



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

Newsletter

February 2011

Are We Heading Toward Another Recession In 2013?

In our recent **Newsletters** we have discussed the fact that the technical expansion that started with the end of the recession was slowing. We have also discussed that while its velocity was diminishing, we expected the expansionary trend to continue as it slowed into 2012. ([Click Here to see our December **Newsletter** Article, "Is The Conflicting Economic Data Confusing Or Really Consistent?"](#))

The U. S. leading indicators currently appear to reinforce our expectation. They are up in January 2011, 0.1% over December 2010 and 4.4% above January 2010. This is the most aggressive rise since we emerged from the recession in the early 1980s.

The major factors driving the current rise in the leading indicators are the interest rate spread, supplier

deliveries, stock prices, consumer expectations and new orders. Based on these factors, many consensus economists and the administration see the current policies as working and the country as headed in the right direction.

Expansion certainly is better than contraction, but not all expansions are created equal. Sustained *broad based* recoveries with *healthy underlying fundamentals*, as in the early 1960s and 1980s, reduce deficits and build meaningful broad based employment and prosperity.

But is that what we have here? The rate of change data for the U. S. leading indicators since March 2010 tells a very different story. The rate of change data currently shows the steepest decline in the last 25 years! In this recovery, different segments of the economy are experiencing the recovery in different degrees or not at all.

The data indicates, that depending on government policy, the general

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economy could go in either direction over the next 2 years. From a business point of view, the dilemma is one of short run verses long run. That means what we see for the rest of 2011 may not be the trend prevailing by the end of 2012. Our strategic partner, the Institute for Trend Research (“ITR”) is beginning to see signs that the economy may slow materially by 2013.

The problem is that the administration and Fed looks at what should be done in terms of short run economic impact, rather than long run, strong economic growth. Both the administration and the Fed appear to not be cognizant of how our domestic policies impact international economic conditions.

What about this recovery is so different from 1960 or 1980? This was not a “V” shaped recovery. Rather, we had a steep decline followed by a leveling out at a much reduced level of activity. Those businesses that could survive or grow at that level of reduced activity began a slow, mild recovery.

That is why some segments or businesses didn’t recover. The housing market is an example. This type

of recovery is inherently unstable. That means that there are a number of key economic components that are restraining the growth of a meaningful recovery.

We see the effect of this in the reports on critical areas such as housing, unemployment, inflation, long term government bond rates, and petroleum prices. What actions the administration or the Fed takes affect each of these areas and thereby the greater economy.

By examining each of these critical areas and the government’s approach, we can see why economists should be questioning whether we will have growth, recession, or even a depression as 2013 progresses. The answer depends on what the government does over the next two years.

What is inflation telling us? As economists try to determine if we are headed toward stagflation, one of the biggest unknowns is inflation. Our **Newsletters** have been discussing for many months the strong inflationary pressures in raw materials, food, and petroleum. ([Click here to see our January Newsletter Article, “Will Inflation Be A Problem Over The Next Six Months?”](#)) Consensus

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economists are now beginning to recognize that inflationary pressure is here now, but not what it really means.

Hyper inflation usually arrives in three interrelated phases. First is inflation in speculative commodities such as copper. Copper is currently up more than 240%. The second phase is when we begin to see it in long term government bond yields and oil prices. We are now seeing inflation arrive there as well. Phase three is when we begin to see inflation reflected in the CPI.

The Labor Department's most recent figures show that over the last 12 months, the food index has risen 1.8% with the cost of food at home up 2.1%. The cost of food at home posted its largest increase in over two years, with all six major grocery store food groups rising.

At the same time, energy costs have increased 7.3% over the last 12 months, with gasoline up 13.4% (pre-mid-east crisis). These figures reflect a strong upward trend in petroleum products and food costs.

Consensus economists and the government tend to discount these disturbing trends claiming that the

falling or stable price of services will keep inflation under control. They argue this difference distinguishes the U. S. from China, Europe, and emerging markets, where inflation is a real growing problem. Where others, such as China, are addressing the problem of inflation with monetary and other restraints, the U. S. is not.

Our government has discounted the problem based on low inflation in service costs and it justifies the failure to act by arguing that persistently high unemployment, the slow recovery, and the weak housing market will offset rising food and fuel costs keeping inflation low! Fed Chairperson, Ben Bernanke, for example, "is betting that rising prices for goods like gas and food will not spread into the broader economy." Bernanke said, "Inflation made here in the U.S. is very, very low."

The Fed uses these low inflation concepts (services and slow recovery) to justify low short term interest rates and quantitative easing (printing \$600 Billion to buy U. S. Treasury bonds). The idea that low service sector inflation will prevent broad based real inflation is misguided at best.

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The more food, especially food at home, gasoline, natural gas, heating oil and other petroleum product costs go up, the less disposable income people have to spend on other goods and services. One reason the service industry cannot pass on higher costs and must suffer reduced margins is that consumers have less disposable income to buy services! This reduces the demand for services.

Thus, low inflation in service costs at a time of high inflation in food, etc. merely reflects how much real inflation is retarding the recovery. The more spent on necessities, the less demand for other goods and services.

The chronically long term unemployed have little or no income so inflation in food costs, especially food at home, gasoline, natural gas, and heating oil, decreases their disposable income and ability to survive. How do you buy services if you don't even have money to buy food?

The impact is that this takes liquidity out of the economy. It affects people living on a fixed income the same way. Thus, the Fed's current policy of pumping dollars into the economy and keeping short term in-

terest rates low, causes inflation, reduces liquidity, drives investment overseas, and has contributed to slowing the recovery. It is counterproductive and out of date economics. ([Click here to see our November Newsletter Article, "Is Fed Chair Bernanke's Defense Of Quantitative Easing Believable?"](#))

If this kind of policy is continued over the next two years, it could be a major contributor to another recession or even depression. The longer the policy is continued, the greater the dislocation of the free market economy will be, and the harder it will be to create a sustained broad based recovery.

By continuing its policy, the Fed will eliminate lowering interest rates and putting liquidity into the economy as an effective tool in a future downturn. It is errors like that which turn recessions into depressions.

The Fed's policy, when coupled with government over spending and increasing debt, impacts housing, unemployment, long term government bond rates, and petroleum prices, among others. If we keep this up, we may be able to convert stagfla-

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tion in 2013 or 2014 into a real depression.

The current budget debates are far more than just politics. It our future that they are talking about.

Will the Rising National Debt Cause A Recession In 2013 or 2014?

Increasing consumer demand for goods and services and thereby private sector employment is a critical factor for broadening the current recovery. If inflation is held in check and consumers' disposable income increases, then history demonstrates consumer demand for goods and services will increase. This type of increase would help create private sector employment and improve the housing market - two areas much in need of a boost in the current economy.

This process increases liquidity in the economy. By contrast, as the national debt increases, the government's borrowing takes liquidity out of the economy. Similarly, when the government increases taxes, it re-

moves liquidity from the economy. Each of these, under current circumstances drive investment overseas.

That is why the rule of thumb is that the government should not increase taxes to pay debt or interest or to maintain or increase the level of government spending during a recession or even during a slow recovery.

At this stage of a fragile recovery, it is important to put money in the pockets of individuals so that they can, through the free market system, buy the goods and services that will create private sector jobs. Normally this is done by a combination of reducing taxes, government spending, and debt.

If government acts promptly when the country is going into recession, the reduction in taxes increases the deficit, but then primes the recovery minimizing loss of private sector jobs. By controlling government spending during the early stages of the recession the size of the deficit is moderated. The recession causes interest rates to come down helping to control the size of the deficit, including lowering interest rates and holding down federal borrowing costs.

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As the country comes out of recession, tax revenues increase and reduced government spending and debt reduction fuel an accelerating growth rate. However, in this recession the government did not follow this time tested methodology for creating a recovery.

By coupling bail outs with unfocused major spending and continuing to dramatically increase the yearly deficit and national debt, the government has increased the risk of destroying the recovery by withdrawing substantial liquidity from the economy. Add to this increasing taxes and the effect is compounded. Add inflation in the cost of necessities such as, food, gasoline, heating oil, and electricity, and the effect is magnified.

Thus the question: is our national debt a growing problem and will it cause a recession by 2013? The GDP for calendar year 2010 was estimated at approximately \$14.9 trillion dollars. The White House estimated the deficit for 2010 at \$1.5 to \$1.6 trillion dollars. Our 2010 deficit represented approximately 10.9% of GDP. Compare that to Germany, whose deficit was approximately 3.4% of its GDP.

In Europe only Greece, Ireland and Spain had higher deficit percentages than us. If actual GDP is revised to be less, then the impact is even greater.

Our cumulative national debt ratio is even more disproportionate than our deficit ratio. As of this week, our national debt reached over \$14,171,295,000,000. Our national debt has risen to 95% of our GDP!

Ireland's 2010 national debt to GDP ratio, as it began a desperate effort to achieve a Euro zone bail out, was 94.2%. The U. S. is at a tipping point. The Congressional Budget Office ("CBO") has conservatively predicted, based on Congress' pre-midterm actions, that by 2015 our National Debt will exceed \$18.2 trillion.

If the U.S. continues to increase its national debt at the current pace by 2015 our debt will exceed \$22 Trillion dollars! Taking that amount of dollars out of the economy's liquidity will have an extremely negative effect.

During fiscal 2010, which ended on September 30 of last year, the government paid \$414 billion dollars in interest on our debt. The average interest rate on the national debt

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during that period was 3.326%. If we take the conservative CBO debt projection for 2015 at the fiscal year average 2010 interest rates, the government would pay \$608 billion dollars in interest in 2015 or \$190 billion more in interest than in 2010.

If the national debt increased at the current rate and applying the 2010 average interest rate, the government would be required to pay \$742 billion dollars in interest in 2015. Since the government projects we will still be in deficit spending in 2015, that means the government will have to borrow the \$742 billion during that year in order to pay the interest on the debt alone. That represents a stunning liquidity reduction for the 2015 economy.

Can we put this interest cost in perspective? \$742 billion dollars is \$78.3 billion more than last year's budget for the Department of Defense. It is \$163 billion more than last year's budget for all of the other meaningful departments of the federal government combined (Department of Health and Human Services, Department of Transportation, Department of Veterans Affairs, Department of State and Other International Pro-

grams, Department of Housing and Urban Development, Department of Education, Department of Homeland Security, Department of Energy, Department of Agriculture, Department of Justice, National Aeronautics and Space Administration, Department of Commerce, Department of Labor, Department of the Treasury, Department of the Interior, Environmental Protection Agency, Social Security Administration, National Science Foundation, Corps of Engineers, National Infrastructure Bank, Corporation for National and Community Service, Small Business Administration, and the General Services Administration).

There is little doubt that interest rates are going up. Assuming the national debt does not increase at all, each 1/2 point rise in interest rates will cost the government \$71 billion dollar in increased interest payments each year. That is \$19.3 billion dollars more than the budget for the Department of State and our other International programs combined. It is \$24.3 billion more than the budget for the Department of Education.

If the deficit continues to grow and interest rates go up over the next

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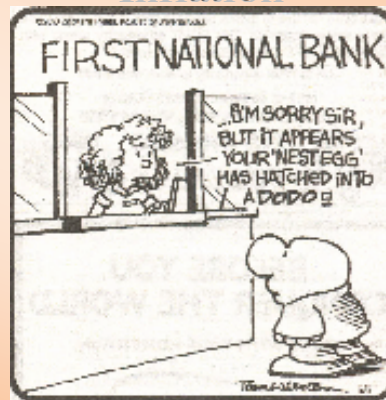
two years the amount of liquidity removed from the economy between 2013 and 2015 could push us back into another recession or worse. While it could slow the recovery in the short run, Congress needs to lead a substantial reduction in spending designed to bring our spending into balance with our revenues and over time begin to reduce the national debt.

new tax increases to preserve economic liquidity. More importantly across the board tax reduction is needed to stimulate growth by increasing liquidity. If these things begin to occur during 2011 we should see a return to growth in constant dollars. If we see continued spending increases and substantial growth in the deficit, then a new recession may just be around the corner.

The Congress also needs to block any

Inflation

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Your planning over the next 6 months to a year may be quite different depending on how the economy goes through 2012 and beyond. If we will continue to grow, then you can make certain capital investments and expand your permanent labor force knowing those resources will be needed over the next 5 years. But would that capital and human expansion make sense if the economy only hovered along at its current substantially reduced level and then took another substantial drop in demand in 2013?

Supposed 2013-2014 turned into a depression? What should you do now to prepare for it? Suppose late 2011 and 2012 saw a major bout with severe Stagflation? Would you prepare differently today for hyper inflation or severe Stagflation? Each segment of the economy will experience these cycles differently. We can help you plan what you need to do now to be ready for where your business is going.



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