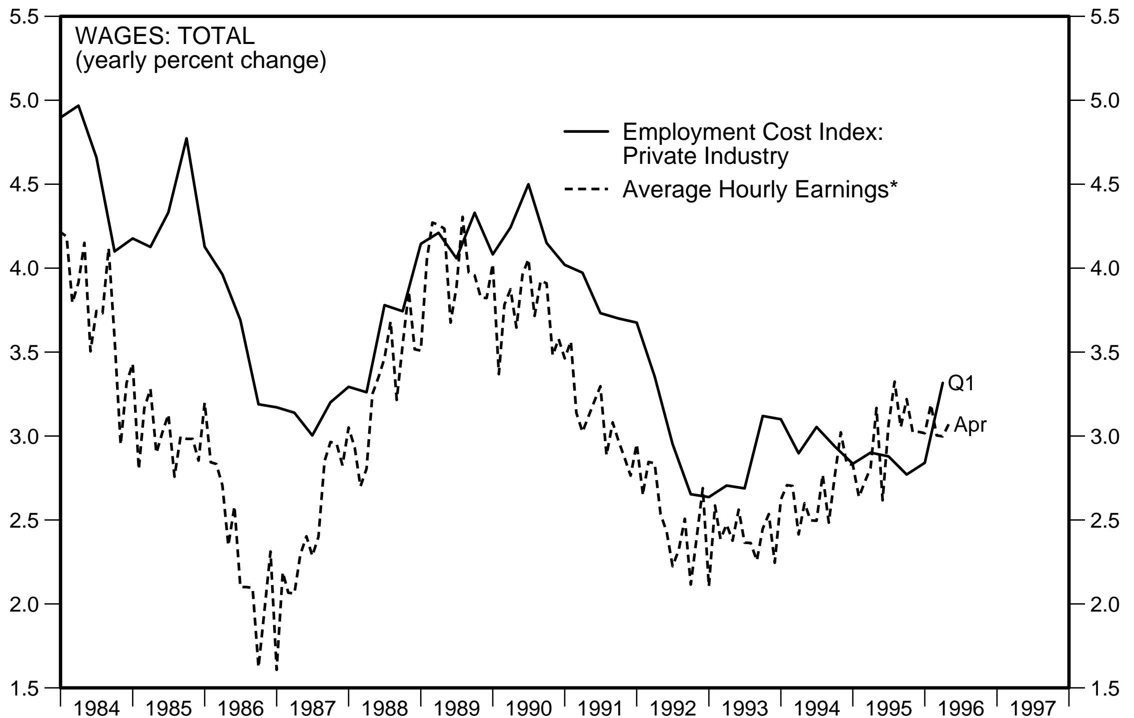
- Labor Costs -

Most companies set their prices by marking up their costs. That is why CPI inflation tracks unit labor costs inflation so closely. Unit labor costs should be up only 2% in 1996 and 1997. (See Exhibit 8.)



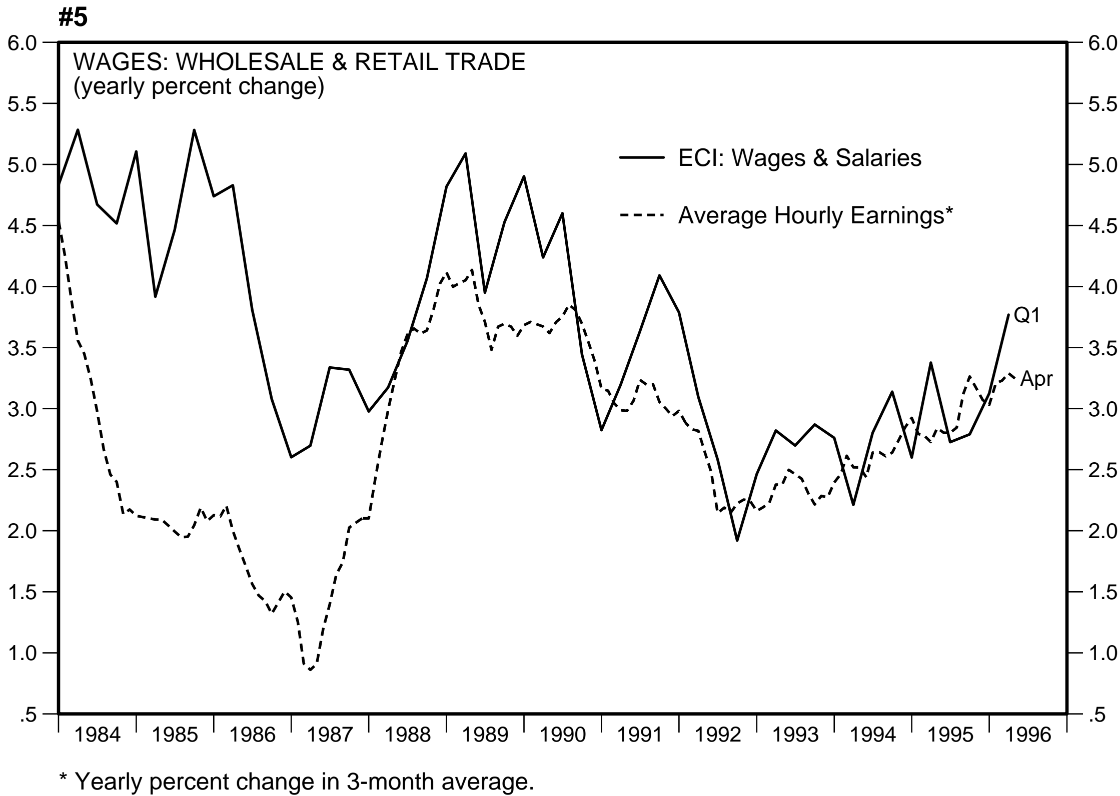
* Yearly percent change in four-quarter average.

Big jump in wage inflation during Q1 looks like a temporary aberration related to unusually big increase in retail industry wages.



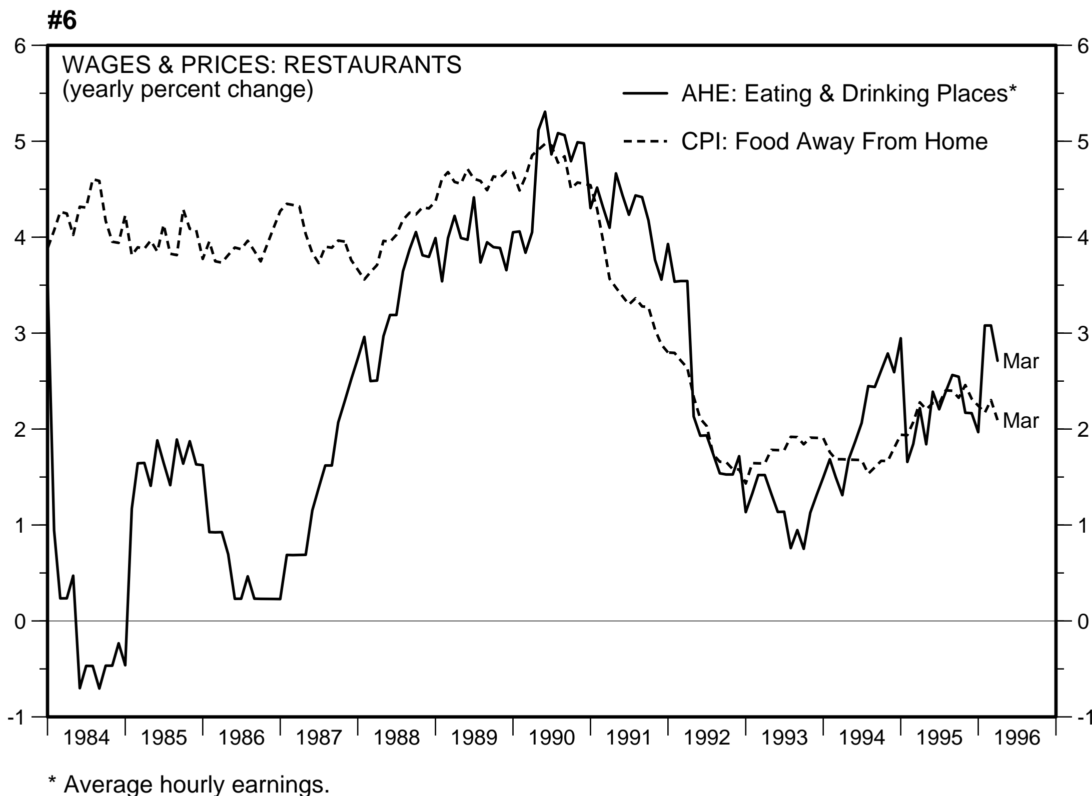
* Yearly percent change in 3-month average.

- Retail Wage Inflation -



* Yearly percent change in 3-month average.

Big increase in ECI retail and wholesale wages during Q1 looks unsustainable.

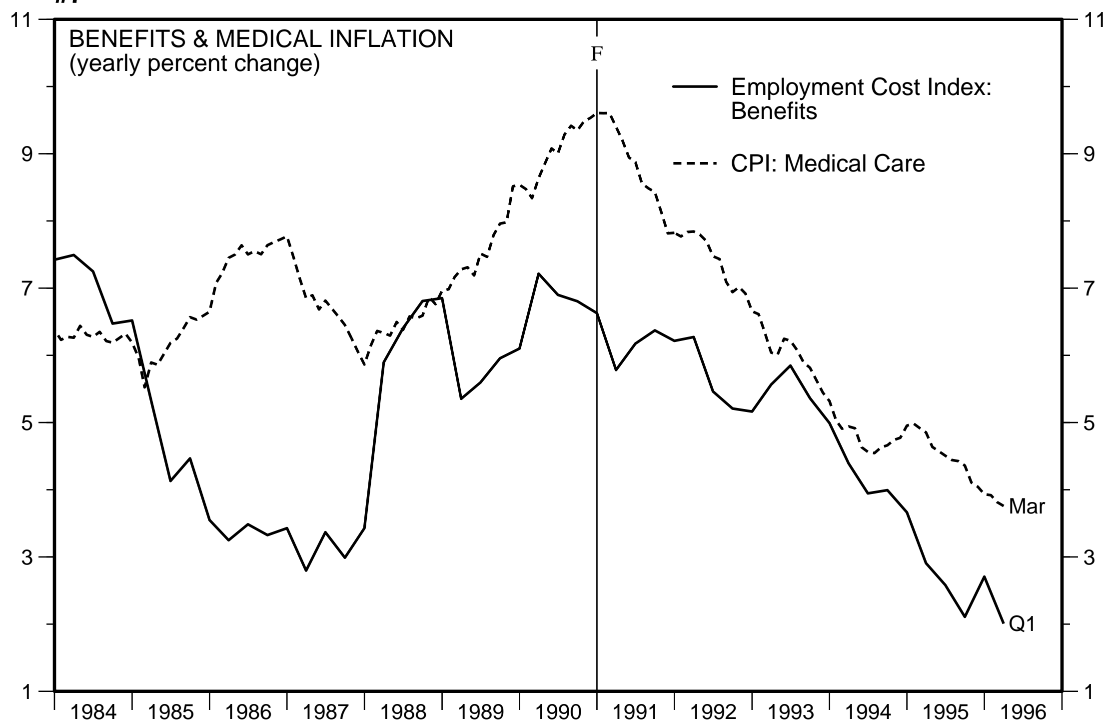


* Average hourly earnings.

Price inflation at restaurants (included in retail sector) moving lower despite recent wage pressures.

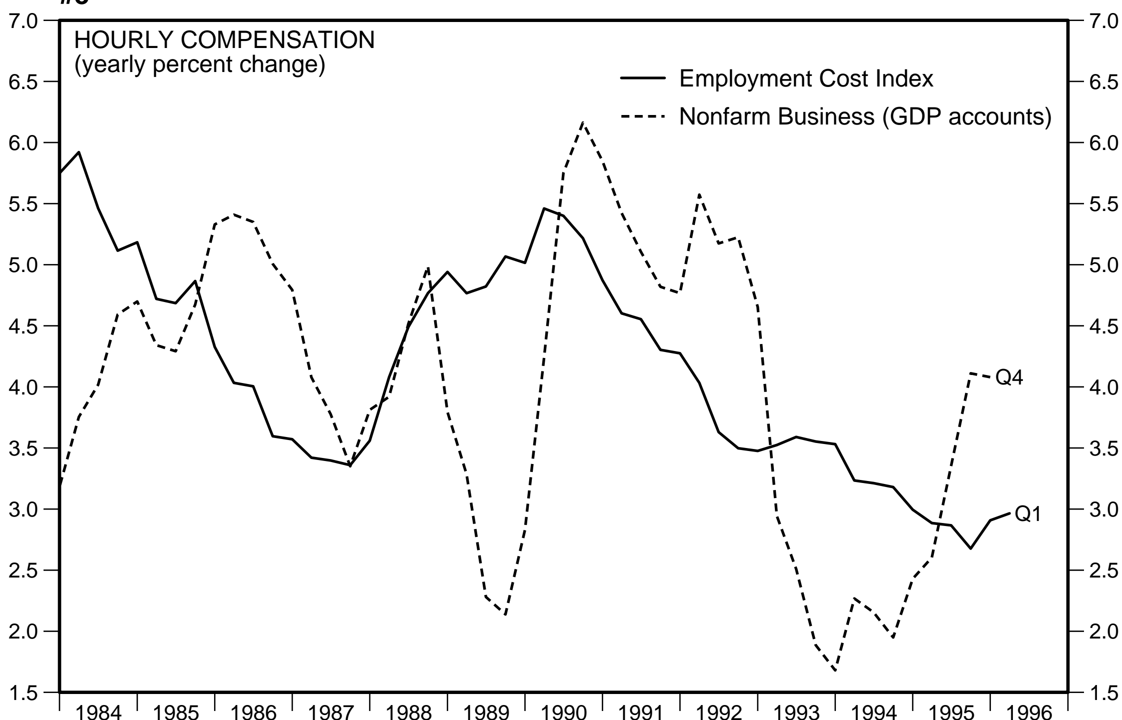
- Compensation -

Benefits inflation rate falls along with health care inflation rate, which is likely to fall still lower in 1996 and 1997.

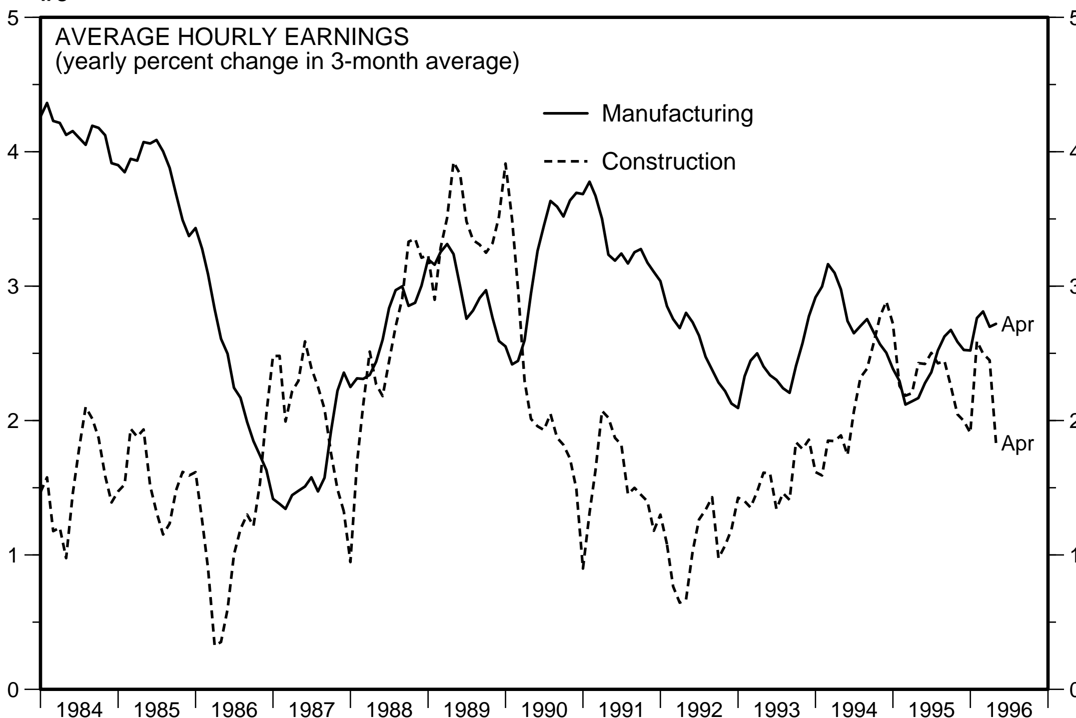


F = FASB No. 6 rule passed.

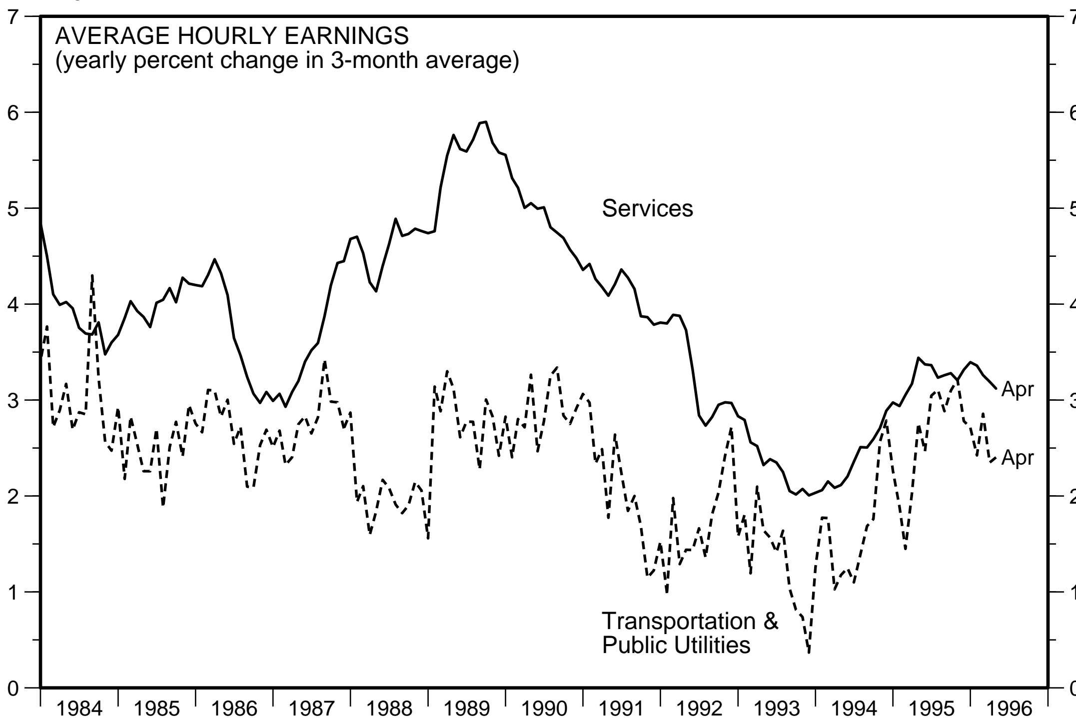
ECI compensation measure is probably more accurate than hourly compensation data used to calculate unit labor costs. If so, unit labor costs inflation is probably closer to 2% than 3% today.



- Wage Inflation -



No clear sign of cyclical upturn in wage inflation in manufacturing and construction.

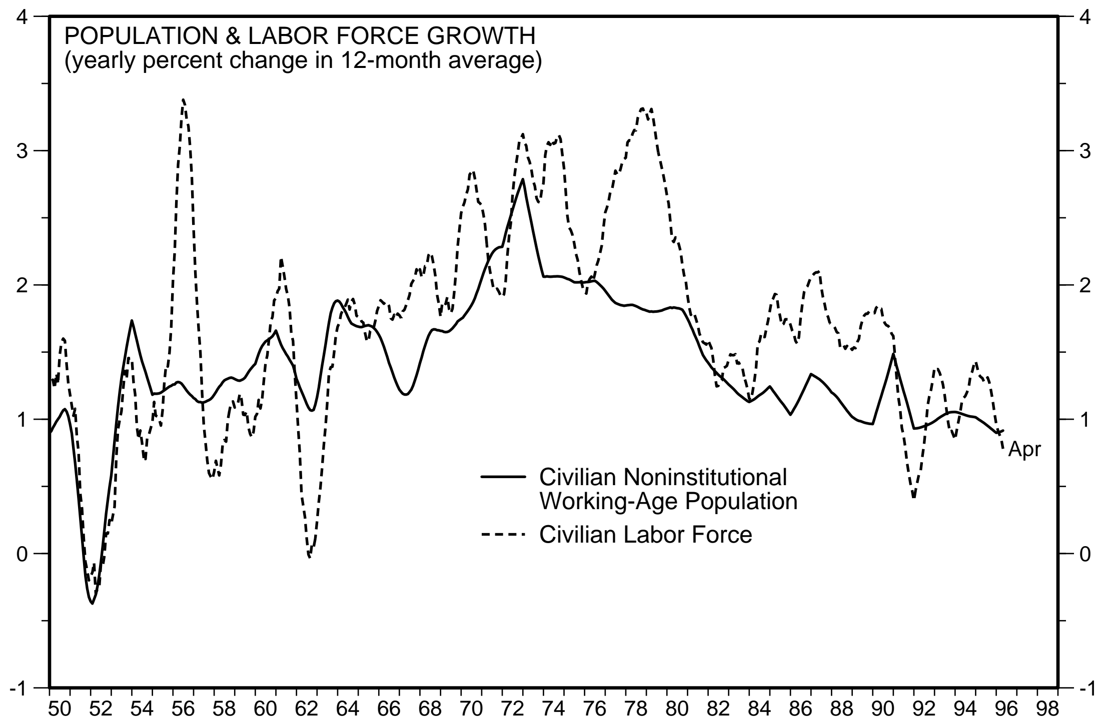


Ditto for services, transportation, and public utilities.

- Labor Force -

Will low unemployment rate push wage inflation higher? Not necessarily. This rate had an upward trend during the 1970s, when the Baby Boomers were entering the labor force. Since then, the trend has been down.

Underlying labor force and working-age population growth rates are lowest since 1950s.



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