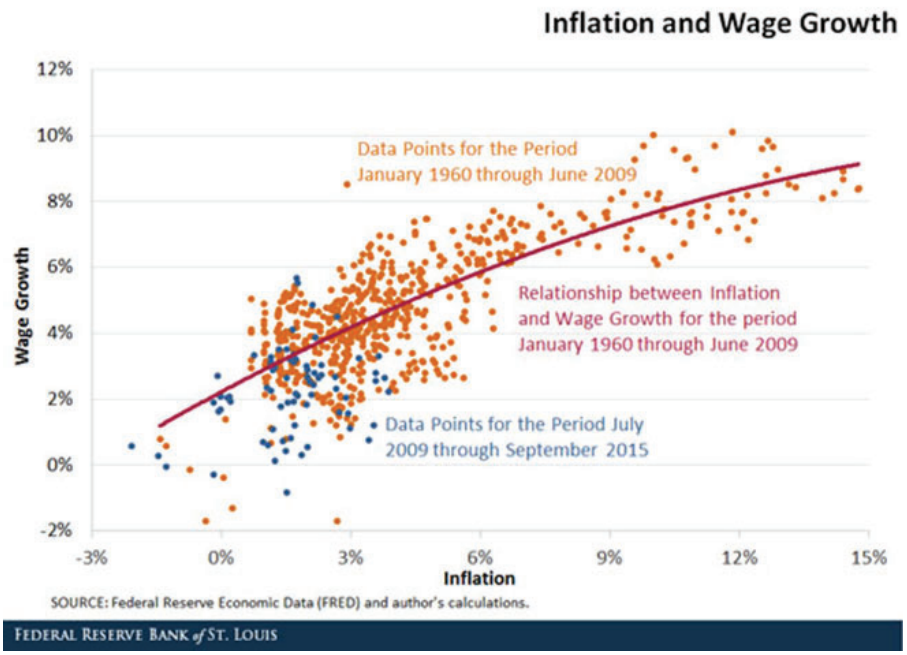
April 23, 2021

INSIGHTS

THE WAGE GROWTH & INFLATION CONUNDRUM

The chart below, courtesy of the Federal Reserve Bank of St. Louis, shows that there is a positive correlation between inflation and wage growth.



However, both the inflation rate and wage growth have been skewed by some mathematical quirks of late.

Composition Effects

In April 2020, at the depths of the pandemic and the worst job losses on record, the Bureau of Labor Statistics (BLS) reported year-over-year growth in average hourly earnings rose to roughly 8% - the highest reading since the series began in 2006. This counterintuitive statistic was the result of millions of relatively low-paid workers losing their jobs, while relatively high-paid workers remained employed – raising the average.

An example can be helpful. Consider a job market with three earners: Worker A makes $10 per hour; Worker B makes $20 per hour; and Worker C makes $60 per hour. The average hourly wage in this illustrative job market is $30. But suppose Worker A gets laid off. Now the average hourly wage, comprised of just Workers B and C is $40 (a 33% jump). The average rose $10, not because of wage growth but because the composition of the workforce changed. Similarly, if worker A gets re-employed at $10 per hour, the average wage rate will fall back to $30. This distortion is called a composition effect.

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Base Effects

Base effects can be described as the artificial rises and falls in measured growth due to the level of the starting value. Using the example above, when worker A dropped out of the workforce, the average wage rate moved to $40. Assume one year later, worker A was re-employed, causing the average to fall back to $30. The move from the higher base of $40 down to the original $30 (a 25% fall) is called a base effect. The move in oil prices from pandemic lows back to pre-Covid levels is a well-known base effect which is skewing headline inflation higher.

With composition and base effects working to cloud the real economic picture for many economic metrics, if we do start to see headlines about high inflation numbers or stalling wage growth, investors are reminded that the sharp fall and recovery in economic activity is playing havoc with economic statistics. As the economy stabilizes these anomalies should clear out and the data will revert to more normal levels.

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