

Research

September 19, 2007

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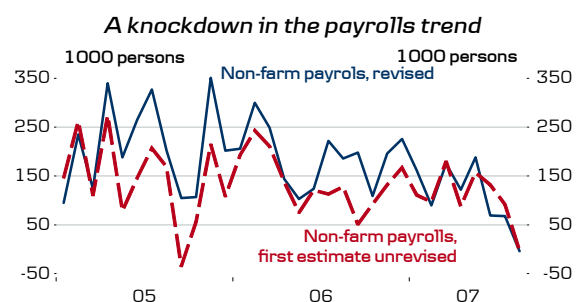
US: A labour market health check

- The August payrolls data has cast doubt over the resilience of the US labour market and motivated fears of a more serious downturn in economic activity. Not only did the labour market experience a net loss of jobs in August, the labour market report also included a negative revision to previous months, implying a considerably weaker trend in hiring than previously.
- There is no doubt that the trend in payrolls has softened over recent years in response to softer economic growth. That said, the pronounced weakness in the job market during the summer months seems more subtle.
- Firstly there are limited signs of a negative overhang from excessive job creation in recent quarters. The labour market quite closely followed the path laid out by GDP data. Secondly, while the signals from other labour market data remain very mixed, these indicators are on average not able to account for such a noticeable weakening. Finally, the slowdown in payrolls has been amplified by a sudden retrenchment in government hiring and a conspicuous drop in manufacturing payrolls in August. Neither of these developments should be sustainable.
- In summary, we find the recent slowing in employment growth somewhat excessive. Most likely the labour market will manage to recover in the coming months. The recent growth pattern as well as the common message from other labour market indicators suggest an underlying trend in hiring close to 100K per month.
- If the job market does not recover, the economy will be facing a quite different scenario. In this case a more serious slowdown could be on the cards. Such a scenario could easily involve more Fed easing than we are currently anticipating.

Weaker – but that weak?

In need of a health check

The August payrolls report has questioned the resilience of the US labour market and the economy in general. With a net loss of jobs in August and a negative net revision to previous months, the trend in payrolls looks considerably weaker than just one month ago (see [Flash Comment - US: Weak job market in August](#)).



The three-month average payrolls growth now stands at 44K. This is substantially lower compared to July's unrevised 127K.

While there is little doubt that the trend in employment growth has been slowing for several quarters in line with a slower economy, we are somewhat surprised by the very soft August numbers.

How weak the 'true' trend in payrolls is, will prove very crucial for the economy and the Fed in coming quarters. If the recent weakness in employment data proves sustained, there will be good reason to expect more Fed easing than we are currently anticipating in our forecast (see *Global Scenarios, September 2007*).

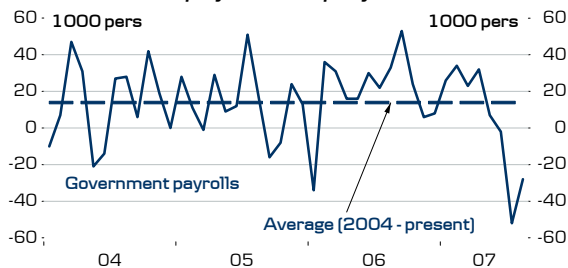
From this perspective it seems relevant to provide a health check of the labour market.

What's noise, what's real?

Before making fundamental judgements about the labour market it may be worth looking into the details of the August labour market report. Several factors seem to have played an important role:

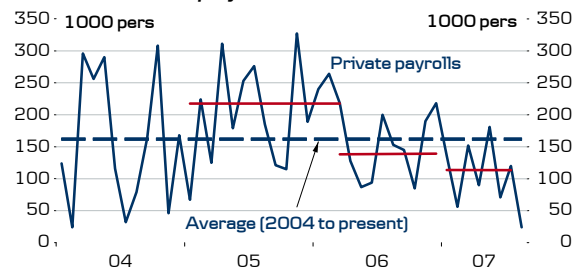
Firstly, government job creation has been surprisingly weak over the last three months. Since 2004, government hiring on average has been around 14K persons per month. However, in the last three months the government has shed 82K jobs. This is a net difference of 124K persons or 40K persons per month. Government payrolls do not usually take such big detours and our best guess is that this is only a temporary fall-out.

Government payrolls amplify the weakness



While government payrolls are clearly amplifying the weakness, they do not explain all of it. Looking at private payrolls, the August report prints a slowdown in the three-month trend from an unrevised 136K in July to 72K. While less dramatic, the slowdown in data remains significant.

Private payrolls have weakened



Another conspicuous feature in the August report was the sharp drop in manufacturing payrolls of 46K. This is in strong contrast to the relatively healthy level of the ISM manufacturing index. Usually, manufacturing payrolls do not drop that sharply with the current levels of ISM manufacturing index, c.f. the chart below.

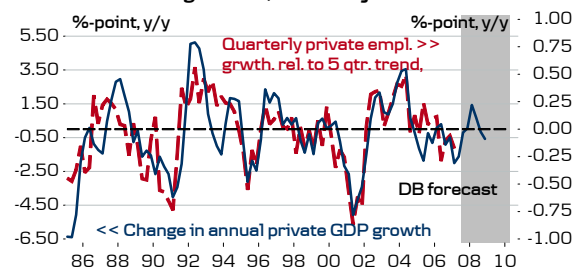
A conspicuous drop in manufacturing employment



Was it a negative backlog from slower growth?

That said, there is no doubt that the trend in private payrolls has drifted lower in the last two to three years. This is very much in line with the slower rate of economic growth.

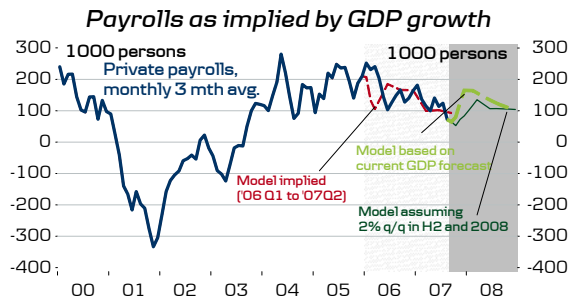
Slower growth, slower job market



Usually, changes in employment growth can be explained quite well from changes in GDP growth. These dynamics are illustrated in the chart below, where deviations in employment growth from the five-quarter trend are closely tracked by annual changes in annual GDP growth.

One possible explanation of the recent slowdown in hiring could be that we are currently experiencing negative reaction in employment growth because it did not slow 'sufficiently' during H1.

One way to assess this is to estimate the simple correlation in the chart above and run actual growth data through the model. The red-dashed line in the chart below shows how the three-month average private payroll growth would have evolved according to the model given realised GDP growth.



Note: The model between changes in the trend of private non-farm payrolls growth (ie, deviation from five quarters trend, Y variable) and annual changes in GDP growth (X variable) is estimated by OLS for the period 1985 - present. The estimation runs on a quarterly frequency. The chart above showed the forecasted values as changes in private payrolls. The OLS regression is specified as: $Y_t = a + b_1X_t + b_2X_{t-4}$.

According to this, hiring did not overshoot in any spectacular way during H1. During the period Q1 06 to Q2 07, accumulated employment growth was 240K higher than forecasted by the model. This corresponds to only 13K per month and is clearly within the standard deviation of the model. Hence, the labour market has reacted very much in accordance with the historical patterns and there are only limited signs of a negative employment overhang.

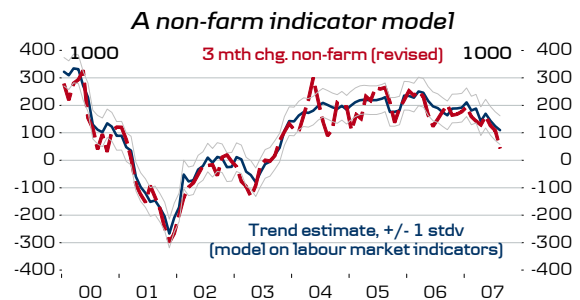
Moreover, the model suggests a fair value of private payroll growth in the neighbourhood of 130K - quite far from the current three-month average of 72K - given the recent growth pattern.

Going forward, our current GDP forecast (3% in Q3, 2.5% in Q4, 2.0%-2.2% for the 2008 quarters) implies a slight reacceleration in payrolls when applying the framework above. This simulation is depicted by the green line in the chart above.

Importantly, much of the positive stimulus from economic growth to this reacceleration is already in the pipeline due to the solid Q2 growth rate. Even when assuming a softer growth path of 2.0% q/q AR in H2 07 and in 2008, employment growth should rebound to above 100K by early 2008 (the dark-green solid line) according to the model.

What do other labour market indicators tell?

Another way to assess the slowdown in hiring, is to compare non-farm data with other labour market indicators. The chart below shows a model on changes in private non-farm payroll, which has been estimated using labour market indicators with a history dating back to at least 1980 (see note below the charts).



Note: Estimated from 1979 to present by Ordinary Least Squares on a monthly frequency. Only data with a long history is applied to ensure stability of the model. The model is estimated on lagged and current values or differences of the following variables: Conference Board jobless differential (jobs plentiful less jobs hard to get), Help Wanted index, Initial and Continuing claims, Household survey employment, the two-year trend in payrolls.

The model broadly captures the softening in the payrolls trend over the last couple of years. However, it cannot explain the recent sharp slowdown in employment growth. In fact, the model suggests that total payrolls growth should be trending close to 100K.

That said, the picture remains very mixed for different labour market indicators. To demonstrate this we run a range of single-equation regressions on individual labour market indicators.

As the table indicates, there is no clear picture when looking at the individual indicators. However, on average the regressions suggest that the 3 month change in payrolls is close to 100K, which is relatively consistent with the indicator model above.

Single equation regressions on individual job market indicators

Three-month average change in non-farm payrolls

| | --- Estimation period --- | |
|--------------------------------------|---------------------------|-------|
| | Entire | 2000- |
| <i>Indicators with long history</i> | | |
| Initial claims | 174 | 174 |
| Continuing claims, 3 mth | 128 | 68 |
| Household survey, 3 mth chg. | 10 | - |
| Conference Board*, 3 mth chg. | 154 | 142 |
| Help wanted, 3 mth | 34 | 94 |
| <i>Indicators with short history</i> | | |
| ISM employment** | 40 | 28 |
| AD | - | 101 |
| JOLTS*** | - | 163 |
| Monster employment | 187 | 97 |
| Average | 104 | 96 |

* Jobs plentiful less jobs hard to get

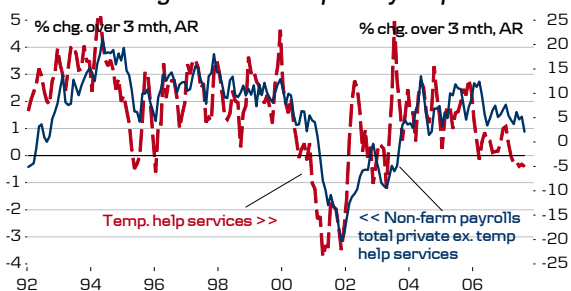
** Applying both the manufacturing and non-manufacturing employment indexes, common sample start in 1998

*** Hires less separation, sample start in 2001 (July observation)

The models have been specified with appropriate number of lags based on t-values and information criteria

Another widely used gauge of the future hiring trends, which deserves some attention, is the development in temporary help services. This part of the labour market tends to lead shifts in overall labour demand, as temporary help employment reflects the marginal demand for labour. Hence, when employment in temporary help services is increasing, it signals increasing demand for labour in general and vice versa.

Downbeat signal from temporary help services



As the chart above suggests, the signal from temporary help services is relatively downbeat. Hence, looking at this indicator, continued softness in hiring cannot be ruled out.

In summary, there remains little agreement among different indicators about the health of the labour market. On average, labour market data is able to capture the gradual slowdown in hiring over the recent year, but not the recent sharp retrenchment in hiring.

Conclusion

While it seems appropriate that the labour market has been experiencing a softening trend over the

recent years as a response to slower economic growth rates, it is generally difficult to explain the pronounced weakness in August and the sharp deterioration in hiring over the recent months.

However, when judging employment trends, one should remember that payrolls data are very volatile – not only on a month-to-month basis, but also on a three-month horizon. Moreover we usually see notable revisions.

Another possibility is that the financial turmoil has caused businesses to hold back hiring for a while, until the visibility has improved. While such a conclusion seems tempting, it remains very difficult to assess.

Although the signals from the labour market are very mixed indeed, we find it most likely that the hiring will recover from its weak level in the coming months. The evidence presented above broadly indicates that the underlying trend in payrolls probably runs close to 100K.

If the labour market – in contrast to our expectations – does not recover, the economy will be facing quite a different scenario. Such a development will increase the risk of a more serious slowdown and could easily involve more Fed easing than we currently anticipate.

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