

# Insights

## US labour market tighter than people think

Nordea Research, 20 March 2014

- According to the Fed sufficient slack in the labour market justifies an extended period of low interest rates.
- However, we are sceptical that there is as much slack in the labour market as the Fed indicates. We believe that even the factors Fed Chairman Yellen has cited as evidence of slack in the labour market – high long-term unemployment and high involuntary part-time employment – are themselves largely structural and hence beyond the control of the Fed.
- In our view, the possibility of a large and sudden return of job seekers to the labour market is remote.
- We dispute the widely-held idea that the unemployment rate understates the amount of slack in the labour market. As a matter of fact, we believe the unemployment rate is most likely overstating slack.
- Against this background, we expect to see a clear upturn in wage increases in H2 2014. Signs of increasing labour market pressures are the reason we expect markets later this year to start pricing in more rate hikes from the Fed in 2015 and 2016.
- If we are right, USD rates will start trending up again, and the USD will strengthen, we believe.

### Labour market slack is diminishing

The issue of the degree of labour market slack in the US economy is now a hot topic. This is an important concern for monetary policy as the general consensus at the Fed is that sufficient slack will continue to justify an extended period of low interest rates, with rate hikes delayed until Q3 2015.

However, there is considerable uncertainty about the degree of slack in the labour market. Indications of less than expected slack will tend to move forward the timing of the first rate hike and, perhaps the pace of subsequent tightening. Wage pressures are likely to be an early indicator that slack is diminishing.

We are sceptical that as much slack exists in the labour market as the Fed has indicated. Our forecast of a clear acceleration in wages this year is the reason we expect markets to start questioning the Fed's ultra-dovish forward guidance for the fed funds rate in 2015 and 2016.

If we are right, USD rates will start trending up again, and the USD will strengthen, we believe.

In this analysis we take a closer look at how close the US is to full employment and argue why we believe higher wage increases will be the key US story for 2014.

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What will happen to the 12.6 million who have left the labour force since the recession?

Permanent rather than temporary factors dominate

Only 10% have searched for a job within the past year and are available for a job now

Discouraged workers only a minor factor

**Permanent drop in labour force participation**

The debate about labour market slack mainly focuses on the degree the unemployment rate may overstate labour market improvements. The sharp decline in labour force participation has clearly placed additional downward pressure on the unemployment, leading to speculation that the unemployment rate is underestimating the degree of slack. Many still seem to believe that an improving economy will trigger a flood of previously discouraged workers into the labour force to provide additional slack.

Thus, a key question related to the degree of slack in the labour market and hence the inflation outlook is what will happen to the 12.6 million who have left the labour force since the start of the Great Recession in early 2008.

In our view, the possibility of a large and sudden return of job seekers to the labour market is remote because evidence is mounting that structural/permanent factors – retirement and illness/disability – are the primary reasons for the decline in labour force participation.

This long-held view of ours is partly based on the table below, which suggests that the majority of those who have left the labour force do not want a job.

The labour force participation rate fell by 3.2% points between Q4 2007, just before the recession, and Q4 2013. Of this, 2.8% points (86%) reflect those who no longer want a job and just 0.5% point (14%) those who do want a job.

In turn, of those who no longer want a job, the vast majority (69%) of the increase has been in the 55+ age cohort, consistent with a significant move into retirement by baby boomers.

Importantly, only 10% of those who have dropped out of the labour force since the recession started have searched for a job within the past 12 months and are available for a job now (so-called “marginally attached” to the labour force). We see this as a rather clear indication that most of those who have left the labour force won’t come back.

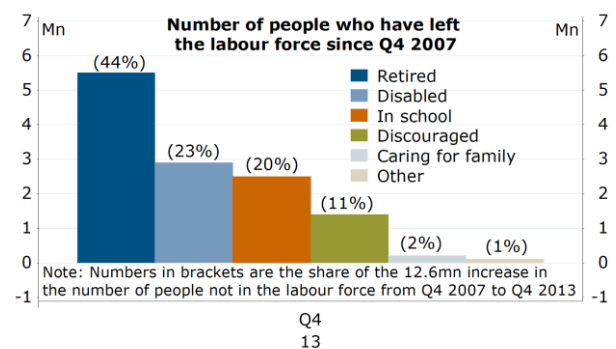
An increase in the number of discouraged workers – persons who have stopped looking for jobs because they don’t believe that any jobs are available for them – is only a minor factor in the decline in labour force participation. Thus, in late 2013 there were 490k discouraged workers more than normal relative to the size of the population. Returning all these persons

Explaining the decline in labour force participation

% of population	Q4 2007	Q4 2013	Change
In the labour force	66.0	62.8	-3.2
Not in the labour force	34.0	37.2	3.2
Do not want a job	32.2	34.9	2.8
16-24 years	6.1	6.6	0.5
25-54 years	8.2	8.6	0.4
55 years over over	17.8	19.7	1.9
Want a job	1.8	2.3	0.5
Marginally attached <sup>1</sup>	0.6	0.9	0.3
Discouraged workers	0.1	0.3	0.2

1) Available to work now. More precisely, persons “marginally attached to the labour force” are those who want a job, have searched for work during the prior 12 months, and were available to take a job during the reference week, but had not looked for work in the past 4 weeks. Note: Non-seasonally adjusted data.

Explaining the decline in labour force participation



back into the labour market would only boost the participation rate by 0.2% point and lift the unemployment rate by 0.3% point. (In comparison, unemployment has fallen by an average 0.08% point per month over the past year).

Moreover, many of the discouraged workers who have been out of the labour market for an extended period may lack the needed skills to return to the labour force any time soon.

A new [Atlanta Fed study](#) also supports our point that the primary drivers behind the decline in labour force participation over the past six years are of a more permanent nature.

Retirement and disability key reasons for leaving the labour force

According to this study, retiring workers account for 44% of the drop in labour force participation since late 2007 and an additional 23% has left the labour force because of disability (see chart). (At the end of 2013, 11 million Americans were on disability issuance, almost 6% of adults aged 20-64 years).

20% has left the labour force to go back to school, while discouraged workers – those who have left the labour force because they couldn't find a job – only account for 11% of the decline.

The fact that two-thirds of the drop in labour force participation can be attributed to either retirement or disability suggests that while the causes might be partly cyclical, the effects are largely structural/permanent. Once a worker has retired or dropped out of the labour force because of disability, the likelihood of his or her coming back to the labour market is believed generally to be small, as also suggested by a recent [Philly Fed study](#).

Employment-population ratio is misleading

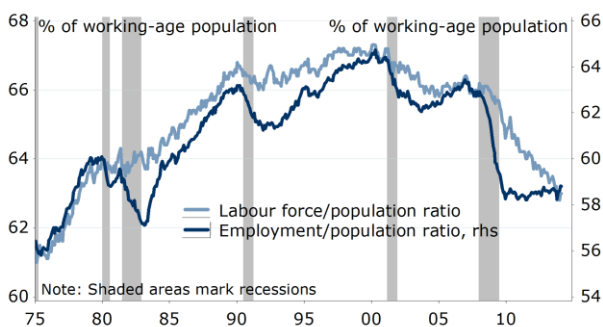
Due to the evidence indicating that long-term factors account for most of the decline in labour force participation since the crisis, we also believe that the employment-to-population ratio significantly overstates the degree of slack in the labour market. Interestingly, a recent [New York Fed study](#) reached the same conclusion.

Fed believes unemployment rate understates degree of slack

**Fed looking in the wrong direction?**

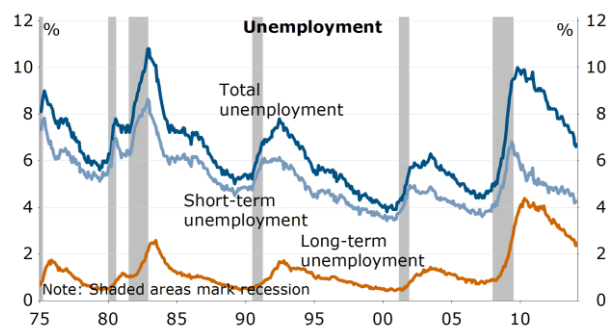
It is our impression the consensus at the Fed over the years has shifted from seeing the decline in labour force participation as mainly a cyclical phenomenon to now believing it is more permanent.

Employment-population ratio is misleading



Source: Nordea Markets and Reuters Ecowin

Short-term unemployment suggests little slack



Source: Nordea Markets and Reuters Ecowin

Nevertheless, the consensus at the Fed still seems to be that the decline in the unemployment rate may overstate labour market improvements and understate the degree of slack in the economy.

In making the case for keeping monetary policy highly accommodative Fed chairman Yellen – like her predecessor Bernanke – points to the fact that long-term unemployment is still elevated, making up an unusually high fraction of total unemployment.

Fed looking in the wrong direction?

However, by focussing on bringing long-term unemployed back to work before they are lost for good, the Fed might be missing an important inflation risk stemming from the fact that short-term unemployment indicates little, if any, slack. That is not to say that high long-term unemployment is not a serious problem that needs to be addressed. However, monetary policy may no longer be the best instrument.

Short-term unemployment indicates little, if any, slack

At 4.2% in February, the short-term unemployment rate (less than 26 weeks) is virtually back to where it was in December 2007, just before the recession (see chart on page 3). Long-term unemployment, however, is much higher now than it was then – 2.5% versus 0.9%.

Short-term unemployment a better predictor of wage growth

The low level of short-term unemployment is especially important for the inflation outlook. Thus, a recent [New York Fed study](#) found that short-term unemployment is a better predictor of wage growth than the total unemployment rate. The long-term unemployed, in essence, place no downward pressure on wages, because employers may be unwilling to hire them because of deteriorated job skills. This also helps to explain why the US economy didn't experience a larger fall in inflation in the wake of the recession when unemployment was much higher than today.

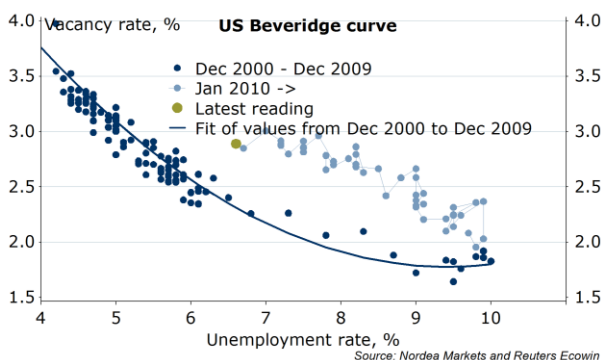
Numerous articles in American media over the past year have reported about discrimination against long-term unemployed in the job application process.

Recent research by [Robert Gordon](#) of Northwestern University suggests that the short-term NAIRU (Non-Accelerating Inflation Rate Of Unemployment) is currently around 4.3%. If that is correct, we should soon see higher wage increases, as also indicated by several leading indicators. We'll return to this discussion shortly.

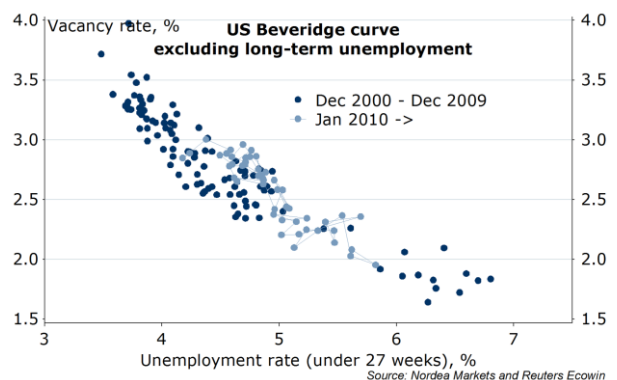
US labour market turning European

In 2005 an [ECB study](#) found that short-term unemployment predicted inflation in European economies better than total unemployment. This was less true for the US at the time, because short-term and long-term

Signs of a higher NAIRU...



... because of high long-term unemployment



unemployment had tended to move together. But in recent years the two have parted ways, and the new evidence supporting these so-called insider-outsider models for explaining movements in US wage rates suggests the US labour market in that sense has turned more European.

The fact that this evidence was published by the New York Fed could be a sign that the perception of inflation risks might be slowly shifting in a more hawkish direction at the Fed.

**Unemployment rate is likely overstating slack**

Unemployment rate is likely overstating slack

More generally, we dispute the widely-held idea that the unemployment rate understates the degree of slack in the labour market. As a matter of fact, we believe the unemployment rate is most likely overstating slack.

Signs of a higher NAIURU

For a long time we have argued that the high level of long-term unemployment is consistent with a significantly higher NAIURU than before the crisis – and a higher NAIURU than implied by Fed officials’ long-run estimates (in the range from 5% to 6%).

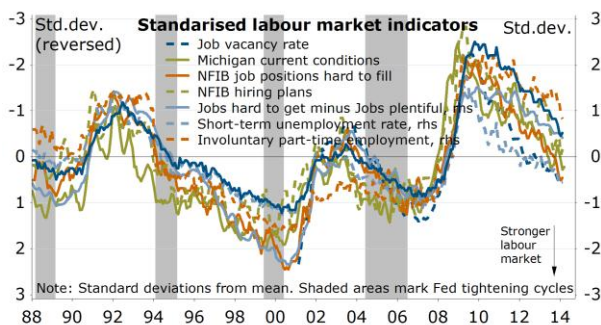
This is suggested by the so-called Beveridge curve, which has shifted out to the right since early 2010. As the chart on page 4 shows, the recent shift in aggregated labour demand as reflected in rising job vacancies has not been accompanied by a similar decline in the unemployment rate. The increase in structural unemployment seems primarily to reflect so-called hysteresis: the tendency of long-term unemployed to become unemployable. Thus, the Beveridge curve plotting the job vacancy rate against short-term unemployment does not show an outward shift (see chart).

[Robert Gordon](#) recently estimated that the NAIURU for the total unemployment rate (short-term plus long-term) has increased from 4.8% in 2006 to 6.5% in early 2013.

Indicators suggest unemployment rate overstates slack

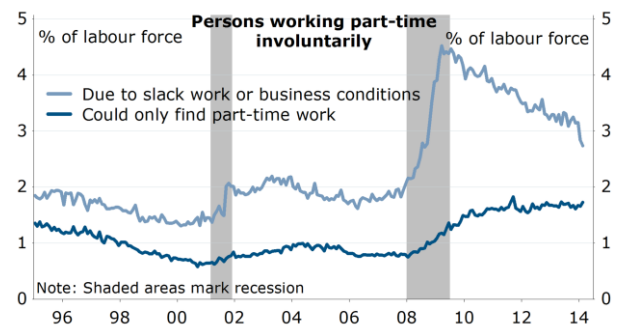
Other indicators also support the view that the labour market is tighter than suggested by the unemployment rate. The chart below shows various measures of labour market slack derived from entirely difference sources. While the unemployment rate is now about 0.5 standard deviation weaker than its long-term average, 4 out of the 7 other indicators are actually now stronger than their historical averages. As also indicated in the chart, some of these indicators are already in normal Fed rate hiking territory.

Unemployment rate might be overstating slack



Source: Nordea Markets and Reuters Ecowin

Still high involuntary part-time employment



Source: Nordea Markets and Reuters Ecowin

**High involuntary part-time employment – Obamacare partly to blame?**

Admittedly, one of the measures in the chart with standardised labour market indicators – involuntary part-time employment – points to more slack than suggested by the unemployment rate. This fact, alongside high long-term unemployment, is also raised by Fed chairman Yellen as an argument for keeping interest rates low.

High involuntary part-time employment partly due to structural factors?

Taken literally the data suggest that many companies, before hiring new workers, have the scope to simply increase the hours of these part-time workers as the economy strengthens. But here, too, we see evidence of problems beyond the power of monetary policy.

First, while those employed part time for clearly cyclical reasons (slack business conditions) are falling, those employed part time because they could not find full-time work are holding steady (see chart). This could suggest that the job skills of the latter group may not be consistent with the current types of full-time jobs.

Second, the persistent high level of involuntary part-time work might also at least partly reflect companies’ response to Obamacare’s employer mandate. Media stories have suggested that some employers are only hiring part-time workers to minimise the cost of expanded health coverage. The employer mandate requires businesses of 50-plus workers to offer health benefits to employees working more than 30 hours a week.

Factory workers putting in longest workweek since WWII

Finally, we also note that, just before the unusually bad weather hit the US in December, the average workweek for all private sector employees was back close to the peak level seen just prior to the recent recession (see chart). For factory workers, the 42-hour average workweek was actually the longest seen since World War II. Thus, in this respect the labour market seems pretty tight.

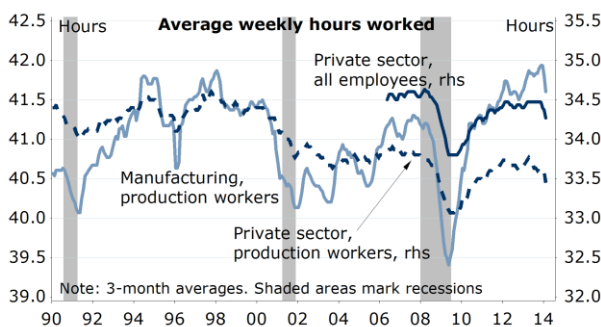
**Wage growth poised to take off**

Wage growth will ultimately settle the debate

Overall, we believe that even the factors Fed chairman Yellen has cited as evidence of slack in the labour market – high long-term unemployment and high involuntary part-time employment – are themselves largely structural and hence beyond the control of the Fed.

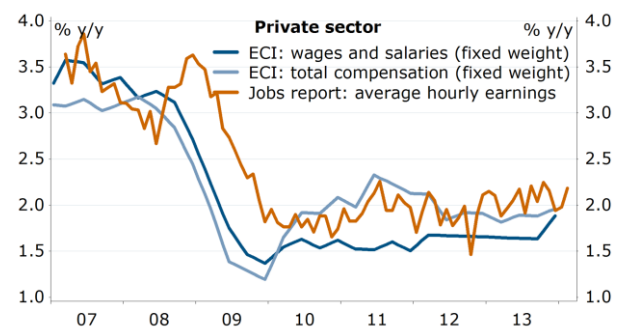
Anyway, wage growth will ultimately settle the debate about labour market slack. We will know – with a lag – that the recovery has evolved into a self-sustaining expansion with little slack when wage inflation starts to pick up.

Working longer hours (before the bad weather)



Source: Nordea Markets and Reuters Ecowin

Going forward, watch these data very closely



Source: Nordea Markets and Reuters Ecowin

Indicators point to higher wage growth

If wage acceleration does not occur, the degree of slack remains high.

The labour market is tightening, but it is objectively not tight as wage increases remain tame (see chart). But several leading indicators support our view that wage data will show more acceleration later this year as unemployment continues to trend down.

Increasingly difficult to find qualified workers

One of our preferred indicators is the NFIB small business survey series on the percentage of firms with hard-to-fill job vacancies. At 22% in February, it is close to where it was in January 2008 when unemployment was 5%.

As shown in the chart below, the NFIB series on labour market tightness points to what could be a fairly significant acceleration in wage growth this year, consistent with the view that short-term unemployment is much more important than long-term unemployment for wage pressures.

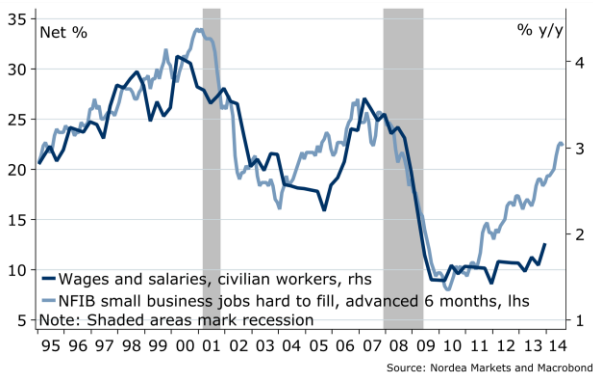
Indicators from the Conference Board's consumer confidence survey and the JOLTS survey on labour turnover also point to a pick-up in wage growth, although of varying degree (see charts).

Markets are pricing in a fed funds rate below the Fed's dovish rate path

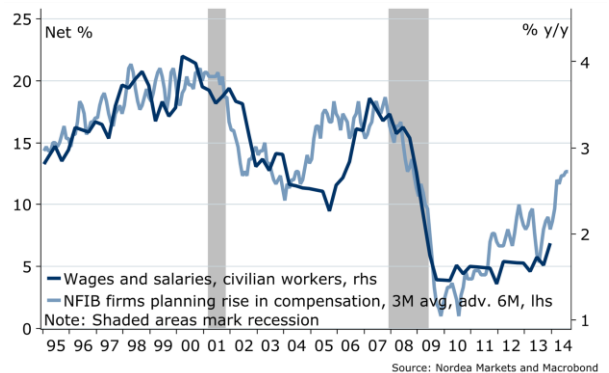
**Markets to start questioning the Fed's dovish forward guidance**

Financial markets are currently taking the Fed at its words that it will keep interest rates low for a considerable time. Actually, after yesterday's FOMC meeting when Fed officials slightly raised the projected path for interest rates in 2015 and 2016, markets are now pricing in a fed funds rate *below* the

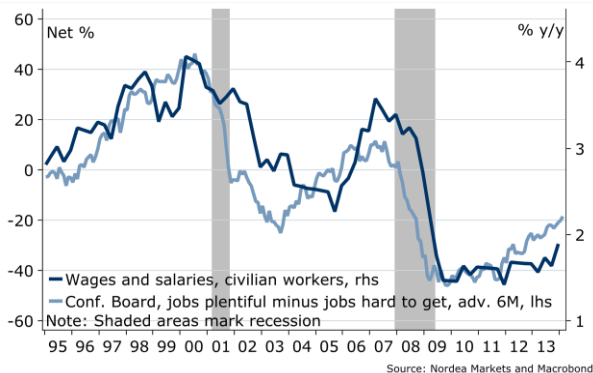
Reason to expect pick-up in wage growth



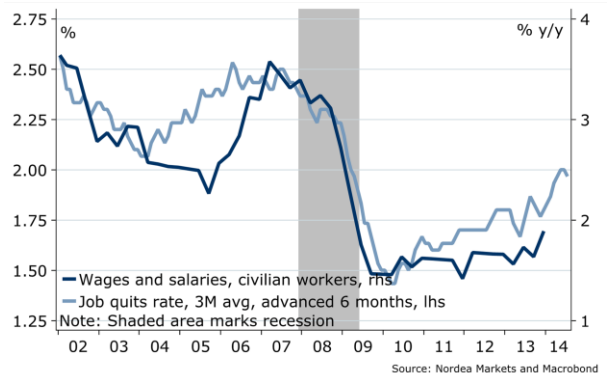
Reason to expect pick-up in wage growth



Reason to expect pick-up in wage growth



Reason to expect pick-up in wage growth



FOMC’s median forecast (see chart). For more on the FOMC meeting, see [US: Fed’s taper continues – more aggressive rate path](#).

As we have repeatedly emphasised, FOMC participants forecast just a 2.25% fed funds rate, or close to zero in real terms, by the end of 2016, even though the economy is projected to be back at full employment and inflation close to the 2% target at that point (see chart). The low fed funds rate contrasts with the participants’ estimate that the long-run neutral fed funds rate is 4%, which is consistent with the level implied by a standard Taylor model. For more analysis of the Fed’s current “irresponsible” rate guidance, see [Fed will get its inflation – time to start hedging](#).

Persistent headwinds seem to have faded

Fed officials argue that the neutral level for the fed funds rate even by end-2016 will be lower than normal due to persistent headwinds from the financial crisis. However, with real GDP, excluding the fiscal drag, expanding by at least 4% in the past year, or about double the potential growth rate, we believe most of these headwinds have already eased significantly. And the end of 2016 will be almost a full decade after the crisis began.

Markets expected later this year to start pricing in more Fed tightening

Our forecast of wage acceleration is the key reason we expect markets later this year to start questioning the Fed’s dovish forward guidance for the fed funds rate in 2015 and 2016. Even a modest acceleration in wages would likely encourage speculation that the Fed has overestimated the extent of slack in the labour market.

Watch these indicators very closely

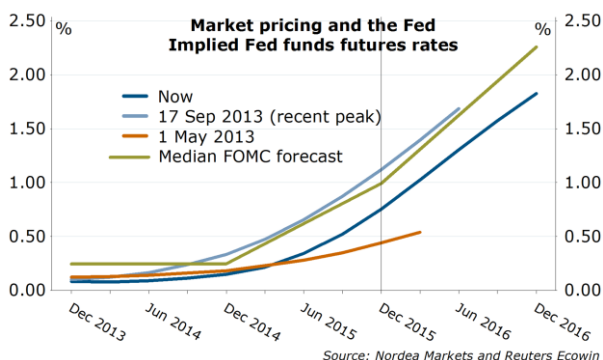
Thus, the trigger for markets to start pricing in significantly more Fed tightening is expected to be clear signs of increasing labour cost pressures. We will closely monitor average hourly earnings in the monthly employment reports and the quarterly fixed-weight employment cost indices (ECIs, see chart). (Our forecast is that average hourly earnings growth in the private sector will reach 2½-3% y/y by end-2014, up from a 2.2% pace over the past year).

Higher USD rates and a stronger USD

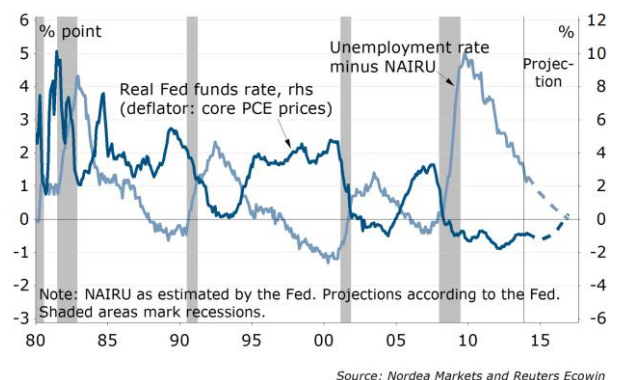
If we are right, USD rates will start trending up again. Especially in the 2-5 year segment of the curve, we believe, and for the same reason we remain optimistic on the longer-term outlook for the USD.

We believe that clear signs of wage acceleration will make the Fed more confident that the recovery has evolved into a self-sustaining expansion. The first Fed rate is therefore still seen in Q1 2015, with the fed funds rate reaching 1.25% by end-2015 – a level which, in our view, would still imply

Markets take the Fed at its (“irresponsible”) word



Unsustainable: Fed promising to be “irresponsible”



a very accommodative monetary policy, especially considering the Fed's USD 4½ trillion balance sheet (almost 25% of GDP) at that point.

We expect 2-year Treasury yields to rise to 1.00% by end-2014 and 2.25% by end-2015. For 10-year Treasury yields our forecasts are 3.25% and 3.90%, respectively. Our EUR/USD forecast is 1.30 by end-2014 and 1.25 by end-2015.

For more on the longer-term outlook for USD rates, see [Insights: The secular bond bull market will not return](#).

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