



America's Evolving Social Contract



It's sort of a rule that in financial markets things tend to evolve along the lines of lowest expectation. For whatever reason, when it comes to markets and the economy, the things we expect to happen, don't and the things we don't, do. It must be some kind of built-in feature of mass psychology—a very human manifestation of herd behavioral dynamics. This rule is what's behind the contrarian ideological impulse you find so often in the thinking of the great practitioners of the investing art. Often, it pays the most to take on positions that seem the least popular or likely in the moment.

I bring this up because the unexpected seems to be happening once again. It's a bit too early to declare victory here but what I think we're seeing in the market is something almost no one expected! The Fed might actually be able to get through a tightening cycle and resolve this inflation problem without either crushing the economy or causing an existential market crash or both. Imagine that!

I can tell you this: If you would have taken a survey of the world's greatest investors back in January and asked—"Assume the Fed has raised Fed Funds by 250 bp including two back-to-back 75bp hikes in the face of persistent 9% CPI, how will things look in the economy and the market?—no one would have predicted unemployment sitting at all-time lows and the market only down 20%. No, not even close. Their predictions

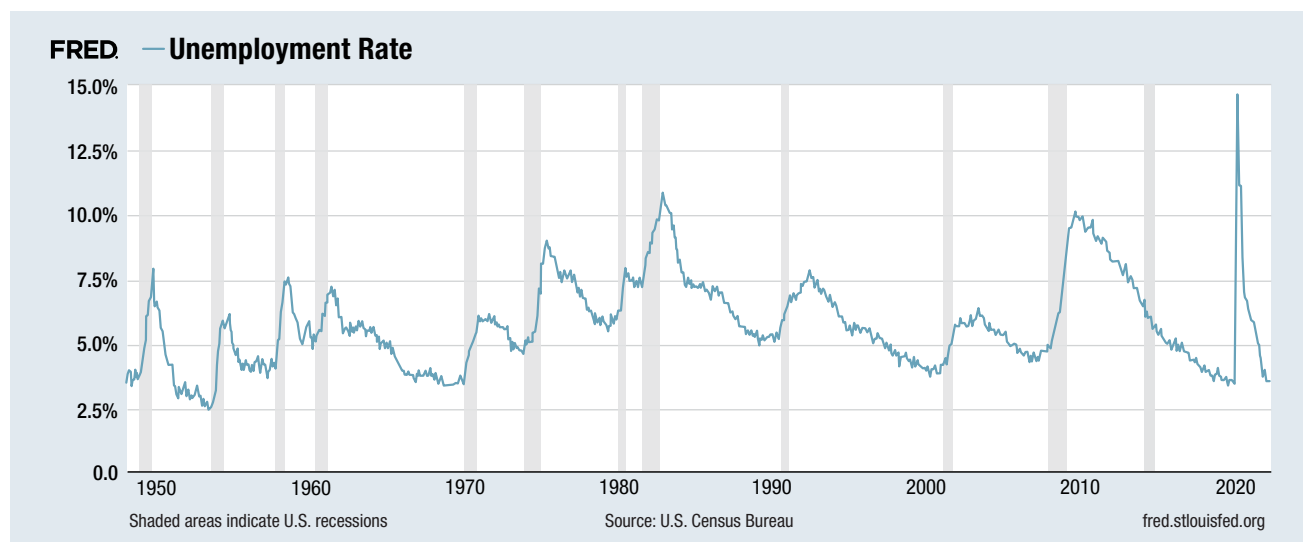
would've been for far more dire circumstances.

You might ask: "Wait but what about the crypto crash? Isn't that something?" Well, certainly it is. There's been a ton of destruction there. Massive fortunes have evaporated overnight. Expectations (hopes) have been smashed. And the vibe on Twitter has certainly changed. It's been awfully quiet from the "have fun staying poor" crowd, that's for sure. All of a sudden now, everyone has gone from braggart to serious builder. We went from "laser eyes" to "Heads down building the future today."

Look, crypto had it coming. What we've seen this year is simply the inevitable consequence of speculative overreach. But it's not all bad news or gloom and doom. The destruction we've seen feels more like—dare I say—of the "creative" variety, a necessary and ultimately healthy stage in capitalist evolution. In any event, a crypto rout and a 20% drawdown in equities is a small price to pay for normalizing interest rates, right?

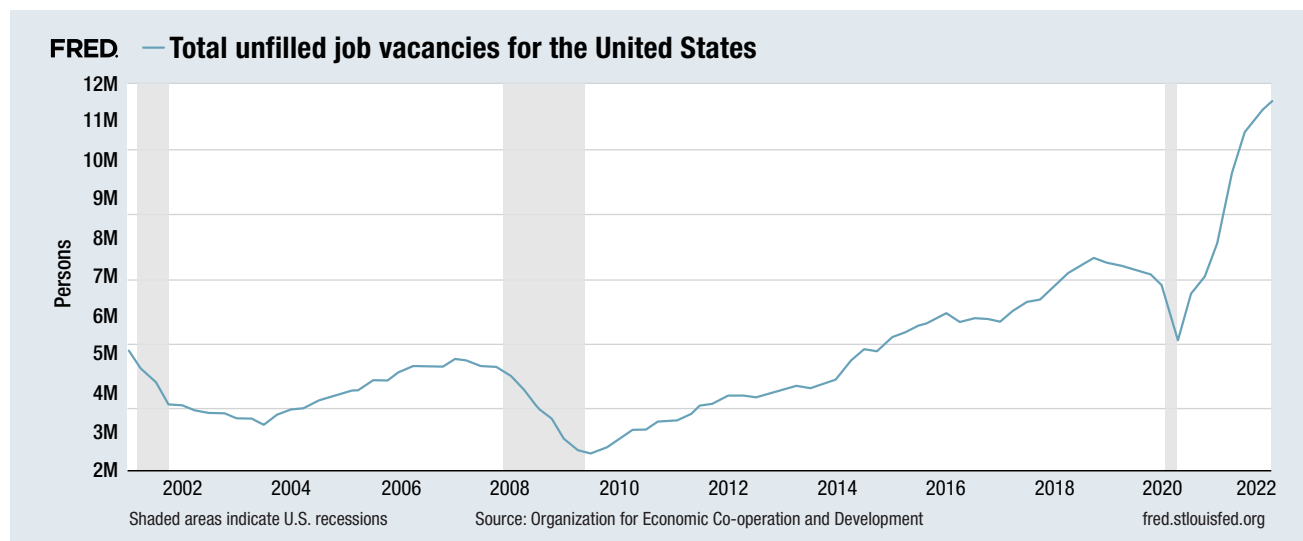
Of course, I could be completely wrong here. We could be on the precipice of another great depression for all I know. But right now things aren't looking that bad. And if I am indeed right, politicians and central bankers around the world will celebrate this as a huge win, the ultimate vindication for all the manifestations of central bank activism that have come to dominate our age. "You see, Modern Monetary Theory really does work!" The politicians might add "Yes indeed... Even helicopter money?"

What happens next will largely depend on how labor market dynamics evolve in the face of rapidly tightening financial conditions. The headlines, especially from mortgage lenders, tech and crypto, suggest that we're going to see some deterioration in conditions before too long but thus far the headline numbers have held up. The Unemployment Rate, at 3.5%, is close to as good as it can get.



To be fair, the headline number doesn't quite tell the whole story. No, the truth about America is rather more complicated. It certainly doesn't feel like an economy firing on all cylinders. Just think of your recent experiences at the airport or restaurants or trying to buy appliances or whatever really. Something is seriously amiss here, right? Well, as you dive deeper into employment data you start to see a picture of a labor market that is, in fact, pretty messed up.

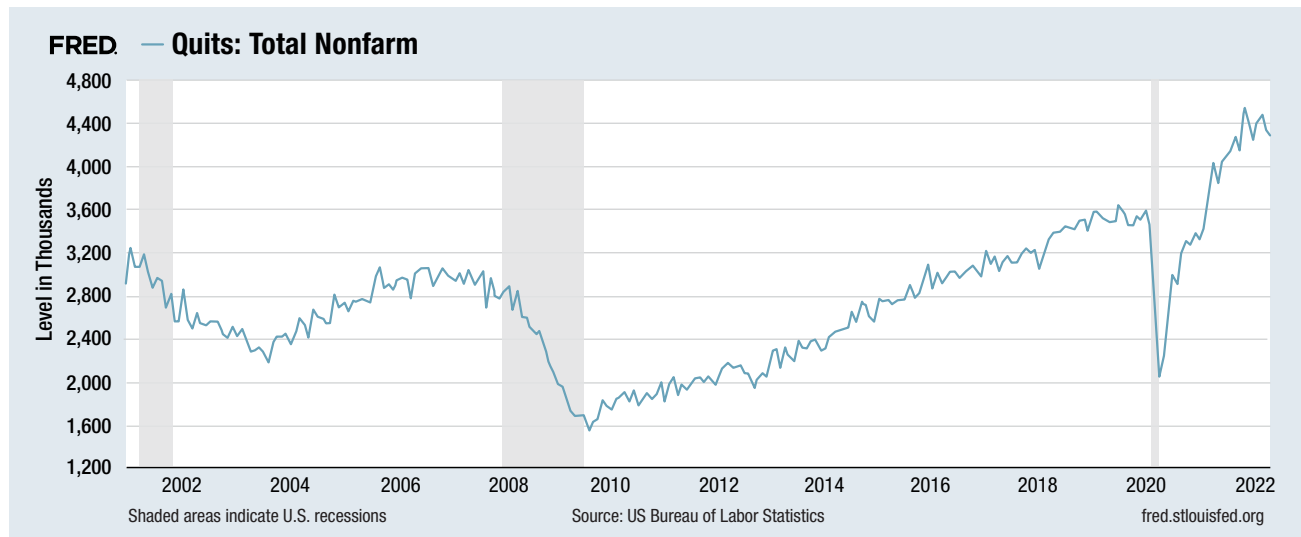
Take, for instance, this chart.



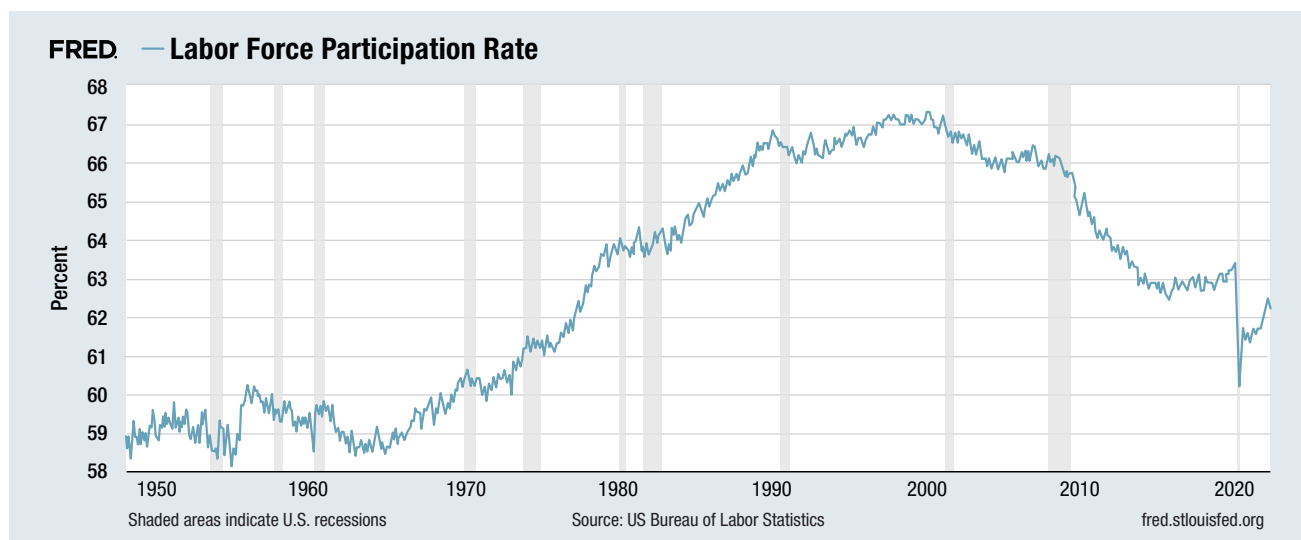
How in the world can we have 3.5% unemployment and 11M unfilled job openings? And how should we interpret something like this? On the one hand, it's tempting to look at this as pretty good news. To keep the economy going, all we have to do is get these positions filled. Mission accomplished. But there's something else to this story.

For a long time now, employers have been complaining about a "skills" gap, suggesting that the open positions remain unfilled because companies simply cannot find qualified talent. I think there's definitely some truth to this and I wrote a bit about it last year when discussing America's pathetic stance on immigration. It's also a function of a systemically failing higher education system that works only for the elites and has saddled an entire generation

with a \$1T of student loan debt. But, look, that’s a much longer story for another day! The 11M unfilled jobs is also a consequence of something else happening in America. Just consider this chart for a second.



Why are all these people quitting? The mainstream media picked up on this story last year and quickly coined a term for it—the Great Resignation. The reporting around it suggested that it was basically a COVID story, a function of relocations, reactions to evolving work from home policies and resetting of work-life balance priorities. Again, there’s some truth here but this has been going on for a very long time actually. Consider this multi-decade picture of labor force participation.

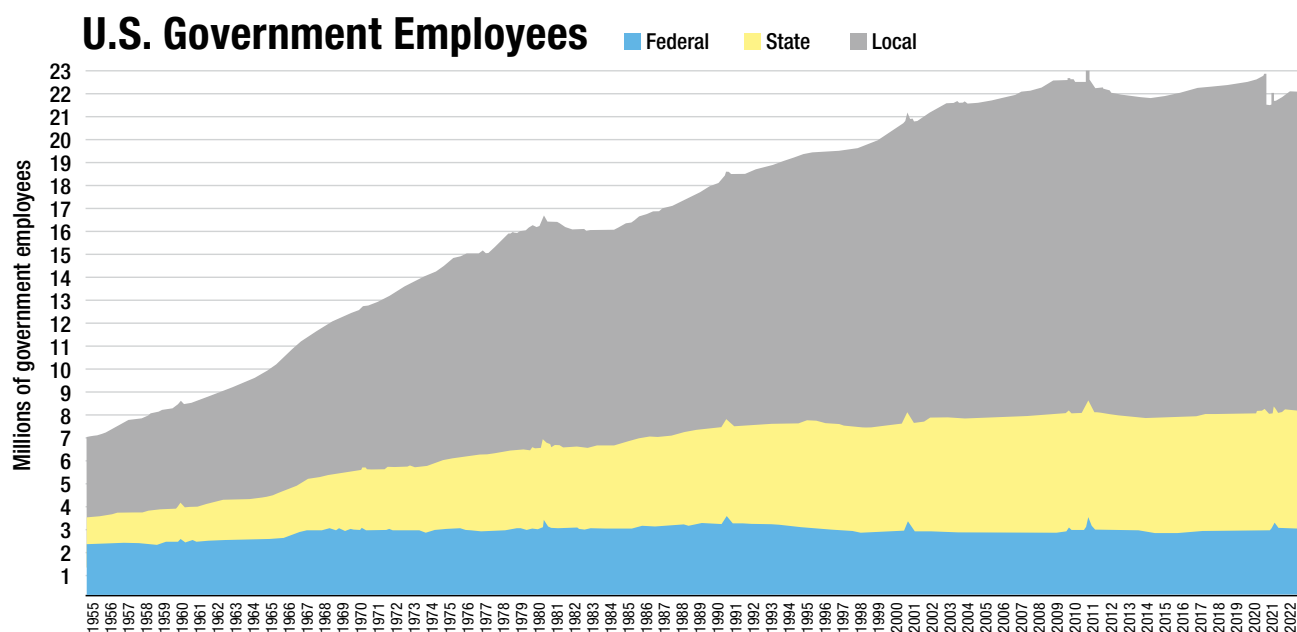
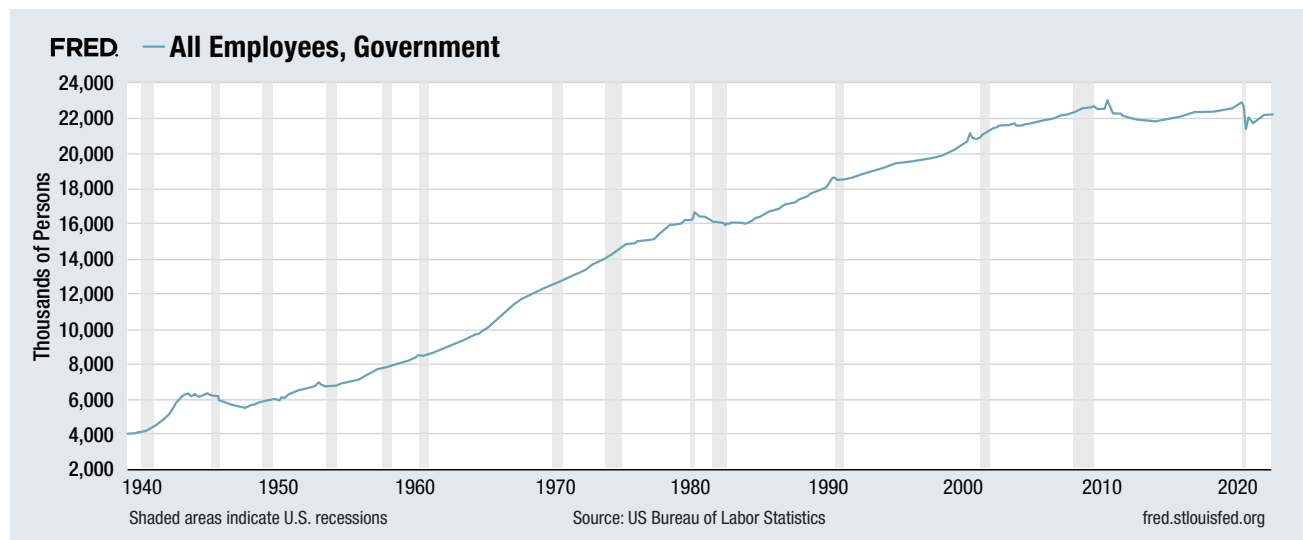


This chart suggests we’re in a massive multi-year bear market in “willingness to work.” Why in the world have people been dropping out of the labor force like this? This is one of the biggest questions of our era. From an economic standpoint it couldn’t be more important. The way we define unemployment in America and calculate the “official” rate is based on a survey that tries to determine whether unemployed individuals have been actively seeking work. And only those who are determined to be actively seeking work get counted as part of the labor force. Here’s the scary part. If you were to add back all the people that have dropped out of the labor force the unemployment rate would be way higher than 3.5%. That’s for sure!

I think this phenomenon is a function of things like the skills mismatch and pandemic psychology but it’s also a result of something for more elemental. The truth is that many jobs in our economy suck and offer no real hope of survival, let alone financial prosperity. No wonder people don’t want to work! I understand that I’m making a big sweeping statement here but is anyone really going to argue with me here? Sure, there are pockets of prosperity here

and there and a lot of good, high-paying jobs. But at a macro-level you cannot deny the truth. Working in America, at least in terms of having a “job,” is an increasingly unpopular proposition.

Here’s something interesting. At the same time as all this, we are in the midst of a huge bull market in government employment.



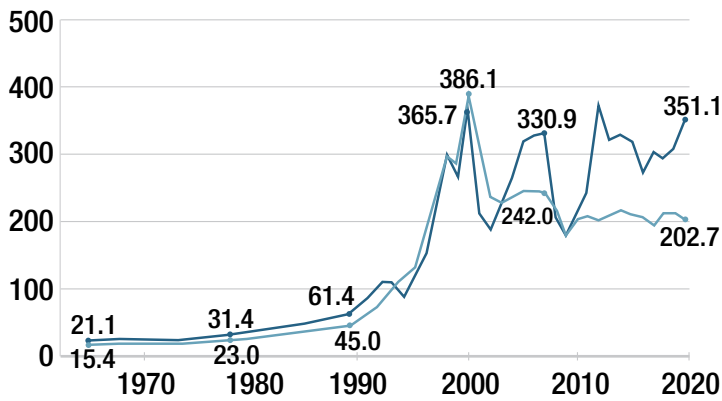
Given the frustrating lack of efficiency and basic human decency in many government services, this kind of feels like a soft form of Universal Basic Income. Perhaps that’s a little too harsh but you get the point. Why are people so willing to work for the government and not everyone else? Well, for one, when you work for the government you can actually make some decent money and get some good benefits, at least for now. Whether these pay packages are sustainable or not is another question.

Meanwhile, things just keep getting better and better at the top.

CEOs make 351 times as much as typical workers

CEO-to-worker compensation ratio, 1965-2020

■ Realized CEO compensation
■ Granted CEO compensation



I think this chart is a really important part of the picture. Obviously, it's something we should be concerned about, for it's steadily eroding whatever is that's left of the American Dream. When I think about this whole issue of massively rising wealth inequality, I can completely understand the psychology behind the declining labor force participation phenomenon. Who wants to take a low-paying job—that doesn't even come close to keeping up with inflation—just so all the bosses can get richer and richer. Look, the game has always been rigged and there's a certain amount of rigging (exploitative behavior) that people are generally willing to accept. But there's a line where, if you take things too far, people will just throw up their hands and start walking away. Well, I'm pretty sure we've crossed that line. I think that's a big part of the story here anyway.

I'm convinced that what we're seeing here with these strange labor market dynamics is really a manifestation of something much bigger and far more important. It goes back to an old enlightenment idea actually—Rousseau's social contract, which posits that the foundation of every society essentially comes down to a kind of implicit agreement. Members of society cooperate with each other, often in rather complex ways, for their mutual benefit. The rules, norms, standards and morals, instead of coming from some process of deliberate or centralized design, emerge organically from the small interactions of all the members of society. It's a decentralized, bottoms-up and evolutionary kind of process. As such, it's subject to change! It was Rousseau's idea that provided a big part of the moral justification for the American Revolution actually.

Well, the reason things seem so crazy these days is that our social contract is in the midst of a fundamental redefinition. There is a sense in which we are rejecting the mythology that has held us together and looking to establish the new ground.

The promises made to our parent's generation are falling increasingly on deaf ears. It's not that there are no morals or standards today, it's that they are changing and that flux is what is making people feel scared, confused and unsettled. This, by the way, is manifesting at every level of society and culture, not just the economy. Think about the whole abortion debate. This is a perfect example of something that people basically just took for granted or assumed as settled for good. Well, now, just like that, it's up for a big debate.

To bring things back our topic of the labor market. The problem today is that corporations and the government are out basically touting the rallying cry of the old order:

“Hey...Work for us for your whole career. Give us the best years of your life and if you get lucky you will make it to the top and become fantastically rich but either way you'll have enough money for retirement, when you can actually enjoy your life.”

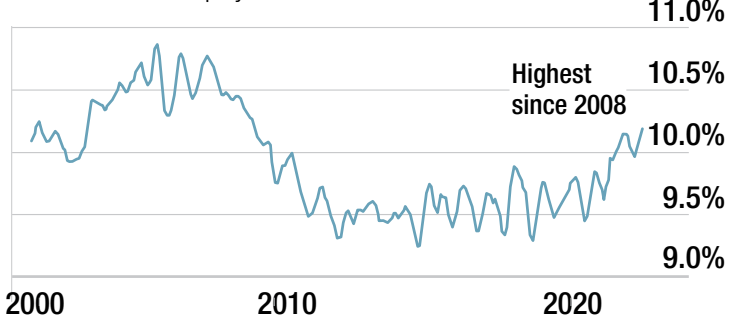
And increasingly, people are looking at this and saying: “Yeah, No Thank You!” People are rejecting not the idea of work but the idea of working for corporations for insufficient pay and benefits.

I think one of the big questions for the economy comes down to this chart.

Self-Reliant

Americans are increasingly looking inward for employment

■ Share of self-employed workers



Source: Bureau of Labor Statistics, Bloomberg calculations
Note: 3-month moving average

To the optimistic part of me, this chart suggests we're in the beginning stages of a bull market in self-employment. Whether this chart resolves to a meaningfully higher number or not is the big question. The crypto / Web 3 builders believe firmly that we are at a major inflection point in the history of capitalism. Their idea is that new technologies are going to unleash the entrepreneurial spirit across the world and we're going to move from the era of corporations and jobs to the era of creators, solopreneurs and independent contractors.

I'm inclined to hope that the creator economy prophets are right about all this. Personally, I've always been averse to the idea of

having a job. Even as a kid, I almost couldn't stand the thought. Still though, I'm a bit skeptical. Most of the things we consume demand large scale organization. There's just no other way, at this point at least, to produce cars, clothes, airplanes, iPhones and other consumer goods in any sort of economical way without the enormous capabilities, efficiencies, and economies of scale afforded by modern industrial corporations. Just imagine your life for a second without Apple or Amazon.

I do think though that there is something real to the social and philosophical dreams of the crypto / Web 3 movement. It's not a coincidence that people are absolutely fascinated by these technologies. Even today amidst the financial bloodbath of the crypto winter, crypto and the metaverse still dominate the business headlines. In my mind, these technologies are so captivating to people because they are the manifestation of this process of the evolution of the social contract. By the way, this has been going-on for a while. These days it's tempting to point to the COVID crisis as the beginning of things but I think it's been more an accelerant than anything. The process really started probably shortly after the rise of the internet, manifesting first in creative, information based fields like media, news and entertainment and then slowly moving more and more into the real economy. What we were seeing with the rise of the gig economy (think Uber, Doordash) is a good example of this.

Today, things are still very much in flux when it comes to the evolution of the social contract. The only thing that seems to

be settled is this: the old model is no longer tenable. Clearly, there's massive change coming and big fights on the horizon. As a society, we are going to have to do nothing less than completely re-decide what's most important to us.

As an investor, I find myself paying closer and closer attention to political dynamics. As new power structures and coalitions emerge to pursue new priorities, government action is becoming increasingly important. Just think about what's happened over the last few years with all the radical COVID-era government interventions. This stuff is just the beginning. Think even about the last few weeks. Not only did we get a major climate change bill we also got a big incentive program for domestic semiconductor manufacturing. These are things that we've been talking about for years yet only now are we actually doing something. Interesting, right? With the semiconductor stuff, I'll never understand why we allowed the world economy to become almost completely dependent on a geopolitical hotspot for something so obviously important. But at least we're doing something now.

As I look out into the future, I think this idea of the evolving social contract is a useful framework for understanding what's happening in the economy, in politics and in culture. Time will tell of course whether this makes any sense. For now, let's just hope I'm right that the Fed might actually be able to tightrope out of this situation and the labor market doesn't completely fall apart. □

