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Serving Your Personal Investment Needs Since 2003

July 18, 2011

CRYSTAL BALL LOOK INTO THE FUTURE

If what you are asking for is a crystal ball view into the future, I think that you can feel good about the prospects for the domestic U.S. economy during the coming 3 to 6 months. That also means that the stock market, as measured by the S&P 500 Index, will be positive for that period. Why can't we forecast further out into the coming years? Because that data is not in the system yet, nor is there any real predictability to those future data releases. For now, plan to hold your investments in stocks, mutual funds and gold. It is not yet time to sell them and go to cash! If you own government guaranteed assets, don't worry, you are safe. That includes GNMA, FNMA, and FHLMC mortgage backed securities.

Now, if you want to read the academic part of this letter, read on. If not, then you have already read the important part – at least, that's what Iris thinks!!

JOB CREATION COST VS. LEVERAGE

Most market analysts will acknowledge that the recent jobs report was not very "pretty". Certainly, it was not a positive report - showing only about 18,000 net jobs created in June, when the goal is more than 250,000 jobs created every month. In addition, the May jobs report was revised downward, which is indicative of the longer term direction of change in these numbers. In fact, what the jobs numbers really show is pretty much what we know is happening: the Federal Government, and state and local governments, are laying off employees. This process is gaining momentum as budgets are balanced to current and projected tax inflows. That is no surprise!

What we have to anticipate is where these cuts will show up in the overall GDP and how government layoffs will affect near and longer term economic growth.

For June, the private sector added 57,000 jobs, while the government sector lost 39,000 jobs. Expect government sector job losses to continue and to gain momentum for the coming 6-12 months.

An important real question, from a forecasting standpoint, is "How will government job losses impact our economy?"

I think that what we are seeing take place – the comparative job losses in the government sector, versus job gains in the private sector - will ultimately have significant impact on our understanding of Keynesian economics, and the affect, not only, of growing government employment, but also, the effect of stimulus money that is targeted to "shovel ready" ("make work" would be my term) projects designed to support the economy during recessions and depressions.

The real issue – and I have not seen significant academic work done on the subject – relates to the economic leverage (multiplier) gained from private sector employment growth, comparing that to the negative aspect of increasing employment at the government level.

There is a multiplier effect to the spending that is related to "hiring" in the private sector. Adding employees increases production levels, increases profitability (even if the marginal profit may be reduced - "marginal": meaning a decreasing rate of profit growth with each unit increase in production). That productivity multiplier is probably 1.2 to 1.4, but at least, it is a positive multiplier.

Compare that to what is a negative “multiplier” from government expenditures – in this case, job creation through “hiring”. Government jobs typically have a negative multiplier of perhaps 0.95. That is, it costs money, through the spending process, to make hiring decisions. No profits are generated directly. That employee income usually goes directly to consumption and other living expenditures. At best, in today’s economy, perhaps 5% will go to savings, a source for generating some positive multiplier – assuming those savings are recycled into the economy through the lending process. This multiplier factor is the cost we pay for government services, and it is why we must be very conscious of our spending at the government level – focusing those expenditures on responsible, mission oriented spending.
There is a “worser” (if I can use the term…) case to consider, which seems to be occurring today. It appears that there are incremental steps to the multiplier calculation. As government expenditures increase to higher and higher percentages of our GDP, that multiplier mentioned above of 0.95, probably decreases to 0.90, and to 0.85 and probably even lower, depending on the increasing costs of running the government. This is where we are today.

If you follow this to its logical conclusion, reducing government costs – decreasing government job expenditures – is positive for future GDP growth! Certainly, it is not particularly positive for those losing their jobs, or having their income reduced, but in the long run, this is the only course option available to us when government spending is growing beyond (faster than) the growth curve of our GDP.

Getting back to my original point about the June “jobs created” number, the components – government and private sector – are going in the right direction. The important number, the one that we want to focus on, is the growth in private sector employment. That will tell us more than any other data, about how well – or badly – our domestic economy is progressing. The hope is that private sector growth momentum will increase, compensating for the loss of government spending, and carrying the rest of the economy to an ever increasing GDP growth rate. Money supply growth rate forecasts the future. The best coincident indicator for real growth is the number of jobs created each month.

Sincerely,

Dick Brackett
High Desert Investment Advisors