



L. R. Levin Consulting, L.L.C.

Newsletter

May 2009

Can we really read the “Tea Leaves” about the rest of 2009?

Reading the Tea Leaves reveals a very strange brew these days. The top one hundred economists' consensus view appears to be that this economic downturn will hit bottom this fall or by the end of 2009. One enthusiastic economist was even on radio last week proclaiming that we hit bottom in April and the recovery had begun!

Does the economic data substantiate this? The stock market was up in April by a substantial amount. By Mid-May it was showing signs of uncertainty as it fell last week after being up 9 straight weeks. The stock market, in times like these, is not a reliable leading indicator. It will remain volatile and subject to emotional swings of varying degrees and directions through the rest of this year. The tea leaves are giving a mixed message.

It appears that the rate of decline may be slowing. Retail sales and industrial production continued to fall in April. One reason it is hard to read the tea leaves is that different segments of the economy are experiencing the downturn in different ways. Another is that how various government actions will affect the economy is very hard to predict. Take, for example, the automobile industry.

Over the last 6 months billions of taxpayer dollars have been transferred to Chrysler and GM. As

they are reorganized, more taxpayer dollars will be transferred to Chrysler and GM to provided the needed bridge financing of the new operations. But what can the economy, and, therefore the taxpayer, expect to be the benefit from transferring these dollars from the disposable income of the private sector?

Last week Chrysler and GM began terminating thousands of dealerships (between 2,000 and 3,000). It is expected that this will result in the loss of over 200,000 dealership jobs and a further loss of at least another 100,000 jobs as a secondary affect. Moreover, GM admitted that it hopes to begin importing a substantial number of cars from China. In that sense it may be that the real beneficiary of this program will be the Chinese economy and workers.

Another aspect of the Chrysler bailout is that the government insisted financial entities that had provided Chrysler with the funds needed to operate for the past several years *take an extraordinary “hair cut.”* These were primarily banks and financial funds. The financial funds were private investors who pooled their capital to make investments that were generally secured by Chrysler's assets.

The normal expectation of such investment funds is that in bankruptcy their security protects them, and any change to those security interests that frees up the assets is negotiated. Normally they would get equity or assets in exchange for their giving up liens or some other prorata negotiated participation. But here the government changed “the rules of the game” and exerted extraordinary pressure to do it.

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The investment funds did not get equity and the opportunity to make up their losses in the long run. Rather they have been asked to take 2 billion dollars and give up 4 billion dollars.

This affects the economy in two critical ways, among others. For one, it means that in the future people who finance commerce must take into account a new and difficult to value risk that may happen to their investment. This will increase the cost of capital in the economy for years to come and hurt the economy's ability to recover and grow. In the short run, it removes permanently another 4 billion dollars from the economy.

Removing 4 billion dollars from the economy is a meaningful reduction in buying (and investing) power of the private sector. It also makes investors that much more cautious about making capital available at a time when the economy needs all the private capital it can get. Another affect of the Chrysler restructuring is a transfer to foreign investors.

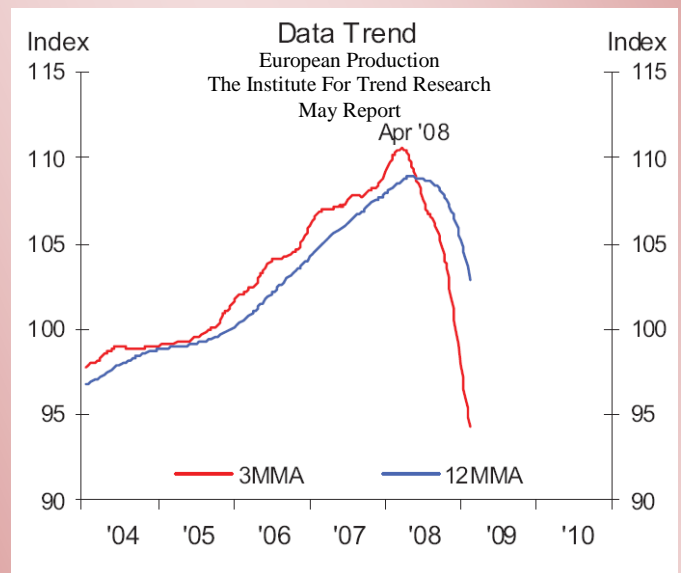
A foreign automobile firm is gaining a substantial, cheap equity piece of Chrysler. Thus, if Chrysler recovers, it is again a benefit to a foreign country paid for in part by taking 4 billion dollars away from US private investors. These "unintended consequences" may contribute to a longer, deeper recession.

By contrast, as infrastructure projects begin to impact this summer there should be an infusion of buying power into the economy. Driven by lower prices, store shelves have begun to empty, creating the need for new inventory, which should help manufacturing. Each of us applying 5 scenario planning (Newsletter March 09) must assess the impact these divergent forces will have on our segment of the economy over the next 12 to 15 months.

The global Economic Down Turn has continued pushing the world economy deeper into recession.

European production has dropped 14.5% for the past three months compared to the same period last year. Europe is experiencing the worst recession since World War II.

Often a graph can illustrate the meaning of the data better than just numbers.



In spite of its substantial stimulus package, China's growth in production is the slowest in 6 years. China continues to experience high unemployment. For China to sustain its economic recovery, it needs exports to return to prior levels of growth. In March its exports were down 17% and in April they were down 22.6%. China has turned to commodities to hedge against a loss in value of the US dollar. By turning its attention to a world-

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Should we worry about inflation in the next 12 months?

April saw US consumer prices take the biggest tumble in 50 years! More than anything else, this reflects that energy prices have fallen dramatically in the last 12 months as the worldwide recession took hold. In fact, that drop was beneficial freeing disposable dollars equivalent to a major tax cut. Without it the economy would be much worse.

We cannot expect any further help from oil prices. The other key component has been the drastic reduction to retail prices to clear store shelves of excess inventory. As inventory comes into line with current demand, this stimulus to retail sales will also fade away. The real news was that, excluding food and energy, consumer prices jumped 0.3% last month. Food prices were also up. The core consumer price index rose as well, 1.9% from a year ago, now climbing at a 2.5% yearly rate.

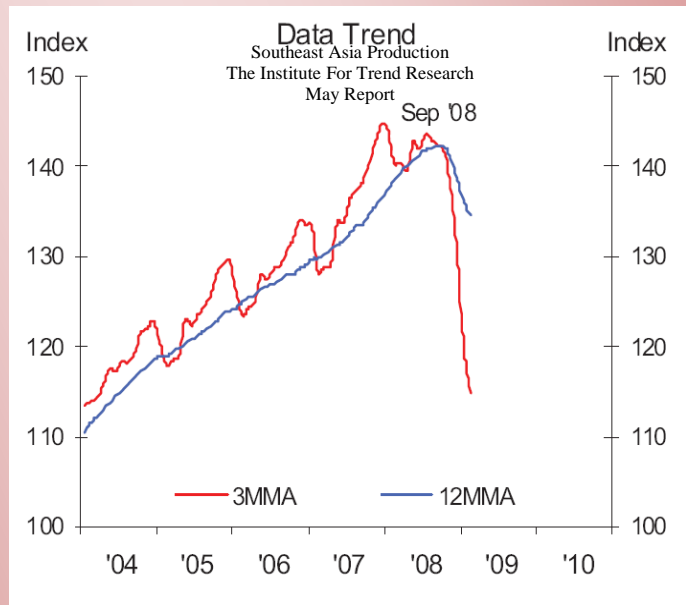
When added to the Fed's continuing to dramatically increase the money supply, inflation within the next 12 to 15 months could become a very real factor. The Fed is injecting money into the economy at the same rate as in 2003 when it caused the housing bubble. If the Fed becomes the purchaser by necessity of our increasing new federal debt, it may not be able to stop increasing the money supply as real inflation sets in.

Recent Cartoon



wide commodities acquisition program for investing their trade surpluses, it will make it increasingly harder for China to buy US debt. We may see the affect of this over the next 6 to 12 months. Funding the US debt could become an issue.

Southeast Asia with reduced exports, including to China, experienced a further 2.9% drop in production last month.



Japan is experiencing the worst recession since the 1970s. Electronic exports, for example, are down 49% and machinery exports are down 40.9%.

Closer to home, Canada's retail sales dropped 8.9% year over year and its economy is solidly in recession. It appears their industrial production will continue to decline "at an accelerating pace" into 2010.

Mexico saw a 40.5% drop in light vehicle production in the first quarter of this year. Brazil's exports are down 12.3% year over year reflecting the US economy and causing China to become Brazil's biggest customer. Even in India, declining exports are causing a drop into recession.

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Our prior **Newsletters** suggested 8 key drivers to track the economy.

+ Petroleum Prices

Petroleum prices have risen slightly with increased consumption over the past few months. Summer driving and a psychology that “things must be improving” will keep them slightly higher. The increase in prices and driving will begin to remove discretionary dollars from the economy.

+ Natural Gas Prices

Like petroleum, we expect gradually increasing prices. As the government’s program of reducing the use of coal by utilities gains momentum this will have a negative impact on the economy. Expect a slightly negative affect over the next few months as retail sales dollars are diverted to energy.

+ Exports

The global recession over the next few months will outpace the moderate drop in the dollar continuing the negative effect on exports and hurt manufacturing. Protectionism is hurting trade.

+ Retail Sales

Retail sales will continue to be hurt by the downturn through 2009. Once inventories are brought in line by promotions, the pricing of new inventory may be higher further negatively impacting retail sales and manufacturing.

+ Strength of the Dollar

The flight to quality has run its course and risk taking is returning to international currency trading. The dollar should decline slightly over the next several months, but may not help exports.

+ M2 Money Supply

Continues to increase at an abnormal pace. Inflation could be its hand maiden.

+ Industrial Production

Continues to fall. This reflects the deepening recession and is pressuring layoffs in all sectors.

+ Raw Material Prices

Stable. China could change that.

The Wise Old Owl

Keep an eye on tax increases over the next several months. If we are seeing signs of things improving, tax increases could siphon off critical discretionary dollars from the recovery. Local and state governments are seeing a substantial drop in revenue from loss of sales tax on car sales, reduced income tax revenues, gas tax revenues, etc. The response may be a broad increase in user fees or alternative taxes. One of the drivers of inflation this month was the more than 100% increase in tobacco taxes.

Governments at all levels are pursuing major tax increases even if they try to hide them with names like “closing loop holes.” Each day brings another Federal proposal to raise taxes each in the billions of dollars. This week, for example, there was the simultaneous suggestion that the life insurance industry be bailed out while raising taxes that affect life insurance by \$12.8 billion. If billions of tax increases become law at the local, state, and federal level, you should plan on the downturn being deeper and longer than currently expected.

Reducing costs, *reactive planning*, will not maintain your profits. **Proactive** 5 scenario planning, as we refer to it, is becoming a necessity. Focused marketing is a vital key. Choose strategic planning over panic. Doing a real 360 style strategic planning review of your business now is what will make the difference over the next 12 months.

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