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More jobs and more productivity

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- Employment growth continues along its “normalization” path, expanding at a historically strong rate for both goods and services industries. The labor force participation rate was unchanged at 62.6%, and the unemployment rate ticked down to 3.5%. Overall, the labor market remains tight.
- Wage growth eased in Q2 2023, especially in goods industries, and annual growth in labor productivity entered positive territory for the first time the beginning of 2022. Growth in unit labor costs have fallen to pre-pandemic levels as a result, potentially lightening the impact that the labor market will have on inflation going forward.

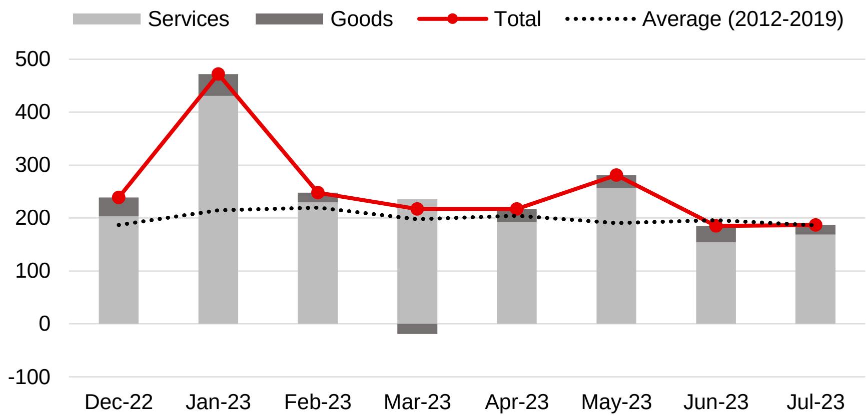
Few changes in the labor market

The labor market added 187,000 jobs in July 2023, equal to the average monthly job gain in July from 2012-2019. Growth occurred in both goods and services industries with strong job gains in health care and financial activities. Growth in leisure and hospitality slowed in July, adding only 17,000 jobs despite employment still being 2.1% below the pre-pandemic level.

Notable is the continued flat growth in manufacturing and transportation and warehousing. These industries are, in many ways, interconnected and experienced strong growth from 2020-2022. But as consumption habits shifted, growth stalled beginning in 2023 and there is no indication, especially in the latest consumer spending figures, that it will pick back up. Manufacturing, along with transportation and warehousing, will likely be among the first industries to experience job losses in 2023.

Even if the overall US economy manages to skirt past a recession, which still seems unlikely, job losses in manufacturing seem all but certain. ISM’s Manufacturing PMI showed that all 5 subindexes were in contraction in July and the only industry that registered growth was petroleum and coal products. Additionally, the New Orders index was in contraction for the 11th straight month. Employment in manufacturing looks to be the only factor keeping the industry out of a recognized recession, but that may not last for much longer.

Jobs growth continues along its "normalization" path
Nonfarm payroll employment growth, thousands

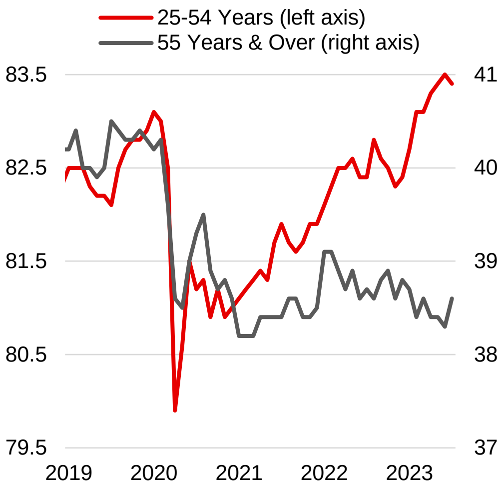


Source: BLS, MUFG Bank Economic Research

Like overall employment growth, little has changed on the status of labor supply. The labor force participation rate was unchanged in July for the 5th consecutive month, standing at 62.6%. There was a small uptick in the participation rate for older workers (55 and older), but that was offset by a small decline in prime-age workers (25-54). It's unclear how much more the participation rate for prime age workers can grow since it has already surpassed the pre-pandemic rate. Some modest growth still appears likely, but it won't be enough to compensate for the vast number of older workers that will not return to the labor force.

Little recovery for older workers

Labor force participation rates, %

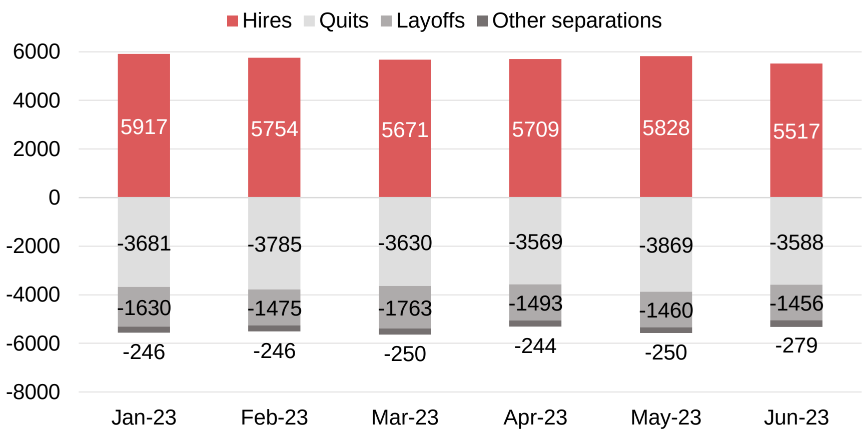


Source: BLS, MUFG Bank Economic Research

On the labor demand side, job openings was little changed in June (job openings data lags employment data by one month). The vacancy to unemployed ratio was unchanged at 1.6, but there was a noticeable drop in hires and quits. This could indicate that employee turnover is shrinking for firms, but it may be too soon to call this a trend. Hires will likely increase again in July given that the unemployment rate fell back down to 3.5% this month. In regard to both labor demand and supply, the labor market remains tight.

Hiring and quits eased in June, signalling less turnover

Hires and separations, thousands



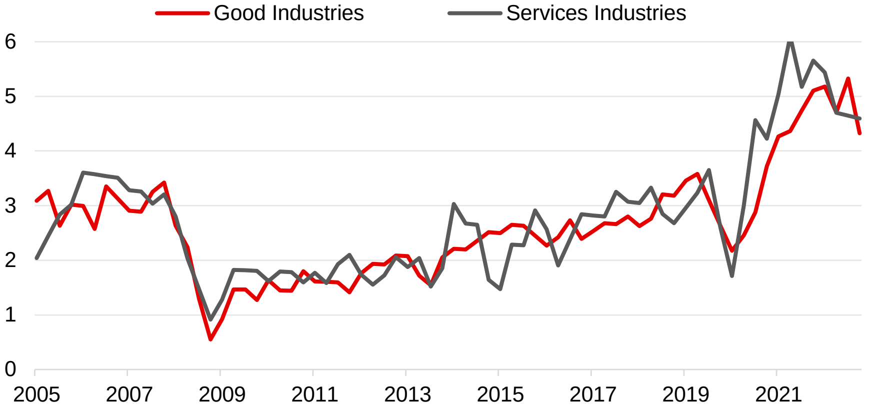
Source: BLS, MUFG Bank Economic Research

Slowing wages and growing productivity

Wages and salaries in the Q2 2023 Employment Cost Index (ECI) were mostly positive in relation to inflation. Wage growth fell to 4.3% for goods industries on a 2-quarter moving average annualized rate, and it eased down to 4.6% for services industries. This is welcomed news for the Fed, as it signals lower inflationary pressures coming from the labor market, but the level is still well above what it was before the pandemic. Even looking at average hourly earnings, wages grew 4.7% annually in July for private production and non-supervisory employees, well above the pre-pandemic average of around 3.5%. This slow burn in wage growth is not consistent with inflation falling to 2% anytime soon.

Wage growth in decelerating faster in goods industries

ECI wages & salaries, 2-quarter moving average, % AR



Source: BLS, MUFG Bank Economic Research

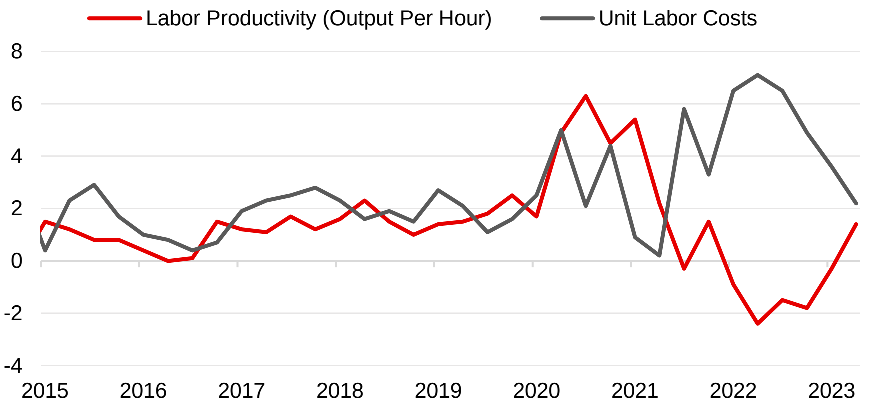
However, with that said, wages may make less of a perceived mark on inflation going forward. Historically, wage growth that is not accompanied by productivity growth is what can influence prices. The logic follows that prices rise when higher labor costs can't be offset by more worker output, making unit labor costs an important metric.

Unit labor costs have been shown, empirically, to be a better indicator of inflationary pressures than just wage growth alone. This also appears to be the case in our current post-pandemic inflationary saga. Annual growth in labor productivity, or output per hour, was consistently negative since the start of 2022, driving annual growth in unit labor costs to 7.1% in Q2 2022. Price growth also largely peaked in mid-2022, helping support the notion that once supply-side issues dissipated, the labor market became a significant contributor to inflation.

Annual growth in labor productivity has now entered positive territory as of Q2 2023 and annual growth in unit labor costs have fallen to 2.2%, similar to the pre-pandemic growth rate. If this trend continues, elevated wage growth may prove to be less of an inflationary pressure than it was in 2022, but beware of base effects. Annual growth in one quarter after 5 consecutive quarters of declines may not reflect a substantial change in labor productivity. Elevated wage growth is likely to still play an important role in price growth and determining the Fed's actions moving forward, but labor productivity is certainly moving in the right direction.

Increase in productivity brings unit labor costs down

Labor productivity and unit labor costs, % Y/Y



Source: BLS, MUFG Bank Economic Research

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