

Evaluating the Changing US Labor Market

Ronald Temple | Lazard Asset Management | 10 February 2015

SUMMARY

At first glance, it appears that much of the pain caused by the global financial crisis is behind us and that the job market has healed. Unfortunately, it is not that simple.

Short-term indicators suggest a more constructive job environment, but other metrics suggest that millions of workers are lacking adequate employment.

Demographics explain some of the dynamics of employment that followed the financial crisis, but not all of them.

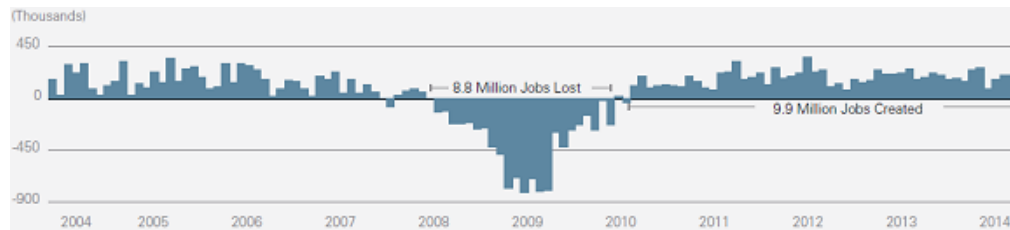
Our analysis suggests the United States still has substantial excess labor supply which should reduce the risk of meaningful labor inflation in the near term. In spite of this lack of pricing pressure, we worry that the US Federal Reserve might unintentionally aggravate the challenges facing the underemployed and weaken future economic growth by normalizing monetary policy prematurely.

HAS THE US EMPLOYMENT RECOVERED?

Since the beginning of the global financial crisis, the US Federal Reserve (the Fed) and the Federal Open Market Committee (FOMC) have aimed to prop up the economy and labor market through a range of measures, including lowering interest rates to a range of 0.00% to 0.25% and purchasing over \$3.5 trillion of US fixed-income securities. Through this process, the FOMC has guided investors to watch the US labor market for clues as to when it might change course and begin to normalize monetary policy.

While the Fed's dual mandate focuses on employment and price stability, in reality the two are inextricably linked given that between 55% to 65% of the cost of goods sold in the United States is labor¹. Hence, price stability is contingent on the labor market being in an optimal position. For the last several years, there has been a large excess supply of labor relative to demand. However, some believe we are now at the point where supply and demand are roughly equal or even where there is not enough supply of the type of labor needed to meet demand. If this is correct, we would expect wages to increase since, historically, when they do, prices throughout the economy increase, leading to further demands for wage increases and the risk of a wage-price spiral.

Exhibit 1: Aggregate employment has recovered
Private Non-Farm Payroll, Job Gain/Loss



Sources: Bureau of Labor Statistics, Haver Analytics. As of July 2014

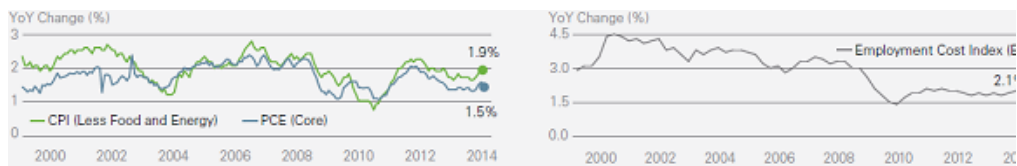
On the surface, it appears that much of the pain caused by the global financial crisis is behind us and that the job market has healed. After losing 8.8 million private sector non-farm jobs in only twenty-three months during the economic crisis, the trend has reversed with a gain of almost 9.9 million since 2010 (Exhibit 1). A number of short-term indicators support the idea that the labor market has healed. The Job Openings and Labor Turnover Survey (JOLTS) from the Bureau of Labor Statistics shows that there are currently 4.7 million job openings in the United States, which equates to 3.3% of all current and open jobs, an increase of 700,000 from a year ago. Adding to this positive story is the Manpower Employment Outlook Survey which shows 19% of employers planned to increase headcount in the three months to the end of September 2014 versus the prior quarter. This compares to only 5% that planned to reduce headcount. Another survey we would highlight is conducted by the Society for Human Resource Management and Rutgers University, which currently indicates that finding employees in manufacturing and in services is becoming more difficult for many companies².

Given the Fed's dual mandate, we would be remiss if we did not look at inflation indicators alongside the labor metrics. Many of us discuss the Consumer Price Index (CPI) as the primary inflation indicator, but the Fed tends to focus on the Personal Consumption Expenditures Index (PCE) instead. The top graph in Exhibit 2 clearly shows that PCE remains below the Fed's target of 2% inflation. As explained earlier, labor is a key driver of aggregate inflation levels. Therefore, we find the Employment Cost Index (ECI) to be a useful indicator to watch. The bottom graph in Exhibit 2 shows that the most recent ECI reading was stronger, a 2.5% increase versus the prior year, raising some concerns that the labor market might be tightening sufficiently to lead to price pressure.

At first glance, all of these short-term indicators together suggest that employment conditions have normalized and the Fed perhaps should pull back from its monetary stimulus programs more rapidly than the market expects. Unfortunately, the situation is not that simple. In fact, the members of the Fed have expressed profound disagreement regarding where we stand in the labor market. The primary disagreement relates to how we should think about the millions of people who are unemployed, either because they cannot

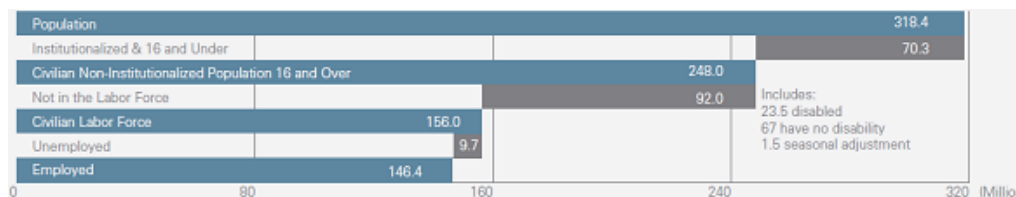
find a job or because they have given up looking for a job. The monetary policy hawks believe the demographics of the labor force have sufficiently changed to lead to a new longer-term equilibrium in which a lower percentage of the adult population is likely to be employed. The monetary policy doves accept the demographic argument, but generally also believe that millions of Americans who want to work remain on the sidelines or are partially employed awaiting better economic times.

Exhibit 2: Employment costs should be monitored along with other inflation



Sources: Bureau of Labor Statistics, Federal Reserve Bank of San Francisco, Haver Analytics. As of June 2014

Exhibit 3: Population, Labor Force, and Employment



Sources: Bureau of Labor Statistics, Haver Analytics. As of July 2014. All figures above are seasonally adjusted except for the composition of individuals not in the labor force and the number of workers who are marginally attached to the labor force which are seasonally unadjusted figures.

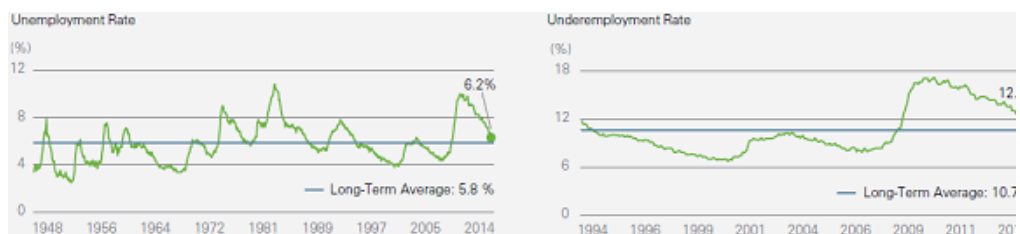
UNEMPLOYMENT BY THE NUMBERS

Analyzing the key metrics that measure the health of the labor market is instructive when determining the current economic cycle and the consequences for future Fed policy. To illuminate some of the data, it is useful to deconstruct the components of the US population and labor force. Currently the population of the United States is just over 318 million people, of which 70 million are under the age of 16 or are institutionalized (and therefore are not part of the labor force). Of the remaining 248 million adults, 92 million are not part of the formal labor force. These 92 million individuals include approximately 23.5 million who are disabled, of which nearly half are 65 or older, and 67 million adults who are not disabled (including homemakers). Therefore, the formal civilian workforce is 156 million people of whom 9.7 million are currently unemployed but seeking work and 146.4 million people who are employed on a full- or part-time basis (Exhibit 3).

Of the many indicators of population and labor data, the headline unemployment rate gets the most popular attention. While the unemployment rate has been measured for over sixty years and has normalized (currently 6.2%), the more recently introduced (since 1994) underemployment rate has (Exhibit 4). In addition to the 9.7 million people who are unemployed, the underemployment rate includes 7.5 million people who indicate that they want full-time work but have accepted part-time employment for lack of full-time alternatives. It also includes 2.2 million people who are marginally attached to the labor force. That is, they have not looked for work in the last four weeks (which is usually required to be considered part of the labor force) but have looked in the last year and are considered discouraged.

While many observers watch the unemployment and underemployment rates, Fed officials speak frequently about whether the long-term unemployed remain relevant to the supply/demand equation in the labor markets. The implicit question is whether these people can reasonably expect to find a job even if the economy is strong or whether they might be obsolete from a skills and employability perspective. The number of individuals who are long-term unemployed (about 3.2 million people defined as those who have been unemployed for twenty-seven weeks or more) remains well above historical levels. At the same time, the number of short-term unemployed has normalized.

Exhibit 4: Key Metrics: Unemployment and Underemployment



Sources: Bureau of Labor Statistics, Haver Analytics. As of July 2014

Exhibit 5: Evaluating the Employment-to-Population Ratio



Sources: Bureau of Labor Statistics, US Census Bureau, Haver Analytics, Lazard. As of July 2014

The labor force participation rate is also a focal point of many Fed statements. They care about this figure because it reflects how many of the 248 million adults are in the formal labor force. The decline in labor force participation, since the peak in 2000 from 67.3% to the reading in July 2014 of 62.9% is troubling and we will discuss some drivers of this ahead.

In our analysis, we like to take the labor force participation rate one step further and look at the employment-to-population ratio as an indication of the capacity utilization of human capital in the United States. In the simplest of terms, this ratio measures the percentage of adults who are working. This ratio is different from the labor force participation rate as it measures the percentage of adults who work, even if they are outside the formal labor force. The percentage of adults in the United States who are working declined from 64.7% in 2000 to only 58.2% in October of 2013. Even with the job recovery since 2009, the employment-to-population ratio has only recovered to 59.0%. The difference between 59% employment-to-population ratio and the 63.4% the US had just before the crisis is approximately 11 million jobs (Exhibit 5). Our immediate instinct based on this statistic is to side with the monetary policy doves who believe that labor has not yet recovered. This, however, might be a too simplistic interpretation of the situation.

THE AGING LABOR FORCE

Over the last five years there has been a major shift in the demographic profile of the US population and the US labor force. Drawing from the data in Exhibit 6, there are five key points concerning demographics and the labor force.

- The number of individuals employed increased by 8.3 million since December 2009³. Of this net job growth, 63% occurred for people aged 55 and older. These are not people just starting work; rather they were most likely under 55 in 2009 and have aged into this band over the past five years.

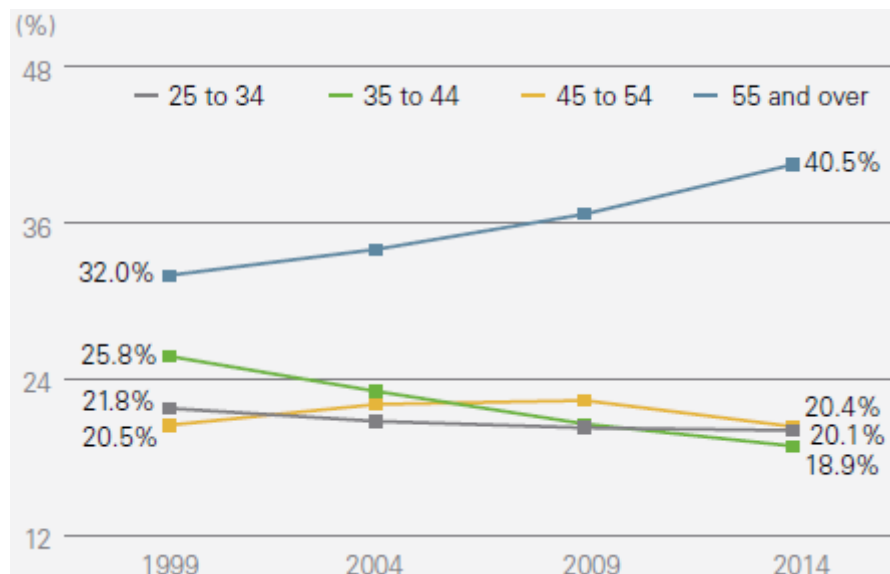
Exhibit 6: Demographics and the uneven job recovery

	Total employment (millions)		Change 2009 – 2014 (millions)		
	2009	2014	Employment	Labor Force	Population
16–19	4.4	4.5	0.1	-0.4	-0.3
20–24	12.4	14.0	1.5	1.0	1.5
25–34	29.8	31.9	2.1	1.0	1.7
35–44	30.8	30.8	0.1	-1.3	-1.1
45–54	33.3	32.6	-0.7	-2.0	-1.7
55+	27.3	32.5	5.2	4.6	11.1
Total	138.1	146.4	8.3	2.9	11.1

Sources: Bureau of Labor Statistics, Haver Analytics. For the period December 2009 to July 2014. Figures may not sum due to rounding.

Exhibit 7: The Labor force is aging

Share of Population over 25 by Age Band

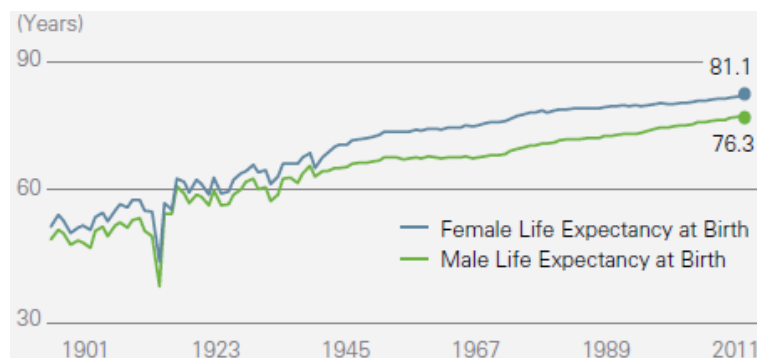


Sources: Bureau of Labor Statistics, Haver Analytics, Lazard. As of July 2014

- The absolute growth in the population of those 55 or older has been 11.1 million, which is equal to the entire increase in the US population since 2009.
- Strikingly, the 11.1 million population increase only translated into 2.9 million more labor force participants. This reflects the demographic reality of low labor force participation for people who are over 55 and especially for those over 65.
- The population aged 45 to 54 declined by 1.7 million during this time period. Typically, we would expect only a fraction of this decline to negatively affect the labor force, but instead the labor force band declined by 2.0 million, and 700,000 fewer individuals in this age group work. We believe these statistics indicate the presence of many discouraged workers.
- If the US population had not aged at all from 2006 and the employment-to-population ratio for each age group were the same as it is today, the total employment-to-population ratio for the US in aggregate would be at 60.6% today rather than 59%. This means demographics alone can explain 3.9 million of the missing 11 million jobs⁴.

To highlight the demographic shift further, the 55+ age band now accounts for 40.5% of the population over the age of 25 versus only 32% in 1999. All other age bands have declined as a share of the population in the last fifteen years (Exhibit 7). However, it should not be entirely surprising that many older Americans either want to or need to work longer. Life expectancy has significantly increased in the United States, implying that many individuals can now work well beyond the historically accepted retirement age of 65 or 67. In 1955, a man who turned 55 had already beaten the odds, living beyond the average life expectancy of 47 at the time he was born in 1900. Since 1900, with only one major exception during 1918–1919 when the Spanish flu killed half a million Americans, life expectancy has increased consistently. Today, life expectancy for an American woman is over 81 (Exhibit 8).

Exhibit 8: Americans are living longer, working longer

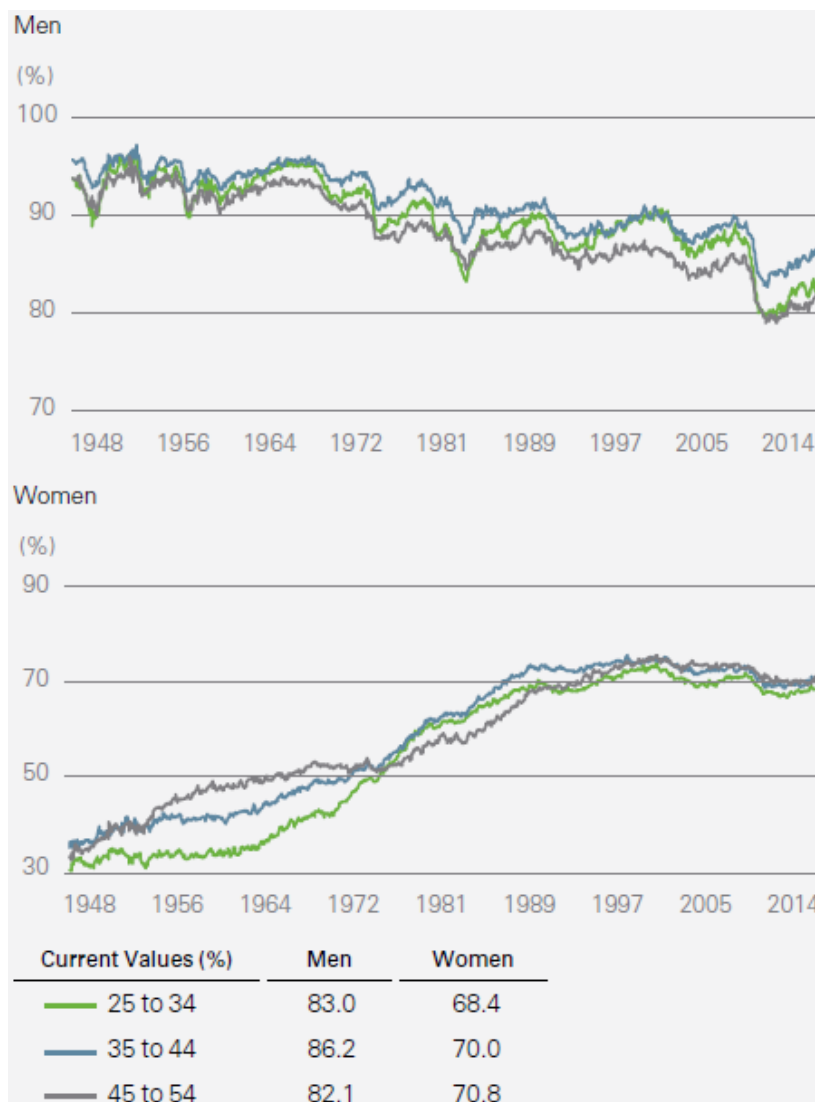


Sources: National Center for Health Statistics, Haver Analytics. As of May 2013

THE GENDER EFFECT AND OTHER FACTORS

So far we have concentrated on basic metrics in the labor market as well as age bands—now we introduce gender to our analysis. Exhibit 9 shows the employment-to-population ratio for three age bands, 25 to 34, 35 to 44, and 45 to 54 for men on the top chart and the same for women on the bottom chart. The data on these charts start in 1948 and highlight the seismic shift that has occurred in society over the last sixty-six years. In the late 1940s and 1950s, about 95% of adult men aged 25 to 54 were employed.

Exhibit 9: Employment-to-Population ratios for men and women are converging



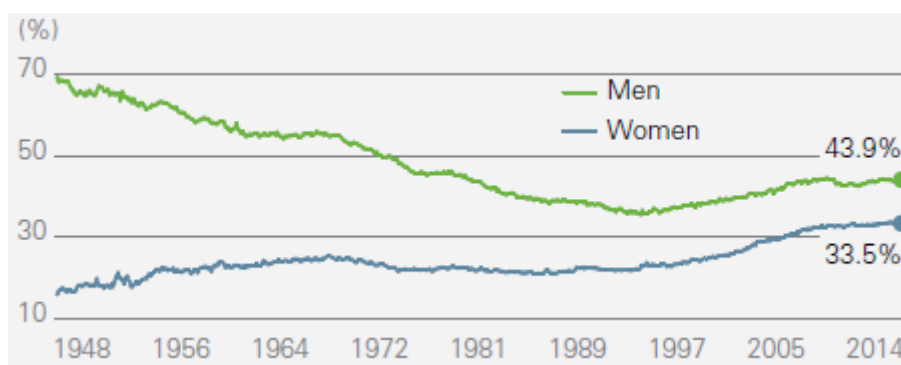
Sources: National Center for Health Statistics, Haver Analytics. As of July 2014

At that time, the United States operated with what had to be nearly 100% capacity utilization as it related to male human resources considering that employment was much more manually intensive and that there have always been some individuals who are not physically or mentally able to fill a job.

The situation for women is almost the exact reverse. In the 1950s, between 30% and 50% of women aged 25 to 54 worked with a substantial rise in formal employment at the age when children left the home. By the 1960s and 1970s we saw employment for 25- to 34-year-old women rise sharply as women became more equal participants in the formal labor force. With the employment-to-population ratio now at 70%, women have almost completely closed the gap with men, who stand at an 80% to 90% employment-to-population ratio.

In the case of men and women who are older than 55, the convergence of employment-to-population ratios is also visible – although the absolute levels of employment are much lower than the younger-age groups, as the 55+ group includes retirees. A central point remains that as the United States ages, the historical experience suggests that the overall employment-to-population ratio should decline. We continue to expect to see (absolute) lower employment-to-population ratios for older age bands than for younger age bands as a result of the aging Baby Boomers. However, it is also noticeable since the 1990s that there is an increasing employment-to-population ratio for older workers (Exhibit 10). From a policy perspective, we believe US policymakers should strive to see this trend continue as the human capital in the 55+ age group is enormous and underutilized. In other cases, many older Americans simply do not have the required savings to retire at the age of 65 or 67, meaning they will have little choice in the matter of trying to work. Moreover, working oftentimes equates with a healthier lifestyle and overall satisfaction for older individuals.

Exhibit 10: Americans 55 and older are increasingly likely to work
Employment-to-Population Ratio, Ages 55 and Over



Sources: Bureau of Labor Statistics, Haver Analytics. As of July 2014

To summarize our analysis so far, it is clear that demographics explain part of the apparent gap between pre-crisis and current employment-to-population ratios. However, we still

cannot explain seven million jobs that would be expected if we were at the same employment-to-population ratio as at the end of 2006. The remaining missing jobs can be partially attributed to two more factors. First, the number of people claiming to be unable to work for physical reasons tends to increase during periods of economic stress. While many of these individuals, have a legitimate disability, some may also claim to be disabled out of desperation for income after their unemployment benefits have run out.

Since December 2006, 2.1 million people have been added to the Social Security Disability rolls. While this is a large increase, it is actually about the same magnitude as what occurred in the prior seven-and-a-half-year period. The percentage of the population that is on disability has also increased, but we also have noted the degree to which the US population has aged. Thus, we believe it is complicated to determine how much of the increase in the disabled population is merely reflective of aging as opposed to a more nefarious explanation. We would argue that fraudulent disability claims are not a significant driver of the gap between expected and actual employment.

The final major aspect of the labor debate revolves around a skills mismatch. While a university degree is not the perfect proxy for being a skilled employee, we can assume that obtaining a degree is indicative of some combination of academic ability and motivation, though it also might reflect having the financial means to afford further education. Evaluating the percentage of individuals in different age bands who have obtained a bachelor's degree or higher, we were surprised to find that the age group with the highest educational attainment is the 35-to-39-year-old age group.

The percentage of Americans with a bachelor's degree has actually declined for those after the group born between 1975 and 1979 (i.e., those currently 35 to 39 years old). Unfortunately, where many nations have continued to send more of their students on to post-secondary education, the United States seems to be failing to do so. The financial crisis is clearly one reason for this as 1) family budgets were sharply constrained at the same time that their access to credit was curtailed; and 2) government funding for higher education was cut.

CONCLUSION

It is clear that the US labor markets have improved substantially since the worst of the crisis. Short-term indicators also suggest that the job creation momentum we have seen this year is likely to be sustained. However, in spite of this good news, we believe the Fed is right to focus on the remaining excess supply of labor that is either in the market now or could be drawn into the market as the economy continues to grow. We expect this "shadow inventory" of underutilized labor will likely contain wage growth for many sectors in the economy in the years ahead.

We recognize that some of the decrease in the labor force participation and employment-to-population ratios is structural. Demographic factors, specifically aging, can explain that about 35% of the decrease in the employment-to-population ratio is based on how people have behaved in the past as they aged. We believe this behavior must change as people continue to live longer lives. Simply put, we cannot expect individuals to retire as young as they did in the past when current US life expectancy has extended to 81 years for women and 76 years for men. Other drivers of lower employment rates that are often cited are disability claims and the skills mismatch. However, we believe the increase in disability filings, while certainly subject to some abuse, is overemphasized and likely reflects the structural element of an aging workforce. The skills mismatch, on the other hand, is a real concern as education levels have actually declined for Americans in the last ten years.

In our view, these explanations still leave a large part of the unemployed and underemployed population explained only by cyclical factors. This means the United States likely still has substantial excess labor supply and much less risk of significant labor inflation in the near term. If we are correct, this means our long-standing view that the FOMC should wait longer than markets expect to normalize monetary policy is sensible. Premature normalization could be a risk to the economy's momentum as millions of workers remain underutilized and eager to work.

ENDNOTES

1. Source: Federal Reserve Bank of St. Louis; University of Groningen; University of California, Davis.
2. Source: Bureau of Labor Statistics, Manpower, SHRM/Rutgers LINE National Employment, Haver Analytics.
3. The increase in employment differs from the increase in payrolls shown in Exhibit 1 due to differences in the data collection methods for these two statistics.
4. Source: Lazard estimates. Estimated or forecasted data are not a promise or guarantee of future results and are subject to change.

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