

Something to Think About



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COMMON CENTS

This morning, the Bureau of Labor Statistics (BLS) released the Employment Situation report for June 2016. It was pretty good, as the economy apparently created 287K net new jobs last month. That number is even better when you consider employers only created 11K during May. In truth, this wild swing was undoubtedly due to problems with the 'seasonal adjustment factors' the BLS uses to smooth out monthly vagaries. To that end, May job gains were probably understated, and June's were/are likely overstated. An average of the two months, 149.5K, gives a better picture of the true health of the current job market.

Seasonal adjustment factors? Believe it or not, they are kind of necessary. For instance, a 25-year old elementary school teacher might get a part-time job waiting tables, etc., to make extra money during the summer. For the purposes of the non-adjusted Establishment Survey, they go off education payrolls in May and onto 'leisure & hospitality,' only to reverse in August or September. As a result, you would see short-term sector swings without a true change in long-term employment trends in either industry, or in the economy in aggregate. Over time, the adjusted and non-adjusted numbers will mostly converge. Basically, seasonal adjustment factors try to eliminate the monthly 'noise,' and didn't do a great job of it in May and, more than likely, June.

As reported, June's job gains were pretty decently distributed across the service sector, even if the 'goods producing' side, which includes mining and construction struggled somewhat. Services and government created 279K jobs last month, and so-called goods producers created 9K. Of that 9K, 13K were in 'food manufacturing,' which was kind of a surprising jump, real surprisingly actually. You see, over the last 20 years, this subsector averages cutting 9 jobs per month, and 1 standard deviation is 4.64K. So, a monthly observation of 13K is close to 3 standard deviations from the mean, which is far from normal.

Clearly, that is my inner nerd coming 'out,' and, I confess, it is getting harder to keep him 'in' these days.

As the old saying goes, you should never look gift horses in the mouth. However, the headline number of 287K jobs is just that, the headline number. While the media and the markets will focus on it today and the days to come, there were some less than, say, exuberant data points, if only you took the time to find them.

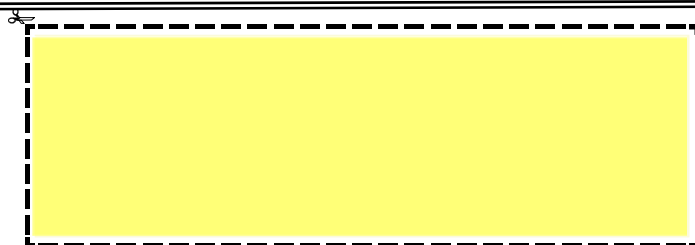
According to the Household Survey portion of the release, the Employment to Population ratio (the percentage of working age people holding down a job) actually slipped during the month back down to 59.6% from 59.7%. While this number is better than it has been for much of the current Administration (58.9%), it appears to have stalled somewhat here in 2016. Further, it is still comfortably less than the 20-year and 40-year averages of 61.6% and 61.1% respectively.

While much of the decrease is due to our aging population, the fact remains: median household income in the United States isn't going to suddenly surge when less than 60% of the working age population is actually working, and with average weekly earnings growing at roughly a 2.3% clip. Factor out inflation, and real weekly earnings are growing in the 1.0-1.25% range.

So, how do we get to that magic 3% GDP number with the Employment to Population ratio where

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it is and real earnings hovering around 1.5%, or maybe even less? Remember, Personal Consumer Expenditures make up a shade less than 70% of the equation. I don't have a good answer for that unless the US consumer starts to really tack on some additional debt, and I don't think that is a positive solution.

Without a doubt, that is a dark cloud in the silver linings of the report. Some might even say it is a glass if half-empty way of viewing the world. I would counter with: "it is what it is, and I am trying to come up with a reason why US GDP, and by association corporate profits, will suddenly surge from this point." Trust me, I want to find one.

In truth, recent US economic data has been pretty decent. However, I feel as though I have been looking at the same data sets for the last several years. If you could roll them up as one, a fair analogy would be white sheet cake with white icing. If cake isn't your thing, how would a cold Budweiser sound? Maybe a Five Guys burger and fries? A Honda Accord? I mean, this stuff has been straight down the middle for some time now. It doesn't really elicit much excitement one way or the other. It is "all good," but it ain't "all great."

We need great, because too many people are getting left behind here, or at least feel like they are. That is really what is most important.

Like many people, I have watched this year's Presidential primaries and campaigns with a mixture of bemusement, frustration, and even resignation. With some risk, I won't mince words here: Bernie Sanders would not have gotten in excess of 13 million votes during the primaries and Donald Trump would not be the presumptive GOP candidate for President IF people thought they were moving forward individually. A full decade, literally, of sub-3% GDP growth will do that to you. Seriously. Over the last 40 quarters, the US economy has grown at a 1.3% annualized clip (real terms).

From 1Q 1957 through 1Q 2016, that is the worst 10-year stretch in our nation's economy. ...*starting with data from 1Q 1947.*

More importantly, and this is the scary thing, in 2014 (*the last year for which the Census published run the numbers*), median household income in the United States was \$53,657 in constant 2011 dollars. By comparison, it was \$57,843 in 1999 and \$53,306 in, get this, 1989. As such, the median US household, smack dab in the middle, hasn't seen an substantial increase in its purchasing power in 25 years. Put another way, our standard of living has basically stagnated, in aggregate, albeit at a high level by global standards. If we want to phrase things even more depressingly, this means upwards of 50% of US households have seen a decline in their purchasing power over the last quarter century! Of course, this will vary wildly among individual households, but the math is the math. If the median hasn't really gotten ahead, everyone under it really hasn't either, for all intents and purposes.

This is and has been my bigger concern; it isn't overall economic growth, which is on pace for 2.0% +/- 0.25%, for the foreseeable future. There will be blips in the road, but that is the long-term trend, and there is no reason to think it is going to sudden change dramatically. However, 2% doesn't mean 2% for everyone. If so, the median household income would be well above where it is, and certainly not below 1999 levels and within spitting distance of 1989's.

The GDP calculation is just that, a calculation. The top 50% can grow on average 4%, and the bottom 50% can grow

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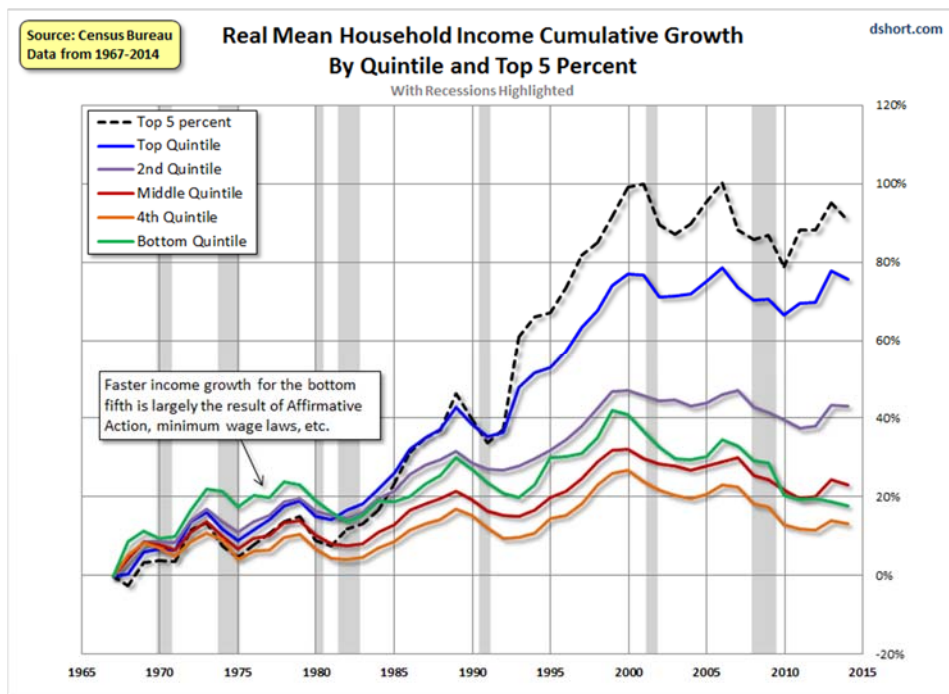
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0%. What is the end number? That's right, 2%. Or the top 25% can grow 6%; the next 25% can grow 2%, and everyone else grows, again, 0%. What is the answer then? Oh, you know it: 2%. There are any number of growth rates I can use to get to 2%, but that doesn't mean I have to distribute them evenly. To that end, the economy hasn't done so evenly either.



Consider the chart to the left. I admit I pulled it off the Internet (advisorperspectives.com), and the numbers might be a little hard to read. However, the lines are pretty self-explanatory. Median household income growth was incredibly disproportionate from the mid 1960s through the end of the recession in the early 1990s. Then something happened; the top quintile income earners started to see significant growth; the next quartile had some growth, not awesome, but growth nonetheless, and; after a slight pump in the 1990s, the remaining 3 quintiles have seen a pretty steady erosion in their purchasing power.

Yes, people move in between income quintiles throughout their working

lives, and, again yes, the definition of household can and will change over time. Still, these are data points for unbiased quintiles, and not individual fluctuations. That should be a smoothing adjustment factor. But, look at that chart. How could that not but engender societal frustration? How could the conditions represented in this chart not disenfranchise people? How could this trend not but give rise to populist politicians? How could it not call into question what we have been doing and forcing hard questions about what we should be doing instead? If this continues much longer, we risk permanently 'losing' vast numbers of Americans from the dream that is our country and its economy.

With this in mind, consider the chart to the right. What number kind of pops out at you? Keeping in mind it was around 1992, from the chart above, when the Top 20% of income earners started to diverge from the remainder of the back in a big way. Then consider the performance of the bottom three quintiles in 2007 (just prior to the gray bar) and since. Then look at the table to find the corresponding years.

At first blush, there would seem to be a pretty significant correlation between the absolute levels of 'entitlement' spending in the Federal budget and the purchasing power performance of the bottom three income quintiles. Perhaps not surprisingly, government transfers constitute a higher percentage of household income for the

The Federal Budget, 1992-2012

IN BILLIONS OF INFLATION-ADJUSTED DOLLARS (2012)

	Discretionary Spending	Entitlement Spending	Net Interest	Total Spending	Total Revenue	Surplus/Deficit
1992	\$803	\$976	\$300	\$2,079	\$1,642	-\$437
1993	795	988	293	2,076	1,700	-376
1994	781	1,035	293	2,109	1,815	-293
1995	770	1,044	328	2,142	1,910	-232
1996	739	1,091	334	2,164	2,015	-149
1997	745	1,104	332	2,181	2,152	-30
1998	744	1,158	325	2,226	2,320	93
1999	760	1,195	305	2,260	2,426	167
2000	799	1,236	290	2,325	2,632	307
2001	825	1,280	262	2,367	2,530	163
2002	918	1,383	214	2,515	2,318	-197
2003	1,010	1,448	188	2,646	2,183	-463
2004	1,066	1,474	191	2,731	2,240	-491
2005	1,117	1,521	212	2,850	2,483	-367
2006	1,135	1,577	253	2,965	2,688	-277
2007	1,131	1,574	257	2,962	2,787	-174
2008	1,205	1,694	269	3,168	2,681	-487
2009	1,300	2,199	197	3,696	2,212	-1,484
2010	1,399	1,987	204	3,590	2,247	-1,344
2011	1,371	2,062	234	3,666	2,344	-1,322
2012	1,289	2,053	220	3,563	2,435	-1,128

Source: Office of Management and Budget, *Budget of the U.S. Government, FY 2013: Historical Tables*, Tables 8.1 and 1.1, February 2012, <http://www.whitehouse.gov/omb/budget/Historicals> (accessed August 8, 2012), and Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012, Table 1-1, <http://cbo.gov/publication/43543> (accessed August 23, 2012).

Federal Spending by the Numbers 2012 heritage.org

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bottom 3 income quintiles than the top 2. The percentages (2011) are as follows by income quintile, bottom first, are as follows: 37.0%; 34.7%; 24.8%; 14.5%, and 4.5%.

<https://www.cbo.gov/sites/default/files/113th-congress-2013-2014/reports/49440-Distribution-of-Income-and-Taxes-2.pdf>.

Obviously, this is common sense. The less ‘market’ income you make, the greater the impact of ‘government transfers’ on overall household income. However, I would be remiss if I didn’t make the following observation(s) in keeping with the time frames on the previous table: there was not a significant increase in Federal outlays as a percent of GDP from 1992-2012 (21.5% — 22.1%), as hard as that is to believe. However, as the table suggests, entitlements as a percent of overall spending increased from 46.9% in 1992 to 57.6% in 2012. As a result, ‘entitlements’ payments increased from 10.1% to 12.7%, with little discernible gain in purchasing power for the lower income quintiles, and a massive increase in our accumulated deficit to show for it.

We could have a chicken and egg debate on the subject until Doomsday; we could discuss the changes in our nation’s demographics; we could harangue about China’s inclusion in the global economy, and how unready we were for it; we could argue back and forth on this and that, but it wouldn’t change the numbers. The median American household is worse off than it was at the start of the century, and not really any better than it was 25 years ago. In the meantime, entitlements programs as a percent of GDP have mushroomed, relatively speaking. As a result, regardless of the reasons and nuances, the black & white data suggests our increased reliance on government spending as a percent of household income hasn’t coincided with any real improvement in overall household wealth. In return, our accumulated deficit increased from \$4.064 trillion and 62.4% of GDP at the end of 1992 to \$16.433 trillion and 100.8% of GDP at the end of 2012.

By comparison, nominal Gross Domestic Product increased from an accepted \$6.539 trillion in 1992 to \$16.663 trillion in 2012. That is an increase of \$9.616 trillion (nominal) for which the US Treasury increased its debt burden by \$12.368 trillion. It kind of makes you wonder: where did the other \$2.752 trillion go? Did we eat it? Well, the growth in employment at ‘food services & drinking places’ over the 20 years suggests that is a real possibility.

Who knows? Maybe things would have been worse for the average American household but for the sharp increase in Federal entitlements expenditures, and that is a real possibility. However, it is impossible to prove with any accuracy. All we know is we have borrowed more than we have made, and an increasing amount of what our government spends goes to so-called entitlements programs. Perhaps counterintuitively, this hasn’t led to any discernible increase in purchasing power for the average American household. In fact, a considerable percent of American households have seen their purchasing power decline, pretty significantly, since the start of the century.

We have the actual data for that...no pro forma spreadsheets or ‘yes...but’ analyses.

Now, I would like to stop short of saying there is a cause & effect here. Perhaps there is one, and perhaps there isn’t. However, I have also heard what Albert Einstein was famed for saying: “Insanity: doing the same thing over and over again and expecting different results.”

This is a huge chunk of the reason why I pour through Employment Situation reports trying to find dark clouds, as op-

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posed to silver linings. I want to be able to extinguish all negative thoughts and say “FINALLY”! Basically, I want to be able to find enough clear evidence of the type of growth that will lift every household up, not just the top 20%, and not this steady stream of 2.0%, or thereabouts, with tepid earnings growth for the most part. I mean, I want it to surge, and I want to be 100% equities 100% of the time.

Intuitively, if the whole shebang is growing 2%, some people will be doing much better than that and others will be doing much worse. That number is just NOT good enough to keep everyone engaged and enfranchised in the system. As I mentioned previously, I think the events of this year suggest we are seeing some real evidence of this, with last night’s events in Dallas being only the most recently example.

Certainly, there have always been the disengaged, and there always will be. However, that number seems to have grown, and seems likely to continue to grow. To that end, a recent NBC News/Wall Street Journal poll conducted 6/19-6/23 had 71% of respondents saying the country was heading in the “wrong track,” and only 21% responding we were moving in the “right direction.” Trust me, these answers are much closer to the historic extremes than the mean.

In the end, despite all the negativity in this week’s piece, the BLS released a very decent Employment Situation report this morning. The fears the markets had about the labor markets falling apart in May proved to be perhaps a little premature. As a result, the markets are having a good day, and I am happy for it. However, not much long-term has really changed, at least not enough to warrant any major changes in investment strategy. We still anticipate the markets will continue to be volatile for the remainder of the summer, and we still don’t see any reason to alter our 2% GDP forecast for the year.

Trust me, some fool thing will happen somewhere in the world that will present a better buying opportunity at a later date than trying to catch up with the market this morning. It came out of the gate hot after a jobs report that played ‘catch up’ from last month, and has pretty much stayed there all day. Given the relatively fragile psyche of the global investor, and for good reason, it probably won’t take too much to reverse today’s gains.

I am getting rather used to this.