THE ECONOMIC SITUATION

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- **An incredible boom is underway. Really???**
- **What about the United States?**
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- **Time to dust off the old Misery Index.**
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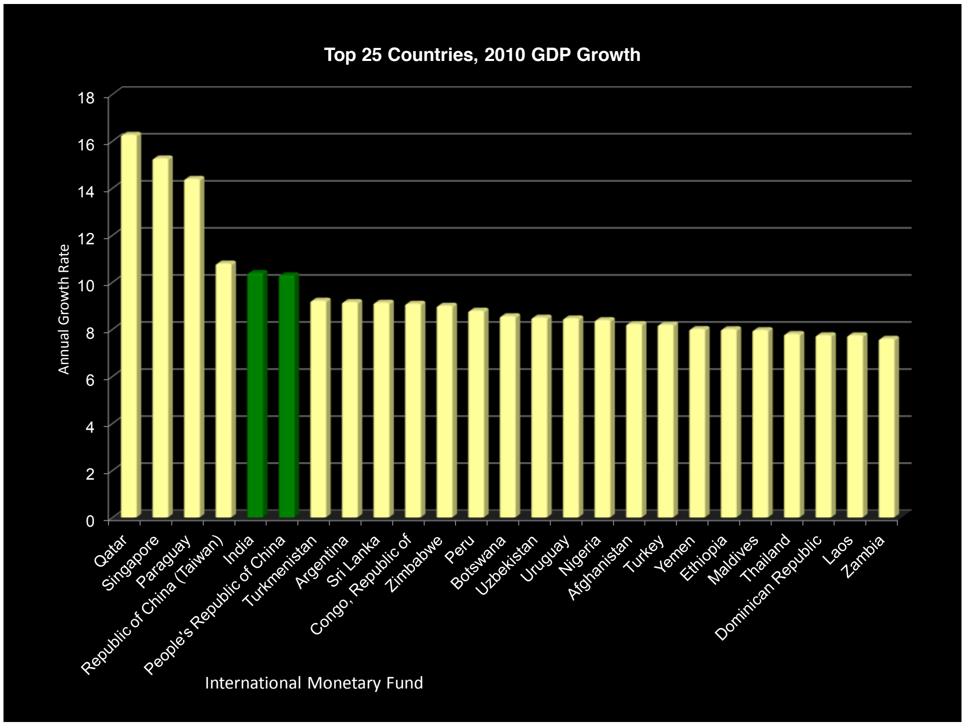
The Incredible Boom That's Occurring Worldwide

I begin this report calling attention to the amazing economic boom that has been occurring on the globe. No, we do not hear about this in the evening news. Why? Because the boom is not occurring here, and it is not occurring in Europe. Indeed, it is not occurring in what we normally call the developed world. It is happening in the developing world, and data tell us exactly where it is happening.

As indicated below, there is amazing growth occurring in countries many of us cannot pronounce and most of us have not visited. The countries, small and large, have growth rates exceeding 7%. We in the U.S. will be lucky to see 2.5% this year, and Europe will be lucky to see a positive number. Yes, a lot of the high growth countries are small, but two familiar ones are huge. India and China are leaders in the pack.



The boom is already making a huge difference in human wellbeing. According to *The Economist,* recent World Bank estimates show that for the first time since keeping track, both the share and number of people living on less than $1.25 per day is falling in every quadrant of the world. Keep in mind that this is occurring during a time of recession and rising food prices.

Now, if global economic growth continues at the current rate, 2.5%, for the next 30 years, which is, by the way, the long-run average, then in just 30 years there will be more goods and services produced globally than has been produced since people began to keep score. It's about compound interest and all that. This may be worth repeating, by 2042, world production of goods and services will be twice as large as the sum of all past GDP generated on the globe.

That's a lot of stuff!

Well, some say, population growth will just eat it all; there will be no gain in global per capita income. There's always a killjoy in the crowd. Not so. At present, global per capita income stands at roughly $10,100. Given population estimates for 2042, which is really not that far away, global per capita income will rise to around $15,000, almost a whopping 50% increase. More people will be lifted out of poverty than ever in history. But a lot of poverty will still remain.

Can the U.S. hook its train to the global engine? Or will the U.S. be part of the engine. The answer is yes. We can be a part of this great boom by investing in global enterprises, producing high tech products and services required for the booming world, and providing educational resources for the growing population of knowledge workers who will be the global builders.

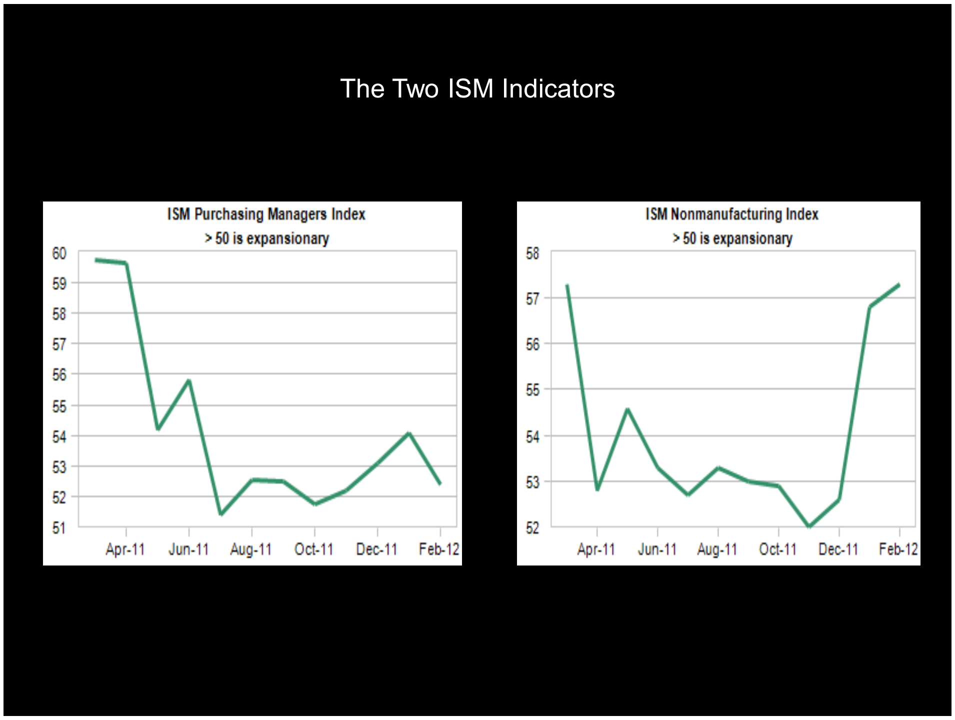
But will the United States economy catch the growth fever? No. Not very likely. Not with the debt we are carrying, and not with our focus on redistributing instead of producing more income. Don’t look for 7% growth on this side of the planet, or even 6%. Let’s just hope for 3.5% or 4.0%.

How is the United Stated Doing?

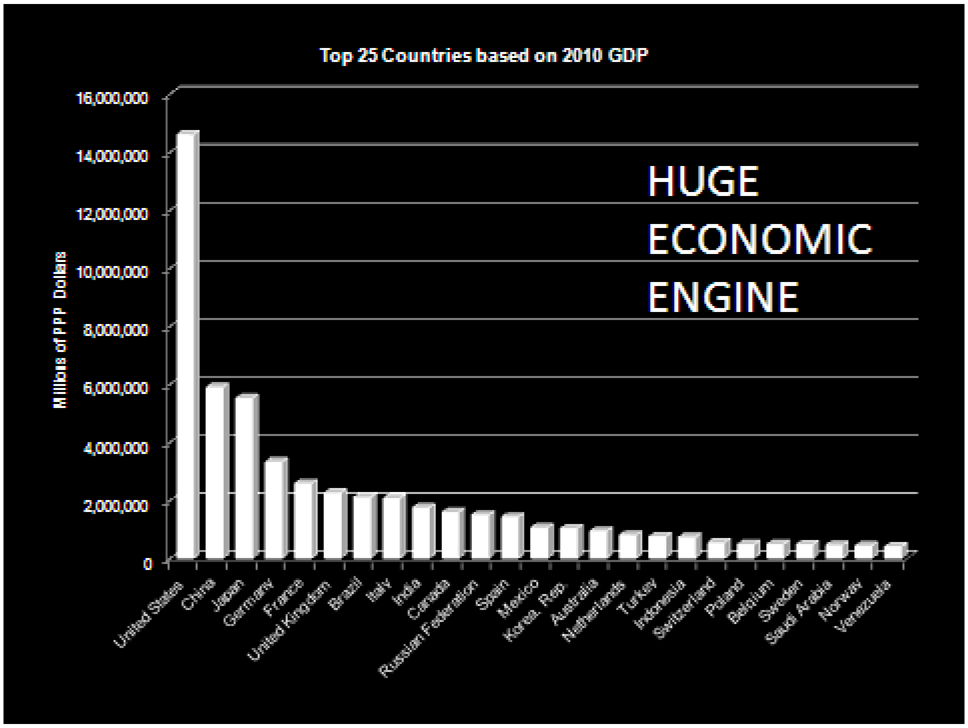
Using a healthcare analogy, the U.S. economy is out of intensive care. Better than that, the economy is walking the halls, gathering strength, and lifting heavier weights than before the great illness, or Great Recession. When the level of GDP exceeds that of the previous peak, we say the economy is in a growth phase, and that is where we are. But we are not comfortable saying that when unemployment is still above 8 percent.

Even so, we should accept good news no matter how cheering it may be.

Consider the next two charts that show the Institute of Supply Managements indexes for the manufacturing and nonmanufacturing economies. As can be seen, the lines move about, but the values exceed 50 throughout the range shown. This means growth. We can see the decline that occurred in manufacturing following a plague of difficulties in 2011, and we can see the recovery since then and the manufacturing bump in the road that arrived in February. And we can also see the impressive upward move of the non-manufacting economy, which, after all, is the larger piece. As bumpy as it gets, we still have an economy that has done more than turn the corner. It is moving to higher ground.

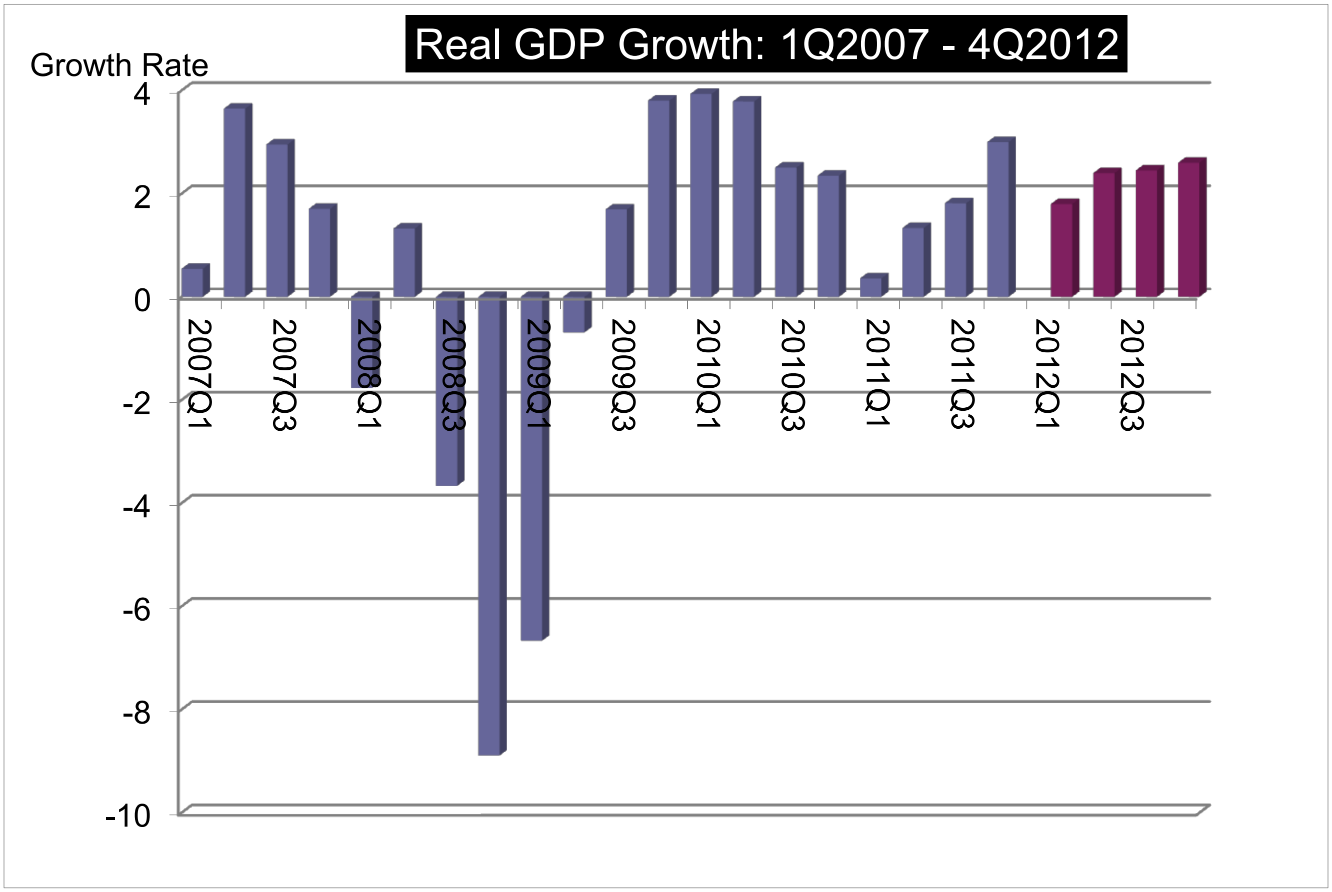


We should remember that the U.S. has a huge economic engine, that even when running at 92% or so, as measured by employment, this engine produces a lot of income and wealth.



How Does it Look in the GDP Corner?

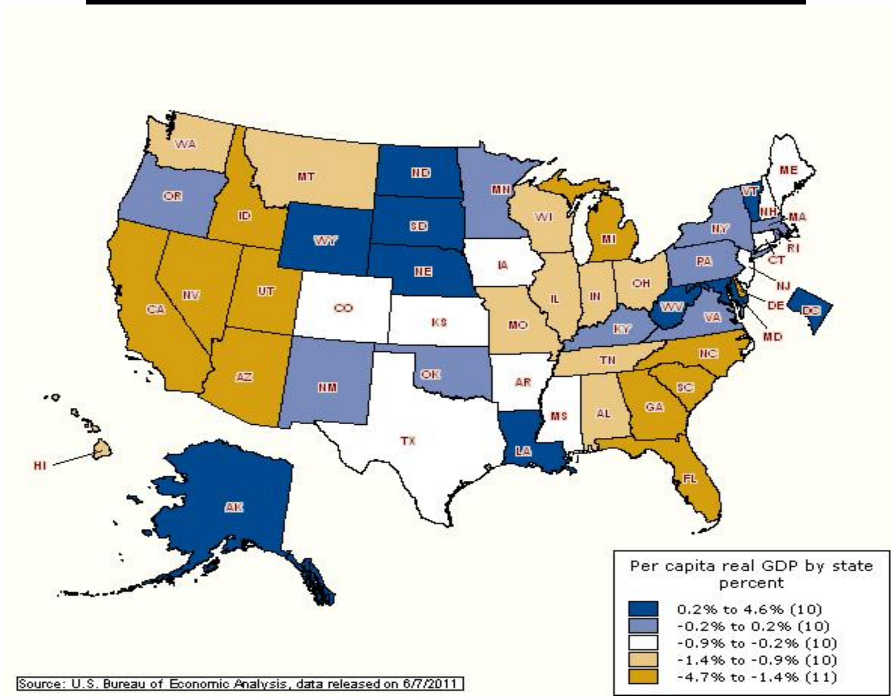
When we put all this in the GDP melting pot, we get a picture of an expanding economy, with a pretty toasty 3% real growth for the second estimate for 4Q2011. But that 3% was driven mainly by inventory accumulation. That can be good and bad. If merchants are betting on better days ahead, accumulation makes sense, if they are right. But if accumulation means final sales hoped for did not materialize, then it's another story. The accompanying chart gives the latest data as well as projections for the year ahead. We see ho-hum growth ahead.



And What about the GDP Growth among the States?

The most recent Commerce Department data for the 50 states reveals again the uneven path taken by prosperity. The accompanying map tells us that it pays to have coal, oil, gas, and hard grain production in your state. And it pays to have high educational attainment. These are common features of many of the blue and white states on the map, especially those square-edged ones in the middle of the country. Generally speaking, the recession hit hardest on the two coasts and moved in. The expansion is coming from the middle and moving out.

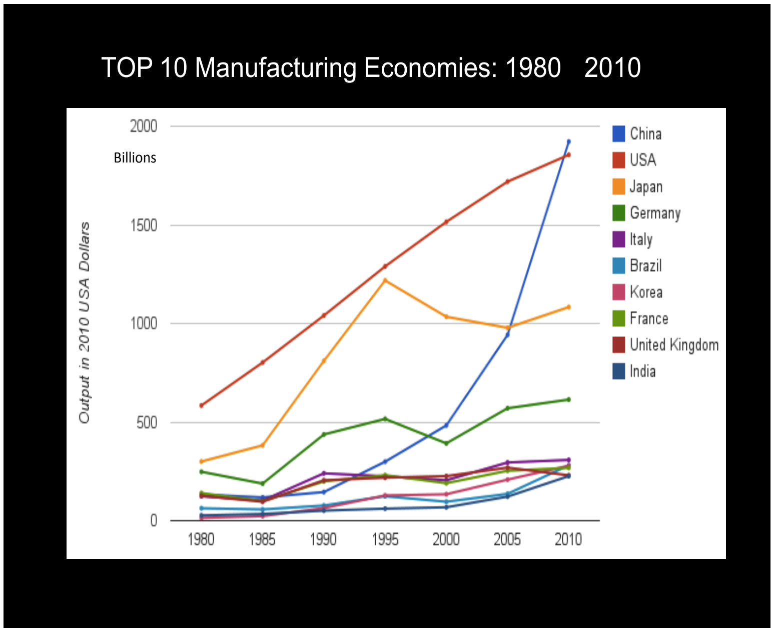
State Per Capita Real GDP Growth: 2007   2010



Are We Losing our Manufacturing Muscle?

While politicians talk about bringing manufacturing back to America, there's some pretty compelling evidence that it never left. There is also evidence that the U.S. position as number one global player is being eclipsed by a rapidly growing Chinese economy. But this doesn't mean we have lost our manufacturing muscle; it means manufacturing muscle is growing worldwide.

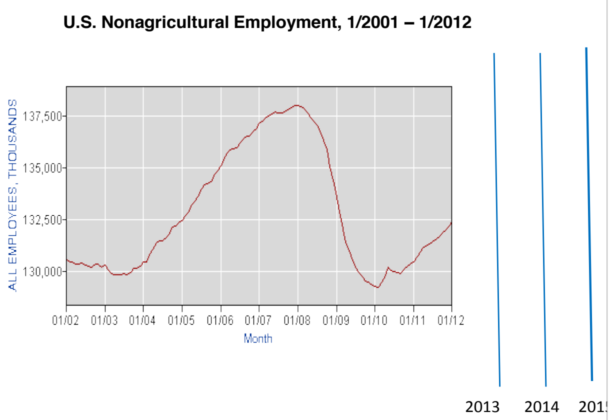
Don't forget what will happen in the next 30 years worldwide. A golden age of growth. Let every flower bloom, but please don't drive through our garden with higher taxes, more regulation, and more redistribution of disappearing wealth.

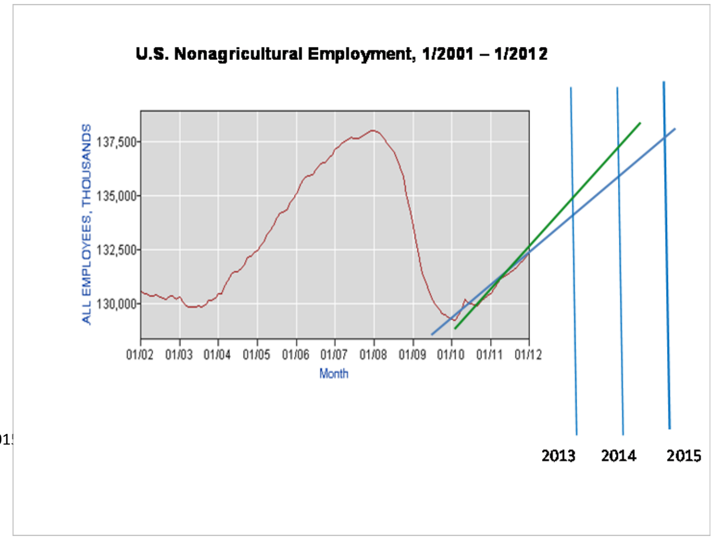


Labor Markets and the Disintegrating Manufacturing Economy

The U.S. economy is in an expansion phase, but the labor economy is still in intensive care, or so it seems. There is meaningful job growth, but not enough to absorb new entrants and the unemployed job seekers. The mismatch continues between rising job openings and sustained unemployment. Part of the problem is structural; another part relates to frozen housing markets that cut down on mobility; yet another part of the problem relates to rising expectations for work qualifications in a knowledge-based economy.

The next charts show total U.S. nonagricultural employment and a rising employment path. I have fit two lines to the growth path—one more optimistic than the other—to project the year when total employment will recover to pre-recession levels. If the slower path prevails, recovery will occur in 2015. The fast path gets to recovery in 2014. The number unemployed will still remain high due to a growing labor force.

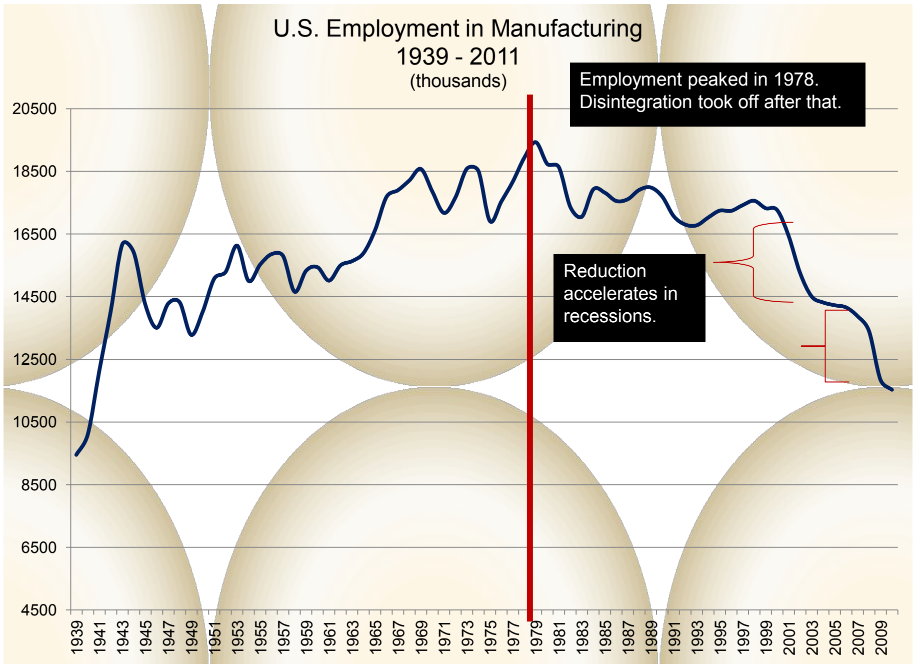




Some politicians of late have begun to emphasize the importance of manufacturing employment for dealing with our unemployment woes. Giving talks in factories seems to be in vogue. Of course, this goes over well in hard-hit manufacturing regions, and job growth anywhere is well worth promoting. But it is unrealistic to pen the nation's hope to the factory floor, and it's not because we don't produce a lot of stuff. In fact, it is just the reverse. We products lots of stuff with fewer and fewer workers.

Manufacturing Employment and Recessions

The next chart shows total manufacturing employment for 1939 through 2011. Notice total manufacturing employment peaked in 1979. I call attention to sharp employment reductions that have occurred during recent recessions. Inevitably, and for very good reasons, employment in manufacturing falls in hard times and never fully recovers. During a slowdown, the old obsolete plants gets closed first, and never reopen. The more modern plants receive new capital, which uses less labor for the same amount of output. Productivity rises during recessions and then flattens out during recoveries.

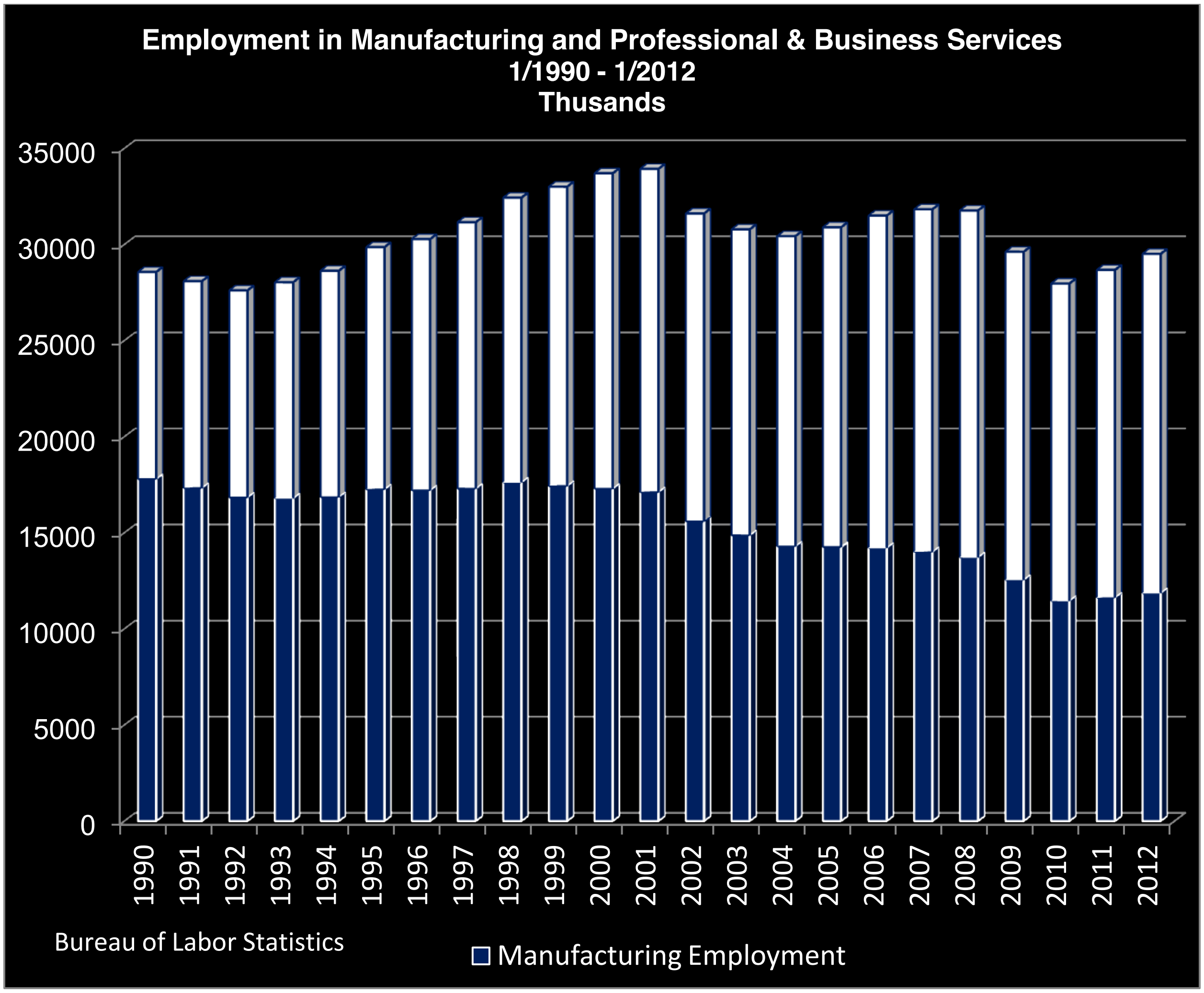


Division of labor and disintegration

Adam Smith reminds us that "the division of labor is limited to the extent of market." In other words, as markets expand, and as population density increases in urban areas, opportunities for specialization increase. What may have been done in one factory, but is not fully utilized, can provide services to another factory, if what was factory work is spun out to the market.

There is more to the story of declining manufacturing employment than just modernizations and productivity gains on the factory floor. The U.S. manufacturing economy has been disintegrating for years. Activities once under the factory roof are now performed by separate firms. Industrial firms contract out trucking, payroll services, engineering, maintenance, and even purchasing. Those people still under the factory roof tend to be highly specialized in production.

A good many of the manufacturing support functions are included in a labor category called Professional & Business Services, a sector that has expanded rapidly as manufacturing employment has fallen. The overlap between manufacturing employment and the business support sector is surely not perfect, but it is interesting to see what happens when we add the two sectors together. We see this in the next chart.

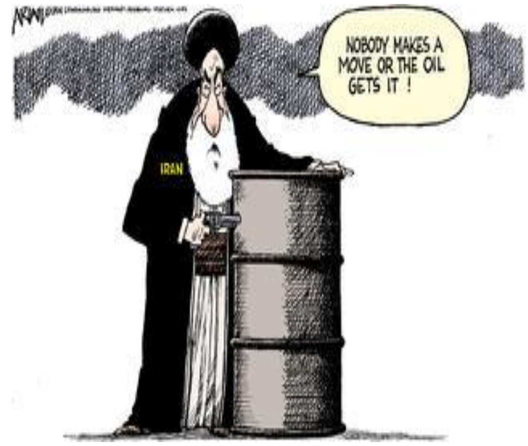


We get a very different picture when we account for a disintegrating economy.

Occasionally someone will say: "We cannot create wealth unless we make things or mine things. Services employment won't get the job done." Not quite true. The two sectors work together.

High Priced Oil and Gas

The December *Economic Situation* report provided a bit of detail on the relationship between the price of gold and the price of crude oil. As regular readers know, perhaps too well, I periodically show this relationship and venture forth with a forecast. In December I indicated that $120 oil was in the offing. My forecast was based simply on the systematic relationship found between oil and gold prices. We have not seen $120, but we are getting close. And the relationship is still signalling higher prices.



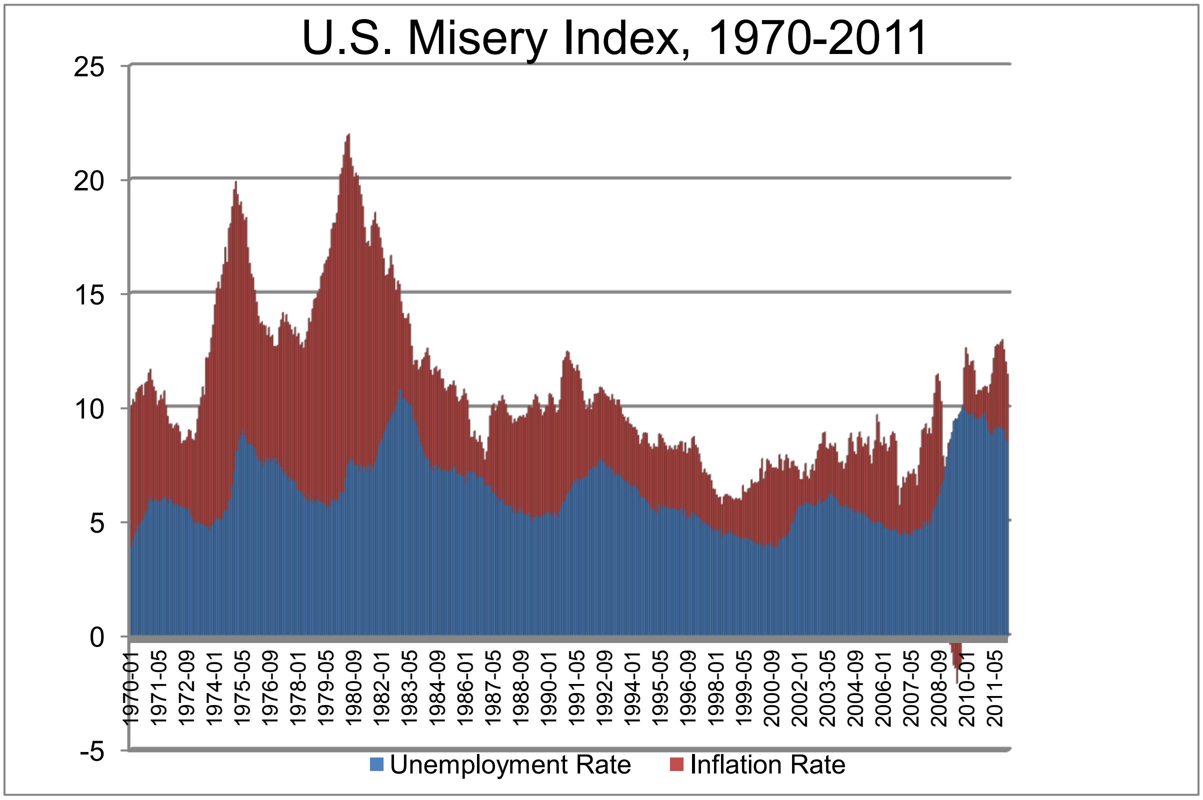
Interestingly enough, the price of oil is falling when expressed in ounces of gold. Two things may explain this. First, times of panic and unrest lead people to put their money into things that will not likely depreciate due to political actions. Gold is the age-old first choice. The Arab spring has brought higher demand for gold. Second, the dollar has weakened against other currencies, and gold. Put the two forces together and we get higher priced oil, and higher priced gold.

Common sense tells us that we cannot drop bombs on and threaten oil-producing regions and expect oil to flow the way it did before the conflicts began. And common sense tells us that we cannot cut off access to energy in our own country in exchange for environmental protection without paying a price.

Time to Dust off the Old Misery Index

Back in the 1970s, economist Arthur Okun (1928-1980) became famous for creating a Misery Index. His index captured widespread economic hardship by adding together the unemployment and inflation rates. The index asked two very serious questions: Are job prospects improving? And if I have a job, what's happening to the purchasing power of my money?

Okun's Misery Index shot skyward in the late 1970s. Driven mainly by oil embargoes and with inflation exceeding 14%, the combined number hit 21.9 during Jimmy Carter's administration. As seen in the accompanying chart, the index fell rapidly from that peak, but started climbing in the late 1990s. Using December 2011 data—unemployment at 8.5% and inflation at 2.9%, the Misery Index now stands at 11.4.



But while high unemployment and rising inflation generate more than enough misery to go around—there are lots of people suffering, I think we should add a couple of less painful things to a new and expanded index. Just think about this, according to the latest census numbers, there are now more than 9 million unattached family member age 20-24 back home living with Mom and Dad. Many of these are young people who graduated from college and just couldn't find a job or a better deal than coming home. Think about the misery this has generated, and think how happy everyone will be when things get better and the young folks head down the driveway.

To add to the misery, think about the couples who want to get a divorce and the cost is just too high. Divorce rates fall with income, and rise when things get better. Right now there are a lot of people who would love to get unhooked but are having to bear up as best they can. More misery. And then there are families that split waiting to be together when the house sells. The U.S. moving rate is now at the lowest since 1948. Even more misery.

Mr. Obama's Marionette Economy

Let's face it. It's crazy season. We can't take seriously every word that flows from a politician's mouth. Election-year politics becloud discussions of economic policy and divert attention from fundamentals that need to be addressed. Unfortuately, trading favors for votes leads to efforts to manipulate the economy, to treat the economy and all of us as if we are marionettes that can be made to perform in politically desirable ways. We received more than a glimmer of this in President Obama's State of the Union Address when he outlined his ideas for top-down management of the economy. The president offered a blueprint for a marionette economy, with the strings pulled in Washington.

This blueprint recommended tax punishments for firms that expand globally, tax benefits for firms that employ people in hard-pressed regions, research and development benefits for firms that attempt to produce the right stuff, fine-tuned rules to support clean energy and higher taxes on individuals who earn a million or more dollars a year. There was even a mandate to require school aged children to stay in school till age 18, or else, whatever that might mean in a free society. Each proposed nudge seems designed to appeal to one or another special interest group. Special interest appeals help elect presidents.

But pulling strings in an effort to manage the economy just doesn't work. The U.S.'s mangled market economy operates on the basis of the uncoordinated actions taken by millions of people in pursuit of happiness. Those decisions can and will be affected by tax changes and regulations, but we cannot build the economy of our dreams by simply sitting in a room and planning it.

Our man, Adam Smith, had something to say about the "man of systems" who wants to manipulate the economy.

He seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. He does not consider that the pieces upon the chess-board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might choose to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably, and the society must be at all times in the highest degree of disorder.

With hope riding high for a stronger 2012 economy, treating the economy like a Washington-directed marionette is not the way to go. It is time for the puppeteers to back off the stage, clear the way and give free people a chance to show what they can do when tax and regulatory burdens are low and opportunity is high.

Wild Plum

American poet Orrick Johns (1887-1946) wrote some beautiful poetry. He seemed at his best when he penned the words to Wild Plum, words many a country boy can relate to:

They are unholy who are born to love
Wild plum at night.
Who once have passed it on the road
Glimmering and white.

We love the fruit of the tree, but even in the springtime we often fail to celebrate the beauty of the blooms.

We may say the same about capitalism. We enjoy its fruit. Why not take a moment to celebrate the flowering tree?