

Slip Slidin' Away

*by John Tuccillo, PhD
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The recovery, which had looked so bright a year ago, is now lapsing into mediocrity at best, and vanishing at worst. The accumulated statistics in the summer of '04 suggest that the immediate bump the economy received from the tax cuts of 2003 has run its course and that the cuts have no legs. This is exemplified most dramatically by the mere 32, 000 net new jobs created in July, a month in which most observers predicted a gain of about 200,000.

There are many reasons why employers have not done what was expected of them. Productivity is one: current demand can be met with existing employees because of the new technologies being used. Outsourcing, that great political whipping boy has added to the jobs stagnation by shipping potential American jobs overseas. Finally, health care costs have risen so dramatically that they have altered the employment cost-benefit calculus facing most companies. As a result of all this, consumer confidence is down. Many consumers are looking at the market with a bit more caution and trying to stretch out their incomes. We are seeing declines in the growth rate of consumption, including home purchases, which declined nearly three percent in July.

Inflation has also become an issue. The overall rate of price increase is showing little in the way of dangerous escalation, but the composite masks some more ominous trends. Energy prices are up and will continue to climb in the wake of the record prices reached in petroleum markets this summer. Food prices are up, to the point where the increase in the cost of a bacon, lettuces and tomato sandwich (Thank you, USA Today for the factoids) has far outstripped measured inflation rates. These are things people actually spend money on frequently; they can only be partially offset by declines in the price of cell phones and home computers.

All this is interesting in the light of the massive tax cuts passed by the Congress in 2003. By all historic standards, these should have propelled the economy into a new wave of prosperity. They did raise economy growth in late 2003 and early 2004, but their momentum appears spent. The bias in the cuts toward upper income individuals weakened the ultimate impact of the cuts on consumption and therefore growth. Unless further action is taken to relieve employers' costs of hiring and maintaining employees, the only legacy of the tax cuts will be the large and persistent Federal budget deficits they will have created.

But deficits are not the only fiscal burden of the long term. We as a nation will be facing hard decisions about the major entitlement programs, Social Security and Medicare. As our population ages, these programs will move from the black to the red. The only salvation will be some combination of higher payroll taxes, lower levels of benefits and later qualification ages. All of these reduce the value of the safety net.

All these developments are being felt by consumers. Most folks may not fully understand the impact of the deficit and the fiscal implications of an aging population for Social Security and Medicare, but they sense their importance. The entire situation, however, is seen clearly by professionals in the bond markets and our overseas creditors, who will seek higher rewards (i.e. interest rates) for holding American debt. So look for rates to go up and perhaps go up dramatically. This will put another stake in the heart of whatever budding recovery we are now enjoying. It is now very possible that the next president, whoever he may be, will be saddled with a recession in 2005. It's time to consider going long in cash.