Trend Macro

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MACROCOSM

Updates on China, Oil, Jobs, the Consumer, and the Fed

Friday, April 9, 2010
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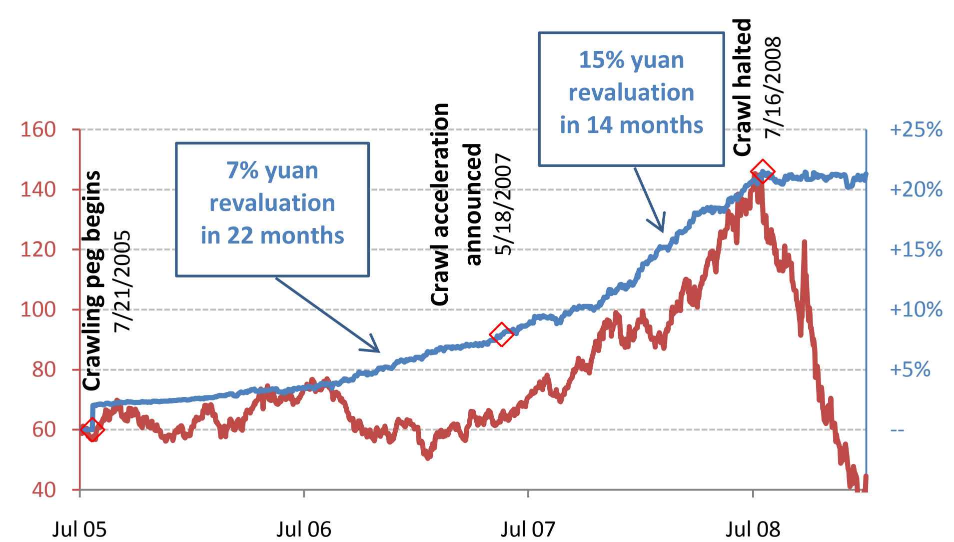
The yuan moves oil, jobs move consumption, and unemployment keeps the Fed on hold.

Yuan revaluation and the oil price

Maybe it's just a coincidence, but right after crude oil broke to new recovery highs last week, Tim Geithner announced a delay in the publication of the Treasury's semi-annual report on currencies -- deferring the date with destiny when the US might officially declare China to be manipulating its currency. Seen as a truce in a war of words, and followed by reports of leaks from Chinese officials, this has been interpreted by the market as validating the expectation that China will resume the appreciation of the yuan after a nearly two-year suspension. This is in line with the expectation we expressed several weeks ago (see "No Protectionism Threat: Yuan To Bet?" March 18, 2010) -- as is oil's move higher, which we see as a direct consequence of expected revaluation.

Crude oil's "super spike" and Chinese yuan appreciation to US dollar
Spot WTI; yuan indexed to 7/20/2005



Source: Reuters, TrendMacro calculations

Update to strategic view

OIL: Oil broke out to new recovery highs with market expectations that China will restart its program of yuan appreciation. A revalued yuan makes China, already the key oil bid, an even more efficient bidder in a supply-inelastic market.

US DOLLAR, EMERGING MARKETS MACRO: The market is now expecting China to resume its yuan appreciation program. This won't affect China's export competitiveness, or slow its economic growth.

US MACRO: The labor market is showing nothing more than green shoots. But that's sufficient to drive continued vigor in consumption. Unemployment is still rising, but consumption can grow because employment is rising, too.

FED FUNDS: After a bullish market reaction to the March jobs report, the Fed was clear this week that nothing has changed. It's still on hold for an "extended period."

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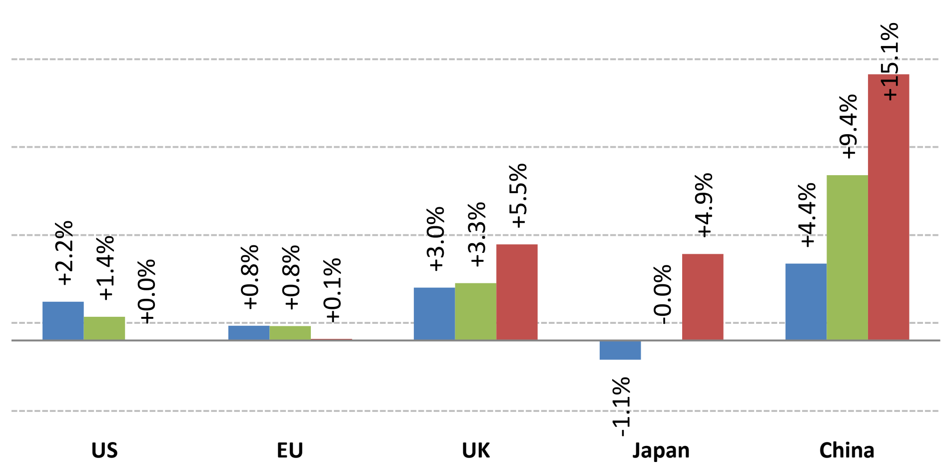
Remember, rapidly industrializing China is already the most efficient bid in strategic commodity markets, in the sense that the marginal unit of commodities is more useful to China than to anyone else. Giving China's currency more buying power in dollars makes it even more efficient. And as we saw from 2005 to 2008, commodity markets with poor supply elasticity can undergo extreme price fluctuations in the face of even modest demand shifts. In fact, the so-called "super spike" in oil prices over those years maps perfectly to China's revaluation program, which represented a secular shift higher in China's energy demand (please see the chart on the previous page).

A gradual revaluation is unlikely to slam the brakes on China's rapid growth. It will help, as it is the most efficient way to tame China's inflation -- the worst among the developed economies -- before it gets further out of hand (please see the chart at the bottom of this page). It won't do any damage to China's export competitiveness, either. Every tick higher in the yuan makes dollar-based commodities such as oil and copper effectively cheaper for China. That's a straight offset to any first-order competitiveness effects. But second-order, cheaper commodities can do much to improve China's productivity, permitting it to buy more units with the same number of yuan. Third-order, that bids up the dollar price of the same commodities for the rest of the world, commensurably reducing everyone else's productivity, thus China's competitive position may actually end up being improved.

Rethinking the March jobs report

We found ourselves distinctly in the minority in our less than enthusiastic view of Good Friday's March jobs report (see "On the March Jobs Report" April 2, 2010). Most of the chatter we've heard treats it as a game-changer, a quantum shift out of jobless recovery. We just don't see it. The reality is that, in terms of payroll employment, March's gain is only a single month's

CPI inflation: — YOY — 3-mo annualized — 1-mo annualized



Source: Respective reporting agencies, TrendMacro calculations

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[About us]

Recommended Reading

The Housing Drag on Core Inflation
Bart Hobijn, Stefano Eusepi and Andrea Tambalotti
San Francisco Fed Economic Letter
April 5, 2010

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up-tick off the December/February double-bottom in payrolls, with 8.363 million jobs lost since the 2007 peak. Yes, it's a green shoot. But, as we pointed out last week, with the monthly job-finding probability falling to all-time lows, that green shoot means only that the recession is over, not that an expansion has begun.

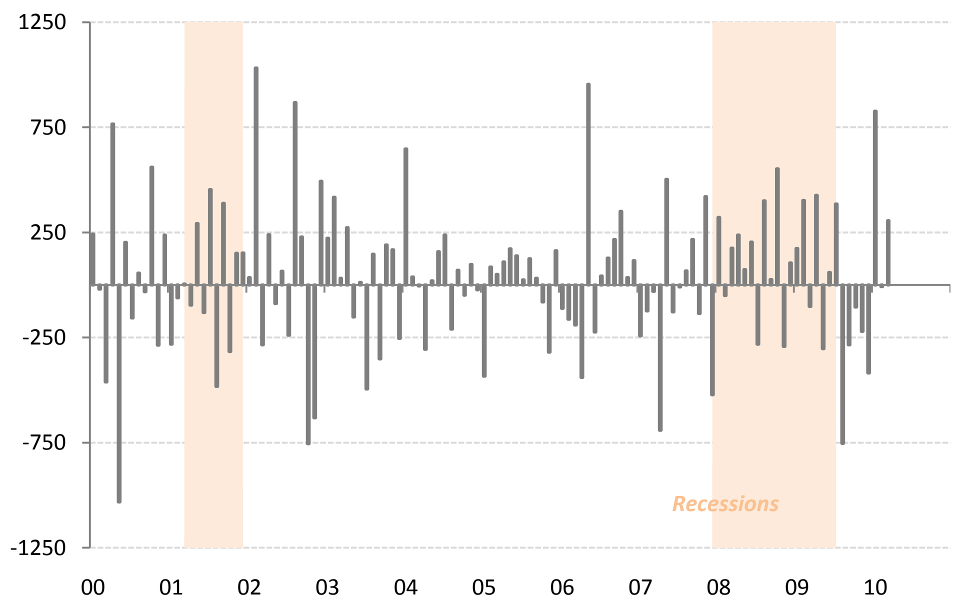
Some of the more bullish commentary has keyed off the fact that March marked the third month in a row of *non-government* payroll growth. We agree that's probably a good sign, although the numbers involved are hardly stellar (16 thousand private payrolls added in January, 8 thousand in February, and 123 thousand in March).

For us, the greenest shoot in the March jobs report was the positive difference in job gains between the "household" survey (biased toward small business) and the "payroll" survey (biased toward large business). From August to December, we had a horrible 5-month streak in which the "payroll" survey outperformed, indicating relative weakness in the small business sector -- which is responsible for most job creation (see the chart at the bottom of this page). Now that the labor market has stabilized and is grudgingly starting to grow, we've flipped to relative strength for small business, with huge relative gains in both January and March, and a virtual tie in February.

The consumer still the "old normal"

While we are lukewarm on overall economic growth prospects, we remain out-of-consensus bullish on the consumer, and yesterday's strong same-

Difference in monthly jobs gains, "payroll" versus "household" surveys
Household on "payroll basis" minus payrolls, thousands



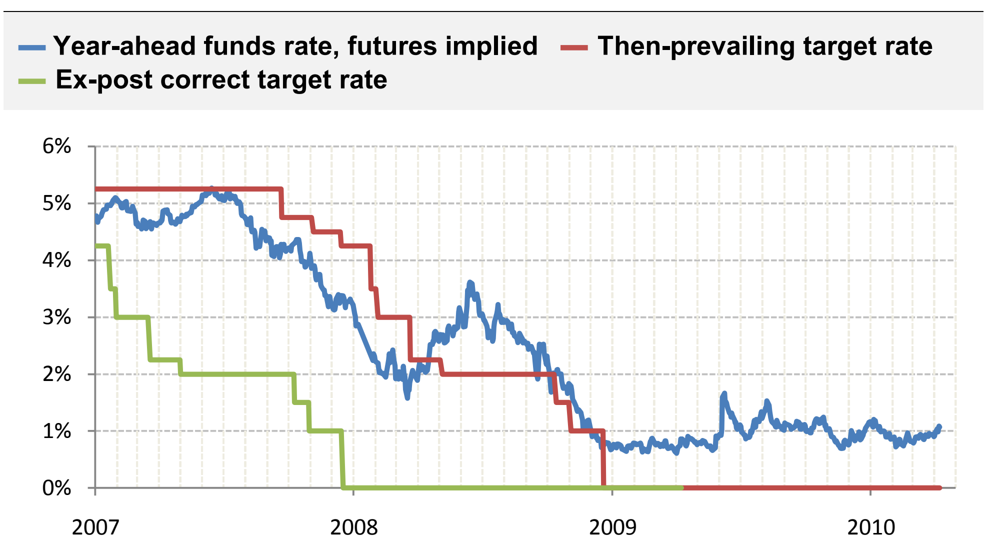
Source: Bureau of Labor Statistics, TrendMacro calculations store sales numbers confirm this view. Standing against the constant drum-beat of "new normal" pessimism on consumption, we've pointed out that in the greatest recession in memory, consumption has moved to an all-time high share of GDP (see, most recently, "On Q4 2009 GDP" January 29, 2010). You wouldn't see that if we were experiencing a "new era" of consumer retrenchment.

The March jobs report perfectly illustrates what makes this possible, even as the economy overall sputters. In March, unemployment rose by 134 thousand, causing the unemployment rate to rise slightly. But at the same time, employment rose by 264 thousand. Saying the same thing another way, the labor force grew by 398 thousand -- and more than two thirds of those new entrants got jobs. That means more hours worked, more income -- and more consumption, even as the unemployment rate slightly rises.

The Fed weighs in

After the upwelling of economic optimism following the March jobs report, the Fed had the perfect opening to get a little more hawkish, and back away from the commitment to an "extended period" of easy policy. But the minutes of the March 16 FOMC and a procession of some of the most influential official speakers including Bernanke, Kohn and even Tarullo -- who normally sticks to regulatory matters -- conspicuously failed to push on that open door, but instead to emphasize weakness in the economy, especially the labor market.

Even though the Fed has developed unprecedented policy responses to an unprecedented emergency, this is one of those times when it doesn't pay to overthink things. As we've pointed out, the simple and obvious reality for the Fed here is that there's no reason to tighten at all so long as reported inflation stays tame, and plenty of reason *not* to tighten so long as



Source: Chicago Board of Trade, Federal Reserve, TrendMacro calculations unemployment remains high. Ben Bernanke telegraphed it beautifully yesterday: "we can hardly be satisfied when 1 out of every 10 U.S. workers is unemployed." And the new Minneapolis Fed president Narayana Kocherlakota put an even sharper institutional point on it when he said this week, "the Federal Reserve is certainly not meeting its full employment mandate when unemployment is at 9.7 percent." It doesn't get clearer than that.

Bottom line

Oil broke out to new recovery highs with market expectations that China will restart its program of yuan appreciation. A revalued yuan makes China, already the key oil bid, an even more efficient bidder in a supply-inelastic market. The market is now expecting China to resume its yuan appreciation program. This won't affect China's export competitiveness, or slow its economic growth. The labor market is showing nothing more than green shoots. But that's sufficient to drive continued vigor in consumption. Unemployment is still rising, but consumption can grow because employment is rising, too. After a bullish market reaction to the March jobs report, the Fed was clear this week that nothing has changed. It's still on hold for an "extended period."