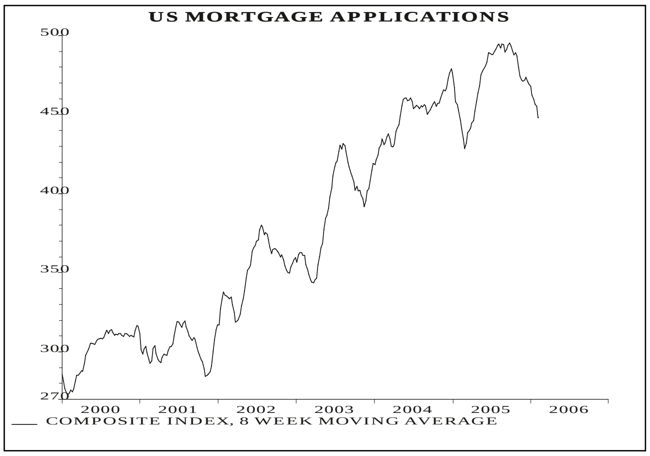
# GFC ECONOMICS

## DAILY COMMENTARY

## A STRONGER US LABOUR MARKET

The pace of hiring is picking up in the US and average earnings growth is accelerating too. Commodity prices continue to race ahead, heightening the risks that rates will rise more than once from here. Indeed, the speed of the decline in jobless claims during recent weeks suggests the payroll numbers for January may not fully reflect the underlying strength of labour demand. Furthermore, last week's monthly consumption report for December showed that consumer demand was actually very strong towards the end of last year, excluding autos. All this raises the possibility that the economy will remain immune to a downturn in the housing market. In truth, that depends how far long term rates climb from here. This is perhaps not the most auspicious time to be relaunching 30-year bond auctions after a four-year hiatus. There is every chance 10-year yields could touch the 2004 high of 4.85% over the next month or two. Either way, it should be noted that mortgage demand is still trending down, and the most recent back up in yields could slow housing further. A strong first quarter in the economy this year could eventually give way to quite a pronounced downturn, and in turn a sharp reversal in the bond market.




### Strong Real Data, Soft Housing

US monetary policy will reach a critical juncture in the coming months. At face value, the pace of hiring appears to be accelerating. While payrolls were only up 193,000 in January, upward revisions to prior months imply that the average 3-month change has climbed to 229,000, its highest level since May 2004. Moreover, in almost every other respect, the labour market was strong. And yet, the housing market is clearly slowing. The MBA mortgage applications index fell back to 435.7 in the final week of January. The data is quite volatile, but even if one smoothes the numbers over eight weeks, it is not hard to see that mortgage demand has continued to soften (see chart). This is perhaps quite significant, since mortgage rates did peak in the first week of November, before drifting gently down over the subsequent two months or so. That did not seem to stabilise mortgage demand. But mortgage rates have started edging higher again, suggesting the housing market could continue to soften. The house price data on both the new and existing home sales reports were very weak during the final two months of 2005, although inevitably a degree of caution is required, since the data is quite volatile (see commentary of January 30th).

Nevertheless, the strength of the real numbers of late does raise the possibility that the economy will remain immune to a slowing in housing. Better still, the acceleration in earnings growth could offset the impact of higher debt servicing costs, and underpin consumer spending. Indeed, it is not inconceivable that should long term rates drift lower from here, the impact of the recent downturn in the property market might be contained. But even here there would be risks, if the stronger real data - and not to mention the perceived impact of rising commodity prices - persuaded the Fed to tighten more aggressively. After all, rising short rates have played an important role in driving mortgage rates up more than longer dated Treasury yields.

All the same, the FOMC may still argue that the labour market has tightened to the point where income growth is set to strengthen. The pick-up in average hourly earnings growth has been the subject of considerable discussion. On one level, the numbers seem quite impressive, with the annual rate climbing to 3.3%, its highest level since early 2003. In some respects, the labour market does appear to be 'tightening'. The share of workers who have been out of work

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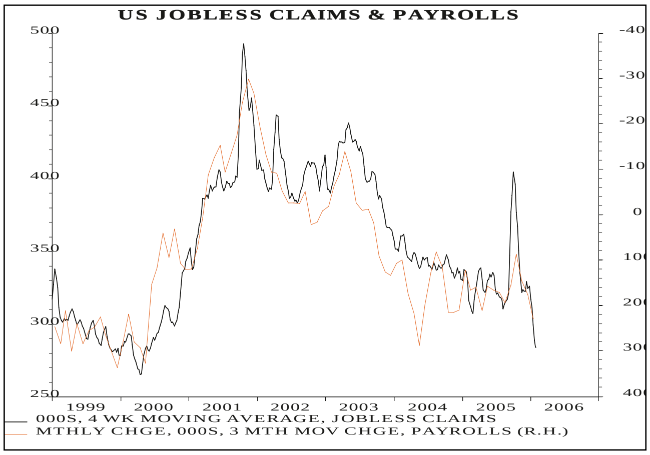
and searching for employment for at least six months fell from 18.2% to 16.3% in January. That was the lowest level since March 2002. There has also been a sharp drop in the number of discouraged workers. However, this potential shift in classic 'wage-cost' pressures does need to be kept in perspective. The annual growth in average hourly earnings is still some way below the highs of 2000, when it peaked at 4.2%. A significant part of the more recent acceleration has come from the construction sector, possibly in response to last year's hurricanes. And while the headline unemployment rate has dropped significantly to just 4.7%, the labour market participation rate remains historically low, having climbed from a 2005 trough of 65.81% to just 65.97%. That is still well down from the 2001 high of 67.33%. In essence, a significant part of the decline in the jobless rate has come from a drop in the growth of the labour force.




However, the speed of the fall in the jobless claims numbers has been quite eye-catching, and does suggest that the January payroll data do not reflect the true rate of improvement in the labour market (see chart). Furthermore, the potential for significant upward revisions to the wages and income numbers should not be underestimated. Every quarter, the Bureau of Economic Analysis incorporates "newly available fourth-quarter wage and salary tabulations from the census of employment and wages from the Bureau of Labour Statistics". These adjustments have not always been in an upward direction. The last two sets of revisons for Q1 and Q2 last year saw the personal income nudged down, for example, by 0.2% and 0.3% respectively. However, a more telling revision in Q4 2004 resulted in incomes being shifted up by a hefty 0.7%. The third quarter data for 2004 was also revised up by 0.3%. Significantly, the biggest upward revisions came in 'other services-producing industries', which includes finance, real estate and information technology. Wages in this category were revised up by 2.4%. Comparable revisions for Q4 2005, an important quarter when bonuses are paid, will not be available until the end of May. But at the very least, they are likely to show the savings ratio, for example, may not have been quite so negative.

Nevertheless, the potential for upward revisions should still be kept in perspective. While they may boost the unit labour cost numbers, the very fact that they may be attributable to higher bonuses, for example, does rather alter the complexion of these figures, and how they are interpreted. Higher bonuses paid out of rising profit margins arguably constitute less of an inflation threat than rising wages rates per se. In this respect, the quarterly employment cost index may provide a more useful guide to the threat of cost-push inflation. And last week's report for Q4 suggests there are few reasons to be worried. The annual growth rate for private sector wages ticked up from a 24-year low of 2.2% to 2.5%. But that remains historically very subdued and well below the post-dotcom high of 4.1%. Furthermore, companies are continuing to squeeze benefit costs. The year-on-year increase for private benefits slipped to 4.1%, comfortably down from the Q2 2004 high of 7.3%, and the lowest rate since Q4 1999.

All the same, aggregate wages are accelerating, and the Fed may consider that poses enough of a risk to justify more than one rate hike from here. Core service sector inflation is trending higher too, and with non-energy commodity prices surging, the risks of a CPI blip in the coming months should not be overlooked. In truth, the underlying inflation trend remains remarkably benign. But as with all asset bubbles, cost pressures can surface during the late stages of the cycle causing policy makers to possibly overreact, and tighten policy a notch too far. That remains the predominant risk - and challenge - facing the new Fed chairman.