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MACROCOSM

Weak Jobs Today, Better News Ahead?

Friday, April 4, 2008

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It's still a slowdown, not a recession -- but whatever it is, it's almost over.

Update to strategic view

US MACRO: This morning's jobs report was weak, but doesn't rise to recessionary levels. The market's reaction to it indicates that, with the apparent cessation of the worst turbulence in credit markets, the present slowdown is nearing its end. **FED FUND**S: Now armed with more effective and less inflationary tools, Bernanke signaled this week the present rate-cutting cycle is at or near its end. We now see, at most, one more 25 bp cut in the funds rate.

[see Investment Strategy Dashboard]

Today's jobs report was undeniably weak, with a decline of 80,000 nonfarm payroll jobs and negative revisions to the previous two months' already negative reports. The total contraction in jobs is now 232,000 in the first quarter. The crisis of confidence spawned by the credit market panic, it's clear, has cast a pall over the economy, with the weak contemporaneous data reflecting the draining of animal spirits that drive the risk-taking and capital formation so crucial to growth.

That said, it's still too early to say the weakness reflected in the quarter's jobs picture means the economy is recession. If this is a recession, then we're probably about three months into it -- and historically, three months into recession, job losses have averaged about 250,000 per *month*, not per *quarter*. And there were also a few bright spots in this morning's report which indicated the labor market is retaining a degree of resilience not typically associated with a recessionary climate. For one, aggregate hours worked ticked higher, which suggests that even while at the margin employers are cutting jobs, the expected return on the labor of the extant work force is still sufficiently attractive to increase its input. Also, hourly earnings grew by a robust 0.3%, which runs counter to any notion that the slowdown has yet created a labor surplus, which would hold down wages. These encouraging notes are not enough to entirely outweigh the weakness portrayed overall in the report. But they do help keep it in perspective.

We are struck by the relatively muted response in fixed-income markets to the data. Typically, such a disappointing jobs number would have sparked a vigorous rally, particularly in Fed-sensitive shorter maturities, on expectations that the weakness would compel even more rate cutting than might have already been expected. But that's not happening today. The yield of the 2-year note, at 1.85%, is down 5 bp on the day, but it remains some 25 bp above the level seen at the beginning of this week. Fed funds futures are up a few ticks, but are still pricing for less than a 50% probability that the FOMC meeting at the end of this month will deliver a 50 bp, rather than only 25 bp, cut in the funds rate.

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We think several things are at work. First, while current indicators are certainly soft, it could be that the present slowdown is at an end, or close to it. Fed chair Ben Bernanke would seem to think so, and based on this morning's reaction in short-term Treasuries, markets don't disagree with him. In his testimony Wednesday to the Joint Economic Committee, Bernanke stated that given the degree of stimulus being introduced by the Fed's easing campaign, which to date has taken 300 bp off the funds rate, he expects the economy to strengthen in the second half of the year. If Bernanke believes that, it's probably a good bet that he thinks the Fed has already come close to doing enough to achieve that outcome.

That sense was reinforced by a compelling nuance in Bernanke's testimony, which was largely overlooked by the media and analytical coverage of the hearing. In other recent appearances, Bernanke has included in his remarks a maximally dovish passage stating that the FOMC "will act in a timely manner as needed to support growth and to provide adequate insurance against downside risks." That language was absent from his Wednesday testimony. Most press reports focused on Bernanke's comment that "a recession is possible" in the first half, which might otherwise seem to imply that a continued course of aggressive rate cutting is in store at least for the next few months, supporting bond prices. But bonds sold off on the day, with the 2-year yield rising by 10 bp, due to this shift in Bernanke's message implying that an end to the rate cuts is probably in sight.

Also feeding into a budding shift in sentiment about the outlook has been the continued signs of stabilization in the credit markets, thanks in large measure to the Fed's innovative -- if tardy -- efforts to provide the liquidity needed to relieve the counterparty risks which were threatening the financial system with implosion (see "Three Quarter Profile In Courage" March 19, 2008). As the worst of the fears seem to have passed, a host of indicators strongly suggest that the market's capacity to bear risk is continuing to improve. The Merrill Lynch High Yield Index spread peaked in the panic last month at more than 860 bp. It closed yesterday just below 780 bp, and the spread has narrowed by about 25 bps just since earlier this week. Similar narrowing can be observed in other credit risk-sensitive indicators, such as indices for leveraged loans and exotic mortgage backed securities. This evident restoration of the market's capacity to absorb risk bodes well for the economic outlook.

BOTTOM LINE: Today's jobs data, capping off a quarter that registered job losses approaching a quarter million, is being widely seen as proof that the economy is in recession. While clearly we're in a substantial slowdown, we're not yet conceding the point on a recession, which typically entails much greater weakness in jobs and other economic indicators. But we're less concerned with the technicalities of whether a recession is or is not at hand than with trying to discern the prospects for a resumption of healthy growth. On this score, we have some reason to be encouraged, and the response of fixed income markets to this morning's weak jobs report also suggests that the present slowdown may be close to hitting bottom.