

Weekly Economic Commentary



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The Labor Market Continues Its Long Climb Back

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Highlights

- Our outlook for the U.S. economy in 2012 is below both the consensus and the Fed's forecast, but above that being priced in by the market and generally discussed in the financial media.
- The November employment report was another step on the long road back for the still-struggling labor market.

Economic Calendar

Monday, December 5 ISM Non Manufacturing Sector Nov Factory Orders Oct	Thursday, December 7 Initial Claims wk 12/03 Wholesale Inventories Oct
Wednesday, December 7 Mortgage Applications wk 12/02 Consumer Credit Oct	Friday, December 8 Trade Balance Oct U of M Consumer Sentiment Dec

The Fed's forecast for the economy represents the upper bound of the range of forecasts for the economy and the labor market for 2012 and beyond.

While this is yet another crucial week for European policymakers, the relatively quiet week (December 5–9) for economic and policy events in the United States provides us with the opportunity to review the highlights of the *2012 Outlook* in this week's *Weekly Economic Commentary*. We will also review the November employment report, which was released on Friday, December 2.

Market participants with the loudest voices and financial media were virtually convinced during the summer and fall of 2011 that the U.S. economy was in, or about to enter, a recession. Our view was, and remains, that the U.S. economy would avoid recession in 2011 and 2012, and the recent run of better-than-expected economic data in the United States has reinforced our view. We expect the U.S. economy to grow about 2% in 2012, which is below the long-term average and the consensus forecast, while emerging market countries post stronger growth and Europe experiences a mild recession.

Our forecast for a economic growth in 2012 is supported by solid business spending and modest, but stable, consumer spending. While inflation may recede early in the year, by year-end it may begin to re-emerge as the impact of a falling dollar, rising commodity prices and the record-breaking monetary stimulus by the Federal Reserve (Fed) begin to be reflected in prices. We expect global growth in 2012 to be supported by solid emerging market growth including the consensus of 8–9% growth in China, the world's second largest economy, while Europe experiences a mild recession.

The Fed's economic projections, released at the conclusion of the November 2011 Fed policy meeting, call for 2.5–2.9% GDP growth in 2012, well above our forecast and the consensus forecast, and an even more robust 3.0–3.5% pace of growth in 2013. The Fed's forecast for the economy represents the upper bound of the range of forecasts for the economy and the labor market for 2012 and beyond, and lies in stark contrast to the financial market and financial media's dour outlook for the economy next year as noted above.

The Fed surprised investors twice in 2011. First, in August, by announcing its commitment to keep rates at their current low level until at least mid-2013; and secondly, in September, by announcing a bolder-than-expected Operation Twist, a program to sell short-term Treasuries and buy long-term Treasuries to pressure long-term interest rates lower. In late October 2011, several Fed officials discussed so-called Quantitative Easing 3 (QE3), or another round of large-scale securities purchases, perhaps this time taking



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place in the mortgage-backed securities market. While we think another program of stimulus from the Fed faces high hurdles, it is clearly leaning towards keeping rates low, which is generally a positive for the bond market.

However, the Fed may find itself increasingly between a rock and a hard place as 2012 matures. Too little growth and the fear of deflation is the “rock” that the Fed has been aggressively focused on avoiding. The Fed is much less concerned about the “hard place,” or the entire stimulus it has provided leading to too much inflation. Now, the distance between the two risks is far apart. However, the Fed may find itself in an increasingly narrow gap between a rock and a hard place as 2012 matures leading to higher yields in the bond market by year-end. While the Fed may have to scramble in 2013 to begin to take up some of the extraordinary amount of monetary stimulus now in the system, in the meantime it is likely that the economy will fail to live up to the Fed’s relatively lofty expectations for growth.

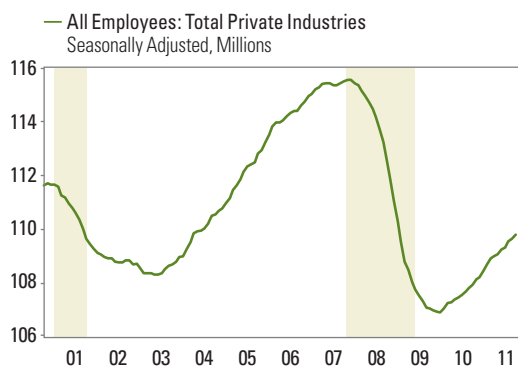
The Labor Market Continued Its Long, Slow Climb Back in November

The solid, but not spectacular November employment report (released on Friday, December 2) points to modest economic growth, not recession, in the fourth quarter. On balance, the details of the November jobs report were mixed, but the report was generally consistent with other data released in recent weeks that suggested a modest improvement in the labor market in November. The survey of businesses within the November employment report revealed that the private sector economy added 140,000 jobs in November, and that the job count in prior months was higher than previously thought. While the result was below both the published consensus (+150,000) and the “whisper number” (175,000 or more), the report generally confirmed further modest improvement in the labor market. The economy shed 8.9 million private sector jobs between late 2007 and early 2010, and has added back just 2.6 million jobs since then. At the current pace of private sector job creation—our forecast as noted in our *2012 Outlook* is for a gain of around 150,000 jobs per month—it would take another three and a half years to recoup all the jobs lost during the Great Recession.

The survey of households within the monthly employment report revealed that the unemployment rate dropped to 8.6% in November from 9.0% in October. The 8.6% unemployment rate was the lowest since March 2009, when the rate was on the way up to its peak of 10.1%. The media’s focus on Friday was on the stunning 0.4% point drop in the unemployment rate in November. The drop was partly due to an improving labor market, and probably partly the result of some statistical quirks.

The unemployment rate is calculated by dividing the number of unemployed (13.3 million) by the number of persons in the labor force (154 million). In November, the labor force fell by 315,000 while the number of unemployed fell by 594,000. Both readings are relatively large by historical standards. However, in the past 65 years, in 60% of the months in which the unemployment rate drops by at least 0.3% in a month, the labor force

1 It is Likely to Take Another Three and a Half Years for the Economy to Recover All the Jobs Lost During the Great Recession



Source: Bureau of Labor Statistics, Haver Analytics 12/05/11

(Shaded areas indicate recession)



2 The 0.4% Drop in The Unemployment Rate In November May Have Overstated the Improvement in the Labor Market, But We Are Headed in The Right Direction



Source: Bureau of Labor Statistics, Haver Analytics 12/05/11

(Shaded areas indicate recession)

also posts a monthly decline. The household survey has its own tally of employment, and that measure increased by 278,000 in November, and has increased by 1.3 million in the past four months. This pace of job growth is consistent with job growth during the economic recoveries in the mid-90s and mid-2000s. It needs to be sustained in the coming months in order for the labor market to continue to heal.

Our view remains that the U.S. economy is likely to grow between 2.5% and 3.0% in the fourth quarter of 2011 and post growth of around 2.0% in 2012. A further, dramatic deterioration of the fiscal and market situation in Europe, a policy mistake here in the United States or abroad, or an exogenous event (terror attack, natural disaster, etc.), among other events, may cause us to change our view.

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Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

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