

As a result of the excess leverage and lax regulatory oversight of our capital markets leading up to the Financial Crisis of 2008, our economy now has structural barriers that we believe will impede economic growth for some time. These structural issues include an excessive level of federal debt, weakened capital positions of the major banks, severely underfunded public pension plans, and a sustained high level of unemployment. As a result of these structural barriers, sustained business development and job creation will be difficult until these structural challenges are addressed.

The Nature of Unemployment

Fluctuations in the growth of the economy, measured by the change in Gross Domestic Product, influence the demand for labor and employment. Economists define our labor force as the total number of people who are at least 16 years old and are currently working or seeking employment. As a result, the size of the labor force changes based on those two criteria. In 1993, the population of the United States was 195.1 million people, 129.5 million of whom were in the labor force. As a result, the labor participation rate in 1993 was 66.4%. By 2010, the population of the United States has ballooned to 237 million and the labor force is estimated at 153.5 million resulting in a participation rate of 64.6%.

Typically, unemployment is the result of mobility within the labor force as workers move from contracting industries to expanding industries and in and out of the labor force. For example, during the late 1980's the growth in personal computers resulted in the decline in typewriters, and with it the decline in typewriter repair shops. However, the recent spike in unemployment is the result of a severe contraction in many industries, including the financial services industry which has grown disproportionately over the past decade. In a large part this growth in financial services was a result of the decline in interest rates and the unconstrained origination of mortgage loans during the period.

In a dynamic economy where information is imperfect and people are free to choose among jobs some unemployment is inevitable. However, sustained high rates of unemployment generally reflect weak demand conditions for labor, ineffective public policy, and/or a lack of incentive on the part of employers to increase the number of jobs. We believe that all of these symptoms currently exist in today's economic environment.

Three Types of Unemployment

Economists classify unemployment into three different categories: frictional, cyclical and structural.

Frictional unemployment is unemployment which is caused by constant changes in the labor market. This occurs as companies looking to hire the best candidate take their time and interview many applicants. At the same time, individuals seeking employment take their time identifying and analyzing the different opportunities that exist with various companies. As a result, the basic cause of frictional unemployment is the inefficiencies that result from the employer and job seeker moving through the search process. While this was more prevalent during the 1990's and early 2000's, this is clearly not evident in today's job market as the number of qualified candidates clearly surpasses the number of available positions.

Cyclical unemployment occurs when there is a general downturn in business activity. Simply, when the rate of economic growth slows, fewer goods are being produced and fewer workers are required to produce them. Unexpected reductions in the general level of demand for goods and services are the major causes of cyclical unemployment. When there is a general decline in demand, most workers have difficulty finding employment. As a result, candidates are willing to accept positions beneath their expectations and at lower wages. When the reduction in aggregate demand is substantial, the adjustment process for the individual may be lengthy and a substantial increase in the unemployment rate is the result.

Structural unemployment results from a dramatic shift in the economy which prevents the matching up of available workers with available jobs. While jobs are still available, the basic characteristics of the economy have changed which ultimately prevents potential workers from finding employment. Dynamic change within the economy is one of the main reasons for structural unemployment. This includes the introduction of new technology or products. Many automobile workers experienced this in the early 1980's as increased competition from foreign producers and changing technology reduced employment in the American auto industry. Shifts in public sector priorities can also cause structural unemployment. For example, as the Cold War drew to a close in the early 1990's the United States significantly reduced its defense spending. The result was an increase in unemployment in New England and California which were two major hubs for defense contractors. Realistically, the *structurally unemployed* worker faces the prospect of either a career change or prolonged unemployment. And, in an economic environment that is not producing significant growth in jobs, the structurally unemployed worker faces the prospect of accepting a job that is beneath his or her current skill level, resulting in an *underemployed* worker.

The Relationship between Unemployment and Economic Growth

Economic output and employment are closely linked through the business cycle. If an economy is going to produce more goods and services, it must increase the number of workers or the output per worker. Over the past year, we have experienced a sharp increase in the rate of productivity – or the output per worker. However, in order to have sustained economic growth, an expanding economy eventually will need to increase the number of workers in order to meet the growing demand.

The current rate of unemployment is running near 9.5%, the highest level since the 1982 - 1983 recession when the rate of unemployment peaked at 10.2%. The economic growth from 2000 to 2007 was supported by growth in the number of jobs in the construction, leisure/hospitality and financial services sectors. According to the Bureau of Labor Statistics, from 2004 to 2007, the economy produced on average over 150,000 jobs per month. However, in the 24 month period between 2007 and 2009 over 8 million jobs in the economy were lost.

The current economic uncertainty, weakened domestic financial system, low demand growth, and current political policies are not conducive to business development and job creation. As a result, the contraction in the economy over the past two years has resulted in a high rate of *cyclical unemployment* which is consistent with a severe economic downturn. In addition, the contraction in certain industries during the Financial Crisis including the banking and mortgage origination industry has resulted in a high level of *structural unemployment*. Further, potentially compounding the unemployment of older workers is the recently passed Healthcare Reform legislation. Given the uncertainty around the employer costs of the new insurance regulation, an unintended consequence of the new law may be an imbedded incentive to hire younger employees who are much less expensive to insure. As a result, the Healthcare Reform Bill may contribute to a sustained higher rate of *structural unemployment* for older workers.

An easy monetary policy in the early part of this decade provided the fuel for a substantial growth in output. As a result, there is a significant amount of excess capacity in our economy which includes manufacturing plants, office space, shopping malls, casinos, residential real estate, hotels, and hospital beds. Until we have growth in a new technology or industry, like cell phones in the 1990's and personal computers in the 1980's, the rate of economic growth will be bounded by replacing infrastructure and limited development.

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