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MACROCOSM

PIIGS, Panic and Jobs

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The stench of deflation rises from Europe, and the US jobs market shoots a little green.

FIRST, ON YESTERDAY'S PANIC We aren't surprised by yesterday's big drop in stocks, except that it has taken this long for a serious correction with a real whiff of fear to materialize. We *are* surprised by the sharp drop in gold, which frustrates our expectation that its correction from December's all-time highs was already complete (see "Redoubling Down" January 25, 2010).

It seemed so obvious to us that over-extended stocks needed a correction, but we thought gold was free to move higher in light of what we've taken as the clarity of the Fed's intention to stay ultra-easy indefinitely. But the rest of the world reads the Fed's intentions, and those of the world's other central banks, more hawkishly. So it's perfectly sensible that stocks and gold should end up correcting together, given the deflationary narrative that has arisen around this correction. Throughout the new year there has been a steady drum-beat of commentary about how 2010 would be "the year of the exit strategy" from extreme monetary and fiscal ease around the world. Thus we have heard aggressive projections that last month's hawkish FOMC dissent by Kansas City Fed president Thomas Hoenig indicates something more substantial than did his many fruitless dissents in 2008 (see "Advice and Dissent" January 28, 2010). We've heard it said with utter certainty that China is "tightening," just because authorities are reining in the worst excesses arising from the massive capital flows flooding into the world's fastest-growing large economy. Yesterday the decisions by the European Central Bank to leave policy unchanged -- and by

Update to strategic view

US STOCKS: The long-needed correction of an overextended market is upon us, aggravated by incorrect expectations that the central banks of the world are tightening. They're not, especially with Greece and Portugal demonstrating the ongoing need for a safety net, and the US unemployment rate still at unacceptably high levels in an election year. We'd like to see more fear develop to establish a strong base for an advance later this year, but we don't expect a substantive test of last year's lows.
GOLD: Inflation-sensitive gold is being dragged down by a sudden re-emergence of deflationary impulses, with sovereign risk arising in Greece and Portugal, and central banks misunderstood as tightening at the same time. We strongly expect continued ease will soon become apparent, and that gold will recover ahead of other risk assets as it did in the deflation panic of late 2008.
FED FUNDS: With markets still hyper-sensitive to systemic risk and the unemployment rate still at unacceptably high levels in an election year, the funds rate will stay at its current near-zero level all year.
US MACRO: A positive surprise in the jobs report in the key dimensions we follow most closely. But it will still take 200,000 net job gains a month for the rest of the year just to hold the unemployment rate at no higher than today's 9.7%.

[see Investment Strategy Dashboard]

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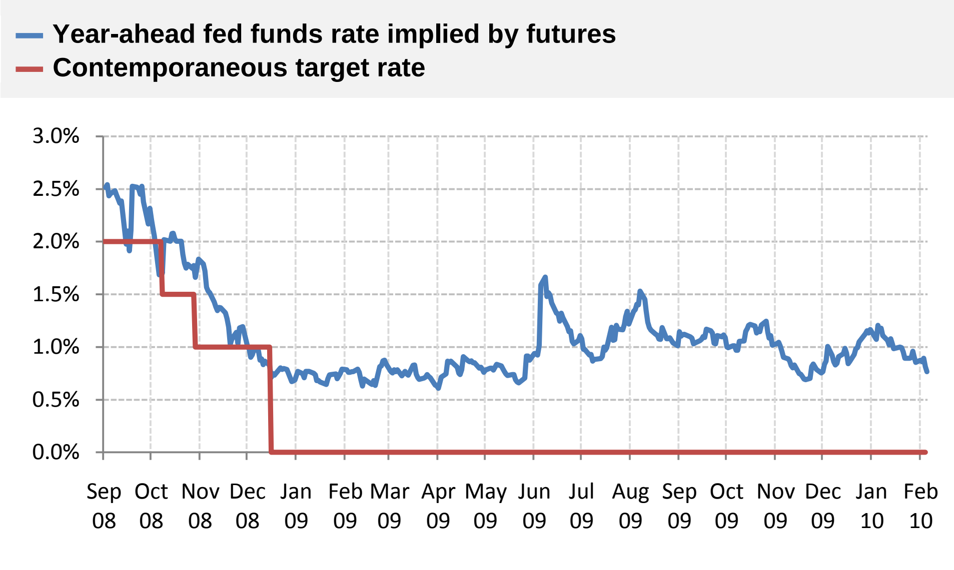
the Bank of England to stop enlarging its quantitative easing program, at least temporarily -- were similarly portrayed as "tightening." With anxieties about Greece's and Portugal's sovereign debt moving from a simmer to a boil at the same time, we have a textbook recipe for deflation -- a sudden fear-driven rise in the demand for money that is not expected to be accommodated by the central bank.



Source: Chicago Board of Trade, TrendMacro calculations

In fact we see now all the same symptoms of deflation we saw in the back half of 2008: stocks down, bonds up, dollar up, default spreads wider, and gold down. Back then, even in the immediate aftermath of the Fannie/Freddie, Lehman, Merrill, AIG, Washington Mutual and Wachovia failures, and the ordeal of TARP, the market constantly expected the Fed to stay behind the curve. As late as the end of November 2008, futures markets were priced for a higher year-ahead funds rate (please see the chart above). Futures markets only showed year-ahead expectations *lower* than the then-prevailing target rate in early December, in the weeks running up to the Fed's decision to lower the target to near-zero -- and the futures markets *never* anticipated *that* could last a full year -- which it *has*, and then some.

We're seeing a version of the same syndrome now. Systemic risks are rising, and money demand is rising too as investors flee to dollar-cash -- and yet all the talk is about central bank "tightening." True, yesterday futures markets lowered their expectations for the year-ahead funds rate by 8 bp, a decent move. And as of this writing, following the jobs report, expectations have fallen by another 5 bp -- but that still leaves the expected year-ahead funds rate at 77 bp, three 25 bp hikes above today's near-zero level. When the market gets that the Fed isn't even close to an exit strategy -- gold should be the first risk market to recover, as it did in 2008. Stocks should follow with a lag, and then the correction will be over.

The opposing bearish view on gold expressed by Nouriel Roubini and George Soros -- the latter at Davos hyperbolically calling gold "the ultimate bubble" -- are based on expectations for a double-dip recession. We don't share those expectations, but even if they are correct, the bearish view on gold further depends on the central banks of the world doing nothing to address the monetary deflation that would arise from the second dip. All the evidence of the experience during the first dip is that they will move heaven and earth to counteract any deflationary impulses, even if it means laying the preconditions for a future inflation.

NOW, ON TO THIS MORNING'S JOBS REPORT This morning's January jobs report was a mixed bag, but on net for us it was an upside surprise. But it was not strong enough --

considering both the 20,000 net payroll jobs lost and the drop in the unemployment rate to 9.7% -- to lock it in (as far as we're concerned at least) that the recession is officially over. This judgment is based on empirical work by UCLA's Edward Leamer, which uses just three variables -- changes in payroll jobs, the unemployment rate, and industrial production -- to nearly perfectly explain the National Bureau of Economic Research's business cycle dating decisions. Industrial production was the first to go positive, in August. The unemployment rate was next, in November. This morning, payroll jobs -- thanks not to the 20,000 loss in January, but rather to the sharp downward revisions announced for previous months -- kept it from being unanimous.

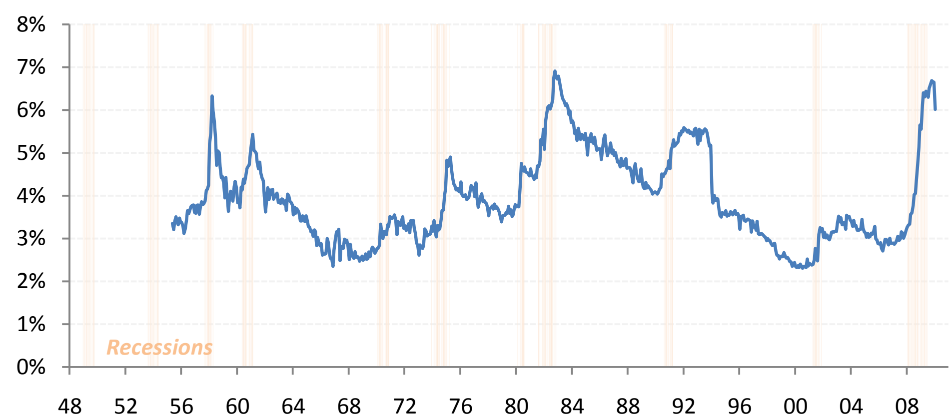
The most positive and attention-getting news is the drop in the unemployment rate from 10% to 9.7%. Whether this is mere noise or a true green shoot, at least it was achieved honestly -- *both* through a fall of 430,000 in the number of unemployed persons *and* an increase of 111,000 in the labor force. This is welcome, but we still think it will be a nearly impossible task for the unemployment rate to improve significantly over 2010 -- it will take a streak of very strong numbers like this morning's. The Bureau of Labor Statistics now estimates that the labor force will grow at an annual rate of 0.6% this decade, meaning that there have to be a minimum of about 80,000 net jobs gained every month just to keep the unemployment rate from rising. Though this is a lower hurdle than the 120,000 jobs assumed for the last decade, it doesn't include the eventual reintroduction into the labor force of the record 1.9 million people who left it in just the seven months following its all-time peak in May 2009, the third worst drop in the history of the statistics. Assuming those who left the labor force come back into it over 12 months, that means about 160,000 additional net job gains each month will be required to accommodate them -- a total of 240,000 each month to keep the unemployment rate from rising.

Recommended reading

How inflation can destroy shareholder value
Marc Goedhart, Timothy M. Koller, and David Wessels
McKinsey Quarterly, February, 2010

[Recommended Reading home]

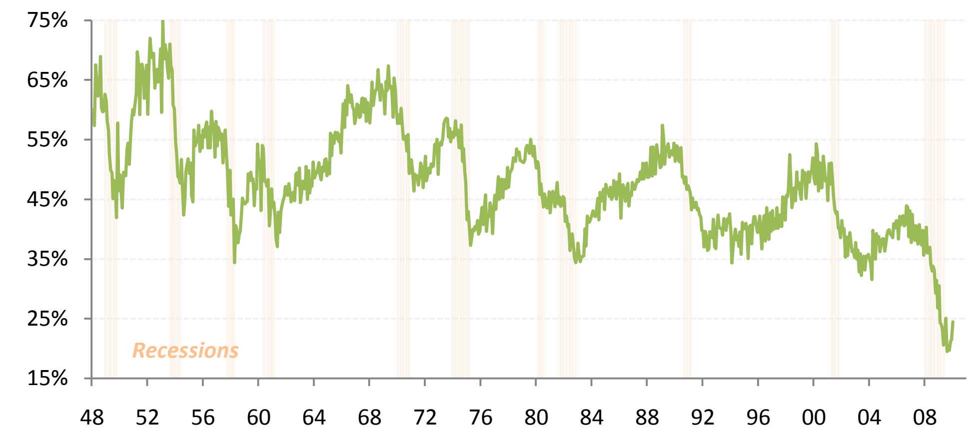
Portion of employed working part-time involuntarily



Source: Bureau of Labor Statistics, TrendMacro calculations

The improvement in the unemployment rate would not have been possible without a simultaneous improvement in the percentage of the labor force working part-time involuntarily. In January, it fell 0.6% to 6.01%. That's the fourth sequential drop -- and the first significant one -- from October's worst-ever reading of 6.7% (please see the chart above). These part-timers who would prefer full-time work still represent a large inventory overhang in the labor market that must be cleared before fully unemployed persons will be hired. At least we're seeing some real evidence that such clearing is beginning.

The monthly job-finding probability -- the "outflow rate" from unemployment

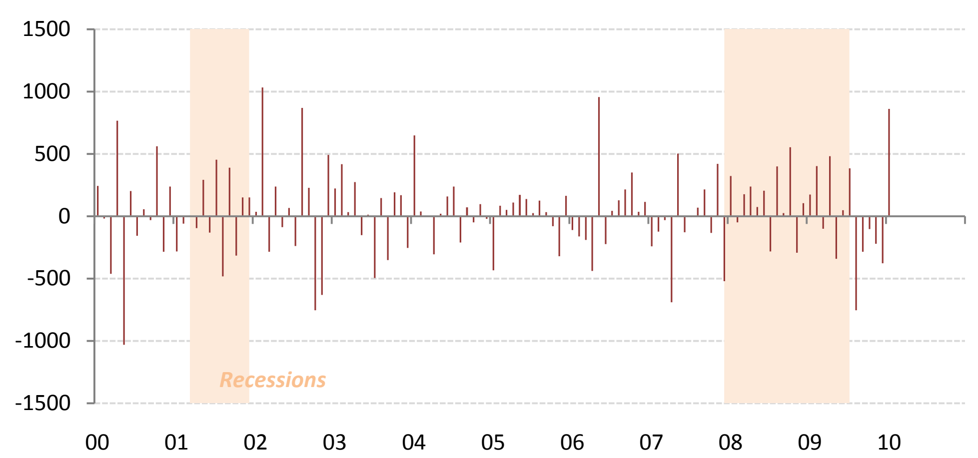


Source: Bureau of Labor Statistics, TrendMacro calculations based on [Shimer (2005)]

As we'd expect given all this, we also saw a nice improvement in the monthly job-finding probability -- the "outflow rate" from unemployment. It up-ticked to 24.5%, its fifth sequential gain, and a new recovery high above the scary all-time low at 19.5% in August (please see the chart above).

This means that 24.5% of unemployed persons found a job in January, while only 19.5% did in August. This is a result of the *decline* in unemployed persons by 430,000, at the same time as the number of persons unemployed for five weeks or less *grew* by 79,000. But this is still a very low number by historical standards. It means that while there was a larger number of *newly* unemployed persons, the inventory of *previously* unemployed persons nevertheless cleared somewhat during the month.

Difference in monthly net jobs, payroll survey minus household survey
Payroll-concept adjusted



Source: Bureau of Labor Statistics, TrendMacro calculations

Yet another positive in this morning's report -- so positive as to be too good to be true -- was the out-performance of net jobs in the household survey, which is biased toward *small* business, versus the payroll survey, which is biased toward *large* business. While the payroll survey showed a drop of 20,000 jobs, the household survey (when adjusted to payroll-concept) showed a gain of 861,000. This is a sharp reversal of the previous five month's streak of constant *under*performance by the household survey (please see the chart at the bottom of the previous page). Based on past history, there's no particular pattern or meaning in when such large differentials in favor of the household survey show up. But as a sign of progress, it's important because small business is the engine of the US labor market -- and until this morning, it looked like it had completely sputtered out (see "On the December Jobs Report" January 8, 2010). It's ironic, because this morning introduced significant revisions of past payroll survey data that had the effect of bringing it more in line with the relatively poorly performing household data. All in all, it subtracted 930,000 jobs for the twelve months ending March 2009, highlighting a systemic bias against capturing small business dynamics.

All in all, the jobs report was a positive surprise for us, despite the headline loss of 20,000 payroll jobs and the sharp downward revisions to past data. It's consistent with our strategic view of a gradually improving economy -- more of a recovery than an expansion. It will still take years of good growth to get back to full employment, and we still see a great challenge in getting the unemployment rate much lower than it is now over the rest of this year. It's welcome progress, but a long road ahead -- and consistent with our view that the Fed is highly unlikely to tighten this year.

BOTTOM LINE: The long-needed correction of an overextended market is upon us, aggravated by incorrect expectations that the central banks of the world are tightening. They're not, especially with Greece and Portugal demonstrating the ongoing need for a safety net, and the US unemployment rate still at unacceptably high levels in an election year. We'd like to see more fear develop to establish a strong base for an advance later this year, but we don't expect a substantive test of last year's lows. Inflation-sensitive gold is being dragged down by a sudden re-emergence of deflationary impulses, with sovereign risk arising in Greece and Portugal, and central banks misunderstood as tightening at the same time. We strongly expect continued ease will soon become apparent, and that gold will recover ahead of other risk assets as it did in the deflation panic of late 2008. With markets still hyper-sensitive to systemic risk and the unemployment rate still at unacceptably high levels in an election year, the funds rate will stay at its current near-zero level all year. A positive surprise in the jobs report in the key dimensions that we follow most closely. But it will still take 200,000 net job gains a month for the rest of the year just to hold the unemployment rate at no higher than today's 9.7%.