Get A Job

Should we work to live or live to work? One of the strengths of the American economy since the early 1980s has been its almost miraculous ability to assimilate new workers into the labor force even as vast investments in productivity eliminated entire job classifications, such as secretaries, that were once well populated.

While the American practice of shedding workers rapidly may be regarded as callous and inhumane, it has allowed American businesses to adjust quickly to changes in economic conditions and to keep its cost structure in line. This practice stands in stark contrast to the European welfare states wherein "being on the dole" is an actual career choice or to the Japanese refusal to acknowledge anything bad has happened, is happening, or for that matter, ever will happen. Sayonara, Nikkei-san.

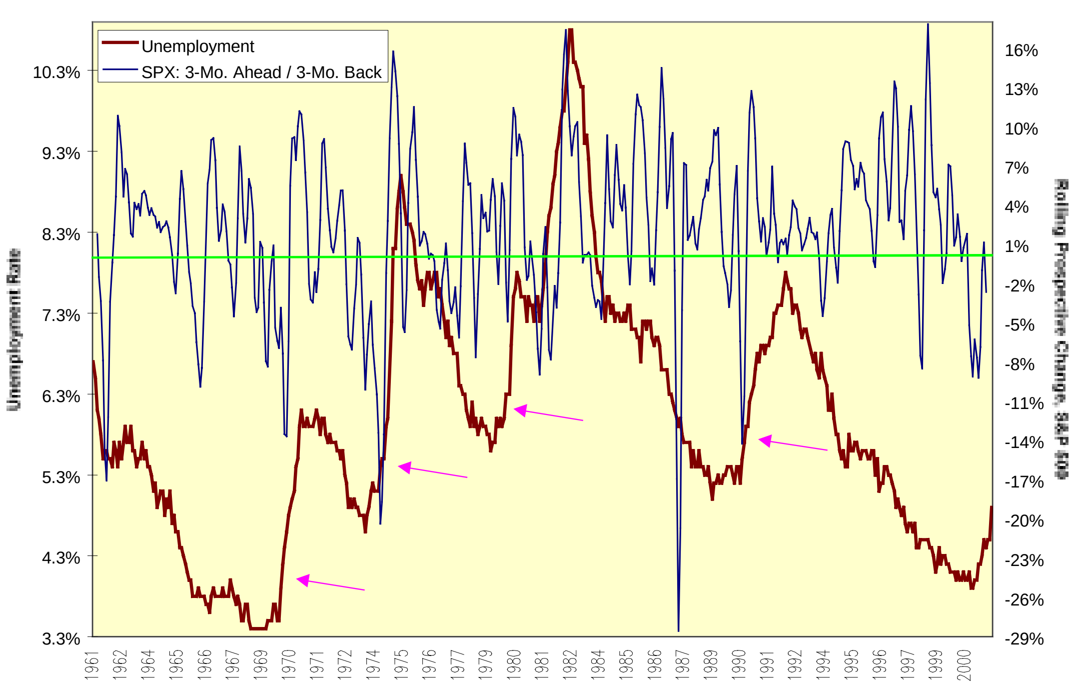
Last Friday's reaction to the monthly employment situation report was a classic demonstration, as if we need more of these, that in a bear market all news is bearish. The connection has been made that higher unemployment will decrease consumer confidence and consumer spending, and thus, depending on your point of view, either initiate or prolong a recession.

A review of retail sales and stock prices as a function of consumer confidence appeared in this space last March (see "So, How Do You Feel About Confidence"). The conclusions were that higher stock prices boosted confidence, but not vice versa, and that a negative wealth effect – reduced consumer spending in response to lower stock prices – was far more observable than any positive wealth effect.   Let's see if we can throw unemployment into the mix and reach any conclusions based on a lengthy data sample, forty years in this instance.

A Secular Economic Trend

The unemployment rate is one of the trendier economic statistics; it tends to move in the same direction for months on end, reverse suddenly, and then proceed in the other direction for months on end. Stock prices are far noisier, so let's smooth them out a little by taking the ratio of the next three months to the last three months for the S&P 500. This will allow us to see whether the unemployment trend affects prospective changes in stock prices.

Unemployment Rate And Stock Market Trend



Four periods of rapid increases in unemployment are highlighted, 1970, 1974, 1979-1980, and 1991. Each of these periods was preceded by a period of weakness in the stock market. The 1970 episode, which was accompanied by rising inflation and interest rates, presaged a short-lived stock market recovery and the establishment of a new all-time high on January 11, 1973 – a high that would stand until July 17, 1980, nearly 1,900 trading days later.

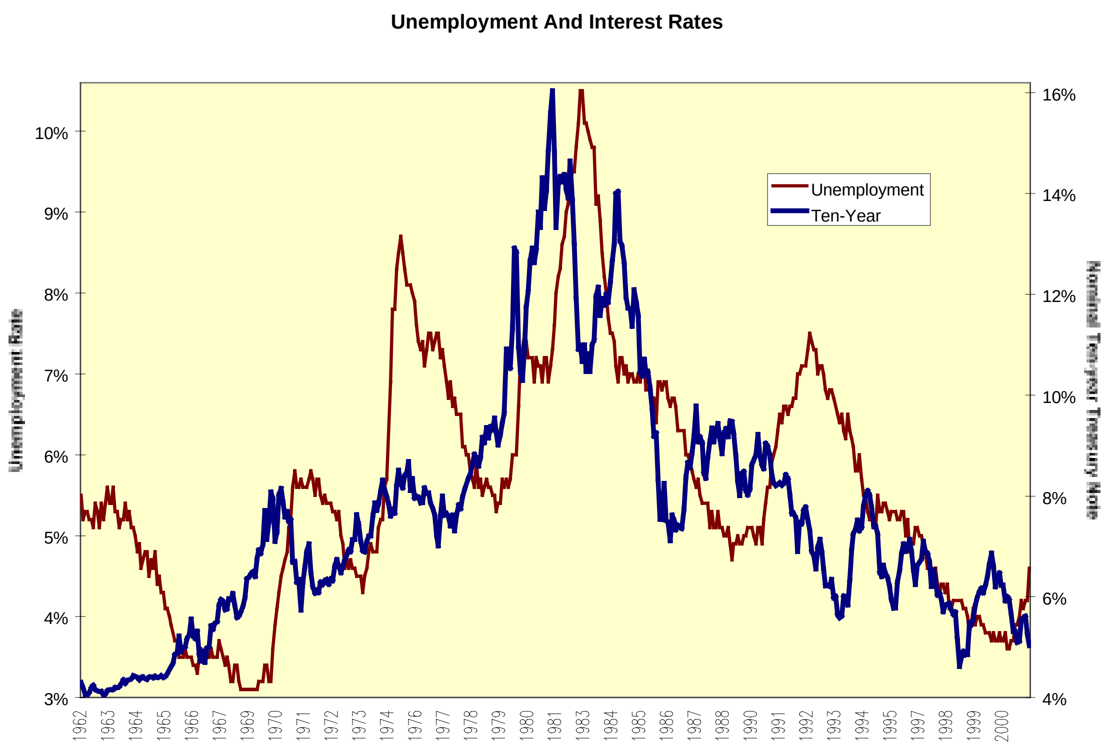
The 1974 episode also was followed by a strong rally from December 1974 to June 1975, a rally that dissipated quickly. The jump in unemployment in 1979-1980 came during the midst of double-digit inflation, the highest interest rates in modern U.S. history, and the second energy shock of the decade. Needless to say, no one stepped up to the plate to buy stocks until the historic bull market began in August 1982.

The jump in the jobless rate that came during the 1990 Persian Gulf War continued into 1992. Like the 1970 and 1974 episodes, it too was followed by firmer stock prices. The long bull market of the 1990s led and was accompanied by a long decline in the unemployment rate. Only when the stock market peaked in early 2000 did the unemployment rate stop declining.

The conclusion is similar to those reached for consumer sentiment and retail sales: Falling stock prices precede economic weakness and rising unemployment, while rising stock prices don't appear to be a consistent leading indicator of economic strength. Moving the other way, a rise in unemployment, which is a lagging indicator, generally occurs after the worst economic news has already been discounted.

Unemployment And Interest Rates

It's been noted several times in this space (see "Remember The Money Supply," March 2001) that the bond market is often more effective in anticipating economic trends than is the stock market. This may be true in the long-term, but in the short-term, bond traders can embarrass well-meaning imbeciles, as they demonstrated last week in their reaction to a slightly higher but still recessionary Chicago Purchasing Managers report. Their minute-to-minute reaction inevitably adheres to the discredited Phillips Curve notion of a tradeoff between inflation and unemployment. Let's take a look at the long-term relationship between ten-year Treasuries and the unemployment rate.



With the notable exception of the disinflationary early 1990s, note yields and unemployment have tended to move more in the same, rather than in the opposite, direction. Falling unemployment creates both a greater pool of savings and lower demand for government services, while rising unemployment usually stimulates poorly conceived and executed government stimulus programs that raise the risk level in the financial system.

What will the outcome of the present situation be? Given the Hooveresque fixation in Washington on a balanced budget in the midst of an economic downturn, we are likely to remain in a contractionary policy mix of too-tight monetary policy and too-high tax levels. Monetary policy is ineffective in a surplus capacity environment; why borrow to expand capacity when you can't sell what you're making already? Unless we see some tax cuts to spur demand, and I mean some real tax cuts on marginal rates as opposed to the rebate nonsense of the present, we'll stay in a recession and witness higher unemployment.

Past history suggests the market has discounted much of this outcome by now. Unfortunately, there's still nothing yet to suggest we're about to turn higher.