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Economics Group

WELLS FARGO SECURITIES

Special Commentary

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Four Wobbly Legs Beneath the Throne of Economic Growth

Public policy has elevated the goal of jobs (with economic growth) to the throne of the economic kingdom and the benchmark for political success in this election year. Yet, four issues among the business leaders at my presentation yesterday at Cornell's School of Hotel Administration drove home the point that the support to the economy from these four wobbly legs remains uncertain at best. Our outlook is for a growth slowdown in the second half of this year even after go the stimulus and all those special programs have passed. Federal spending has been easy, but the real work of setting up conditions to move the economy forward has not been done. There has not been significant follow-through. Why? [1]

Jobs: Simply Counting the Jobs Hides More Than It Reveals

For the group of food and hospitality executives at our meeting, the issue of jobs, and thereby consumer incomes and confidence, were foremost in their minds. With consumer spending being over 60 percent of economic growth, this issue remains foremost in public policy as well. Yet, Figure 1 (on the following page) has drawn out several poignant questions. How long will it take to get back to normal? Who would get the jobs during the economic recovery? Finally, and very pointedly, will the same people who lost the jobs get those jobs back?

As for time, Figure 1 suggests two to three years, especially in some areas of the country, to get back to what many would perceive as a normal labor market. By coincidence, the Federal Open Market Committee (FOMC) at the Federal Reserve made a similar, but more pessimistic, point that "it would take some time… five to six years" to get back to the long-run trend for growth. That's quite a challenge for many households, businesses and some regions in the United States.

As for who will get the jobs, the stimulus program certainly protected many public-sector workers, particularly federal workers, but not private-sector jobs. Therefore, job gains in this recovery have been in the public not private sector. Within the private sector, construction jobs remain the big loser (Figure 2). Elsewhere, the problem of the disparity of unemployment rates by education underline the ongoing long-term trend in the American job market, that the demand for workers tend to focus on two areas—first, highly educated knowledge workers in finance, business services, information technology, education and health—then, at the other end of the wage spectrum—lesser trained services workers throughout the economy. What are missing are the workers in the middle. Often portrayed as the salt of the earth, these workers are the factory workers and people who are skilled with their hands in places like Worcester, Mass., Rockford, Ill., and Torrance, Calif. These skill/location mismatches have been developing since the 1970s and have now come to full bloom in this economic cycle.

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[1] **We have not been a newcomer to this. The disconnect between simplistic macro stimulus in policy statements and the reality of decision-making on the ground has been a theme of ours for some time. See our November 2009 commentary, *An Economy at Non-Market Prices*, based on the presentation at the Annual Meeting of the National Association for Business Economics on Oct. 13, 2009.**

Figure 1

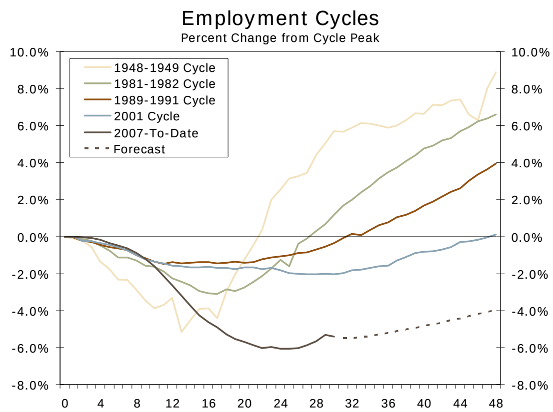
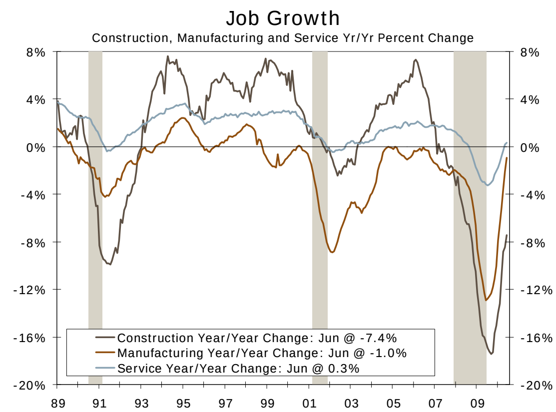


Figure 2



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

This skill mismatch leads us, unfortunately, to realize that many of the new jobs being created will not be filled in the same area of the country by the same people that lost those jobs. While this has always been true to some extent throughout U.S. history, there were times when the South and West offered the escape valve, an opportunity to start anew. Today, however, there are fewer green fields out there. Instead the need for the retraining and relocation of displaced workers become primary requirements to deal with current structural problems in today's labor market. Yet, we also recognize that retraining and relocation does not come with any guarantee of success.[2]

Housing Starts: Big Dipper or Galactic Shift?

The housing starts data are clearly below what the consensus outlook was at the start of the year (Figure 3). Moreover, recent home sales data have been disappointing as the end of the first-time homebuyer credit brought out the concerns that there is little forward momentum in housing. Housing represents a significant share of household wealth. Therefore, renewed weakness in home prices raises the concerns of poor consumer confidence along with little willingness to spend. The business leaders at Cornell were especially concerned about the household sector's housing wealth and the growth/prosperity of the rural and suburban areas that are served by many of the food/restaurant/supermarket leaders in the audience.

Housing is not merely a cyclical problem, despite the fact that stimulus spending policies are often justified on the basis that they will return us to where we were before the recession. Instead, the real challenge to many housing industry builders, developers, lenders and appraisers as well as those food industry firms that follow housing success is one of scale. These industries built up their infrastructure for 1.5 million-1.8 million starts over the past thirty years and starts are now getting just 600,000. This might be a good time for a serious reappraisal of scale.

Yes, housing starts will recover, but to what level, what type of housing and where? Over the next three years the scale is likely to be 1.2 million-1.5 million starts, and so many businesses, and government agencies too, are just too large. These institutions were built up to serve 1.8 million-2.1 million starts, and now they are getting just 1.2 million-1.5 million in three years—not today. Second, the types of structures are unlikely to be so dominated by the 5,000-square-foot-plus McMansions of the suburbs today. Higher property taxes and higher gasoline prices, along with smaller families, are three forces suggesting smaller, less ex-urban, energy efficient homes. Finally, the location for housing starts has been shifting more to the Sunbelt for many years as the South/West region has dominated economic growth over the Midwest and Northeast for some time.[3]

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[2] **See John. E. Silvia, "Domestic Implications of a Global Labor Market," Business Economics, July 2006.**
[3] **For more on housing, see our July 2010 Housing Chartbook.**

Galactic Shift

For some time, at least since the 1960s, public policy in the United States has been criticized as oversubsidizing housing relative to other forms of investment and saving by households and for society at large. For housing, there are special tax deductions and home improvement credits. In 1998, a special capital gains break was given to housing. Special lending agencies, the Government Sponsored Enterprises (GSEs), were set up, along with the Federal Housing Administration (FHA), to subsidize the secondary home mortgage market. Housing and housing credit has been mispriced so much and for so long that it is impossible to truly gauge the extent of the public subsidy of housing. What we do know is that there is very little true guidance of what housing is really worth, and therefore we remain very concerned that the scale of all public and private institutions that are committed to housing is a function of public subsidies as much as private demand. This is a risky proposition given the financial breakdown of the GSEs and the scale of federal debt today.

Low Inflation and the Lack of Pricing Power: Fruition of Global Trade

The June Consumer Price Index report reinforced the low-inflation/low-pricing power story for many food and hospitality firms. In addition, earlier this week the FOMC cited the low-inflation data as a factor in its current policy setting (Figure 4). In the audience at Cornell University, many in the food/restaurant industry suggested that they had little pricing power.

Ever since the emergence of discussions on the North American Free Trade Agreement (NAFTA), there has been a sentiment that global forces will put a downward bias on prices and overall U.S. inflation as trade would offer a competitive incentive to meet consumer needs, in part, through lower prices. What has surprised many analysts is that since the World Trade Organization agreements, especially with China, the global forces have truly kept a lid on inflation and now those forces have been reinforced by the Great Recession.

Unfortunately, the mental model for many public and private decision-makers remains in the global economy of the 1950s and 1960s when they grew up. After WWII, the U.S. economy and its production capability stood alone. Economic potential in Japan and Germany had been destroyed. China, India and the Soviet Union were inwardly looking and competing on a military, not economic, battlefield. Countries such as Brazil and Mexico were playing with socialist revolution alternating with military dictatorships.

Today, nations compete in the economic arena through trade and, for now, the challenge for both public and private decision-makers is that the United States is not alone and everyone else is catching up. Economic competition is great as a theoretical concept but tough on political rhetoric that resorts to the romanticism of the past.

Figure 3

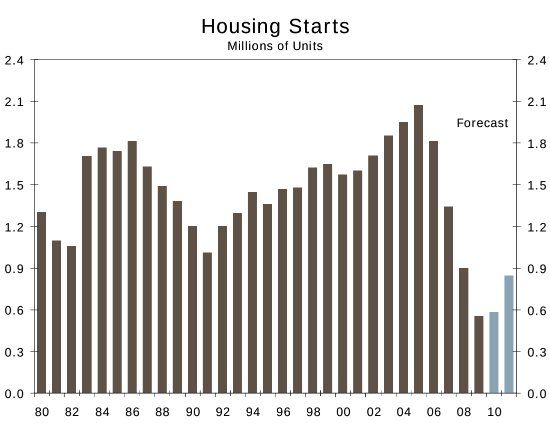
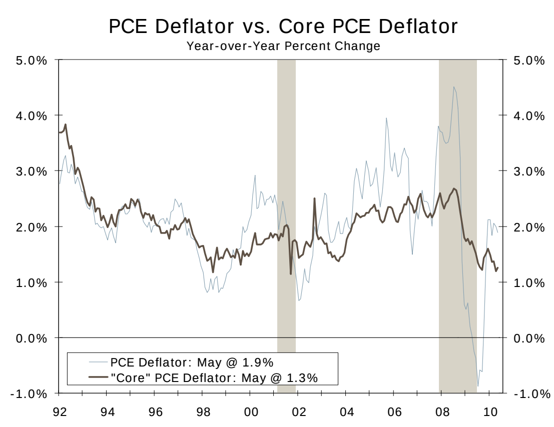


Figure 4



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Corporate Profits: Slowdown Ahead

Cycles define the very nature of corporate profits (Figure 5). But before we discuss the cyclical patterns, let's review two points. First, a significant percentage of S&P profits are actually earned abroad. Once again, we must remind ourselves that we work in a global economy. This is very important when we hear the misleading whine of political leaders that corporations are making all this money and the economy still struggles. The reality is that much of these profits are made abroad and therefore have very little link to U.S. domestic growth. Second, profit growth can be the result of two alternative forces. First, productivity gains in recent years have lowered unit labor costs, therefore greater cost controls and efficiency have been the driver for much of the domestic profit gains. Second, top-line revenue growth has been limited, and with the observations on jobs and inflation above, our outlook remains dim for this area.

On the cyclical front, Gina Martin, a Wells Fargo Equity Strategist, and the Economics group emphasized that there is a strong cyclical pattern to profit growth in the United States and that profit growth is expected to slow in the year ahead even if economic growth had sustained earlier momentum.[4],[5] Yes, profits will still be positive, but the biggest year-over-year gains are behind us. For the audience at Cornell, decision-making was still in cost-control mode—not ready for growth.

Federal Deficits and Debt: A Wind From Outside the Window

From outside the world of private decision-makers lies the world of public deficits and debts. We have illustrated the unusual nature of the deficit situation and its suggested implications for the failure of the stimulus to, well, stimulate (Figure 6). The stimulus put a finger in the dike and stopped the flood; it did not clean up the basement and get the house in order. Why?

Economic models, especially macro models that estimate the "multiplier effect" of a given stimulus, are based on history and the reactions in the economy in that context—that is not what we have today. There are two problems. First, as cited elsewhere over a long period, when there is an associated credit crunch with the recession, the workout/recovery period is longer and far more complex than the typical inventory/demand shortfall recession.[6] Standard macroeconomic textbooks deal with the basic shortage of aggregate demand without any associated credit model, and so the conventional thinking, and certainly public pronouncements of public policy makers, reflects this basic model.

Second, the scale of the deficits and the implications for future deficits are clearly outside the bounds of both the theoretical and estimated models of these policymakers. There simply is no precedent for this scale of deficits, and expected future deficits, in a global capital marketplace where the financing of these deficits reflect the political commitment of a very small set of foreign countries. What made this worse was the timing of the Greek sovereign debt problem. That debt problem highlighted the structural weakness of sovereign debt issuance that was outside the bounds of the ability to pay back at the current level of interest rates and value of the currency over the long run. By the way, in the long run, we may be dead but our children are not.

Lessons for Decision-makers

What have we observed as lessons for decision-makers from the events of the past year? From our viewpoint, there are three problems, or biases, that have hindered effective decision-making over the past year. First, and most critically, is the overconfidence bias of both public and private decision-makers. This is most readily seen in the public sector with the assertion on the economic multiplier effect and the prediction of jobs and growth. In reality, our economic models are not perfectly specified or perfectly rational. Instead, real-world decisions exhibit bounded rationality—we look for an answer that works, *satisfices,* not the perfect answer.[7] We have limited resources of time and ability to try all solutions. Therefore, we find a solution that works, if only temporarily, or imperfectly. We "sacrifice." Unfortunately, the multiplier approach that was used

[4] Wells Fargo Economics, Monthly Outlook, July 7, 2010.
[5] Gina Martin, Earnings Monitor, July 12, 2010.
[6] For example, Reinhard, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crises." NBER Working Paper 14656. January 2009. http://www.nber.org/papers/w14656
[7] Simon, Herbert. *Models of Man: Social and Rational*. New York: John Wiley and Sons, Inc., 1957.

to guide public policy as a rule of thumb was a critical mistake given the implications of the size of the deficit in a global capital market as examined above as well as the special role of credit constraints in the current recession/recovery period. Private market decision-makers simply cannot rely primarily on such rules of thumb as an indication for future top-line revenue gains.

Figure 5

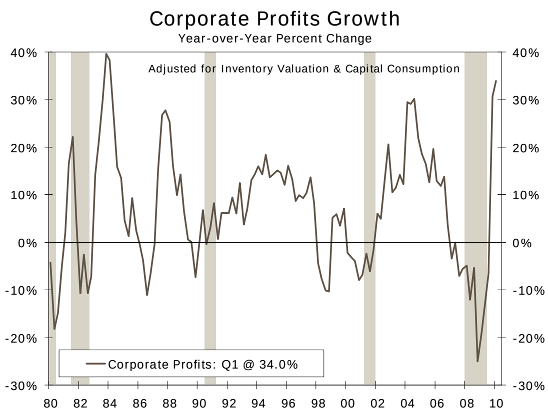
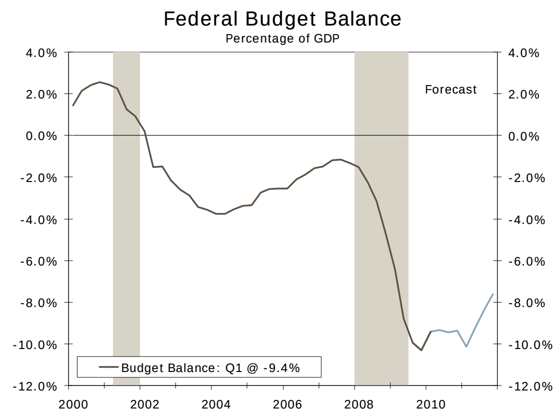


Figure 6



Source: U.S Department of Commerce, U.S. Department of Treasury and Wells Fargo Securities, LLC

Second, there is a confirmation bias, certainly in public decision-making and, unfortunately in the media, where evidence in support of the suggested or enacted program is exulted and signs of failure ignored. The whole concept of "saved" jobs is a classic example of this bias. We cannot recall any discussion about stimulus "saving" jobs in either undergraduate or graduate courses. This concept presents a false target for success, especially given the real structural challenges for the labor market as highlighted in our earlier discussion. Moreover, "saving" public-sector jobs today by issuing more debt that must be repaid out of future generations and, therefore, cost future private-sector jobs, is a misleading enterprise. Politicians make political decisions, not economic ones, and awarding jobs to "what is" today at the cost of "what will be" tomorrow is not good economic policy. For the media, there is too much of a tendency to decide the answer before looking at the evidence. Political biases dictate the choice of sound bites and anecdotes, while the public fails to get the careful discussions and analysis it needs to make informed decisions.

Finally, there is a sunk cost problem where policymakers up the ante in their commitment to a program even as the program is a failure. Military escalation abroad and climbing Mt. Everest are classic examples of this bias.[8] In public policy, continued large public subsidies to agencies and even private companies as well as consideration of a more of the same, just another stimulus program, reflects this bias. There is very little honest discussion in public circles on the failures of these programs—which is understood given the penalties to any public servant who ever admits a mistake. Many thoughtful analysts doubt the wisdom of another stimulus program given what we know as the high level of uncertainty of success.

For decision-makers, the problem remains to develop a set of guidelines for strategic decision-making given the wobbly nature of the outlook for economic growth and the high level of uncertainty, not simply of risk, in the environment. Finally, private decision-makers must also be aware of the decision-making traps that appear to have affected the effectiveness of decision-making in recent years.

[8] **Krakauer, J. *Into Thin Air: A Personal Account of the Mount Everest Disaster*. New York: Anchor Books, 1997.**

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