Insights and Observations: Third Quarter 2022

Until the second half of the 20th century, America's population was spread out. Many lived in areas where land was cheap. But as more people moved to the cities, and stricter zoning codes were passed, land prices and housing costs have soared.

According to Morris Davis, a professor of finance at Rutgers Business School, rising land costs are responsible for most of the increase in home values over recent decades. It is estimated that land now accounts for 47% of U.S. home values … up from less than 20% in the 1960s.

> **The United States, a country of wide-open spaces, is short on land. Or at least land where people can live.**
>
> **Konrad Putzier – WSJ 9/25/22**

For example, land values in Manhattan remained relatively stable, adjusted for inflation, from the 1880s to the 1970s. Since then, they are estimated to have grown at a 13% annualized rate.

From 1967 to 2017, government transfer payments to the bottom 20% of household earners increased 269% … while middle-income earners saw after-tax earnings rise by 154% over the same period. The Census Bureau, however, reports that income inequality has risen by 21% since 1967. How can that be?

In 1947, over 90% of all employment compensation and government assistance was received in cash. At that time, the decision was made to not include noncash payments, which are inherently more difficult to measure. Oddly enough, the Census Bureau continues to exclude most government transfer payments as income. These non-cash payments include food stamps, Medicare, Medicaid, housing subsidies, and various other government benefits.

For example, the bottom 20% of households earned only $6,941 on average in 2017. But their average income jumped to $48,806 when transfer payments were included.

Taxes paid are also not treated by the Census Bureau as being income lost to the taxpayer. In addition, household size is not considered. After adjusting for transfer payments, income taxes, and household size, the bottom three household income quintiles (60% of all American households) had roughly the same average income levels.

Contrary to conventional wisdom, the most dramatic and consequential change in the distribution of income in America in the past half-century isn't rising income inequality but the extraordinary growth in income equality among the bottom 60% of household earners.

Gramm/Early – WSJ 8/29/22

A recent article by PBS reporter Paul Solman cited a 2018 academic report that concluded *"since the early 1960s, increasing government transfers and tax progressivity have resulted in little change in after-tax top income shares."*

In the course of validating report's conclusion, one of Mr. Solman's resources asked not to be quoted, stating *"There is widespread public perception that the distribution of income and wealth has become so much more unequal. The consensus is so strong that no one is really allowed to question it in public."*

Starting in 2009, the Census Bureau added non-cash payments to the measurement of poverty. Not surprisingly, child poverty has fallen 59% over the past 30 years, according to Census Bureau data.

What is the right amount of redistribution of income? It now remains to contemplate and debate the big question, armed with a much-improved knowledge of the data.

Michael Edesess, Advisor Perspectives – 10/10/22

Millions of people stopped working during the pandemic for such reasons as retirement, lack of child care, and fear of Covid. In August, the total size of the U.S. labor force reached 164.7 million people, exceeding pre-pandemic levels for the first time.

According to a recent study by authors from Stanford and MIT, the U.S. would have another 500,000 workers if not for people who suffer from lingering symptoms … so-called long Covid. From March 2020 to June 2022, the study found an estimated 10 workers per thousand missed an average of one week from work due to health reasons. This was up from an average of 6 workers per thousand before the pandemic.

Many economists see the nation's workforce's slow recovery combined with the high demand for workers as among the U.S. economy's key challenges, restraining many employers' ability to provide goods and services and contributing to price pressures. Fixing this imbalance, they say, will be essential to lowering high inflation.

Gwynn Guilford – WSJ 9/12/22

The Internal Revenue Service received $80 billion from Congress to update technology and strengthen enforcement. They will need to hire tens of thousands of workers at a time when IRS human resource workers are understaffed, government pay scales are not very competitive, and the labor market is unusually tight. The U.S. unemployment rate is at a historically low 3.5% … with an even lower 1.3% unemployment rate in the finance sector.

The Brookings Institute estimates the cost of raising a child through high school has climbed to more than $300,000. The estimate includes expenses such as housing, food, clothing, healthcare, and child care, as well as childhood milestones and activities.

A lot of people are going to think twice before they have either a first child or a subsequent child because everything is costing more. You also may feel like you have to work more.

Isabel Sawhill, Brookings Institute – WSJ 8/19/22

China's economy continues to struggle with its zero-Covid polices and a collapsing real estate market. While economists have reduced short-term growth forecasts, they are becoming more concerned about China's high levels of debt and unfavorable demographic trends.

The sharp slowdown in China's growth in the past year is prompting many experts to reconsider when China will surpass the U.S. as the world's largest economy – or even if they ever will.

Stella Yifan Xie – WSJ 9/2/22

So, when is China's economy projected to overtake U.S. GDP? The Centre for Economics and Business Research and The Japan Center for Economic Research have both pushed back their estimates to sometime after 2030. Former U.S. Treasury Secretary Lawrence Summers sees parallels between earlier prognostications that the U.S. economy would be outpaced by Japan or Russia … predictions that now seem laughable.

> **I think there is a real possibility that something similar would happen with respect to China.**
>
> **Lawrence Summers, Harvard University – WSJ 9/2/22**

Capital Economics researchers believe that China's economy will reach about 87% of the size of the U.S.'s in 2030 … before dropping back to 81% in 2050. They reference China's declining working-class population along with weak productivity growth.

> **A lot of people for a long time have overestimated the competence of China's leadership and have been shocked by the missteps with Covid and the property sector.**
>
> **Mark Williams, Capital Economics – WSJ 9/2/22**

It’s probably inevitable that China’s economy will someday out-produce the U.S. Remember, China’s population is more than four times larger, and economic growth is simply a function of hours worked multiplied by worker productivity. We should be comforted with the fact that living standards in the U.S. (on a per capita basis) are five times greater than in China. That measure won’t be challenged anytime soon.

At the end of 2021, over $7 trillion was indexed to the S&P 500 Index in *passively* managed funds, while about $8.5 trillion was benchmarked to the index but *actively* managed. History has demonstrated that very few active managers consistently beat their respective benchmarks.

According to data from S&P Dow Jones Indices, only about 5% of domestic large-cap mutual funds (investing in large U.S. companies) beat the S&P 500 Index over the past 20 years. Only about 26% of the funds actually survived over that entire time period. Last year, 85% of actively managed funds fell short of the 29% return of the S&P 500.

During the first half of 2022, active managers did better than usual, with 49% beating the benchmark. The last time the majority of active managers outperformed the index was in 2009. Stock performance during both periods was characterized by a high level of dispersion. Dispersion measures the spread of returns by the index’s stocks.

What higher dispersion does is it magnifies the rewards to skillful insights. It also magnifies the rewards of luck.

Tim Edwards, S&P Dow Jones Indices – WSJ 9/15/22

The Organization for Economic Cooperation and Development (OECD) estimates Russia's invasion of Ukraine will cost the global economy $2.8 trillion in lost output by the end of next year. The biggest conflict on the continent since WWII has caused energy prices to surge, dislocated supply chains, and aggravated global food shortages.

We are paying a very hefty price for the war.

Alvaro Santos Pereira, OECD Chief Economist – WSJ 9/26/22

The nonpartisan Congressional Budget Office expects student-loan forgiveness to cost the federal government $400 billion. The decision to extend a suspension of payments to December 2022 will also add another $20 billion to the tab. The CBO's analysis did not include estimates for the cost of the changes to income-driven repayment plans. The Penn Wharton Budget Model estimates the total program could cost up to $1 trillion.

There is never a shortage of big issues to discuss. But one of the most important is our growing U.S. government debt, which just reached $31 trillion. It's hard to believe, but the outstanding debt was *only* $10.6 trillion when Barack Obama took office, and *only* $22.7 trillion pre-pandemic.

It's really difficult to get your arms around $31 trillion. Consider these observations from the Peter G. Peterson Foundation:

- It is more than the combined economies of China, Japan, Germany, and the United Kingdom.
- It amounts to $236,000 per household or $93,000 per person in America.
- If every U.S. household contributed $1,000 per month, it would take 19 years to pay off the entire balance.
- It would cover a four-year college degree for every graduating U.S. high school student for 73 years.

Thanks to low interest rates, we may have become complacent about mounting U.S. debt levels. But higher interest rates and nonstop deficit spending will eventually overwhelm our prospects for economic growth. It will be the equivalent of trying to run a marathon with a refrigerator tied to your back.

At some point investors could lose confidence … spiking interest rates along with inflation. We need to get ahead of this issue, hopefully sooner rather than later.

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