



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

# Newsletter

June 2009

## Has the stimulus package stimulated anything but talk?

All the discussion of how the economy is doing may not be what it seems. The terms used by economists in discussing what is happening in the economy as reported in the press are, at best confusing, and at worst misleading. When they have said recently the economy is “improving” or getting “better” what are they really conveying? What do “hopeful” signs mean?

The answer is that it depends on how you define “improving” or getting “better.” The risk is in unnecessary disappointment if things don’t improve as quickly as these terms imply. The good news is that the hard economic data shows that the rate of deterioration of the economy has slowed materially. With respect to retail sales and production that does not mean that the decline has hit bottom or that we will see an upturn in the next few months.

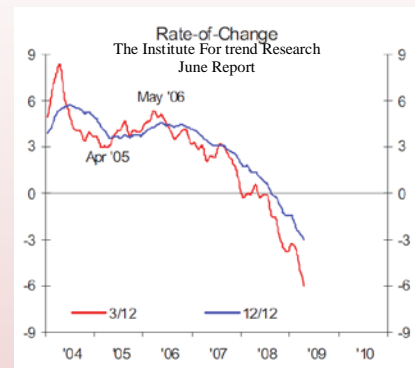
What it does mean is that many soft indicators reflect a belief that by the end of 2009 or the first half of 2010 we will have flattened out and some type of recovery should begin. In fact, time wise, the economic data shows we are about where you would expect in this type of dislocative severe downturn. That is “hopeful.” *Does that mean the stimulus package is working?*

Not necessarily. To begin with, the stimulus package is not what economists normally call stimulus. Perhaps only about 5% of the funding has entered the economy.

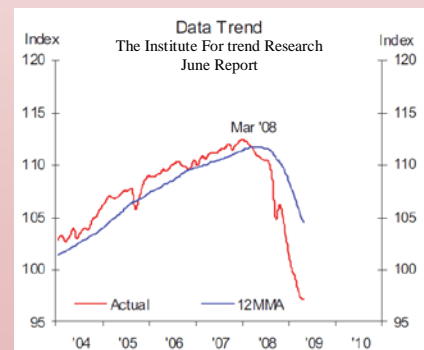
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## To paraphrase an old political tidbit, reports of the U.S. recession’s demise are premature.

Retail sales are down 3.9%, year over year, reflecting the worst decline in 60 years. The monthly rise in May merely reflected that we paid more per gallon for gasoline.



The industrial production data is the weakest in 10 years.



Commercial construction, for example, is down 23.4% year over year, with permits over the last 3 months dropping 55%. But many economists believe the bottom is in sight. Their prediction is that the economy is stabilizing and will reach bottom by year end.

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Realistically, the stimulus package has not had time to work. That is because most of the package is what is referred to as “spending” which will help those segments where it is targeted *as it is spent*, but only *as long as the extra spending is repeated*. For example, studying the habits of fish ceases to help when the funds and the study stop. Even road projects don’t stimulate repetitive purchases. Normally, economists speak of stimulus when you infuse significant extra long term dollars into consumer’s pockets.

That is because when ordinary consumers spend, they buy things that cause production and employment in areas of the economy whose products consumers will continue to buy in the future. This is normally done through tax cuts because those dollars can return to the economy almost immediately. It is important to remember that for tax cuts to have this effect they need to be substantial and for a long term. Otherwise the money just goes into savings.

Infrastructure dollars, for example, take time to enter the economy because of all the planning that is necessary. The plus side of the current stimulus package is that it will put dollars into the economy over the coming months and into 2010 at a time when the economy will need an infusion, if it is to have an upswing rather than a flat recovery. Again this is more in the realm of “hopeful” rather than current impact.

Three very important factors have contributed to putting the economy back on track to reach bottom. The decline in 1) gasoline prices, 2) natural gas prices, and 3) raw material prices. The combination of these is the equivalent of a tax cut, freeing discretionary dollars to ease the economic downturn. We are also experiencing, albeit weak, the usual increase in economic activity that comes at this time of year. The fear is that a combination of taxes, inflation, and rising interest rates, among other factors, will choke off the recovery.

## Will the China Factor Hurt the World Economy?

China has assumed a leading role in trying to influence the changing world economy. It has aggressively been pursuing tying up raw materials ([May Newsletter](#)) and changing the medium of world trade ([April Newsletter](#)).

It has extend its program to convert its trade to the *yuan*, from Hong Kong and South Korea, to include Malaysia which announced that it may move to the *yuan* because it “worries \*\*\* the [U.S.] deficit is being financed by printing more money.” As part of China’s drive to replace the dollar as the medium of international trade, it has increased its efforts to persuade trading partners to move off the dollar.

China has replaced the U.S. as Brazil’s largest trading partner. China also invested \$10 Billion in buying into Brazilian Oil properties.

Brazil, Russia, India, and China are each moving to reduce their holdings of U.S. Treasury obligations by replacing them with IMF bonds. Russia, India, and Brazil are planning to sell 10 Billion each of treasuries to buy IMF bonds and China is planning to sell 50 Billion of treasuries to buy IMF bonds. What if other countries follow?

These moves could have a profound impact. At a time when our expanding debt requires us to sell 150 Billion a week in new debt these moves make it harder for the U.S. to finance its debt. It also makes it harder for international trade to function by eliminating a single common median of exchange, the U.S. dollar.

More and more countries will need to buy IMF units or *yuan* rather than dollars to use for trading. This will lower worldwide demand for U.S. dollars and reduce our ability to expand our debt at favorable interest rates.

These Chinese strategic moves are one reason treasury rates have been less stable recently.

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# Will Rising U.S. Debt Choke Off the Recovery?

*How will we know when the economy has stabilized and a real recovery has begun?* Two key indicators are retail sales and housing. When the consumer is once again able to begin buying products at levels that will sustain reasonable inventory turnover and promote employment the economy will begin to heal.

As housing comes back to a reasonably sustainable level it will stabilize many aspects of the economy and allow consumer spending to create real jobs. For that to happen the inventory of available houses must return to a normal level and housing values stabilize at a reasonable level as well.

Currently, new housing starts are 39.2% below year-ago levels. If interest rates begin a substantial rise, that would complicate mortgage financing, increase the cost of business financing and with it the cost of goods sold, inhibiting both of these key indicators.

Substantial inflation, likewise, hurts both retail sales and housing. Again this could materially slow any recovery. Substantial inflation could wipe out savings and add pressure for increased unemployment. If our **increasing debt** caused substantially higher interest rates and inflation, it would hurt real retail sales, housing, and employment.

Economists fear we will reach at least 11% to 12% unemployed before we hit bottom (currently we are at 9.4% or 9.5 million people). It will take more than a tepid up tick to create 14 to 15 million new real jobs.

Economists have shown increasing concern over the rapidly growing debt. In March 2009, 10 year

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## Recent Cartoon

### Ziggy



benchmark treasury notes were selling at an interest rate of 2.5%. This low rate was helping to moderate the decline in the economy generating the optimistic belief that things were getting better.

Recently, 10 year benchmark treasury notes reached yields as high as 3.937%. The 30 year government bond rate went as high as 4.745% this month.

Based on the Congressional Budget Office's figures, the rise in government interest rates in the past month alone could mean, even if we did not embark on any new programs, that by 2012 more than 25% of the Federal budget would go to pay just the interest on the debt. That would grow to more than 35% of the budget by 2025!

Given the projected debt, suggested tax increases, increased cost of gasoline, etc. continuing to add more debt could sap the life out of our recovery and foreshadow the potential for problematic inflation.

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## Will We See Stagflation in the Next 12 Months?

Over the past month, we have seen a growing number of world leaders and now economists, express concern that the U.S. will try to solve its growing borrowing problem by monetizing the debt. This could not have been helped on Tuesday, when the Congressional Budget Office released figures showing that the pending health care proposal could cost from 1 to 3 **Trillion** dollars.

Careful examination of the figures showed this was a low estimate, since it was based on a substantial tax increase in the form of a value added tax, a major reduction in the level of fees insurers pay doctors for the services they provide, and the government determining what treatments, if any, a patient may receive for a given medical condition. Certain questionable assumptions made it appear that the real costs of implementing the program were back loaded making the first several years look less costly.

*Putting health care to one side, for the immediate future, inflation appears in check with a mild fall in the CPI.* As the effect of last year's high commodities prices recede along with inventory fire sale prices, this check on inflation will also fade. Looking only at the most recent month, the Producer Price Index rose 0.6% in April.

Foreshadowing coming CPI rises, the 30 year fixed mortgage rate climbed to 5.81%. If this trend continues it will adversely affect the economy. The Fed program to buy \$125 Trillion of mortgage backed securities by the end of the year and the purchase of \$555.9 billion of mortgages has not kept rates low, but is contributing to inflation fears.

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Similarly, while the Fed has purchased \$165.5 billion of government bonds as part of its program to buy \$300 billion of bonds by August, this has not kept rates low, but is further contributing to higher interest rates and inflation fears.

How the government moves forward over the next few months will determine if or when we see Stagflation. It *appears* that we may only continue to see mild increases in inflation and interest rates as we head into 2010. But, over the next 18 months, conditions could see a rapid change. Businesses should be looking at what investment they need to make in assets that will appreciate in value as the next inflation cycle begins.

## The Wise Old Owl

To position your business for the long haul, it is now critical to do Focused Scenario Strategic Planning covering the next 18 months. Especially so with respect to your business's coming needs for plant, equipment, etc. Take advantage of bargain prices for future needs. Think in terms of rising interest rates and growing inflation as the economic cycle progresses. See the recent article on "5 Scenario Planning" in ***Managing For***



***Success.*** Following the action steps of Focused Scenario Strategic Planning will pay real dividends and help you out perform your competition. Being prepared to act as the cycle develops is more important than ever.

[Click Here to see "5 Scenario Planning" Article](#)



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