

MARKET MUSINGS & DATA DECIPHERING

Lunch with Dave

NO FIREWORKS

U.S. nonfarm payrolls came in light in June with the closely-watched private payroll tally coming in at 83,000 against expectations of 110,000. As was widely expected, the headline of -125,000 was dominated by the drop-off in Census hiring (though we must add here that the 147,000 boost the headline data received from the Birth-Death model is pure fantasy). Private payrolls for May were also revised to show a lower 33,000 gain instead of the initially reported increase of 41,000.

The unemployment rate turned in a surprising decline in June, to 9.5% from 9.7%, and this got the equity market excited for a millisecond — the consensus was looking for a bump-up to 9.8%. However, this was nothing more than a statistical illusion because the labour force plunged 652,000 in the steepest decline of the year and second largest falloff in the past 15 years. If not for that, the unemployment rate would have jumped to 10%.

Besides, what is important for any labour market expert is the 'employment rate' — the employment-to-population ratio — and it actually sank to a four-month low of 58.5% from 58.7% in May. But it pays to note that in the past two months, nearly one million Americans have dropped out of the labour market, and by our calculations, the number of discouraged workers — those who have become disengaged and have given up the job search altogether — rose 124,000 in June to an all-time high of 1.207 million last month. It is getting so tough to find a job, in fact, for those still in the hunt, it is taking an average of 35.2 weeks to find a job, which is unheard of. Nearly 46% of the ranks of the unemployed are populated with people who have been out of work and looking fruitlessly for at least six months — again, this is without precedent.

The story beneath the story is one of a renewed weakening in labour market trends as the effects of the fiscal and monetary stimulus fades, the inventory cycle peaks out and the impact of the tightening in financial conditions and softening in demand abroad begin to kick in. At this stage of the cycle, if this were a normal recovery following a normal recession, we should be seeing private payrolls printing well in excess of 150k with near consistency; in this cycle, we have had the grand total of two months of that so far, and now the hiring trend is clearly slowing.

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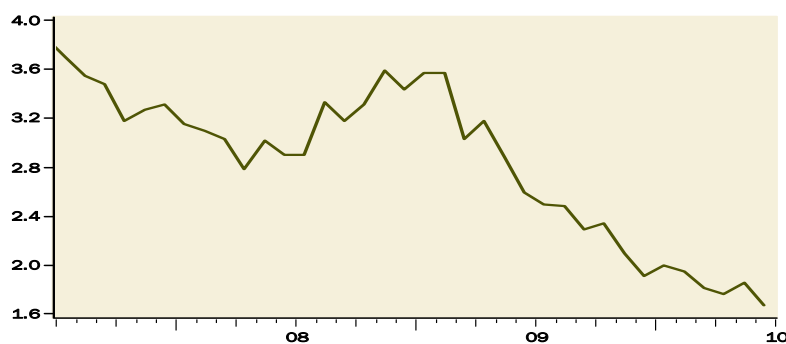
We see that not only in the headline but also in the diffusion index for private sector hiring, which fell from 54.8% in May to 52.2% in June. This tells us that almost half of the companies in the survey are no longer adding to their payroll. It should also not be lost on anyone that the companion Household survey, which has more sensitivity to what is happening at the small-business level compared to the nonfarm payroll survey, showed a 301,000 job plunge in June and that followed a 35,000 falloff the month before — the steepest contraction for the year and the first back-to-back declines since last fall.

The amount of slack in the U.S. labour market is palpable, and the seeds of deflation are being sown. When I went to school back in the late 1970s, you learned that wages are “sticky” and, as a result, deflation is virtually impossible. Well, it’s time to throw those old Economic 101 textbooks into the garbage bin. Concessions are clearly the order of the day, as one would expect with an aggregate unemployment rate (the U6 measure) stuck in the stratosphere at 16.5%. To put that U6 jobless rate into perspective, and keep in mind that we are supposedly a year into an economic expansion, it never even pierced 10.5% in the recession and jobless recover in the 2001-2003 cycle.

Unless the laws of supply and demand have been repealed in the labour market, it would stand to reason that wages would come under downward pressure, and this was one of the most, if not the most important, takeaway in today’s report because average hourly earnings dropped 0.1% in June — THIS IS A 1-IN-50 EVENT! — and this dragged the year-over-year trend down to 1.7% from 1.9% in May, and 2% at the turn of the year. It’s a good thing that we are headed towards a prolonged period of consumer price stability because if the headline inflation rate were to stay at 2% indefinitely, we would be talking about a sustained decline in real wage-based personal income based on the lingering huge amount of slack prevailing the labour market. In the name of trying to be as hopeful as possible, at least our forecast of eventual 0% inflation will limit the erosion in real take-home pay when measured in “real” terms.

CHART 1: WAGES ON THE SLOW TRACK

United States: Total Private Average Hourly Earnings
(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

The amount of slack in the U.S. labour market is palpable, and the seeds of deflation are being sown

The workweek fell 0.3% as well so what that in turn means is that average weekly earnings – the proxy for wage-based personal income coming out the payroll report – contracted 0.4% last month. At least that provides some explanation as to why auto sales slipped 6%, consumer confidence sank and chain store sales came in below plan in June.

What was particularly disconcerting in the payroll data was the sharp slowing in factory payrolls – from 38,000 in April, to 32,000 in May, to 9,000 in June in what was the low water-mark for the year. Not only that, but in line with the soft ISM reading, the diffusion index for hiring in the manufacturing sector sank to 52.4% from 62.2% in May, the most pronounced decline since June 2008 when the recession was in full swing.

We say this is disconcerting because it was the manufacturing sector that carried the ball for this nascent recovery and it increasingly looks as though the inventory cycle is in the process of being truncated. Who is left to pick up the baton? Nobody we can think of. Retailers are certainly not looking at a bullish consumer outlook or they wouldn't have cut their workforce by 7,000 in June after an 11,000 slice in May. If banks were looking at stronger loan demand, they too likely would not have slashed 15,000 from their payrolls after cutting 12,000 in May. Construction firms shed 22,000 after a 30,000 slice in May – no surprise here. This begs the question that without hiring out of the banks, the retailers, the builders and now the manufacturers, it stands to reason that we are in for a prolonged period of labour market malaise. Let's not confuse pessimism for realism.

The outlook is not constructive as the components of the payroll report that tend to "lead" all faltered. Revisions tend to build on themselves and once again, they were on the downside. The workweek fell 0.3% and by 1.2% in manufacturing. Temp agency hiring slowed in June, to 21,000 from +31,000 in May and was the smallest tally since last September. And, we finished the month of June with initial jobless claims at 472,000, which history would suggest is consistent with net job losses. There is no more important metric to watch over the course of the next month.

The U.S. Congress has been busy putting the finishing touches on the financial reform bill. There is obvious tension and debate over what to do in Afghanistan after a 10-year presence. The ecological disaster of our lives is in day 73. The government has frittered away valuable taxpayer resources on short-term quick fixes to fuel spending and confidence from cash-for-clunkers, to cash-for-appliances, to homebuyer tax credits, to continued extensions in jobless claims that would make Newfoundlanders blush. We need a war room dedicated to reviving the moribund labour market, but in a way that is less intrusive, not more.

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According to White House projections, in the aftermath of all this fiscal stimulus and government intervention over the past year-and-change, the unemployment rate by now should be close to 8%, but it is nowhere near that mark (as if that is a laudable goal — its nearly two-percentage points higher than the peak of the last recession). So something isn't working, and it is because there is no attack on impediments in the way of more durable job creation such as payroll tax reductions, permanent reductions in corporate tax rates, elimination of the minimum wage and greater efforts at retooling and retraining the near-15 million unemployed.

If our kids are the future, then the current 18.2% youth unemployment rate is a disaster that deserves more attention than it currently receives. Incentives to spend more are not the answer. We need incentives to employ. It's probably time to dust off the Economic Recovery Act of 1981 (and we are sure Peggy Noonan would agree!).

MARKET THOUGHTS

Is it the correction that is unusual, or is it the fact that in a matter of 12 months, the S&P 500 managed to shoot up 80% — and amidst the weakest recovery in real final sales in recorded history? The few times that the market had ever rallied so sharply off such a deep interim bottom were both in the 1930s, and we saw a pullback of around 40%. So, the reversal of the past three months very likely has further to go, and, sadly, many market participants are still not braced for it. The old buy-the-dip habits die hard.

The 12% slide in the market in Q2 wiped out \$1.6 trillion of paper wealth off the books. In a particular ominous sign, the 3.7% decline in the S&P 500 this past week stood in stark contrast to what we usually see this time of year because seasonally, the equity market rallies three-quarters of the time heading into the fourth of July festivities — the 4.6% decline so far this week stands in stark contrast too.

Taking into the year as whole, with the S&P 500 off nearly 8%, this goes down as the worst first half to any year since 2002. That year, if you recall, was an aborted recovery as opposed to a classic double-dip; however, it didn't really matter because a market priced for over 3% and got basically near zero growth in the second half of that year, did not bottom until October. As for the much-maligned Treasury market, universally deemed to be in some sort of bubble — well, the total return to date is 6%, the best first-half finish in 15 years (not to mention coming off the steepest yield decline since last May).

BONDS STILL HAVING MORE FUN

The Investment Company Institute (ICI) data showed that equity funds suffered outflows of \$1.27 billion last week on top of \$1.8 billion in net redemptions the week before. Lo' and behold, as if to spite the strategy and economics community on Wall Street, the retail investor ploughed a further \$6.2 billion into bond funds (even \$438 million into municipals too!) and a further \$491 million into hybrids. Income rules!

The 12% slide in the market in Q2 wiped out \$1.6 trillion of paper wealth off the books

Retail investors ploughed a further \$6.2bln into bond funds ... income rules!

HOUSING IN A DEEP FUNK

The mortgage application data for purchases in the U.S. plunged 15% in June, which strongly suggest another new low coming in the official new home sales data. If that wasn't bad enough, pending home sales declined 30% in the aftermath of the expiry of the homebuyer tax credits — hitting a record low in May. This was more than twice the falloff predicted by the consensus.

In a nutshell, the pending home sales, which measures contracts signed, is pointing to a four million-ish reading on existing home sales, which would mark a 13-year low (and well off the 5.7 million tally in May).

THE FED IS GETTING WORRIED

In the last few days, we have heard from a few Fed bank presidents, and what they had to say was rather startling, especially since, as a group, they tend to be on the “hawkish” side of the debate.

Atlanta Federal Reserve President Dennis Lockhart stressed that the recovery remains so weak that deflation is a real risk. To wit:

“To sum up, I don't see inflation as much of a current worry. If anything, there is a small risk of deflation that must be monitored ... it's appropriate to think about what we would do under a deflationary scenario.”

He is 110% of the view that short-term interest rates should stay at near-zero levels for a sustained period of time.

We also heard from Governor Kevin Warsh who warned that the economic outlook is highly uncertain and he emphasized the downside risks:

“If volatility in financial markets persists at elevated levels, the expected pickup of business fixed investment may disappoint. Business leaders in the United States may react to the latest in a long series of shocks by postponing investments in capital and labor alike. In that way, massive excess cash balances might not be a source of strength, but a reminder of caution.”

That is indeed a slap in the face to the growth bulls who cling to the view that all this “liquidity” on corporate balance sheets is somehow a good thing.

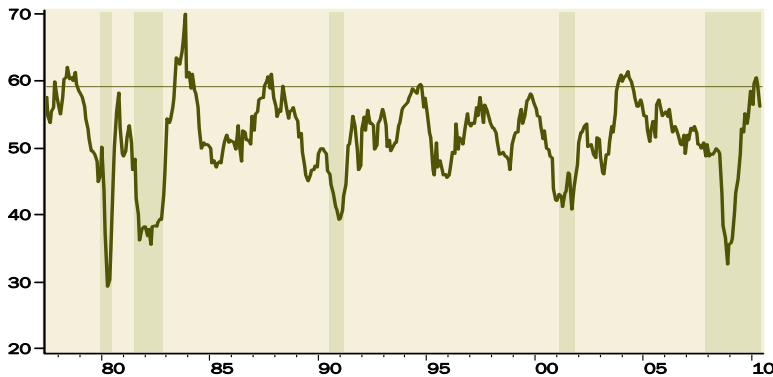
ISM SINKS — INVENTORY CYCLE RUNS ITS COURSE

The ISM manufacturing index fell much more than expected, but close to what our models were foreshadowing — down 3.5 points, to 56.2 in June, the low-water mark of the year. The number of industries reporting growth fell to 13 from 16 in May and 17 in both March and April. Not yet a hard landing, but not a good direction for the bulls.

The U.S. ISM manufacturing index tumbled 3.5 points in June, to 56.2, the low-water mark for the year

CHART 2: MANUFACTURING ACTIVITY HAS ROLLED OVER

United States: ISM Manufacturing Index
(50+ = Economic Expansion)



Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

The ISM orders component cratered to 58.5 after two readings of 65.7 — still a high level to be sure but the lowest this metric has been since last October. The only segment that managed to eke out a gain was the inventory component — to 45.8 from 45.6. The ratio of orders-to-inventories slid to 1.28 from 1.44 — portending further ISM declines ahead.

Moreover, when the ISM is down over four points in a two-month span, it practically signals that the peak in manufacturing activity has been turned in. The problem is that outside of all the stimulus out of the federal government, this whole recovery has been led by an inventory-induced rebound in manufacturing production. There are no other offsets if industrial activity starts to slow down! Ditto for exports, which slid to 56 from 62, again a low for 2010.

And no wonder the bond market is rallying. Look at the meltdown in the inflation indicators. Backlogs down 2.5 points in June, to 57. Vendor delays down to a six-month low of 57.3 from 61 in May. And, prices paid collapsed from 77.5 to 57 — it hasn't been that low since last November and before that last July.

The “nominal” ISM slumped to 113.2 from 137.2 in May and the 138.4 peak in April — just as the stock market was hitting its highs. The only other time that “nominal” ISM fell so much in one month was in September 2008 ... when Lehman failed! This is what we have been trying to say. This reversal in the stock market is not a financial event as was the case then. This is an economic event. In September 2008, the funds rate was 2%, the size of the Fed's balance sheet was \$900 billion and the fiscal deficit was \$450 billion. Why a turndown in the economy is such a big deal this time around is that there are far fewer policy bullets in the chamber.

When the ISM is down over four points in a two-month span, it practically signals that the peak in manufacturing activity has been turned in

As we have already discussed, the arithmetic of inventory withdrawal lessening in intensity and ultimately swinging into an actual build in the past year was responsible for nearly two-thirds of the overall increase in GDP off the bottom. In May of last year, only 46% of ISM respondents said their customers' inventories were "about right." This past month, a year after production growth accelerated 8%, the share saying that inventories are back to desired levels is all the way up to 68%. This is where it was at the peak of the last economic expansion in late 2008.

To reiterate, this all adds up to the end of this mini-inventory cycle. What this in turn means is the prospect that real GDP growth will converge on real final sales growth at barely over a 1% annual rate. This would then represent a growth collapse similar to what we had in the back half of 2002, and we ended up surprisingly at a new low in the markets by October. This period was not labeled a double dip, but felt like one nonetheless.

The problem with sub 2% growth, and that is the cutoff, is that the unemployment rate heads back to a cycle high. The reason why the unemployment rate is a lagging indicator is because it typically only falls slowly in a recovery. Hitting a new high, however, in a credit cycle would be awful news, especially for the financials, let alone consumer cyclical.

So, the lesson from 2002 is that a growth relapse is enough to generate a huge downside surprise for the market. Now in 2002, Bush sliced taxes across the board, the Fed took the funds rate down a further 75bps and we started a war. This time around, there are fewer bullets in the chamber. One more thing — real final sales growth has averaged barely more than 1% since the recovery began — the weakest ever. If as in 2002, GDP growth converges on final sales — this happens as the inventory cycle subsides — you end up with 1% second half growth. 2002 redux.

In addition to ISM, we got another diffusion index — to little fanfare. The NACM (National Association of Credit Managers) index slipped to its low-water mark for the year — down to 54.1 in June from 55.9 in May and again, the peak of 56.5 in April as the equity market was hitting its cycle high. What this data strongly suggests is that credit conditions are tightening again.

ISM LEADS EMPLOYMENT ... UH, OH!

Have a good hard look at the chart below. It shows the ISM index (right hand side scale) and year-over-year payroll growth (left hand side scale). ISM leads employment growth with a six-month lead time and with a decent 73% correlation.

The mini-inventory cycle is over, which implies that real GDP growth converges on real final sales growth, which is running at barely over a 1% annual rate

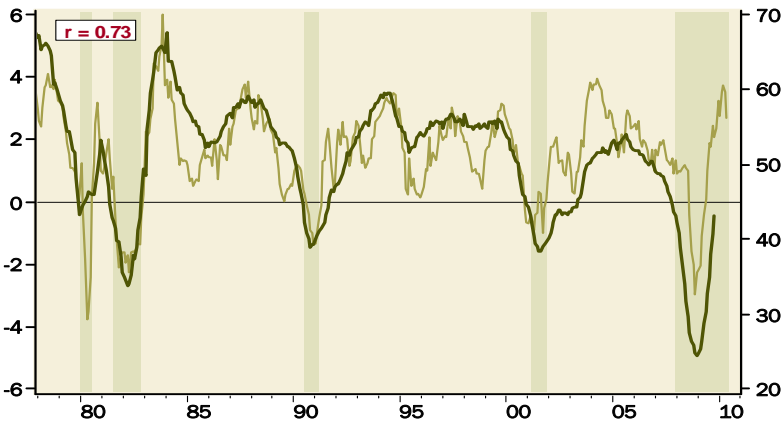
Uh, oh! The ISM has peaked, and it leads employment growth by at least six months, and with a decent 73% correlation to boot

CHART 3: ISM LEADS PAYROLL GROWTH**United States****Nonfarm Payrolls**

(year-over-year percent change, 6-month lag; left hand scale)

ISM Manufacturing Index

(50+ = Economic Expansion, right hand scale)



Shaded region represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

The ISM is useful because it is timely, highly cyclical, moves in regular patterns and goes all the way back to 1948!

But here's the rub. Never before have we hit a peak in ISM with employment growth still negative. That has never happened prior to this post-bubble experience. What is normal, and there are 15 ISM cycles over the past 62 years, is that job growth is positive at the ISM peak, and that peak, more often than not, is around 60 as was the case this time around in April.

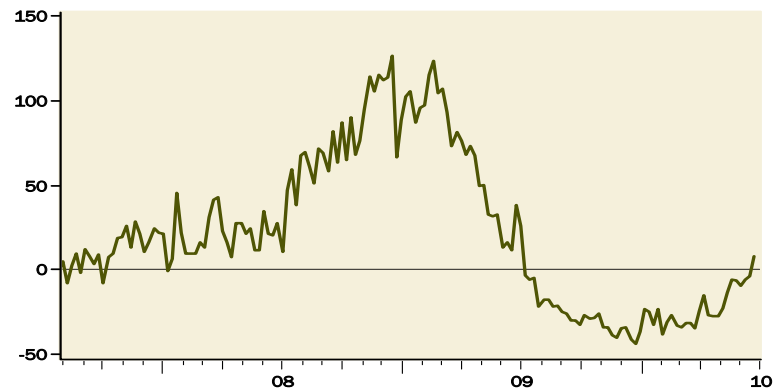
On average, at the peak in ISM, year-over-year payroll growth is running at 3% and has another six months to go in terms of acceleration before the trend reverses. The median is 2.5%, as is the mode. And, the range is +1.0-5.3%. This time around, the pace was -1.1%. This means that not only will we never get back to the old pre-recession highs in employment, but that the jobless rate is going to grind ever higher in coming quarters and, in turn, that means so long as the laws of supply and demand are still relevant as far as the labour market is concerned, wages move from disinflation towards outright deflation.

CLAIMS NOT PAINTING A REVIVAL PICTURE

Jobless claims jumped to 472k to close out the month of June from 459k in the June 19th week. Continuing claims also rose to 4.66 million from 4.573 million. We finished May at 459k on claims so this is very disconcerting to see the labour market softening again. The key four-week moving average rose to 466.5k from 463.2k and has been above the 450k threshold since early April.

CHART 4: OOPS ... SIX-MONTH TREND IN CLAIMS HOOKS UP TO POSITIVE TERRAIN

United States: Initial Jobless Claims
(26-week percent change at an annual rate)



Source: Haver Analytics, Gluskin Sheff

In addition to the claims data, we also received some downbeat news out of the Challenger survey. Layoff announcements rose 548 to 39,358 in June while new hiring sank 3,190, to 11,732.

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*For further information, please contact
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