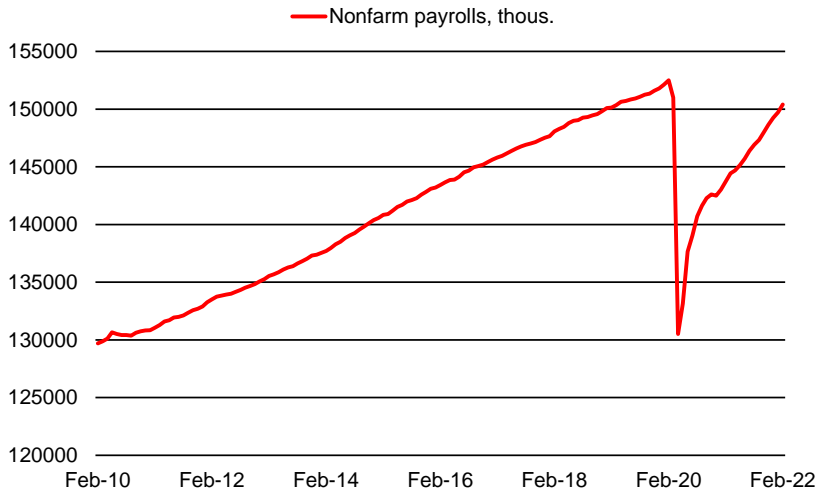


US: Strong payrolls and weaker wage growth will please the Fed

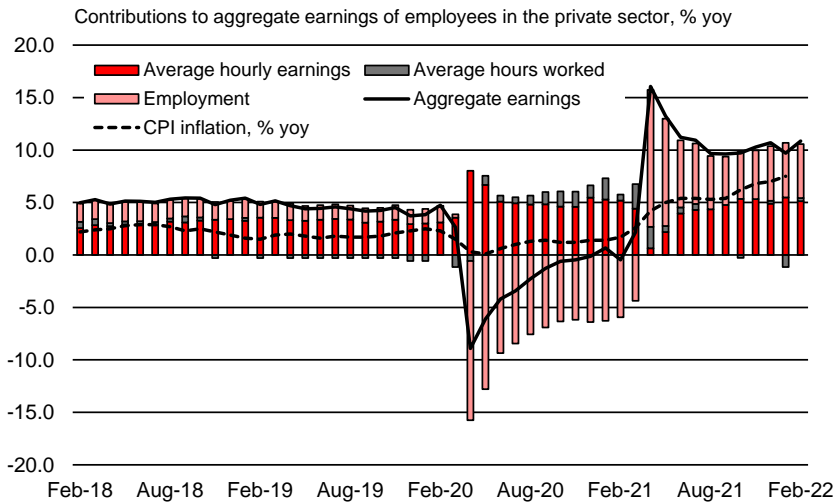
- **The data:** The US economy added a strong 678k jobs in February, more than expected, and a seven-month high. Payrolls in the prior two months were revised up a net 92k. The unemployment rate fell 0.2pp to 3.8% - a pandemic-era low and below the FOMC's estimate of the longer-run equilibrium at 4.0%. The fall in unemployment came despite the participation rate moving up slightly, to 62.3% from 62.2%. The underemployment rate rose 0.1pp to 7.2%, due to a 418k rise in the number of Americans working part-time for economic reasons (i.e. they would prefer a full-time job). Average weekly hours rose to 34.7 from an upward revised 34.6 in the prior month – it remains above its pre-pandemic level of 34.4. The biggest surprise was for average hourly earnings, which was flat (0.0% mom) in February after a (downward-revised) rise of 0.6% mom in January. It comes after rapid rises in the prior ten months, averaging 0.45% mom. The year-on-year rate for average hourly earnings eased to 5.1%, down from a downward-revised 5.5% in January.
- **Our view:** The pick-up in payroll gains in February is consistent with the sharp decline in COVID-19 cases since mid-January, as well as strong underlying momentum. Payroll gains were broad-based across sectors but were led by a 179k rise in leisure & hospitality (the most exposed sector to the pandemic) as the economy reopened and Omicron subsided. Payrolls are still 2.1mn below their pre-pandemic level in February 2020 (see Chart 1), with the biggest shortfall in leisure & hospitality (-1.5mn). The labor force participation rate continues to rise, albeit gradually. It implies labor supply shortages are easing somewhat, but they remain acute, as evident in the further decline in the unemployment rate and higher average hours worked in February.
- **The key question:** The most pertinent question is what is behind the stagnant average hourly earnings. It's difficult to explain, but what we can say is the following. First, one month doesn't make a trend, we'd need to see at least the March data before we can be confident that the underlying trend in pay growth has weakened. Second, so-called selection effects are likely partly, but not fully, responsible. Selection effects are where changes in, say, the industry or occupational composition of those in employment can affect average pay in the whole economy. During the pandemic, below-average pay sectors like leisure & hospitality experienced large falls in payrolls, which had the effect of pushing up the average wage in the whole economy. The return of workers to below-average pay sectors has pushed down on average earnings, but the payroll gains were broad-based across sectors so it's unlikely to be the main explanation for stagnant average hourly earnings. Third, the rise in average hours worked could help to explain some of the weakness in hourly earnings growth. In the establishment survey (from which payrolls are computed), around one-third of businesses have a weekly pay period, slightly over 40% bi-weekly, about 20% semi-monthly, and a small amount monthly. If weekly pay is unchanged and average hours worked rise then, mechanically, average hourly earnings fall, so changes in average weekly hours often induce opposite moves in average hourly earnings. But this is also unlikely to explain most of the weakness in pay. Fourth, the rise in the participation rate, albeit gradual, means labor shortages are easing, which is likely applying some downward pressure to wage growth. The weakness in average hourly earnings in February was broad-based across industries, including leisure & hospitality, so this may suggest the beginning of a new, slower trend for pay growth. The incentive to actively seek work has likely risen as a result of several factors, including the expiry of enhanced unemployment benefits on 6 September, a return to fully in-person schooling, a reduction in savings buffers, and strong wage growth. Fifth and finally, slower wage growth is consistent with the recent easing of household measures of inflation expectations.
- **Implications for Fed policy:** The Fed will clearly welcome this report. Their primary concern has been, and will continue to be, that the very high level of actual inflation will feed into price and wage expectations, thereby creating a reinforcing loop that could see high inflation becoming entrenched. This has triggered the Fed's hawkish pivot in the last few months. So, the flat average hourly earnings reading, and the decline in the year-on-year rate, will ease their concerns somewhat. A 25bp rate hike at the FOMC meeting on 16 March is effectively a done deal, and it will kick off a series of rate hikes that we expect to total 125bp this year. Inflation is well above target (three times higher than target), the labor market is very tight (as evident in low unemployment), and economic growth is solid. And while personal real disposable income is being squeezed by higher inflation and the reduction of fiscal transfers, the solid rise in employment means aggregate labor income is still rising faster than inflation (see Chart 2). But the risks of the Fed moving faster than we expect have reduced following the February employment report.

CHART 1: PAYROLLS ARE RISING AT A STRONG AND STEADY PACE



Source: BLS, UniCredit Research

CHART 2: WHILE AVERAGE HOURLY EARNINGS GROWTH HAS EASED, AGGREGATE WAGE INCOME IS STILL GROWING FASTER THAN INFLATION



Source: BLS, UniCredit Research

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