Economic Analysis

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The big fix

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Attention MBA Grads: Leave Wall Street and head for engineering school, and don't forget to bring a lunch box (and a shovel).

Barack Obama set to unveil a new industrial policy

In our employment write-up on Friday, we finished off with: "The bad news is that help is wanted. The good news, given what we know about Messrs. Bernanke and Summers, is that it's on its way." Indeed, in our view, Barack Obama is within weeks of unveiling a new industrial policy of Eisenhower-like proportions – an initiative that is very likely to have an "urban renewal" feel to it.

A lot of fiscal goodies coming out of Washington

How do you explain the Dow managing to rise 400 points after what was undoubtedly the worst employment report in a decade? It was that it dramatically increased the urgency of a large-scale fiscal package. So, while the jobs data were yesterday's story to some extent, if we were to put our optimist hat on, we would say that tomorrow's story is going to be a lot of fiscal goodies coming out of Washington. The weekend Wall Street Journal put it just like this: "Democrats seized on the jobless numbers to argue for the urgency of a sweeping stimulus plan, and lawmakers will meet next week for a "forum" on the economy. They hope to have the recovery plan on the House and Senate floors in early January, with an eye toward putting it on Mr. Obama's desk by Inauguration Day". A similar story ran on the front page of the Sunday New York Times as well ("Obama Vows Publics Works On Vast Scale"). And Obama himself made it very clear in his weekend address. To wit: "We can't worry, short term, about the deficit. We've got to make sure that the economic stimulus plan is large enough to get the economy moving".

Government to forcefully combat deflation and depression

So we have the Fed embarking on quantitative easing, which means it is going to increasingly devote its time and resources towards expanding its already-bloated balance sheet. The central bank is emerging as a direct lender to Main Street to offset the contraction in bank lending and the evaporation of the securitized credit market. We also have our fiscal policymakers about to aggressively move to arrest the sharp deterioration in the pace of economic activity, regardless of the fiscal cost. The equity market on Friday sent out a very loud message that it will dodge the torpedoes if there is someone in Washington willing to move full steam ahead. This may be why the nonfarm payroll report wasn't bearish for the market. It was a cathartic event that is now going to mobilize the government's resources more forcefully in this war against the Double-D (Deflation and Depression).

Refer to important disclosures on page 4 to 5.

Need $600 billion to offset drop in private sector spending

Just to offset the withdrawal in private sector spending we expect to see in 2009, the government needs to come up with at least a $600 billion stimulus package, and in one year, not two. To just prevent the unemployment rate from rising any more than it already has – to nearly a 15-year high of 6.7% – then we would need to see a plan closer to $1 trillion in size for next year. Since prior commitments, the automatic stabilizers and the recession's impact on tax revenues meant the deficit was already set to rise to a record $1.5 trillion in the coming year, the stimulus plan that would be big enough to stop the recession in its tracks would approximate 14% of GDP. By way of comparison, the highest the deficit-to-GDP ratio ever got to in the 1930s was 6% (but there were no automatic stabilizers back then such as jobless benefits or welfare), in WWII it reached 30%, and in Japan it topped 10% by the mid-1990s.

Obama will provide immediate near-term relief…

In terms of strategy, it looks like the Obama team is going to adopt two-pronged approach. The first fiscal volley will be aimed right at the current economic malaise. This should include immediate near-term relief in the form of extension of unemployment insurance benefits, increased food stamp distribution, broadening of the child tax credit, lower payroll taxes, and, we are hearing, a possible $500 tax rebate. That could be some good news for low-end/discount retailers, drug stores, food retailers and the like. We are also hearing that we could see as much as $40 bln in Medicaid assistance for the states. This could help the strained (but attractively priced) muni bond market – and efforts to restart capital spending at the local government level that is ready to go but has been shelved due to the financial crisis.

And then will unveil a dramatic new industrial policy

The second prong is more strategic in nature. It looks as though Obama is going to unveil a dramatic new industrial policy covering a broad range of initiatives: renewable or 'green' energy projects, upgrade of the electricity grid, refurbishing universities/schools, road and bridge repair, water and sewer projects, medical technology, and the really big kicker, we believe, will be high-speed rail transit. In fact, if we were advising Obama, we would be talking more about Eisenhower than about FDR, because Eisenhower's legacy was the rollout of the nation's extensive highway network in the 1950s and the future returns on that massive capital investment was huge in terms of what it meant for business costs, labor mobility and productivity.

People are radically changing how they move around

Call it 'urban renewal' and it makes a lot of sense because people are in the process of radically changing how they move around. Last week, for example, we saw that even in the face of sharply lower gasoline prices – down nearly 60% from the summertime peaks – motor vehicle sales slipped below an 11 million unit annual rate for the second month in a row (10.5 million in October and 10.1 million in November). Such a weak back-to-back performance has not happened in a quarter-century – and also keep in mind that the population is one-third larger today than it was in the early 1980s. Now, when you multiply the 240 million vehicles on the road today by an estimated 5% scrap rate, what that means is that any annualized sales number below 12 million units actually removes units from the existing fleet. In other words, at current sales rates, nearly 2 million autos are now being taken off the roads – for the first time.

Infrastructure focus should be on mass public transit

This is exactly where urban renewal comes into the picture. To reiterate, what a declining fleet of vehicles means is that the people are already in the process of altering their modes of transportation, and this secular change represents a long-term growth opportunity, not something that is merely cyclical or transitory. So, the focus on infrastructure, in our view, should be targeted towards mass public transit. And if we are prescient on this call, the critical challenge for investors will be identifying who the next Bombardier is in terms of who the dominant player will be to provide the feedstock, for example, for a nationwide high-speed light rail system. Maintaining the country's labor mobility, which is the envy of the world, may depend on it.

Consumer demand for mass transit is booming

There has been absolutely no growth at all in the past three years in the federally-funded transportation capital stock, whereas the capital stock for the country as a whole has managed to expand 8%. At least it now looks as though these years of neglect are about to end. At the same time, the growth in consumer demand for mass transit is booming, but is bumping against the lack of supply. We said last week that consumer spending in the aggregate has declined at a record 4-1/2% annual rate from July to October, and we could only identify four categories that have managed to advance – the strongest being spending on mass public transit, which ballooned at a 26% annual rate. Over this time, air travel is down 22%, bus demand is down 25% and car/truck purchases are down 40%. So, if we are flying less, driving less, and bussing less, then it would stand to reason that any transportation infrastructure package would emphasize a national high-speed transit system.

Light rail transit may be where you want to be situated

To quote the legendary 19th century French economist, Jean-Baptist Say, this is a clear cut case of "supply creating its own demand" (for baseball buffs, this is akin to "if you build it, they will come"). If you're looking for secular growth, in an area that has been constrained by supply but facing burgeoning demand, light rail transit and anything connected to it is probably where you want to be situated.

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