Economic Indicator — April 30, 2024

Q1 ECI Delivers Another Setback for the Fed's Inflation Fight

Economist(s)

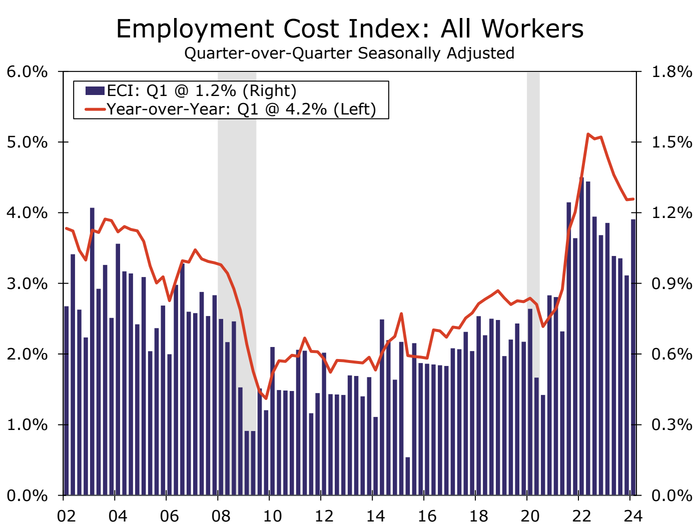
Sarah House
Senior Economist | Wells Fargo Economics
Sarah.House@wellsfargo.com | 704-410-3282

Michael Pugliese
Senior Economist | Wells Fargo Economics
Michael.D.Pugliese@wellsfargo.com | 212-214-5058

Summary

The Q1 reading for the Employment Cost Index (ECI) was yet another data point suggesting that progress on inflation is stalling out. The ECI is the Fed's preferred measure of labor cost growth, and the 1.2% quarter-over-quarter increase was stronger than consensus expectations for a 1.0% gain. An equally-high reading one year ago kept the year-over-year gain stuck at 4.2%. Seasonal factors may not quite be fully capturing the wage and benefits dynamics at the start of the year, but otherwise the details were not suggestive of many one-off quirks. Private sector employment costs jumped sequentially, and excluding sometimes volatile incentive paid occupations did nothing to dampen the gain.

On balance, today's ECI reading is not the end of the world for the FOMC, but it is yet another data point that suggests the inflation slowdown that began this time last year stalled out in the first quarter of 2024. We expect the FOMC to hold the federal funds rate steady at its next few meetings, leaving plenty of time to ascertain whether the Q1 data is a bump in the road or a canary in the coal mine. Signs of faltering labor demand, declining labor market turnover and still solid labor supply suggest to us that employment costs will decelerate further as the year progresses. But, it will take time to see that in the data, and this is why we think the FOMC will keep rates unchanged through at least the summer.



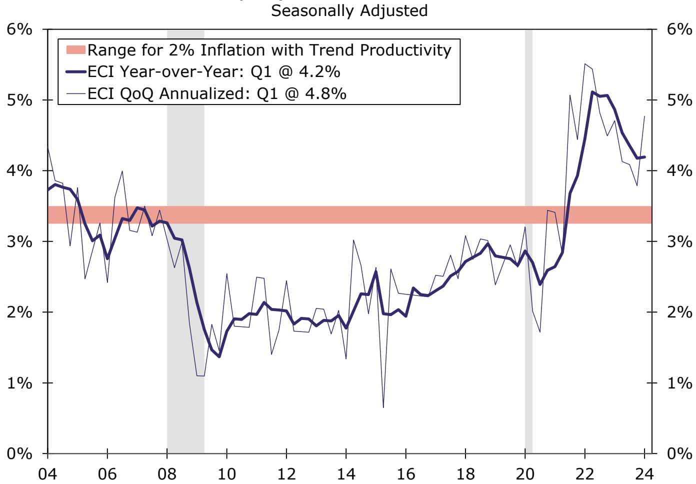
Source: U.S. Department of Labor and Wells Fargo Economics

Broad Pickup in Q1 Employment Costs Keeps Work Cut Out for Fed

The first quarter Employment Cost Index (ECI) delivered another setback in the Fed's fight against inflation. The ECI capped off a quarter of price growth coming in stronger than expected, with labor costs over the quarter advancing 1.2% versus consensus expectations for a 1.0% gain. On a year-ago basis, compensation costs are up 4.2%, an improvement from this time last year (4.8%) but unchanged from Q4 in the latest sign progress, in lowering inflation stalled early this year (chart).

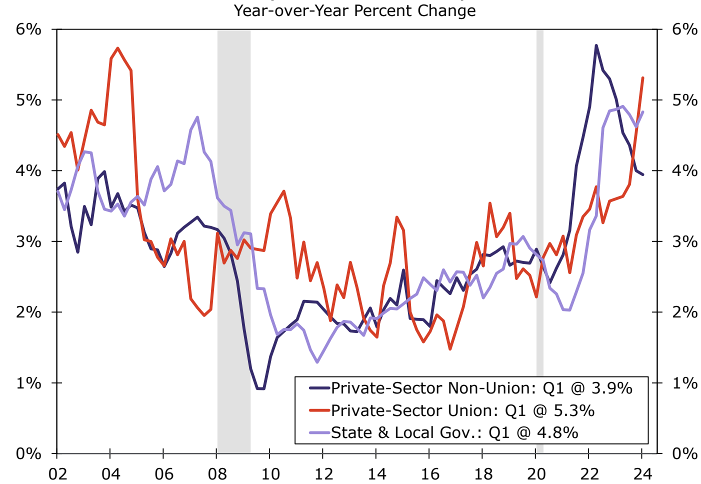
The pickup in Q1, from a 0.9% increase in Q4, is particularly disappointing given that the ECI tends to offer the cleanest and most encompassing read on labor costs and thus is the Fed's preferred gauge of inflationary pressures from the labor market. Unlike the more timely average hourly series from the monthly employment report, the ECI controls for compositional shifts in the economy's jobs and includes compensation growth for public sector workers. It also includes the cost of employee benefits, which account for about one-third of compensation.

Employment Cost Index
Seasonally Adjusted



Source: U.S. Department of Labor and Wells Fargo Economics

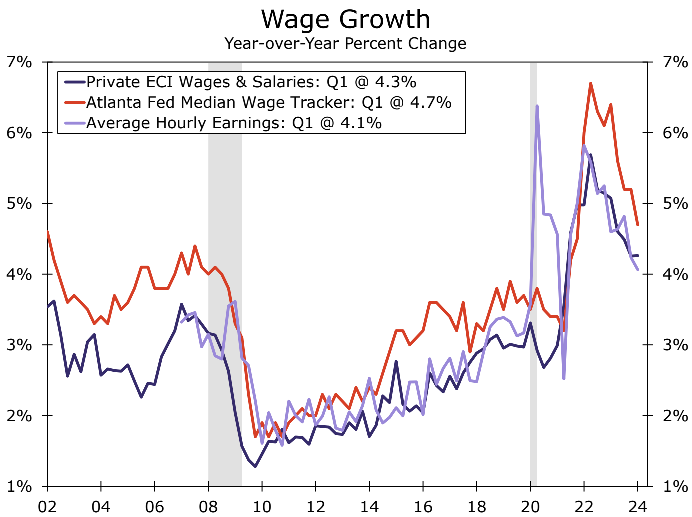
ECI Compensation Comparison
Year-over-Year Percent Change



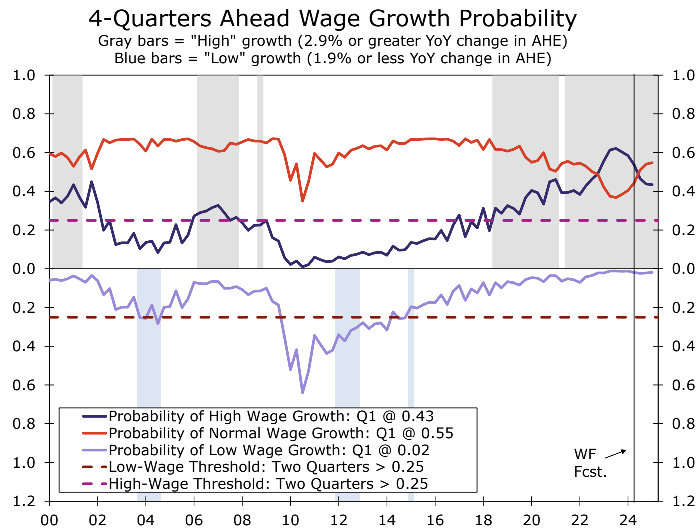
Source: U.S. Department of Labor and Wells Fargo Economics

The details of the report were broadly consistent with labor cost growth that rebounded in Q1. Excluding the sometimes volatile incentive paid occupations, employment cost growth was actually a touch stronger than the headline reading. Benefit costs for all workers were up 1.1% quarter-over-quarter, the biggest increase since Q1-2023. Both private sector (+1.1%) and state & local government workers (+1.3%) saw sequential compensation gains that were stronger than the Q4 readings. Over the past year, employment costs have decelerated the most in the more cyclically-sensitive private sector non-union industries. After lagging for much of the expansion, compensation cost growth for state & local government and private sector union workers has rapidly caught up in recent quarters (chart).

The ECI was not alone in registering a pickup in Q1—average hourly earnings rose at a 4.4% quarterly annualized rate after advancing at a 3.6% clip in Q4. However, similar to the ECI, average hourly earnings and the Atlanta Fed's median wage tracker show labor cost growth subsiding over the past year, with the year-over-year pace of both series increasing at the slowest pace in more than two years in Q1 (chart).



Source: Federal Reserve Bank of Atlanta, U.S. Department of Labor and Wells Fargo Economics



Source: Wells Fargo Economics

While labor costs posted a solid sequential increase, we believe the overarching trend remains downward. Hiring has remained robust in recent months, yet the jobs market is not tightening thanks to solid growth in labor supply. Our wage growth estimation framework shows the probability of "high" wage growth in the year ahead declined in Q1 for the sixth consecutive quarter (chart). "High" wage growth is defined as a year-over-year increase of 2.9% or higher (one standard deviation above the pre-pandemic cycle's average of 2.4%) in average hourly earnings (AHE). The ebbing likelihood of "high" wage growth has coincided with a rising probability of "normal" wage growth, defined as a 2.0%-2.8% year-ago change in AHE. We are skeptical wages will decelerate that much in the year ahead, but the Q1 model output suggests the labor market's inflationary impulse will ebb further as the year progresses.

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	212-214-1164	Jeremiah.J.Kohl@wellsfargo.com
Aubrey George	Economic Analyst	704-410-2911	Aubrey.B.George@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures