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Daily Observations

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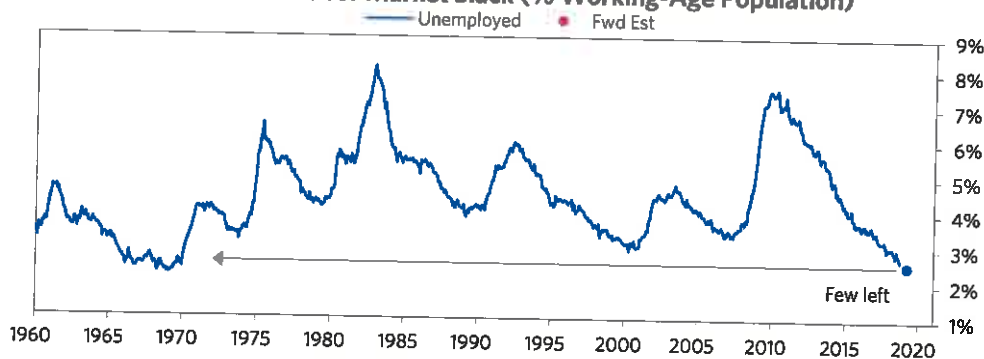
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Perspective and Context on the Secularly Tight US Labor Market

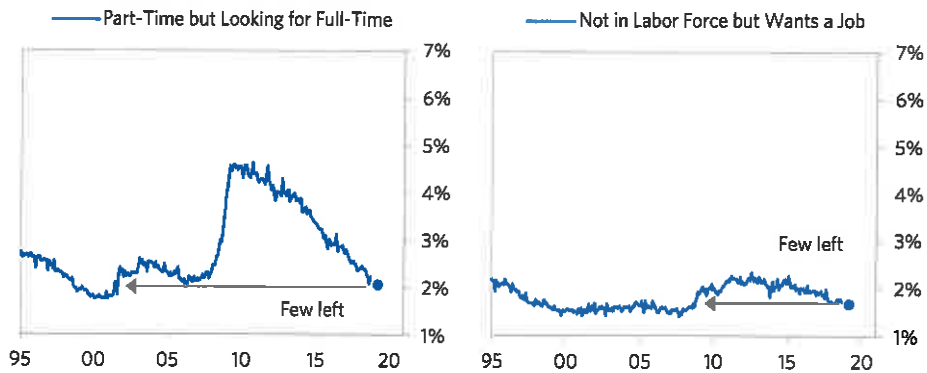
The US labor market is about as tight as it has ever been and will likely keep getting tighter. Looking ahead, visualizing how businesses will meet new demand is therefore a useful exercise to inform our thinking about the path of inflation. As we discuss below, we think it is likely that wage inflation will continue to drift higher and may well accelerate. Yet focusing on the part that is easiest to measure—i.e., what is happening to wages—does not erase the more secular forces that have kept inflation at or below 2% in developed economies for decades. Nor does it eliminate the downside risks to inflation during the next downturn. But the combination of cyclical pressures and other short-term pressures such as oil prices and increased tariffs leads us to expect US inflation to rise modestly above the Fed's target. As we look at how the Fed has been operating and the modest tightening priced in, we think the odds are tilted toward more tightening than what is discounted. Below are some key observations on how tight the US labor market is and how we see current dynamics playing out.

- September's employment report didn't materially alter our read on the strength of current US cyclical conditions. Last month the unemployment rate fell to a multi-decade low of 3.7%.
- Most new hires continue to come from pools of people who want jobs. As the first set of charts show, these groups are now secularly low.
- The US has never run out of people who are looking for jobs and this isn't going to happen now. Employers just have fewer workers to choose from, and must either hire less productive workers or pay more to attract someone back into the labor market and to retain workers.
- Most of the drop in participation this cycle came from workers retiring; this aging trend is unlikely to reverse.
- Women who don't want jobs because of home responsibilities are one large source of potential hires that do rejoin the labor force late in cycles. They tend to be educated, but would need to be incentivized to return to work through higher pay. This is one area where technology and flexible work arrangements can help relative to prior cycles.
- Over time, technology will be able to replace more workers. But most of these secular adjustments entail tough choices that are often forced on companies during downturns. The secular drop in manufacturing jobs, for instance, happened almost entirely during recessions. These jobs just never came back.

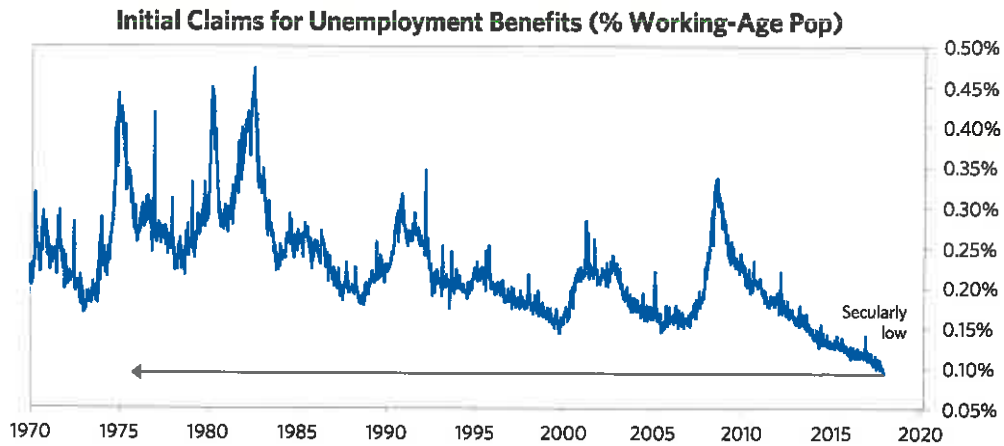
Additional US Labor Market Slack (% Working-Age Population)



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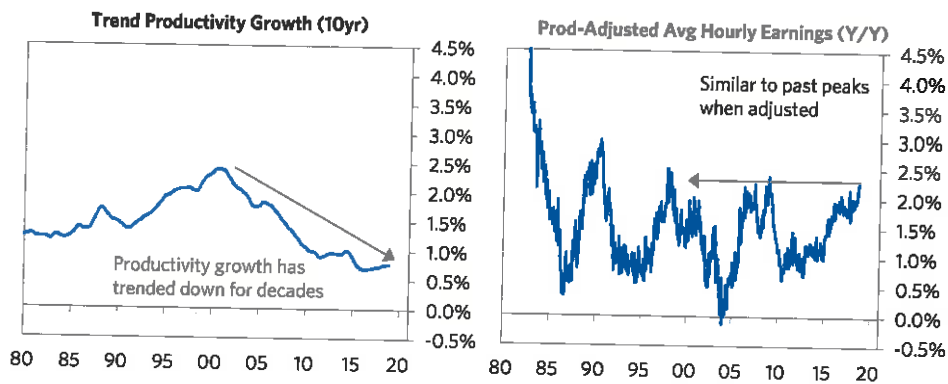
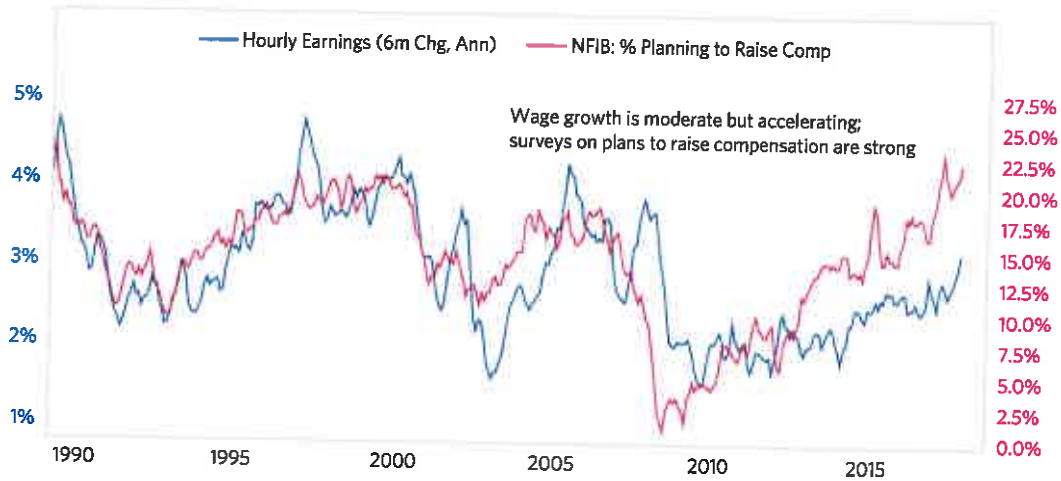


One of the most striking indications of labor market tightness is the secularly low level of initial claims. Companies don't have the luxury of firing almost any workers without falling behind.

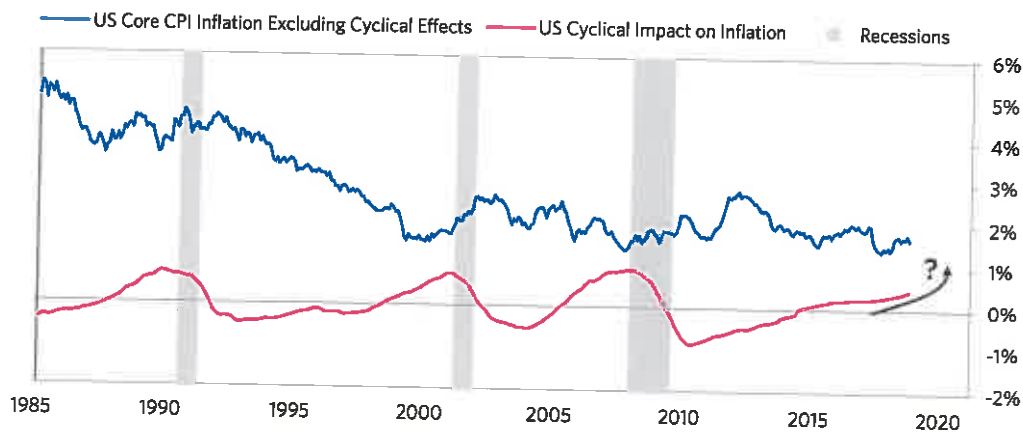


Wage Inflation Is Accelerating and Is Similar to Prior Cyclical Peaks after Adjusting for Productivity Levels

At first glance, the rise in wage inflation this cycle has been pretty muted, going from a bit less than 2% to about 3% over the course of a decade. We don't believe that wage inflation is a material issue yet, and it is just one of the drivers of broader inflation, but we think this understates the pressures. In this cycle, companies have largely met growing demand by hiring, while productivity growth has weakened (though changes in productivity are generally hard to measure). As a result, wage growth looks to have picked up a bit more when adjusted for productivity, and the level looks more in line with wage growth at prior cyclical peaks.



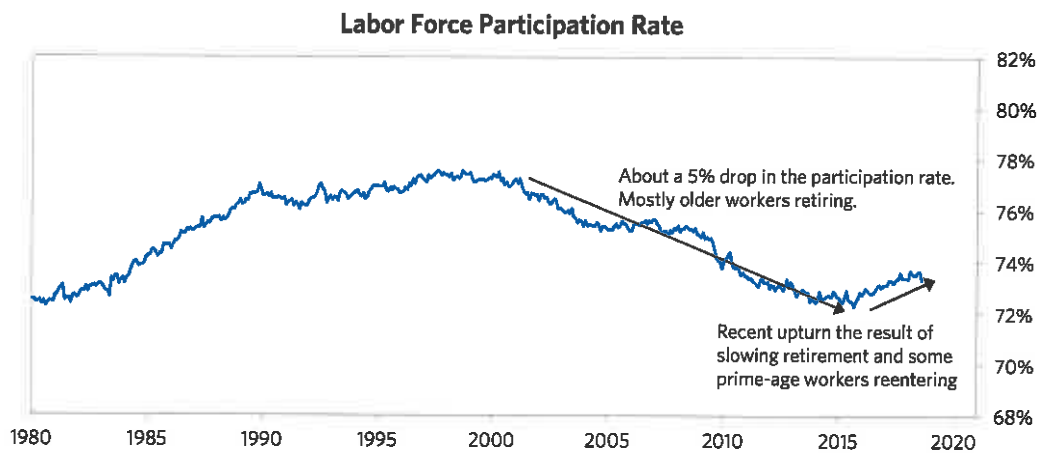
This cycle, our measures of cyclical pressures have taken longer to normalize, but are now similar to what we have seen in prior cyclical peaks. We expect to see these pressures rise and potentially accelerate. This of course has to be put in context with the broader secular disinflation pressures that have kept overall inflation low.



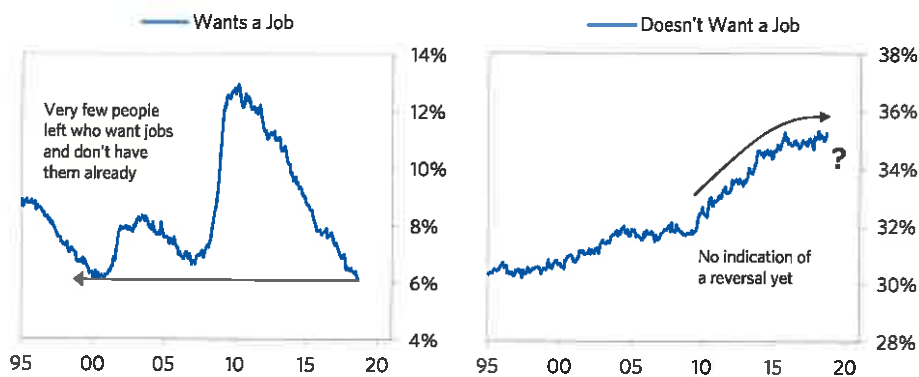
In the section below, we do a deeper dive into labor market dynamics, exploring where the potential additional labor supply may come from.

Drop in Labor Force Participation Primarily Reflects Demographics, Coming Largely from People Who Don't Want Jobs

Looking more closely at where the hiring has been coming from allows us to better understand which pools of workers are left. Most of the employment growth in this cycle has been drawn from traditional pools of labor market slack—workers who want jobs. At this point, most of the workers who are inclined to want a job have found one. At the same time, there's been a steady rise in the share of the population over 16 who say they do not want a job, contributing to the lower participation rate shown below.



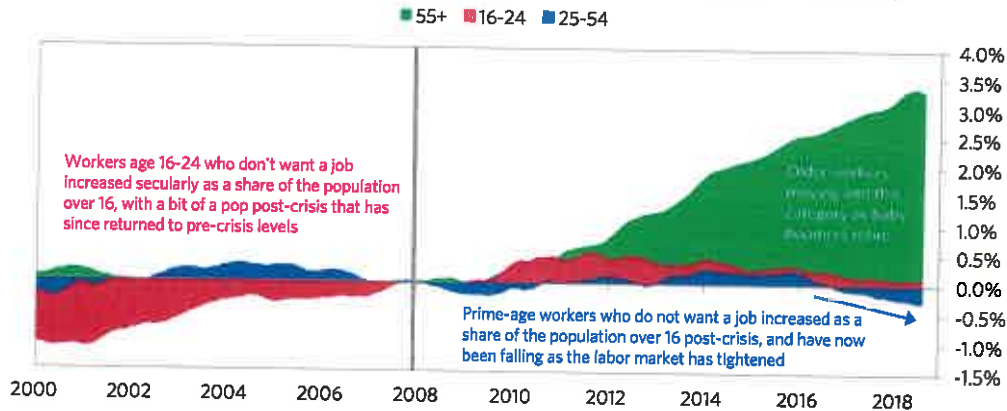
Share of Population 16+ by Desire for a Job



The age breakdown of the group of people who say they don't want a job then helps to disaggregate whether they have left for demographic reasons or for more cyclical reasons that are likely to reverse. This closer look helps size the pool of people who we might expect to be enticed into employment.

As shown below, most of the increase in the share of the population over 16 who say they do not want a job was driven by demographics, as baby boomers retiring comprise a larger and larger share of the population. The 16-24 group rose as a share in line with secular trends toward longer schooling, with a bit of an increase post-crisis that has since reversed. By contrast, prime-age workers outside the labor force who say they don't want a job are now falling as a share of the population over 16 and tend to be more responsive to cyclical labor market pressures.

Share of Pop 16+ Not in Labor Force and Don't Want a Job (Indexed to Pre-Crisis)

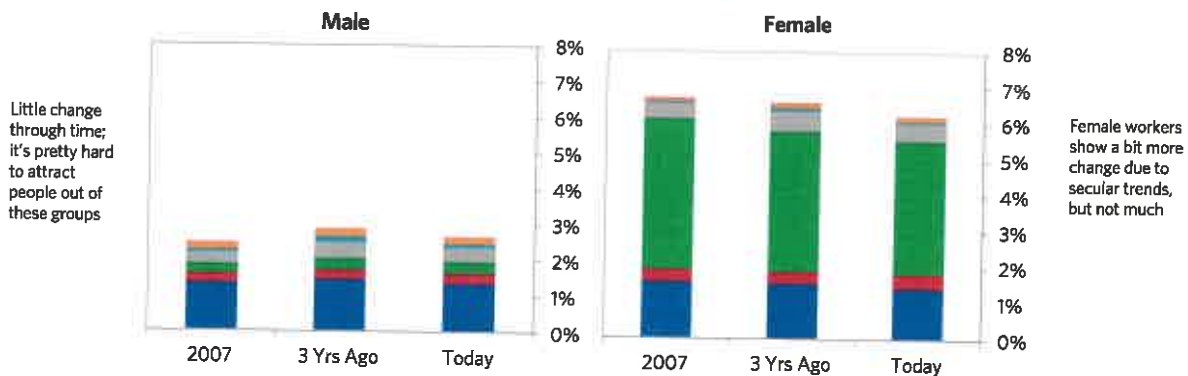


Looking Ahead, Most Additional Jobs Will Have to Be Filled by the Labor Market's "Reserves"

As shown below, the breakdown of people over 16 outside of the labor force by reason is largely stable through time. Most of the people who haven't entered the labor force yet will be harder to attract, and will likely need higher wages or require more training if they are less qualified. The group that says they could not find work is extremely small.

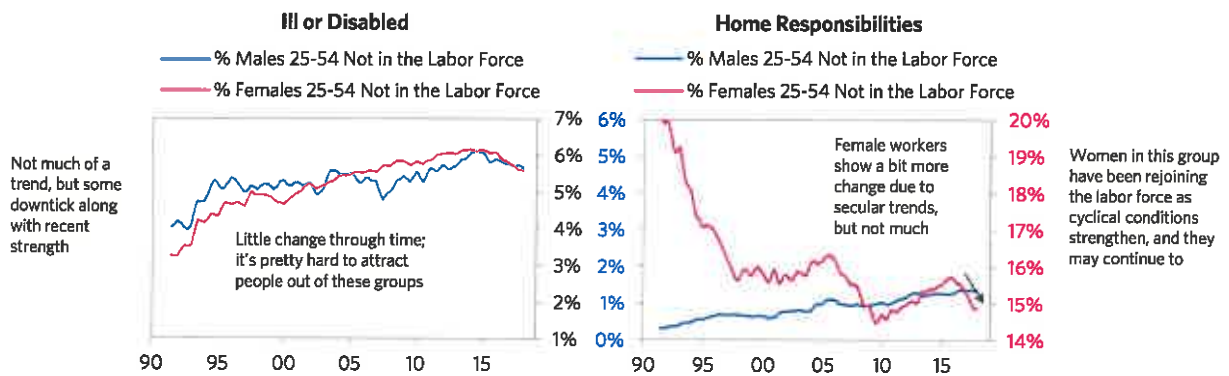
Share of the Working-Age Population Not in the Labor Force by Gender and Reason

■ Ill or Disabled ■ Retired ■ Home Responsibilities ■ Going to School ■ Could Not Find Work ■ Other Reasons



We have seen a small net return to the labor force from a few of the largest remaining groups of potential workers, but it hasn't been large. There are a lot of structural reasons why it is hard for some people to rejoin. Some people on disability would have to find jobs that cover their healthcare costs, even assuming they can work. A significant portion of potential prime-age workers also have criminal records, making finding good jobs harder.

This doesn't make some return impossible. Probably one demographic that has the highest potential to return is prime-age women with home responsibilities. Their willingness to work has been cyclical in the past, and with good enough pay or flexibility some of them may return. Many of these workers are highly educated and highly skilled. But as the chart below on the right shows, the share not in the labor force is also near what it was prior to the crisis, and it's not high relative to history.



The Secular Decline in Manufacturing Jobs May Provide Some Perspective on How Future Secular Shifts in Employment May Play Out

One of the key secular questions of the US labor market is whether new forms of automation will be able to replace workers in jobs that have been tough to automate in the past. Most indications, including the fact that employment gains continue to be high and wages are rising, suggest that these shifts are happening slowly.

The US manufacturing industry is an example of how such secular shifts in employment can happen, with cyclical downturns prompting an outflow from the sector that is never fully recouped; this dynamic was most dramatic following the financial crisis. It is of course an entirely separate question what kinds of jobs and wages displaced workers may be hired into.

