WELLS FARGO

Special Commentary — July 30, 2021

The Probability of High Wage Pressure Increases in Q2

Beware of the Persistent Rise in the Probability of High Wage Pressure

Summary

As measured by the Employment Cost Index (ECI), the sequential increase in compensation in private industries slowed to 0.8% in Q2, dragged down by slower benefits growth. The moderation came as a bit of a surprise given the plethora of survey evidence suggesting that firms have been raising compensation to bring in new workers. That said, wages & salaries were a bit stronger than the headline number. The 1.0% increase in the second quarter puts wages & salaries up 3.6% versus a year ago, more in line with the strong wage increases shown in the monthly employment reports.

Looking forward, our model to predict wage growth in the coming quarters suggests the probability of high wage pressure increased in Q2 to 43% from 38% in Q1, notching its 16th consecutive quarter above the 25% threshold. Higher wage growth could provide a more persistent boost to inflation, beyond the supply-related drivers detailed in our The Chains That Bind series, as employers pass on their higher labor costs to consumers. To what extent wage growth feeds through to broader inflation, however, will depend on productivity and pricing power.

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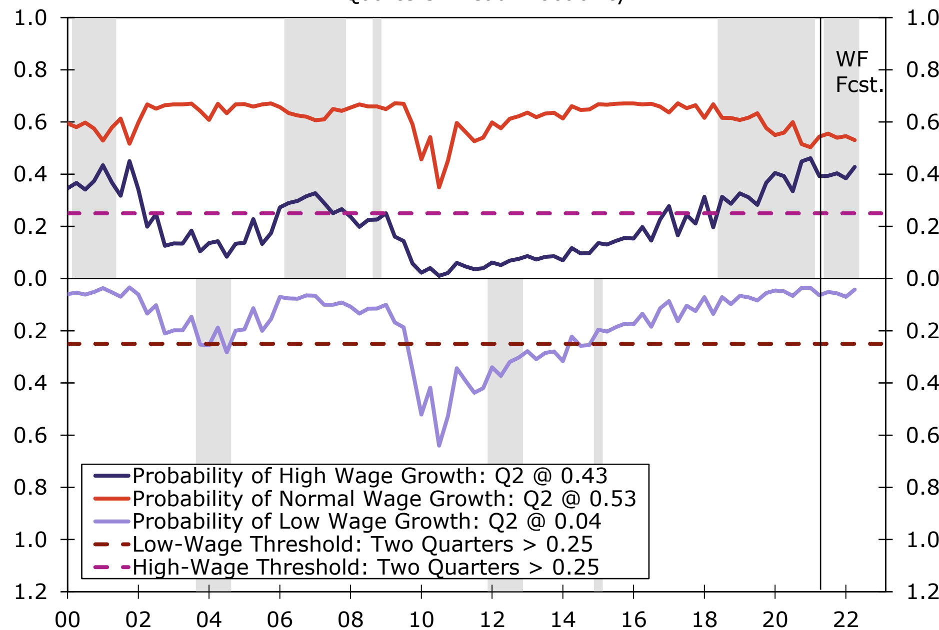

Source: Wells Fargo Securites

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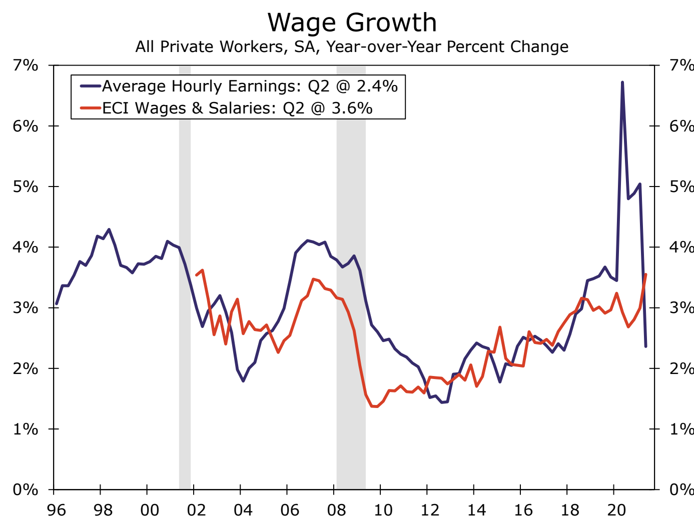
Predicting the Probabilities of Wage Growth Scenarios

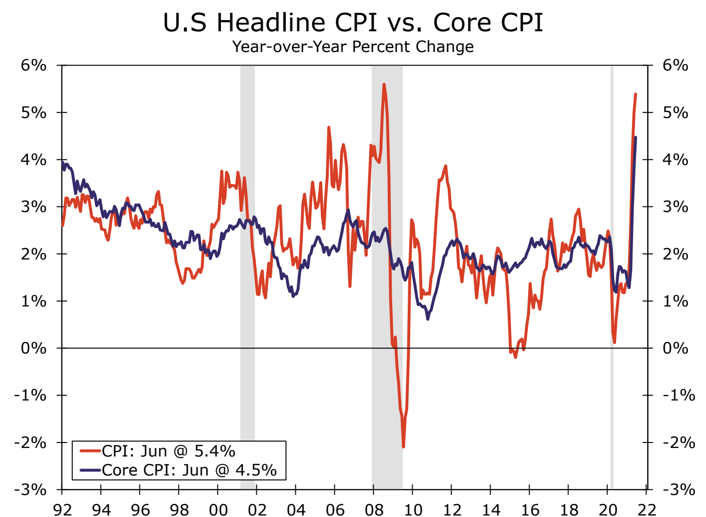
The probability of high wage growth came in at 43% in Q2, marking the 16th consecutive quarter above the high wage threshold. Specifically, this quarter's reading suggests there is 43% probability that growth in average hourly earnings (AHE) will exceed 2.9% a year from now. We define "high" wage growth as a wage inflation rate that is more than one standard deviation *above* the cycle mean, and "low" wage growth as a wage inflation rate that is more than one standard deviation *below* the cycle mean. For example, the average year-over-year percent change in AHE from Q3-2009 to Q4-2019 cycle was 2.4% with a standard deviation of 0.5 percentage points. As we look ahead, we use the criteria of the past cycle, so high wage growth four quarters ahead would be a year-over-year increase in AHE of 2.9% or higher, while low wage growth would be 1.9% or less. "Normal" wage growth would lie *between* these two reference points (for more details on the model see Will the Trend of Wage Acceleration Continue?).

It is worth noting that our wage growth model aims to predict trends in AHE, which has been distorted by compositional shifts in the labor market during the COVID crisis. That said, the ECI and AHE have historically had a fairly high correlation, and the ECI has averaged 2.5% over the past 16 quarters, which is higher than the average (1.9%) of the first-half of the last cycle, consistent with the model's estimates.

The results of our analysis are shown in the chart above. Periods of high wage growth are denoted by the gray vertical bars above the centerline. Upward trends in the probability of high wage growth are often followed by periods of wage growth exceeding one standard above the cycle average. This is especially true when the estimated probability of high wage growth exceeds the 25% threshold.



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



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

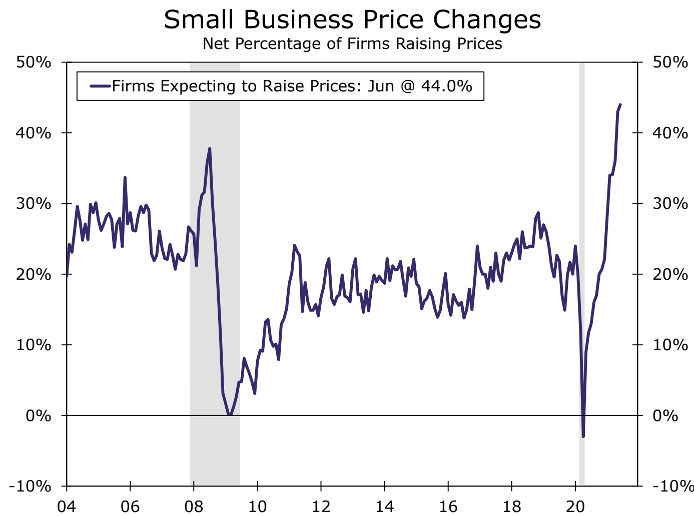
A Period of Higher Wage Inflation for the U.S. Economy?

It is possible that this faster wage growth could provide a more persistent boost to inflation if employers decide to pass on the additional labor cost rather than cut into profit margins. At the moment, it does not appear that the FOMC is too concerned with this sort of cost-push inflation. When asked in his press conference on Wednesday whether he was worried about rising wages feeding into inflation, Fed Chair Powell noted that wages have picked up, but not in a disconcerting fashion, saying "there is a form of wage inflation that can lead to price inflation, and we're not seeing that right now." Similar to his characterization of other forms of inflation, it appears that the Fed Chair believes the recent acceleration in wages may subside as the labor supply starts to normalize.

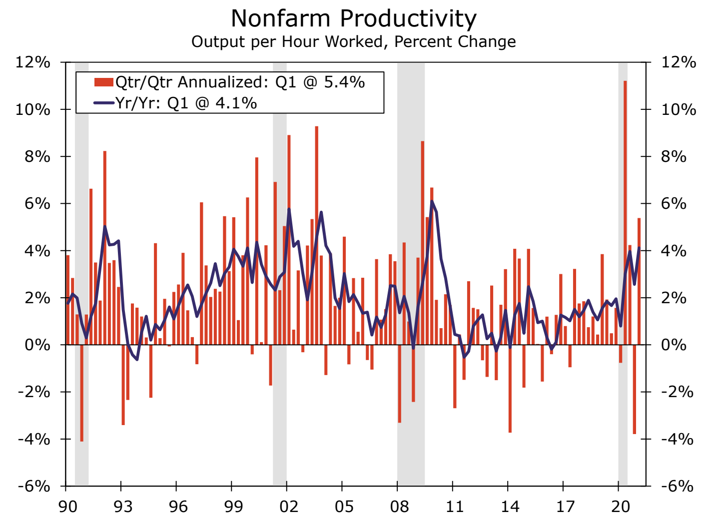
Even if the current degree of wage inflation is transitory, it is unclear to what pace wage inflation will revert. Our model seems to suggest that wage growth is unlikely to return to the lows experienced after the Great Recession. If it returns to its 2019 pace or higher, wages could provide a boost to inflation. Exactly how large of a boost, however, will depend on pricing power and productivity. With the highest net percent of small businesses planning to raise prices since 1981 and increases in consumers' inflation expectations, it seems that firms do not anticipate any problems passing their

higher costs on to consumers (for more on firms' pricing power, see The Chains that Bind: Profits & the Courage to Pay Up).

Firms may not need to raise prices, however, if they are able to get more output for the same hours worked. To that end, productivity has picked up recently. Although some pick up in productivity growth is to be expected coming out of a recession, there is also some reason to believe the shift to a more flexible working arrangements and increased investment spending could translate to a more durable acceleration in productivity. In the late 1990s, the adoption of new technology helped boost productivity growth, which coincided with a slowdown in inflation, but whether productivity will be the panacea this cycle remains to be seen.



Source: NFIB and Wells Fargo Securities



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

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