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Economic Indicator — July 30, 2021

Employment Costs Rise Strongly, but Not Running Away

Summary

Employment costs rose 0.7% in Q2. That was slower than expected amid a weakening in benefits growth and lackluster private wage growth relative to the recent readings on average hourly earnings. Nevertheless, labor costs are up 2.9% over the past year and match the high watermark of the past cycle, as inflation pressures have broadened out.

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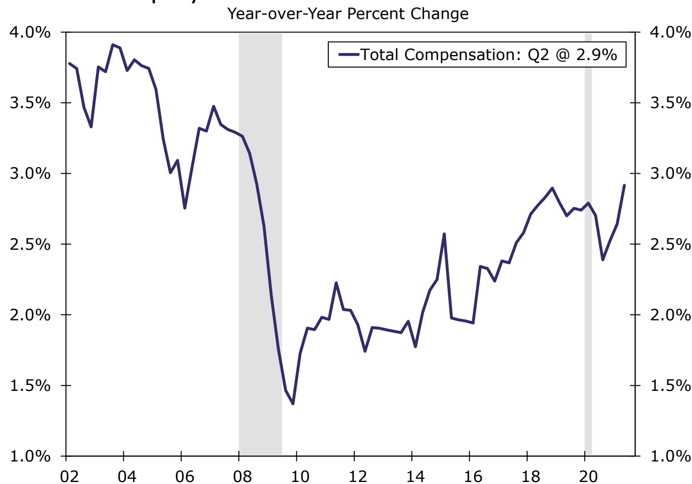
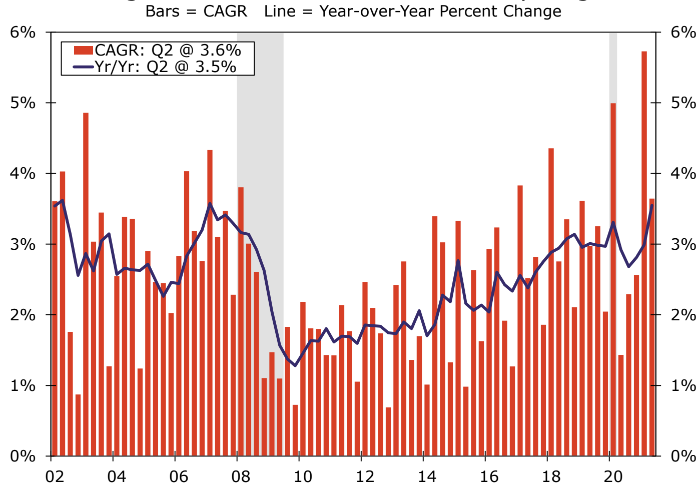
Q2 Wage Costs More Subdued than Recent Average Hourly Earnings Indicate

Recent average hourly earnings data from the monthly employment reports have suggested that wage growth has been on a tear as employers scramble to attract and retain workers. Average hourly earnings for private sector workers were up 1.4% from March to June. That was an impressive feat considering lower-pay sectors like leisure & hospitality, retail and transportation & warehousing accounted for an outsized share of job gains, but reflected that employers in those industries were raising wages at a breakneck pace. Today's Employment Cost Index suggests compensation is rising at a more moderate rate. The ECI rose 0.7% over the three months ending in June. That marked a slowdown from Q1, where compensation costs increased 0.9%.

Wage & salaries growth came in stronger than the headline, increasing 0.9% and 1.0% for industry workers. That still fell short of the gain in AHE over the quarter, even before accounting that the AHE numbers faced compositional headwinds recently with lower-paying jobs being added more quickly. The ECI has a few advantages over the average hourly earnings series, in our view. The first is that it controls for shifts in the composition of the workforce, as already alluded to. That was particularly useful a year ago, when lower-paid jobs declined severely, sending average hourly earnings soaring. Another is that the ECI tracks benefits costs, which we discuss shortly. It also captures pay and benefits for the public sector. A disadvantage of the ECI, however, is that it samples only about 6,000 private industry establishments compared to 144,000 businesses in the average hourly earning series. We are therefore inclined to put more weight on the signal coming from the average hourly earnings data: labor has gotten notably more expensive as of late.



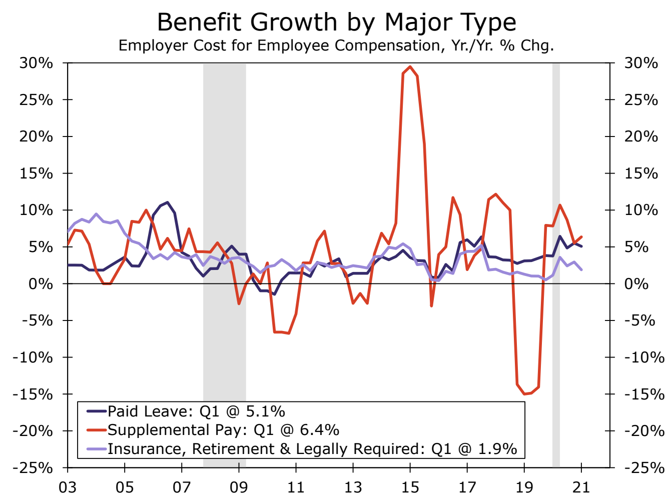
Source: U.S. Department of Labor and Wells Fargo Securities



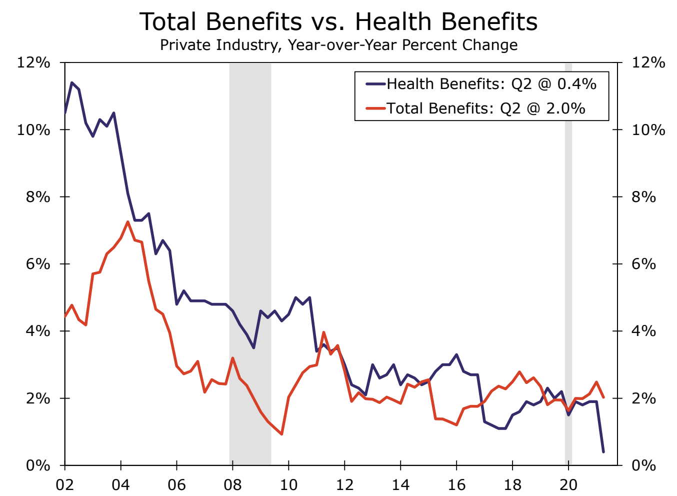
Source: U.S. Department of Labor and Wells Fargo Securities

Benefit Growth Takes a Breather

The slowdown in benefit cost growth also surprised us. Benefits rose just 0.4%, the smallest gain in six years, and is entirely traceable to the private sector. The slower benefit costs growth came despite ubiquitous anecdotes of employers offering signing bonuses and more paid leave. A full-fledged breakdown of the type of benefits employers are doling out more for will not be available until mid-September with the second quarter release of the Employer Cost for Employee Compensation (ECEC) report. Data through the first quarter, however, showed employers were already leaning more heavily on paid leave and non-production bonuses, which are part of supplemental pay (see chart). That trend seemed to strengthen in recent months; the Fed's July Beige Book noted all districts heard of businesses increasing the use of non-wage cash incentives to attract and retain workers. It may be that these benefits have yet to be paid out, considering that in many cases they seem contingent on workers staying with a firm for a given period of time. Instead, it appears the slowdown was likely traced to healthcare benefits, which eased to 0.4% year-over-year.



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



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

Labor Supply Remains Key to Wage Outlook

Even with today's surprisingly soft readings for Q2, overall, employment costs have risen 2.9% over the past year. That matches the high watermark of the past cycle and illustrates inflationary pressures have broadened beyond physical inputs and transportation costs. We expect employment cost pressures to remain intense for at least another couple of months, with labor demand continuing to far exceed supply for jobs at this unique moment. Job openings, voluntary quits and the share of businesses reporting at least one job "hard to fill" are all well-above previous highs.

While the inability for firms to find workers has held back the overall pace of hiring since the early spring, we expect workers to return to the labor market in greater force over the next few months. Not only are current constraints like extra unemployment benefits and childcare issues expected to fade, but the payoff of going back to the jobsite has become more lucrative with strong compensation growth. Employers should be less desperate for workers as a result, which we expect will keep compensation cost growth from breaking significantly higher. However, there remains a good degree of risk of that the labor supply does not return as easily as business' policymakers hope, keeping upward pressure on labor costs and preventing inflation from easily falling back to the Fed's 2% inflation goal.

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