

The Week

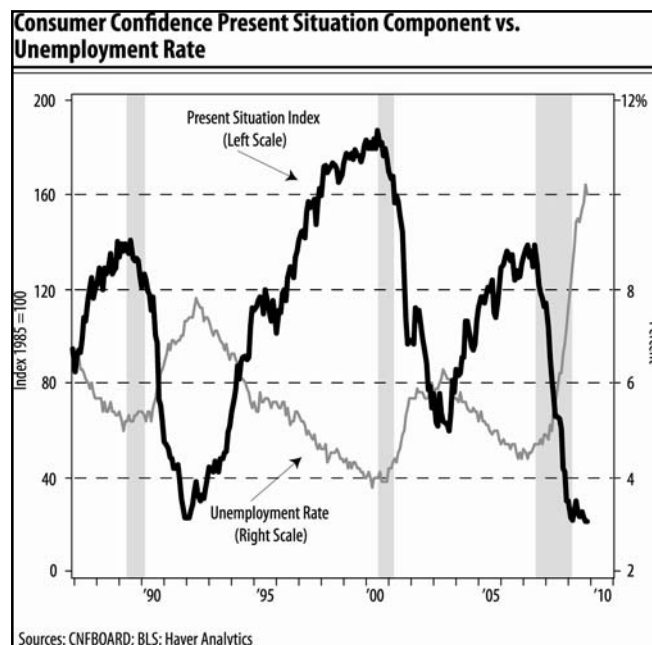
Gary Thayer, Chief Macro Strategist

High unemployment depresses sentiment and spending

- The U.S. economy and the financial markets have come a long way since last March. However, high unemployment and lingering credit problems remain major headwinds that are likely to dampen U.S. economic growth in the year ahead. At this point, the economy is most likely to grow at only a modest 2.5% in 2010.
- Last week's employment report showed that the economy lost 11,000 more jobs than it created in November. This is a significant change from early this year when the economy lost a net 741,000 jobs in January alone. The smaller job losses are a step in the right direction, but the employment situation needs to improve even more in order for the economy to enjoy a robust recovery. Unfortunately, businesses are still holding back and are trying to do more with fewer workers. This reluctance to hire keeps the unemployment rate high and dampens consumer confidence and consumer spending.
- The details of the November employment report reveal that high unemployment is also dampening worker wages, limiting their purchasing power. Average hourly earnings increased only 0.1% in November. Looking back further, wage inflation, as measured by the 12-month percentage change in hourly earnings, declined to only 2.18% in the year ended in November. That was down from 3.85% in the year ended November 2008. This shows that high unemployment dampens wage growth, restraining inflation. However, at the same time, low wage growth hurts consumer confidence and spending.
- Retail sales also appear to be negatively impacted by high unemployment this holiday season. The International Council of Shopping Centers reported that retail sales decreased 0.3% in November of this year compared to the year-ago level. This was disappointing. After all, the economy was in the depths of the financial crisis a year ago, and November 2008 retail sales were down 7.7% from November 2007 sales. With November retail sales this year below last year's depressed levels, businesses may be forced to offer more discounts than they anticipated. Earlier this year, October retail sales were ahead of the 2008 levels, and retailers were hoping that holiday sales would be better in 2009. Unfortunately, consumers, like businesses, are holding back and are spending cautiously because of concerns about jobs, home values and the general direction of the country.
- Looking overseas, several of the major international stock markets have entered a time out after an all-out sprint earlier this year. Investors appear to be taking profits and/or limiting purchases after big gains in 2009. The global economy is in recovery but unemployment remains high in many countries. Therefore, investors may be adjusting expectations towards a modest global recovery rather than a robust recovery.
- Finally, profit-taking also hit the currency markets and the gold market this past week. The euro declined slightly and the dollar turned up, causing traders to lighten positions in the gold market. Even crude oil prices dipped slightly. Traders may be taking profits because smaller job losses in the United States could lead the Fed to exit from its easy money policies earlier than previously anticipated. Reduced central bank liquidity would reduce the supply of funds fueling the rallies in foreign equity markets and gold this

year. Of course, the Fed is only likely to talk about its exit strategy right now rather than reverse policy quickly. Nevertheless, traders may be more sensitive to talk about the timing of a policy reversal with many markets trading at much higher prices than earlier this year.

- In this environment, we are recommending a neutral weighting on equities, both domestic and foreign, after over-weighting these sectors earlier this year.
- This week's chart of the week looks at the relationship between unemployment and consumer confidence. The latest reading on consumer confidence from the Conference Board shows that consumers are not feeling good about the economy despite some signs of an upturn. In particular, the present situation component of the consumer confidence index remains near its cycle low because the unemployment rate is high and could go higher.
- The Conference Board's consumer confidence index is a combination of two components. One is based on consumer expectations for the future, and the other reflects current economic conditions. Expectations have improved during the past year because the financial crisis has abated. However, consumers still feel bad about current economic conditions, especially the job situation.
- The good news is the job situation appears to be stabilizing with smaller monthly job losses than earlier this year. Consequently, consumer confidence has also stabilized, albeit at a low level.
- Looking ahead, the recent decline in initial jobless claims suggests that companies are cutting fewer workers. If this trend continues, job growth could turn positive early next year. Consumer confidence is likely to improve once businesses begin to create more jobs than they cut.



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