SIGNATUREFD

THE CRISIS OF CONFIDENCE

A SIGNATUREFD WHITEPAPER

abstract

What has happened to the American Dream? Since the economic crisis four years ago, we've witnessed a serious crisis of confidence in the general U.S. population, which is struggling with still-high unemployment figures, a slow-to-nonexistent housing recovery, and concerns about inflation and stagnant wage growth. That shrinking confidence has been accompanied by growing populist rhetoric from both the right (in the form of the Tea Party) and the left (with the Occupy Wall Street movement), who are ready to take elites to task for the country's problems. While we predict political upheaval in the years to come, as people attempt to resolve America's various challenges, the real antidote to the crisis involves a turn back toward true free market capitalism, so that the U.S. can again move forward with confidence.

In their book, *Mad as Hell*, Scott Rasmussen and Doug Schoen conclude that, "The new populist revolt isn't about partisan identification. It's about a *loss* of identification. Americans no longer know whom to trust. They no longer know who is on their side. They no longer identify with the political establishment, because the political establishment no longer understands them."[1]

Something about this downturn seems different than those that have come before. Certainly this is due in part to the depth and duration of the economic slump, but four years from the last peak in U.S. economic output, one gets the sense there is more behind it. There is a crisis of confidence that seems to risk pulling in all of our society's foundational institutions. Christine Lagarde, the new managing director of the International Monetary Fund, recently said, "The global economy is facing a crisis of confidence worsened by policy indecision and political dysfunction."[2] The typical American views the system as being rigged against them in favor of the elites. Similarly, nearly a third of international investors would back "radical reworking of the rules and regulations,"according to a recent Bloomberg survey.

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>
> —CHRISTINE LAGARDE, MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND

SOURCES OF DISCONTENT

After any significant economic downturn, anxiety and uncertainty are always present, but by this point, with the economy growing again and the stock market near all-time highs, confidence should be coming back. Instead, even with the U.S. economy technically having emerged from a recession in 2009, measures of consumer confidence remain near their lows. What can account for this continuing lack of confidence and fear of the future? Certainly the most relevant economic indicators for the average American have shown little improvement—unemployment, housing prices, and inflation.

The unemployment rate seems stuck over 8%, with comprehensive measurements of the "under-employed" rising into the mid-teens. Though these figures are off their highs of early 2009, the recovery in employment has been extremely weak by historical comparison. Additionally, the figures would be even worse if it were not for the fact that labor participation (those who say they are working or want to work) has dropped to multi-decade lows as many long-term unemployed have simply given up and withdrawn from the labor pool altogether.

Housing prices are also a critically important factor in consumer confidence. First, housing is traditionally the largest single investment for most Americans. We are now more than six years from the peak in housing activity and price declines remain the norm. Other than a brief respite in 2009 and early 2010 created by government tax credits, home prices have declined steadily since mid-2006. This has left not only overall home equity at its lowest levels on record, but also means that millions of homeowners owe more on their homes than they are worth. This could be the case even for homeowners who have been in their current properties for seven years or more, which harms confidence and creates structural roadblocks for recovery. Homeowners with underwater properties may not be able to refinance to improve monthly cash flow. They also may be unable to sell and take advantage of current bargains by moving up to a larger home.

Low housing prices also affect employment mobility, as many homeowners are confronted with the decision of either remaining unemployed in their current location or defaulting on their home mortgage so they can move in search of new employment. Although homes are now very attractively priced (see SignatureFD's white paper from March 2011[3]) they are not likely to rise sharply until these structural roadblocks are removed.

THOUGH OFFICIAL INFLATION STATISTICS SHOW RELATIVELY LITTLE PRICE CHANGE FOR THE LAST SEVERAL YEARS, THOSE AT LOWER INCOME LEVELS ARE BEARING THE MAJORITY OF PRICE INCREASES IN FOOD AND ENERGY.

Finally, the impact of inflation doesn't hit all consumers in the same way. Though official inflation statistics show relatively little price change for the last several years, those at lower income levels are bearing the majority of price increases in food and energy. The growing pressure on lower-income Americans is exacerbated by the stagnation in real wage growth. Recent government reports show that the median male wage has been stagnant for almost 40 years. According to a recent article: "Median earnings for full-time, year-round male workers: 2010—$47,715; 1972—$47,550. That's not a typo. In 38 years, the annual earnings of the typical male worker, adjusted to 2010 dollars, have risen by $165, or $3.17 a week."[4] During this same period, after-tax corporate profits as compared to the total size of the economy have risen by nearly 70%—from 7% to more than 11%.

Warren Buffett, who has been outspoken on the issues of taxation and income disparity, recently quipped, "There has been class warfare going on for the last 20 years and my class has won." It is true that the majority of capital is controlled by a small percent of the population and thus these gains, which have come at the expense of wage increases, have tended to flow to the wealthiest Americans. Robert Reich writes, "The share of total income going to the richest 1% of Americans peaked in both 1928 and in 2007, at over 23%. The same pattern held for the richest one-tenth of 1% ... and the same pattern applies for the richest 10%, who in each of these peak years received almost half the total."[5] In a country that has been built on the growth of the middle class it would seem alarming that income disparities here are larger than in most countries, including South Africa and Argentina.[6]

THE WEALTH OF NATIONS

A true free market capitalist system will always create inequality of wages and wealth, so the data on income and wealth disparities should not be a complete surprise and at some level is desirable. Moreover, capitalism will create booms and busts and these are part of the cleansing system to reward discipline and penalize carelessness. That said, history does not look kindly on periods when these figures are stretched or when the market cleansing process temporarily breaks down.

Many have wondered what growing economic inequality means for the future of our country. James Truslow Adams coined the phrase "American Dream" during the depths of the Great Depression (1931). In his definition, "Life should be better and richer and fuller for everyone, with opportunity for each according to ability or achievement." Today, many see this as a broken promise.

George Friedman of Stratfor writes that the lesson we get from Adam Smith's classic economic treatise, *The Wealth of Nations*, is that, "The measure of the system is not whether individuals benefit, but whether in benefiting they enhance the wealth of the nation." Friedman goes on to say:

> *"The greatest systemic risk, therefore, is not an economic concept but a political one. Systemic risk emerges when it appears that the political and legal protections given to economic actors, and particularly to members of the economic elite, have been used to subvert the intent of the system … Put another way, the crisis occurs when it appears that the financial elite used the politico-legal structure to enrich themselves through systematically imprudent behavior while those engaged in prudent behavior were harmed, with the political elite apparently taking no action to protect the victims."*[7]

So in Friedman's view, the economic and financial systems are created and maintained as part of the overall political system. When operating properly, these systems help to balance each other. However, at certain points in history, financial crises expose underlying structural challenges that eventually lead to a political crisis.

AT CERTAIN POINTS IN HISTORY, FINANCIAL CRISES EXPOSE UNDERLYING STRUCTURAL CHALLENGES THAT EVENTUALLY LEAD TO A POLITICAL CRISIS.

Why is it important to recognize the distinction between economic and political crisis? In our opinion, it is because if one believes we are living through a political crisis rather than an economic crisis, the length of time to full recovery in confidence will be longer than expected, and eventually the focus of change will be on the political system rather than on the markets, business, or banks. This will occur because the populous believes they can't directly control the economic and business elite, but they can have a direct impact on the political elite.

In our opinion, both parties are misreading the current crisis. The Democrats are speaking a populist message against the economic elite, but their actions have only delayed adjusting the structural and long-term forces at work. The Republicans, on the other hand, seem focused on adding even more incentive to the holders of capital, which is likely to increase the dispersion between the richest few and the average American. Maybe they do understand the focus of the crisis and would rather use these tactics to purposefully misdirect the frustration of the populous.

THE TEA PARTY AND OCCUPY WALL STREET

The disaffection for the traditional parties has thus resulted in populist movements springing up on both ends of the political spectrum. Though very different, both the Tea Party and Occupy Wall Street seem to share some similar traits. In periods of significant change, populist movements are normal and eventually force the political system toward a new equilibrium. In the end, the populist move seems to be about the hollowing out of the core, which is an issue that has been brought into the open as a result of the crisis, but has actually been underway for many years. Natural forces within the changing

IN PERIODS OF SIGNIFICANT CHANGE, POPULIST MOVEMENTS ARE NORMAL AND EVENTUALLY FORCE THE POLITICAL SYSTEM TOWARD A NEW EQUILIBRIUM.

economy are partially responsible, but the issues have been exaggerated by the growing role of policy makers in trying to alter the system. As a result, a larger share of the electorate feels disenfranchised with the traditional political parties and they begin to seek out alternatives. In fact, in a poll last fall by *The Wall Street Journal* and NBC News, nearly 50% of voters now identify with either the Tea Party or the Occupy Wall Street movements.[8]

The evolution of technology, globalization, and the failure of our education and training institutions are at least partially responsible for this disconnect. Low-skill workers, such as those in the service sector, agriculture, and transportation, are not easily outsourced or replaced by technology. As such, their wages are somewhat protected. However, the medium-skilled workers in manufacturing, middle management, clerical, and administrative are more easily replaced by technology and outsourcing, which affects their ability to demand higher wages. At the other extreme, higher-skilled workers have generally accumulated wealth through hard work and leveraging education and technology.

We believe education and good employment opportunities are the solutions, which haven't been as widely available to many in the middle class as they were in generations before. The transformation of the economy from an industrial- and manufacturing-based job creation system to one centered on information and technology is underway. We have been through similar periods in the past, and successfully transitioned our system. For example, "In 1900, 41% of the U.S. workforce was employed on farms, a portion that plummeted to 16% by 1945 and fewer than 2% by 2000."[9]

The single biggest opportunity to improve the employment situation and the financial outlook for all Americans is education reform. A system that is designed to educate based on the jobs likely to exist in the future and adopts new learning methods that are more efficient and teach more science, math, and problem-solving skills will create a more flexible and employable workforce.

So what on the surface look like two unrelated political movements are—maybe unknowingly—in agreement on at least one major issue. The groups on the right and left believe that the distortions and misaligned incentives in our system have allowed some to make money off of others, rather than creating a "rising tide that lifts all boats." Both organizations believe that the elite—who are viewed as the creators of the crisis—then used the crisis to increase their wealth and power. Until the average citizen again feels the system treats everyone fairly and the elite aren't able to manipulate the system, turmoil is likely to exist.

In the end, it is too early to see how the populist movements will permanently impact politics. We will likely get a better idea once the Presidential election season is fully underway. But this is a longer-term cycle that is not likely to be resolved in just one election.

HOPE FOR FREE MARKET CAPITALISM

In a recent *Financial Times* series entitled, "Capitalism in Crisis," George Osborne, the UK Chancellor of the Exchequer, concludes that it is not capitalism that is at fault, saying that, "[M]y argument is that the way to address this doubt is not to run away from capitalism but to run towards it."[10] We agree with this line of thinking. In fact, as we wrote in Part I of this white paper series, much of the fault for the current Debt Supercycle moving to such extremes lies at the feet of policymakers, not in the capitalistic system. Economics is about incentives and crises are generally about distortions of incentives over time. The period since WWII saw numerous distortions, many focused on incentives to take on debt. Now that the system has started to rebel against taking on more debt, growth is being constrained.

Evidence of this thesis can be seen in the emerging economies, such as China, India, and Brazil. As we will touch on later in this series, the major emerging countries aren't blameless in creating the current global imbalances, but at the same time, citizens in these countries aren't claiming that capitalism is in crisis. Rather the opposite. They are rejoicing in the advancement of more than a billion people from poverty to middle class over the last 20 years. The pressure in these countries originates more from the need for political reform as higher income breeds more desire for individual liberty.

As we concluded in the first paper, though the economy has stabilized in many ways, the distortions that have existed have not been fully removed. In some ways, the antidotes for the crisis have actually extended and exacerbated these distortions. Simply looking at the unemployment rate differential for high school vs. college graduates, or the wage gains in the bottom vs. top deciles, shows that nothing constructive has been done to ease the growing disparity between the haves and the have-nots. The efforts to stabilize the financial system and help support the functioning of the market have pushed ever larger amounts of wealth toward the small percent who control the majority of the capital. The stock market is approaching all-time highs again and corporate profits are at record peaks. These are certainly constructive and welcome signs, and if used to lift up the average American, should be celebrated. But if they come at the expense of fixing the system, they will be unsustainable gains.

THE GREATNESS OF AMERICA LIES NOT IN BEING MORE ENLIGHTENED THAN ANY OTHER NATION, BUT RATHER IN HER ABILITY TO REPAIR HER FAULTS.

We will touch more on lasting solutions in a future paper, but for now it is clear that reducing distortions from the system is the only way to correct the imbalances that remain. This generally means reducing government involvement in the economy via "right-sized tax reform," reduced regulatory oversight, and the removal of special interests from the political process. During his campaign for President, Newt Gingrich said, "What is needed is not an expanded safety net, but a trampoline." As we will address in the next paper, the current promises made by governments as part of the expanding welfare state are not sustainable. When this issue is fully recognized and free market solutions are allowed to prevail we will then, and only then, begin the process of rebuilding confidence and prosperity.

RESTORING THE AMERICAN DREAM

The current period has many similarities to the years following 1870 in the United States and Britain and the years following 1930 in the United States. Because the source of the crisis is seen as a collusion of political and economic elites causing a loss of fairness, the result is much more than an economic crisis; it is also a political crisis. These periods often lead to unpredictable election cycles with large turnovers until the people get the change they want—either out of the established political parties or new ones that rise up. Indications are that we are in the early stages of this political change now.

As in these previous periods, confidence will eventually be restored, but a reworking of many of our institutions—political, business, educational, and religious—is likely to be the legacy. Alexis de Tocqueville wrote in the first volume of *Democracy in America*, that, "The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults." In the end, confidence will return, when the populous is convinced that the political system can fix the structural problems and once again create an environment where the *Wealth of Nations* and the American Dream can be restored.

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