

Tectonic Shifts in the American Class System

by Mohnish Pabrai

As a recent transplant from the Midwest to California, my friends warned me to brace myself for the tectonic shifts I'd experience periodically. I have been witnessing a massive one since I got here, but it's quite different than what I had imagined.

Over the last few decades the U.S. has seen a gradual erosion in the size and scale of its manufacturing sector as businesses have relocated plants to leverage low-cost Mexican or Chinese labor. Businesses needed both size and scale to offset the significant effort and price tag that such moves entailed, so as a result, we saw mostly Fortune 500 companies and their suppliers embrace the offshore manufacturing phenomenon early.

Stronger Offshore Current

Over the last five years however, the internet has played a very large role in making it much easier and cheaper to setup shop offshore. As a result, even relatively small businesses are moving beyond simply sourcing from China. They've started experimenting with offshore manufacturing, IT Services, call centers and even accounting. Finding credible offshore partners and doing due diligence are getting easier by the day.

The numbers today are tiny. Businesses in the United States with under \$10 Million in annual revenues still have negligible dollars invested in foreign assets. But the situation is rapidly changing, and, I'd argue, accelerating.

There are about 20 Million nonfarm businesses in the United States. Each year about 1½ million new ones are formed and about 1½ million old ones cease to exist. Well over 90% of the businesses that exist today are unlikely to be around 20 years from now. And businesses that are being formed by entrepreneurs today tend to be the kind that fully leverage the global economy and the connectivity enhanced by the internet.

I would go so far as to speculate that if we had no automobiles and Henry Ford started the Ford Motor Company in 2010 instead of 1910, it would look nothing like your father's Ford. All manufacturing operations would be based in Guangzhou, auto design teams would be based in Milan and Los Angeles, all inbound call centers would be based in Gurgaon, while the basic back-office functions like IT, legal, accounting and financial services would be run out of Bangalore. Indeed, the company would end up with well under 1% of its workforce in Dearborn.

Its not so farfetched. GE already has a team of 300 lawyers based in India who do nearly all of the firm's internal legal work. The average GE lawyer in India earns well under \$10,000 per year. China has a nearly limitless workforce of 300 Million people who are unemployed and ready, and are willing to work for \$100 per month.

These trends have broad implications for the U.S., which provides perhaps the best nurturing environment for entrepreneurs. So I do believe that the companies and industries that create the most wealth in the 21st century will be born and based here. But, most of their respective workforces won't be.

The shareholders of these businesses will do very well. The richest 2% will get richer and the bottom 80% is likely to end up poorer as nearly every type of white- or blue-collar job becomes portable offshore.

This is a massive tectonic shift and is heavily responsible for the prolonged recession we've been undergoing. It is also the reason why 13 Fed cuts – bringing interest rates to 40 years lows – have failed to stimulate the economy. Alan Greenspan can take interest rates to zero and it won't make much of a difference.

Because it is a fundamental shift, I don't believe coming out of this recession anytime soon is in the cards. The official unemployment rate in the United States of 6% is a fairy tale. It counts the worker who went from a \$40,000 wage to \$7/hr at McDonald's as fully employed. It also does not count the "discouraged unemployed," who haven't been able to find a job for more than six months and have simply give up.

I believe the real unemployment rate is easily double digits, and if one includes folks who found new jobs but make much less than before, it approaches 20%.

When I first moved to the U.S. 20 years ago, one thing that most impressed me about America was the breath and depth of its middle class. The striking similarity in lifestyles of families in the top and bottom 25% has always been one of the best aspects of America for me. The rich have always had bigger homes and fancier cars, but nearly all seemed to find the American Dream within reach.

Here in Southern California, for the first time I've seen clear evidence of a widespread dual-class society: One routinely sees a beater car parked outside a fancy home domestic help is widely and easily available. One doesn't see the same scene in the Heartland nearly as often. And while California's situation is exacerbated by a continuous flow of illegal migrants from Mexico, we'll see the same phenomenon play out in the Midwest – only the domestic help will be laid-off workers.

A strong and vibrant middle-class is fundamental to a healthy America – and we're witnessing its gradual erosion. These are troubling realities, but we'd be far worse off if we erected trade barriers as a response. The good news is that, over time, the average standard of living would rise outside the United States – resulting in a reduced wage differential and a greater ability to export US goods and services. But, until then, it will be painful as we live through these tectonic shifts.

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