THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

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A lackluster jobs report: We're surprised so many were surprised

Here's what is important to know about the August jobs report.

The disappointing 96,000 increase payrolls and the downward revisions in the previous months will force the Federal Reserve to announce some form of quantitative easing next week. Whether QE 3 will ultimately have any palpable impact on the economy is another issue; we have argued it will not. (Frankly, decisions made by European Central Bank in the coming weeks may have a greater impact on the US economy than what the Federal Reserve does.)

The more interesting question is why people seem so consistently perplexed by the poor job growth this spring and summer? Indeed, it would have defied logic if employment had been much stronger this year.

When an economy manages to squeak out a growth rate of below 2%, it will generate on average just 90,000 net new jobs. After all, with demand in the economy so sluggish, what's the incentive for businesses to significantly ramp up hiring? There isn't any. In order for the jobless rate to fall back down to 6%, companies need to boost payrolls by an average 325,000 a month for the next three years --- and that will only occur if the economy races ahead at a 4% clip during this period. But that kind of economic activity appears like an alternative universe right now. Total nonfarm payrolls last month stood at 133.3 million, ***the same level as in 2005.*** Average weekly hours worked in the private sector has fallen this summer to 34.4 hours; ***it was higher during the recession!***

Clearly what is lacking now is any economic justification for business to accelerate hiring. While it is true that the underlying fundamentals of the economy have improved: That is, banks are better capitalized and making a few more loans. Households have worked hard to deleverage and made progress repairing their balance sheets. Consumers seem more relaxed about buying cars and houses. Corporate profit margins are greater than ever. These are all positive developments. But what looms even larger for business are the multiple downside risks the US economy faces the rest of this year---and their implications for 2013. It is difficult for many employers to justify taking the costly step of hiring workers when there is so much uncertainty about the next 18 months.

What specifically troubles corporate leaders?

- There is great uncertainty over tax policy, which can affect both the cost of capital and return on invested capital!
- There is uncertainty about future government spending and regulatory policies?
- There is uncertainty who will win the presidential election and the implications that carries, since Romney and Obama are pushing two radically different domestic agendas.
- There are questions whether the European financial crisis will get worse, or has turned the corner.
- There is uncertainty about China and whether its economy will weaken more than previously thought, and the ramifications that has for the rest of Asia.
- There is uncertainty about the path of oil prices should war erupt with Iran?

It's hard for an economy to gather much steam when the outlook is so opaque. So this anemic jobs report is far from a surprise to us.

But this latest release raises an intriguing issue. We know that cyclical factors have depressed employment growth. Demand for goods and services have fallen around the world, not just in the US. The global economy has slowed markedly. But too many economists have underestimated the structural employment issues. August's labor force participation rate (the percentage of the civilian working age population in the US that is either at work or actively looking for employment) has now fallen to 63.5, the lowest in more than three decades!! Is there a paradigm shift underway in the dynamics of the labor market? Could we be edging closer to a labor--less society?

For example, there are signs that the calculus of hiring workers has changed for business. Firms today operate in a hypercompetitive global economy. Since labor is expensive, companies are laser focused on improving the productivity of their existing workforce. (Case in point: Second quarter productivity rose a stronger than expected 2.2%). The singular question corporate managers ask is “how can I serve more customers and generate more output without necessarily adding on permanent workers?” It is a perfectly rational question when operating in a global economy, and when the outlook for employee-related health care costs remains so unclear, and with pressure building to better manage their future pension liabilities.

For the unemployed, the strategy has change as well. Some have left the workforce and returned to school for advanced studies --- or to seek training for skills that are in demand. But one can also deduce from the statistical data that in the aftermath of the Great Recession and the agonizingly slow jobs recovery, a greater number of jobless individuals have chosen instead to enter the underground economy, which may now represent as much as 5% to 8% of GDP. To feed their families and pay for shelter, this group has chosen to earn income under the table as computer repairers, web site designers, tutors, carpenters, drivers, flea market merchants and etc. What is key here is that the growing number of those “chronically unemployed” are actually earning enough in the underground economy to support demand for goods and services in the overt economy. It’s partly why with an unemployment rate above 8% and an economy expanding consistently less than 2%, the threat of price deflation remains minimal.

Bottom line:

So long as the economy is being held hostage to so many domestic uncertainties and geopolitical threats (the fiscal cliff, presidential elections, China, and the Middle East) it will be hard for employers to justify ramping up employment. Having said that, we do believe that after November 6, the decision making process on capital spending and hiring will improve, and with that the economy too. In fact, we have lifted our forecast for US growth in 2013 to 3.2% (from 2.7%), with the unemployment rate falling back to 7.2% by the end of next year.

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