Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

The Square Root of Recovery

Thursday, July 2, 2009

Donald Luskin

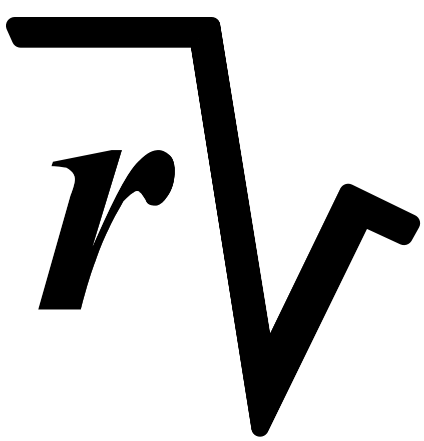
Today's jobs report raises issues about the shape of recovery and the risk of deflation.

Today's worse-than-expected June employment report underscores a question we asked several weeks ago (see "The Case for Ambivalence" June 12, 2009) -- "where do we go from here, now that we're not going to zero?" Last month's May report seems to have been a high water mark of sorts for growth expectations, jolting expectations for Fed tightening to the highest levels of the year, and propelling stocks to new recovery highs. While still portraying a declining labor market, it was the first in many months to be less than outright horrible (see "On the May Jobs Report" June 5, 2009). But mere evidence that the recession was not inevitably spiraling into depression -- as surprising as that was to the consensus a month ago -- turned out not to be the same thing as an all-clear signal for growth. Fed expectations have made a round-trip back to within basis points of their most dovish levels. The stock market rally from the March lows has stalled out, with the S&P 500 having never traded higher after the day we said the rosy glow of the May jobs report would wear off, and that ambivalence about the shape of recovery would come to the fore (again, see "The Case for Ambivalence").

Update to strategic view

US MACRO, US STOCKS: Today's disappointing jobs report doesn't change our view that the recession is bottoming, or that the March lows for stocks represent a durable bottom. But the report is evidence that recovery will be slow and painful, and there remain important ambiguities about what the Fed will do to support growth and avoid deflation. We expect that stocks will continue to correct their rally from the March bottom.

[see Investment Strategy Dashboard]



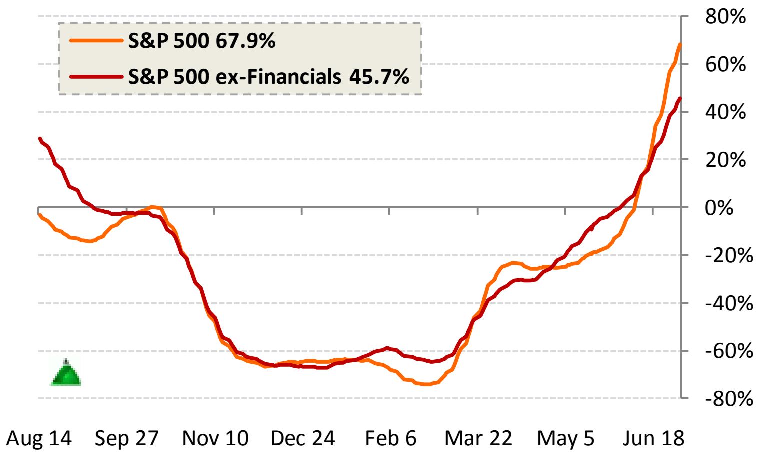
Nothing in today's data changes our mind about the recession being in the process of bottoming out (see "Green Overshoots" May 29, 2009). But what comes next? There really isn't a letter of the alphabet that captures our expectation for upward but halting shape of recovery. Some clients have suggested the mathematical symbol for square root: $\sqrt{\ }$. The mirror image of it would actually work quite well. A "V" shaped recovery would seem to be off the table, except in the narrow arithmetic sense of spurious bouncebacks from easy comparables. The present astronomical 68% rate of S&P 500 forward earnings

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

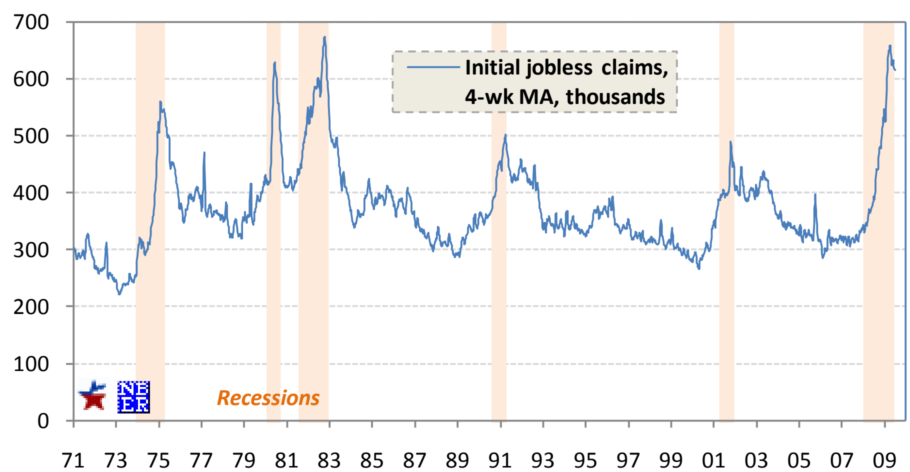
Phone:
650 429 2112
973 335 5079
704 552 3625

upgrades, month-over-month on an annual basis, is one example of that (see the chart and table below, and don't forget the distorting effect of dropping General Motors from the index). If it wasn't obvious before, after today's jobs report, the best the most optimistic among us could hope for would be a "U" shaped recovery. That said, we see an "L" shaped recovery as unlikely, too. With a credible safety net under the banks (see "The Stress Tests' Hidden Mickey" May 4, 2009), investment is beginning to recover and some degree of growth should follow.

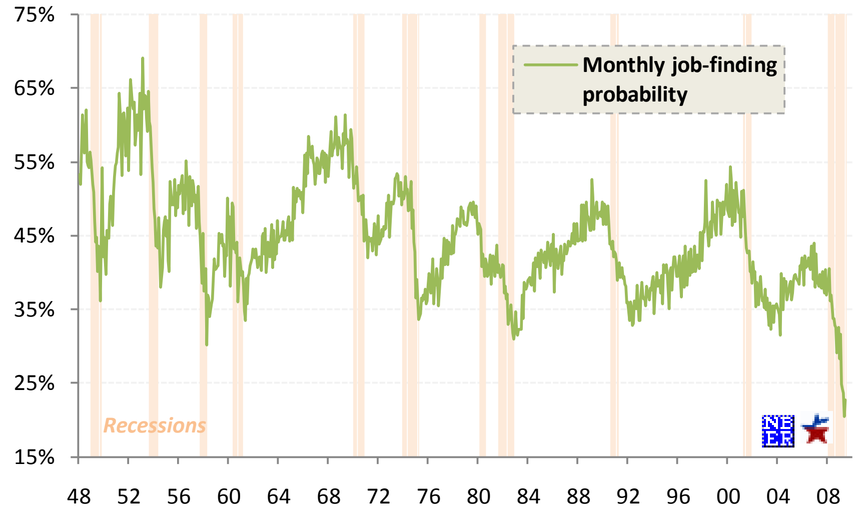


Annualized earnings revision rate	
Consumer Discretionary	+4984.1%
Consumer Staples	+3.3%
Energy	+53.8%
Financial	+350.6%
Health Care	-17.3%
Industrials	-7.0%
Information Technology	+28.6%
Materials	+55.1%
Telecommunications	+9.4%
Utilities	+17.0%

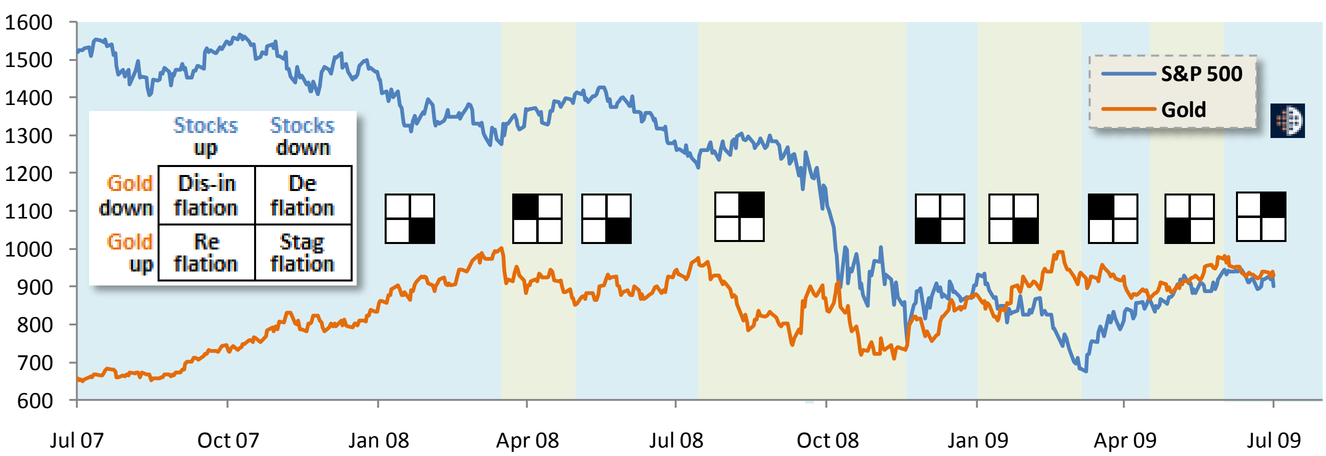
The good news in today's labor data was the ongoing fall in the four-week moving average of initial jobless claims, now off more than 6% from its peak in early April. Since 1975 this has been a perfect indicator of the end of recessions, at least as officially dated by the National Bureau of Economic Research (see the chart at left).



But this indicator says nothing about the shape of recovery. We continue to be disturbed -- and a little mystified -- by the so-called "unemployment outflow rate," which can be understood as the probability of an unemployed person finding a new job within a month (see the chart on the following page, and again, see "The Case for Ambivalence"). That probability now stands at 22.8% -- thankfully, an uptick from last month's all-time low of 20.5%, but still the second lowest reading in history. While the focus is on the net job losses in today's report, it's important to understand that the reason behind them is not so much that employers are shedding workers -- the probability of losing your job within a month, the so-called "unemployment inflow rate," stands at a very low 2.5% -- but rather that the economy is not generating *new* jobs to employ the already unemployed. This is a configuration of labor market internals that we have never encountered before. It would seem to mean that recovery won't be driven by employers simply no longer firing workers, relying on the background rate of new job creation to absorb the unemployed. This time, recovery will be contingent on increasing the pace of new job creation -- and it's difficult to see how that's going to happen right now. At the same time, the percentage of the employed labor force working part-time involuntarily remains at all-time highs. As the economy recovers, employers are likely to give such workers more hours, rather than calling up unemployed workers. Because part-time workers are already counted as employed, this means that the unemployment rate is unlikely to recover much even when the economy does.



As noted already, expectations in the futures markets for Fed tightening have come back pretty much to where they were a month ago, with a substantial downtick coming this morning upon release of the jobs report. Yet gold, after a brief initial uptick following the report, has ended up trading lower as of this writing mid-day -- it doesn't seem to be interpreting any of this as raising the risk of an inflationary Fed response. We doubt this reflects the market's agreement with the super-dove manifesto articulated Tuesday in a speech by San Francisco Fed President Janet Yellen, setting out in the strongest possible terms that a weak labor market, *ipso facto*, rules out inflation risk. More likely it's a matter of *deflation*, rather than *inflation*. With the Fed having signaled in the last FOMC statement that it is off deflation-alert (see "Steady -- And Easy -- As She Goes" June 25, 2009), there arises some probability that the Fed might withdraw its present level of massive monetary stimulus too soon, before the healing of the global risk aversion that triggered an equally massive demand for liquidity last year. Remember, just six months ago we saw levels of Consumer Price Index deflation similar to those of the Great Depression. The fact that stocks and gold are both correcting today -- as they have been, in fact, for most of the last month -- may be the markets' way of signaling the Fed that it is too soon to declare "mission accomplished" on deflation (see "Too Soon to Stray" June 23, 2009).



BOTTOM LINE: Today's disappointing jobs report doesn't change our view that the recession is bottoming, or that the March lows for stocks represent a durable bottom. But the report is evidence that recovery will be slow and painful, and there remain important ambiguities about what the Fed will do to support growth and avoid deflation. We expect that stocks will continue to correct their rally from the March bottom.