Commentary

The Pareto Principle and the Goldilocks Economy

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> **Pareto Principle** - A principle, named after economist Vilfredo Pareto, that specifies an unequal relationship between inputs and outputs. The principle states that, for many phenomena, 20% of invested input is responsible for 80% of the results obtained. Put another way, 80% of consequences stem from 20% of the causes. Also referred to as the "Pareto rule" or the "80/20 rule".
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> - TheFreeDictionary.com

While the Pareto Principle has long been familiar to self-help gurus, its use in the business world has become increasingly widespread, including applications to time management, manufacturing efficiency, quality control, and engineering design. Not to be left out, in this Commentary we apply a loose version of the Pareto Principle to the U.S. economy.

Keeping it Simple

Our premise is that the U.S. economy can be summarized more succinctly than one might expect, judging by the myriad of financial data reported through the media. We argue that the most important economic results of the past 10-15 years can be explained by just two developments: **the resilience of the consumer and the absence of pricing power.**

The unwavering U.S. consumer has kept the economy growing steadily and provided the engine for corporate earnings growth. As shown in Chart 1, consumption has consistently increased in every quarter for the past 15 years. This is no small feat considering that consumption has never before grown continuously for more than 10 years.[1] Overall economic growth has clearly benefited from the consumer's consistency. Since 1992, we have experienced just one recession, in 2001, and that was a shallow one.

The absence of pricing power refers to companies' inability to increase prices in today's competitive global environment. It is most evident in the impressive performance of the core inflation rate, which excludes the volatile food and energy components from the total inflation rate.[2] As shown in Chart 2, core inflation settled below 3% in 1996 and, since then, has remained within a tight band of 1% to 3%. This unprecedented period of low and stable core inflation now exceeds 11 years and continues today. The last such period of core inflation remaining below 3% began back in 1958 and lasted for only 8 years.[3]

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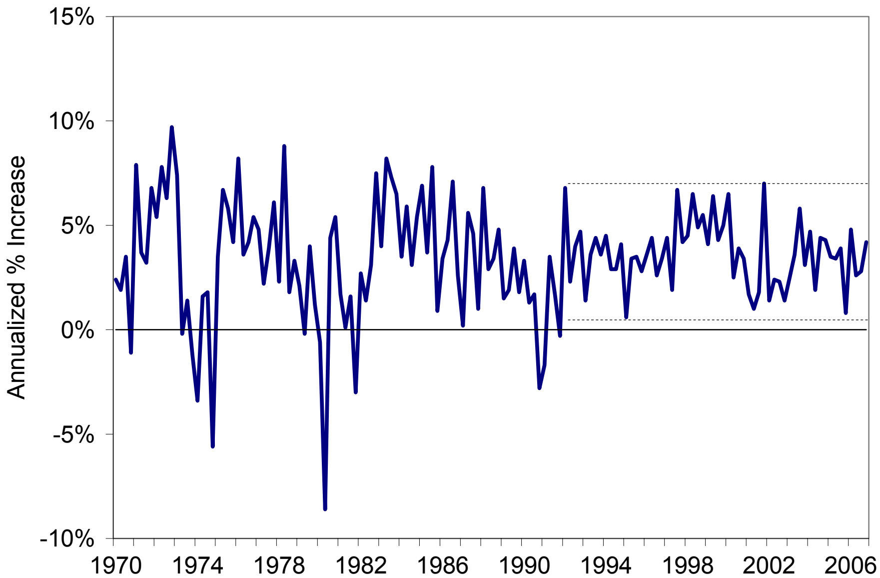
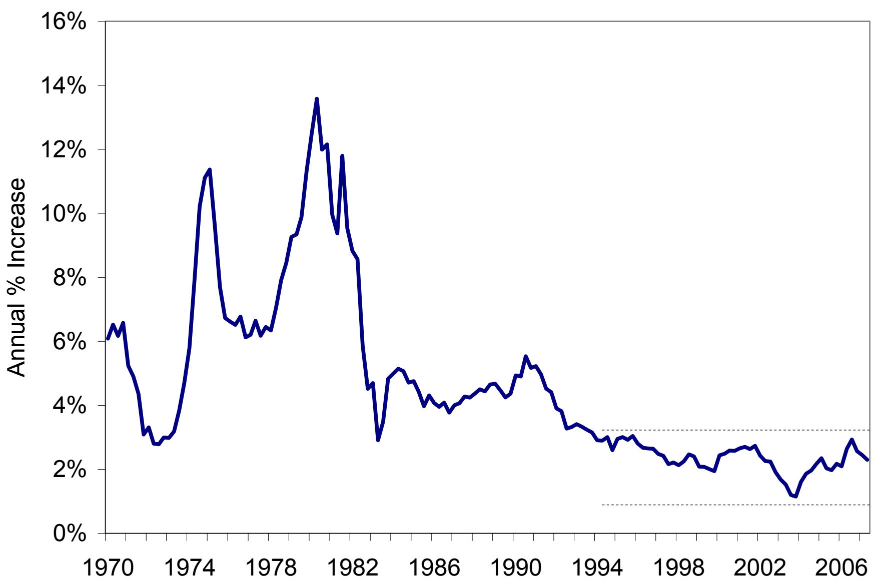
[1] According to U.S. Commerce Department data beginning in 1930.
[2] Although total inflation is a better measure of inflation at a point in time, analysts and policy makers monitor core inflation closely because many believe it provides the best indication of intermediate-term inflation trends.
[3] According to U.S. Labor Department data beginning in 1957.

Chart 1: Personal Consumption Expenditures



Source: Bureau of Economic Analysis

Chart 2: Core Consumer Price Inflation (CPI)



Source: Bureau of Labor Statistics

For investors, the consumer's resilience and the absence of pricing power are especially relevant. Rising consumption supports the stock market by preventing the economy from getting too cold. Low core inflation prevents the economy from getting too hot, while keeping interest rates and the cost of capital low. This benefits both stocks and bonds. In other words, these trends help to achieve the **Goldilocks economy** – neither too hot nor too cold – favored by investment markets.

With this simple economic view in mind, the most critical questions for investors are:

1) **Can we expect these trends to persist?**
2) **Which of the two trends is more vulnerable to change?**

We believe these questions capture much of the uncertainty in today's markets. Equity investments will perform best if both trends remain in place, while bonds will benefit most from continued low core inflation. To answer the questions as best we can, we consider factors affecting inflation and consumption in today's economy.

The Return of Inflation?

Casual observation suggests that rising inflation is a greater risk today than falling consumption. Core inflation has remained stubbornly above the 1-2% range favored by Fed policy-makers, while rising food and energy prices have lifted the total inflation rate above the core rate. Furthermore, the Fed has clearly emphasized inflation risks in their public statements.

However, there are a number of reasons to believe that inflation is not quite as threatening as it appears.

First, economic growth has slowed to a 1.9% annual rate over the past four quarters, significantly below the roughly 3% rate considered by many to be the economy's long-term potential. By comparison, the economy grew at a 3.6% annual rate from 2003 through the first quarter of 2006. Although changes in growth normally affect inflation with a lag, it is unusual for inflation to accelerate as the economy slows.

The effects of the growth slowdown appear to be borne out by the most recent inflation data, showing that core CPI declined from 2.9% as of September 2006 to 2.3% through April 2007. When the inflation measure is narrowed further by excluding shelter costs, the result is particularly encouraging. The CPI, excluding food, energy, and shelter costs, believed by many to capture inflation trends even better than the core rate, fell to 1.2% for the 12 months ending in April.

Second, leading inflation indicators such as core PPI and unit labor costs – which measure increases in input costs that could later flow into consumer prices – also appear benign. The most recent data shows both of these measures between 1% and 2%. These levels are especially non-threatening considering rising productivity, since gains in productivity provide a buffer against rising input costs. Productivity and labor cost trends pushed the corporate profit share of national income to a 40-year high in 2006, suggesting companies have plenty of latitude to absorb cost increases without raising prices.

Third, in addition to the recent data, optimists point to key structural restraints on inflation, including globalization and monetary policy. Globalization is among the popular explanations for the low inflation of the past 10-15 years. Assuming recent protectionist rhetoric from lawmakers in Washington does not deteriorate into trade wars, globalization's benefits to the consumer appear to be ongoing. Inflation for goods and services that are subject to global competition is substantially below the economy-wide inflation rate. Areas of intense global competition – including apparel, motor vehicles, and personal computers – have all seen falling prices in the trailing 12 months through April. Furthermore, advances in technology continue to expose more of the economy to global competition.

Economists have also argued that low inflation is a result of improved monetary policy. While this is difficult to validate quantitatively, the Fed's monetary policy guidelines have certainly changed since the last period of extreme inflation volatility in the 1970s and early 1980s.

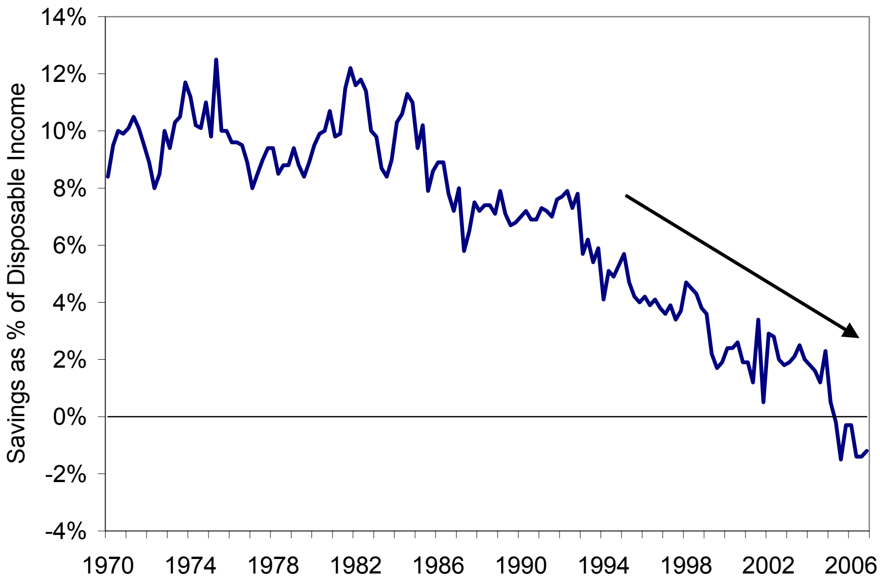
Fed Chairman Ben Bernanke has often written and spoken on this topic, arguing that global central banks have dampened economic volatility and lowered inflation through better management of inflation expectations. Considering the Fed's actions after Bernanke assumed leadership last year – raising interest rates three times and then holding rates steady even as growth slowed – there is ample reason to expect the Fed will continue to contain core inflation successfully. In other words, rather than being alarmed by the Fed's hawkish stance, it may be more appropriate for investors to gain confidence from the actions the Fed is taking on their behalf.

Will the consumer slow down?

While inflation risks may be less threatening than they appear, consumers continue to spend. According to the two most recent GDP releases, consumption grew by 4.2% in the fourth quarter of 2006 and by 4.4% in the first quarter of 2007. This recent pace is even higher than the impressive 3.6% annual rate of the past 15 years. However, as consumers have plowed ahead, a number of risks have emerged.

Perhaps most worrisome for future consumption is the fact that home prices have begun to decline by most measures. During the current economic expansion, rising home prices seemed to fuel consumer spending just as the bull market for stocks supported spending during the latter half of the 1990s. These "wealth effects" have encouraged consumers to spend a greater percentage of their income, implying a lower savings rate as shown in Chart 3. However, stagnant house prices may yet slow spending and reverse the downward trend in savings. Much depends on the extent of further weakness in the housing market. Should the drop in house prices accelerate, the potential drag on consumption would be significant.

Chart 3: Personal Savings Rate



Source: Bureau of Economic Analysis

Other housing-related drags on consumption stem from increases in delinquencies and from scheduled interest-rate resets to adjustable-rate mortgages (ARMs). According to the Mortgage Bankers Association, mortgage delinquencies increased for all major loan types in the fourth quarter of 2006. The increase was especially severe in the sub-prime sector, where many lenders have been forced to shut down. Rising delinquency rates bear watching for effects on consumer spending, particularly if credit fundamentals deteriorate in loan categories of higher quality than sub-prime.

Rising interest rates on adjustable-rate mortgages (ARMs) may also affect consumer spending by increasing homeowners' interest rate burden and potentially fueling the rise in delinquencies. Issuance of ARMs increased dramatically in the later stages of the housing boom, exceeding $2 trillion in outstanding loans by 2005. Hybrid ARMs, which present the greatest credit risks, were especially popular. Hybrid interest rates are typically fixed for the first several years at levels *lower* than prevailing adjustable rates, so that interest-rate resets are even more wrenching. Analysts have shown that the fixed-rate period is scheduled to end for increasing amounts of hybrids in 2007 and 2008, which will result in higher interest payments.

Another key indicator for future consumption is real wage growth. Real wage growth, defined as wage growth in excess of inflation, has fallen from over 3% at its recent peak in October 2006 to 1.1% as of May 2007.[4] While still positive, the falling growth rate indicates that consumers' purchasing power is being pinched by a combination of rising food and gas prices and slower nominal wage gains. In response to these developments, as well as the ongoing contraction in housing, many economists have marked down their consumption forecasts for the rest of this year and for 2008.

[4] Based on average hourly earnings data reported by the U.S. Labor Department.

Conclusions

Despite the risks cited above, we believe income gains are strong enough to support continued growth in consumer spending, albeit at a weaker pace than the 3.6% annual rate observed since 1992. We believe consumer prices will also grow at a moderate pace, with lagged effects from the Fed's 17 interest rate hikes between 2004 and 2006 helping to lower core inflation to the middle of the 1-3% range of the past 11 years. In other words, to answer the question of whether continuously growing consumption and low core inflation will persist, we are optimistic that these trends will remain in place.

With regard to the question of which trend is more vulnerable to change, we view risks to consumption as slightly greater than risks to core inflation. Although the Fed has emphasized inflation risks in its rhetoric and actions, its aggressive stance should give investors greater confidence that core inflation will remain low. At the same time, consumption has been bolstered by rising house prices and a falling savings rate, and these dynamics are unlikely to continue indefinitely.

Consumption and core inflation should be closely monitored because they describe the two pillars of the Goldilocks economy: the resilience of the consumer and the absence of pricing power. The consumer's resilience has prevented the economy from getting too cold, while weak pricing power has prevented the economy from getting too hot. Together, the trends have produced the moderation preferred by investment markets.

Should either trend falter, the consequences could be particularly severe. Falling consumption would likely spread to the broader economy and damage corporate earnings and stock performance. Rising and unstable core inflation would create strong headwinds for both stocks and bonds. According to the Pareto Principle, the outsized importance of these trends should come as no surprise.

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