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MARKET PULSE

August 2018

Help Wanted: Why Inflation Fears Might Actually Be Right This Time

For a long time after the financial crisis, a large pool of unemployed and underemployed workers — and corresponding weak wage growth — kept US inflation in check. However, as the unemployment rate has declined to historically low levels, consumer prices have been slow to rise, puzzling many economists. Some market commentators have highlighted the role of the decline in labor force participation as a factor. They argue that even though unemployment is near all-time lows, a large number of people who are not part of the labor force might consider entering, and their presence is enough to keep inflation low for the foreseeable future.

We do not believe this is the case.

The key to our analysis is simple: We think that only a small percentage of Americans not currently looking for a job, on a net basis, will rejoin the labor force. Individuals come and go, but — as a group — people out of the labor force today are unlikely to fill jobs tomorrow.

As a result, by sometime in 2019, based on our calculations, the labor market could hit levels of tightness last seen in the late-1960s, just before the beginning of the 1970s inflationary spiral. In other words, the kind of pressures that could cause inflation to accelerate are starting to build. This raises the risk that the US Federal Reserve (Fed) will either be too complacent (allowing inflation expectations to rise) or too aggressive (causing a recession). In either case, it could cause significant disruptions in financial markets.

The Shadow Labor Pool Myth

The US labor force is quite dynamic. As an example, over the past year more than 64 million people left or lost their job, and more than 66 million were hired to replace them or to accommodate new job creation resulting from economic growth. People are temporarily leaving the labor market (to deal with an illness or care for family members) or joining (students working during their summer break, seniors picking up extra income around the holidays) all the time, and particularly with the growth of the gig economy there is a wide spectrum of full- and part-time workers. The responsibility of tracking these inflows and outflows and measuring these various classifications of workers falls to the US Bureau of Labor Statistics (BLS). Suffice it to say, for investors it takes work to get past the surface turbulence to what's really going on in the data.

As of July 2018, there were about 156 million people employed in the US and another 6.3 million actively seeking work (Figure 1). The number of jobs in the US has grown by 11 million since 2013, cutting the pool of unemployed in half. Besides the unemployed finding jobs, population growth has added about another 6 million jobs, as young people leave some level of schooling and join the labor force for some sustained period.

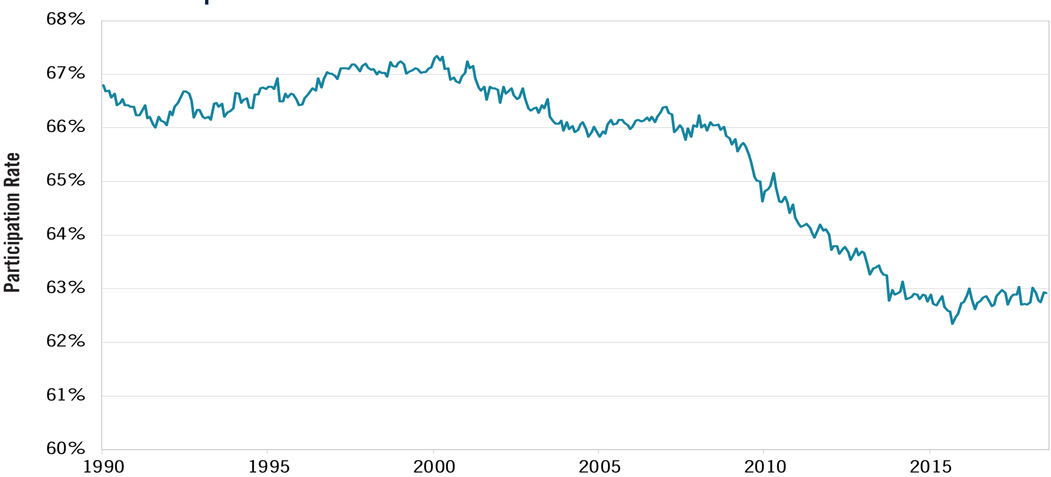
1/ Labor Statistics (Seasonally Adjusted)

	2009	2013	2018
Employed	138.0 million	144.8 million	156.0 million
Unemployed	15.1 million	12.3 million	6.3 million
Unemployment Rate	9.9%	6.7%	3.9%

As of 7/31/2018.
Source: US Bureau of Labor Statistics, QMA.

At the same time, the labor force participation rate (the labor force as a percent of the civilian non-institutionalized population, per the BLS) has been dropping over the past decade (Figure 2). This has led some to conclude that there remains a large pool of available workers who could rejoin the labor force if they wanted to. If the participation rate rose to the level it was before the financial crisis in 2008, for example, about 5 million additional people would re-enter the labor force. According to this line of thought, real wage growth has been weak because there is a shadow pool of workers fighting for available jobs, keeping wage growth contained.

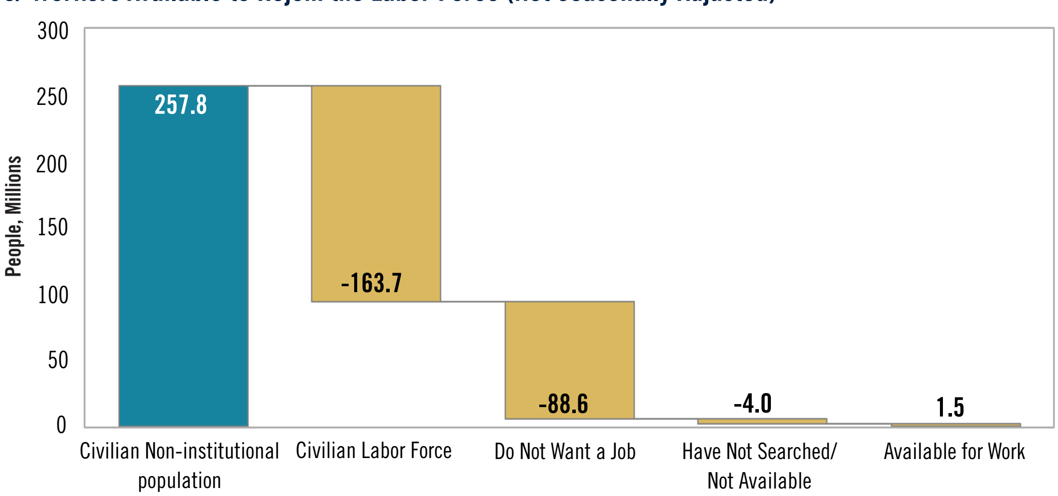
2/ US Labor Participation Rate



As of 8/7/2018.
Source: FactSet, US Bureau of Labor Statistics, QMA.

But, based on our analysis of the most recent BLS data, the shadow pool is largely a myth. Most of the drop in labor force participation since 2000 is due to the aging of the Baby Boomers. Digging into the BLS stats, over 94% of those outside the labor force do not want a job, primarily because they have retired, or, to a lesser extent, because they are raising a child or are in school. Even of those who say they want a job, half say they are not available to work now. Figure 3 shows the breakdown of the US population, including the categories provided by the BLS for those outside the labor force. The small sliver on the far right-hand side represents those willing and available to start working again, about 1.5 million people today, down from 2.5 million in 2009. In addition, the total of those who say they do not want a job, mostly retirees, has been steadily climbing, up almost 10 million in the same time frame.

3/ Workers Available to Rejoin the Labor Force (Not Seasonally Adjusted)

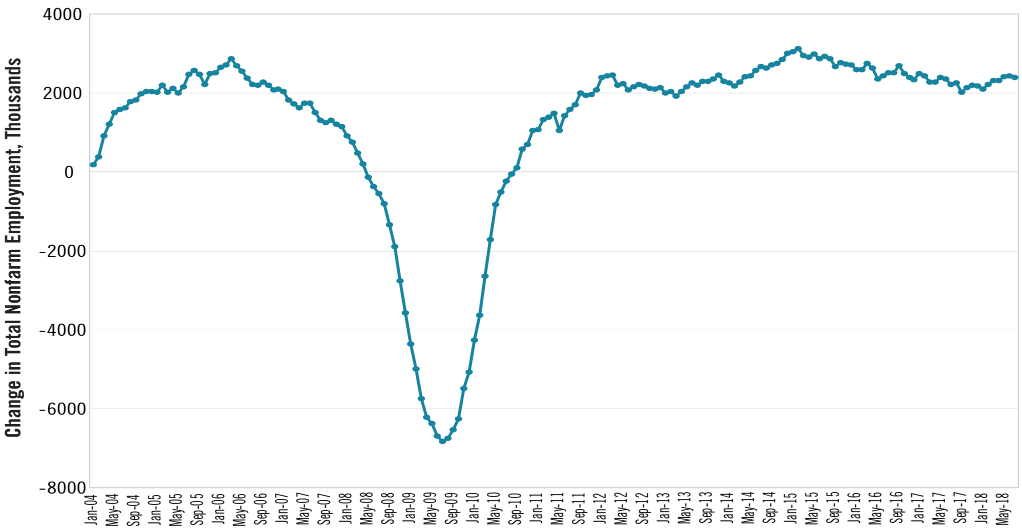


As of 7/31/2018.
Source: US Bureau of Labor Statistics, QMA.

Hire and Higher

According to the July jobs report, published August 3, 2018, the economy added 224,000 jobs on average per month over the last three months, an annualized rate of 2.7 million. That's up from a rate of 2.2 million added in 2017, before the December 2017 Republican tax cuts, and starting to be more in line with the yearly job gains seen earlier in the cycle (Figure 4).

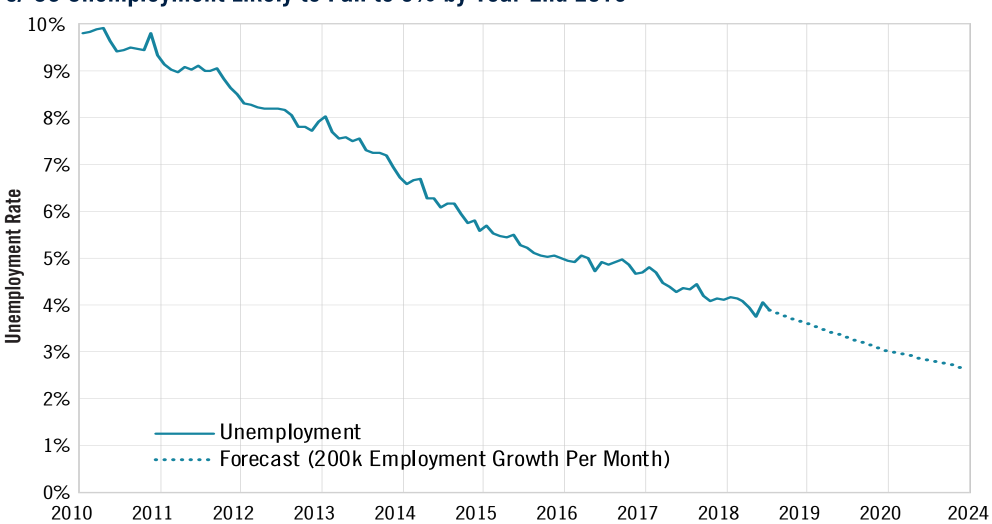
4/ Job Gains Heading Back Up Again? (Seasonally Adjusted)



As of 7/31/2018.
Source: Haver Analytics, QMA.

This job growth will reduce unemployment, despite the fact a growing population will add about 1.3 million persons to the labor force by mid-2019. We estimate that the number of unemployed will shrink by about 1.4 million in the next year. That could bring the unemployment rate down to about 3.3% by the summer of 2019 and potentially below 3% by the end of 2019 (Figure 5), even allowing for a like number of net new people coming off the sidelines (about 200,000 a year) who have been rejoining the labor force over the past five years.

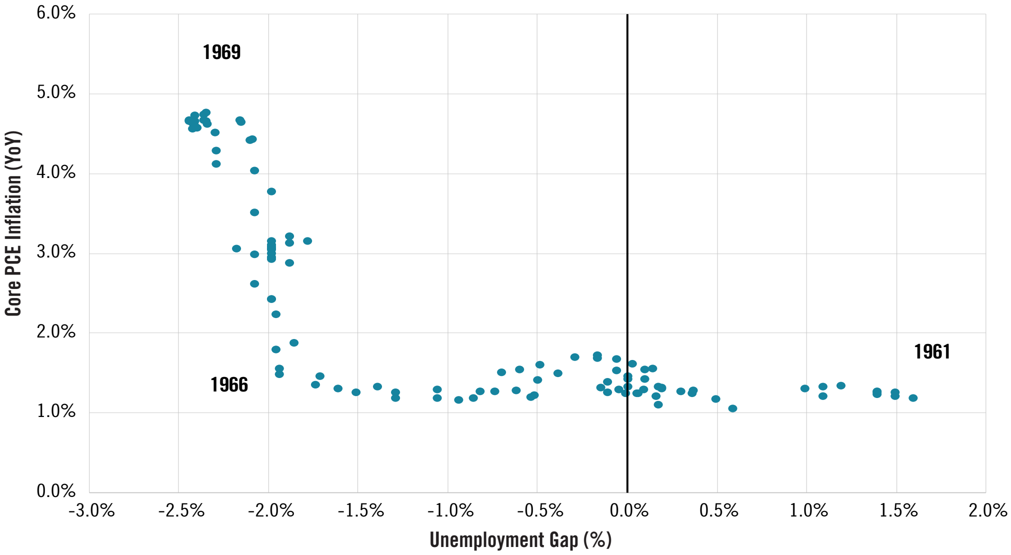
5/ US Unemployment Likely to Fall to 3% by Year End 2019



As of 7/31/2018.
Source: FactSet, US Bureau of Labor Statistics, QMA.

The Federal Reserve forecasts unemployment will average around 4.5% over the long-run, modestly above the current 3.9% rate. If our forecasts are correct, the unemployment rate will fall below the Fed's long-run forecast by 1.5% by the end of 2019. As Figure 6 shows, a labor shortfall in the 1960s of 1.5 – 2% led to a rapid increase in inflationary pressures. Granted, other factors (LBJ's Great Society and Vietnam War spending, chief among them) had also come into play, but the increasingly negative unemployment gap was a major catalyst.

6/ Inflation Surged as Unemployment Gap Shrank



As of 8/7/2018.
Source: FactSet, US Bureau of Labor Statistics, Bureau of Economic Analysis, Bernstein Research, QMA.

The Connection to Stocks

Recall that the correction in stock prices in February 2018 was triggered by high valuations in combination with a hot wage number. Subsequent reports have been less worrisome, and markets are again around all-time highs. If our analysis is correct, higher wage numbers might become pretty common sometime over the next 18 months or so.

American workers have been coping with weak real wage growth for a long time. Rising wages would be a welcome relief for Main Street, at least until they translated into more rapid price increases at the checkout line.

However, rising wages could cause problems for Wall Street and for the Fed. Wall Street would see the historically high profit margins that have recently provided support to valuations begin to compress, unless companies are able to pass on the cost increases to consumers. The Fed might have to choose between letting wages and inflation run a bit hot, risking rising inflation expectations, or tightening monetary policy more rapidly than planned, potentially causing a recession.

We do not think this threat is imminent; we remain overweight stocks in our multi-asset portfolios. We are reasonably optimistic that rising productivity could support higher wages without inflation (see our recent note inside our Q3 2018 Outlook and Review "Productivity: Still the Wild Card"). But we also think that markets might have become too complacent on inflation, which, in the manner of the boy who cried wolf, has been oft-predicted but not seen in any kind of truly destructive fashion for many, many years. We will be watching the dynamics of the labor market quite closely for signs that the tipping point for wages might be closer than the consensus thinks.

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*As of 6/30/2018.

NOTES TO DISCLOSURE

Sources: QMA, US Bureau of Labor Statistics, Haver, FactSet, US Bureau of Economic Analysis, Bernstein Research.

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