WESTWOOD CAPITAL, LLC

MACRO NOTE

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Waging War on Wages
The Global Game of Supply Glut

We have written for years on the subject of the worldwide glut of labor and capacity relative to aggregate global demand. You are likely sick of hearing from us on the subject. But do read on – or if you are short on time, skip to our newest graphs at the end.

Last Friday's U.S. Employment Situation report - having startled so many in the economic forecasting dodge - is so profoundly illustrative of what we have been saying that it is appropriate to comment once more.

There are many ways to gauge the status of employment in any country - and the U.S. is so rich in data points that economic professionals tend to either over-analyze matters or reduce them to simplistic talisman such as the official unemployment rate. During most periods, basic trends suffice in establishing policy. But in times of global change and new macroeconomic challenges it is of vital importance that we focus on the indicators that really address the salient matters facing us.

The U.S. is facing perhaps its greatest economic struggle - not just since the 1930's, but possibly in its history. We are faced not merely with domestic problems that we are in control of remedying - but with the results of a changes to the global playing field that make the contest in which we are engaged seem unfamiliar, as though we are visitors on another team's home turf.

So much is this the case that we aren't able to score the game in a manner that makes clear who is winning and who is losing, or what strategies to employ that might enable the U.S. to prevail in a comeback.

Let's try to change that, below.

The Global Contest for Jobs

As detailed in depth in our report last month entitled "The Flight of the Doves," we are faced with a "war on wages" launched by the severe and unprecedented supply-shock following the massive shift in the global political-economic paradigm when the full force of post-socialist, poor, emerging nations with some 3,300,000,000 people was let loose on a post-industrial, wealthy developed world of only 660,000,000.

This is a numbers game if there ever was one. It's been engaged in earnest for some 15 years (longer than even a cricket test match) and features sides that are decidedly lopsided – extraordinary human resources on one and astonishing wealth on the other.

The resulting imbalances affecting both sides are without parallel in the modern era and are destined to play out in a way that defies the conventional game plans of developed economies.

The objective of this new pastime is for each side to try to accommodate the imbalances in a way that minimizes social and economic disruption long enough to make it to the final round of rebalanced global growth and productivity. And in the finals to come, the leading countries will be afforded the opportunity to once again play on a leveled pitch that features fair and sustainable competition, with wealth accruing to those able to play better – not just field a bigger team.

We need to make it to the finals. And to do that we will need to understand the rules of play a whole lot better than we have been.

The Rules of the Game

Here are the metrics that matter in the global competition:

- The extent to which each side's economy actually produces what it consumes (or exports something in the neighborhood of what it imports).

- The ability of each sides production to support its population – either in the style to which its people have become accustomed (in the case of the developed world), or in the style to which it's people aspire to (in the case of the emerging markets). This is necessary in order to maintain social stability without recourse to unconventional methods (such as totalitarianism).

- Three employment measures – solving for aggregate real wages;

    - The level of employment relative to population – the more workers employed, the higher the per capita GDP (in real terms if prices are relatively stable or falling) as jobs create consumption and growth throughout the private sector;
    - Wages in real terms (relative to the cost of living);
    - Hours worked (seen in terms of the number of employees that can only find part time jobs, when they would prefer to work full time)

- Multifactor productivity, adjusted for unemployment levels or underemployment levels – take your pick – because even the most productive economy that fails to adequately employ its people cannot sustain itself as a political matter.

- The relative diffusion of income – one wealthy worker making trillions of dollars a year in a society of millions of people, the rest of whom are unemployed, may make for attractive per capita wage and aggregate wage metrics. But it affords nothing by the way of political stability or social adhesion. Prosperity, in a fully functional economy, must certainly be enjoyed by those who risk capital and deliver results – but one test of the stability of an economy is the extent to which its non-entrepreneurial constituents also reasonably prosper.

What is fairly extraneous, in an era of excess labor relative to aggregate demand, is how a country determines the size of its labor force (who is counted and who isn't), or the precise nature of what it means to be employed, unemployed or underemployed. Those issues are all quite relevant at the margin in what used to be called "normal" periods without excess labor and productive capacity.

It is clear that, measured by the forgoing normal indicators, the U.S. is doing poorly. But measured against the important metrics above, our present level of competitiveness is even more alarming.

The U.S. is failing in its recovery because it is falling back on the game plan of the past three decades: the plugging of the gap between (i) personal income and (ii) the living standards and entitlements demanded by the polity, with oceans of private sector debt and government deficits, which are funded either with more government debt or, more recently, by simply printing money.

It would be fair to say that these policies really were doomed even before the bubble began, as the productivity boom of the late 1990's petered out and emerging market labor organized its successful offensive attack on U.S. manufacturing and other jobs (using, by the way, many of the tools that the U.S.-led internet technology revolution provided to enhance their ability to compete). As the gap between production and consumption widened in this country, we embarked on a destiny that was unsustainable – inflating assets beyond their productive values (housing assets chief among them) to funnel oceans of debt to consumers and incurring additional government debt to finance that for which the electorate is unwilling to be taxed to provide[1].

The emerging markets and other net exporters were all too pleased to buy our treasury debt and other bonds to cycle the very cash we were paying them for their manufactures back to the U.S. as a creditor – ensuring that interest rates remained low and demand for debt capital was exceeded by supply. Plugging the U.S. production shortfall, relative to consumption, was and remains the emerging markets' (particularly China's) path to meeting the aspirations of their peoples through greater employment.

The Score Card

At the very least the U.S. real economy, corporate equities aside, has been suffering a "losing season" (to continue the metaphor) that has lasted years. The pool of excess domestic labor is added to monthly – both in terms of (i) the number of people idled in nominal terms, and (ii) the percentage of our population that can actually find work. For those who are employed, real wages have remained flat for many years (although they spiked up slightly during the period of recessionary deflation) and we are now seeing the prospect of nominal wages falling in many categories, together with a decline in real wage levels overall. The number of people who are recorded as being employed but can only find work part time (1 to 34 hours per week) because the economy is weak, has begun to rise again as a percentage of total employment.

We believe that with the failure of reflationary policy becoming clear, the burdens of unresolved excess household debt continuing to impact consumers, and the global wage rate imbalances impacting more industries as time goes by, some degree of wage and price disinflation is likely to be realized over the coming years. In fact, we believe the wage side of the equation is already being played out.

The following graphs demonstrate the inflection points at which the U.S. economy finds itself with regard to labor and employment.

In this first graph, on the following page, we have stacked the unemployed, underemployed, employed and the total labor force into a stack, comparing those components to the overall civilian non-institutional population (people 16 years and over who are not full time students, in the military or incarcerated), or the "CNIP." This illustrates not only the extent to which the number of employed has dropped since the crisis, but how the labor force itself has failed to track growth in the CNIP since 2000 and, more acutely so, since the commencement of the financial crisis.

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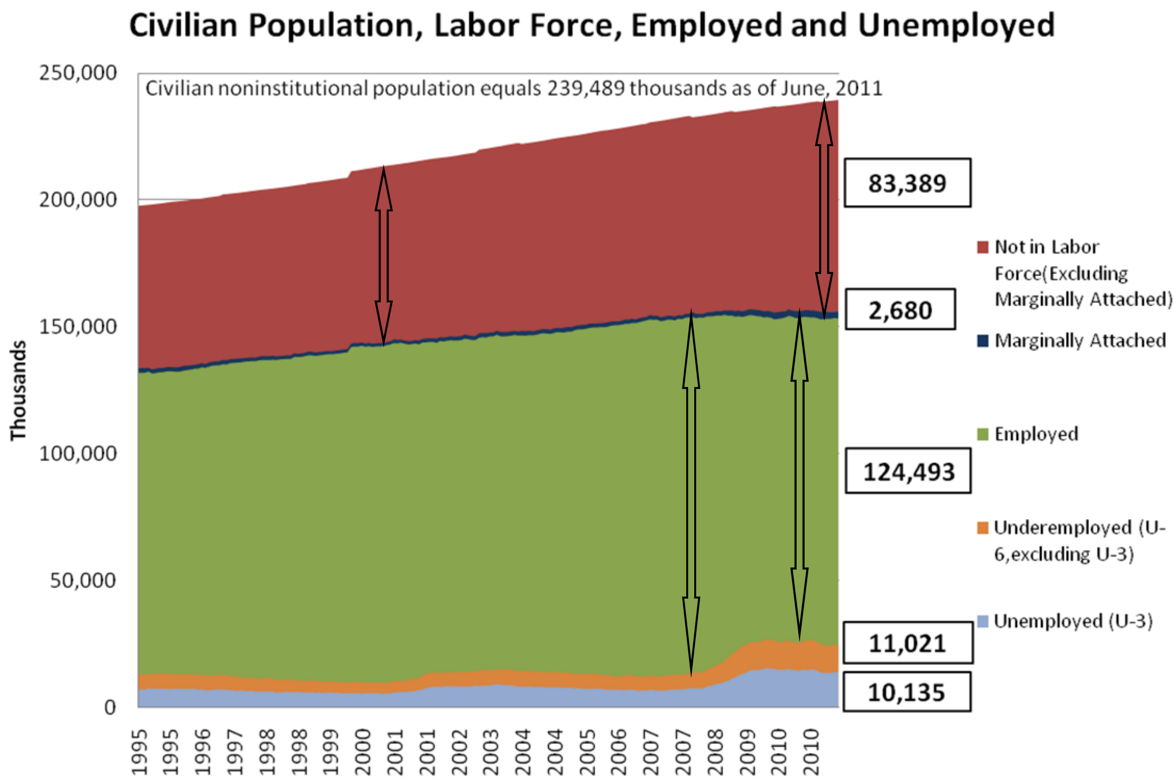
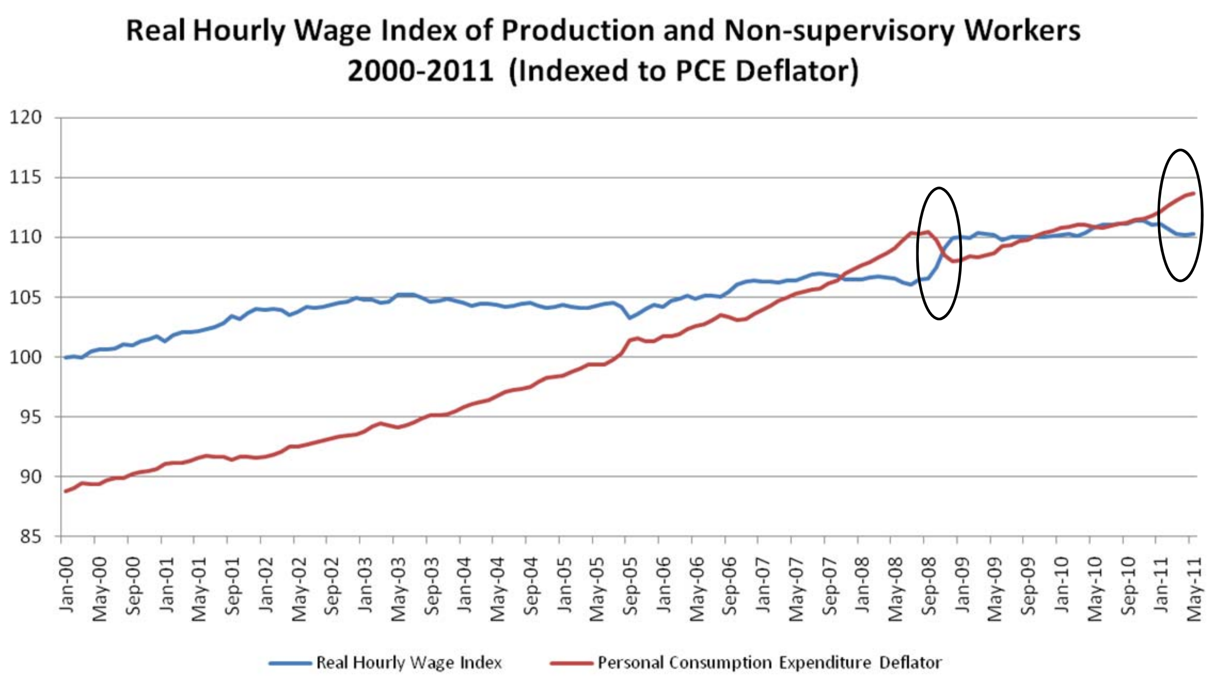
[1] Much is made of the expenses of the ongoing wars against terrorism and tyrants following 9-11, in this regard. But we must insist that the issue isn't the expenses war or social entitlements alone. The issue is a combination of spending <u>and</u> the unwillingness of the population acting through their representatives to be taxed to pay those expenses – a policy of the so-called Conservative element that we call "Don't Tax and Spend Anyway."



As noted above, real wages in the U.S. have been flat for an extended period – since 2001. Some relief was offered by deflation during the recession in 2008, but we are now seeing (i) renewed inflation, plus (ii) flat to declining nominal wage rates, combining to force real wages back down. And this is in an environment where much of downward nominal wage pressure has been "banked" in the form of high un- and under-employment. Without additional disinflation – which we believe is not out of the question – the U.S. consumer lacks the wherewithal to sustain any continuation of flat to declining nominal wages. See the below graph for an illustration of the foregoing:



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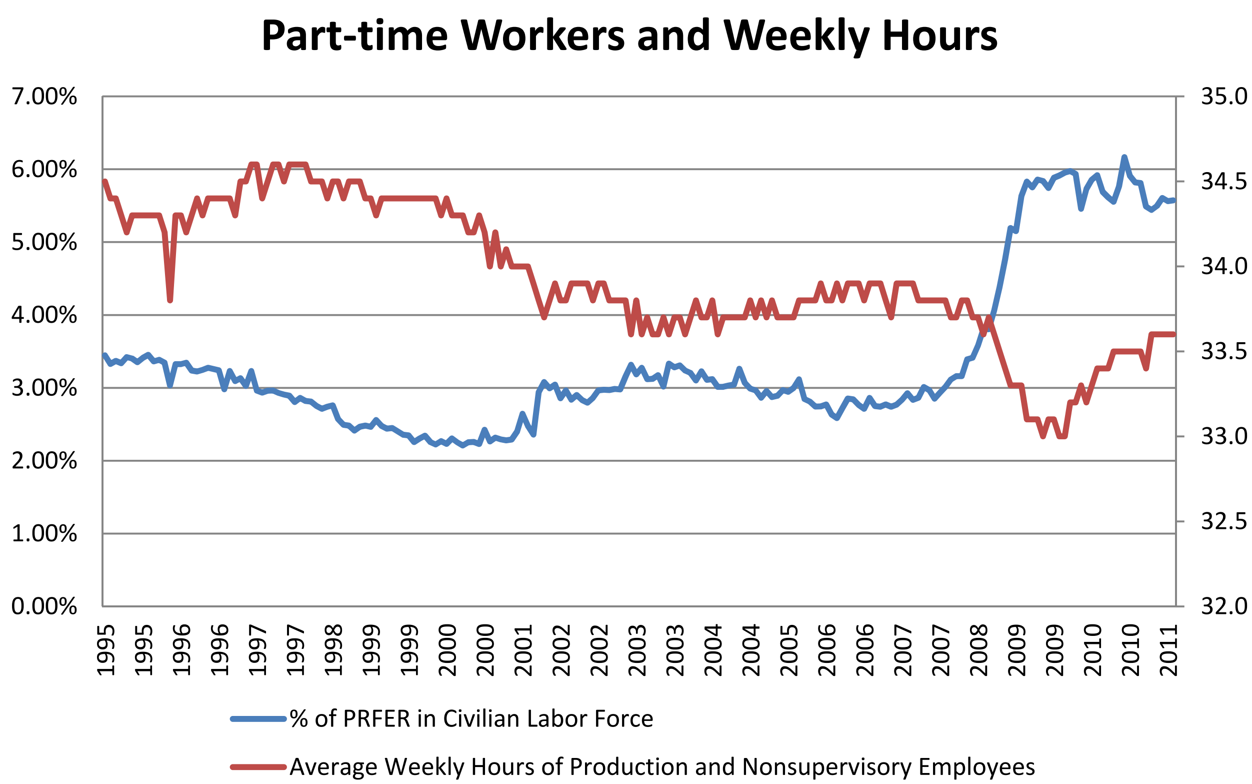
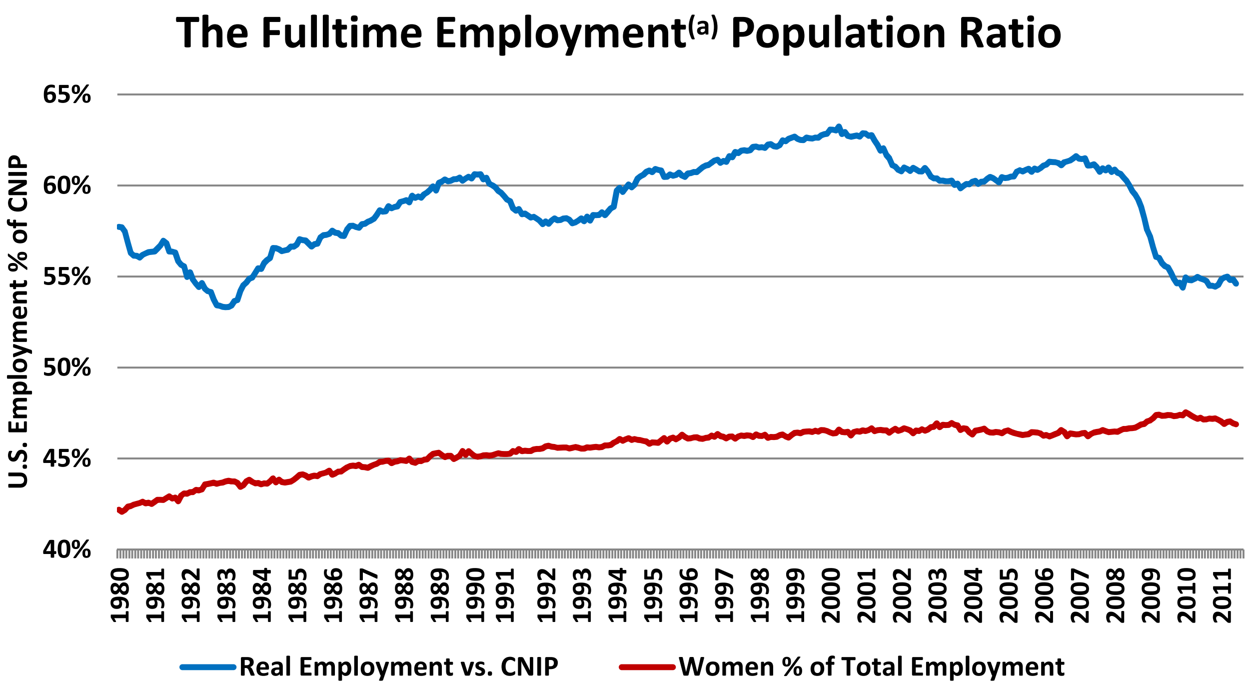
The next two graphs address the substantial increase on workers who are counted as employed, but are employed part time (1 to 34 hours a week), because they can't find a fulltime job: the so-called "Part Time for Economic Reasons" sub-group ("PTFER").

As the below graph illustrates, the number of employees in the PFTER cadre has spiked to a record high as a percentage of the labor force going back to 1995. As one might expect, this rise evidences an inverse relationship to average hours worked by those employed. But note that the post-recession recovery in average hours worked has not produced a material decline in workers who are PTFER.



Finally, we have recently been tracking the Employment-Population Ratio adjusted for the PFTER sub-group, which has returned to levels unseen since the recession of the early 1980's (and has continued at current levels for much longer than it did in 1982). But as bad as that ratio appears, it must be remembered that during the intervening three decades, the complexion of the labor force has changed considerably with the addition of many more women needing or wanting to work. Prior to adding millions of more gainfully employed women, the economy ostensibly enjoyed their labor – albeit uncompensated – in different ways as childcare givers, volunteers, etc. Arguably, therefore, the Fulltime Employment-Population Ratio illustrated <u>on the following page</u> does not yield an apples-to-apples comparison across the decades….the current period is significantly more distressed than that of 30 years ago.



(a) Total Employed minus Part Time for Economic Reasons, divided by the Civilian Non-institutional Population ("CNIP").

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