

Riding momentum

Crummy US jobs reading spooks markets, but momentum pushes recovery!

July 8, 2011 – The American wealth-creation machine appears to be stuck in low gear. If you were to draw any conclusions from the latest job numbers, you might even say it is about to stall!

The US economy created 18,000 new jobs in June. Read that again! The miserable new jobs tally comes on the heels of a downwardly revised 25,000 new jobs in May, or less than half of what had initially been reported. Making one wonder if the June numbers will eventually see their own downward revision?

Clearly the US economy has problems. The unemployment rate ticked up to 9.2%, a worrying prospect for the Federal Reserve Board (Fed) and its Chairman Ben Bernanke. Besides price stability, the Fed is also responsible for helping the economy attain “full employment,” which Mr. Bernanke recently defined as an unemployment rate of 5.5%. We are a long way from attaining that number.

Of greater concern to investors was the fact that the job creation number was not even close to consensus. Economists had pegged the number somewhere between 100,000 and 120,000. It caught everyone off guard and explains why stocks stumbled out of the gate on Friday.

Chart 1 – YTD performance S&P 500 Composite Index



That stocks recovered more than half their early losses by day’s end, can be credited to the momentum-driven euphoria that has gripped investors since the middle of June (see Chart 1).

You can be excused for wondering why stocks have performed so well during what appears to be a very soft patch, or possibly the beginning of a double dip, for the US economy.

Certainly as we said, momentum is one driver of the current rally. But it may be more than just that.

Seasoned investors know that job growth, particularly within the private sector, is a lagging indicator. Which means that a double dip in the jobs market does not necessarily translate into a double dip in GDP growth.

For example, while the US labor market is stalled, manufacturing continues to expand. The Institute for Supply Management's June manufacturing purchasing managers index (PMI) rose to 55.3%, up from 53.5% in May. According to the ISM, the US economy has now been expanding for 25 consecutive months. More importantly, June's manufacturing index corresponds to 4.5% annualized increase in gross domestic product. While that number is down from the 5.7% annualized GDP growth assumptions in the first half of the year, it is still a very healthy number.

If you buy into that thesis, then jobs will follow. The key dynamic here is private sector job creation. What US investors have been seeing in the last few months is significant job losses in the public sector. Particularly among state and municipal governments that have been downsizing, or as some might say...right-sizing!

While the loss of public sector jobs has a short-term negative effect on job creation, it is not nearly as influential to GDP growth as are job losses in the private sector. The problem is that it takes time for the private sector to replace lost public sector jobs.

Private sector employers tend to be more realistic when hiring. They base decisions on economics, like having enough revenue to support new hires, rather than well-intentioned political objectives designed to prevent the economy from falling off a cliff. Over time, assuming the economy is growing, you would expect those jobs to re-emerge in the private sector.

In fact according to a recent Reuters poll, economists at top financial institutions expect the US unemployment rate to fall in 2011 and 2012 despite the surprisingly weak June jobs report. As well, it may turn out that the June numbers were a blip. The data certainly did not mesh with the ADP report that came out on Thursday revealing that weekly jobless claims dropped 11,000 (consensus estimates were for a 3,000 decline in claims) to 418,000.

According to www.CNBC.com, the private sector added 157,000 jobs from May to June, well ahead of estimates, though still not enough to make a meaningful dent to the jobs lost in the public sector.

Looking back at this, it may be nothing more than the timing of when data are released, which does not accurately reflect the transition from public sector job losses to private sector job gains. Certainly based on what we saw with the ADP report, one could argue that the shock to the global supply chain from the Japanese earthquake and tsunami in March is just beginning to wane. If so, that could auger well for private sector jobs in the second half of the year. And it would also explain the market's propensity to move higher.

In the interest of full disclosure, we cannot discount the fact that this transition may take longer than previous cycles. If for no other reason than US manufacturers are not clear as to the potential costs associated with health care reform. Within the financial services industry, there are additional concerns about the extent of new regulatory requirements. In short, companies are typically reluctant to hire amidst so much uncertainty.

One could also make the case that US companies are simply operating with greater efficiency and may opt to manage within current employment levels. If so, that would auger well for profit margins and earnings which also could explain the market's rally.

Still, the longer term recovery in US GDP will hinge on the health of the US consumer. And demand from that segment of the economy faces the hurdle of a stubbornly depressed real estate market, which, unlike the wider economy, has undergone a wrenching "double dip." Not to mention an ever-widening global "soft patch," spread even further by growing signs of a slowdown in Chinese growth and the threat of a eurozone debt crack-up that have flattened stock market performance, and taken the edge off that "well-monied" feeling.

Businesses aren't feeling all that well-monied either, and look to be less so going into the second half. With quarterly earnings reports set to be released over the next couple of weeks, indications are that profit growth is about to turn sluggish. A survey by Bloomberg LP showed that earnings per share for companies in the S&P 500 Composite Index are expected to grow 13% in the second quarter, down from 18% growth in the first. And it could get worse if commodity prices remain elevated and the US housing market stays depressed. That troublesome residential real estate will force a continuing focus on household balance sheet repair ("deleveraging") and will keep consumer spending restrained for the second half.

Of course much of this is already priced into the market. Companies have been very cautious about sales and profit guidance. The objective to under-promise and over-deliver seems fitting at a time when market takes a very big pound of flesh out of companies that disappoint. Just ask the management team at Research in Motion. The bottom line is that the second quarter's earnings while sluggish, could still produce some interesting upside surprises.

Another positive for the bulls is that a less-than-buoyant outlook for the next six months means no action by the Fed to raise interest rates until 2012 at the earliest. And it could push the Fed into a QE3 or some version of that, to further stimulate the economy.

Certainly, the end of the latest quantitative easing program has left the US Treasury market in a quandary. After a rally lasting about two and a half months, Treasuries have stalled as investors take a more neutral stance. Yields have crept up after bottoming around 2.85% in late June, with 10-year notes yielding 3.025% at the close of trading on July 8th. With buying support from the Fed now gone, many observers believe it's only a matter of time before the bears emerge and yields rise. For now, US Treasuries remain

bolstered by surging safe-haven demand driven largely by the spectre of a Greek sovereign debt default.

The surprisingly poor new job numbers in the US was enough to halt – temporarily at least – what had appeared to be a decent stock market rally in the making. Too bad, because Canadian companies continued to hire in June, unlike their US counterparts, creating over 28,000 new jobs in the month (so that's 10,000 more jobs than the US with only one tenth of the population).

Nevertheless, Canadian stocks reacted to US events (most of our trade is with the US), and so further rallies in the Canadian market will be dependent on what happens south of the border.

The best that can be said is that markets edged higher recovering ground lost during the May-June mini correction. But don't break open the bubbly yet. A break out above 1365 for the S&P 500 would be a requirement before we could envision the end of a summer of discontent. ■

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