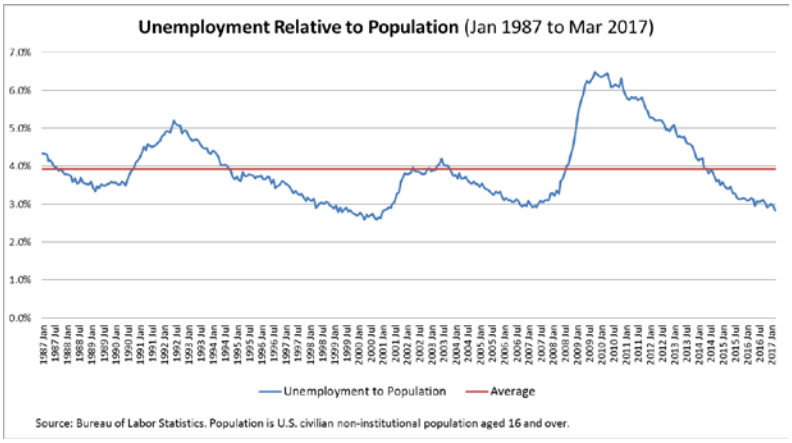
Unemployment, Demographics and Growth

April 2017

On April 7, 2017 the widely anticipated employment data for March showed that the most followed number, the change in Nonfarm Payrolls, came in well below expectations (98,000 vs 180,000), and appeared surprisingly weak compared to the ADP number published two days before. Less noticed was a 0.2% drop in the unemployment rate to 4.5% which resulted from a sizeable 472,000 employment gain in the Department of Labor's Household Survey. The Federal Reserve (Fed) has a dual mandate to control inflation and maximize employment. The Fed raised rates on March 15, 2017, a move that was unexpected in early February, and indicated they will likely raise rates again a few times in 2017. The market is well aware of the Fed's inflation target, 2%, but has less clarity on the unemployment target. How should markets interpret March's employment release?

From March 15 through April 12 the S&P 500 declined 1.7% and the 10-year U.S. treasury yield fell 36 basis points from 2.60% to 2.24%. The short-term market reaction might be interpreted to reflect concern over the economy and its prospects. However, at 4.5% the unemployment rate is the lowest it has been since May 2007, and not far from the low prints over the last 30 years. At the same time, given the country's demographic composition, the size of the economy, and labor market conditions, we think the employment data may tell a different story than the markets are reflecting.

In our 1Q 2013 Commentary we wrote about the falling Labor Force Participation Rate, noting that it was likely a secular trend because the "baby boom generation" was beginning to retire. We used data from the 2010 Census which shows that the two largest 5-year population cohorts have begun to retire, the smallest cohort is traversing its most productive years, and the third largest cohort, baby boomer kids, is now in its early stages of work. Even with the baby boomer kids added, over the next decade, people reaching age 65 will exceed people reaching age 15 or 20 meaning the participation rate will likely tend to decline. Since the unemployment rate is the number of people not working divided by the number of workers (the participants), relatively, the number of unemployed is close to levels seen in 2000, the best year in the last 30. The chart to the right shows the number of unemployed relative to the total non-institutional population, rather than just the participants. Alternatively, if we had the same labor force participation rate now as existed in April 2000 when the unemployment rate was 3.8%, the number would be 4.2% rather than 4.5%.



After the recession in 2008-2009, the Fed and many private sector economists began to argue that the "natural rate of unemployment," which can be thought of as the rate at which the economy is operating at its potential long-term growth pace (i.e. between 2.0% and 3.0%) had risen. In a 2010 Commentary entitled "Unemployment after the Recession: A New Natural Rate?," authors Murat Tasci and Saeed Zaman of the Federal Reserve Bank of Cleveland argued the unemployment rate's long term trend was higher and modeled the Natural Rate to be between 5% and 6%. After the 2008-2009 recession unemployment spiked and the Fed was forced to take extraordinary measures. Even as the unemployment rate declined, the Fed was slow to

withdraw stimulus for fear of derailing an economy that seemed unable to gain momentum. Almost certainly, as the unemployment rate broke through 5.0% in January 2016, shortly after their first rate hike since the recession, the Fed disregarded all notions of a Natural Rate exceeding 5.0%. Now the Fed insists it wants to be ahead of the curve, but with a dramatic shift in Washington's economic policy priorities since the election, it may already be behind.

In 2000, when the unemployment rate averaged 3.97%, GDP was approximately $87,000 per active worker. Year 2000 came at the end of the "tech boom," which brought tremendous investment, partly due to fears that many computer systems were not coded to handle the turn of the century. In 2016, each active worker produced about $104,000 of GDP. A puzzling feature of the post-recession recovery has been the absence of investment. We have argued that comprehensive corporate tax reform could bring a wave of investment, which could boost growth and further increase employment. If this occurred and the unemployment rate reached the April 2000 level of 3.8%, we estimate the growth effect could be 0.75 to 1.0%. However, the labor market is tight and might, surprisingly, be a hurdle rather than an impetus to growth. In the last 30 years the average annual unemployment rate was under 5.0% in only 8 years (including 2016) and under 4.5% in only 2 (1999 and 2000). We believe we can get back to 4.0% with the right policy mix, but we wonder whether the monetary and fiscal authorities will be bold enough to get us there.

Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Federal Reserve Bank of Cleveland, Federal Reserve Bank, Census Bureau.

GIA Partners, LLC

At GIA Partners, credit is in our DNA. We are a bottom-up credit manager who has managed credit portfolios in virtually every part of the world's fixed income markets as well as through some of the most severe credit events in history. Additionally, our investment team has the distinction of being among the first to recognize and actively invest in global high yield and emerging markets debt.

We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

Gloria Carlson
Director, Sales and Marketing
212 893-7835
gcarlson@giallc.com

Arnold West
Director, Institutional Sales
212 893-7815
awest@giallc.com