APRIL 2014

SETTING THE STAGE FOR HIGHER WAGES

Together, employment and wages play a tremendously important role in determining a wide range of other economic variables (Exhibit 1). Alas, employment and wages sputtered their way through the post-crisis doldrums, limited by slow economic growth and crippling uncertainty. Bracing winter weather in North America has more recently impeded progress.

Fortunately, we anticipate a more upbeat scenario over the coming months and years, with particular relevance to the U.S. In the short run, better weather should unleash a coiled spring of hiring through the middle of 2014. Beyond that, the long-awaited economic normalization story should take over, thanks to fading fiscal drag, declining uncertainty around the path of public policy and rising risk appetite. In its wake should come more hiring, higher wages and rejuvenated consumer spending.

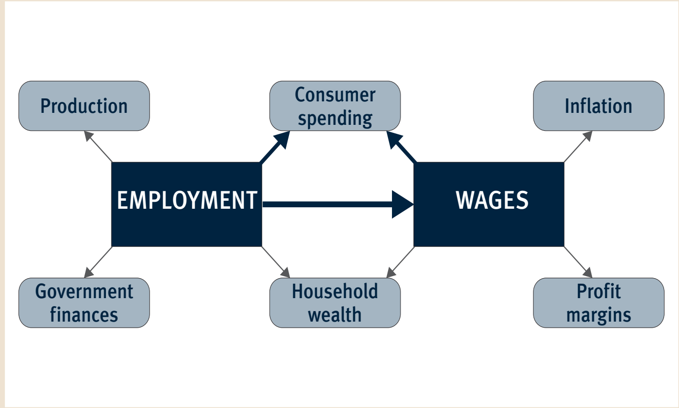
Labour market cues

We begin with a U.S. labour market checkup. As a simple starting point, the imminent arrival of brisk economic growth should prod previously sidelined businesses back into hiring mode. In fact, if economic growth manages to eat through between 0.5 and 1.0 percentage point of economic slack annually over the next three years – our base case – history argues for between 223,000 and 471,000 net new jobs per month along the way. Even the low end of this range would represent a marked improvement from the recent performance.

There are already signs that the labour market is healing and momentum is building. Our aggregate employment index[1] shows steady improvement, though not yet fully normal conditions (Exhibit 2). Job creation over the past two years has averaged 178,000 new jobs per month. Accordingly, the unemployment rate has fallen to 6.7% from 8.2% over the same period.

Offering a partial counterpoint after all of this rosy commentary, let us concede that all is not perfect. The breadth of hiring is a little worse than normal. The quality of new jobs created is also below average, though it is customary for job quality to be temporarily inferior during an economic recovery. The key message is that most of the bad things about the labour market are becoming less bad, and the good things are getting better.

Exhibit 1: Employment and wages are key economic drivers



Source: RBC GAM

Loosely speaking, we anticipate job creation of 200,000 to 300,000 new positions per month over the next few years as the unemployment rate wends its way to just under 6%.

Slack off

The outlook for wages is determined in large part by the extent of economic and labour market slack. It is notable, then, that we believe there is presently less slack in the U.S. than commonly imagined. This can be demonstrated in a few ways:

Output gap math

The first approach focuses purely on the output gap – the difference between how much an economy is producing and how much it is capable of producing. Our model of the U.S. output gap points to economic slack of just 2.0% to 2.5% of GDP, not the 3.0% to 4.6% estimated by other sources.[2]

[1] Includes the unemployment rate, employment rate, part-time share, unemployment duration, the U6 (broadest) measure of unemployment, the job openings rate, the involuntary turnover rate and the voluntary turnover rate.

[2] Alternate estimates come from the CBO, IMF and OECD.

Acknowledging decay

Another way of gauging the amount of economic slack is to consider the decay of workers' skills and of machinery that occurs when they go unutilized for long periods of time. If we assume that 10% of idle resources are lost in this way each year,[3] the persistent underperformance of the economy during and after the financial crisis explains the cumulative loss of over 2 percentage points of output, meaning there is less economic slack than conventional estimates would suggest.

Labour market slack

The labour market can also tell us something directly about economic slack. Normally, we'd just look at the gap between the unemployment rate and its historical norm, and map this onto the economy. However, any such calculation now demands tweaking, for three reasons:

1) Undercounting unemployment

It seems clear that the unemployment rate does not fully reflect the extent of labour market suffering in the U.S. The labour force participation rate has fallen by a sharp 3 percentage points since before the financial crisis. In other words, there are many people who have stopped working but fail to appear in the official unemployment figures. This means that the "true" unemployment rate is around 1.1 percentage points higher than officially estimated. Thus, the 6.7% jobless rate should really be acknowledged as 7.8%.

2) Underestimating "normal"

On the other side of the equation, academic estimates increasingly point to a new "normal" unemployment rate of around 5.75%,[4] which is substantially higher than the 5.0% rule of thumb that prevailed before the financial crisis. The reason is that there is an expanded cohort of people still looking for work and appearing on unemployment rolls who are probably all but unemployable due to the decay of their skills and a changing economy.

3) Labour-economy linkage

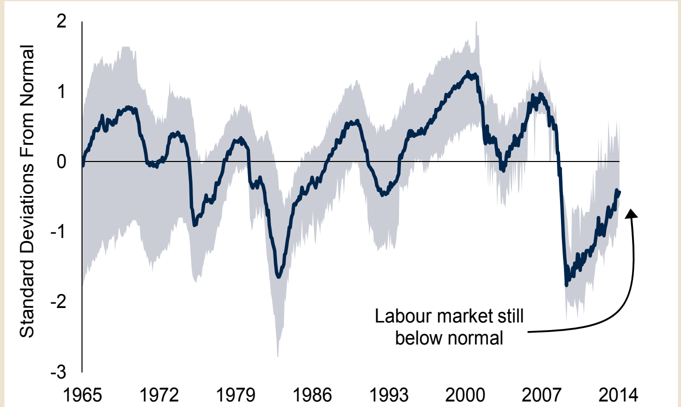
Weighing the offsetting effects of a higher unemployment rate and a higher "normal" rate, the implication is that the true unemployment gap is 2.1 percentage points. What does this mean for the amount of slack in the economy? We believe the relationship between the labour market and economy[5] has changed somewhat in recent years, with the multiplier between the two falling from 1.5x to something more like 1.25x for the U.S. In turn, a 2.1 percentage point unemployment gap becomes a 2.6% output gap. This is a little higher than our other estimates, but still materially lower than the consensus.

[3] This is a concept known as hysteresis.

[4] In a report published in July 2012 entitled "Hi-Ho, Hi-Ho, It's Back to Work They Go," we estimated at the time that the new normal unemployment rate was 6.00%–6.50%. Subsequent evidence suggests it is probably a bit lower.

[5] This relationship is known as Okun's Law.

Exhibit 2: U.S. labour market conditions improve



Note: Normalized index of employment variables measuring state of labour market relative to historical norm; shading shows central tendency of indicators. Source: Haver Analytics, RBC GAM

Labour's loose ends

There are still two loose ends that warrant attention: the saga of part-time workers and the long-term unemployed.

Part-time blues

Until now, we have ignored the fact that there are three million more involuntary part-time workers than usual in the U.S. economy. Shouldn't they be factored into our estimates of labour market slack? Ultimately, no. One reason is that there is a partial offset: the average manufacturing worker (and likely those in a handful of other sectors) is clocking unusually long hours. So whereas a large number of people are underemployed, another group is actually overworked. The best way to reconcile these opposing findings is by evaluating the average weekly hours worked across the entire economy. We find that the average employee is working 0.5 hours per week (or 1.2%) less than normal. It is customary for hours worked to decline alongside the economy and employment during a downturn, and the drop during the last recession was in line with the usual response. Thus, the decline in hours worked is already implicitly factored into our various estimates of slack. To acknowledge it again would be double counting.

Long-term suffering

The fact that the long-term unemployment rate is still extremely elevated is a popular justification for the view that the labour market remains quite weak. However, it is a mistake to dwell excessively on this variable, at least if one's focus is the wage outlook. We find short-term unemployment to be the more important variable, making it quite heartening that it is already back to its normal range. The sad reality is that employers believe that the long-term unemployed are flawed in some way, by dint of their earlier inability to secure a job and because their skills have likely deteriorated over the duration of their unemployment.[6] Growing businesses consequently find themselves battling over the smaller pool of short-term unemployed. This puts upward pressure on wages even when long-term unemployment rates remain relatively high. Whatever the underlying rationale,[7] the fate of the long-term unemployed simply isn't useful in determining the true extent of economic slack. In turn, we should not focus on this group when forecasting wages.

Wage outlook

We can finally proceed to the wage outlook. Our sunny forecast is predicated on several things:

A) Tighter economy and labour market

As discussed earlier, the economy and labour market are tighter than they look, and set to tighten further at a fairly brisk clip. Employers will eventually realize that the perfect employee they are holding out hope for simply does not exist, and job openings should increasingly translate into hires. This should shift the balance of power from employers to employees, boosting wages.

B) Quits rate

The labour market's "quits rate" is rapidly normalizing. In other words, workers are increasingly willing to voluntarily leave one job for another. Not only does this signal a healthier labour market and growing worker clout, but voluntary job hoppers also manage to extract an 8% salary boost on average. All of this is clearly momentous for wage growth.

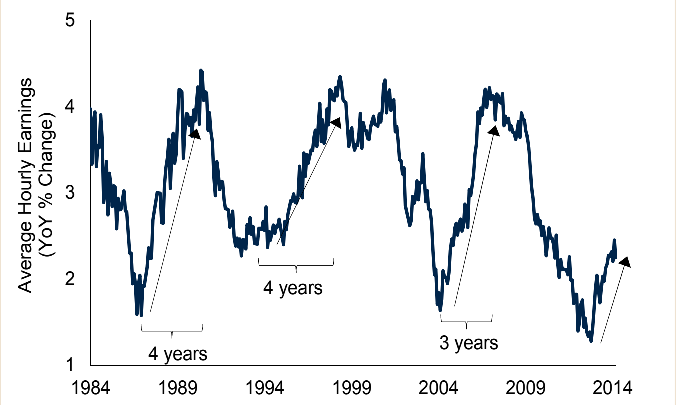
C) Catch-up effect

Wage growth has been unusually poor in recent years. Wages have undershot productivity growth by a cumulative 6.4% since the mid-2007 arrival of the financial crisis. Almost half of this is probably unrelated to the crisis and instead connected to a longer-term underperformance. But even after adjusting for this trend, we find that wages are 3.3% lower than they should be. They should eventually catch up. That's more than a year's worth of additional wage growth waiting to be ladled on top of the normal progression of salaries over the next few years.

D) Accelerating wage growth

Wage growth already appears to be picking up (Exhibit 3). Private-sector hourly wages are now rising by 2.25% per year, finally higher than inflation and much quicker than the 1.3% nadir of mid-2012. Historically, such upward trends can be sustained for three to four years, implying another 1.5 to 2.5 years of accelerating wages, followed by a multi-year period of growth near 4%.[8]

Exhibit 3: U.S. wages rising with further room to run



Note: Average hourly earnings of production and non-supervisory workers on private nonfarm payrolls. Source: Bureau of Labor Statistics, Deutsche Bank, RBC GAM

Consumption implications

Faster economic growth promises to deliver more hiring and better wages, and these gains should, in turn, boost consumer spending, which represents a gargantuan 68% of U.S. GDP. Altogether, the combination of faster hiring, zippier wages, rising wealth and rising credit suggests nominal consumer spending could clock a remarkable 6% annual growth rate within a few years – more than twice the recent rate – without even accommodating any wage catch-up. In real terms, this range translates to inflation-adjusted consumer spending growth of about 4.0%. If this seems like a fantastical claim given the recent era of barely more than 2% growth, note that it happens surprisingly often when the economy is finally permitted to spread its wings.

Bottom line

The ongoing process of economic normalization should ultimately result in stronger hiring and faster wage growth, leading to improved consumer spending. We forecast 200,000 to 300,000 new U.S. jobs per month over the next few years, and see nominal wage growth rising to 3.5% per year, if not beyond. With further help from rising wealth and readier access to credit, nominal consumer spending growth should eventually double to around 6% per year, or 4% in real terms. While this report focuses on the U.S. economy, there is tentative evidence that other developed regions are also improving. Canada, the U.K. and even the Eurozone are also managing rising compensation growth, with nominal wages finally outpacing inflation in each.

[6] One study found that just 10% of the long-term unemployed find a new job in any month, whereas 24% drop out of the labour force altogether over the same period. The recent expiry of extended unemployment benefits should accelerate this process.

[7] Factors such as the job losses that result from globalization and automation are often cited, alongside the generalized acceleration in the rate of change at which various skills are valued.

[8] Note that the wage growth for the average individual worker should rise more quickly than this since wages tend to go up across a career as the worker gains experience and tenure. This doesn't appear at the aggregate level since the effect is offset by the constant replacement of high-earning retiring workers with young entry-level workers.

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