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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

U.S. UNEMPLOYMENT RATE HEADED FOR 12.0-13.0%

There are serious structural issues undermining the U.S. labour market as companies continue to adjust their order books, production schedules and staffing requirements to a semi-permanently impaired credit backdrop. The bottom line is that the level of credit per unit of GDP is going to be much, much lower in the future than has been the case in the last two decades. While we may be getting close to a bottom in terms of employment, the jobless rate is very likely going to be climbing much further in the future due to the secular dynamics within the labour market that need to be discussed:

- For the first time in at least six decades, private sector employment is negative on a 10-year basis (first turned negative in August). Hence, the changes are not merely cyclical or short-term in nature. Many of the jobs created between the 2001 and 2008 recessions were related either directly or indirectly to the parabolic extension of credit.
- During this two-year recession, employment has declined a record 8 million. Even in percent terms, this is a record in the post-WWII experience.
- Looking at the split, there were 11 million full-time jobs lost (usually we see three million in a garden-variety recession), of which three million were shifted into part-time work.
- There are now a record 9.3 million Americans working part-time because they have no choice. In past recessions, that number rarely got much above six million.
- The workweek was sliced this cycle from 33.8 hours to a record low 33.0 hours — the labour input equivalent is another 2.4 million jobs lost. So when you count in hours, it's as if we lost over 10 million jobs this cycle. Remarkable.
- The number of permanent job losses this cycle (unemployed but not for temporary purposes) increased by a record 6.2 million. In fact, well over half of the total unemployment pool of 15.7 million was generated just in this past recession alone. A record 5.6 million people have been unemployed for at least six months (this number rarely gets above two million in a normal downturn) which is nearly a 36% share of the jobless ranks (again, this rarely gets above 20%). Both the median (18.7 weeks) and average (26.9 weeks) duration of unemployment have risen to all-time highs.

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- The unemployment rate is likely headed for 12.0-13.0%, but this is really meaningless except that it is very likely going to be a headline grabber
- Small businesses in the U.S. still have the recession mentality
- How does the U.S. government do the things it does with a 10% deficit-to-GDP ratio?

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- The longer it takes for these folks to find employment (and now they can go on the government benefit list for up to two years) the more difficult it is going to be to retrain them in the future when labour demand does begin to pick up. Not only that, but we have a youth unemployment rate now approaching a record 20%. Again, this is going to prove to be very problematic for employers in the future who are going to be looking for skills and experience when the boomers finally do begin to retire.

Employment is not going to zero, of that we are sure. But when the economic clouds do depart, what are U.S. employers likely to do first?

In a nutshell, to be calling for a 12.0-13.0% unemployment rate is meaningless except that it is very likely going to be a headline grabber. The most inclusive definition of them all, the U6 measure of the unemployment rate, which includes all forms of unemployed and underemployed, is already at 17.5%. The posted U3 jobless rate that everyone focuses on is at 10.2% (though if it weren't for the drop in the labour force participation rate, to 65.1% from 66.0% a year ago, the unemployment rate would be testing the post-WWII high of 10.8% right now). The gap between the U6 and the official U3 rate is at a record 7.3 percentage points. Normally this spread is between 3-4 percentage points and ultimately we will see a reversion to the mean, to some unhappy middle where the U6 may be closer to 15.0-16.0% and the posted jobless rate closer to 12%. This will undoubtedly be a major political issue, especially in the context of a mid-term elections and the GOP starting to gain some electoral ground.

Think about it. We haven't yet hit bottom on employment but that will happen at some point. Employment is not going to zero, of that we can assure you. But when we do start to see the economic clouds part in a more decisive fashion, what are employers likely to do first? Well, naturally they will begin to boost the workweek and just getting back to pre-recession levels would be the same as hiring more than two million people. Then there are the record number of people who got furloughed into part-time work and again, they total over nine million, and these folks are not counted as unemployed even if they are working considerably fewer days than they were before the credit crunch began.

Well, the first thing companies would do is to increase the workweek, not to instantly hire new workers

So the business sector has a vast pool of resources to draw from before they start tapping into the ranks of the unemployed or the typical 100,000-125,000 new entrants into the labour force when the economy turns the corner. Hence the unemployment rate is going to very likely be making new highs long after the recession is over — perhaps even years.

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After all, the recession ended in November 2001 with an unemployment rate at 5.5% and yet the unemployment rate did not peak until June 2003, at 6.3%. The recession ended in March 1991 when the jobless rate was 6.8% and it did not peak until June 1992, at 7.8%. In both cases, the unemployment rate peaked well more than a year after the recession technically ended. The 2001 cycle was a tech capital stock deflation; the 1991 cycle was the Savings & Loan debacle; this past cycle was an asset deflation and credit collapse of epic proportions. And economists think that the unemployment rate is in the process of cresting now? Just remember it is the same consensus community that predicted at the beginning of 2008 that the jobless rate would peak out below 6% this cycle. Thanks for coming out.

The unemployment rate almost always peaks after the recession technically ends

SMALL BUSINESSES STILL HAVE THE RECESSION MENTALITY

First, let's put the 89.1 reading into some perspective. In recessions, the National Federation of Independent Business (NFIB) small business optimism index averages 92.5. In expansions, it averages 100.2. So let's get a grip — the index, at its current level, is still consistent with a contracting economy. In fact, private payrolls are declining and GDP excluding government support is stagnant at best. By the time the S&P 500 was up 60% in the fall of 2005, the NFIB index was already well north of 100.

The NFIB small business optimism index, at 89.1, is still consistent with a contracting economy

The labour components of the small businesses survey are worrisome. The net share with a job opening was stuck at +8. Hiring intentions did improve from -4 to -1 but remained in negative terrain as it has since Lehman collapsed. The index measuring wage increases fell to a four-month low of 4 from 7 in September.

The data from the NFIB seem to be completely at odds with the profit data coming out from the S&P 500, but we are talking about two different universes here as the NFIB focuses on small companies. For the third month in a row, the profit improvement index remained and an abysmal -40. The net share reporting higher sales actually worsened to a three-month low of -31 from -26. When it came to citing top concerns, what was at the very front of the list was "poor sales" at 33% (from 32%) — tied for a new high.

With regard to business spending — the index measuring expansion plans dropped form 9 to 7. Capex intentions dipped to 17 from 18, and we see no signs at all of an inventory-cycle taking hold at all. The net share saying inventories were "too low" actually went from 0 to -3; the share adding to inventories declined to -26 from -24 in September (second worst reading ever); and the net share indicating a desire to re-stock went from -6 to -3 (again, this shows that even if companies may be cutting inventories in the future at a lower rate, they will still be cutting nonetheless and we find this a very bizarre way to embark on a sustained economic revival).

The biggest worry for small businesses in the U.S. is poor sales

In terms of financing, the net share saying that 'credit is hard to get' stayed at a high 14 (third highest in the past three decades); ditto for the share believing that credit conditions are going to improve in the near-term (this index actually declined to -16 from -15 and again the third worst reading in the past three decades). So, somehow all the best efforts to unclog the credit arteries have bypassed the small business sector.

The inflation data were extremely bond-friendly — the pricing power index sagged to a four-month low of 5 in October from 6 in September and 8 in August. What was truly striking was that of all the items listed as a top concern, only 2% cited inflation as the major problem — a six-year low. Compare that to the 33% who cited poor sales; the 22% who said taxes were the most profound worry; and the 11% who complained about government policy (but what about the stimulus?).

HOW DOES THE U.S. GOVERNMENT DO THAT (WITH A 10% DEFICIT/GDP RATIO TO BOOT)?

- It is trying to promote consumer spending at a time when the consumption/GDP ratio is at a record high of 71% and well above the long-term norm of 64%.
- It is trying to promote credit creation at a time when household debt/income ratio at 125% is still near an all-time high and twice the historical norm.
- It is trying to promote a higher homeownership rate even though, at 67.4%, it is just about the highest in the world and still well above the historical norm of 64.0%.

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Gluskin Sheff at a Glance

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Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively the largest client of the Firm's investment portfolios.

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