Equity Strategy

Revisiting Plutonomy: The Rich Getting Richer

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Global

Ajay Kapur, CFA
+1-212-816-4813
ajay.kapur@citigroup.com

Niall Macleod
+44-20-7986-4449
niall.j.macleod@citigroup.com

Narendra Singh
+1-212-816-2807
narendra.singh@citigroup.com

SUMMARY

- The latest Survey of Consumer Finances, for 2004, has been released by the Federal Reserve. It shows the rich continue to account for a disproportionately large share of income and wealth in the US economy: the richest 10% of Americans account for 43% of income, and 57% of net worth. The net worth to income ratio for the richest 10% of Americans increased from 7.4x in 2001, to 8.4x in the 2004 survey. The rich are in great shape, financially.
- We think this income and wealth inequality (plutonomy) helps explain many of the conundrums that vex equity investors, such as why high oil prices haven't seriously dented growth, or why "global imbalances" are growing along with the equity bull market. Implication 1: Worry less about these conundrums.
- We think the rich are likely to get even wealthier in the coming years. Implication 2: we like companies that sell to or service the rich - luxury goods, private banks etc. Favored names include LVMH and Richemont.

PLUTONOMY: TAKE ANOTHER LOOK

The latest Survey of Consumer Finance data was released Friday 24th of February. It shows that the rich in the US continue to be in great shape. We thought this was good time to bang the drum on plutonomy.

Back in October, we coined the term ‘Plutonomy’ (The Global Investigator, *Plutonomy: Buying Luxury, Explaining Global Imbalances,* October 14 2005). Our thesis is that the rich are the dominant drivers of demand in many economies around the world (the US, UK, Canada and Australia). These economies have seen the rich take an increasing share of income and wealth over the last 20 years, to the extent that the rich now dominate income, wealth and spending in these countries. Asset booms, a rising profit share and favorable treatment by market-friendly governments have allowed the rich to prosper and become a greater share of the economy in the plutonomy countries. Also, new media dissemination technologies like internet downloading, cable and satellite TV, have disproportionately increased the audiences, and hence gains to “superstars” – think golf, soccer, and baseball players, music/TV and movie icons, fashion models, designers, celebrity chefs etc. These “content” providers, the tech whizzes who own the pipes and distribution, the lawyers and bankers who intermediate globalization and productivity, the CEOs who lead the charge in converting globalization and technology to increase the profit share of the economy at the expense of labor, all contribute to plutonomy. Indeed, David Gordon and Ian Dew-Becker of the NBER demonstrate that the top 10%, particularly the top 1% of the US – the plutonomists in our parlance – have benefited disproportionately from the recent productivity surge in the US. (See “*Where did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income*”, NBER Working Paper 11842, December 2005). By contrast, in other countries such as Japan, France and the Netherlands (read much of continental Europe), egalitarianism has kept the rich to a similar share of income and wealth that they accounted for in the 1980s – in other words, they haven't really gotten any richer, in relative terms.

We believe that the plutonomy thesis helps explain some of the conundrums that vex so many equity investors, such as why high oil prices haven't slowed the global economy, why consumer confidence might be low yet consumption remains robust in the US, why savings rates are low, and why the dollar depreciation hasn't done much for the US trade deficit.

Why as equity investors do we care about these issues? Despite being in great shape, we think that global capitalists are going to be getting an even greater share of the wealth pie over the next few years, as capitalists benefit disproportionately from globalization and the productivity boom, at the relative expense of labor. As we believe plutonomy explains away some of the conundrums we highlighted above, we are very relaxed about these issues.

Indeed, if the rich keep getting richer, as we suggest, savings rates might get even worse in the plutonomy countries. If plutonomy explains away many conundrums that our equity clients worry about, then this suggests the risk premia ascribed to equities might be too high.

Furthermore, if the rich will be getting even richer in the coming years, this bodes extremely well for businesses selling to or servicing the rich, be it for example luxury goods stocks or private banks. The rich are a growing and captive market, who have the nice habit of relatively little price elasticity. The plutonomy basket of luxury goods stocks, private banks etc. has handsomely outperformed the S&P500 index since 1986, and we expect similar outperformance from these types of stocks in the years to come. In the last 3 months alone, these stocks have outperformed the MSCI AC World index by 7%.

For these reasons, the recently released US Survey of Consumer Finances, which confirms that the rich continue to get wealthier and account for a disproportionate share of income and wealth in the US, is important. It confirms that the dynamics of plutonomy are still intact.

SURVEY OF CONSUMER FINANCES

The Federal Reserve recently released their triennial Survey of Consumer Finances (SCF), conducted in 2004, which looks at the state of household finances in aggregate and by various sub-categories. The data shows that the gap in incomes and wealth between the rich and the poor in the US shows no signs of significant change, and that the richest 10 and 20% of Americans continue to earn disproportionately high chunks of national income, and own an even higher share of the national wealth.

Figures 1 and 2 show the income and wealth shares of the top two deciles, the next two quintiles and the remaining 40% of US households. We have lumped the bottom 40% into one to emphasize how relatively small their income and wealth shares are.

Figure 1. U.S. Plutonomy Remained Intact in 2004: Based on the Consumer Finance Survey, the Top 10% of the Families Accounted For 43% of Income, while the bottom 40% of Families Accounted For Only 10% of Income

Survey	1995	1998	2001	2004
Percentile of income	**Mean Income** in thousands of 2004 dollars			
Top 10%	215.8	254.5	322.4	302.1
Next 10%	85.7	92.2	104.4	106.5
Next 20%	57.0	63.0	69.4	69.1
Next 20%	37.1	39.4	42.9	43.4
Bottom 40%	14.9	16.3	18.2	18.5
		Share		
Top 10%	39%	41%	45%	**43%**
Next 10%	16%	15%	14%	15%
Next 20%	21%	20%	19%	20%
Next 20%	14%	13%	12%	12%
Bottom 40%	11%	11%	10%	**10%**

Source: Survey of Consumer Finances, Federal Reserve Board, and Citigroup Investment Research

Figure 2. Little Change in the Net Worth Share in 2004: The Top 10% of Income Groups Account for 57% of Households' total Net Worth While the Bottom 40% Has 9% of Net Worth

	1995	1998	2001	2004
Percentile of income	**Mean Net Worth** in thousands of 2004 dollars			
Top 10%	1,338.0	1,793.9	2,406.7	2,534.4
Next 10%	316.8	377.1	486.6	485.0
Next 20%	198.5	238.3	311.3	342.8
Next 20%	126.0	146.6	171.4	193.8
Bottom 40%	76.1	83.5	89.0	97.3
		Share		
Top 10%	51%	55%	57%	**57%**
Next 10%	12%	12%	12%	11%
Next 20%	15%	15%	15%	15%
Next 20%	10%	9%	8%	9%
Bottom 40%	12%	10%	8%	**9%**

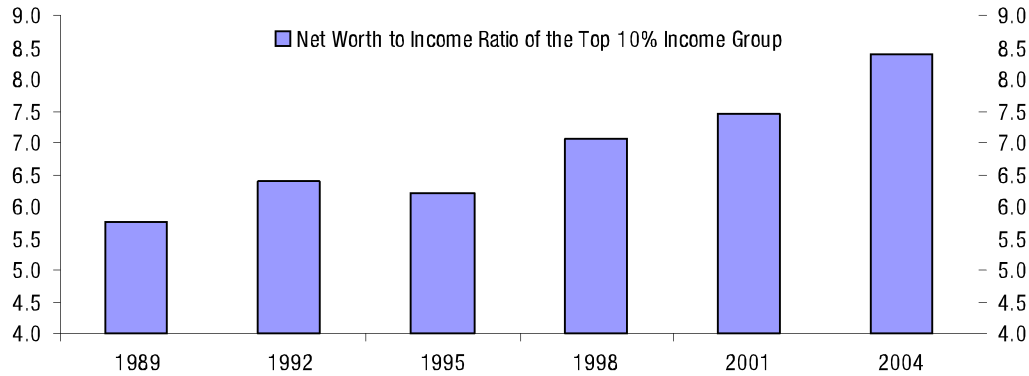
Source: Survey of Consumer Finances, Federal Reserve Board, and Citigroup Investment Research

The top 10%, whose mean annual income level was U$302,000 in 2004 have lost out a little in terms of their share of income, with this falling from a peak of 45% of national income in 2001 to "just" 43% of total US income, in 2004. Meanwhile, the fortunes of the next 10% improved modestly, to 15% of total income. The top 20% account in aggregate for 58% of total income (down from 59% in 2001). By contrast, the bottom 40% account for only 10% of total income. The top 10% earn over four times as much as the bottom 40% combined.

The share of the wealth continues to be even more aggressively skewed, with the top 10% accounting for 57% of the national wealth, as they did in 2001. In total, the top 20% account for 68% of total income; the bottom 40%, for just 9%.

The overall point here is that the rich continue to be in great shape, in relative terms. Indeed, their net wealth to income ratio (Figure 3) has risen since the 2001 survey was published. It now stands at 8.4, in other words, net wealth is over eight times annual income. In 1995 this ratio was a relatively meager 6.2. We think this rising wealth is the real reason why the rich are happy to keep consuming, and are behaving rationally in so doing. They simply do not need to save as much to maintain a healthy wealth balance, as they did in prior decades, because their wealth is growing rapidly.

Figure 3. U.S.: Net Worth to Income Ratio for the Top 10% Is High and Rising. Drives and Sustains High Consumption out of Their Wealth and Income; Keeping Aggregate Savings Rate Low and Current Account Deficit Large



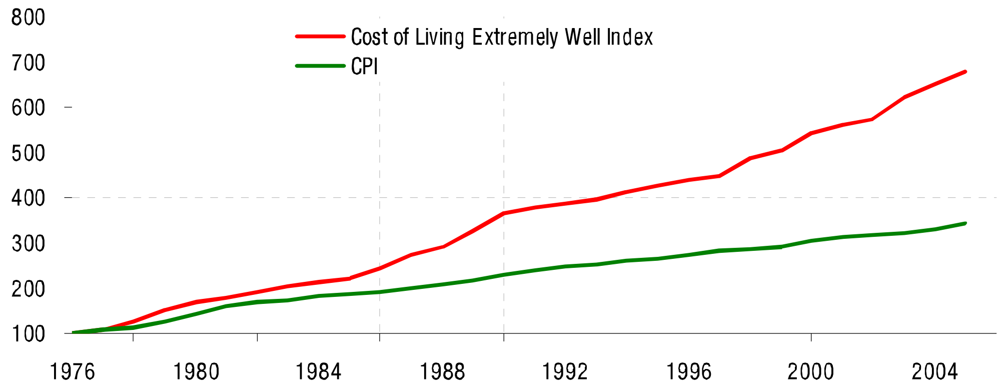
Source: Survey of Consumer Finances, Federal Reserve Board, and Citigroup Investment Research

IT'S NEVER BEEN MORE EXPENSIVE TO BE RICH....

Another new data point we have is the CLEW (Cost of Living Extremely Well) Index from Forbes Magazine for 2005 (in our original Plutonomy note back in October, we didn't have the latest data point for the year 2005).

CLEWI is an inflation index of the cost of luxury goods. It measures such things as the cost of suite at the Four Seasons in New York (up 15% year on year) and a kilo of Imperial Beluga caviar (at US$6840, up 40% year on year). In 2005, the CLEW Index rose 4%, while US CPI rose at 3.6%. Luxury goods still have relative pricing power. The 0.4% gap might not sound all that impressive, but bear in mind that a stronger US dollar, probably helped check this inflation rate (many luxury goods come from Europe, but the CLEWI is a measure in dollars). At any rate, the year to year fortunes of the CLEWI versus the CPI are less relevant. The long-term chart says it all (Figure 4). The most recent data point just confirms that in the search for pricing power, we'd rather be in luxury goods, than low end consumer businesses.

Figure 4. Forbes "The Cost of Living Extremely Well Index" – Pricing Power for Luxury Goods Much Stronger than Overall CPI Over Time



Source: Citigroup Investment Research, and Forbes

THE 4 CONUNDRUMS

This is a good time, with the release of the latest SCF data, to reiterate our plutonomy thesis, and how when viewed through the prism of plutonomy, many of the apparent conundrums in the world seem less tricky to digest.

➤ **1) Oil and the Consumer.**

We have heard constantly that oil will slow consumption down as it eats into disposable income. But it remains a conundrum to many that consumption has remained robust, despite oil prices remaining high. What's going on? We don't see a conundrum. As we wrote about in September (The Global Investigator, *Is Oil Relevant for Equities,* September 2 2005), in the plutonomy countries, the rich are such a massive part of the economy, that their relative insensitivity to rising oil prices makes US$60 oil something of an irrelevance. For the poorest in society, high gas and petrol prices are a problem. But while they are many in number, they are few in spending power, and their economic influence is just not important enough to offset the economic confidence, well-being and spending of the rich.

➤ **2) Consumer Confidence and Consumer Spending**

A second related conundrum, and one that ex Fed Vice–Chairman Roger Ferguson spoke of as long ago as 2001, is why consumer confidence and spending have not moved in sync with prior patterns. As Mr. Ferguson put it "A somewhat puzzling feature of the recent period has been that, despite the sharp weakening in sentiment, household spending appears thus far to have held up well. How these apparently conflicting signals will be resolved going forward is not at all apparent from today's vantage point, and will bear close scrutiny." Remarks to the University of North Carolina School of Law, Feb 27 2001**.** This thesis came up again last year in relation to Hurricane Katrina, when consumer confidence fell sharply, yet consumption (ex autos) was just fine.

Again, we see this as being a lot easier to understand if viewed through the prism of plutonomy. While the average consumer might not be feeling great, the important consumers – the richest 20%, who account, as we've shown, for 58% of income – are in good shape. Rather than focus on consumer sentiment indicators like the Conference Board sentiment index, we highlight our own February Citigroup Smith Barney/CNBC Affluent Investor Poll. Affluent investors appear quite optimistic about the future prospects. Indeed the more affluent they are, the more upbeat they are about future prospects. "*Projections for the next year are positive among all investors. About two in five believe they will be better off financially in the coming year and 39% foresee things being no worse. An even brighter*