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Don't expect a re-acceleration of labor demand

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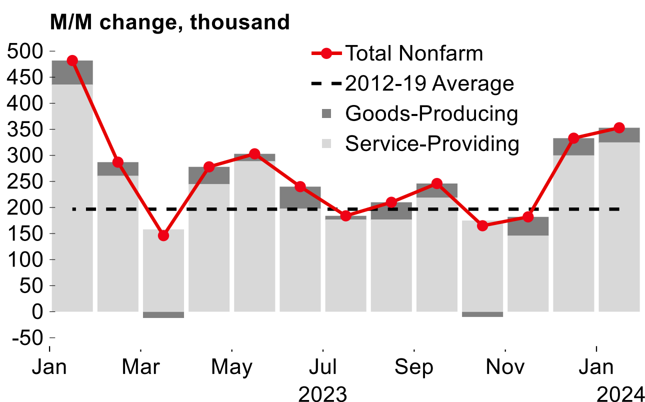
- January payroll employment growth came in surprisingly high and well above expectations. This news was accompanied by a large upward revision to December employment, diffuse growth across industries, and a steady unemployment rate. The labor market is likely too strong for the Fed to consider cutting rates in March, but that isn't to say we should expect accelerating labor demand. Surging December and January growth is likely correcting for high job openings relative to weak hiring (i.e. hiring difficulties) from late 2023.
- Growth in average hourly earnings accelerated in January, but composition effects from surging jobs growth in the professional and business services sector are largely to blame. The most reliable wage measure, the ECI, showed that wage growth continued to ease for most workers in Q4 2023, except for those in unions whose wages accelerated from the large number of contract re-negotiations. Wage growth remains above 4%, but growth in labor productivity and falling unit labor costs may limit the passthrough into prices.

Growth was strong and diffuse

January's employment report came with a few surprises. Jobs growth was much stronger than expected in January (+353,000) and December's growth was revised up by an unusually high 117,000 (Chart 1). Growth was strong in both goods and services industries, and at a surface level, it seems as though demand is re-accelerating in certain sectors after stagnating in the second half of 2023.

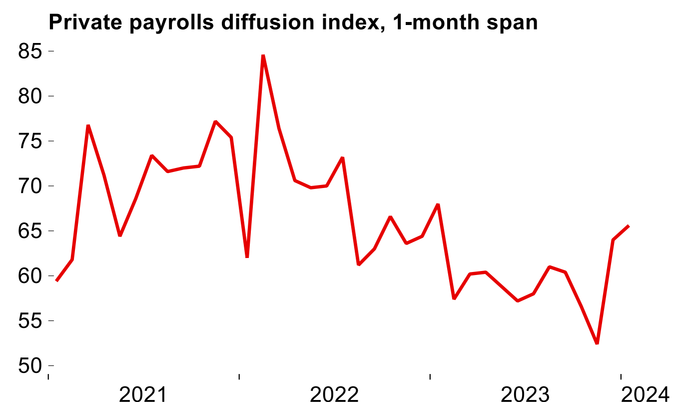
But before we definitively reach this conclusion, it's important to note that every year's January jobs report factors in the annual benchmark revision. This year, employment levels were revised down for every month in 2023 except for December, which as noted, was revised up. Seasonal factors that don't align with current consumer and employer behavior could be playing a role. As could strange weather patterns, which were frequently cited as the explanation for last January's strong growth.

Chart 1: Headline payroll employment growth shows accelerating labor demand in December and January



Source: BLS, MUFG Bank Economic Research Office

Chart 2: Employment growth has become more dispersed across industries



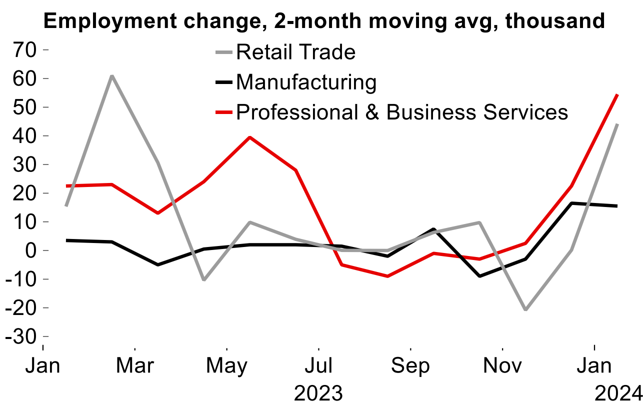
Source: BLS, MUFG Bank Economic Research Office

But more likely than both, is that next month's revision will probably bring December and January's growth back down a bit. Monthly revisions have been volatile in this post-COVID era and before numbers are finalized, it's difficult to draw strong conclusions and assume seasonality and weather are to blame. Nevertheless, both December and January will still likely exhibit stronger growth than prior months, even if they get revised down. And perhaps even more relevant than the magnitude of growth, are the industries in which they occurred.

In the second half of 2023, growth was concentrated in a select few major industry groups such as health care, leisure and hospitality, and construction. December and January's growth were much more dispersed (Chart 2). The BLS diffusion index shows how dispersed employment growth is, with values above 50 indicating that more industries added jobs than lost. Historically, when growth is more evenly distributed across industries, that is a sign of a strong and healthy labor market. In today's case, growth re-accelerated in key sectors such as professional and business services, manufacturing, and retail trade (Chart 3).

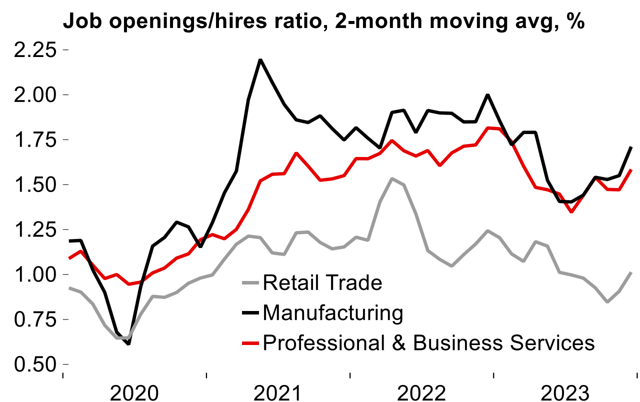
But to temper our inclinations once again, it is likely that labor shortages are distorting these growth signals. Hiring difficulties were especially acute in the later months of 2023, and they were concentrated in the industries whose employment grew strongly in December and January (Chart 4). The ratio of job openings to hires is a proxy for the average time to fill a position, and when it rises, it signals greater hiring difficulties. Surging December and January jobs growth in these industries is likely correcting for high job openings relative to weak hiring (i.e. hiring difficulties) from late 2023.

Chart 3: The acceleration in growth was concentrated in select industries



Source: BLS, MUFG Bank Economic Research Office

Chart 4: Surging jobs growth is likely correcting for difficulties in filling those positions in late 2023



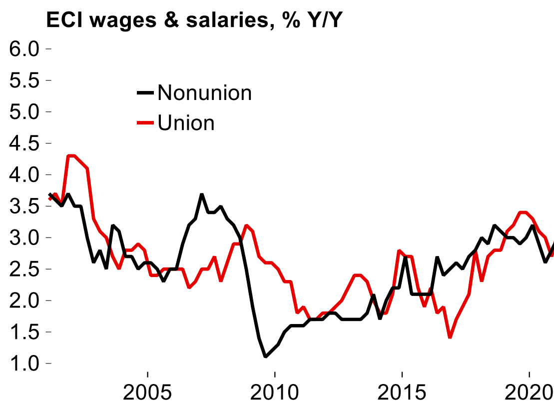
Source: BLS, MUFG Bank Economic Research Office

By nearly all other indications from January's jobs report, the labor market hasn't changed by much. The unemployment rate remained at 3.7% and the labor force participation rate was unchanged. Sluggish growth in the labor supply will ensure ongoing shortages in key industry sectors. This will likely continue to keep the unemployment rate relatively low in the coming months. There is very little indication that labor demand is re-accelerating in the US (that can't be explained by labor shortages or hiring difficulties). We can expect the general cooling of labor demand to continue in 2024, and for monthly growth to be less diffuse as it was in the latter half of 2023.

Productivity may limit the impact of wages

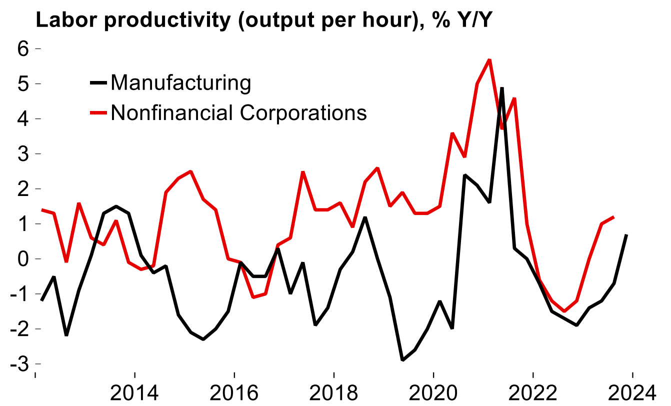
Like employment levels, average hourly earnings accelerated in January, coinciding with the strong growth in the high income and high salary professional and business services sector. Composition effects such as this are most likely contributing to the growth in January, which should ease fears of emerging inflationary pressures coming from wages.

Chart 5: Wage growth continued to slow in Q4 2023, except for unions workers where growth accelerated



Source: BLS, MUFG Bank Economic Research Office

Chart 6: Growth in labor productivity may limit the passthrough of wages into prices



Source: BLS, MUFG Bank Economic Research Office

A more reliable measure of wage growth, the Employment Cost Index (ECI), shows a general easing of wage growth that is more in line with expectations (Chart 5). Most American workers (nonunion) are experiencing a continued deceleration that began in Q3 2022. Union workers are the exception, whose wages accelerated in Q4 2023 from the large number of contraction re-negotiations (e.g., UAW strikes).

With that said, wage growth still sits above 4% for most American workers, which would normally not be consistent with 2% inflation. The difference now is the subsequent growth in labor productivity (Chart 6) that should give the Fed confidence that wages are a less potent inflation pressure in the near term. Historically, wage growth that was accompanied by productivity growth did not lead to price growth. If that relationship still holds (we have no reason to believe it doesn't), then the labor market is moving in a comfortable direction. This may even be the case for the manufacturing sector that has a relatively large number of union workers. Wage growth that accelerated above 5% in Q4 2023 may have less of an impact on prices given the growth in productivity in manufacturing.

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