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ECONOMIC TALKING POINTS

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Good News on Claims & Productivity --- and Forget About ISM Services

After two years that saw employers brutally hack away at payrolls, the ax pendulum has begun to swing back the other way. Business leaders are now beginning to reassess future staffing needs. With the recession over and economic growth resuming, employers have long relied on a smaller workforce to keep their business operating. But as the pace of global economic activity picks up, a growing number of companies have decided to slow layoffs, and some have even been forced to hire back people.

Still, the turnaround in the labor market is proceeding at an agonizingly slow pace. What cheers we hear today are not because companies are hiring workers in greater numbers than are being fired, but simply that fewer workers are being let go. And given the scarcity of good news on the labor front these last two years, we'll applaud even that slight turn for the better.

Claims for Unemployment Insurance

Today, the good news is that for the first time in more than a year, weekly claims for new unemployment insurance held below 500,000. There were 457,000 filings for jobless benefits in the week ending November 28, and that followed 462,000 applications the previous week. The four-week moving average of new claims, which smoothes out some weekly volatility, fell to 481,250 last week, versus 495,500 the prior week.

Some will argue the latest tally was taken during the shortened Thanksgiving week, which may have skewed the numbers down. But we doubt the abbreviated week was a significant factor this year. First of all, the data is seasonally adjusted so it already makes corrections for the holiday period. Second, if you look at the unadjusted numbers, which reflect the raw data, the drop was even larger than many expected. Take look at the numbers: last week's new claims fell by 5,000 from the previous week on a seasonal adjusted basis. On an unadjusted basis, claims plunged by much bigger 78,263.

Our conclusion is that as evidence mounts the global economic recovery is real, firms will continue to scale back layoffs. We're looking for the numbers to drop to 350,000 by the spring of 2010.

Revised Productivity – 3rd Quarter

One important harbinger of future employment growth is labor productivity. Productivity is the output of goods and services that workers produce each hour. Simply put, it reflects how efficiently companies use their employees. We know that 7.3 million jobs have already been eliminated since the start of the recession, which means that as firms now ramp up production, they will do so with far fewer workers. As a result, existing employees end up working harder. How much harder? Revised figures showed third quarter productivity jumped by an 8.1% annual rate which, while less than the preliminary 9.5% pace reported a month ago, is still the fastest pace in six years!

The jump in labor productivity will certainly lift corporate profits (i.e., companies produce more, with lower labor costs). But this jump in productivity also comes with one serious side effect. At some point employees grow tired from working so hard. Exhaustion sets in, morale declines, and quality control is sacrificed. As a consequence, employers are moving to bring on more workers, even if on a temporary basis, and we therefore expect the jobs report to show payrolls turning positive early next year.

Unit Labor Costs and Inflation

There's one other noteworthy measure in the productivity report. So long as wage increases are muted, inflation will remain subdued. What really heats up retail price inflation is not rising commodity prices nor the falling dollar. It is wages increases that exceed productivity growth --- and clearly we're nowhere near this state and may not be for years. Unit labor costs declined of 2.5% in the third quarter (and fell 1.4% over the year). So we see no inflation threat surfacing at least through 2011.

ISM Non-manufacturing

One other key economic indicator out today was something of a surprise. In a bizarre turn of events, the ISM index of non-manufacturing activity, which makes up some 90%

of the US economy, fell back to below 50 in November. It suggests the domestic economy contracted during the month. The index dropped to 48.7 last month from 50.6. Of the 17 industries surveyed, only six saw their businesses grow last month, including health care, construction; finance & insurance; and retail trade. The rest noted declines in activity.

No doubt Wall Street bears and forecasters who foresee a double dip recession will jump on this data set to support their predictions. Let them have their day. Our expectation is the economy will continue to show moderate growth through 2010. There is no reason to even reexamine that outlook on the basis of a single, as yet uncorroborated, economic number.

Remember, the service sector is not as sensitive to turning points in the business cycle as manufacturing. The ISM services index falls short as a reliable predictor of future economic activity, and with good reason. People continue to seek out services in good times as well as bad. Demand for health care, legal services, and haircuts do not undergo major swings.

Having said that, we still want to point out that even in the latest ISM services report, the new orders index remains ensconced well above 50, which indicates that demand for services is still rising. The index stood at 55.1 in November, largely unchanged from 55.6 in October. New orders have now been expanding for the third month in a row.

Our take is that no one should draw any dramatic conclusions from the disappointing headline number on ISM services. It has been stuck in this up and down mode each month since the beginning of the year. About the best we can say for this series is that the purchasing managers index, even at 48.7, is still above the 12-month average of 45.4, and markedly higher than the 40.1 low during the last year.

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