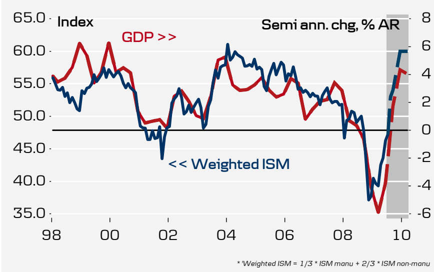
10 September 2009

Research

US: Job recovery ahead

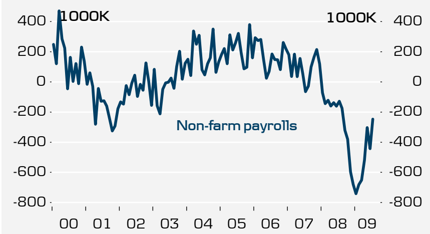
- **Focus on job market data is set to intensify in the coming months, with job growth being a key factor for the sustainability of the current recovery. A repeat of the jobless recoveries in 1991 and 2002 would be a serious blow to outlook. However, for several reasons we believe this is less likely to happen.**
- **First, the current recovery will see sufficiently strong growth during the initial three to four quarters to kick-start the labour market. In fact the very weak recoveries in 1991 and 2002 were the main factor behind the lack of job creation.**
- **Second, the economy and in particular businesses saw renewed (in some instances intensifying) headwinds during the 1991 and 2002 recoveries. So far this is not the case. Although businesses remain under pressure, most headwinds have eased rather than intensified.**
- **Third, because of the extreme pressure on the corporate sector during this crisis businesses are leaner now compared with exits from the 1991 and 2001 recession. In the two previous recessions labour hoarding and a subsequent rise in productivity explains some of the weakness in job growth. While a further strong rise in productivity this time cannot be ruled out, the moderate investment growth prior to this crisis does not support this.**
- **Finally, hours worked have not declined more than usual in this downturn. Hours will go up as activity rises but it is not likely to fully crowd out jobs.**
- **In absence of new unexpected headwinds job growth is likely to return by year-end and to reach the 200,000-250,000 range by the middle of next year, with the unemployment rate peaking in Q1 at 10.1%.**
- **This would be a positive surprise and a very important signal for further risk-taking in the market. This should also pave the way for the next leg up in bond yields and increase market speculations about Fed tightening.**

The economy is turning...



Source: Ecowin and Danske Markets

...now we need job growth



Source: Ecowin and Danske Markets

Strong growth to kick-start the job market

While the initial recovery phase, driven by recoil in the manufacturing and residential construction sectors, has sufficient steam to drive the economy for the coming two to three quarters, it is very obvious that a recovery in final demand – in particular private consumption – will eventually be needed for a sustained recovery to materialise. Hence, job growth is needed to return rather sooner than later. If job growth does not reach close to 200,000 per month by the middle of next year there is an increased risk that the recovery will fizzle out. This is exactly what the markets have begun worrying about

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With the outlook for around 4% growth in the current and coming two quarters, our main expectation is that job growth will return by late this year. Moreover we believe it is likely that pass-through from growth to jobs will be more normal in the current recovery, than following the past two recessions (see the following sections). Hence we forecast job growth to reach about 200,000-250,000 people/month by mid-2010.

Indeed this would be sufficient to take nominal aggregate compensation growth back to around 3% by the middle of next year, which in turn should make room for consumption growth to reach about 2% given relatively subdued inflation and some slight accommodation in the savings rate. This should provide the green light for further risk-taking, add renewed upward pressure on bond yields, and increase speculation about monetary normalisation.

Alternatively, if job growth is not able to keep up with the business cycle, as in the past two recessions, it spells problems. In that case the unemployment rate will continue to climb and job growth will be too weak to secure sufficient nominal income growth for consumption to return to a pace, which is consistent with a sustained recovery. That would be bad news for risk taking and put central banks on hold for longer.

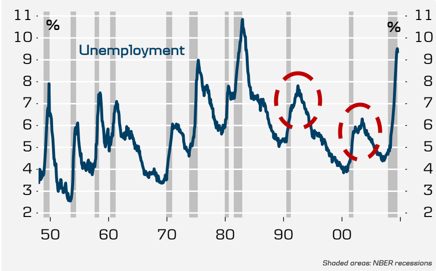
The roadmap below depicts different scenarios for the economy and the job market based on: a) A normal pass-through from GDP to jobs; and b) A “jobless” pass-through as seen during the jobless recoveries in 1991 and 2002 where job annualised growth was about 1-1½% lower than what should be expected given the level of GDP growth. The scenarios are based on a model, which estimates non-farm payrolls on current and lagged GDP growth and the underlying trend in labour productivity.

Roadmap for the labour market (monthly payrolls)

Avg. quarterly GDP growth, AR	End Q4 2009 Normal	End Q4 2009 Jobless	End Q2 2010 Normal	End Q2 2010 Jobless	
5%	142	-22	394	230	*Sustainable for 2010 recovery*
4%	77	-88	296	131	*Insustainable for 2010 recovery*
3%	0	-164	208	44	
2%	-66	-230	110	-55	
1%	-405	-570	11	-153	
Danske's GDP fcst	90	-75	220	60	

Note: The scenarios are based on model which estimates non-farm payrolls on trend productivity and current and lagged GDP growth. In the 'jobless scenarios' a negative residual resembling the 2001 jobless recovery has been added to the model forecast

Jobless recoveries in 1991 and 2002



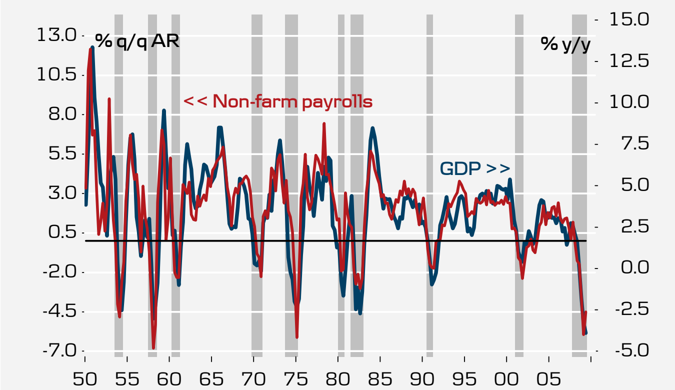
Source: Ecowin and Danske Markets

Stats on unemployment and recessions

Recession start	Recession end	Unemp. peak	Unemp. peak, mths after recession
Nov-48	Oct-49	Oct-49	0
Jul-53	May-54	Sep-54	4
Aug-57	Apr-58	Jul-58	3
Apr-60	Feb-61	May-61	3
Dec-69	Nov-70	Dec-70	1
Nov-73	Mar-75	May-75	2
Jan-80	Jul-80	Jul-80	0
Jul-81	Nov-82	Dec-82	1
Jul-90	Mar-91	Jun-92	15
Mar-01	Nov-01	Jun-03	19
Dec-07	Jul-09	Jan-10	6

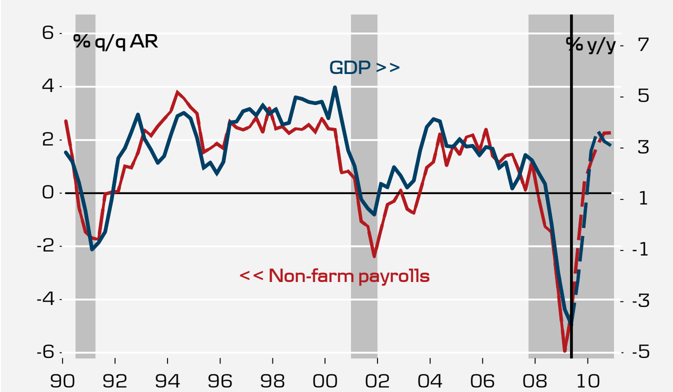
Source: Ecowin and Danske Markets

GDP and job growth 1950-present



Source: Ecowin and Danske Markets

Strong growth to kick-start labour market



Source: Ecowin and Danske Markets

Evidence from jobless recoveries

Growth usually implies jobs. However, the exits from the past two recessions have been quite unusual for the labour market. These two recessions mark the only instances among post-WWII recessions, which have experienced a sustained rise in unemployment after the recession ended. While unemployment on average peaked only two months after the recession in the first eight post-WWII recessions, it took 15 and 19 months respectively in 1992 and 2002 for the unemployment rate to peak.

First and foremost the jobless recovery in 1991 and 2002 was a consequence of very slow GDP growth out of the recessions. One explanation for this is that the recessions were relatively shallow. Consequently, the inventory cycles and the force of pent-up demand, which are usual among the initial recovery drivers, was weaker than average. In turn the initial recovery phase never became strong enough to initiate a positive and self-sustaining loop between the economy and the labour markets.

However, the lack of job growth in 1991 and 2002 is not only explained by slow GDP growth. On top of this there is evidence that employment growth was 'too weak' relative to the already slow pattern in GDP growth. In both cases annualised growth in payrolls ran at 1-1.5% (or 100,000-200,000 annualised) below its usual path – even when taking into account the changes in trend productivity.

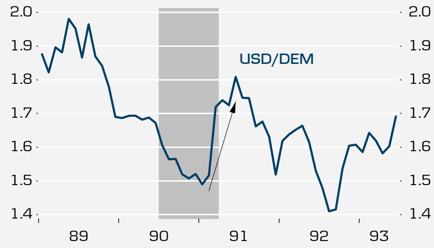
Below we analyse the background for the slow recoveries in 1991 and 2002 and why business hired 'too few' people relatively to the already sub-par GDP growth.

The 1991 jobless recovery

The jobless recovery of 1991 followed a short recession, running from July 1990 to March 1991. The economy was already slowing down late-1989 and early-1990 as the savings and loan (S&L) crisis put pressure on the financial system and private businesses. The recession hit mid-1990 as oil prices shot higher when Iraq entered Kuwait preceding the first Iraq war. Oil prices more than doubled from USD17/barrel in June 1990 to USD36/bbl in August 90. The US attacked Iraq on 17 January 1991 in what proved to be a very short mission. On 28 February 1991 the war ended and oil prices fell back sharply. In combination with tax cuts and monetary stimulus this proved sufficient to end the recession.

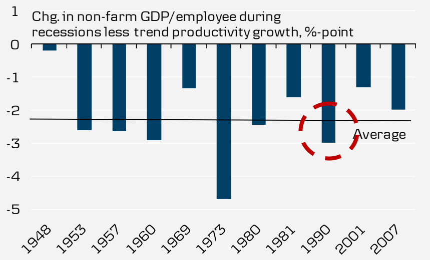
However the recovery proved very slow. After rising to 2.7% q/q annualised in Q2 91 GDP growth slipped back below 2% in the second half of 1991. Growth didn't recover to above trend growth (of 3% at the time) until the beginning of 1992.

1991: Stronger USD weighs on businesses



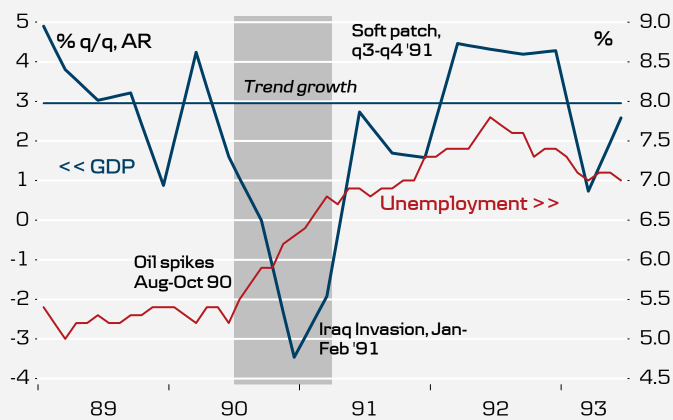
Source: Ecowin and Danske Markets

1991: Labour hording could be a factor



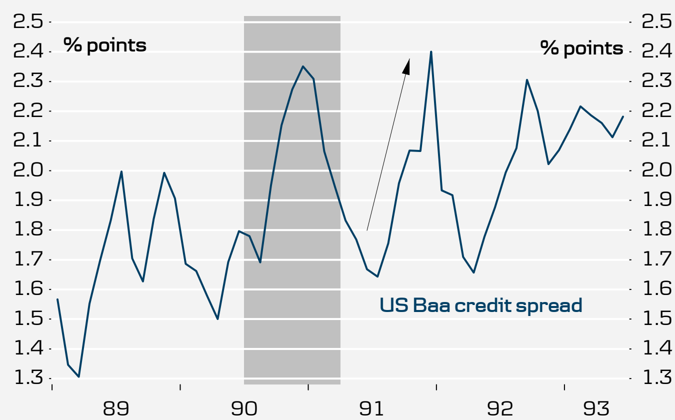
Source: Ecowin and Danske Markets

Weak recovery: it took 4 quarters to get above trend growth



Source: Ecowin and Danske Markets

Corporates under pressure throughout 1991



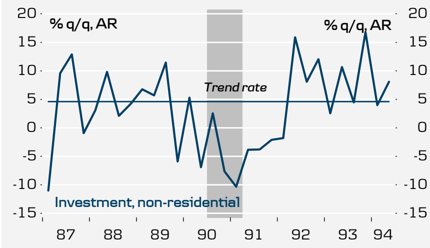
Source: Ecowin and Danske Markets

The “soft patch” in the second half of 1991 was partly caused by *new headwinds* hitting the economy. The economy was still quite fragile as the S&L crisis continued to linger and in mid-1991 credit spreads widened again putting businesses under renewed pressure. Adding to the headwinds was a sharp appreciation of the US dollar after the Iraq war ended.

The renewed pressure concentrated in the corporate sector likely explains the caution of the companies as focus quickly returned to cost-cutting. This is also evident from the continued decline in non-residential investment throughout 1991. In all eight post-WWII recessions before 1990 non-residential investment turned positive within two quarters. After the 1990 recession it took five quarters. Another factor behind the slow recovery in investment and jobs was probably also that companies were not as lean as normal when coming out of the recession, since the recession was milder than usual. Labour hoarding was also higher than normal, which can be seen when comparing the ratio between non-farm GDP and non-farm payrolls (see chart overleaf).

When growth in corporate investment finally came in mid-1992 it rose 15% q/q annualised. This coincided with the time the unemployment rate peaked.

1991: Slow investment recovery



Source: Ecowin and Danske Markets

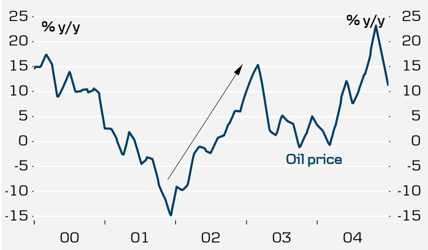
The 2002 jobless recovery

The 2001 recession ended in November 2001 after a very turbulent year. The burst of the IT bubble led to a severe decline in business investment dragging down the economy. And the terror attacks on September 11 gave an extra shock to demand as it led to extreme uncertainty of what was to happen next. It was therefore quite a surprise when the economy apparently recovered very quickly with ISM shooting higher in early-2002.

However, as with the 1991 recovery growth suffered a setback and the recovery proved weak and protracted. Again it was the case that the economy was hit by *new headwinds*. First, the unravelling of corporate scandals led to a crash in the equity markets and extensive widening of credit spreads starting in spring 2002. Second, oil prices spiked higher during the year as the run-up to the second Iraq war intensified and resulted in the war in March 2003. The headwinds implied that growth only exceeded 3% in the first quarter after the recession and then turned lower with sub-trend growth in the following year.

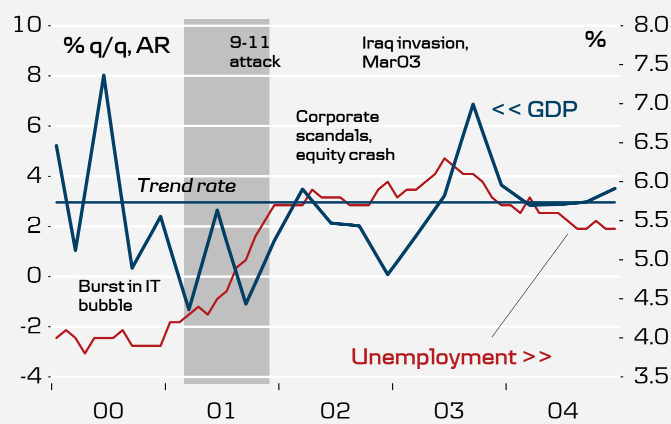
As in 1991 investment recovery took place over a long period of time because the corporate scandals kept the focus on cost-cutting, as top line growth was very weak. The investment boom in the late 1990s also paved the way for a strong rise in productivity which meant fewer jobs were needed for every unit of output. Investment growth finally

2002: Another headwind from oil prices



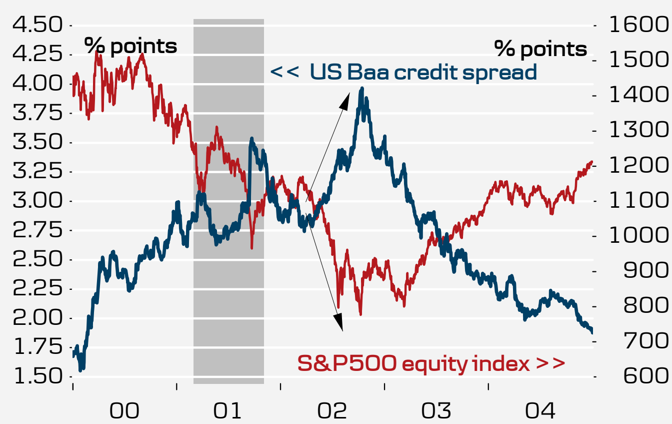
Source: Ecowin and Danske Markets

An extremely bumpy road to recovery in 2002



Source: Ecowin and Danske Markets

Corporate scandals led to severe stress in credit and equities



Source: Ecowin and Danske Markets

turned positive in Q2 03, six quarters after the recession ended, and rose to 12% q/q annualised. This – as in 1992 – coincided with the peak in the unemployment rate!

The outlook: Jobless vs job-full

The 1991 and 2001 recessions and the following recoveries in many ways were quite unusual by historical standards. The recoveries were very weak with sub trend growth for around a year. This was partly explained by the fact that the 1991 and 2001 recessions were quite mild by historical standards, partly by the new headwinds arriving during the initial recovery phase.

In that respect the current situation is somewhat different. First and foremost the US economy has just experienced the deepest setback since the WWII. Even taking into account that there are still strong headwinds from the injured credit markets these headwinds are easing and the recovery dynamics should be strong enough to generate growth sufficiently above trend to kick-start the labour market over next two to three quarters. However, it is important to look out for potential new headwinds. The main candidates in our view are renewed financial turmoil and a strong rise in oil prices. If this was to take place growth would be hampered and the corporate sector would try to cut costs even further.

Another lesson from the two recent jobless recoveries is that the headwinds specific to the corporate sector was intensifying after the recession has ended. In turn this increased the focus on cost-cutting. This time around the stress level is still high, but abating, which should make life easier for the corporate sector going forward. One sign of this is the recent narrowing in credit spreads and the unfreezing of lending markets.

Finally the development in business investment in 1991 and 2002 mirrored what we saw in job growth – a very sluggish recovery. It suggests that one should keep an eye on corporate investment growth as a signal of how lean the corporate sector have become during the recession and whether businesses are experiencing a higher or lower level of stress. Indeed the recent signs of improvement in business spending are an encouraging sign in this respect.

Comparison of jobless recoveries and current situation

Headwinds in recoveries	1991	2002	Now
War		√	
Oil prices		√	?
Increasing credit headwinds	√	√	?
Corporate scandals		√	
Slow investment recovery	√	√	
A rise in trend productivity[1]		√	

Source: Ecowin and Danske Markets.

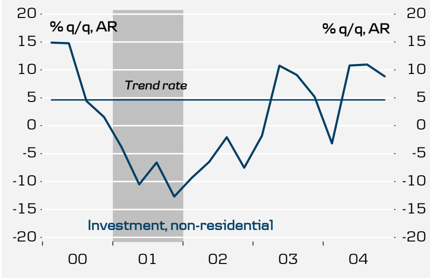
1) Rise in trend productivity was a headwind for *job growth* in 2002

Leaner than usual

Another important question is whether businesses are leaner than usual at the moment. With businesses having cut both inventories and investment spending unusually hard during the recession, this it might also be the case with labour.

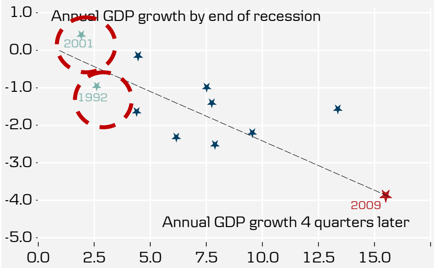
In fact there is some evidence that jobs have been cut harder relative to the decline in GDP this time around compared to 1991 and 2002, which is demonstrated in the scatter plot on to the right.

2002: Very weak investment recovery as stress level high during scandals in



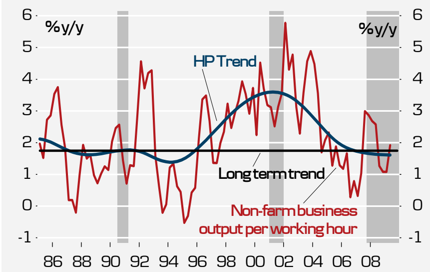
Source: Ecowin and Danske Markets

Shallow recessions make soft recoveries



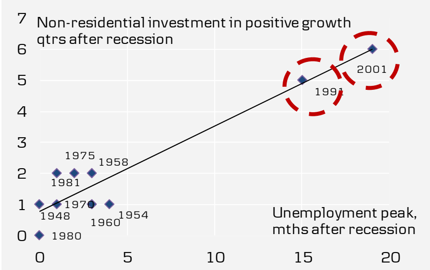
Source: Ecowin and Danske Markets

Trend productivity rose ahead of 2002



Source: Ecowin and Danske Markets

Watch investments



Source: Ecowin and Danske Markets

Moreover labour productivity increased just ahead of the current recession and has not slowed much during the recession. This could also suggest that layoffs have been somewhat frontloaded.

Of course this could reflect a permanent upward shift in the underlying growth rate of labour productivity, which in turn would increase the risk of a jobless recovery, as was partly the case in 2002. In our view this is not very likely. If anything, these days, the academic debate centres on lower potential growth rates – not higher.

Another way to assesses whether jobs have been cut harder this is to apply the law of Okun to the unemployment rate.

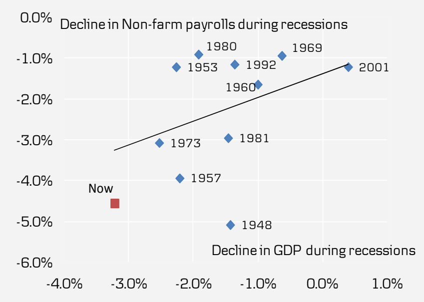
$$\Delta \text{ Unemployment rate } \%(t) = \alpha + \beta \text{ GDP growth } \%(t) + \varepsilon(t)$$

While it is quite normal to see big residual in Okun's equation during recessions, they seems to be at the high end this time around. Again this suggests that job cutting has been more aggressive than on average. Interestingly however, there is a tendency for the unemployment rate to decline relatively fast following a recession where is has risen relatively fast (see the residual scatter plot below). Indeed this suggests that that unemployment could decline faster than average, when the labour market starts to turn.

Will hours absorb the rise in activity?

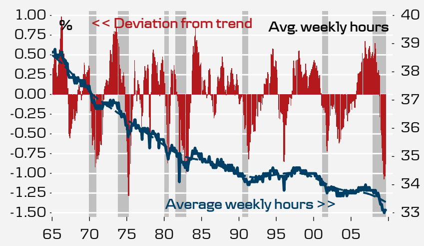
Apart from boosting productivity a jobless recovery could come from companies increasing hours rather than hiring new employees to increase production. Working hours have been reduced during the recession and hence there should be scope for increasing hours. However, this pattern is quite normal. Companies normally reduce both hours and employment during recessions and *vice versa* when the economy recovers. Taking into account the declining trend in working hours there is no sign that hours have been reduced more than usual during this recession. If anything – taking into account the sharp decline in employment – hours have been reduced less than normal. This does not preclude, though, that businesses will mainly increase production through increasing hours and hence it is difficult to make a firm conclusion in this area. But the starting point is better than one in which hours had been cut more extensively. Moreover a decline in hours did not prevent jobs to arrive relatively fast in earlier recoveries, which preceded deep recessions – e.g. in the 1970s and 1980s.

Jobs have been cut harder than usual



Source: Ecowin and Danske Markets

Decline in hours not unusual



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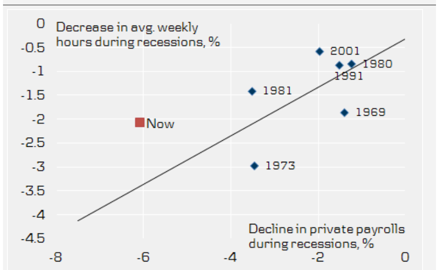
Hours not reduced more than usual relative to employment



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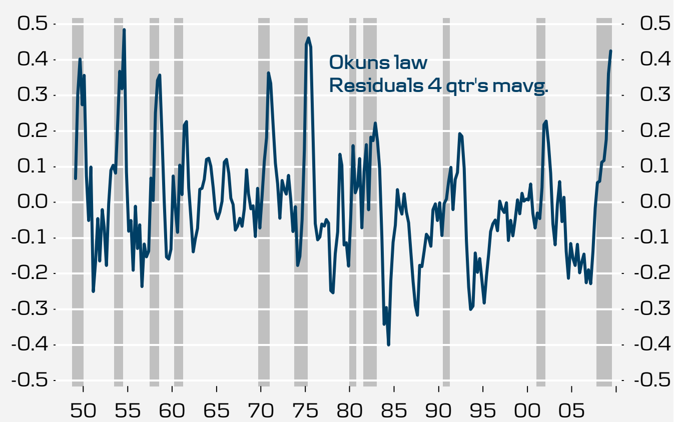
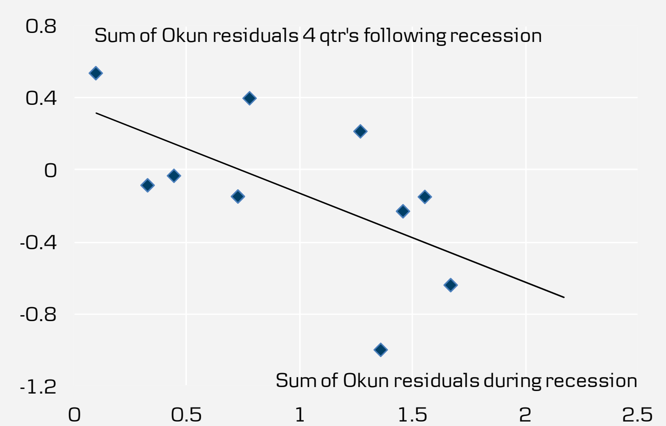
Unemployment has overshot significantly…



Source: Ecowin and Danske Markets

…usually this implies a faster decline during the recovery



Source: Ecowin and Danske Markets

Disclosure

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