May 7, 2012

A Half-Full Employment Report

Private businesses add 130,000 jobs

Friday's April employment report was a dud in the eyes of Wall Street, but a closer look reveals positives. The number of jobs created was less than expected (115,000 jobs added versus expectations of 160,000), but the direction, source, and composition of the changes tell a different story.

To see the bigger picture, it is important to take a slightly longer view with a focus on the private sector. Viewed over a series of months, the critically important private sector continues to add employees at a rate commensurate with a moderately expanding economy (today's job growth rate is similar to the 2002-2007 period, graph below). As of April, 111 million people work in the private sector – a high water mark for this recovery. The average monthly number of private jobs added during this recovery so far is similar to the average monthly number of jobs created in the 2001-2007 expansion (see graph below).

The fact that an expanding private sector is now acting as a counterbalance to a contracting government sector is important. Private sector jobs are up 824,000 since the start of the year versus a 24,000 decrease in government jobs, for example. This shift from public to private leadership is consistent with the "handoff" required for sustainable longer-term growth.

Other interesting details are also found in the report. March's preliminary estimate of employment gains was revised up by 34,000 to 154,000, and the number of people unemployed more than 27 weeks (5.1 million) is down by nearly 13% from a year ago (that category of unemployed is falling fastest).

Wall Street saw April's report as disappointing. The economy is far from well, but our bottom-line view is that underlying fundamentals are still improving.

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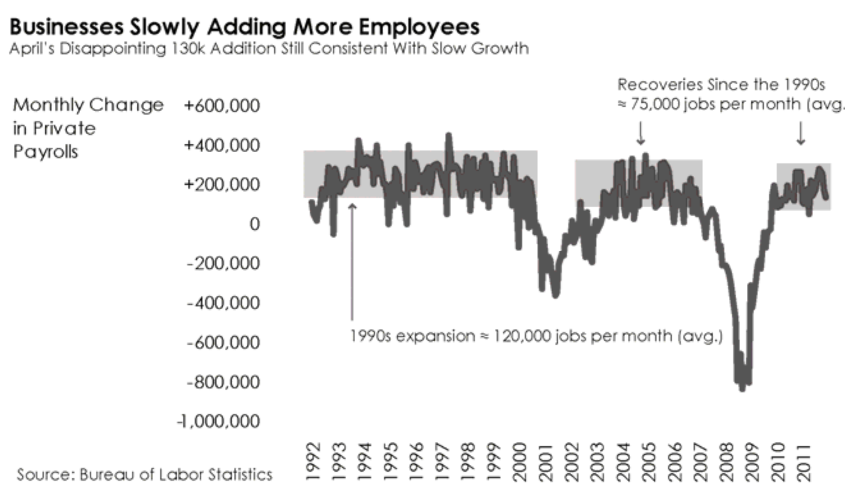

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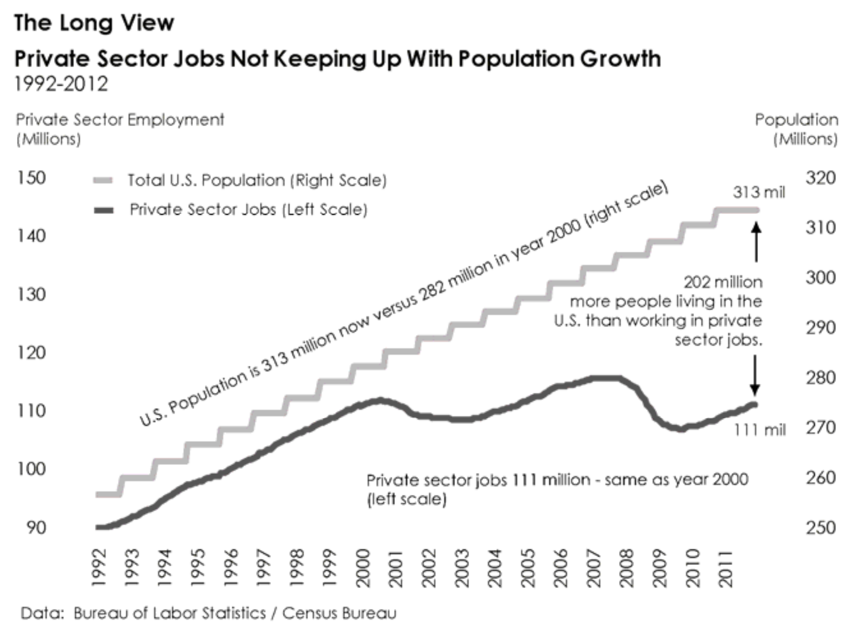
The Long View

During the 1990s, private companies added jobs consistently, which provided for the longest post-war expansion on record. Since 2000, and despite both Republican and Democrat leadership, the number of people in private employment has remained virtually unchanged. The graph below shows the total number of privately employed persons remains near 111 million. This is near year-2000 levels despite the addition of 31 million to the population.

A great deal of progress needs to occur if private employment is to "catch up" with the steadily increasing population. Government jobs and welfare can temporarily fill a portion of this gap, but since the vast majority of production rests in the hands of private companies and individuals, such government initiatives cannot be relied upon alone as a permanent source of growth. The modest and continued expansion of privately employed persons is especially important in light of now falling government payrolls.



There are many potential explanations for why employment has not grown at a sufficiently rapid pace. Productivity and globalization offer one potential answer, but both of these trends existed long before the year 2000. The outsized investment boom in the 1990s and the subsequent lack of capital formation in the years since then is another potential contributor to the poor performance. Increased volatility in the business cycle and significant resulting uncertainties is yet another factor. An increased debt load is yet another explanation.

Regardless of the cause, a large and growing gap between overall population and the privately employed population is not desirable or sustainable over time. Fortunately, private companies are again expanding their workforce faster than the overall population is growing.

A Barometer for Assessing Changing Conditions

We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions.

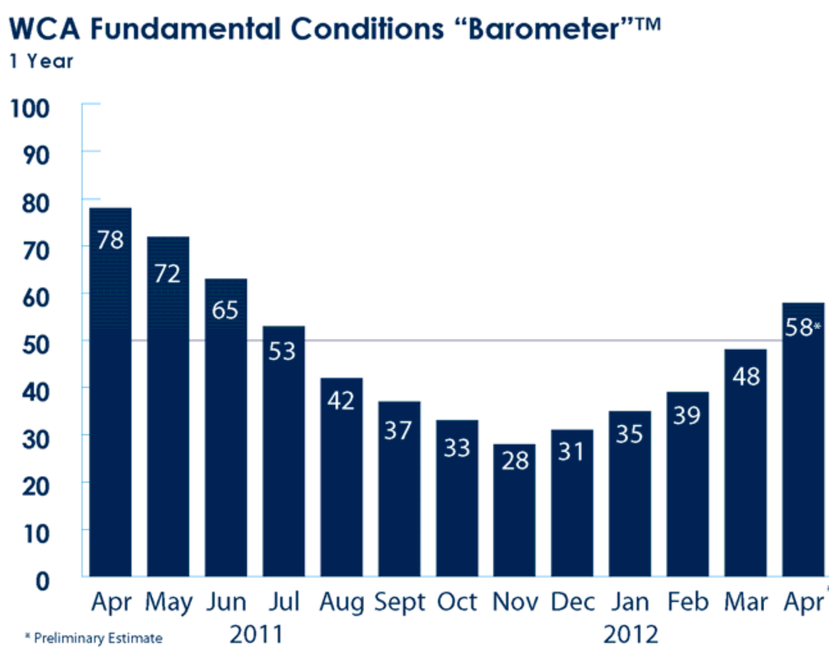
Analysis incorporates approximately 30 forward-looking indicators in categories ranging from **Credit and Capital Markets** to **U.S. Economic Conditions** to **Foreign Conditions.**

From each category of data, we create 3 diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks); while readings below 50 would indicate potential deterioration (potentially favoring bonds).

The WCA Fundamental Conditions Index™ combines the 3 underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

Fitting the Pieces Together

The jobs number is but one data point. It is important to put each month's data into a broader context. For this reason, we regularly update our readers on the WCA Fundamental Conditions Barometer. Despite the smaller rise in employment in March and April compared with January and February, the WCA Fundamental Conditions Barometer is generally on the rise (see chart below). The barometer takes a longer month-to-month view and incorporates a broad set of inputs. Inputs include real-time financial market indicators and a host of forward-looking domestic and foreign economic data. As of this writing, the index stands at 58 compared to a low of 28 last November. Today's level is consistent with modest growth.



Some Observations

There are several areas that are showing continued slow improvement from a fundamental perspective. Some of these observations include:

1. Earnings expectations for the S&P 500 stand at $110.67 for the next 12 months compared to $106.88 at the start of the year.
2. Long-run inflation expectations priced into the bond market remain near 2.4% compared with 2.1% at the start of the year.
3. Financial system stress in the United States (as measured by a gauge from the St. Louis Federal Reserve) is lower than at the start of the year.

Balance sheet repair is underway.

U.S. households have:

Increased cash by $600 billion

Reduced debt by $500 billion

Seen income levels increase by $1.3 trillion

4. Yields demanded by holders of corporate bonds compared to U.S. Treasury bonds are lower now than at the start of the year by 0.25%.
5. Sales of automobiles are running at about 14.5 million units per year now compared to a 13.5 million unit run rate at year-end.
6. The weekly leading index of U.S. economic growth compiled by the Economic Cycle Research Institute stands near 125 compared to a reading of 120 at the start of the year.

Our Perspective

We are again reminded of the special challenges that confront an economy in the midst of balance sheet repair. That theme remains a dominant one and has slowed the pace of recovery. The balance sheet repair process is underway.

As evidence of this fact, U.S. households have increased cash by $600 billion, reduced debt by $500 billion, and have seen an overall increase in income of $1.3 trillion since the start of the recovery. The net effect of this is to reduce household leverage, depress borrowing, curtail growth, and lower the level of interest rates and inflation.

We view most of the incoming data on global growth as consistent with continued, but slow, expansion. Financial markets continue to provide liquidity to the real economy to allow for this continued growth.

These facts, coupled with reasonable valuations for risk assets (particularly equities trading at 12 times forecast earnings), provide support for a more constructive outlook despite the recent weaker-than-expected April jobs report.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."