



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

# Newsletter

October 09

Look Back Issue

## Why A Look Back Issue?

The purposes of our **Newsletter** is to give our clients and readers, especially those that use 5 scenario planning, the latest insight on key developments that will affect the next 12 to 15 months. As the *Managing for Success* article on Scenario Planning explains:

“By reacting quickly as economic conditions change, high performing businesses stay successful and grow revenues and profits even in economic times like these.”

More importantly even the top economists cannot accurately predict what the economy will do over the next 12 months, because they can only guess how the factors that drive the economy will develop over the next 12 months.

Our **Newsletters** are designed to help business people understand

what those factors are and how they will affect the economy depending on how they develop. The **Newsletters** also try to give insight on how the factors appear to be developing at a given point in time.

Often current news stories or leading economists use terms like “stimulus”, “recovery” or “growth” that sound normal, but can be technical or misleading to the lay reader, so we try to translate these discussions into lay terms that even we, as business people, understand.

This permits our readers and clients to adjust their business activities to reflect the changing scenarios as they occur. From time to time, we do a **Look Back Issue** to assess how we did and to discuss the confluence of the trends going forward. We hope you enjoy this issue and learn more about how to meet the future.

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## Was September 2008 the Pivotal Month In This Downturn?

In a word, “yes!” In hind sight the pivotal event in this business cycle came in September 2008 with the Lehman Brothers debacle. Business cycles can follow different courses. How September 2008 developed, may have been very different, if secretary of the treasury Paulson and the Federal Reserve had not decided to treat the Lehman Brothers liquidity problems quite differently from how they treated other similarly situated Banks and investment firms. Their decision to let Lehman Brothers go under without government assistance shocked the worldwide financial markets.

In our September 2008 **Newsletter**, which came out just after the decision on Lehman, we summarized the Institute for Trend Research (“ITR”) forecast, that preceded the Lehman decision. We explained ITR had predicted “a continuing decline in economic activity in the last quarter

of 2008 continuing through 2009, and culminating in a more severe business cycle crunch in 2010.” As we discussed in the September **Newsletter** this was consistent with all the economic data prior to the Lehman’s collapse. We expected a steady, but slow, mild decline during 2008 and 2009 absent some major event.

The shock of letting Lehman go under, however, caused the credit markets to begin freezing, as all the major players rushed to withdraw their funds from the normal market place and put them into U.S. treasuries. Reflecting this sudden shift, our **Newsletter** noted that “What is certain is that the banking system had begun to freeze up restricting credit and there are no easy solutions. Each action outside normal market forces has its own consequences. The questions are simple, the solutions are complex.”

We were right to warn the “solutions are complex.” The September **Newsletter** pointed correctly toward the rocky road ahead and the need for our readers to prepare action steps to avoid the pit-falls of the next 12 months.

Reviewing the government’s reaction to the crisis and its bail out

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strategy, our September **Newsletter** pointed out that there were “noted economists who believe that these actions not only will make the coming recession much worse, but materially delay the recovery process.” The September **Newsletter** went so far as to say, given the direction the government was headed, “we may not see moderate growth again before 2012.”

In our November **Newsletter** we assessed the impact of the expected post-election government bailout/stimulus strategy. “The credit freeze and massive bail out appear to have hastened the deterioration of the economy and deepened the downturn. The expectation is that the recession will continue to deepen through 2009 and into at least the first half of 2010.”

The deterioration over the past 12 months did, in fact, come more quickly than pre-September 2008 economic data indicated. The drop during the ensuing 12 months was much worse than the pre-September 2008 data indicated it should be.

The good news is that many soft and hard data points indicate that we will reach a plateau during the first half of 2010. The data on Retail Sales, Housing Starts, and Stock Pric-

es, all support the Conference Board’s index of leading indicators and the September 2009 Purchasing Managers Index which show a recovery in 2010. But what is meant by “recovery.” We covered that in depth in our August and September **Newsletters**.

What about the ITR’s suggestion that the business cycle might culminate “in a more severe business cycle crunch in 2010?” Unfortunately that suggestion also appears to be correct. Before the Lehman decision it appeared that the downturn in 2009 would be mild. As the September **Newsletter** pointed out, given the government’s reaction, 2009 could be much deeper. Having fallen beyond the level of the 1980 recession, we have hit the level of a “severe business cycle crunch” early, and will clearly be at that level as 2010 begins.

How long we remain at that severely depressed level depends on the type of “recovery” we have in 2010. Today no one is predicting that unemployment will ease materially during the first half of 2010. In fact we are conservatively at 9.8% unemployment with most economists predicting 2010 will see us conservatively above 10%. See our September **Newsletter**.

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While the September and November **Newsletters** discussed many details of what was occurring, these broad themes *were right on target*. “Recovery” is an allusive term and a jobless recovery in 2010 may be so mild it may be hard see that it is here. September 2008 proved to be a turning point, and our 2009 **Newsletters** continued to explain quite accurately how the key factors were developing and what that meant over the next 12 months.

## The Impact On The U. S. Of The Developing Global Recession

In our January **Newsletter** the global nature of the recession and its meaning for clients and readers doing business here or abroad was a focus. Reviewing the global economy, the March **Newsletter**, discussed the impact of laying off 25 to 40 million workers in China and the impact of this change on companies that rely on China or India as suppliers.

In our April **Newsletter** we asked “Is China on the Prowl?” The

answer was most definitely, yes! At home China was implementing a \$585 billion stimulus package with required matching local participation. This may complicate China’s managing its economy in 2010-2012.

The April **Newsletter** highlighted how, without a significant increase in exports, real recovery could not be sustained in China. As the graph below illustrates, an increase in Chinese exports remains tied to the U.S. and Global economy.



Throughout 2009 China has been implementing an aggressive worldwide program to acquire raw materials like oil and copper and to replace the U.S. dollar as the medium of international trade. We discussed the impact of these activities on the U.S. economy in our April **Newsletter** and devoted two entire sections in our June and July **Newsletters** to the meaning of China’s increasingly successful attack on the U.S. dollar.

The U.S. has, apparently, in the belief that a cheaper U.S. dollar will help exports and assist our avoiding

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the harsh impact of a dramatic increase in our National debt, actually helped lay the ground work for China's continuing effort. Russia, India, Brazil and now Saudi Arabia have joined China in this aggressive move. See **Dark Clouds** below.

Our July **Newsletter** addressed the impact of worldwide unemployment as it reached a 5 ½ year high. Like the U.S., worldwide unemployment has been a negative drag on the economy. As we pointed out in the **Newsletters**, this will continue to be a problem going into 2010.

## The Striking Similarities to the 1980 Recession

In our January **Newsletter**, we also recognized the striking resemblance of this recession to the late 1970s and early 1980s. This perspective helped our clients model their action plans for the next 12 months. As it turned out, the statistics in this recession have so far closely followed the pattern of 1980.

As our **Newsletters** point out what is different this time is the government's response. The **Newsletters**

have explored why the difference in the government's actions now as compared to 1980 have lead to very different results so far. The risk is a flat recovery vs. a long lasting "V" shaped recovery.

The March **Newsletter** explained that "The rate of decline should slow during the second half of 2009, with the bottom occurring during the first 6 months of 2010." Approaching their action plans for the remainder of 2009 and early 2010 with this overview, and the 5 possible scenarios this recession could take, helped our clients remain growth oriented and profitable.

We also addressed in depth, as part of the March **Newsletter**, the bailout and debt situation that was developing as Congress descended into its multi-trillion dollar spending program. As the March **Newsletter** pointed out these "spending plans \*\*\* require the Bureau of the Public Debt to borrow \$150 billion a week to service and expand the debt of the United States." In fact we are now borrowing at the rate of **\$160,000,000,000** per week to handle the almost \$11 trillion in debt currently outstanding.

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The March **Newsletter** suggested that “for now we can expect increasing unemployment with contained inflation and low interest rates.” It also looked at factors like how equity market drops increased under funding of local and state government pension funds increasing “pressure for tax hikes.” The April **Newsletter** addressed the depressing impact that the sale of foreclosed homes was having on the economy. We also began a detailed discussion of how the government’s spending programs and increasing taxes at the state and local level were damping the recovery prospects.

Commenting in our April **Newsletter** on one of the favorable trend indicators, we said that “unfortunately \*\*\* the trend dynamics of this early turning indicator means that we are going to see a tepid pace to the recovery when it begins in 2010.” We added that another “concern is extremely high deficit spending and the Federal Reserve’s dramatic increase in the supply of money. Economists are suggesting that the cumulative effect of these two government driven behaviors could include substantial inflation by 2010 or 2011.” That concern continues to grow. Many factors

will determine whether 2010 or 2011 see us hit levels of inflation above 6%. We will, of course, continue to track these as the year progresses.

In the May and July **Newsletters**, we highlighted the structural problems with the auto sector bail out. These included the potential loss of over 300,000 jobs and its impact on increasing unemployment. The July **Newsletter** devoted an entire section to the affect of real unemployment on the economy as we approach “recovery.” In the September **Newsletter**, we followed up on how unemployment was an increasingly important factor in flattening the hoped for recovery. Our September **Newsletter** also had an entire section discussing the impact of the construction downturn on the future of the economy. We warned that at a critical stage in the recovery, during 2010, more than 85 billion in commercial and office building loans will reset.

In the June **Newsletter**, we had an in depth discussion of the lack of impact of the stimulus package and the negative impact of the rising U.S. debt. Also we had a column discussing when and if Stagflation might occur. This was followed in our August **Newsletter** with a discussion of how

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the impending recovery will affect your business over the next 9 months.

In the September **Newsletter**, we addressed Fed Chair Bernanke's declaration that "we are in a recovery" explaining what this really meant was a slight one month increase in the growth rate, and how the "recovery" would affect your business over the next 5 months and going forward.

On reflection the **Newsletters** have given a realistic picture of how the downturn is developing and what our readers and clients can expect each month to occur over the succeeding six to 12 months. **Having reviewed these discussions and the government's joy that we are in recovery, we must ask, is the future all warm sunshine and roses?**



## Are There Dark Clouds On the Horizon?

With all the hype about the developing recovery and with the government about to spend billions, all in time for the November 2010 election, the remainder of 2009 and beginning of 2010 should see the economy bottom out. The plateau is far below where we were at the beginning of 2008. By no definition are we in a strong recovery as opposed to just what it is, hitting bottom.

Where will we go from there? A "V" shaped upward recovery, a jobless flat recovery? A renewed downward spiral?

To name a few, there are five major negative factors that loom large in how 2010 may develop. These include the value of the dollar, unemployment, "cap and trade," health care "reform," and value added taxes.

### *1. A Weaker Dollar*

With the U.S. backing a shift in power to developing countries at the IMF, China's strategy to gain capital from weak currencies and value-added manufacturing (productivity) could receive a meaningful boost. One part of China's strategy to replace the dollar as the medium of international trade will reach a key point at the IMF in 2010.

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That is when the IMF will a) reassess the basket of currencies that comprise Special Drawing Rights (“SDRs”) and b) decide whether to use SDRs and SDR denominated bonds as a substitute medium of international trade. See July **Newsletter**, China article. If that occurs the value of the dollar could materially deteriorate. We have seen over the last few weeks concerns about this and the U.S. monetizing its debt cause a serious deterioration in the value of the dollar.

*Why is a materially weaker dollar bad for the U.S.?* Contrary to what some commentators have said, this level of cheap dollars doesn't create enough trade to offset the loss of jobs to off shore investments.

When the dollar becomes materially weaker it causes the investment banking community to divert dollars into commodities, foreign currencies, foreign stocks. This is the only way to protect against the impact of devaluation.

We have seen this when the British pound (1950-60), Mexican peso (1990), and Russian ruble (1999) lost substantial value. To illustrate, suppose this happens and the Fed keeps interest rates low to help a weak

economy. Firms will borrow money in the U.S. and invest it overseas to buy foreign companies or increase their foreign operations and buy foreign commodities. The U.S. financial industry will invest in foreign commodities, foreign currencies, and foreign stocks. Many Tarp dollars flowed through U.S. banks to investments in China.

This will drain needed capital out of the U.S. The beneficiaries will be foreign economies not ours. U.S. manufactures will find that they are severely disadvantaged. Commodities like oil, aluminum, and steel will cost more for U.S. companies using devalued dollars than for foreign companies, such as European or Chinese manufacturers using stable currencies like the Euro or Yuan.

By eliminating the dollar as the currency for trade, China, India, Brazil, and Saudi Arabia, for example, can make commodities and manufactured goods more expensive for the U.S. and less expensive for themselves.

Further negative fallout would be increasing U.S. unemployment. As manufacturing costs rise here, we would continue to outsource manufacturing to artificially low cost coun-

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tries, continuing the loss of U.S. jobs. Eventually this would mean rising interest rates and further complications.

## 2. Unemployment

In September, if we include the people who have exhausted their benefits (but “wanted and were available for work”) and people who wanted full time work, but could *only* get part time, the number of unemployed is approximately 26.8 million people and growing. This represents a real unemployment rate of 17%.

Today even the government is talking about a jobless recovery. Some forecasters say it may take until 2013 to 2019, before unemployment returns to normal levels of between 8.1% and 5%. That would mean a dramatic reduction in buying power and the size of our economy.

Even that forecast is based on the strength of our economy growing unimpeded by such blockages as the shrinking value of the dollar, growing deficits, or heavy tax increases. A jobless recovery is a major threat to our long term economic health.

## 3. Cap and Trade

*Does the Congress have the power to repeal the laws of economics?* The last time I looked, the law of supply and demand still applied just

the way I learned it in college and grade school. Contrary to popular belief, Congress has no power to repeal the laws of economics.

When we reduce buying power, it has an impact on the economy. Many things can reduce buying power, including psychology. Last December with the market drop and credit freeze, the Nation was a lot poorer. The consumer psychology changed, for a long time to come, how even those with resources and credit, spent their disposable income.

To create jobs, the government needs to think about how its actions affect disposable income and consumer spending. The economic recovery is very weak at the moment and the best approach would be to repeal the heavy spending and substitute real stimulus. See article in *Managing for Success* on Stimulus.

As discussed in the *Managing for Success* stimulus article, cap and trade as currently proposed will have a substantial inflationary affect while also initially dislocating numerous aspects of diverse portions of our economy.

These types of structural dislocations reduce employment, further weaken the dollar, affect interest

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rates, and capital creation, to name a few.

#### **4. Health Care “Reform”**

Like Cap and Trade, Health Care “Reform” has been a highly political topic for months. Our **Newsletters** are not concerned with the politics or whether Cap and Trade or Health Care “Reform” are good or bad. Rather the **Newsletters** are only interested in their economic affect and what it means to your business.

As currently proposed (there are, at present five versions) Health Care “Reform” contains substantial new taxes and inflationary provisions. These come in many forms.

It does not matter whether the taxes are on medical devices such as testing supplies for diabetics, insurance premiums, or people who do or don’t have medical insurance. In the end, the taxes are all passed on to the consumer. They all represent a reduction in discretionary spending or disposable income.

If you reduce current government subsidies for Medicare and Drugs that merely increases the providers’ cost of continuing a service that is needed and used by millions of Americans. Again the added cost just gets passed on to the consumer. It

may reduce what government pays, but with respect to the consumer, it all represents a reduction in discretionary spending or disposable income as the increased cost gets passed along.

We currently have too few doctors to care for the number of people needing medical care. If we add 10, 20, or 30 million more people, the law of supply and demand, means rationing and higher costs. An increase in demand for doctors without an increase in the supply of doctors still means an increase in price.

Reducing what we pay doctors or rural and urban hospitals may cut government costs, but it won’t increase the supply of doctors and facilities. Increased demand without increased supply means increased prices.

With few exceptions, the current bills will have the effect of increasing taxes by at least one trillion dollars at a time when removing that discretionary spending from the economy will have a negative effect on the recovery. It could materially restrict capital formation and cost jobs.

#### **5. Value Added Taxes**

There has been increasing discussion of the Federal government adopting a substantial value added tax

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of 10% to 15% to supplement the current income tax. This has been cited as a way to reduce the deficit and to finance health care.

We are already slated for substantial federal tax increases by virtue of letting the previous tax cuts lapse. When coupled with the needs of State and Local governments to raise taxes to maintain basic services, adding a value added tax could materially adversely affect the economy. It would create inflation as it is passed on layer by layer and it will take away

discretionary spending.

***The 5 Dark Clouds***

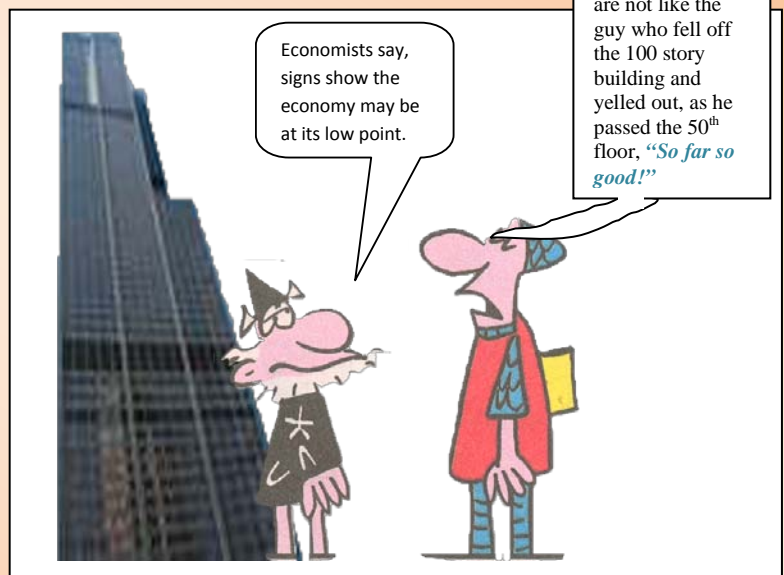
These are 5 of the dark clouds that bear careful watching over the next 12 months for how they will affect your business. As we look back over the past 12 months a lot has happened. The next 12 months look to be just as event filled, and in our **Newsletters** we will do our best to help you focus on what the developing economic climate means for your business.

**Our Favorite Cartoons of the Past 12 Months**

**March 2009**



**May 2009**



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