EPIC
INVESTMENT MANAGEMENT

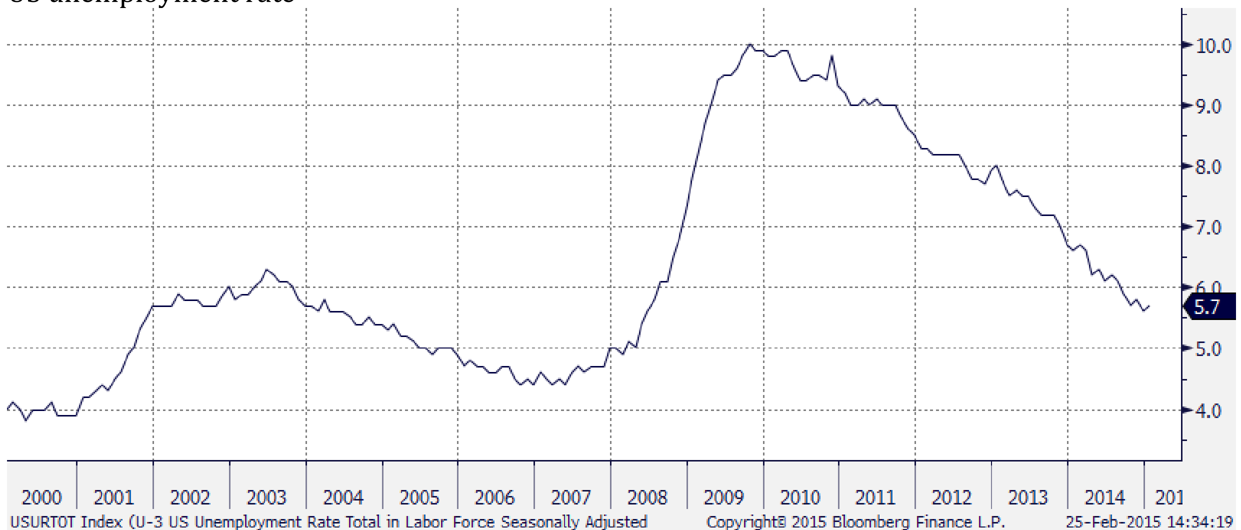
Issue 28 March 2015

Jobs Revival

There is an old line about anyone's most reviled public figure that says "you can tell he is lying, because his lips are moving". Modern-day politics requires a corollary that "you can tell the President is confused, because he is talking about economics."

In his recent State of the Union address, President Obama displayed a bit of rhetorical chest-pounding over the state of the economy. In particular, the President cited the improvement of the US labor market. And why not? Total job gains in the prior year were the highest in over a decade. The unemployment rate, once at ten percent, has dropped below six percent. In the past three months, payrolls have grown at their fastest pace in 17 years. Wages are beginning to accelerate. Why not promote the achievement?

US unemployment rate



Here's why.

The employment recovery in the past year was a result of economic policy the President opposed. Specifically, unemployment benefits were cut when Congress allowed extended support to expire,

over the President's objection. Under the expiring policy, jobless benefits had been raised from the typical 26 weeks to as much as two years.

Here is a pop quiz for any first year economics student: what happens when people are incentivized not to work?

Full credit to anyone who answers that more people will sit at home, collecting their government-sponsored free lunch.

The White House saw things differently, warning of the harmful effects of cutting support for out-of-work Americans. As recently recalled in the Wall Street Journal:

> "… Mr. Obama invoked the needy and explained that this supposed abdication was 'bad for our economy and that's bad for our cities, because if they don't have the money to pay the rent or be able to buy food for their families, that has an impact on demand and businesses and it can have a depressive effect generally. In fact, what we know is the economists have said failing to extend unemployment benefits is going to have a drag on economic growth for next year.'
>
> The White House Council of Economic Advisers forecast direct job losses reaching 240,000 as aggregate demand fell. The Keynesians at the Congressional Budget Office warned of a recession. As late as a June 2014 rally in Minneapolis, Mr. Obama added that the Republicans had harmed 'more than three million Americans who are out there looking every single day for a new job, despite the fact that we know it would be good not just for those families who are working hard to try to get back on their feet, but for the economy as a whole.' "

As a reminder, that 'drag' on the economy spurred the best payroll growth in over a decade. Coincidence? We think not. Nor do economists Marcus Hagedorn, Iourii Manovskii, and Kurt Mitman. In a paper recently published by the National Bureau of Economic Research, the trio examined the effects of reduced jobless benefits on the labor market. Here's what they wrote:

> "We find that a 1% drop in benefit duration leads to a statistically significant increase of employment by 0.0161 log points. In levels, 1.8 million additional jobs were created in 2014 due to the benefit cut. Almost 1 million of these jobs were filled by workers from out of the labor force who would not have participated in the labor market had benefit extensions been reauthorized."

To put this in context, the 1.8 million additional jobs created due to the benefit cut represent a majority of payroll gains in 2014.

The last point from the above quote brings us to a second consideration -- that of labor market participation. It is all-too-convenient to point to an improving unemployment rate as evidence of labor market strength, but sometimes numbers can lie. In particular, the unemployment rate

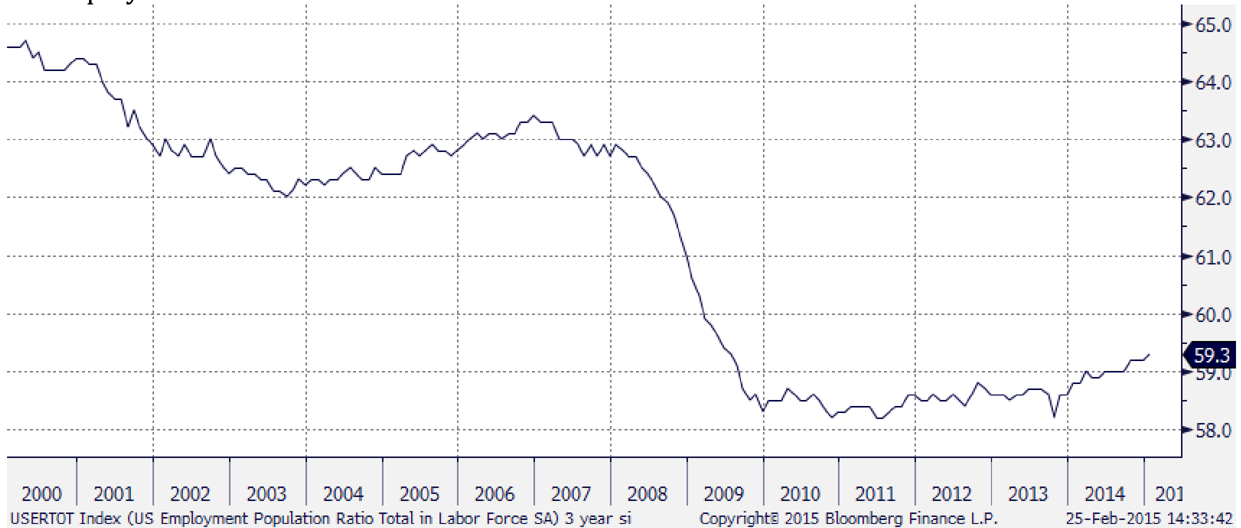
considers only those people who describe themselves as part of the labor pool. As government economists properly see it, you are only counted as out of work if you want to be working.

When Americans become discouraged by the weak job market -- or incentivized by extended jobless benefits -- a number of them drop out of the labor pool and are no longer counted as unemployed. This has the effect of reducing the stated jobless rate without reflecting real improvement in the labor market.

What to do? Fortunately there is a tidy solution to this statistical problem; it is known as the employment ratio. This ratio represents persons currently employed as a percentage of the working-age population. It does not ask if working-age people are out of work by choice, or enticement, or bad luck; it simply asks whether they are employed.

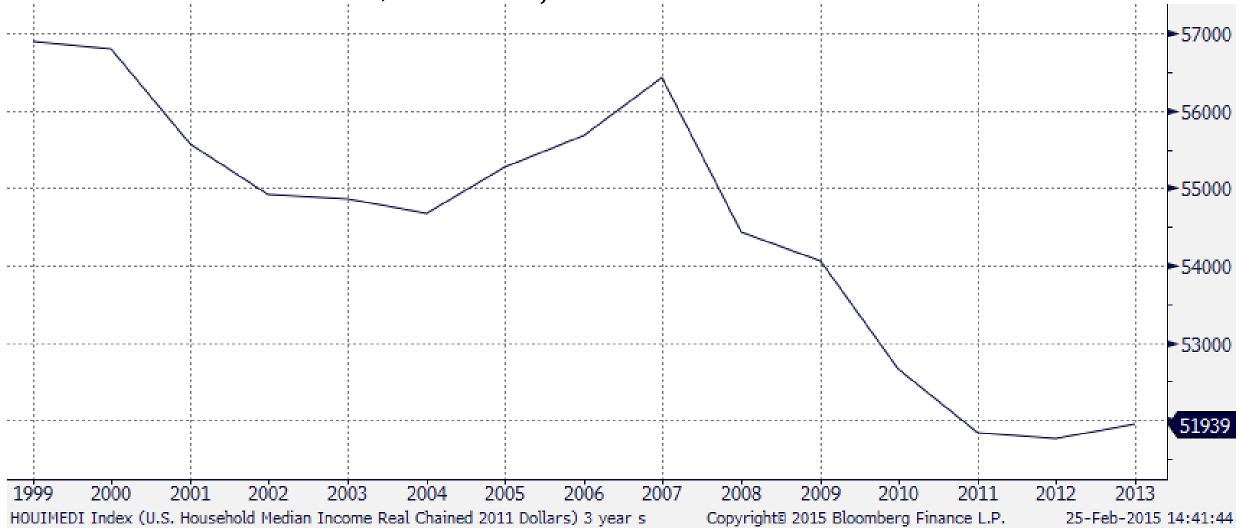
What it shows is disheartening. While the commonly-quoted jobless rate has dropped from ten percent to under six percent, the employment ratio has bounced only one percentage point since its cycle low. Now in our sixth year of economic growth, this indicates that people have either chosen, or been forced to, drop out of the labor market. We have inadvertently created a new subset of the leisure class -- fewer Americans who should be working, are working.

US employment ratio



Finally, there is the issue of wages, and again the numbers look grim. According to data from the U.S. Census Bureau, real median household incomes have fallen from over 54,000 dollars in 2008 -- a time of recession -- to just under 52,000 dollars today; this despite the broader economy's recovery. After trending lower for five years, the numbers barely ticked up in the latest annual survey, rising less than one half of one percent. At the peak in 1999, median household incomes on an inflation-adjusted basis were nearly ten percent higher than today. That's 14 years of mostly declining wages. The middle class is getting squeezed.

US Household Median Income, inflation-adjusted



Perhaps it is not so dire, and there is something here for everyone. Skeptics will point to working-age Americans dropping out of the labor force; to a decline in real wages; to a widening income gap separating the wealthy from the masses. Cherry-picking favorable statistics does not change the reality of a shrinking middle class; cyclical strength does not alter the secular trajectory; and improvement is not the same as healthy.

Optimists -- and there are some out there -- will counter that payroll growth is accelerating, the unemployment rate has been cut nearly in half, and wages are beginning to pick up. The gains may come later than hoped, but these are significant advances, and improvement has to start somewhere.

If the latter view inspires you, go ahead, act presidential… pound your chest.

Big Government

Reprinted from The Wall Street Journal:
Economist Donald Boudreaux writing in his blog, Café Hayek, Jan. 8

In a market economy a worker's low wage reflects that worker's low marginal productivity… [W]hile there are good and bad ways to raise that worker's marginal productivity (the best way is for that worker to become more skilled), to demand a pay hike for that low-skilled worker changes only the reported symptom without addressing, much less curing, the underlying illness.

Changing analogies somewhat: just as a Toyota Yaris cannot be made as valuable to car buyers as is the more luxurious Toyota Avalon by a government diktat demanding that Yarises sell at prices no lower than the price of Avalons -- just as such a diktat simply ensures that sellers of such low-end cars find no buyers -- a low-skilled worker cannot be made as valuable to labor buyers as is a higher-skilled worker by a government diktat demanding that hours of low-skilled work sell at wages no lower than the wage of higher-skilled workers. Such a diktat simply ensures that sellers of such low-skilled work find no buyers.

Reprinted from The Wall Street Journal:
Geoffrey Norman, writing online for the Weekly Standard, Jan. 21

What should be a recovery on steroid -- after all, it has had six years to get in shape -- is still not up to speed. If there were as many people in the labor force now, as there were when President Obama came into office, the unemployment rate would be close to 10 percent. And the spirit of entrepreneurship has dimmed to the point that, as Gallup finds:

"The U.S. now ranks not first, not second, not third, but 12th among developed nations in terms of business startup activity. Countries such as Hungary, Denmark, Finland, New Zealand, Sweden, Israel and Italy all have higher startup rates than America does. We are behind in starting new firms per capita, and this is our single most serious economic problem."

Reprinted from The Wall Street Journal:
From a Dec. 6 speech by Ed Gillespie at the Republican Party of Virginia's annual meeting in Chantilly, Va.; the former Republican National Committee chairman was the GOP's 2014 U.S. Senate candidate from the state.

We can see an influence economy starting to take shape. CEOs are becoming less concerned about inventing the right products, targeting the right markets and hiring the right people in hopes of making a respectable profit for investors -- and more concerned about getting the right lobbyists, retaining the right lawyers and attending the right fundraisers in hopes of getting a hefty subsidy from taxpayers.

Making the right campaign contributions are becoming as important to a company as its research and development budget, and federal-compliance lawyers will soon outnumber patent lawyers.

Fully implemented, Obama 's influence economy will be one where ordinary Americans must get permission from a government agency or department before they can buy, build, invest or hire. It's an economy rooted in mandates and waivers, tax credits and targeted subsidies, Federal grants and government loan guarantees.

Can you get the Department of Justice to file a suit against your competitor? Can you get the NLRB to compel workers to pay dues to your union? Can you get the Department of Energy to guarantee your loan? Can you get the HHS to mandate that consumers buy your product?

It's an America where Washington limits our choices, constrains our decisions, controls our behavior and manages our lives. Where more and more regulations are vigorously enforced by an executive branch that recognizes fewer and fewer limits on its authority, because this president disdains the checks and balances of two branches of government our Founders created as equal but he sees as inconsequential.

Reprinted from The Wall Street Journal:
From a Jan. 9 article by Luke Rosiak, senior watchdog reporter and data editor for the Washington Examiner

Records obtained by the Washington Examiner under the Freedom of Information Act show that HHS executives spent $31 million taking 7,000 first class and business class flights between 2009 and 2013, including 253 trips for which a one-way ticket cost more than $15,000. Half the records listed the price of a coach ticket for comparison. For that portion alone, the upgrade boosted the cost by almost $14 million, from $4.9 million to $18.5 million.

Federal employees are allowed to fly business or first class if the flight is longer than 14 hours, but only 1,400 of the 7,000 flights met that description. For the vast majority of the flights -- 5,100 -- the government executives upgraded because they claimed they had a medical disability that necessitated it. Others cited "exceptional security circumstances," that no coach tickets were available, that a non-federal source was footing the bill, that first or business class was "required because of agency mission."

Then-Secretary Kathleen Sebelius took 14 first- or business-class trips totaling $56,000, including flights to and within India and from Paris to Vietnam. . . .

And the Centers for Medicare and Medicaid Services, which manages Obamacare, took 50 upgraded flights, including a trip from Baltimore to a three-day conference in Phoenix where a first class ticket cost $3,000 each way. On another equally expensive trip to Baltimore, CMS' Joseph Fine said first class travel was "required because of agency mission." CMS officials also flew business class from Charlotte, North Carolina to Charleston, South Carolina for $1,000 each way rather than drive three hours.

Source:
Bloomberg
National Bureau of Economic Research
U.S. Census Bureau
Wall Street Journal

Tidbits..

European Central Bank announces Quantitate Easing program, emulating policies of US, other central banks.
Switzerland cuts currency peg to Euro. Swiss Franc surges, shock waves hit forex markets.
Greece challenges Europe's austerity measures, raises specter of exiting Euro currency, receives concessions in managing debt burden.
Russia's credit rating is cut to junk status, currency plunge continues.

German, Swiss, Japanese five-year government notes offer negative yields.

Venture Capital firms raise 33 billion dollars in 2014, largest fund-raising in seven years.
105 venture-backed companies go public, highest number since 2000.

A sign of froth, but if a bubble, likely a manageable one.

Federal Communications Commission approves net-neutrality rules, marking new age of regulation on internet providers.

Irresistible: Too much of a good thing in the sights of government regulators.

Oil prices fall 60 percent from peak, reach six year low.
Copper, 'world's greatest economist', also hits six year low.
World Bank, International Monetary Fund cut global growth forecasts for 2015.

Target to close Canadian stores after failed expansion effort.
Tiffany reports disappointing holiday sales.
Best Buy warns of sluggish sales outlook for coming year.
Retailers Wet Seal and RadioShack file bankruptcy.
Wal-Mart, TJ Maxx to raise pay for low-wage workers.
US auto sales in 2014 reach highest level in eight years.

Car buying aside, surprisingly tough times in retailing.

Office supply retailers Staples, Office Depot announce plans to merge.

Expect a long, hard look from regulators.

McDonald's, facing sales slump, hires third new CEO in past decade.

White House proposes Medicare payment overhaul, rewarding quality of care over volume.

Why didn't someone think of this years ago?

Home ownership rate falls to lowest level in 20 years.

President Obama uses veto power to block Keystone XL Pipeline after Congressional approval.
White House proposes taxing '529 Plan' Education Savings Accounts, reverses course a week later.

"Never mind."