Full of Employment….or Full of Something Else…

By: Dave Lavigne

U.S. unemployment figures were released on May 4, 2018 and they reflected a 3.9% unemployment rate. Starting with October 2010, April was the 91st consecutive month of U.S. employment growth. Moreover, April's number represents a notable milestone (unemployment below the 4% threshold), which I believe is measurably below what we have typically assumed to be "full employment". Just to edify, "full employment" is that theoretical place that unemployment can fall to before it starts creating wages pressures. Economists (in typical fashion) have their own esoteric term for that which they refer to as "*non-accelerating inflation rate of unemployment*," NAIRU for short. I will revisit that momentarily, but suffice it to say, Wall Street found those figures encouraging, as the DOW Jones Industrial average has climbed over 4% in the 10 days from the unemployment release to the date of this writing. Perhaps that's anecdotal (we have also had some robust earnings results in an around the releases), but I think at least some of the enthusiasm can be attributed to those numbers. Regardless, as illustrated below, the path of unemployment since the country's emergence from the financial crises has been stark:

Currently, the Congressional Budget Office suggests that NAIRU is 4.6%, which provides an interesting datapoint for the current environment. That is, the most recent 3.9% unemployment rate is well below the 4.6% assumed NAIRU, **and it has been since March 2017** when the unemployment rate stood at 4.7%. On the other hand, while the rate has been under the "natural accelerating inflation rate of unemployment" for what is now 14 straight months, wages still appear to be relatively "*non-accelerating*". I am not sure what that means (and many economists and associated financial experts seem to be baffled by the same) but if nothing else, it suggests that "full employment" might not be 4.6%, which begs the greater question, "when it comes to the current labor market, do we collectively really have a clue what is going on here?". Apparently, the street seems to think it does, because it bid the market up nicely following the data. Then again, as I have argued in this column before, in the short term, market valuations are not always about the data.

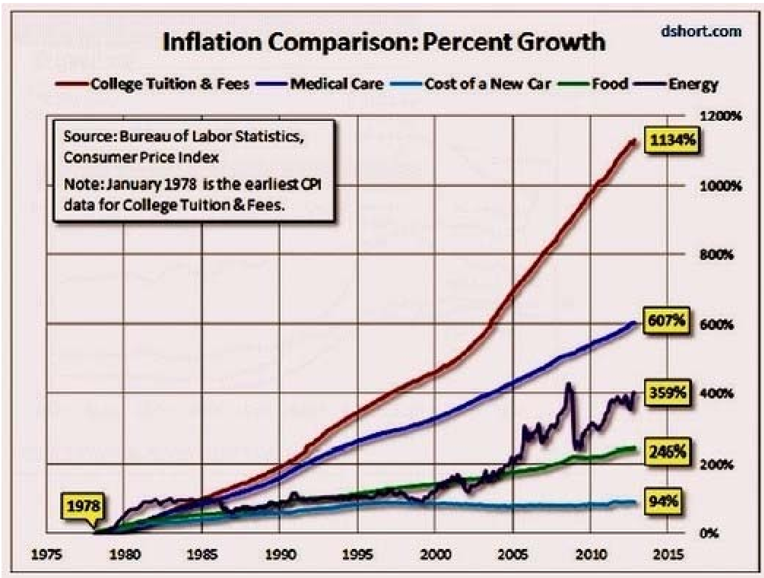
Of course, unemployment *is* germane to several important economic issues. As I noted, beyond the raw unemployment number, what policy makers (the Fed) are really trying to ascertain is resulting wage pressure due to tight labor markets, which in turn leads to inflation, which in lockstep may require additional and/or accelerated rate increases by the Fed. That inverse relationship (inflation to unemployment) was first postulated in the 1950's by an Economist named of William Phillips. While the "Phillips Curve" seeks to illustrate that relationship, I am not sure it has ever been substantially understood, but presumably, the continued compression in the unemployment rate should on the face cause the street some concern about resulting Fed tightening, but the associated *lack of wage pressure* provides that perhaps the Fed will rethink a rising rate path if wage growth remains relatively benign. While the recent bounce in the equity markets have some believing that recent earnings strength is enough to carry the market higher *regardless of the Fed tightening*, I would submit, while I can appreciate the glass half full approach, continue Fed tightening will not be good for equity markets and/or other financial asset markets that have been substantially bolstered by massive central bank liquidity.

From another perspective, I can accept that many simply do not see the unemployment rate as a particularly good data point in and of itself. For example, much has been made about the unemployment rate in the context of the labor participation rate. In short, some would argue that the unemployment rate is at extraordinary lows because the labor participation rate is also low. That is, the unemployment rate has dropped because many people who might otherwise be counted as unemployed have simply dropped out of the labor market altogether. I would submit, that does take some of the shine off the unemployment numbers. Further, that may provide as much explanation as anything as to why the falling unemployment rate has yet to produce marked wage gains. I think there is at least the prospect that higher wages might ultimately get some of those who have opted out of the employment pool back onto the field, which would in turn temper wage growth.

From yet another perspective, looking around at some of the datapoints from the employment landscape, I can't help but wonder if some of the employment/wage disconnect isn't related to the makeup of the labor force. For example, I have this notion that somewhere along the line the U.S became so fixated on telling young adults that they had to go to college to remain competitive in a changing world, that we created instead a host of unintended consequences. Some of these issues were raised in a recent Marketwatch opinion article entitled "If You Want a Good Job, Learn a Skill Instead of Going to College".

https://www.marketwatch.com/story/if-you-want-a-good-job-learn-a-skill-instead-of-going-to-college-2018-05-14

Among other things, the article's author Peter Morici notes that according to the National Center for Educational Statistics, nearly 70% of high School graduates enrolled in college by the following October. Further, "*from 2000 to 2015, the immediate college enrollment rate increased by 6 percentage points*". Perhaps counterintuitively, that increase in marginal college enrollment has grown in spite of breathtaking increases in tuition. While rising medical costs have garnered their share of headlines, they don't hold a candle to rising college tuitions costs, which explains why student debt is now nearly $1.5 trillion. (The rising marginal college enrollment rate has likely played a role in the declining labor participation rate as well).



As Morici points out, "*the United States spends a much larger share of gross domestic product on higher education, than do other countries but gets too little return on that investment. Too often four years of college adds little to students' analytical abilities and businesses report many graduates are ill-prepared for entry-level managerial or other professional work*". Further Morici alludes that in the meantime, employers struggle with "*shortages of diesel mechanics, electricians, conductors and many other trades. Similar shortages abound throughout the manufacturing and technology sectors and pose a major obstacle to keeping the economic recovery going*". To that end, he also notes the following:

Finishing college pays 73% more than going to work after high school but that's an average, which includes engineers, accountants and the like. The Department of Labor certifies apprenticeship programs. Usually completed in well less than four years, those generally offer about $15 an hour while students take courses and get hands on experience. On completion, 87% of students are in positions that pay an average of $60,000 a year — for college graduates the average is about $50,000 and subtracting the above-mentioned skills-based majors, the college average is a lot less. To translate that a bit, while students have been conditioned to believe that a college degree will secure them a better paying and more stable job, the truth of that statement depends more on the type of degree than a degree itself. Many are finding that their degrees (and corresponding pile of student debt) are providing less opportunity than a trade might have otherwise. Further, this applies not only to "blue collar" trades, but technology as well. As Morici also points out, "*some 95 coding schools matriculate about 23,000 graduates through programs that last about 14 weeks, cost about $11,000 and place graduates in jobs with starting salaries averaging nearly $71,000".* I think that phenomenon (too many liberal arts graduates who work at Starbucks and not enough electricians) may be playing a role in our current employment complexities.

Again, I have used this column on several occasion to voice my skepticism of central bank policy that has pushed massive amounts of liquidity into the system. Rising tuition costs and rising corresponding student debt paying for degrees that don't pay for themselves may be some of the unintended consequences associated with that liquidity. In turn, shortages of blue collar workers required to advance economic growth may be another. The fact is, a student graduating from college with a philosophy degree can't plumb a new home, and unfortunately may have to seek employment in a low skill job that has little to do with philosophy and gives them little ability to demand higher wages. Certainly, in some instances our collective push for students to seek "higher education" has created some poor and even tragic results.

In addition to the above, the declining employment rates may be telling with respect to the financial markets. Nine months ago, Fox Business News opined that *"if you drew up a list of preconditions for recession, it would include the following: a labor market at full strength, frothy asset prices, tightening central banks, and a pervasive sense of calm".* Take a look around.

The Wall Street Journal recently reported that "*Signs of financial excess are building now. Net wealth of American households—driven by their stock, bond and real-estate investments—was <u>nearly seven times their income</u> in the fourth quarter of 2017, above levels seen during the Nasdaq bubble and the housing boom".* Further, *"the past two recessions were ushered in by a rise and subsequent collapse in asset prices. In both cases, the unemployment rate dropped to low levels as asset prices soared, hitting 3.8% in April 2000 and 4.4% in October 2006.*

I recognize that central bank policy has proven effective at driving employment compromised by the financial crisis, and that strong medicine may have been quite appropriate at the time. However, I also think that prolonged posture has created additional risks and distortions that may ultimately lead to the same kind of financial asset bubbles that created some of our most prolific (and recent) economic recessions. While I certainly would agree that low unemployment is a desirable environment for nearly everyone across the socioeconomic spectrum, I question the context of some of those numbers, and I worry about what some of the eventual trade-offs associated with maintaining it might be.