WEEKLY
Economic Commentary

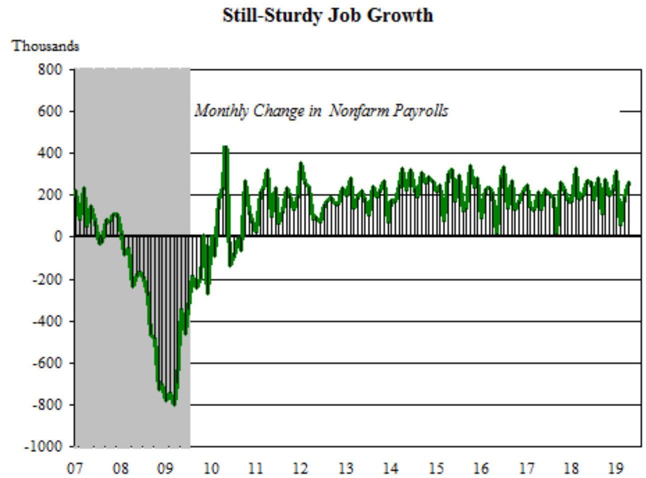
May 3, 2019

Millennium
CORPORATE CREDIT UNION

For the second consecutive week the government released a key economic report that blew past expectations. Following last week's GDP estimate, which revealed an above-consensus 3.2 percent growth rate in the first quarter, the Labor Department on Friday reported that the economy generated far more jobs in April than had been expected. But whereas the GDP report had shaky underpinnings, including soft readings on consumer and business spending, the monthly employment report had a muscular foundation. As usual, the details exposed a soft underbelly in some areas, but they should not detract from the surprisingly robust reading of the headline 263 thousand gain in payrolls or the 0.2 percent drop in the unemployment rate to a fresh 49-year low of 3.6 percent.

Yes, there was some bloat in the headline gain, as the government stepped up hiring of workers in preparation for the 2020 census, a typical bump that occurs a year before the actual survey takes place. But even discounting the 27 thousand increase in government payrolls, the 236 thousand increase in private-sector jobs handily topped the consensus forecast of an overall 190 thousand gain. More to the point, the job market continues to reach milestones that overshadow the accomplishments seen in previous postwar expansions. The April increase in payrolls extended the record stretch of job gains to 103 months, and the average monthly gain so far this year is tracking an annual pace that would top 2 million for the ninth consecutive year, also a record.

The job gains were spread broadly across the economy, with more than 60 percent of private industries reporting increased payrolls last month. That said, there were some notable exceptions. Among manufacturers, only 48 percent reported higher payrolls, the first time



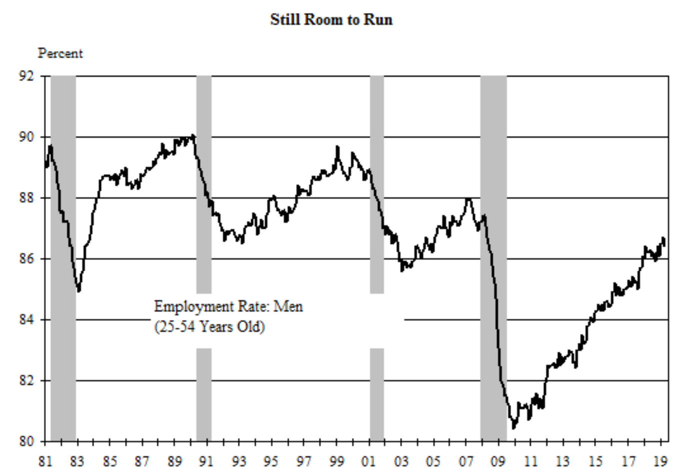
in two years that the share of firms taking on more workers in this sector fell below 50 percent. Clearly, factories are coping with some powerful headwinds that will not dissipate anytime soon. Indeed, a discouraging auto sales report for April reinforces the drag on manufacturing coming from a soft global backdrop and trade-retarding tariffs on the books. The good news is that manufacturing has a smaller influence on overall economic activity than in the past. Recall that this sector fell into a deep slump in 2015 and 2016 without taking a serious toll on the broader economy.

As long as the labor market continues to create jobs at such an impressive rate, the endgame for the expansion, which would set a record for longevity in July, remains a distant prospect. The economy relies heavily on consumer spending, the vast majority of which is made by workers whose spending decisions are deeply linked to their paychecks. Not only are worker earnings still growing at a respectable pace, their paychecks are going a longer way thanks to slowing inflation. That said, the trend in worker earnings has recently been a mixed bag. Growth in average hourly earnings finally broke out of the years long 2.0-2.5 percent annual pace in late 2017, accelerating to over 3.0 percent in August of last year. In April, it continued to exceed 3.0 percent for the ninth consecutive month.

However, the upward trajectory appears to have hit a brick wall. After hitting 3.2 percent last August, the annual growth rate in earnings for all workers has barely moved, remaining at the same 3.2 percent in April. The news is somewhat better for rank-and-file workers, those in nonsupervisory positions that account for about 80 percent of the workforce. Their average earnings increased by 3.4 percent from a year ago. But here too, the trend is pointing in the wrong direction, drifting lower after hitting a peak growth rate of 3.5 percent in December. No doubt, the hike in minimum wages across a wide swath of states this year is contributing to the stronger increases among lower paid workers than their upper-income colleagues.

But the fact that the growth in worker earnings has stalled out despite the sustained above-trend increase in payrolls and decline in the unemployment rate is somewhat perplexing. For April, there is a reasonable explanation, as the dip in the jobless rate to a 49-year low of 3.6 percent occurred for the "wrong reason". In the household survey from which the unemployment rate is derived, the number of unemployed workers fell by 387 thousand, but the labor force fell by an even larger 490 thousand. In other words, more people dropped out of the labor force than obtained jobs, which drove the unemployment rate lower. The labor force participation rate, which is generally viewed as a barometer of slack in the job market, slipped to 62.8 percent in April from 63.0 percent in March.

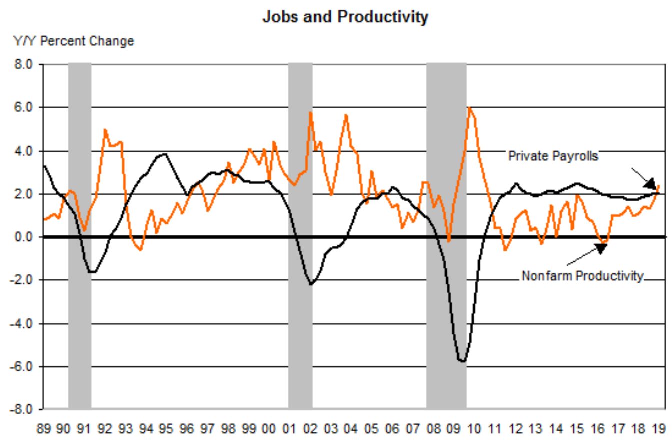
To be sure, the household survey contains more noise than the survey of businesses, which has a much larger sample size. Hence, the April dip in the unemployment rate may be a blip rather than a sign of less slack in the job market. But other measures suggest that labor conditions may not be as tight as generally thought. For example, the employment to population ratio, at 60.6 percent, is the same as it was last October and remains nearly three percentage points below its prerecession peak. This, of course, is being depressed by the same influence that is lowering the overall labor force participation rate, namely an increase in retirements underpinned by an aging population. But the employment to population ratio for prime age workers, those between 25 and 54 year olds, is also a half-percent below its prerecession peak. Worse, the gap is three times as large for men in this age-cohort - 86.4 percent in April versus a prerecession peak of 87.9 percent.



Simply put, there may still be a sizeable pool of workers outside of the labor force that companies can tap into. This "shadow" workforce in essence implies that there are workers in the wings that can potentially compete for jobs, which may be another factor holding back wage gains in addition to such well-known depressants as globalization, automation and declining union membership. Interestingly, one influence that should be boosting wages - productivity growth - appears to be a no-show so far this year. Nonfarm productivity increased by a stellar 2.4 percent in the first quarter from a year ago, the strongest gain in a decade. Ordinarily, stronger productivity enables companies to give workers larger pay hikes without hurting profits - a time-honored route to higher living standards. But with the increase in worker earnings stagnating so far this year, the main effect of the productivity increase was to drive down unit labor costs, which were virtually unchanged over the past year.

Indeed, the trends in productivity and jobs are turning out to be strange bedfellows in the current cycle. It is not unusual for productivity growth to pick up late in an expansion as the positive effects from capital spending kicks in and companies strive for labor-saving cost efficiencies in a tightening job market. Indeed, productivity strengthened in the late stage of the previous two expansions. But the dark side of stronger productivity growth is that it is usually accompanied by slower job gains. This makes sense when you consider that workers become scarcer late in an expansion and rising labor costs prod companies to spend more on labor-saving capital equipment and software, which boosts productivity.

But this time, stronger productivity has not been accompanied by any weakening in job growth. Indeed, growth in private payrolls has actually increased from an annal rate of 1.7 percent in the fourth quarter of 2017 to the current 2.0 percent, even as productivity growth has picked up from 1.0 percent to 2.4 percent. No doubt, the pick-up in productivity reflects the outsize increase in output in the first quarter that was temporarily boosted by special factors, such as a big inventory buildup and narrower trade deficit. Both should unwind and lead to slower output growth in coming quarters, which should also bring productivity closer to its trend growth rate. It remains to be seen, however, if the long-term trend in productivity is as low as the 1.0-1.5 percent that is generally perceived, as it has significantly exceeded that pace in three of the past four quarters.



While a tightening labor market may be spurring companies to invest in more productivity-enhancing capital equipment and software, it is not as overriding an influence as it might have been in the past. For one, there is still some slack in the job market, as evidenced by the sizeable pool of prime-aged men on the sidelines. For another, with worker earnings rising at a moderate pace, companies do not feel pressured into substituting capital for labor to keep costs down. Even if productivity reverts to a 1 1/2 percent growth rate, a 3-3.5 percent increase in labor costs can be covered by a 2 percent inflation rate, which is what the Federal Reserve is striving to achieve.

As for the Fed, the latest data validates its current stance of patience, which was reiterated at its latest policy meeting held this week. The economy is in “a good place” as Chairman Powell likes to say, with growth exceeding expectations and underpinned by a solid job market. Admittedly, inflation continues to disappoint, coming in persistently below the 2 percent target, which bolsters the odds of a rate cut priced into the financial markets. From our lens, the Fed has come to the end of its rate-hiking campaign for this cycle, but it is difficult to envision a cut this year unless growth in jobs and economic activity slows dramatically, something that does not appear to be in the cards.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	**May 3**	**Week Ago**	**Month Ago**	**Year Ago**
3-month Treasury bill	2.44%	2.42%	2.42%	1.85%
6-month Treasury bill	2.46	2.45	2.46	2.05
3-month LIBOR	2.57	2.58	2.59	2.36
2-year Treasury note	2.34	2.29	2.33	2.50
5-year Treasury note	2.34	2.29	2.30	2.78
10-year Treasury note	2.53	2.50	2.49	2.95
30-year Treasury bond	2.92	2.93	2.90	3.12
30-year fixed mortgage rate	4.14	4.20	4.08	4.55
15-year fixed mortgage rate	3.60	3.64	3.56	4.03
5/1-year adjustable rate	3.68	3.77	3.66	3.69
STOCK MARKET				
Dow Jones Industrial Average	26504.95	26543.33	26424.99	24262.51
S&P 500	2945.64	2939.88	2892.74	2663.42
NASDAQ	8164.00	8146.40	7938.69	7209.62
Commodities				
Gold ($ per troy ounce)	1280.20	1288.20	1295.60	1315
Oil ($ per barrel) - Crude Futures (WTI)	61.90	63.20	63.28	69.67

ECONOMIC INDICATORS

	Latest Month/Quarter	**Previous Month/Quarter**	**Two-Months/ Quarters Ago**	**Average-Past 6 Months or Quarters**
ISM Manufacturing Index (April)	52.8	55.3	54.2	55.3
ISM Non-manuracturing Index (April)	55.5	56.1	59.7	57.8
Nonfarm Payrolls (April) - 000s	263.0	189.0	56.0	207.0
Unemployment Rate (April) - Percent	3.6	3.8	3.8	3.8
Average Hourly Earnings (April) - % change	0.2	0.2	0.4	0.3
Personal Income (March) - % change	0.1	0.2	-0.1	0.3
Personal Consumption (March) - % change	0.9	0.1	0.3	0.3

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