

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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Is the Economic Medicine Working? Yes, But It Can Only Go So Far In Terms of Job Creation

The June employment report was a disappointment and should kick off a vigorous debate on whether the economic medicine of the last 18 months is working in the US. Superimposed over that question is another. Are the austerity measures being taken by other key countries about to make things a lot worse for everyone?

Let's face it. This has not been a good week for economists who believe the US economy is on the rebound and that the fundamentals of the recovery are getting stronger. Consumer confidence has fallen. New claims for unemployment insurance remain stubbornly high. The pace of manufacturing activity, while still growing, decelerated last month to the slowest pace of the year. New orders for manufactured goods (from the ISM report), which influences future production, dropped back to an eight-month low last month.

And now we got an unexceptional June employment story. All the recent data has led us to reassess our outlook for the economy for the near term. While we continue to believe the economic recovery itself is not in danger of faltering --- that is we do not see a double dip coming --- the totality of the data out this week does require some tinkering with our forecasts.

Looking at the details of the employment report, it becomes increasingly clear that many employers are still adverse to hiring permanent workers, even though we are one

year into the recovery. Here are some of the highlights of the June jobs release.

- While the unemployment rate fell to 9.5%, the lowest since July 2009, it's largely the result of a sharp drop in the labor force. According to the government, 652,000 Americans left the civilian work force last month, the largest fall-off we have seen this year. There is, of course, some noise in the data that we can attribute to the departure of 225,000 census workers and the transition of teachers and other academics leaving the classroom for the summer. But it's hard to rationalize much beyond that. We haven't seen such a huge drop in the labor force for June in 30 years --- and that was in the midst of the 1981 recession.
- The number of discouraged workers also increased by 123,000 in June. Marginally attached workers (which includes discouraged) rose by 368,000. These are people who are available for work, but for a variety of reasons left the labor force and had not bothered to look for work in the last four weeks.
- Total nonfarm employment declined by 125,000 in June, but that was not a surprise given the expected dismissals of census workers. What was troubling in the June numbers was that private payrolls were actually revised downward in May from 41,000 to 33,000, and that hiring in the corporate sector in June rose by a rather modest 83,000. We should be seeing three to four times that number by now.
- Americans even worked fewer hours last month. Average weekly hours on the job in the private sector dropped back to 34.1 in June, from 34.2 the month before. It's not much of a decline, but we see the slowdown occurring across the board. Weekly hours for manufacturing were down to 40.0 last month from 40.5 in May. Overtime fell from 3.0 hours a week in both April and May to 2.9 hours in June. With both regular hours worked and overtime slipping, we can expect more soft job numbers in the months ahead.
- Even temp agencies are hiring fewer people. Temporary employment rose by just 20,000 in June, the smallest increase since September 2009.
- The length of time Americans are unemployed has also kicked higher, to an average of 35.2 weeks in June. What's so disconcerting is that when the recession finally hit bottom a year ago, the average was 24.4 weeks.

What does it all mean?

The metaphor we can use to describe the U.S. economy would be akin to a four-stage rocket that was back in 2008 and 2009 sitting motionless on a launch pad. To lift that rocket (the economy) up, the government fired up the first stage, which consisted of a massive federal spending program. All that stimulus, in turn, eventually ignited the second stage, which was business spending. As the rocket picked up more speed, the combination of government and business outlays helped trigger the third stage, which

was consumer spending. But it's the fourth and final stage, one designed to place the rocket in full orbit, which is malfunctioning. The fourth and most critical stage is supposed to be rising employment. Without that fourth stage coming on, the economy will lose momentum and eventually fall back to Earth. Right now, the US labor market is simply not contributing to the thrust of the economy. The rise in private payrolls peaked in April and has since not even come close. The lack of sufficient job creation cannot sustain demand in a \$14 trillion economy.

This is a departure from our usual optimism, but it's warranted. Despite the plethora of the federal spending programs, the numerous tax incentives for companies to hire workers, and a record low interest rate environment, the fact remains companies in both services and manufacturing are still generating fewer jobs than we expected.

While all the fiscal and monetary medicines did successfully keep the economy from tipping into a depression, the government cannot, short of war, get private companies to ramp up hiring if these firms do not want to. Lowering corporate taxes and accelerating depreciation write-offs will please CEOs. But in the final analysis, these measures by themselves are not going to motivate employers to go out and hire. Subsidies and tax incentives, in and of themselves, will not lead to significantly more hiring. What will do the trick is rising demand for the goods and services. A credible expectation of increased revenues now *and in the future*, is what will turn the corner in private sector hiring.

Evidently we are not at this stage yet. The world economy may have averted another Great Depression, but there are still too many cracks in the global economic architecture that can be traced back to the recent financial crisis. While some of these cracks are being repaired, fresh ones seem to appear.

For example, in the US, Washington hopes the financial regulatory bill will clamp down excessive risk taking by banks and thus avoid a repetition of the 2008 financial meltdown. But Europe is having more difficulty time solving its financial woes, in part because the current structure of the single currency system is flawed and there's the perception no one quite knows how to fix it in a manner that is quick and agreeable to all 16 Eurozone countries! The fallout from the European sovereign debt crisis has undermined confidence in banks on the Continent and those worries have spread to here where they have raised concerns about the durability of the US recovery.

Another unnerving development to US employers is China. Chinese policymakers are deftly managing to cool down their economy. But even a successful soft landing by world's fastest growing nation has exporters and investors around the world worried. Asia was to be one of the few bright spots for the global economy. We've already gotten signs that manufacturing activity in India and South Korea is decelerating. If China were now to slow as well, the perception builds that the global economic recovery will soon falter. Dependence on China now has reached a point where what is good for that country may be harmful for the rest of the world, especially when global demand is still weak.

To make matter worse, many key countries are rapidly scaling back stimulus spending in an attempt to rein in their own official deficits. There's the fear such synchronized austerity across countries in Europe, along with Japan, and China may bring the world recovery to a screeching halt.

Then there's the problematic issue of housing in the US. If the lowest mortgage rates in history and plunging residential real estate prices are not enough to get even Americans who *are* working to go out and buy new homes, what will?

What of the banks? If a year old economic recovery, rising household income, and record strong corporate profits are not enough to get banks to accelerate lending, what will it take?

In addition to all these points, there's the sensation of vertigo that investors and business leaders go through after a week that saw a barrage of conflicting data points. Here's a brief sample.

- The June employment numbers were clearly unimpressive. Yet, announced corporate layoffs in the first half of 2010 were the lowest in a decade, according to Challenger, Gray & Christmas. We also got the Monster Employment Index, which tallies jobs posted online; it jumped in June for the fifth consecutive month.
- The University of Michigan's consumer sentiment survey showed Americans were the most optimistic in more than two years in June. Not so says the Conference Board. Their Consumer Confidence series dropped sharply for the same month.
- Retail sales fell 1.2% in May, the largest decline in eight months. Yet just days later the government reported that personal spending rose 0.2% during the month, beating out the forecast of experts.
- The stock market just ended its worst quarterly performance since 2008, when the financial crisis erupted. Yet corporate profits are climbing at the fastest pace in 26 years, and these earnings will only add to the massive \$1 trillion in cash that already sits on company balance sheets.

What to do??

Given the uncertain economic backdrop and the questionable timing of the austerity programs overseas, we are advising clients to turn defensive for the summer, or at least until there is greater clarity on where the global economy is headed. For now, the economic fog is simply getting thicker and that requires a more conservative asset allocation strategy.

- Cyclical stocks, financials, and housing, continue to look especially vulnerable, as do industrial commodities.

- Cash and cash equivalents, gold, food, large capital goods exporters, and high quality dividend stocks are recommended through the summer.
- US Treasuries are too richly priced in our opinion, even though the odds of a global slowdown have increased. The risk of holding a 10- year note with a two handle is just too high given how quickly bond prices can turn if the economic statistics suddenly appear better.
- Among the foreign markets, Canada and Brazil remain our favorites.
- In terms of currencies, the US dollar, British pound, and the Australian dollar look less attractive relative the Canadian loonie, the Brazilian real, and the Japanese yen. The euro will likely stay within a narrow range of \$1.22 to \$1.27 versus the greenback the rest of the year.

Does all this mean we are finally bowing to the double dippers or the proponents of the new normal?

Not at all. What has changed in our forecast is for the second half of the year, where US growth has been downgraded from a 3.4% annual pace to 3.0%. But this should be viewed as a temporary pause in the business cycle. In fact, we're calling for a fairly vigorous rebound in 2011, with growth averaging above 3.5%. We do so for the following reasons:

- (1) By early next year, the management of the European sovereign debt crisis will be more orderly, which should reduce investor anxiety. The weak euro will help boost European exports and local tourism. Indeed, we believe the euro will not retest its \$1.19 low for this crisis.
- (2) China's economic slowdown will prove to be milder than thought as domestic demand picks up. Chinese household spending will accelerate following the rise in the minimum wage and the fact that a growing number of foreign firms have agreed to boost worker pay to avoid labor unrest. The rise in the RMB and higher income will work to lift consumer purchasing power in China and lead to higher demand for foreign goods.
- (3) With the financial regulatory bill soon to become law, the uncertainty about the new rules are will fade and that should clear the way for increased lending.
- (4) Finally, interest rates, both targeted and market rates, will remain historically low through 2010, and likely boost credit demands in the second year of the US recovery.