

# Monthly Chartbook

## August 2006

# Inflation, what inflation?

*Potentially from the labor market, but you may miss it in some of the official numbers...*

## **Why we think there may be wage inflation:**

- Some methods of measuring job growth are not capturing a major structural shift in labor markets.
  - Household survey vs. Establishment survey.
- Persistently low jobless claims.
- Power shifting from companies to workers.
  - Using the Help Wanted index is not as valid anymore.
- Inflation-adjusted wage growth is still below trend.
  - With any type of pressure from employers, this will not continue.

But, the primary number economists monitor is not reflecting some of these pressures and is potentially exposing investors to the risk of unanticipated inflation.

## *Macro-economic research*

One of our primary concerns with employment data has been that the unemployment rate does not seem to be consistent with the total number of jobs created each month.

This is because the numbers are from two separate surveys compiled by the Bureau of Labor Statistics (BLS) using different methodologies. The Household survey is the source of the Unemployment number while the Establishment survey provides a record of total new jobs created.

While there are pros and cons of each process, it is important to understand their differences to correctly interpret their results. In fact, we believe these different methodologies contribute to the Establishment survey missing a large structural change in economy...

## *Macro-economic research*

### **Household survey –**

Sample survey of 60,000 households

Classified as employed, unemployed, not in labor force

### *Used for –*

Calculation of the unemployment rate

### *Advantages --*

Households are contacted individually

### *Drawbacks –*

Small sample size

Volatility / sample revisions

Methods of contact may not reflect changes in behavior

## *Macro-economic research*

### **Establishment survey –**

Survey of 160,000 businesses / government agencies

#### *Used for –*

Jobs added for the period (total non-farm payrolls)

#### *Advantages --*

Includes about 1/3 of all nonfarm payroll workers

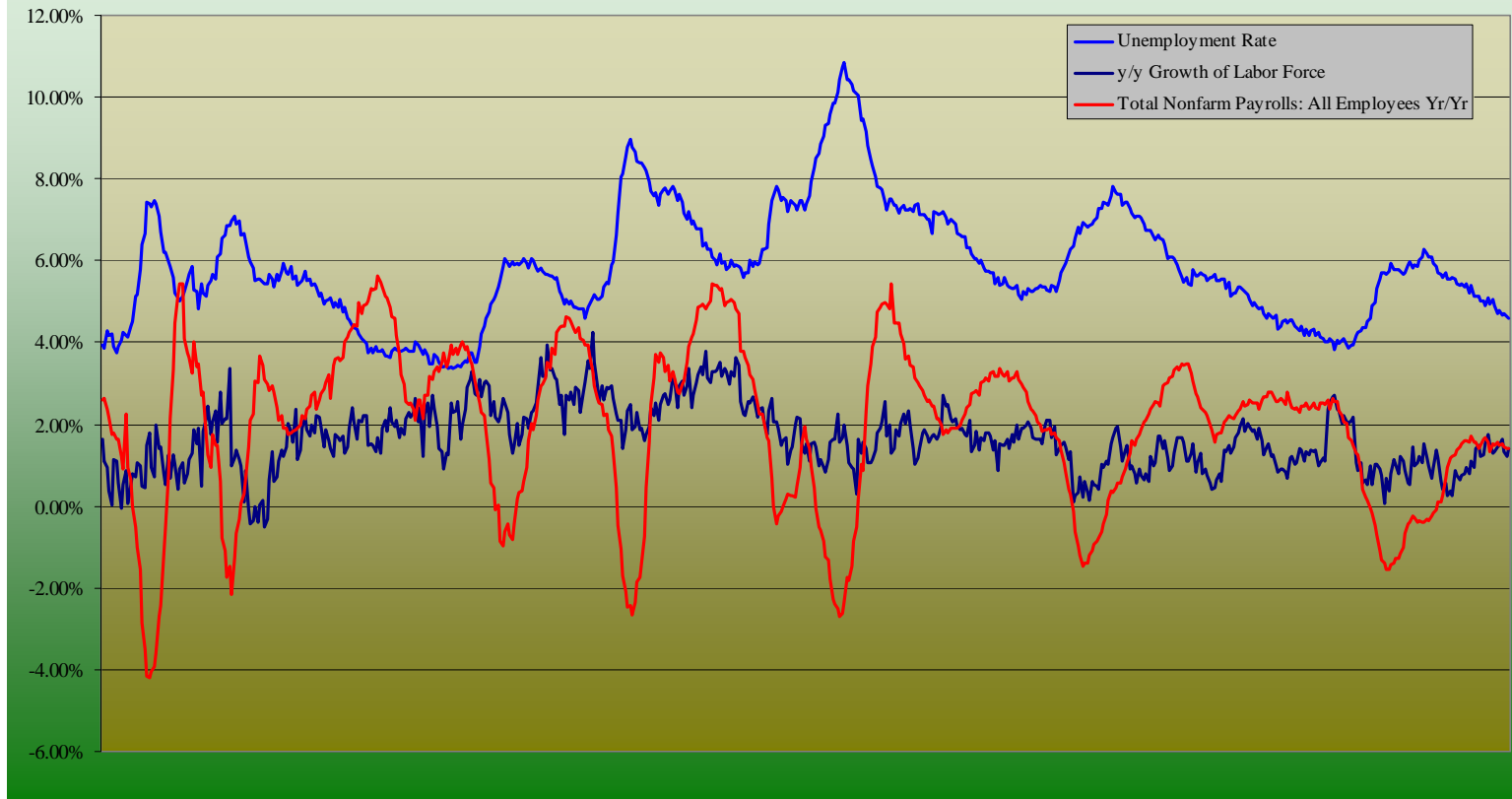
Lower volatility allows better period-to-period comparisons

#### *Drawbacks –*

Double-counts those who change jobs or work more than one job

Does not include those who are not on a payroll (primarily those who are self-employed)

## Unemployment vs. Labor Force Growth



The unemployment rate (household survey) has declined as self-employment has increased while the year-over-year increase in non-farm payrolls remains stunted.

# *Macro-economic research*

## Our Conclusion --

The Establishment survey may be missing a number of those who are participating in a major shift within the labor markets. As employees make the transition from being on a company payroll to being a self-employed, this survey will likely undercount the number of new jobs created.

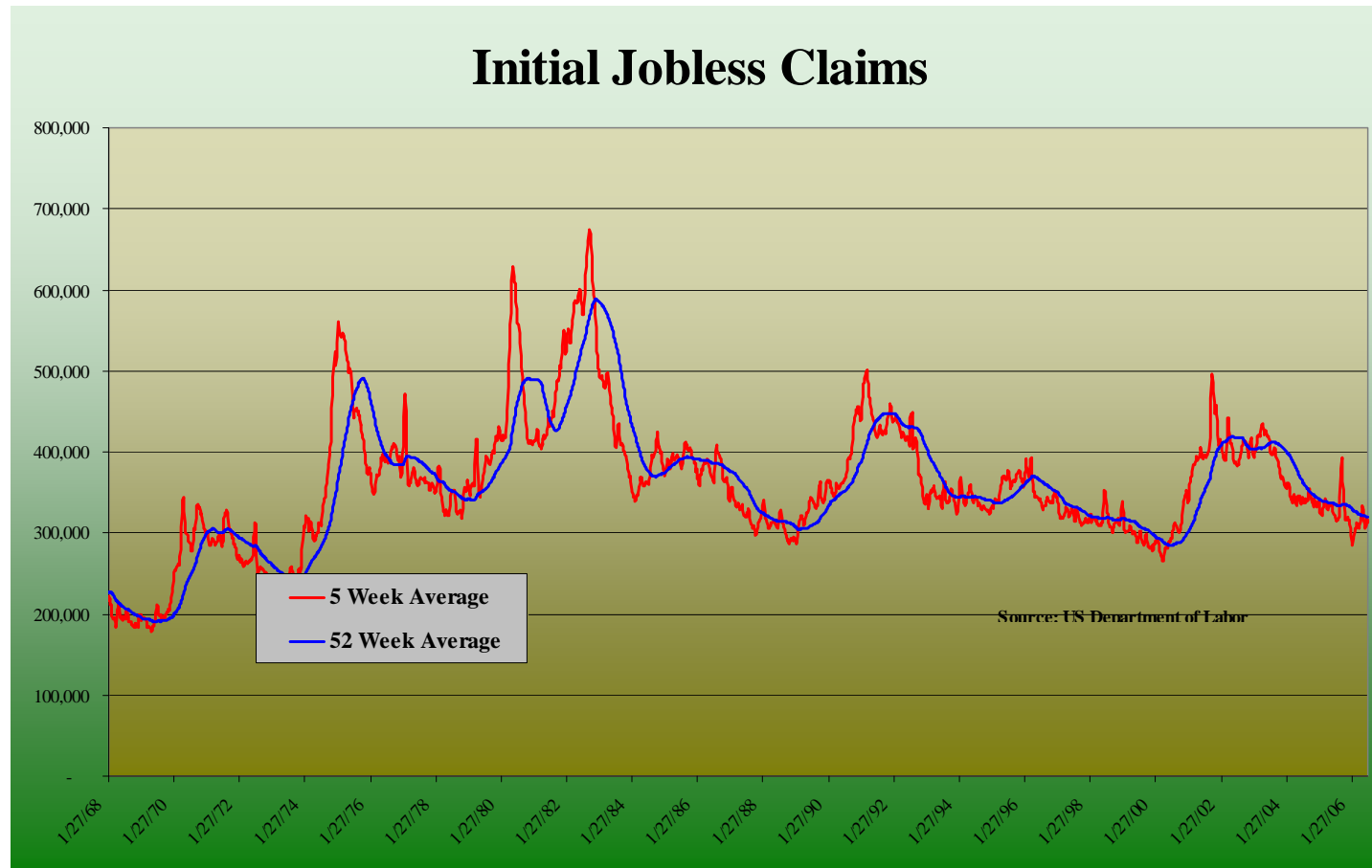
Also, consider that...

When the former positions are replaced by a contract employee or consultant, it appears a job has been “lost”.

The Household survey may even be under-stating unemployment as fewer homes are accessible via land-line, and cell phones numbers remain unpublished (especially consider the immigrant community’s likelihood to respond).

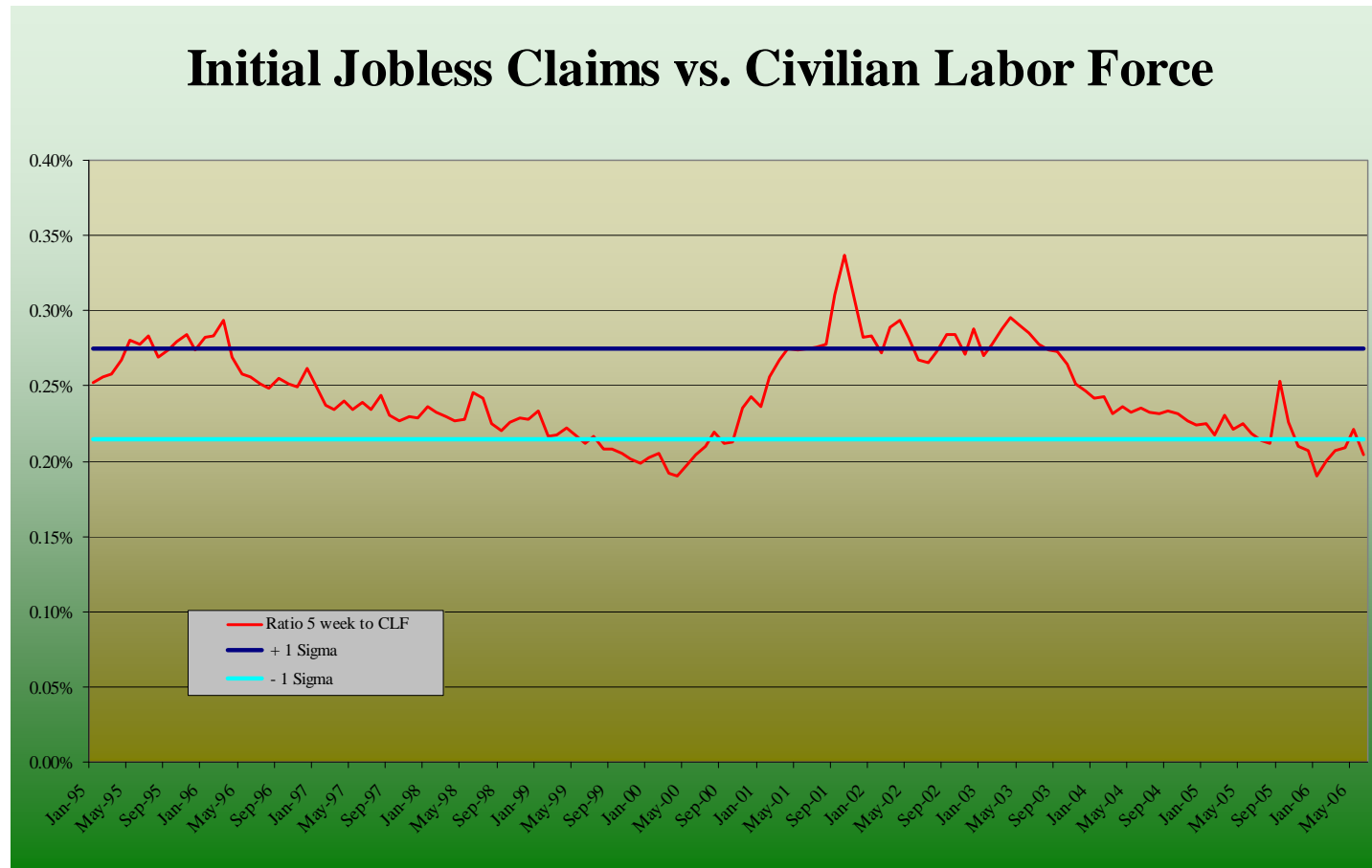
When we began Cornerstone in early 2003, we were among a very few who had decided to “start our own shop”; it seems now that there were several others with the same idea as the number of smaller companies (self-employed) within our community has increase considerably. And, this is south Alabama – probably not the most entrepreneurial region of the country.

## Macro-economic research



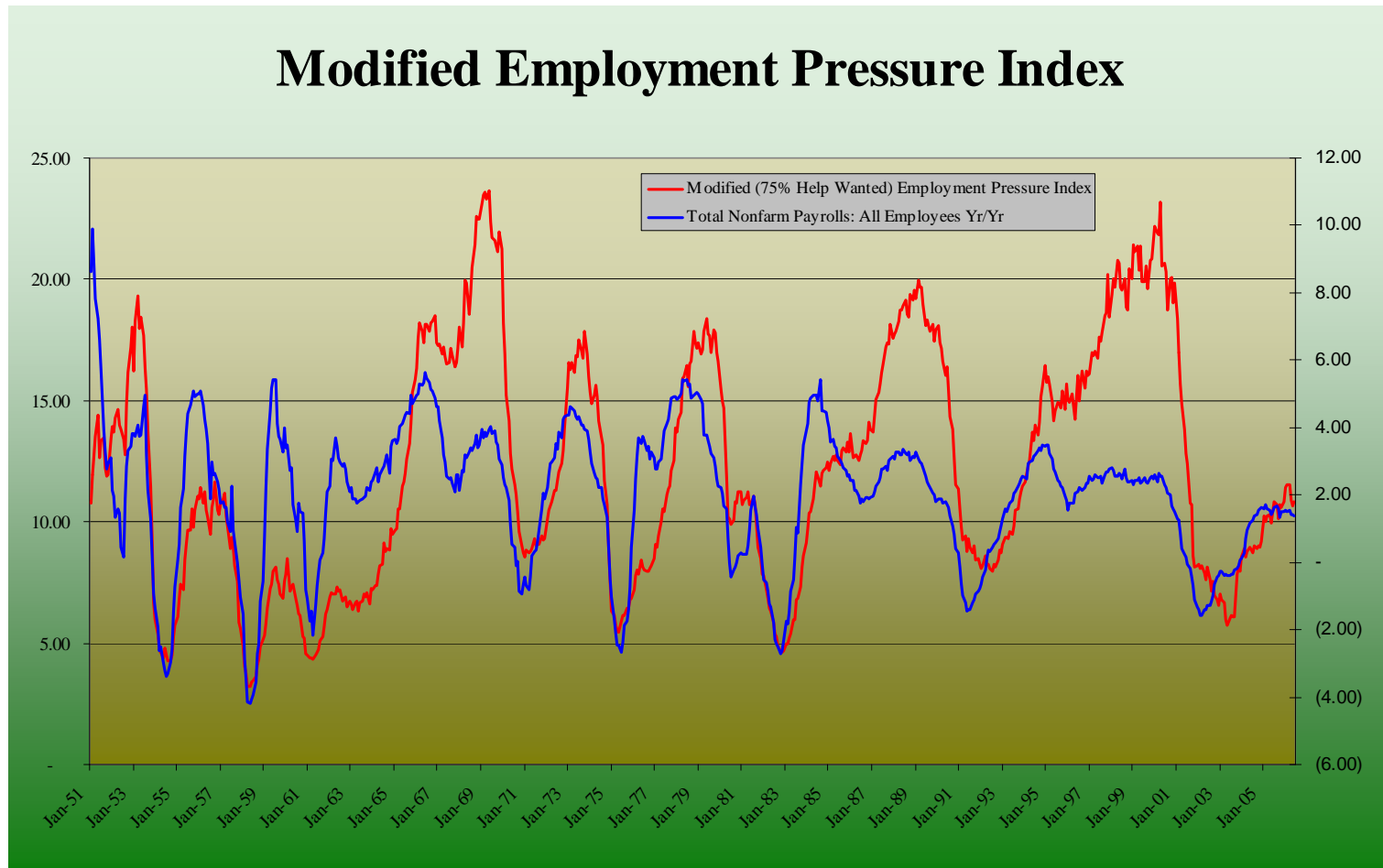
Jobless claims continue to be low, which is consistent with strong employment (and potential wage inflation). It is, however, inconsistent with the low number of jobs created each month according to the Establishment survey.

## Macro-economic research



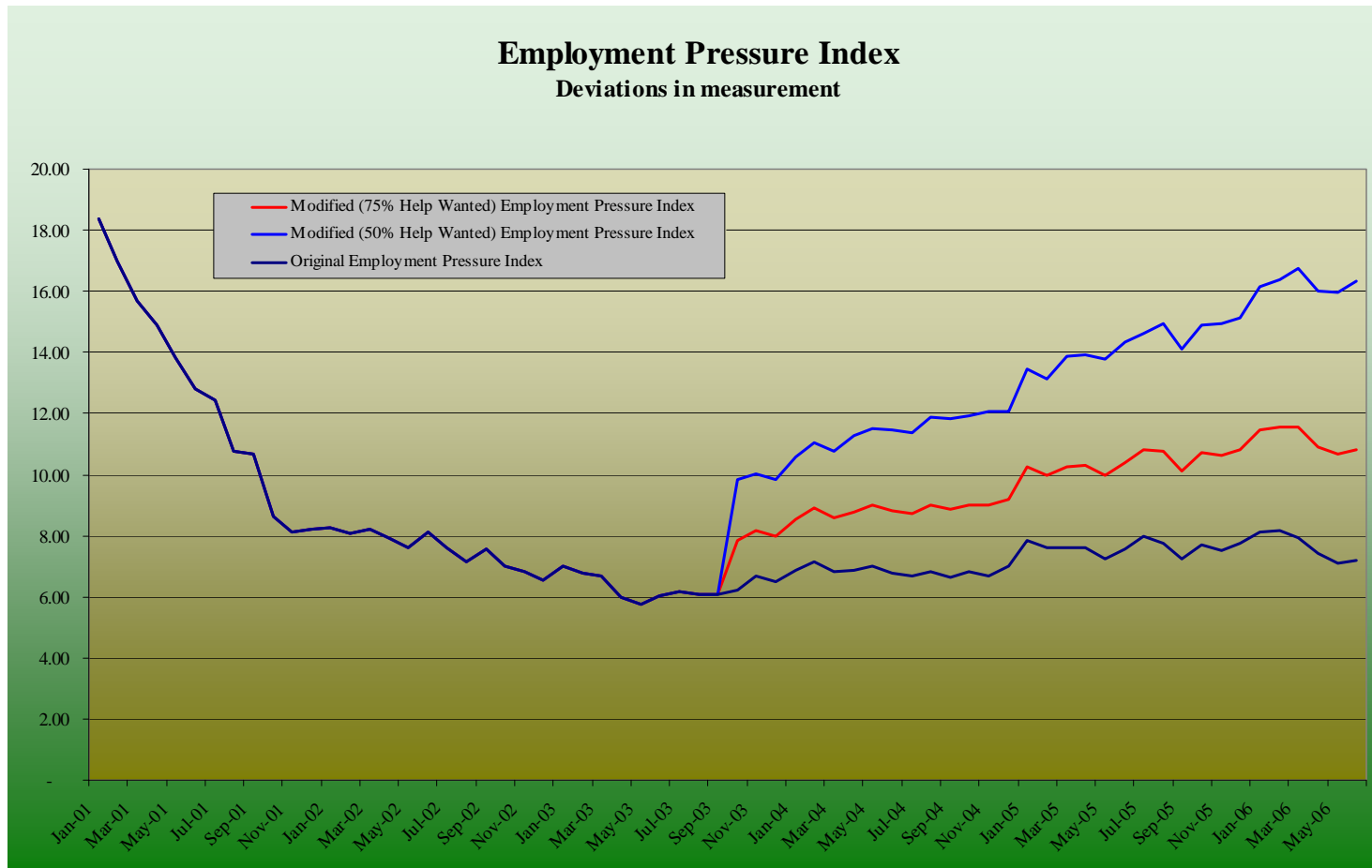
Also, jobless claims as a percent of the Civilian Labor Force are towards the lower end of their range over time – also indicative of a strong labor market.

## Macro-economic research



As employment pressure increases, the power shifts from those hiring to those being hired... this also has the potential for wage inflation.

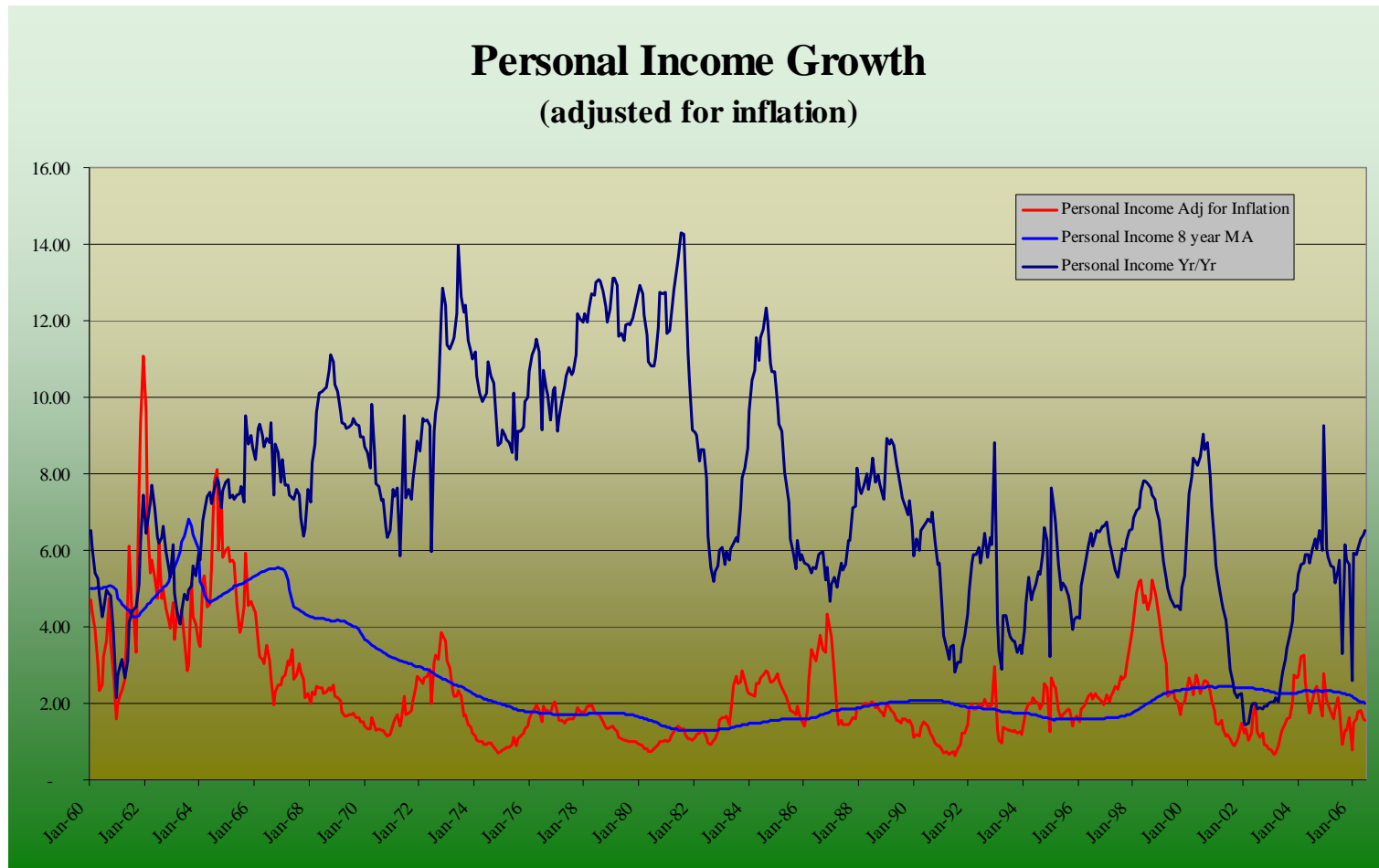
# Macro-economic research



Another example of traditional sources of data not capturing the information necessary for analysis

The Employment Pressure index has also had to evolve as the Help Wanted measure is just not valid since more companies use the internet for job postings. Prior to mid-2003, there was no metric publicly available for measurement of on-line job advertisement. Since then, the original Employment Pressure index (primarily using Help Wanted) has remained flat, while other derivations indicate the increased pressure on employers.

## Macro-economic research



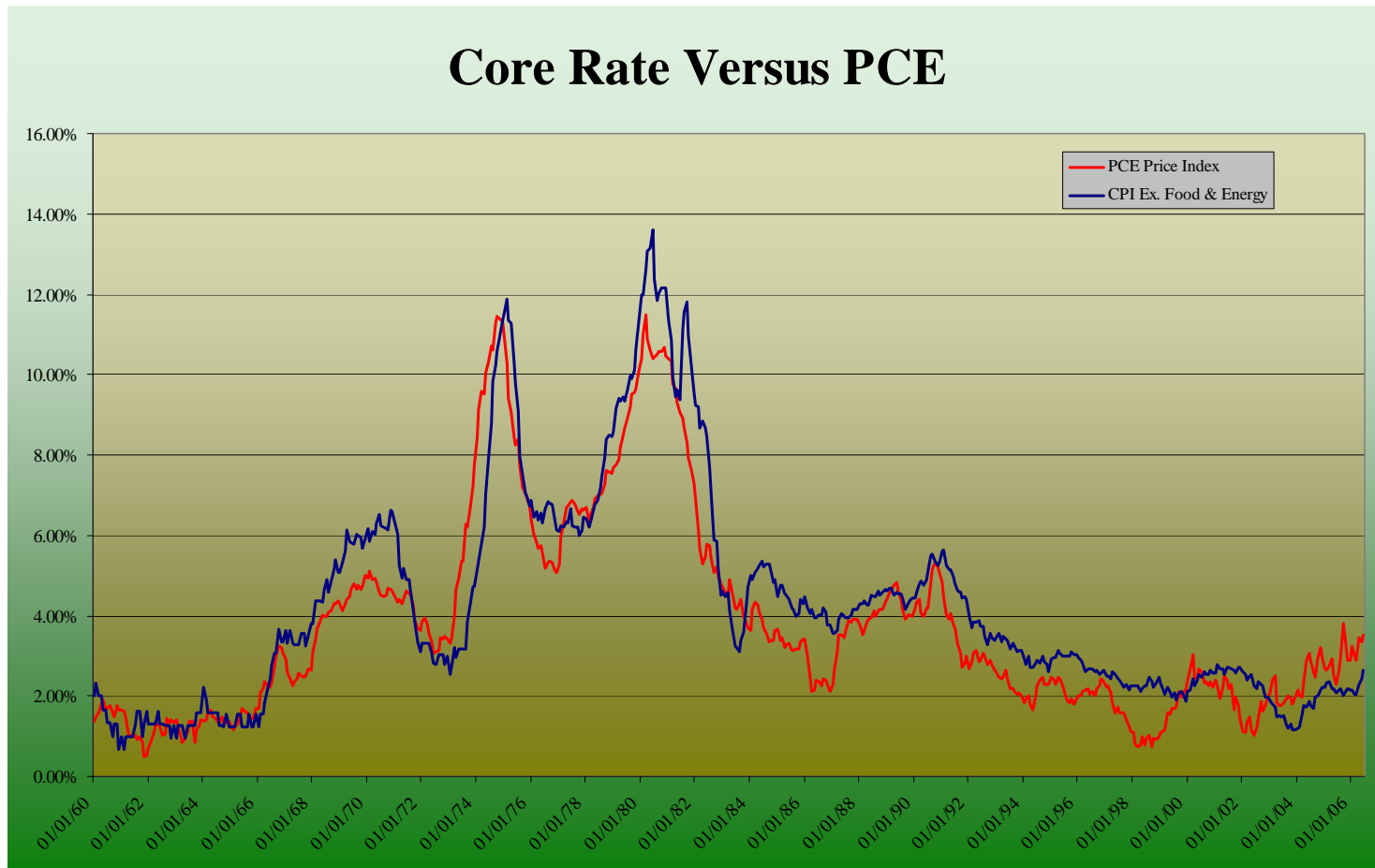
Year over year growth in personal income is adequate until it is adjusted for inflation. It is presently below trend-line and will likely increase both as it returns to its average and as inflation increases.

# Inflation expectations

In the recent past, we have seen the impact that higher commodities prices have had on inflation measures, and these prices are now reflected in both current inflation statistics as well as potential price pressures.

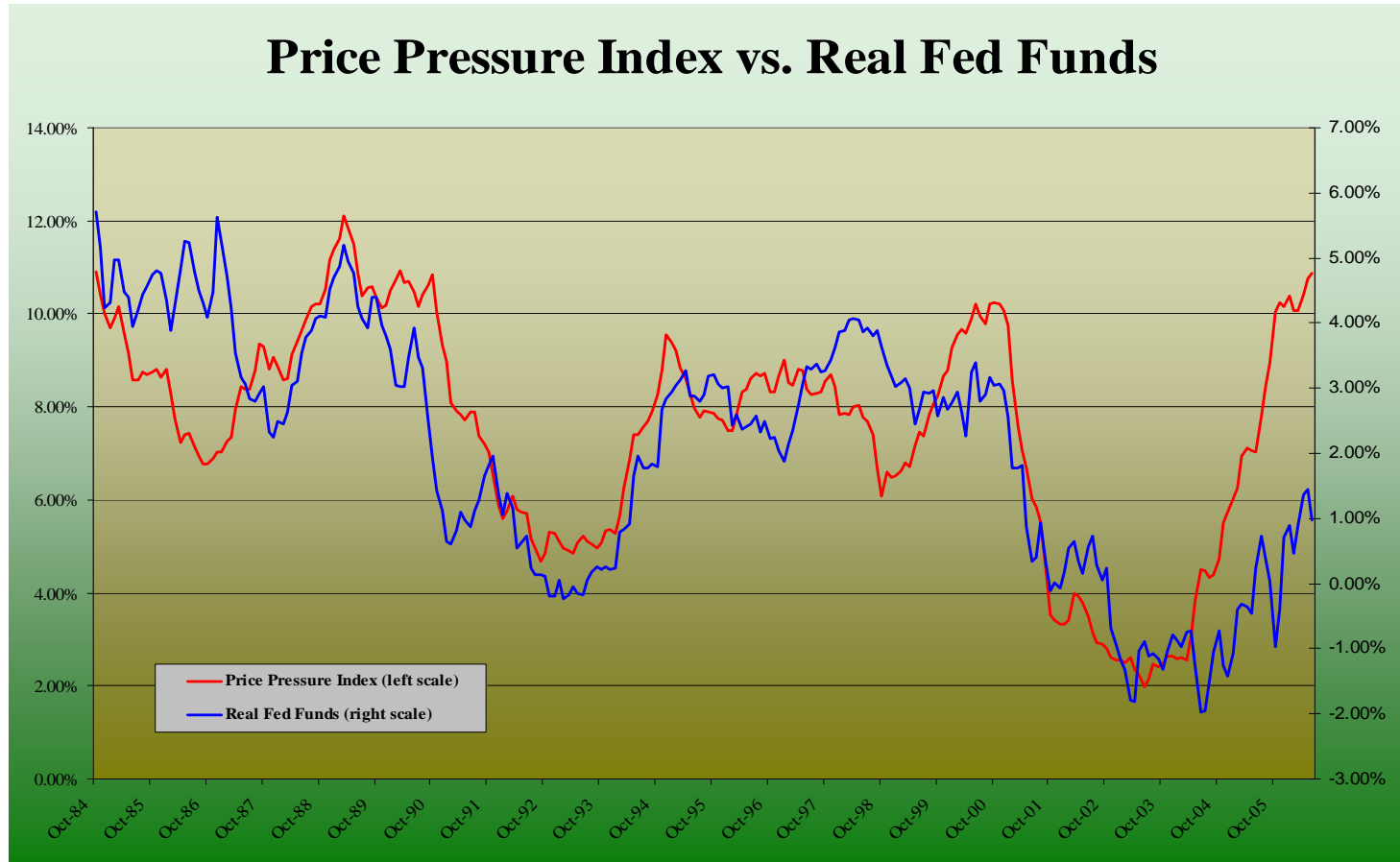
Now, consider that labor is the largest component of costs in our economy, and you will understand why we have concerns that the US stock market may be stuck in a trading range while workers begin to benefit from real wage increases.

## *Inflation expectations*



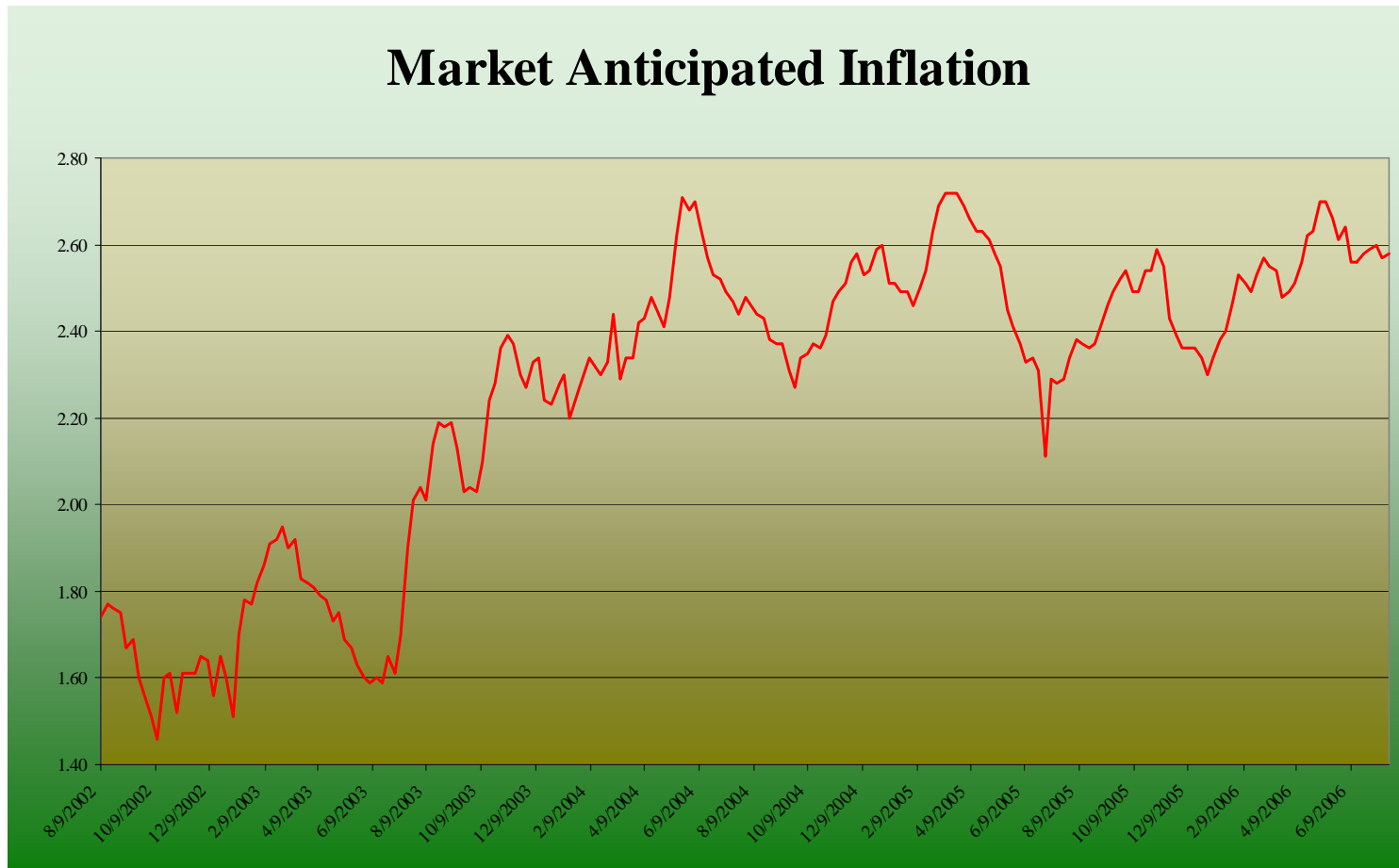
The personal consumption expenditures index remains outside of the Federal Reserve's target of 1-2% for price stability; it is currently up 3.53% yr/yr and climbing.

## *Inflation expectations*



Price pressure shows no signs of slowing, and likely won't moderate until input costs (including labor) do so. Until this relationship returns to parity, we anticipate interest rate increases.

## *Inflation Expectations*



Yet, the markets anticipate long-term inflation of just 2.58%. Is this confidence that Dr. Bernanke will get the job done, strong demand for Treasuries for duration matching, or something else?

# Federal Reserve Watch

Dr. Bernanke is not printing money... but, as we mentioned in our last Chartbook, it is Congress we are worried about given the unfunded promises that will have to be addressed in the near-term.

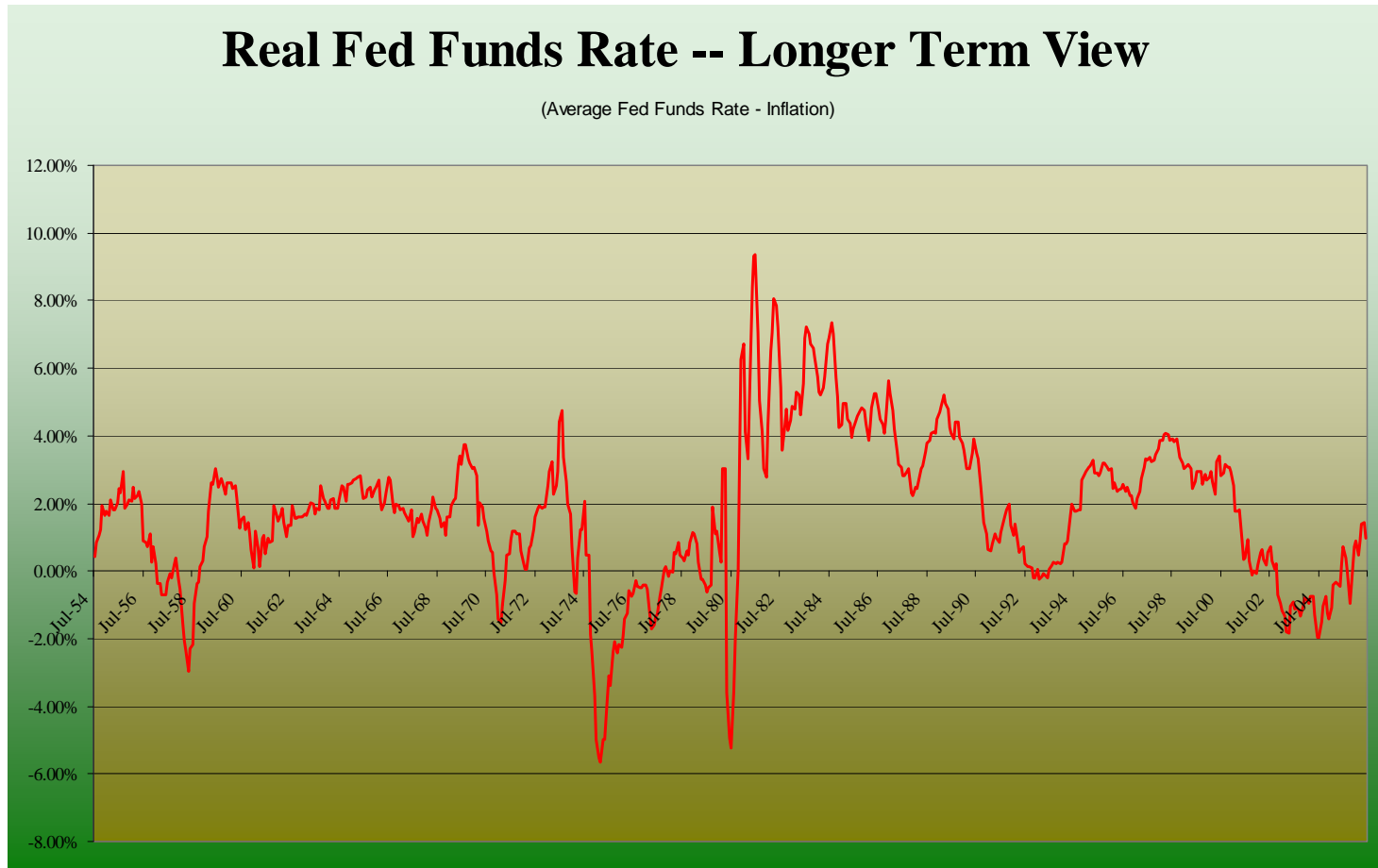
What is happening (apart from rising interest rates) –

Real yield is available for savers

Money supply growth is slowing

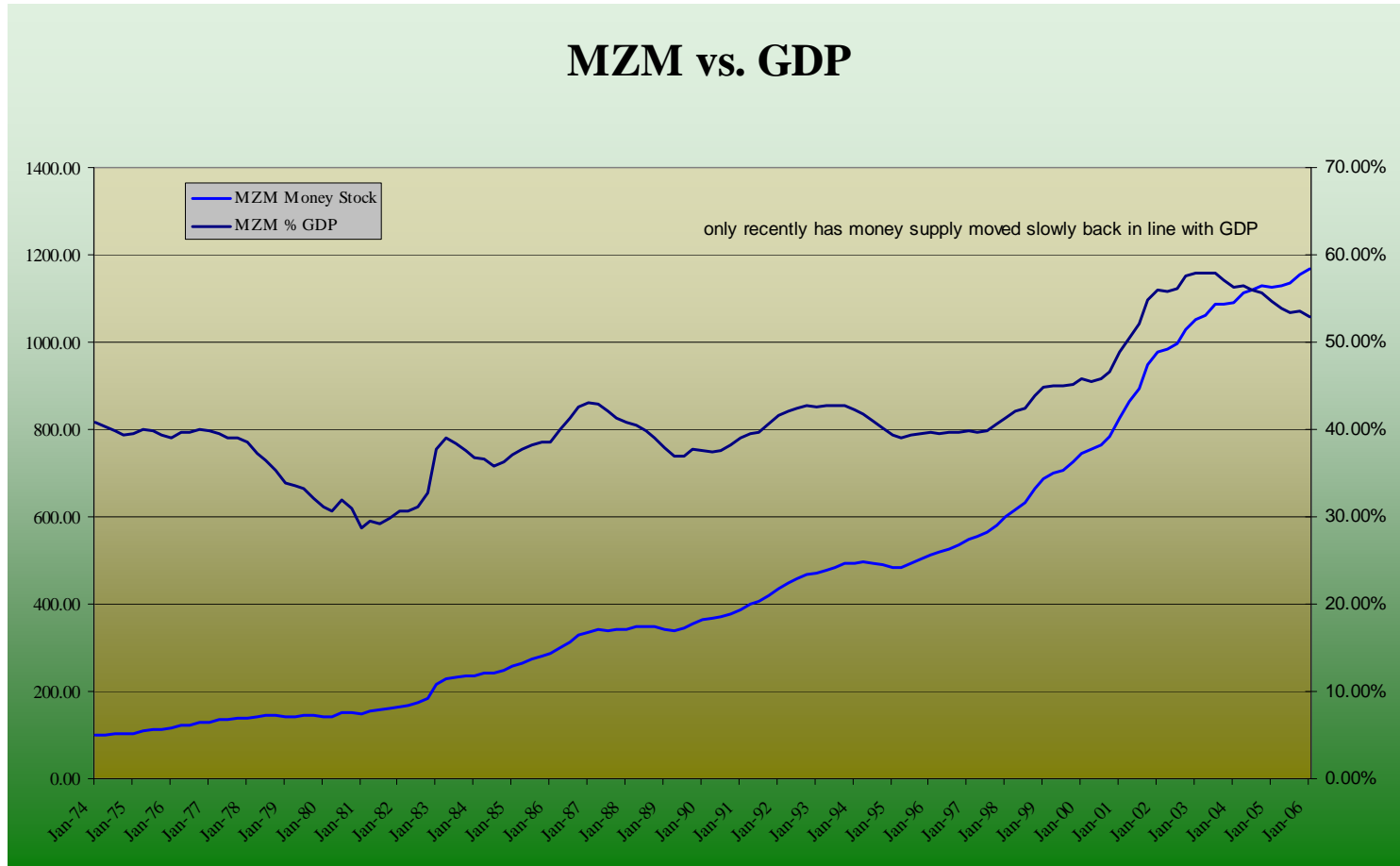
Overall monetary conditions are not accommodative

## Federal Reserve Watch



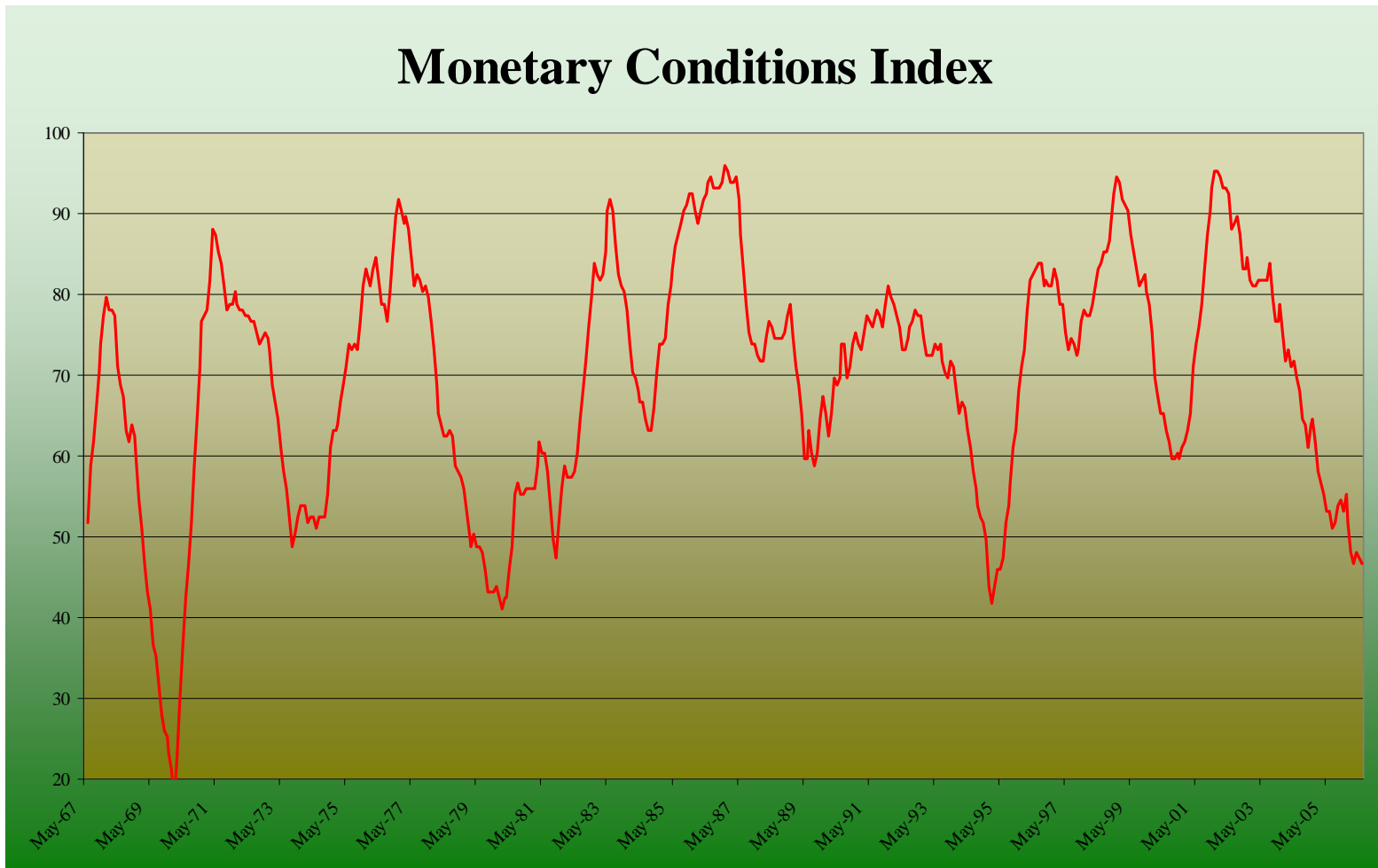
People are again being encouraged to save as there is real yield in short-term fixed income, but the Fed is having to work hard given the increases in inflation.

## Federal Reserve Watch



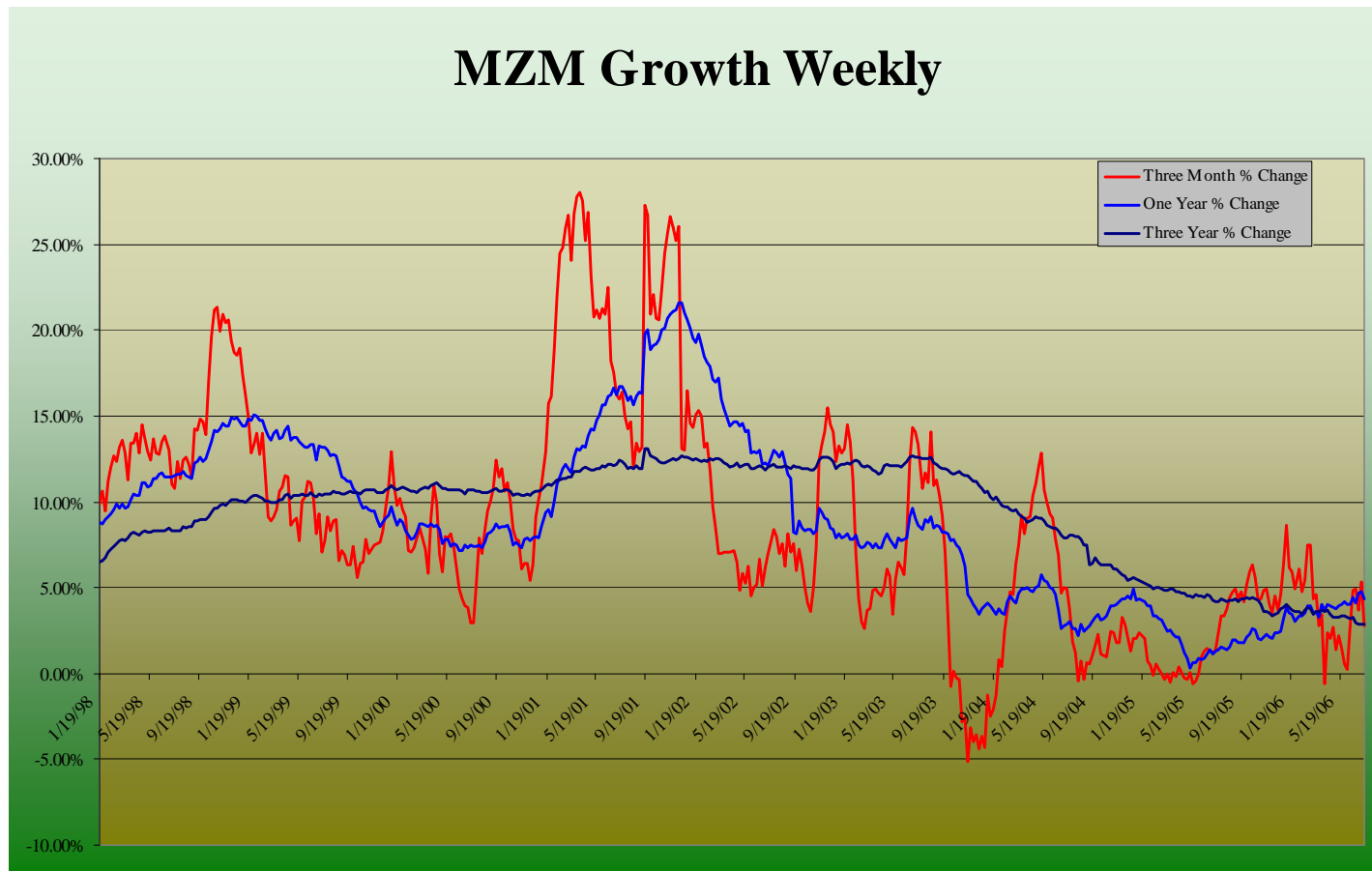
We provided this chart last month, but it is an important illustration that monetary conditions are much tighter than they have been in the recent past as money supply as a percent of GDP declines.

## Federal Reserve Watch



Yet another illustration of tightening monetary conditions as indicated by our proprietary model.

## Federal Reserve Watch



Money supply growth is still at the lower end of its intermediate term range.

# Outlook & Forecast

Does the equity market “know” something that the bond market doesn’t?

Earnings growth has been strong, but is beginning to taper; we anticipate this will continue to be the case as wages pressure company earnings.

When inflation increases, the market PE contracts. Over the past 50 years, when...

Inflation is less than 3%, S & P 500 PE (average over time) is 21.55.

Inflation is between 3% and 5%, PE is 17.26.

Inflation is above 5%, PE is 11.28.

The market has reacted accordingly and pushed the current PE down to 17.01 times earnings (that have shown strong growth).

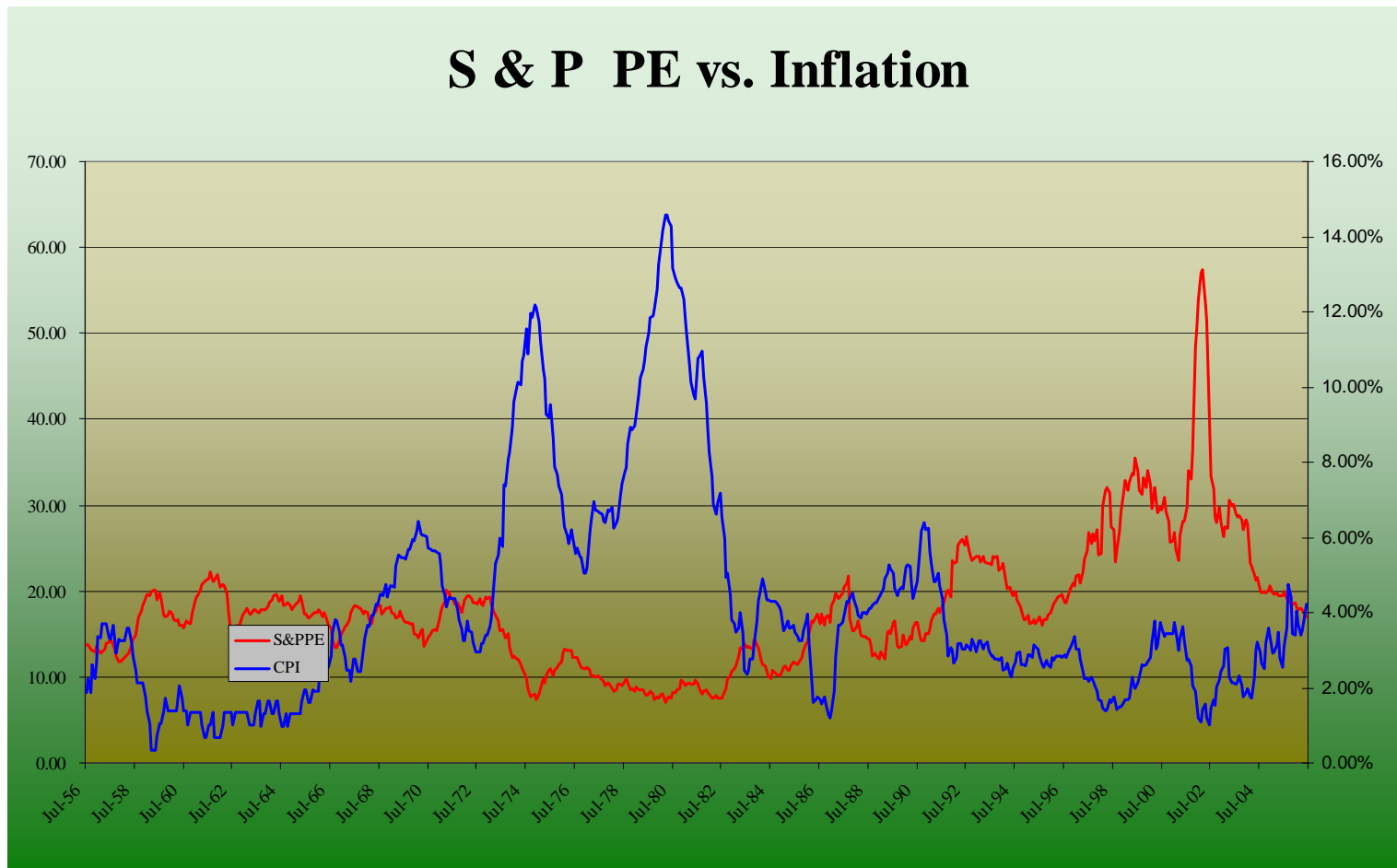
However, because there is still a lot of cash available for investment and we do not anticipate inflation growing wildly out of control, we forecast annualized returns for the US markets to be between 5 – 7 % for the near term and advise caution when investing new funds.

## Outlook & Forecast



The market PE has contracted even as there has been strong earnings growth (both on right scale).

## Outlook & Forecast



Illustrating the inverse relationship of inflation and the market's PE.