FEBRUARY 2012 – FEELS LIKE SPRING

Unemployment

The unemployment figures continue to march steadily in the right direction. The number of new hires was much higher than expected and the rate dropped again to 8.3%. US stocks are up better than 1% today and bonds and gold are up again as well. It has been a great start to the year and there are so many skeptics that have withdrawn their money over the last three years that there is still plenty of fuel for a very good year, both here and overseas.

I often complain about the unemployment numbers because of the seasonal adjustment, which many think was huge this month, and the birth-death model which estimates, not counts, how many jobs were created in small business. I also have a beef with the way the unemployment rate is calculated.

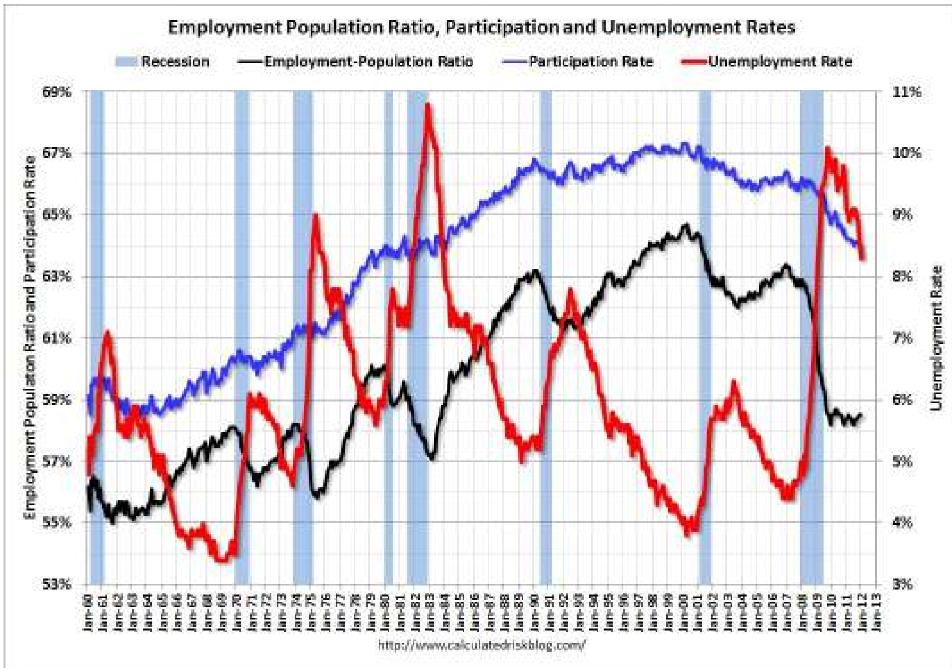
Look at the following chart that shows the total number of Americans not in the labor force. You will need to stretch it to see the labels.

See the huge spike last month? Are we supposed to believe that 1.2 million people suddenly dropped out of the labor force in one month? No, this is an annual adjustment that is made after going through payroll records and renders the month in which it is adjusted virtually useless.

Source: http://forums.floridasportsman.com/showthread.php?37943-Labor-force-participation-rate-falls-to-30-yr-low-(Folks-have-quit-looking-for-work!)

The number of people in the labor force is important because it is half the calculation for the unemployment rate. You take the number of people listed as unemployed and divide by the number available for work. When one reduces the number of people available for work, the percentage of unemployed drops automatically. Add that to the way the Bureau of Labor Statistics estimates the number of jobs added and you have an employment report that is hard to take very seriously.

A more direct way to look at this is the labor force participation rate. Look at the blue line below.



Source: http://www.calculatedriskblog.com/2012/02/graphs-unemployment-rate-participation.html

This chart is actually not updated to include today's BLS unemployment report. If it were, you would see the blue line had dropped further to 63% (left scale), the lowest since 1981. Look at the black line which shows those working as a percentage of the entire population. While it has leveled off recently, it is still the lowest since the early 1980s. These give you a much more accurate picture of employment in the US today than what you will see on the evening news.

How can we reconcile the dropping number of people working with a dropping unemployment rate? That's easy thought almost never discussed. The unemployment survey was changed in 1994 when it stopped counting people as unemployed if they had not looked for work in the last month. This is commonly associated with giving up and is common to the long term unemployed. Critically, the unique feature of this recession is the huge number of long term unemployed. Those who took early retirement in order to avoid being laid off are also not counted. Add these two groups back in and you have an unemployment rate that is actually 10.3%, not 8.3% and is little changed over the last six months.

There is something else important to note about these charts. **It is very difficult to have a growing economy when the percentage of those not working keeps going up.** The truth about unemployment and how it affects the economy is thus the opposite of what you will hear reported and the truth fits with the very slow post-recession recovery in which we are still mired.

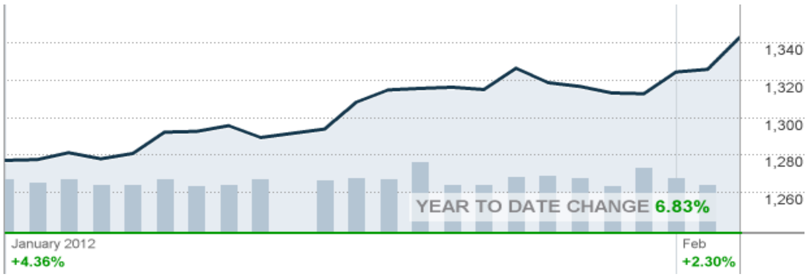
Europe

I am actually not going to write about Europe this month because 1) I have written on it extensively the last few months and 2) whatever I write in a monthly newsletter will be outdated very shortly.

OK, I will make one short comment. Europe is really cheap right now. Stocks sell at an average ten times earnings and there are many high dividend household names on sale. Either it is darkest just before the dawn (unfortunately an illustration that is patently false, though the idea has comforted many people) or it is darkest just before the lights totally go out. I can't really call the timing on Europe – I could be off by years, but it is currently cheap based on earnings, dividends, book value and other measures.

Stocks

Stocks are off to a great start on the year, both here and overseas. Through Feb 2, stocks are up about 8% on the year already. This is in spite of a rather disappointing earnings reports season. The number of pleasant surprises on reported earnings for the last quarter was much smaller than usual.



Since people usually say that a company's stock price goes up along with increases in earnings, why is the stock market up when earnings reports were unexpectedly poor? Good question. I have some thoughts on that.

- Many investors, not just retirees had either drastically reduced their allocations to stocks or just given up, especially because 2011 was the 4th year in a row of high volatility and losses for many
- After years of stock investors dropping out, the process is apparently going through the bull market conversion of skeptics into believers
- Economic reports have been better the last 3 months
- The Federal Reserve is rumored to be strongly considering another round of quantitative easing if economic reports falter again. During QE I and QE II stocks and bonds did very well indeed.
- People are bored with European troubles and think it won't be as bad as they thought recently
- Momentum creates momentum – people are buying just because stock prices are going up

Will stocks keep going up? Who knows? Clients are right at their long-term allocations for stocks.

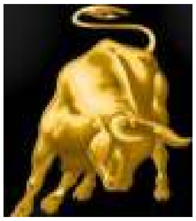
Bonds

Bond prices have also been going up, with international bonds, corporate bonds, municipal (tax-free) bonds and long-term treasuries doing the best. This is partly due to the rumors that the Federal Reserve may be ready to start another round of buying bonds, trying to drive bond prices up and rates down.

In terms of treasury bonds, if the economy stays OK in the eyes of Ben Bernanke then treasury prices have gone about as high as they can go. The US Treasury just the other day, agreed to issue bonds with a negative interest rate. Only much bigger problems in Europe could drive them higher. I would completely avoid treasury bonds.

Gold

Both gold and gold mining stocks have been on fire so far this year. Gold is up 13% so far. I bought back our gold recently for three reasons. First, gold has been seen the last couple years as a risk-on asset, so when people are confident and take more risks, gold fits the bill.



Second, if the Fed prints money again, gold will benefit in spades and third, there is the potential for bad things in Europe. It has acted like the perfect hedge – it not only goes up and bad news, it also goes up on good news. If that seems too good to be true, I can only say that since 2000 stocks have had some really awful years and some really good years and gold went up during both. It will eventually show signs of mania ala tech stocks in 1999 but we are not there yet.

Taking Care of Yourself

Whether you feel that you did well or did poorly the last few years you have likely been affected by the extreme volatility in investments, the long-drawn out process of hearing bad news on the TV or from out-of-work friends, all the blaming of one party or another and one candidate or another, the drumbeat of poor news from Europe and all the other bad news that fills most of our news broadcasts. Many are just plain tired or worn out.

While a late February or March cold spell may frost them, buds are appearing on trees and some trees are even flowering. Daffodils are coming up and the air feels like spring. That actually might be a good metaphor for the markets so far this year.

Let me suggest that you make a decision to relax with someone you love, go for some walks or runs, get together with friends, go on a dress-up date, plan a trip – whatever healthy things make you feel better. Among other things, I like to put the top down on my convertible and just drive.

We’ve earned a little bit of loosening up, stretching out tight muscles in our necks and backs and legs and just realizing that the world hasn’t ended (it only ends once). If we continually worry and fret it leads not only to depression but the clouding of our mind and skewing of our thoughts so that we make suboptimal decisions.

Being a Bible reader let me pass along some wise words from the best book I know:

- “ Do not fret; it only leads to harm (Psalm 37:8).”
- “Cast your burden upon the LORD and He will sustain you (Psalm 55:22).”
- “Behold, God is my salvation, I will trust and not be afraid for the LORD GOD is my strength and song, and He has become my salvation Isaiah 12:2).”
- "So do not worry about tomorrow; for tomorrow will care for itself. Each day has enough trouble of its own (Jesus in Matthew 6:4).”
- "Come to me, all you who are weary and burdened, and I will give you rest (Jesus in Mathew 11:28).”

There is always the choice between letting stress get the better of you and you getting the better of stress. It doesn’t always feel like you have the choice but you always have some amount of choice. Choose life.

Dave Hoshour
DaveH@CornerstoneInvestment.com