



The Unseen

Garbage in Garbage out

Those relying on the traditional financial and business media outlets are likely to think that the U.S. labor market is in great shape. Who can argue with an unemployment rate that, with the exception of a few months in 2000, is lower than at any other time since 1970?

We can.

Despite a steadily declining unemployment rate, there are a few facts that have persisted for a number of years that make us question the heralded condition of the labor market. At the top of the list, are the data on wages and income. If unemployment is to be factually characterized as “low”, why is wage growth trending below growth levels seen before the financial crisis despite an unemployment rate that was higher? **In this article, we show that weak wage growth may be telling us the real story and that the perception of an economy at full employment may be misleading.** In support of this argument, we provide data that further challenges the notion, broadly believed by most economists, of an economy running at full employment and a healthy labor market.

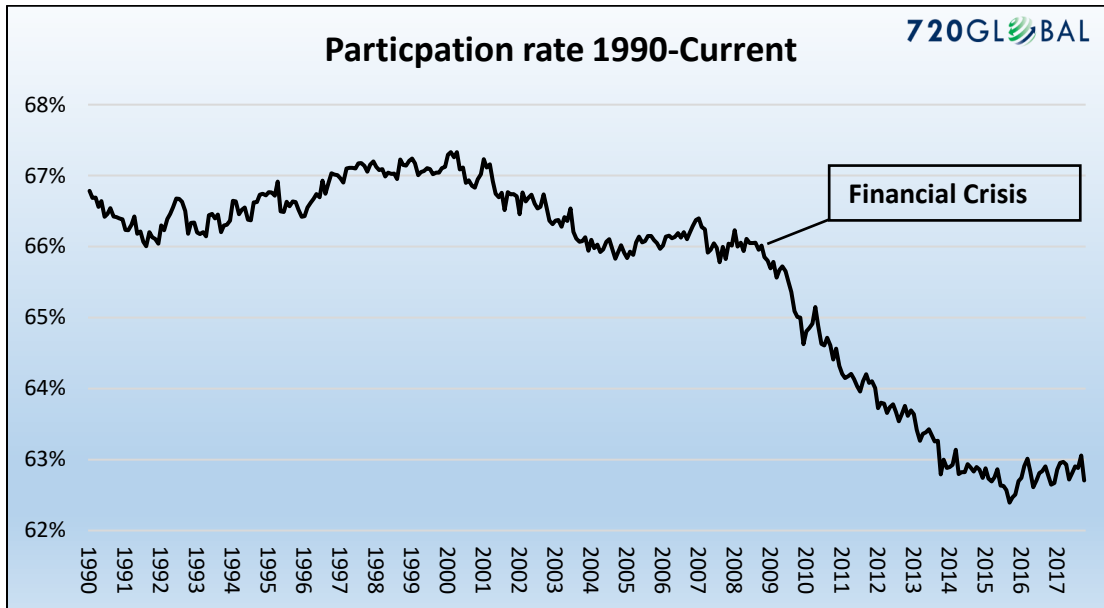
For investors, debating the health of the labor market is not an intellectual exercise in semantics. Economic activity and corporate earnings are closely correlated; therefore, assessing labor market conditions is not just for PhD roundtables but crucial to understanding the trend in corporate earnings. Employment is a particularly important economic factor, as almost 70% of GDP comes from personal consumption.

Labor Participation Rate

Within the many data tables produced by the Bureau of Labor Statistics (BLS) is the labor participation rate. While this data point is typically quoted by the financial media when the monthly employment data are released, they tend to brush it aside owing to its odd divergence from the “headline” U3 unemployment rate.

The labor participation rate measures employed people and those “looking for work” as a percentage of those aged 16 and older. During economic recessions, the ratio tends to decline as unemployed workers get discouraged, stop looking for work, and are removed from the numerator of the ratio.

The graph below shows that, despite eight years of economic recovery since the 2008 financial crisis, the participation rate has not only trended lower but clearly broke the trend from the prior 20 years. We repeatedly see this same fractured pattern in many fundamental indicators.



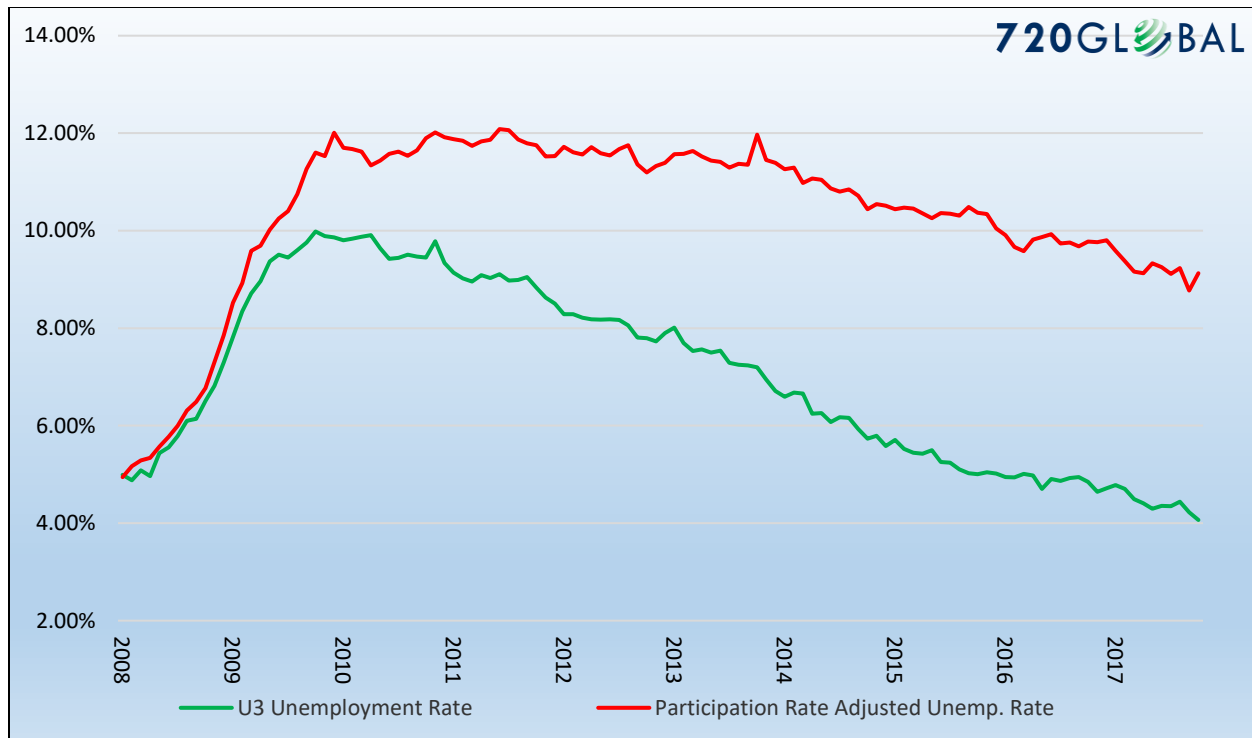
Data Courtesy: Bureau of Labor Statistics

Closer inspection of the BLS data reveals that, since 2008, 16 million people were reclassified as “leaving the work force”. To put the 16mm people into context, from 1985 to 2008, a period almost three times longer than the post-crisis recovery, a similar number of people left the work force.

Why are so many people struggling to find a job and terminating their search if, as we are repeatedly told, the labor market is so healthy? Jobs should be abundant given such a low unemployment rate.

A Realistic Unemployment Rate

The preceding question prodded us to rethink the popular BLS “headline” U-3 unemployment rate that so many take as gospel. When people stop looking for a job, they are still unemployed, but they are not included in the U-3 unemployment calculation. If we include those who quit looking for work in the data, the employment situation is not nearly as rosy. The graph below compares the U-3 unemployment rate to one that assumes a constant participation rate from 2008 to today.



Data Courtesy: Bureau of Labor Statistics

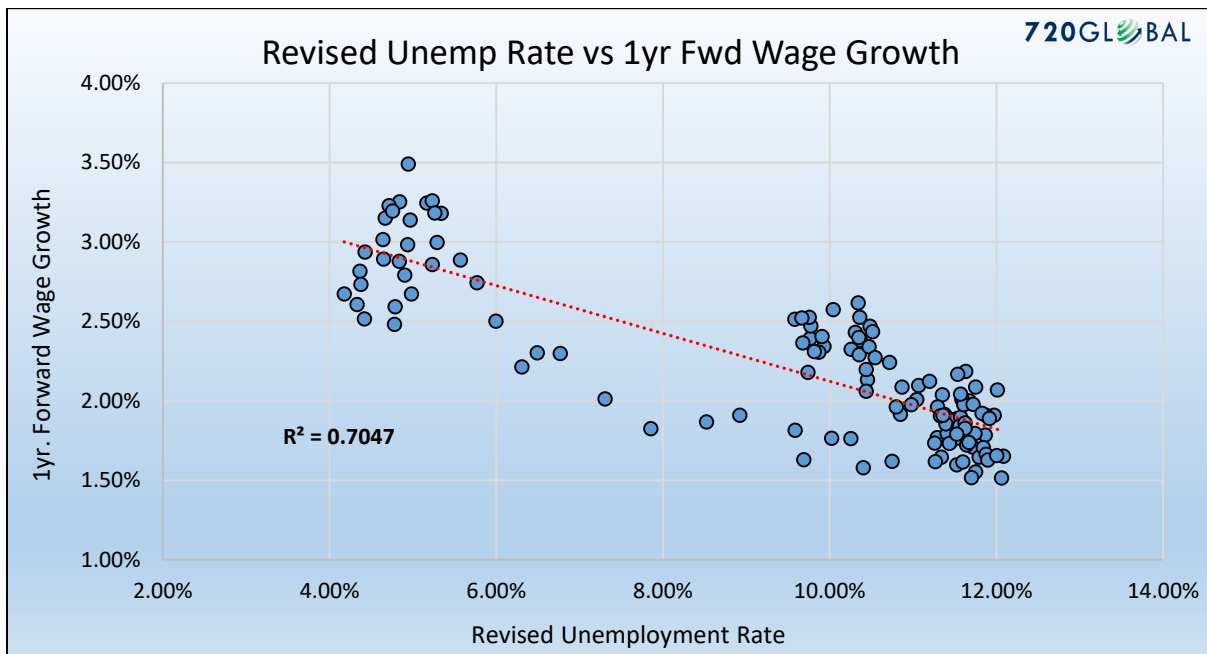
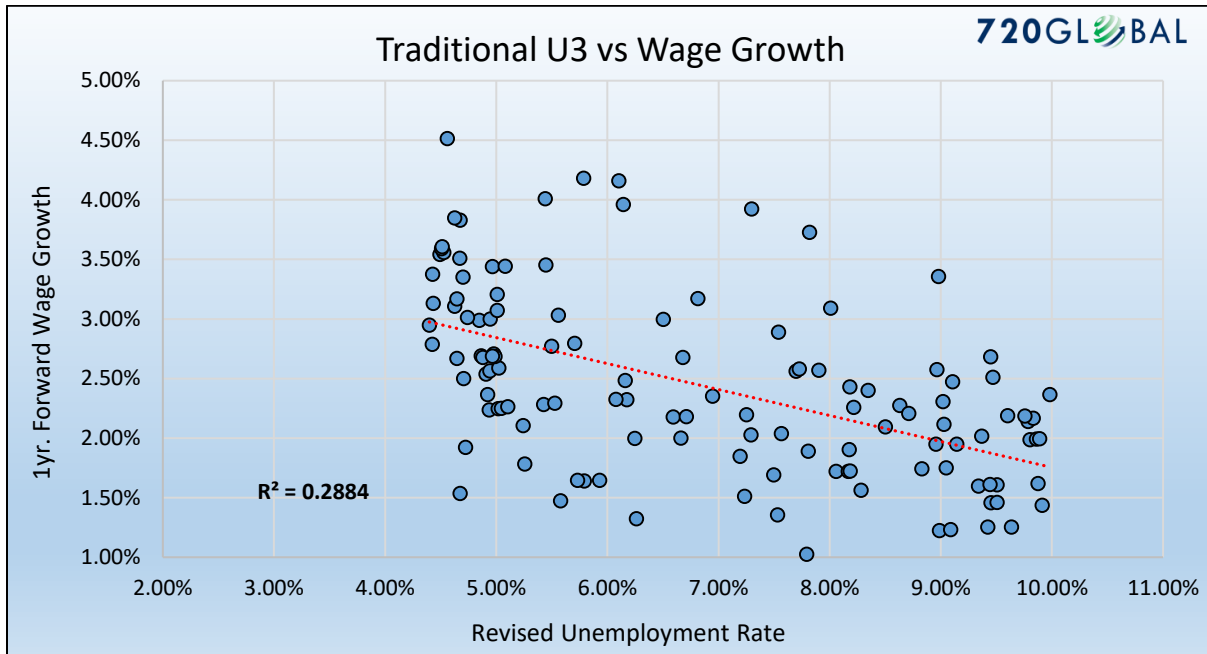
Phillips curve

The Phillips curve, named after William Phillips, is a simple measure describing the inverse relationship between the unemployment rate and wage inflation. The logical premise behind the Phillips Curve is that, as unemployment drops and workers become harder to find, workers are able to demand higher wages. When unemployment rises, conversely, the supply of workers is greater and therefore wages fall. The Phillips curve follows the basic tenets supporting supply and demand curves for most goods and services.

Many economists and media pundits have pronounced that the Phillips curve relationship is dead. They deem it an economic relic that has ceased to provide expected results. **Has a basic, time tested law of supply and demand ceased to work in the labor markets, or are economists measuring the inputs incorrectly?**

There are a large number of social and economic factors that affect wages and the supply of workers. We do not ignore those factors, but it is a good exercise to observe the Phillips curve relationship if one uses the more “realistic” unemployment rate shown above. Further, we substitute wage growth a year forward for the traditional method of using current wage growth. The logic here is that it takes time for employees to apply the leverage they gain over employers to boost their income.

The first graph below shows the traditional Phillips curve as typically displayed (U-3 and recent three month wage growth). The second is a modified Phillips curve which uses the revised U-3 from above and one-year forward wage growth.



Data Courtesy: Bureau of Labor Statistics

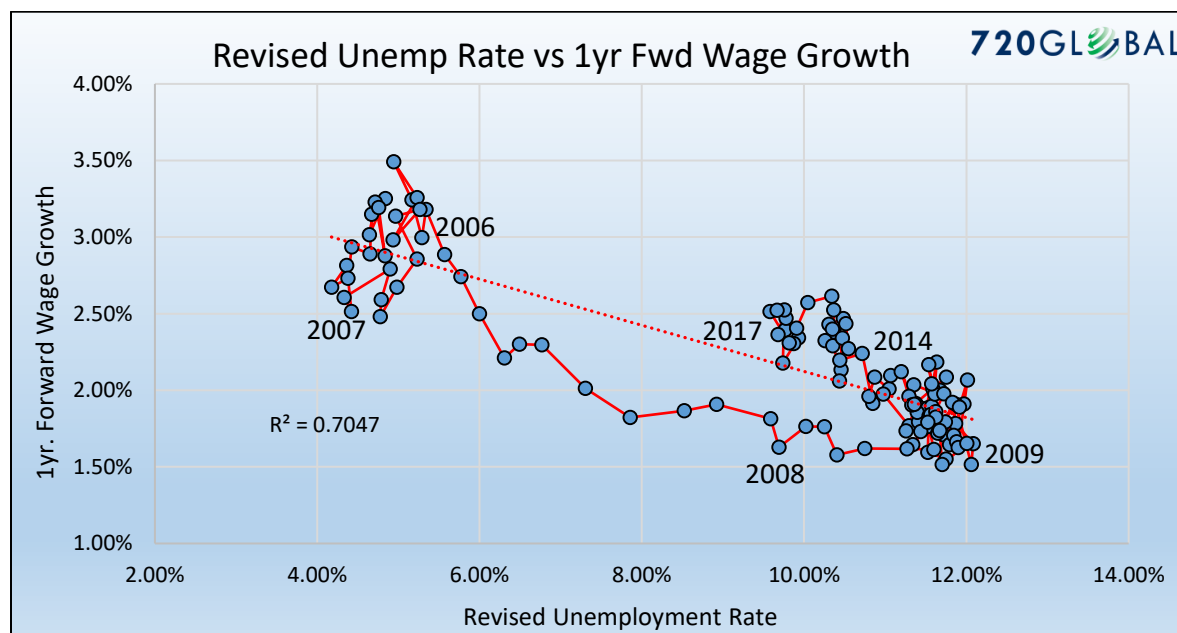
Both graphs highlight R-squared (R^2), which shows the statistical relationship between the two factors. The first graph, with an R^2 of .2884, demonstrates that only 28.84% of the change in wages was due to the change in the unemployment rate. Visual inspection also tells you the relationship between wages and unemployment is weak. It is this graph that has many

economists declaring the Phillips curve to be irrelevant. The second graph has a statistically significant R^2 of .7047 and a visible confirmation that the Phillips curve relationship continues to hold.

Recently, Federal Reserve Bank of Chicago President Charles Evans stated, in relation to the Phillips curve, “*We don’t have a great understanding of why it’s gotten to be so flat.*” Mr. Evans, perhaps employment is not as strong as you and your Fed colleagues think it is.

To provide more detail we take a second look at the alternative Phillips curve chart shown above.

We added a red line and selected date markers to the graph above to show how the relationship has progressed over time. As economic activity began weakening in 2006 and 2007, the red line trends lower from the top left to bottom right. Directionally, this is what one would expect to happen as unemployment rose and wage growth fell during the financial crisis. Following the recession, the line progresses back up and to the left as economic recovery took hold.

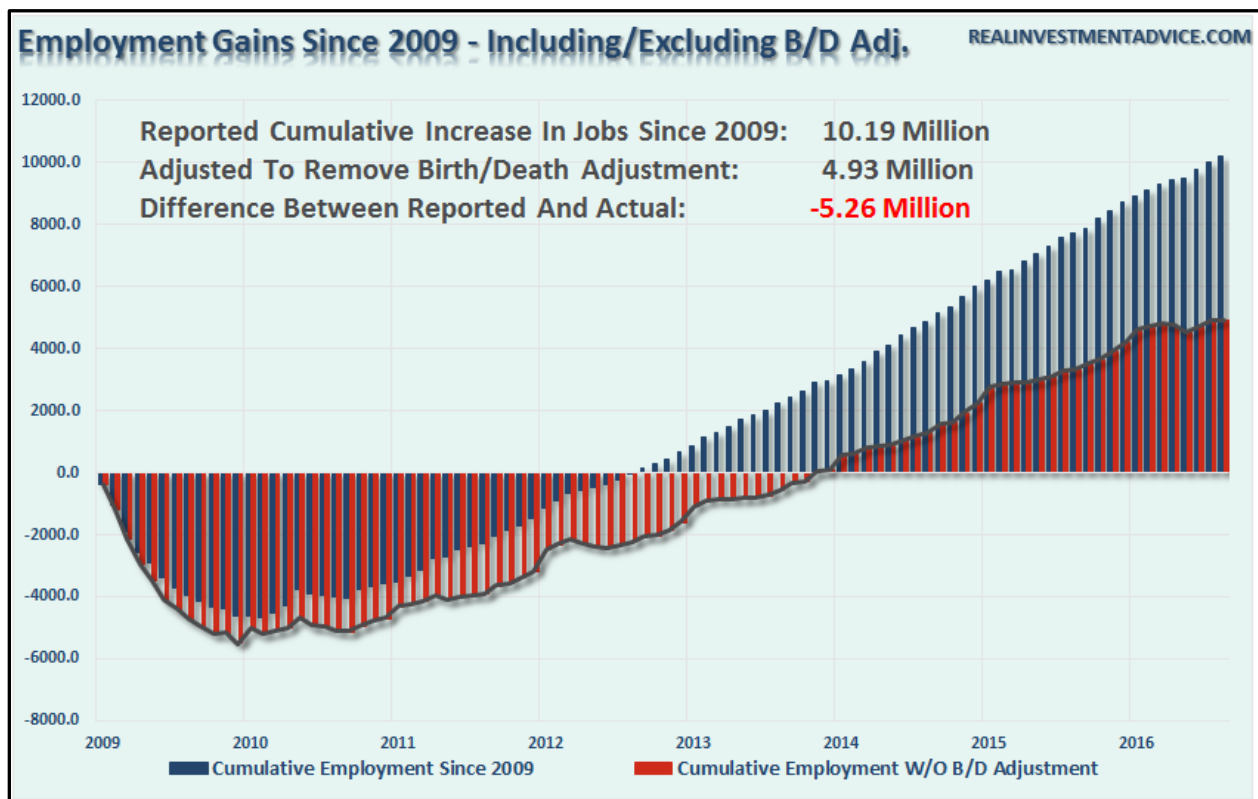


If one believes that the laws of supply and demand continue to hold true, then the revised Phillips curve graph above argues that the unemployment rate is in reality much closer to 9% than 4.1%. To believe that the Phillips curve is useless, one must be willing to ignore a more rigorous assessment of labor market and wage data. The only reason economists and Fed officials voluntarily ignore this data is that it belies the prettier picture of the economy they wish to paint.

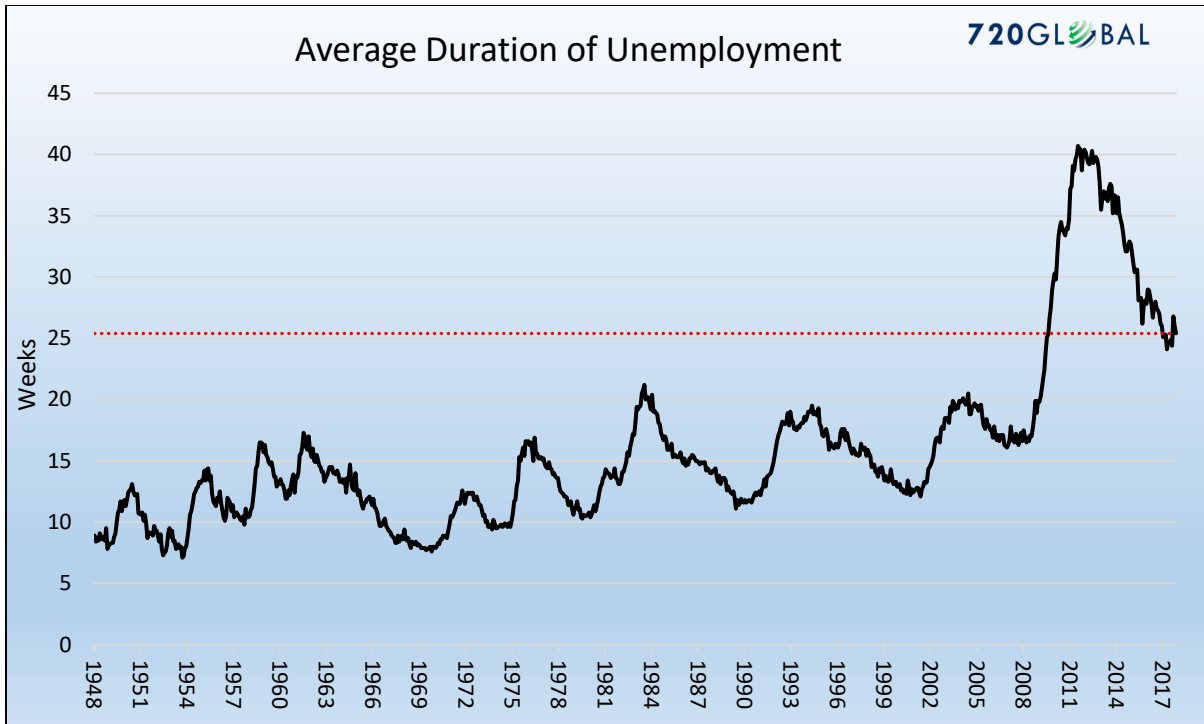
Supporting Graphs

The analysis thus far presents one side of the employment picture. The following graphs show various aspects of the labor force that further question the so-called strength and historically low unemployment rate.

- The BLS adds roughly 180k jobs each month for what it calls a birth/death adjustment. These are not human births and deaths but the number of jobs resulting from the net formation of new businesses. The problem, as Lance Roberts points out in his article, *Business Insider Unwittingly Exposes BLS Employment Error*, is it is quite likely that, since 2008, there are more firms dissolving than forming. As such the birth/death adjustment should actually be a negative number. The graph below from Lance's article removes the birth/death adjustment from the cumulative number of jobs created since 2009. If one subtracts the 5.26 million jobs added due to the birth/death adjustment, the unemployment rate would be 7.40%.

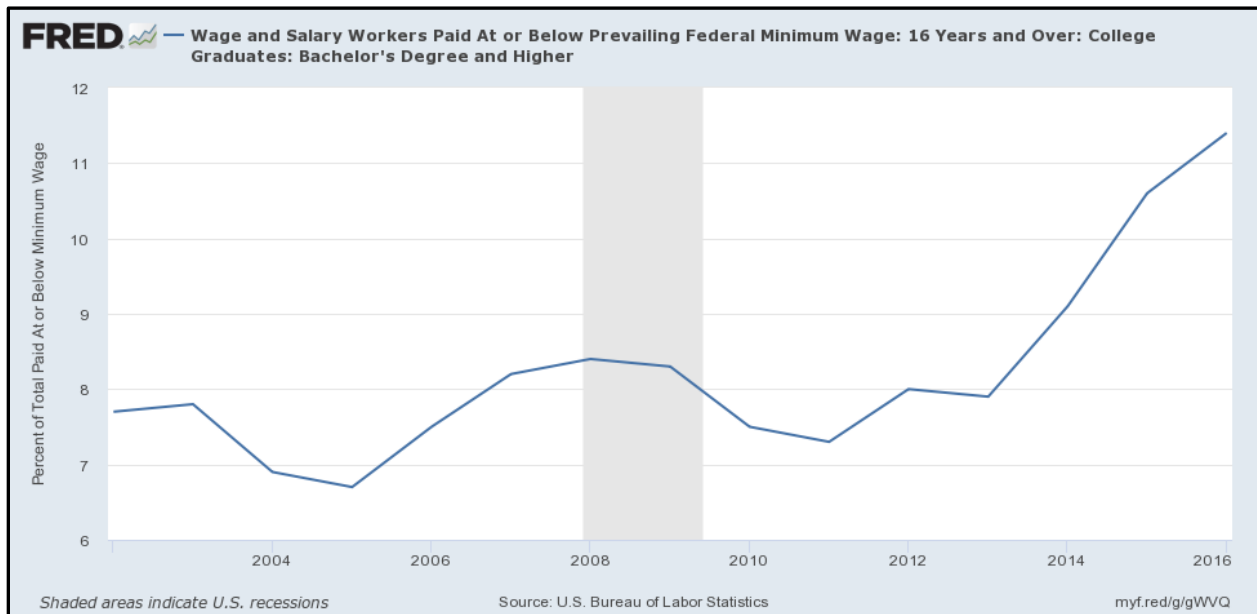


- The next graph plots the average duration of unemployment. This provides an indication of how hard it is to find a job once unemployed. Currently, it is well off of the highs of the last recession, but it still remains well above the worst levels hit in the depths of every recession since 1950.



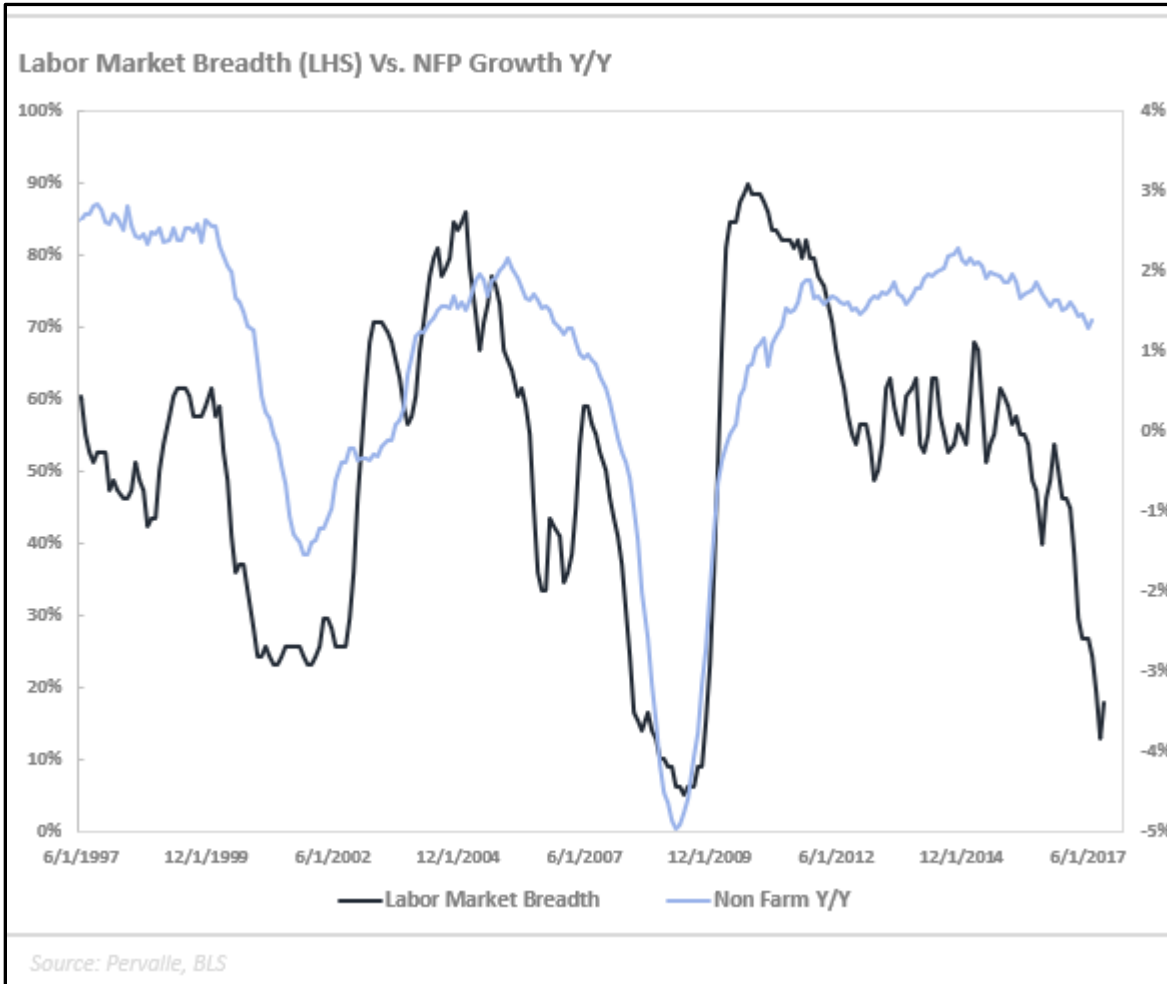
Data Courtesy: Bureau of Labor Statistics

- The graph below shows workers with a college degree earning a wage that is below the national minimum wage. The rising trend since 2012 is concerning and suggests college graduates are increasingly turning to low-wage jobs to maintain employment. When over-qualified individuals resort to these tactics, it likely is not a sign of a strong labor market.



- We end with a telling graph from Teddy Vallee (www.pervalle.com). Teddy created a proprietary index that uses 27 factors to quantify the health of the labor market. His graph

below compares this index to the growth of payrolls. Over the past two years, Teddy's breadth indicator has weakened to levels that are on par with the depths of the prior two recessions. If his index continues to provide an accurate assessment of labor market conditions, one should shortly expect a period in which the number of jobs declines by 3-4% annually.



Summary

One of the reasons the Federal Reserve has been raising interest rates and is forecasting that it will continue to do so is the perceived low level of unemployment. Simultaneously, multiple comments from Fed officials suggest they are justifiably confused by some of the signals emanating from the jobs data. As we have argued in the past, the current monetary policy experiment has short-circuited the economy's traditional traffic signals. None of these signals is more important than employment. Logic and evidence argues that, despite the self-congratulations of central bankers, good wage-paying jobs are not as plentiful as advertised and the embedded risks in the economy are higher. We must consider the effects that these sequences of policy error might have on the economy – one where growth remains anemic and jobs deceptively elusive.

Given that wages translate directly to personal consumption, a reliable interpretation of employment data has never been more important. Oddly enough, it appears as though that interpretation has never been more misleading. If we are correct that employment is weak, then future rate hikes and the planned reduction in the Fed's balance sheet will begin to reveal this weakness rather soon.

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