DALLASFED Economic Update
National

U.S. Labor Market Resilient as Output Slumps (Again)

May 3, 2016

Indicators of economic activity have mildly declined since mid-March, reflected by a weak first reading of output growth for first quarter 2016. Despite this, the labor market has continued in stride, while measures of inflation have edged up from low levels. Gains in oil prices and decelerating growth in the trade-weighted value of the dollar, if maintained, will support stronger business sector activity in the medium term. Households continue to benefit from low energy prices and have positive expectations about the future, suggesting that consumption demand will continue to support output growth. On balance, professional forecasters and forward-looking indicators point to a return to healthy growth this year.

Another Slow First Quarter?

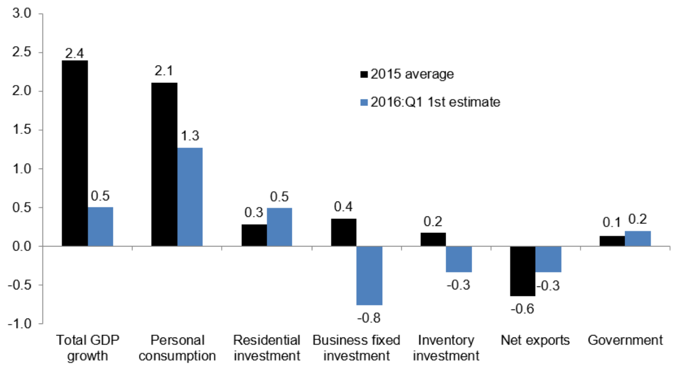
The economy expanded softly in the first quarter, held down by weaker contributions from personal consumption and a large drag from business fixed investment *(Chart 1)*. Real gross domestic product grew 0.54 percent at a seasonally adjusted, annualized rate, significantly below the annual average growth of 2.4 percent in 2015. This figure may belie strength in the economy—at least one analysis shows that first-quarter estimates exhibit some "residual seasonality."[1]

Nevertheless, business investment in equipment and structures decelerated considerably to a 5.8 percent annualized rate in the first quarter, subtracting 0.8 percentage points from overall growth. Much of this decline owed to contractions in the oil and gas sector. Investment in mining exploration, shafts and wells reduced business investment growth by approximately 2.6 percentage points, and the category is now at its lowest level on record. Similarly, investment in mining and oilfield machinery equipment shaved off approximately 0.2 percentage points in the first quarter. Generally, changes in oil and gas investment are highly correlated with changes in the active rig count. If recent oil price gains are sustained, the rig count decline will likely slow in the medium term, and negative contributions from oil and gas investment will fade over the year.

Labor Market Strong, but Wage Growth Slow to Follow

Despite anemic output growth in the first quarter, labor market indicators were strong. March nonfarm payrolls grew by 215,000, keeping the three-month moving average at 209,000, slightly above the average recovery

Chart 1
Economy Off to a Slow Start in First Quarter 2016
Percentage points*

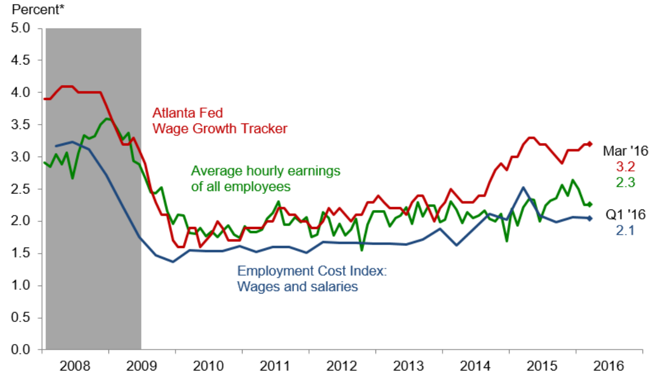


*Contribution to total gross domestic product (GDP) growth.
SOURCE: Bureau of Economic Analysis.

Chart 2
Initial Unemployment Claims at Historic Lows
Percent*

*As a share of the civilian labor force.
NOTE: Shaded areas indicate U.S. recessions.
SOURCES: Bureau of Labor Statistics; Department of Labor.

Chart 3
Wage Growth Still Relatively Low
Percent*



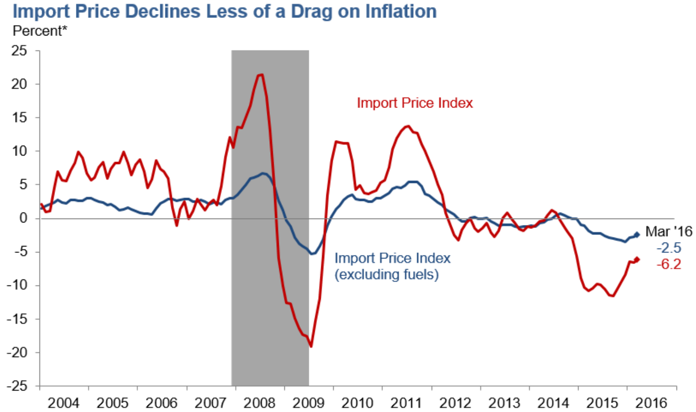
*Year-over-year growth, seasonally adjusted.
NOTE: Shaded area indicates U.S. recession.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Atlanta.

pace. A strengthening labor market has encouraged a greater share of prime-age workers (25 to 54 years) to enter the labor force, signaling greater confidence in job prospects.

As employment has grown, labor market slack has continued to diminish. Although the unemployment rate ticked back up to 5.0 percent in March, it has been near this relatively low level since October 2015. Additionally, the rate of initial claims filings relative to the labor force fell to a historic low *(Chart 2)*, confirming that labor market conditions remain strong.

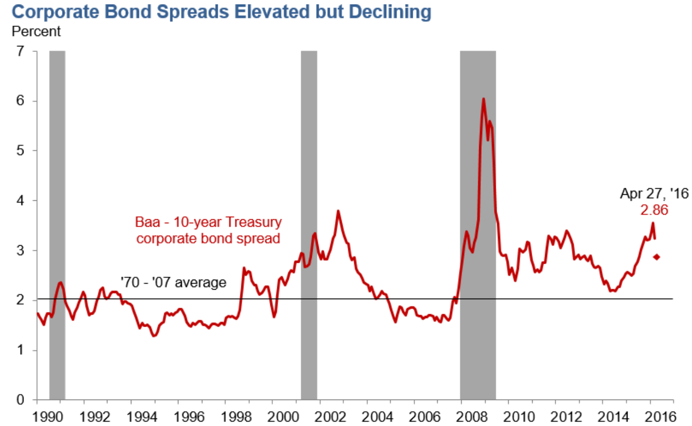
Generally, wage growth should accelerate as slack diminishes, but various measures of wage growth have risen slowly and remain below prerecession levels *(Chart 3)*. Part of this slower wage recovery could be explained by the increasing flow of people from outside the labor market directly into employment. Approximately 52.4 million made such a move in 2015, compared with 47.8 million in 2014 and 45 million in 2013. This acceleration in labor force flows has increased labor supply and kept wage growth modest but has not affected traditional measures of slack such as the unemployment rate. Given that participation rates are at low levels, these flows may continue to grow and, thus, wage growth may not return to precession levels for some time.

Chart 4
Import Price Declines Less of a Drag on Inflation



* Year over year, seasonally adjusted.
NOTE: Shaded area indicates U.S. recession.
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Dallas; Bureau of Labor Statistics.

Chart 5
Corporate Bond Spreads Elevated but Declining



NOTE: Shaded areas indicate U.S. recessions.
SOURCE: Federal Reserve Board.

Inflation Expected to Reach Target Rate in Next Two Years

Import prices remain a drag on inflation, especially accounting for the effect of oil prices *(Chart 4)*. However, growth in the trade-weighted value of the dollar has decelerated in recent months, and import price deflation has eased, reducing downward pressure on domestic inflation.

Core measures of domestic inflation held steady in February and March after bouncing back in January. The core Consumer Price Index (CPI) registered 2.2 percent on a year-over-year basis in March, roughly consistent with Federal Reserve's target.[2] Professional forecasters predict that headline measures of CPI will rise to 2.3 percent in 2017. The personal consumption expenditures index, however, is expected to rise more slowly, reaching 2.0 percent by 2018. Long-term inflation expectations remain well-anchored.

Financial Stress Eases; Bond Yields Improve

Financial market stress has continued to fall since March's Federal Open Market Committee meeting. Corporate bond rates remained flat in April as U.S. Treasury rates rose, driving down corporate bond spreads *(Chart 5)*. Alternative measures of financial stress have also eased, with the VIX (volatility index) remaining at low levels and various Federal Reserve financial stress indexes indicating normal conditions. Favorable financial conditions supported by low interest rates will continue to bolster the real economy going forward.

—Camden Cornwell

Notes

1. For more discussion, see "The Puzzle of Weak First-Quarter GDP," by Glenn Rudebusch, Daniel Wilson and Tim Mahedy, Federal Reserve Bank of San Francisco Economic Letter, May 18, 2015, www.frbsf.org/economic-research/files/el2015-16.pdf, and "Residual Seasonality in GDP," by Charles E. Gilbert, Norman J. Morin, Andrew D. Paciorek and Claudia R. Sahm, Federal Reserve Board FEDS Notes, May 14, 2015, www.federalreserve.gov/econresdata/notes/feds-notes/2015/residual-seasonality-in-gdp-20150514.html.

2. Assuming that CPI inflation is on average 0.3 percentage points higher than PCE inflation.

About the Author

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