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TRENDMACRO LIVE!

On the December Jobs Report

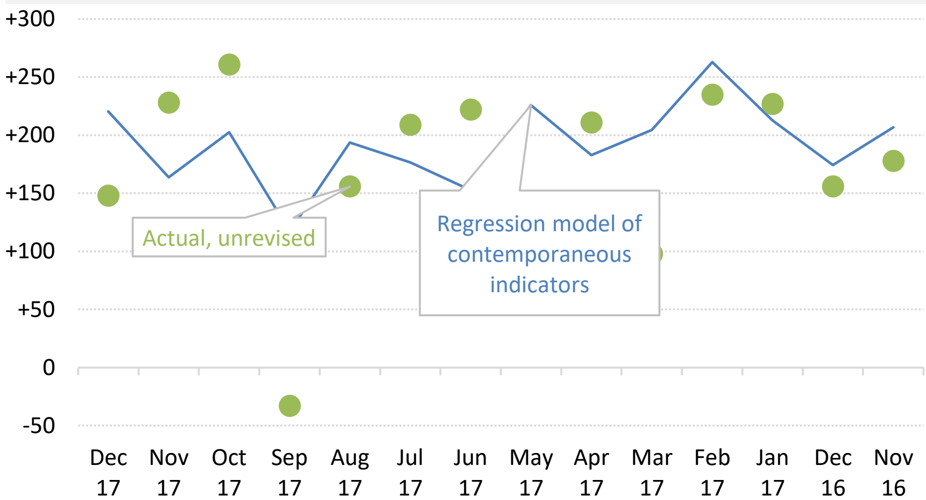
Friday, January 5, 2018

Donald Luskin

Don't worry about today's miss. Or the Fed. We're miles from full employment.

This morning's December Employment Situation report with 148,000 net payrolls gained was a miss versus the consensus for 190,000. It's not explained by small downward net revisions to the prior two months. It is out-of-pattern with other contemporaneous labor market indicators that imply about 215,000 to 220,000 payrolls. But it's well within the large error-range that we've come to expect, with some months higher and some months lower (a couple sharply lower), since the 2016 presidential election (please see the chart below).

Model-estimated 2017 net payroll gains ● **Actual** Thousands



Source: BLS, ADP, Challenger, NFIB, ISM, TrendMacro calculations

While we see this as an entirely normal jobs report – offering no new information – it will come as a disappointment to the new conventional Wall Street wisdom, or at least the over-excited media version of it. The new narrative imagines the Fed will aggressively step in, as soon as this year, to keep the economy from over-heating (throwing it into a recession, if necessary) as tax cuts "stimulate" it, and move the unemployment rate to perhaps record lows (see "2018 Outlook: From Denial to Acceptance" December 29, 2017).

- Even for the few dead-enders on the Fed who still believe in the self-evidently non-existent Phillips Curve relationship between

Update to strategic view

US MACRO, US FED: A miss on payrolls is on the low end of the error-range we have come to expect since the 2016 election – contemporaneous labor market indicators imply that the real number was in fact a beat. Another sluggish month of average hourly earnings growth – only even as good as it seems because of a downward revision to last month's – and no change in the unemployment rate, give the Fed nothing to get excited about. The seemingly low unemployment rate continues to give a false impression about the remaining capacity in the labor force. We think structural features of today's economy call for a lower-than-historical unemployment rate, and that demographics imply 3.1 million payrolls could be added before we hit full employment.

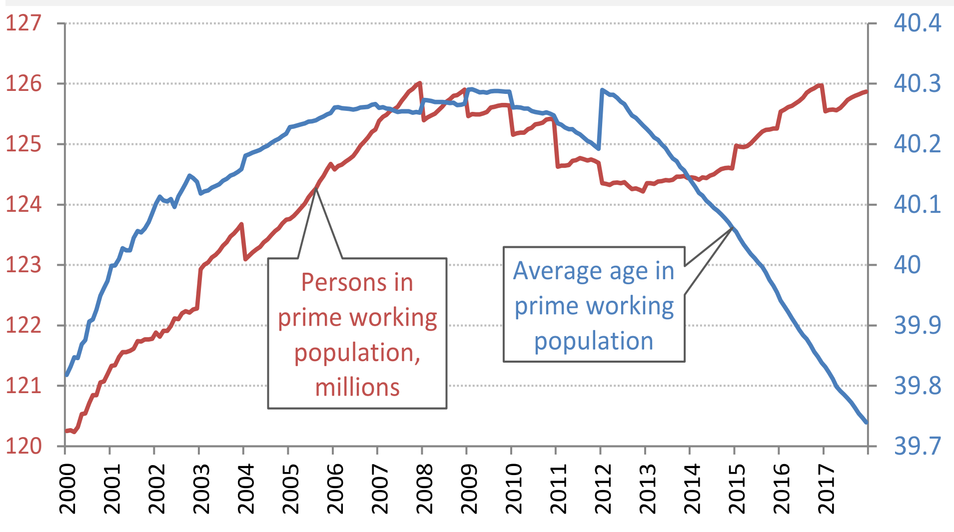
[Strategy dashboard]

unemployment and inflation, this morning's report should give nothing but comfort. While the unemployment rate hung in at a low 4.09% (actually, down 0.03% month-over-month), average hourly earnings grew by an entirely uninteresting 0.3%, and that only on a downward revision to the prior month by 0.1% (see "Data Insights: Jobs" January 5, 2018).

For us, the more interesting question about the low unemployment rate is not what it implies about inflation, but what it implies for the ability of the economy to keep growing. For many reasons, we think there are more workers available to sustain growth then the unemployment rate alone would lead you to believe.

- The US prime working age population is growing. After falling from 2007 to 2013, it is back to all-time highs (please see the chart below).
- At the same time, the average age within the prime-age population is sharply falling (please see the chart below). *For the population to rise as its average age falls means that there are more young people coming in than there are old people going out.*
- *And that means, for the first time in two decades, the American workforce is facing a demographic dividend, not a deficit* (see "The Demographics Myth" March 20, 2017).

US population age 25 to 54 Jumps are annual adjustments in data



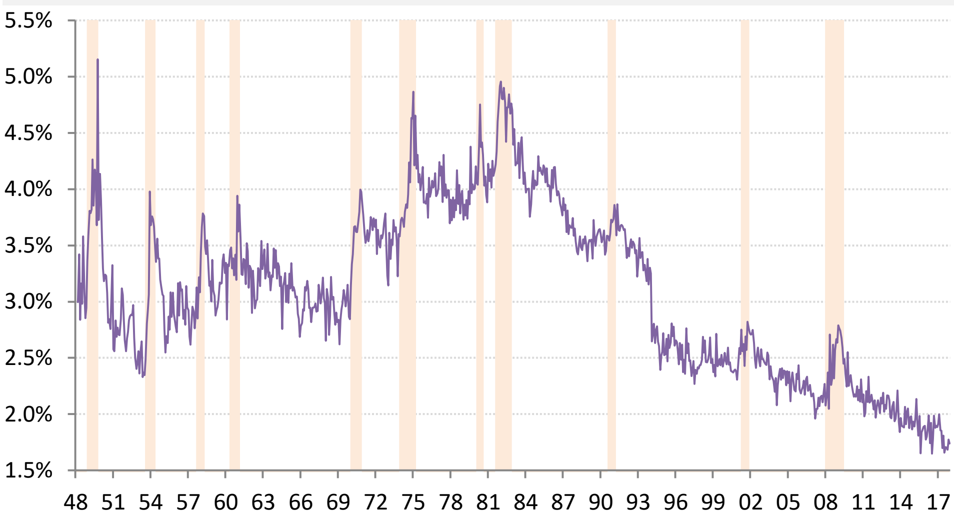
Source: BLS, TrendMacro calculations

- The aging of the prime-age population from 2000 to 2012 explains much of the fall in the labor force participation rate over the same years. But the participation rate should have recovered more since then, as the population got younger – but it hasn't, at least not by enough.
- At the same time, large advances in educational attainment by the population since 2000 ought to counteract any aging effects, because better-educated people participate more in the labor force

(again, see "The Demographics Myth" March).

- *All that notwithstanding, the unemployment rate just taken at face value as a raw number still has some room on the downside. It was lower for most of 2000, and consistently through the last half of the 1960s, and the first half of the 1950s.* Why shouldn't this most anomalous business cycle – we've always called it "the not-so-great expansion following the Great Recession" – end up being the longest and best in history?
- *Matching the 3.9% unemployment rate of 2000, and assuming that our demographic analysis implies that the labor force could expand considerably, we see payrolls having 3.1 million to go before hitting "full employment"* (again, see "Data Insights: Jobs").
- *But perhaps that is too conservative.*
- We should also consider the implications of the basic theoretical question, "other than in a recession, why should there be any unemployment at all?" There are a number of answers, including temporary mismatching of skills, or temporary displacement of workers due to competitive dynamics or personal preferences.
- Those dynamics should show up in measure of the velocity with which workers leave employment for unemployment – the so-called "inflow rate"). While it subjectively may seem that employment today is more precarious than ever – in a world of globalization and the "gig economy" – *the statistical fact is that the rate of moving from employment to unemployment over the last year or so is the lowest in the history of the data* (please see the chart below).

Monthly "inflow rate" from employment to unemployment



Source: BLS, per Shimer 2005, TrendMacro calculations

- We could argue that this reflects, sadly, a certain loss of dynamism in the economy. Or perhaps it just reflects the reduction in the labor market's cyclicality as we evolve from a manufacturing economy to a service economy. Be that as it may, *with a smaller percentage of employed persons becoming unemployed each month, the reservoir of the temporarily unemployed is likely to be smaller as a portion of the labor force. So even if the Phillips Curve logic that*

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New York Times
December 30, 2017

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low unemployment leads to inflation is correct, the level of unemployment that should be considered low enough to be a danger can be lower than in the past.

Bottom line

A miss on payrolls is on the low end of the error-range we have come to expect since the 2016 election – contemporaneous labor market indicators imply that the real number was in fact a beat. Another sluggish month of average hourly earnings growth – only even as good as it seems because of a downward revision to last month's – and no change in the unemployment rate, give the Fed nothing to get excited about. The seemingly low unemployment rate continues to give a false impression about the remaining capacity in the labor force. We think structural features of today's economy call for a lower-than-historical unemployment rate, and that demographics imply 3.1 million payrolls could be added before we hit full employment.