



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

Newsletter

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Will Inflation Be A Problem Over The Next Six Months?

The U.S. consumer price index is not configured today to give an accurate picture of how inflation will affect the economy. The core price index figures, for example, exclude petroleum and several other costs that can profoundly affect the economy. The basic government index shows consumer price inflation remains subdued, with a year-over-year rise of only 1.7% in the CPI this month.

The continued recession in housing has not only been a real drag on economic recovery, but helped to keep the CPI index's rise very low. However, people, especially today, do not buy new homes every year. *So what affects consumer buying power and demand?*

Petroleum prices and food costs are two primary drivers. Petroleum is experiencing a major price rise. Oil

prices ended the year above \$91 per barrel for the first time in over two years. Most economists predict that petroleum will be over \$100 a barrel by the end of 2011. This represents about a 16% higher cost for petroleum in 2011 than in 2010.

Increasing demand in China and the developing countries, coupled with the cheaper U.S. dollar, caused by quantitative easing, will continue to drive oil higher. Increased oil prices have two major effects.

The higher cost of petroleum products causes inflation by raising raw material and transportation costs across the board. It also reduces liquidity in the economy by reducing discretionary disposable income and spending.

The Producer Price Index has begun to accelerate, up 4.2% from last year. Higher commodities prices are eroding margins and forcing manufacturers to begin passing these costs down stream.

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At the same time, food costs are experiencing a major period of inflation. Beef, fish, poultry, grain, and dairy prices have risen dramatically.

The extension of the Bush tax brackets did not reduce taxes. The small social security tax cuts included in the compromise legislation will do little to offset the increases in oil and food prices. More is needed to get the private sector back on track.

Accelerating inflation is becoming a global issue. The EU, China, Brazil, Argentina, South Korea, Australia, Russia, and other nations are all beginning to address real concerns about stabilizing prices.

While inflation does not appear to be a major problem in the U. S. during the first half of 2011, pressure is clearly building. Continued quantitative easing coupled with inflation, higher long term interest costs to the government, and increasing spending all look like we are creating potential new disconnects as 2011 progresses.

What policies the government adopts over the next six months will have a major impact on how the economy will behave as we approach 2012.

Will Manufacturing Continue To Lead The Recovery In 2011?

The leading indicators point to an acceleration of the recovery in early 2011, followed by a slowing continuing recovery through the rest of 2011. *Is the recovery going to accelerate and take off into 2012?* No. The U.S. appears to be mired in a slow, steady, defuse recovery which may slow as 2011 progresses.

Unfortunately, for those who are unemployed or just entering the work force, this is a classic “H” shaped recovery. That means that various sectors of the economy will experience different levels of recovery or no real recovery at all. Those with jobs and businesses that have adjusted to the new lower level of demand for goods and services will increasingly see a mild continuing recovery and growth through 2011.

Retail sales improved in December with the employed feeling more secure and willing to spend more. High-end shoppers showed a

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45% increase in purchases over last year. Sales of items like electronics, jewelry and apparel increased tenfold over last December.

Over the past 12 months, domestic demand relative to supply has grown faster than inventories. This coupled with the continuing international recovery and the cheaper U. S. dollar is helping exports. For these reasons manufacturing will continue to lead the recovery during the next six months.

Several factors are confining the scope of the recovery. As we discussed in previous Newsletters, 2011 promises a number of major federal tax increases including about a half billion in new taxes under the new healthcare law. In addition, many state and local governments are planning major tax increases.

In Illinois, for example, the state income tax was raised for individuals from 3% to 5% and for businesses from 4.8% to 7%. These types of tax increases tend to drive manufacturing and investment away. In addition to the state income tax, Illinois has a separate state personal property replacement tax on corporate profits. A manufacturing operation in

Illinois now faces an effective tax rate, including the 2.5% replacement tax, of 44.75% as compared to a less than 16% rate in Canada.

Property taxes are also climbing in most states. Continued high unemployment is perhaps the single most pressing current problem. Excessive government spending and debt coupled with inflation issues round out the key problems going forward. The next six months should clarify where these are going. For now, slow but steady recovery seems to be what the next 6 months hold.

Will It Take 5 to 6 Years For Unemployment To Improve?

In 1937 there were many businesses that had adjusted to the reduced rate of spending and high unemployment rate. These were making profits, while most of America suffered. Economists have historically attributed the lack of a broad recovery to the government adopting counterproductive policies that inhibited a

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free market economy from making the needed adjustments.

These policies included extraordinarily high government deficit spending over a prolonged period coupled with increasing taxes. This led to increasing government jobs, while stifling private sector job creation. These government actions created a lack of real liquidity in the private sector economy and restricted demand for goods and services in that part of the economy where infrastructure already existed to create private sector jobs.

Today, long term unemployment is greater and has lasted longer than in any recession since the great depression. The most recent figures showed that the decline in unemployment in December from November of 9.8% to 9.4% was caused by discouraged people who stopped looking for jobs.

Real unemployment is still over 16.86% or 26 million Americans. Given how the government counts the unemployed, this underestimates the true figure, because it does not include those who have been unemployed for so long that they have totally stopped looking for work.

The economy is creating less than 1/3 of the jobs necessary to employ new workers coming into the market place for the first time or to reemploy those who have lost their jobs over the past two years. Today, the economy is only creating about 100,000 jobs a month. To really improve the situation the economy needs to create approximately 350,000 new jobs a month.

Temporary help services continued to grow in December, adding 495,000 jobs since December 2009. Manufacturing only added 10,000 new jobs while the average work week declined to only 40.2 hours. Converting temporary help to permanent production jobs is important.

It is conservatively estimated it could take 5 years to reduce unemployment to a "normal" level. Many economists suggest it could, at this pace, take as many as 10 years for that to happen!

Unless the government turns its attention to seriously adopting policies that help the private sector start creating jobs, the economy will face even more serious problems over the next 5 years.

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Recent Cartoon

FRANK & ERNEST



THE WISE OLD OWL

Much more than normal, 2011 is a year in which what the government, including the Fed, does will impact how the various segments of the economy develop. The wrong moves could set the stage for hyperinflation and stagnation. To support the economy, federal spending must be brought under control and the deficit strongly addressed.

Only through improving the environment for private sector jobs and increased consumer spending can unemployment be addressed. Creating meaningful private sector job growth is essential to stemming the mortgage crisis, stabilizing housing and construction, and fostering increased demand for domestic goods and services.

The federal government must act to restore the position of the dollar in international trade, to stabilize raw material and petroleum prices, and increase investment back into the United States. The government must confront China's aggressive moves to undermine the U. S. economy, especially our domestic manufacturing and exports.

For your business, you need to focus on the action steps necessary to adjust to the rapidly changing economic conditions that may storm across your industry over the next six months depending on what course the government takes. In Illinois, we face an especially difficult period as the effect of an extraordinary tax increase combined with the complete failure to address runaway spending to date, endangers the solvency of the state and local governments throughout Illinois.

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