



Does the Tight Labor Market Pose a Threat to Investors?

Profit margins are vulnerable even if inflation remains tame.

January 2020

KEY INSIGHTS

- Whether the tight labor market will eventually cause a spike in inflation is a key question facing investors.
- While the inverse relationship between the unemployment and inflation rates has broken down, corporate profit margins are likely to decline if slack in the labor market remains tight.
- The impact on profit margins is likely to be muted over the near term, but margin deterioration will be an important trend to monitor when assessing the durability of the current economic expansion.

Whether the historically tight labor market will eventually result in a surge in inflation is one of the key questions facing investors. Low inflation has permitted the Fed's accommodative monetary stance, which, in turn, has been one of the key factors supporting the aging economic recovery. Low inflation and interest rates have also decreased corporate borrowing costs and heightened the relative appeal of equities, helping equity benchmarks reach new highs.

We analyzed the relationship between inflation and slack in the labor market over the past few decades, and we found both good and bad news for investors. Our research indicates that the relationship is nearly insignificant, suggesting that the labor market might even be able to tighten further without a noticeable impact on price levels.

However, we discovered a somewhat stronger relationship between corporate profit margins and employment slack. Indeed, we believe investors should be wary of declining corporate profit margins going forward.

Is the Phillips Curve Dead?

The inverse relationship between the unemployment rate and the rate of inflation is commonly described by the Phillips Curve, named after New Zealand economist William Phillips, who first articulated the concept in 1958. The Curve, which charts the rate of inflation on the vertical axis against the unemployment rate, functioned well over the decade of the 1960s. As the unemployment rate fell back throughout the decade, the inflation rate crept up from roughly 1% in 1961 to 5% in 1969.

The Curve broke down over the coming decades, however. The stagflation



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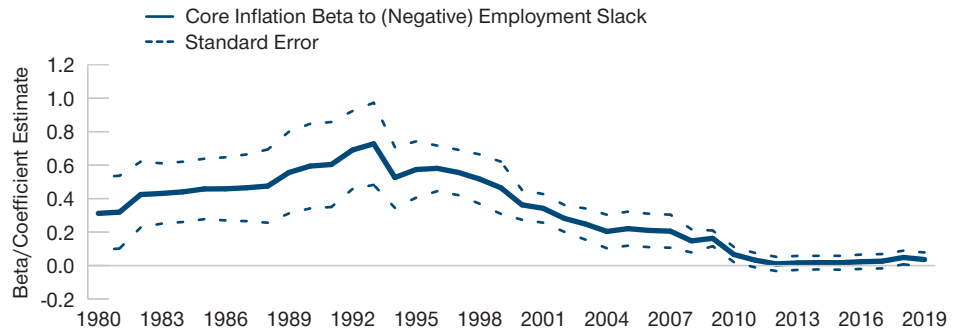
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(Fig. 1) Correlation Between Employment Slack and Inflation Has Largely Disappeared

Twenty-Year Rolling Regressions—Coefficient Estimates

As of January 1, 2019



Source: Inflation and unemployment data from Bloomberg Finance L.P. NROU data from Federal Reserve Economic Data (FRED). See footnotes.

“...domestic labor costs now play a smaller role in determining the prices of goods and services...”

of the 1970s saw U.S. inflation and unemployment rise together. By 1980, the unemployment rate was slightly above where it had been in 1961, but inflation was starkly higher as well, reaching 13.5%—the fastest pace of price increases since 1947. The trend over the current decade has been equally paradoxical, if more favorable. The unemployment rate fell alongside the inflation rate in the first half of the decade, and the U.S. economy barely avoided outright deflation in 2015, when the annual rate reached 0.1%—even as the unemployment rate had declined from 10% in 2009 to just over 5%.

A host of explanations have emerged to explain why the Phillips Curve is now “dead.” Most of these explanations hinge upon another relationship breaking down: higher wages leading to higher prices. Historically, low unemployment led to higher wages, which then led to higher prices because wages were an important input cost into goods and services. However, the transmission from higher domestic wages to higher prices has weakened considerably.

The most notable driver is that domestic labor costs now play a smaller role in

determining the prices of goods and services, as domestic labor has become less prevalent as an input cost. This can be attributed to a number of factors, including: (1) globalization in the form of both offshoring (moving production overseas) and outsourcing (relying on foreign suppliers), (2) structural changes in the negotiating power of the U.S. workforce, such as a decline in unionization, and (3) automation, which has reduced the amount of labor used to produce goods and services. Additionally, China’s reduced demand for commodities and new supplies of oil have eased input price pressures—meaning costs not attributed to labor have fallen.

Meanwhile, the power of sellers to pass rising costs on to consumers has been reduced significantly. Dramatically better price transparency due to the internet—the so-called Amazon effect—has given consumers the upper hand.

Testing a More Nuanced Version of the Curve

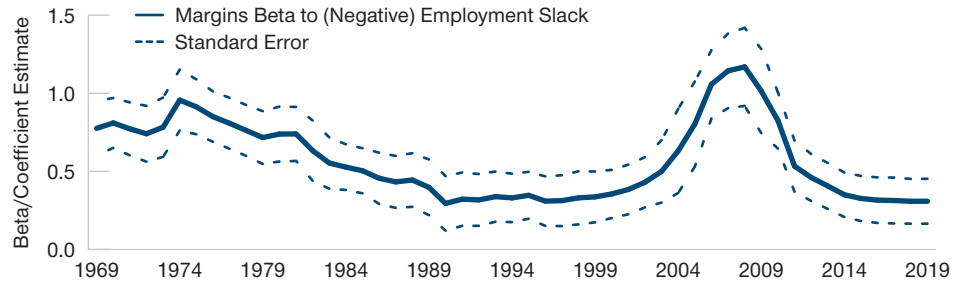
To test whether the relationship between unemployment and inflation has broken down entirely, we examined the evolution of the relationship since the 1960s.¹

¹ Modeled after the approach taken in “Some Implications of Uncertainty and Misperception for Monetary Policy,” Division of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C.

(Fig. 2) Relationship Between Employment Slack and Profit Margins Has Weakened but Persists

Unemployment Slack—U3 Minus Natural Rate of Unemployment

As of January 1, 2019



Source: U3 Unemployment data from Bloomberg Finance L.P. NROU data from Federal Reserve Economic Data (FRED). See footnotes.

“...wages remain a significant cost input in profit margins.”

Because employers are likely to respond to a tighter labor market with some delay, we examined lagged core (excluding food and energy costs) inflation. We also added the difference between the unemployment rate and the natural rate of unemployment² (NROU), as a proxy for the amount of slack in the labor market. Finally, to smooth out the impact of price shocks and other idiosyncratic events, and to unearth the dynamic nature of the relationship, we analyzed the data based on 20-year rolling regressions.

As shown in Figure 1, the relationship between inflation and unemployment has, in fact, weakened considerably since the 1990s. Put differently, in the early 1990s, the current low level of slack in the labor market would have been expected to lead to a roughly 60 basis point (0.60%) increase in core inflation. Currently, the impact appears to be borderline insignificant.

A couple of caveats are in order. First, measurement errors may be playing some role, particularly the Fed’s estimate of NROU. The current very low level of inflation might be explained if there is more slack in the labor market than the Fed is able to observe. Second, the forces driving the breakdown in

the relationship could fade or even reverse. Just as the Amazon effect could not have been predicted before the rise of the internet, for example, further changes that we cannot foresee may have an unanticipated inflationary impact. The deflationary effects of globalization may also be undone amid rising nationalism and heightened trade barriers. In other words, the Phillips Curve may not be dead—but it appears to be in a coma.

Tight Labor Markets Continue to Threaten Margins

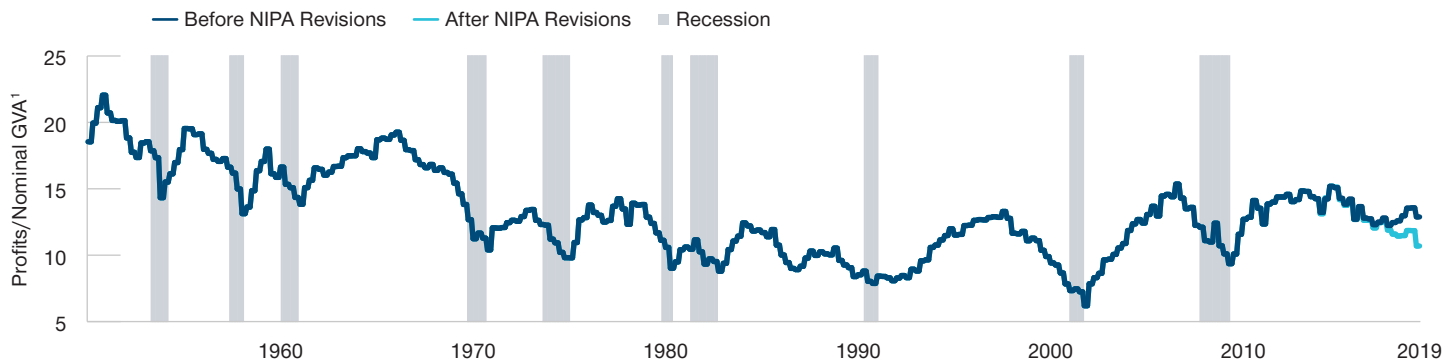
A more significant source of caution for investors may be that wages remain a significant cost input in profit margins. This is due in part to the price transparency created by the Amazon effect, which has made it more difficult for companies to pass on cost increases to consumers. The challenges in maintaining margins have been illuminated by the recent tariffs on imports of raw materials and intermediate goods from China, which have largely been absorbed by U.S. businesses rather than passed on to customers. The implication is that rising wages may not result in rising

² U.S. Congressional Budget Office, Natural Rate of Unemployment (Long-Term) [NROU], retrieved from FRED, Federal Reserve Bank of St. Louis; fred.stlouisfed.org/series/NROU.

(Fig. 3) Margins Have Not Fallen Much When Compared With Past Long Expansions

Profit Margins of Nonfinancial Corporations

As of March 31, 2019



Source: Bureau of Economic Analysis.

¹ Gross value added, or output minus intermediate consumption.

inflation, but they may result in falling profit margins.

To test the relationship between profits and wages, we developed another model comparing employment slack against year-over-year changes in the profits of all U.S. corporations as contained in the Bureau of Economic Analysis's national income and product accounts (NIPAs). NIPA profits provide a broader measure of corporate margins than S&P 500 operating profits and, thus, a better picture of how smaller businesses are coping with rising wage pressures. Smaller companies are generally less exposed to globalization and have invested less in automation, making wages a larger part of their total operating expenses. We again analyzed the data using 20-year rolling regressions.

As shown in Figure 2, the relationship between employment slack and profit margins has also weakened over time, especially following the global financial crisis. However, unlike the Phillips Curve relationship, it remains statistically significant: The data suggest that we should expect the current low level of slack in the labor market to cause corporate margins to drop by 25 basis points (bps) annually over the coming years.

While the current cumulative decline in margins has already been larger in both duration and magnitude than average, margins have only compressed by roughly 450 bps, less than they did during the long expansions of the 1960s (650 bps) or the 1990s (596 bps). Margins are currently 10.70%, which is 134 bps above the low point for margins in this cycle (2Q09). In this context, an additional 25 bps contraction over the coming year may not be concerning (See Figure 3).

What Are the Implications for Investors?

Generally, the data suggest that we should not be concerned about rising wages leading to an inflation shock over the near to medium term, despite the very low current base of inflation and the Fed's dovish stance. However, investors should be aware that some downward pressure on corporate profit margins is likely in the coming year. The data also imply that it is worth paying particular attention to the margins of smaller businesses, which are more likely to struggle under the burdens of price transparency and higher labor costs. This may prove to be particularly problematic if corporate revenues

continue to grow slowly amid modest economic growth.

Ultimately, falling corporate profit margins could become a serious issue for the economy—as companies need healthy margins in order to service debt obligations, pay their employees, and reinvest in their businesses. Even if

significant margin weakness is confined only to smaller companies, it could have a snowballing effect should the banking system become beset with widespread defaults. Undoubtedly, the impact on risky asset classes, such as equities and high yield debt, would be painful in such a scenario.



WHAT WE'RE WATCHING NEXT

If the Phillips Curve is, in fact, dead (or at least in a coma), there are important implications for Fed Policy. The official objective of the Federal Open Market Committee is “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” In other words, it is the Fed’s job to keep unemployment as low as possible while keeping inflation (and consequently interest rates) stable. This objective is commonly referred to as the Fed’s “dual mandate.”

When the Phillip’s Curve was functioning, this meant that the Fed’s two mandates were often at odds with each other. Achieving low unemployment traditionally meant prices would soon become inflated. This led to a difficult balancing act whenever unemployment reached low levels. But if the relationship between unemployment and inflation has broken down, these mandates are no longer at odds with each other. Furthermore, if this relationship does, in fact, remain dormant, the Fed can cut rates (or keep them at a low level for a long period of time) without fear of creating runaway inflation. Fed Chairman Powell has recently hinted at this by stating that he would want to see an increase in inflation that is “persistent” and “significant” before raising rates again.

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