

## Great News!!! 9.4% Unemployment?

We supposedly received great news on Friday...we only lost 345,000 jobs in May. This was far better than expectations – so things are improving. Unfortunately, the unemployment rate rose to 9.4%. I want to take you through some background material about the employment report and then the data.

### Background

The Employment Situation is a monthly report put out by the Bureau of Labor Statistics. The report is actually two surveys:

1. **Household Survey** – a sample of 60,000 households in which they determine whether each person (16 years and over) is employed, unemployed or not in the labor force.
2. **Establishment Data** – collected from payroll records; the sample includes approximately 160,000 businesses and government agencies. Approximately 40% of the sample comes from small businesses.

The key differences in the surveys are that the Household Survey:

1. includes agricultural workers, the self-employed and unpaid family workers
2. includes people on unpaid leave (among the employed)
3. counts each person only once (while the Payroll Survey may capture some people twice)

## Key Data From the May Report (Released June 5, 2009)

1. There were 345,000 jobs lost in May according to the Establishment Data. This is approximately half the average monthly decline for the prior six months. The Establishment Data provides the job loss (or creation) number that everyone uses – it's more reliable.
2. Using the Household Report, the number of jobs lost was 437K. In the Household Survey, the number of unemployed persons increased 787K to 14.5 million. (The Household Survey showed 437K people losing jobs and 350K more people in the work force for a total increase in unemployment of 787K). Since December 2007, the number of unemployed people has risen by 7 million. Using the Establishment data, 6 million jobs have been lost (but the Establishment data doesn't include certain groups).
3. Out of the 14.5 million unemployed people (Household Data), 48% have been unemployed for 15 weeks or longer. One year ago, less than 33% of unemployed people had been unemployed for 15 weeks or longer. As the job losses slow, this percentage will likely increase to over 50% in the coming months (because there will be a smaller percentage that has been unemployed for a short time if job losses slow). This means that approximately seven million workers will be unemployed for more than four months – this puts most people in a really difficult situation.
4. The unemployment rate increased from 8.9% to 9.4%.
5. The broadest measure of unemployment reached 16.4% (1 in 6 people)! This measure includes the 9.4% of the work force that we already described as unemployed plus people who are not typically included as unemployed (people who don't look for a job because they are discouraged, people who didn't look for a job in the last four weeks because they had other things to take care of and people who accepted part-time work even though they wanted full-time work). In effect, you can think of this as unemployed plus under-employed (the part-time workers).
6. The Establishment Data reports that 19 million people (14% of the work force) work in "Goods-Producing" industries (i.e., construction, manufacturing, etc.) and 113 million (86% of the work force) work in "Service Producing" industries. Yet, 65% of the jobs (225K) were lost in Goods Producing industries and 35% of the jobs (120K) were lost in Service Producing industries.
7. Since its most recent peak in February 2000, employment in motor vehicles and parts has fallen by approximately 50%.
8. The one-month diffusion index (which roughly measures the percentage of industries which increased employment) jumped to 32.7 in June (from 25.8 in May and 19.6 in March).

## **Final Thoughts**

The employment report for May was certainly an improvement. With that said, the unemployment situation is ugly and it's going to continue to get worse. We all knew that we weren't going to keep losing 600K jobs each month. But we need to create 150K jobs each month to keep up with new workers entering the work force. We're still far below that level (there is a 500K difference between losing 350K jobs and creating 150K jobs). I think that the job market will improve, but it will happen slowly. I still expect that we'll go above 10% unemployment this year. My guess is that unemployment will peak between 10 - 11%. Of course, that assumes that there is no other shoe that drops...

In addition, the alarming thing is that the employment situation is unlikely to have a strong rebound in the near future. Chairman Bernanke summed it up when he testified before the Budget Committee on Wednesday:

*Even after a recovery gets under way, the rate of growth of real economic activity is likely to remain below its longer-run potential for a while, implying that the current slack in resource utilization will increase further. We expect that the recovery will only gradually gain momentum and that economic slack will diminish slowly. In particular, businesses are likely to be cautious about hiring, and the unemployment rate is likely to rise for a time, even after economic growth resumes.*

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## Who is the Next GM-Type Catastrophe?

I have received emails from many of you asking who is the next GM. In other words, what disaster will happen next? While I appreciate your mistaken belief that I know, I think that many people fundamentally misunderstand what I do. I spend my time teaching – and that means that I learn things and teach students. I don't spend my time analyzing companies. The amount of time that I spend following the markets (and the economy) is also very limited. I read current news and academic research and I think about it – but it's a small part of my time.

With that said, I'll tell you who I think the next GM could be. I think it could be the United States. Let me start with a story...

For years, I've spoken about GM in class. I'm sure that I was one of hundreds (or thousands) of teachers who talked about them. Their debt burden is not something that happened overnight. Their debt changed – it used to be that money was owed to their pension fund and healthcare fund. But, a few years ago, GM issued debt and used the proceeds to fund the pension fund. As a result, the debt changed from money owed to the pension fund to straight bonds. (Yes bondholders, while you gripe about your bankruptcy allotment, you effectively financed the UAW's pension fund. I'm not sure you have anyone else to blame but yourself.) Regardless, GM has always had a lot of debt.

Now, some former students might claim that I went a tad further in my comments about GM. I may have (once or twice???) mentioned that the quality of their product was (slightly???) lacking. Regardless, I never said anything that wasn't extremely obvious: the firm was highly leveraged and the product was not overly competitive. Their employees were overpaid and they had a huge healthcare liability (and until they issued bonds, they also had a pension liability). They relied on their union to get them excess compensation.

Who does that sound like? Think about the US...we're becoming more highly leveraged. More importantly, as I discussed a few weeks ago, if you consider Social Security, Veterans Affairs and Medicare / Medicaid as an obligation, we are incredibly overleveraged. In effect, we have too much debt and we have a huge healthcare and pension liability. Our citizens rely on their political parties to steer a larger piece of the pie their way (political parties are our UAW). Think about it...too much debt, healthcare and pension liability and political parties which act like unions. We are GM.

When I would talk about GM in class, some annoying student would always ask when something was going to happen to GM. Normally, I'd tell the student to shut up and then I'd ask if anyone had a good question. Actually, I would tell the students that I expected housing to turn down in 2007, the economy to turn down in 2008 and GM would file for bankruptcy in 2009. Okay, not really. My real answer was, "I have no idea."

So when you ask when bad things will happen to the US, my answer is the same – I have no idea. I don't think it's in the immediate future. Similar to how GM operated for years in a dire financial situation until the market refused to finance them, the US will probably be able to continue on for some time. Eventually, something bad will trigger the event and I have no idea what it will be. Maybe there will be a run on a well-established country's currency and investors will start to think about the dollar and our debt. Maybe some type of catastrophe will occur that will shut down a significant part of our economy for a while. There's no way to know what the trigger will be. But, just like GM, I'm fairly confident that it will happen.

Interestingly, I think Ben Bernanke is also confident that it will happen. This week, he testified before the Budget Committee in the House of Representatives. Here's part of what he said (in italics) (with emphasis added by me):

*The increases in spending and reductions in taxes associated with the fiscal package and the financial stabilization program, along with the losses in revenues and increases in income-support payments associated with the weak economy, will widen the federal budget deficit substantially this year. The Administration recently submitted a proposed budget that projects the federal deficit to reach about \$1.8 trillion this fiscal year before declining to \$1.3 trillion in 2010 and roughly \$900 billion in 2011. As a consequence of this elevated level of borrowing, **the ratio of federal debt held by the public to nominal GDP is likely to move up from about 40 percent before the onset of the financial crisis to about 70 percent in 2011.** These developments would leave the debt-to-GDP ratio at its highest level since the early 1950s, the years following the massive debt buildup during World War II.*

*Certainly, our economy and financial markets face extraordinary near-term challenges, and strong and timely actions to respond to those challenges are necessary and appropriate. Nevertheless, **even as we take steps to address the recession and threats to financial stability, maintaining the confidence of the financial markets requires that we, as a nation, begin planning now for the restoration of fiscal balance.** Prompt attention to questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby-boom generation and continued increases in medical costs. **The recent projections from the Social Security and Medicare trustees show that, in the absence of programmatic changes, Social Security and Medicare outlays will together increase from about 8-1/2 percent of GDP today to 10 percent by 2020 and 12-1/2 percent by 2030. With the ratio of debt to GDP already elevated, we will not be able to continue borrowing indefinitely to meet these demands.***

***Addressing the country's fiscal problems will require a willingness to make difficult choices.** In the end, the fundamental decision that the Congress, the Administration, and the American people must confront is how large a share of the nation's economic resources to devote to federal government programs, including entitlement programs. Crucially, whatever size of government is chosen, tax rates must*

*ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run. In particular, **over the longer term, achieving fiscal sustainability--defined, for example, as a situation in which the ratios of government debt and interest payments to GDP are stable or declining, and tax rates are not so high as to impede economic growth--requires that spending and budget deficits be well controlled.***

With my normal caveat that I'm not an economist, I have to say that I'm shocked that Bernanke speaks in terms of "debt held by the public to GDP". This strikes me as incredibly misleading since the Federal government (the Social Security fund) holds almost as much of our debt as the public does. In other words, he is understating our debt by half!

While I've explained this before, I want to explain this one more time. Currently, Social Security is grossly underfunded. We can not meet our obligations. But, Social Security still has money right now. (They just don't have enough for all of the baby boomers.) (It's like if you have a \$1MM obligation and you have \$100,000 – you're grossly underfunded even though you have cash.) The Social Security Fund uses that cash to buy Treasuries. Regardless of the fact that Social Security is really not a retirement fund, you can think of this as the government using our retirement fund money (that we don't need yet) to buy Treasuries and acting like that doesn't count as part of our debt. Under this line of thinking, the only debt that matters is the debt owned outside of our retirement account. It's really silly. More important, I think it's incredibly misleading.

You might ask why Bernanke isn't more direct about our problems. The answer is relatively obvious. If he came out and said that there will be a point in time at which we can't honor our debt, there would be a collapse. You can't expect him to be so direct. You need to use common sense. It's sort of like being the father of a teenage girl. Do you really expect a teenage boy to describe his true intentions?

Even using Bernanke's fake numbers, our deficit is going to grow significantly. When you use the real numbers, it's really ugly. But, as Bernanke says, we need to make some really hard decisions. To be honest, I don't know that I think we can do it. Not only do we not have the political will to do this, I think it's going to be really difficult. What will happen if we cut Social Security benefits? Like it or not, people rely on these. What will happen if we cut healthcare benefits? It's really scary.

The recent action in the bond market may be reflecting some of these issues. The ten-year Treasury yielded 2.9% three months ago, 3.1% one month ago and 3.83% at the end of this week. Investors are selling bonds – which results in lower prices and higher yields. My thoughts about this are:

1. Rates are rising even though the Fed has been buying Treasuries. This signifies the weakness in the Treasury market (and the fact that it's difficult

- for the government to manipulate such a large market – this is why we usually see government intervention in currency markets fail).
2. It's hard to know whether the drop in Treasury prices is due to fear about our deficit or simply a reflection of investors selling Treasuries and buying stocks (and other risky securities). In other words, this may reflect a healthy acceptance of risk.
  3. The increase in rates still leaves Treasuries yielding less than 4% -- which is relatively cheap. With that said, mortgage rates are tied to the ten year Treasury (plus a premium) and the direction is up. Higher interest rates hurt the housing market and make debt financing more expensive for both consumers and companies.

In sum, we're the next GM. If we don't want to experience a huge currency devaluation, we need to make significant changes. We can't wait until it's too late. But, I'm not sure that we have the political willpower to do this.

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## The Final Slap in the Face for Citi

While Citi clearly has had problems during the past two years, they are still a blue chip company. The company is part of the Dow Jones Industrial Average (DJIA). So they should be safe. **Not so fast my friend...**(for you sports fans, that's a Lee Corso line – and if you hadn't heard, Lee Corso had a small stroke this past week – personally, I find him to be hilarious and I'm hoping he gets better soon).

This week, Dow Jones announced changes in the DJIA (and S&P announced a change in the S&P 500). Dow Jones removed GM and Citi from the index and replaced them with Cisco and Travelers. This is the most recent slap in the face for Citi.

It was relatively obvious that Citi and GM would be removed (I spoke about it in our evening MBA program earlier this semester). The reason that this was obvious is that the Dow Jones Industrial Average is "price weighted" – which means that the importance (weight) of each stock is based on its price. In other words, a 10% move in a \$30 stock would have three times as large an impact on the index as a 10% move for a \$10 stock. The thing to realize about this is that we have no idea whether the \$30 stock or the \$10 stock is a larger company. The \$30 stock may only have 1 million shares outstanding (making its market cap \$30 million) and the \$10 stock may have 1 billion shares outstanding (making its market cap \$10 billion). While the DJIA is price-weighted, most stock market indexes are market cap weighted. (Others are equal weighted or fundamental weighted.)

The fact that the DJIA is price-weighted and the two stocks are priced so low (GM's stock is trading for less than \$1 and Citi is trading for less than \$4) resulted in their removal (GM's bankruptcy filing also indicated it might not be a "blue chip" stock...). These low prices meant that changes in these companies' stock prices had little discernable effect on the index. There's no point in having a stock in an index if a move in the stock's price is meaningless to the index.

Citigroup still has a decent-size market cap (\$20 billion), but they have so many shares outstanding that the per share price is low (less than \$4). The ultimate insult for Citi is that they were replaced with Travelers. Travelers had been part of Citi until it was spun off in 2002. St. Paul Cos. acquired Travelers in 2004 and the combined company uses the name Travelers. Aside from the pure insult value of being replaced by your child (without the pride of your child's accomplishment), this also makes people take notice of the fact that the market cap of Travelers (\$24 billion) is larger than the market cap of Citi (\$20 billion). (Realize that this comparison is not fair since Travelers merged with St. Paul Cos., but the sting still exists.) The best analogy is probably how a father feels when he finds out that his child is taller than him and it's not because his child has grown; rather, dad has shrunk.

While Citi executives cry into their beer (cheap, domestic beer produced by a non-American company...), GM executives can sit on the stool right next to them. This

fine auto company was replaced in the S&P 500 by the fine education company... DeVry.