



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

Newsletter

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Will The Recovery Continue To Strengthen, Driven By Manufacturing?

Normally economists explain that economic growth in the U.S. is driven 70% by consumer spending. That is because consumer spending is approximately 70% of GDP. More importantly, it is normally consumers that drive recovery from economic downturns. This recovery has been different.

We are having an “H” shaped recovery. (See the [Managing For Success](#) article on [An "H" Shaped Recovery and What It Means For You](#)) “H” shaped recoveries are inherently unstable and this recovery has been driven by manufacturing in its early stages not by strong renewed consumer spending.

The monthly data for U.S. Industrial Production in March came in 4% higher than one year ago. This is the highest point in 14 months. When we look only at manufacturing, year-over-year, March was 5.1% higher than last year.

Two factors drove this growth, improvement in the world economy and strong government spending. The Institute For Trend Research (“ITR”), noted that, “we think the global recovery will continue but there are certainly going to be some anxious months/quarters ahead for Europe.” China’s economy is overheating and this could cause problems in Asia.

Deficit spending will put increasing pressure on U. S. government spending in the months ahead. That said, *the recovery is real and should continue to gain strength.* As manufacturing adds jobs, consumers who have jobs will help to maintain the modest recovery we are experiencing.

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The ITR believes that, “the European business cycle is trending upward *** with the leading indicators and industrial production numbers looking good in most countries (of the major economies, the UK, [Spain,] and Italy are of concern).”

In the U.S., housing starts in the first quarter of 2010 were 17.4% higher than the same quarter in 2009. This is the strongest first quarter year-over-year rise since 1951.

Single family housing starts finished the first quarter of 2010 up 46% year over year for the strongest quarterly growth in nearly 18 years. Non defense capital goods New Orders are 10.2% above the same quarter last year. Even consumer spending on durable goods was up 4.4% year over year.

It is business to business sales and production that is currently leading us out of the recession. Inventories are rising and government spending is fueling growth in manufacturing. It is unlikely that 2010 will see the recovery end.

Business is investing in plant and equipment with technology a big component. But the real questions are, is “recovery” just another term

for stability at a slightly improved level, what will 2011 see, and which of the 5 alternative economic scenarios will emerge as 2010 progresses?

What Is Threatening The Economy?

We asked the question, “*What Is Threatening The Economy?*” rather than, “What is threatening the recovery?” because those are different concepts. To an economist, the “recovery” will continue as long as GDP continues to increase, even at a 3.5% rate.

The economy and your business could be severely and negatively impacted, if GDP grew, but sustained unemployment, inflation and interest rates increased dramatically. As business people, we view real recovery as a return to normal levels of employment fueling general prosperity in which our expanding sales create greater real *after tax* profits.

As the economy continues to strengthen in 2010, will unemployment drop back to the normal 5% Level? The April unemployment figures gave confusing indications in many directions about the future of

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the economy. Unemployment rose to 9.9% with over 195,000 hopeful applicants returning to the job hunt. Based on this, some economists saw the rise to 9.9% unemployment from 9.7% as a positive sign.

Of course, some economists muse that the 195,000 hopeful applicants returned because their savings are running out and they must seek employment to survive even at a reduced standard of living. This is a far less upbeat view of an “H” shaped recovery. Even Wal Mart now questions the strength of the recovery.

The fact that manufacturing is driving the recovery was highlighted by a 44,000 gain in manufacturing jobs for April. Durable and non-durable goods contributed 31,000 of those jobs.

In reality this still left 17.4% real unemployment or **26.9 million Americans without work**. The number of long term unemployed rose by 9.84% with over 44% of the unemployed out of work for more than 27 weeks. With such a substantial number of long term unemployed exhausting their resources, it cannot help but have a negative impact on what “recovery” means for the economy.

Even if the recovery continues to create jobs at an increasing rate, as the government projects, it will take more than five years to restore unemployment to reasonable levels.

With an “H” shaped recovery, retail sales are increasing based on the half of the economy that is stabilizing. Failure of retail sales to rebound in absolute terms to drive a strong recovery is very much a function of the high level of continuing long term unemployed and failure to provide real stimulus. (See ***Managing For Success*** article on **Why Is “Stimulus” A Key Component To A Dynamic Recovery?**)

It is like trying to accelerate a V-8 sports car with almost 30% of your spark plugs gummed up! High long term unemployment also drives loan defaults and mortgage foreclosure rates.

In April retail sales were soft with same store sales rising only 0.5%. This did little to restore the 2.7% drop experienced in 2009.

In a normal “V” shaped recovery, consumer optimism and faith that things are on the upswing help to unleash broad pent up demand, job creation and business growth. In this “H”

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shaped recovery the lack of these emotional factors is slowing the recovery.

Even with business stabilizing and picking up, there is a lot of tentative hesitation based on fear that any one of a number of factors may derail a real recovery. With 26.9 million people still unemployed, there obviously are a substantial number of people detracting from consumer and business confidence.

Among the concerns troubling business are increased taxes and inflation. The new “stimulus” package just introduced in Congress contains more than 50 billion in new taxes on business. These would be added to the numerous new taxes that already are scheduled to begin going into effect in 2011. Small businesses which provide much of the employment have continued to have trouble accessing capital.

As the economy continues to strengthen in 2010 will inflation and interest rates threaten the economy?

The Wall Street Journal reflected many economists joy with the headline: “Inflation at 44-Year Low.” However, this does not reflect the

many changes occurring just below the inflationary surface.

The Producer Price Index has begun to rise substantially. This has been driven by increases in raw material costs such as steel, aluminum, and industrial chemicals. The Producer Price Index is a 6% higher than it was in March 2009.

Presently, a variety of factors have kept this dramatic rise from impacting the consumer price index. Economists project Consumer Prices to rise only about 3% in 2010. The melt down in Greece and its implication for Europe, along with high U.S. unemployment have checked most consumer prices for now.

Petroleum prices have hovered at \$70 per barrel recently pushing down gasoline prices. While this restrains consumer prices temporarily it will not last indefinitely. This has also acted like an offsetting tax reduction for consumers, materially helping current retail sales numbers.

The ITR projects that inflation may begin to overshoot the “historically normal levels” by 2011. Businesses need to start strategic planning for this possibility now, if they are to avoid the consequences.

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The hand maiden of inflation is interest rates. Economists continue to express great concern over the unprecedented growth of the federal debt. This could lead to significant inflationary difficulties next year and beyond.

Interest rates have been kept low by the Federal Reserve. The Greek meltdown and the drop in the value of the Euro have caused a flight to the U.S. dollar and purchase of U.S. Treasuries, keeping long term rates lower than otherwise would be the case. Mortgage rates have dropped, and this is helping housing.

Largely unnoticed has been the Fed's restraining the growth of the M2 money supply to control inflation. It has been essentially flat for the last five months. As the federal debt grows and higher taxes begin, this will begin restricting economic growth as 2011 approaches.

If the Fed continues to hold the M2 money supply constant, it will put in question the viability of the recovery beyond 2010. The Fed may face a choice between growth and substantial inflation. While single family housing starts are up, there has been little discussion of the fact that multi

unit housing starts were down 44.6% year over year.

The main growth in single family units has been in homes below \$350,000. Government figures show there are more than two million vacant homes for sale in the U.S., about double the historical level.

The Fed holds a substantial portfolio of mortgage backed securities. At present more than half of the Fed's assets, backing the value of the dollar, are in Mortgage backed securities. As it stops buying these, and if interest rates climb as 2011 approaches, the housing market could suffer.

The last quarter of 2010 and 2011 are shaping up to be more interesting than any business would like to see. The tea leaves are not consistent. Mortgage rates are falling, the tax credit for buying a new home has expired, costs and taxes are rising, many things can cut in either direction. While the European problems have strengthened the U.S. dollar, our states are facing a growing fiscal crisis of their own. As 2011 approaches this will add great complexity to our economic worries.

Uncertainty continues to be a certainty.

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Listening To The Latest Economic News



THE WISE OLD OWL

Compared to the steep slump of last year the economy should show respectable percentage gains each month for the rest of 2010. As we have said in the past, that does not equal a return to pre-recession prosperity. Of even more concern from a business planning perspective is that there are so many variables that could derail the recovery and the economy. In a normal recovery, this is the time that businesses start training programs to prepare for better times, where possible, negotiate long-term leases and union contract changes that help their recovery, develop and start marketing and advertising programs that increase their brand penetration, expand their supplier lists and commitments, and make capital expenditures to prepare for coming market expansion, among other things. But with different economic sectors in different stages of recovery and with so many variables, predicting your business' situation 6 to 18 months from now is increasingly difficult. We are doing a great deal more customized 5 scenario planning focused on each client's specific business situation. If you would like to explore how 5 scenario planning and custom focused action steps could help you, please contact us.



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