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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

This week, you might think investors are agonizing over the particulars of the proposed healthcare legislation. Some might be; however, I would argue the details aren't as important as the Administration's ability to get legislation through the Congress. After all, the markets assume President Trump has a pretty aggressive pro-growth agenda, and this is the first major test of his actual political clout in Washington.

If this fails, what will happen when the tax reform proposals hit Capitol Hill? That is what really interests investors, and for good reason.

At this time, it is difficult to imagine a sudden surge in corporate earnings, at least one which would engender another significant 'leg up' in the stock market. Sure, increased business owner and consumer sentiment might drive an increase in economic activity. However, I would counter with much of that increase in sentiment has to do with the prospect for meaningful tax reform. If it doesn't happen, or is so watered down in the sausage making, it could be a more tricky year than it would currently seem.

The reason is simple: economic conditions suggest the need for a higher overnight lending target. Put another way, historically, the overnight rate would not be as low as it has been, and currently is, given the overall level of economic activity and expectations for inflation. On the flipside of the coin, in a simpler time, the Fed probably wouldn't be 'raising interest rates' given, again, the current overall level of economic activity and expectations for inflation.

The Fed apparently believes conditions are strong enough to warrant a more 'normalized' interest rate environment, and is behaving accordingly. Obviously, this will raise borrowers' debt service on floating rate obligations, both individual and corporate. Without a corresponding increase in revenue, this will have a compressing effect on earnings. Period.

As we all know, stock prices ultimately come down to profitability or the prospects for it. As I type, the BEST prospects for a sudden surge in corporate earnings is a pretty sharp decrease in the corporate tax rate. If the Congress ultimately takes the Federal corporate rate from 35% to 30%, stocks will sell off in disappointment. If it takes it to 25%, the markets might hold onto the gains thus far this year. 20% could lead to another tidy rally, and 15% could mean an additional 10% or more in the S&P 500….all other things being equal. Oh yeah, if Congress doesn't do **anything** to the corporate tax system, the markets will end the year in the red.

So, the healthcare reform bill? According to the CFOs with which I have spoken, it might actually cost companies more money to unwind what they have already implemented of the Affordable Care Act. Now, IF the proposed changes result in a reduction in corporate health insurance premiums, that is a different story. However, no one anticipates that as much as hopes 'we' don't get another massive increase this year like we did last year. To that end, none of these same CFOs anticipate nor have planned for a DECREASE in health insurance premiums because of this bill.

I could make it more complicated than that; I could pull out a slide rule and sharpen the pencil; I could make a lot of wild predictions with little basis in fact, but what's the point? Very little or no change = BAD. Significant change = GOOD. More precise predictions would suggest an over-

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staffed analytics/analytical department.

More disturbing to me this week was a story I read on Bloomberg.com about the auto parts industry here in Alabama. I won't mince words: the writer painted a pretty ugly picture. So much so, while I am ordinarily staunchly pro-business, I was disgusted by some of what I read. In fact, it made me kind of angry. However, when I reflected on it later, I was equally angry for another reason.

Let me give you what I submitted for my newspaper column:

> This past week, I read an article on Bloomberg.com regarding the auto industry in Alabama. More specifically, I read an article about the potential for significant bodily harm, and even death, when working in an auto parts manufacturing facility in our state. You can check it out for yourself by searching for "inside Alabama's auto jobs boom Bloomberg" on the Internet.
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> At the core of the writer's argument is a simple hypothesis: many auto suppliers are paying workers relatively low wages, while treating them as a somewhat expendable means to an end, as opposed to living, breathing, and sentient individuals. Frankly, I found it pretty difficult to read some of the sections.
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> With this in mind, I made an economic presentation to a group of German businesspeople in Huntsville about 5 years ago. The organizer of the conference had asked me to speak about the US labor markets, and why foreign businesses, specifically German, should invest in the Southeastern United States. This seemed simple enough to me, and I gave the audience the following two reasons, and two reasons only: 1) the reduction in supply lines to the important US market cuts unit costs, and; 2) relatively lenient US labor laws, especially in the South, allow businesses to fire employees far more easily than those in Europe.
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> After my remarks, a small group surrounded me. They said my comments were completely accurate, and that I was the first speaker they had heard who didn't mention something about US worker productivity. When I asked their opinion about the quality of the workforce in the South, the extrovert in the bunch wasted no time in saying: "American workers are incredibly enthusiastic, at least when they start their employment." That was all he said, period. At best, the implication was the local workforce was no better and no worse than anywhere else over time.
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> While I stood somewhat expressionless, it took about a minute for the rest of the group to quit laughing. Frankly, I should have seen it coming, and it was kind of surreal. I mean, one is not surrounded by laughing German businessmen every day.
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> Clearly, the joker's contention was not and is not the official position of any German, or other foreign, company operating in the United States. You would never, and I mean ever, hear any corporate mouthpiece say something along the lines of: "We are very pleased to be coming to your state, where we can fire people much more easily and hire many more temporary workers than we can in Dusseldorf. This allows us to access your markets, keep our costs down, and respond to downturns in global demand without laying off significant numbers in our home market."
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> As much as anyone cares to admit, workers are, indeed, a means to an end. To be sure, a good employer treats its workers fairly, and pays them a reasonable wage for their level of output. However, even human beings are subject to the law of supply and demand.
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> When the demand for workers is greater than the local supply, wages and working conditions will, or should, rise. The marketplace will mandate this. When the supply is greater than the demand, the local labor force can't be real picky or demanding, as bills don't pay themselves.
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> Basically, the bigger problem in Alabama, which the writer didn't address, is simply: there are too many idle, blue collar workers and not enough jobs to go around.

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I have traveled around this state and others throughout the Southeast, and can tell you this: “many of our communities look as though anyone with any get up and go got up and left.” I wish I could call that quote my own, but it is as old as the hills. When the paper mill, saw mill, and/or textile mill close, so did the opportunities and, for all intents and purposes, the town.

In response to the tragic death of a worker in one of the auto supply plants, somewhat noted Alabama historian Wayne Flynt had this to say in an article in the Financial Times about the economic development history of the state:

> Wayne Flynt, an Alabama historian, says the state has failed to absorb the lessons of the past. Since the 19th century, he says, Alabama has been caught in a vicious circle. It has sought to attract industry with low taxes, government assistance and cheap non-unionised labour. As a result, it never collects enough revenue to fund the kind of education system it needs to move up in the world.
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> “The only thing we have to sell is the labour of our people,” Mr Flynt says. “We don’t have the minds to sell.”

Please follow this link to read the whole article: https://www.ft.com/content/54d05c3e-e9fa-11e6-893c-082c54a7f539.

While Flynt’s contention “we don’t have the minds to sell” might be a little harsh, there is some measure of truth. For years, I have told groups during the Q&A after economic presentations the following: “we can’t compete with the emerging markets when it comes to worker pay, and it doesn’t really matter. It all has to do with unit costs, and wages are just a part of the equation. We just need to be more productive than, say, the Chinese are cheap.” Obviously, if workers in different countries have roughly the same access to the necessary technology, that will present a problem.

Currently, the accepted ‘labor force participation rate’ in Alabama is 57.6%. This is the percent of non-institutionalized, working-aged individuals actively participating in the workforce. In February 2017, the national average was 63.0%. Perhaps not surprisingly, the median household income in 2014 in Alabama (American Community Survey) was $42,830 compared to $53,657 for the country as a whole.

This makes sense: fewer people actively participating in the economy means fewer paychecks, and, therefore, fewer paychecks per household. That is just math. To that end, of the 10 states with the lowest median household income, fully 8 of them were in the bottom 10 in terms of labor force participation. The outliers were Tennessee, with the 12th lowest participation rate, and Oklahoma at 13th. The remaining 8 were: Alabama (of course), South Carolina, New Mexico, Louisiana, Kentucky, Arkansas, Mississippi, and West Virginia. Ah, the usual suspects.

Want to know what else these places have in common: generally lower levels of educational attainment and standardized test scores, when compared to the national average. I think you can probably see the correlation: Lower levels of education/training = fewer people working. Fewer people working = lower median household income. Lower median household income = less money to spend on education.

Care to guess how many of the Bottom 10 states in median household income spent less than the national average for ‘public school revenue per student in fall enrollment 2014-2015 (from NEA)’? I will spare you: 9, only West Virginia spent more. Now, care to guess how many of the Bottom 10 received MORE of their education revenue from the Fed-

Disclosure

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eral Government than the national average? Well, all 10. Obviously, this means state & local sources of revenue spent on education were below the national average, as a percent (not in absolute terms).

But, where am I going with all of this?

I have written in this newsletter and said in public, on numerous occasions, our corporate tax code is a major impediment for US manufacturers. After all, the government taxes revenue companies realize in the United States at the applicable Federal and local rates. In some states, this means upwards of 12% at the state & local level PLUS the 31.85% (for QPA) at the national on profits. In Alabama, the state tax rate is 5%, making the total potentially 37% on profits. That is significantly higher than the 24.2% South Korean companies have to pay at home, and puts their US subsidiaries at a disadvantage from the start. *As a point of edification, the Bloomberg article paints an incredibly unfriendly portrait of Korean parts suppliers.*

As such, US workers have to compete against lower cost emerging market labor, a shrinking technological advantage, and the tax code. Therefore, is it really all that surprising (if you read the Bloomberg article) foreign auto parts suppliers pay so poorly (relatively), use a large number of temporary workers, and push their workers as hard as they do? What's more, with an Unemployment Rate 1.5% higher than the national average AND a significant lower labor force participation rate, resulting in a higher idle workforce, what other options do under-skilled, blue-collar workers have in Alabama? What leverage do they really have? When there are 'plenty more where they came from' or seemingly so?

For this reason, like many people, I have been waiting with baited breath for Washington to start implementing a truly pro-growth agenda. To my way of thinking, line item #1 needs to be, or should have been, tackling our Byzantine tax code and substantially cutting the corporate tax rate. While doing such things might not lead to a sudden surge in US manufacturing employment, it would help to level the proverbial playing field. Basically, it would remove an anti-competitive impediment for domestic producers, manufacturers, and suppliers. Every job 'we' outsource to another country to make products for export back into the US, for whatever reason, is a job the folks in Chambers County, Alabama, don't have.

Admittedly, 'we' won't get all of these back, if any. However, we need to make it less of a slam dunk decision for US multinationals moving forward.

However, first things first...a healthcare bill, one which seemed to make very few people happy. I suppose this was politically important, but I am tired of politics and Washingtonian chicanery. Let's tackle the lower hanging fruit first, and then diligently work on whatever is to replace Obamacare….tighten all the screws, dot all the I's, cross all the T's, and potentially get a buy-in from the AMA or some other such organization. It all felt, dare I say, a little rushed.

As I type, we all know the powers that be scraped the healthcare legislation from a vote. It is still way too early to assess exactly what this means for President Trump's clout on Capitol Hill and any future pro-growth agenda, specifically tax cuts. On its face, it doesn't look so great, but who knows? Maybe the President put forth this healthcare legislation as quickly as 'he' did just to get it out of the way. "You asked for something. I gave it to you. You shot it down. Next."

That wouldn't be all that surprising. If so, perhaps the White House will get to work on the next item on the list, and spend more time selling it on Capitol Hill...a lot more time.

One can only hope….because corporate profits aren't going to skyrocket in 2017 without a big push from somewhere.