Mixed message

October 1—The headline for the September jobs report sounded good, as unemployment fell to 7.3%. But a closer look at the report revealed more economic weakness than strength.

• Total jobs created in June and July were revised downward, a shortfall of 74,000. The revisions are generally more accurate that the initial reports.
  • Were the current rate of job creation continued, we won’t close the jobs gap until 2023.
  • Although 169,000 jobs were created in August, 312,000 people dropped out of the labor force. For every two jobs created, three people dropped out. That’s the math that underlies the falling unemployment rate. One wag compared the reduction in the unemployment rate to losing 20 pounds by cutting off one’s arm.

The labor force participation rate, which measures the percentage of people who are working, has fallen to the lowest level in 35 years. At the peak, more than 67% of working-age Americans were working, and now we are down below 63%. That 4% swing has enormous implications for tax and Social Security revenue collections, and for the federal deficit.

Gridlock

Political controversy over what to do about the federal deficit led to a government shutdown on October 1, which remains unresolved at this writing. Conventional wisdom long has suggested that investors prefer a divided government to an activist one, holding down the pace of change. However, the polarization at this time is deep enough to characterize as dysfunction.

Regardless of how the continuing resolution to fund the government is resolved, it is but a dress rehearsal for the larger question of raising the debt ceiling later in the month. Going without nonessential government services for some days or weeks won’t have the same impact as the loss of the Treasury’s borrowing power. One side is going to have to blink.

Markets

At the end of the third quarter, stocks were ahead 18% on the year, outperforming most economist forecasts and far ahead of the pace of economic growth. The S&P 500-stock index set an all-time high on September 18, and finished the quarter 2% below that mark. Much of that growth happened early in the year, as the S&P 500 was up only 0.7% from May 21. The next day Fed Chairman Ben Bernanke warned that the Federal Reserve was going to consider easing off its monthly bond purchases, which has led to considerable volatility in the stock and bond markets.

Current stock valuations are on the high side, as expected after such a run-up. The price/earnings ratio of the S&P 500 is 14.3 times the next 12 months expected earnings. That’s higher than the 10-year average of 14.0, and sharply higher than the 12.9 multiple for the past 5 years. Still, that’s well off the 18.0 p/e the index hit back in 2004.

Corporate profits continue to grow, if weakly. That, plus the relative unattractiveness of the alternatives, may be supporting stock prices. The Fed has a major puzzle on its hands in determining how to taper off its bond purchases without disrupting the bond market.

DJIA
On September 20, S&P Dow Jones Indexes announced a change to Dow Jones Industrial Average (DJIA) lineup. Alcoa, Bank of America and Hewlett-Packard were dropped from the index. The newcomers are Goldman Sachs, Visa and Nike. The change will better reflect the changing American economy, according the index managers.

The DJIA is a price-weighted index, unlike the capitalization-weighted S&P 500. That means the companies with the highest share prices exert a larger pull on the index, even if they aren’t the largest companies. The companies that were dropped from the index each had share prices in the single or low double digit range.

The change could have a temporary effect on the prices of shares in the companies added or dropped from the index, but should have a minor effect on the DJIA itself.

(October 2013)

© 2013 M.A. Co. All rights reserved.