

HUMBLE STUDENT OF THE MARKETS

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Mr. Hui posts a market comment on the weekend plus one or two articles of interest during the week.

His subscription service includes annual, monthly, or daily pass options, and is focused on building a community of like-minded individuals with a common interest in investing and trading.



The article begins on the following page, and is entitled:
Solving The Data Puzzle At The Center Of Monetary Policy

You can access his website and subscribe to his service at the following link:
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Bob Weir, CFA
Director of Research

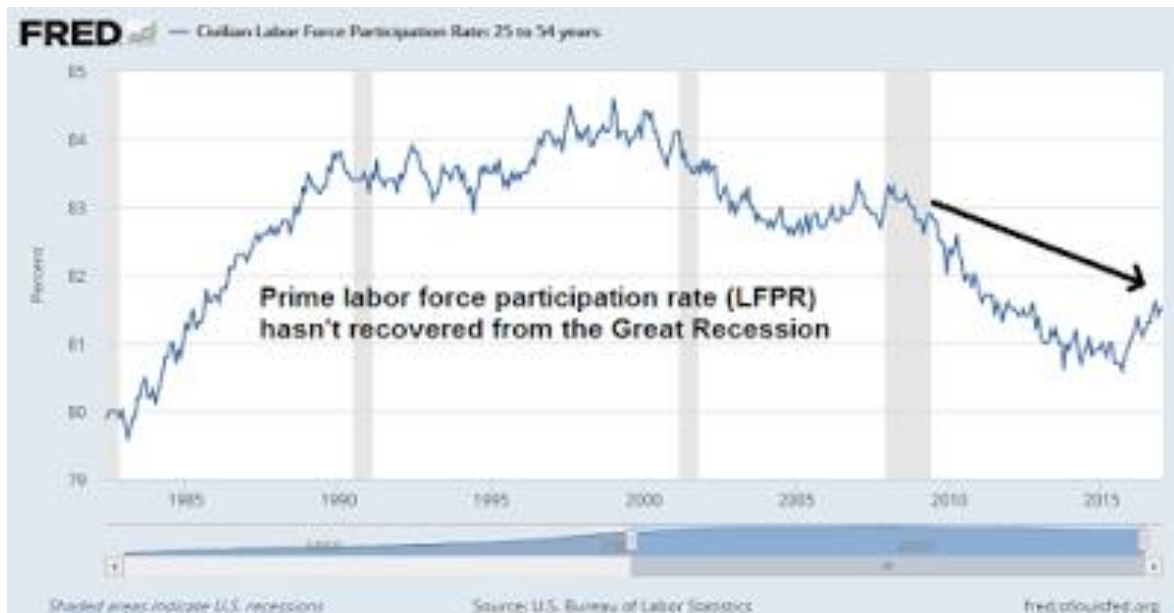
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Thursday, February 23, 2017

Solving The Data Puzzle At The Center Of Monetary Policy

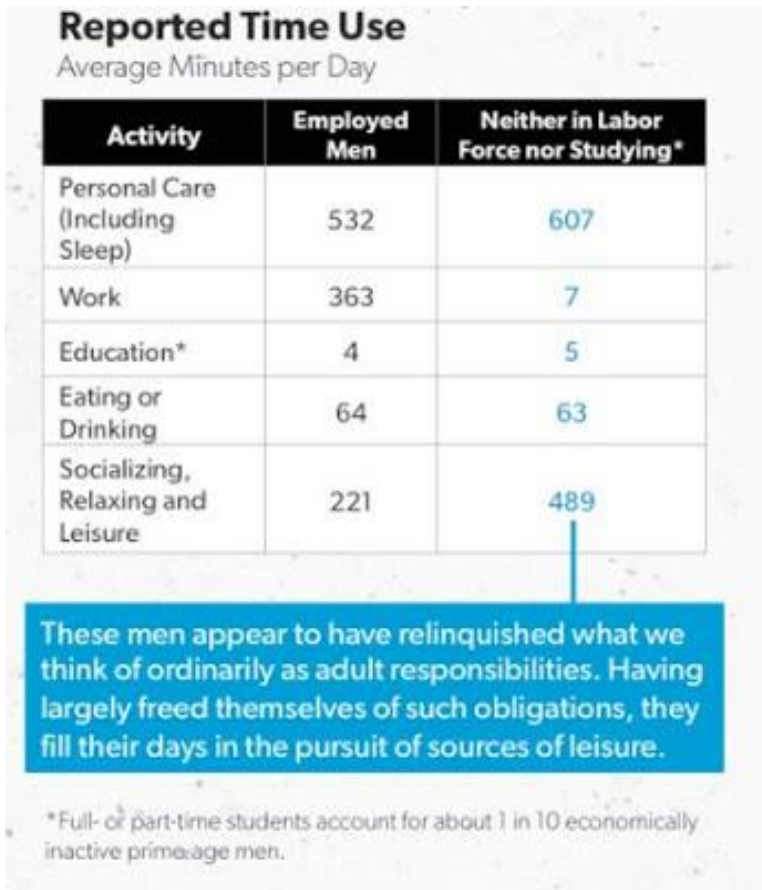
There has been much hand-wringing by economists over the falling labor force participation rate (LFPR). As the chart below shows, the prime age LFPR, which is not affected by the age demographic effect of retiring Baby Boomers, has not recovered to levels before the Great Recession.



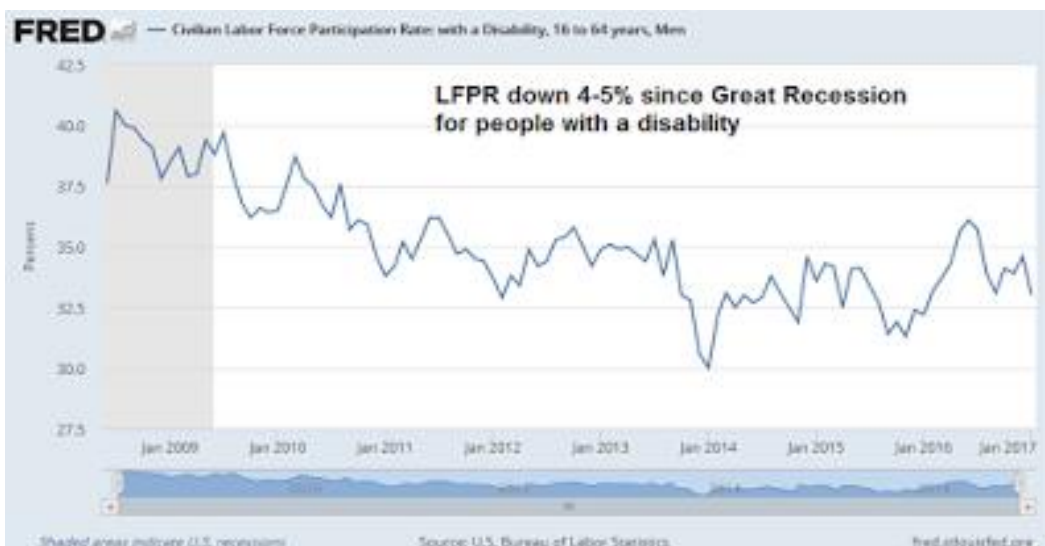
The lack of recovery in LFPR has caused great consternation over at the Federal Reserve. These readings suggest that there is still considerable slack in the labor market, despite the sub 5% unemployment rate.

A number of explanations have been advanced for this phenomena, such as jobless Millennials spending all their time playing video games in their parents' basement instead of looking for a job (via [Nicholas Eberstadt](#) of the American Enterprise Institute).

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Another possible explanation is the growth of disability as a shield against unemployment payments running out. As the Great Recession hit, disabled workers became discouraged and chose to rely on their disability payments instead of trying to find another job.



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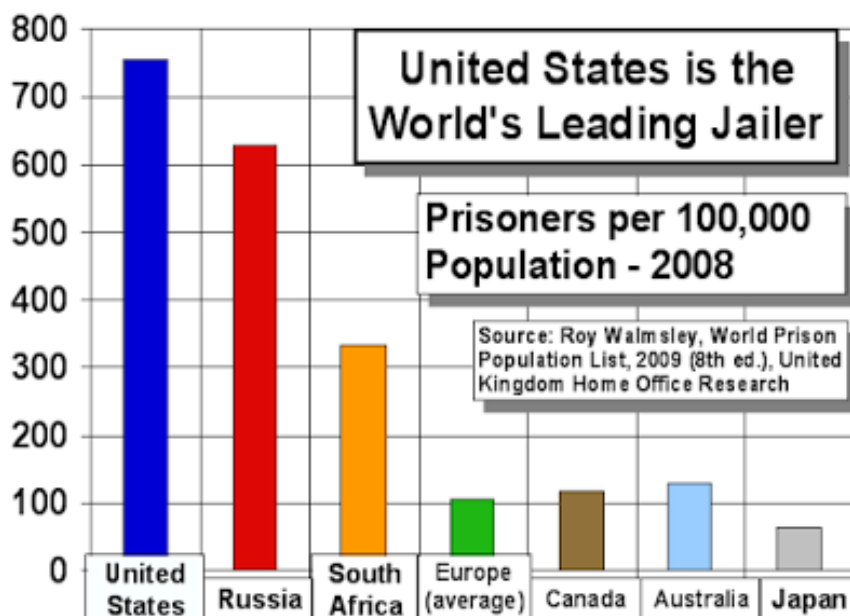
There may be another very simple alternative explanation for the collapse in LFPR. The answer is so simple, it is criminal that anyone missed it.

It Is Criminal!

Nicholas Eberstadt of AEI, who advanced the theory of the lazy Millennials, suggested a very simple explanation. The explosion in the incarceration rate in the United States has rendered a segment of the population virtually unemployable, which consequently depressed LFPR (via [Bloomberg](#)):

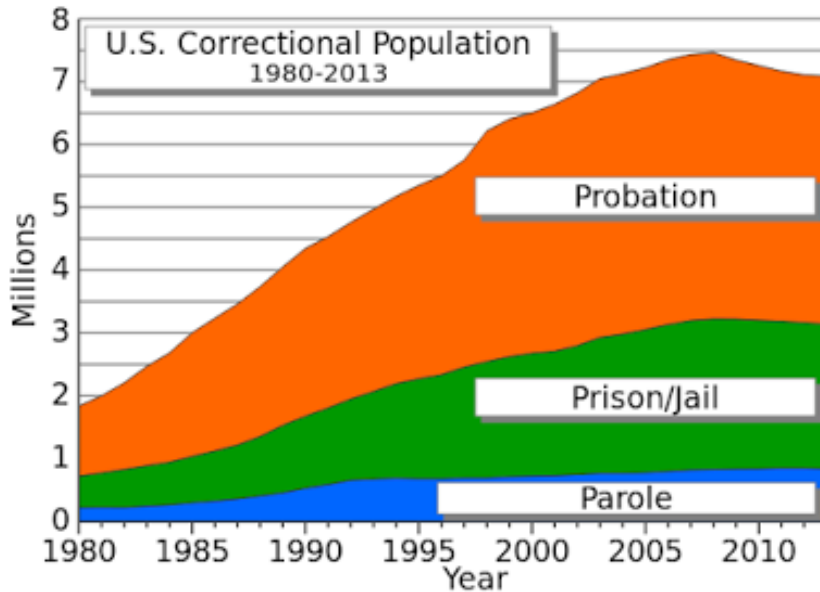
A single variable -- having a criminal record -- is a key missing piece in explaining why work rates and LFPRs [labor-force participation rates] have collapsed much more dramatically in America than other affluent Western societies over the past two generations. This single variable also helps explain why the collapse has been so much greater for American men than women and why it has been so much more dramatic for African American men and men with low educational attainment than for other prime-age men in the United States.

The idea has some merit. Consider that the USA has the highest incarceration rate of the major countries in the world, beating the likes of Russia, South Africa, and other industrialized countries (via [Wikipedia](#)):



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Prison and jail populations have exploded over the years (via [Wikipedia](#)).



The problem is not just the number of people in prison and jail, but what happens to them when they are released. Research from the [Sentencing Project](#) found that 60% of former inmates could not find work a year after release.

Barriers to employment

With 87 percent of employers conducting background checks, a criminal record can be a major barrier to employment

More than 60 percent of formerly incarcerated individuals are unemployed one year after being released;



those who do find jobs take home **40 percent less** pay annually



Sources: Society for Human Resource Management, "Background Checking—The Use of Criminal Background Checks In Hiring Decisions" (2012), available at <http://www.shrm.org/research/surveyfindings/articles/pages/criminalbackgroundcheck.aspx>; Bruce Western, "Collateral Costs" (Washington: The Pew Charitable Trusts, 2010), available at http://www.pewtrusts.org/~media/legacy/uploadedfiles/pcs_assets/2010/CollateralCosts1pdf.pdf?la=en.

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That is just people with criminal records. What if you were arrested but never convicted. The [WSJ](#) reports that the proliferation of private databases has created employment barriers for people with arrest records. These are people who were arrested, but not convicted. It could be something as simple as a misdemeanor offense, or a case of mistaken identity.

When Precious Daniels learned that the Census Bureau was looking for temporary workers, she thought she would make an ideal candidate. The lifelong Detroit resident and veteran health-care worker knew the people in the community. She had studied psychology at a local college.

Days after she applied for the job in 2010, she received a letter indicating a routine background check had turned up a red flag.

In November of 2009, Ms. Daniels had participated in a protest against Blue Cross / Blue Shield of Michigan as the health-care law was being debated. Arrested with others for disorderly conduct, she was released on \$50 bail and the misdemeanor charge was subsequently dropped. Ms. Daniels did not anticipate any further problems.

But her job application brought the matter back to life. For the application to proceed, the Census Bureau informed her she would need to submit fingerprints and gave her 30 days to obtain court documents proving her case had been resolved without a conviction.

Clearing her name was easier said than done. "From what I was told by the courthouse, they did not have a record," says Ms. Daniels, now 39 years old. She didn't get the job. Court officials didn't respond to requests for comment.

Could something like this happen to you?

Estimating The "Criminal Class" Effect

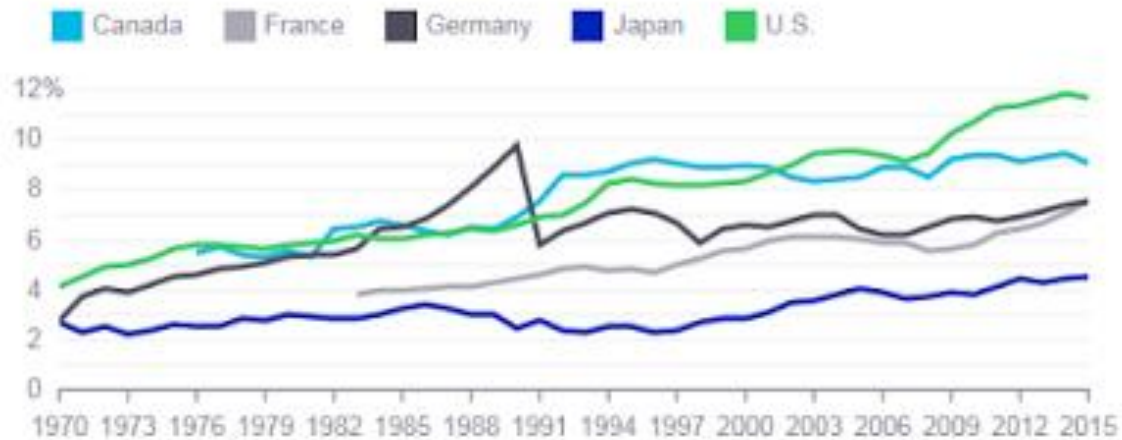
I have a couple of rough ways of estimating the "criminal class" effect on the LFPR. Using top-down data, the chart below from [Bloomberg](#) shows the differences between the "not in labor force" rate (NILF) between the United States and other major industrialized countries.

The latest data (2015) shows a 2.6% spread in NILF rate between the USA and Canada. The NILF rates of those two countries last crossed in 2007. Before that, they crossed in 2001.

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American Exceptionalism

Share of men ages 25 to 54 who aren't in the labor force



Source: Organization for Economic Cooperation and Development

What if the American NILF rate fell to the Canadian rate due to an equalization of incarceration rates? As the chart below shows, if we add back the 2.6% US-Canada NILF spread, the U.S. prime LFPR would jump to 84.1% (red dot), which is above the rate seen before the Great Recession, and slightly ahead of 2001 and 2007, when the NILF rates of the two countries last converged (black dots).



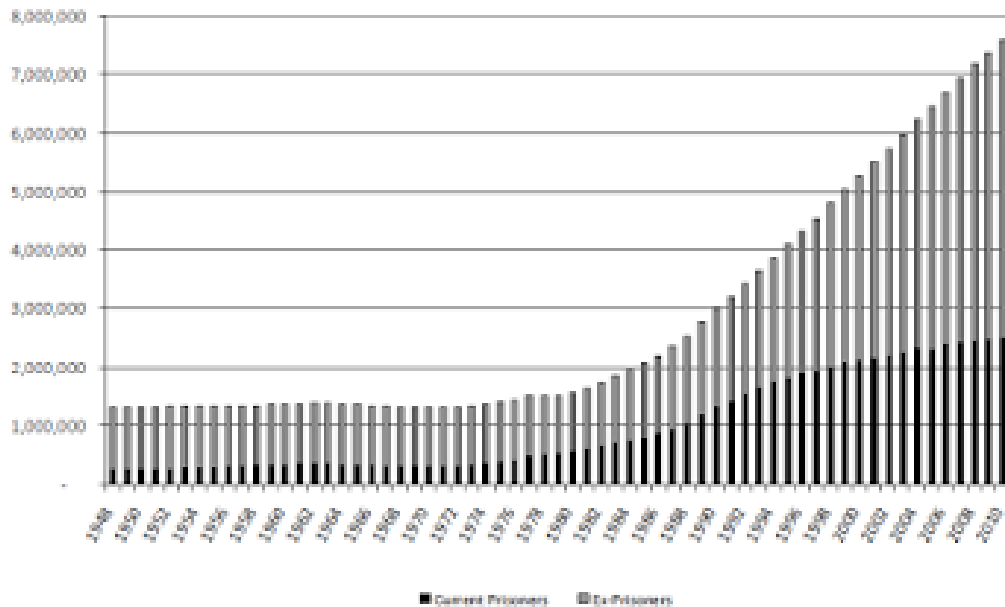
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Bottom-Up Estimates

Another way I estimate the "criminal class" effect on the LFPR is to ask the question, "What if all former inmates found jobs as easily as the rest of the population?"

To answer this question, I used estimates by the academics Shannon, Uggen, Thompson, Schnittker and Massoglia in the paper "[Growth in the US ex-felon and ex-prisoner population, 1948 to 2010](#)". I took the grey bars in this chart (ex-prisoners) as estimates of the former prisoner population.

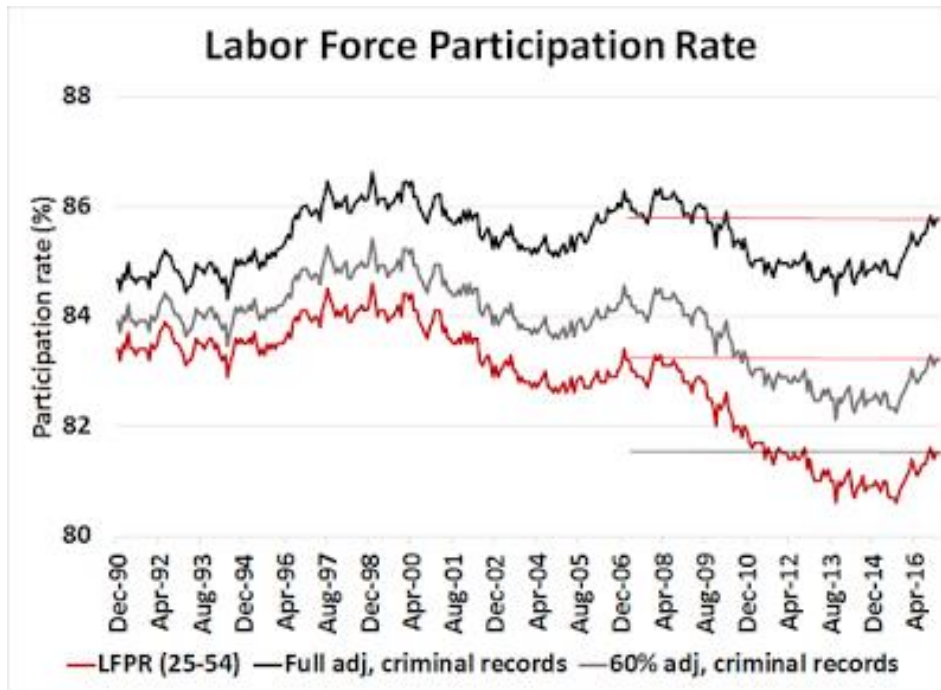
Figure 2 – Growth of Prisoners and Former Prisoners in the U.S., 1948-2010



<continued>

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The chart below shows adjustments to the LFPR, assuming different levels of difficulty for former inmate participation in the labor force. The red line shows the actual prime age LFPR (data from FRED). The black line assumes that all former inmates re-entered the labor force and none were discouraged. The grey line assumes that 60% of former inmates get discouraged and left the labor force (see [Sentencing Project](#) analysis above).



Based on this approach, the LFPR would have fully recovered from the Great Recession if we assume a full adjustment for people with criminal records. Assuming a 60% discouragement rate among former inmates, the LFPR has significantly recovered from the Great Recession effects, and the recovery is better than the unadjusted LFPR rate.

A Feature, Not A Bug

I would add that this analysis assumes that there was no employment discouragement effect on people who were arrested but not charged. In reality, this "arrested but not convicted" category undoubtedly also had a depressing effect on the participation rate, as that population would have had sufficient difficulty in finding work that they would be more likely to leave the labor force than the general population.

In conclusion, using two separate approaches, I estimate that the surge in the incarceration rate in the United States in the last couple of decades has dramatically affected labor force dynamics. The plunge in labor force participation rate is an unintended consequence of the country's law-and-order focus.

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In other words, falling LFPR is a feature of past policy, not a bug.

As a result, the economy is likely far closer to full employment than standard unfiltered statistics, which has bullish implications for cost-push inflation. The slightly more hawkish tone of the [latest FOMC minutes](#) should therefore be taken as a welcome sign that the Fed will not fall behind the inflation fighting curve:

Many participants expressed the view that it might be appropriate to raise the federal funds rate again fairly soon if incoming information on the labor market and inflation was in line with or stronger than their current expectations, or if the risks of overshooting the committee's maximum-employment and inflation objectives increased.

Based on the results of this study, it could be argued that monetary policy should be on an even hawkish trajectory than three hikes in 2017.

Regards,

Cam Hui

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