



July 12, 2011

HIGHLIGHTS

- U.S. employment growth slowed to a crawl in June of this year with just 18,000 jobs created.
- The extent of the disappointment has led to some speculation that the number may be misrepresenting the true state of the U.S. labor market.
- This notion is supported by the fact that the seasonal adjustment factor in the June data was large relative to history.
- We caution against reading too much into one month's data, but find little reason to doubt the Bureau of Labor Statistic's estimate.
- Looking at a broader range of indicators the trend pace of job growth over the first half of 2011 is entirely consistent with economic performance.
- The bottom line is that with only 2.0% real GDP growth it is difficult to get much traction in the job market. Fortunately, the tide does appear to be turning.
- A return to trend growth of around 3.0% in the second half of this year should allow job growth to average 200,000 per month.

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U.S. JOB MACHINE NEEDS FASTER ECONOMIC GROWTH

The U.S. payrolls report for June came in with an audible thud. With just 18,000 created in a job-market of 130 million, job growth effectively came to a halt in the month. The disappointment has led to market chatter that the number reported by the Bureau of Labor Statistics may have understated the true strength of the U.S. job market. This notion is based in part on the observation that the seasonal adjustment factor in June was unusually large relative to history.

There is always need for caution in interpreting monthly data, especially before revisions. However, there is little reason to believe that the BLS is vastly misrepresenting the underlying pace of job growth in the U.S. economy.

Over the first half of the year, job growth averaged 126K per month, entirely consistent with a U.S. economy that grew at around 2%.

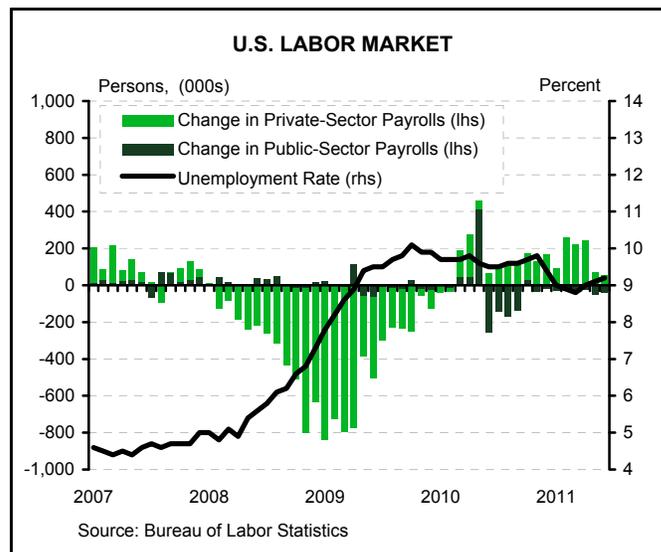
The bottom line is an intuitive one: faster job growth will require faster economic growth. As temporary factors ease, economic growth should move closer to 3.0% over the second half of this year, enough to support job growth of around 200,000 per month.

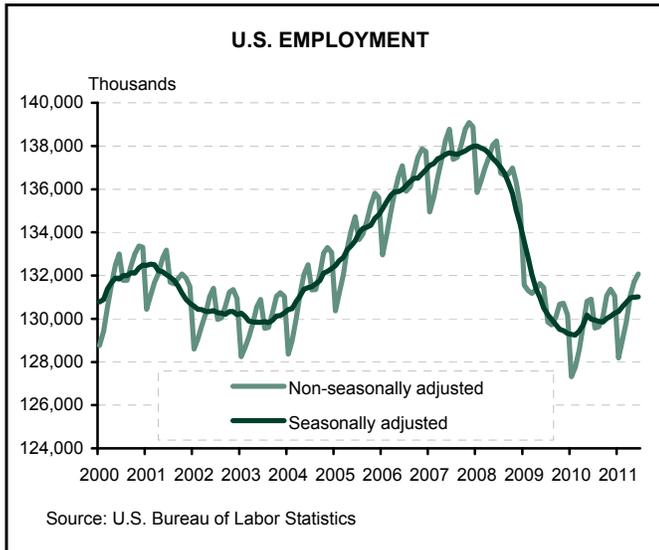
Seasonal adjustment: what else is new?

The removal of seasonal patterns from economic data is a source of constant debate among economists and market analysts. Few argue about the necessity for seasonal adjustment, but the reliance on historical patterns to generate the adjustment makes it a constant source of uncertainty.

So, it was little surprise that following the release of the June payrolls report, stories began to appear that an unusually large seasonal adjustment factor may have played a role in the weakness in the headline number. The seasonal adjustment factor is the difference between the raw employment data and the headline seasonally-adjusted number. The controversy comes from the fact that in June of 2011, the seasonal adjustment factor was 1.06 million, while in June 2010 it was 927,000. The difference between the two – 135,000 – implies that if the BLS had used last year's seasonal factor, total job growth would have been 153,000 instead of 18,000.

Game, set, match? Not quite. Just because the seasonal factor was lower last





year than this year, does not mean that the seasonal factor this year is misrepresenting the data. Some seasonal patterns are relatively easy to correct, but irregular changes in holidays, weather, pay periods or production schedules can lead seasonal factors to differ considerably from year to year. The methodology employed by the BLS takes into account both regular seasonal patterns and these irregular patterns.

There is little reason to suspect a major error in the BLS calculations this time around. While the swing factor between 2010 and 2011 is somewhat large relative to history, comparing the June 2011 factor to the average over the last 10 years reveals a difference of only 16,000 for total non-farm employment. Moreover, the stronger seasonal factors over the past three months offset weaker factors in the first three months of the year. Taking the raw unadjusted numbers for the first six months as a whole and applying last year's seasonal adjustment factors (instead of this year's), results in a difference of just 13,000.

The lesson is that reading too much into a single month of data can be hazardous. While May and June were particularly weak, they followed very strong job growth from February through April. There is a tendency to regard the job data as a momentum indicator, but the regular margin of error on any single estimate is around 100,000, 9 times out of 10. If some market pundits are speculating that May and June were distorted down, the opposite may be true in the previous months. Looking at the data over a slightly longer horizon, allows the seasonal pattern to net-out with roughly the same year-to-date tally.

What are other indicators telling us about job growth?

Another important consideration when looking at the

trend in job growth is whether it is out of line with what other economic data are telling us. Certainly, one of the reasons that payrolls fell short of expectations was that the ADP report – a private estimate of private-sector job growth – came in at 157,000, a whole 100,000 above the actual reported number. Unfortunately, as forecasters have come to recognize, the ADP has been a hit-and-miss indicator of monthly job growth.

Other monthly indicators have certainly not created the impression that the job market is busting at the seams. Indeed, from weekly jobless claims, to consumer confidence, to the employment sub-indexes of the ISM reports, the best anyone could say is that we are in a holding pattern, with trend growth too weak to bring down the unemployment rate.

All of this comes back to the point that economic growth has been underwhelming in the first half of 2011. Real GDP expanded by 1.9% in the first quarter and is on track to record a similar pace in the second quarter. With the slowdown in May and June, employment growth over this same period has averaged 1.2%. Changes in productivity growth can lead to a divergence with job growth, but in fact job creation in the first half of the year reflects a significant slowdown in productivity. The bottom line is that stronger job growth will require stronger economic growth.

Bottom Line

In conclusion, there are good reasons for using seasonally adjusted data to determine the underlying trend in job growth. While the use of historical data to parse out the trend from the seasonal pattern can sometimes lead to errors, there is little evidence that the seasonally adjusted data is giving an incorrect picture of the underlying pace of U.S. job growth.

Given the inherent uncertainty of monthly estimates, the lesson should be to take a step back and gauge whether the number is consistent with the underlying pace of economic growth. Smoothing over the monthly volatility, we must concede that it is. The real disappointment in the first half of the year was that real GDP grew by just 2.0%.

Fortunately, there are signs that a turn in economic growth is just around the corner. Consumer wallets have been fattened by falling energy prices, auto manufacturers have indicated a run up in production levels, and supply shortages have been alleviated. Despite the setback in June, we continue to expect economic growth of just over 3.0% over the second half of the year and employment growth to average roughly 200,000 per month.



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