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TRENDMACRO LIVE!

On the February Jobs Report

Friday, March 4, 2016

Donald Luskin

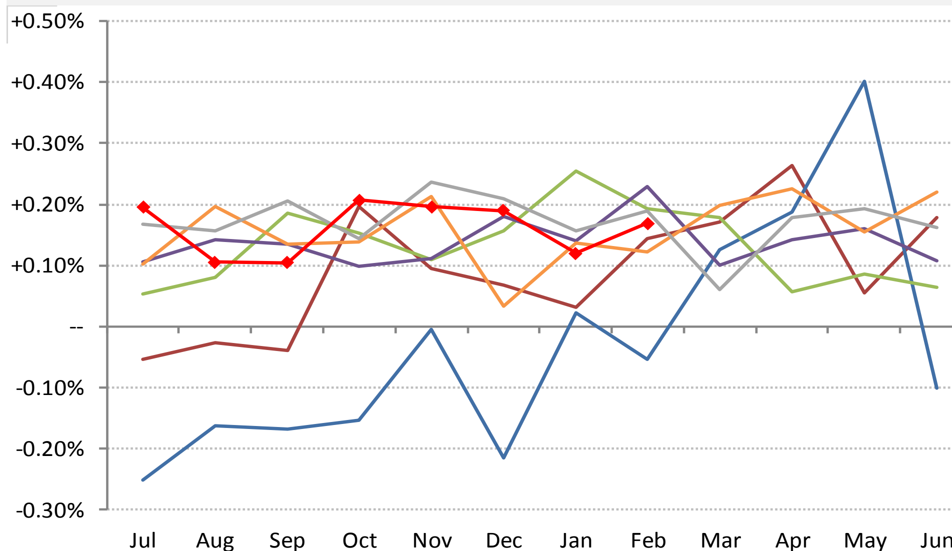
More people are working fewer hours for less pay. The inflation risk in that is what, exactly?

This morning's February Employment Situation report revised away some of last month's big miss (see "On the January Jobs Report" February 5, 2016) and delivered an upside surprise, too – 242,000 net payrolls versus 195,000 expected. For us, the most fascinating development is the surge in labor force participation we seem to be seeing, to which we will return in a moment.

- Focusing first just on payrolls, the upward revisions to the prior month still left it the second worst January since the Not So Great Expansion following the Great Recession stopped being entirely jobless in 2011.
- February wasn't much better – the third worst (please see the chart below).

Monthly payroll growth in post Great Recession expansion, starting July

— 2009-10 — 10-11 — 11-12 —12-13 —13-14 —14-15 ♦ 2015-16



Source: BLS, TrendMacro calculations

- For Fed-watchers, today's key datapoint was the 0.1% decline in average hourly earnings – a critical (if chimerical) input to the Phillips Curve framework in which the Fed mistakenly operates

Update to strategic view

US MACRO, US FED: A nice headline beat, with upward revisions that partially erase last month's big miss. The Fed will focus on the drop in average hourly earnings. But this comes in addition to a drop in hours worked, and a worsening of long-term unemployment. The labor force expanded again for the fifth straight month. But it remains well below trend, and the newly employed concentrated in poor-paying jobs. With more people working fewer hours for less pay, even a Phillips Curve dead-ender would be hard pressed to hike rates again for quite a while, especially given the markets' severely negative reaction to "liftoff."

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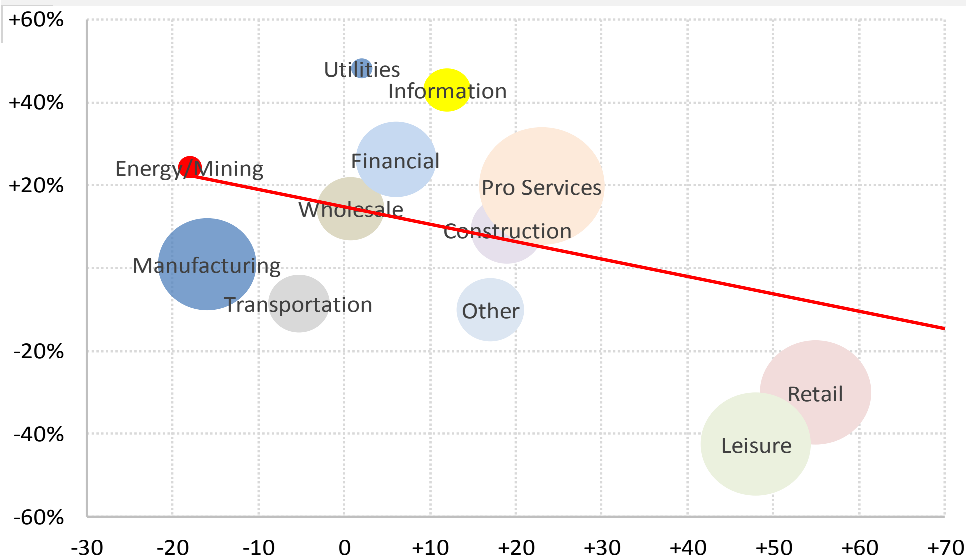
(see "One Small Step -- In the Wrong Direction" November 23, 2015).

- *There were other subtle negatives.*
- The "outflow rate from unemployment" decreased 0.6%, which means the probability of getting a job within a month went down. This is reflected in the 0.1% increase in the average number of weeks unemployed, and the 0.8% increase in the long-term share of unemployment.
- The raw number of long-term unemployed persons has been ticking up now for three months, while the raw number of short-term unemployed persons has been ticking down. *This suggests a labor market in which employment is a binary – a worker either has got the goods and can be employed right away, or he doesn't, and he can't be employed at all.*
- When we say "the goods" we don't necessarily mean highly specialized technical skills. We mean the total portfolio of attributes that creates "fit" with a job opening. This can, and probably does, mean a lack of skills, or at least a willingness to work in an unskilled job at an unskilled pay. As we have seen throughout the Not So Great Expansion – and heard endlessly from every presidential candidate, seemingly robust jobs growth has been dominated by poorer-paying sectors (please see the chart below).

Relation of pay-level to payroll gains, by major sector
Left axis: **Hourly wages vs average** Right: **Payrolls gains/losses February**
Size of circle: **Portion of total employment**



Source: BLS, TrendMacro calculations

- At the same time, total hours worked fell in February by 0.4%. With hours worked lower, and average hourly wages lower – yes, aggregate weekly hourly earnings were lower, too, by 0.5%.
- *Even the most dedicated Phillips Curve dead-ender bears the burden of proof to show why a labor market growing in this way ought to lead to inflation.*

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Recommended Reading

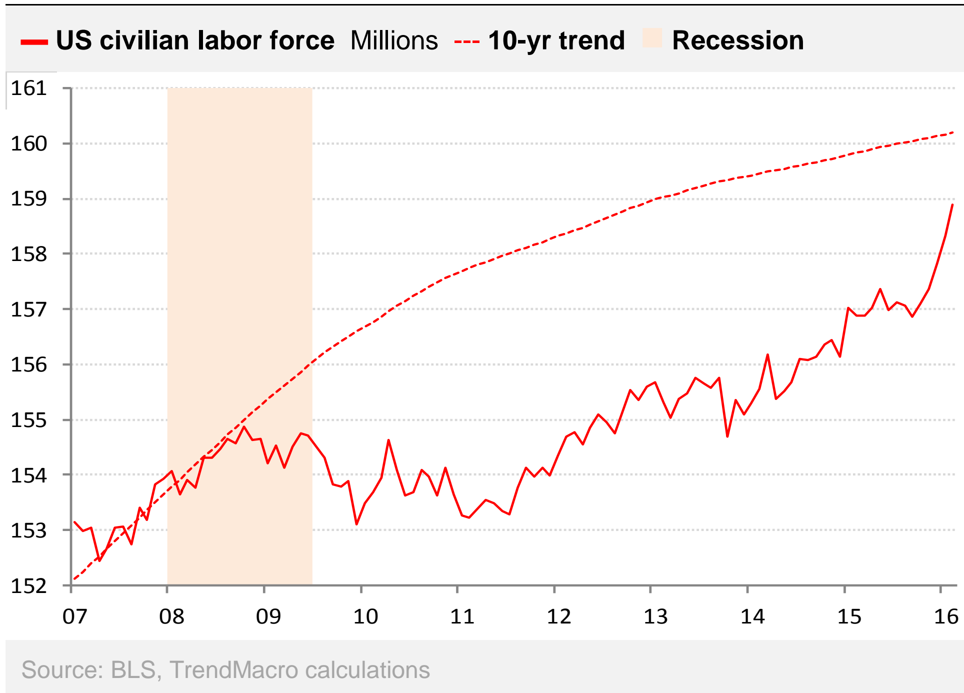
The Case for a Capital Gains Tax Rate Cut
Stephen Moore, Arthur B. Laffer and Joel Griffith
Laffer Associates
March 2, 2016

The implications of Brexit for the rest of the EU
Willem Buiter, Ebrahim Rahbari and Christian Schulz
VoxEU
March 2, 2016

[Reading home]

In February the labor force participation rate rose to 62.9%. Objectively this is a horrible number – it seemed so in October 2013 when we first hit it from above, eventually to hit 62.4 in September 2015. The participation rate has been rising every month since that bottom, and now, hitting it from below, 62.9% feels like a great victory. But make no mistake about it, that's the worst rate since March 1978.

- *The labor force has grown in each of the last five months, cumulatively by 2.02 million persons. But it remains 1.3 million persons below the 10-year trend* (please see the chart below).
- That's a great improvement from 4.72 million gap below-trend seen at the worst, in July 2011. But remember, the trend "learns" as each month goes by, so as the Not So Great Expansion has dragged on, the trend has lost slope, and gets increasingly easy to beat (again, please see the chart below).



Source: BLS, TrendMacro calculations

- One has to wonder why *now* – why would persons out of the labor force come back into it, only to take bottom-of-the-ladder jobs?
- An obvious speculation – no more than a speculation – is that they've simply run out of whatever resources were enabling them to live outside the labor force, and now must come back on any available terms.
- But while it's obviously a plus to have more people in the labor force, once again we must insist that it would be a mistake for the Fed to raise rates in the belief that a tight labor market will lead to dangerous consumer inflation.
- With the labor force participation rate still basically at multi-decade lows, with the labor force still well below its trend – a slowing trend, at that – there is no way to argue that there is not still plenty of slack in the economy. *Here's the slogan – more people are working fewer hours for less pay.*

- We shouldn't even have to argue that. Employment does not create inflation. That's a myth. But even those who believe the myth should see that it doesn't really apply now.
- As the edge of panic has come off global markets, the market-implied probabilities for at least one more Fed rate hike in 2016 has now risen above 60%. We think that's generous.
- Surely that Fed is chastened by markets' reactions to "liftoff."
- With so little real intellectual ammunition behind the Phillips Curve framework, the reality of continuing soft global data, continuing easing from other major central banks, and continuing historically low levels of market-implied steady-state inflation expectations, we think that recent cautious statements by Federal Reserve Board Governor Lael Brainard and New York Fed President William Dudley will carry the dovish day.

Bottom line

A nice headline beat, with upward revisions that partially erase last month's big miss. The Fed will focus on the drop in average hourly earnings. But this comes in addition to a drop in hours worked, and a worsening of long-term unemployment. The labor force expanded again for the fifth straight month. But it remains well below trend, and the newly employed concentrated in poor-paying jobs. With more people working fewer hours for less pay, even a Phillips Curve dead-ender would be hard pressed to hike rates again for quite a while, especially given the markets' severely negative reaction to "liftoff."