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Investment Commentary—April 2014

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By the time you read these words, the very long winter of 2013-2014 should be safely in the history books. Our sympathies to readers in the Midwest who experienced the worst of what nature had to offer. If you reside in a warmer location and experienced the snow and cold by way of the Weather Channel, be grateful.

Sadly, the long winter is an apt metaphor for the more serious plight of millions of our fellow citizens who lost jobs in the Great Recession and have struggled mightily since to find work. Their difficulties are strikingly illustrated by the gray line in the graph below. While the blue line shows that the rate of short-term unemployment (less than 26 weeks) is now below its long-run average, the percentage of the job force that has been out of work for more than 26 weeks remains almost as high as it was during the depths of the relatively severe recession of the early 1980s.

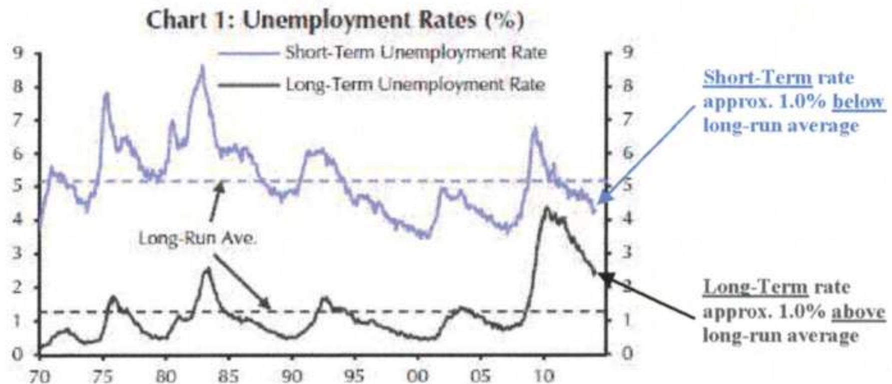

Chart courtesy of Capital Economics, data source Thomson Datastream

The future shape of the gray line is vitally important to the work of the Federal Reserve and new Chair Janet Yellen. Is it possible to drive this metric back to, or even below, its historical average in coming years? Or, has there been a structural change in the U.S. economy that will result in elevated long-term unemployment until the affected workers age out of the labor force? Just last month Princeton economist and former Obama advisor Alan Krueger weighed in on this question in the descriptively entitled "Are the Long-Term Unemployed on the Margins of the Labor Market?"[1]

[1] Alan B. Krueger, Judd Cramer and David Cho, "Are the Long-Term Unemployed on the Margins of the Labor Market?," Brookings Papers on Economic Activity, http://www.brookings.edu/about/projects/bpea/papers/2014/are-longterm-unemployed-margins-labor-market. Our references here to Krueger are intended to include his colleagues as well.

Krueger, perhaps to the dismay of his former boss, answers this provocative question in the affirmative, with enormous implications for Yellen et al. Coming out of a recession the Fed's mission is twofold: stimulate the economy with cheap money to drive unemployment down; but don't stimulate so much hiring as to trigger significant wage inflation. In the initial phases of a recovery, employers have plenty of job seekers to choose from. Or as economists like to say, there is excess capacity in the labor market. Eventually the excess capacity dries up and companies resort to dangling pay increases in front of people who are happily employed. And thus begins a bout of wage inflation. Crucially, Krueger argues that, *for purposes of measuring excess capacity in the labor market, the long-term unemployed are not part of the equation.* Either because their skills have deteriorated or because of outright discrimination, employers are predisposed against hiring anyone who has been out of work for an extended period of time. To put it harshly, the long-term unemployed may in fact be *unemployable*.

If Krueger is right, the blue line in the graph on the first page is the only one that matters for determining excess labor market capacity. And the message it's sending is that there isn't a heck of a lot left. Which is pretty interesting when you consider Fed Chair Yellen's comment in her March 19th press conference that "...by any measure there remains substantial slack in the labor market." *Any measure?* Really?[2]

All of this is likely to play out over the remainder of 2014. The economy seemed to strengthen considerably in the second half of last year as the impact of various congressional actions over the last several years ("fiscal drag") waned. The rough winter has created a lot of noise in recent economic data but monthly job creation seems to be back in the vicinity of 200,000. That pace of hiring will continue to push the unemployment rate lower and should, if Krueger is right, create noticeable upward pressure on wages before too long. And that wage pressure in turn could force the Fed to consider tightening earlier than most investors seem to expect.

If wage pressure does appear sooner than anticipated, how will that impact the stock market? Assuming we're right that the U.S. economy, freed from the fiscal drag of recent years, will be reasonably strong, there are likely to be two forces involved in a bit of a tug-of-war. On the one hand, a strong economy will keep profit margins robust and help maintain investor enthusiasm for equities. On the other hand, one of the pillars of the bull market has been paltry bond yields that make earnings and dividend yields on stocks look pretty attractive by comparison. If the perception that Fed tightening is coming sooner than expected leads to a spike in interest rates, the relative yield argument for stocks could be undercut. It's not clear whether robust profits or spiking rates carry the day, but let's just say we're cautious.

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[2] We should point out that the legions of the long-term unemployed are vast, and even vaster if you include those who have given up looking and are therefore not considered part of the labor market at all. If even a meaningful fraction of these folks are employable, they would add materially to labor market capacity. So, maybe there is more slack in the labor market than the blue line would suggest. But perhaps not as much as the Fed and capital markets are assuming.

Perhaps though the economy won't be as strong as we think. And it's not hard to come up with reasons it could falter. Two possibilities that leap to mind are a "hard landing" of the Chinese economy and the crisis in Ukraine.

After several years of growing at a 10%+ annual clip, the Chinese economy slowed down dramatically in the wake of the financial crisis. In early 2009 Hu Jintao undertook a $600 billion stimulus program, including huge infrastructure projects, that caused GDP growth to pick back up. As the effects of the stimulus have faded though, GDP growth has settled down to around 7 or 8%. By official measures it is stable, but more credible estimates suggest that it may have fallen below 7% and is slowly declining. The $64,000 question is whether Beijing responds to faltering growth by reaching into its old bag of tricks. Even before the financial crisis, economists criticized Chinese authorities for relying too much on infrastructure spending to spur the economy. The money flows through state-controlled banks and large state-owned enterprises and supports lavish lifestyles for corrupt local officials. The construction itself has been relatively unproductive, with vast tracts of empty buildings and bridges to nowhere. Meantime, the consumer and entrepreneurial sectors of the Chinese economy remain underdeveloped.

Since taking over from Hu in 2012, General Secretary Xi JinPing has seemed determined to tackle these imbalances. Xi has exercised restraint on infrastructure spending, made some initial attempts to rein in corruption, and laid out a series of financial reforms--all in an attempt to engender a long-term transformation of the Chinese economy. Although the new leadership's efforts have a long way to go, the initial signs are encouraging. The 2014 GDP target was telling. The number itself—7.5%--was widely anticipated, but in the announcement Premier Li Keqiang added a qualifier, setting the target at "*about* 7.5%." As with our Federal Reserve, subtle changes in wording from Chinese authorities can be fraught with meaning. In this case, Li seemed to signal a commitment to reform even if that requires flexibility on growth.

Some observers, cognizant of the laundry list of problems confronting Beijing--corruption, pollution, weakening demographics, a problematic shadow banking system, and overreliance on infrastructure spending to name a few--see slowing growth as an early sign that it's all about to unravel. Others see a leadership prepared to make the tough decisions that will eventually put the Chinese economy on a firmer foundation. We're hopeful that the latter is closer to the mark.

The standoff over Ukraine is harder to handicap. It's impossible to know how far Vladimir Putin--perhaps intoxicated by a surge of Russian nationalism--is prepared to go in pursuing his vision of a Eurasian Union of former Soviet states. And it's just as difficult to know how united Europe will be in countering Putin's aggression. Some would argue that Mr. Obama is the key player, but this is very much a European problem and for better or for worse, the days when the man or woman in the White House could captain the effort as "leader of the free world" are likely over. Putin would probably be wise to be satisfied with Crimea. To the extent the European response has been overly cautious, that might change dramatically if Russian troops move into eastern Ukraine. Should it come to that--and let's certainly hope it doesn't--the economic fallout could be significant though probably not catastrophic (unless one has large holdings of rubles). The global

economy has tended to be more resilient than one might think in the face of major military conflict.

Assuming though that Mr. Putin behaves, we expect the major influence on capital markets for the remainder of the year will be an improving U.S. economy. Economic strength will likely drive the unemployment rate lower and at some point raise the question of how much excess labor market capacity truly remains. If Professor Krueger is correct and the long-term unemployed have for all practical purposes been excluded from the labor market, the answer is not much and an interest rate spike and some attendant volatility in the stock market may be in the offing.

April 10, 2014
Boston, MA