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John Dessauer's market review and update as of Wednesday March 9, 2016.

One benefit from the run-up to a national presidential election is that we get detailed information on Americans' feelings about a list of serious matters. It is clear that many Americans are anxious and angry about the economy. They feel they have been left behind. Election polls found that a majority of Americans feel we are still in a recession even though the Great Recession officially ended seven years ago. Clearly this recovery has been very different from past recoveries. The question is, what can be done to lift the pace of growth and improve household financial circumstances? The answer is easy to say and very difficult to achieve. We need to increase the rate of growth in labor productivity. Since mid-2010 the annual rate of productivity growth has been 0.5%. That is far below the 2% annual growth in productivity we enjoyed in the 20 years prior to the 2008 financial crisis. The challenge is to achieve a consensus about what caused the slump in productivity growth so we can correct mistakes and adopt new policies that will be constructive.

There are three basic views about the causes of the productivity slump. Some economists think this will pass by itself and productivity growth will begin to improve in coming years. Others, such as Robert Gordon at Northwestern University, argue that this is a return to normal after a temporary boost from the advent of information technology. The third view is that the slump is curable with the right combination of monetary and fiscal policies.

The super-optimists, those who think things will get better by themselves, have a big problem: productivity growth has been deteriorating, recently running at 0%. That is a strong indication that whatever has been causing the productivity growth slump is getting worse, not better.

This recovery is very different from past recoveries. Not only has the headline GDP growth been slower, it has taken seven years for household income to regain what was lost in the recession. After past recessions it took only two years for household income to recover. The strangest twist of all is that, as meager as it has been, since 2009 the earnings of production and nonsupervisory workers has grown at an average annualized rate of 4.2% - far better than the 3.7% growth of GDP. This is a first since 1975. Clearly, something has to change for productivity and the overall economy to improve.

Economists who argue that the decades of 2% annual growth in productivity were the exception also have a problem. First: for more than 100 years Americans have been innovative. We have enjoyed growth from one invention after another. Each successive innovation amplified the benefits of the previous. For example, airplanes added to the growth of the railroads. There have been interruptions caused by recessions. But they have been the temporary periods rather than the norm. We have not exhausted the benefits of the computer and information technology generally. That should be obvious, even to ivory tower economists. Today's cell phone is a very new device, able to do things that were impossible with the best phone a year ago. Electric cars are becoming a common sight on our roads. Commercial airplanes are now able to fly nonstop for longer

distances than ever before. And technology has increased the supply of oil and driven the oil price down, to the benefit of all oil consumers.

Economists who believe that change for the better is possible have history on their side. The U.S. economy has recovered and increased productivity growth after prior nasty recessions. The recession of the early 1980s, for example, devastated household finances and slashed the rate of productivity growth, but both recovered. It can be done again, but a full recovery is going to take more time and the right government policies.

Consumption accounts for two-thirds of our economic growth. Some economists look at the increased spending in January as a sign that consumers are coming to the rescue. That, however, is shallow thinking. Yes, we want consumers to spend, but not as spendthrifts. We want financially strong consumers who are able to save and invest as well as spend. Productivity growth is crucial for the necessary underlying economic strength. **The more workers produce for every hour on the job, the more companies can afford to pay them without increasing prices.**

Most economists agree that the U.S. needs substantial improvement in our infrastructure, roads, bridges and airports. Well executed spending on infrastructure would boost productivity. The U.S. problem is the amount of government debt. That limits the amount that could sensibly be borrowed to pay for the infrastructure projects. That is not to say our government won't continue to borrow. But it means that proposals to borrow more billions for infrastructure projects are a hard sell. The alternative is to raise taxes. But raising taxes would be counterproductive. Taxes transfer money from the private sector to the government. That decreases private sector capital that otherwise would be spent or invested by individuals and businesses. Paying for infrastructure

projects by raising taxes decreases productivity enhancing private sector efforts. Further, government does not have a good record when it comes to spending taxpayer money. Shifting capital from the private sector to government too often means a lesser outcome due to the cost of government bureaucracy.

Between February 17 and 24 the Associated Press surveyed a range of corporate, Wall Street, and academic economists. Nearly half agreed that the volume of new corporate and bank regulations implemented by the Obama administration has slowed growth. They introduced uncertainty, increased costs, and reduced opportunities.

The bottom line is that we cannot expect help from the federal government - at least for the next twelve months. Even with a new administration, the best we could expect right away would be a reversal of the most inhibitive government regulations.

For at least the next year this places the burden for sustaining GDP growth and improving productivity on the Federal Reserve and monetary policy. No wonder investors are so sensitive about raising interest rates.

The very low pace of productivity growth is one major reason Federal Reserve board members are so anxious to lift interest rates back to "normal." Long awaited wage increases could quickly result in higher inflation as businesses raise prices to protect profit margins. So far our Federal Reserve has done a remarkable job balancing the need for stimulus against the economic devil called inflation. The economy has grown and inflation has remained low.

Morgan Stanley is optimistic that the Federal Reserve is up to the challenge. Their economists and analysts expect the U.S. economy to grow 1.8% this year and next. They see a continuation of the slow growth we have gotten used to and complain about.

Morgan Stanley adds that patience will be required because: “It will take a much better pace of investment over a sustained period of time to support an improving labor-productivity trend.”

My conclusion is that Morgan Stanley is most likely correct. We will have slow growth for the foreseeable future. In this slow growth environment stocks will continue to be a better choice than bonds or cash.

I will have the next market review and update for you one week from today on Wednesday March 16, 2016.

All the best,

John Dessauer

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