Employment Growth Is the Missing Piece of the Puzzle

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Highlights

- We are revising our expectation for the peak unemployment rate up from 10.3% to 10.8%. This peak should still be reached sometime in the first half of 2010.
- Temporary help services, a leading indicator of overall employment, has turned positive. Employers will often test the waters with temporary workers before bringing on full time employees.

The October job figures were a disappointment, with the US economy shedding 190,000 jobs and the unemployment rate rising to 10.2% –its highest level since April 1983. A total of 7.3 million jobs have been lost since the recession began in December 2007.

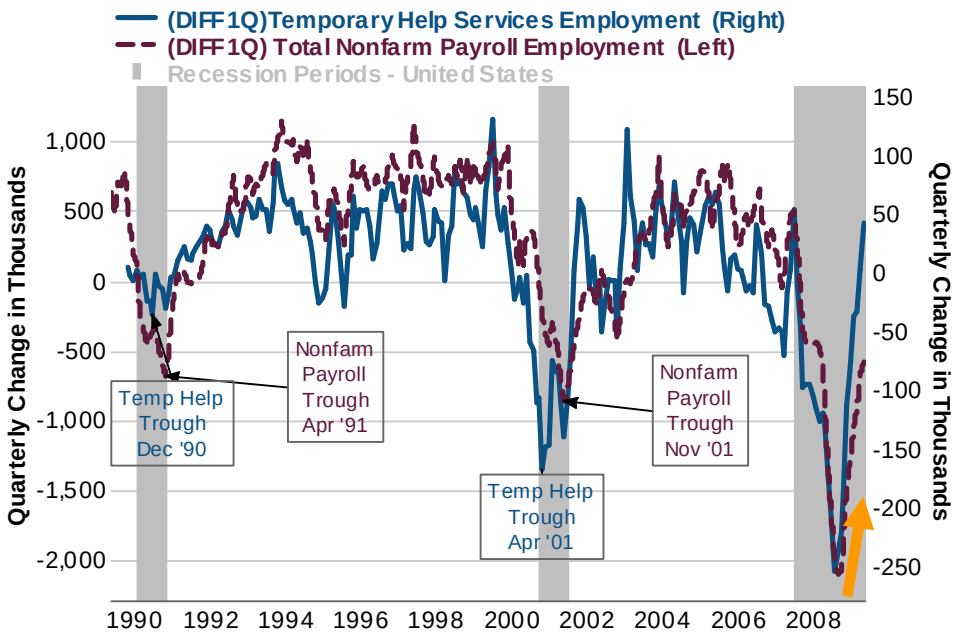
However, we continue to believe that a US recovery is underway and that the economy will begin generating jobs by early next year. Unfortunately, it will probably take two or three more quarters before the economy is creating the 150,000 or so jobs necessary each month to absorb new entrants to the labor force and keep the unemployment rate from rising. Therefore, we are revising our expectation for the peak unemployment rate up from 10.3% to 10.8%. This peak should still be reached sometime in the first half of 2010.

But even after the unemployment rate begins to decline, it is unlikely to fall back to the 4% or 5% levels we saw during the last economic boom. Instead, the long-term or *natural rate of unemployment* is likely to be closer to 6% or 7% as a result of lower economic growth rates caused by household deleveraging and structural changes in the labor market. Indeed, approximately three-quarters of the unemployed are considered long-term unemployed (out of work 27 weeks and longer). This suggests a large portion of the rise in the unemployment rate may be permanent (structural) in nature as opposed to temporary (frictional).

The Good News

The employment report did contain some good news. For example, 91,000 fewer jobs were lost in August and September than previously reported. In addition, the rate of job loss has moderated to 188,000 over the past three months compared to 523,000 during the first seven months of the year. The aggressive reduction in corporate payrolls has also had a positive impact worker productivity, which surged at an annual rate of 9.5% in the Q3 2009. This, along with very low interest rates, has resulted in considerable earnings leverage for companies. According to

Temporary Help Hiring Points to Labor Market Recovery



Source: The Labor Department

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- Historically, the Federal Reserve has never raised its benchmark policy rate before the unemployment rate has peaked.

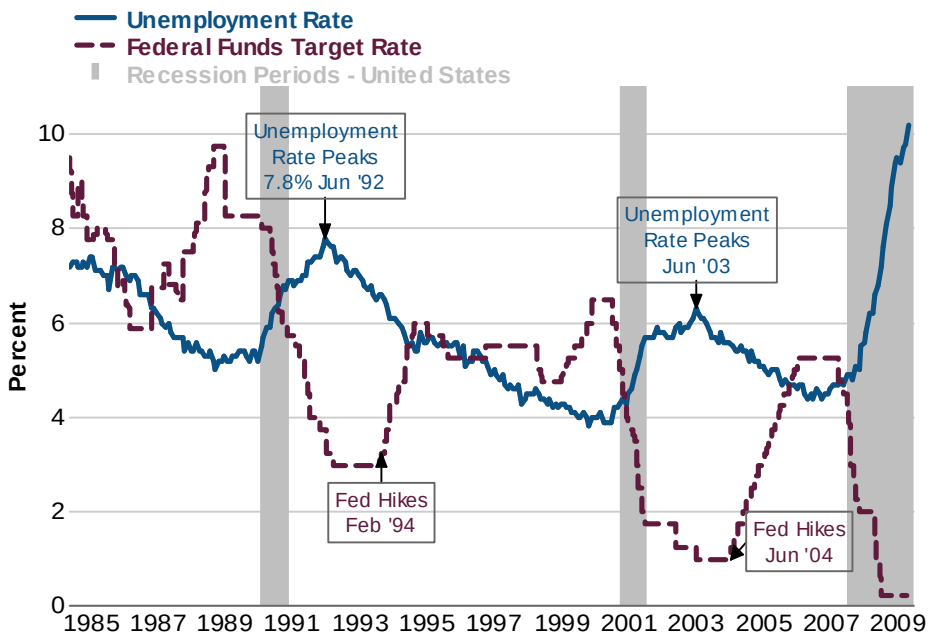
Bloomberg, 83% of the S&P 500 corporations that have reported third quarter earnings beat expectations. Eventually the improvement in profitability should lead to further hiring. In fact, temporary help services employment, a leading indicator of overall job growth, has turned positive and added 44,000 jobs since July. Employers will often test the waters with temporary workers before bringing on full time employees.

Calls for Further Stimulus Are Premature

Despite these hopeful signs, the weak jobs numbers have revived the debate amongst policymakers in Washington, DC about the need for additional fiscal stimulus. Congress has already voted to provide up to 20 additional weeks of jobless benefits to unemployed Americans and extend the $8,000 tax credit for new homebuyers into the middle of next year. However, beyond these measures, the discussion of further fiscal stimulus seems premature given that only about $200 billion of the $787 billion associated with the American Recovery and Reinvestment Act has been spent.

In terms of monetary policy, the soft labor market appears to reaffirm the Federal Reserve's decision this week to leave its benchmark interest rate unchanged in a range between 0% and 0.25%. Historically, the Federal Reserve has never raised its benchmark policy rate before the unemployment rate has peaked. In fact, on average, the Fed has waited more than a year after the unemployment rate has peaked to hike rates. Thus, interest rates are likely to remain low for most of 2010.

The Fed Is Unlikely to Hike Before the Unemployment Rate Peaks



Sources: The Labor Department and the Federal Reserve