Stuck in the Middle

Per data released by the U.S. Census Bureau in September, real median income rose +3.2% in 2016, and poverty levels dropped to 12.7%, down -0.8% from the prior year. As broad economic conditions in the U.S. continue to improve, both income and poverty statistics have recovered to levels not seen since before the Great Recession. On the surface, the U.S. household sector appears to be in good shape; finances have improved significantly, debt service costs are low, unemployment is near historic lows, and overall wealth has surpassed pre-crisis levels. However, deeper analysis shows that recent growth has been concentrated in the top income brackets, further widening a growing income gap.

"Average" or "aggregate" numbers can be very misleading as they mask significant and growing divergences between U.S. households. Income and wealth distribution have shifted dramatically over the last 30 years. The income and wealth accruing to the top 10% of households has reached its highest level in a century. The trend is even more stark looking at the top 5% or 1% of wage earners.

Figure 1 shows the evolution of income inequality in the U.S. since 1980 as measured by the U.S. Census Bureau. An article in the New York Times earlier this year showed a similar chart, and highlighted the fact that the bottom 50% of households experienced their highest income growth in the 30 years prior to 1984. Very much the opposite is true of the last 30 years, when the bulk of income growth and wealth accumulation has been concentrated in the top 10% and 1%, while the growth for other income groups has been stagnant.

Figure 1. U.S. Mean Household Income (1980 to 2016)

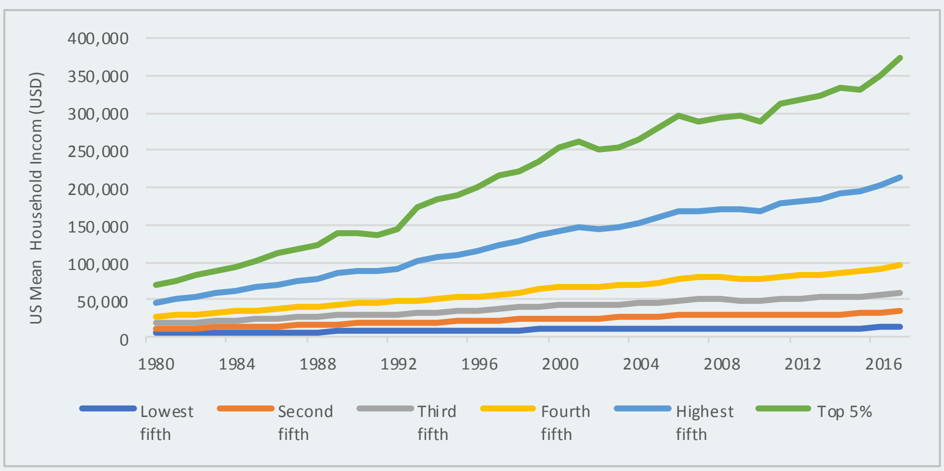

Figure 2. Mean Income Growth Rate

	2000-2016	1995-2016	1990-2016
Lowest Quintile	-8.60%	-0.90%	1.40%
Quintile 2	-2.40%	8.10%	7.40%
Quintile 3	0.50%	10.80%	11.50%
Quintile 4	4.00%	16.00%	19.00%
Highest Quintile	7.90%	24.90%	37.80%
Top 5%	6.60%	26.90%	51.70%

Source: U.S. Census Bureau

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This trend has important implications on how we assess the effects of public policy and fiscal stimulus on the economic growth outlook. A recent research paper by Carroll, Slacalek, Tokuoka, and White analyzes the impact of wealth distribution and the marginal propensity to consume. They concluded that fiscal stimulus focused on individuals in the bottom half of the wealth distribution would be two to three times more effective than a blanket stimulus.

Given the results of their research, it would be prudent to track which stimulus measures are ultimately passed or rejected to assess the potential impact on the broader economy. The highly-skewed income and wealth distribution makes job creation and hourly wage growth much more important, not only for the short-term outlook, but also for the longer-term stability and composition of the economy.

As investors, it is critical to not only assess the economic implications of a growing income gap, but also the effects on aggregate demand and consumption. While the middle class has traditionally been perceived as a growth market, it has become a more challenging demographic in developed markets over the last several years. The segments on the low and high ends of the market are growing, while the middle segment is either shrinking or stagnating.

The evolution and shape of the income distribution points to a continuing bifurcation in several industries, including retail, financial services, food and beverage, travel and leisure, autos, etc. where growth is concentrated at the high and low ends of the market. For example, private label products, hard discount formats, and off-price retailers have showed strength in retail and grocery, as have luxury brands catering to wealthy clientele. These trends validate growth at the far ends of the market while the middle lags. We are simultaneously seeing more diversity in terms of ethnicity, education levels, and technology adoption and utilization. The increasingly fragmented population is challenging corporations with how to define and address their relevant end markets.

As growth is harder to come by and the cost of doing business domestically is going up, we are seeing companies either accelerate their presence in growth areas abroad, or invest in niche areas and/or re-assess their domestic cost base. The most prolific example of this is the M&A activity G3 has engaged in, and the spill-over effects to other consumer companies in the form of accelerated restructuring and cost cutting.

While this environment has created challenges for certain companies, it has generated opportunities for other/new players. For example, some of today's more successful banks, such as Silicon Valley Bank and First Republic, are those that have targeted a niche, but very profitable client base. Being nimble in these markets can be an advantage, and in more cases than not, size has been a hindrance to seizing specific opportunities.

The changing landscape requires both a different mindset and skill set. It has become increasingly important to identify those companies and management teams that can successfully adapt to the U.S. economy as it evolves, and avoid getting stuck in the middle from an operational or financial perspective. As Darwin famously stated, "It is not the strongest of the species that survives, not the most intelligent that survives. It is the one that is the most adaptable to change."

Sources:

US Census Bureau

"Our Broken Economy, in One Simple Chart", David Leonhardt, New York Times, August 7, 2017

"The Distribution of Wealth and the Marginal Propensity to Consume", Christopher Carroll, Jiri Slacalek, Kiichi Tokuoka, Matthew M. White, Forthcoming Quantitative Economics, June 3, 2017

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