# THE PIPING HOT LABOR MARKET THREATENS PROFIT MARGINS

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I'm still thinking about the market's shock a few weeks back when the nonfarm payrolls report showed an increase of 467,000 jobs in January, well ahead of the 150,000 that was expected by the market.

I will not be surprised if that report is a taste of what is to come in the next few months, because I contend that this may be the hottest labor market of my career.

Wage inflation and a profit margin pinch is the hypothesis.

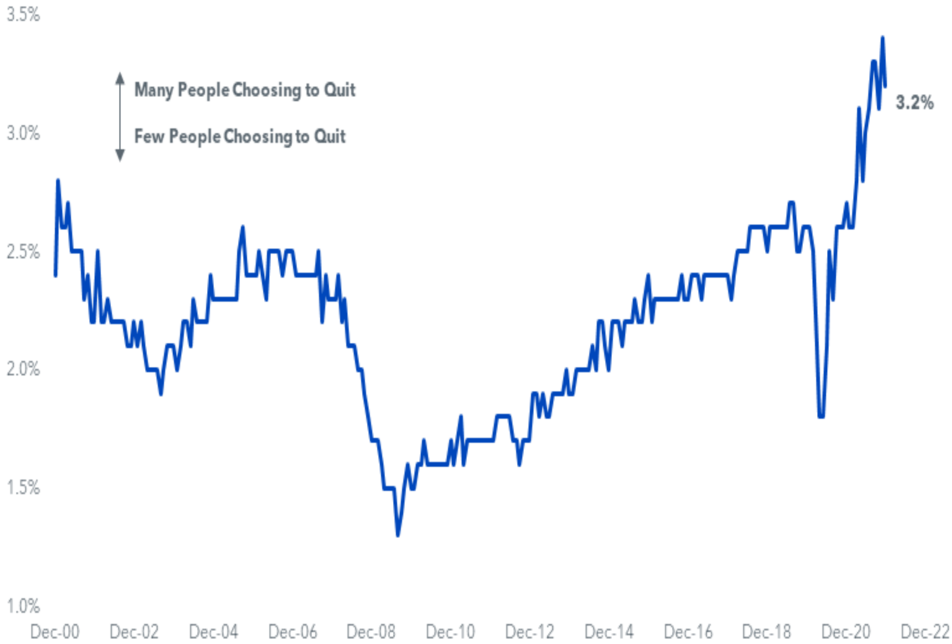
As we get to the charts, think about what has worked in the stock market lately. Since November, the bears have been coming after stocks with distant cash flows whenever rates have headed higher, owing to the math behind discounting future values to the present. In contrast, companies that are profitable now—many of which populate value indexes—have held up.

It's something like this:

**Inflation "on" □ More Fed hikes □ Value stocks beating growth**
**Inflation "off" □ Fewer Fed hikes □ Growth stocks beating value**

Figure 1 shows the steady climb in the U.S. quit rate over the last two years. People dump their jobs when they are confident that they can line up new ones. Critically, the biggest pay bumps often come when you go to a new company —and a lot of people are doing just that.

**Figure 1: U.S. JOLTS Survey, Quit Rate**



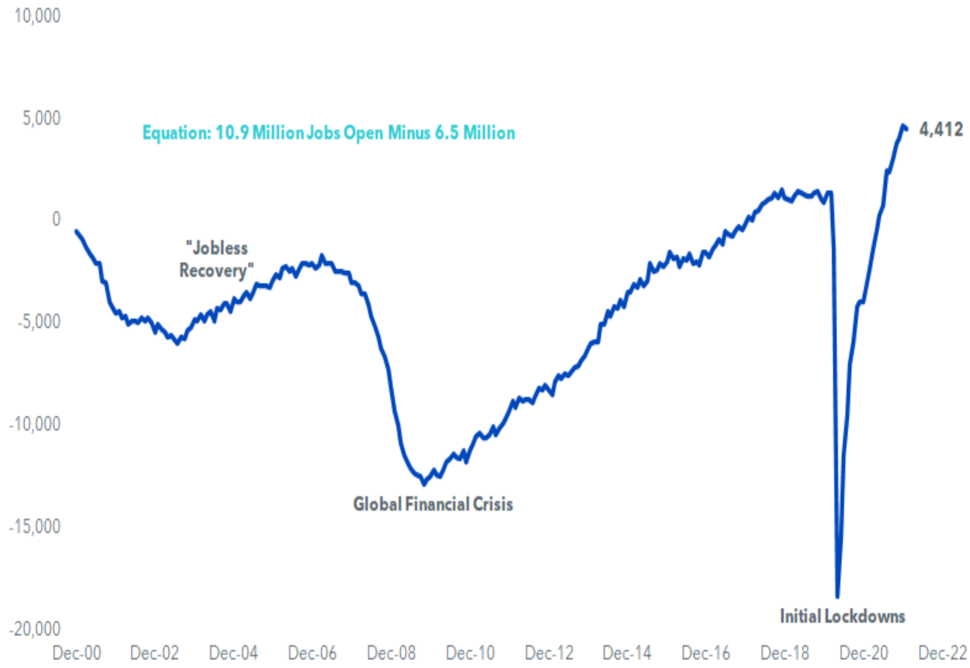

Sources: Bureau of Labor Statistics, U.S. Dept. of Labor, as of December 2021.

Their confidence stems from basic arithmetic. We had a few years prior to Covid when, for the first time in generations, there were more job openings than unemployed people.

Lockdowns ended that.

But 2022 is not 2020; job postings once again exceed the ranks of the unemployed, this time by a country mile (figure 2).

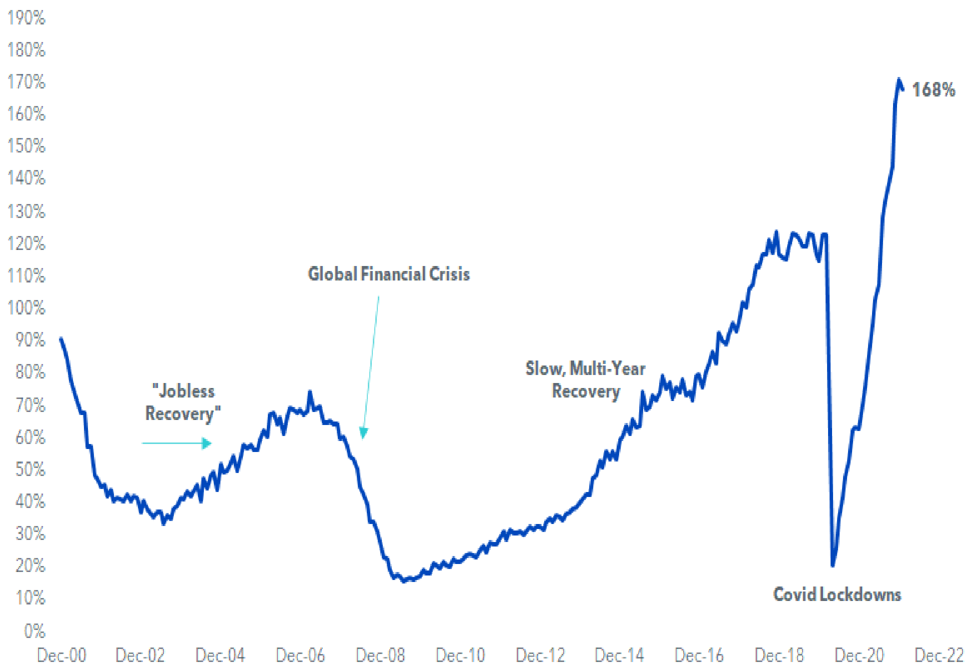
**Figure 2: JOLTS Survey, Total Job Openings Minus Total Unemployed (Thousands)**




Sources: Bureau of Labor Statistics, U.S. Dept. of Labor, as of December 2021.

Figure 3 shows another way to look at it. As hot as the 2018–2019 job market got, this one far exceeds it.

**Figure 3: U.S. Job Openings as % Unemployed**



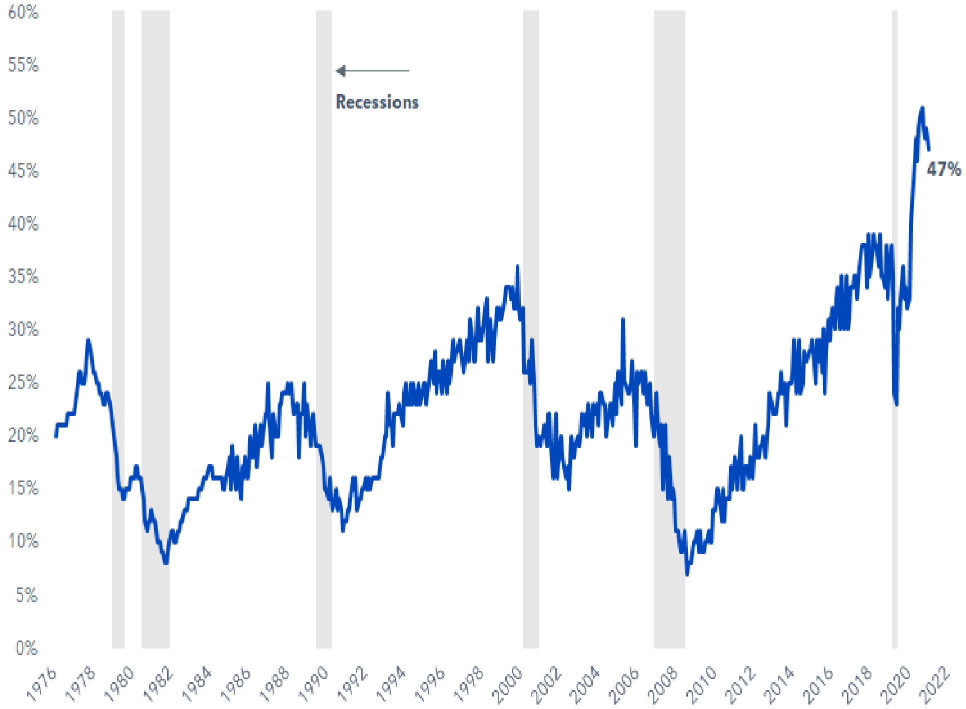

Sources: Bureau of Labor Statistics, U.S. Dept. of Labor, as of December 2021.

You can glean a lot of information about the labor market by checking the National Federation of Independent Businesses (NFIB) survey. In January, the most recent report, 47% of small businesses said they had one or more jobs that were hard to fill (figure 4).

You know the old saw? "The cure for high commodity prices is high commodity prices." If copper zooms, miners mine more copper, sending the price down.

Well, if you post a job and can't find anyone, the solution is to hike the pay. Applicants will show up…once you change the compensation.

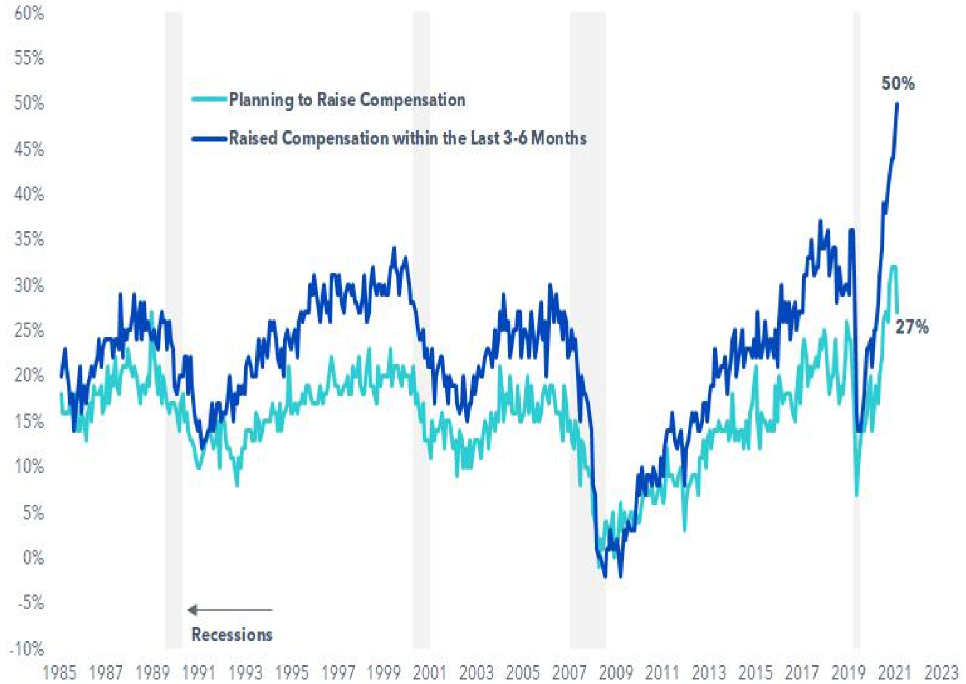
**Figure 4: NFIB Survey: "1 or More Jobs Hard to Fill"**




Sources: National Federation of Independent Business (NFIB), as of January 2022.

The same NFIB survey shows that 50% of employers were actively ratcheting up compensation toward the end of 2021, with 27% saying they intend to do so in the coming months (figure 5).

**Figure 5: NFIB Survey, Worker Compensation**




Source: National Federation of Independent Business (NFIB), as of January 2022.

The Atlanta Fed's wage growth tracker showed a 4% year-over-year increase in January. I suspect it's headed higher (figure 6).

**Figure 6: Atlanta Fed Wage Growth Tracker**


Sources: Current Population Survey, Bureau of Labor Statistics, Atlanta Fed, as of 1/31/22.

In the wake of the most recent inflation report, which recorded a 7.5% year-over-year spike in the headline Consumer Pric e Index (CPI), the Fed Funds Futures market now expects the policy rate to be north of 1% by summer (figure 7).

**Figure 7: Fed Funds Rate Probabilities, July 2022 FOMC Meeting**

The good news is that I think the labor market is going to be so hot that the Fed will not break this economy's back just yet, at least not in 2022. The bad news is that we may be in for a shower of profit-margin warnings.

Because return on equity (ROE) math is a function of profit margins, the way to navigate this is by screening for firms that can give staff a pay bump without black ink turning red.

I did something new in figure 8. By dividing ROE by P/E, I came up with a quotient that will put in context how much high-quality equity baskets will cost you. The WisdomTree U.S. Value Fund (WTV) gets a particularly high score, 1.69. Maybe that's the one to use if you have a theory that has inflation pinching profit margins.

**Figure 8: ROE vs. P/E**

*For definitions of indexes and other terms in the table above, please visit the glossary.*

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## DEFINITIONS

**Bear market** : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

**Value** : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**Commodity** : A raw material or primary agricultural product that can be bought and sold.

**Consumer Price Index (CPI)** : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

**Fed fund futures** : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

**Federal Open Market Committee (FOMC)** : The branch of the Federal Reserve Board that determines the direction of monetary policy.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Return on Equity (ROE)** : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**Price-to-earnings (P/E) ratio** : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**Baskets** : The composition of an ETF in terms one creation/redemption unit.