



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

# Newsletter

May 2011

## Is The Economy On Track For Increasing Growth Through 2011?

Economic data during the last two months has been mixed in its implications. Careful analysis has indicated that in the short run, 2011-2012, the economy should continue to see accelerating growth.

The main driver has been manufacturing. The confusion in the data appears to be caused by the implications for 2013. If conditions continue to develop in accordance with current trends, the second half of 2013 is where we see problems developing.

The Fed's policies have kept current long term interest rates low, increasing the upside potential for industrial product during the 2009-2014 economic cycle. As interest rates rise

for federal and corporate debt, it will likely have a substantial impact on the next major economic cycle.

Economists are now beginning to focus on when and what this will be. They are forecasting the next recession to be in mid-2013 and 2014. For your planning for the next 6 to 18 months, it is likely that the current growth will accelerate, providing important opportunities.

The recent unemployment reports support the potential acceleration in the economy. The lack of data showing any acceleration in velocity of money suggests the Federal Reserve will indulge in keeping interest rates low for at least the next 6 months, contributing to the expansion.

While the M2 money supply is 1.4% higher than a year ago, inflation over the past several months has kept the real money supply constant. When the Fed ends its quantitative easing in June, it will put upward pressure on interest rates and hopeful-

**Annual subscriptions** to our **Newsletter** are \$250.

**Put Our Experience To Work For You**

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: [www.LRLevin.com](http://www.LRLevin.com) ■ [LLevin@LRLevin.com](mailto:LLevin@LRLevin.com)

© Copyright 2011, L. R. Levin Consulting, L.L.C.. All Rights Reserved.



# Newsletter

May 2011

ly take pressure off the dollar's weakening trend.

With industrial production beginning to lose momentum, it is unlikely the Fed's extraordinarily accommodative monetary policy will end in the short term as the Fed tries to offset this trend. The problem is that the Fed will need to balance its expansive monetary policy with inflation which is beginning to accelerate.

Some economists now see a risk that the Fed will maintain low rates into 2012. Continuing artificial low rates will hurt the dollar while restraining long term rates. If this happens, the Fed will run substantial inflationary risks. As you plan, you need to watch this carefully.

Generally, there are three legs to the economic stool that supports a strong economy: manufacturing, housing, and consumer spending. While manufacturing has continued to recover, housing has not. It is at near depression levels.

Housing starts for the first quarter of 2011 were 9.9% below the depressed levels for the same period

last year. Housing starts are projected to decline through the summer.

The sale of new homes over the past 12 months was only 306,000 units, down 76.2% from their all-time peak in December 2005. Foreclosed properties have severely depressed housing prices, hindering the sales of new homes.

The economy has moved demand toward multi-unit housing. Multi-unit housing starts for the past 12 months are up 36.7%. In the first quarter of 2011, they were up 55.5% above the previous year.

This has not given much support for the recovery given other trends. If your operations depend on the housing sector, you need to take into account that, even with some improvement in 2012, this sector will remain weak during this cycle going into the 2013 down turn.

The third leg, retail sales, has been showing mild improvement. The temporary reduction in payroll taxes has helped offset the increases in gas prices. Retail sales should continue to show modest increases for the next 6 months and into 2012.

---

Put Our Experience To Work For You

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: [www.LRLevin.com](http://www.LRLevin.com) ■ [LLevin@LRLevin.com](mailto:LLevin@LRLevin.com)

© Copyright 2011, L. R. Levin Consulting, L.L.C. All Rights Reserved.



# Newsletter

May 2011

Factors like various tax increases and inflation will affect retail sales clouding the strength of the recovery. A drop in gas prices would help.

If your operations relate to retail sales, the coming change in transaction fees and inflation are important to your margins. Watch developments carefully to plan the next 18 months to position yourself for the coming of the next cycle.

## Will The National Debt Tank The Recovery?

As Congress returns to work, we are careening toward the National Debt limit without any clear understanding of what Congress should do next. We are hearing many political arguments whether or how the Congress should increase the National Debt limit. It is not clear whether what we are seeing is good politics or even good theater. It certainly is not good economics.

Many economists believe that the rapid increase in the National Debt coupled with poorly focused massive spending has blunted the recovery and is beginning to negatively affect the world economy. ***Does the U. S. have a real National Debt problem?***

The National Debt has now reached more than \$14,268,000,000,000. Our annual budget deficit currently exceeds 10% of our gross domestic product (GDP) and our total deficit is in excess of 91% of our GDP.

These facts alone may not answer the question, does the U. S. have a real National Debt problem? Other major countries have experienced similar annual deficits as a percentage of GDP coming out of the great recession:

US	10.6
UK	10.4%
France	7.0%
Canada	5.5%
Australia	4.6%
Germany	3.3%

Put Our Experience To Work For You

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: [www.LRLevin.com](http://www.LRLevin.com) ■ [LLevin@LRLevin.com](mailto:LLevin@LRLevin.com)

© Copyright 2011, L. R. Levin Consulting, L.L.C.. All Rights Reserved.



# Newsletter

May 2011

We are on the high end of major developed countries when it comes to total deficit as a percentage of GDP:

Japan	220.3%
US	91.6%
Canada	84%
France	81.8%
Germany	80%
UK	77.2%
Brazil	66.1%
Spain	60.1%
Norway	54.3%

Focusing on the national debt percentages without putting them in context is a little like trying to gauge the speed of the world's fastest train from a still picture. Historically, as illustrated by Japan, when a country's total debt as a percentage of GDP exceeds 100% it is a clear sign of stagnation. Japan has experienced 20 years of poor growth.

When developed countries experience a major recession, their debt as a percentage of GDP can increase substantially as part of the steps taken to create the conditions for a recovery.

To gauge the meaning of a rapid increase of the national debt, economists look at factors like where the economy is in the economic cycle and the trajectory for reducing the temporary rise in the various debt ratios.

The developed countries whose debt ratio are in the 80% range have seen increasing growth in this phase of the economic cycle, but are pursuing a delicate policy balance to control the impact of their national debt. Germany is experiencing real growth and through spending controls has reduced its debt ratio as a percentage of GDP to a manageable 3.3%.

Careful examination of the data shows that it is not the mere percentages, but the circumstances that determine whether higher ratios such as 10% annual deficits and 90% total deficits spell trouble. Substantial sustained growth is a key indicator.

*What do our circumstances tell us about the significance of our high debt to GDP ratio?* We have had an unusually rapid run up of our debt over the past 2 years. At the same time, we have until now avoided the sovereign debt crisis that is plaguing

---

Put Our Experience To Work For You

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: [www.LRLevin.com](http://www.LRLevin.com) ■ [LLevin@LRLevin.com](mailto:LLevin@LRLevin.com)

© Copyright 2011, L. R. Levin Consulting, L.L.C. All Rights Reserved.



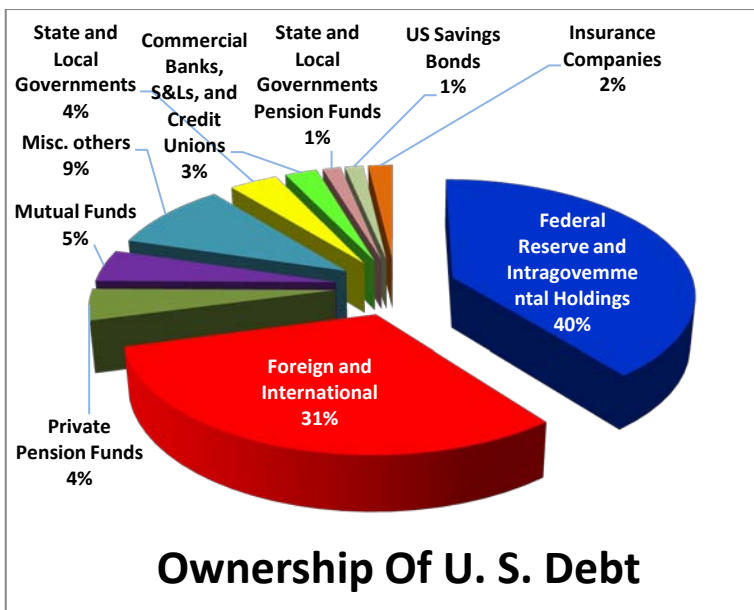
# Newsletter

May 2011

countries like Greece and Spain. However, our GDP growth rate has fallen to 1.8%.

It is very important to look at how much interest the U. S. has to pay on our debt, who owns our debt, and what effect these factors will have in the short run and longer run on our economy and standard of living.

### *Who owns the U. S. debt?*



Approximately 31% of our national debt is owned by foreign countries. Another 40% is owned by U. S. governmental entities. These are the two largest holders, with the rest widely spread among many other smaller domestic categories such as

private pension funds and state governments (4% each).

Can the U. S. continue to sell its growing national debt at reasonably low interest rates? Foreign ownership of our debt has increased by more than 8% in the last two years to more than \$4.25 trillion dollars. The major holders of this debt are China, Japan, United Kingdom, the oil producing states, Brazil, Russia, and India.

All of these holders have warned the U. S. about their concern with our rapidly increasing deficits. China, the oil producing states, Brazil, Russia and India have taken steps to permit them to reduce their holding of U. S. debt. They have increased their purchases of gold as a reserve for trading, and moved to purchase IMF drawing rights denominated securities rather than U.S. debt.

The two largest holders are China and Japan. Japan, because of its recent earthquake and tsunami, must now begin using its reserves to rebuild its economy. This may require it to reduce or eliminate its ability to buy our increasing debt and even

**Put Our Experience To Work For You**

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: [www.LRLevin.com](http://www.LRLevin.com) ■ [LLevin@LRLevin.com](mailto:LLevin@LRLevin.com)

© Copyright 2011, L. R. Levin Consulting, L.L.C. All Rights Reserved.



# Newsletter

May 2011

force it to begin reducing its total holding of U. S. debt as its current holdings mature.

China has embarked on a broad program to permit it to materially reduce its holdings of U. S. debt. It has said it wants to decrease its holds of U. S. debt by 2/3. China is creating mechanisms for other countries to trade its currency and to buy interest bearing Yuan denominated debt for their reserves and to conduct trade with China in Yuan instead of dollars.

China is moving, with U. S. help, to make the Yuan a reserve currency. It is also promoting the use of IMF drawing rights as a major medium of international trade.

The clear indications are that this shift by major foreign debt holders away from supporting our debt may continue and intensify during the coming year. This is especially true if our debt levels continue to increase at their current rate and are funded, as they have been lately, by devalued dollars. The oil producing states are working with China to establish alternative means to the U. S. dollar to buy oil. The oil producing states such as

Iran are working to establish a two tier system for pricing oil. This would permit them to price oil at a higher price to the U. S. than to China or Europe.

As the international need for the dollar as a means for conducting trade diminishes, it reduces the demand for dollar denominated debt as a means to earn interest on trading reserves. All of this makes it increasingly difficult to sell our debt.

A weaker dollar coupled with the move away from the dollar will have two important effects. It will drive the interest rate on our debt up in order for the U. S. to continue selling it and it will drive capital overseas, driving up interest rates generally for investment here.

The U. S. has been funding with primarily short term obligations, keeping rates low. On the up side, this will accelerate the cost of the debt as rates rise.

Every quarter percent increase in interest rates cost the U. S. \$35.6 billion dollars a year in added interest. With continuing deficits, we must raise this by either borrowing more

---

Put Our Experience To Work For You

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: [www.LRLevin.com](http://www.LRLevin.com) ■ [LLevin@LRLevin.com](mailto:LLevin@LRLevin.com)

© Copyright 2011, L. R. Levin Consulting, L.L.C. All Rights Reserved.



# Newsletter

May 2011

money or raising taxes. Either of these will negatively affect our growth rate and the economy.

The largest holder of U. S. debt are federal entities such as the Fed. As part of quantitative easing, since November of 2010, the Fed has purchased 85% of all new government debt sold by the treasury. The Fed's massive purchases of our debt in April drove the 10-year government bond yield down 15 basis points to 3.32 percent.

Without this Fed support, yields will rise. Beginning around mid-June, the U. S. must find another purchaser for approximately \$1 trillion per year of our debt!

Moreover, as banks begin to lend more to business, they will also reduce their purchasing of our debt. U. S. banking institutions currently hold 3% of our debt or \$337,500,000. By keeping interbank borrowing rates low, the Fed has encouraged banking institutions to borrow from the Fed and buy our debt.

As the Fed raises rates, this will also cause banking institutions to reduce buying federal debt. This will

add pressure on the cost of selling our debt. Coupled with increasing interest rates abroad, this also hurts the value of the dollar and puts pressure on our national debt rates.

Politicians have for years treated having federal entities such as the Social Security Administration buy our debt as meaningless, since we owed the debt to ourselves. That is now coming home to roost. We no longer collect enough social security tax, for example, to currently cover the expense of these programs. The Social Security Administration, in order to cover their costs, will have to reduce their holding of federal debt.

The only way for the government to pay this debt is to borrow more money or raise taxes. This then withdraws liquidity from the economy and has a negative effect on interest rates and economic activity.

The only way for the government to reduce the debt and increase revenue is through growing the GDP. History teaches that no matter what the tax rate, government revenues stabilize at about 8% of GDP. What this illustrates is the need for the gov-

---

Put Our Experience To Work For You

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: [www.LRLevin.com](http://www.LRLevin.com) ■ [LLevin@LRLevin.com](mailto:LLevin@LRLevin.com)

© Copyright 2011, L. R. Levin Consulting, L.L.C. All Rights Reserved.



# Newsletter

May 2011



ernment to take the steps necessary to stimulate real inflation adjusted GDP growth.

Historically, this point in the economic cycle requires lowering tax rates and reducing federal spending to the point where the government can reduce the deficit going forward. In the short run, the economy is continuing to

improve. It is the longer term impact that the current debt ceiling increase negotiations will most impact.

We are at the tipping point for the future. The choices the government makes now, will affect the nation's standard of living and economic strength going forward.

## Recent Cartoon

### FRANK & ERNEST



## THE WISE OLD OWL

With an economy that is approaching a general acceleration while many segments are still experiencing differing conditions, it is always hard to plan. When we are coming off deep lows, it is even harder. When the picture is one where it is expected that in 24 months we will face a possible new cycle with a recession, it gets even harder.

If you add the potential for stagflation into the mix it becomes even more confusing. But that appears to be where we are in this cycle.

Since each segment in the economy is facing a different set of conditions with different timing, we have been helping our clients plan to take maximum advantage by helping them analyze the unique circumstances that apply to their situation, and develop focused marketing and production strategies. Call us to help you take advantage of your opportunities.



Put Our Experience To Work For You

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: www.LRLevin.com ■ LLevin@LRLevin.com

© Copyright 2011, L. R. Levin Consulting, L.L.C. All Rights Reserved.