Don’t Look Now, but Labor Costs are Slowing

The percentage change in the employment cost index (ECI) rounded up to 1.0% last quarter, the third quarter in a row in which its growth rate slowed. The Q4 2022 increase in the ECI was also the smallest gain since Q2 2021 (+0.8%). But the slowdown in labor costs does not stop here.

In the Q4 2022 productivity and costs report, total labor compensation also grew a modest 1.0% after a string of sub-1% increases. Over the last year, compensation per hour has increased only 3%, which is down from 4% in the previous quarter and down from over 6% at the start of last year.

The sharp downtrend in compensation is illustrated in the graph below. The current growth rate in compensation is already back in line with its pre-covid trend. And remember this is with a 3.5% unemployment rate. So, as the economy weakens and unemployment begins to rise, compensation growth — all else being equal — is likely to slow significantly further. This will push compensation growth even lower!

Importantly, the moderation in compensation is dampening growth in unit labor costs, too. They rose just 1.1% last quarter, the smallest gain in nearly two years. Over the past four quarters, unit labor costs are up 4.5% versus a 7.0% cyclical high. More moderation can be expected if employment growth continues to slow.

Regarding the next set of labor data, January average hourly earnings are poised to rise 0.3% for the second month in row when new figures are released tomorrow. Recall that last month’s lower than expected increase (coupled with a downward revision to November) was the catalyst for the rally in rates and risk markets. Further downward revisions may be forthcoming. Why?

Every year the Bureau of Labor Statistics conducts a benchmark revision that alters previously reported data on jobs, earnings, and hours. Generally, the pattern in revision reflects the underlying momentum of the economy. Last year, real GDP increased just 1.0% compared to four quarters earlier. This was down from nearly 6% growth in the previous year. Hence if there are any surprises in tomorrow’s report, they are likely to be skewed to the downside.
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