KBC Banking & Insurance

KBC FLASH

5 OCTOBER 2006

From KBC Market Research Desk

SEPTEMBER PAYROLLS TO BE A NON-EVENT??

- ***Payrolls growth has shifted to a slower pace of about 120 000 in recent months …..***
- ***….while monthly volatility has decreased sharply….***
- ***….convincing forecasters that more of the same is likely in September….***
- ***…This complacency might lead to a sharp market reaction in case of a surprise***

At the start of Q2, payroll growth shifted down, following about 10 quarters of robust employment growth, but stabilized since in a remarkable tight range. So the labour market reacted very fast to the downshift in economic growth. The slowdown in payrolls growth was the result of firms stopping to hire extra workers and not of firms cutting their workforce. This story is underpinned by the (stable) initial claims and the JOLT data. There are as yet little signs that firms started to cut jobs massively in September, but as usually surprises cannot be excluded. We see some downside risks for the payrolls in the ADP employment report. In this respect, it is interesting that the September consensus estimate is not materially different from the 3- and 6-month average, but also that the dispersion of forecasts is in an unusual tight range. Is this complacency of forecasters or are the payrolls simply less volatile than before? Whatever, it might lead to sharp(er) market movements if the ultimate result surprises.

Payrolls growth stabilized

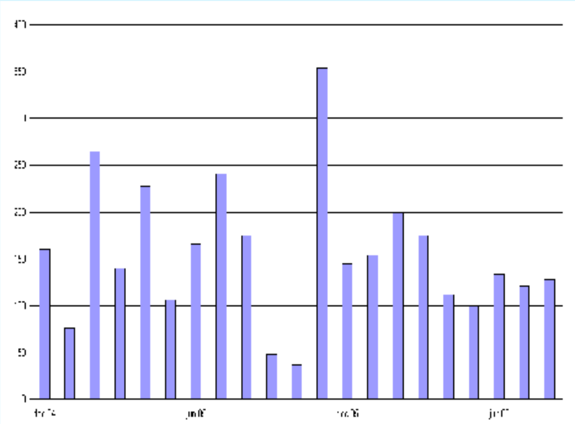
In August, payrolls grew by 120 000, which was very close to the 3- and 6-month average increase of 128 000. Since April, payrolls came out between 100 000 and 134 000, an unusual tight range.

The payrolls slowdown at the start of Q2 and its stabilization at a lower level since is well supported by other evidence. The **Temporary Help Agency Payrolls,** a leading indicator for overall payrolls peaked in December 2005 and since moves sideways to slightly lower. These workers are hired early in the cycle, when companies aren't sure yet that the recovery is durable and therefore they don't want to hire permanent workers, but they are also fired first as the cycle turns down and companies have too many workers. Should we see the payrolls at these Agencies drop consistently, it would signal a further deterioration in the overall labour market conditions. In this respect, the developments at the end of 2000/early 2001 (cf. graph below) are telling. The current stabilization in the Temporary Help Agency payrolls suggests that the labour market hasn't reached that point.

Also the stabilization in the **initial claims** at around 315 000 suggests that firms haven't yet started to trim their workforces. The downtrend in **continuing claims** (2.4 to 2.5 M) stalled in late April and since they drift sideways to only marginally higher.

Looking to the employment situation in various sectors, the slowdown in the **housing sector** is reflected in slower payrolls growth in the construction sector. Indeed, monthly growth has fallen from about 30 000 at the turn of the year to close to zero in recent months, August being an outlier with an increase of 17 000. In September construction payrolls should revert to about zero. **Manufacturing payrolls** have slowed to slightly negative from slightly positive a few months ago. Car producers have announced large job layoffs and these should affect the figures in the months to come. The **ISM employment sub-index** fell in September sharply to 49.4 from 54 in August, suggesting that manufacturing payrolls may surprise on the downside. Consensus stands at –5 000. However, the **ISM Non-manufacturing employment index** actually increased to 53.6 in September from 51.4 in August, suggesting that employment growth in the large service sector remains stable.

Another interesting sector is **retail**. The slowing in consumption, a result of higher gasoline prices, has taken its toll on retail payrolls, especially in March and April. Since, retail payrolls have been only marginally negative. As consumption seems to have stabilized in recent months, retail payrolls have probably reached an equilibrium level.



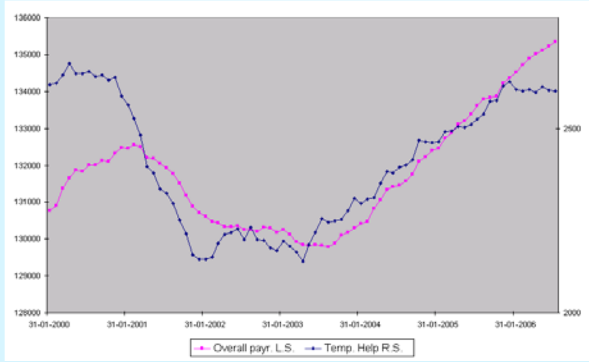
Payrolls stabilizes in tight range in last five months

ADP employment report shows weak employment growth

While most indicators point to a trend-like increase of about 120 000, the **ISM manufacturing employment index** suggests some downside for manufacturing payrolls and more importantly also the ADP employment put some risks on the downside.

The ADP employment release reports on private employment and is construed in such a fashion to replicate changes in (private) payrolls as per BLS report. As a consequence, it has a good correlation with the BLS payrolls, after making a correction for public payrolls. However, it's standing in the market diminished when its June result (368K) diverted sharply from the BLS report (109K). Since, its results have again moved in sync.

In September, the ADP reports the net creation of 78 000 jobs, which if translated in BLS payrolls would be about 90 000, falling slightly short of the consensus estimate.



Temporary Help payrolls (blue, right) top out in December. Will overall Payrolls (red, left) follow? A decline in Temporary Help payrolls (cf. 2001) precedes a decline in overall payrolls

Unemployment rate bottomed?

The **unemployment rate** rose in July to 4.8% from 4.6% previously, which represented the bottom in the current cycle. In August, the unemployment rate fell again slightly to 4.7%. While these data have some noise (labour force is volatile) and therefore show some monthly variation, it looks to us that the unemployment rate will remain stable in September at 4.7%, but in the next months the stabilization may gradually change into a gentle up-tick of the unemployment rate.

Some statistical issues

Consensus estimate for September stands at 120 000. If one strips out the highest (200K) and the lowest individual estimate (90K) all remaining 69 forecasters in the Bloomberg survey have estimates between 100 000 and 150 000, an unusual tight range.

Payrolls results have been less volatile recently and this might be due partially to the absence of special factors and partly due to a better seasonal adjustment method. There are two potential "events" that might distort the September report. Firstly, in September, many teachers traditionally re-enter the payrolls, as they do each year. As such, this should be captured by the seasonals, but small differences in timing may play havoc with the seasonal adjustment and therefore distort the seasonal adjusted figures. The hurricanes that suppressed employment growth in September 2005 are the second event. This might eventually also be reflected in distorted seasonals for September 2006 payrolls, if the BLS hasn't adequately kept the hurricane-related losses last year out of the calculation of the seasonal adjustment factors.

While the individual forecasts are all clustered in a tight range, analysts have traditionally a difficult time in forecasting the September payrolls correctly. Actually, the September mean forecast resulted in the second worst result (standard error median estimate) for all months. Analysts were still less successful in predicting the February result. On average, the February forecast was 64 000 lower than the actual outcome. Most of the time, however, the errors occurred when hurricanes intervened, something that is not the case today and quite often the initial results were revised higher subsequently.

Average Hourly earnings rise strongly

In August Average Hourly Earnings rose by only 0.1% M/M, but this followed a strong 0.5% M/M increase in July. In year-on-year comparison, AHE was up 3.9% in July and August, the highest since mid-2001. For September, consensus expects a 0.3% M/M and 4% Y/Y increase. Given the recent decline in energy prices and in headline inflation, the market might be less sensible in case of upward surprises.

Conclusion and market reaction

The consensus suggests that the September payrolls report shouldn't be materially different from those of previous months (100 000 to 125 000), However, the ADP report suggests some downside risks and there is the historical argument that forecasters traditionally are too optimistic on the September payrolls. If the employment component of the Non-manufacturing ISM survey would have showed a decline too, we would have been more vocal on the downside risks.

In this context of historical too optimistic forecasts, it is still more surprising that the range of forecast is so narrow. Is this complacency from the part of analysts?

We'll know on Friday. However, it means that should we get a surprise + or – 50 000 from consensus, we might see some firework.

Sentiment on the **bond market** is outright bullish and 10-year yields have come off sharply since the peak was reached in early July. Corrections have been few and small. **So there seems to be scope for a profit taking reaction in case of a materially stronger-than-expected report**. It would challenge the markets' belief in the start of the easing rate cycle in early 2006, especially should at the same time AHE surprise on the upside. However, as we don't expect such an outcome to change the overall view (of slowing growth), we would use such corrections to buy into the market.
A weaker report underpins the reigning bullish sentiment and some additional gains may be expected and even new cycle highs may be registered, but as we don't like to buy bonds after a strong run and at the highs, we would still wait on some correction to add long positions.

In the **currency market**, we saw quite some euro disappointment of late. Therefore, the euro needs a much weaker-than-expected report that would make the market consider the possibility of a hard landing. Even then we might see erode the euro gains in the next sessions, just like we saw recently after for instance the weak Philly Fed, unless the tough **1.2979 resistance is broken in the next few sessions. Only then we would give the euro the benefit of the doubt.**

Piet Lammens, KBC Brussels

KEY Data

	Total/change	Manuf.	AHE (M/M)	Workweek	Diffusion	Unempl.rate
6m average	128K					
3m average	128K	-1K				4.7%
April	112K	19K	0.6%	33.9	64.4	4.7%
May	100K	-10K	0.1%	33.8	55.9	4.6%
June	134K	25K	0.4%	33.9	56.7	4.6%
July	121K	-23K	0.5%	33.9	55.4	4.8%
Aug.	128K	-11K	0.1%	33.8	55.9	4.7%
Sept exp	**120K**	**-5K**	**0.3%**	**33.8**		**4.7%**