



April, 2010
S&P 500: 1169

OUTLOOK MEMORANDUM

Job Growth Soon Will Make The Recovery Sustainable

Skeptics have doubted that the substantial improvements in the markets and the economy over the past year are sustainable because there has been no job growth. But, job growth always lags an economic upturn by close to a year, and various indicators we discuss here are signaling that we should now begin to see 200,000-300,000 new jobs created each month during the months ahead. This will make the economic recovery sustainable and increase investor confidence that company earnings can continue to rebound back toward more normal levels. These developments are likely to push stock prices higher, although a strengthened economy also will create a short-term headwind from anticipation of a tightening in Fed policy. Bond prices, on the other hand, are likely to be pushed lower as job growth resumes.

A year and a half ago, when the near-collapse of our financial system interrupted the flow of essential credit to our economy, a major recession resulted. When the Fed and US Treasury took steps to strengthen the major banks and to inject unprecedented liquidity into the economy to begin to restore the flow of credit, the bears said it was insufficient and would not work. When sensitive credit market spreads that had signaled bank and credit market problems began to improve by late-2008, indicating that these actions were beginning to work, the bears said the credit crunch would continue. When unemployment claims began to fall and industrial commodity prices began to rise during the next several months, indicating that the improved credit flows were having a positive economic impact that would bring the recession to an end, the bears saw only an endless cycle of economic decline. When the Index Of Leading Economic Indicators began to rise during the spring, signaling that the end of the recession was only months away, the bears characterized the resulting stock market upturn as an unsustainable bear market rally. When retail sales, business orders, industrial production, housing prices, and many other measures of economic activity stopped falling and began to rise during the second half of 2009, the bears attributed it to the effects of the government's stimulus program and predicted a "double dip" when the stimulus was done. When the pace to economic rebound accelerated as 2009 ended, these same doubters pointed to unsustainable inventory building being the cause.

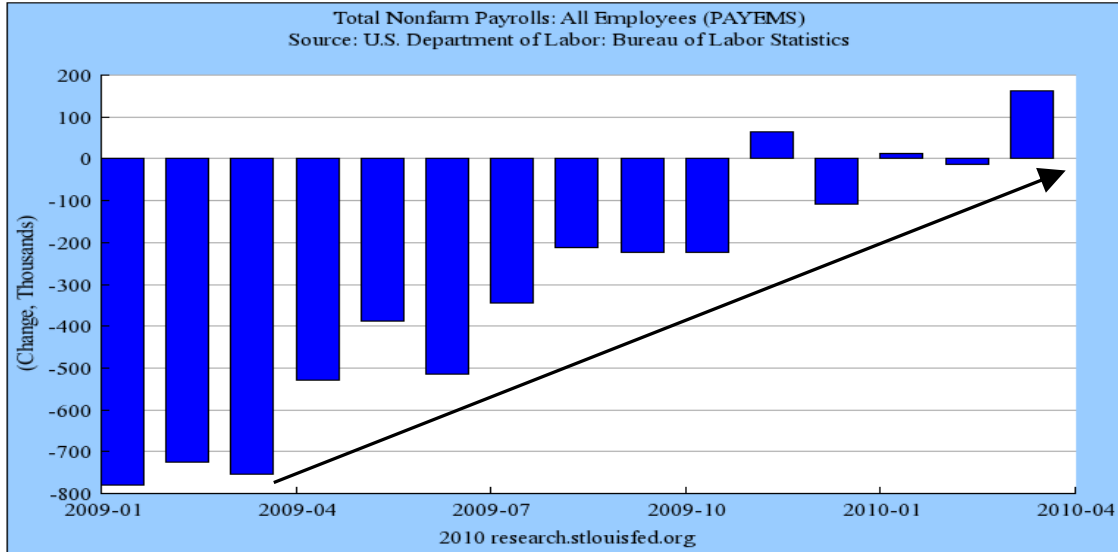
The bears have doubted every step of the recovery. What the bears have missed is that all of these developments have been a part of a well-understood process by which modern economies emerge from recession. Most recessions are in some way related to a disruption in credit flows,

with the 2007-2009 credit interruption having been monumental. To end any recession and begin the process of economic recovery, credit flows first must be restored, often accompanied by some other government stimulus. Improved credit flows then result in an upturn in retail demand. Because inventories and employment continue to fall during this phase, skeptics usually pronounce this improvement in economic conditions as unsustainable. This rise in demand, however, soon causes businesses to realize that they will lose sales if they continue trimming their inventories, and through a process we discussed last year, the ending of inventory reduction naturally triggers a significant rise in production. This is the portion of the process we have been passing through during the past six months as inventory reduction has waned, causing Industrial Production to rise at more than an 8% annual rate, one of its fastest growth paces of the past 25 years. "But, there is no job growth," the bears proclaim, "and without job growth, the recovery cannot be sustained." The bears are correct, we need job growth to sustain the recovery, and it now is arriving.

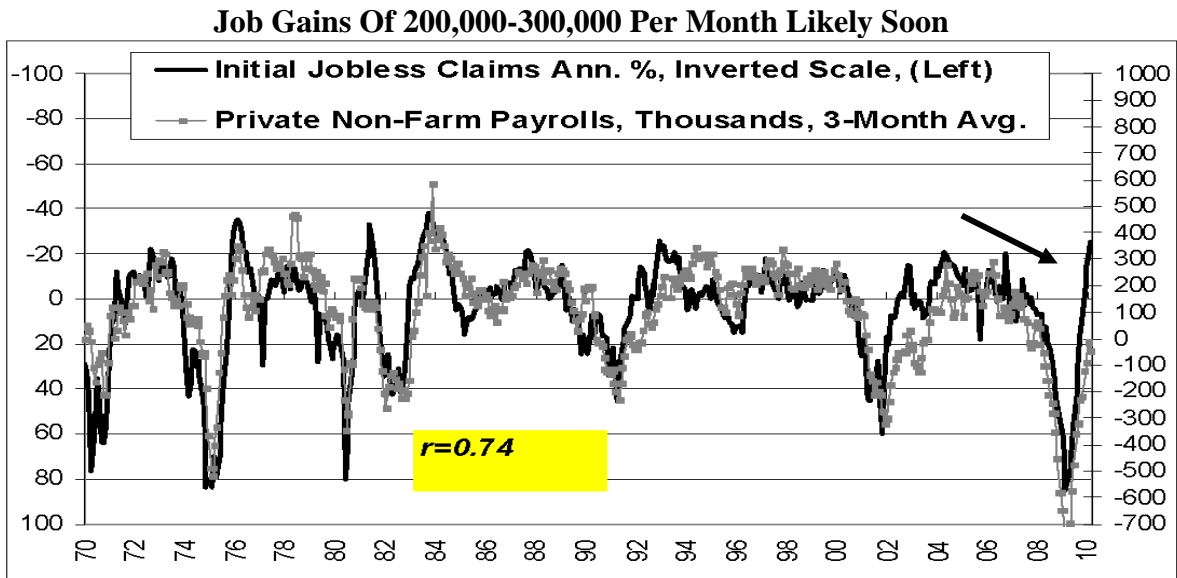
Job growth logically lags an economic upturn. Businesspeople are profit maximizers. When sales begin to rise, they generally do not rush to hire new workers immediately. The first change we can observe in their behavior when business begins to improve is that they stop laying off workers, and we can see this in the weekly unemployment claims data. Then, since some of the workers they have retained during the recession have had their working hours reduced, employers next will increase the length of the production workweek, and we have monitored this in monthly Labor Department data. At the same time, some businesses, needing to increase production, but lacking confidence that the improved conditions will last, hire temporary workers, and we have been observing this in the employment reports. In normal cycles, only after all of these "easy" steps have been taken and profits have increased sufficiently to warrant an increase in full-time hiring do businesspeople commit to hiring new, full-time employees. Generally, this phase of the business recovery has not occurred until six-to-twelve months after the recession has ended, but in some cycles, it has taken much longer. When job growth resumes, household incomes begin to rise at a faster rate, consumption growth accelerates, and the economic recovery becomes self-sustaining. By observing these improvements in the series that normally precede the beginning of the hiring phase, and by knowing by how long they normally precede a pick-up in full-time employment, we can predict fairly accurately when business is ready to begin hiring. We are reasonably confident that this economic recovery now is reaching this critical point.

Job growth is imminent. The chart at the top of the next page shows the monthly changes in Payroll Employment since the beginning of 2009, with each bar representing the number of full-time jobs lost or gained for each month. Early in 2009 our economy was losing jobs at a rate of more than 700,000 per month. Simple trend extrapolation of the diminishing trend of job losses through 2009 suggests our economy has reached the point in the recovery process of transitioning from job losses to job gains that will make this recovery sustainable. In fact, on April 2 a payroll gain of 162,000 was reported for March (the last bar in the chart at the extreme right).

Our expectation of impending job growth is supported by the well-established relationships between the various series we mentioned on the previous page and trends in payroll employment. We are indebted to economist Michael T. Darda of MKM Partners for his work on this subject. For example, he has found a consistent relationship between weekly filings for unemployment



insurance and changes in payroll employment. As shown in the chart below, the number of jobs gained or lost over moving three-month periods (plotted on the right scale of the chart) has been very closely related to the year-over-year changes in unemployment filings during each period (i.e. the two lines move up and down together).

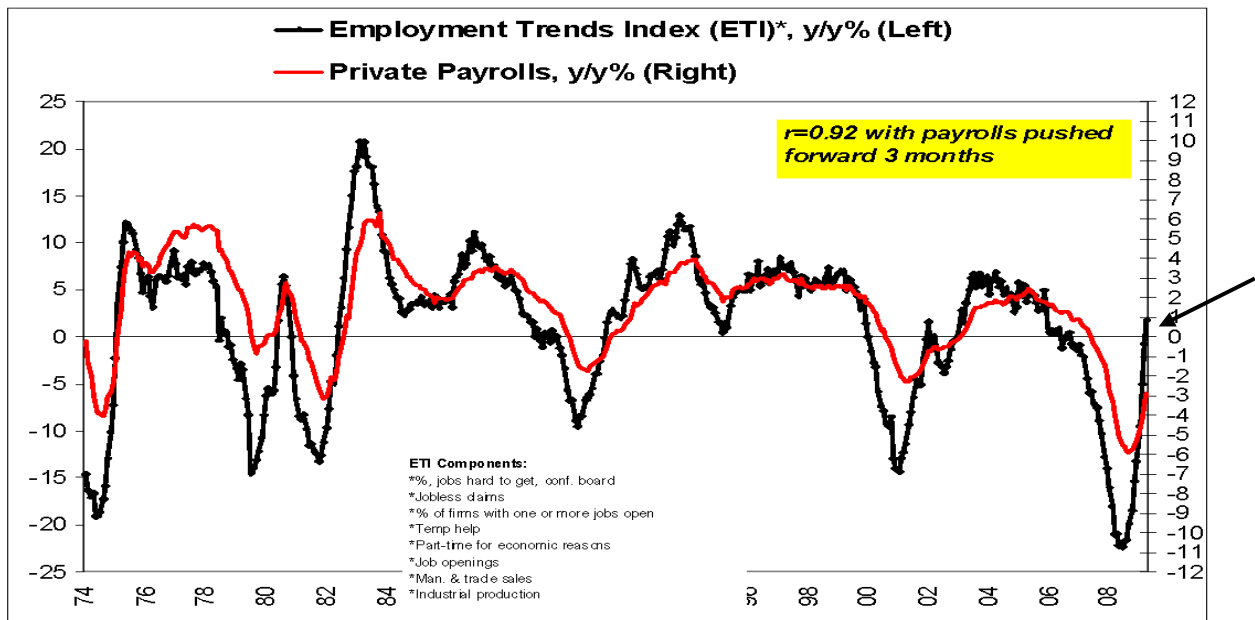


Source: Bloomberg; MKM Partners

A year ago the dark, solid line in the chart above plotting the year-over-year percentage changes in weekly unemployment filings (inverted, left scale) was at its worst level of the past 40 years, with claims 80% higher than a year earlier. At that time, the three-month average of payroll employment changes (grey line with boxes) was running at -700,000 per month, also its worst level for the period. Since then, as the economy has improved, weekly unemployment filings have diminished so that they now are more than 20% lower than they were at this time last year. This is depicted in the chart by the solid black line rising to above -20% on the inverted left scale. As this

has occurred, the monthly payroll employment numbers have improved and the grey line is following the black line up. If this close relationship continues, the chart's right scale suggests we should see job growth averaging 200,000-300,000 per month during the months ahead.

There are similar close relationships between payroll employment levels and trends in temporary employment, average workweek, industrial production, and surveys of the percentage of respondents saying jobs are hard to find. Rather than showing each of these relationships, we are fortunate that the Conference Board, an economic research organization, has combined many of these and others into a single employment indicator it calls the Employment Trends Index. The chart below shows that this combined Index (the black line) accurately forecasts trends in payroll employment (red line) three months ahead. This Index now is rising at its fastest six-month pace since 1994. If the relationship between these two series continues, the red line should rise to between 0% and +1% on the right-hand scale over the next several months, meaning payroll employment should move back to about even with, or slightly above, its mid-2009 level by June. If this occurs, payroll employment will rise by almost 300,000 per month between now and June.



*Source: Conference Board; Bloomberg; MKM Partners

We conclude from the foregoing that despite the unprecedented financial crisis of 2008, many aspects of the economic recovery are proceeding normally and that the economy is likely to transition over the months ahead into a period of significant job growth. This will make the recovery self-sustaining and reduce the need for Fed and government stimulus. For investors, the improving health of the economy has obvious benefits, but it also poses some market risks.

Job growth will drive the next leg of the market rebound. Over the past year we have discussed how stock market recoveries from bear markets generally continue without a serious interruption until around the time when the Fed begins to raise its important fed funds rate. We have noted that historically the first fed funds hike has not occurred until much of the economic slack created by the recession has been eliminated, until bank lending to businesses has begun to

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expand, and until significant job growth has occurred. The markets have been obsessed this year with anticipating when the Fed will begin to remove some of the immense liquidity it pumped into the banking system during the crisis. Even though the Fed recently has gone to great lengths to make clear to the markets that it is a long way from beginning to tighten monetary policy, leading some economists to push out their forecasts for the first fed funds increase to early 2011, it is quite possible that a couple of months of significant job growth between now and mid-year will rekindle the market's fears and produce some stock market sloppiness. Nonetheless, we see the beginning of job growth as an important positive development for the economy and for the stock market.

The stock market underwent a bout of nervousness in January and February when some modest central bank tightening moves in China raised fears that this was initiating a wave of worldwide credit tightening soon to be joined by the US Fed. At the same time, concerns that Greece's debt problems would be the precursor of international capital flight from all countries running large fiscal deficits, including the US, pushed stock prices even lower. From the January highs to the February lows, stock prices fell, but the decline stayed within the relatively minor 8% band that has been the historical limit of market corrections until the Fed begins tightening.

With the economy recovering, corporate earnings continue to exceed market expectations and analyst forecasts of S&P 500 earnings for this year now are approaching our own longstanding estimate of \$80. This would represent a gain of almost 30% from last year's earnings, while still leaving them 15% below their normalized level. In order to reach our targeted range for this year of 1300-1400, the S&P 500 will have to sell at a price-earnings ratio of around 17 times this earnings level. This PE is below the index's 17.5 PE at the end of March. If investor confidence rises as job growth resumes, a PE assumption of 17 seems quite reasonable for later this year. We share the concerns of some regarding our nation's rising federal debt and tax levels that could make the investment environment more difficult in the years ahead, but we think the positive forces of cyclical recovery from the recession will dominate these in the short run.

We noted above that the initial stages of stock market recoveries always have continued with only relatively minor corrections until the Fed has begun to raise its fed funds rate. In our January Outlook we detailed our expectation that the Fed would not begin to raise rates this cycle before late-2010, but that investors might anticipate the rate hike this time by as much as six months. Thus, we thought the market could continue to advance strongly through roughly mid-year, at which time a 10-15% correction would interrupt the recovery for several months. In light of investors' preoccupation over the past three months with when the Fed will begin to tighten, we now think we may experience a gentler advance in stock prices during the first half of this year, but less of a market correction during the second half as much of the rate hike already is being discounted by investors.

Normal rate relationships have been reestablished over the past year for most investment-grade bonds following the credit crisis. Therefore, a strengthening of the economic recovery through job growth, which often coincides with a pick-up in credit demands, will be a cyclical negative for bonds, causing rates to rise and bond prices to decline. Thus, it is a time for caution for bond investors.