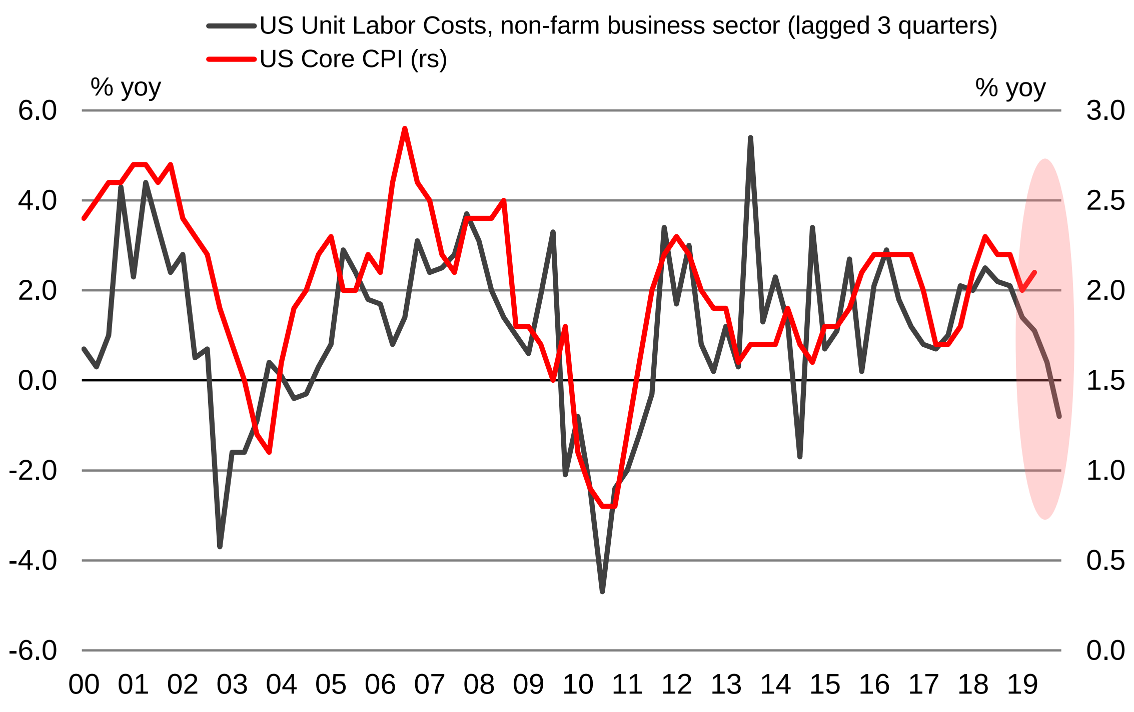
The US labor market is not “hot”



Source: BLS, UniCredit Research

- Fed Chairman Jerome Powell’s unambiguously dovish remarks this week, backed up by the June FOMC minutes, means a rate cut at the end of this month is effectively a done deal. The relatively sharp shift in Fed communication over the last couple of months may be surprising, particularly given the strong jobs market. But our *Chart of the Week* shows that even this bright spot of the US economy – the labor market – is currently not generating sufficient labor cost growth to cover productivity growth, let alone generate any upward pressure on consumer price inflation. The chart shows that not only is core CPI inflation closely associated with unit labor cost growth, but the latter also leads the former by around three quarters.

- To be sure, unit labor cost growth (i.e. labor compensation per hour growth minus productivity per hour growth) would need to be around 2% to be consistent with the inflation target (since only labor cost growth in excess of productivity growth is inflationary). The decline in unit labor cost growth in the US has been driven mostly by lower growth in compensation per hour and partly by higher productivity growth. The easing in compensation per hour growth is in part explained by the easing of average hourly earnings growth, but likely mostly reflects slower growth of non-wage costs.

- Among the many risks to the economic outlook Mr. Powell listed was the risk that “weak inflation will be even more persistent than we currently anticipate”. When asked whether the strong jobs report changed the outlook for a possible rate cut, Mr. Powell said "we don't have a hot labor market ... wage growth at 3% is certainly not high enough to put any upward pressure on inflation". Our chart explains why neither last week's strong jobs report nor core CPI rising a solid 0.3% mom in June seem to have changed the Fed's view on the need for rate cuts in the near term. With global growth slowing and trade tensions unlikely to be resolved in the medium term, the likelihood of further rate cuts is high.

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