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# The Idle Speculator™

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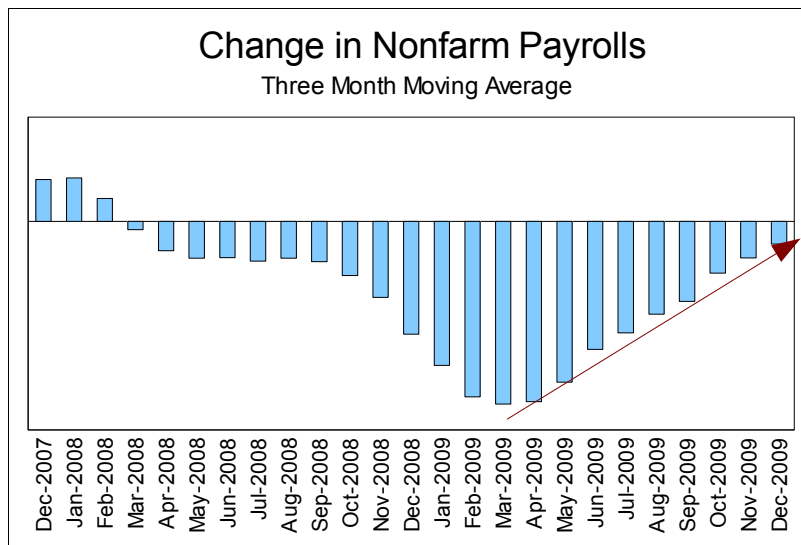
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## Payrolls, Policies, and Politics

*Friday morning's report on the employment situation had a little bit for everyone, bulls and bears alike. November revisions saw the first positive month for payroll growth since the current recession began, and the "less bad" trend remains firmly intact. However, the number of discouraged workers jumped dramatically, and payroll growth is still far too low to significantly bring the unemployment rate to a persistently lower level. While unemployment continues to pose a risk to Democrats in 2010, neither party is making a compelling offer to the electorate at the moment, and both of them are too focused on scapegoating the other. While we expect some positive economic surprises in 2010, the U.S. electorate and economy will remain stuck between an elephant and a donkey for some time.*

### December Jobs Report

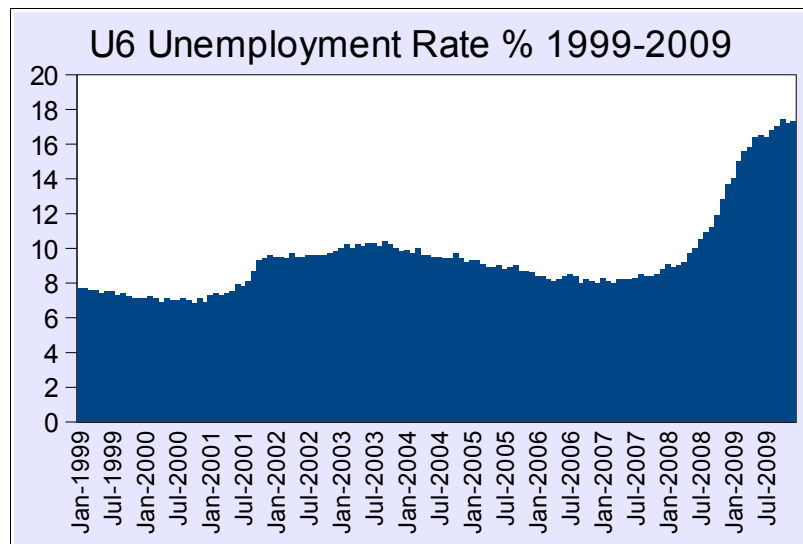
December payrolls were lower by 85,000, near the lower end of expectations, while the initial November estimate was revised to an increase of 4,000. This is the first positive data point since December 2007, when the recession officially began. Unfortunately, October was revised downward to -127,000, so the net revision was 1,000 more jobs lost in 4Q09 than initially estimated. However, as seen in the chart below, the "positive" trend in job losses is still intact. Note that the trend is positive only in a geometric sense; even monthly payroll gains, if they aren't sufficiently large, will result in higher un- or under-employment:



Unfortunately, the household survey, which can sometimes detect shifting trends in the employment market, was very negative, with 589,000 fewer employed, and 661,000 leaving the workforce. This implies that discouragement is *increasing* among potential employees, which is why the unemployment rate ticked *down* slightly to 10%, as the number of people in the workforce declined.

As we've noted elsewhere, the upward trend in the unemployment rate is likely to remain intact, if a notably healthier job market brings more people off the sidelines to seek employment. And if that doesn't happen, then underemployment should continue to rise, even as unemployment levels off or declines. It's even conceivable that unemployment could stabilize or decline, while underemployment ticks higher, which would be somewhat analogous to the dynamics of Japan's labor market since the 1990s, where temporary employment has become widespread and rather permanent in many domestic industries.

Whatever the future holds, when we look at unemployment that includes discouraged workers, the picture looks rather dismal:

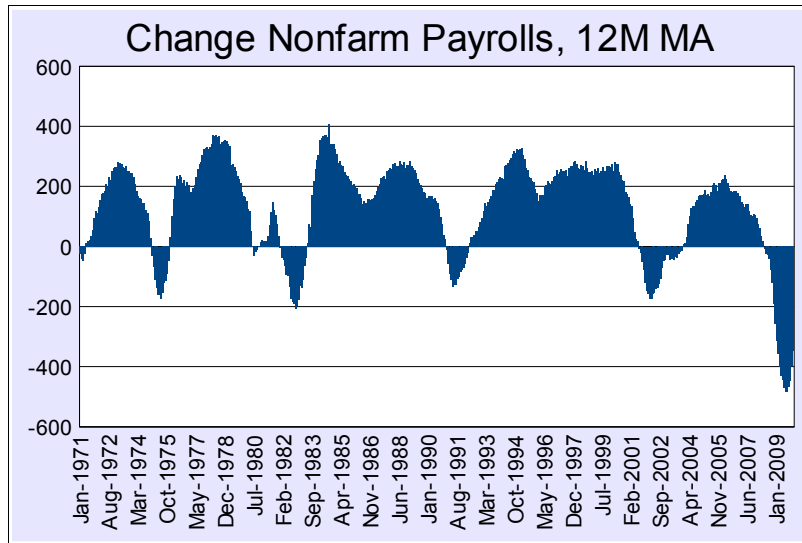


### Payrolls and Unemployment

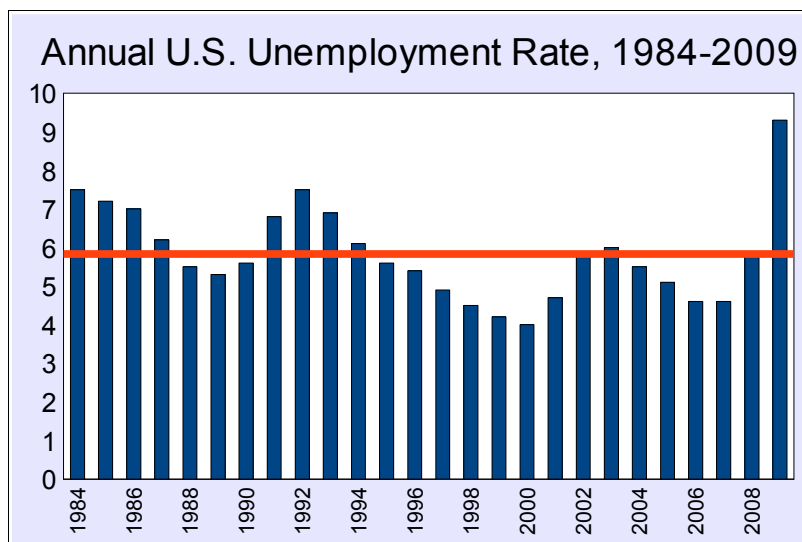
As a statistical rule of thumb, the official U.S. unemployment rate is not likely to decrease steadily until payrolls are growing by roughly 200,000 per month or more. However, since December 2000, the twelve month average change in non-farm payrolls has only exceeded that level nine percent of the time, with all of those instances occurring during a single stretch from July 2005 to May 2006.

Two things stand out to us in that trend, as depicted in the chart below. First, what appears to be a secular decline in payroll growth began at the end of the 1990s, which

happens to coincide with the downturn in the ratio of middle aged to younger adults in the U.S. Second, even with a clear “less bad” trend in payroll growth since the spring of 2009, there is precious little evidence to suggest that the U.S. unemployment rate will be anything other than stubbornly high.



Even in our best case forecast, we don't see it falling below 8% by year's end. That's a far cry from the average annual unemployment rate of 5.8% experienced during the 'Great Moderation':



### President Speaks Off Topic

On CNBC's Kudlow & Co last Thursday night, guest Ron Insana speculated, after seeing an announcement cross the wire that President Obama would make a statement on Friday afternoon, that the jobs data would be positive<sup>1</sup> (Insana's comment is at the very end of the clip). After seeing Friday's data, our initial takeaway was that the President's remarks would be directed towards new federal stimulus programs. Some undoubtedly would see that as opportunity to push for more federal spending, but we were less cynical. First, we felt that his willingness to speak after a somewhat negative report, rather than only after a rosy one, was a sign of courageous leadership. And second, we hoped that he would have something to say about meaningful government measures aimed at job creation and growth. Unfortunately, what the President said in his statement was so tangential to the employment problem that it was off topic at best, and hawkish at worst.

If you follow our writing, you know that we are fully behind the idea that the federal government, because it has (some measure of) control over production of the money used to service its debt (and ours, including taxes) *can* enact measures designed to pick up slack demand, and perhaps more importantly, gaps in intermediation and risk taking, when they exist in our economy. This idea is anathema to many, primarily because it has been such a long time – at least 25 to 30 years – since we've experienced such conditions. However, after taking a closer look at long economic cycles and demographics<sup>2</sup>, we've staked out the unheard of position that *both* Keynes and Friedman were right – but that they're right at different times and under different circumstances (and in fact, their respective popularity seems to have waxed and waned in concert with long cycle demographic trends).

Based on damage from the financial crisis, poor demographic ratios, policy uncertainties, and pessimistic expectations, we believe that the U.S. and several other G-7 nations, like Japan circa 1989, are in a 'Keynesian moment' which leaves plenty of room for smart but concerted federal expenditures and incentives. In fact, in an environment where the banking sector is repairing its balance sheet largely by financing public deficits (borrowing short and earning the spread on longer term Treasuries), it's *necessary* for the government, as beneficiary of that financing, to become the marginal actor in the real economy. Otherwise, employment, income, and real output will continue to suffer, as will public revenues, and more risk capital will be chased abroad to attractive destinations with healthier private sector balance sheets, better demographics, and more policy certainty and optimism.

Clearly, there are philosophical differences on this argument, and we believe that one can fairly argue that the financial crisis, insofar as it was caused by greed and stupidity, is not fair cause for public sector remedies (though to the extent that it threatened functioning of

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1 <http://www.cnbc.com/id/15840232?video=1379928547&play=1>

2 See the work of John Geanakoplos and his M/Y ratio (or Ajay Kumar's Demi/Ashton ratio), and Diane Macunovich, who in the 1990s predicted that a rather nasty recession would unfold around 2008!

the global payments system, we would argue that it was absolutely necessary, and that the cost should be regulatory reforms that will prevent the kinds of errors that led to systemic fragility). But insofar as the current job market malaise is driven by poor demographic composition, it's hard to blame anyone for the reproductive profligacy or surfeits that are impacting real economic conditions today.<sup>3</sup>

Unfortunately, President Obama seems to have fallen under the influence of the more hawkish economic advisors in his camp, such as Larry Summers<sup>4</sup>, whose views were probably well suited to the 1990s, and away from Christina Romer, whose background we think is better suited to the present day. While the intellectual divides between them may not be terribly wide, they are wide enough to make a difference when it comes to policy making, and by extension, to impact the outcome of 2010 elections. Instead of proposing additional or even standby measures to stem further labor market slackening, the President repeated his high tech, green jobs economy mantra, which has everything to do with long term industrial policy, and very little to do with the current job market.

### **What Would “Meaningful Economic Measures” Look Like?**

To us, meaningful economic measures would have included some combination of tax reform, public spending, and employment of last resort. By tax measures, we don't mean Washington's current favorite, tax credits, but rather, meaningful reforms aimed at improving competitiveness and efficiency, e.g.:

- Making our corporate tax code more globally competitive in order to attract wider investment and stimulate employment<sup>5</sup>
- Rate harmonization between forms of capital<sup>6,7,8</sup>, and between forms of business organization<sup>9</sup>

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3 Even if you could come up with the tortured logic required to justify it, the statute of limitations has surely passed, given that those reproductive decisions made by millions of people occurred twenty or more years ago!

4 [http://www.roubini.com/us-monitor/256542/larry\\_summers\\_new\\_model](http://www.roubini.com/us-monitor/256542/larry_summers_new_model)

5 See footnote 9.

6 We're viewing labor as a form of capital, which is heretical under most economic theories, but important when talking about sources of income and tax policy. Labor income is impossible without a physical human body, the potential output of which improves with ongoing investment (e.g., childhood, adolescent, and adulthood development), has a maximum capacity (caloric, sleep, and social and recreational requirements), requires routine maintenance and occasional repair, and eventually depreciates to zero. In other words, the bodies that we labor with are a form of capital.

7 There's a 'supply side' argument that capital gains should not be taxed, as that would stimulate higher levels of capital relative to labor. This is a bastardization of the classical capital/labor ratio, as it primarily refers to the gains on financial capital, rather than direct investment in labor productivity. As long as we're going to tax income, it should be done in a way that maximizes efficiency.

8 Some conservative think tanks have pointed out that many income tax payers have a zero or negative liability. As we've pointed out before, analyses that ignore the payroll tax burden do not offer a clear picture of tax fairness.

9 The tax code should be as neutral as possible in the decision to organize a firm as a proprietorship, a partnership, a corporation, or a hybrid form. Due to the existence of pass through entities and sole proprietorships, this means that any reform to corporate taxes requires harmonization with income and payroll taxes as well.

By spending measures, we don't mean three figure hair appointments or six figure office budgets for public servants, but measures aimed at:

- Using the unrivaled risk taking capacity of the federal government to enhance social welfare<sup>10</sup>
- Expanding investment in public goods such as education, infrastructure, R&D, and defense<sup>11</sup>
- Absorbing significant slack in the real economy<sup>12</sup>, including labor markets

An 'employer of last resort' function, while largely absent in the U.S. since World War II and the post war economy absorbed manpower previously employed by Roosevelt's Civilian Conservation Corps and similar programs, is not a radical proposal as counter cyclical policies go. It has been proposed on both the left and the right (see L. Randall Wray's writings on the subject, and Edmund Phelps Rewarding Work), and it would arguably help mitigate a range of social ills, as well as the perceived need for industry "bailouts".

To the extent that tax reform and spending measures are well designed and reasonably well implemented, expanded federal deficits can be viewed as *sound investments*. And while that will sound like fingernails on a chalk board to those of us who want to believe that government is always and everywhere the problem, or those who believe that tax burdens are too low, or those who fret about public deficits being an unfair burden on our children and grandchildren, history shows that countries have carried public debt at levels well in excess of those currently projected without any ill effects.

### Public Finances and Common Sense

Common sense, as informed by our experiences in households and businesses, leads us to doubt the possibility that governments can run deficits without negative consequences. But this ignores the unique position of governments. Governments service their debts with money, which is simply another form of government debt – a non-interest bearing form. Imagine that you had the ability to simply create monetary entries in the ledgers of your mortgage company or credit card issuers, which you matched with a corresponding

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10 There are sound reasons why U.S. government debt is the risk free benchmark for credit markets. The government, unlike any private sector enterprise, has the ability to tax, and our government has the ability to tax the largest and most productive economy in the world. Financing welfare investments that support or enhance the wealth and productivity of the country, e.g., universal catastrophic health insurance, or personal pension schemes such as those in Australia, would seem to be a no-brainer.

11 To the extent that productive investments are subjugated to budget concerns, we actually impose a lower standard of living on future generations, albeit with a (theoretically at least) lower level of public debt (to the extent that underinvestment leads to lower future GDP, the level of future debt relative to economic capacity may actually be *higher*). Deficit phobes must remember that by definition, economic decisions involve tradeoffs, and public finance is no exception.

12 This one is admittedly tricky, and fraught with agency risks, as perceived in the widespread resentment of "bailouts". But when systemic breakdown is a real and present risk, as opposed to mere cyclical developments, government arguably has a role to play as the backstop.

reduction in your personal liabilities. Assuming your actions were legal, how concerned would you be about your debt levels? That's the situation that governments exist in, especially in large, mature economies such as ours.<sup>13</sup> They issue interest bearing debt, and they create the non-interest bearing debt used to service it.

When the value of money was defined in ounces of gold, and public treasuries guaranteed convertibility between government money and precious metal, the situation was far different. Governments did indeed face a 'real' budget constraint, which was the availability of monetary gold and the government's perceived commitment to maintaining the parity between money and gold via convertibility. That commitment, while it tended to confer price stability over long periods of time, was also the primary reason that financial panics and bank runs were a recurring feature of the classical gold standard.

### **Inflation, Demographics, and Return of the 'Eurodollar Problem'**

Today, the only meaningful constraint on public debt and deficits (besides the Federal Reserve's quasi-public status) is inflation, i.e., the level of inflation the public is willing to endure. If we're correct that the real economy is in a long run down cycle due to shifting demographic ratios, then expanding public deficits are highly unlikely to cause inflation. There are two flies in the ointment, however – the existence of Euro-dollars and the dollar's status as global reserve currency.

In financial markets parlance, 'Euro-' was attached to currencies many decades ago to indicate that they were held outside of their country of origin. Thus, Euro-dollars are an obscure way of saying “dollars held outside of the U.S.”, Euro-yen are Japanese Yen held outside of Japan, etc.<sup>14</sup> Euro-dollars were a major culprit<sup>15</sup> in the breakdown of the post-World War II Bretton Woods global monetary system, as domestic economic policies in the U.S. cheapened the value of dollars held abroad, fueling inflationary pressures in certain regions, countries, and markets.<sup>16</sup>

The dollar's status as global reserve currency, which has continued since the Bretton Woods Agreement, means that it acts as a capital asset on the balance sheets of many financial intermediaries outside the U.S., and also plays a role in the settlement of countless international transactions, including in commodity markets (that's why the dollar and commodities often exhibit inverse correlation – when dollars are perceived as being cheap, the dollar price of commodities rises, and vice versa).

Due to these circumstances, when U.S. policymakers take fiscal or monetary actions to

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13 Many left leaning analysts and pundits miss this point too, eg: [http://www.roubini.com/us-monitor/254996/no\\_new\\_tax\\_cuts](http://www.roubini.com/us-monitor/254996/no_new_tax_cuts)

14 I don't know what euros held outside the EMU are called. Are they Euro-euros?!?

15 See, for example, Helmut Mayer's “Some theoretical problems relating to the Euro-dollar market”, Essays in international finance, no. 79 (1970).

16 The inverse outcome occurred in 1994-2001 and in 1983-85. Dollars were highly valued in those periods and thus difficult to come by internationally. This led to falling commodity prices, underinvestment in some regions, currency crises, and sovereign debt defaults.

address *domestic* economic conditions, they have effects that extend *beyond* our borders. If domestic actions are inflationary in a global context, commodity prices will tend to rise, and faster growing economies will see even higher levels of investment. We saw this with Japan and Germany in the 1960s and 1970s, and today we're seeing it with China, Brazil, India, and to a lesser extent Russia. And these are precisely the conditions that lead to stagflation: domestic economic policies inadvertently support investment *abroad*, and as global inflationary pressures arise, they feed back into the domestic price level through tradable goods like commodities.

### **Addressing the Policy Conundrum**

So the conundrum for U.S. policymakers today is how can the federal government support the domestic economy without stoking inflationary pressures abroad? There are at least two possibilities we can think of<sup>17</sup> – an improved policy mix, and a bifurcated currency.

The first, an improved policy mix<sup>18</sup>, harkens back to the tax reform program introduced by President Kennedy in the early 1960s, which aimed to raise the level of economic activity in the U.S. That approach could have similar effects today, to the extent that it improves expectations in the private sector.<sup>19</sup> One key benefit of this approach, besides supporting the jobs market, is that it would create room for the Federal Reserve to protect the value of the USD without causing as much economic damage.<sup>20</sup>

The second possibility is more radical, and I'm not convinced that it's even possible. It would involve separating non-interest bearing debt (money) into two types. We would still have the U.S. dollar, but we would also introduce, perhaps via direct Treasury issuance, some sort of voucher that could be used, for example, to pay wages in an employer of last resort program, as legal tender in private domestic transactions, and to pay federal taxes (and perhaps state and local taxes as well). Properly designed and regulated, these vouchers would act as a parallel base money, similar to cash in hand, but they could only be used for transactions inside the U.S., and they could not be used as the basis of credit, i.e., to create new financial assets. Design and implementation of such a system would be complicated and take a great deal of time and effort, even some international coordination. But the alternative would be to wait for long cycle trends in the real economy to reverse, which will take another decade, or to wait for the dollar to be supplanted as global reserve currency, which could take many decades (and will come with its own set of costs).

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17 Besides abandonment of international trade and finance, that is.

18 The term 'optimal policy mix' was coined by Nobel economist Robert Mundell in 1961.

19 It would have to be accompanied by measures designed to lower private sector uncertainties associated with ambitious public sector initiatives envisioned by many Democrats. That's the much harder, perhaps politically impossible, piece of the puzzle.

20 [http://symmetrycapital.net/idlespeculation/20080925\\_policy\\_mix.pdf](http://symmetrycapital.net/idlespeculation/20080925_policy_mix.pdf)

In the short to intermediate term, we think that the Kennedy approach<sup>21</sup> is immediately available to policymakers, and that Democrats might even dip their toes in, perhaps with measures like zero capital gains taxes on small business investment. It would certainly improve their chances in November, we think.

### **A Lonely Wingnut**

As human beings, our thinking is often based on huge, unexamined assumptions, such as the assumption that governments should not run large deficits. Another one is the assumption that private sector economic activity will be most productive and robust when government is involved least. Under certain conditions, that is almost certainly true. But to us, historical evidence indicates that the assumption is indeed a purely conditional one, even when governments' contributions to economic crises are accounted for. Under certain other conditions, the opposite or more 'Keynesian' assumption is likelier to be true.

As noted recently, these views make me a rather lonely wingnut.<sup>22,23</sup> But most wingnuts would agree that well designed fiscal measures can improve expectations and output, and that this would in turn allow the Fed to return to a more normal policy stance and thus support the USD. That would benefit savers and pensioners, and help stem financial speculation currently being fueled by the dollar carry trade.

Of course, as Reuven Brenner reminds us<sup>24</sup>, one of the main risks of public sector action, especially action by the federal government, is that it faces little if any competition. Thus, there's a risk that fiscal policies, if pursued, will not be designed and executed well. If that happens, their impact is likely to be fleeting or even negative. There's also a risk, given the uncertainty of politicians and their advisors over the mood and intentions of voters, that nothing gets done. If we end up with poor (or no) fiscal policy decisions in the year ahead, then beyond 2010, we're likely to see increasing economic paralysis caused by difficult conditions in the real economy, negative psychology, and growing disagreement about what does and doesn't work to improve the status quo. This would be quite reminiscent of Japan's lost decade(s). The opportunity costs of such a state would be significant, and deficit phobes should keep in mind that such costs would be borne in part by the future generations they are so fond of invoking.

### **Mixed Signals, and Sound and Fury Signifying Little**

The political uncertainty mentioned above is causing Democrats to issue mixed signals regarding the direction of economic policy in the year ahead. For example, in a recent

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21 The typical objection to this will be that fiscal measures act with a lag, so by the time they are enacted, they might prove to be 'too much too late', i.e., inflationary. We would point out that (1) as noted above, it would allow the Federal Reserve to better support the USD, and (2) if demographic ratios are as potent a force as the (admittedly limited) evidence seems to imply, there's still about a ten year window.

22 <http://symmetrycapital.net/index.php/blog/2010/01/auerback-deficit-hawking/>

23 <http://symmetrycapital.net/idlespeculation/2007110701.pdf>

24 [http://www.amcreativityassoc.org/Articles/Barnes\\_interview\\_with\\_Brenner.pdf](http://www.amcreativityassoc.org/Articles/Barnes_interview_with_Brenner.pdf)

interview we heard Rep. Steny Hoyer claim that the objective of policy would be “jobs and fiscal responsibility”, and that the ultimate aim would be to return to the balanced budgets at the end of the Clinton administration.

But balanced budgets are not the real issue – the tradeoff that policy makers ought to be focused on is between employment and inflation/stagflation. In fact, there is nothing particularly virtuous (or immoral) about a balanced federal budget. That argument can only be contemplated when one has accounted for the net opportunity costs imposed or avoided by a budget surplus. And in the decade ahead, we believe that balanced budgets will impose, rather than limit, opportunity costs. And again...the effects of those opportunity costs will be borne by the same grandchildren and great grandchildren that are invoked when decrying public deficits.

Like other Democrats we've been hearing, Hoyer did distinguish between the government being supportive of investment in the short term (deficits), while developing long term plans to 'bring the fiscal house in order' (deficit reduction). Whether Dems end up making a serious fiscal error in the coming year will depend almost entirely on what they end up defining as the long term. If it's anything under ten years, watch out.

Meanwhile, the Republican party line is that Obama's economic policies are the only factor preventing full economic recovery. Granted, these are just political PR tactics, but it's not clear to us that anyone in the GOP has a good grasp of recent history or the underlying realities of our economic situation<sup>25</sup>, which is somewhat reminiscent of the 1930s. By the end of the 1920s, lax regulation under Republican governance had allowed systemic leverage – and thus systemic fragility – to reach historic levels. When a concerted deflationary move was instituted by the Federal Reserve and the Bank of France, against a backdrop of worsening demographic ratios (as well as negative trade and tax policies), the result was the sharpest and deepest contraction in memory. By the middle of the 2000s, regulatory rollbacks under mostly Republican rule had allowed systemic leverage and fragility to once again reach historic levels. Against a background of negative demographic shifts, a fairly hawkish Federal Reserve, and rising uncertainty about domestic tax, trade, and regulatory policies, the result was similar to 1929-1932 – thankfully without the pro-cyclical constraints that would have been imposed by a gold standard (though some politicians argued, and continue to argue, for measures that would have had similar effects).

We agree, and have argued, that rising policy uncertainty following the reemergence of Democrats in 2006 to 2008 may well have played a catalyzing role. But the conditions for a financial and economic crisis were already in place, enabled in no small part by prior GOP policies. Events of 2008 almost surely would have unfolded, even if Newt Gingrich had been made king for life and the Democratic Party had been outlawed – recall that, as noted earlier, Diane Macunovich was able to predict a nasty recession in 2008 about a

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25 <http://thehill.com/blogs/blog-briefing-room/news/74921-steele-obama-policies-alone-preventing-economic-recovery->

decade before the fact, using only demographic data.

For now, it looks, unfortunately, like the U.S. electorate and economy will remain stuck between an elephant and a donkey until more enlightened leadership steps forward in one party or the other (or ideally, in both).

### **All Doom and Gloom?**

It's not all doom and gloom, and in fact, in the shorter term, we expect GDP and employment to rebound very nicely, as they usually do following such precipitous declines. Our pessimism is more about the long term, by which we mean the decade ahead. Keep in mind that under performance of U.S. financial markets and the economy began around 1999, a key point in the demographic cycle. Judging by the empirical research that's available, these trends last for roughly twenty years, as a key cohort (currently the 'Echo Boomers') goes from age 24 to age 45 or so. That means that overall, the U.S. economy is in for a slow and potentially painful slog between now and 2020. That slog will be worse if policymakers don't take steps to address weakening economic potential directly, and it will be much worse if they enact measures that aggravate the problem (a concerted balanced budget push, for example).

If we simply muddle through like Japan has since 1989 <sup>26</sup>, we will enjoy short periods of surprising growth, receding unemployment, and other pleasant surprises. But the longer term trajectory is likely to remain in place until demographic ratios begin shifting once again.

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<sup>26</sup> <http://symmetrycapital.net/idlespeculation/20091109.pdf>