ClearBridge Investments

Recession Indicators Update: Wage Pressures Mounting

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Key Takeaways

- The Wage Growth indicator has turned to red from yellow as wages continue to rise, particularly for lower earners. While this may be a short-term positive to consumption, over time it should lead to higher inflation as companies raise prices to defend margins.
- The Wage Growth indicator is one of the longer leading indicators on the ClearBridge Recession Risk Dashboard. As a result, this change does not signal a material shift in the near-term recessionary outlook.
- The Commodities indicator has also turned to yellow from red while the overall signal from the ClearBridge Recession Risk Dashboard remains unchanged at a cautionary yellow.

Growing Wage Pressure from Lower-Paying Jobs

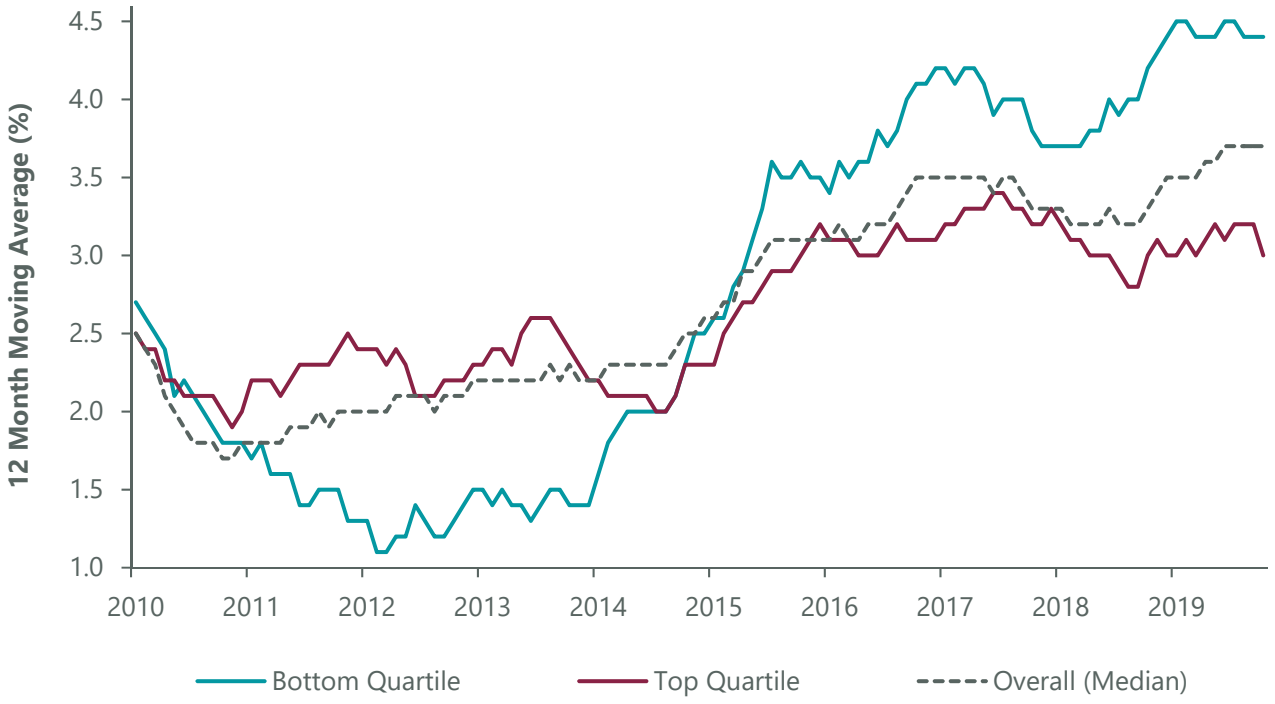
The ClearBridge Recession Risk Dashboard experienced two changes during November, with Wage Growth turning to red from yellow and Commodities improving to yellow from red. Having previously detailed commodities, this month we will focus this month on wages. Rising wages are a double-edged sword for the U.S. economy, as we outlined earlier this year. On the positive side, higher wages can help boost consumption which tends to be the primary driver of U.S. economic activity. Rising compensation can also bolster savings, and the consumer is now saving 8.3% of their disposable income, up nearly four times from the 2005 low. While higher savings has contributed to slower economic growth, it has helped strengthen consumer balance sheets which should allow for greater spending in the event of a sustained slowdown.

The downside to stronger wage growth is the potential to hurt corporate profitability, as wages are one of the largest expenses for most businesses and those in the services sector particularly. If companies raise prices in order to maintain margins, this can lead to inflation which, in turn, can lead to a more hawkish U.S. Federal Reserve that raises rates more aggressively. Additionally, layoffs could become more commonplace as we are late in the economic cycle and companies may be unable to fully raise prices to offset higher compensation costs. This can drive a negative feedback loop, with slower consumer spending and economic activity. Tight monetary policy and rising unemployment can be a powerful recessionary concoction. While higher wages are often a short-term benefit, over time they have the capability to do harm.

Corporate profits typically get squeezed the most when wage increases outpace productivity gains. This is currently the case, as over the past five years overall wage growth has averaged 2.7%, well ahead of the 1.0% average increase for labor productivity (output per hour). Several months ago, the Profit Margins indicator on the ClearBridge Recession Risk Dashboard turned yellow as this dynamic started to take its toll on the small businesses that are the country's primary employers. Larger businesses are also seeing margin pressures, with the contribution to growth from margins for the S&P 500 Index constituents having been negative for the last two quarters.

The latest data does not show that wage pressures are abating, either. While the headline figure for wage growth has softened a bit and is now running at 3% per year, median wages are growing at a cycle-high 3.5%. Demographic shifts are partly the reason for the divergence between the average and median figures. As older, higher earning workers exit the labor force and are replaced by younger ones at lower salaries, the average gets pulled down. The median figure is less impacted by this dynamic and as a result can be more representative of the wage gains the typical worker is receiving.

Exhibit 1: Lower Paying Jobs Have Seen the Strongest Wage Gains



As of Oct. 1, 2019. Source: Federal Reserve Bank of Atlanta.

An additional source of wage pressure is coming from stronger raises for lower-earning workers. Salaries for production and non-supervisory workers are growing at a higher rate (3.5%) than the national average. Eighty percent of Americans have these types of jobs, which on average pay about half of what the other 20% of Americans earn. This divergence is also evident when looking at wage gains for the top and bottom quartile of earners (Exhibit 1). While the early part of the expansion was defined by faster wage gains for the top earners, this flipped around in 2015, and the bottom earners have been leading ever since. Currently, these lower wage earners are seeing very strong increases of 4.4% annually. In the short term, this can result in a larger boost to consumption, as lower wage earners typically have a higher propensity to spend. However, the same longer-term drawbacks described above are likely to play out here as well.

Exhibit 2: ClearBridge Recession Risk Dashboard

	Current	Third Quarter 2019	Second Quarter 2019
Yield Curve	✕	✕	✕
Credit Spreads	↑	↑	↑
Money Supply	●	●	●
Wage Growth	✕	●	●
Commodities	●	✕	✕
Housing Permits	↑	↑	↑
Jobless Claims	↑	↑	↑
Retail Sales	↑	↑	↑
Job Sentiment	↑	↑	●
ISM New Orders	✕	✕	●
Profit Margins	●	●	↑
Truck Shipments	↑	↑	↑
Overall Signal	●	●	●

↑ Expansion ● Caution ✕ Recession

As of Nov. 30, 2019. Source: ClearBridge Investments.

The Wage Growth indicator turning to red is an incremental negative, although this indicator has traditionally been one of the longer leading indicators ahead of recessions. While its efficacy in this cycle will only be known with the benefit of hindsight, history would suggest this signal change should not be interpreted as an indication that a recession is on the immediate horizon, particularly when combined with the improvement in the Commodities indicator. As a result, our longer-term views on the economic cycle, as well as the overall yellow signal on the ClearBridge Recession Risk Dashboard, remain unchanged.

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