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# Memorandum

To: Clients, Associates & Friends of Pro@ctive Advisory
From: Mark L. Wyssbrod, CPA
Date: September 22, 2014
Re: What does the Fed see?

In this memorandum, you will receive information about the following:

- The Fed's new interest rate policy
- The small business labor force environment
- The winners

Please contact me should you have any questions.

<u>The Fed's new interest rate policy</u>
The U.S. Federal Reserve Bank (the Fed) made a statement regarding interest rate policy which I found very interesting. The Fed stated they would keep rates lower longer than originally planned, but when rate hikes begin to occur they would most likely increase quickly.

What does the Fed see which would set the policy this way? First, the Fed wants to make sure the economy is on solid footing before raising interest rates. An interest rate hike before more than solid growth may result in harmful side effects to the economy which may take multiple years to correct.

Second, the Fed wants to be on the side of caution before raising interest rates. The economy may need to show green lights across the board before the Fed raises the rates.

Third, as the economies lights begin turning green pressure on labor rates will increase significantly. As the economy picks up speed hiring may become contagious. Speaking with smaller employers it is difficult at the moment, in a 6+% unemployment rate environment, to find good and talented employees. Mega-corporations may be signally more green lights are on the way by refocusing their cash flow from repurchasing their shares via share buyback programs to investments which are aimed at growth.

<u>The small business labor force environment</u>
I would like to take the next several paragraphs to discuss the labor force.

Retaining good and talented employees will be an increasing challenge. Companies who have witnesses pricing pressure and margin issues will have to figure out a way to handle increases in labor costs. Companies may need to increase prices just to stay current with labor costs. You might find a new surcharge for labor as we have seen with fuel in the past decade. Without these price increases companies will see a reduction in margins unless they can find savings elsewhere, which I believe is unlikely due to the company's subcontractors and suppliers are facing the same challenges and raising labor prices as well.

The labor force will be in a trap. They will feel good due to earning more. However, all of the goods they consume will cost more. The question is will labor rates increase faster than their consumption and living costs? If so, then their real financial scenario will increase. If not, then labor will find itself happy for a short period of time due to earning more, but eventually wake up frustrated due to a feeling of falling behind in life.

Meanwhile the top talent has received some confidence in the past two years they will not be losing their employment. They are frustrated with the large profits of the companies, but no or minimal raises and bonuses. As their confidence continues to grow they will begin interviewing with other potential future employers to receive a reduction of duties and an increase in compensation. Then this occurs, companies will have to hire multiple employees at an overall higher labor rate to replace the employee which left. The labor costs will increase and short-term efficiencies may decline due to the labor turn over; but long-term efficiencies may increase since new ideas and replacing someone who may be burnt out with an energetic creative team member. This short-term costly transition may lead to long-term improvements which cover the costs.

The winners

The winners will be government agencies who tax based on income and the most in demand and talented top 3% of the population who will have earnings rise much faster than consumption and living costs.

Conclusion

In conclusion, employers should do their best to retain their most talented employees. The cost of labor might be about to increase at a significant rate (within the next twelve to thirty six months). The cost of a recruiter is material and the cost of a missing employee can cause serious operating performance issues, especially for smaller organizations. Companies should begin to prepare for what appears to be a growing and elongated labor cost cycle (for good and talented team members).

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