



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

Newsletter

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Is The Drop In Unemployment More Good News?

When the heavy weight title contender throws his “Sunday Punch” and the champ goes down for the count, that’s good news for the contender. In economics, when it comes to government unemployment statistics, it’s a little more complex.

On its face, a drop from 10% unemployed in December 2009 to 9.7% in January appears to be a positive development. Similarly, a drop in the broader measure of unemployment from 17.65% in December to 16.78% would appear even more positive.

But in economics, often it is not the amount by which the statistics change, but why they change that is important. Even at 16.78% unemployment that means 25.6 million Americans are unemployed. Unemployment is an important indicator of how we are doing, among other

reasons, because it affects liquidity in consumer spending.

The most important aspect of any recovery is creating jobs and putting Americans back to work. ***The reason unemployment decreased in January was based on how unemployment numbers are calculated by the government, not on a reduction in the number of people who wanted and could not find jobs.***

One figure we track is what the government calls the number of long term unemployed. In January that number increased by 3.38%. In addition, the number of unemployed who want and were available for work and have been looking for a job for the last 12 months increased by 409,000.

The January numbers indicate that the length of time people who want jobs are remaining unemployed is continuing to lengthen. Also, the number of people who want jobs, but are giving up on finding work, dropping out of the labor force in the near term, is increasing.

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All of this suggests very real negatives for the economy, including increasing foreclosures as unemployed people exhaust their resources causing a withdrawal of liquidity from the economy. The unemployment figures suggest the economy may be stabilizing, but not approaching a dynamic recovery.

On the positive side, more people who were only working part time have had their hours increased to full time. This accounts for much of the gain in employment.

This is a natural occurrence as manufacturing activity begins to increase with economic stabilization. In December and January we saw an increase in activity generated by the very low level of inventories going into the holidays. Whether this will continue depends on many factors.

The other very noticeable trend in the unemployment numbers is the marked increase in federal government employment. In January the government added 33,000 regular jobs, as well as continuing to add temporary jobs for the Census.

Federal jobs, unlike private sector jobs, are a “mixed blessing.” They are not self-sustaining. Public sector

jobs, in good times, are paid out of tax dollars. With a projected \$1.6 trillion deficit, federal jobs are paid for with borrowed money.

That means that they not only cost the full amount of the yearly salary, but 2.5% to 4.5% a year in interest going forward on each year’s borrowed salary! Such jobs not only don’t effectively reduce unemployment, but by increasing the national debt they actually contribute to taking liquidity out of the economy and creating greater unemployment.

As we can see from California’s experience, government jobs under current economic conditions are not sustainable and eventually layoffs are inevitable. In the past, government paid lower salaries and much higher retirement benefits to attract employees. Today, federal government salaries are increasing and in many instances higher than private sector salaries.

In spite of the increase of federal government salaries, no reduction in retirement benefits has occurred creating even more problems for the future. In the Roosevelt era, the federal government employed a public works type of welfare, the CCC for example,

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where the country receives the benefit of real, long term, tangible infrastructure. Apparently today, the federal government is just adding to an already bloated bureaucracy with no long term tangible infra-structure as a benefit.

The economy continued in January to lose jobs in construction, transportation, and warehousing, with manufacturing holding steady. Since the beginning of the recession we have lost more than 8.4 million jobs and the consensus view is that it may take more than 5 years to gain them back. *So is the January jobs report good news?* No.

In response to a reporter's question, the President recently said federal government spending "is stimulus." "Stimulus" to an economist has a very different meaning. See the recent [Managing For Success](#) article on what stimulates the economy and creates jobs. [Click Here to read Stimulus Article](#)

Washington is focused on recent economic indicators showing economic activity should continue to improve throughout 2010. Based on this cheery news, Washington believes increased government spending will

grow the economy and create employment gains going forward.

How Will The Two Trillion Of Tax Increases In The Budget Affect The Economy?

In the first half of 2009, our economy experienced the steepest drop in business activity since the end of World War II. In spite of the recent jobs report, 2010 has brought the hope that we have hit bottom and a "recovery" will continue to draw strength. The leading indicators have increasingly pointed to a stabilizing and strengthening of the economy for 2010.

Two important factors have coalesced to support the belief that the government should be sensitive to avoiding any action that could deflate the recovery during 2010. This is an election year with a lot of spending planned and most major tax increases timed to occur after the election. Heavy government spending in the immediate term does create, albeit

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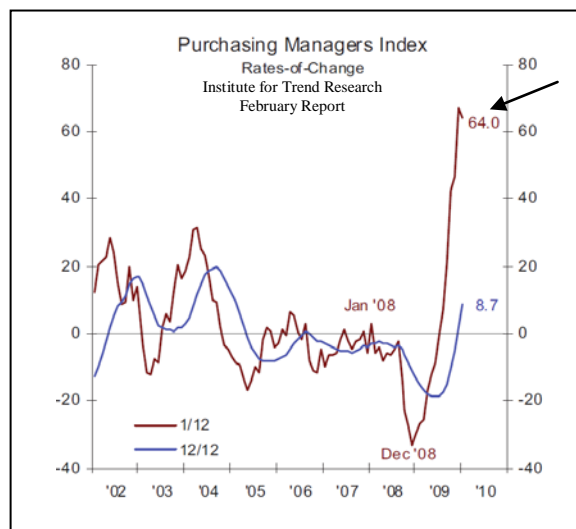
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short term, contemporary economic activity.

“One year does not a recovery make” as a wise old philosopher once said, or should have said. How you conduct your business activities during the next 12 months certainly should be influenced by what will happen to the economy in 2011. If I told you we would have another 20% drop in economic activity in 2011 with 50% unemployment, you would act far differently with respect to profits achieved in 2010, than if I said the economy would be rocketing ever higher.

So what does economic activity in 2011 look like today? The Institute for Trend Research (“ITR”), a leading forecasting firm and our strategic partner, tracks the rate of change of key indicators as part of its forecasting operations. A few days ago, ITR alerted its clients that the 1/12 rate-of-change of the Purchasing Managers Index “ticked down in January.” This was the “first negative movement” in the Purchasing Managers Index in over a year. If this negative trend continues, it’s the third leading indicator signaling a possible weakening of the economy in 2011.



For the economy to experience recovery and growth with permanent job creation and sustained economic activity a number of key factors must occur. One is a substantial increase in consumer liquidity to sustain a higher general level of consumer spending. This means that any actions which the government takes to reduce consumer liquidity will dampen economic activity. Increasing unemployment, or long term substantial unemployment, reduces this type of liquidity.

That is one reason private sector jobs creation is so important to sustained recovery. One of the biggest negatives to this form of liquidity is increased taxes. Increasing taxes reduces consumer’s (whether individuals or business entities) disposable income. **If economic activity increases**

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in 2010, will we have the consumer liquidity to resume real growth in 2011?

The new federal budget provides for more than \$2 trillion dollars in tax increases beginning in 2011. Add an upwards revised likely deficit of over \$1.6 trillion, and we are looking at taking more than \$3.6 trillion of liquidity out of the economy in 2011 from these two factors alone! There are many nuances to how and where the taxes will be raised. In the end, however, the net effect is to withdraw liquidity from the economy.

Think of it this way, a home owner sells his house in 2011 for a gain after holding it for 10 years. The capital gains tax in 2011 increased from 15% to 20%. That means that 5% more of the proceeds than in 2010 are removed from consumers' purchasing power.

It does not matter whether we are talking about business taxes or personal taxes, as taxes increase, economic liquidity decreases. Decreases in economic liquidity dampen economic activity and retard private sector job creation.

That is why the conventional wisdom is that you do not raise taxes in a

recession. The last time the U.S. imposed major tax increases in an economic downturn was the mid 1930s. It was a major cause of the decrease in economic activity and deepening depression from 1937 to 1940.

If the government is only going to raise taxes on people that make more than \$250,000 how could that impact the economy? Irrespective of such rhetoric, tax increases can adversely affect the economy in many ways impacting every person and business.

Family owned businesses, for example, contribute more than \$9.1 trillion dollars to the U. S. economy. That represents over 64% of the GDP.

Family businesses employ more than 62% of the workforce or approximately 82,000,000 people.

The majority of job growth over the last 10 years has come from businesses that are "pass through entities" for tax purposes. Many of these are family owned. Whether family owned or not, "pass through entities" report their income on the tax returns of their owners not on a separate company tax return.

Businesses, for example, finance their increasing inventories, new

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equipment purchases, increases in employment, debt principal repayment and other expansion out of after tax profits. Business profits do not mean there are funds available and unused or that the owners actually have any disposable cash in their pockets.

The owners could report \$2 million in profit on their personal tax returns, but the actual money may have been used to pay principal on the business's lines of credit or other loans, to purchase computers or hire new employees among other things. If the owner's tax increases by 10% (\$200,000 in our example), instead of the business spending the \$200,000 on principal payment for the business's lines of credit or other loans, to purchase computers or hire new employees, the \$200,000 must be passed through to the owners who pay it to the government as tax.

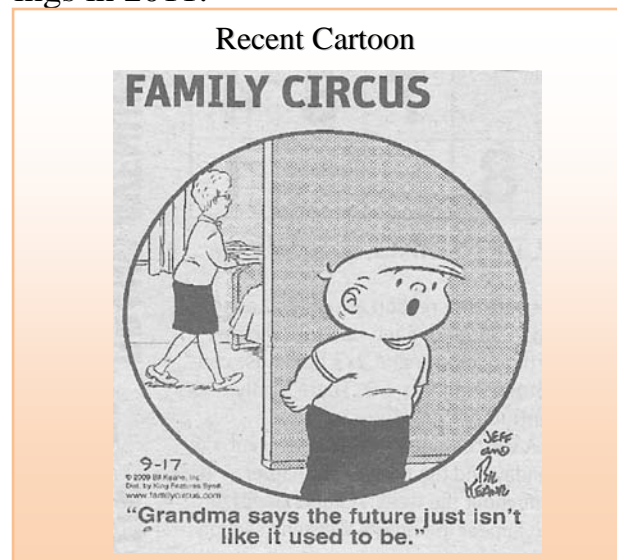
So increases in individual taxes retard employment and slow economic recovery. Increases in non-pass through entities corporate taxes have the same effect. If economic conditions prevent the corporation from passing on the tax, they must reduce

other activities to free up the money to pay the tax.

If economic conditions permit the business to increase prices and pass on the tax, then consumers pay the tax in the form of higher prices. Either way, liquidity is reduced and the economy suffers.

By continuing to run high deficits and spend on counterproductive expenditures, the federal government increases the length and depth of the economic dislocation.

The leading indicators are telling us that if business becomes convinced that 2011 will see a further deterioration of economic activity, then they cannot plan to use 2010 improved profits for real expansion. Rather, they will have to deploy any benefits gained in 2010 to prepare for bad tidings in 2011.



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THE WISE OLD OWL

The number of variables that could change how the economic cycle plays out over the next 6 to 18 months makes it impossible to predict what conditions your business will, in fact, experience. As we discussed, different portions of the economy will experience different conditions simultaneously, and each will experience changing conditions over time. Our successful clients have been working with us to develop the key action steps to be ready for each of the variables as they occur.

[See our article on 5 Scenario Planning in Managing for Success.](#)

We cannot tell if the government will adopt “Cap and Trade,” health care reform (with \$500 Billion in new taxes), a value added tax, a further 20% increase in discretionary departmental spending (more than 45% cumulative over two years), a second broad spending plan (“jobs bill”), green energy bill raising fuel costs, or other initiatives that will impact how the economy performs over the next 6 to 18 months. These and other pending actions could radically affect the size of the deficit, the amount and timing of new government borrowing, the value of the dollar, the cost of petroleum, exports, etc.

Few businesses have thought about the economic impact if Israel were to attempt to take out Iran’s nuclear capabilities and a fierce broad Middle East conflict ensued during the next 18 months. Turkey, Syria, Hezbollah, and Hamas are all pledged to come to Iran’s assistance in case of such an attack. Such a conflict could easily result in \$600 a barrel petroleum prices. The conflict may not be easily contained nor confined to the Middle East.

With all of the unpredictable possibilities over the next 6 to 18 months, is it any wonder that economist cannot tell if interest rates might rise substantially or inflation become active and wide spread? Unemployment, capital availability, and business activity could go either way. What experience has taught, is that assuming, or betting on the economy, going a single direction over the next 6 to 18 months is a real mistake.

On this 100th anniversary of the Boy Scouts, we are actively working to help our clients “be prepared,” as the Scouts say. If you would like some help in positioning your company with 5 Scenario Planning or to increasing revenues and profits as this year unfolds, give us a call.



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