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No Respect

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This expansion remains robust -- and its detractors are focusing on every risk except the relevant ones.

Call it the **Rodney Dangerfield economy**. Despite gains in **output**, **income** and **profits** that routinely surprise on the upside, this **expansion** continues to get no respect from the **mainstream media** and a large part of the **economic establishment**. This week, two of the pillars of big media, the ***Wall Street Journal*** and ***New York Times**,* each ran stories suggesting that even good economic news carries the seeds of its own potential demise. "For every encouraging sign, there is an explanation," the *Times* offered, as if that fact should be considered unusual in some way. Given the relentless drumbeat of negativity, it's not terribly surprising that a recent poll showed more than 40% of respondents believe the economy is now in **recession**, up from less than 30% a year ago.

This lingering anxiety also helps explain the persistence of the misguided belief that **the Fed's rate normalization program** threatens to derail the economy, which has led to repeated rounds of unfounded speculation that the Fed is about to put an early end to the cycle. This, despite the fact that the economy has chalked up **real GDP growth rates** averaging 3.7% in the five quarters since the **rate hikes** began in mid-2004, and just recorded the best quarter of the bunch, with real growth of 4.3% in this year's third quarter. Contrary to much of the conventional wisdom, one of the biggest risks to the expansion would be a premature halt to the central bank's campaign to restore **monetary equilibrium**, allowing a damaging spike in **inflation** to break out.

A major theme of much recent commentary is that the expansion has become overly dependent on over-extended **consumers**, riding high on a **housing bubble** that's sure to burst, bringing the economy down with it. The impression created is that **business investment** must be lagging, with **corporate cash** being funneled into **dividends** and **stock buybacks**. A front-pager in Monday's *Wall Street Journal* expounded on this premise, suggesting that rising dividend payments were potentially hindering future growth, a sign that **corporate America** sees dwindling opportunities to profitably put **capital** to work.

This proposition is woefully lacking in empirical support. While it's gone largely unnoticed by the popular press, **capital investment** has been the fastest growing segment of the economy. Yesterday's revised third quarter GDP numbers showed **core capital goods expenditures** -- for **equipment** and **software** -- growing at a 10.8% annual rate. On Tuesday, the **Commerce Department** reported **new orders for nondefense capital goods excluding aircraft** rose by 1.3% in October, are up at an annual rate of more than 14.5% the last three months, and have grown by 10.7% in the past year.

A sea change in the climate for business fixed investment was catalyzed by the **2003 tax cuts on dividends and capital gains**, which at the stroke of a pen increased expected **after-tax**

returns producing a concomitant reduction in the **cost of capital**. Since passage of the tax cuts, **fixed investment** has grown at annual rate averaging better-than 8%, more than double the growth rate of the overall economy. This has been an exercise in capturing the available returns while at the same time expanding the economy's **productive capacity**, laying the foundations for the income gains to power future growth. Now, however, this virtuous cycle faces a real threat. With the tax cuts due to sunset in 2008, the **Republican congressional majority** has been stymied by splits in its own ranks in attempting to enact a two-year extension of the cuts. Such disarray can only increase uncertainty about future investment returns, adding a **risk premium** to the cost of capital and potentially posing new obstacles to **capital formation**.

We continue to find the alarmist case pointing to the supposed fragility of **the residential real estate market** as a major source of economic risk significantly overdone (see "Housing Bubble Bunkum" August 26, 2005). Income growth and **non-real estate gains** to **household net worth** remain robust and will in all likelihood continue to support **consumption** even in the face of a cooling housing market.

Another source of worry in some quarters is the relatively **flat yield curve** and the specter of it possibly moving to **inversion**, a development often reputed to be a precursor of recession. It's worth noting that the late 1990s also were marked by a flat curve. During 1998 and 1999, the **10/2 curve** averaged less than 20 basis points with no deleterious economic consequences. The curve did not invert on a sustained basis until 2000, when a **deflationary** Fed pushed **real short term rates** to economy-choking levels above 4%. The subsequent economic **downturn** was precipitated by a massively **too-tight monetary policy**, one byproduct of which was the inverted yield curve. The curve inversion, in other words, was an *effect*, not the *cause*, of the economic slump precipitated by deflationary **monetary error**.

With **gold** at $500 for the first time in 18 years, it's apparent that a too-tight Fed is not the relevant risk factor. Indeed, gold continuing to rally in the face of a real funds rate of 2% on a **core-inflation** basis indicates that the Fed remains too **accommodative**, and that the market is upping the odds that policy will not move to **equilibrium** before a significant inflation event transpires.

Bottom Line: The climate of skepticism surrounding the health of the economy belies the fact that this expansion continues to perform impressively by nearly every measure. The forces driving growth are likely to prove self-sustaining on a long-term basis unless policy error interferes with the expansionary impulse. Two sources of potential error -- in tax and monetary policy -- are currently in play and are imparting some degree of uncertainty in an otherwise highly positive economic environment. TM