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Q2 ECI: Inflation Pressures from Jobs Market Subsiding

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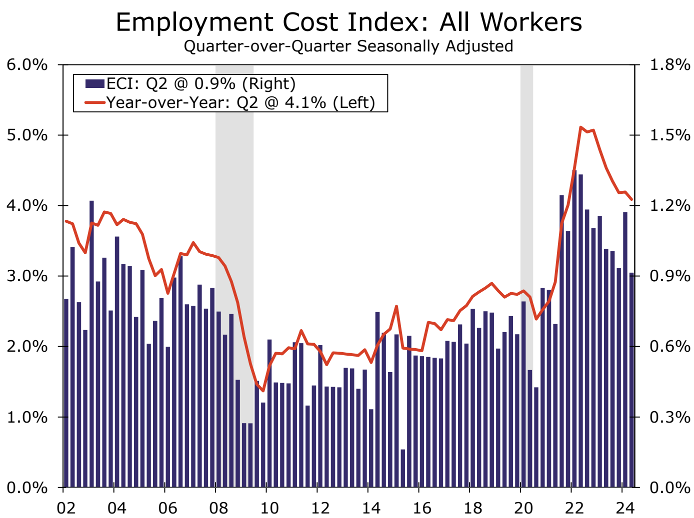
Summary

The second quarter Employment Cost Index offers the latest sign that the downward trend in inflation is back on track after a derailment at the start of the year. The ECI came in touch softer than expected, advancing 0.9% over the quarter, or at a 3.7% annualized rate. The second quarter's moderation leaves it closely approaching a pace consistent with the Fed's inflation goal once accounting for productivity. With the ECI the Fed's preferred barometer of labor costs growth, today's data mark an important step toward the FOMC gaining "greater confidence" that inflation is cooling sufficiently to begin reducing the fed funds rate.

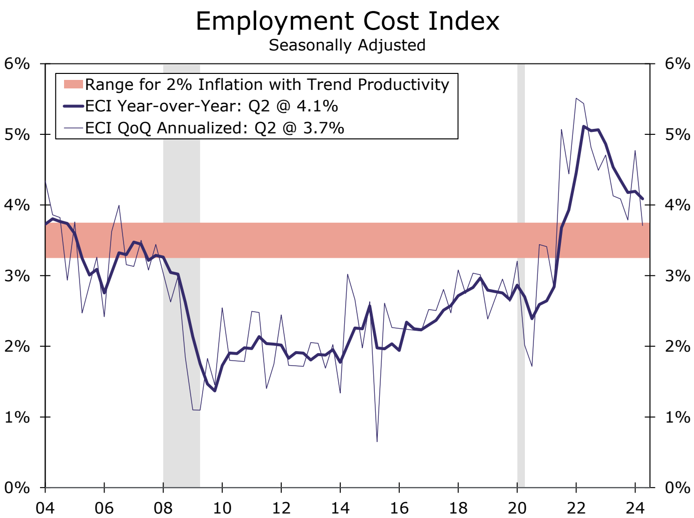


Source: U.S. Department of Labor and Wells Fargo Economics

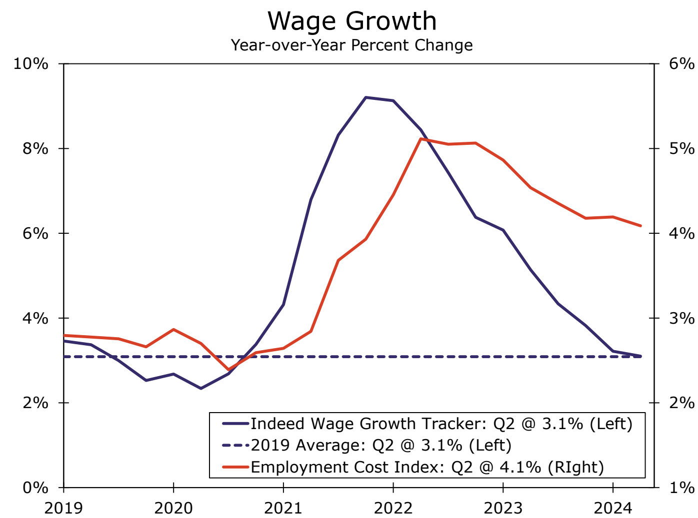
Back on Track

Second quarter data on employment costs showed further signs that the Fed's efforts to reduce inflation pressures are bearing fruit. The Employment Cost Index rose 0.9% over the second quarter, which was a touch softer than consensus expectations. While still noticeably above last cycle's peak of 2.9%, employment cost growth slowed to 4.1% year-over-year in Q2, the smallest gain in two and a half years. Moreover, having increased at an annualized rate of 3.7% in the three months ending in June (chart), the second quarter's figures show employment cost growth closely approaching a pace consistent with the FOMC's 2% inflation objective once accounting for productivity growth (productivity gains allow businesses to raise compensation faster than prices).

The second quarter's moderation in employment cost growth jibes with other signs of labor costs slowing. Average hourly earnings growth slowed to 3.9% year-over-year in the second quarter, while the newer and more forward-looking measure of posted wages from Indeed slipped to 3.1% to move back in line with its pre-pandemic average (chart). But importantly, the Employment Cost Index is considered the gold standard among Fed officials as it controls for compositional shifts in the economy's jobs and is a more encompassing measure than average hourly earnings. The ECI accounts for the cost of employer provided benefits—which are just over 30% of total compensation costs—in addition to wage & salaries. It also includes labor cost growth for public sector workers in addition to private sector workers. As a result, the ECI's moderation in Q2 marks an important step for the FOMC obtaining “greater confidence” that inflation is subsiding back toward 2%.

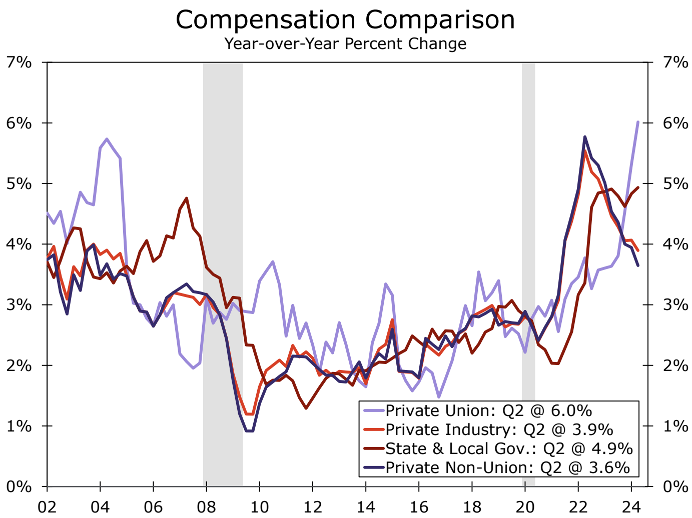


Source: U.S. Department of Labor and Wells Fargo Economics

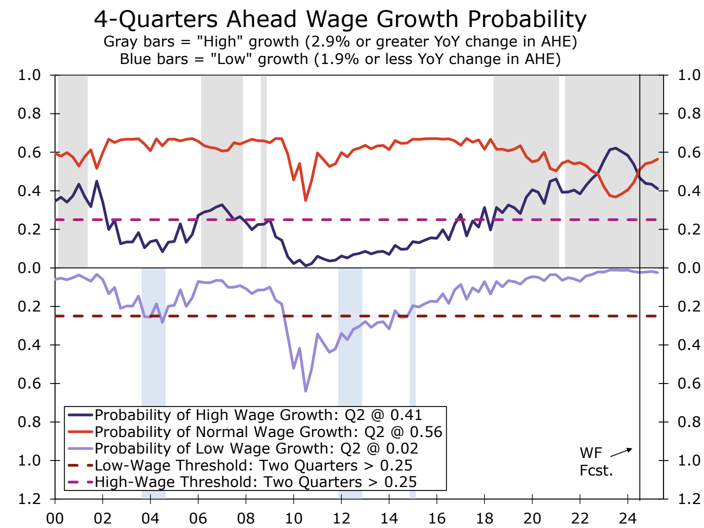


Source: Indeed Hiring Lab, U.S. Department of Labor and Wells Fargo Economics

After a widespread pickup in the first quarter, the drivers of the second quarter's moderation in employment cost growth were broad-based. The reversal, like other recent readings on inflation, hints at potential seasonal adjustment issues around price increases at the start of the year. Private sector compensation cost growth advanced 0.9% over the quarter after a 1.1% rise in Q1, with wages & salaries and benefit cost growth moderating. The slowdown came despite another hefty increase to private sector union workers (+1.6%) to help catch up to the compensation gains with non-union workers since the start of 2020. Public sector employment costs also eased over the quarter but are still running ahead of private industry gains over the past year after having initially lagged this cycle (chart).



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



Source: Wells Fargo Economics

We expect employment costs to slow further ahead. As demonstrated in yesterday's JOLTS report, employee retention has greatly improved, while waning demand for workers and growing pool of unemployed workers are lessening the extent to which employers need to raise compensation to retain existing or attract new workers. Our forward-looking framework points to a continued easing in wage pressures. The probability of “normal” wage growth in the year ahead rose for the seventh consecutive quarter to 56% in Q2, or its highest since late 2020. We define “normal” as average hourly earnings (AHE) growth that falls within a range of 2.0%–2.8% on an annual basis, which is one standard deviation from the past business cycle's average. The framework has deemed “normal” wage growth as the most likely scenario for four straight quarters, as the steady loosening in labor demand has underpinned a gradual slide in the probability of "high" wage growth (AHE of 2.9% or higher). While average hourly earnings are more volatile than the ECI, our framework signals that the labor market's inflationary impulse will wane in the coming year.

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