

#46 Irrational Exuberance: Earnings Growth & Stock Valuation

#47 The Technology Lottery

#48 The Baby Boom Chart Book 2000

#49 How To Value Earnings Growth

Topical Study #50

LIVING

LA VIDA LOCA

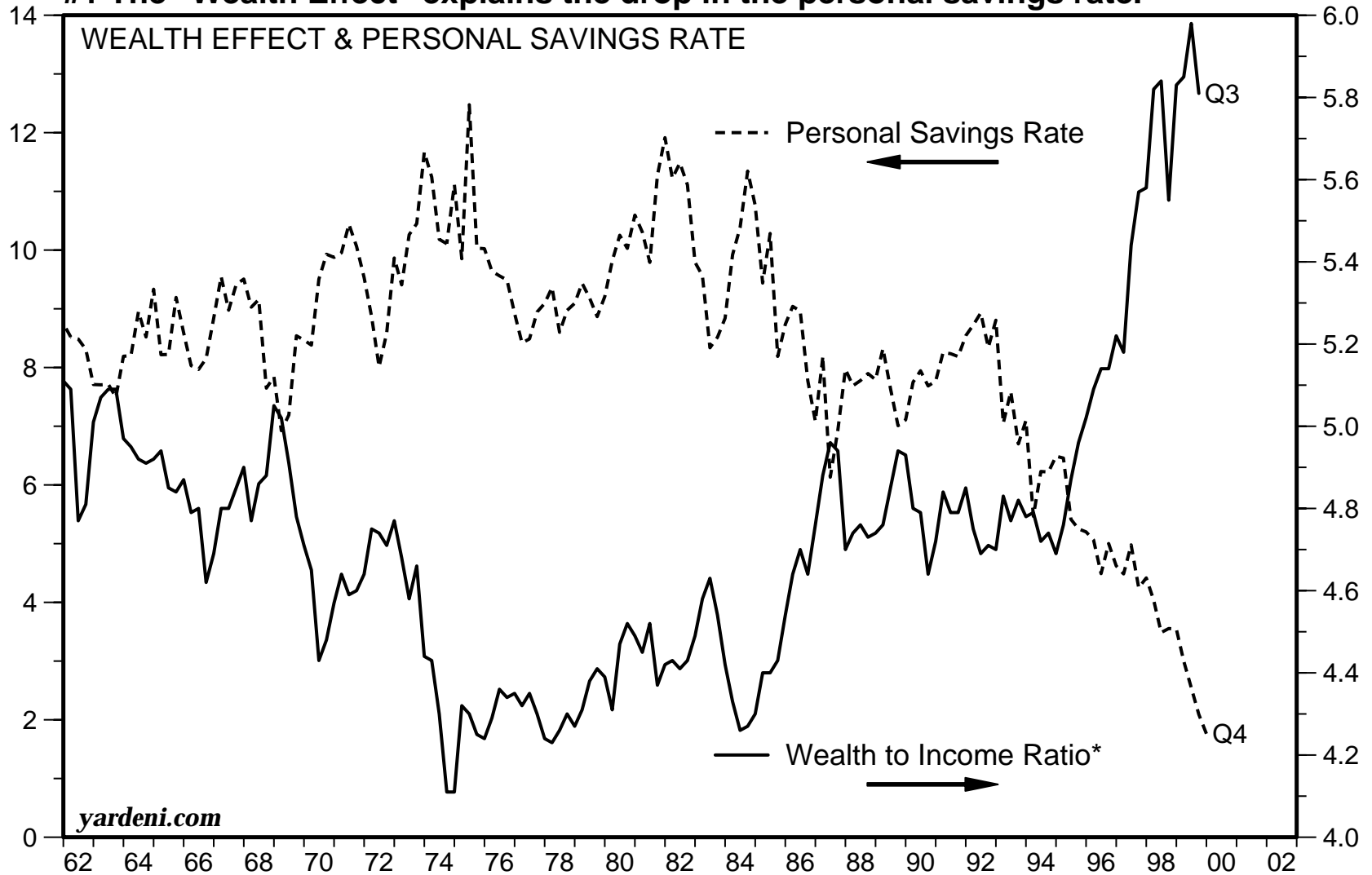


Dr. Edward Yardeni
Chief Economist
& Global Investment Strategist

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www.yardeni.com

#1 The "Wealth Effect" explains the drop in the personal savings rate.



* Ratio of net worth of households to disposable personal income. Source: Federal Reserve Board, Flow of Funds Accounts.

I. Perpetual Productivity-Propelled Prosperity?

Federal Reserve Chairman Alan Greenspan is concerned that too many of us are “living *la vida loca*,” to quote Ricky Martin’s hit song. Mr. Greenspan concedes that we are working harder and more productively. But we are spending money faster than we are earning it thanks to the stock market’s wealth effect. Consumption is growing faster than income, so the personal savings rate is falling. In his opinion, this excess demand is bound to revive inflation as workers become scarcer and as foreigners tire of financing our swelling trade deficit.¹

I respectfully disagree. Mr. Greenspan acknowledges that productivity is awesome. But he claims that it is driving up earnings expectations, stock prices, and wealth, which in turn is causing demand to grow faster than supply. In my opinion, many businesses have worked hard for well over a decade to improve supply-side productivity. Until the second half of the 1990s, though, demand was weak. The demand boom is now giving companies the opportunity to show how efficient they’ve become. They’ve increased their *potential* productivity over the past 10 to 15 years. But only in recent years has consumer spending been strong enough to *realize* this potential.

Besides, the notion that spending out of wealth, rather than income, doesn’t produce the goods and services that are demanded is an odd one. It presumes that there is no *potential* productivity on the supply side of the economy. It also implies that businesses aren’t rational enough to anticipate that the stock market boom might boost the demand for their products and services. Even if they aren’t, that’s what inventories are for.

Mr. Greenspan has conceded that the Fed’s macroeconomic models aren’t working. The NAIRU and Phillips Curve paradigms have been predicting a rebound in wage and price inflation since the jobless rate fell below 6% during September 1994. Yet, the Fed Chairman clings to the most elementary of all macro models, namely, that excess demand in the labor markets will eventually boost labor costs and that excess demand for goods and services will eventually raise the inflation rate.

In my opinion, with wage inflation showing no sign of rebounding—despite an adult unemployment rate down to 3% currently—why must it do so if this rate drops to 2% or even 1%? Could it be that tighter labor markets are one of the main reasons that productivity growth has been so strong recently? I think so. In competitive markets, employers will go out of business if they pay their workers more than is justified by their productivity. Wage inflation has been hovering in a relatively flat trend between 3.5% and 3.8% since October 1998.

In competitive markets, entrepreneurs respond to the labor shortages by devising new methods and technologies for working around the problem. Companies continue to outsource to firms with specialized workers who can produce certain components, parts, and services more efficiently than they can do so internally. This has been an important

¹ See the Greenspan Center at www.yardeni.com/greenspan.asp.

source of productivity increases, and it should continue to be so as Web-based outsourcing proliferates.²

II. The Second Stage Of The High-Tech Revolution

The proliferation of Web-based exchanges for goods and services means that participating firms will most likely need fewer internal resources for managing purchasing. These exchanges will likely offer plenty of other outsourcing services including accounting, human resources, legal, and travel. The cost-saving and productivity-boosting powers of the Internet are likely to be awesome.

In my *Topical Study #31*, “Economic Consequences of the Internet,” dated October 22, 1996, I wrote:³

The Internet is fast becoming a global auction market and could commoditize most markets for products and services. The Internet lowers the cost of comparison shopping to zero. Increasingly, the consumer can easily and quickly find the lowest price for any good or service. In the cybereconomy, the low-cost producer will offer the lowest price and provide this information at no cost to any and all potential customers anywhere on the planet. In the low-tech economy, the cost of searching for the lowest price was relatively high, thereby limiting a customer’s search process to local or well-established vendors. Now vendors anywhere in the world can bid for business anywhere in the world. Only the lowest-cost producers are likely to survive and prosper in the global cyber-marketplace. The resulting competitive pressures will force every business to strive to be among the low-cost producers. Prices for identical products will rapidly converge to the lowest price offered on the Internet.

In my opinion, the Information Revolution is just finishing Stage I. This first stage spanned the previous decade, when the PC and the Internet proliferated. In the decade ahead, Stage II should encompass the interaction of broadband and wireless technologies with the PC and the Internet. Telecommunication costs are likely to plummet over the next 10 years. Video streaming will likely be easy and cheap. Cell phone calls should be conducted routinely over the Internet. Net2Phone has already lowered its domestic call charges to a penny a minute, and has been promoting a limited-time offer of free calls.⁴

So my unsolicited advise to the Fed folks: Why can’t we all just let the good times roll? Productivity-propelled prosperity is good, not bad. I could be wrong, in which case inflation will rebound. Then the Fed will be fully justified in tightening credit conditions. But, in the meantime, let’s give the New Economy experiment more time and room to grow. We might all continue to be pleasantly amazed by the performance of the New Economy.

² See the New Economy Center at <http://www.yardeni.com/neweco.asp>

³ <http://www.yardeni.com/topical.asp>

⁴ I’ve been hyperventilating about the High-Tech Revolution since 1995. See my Topical Study #25, “The High-Tech Revolution In The US of @,” <http://www.yardeni.com/topical.asp>.

III. Life In The Fast Lane

The Fed Chairman's concern that the wealth effect might cause inflationary excess demand isn't justified based on the experience of the auto industry. I believe that when consumers experience a wealth windfall, buying a new car is probably near the top of their list of "things to buy if I win the lottery." Sure enough, in February, domestic car and light truck sales soared to a new record high of 16.2 million units at a seasonally adjusted annual rate. Somehow, the auto industry has managed to have the cars that consumers want with employment in the industry at a standstill. Instead of rising, new car prices are actually falling. Over the past 12 months through January, the new vehicle CPI index is down 0.8%. Indeed, this index has been going down since the middle of 1997.

IV. Why Private Ryan Isn't Saving

I believe that the folks at the Fed don't fully understand how rising stock prices are pushing the savings rate down. If they did, they'd be less worried.

Mr. Greenspan has his favorite economic indicators. They aren't always the same ones. He wisely picks and chooses the indicators that are most important for guiding monetary policy as economic conditions change. In his Humphrey-Hawkins Congressional testimony on February 17, he stressed the importance of monitoring the ratio of household net worth to personal income. His concern is that as this ratio goes up, the savings rate goes down.⁵

This concern was more graphically discussed in the Monetary Policy Report that accompanied the Fed Chairman's testimony.⁶ It included an interesting chart showing the personal savings rate versus the ratio of household net worth to personal income (Exhibit 1). The following excerpt from the report explains the chart:

Added impetus came from another year of rapid growth in net worth, which, coming on top of the big gains of previous years, led households in the aggregate to spend a larger portion of their current income than they would have otherwise. The personal saving rate, as measured in the national income and product accounts, dropped further, to an average of about 2 percent in the final quarter of 1999; it has fallen about 4-1/2 percentage points over the past five years, a period during which yearly gains in household net worth have averaged more than 10 percent in nominal terms and the ratio of household wealth to disposable personal income has moved up sharply.

The savings rate is falling because consumer spending is growing faster than incomes. Most economists say this is happening because consumers are enjoying capital gains, which are boosting spending, but are not included in income. Of course, they should not be included in income because they come from asset revaluations rather than from current production.

⁵ <http://www.bog.frb.fed.us/boarddocs/hh/2000/february/testimony.htm>

⁶ <http://www.bog.frb.fed.us/boarddocs/hh/2000/february/FullReport.htm>

In his testimony, Fed Chairman Greenspan observed:

Historical evidence suggests that perhaps three to four cents out of every additional dollar of stock market wealth eventually is reflected in increased consumer purchases. The sharp rise in the amount of consumer outlays relative to disposable incomes in recent years, and the corresponding fall in the saving rate, has been consistent with this so-called wealth effect on household purchases.

Multiplying the market value of all US stocks by \$0.035 suggests that the wealth effect from the bull market in stocks is currently boosting annual consumption by roughly \$600 billion, or 9.5% of consumer spending. This wealth effect is up about \$400 billion since 1993, and can easily explain why personal savings is down roughly \$200 billion over this same period (Exhibits 2 and 3).

This is only part of the falling savings rate story. A bigger part, I think, is the fact that there is a growing divergence between private pension benefit payments and employers' contributions to their pension plans. The contributions are included in personal income, not the benefits. In 1998, benefits exceeded contributions by a record \$216 billion. Pensioners, undoubtedly, behave as though their benefits are income. And they are likely to have a very low relative savings rate for such income. The government's bean counters, on the other hand, correctly count corporate pension plan contributions as personal income, not the benefits paid out (Exhibits 4, 5, 6, and 7).

The divergence between the official savings rate and the unofficial "behavioral" rate can be largely explained by the divergence between pensioners seeing their benefits as their income and the government statisticians defining contributions as income. In 1998, the official savings rate was 3.7%. The behavioral rate was 6.9% (Exhibit 9).

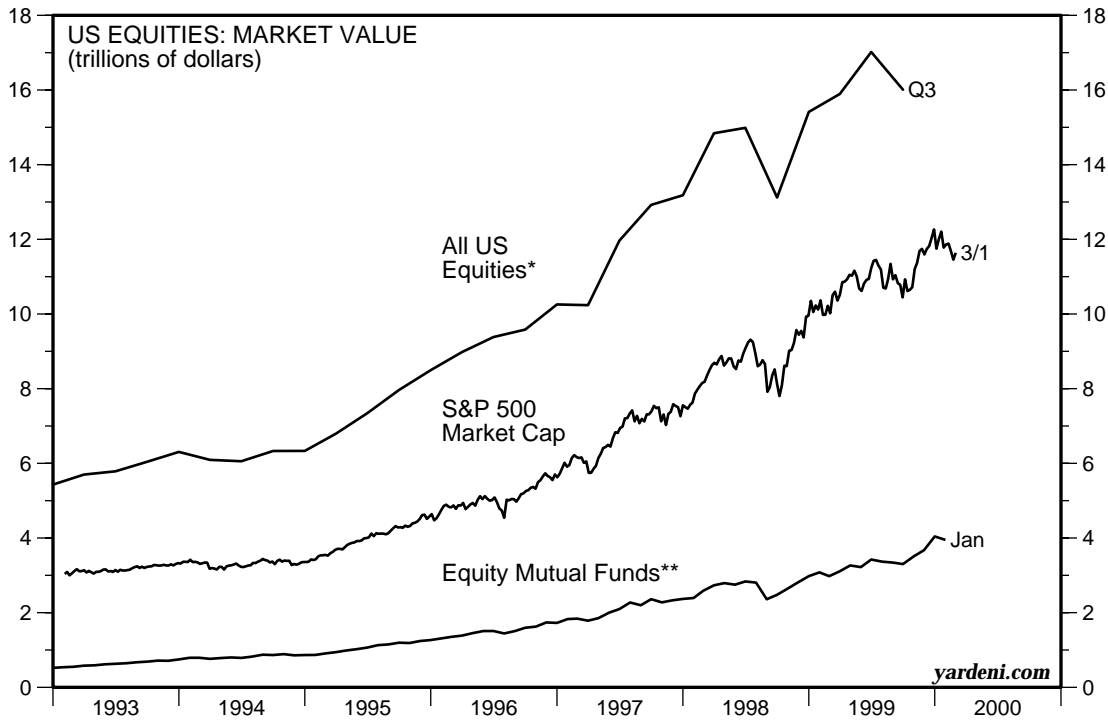
So the official savings rate is falling mostly because soaring stock prices are "overfunding" corporate pension plans. The corporations can pay out their rising benefits to retirees, while increasing their contributions at a much slower pace (Exhibits 10, 11, 12, and 13). This means that corporate profits are higher and cash flow stronger as a result of the bull market in stocks. So corporations are in a great position to continue to spend more on capital equipment, which is great for productivity. This is a wonderful consequence of the New Economy.

Hopefully, Fed Chairman Greenspan will come to agree with me that although productivity-propelled prosperity may not be perpetual, we should give it a chance to keep on going as long as inflation remains subdued.



- Wealth Effect -

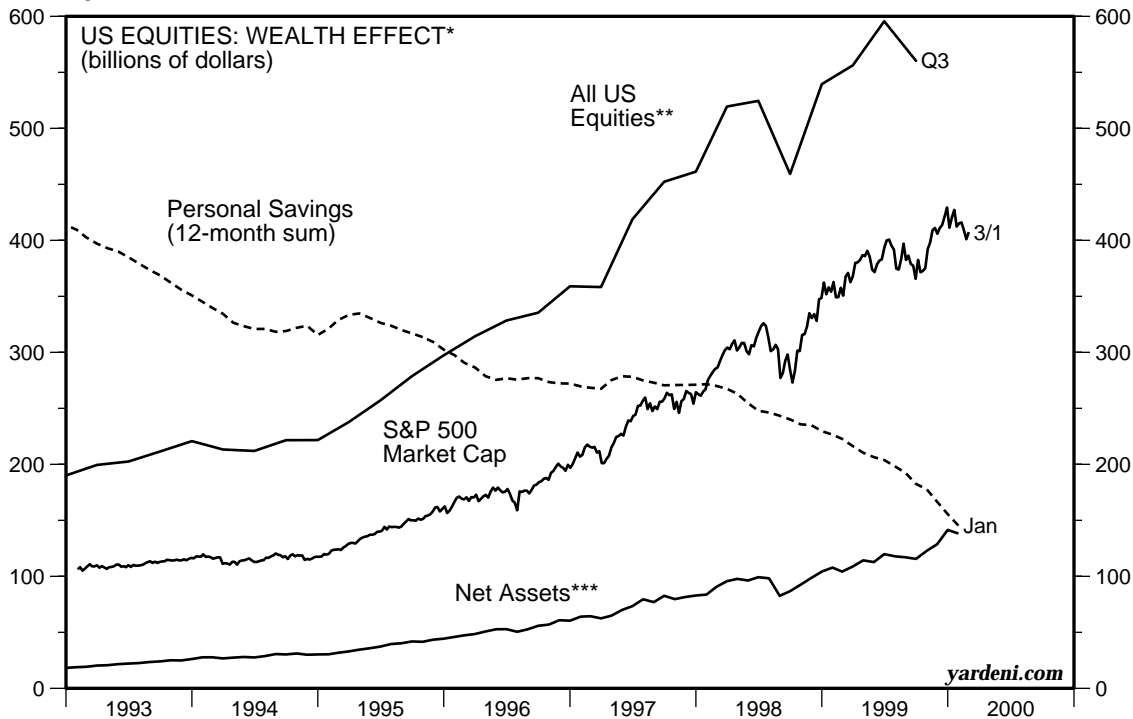
#2



Market value of all US equities has doubled since 1996 to roughly \$16 trillion.

* Flow of Funds Accounts, Board of Governors of the Federal Reserve System.
** Investment Company Institute.

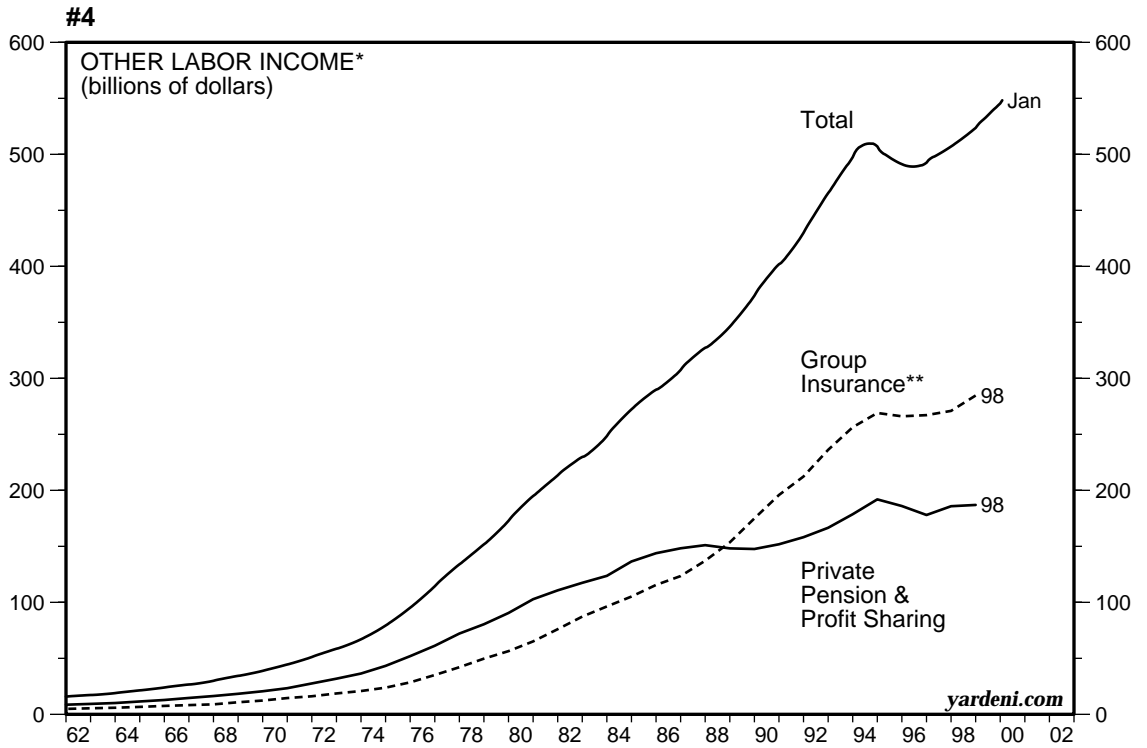
#3



Econometric models show that consumer spending is boosted 3-4 cents for every dollar in wealth. If so, then soaring stock values can easily explain the drop in personal savings.

* Market value times 3.5 cents.
** Flow of Funds Accounts, Board of Governors of the Federal Reserve System.
*** Investment Company Institute.

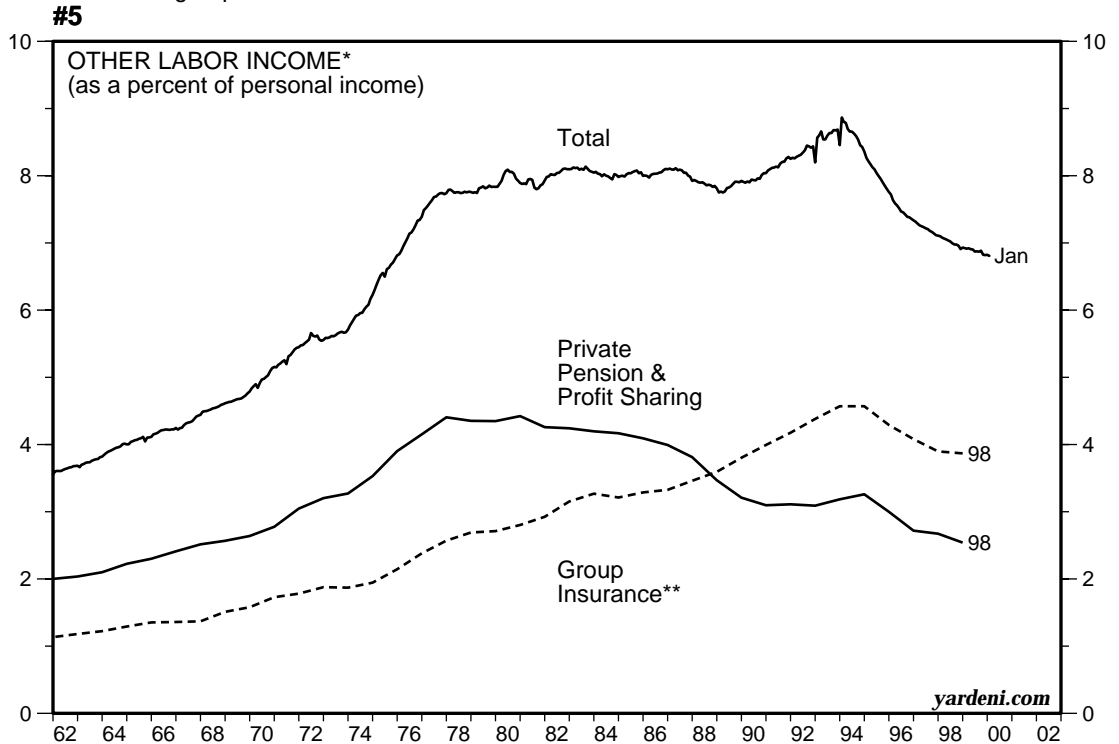
- Other Labor Income -



"Other labor income" currently accounts for 7% of personal income. Its two biggest components are employer contributions to group insurance and to pension and profit sharing plans.

* Includes employer contributions to private pension & welfare funds which includes pension & profit sharing, group insurance (group health & life insurance), workers' compensation and supplemental unemployment. Also other category consisting largely of directors' fees and of judicial fees.

** Includes group health & life insurance.

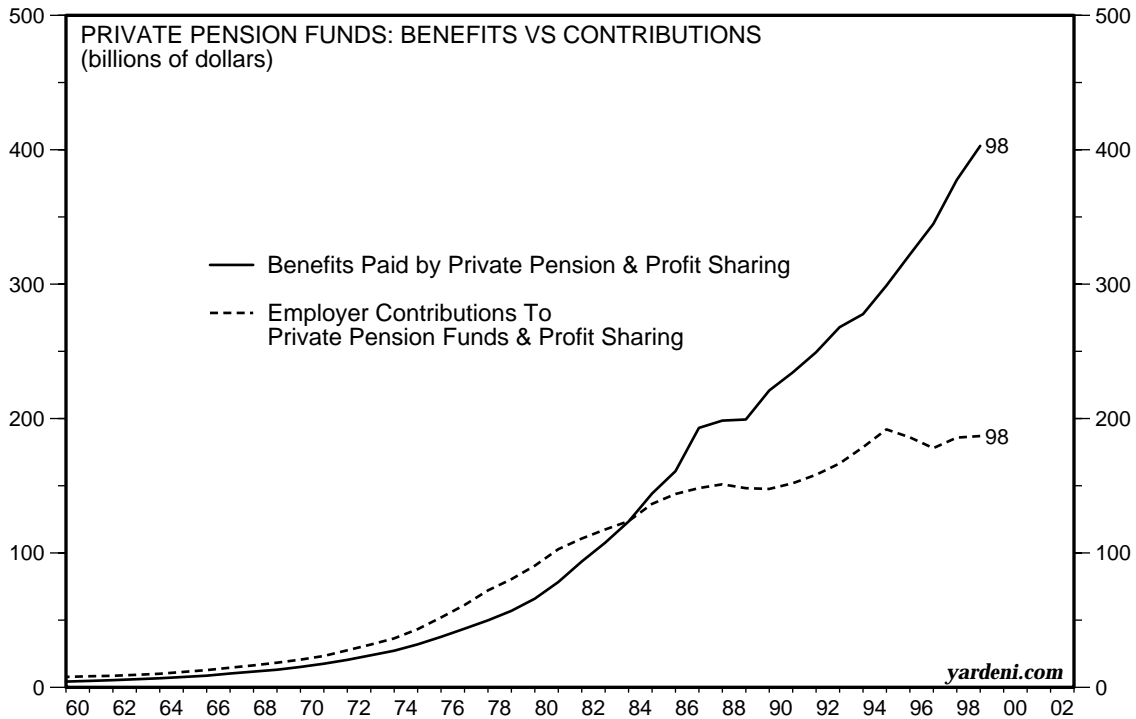


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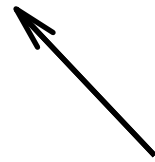
** Includes group health & life insurance.

- Pension Funds -

#6

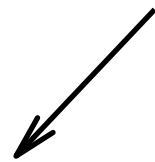
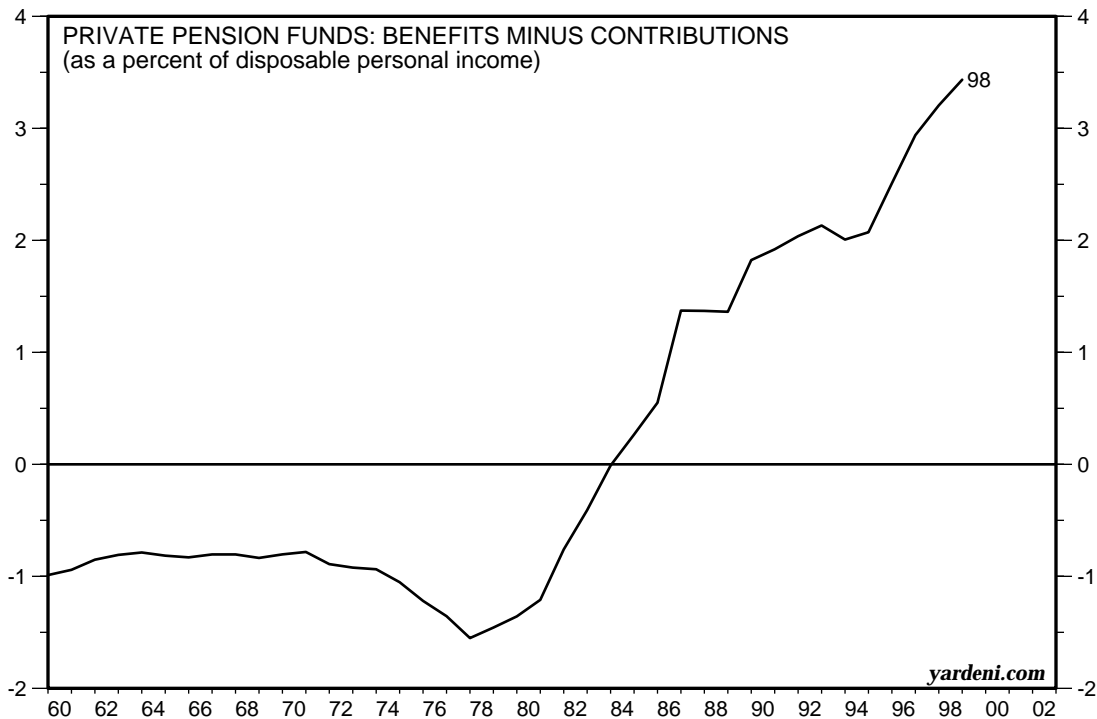


* Source: US Department of Commerce, Bureau of Economic Analysis, "Survey of Current Business".

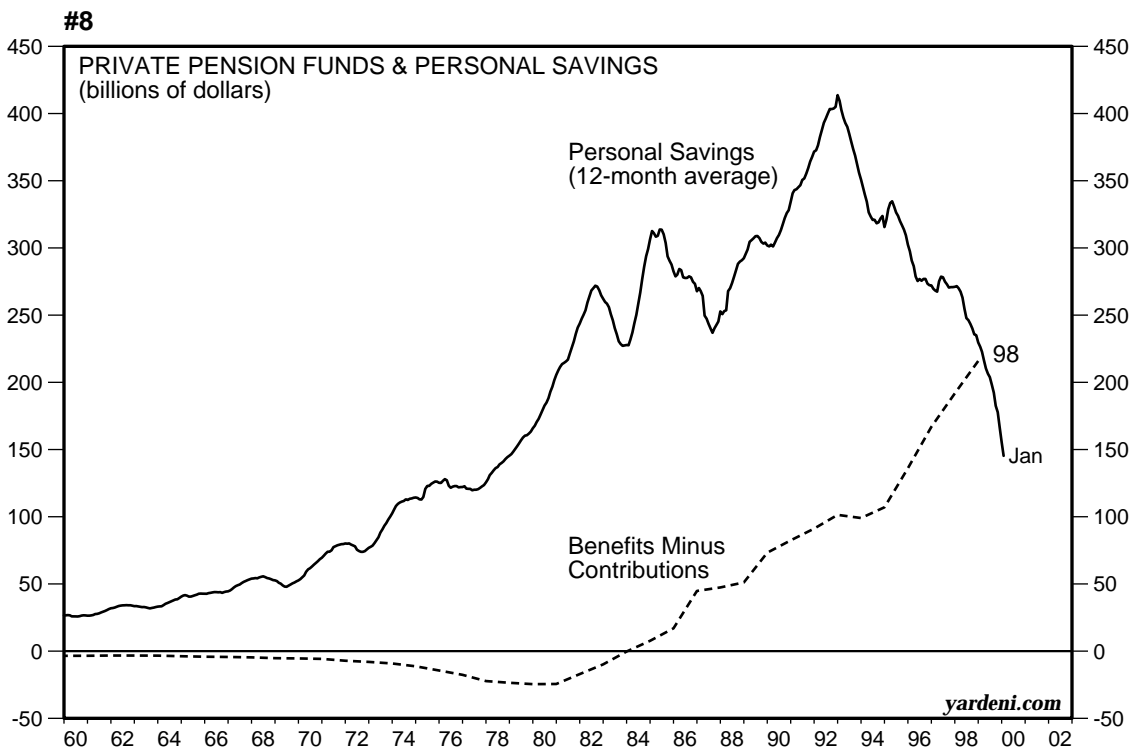


Pension fund contributions are counted as personal income; benefits are not. Benefits now exceed contributions by a record \$216 billion. Pensioners, undoubtedly, behave as though their benefits are income.

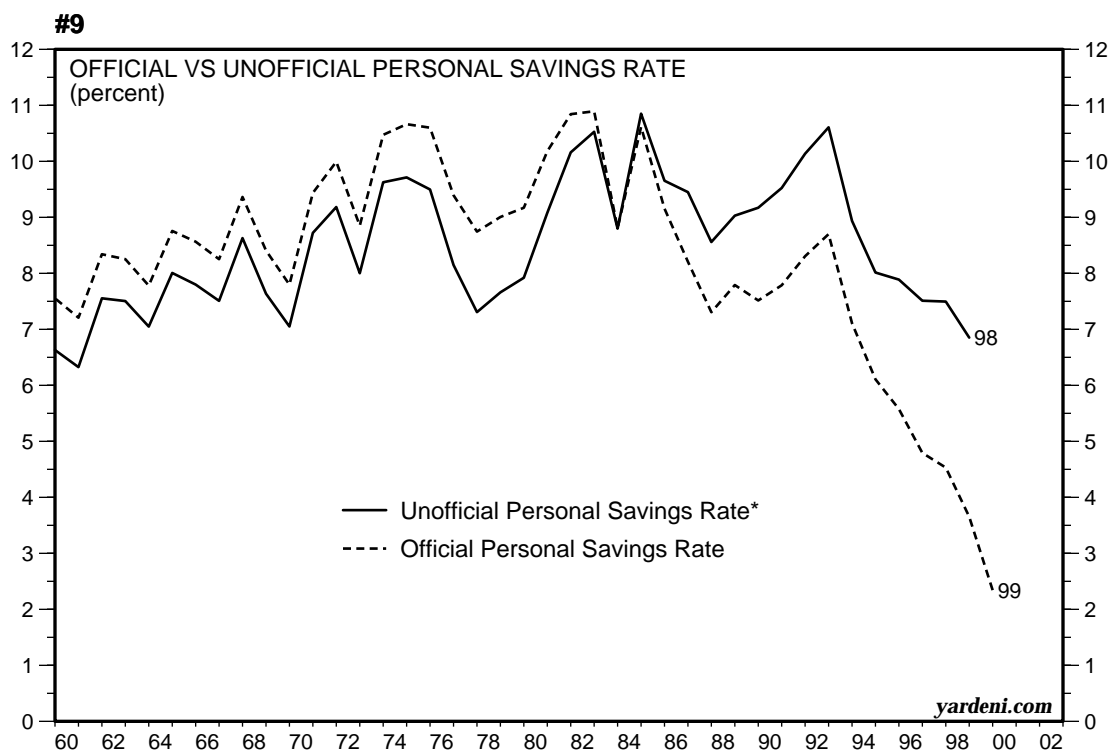
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- Pension Funds & Savings -



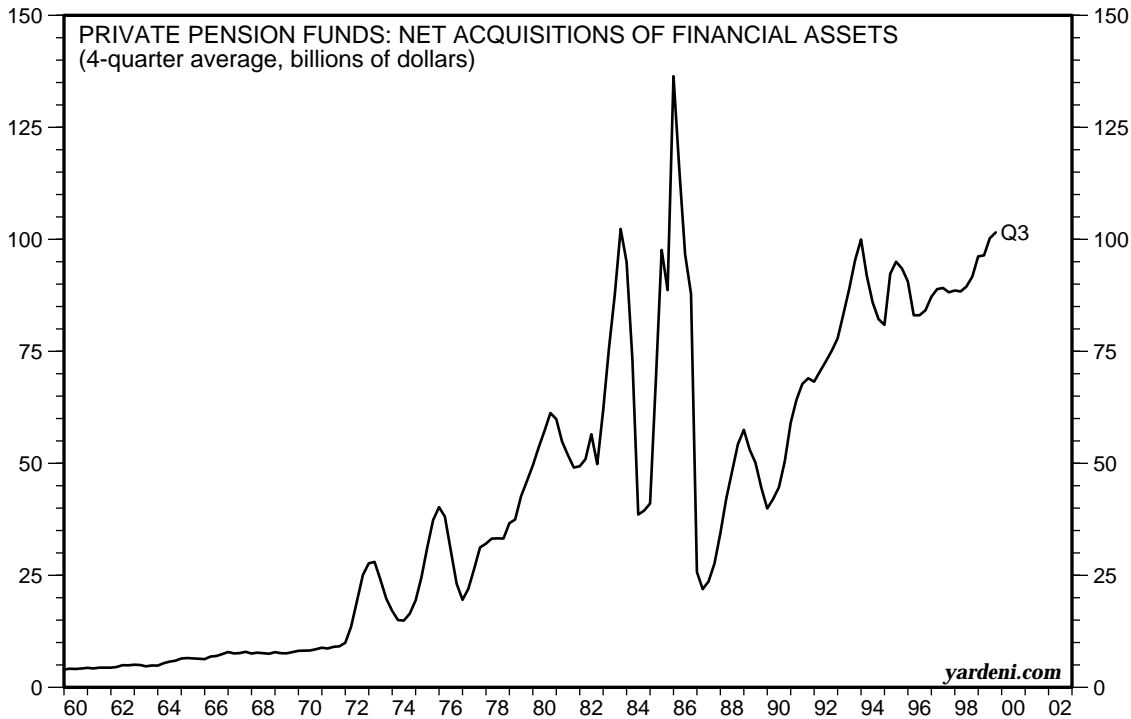
Pensioners view their benefits, not their employers' contributions to pension plans, as income. Adjusting the official savings rate for this shows that this unofficial, behavioral savings rate is much higher than the official rate.



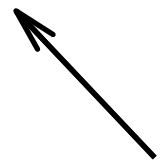
* Personal savings plus difference between private pension fund benefits and contributions divided by personal disposable income plus benefits less contributions.

- Pension Fund Assets -

#10

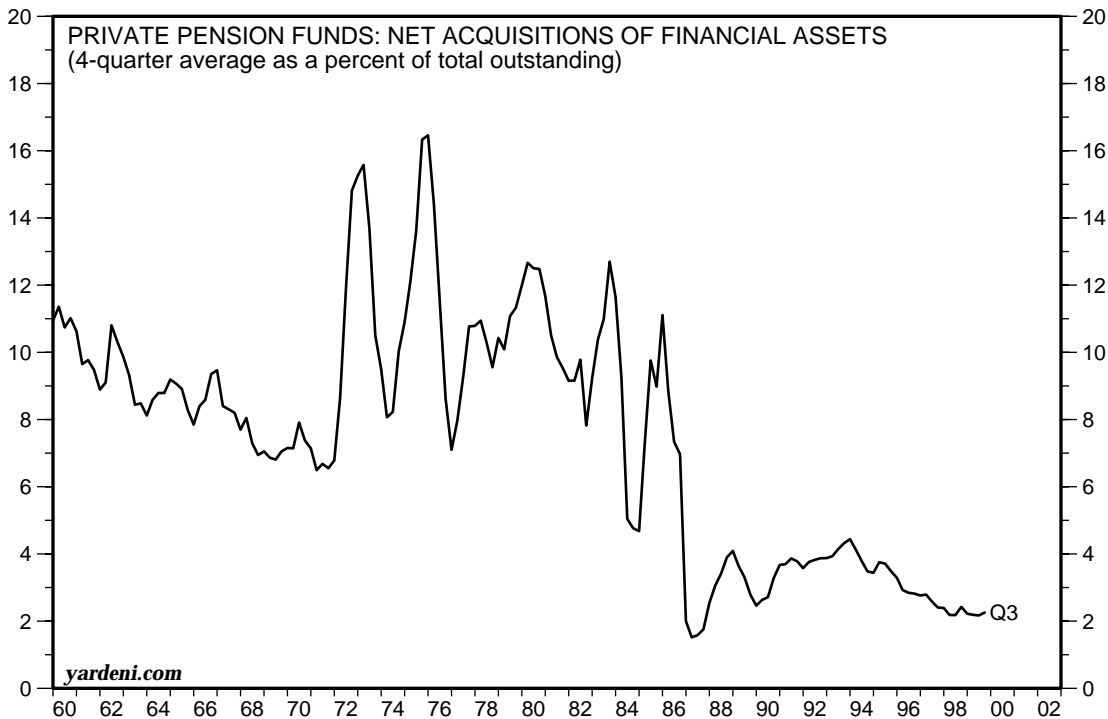


Source: Federal Reserve Board, Flow of Funds Accounts.

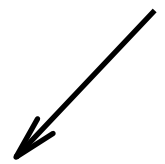


Thanks to the bull market in stocks corporate contributions to private pension plans are near a record low relative to assets.

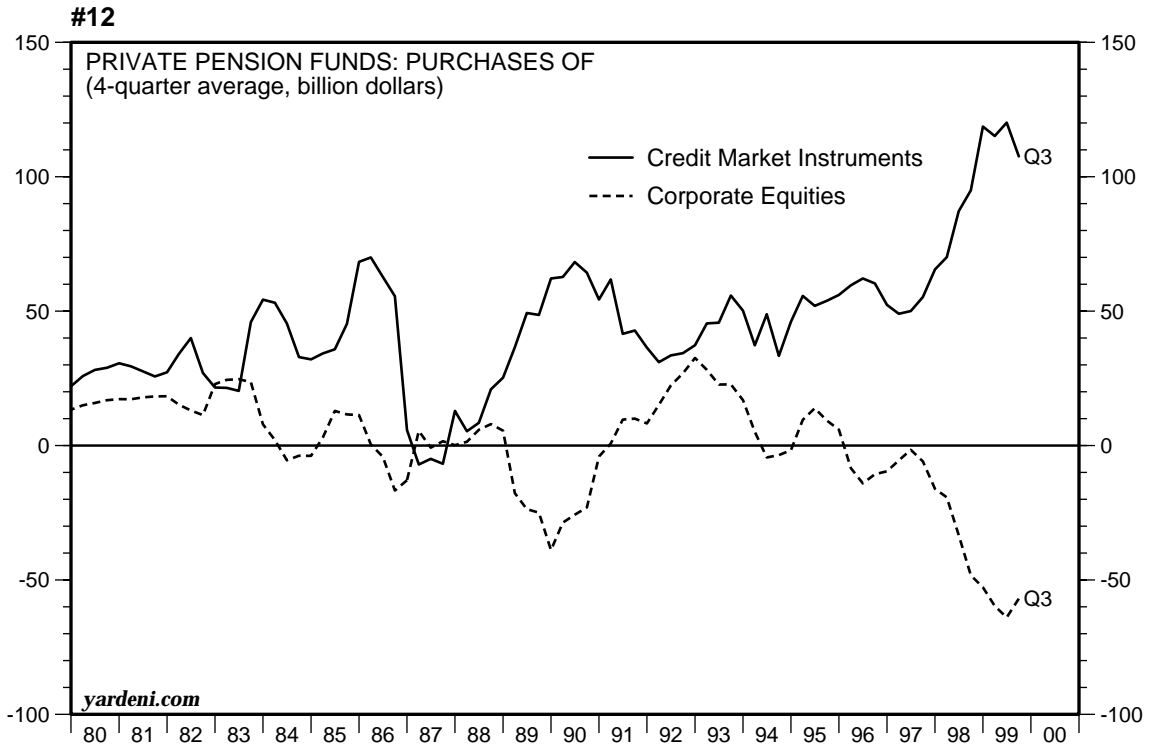
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Source: Federal Reserve Board, Flow of Funds Accounts.

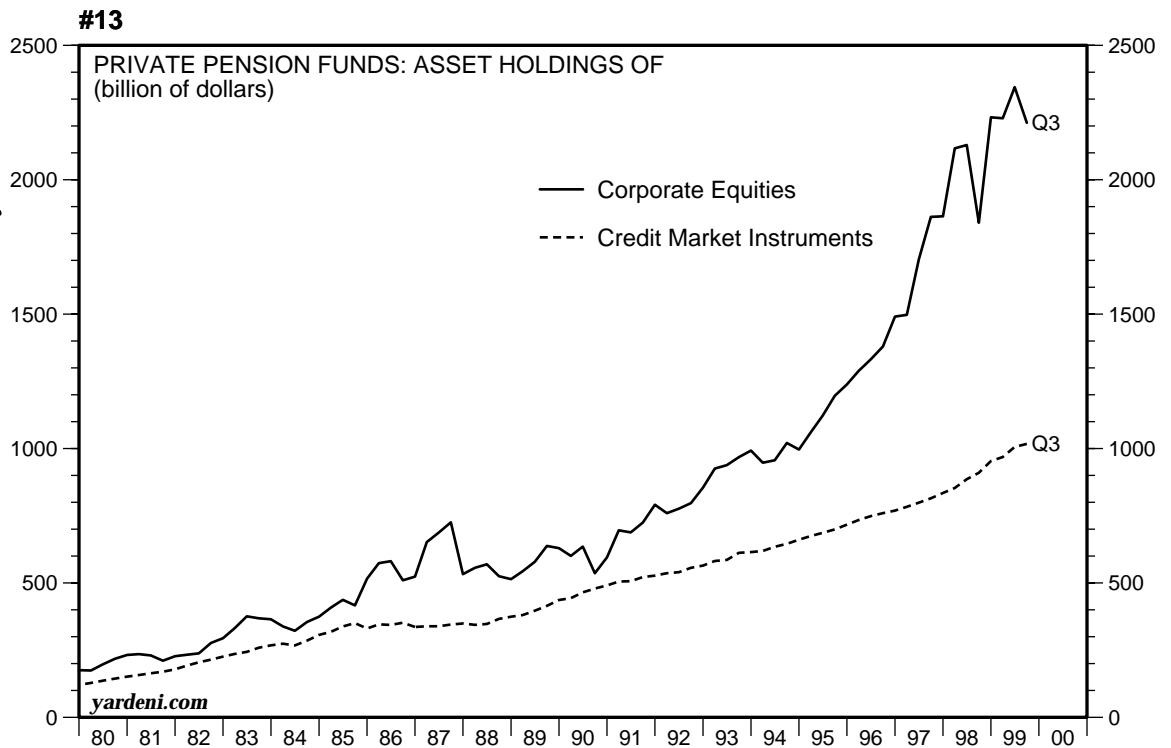


- Pension Fund Assets -



Source: Federal Reserve Board, Flow of Funds Accounts.

Private pension funds have been net sellers of stocks as the market value of their stocks soared.



Source: Federal Reserve Board, Flow of Funds Accounts.