SeaBridge Core Global Strategy

March 2015 Commentary

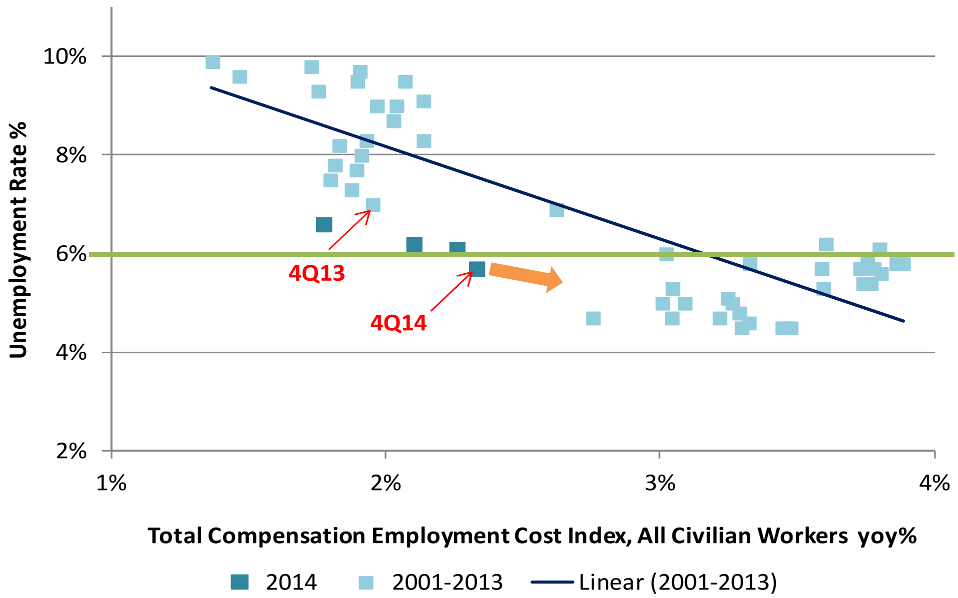
In February, we expressed our belief that the U.S labor market is tightening rapidly. We further suggested that growing demand could lift inflation close to the Fed's 2% target more quickly than currently implied by intermediate and longer-term interest rates. If the labor market were to continue to strengthen, the Federal Open Market Committee (FOMC) could begin the process of normalizing the Fed Funds rate as early as mid-year. Our belief hinges on rising spending empowered by not only savings from reduced energy and healthcare spending but, more importantly, acceleration in wage growth as more people find employment. In this commentary, we analyze worker compensation trends within an historical context. Our analysis suggests that the labor market may have reached the point at which a further decline in the unemployment rate could trigger a broadly based increase in wage growth. We believe that without a near-term increase in worker productivity, wage-induced demand growth should lift short-term inflation, which could lead to interest rate normalization.

In the U.S., the Federal Reserve (Fed) operates through 12 district Reserve Banks. Each serves its region of the country and periodically gathers anecdotal information on current economic conditions in its district. These anecdotes are released to the public through the Beige Book report. Despite strong payroll expansion, the Fed's Beige Book continues to note that most measures of labor compensation have showed no broadly based increase in wage inflation. Findings from district banks indicate that upward pressure on wages is present only in specific industries and occupations associated with labor shortages or difficult-to-fill jobs. However, survey data from the National Federation of Independent Business paint a different picture. Small businesses employ about half of private-sector employees and generated 60-80% of net new jobs annually over the last decade. In January 2015, a net 25% of small businesses reported higher compensation. This is consistent with the pre-recession period 2005-2007, which implies that the job market may be in better shape than the Fed is assuming in crafting current monetary policy.

The Average Hourly Earnings Index (AHE) and the Employment Cost Index (ECI) are two of the measures commonly used to measure wage growth. The AHE is the ratio of total payroll for private non-farm employees to their total paid hours. The AHE is available monthly, making it a timely measure. However, only some employee benefits are included in the Index, such as overtime, paid vacation, paid holidays, and sick leave. The AHE does not, however, include insurance benefits or retirement benefits. In addition, the AHE reflects both wage changes and workforce composition changes. For example, the AHE might increase when lower paid workers are laid-off during a recession even if the earnings of remaining workers declined. Alternatively, the ECI, although available only on a quarterly base, is easier to interpret because it is a fixed-weight index of compensation paid for specific jobs, free from the influence of employment shifts among occupations and industries. The ECI also captures a more comprehensive list of benefits including for example, paid leave, insurance benefits, and retirement benefits.

Chart 1 depicts the relationship between the ECI and the unemployment rate from 2001 to 2014 on a quarterly basis. Clearly, observations are more densely located on the two ends, high and low wage growth. Intuitively, when unemployment is sufficiently high, slack in the labor market inhibits wage increases. At a certain unemployment threshold, however, the upward pressure would be released and could prompt a sudden acceleration in wage growth. Although it is difficult to pinpoint the exact unemployment rate that could trigger an acceleration in wage growth, the historical relationship suggests that 6% may be the magic number. If so, as unemployment dips below 6%, wage growth should increase 1-2% to a 3-4% level from around 2% since 2010. In fact, however, as unemployment fell from 7% in the 4th quarter of 2013 to 5.7% in the 4th quarter of 2014, wage growth increased, but only at a modest pace going from 2.0% to 2.3%. We believe a below trend inflation rate, induced by declining energy and health care costs experienced in 2013 and 2014, could have impeded wage growth in 2014 as the unemployment rate crossed below the 6% threshold.

Chart 1:

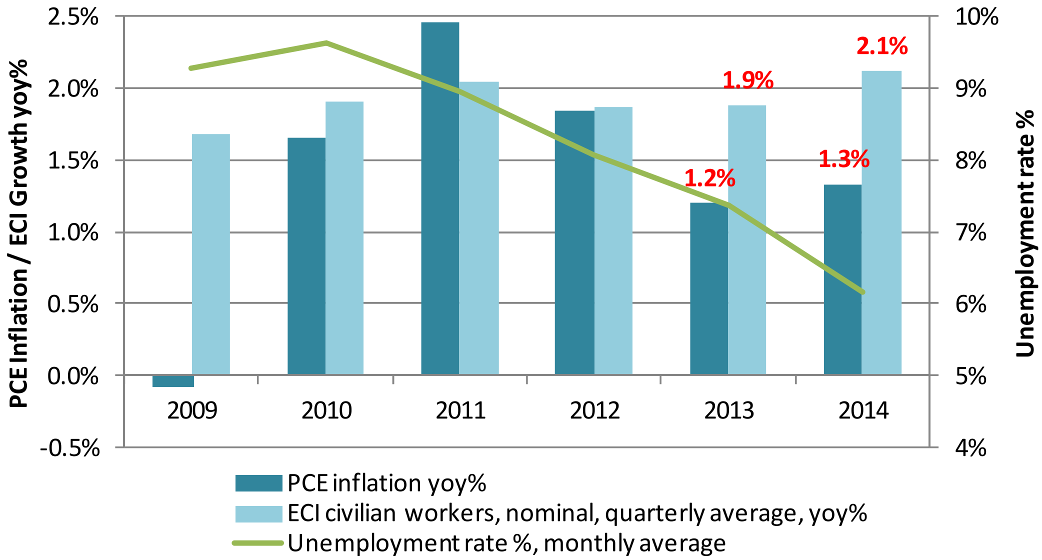


Source: Bureau of Labor Statistics

Chart 2 provides a side-by-side view of PCE inflation and ECI nominal growth from 2009 to 2014. In 2009, while GDP declined at a rate of 2.8%, the largest decline in output of any post-war recession, ECI growth only softened modestly. The hesitancy of employers to cut nominal wages, even during such a severe recession, perhaps led to more layoffs and a higher unemployment rate. Deflation in 2009 further aggravated the pain of the recession for employers as it boosted real wage growth to 1.7%, which is even higher than the 2002-2007 average of 1.2%. During 2010 and 2012, thanks to inflation, employers were able to keep real wages nearly frozen and work off the excess gains in real wage growth. Inflation was low in 2013 and, despite a strong economy, edged up modestly in 2014.

In our February commentary, we illustrated that two unique circumstances, the global oil supply/demand imbalance and the domestic healthcare market intervention, kept the U.S. inflation rate below trend for the past two years. Yet, encouragingly, after a 0.7% real wage boost in 2013, nominal wage growth was further pushed up to 2.1% in 2014, netting an incremental 0.8% in real terms. As we have discussed above, based on past experience, the rapid decline in the unemployment rate should have contributed to a much faster wage growth by the end of 2014. Perhaps such mild growth reflects unusually low inflation expectations due to the low actual inflation rate experienced in 2013. In 2015, however, without an increase in worker productivity, inflation could be pushed up above the Fed's comfort zone, thus triggering expectations of an increase in interest rates.

Chart 2:



Source: Bureau of Labor Statistics and Bureau of Economic Analysis

In our view, the US investment environment in the first half of 2015 will likely be characterized by reasonable growth, moderate inflation and low interest rates. Towards the end of the year, however, inflation pressure attributable to a rapidly tightening employment market may become more apparent. (Witness the recent pay increase for minimum wage workers at Walmart). The strength of the dollar relative to the euro and the pace at which the price of oil regresses to the mean will likely be the arbiters of interest rates as the Federal Open Market Committee (FOMC) searches for the right path to normalize monetary policy.

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