Economic Analysis

Unemployment Hits 5.3% but Wages Hold Flat

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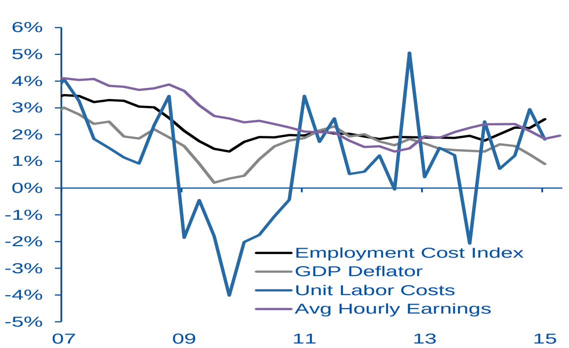
- **Nonfarm payrolls increased 223K in June following downward revisions to April and May**
- **The unemployment rate declined to 5.3% alongside a drop in labor force participation**
- **Fed will continue to monitor wage growth as a key factor in timing the first rate hike**

June's employment report fits right in with the inconsistencies we have seen in the labor market throughout the past year. Nonfarm payroll growth was slightly below expectations, up 223K for the months, while payrolls in both April and May were revised down a combined 60K. However, the unemployment rate dropped to 5.3%, a new recovery low. Not surprisingly, unemployment fell hand-in-hand with a drop in labor force participation. In fact, the participation rate declined to 62.6%, the lowest since late 1977, reflecting a big monthly jump in individuals leaving the labor force. This is one of the many factors that Janet Yellen and her FOMC colleagues point to as a primary concern in current labor market trends, and further declines may be enough to slow the pace of tightening in the coming year.

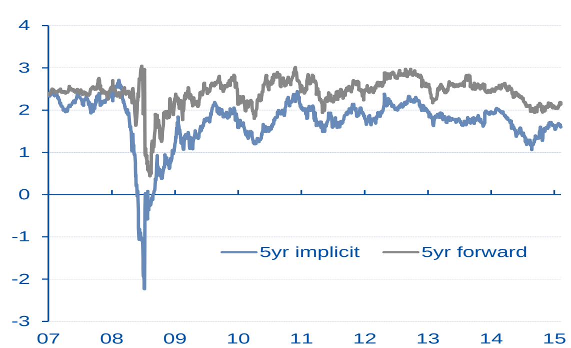
Another key concern in June's employment report is the lack of wage growth. Average hourly earnings were flat for the month and decelerated to 2.0% YoY growth. This is in line with our expectations for subdued wage growth but contradicts data from the past few months suggesting that wages are gaining some momentum. Many had interpreted this data as a sign that inflation was going to pick up in the coming months, but research has shown that measures of wage growth are not a good predictor of inflation. However, inflation tends to be a good predictor of wages, and with inflation trending so low over the past year, it is not surprising that wages have not accelerated significantly. Inflation expectations remain low, keeping downward pressure on demands for higher wages, and we don't expect to see a reversal in this trend anytime soon. This dynamic of wage growth and inflation has certainly played an important role in holding back the first federal funds rate hike thus far, and we expect that the Fed will continue to closely monitor developments in the coming months. However, we expect that stronger components of the labor market will eventually help offset stubborn wage growth, and therefore we maintain our projections for the first rate hike in September 2015.

Chart 1
Wage Metrics and Inflation (YoY % Change)



Source: BLS, BEA, & BBVA Research

Chart 2
Inflation Expectations (%)



Source: Federal Reserve & BBVA Research

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