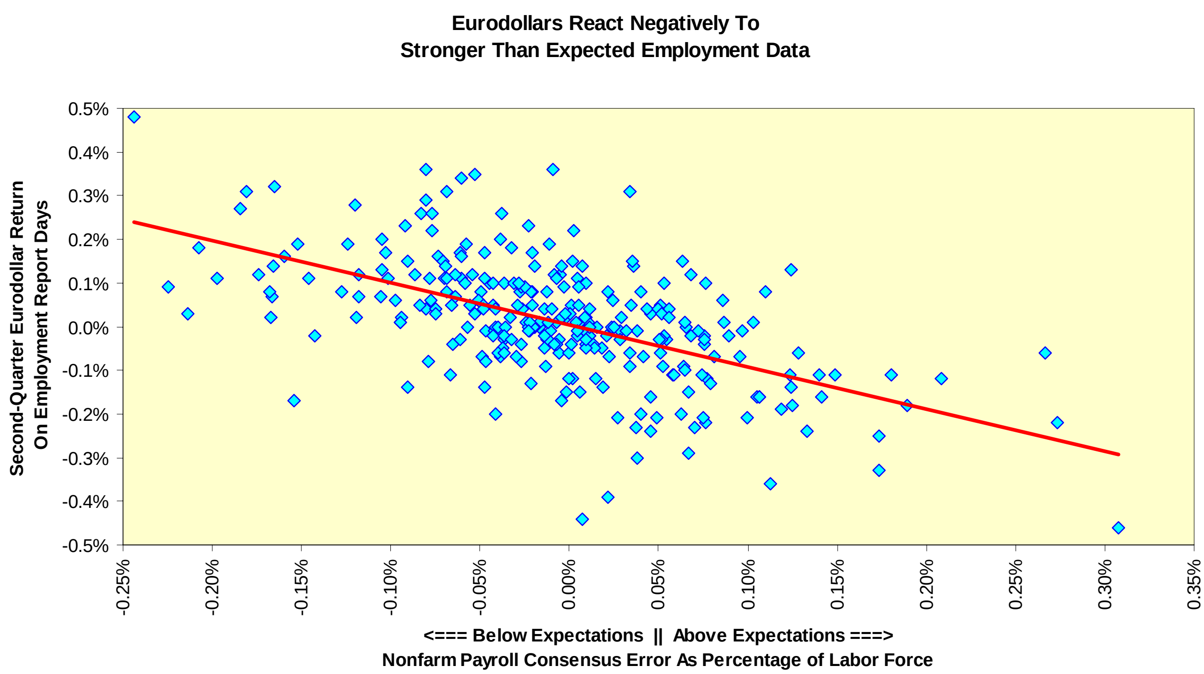
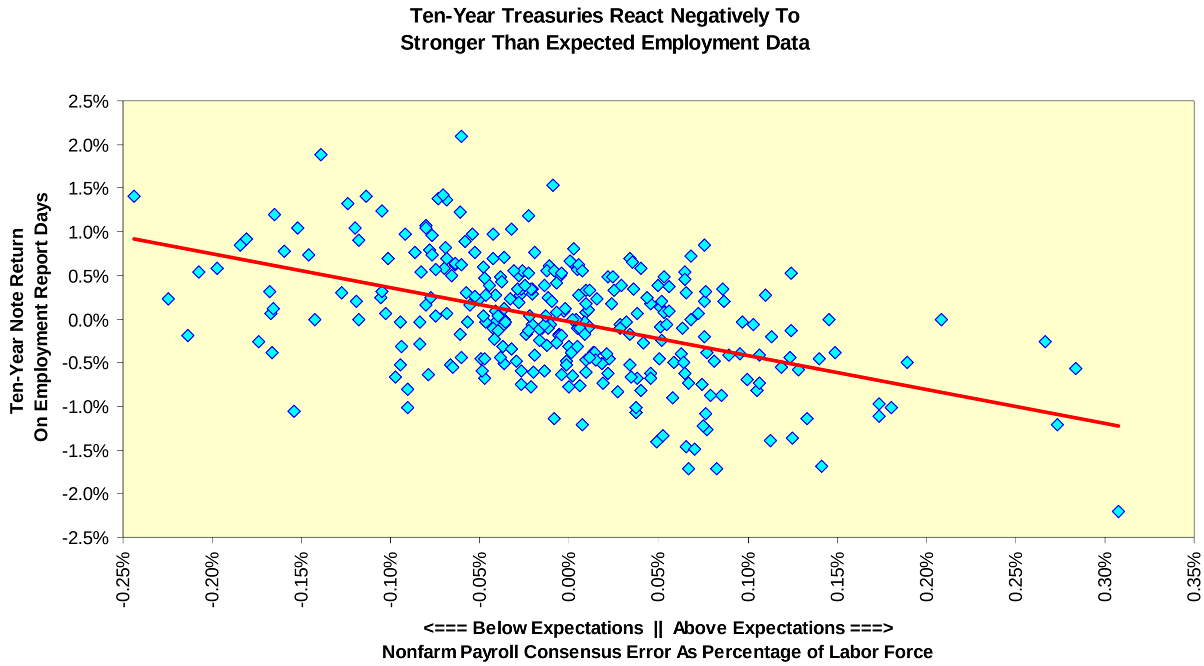
Market Reactions To Employment Surprises

T.S. Eliot's protagonist in *The Love Song of J. Alfred Prufrock* may have measured out his life with coffee spoons, but market veterans can be excused for thinking they have measured out their life in employment situation reports. Every first Friday of the month, bright and early, there it is: High heat and chin music coming off the mound served up by the Bureau of Labor Statistics.

While the report is full of details, those are firecrackers compared to the bomb of nonfarm payroll additions or subtractions. That number is predicted widely and with a surprising degree of accuracy: Over the past quarter-century, the average forecast error of the first release of payroll additions has been on the order of 85,000 jobs, or 0.07% of the labor force. But sometimes your best is not good enough, and that appears to be the case here. The markets generally want to trade off the number, and trade they do.

If we map the daily percentage changes in ten-year Treasury futures and the second-quarter Eurodollar futures against the forecast error as a percentage of the labor force, we can confirm what we all sense to be true: Stronger-than-expected reports lead to selloffs in interest rate futures, and vice-versa. This relationship has remained constant in recent years even though the probability of a policy response to weaker-than-expected data has dwindled toward zero. Really; what is the Federal Reserve going to do with a weaker number right now, and you know they will find every reason in the book to ignore a stronger number. Holding interest rates low for a considerable period breeds considerable cynicism.





Other Markets

As stronger-than-expected employment data tends to raise both prospective returns on American assets and raises, at least for a day, the prospect of higher short-term interest rates in the U.S., the reaction to strong employment data tends to be dollar strength. However, this relationship is not a particularly strong one, and given the extraneous factors buffeting currency markets about, it seldom is tradable.

The real surprise, at least on first blush, is the negative reaction of the S&P 500 to strong employment data. The stock market's knee-jerk reaction to the prospect of higher short-term interest rates outweighs any impulse towards higher earnings. Conversely, the stock market likes the prospect of the Federal Reserve staying out of its face. This is still a game driven by free money and high financial liquidity; always has been and always will be.

Finally, one of the biggest effects of the employment data is glacial in pace but very powerful, and that is labor force participation. This number grew strongly in the 1970s and 1980s as the Baby Boom generation and women en masse entered the labor force. Even though the initial impact on productivity was negative, it forced total output higher and contributed mightily to the prosperity seen into 2000. Labor force participation now is declining under pressure from recession, Baby Boom retirement, the replacement of labor with capital and technology and global competition. This trend will not grab headlines – glaciers seldom do until they start calving icebergs – but it will affect the economy significantly for years to come.