MainStream Management
Creating Value, Driving Results

Newsletter
January 2013

MainStream Monthly Research

High Unemployment to Continue

The employment outlook for 2013 offers little cause for New Year's celebration. Champagne bottles will have more fizz than the U.S. economy in the near term, and the same unemployment headaches cited 16 months ago will persist.

That's the bad news MainStream has to report, as we revisit last year's MainStream employment newsletter to take another look at the labor force landscape. True, the unemployment rate has decreased from 9.3% to 7.8% since our June 2011 issue, but this rate fails to tell the whole story. It is an inadequate measure for several reasons — one weakness being that it does not reflect the duration/permanency of jobs being lost or gained.

The good news: long-term structural shifts in employment will produce a distinct group of winners as well as U.S. workforce growth will rely largely on two factors:

1. The private sector's ability to take advantage of these structural shifts.
2. The right incentives and regulatory backdrop from the public sector to allow the private sector to succeed.

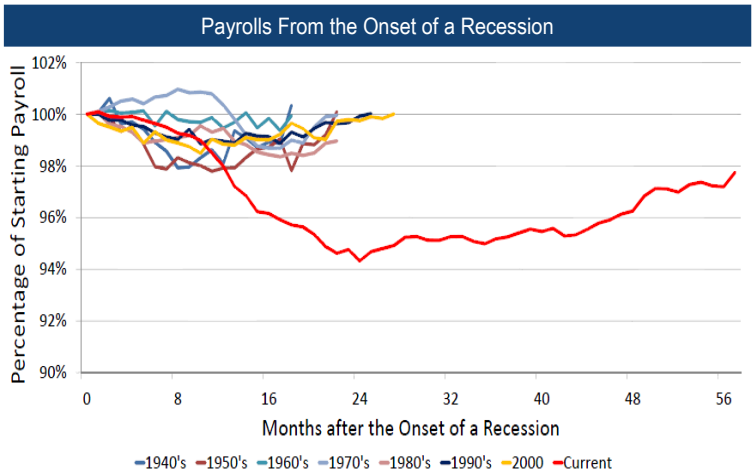

Figure 1. Source: Bureau of Labor Statistics

For the next several years, however, deleveraging will be employment enemy number one. It will likely have a painfully prolonged dampening effect on economic growth that will by extension cause persistently high unemployment.

Deleveraging: Finance-Driven Full Employment

At the economy's peak in November 2007, the U.S. had more than 146 million people employed. The economy then lost nine million jobs over the next two years. So far, the U.S. has yet to regain half of those jobs, despite being 57 months removed from the recession's onset.

PUBLIC AND PRIVATE DEBT INCREASED FROM $26 TRILLION TO $57 TRILLION (OR 296% TO 400% OF GDP) FROM 1998 TO 2008

While this is unusual for most post World War II recessions (Figure 1), not so much for those that are exacerbated by deleveraging. The proliferation of debt has directly (government and finance related positions) or indirectly (construction, automobiles, etc.) driven job creation in several industries over the last decade.

Public and private debt increased from $26 trillion to $57 trillion (or 296% to 400% of GDP) from 1998 to 2008. That debt, and the spending it enabled, supported an unsustainable level of employment in many of these industries that is still in the process of normalizing (Figure 2, Page 2).

Without debt accumulation, the result will likely be a lower employment baseline rather than new highs. This lower baseline in the construction, motor vehicles, finance, and retail industries suggests that full employment (under 5% unemployment) will be unattainable over the next several years due to deleveraging.

Consider these reality checks:

- Residential construction: Despite the recent rebound in residential construction, annualized new housing completions remains in the bottom 4% of all observed data (Figure 3), and the number of vacant homes remains near all time highs (Figure 3).
- Nonresidential construction: Spending has stalled for the last six months and remains 29% below its high.
- Commercial real estate: Vacancy rates have exceeded 15% for the last four years.
- Automobiles: Production is at 1994 levels, despite increasing over 60% from its recessionary low.
- Finance: There are 16% (1,357) fewer bank branches than there were prior to the beginning of deleveraging. Moreover, the number of bank branches have decreased every quarter for the last 18 months and has decreased by an average of 25 per month over the last four years.
- Retail: Inflation adjusted retail and food sales to be at the same levels they were five years ago despite an increase in population of 14 million.

These industries rely on flowing credit to expand capacity and increase employment at a faster rate than population growth. However, the economy is still likely to be three to five years away from becoming a reality.

The Debt-Level Disconnect

In aggregate, debt levels are not falling dramatically — solely due to government involvement. The government has increased its debt by $4 trillion since deleveraging began, while the private sector (corporations and households) has decreased its debt levels by $3.2 trillion. This has caused a profound change in consumption, investment, and savings habits for households and corporations that will have a long term impact on employment growth.

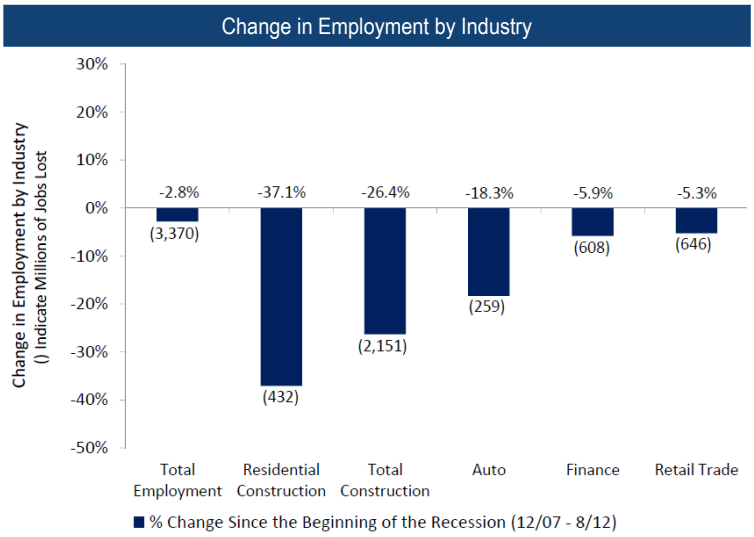

Figure 2. Source: Bureau of Labor Statistics

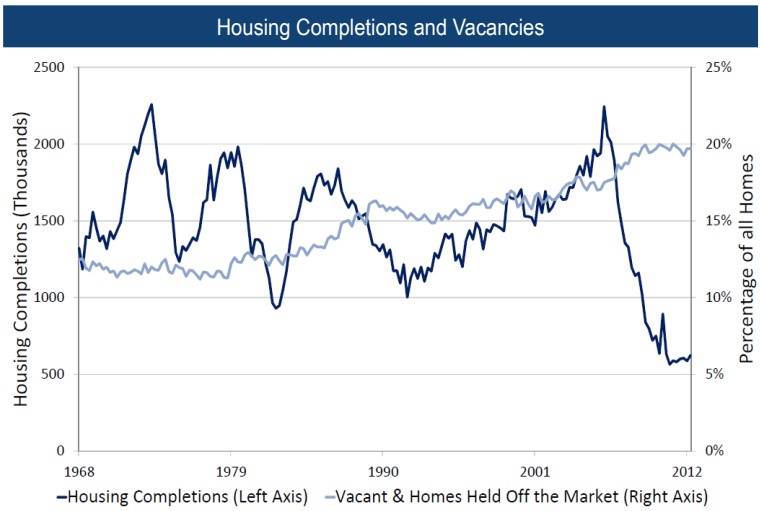

Figure 3. Source: United States Census Bureau

THE FINANCIAL CRISIS BROUGHT ON AN ERA OF PRIVATE SECTOR AUSTERITY IN WHICH HOUSEHOLDS AND CORPORATIONS STOPPED ACCUMULATING DEBT AND DRAWING DOWN SAVINGS

From the point the leveraging of the economy began in the early 1980s to when it ended before the financial crisis, household debt increased by 8.7% per year while consumers cut down savings (Figure 4, Page 3). This fueled consumption, which in turn supported employment growth and income growth.

Deleveraging had similar effects on the corporate level. Households stopped investing (purchasing real estate, for example) in addition to preserving savings; corporations stopped investing above maintenance levels, while increasing their cash balances to record levels (Figure 5, page 3).

The financial crisis brought on an era of private sector austerity in which households and corporations stopped accumulating debt and drawing down savings. These were the two main drivers for the U.S. economy for roughly 25 years. Employment, investment, trade, government spending, and taxes were all supported by spending of unearned and previously earned money.

Consumers and corporations have continued to reduce debt while the economy has grown, but this has been possible because of the government's continuing debt accumulation — which is not a permanent solution.

What to Expect

This is why the current economic malaise will last as long as deleveraging itself. It will take a change in private sector behavior, back to the previous normal, in order for consumption and investment to regain previous levels of growth. Consumption precedes employment growth (Figure 6, Page 4), meaning that it will likely be even longer before we see the robust employment growth of the quarter century preceding the financial crisis.

IT WILL TAKE A CHANGE IN PRIVATE SECTOR BEHAVIOR, BACK TO THE PREVIOUS NORMAL, IN ORDER FOR CONSUMPTION AND INVESTMENT TO REGAIN PREVIOUS LEVELS OF GROWTH

In the past, high unemployment would serve as its own cure. An excess of labor would push wages down, which would in turn increase corporate profits. These profits would be reinvested or spent, causing capacity growth, an increase in demand, and rising employment until an equilibrium was reached at or below 5% unemployment.

This time has been different. Low wages have led to higher corporate profits, but not increased corporate spending and investment. There is not enough sustainable demand to warrant corporate spending, but this should change as deleveraging ends and consumers begin to take on debt.

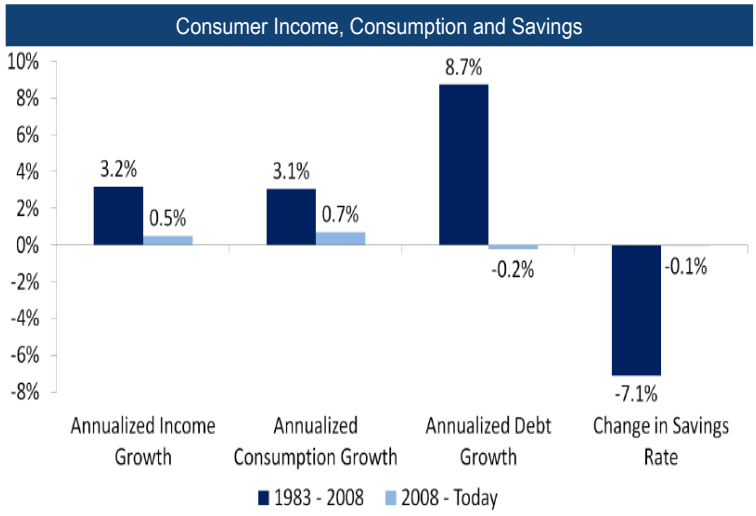

Figure 4. Source: Bureau of Economic Analysis

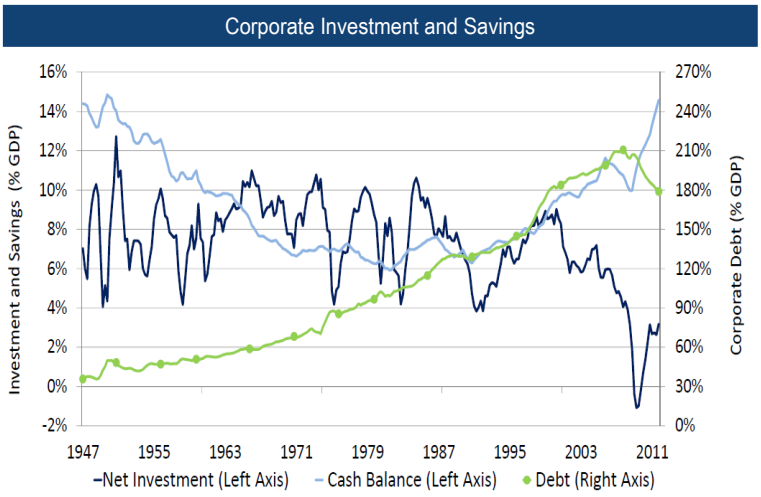

Figure 5. Source: Flow of Funds, Bureau of Economic Analysis

By causing an overcapacity in several industries (construction, automobiles, finance), deleveraging has dampened the demand for employment. While this excess capacity will eventually work itself through the system as prices decline (deleveraging is deflationary), debt levels stabilize, and the economy begins to leverage again. The immediate future looks much worse than what is expected in this country: persistently high unemployment and low wage growth for an extended period of time.

Time is the key word. The current employment story is not very uplifting, but it is still a work in progress. Deleveraging follows a path that is largely predetermined, with variance occurring mostly due to government response. Its effects will likely weaken over the next several years, depending on how the government handles its own deleveraging. It is already being solved in the private sector, and the government must follow suit in a measured process that demonstrates fiscal leadership and responsibility.

Ultimately, the ending will depend on how all the key players (employers, labor, and government) choose to address the problems on the horizon. Those problems go beyond the factors that influence deleveraging. Demographics and increased efficiency and innovation will have a much greater effect going forward, since population growth, aging, and productivity are the long term drivers of all employment growth.

Strategy Alignment

What do these observations mean to your business? In a word: opportunity. There are 3 steps that can immediately be implemented to impact your business performance in 2013.

1. *Top talent is readily available.* With business complexity at a peak, take the steps to improve organizational performance by capitalizing on the A-players in the marketplace. Undertake a thorough review of business imperatives, the essential initiatives that must be implemented and the skills required for their achievement. Balancing these objectives against the performance levels of your current employees, there likely will be opportunities to upgrade talent and introduce new skill sets. In this manner, the business will be refreshed with the necessary capabilities to navigate future market challenges.

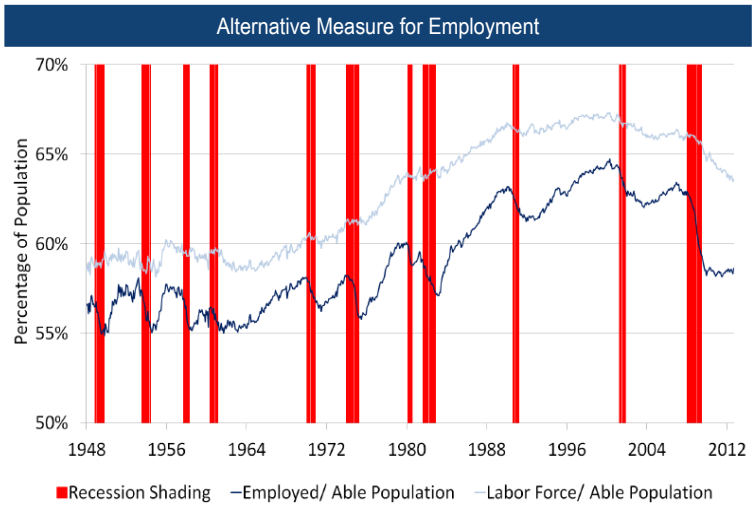

Figure 6. Source: Bureau of Labor Services

2. *Evaluate your business processes and production locations.* The rising costs of overseas labor along with demanding customer lead times, supply chain challenges, and delivery expenses provide an opportunity to "right size" and/or "right shore" operations. Combined with Lean, other technology advances, and with favorable hiring conditions in the U.S., organizations can not only achieve higher customer satisfaction levels but also increase competitiveness, cash flow and profit gains by optimizing their operational footprint.

3. *Refine your strategies for revenue growth.* With interest rates at their lowest levels, now is the time to boldly invest in the growth of your business and drive value creation amidst a flat economic outlook. Private sector deleveraging and government uncertainty continue to exacerbate a weakened U.S. economy. The optimal business response to these difficult market conditions: develop a structured plan for organic growth to maintain asset values and achieve above trend line performance.

The benefit of taking these steps is a more profitable 2013 outlook for your company with all the resulting rewards that profitability brings.

About MainStream Management

MainStream can help by taking a holistic view of your business performance from bottom-line operational effectiveness to top-line value creation. Since 1999, our leadership in the design of revenue strategies in addition to MainStream's expertise in the renewal of distressed organizations has sustained the long-term asset values and financial growth of our clients.

For questions or additional information, please contact:

Justin Cohanim (justin.cohanim@mainstreamllc.com) conducts the firm's research and economic analysis.

Laurie Brunner (laurie.brunner@mainstreamllc.com) leads MainStream Management, as President of the firm.
