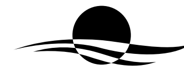
# Growth STRATEGIES



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## 1 – THE WINNER ECONOMY AND THE LOSER ECONOMY

In a compelling analysis in the *Asia Times Online*, David Goldman makes the following points:

- Final sales of domestic product rose by 3.8% (without adjustment for inflation) from the second quarter of 2010 to the second quarter of 2011. Sales of S&P 500 corporations rose by 10%.
- Employment in the S&P 500 corporations rose by 10.6% between 2009 and 2010, to a total of 18.66 million. Total employment in the United States rose by 0.7% over the same period, to 130.26 million. Employees of the S&P 500, that is, comprise less than 8% of total US employment, and their employment pattern bears no resemblance to the aggregate.
- Profits of S&P 500 corporations rose by 19% between the second quarter of 2010 and the second quarter of 2011. Nominal GDP (gross domestic product) of the US rose by 3.7%.
- 47% of S&P 500 sales are overseas.
- Americans with no college-level education have an unemployment rate of 9.9% and (which is much more revealing) a labor-force participation rate of just 61%. Americans with some college education have an unemployment rate of 8.6% and a participation rate of 70%. And Americans with a bachelor's degree or more have an unemployment rate of 5%, but a participation rate of 76%. Huge numbers of less-educated Americans, that is, don't "participate" in the labor force because there is nothing for them to do. But Americans with a college degree (as devalued as those degrees are) have little unemployment and a very high rate of "participation."

America imported $6 trillion of the world's savings between 1998 and 2007. That great migration of capital employed an army of construction workers, mortgage bankers, retailers, lawyers and others dragged along by the tide. Real estate tax collections surged along with home prices and local governments grew fat and hired legions of workers.

And the construction boom kept less-educated Americans (and a great many immigrants) occupied. The construction industry has imploded, local governments have laid off 400,000 workers since August 2008, and countless service firms have disappeared. Nothing will bring them back.

Given the magnitude of the bubble that had to be popped, the outcome actually is encouraging. Most Americans with a college degree barely can add and subtract and compose a business letter, and most of them rode the bubble in various capacities. Yet despite the collapse of many white-collar professions, the unemployment rate of college-educated Americans remained around 5%. That testifies to the flexibility of the American economy and the resourcefulness of American job-seekers.

The other encouraging fact is that portions of the US economy that did not participate directly

in the bubble – established corporations with a global presence – have done extremely well in a virtually zero-growth environment. Their 19% increase in profits came both from increased sales and better profit margins. A smidgen of the profit growth came from the falling dollar (which magnifies foreign earnings), but not too much. Corporate America managed to show strong profit growth even while the aggregate economy was dead in the water.

In short, the non-bubble portions of the US economy are doing perfectly well, thank you. The railroads and airlines are carrying more freight, the airlines are carrying more passengers, and exports are up by nearly 20% over a year ago. It is pointless and confusing to speak of overall economic performance, because there are two quite different economies to consider: one that is doing reasonably well in the world market and one that still must be scraped from the ceiling. It is just as meaningless to speak of a double-dip recession as it was to speak of a recovery a year ago. Some parts of the economy remain profoundly depressed and will languish for years if not decades, while other parts are functioning perfectly well. Which outweighs the other in the aggregate numbers is of interest to no-one but the macroeconomists.

A number of economists, including Nourel Roubini, opined a year ago that America had two economies, one of which was recovering and another that was not. But they pointed to the wrong distinction, namely between personal consumption (which then appeared to recover) and capital investment, which remained moribund. The error here, as usual, stemmed from thinking in terms of aggregates in the GDP tables. These aggregates mask a more fundamental qualitative distinction.

Perhaps we should think about America the way we think of an emerging market, except that America is submerging instead. The Chinese have warned for years that they are two countries, a First World country on the seacoast and a Fourth World country in the interior. We know that India has two economies, a small modern one and a vast backward one, and we are not particularly concerned with the GDP of impoverished rural people (if indeed we could measure it). We want to know what Tata Industries or Reliance Industries are up to.

China and India have become a dual economy because a portion of their population has clambered up into prosperity; America has become a dual economy because a portion of their population has tumbled into destitution. But the fact that larger American corporations have had a strong recovery should reassure us that America is capable of a broader recovery.

For the moment, investors will not buy an 8% earnings yield on the S&P 500 even while 10-year Treasury yields trade around 2%. They are all the more reluctant to take risks on startups, which in the past 40 years have accounted for more than two-thirds of job growth. The right combination of economic policies could revive the startup engine, albeit slowly and fitfully. Lower taxes on corporations and capital income and less oppressive regulation (especially US President Barack Obama's health care mandates for businesses) would help. So would a rational immigration policy that favored entrepreneurs and highly skilled professionals.

## 2 – ANOTHER LOST DECADE VS. THE CASE FOR STOCKS

Historical data indicate a strong relationship between the age distribution of the US population and stock market performance. A key demographic trend is the aging of the baby boom generation. As they reach retirement age, they are likely to shift from buying stocks to selling their equity holdings

to finance retirement. Statistical models suggest that this shift could be a factor holding down equity valuations over the next two decades. So writes Mike "Mish" Shedlock (globaleconomic-analysis.blogspot.com).

Countering that view are Jeremy Siegel and Jeremy Schwartz in the *Wall Street Journal:*

Despite the slow growth over the past decade, US corporations, as typified by those in the S&P 500 Index, have been making record profits by enhancing productivity and deriving nearly half their sales from growing overseas markets. [And productivity growth is more likely to accelerate in the future, not decelerate, as the global economy becomes more connected and firms use their resources more efficiently.]

The dividend yield on the S&P 500 index exceeds 2%, and these dividends represent less than 30% of profits these firms earn. This gives management a huge cushion to maintain dividends if indeed the US economy experiences a double-dip recession.

Investors have flocked to inflation hedges like gold out of fears about out-of-control government debt and deficits. The S&P downgrade of the US credit rating heightened concern that the Fed would turn on the printing presses. But equities, like precious metals, are also real assets whose return has compensated investors for inflation. Per share dividends of the S&P 500 firms have grown at 5% per year over the last half-century, which handily beat the average rate of inflation of 4% during the period.

Some investors who avoid dividend-paying stocks point to the 2007-09 debacle, when the high-dividend financial stocks crashed. Yet it is little known that the entire decline in dividends of US stocks during the recession was due to the fall of the financial sector. The sum of the dividends paid by firms in the other nine sectors of the US equity markets was actually higher in 2009 – at the bottom of the worst recession and bear market in the past 75 years – than it was in 2007, when stocks and the economy were at their peak.

Today the aggregate dividends paid by the non-financial sectors are about 20% higher than they were at the 2007 peak. Furthermore, the dividends of financial firms today comprise only 16% of the total dividends paid, less than half their proportion in 2007. In other words, another financial crisis cannot have the same impact on either the earnings or dividends of the US equity markets. Finally, dividend growth in the last two years has averaged over 10% a year, more than twice the long-term dividend growth rate, as firms rightly begin to return their record cash balances to shareholders.

Despite the sluggish economy, the corporate sector is churning out record profits and increasing dividend payments.

Shedlock again:

In fact, there is nothing novel about a period of falling stock prices and rising earnings. Since the end of World War II, corporate profits have more or less trended continuously higher, with only minor interruptions during recessions. However, stock prices have gone through long periods in which they trended sideways or down, even though earnings continued to rise. From 1966 to 1980 after-tax corporate earnings rose 244%, but the price of the S&P 500 rose only 18% during that period. In contrast, earnings grew only 112% during the next 14 years from 1980 to 1994, but the S&P 500 rose 327% over that time.

Since 1995, the market had been above 10-year P/E valuations of 22 for 13 consecutive years, until July 2008. After a brief decline in 2009 into valuations that would be considered "average" historically, the market ended 2010 with a 10-year P/E of 23. Although this is about half of the peak

valuation in 2000, it is still above valuation levels that have produced positive inflation-adjusted returns in the past.

With a peak 10-year P/E ratio of 44 in 2000, it is no mystery why returns over the past decade have been poor. On a consumer price index adjusted basis, the S&P 500 ended last year 31% below its 2000 peak, for an annualized return of −3%. Although we'll have to wait another 10 years to see the S&P 500's 20-year inflation-adjusted return from its record P/E of 44, it is almost certain to be a negative number, and probably a large negative number.

## 3 — CDI POINTS THE WAY ON CONSUMER EXPENDITURES

No one really knows which direction the US economy will move, but you ***can*** know which way US private consumption expenditure will move, and ***private consumption expenditure is the largest motor driving the direction of the US economy.***

How can you know which way US private consumption will move? The **US Consumer Demand Index,** now available at your Bloomberg Terminal, is the most accurate predictor of US private consumption available. Why? Because we do not measure consumers' "sentiment" or "confidence" but ***their actual spending plans as revealed to us in our monthly national surveys.***

**The US Consumer Demand Index from August (attached) shows resilience for the third month in a row and reduces fear of a double dip.**

The net index for durables is up from 31.8 in July to 34.2 in August, significantly higher than in August last year, and is driven mostly by an increased demand for new cars.

The index for non-durables is marginally down from July to August, but significantly higher than in April, May and June. Considering the general economic, social and political conditions in the US, this is a remarkably positive development.

**Why is The Consumer Demand Index showing resilience, while the consumer confidence indices from Michigan-Reuters and The Conference Board are edging down?**

The CDI measures consumers' behavior in the form of decisions to purchase. This is what you need to know. The other indices are measuring consumers' evaluations of business, employment and political conditions. The fact that consumers think business conditions are poor but continue to plan purchases shows longer-term resilience in the face of shorter-term difficulties.

The Consumer Demand Index is a monthly survey of American households' buying decisions for the next 90 days. Unlike other measures of consumer "confidence" or "sentiment," the CDI measures what percentages of US households WILL BE making purchases in the next 3 months across a wide range of durable and non-durable goods, including cars, white goods, PCs, TVs, home furnishings, kitchenware, clothes/footwear, and food/groceries. We also measure, uniquely, what percentage of households WILL NOT be making purchases in ANY of the product categories surveyed.

For more information and to subscribe, go to www.consumerdemand.com.