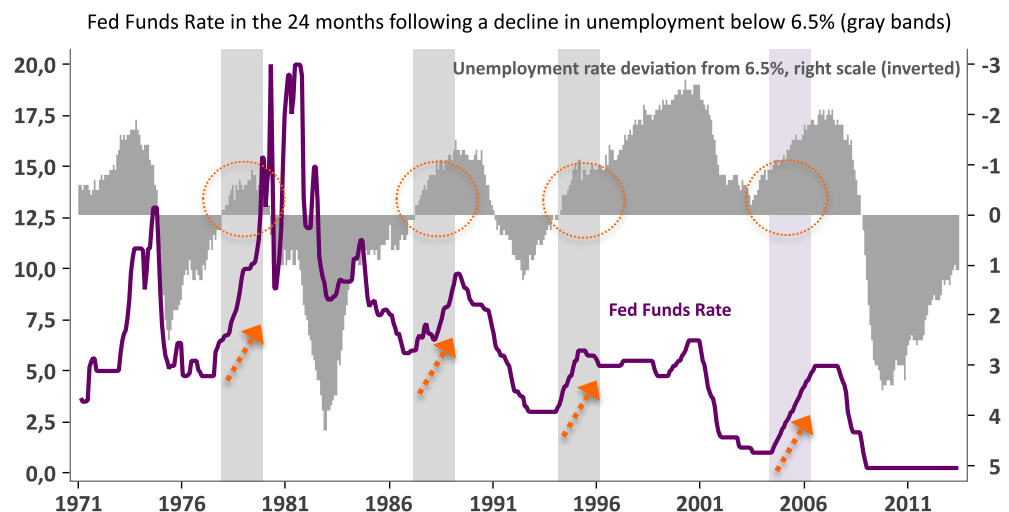




Bernanke and the Fool's Gold of Falling Unemployment

The last time U.S. unemployment fell below the 6.5 percent mark, the country's GDP was growing at an annual clip of about 3 percent, real household spending was rising at nearly 4 percent a year, monthly job creation was flirting with 300,000, and annual wage growth was just over 2.5 percent. That was back in March 1994, but similar conditions prevailed in March 1987 and in December 1977. Each time around, labor utilization and capacity utilization were close to potential output—making monetary tightening to one degree or another the right choice. And each time around, a cycle of higher interest rates duly ensued. But in 2003 and 2004, the economic climate was entirely different. Not only had the jobless rate been stuck below 6.5 percent for about a decade; there wasn't a single blip on the radar screen to suggest that the economy might overheat. So it wasn't until mid-2004, with unemployment hovering at around 5.5 percent, that the Fed initiated a rate-raising campaign. A good many pundits would later criticize this belated adjustment, identifying it as a major inflator of the now-infamous real estate bubble.

Key Lending Rate and Deviation in the Unemployment Rate from 6.5%



Sources: RichesFlores Research, Macrobond

Thus, when it came time a few months ago to provide forward guidance on monetary policy, the Fed understandably selected the 6.5 percent unemployment mark as a key criterion for when and how to taper its quantitative easing program.

Even so, this policy choice raises a whole host of questions. A given jobless rate may in fact reflect a much shakier economy today than it would have during previous, seemingly similar periods.

The Flip Side of the 6.5 Percent Unemployment Coin

We believe U.S. unemployment will fall to 6.5 percent in the second quarter of 2014. Unfortunately, our growth and jobs forecasts don't point to any serious improvement in the U.S. economy between now and then. We don't expect real GDP growth in 2013 to exceed 1.7 percent for the full year or 1.8 percent at year-end—a rate barely two tenths higher than at the close of the first quarter. We have also lowered our 2014 forecasts by a half a percentage point to 2.2 percent for the full year or 2.3 percent for Q4 (YOY), and due to lackluster productivity gains, we expect the pace of job creation to edge up only gradually to just over 200,000 a month in the second half of 2014 (see [Outlook 2013-2014](#) of June 21, 2013 and [The U.S. Economy: Don't Count Your Chickens Before They Hatch](#) of June 5, 2013).

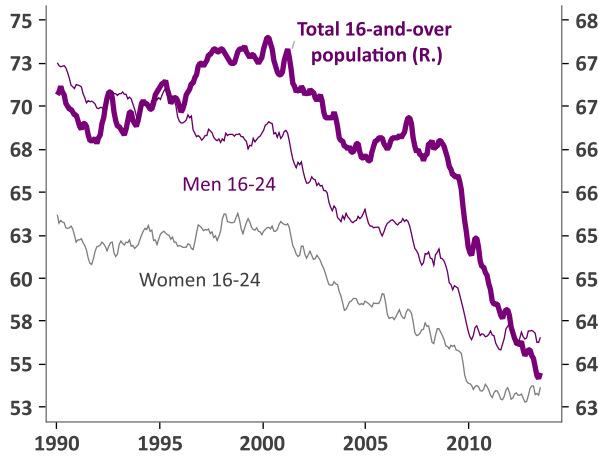
So the reasoning behind our 6.5 percent unemployment forecast is more pessimistic than would first seem: with fewer jobs on offer in today's anemic labor market, labor force participation is low—and likely to stay that way. And while unemployment forecasts can easily go wrong, a closer look at the factors driving the numbers can help clarify the dilemma the Fed may face in the months to come.

Over the past five years, the labor force participation of people aged sixteen and over has tumbled in the U.S., from over 66.5 percent at the end of 2006 to under 63.5 percent today. Three main causes are at work here:

- First, the job market has taken a turn for the worse. The employment rate—or the percentage of people aged sixteen and over who hold jobs—has collapsed from 63 percent at end-2006 to 58.7 percent in June of this year. This is no slight change: using comparable metrics, we estimate that it is more than twice the decrease recorded in France over the same time. Grim news of this kind tends to discourage prospective job-seekers, and as it turns out, the labor force participation rate for young people—often the age group hit hardest by a shrinking job supply—has shed six percentage points since end-2006.
- Second, many of the low-skilled jobs traditionally available in the construction and retail sectors have evaporated, as both sectors were particularly squeezed by the financial crisis.
- Third, the U.S. has an aging population with a growing percentage of retirees who are counted in the government's labor force participation statistics, since these statistics measure the number of people employed or actively looking for work relative to the total population aged sixteen and over.

Labor Force Participation Rate

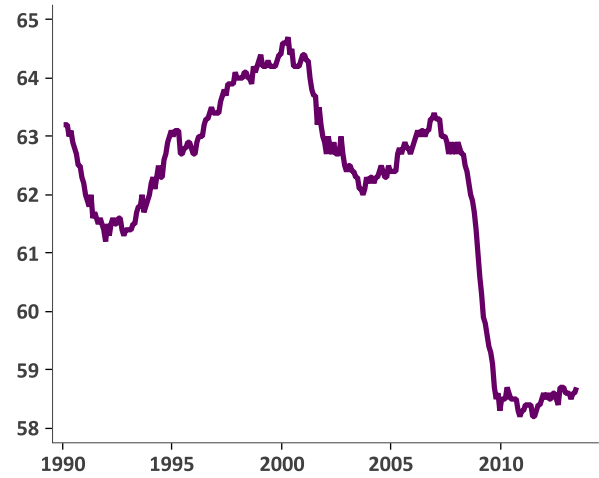
People employed or actively looking for work as a % of total population



Sources: RichesFlores Research, Macrobond

Employment Rate, Population 16 and Over

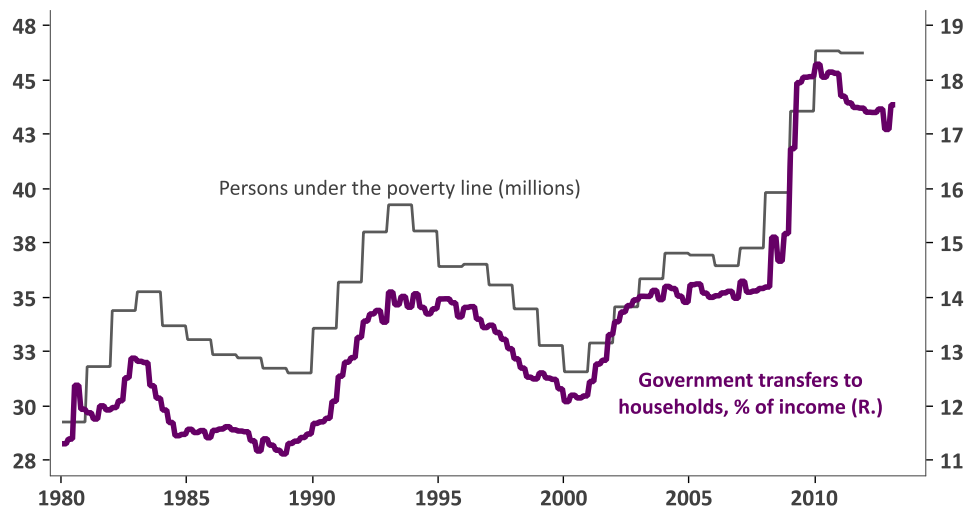
People employed/Total population aged 16 and over (%)



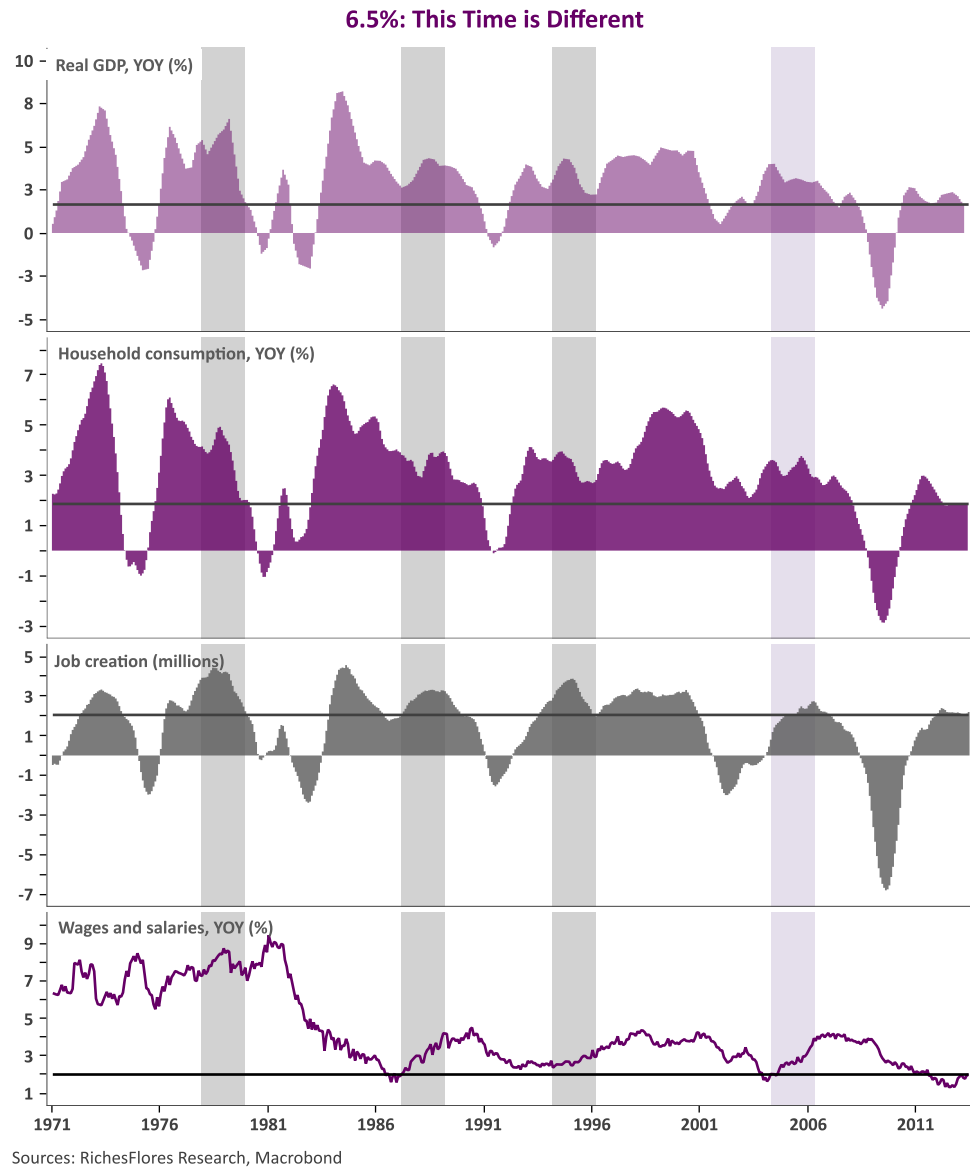
Sources: RichesFlores Research, Macrobond

The otherwise heartening fall in U.S. unemployment thus distracts attention from what is still a very shaky recovery. Not only do many economic indicators point to much less encouraging trends than during comparable stages in previous cycles (see next page), but the poverty rate still stands close to a record high.

Poverty and Transfer Payments in the U.S.



Sources: RichesFlores Research, Macrobond



The Jury is Still Out

All this suggests that returning to normal on the monetary policy front will be very much a tightrope act. A U-turn away from quantitative easing is likely to drive long-term yields way up, judging from their current gap relative to nominal GDP growth. So what it all boils down to is this: can the U.S. economy withstand such a shock or not? There are two possible interpretations of what Ben Bernanke said at his press conference after the FOMC's monthly meeting on June 18–19.

- The first one is that a return to normal is under way, with the U.S. economy apparently healthy enough by now to be taken off life support—in the form of massive injections of liquidity by the central bank—and to handle the higher borrowing costs that such a withdrawal would inevitably entail. As a sort of signal that the 2007 crisis is officially over, this shift in monetary policy would be viewed as highly auspicious. Such a scenario assumes GDP growth in line

with the Fed's expectations (i.e., 2.5 percent for Q4 2013 YOY and 3.3 percent for Q4 YOY 2014), and suggests a sanguine outlook for the U.S. economy, the dollar—buoyed by the prospects of economic growth outstripping the rest of the developed world, and by higher returns —and the stock markets, despite their temporary swoon in response to the latest policy announcement.

- The second one is that we may in fact be dealing with an overhasty response stemming from tensions within the Fed's Governing Board on a policy deemed responsible for speculative bubbles, and/or from a desire to smooth the way for Bernanke's successor, who will almost certainly have to manage a policy shift some time in 2014. If this second interpretation is on target, then it is not clear whether the Fed will actually change course in the short term. And if it does, we may wake up to find that the central bank has phased out its support for economic growth too soon. Needless to say, this interpretation would have entirely different ramifications from the first one for the financial markets. A particular worry is that the credit markets, the dollar, and the stock markets would experience higher volatility, accompanied by greater risks for the U.S. economy—and the rest of the world.

We still consider this second interpretation the more likely of the two, leading us to the following conclusions:

1. The Fed will not shift gears as fast as the markets currently anticipate, but if it does, the outlook for the U.S. economy—and consequently for the world economy—will be strongly affected.
2. Long-term U.S. bond yields should fall back from their present levels and settle in, at least temporarily, at around 2.25 percent.
3. The dollar will weaken.
4. Although stock markets won't be hurt directly by rising interest rates, they will enter much choppier waters. In the period ahead, corporate earnings are likely to take precedence over stock prices.

Véronique Riches-Flores
contact@richesflores.com

RichesFlores Research is an economic and financial research provider. We produce international economic analysis and forecasts, as well as research on broader short-, medium-, and long-term trends in the global economy.

RichesFlores Research is a transparent company, with the databases and information resources we need to remain fully independent and objective. Because RichesFlores Research is not an investment service provider and does not sell financial products, we can offer clients added confidence in the independence and objectivity of our assessments, recommendations, and advice.

This document is provided for information purposes only. It is not and should not be construed as investment advice, or as an offer or solicitation of an offer to buy or sell securities. It contains strictly confidential information intended only for the use of the individual or entity to which it is addressed. This document may not be disclosed to any third party without the express written consent of RichesFlores Research.

This research and its content are the sole property of RichesFlores Research. They may not be reproduced without the express consent of RichesFlores Research and without indication of the source and date thereof.

RichesFlores Research makes no warranty, express or implied, nor assumes any legal liability or responsibility for the accurateness, completeness, or usefulness of the research, conclusions, data, and assessments available on this website.

The content of this website does not constitute a contract and is non-binding. It is not and should not be construed as investment advice or as an offer or solicitation of an offer to buy or sell securities.

Véronique Riches-Flores, contact@richesflores.com