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What We Think……

Employment, Housing and the Fed

I had been planning to write about employment for this quarter's commentary for some time, so how appropriate that Fed Chairman Bernanke decided to offer up some thoughts for us to chew on. With his prescient speech on *Recent Developments in the Labor Market*[1] on March 26th, Bernanke provides immediate context for his views on the labor markets and Fed policy. We don't necessarily agree with Bernanke's conclusions, but we think he makes it abundantly clear that the fortunes of the U.S. labour markets will be central to his Fed's monetary policy over the next while. Furthermore, we think central bank policy elsewhere will find it necessary to be sensitive to employment, even those central banks that do not have the Fed's explicit employment objectives.[2]

Following the *Great Recession*, developed economies globally have experienced sub-par recoveries when measured against past recessions. A main problem following the recession has been the inability of developed economies to rebound through job creation, especially given the vast number of job losses following the downturn. (Figure 1 shows developed countries with the highest job losses per worker.) In addition to job losses there has been a significant problem of underemployment as workers have been forced to work part-time or take on lesser paying jobs just to make ends meet. Also, the duration of unemployment has increased, and we have seen increasing numbers of workers electing to leave the labour force. This has been particularly acute amongst youth who in many cases have chosen to avoid the workforce altogether, and in some cases deciding to go back to school (despite the apparent mismatch between qualifications and jobs). As Figure 2 shows, youth participation rates have decreased just as youth unemployment rates have increased. The U.S. and a majority of European countries have been at the centre of these labour market woes, although the U.S. situation has recently shown some, albeit in our opinion unconvincing, signs of improvement.

Figure 1 – Highest Job Losses Per Worker During The Great Recession In The OECD

	Job Losses (000's)	Recession Q1/08-Q4/09	Recovery Q4/09-Q4/11
Denmark	95	-3.4%	-0.7%
Estonia	76	-11.6%	5.2%
Finland	66	-2.7%	2.0%
Iceland	8	-4.3%	-0.8%
Ireland	247	-11.6%	-3.7%
Portugal	162	-3.1%	n/a
Spain	1,756	-8.6%	-4.1%
United States	6,031	-4.2%	1.5%
Reliable data for France unavailable			

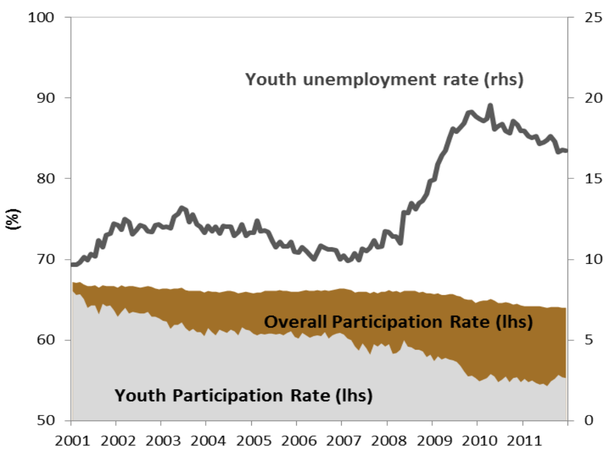
Source: OECD, OECD.Stats.

Non-farm payrolls in the U.S. have increased by an average of 158,000 jobs per month over the last year to March, and 212,000 over the last three months. However, looking back over the last two years, the U.S. economy experienced similar increases at the beginning of the year, only to be subsequently disappointed as job growth stagnated through the spring and summer. In hindsight, it is perhaps not surprising that labour market improvements have coincided with the general improvement in consumer confidence which has followed capital market rallies. Unfortunately, these capital market

[1] Speech delivered at the National Association for Business Economics Annual Conference, Washington DC; March 26, 2012.
[2] The Fed is unique in its dual mandate, the Monetary Policy Objectives, Federal Reserve Act: The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

rallies have not demonstrated any kind of lasting durability, and in hindsight have been largely engineered by the Fed in concert with the obliging *risk-on/risk-off crowd*. (Note that equity trading volumes during the most recent rally have been low in comparison with previous rallies, consistent with a large proportion of high frequency speculative "*risk-on/risk-off*" trading.)

Figure 2 – U.S. Youth Unemployment And Workforce Participation



Source: Bureau of Labour Statistics, Bloomberg & Lorica Investment Counsel Inc.

In 2008-2009 some 8.7 million jobs were lost in the U.S., with the biggest losses coming from the and manufacturing, construction, trade transportation utilities, and professional and business services sectors. (On a percentage basis, the biggest losses were from construction and manufacturing.) Since the beginning of 2010, professional and business services, and manufacturing have added about 1 million and 350,000 new jobs respectively. Sadly, over the same period, an additional 350,000 new jobs have been lost in construction. Since 2008, residential construction has accounted for 1.1 million job losses with virtually no net jobs created last year and a net loss of another 82,000 so far this year. Of course, these numbers only take into account actual construction jobs and do not include:

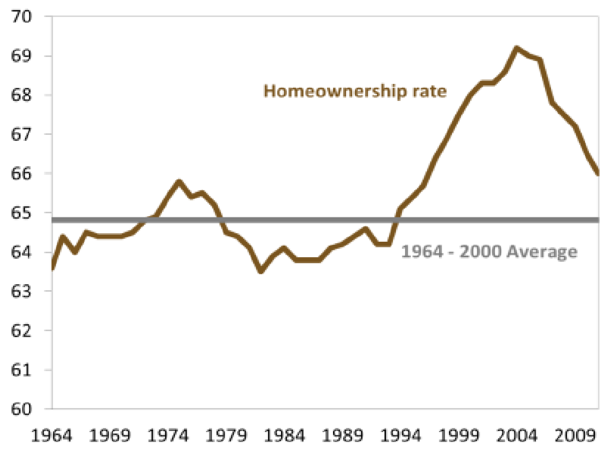
i. Other housing related jobs such as legal and brokerage service, furniture and electronic sales, etc.;
ii. The number of jobs lost between April 2006 and 2008, following the slowdown in home building yet before the broader recession; and
iii. The number of jobs lost but not accounted for due to illegal employment.

U.S. Residential Construction

Employment Fortunately for U.S. labour markets there have been some gains in construction employment, related to the growth in demand for rental units, and the corresponding inadequate stock of those units. According to the most recent new residential construction statistics[1] released in March, there are 233,000 multi-family units (of 5 units or more) under construction – a 100% increase from the previous year. However, studies conducted by the National Association of Homebuilders[1] indicate that construction of an average new single family home will generate 3.1 jobs compared with 1.2 jobs for an average new multi-family rental unit. Of course, the number of occupants per unit in a multi-family residence is lower, but even making adjustments for this fact, leaves less potential for job creation resulting from rental demand. There has been much discussion of the conversion of some of the stock of unsold and more specifically foreclosed homes into rental properties, but this appears to be a difficult process, that will not likely have much of an impact on house prices or new rental construction.

For most readers, the decline of the U.S. housing sector is old news: we all know that the inventory of unsold homes is still very high – 6.4 months, and the pipeline of foreclosures is similarly still high – estimated at 7.5 million homes. However, there still seems to be a *disconnect* between the expectations for future jobs gains and the state of the housing sector.

Figure 3 – U.S. Home Ownership Rate



Source: U.S. Census Bureau & Lorica Investment Counsel Inc.

During the residential construction boom of the previous decade, job growth in the U.S. was concentrated in several areas – housing, health care and financial services. In the boom period from 2003 to 2006, housing related employment represented 17% of job growth while only representing just over 2% of all employment. The movement of labour into housing related sectors was consistent with the growth of home ownership during the period. However, the growth in home ownership was not consistent with historical averages (see Figure 3); and with hindsight had more to do with cheap financing, surreptitious government policy, and negligent consumer behaviour, then any lasting structural change in housing demand. In the end, housing growth was borrowing from the future and from the rental market, while distorting housing-related employment. Today, U.S. home ownership is falling back to it's historical average as households on the margin of home-ownership wherewithal gravitate towards renting as a preferred option. (Rental vacancy rates have slipped from 11.1% in Q3/09 to 9.4% in Q4/11.) It is worthwhile asking what the implications for employment are, especially as it relates to housing.

Consistent with the Fed's bid for transparency, Bernanke is clear as to where he stands on the employment recovery: "*... while both cyclical and structural forces have doubtless contributed to the increase in long-term unemployment, the continued weakness in aggregate demand is likely the predominant factor.*" Furthermore, Bernanke makes the point that "*… further significant improvements in the unemployment rate will likely require a more-rapid expansion of production and demand from consumers and businesses, a process that can be supported by continued accom-modative policies."* We find merit in Bernanke's assessment of the importance of cyclical forces on employment, but we feel a recovery in aggregate demand is no simple matter. Notwithstanding our contentions, what is most important is that Bernanke believes the main cause is aggregate demand and sees accommodative policy as the necessary antidote.

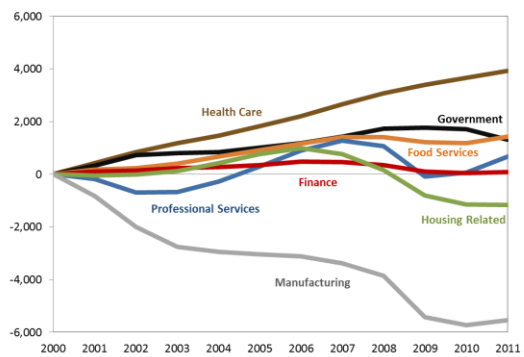
The Chairman sites some recent studies to support his analysis – notably Aaronson et al.[3], "What is behind the Rise in Long-Term Unemployment?" and the OECD's *Employment Outlook 2011*[4]. Our reading of this and other research is that the emphasis

[3] Daniel Aaronson, Bhashkar Mazumder, and Shani Schechter (2010), "What Is behind the Rise in Long-Term Unemployment?" Federal Reserve Bank of Chicago, *EconomicPerspectives*, vol. 34 (2), pp. 28-51, www.chicagofed.org/digital_assets/publications/economic_perspectives/2010/2qtr2010_part1_aaronson_mazumder_schechter.pdf.

[4] Organisation for Economic Co-operation and Development (2011), *OECD Employment Outlook 2011,* www.oecd.org/employment/outlook

seems to be on the distinction between the cyclical and structural nature of the job losses.

U.S. Employment Growth In Select Sectors (2000-2011)



Source: Bureau of Labour Statistics & Lorica Investment Counsel Inc.

The above graph shows the change in employment by sector over the last decade. Clearly manufacturing has been on a steady decline with only health care, food services and the government providing significant offsetting growth. Unfortunately, in many cases, the loss of well-paid manufacturing jobs has been met with the gain of low-paid food service jobs. Housing related employment has not yet rebounded from the housing bust, but new multifamily construction should provide some lift.

Conventionally, structural imbalances are thought to relate to demographic changes such as ageing and female participation, skills mismatch or behavioural effects from changes to unemployment compensation. The research suggests that the structural factors listed above are only slightly responsible, collectively on the order of 0.5-1.5%[5], for higher unemployment.

While for the moment, cyclical forces may be the overriding factor suspending employment growth, we are doubtful that aggregate demand can easily be increased to offset the significant numbers of unemployed in the U.S. – now numbering 12.7 million (22.8 million if you include involuntary part-time and marginally attached workers). We believe aggregate demand is in the process of structural change – the housing market, which drove much of the excess demand in the last decade, will not likely drive the same kind of broad based demand today; and hence it will take time for the labour force to adjust.

Unemployment is not just a problem in the U.S. In a recent report, McKinsey&Company estimate that 40 million people are out of work in advanced economies around the world, and "*tens of millions more … are underemployed or have become discouraged and dropped out of the labor force.*"[6] Unfortunately for the unemployed, the response of governments in advanced economies has generally lacked direction and conviction. In Europe, countries have been facing the *double whammy* of inadequate employment growth and sovereign debt problems (persistent budget deficits have led to unwieldy debt burdens). Because of the gravity of the Eurozone debt problems, many member countries have been forced into austerity programs with feint attention to growth. Austerity has only aggravated cyclical unemployment, which some see as dangerously morphing into structural employment issues. While the U.S. has not yet headed down the path of

[5] Barnichon, Regis, Michael Elsby, Bart Hobijn and Ayşegül Şahin (2010), "Which Industries are Shifting the Beveridge Curve?" *FRB SF Working Paper 2010-32*.

[6] McKinsey Global Institute (March 2012), "Help wanted: The future of work in advanced economies", Discussion paper, www.mckinsey.com/mgi

austerity, one cannot help but wonder how long politicians and creditors can choose to ignore its massive debt burden. It is also worth pondering if policy-makers implementing opposed solutions to essentially the same set of problems can both be right.

The Canadian Employment Mystery

Once again Statistics Canada has provided us with much to think about in the way of Canada's employment situation. Just when we were really getting concerned as to the direction of job growth, March's blockbuster numbers were released – the best in three years! We have long known that one can only look at moving averages where StatsCan employment data is concerned, but nevertheless, with the weakening trade balance and the headlines surrounding RIM, and its layoffs, top-of-mind, we got lulled into watching the high frequency numbers. In all probability, the bounce to the data seen in the U.S. for January and February is showing up in Canada's March numbers. Ultimately, employment is likely not as bad as we were thinking (averaged 2,900 for the six months to February), but also not as good as what we saw in March (82,300).

While the employment situation in the U.S. has shown some signs of improvement, we expect this improvement to continue to be uneven, influenced by the changing nature of aggregate demand, policy intervention, and structural changes. For the time being, we don't expect U.S. fiscal policy to take on much direction; but we are skeptical that changes can be avoided for ever. Unfortunately for Bernanke, for the time being solving unemployment has been left mostly to the Fed. Consequently, we expect monetary policy to remain supportive of low government bond yields and "*risk-on*" assets – importantly credit markets for bond investors. We are however cautious, heading into the fall as we feel that November's election has the potential for dramatic impact on government spending and taxation, and possibly the Fed itself.

While Europe has largely plotted its path, we expect the resolve of government and populace to be tested as employment and economic growth continue to struggle. The ECB, which prides itself on its *inflation-fighting* credentials, will find it difficult to ignore the employment issues in the economies facing tough austerity measures, and hence will be compelled to endorse more accommodative policies. As for the Bank of Canada, Governor Carney will stay safely on the sidelines (giving him time to focus on the FSB) as employment growth remains uncertain.

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