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VIEWPOINT

A Stephens Inc. Economic and Financial Commentary
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The spring air of an election year is often filled with hyperbole and myriad political pledges, including promises about the economy. In these promises lies the hope that Americans will cast their votes to one candidate or another. The 2016 presidential election cycle is no exception.

This issue of Viewpoint discusses the current state of the U.S. economy and assesses economic improvement we might expect in the near term—without hyperbole, or expectation of your vote. The analysis includes:

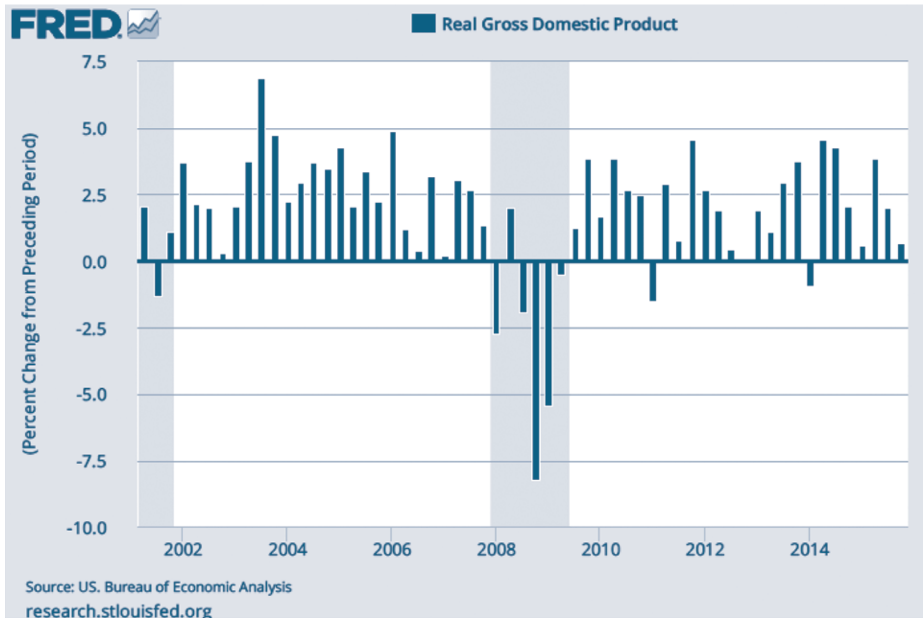
- **Economic growth:** Where are we and what can we expect in 2016? Is the U.S. headed into a recession in 2016?
- **Unemployment:** Can we expect improvement?
- **Real wage growth:** Can workers expect better than the minimal growth of the last eight years.
- **Labor participation rate:** Can its downward trajectory be reversed?
- **Income inequality:** Can it be mitigated?

Some of these issues are straightforward but others are complex and at the core of the current presidential campaigns.

Economic Growth

Economic growth over the past two administrations has been anemic with growth of roughly 2% a year. (*See Figure 1.*) The Bush presidency benefited from somewhat lower tax rates while Obama-era growth benefited from large federal deficits and unprecedented easy monetary policy. Collectively the growth was sub-par compared to post-World War II standards. By comparison, growth in the Reagan and Clinton administrations was about 3.5%.

Figure 1:
Change in Real Quarterly GDP (2001 to Present), Seasonally Adjusted Annual Rate



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED), March 2, 2016.

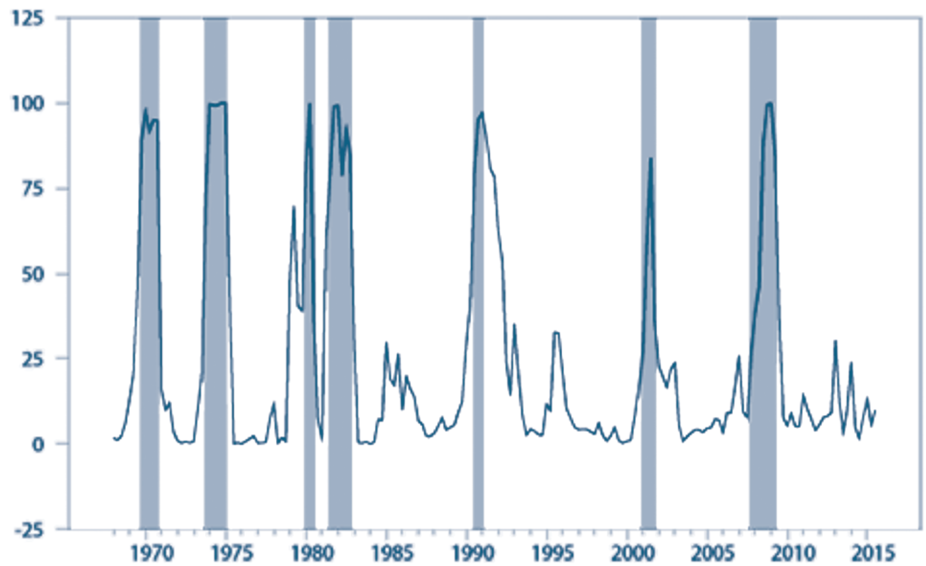
The fourth quarter of 2015 was especially weak with real GDP growth of 1.4%. For all of 2014 and 2015, the growth rate was 2.4%, which was slightly better than the 2.3% and 2.2% of 2012 and 2013, respectively. The four-year growth rate was nevertheless weaker than the 3.5% to 4.0% economists believe is the non-inflationary growth potential of the U.S. economy.

Best Guess on Economic Growth

Given the current economic policies emerging from Washington, the economy is likely to experience more anemic growth of about 2%. This low growth is far short of the American economy's potential, but the economic data are not pointing to a recession in the short run.

Notwithstanding, alarmists in the business and media communities are suggesting the U.S. will experience a recession in the near future. The famous investor Jim Rogers stated recently that the probability of a recession in the next 12 months is 100%. We do not think that the data support that conclusion at the present time. The Federal Reserve Bank of Atlanta's recession forecasting model predicts a 10% probability of a recession. (*See Figure 2.*)

Figure 2:
GDP-Based Recession Indicator Index



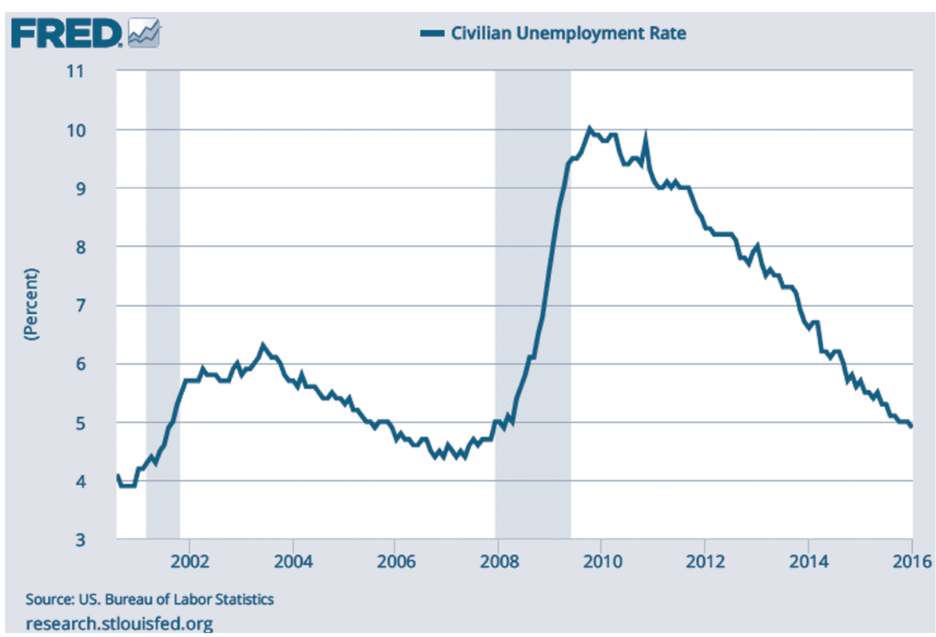
Source: Federal Reserve Bank of Atlanta. "GDP-Based Recession Indicator Index." (by James D. Hamilton.) February 4, 2016.

The Wall Street Journal Survey of Economists places the risk of a recession in the next 12 months at about 20%. The longer-term conditions for a recession look more serious because recent administrations and Congresses have been hesitant to tackle some very nettlesome issues. The U.S. economy likely will experience a recession sometime during the next administration.

Employment and Labor Markets

Employment conditions are somewhat stronger than what might be suggested by America's weak economic growth. The current unemployment rate is close to full employment at 4.9%. (*See Figure 3.*) That rate is within the range that most economists consider full employment.

Figure 3:
Civilian Unemployment Rate (2001 to Present), Seasonally Adjusted



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED), March 2, 2016.

In addition to strong employment, initial jobless claims by unemployed workers are near multi-decade lows. The number of job openings is large compared to the number of people seeking employment. In other words, the next president should inherit a positive employment situation.

Best Guess About Unemployment

No president, whether a Democrat or Republican, is likely to significantly lower the unemployment rate from its current levels. The headline unemployment number of 4.9% is consistent with a healthy labor market—at least from a superficial point of view.

However, the real problems in the labor market are deeper than the headline numbers. Those problems include the sub-par growth in real wages and salaries as well as the types of jobs that are available in labor markets—part-time positions, not full-time positions.

Real Wages and Household Income

Growth in real weekly earnings for American workers has been minimal during the G.W. Bush and Obama administrations. (*See Figure 4.*) Real weekly wages from 2001 to 2015 increased by 3.6% from $333 per week to $345: very weak. Over a 30-year period from 1986 to 2016 (not shown in the chart), the total increase in real weekly earnings is 3.7%: again, very weak.

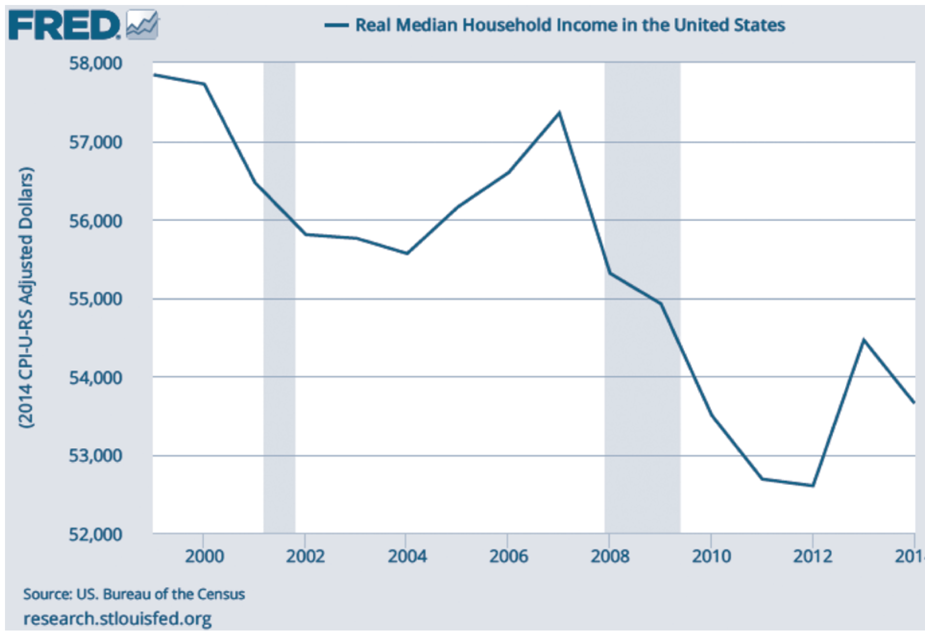
Figure 4:
Median Usual Weekly Real Earnings for Full-Time Workers (2001 to 2015)

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED), March 2, 2016.

The impact of minimal real wage growth for American workers is seen most clearly in the decline in real median household incomes over the period 1999 to

2014. (*See Figure 5.*) When real wages stagnate, the impact is felt on incomes at the household level. In the most recent 15-year period, real household incomes fell by 7%, a performance that is hardly indicative of a vibrant American economy. This decline in household incomes occurred during Republican (George W. Bush) and Democratic (Obama) presidencies.

Figure 5:
Real Median Household Income in the United States (1999 to 2014)



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED), March 2, 2016.

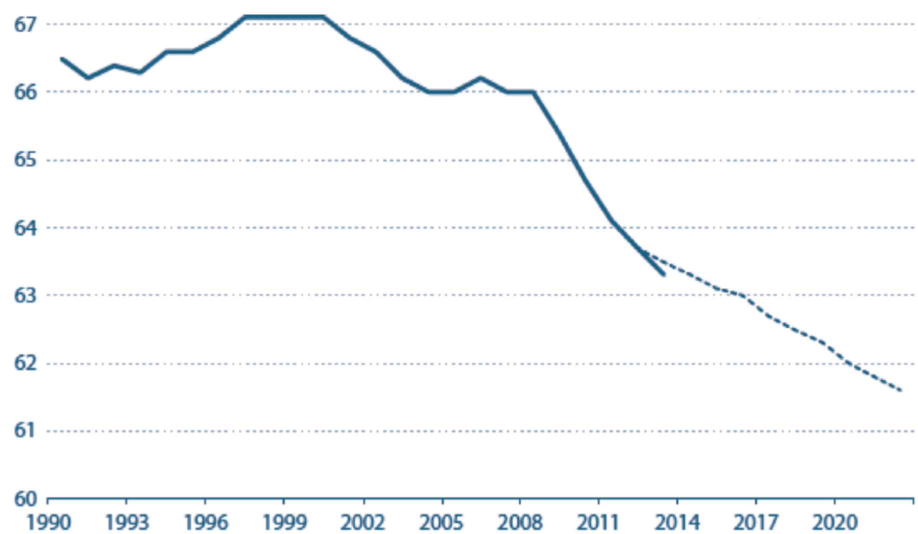
Best Guess About Real Wages and Real Household Income

We think the decline in real wages and real household incomes is likely to abate over the next several years. Workers are beginning to see a slight increase in their market power given almost full employment conditions. The number of job openings relative to the number of unemployed workers is at a multi-year high. Real weekly earnings are growing slightly. The improvement in real household income is likely to be modest and unlikely to reach the year 2000 level anytime soon. Nevertheless, the outlook is positive.

Labor Participation

A factor that is exacerbating the decline in household income is the unrelenting drop in the labor participation rate of American workers. Since the turn of the century, the relative number of workers compared to the size of the working-age population has continued to decrease. (*See Figure 6.*) Projections from the Bureau of Labor Statistics suggest that the trend will continue into the next decade.

Figure 6:
Labor Participation Rate From 1990 to 2013 and Projected Rate From 2014 to 2023

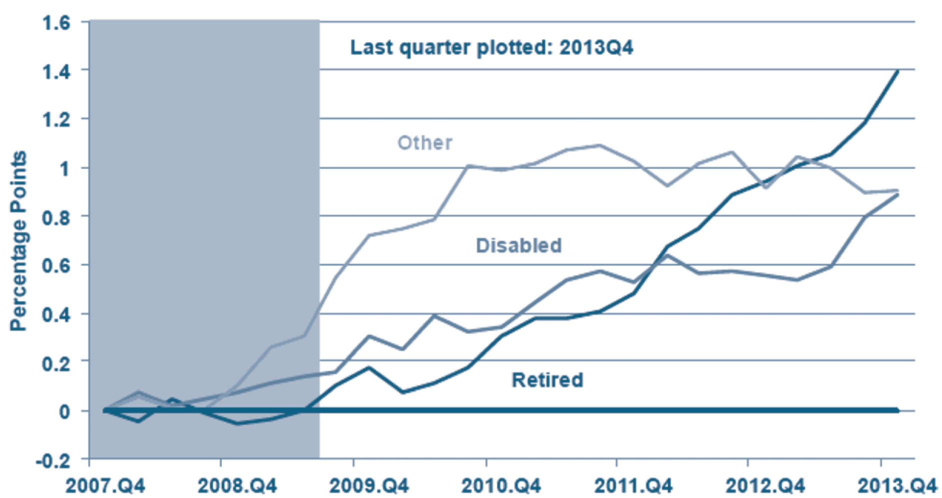


Source: Federal Reserve Bank of St. Louis. "The Rise and Fall of Labor Force Participation in the United States." (by James Bullard.) *Review*. First Quarter 2014. Page 6.

This decline in the labor participation rate is clearly understood by economists even if politicians continue to argue about its causes. (*See Figure 7.*) The three main causes—in decreasing order of importance—include:

- Retirement of older workers (the baby boomers)
- "Other" factors (mainly students staying in school longer for extra education)
- Disability retirement

Figure 7:
Cumulative Explanation for Non-Participation in Labor Markets (from 2007 to 2013)



Source: Federal Reserve Bank of Philadelphia. "On the Causes of Declines in the Labor Participation Rate." (by Shigera Fujita.) *Special Report: Research Rap*. February 6, 2014. Page 11.

The retirement of older workers and falling labor participation adversely affects the economy. Studies by the Federal Reserve Bank of Boston and other organizations suggest that as workers retire they are replaced by individuals with less education and fewer skills, which hurt labor productivity. In recent years, labor productivity growth has been especially weak, thereby slowing economic growth.

Best Guess About Labor Participation Rate

The labor participation rate has decreased by about 4 percentage points since 2000. This decrease represents about 6 million fewer workers. Most of the decline is attributable to the three factors noted in *Figure 7*. There is an objective basis to think that the rate will continue to decline into the next decade regardless of policy decisions by politicians in Washington, D.C. Older "boomers" are retiring, and older workers who have not yet chosen to leave the workforce are more vulnerable to injury and disability, which may precipitate forced retirement. In addition, young people understand the economic value of education and are choosing to stay in school for more education. Politicians are unlikely to reverse these trends.

Income Inequality

The stagnation of real wages, the decline in real household incomes and lower labor participation since at least the turn of the century leads inexorably to a bitterly contested issue in the current presidential election cycle: inequality of family incomes. (*See Figure 8.*) This chart provides important socio-economic characteristics of U.S. households by income quintiles (from lowest to highest income).

Figure 8:
Selected Characteristics of U.S. Households by Income Quintiles (2012) From the U.S. Census

Selected Characteristics of U.S. Households by Income Quintile, 2012

Source: Census Bureau	Lowest fifth	Second fifth	Middle fifth	Fourth fifth	Highest fifth
Average Income for Each Quintile	$11,490	$29,696	$51,179	$82,098	$181,905
Mean Number of Earners per Household	0.45	0.90	1.32	1.71	2.04
Households with No Earners (%)	61.0	31.8	14.4	6.6	3.0
Household Income per Earner	$25,533	$32,996	$38,772	$48,011	$89,169
Marital Status (%)					
Married Couple Families	17.0	35.7	48.0	63.6	77.5
Single-Parent Families or Singles	83.0	64.3	52.0	36.4	22.5
Age of Householders (%)					
Under 35 years	23.5	23.5	23.7	22	14.8
35-64 years	47.3	48.6	59.6	68.3	79.5
65 year and over	29.2	27.9	16.7	9.7	5.7
Work Status of Householders (%)					
Worked Full-Time	18.2	43.5	61.4	71.7	78.2
Worked Part-Time	14.5	13	10.6	9.8	9.3
Did Not Work	67.3	43.5	28.0	18.5	12.5
Education of Householders, 25 years and over (%)					
Less Than High School Degree	26.7	15.9	8.3	3.8	1.0
High School Diplmoa	35.6	35.8	29.8	21	8.0
Some College	24.8	30.1	33.4	30.6	13.8
Bachelor's Degree or More	12.9	18.2	28.5	44.6	77.2

Source: American Enterprise Institute. "Explaining Income Inequality by Household Demographics." (by Mark J. Perry.) December 6, 2013.

A number of facts can be gleaned from the figure, including the following:

- **Employment:** The overwhelming majority of upper income householders are employed full-time (78.2%), while the overwhelming majority of the lowest income householders have few full-time workers in their families (18.2%). Only 3.0% of the highest quintile families have no workers compared with 61.0% of the lowest quintile families. In general, there are two workers per household in high income families versus less than one in the lowest income families.
- **Marital Status:** The vast majority of high income families are composed of married couples (77.5%) versus the lowest income family (17.0%).
- **Age of the Householders:** Among the highest income earners, about four out of five families are in their prime working years of 35 to 64 (79.5%), while in the lowest income quintile 47.3% are in their prime earning years. In addition, in the lowest quintile families, 29.3% of the poor are elderly (65 and over) compared to 5.7% of the highest quintile.
- **Education of Householders:** Over 77% of high income householders have at least one college degree compared to 12.9% of the lowest income families. Only 1% of the highest income families have less than a high school degree compared to 26.7% of the lowest income households.

In simplest terms, the highest income households typically are:

- married
- both working
- college-educated
- employed in the prime of their working lives

The lowest income families typically are:

- single-parents or single
- not working or working part-time
- relatively poorly educated
- relatively young or old

When analyzing government census information, it is important to note that the economic value of government entitlements to the poor is not included in household income data collected by the government. In other words, food stamp, free school lunches, housing subsidies, free or low cost medical care, government disability payments and other entitlements are excluded from the government's data. Exclusion of this information provides a distorted picture of the degree of income inequality between the richest and poorest American households. Inclusion of the economic value of these entitlements would significantly lessen the real inequality in income.

A related concern of Americans is the shrinkage in the size of the middle class. Politicians of both parties lament this shrinkage. The Pew Research Center has analyzed government income data from 1971 to 2015. Its findings are quite revealing about the "middle class". (*See Figure 9.*) The relative size of the middle class is indeed shrinking, from 80% of the households in 1971 to 71% in 2015.

The surprise for many people is that more than half of the 9 percentage points drop in the size of the middle class is due to an increase in the number of upper income households, from 4% to 9% of American households. The remainder of the shrinking middle-class income households was due to an increase in low income households, from 16% in 1971 to 20% in 2015.

Figure 9:
Share of Adults Living at Various Income Levels (Family of Three)

Year	Low Income (Less than $31K)	Middle Income ($31K to $188K)	High Income (Over $188K)
1971	16%	80%	4%
1981	17	80	3
1991	18	77	5
2001	18	75	7
2011	20	72	8
2015	20	71	9

Source: Pew Research Center. "The American Middle Class is Losing Ground." December 9, 2015.

In 1971, a total of 84% of American households were middle and high income families: a goal for many Americans. In 2015, 80% of the households met the threshold of middle and/or high incomes. Notwithstanding the huge amount of political rhetoric surrounding the issue of the declining fortunes of "middle" Americans, the evidence seems to suggest that the vast majority of American households, four of five families, are still living the American dream of financial success.

One proposal to mitigate income inequality that garners attention from politicians is raising the minimum wage and thereby the income of lower income families. Census Bureau data cast some doubt on the efficacy of raising the minimum wage. The vast majority of low income families have little involvement in the labor markets. Only 9% of individuals age 16 or older living below the poverty line are employed full-time. (*See Figure 10.*) Two-thirds of low-income individuals did not work during the year.

Figure 10:
Work Status of Individuals Age 16 or Older and Living Below the Poverty Line

Work Status	Percent
Work full-time and year-round	9%
Work but not full-time year round	25%
Did not work during the year	67%

Source: The Heritage Foundation. “Who Earns the Minimum Wage? Suburban Teenagers, Not Single Parents.” (by James Sherk.) February 28, 2013.

According to a study done by the Heritage Foundation of Census Bureau data, most minimum-wage earners are young, part-time workers with relatively few living below the poverty line. They live in households with family incomes of over $53,000 per year. As noted in the study, “minimum-wage workers under 25 are typically not their family’s sole breadwinners.” Rather, they tend to live in middle-class households that do not rely exclusively on their own earnings.

Best Guess About Income Inequality

Given that 67% of low-income American householders are not employed, it is unlikely that economic growth rate (high or low) will affect or mitigate income inequality. If a low-income worker cannot find a job when the economy is at full employment, it is difficult to see how inequality can be reduced without drastic changes in public policy.

The political rhetoric in this election cycle is about the desirability of increasing taxes on married, educated two-income families and transferring those tax dollars via entitlements to single, less educated, and unemployed (or underemployed) families.

Some politicians seem to suggest that the incremental tax dollars to support new and/or larger entitlements will come from the wealthiest Americans, such as Warren Buffett and Bill Gates. However, the tax proposals floating about suggest that the new tax dollars will be generated by taxing upper quintile households: educated, married, two-income families.

Final Thoughts

The U.S. economy is likely to experience four more years of mediocre non-inflationary growth of about 2.5% or less. That rate may be the best case scenario. It is quite conceivable that growth could be close to zero if some critical issues are not addressed by the next administration and Congress.

Still, it is important not to lose track of the positive current news about the U.S. economy.

- **Growth:** The American economic growth of 2% is substantially higher than almost all other developed countries.
- **Inflation:** The inflation rate is a low 1.5%, well under the Federal Reserve’s target of 2.0%.

- **Employment:** Almost all headline job numbers (unemployment rate, initial jobless claims) are at or near multi-year lows.
- **Monetary Policy:** The Federal Reserve is maintaining monetary policy that is moderately accommodative to continued growth.
- **Fiscal Policy:** Federal spending is not out of control at the present time. However, the outlook does turn negative in the next decade when existing entitlement payments will begin to soar as more people retire. Yet there is time to fix this problem.

The 2016 presidential election cycle is filled with growth-damaging rhetoric: anti-trade proposals, higher marginal tax rates on individuals, disdain for a rational immigration policy, large increases in federal deficits to fund new entitlements, and greater controls on financial institutions. Enactment of these policies is a formula for weak economic growth over the next four years and beyond.

Long-term economic problems can't be fixed with the "sound bite" solutions that are being advertised by Republican and Democratic presidential candidates. The issues our country faces are deep and not easily solved, but they must be addressed if the American economy is to achieve strong and sustainable growth.

- **Regulation of Financial Institutions:** It is praise-worthy to create thoughtful regulations of financial institutions that might prevent a repetition of the recent financial crisis. But it's important to review these same regulations for unintended consequences. A myriad of these new regulations are crushing America's smaller financial institutions, which are the backbone of small business lending and entrepreneurship in this country. It is vital that in the near future regulations be rewritten (or eliminated) to protect the economic viability of those small financial institutions that small and medium-sized businesses are so dependent on.
- **Tax Policy:** U.S. corporate tax policy is "broken." Rates are too high relative to all of our major trading partners. They need to be lowered to retain and attract additional business investment.
- **Trade Policy:** The imposition of high trade barriers is a formula for trade wars and economic stagnation. America is competitive in the global trading of goods and services and must continue embracing global trade competition if this country expects to strengthen its economy as well as the economies of our world partners. Until the recent collapse of energy prices, America was on the cusp of becoming a major energy exporter (instead of an importer) that would have moved the U.S. toward a small trade deficit—if not a trade surplus in future decades.
- **Immigration Policy:** Industrialized countries such as Canada, Australia and New Zealand have immigration policies that focus on admitting immigrants with needed skills and resources. The United States needs to build a similar workable system. A viable policy can't be one that accepts individuals just

because they can walk across the border or overstay an expired visa. This latter policy weakens the market power of the least skilled workers in America who regularly compete with the newcomers—not a formula for improving the plight of the neediest Americans.

In the past, many politicians understood that complex issues had to be addressed in a bi-partisan way. It is not obvious that the current Democratic and Republican politicians have their perspectives. Bi-partisan solutions to the issues we face could be the difference between strong and weak economic growth that will affect the prosperity of American families.

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