MORNING BRIEFING
December 16, 2020

The Mobility Question

Check out the accompanying chart collection.

(1) Income inequality is controversial. (2) The pandemic has exacerbated the divide between the Haves and Have Nots. (3) Prosperity is good for everyone, even though the rich tend to prosper more. (4) A nation of proprietors: A happy trend that should resume after the pandemic. (5) Marx and Engels were terrible forecasters. (6) Class warfare is a wrong-headed ideology. (7) Entrepreneurial vs crony capitalism. (8) The rise and triumph of passthroughs. (9) Proprietors generating almost as much income as corporations. (10) An important source of capital spending and employment. (11) Economic mobility is also a controversial subject in need of more data and analysis.

Business Mobility: Greasing the American Dream? Has income stagnated for most Americans over the past few decades? Has income inequality worsened over the past few decades? Has economic mobility decreased in recent decades? These are all highly controversial questions. From our perspective, if the standard of living has been deteriorating for years in the US, we doubt that the stock market would be making record highs. Nevertheless, that's undoubtedly a controversial point of view, since others believe that the stock market is rigged for the rich and that the rich are getting richer. The controversy has only grown more intense amid the pandemic-induced recession and wobbly recovery, which some have suggested is a K-shaped one, i.e., good for the Haves and bad for the Have Nots.

Even before the pandemic hit, evidence suggested that the rich have been getting richer in recent years. However, they typically do during periods of prosperity. Those less well-to-do likewise tend to prosper during such times, but not as fast as the rich. In other words, the benefits of economic growth on personal finances may be unevenly distributed early in an expansion, but over time a growing pie benefits everyone. But as Melissa discusses below, income distribution is not static; there is movement among groups of those who prosper greatly and less so—i.e., economic mobility. So not only is income inequality a controversial subject; it is also a very dynamic and complicated one.

Of course, the pandemic isn't over, and too many people and small businesses are still suffering. Nevertheless, we'd like to start today's commentary with an upbeat and widely

overlooked trend in America: The number of sole proprietorships has been growing very rapidly. We have become a nation of proprietors. The pandemic may weigh on that trajectory, but not for long once the pandemic is over, in our opinion.

This proliferation of sole proprietorships is an important development that challenges the core beliefs of proponents of class warfare. They see the economy as composed of numerous battlefields where workers clash with capitalists. *The Communist Manifesto,* written by Karl Marx and Friedrich Engels in 1848, was intended by its authors to be the proletariat's declaration of war against the owners of capital. It was an overly simplistic analysis back then, resulting in some of the worst economic forecasts in history and widespread economic misery rather than a workers' paradise. The class warfare concept is even less relevant today considering the growth of entrepreneurship.

The robust growth of the proprietors class certainly complicates the simplistic class warfare ideology, since they are both workers and owners of capital. Proprietors are entrepreneurial capitalists, which distinguishes them from crony capitalists. To stay in and succeed in business, they must satisfy their customers and keep their employees happy. Crony capitalists tend to be corporations that have grown big along with government. They have trade associations with lobbyists as well as their own lobbyists to influence the government's regulatory policies, mostly aiming to create barriers to entry for would-be competitors.

Let's cut to the chase and examine the available data on the growing importance of proprietors in our economy:

(1) *The number of corporations.* We have IRS data from 1980 through 2015 on the number of returns filed by business entities in America. The total number of corporations increased from 2.7 million to 6.1 million over this period (*Fig. 1*). These include C and S corporations. The former file corporate tax returns. Their profits are taxed at the corporate level, and the dividends they pay are taxed in individual tax returns. S corporations can have no more than 100 shareholders. Their profits are not taxed at the corporate level. Instead, they are treated as dividends and taxed in the individual income tax returns of their shareholders. That way, double taxation of income is avoided.

As a result, S corporations have become very popular. From 1980 through 2015, they increased 4.0 million from 0.5 million to 4.5 million, while the number of C corporations declined 0.6 million from 2.2 million to 1.6 million (*Fig. 2*).

(2) *The number of passthroughs.* S corporations are categorized as "passthrough" business entities since their profits are passed on to their owners to be taxed once as personal income. Sole proprietorships and partnerships are also taxed as passthroughs. The former has increased significantly by 16.3 million from 8.9 million during 1980 to 25.2 million during 2015 (*Fig. 3*). Over this same period, the number of partnerships has increased by 2.3 million from 1.4 million to 3.7 million.

Together, there were 33.4 million passthroughs in 2015, including 25.2 million sole proprietorships, 3.7 million partnerships, and 4.5 million S corporations. Each employed at least one worker, obviously—i.e., their owner. At the beginning of 2015, private payroll employment totaled 118.6 million, implying that passthroughs accounted for at least 28% of those jobs (*Fig. 4*). That's significant and impressive!

(3) *Impact on National Income.* The IRS data show that, in 1980, C corporations accounted for a whopping 86.8% of business sales receipts and 74.6% of the net income of all businesses (*Fig. 5*). By 2015, these percentage shares were down to 60.5% and 36.7%. In 2015, these were the net income results for C corporations ($1,155 billion), S corporations ($457 billion), and sole proprietorships and partnerships ($1,112 billion) (*Fig. 6*).

Interestingly, in the National Income and Product Accounts (NIPA), proprietors' pre-tax income is almost as large as corporate profits (*Fig. 7* and *Fig. 8*). The former is currently running around 80% of the latter. Both having been trending higher at an annual growth rate of about 6%-7%.

In many ways, the business cycle is really a profits cycle. Profitable corporations and passthrough businesses increase their payrolls and expand their capacity. Unprofitable ones decrease their payrolls and cut back on capacity expansion. Therefore, the corporate profits and proprietor's income cycles are procyclical, rising during expansions and falling during recessions (*Fig. 9* and *Fig. 10*).

(4) *Impact on capital spending.* Nonfinancial noncorporate businesses accounted for 14.5% of capital spending in nominal GDP during Q3-2020 (*Fig. 11* and *Fig. 12*).

(5) *Impact on employment.* ADP compiles monthly data for the private-sector payrolls of large, medium, and small companies. Passthroughs are likely to account for the bulk of small

companies, which currently employ 31.3 million workers and account for 26.2% of total private-sector payrolls (*Fig. 13* and *Fig. 14*).

Economic Mobility: Ceasing the American Dream? The pandemic has heightened concerns about income inequality, as lower-income households have sustained a greater economic hit than higher-income ones. Thanks to the recent emergency use authorization of Pfizer's vaccine by the Federal Drug Administration, the pandemic may be over sooner rather than later. But discussions about income inequality are likely to persist, especially under the incoming Democratic administration.

In recent notes, Melissa and I have analyzed the data on income inequality, which suggest that—while it undeniably exists—it hasn't worsened in recent years as much as some economists claim. We wondered whether a similar analysis of economic mobility—or the ability of individuals, families, or other groups to advance their earnings over time regardless of their socioeconomic status at birth—might yield insight into income inequality that supports our more sanguine view of it and quells the concerns of others. Unfortunately, the available studies we review below conclude that economic mobility has deteriorated in recent years.

We are clearly going to have to do more work to understand how economic mobility has worsened while income inequality has not, based on our previous analyses. Something doesn't add up. For today, our focus is on the available studies of economic mobility. Consider the following:

(1) *Measuring mobility*. An upbeat 2008 US Treasury study purporting to shed light on income mobility really did not because of its narrow individual focus. It measured individuals' income changes over time with no data relevant to children's chances of faring better economically than their parents and no adjustment for the fact that people's incomes tend to rise over time as skills and experience accrue.

A 2016 Federal Reserve Bank of Boston study took a hybrid approach. It evaluated income mobility for several overlapping decades (i.e., 1977 to 2012). The Treasury report did compare the 1996 to 2005 timeframe to the prior decade (i.e., 1987 to 1996), concluding that income mobility had remained relatively similar over the two decades, but the Boston study covered a much longer time horizon. The Boston Fed researchers found that trends in income mobility were not monotonic. That is, they moved "up over several periods, and then down, or vice

versa." That is part of the reason that earlier research, "which generally compares two adjacent periods, fails to document a significant downward trend," the researchers observed.

The report concluded: "All the mobility measures except origin-specific measures for the rich show a decline in mobility in the most recent period, 2001–2011, compared with the next-most-recent period, 1999–2009, and furthermore indicate lower mobility during these two decades (which include the Great Recession) than in 1997–2007, before the recession began. It appears that the Great Recession further depressed economic mobility for those with low incomes." It does not seem farfetched to think that an update of the research following the pandemic era would show further deterioration of economic mobility.

(2) *Generational decline*. Not many studies have directly linked earnings data between parents and children because of how cumbersome it is to obtain and analyze that amount of data, but there are a few relatively recent ones. In a 2015 report, Pew measured economic mobility in terms of "intergenerational elasticity," which is the strength of the relationship between the income of parents and that of children. Pew found that about half of parental income advantages are passed on to children, which it qualifies as meaning that the US is "very immobile."

Similarly, a 2016 National Bureau of Economic Research (NBER) working paper co-authored by economists at Harvard, Stanford, and UC-Berkeley found that rates of absolute upward income mobility in the US have fallen over time. Specifically, the fraction of children earning more than their parents at 30 years of age (adjusted for inflation) fell from 92% for those born in 1940 to 50% for those born in 1984.

(3) *Bigger pie needed*. Despite the apparent rise in income immobility, improved standards of living are evident across all income quintiles. We can look to historical evidence for this. For example, the US Treasury report found: "Median incomes of taxpayers in the sample increased by 24 percent after adjusting for inflation. The real incomes of two-thirds of all taxpayers increased over this period."

On the other hand, the NBER researchers simulated the impact of various GDP growth rates on income mobility. They found that real GDP growth rates above 6% per year would be needed to return to the rates of absolute mobility seen for those born in the 1940s. In other words, "changing the distribution of growth naturally has smaller effects on absolute mobility when there is very little growth to be distributed. The key point is that reviving the 'American

Dream' of high rates of absolute mobility would require more broadly shared economic growth rather than just higher GDP growth rates."

(4) *Connecting the disconnect*. We are just thinking out loud, but the apparent disconnect between stable income inequality and worsening economic mobility may have to do with the growing share of higher-paying jobs on the income scale that rely on technology. It's not so simple for workers to move up the income escalator if they don't possess the skills or access to relevant education and training to leverage technology. In the past, moving up the income scale may have had more to do with workers moving into a supervisory or management position in a field in which they had gained knowledge and experience. Today, organizational leadership is increasingly horizontal, and the highest earners may be those who are able to most productively use technology rather than those that effectively supervise humans.

Separately, another possible reason for the disconnect is that income inequality is stable because government transfers have made up for worsening income gaps. In other words, income inequality would have worsened if it were not for government supports. We will further explore these hypotheses in future research.

CALENDARS

US: Wed: Retail Sales Total & Ex Autos -0.3%/0.1%, Business Inventories 0.7%, NAHB Housing Market Index 88, IHS Markit M-PMI & NM-PMI Flash Estimates 55.8/55.0, MBA Mortgage Applications, EIA Crude Oil Inventories, FOMC Interest Rate Decision 0.25%, FOMC Economic Projections. **Thurs:** Housing Starts & Building Permits 1.53mu/1.55mu, Philadelphia Fed Manufacturing Index 20, Kansas City Manufacturing Index, Initial & Continuous Jobless Claims 800k/5.598m, EIA Natural Gas Storage. (DailyFX estimates)

Global: Wed: Eurozone, Germany, and France C-PMI Flash Estimates 45.8/50.4/42.9, Eurozone, Germany, and France M-PMI Flash Estimates 53.0/56.4/50.1, Eurozone, Germany, and France NM-PMI Flash Estimates 41.9/44.0/40.0, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 51.3/55.9/50.5, UK Headline & Core CPI 0.6%/1.4% y/y, Canada CPI 0.8% y/y, Australia Employment Change & Unemployment Rate 50k/7.0%, Guindos, Schnabel, Weidmann, Buch. **Thurs:** European Car Registrations, Eurozone Headline & Core CPI -0.3%/0.2% y/y, France Business Confidence 92, UK Gfk Consumer Confidence -31, Japan CPI, BOE Interest Rate Decision 0.1%. BOJ Interest Rate Decision -0.1%, Guindos, Schnabel, Broadbent. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Basic Shares Outstanding During Q3-2020 (*link*): The total basic shares outstanding for the S&P 500's companies declined 0.4% y/y during Q3-2020, which was the lowest rate of decline since Q3-2011. The pace of decline slowed for a fourth straight quarter during Q3-2020 and is down from a record -1.7% y/y decrease during Q3-2019. That suggests companies have focused more on conserving cash than on buying back their shares during the Covid-19 economic crisis. The share count for Financials was down to -3.7% y/y from a record -5.7% during Q1-2020 as the Fed ordered the 33 biggest US banks to preserve capital and suspend their buyback programs. On a q/q basis, S&P 500 shares ticked up a hair less than 0.1% for the first increase since Q1-2012. Looking at the 11 sectors during Q3, just two had their basic share counts decline q/q: Tech (-0.6%) and Materials (less than -0.1%). Here's how the sectors ranked by their y/y percent change in shares outstanding along with their q/q percent change: Financials (-3.7%, 0.0%), Information Technology (-2.2, -0.6), Consumer Discretionary (-0.9, 0.3), Materials (-0.8, less than -0.1), S&P 500 (-0.4, less than 0.1), Consumer Staples (-0.4, less than 0.1), S&P 500 ex-Financials (0.2, less than 0.1), Communication Services (0.8, less than 0.1), Energy (0.9, 0.4), Utilities (2.0, 0.1), Health Care (2.1, 0.1), Industrials (2.2, 0.5), and Real Estate (3.2, 0.2).

US ECONOMIC INDICATORS

Industrial Production (*link*): Industrial output continued to climb in November, as factory production got a boost from a rebound in auto output after a multi-month decline. Headline production increased for the sixth time in seven months, by 0.4% in November and 13.9% over the period to within 4.9% of its pre-Covid level, while manufacturing output has climbed steadily since bottoming in April, up 0.8% last month and 20.5% during the seven months through November—to within 3.6% of its pre-pandemic reading. Auto output rebounded 5.3% last month after a three-month slide of 7.6%, which was proceeded by an unprecedented 520.4% surge the previous three months. Meanwhile, mining output rose 2.3% last month, while utility output fell 4.3%. Here's a snapshot of output by market group (and their components) since their April lows and where they stand relative to their February levels: Business equipment (34.2% & -5.1%), led by transit equipment (284.9 & -2.8), followed by industrial equipment (20.7 & -7.1), and information procession equipment (3.1 & -2.7)—with the latter showing little volatility during the pandemic shutdown. The same exercise shows the rebound in consumer goods production (18.5% & -1.8%) is being driven by durable goods

(103.5 & +0.2)—mostly automotive products (361.7 & +2.2). The gain in consumer nondurable goods (4.9 & -2.4) production has paled in comparison, and has dropped for two of the last three months (by 1.4%).

Capacity Utilization (*link*): The headline capacity utilization rate hasn't posted a decline since bottoming in April at 64.2%, climbing to 73.3% in November, a reading that is 6.5ppts below its long-run (1972-2019) average but 9.1ppts above its April low. Manufacturing's capacity utilization rate has increased steadily since reaching bottom in April at 60.1%, rising to 72.6% last month—12.5ppts higher than its trough in April but still 5.6ppts below its long-run average. The utilization rate for mining has been in an up-and-down pattern in recent months, rising to seven-month high of 79.4% last month, though it remains well below its long-run average of 87.2%. The operating rate for utilities declined for the third time in four months to a record low of 70.2%—a rate that is 15.0ppts below its long-run average

Regional M-PMIs (*link*): The New York Fed gives the first glimpse of manufacturing activity in December and shows growth slowed for the third month, though firms remained optimistic that conditions would improve over the next six months. December's composite index eased to 4.9 this month from 6.3 last month and 17.0 in September—which virtually matched July's 20-month high of 17.2; it was at a record low of -78.2 in April. Shipments (to 12.1 from 6.3) improved this month after falling 11.5 points in November, while new orders (3.4 from 3.7) held steady. Inventories (to -4.3 from -8.6) continued to contract this month, though at a slower pace, narrowing steadily from October's -14.6; delivery times (4.3 from 0.7) were somewhat longer. The employment measure (to 14.2 from 9.4) recorded its best pace since December 2018—improving every month since bottoming at -55.3 in April, while the gauge for the average workweek was unchanged at 4.8 this month, a third September's rate. The index for future business conditions (to 36.3 from 33.9) was little changed—averaging 36.0 the past six months—indicating that firms remained optimistic about future conditions. The index for future new orders (to 32.3 from 32.9) was similar to last month's reading, while the shipments (32.7 from 28.2) measure improved a bit from last month. Employment levels (to 21.2 from 22.2) and the average workweek (7.1 from 9.3) are expected to continue to increase in the months ahead. The indexes for future prices paid (to 48.6 from 22.7 in August) and prices received (30.0 from 7.9 in September) both showed an acceleration in prices in recent months.

Import Prices (*link*): Import prices ticked up a smaller-than-expected 0.1% in November after ticking down 0.1% in October (which was its first decline in six months); an increase in petroleum costs was offset by declines in food and motor vehicle prices. Petroleum prices

rebounded 2.1% in November following a two-month decline of 6.2%, while nonpetroleum prices were flat last month after edging down 0.1% in October—its first decline in six months. The yearly rate for import prices remained at -1.0% y/y last month, narrowing steadily from -6.8% in July. The rate for nonpetroleum prices (1.6% y/y) barely budged from the September and October rates of 1.7%—which were the highest since May 2018. Petroleum prices were 27.0% below a year ago last month—holding around that rate for the past few months. The rate for capital goods imports (1.3% y/y) continued to accelerate, posting its highest reading since January 2012; it was at recent low of -2.0% a year ago. Meanwhile, the decline in the rate for industrial supplies & materials (-6.6% y/y) has narrowed from April's 26.5%—which was the lowest reading since November 2015. Rates for consumer goods ex autos (0.2% y/y) remained around zero last month, though has moved to the north side, while the rate for autos (1.0) eased a bit from September's 1.3%, which was the highest since February 2013. Food prices were 0.2% above a year ago, slowing from October's 15-month high of 2.1%; the rate was negative from March through August. Import prices are showing signs of picking up among some of our trading partners, with import prices for goods from the EU (to 1.5% from 1.9% y/y) holding near October's two-year high, while China's (0.4% y/y) moved further above zero last month—after posting its first positive reading in October in two years. The rate for the NICs (-0.9% y/y) remained negative in November, though has narrowed from -4.0% in April, while the rate for Japan has held around zero.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823