QMα Insights

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Talking 'Bout My Generation

Boomers retiring might be distorting economic data and clouding the economic and investment outlook

Part One: Possible Hourly Wage Growth Distortions

We Baby Boomers have always thought it was all about us, so it will not be surprising that I will argue that the retirement of the Baby Boomers is having a large impact on life in the U.S. The surprising part is that much of the impact is positive, and many of the benefits of it will be felt by folks younger than us. I will argue that:

- Wage growth and the outlook for economic welfare for Americans younger than the Boomers is much more robust than conventional wisdom believes.
- Interest rates and inflation are likely to remain low by the standards of the past several decades for many more years.
- Although economic growth and corporate earnings growth are likely to be slower, on average, than they have been in the post-World War II period, this economic expansion and equity bull market might last much longer than usual.

Being an investor is sometimes a bit like being a detective. In making asset allocation decisions at QMA, we consider macroeconomic factors to be key drivers of expected returns, especially if we believe that the economy is likely to perform differently than the consensus expects. As we look at the macroeconomic situation in early 2015, we face several mysteries:

- The U.S. unemployment rate fell to 5.6% at the end of 2014. The economy added nearly 3 million jobs in 2014. The JOLTS report found that there are more job openings today than there have been since 2002. Yet the labor force participation rate continued to fall in 2014, reaching 62.7%, down more than 3 percentage points in 10 years and the lowest level in many decades. With strong demand for labor and a shrinking supply, Econ 101 would suggest that wages should be rising robustly. Yet the December labor report showed average hourly wages falling that month, and rising just 1.7% for 2014 as a whole. If wage growth was weak or negative, we would expect consumer confidence to be weak despite lower gas prices. Yet the latest surveys show confidence hitting multi-year highs. We would expect consumption spending to be weak, but the Q4 GDP report showed consumption growing at a robust 4.3%. How can that be?
- With aggressive monetary policy in the U.S. and much of the developed world since the financial crisis, many have expected that inflation would rise, especially if economic growth started to recover. Growth did pick up in 2014 after a weak Q1 due to bad weather, reaching 5% real GDP growth at an annual rate in Q3. But rather than rise, inflation plunged to under 1% as measured by CPI at year end. Of course, the drop in oil and commodity prices bears much of the responsibility, but other measures like core PCE are falling and remain well under the Fed's target of 2%. Isn't inflation, as Milton Freidman told us, always and everywhere, a monetary phenomenon?
- The 10-year Treasury Bond yield ended 2013 at 3%. The consensus at the time was that rates would rise in 2014 as growth picked up and the Fed ended QE. The Fed tapered and ended QE as expected. Nominal GDP growth picked up to over 6% in Q2 and Q3. Historically bond yields have been close to nominal GDP growth. Yet rates did not rise—they plummeted to under 2%. As I write this, the 10-year yields about 1.7%—lower than at any point during the Great Depression—yet it appears that growth will remain robust in 2015. Can it be that this time is different?

Some think that all anomalies can be explained by market manipulation by central bankers. Others think that the underlying economic picture is much worse than official statistics indicate—that low rates and falling commodity prices are a signal that we are about to enter another recession.

But we offer another hypothesis: it's mostly about the Boomers

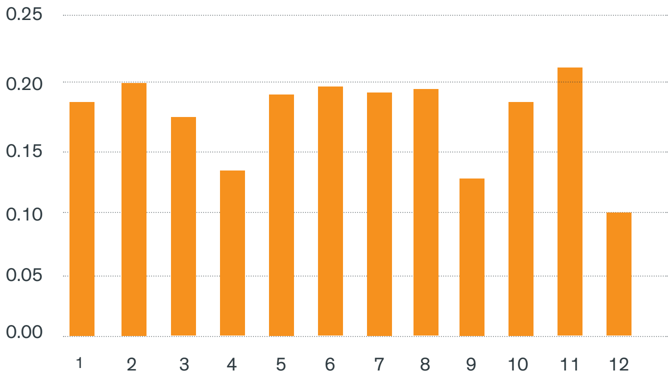
We will discuss this theme in multiple QMA Insight pieces. This piece will focus on one issue: average hourly wage growth.

According to the Bureau of Labor Statistics (BLS), average hourly wages fell by 5 cents (0.2%) in December, and rose just 1.7% for 2014 overall, despite strong job growth of about 3 million. There is, of course, some noise in all economic data, and the December drop might just be random fluctuations. December has historically been the weakest month for wage increases (Figure 1). Perhaps companies with fiscal years ending in December are more likely to grant raises in the new year rather than in December.

But we offer another potential hypothesis: there has been a persistent drag on the average hourly earnings calculation recently due to the retirement of Boomers and their replacement with a larger number of lower-paid workers.

Of course, the U.S. labor force is quite dynamic; every month there are many exits and entrants. There have always been many retirements every month and many new workers. But the substantial increase in Boomer retirements combined with the surge in new jobs makes the influence on average hourly earnings interpretation trickier than normal.

1 / AVERAGE WAGE GROWTH / MONTH (%)



Source: QMA and Datastream

The BLS calculations are quite complex (we thank the statisticians for explaining them to us), but the basic math is that average hourly earnings are total wages divided by total hours worked. There are just under 145 million civilian employees in the U.S. The average non-farm work week is just under 35 hours (the average is pulled down by part-time jobs), and the average wage is a bit under $25 per hour. That's roughly a $125 Billion weekly payroll for roughly 5 billion hours worked.

How many Baby Boomers retired in December 2014? We cannot know the exact number, but we can make a rough estimate based on annual new claimants for Social Security retirements benefits. Figure 2 shows the data, which is currently available through 2013. Of course, some might claim benefits while still working part time, and others might defer collecting benefits for months or years after retirement for various reasons, but as a first cut this seems a reasonable approach. There was a big jump in new claimants during the Great Recession and its immediate aftermath, but new claims have continued to trend up. The new claims were 2.8 million in 2013 versus fewer than 2 million in 2006.

2 / INITIAL CLAIMANTS FOR SOCIAL SECURITY RETIREMENT BENEFITS

	NEW CLAIMANTS
DEC-13	2,802,162
DEC-12	2,730,378
DEC-11	2,587,171
DEC-10	2,617,453
DEC-09	2,729,691
DEC-08	2,267,478
DEC-07	2,026,801
DEC-06	1,974,431
DEC-05	1,982,916
DEC-04	1,878,065
DEC-03	1,791,331
DEC-02	1,827,709
DEC-01	1,796,593
DEC-00	2,171,019

Source: QMA and Social Security Administration.

Let's assume that the number increased again in 2014 to 3 million, or 250,000 per month. We know from the BLS data that 250,000 net jobs were added in December. Let's make the simplifying assumption that the basic dynamics of the labor market that month were 250,000 folks retired, and that 500,000 people were hired to replace them and grow the work force as the economy expanded. We know that new entrants to the labor force make less than experienced persons. Let's assume that the retirees were earning $40 per hour ($15/hour above the overall average), and that the newbies got $15 per hour. Let's assume both groups work 35 hours per week. How might that influence the calculation of average hourly wages?

Total wages paid in our hypothetical example would drop. Although twice as many people are working, the new entrants are earning less than half the retirees per hour. Yet hours worked would rise due to the net increase in workers. That is, these changes taken in isolation would decrease payroll and increase hours worked, depressing average hourly earnings. How much? If you run the numbers, payroll drops by about $100 million per week and hours worked increase by about 8.75 million per week. That drops the calculation of average hourly wages by about 6 cents, or about 0.25% on a monthly basis. If we annualize these numbers we get almost 3%.

That is, if the 99%+ of the workforce that isn't entering or retiring from the labor force in a given month were to have flat wages for the year, based on the assumptions we have made above, the average hourly wage would drop by about 3%.

Said another way, if our estimate of the hourly wage drag from retirements/new entrants is close to correct, wages of those in the labor force continuously might be rising much faster than 1.7% per year.

The wage growth that the typical worker experienced in 2014 might have been closer to 3-4% than 1.7%.

Of course, there are a lot of caveats that must accompany this analysis. The U.S. labor force is much more dynamic than simply new entrants and retirees. Not all retirees earn premium wages and not all new entrants start at a lower wage. This work says nothing about the distribution of wage gains, which other research suggests might be concentrated among those already earning higher incomes. As noted above, the phenomenon of higher wage earnings retiring and lower earnings coming in is by no means new; our point is that it matters more to the calculation today than it has in the past because the number of retirees seems to have jumped by about 50% compared to 8 years ago, and the number of new jobs has finally accelerated sharply in the past couple of years. Also, I do not mean to imply that the excellent work done by BLS is somehow "wrong"—it is not. But for investors and others who are trying to make sense of economic data, numbers that correctly show weak average hourly wage growth might need more intense analysis and interpretation to glean the truth of the underlying health of the labor market.

In brief, our analysis suggests that the wages of the average worker might be growing much faster than the average hourly wage calculation suggests. That might explain why the December 2014 NFIB report found higher readings of small business optimism and an intent to raise compensation by 4% in 2015. In addition to lower gas prices, that might explain soaring consumer confidence. It also helps explain the Q4 consumption spending growth of 4.3%.

But if wages for most folks are growing faster than 1.7%, does this suggest that the Fed is behind the curve, and that inflation and interest rates will soon accelerate? We think that the answer is probably not, for reasons we will discuss in more detail in future installments of this series. But here are a few brief thoughts:

In the hypothetical example we have used in this piece, the average hourly wage is a good indicator of the hourly labor costs experienced by business, which are growing quite slowly. The level of productivity might face some pressure, since we old dogs do know a few tricks. But the potential future growth of productivity is likely enhanced, as new entrants to the labor force enter the steepest slope of the learning curve.

An aging population is also a more price sensitive population. There is a reason advertisers focus on younger demographics. For inflation to rise, someone must be willing to pay the higher prices. Of course, lower oil prices and a stronger dollar are keeping inflation quite low in 2015; we think it is possible that price conscious older Americans might help keep it low for several years.

We think that a big part of the reason for low interest rates in developed markets worldwide besides central bank policies is supply and demand. Quite simply, older folks are less likely to go into debt and more likely to want to buy fixed income products. This keeps demand for fixed income high and the growth of debt low, driving prices up, and yields down.

The investment implications of all this from our perspective are that inflation and both short and long term interest rates might stay lower for longer, despite solid real economic growth of 2%-3.5% over the next couple of years. We have not seen, and might not see, in this cycle the sort of rapid credit growth that usually fuels rapid recoveries from severe recessions: an older population doesn't want to borrow and constrained financial institutions are reluctant to lend. Yet if much of the labor force is starting to see real wage growth accompanied by higher potential productivity growth, this might be an unusually long, slow economic cycle, and the long bull market might have a way to run.

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