630-322-7756
www.ftportfolios.com

FIRST Trust ADVISORS L.P.

April 23, 2007 Economic Commentary

Labor Pains

On the first Friday of every month, financial markets wait expectantly for what many believe to be the government's most important economic release – the Labor Department's employment report. This report moves the equity and bond markets like no other. It influences Federal Reserve policy and investor attitudes, it alters political debate and impacts public policy decisions.

The problem is that in recent years the payroll survey has consistently underestimated the strength of the labor market. In fact, in just the past ten months, revisions alone have added 444,000 jobs.

On release day the Bureau of Labor Statistics (BLS) reports two different job surveys. One is the Household survey, which tracks 60,000 households each month and asks questions about jobs and unemployment. This BLS uses this survey to calculate the unemployment rate, but it also includes estimates of job growth.

The other survey, called the Establishment (or payroll) survey, is considered more reliable by many economists and market participants because the payroll survey samples 160,000 businesses and government agencies covering about one-third of US workers. It asks these employers how many people are on the payroll every month, and calculates the net number of jobs created or lost.

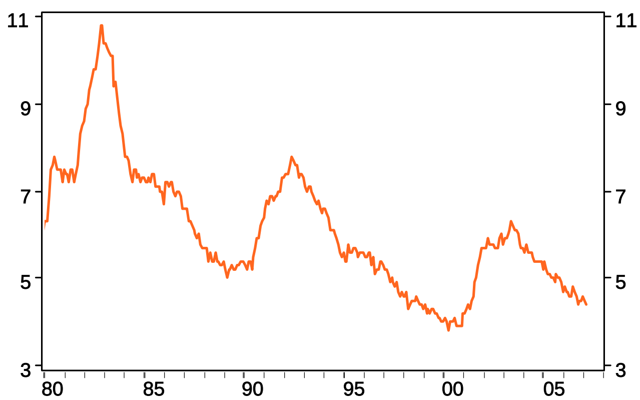
Alan Greenspan weighed into an ongoing debate about which survey is better during Congressional testimony back in 2004, when he said, "I wish I could say the household survey were the more accurate…[but] everything we've looked at suggests that it's the payroll data which are the series which you have to follow."

Given the pattern of revisions since then, Alan Greenspan may want to take back those words. What he said was technically correct – the payroll survey has a bigger sample size and is therefore less prone to statistical noise. However, in recent years, the month-in, month-out data flow on payroll job creation has been off by a mile. The BLS has consistently been forced to revise its initial monthly estimates upward by substantial amounts.

For example, during the twelve-month period from April 2005 through March 2006, the initial estimates of payroll job growth each month averaged 155,000, for a total of 1.9 million. This is solid job growth, but not spectacular. As a result, many analysts complained of economic malaise stemming from excessive Fed tightening, job losses to China, and the faulty economic policies of the Bush Administration.

However, these early estimates of job growth were entirely too low. Every month the Labor Department goes back and revises data for the previous two months. These revisions added another 228,000 jobs for the year ending in March 2006.

United States Unemployment Rate
(Percent of Labor Force)



Source: Bureau of Labor Statistics /Haver Analytics

But the revisions for that period didn't stop there. In February 2006, the BLS dropped a bombshell during its "benchmark revision" process, which recalibrates the payroll employment figures based on tax records from the unemployment insurance system. During this revision process, the BLS added another 750,000 jobs, bringing the total to 2.85 million, or 237,000 per month, a fantastic rate of job creation. In retrospect, the data show that economy was much stronger than the pessimists were able to assert at the time. The problem is that it took revisions to the data to reveal the actual facts.

No month stands out like September 2005, the month most affected by Hurricanes Katrina and Rita. The original estimate reported a loss of 35,000 jobs. A month later the September figure was revised upward to show a smaller loss of 8,000 jobs. Another month later and it was revised to show a 17,000 gain. And finally, more than one year later the BLS benchmark revision recalculated the data for September 2005 and found that jobs actually grew by 105,000, a whopping number considering the dislocation caused by the Hurricanes.

Despite all of these revisions, there are still serious data problems. The original monthly job estimates continue to severely underestimate job creation. The table below lists the original data and monthly revisions for the payroll data from April 2006 to March 2007. (The original estimate is called "first preliminary," the first revision is called "second preliminary," and the last revision, before the annual benchmark, is called "final.")

Payroll Employment Revisions

		"First Preliminary"	"Second Preliminary"	"Final"
			(all figures in thousands)	
2006	April	138	126	112
	May	75	92	100
	June	121	124	134
	July	113	121	123
	August	128	188	230
	September	51	148	203
	October	92	79	86
	November	132	154	196
	December	167	206	226
2007	January	111	146	162
	February	97	113	NA
	March	180	NA	NA
Apr 06 - Jan 07 Average		113	138	157

As the table shows, original estimates have reported just 113,000 new jobs per month, but after the two revisions, these have been lifted to 157,000 per month. In other words, for the most recent ten months, job creation has already been revised up by an average of 44,000 per month. And this is before the benchmark revision.

Why is this happening? No one knows for sure, but one theory is that the most rapidly-growing firms, which tend to be smaller and more entrepreneurial, are consistently tardy in responding to the BLS survey. As a result, their growing payrolls are reported with a lag, pushing up the later revisions.

Whatever the case may be, we believe the trend of upward revisions is going to continue, although probably not every month. The Household survey, which is not revised on a monthly basis, says job creation was much stronger in the ten months through January than the payroll survey, averaging 260,000 new jobs each month rather than 157,000. Ultimately, we believe these two surveys will converge.

In the end, investors, the Fed and policy makers should be very careful before making decisions based upon month-to-month changes in payroll jobs as initially reported. The US is experiencing a surge in entrepreneurship, and this is particularly hard to measure with statistics designed in the age of large factories and time clocks.

Data-centric forecasting models, which have consistently underestimated economic strength in recent years, should be viewed with skepticism. With tax rates low, the Fed still holding rates below neutral, and technology enhancing efficiency gains, the economy will be a stronger than the initial monthly payroll figures suggest.

Brian S. Wesbury, ***Chief Economist***
Robert Stein, ***Senior Economist***
Trevor Scott, ***Economic Research Analyst***