# A. Gary Shilling's INSIGHT

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The U.S. economic recovery is increasingly a two-tier affair. Americans on the top have benefited from the two-year rally in stocks and other investments that were slaughtered during the Great Recession. The rest are more affected by falling house prices that are likely to drop another 20%, given the massive overhang of excess inventories that will take four or five more years to absorb. That house price drop will wipe out the remaining equity of most mortgagors and push the number under water from 23% to 40%, much to the detriment of consumer spending and mortgage financing.

The recent spike in energy costs also disproportionately hits lower-income folks. State and local governments facing huge budget and pension shortfalls are resorting to compensation cuts and layoffs. And discharged municipal employees will suffer income declines if they do find private sector jobs, given the higher pay levels in government. The increasing use of part-time and temporary employees as well as layoffs and subdued hiring has promoted productivity and profits, but restrained the incomes of many individuals.

Renewed recession could be triggered by a further big drop in house prices, a hard landing in China, a sovereign debt crisis in the eurozone or a Middle East oil crisis.

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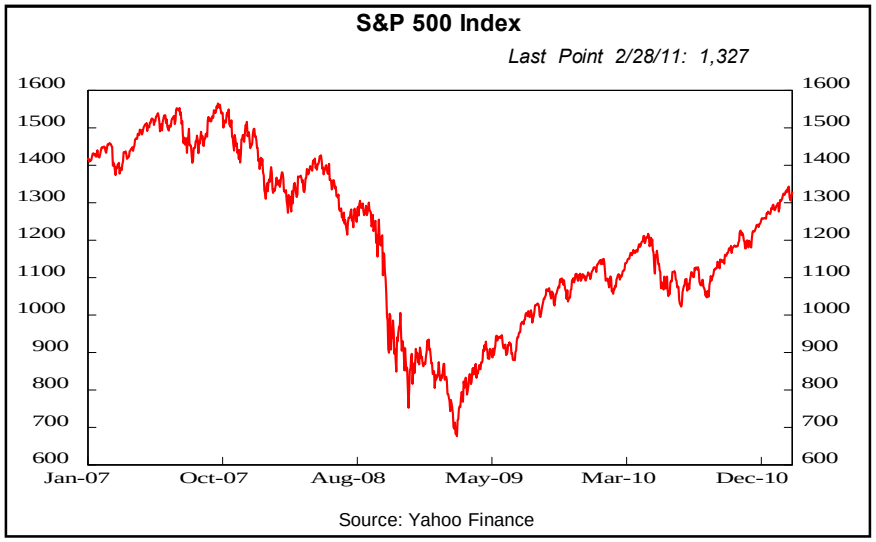
## The Two-Tier Recovery

The U.S. economy is increasingly in a two-tier recovery mode with many of those on the top benefiting from the post-recession revival of stocks (*Chart 1*), commodities, junk securities, corporate finance, foreign securities and other financial markets. But the rest continue to face high unemployment (*Chart 2*), depressed pay and short hours as well as falling house prices (*Chart 3*).

### A Hit and Misses

Pumping up stock prices was one of the Fed's goals for its QE2 program in which it is buying another $600 billion in Treasurys, net. Contrary to the misrepresentation by the vast majority of the media, the Fed does not create money. As we've noted repeatedly in past *Insight*s, the Fed, in buying securities, creates reserves for the banks. Then it's up to the banks as lenders and creditworthy borrowers to turn those reserves into money, but they aren't doing so at present with any meaningful zeal (*Chart 4*). The nonfinancial corporate sector is already loaded with cash so why borrow more (*Chart 5*)? And creditworthy consumers are paying

CHART 1

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off debt with considerable gusto (*Chart 6*). Surely, the central bankers didn't believe that adding another $600 billion to excess reserves of already $1 trillion would induce more rapid lending and borrowing (*Chart 7*).

The Fed also hopes QE2 will stave off deflation, which it, us and only a very few others are concerned about. Most, of course, believe the excess reserves, sooner or later, one way or another, will unleash the inflation demon. Nevertheless, the year-over-year change in the consumption deflator ex food and energy—the Fed's preferred measure of price movements—is getting close to negative territory (*Chart 8*). The rest see the U.S. economy as an island in a worldwide sea of agricultural and industrial commodity inflation that is about to be engulfed, as we'll explore later in this report.

Deflation worries U.S. central bankers because, if it occurs, even zero interest rates are positive in real terms, as has been the case in Japan in many recent years (*Chart 9*). Negative real rates, which pay borrowers in real terms to take away the filthy lucre from lenders, are preferred for spurring a weak economy. The Fed also worries that growth in the money supply, about 3% annually in the last two decades in Japan, doesn't always prevent deflation (*Chart 10*).

**We're Baffled**

It beats us as to why U.S. stocks rallied in parallel with QE 2, starting with its announcement last August (Chart 1). You can't prove causality with statistics so maybe the two are just coincidences. We absolutely, positively guarantee that if you go outside and beat a drum every time there's a solar eclipse, the sun will return. Maybe stockholders became zealous because they assumed that all those bank reserves would eventually be used to create profits-spurring economic activity. Maybe U.S. stocks jumped because investors began to agree with us that a hard landing is likely in

**CHART 2**

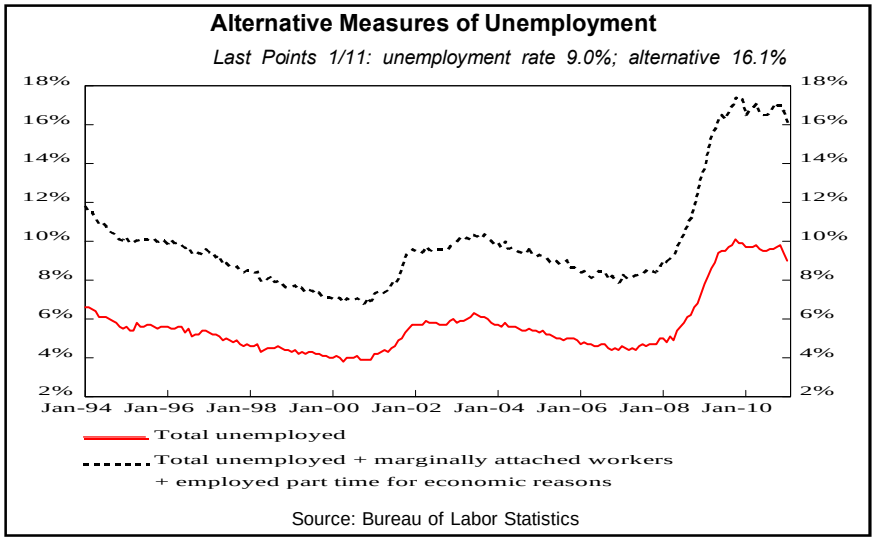



**CHART 3**

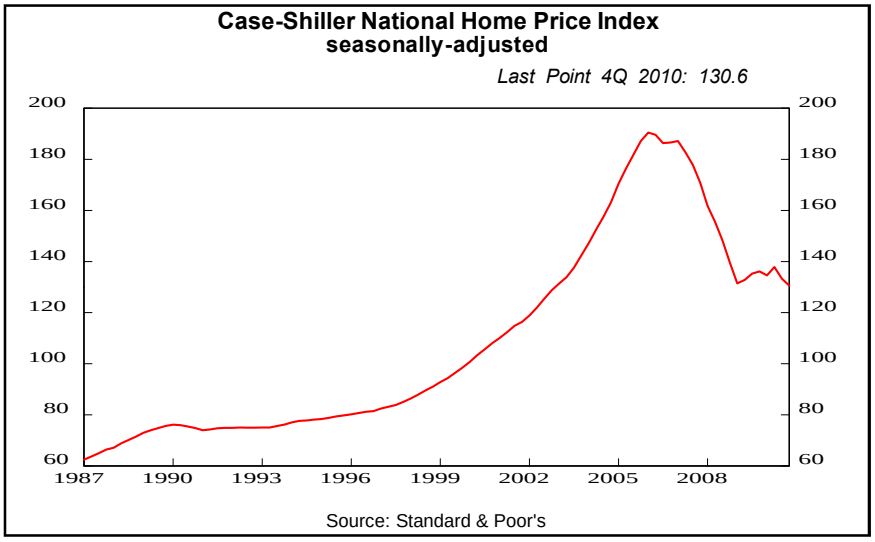
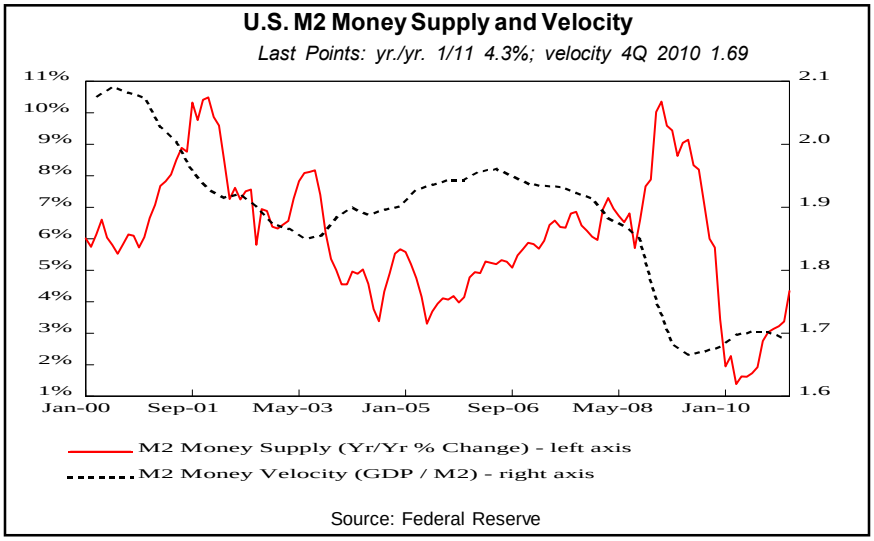



**CHART 4**



China (see our February *Insight*, "Myopic Love Affair With China") and began retreating to the safety of the U.S. Note, however, that foreign events can affect American equities both ways. The recent unrest in Egypt, Libya, Bahrain and other Arab lands is threatening oil supplies and boosted crude prices (*Chart 11*), much to the displeasure of U.S. stockholders.

In any event, the Fed's goal for QE2 of depressing Treasury, and therefore mortgage, yields to aid the beleaguered housing sector has backfired. From the time Fed Chairman Bernanke hinted at QE2 last August, 30-year Treasury bonds sold off (*Chart 12*). So too did 10-year Treasury notes, which influence 30-year fixed-rate mortgage rates, which also rose (*Chart 13*).

It is true that lower mortgage rates make home ownership more affordable, but it already is. The National Association of Realtors' calculation, which assumes a family with median income buys a median-priced single-family house with a 30-year fixed-rate mortgage at the current interest rate, is already at record high levels (*Chart 14*). But why, then, are house prices falling (Chart 3) and sales weak (*Chart 15*)? It's because high unemployment (Chart 2) discourages home-buying by the unemployed and those who worry about losing their jobs. Also, in the aftermath of the house price collapse, mortgage lending terms are extremely tight. And with house prices falling, who wants to buy a big asset that probably will be worth less next year? So past conditions, which make houses look very affordable today, are irrelevant. Earlier, employment was much more secure, lending standards were drastically easier and, most of all, almost all home buyers were convinced that prices never fall as they hadn't since the 1930s.

## Another 20% Decline

The massive overhang of excess house inventories, the mortal enemy of prices, suggests another 20% fall in prices,

**CHART 5**

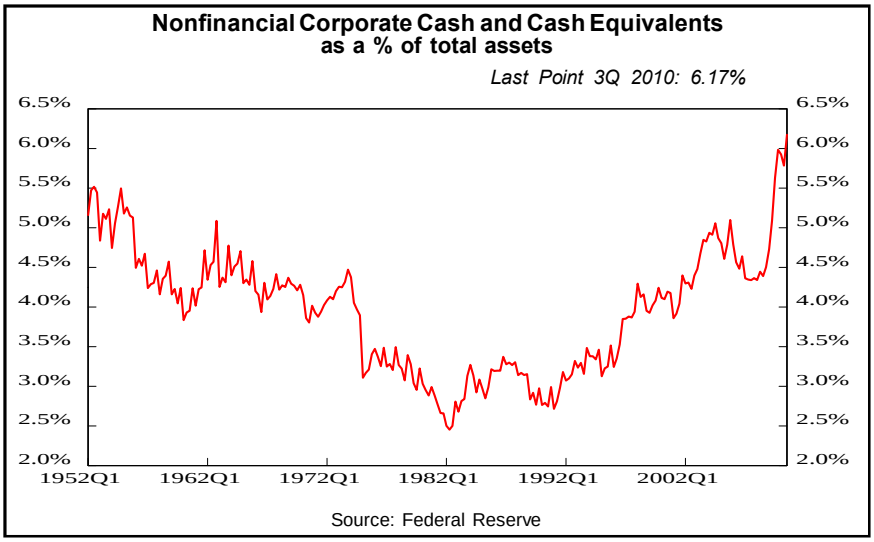



**CHART 6**

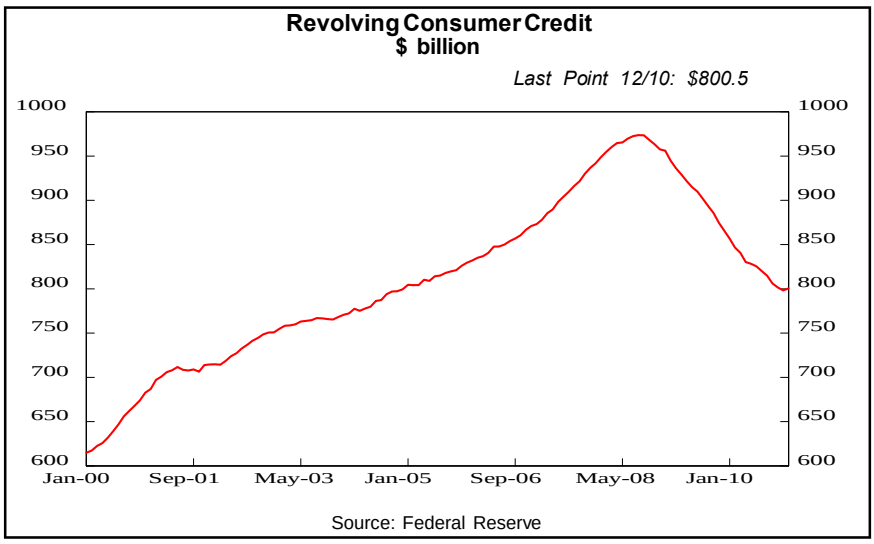
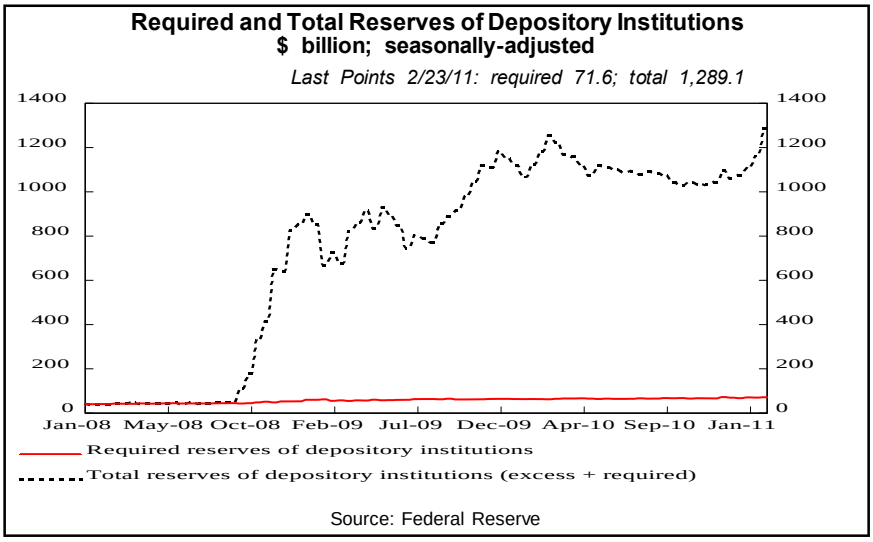



**CHART 7**



resulting in a 43% peak-to-trough total decline. This decline would return prices—adjusted for general inflation as well as for the tendency for houses to get bigger and, therefore, more expensive over time—to their century-long flat trend (*Chart 16*). And the decline from here may exceed 20% since corrections tend to overshoot the trend on the downside just as bubbles do on the upside.

We estimate that excess house inventories exceed 2 million, a huge amount considering that the long run trend of homebuilding is 1.5 million houses built per year (*Chart 17*). *Chart 18* suggests that normal inventories run about 2.5 million so anything over that number is excess—now 1.5 million. In addition, Census Bureau data suggests that at least 500,000 housing units have been held off the market by owners who want to sell but are hoping for higher prices. Further price weakness will probably convince many of them to dump their properties on the market for whatever they'll bring.

Furthermore, as discussed in our January *Insight*, the government-imposed moratorium on foreclosures during the Home Affordable Modification Program is essentially over. HAMP aided only 521,630 borrowers compared to the hoped-for 3 to 4 million and frequently left borrowers further under water. The Congressional oversight panel wrote that those borrowers "have a slim chance of returning to positive equity in the foreseeable future." A third of mortgagors tentatively approved under HAMP for temporary modification do not complete the three-month trial period. Half of those who make it to modifications are again delinquent within six months. Also, the lender-imposed moratoria on foreclosures during the robo-signing flap is unwinding as proper documents are prepared. So foreclosures are resuming as delinquencies remain high. And when banks and other lenders foreclose on properties, they usually want to sell then immediately, often at

**CHART 8**

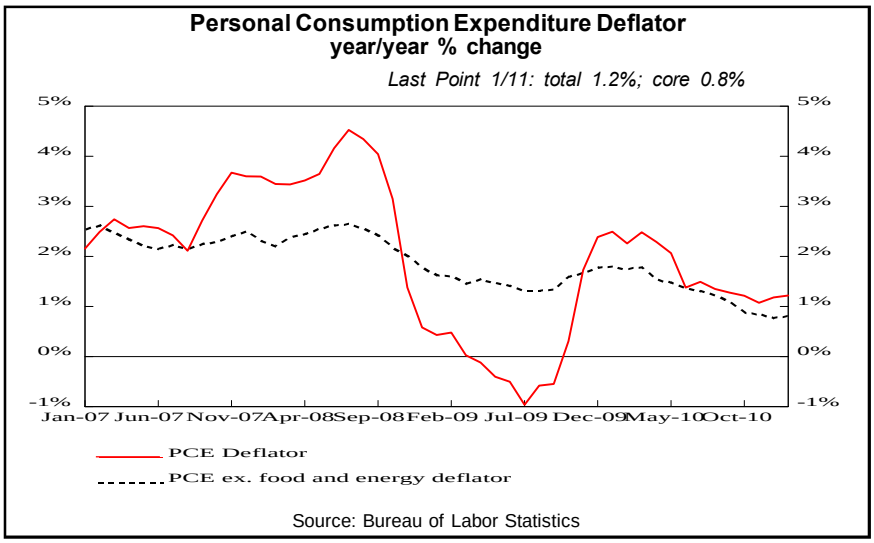



**CHART 9**

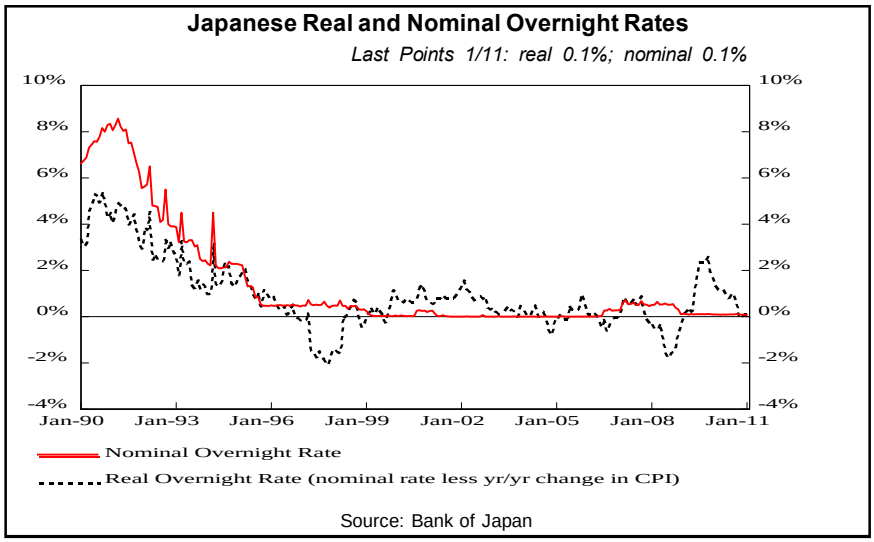
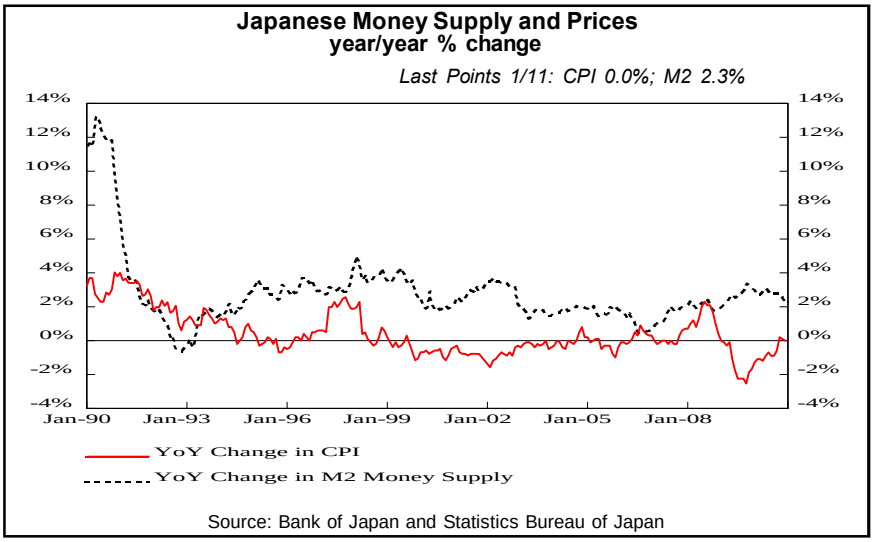



**CHART 10**



market-depressed prices.

## Surprising Help

Massive foreclosures would actually help to revive the housing market. The subsequent sales of those houses at low, distressed prices would set a floor and the foundation for a self-feeding rebound that would restore confidence to the market. That's what happened two decades ago when the Resolution Trust Corp. sold the busted savings and loans and related securities and properties.

In contrast, mortgage modifications have proved a dismal failure, as discussed earlier. Modifications often simply drag out the loss of abodes for many distressed homeowners. Houses in the process of foreclosure drag down prices of others in the neighborhood. Empty houses are often vandalized, and homeowners in the process of foreclosure are unlikely to replace dead shrubs. Banks will probably remain reluctant to make new mortgage loans as long as they own piles of delinquent mortgages. New construction is inhibited by the overhang of troubled houses as well as excess inventory.

Unfortunately, as we've discussed in past *Insights*, there is a concerted national effort to keep distressed homeowners who can't afford chicken coops in their four-bedroom houses on which they put zero down. HAMP is one example of this. Another is the proposed deal between the multitude of regulators and some 14 mortgage servicers that didn't follow correct technical procedures in initiating foreclosures. The government proposal calls for $20 billion, paid by the servicers, to reduce the loan balances of underwater mortgagors. Unfortunately, this may well encourage those who can make their mortgage payment to stop doing so in the hope of having their loan balances cut. In any event, $20 billion is tiny in relation to the underwater mortgage shortfall total of around $744 billion.

**CHART 11**

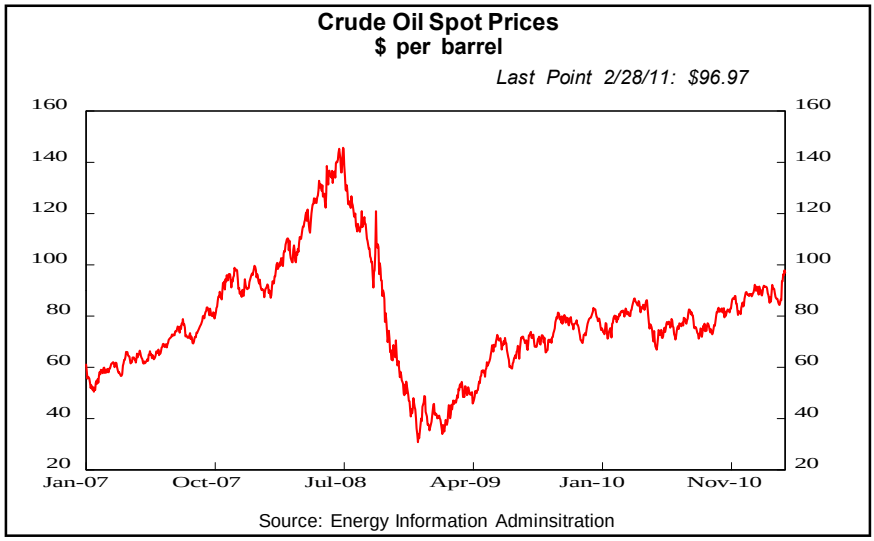



**CHART 12**

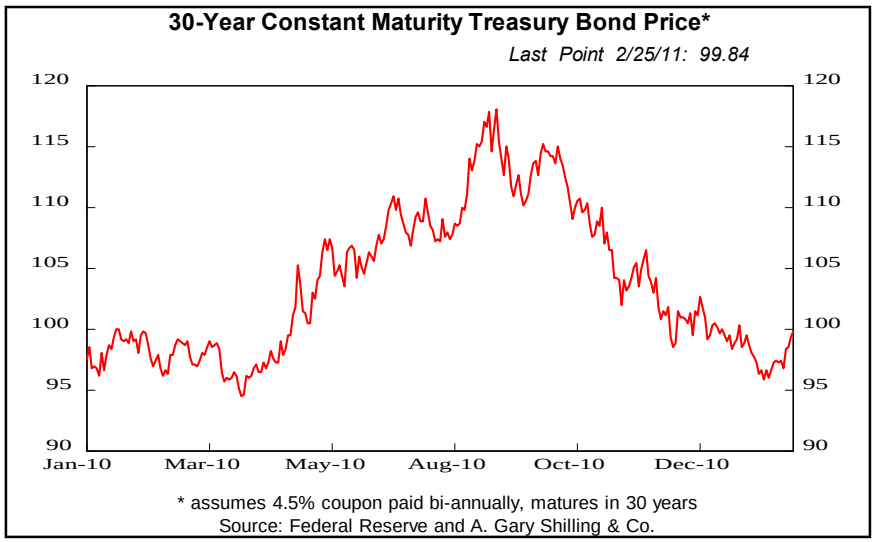
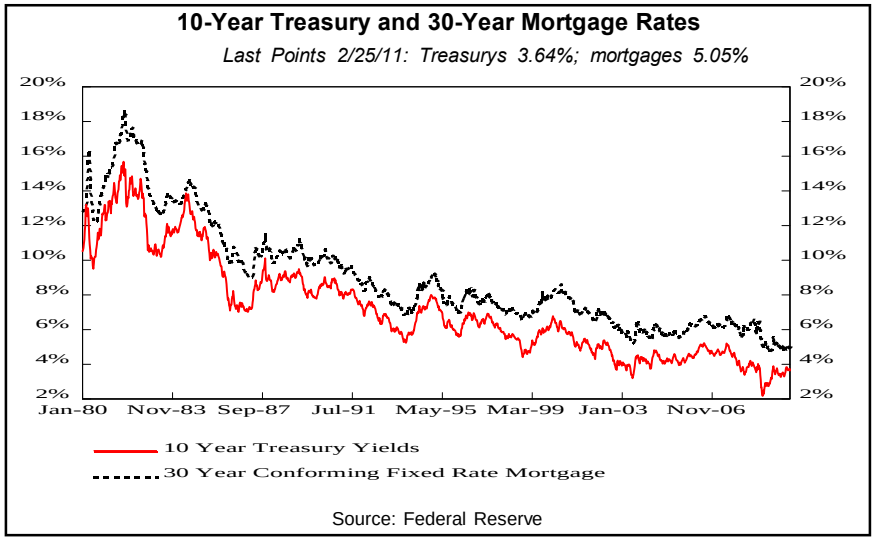



**CHART 13**



As discussed in our January *Insight*, excess inventory is also added as many of the homeowners foreclosed out of their abodes go back to living with parents or with friends (*Chart 19*), and as owners of investment properties that are empty or rented at below carrying costs give up and dump their houses on the market. The total excess house inventories will probably soon be in the 2.0 to 2.5 million range.

**Annual Absorption**

House completions plus manufactured home shipments are likely to remain at about the 700,000 level (Chart 17), and around 300,000 per year are lost to demolitions, conversions to other uses, etc. So the increase in supply will likely run about 400,000 annually in coming years. Household formation, depressed by falling prices, high unemployment and stringent lending standards, will likely run at about 800,000 annually. That's a bit below the 952,000 average for the last decade, which includes the housing boom when many wanted an abode of their own—and the bust when they didn't.

Many assume that a growing population will absorb excess houses quickly because, they believe, household formation follows in lockstep. But a household is defined as one or more people occupying a separate dwelling unit, so all the factors that make people want to or not want to buy or rent a house also affect household formation. Not surprisingly, its cyclical pattern resembles closely that of housing starts and completions.

With new household demand likely to average around 800,000 annually in the years ahead and new supply of about 300,000, excess inventory will be reduced about 500,000 per year. So with 2.0-2.5 million housing units in excess, it will take four or five years to eliminate them. That's plenty of time for those surplus inventories to depress house prices by the further 20% we're forecasting.

**CHART 14**

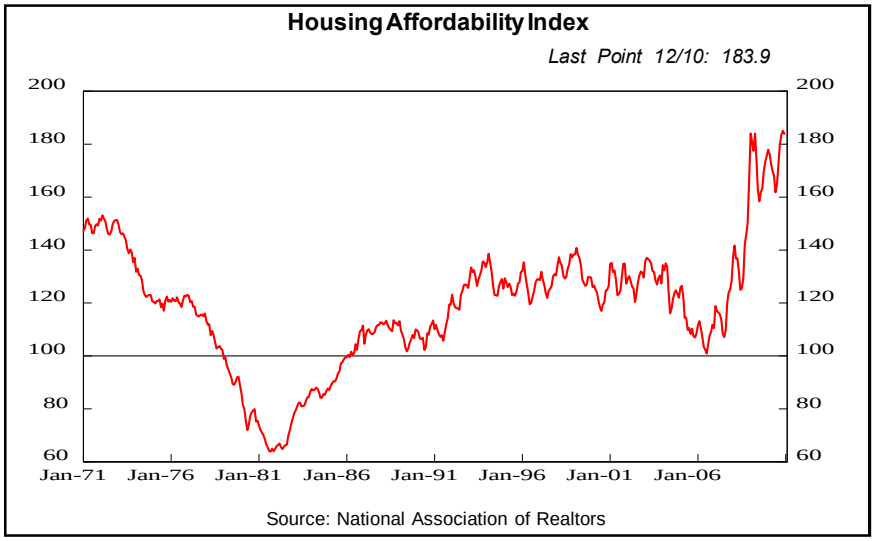



**CHART 15**

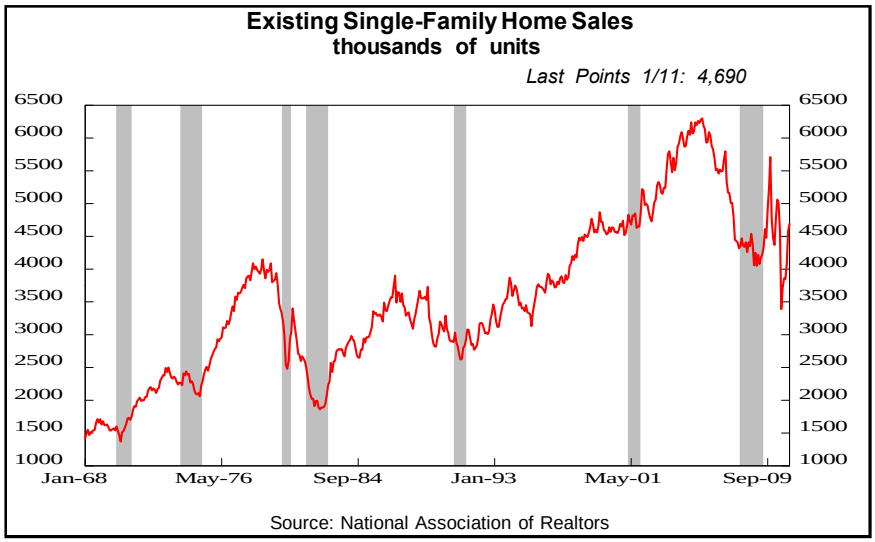
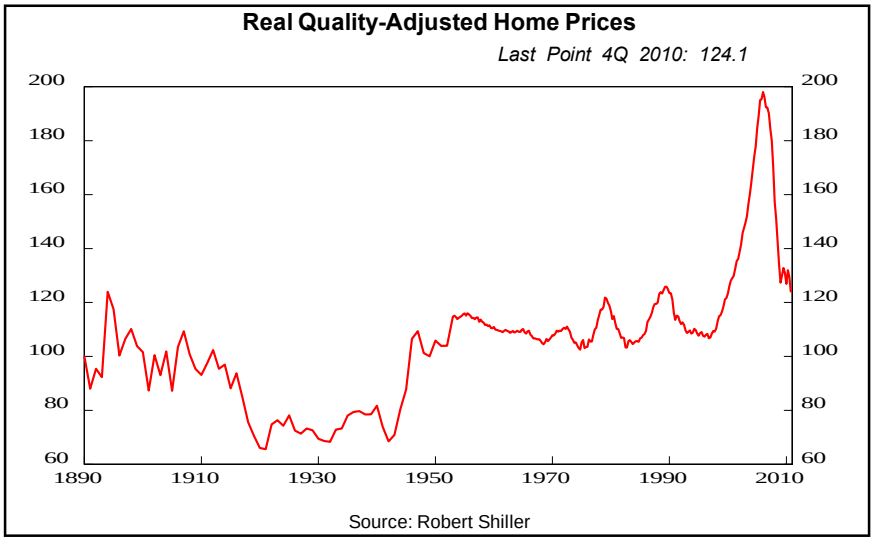



**CHART 16**



## More Underwater

With that further drop in prices, we estimate that about 40% of mortgages will be under water, up from 23% in the fourth quarter 2010. At that point, few will be able to get above water by repaying their mortgage principals. The New York Fed estimated that only a third of those now under water could return to fiscal health in five years by commencing to make monthly payments, even if house prices remain flat. Those under water got there not only due to the collapse in house prices, but also by withdrawing home equity in the boom days. A total of $1.1 trillion was withdrawn in 2006 and 2007. In 2009, 36.7% of all households, or 41.7 million, had housing costs that topped 30% of pretax income, the accepted norm of affordability, up 1.5 million from 2007.

Furthermore, the home equity well is essentially dry with the percentage of equity of those with mortgages now 19%, down from 50% in the early 1980s (*Chart 20*). Not surprising, home equity loans and unused lines of credit, which exploded during the housing boom, are declining with unused lines at FDIC-insured institutions down $236 billion, or 33%, from the end of 2007 (*Chart 21*).

Many of those going under water with further house price declines would no doubt join the ranks of the "strategic defaulters," those who can afford their mortgage payments but default anyway. Their desire to not throw good money after bad overcomes their moral responsibility, if any. If 40% are under water, "jingle mail" will become the new rage as strategic defaulters mail their house key to their friendly lenders.

Furthermore, if 40% of mortgages exceed the values of the houses they finance, almost all of the remaining equity of mortgagors would be wiped out (Chart 20). The effects on consumer spending, mortgage loans and related securities, and the economy would be

**CHART 17**

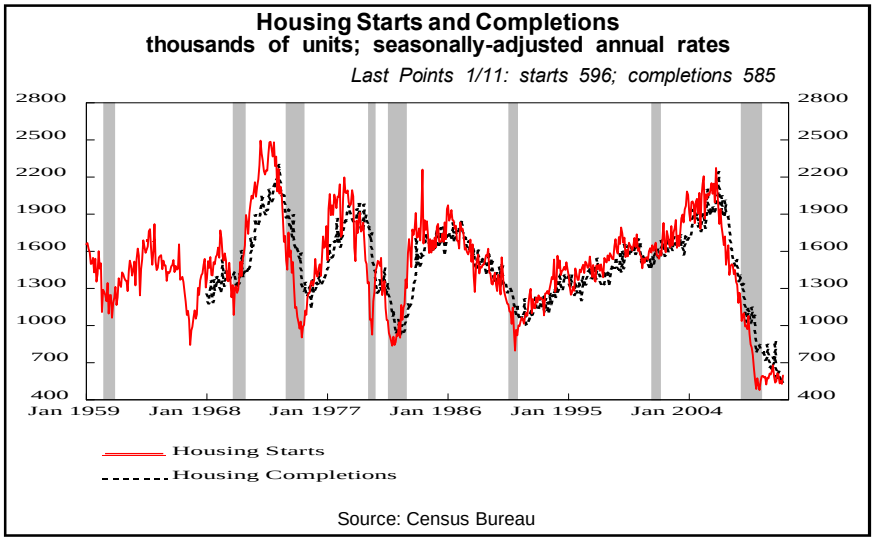



**CHART 18**

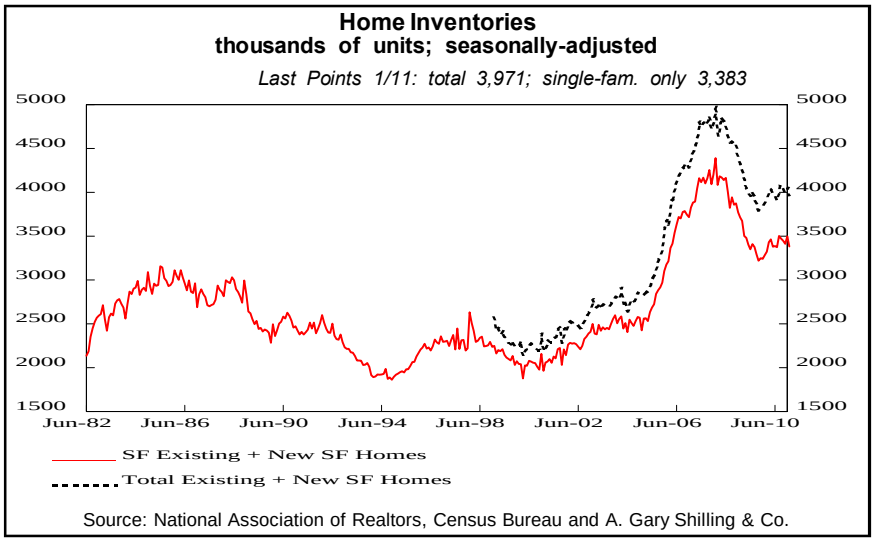
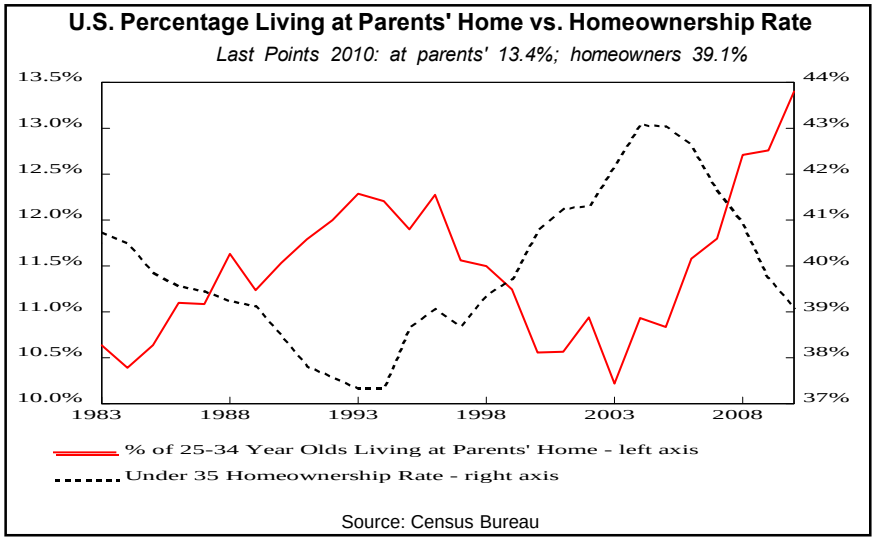



**CHART 19**



devastating. Homeownership leaped during the housing boom when renters looked at ownership as a great investment (*Chart 22*). Back then, if they put down 5% on their abodes and they rose 10% annually in price, those folks made a whopping 200% *per year* on their investments, neglecting mortgage interest, taxes and maintenance.

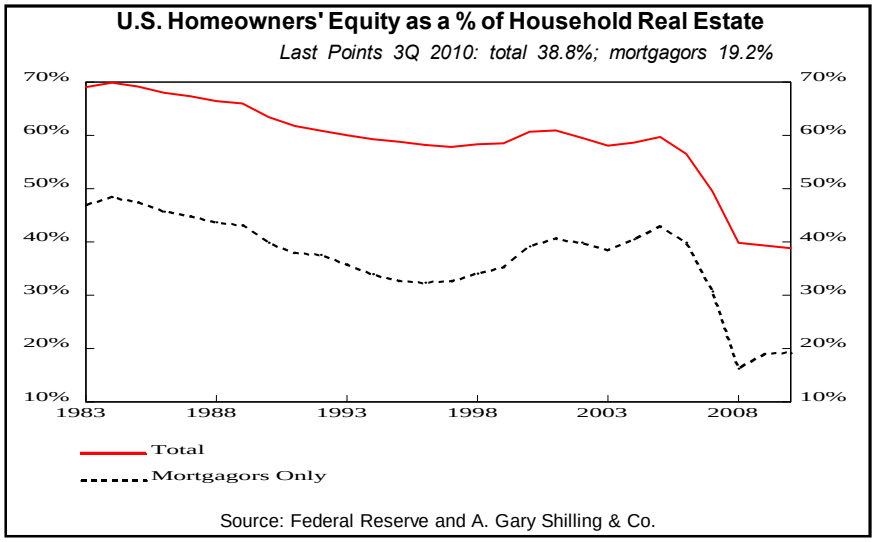
But in today's world of falling house prices, high unemployment and stringent mortgage lending standards, the homeownership rate has retreated from 69.2% at the peak in the fourth quarter of 2004 to 66.5% last quarter and might well drop back to the previous norm of 64% to 65% (Chart 22). Home ownership already is at the lowest rate since the end of 1998. Meanwhile, rental apartments, one of our short- and long-term investment themes, are reviving. Vacancy rates are falling and effective rents are rising (*Chart 23*).

**Skewed Distribution**

The continuing decline in house prices along with ongoing foreclosures and underwater mortgages have hurt the average American much more than the rise in stock prices has helped. That's because stock ownership is skewed much more to the top income groups than is home ownership. Notice that in 2007, the latest available data from the Federal Reserve triennial survey, the highest 10% income group's abodes were worth $500,000 on average, or five times the lowest 20%'s home values of $100,000 on average (*Chart 24*). But the value of the top 10%'s stock holdings averaged $219,600, or 34 times the $6,500 of the lowest 20% (*Chart 25*).

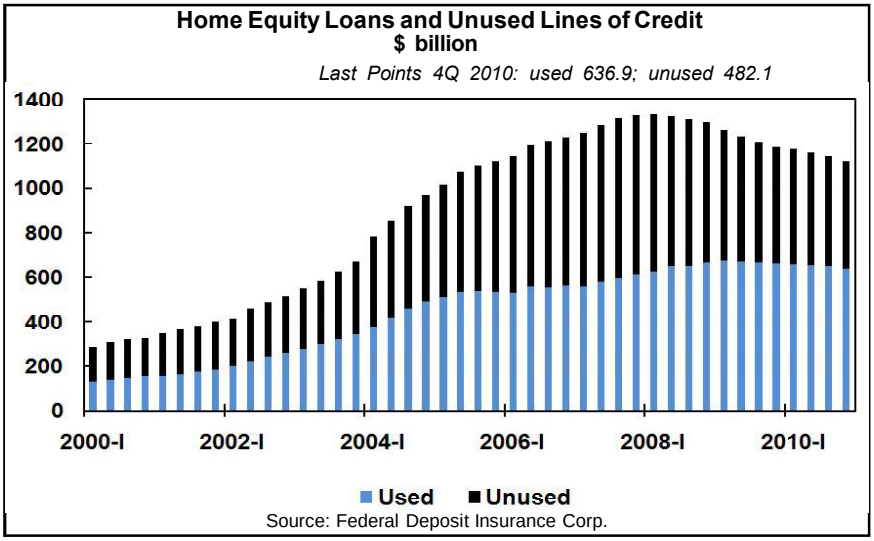
Further enlarging the gap between the rich and the poor, house prices have held up much better in wealthy New York commuter suburbs than in further out towns. That's even as house prices in the New York metropolitan area in December were down 2.3% from a year earlier and the lowest since 2004, according to the Case-Shiller Index

CHART 20



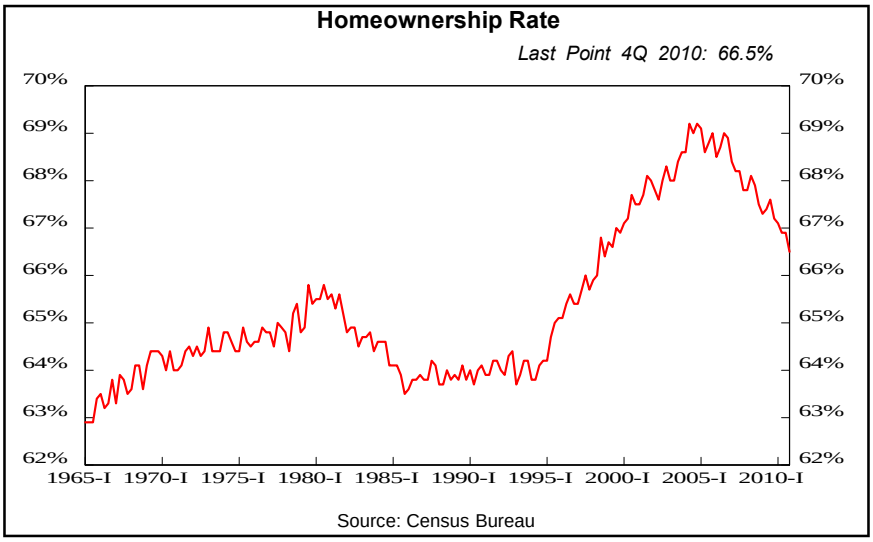
Source: Federal Reserve and A. Gary Shilling & Co.

CHART 21



Source: Federal Deposit Insurance Corp.

CHART 22



Source: Census Bureau

(*Chart 26*). Many residents in wealthy suburbs work on Wall Street and have enjoyed the rebound in security markets since early 2009. So have Manhattan residents. Their pay leaped 9% from the second quarter of 2010 from a year earlier, the second largest rise of any county in the U.S. In the other four New York City boroughs, wages rose less than the 3% for the U.S. as a whole. In the financial activities sector, Manhattan wages jumped 25.8%. But the good times may have stopped rolling: Wall Street bonuses fell 8% compared with a year earlier.

Furthermore, the recent spike in energy costs is simply a tax on energy users, especially lower-income consumers. In the short run, there's little they can do to reduce gasoline and home heating energy consumption. In the 12 months ending in February, household energy costs have spiked $78 billion, the equivalent of 0.7% of consumer spending. That more than wipes out the net increase in federal fiscal stimulus for consumers between 2010 and 2011 of $25.9 billion (*Chart 27*).

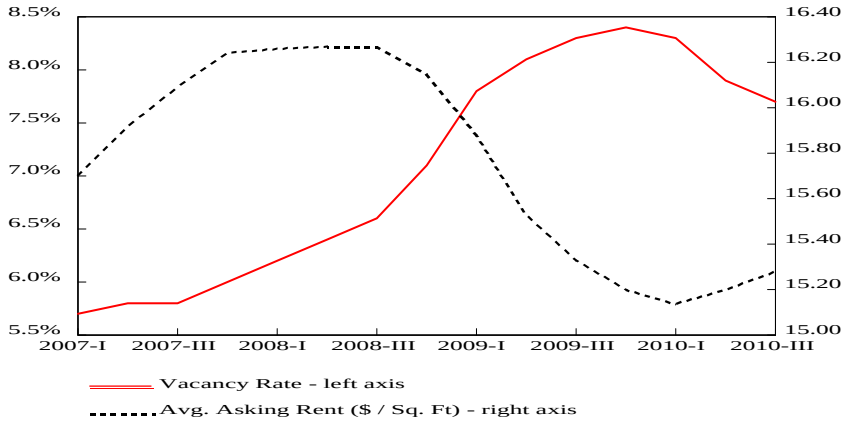
**Skewed Income Distribution**

The ongoing increases in the skewing of home values and stock prices toward higher income households mirrors the same trend in income distribution. *Chart 28* shows that by quintiles, the top 20% of households' share of income has been rising since the data began in 1967. The other four quintiles' share have consistently fallen. Note, however, that a falling share of income is not the same as an absolute fall in income. Nevertheless, the real median income per household actually fell 5% between 1999 and 2009 (*Chart 29*). For men it's lower than in 1973. Furthermore, of those who were employed at least three years, lost their jobs between Jan. 2007 and Dec. 2009 and are now employed full-time, 54.9% are earning less than before and 35.8% have suffered 20% or greater income declines (*Chart 30*). State and local government spending, the second largest GDP component

**CHART 23**

**Commercial Real Estate Average Vacancy Rates by Property Type**

*Last Points 3Q 2010: vacancy 7.7%; rents $15.28*




Source: Mortgage Bankers Association

**CHART 24**

**Median Value of Primary Residence by income class; thousands of dollars**

| | 1998 | 2001 | 2004 | 2007 |
|---|---|---|---|---|
| All Families | 115.8 | 131.0 | 175.7 | 200.0 |
| percent of income | | | | |
| Less than 20% | 63.8 | 69.2 | 76.9 | 100.0 |
| 20%-39.9% | 86.9 | 85.2 | 109.8 | 120.0 |
| 40%-59.9% | 98.5 | 101.2 | 148.3 | 150.0 |
| 60%-79.9% | 127.4 | 138.5 | 192.2 | 215.0 |
| 80%-89.9% | 158.7 | 186.4 | 247.1 | 300.0 |
| 90%-100% | 260.7 | 319.5 | 494.2 | 500.0 |

Source: Federal Reserve Survey of Consumer Finance

**CHART 25**

**Median Value of Direct and Indirect* Stock Holdings by income class; thousands of dollars**

| | 1998 | 2001 | 2004 | 2007 |
|---|---|---|---|---|
| All Families | 31.8 | 40.4 | 35.7 | 35.0 |
| percent of income | | | | |
| Less than 20% | 6.4 | 8.8 | 8.2 | 6.5 |
| 20%-39.9% | 12.7 | 8.8 | 10.9 | 8.4 |
| 40%-59.9% | 15.3 | 17.5 | 16.5 | 17.7 |
| 60%-79.9% | 24.4 | 33.9 | 29.0 | 34.2 |
| 80%-89.9% | 57.3 | 75.6 | 62.1 | 62.0 |
| 90%-100% | 173.8 | 291.3 | 225.1 | 219.6 |

* Indirect holdings are mutual funds, retirement accounts and other marginal assets
Source: Federal Reserve Survey of Consumer Finance

after consumer outlays, has accounted for a stable 12% of GDP for decades (*Chart 31*). And state and local government employees are paid well, averaging 44% more in total compensation than private sector workers, 34% more in wages and 68% more in benefit costs (*Chart 32*). And researchers find that these vast differences persist even when adjusted for differences in age, education, etc. So the 426,000 state and local job losses since the peak in August 2008 (*Chart 33*) have been significant and many of those affected probably got lower paying jobs in the private sector—if they have been re-employed.

**CHART 26**

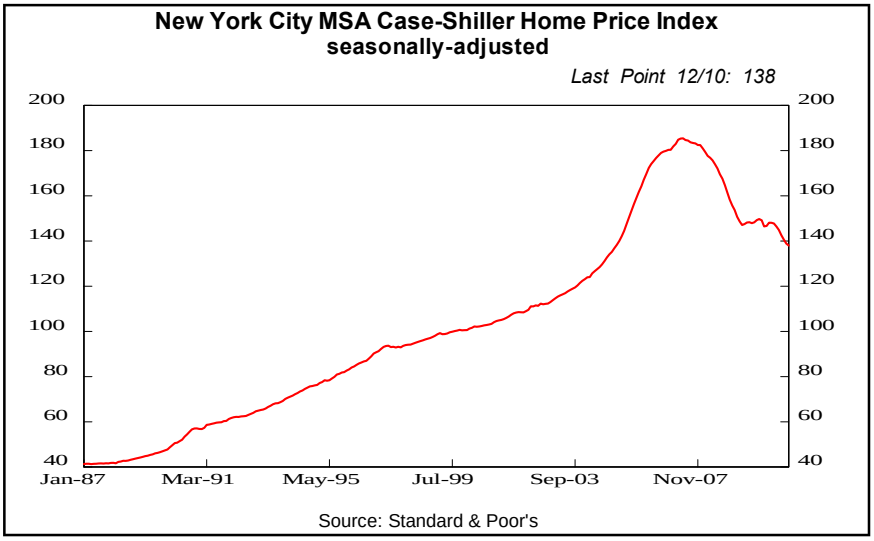



**CHART 27**

**Reduction in Net Consumer Stimulus Due to Changes in Energy Prices**

| | Yearly Residential Consumption* (billions of units) | Price per Unit ($)** 2010 | Price per Unit ($)** 2011 | Outlays ($ billion) 2010 | Outlays ($ billion) 2011 | Difference |
|---|---|---|---|---|---|---|
| Gasoline | 137.93 | 2.7 | 3.2 | 373.7 | 447.3 | 73.7 |
| Home Heating Oil | 4.63 | 2.9 | 3.6 | 13.5 | 16.6 | 3.2 |
| Natural Gas | 4,778.48 | 0.011 | 0.011 | 50.5 | 51.3 | 0.8 |
| Total Outlays | | | | 437.6 | 515.3 | 77.6 |

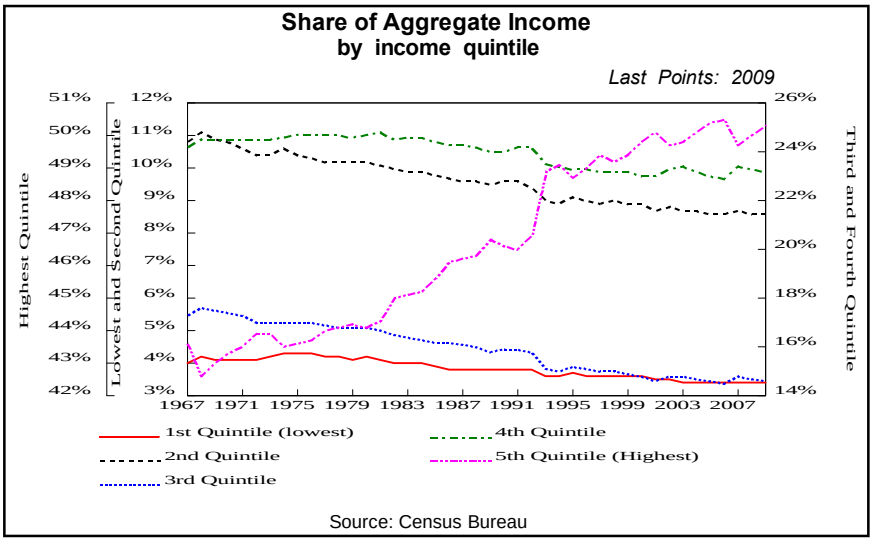
| | |
|---|---|
| Estimated Net Change in Consumer Stimulus 2010 to 2011 | $ 25.9 |
| Change in Residential Energy Outlays | -$ 77.6 |
| Estimated Net Change in Stimulus Including Changes in the Cost of Energy | ($51.7) |

* based on 2009 U.S. household consumption ** prices are Feb. 2010 vs. Feb. 2009 Source: Energy Information Administration

With municipal governments continuing to run large deficits and looming pension fund shortfalls, employment woes for state and local employees may be just beginning. Ongoing showdowns between the governments and their employees in Wisconsin and other Midwestern states may well result in compensation cuts for existing employees, with massive layoffs the only alternative.

We're watching these fights at the state level because the outcome will probably be reflected in Washington before long. As we discussed in *The Age of Deleveraging*, states have superseded the federal government as the initiator of new ideas

**CHART 28**



since the 1980s.

Federal government involvement in the economy had been growing since it was initiated in a major way by the New Deal reaction to the Great Depression. It's debatable whether those programs were responsible for economic revival. Indeed, it can be argued that government involvement created uncertainty and fear among businesspeople and markets and thereby impeded recovery. It's also likely that rearmament and World War II were what really ended the Great Depression. But the economy did revive and World War II was a successful one, so Americans associated increasing government involvement in the economy with economic growth. Both the economy and government's role in it were rising together.

Washington policymakers also increasingly believed they could successfully manage the economy, to the point that in the mid-1960s, they way overreached their abilities. At that time, administration economists believed they were so skillful at implementing monetary and fiscal policy that they could prevent not only a major recession but minor dips as well—the "fine-tuning" policy. At the same time, the Johnson administration believed that with just a modest increase in government spending—the Great Society programs—the nation's social ills could be cured. And then there was the conviction in Washington that the economy was strong enough to fight a land war in Asia and simultaneously embark on massive domestic spending without creating inflation and other major problems—the guns and butter strategy.

## Overreaching

Needless to say, this government overreaching proved disastrous. Recessions proved far less than extinct. Social problems persisted despite huge government outlays, and even grew. And massive federal outlays for military

CHART 29

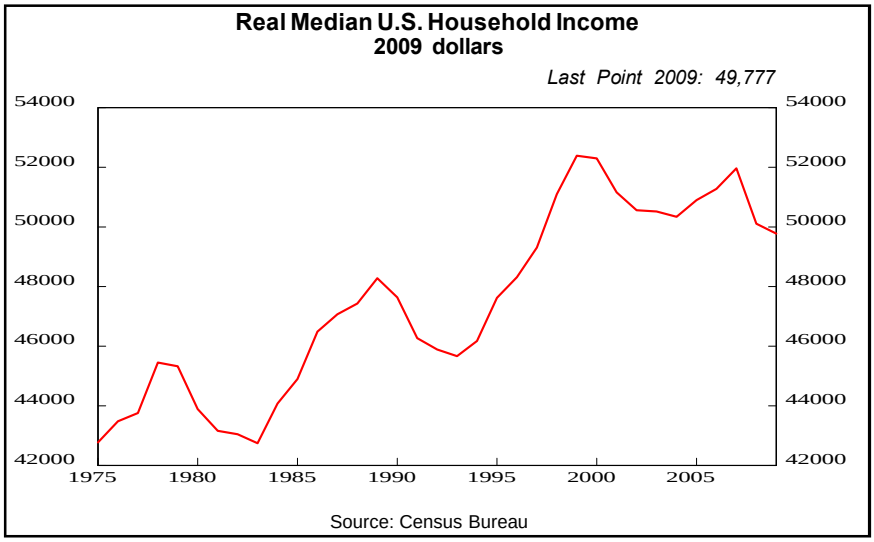



CHART 30

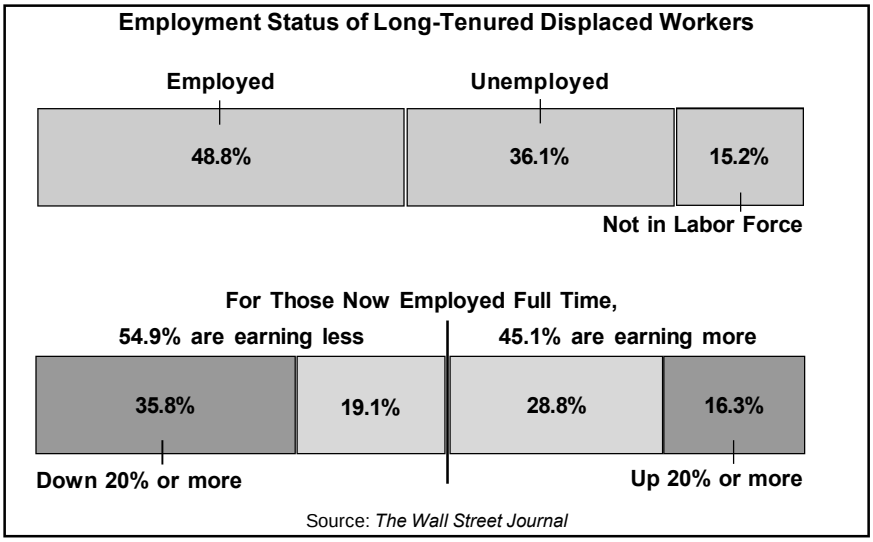
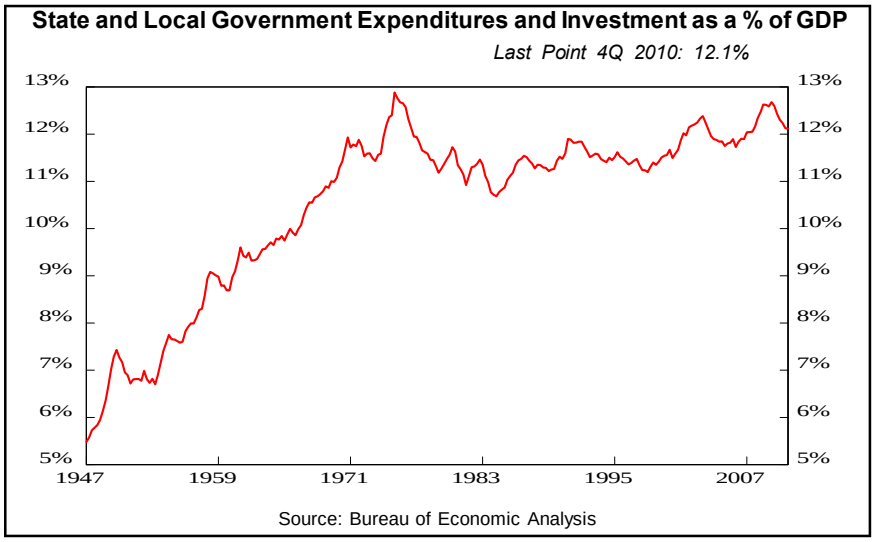



CHART 31



and domestic programs spawned aggregate demand far in excess of supply, with the inevitable result: rapid inflation.

Voters revolted, as witnessed first by Proposition 13 in California in 1978, which severely limited property taxes to 3% of assessed valuation. The movement strengthened with the election in 1980 of President Reagan, who said that government was the problem and not the solution, and a substantial shift to the right in Congress. Reflecting voter disdain for national politicians, every presidential candidate since then has run as a Washington outsider, even Al Gore, who lived most of his life there.

Furthermore, virtually every meaningful legislated change since then has not been initiated in Washington, but bubbled up instead from the state and local levels. Workfare, which requires welfare recipients to work or enter job training, is a good example, and term limits for politicians is another. Before the federal Consumer Financial Protection Bureau was established in mid-2010, a number of states had restricted payday lenders, auto loans and costly tax refund loans. While Congress continues to avoid the immigration hot potato, Arizona, Oklahoma and some cities have put strict limits on illegal aliens.

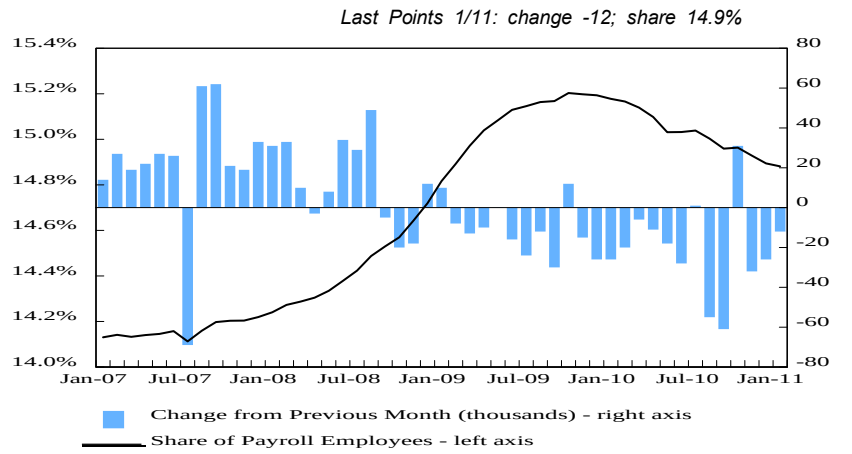
**CHART 32**

**Average U.S. Compensation: Sept. 2010**
**$ per hour worked**

| | a. State & Local | b. Private Sector | Ratio a/b |
|---|---|---|---|
| Total compensation | $40.10 | $27.88 | 1.44 |
| Wages and salaries | 26.25 | 19.68 | 1.33 |
| Benefits | 13.85 | 8.20 | 1.69 |
| Paid leave | 3.03 | 1.88 | 1.61 |
| Supplemental pay | 0.33 | 0.78 | 0.42 |
| Health insurance | 4.65 | 2.10 | 2.21 |
| Defined-benefit pension | 2.94 | 0.44 | 6.68 |
| Defined-contribution pension | 0.32 | 0.55 | 0.58 |
| Other benefits | 2.58 | 2.45 | 1.05 |

Source: Bureau of Labor Statistics

**CHART 33**




Source: Bureau of Labor Statistics

Furthermore, with 50 states, there are 50 laboratories in which new ideas can be tried. If a new concept developed in one state gains traction in others, it may soon work its way to Washington. If not, national interest will shift to new ideas in other states. Wisconsin Gov. Scott Walker is the man of the hour as he blasts Democratic Senators who are holed up in Clock Tower Inn in Rockford, Ill. to avoid a quorum call and vote by the majority Republicans that would eliminate most collective bargaining rights of the state's 170,000 public employees. If he wins, he'll be a national hero to taxpayers who see state employees as ridiculously overpaid and their pensions as excessive and budget-busting. And he might well win. We've stayed at the Clock Tower Inn and would not recommend it as a permanent residence.

Similarly, New Jersey Gov. Chris Christie is in the right place at the right time in terms of public sentiment. Ten years ago, he probably would have had no success in getting spending cuts and tax limits through a Democratic-controlled legislature. Now, the state's finances are so dire that the voters—and legislators who hope to be re-elected—are accepting his plans.

### Temps and Part-Timers

Increasing numbers of temps and part-timers are another source of lower compensation since many of them have lower hourly pay and shorter hours than full-timers and few benefits. Notice (*Chart 34*) that the percentage of people working part-time for non-economic reasons—because they only want part-time work—has actually declined a bit lately. But those employed part-time for economic reasons—they'd prefer full-time but can't find such jobs—have leaped. Employers often hire part-timers for efficiency because they only work at the time of day or season of the

year they're needed.

People hired through temporary help services can work full-time or part-time, but they too have been increasing as uncertain employers avoid the costs and obligations of permanent employees. Since the trough of the labor market in February 2010, 21% of the payroll jobs added have been temporary positions. But note that even with these job additions, payroll employment is still 7.7 million, or 5.6%, lower than when the recession started in January 2008.

Many of those with no choice but part-time or temporary jobs are lower-income folks to start with, further widening the gulf between upper and lower income Americans. The same reality can be seen in the rise in unemployment rates by education levels (*Chart 35*). All have risen, but the lower the education, the higher the unemployment rate before the recession and the greater the leap since it began. And relatively higher birth rates in minority groups as well as legal and illegal immigration are producing many young people who need to be educated. In Texas, whites shifted from 52.4% of the population in 2000, a majority, to 45.3% in 2010 while Latinos rose from 32% to 37.6%, according to the Census Bureau (*Chart 36*).

With high unemployment, it's not surprising that the federal government is stepping up audits of employers to force them to fire illegal immigrants. These "silent raids" are less spectacular than earlier on-site raids in which illegals were led off in handcuffs, but are much more effective. Still, the feds just busted a 22-person ring that produced over 15,000 false Social Security cards, driver's licenses and work documents for 15,000 illegal immigrants in 11 states. The sold for $150 to $200 each.

## Cost-Cutting

Employment and incomes have also been affected by vigorous cost-cutting

**CHART 34**

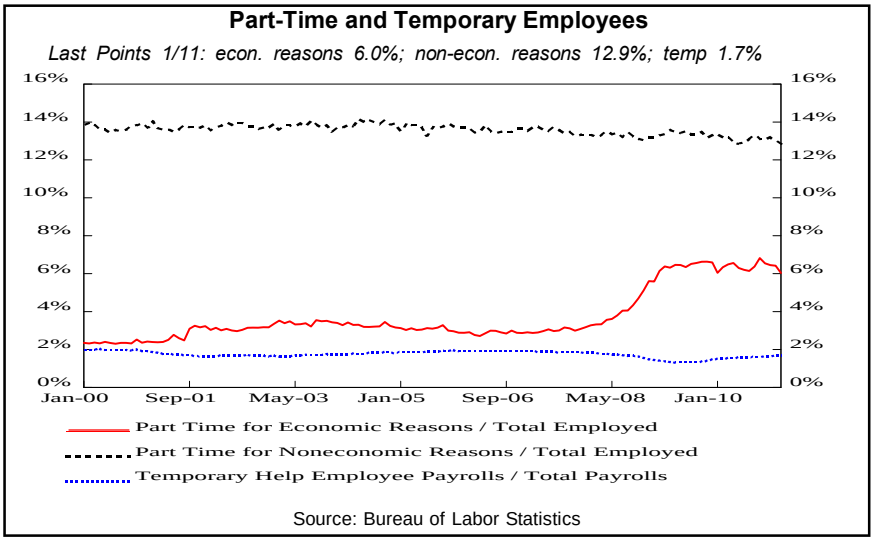



**CHART 35**

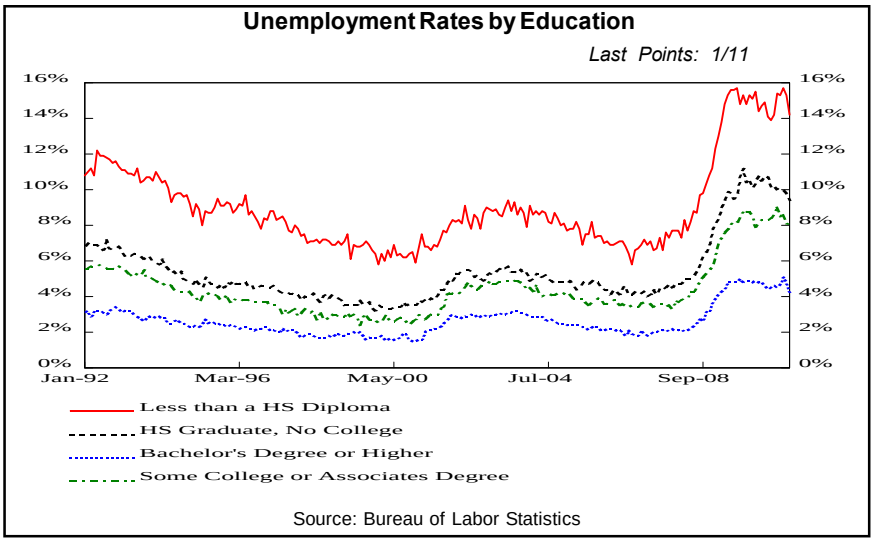
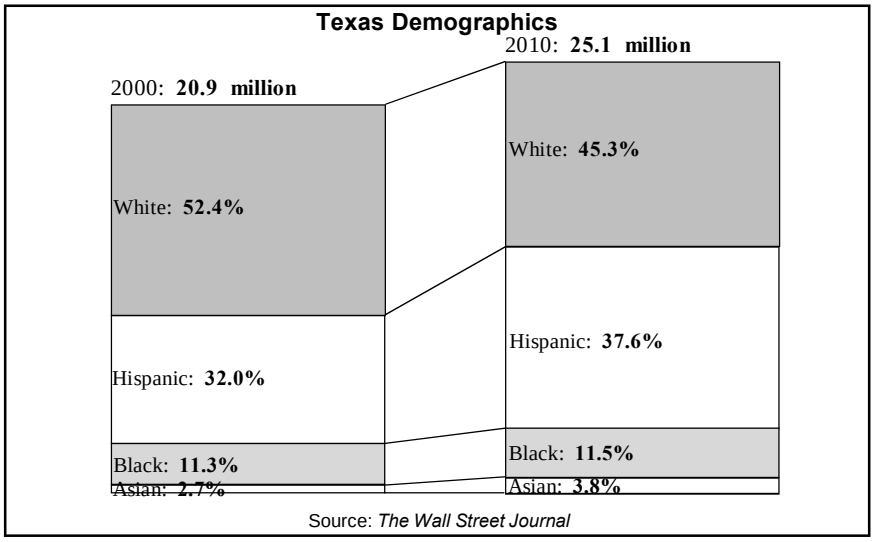



**CHART 36**



by American business. In an era where volume increases are minimal and selling prices can't be raised easily to offset higher materials and other costs, slashing costs, especially labor costs, have been the route to robust profits gains for many firms (*Chart 37*).

Banks continue to slash costs in response to bad loan losses, expensive new regulations that limit their lucrative proprietary trading among other changes and limited loan demand from creditworthy borrowers. From the third quarter of 2007 to the third quarter of 2010, bank profits fell 48%, according to the FDIC, with bank employment down 9% to 2.04 million. Further cost cuts in operating costs of 20% over the next three years are likely with 75% coming from personnel reductions.

Many were surprised by the tiny gain in payroll employment of only 36,000 in January (*Chart 38*), far less than the 200,000 needed to accommodate the trend rise in the labor force. And bad weather didn't explain the shortfall. The payroll survey is made in the week that contains the twelfth day of the month, and an employee is counted if he worked only one day in the week. Severe snowstorms in the January week did keep many from their jobs, but not for the entire week.

## Many Years of Cost-Cutting

Serious cost-cutting by American business has been going on for years, importantly in reaction to the international competition brought on by globalization. Even at their tops in 2006-2007, job openings and hires did not exceed their peaks right before the 2001 recession (*Chart 39*), even though real GDP rose 17.5% between the second quarter 2001 cyclical peak and the second quarter 2008 top. Business has been improving productivity and cutting costs for years by not hiring new people as output expands rather than laying off existing employees. After rising in the Great Recession, layoffs have returned to their flat trend (Chart

**CHART 37**

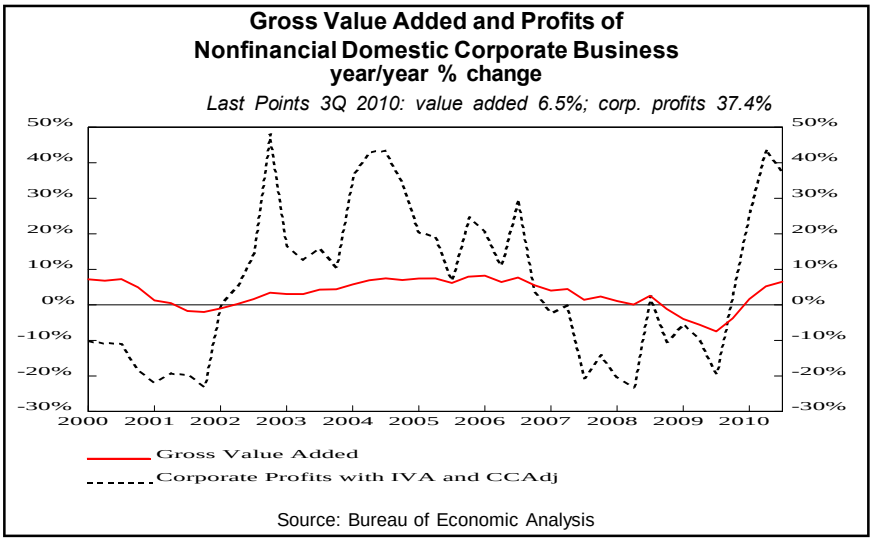



**CHART 38**

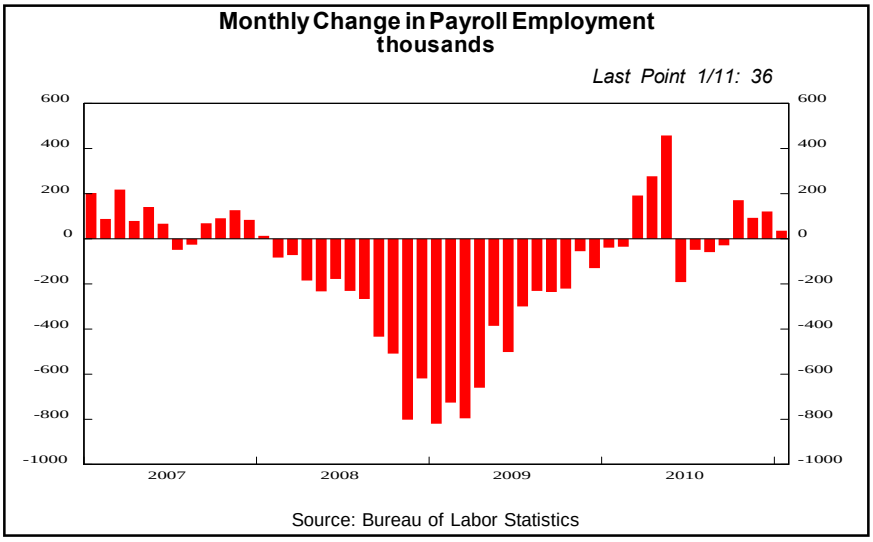
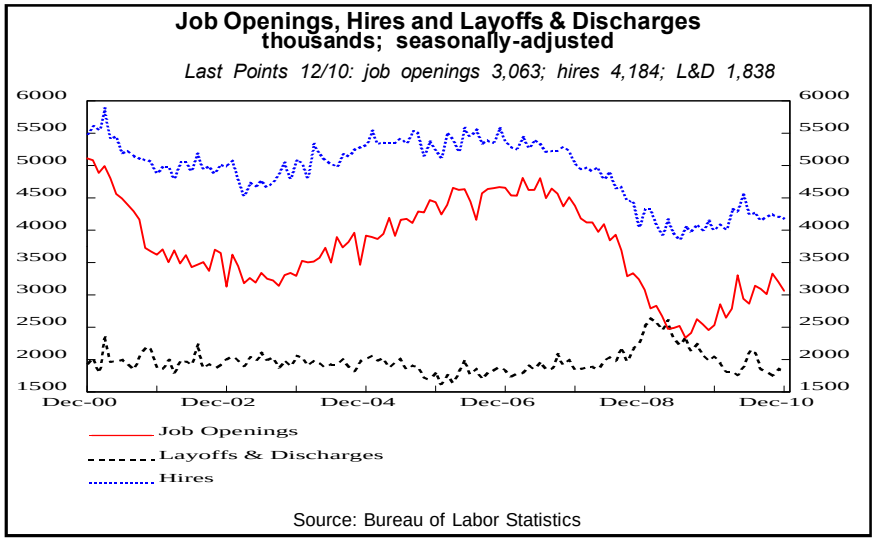



**CHART 39**



39), while job openings have jumped. But new hires have been relatively flat. Why?

With so many unemployed, businesses can be choosy and take their time in hiring. Unemployed people per job opening has declined from its peak but remains very high (*Chart 40*). Also, many of the unemployed probably lack the skills needed for the available jobs. With the collapse in housing stocks (Chart 17) and drastic decline in commercial construction, many mechanics are mismatched to job openings. Alot of them are Hispanics and a number have returned home, but others remain on U.S. unemployment rolls. Some people have been unemployed so long that their skills are obsolete (*Chart 41*). Others are reluctant to take jobs, especially temporary positions in distant locations because their working spouses may not be able to find employment in those areas. Also, firms have been slashing relocation benefits for new and existing employees.

Some job-seekers are under water on their home mortgages and can't move to take job offers. Labor immobility is a new and disturbing hindrance in the U.S. job market. The ease of moving across the country if necessary has always been a boon to American employment and growth. It was key to opening the West in the 19th century. In the early 1990s, Southern California entered its first serious recession as the end of the Cold War slashed defense and aerospace spending. Even in the 1930s, immigration sustained growth in Southern California—recall the trek from Oklahoma in *The Grapes of Wrath*. Many displaced workers in the early and mid-1990s in Southern California moved to New England where jobs were plentiful.

In contrast, Europe suffers from labor immobility even though people are allowed to move throughout the 27 European Union countries and take jobs anywhere. But people in chronically depressed Sicily don't want to move to booming Germany in search of work. They don't speak German, don't enjoy beer and bratwurst and probably have lived in the same village, maybe the same house, their entire lives so they are uncomfortable in new places.

**CHART 40**

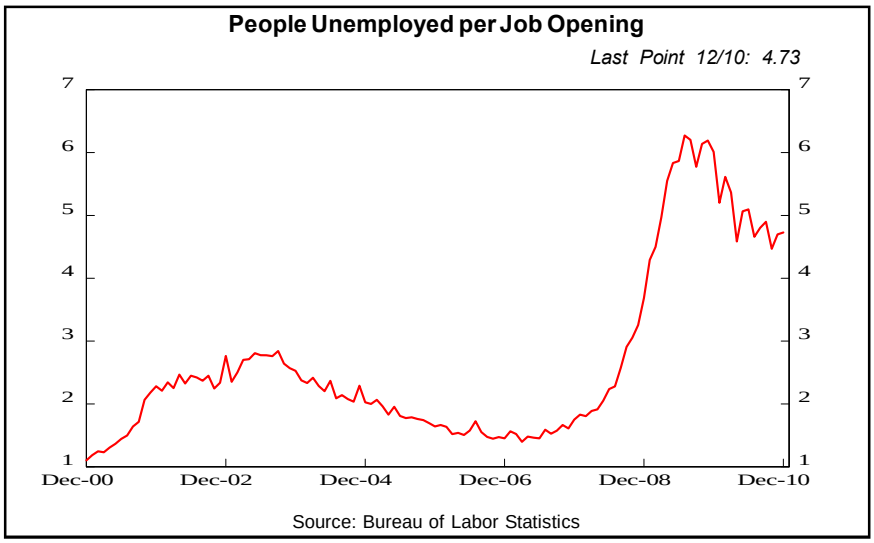
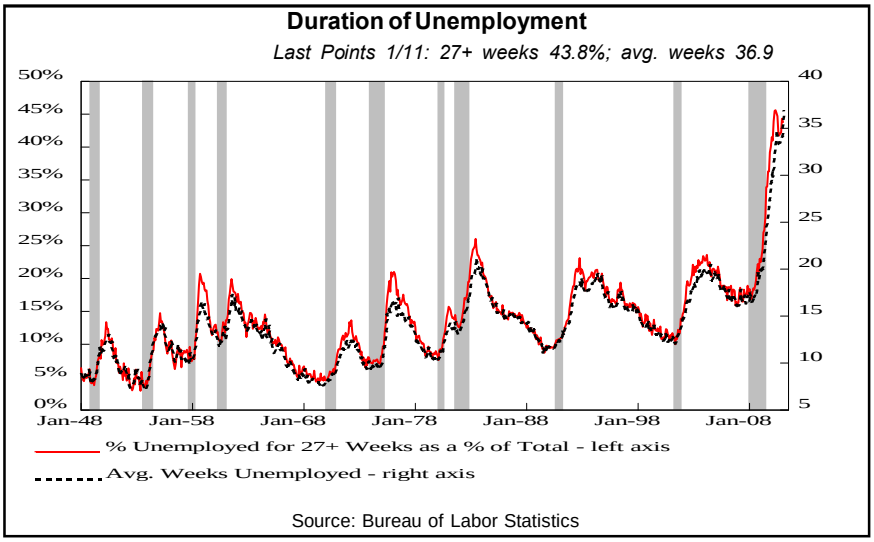



**CHART 41**




## Government Regulation

Increased government regulation in response to the housing collapse and the near meltdown of the financial sector is also inhibiting employment and economic growth, as discussed in our new book, *The Age of Deleveraging*. Small businesses often lack the resources to adapt to new government rules, and a Small Business Administration report estimates that if regulations were geared to promote business growth, based on the World Bank index, GDP in the U.S. would be $1.24 trillion larger than the current $13.37 trillion. Small business complains that they got little of the $787 billion federal stimulus enacted in 2009 despite government favoritism.

Between January 2009 and August 2010, the SBA approved $22 billion in small business loans, but many small

businesspeople don't believe they have access to credit and their overall borrowing dropped 6.2% between 2009 and 2010. The small business tax breaks contained in the stimulus package weren't effective, in part because they only were realized when returns were filed, not earlier when relief was needed.

State professional licensing requirements have mushroomed over the years. A recent study found that in 2008, 23% of U.S. employees were required to have licenses, up from 5% in 1950. Some 800 professions are covered in at least one state, ranging from florists, interior designers, private eyes, conveyor-belt operators, librarians, respiratory therapists, hearing aid fitters, nutritionists, electricians, plumbers and retailers of frozen desserts. By erecting barriers to entry, licensing raises the incomes of those covered by 15% compared to their unlicensed counterparts and adds an estimated $116 billion to the cost of consumer services. Then there's the cost of the huge bureaucracies and armies of inspectors spawned by licensing laws.

## Manufacturing Revival

Some see the salvation to a generally miserable employment picture in manufacturing, which has experienced a recent revival. We estimate that $40 billion of the $92 billion rise in real GDP in the fourth quarter, seasonally adjusted at annual rates, was contributed by manufacturing. And as a share of GDP, manufacturing output is rising for the first time in years (*Chart 42*). Furthermore, manufacturing employees are well-paid compared to other workers (*Chart 43*).

But productivity in manufacturing is high and growing rapidly (*Chart 44*). With the tremendous automation in today's factories, few people needed to be added to accommodate even the recent big jumps in output. From 1950 through 2007, U.S. manufacturing employment dropped by 0.1% annually

**CHART 42**

**CHART 43**

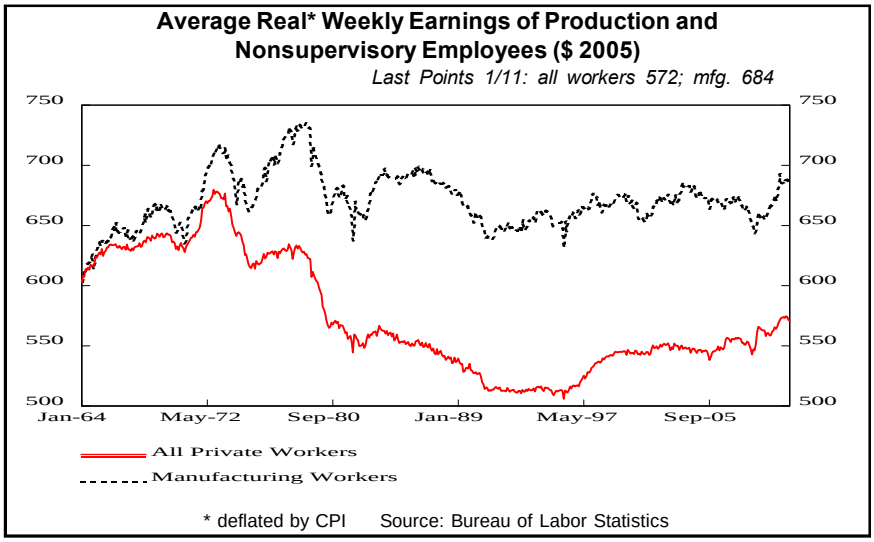
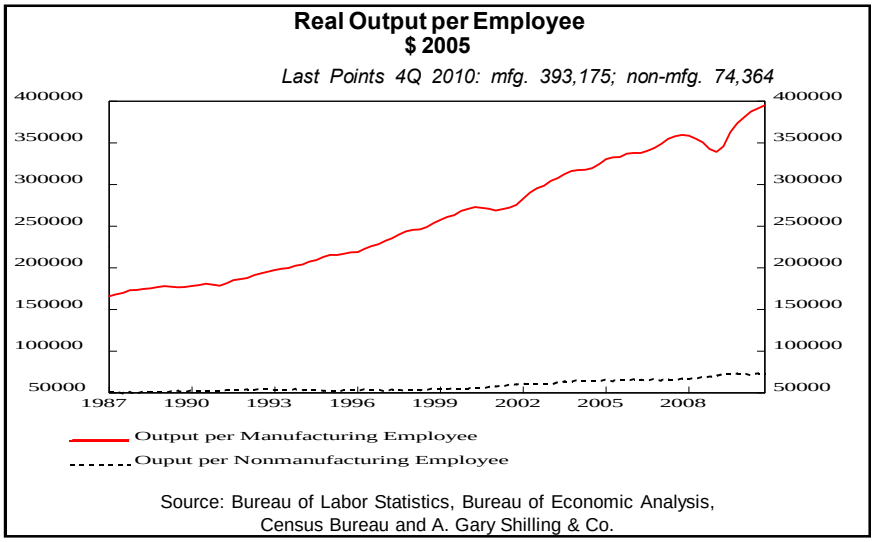


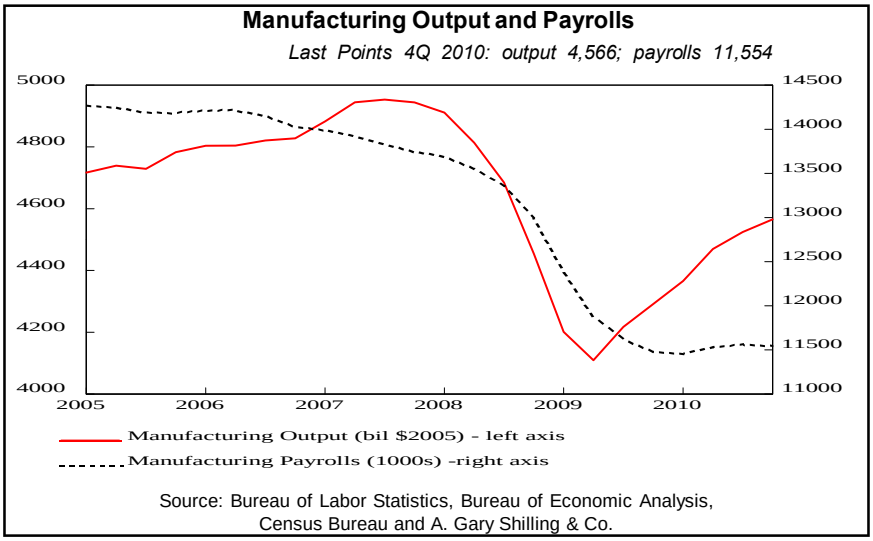

**CHART 44**



on average, but output rose 3.4% per year.

So manufacturing payrolls have grown little in relation to the rise in output in this cyclical recovery (*Chart 45*). In fact, with rapid productivity growth and restrained labor cost increases, unit labor costs in manufacturing have been falling (*Chart 46*). That in large part is the reason that unit labor costs in nonfarm business fell 1.5% in both 2009 and 2010, the first time since 1962-1963 that unit labor costs dropped in two consecutive years. Manufacturing jobs are high paid, but relatively few new ones are being created.

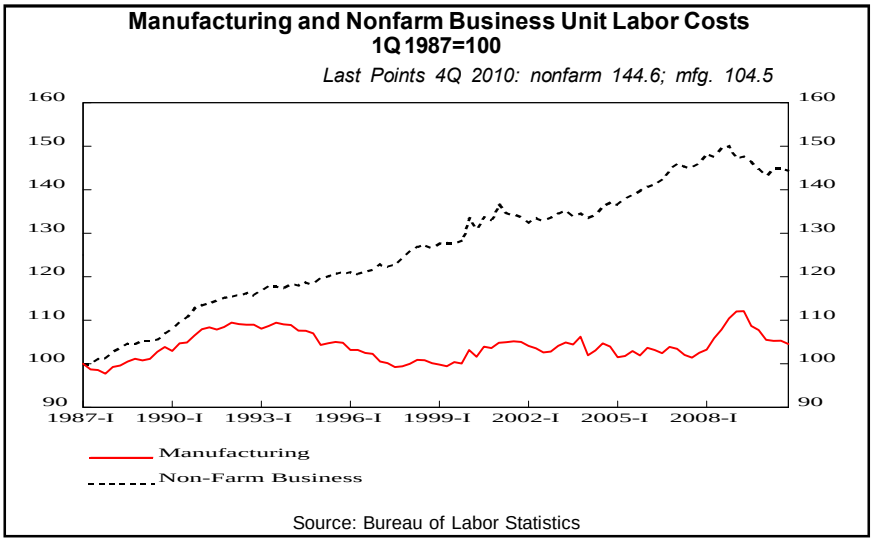
CHART 45




## A Paradox

The cost-cutting zeal of American business has created a paradox, as discussed in *The Age of Deleveraging*. As noted earlier, American business has been cutting labor costs, not so much through layoffs as by not hiring additional employees (Chart 39). Productivity growth has been strong as workers produced more per hour. Much of that productivity growth fell to the bottom line and corporate profits rose robustly (Chart 37).

CHART 46




This presents paradox, a fallacy of composition. Every business, acting in its own best interest to meet domestic and foreign competition, needs to cut costs to promote productivity and profits, especially in today's slow-growth economy. But when most businesses do so, there probably won't be enough labor income paid out to purchase the combined output of the business sector. That great economist, Henry Ford, paid his auto workers an unprecedented $5 per day so they could afford to buy the Model Ts they built.

This paradox has been hidden until recently. Consumers lacked adequate purchasing power from their paychecks, so they saved less and borrowed more to bridge the gap between their income and their spending growth. But now we believe that consumers have reversed from a 25-year borrowing-and-spending binge to a saving spree (*Chart 47*), so the mask is off. Their incomes and spending are inadequate to buy all of the domestically-produced goods and services plus net imports.

## Profit Margin Squeeze

This will add further to the already clear squeeze in profit margins, covered in previous *Insights*. Commodity prices have been on a tear (*Chart 48*), most recently pushed in part by the oil price spike spawned by the Middle East unrest. The commodity boom has also been fueled by expectations of robust economic growth, especially in China, which appeared to be buying up all the industrial materials, food stocks and other commodities in the world. Another factor was bad weather in many countries, including Russia, Argentina and Australia, that restricted agricultural output.

Much—no doubt far too much—of the leap in commodity prices is due to buying by investors and other speculators. ETFs have already tied up much of the physical supplies of gold and other precious metals. Talk about bubbles! If

commodities aren't in one, we don't know what they look like! As is spelled out in *The Age of Deleveraging*, we've studied a lot of bubbles over the years and concentrated on predicting their demises.

Meanwhile, as discussed in our December *Insight*, consumers continue to resist the determined efforts by producers, wholesalers and retailers to pass leaping commodity prices through to them (*Chart 49*). The Institute for Supply Management's regional survey for the Dallas area in January showed that its prices-paid component leaped from 42.6 in December to 61.6, but prices received rose only eight points to 19.4.

The ratio of producer prices at the crude stage to prices at the finished stage is jumping back toward the peak reached in the 2008 commodity bubble (*Chart 50*).

Because they can't pass through cost increases, producers, importers, wholesalers and retailers are working vigorously to hype marketing, cut labor and other costs and resist price increases from suppliers. Whirlpool is slashing costs and promoting productivity, as mentioned earlier, but also hopes to raise prices 8% to 10% in April to help offset material cost increases. But the Korean appliance makers LG and Samsung may not go along in order to increase their market shares as U.S. consumers continue to react to price hikes by switching to cheaper products. Raw milk prices in 2010 jumped to $15.40 per hundred weight from $11.48 in 2009. That rise stemmed the profits of Dean Foods, the nation's largest milk distributor that couldn't pass the cost increase on to supermarkets.

**Private Labels Win**

Colgate-Palmolive, Clorox and Energizer Holdings are all cutting costs since passing them through is already impossible. The profit margins of well-managed and lean Kroger, which

CHART 47

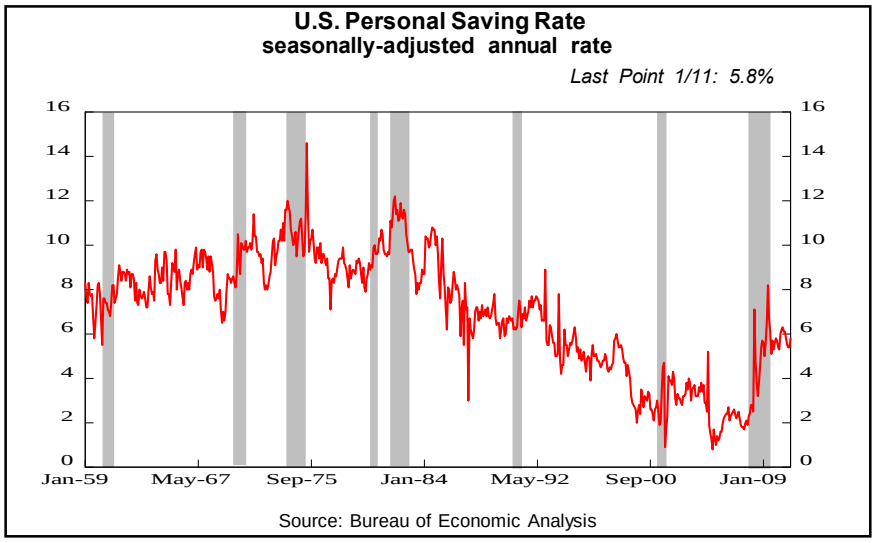



CHART 48

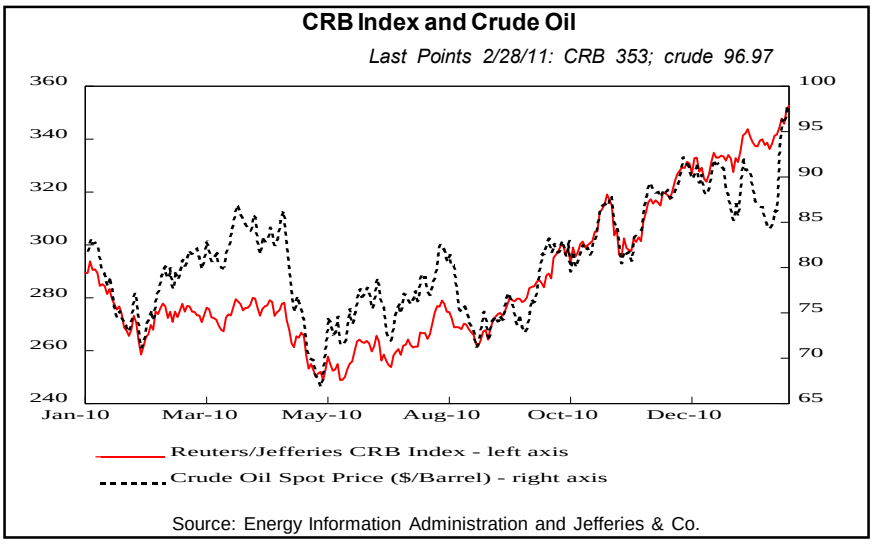
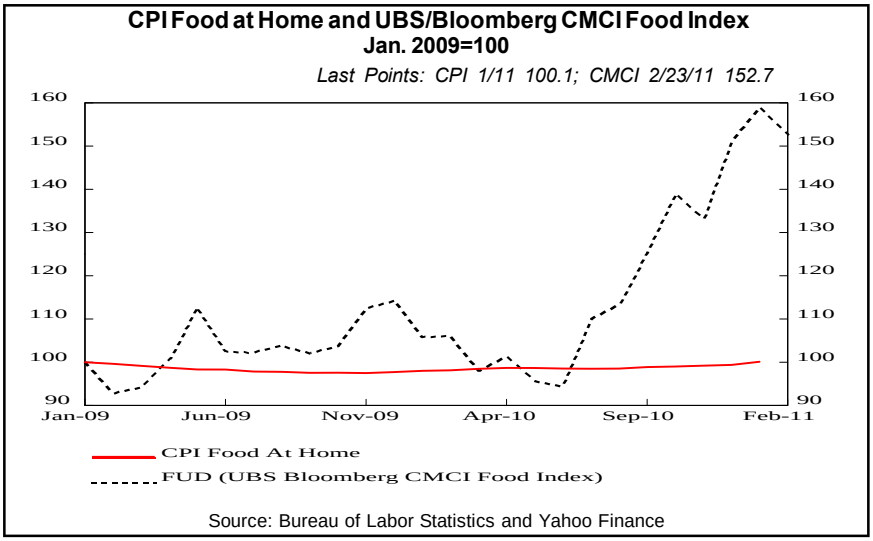
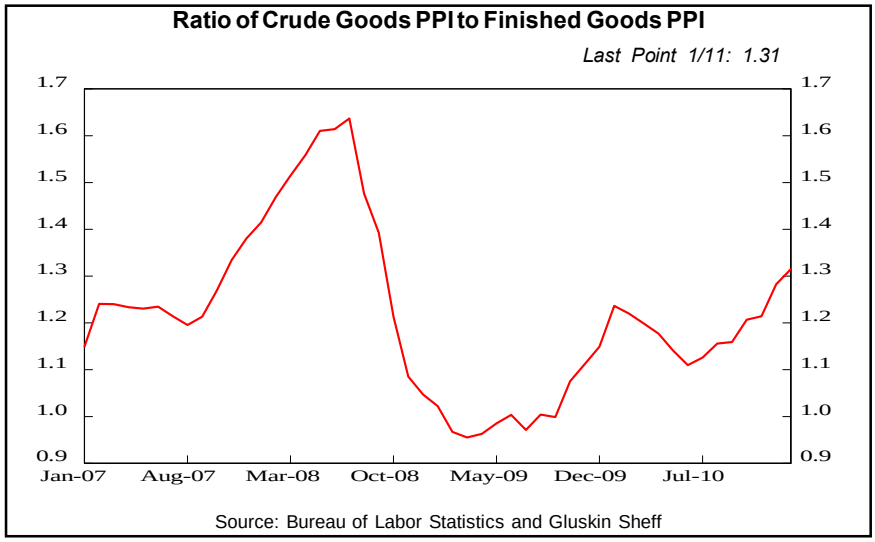



CHART 49



successfully competes with Wal-Mart, are being squeezed by rising costs. Proctor & Gamble, which prides itself on selling premium products at premium prices to customers who are insensitive to costs, is being squeezed by slow sales as frugal consumers do exhibit price sensitivity. The firm is vigorously cutting costs in response, but expects rising costs to slash $1 billion from profits in its fiscal year ending June 30, twice the impact it expected eight months ago. Sara Lee's CEO recently said his company faces $550 million in higher commodity costs this year vs. 2010. Kraft recently stated that its commodity costs in 2011 will be up $700 million to $800 million over last year. In the four weeks ending Dec. 25, 2010, private label sales rose 1% from a year earlier while national brands fell 0.8%. In the same period in 2009, private labels gained 5.7% while brands dropped 1.9%.

CHART 50




Many wine lovers switched from high-priced vintages to bottles selling below $20 during the recession and have stayed there. Wine at $9 to $12 a bottle rose 12% in food, drug and convenience store sales by volume in 2010 while overall sales grew only 3%. Restaurants realized they can't hike menu prices without driving diners elsewhere, and are responding with cheaper cuts of steak and other lower-cost substitutions. And bear in mind that raw materials are often only a tiny fraction of finished consumer products. A loaf of bread that sells for $2.50 to $3.50 contains only about 12 cents in wheat. A 1% rise in food producer selling prices offsets about a 5% rise in commodity costs. Prices, for flat-rolled steel, have risen 20% to 30% since November, but steel constitutes only 4% of the cost of a car.

Jet fuel, however, is a major component of airline costs, approaching 40%, up from 25% in 2010, and airlines have been able to pass on higher fuel costs through airfare hikes. This year, they've made five broad-based fare increases of at least $10 on round trips on two-thirds of their routes, compared to three last year and four in 2009. On the other hand, oil refiners are unable to pass on their increased costs of crude oil (Chart 11) in higher selling prices for gasoline and diesel fuel without risking a drop in demand. Recall that in 2008, the peak crude oil price of $145 per barrel and gasoline costs over $4 per gallon led to slashes in driving.

### Pressure From Amazon

Online retailer Amazon is thriving among cost-conscious consumers and putting immense pressure on bricks and mortar stores. Sales rose 40% last year, and a diverse basket of products cost 19% more at Wal-Mart, plus the sales tax that online shoppers don't pay. Wal-Mart has also suffered as it tried to compete with more upscale Target and has seen its low-income customers move to even cheaper dollar stores and discount grocery chains. So the retailing giant, which has suffered declining U.S. same-store sales for two consecutive years, is going back to its roots of everyday low prices for low-income folks—and others, like us, who love bargains. Welcome home, Mr. Sam!

At the same time, consumers, rich and poor, continue to indulge themselves on the very best of what they can afford. This is the heart of the "small luxuries" investment theme we've been advocating for years. Proctor & Gamble's Gillette Fusion Pro-Slide spring-loader razor with a five-blade cartridge and battery-powered vibrator is in this category. As discussed in *The Age of Deleveraging*, it was introduced last June and a four-pack of manual cartridges sells for $16.99, $17.99 for the battery-powered version. It's now selling so well that supply shortages exist. Last Christmas, Tiffany, which sells high-end jewelry but also low-cost trinkets in its distinctive blue boxes did well. So did down-scale jewelers Zale and Kay Jewelers owned by Signet Jewelers.

### The Squeeze

The squeeze between the rises in commodity and other costs and the inability to pass them through to consumers and other buyers will be resolved, one way or another. Inflation bulls believe it will be through a burst of higher prices and renewed serious inflation. We, on the other side, believe that we're in the Age of Deleveraging, that consumers are determined to increase their saving rate (Chart 47) and reduce their debts (*Chart 51*) as they rebuild their net worth.

*(continued on page 22)*

# INVESTMENT THEMES

**Our Investment Themes section reflects the positions that are in or being considered for our managed portfolios. We may add or delete portfolio positions in the course of the month, but those changes will not be shown in *Insight* until the following month's report.**

The turmoil in the Middle East has introduced considerable volatility into security markets and threatens global oil suppliers and the worldwide economic recovery. In this environment, we're investing cautiously.

**Treasury bonds** (favorable) Treasurys have rallied as a safe haven in a sea of trouble. Slowing growth and looming deflation will also favor Treasurys. These are available through security brokers, banks and www.treasurydirect.gov as well as via ETFs and futures contracts.

**Income-producing stocks** (favorable) Included are utilities, drugs and telecoms with high, safe and rising dividends. Also, master limited partnerships. They can be purchased individually or through ETFs.

**The dollar vs. the euro**. Also the **Dollar Index** (favorable) The eurozone remains in deep trouble and the buck is the world's safe haven. Implement this theme with futures contracts and ETFs on the dollar index as well as put options.

**The dollar vs. Australia dollar** (favorable) Australia has become a Chinese colony as the island continent's minerals are dug up and sent to China. And China is in the "stop" phase of her stop-go economic policy. Implement this theme with futures.

**Eurodollar futures** (favorable) This theme depends on the Fed continuing to keep rates flat in the face of an uncertain economy, at least through the middle of next year. Big moves in eurodollar prices are small in absolute terms, so an investor needs the leverage of futures contracts to make meaningful money. Calls on the futures are also available.

**Rental apartments** (favorable) are gaining favor by those who can't afford home ownership and are discouraged by falling house prices. REIT prices seem overblown, but direct ownership of rental apartments may still be attractive. See "The Two-Tier Recovery," page 1.

**North American energy** (favorable) As a nation, the U.S. has decided to reduce dependence on imported energy from high-risk areas such as Venezuela, Africa, Russia and, especially, the Middle East. We like conventional energy investments including natural gas. Renewable energy depends heavily on unpredictable government subsidies. Implement with futures, ETFs and individual stocks.

**Sell your house, second home or investment single-family houses yesterday, if you plan to do so any time soon** (unfavorable) Excess inventories are likely to push prices down another 20%.

**Developing country stocks** (unfavorable) We're short China in anticipation of a hard landing there.

**Commodities** (unfavorable) The commodity bubble may be beginning to break as others join us in thinking about a hard landing in China, falling U.S. house prices and an oil shock. We're short copper and sugar, but very modestly.

# Summing Up

Stocks weathered the relatively peaceful Egyptian revolution early in February but the violent upheaval in oil-rich Libya gave the market several days of fits late in the month as crude prices pushed towards the $100 per barrel mark. The Dow Jones Industrials rose 2.8% in January while the S&P 500 was up 3.2% and the Nasdaq was up 3.0%. Overseas markets were mixed.

The dollar was down slightly against the yen and the euro in February. Yields on 10-year Treasury notes rose in early February to the 3.7% level before settling back near where they began the month.

The Fed last month upped its 2011 forecasts for the economy, with the central bank now looking for GDP growth rates of 3.4%-3.9% vs. the 3.0%-3.6% forecast issued last November. The jobs outlook barely improved, with the Fed expecting the unemployment rate to be 8.8%-9.0% this year, a tenth of percentage point better than its earlier forecast.

While minutes from the Fed's January policy meeting showed a lessening concern about deflationary risks, policymakers expect inflation rates to remain below the Fed's 2% target level "for some time." Chairman Bernanke echoed this expectation last month before Congress, and added that the run-up in commodity prices was "a result of the very strong demand from fast-growing emerging market economies, coupled, in some cases, with constraints on supply." The Fed's next policy meeting will be March 15.

CPI rose 0.4% in January vs. December and is up 1.6% year-over-year. Core CPI rose 0.2% and was 1% higher than a year earlier. Producer prices rose 0.8% in January, driven by a 1.8% rise in energy prices, although food costs were up only 0.3%. Core PPI was up 0.5%, the fastest since October 2008. As the Egyptian revolution resolved itself peacefully, crude oil prices trended downward before shooting up later in February amidst anti-government protests in Libya and elsewhere in the Arab world.

The revised reading for fourth quarter 2010 GDP showed a 2.8% gain, slower than the 3.2% initial estimate. Consumer spending rose 4.1%, the fastest rate in four years.

Retail sales rose 0.3% in January—the seventh straight monthly increase—but the figure was below expectations. December's gain was revised down a tenth of a point to 0.5%. Ex autos, sales rose 0.3%

Despite an onslaught of lousy weather across much of the country, retailers in January saw better-than-expected sales. Overall same-store sales rose 4.2%, according to Thomson Reuters, above forecasts and higher than the 3.3% gain of a year earlier. Department store sales were up 2% while discounters saw a 5.2% gain. No. 1 Wal-Mart, which reports its data on a quarterly basis, said same-store sales fell 1.1% in the period ending in January, the seventh straight quarterly decline.

Job creation continued to be weak in January as only 36,000 nonfarm payroll jobs were added. November and December's jobs gains were revised upward, to +93,000 (vs. +71,000) and +121,000 (vs. +103,000), respectively. The national unemployment fell to 9.0% from 9.4% in December.

In early February, Bernanke said: "Until we see a sustained period of stronger job creation, we cannot consider the recovery to be truly established. It will be several years before the unemployment rate has returned to a more normal level."

Housing starts rose 14.6% in January, fueled by a 78% increase in multi-family construction. Single-family home starts fell 1.0%. Building permit issuance in January fell 10.4%. New home sales fell 12.6% in January vs. December. Sales were down by double digits in the South and West but up in the Midwest and Northeast. The median price stood at $230,600, down 1.9% from December. Existing home sales rose 2.7% in January but most of that gain was due to rising foreclosures (37% of sales) and all-cash deals (32%). Unsold inventories stood at 7.6 months and the median price was $158,800, down 3.7% from a year earlier and the lowest since April 2002.

The Case-Shiller 20-city home price index declined 1% in December from November, and is off 31.2% from its July 2006 peak.

Consumer sentiment rose to 77.5 in February from 74.2 in January, the University of Michigan reported. The Conference Board's index of consumer confidence rose to 70.4 in February—its highest level in three years—from 64.8 in January.

*Fred T. Rossi*
*Editor*

**INSIDE THE NUMBERS**

| | Feb. 2011 % Change* | Year-to-Date % Change |
|---|---|---|
| Dow Jones Industrials | +2.8% | +5.6% |
| S&P 500 | +3.2% | +5.6% |
| Nasdaq Composite | +3.0% | +4.9% |
| Nikkei Average | +3.8% | +3.9% |
| FTSE 100 | +2.3% | +1.6% |
| Hang Seng | -0.5% | +1.6% |
| | **Feb. 28** | **Jan. 31** |
| 10-yr. Treasury note | 3.41% | 3.38% |
| $=¥ | 81.76 | 82.09 |
| $=€ | 0.72 | 0.73 |

**through Feb. 28*

# Two-Tier Recovery

*(continued from page 19)*

This implies that they will continue to resist higher prices, search diligently for cheaper alternatives when price hikes are attempted, and force producers and retailers to offer ever-bigger discounts and promotions. And this downward pressure on prices, in our judgment, will continue to back up to wholesalers, producers of final goods, their suppliers and, ultimately, to commodity producers.

In addition, the commodity bubble may burst (Chart 48) as Chinese policymakers slam on the brakes to curb her robust economy. The economic growth outlook in the U.S. appears muted since no sectors appear poised to pick up the slack as the inventory cycle and fiscal stimulus play out. Growth prospects are even worse in Europe where the financial woes in Greece and now Ireland threaten to spread to Portugal and Spain and disrupt the eurozone and other countries' financial structures and economies.

U.S. retail sales growth is on a weakening trend. Early in last Christmas's selling season, sales were robust, apparently responding to very attractive prices, but grew less rapidly as the season progressed. Sales in January were up only 0.3% from December, the third month of deceleration. This isn't surprising given the strong statistical and logical relationship between retail sales and employment whose growth is flagging (*Chart 52*). Notice that employment leads retail sales, as you'd expect.

Slower consumer spending growth is also necessary if the household saving rate is to resume its upward trend towards double-digits, as we expect (Chart 47). And slower economic growth coupled with the cost squeeze on profit margins will further arrest the growth in profits. Congressional Republican-led efforts to cut federal spending this year could further reduce economic and profits growth. Furthermore, low interest rates and increased government regulation are curtailing earnings of financial institutions. Energy cost spikes will damage the bottom lines of heavy users like airlines and truckers. Falling house prices will hurt homebuilders and their suppliers as well as those involved in mortgages.

**CHART 51**

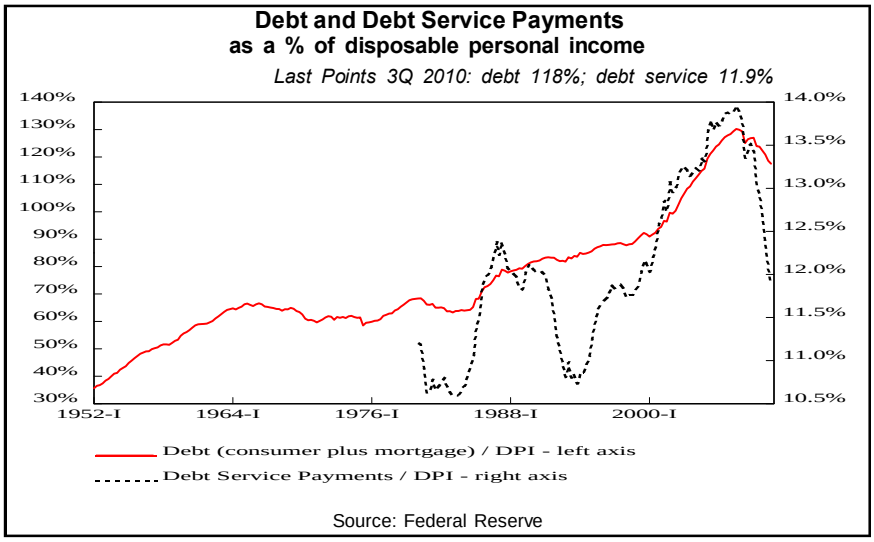
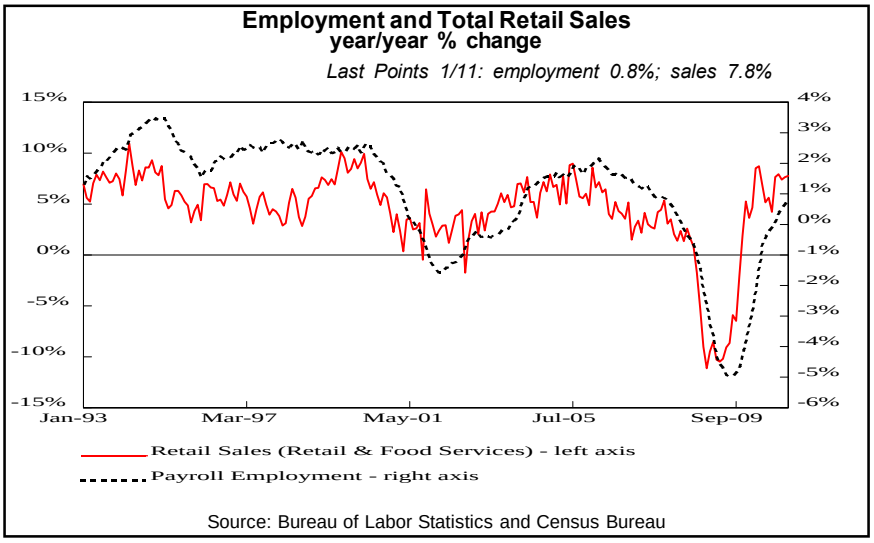



**CHART 52**



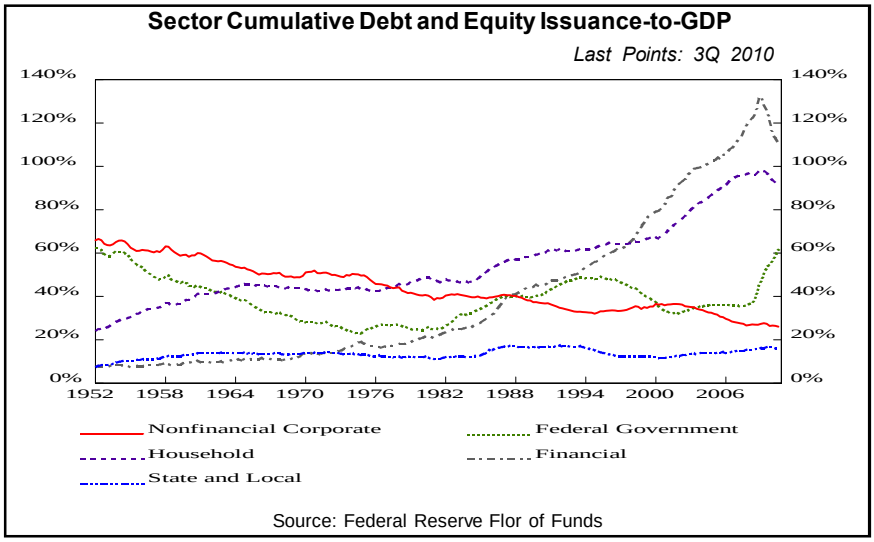

### Four Downside Risks

Furthermore, we continue to believe that the U.S. economy remains so fragile that it could easily be driven into another recession by even a moderate shock. We discussed one of those, a further decline in house prices, earlier in this report and in previous *Insight*s. A second possibility, a hard landing in China, was covered in detail in our February *Insight*. We've explored a third possible shock, a sovereign debt crisis in the Eurozone, in earlier *Insight*s and will revisit this soon. A fourth and new possibility, a Middle East oil crisis, is suggested by the riots and/or government overthrows in Tunisia, Libya, Egypt, Algeria, Yemen and Bahrain as well as rumblings in Saudi Arabia. Remember that the first oil crisis in 1973 when the Saudis suspended oil exports and the

second in 1979 in the aftermath of the Iranian revolution were both associated with major recessions.

Slow economic growth and the related disappointing profits would probably spell the end of the robust stock market rally that commenced in March 2009 (Chart 1). And that would curb the incomes and spending of the upper crust, which has benefited so much from equities' revival. So what has been a two-tier economic recovery—with the fortunes of higher-income folks reviving swiftly while the rest suffered—could revert to everyone being in the same slowly-moving boat.

**CHART 53**




We remain convinced that the deleveraging process, especially in the financial and consumer sectors that leveraged up tremendously in earlier decades (*Chart 53*), is a multi-year process, dominated by slow growth and retrenchment.

The euphoria created among upscale consumers by the rebound in security markets in the last two years is not sustainable, in our judgment.


# Endgame

Our great friend John Mauldin, along with Jonathan Tepper, has written *Endgame: The End of the Debt SuperCycle and How It Changes Everything*, which is being published this month by John Wiley & Sons.

We've known John for many years, and *Insight* readers may be familiar, as are we, with his weekly e-letters, *Thoughts From the Frontline* and *Outside the Box*. John's thoughts on the economy, finance and investing have always been insightful, informative and useful—and *Endgame* delivers on all three.

This book offers a treasure trove of analyses and research on how the decades-long debt supercycle resulted in the financial crisis and, then, the massive deleveraging that is still underway by debt-burdened individuals, corporations and governments. The authors also take us on a country-by-country tour to explain each nation's problems, the policy options—both good and bad—available, and possible investment opportunities.

We've always benefited from John's advice and observations, and his new book certainly doesn't disappoint in that regard. We highly recommend that you pick up a copy!

*Endgame* is available on amazon.com and barnesandnoble.com as well as at major bookstores

# Book Review: *The Age of Deleveraging*

By Mark K. Bhson, as published on Feb. 16, 2011 in *The Finance Professionals' Post*, a publication of the New York Society of Security Analysts (NYSSA).

As the US recovers from its longest and deepest recession since World War II, financial practitioners and economists have varying opinions on the future of the global and American economies. In *The Age of Deleveraging: Investment Strategies for a Decade of Slow Growth and Deflation*, A. Gary Shilling argues that the global economy is experiencing a prolonged period of deleveraging and muted growth that will make deflation a likelier and greater threat to investors than inflation. Shilling is president of A. Gary Shilling & Co., an economic consulting firm and a registered investment advisor, and a former economist at Merrill Lynch.

Shilling predicts sustained price declines of approximately 2.50% annually and asserts that the robust growth that began in the early 1980s was fueled by significant financial leveraging and excessive debt, first in the global financial sector and later among American consumers. These two sectors are now deleveraging and are transferring their debts to governments and central banks. Shilling concludes with his view on the equities market and his insights into which investments to avoid and which to buy.

Before exploring his prediction of slow growth and deflation, and the optimal investing strategies in this environment, Shilling describes seven "great calls" that he has made in his career. These great calls include forecasting the 1969–1970 recession, the 1973–1975 recession, the Japanese real estate/stock bubble of the 1980s, and the recent financial crisis. A great call must meet three criteria: (i) it must involve an important economic or financial development, (ii) it must be nonconsensus, and (iii) it must evolve for the reasons stated, not just due to random luck.

Shilling maintains that slow growth in the global economy over the next decade will result from US consumer retrenchment, financial deleveraging, increased government regulation and involvement in advanced economies, low commodity prices, and the shift by advanced economies to fiscal restraint. Other reasons he cites for slow global growth are rising protectionism, continuing weakness in the US housing sector, deflation, and weak state and local government spending. According to Shilling, deflation presents itself in several forms but is fundamentally driven by supply exceeding demand. New productivity-enhancing technology and globalization will drive the "good" deflation of excess supply, while slow economic growth will spur the "bad" deflation of deficient demand.

In regard to equity markets, Shilling notes that corporate earnings grow with gross domestic product in the long run. Given the current environment of slow growth and deflation as well as falling price-to-earnings ratios, stock appreciation will be constrained and below dividend yields. He argues that history favors market timing over buy-and-hold strategies, a situation that will be accentuated in this current environment.

Shilling's 12 investments to sell or avoid include big-ticket consumer purchases, consumer lenders, conventional home builders, collectibles, banks, junk securities, companies with below-average revenue growth, low-tech equipment producers, commercial real estate, commodities, Chinese stocks and bonds and those of other developing countries, and Japanese securities. His 12 investments to buy include Treasury bonds, dividend payers, consumer staples, small luxuries, the US dollar, asset managers and advisers, factory-built houses and rental apartments, healthcare companies, productivity enhancers, and North American energy. Assuming that Shilling's economic thesis of muted growth and deflation is accurate, these investments to avoid and buy seem logical. It will be interesting to observe if his current economic thesis turns out to be his eighth great call.

–Mark K. Bhasin, CFA, FRM, CAIA, is a vice president at Basis Investment Group, a multi-strategy commercial real estate finance platform based in New York City. He is also an adjunct professor at SUNY Stony Brook and Columbia University, and a current faculty member of NYSSA.

# Impressions, Expressions & Experiences Of the Revolution of January 25th, 2011

By Tarek Swelim

*Editor's Note*: Gary and his wife, Peggy, met Tarek Swelim as their guide on an upscale Stanford-sponsored tour of Egypt in 2009. He holds a Ph.D. in Islamic art from Harvard and is recognized as among the best tour guides in Egypt. He has lectured throughout the world on Islam and Egypt's history, and in that role has visited the U.S. many times. Dr. Swelim's wife is from a prominent Egyptian family in the furniture business, and the farewell dinner on the Stanford tour was held in his home, which is in the family compound.

When the Egyptian revolution started, Gary sent Tarek an e-mail to inquire about his well-being, and he responded with this report. We've never run a guest article in *Insight* but thought that you, too, would be interested in the observations of Dr. Swelim, "our man on the ground" in Egypt.

The Revolution of January 25th, 2011—had a tremendous impact on me. This was the reason why I had to write the following lines. Please bear with me.

Through Facebook and Twitter, a call was announced to a large congregation on Tuesday January 25th, as it was a public holiday observing Police Day. Such a call had happened several times in the last couple of years. I thought it was going to pass as always, without any concrete results. The day passed and was well advertised on the different satellite channels.

Another call was announced to have a demonstration on the following Friday (January 28th), which was to take place after the Friday Prayer, at everyone's nearest square and specifically at Tahrir (Liberation) Square, to demonstrate against the 30 years oppressive Mubarak regime, with three aims in mind: 1) Change. 2) Freedom. 3) Social Equality.

During the course of the day, all mobile communications got cut off. As a result, I could not communicate with anyone. Following that, all Internet communications were also cut off. Of course, this paralyzed and upset me a great deal.

At Tahrir Square in downtown Cairo, the protestors were peacefully standing and calling out their demands. Little by little, the police forces started to harass them. Shortly after, they attacked them, beating them very hard, and when the protestors showed more toughness, the police forces escalated their brutality by using tear gas and even rubber bullets. Later, the fighting increased and police started to use live ammunition and water cannons everywhere. A few people were killed and hundreds injured.

The same day, I happened to be leading a tour at Saqqara. I had some wonderful guests coming to enjoy Egypt, its history and monuments. I was quite impressed by their dynamic enthusiasm about Egypt, as they were well read and all for it. I was trying to be pleasant, interesting and entertaining. However, I have to admit, I was very nervous at the consequences of the demonstrations. My main concern was the safety of my guests, and to take them back safely to their hotel without causing any panic. I succeeded. However, my difficult task in the following days was trying to convince them to fly back home as quickly as possible, as things were deteriorating. With much reluctance, they finally did when the American Embassy ordered all American citizens to leave Egypt.

At night, President Mubarak gave a speech, where he dismissed his government and appointed a Vice President for the first time in his 30 year reign. The next day, a new government was appointed. Demonstrators found that Mubarak did not understand their demands. They wanted him out, not his government.

The demonstrations continued the following day, but the police started to attack them brutally. However, the crime of the day was that Police forces were ordered to evacuate Tahrir Square after fierce fighting had been used against protestors. We were told that the military was to intervene in order to assist police. Contrary to what had been announced, police forces vanished from the scene entirely. In about a half an hour's time police forces were not there. A few hours later, the military started showing up.

The crime was brilliantly orchestrated. Because of the brutality of the police forces during the demonstrations, demonstrators throughout the country started attacking police stations, burning and destroying them. As a result, prisons were opened and thousands of prisoners escaped, and started looting, throughout the whole country. Mega malls were looted, all kind of shops destroyed, hotels, and cars burnt everywhere—even including the head quarters of the NDP (National Democratic Party), right behind the Egyptian Museum of Antiquities! Cairo and Giza had become military zones. Streets were barricaded with everyone protecting his/her family and homes, with sticks, knives and any kind of weapons. Army tanks were everywhere in the city and traffic was organized by their MPs.

As the situation got out of control, a curfew was imposed. This was a new situation for us, as we had not experienced it since 1986.

My wife, Hend, and our sister-in-law Hind were arriving from a 10 day business trip in Paris, where they had been participating in the annual furniture exhibition of "Maison et Objet". Hend called me saying that their flight had been diverted mid-flight to Beirut, as Cairo Airport was closed. I was relieved to know that they were both fine, and eventually made it home the following day.

At home, I was glued to the TV watching the development of events, all the time. However, there was a security situation, which I had never experienced before. Not having any police, we had to find ways of securing the compound where we live. We had no weapons, only long thick sticks and knives. We had an emergency escape planned if ever our house was attacked. Gunshots were fired all and every night.

Another situation came up. Our best friend Katherine Precht and her daughter Miranda decided to come to stay with us, during these difficult days. The reason was that her husband Chris could not make it back from London as flights were canceled and Cairo Airport was closed for some time and they were stranded in an almost empty building in Maadi with no internet or TV. So it was lovely to have them come and stay with us spending time cooking different dishes of pasta everyday.

Personally, I was never into politics and usually preferred to have a global view on things, with not much focus on details. I had never participated in a public demonstration ever in my life. However, with the current circumstances taking place, I decided that it was time to do so—it was my duty to participate in that process of transition. On Tuesday, February 1st—I was part of the "Million Man March" at Tahrir Square, in downtown Cairo. It was a relatively large group of people including my wife Hend, son Karim (20 years old), daughter Farida (17 years), other family members, and many other friends.

Tahrir Square is the center of Cairo. In the 1860s when the Khedive Ismail was preparing for the flamboyant inauguration of the Suez Canal, being largely impressed with the works of the Baron Haussmann in Paris, he founded the new European city of Cairo, west of the mediaeval one. However, the project was executed by the Egyptian Ali Basha Mubarak and designed by the French Urban Planner Pierre Grand Pasha. The downtown business center of Cairo was originally named *Al-Ismailiya*, relative to the name of the Khedive Ismail. Hence, the name of its main square was *Midan Al-Ismailiya*—or Ismailiya Square. However, after the 1952 Coup, its name was changed to *Midan Al-Tahrir*—Liberation Square. This is one of the most important and largest squares of Cairo. There lies the Egyptian Museum of Antiquities, the building of the ex-Nile Hilton Hotel. In front of it is a large open area, which is a construction site for an underground multi-storey garage. Next is the Arab League Building. On the opposite side lie the ex-Ministry of Foreign Affairs, the mosque of Umar Makram and its underground garage, the *Al-Mugamma* Building (which is the center of Egypt's bureaucracy) and the downtown / old campus of the American University in Cairo. It is also the entrance into the center of downtown Cairo. Therefore, Tahrir Square is of great symbolic value and meaning to modern Egyptians.

At Tahrir Square, there was a large diversity of people—intellectuals, westernized people, professionals, people from Al-Azhar, people from Upper Egypt, Aswan and many more. Christians, Muslims, people of all ages were present. Representatives of political parties and celebrities were also present as well as people from all walks of life. Moreover, members of the "*Ikhwan*"—Muslim Brotherhood party—were there (why not?), but most importantly, all were Egyptians together.

What really amazed me most was the discipline of the young organizers; the politeness, and civilized attitude, marking the importance of each one's physical personal space. It was full of people I meet everywhere in my business and social life. It did not include any hooligans. The people had pleasant faces, not ugly ones. They had happy smiles, not grumpy frowns. They had fresh looks and not shabby-looking ones. They were demanding a better future, not a gloomy one. There was not a single act of harassment among the protestors.

I was so proud to see our young Egyptian girls distributing food to everyone who needed to eat. Others were distributing bottled water without expecting anything in return. Some of these girls were veiled; some were unveiled, while others with total *niqab*s. Furthermore, I saw western-looking young girls—in blue jeans—who were collecting the accumulated garbage, in plastic bags. Everything was being done voluntarily. More so, I really never felt safer. In way it seemed like being in musical event, and during time of prayer, it seemed like being in Mecca. People were happy, some were singing, dancing, while others were reciting poetry. We had banners saying "Egyptians Together", "We Love You Egypt". It looked wonderful and was just a fantastic experience.

President Mubarak's speech that evening turned out to be most disappointing. However, because of its brilliant style by which it was compiled, it gained the sympathies of a lot of people.

The following morning (Wednesday), there would be a counter pro-Mubarak demonstration, which was starting at Mustafa Mahmud Square in Giza. Predicting the consequences of such demonstration, I decided not to participate. It was clear that Mubarak's NDP people were going to send their "*baltagiya*" thugs in order to beat up the innocent young protestors. And they sure did. But, even worse, they appeared on camels and horses dashing, charging in, and storming at the anti-Mubarak protesters, by swinging their whips and metal clubs. I must say, these

were very well trained professional gangsters who were there to spark a civil war at Tahrir Square.

The scene reminded me of the 1962 Epic "Lawrence of Arabia" when the Arabs were charging into Aqaba. At least they had dignified cause. Another was the1968 movie "Planet of the Apes," when gorillas were dashing on horses attacking Charlton Heston! Well, that was fiction. I was also thinking of the 2005 movie "Kingdom of Heaven?" But, they were wearing helmets and shields to protect themselves. These young demonstrators did not have anything. The massacre was indeed disgusting. It was a shame to have this bloody attack take place right next to the Egyptian Museum of Antiquities—the pride of Egypt's heritage.

The young Egyptians who were at Tahrir Square on January 25, 2011 have revived our feeling of "Belongingness" to Egypt. They regained and spread "National Pride," and now people are finally calling out for some democracy, which has been lost over the last sixty years, since the Coup of 1952.

The same night - at 2:00 AM (Thursday after midnight), we had an alarming break-in into our compound. Looters managed to break in and destroy a bedroom window by force, trying to enter my in-law's home. They had guns, automatic weapons and started shooting. In a matter of 2 minutes, 30 of our neighbors came to protect us. Thank God—the looters got scared and fled. We were lucky.

But we also looked pathetic; we seemed like the Mamluks, with backward weapons, fighting Bonaparte, the French invader, who had the most up-to-date machinery, at the Battle of the Pyramids in 1798 …!

I would like to say that Egypt—(together with China)—is the longest continuous civilization on Earth. This country has produced great figures in its history who transformed Egypt and made it a powerful state. These figures include: Narmer, Imhotep, Senefru, Hemiuynu, Khufu, to Amenemhat, Senosert to Seqenenra, Kamose and Ahmose, Hatshepsut, Tutmosis III, Amenhotep III, Queen Tye, the Son of Hapu, Akhenaton, Hormehab, Seti Ist, and the great Ramesses II, and Ramesses III, Pasmatic and Necktanebo II, not forgetting Ptolemy II and Cleopatra VII, Trajan and Hadrian. Other great figures were Pakhomius, Ahmad Ibn Tulun, Gawhar al-Siqilli, Ya'qub Ibn Kilis, Salah ad-Din, Baybars, Qalawun, Nasir Muhammad, Ibn Duqmaq and Maqrizi and Sultan Qaitbay, Ali Bey al-Kebir, Murad Bey and Umar Makram and Ali Basha Mubarak. It is also worth remembering that Egypt's "Modern Era" started 206 years ago, with the genius of Muhammad Ali the Great. Our "Europeanization Period" started about 140 years ago with the brilliance of the Khedive Ismail. Our national political parties fought the British Occupation about 100 years ago, under the Khedive Abbas Hilmi II. Then, ninety years ago we had our revolution of 1919. Cairo was the place where everyone who wanted to make a prestigious living would come and work. Investors from all over the world were racing one another to come here. We were the center of the Arabic-speaking world. We were the center of the Arabic movie industry- parallel to Hollywood. We were the center of entertainment in the Middle East. We were the masters of Arab literature, women's liberation movements, all the arts, you name it, and we've had it: architecture, music, theater, crafts and textiles.

The history of Egypt has witnessed the formation of three important organizations. One was the Library of Heliopolis (Iyunw / On) in Ancient Egypt, which was to become the nucleus of the Library of Alexandria, in the Ptolemaic and Roman era. The second was the al-Azhar mosque / madrasa, which was the oldest most popular Sunni institution in the world—during the last 1000 years. The third was the Suez Canal, which became the major waterway between the east and west during the last 140 years.

Where are we from all that now? What the hell is happening to us? What we have now is horses and camels beating our own young people—while, at the same time—throwing Molotov cocktails at the Egyptian Museum of Antiquities, which is the backbone of our Egyptian heritage!

Are we witnessing another Nero, who had Rome burnt in 68 AD? Or are we confronting another Shawar, (the Fatimid Vizier) who—one thousand one hundred years later (in 1168), ordered the city of Fustat—the first Islamic Capital of Egypt—deliberately burnt and destroyed forever?

It gives me great pain to see this happening to my country. It is no doubt the culmination of oppression under the Mubarak regime, a bad educational system, denial of Egypt's heritage and ultimately, the extreme degree of corruption we have reached.

We will certainly read about such barbaric aggressions in the future. We will then look back and contemplate about these dark days of our history. The Mubarak regime will be remembered for it success in bringing the honorable "State of Egypt" to its lowest disgrace—by bringing it down to an "Intermediate Period"—this time, a modern one.

Finally, I would like to say that I am worried about the coming period of transition. My only hope is that we do not repeat the scenario of the 21st Dynasty (of Ancient Egypt) —when the High Priests of Amun, took over the "State of Egypt." History has proven that strict religious regimes lead to political decline and indeed military weakness. I wonder if my children will ever enjoy a democratic environment in the future.

Your sincere thoughts and genuine concern are very much appreciated. Your emails and phone calls were simply overwhelming.
*From "Egypt" with Love,*
Tarek

## Commentary

# The Middle East—Now and Then

The ongoing civil unrest in the Middle East brought back memories stretching over 50 years. In February 2009, my wife and I were on a splendid Stanford-sponsored tour of Egypt. It concentrated on the pyramids, Sphinx and other ancient monuments and artifacts, but also covered Islamic and Coptic art and architecture.

We also toured modern Cairo and its bazaar and ate lunch in a restaurant there. The news that a bomb exploded outside that restaurant a few days later certainly got our attention. So did the recent report from one of our excellent guides, Tarek Swelim, that you can read on page 25.

That wasn't my first trip to Egypt. I took a year out of college in 1958-1959 and traveled the world on oil tankers owned by a friend of mine's father. Tankers travel from where crude oil is produced to where it's refined, so I visited a number of Middle East countries where turmoil was as much a fact of life as it is today.

From Sidon in Lebanon, I hired a car to drive to Beirut. On the way, the driver pointed out the place U.S. Marines were encamped just months earlier while trying to quell the perennial animosity between Lebanon's Muslim and Christian populations.

To get to Kuwait, oil tankers traverse the Suez Canal, which then was lined with smokestacks of ships sticking out of the water. They had been sunk in the 1956 Egyptian-Israeli war, and pulled to the side of the Canal to allow traffic to flow, but not yet removed.

When President Eisenhower and Secretary of State John Foster Dulles refused to back the British and French occupation of the Canal in 1956, Gamal Nasser and the Egyptians took over. They gradually replaced the Canal pilots, then predominantly Europeans, with Egyptians. One of our pilots, a gregarious Egyptian, was obviously picked for his nationality, not his ability.

The pilot gives steering orders directly to the helmsman, but technically he is advising the captain, who remains responsible. We were moving through the Canal at night but when I awoke in the morning and looked outside, the buoy that marked the edge of deep water was on the wrong side of the ship. This Egyptian must have thought he was turning a kiddie car, not a 30,000-ton tanker, a huge ship by the standards of the day. We were aground and blocking the canal. It took two powerful tugs and high tide 12 hours later to refloat the ship and let normal traffic resume.

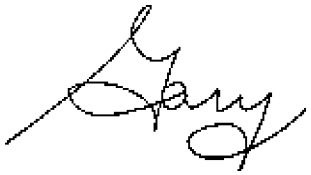
The workers who came on board to hook up hoses and lines while a ship was in the Canal were also Egyptians. It was the first time I'd heard Arabic spoken, and I thought they were clearing their throats before I realized that they already had two or three sentences out. It was also the first time I saw Muslims pray. I got out a compass and map, and sure enough, they were properly pointed southeast toward Mecca.

In Kuwait, however, I first thought the prayers were headed the wrong way until I realized that Mecca is southwest of Kuwait. That country's oil wealth was then being used to turn all the streets in Kuwait City into boulevards. To widen the streets, they simply took bulldozers and knocked down the first row of mud huts. That forced some of the money changers to move their big glass cases of American, Indian, British and other currencies. It seemed risky to display all of that money in the open air until I learned that thieves got their hands chopped off.

To get from Kuwait back to the Suez Canal, tankers pass the coast of Yemen and on one trip there was an uprising in progress. I heard a shortwave radio broadcast from Aden, then controlled by the British, that was aimed at quelling the riots. The announcer in British English emphasized the importance of respect for the law and noted that in official British processions, the Lord Chief Justice is fourth in line, preceded only by the Queen and the two Archbishops. That broadcast was repeated many times, but I wondered about its effectiveness on Arabs.

At the northern end of the Canal, near Alexandria, I had dinner with the parents of Costas Joannidis, my friend who had graduated from the American University of Cairo, learned American English by watching Hollywood movies and was in the U.S. for graduate work. It was a surprise when I learned that this Greek family had lived in Egypt for generations, were Greek citizens and had no interest in becoming Egyptian nationals. Quite different that the American melting pot. I was also surprised by Mrs. Joannidis' armload of heavy gold bracelets. You never know when you might need to leave Egypt in a hurry, she explained, and the gold on your arm is something you can take along easily.

Sadly, political instability was as prevalent in the Middle East 50 years ago as it is today. Let's hope the next 50 years are better.



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