US Daily: Has Wage Growth Slowed? (Briggs)

- Wage growth measures are sending conflicting signals. Average hourly earnings have decelerated meaningfully in the first half of this year, while the Atlanta Fed's Wage Tracker has instead accelerated.
- The Q2 release of the employment cost index (ECI) this Friday will help to clarify the current underlying pace of wage growth. We forecast that the ECI rose by a firm 1.2% (not annualized) in Q2 (vs. 1.4% in Q1), both because we think the underlying pace of wage growth remains fairly strong and because the ECI has undershot other wage measures so far during the pandemic, suggesting that it has some catching up to do.
- We expect wage growth to slow going forward for a few reasons. First, the firmness in wage growth in 2021 and early 2022 likely partially reflected one-off factors related to the pandemic that are no longer relevant. Second, the breadth of wage increases has fallen in recent months. Third, forward-looking wage growth expectations have started to moderate.
- We forecast that wage growth will slow to 4½% year-on-year by end-2022 and to under 4% by end-2023 before settling at the 3½% pace we estimate is compatible with the Fed's 2% inflation target in 2024.

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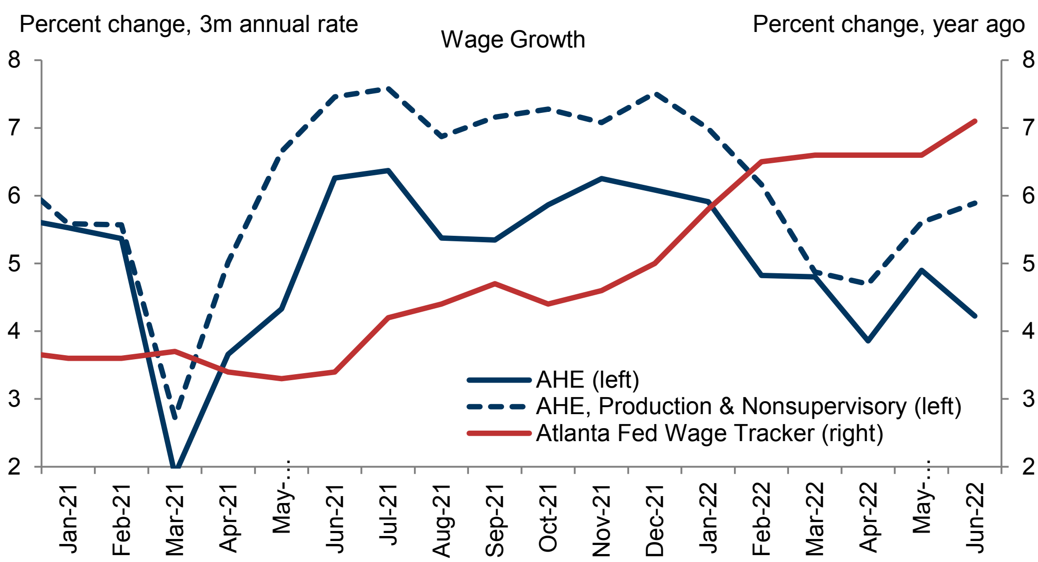
Has Wage Growth Slowed?

Wage growth measures are sending conflicting signals. Average hourly earnings decelerated to just over a 4% annualized pace after having run 5-6% over the last year, and wage growth for production and nonsupervisory workers points toward a similar deceleration. In contrast, the Atlanta Fed's Wage Tracker accelerated to a 7.1% year-over-year pace in June. Although the sequential wage growth pace in Q2 is hard to distill from the year-over-year growth rate—which is the only measure the Atlanta Fed provides—the 1.5pp pickup implies a sequential acceleration (Exhibit 1).

Exhibit 1: Average Hourly Earnings Signal Slowing Wage Growth but the Atlanta Fed Wage Tracker Accelerated in Q2

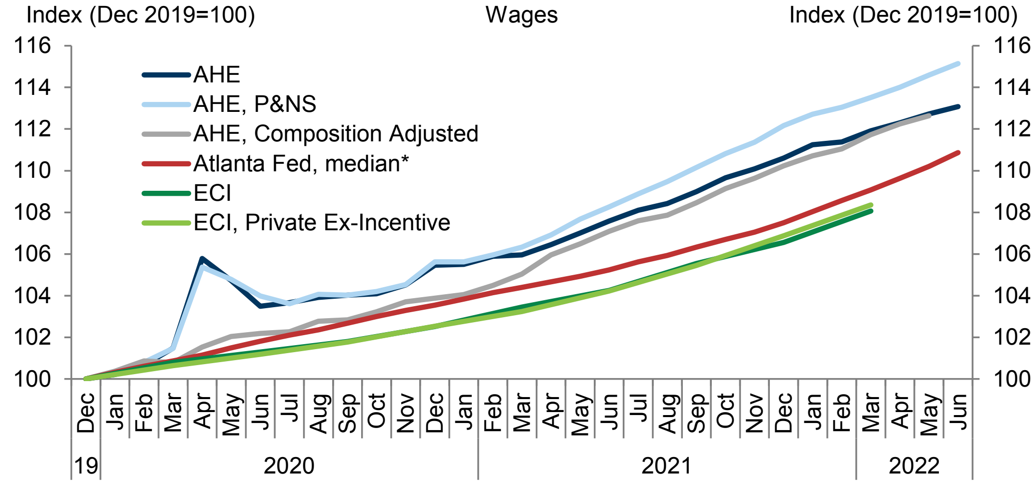


Source: Department of Labor, Federal Reserve, Goldman Sachs Global Investment Research

The Q2 release of the employment cost index (ECI) this Friday will help to clarify the current underlying pace of wage growth. We forecast that the ECI rose by 1.2% (or 4.9% at an annualized rate) in Q2, representing a sequential slowdown from the 1.4% (5.8% annualized) pace in Q1, but above the 4.2% annualized pace implied by average hourly earnings in Q2.

A key reason that we expect the ECI to grow at a faster pace than average hourly earnings in Q2 is that the level of the ECI has undershot the levels of other wage measures since the pandemic began (Exhibit 2), including those that should be similarly unaffected by shifts in workforce composition, namely the Atlanta Fed Wage Tracker and composition-adjusted average hourly earnings. This undershoot suggests that the ECI has some catching up to do. We expect this to be partially offset by a roughly 0.1pp drag from a decline in incentive compensation due to slower real estate and credit intermediation activity in Q2.

Exhibit 2: The Employment Cost Index Has Risen Less Than Other Wage Measures, Suggesting That It Has Some Catching Up to Do

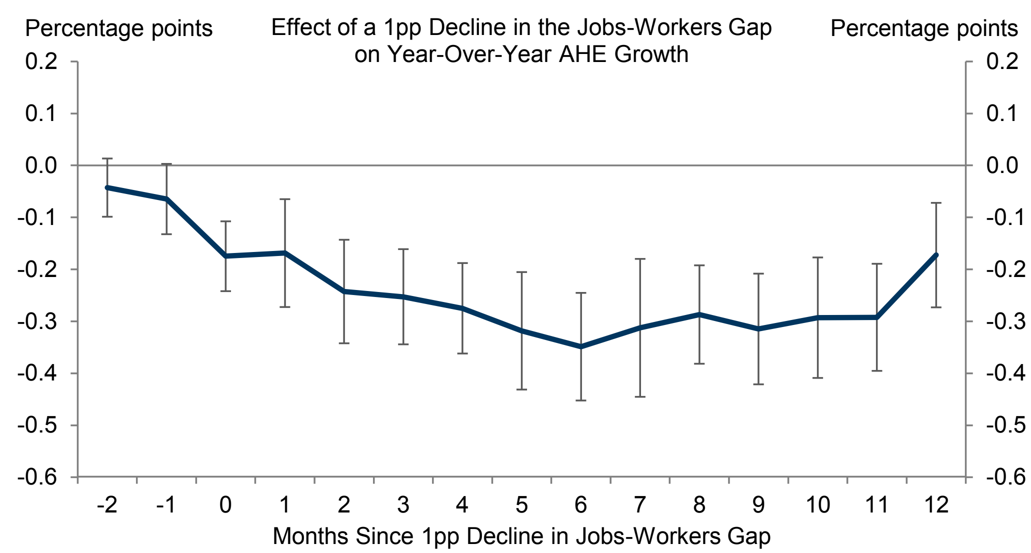


* Month-on-month growth rates estimated from year-over-year observations by assuming that annual

Source: US Bureau of Labor Statistics, Bureau of Economic Analysis, US Federal Reserve Bank, Goldman Sachs Global Investment Research

Another reason we expect firm ECI growth in Q2 is that the labor market remains very imbalanced and we still think the underlying pace of wage growth is fairly firm. The jobs-workers gap has declined only modestly from 5.9mn in March to 5.3mn in May, and the hit from increased labor market slack typically phases in over 6 months (Exhibit 3). These patterns suggest that the limited narrowing we have seen in the labor demand-supply imbalance probably had only a small effect on wage growth in Q2.

Exhibit 3: It Is Still Too Early for the Recent Softening of the Labor Market To Weigh on Wage Growth



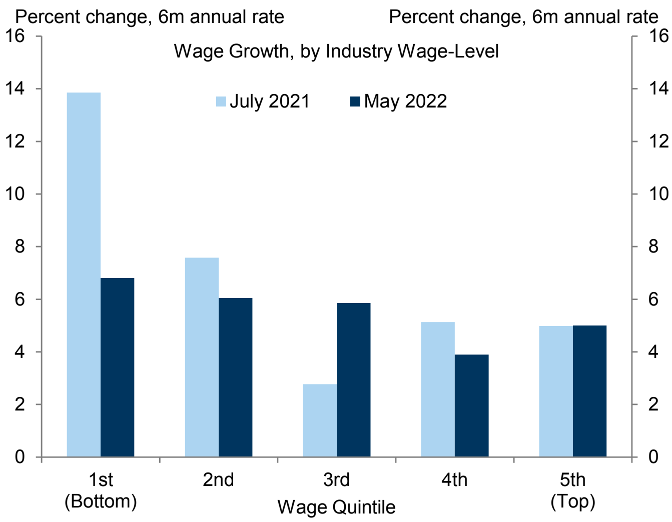
Source: Department of Labor, Goldman Sachs Global Investment Research

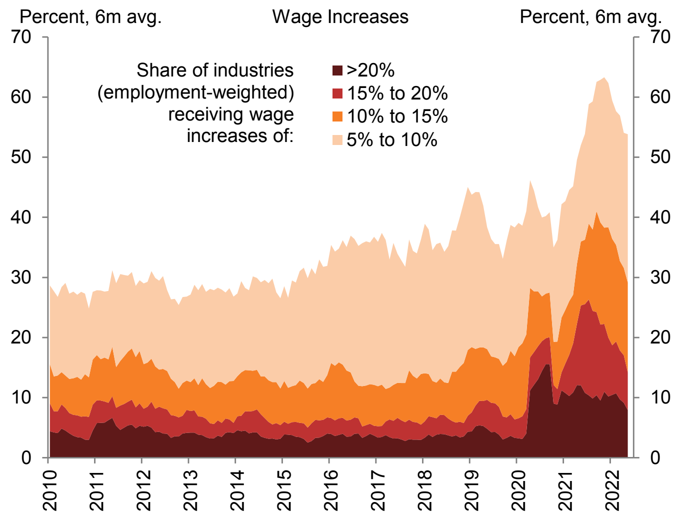
Going forward, however, the drag on wage growth from a normalizing labor market should increase as slower growth further reduces job openings and lagged effects kick in. We also see three other reasons why wage growth is likely to continue to slow.

First, the firmness in wage growth in 2021 and at the start of 2022 likely partially reflected one-off factors related to the pandemic that will not be repeated. For example, the very elevated level of fiscal transfers to households may have forced employers to raise wages to compete against the option of not working, and employers may have raised wages at the start of the year to induce workers to return to the office.

Second, although wage increases remain broad-based relative to last summer when wage growth was driven by a surge in wages for the lowest-paid workers (left chart, Exhibit 4), they are less broad-based than a few months ago (right chart, Exhibit 4). Because broader wage gains tend to be more persistent, this reduction in breadth argues for a faster normalization of wage growth.

Exhibit 4: Wage Increases Remain Broad Based, but Less So Than a Few Months Ago

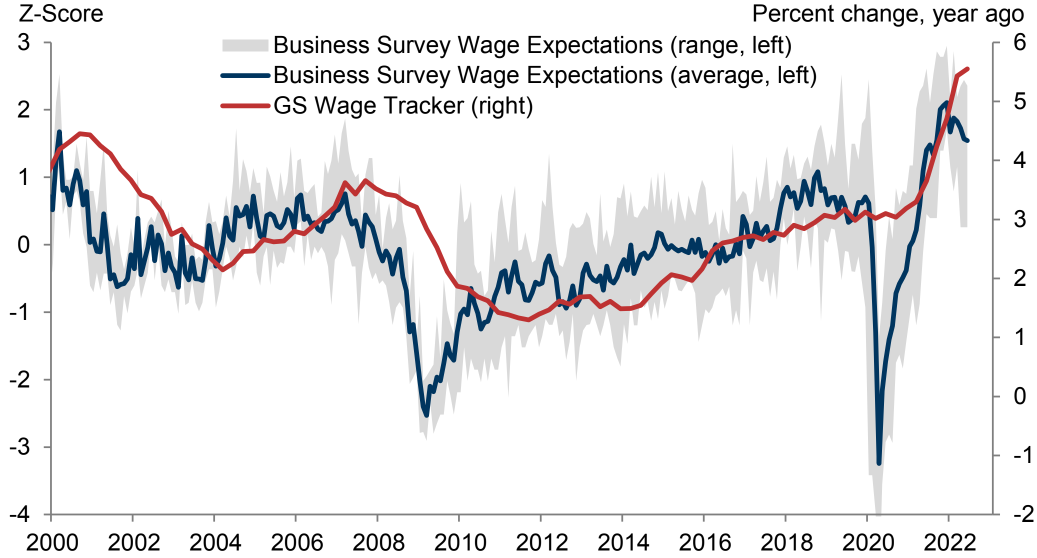




Source: Department of Labor, Goldman Sachs Global Investment Research

Third, wage growth expectations in business surveys—which have historically been a leading indicator of realized wage growth—have started to moderate and point towards an upcoming slowdown in wage growth (Exhibit 5).

Exhibit 5: Employer Surveys Point Toward an Upcoming Slowdown in Wage Growth



Source: Federal Reserve, Goldman Sachs Global Investment Research

Taken together, these patterns suggest that wage pressures should continue to ease. We forecast that wage growth will slow to 4½% by end-2022 and to under 4% by end-2023 before settling to the 3½% pace that we estimate is compatible with the Fed's 2% inflation target in 2024.

Joseph Briggs

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