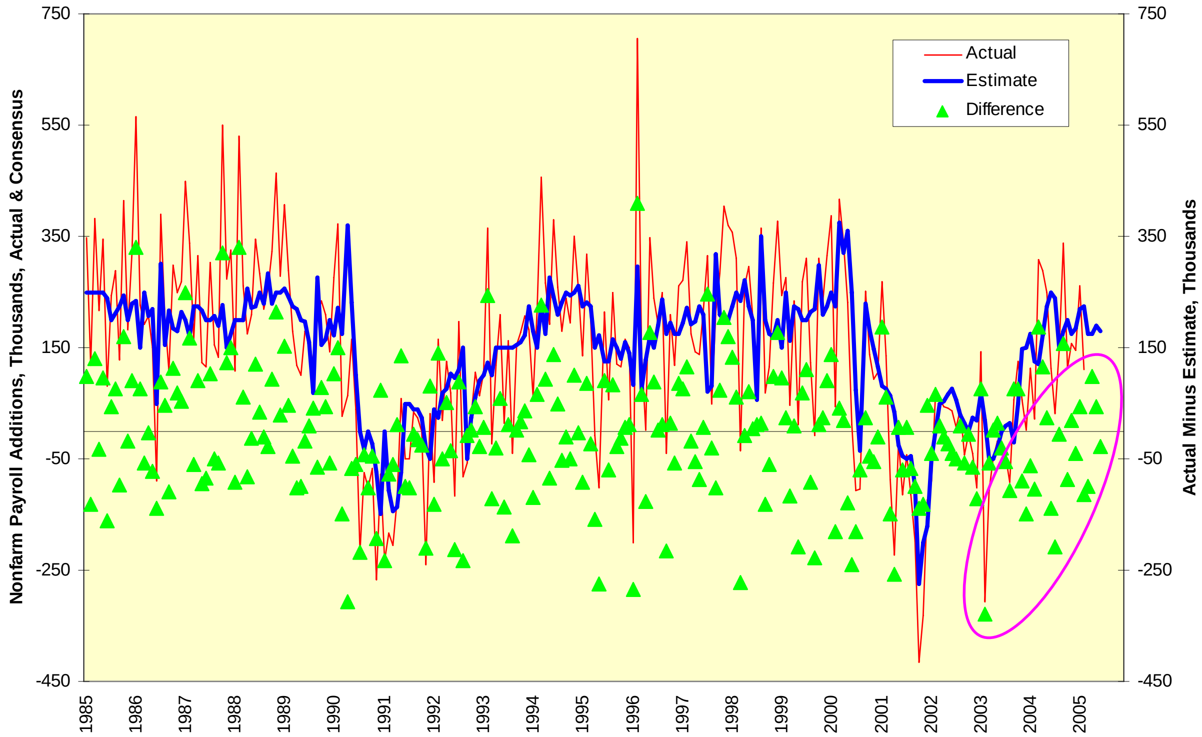
Employment Errors And Unearned Runs

Nothing says "agriculture" more than a barn, which is why the emphasis on non-farm payrolls is so appropriate: Economists metaphorically cannot hit the broadside of a barn with their estimates for first release of the non-farm payroll number each month. With this Friday's employment situation report incorporating the massive distortions of the hurricanes, a tough job is about to get a whole lot tougher. It is quite possible for the number to come in plus or minus several hundred thousand from the loss of 169,000 jobs forecast at the time of this writing.

Let's look at these errors and their origins and then conclude by asking whether we should care come Friday.

If we map the Wall Street consensus against the first estimate of non-farm payroll additions for the past two decades and overlay the forecast error, we can see some patterns emerge. The first is a surprisingly small bias for the consensus forecasts to overshoot the actual number. You might think this was a consistent and consistently large error, but it is not: Only 127 of the past 246 monthly forecast errors, just 51.6%, were negative, and the average error of estimate relative to the nation's labor force was as mere -.004%. Wall Street may cheerlead earnings, but it really tries to get the payroll numbers right.

Bet The Under

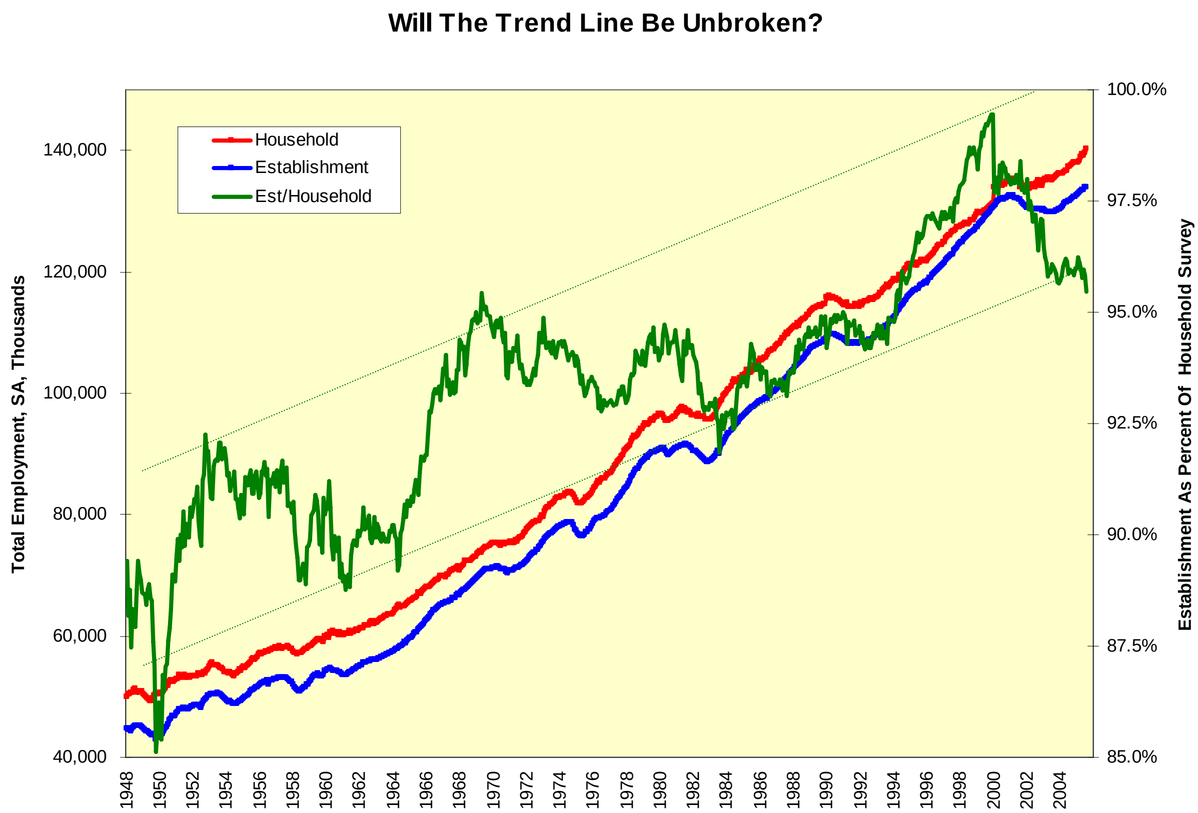


But as the cluster of recent forecast errors highlighted in the oval indicates, the recent performance of economists has deteriorated. Since the December 2002 report, those who "bet the under" would have won 19 out of 32 times, or 59.4%. The average error relative to the size of the labor force over this period was a far more sizeable -.023%. As some officials might note, there's a divergification we need to explain.

Household Vs. Establishment

Our friends at the Bureau of Labor Statistics (motto: "hold still while I count") conduct two employment surveys. The headline number, the one flashed on the screen that produces much ululating and hand-waving among those still trading bond futures via open-outcry, is derived from a mail survey of 400,000 business establishments. A separate telephone survey of 60,000 households is conducted as well. The two surveys can differ markedly, and as usually the case, we can learn something from the differences.

If we display the establishment survey's total as a percentage of the generally larger household survey, a pattern emerges. Periods of strong labor demand, such as the Korean War in the early 1950s, the Vietnam Was in the late 1960s, and the late 1990s technology bubble see an increase in the ratio of establishment to household labor totals. The percentage falls once labor demand falls. This suggests incremental labor demand comes not from sources such as self-employment and entrepreneurial activity, both of which are represented in the household survey, but rather from business establishments. When hiring gets large, the large get hiring: Business establishments can raise wage levels and bid people away from self-employment and the like.



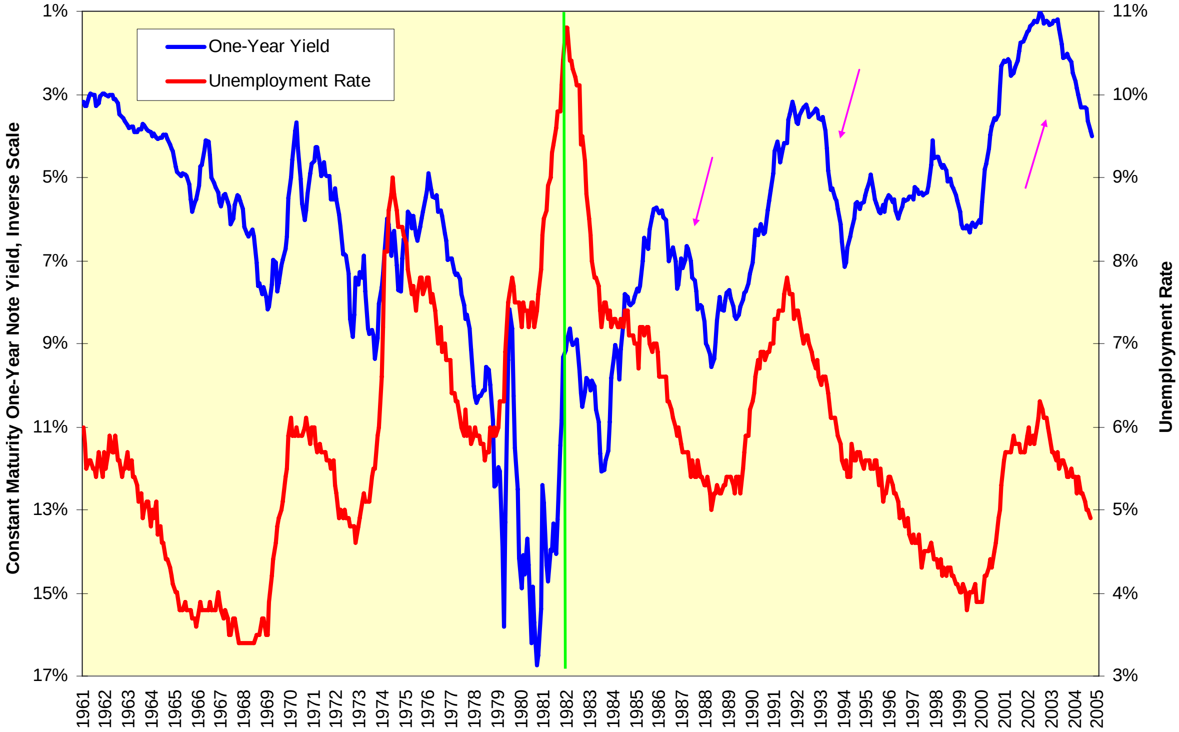
The unmistakable trend of the past six decades has been that of a secular increase in the percentage of the workforce working in establishments; this is in spite of a celebrated American tradition of entrepreneurship and labor force flexibility – read "ability to fire people" – unmatched amongst the industrial economies. We are now perilously close to breaking this long uptrend. Given the massive costs associated with hiring people in the U.S. - each one of us is a short call option on benefit-linked resources and a potential plaintiff – we can summarize the situation thusly and move away from this overview: You may want to work for a large employer, but they really do not want you.

The Market Impact

The bond market often gets things right for the wrong reason. The prime error is associating growth with Federal Reserve policy responses, inflation and higher interest rates. Let's state the conclusion first: There are numerous reasons to sell bonds, but someone else getting a job or a raise should not be on that list. But standing in front of a knee-jerk reaction may be a poor way to preserve the integrity of various body parts, as anyone who was long ten-year notes after last Friday's personal income data were released.

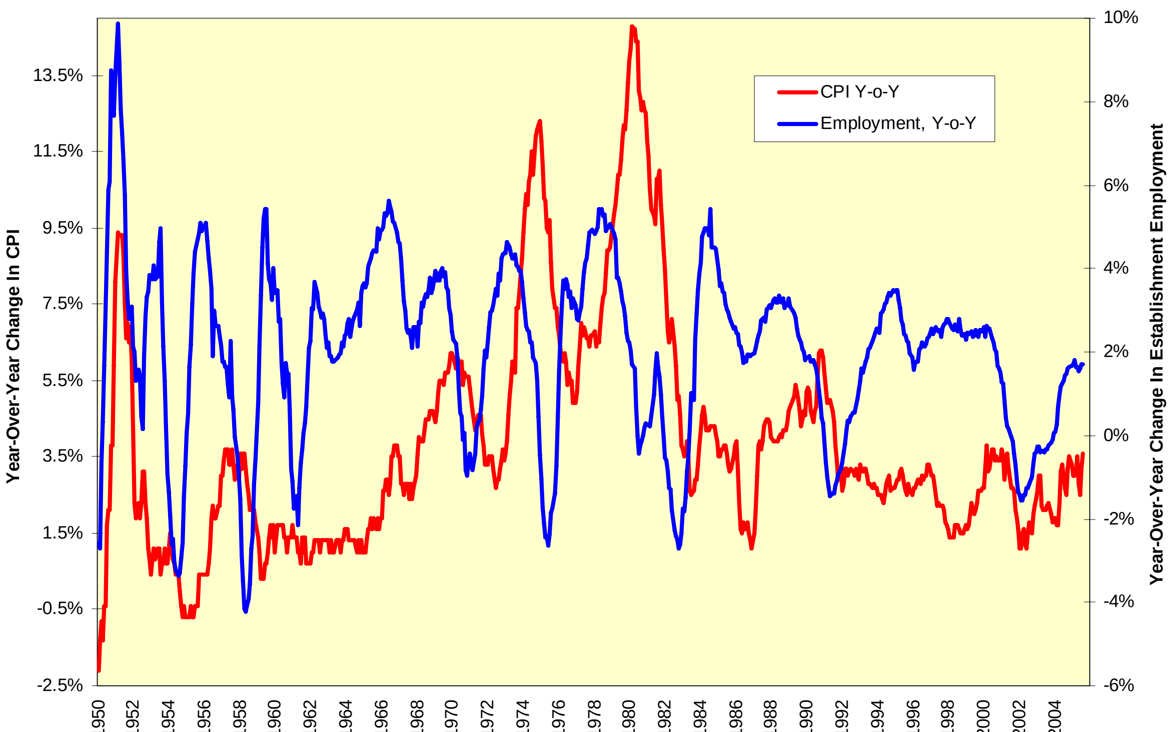
Let's take two simple and simplified comparisons. The first is the unemployment rate against nominal one-year Treasury note yields. Unemployment peaked at 10.8% of the workforce at the end of 1982, and has declined for a large number of reasons in the quarter-century since. The recessions of 1992-1992 and 2001 interrupted this decline, which has now resumed. What have short-term interest rates, those most sensitive to monetary policies, done over this period? They have declined. The present upturn, like those of the late 1980s and early 1990s, all marked with arrows, scarcely matched the duration or intensity of declines in the unemployment rate.

Does Low Unemployment Lead To High Rates?



The second question is whether rising employment levels and the pace of those gains lead to inflation. Here we can compare the year-over-year changes in the CPI with those in the establishment survey. If there are any causal connections, I am unable to discern them.

Do Jobs Cause Inflation?



We are set up for a surprise on Friday born from the hurricane-produced uncertainties in the labor force. Something will happen, and it could happen in a big way. But should be believe this will induce the Federal Reserve to change its policy, seemingly set on autopilot, of raising rates again in November? No, if they did not back off in September, they will not back off in November. Will any number cause them to accelerate their rate hikes? Once again, probably not given the noise in the data.

So without either a policy response or a predictable market outcome from that response, and with no history of these numbers producing major turns in key economic indicators, should you care? For short-term trading purposes yes, otherwise, no. You will only be trying to close the barn door after the horses escaped.