

Job Figures Show Further Improvement

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Highlights

- We expect the economy to begin generating an average of 100,000 jobs per month by early next year.
- Unfortunately, this is still below the 150,000 to 200,000 jobs that are necessary to absorb new entrants to the labor force. Therefore, the unemployment rate will continue to rise.
- Structural changes imply the natural rate of unemployment could be as high as 6% or 7% today compared to 5% during the prior economic expansion.

The deterioration in the US labor market continued to moderate in August with the economy shedding 216,000 jobs compared to an upwardly revised 276,000 in July. The two months combined mark a dramatic improvement from the first half of the year when the US economy lost an average of 560,000 jobs per month. However, the unemployment rate, which was artificially suppressed in July by the large number of workers who dropped out of the labor force, increased 0.3% to a new cyclical high of 9.7% in August.

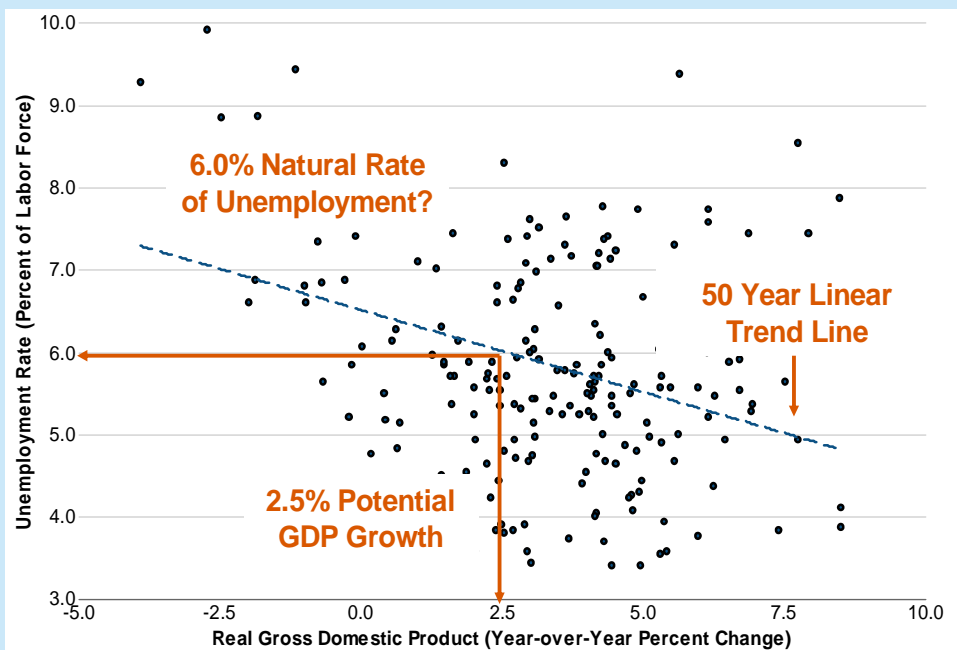
Nevertheless, given our expectation that real gross domestic product (GDP) will increase at an annual rate of around 3% in the third quarter, we expect the economy to begin generating an average of 100,000 jobs per month by early next year. Unfortunately, this is still below the 150,000 to 200,000 jobs that are necessary to absorb new entrants to the labor force. Therefore, the unemployment rate will continue to rise through the first half of 2010 before peaking somewhere north of 10%.

Furthermore, even after the unemployment rate peaks and begins to come back down in the second half of 2010, the natural rate of unemployment is likely to be much higher than it was in the recent past due to structural changes in the labor market and lower economic growth rates caused by the deleveraging of the household sector in the United States.

Structural Changes May Keep Unemployment Elevated Even After Recovery

A total of 6.9 million jobs have vanished since the recession began in December 2007 and a portion of those will never return due to structural changes in the economy. The share of employment in the manufacturing sector has been in decline since the 1940s, dropping from a war-inflated peak of 39% in 1945 to 9% today. While a rebuilding of inventories may lead to a stabilization of manufacturing employment in the coming quarters, we are unlikely to see the sector's share of employment increase even after the US economy recovers.

Lower Growth Potential Implies Higher Unemployment



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The same may be true in the construction and financial industries where employment was inflated by the credit and housing bubbles. At a minimum, workers in these fields are likely to experience a longer duration of unemployment and may have to seek retraining in order to find jobs in other sectors. This may explain why the percentage of unemployed who have been out of work for 27 weeks or longer has risen to a record high of 36.5% in August.

Higher structural unemployment will also be aggravated by a lower trajectory of US economic growth in the future. Economists estimated that potential output, which is a measure of how fast the economy can grow without generating inflation when its labor and capital resources are fully employed, was somewhere around 3.2% in the late 1990s. Today, by contrast, estimates of potential output have fallen to 2.5% as a result of the deleveraging in the household sector and a lack of investment in productivity enhancing technologies in the economic expansion that occurred between 2001 and 2007.

Consequently, the natural rate of unemployment at full employment is likely to be higher than it was in the past two economic cycles when economists estimated it was somewhere around 5%. In fact, we believe it is probably somewhere around 6% or 7% today. This implies that only 4.0 to 5.5 million of the nearly 7 million jobs that were lost in this cycle are likely to return.