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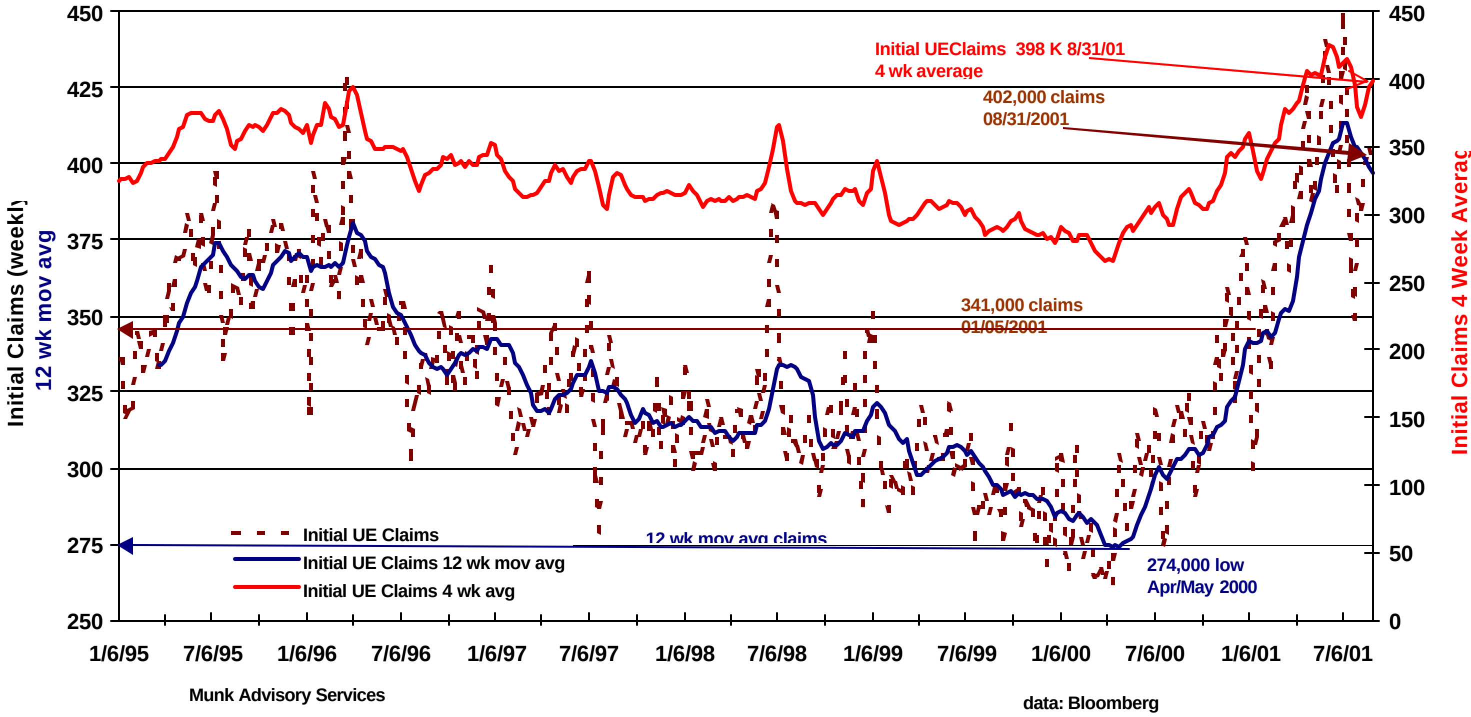
Jobs, jobs, jobs & Inventories, inventories, inventories? What's Next?

Initial Unemployment Claims
4 Wk Averages & 12 Wk MAV
01/06/95--08/31/01

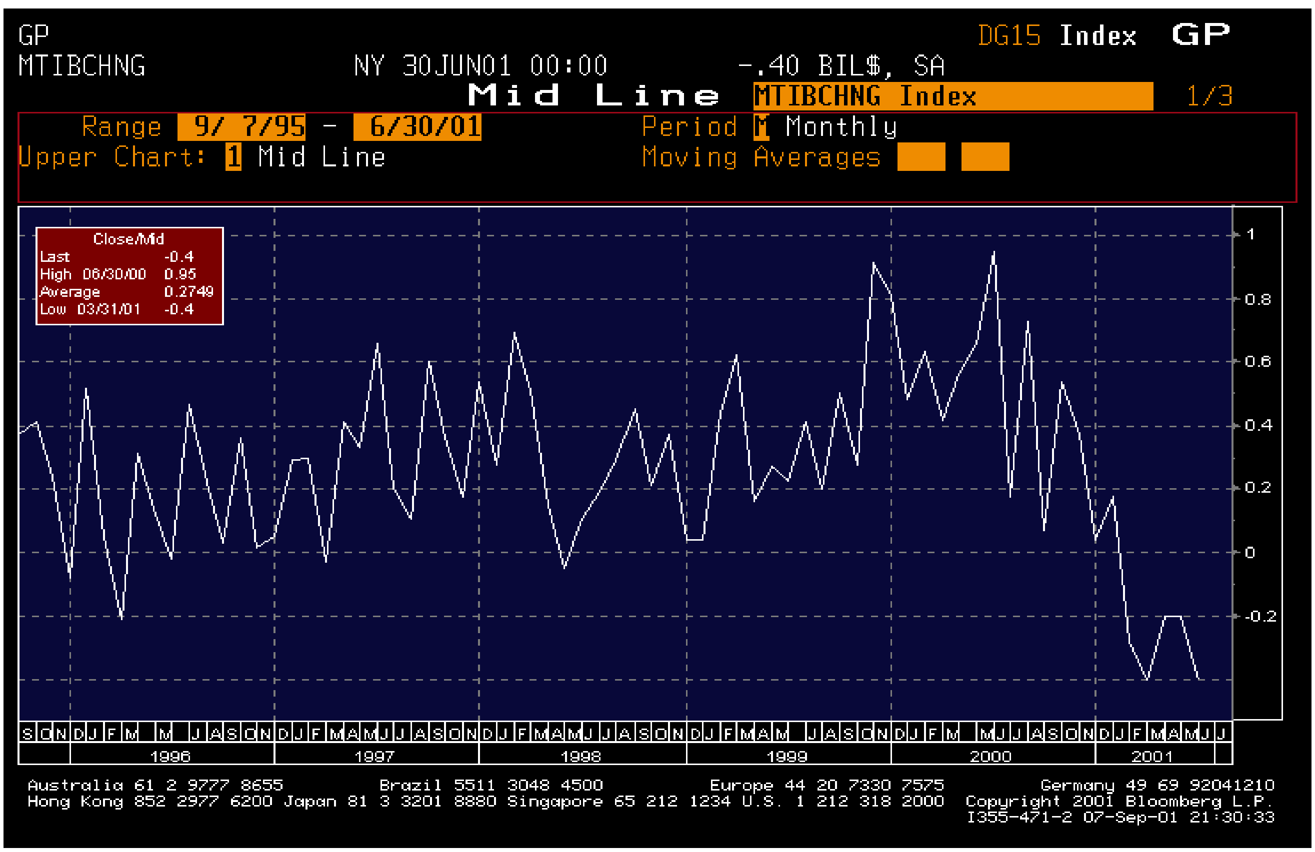


UNEMPLOYMENT RISES: Various measures of "initial unemployment claims" have been telegraphing the ultimate move in the basic unemployment rate, although the month of July appeared to give a counter-signal, as initial claims fell from their June highs. Last week's initial claims were 402,000 only slightly over the 4-week averages and close to a 12 week moving average (398,000). There has also been some weakening of labor force participation as jobs are clearly harder to get and the least skilled and those having the most difficulties securing employment have a tendency to drop out of active employment searching. Rising initial claims ultimately turn into higher unemployment rates as job growth fails to keep pace with the growth of the active labor force. **Today's employment report showed unemployment rising .4% to 4.9%, the highest level since** September 1997, as another 113,000 jobs were lost.

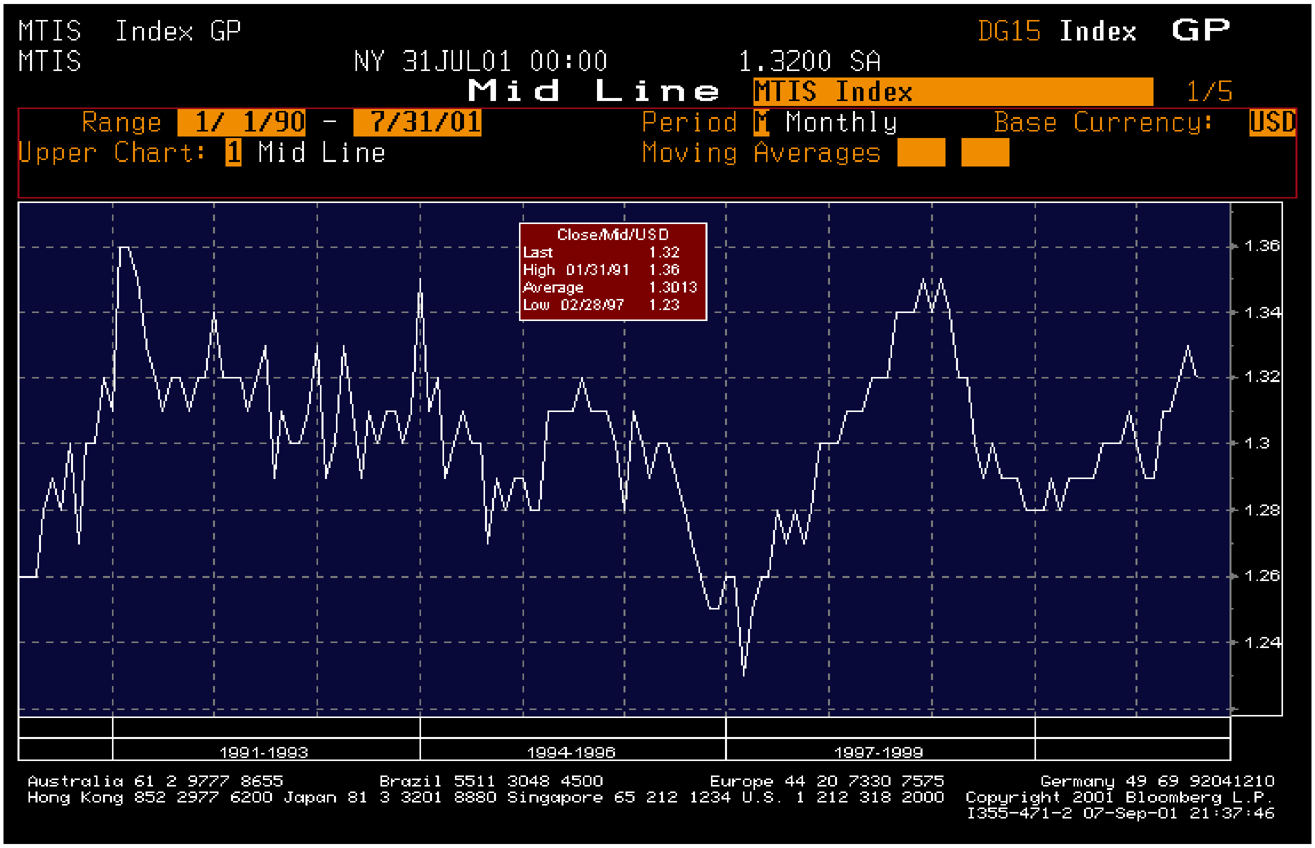
JOBS LOST: "It's all about jobs," former Secretary of the Treasury James Baker said when trying to **explain the American intervention in Kuwait. Shortly, thereafter, the U.S. economy experienced its last recession.** It had been anticipated that unemployment rate would finally rise, reflecting the contraction in the manufacturing and service sectors of the economy revealed by a number of indicators. The number of unemployed rose to nearly 7 million, up over 500,000 and participation in the labor force declined. The civilian labor force fell by 400,000 to 141.4 million.

Jobs were lost in both the private sector (110,000) and government sector (3,000). In the private sector, the goods producing industries lost 136,000 while service producing industries gained 23,000 jobs. The declines in the goods producing industries were broad based with only a modest rise in construction. In the service producing industries, gains were experienced in health services, hospitals, social services and personal supply. While average weekly earnings continued to rise, (.3% for the month, 4.2% year on year), average hours worked were unchanged for the month. Hours worked in the private sector peaked at 34.4 at the end of January, slightly less than the peaks experienced in 1997 and 1998. The rate of growth of average weekly earnings (y-on-y) reached a peak at the end of April 1998 and declined to between 3.5% and 3.8% before accelerating in 2001.

THE LEDGE: The weakness in employment can translate into a slower growth in spending by consumers. Consumer spending remains the main support for GDP growth. With private domestic investment and exports falling, the maintenance of spending by consumers is critical if the economy is to avoid a true recession. In light of the negative data points this week, several leading forecasters have marked down real GDP growth in Quarter III. Whether the economy has entered a period of negative growth in QIII clearly depends upon the inventory cycle now underway throughout manufacturing and the service sector. GDP could continue to grow if, other things equal, the rate of inventory reduction were to slacken or if inventories started to build. As weak as the economy appears, it may be counterintuitive that some inventory replacement may now be going on. Wholesale and retail inventories have been dropping. The central business issue is whether current levels of inventories are deemed sufficient to sustain a slower rate of growth of spending by consumers and the very much diminished spending levels by business firms. Wholesale inventories fell sharply in July (.7%) after having fallen .4% in June. The rate of change of business inventories began falling in mid 2000, and while following a jagged path, have largely continued through June.



Aside from the clear collapse in business investment spending noted through the first half of the year and which undoubtedly has continued through much of QIII, there is ambiguity with regard to inventory developments at the wholesale and retail levels. This is another aspect of the quixotic behavior of consumers during this downturn. Slowdowns at the retail level often create unanticipated inventory builds at the wholesale level. Notice in the graph below that prior to the 1990/91 recession, there was a dramatic build in the inventory /sales ratio at the wholesale level. Similarly, a rapid build occurred in 1998 when there was considerable concern that difficulties in credit markets around the world would precipitate an upset.



GROWTH DRIVERS AND ECONOMIC POLICY: The economy now hangs by tenterhooks. There are three principal questions: (1) is household spending poised to collapse, adding sufficient downward pressure to produce a full, unequivocal recession? (2) Have business inventories been reduced to levels that will require some restocking, thus producing some new orders? (The NAPM PMI data on manufacturing suggest that but there was a substantial head fake from the NAMP non-manufacturing survey). (3) What is the likeliest course for monetary policy as we move into QIV?

Consensus forecasts have centered on 3-3.5% real growth beginning QIV 2001. It is hard to imagine what will drive growth at this rate unless business spending on new investment begins to relinquish its powerful negative thrust and turns upward, even moderately. If the Fed judges that the investment boom collapse will continue, it has no choice but to vigorously lower the Fed Funds rate between now and year in.

"In for a penny, in for a pound." Greenspan speaks in Atlanta next Thursday. The ECB meets again on the same day. The IMF/World Bank meetings begin a few days later. The FOMC meets on October 2nd. The October Fed Funds futures traded during the week at levels that clearly suggest at least another 25 basis points, but there were catcalls today for 50 basis points as the equity market finished a dreadful week. Eurodollar futures are implying a 3.30 short rate that allows for at least another 25 basis points on both sides of the Atlantic. The only issue is timing. Timing is everything.