

**Recessions Are on the Margin**  
**A Rose is Still a Rose**  
**If It Feels Like a Recession**  
**The Rough Road Back**  
**Mexico, New York, and The Endgame**

**By John Mauldin**

I've got to admit it's getting better  
A little better all the time  
I have to admit it's getting better  
It's getting better since you've been mine  
Getting so much better all the time

- John Lennon / Paul McCartney, *Sgt. Pepper's Lonely Hearts Club Band*

And the data out over the last few weeks tells us it *is* getting better. Does this take us out of the double-dip woods, even as the Fed is lowering its forecast? And what is a recession? Yes, we all know it's when the economy doesn't grow, but we are in a rather unique economic environment, this time. Maybe things are getting better, but is it enough to get us back on the road to full employment?

Let's start off with what is going right. We had a slate of news over the past few weeks that was good. The ECRI weekly Leading Index, after some ugly downtrends, is showing signs of turning around. We have had small increases each week since October 15, and the annualized growth rate of the index is now only -3.1%, having increased for 12 weeks. Its recent low was in July. Yes, I know that a large part of that growth is in the financial sector, as the stock market is up and interest rates are low, but it does suggest that 2011 should not be a recession year.

The Federal Reserve Bank of Chicago's National Activity Index improved in September and is now only slightly negative, again suggesting that there should be no recession in '11. The Richmond Fed Manufacturing Survey was up this last week, as well, to its highest level since August. And the Kansas City Fed survey was up for the third month in a row.

Moody's World Business Confidence Survey is up slightly. "Business sentiment has taken on a slightly better hue in late November. Although overall confidence has remained largely unchanged since early July, responses in regard to current business conditions, sales strength, and investment in equipment and software have improved in recent weeks. The survey results suggest that global growth may be gaining some traction at year's end after a lull this summer and fall. It is also encouraging that hiring intentions remain firm, and while pricing is soft, there is no indication that deflation is a serious problem.

Nonetheless, businesses do not anticipate a significant acceleration in activity anytime soon, as expectations regarding the outlook into mid-next year have shown no meaningful improvement.” ([www.dismal.com](http://www.dismal.com))

Third-quarter GDP was revised up to 2.5%, although inventories accounted for just over half of the growth. Building inventories counts as a plus in GDP accounting, and selling them deducts from GDP growth. Just the way it's done. But at some point inventories will stabilize. That headline number will be harder to get up over 3% when that happens. (I decided to go back and look at the BEA historical inventory numbers. Interestingly, there seems to be a bug in that particular data and it shows up as -9999 in both online and printed formats. All the other data was fine. Someone should fix that. After 20 minutes of trying to find it elsewhere, I decided I needed to get on with writing.)

Initial jobless claims dropped to a seasonally adjusted 407,000 this week, a rather amazing number, as the actual number was 462,000 (although the week before the actual number was just 409,000). That is why most people pay attention to the seasonally adjusted number, as this data series is extremely noisy. Let us hope this is a trend.

And what's this? Personal income was actually up 0.5% for the month? That's positive, as personal income growth has not been all that good, and is now up 4.1% over the last year. Just six months ago, in May, it was up only 1.8% over the preceding year.

Mortgage applications were up, although new-home sales dropped a rather dismal 8.1%. New-home sales are close to the 47-year record low set last August, and down 29% from a year ago. The median sales price is down 9% from a year ago. The good news in all this is that as prices drop and foreclosures keep on coming, homes will become more affordable to people who want to buy. The cure for low prices is low prices. While it may be well into 2012 before we work through the excess inventory and the aftermath of the housing bubble, as I wrote here in 2008 (I was told I was such a doom and gloomer!), we are closer to that point than we were a year ago. These things work themselves out over time.

The economy has now grown at a rate of 3.1% over the last four quarters. That is the good news and it's the best growth we have had for four quarters since 2005. We have been slowing down somewhat the last two quarters, but are still north of 2%. With inventory growth slowing, it is really possible to be below 2% for the 4<sup>th</sup> quarter.

### **A Rose is Still a Rose**

There is a theme to a lot of the positive news we've been getting lately: it is positive, but not by much. Normally at this time in a recovery we would be seeing 4-5% (or more!) GDP growth and some real recovery in employment.

Still, 2% is not a recession. And given what we have seen, there should now not be a recession in 2011, barring some “exogenous” shock. Something that is from outside the normal system. I have written for a long time that the one thing I really am concerned about is that the Bush tax cuts will not be kept. If the Bush tax cuts on the middle class are not kept, it seems a lock to me that we’ll be in recession rather soon in 2011.

At 2% growth, the economy MAY be able to handle it if we only end up taking away the tax cuts for those with over \$250,000 in income. It will slow things down, but probably not enough to cause a recession, if we are growing at 2.5%.

I know a lot of my readers think it is just me being political, but that is what the research and the data tells us. Maybe if I called them the 2001-03 tax cuts and didn’t use the name Bush it would be less offensive to some. I really get that. But the research is the same no matter what name I use. A rose is still a rose.

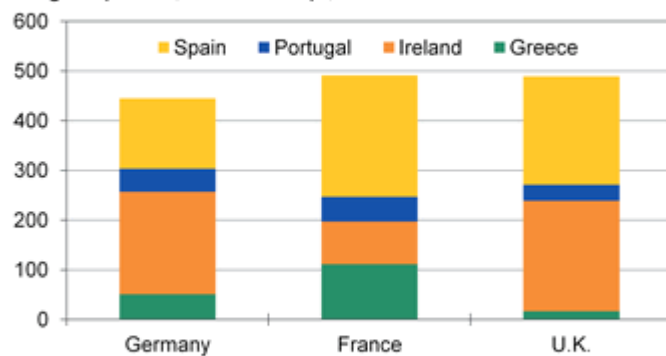
Take capital gain taxes. An increase in capital gains taxes has never – NEVER – increased tax collections as much as forecast. And a decrease in capital gains taxes has always – ALWAYS – produced more tax revenue than forecast, and often more in taxes than was being collected before the tax cut. People change their behavior over what seem like small changes in capital gains taxes. The data and history are clear.

Right now the people who seem to know think those tax cuts will get extended. If they do, is there anything else that could shock the system? The first thing that leaps to my mind is a real credit and banking crisis in Europe. European banks are in bad shape and own a massive amount of government debt in Greece, Ireland, Spain, and Portugal. Truly massive.

This is a graph of the exposure of French, German and UK banks to Spain, Portugal, Ireland, and Greece. For those who are seeing this in black and white, the top part of each bar is Spain, and going down to Greece. Any wonder why the markets get nervous when Germany starts talking about the need for bond holders to take a haircut in any debt restructuring?

## German, French and U.K. Banks Highly Exposed

Foreign exposure, end of first qtr, \$ bil



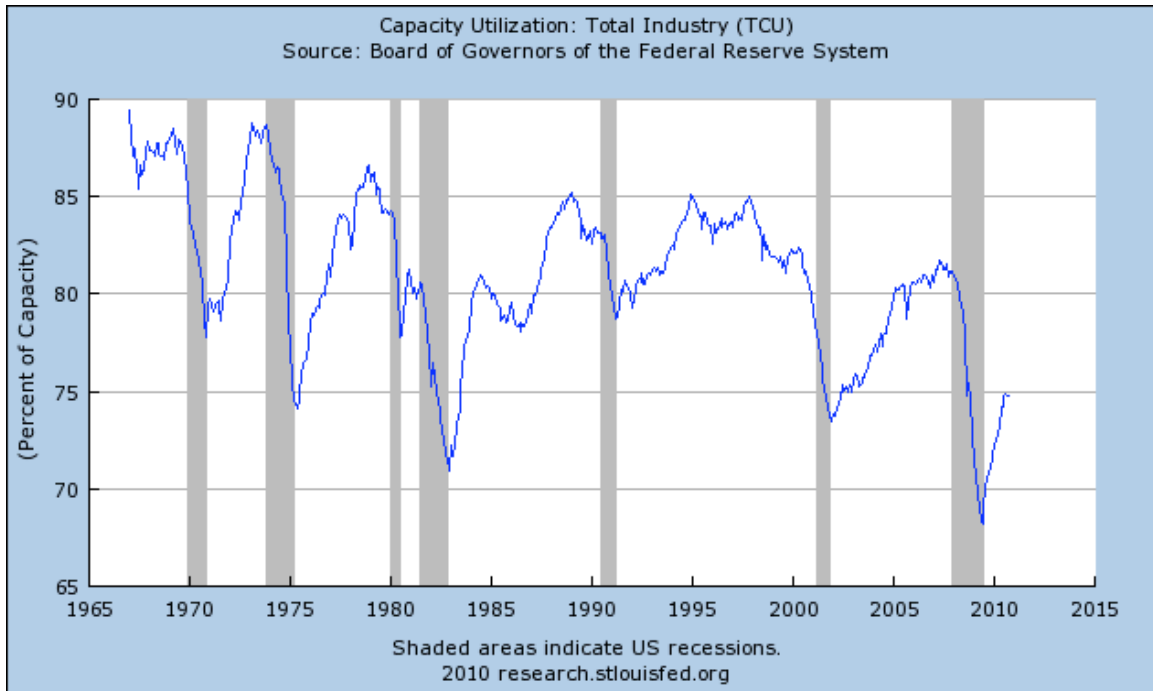
Source: Bank for International Settlements

We will take a look at Europe next week. But as I have written on numerous occasions, and as should be very clear by now, the international credit and banking systems are very connected. While US banks are not overly exposed to European sovereign debt, we are exposed to their banks. We just simply do not know what the ramifications of a credit crisis will be here. But it bears watching.

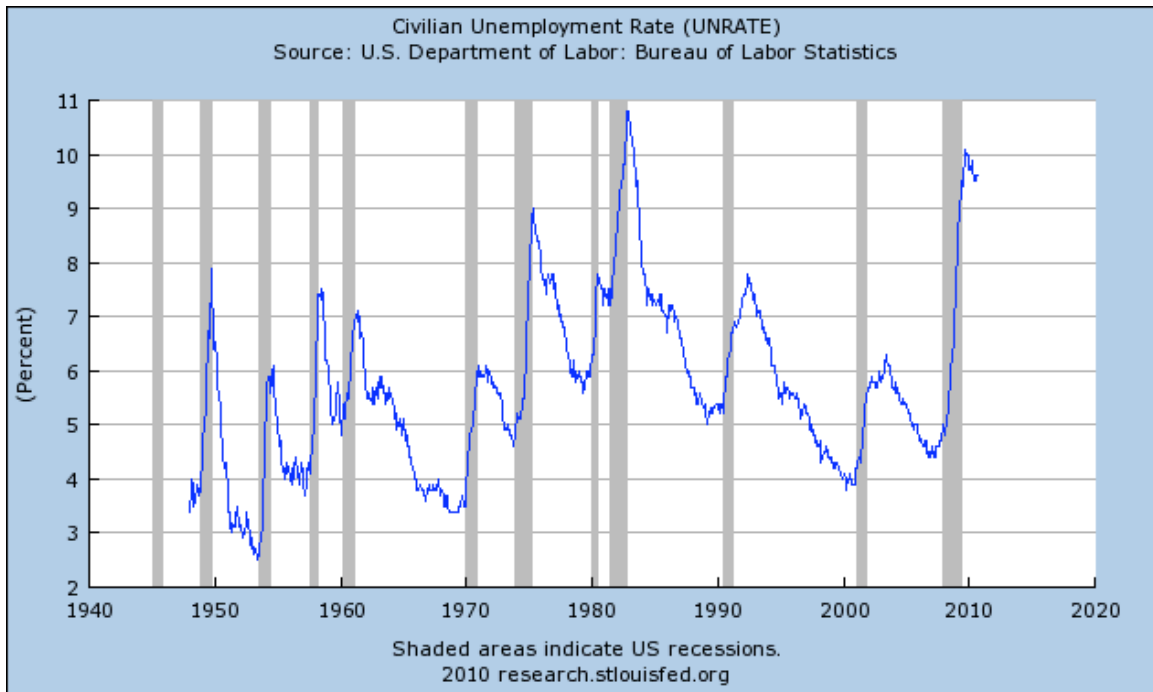
## If It Feels Like a Recession

The old joke is that a recession is when your neighbor loses their job and a depression is when you lose yours. As noted above, the economy is growing, so why does it feel like a recession? Maybe because the data is still in recession territory. Let's look at a few items.

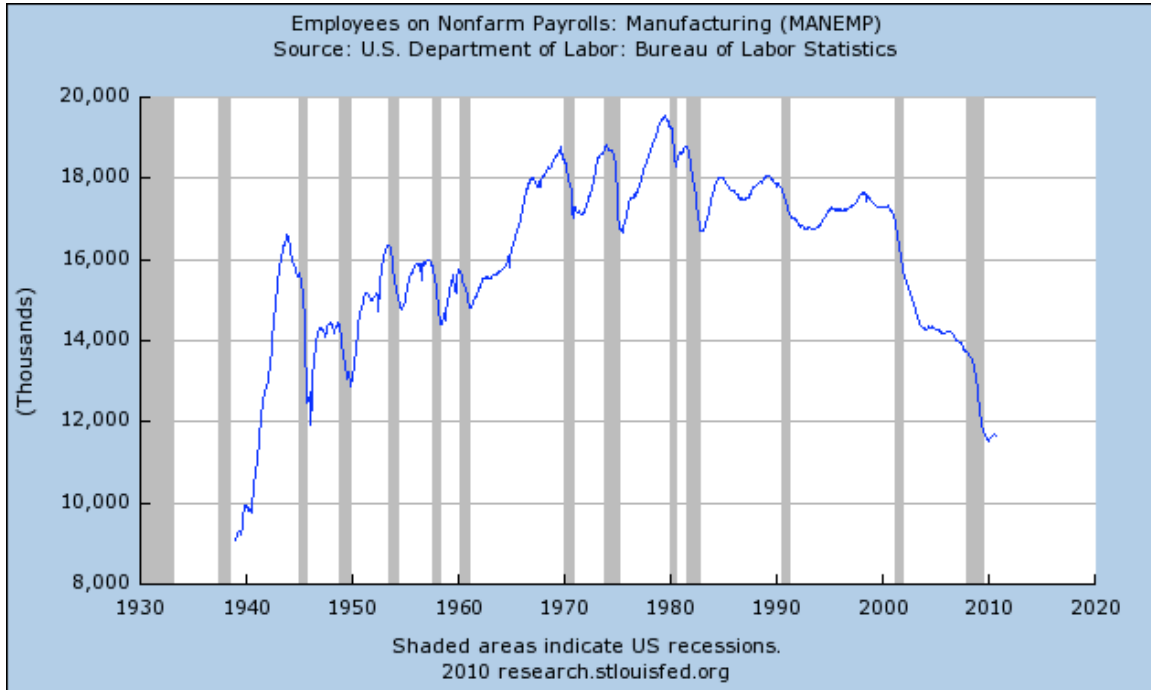
Capacity utilization is well off its lows but is in territory normally thought of as a recession. Look at the latest data from the St. Louis Fed FRED research database (a treasure trove of all sorts of data; love this site!). 75% capacity utilization has only been seen in past recessions, and indeed in many recessions never got this low!



We all know unemployment is high, but it bears looking at *how* high, to get an historical perspective. Only once has it been this high. Notice that it took almost 8 years in the '80s, with a powerhouse economy, for the unemployment rate to drop 6.5%, and in the '90s it took 9 years to drop 3.5%. It only dropped by about 2% over five years in the middle of the last decade. We are now at an effective 10%. Nine years to get back to 6.5%? Five years to get back to 8%?



Now some will point out that unemployment fell about 4% in just a few years in the '80s, back to 7%, before taking a breather and then falling a lot more over time. And that is true. But we had a lot more manufacturing jobs back then. Take a look at the past 70+ years of manufacturing employment in the US.

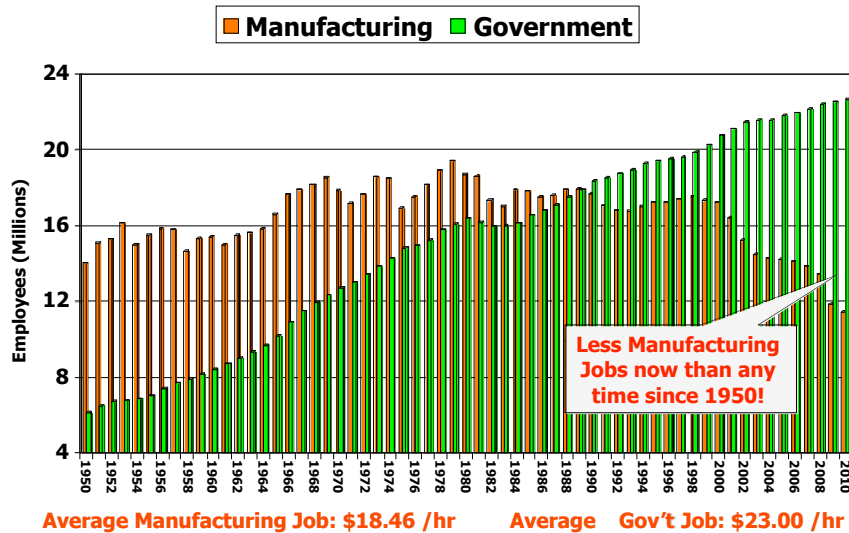


At the peak in the late '70s the US had almost 20 million manufacturing jobs with a population of a little over 220 million. In June of 1998 we still had 17.7 million manufacturing jobs. But by October, 2010 we were down to 11.6 million manufacturing jobs in a country of 320 million people.

Six million manufacturing jobs have been lost in the last 12 years, and 2 million in the last two years alone. We now have fewer manufacturing jobs than we had in 1941. And the following charts shows that as manufacturing jobs have fallen, government jobs have risen. Which of course means that taxes (or debt) have risen. This is not a pleasant chart, for me at least.

# Red Taping of America

Employment in Manufacturing vs. Government Sectors

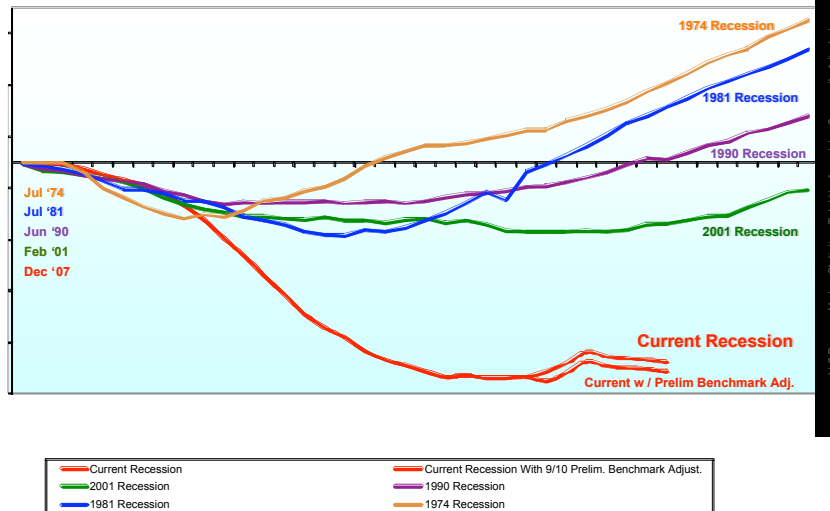


Source: U.S. Bureau of Labor Statistics, Current Employment Statistics Survey, Not Seasonally Adjusted, National Industry -Specific Occupational Employment and Wage Estimates

The rapid drop in unemployment in the early '80s after a major recession was manufacturing workers going back to work. Those jobs are gone now and there are few left for people to return to.

Let's look at the following comparisons of job losses and gains from the peak job months prior to recent recessions. Notice that job recoveries are slower as we go forward in time. A large part of that is due to the falloff in manufacturing.

## Job Losses in Recent U.S. Recessions



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### The Rough Road Back

There are roughly 14.5 million unemployed in the US, another 9.4 involuntary part-time workers, and 2.5 million marginally attached workers. The latter category is basically people who would take a job if they could find one but haven't looked in the past four weeks. Plus younger people who have gone back to school because they can't find a job.

For the part-time workers to get full-time jobs we need to create (guessing) at least 4-5 million full-time jobs to give them the hours they want. That is at least 11-12 million jobs we need to have to get back to the unemployment levels of 2007 (assuming that about 7.5 million jobs gets us to 5% unemployment).

Now, we need about 1.5 million jobs every year to cover new people coming into the labor force – or that is what history and economists tell us. I am not so sure that number is not itself history. What group of people has seen its unemployment level go down? People over 55! My generation is not retiring as planned and indeed is going back to work. Retirement is somewhere in the future in a world where stocks have gone nowhere for ten years and housing values have collapsed.

We may need more than 1.5 million jobs a year (125,000 a month) if Boomers aren't going to quit. But let's assume they do, for the sake of argument.



That means in the next five years we need more than 19 million jobs to get back to under 5% unemployment. That's almost 4 million jobs a year or more than 325,000 a month, each and every month. Or 27 million jobs to get back there in ten years, or almost 230,000 jobs a month each and every month.

No recessions allowed. No crisis can show up. And the economy needs to grow at 3.5% plus on average to really give us jobs. Below are the employment statistics for the last 20 years. Straight from the BLS web site into my Excel spreadsheet. Notice that with the exception of 1994 and the last quarters of 1997 and 1999, we had no consistent quarters of 300,000-plus jobs a month. Also note that the economy grew (if memory serves) at 3.3% in the '90s and at 1.9% in the last decade. That marginal growth makes a big difference.

**Employment, Hours, and Earnings  
from the Current Employment  
Statistics survey (National)  
1-Month Net Change**

**Series Id:** CES0000000001  
**Seasonally Adjusted**  
**Super** Total nonfarm  
**Sector:**  
**Industry:** Total nonfarm  
**NAICS** -  
**Code:**  
**Data Type:** ALL EMPLOYEES, THOUSANDS  
**Years:** 1990 to 2010

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1990	342	245	215	40	149	17	-42	208	-82	161	144	-60
1991	-119	-306	-160	-211	-128	87	-47	15	35	12	-58	23
1992	49	-66	50	158	126	60	71	141	35	177	140	211
1993	310	242	-51	309	265	173	295	161	241	277	261	308
1994	268	201	462	353	331	315	363	300	354	207	423	274
1995	321	209	222	162	-16	231	79	271	245	147	148	131
1996	-19	434	263	161	323	278	232	196	220	243	296	167
1997	230	301	312	291	256	253	283	-18	508	339	303	299
1998	270	189	144	277	401	212	119	352	218	193	284	342
1999	121	410	106	376	213	266	291	192	202	408	294	294
2000	249	121	472	286	225	-46	163	3	122	-11	231	138
2001	-16	61	-30	-281	-44	128	125	160	244	325	292	178
2002	-132	-147	-24	-85	-7	45	-97	-16	-55	126	8	156
2003	83	-158	-212	-49	-6	-2	25	-42	103	203	18	124
2004	150	43	338	250	310	81	47	121	160	351	64	132
2005	136	240	142	360	169	246	369	195	63	84	334	158
2006	262	326	304	174	31	69	232	141	100	43	201	177
2007	194	104	239	92	149	55	-20	-71	52	86	128	70

<b>2008</b>	-10	-50	-33	-149	-231	193	210	334	458	554	728	673
<b>2009</b>	-779	-726	-753	-528	-387	515	346	212	225	224	64	109
<b>2010</b>	14	39	208	313	432	175	-66	-1	-41	151		

This recovery is going to be long in coming, at least in terms of employment. And that brings us to the thought that started this letter.

### Recessions are on the Margin

10-12% of the US is really unemployed. Over time, that number will come down, albeit slower than anyone would like. But that also means that 88-90% of us have jobs or are working at least part-time. The plane I get on tomorrow is completely sold out. The malls I visit are full. We are buying Beatles music like there was only Yesterday (when troubles seemed so far away). Retail sales are up. Things are slowly improving.

But we dug a very deep hole for ourselves, and until we create whole new industries (which we will) unemployment is going to remain high. If you are among the 10% who are unemployed, or the 7% who are underemployed, it is going to feel very much like we are still in a recession.

And that is the crux of it. The difference between a technical “recession” and growth is meaningless if you can’t find a job. If sales are slower because 17% of people are underemployed and governments are cutting back, it certainly doesn’t feel like a growing economy to you. That difference is the margin between 2% average GDP growth and 3.5% average growth. That doesn’t seem like a lot, but the compounding effects are large over time.

The US economy grew at 1.9% for the last decade, the slowest since the 1930s. Given that government spending is going to go down (at least I hope so), unemployment is going to take some time to get under control; and with the whole developed world in a mess, it is hard to see an economic environment where we can average 3.5% a year for this decade. It is going to be another Muddle Through decade. Unless you are on the margin.

As businesses adjust, as entrepreneurs respond, we will slowly come out of this. But it is going to take longer than we would like.

### Mexico, New York, and The Endgame

I leave tomorrow for the Forbes cruise around the Mexican Riviera. I am looking forward to it, as there will be good friends sailing with us, and Tiffani and Ryan are coming as well. And, armed with my IPad, I have a few sci-fi books to read.

I sent the final (well, almost) version of *The Endgame* to Wiley today. Seems they wanted a few revisions but, I must say, a lot fewer than I thought and a lot less than for *Bull's Eye Investing*. Those who have read it are giving us very good reviews.

Dylan Grice, macroeconomist at Societe Generale in London, said, "I think the book is brilliant. Well-written, crystal clear and hits the spot. My favourite chapters were the ones on Fingers of Instability (which I think everyone in finance should read and reread each year lest they forget), and the one on East Europe as both a lead indicator for what's in store and a potential land mine which could yet do for the euro what Credit Anstaldt did for the gold standard. But it's a tough call. Lots of very good stuff in there."

When I get back from Mexico, it will be time to start thinking about promoting the book. It is more than just book sales. My real dream is to help foster the debate about how we as a country (and indeed the developing world) need to get our act together if we want to avoid becoming Greece. If you are a producer for radio or TV or print media, drop me a note. We'll set something up.

I will be in New York the 12-14 of December for meetings and then home for the holidays. All my kids will be here for Christmas, so we may have an even bigger crowd than last Thursday, which was around 35. I thought we had a lot of food, but it was almost gone by the end of the day.

It is time to hit the send button. My torturer (AKA my trainer) has some especially hard stuff in store for me after Thanksgiving and before Mexico. We use these small weights, or nothing, but I leave the gym like a wet rag. Lots of reps and less impact on my body, but it is doing more than my old, simple pumping-iron workouts. Although I do miss the iron. Maybe I can sneak in a few pumps on board the ship.

Have a great week. And keep yourself away from the margin!

Your ready for some relaxation analyst,

John Mauldin