Tepid US recovery – it’s the middle class, stupid

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The only point of economic forecasting is to make astrology look respectable, said J K Galbraith. Economists blame most of the US’s 1 per cent shrinkage in the first quarter of this year on the harsh winter. Now that the polar vortex is over, America’s much-awaited take-off will finally happen, they say. Such is the profession’s unshakeable self-belief. For my money, I would sooner consult the star signs. Or the weather report.

Economic forecasters have yet to internalise the fact that the US economy has fundamentally altered. The purchasing power of the majority of Americans has not only stagnated since the recovery began five years ago – it has actually declined.

At $53,000, the median US household is more than $4,000 – or 7.6 per cent – poorer in real terms than it was at the start of the recession in 2008, according to Sentier Research. Yet the economy as a whole has long since overtaken its pre-recession size.

The culprit is rising income and wealth inequality – a central economic truth of our time. As Mark Carney, the governor of the Bank of England, put it last week: “Within societies, virtually without exception, inequality of outcomes both within and across generations has demonstrably increased.”

When most of the gains of growth go to a small slice of high earners at the top, little of it is spent. Aggregate growth is perennially vulnerable. There is nothing mystical about the forces at work. Take the US housing recovery, which has once again stalled in the past few months (a negative trend that both predates and postdates the terrible winter).

During the first four months of this year, the sales of the 1 per cent most expensive US homes – those worth $1.67m or more – have increased by 21 per cent, according to Redfin, the real estate group. It followed a gain of 35 per cent in 2013 – led by the gilded San Francisco Bay area, where the priciest homes start at $5.35m.

Sales of the bottom 99 per cent of homes in the US, meantime, have fallen by 7.6 per cent so far this year. Here, in a nutshell, you have the US economy. The total value of home sales has risen. But most people are not seeing it.

The same is true of other forms of consumption. The high end is booming. And so are parts of the bottom end. Most things in between are struggling. In the first quarter of 2014, revenue growth at LVMH, the luxury goods conglomerate that includes high-end brands such as Louis Vuitton and Bulgari, rose by 9 per cent worldwide – led by robust sales in the US.

At Tiffany, the US jeweller, sales also surged by 9 per cent in the first quarter, while the overall US economy was contracting. Businesses that rely on the top 1 per cent are doing fine.
At Walmart, the supermarket chain, meanwhile, revenues dropped by 5 per cent in the first quarter. Revenue growth at Sears Holdings, which was once a bellwether of the US middle-income consumer, declined by 6.8 per cent. And so on.

Only at the bottom of the market, where the poorest Americans are hunting for bargains, does performance match the luxury end. Sales at Dollar Tree, America’s leading retail discounter, surged by 7.2 per cent in the first three months of 2014. Discount stores tend to take business from the larger box retailers when times are tough. Likewise, revenue growth at Public Storage and Extra Space Storage, the two largest operators in an industry that serves as a bellwether of economic distress, were both in double digits.

Such sharp disparities mirror the confused signals from the asset markets – US equity prices continue to do well, driven by optimism about corporate earnings growth, while US Treasury bonds are pricing in Depression-level pessimism.

The yield on the US 10-year Treasury dropped from 3.04 per cent at the start of this year to just 2.45 per cent last week – a bleak take on the absence of US inflation prospects. Which should we believe? The stock or the bond market? The answer is both.

Many US stocks will continue to do well on the basis of high-end revenue growth and overseas sales. But overall US growth is unlikely to take off, which is why bond yields remain so low.

The bond markets have grasped something that continues to elude many economists. We live in a confused world. Yet the underlying story is simple. The US middle continues to hollow out, even as the economy continues to grow.

But the latter’s upside is limited by the crisis in the former. Unless the middle class starts to post healthy income gains, we will be stuck in what has been annoyingly named the “new normal”.

Neither the Democratic nor the Republican party – nor most of their European counterparts – appears to have an answer. President Barack Obama pushes for a higher minimum wage, which would certainly help the poorest sections of the US labour force. But it would do nothing to fix the central problem. And Republicans keep arguing for lower taxes on the wealth creators. Ditto. They have argued each other to a standstill.

Both parties might find it instructive to look north to Canada, which has endured its harshest winter in 20 years.

First-quarter Canadian growth was plus 1.2 per cent, as opposed to minus 1 per cent in the US. Canada happens to have a more robust middle class. There is far more to America’s disappointing recovery than the weather.

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