FOCUS ON THE ECONOMY

WELL, STANLEY, THIS IS ANOTHER FINE MESS YOU'VE GOTTEN US INTO

by Hugh F. Kelly, CRE

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When the conceptual schedule for this year's series of columns was laid out, I indicated that the summer's essay would treat with the private sector's key contribution to economic recovery: attaining a sustainable trajectory of long-term profit growth. That subject has become exceptionally timely over the past few months. At first glance, the return of the bear market in corporate stocks in the April to July period would seem to make the story obvious. But there is a difference between investors' frustration at companies that missed their quarterly earnings and the far more serious business of managers disregarding long-term profit planning almost entirely.

Often the burden of pulling the economy out of its cyclical downturns is assumed to fall on the federal government. As we reviewed in the Spring 2002 issue, there is a critical role for Washington to play. It has fiscal tools: the power of the federal purse. Recent estimates of the federal budgetary deficit are running at an annual rate of $165 billion. That's $165 billion more that's being spent by Washington than it is withdrawing from the economy in taxes and fees, money that in effect is being largely spent in the private sector for goods and services, either directly in appropriations or indirectly through government employment, transfer payments, or revenue sharing grants. The other side of the coin is the Federal Reserve's monetary operations. The sustained reduction in interest rates has cut the cost of capital across the entire economy. In just one measure, mortgage refinancing, lower interest rates had the effects of generating $450 billion (roll that number around for just a minute; macroeconomic figures can be numbingly large, and it helps to think about their magnitudes before just reading on) in the fourth quarter of 2001 alone. If you are wondering how the first quarter GDP could grow by 5.0 percent, fueled by consumption when the unemployment rate was still rising, that $450 billion will clear up a lot of the mystery.

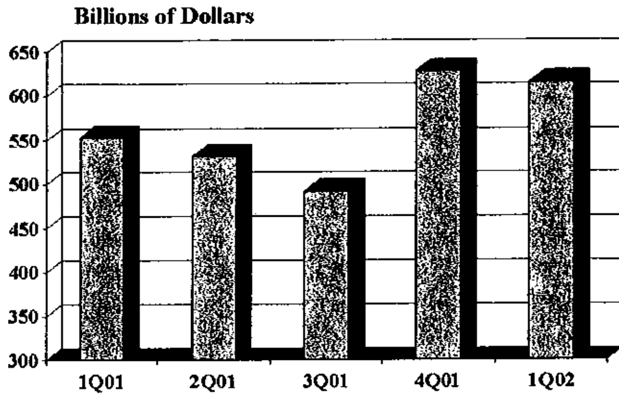
Business really likes to pretend that government is supposed to do the heavy lifting in recessions and immediately thereafter. But as big as Big Government might seem, combined federal, state, and local spending accounts for just $591 billion of a $9.5 trillion Gross Domestic Product, about 6 percent of total output. It is the private sector that, rightfully, needs to provide most of the lift to an economic expansion.

Profits are the yardstick by which we evaluate how well private businesses are doing their part. There is no question (Figure 1) that profits took a serious tumble during 2001, falling from $551 billion (after tax) in the first quarter to $492 billion in the third quarter. That's a drop of 10.7 percent, and surely not what investors were expecting when they bid stock prices up to their highs in early

Exhibits 1 - 4

Exhibit 1

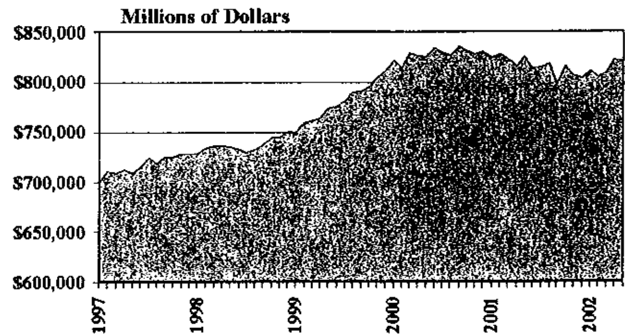
Corporate Profits Come Off the Mat



Source: BEA; "corporate profits after-tax, with inventory valuation and capital consumption adjustments"

Exhibit 2

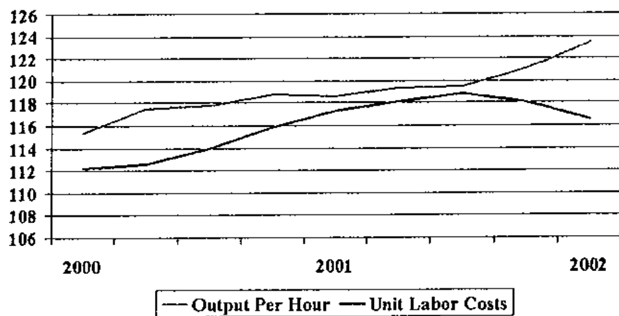
Total Business Sales Firming Up



Source: U.S. Bureau of the Census

Exhibit 3

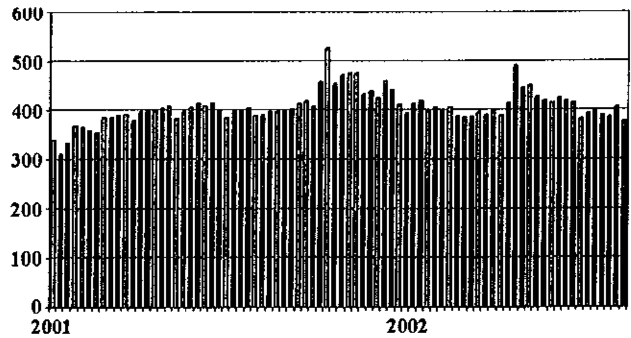
Productivity Resumes Its Advance; Labor Cost Start to Dip



Source: U.S. Bureau of Labor Statistics

Exhibit 4

Unemployment Claims Retreating



Source: U.S. Bureau of Labor Statistics

2000. But fourth quarter profits bounced back nicely to $628 billion (up 28 percent), and stocks rallied accordingly through March of 2002. Profits slipped slightly in the first quarter 2002 (2.0 percent), but nothing in those numbers prepared us for the destructive experience ahead on Wall Street. From March to July, the S&P 500 dropped 22 percent, the DJIA 24 percent, and the NASDAQ Composite 30 percent in value.

Second quarter earnings announcements could hardly be blamed for the plunge. Better than expected results were reported by a range of firms, including Daimler Chrysler, General Motors, Microsoft, Sun Microsystems, Motorola, and even Merrill Lynch. The issue, of course, lay with another array of companies: Enron, Tyco, Global Crossing, Worldcom, ImClone, and others—an uncanny number of which were audited by the disgraced Arthur Andersen & Company. The market was punishing uncertainty in the most sensitive of places: in earnings reports audited under Generally Accepted Accounting Principles. At the heart of the troubles, the so-called "management" of earnings to meet or exceed quarterly targets. When investors lose confidence in the reliability—the honesty, to use an old-fashioned term—of the numbers in financial statements, then who can blame them from leaving a casino where the odds suddenly look unacceptably stacked against them? Alan Greenspan ruefully remarked, "My view was always that...the market value of companies rested on the integrity of their [financial] operations. I was wrong."

With the sell-off in mid-July, however, the markets dipped below a critical historical measure. At the levels of the Dow and S&P indexes, as of this writing, the market's price/earnings ratio had fallen beneath its long-term average. This should signal a buying opportunity for value-oriented investors, if they themselves can get comfortable with some economic basics and can regain some of their trust in corporate management.

What are the economic fundamentals? First of all, after posting flat to declining figures for more than a year, total business sales (which include sales at the manufacturing, merchant wholesaling, and retailing levels) bottomed out in the first few months of 2002, and began to rise during the spring (Figure 2). Improvement in sales is the key to increasing production, now that the inventory correction of 2001 has run its course. The industrial production index rose from 138.6 in March to 140.6 in June, and its rate of growth was accelerating as the year progressed. Consumer goods production was the most robust, but after a long slide, business equipment production picked up in both May and June.

New business equipment purchases are absolutely critical to this recovery. Not only was that the key area of weakness that softened the economy, leaving it vulnerable to recession, but business modernization is an ever-present need if we are to sustain productivity growth. Productivity, or "output per hour of work," is the driving force for U.S. GDP growth now and into the foreseeable future. This is because the nation is in a demographic trough that makes us a labor-short economy. There are many complicated ways to think of GDP growth, and one very simple shortcut to that basic economic statistic. The simple way is to take the change in the number of workers times the average hours worked, and then factor in the output per hour. The result is the percent change in real GDP: end of formula. If we can only grow our workforce by 2 percent per year or so (and we need a lot of immigrants to reach even that modest goal), and we hope to have GDP growth of 3 percent or higher, then productivity has to make up the difference.

So it is encouraging news (Figure 3) that output per hour has started to climb once again, after nearly two years of tepid growth. If you will, take another pause to think about the number. The productivity index of 124 means (since the index is set at 1992 = 100) that output per hour worked is 24 percent higher than just a decade ago. That's huge in an economy the size of the United States. Furthermore, unit labor cost increases have been lower than the output gains, and that differential helps the bottom line for U.S. businesses. It also helps the economy broadly speaking, helping keep inflation tame and giving the Fed necessary policy elbow room. Assuredly, there are limits to how much growth can come simply from productivity and when those limits are approached, businesses will have to step up their hiring once again. Unless the bear market on Wall Street turns utterly catastrophic, an acceleration in the job numbers should be in place by the end of this year.

Already the trend in weekly unemployment claims (Figure 4) seems to be setting the stage. This series

is a component of the Index of Leading Economic Indicators, and had the second strongest positive contribution (after Money Supply growth) for the June index. Incidentally, the S&P 500 had the heaviest negative influence on the index, which was unchanged overall from its May results.

Keeping some historical perspective, unemployment topped out at 6 percent in this downcycle. Six percent used to be considered the NAIRU benchmark that was the economy's putative speed limit. (NAIRU is one of those ugly economic acronyms, standing for an even more unwieldy phrase: the Non-Accelerating Inflationary Rate of Unemployment.) This was embedded in one of the concepts that virtually every business person learned in Economics 101: the Phillips Curve, which assumed a trade-off between inflation and unemployment. That relationship proved very weak during the 1990s, as unemployment dropped to 4 percent or so, while inflation stayed very mild. The reason? It looks like productivity overrides the Phillips Curve in a profound way. If you are looking for a measure of this era's "labor shortage," consider that the jobless rate peaked at 9.0 percent in the recession of 1975, at 10.8 percent in 1982, and at 7.8 percent in the recession of 1992. You have to go back to the 1960s, when the Baby Boom had yet to enter the workforce, to find peak jobless rates as low as we have recently.

Looking to the future, the question is this: Can American business operate profitably, without cooking the books, in a low-inflation, low interest rate era characterized by rising productivity and nearly full employment? And if the answer is yes, will investors regain the confidence needed to reinvest in American business, so that corporations can in turn devote their time, attention, energy, and resources of physical, human, and financial capital to providing quality goods and services to the public?

Perhaps that is a loaded way of posing the question, but I think it strikes at the heart of the matter. In the next column, I'll conclude this series with some thoughts on the international side of the story, how in a global economy we must "get by with a little help from our friends." REI

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