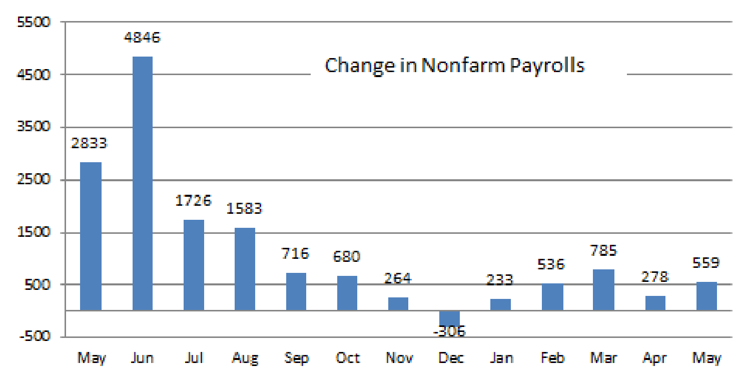
WEEKLY ECONOMIC COMMENTARY

The search for answers didn't get any easier on Friday after the Labor Department released its monthly jobs report. While the key takeaway is that job growth in May was disappointing, the headline reading leaves a host of questions still unanswered. Topping the list is whether the weaker-than-expected showing reflects labor shortages, confirming widespread anecdotal reports that businesses can't find workers to fill open positions. If so, the question is why. There are still 7.6 million fewer workers drawing paychecks than there were just prior to the pandemic. How many in this vast pool of workers are remaining on the sidelines voluntarily – for health reasons, family responsibilities, such as child care, or because generous unemployment benefits make job openings less attractive? Alternatively, how much of the shortfall is involuntary, reflecting a mismatch between the type of skills needed by businesses and the skills of unemployed workers.

One restraining force that can be ruled out is a softening in demand for labor by businesses. The economy is reopening and galloping ahead at a breakneck pace. Leading the charge is the highly labor-intensive service sector. Restaurants and bars, amusement parks, casinos, and sporting events all require workers to accommodate customers eager to satisfy pent-up demand for services denied them during the pandemic. With newly vaccinated households more comfortable attending in-person events and flush with savings built up during the pandemic, they are returning to these venues in droves. Spending on services is the economy's main growth driver - the Institute for Supply Management reported this week that its index of service-sector activity hit a record high in May.

Against that backdrop, the consensus of forecasters looked for a job gain of close to 700 thousand in May, building on the 278 thousand increase posted in April. Instead, the economy generated an underwhelming 559 thousand jobs during the month, marking the second straight month that forecasters overestimated job prospects. The breadth of the job gains was also disappointing, as only 62 percent of industries expanded payrolls. Two months ago, 73 percent were expanding. To be sure, this narrowing breadth is not entirely a labor issue but rather a shortage of parts in the goods sector related to supply-chain disruptions that have stifled output and, hence, hiring. This is particularly the case in manufacturing, where only 57.3 percent expanded payrolls in May versus 75.3 percent two months earlier. The auto sector, which is bedeviled with a shortage of semiconductor chips, is a major victim of these disruptions. In April, motor vehicle assemblies fell to 8.8 million from 9.4 million in March; we suspect that production contracted further in May, keeping workers on the sidelines.

Modest Pickup in Jobs



That said, the service sector did most of the heavy lifting in the job market last month. Of the 559 thousand jobs created, fully 489 thousand were from private-sector service companies. That's nearly double the 255 thousand gain in April but less than the 642 and 565 thousand increases seen in February and March. Not surprisingly, firms in leisure and hospitality did most of the hiring, taking on 292 thousand new workers last month. Bars and restaurants did the bulk of the hiring, expanding payrolls by 186 thousand, a pick-up from the 119 and 168 thousand increases in March and April. In this sector, demand for workers is outstripping supply. It is also at the center of the debate regarding the causes of the imbalance.

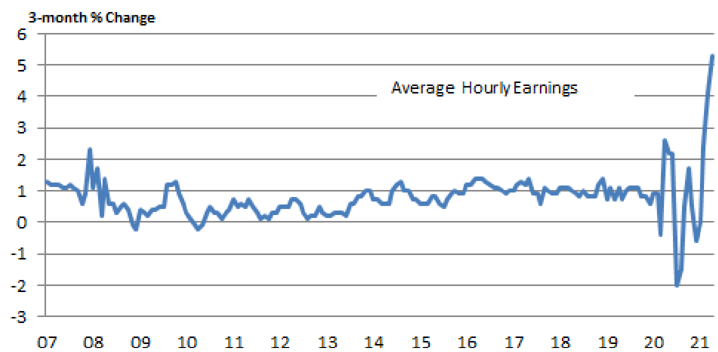
Workers in the leisure and hospitality sector are among the lowest-paid workers. As a result, some believe they refuse to take a job as long as the pay is less than the unemployment benefits they receive. That's a key reason why almost half of the states are opting out of the Federal program that gives unemployed workers an extra $300 a week in benefits. That program is set to expire in September, but these states are betting that cutting off that incentive sooner will spur an increase in the labor supply. No doubt, that argument draws some support from numerous attention-getting reports by businesses claiming that they can't compete with the government for workers.

We suspect, however, that the generous unemployment benefits rank below other reasons causing labor shortages, including health concerns and child care responsibilities (until schools fully reopen in the fall). There is also the natural friction that should be expected as the economy swiftly transitions from lockdown to reopening in a matter of a few months. Whereas restaurants and their business colleagues in the service sector are all reopening at once, it takes time for people to reorganize living arrangements established since the pandemic struck a year ago. This process will take a bit longer from our lens, but the stage is set for a more rapid expansion in the labor supply later this summer and into the fall.

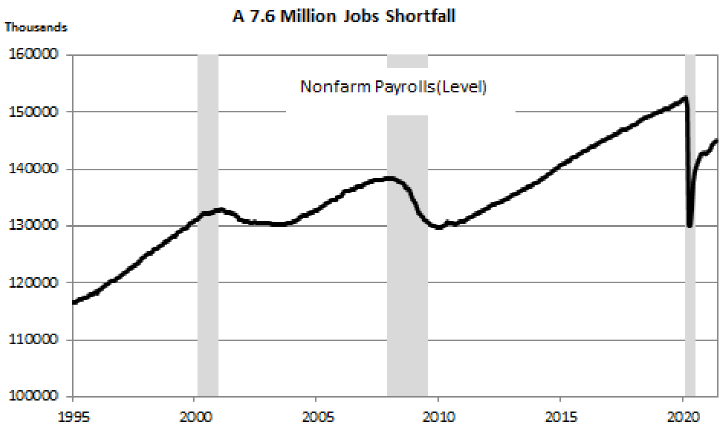
Importantly, whether it is the competition from enhanced unemployment benefits or other restraints causing labor shortages, the surge in demand for workers is having a time-honored effect. Simply put, it is driving up wages where the shortages are the most acute. Overall, average hourly earnings for workers increased a solid 0.5 percent last month, lifting the annual increase to 2.0 percent from 0.4 percent in April. Moreover, the accelerated pace of wage gains occurred even though most of the employment gains last month took place in low-paid industries - which would ordinarily drag down the average increase. But it is among the lower-paying jobs that are getting the most significant pay raises.

For example, workers in leisure and hospitality saw their average hourly earnings increase by 1.3 percent, more than double the increase for all workers. Nor was last month a fluke, as outsize gains were also achieved in each of the previous two months. Hence, over the past three months, average hourly earnings for this group increased by an eye-opening 4.1 percent. Digging down further, the gains are even more impressive for workers at restaurants and bars. Data for May are not yet available, but the trend through April highlights the growing strength of worker bargaining power with owners struggling to fill positions at these establishments. As a result, average hourly earnings for this subgroup increased by a whopping 5.3 percent over the three months through April, a record for the period. Most likely, upward wage pressure for these workers intensified in May.

Surging Pay at Bars and Restaurants



For sure, not all workers in the services sector are faring as well. Retail stores lopped off 6 thousand jobs in May after slicing 30 thousand in April. This strikes somewhat of a discordant note, as improving health conditions should send customers back to stores instead of online. We may have a case where mom and pop establishments cannot meet higher wage demands, sending workers to higher-paying jobs elsewhere. Alternatively, it may simply be that retail workers have far fewer stores to which they can return. According to commercial real estate industry sources, a record-breaking number of more than 10 thousand stores were forced to close their doors in 2020 due to the pandemic. That trend continued into the early months of 2021, leaving even fewer job opportunities in this sector.



From our lens, the key takeaway from the May jobs report is that the supply of labor is not expanding as rapidly as the demand for workers. For a variety of reasons, companies are having difficulty bringing workers back from the sidelines. The labor force actually shrank last month, lowering the labor force participation rate to 61.6 percent from 61.7 percent. Since unemployment fell even more, the unemployment rate slipped from 6.1 percent to 5.8 percent, marking a considerable descent from the 14.8 percent peak of last April. Still, there's a ways to go before the jobless rate hits the prepandemic level of 3.5 percent. What's more, following the 559 thousand increase last month, payrolls still remain 7.6 million below where they were in February 2020.

Odds are, the robust pay increases of recent months will stoke inflation concerns, giving heft to the argument that wage-price pressures are building, requiring the Federal Reserve to start pulling in the policy reins sooner than later. We disagree. Inflation is a process that builds over time, and the outsized increases given to low-wage workers are not likely to be repeated consistently; as more of them return to the workforce in coming months, supply shortages will ease and reduce upward pressure on wages. The recent increases in labor costs and supply chain disruptions combined with the rapid reopening of the economy are producing the well-telegraphed spike in inflation, but they have not dialed up long-term inflation expectations. As these influences fade later this year, so too should inflationary pressures.

Meanwhile, the job market has not fully recovered, despite the steady growth in employment. While the pace of gains should accelerate in coming months, considerable inequities still persist, with joblessness among minority and low-skilled workers substantially higher than among white and educated workers. The Fed has repeatedly stated that it would allow the economy to run hotter and inflation to exceed its target for a period of time to enhance job opportunities for these marginal workers. We expect Fed officials to soon begin talking about when to pull in the reins a bit, but an actual rate hike is still a ways off.

FINANCIAL INDICATORS				
INTEREST RATES	June 4	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.02%	0.01%	0.02%	0.15%
6-month Treasury bill	0.04	0.03	0.03	0.18
3-month LIBOR	0.13	0.13	0.16	0.35
2-year Treasury note	0.15	0.14	0.15	0.22
5-year Treasury note	0.78	0.79	0.78	0.47
10-year Treasury note	1.55	1.55	1.57	0.91
30-year Treasury bond	2.23	2.26	2.28	1.68
30-year Fixed Mortgage rate	2.99	2.95	2.96	3.18
15-year Fixed Mortgage rate	2.27	2.27	2.30	2.62
5/1-year Adjustable rate	2.64	2.59	2.70	3.10
STOCK MARKET				
Dow Jones Industrial Index	34756.39	34529.45	34777.76	27110.98
S&P 500	4229.89	4204.11	4232.60	3193.93
NASDAQ	13814.49	13748.74	13752.34	9814.082
COMMODITIES				
Gold ($ per troy ounce)	1894.10	1906.30	1832.00	1683.45
Oil ($ per barrel) - Crude Futures (WTI)	69.38	66.63	64.84	37.32
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (May)	61.2	60.7	64.7	61.1
ISM Non-manufacturing Index (May)	64.0	62.7	63.7	59.8
Nofarm Payrolls (May) - chg. 000s	559	278	785	348
Unemployment Rate (May) - Percent	5.8	6.1	6.0	6.2
Average Hourly Earnings (May) - % chg.	0.5	0.7	-0.1	0.4