Employment & Income to Sustain Expansion

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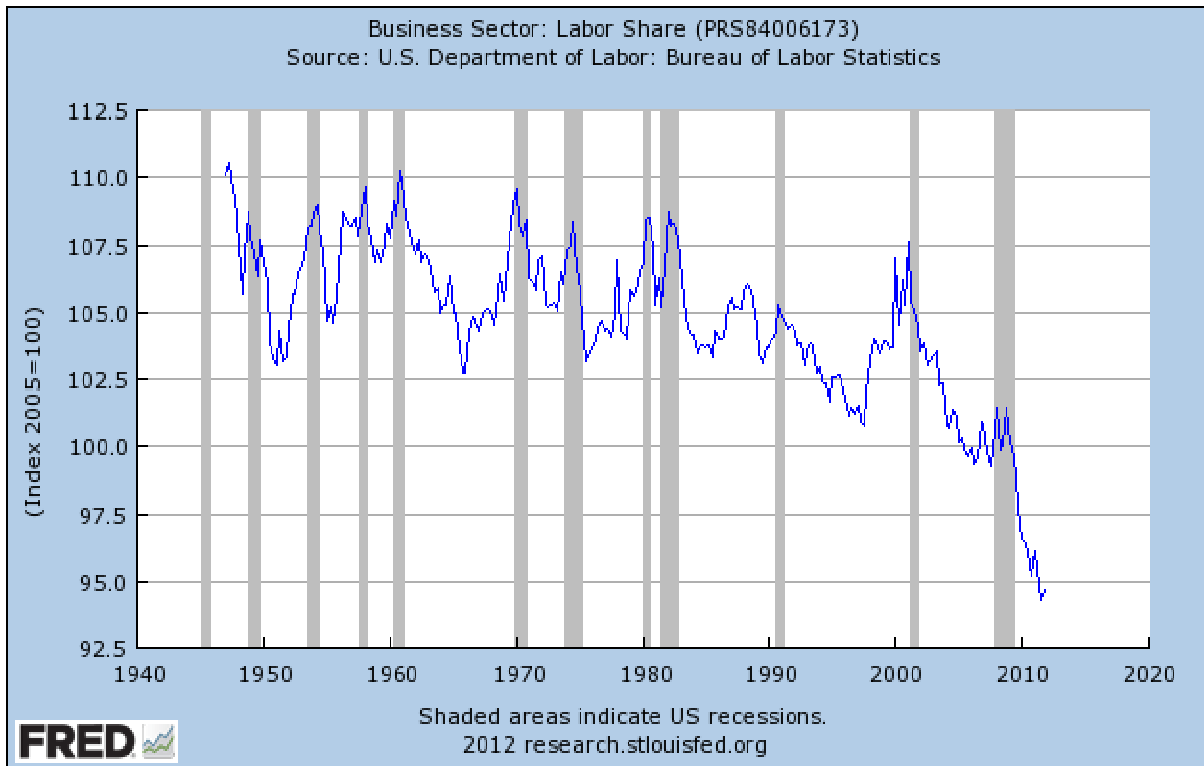
- Employment increased by 227,000 in February, while the prior two months were revised higher by 61,000 bringing the three-month average to 245,000. **Aggregate payrolls (hours worked times hourly earnings) — the largest component of personal income — increased 4.6% year over year, comfortably above 2.9% year-over-year CPI inflation, which supports continued economic expansion, in our view.** The unemployment rate was unchanged at 8.3%, but this was because the labor force grew along with the number employed, another positive in our view. As Ned Davis Research explains: "there were more unemployed new entrants and reentrants, a sign that Americans are growing more confident about the jobs market and are beginning to look for work again."

- As we wrote last week, rising incomes are helping support the housing market, despite ongoing price declines. According to the Federal Reserve's fourth-quarter Flow of Funds report, household real estate values fell $213 billion, to $15.96 trillion, and are now down a total of $6.75 trillion from its 2006 peak. Meanwhile, mortgage debt declined by $42 billion, to $9.84 trillion, and is only off $777 billion from its peak. Homeowner's equity at 38.4% remains near record lows (historically it has been above 60%) and suggests further declines in mortgages. As household balance sheets become less encumbered by mortgage debt, however, they are freed up for other kinds of borrowing. **Consumer credit is now rising and overall household debt has increased for the first time since 2008.**

- Greece's bond exchange was successfully tendered with almost 86% participation among private Greek-law bondholders; coercive collective action clauses raised participation to near 96%, placing Greece in technical default. This wiped out only about one-third of Greece's debt since the ECB, EU and IMF took no writedown. With Greece's new bonds trading at 75% of face value, reflecting ongoing investor skepticism, private bondholders had a bad week. Another default seems unlikely in the near term given Greece's (newly) low debt servicing costs: 2% through 2015 and 3% through 2020. More problematic is a yawning budget deficit that will require either more public support from official creditors and/or further austerity, both politically contentious. **We think the determination by all parties to work towards an orderly write down of unsustainable sovereign debt loads in the Eurozone reduces systemic risk. This supports our pro-stock, pro-high yield bond, anti long-term Treasury bond positioning. However we do not think investors should expect double-digit stock gains from current levels in 2012.**

The Effects of Rising Labor Costs on Monetary Policy and Corporate Profits: One reason for expecting stock gains to slow was reported last week in the Bureau of Labor Statistics revisions to fourth-quarter productivity and costs data. Unit labor costs (ULC) — the ratio of hourly compensation to output per hour — for nonfarm businesses was revised to 2.8% annualized growth from 1.2%, as hourly compensation grew faster (3.7%) than output per hour (0.9%). Furthermore, third-quarter ULC was revised to a 3.9% annual rate from -2.1%, mostly due to a large upward revision to hourly compensation. **We think this data will be a dampener on both further Federal Reserve money printing and corporate profits.** The current ULC year-over-year growth rate of 3.1% has not historically been too bad for inflation — since 1948, during periods when ULC growth ranged between 1.25% and 7.2%, CPI has averaged about 3.4% according to Ned Davis Research. However, the sharp increase in ULC — it was falling by about 4% at the end of 2009 — will not escape the Fed's attention, especially in light of their 2% inflation target. **The inflationary pressure implied by this data reinforces our view that cash will deliver negative real returns and should only be used tactically.**

THE WEEKLY CHART: LABOR JUST STARTING TO BENEFIT FROM RECOVERY



We think rising ULC is the first sign of workers receiving a larger share of total output. Labor's share of output has been declining since the early 1980s, except for a brief surge during the tech boom, and is at record lows. While we ***do not*** expect labor's share of output to return to the levels of the US' industrial heyday of the 1950s and 60s, a modest increase would be beneficial to the US economy, in our view, of which about 70% is consumption based. The sharp drop in labor's share of output since the early 2000s has greatly increased US global competitiveness and supports a manufacturing renaissance in the US. US manufacturing ULC fell almost 11% between 2002 and 2010 during which the rest of the developed world had rising ULCs. **Finally, even with ULC rising 3%, we expect earnings growth to decelerate but still remain positive as consumption-based sales increase. Since 1948, S&P 500 earnings have risen an average of 5.1% a year when CPI minus ULC (currently -0.2%) ranges between -1.1% and 1.6%, according to Ned Davis Research.**

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