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Ambiguous Macro Data and Tentative Markets

Three pieces of data this week (all surveys to be sure) tend to support a thesis that the consumer is fine, albeit 'shocked' by oil prices and oil price anxieties. Slumping auto sales last month might indicate that the consumer has become addicted to being royally treated through auto company incentives, and as they vanished, so did his checkbook. Those incentives are being put back again as Detroit tries to clear its inventories for the new model year. The Fed may have to revise its thinking on "pricing power," but clearly carrying excess inventories has become a "no-no."

Employment growth was tepid although positive last month, a "real indicator" that if it were to turn sour, would increase the use of our worry beads, but the industrial survey data from NY and PA suggest that firms will continue their attempts to expand their work forces. That is something of a paradox, requiring some hard thinking. If the consumer is "failing," why would business firms be thinking about expanding employment? Maybe failure is too strong? Or, has this recovery been carried out with less than an optimally sized work force which is now in need of repair?

The fall in industrial production seems to us one of the "variations" that one should expect in an economy that is now trained to dance on the head of a pin, parodying Schumpeter's "creative destruction" in real time. Sales data trigger virtually instantaneous inventory and production adjustments, mixed blessings of the information economy. In the longer run, such adjustments lead to a more efficient use of capital stock, but in the short run, it leads to a rather nervous workforce. Further, as permanent employment becomes less a feature of the information economy, it means that labor becomes more of a variable input, as was once taught in the first course in price theory. Another paradox of the information economy seems to be faster adjustment of marginal labor inputs and much more reluctant commitments by firms to hire "permanent" employees. Thus, uncertainty over sales, however produced, could lead to both more temporary and less permanent hires.

In the 1960's and 1970's as modern econometric techniques proliferated, a great deal of theoretical and empirical work was done on labor as a 'fixed' rather than a variable factor. This shift from the textbook version of the theory of the firm was stimulated by the observation that benefit costs were becoming a larger component of total labor expenses. Today's economy is a much more extended version of that theme and with the information economy becoming the accepted 'way of doing business,' labor may actually return to becoming a 'variable' production input, at least for certain 'varieties' of labor.

The result is that hiring becomes more of a capital investment decision, and in a world dominated by the importance of human capital, shouldn't that be so? The firm is making an investment in 'training' a new worker who---with that increased training and human capital---could move away from the firm that trains him, taking his new skill base. Alternatively, the demand for the services of that skilled labor could be suddenly impacted by a global economic shift that is unexpected and violent and sudden. Thus, choosing which worker to "count on" for the future and which level of benefit costs to incur to attract and keep such a worker has the character of an investment in physical capital (machines). It is a rate of return calculation and therefore, higher degrees of demand uncertainty have to restrain the movement of the firm in moving to its desired level of employment. Under these conditions, the 'hiring decision' becomes a risk management decision. (In the face of uncertainty, the optimizing firm moves less quickly or not fully toward its "optimum" factor proportions until the uncertainty is reduced or dispelled. Maybe the downward trend in the inventory/sales ratio should be used to model a labor inventory/output relationship that is being expressed by slower hiring in response to changes in demand.

In our view, this produces a two-sector labor market for skilled and non-skilled workers. The non-skilled are given jobs that involve less human capital-improving training and where possible create less of a benefit cost burden for the firm. Unskilled labor then becomes a strictly current expense for the firm, and its employment duration fluctuates with output much more closely. Skilled labor is different because it involves some long run planning on the part of the firm. Here's where uncertainty can play havoc with more simple-minded macro economics and it can lead to claims that "this time it's different." It is and it isn't!

It is true that something is different. Complex benefit cost structures and plant locations and product variability create management incentives to make rather careful calculations as to when new "labor" should be brought on board--particularly labor that will be subject to firm-supplied investment in skill training. The same sorts of considerations should produce a demand for a 'floating labor supply,' even at comparatively high wages. We are seeing just that, for example, in the computer-and information services industry where you can 'buy very high levels of computer and programming skills by the hour' through labor contracting.

There is a fear in some quarters that the origin of this problem is "outsourcing." That is kind of strange to an international trade economist because outsourcing, despite its somewhat jaundiced political connotations, should **improve** not worsen the allocation of resources and thereby should be, net-net, a benefit for the overall economy. Outsourcing is one of the weapons in the managerial toolbox that allows more internal efficiency in the deployment of capital by the firm. Isn't that what we are supposed to be paying our managers to do?

A better way to think of this is Professor Ronald Jones's concept of 'fragmentation,' rather than outsourcing. Fragmentation is actually visible in many parts of the Information Economy. It means slicing and dicing the production process---but it can happen in the service side of the economy as well as the manufacturing side, a result that has suddenly surprised and alarmed some politicians. The politicians began to become agitated when they realized that many technical advisory services were being supplied out of other English speaking countries, such as India. But, fragmentation can take place in some rather sophisticated parts of the economy, such as finance. Fragmentation, for example, has been occurring in the financial sector of the economy as layers of risk bearing are peeled out of financial institutions that used to bear it and taken on by new financial firms prepared to supply critical skilled labor inputs to handle that risk bearing.

Consider for example the trend in commercial banking that is shifting much commercial loan demand into alternative suppliers of credit, such as hedge funds. Smaller and medium sized firms are finding that large commercial banks would prefer not making 'riskier' loans. One can understand why. To evaluate and monitor a smaller firm may require even greater skills and much more human capital-intensive activities that deploy those skills. Credit staffs capable of doing that are high benefit cost users. Better to shift the function to a hedge fund that is performance pay driven. For the Hedge Fund in the credit dispensing business, labor becomes a variable cost, because as they say in the hedge fund world, 'you get to eat what you kill.' Make bad loans, and the dinner bell won't ring for you this year. Make good ones, and you get to buy a home in the Hamptons!

And what about employment and the cost of credit? Per unit of loans dispensed, less labor in commercial banking and more hedge funds dealing in the credit market. Credit becomes more variable, more sliced and more diced and it goes to those who "need" it but at risk-adjusted rates. Banks become proprietory traders and servicers of consumer credit needs. We don't call it outsourcing because the Hedge Fund is a local industry, but it is the same process so why not use a more generic, less politically charged nomenclature such as fragmentation? Fragmentation has many dimensions, and it does not have to have the connotation that 'we are giving away jobs to the foreigner.' Are you listening Dr. Mankiw?[1]

Some macroeconomic economists with large public followings are bemoaning the apparently "poor" job growth that is a feature of this recovery. With little job growth, as conventionally measured, they are unable to account for the consumer spending that shows up in the national accounting data. Consequently, they think of the world as being asset driven and the consumer soon to be tapped out in his ability to to use his home equity, financial assets and/or retirement funds to finance current consumption. Hence, there is a continuing 'over the cliff' worry that this recovery will falter as the consumer fails. Some hedge fund managers bought that story in 2003 and followed it to the logical conclusion that consumers were bound to fail. Strangely, for those managers, the consumer did not fail. Rather, it was the hedge fund managers who made that bet that failed. . Betting against Joe Six-Pack's love of things can be a costly affair. There are a couple of lessons to be drawn from this story. One is that the BLS will have to look much harder to find where employment is growing. It is probably growing in new firms at an even faster rate than their statistical models allow. Second, the danger of the current "slow" is less that the economy 'slows,' because of a reluctant, tapped-out consumer, then of fearful expectations of managers that they should cut back on their capital investment decisions---for both human and non-human capital. The survey data so far don't indicate that but that is what we should be watching. The problem is that we don't really have very good measures of expectations except the survey data referenced above, and no one is quite sure how reliable that will turn out to be.

Sometimes old wives' tales work to explain how the economy works, and other times such tales can be quite misleading. Chicken Little's famous chant that "the sky is falling" may be a good story to read to our children, but maybe not one upon which to base investment and portfolio decisions. Currently, markets have bought the Chicken Little story because complexity is not something one can deal with every morning at 9:30---but thinking about it after the screen goes dark at 4:00 may pay some dividends.

More than likely, some parts of the equity world have been beaten down below their longer run "values." While the old saw about trying to catch a falling knife has merit, our view is that the market is peeling away the onion, layer by layer, with valuations increasingly likely to become more attractive as this process goes on. The consumer and producer survey data tell us something about expectations of consumers and managers. They are not consistent with the reduced opportunities signaled by falling equity prices. That is an inconsistency that clever traders will ponder, sooner or later.

[1] The SEC has recently proposed to regulate hedge funds presumably on the grounds that risks to investors are large. But, commercial banks are *de facto* becoming the largest of all hedge funds. Should we ask the SEC to police the proprietary books of commercial banks? After all, as the commercial banks become larger players in homogenized credit instruments, it becomes hard to distinguish them from hedge funds. Traditionally, it is the Comptroller of the Currency and the Fed who have supervisory authority over Banks, but the logic underlying the SEC's proposal suggests a kind of regulatory imperialism now underway. First, hedge funds, then banks? Should we be surprised that the Fed is not on board with Chairman Donaldson's recommendations?

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