



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

# Newsletter

March 2010

## Is 2010 A Year Of Stabilization And Moderate Growth?

When we do strategic planning to build revenues and profits, we teach that each quarter you must apply the 3 basic concepts based on 5 Scenario Planning: Assess, Adjust, and Improve. *Which of the 5 possible economic recovery scenarios should you expect in 2010?*

We are now into the 3<sup>rd</sup> month of the year and top performing companies are beginning their first key revision to their operating strategy applying the Assess, Adjust, and Improve approach. Based on our strategic partner, The Institute For Trend Research's analysis for the general economy, **we appear on track for 2010 to be a year of modest growth and stability.**

As a practical matter, what that means is that generally business

should be moderately better than 2009. An example of this is that housing starts in February 2010 were 18.5% better than February 2009.

This is important because, as people move to a new house, they buy a lot of items to build it and furnish it. Housing dollars can have a multiplier effect.

We are seeing many signs of the impact of federal dollars flowing into the economy. What we are not seeing is substantial evidence of a "V" shaped recovery with rapid growth. One possibility is that the economy continues to grow modestly through 2011 and 2012.

Another possibility is that 2011 will see a double dip recession emerge. We are seeing many cautionary signs that this is a possibility. Layer over these alternatives the possibility of rising inflation and interest rates with either of these economic possibilities, and what business adjustment you should make becomes far more complex.

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In February, real unemployment rose to 17.06% with a meaningful increase in the number of persons who have been out of work for an extended period of time or have been forced to accept part time rather than full time work.

This signals that business is proceeding with caution before it adds to the work force. There are still too many factors that can go either way, to predict how the last half of 2010 and the first half of 2011 will develop. You must be ready for whichever of these conditions occurs.

## Is Inflation Under Control?

When the Labor Department released its consumer-price index recently, **The Wall Street Journal** and consensus economists exclaimed happily, “Flat Prices Bode Well For Economy.” *But was that because economists are still focused on the normal trends experienced over the last 20 years of economic expansion?*

The consumer price index rose 0.2% in January and over the past year has risen 2.6%. This should normally cause economists to worry

given the incredibly low interest rates and the amount of liquidity the Fed has pumped into the economy.

However, economists took away a quite different message because the “core” rate of inflation in fact dropped 0.1% in January. This left economists explaining that the drop didn’t signal the dreaded “deflation” and that “there is just no inflation pressure in the U.S., so our focus has to be on growth and jobs” according to the president of the New York Federal Reserve.

Controlling inflation is an important part of creating “growth and jobs.” These are not normal times, and economic news is not always what it seems.

One of our 8 economic trackers that business people use is *petroleum prices*. As we discussed in prior **Newsletters**, rising petroleum and gasoline prices are like tax hikes, siphoning discretionary income out of the economy.

The reason that core inflation fell 0.1% was that it does not include the volatile food and energy price components. The biggest reason that the inflation rate rose 0.2% was that petroleum prices are on the rise. Oil

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rose 9.3% in February to approximately \$80 per barrel or more.

Economists should be concerned with the value of the dollar and other forces that affect oil prices because the higher petroleum goes, the harder it will be to obtain growth and jobs. Moreover, oil prices are one of the primary causes of inflation.

Economists tend to focus on using monetary policy to control inflation. History teaches there are critical factors that influence inflation that cannot be controlled by monetary policy. One is oil.

In the late 1970s and early 1980s, for example, OPEC raised oil prices materially, setting off a major wave of inflation in the U.S.. Almost everything we manufacture or consume uses petroleum based plastic, paint, and chemicals, etc. When petroleum goes up, so do a wide number of critical raw materials, and with it the cost of consumer goods. Transportation of raw materials, finished goods and services, and power production are heavily dependent on petroleum products.

The result is that whenever we see meaningful increases in “energy prices” as we did in January, we need

to be concerned about the potential of inflation. This is not a form of inflation that monetary policy through raising interest rates can effectively handle.

The Fed needs to think about whether allowing the excessive level of liquidity it has been maintaining can be left in place until a petroleum driven inflation sets in. So far, neither the consensus economists, nor the Fed, seem to have thought about this issue. If they had, we wouldn’t see headlines like “Flat Prices Bode Well for Economy.”

#### *What of wholesale prices?*

The Fed should be far more concerned about the fact that Wholesale prices in January were up 1.4% month over month. **This was because energy prices rose driven by an 11.5% rise in gasoline prices.** The Fed might even think about and comment on the idea that the budget contains \$39 billion in tax increases on fossil-fuel producers. How the “recovery” will develop over the next 6 to 12 months is still a very open question.

*What is clear?* No one can tell which of the 5 scenarios the economy will take over the next 18 months. If

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you want to raise revenue and profits, good planning will count.

## What Can We Learn From Spain?

Recently the **Wall Street Journal** ran a front page article on whether Spain's economic problems will force it to abandon the Euro. Spain is one of the Euro Zone's biggest problem economies along with Greece, Portugal and Ireland.

According to the IMF's most recent data (2008), Spain is one of the 15 largest economies in the world. It represents 2.65% of world's GDP as compared to India with 2.01% of world GDP or by comparison the U.S., with 23.44% of world GDP.

**The Wall Street Journal** article looked at Spain through the eyes of the traditional Wall Street financial analyst concerned over how Spain's economy will affect its bond rating and return to positive growth.

Several years ago, Spain was pointed to as one of the shining lights of Europe, its 4<sup>th</sup> largest economy, experiencing a boom and implementing a broad program to "go green."  
*What happened to Spain?*

For one thing it lost 5 jobs for every green job it created, and with the European recession, unemployment hit 19%. Spain's housing boom, as in the U. S., became a bust, and it experienced a ballooning national debt with large budget deficits equal to as much as 11.4% of its GDP.

Wall Street worried that Spain may have to drop the Euro and return to its own currency in order to save its economy. The focus was on Spain's inability to devalue the Euro as a means to make its exports more attractive or attract tourists to its resorts. Moreover, Spain cannot unilaterally lower interest rates or print money to stimulate borrowing and spending. All of those decisions are centrally controlled for the Euro zone by Europe's major economic powers such as Germany and France.

There is much we can learn from Spain's experience. The U.S. is comprised of 50 separate states whose economies are subject to the same restraints as Spain, only we use the dollar. Each of the 50 states has a local economy that is driven by different factors.

Some are manufacturing driven, some are tourist driven, some

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service driven, etc. All are subject to the same fiscal constraints as Spain.

If we look at not only the 50 states, but also all the units of local government that comprise each state, we see all of the same problems as Spain. Large deficits. Over spending and creation of enormous entitlement programs in good times. Struggling to maintain services. Pension programs alone may bankrupt almost every state and local government in the U.S.. The required contribution to the state run pension funds for municipal employees, for the Village where I live, increased by approximately 25% for 2010.

Like Spain, the only real way for states to stimulate their economies is through tax cuts and deficits. Raising taxes just reduces long-term revenues. Like Spain, once Wall Street realizes the similarities to Spain, states may not be able to borrow to finance future deficits.

In recessions, raising taxes reduces long term revenues. Cost cutting may be unpleasant but necessary in recessionary business cycles. The comparison of Spain to California, for example, is striking. Hopefully, California won't drop the dollar.

Just as Spain is, in effect, dependant on the Euro Zone for its salvation, so too are the states increasingly dependent on the Federal government. Perhaps as many as 2 million state jobs today depend on federal funds transfers to meet their salaries. Once the funds stop, the jobs go away.

Think of the impact of unfunded healthcare mandates on states like California and Illinois. Jobs subsidies and unfunded mandates are but a few examples. *So what is Spain's lesson for the Federal government?*

Creating subsidized green jobs at the expense of fossil fuel jobs won't create economic growth. Whether it be wind mill farms or new atomic energy facilities, we have driven the manufacturing of the components out of the U.S. Until we change our policies to invite manufacturing back, all we are doing is creating jobs in foreign countries, to date, mainly China.

Our deficits are running at 10.6% of GDP compared to Spain's 11.4%. Like Spain, the U.S. over spent during good times, creating large entitlements and unfunded mandates. We are also experiencing a

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ballooning national debt. Our housing boom is now a bust.

***Can we do what Spain cannot: work our way out of the recession by printing money and devaluing our currency?*** No. Printing trillions of dollars with no GDP increase to back it up will only lead to runaway inflation and even more severe problems. Devaluing our currency would have the same effect.

Our economy, like Spain's, is running on borrowed time. Having driven manufacturing out with the rising cost of government regulation coupled with most favored nation's treatment for those countries which don't regulate, has made us import dependent. Inflation and devaluation will limit importation further, negatively affecting our economy and standard of living.

Besides living on borrowed time we are living on borrowed foreign money. As deficits increase, so too does our dependence on foreign loans. We are reaching a point where continued borrowing will narrow the opportunity to return to prosperity and limit our control over our future.

Devaluation, for example, by increasing the cost of imported raw

materials and goods reduces our economic liquidity. This in turn reduces financial resources available to the private sector. High interest rates and inflation have a similar effect. Like Spain, our true road to recovery leads through tax cuts, reduced federal spending, and debt reduction.

The Euro Zone has shied away from IMF help in responding to the Greek and Spanish meltdowns because of concern that the IMF will require greater fiscal discipline than a liberal European social system desires.

The IMF is right and for the U.S. the lesson is we must adopt the discipline of fiscal responsibility. The alternative is a reduced standard of living for everyone for the foreseeable future.

Growth and jobs come from the private sector. By continuing to spend like Spain, without limiting entitlements, there will be no real growth.

It appears that if the U.S. continues to confuse spending with stimulus and create more new entitlements, we will experience a down sized economy. That is a jobless re-

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covery followed by a further economic down turn.

Such a condition certainly is viewed as economic pain. By the same token, exercising economic responsibility and cutting federal spending and paying down the debt will also cause “economic pain.” The difference is the ultimate result. With the first the economy continues to shrink relative to our standard of living, while with the second we can resume growth and opportunity.

Which course Washington chooses will impact what your business sees over the coming months. Remember, doctors often say that with cancer there is an unexplained sudden improvement just before the lights go out.

**Recent Cartoon**

“Business is proceeding with caution before it adds to the work force”



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**THE WISE OLD OWL**

What do our **8 Key Drivers To Track The Economy** tell us?

**Petroleum Prices**

They have been rising over the past month and we expect them to continue to rise over the next 6 to 12 months. This will continue to put upward pressure on inflation over the next 12 months and reduce liquidity in the economy.

**Natural Gas Prices**

Prices are stable within a range, but some upward pressure is developing. Like petroleum, this could add inflationary pressure and reduced liquidity as 2010 progresses.

**Exports**

The global economy other than Europe has improved and this should have a positive effect on U.S. exports in the coming months, improving the U.S. manufacturing picture. One negative is the increasing hostility of nations like China, India, Brazil and Russia to the U. S.’s influence and impact throughout the world.

These countries are increasingly looking to China for economic alliances and actively working to impede U. S. imports. This could hurt U. S. manufacturing.



### **Retail Sales**

There was much excitement when the 2009 holiday sales beat the disastrous 2008 sales. However, January saw retail sales give back more than gained with spending hitting a 4 year low. February appears to indicate that we may see a mild upward trend continuing into the last quarter. Food stores and restaurants are experiencing a mild turn around.

Home improvement stores are selling more higher-priced goods and services, which reinforces what we are seeing in home construction. This should help manufacturing over the next few months.

### **Strength of the Dollar**

The troubles in the Euro Zone have been helping maintain the strength of the dollar. This has helped hold down bond prices and U. S. debt sales. China's exports drop 16.3% last month, and it is beginning to see shrinking trade surpluses, inflationary pressures, and liquidity problem with its banks and local government units.

Whether this will help the sale of the enormous amount of new Federal debt coming to market over the next 6 months is unclear.

### **M2 Money Supply**

The Fed has reduced the M2 money supply recognizing a number of monetary disconnects. If the M2 money supply continues to fall over the next 6 months, it will negatively affect the general economic recovery as 2011 approaches.

### **Industrial Production**

The economic data and a better than normal seasonal rise suggests that in spite of a month to month drop in nondefense capital goods orders, business to business sales are increasing. Nondurable consumer goods orders for the quarter ending January 2010 are up 8.9% from one year ago.

This indicates that industrial production and retail sales should continue a moderate rise over the next 6 months.

### **Raw Material Prices**

Both consumer and wholesale prices are beginning to increase. Currently inflation in 2010 is moving toward approximately 3.3%. 2011 looks like that may accelerate to approximately 6.1%. Many factors could cause those figures to double. More than ever we are stressing our action step planning.

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