Weekly Economic Commentary

August 4, 2014

Reconnected?

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Highlights

With the release of the GDP figures for the second quarter of 2014 (along with revisions to the data back to 1999), the disconnect appears to be fading.

The data released so far for the third quarter suggest that the underlying economy had decent momentum as the third quarter began.

The data continue to suggest that the U.S. economy is poised to post growth in the second half of 2014 above the long-term run rate of the economy.

With plenty of slack still in the labor market, in our view, the Fed is not likely to begin raising rates until late 2015, or even early 2016.

ISM noted that if the manufacturing index remained at 57.1 over the final two months of the third quarter, it would be consistent with 4.6% GDP growth.

Recently, we wrote about the potential disconnect between the weak performance of the economy as measured by gross domestic product (GDP) in the first quarter of 2014 and the run of strong economic data for April, May, and June 2014. On balance, the economic data released in recent weeks for July 2014 continued to meet or exceed analysts' expectations, including data released last week (July 28–August 1, 2014) on second quarter GDP, July employment, and the July readings on the Institute for Supply Management's (ISM) manufacturing survey and vehicle sales. In this week's commentary, we'll examine whether or not a reconnect has occurred and also revisit Federal Reserve (Fed) Chair Yellen's labor market dashboard in the wake of the release of the July 2014 Employment Situation report as Fed officials prepare for the Kansas City Fed's Monetary Policy Symposium at Jackson Hole, WY on August 21–23, 2014.

Disconnect Reconnected?

In our July 7, 2014 *Weekly Economic Commentary,* we posed the question:

> The rapid improvement in the labor market, and in other economic data reported over the past several months, is at odds with the 2.9% decline in gross domestic product (GDP) in the first quarter of 2014. Which is correct?

With the release of the GDP figures for the second quarter of 2014 (along with revisions to the data back to 1999) the disconnect appears to be fading, and the data released so far for the third quarter (vehicle sales, ISM, initial claims, employment, vehicle sales, etc.) suggest that the underlying economy had decent momentum as the third quarter began. Inflation-adjusted GDP rose at a 4.0% annualized rate in the second quarter of 2014, and the revised data show that GDP growth was 3.5% or higher in three of the past four quarters dating back to the third quarter of 2013; the exception was the 2.1% decline in GDP in the first quarter of 2014, which now looks even more like a weather-related outlier. The readings from the ISM manufacturing report corroborate the strength seen in the GDP report.

The July 2014 reading on the ISM was 57.1, well above the consensus expectation (56), and also well above 50. A reading above 50 on the ISM indicates that the manufacturing sector is expanding, while a reading below 50 signals that the manufacturing economy is contracting. Additionally, a reading above 43.2 on the ISM suggests that the overall economy is expanding. In a comment accompanying the report, ISM noted that the average year-to-date

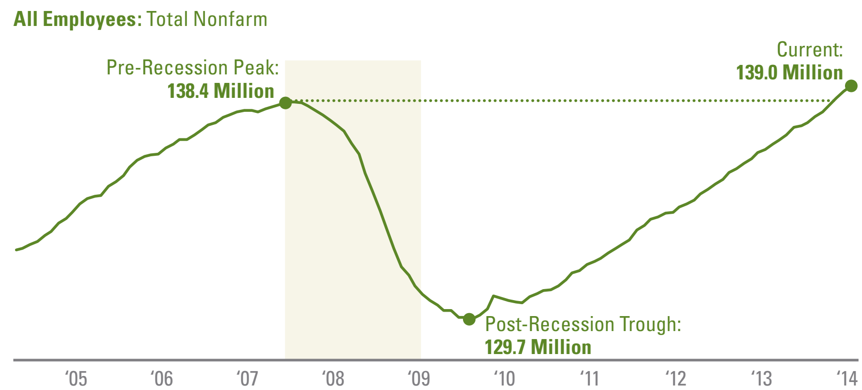
A Closer Look: Participation Rate

- For years, the labor force participation rate has been an afterthought in the monthly employment report and received little attention from the market, the media, the public, or political pundits. Although the market continues to largely ignore the number, it gets a lot of attention each month from the other groups noted above. The participation rate (62.9% in July 2014) is calculated by dividing the labor force (156.0 million in July 2014) by the civilian population over the age of 16 (248.0 million in July 2014). This metric ran up sharply between the early 1960s (58%) and early 1990s (67%), when women entered the labor force like never before. The participation rate among women aged 20 and over was around 37% in the early 1960s, but by the early 1990s, it was close to 60%. The overall participation rate plateaued in the 1990s, peaked at just over 67% in the early 2000s, and has been falling ever since.
- According to the nonpartisan Congressional Budget Office (CBO), the sluggish economy, demographic trends, and the unusual nature of this recovery account for the three percentage point drop in the participation rate since 2007, with the aging of the population accounting for half of the drop. The oldest baby boomers began turning 65 in 2011. The participation rate of people 65 and above is less than 20%, so as a greater portion of the population turns 65, the participation rate will continue to decline. Indeed, the CBO projects the participation rate will continue to decline over the next 10 years (albeit at a slower pace than over the past few years) and hit 60.8% by 2024.

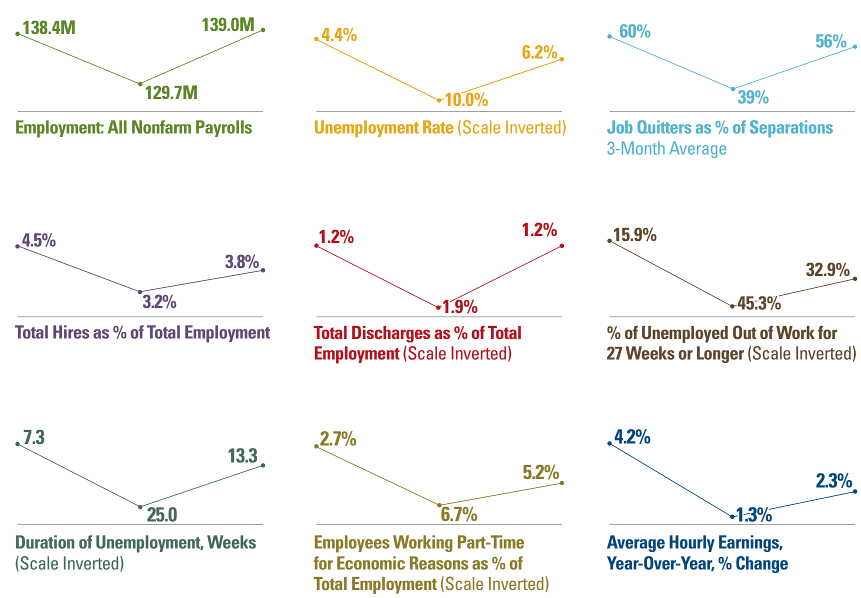
reading on the ISM (54.4) is consistent with real GDP growth of 3.7%. ISM also noted that if the index remained at 57.1 over the final two months of the third quarter, it would be consistent with 4.6% GDP growth.

Another piece of the disconnect had been the tepid pace of job growth in late 2013 and early 2014, which we chalked up to the poor weather, while others suggested it was a sign of overall weakness in the economy. The July 2014 Employment Situation report (released on Friday, August 1, 2014) helped to resolve the disconnect and supported our view. During

The Labor Market Is on the Mend, but Not "Back to Normal"



The peak/trough/current pattern exhibited by various measures of the health of the labor market are all telling the same story:



Source: BLS, Haver Analytics 08/03/14

Shaded area indicates recession.

Note: The time frame for all charts is the last 10 years: 2004–14.

For more details about Janet Yellen's labor market indicators, please see our *Weekly Economic Commentary: Janet Yellen's Employment Report* from March 3, 2014.

the harsh winter of 2013–2014 (December 2013 through March 2014), the economy added an average of just 163,000 net new jobs per month. As the weather normalized in the spring and early summer of 2014, job growth accelerated to 260,000 per month for the four months ending in July 2014. The economy has now generated job growth of 200,000 or more per month over the past six months, the longest stretch of 200,000+ monthly job gains since 1997, when the economy was growing at nearly 4.5% (please see our *Weekly Economic Commentary—FOMC: Need to Know* from June 16, 2014 for more details).

In addition to job growth, the July 2014 Employment Situation report also provided an update on the unemployment rate. The unemployment rate ticked up to 6.2% in July 2014 from 6.1% in June 2014, but has declined by 1.1 percentage points over the past year—and is nearly four percentage points below its cycle high of 10.0% in 2010. We viewed that July 2014 jobs report as a "payback for the payback"—a pause in the labor market after a strong run of reports in the spring and early summer after the unusually harsh winter of 2013–14.

On balance, the reports released last week all but confirmed that the 2.1% drop in GDP in the first quarter was an aberration due to severe weather. Looking ahead, the data in hand continue to suggest that the U.S. economy is poised to post growth in the second half of 2014 above the long-term run rate of the economy.

The Yellen Dashboard

Earlier this year—in testimony before the Senate Banking Committee, in her post-Federal Open Market Committee (FOMC) press conferences in March and June 2014, in testimony before the Joint Economic Committee (JEC) of Congress, and in other public appearances—Fed Chair Yellen has mentioned several labor market indexes that she and other FOMC members are watching closely.

The infographic on page 2 details the performance of nine key labor market metrics mentioned by Yellen in these recent public appearances. As we have noted in recent months in this publication, although most metrics have partially recovered from their Great Recession nadirs, only a few have returned to "normal." Until they do—or at least until they make significant progress toward normal—markets should expect that the Fed will be content with keeping its fed funds rate target near zero. In our view, the Fed is not likely to begin raising rates until late 2015, or even early 2016. ■

A Closer Look: Labor Market Surveys

- A survey of 60,000 households nationwide — an incredibly large sample size for a national survey — generates the data set used to calculate the unemployment rate, the size of the labor force, part-time and full-time employment, the reasons for and duration of unemployment, and employment status by age, educational attainment, and race. The "household survey" has been conducted essentially the same way since 1940, and although it has been "modified" over the years, the basic framework of the data set has stayed the same. The last major modification to the data set (and to how the data are collected) came in 1994. To put a sample size of 60,000 households into perspective, nationwide polling firms typically poll around 1,000 people for their opinion on presidential races.
- The headline unemployment rate (6.2% in July 2014) is calculated by dividing the number of unemployed (9.7 million in July 2014) by the number of people in the labor force (156.0 million). The civilian population over the age of 16 stood at 248.0 million in July 2014. A person is identified as being part of the labor force if they are over 16, have a job (employed), or do not have a job (unemployed) but are actively looking for work. A person is not in the labor force if they are neither employed nor unemployed. This category includes retired persons, students, those taking care of children or other family members, and others who are neither working nor seeking work.
- In July 2014, the labor force was 156.0 million, which consisted of 146.3 million employed people and 9.7 million unemployed people. Another 92.0 million people over the age of 16 were classified as not in the labor force. The 156.0 million people in the labor force plus the 92.0 million people not in the labor force is equal to the over-16 civilian population, 248.0 million.
- The payroll job count data are culled from a survey of 440,000 business establishments across the country. The sample includes about 141,000 businesses and government agencies, which covers approximately 486,000 individual worksites drawn from a sampling frame of Unemployment Insurance (UI) tax accounts covering roughly 9 million establishments. The sample includes approximately one-third of all nonfarm payroll employees. From these data, a large number of employment, hours, and earnings series in considerable industry and geographic detail are prepared and published each month.