RBC Global Asset Management

ECONOMIC COMPASS

JULY 2012

HI-HO, HI-HO, IT'S BACK TO WORK THEY (GRADUALLY) GO

Overshadowed by the financial world's myriad risks, there exists a neglected but golden thread: the gradual stitching together of America's old wounds. The housing market's fever has broken. Credit's pulse is beginning to beat more regularly. And employment – the focus of this report – is arguably recuperating.

Despite decelerating job creation, a more comprehensive check-up uncovers evidence of active healing:

- The unemployment rate has dropped by two percentage points since 2009, and almost 4 million lost jobs have been restored (Exhibit 1).
- Job creation is reasonably broad and of a high quality.
- Companies have largely stopped laying off workers – a traditional precursor to more significant job creation.
- Job openings have risen nicely.
- Americans' perceptions of the job market are mending.
- Businesses report decent hiring intentions.
- Temporary employment – a frequent precursor to permanent hiring – is rising briskly.

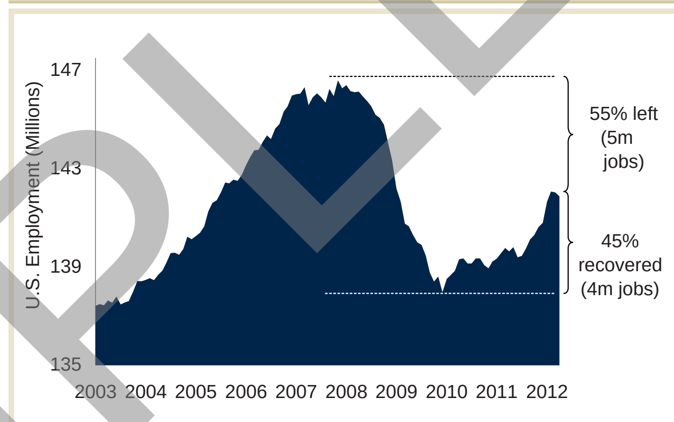
In all likelihood, none of this is about to translate into outright robust hiring, but hiring of a sort should be achievable. We believe this should centre around 120,000 new jobs per month – somewhat faster than the recent trend.

The U.S. Suffered Disproportionate Job Losses

From peak to trough, nearly 9 million American jobs evaporated. The decline in U.S. GDP during the financial crisis was also the worst in decades and more severe than in most countries (Exhibit 2), but still doesn't come close to justifying the full extent of the job losses. In fact, the U.S. suffered the worst ratio of job losses to economic losses in the G-7 largely due to:

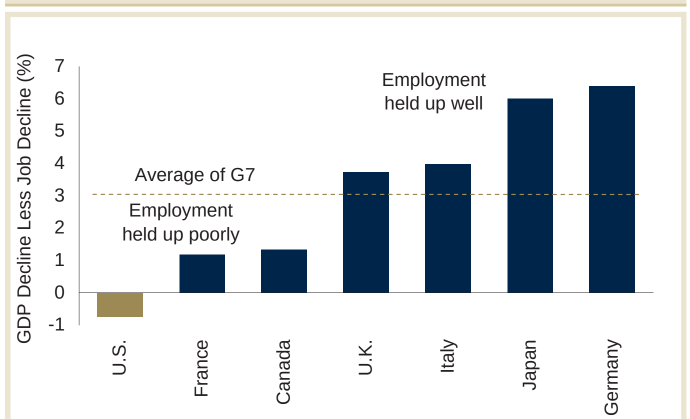
- The bursting of America's housing bubble, which slammed the labour-intensive construction industry

Exhibit 1: Employment Almost Half Way Back to Scratch



Sources: Haver Analytics, RBC GMA

Exhibit 2: U.S. Suffered Disproportionate Job Losses



Sources: Haver Analytics, RBC GMA

- U.S. labour market flexibility – the very thing that makes it easy for American companies to hire also makes it easy for them to fire

Fortunately, the U.S. economy eventually clawed its way back to growth, enabling the job market to rebound off its early 2010 lows. Almost half (45%) of the jobs initially shed have been regained. However, things are not as cheery as they may seem:

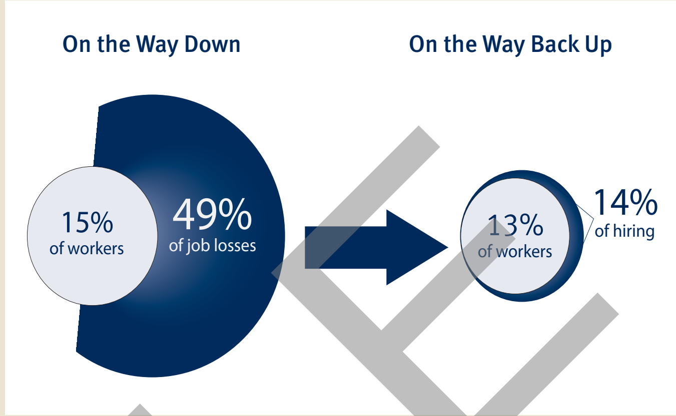
- While 3.8 million of 8.8 million lost jobs have been regained, the population has since grown. Recalibrating for this, employment has recovered by only 36%.
- Population growth and demographic change make for a moving target if the U.S. manages to add 100,000 new jobs per month from here – consistent with the latest trend – then the residual labour market slack never actually closes.
- The unemployment rate has come down from a towering peak of 10%, first to 9%, and now to 8.2%. This is material progress, but artificial assistance is coming from discouraged workers who are dropping out of the labour force, and an aging population.

By each measure, gains are being made, but the progress is slower than it first looks, and there remains a very long way to go.

Frequently, economic recoveries are sufficiently vigorous that they enable robust job creation. However, several constraints hint that the outcome could be less sprightly this time around.

- **Irreparable damage inflicted when American workers became unemployed for an extended period** – even a short bout of unemployment results in an average 6% decline in wages in the subsequent job, and a multi-year bout translates into a 14% decline
- **A skills mismatch** – Although construction and manufacturing employed just 15% of the workforce before the crash, they were subsequently brutalized in a way unparalleled elsewhere in the economy (Exhibit 3). Since job creation has returned, construction and manufacturing have failed to capture a disproportionate share of new jobs.
- **Geographic mismatch** – Labour mobility is worse than usual due to the growing incidence of two-income families (the loss of just one job may be insufficient to prompt relocation) and underwater mortgages and sluggish home sales are also depressing household mobility.

Exhibit 3: Construction and Manufacturing Were Decimated



Source: RBC GAM

- **Skewed incentives** – Studies have shown that extending employment insurance has helped swell the ranks of the unemployed by reducing the incentive to find work.
- **Policy uncertainty** – Given the uncertain environment, businesses shun hiring, and by some measures this attitude can explain as many as 2.5 million additional unemployed

Combined, these distortions / constraints may suppress employment by as many as 4.5 million positions.

Job Outlook

Having critiqued the experience to date and laid out the unique constraints holding down the labour market, let us now turn our sights toward the future. We formulate our job outlook by using a large number of disparate techniques, and piecing them together into a coherent mosaic. Following are the factors and techniques we considered:

Recent experience – The hiring rate has substantially ebbed and flowed since the recovery began, operating mostly within a choppy range of -30,000 to +240,000 new jobs per month, and averaging +116,000.

Prior recoveries – During the recovery phase of earlier economic cycles, a superior 125,000 to 225,000 new jobs per month was regularly achieved.

"Normal" economic growth rate at 2% – We project plodding 2% growth, versus an erstwhile 3% to 4% norm. In turn, this is usually consistent with 75,000 to 125,000 new jobs per month.

Post crisis experience – The record of prior international financial crises is that while job creation of a sort is achievable, it is usually insufficient to eat up labour market slack for the initial six years.

Firms play catch-up – The U.S. achieved muscular productivity gains in the early stages of the recovery by working downtrodden employees extra hard. Reverting hours worked to more normal levels would enable the addition of another 275,000 workers, and extending this effect across the entire economy might boost achievable job creation to as many as 150,000 positions per month.

RBC GAM short-term model – Our own short-term econometric model takes the signals emitting from a handful of labour market proxies, and foretells of job gains just above 100,000 per month.

Job Market Perceptions – Job market churn – voluntarily leaving one job for another – is increasing, but remains well below normal. This suggests that good job opportunities remain scarce, and American workers remain skittish.

Company Hiring Intentions – By combining seven surveys of company hiring intentions into a single hiring intentions index we can see hiring intentions are back to average.

Leading Indicators

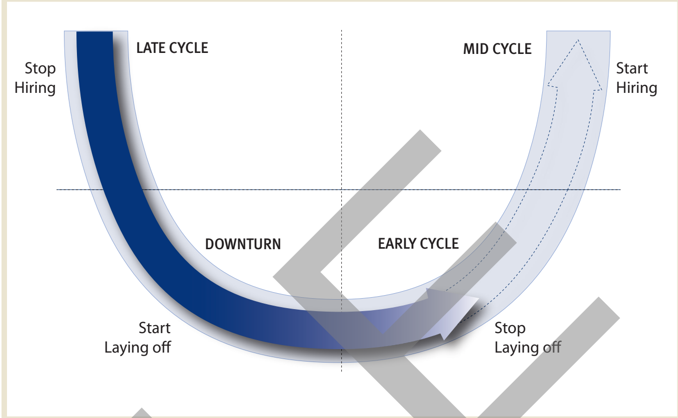
- Temporary workers are rising briskly. Companies frequently begin by hiring temporary workers, and as their confidence grows, they become more comfortable hiring permanent workers. There is a four-month lead time from one to the other.
- Job openings have improved substantially, and are now nearing normal levels
- The birth rate of new companies is not fully cooperating. Recently, a rising number of new companies have been formed, but the rate is still abnormally low.

Cyclical Perspective – Finally, let us assess the outlook for the labour market from a cyclical perspective. Before we do this it is important to clarify that when the U.S. is reported to have added 100,000 jobs in a month, this is the net figure – hiring minus departures – not total hiring.

Tracing the labour market cycle (Exhibit 4):

- First, as economies sputter into the late stages of a cycle, they begin with nothing more than a retrenchment in hiring. Indeed, in the summer of 2007, hiring began slowing from a peak of 5.2 million new jobs per month, eventually descending to just 3.8 million.

Exhibit 4: Firm Behaviour Across Economic Cycle



Source: Haver Analytics, RBC GAM

- Second, as economies shift into an outright downturn, simple hiring constraints prove inadequate. This necessitates a more extreme measure: layoffs. In the summer of 2008, layoffs spiked from around 1.9 million workers per month to a peak of 2.6 million.
- Third, economies eventually begin to recover, entering the early phase of a new economic cycle. At this point, layoffs usually cease, but hiring freezes remain. Indeed, layoffs began plummeting in the spring of 2009, collapsing from 2.6 million per month to 1.8 million by the spring of 2010.
- Two years later, this is where the U.S. labour market remains. Layoffs are back to normal – actually, contrary to the public imagination, a little lower than normal. But hiring has still not yet fully recovered.

Economic implications

The U.S. job market suffered a fierce decline, whether measured against the historical precedent or the example of other countries. Fortunately, the economy has returned to job creation that exhibits good breadth and quality. Nevertheless, the labour market remains an enormous distance from fully mending the damage done. At best, job creation is 45% of the way back to normal, but more realistically it could be said to be no more than 15% done. In particular, a number of constraints such as skill decay, skills mismatches and geographic immobility exert a drag upon job creation, suggesting that a return to the halcyon days of full employment may not occur until the end of the decade.

We have drawn upon a wide variety of employment forecasting techniques, and uncovered signals with temperaments as enormously mixed as the Seven Dwarves who inspired this report's title. In truth, no single technique can predict the future with precision. Heeding the best advice from each, we anticipate a central tendency of about 120,000 net new jobs per month n the future. The actual figure will undoubtedly fluctuate, depending upon whether Grumpy or Happy happens to hold court each month.

This pace may permit the unemployment rate to edge lower, but not quickly. In turn, barring the arrival of a Prince Charming to set the labour market's pulse pounding (the Federal Reserve has so far been an underwhelming suitor), the U.S. remains on track for only gradual progression, but progression nonetheless.

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