TrendMacrolytics

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Risks to Expansion: Reality or Spin?

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Today's pessimism is due more to media bias than to economic fundamentals.

Reports of the threatened demise of this economic expansion, to paraphrase **Mark Twain**, have been greatly exaggerated. While we don't minimize the risk factors in the economic landscape, there are few indications as yet that these risks pose obstacles daunting enough to torpedo prospects for sustained growth, and fairly robust levels of growth at that. To a considerable extent, the down-shift in economic sentiment appears based at least as much on the dour tone of media reports of the economy's recent performance as it is on a clear-eyed assessment of actual performance. In much of this coverage, it's not difficult to discern the news coverage being trimmed in such a way as to reflect negatively on **President Bush's** economic stewardship. That may help explain the apparent disparity in the polling which shows that although a solid majority of voters are quite content with their personal financial situation, they continue to have strong misgivings about the economy's health.

The galvanizing event shaping the gloomier perceptions of current economic conditions was the release of the July employment report by the **Bureau of Labor Statistics** on August 6. More specifically, though, it was the establishment survey portion of the report which recorded a second consecutive month of paltry payroll gains, with only 32,000 new jobs reported. In treatment typical of the big media response to the data, the ***New York Times*** headline screamed, "Slow Job Growth Raises Concerns on U.S. Economy." The lead sentence of the article set the tone: "Job growth ground nearly to a halt last month, the Labor Department reported yesterday, raising new concerns about the economy's strength and reshaping the political debate over its performance less than three months before election day."

Of course, as the "newspaper of record" and the organ viewed as the standard setter for news coverage by the establishment press, such reporting by the *Times* in and of itself plays a critical role in "raising new concerns" about the economy and "reshaping the political debate." With a blatant act of omission, however, the *Times* also provided a telling insight about which side it stands on in that debate. While the establishment survey captured a weak month for payroll expansion, the accompanying household survey showed the number of people working actually grew by a stunning 629,000. Economists have engaged in a long-running debate about the relative merits of the two surveys, but it would seem the disparity between the two would at least be worth noting in a "news" piece about the employment data. The *Times,* however, even while mentioning the household survey as the source of data showing the unemployment rate falling from 5.6% to 5.5%, studiously avoided it.

The *Times* was hardly alone, however, as neither the ***Wall Street Journal*** nor the ***Washington Post*** -- which together with the *Times* comprise the Big Three of the establishment print media -- saw fit to acknowledge the job creation documented by the companion household survey. The exclusion seems difficult to excuse as an innocent matter of news judgment, coinciding as it did with release by BLS of a report concluding that "both the payroll and household surveys are needed for a complete picture of the labor market." For our part, as we've discussed previously,

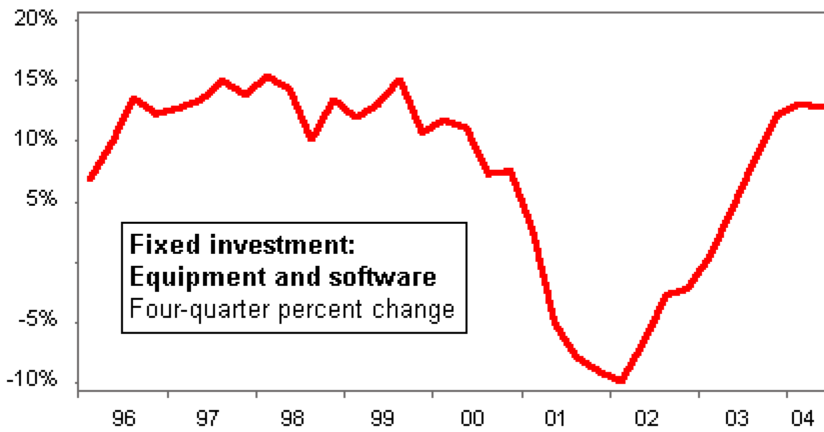
the household survey appears to be more sensitive to current elements of a dynamic and changing labor market. For one thing, the establishment data -- derived as it is from a survey of employers -- entirely excludes the self-employed. But with growth of more than one million self-employed workers since the last recession ended in November 2001, the household data shows that this has been one of the fastest growing segments of the labor market. In fact, growth in the number of people identifying themselves as self-employed is more than double the 400,000 net payroll gains during this period. In addition, because participation in the establishment survey is concentrated among larger businesses, it typically lags the household survey during early stages of economic expansions, since hiring tends to pick up first in small businesses.

Having set the scene of an expansion showing signs of stress during a presidential campaign season, it wasn't much of a leap for elements of the media elite to finger President Bush's economic policies -- particularly his signature tax cuts -- as responsible for his heightened vulnerability on the economy. "[A]fter three successive tax cuts…the president faces an unenviable choice," the *Post* intoned on its news pages last week. "He can either concede that his $1.7 trillion tonic has not worked as advertised, or he can insist that the economy is strong despite the slowdown in growth and job creation." With its primary sources questioning the efficacy of the tax cuts while casting doubt on the durability of the expansion, the intended linkage of the two was clear. "The jobs figures allow Kerry to say that the recovery is sputtering and the tax cuts didn't help much," said one such source. "Kerry can say for the next month that the tax cuts didn't work. And he can say that with some justification. The tax cuts worked for a few months, but the impact has faded."

The *Post* article was published the day following last week's **FOMC** meeting, after which the Fed's announcement pointed to rising oil prices to explain the recent softness in output and job growth, while asserting that the economy "appears poised to resume a stronger pace of expansion going forward." There was no mention of the **Fed** statement in the *Post*. In a perhaps even more telling omission in what was purportedly a journalistic exercise assessing the economic/political consequences of the Bush tax cuts, the *Post* story quoted no one outlining the effects of the reduced tax rates in boosting incentives for capital investment, risk-taking and wealth creation. From the perspective of the *Post's* editors and writers, that was understandable, we suppose. To have acknowledged such beneficial effects would have countered the obviously intended gist of the piece in the first place.

Because from all available evidence, the slashed tax rates on capital gains, dividends and marginal personal income continue to provide a critical foundation for the capital formation and entrepreneurship that are the lifeblood of any sustainable economic expansion. We don't dispute that the volatile and weak performance of the equity markets has been a source of considerable concern. Political uncertainty and the potential deleterious effects of surging energy prices are taking a toll, boosting the market's risk premium to levels that -- at least in the case of tech stocks -- have risen all the way back to levels seen at the October 2002 panic bottom.

At the grassroots, however, where the rubber meets the road in terms of the growth-driving decisions to put investment resources to work to capture available returns, there has been no signs of slackening. In our analysis, the crucial payoff of last year's tax cuts came in boosting the marginal expected after-tax returns to risk taking, reducing the cost of capital and thereby encouraging expansion of the capital stock. The results continue to impress. The advanced report of a third quarter GDP growth rate of 3% was widely regarded as disappointing, and we'd be inclined to agree if we saw indications that it was matched by a decline in expected returns that was hindering fixed investment. To the contrary, however, equipment and software expenditures steamed ahead at an annual rate of nearly 10%, more than double the pace of the same quarter a year ago, which ended just as the tax cuts were coming into force. On a four-



quarter basis, equipment and software investment is up at a rate of 12.8%, best since the late 1990s. Meanwhile, the industrial production report for July released by the Fed earlier this week showed production in the high tech category of computers, communications equipment and semiconductors grew by 2.5% in July, and is up at an annual rate of some 35% the past three months. At the same time, the economy's entrepreneurial engines appear to be well oiled. In the third quarter, proprietors' income -- which is as close as the GDP accounts get to capturing entrepreneurial activity -- grew at an annual rate of 15%. On a four-quarter moving average of a four-quarter rate, proprietors' income is growing at a better-than 10% rate, highest since the mid-1990s.

Again, we don't dismiss the risks to what we see as a generally vibrant outlook. Of course, crude oil nearing the $50 level is a risk factor that cannot be ignored, and if it remains at this level for an extended period of time, or goes higher, it will pose a considerable impediment to maintaining vigorous growth levels -- at least until the economy adapts to it. However, the speculative dynamics of the market appear to have overwhelmed fundamental supply and demand factors, which suggests that once the fever breaks, the price could crack just as sharply as it ran up. While we offer no guarantees in that regard, neither are we prepared to downgrade our generally upbeat view. We note again, though, that perhaps the greatest risk posed by the oil price escalation is that the Fed will accommodate it, further cheapening the dollar's real value and permitting the general price level to ratchet higher along with petroleum prices. TM