NATCAN MARKER

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TRENDS IN UNEMPLOYMENT: DISTINGUISHING BETWEEN CYCLICAL AND STRUCTURAL FORCES

The Great Recession, which appears to be ending, has been at its core a consumer-led downturn. This explains the near obsessive way investors react to every new statistical release on unemployment. In this edition of the Natcan Marker, we review cyclical and structural issues related to current unemployment in order to help readers avoid misguided conclusions.

UNEMPLOYMENT TRENDS: A SOURCE OF CONCERN

Economists rely on Okun's Law[1], a reliable observation of the relationships between GDP and unemployment, to assess a "normal" level of unemployment given economic growth or contraction. Based on this rule, unemployment should be 8% in the U.S. today. Instead, it stands at 9.5% (see chart 1)[2] and the Federal Reserve has gone on record stating it is likely to reach 10% within a year. This important difference leads many observers to claim "things are different this time", and either the highly touted economic recovery will fail to materialize or the economy is undergoing some fundamental and far-reaching changes. The pessimists' case is bolstered by an explosion in the so-called long-term unemployment rate, i.e., those unemployed for more than 14 weeks (chart 2) and the alleged rehiring rate, which measures how many laid-off workers have found new employment. It currently stands at 20%, half the historical rate.

Several indicators point to the existence of structural changes taking place in the U.S. labour market. Those include the fact that University educated workers are experiencing less unemployment and greater success at getting rehired. Almost half the job losses occurred in manufacturing (restructuring of the auto industry) and areas related to real estate (many of those jobs won't return). Additionally, worker mobility is down, which is not surprising considering the number of Americans with houses that are worth less than their mortgage.

UNEMPLOYMENT TRENDS: A SOURCE OF OPTIMISM

It is somewhat ironic that investors in recent weeks have used unemployment data to justify higher equity values. In doing so they are relying on another time tested indicator of turning points in the economy: the four week moving average of initial unemployment claims (Chart 3). History shows that a four week consecutive drop in new claims usually corresponds to a trough in economic activity. Investors have relied on this measure as a sign post of economic recovery (or at least the ends of recession) and pushed equity values higher since the start of the second quarter and throughout the month of July.

CHART 1 – CHANGE IN UNEMPLOYMENT RATE: ACTUAL AND PREDICATED BY OKUN'S LAW (1960 THROUGH 2009E)

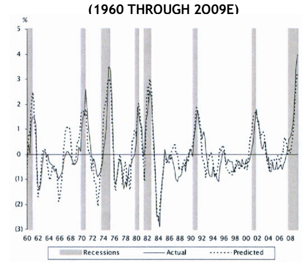


CHART 2 – LONG-TERM UNEMPLOYMENT RATE (1948 THROUGH JUNE 2009)

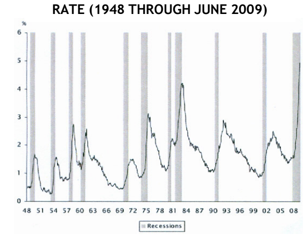
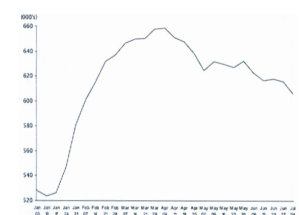


CHART 3 – INITIAL UNEMPLOYMENT CLAIMS (2009 TO EARLY JULY)



Source: Empirical Research Partners

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As with almost every economic and market benchmark unemployment data reveals as many confusing signals as it does clear ones. There is no doubt the labour market will continue to undergo structural changes in the coming months. Financial markets however are all about discounting the *most likely* future. Investors must distinguish between short term and structural unemployment trends in order to evaluate the environment. Odds are short term measures related to employment could surprise to the upside in the coming weeks, an outcome a majority of investors is unprepared for.

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FINANCIAL MARKETS

RETURNS AS AT AUGUST 21, 2009 (%)	MTD	QTD	YTD
S&P/TSX	0.53	4.77	23.17
S&P 500	4.55	4.19	2.67
S&P/TSX Small Cap	4.10	8.31	27.73
Russell 2000	4.96	6.61	4.52
MSCI EAFE	3.49	5.14	6.77
MSCI World	3.52	4.52	4.58
DEX Universe Bond	0.45	1.12	3.94

	RATES AS AT AUGUST 21, 2009
CAD/USD	1.08
CAD/Euro	1.54
US Treasuries yield 10-yr/30-yr	3.55/4.36
GOC bond yield 10-yr/30-yr	3.48/3.96
Fed Fund Rate (target)	0.25

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

[1] Arthur M. Okun (1928 – 1980), professor at Yale University and member of John F. Kennedy's Council of Economic Advisors
[2] Empirical Research Partners. *Stock Selection Research and Results*, July 2009.