



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

Newsletter

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Will Deflation And Europe's Euro Debt Crisis Cause Us To Have A Double Dip Recession?

A number of consensus economists have begun to worry that deflation in the U.S., coupled with the debt crisis now hitting Europe, will cause the U.S. to go back into recession within the next six months. The economic data does not presently support this fear.

The various leading indicators in the U.S. remain solidly positive. Seven of the eight indicators were up in May. What the economic data does signal is caution. All indications are that the "recovery" will begin to slow as the fourth quarter approaches and will continue to slow in 2011.

As business people, we often look at 8 practical indicators to see how the economy will affect us over

the next 6 to 18 months. These appear to be primarily positive. *Petroleum and natural gas* prices have been down slightly. This has increased liquidity in the general economy. *Exports* have been up, helping *manufacturing*, which has been driving the recovery. *Raw material* prices have been stable to lower, helping manufacturing.

At the same time the *strength of dollar* has remained stable, helping to fund our increasing debt. Lack of growth in the *M2 Money Supply* has helped contain inflation, but is taking liquidity out of the economy. If the Fed continues this policy it will have an increasingly negative effect on small business and the economy.

The Fed's most recent appraisal of the economy indicated that it is not strengthening as fast as it had previously expected. Based on this, the Fed has indicated that it expects to continue low interest rates. The hand maiden of low interest rates has been its recent policy of holding down the

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M2 Money Supply in order to fight inflation.

Retail sales have not responded as is normal in a recovery. They have improved in some categories, but overall are weak. The weakness in retail sales and construction signal an unstable recovery.

These factors also point toward a slowing recovery. As our newsletters have been explaining for the past 8 months, it is 2011 that is a significant danger point. A pocketed recovery experiencing erratic shifts very much puts 2011's direction in question.

Deflation and Europe's debt problem are not the real issue. We suspect the talk about deflation is intended to support the Fed's continued low interest rate policy. The real threats to the economy are far more complex.

The government's focus in severe down turns, like the great recession of 2009, should be on returning liquidity to the private sector and providing a catalyst for increasing private sector activity. Each action taken by the government should be measured by its impact on increasing liquidity in the private sector and the velocity

and turnover of dollars to drive a recovery.

Fed Chair, Bernanke recently said "My best guess is we'll have continued recovery, but it won't feel terrific." This type of talk sounds like code words for government policy is not really working. It is not working because the government does not have a coherent policy focused on increasing liquidity in the private sector and the velocity and turnover of dollars in the private sector to drive a recovery.

There are many aspects of current government actions or inactions that appear to put the recovery at risk. These include rising federal and state debt, lack of borrowable capital for small and mid-sized business enterprises, increasing taxes, high unemployment in the private sector, increasing government employment, the affects of the oil spill on the Gulf Coast economy, and political instability in the Middle East and Latin America to name a few.

The government has "bailed out" the large players in the financial segment of the economy in an effort to undo the freeze that set in at the end of 2008. However, this selective effort has not been effective. The in-

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fusion of dollars into the banking system has helped large companies.

Large companies borrow primarily through the bond market. Thus, their source of capital has returned, benefited by low interest rates. Small to mid-sized companies borrow primarily through the banking system. We think of companies with sales below \$1,000,000 to as much as \$400,000,000 as small to mid-sized.

These companies provide the lion's share of employment growth in the U.S. economy. Increased pressure by the Comptroller of the Currency and the Fed on the banks to raise capital and lending standards have made it much harder for small to mid-sized companies to borrow needed capital.

While the Fed has kept interest rates low, its regulatory pressure has kept banks from lending. Banks have used their increased liquidity to buy government debt and to rebuild capital out of the spread. As recent figures show, while bank loans have declined, the holding of federal obligations has increased.

This practice has helped finance the federal government's rapidly expanding debt. But the consequence has been a lack of liquidity in

the private sector for small and mid-size businesses. Rapidly increasing public debt at the local, state, and federal level competes with business for capital and has a negative effect on the recovery.

Just as rapidly increasing federal debt takes liquidity out of the economy, so does increasing local and state debt. Local and state governments have generally failed to reduce costs to match their falling revenue streams. Many state governments, including Illinois have continued to expand entitlements and costly programs started before the recession.

State and local government pension costs have been increasing dramatically. As a result we have seen a substantial increase in state and local government debt. Like the rapid increase in Federal debt, the increase in state and local government debt has drained borrowing capacity from small to mid-sized companies

Our Newsletters have pointed out that as taxes at all levels of government increase, it continues to drain liquidity from the economy. Currently, 2011 is shaping up to see one of the greatest increases in Federal and state taxes in the last 50 years.

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The new “Medical Reform” act has hundreds of billions in new taxes set to begin in 2011. There are hundreds of billions of other new federal business and excise taxes scheduled to begin in 2011. The expiration of the Bush tax cuts and the end of the estate tax moratorium will add billions to these.

Most economists have not focused on the impact all of these increases will have. Few have looked at things like the return of the marriage tax or the increasing impact of the alternative minimum tax beginning next year. These increases will affect many who make far less than \$200,000 per year.

There are far more billions in tax increases currently pending in Congress. One of the current economic drivers of the economy has been the leveraged buyout funds. These funds are facing major tax pressures at both ends. With taxes on capital gains set to rise substantially and taxes on fund managers and portfolio company executives possibly rising even more dramatically, we could see a major dampening of this economic activity.

Cap and Trade, again being considered by the Congress after the oil spill, represents an enormous potential tax increase for 2011. It would affect every household in the U.S., draining buying power from American consumers.

All of these taxes withdraw liquidity from the economy at a time when the private sector of the economy most needs it in order to broaden and strengthen the recovery. Normally, economists would expect broad, across the board tax cuts designed to increase private sector spending, not the opposite, dramatic increases.

When all taxpayers receive added spending power through across the board tax cuts, they buy private sector goods and services of the type that reflect continuing demand. This fuels the industries, where prior consumer demand, has already created real infrastructure. This type of increased demand creates sustainable private sector jobs at minimal cost to taxpayers.

Private sector jobs are critical because they are self sustaining and add products and services to the economy. This creates velocity of

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turnover of money and growth. It also generates more taxes.

Public sector jobs have the opposite effect. They do not pay for themselves or create products or private sector services. They can only be maintained by increasing taxes to pay salaries and benefits. They drain liquidity from the economy and hurt recoveries.

Currently, the fastest growing sector of the economy is government jobs! Today, government pay and benefits are approximately 12% higher than private sector pay and benefits. We are actually borrowing to pay for growth in government jobs, increasing their negative long term effect on the economy.

The substantial continuing increase in Federal government employment going into 2011 is a very negative factor. Just one example is the more than 150 new Federal agencies created by the Medical Reform act.

Another factor that has taken liquidity out of the economy is the continuing high level of private sector unemployment. While base unemployment fell in May to 9.7%, real unemployment hit 16.8%. This

pushed the real unemployment figure to over 26 million Americans with over 6.8 million long term unemployed.

For the economy to move from stabilizing at a low level of activity to a meaningful recovery, this must change. With unemployment at this level, the housing market will continue to experience trouble.

Two new factors are beginning to cloud 2011. The oil spill in the gulf is materially impacting economic activity in the South. To date, the relief efforts have not replaced the drain on economic activity being experienced in that region.

At the same time that this is occurring, the situation in the Middle East has continued to deteriorate. A crisis could develop at any time. Without strong American leadership in this area of the world, the many political actors there could easily miscalculate the impact of a sudden move to change the balance of power.

A destructive war or major confrontation in the Middle East is a real possibility. The world economy remains dependant on Middle East oil and disruption could affect many of

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the world's slowly recovering economies.

The seven factors just discussed represent a far more dangerous threat to our economic recovery than deflation or the Euro zone's debt problems. If the U.S. continues to expand its debt and spending at current rates, when coupled with major tax increases, the reduced liquidity in our economy could have an extremely negative effect as 2011 progresses.

Unlike the U.S., Europe appears to be realizing the need to return liquidity to the private sector. This could reduce our export trade. The possibility that 2011 could be a pivotal year with the economy experiencing new difficulties appears to increase every day.

Is China Continuing Its Attack On The U.S. Dollar?

China is a very patient country, generally taking a long term view of the world and how to achieve its objectives. While the full scope of its long term financial planning has been

little noticed, China has continued to move to replace the U.S. dollar as the primary reserve currency of world trade. Last week it took another step.

China has been pursuing a multipronged approach to replacing the U.S. dollar in world trade. The cornerstone of China's approach is to convert its world trade from dollars to Yuan. (See our [April Newsletter, "Is China On The Prowl,"](#) and our [June Newsletter, "Will The China Factor Hurt The World Economy?"](#)) To support this effort, it has carried on a campaign to convert International Monetary Fund ("IMF") "Special Drawing Rights" ("SDR") from a method of accounting between member states and the IMF, into a method for settling international transactions as a substitute for the dollar. (See our [July Newsletter, "Will China's Aggressive Monetary Policy Hurt The U.S. Economy?"](#))

China has coupled its Yuan conversion and IMF SDRs program with an aggressive global campaign of buying up raw materials such as oil and iron ore. (See our [May Newsletter, "The Global Economic Down Turn Has Continued Pushing The World Economy Deeper Into Reces-](#)

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sion”) 2010 has seen China relentlessly pursuing its multipronged strategy.

Why is this strategy a concern? China, in spite of all its efforts to modernize its economy, is still a country governed by a nondemocratic centralized government whose basic philosophy is quite alien to ours and the free world. One element that has facilitated world trade since the end of World War II is that all nations have settled their international trade transactions in U.S. dollars.

The use of the U.S. dollar has created an unprecedented increase in free trade, tremendously benefiting the world economy. Replacing the U.S. dollar will lead to protectionism and economic dislocation. For the U.S., if the dollar ceases to be the primary reserve currency, it will cause inflation here at home from those excess dollars returning and make it increasingly hard to finance our growing debt.

One primary purpose for China's approach is that it can create a two tiered system for world trade in raw materials. For example, OPEC or Brazil could sell oil to the U.S. at one price in dollars and to China at a low-

er price in Yuan. The same could be true with respect to manufactured goods.

How does this strategy work?

The IMF is due to begin a review of its Special Drawing Rights this year. (See our [July Newsletter](#), “[Will China's Aggressive Monetary Policy Hurt The U.S. Economy?](#)” for a full explanation of how SRDs' work and the coming reevaluation.) By increasing its international trade and converting its trade to Yuan, China can impact its ability to have the Yuan added as the 5th major reserve currency component of SDRs. China wants the Yuan to have a 20% weighting in valuing SDRs.

To facilitate this, China has been under valuing the Yuan and dumping cheap goods as exports into many countries in 2010. At the same time it has moved to limit importation of U.S. goods into China. This has increased its bargaining power with the IMF.

China has been promoting the idea that the U.S.'s rapidly expanding debt and stimulus program is undermining the long term value of the dollar as part of its campaign to increase the relative importance of the Yuan.

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This past week the Chinese State Council announced they intend to expand their program of settling international trade transactions in Yuan from its limited beginning last year to most of the country. Until now their program has only involved approximately

\$6.5 billion of China's \$1.1 trillion of trade.

Their announced purpose for the change is to accelerate the internationalization of the Yuan and reduce China's reliance on the dollar. China said it wants to reduce the impact of the U.S. economy on China and other countries.

Recent Cartoon



THE WISE OLD OWL

The most certain thing about the next 12 months is that no one can predict how the economy will go. Clearly, there are too many variables to predict which will have the most affect. You need to plan for which of the 5 ways the economy as a whole will turn and what that means for your segment of the economy.

That the recovery will slow in the 4th quarter appears likely today, but even that could be impacted by events. Our clients have started their planning for the next 18 months early so they can more effectively identify the break points and have alternative scenarios ready to put into action.



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