Trend Macro

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MACROCOSM

Bad Friday for Jobs

Monday, April 9, 2012

Donald Luskin

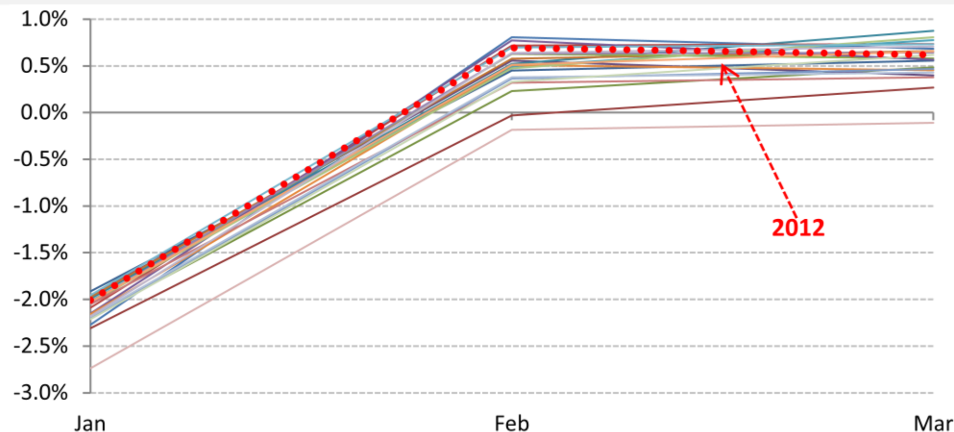
At last a correction in stocks, and in the belief that the labor market has turned the corner.

With the disappointment of Friday's March Employment Situation Report, US stocks are finally getting the correction we've expected (see "Snapple, not Kool-Aid" April 2, 2012). This ends the slow-motion melt-up that began at the low on December 19 and lasted for 76 weekdays and an 18.3% gain (excluding dividends) through the high last Monday, all without a 3% correction. This handily beats the slow-motion melt-up of a year ago, when stocks gained 14.5% over 69 days with no correction. Such is the power of a quantum reduction of the systematic risk investors must bear, even without a similar shift in expected returns or risk aversion. (see "Risk Reappraisal" January 20, 2012).

The front page of our "Data insights: Jobs" bulletin on Good Friday is a relentless catalog of disappointments and downright negatives in the March Employment Situation Report -- "Bad Friday" is more like it.

- The excuse making the rounds -- seasonal distortions from the unusually warm winter -- is just plain wrong. With *no* seasonal adjustments, this winter's pattern and magnitude of percentage changes in payrolls are precisely in line with those of the last two decades (please see the chart below).

Winter changes in non-farm payrolls 1990-2012, not seasonally adjusted
Sequential monthly percent change; ex-temporary decennial census workers



Source: Bureau of Labor Statistics, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, US FED, US BONDS: Good Friday's jobs report was bad. The excuse that it was an artifact of warm winter weather is simply wrong. Now stocks are finally in a long overdue correction, after 76 weekdays without a 3% down-move. The jobs numbers guarantee the Fed will stay easy -- or maybe get easier -- and they've throttled the nascent up-move in Treasury yields of the last several weeks. In combination with forward earnings rising -- even without Apple, they are probably only days away from all-time highs -- this will at least somewhat rehabilitate the value proposition in stocks after an almost 30% bull run from the October lows. We are still extremely cautious in the intermediate term. But in the short term, we think this will be another opportunity to buy the dip, and that stocks will be able to recover.

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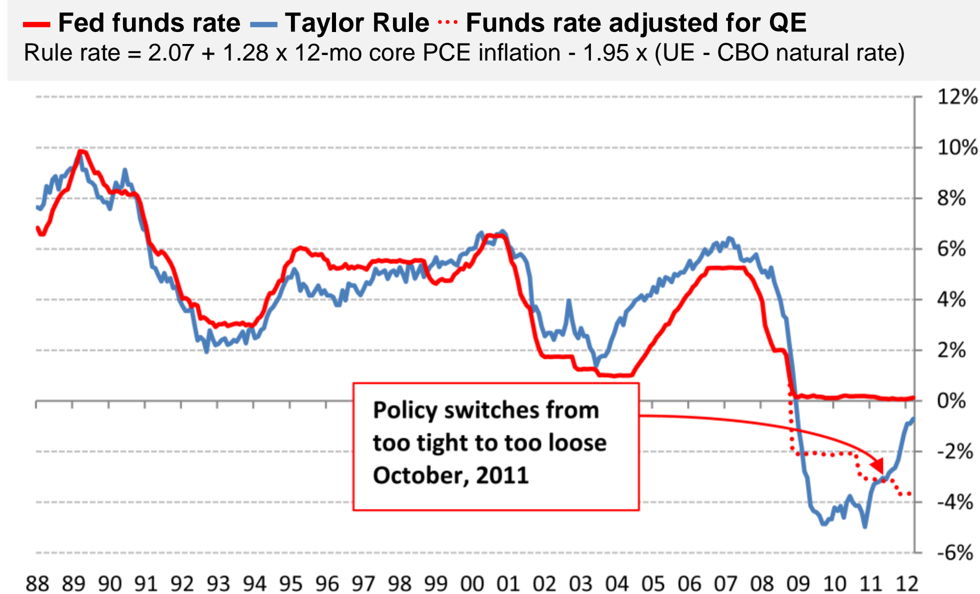
- The drop in the unemployment rate, the seeming saving grace in Friday's numbers, was strictly due to a contraction in the size of the labor force. 164,000 persons left the labor force, 81% of them from among the unemployed, leaving the labor force now 4.3 million below trend.

We've been warning it's too early to get excited about the US jobs outlook. We said in February -- when a single out-of-context sentence in Ben Bernanke's congressional testimony was taken as signaling the Fed's belief that the jobs market was sharply improving -- that the drop in new unemployment claims could not sustain the apparent momentum in payroll jobs: *the problem all along has not been too many people losing their jobs, but too few people able to get new ones* (see "When Bernanke Talks, People Sell" March 1, 2012). For what it's worth, Bernanke himself agrees with us. He clarified that one February sentence with an entire March speech documenting the extent to which the jobs market seems secularly broken, using some of our charts to do so.

Still, markets have been eager to seize on any evidence that the Fed might tighten -- last week, even just the absence of any overt commitment to loosen in the minutes of the March FOMC meeting. We agree with this consensus to the extent that we think Bernanke himself is not inclined to ease further in the absence of *substantial* economic deterioration. We believe he is fully cognizant of the fact that the Fed's version of the Taylor Rule has shown policy to have already become easy in relation to inflation and unemployment, starting last October -- and now very much so, and after several years of tightness (please see the chart below, and "On the March FOMC" March 13, 2012).

But Bernanke's personal autocratic control over policy is the weakest it has ever been. Two other highly influential members of the FOMC's aristocracy -- Janet Yellen and William Dudley -- are very eager to ease aggressively



Source: TrendMacro calculations per Rudebusch 2009

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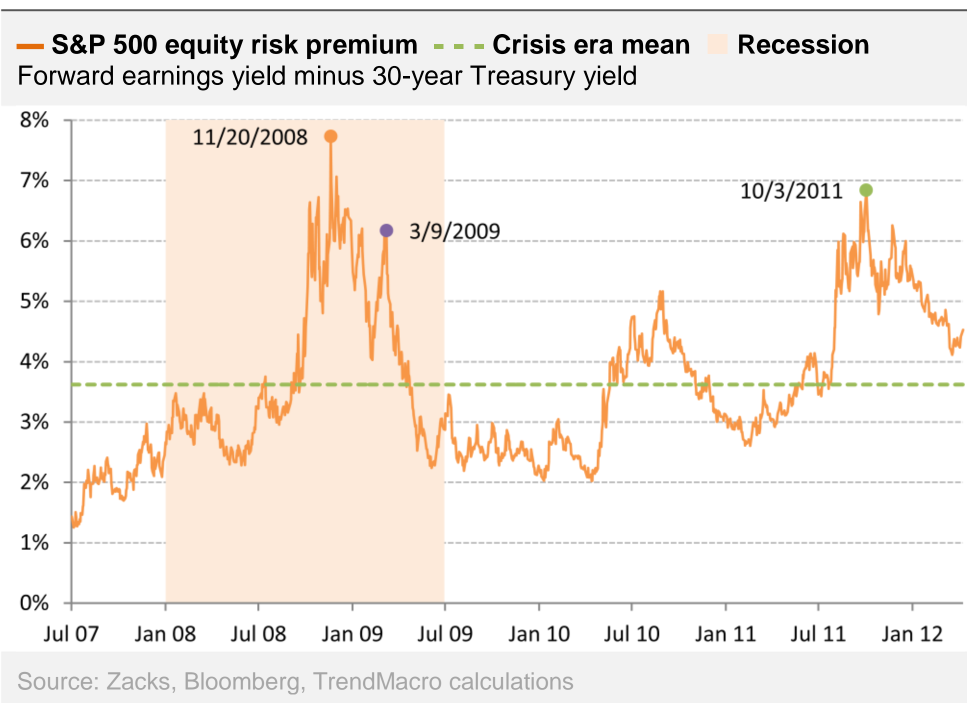
at any excuse. They are both ideologically committed to intervention -- and if at first it doesn't succeed, to try, try again. And they're both Democrats, and this is an election year (again, see "On the March FOMC"). Both will be speaking on the economy this week. Expect Friday's jobs report to be the centerpiece of a major dovish initiative.

An easy Fed, and a Fed likely to get even easier at the slightest sign of softening, is one of the reasons why we think this correction in stocks will just be a correction -- at least over the shorter term. But it's hard to have a lot of enthusiasm about it for the intermediate term.

- After a 29.1% move (excluding dividends) from last October's bottom -- with forward earnings about flat -- the S&P 500 is hardly an overwhelming value proposition at this point.
- More quantitatively, the S&P 500 equity risk premium has reverted from two and a half standard deviations above the crisis era mean to only one half standard deviation (please see the chart below).



Source: Zacks, Bloomberg, TrendMacro calculations

- But the equity risk premium is above the mean, and the crisis era mean we are using is itself extremely elevated by historical norms established over two generations. Every tick lower in the S&P 500, and every tick lower in Treasury yields -- once again, a false alarm about those bond vigilantes! -- just establishes more value in stocks.
- At the same time, forward earnings are attempting a comeback after seven months of no growth at all -- and with every tick higher, they too establish more value in stocks. They're now at new all-time highs if you include Apple in the calculation. If you look at Snapple -- the S&P no Apple -- forward EPS are still 40 bp from all-time highs, but they're moving higher and could make all-time highs in a

matter of days (see "We Love Our New iPhone, But..." March 22, 2012 and "Snapple, not Kool-Aid" April 2, 2012). This is hardly stellar forward earnings growth, but it's moving in the right direction -- and it should limit the depth and duration of this correction.

- Finally, it is in the nature of mean-reverting series like the equity risk premium to spend time *both above and below* the mean. While we think the economy will continue to be as lackluster as Friday's jobs report suggests, our sense is that investors have acquired enough hope -- and maybe even a little greed -- over the last six months' bull market to become somewhat less risk averse. It's always safer to bet that the equity risk premium will mean-revert, but if the mean is really the mean, there comes a time to speculate that the equity risk premium will *more* than revert -- in this case, that means falling to the mean, and then below it. Even the smallest move below the crisis era mean would likely take stocks to new all-time highs -- they really aren't that far away.
- Slightly longer term, we are very worried about what will happen in world markets when they wake up one morning and recognize what's coming inevitability near year-end. There will surely be terribly destabilizing political brinksmanship in the lame duck session of Congress -- and the risk of catastrophic bargaining failure -- as it grapples with the expiration of the Bush-era tax rates, new taxes on capital under Obamacare, and raising the debt ceiling to avoid a Treasury default (see "What Could Possibly Go Worng?" March 8, 2012). Yet our trader's gut tells us that morning is still some months away, awaiting some subtle political signal to catalyze awareness.

Bottom line

Good Friday's jobs report was bad. The excuse that it was an artifact of warm winter weather is simply wrong. Now stocks are finally in a long overdue correction, after 76 weekdays without a 3% down-move. The jobs numbers guarantee the Fed will stay easy -- or maybe get easier -- and they've throttled the nascent up-move in Treasury yields of the last several weeks. In combination with forward earnings rising -- even without Apple, they are probably only days away from all-time highs -- this will at least somewhat rehabilitate the value proposition in stocks after an almost 30% bull run from the October lows. We are still extremely cautious in the intermediate term. But in the short term, we think this will be another opportunity to buy the dip, and that stocks will be able to recover.