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ECONOMIC TALKING POINTS

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Nonfarm payrolls to bottom out in third quarter as business begins to tune out Washington and focus on the real economy

We waited so long, and in the end got so little of value from the September jobs report.

Let's get right to it. There is a dichotomy in the US economy. On the one hand, the fundamentals in the private economy are really the best we have seen in nearly a decade.

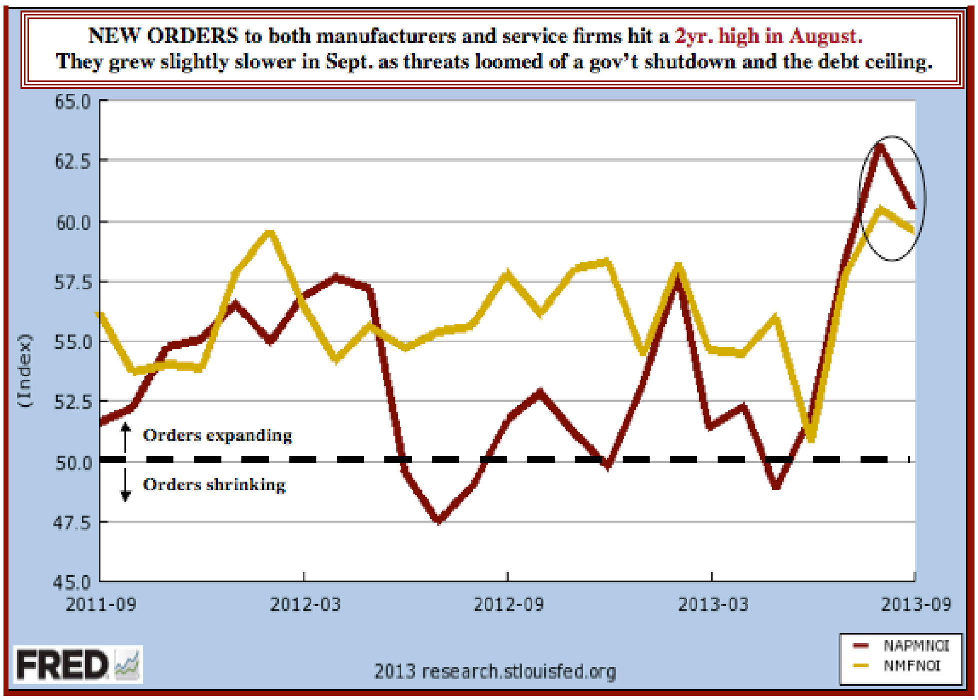
Yet employers continue to resist matching that improvement with genuine increases in permanent full time employment. Of the 148,000 increase in nonfarm payrolls last month, about one-in-four went to temporary and part- workers. (You can thank the disruptive proclivities in Washington for that!) Ex-out part-time and temp workers and you are now left with a mere 113,000 workers.

But even that figure needs to be adjusted to net out the return of teachers to the classrooms, which added 29,000 to payrolls. Subtract those educators and the core business cycle payroll number has now dropped to a lackluster 84,000.

That is an astonishingly low number for a private economy that in many respects is in very good shape (that is, economic growth without excessive leveraging by households or business, no inflation, and no inventory imbalances). Even with that healthy backdrop, however, companies have been unwilling to ramp up hiring. Indeed the trend has been the perverse!! Average monthly nonfarm payrolls rose 207,000 in Q1, slipped to 182,000 in Q2, and then dropped further to 143,000 in Q3. (The deceleration was even more pronounced in the private sector as average monthly payrolls declined from 212,000, to 190,000, 129,000 during the same three quarters.)

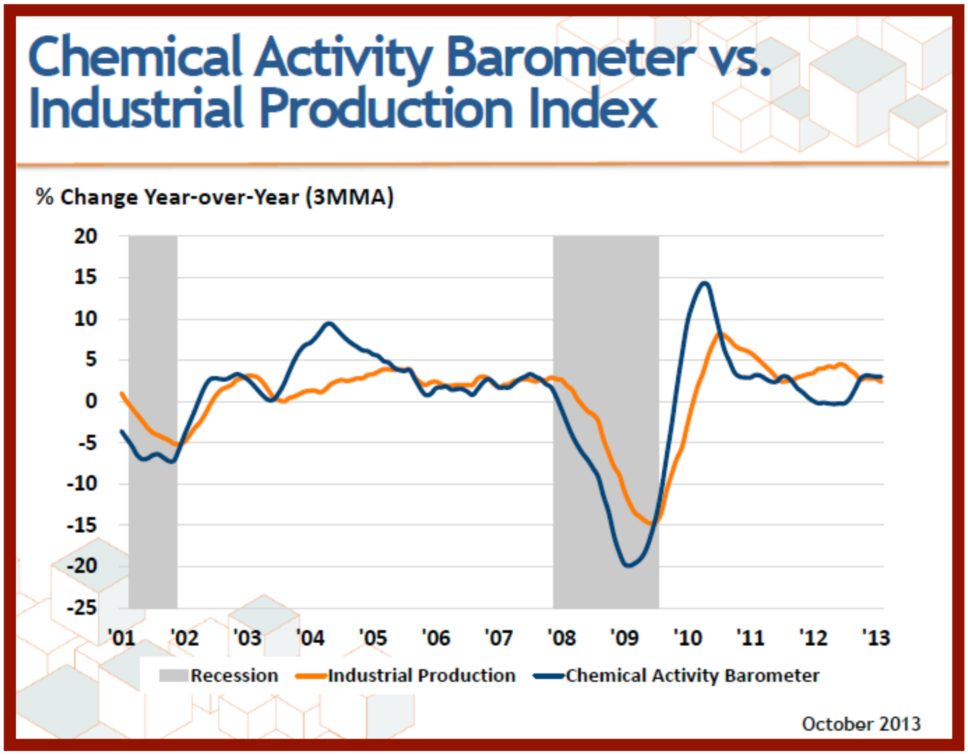
Again, what's remarkable is that this deterioration in hiring comes at a time when domestic and foreign demand for US products is getting stronger. In the absence of official government data, let's consider other very reliable economic data points released by trade groups in recent weeks:

- **The Institute for Supply Management** noted that new orders for both manufacturing and services are now close to two-year highs. Export orders are also expanding.



Source: ISM, Federal Reserve

- **The Association of American Railroads'** weekly report on freight traffic shows the number of carloads carrying such basic commodities, such as metallic ores and metals, forest products, petroleum and petroleum products are all up substantially from last year's levels. Usage of intermodal rail cars, which transport mostly finished goods to distributors and retailers, was also higher than year ago levels.
- The **American Chemistry Council** today released one of the best leading economic indicators out there, the Chemical Activity Barometer (CAB). Remember, the chemical industry is among the most sensitive to detect any shift in the business cycle. Their CAB, which is a 3-month moving average that ends in September, was up more than 3% from its level a year ago; it now stands at the highest since June 2008. This reading provides additional evidence that despite the soft job numbers last month, the US economy is actually gaining more, not less, traction.



Source: American Chemistry Council

What does all this say about future employment trends? I have been on the road talking to clients the last two weeks about their business, the political gridlock in Washington and plans for hiring, and I came away quite encouraged. Here are my main conclusions:

(1) Business leaders have grown terribly weary of all the histrionics in Washington. The country has gone through three rounds of fiscal brinksmanship the last two years and they have clearly had a corrosive effect on economy. But the lesson learned is that in every instance, Congress has pulled back at the 11th hour from the abyss of national default and the threat of another recession.

So while the country may face another government shutdown and debt ceiling crisis on January 15th and February 7th, respectively, virtually everyone I spoke to think the odds of either happening are much less likely next time given the political damage House Republicans suffered these past several weeks.

In others words, business leaders are increasingly tuning out the partisan battles and the dysfunctionality in Washington, going so far as to conclude that the political food fights may be the norm until the 2016 elections.

Sure, that is hardly an ideal situation, but going forward corporate managers say their real focus will be more on what is happening outside the Beltway --- and that is good news!

(2) Given the follies in the nation's capital and the scarcity of noise-free

government economic data the next few weeks, the Federal Reserve, under Janet Yellen, will likely begin to dial back on QE no sooner than late in the first quarter. That means the cost of capital will remain low for most of next year --- even as the US and international economy gains momentum.

(3) Finally, one of the unusual characteristics about the current expansion is the absolute disconnect between the surge in corporate profits (and the record cash they have accumulated) --- and --- the lack of capital investments and hiring. Historically, strong profits lead to more business spending and rising employment. That relationship has broken down in this recovery. I expect this will be corrected in 2014 as the private economy in the US picks up speed, and with Europe, Japan and China back on the mend as well.

Bottom line:

Our take is that nonfarm payroll numbers probably bottomed out in the third quarter. We expect to see a meaningful acceleration in hiring early in 2014 as global economic conditions keeps improving.

Our forecast calls for nonfarm payrolls to average 220,000 a month in the first half, and then rise to 245,000 in the second half of the year. Though GDP growth in the final quarter of this year will experience a setback (to 2.2% vs. 2.5%) due to the effects of the government shutdown, we believe it will be partially offset by a better than expected holiday shopping season.

There is no change in our overall forecast, which projects the economy will grow 3.2% in 2014, with the jobless rate sliding to 6.6% a year from now. That will lift yields on 10-year Treasuries into in a range between 3% and 4%.