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MACROCOSM

Bad Jobs

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Let us be the last to say so -- the Fed will cut rates on September 18. But that doesn't mean recession, or a prolonged easing cycle, is around the corner.

We're not going to sugarcoat it. This was a very worrying jobs report. If the labor market braking suggested by today's employment data is sustained for any significant length of time, it will surely indicate an economy shifting into a much slower growth mode, if not outright recession. To help guard against that, it now seems a foregone conclusion that the Fed will cut its funds rate target by 25 bp at the next FOMC meeting on September 18 (see "Cut or No Cut" September 5, 2007).

But we would strongly advise against rushing to what could be a very premature conclusion about the macroeconomy on the basis of one data point. It is a trite truism that one month does not make a trend, but it's still worth keeping in mind. In the expansion of the 1990s, generally regarded as a period of unprecedented prosperity and job market nirvana, there were four occasions when payrolls printed negative for a month, and by larger amounts than the decline of 4,000 reported today. One of those, a decline of 7,000 jobs in August 1997, came in the midst of a quarter that produced a 5.1% real GDP growth rate.

We're not going to make the case that the current economic environment is as robust as *that*, but neither does it bear much resemblance to conditions evident the last time payroll growth turned negative, in mid-2000. The first reported decline of 43,000 jobs that June coincided with other indicators suggesting a marked deceleration of growth was underway. Industrial production and retail sales, for example, were showing the first signs of the slump that would bring a full-blown recession the following year. Currently, there are no such signs in any other data. It is true that, as yet, the full complement of releases covering the period of sharpest credit market turmoil last month has not been published. But those that are available, including the ISM manufacturing and services indexes and the Fed's beige book, do not suggest that any significant growth pullback is at hand.

Update to strategic view
FED FUNDS: We concede -- today's jobs report makes a 25 bp funds rate cut at the September 18 FOMC meeting all but inevitable. We disagree with the consensus that this necessarily means the onset of a prolonged easing cycle. **US MACRO:** One bad jobs number does not make an inflection point. Reports like today's are not untypical in expansions, and so far all the other data we look at points to resiliency in the economy. With the Fed coming into this moment already accommodative, and likely to get more so, we do not expect severe or prolonged weakness ahead.
[see Investment Strategy Dashboard]

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The major distinction between the macro environments then and now is that monetary policy in 2000 was in an excessively tight deflationary posture, while today it remains in an accommodative surplus-liquidity mode. The toll being taken by the Fed's stance at that time could be seen in the price of gold plunging from $315 early that year to below $275 by early June. The economically destructive intensification of risk aversion spawned by a massively too-tight Fed could be seen in high yield credit spreads spiking from around 450 bp to more than 600 bp between February and June of that year. In the current turbulent repricing of risk, credit spreads have also spiked, but this should be kept in perspective. In a range around 450 bp, the high yield spread can be seen as only having undergone a normalization. These levels, in fact, were considered growth-positive during the early 2000 timeframe.

The market turbulence experienced over the past several weeks has commonly been characterized as reflecting a drain on liquidity availability, but this is misleading. Yes, in the early stages of the episode, a panicked rush to liquidity could be seen in the gold price dropping some $20 to around $660 and the dollar briefly rising sharply against its foreign counterparts. But since that early fear faded, it has become apparent that a dollar scarcity is hardly the problem and the Fed's excess liquidity stance has once again become plain. Whatever short-term dislocations might arise from the market's current upheaval, a sustained growth dampening is unlikely in such a monetary environment.

The price of gold today rallied to close above $700 for the first time in 16 months after the weak employment report intensified bets that the Fed would be compelled to embark upon an aggressive course of policy ease. But while the central bank is likely to sanction a 25 bp cut as what they would regard as an insurance policy against further weakness, they are unlikely to signal that they are prepared to be nearly as generous as the markets now expect. One FOMC member told us this week that while downside economic risks might make some policy response appropriate, he remained cognizant that the inflation battle could hardly be considered won. Indeed, while the Fed's model does not incorporate the market price signals that we interpret as very likely foreshadowing an eventual turn higher in reported inflation, at some point they will be faced with little choice but to respond with a renewed course of rate hikes. Obviously, that day has now been put off indefinitely. But present circumstances only make it more likely that when the Fed is eventually moved to re-enter tightening mode, it will be forced to raise rates to potentially economy-crushing levels.

BOTTOM LINE: Today's employment report showing a modest decline in payroll jobs has immediately been seized on as reflecting a marked economic slowdown, with interest rate futures markets significantly upping their bets on the likely course of Fed rate cutting in response. But more likely than not, this weak number will come to be seen as an outlier in the context of a still solid economic expansion. Fed funds futures are now well on their way to pricing for 100 bps in rate cuts by year end. We view that as an extremely aggressive bet which is highly likely to overshoot the Fed's actual reaction.