WHAT I LEARNED THIS WEEK

Excerpt from October 12, 2017

4 A rising U.S. stock market widens the wealth divide—fueling social unrest and a weaker U.S. dollar.

The Federal Reserve's September 2017 Survey of Consumer Finances carried the following stark illustration: **the wealth share of the bottom 90% of families has fallen from 33.2% in 1989 to 22.8% in 2016,** while the wealth share of the top 1% has risen from just below 30% to 38.6% over that same time period

The booming wealth of the top 1%, which accelerated after the Global Financial Crisis, is largely a result of the inflation of asset prices, especially stocks, after QE. While the S&P 500 nearly doubled between 2012 and 2016, average annual U.S. real GDP growth was only 2.2%—roughly half the level achieved during the bull markets of the 1980s and 1990s.

Moreover, as the chart attests, the **wealth share of the bottom 90% fell more precipitously after 2007,** underscoring how benefits from post-crisis policies largely accrued to a narrow segment of the population. If the stock market continues to advance to new records—and is accompanied by tax rate cuts whose benefits mainly flow to the rich—it will exacerbate the disparity of wealth even further, which will likely add to social unrest and, in time, undermine the value of the dollar.

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Source: Federal Reserve

Clients often ask us: **why is the U.S. stock market setting record highs when growth is so weak?** The Fed's "free money" QE is one reason, because the liquidity did not reach the people who could spend it. Corporate buybacks are another reason, because they boosted EPS growth by lowering the share count, not by driving organic growth. A weak dollar is another cause, because multinational companies gain a dual benefit from currency-translation gains and stronger export markets. Finally, the prospects for a cut in the top marginal corporate tax rate, from 35% to 20%, along with a tax on repatriated foreign earnings of around 10%, have spurred hopes for even more market gains, though the odds of a major tax cut are diminishing.

The net result has been a stock market that is increasingly disengaged from the wealth and income of the average wage earner—which is unsustainable. Given that the growing wealth divide is one of the major causes of middle-class frustration and social unrest in America, **any tax law changes need to address this disparity.** However, if any tax law change is perceived as merely a tax cut for the rich, it will not rectify the core problem affecting America, namely that the economic and wealth gains are increasingly concentrated among a small subset of the population. If future stock market gains are driven merely by higher profits being plowed back to shareholders, it would exacerbate this core problem.

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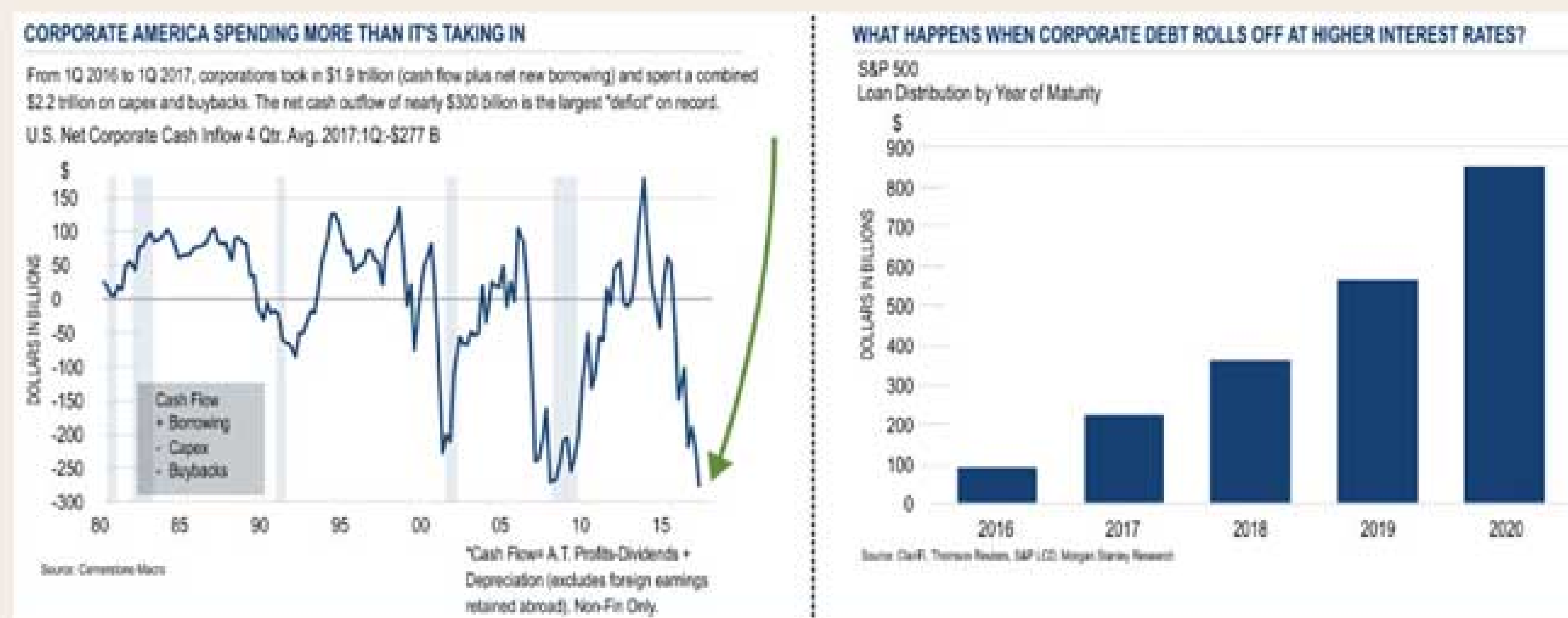
This is why the current U.S. equity market advance has to be viewed in a different light than that of the 1980s and 1990s, and why the broader economy and the value of the U.S. dollar could deteriorate further despite new market highs. As the earlier chart illustrates, the wealth share of the bottom 90% exceeded the share of the top 1% in 1989, implying that the economic gains were distributed more broadly during the 1980s. Even during the late 1990s, the gap between top 1% and the bottom 90% was much narrower than it is today.

There is little reason to be confident that corporate behavior will change under a new tax regime. Capital has been abundant ever since QE began, interest rates have been at their lowest level in 5,000 years and corporations have been flush with cash, as investors have been forced to chase yield by migrating away from government debt markets. But other than shale oil, refining and petrochemicals, **U.S. corporations have largely been tight-fisted when it comes to long-lived investment, relative to historical trends.**

The following chart on the left shows that U.S. corporations are spending far more on capex and buybacks than the cash flow they are taking in, which begs the following question: if short and intermediate-term interest rates accelerate upwards, **how will corporations fare as they attempt to roll over more than $1.7 trillion of maturing debt at higher interest rates**, as the chart on the right implies?



Source: Calamos Investments

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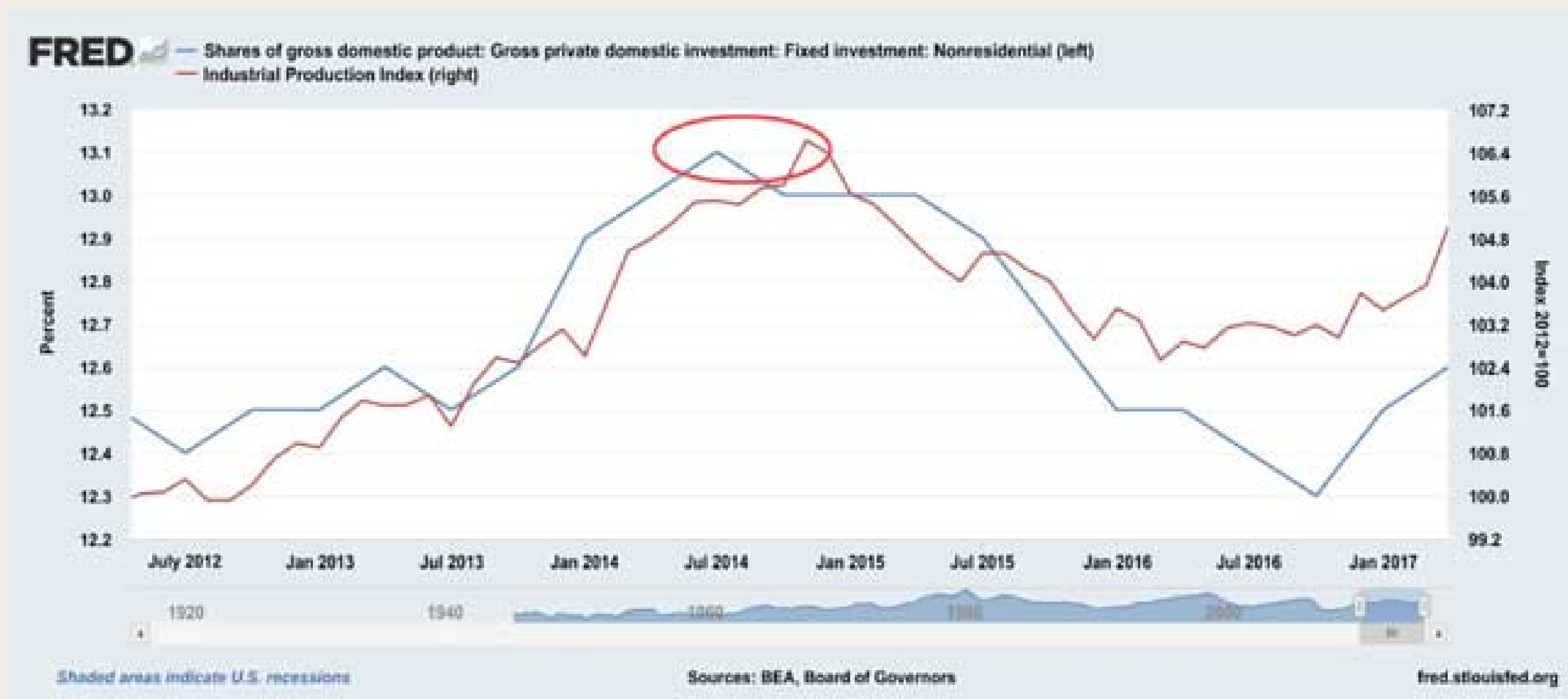
The most worrisome part of the excess spending and future debt rollovers is that the economy has relatively little to show, in long-lived investments, for the increased risk taken on. Both nonresidential fixed investment-to-GDP (the source of future productivity gains) and industrial production both peaked three years ago for this cycle, and the recent bounce in these measures could be undermined if spending on shale oil, some of which is uneconomic at current prices, is scaled back from here. Moreover, nonresidential fixed investment-to-GDP of 12.6% remains well below its early-1980s peak of 15.3%, and **current industrial capacity utilization is almost 5 percentage points below its pre-recession high** of 81%.

Gross private domestic fixed nonresidential investment as a % of GDP (blue, lhs) versus industrial production index (red, rhs)



Source: St. Louis Fed

Making matters worse, **job creation over the past decade has not lived up to historical standards.** Since the Great Recession began in December 2007, nonfarm payrolls have grown by an average roughly 850,000 a year—almost 40% below the 1.4 million annual growth during the decade that ended in 2007 and less than half the 1.8 million annual payroll gain during the 1980s. Granted, December 2007 is a tough comparison given the massive job losses that immediately followed, but the other periods also contained recessions and serious geopolitical uncertainties.

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This analysis underscores our fear that further stock market gains will only exacerbate the problems that have inflamed so much resentment in American society. Corporations have rarely been more profitable, and have never enjoyed this level of access to cheap and abundant capital, but they have not invested nearly as much as they have historically in relative terms, nor have they created the same number of jobs that they have historically. Yet, the stock market chugs along, with one record high after another, and **Washington is contemplating an even bigger giveaway in the form of a tax cut, without any strings attached to how those savings are ultimately spent.** Something has to give.

Marcus Ryu, the co-founder and CEO of Guidewire Software, wrote eloquently on this topic from the perspective of a private-sector job creator. His Op/Ed for *The New York Times*, dated October 9th and headlined "Why Corporate Tax Cuts Won't Create Jobs," said the following: "As an entrepreneur myself and a friend to many others, I know that lower tax rates will not motivate more people to start companies…**What a tax cut would do is increase our post-tax profitability, which effectively transfers money from the federal government to our shareholders.** One consequence of this would likely be a one-time increase in our stock price, but with no impact on our operations or employment plans."

It is difficult to envision an acceleration of real GDP growth unless prosperity is distributed more broadly, as it was during the 1980s and 1990s, and without this, the U.S. dollar is likely to encounter more headwinds. Former Morgan Stanley economist Andy Xie wrote an Op/Ed for the *South China Morning Post* dated October 8th and headlined "The bubble economy is set to burst, and US elections may well be the trigger," which warned of the troubling direction in which we are headed: **"The most likely cause for the bubble to burst would be the rising political tension in the West.** The bubble economy keeps squeezing the middle class, with more debt and less wages. The festering political tension could boil over. Radical politicians aiming for class struggle could rise to the top. **The U.S. midterm elections in 2018 and presidential election in 2020 are the events that could upend the applecart."**

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