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ECONOMIC TALKING POINTS

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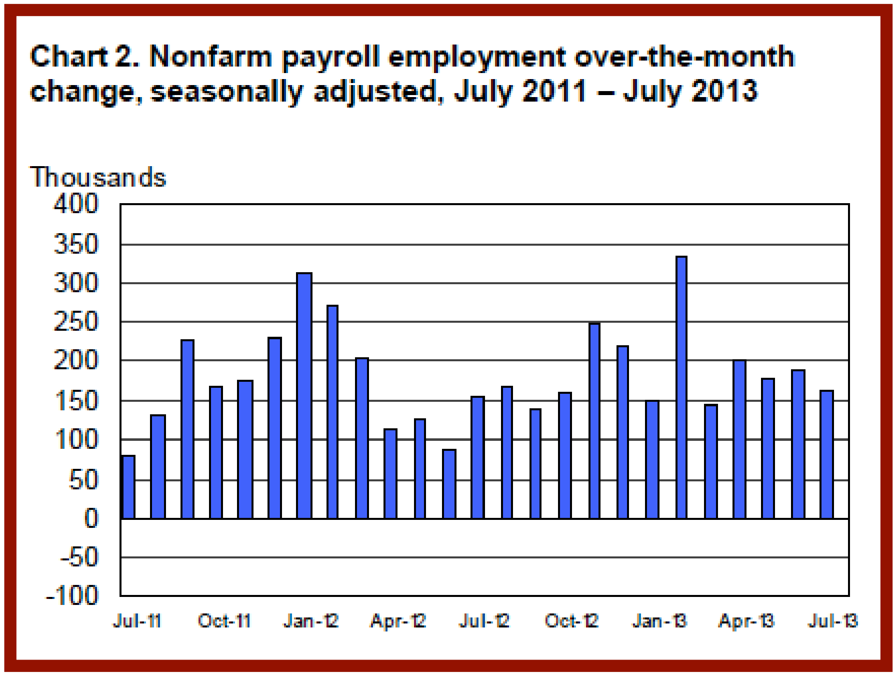
A strong private economy--- but weak job numbers. What's really going in the labor market?

Every once in a while we get a week's worth of economic news that helps lift the fog on the health and direction of the economy. This appeared to be one of those weeks. After all, we got strong ISM manufacturing numbers for July, with the production index soaring to the highest in nearly a decade and new orders at a two-year high. We also got a pretty good ADP Employment Report, which suggested labor market conditions were getting much better. Another surprise was that applications for unemployment benefits plummeted to the lowest since January 2008.

All this positive news allowed the Dow and S&P 500 to break into record territory on Thursday. This looked like a week that could have even sealed the deal for the Fed to begin tapering in September!

And then came Friday and we were hit with a case of statistical whiplash, thanks to a muddled and muddy July employment report. Many forecasters, including us, expected to see payrolls exceed 200,000 last month. It was not to be. Topline payrolls rose by 162,000, the smallest increase since March. Moreover, the government revised downwards June and May numbers to show 26,000 fewer jobs established.



Source: BLS

A similar trend showed up in the private sector, where only 161,000 net new jobs were formed last month, along with corrections showing more than 20,000 fewer positions filled during the two previous months. **Except for last February, the job market has been incapable of gaining enough momentum to push payrolls above a 200,000 monthly --- and that has to be disconcerting.**

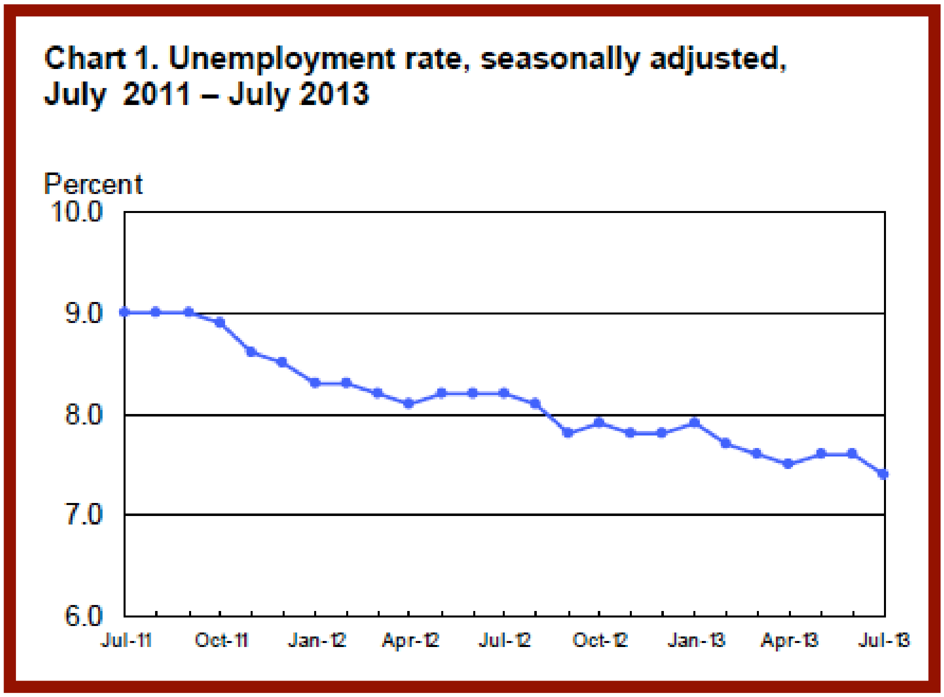
Indeed, July appears to show employment conditions getting worse!

• Average weekly hours worked in the private sector slipped to 34.4 hours last month, compared to 34.5 in June, and 34.6 in March, the high for the year.

• Also troubling was the rather sharp drop in manufacturing overtime from 3.4 hours to 3.2, which we cannot attribute to the summer shutdown of auto plants since these figures are seasonally adjusted. In fact, we haven't seen a drop manufacturing overtime for the month of July in four years!

• While the household survey was a tad better, with employment increasing by 227,000 last month, that was still below the second quarter average of 257,000.

• With other signs showing business activity picking up, we were hoping to see more of the long-term unemployed step back into the labor force and resume looking for work. Instead, 37,000 chose to leave the workforce! That helped bring the unemployment rate down to a four and half year low of 7.4%. Sure, a falling trend line in the jobless rate may look good as a newspaper headline, but it remains a hollow achievement since fewer people are counted as unemployed.



Source: BLS

- Another disturbing data point was the number of people stuck at part time work due to a lack of suitable full time employment; this measure jumped by 19,000 in July, to 8.25 million, the same level of a year ago.

Does the jobs report tell us anything about the future?

There are three sub-components in the jobs report that have shown some predictive value in telling us where the economy and the job market are headed.

The first is employment in the trucking sector, which did jump by 6,300 last month. Companies hire more truckers when the demand to transport commodities and finished goods increases. There are now 1.39 million truckers on the road, more than anytime in the last five years. Good news!

Another leading metric is temporary work. It rose by 7,700, the slowest pace since last September. Fewer temp workers can be a sign that employers are gearing up to hire more people on a permanent basis. (Of course, it could also mean the perverse; companies simply have less work for temps to do. Stand by for future data to see which it is.)

A third leading indicator was quite a disappointment: employment in childcare services. Parents of small children typically rely on childcare centers if they succeed in getting employment, and these centers are usually required by state law to have a minimum ratio of caregivers to children. Unfortunately, employment in childcare has declined again in July, for the fifth consecutive month. Not good news.

So, just what is going on in the job market?

When faced with a stronger private economy, as evidenced by a series of other upbeat economic data the last several weeks (e.g., housing, car sales, confidence levels, business capital spending, and exports) but persistently weak employment numbers, you have to wonder whether the calculus that goes into hiring has undergone a fundamental change. **Are there more serious structural impediments at work here that prevent us from clearing the labor markets at this time?**

We believe there is growing evidence the job market has undergone a transformative change the last several years. It is a change so significant that so long as private sector GDP growth remains under 3.0%, it will not lead to materially greater hiring.

Here are five reasons why the pace of job growth has diverged from economic activity?

(1) Companies now operate in a tougher global marketplace. Being price competitive is essential to acquire new customers and prevent, at the very least, a loss of market share. But being price competitive can also hurt profit margins. Since labor poses the greatest production expense, companies are more focused than ever on boosting productivity to increase output without driving costs higher. The corporate theology nowadays is simple, if discreet: How can you do more with less. This is a process that will likely place a long-term chill on permanent employment.

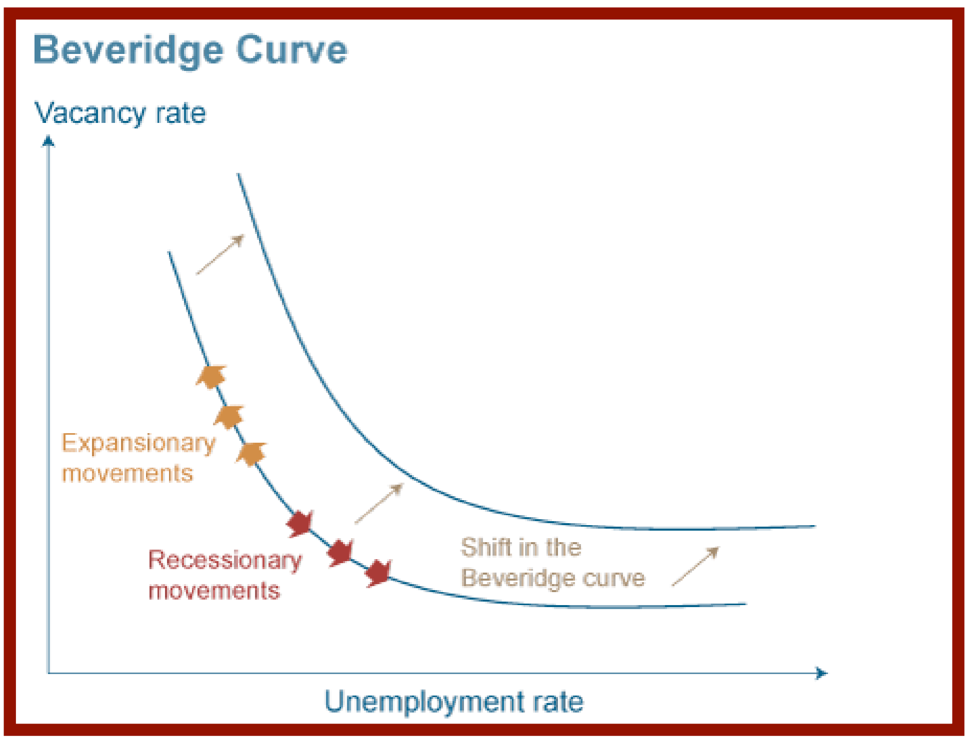
(2) Older workers are also sticking round longer. Many in their 50s and 60s fear they may not have enough income and/or savings for retirement, especially given the concerns expressed on the solvency of social security and Medicare. Will these benefits be there for them? Will they have to pay more out of their own pockets for coverage? These worries have prompted older employees to remain on the job longer, a decision that consequently reduces the number of open positions.

(3) Employers are still struggling to assess the costs imposed by the Affordable Care Act (Obamacare) when they hire new employees. In addition, there is the challenge of funding pension liabilities of current and future hires, a task made more difficult as pension managers receive meager returns on fixed income investments. Efforts to better control corporate health care costs and fund pension obligations may explain the propensity of employers to hire temporary and part time workers, who receive fewer benefits than permanent hires.

(4) Let’s face it; advances in computer and information technologies have also reduced the demand for workers. The price of capital goods ---such as computers

and software --- has declined sharply relative to labor. That means the bar has been raised much higher to justify adding to payrolls permanently.

(5) Another key factor is simply the lack of proper skills among the unemployed. For this, we look at the Beveridge Curve to see how efficient labor markets are these days in terms of matching unemployed workers to available job openings. Typically, the unemployment rate would decline as job vacancies increase. But that process can slow markedly if the unemployed do not have the prerequisite skills for those available jobs. As a result one can now have ***both*** high unemployment and a high job vacancy rate, which would be symptomatic of a dysfunctional labor market. This is what the Beveridge Curve shows. By comparing the number of job openings in the Job Openings and Labor Turnover Survey (JOLTS) with the unemployment rate, it becomes apparent that there are more structural rigidities now than before in the labor market and this has slowed the process of filling jobs.



Source: Federal Reserve Bank of Cleveland

While it goes without saying that we need to see faster economic growth to get more robust job creation, the disappointing July employment report is a particularly troubling one. It sends a stark message that cyclical growth in the private economy below 3% may still not be enough to offset the structural barriers that prevent real progress in employment.

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