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ECONOMICS GROUP

SPECIAL COMMENTARY

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Employment: Digging Under the Headlines

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Employment is a driving factor for consumer income and spending and therefore must underlie any strategic thinking about the economy and financial services. In this essay we take an expanded view of several aspects of the "consumer as worker" experience. First we highlight the cyclical pattern of employment with emphasis on the extent of the deviation of the current experience relative to the recent past. We conclude that the extent of the pressure on the consumer is far more significant today relative to recent cycles. Next, we break down employment by macro categories such as education, industry, and region. These characteristics distinguish the winners and losers in the search for the best jobs, with some results reflecting short term shocks and others representative of long term trends. We focus on education in particular, which has been a long running theme in our work.[1] The results reinforce our view that, even in a recession, the economic returns of an investment in education are significant. We then examine the employment experience at the industry level. Emerging themes here include the long-term secular decline in manufacturing employment, the highly cyclical nature of construction employment, and the very few parts of the service sector which have escaped the otherwise omnipresent loss of jobs. Finally, we highlight some regional trends we find interesting. In particular we note the boom/bust pattern associated with the housing and energy cycles, clearly a driving factor in the success of households to find or lose employment in a national business cycle.

Cyclical Employment Patterns: The Past is not Prologue

Over the last three months the labor market has taken a definitive turn for the worst, losing 1.5 million jobs, while the total losses for 2008 amount to nearly 2.6 million. (Figure 1). To illustrate the degree of deviation in employment in this cycle we look at two sets of data. First, we illustrate the total change in employment in the current

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[1] See for example the 2006 Adolph G. Abramson award-winning article: Domestic Implications of a Global Labor Market, *Business Economics*, V. 41, No. 3, July 2006.

recession thus far relative to earlier periods in the post World War II era (Figure 2). The decline in employment during this recession is already on scale or greater than that of the prior two recessions (1990-91, 2001), and will most likely surpass the 1981-1982 recession as well. Effectively this employment decline will exceed the experience of most workers and managements, and thereby present a real challenge to strategic thinking. Second, we illustrate the degree of deviation of service employment compared to its historical departure in Figure 3.[2] Here we see that the decline in service employment is in fact well-outside the historical experience of most workers and managements alike.

Figure 1

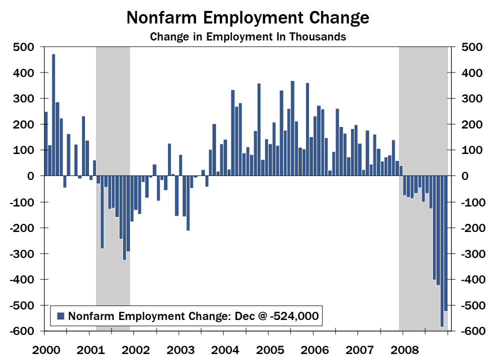
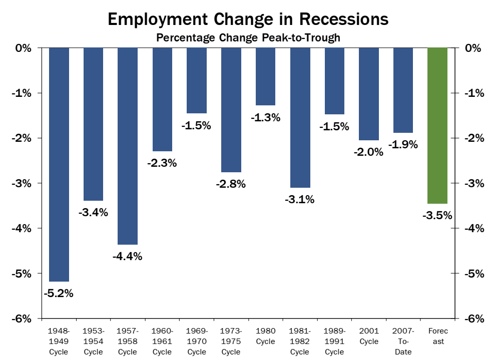


Figure 2



Source: U.S. Department of Labor and Wachovia

Whenever the economic cycle takes workers and management outside their historical experience, there is a high degree of uncertainty and a high cost to finding a new equilibrium. We see the current situation as reminiscent of the significant structural change that occurred after World War II and in 1980-82 in the Rust Belt. We are well-outside our economic comfort zone and into territory more complex than that suggested by simple headlines.

Figure 3

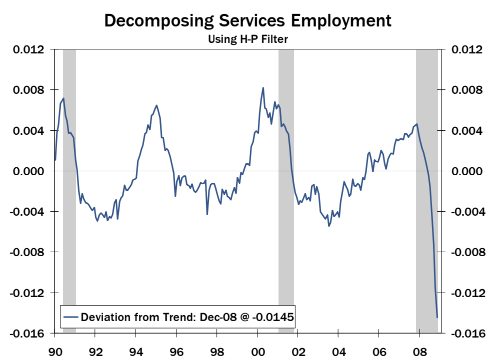
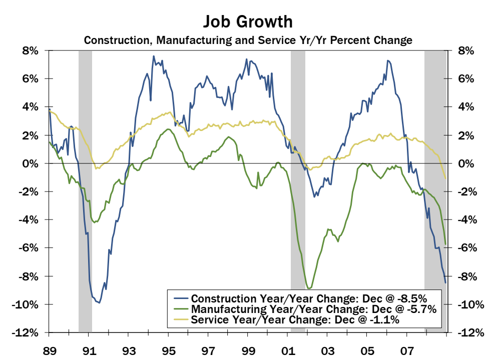


Figure 4



Source: U.S. Department of Labor and Wachovia

Already having suffered through the worst year for employment since the aftermath of World War II, losses will continue to mount through 2009. Job losses have become apparent across all of the major sectors: services, construction and manufacturing (Figure 4). Less than 30 percent of all industries added employees over the past three

[2] For a review of the Hodrick-Prescott filter approach used here please see our article "Subprime Credit: The Evolution of a Market," *Business Economics*, July 2008

months (Figure 5). The unemployment rate has jumped more than two percentage points in just nine months. Broader measures of unemployment indicate an even more troubling picture. U-6, which includes those employed part-time for economic reasons, marginally attached workers and those traditionally classified as unemployed, is up a startling 4.3 percentage points over the same period (Figure 6).

Figure 5

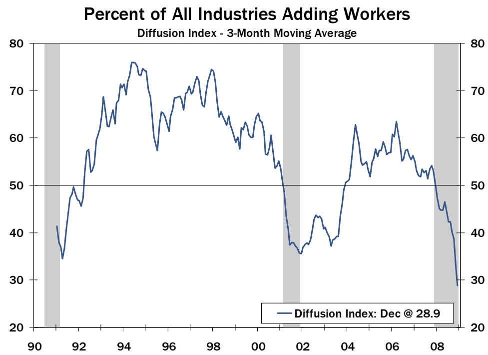
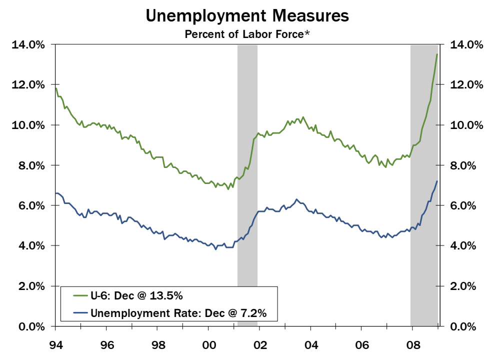


Figure 6



Source: U.S. Department of Labor and Wachovia

While the national headline figures certainly garner attention—for their extreme magnitude if nothing else—they hide a wealth of information on just who is having the most trouble and where the problems are greatest in magnitude. This cycle has been witness to the swamping of many previous norms; even normally "recession-proof" industries are seeing slowdowns, former standout regions are struggling to hold on to gains, and the best prepared workers are having troubles. That said there are still relative winners to be found in certain regions and specific industries. We aim to identify which workers are seeing the best and worst situation today, as well as who is best positioned to succeed when the economic cycle turns, as it is bound to, in the coming years.

We outline the common characteristics and differences among four groups of workers in Figure 7, beginning with Today's Winners and Today's Losers. While Today's Winners are few and far between, there are some groups which may benefit in this environment, or will at least hold even, ensuring relative gains. Second are Today's Losers—admittedly the vast majority of the American labor force falls into this category at present. The pervasiveness and sheer depth of the current recession means there are few industries, regions or people that can escape the pain. The key at this point in the cycle is not to identify who is winning and who is losing today, considering the sheer breadth of the losses, but instead to differentiate between those who have the potential to land in the winner's circle after the recovery and those who may have difficulty emerging from the loser category. Half of Tomorrow's Winners will be those who are managing to make it through the current cycle relatively unscathed, while others will come from those areas suffering the worst from the cyclical downturn. The determination of who will be a winner and who will be a loser in coming years will depend on many factors. Ahead we delve further into the factors of education, industry, and region.

Figure 7

Today's Winners
They Are Few and Far Between But Exist
- Higher Education
  - Adaptable Skill-sets
- Service Sectors
  - Health & Education
- Regional Hotspots
  - Texas & Greater Washington, DC

Tomorrow's Winners
Who Continues to Excel Into the Future
- Higher Education
  - Adaptable Skill-sets
- Sunbelt States
  - Return of Growth Even in Hard Hit Markets

Today's Losers
Who Has Problems Today?
- Low Education
  - Non-transferable Skills
- Slow Growth Markets
  - Upper Midwest
- Low-Value Add, Labor Intensive Manufacturing
- Housing Bubble Markets
- Cyclical Problems
  - Construction & Real Estate
  - Financial Services

Tomorrow's Losers
Who Continues to Face Problems?
Low Education
  - Non-transferable Skills
- Slow Growth Markets
  - Upper Midwest
- Low-Value Add, Labor Intensive Manufacturing

Education

Education is touted as an investment, and unlike other asset classes the value of education has stood the test of even recessionary times. The creation of human capital, the skills and knowledge acquired through training and education, generates consistently positive returns. Thus, those with higher education will retain their winner status in the future, while lower educational attainment will usually be a trait on the losing side of the employment figures.

Figure 8

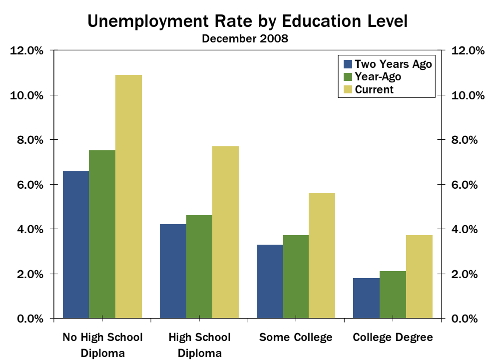
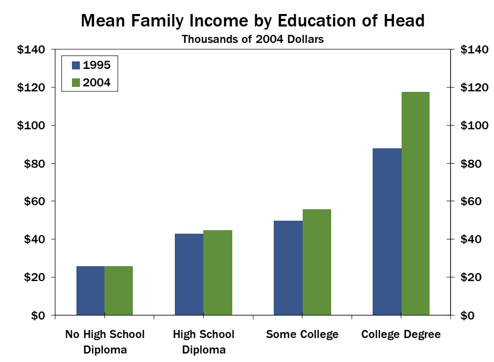


Figure 9



Source: Federal Reserve, U.S. Department of Labor and Wachovia

Reflecting a trend that holds in times of economic expansion as well as contraction, those having earned a college degree currently have an unemployment rate over seven percentage points lower than those who failed to graduate high school (Figure 8). In terms of winners and losers, higher education provides an adaptable skill set which enables the winners to have access to a variety of positions in many industries. A lack of education tends to lead to a single industry, such as labor-intensive manufacturing or construction, and fosters a narrow set of skills that cannot be adapted easily to a new career. With mostly non-transferable skills, workers find themselves pinned to a specific industry or even a specific employer. As the industry turns down, workers are unable to flee for greener pastures. The flexibility afforded to individuals with higher education is one of the keys to maintaining their historically low level of unemployment, and high employment growth, because such people can take their adaptable skill set to the industry which demands it the most at a given time.

Besides more job opportunities, more education also yields higher wages. Education is rewarded on an individual basis in the workplace, frequently in the form of increased income, reflecting the increased productivity of workers with higher education. Currently and historically income is greater and has grown faster for individuals with higher education (Figure 9). At a national level positive returns to education are evident in productivity gains, which drive output. Highly productive countries are often the wealthiest nations as well. As the unemployment rate continues to creep to levels not seen since the aftermath of the 1990/91 recession, the value of an education, as one of the few asset classes whose value has not declined, becomes abundantly clear.

Industry

For the time being, there are very few industries that are escaping what will most likely turn out to be the sharpest and deepest downturn in a half century. The notable outliers at this point are in education & healthcare and government, which have both added sizable numbers to their payrolls over the past year. These are traditionally more stable sectors in economic downturns and to-date this cycle has not proven different. We believe there is some risk to this holding up in coming months, however. As state and local governments face revenue shortfalls and massive budget deficits, the normally stable employment base may come under intense pressure. With credit markets still locked up, many municipalities have somewhat limited access to credit to tide them over in the tough times. Education & healthcare will also see pressure as consumers seek to limit medical care to absolute necessities and private education may take a hit as well. Even with all the downside risks mentioned above, we think these sectors should at the minimum be relative outperformers.

Figure 10

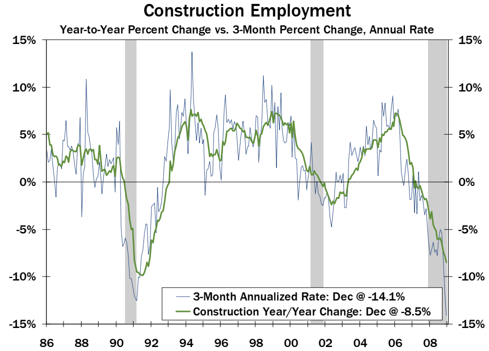
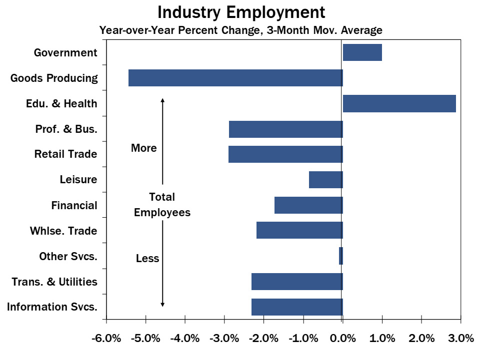


Figure 11



Source: U.S. Department of Labor and Wachovia

Manufacturing: Cyclical Weakness Reinforces Secular Decline

Manufacturing, especially labor-intensive manufacturing, has endured a long structural decline in the U.S. over the last several decades. Employment actually peaked in this sector in the late 1970s, and this downturn, just like the many downturns in between, will hasten job losses in the sector. Goods manufacturing is especially susceptible to recessionary periods as the build up of excess inventories can lead to rapid and major shifts in production as companies attempt to reduce exposure in downturns.

With this in mind, the losses we see over this cycle—sure to be extremely large in magnitude—will largely not be recovered after this cycle has ended. Many businesses will fail to make it through this cycle and some of those that do will be forced to seek lower cost areas or processes for production. The notable exception may be in high-tech automated processes. The relative winners will be in sectors such as semi-conductors while the losers will continue to be in textiles and furniture.

Construction Woes Continue into the Future

We continue to expect large declines in construction across the nation and across product types. We expect that real residential investment will drop another 17 percent in 2009 after dropping almost 18 percent in 2007 and more than 20 percent in 2008. While non-residential construction held up through 2008 we look for declines to begin this year and carry through 2010, as funding for the sector has all but evaporated. With such a bleak outlook for both components of the construction sector we do not see much hope for employment. Declines in aggregate employment will likely continue for some time in these sectors.

The best hope for employees in construction will come in late 2009 and 2010 when infrastructure investment is expected to pick-up as part of a fiscal stimulus package. While this will help stem the tide of job losses in the sector, there simply will not be nearly enough government work to offset the losses in the private sector. With businesses continuing to pull back on capital expenditures and consumers looking to cut back as well, the private side losses will far outweigh even the largest of stimulus efforts.

Sector Winners: Health & Education, Government

Government gains will most likely slow but continue over the next several quarters. A fiscal stimulus package and investment from the federal government will offset some declines at the state and local level as they struggle with the fallout from the credit crisis and declining revenues across the board. However, assistance from Washington is not assured yet. An interesting societal shift may occur as the government sector gains jobs relative to the private sector in the coming year. The implications of this may not be fully understood for years to come, and present a pressing case for future research.

Gains in healthcare & education employment follow a long running demographic trend of a growing and aging population. Rising expectations in the quality and availability of healthcare may slow with a deep recession but they will not evaporate. Americans have become accustomed to a superb but expensive healthcare system whose costs will continue to balloon over the next decade. Similar expectations of and demand for more and more education will drive this sector as well.

Regional

Trends in regional employment reflect the confluence of temporary shocks sometimes associated with the business cycle, and long-run trends associated with the relative competitiveness of regional economies. Temporary shocks, such as hurricanes, housing busts, financial upswings or fluctuating energy prices have certainly affected the fortunes of certain regions (Louisiana, Florida, New York, Texas and Oklahoma) over the last ten years (Figure 12) as well as over the last year (Figure 13). Meanwhile, the long-term secular decline in the relative importance to the economy of large scale durable manufacturing has been a constant drag on growth in states such as Michigan, Ohio and Indiana.

Figure 12

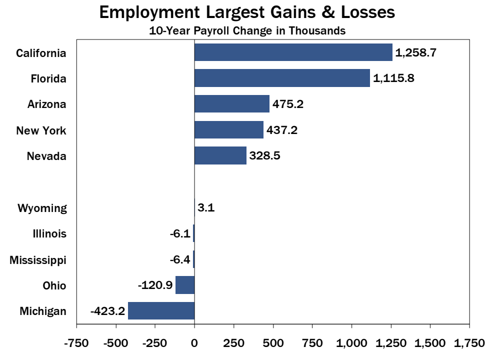
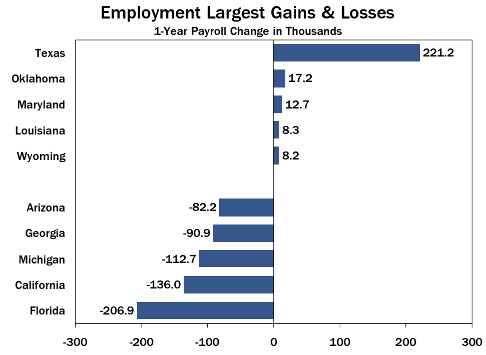


Figure 13



Source: U.S. Department of Commerce, U.S. Department of Labor and Wachovia

On the other side of this downturn, we expect the longer-run trends to once again dominate. After the excesses of the past cycle are worked through in Sunbelt states such as Florida and Arizona, they will once again be in a position to lead the nation in growth because of their demographic advantages. The caveat to this message of course is the sheer length of time it may take to work through some of the excesses, especially in markets that overbuilt housing to such an extent that this alone will weigh on the communities for years to come. We do not expect the upswing to be nearly as kind to states in the upper Midwest who still have an overwhelming reliance on hard line manufacturing, such the automobile industry.

A Final Note

Our work emphasizes the many distinct outcomes of the employment experience that drives the American consumer which are not fully captured by headline news and headline numbers. In fact, the headlines in isolation are often not only incomplete but can also be misleading. The diversity of worker experience suggests that simple, universal labor policy mandates are unlikely to meet the needs of every American worker. It is important to use the abundance of available data to draw appropriate and meaningful conclusions. These results can then be used by decision makers when forming policies relating to the diverse labor force in an increasingly dynamic economy.

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