



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

# Newsletter

August 2011

## Is The World Headed For A Major Structural Dislocation And Another Recession?

In recent weeks the U.S. stock market has experienced a dramatic level of instability with multiple swings of more than 400 points followed by a period of ups and downs. The last time the U.S. stock market experienced this level of rapid dramatic swings was in 1929, shortly before the crash and great depression.

Economists tend to think that the current swings are the result of the conflicted views of where the economy is headed. Is the world about to slip into an even worse recession than in 2008? The market was betting on

substantially improving earnings as with a normal real recovery and thus growing price earnings ratios.

Another recession would change all of that. Uncertainty means analysts cannot predict whether earnings and profits will increase or decrease in inflation adjusted dollars.

*So are we headed toward another recession?* The underlying economic data has not fundamentally changed. We are still at the point where, as we have been reporting, the economy has hit bottom and is limping along, improving only slightly. The latest U.S. leading indicators continue to support this view.

The real question is whether the government's actions will be driven by political considerations, or by reality based economics which would restore free market economic stability and create growth and jobs. The debt ceiling compromise process made it appear that the government has turned

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away from problem solving to political campaigning a year before one would have expected, given that the next national election is not until November of 2012. To many, this means anything could happen, but the least likely is the application of reality based economics.

**Whether the world continues to recover or sink into another recession depends upon the three dominant world economies comprising 37% of the world's GDP:**

1. The United States with 23%;
2. China, with 9%; and
3. Germany, with 5%.

Moreover, U.S. trade supplies essentially 20% of the GDP of most other countries. The state of our economy is very important to a healthy world economy.

*How is the U.S. affecting the world economy?* If we are slipping into a new recession, then it will impact the world economy. Just in the last several weeks the U.S. economic data confirmed several trends we have been discussing. Gasoline prices remain 30% higher than a year ago. This acts like a major tax increase,

taking liquidity out of the economy. Inflation is on the rise. Producer prices are 7.2% ahead of last year.

The general inflation rate is not much higher only because housing is losing value bringing it down. In this sense, the low over-all inflation rate represents a real negative. Housing prices have continued to be depressed. The Commerce Department recently reported another 0.7% drop in the sales of single-family homes.

Unemployment has not improved and more than 24 million people remain essentially out of work with many more having given up looking for jobs. We are not creating enough new jobs to handle those entering the work force, let alone those who have lost their jobs. Multiple segments of the economy have had major employers announce plans to lay off thousands of workers in the coming months.

The Fed, by announcing that they expect to leave interest rates low for the next two years, has continued to hurt the overall economic recovery. By maintaining artificially low rates, the Fed undermines the value of the

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dollar, increasing raw material costs, driving investment dollar overseas, and reducing the liquidity of fixed income consumers.

The little economic growth the economy has been experiencing has come from exports and a slight increase in consumer spending. Both of those supports are now under pressure. One disturbing trend that has resulted from the drop in the value of the dollar is the substantial increase in the imbalance between export and imports.

In reality the instability in the U.S. dollar is hurting international trade and world economic recovery. The government has ignored the critical role the dollar plays in international trade. After World War II, gold no longer was capable of providing adequate quantities of the precious metal to be the medium of exchange for world trade.

There needed to be a medium of exchange whose value was stable and accepted by all countries to replace gold. The dollar provided that medium with a valuation mechanism that all countries could use.

Initially, after World War II the dollar was backed by gold. The number of available dollars which was much greater than the gold supply permitted world trade to expand.

With the exponential growth of world trade it became impractical for the dollar to be backed by the scarce gold supply, and instead its value was based upon the U.S. GDP. Under this mechanism each country's GDP was used to establish a value ratio with the U.S. dollar, and the dollar could be used as the common denominator to conduct world trade. In reality the laws of supply and demand set the ratios.

At the time the U.S. was the world's leading manufacturer and the demand for our goods and services meant all nations could verify and use the value of the dollar. The value of the dollar was reinforced by the fact that the dollar was accepted by all nations as the medium of exchange.

In effect, the dollar became an important commodity in itself. This created a market segment for U.S. treasury obligations as a means for other nations' central banks to earn a

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return on the commodity (the dollars) they were holding to enable them to conduct world trade. This was an even more economically efficient medium than gold.

The long term stability of the U.S. dollar became an important factor in permitting and stabilizing world trade. One of the Fed's main functions was to maintain this stability by managing the quantity of dollars based on U.S. GDP growth and economic stability.

This function required a firm grasp of reality based economics and the impact of various monetary tools available to the Fed. It also required a fundamental understanding of the U.S. position in world trade and the impact that being the dominant economy in the world had on each country's economy.

Because of the importance of world trade to the US. economy, from the birth of our country to the present, grasping the significance of this factor is very important to the health of the U.S. economy. In the past two years the government, including the Fed, has lost focus on this fundamental.

Thus, implementing policies that are focused solely on our domestic short term political objectives can have a very negative effect on our long term interests. This loss of focus has coincided with China pursuing a policy aimed at materially changing the role of the dollar in world trade and tilting international trade toward building its own domestic economy.

Unless the government, including the Fed, shifts to a greater focus on reality based economics, the next 6 to 18 months will see the U.S. economy headed into much rougher seas. While the economic data indicates the U.S. economy will continue to limp though improving growth, the data is weak and any one of a number of storm clouds could change our direction.

*Are the economies of China and Germany pushing the world toward another recession?* This month the German economy began to slow materially. Germany and France are the two main economic engines in Europe. The continuing deterioration of Euro zone economies in Ireland, Portugal, Italy, Spain, and Greece (the

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“Euro zone troubled economies”) are affecting the ability of Germany and France to maintain growth and stability in the Euro zone.

Much of Europe is heavily overburdened with the cost of social programs (entitlements). The demographics of the number of people in Europe productively employed as compared to the high cost of entitlements to support the nonproductive portion of the population is so great the European economy can no longer carry the burden.

Unless Euro zone troubled economies take substantial additional steps to bring entitlements under control and reduce their debt, Germany and France will find their economies increasingly slowing. This will affect U.S. exports.

Germany and France have, like the U.S., increasingly found their exports and manufacturing sectors being hurt by China’s monetary policy. The manipulation and under valuing of the Yuan has increasingly hurt the exports of India, U.S., Germany, and France.

Even with the advantage of a very favorable trade balance, China’s

economy has begun to overheat in several key respects. China has spent far too much on military expansion at a time when it is not necessary for its security, starving its private sector.

By holding interest rates low, China has been creating economic bubbles and driving investment into nonproductive assets such as real estate speculation.

The Fed policies driving capital from the U.S. to China has partially delayed the consequences of this. Further, the spending of U.S. stimulus dollars to buy Chinese manufactured goods has also partially delayed the consequences. Even the new Martin Luther King memorial was “made in China!”

However, all of these factors are beginning to create instability. This means like Europe the economic cycle in China is beginning to change.

We now face an economic situation in which the three main world economic blocks, China, Europe, and the U.S. are all simultaneously facing changing economic cycles which limit their options.

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There are fundamental economic disconnects occurring in all three key economic blocks. At the same time nationalism and unrest are sweeping the globe. To avoid stagflation the U.S. needs to change direction.

## **Did President Kennedy Have The Right Answer To Creating Growth And Recovery?**

Our attention has been heavily focused domestically, and on election politics. In the long run, world events will have a real impact on our economy and liberty.

There is an increasing tension in the U.S. between short run pain and solutions and long run revitalization of our free market system and return to real economic growth and prosperity.

What is required now are U. S. government policies that incorporate an understanding of the world situa-

tion and its impact on the U.S.. Policies that may cause short run pain are required to achieve longer run change.

The role of the states in our economy is very much like the role of Euro zone troubled economies in the European economy. Like Euro zone troubled economies, for example, California and Illinois do not have their own currency.

If the burdens the federal government places on our states and the states' own entitlement programs drive them bankrupt, like Europe, our economy will suffer long run fundamental damage. Only through reform of our approach to these issues can we achieve a return to growth.

Currently, state and federal revenues are at an all-time high. By the state and federal government reducing their spending to current revenue levels, investment capital can be freed up to invest in the private sector.

Reduced regulation and interference in the private sector would permit the laws of supply and demand to determine the most productive use of that capital and begin a growth process. It is only through an increase

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in consumer liquidity, that growth can be returned.

What is required is a coordinated effort at the federal level to pursue policies that encourage investment dollars to stay in the U.S. to modernize our manufacturing sector. This includes a thorough reform of our tax code.

It is a myth that the tax burden has been reduced on upper income tax payers since the Reagan years. The Federal government shifted many of the responsibilities and costs of government programs to the states over the years.

To meet this increased burden, State and local governments have materially increased their taxes. This has resulted in those who pay taxes paying a greater percentage of their income in total tax dollars to state, local, and federal governments than when Reagan was president. This has now caused a real reduction in the liquidity of our economy.

A change in policy no doubt would create short term pain. In the long run it would create more dollars available to reduce our debt and stabi-

lize the economy. It should not be a political debate. John F. Kennedy, who like Reagan, brought the U.S. out of a similar recession explained the need at the federal level to change these policies, including reducing taxes, quite well.

John F. Kennedy said:

“In today's economy, fiscal prudence and responsibility call for tax reduction even if it temporarily enlarges the federal deficit – why reducing taxes is the best way open to us to increase revenues.”

“It is a paradoxical truth that tax rates are too high and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now. Cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus.”

“Lower rates of taxation will stimulate economic activity and so raise the levels of personal and corporate income as to yield within a few years an increased – not a

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reduced – flow of revenues to the federal government.”

***“It is no contradiction – the most important single thing we can do to stimulate investment in today's economy is to raise consumption by major reduction of individual income tax rates.”***

“Our tax system still siphons out of the private economy too large a share of personal and business purchasing power and reduces the incentive for risk, investment and effort – thereby aborting our recoveries and stifling our national growth rate.”

“A tax cut means higher family income and higher business profits and a balanced federal budget. Every taxpayer and his family will have more money left over after taxes for a new car, a new home, new conveniences, education and investment. Every businessman can keep a higher percentage of his profits in his cash register or put it to work expanding or improving his business, and as the national income grows,

the federal government will ultimately end up with more revenues.”

“Present tax laws [and as we have explained other government policies] may be stimulating in undue amounts the flow of American capital to the industrial countries abroad \*\*\*.”

**“Our present tax system \*\*\* exerts too heavy a drag on growth \*\*\*. It reduces the financial incentives for personal effort, investment, and risk-taking \*\*\*. The present tax load \*\*\* distorts economic judgments and channels an undue amount of energy into efforts to avoid tax liabilities.”**

“The present tax codes \*\*\* inhibit the mobility and formation of capital, add complexities and inequities which undermine the morale of the taxpayer, and make tax avoidance rather than market factors a prime consideration in too many economic decisions.”

“In short, \*\*\* the soundest way to raise the revenues in the long run is to cut the rates now. The experience of a number of \*\*\* countries \*\*\* have borne this out. This country's own experience with tax reduction \*\*\* has borne this out. And the reason is that only full employment can bal-

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ance the budget, and tax reduction can pave the way to that employment. The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus.”

“The largest single barrier to full employment of our manpower and resources and to a higher rate of economic growth is the unrealistically heavy drag of federal income taxes on private purchasing power, initiative and incentive.”

“Expansion and modernization of the nation's productive plant is essential to accelerate economic growth and to improve the international competitive position of American industry \*\*\*. An early stimulus to business investment will promote recovery and increase employment.”

“We must start now to provide additional stimulus to the modernization of American industrial plants \*\*\*. I shall propose to the Congress a new tax incentive for businesses to expand their normal investment in plant and equipment.”

“A bill will be presented to the Congress \*\*\*. ***It will include an across-the-board, top-to-bottom***

***cut in both corporate and personal income taxes. It will include long-needed tax reform that logic and equity demand*** \*\*\* The billions of dollars this bill will place in the hands of the consumer and our businessmen will have both immediate and permanent benefits to our economy.

Every dollar released from taxation that is spent or invested will help create a new job and a new salary. And these new jobs and new salaries can create other jobs and other salaries and more customers and more growth for an expanding American economy.”

“Next year's tax bill should reduce personal as well as corporate income taxes, for those in the lower brackets, who are certain to spend their additional take-home pay, and for those in the middle and upper brackets, who can thereby be encouraged to undertake additional efforts and enabled to invest more capital \*\*\*. I am confident that the enactment of the right bill next year will in due course increase our gross national product by several times the amount of taxes actually cut.”

As we have said, a total overhaul of the current federal tax code, lowering

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all brackets, would achieve the same effect today. These were the policies that created “V” shaped recoveries in 1921, 1960, and 1980.

The current policies didn’t work in 1932 and they haven’t worked now.

## THE WISE OLD OWL

Today the economic cycle could move toward stagflation or growth. As the new economic cycle that we are entering develops, it could trend in any one of five scenarios.

Not knowing the direction governmental policy will take over the next six months, how the current economic cycle will develop is not predictable. If spending is cut, taxes reduced, negative business regulations eliminated, the economy will strengthen. If the government does nothing, we will continue to drift.

There are over 1.5 trillion in new taxes currently scheduled to take effect over the next several years. Increasingly these and other costly regulatory changes currently in process will cause the economy to lose liquidity. Absent a major turnaround in the unemployment picture liquidity will be further reduced.

We have the highest long term unemployment rate since the Great Depression. The consequences of this continuing will structurally damage the ability for housing and other sectors of the economy to recover.

Depending on how the cycle affects your sector of the economy, the steps your business should take may be very different. What is certain is that your strategic plan for the next six months needs more than one set of action steps, so you can adjust to the rapidly changing conditions. We have seen many businesses go from optimism about 2011 to seeing demand dropping unexpectedly. In many instances, optimism changed to margin compression and uncertainty.

Our clients who planned for these changing scenarios are doing well and have been able to rapidly adjust to the changing moods of the market place, shifting marketing, branding and production operations to meet the challenges. We can help you meet the future as well.



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