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

TRENDMACRO LIVE!

On the February Jobs Report

Friday, March 4, 2011

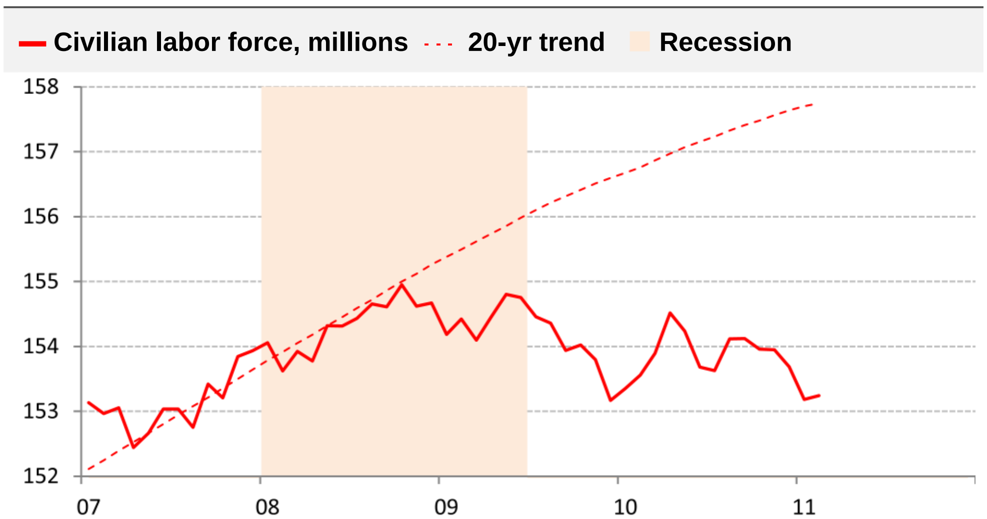
Donald Luskin

Paradox -- the unemployment rate falls, yet Fed tightening expectations recede.

There was nothing especially outstanding in this morning's February jobs report. The most notable market reaction has been in the Fed funds futures markets. After the data this morning, year-ahead contracts jumped higher, completely reversing yesterday's drop that had followed the ECB's press conference indicating that it would likely raise rates next month.

On the face of it, this indicator that the Fed will defer tightening is counterintuitive in light of this morning's unexpected drop in the unemployment rate, and Ben Bernanke's statement Tuesday at the Senate Banking Committee that the Fed would tighten "well in advance of the time that the economy is completely back to full employment." All the more so with this morning's move up in the crude oil price, which statistically will add pressure to headline inflation (see "An Oil Shock Tipping Point?" March 3, 2011).

Perhaps the key is how exactly the drop in the unemployment rate occurred. Seemingly it happened the old-fashioned way -- employment increased by 250,000, and unemployment decreased by 190,000. All to the good, except that the size of the labor force only increased by the difference between these two numbers, or 60,000 -- which is to say it didn't



Source: Bureau of Labor Statistics, NBER, TrendMacro calculations

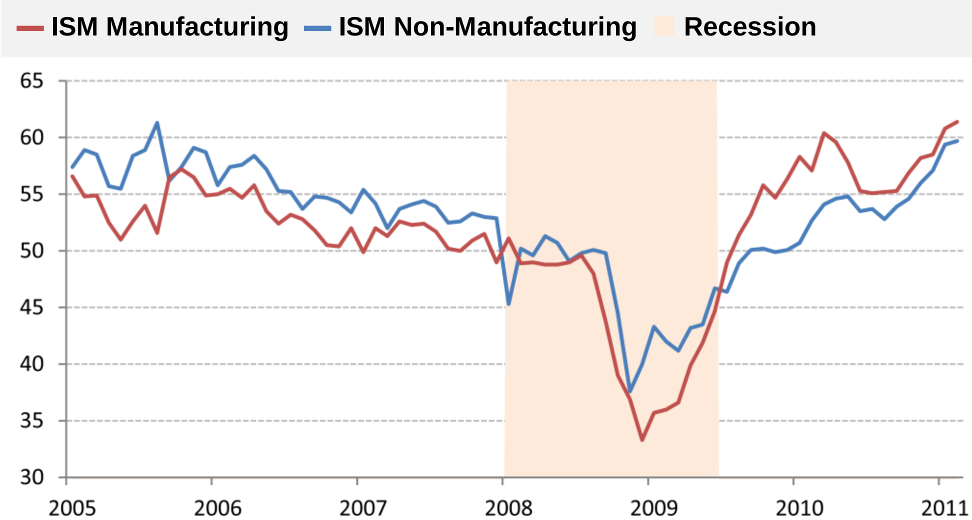
Update to strategic view

US MACRO: The fall in the unemployment rate shows both more people working and fewer people not working. However, the size of the labor force didn't expand at all, indicating that the better pace of expansion seen in this week's ISM hasn't taken deep root yet.

FED FUNDS: Yesterday's move toward more hawkish Fed expectations, in light of indications that the ECB will soon tighten, entirely dissipated after this morning's jobs report. Nothing here shows Bernanke the "self-sustaining recovery" he is looking for -- so the Fed will continue to err on the side of inflation.

[Strategy Dashboard home]

increase at all (please see the chart at the bottom of the previous page). After the largest-ever contraction of the labor force, 1.8 million between August 2008 and December 2009, there has only been a net recovery of 74,000 to date. So, yes, taking the shrunken labor force as a given, there was improvement last month. But from Bernanke's perspective, that's *not* a given. He said Tuesday that to begin tightening he'll want to see "the economy is in a self-sustaining recovery." A static labor force at this point doesn't show him that. The better pace of growth we're expecting -- and that shows in so many data points now, such as this week's ISM reports (please see the chart below) -- hasn't taken deep root in the labor market yet.



Source: Institute for Supply Management, NBER, TrendMacro calculations

It will. When persons outside the labor force can observe the unemployed already within the labor force becoming employed -- as this morning's jobs report shows -- they will have reason to rejoin the labor force. Paradoxically, when they do so, initially most will join as unemployed -- which will send the unemployment rate higher. *But this will be real evidence that the economy has improved*. So don't just read the headlines about the unemployment rate -- what's key is to read the footnotes about the labor force. The Fed will have to do both, and will be hard-pressed to resolve the paradox between them. Its likely safety-first approach will be to defer tightening, which will be to err on the side of inflation.

Bottom line

The fall in the unemployment rate shows both more people working and fewer people not working. However, the size of the labor force didn't expand at all, indicating that the better pace of expansion seen in this week's ISM hasn't taken deep root yet. Yesterday's move toward more hawkish Fed expectations, in light of indications that the ECB will soon tighten, entirely dissipated after this morning's jobs report. Nothing here shows Bernanke the "self-sustaining recovery" he is looking for -- so the Fed will continue to err on the side of inflation.

Contact TrendMacro

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

[About us]