NAVIGATING THE REEF

I need something to stand on, something I won't fall through. That is this piece because going forward without a sense of place makes no sense. Full accuracy would be an accident.

If it turns out chance or some exogenous forces are at work, they may well be these:

- Taxes won't cover all of the debt coming due.
- Half the population will receive some form of government cash.
- The very long-term gap between taxes and embedded entitlements exceeds 3 or more times our total GDP.
- The service sector has only temporarily replaced the manufacturing sector.
- Economic cycles will be more frequent and softer when consumer or investment driven and more violent when credit driven.
- Two-earner families will continue, implying fewer children per couple.
- We are unlikely to allow meaningful immigration given the existing 25% rate of unemployment among our young.
- Longer work lives are required and will produce more job competition and foster higher levels of long-term unemployed.
- Real wages (salary rate minus inflation) will remain stagnant for the middle class given the unemployed pool and continued automation of the new manufacturing economy.
- A need to protect ourselves will keep defense spending high.
- For now we can only inflate our currency to pay our bills.
- Increased tax revenue will be spent, not used to pay debt.
- No model can predict human behavior, but some human behaviors are predictable:
    a. About $1 in $6 was a tolerable tax rate for at least the last 2000 years; we cheat beyond that, so expect more of that, more "off the books" work.
    b. We continue to think equality means benefits, not rights.
    c. We can't tell need from want.
- Politicians and economists will nonetheless continue to create policies, models and programs to control human behavior for the good of their personal balance sheet because they have a receptive public.

THE NEW ECONOMICS: A PLAY IN MANY ACTS

The Performers

Consumers	Manufacturers	Defense Industry
Unions	Credit Industry	Government Bureaucrats
The Treasury	Investment Industry	Teachers
Service Sector	Retailers/Wholesalers	Social Benefit Providers

. . . . and a cast of thousands of lobbyists, special interest groups, paramilitary types, greenies, warmists, drug dealers, retirees, clergy, both radical and what passes for normal, global meddlers, immigrants, ethno-centric movements, revisionists, alarmists, separatists, TV screamers, media darlings, "stars," animal haters/lovers, news readers, old hippies, older politicians – with music and lyrics by narcissistic children.

I wrote the above to give you a sense that I know, in a nation that continues to divide and divide again, any attempt to speak of a homogeneous "Economic American" is problematic.

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THE AMERICAN CONSUMER

My premise in the New Economics is that those above-noted groups exist because they can, either because as a heretofore more wealthy nation, they could afford to play at causes or, more likely, be funded with donations from the wealth we create. I would propose three trends;

1) Funding will dry up for many for lack of credibility and donations.
2) Survivors will grow ever stronger and more radical as loss of their entitlements, lack of economic judgment (and old age) kick in.
3) A search for "answers" will focus not on religion or Washington, but on another, long-gone time in American history when self sufficiency was rewarded. This is key, this rebirth of an American identity, as it will be driven by women who still have the best long view for their family.

With these trends possible, a return to simpler times, simpler ways, could occur. In the context of an aging population with sharply reduced savings, it's not hard to see a change in what we buy. What may not be so clear is my guess that this cohort will be more of a "joiner" than historic – primarily to protect what they still have. My fear is that their economic ignorance will lull them into some very bad decisions. The point is, the search for answers, forced by circumstances, spawns all kinds of new charlatans selling bogus solutions. And, thankfully, new leaders as the old are displaced.

Fewer children, more saving, more focus on education, emigration – these are the easy calls. Equally easy is a lower level of consumption, but some allowed luxury goods, less use of credit cards, but more existing home remodeling rather than moving and maybe just one car – or two cheap ones. Shop at Whole Foods instead of eating out, "green activity" to be fashionable and, secretly, maybe save some money, local travel versus Europe (especially with a weak dollar) and more local store shopping as the big chains struggle to maintain the volumes they need to maintain their edge in pricing. Hobby purchasing – cars, skis, cameras, etc. all suffer, but with the premium end doing well . . . haves/have nots again.

The hard call is how they vote. If they continue to see no link between voting for new entitlements and, ultimately, higher taxes to pay for it . . . well, then we've just opened the door to Sovereign Default. If they do see it and vote actual cuts in entitlements by voting in those who will do so, I must be optimistic about our future. I must also accept social unrest and higher unemployment as a by-product in all cases. Emigration looms. Where? Canada.

EMPLOYMENT

Of late, the thesis that some jobs must have a human, like child care, lawn cutting, laundry work, basic construction, etc. portends wage gains for this lowest paid, especially as the border closes. *The Economist* notes that's a global trend. The middle – middle class, middle skill, suffers most as they are increasingly automated. The upper 1/3 of wage earners are, like the bottom 1/3, bringing to the table what a machine can not. I think of my friend Jon – he needs men to offload and stack steel so that automated machines, programmed by skilled employees, can cut, fold, weld, whatever. At the end of the line, humans do some (less each day, I suspect) final assembly and test – and those, too, are headed for automation. This is a somewhat different view of who might see wage growth.

HOUSING

It's a long way from done; foreclosures are the big issue for at least 2 more years.

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CREDIT
Credit, in the hands of uninformed consumers, is cocaine. Of late, "debt pay down" is mostly default, not actual payment. I suspect the gross-spending habit is broken for some time to come. My optimism rests on two factors:
1) the gray population, stripped of ½ of their life savings, gets it and
2) the young population, lacking a job, might see the link between work and the ability to pay bills.

In the New Economics, then, I see lower annual growth in our overall consumer economy, especially when so much (near 40%) of our prior GDP growth was fueled by consumer credit. Forget the fact that we have trillions of personal debt to dispose of – I'm of the view that we will do that one way or another and use far less going forward. This has implications for banks and consumer credit firms. The cash we save will go to Nordstrom before Target, Disneyland for the whole family before Carnival Cruise Lines for mom and dad, gadgets before furniture, and on. In short, what little spending we do will tend to seek better goods and services for their singular pleasure as a form of compensation for not being able to splurge as before. Numbers-matching collector cars hold value, the rest continue to soften, for example. Again, instead of broad strong growth, narrower and more focused, and only for some.

C + I + G
Our economy has 3 engines: Consumer (C), Investment in plants and equipment, etc. (I) and the Government (G). A 4th factor, net exports or imports, is often added, but imports at 16% of GDP and exports at 13% of GDP often offset and are a separate issue. They tilt GDP, however.

The weight of each is, roughly, C: +/- 70%, I: +/- 7% and G +/- 23%. All of them need money to do their part. The Consumer works, saves and consumes. The Investment (businesses) borrow, build, sell and make a profit, paying workers in the process. The Government, of course, taxes all of the above. It makes nothing, but provides services, regulations, protection and the like. Key to the process is that it's a loop – you work, I work, we pay taxes and save; businesses borrow our savings to invest to employ us, sell us stuff, and we consume. Not hard, really – actually simple. If (G) creates bills for us to pay, we allocate income for taxes accordingly. It is always in concert; if one shrinks or grows, all are impacted. Credit is the facilitator.

For example, reduced consumption by thee and me meets businesses needing less of us, lower tax revenues meet higher tax rates and, in theory, the government reduces services.
In the New Economics, however, Keynesian policy tools like deficit spending, jobs programs, easing of credit – well – they are as a group pretty much off the table or sharply reduced. The New Economics will more likely see
1) election of officials who cut entitlements to keep their jobs (New Jersey comes to mind) but not enough of them;
2) push back on union objectives;
3) some states becoming more attractive than others (per 1 above);
4) planned inflation to pay our bills with depreciated currency – a now global event.

The last of these guarantees a further depreciation of the dollar vis-à-vis world currencies and establishes some new beneficiaries.

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MANUFACTURING

A new manufacturing cycle is beginning. It is being driven by the elimination of middle-class labor. In the New Economics, the manufacturing sector has had an accelerated situation as a by-product of the last 33 months of recession which forced massive layoffs, massive capacity reduction and cost cutting to survive. About capacity: my friend Carl makes it clear some equipment went to Canada or overseas, some buildings were closed or leveled – but a lot were sold for pennies on the dollar and are still out there. To be revisited.

Unlike Congress, most businessmen in the manufacturing world know the risks in re-levering or overextending themselves – and the last few years probably hard wired it into their DNA. This, to me, is a signature characteristic of the New Economy – this rebirth of low-cost manufacturing. It is further supported by two more factors: a persistently depreciated dollar makes our goods far more attractive to the world and, more importantly, the low-cost producer nations against which we compete (China, Korea, et al) now face the rise in unions, wages and worker unrest. As none of these elements are likely to change quickly, U. S. manufacturers (maybe autos) have a rare window of recovery. Regrettably, some skilled labor is not a participant. Retained employees will see lower starting wages, higher participation in insurance costs and the looming pool of skilled unemployed tempering a mood to strike. Further, the closed plants bought for pennies loom as future supply. Sadly, however, manufacturing starts as a small part of the overall economy.

SERVICES

The big engine in the economy is health care, especially for the aging boomers. The medical infrastructure will be in continued significant demand. Many object to folks looking for work outside Home Depot. I suspect our unemployed will slowly edge them aside. Ironic that the claim "these people" were taking American jobs (which at the time nobody wanted in any case) is now moot as Americans increasingly want those jobs as they lack the skills to work in the health or automated manufacturing sectors. The Hispanic community continues to educate their children out of the Home Depot parking lot and into school and then into growing industries. The question is whether our unemployed are willing to go back to school.

And then there is that other huge service industry, Financial Services. More and more Americans still able to use Wall Street are aware of the Street's conflict. Massive paychecks to M & A types, traders, bond and stock brokers (now renamed Financial Consultants) are common knowledge, as is the brilliant job the Street has done of managing risk in the process of selling their wares – there isn't any. Risk has never been an issue at the product level; it has been in the pocket of the customer since the turn of the last century. Many new answers and products will be proposed for those who survive this meltdown, but this time I believe the consumer's level of critical analysis is far higher than ever before. Accordingly, we might expect fewer brokers on commission and a growth in fee-only service. The downside to this is that stock ownership as a percentage of assets will likely continue to fall, from fear, as it has in prior disasters. The irony here is that corporate balance sheets, et al, are improving. Although sales may be at lower levels, margins are rising and corporate boards know dividends are desired and possible, especially when less capital for growth is required.

The push to require banks to trade with their own money, not depositor funds, will also impact the New Economics much the same way a wise consumer impacts Wall Street profits – there will be less. All in all, Wall Street profits and bank profits will suffer, especially at the larger firms. To my mind, it's a return to uncluttered community banking; boutique investment advisors with no products to push and simple savings accounts – big ones – for a while.

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- AND THE MARKETS

The financial services world, the second or third largest industry in our economy, needs working bond and stock markets. If, as I suspect, broad stock returns going forward will be at historically low levels – say 3% to 5% year over year, they will be more than a reflection of slower earnings growth. Below-average price/earnings ratios will reflect a period of rising inflation. In a nutshell, lower earnings growth, broadly, with lower premiums paid for them. Exceptions, of course, but primarily in Asia and, as noted, a few sectors of the U. S. economy – these would include manufacturing, technology, high-end consumer goods wherever originated, commodities, medical supplies and drugs, some food suppliers and some clothiers. There are others; it's just not a universal recovery.

GOVERNMENT

It's not worth belaboring the chaos of Congress and its rituals of tax and spend to buy votes. What I believe is worth stressing is that only a full attack on entitlement programs will restore any confidence in both the dollar and our future. Massive cuts to government hiring and wages, the Social Security, Medicare and Pentagon budgets and all of the industry-specific grants, tax benefits and subsidies are the only way any impact on the long-term deficit will be felt and it's not likely. Tax increases, however, in an environment of true cuts would likely fly with the voting public as it would be seen as a two-pronged effort to fix our future. Tax increases alone guarantee stagnation and we are betting the entitlement cuts will be more talk than action – or so small as to be irrelevant.

CONFIDENCE AND MUDDLE

All business cycles in my memory have substantially rescued themselves. Yes, grand thinkers in academia claim victory of pet theories, but reality is that excesses correct. I believe that we, as a people, unspoken, believe in "muddle through." I further believe even now, that most of us believe that "muddle" is in play. Like the common cold, they believe passage of time is sufficient. Reality is, the very blood of this consumer economy – credit – is tapped out – there is no more room for debt. A Congressman said a year or so ago, ". . . it's all in our heads – it's a lack of confidence." Yes, sure. The fact that I cannot drive at Formula I levels is a hell of a lot more than a lack of confidence and the fact that the economy must de-lever before it can lever again is also more than a lack of confidence. Some confidence would help – but in what? Washington? Religion? Tea Party? To all, no. Perhaps each other, as many times before, but not yet; we aren't in a trusting mode, yet. *The irony is the "haves" will navigate right around all this and that is the point of this paper. They don't really care if the problem is ever properly defined or a solution found. They will navigate and that is a recent, significant change.*

DEMOGRAPHICS

The age group 35-54 has historically been the "savers" – major costs behind, some free cash, retirement on the horizon – a time to start saving. Tim Bond of Barclays shows an interesting link however: Rising stock values correlated strongly with the rising ratio of this 35-54 group in the population. Of course, a belief in stocks as a universal panacea is part of it, but this trend of correlated stocks and "savers" has persisted since the Second World War, in both directions.

Today, the direction has changed again and the number of retired is the larger cohort. Full-service brokers' share of American wealth has fallen from 43% to 27% and saving, not stocks, is deemed sufficient financial planning.

In the U. S., we know we have an increasing number of retirees relative to the work force – but it is worse in Europe as low birth rates also kick in, and in Asia – Japan in particular – it's severe. The

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point is an aging labor force translates to a slowing economy. (Only the African continent is seeing labor-force growth.) Of course, immigration can flip this model around, but that trend is not likely as it threatens a nation's sense of self. Thus we see in the press a marked push to raise retirement ages, encourage more children and allow skilled immigration only.

The other side of this global aging is the way the aged vote. We know they are more reliable voters – a case study is now underway as the Obama White House watches the massive number of young voters, marshaled in 2008, via Twitter, et al, fade away. Lack of attention from that age group is not unique – but full attention of (new) older Twitter users is. This could get interesting, I think.

Some possible outcomes from these demographics, especially here in the States, might include

1) a boost to entrepreneurialism as near-retired and retired pursue one of the last American dreams – self-employment (61% of Americans surveyed said it's their preference, older Europeans with massive social safety nets, well, not so much);
2) massive votes for health care et al, paid by "the government" pushed back by women voters who "get" the cost to their grandchildren;
3) inherent pessimism, reflecting life's scars more than facts or, if you prefer, less of the joy and optimism of youth.

CONCLUSIONS

It is a perfect storm of debased politicians, debased currency and debased confidence triggered by a collapse of credit and fueled by two bubbles; housing and Wall Street. Wow. A faith that government can fix things, a free market can create wealth, social policies can be modeled, and will work, and global personal interests can be aligned, all are under attack. The government can fix the mess they made, as noted prior, wealth can be created in a regulated free market and a few social policies (charter schools, for one) actually do work. When the world's angry people see a way out of their cycle of religious or ethnic hatred, have food on the table and a chance at a better life, then maybe global interests will further align. In the meantime, kick the can down the road, experiment, pretend wisdom and . . . well . . . punt. We investors are left to maneuver around that, whistle on.

Which brings me full circle to the beginning of this screed. The lack of any clear, painful plan to a better future is missing. Delivering it will cost the elected their jobs. Accordingly, the New Economics may be described as a vacuum being filled in Asia by people who have adopted what we used to preach. Oh, profits as a percent of GDP will rise for corporations – it's a given. Exports will help that, of course. Expanding your business makes little sense, however, given the currency wars. Improved efficiency, not hiring, is the New Economic model for business, as is punishing suppliers. Sadly, firms that need fewer humans will be the better investments.

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