

Hello CFG Clients . . . Brian here. My family and I are in Huntsville, Alabama visiting family. On Monday, we are headed to Atlanta, Georgia to visit more family and then on Wednesday onward to West Palm Beach, Florida to spend Christmas with more family. We absolutely love to visit family in this manner because just about the time we've visited and caught up with conversations of years past, it's time to depart and move on to the next phase of the trip.

This weeks' email is a borrowed article from John Mauldin, an investment author who writes from a historical and economic perspective. He lays out a great piece here that helps to tie together the year we've had and where we may be going in the coming year. I hope you enjoy the read . . .

## **THOUGHTS ON THE STATISTICAL RECOVERY**

By John Mauldin

We are clearly starting to get some better data points here and there. But as I pointed out this summer, it is going to be a recovery in the statistics and not in the things that count, such as income and employment. This week we look at the nascent recovery (which could be at 3% this quarter) and try to peer out into the future to see what it means. We look at how recoveries come about, and why I am concerned that we will see a double-dip recession.

### **Thoughts on the Statistical Recovery**

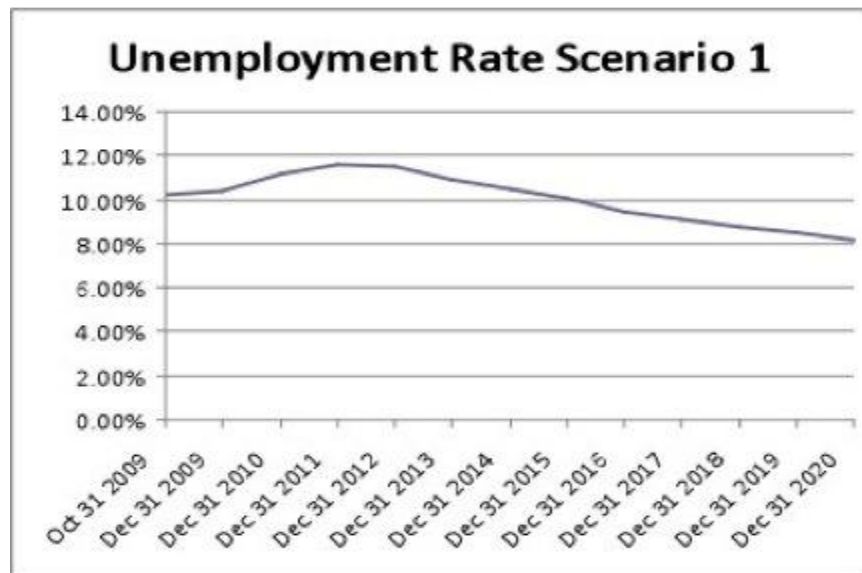
In the '50s through the early '80s, recessions were typified by large layoffs at manufacturing businesses, as they had built up too much inventory. Businesses had increased capacity and often borrowed a little too much. Rising prices in the '70s, along with extremely high interest-rate costs, led to the two severe recessions of the early '80s, which Paul Volcker had to essentially force into existence, in order to begin the process of wringing inflation out of the economy.

But, and this is important, as the economy improved, inventories were eventually worked through and employees were brought back to work. Things returned to normal. The economy would once again grow at a robust rate. Then, in the last two recessions, in the early '90s and early '00s, it took longer for employment to rise. A great part of this was because the manufacturing sector of national employment was becoming an ever smaller part of the economic pie. We were, and still are, turning into an economy driven by services.

I should note that, on an absolute basis, manufacturing in the US has grown (going back to before this recession started.) We just produced more "stuff" with fewer employees. We became more productive. But this means that there are fewer jobs that will be brought "back" to make up for increasing sales than in past recessions. There are estimates out that as many as 2 million of the 8 million jobs lost are permanent job losses.

We know that businesses have made large cuts in numbers of employees in order to address lower sales and to increase their profits. Increasing profits by cutting costs even as the "top-line" sales number is shrinking is not a growth strategy that can be sustained. It also eats into research and development and postpones growth.

How likely are businesses to bring back employees if they have found they can produce more with less? This is a prescription for the mother of all jobless recoveries. A few weeks back, I went into some detail outlining why employment is likely to be uncomfortably high for a number of years, and that assumes we do not go back into recession. The graph below is the most likely scenario. You can see the entire piece, which goes into detail on this and other scenarios (developed with Mike Shedlock), by [clicking here](#).



Quoting from that letter: "In August, I did an interview with CNBC from Leen's Fishing Lodge in Maine (<http://www.cnbc.com/id/15840232?video=1207956774&play=1>). The unemployment numbers had just come out. I did a back-of-the-napkin estimate that we would need about 15 million new jobs over the next five years just to get back to where we were when the recession started." It rather startled some of the hosts - "Where can we get that many jobs?"

Again, quoting from that letter: "That works out to a need for about 125,000 new jobs each month to handle new workers coming into the market (which comes to a total of 7.5 million over five years), plus the 8 million and rising jobs we've lost. That is a daunting number. It amounts to 250,000 new jobs a month every month for five years."

As it turns out, Princeton Professor Paul Krugman agrees. He writes in today's *New York Times* (<http://krugman.blogs.nytimes.com/>): "I don't think many people grasp just how much job creation we need to climb out of the hole we're in. You can't just look at the eight million jobs that America has lost since the recession began, because the nation needs to keep adding jobs - more than 100,000 a month - to keep up with a growing population. And that means that we need really big job gains, month after month, if we want to see America return to anything that feels like full employment. How big? My back of the envelope calculation says that we need to add around 18 million jobs over the next five years, or 300,000 a month. This puts last week's employment report, which showed job losses of "only" 11,000 in November, in perspective. It was basically a terrible report, which was reported as good news only because we've been down so long that it looks like up to the financial press." That just goes to show you that I am an optimist. His back-of-the-napkin number is 20% larger. He is probably right, as he has a Nobel Prize and I don't, and I didn't actually use a napkin. I did the math in my head on camera while we were getting ready to go fishing.

Krugman uses this to suggest the Fed should double their balance sheet by another \$2 trillion (seriously). That would not be very helpful to the dollar, I would think. (Aside: we are in a balance-sheet recession. We overleveraged our banks and consumers. Now they are having to retrench. We are watching consumer and business loans fall. Putting \$2 trillion more into the system is not going to make consumers want to borrow more. I can't quite see where you deal with the problem of too much leverage by trying to create more leverage somewhere else. But that's a topic for another day.)

And just to demonstrate that I am not being too pessimistic, you can go to a study the Bureau of Labor Statistics put out yesterday. They estimate that the economy will create 15.3 million more jobs in the next ten years, which is an average of about 1.5 million a year, or 125,000 a month. That is not

a robust number, and suggests that the continued high unemployment projected in the graph above may not be far off target, as the employment assumptions are not that dissimilar. If you have no social life, you can read it yourself at <http://www.bls.gov/news.release/ecopro.nr0.htm>.

## Lies, Darn Lies, and Government Statistics

We are going to look at the unemployment numbers of last week, along with the unemployment claims that came out yesterday. But first, I want to quote a section from Dennis Gartman's letter this morning. It illustrates why we have to be very careful how we use government data. Too often, we think the data is straightforward math and simply draws on the underlying data sources. The reality is that it is anything but. To wit:

**"A PROBLEM AT THE VERY HEART OF DATA GATHERING:** Recently in Washington a rather large number of economists from academia and from government met to try to hash out a problem with data gathering that has become more and more serious here in the US and has more and more distorted how we value the American economy itself. At heart is how imports into the US are accounted for. "For example, when a part for perhaps \$100 is imported from China and is used in an American automobile ... something that happens more and more and more often these days ... the stats show that the finished car is American-made because it was assembled here in the US and in the process the US GDP is raised by that same \$100 when in fact it should have been deflated by that figure instead. In the process, American workers who might in the past have made the part in question are no longer doing so and are obviously made redundant, hence a job or jobs is lost.

"The unemployment data then 'finds' that unemployed worker and accounts for him or her, but the car that is assembled does not, and when it is produced and sold and its value makes its way through the system, it appears that productivity has risen ... and rather dramatically so, when in fact it has not. As one of the economists attending that meeting said, " *'We don't have the data collection structure to capture what is happening in a real-time way, or what is being traded and how it is affecting workers. We have no idea how to measure the occupations being 'offshored' or what is being 'inshore.'*

"Or as the Assistant Commissioner for International Prices at the US Bureau of Labor Statistics (and how "politburo-like" is a title like that?!!) Mr. William Alterman, said regarding this problem " *'What we are measuring as productivity gains may in fact be nothing more than changes in trade instead.'*

"This is not an insignificant problem, for as the US has become more and more international in its trading scope the data has become more and more important. Back in the 1975, imports into the US were only 5% of our total economic activity, but in recent years that has swelled to 12%, excluding imports of energy. Thus, many imports into the US are being, and have been, and will continue to be, valued as though they were manufactured here in the US, when indeed they were manufactured abroad and merely assembled here in the US.

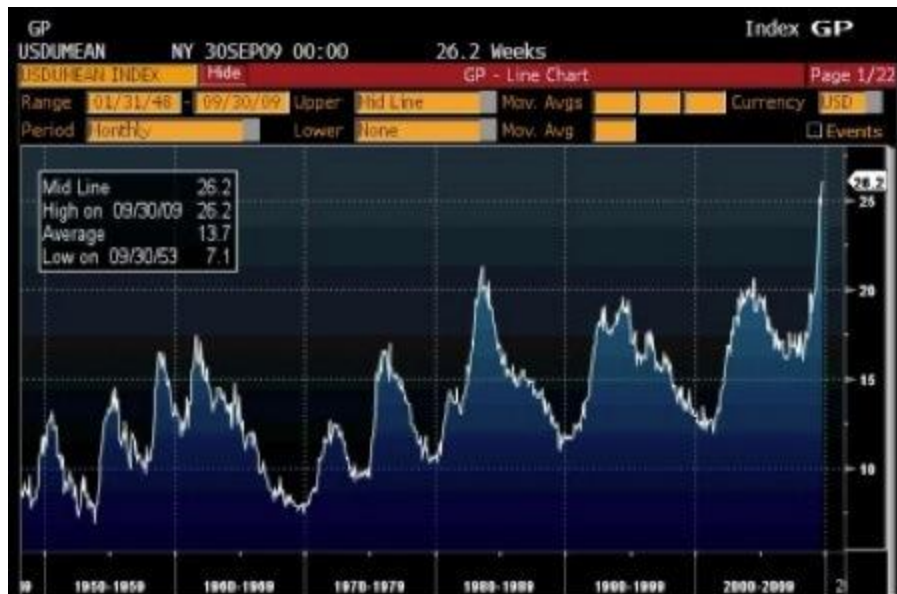
"In autos, in computers, in appliances, this is a large and growing problem, but this is a problem too in the areas of services. For example, when an accounting firm out-sources some of its number-crunching to an accounting firm in India, for example, and then bills a client here in the US in US dollar terms, the work is done abroad but billed here and the work is recorded as having been done in the US, adding to US GDP when clearly that is not the case. It happens too, these days, more and more often in medicine, when patient files are sent to India or somewhere else abroad for diagnosis and the patient is billed here in the US as if the 'work' had been done here. GDP rises here in the US when it really should have been accounted for in India; productivity goes up; GDP goes up, when in reality neither has happened. 'Tis a conundrum."

## The Problem of Seasonal Adjustments

Yesterday we were told that initial unemployment claims were up slightly to 474,000 on a seasonally adjusted basis. That is down 78,000 from the same week last year. The four-week moving average is almost exactly the same. On a four-week-average basis, initial claims are down about 10% from last year. Let's look under the hood. The non-seasonally adjusted number (NSA) is 665,000, down almost 95,000 from last year, which is good, but still a very large number. The actual average had been over 550,000 for the last three weeks.

Everywhere the headlines said continuing claims are plunging. And they did. But what really happened is that the drop was not from people getting jobs but from people rolling over to the extended benefits programs. The states by and large pay for the first 26 weeks, and that is where we get the continuing-claim reported number from. (In some parts of the US however, you can get unemployment insurance for up to 99 months, paid for by the federal government.

There are 5.16 million on the continuing-claim rolls. But when you add in the extended benefits rolls, it increases to over 10 million. Average length of unemployment is now over 26 weeks, and the median length is over 33 weeks!



It was reported that the unemployment rate dropped to 10% from 10.2%. To get that number, they had to shrink the number of people looking for work by 98,000. Basically, if you have not looked for work in the last four weeks, you are said to be "discouraged" and are taken out of the unemployment statistics. If you add back in the discouraged workers, the rate goes up to 10.5%. And it is worse than that. If you have not looked for a job in 12 months, you are taken off the rolls altogether.

Here is one of the reasons that the unemployment number is going to remain stubbornly high through 2010. Let's assume a modest recovery of 3%, which is maybe enough to get jobs back into the 150,000 range. As people go back to work, that 0.5% of discouraged workers starts to look for jobs and they are now counted as unemployed. That small number of 0.5% is 750,000 people that will be (should be) added back into the unemployment numbers! Let's use Krugman's 100,000 jobs a month needed to keep up with population growth. (Studies are all over the place on this. 100,000 is the low estimate and 150,000 is the high.) That means we need 1.2 million new jobs next year just to keep the unemployment rate at 10%. And another 750,000 jobs to go to the discouraged workers who will

want to start looking. Close to 2 million jobs will be needed to keep the unemployment rate from rising. And the current business climate says that is not going to happen.

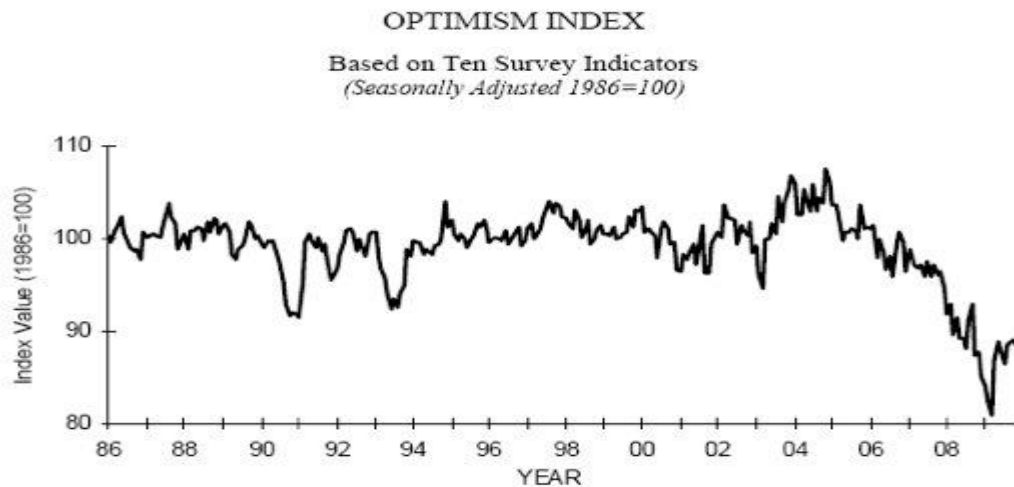
## The Job Creation Engine

Small businesses employ 85% (or thereabouts) of American workers. That is always where the employment growth comes from. So when we see the ISM surveys, which are mainly of large businesses, that suggest they may start employing more people in the next few months, we need to see how their smaller brethren are doing. Fortunately, we have a very reliable survey by the National Federation of Independent Businesses, which does a lengthy monthly survey to give us the temperature in the small-business world. You can review it at <http://www.nfib.com/Portals/0/PDF/sbet/SBET200912.pdf>. (My friend and Maine fishing buddy Bill Dunkelberg puts out the report.)

It is a mixed bag, as some of the scores of questions in the survey indicate that small businesses are feeling better than a year ago. On the whole, though, they are not very upbeat. 72% of small businesses say their earnings are down over the last three months, and that has been the case for over a year. The most important reason for lower earnings is listed as poor sales volume. Sales expectations, however, are much better than earlier this year, with almost half of those surveyed thinking things will get better.

### OVERVIEW - SMALL BUSINESS OPTIMISM

---



While the number of businesses that are not planning to hire any more employees in the next three months is still slightly negative, it is improving. 54% have job openings. There is not much in the way of wage pressure, as wage levels are dropping; and actual prices of the goods and services they are selling and the materials and services they are buying are falling (on average). Inventory levels have dropped precipitously, and that bodes well for hiring, as inventories at some point are going to have to be built back up. However, as Bill points out, "In November small business owners reported a decline in average employment per firm of 0.58 workers reported during the prior three months, a big improvement from May's record loss of 1.26 workers per firm - but still a loss of jobs. Nine percent of the owners increased employment by an average of 2.3 workers per firm, but 21 percent reduced employment an average of 4.2 workers per firm (seasonally adjusted). The "job generating machine" is still in reverse. Sales are not picking up, so survival requires continuous attention to costs - and labor costs loom large. But, job reductions are fading and job creation could cross the "0" line by the end of the year.

"Owner optimism remains stuck at recession levels. The proximate cause is very weak consumer spending, better than a year ago, but that was pretty bad. Fifteen (15) percent reported gains, while 43 percent reported weakness. With weak consumer spending, there is little need to invest in inventory (and borrow money to support inventory investment). Inventory investment plans are at historically very low levels. Similarly capital spending is on hold, with actual outlays and planned outlays at record low levels along with the demand for loans to finance the outlays. More firms still plan on reducing employment than plan on adding to their payrolls. Inventory reductions are still widespread, eight percent reported accumulation, 33 percent reported reductions. This sets the stage for new orders in future periods, but does not help much now."

The survey kept highlighting the concerns and uncertainty about government plans for new taxes and regulations. It is hard to make plans to expand when you are not certain what your costs will be for health care, taxes, cap and trade, etc. This is a survey we need to watch, because when it turns up we can start to feel confident about the recovery (which is still stimulus-driven). We will look back at it in a few months.

## **A Double-Dip Recession?**

Finally, this highlights my concern about a double-dip recession. I think we could see one in 2011, as a result of the massive increases in taxes as the Bush tax cuts expire and the Pelosi-Reid-Obama crowd want to raise taxes on the "rich." Their assumption is that if we could grow quite well in the Clinton years with higher taxes, then we can do it again.

First, if there are no changes to the proposed tax increases, this will be a massive middle-class tax hike. Make no mistake, the Bush tax cuts resulted in a huge cut in the taxes of the middle class. The data clearly shows the wealthiest 20% are paying significantly more of the total taxes paid.

If you combine a large middle-class tax increase with an even larger new wealth tax (75% of which will affect the very small businesses we just highlighted), it will be a one-two punch to the economic body, when unemployment is already at 10%. You can't take out well over 2% (and maybe 3%) of GDP from the consumer without it having significant consequences. Obama mentioned minor tax credits for small businesses in his plan, but then proposes to raise their taxes and health-care costs. It doesn't work that way.

For Val, Shari and me, we wish you and your family a warm and blessed Christmas holiday and we look forward to an exciting new year!



607 Cascade West Parkway  
Grand Rapids, MI 49546  
(616) 575-2020  
(616) 957-4142 Fax:  
[www.CFG2020.com](http://www.CFG2020.com)

*This communication, including attachments, is for the exclusive use of addressee and may contain proprietary, confidential and/or privileged information. If you are not the intended recipient, any use, copying, disclosure, dissemination or distribution is strictly prohibited. If you are not the intended recipient, please notify the sender immediately by return e-mail, delete this communication and destroy all copies.*