

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

JUNE 3, 2011

IS THE SKY FALLING?

Friday's *Employment Situation* report for May reignited concerns about US economic growth. The US economy added "only" 54,000 net new jobs in May and the unemployment rate ticked back up to 9.1%. A disappointment, yes, especially after April's 232,000 increase in payroll employment. Stocks sold off and 10-year Treasury yields plunged back below 3.00% on the news.

Is the sky falling on the US economy? Does this latest data patch mean a "double-dip" recession? In short: **we don't think so**. Here are a few points to consider:

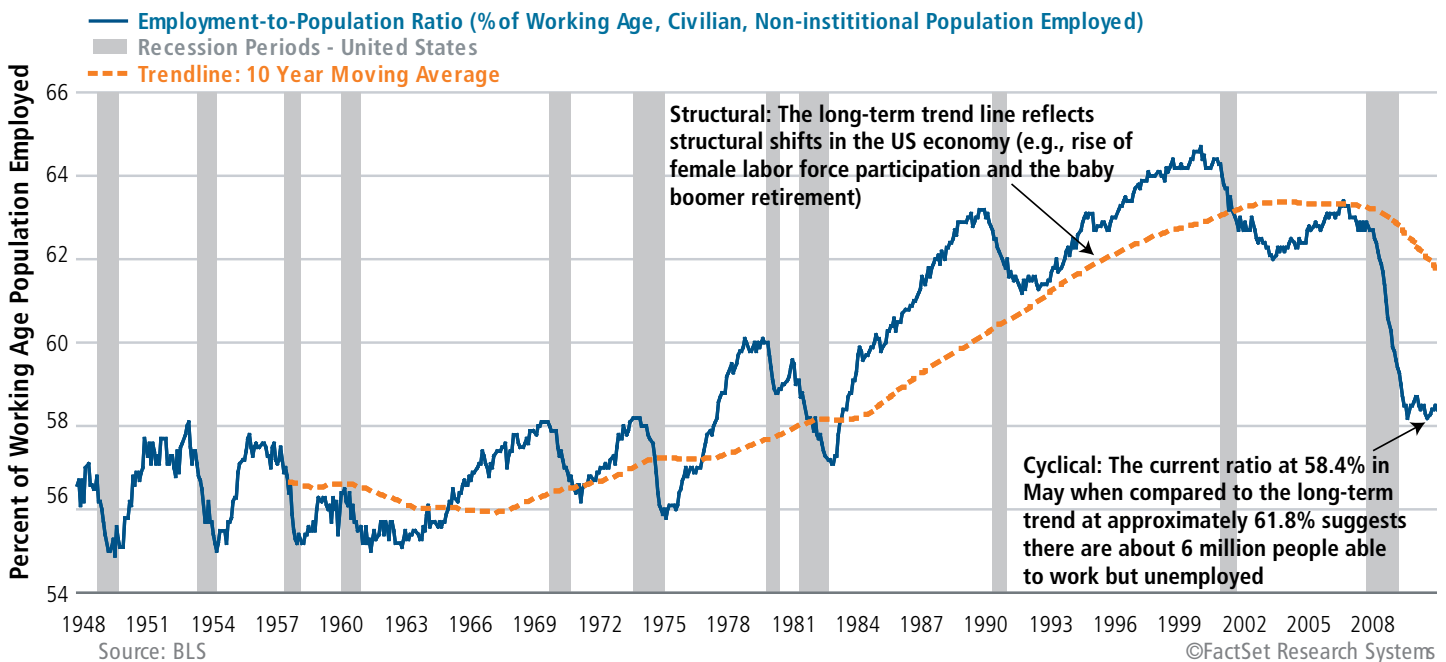
First, the pace of US economic growth has indeed slowed – but it was never great to begin with. The May employment report arrived on the heels of a series of poor economic data reports that point to growth in the 2-2.5% range (our forecast) in the first half of the year. Some of this is due to temporary factors (e.g., weather, Japan, oil/gas prices) but at the start of 2011 optimism for US economic growth

had consensus forecasters positively giddy. Forecast numbers were in the 3.5-4.5% GDP growth range for the year. The unemployment rate also dropped from 9.8% in November to 8.8% in early 2011—a full percentage point in just 4 months!—seeming to justify this optimism. Our view at the time was that the pace of economic activity and job growth did not justify a sharp fall in the unemployment rate. Instead, workers were leaving the labor force. The recent tick up in the unemployment rate supports that view (indeed, workers actually re-entered the labor force in May – a good sign!).

Further, the March/April/May payroll employment increases, which averaged 220,000 net jobs per month, again inspired a more optimistic outlook about the pace of growth and the rate of employment gains. However, May's data is a reminder that **the actual pace of jobs gains is probably closer to the 100,000-150,000 range**. Good, but not great.

Second, the labor market is better than a year ago. Really, it is! So far in 2011 the private sector has added 908,000 jobs, or 180,000

NOT THERE YET: EMPLOYMENT-TO-POPULATION RATIO SUGGESTS FED RATE HIKE NOT IMMINENT



per month. Compare this to the same period a year ago. Over the first 5 months of 2010, the private sector added just 358,000 jobs, or 71,000 per month. The labor market is clearly better off than a year ago, but the pace of jobs gains is still not fast enough to put a meaningful dent in the unemployment rate by year end and public sector job losses continue to drag the headline figure lower.

Third, economic indicators are not pointing to a “double-dip”.

In previous months we’ve highlighted the weak condition of the US labor market and the lengthy prospects for recovery. Yet even the employment report points to continued GDP growth, not a “double dip” recession. What’s more, the Bond Market happens to have a better track record than any macro forecaster. Benchmark 10-year Treasury yields at 3.00% and 3-month T-bills at 5 bps convey two messages: 1) the market *is more concerned* than a few months ago about economic growth prospects and *less concerned* about debt/inflation and 2) a steep yield curve (the difference between 10-year yields and 3-month yields) still portends moderate economic growth, not a double-dip recession.

Fourth, what about QE3? We still think the bar is high for a “QE3”. QE2 “ends” June 30 in the sense that the **Fed’s creation of new bank reserves to buy additional Treasuries will halt**. However, keep in mind two considerations: 1) The Fed thinks QE2 affects the economy occur primarily through the “stock” effect, not the “flow” effect of purchases. The “stock” effect will be unchanged. And 2) Asset purchases are seen as bolstering the FOMC’s commitment to “low rates for an extended period”. The “exit sequence” we’ve highlighted leaves room for the FOMC to continue reinvesting proceeds of its QE1/QE2 purchases, maintaining the size or “stock” of its balance sheet and keeping its “extended period” language in the FOMC statement. In short: the end of QE2 is not a “tightening” of policy.

THE SKY IS NOT FALLING.

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