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U.S. Forecast

You don't have to look very hard to find current economic forecasts that range from fabulously optimistic to near apocalyptic. Some of the most optimistic forecasts are self serving. Some people and organizations are heavily invested in a bright future. We have no idea why those with no obvious incentive to produce an optimistic forecast do produce them. Maybe we can chalk it up to mankind's natural tendency toward optimism.

There are lots of reasons to believe a highly-optimistic forecast is wrong. China's growth has slowed. Japan is in an enduring recession. Europe is in recession and suffering another bout of its reoccurring geopolitical spasms. The West is over indebted and increasing its debt, at the same time that it is dragging its economic growth down with evermore burdensome regulations. Capacity utilization, the percentage of business assets fully employed, is near 80 percent, a number that increasingly appears to be near the upper bound. Population growth is slowing everywhere, and increasing numbers of countries are seeing declining populations. Oil supplying countries are in turmoil or are downright hostile to the West. Terrorist threats appear to be increasing.

Interest rates are perhaps the most important reason to reject an expectation of rapid economic growth. Strong economic growth has to be preceded by investment. We're not seeing much investment, and we're not going to see much investment. We've seen very low interest rates now for a very long time.

We don't believe that the Fed can control long-term interest rates, but we readily acknowledge that they can control the overnight rate. They've maintained a near-zero overnight rate for about six years now, in a misguided attempt to stimulate economic growth by increasing consumption. This completely ignores the fact that people consume out of wealth.

The long-term interest rate is the long-term return on capital, and there is little, if anything, the Fed can do about it. We are quite confident that monetary policy has the potential to create great harm, but we are increasingly skeptical that monetary policy can do great good. So, we reject the idea that the Fed should engage in a new initiative to increase long-term rates. What they should do is cease quantitative easing, cease responding to equity markets, and provide us with a regime that results in stable prices.

To the extent that current long-term rates reflect the return on capital, there is really very little reason for optimism. Absent higher returns, capital will continue flowing to deficit-spending governments that investors perceive as risk free, or because the Fed continues to create excessive liquidity, to overheated markets. This, in a sense, creates bubbles in government debt and in the overheated markets. That is, they become overpriced. Someday prices will adjust, and that could be difficult economically.

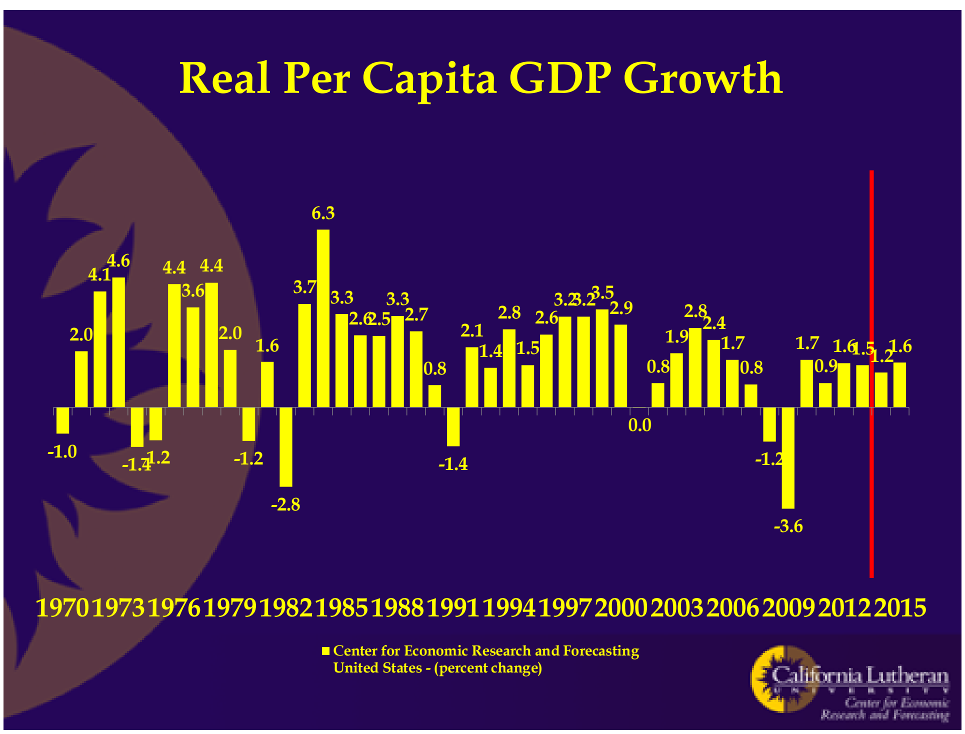
So, are the dismal forecasts the correct forecasts? We don't think so.

In our view, the United States economy is showing remarkable resilience. In spite of all the external things going on and in spite of what in our opinion is seriously misguided fiscal and monetary policy, the United States economy continues to generate economic growth. It is slower than its potential. It is definitely slower than we'd like to see. It's certainly more volatile than we'd like to see.

We mention in another essay that volatility caused by small shocks are an indication of our economy's weakness. It is, but it's a testament of the fundamental strength of the United States economy that it continues to rebound from these shocks in spite of increasing regulations and what bad policy decisions at just about every opportunity.

If policy weren't so bad, we would be among the optimistic forecasters.

As it is, we expect to see continued slow economic and job growth. We look at two measures in particular. Real per-capita GDP growth is a measure of the average income. It will continue to grow, but at a far slower pace than we saw over the previous 30 years.



Job growth is critical, and it's a problem. Wealth creation without job creation will only increase the social issues we see now. Unfortunately, we expect to see only very slow job growth. This is mostly a result of policies that inhibit the creation and growth of small businesses, policies we discuss in another essay.