ECONOMIC OUTLOOK

REGIONS

April 2021

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Labor Market Update: Picking Up The Pace, But Still Far To Go

Largely reflecting the flow of Economic Impact Payments (EIP), personal income has been on a roller coaster ride since the onset of the pandemic. Led by the first round of EIP, provided for in the CARES Act, total personal income jumped 12.4 percent in April 2020 then declined in subsequent months. With the second round of EIP mostly distributed in January 2021, total personal income rose by 10.1 percent before declining by 7.1 percent in February. The wild ride will continue as the third round of EIP was mostly distributed last month, which will push total personal income up by close to 20 percent in the March data. That increase would be even larger had a portion of the third round payments not slipped into April, but even with a nudge from the final portion of EIP, the April data will show a significant decline in total personal income.

Somewhat lost amid the sharp monthly swings in total personal income is that private sector wage and salary earnings have, as of the January data, surpassed their pre-recession peak. That is noteworthy in that private sector wage and salary earnings are far and away the largest single component of total personal income, and in more normal times the rate at which private sector labor earnings are changing dominates changes in other components, thus largely setting the path of total personal income. At some point in the months ahead, the Economic Impact Payments and other forms of transfer payments that have been key supports for total personal income since the onset of the pandemic will have run their course, meaning the path of personal income will once again be largely shaped by labor market conditions.

In that sense, it may seem surprising that aggregate private sector wage and salary earnings have surpassed their pre-pandemic peak when, as of the March 2021 data, the level of private sector nonfarm employment is 7.181 million jobs below the pre-pandemic peak. The gap in total, i.e., combined private and public sector, nonfarm employment is 8.403 million jobs as of March, but our focus here will be on private sector employment and earnings given what are typically long lags in public sector payrolls changing in response to changing conditions in the broader economy. While it may seem surprising that private sector wage and salary earnings have rebounded so much faster than has private sector employment, in reality this has been the case in every cycle since the 1960s, which is as far back as the monthly data on private sector labor earnings produced by the Bureau of Economic Analysis (BEA) go. It helps to recall that aggregate wage and salary earnings in a given period are the product of the number of people working, the number of hours they work, and how much they earn for each hour worked. As such, there are a number of factors that help account for the faster recovery in the level of wage and salary earnings than in the level of employment.

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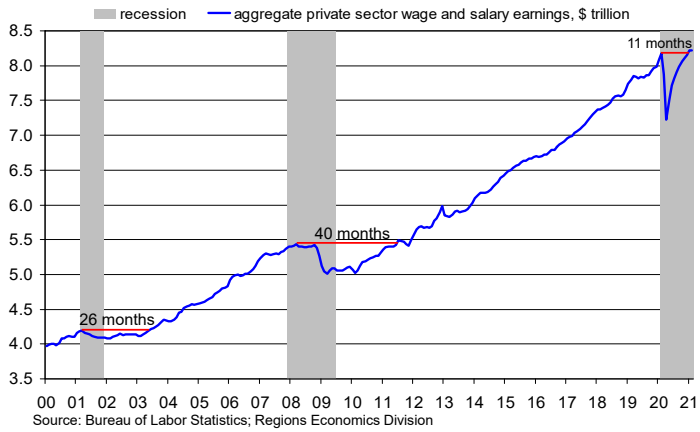
Labor Earnings Rebound Relatively Quickly . . .



Source: Bureau of Labor Statistics; Regions Economics Division

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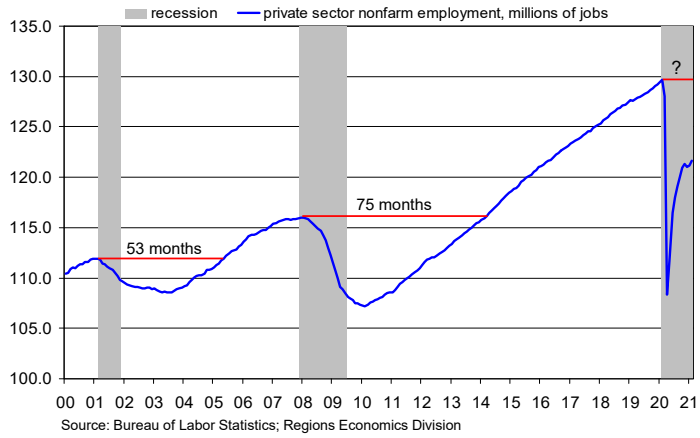
. . . Employment Not So Much



Source: Bureau of Labor Statistics; Regions Economics Division

The above charts illustrate our point, showing the relative recovery times over the most recent cycles. Though over the prior two cycles the recovery in private sector employment took right around twice as long as did the recovery in wage and salary earnings, going back further reveals quite a bit of variation in the ratio of recovery times, so there is little there to inform us on the current cycle. But, as of January 2021, when wage and salary earnings surpassed the prior peak, the level of private sector employment was 6.6 percent below the prior peak, which is the largest such gap in any of the cycles we have data for.

As noted above, there are a number of factors that help account for the relatively quicker rebounds in private sector wage and salary earnings. For instance, we simply do not see declines in hourly earnings, even during the deepest contractions when there is substantial labor market slack, which helps cushion the impact

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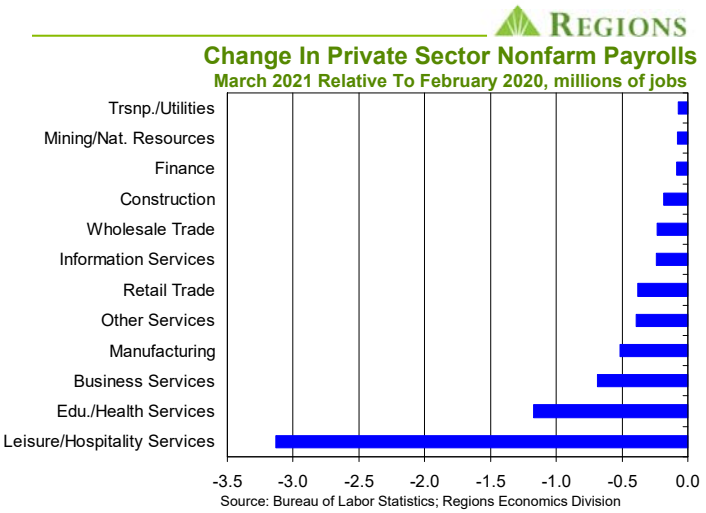
of the declines in the level of employment and in average weekly hours, and which also helps lead to a turnaround in wage and salary earnings when employment bottoms and hours worked begin to stabilize. The recovery in wage and salary earnings gains momentum once the level of employment hits a trough, which in almost every cycle we have data for, including this one, happens before wage and salary earnings recapture their prior peak. In other words, though still below its prior peak, the level of private sector employment nonetheless begins to increase, so that rising aggregate hours worked and average hourly earnings spark a faster rebound in aggregate wage and salary earnings.



The mix of jobs lost during the downturn and then added in the subsequent recovery also plays a role in the rate at which the level of aggregate wage and salary earnings recovers. This is very much in evidence in the current cycle. For instance, the one industry group most severely impacted by the pandemic and the efforts to stem its spread is leisure and hospitality services. Payrolls in the broad industry group fell by a net 8.224 million jobs over March and April 2020, and while over five million jobs have been added back since May 2020, payrolls in leisure and hospitality services are, as of March, 3.134 million jobs below the level of February 2020. This is the industry group with the lowest average hourly wage, meaning that the gap in jobs relative to February 2020 has biased the average hourly wage for all private sector workers higher, an example of what we mean by a mix issue. This is also the industry group with the shortest average workweek, so between wages and hours worked, the contribution of leisure and hospitality services to aggregate private sector wage and salary earnings is much lower than was the case prior to the pandemic.

In terms of the above chart, the two industry groups with the largest gaps in employment relative to February 2020 are leisure and hospitality services and education and health services, both of which have below-average hourly wages and average workweeks. In contrast, the five industry groups with the smallest gaps in employment relative to February highlighted in the chart each have above-average workweeks and, with the exception of transportation services, above-average hourly wages. With each making contributions to growth in private sector employment and hours worked, this has boosted growth in aggregate private sector wage and salary earnings over the past several months.

Again, there are a host of factors that account for faster recoveries in wage and salary earnings than in the level of employment. But, with private sector wage and salary earnings now above their pre-pandemic peak, the question becomes how much longer it will take for the same to be true of the level of private sector employment. As noted above, when private sector earnings rose above their pre-pandemic peak, the level of private sector employment was 6.6 percent below its prior peak, the largest such gap of any of the cycles for which we have data. While a full rebound in the level of private sector employment may not take as long as that gap may imply, it nonetheless could still take quite some time.

As seen in the prior chart, the largest single gap is in leisure and hospitality services, which accounts for over 37 percent of the remaining shortfall in private sector employment. But, as the economy more fully reopens in the months ahead, this is where we will see the most rapid job gains, as the broad leisure and hospitality services group encompasses entertainment, lodging, and recreation establishments in addition to travel services and restaurants. To that point, over the past two months restaurant payrolls have risen by 660,000 jobs while March saw stepped-up hiring in other segments of the broad industry group, reflecting further easing of remaining restrictions on activity in these areas. Additionally, further reopening of the economy will lead to faster job gains in education and health services (and also in government sector payrolls as instruction increasingly transitions from online to in-person).

More broadly, the robust pace of overall economic growth expected over the remainder of this year will support steady job growth, further whittling down the remaining gap in nonfarm employment. Still, fully closing that gap may take some time, reflecting what are likely to be more lasting changes in the economy stemming from the experiences of the pandemic. The most obvious is that not all firms will have survived, leaving a structural gap in employment that may take longer to fill.

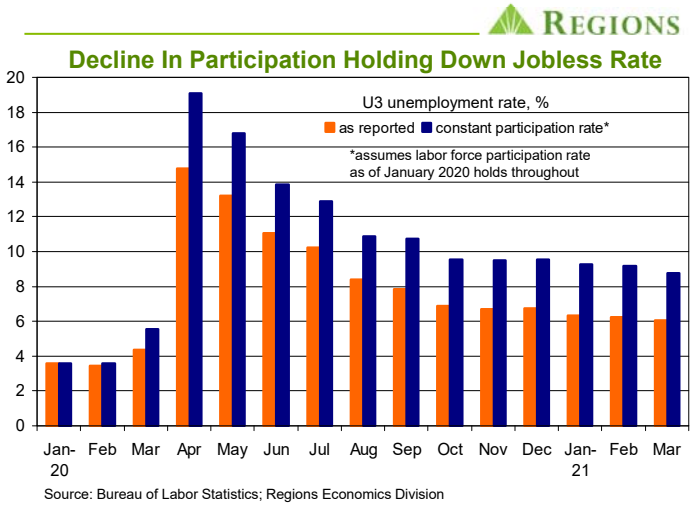
Another factor to consider is that the pandemic has accelerated the rate at which firms have substituted capital for labor via the increased use of automation, and this could be felt in areas ranging from factory floors to physician offices. For instance, the increased reliance on telemedicine enables physicians, or their staffs, to "see" a greater volume of patients in less time, meaning there may not be as great of a need for office staffs as was the case prior to the pandemic. Increased use of automated ordering and check-out platforms will mean fewer workers in retail and fast-food establishments. To the extent there is less demand for office and retail space, construction payrolls may take much longer to be fully restored – though the gap is relatively small, at 182,000 jobs as of March, the remaining shortfall in construction payrolls is entirely accounted for by non-residential construction, as residential construction payrolls are back above their pre-pandemic peak.

These are but a few examples of our broader point, which is that whether due to increased reliance on technology/automation or structural changes in the economy, there could be less demand for labor than was the case prior to the pandemic. While this does not mean the level of nonfarm employment will not return to the pre-pandemic peak, it would mean it will take longer for it to do so. It could be that most of the remaining shortfall in employment closes rather quickly over coming months as more and more people are

vaccinated against the COVID-19 virus and the economy more fully reopens but closing the remaining portion of that shortfall takes longer. Still, it is reasonable to expect that at some point in 2022 the level of employment will surpass the pre-pandemic peak.

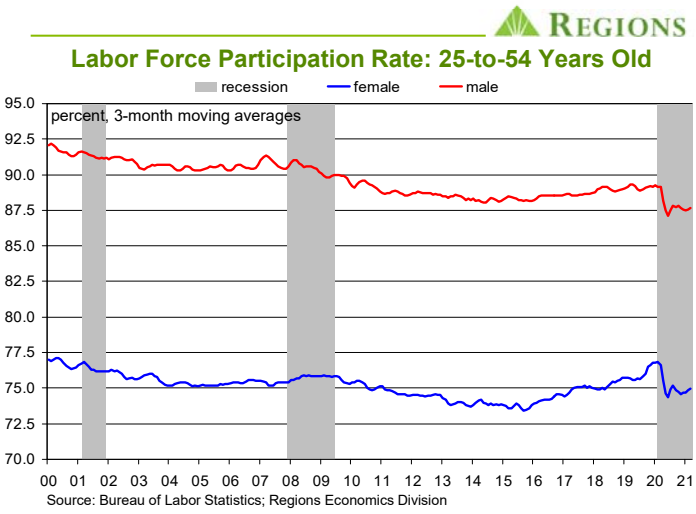
Other Indicators Show Labor Market Has Further To Go

Even if we are correct about the level of nonfarm employment surpassing the pre-pandemic peak at some point in 2022, that would not necessarily mean the recovery in the labor market would be considered complete at that time. We could make the same point using the unemployment rate, rather than the level of nonfarm employment, as our frame of reference, i.e., the jobless rate falling back to the pre-pandemic rate of 3.5 percent. Other labor market indicators show a greater degree of labor market slack than is implied by the "headline" labor market indicators. We think it worth discussing some of these indicators here. In addition to this being a topic we've frequently discussed, here and in other forums, it is also a topic many FOMC members, most notably Fed Chairman Powell, have discussed a good deal of late, and one which will shape their interpretation of labor market conditions as they deliberate the appropriate course of monetary policy.



The first, and to us most obvious, factor to account for is what has been a significant decline in labor force participation since the onset of the pandemic. As of March, there were 3.890 million fewer people in the labor force than in February 2020, which puts the labor force participation rate at 61.5 percent in March compared to 63.3 percent as of February 2020. One implication is that the "headline," or, U3 unemployment rate is lower than otherwise would be the case – keep in mind that those not in the labor force are not accounted for in the unemployment rate. We illustrate the difference in the above chart, where the blue bars show what the unemployment rate would be were the participation rate the same as it was in February 2020. As of March, this would put the unemployment rate at 8.8 percent, rather than the reported rate of 6.0 percent. If anything, 8.8 percent is a conservative estimate, as it is based on a constant participation rate from February 2020 on, when in reality the participation had been trending slowly but steadily higher in the years leading up to the pandemic. Assuming that trend would have continued, the labor force would be larger, and the unemployment rate would be higher, than is implied by the constant participation rate calculation shown in the prior chart.

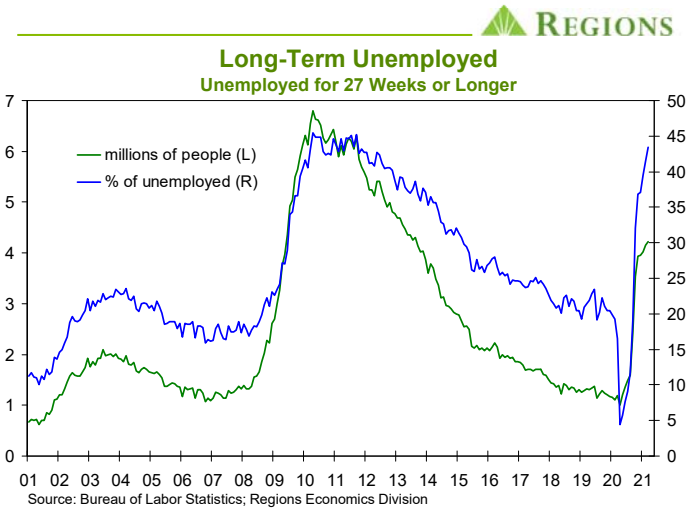
Either way, the broader point is that there is a substantial degree of labor market slack not accounted for by the U3 unemployment rate. Between accommodating first-time entrants into the labor force and the return of those who have dropped out over the past year, it will take either a faster rate of job growth or a longer period of time to pare down this labor market slack. And, if we are correct in thinking that demand for labor in the post-pandemic world will be lower than in the pre-pandemic world, that pushes the timeline even further out into the future. It is also concerning that the decline labor force participation over the past year has been concentrated amongst the "prime working age" population, i.e., those between 25 and 54 years old.



Those in this age cohort account for over 48 percent of the decline in the total labor force between February 2020 and March 2021 and, as seen in the above chart, the decline within this age cohort has been more pronounced amongst females than amongst males. Indeed, the increase in the total labor force between 2015 and the start of the pandemic was more than accounted for by rising female participation, as total participation amongst males was basically flat over this same period. Note from the above chart that while participation amongst prime working-age females had pushed past the prior cyclical peak by 2020, participation amongst prime working-age males had not. But, in part due to them taking greater responsibility for overseeing in-home learning or caring for ill family members, the decline in labor force participation since the onset of the pandemic has been more pronounced amongst females. It remains to be seen how long it will take to reverse this decline in the post-pandemic world, but clearly rising female participation has been a key driver of overall labor force growth.

Another, and not totally unrelated, area of concern is the rising incidence of long-term unemployment, i.e., those unemployed for 27 weeks or more. As of March, there were 4.218 million people who fell into this group, accounting for 43.4 percent of total unemployment, and this share will almost surely rise further in the months ahead. For reference, in February 2020 there were 1.111 million people unemployed for 27 weeks or longer, accounting for

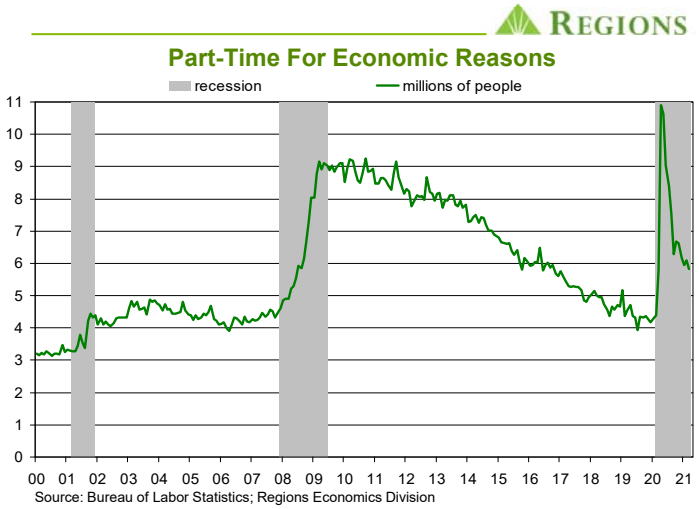
19.3 percent of total unemployment. In past cycles, long-term unemployment has peaked well after the end of recessions, and there is no reason to think this cycle will be any different.



There is ample empirical evidence showing the longer one is unemployed, the longer the odds of their landing another job. This could reflect skills atrophying, network connections being lost, or a bias, even if implicit, amongst prospective employers who may take a prolonged period of unemployment as a signal of a skill(s) deficiency on the part of a job seeker. To the extent that the pandemic has accelerated the push toward greater utilization of technology and automation, the skills mismatches between the long-term unemployed and those sought by employers could be even wider than was the case prior to the pandemic.

For whatever reason, the hurdles facing the long-term unemployed are higher than those facing other job seekers, raising the odds that someone experiencing a prolonged period of unemployment ultimately gives up and exits the labor force. The data on labor force flows, tracking the month-to-month labor force status of individuals, show the number of people transitioning from unemployed in one month to out of the labor force in the next month remains considerably higher than was the case prior to the pandemic. While some of these people will ultimately return to the labor force, not all will. This is a reminder that, while the level of employment will at some point surpass the pre-pandemic peak, that does not mean all of the people who were employed prior to the pandemic will be employed in the post-pandemic world.

Another indicator of labor market slack, and one which ties back to the earlier discussion of aggregate hours and earnings, is the number of people working part-time for economic reasons. In other words, people who would prefer to be working full-time but are only able to find part-time work. It is common for the incidence of involuntary part-time employment to increase during recessions, peak only after the recession has ended, and then recede only gradually during the subsequent expansion. Keep in mind that, along with the number of workers, hours worked is one lever firms use to manage total labor input, with managing hours worked less costly and disruptive, though less sustainable, than altering the number of workers. For instance, during the 2007-09 recession, the number of people working part-time for economic reasons rose sharply and didn't actually peak until September 2010, at 9.246 million people. From there it was a gradual decline, befitting the frustratingly slow pace of the expansion, with the number "settling" in at around 4.3 million per month over the second half of 2019. In February 2020, there were 4.398 million people working part-time for economic reasons, a number which shot up to 10.899 million people last April. Though having declined sharply since then, as of March there were still 5.828 million people working part-time for economic reasons.



The elevated incidence of involuntary part-time work is weighing on growth in aggregate hours worked, and hence the productive capacity of the economy. Additionally, growth in aggregate wage and salary earnings is slower than it otherwise would be, which in turn weighs on growth in personal income. While the incidence of involuntary part-time employment figures to decrease as the economy more fully reopens over coming months, post-recession declines have historically come at only a gradual pace. It could be that the number of people working part-time for economic reasons eventually stabilizes at a higher level than was the case pre-pandemic, another potentially lasting change in the labor market.

While that remains to be seen, the broader point is that involuntary part-time employment is another source of labor market slack. As this discussion has illustrated, the "headline" figures atop the monthly employment reports, i.e., the unemployment rate and the change in nonfarm employment, are incomplete measures of the degree of labor market slack. No assessment of labor market conditions can be considered complete until factors such as labor force participation, the duration of unemployment, and involuntary part-time employment have been accounted for, nor is this an exhaustive list. Metrics such as voluntary quit rates, the rate at which firms are filling open jobs, and disparities in the rates of wage growth across jobs of varying skill levels are also instructive.

To be sure, this cycle is like no other cycle any of us has ever seen. But, to the extent that history can still serve as a guide, even after the level of nonfarm employment has surpassed its pre-pandemic peak, there will still be a considerable degree of slack in the labor market. As long as this remains the case, this labor market slack will act as a persistent, even if not clearly visible, drag on overall economic growth.

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Q3 '20 (a)	Q4 '20 (a)	Q1 '21 (f)	Q2 '21 (f)	Q3 '21 (f)	Q4 '21 (f)	Q1 '22 (f)	Q2 '22 (f)		2018 (a)	2019 (a)	2020 (a)	2021 (f)	2022 (f)
33.4	4.3	6.3	8.3	6.3	4.5	3.8	3.2	Real GDP[1]	3.0	2.2	-3.5	6.2	4.1
41.0	2.3	8.5	9.1	5.8	4.8	3.8	3.3	Real Personal Consumption[1]	2.7	2.4	-3.9	7.1	4.2
22.9	13.1	6.9	8.6	7.1	6.0	6.4	5.9	Real Business Fixed Investment[1]	6.9	2.9	-4.0	7.6	6.3
68.2	25.4	9.9	11.8	7.0	3.8	3.9	4.1	Equipment[1]	8.0	2.1	-5.0	14.2	4.7
8.4	10.5	6.5	7.4	8.1	8.0	7.0	5.6	Intellectual Property and Software[1]	7.8	6.4	1.7	6.7	6.7
-17.4	-6.2	-0.6	1.6	4.8	8.3	12.5	12.1	Structures[1]	3.7	-0.6	-11.0	-5.0	9.4
63.0	36.6	16.1	11.9	4.6	5.5	-0.4	-3.2	Real Residential Fixed Investment[1]	-0.6	-1.7	6.1	17.0	1.5
-4.8	-0.8	1.4	-2.4	5.1	1.7	2.5	2.2	Real Government Expenditures[1]	1.8	2.3	1.1	0.0	2.1
-1,019.0	-1,122.0	-1,149.4	-1,158.2	-1,174.5	-1,180.6	-1,179.3	-1,177.6	Real Net Exports[2]	-877.7	-917.6	-926.0	-1,165.7	-1,185.7
1,037	1,227	1,124	1,228	1,269	1,263	1,244	1,240	Single Family Housing Starts, ths. of units[3]	872	893	1,000	1,221	1,245
395	357	425	380	378	379	381	383	Multi-Family Housing Starts, ths. of units[3]	376	403	396	390	385
15.3	16.1	16.7	16.6	16.7	16.5	16.6	16.6	Vehicle Sales, millions of units[3]	17.2	17.0	14.4	16.6	16.6
8.8	6.8	6.2	5.7	5.2	4.9	4.7	4.4	Unemployment Rate, %[4]	3.9	3.7	8.1	5.5	4.4
-6.8	-6.0	-5.6	9.2	5.2	4.7	4.8	3.4	Non-Farm Employment[5]	1.6	1.3	-5.7	3.1	3.2
-17.4	-10.1	58.6	-27.1	-7.3	-2.1	4.5	3.4	Real Disposable Personal Income[1]	3.6	2.2	5.8	2.7	-1.1
1.2	1.3	1.6	2.6	2.3	2.4	2.0	1.9	GDP Price Deflator[5]	2.4	1.8	1.2	2.2	1.8
1.2	1.2	1.6	2.5	2.2	2.4	2.1	2.1	PCE Deflator[5]	2.1	1.5	1.2	2.2	2.0
1.3	1.2	1.9	3.4	2.7	2.5	2.1	1.8	Consumer Price Index[5]	2.4	1.8	1.2	2.6	1.9
1.4	1.4	1.5	2.2	1.9	2.1	2.1	2.1	Core PCE Deflator[5]	2.0	1.7	1.4	1.9	2.0
1.7	1.6	1.4	2.3	1.9	2.1	2.4	2.4	Core Consumer Price Index[5]	2.1	2.2	1.7	1.9	2.3
0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	1.78	2.16	0.42	0.13	0.13
0.65	0.86	1.32	1.77	1.83	1.88	1.93	2.00	10-Year Treasury Note Yield, %[4]	2.91	2.14	0.89	1.70	2.02
2.95	2.76	2.88	3.30	3.41	3.52	3.61	3.70	30-Year Fixed Mortgage, %[4]	4.54	3.94	3.12	3.28	3.71
-3.4	-3.5	-3.3	-3.2	-3.3	-3.4	-3.4	-3.3	Current Account, % of GDP	-2.2	-2.2	-3.1	-3.3	-3.4

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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