GENERALI INVESTMENTS

Focal Point

US: The labor market continues to support growth

July 7 2016

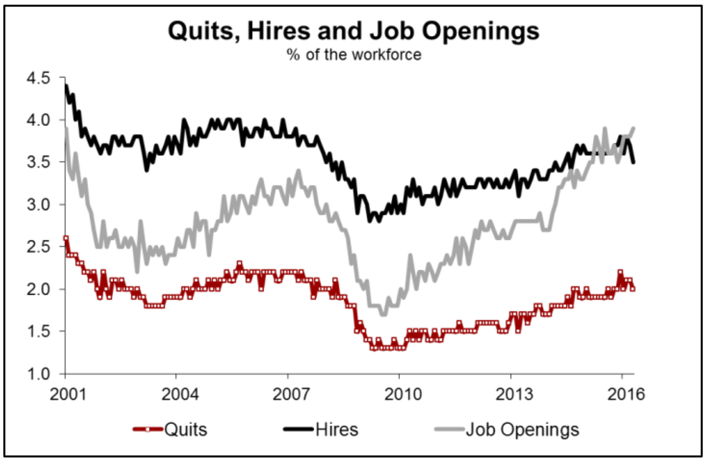
Author: Paolo Zanghieri

- After more than five years of solid job creation, in May payroll barely increased. However, looking at a broader set of indicators, it appears that – with the unemployment rate down to 4.7% – the labor market is still performing well.
- The steady labor income expansion supports consumption, which will continue to underpin smooth growth going forward. However, the weak productivity increase is pushing up unit labor costs, with negative repercussions on profitability and capex.
- The outcome of the UK vote will increase short-term uncertainty related to the possible spillovers on the US presidential election. A longer lasting and more dangerous risk could materialize in case of a strong appreciation of the dollar.
- Looking through some volatility in H2, the smooth and domestic demand-driven expansion in real GDP is set to continue, with an acceleration in 2017 as investment stabilizes and the drag from net trade abates.

After more than five years of sustained job creation, in May payroll growth was a paltry 38K, a sharp contraction with respect to the nearly 180K average seen in the first four months of 2016. The extremely weak May figures can to some extent be explained by temporary factors. Yet, when read in conjunction with the disappointing investment figures for Q1 and the volatility in the most recent readings of the PMI surveys, they have raised concerns about an abrupt slowdown in GDP growth. Moreover, the outcome of the UK referendum has ignited market volatility, raising the fears of a negative impact on US growth. In what follows we seek to put these risks into perspective and sketch the outlook for the US economy over the next quarters. Our conclusion is that, after a period of slower growth due to higher uncertainty, US growth is set to return to around 2% in 2017.

The economy is approaching full employment

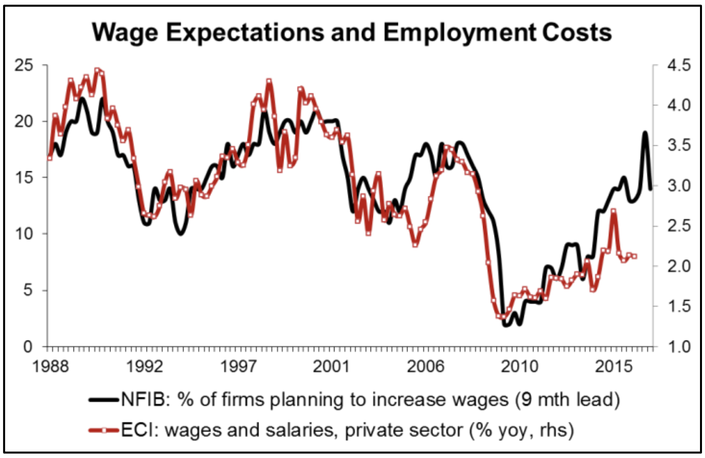
Consider the labor market first. It is true that payroll growth has slowed down since the beginning of 2016, exceeding 200K only in February. Yet, looking at a broader set of labor market indicators, the picture does not appear that worrisome. Jobless insurance claims, a timelier gauge of the state of the economy, have remained at all-time lows, indicating that firms are not cutting staff at all. On the contrary, the rise in hiring has not visibly changed pace in recent months and job openings as a share of workforce remain at record high. On top of that, the share of workers voluntarily quitting their job (a measure of workers' confidence) is still on the rise.



Quits, Hires and Job Openings

Further evidence of the ongoing tightening in the labor market comes from business surveys: according to the NFIB one on small and medium businesses, filling vacancies and finding qualified workers remain by far the biggest concerns. Moreover, despite poor employment growth, in May the unemployment rate fell to a post-crisis low of 4.7%: This indicator has been quite volatile over the last months, but it is hovering around or slightly below what has been estimated as the equilibrium rate. Taken together, all this evidence reinforces the view that the labor market it is reaching its long-term equilibrium: increasingly less extra workers are needed to satisfy demand and the difficulty in finding the right skills acts as a constraint to actual hiring. If this assumption is correct, we should see in the next few months employment growth to regain strength, but to remain slower than what we saw in 2015. Indeed, we expect June payroll growth (published on July 8) to go back to just above 160K, some 10K below consensus, and it will continue for the next few quarters at more the 85-100K per month needed to stabilize the unemployment rate given the demographic trends. This would bring the unemployment rate marginally down to around 4.6% by next year. With only limited labor market slack still in place, the focus should now shift on wages. On this side, the May employment report had no big surprises. Hourly wages were up by 2.4% yoy, broadly in line with the previous months of 2016. Adjusting for the demographic shifts in the pool of employees (resulting from the retirement of a large number of highly paid older workers), the median wage continues to rise at above 3% yoy.

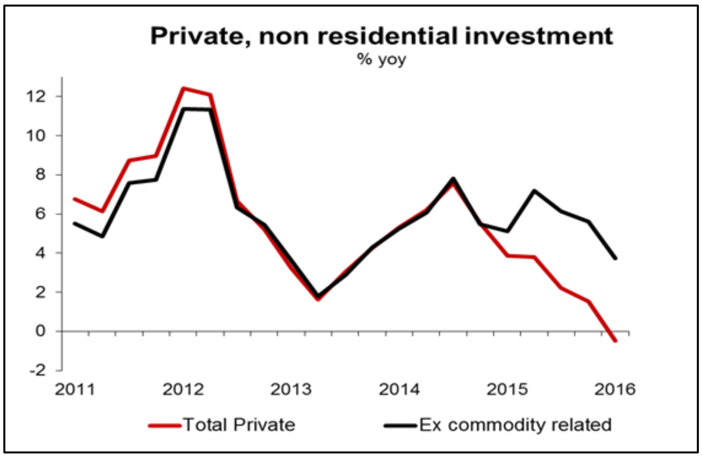
Surveys show a net majority of firms planning to increase wages over the next months: looking at past evidence, this is normally followed by an acceleration in compensations.



A striking feature of the current recovery is the sluggish increase in labor productivity. This is largely the outcome of trends affecting all industrialized economies. The most important one is population ageing, which dampens the average productivity of the labor force and tilts demand towards low productivity service industries. On top of that, US productivity suffers from a relative shortage of skilled workers, which may have been exacerbated by the sharp increase in long-term unemployment, and by the subdued growth in corporate capex. Moreover, the protracted period of favorable financing conditions may have kept in activity less productive and profitable firms.

Rising labor costs further depress capex...

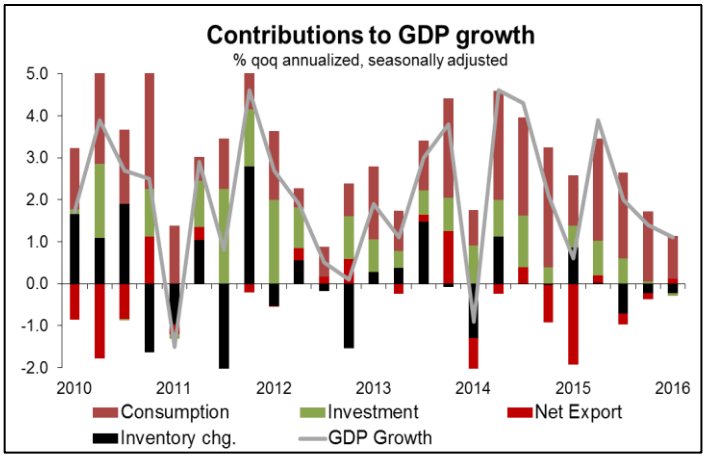
Stagnating labor productivity is fueling unit labor costs even if wage growth remains moderate in a historical perspective. In Q1 2016, they were up 3% yoy, continuing to outgrow business output prices. The ensuing squeeze on margins is one of the main reasons of the ongoing fall (albeit from all-time high levels) of firms' operating surplus as a share of value added. This has largely contributed to keep capital expenditure at "very depressed" levels (as Governor Yellen recently pointed out) also if we take out the collapse in investment in the oil-related industries. Going forward, we expect rising labor costs to be translated to an increasing extent into retail prices, nudging up core inflation. Indeed, several years of weak investment have reduced productive capacity, entailing a reduction of competitive pressures; moreover, the still steady increase in real household income may allow for higher markups.



…but props up income and consumption

The other side of higher and accelerating wages is the ongoing support to disposable income. In the first quarter of 2016, the latter was up by 4.0% qoq annualized in real terms and ha only margnally slowed down in first two months of the second quarter. At the same time, falling unemployment is boosting consumers confidence, keeping consumption and construction activity high.

The upshot is that domestic demand, by far the key driver of GDP growth, is increasingly reliant on consumption, with investment lagging behind.

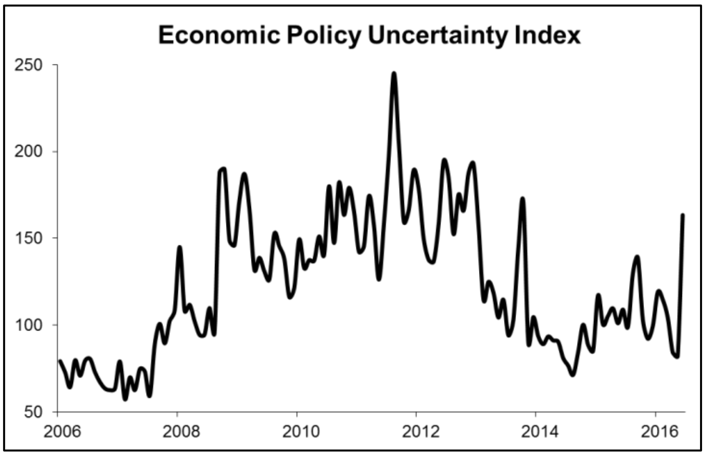


In our outlook for the rest of 2016 and 2017, we see a less pronounced growth differential between these two spending items, as investment picks up, with some possible delays caused by uncertainty due to the result of the UK referendum overlapping with the beginning of the campaign for the November presidential election.

Uncertainty to weigh temporarily on H2 growth

The anti-elite and isolationist stance featured by the winning "leave" campaign in the UK resonates in the themes favored by Donald Trump, the presumptive presidential candidate of the Republic party. We believe that this could help reduce the gap that opinion polls and betting markets indicate between him and the Democratic runner Hillary Clinton. A tighter race will reinforce the businesses' tendency to "wait and see" typical of the pre-election period. This would add to the already increasing level of uncertainty on the conduct of economic policy, including the monetary policy stance. Moreover, the turmoil following the referendum outcome and the expected negotiations between the UK and the rest of the European Union may lead to another appreciation of the US dollar. This would raise again concerns about the still fragile recovery of the export-oriented manufacturing sector, on top of the possible slowdown in the euro area following political turmoil.

The electoral campaign in the US is still at a too early stage to predict a persistent increase in volatility. However, the steady increase in uncertainty seen in recent months is likely to affect investment and consumption decisions in the short term, leading us to revise marginally down the forecast for the second half of this year. Overall, we see real GDP to expand by 1.6% in 2016.



Stronger growth in 2017

Looking through temporary volatility, the fundamentals behind the expansion of the business cycle remain overall solid and we expect for 2017 growth of at least 1.8%. The end of the support of low oil prices to households' real disposable income will likely result in a small deceleration in consumption. This will be offset by an acceleration in non-residential investment. First of all the cutback in capex from oil producers has likely come to a halt and, given the rapid decrease in marginal cost of extraction, oil prices at or just above 50 USD per barrel could justify an expansion in productive capacity. In the non-oil industry, increasing pricing power will offset higher labor costs. Therefore, the restoration of margins, and still accommodative financial conditions, will help capital formation. Moreover, the drag of political uncertainty on investment decisions is expected to dissipate by the end of 2016, after the presidential election. However, the uptick would be too feeble to make up for the drop in nonresidential investment seen in 2015 and projected for this year.

A key risk to this forecast is clearly the behavior of the dollar: a strong and sustained appreciation of the currency would again compress export, possibly leading to a reversal in investment growth.

Summing up, employment growth will continue to underpin consumption and the reduction in uncertainty will strengthen investment. Stronger domestic demand will then prop up core inflation. However, even though the domestic conditions would be in place to restart monetary policy normalization, over the coming months the shaky global financial conditions will continue to determine the Fed's choice to stay put.

Imprint

Head of Research (*ad interim*):	Santo Borsellino (santo.borsellino@generali-invest.com)
Deputy Head of Research:	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
Team:	Luca Colussa, CFA (luca.colussa@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Frank Ruppel (frank.ruppel@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri (paolo.zanghieri@generali.com)
Edited by:	Tamara Hardt (tamara.hardt@generali-invest.com) Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)
Issued by:	Generali Investments Europe Research Department Cologne, Germany · Trieste, Italy Tunisstraße 19-23, D-50667 Cologne

Sources for charts and tables:	Thomson Reuters Datastream, Bloomberg, own calculations

In Italy:
Generali Investments Europe
S.p.A SGR

Corso Italia, 6
20122 Milano MI, Italy

In France:
Generali Investments Europe
S.p.A SGR

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Investments Europe
S.p.A. SGR

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-invest.com