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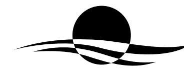

LA JOLLA INSTITUTE
Steve PonTell

Dr. Roger Selbert, Editor & Publisher
E-mail: roger@rogerselbert.com

3200 S. Barrington Ave. #4 ▪ Los Angeles, CA 90066
Telephone: (310) 721-6322

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1 – GLOBALLY: THE AGE OF TRANSFORMATION

We are in the Age of Transformation, writes John Mauldin: multiple, rapid and simultaneous changes to our fundamental social and economic structures. So profound are these changes that they are comparable to such past transformations as the rise of the nation state, the steam engine, electricity, the advent of the social safety net, the personal computer, the impact of the internet, and the collapse of communism.

There are two themes to the Age of Transformation. The first is the emerging failure of multiple major governments around the world to fulfill the promises they have made to their citizens. We have seen these failures at various times in recent years in both developed and developing countries, where enormous debts and deficits forced painful restructuring of social commitments.

Similar challenges are already developing throughout Europe and in Japan and China, and will probably hit the United States by the end of this decade. While each country will deal with its own crisis differently, these crises are going to severely impact social structures and economies not just nationally but globally. Taken together, writes Mauldin, these emerging developments will be bigger in scope and impact than the credit crisis of 2008.

While each country's crisis may seemingly have a different cause, the problems stem largely from the inability of governments to pay for promised retirement and health benefits while meeting all the other obligations of government. Whether that inability is due to demographic problems, fiscal irresponsibility, unduly high tax burdens, sclerotic labor laws, or a lack of growth due to bureaucratic restraints, the results will be the same. Debts are going to have to be "rationalized" (an economic euphemism for default), and promises are going to have to be painfully adjusted.

This breaking wave of economic changes will not be the end of the world, of course – one way or another we'll survive. But when the world doesn't come to an end as predicted, we seem to get complacent and ignore the basic arithmetic that you have to have more income than you have expenditures, and to conveniently forget that debt, even at low interest rates, is compounding. And yes, it is possible to grow your way out of the problem – but only if you have real growth. Now, however, much of the world is structurally imbalanced in ways that inhibit growth at the rate necessary to significantly put a dent in swelling debt levels.

THE SECOND THEME OF THE AGE OF TRANSFORMATION

The second theme in Mauldin's Age of Transformation is the continuing acceleration of technological advance. It's not too much of a stretch to say that we're in a race between how much wealth and value and improvement in lifestyles human ingenuity can create, versus how much destruction of wealth and lifestyles governments can destroy.

Echoing Alvin Tofler's seminal insight in *Future Shock* (1970) that fundamental change occurring at an *accelerating pace* restructures society, Mauldin predicts that we are going to see multiple tech-

nologies advance explosively, simultaneously, in the near future, with profound impact.

The mobile and wireless internet, artificial intelligence and automation, the internet of things, advanced robotics, autonomous vehicles, advanced energy exploration technology, renewable energy (especially solar energy), advanced materials, the rapidly accelerating biotechnology revolution, nanotechnology, and even electronic currencies (Bitcoin et al.) are all rapidly approaching their "escape velocities." Each of these areas is going to expand exponentially in the next 10 to 20 years.

We are in for a radical adjustment to the very mechanisms of production and the very structure of our economic and social life.

2 – NATIONALLY: THE ASSET-RICH, INCOME-POOR ECONOMY

By flooding the economy with liquidity and keeping interest rates low, the Federal Reserve Bank has engineered a "balance-sheet recovery" (dramatically increasing asset prices). But business investment – the real driver of the real economy – hasn't been stirred. The result is that the Fed's extraordinarily loose monetary policy since the financial crisis of 2008-09 continues to kill opportunities for American workers.

As explained by Kevin Warsh and Stanley Druckenmiller in the *Wall Street Journal*:

> The aggregate wealth of US households, including stocks and real-estate holdings, just hit a new high of $81.8 trillion. That's more than $26 trillion in wealth added since 2009. No wonder most on Wall Street applaud the Fed's unrelenting balance-sheet recovery strategy. It's great news for those households and businesses with large asset holdings, high risk tolerances and easy access to credit.
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> Yet it provides little solace for families and small businesses that must rely on their income statements to pay the bills. About half of American households do not own any stocks and more than one-third don't own a residence. Never mind the retirees who are straining to make the most of their golden years on bond returns.
>
> The Fed's extraordinary tools are far more potent in goosing balance-sheet wealth than spurring real income growth. The most recent employment report reveals the troubling story for Main Street. While 217,000 jobs were created in May, incomes for most Americans remain under stress, with only modest improvements in hours worked and average hourly earnings.
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> It's taken a full 76 months for the number of people working to get back to its previous peak, a discomfiting postwar record. Unfortunately, during the same period the US working-age population increased by more than 15 million people. That's why the share of the working-age population out of work is now at a 36-year high. There are now more Americans on disability insurance than are working in construction and education, combined.
>
> Meanwhile, corporate chieftains rationally choose financial engineering – debt-financed share buybacks, for example – over capital investment in property, plants and equipment. Financial markets reward shareholder activism. Institutional investors extend their risk parameters to beat their benchmarks. And retail investors belatedly participate in the rising asset-price environment.
>
> All of this lifts balance-sheet wealth, at least for a while. But real economic growth – averaging just a bit above 2% for the fifth year in a row – remains sorely lacking.

Higher asset prices are not translating into meaningful increases in capital expenditures, and the weak growth in business investment is proving to be an opportunity-killer for workers. Those with jobs have some job security. But they are less willing to run the risk of finding a better opportunity, or negotiating for higher wages.

Those without jobs, especially in the younger cohorts without a post-high school education, do not attach to the workforce, thus never gaining the entry-level skills and discipline to build a career. The malaise in the labor markets – and muted business investment – help explain why productivity measures are a full percentage point below historical norms.

The Fed's latest forecast has the economy growing above 3% during the balance of this year and next, and the unemployment rate falling to about 5.5% by the end of 2015. If the Fed's sanguine scenario finally comes to pass, interest rates are likely to move meaningfully higher across the yield curve. The money pouring into the financial markets may be redirected, in part, to the real economy. Stocks, leveraged loans and real estate are likely to re-price in a higher interest-rate environment. If rates move quickly or unexpectedly, the vaunted balance-sheet recovery could suffer a blow.

Balance-sheet wealth is sustainable only when it comes from earned success, not government fiat. Wealth creation comes from strong, sustainable growth that turns a proper mix of labor, capital and know-how into productivity, productivity into labor income, income into savings, savings into capital, capital into investment, and investment into asset appreciation.

The country needs an exit from the 2% growth trap. There are no short-cuts through Fed-engineered balance-sheet wealth creation. The sooner and more predictably the Fed exits its extraordinary monetary accommodation, the sooner businesses can get back to business and labor can get back to work.

3 – IN CALIFORNIA: SUCCESS IS NOT EVENLY DISTRIBUTED

Bill Watkins, a professor at California Lutheran University and head of the Center for Economic Research and Forecasting, writes at NewGeography.com that praise for the "California comeback" being heralded in much of the media, along with praise for Jerry Brown, is misplaced. Those articles are part of an adoring press's celebratory spasm occasioned by the facts that California has a budget surplus and has had a run of strong job growth.

But as Watkins explains, for all the job growth, the state's unemployment rate is still one of the highest in the nation. Furthermore, California has unsustainable pension obligations and a bloated public-employee sector, led by the prison guard union. And it is so expensive to live here that clashes over the class divide are threatening to get nasty. But that's not the worst of it.

California has a budget surplus because of a temporary income tax on its highest earning citizens and because of large capital gains reaped during an amazing year for stocks. The S&P 500 was up almost 30% last year, an event unlikely to be repeated. California's tax revenues are excessively dependent on a relatively few wealthy tax payers. This makes revenues extremely volatile. When these tax payers do well, Sacramento is flush with cash. When the high end tax payers don't do well, Sacramento has very serious problems.

By increasing California's reliance on a few wealthy tax payers, writes Watkins, Brown's tax increase made California's revenues more volatile. The ongoing bull stock market would have generated higher tax revenues for California without the tax increase. It generated even more with the

tax increase. When a bear market comes, the state will again face deficits. This is one reason that Standard and Poor's ranks California's credit as second worst in the country, only above Illinois.

So far, to his credit and in stark contrast to what we saw in the dot-com boom under Gray Davis, Jerry Brown has, with the exception of his pet project, the high-speed train, effectively resisted the legislature's knee-jerk impulse to increase long-term spending commitments. What he has not done is perhaps more important: addressing California's other financial issues, the ones that are contributing to California's dismal credit rating.

California has had several quarters of stronger-than-the-nation job growth, but is still 113,500 jobs below the level in 2007. Nor can it be sure that growth will continue, warns Watkins.

Further, writes the author, the state is sitting over estimated oil reserves that are about four times as large as the Bakken Shield, a major contributor to North Dakota's boom. Any serious effort to tap that resource would generate huge numbers of jobs. Many of those jobs would be high wage positions for less educated workers who were hurt the most by the recession.

California has many advantages over North Dakota, or Texas for that matter, besides oil. These are well known and include location between Pacific Rim producers and the world's largest consumer market, ports, workforce, and climate. Even without oil, we should be doing better. Policy though, particularly environmental policy, is restraining the state's job creation.

A whopping 57% more people moved from California to Texas than moved from Texas to California, which was the case for decades. People are leaving California; true, the state's population is up 1.5 million, but that's mostly a result of California's fertile young people. Census data show that California's domestic migration has been negative for over 20 consecutive years, a reversal of about a 150-year migratory trend.

Then, continues Watkins, there is poverty and unemployment. Poverty, unemployment and lack of opportunity are why California's domestic migration data is negative.

The geographic distribution of California's poverty is one reason many people fail to understand California. Most of California's poverty is concentrated in regions where the political class seldom venture. It's mostly inland, not where most of California's elite live or travel. If you stay on the 101 corridor, or hug scenic Route 1, it's easy to avoid. You can find it, but you have to have eyes that are open to it, and it helps if you get off the beaten path.

In places like Santa Barbara, life can be as good as it gets, particularly for the affluent and boomers who bought their homes decades ago. But, the city of Guadalupe in Santa Barbara County gives a taste of how the other half lives. Just take a look sometime: it's about as hardscrabble a town as the Texas town in the movie "The Last Picture Show."

California's poverty is harder to ignore along the 99, but is even more evident in roads like 33, which winds along the eastern side of the coastal range. Go there, and you will find it hard to believe that you are still in the United States, much less California. There you will find grinding, hopeless poverty more reminiscent of the Third World than the center of the economic jobs.

A high speed train won't help these people, writes Watkins. Neither will Silicon Valley tech jobs, even if they don't shrink in the inevitable social media shakeout. Neither will Sacramento, apparently. Until we start doing something for the state's huge and struggling working and middle class, and that means creating opportunity for them, we should refrain from congratulating ourselves and each other for our good work.