630-322-7756
www.ftportfolios.com

First Trust Advisors L.P.

Feb 2, 2007

Economic Commentary

Rising Wage Gap, But No Squeeze

In time-honored tradition, recent political-economic discourse has revolved around some form of the "Two America's," the "Middle Class Squeeze," or the "Rich vs. Poor." This political minefield of "wealth creation versus redistribution" is no place for a business economist. But if there really is a huge swath of Americans experiencing falling incomes and living standards, this would signal some serious ramifications for the economy and for investors.

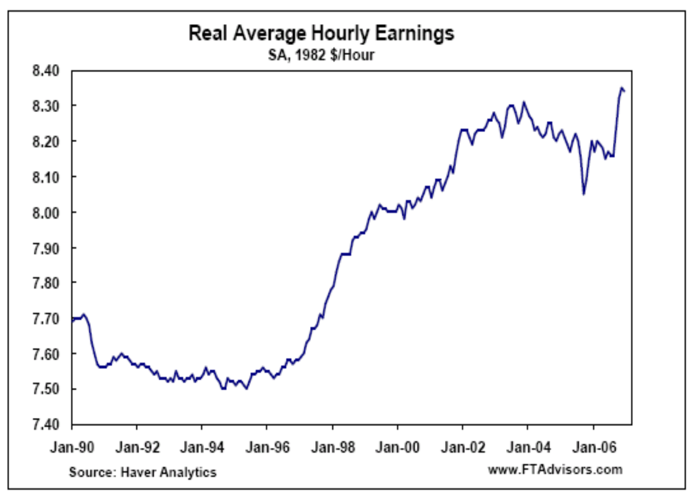
For example, if incomes were falling, credit problems would likely proliferate, government tax revenues might be weak, interest rates could fall, and the economy would be at greater risk of recession than the consensus expects. If the middle class and poor are really being squeezed, luxury good retailers will perform better than discount retailers, while large homes and expensive cars will sell better than those in the middle market or below.

But companies serving consumers across the income spectrum have performed well despite high energy costs. And even with recent weakness more new homes have been sold in the past four years than during any four year period of history, while homeownership rates have surged to record highs. Air miles flown, sports attendance, cell phone ownership, flat screen TV sales, jewelry sales, and dining out are all at record levels. This is not the type of economic activity one would expect in an economy where wide swaths of citizens are falling behind.

Nonetheless, the dismal picture persists, and many argue that incomes rose faster in the 1990s than they have so far in the 2000s. And this is true. Inflation-adjusted weekly earnings for middle income workers during the 1990s increased 2% for men and 12% for women. By contrast, so far in the current cycle these wages are down slightly for men and up only 4% for women.

But this comparison is misleading. It relates data from the entire 1990s business cycle to data from just the early stages of the current cycle. It is not unusual for middle class incomes to lag economic growth in the early stages of a business cycle, only to rise rapidly once the labor market tightens. This was particularly true of the 1990s, when after a slow start, the stock market boomed, venture capital flowed, the unemployment rate plummeted, and companies were madly competing for workers.

A truly balanced analysis would compare similar periods of business cycles before passing judgment, before arguing government policy and especially before providing investment advice. Not doing so would bias the results and could lead to bad investment decisions and serious policy mistakes.

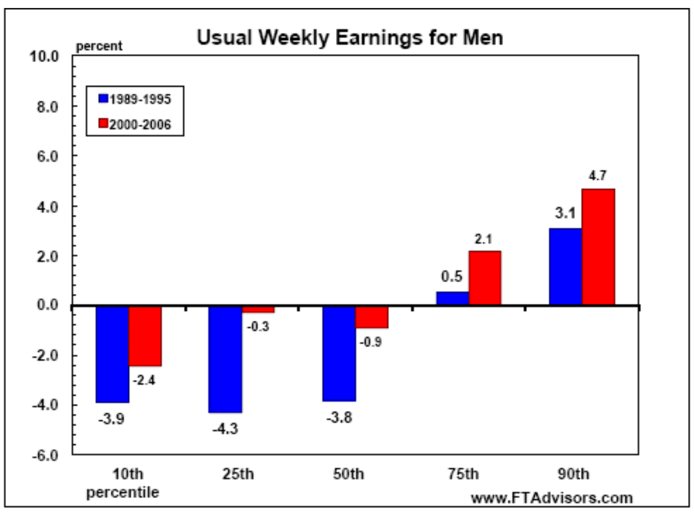


Because the US economy moves through cycles – from peak to trough to peak again – with each peak higher than the last, a proper analysis would compare income levels today to those that existed in 2000 – the last full year prior to the recession of 2001.

And then, in order to make those measurements relevant, these data should be compared to an equivalent six-year period that started in 1989 – the last full year before the recession of 1990/1991. Using full-year earnings is important because seasonal factors affect quarterly data.

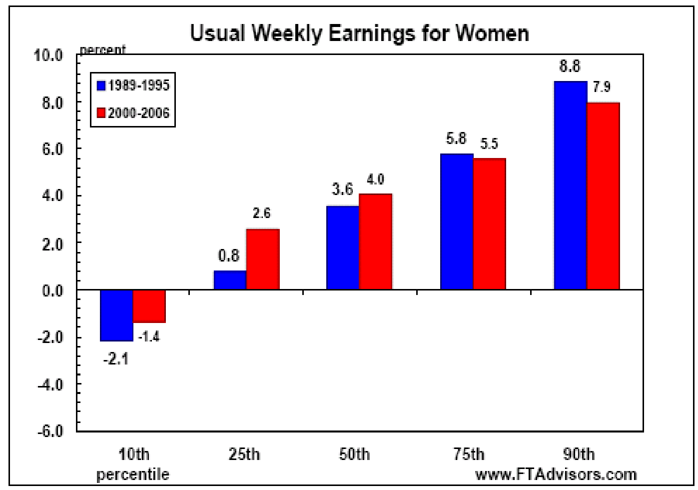
Usual Weekly Earnings

Every three months the Census Department publishes data on weekly earnings. This data is gathered from a survey that asks workers directly what their "usual" weekly earnings have been. It is the timeliest data on earnings from across the income spectrum, and it includes regular wages and salaries, overtime pay, commissions, and tips. It does *not* include stock options or capital gains or even fringe benefits such as health care. Nor does it factor in the benefits of government transfer payments or tax cuts.



As can be seen in the nearby charts, real (or inflation adjusted) usual weekly earnings for middle income men (50th percentile) were down 0.9% in 2006 versus 2000. This is obviously not great news. However, in the same phase of the previous business cycle, the wages of middle class men were down a much larger 3.8%. Earnings for women in the middle of the income distribution were 4.0% higher in 2006 than they were in 2000, versus a smaller gain of 3.6% in the same phase of the 1990s cycle.

The same goes for men and women in the lower part of the income distribution. In 2006, males with incomes at the 25th percentile (meaning 75% were above and 25% below) earned 0.3% less than in 2000. But from 1989 to 1995, the loss for the same group was an even larger 4.3%. In 2006, women at the 25th percentile earned 2.6% more than their counterparts in 2000. During the same phase of the 1990s cycle, women in that part of the income spectrum had only gained 0.8%.



On a comparative business cycle basis, the average American has been much better off in the past six years than in the recovery of the early 1990s. By income level, both the middle and lower-income groups have significantly outperformed.

With the unemployment rate now down to 4.6%, evidence of labor shortages in many industries, and energy prices significantly off their peaks, real wages are beginning to climb rapidly. Inflation-adjusted average hourly earnings have increased sharply in recent months, pushing real earnings to the highest levels in the past 20 years. (See chart on page one.)

This is the same pattern the US experienced in the 1990s – a disappointing first half of the recovery (through 1995) and then a huge shift in momentum which lifted earnings sharply in the second half of the decade. It was this strong finish to the 1990s decade that seems to have erased memories of the early 1990s, when wages were stagnant even as the economy expanded.

Widening Income Gap

Despite all of this, there is a clearly a continuing pattern of a widening wage gap, where higher income earners see better performance than lower income earners. There are a number of reasons for this. First, the benefits of intelligence and education continue to increase. Those with college degrees have experienced much faster earnings growth than those who drop out of high school. This is mostly due to the fact that more and more value in the economy is being produced by intellectual advances, rather than physical effort. And, second, much of the low-skill, low-wage, physical labor is provided by immigrants.

But a widening gap also reflects a long-running historical truism. Whenever technology advances rapidly, the so-called gap between the rich and the poor widens. This does not mean that those at the low end actually experience falling standards of living. In fact, technology lifts standards of living for all, often by lowering the prices of goods and services.

Nonetheless, incomes at the top (earned by entrepreneurial innovators or early-technology-adopters) rise more rapidly. This divergence happens whenever growth picks up due to technological innovation. And it is even more pronounced in recent decades because of technology. For example, Michael Jordan and Tiger Woods earn much more than Larry Bird or Jack Nicklaus ever did because of the global reach of television. A rising income gap signals growth and opportunity for investors and the economy, and should not be viewed as a problem in a free economy. Income gaps in third-world countries, ruled by dictators, are a more serious development because they reflect exploitation and an abuse of political advantage.

The Bottom Line

The bottom-line is that some workers are clearly going through tough times as productivity growth causes a reduced demand for labor in many old-line industries that were once considered untouchable engines of growth. Nonetheless, the vast majority of workers are much better off today than they were five, 10 or 15-years ago.

With productivity booming, the unemployment rate well below 5%, tax rates low, and Fed policy still accommodative, the future looks pretty darn bright. Not only are workers better off at this point in the business cycle when compared to the last one, but the best is yet to come.

Brian S. Wesbury, ***Chief Economist***
Robert Stein, ***Senior Economist***
Trevor Scott, ***Associate Economist***