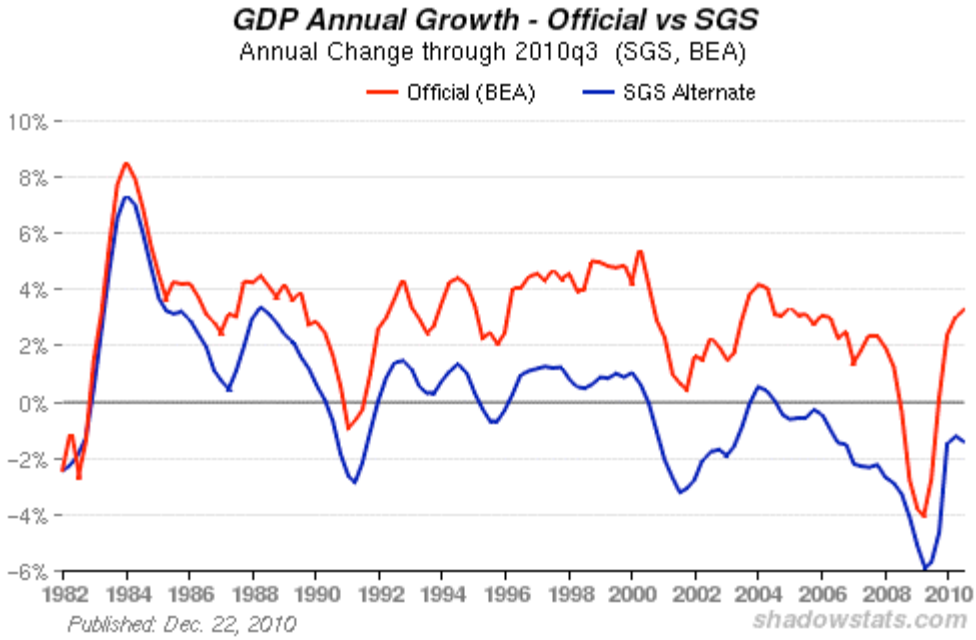
Headwinds

It was announced that our economy grew 2.6% in the most recent quarter. In fact that number is what the GDP *could* be for the year to come if you multiply this quarters' data by four. You are reading what is called an annualized number, the current quarter projected out a year. So what, you say—this is all gibberish to me anyhow. Well, suppose instead we measure economic growth or lack thereof the way you measure your salary or the way a business measures this year against last year…would that help? Suppose, to make this as clear as I can, you were interested in what *is*, rather than what *might be*? What the change has been instead of what might happen? I propose the only honest way to report so critical a number is as a reality rather than a forecast.



Periodic "good" numbers of 3% or 4% for the next few years in that upper line are likely with this "annualized" methodology. What is missed is that 4% or more real growth, *year over year*, in that bottom line, is needed to have any hope of pulling unemployment down, to say nothing of absorbing the discouraged drop-outs and our youth. It's not in sight and, in fact, neither is a positive 2% year over year, headlines notwithstanding. Economists have thus begun the silly season with this "hope" mentality – group-thinking to 3%, 4% and even a few "near 5%" growth estimates for 2011. In a phrase, we are still a long way behind the "good" years and I sure don't like the trend of that lower line.

Perhaps much ado about nothing. Perhaps it doesn't matter in the end. Perhaps we need this type of sloppy accounting to keep getting up in the morning. Perhaps.

For these and other reasons I have been reluctant to fully invest stock money (or bond money for that matter) and reluctant to try and publicly tackle so religiously followed a number as "reported GDP growth". Current data, though, is just too much for me to ignore, particularly as the two industries that are the necessary drivers of every post-war full recovery are still missing in this one.

In the following pages I'd like to broadly survey housing and autos. No recession has fully recovered without a significant resurgence in home and auto sales. Significant means indicators like overtime in auto plants, low dealer inventory, help-wanted ad growth, rising land prices for builders, low numbers of unsold new homes, a drop in the number of day laborers outside Home Depot and rising retail sales, among others. Further, state and local tax revenue is rising, folks are generally upbeat and the mood of confidence in the land gets the sitting President re-elected. Unemployment at 4-5% caps off the good times.

The Case For 2% Growth…maybe 2 ½%

HOUSING The housing problem is two-fold; shadow inventory and little or no new construction, neither of which is news to just about all of us. The sheer number of homeowners a mere heartbeat from foreclosure matches the 40-year low in new construction. Foreclosures are running at three times the 2005 rate, and rising. They are soon to be joined by the shadow inventory of 4 to 7 million more homes held by buyers upside down to varying degrees on their mortgage. At this writing, near 3.4 million homes are already listed for sale, which likely will double over the next year or so. Somewhere over 20% of all homeowners – 11 million more homes – owe more than the house is worth. A further 10 million will join them if home prices drop the expected 15% to 20%. Laurie Goodman at Amherst Securities notes that when loan-to-value exceeds 120%, default rates run near 20%. She notes further that when loan-to-value is between 100% and 120%, defaults still run 10% to 12%. A poor job market exacerbates payment problems.

A fair question is why so large a price drop from here? Some possible answers include:

- a very slim, if any, chance the Government will step in and let folks default on their mortgage and compensate the banks in the process;
- the banks have restarted the foreclosure process after a brief delay and their balance sheets and their existence, require dealing with this issue in a manner stockholders view as final;
- these same banks already hold 8.5 million mortgages either non-performing or in default;
- the supply of homes so far exceeds demand, with more supply coming, that a price drop is inevitable. This last point is likely the only one with no work-around.

Traditionally, by the way, the young family is a significant part of new home construction, especially with very low mortgage rates. Part of the problem here is that with the current low rates comes far more strict bank-lending terms, if any lending at all, and real family concern about continued employment. So, not only is a new home likely off the table, so is a used one until the monthly payment, with taxes (and considering likely higher food and fuel costs), is less than rent.

The impact on national employment is even more onerous. Using Laffers' example:

> *…consider a town of 100 families each in their own home. Assume 1 house per year is lost-say to wear and tear or depreciation, and replaced. Now assume a new family arrives and needs a home. New construction doubles. In this test tube, a 1% growth in population creates a doubling of demand. Near doubling of demand in Las Vegas, Sacramento, Ft. Meyers and the like was the case and meeting the demand required a near-equal growth in construction crews. But that was the least of it. Add spec building for "future" demand, unqualified buyers and multi-home speculators and you begin to see the immediate problem of too much labor on site after the initial demand cools.*

Would that it ended there.

The accelerator effect now takes hold. Peripheral industries in lumber, fixtures, appliances, furniture, movers, etc. all begin to see a steady flow of orders and begin to chase raw materials, production facilities and workers. Competition for workers and materials run prices up, moves people around and, not incidentally, runs up the price of existing homes in the process. Real or imagined, demand exceeds supply for a time and that is levered right into the heart of the most labor-intensive elements of our economy. One can see similar rates of growth, for example, in the financial services industry and even to a lesser degree in health care but without the same size downstream disruption nor the point to point downstream demand for labor. One of the findings new to me was that this last 20 years was a land bubble, not a housing bubble. Dividing a "typical" house into two parts, land and structure, and reviewing price changes, one finds interesting things: first, that structure cost varies little – a house in the lowest structure cost market is about $106,000 and in the highest structure cost areas, $128,000. Land, on the other hand, varied from $73,000 to $440,000. In 20 years, land rose over 90% and materials/structure rose 20%. It then comes as no surprise to see California builders tearing down new homes to reduce tax and maintenance costs. Labor has no such relief.

It becomes clear, I think, why unemployment jumped so much and has persisted at high levels. The likelihood of these workers finding jobs where they live grows more remote as they compete with workers from all the downstream industries tied to housing, even remotely. Until inventory clears, new home construction is likely to remain focused on the high end and select pockets, i.e. Texas, Tennessee. An industry perhaps 3% of GDP in normal times is, via this accelerator effect, reducing overall economic growth perhaps ½% to 1% year over year. The indirect impact on retail sales, car sales and the like is yet another hit. Here, leverage that created so much impetus on the upside, and can do so again, is now a price to be paid.

To wrap up this section I note that in the Federal Reserve's Flow of Funds data the value of ALL real estate in the U.S. has fallen for the first time in two years to $18.3 trillion – down some $698 billion and offsetting the prior five quarters of ever so modest rises.

AUTOS The good news is the auto companies have a chance to be profitable at low sales volumes. The bad news is the old stockholders at GM and Chrysler will see none of it. Ford, for example, is forecasting 12 million units for this year and 13 million units next year. The fine print in their announcement was that this year was good because of massive fleet sales and next year will be better because retail customers will arrive.

A little history: shown below, by year, are all North American car and truck sales for the last decade or so. This includes Canadian and Mexican production.

Millions of units

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
17.6	15.8	16.7	16.2	16.2	16.3	15.8	15.4	12.9	8.7	11.8E

The sale of cars alone peaked in 1999 at 8.7 total North American units as trucks arrived on the scene. Detroit, interestingly, increased auto production over these last ten years, albeit a modest 4%, but still better than all US auto production.

This is a huge industry. It alone is +/- 4% of GDP and can impact quarter-to-quarter change in that number by multiples 4 and 5 times its size. Think of it: a 15% to 20% impact on GDP; larger still than housing, itself in the low teens for impact. For example, back in 1993 a slowing in the

industry was almost all because of a modest sales slump. Overall, total manufacturing fell 3%, but downstream the accelerator effect was 5 times that as glass, tires, parts, and an endless list of other suppliers tried to manage production and inventories. The similarities to the housing industry are remarkable, true, but when their cycles are in synch we see huge change to the overall wages and employment picture.

We can fairly conclude, based on the numbers above, that the industry has sufficient, if not excess, capacity for at least 18 million cars and trucks. We can debate the efficiency of that capacity and here I must acknowledge that car people define capacity rigorously. Does it mean with or without overtime? Two shifts or three? Can the line build uni-body? How long is conversion time for the line? In any case, simply managing to a capacity number has enormous downstream impact.

So the issue seems to me to be whether autos are dependent on the economy or the economy is dependent on autos. One can easily argue either and end up acknowledging they can destroy each other. Slowing demand ends up with reduced production of cars. Auto plant hours are next reduced, then a line or two is closed, and if it persists, the plant. At this point, lower rates on car loans do little. Further, even if the plant stays in production and builds inventory (not necessarily profitably) hiring is still not necessary as overtime can meet short term needs.

It was this management of capacity coupled with wage and quality issues that forced the Big Three to change. We all saw how competition from Asia and Europe forced quality improvement, lean production techniques and supplier consolidation. This led to cuts in head count, in fact, almost by half over the last 30 years. Decades of isolated behavior relative to the global auto market disappeared but the characteristic of downstream leverage remains and, in my opinion, grew more powerful.

The auto industry encompasses over 9,000 companies that make parts and sub-assemblies. Over half employ more than 500 people. About 70% of those firms make parts, about 20% do sub-assembly, and the last 10% or so are in the trailer, motor home, etc., sectors. The labor force, some 900,000 in 2008, follows the same rough breakdown. These 900,000 are down from peak employment nearer 3 million. And this is just the auto industry.

According to the Bureau of Labor Statistics (BLS), continued productivity improvements alone will drive employment down a further 16% over the next 10 years. Oddly, all other industries in this same time frame are forecasted to increase employment 11%. In this same time period, the absolute number of cars to be produced will rise and about a quarter of the remaining jobs will be in Michigan. The average age of cars on the road, having risen from 5 years in 1970 to just shy of 10 years in 2007 will, in the short run, continue to rise. This will reflect the current period of restrained borrowing and, not incidentally, the aging population and their proclivity to be less “latest and greatest” influenced.

The 2008-2010 auto collapse was caused by a litany of events: tight credit, longer car life, rising operating fees including gas and taxes, job uncertainty and, as noted, boomers and others altering their buying habits. The “cash for clunkers” program, as all well know, simply borrowed future sales. Given the massive downstream accelerator impact one can argue the program did far more harm than good. Most cars sold in that absurd program came from inventory (marked up) and so new production that followed likely exacerbated supplier chain difficulties.

In autos and housing, long lead times apply. Orders for goods spill over into raw materials, shipping, the guys who make boxes – a long chain further compounded by materials shortages, shipping delays, weather, deer season and labor shortages. Workers in both industries live in the moment, they know today’s hiring may not be tomorrow’s. The wise among them stash overtime

and learn from hard experience to pick their pleasures carefully. A friend recently shared with me the large jump in the sale of Harley-Davidsons in northern Ohio. He theorized that the "haves" are racking up overtime and picking their pleasures. I suspect he's right.

Homes and cars are thus the largest economic multipliers in our economy by virtue of two common factors: one, very high levels of human labor and two, very long interlinked supply chains.

But it isn't just the sheer number of workers. They, and all the related companies involved, impact so many other firms in retail, banking, health, food, clothing, travel and entertainment that one can reasonably argue that together they drive or end business cycles. The table that follows, courtesy of *Industry Week*, is a display of a real but anonymous auto plant proposed for the Midwest. One need only reverse the direction you read it to see what a single plant may do.

Direct, Indirect and Induced Impacts *(,000)

	2006	2007	2008	2009	2010	2011
Employment	189	3,583	7,800	10,611	12,240	12,242
Personal Income*	7,114	141,192	368,820	561,168	684,180	735,896
State Revenue*	1,032	20,585	53,498	81,399	99,242	106,714
Sales*	16,620	318,492	1,405,080	3,024,000	3,792,960	3,864,240

At the state level revenues are currently down 12%. State and local budget shortfalls next year are estimated at $140 billion. Talk of increased property taxes, sales taxes and whatever other tax they can call a fee is afoot. When governments can no longer tax, they will borrow. That will also require taxpayer approval and the more likely outcome will be a rise in local bankruptcies. Thus a collision of politics and economics will have finally arrived and market forces will have begun to undermine government belief that *it* creates wealth.

Leverage, of course, works both ways. These last years of bitter lessons have done us a service. We will move on at a rate in the "twos". We will pay down debt and save. We will work off homes at prices lower than today, though I do not yet see where the bulk of the buyers will come from. Perhaps modest up-ticks in hiring and perhaps a few million Asian and European immigrants will help absorb these inexpensive homes. The "haves" will keep car sales in the 12-14 million unit range. Corporate earnings will show up as dividend increases, technology and automation purchases and corporate acquisitions. Currently overpriced, many stocks will settle in to lower expectations.

Failure to address our deficits is for next time, or as I recently read, we shall again the kick that grenade further down the road.

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