The Quarterly Report

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JOBS

INSIDE STORY

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There is a legend in the economic world of an economist who traveled to a developing country.

I have heard the story attributed to Milton Friedman and a vacation in China, and I also have heard it attributed to a nameless economist doing mission work for his church. Personally I doubt it ever occurred, but as with many legends and myths, the fact it didn't really happen does not make it any less true.

It goes like this: An economist travels to a far-off land to help the native people build a dam to provide power and a source of clean water for their village. Before leaving for his trip, he gathers donations to pay for the heavy equipment they will need to build a modern dam in this remote area. Upon arriving he notices that the heavy equipment has arrived safely. He also notices that the natives have already begun work; however, they are not using the modern machinery. What he sees looks like a scene out of movie about the building of the pyramids of Egypt – he witnesses a mass of humanity battling the force of a river with nothing but shovels. It looks awful to the modern eye.

Our economist hero immediately demands to see who is in charge. The foreman comes forward – our hero half expected him to be carrying a whip – and greets the new visitor with enthusiasm. "We are glad you are here, thank you for your financial support and the help you are giving us," he says.

"No problem, glad to do it," the economist responds, "but I have to ask. What is going on here? Why isn't the equipment we paid for being used?"

"If we use this heavy equipment we would eliminate many of these jobs and we simply cannot do that," explained the foreman.

"Oh," responded the economist. "I think there has been a misunderstanding. My organization was under the impression you were trying to build a dam. But you are trying to create jobs. If that is the case, you should take away the shovels and give the workers spoons."

The moral to the story is that it is important to distinguish from a symptom of a problem versus the problem itself. If the leaders of this mythical community really wanted to create jobs they should focus instead on economic growth. The faster they finished the dam, the faster they could generate energy and better control the water supply, which could bring industry and/or agriculture to their community, which would create much better jobs than shoveling mud. These jobs would also last beyond the length of the dam-building project, and the jobs themselves may create needs for other jobs in services such as childcare; they may even need a local bank…oh no, there goes my make-believe town, now it will be destroyed by the 'evil banker.'

Those future jobs are hard to see in the present moment. It all makes sense in my mythical village, as it does when we look back in history. In 1800 America was a nation of farmers, with roughly three-quarters of the labor force working in agriculture. By the eve of the Civil War, only half worked in

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agriculture; by 1900, one-third; and today, less than three percent of our labor force is in agriculture. This does not mean that food production has gone away – U.S. agriculture has maintained a positive trade surplus for decades, producing more food than even our overweight society can consume.

The industrial economy has seen the same phenomenon over the last 60 years. There is a firmly held belief that America has lost its manufacturing edge to competitors overseas, mainly to China. Like most conventional wisdoms, this belief is not true. In 1947, a little less than 15% of the total gross domestic product (GDP) came from manufacturing. Today that percentage is roughly the same and it has been stable throughout that 60-year period, meaning American manufacturing has grown in line with the economy as a whole. However, in 1947 manufacturing represented over a third of total employment in the U.S. There were lots of relatively low-skill, high-paying union jobs. Today that is no longer the case. Manufacturing represents less than a tenth of our total workforce, but the vast majority of those jobs were lost not to competitors but to technological advances. This is important to understand because jobs lost to competitors could be won back, while jobs made obsolete by technology are gone forever.

This reality is hard to hear and it is painful to go through, but this is a necessary process which the famous economist Joseph Schumpeter called 'creative destruction' – the old must be destroyed so the new can take its place. American history is full of these episodes and we owe much of our global success to the fact that, for the most part, throughout our history we have allowed this economic cycle of innovation, boom, decline, destruction and new innovation to keep on cycling. Most notably, in the last 100 years we faced two times when unemployment reached the levels we are near today. The reaction to those two periods could not have been any different and the lessons learned are important for us.

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REVIEW *of* ECONOMY

DOWNWARD REVISIONS WAS THE THEME THIS QUARTER, as the original report stated that third quarter GDP had grown at 3.5%, but that was revised down to 2.8% and then again to 2.2%. Those are serious revisions. The revisions were pretty uniform but the theme to take from this is that corporate America has not come as far along in the inventory re-stocking process as we thought. This could mean good news over the next few months.

Unemployment remains the real story at 10%, with no signs of the job market improving any time soon. This is not going to happen until we get real growth in the economy, and unfortunately we are facing the most anti-growth policies we have seen in this country in more than 30 years.

The actions of our policy leaders continue to surprise and alarm us. The protectionist theme has continued, this time helping the steel industry. We are on the verge of signing a health care bill that may well be the worst piece of legislation ever past by Congress. Its most ardent supporters' sole argument in support of this bill is that "at least they are passing something," which they hope eventually will lead Congress to revisit the issue and fix the bill. If that is what our legislative process has come to, we are in sad shape, and that makes everyone nervous about the long-term future of our country. +

REVIEW *of* MARKET

IT WAS ANOTHER POSITIVE QUARTER. The S&P 500 was up 6.04%. It was a strange quarter, however, with the market climbing mostly due to the dollar falling. That trend seemed to reverse itself somewhat in December as the economic news improved. Growth heavily outpaced Value, with the Russell 1000 growth index up 7.94% and the Russell 1000 Value index up 4.21% by comparison. Small caps underperformed through November by a large margin, then stormed back. They still underperformed for the quarter as a whole.

Emerging markets continued to shine internationally. The MSCI Emerging Markets Index was up 8.58%, although that growth did not translate to the developed international markets represented by the MSCI EAFE index, which was up only 2.22%. +

MARKET *forecast*

Another year, another guess – I mean forecast – for where the S&P will end the year. I am reminded of Peter Lynch's warning that if you spend 13 minutes on a market forecast you have wasted 10 minutes. I will say that I am fairly optimistic about the markets' chances in the first half of 2010, as corporate profits should continue to recover from their lows and inventories continue to rebuild. To me, the question becomes what happens next and that is very blurry. If history is the judge, the S&P will end up about 15% this year. That seems a little optimistic to me, but a return around 12% would be a reasonable expectation.

While it would not be surprising for emerging markets to take a little breather, the fundamentals remain strong. Small caps should also continue to do well. Europe remains the biggest concern for us regarding equities. We still believe the opportunities in bonds are in the corporate and high-yield bond market. Treasuries, usually the safe haven, look dangerous. Bonds may not prove to be the safe haven they have been in the past. +

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…in the last 100 years, we faced two times when unemployment reached the levels we are near today.

The first such period was the Great Depression. In 1933, the unemployment rate hit 24.9%, and the government reacted by passing a slew of new regulations on industry, increasing spending, and creating new entitlement programs and 'make-work' jobs programs. All of this was very popular as it made the government look like they were 'doing something.' Yet in 1939, the unemployment rate was still 17.2%. Things got better, but not by much.

The second time the unemployment rate got up to near double digits was in 1982. At the end of 1982 the unemployment rate was 9.7%, and the government reacted by reducing regulation, reducing the size of government, and lowering taxes. The public response at first was not positive, since it appeared that government 'didn't care.' By 1989 unemployment was down to 5.3%. Government continued to downsize through the 1990s and in 1999 unemployment stood at 4.2%.

One approach didn't work and the other did. But, there were some side effects to the second approach. Most notably, there has been a disturbingly increasing gap between the haves and the have-nots.

Today we sit between a rock and a hard place. To produce jobs, we must encourage innovation by providing economic freedom, but we must also do something about the growing bifurcation of our society. This dilemma is spelled out very well in Jim Manzi's essay for *National Affairs,* "Keeping America's Edge." Unfortunately what Manzi describes – correctly, in my opinion – as a "dysfunctional political dynamic" is preventing us from actually facing this challenge and has instead "given us the worst of both worlds: a ballooning welfare state that threatens future growth, along with growing socioeconomic disparities."

Liberals are correct when they point out the disparity of the rich versus the poor in our country today, but they are blind to the reality that their attempts to control economic activity centrally are counterproductive and actually make things worse. Conservatives are correct when they argue for the power of the free market, but they are blind to increasing inequality. We live in a world where increasingly people are able to avoid any bit of information that does not fit with their world view. They increase their closed-mindedness by digesting only views with which they know they will agree. This serves only to grow our respective blind spots and our political dysfunction.

There are solutions, and I will discuss some during the course of this year. But they are going to require a mature facing of facts – *all* the facts. Big government does not work. We need to do something about the economic disparity in our society – starting with reforming education. We need a state-of-the-art regulatory system to govern the financial markets. If we do these things, jobs will come. In the meantime, beware of politicians promising jobs programs – they might just be handing out spoons.

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