Growth STRATEGIES
Trend Analysis That Builds Business Decisions

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IN THIS ISSUE: OUR TWO ECONOMIES

In the years since the Great Recession started (and ended?) in 2008-2009, the US has been characterized by two economies. One of these American economies is thriving, as are the economic actors that are part of it. The other economy is miserable, as are its inhabitants. The divergence between these two economies is growing more pronounced. Why is this so, how did it happen, and what does it portend?

1 – DIVERGENT SECTORS, DIVERGENT FORTUNES

American exports are booming, measuring in at about $180 billion each month (up from $140 per month two years ago). Exports account for about 14% of Gross Domestic Product, and are growing about 16% a year. American manufacturing ***employment*** has been hurt by globalization, but manufacturing ***output*** continues to grow and ***exporters*** are thriving.

According to Tyler Cowen, writing in The American Interest, there are three reasons why American manufacturing and export prowess will continue into the future:

- Artificial intelligence and computing power will continue to allow for ever greater productivity, innovation and profitability.
- Recent discoveries of very large shale oil and natural gas deposits will transform the US into the world's largest exporter of energy for decades to come.
- As the developing world becomes wealthier, demand for American exports, and not just or even mainly demand for fossil fuels, will grow.

Export success will resurrect the United States as a dominant global economic power, writes Cowen. America will be wealthier, its products will have greater global reach, and it will largely cure its trade imbalance with China. The fear of American foreign policy being determined by Beijing, or constrained by the financial resources of the Chinese central bank, will be forgotten. No one will view the United States as the borrowing supplicant in the US-China economic relationship, and, all else equal, our exports to China will increase friendly feelings toward that country.

Won't there be political opposition to these developments? Not enough to matter, believes the author. So many of the jobs vulnerable to foreign imports have already vanished that there is little left for voters or less powerful manufacturing-based labor unions to fear from free trade. The new job growth has been in health care, education, services and government, areas that are largely insulated from foreign competition and that will themselves seek out export markets. American higher education is in demand around the world, too, and has little to fear from foreign colleges trying to expand offerings in the United States.

NOW FOR THE BAD NEWS

The new export-based prosperity may not translate into higher wages for everyone, or even most people, in the United States. Skilled laborers who work with smart machines or even hold advanced managerial jobs will continue to make big gains, as the numbers have been showing for some time. Capital will do well too, especially if it is geared toward export success. The class of elite labor will grow, but significant segments of the American workforce are likely to continue suffering falling real wages, even in a time of rising export prowess.

Nonetheless, we'll probably see a lot of the American workforce accept lower wages, figures Cowen. The more America becomes an export-oriented economy, the more it and the nation as a whole will live by the principles of competitive markets. Ever more jobs will be created in the relatively protected service sectors, while much of the economic dynamism and income gains will accrue to the capitalists, CEOs and managers who dare to export. A lot of people complain about this deal from both sides of the political spectrum, but few observers are willing to countenance a truly open, competitive set of educational, governmental and health care institutions as a remedy. Libertarian-leaning recommendations for open competition everywhere may or may not be acceptable to us, but they have a bracing way of pushing the truth before our eyes.

The internet will continue to make it easier for small businesses to export, but many of the growth areas, including fossil fuels, heavy equipment and cars and other high-tech items will remain the province of big business. America will likely see a new age of corporate titans selling their products and services to the entire world, and the world as a whole will be far wealthier than in times past. The wealthiest American earners will be very wealthy indeed, even by current standards.

It's a well-known description in the literature of political economy that the economy of a developing country may have two quite distinct tiers: a relatively dynamic export sector and a relatively backward domestic sector. This old portrait of the two-tiered economy, originally applicable to a developing economy, may be re-emerging for the United States (from a much higher base level of wealth and productivity, of course). We have not thought through seriously enough the possibility that the world's most technologically advanced economy would, over time, develop persistent and indeed growing productivity differentials across sectors. It clearly has, concludes Cowen, and the social and political frictions this has caused now dominate our politics – or soon will.

2 – DYSTOPIAN ECONOMICS

People generally don't like high government debt, high unemployment, profligate spending, bailouts, surging living expenses, and a falling dollar. But these "negatives" are paradoxically good for the economy in terms of earnings and growth. Thus economic developments and phenomena over the past decade are rewriting the rules of macroeconomics. So believes Cetin Hakimoglu, writing on the Seeking Alpha web site.

Dystopian economics, as described by the author:

1 Increased government intervention and aggressive monetary policy to keep economic growth steady and recessions and bear markets increasingly brief.

2 Deficit spending subsidized by foreign holdings of Treasuries, hence necessitating strong trade relations and globalization.

3 Increased government spending for things that create economic growth but are not necessarily socially popular such as war, national security, bailouts, stimulus, and tax cuts for the rich.

4 Disregard for the dollar and deficits by policy makers. A lower dollar combined with low rates makes the deficit less burdensome and helps multinationals.

5 Two-track inflation characterized by low core Consumer Price Index and perpetually low treasury yields, but steadily rising cost of living inflation due to relentless global economic growth, permanently low rates, and to a lesser degree price gouging and speculation.

6 Disproportionate benefit to the "elite" and multinationals though globalization and low borrowing rates.

7 Fed keeping the foot on the gas even during strong economic expansion (unlike the '80s and '90s when interest rates were high as the economy boomed).

8 Breakdown of Okun's law (decoupling of employment and GDP). What this means is economic output is unaffected much less today and in the future by high unemployment than in the past.

9 Asset classes (oil, euro, gas prices, high-end real estate, metals, grains, stocks, and even web 2.0 company valuations) rising and falling in lockstep with the stock market (in contrast to the '80 and '90s when commodities, the dollar, and stocks showed little correlation).

10 Broken correlation between the housing market and overall economic strength.

11 Broken correlation between GDP growth (low) and stock market valuations (high and rising).

Huge gains in exports, productivity, government spending, information technology, permanently low rates, globalization, robust profits and earnings for multinationals and permanently low taxes are the key driving factors for this decade-long economic expansion and huge bull market, writes the author. None of these things shows signs of slowing. Some of his other surprising analyses:

BANK BAILOUTS WERE A SUCCESS AND A NECESSITY

Letting the banks "run wild" can lead to failure and volatility, but it's easy to remedy by printing it away as was demonstrated the weekend following Black Friday, the 1998 Long Term Capital Management crisis and the 2008 financial crisis.

THE DEBT BINGE IS SUSTAINABLE

Seemingly "reckless" spending by the government is encouraged because it's subsidized by an insatiable demand for US treasuries by BRIC (Brazil, Russia, India, China) and public and institutional holders, thus allowing deficit fueled growth without upsetting the bond vigilantes. This is evidenced by perpetually low ten and thirty year treasury yields. The Republican and libertarian fears about tax hikes because of deficit spending were unfounded and still are.

A HUGE BULL MARKET

Even with Main Street sitting on the sidelines, the American economy, in terms of profits and earnings, is now stronger than it was at any other time in history thanks to dystopian economics. Permanently low interest rates combined with booming earnings and profits makes for a formidable bull market.

The Dow Jones Industrial Average is poised to hit 17,000-20,000 within the next two to three years. By the time the interest rate cycle peaks at four to six percent the DJIA may be well above 50,000. The S&P 500 has already doubled from its March 2009 lows and interest rates still haven't bunged. Bernanke may finally raise rates by a quarter or half point when the DJIA crosses 15,000.

LIVING EXPENSES THROUGH THE ROOF

Surging commodity and living expenses will result in even more populist angst on the internet (if that's even possible), but have no negative impact on economy. The demand for food, energy, healthcare, education (the things that are rising the most) is considered to be inelastic. But the increased spending on these inelastic goods will translate into pure top line GDP growth without impacting elastic goods such as computers, appliances, and apparel. Thus, surging living expenses helps the economy and stock market by forcing consumers to spend more on these inelastic goods.

The personal savings rate will fall into negative territory like it did in 2008. We'll see \$6/gallon gas, \$2,000+/ounce gold, \$160+ oil and parabolic charts for grains. Unlike in 2008 there will be no collapse; non-core components of the consumer and producer price index will keep rising, but treasury yields will rise only slightly, confounding many of the experts who have been pounding the table about an impending hyperinflationary economic collapse. Technically there is inflation but it is non-core inflation, which is the kind Bernanke and the bond market ignores.

Healthcare and college tuition costs will not relent. There will be no popping of the credit card or tuition bubble. The seismic shift in the labor market in the past decade to more technical, specialized jobs is contributing to the college boom.

WINNER-TAKE-ALL ECONOMY

Large capitalization companies with global exposure and high net worth individuals are the main beneficiaries of current economic policy. CEO pay is already at pre-recession levels and the wealth gap continues to widen. Job creation, small business, and low and medium-end housing will have to sit on the sidelines in this boom. Small business is unable to take advantage of low corporate bond rates, pricing power and globalization that multinationals enjoy and there's nothing the government can do to spur more hiring and small business expansion that isn't already being done, especially considering interest rates and taxes are at historic lows.

JOB LOSS, UNEMPLOYMENT NOT SUCH A BIG DEAL

High unemployment has been shown to have a negligible to non-existent impact on consumer spending. But the economic gains from high unemployment cannot be dismissed in the context of dystopian economics. High unemployment gives the Fed a good excuse to never raise rates. High unemployment makes the remaining workers more productive which means higher profit margins. When consumers are less confident they are more productive, but still spending the same amount of money on essentials like gas and food as well as iPods, Netflix, Priceline etc. Finally, any weakness in American consumer and business spending from high unemployment is easily compensated by growing foreign business and consumer demand, and when combined with a falling dollar you have a win-win situation for S&P 500 exporters (unlike the '80s and '90s when foreign consumption played a much smaller role in earnings).

Wall Street and the fund managers don't care about unemployment or housing because the economy in terms of S&P 500 earnings and profits is doing great. That's what matters from an investor's standpoint. If you're a trader a good strategy is to buy the dip on any disappointing employment data.

Unemployment will remain above eight percent for remainder of the decade, and may exceed ten percent if more people look for jobs. Their efforts will prove mostly futile as outsourcing, productivity, and technology means fewer workers needed. Baseline unemployment will settle at 7-8% and the total US labor force will continue to shrink. Structured labor tracked by the government will continue to be replaced by underground work.

3 – CLOSING NOTE

The foregoing analyses are unconventional; you probably haven't seen them elsewhere. I find them interesting and insightful – even compelling and persuasive – that's why I share them with you, dear readers. The trends that are creating and sustaining two economies in the US have been building for years and seem strong, even impervious to amelioration. The "two economies model" meets my test of sustainability: being supported and reinforced by other fundamental social, cultural, political and technological trends (or at least not being incompatible with them). It is hard to foresee how the "two economies model" would be reversed or even tempered.