Miracle Mile ADVISORS

Providing Global Opportunities for the Risk-Aware Investor

Employment: Ready to Take Off or Still Delayed?

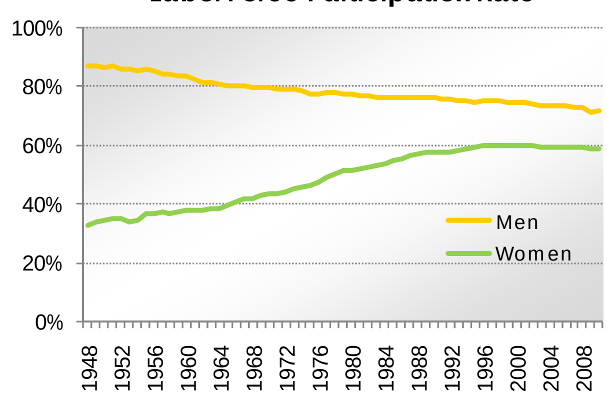
Americans live to work, and for better or for worse, most of us define ourselves by the activities that take up our days. It usually takes no more than 30 seconds of a conversation before someone asks, *"So, what do you do?"* Having an unsatisfactory answer to that question is very difficult for most people; having no answer is even worse. Nearly 15 million people today have to answer "I am unemployed." This number is 56% higher than it was just two years ago, and does not even take into account the people who have stopped looking for work due to lack of opportunities, or so-called "disgruntled workers".

A warning to readers: *this is not an uplifting report*. The employment situation in this country is dire, and we think it is important to fully understand the implications. Consumer used to have several sources of income: jobs, credit, investment wealth, home equity. Today, most of these sources have been depleted or disappeared, and it is imperative for jobs to return for spending to improve in any sector of the economy. Macroeconomic forces are dominating the investment landscape, and employment is the tail wagging the economic dog. Stock-picking investors who rely on traditional bottom-up valuation and earnings analysis are getting crushed by these macro headwinds. Asset allocation is the name of the game. This month we discuss in detail the difficult employment situation we face in the U.S.

Tailwinds

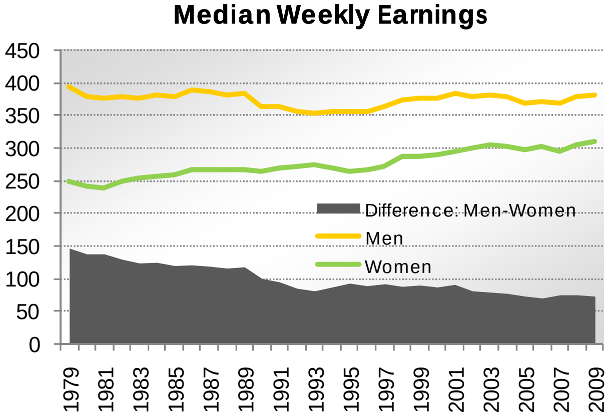
We have seen several structural changes in the labor force over the last few decades that kept us on an upwardly mobile path despite cyclical downturns. First, the increasing number of women working outside the home boosted family incomes. In 1960, only 38% of the female population participated in the paid work force. Today, that number stands at nearly 59%. The two-earner household improved many families' disposable incomes, but total income did not exactly double. Despite gains in the last several decades, there is still a significant gap between pay for men and women. The chart at left also shows that in constant dollar terms, men's earnings have been stagnant for decades.

Labor Force Participation Rate



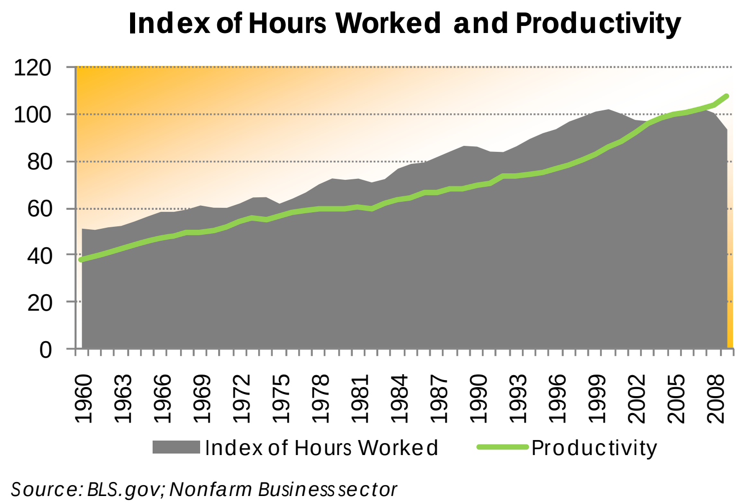
Source: BLS.gov

Median Weekly Earnings



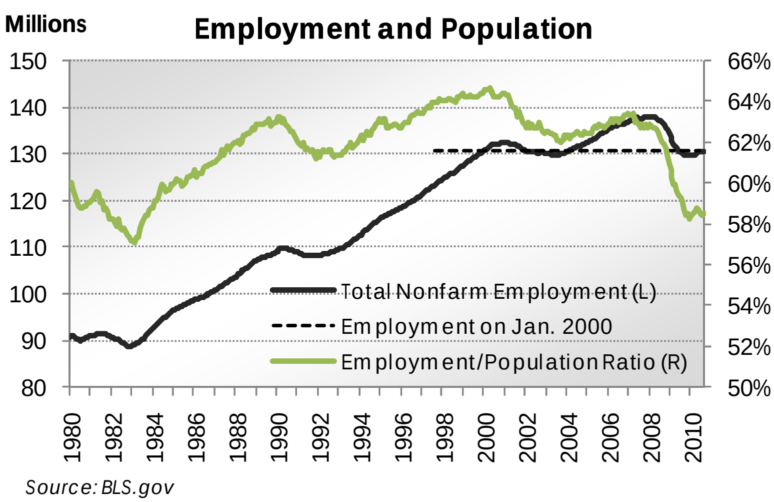
Source: BLS.gov, constant 1982-84 dollars

Another tailwind has been the increase in hours worked. Even without growing wages families could take home more pay by working more hours. This was a win-win for businesses as well as employees worked longer hours and yet productivity (output per hour) was increasing. These trends, along with the increasing availability of credit, enabled Americans to continue spending.



Stuck on the Runway

The two recessions of the past decade have left us still trying to recover from the job losses. The 2000's were book-ended by imploding market bubbles, with a series of corporate accounting scandals and a devastating terrorist attack in between. When the most recent recession began we were already not creating enough jobs to keep up with population growth, and **today the U.S. employs barely as many people as it did in January 2000.** In fact, although the recession "officially" ended in June 2009, the level of employment is still lower than it was when the downturn began in 2008.



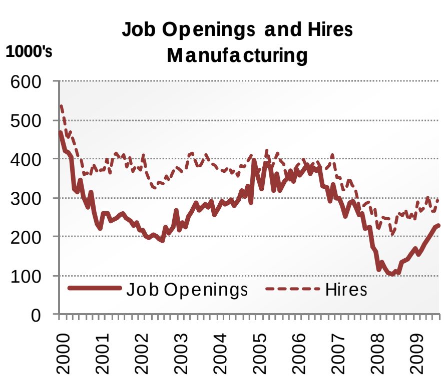
During the most recent recession, job losses followed a fairly typical cyclical pattern. A reduction in consumer wealth led to weaker spending; weaker spending led to excess capacity and a reduced need for business investment; these forces combined led to job losses. The problem we now face is chicken-and-egg: businesses want more certainty about future consumer demand before adding workers, while consumers need jobs to feel more comfortable spending. The difference from past recoveries is that consumers can no longer rely on credit and home equity to help them take that spending leap. They are still in deleveraging mode so the money for any new purchases must be earned. The administration has attempted to step in and cushion that fall – the outlay of government social benefits has more than doubled since 2007 – but it has been merely a band aid. ***Without leverage, consumption is even more dependent on jobs than in the past.***

Detour vs. New Route

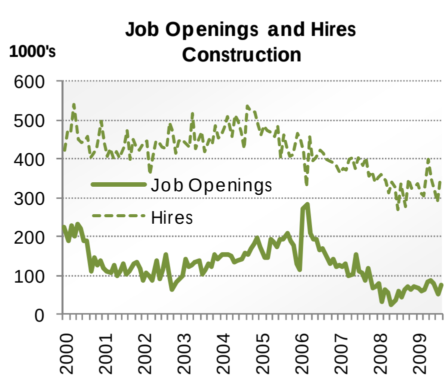
The unwinding of a credit-induced recession is much more complicated and drawn out than a typical monetary slowdown, and this recovery has indeed been slow. Consumers are deleveraging. Stagnant home values are keeping workers tied to their houses thereby reducing mobility. Over-capacity in housing supply has drastically reduced the demand for construction-oriented jobs, while increasing globalization and productivity also have reduced the need for many types of workers in the U.S.

These issues have sparked a debate about the nature of the employment crisis, with major implications for how to solve it. The "cyclical camp" claims that high unemployment is due to lack of consumer demand, full stop. They refute the idea that geographic constraints or lagging skills are inflating unemployment. The solution for this camp is to spark demand and create jobs with additional stimulus measures. This viewpoint is epitomized by Paul Krugman, who wrote in his New York Times OpEd on September 26th, *"…structural unemployment is a fake problem, which mainly serves as an excuse for not pursuing real solutions."* The "structural camp", meanwhile, claims that imbalances between the jobs available and the workers to fill them can only be solved with longer-term solutions such as retraining of the work force. They believe additional stimulus will not create jobs, but instead will produce inflation. The President of the Minneapolis Federal Reserve Bank was recently quoted, *"Firms have jobs, but can't find appropriate workers. The workers want to work, but can't find appropriate jobs. It is hard to see how the Fed can do much to cure this problem."* The ideologies are not necessary split along political lines – former President Bill Clinton has been on the interview circuit supporting the "structural" claim that people do not have the job skills for the jobs that are open. Both arguments have some merit, and the truth likely lies somewhere in the middle.

Zillow.com estimates that around 20% of homeowners are underwater on their mortgages. This most certainly restricts a chunk of the work force to their current geographical area. Jobs in industries such as construction and manufacturing can be clustered in particular areas, while workers with skills specific to these industries could find it difficult to transfer to another industry. The data, however, do not necessarily support those conclusions. The charts below show the number of job openings and hires in manufacturing, construction, and all non-farm industries. The series appear to be trending together, with hires outpacing job openings across the board.



Source: BLS.gov



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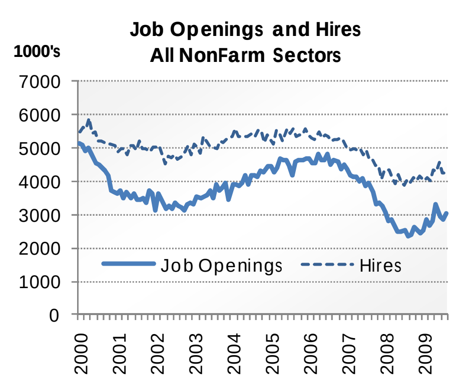
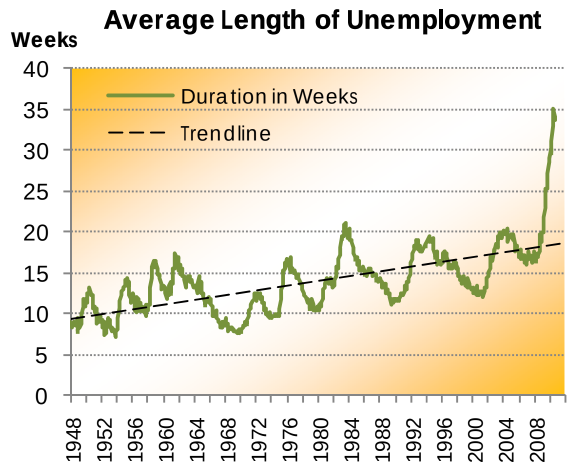


Source: BLS.gov

We believe, though, that such an extended period of high unemployment could eventually ***create*** structural imbalances in the economy. The current duration of unemployment is staggering. Not since World War II have we seen more than half of the unemployed out of work for longer than six months. The longer a worker remains unemployed (or under-employed) the more skills he or she will lose. People may become discouraged and drop out of the labor force if they believe that their skill set does not match available jobs. A report from the Roosevelt Institute finds that for the first time since data are available (1967), it is more likely that an unemployed person will drop out of the labor force than find a job. After extended periods of no or little income, these workers will be less able to afford retraining or additional education to increase their employability.



Source: St. Louis Federal Reserve Bank

Poor Visibility

Businesses want to keep their balance sheets flush to weather any future downturns. Without a clearer picture of how consumer demand would respond to additional production they are not willing to invest, expand or hire. Consumers will not spend unless they know they will have the cash. Both sides are skeptical of government intervention and feel like the previous stimulus benefitted big Wall Street firms more than the consumer or small businesses. This was not a controlled experiment. There is no real way to know how many jobs were saved or created by the stimulus, and distrustful Americans are weary of backing any additional measures.

The political backdrop is also causing upheaval. The health care and financial regulation laws are still in their infancy and businesses are uncertain how the rules will affect them. The midterm elections are in just over a month, with Republicans surging in the polls and within striking distance of taking at least one house in Congress. The Bush tax cuts also hang in the balance of the election results. The Obama Administration has pledged to maintain the so-called middle class tax cuts for individuals earning under $200,000 per year, but opponents claim that reinstating previous higher rates for those above that level would further punish small businesses. All of this uncertainty adds up to pushing the “pause” button on economic activity.

First Class or Coach?

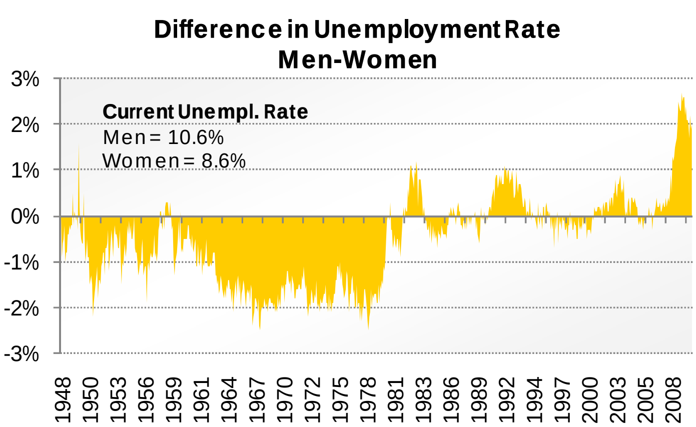
Some areas of the country, as well as some demographic groups, are faring better than others. The table at right shows the best and worst unemployment rates by state. With the exception of Rhode Island, the basement dwellers are no surprise. They are the states hardest hit by the real estate overhang and the auto industry's woes. The best unemployment states are all relatively small, and did not attract flows of workers during the boom days. One interesting note is that there seems to be no relationship between the state's income tax and unemployment rates. Both the top and bottom lists contain several states with no income tax, and several with some of the highest rates in the nation.

Top 5 Best and Worst Unemployment Rates by State

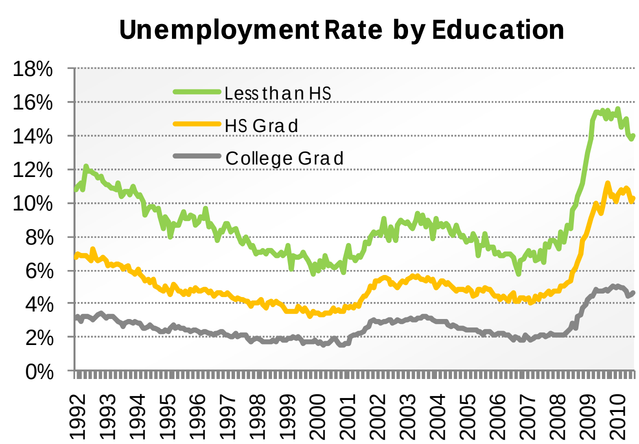
State	UR Rate	Max State Tax Rate
North Dakota	3.5%	4.9%
Nebraska	4.3%	6.8%
South Dakota	4.4%	0.0%
Vermont	5.5%	9.0%
New Hampshire	5.7%	0.0%
National	9.6%	
Rhode Island	11.8%	9.9%
California	12.4%	9.6%
Florida	12.4%	0.0%
Michigan	12.9%	4.4%
Nevada	14.2%	0.0%

Source: BLS.gov, data as of Aug 2010

Slicing the data along demographic lines, women and college grads are holding up better than men and those with less education. Though there has been an education gap for some time, it has widened significantly since the beginning of the last recession. According to a recent report from The College Board[1], not only are jobs more plentiful for workers with a college degree, but they also earned more than those with only a high school diploma. In 2008, the median earnings of full-time workers with bachelor's degrees were $55,700 – $21,900 more than those with only a high school diploma. These data indicate that higher education is somewhat of a differentiator during times of economic distress.



Source: BLS.gov

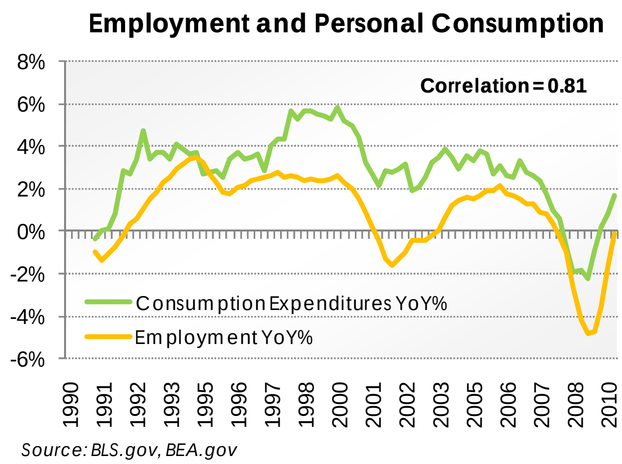


Source: BLS.gov, BEA.gov

[1] "Education Pays: the Benefits of Higher Education for Individuals and Society", CollegeBoard Advocacy & Policy Center

Looking for a Smooth Landing

Current trends are mixed. Continuing unemployment claims had been on a downward trajectory, but leveled out over the summer. Meanwhile initial claims spiked somewhat over the summer before retreating again this month. Payroll data show that we are no longer losing jobs, but we are not creating them fast enough to support growth. We need to see strong gains in employment if we hope for resurgent consumer spending. The relationship between employment and consumption expenditures is strongly positive. Since 1990, the correlation between the annual changes in the two series is 0.81. We would argue that given the reduced use of credit, this correlation will be even higher going forward.



Despite a lack of significant progress in job creation, businesses are no longer blindly slashing workers. A strong corporate earnings season and the ability to raise debt cheaply have given companies some breathing room. They are hiring on the margin, and at least the trend is going in the right direction. In addition, the administration has made it clear time after time that it will do everything in its power to keep the recovery on track. The major question now is: Will further measures be effective? Regardless of the election results, it is likely we will see the Federal Reserve step in with more quantitative easing if the economic data continue to weaken. It appears that (at least) the tax cuts for individuals earning less than $200,000 per year ($250,000 for married couples) will remain in place. These measures, however, are more about maintaining the status quo than a catalyst for growth. We need a more confident consumer to move the economy forward.

We believe that macroeconomic forces will continue to dictate market direction for some time to come. With macro trends dominating, investments within a particular asset class have largely moved in lock step, limiting the effectiveness of stock pickers. Asset allocation plays a more important role than ever.

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