



U.S. Job Report Suggests that Green Shoots are Mostly Yellow Weeds

Nouriel Roubini | Jul 2, 2009

The June employment report suggests that the alleged 'green shoots' are mostly yellow weeds that may eventually turn into brown manure. The employment report shows that conditions in the labor market continue to be extremely weak, with job losses in June of over 460,000. With the current rate of job losses, it is very clear that the unemployment rate could reach 10 percent by later this summer, around August or September, and will be closer to 10.5 percent if not 11 percent by year-end. I expect the unemployment rate is going to peak at around 11 percent at some point in 2010, well above historical standards for even severe recessions.

It's clear that even if the recession were to be over anytime soon – and it's not going to be over before the end of the year – job losses are going to continue for at least another year and a half. Historically, during the last two recessions, job losses continued for at least a year and a half after the recession was over. During the 2001 recession, the recession was over in November 2001, and job losses continued through August 2003 for a cumulative loss of jobs of over 5 million; this time we are already seeing more than 6 million job losses and the recession is not over.

The details of the unemployment report are even worse than the headline. Not only are there large job losses right now, but as a way of sharing the pain, firms are inducing workers to reduce hours and hourly wages. Therefore, when we're looking at the effect of the labor market on labor income, we should consider that the total value of labor income is the product of jobs, hours, and average hourly wages – and that all three elements are falling right now. So the effect on labor income is much more significant than job losses alone.

The details also suggest that other aspects of the labor markets are worsening. If you include discouraged workers and partially-employed workers, the unemployment rate is already above 16 percent. If you consider also that temporary jobs are falling now

quite sharply, labor market conditions are becoming worse. And the average duration of unemployment now is at an all-time high. So people not only are losing jobs, but they're finding it harder to find new jobs. So every element of the labor market is worsening.

The unemployment rate rose only marginally from 9.4 percent to 9.5 percent, but that's because so many people are discouraged that they exited the labor force voluntarily, and therefore are not counted in the official unemployment rate.

The other element of the report that must be considered is that, for the summer, the Bureau of Labor Statistics (BLS) is still adding between 150,000 and 200,000 jobs based on the birth/death model. We know the distortions of the birth/death model – that in a recession jobs created within firms are much smaller than those created by firms that are dying. So that's distorting downward the number of job losses. Based on the initial claims for unemployment benefits, it's more likely that the job losses are closer to 600,000 per month rather than the figures officially reported.

These job losses are going to have a significant effect on consumer confidence and consumption in the months ahead. We've also seen extreme weakness in consumption. There was a boost in retail sales and real personal consumption-spending in January and February, sparked by sales following the holiday season, but the numbers from April, May, and now June are extremely weak in real terms. In April and May you saw a significant increase in real personal income only because of tax rebates and unemployment benefits. In April, there was a sharp fall in real personal spending, and in May the increase was only marginal in real terms.

This suggests that the most of the tax rebates are being saved rather than consumed. The same thing happened last year. Last year, with a \$100 billion tax rebate, only thirty cents on the dollar were spent while seventy cents on the dollar were saved. Last year, people expected the tax rebate to stimulate consumption through September. Instead, there was an increase in April, May, and June, with the increase fizzling out by July.

This year it's even worse. We have another \$100 billion in tax rebates in the pipeline. But the numbers suggest that in April, real consumption fell. And in May it was practically flat. So this year households are even more worried than they were last year about jobs, income, credit cards and mortgages. Most likely

only around 20 cents on the dollar – rather than 30 cents last year – of that increase of income is going to be spent. In any case, that increase in income is just temporary and is going to fizzle out by the summer. So you can expect a significant further reduction in consumption in the fall after the effects of the tax rebates fade.

The other important aspect of the labor market is that if the unemployment rate is going to peak around 11 percent next year, the expected losses for banks on their loans and securities are going to be much higher than the ones estimated in the recent stress tests. You plug an unemployment rate of 11 percent in any model of loan losses and recovery rates and you get very ugly losses for subprime, near-prime, prime, home equity loan lines, credit cards, auto loans, student loans, leverage loans, and commercial loans – much bigger numbers than what the stress tests projected.

In the stress tests, the average unemployment rate next year was assumed to be 10.3 percent in the most adverse scenario. We'll be already at 10.3 percent by the fall or the winter of this year, and certainly well above that and close to 11% at some point next year.

So these very weak conditions in the labor market suggest problems for the U.S. consumer, but also significant increasing problems for the banking system as these sharp increases in job losses lead to further delinquencies on loans and securities and lower than expected recovery rates.

The latest figures – published this week - on mortgage delinquencies and foreclosures suggest a spike not only in subprime and near-prime delinquencies, but now also on prime mortgages. So the problems of the economy are significantly affecting the banking system. Even if for a couple of other quarters banks are going to use the new Financial Accounting Standards Board (FASB) rules and under-provisioning for loan losses to report better-than-expected results, by Q4, with unemployment rates above 10 percent, that short-term accounting fudging will have a significant impact on reported earnings. And this will show the underlying weakness in the economy. So banks may fudge it for a couple of other quarters, but eventually the effects of very sharp unemployment rates and still sharply falling home prices are going to drag down earnings and have a sharp effect on losses and capital needs of the banks and of the entire financial system.

Essentially, the results today suggested that there are not as many green shoots. These green shoots, as we've argued, are mostly yellow weeds that may even turn into brown manure if a double dip W-shaped recession occurs in 2010-2011. And it's not just the employment situation. Real consumption and retail sales remain weak. Industrial production remains weak. The housing market, in terms of price adjustment, remains weak, even if the quantities - demand and supply - may be closer to bottoming out. Indeed, the inventory of unsold new homes is so large that you could stop producing new homes for almost a year to get rid of that inventory. Moreover, about 50% of existing home sales are distressed sales (short sales and foreclosed homes).

The labor market conditions may have a significant effect on how long it takes for the housing market to bottom out. It's already estimated that by the end of this year, there will be about 8.4 million people who have a mortgage who have lost jobs, and therefore have essentially little income. Therefore, the number of people who will have difficulties servicing their mortgages is going to rise very sharply.

Home prices have already fallen from their peak by about 27 percent. Based on our analysis, they are going to fall by at least another 40 percent, and more likely 45 percent, before they bottom out. They are still falling at an annualized rate of over 18 percent. That fall of at least 40-45% percent of home prices from their peak is going to imply that about half of all households that have a mortgage – about 25 million of the 51 million that have mortgages – are going to be underwater with negative equity in their homes, and therefore will have a significant incentive to just walk away from their homes.

The job market report is essentially the tip of the iceberg. It's a significant signal of the weaknesses in the economy. It affects consumer confidence. It affects labor income. It affects consumption. It affects the willingness of firms to start increasing production. It has significant consequences of the housing market. And it has significant consequences, of course, on the banking system.

Overall, it's an extremely weak report and suggests that weakness in the labor markets is going to continue, and that the recession is more likely to continue through the end of the year and the beginning of next year. It also suggests that recovery will be anemic, subpar, below trend. We are still estimating that U.S. growth next year is going to be 1 percent above the 2009 level,

well below a potential growth rate of 3 percent. This is because there is little deleveraging of households, corporate firms and financial institutions while there is a massive re-leveraging of the public sector with sharply rising deficits and debts as many of the private losses have been socialized.

There are also signs that there may be forces leading to a double-dip recession, sometime toward the second half of next year or towards 2011. If oil prices rise too much, too fast, too soon, that's going to have a negative effect on trade and real disposable income in oil-importing countries (US, Europe, Japan, China, etc.). Also concerns about unsustainable budget deficits are high and are going to remain high, with growth anemic and unemployment rising. These deficits are already pushing long-term interest rates higher as investors worry about medium- to long-term stability. If these budget deficits are going to continue to be monetized, eventually, toward the end of next year, you are going to have a sharp increase in expected inflation - after three years of deflationary pressures - that's going to push interest rates even higher.

For the time being, of course, there are massive deflationary pressures in the economy: the slack in the goods markets, with demand falling relative to supply-and-excess capacity. The rising slack in labor markets, which are controlling wages and labor costs and pushing them down, implies that deflationary pressures are going to be dominant this year and next year.

But eventually, large budget deficits and their monetization are going to lead – towards the end of next year and in 2011 – to an increase in expected inflation that may lead to a further increase in ten-year treasuries and other long-term government bond yields, and thus mortgage and private-market rates. Together with higher oil prices driven up in part by this wall of liquidity rather than fundamentals alone, this could be a double whammy that could push the economy into a double-dip or W-shaped recession by late 2010 or 2011. So the outlook for the US and global economy remains extremely weak ahead. The recent rally in global equities, commodities and credit may soon fizzle out as an onslaught of worse- than-expected macro, earnings and financial news take a toll on this rally, which has gotten way ahead of improvement in actual macro data.

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