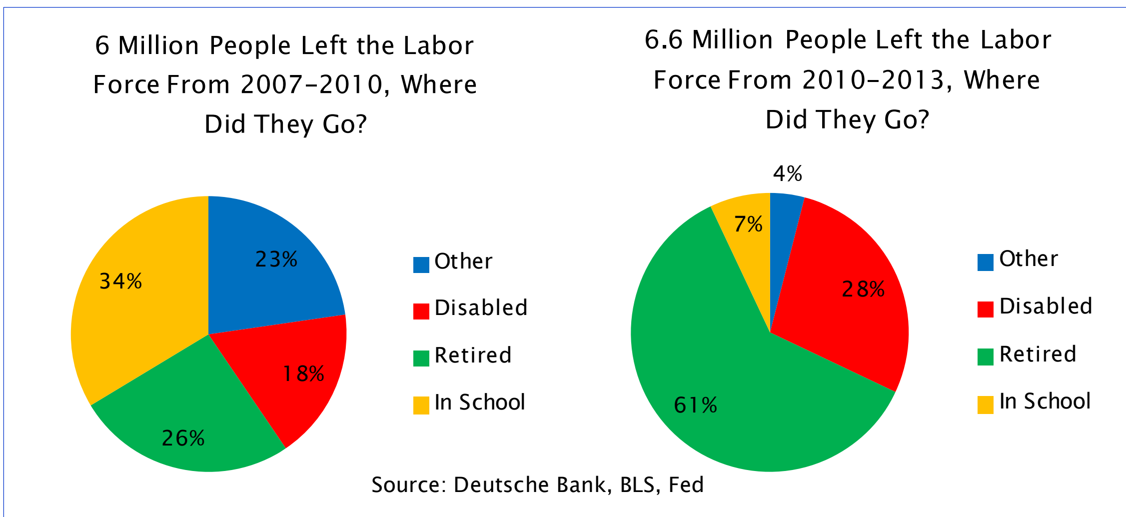
MARCH 2014

INVESTMENT UPDATE

Most measures of the US labor markets have improved significantly over the past five years or so, as companies have been hiring and our economy recovers from the financial crisis. The unemployment rate has fallen from over10% to 6.6% since early 2009, seemingly well on its way to re-tracing the cyclical low reading of 5.0%, which was recorded before the crisis.

These are the headline labor numbers, but, as it turns out, there is much more to this story than these simple measures. And the intricacies of the US labor market are complicating things for policymakers, who have been trying to gauge the real strength of the economy based on economic statistics that might not be as reliable or as useful as they once were.

First, some background. There are two main surveys on which investors and policy-wonks traditionally have relied to judge the health of the US labor markets: The so-called "establishment survey" that measures payrolls, and the "household survey" that measures unemployment. The establishment survey is conducted by the Bureau of Labor Statistics (BLS) and, as its name implies, asks employers (approximately 144,000 employers, covering 554,000 individual worksites in the January survey) about their current and prospective hiring plans. The key number that comes from this monthly survey is the month-to-month net change in non-farm payrolls (NFPs). While NFPs have been averaging gains of approximately 150,000 new jobs over the past few months, keep in mind that this figure is netted out from all the month's firings, retirements, and resignations; this "churn" of people coming and going has been running at approximately 5 million jobs changing hands every month. With millions of workers leaving old jobs and gaining new jobs all the time, it's easy to see how the net NFP figures bounce around each month, and are subject to major revisions.



Source: Deutsche Bank, BLS, Fed

The second survey conducted by the BLS is the household survey, which (again) as its name implies, involves surveying households to determine who is working, who is looking for a job, and who has (for one reason or another) dropped out of the work force. This is the survey that generates the unemployment rate, as well as a host of other important figures that we will discuss later. It is not unusual for the household and establishment surveys, which are released on the same day every month, to show very different results—the just-released February 2014 data showed a stronger-than-expected non-farm payroll gain of 179,000 net new jobs, juxtaposed against a rising unemployment rate of 6.7%. Again, two separate surveys seemingly pointing in two different directions. What gives?

For the answer to that question, we will have to delve a bit into the mathematics of how these numbers are calculated. For the household survey, the data includes a couple of key numbers, including the total size of the US civilian labor force, which has been fairly stable over the past five years at approximately 155 million; this number represents the head-count of all able-bodied adults who are either employed or are actively looking for jobs. While this series has been flat, the population of the country as a whole has been growing over the past five years; that means that the labor force participation rate (LFPR)—the percentage of people who are either working or looking for a job relative to the labor force— has fallen from over 66% pre-crisis to approximately 63% today. In sheer numbers, this means that approximately 12.6 million people have dropped out of the labor force since 2007, a disappointing and somewhat perplexing result for policymakers.

The chart on this page, prepared by Torsten Slok of Deutsche Bank, shows that people dropping out of the labor force have done so for different reasons lately. From 2007-2010, there

was a huge loss of potential workers who chose to stay in (or go back to) school; since 2010, there has been a substantial uptick of people choosing to retire, and many others going on disability. Slok reckons that the increase in retirements is related to the good recent performance of the stock markets, which has boosted personal wealth and the value of older workers' retirement funds to levels where retirement has become an attractive option.

So we see that there are economic and demographic reasons for people to drop out of the labor force; given the aging of the American population, with baby boomers now moving into retirement, we'd expect to see the LFPR decline. Likewise, when the economy turned ugly in 2007-2008, it's no surprise that people decided to stay in, or even go back, to school.

But how about this "disabled" category? What accounts for the three million people added to the disability rolls since 2007? Disability should have nothing to do with the business cycle, should it? Yet over the past 30 years or so, the disability ranks have risen and fallen, with increasing correlation, along with the rate of unemployment. As it turns out, there are demographic and economic factors at work here, too—and political forces as well.

In order to receive unemployment compensation, most states require that recipients be actively engaged in looking for employment. As long as you are trying to get a job (and can prove it by showing job interview appointments and completed employment applications), the state will cut you a check. And these checks have been abundant, as you would expect, over the past few years, as the ranks of long-term unemployed (27 weeks or longer) have remained persistently high, and the broadest measures of unemployment (which include discouraged workers and those working part-time) remain elevated. The Federal government passed legislation early in the crisis to reimburse states for providing extended unemployment insurance, but those extended benefits have all but run out in 2014. Yet there is a large population (3.6 million, compared to 1.5 million, pre-crisis) who remain on the long-term unemployed rolls, with the average length of unemployment at a still-elevated 35 weeks (compared to 17 weeks pre-crisis).

Clearly, there is a large population of the US struggling to find good, long-term employment. And while there are those who have been content to collect unemployment compensation instead of working, that game is coming to an end; most of these people will have to find work one way or another. But increasingly, a large chunk of this group have been moving into a different category, "disabled."

As it turns out, this is not a typical "urban welfare" issue; the biggest recipients of disability payments come from rural states; at more than 8% each, West Virginia, Arkansas, Alabama and Kentucky are the states with the highest percentage of their population receiving disability payments. These rural communities have seen, over the past three decades, a continuing loss of their manufacturing jobs to automation and plants moving overseas. Again, part of this phenomenon is due to the aging of the US working population, as older folks—especially those who work on their feet—are more likely to be unable to work due to a physical ailment. In fact, a National Public Radio "Planet Money" segment focused on a doctor in rural Hale County, Alabama (where nearly ¼ of the work force is on disability) who matter-of-factly categorizes patients with certain back ailments and no college degree as "disabled." The reason education matters is that people without a college degree will not be able to get a job that doesn't aggravate their physical ailments; there are too few non-physical "desk jobs" in his part of rural America. So they go on long-term disability.

There are important implications from moving folks from "unemployed" to "disabled." First, it reduces the unemployment rate. When you are classified as disabled, you move out of the labor force; you are no longer looking for a job, and you are no longer unemployed. As with people who are "under-employed" (e.g., working part-time when they'd like to be full-time) and those who are "marginally attached" (temp work, for example), this serves to reduce the headline unemployment rate, and doesn't fully reflect the underlying weakness in the US labor markets. From a policy standpoint, we've seen the Federal Reserve keep their monetary stimulus going longer than they might otherwise have done, largely due to the fact that they have been looking at the broader measures of unemployment.

Another important point is that when you are moved from unemployed to disabled, your monthly insurance check will come from the Fed's Social Security Disability Insurance (SSDI), not from the state's unemployment compensation fund. With state governments looking to tighten their budgets, they have a strong incentive to reduce their unemployment rolls, and don't care if that means putting folks on Social Security. In fact, there are private companies who are hired by the states' employment divisions to help applicants with their federal disability applications. As one such company, Public Consulting Group, describes on their website, "PCG Human Services offers state and county governments unique and time-tested methods to expedite the process of applying for disability benefits administered by the Social Security Administration (SSA)."

This is not the way the system was supposed to work, but when people have exhausted their unemployment benefits, they become desperate. And while Washington reformed its welfare programs 20+ years ago, there is little call for reform of the SSDI program, even though the fund that supports it is scheduled to run out of money by 2016 (the broader SS system should have funds, in its current state, through 2030). The SSDI system even provides some luster, and some cover for elected politicians, to what otherwise would be a more dismal headline unemployment number each month.