MORNING BRIEFING
August 3, 2021

Income & Wealth in America

Check out the accompanying chart collection.

(1) A forthcoming exposé of corporate profits. (2) In summary: Profits beat the alternatives. (3) Profits drive widespread prosperity, which always entails some inequality. (4) Income mobility offsets income inequality. (5) America has evolved into a nation of proprietors. (6) Pass-through business owners personally account for at least 25% of employment! (7) Number of taxpayers in lowest income bracket has been declining. (8) Tax return data show upward income mobility. (9) Wealth inequality increases during periods of prosperity too. (10) The wealthy tend to be heavily invested in equities, which appreciate most during good times. (11) Real estate and pension entitlements more equitably distributed. (12) Adding Social Security as a retirement asset reduces wealth inequality significantly.

US Income Distribution I: Mobility vs Inequality. I am wrapping up my latest book, titled *In Praise of Profits*. One of the issues that I address is income inequality in the US.

My conclusion is that our system of free-market capitalism, driven by the profit motive, increases widespread prosperity, i.e., aggregate income, better than any other economic system. It naturally causes income inequality, especially during good economic times. That's when high-income households tend to get richer faster, while low-income households tend to get richer as well but more slowly.

Periods of prosperity are often associated with new goods and services introduced by entrepreneurial capitalists. The ones that succeed do so because they bring to market products that benefit lots of consumers. They get rich by increasing the standards of living of their customers with those products. They may very well get richer much faster than their employees and their customers do, but they are the key drivers of technological innovation, productivity, and widespread prosperity.

I've also concluded that upward economic mobility in our economic system tends to offset the negative consequences of income inequality.

US Income Distribution II: Many Happy Returns. In my forthcoming book, I discuss the extraordinary growth of pass-through business entities. These are all owned and managed by entrepreneurial capitalists. The latest available data for 2017 show there were 1.6 million C corporations that year, down from 2.2 million in 1980 (*Fig 1*). They are the ones that are publicly traded and pay taxes on their profits. They pay dividends to their shareholders, who are taxed on these proceeds. That same year, there were 35.1 million pass-through business entities, up from 10.9 million in 1980.

Pass-throughs are not publicly traded and are taxed just on the dividends paid out to their limited number of shareholders. They include S corporations, sole proprietorships, and partnerships. Internal Revenue Service (IRS) rules limit the number of shareholders of an S corporation to 100. They may be individuals, certain trusts, or estates. They may not be partnerships, corporations, or non-resident alien shareholders. The S corporations must be domestic and have only one class of stock. They cannot be certain financial institutions, insurance companies, and domestic international sales corporations. A sole proprietorship is an incorporated business owned by a single person. A partnership is like a sole proprietorship in function but allows for the association between two or more persons who agree to combine their resources and skills for a mutual profit (and loss).

For simplicity, let's assume that during 2017, the 4.7 million S corporations were owned by just one shareholder, as were the 26.4 million sole proprietorships, and that the 3.9 million partnerships had only two partners. That adds up to 38.9 million Americans, or 25.4% of 2017's household employment measure, which reflects the number of people with jobs rather than the number of jobs.

America has evolved into a nation of pass-through business owners. They have had a significant positive impact on income distribution, in my opinion. To see this, let's examine annual data on tax returns provided by the IRS:

(1) *Total returns.* During 2017, Americans filed 152.9 million tax returns, up 22.6 million since 2001. The total number of pass-through business entities during 2017 totaled 35.1 million, up 11.6 million since 2001. So they accounted for about 23% of all returns and for about half the increase in total returns from 2001-2017. Keep in mind that they all must file individual income tax returns. S corporations also file corporate returns, but their owners pay taxes on the dividends they receive on their personal returns.

(2) *Returns by income group.* The IRS provides the number of returns by five different income brackets, based on adjusted gross income (AGI) from 2001 through 2017. Here are the number of returns, in millions, by AGI group during 2001, then 2018, as well as the change over that period (*Fig. 2*):

$0-$50K (92.8, 88.9, -3.9)

$50K-$100K (26.4, 35.2, 8.8)
$100K-$200K (8.5, 21,2, 12.7)
$200K-$500K (2.0, 6.9, 4.9)
$500K or more (0.6, 1.7, 1.1)

The decline in the lowest income group might reflect progressive changes in the tax code that meant that fewer households in this bracket had to file returns. It could also reflect upward income mobility.

(3) *Share of returns by income group.* Another way to slice and dice the tax returns data is to compare the filings of each AGI group as a percentage of total returns during 2001 and as a percentage of total returns during 2018, then to calculate the change in these percentages (*Fig. 3*):

$0-$50K (71.2%, 57.8%, -13.4)
$50K-$100K (20.3%, 22.9%, 2.6)
$100K-$200K (6.5%, 13.8%, 7.3)
$200K-$500K (1.6%, 4.5%, 2.9)
$500K or more (0.4%, 1.1%, 0.7)

These numbers suggest a significant amount of upward income mobility. The percentage of total tax returns filed by the lowest income group dropped from 71.2% to 57.8%, while all the other income groups rose from 28.8% to 42.2% (*Fig. 4*).

(4) *Total AGI.* The IRS also provides total AGI (*Fig. 5*). It increased 88.7% from $6.2 trillion during 2001 to $11.6 trillion in 2018. The average AGI per tax return increased 59.7% from $47,353 in 2001 to $75,683 in 2018 (*Fig. 6*). Over this same period, the PCE deflator rose 37.9%. Overall, Americans have been solidly beating inflation.

(5) *AGI per return by income group.* Then again, this conclusion does not hold up for the average AGI per return for each of the five brackets, which rose by much less than the rate of inflation from 2001 through 2018, as follows (*Fig. 7*):

$0-$50K (1.0%)
$50K-$100K (2.7%)
$100K-$200K (3.9%)
$200K-$500K (-2.0%)
$500K or more (8.8%)

Relative to inflation over that period, real average AGIs per income group show calamitous declines, not stagnation!

(6) *Eureka moment.* It is time for a "Eureka!" moment. The IRS data clearly show that it is upward income mobility, not rising average AGIs per income bracket, that has been increasing both nominal and real AGIs. The averages of the nominal AGIs per income group have been remarkably flat over the past 17 years through 2018, misleadingly implying income stagnation. Almost all the gains in total AGI per income group have been attributable to triple-digit percent increases in the number of households filing returns with AGIs in the top three income ranges.

I submit that the data strongly suggest that the AGIs of the great majority of Americans have improved significantly since 2001. Income mobility has lifted most of them into higher tax brackets. That can be explained in part by the significant proliferation of pass-through businesses.

US Wealth Distribution: Finding More & Less Inequality. Now let's turn to some of my findings on US wealth inequality from 1989 through early 2021. The bottom line is that wealth inequality has worsened slightly during this period. That's because the major source of wealth inequality is ownership of equity in publicly traded corporations and in closely held ones. As a result, wealth inequality, like income inequality, tends to worsen during periods of prosperity, i.e., when strong profits growth increases the market value of corporate equities.

Progressives have had more success in redistributing income than in spreading the wealth. Recently, a few of them have proposed imposing a wealth tax. Their studies on wealth inequality have been based on flimsy data sets and lots of questionable assumptions.

Meanwhile, a large team of the Fed's researchers have been busy constructing a new database containing quarterly estimates of the distribution of US household wealth since 1989. They launched it with the release of a March 2019 working paper titled *Introducing the Distributional Financial Accounts of the United States*.

The Distributional Financial Accounts (DFA) is an impressive accomplishment combining quarterly aggregate measures of household wealth from the *Financial Accounts of the United States* and triennial wealth distribution measures from the *Survey of Consumer Finances*. The DFA's balance sheet of the household sector is much more comprehensive and timelier than previously existing sources. I believe that the new database can be used to resolve lots of controversial issues about wealth distribution in the US. Here are just a few that I explore in my forthcoming book:

(1) *Has wealth inequality gotten worse?* From Q3-1989 through Q1-2021, the net worth of households increased 534% to a record $129.5 trillion. The share held by the top 1% of wealthy households rose from 23.4% to 32.1% over this period (*Fig. 8*). The share held by the top 90%-99% group has been relatively steady between 35.0% and 40.0%. It was 37.7% during Q1-2021. The share held by the 50%-90% group declined from 35.5% to 28.2% over the period. The bottom 50% had only a 2.0% share of household net worth.

Put more simply, the top 10% held 69.8% of net worth during Q1-2021, up from 60.8% during Q3-1989. Yes, wealth inequality is significant and has gotten worse. Not only do the top 10% of wealthy households have a disproportionately high share of household assets but they also have a very small share of household liabilities. During Q1-2021, they had 64.8% of household assets and only 25.2% of household liabilities (*Fig. 9* and *Fig. 10*).

But the story isn't quite as simple as claimed by progressives who favor wealth taxes.

(2) *Inequitably distributed equity holdings.* Much of America's wealth inequality has been attributable to equities. This asset class totaled $37.4 trillion, or 25.7%, of household assets during the first quarter of 2021. The share of corporate equities and mutual funds held by the top 10%, i.e., the wealthiest households, rose from 82.1% in the third quarter of 1989 to 88.7% in the first quarter of 2021 (*Fig. 11*).

(3) *More equitably distributed real estate and pension entitlements.* The next biggest asset class in the household sector's balance sheet is real estate, at $33.8 trillion during the first quarter of 2021. This has been and continues to be among the most equitably distributed assets in America, with the top 10% of households' share at 44.8% and everyone else sharing a collective 55.3% as of the first quarter of 2021 (*Fig. 12*). The same can be said for pension entitlements, which totaled $29.9 trillion during the first quarter of 2021. The top 1% had only a 5.0% share, while the bottom 50% had only a 3.0% share; but everyone else had a 92% share (*Fig. 13*).

(4) *MIA: Social Security.* The Fed's DFA database on household wealth does not include the present discounted value of Social Security income provided to so many American households, especially those that progressives claim aren't getting their fair share of household wealth. Progressive economists never even consider this value as a household

asset. A just-released (July 27) *working paper* by five economists from the University of Wisconsin and the Federal Reserve makes a very good case for including Social Security in studying the distribution of household wealth inequality and finds much less of it as a result!

(5) *Bottom line: Better than the alternatives.* Bull markets in stocks coincide with periods of prosperity in America when corporate profits are growing solidly. Households with significant holdings of equities in their portfolios see their wealth rise faster than those of households with less significant holdings.

Is this a problem that needs to be fixed with a tax on wealth? I don't think so.

There's risk in constraining the ability of the wealthy to seize their opportunities, as that would affect us all. The wealthy tend to diversify their stock market windfalls, benefitting diverse industries. They invest in private equity deals and fund startups; the easy availability of capital provides up-and-coming entrepreneurs with the capital they need to fund their ventures, helping them to flourish and employ.

I conclude that in such ways, our system of entrepreneurial capitalism increases and distributes prosperity faster and better than any other economic system. Both rising income and wealth inequality occur during prosperous times. That beats the alternative, i.e., bad times for all—which constraining the prosperity-seeding activities of the wealthy would invite. In any event, income inequality tends to be more than offset by upward income mobility. The same can be said of the distribution of wealth.

Calendars

US: **Tues:** Factory Orders 1.0%, API Weekly Crude Oil Inventories. **Wed:** ADP Employment 700k, ISM NM-PMI 60.4, MBA Mortgage Applications, Crude Oil Inventories, Clarida. (Bloomberg estimates)

Global: **Tues:** Australia Retail Sales -1.8%, RBA Interest Rate Decision 0.10%. **Wed:** Eurozone Retail Sales 1.7%m/m/4.5% y/y, Eurozone, Germany, and France C-PMIs 60.6/62.5/56.8, Eurozone, Germany, France, Italy, and Spain NM-PMIs 60.4/62.2/57.0/58.3/63.0, UK C-PMI & NM-PMI 57.7/57.8. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings surged for all three of these indexes last week and were at record highs simultaneously for a 21st week and the first time since October 2018. LargeCap's was at a record high for a 22nd straight week; MidCap's was at a record for a 25th week; and SmallCap's posted its 25th gain in 27 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 62 of the past 63 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 59 of the past 61 weeks, and SmallCap's posted 59 gains in the past 62 weeks. LargeCap's forward earnings is now up 50.8% from its lowest level since August 2017; MidCap's has risen 89.5% from its lowest level since May 2015; and SmallCap's is up 136.9% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings rose to a record-high 42.2% y/y from 38.9%. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings rose 2.2ppt w/w to 71.6% y/y. That's down from a record high of 78.8% at the end of May and up from a record low of -32.7% in May 2020. SmallCap's rate gained 0.6ppt to 117.7%; it's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (43.6%, 10.5%), MidCap (66.4, 8.4), and SmallCap (97.2, 15.9).

S&P 500/400/600 Valuation (*link*): Valuation fell to an eight-month low for LargeCap last week, but the SMidCaps were little changed above their recent 15-month lows. LargeCap's forward P/E of 20.7 was down 0.7pt w/w to its lowest reading since the end of October. That compares to a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's ticked down to 17.2 from 17.3, but is above its 15-month low of 17.0 in mid-July. That's down from a seven-month high of 20.5 in early March and is 5.7pts below its record high of 22.9 in June 2020. SmallCap's remained steady at 16.8 and above its 15-month low of 16.6 in mid-July. It's now down 9.9pts from its record high of 26.7 in early June 2020. During March 2020, MidCap's 10.7 and SmallCap's 11.1 were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since

June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 43rd week. That's the longest stretch at a discount since last May and during 2002-03. SmallCap's P/E had been mostly below LargeCap from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a discount to MidCap's for a sixth straight week. It had been at an atypical discount to MidCap around the start of the year for 10 straight weeks.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. Those gains have endured even through the earnings warnings season, when forecasts typically decline. In the latest week, the S&P 500's Q2-2021 blended earnings-per-share estimate soared $3.53 to $50.96 due to positive earnings surprises. That $50.96 estimate for Q2-2021 represents a gain of 82.1% y/y on a frozen actual basis and an 89.8% y/y gain on a pro forma basis. That estimate also would mark the second straight quarter of double-digit percentage growth and compares to a pro forma 52.8% gain in Q1-2021. All 11 sectors are expected to post positive y/y earnings growth during Q2-2021, up from 10 during Q1-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q2-2021 versus their final Q1-2021 growth rates: Industrials (662.5% in Q2-2021 versus 3.0% in Q1-2021), Consumer Discretionary (3419, 226.1), Energy (235.3, 28.0), Financials (152.6, 138.0), Materials (130.1, 62.4), S&P 500 (89.8, 52.8), Communication Services (70.1, 53.1), Information Technology (46.7, 44.9), Real Estate (33.1, 5.8), Health Care (21.5, 26.7), Consumer Staples (15.9, 11.1), and Utilities (1.8, -0.9).

US Economic Indicators

Construction Spending (*link*): Total construction spending in June was stalled within a tick of April's record high, edging up 0.1% in June after dipping 0.2% in May. Private construction spending climbed 0.4% in June and 13.5% y/y to a new record high, while public construction expenditures has contracted every month so far this year, falling 1.2% in June and 5.7% ytd. Within private construction, residential investment was up 1.1% m/m and 29.3% y/y to a fresh record high, while nonresidential investment remains in a slump, falling 0.7% in June and 6.0% y/y. The rebound in residential construction has been widespread. Here's a look at the components compared to a year ago: single-family (51.9% y/y), multi-family (19.7), and home-improvement spending (6.8), with single-family investment at a new cyclical high and multi-family and home-improvement within a fraction of new record highs.

Global Economic Indicators

Global Manufacturing PMIs (*link*): "Supply chain constraints stymie growth of global manufacturing sector in July" was the headline of July's report. The JP Morgan M-PMI was little changed in July for the second month, at 55.4, after accelerating the prior four months from 53.6 in January to an 11-year high of 56.0 in May. The index is up 15.8 points since bottoming at 39.6 last April. The M-PMI for the advanced economies, at 59.8, was little changed for the second month in July after climbing 23.0 points from 36.8 last April to 59.8 this May. The M-PMI for the emerging economies fell for the seventh time in eight months from 53.9 in November to 50.7 in July. Geographically, 22 out of the 29 nations for which July data were available saw operating conditions expand, with Europe once again a bright spot—with the Netherlands, Germany, and Austria posting the top three growth rates; the US was fourth. Meanwhile, readings for China and Japan were well below the global average, and the emerging Asia region was especially weak, containing five of the seven nations contracting last month—Thailand, Malaysia, Vietnam, Indonesia, and Myanmar. Here's a country ranking of July M-PMIs from highest to lowest: Netherlands (67.4), Germany (65.9), Austria (63.9), US (63.4), EUROZONE (62.8), Czech Republic (62.0), UK (60.4), Italy (60.3), Taiwan (59.7), Spain (59.0), France (58.0), Poland (57.6), Greece (57.4), Australia (56.9), Brazil (56.7), WORLD (55.4), India (55.3), Colombia (54.2), Turkey (54.0), Japan (53.0), South Korea (53.0), Kazakhstan (51.4), Philippines (50.4), China (50.3), Mexico (49.6), Thailand (48.7), Russia (47.5), Vietnam (45.1), Malaysia (40.1), Indonesia (40.1), and Myanmar (33.5).

US Manufacturing PMIs (*link*): Manufacturing activity in July remained robust according to both M-PMI measures, with IHS Markit's reaching a new record high, while ISM's eased for the second month though remained at a powerful rate. ISM's M-PMI (to 59.5 from 60.6) showed the manufacturing sector continued to expand in July at a strong pace, not far from March's 64.7—which was its best reading since 1983! The new orders (to 64.9 from 66.0) measure held close to March's 68.0 reading, which was the strongest since January 2004. The new export orders (to 55.7 from 56.2) sub-index continued to bounce in a volatile flat trend around recent highs. Meanwhile, the production gauge moved down to 58.4 in July, still a strong reading, though 10 points below March's 68.1—which was its best reading since the start of 2004. The employment measure moved back above the breakeven point (50.0) in July, to 52.9, after falling steadily from 59.6 in March to 49.9 by June. The supplier deliveries component of the M-PMI moved down for the second month to 72.5 in July from 78.8 in May—which was the highest since the mid-1970s; the measure continues to reflect the difficulties suppliers continue to experience due to Covid-19 impacts. The inventories (to 48.9 from 51.1) gauge continues to bounce around the breakeven point between expansion and contraction. ISM's price (to 85.7 from 92.1) shows prices continued to increase at a rapid rate, though slowed from June's pace, which was the fastest since summer 1979. In the meantime, IHS Markit's M-PMI (to 63.4 from 62.1) shows manufacturers enjoying their best year in the 14-year history of this series. According to the report, a sharper expansion in production at the start of this quarter contributed to the increase in the headline M-PMI last month, linked to stronger client demand and efforts to clear backlogs of work. In addition, new business at factories rose at a robust rate, what was back near May's record pace. Meanwhile, persistent supply shortages and delays continue to put upward pressure on costs, which were at a record-breaking rate in July.

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, 570-228-9102