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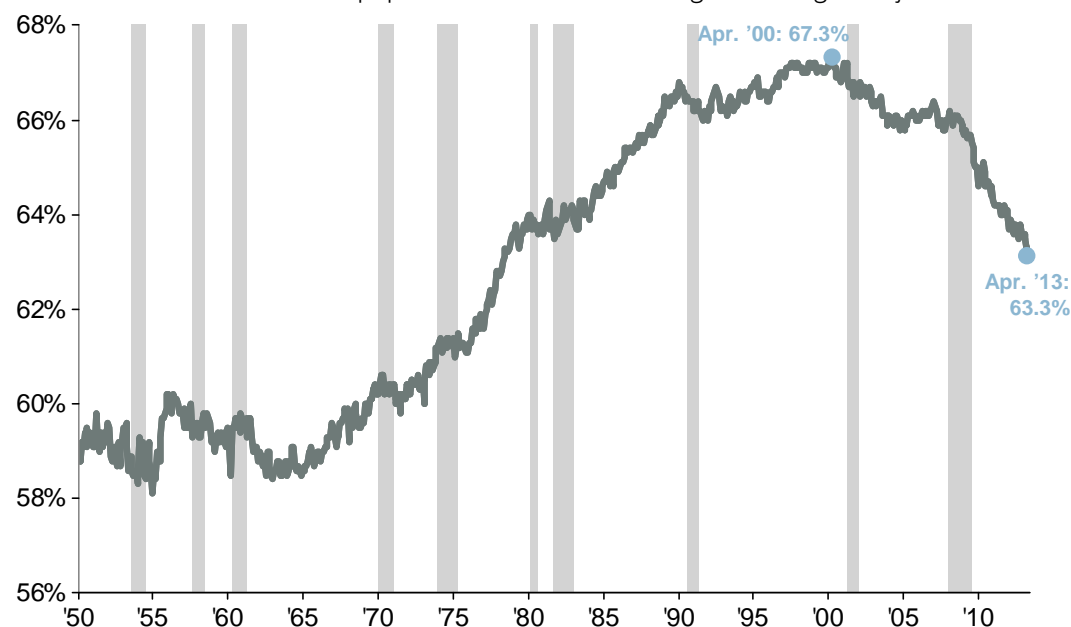
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The Labor Force Participation Puzzle

Slow growth and mediocre job creation have been common themes used to describe the U.S. economy in recent years, as both the labor market and broader economy failed to produce the snap-back rebound many expected following the deep recession seen in 2008 & 2009. Despite that lackluster growth, the unemployment rate has now fallen to 7.5% after peaking at 10% in October of 2009, a much faster decline than expected, given average employment growth of less than 125,000 per month¹.

Chart A: Labor Force Participation Rate

% of civilian non-institutional population 16+ either working or looking for a job



Sources: BLS, J.P. Morgan Asset Management.
Data are as of 5/9/13.

The key to this apparent paradox has been a decline in what is known as the labor force participation rate, which is defined as the number of people in the labor force (that is either working or actively looking for a job) as a percent of the civilian population, aged 16 and older.

¹ Average growth in employment according to the BLS household survey from October 2009 to April 2013.



Media commentary suggests that this decline in participation is due to potential workers abandoning the search for employment because they assume, in this tough economy, there is no job out there for them. However, the facts simply do not support this claim, at least over the past two and a half years. One trend that probably has had an impact in reducing labor force participation has been the explosive growth in those claiming social security disability benefits. However, this can still only account for a small part of the decline. In fact, the evidence suggests that by far the biggest reason for the decline in participation rates has been the aging of the population, as more workers enter age groups which are typically more associated with retirement than work.

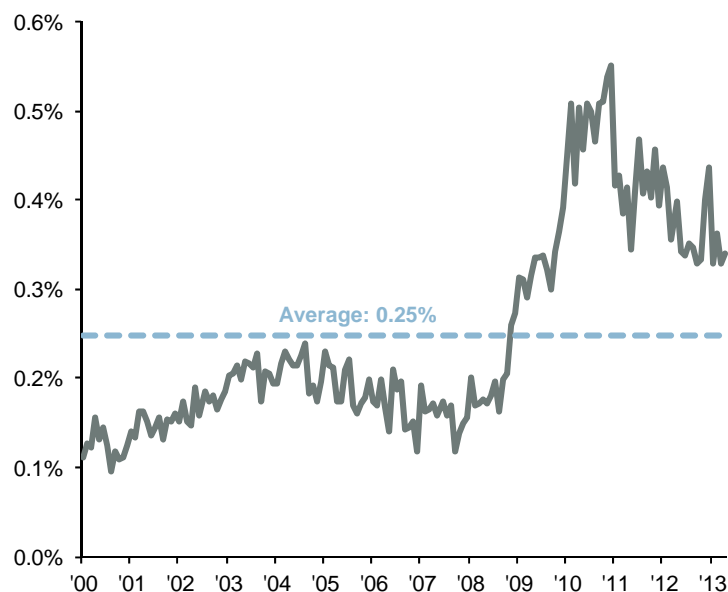
While this might seem like a subject of only academic interest, it is actually very important for investors. If low participation rates are being driven mainly by demographics rather than economics, then faster economic growth will not boost them. If this is the case, then the unemployment rate could well fall faster than the Federal Reserve assumes, triggering an earlier-than-expected increase in short-term interest rates. In addition, a continued fall in labor force participation could limit growth in both the economy and earnings going forward. In short, a continuation of low labor force growth could be a headwind for both the bond market and the stock market in the years ahead.

Falling Participation and “Discouraged” Workers

For almost 40 years, from the early 1960s to the year 2000, the labor force participation rate in the United States rose largely due to the entry of millions of women into the labor force for the first time and the aging of the baby boom, moving into its highest participation years. Since then, however, the participation rate has fallen and this decline accelerated during and since the recession of 2008-2009. Indeed, since October 2009, while the civilian population aged 16 and older has risen by 8.6 million people, the labor force has risen by just 1.4 million people, cutting the labor force participation rate to its lowest level since 1979. Put another way, if the U.S. economy had just maintained the participation rate that prevailed in October 2009, there would be almost 4.2 million more people in the labor force today.

Chart B: Discouraged Workers, % of Working Age Population

Individuals available to work but not actively searching for a job because they believe no jobs are available for them



Sources: BLS, J.P. Morgan Asset Management.
Data are as of 5/9/13.

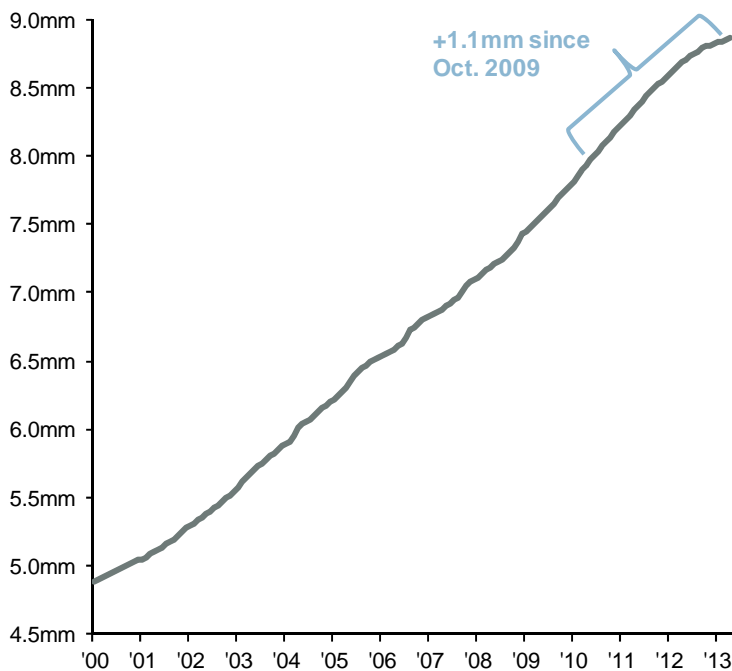
The common commentary on this phenomenon is that this is due to people giving up looking for a job because they think no jobs are available. This is simply wrong. Every month, in the survey used to calculate the unemployment rate, the Bureau of Labor Statistics specifically polls for this, asking those who are not looking for a job if their unwillingness to search is because they believe there are no jobs out there for them. This category, which is called “discouraged workers”, has always been small - averaging just 0.25% of the civilian population. More to the point, over the past two and a half years, the number of discouraged workers has actually fallen from 0.51% to just over 0.34% of the civilian population. Clearly, a rise in discouraged workers is not the reason for falling participation.

Falling Participation and Social Security Disability Benefits

A somewhat more promising lead in explaining falling participation rates has been the number of people claiming social security disability benefits. Recent years have seen explosive growth in this program, with the number of workers receiving benefits rising by 4.6% per year since the year 2000. Indeed, from October 2009 to April 2013, workers claiming disability grew by 1.1 million claimants to a total of almost 8.9 million. Some of this growth may be because people who used to claim unemployment benefits are now claiming disability. However, regardless of the economic forces driving this explosive growth, those claiming unemployment benefits generally say they *are* looking for a job, while those claiming disability generally say they are *not*.

Chart C: Growing Number of Americans Collecting Disability

Millions of workers receiving Social Security disability benefits



Sources: SSA, J.P. Morgan Asset Management.
Data are as of 5/9/13.

Still, even if the rolls of those receiving social security disability benefits had risen only in line with the working age population over the past three and a half years and all the extra claimants had entered the labor force instead, this would at most have explained 730,000 of the 4.2 million “missing” workers. Clearly, most of the explanation must be found elsewhere.

Falling Participation and Demographics

The most promising explanation is, in fact, demographics.

Chart D: Older Groups Have Much Lower Participation

Participation rates among population groups, April 2013

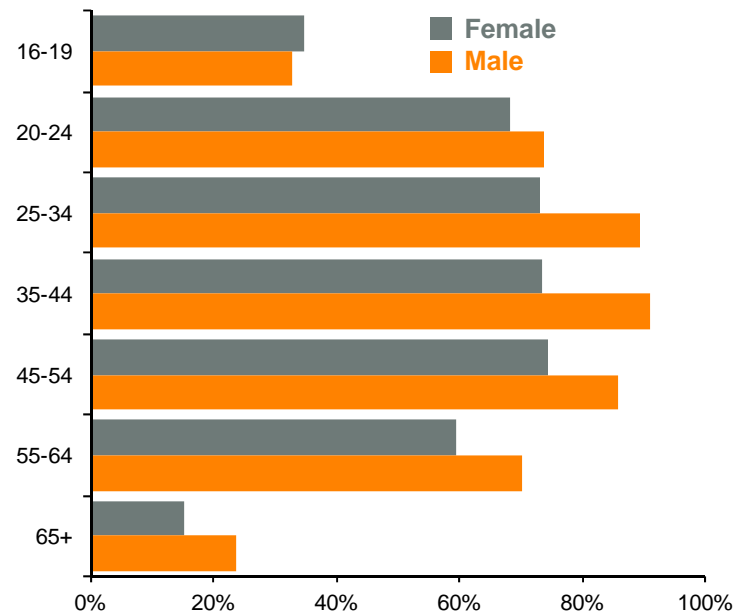
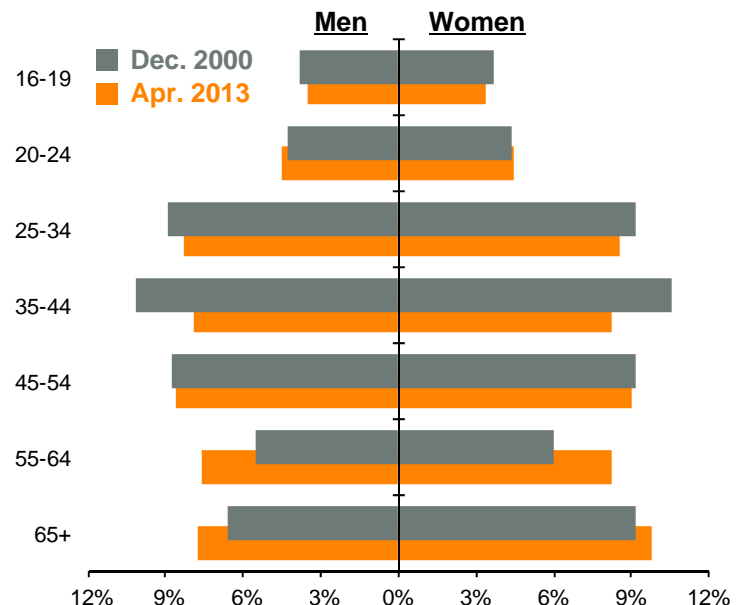


Chart E: Aging Boomers Shifting Weights to Older Groups

U.S. population distribution, percent of total



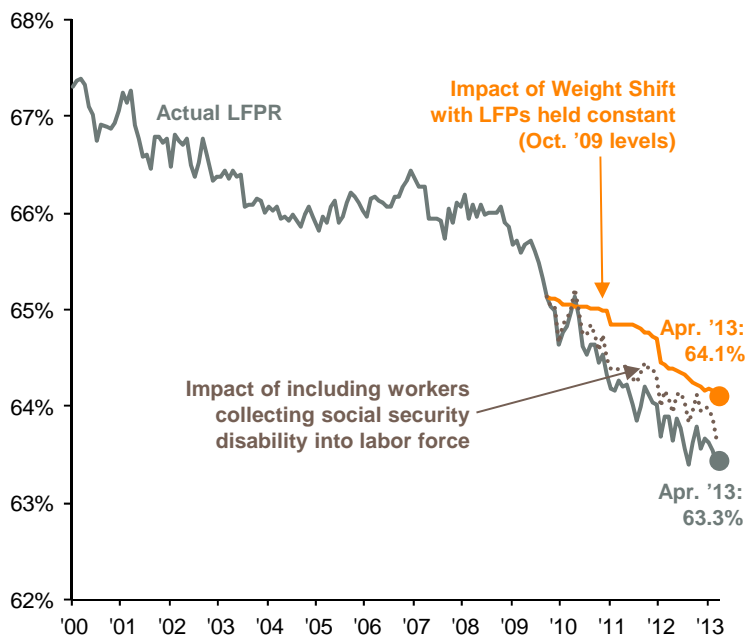
Sources: BLS, J.P. Morgan Asset Management.
Data are as of 5/9/13.

The labor force is far from a homogenous group, and as shown in the charts on the prior page, both age and sex go a long way toward determining one's likelihood of being part of the labor force. Nearly 90% of males in their prime working years consider themselves part of the labor force, but that number drops to 24% for males 65 and older. This would not be an issue if the population was evenly distributed among young and old, but it is not. In particular, baby boomers are distorting the numbers, because they account for an outsized portion of the population and as they move from prime working age into their golden years, their retirement drags down the overall participation rate just as they helped to elevate it when they entered the market.

By holding participation rates for individual groups of the population constant and only shifting the weights applied to each of those groups, we are able to see the impact of an aging population on overall participation. In fact, as the chart below highlights, 57% of the decline in recent years has been caused by this mix shift effect. Furthermore, adding those 730,000 people who may have left the labor force to collect social security disability benefits back into the labor force explains another 11% of the drop since October 2009.

Chart F: Estimated Impacts on Participation

Participation rate among working age population



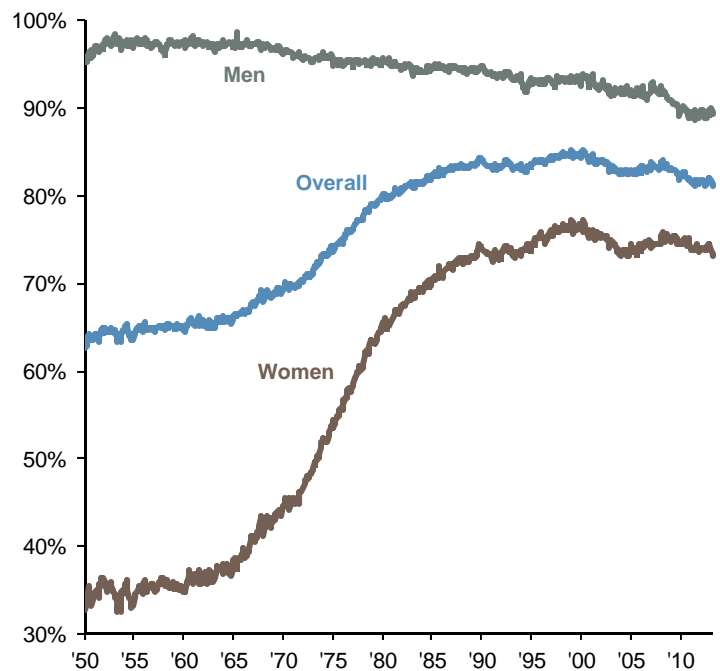
Sources: BLS, SSA, J.P. Morgan Asset Management.
Data are as of 5/9/13.

Declining Participation Set to Continue

Holding participation rates constant can help isolate the impact of shifting cohort weights over short periods, but over longer periods of time there are significant changes in people's attitude toward work that can explain dramatic swings in participation from decade to decade. A careful examination of individual cohorts, broken down by age and sex, reveals three persistent trends exerting their influence on overall participation rates.

Chart G: Women Entering the Labor Force

Participation rate among population age 25 - 34 years



Sources: BLS, J.P. Morgan Asset Management.
Data are as of 5/9/13.

The second half of the last century saw a steady upward trend in overall participation, and as the chart above shows, that trend was largely the result of women entering the workforce. With half of the prime working age population moving from a participation rate of 40% in 1950's to 75% in the last decade, overall participation steadily drifted higher, despite a slow moving downward trend in most of the male population. Female participation rates seem to have stabilized since 2000 and going forward seem likely to track those of their male counterparts, with some cyclical variation around a slightly downward trend.

Chart H: Younger People Working Less to Pursue Education

Participation rate among population age 16 - 19 years

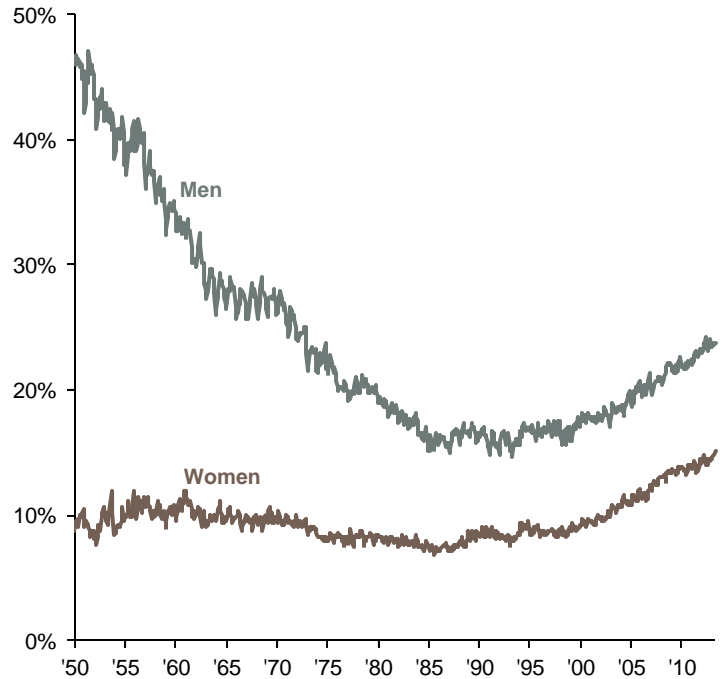


Sources: BLS, J.P. Morgan Asset Management.
Data are as of 5/9/13.

A look at the above chart highlights the shift in attitude toward work among teenagers over the last few decades. Since the early 1980's, labor force participation of those newly eligible for work has dropped precipitously from around 55% to the current level of 33%, as the pursuit of higher education has become more important in a globally competitive economy. When examining these trends and thinking about the outlook for participation of this group, it is helpful to notice that participation rates tend to be flat during expansions and fall quickly when the economy deteriorates. So while the general downward trend is likely to continue toward some lower bound over the long-run, the current economic environment implies a flat participation rate for this group.

Chart I: Pushing Back Retirement to Keep Working

Participation rate among population age 65+, nsa

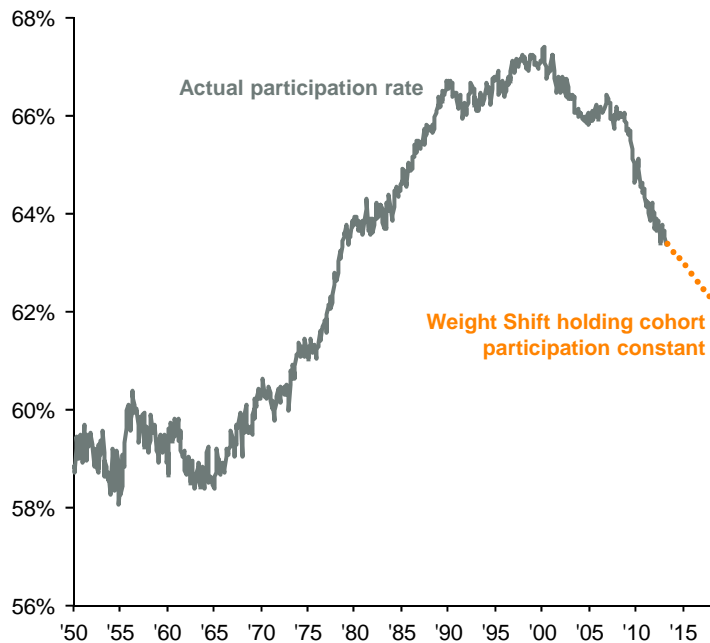


Sources: BLS, J.P. Morgan Asset Management.
Data are as of 5/9/13.

The final group experiencing dramatic shifts in participation is those over 65 years of age, as the last two decades have seen a steady increase in participation among individuals beyond the traditional retirement age. Some may claim that this shift happened because people were forced to work longer due to market losses in retirement accounts during the financial crisis, but this seems unlikely given that the trend started moving up in the mid-90's. What is more likely is that the combination of people living longer, along with rising costs for those in retirement, notably healthcare inflation, have pushed people to work later into life. These trends seem likely to continue, so while plenty of people are still retiring as they age, more baby-boomers will work into their 70s than their parents.

Chart J: Mix Shift Working Against LFP

Participation rate among population age 16+



Sources: BLS, Census, J.P. Morgan Asset Management.
Data are as of 5/9/13.

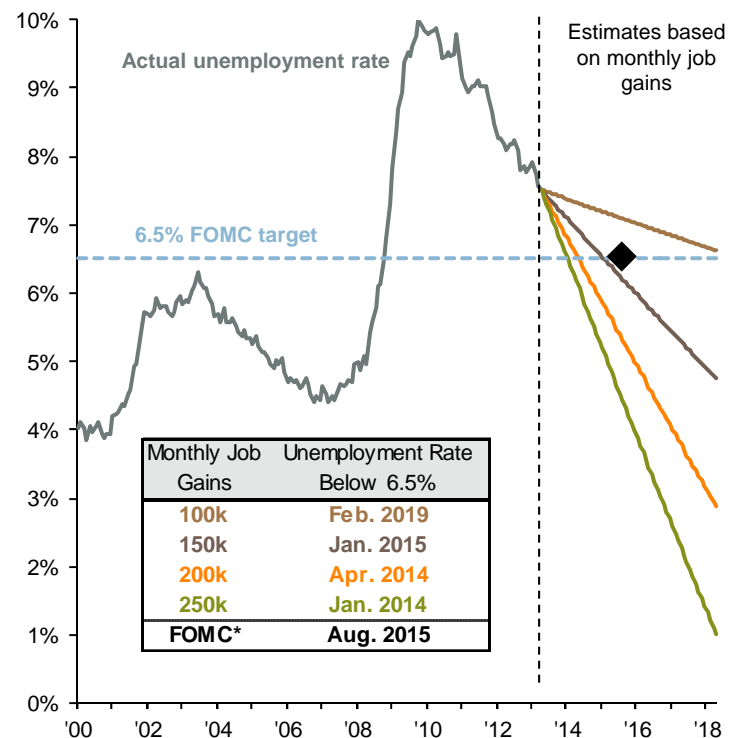
Incorporating the shifting demographic profile with current cohort level participation rates produces an estimate of where labor force participation may go over the next five years, as shown in the chart above. Anyone expecting a sustained rebound in participation is likely to be disappointed, as demographic shifts point to a downward trend in participation, falling 1.1% points over coming five years. It should be evident from the above chart that participation probably will not take a direct path like the projected line shows, but the trend will likely persist, despite any cyclical bounce caused by a faster growing economy.

What Does This Mean for the Unemployment Rate?

When thinking about the outlook for the participation rate and what it means for the economy, it is best to start where we have the most certainty about our forecasts and that is demographics. By applying estimated growth rates to each cohort and adding them together, we can estimate the civilian non-institutional population. Next, combining estimates of the population with our outlook for the participation rate gives us a number for the labor force, which is important because it implies that job creation of only about 75,000 will be enough to keep the unemployment rate from rising, a noticeable change from the 20 years ending in 2000 when it would have taken 150,000 jobs per month to accomplish the same feat. Extending this same concept suggests that job creation above that 75,000 monthly threshold should bring the unemployment rate down and the charts below highlight some of those scenarios based on different rates of job growth impacting the number of people unemployed and employed.

Chart K: Reaching 6.5% May Be Easier Than Expected

U.3 unemployment rate, job gains based on household survey



Sources: BLS, FRB, J.P. Morgan Asset Management.

*FOMC estimate based on interpolation of March 2013 projections of central tendency.

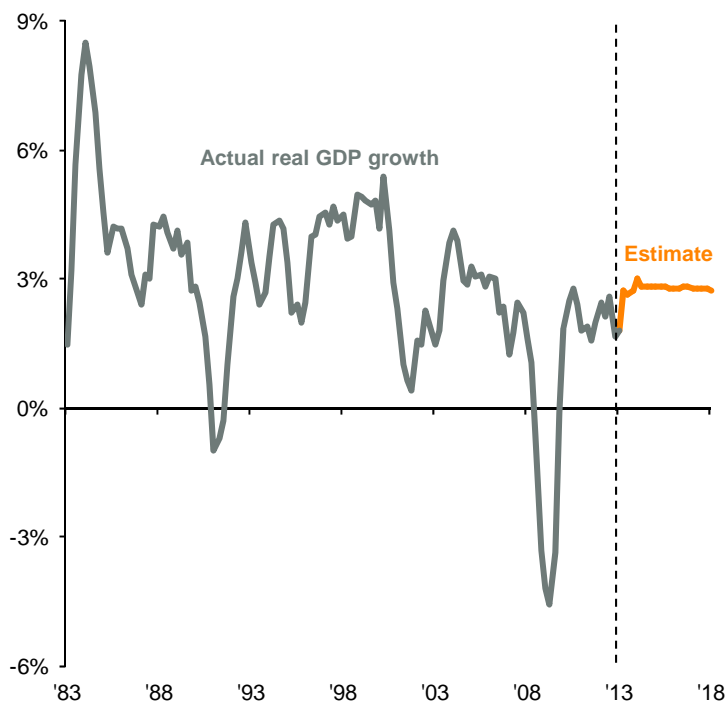
Data are as of 5/9/13.

What Does This Mean for Economic Growth?

Given that a falling participation rate will limit the growth in employment, this also has an implication for the growth potential of the U.S. economy. Over the last 30 years, employment growth in the U.S. has been 1.23% while real GDP growth has been 2.86% which, in its most simplified form², means there has been about 1.63% in productivity growth each year. Assuming that average productivity growth remains constant and the unemployment rate falls by 0.5% per year suggests little change in short run growth prospects, as the falling unemployment rate offsets slower labor force growth. However, in the longer run, as the unemployment rate stabilizes at a lower level, potential growth will slow with that of the labor force unless changes are made to encourage immigration and labor force participation.

Chart L: Real GDP Growth

Estimate based on growth in employment and assumed average productivity growth



Sources: BLS, BEA, Census, J.P. Morgan Asset Management.
Data are as of 5/9/13.

Conclusion & Investment Implications

The labor force participation rate is currently at levels not seen since 1979, grabbing the attention of economists and investors alike. Nearly 70% of the decline since the end of the most recent recession can be explained by the aging population and more people receiving social security disability benefits. Policymakers could mitigate some of these trends by further incentivizing labor market participation and implementing far-sighted immigration reform. It is also possible that a period of faster economic growth could provide a cyclical bump to participation, but demographic and structural trends appear to be the dominant driver of participation and are likely to persist in the coming years, which will continue to put downward pressure on the participation rate. There are two major economic implications stemming from this trend: (1) fewer jobs will be needed to bring down the official unemployment rate and (2) long-term potential GDP growth will be limited by slower employment growth.

All of this is important for investors because any pickup in growth will complicate the development of monetary policy coming from the Federal Reserve. Even slightly faster economic growth and job creation will likely bring the unemployment rate down toward 6.5%, the target stated in the March 2013 FOMC statement³, well ahead of their own projections and could force them to raise rates sooner than expected. A quickly falling unemployment rate could also signal a tighter labor market, a precursor to wage inflation and something that bond markets are likely to notice.

Investment Implications

- Slower long-run economic growth potential could be a headwind for equity fundamentals such as revenue and earnings growth but should be weighed against currently undemanding valuations relative to bonds and cash.
- A lower unemployment rate increases the risk of sooner than expected Fed tightening and raises the potential for rising inflation, both of which could be a catalyst for rising interest rates, a clear negative for traditional fixed income, particularly given currently very low yields.

² Ignoring changes in multiple job-holders and the length of the average work week.

³ Available from www.federalreserve.gov.

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