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ASSET MANAGEMENT

Cast your vote. Recession or Depression?

January 26, 2009 Newsletter

Recession—"_A recession occurs when a nation's living standards drop and prices increase. This downturn in economic activity is widely defined as a decline in a country's gross domestic product for at least two quarters_**."** —Bloomberg Financial Definition.

Depression—"_An economic condition caused by a massive decrease in business activity, falling prices, reduced purchasing power, excess of supply over demand, rising unemployment, and other negative economic factors_."—Bloomberg Financial Definition.

Truth or Dare—Recession or Depression???

As unpopular as it may have been over the past several years, I have been writing about the impending Recession in the United States and in other nations. I am rather used to criticism as a "perma-bear", as it relates to our asset-based, over-leveraged mess that we call our economy. It has been no fun whatsoever to be the one to "call 'em as you see 'em", but to be perfectly frank, an outlier view has been a necessary evil, and one that I have been proud to have had the guts to provide.

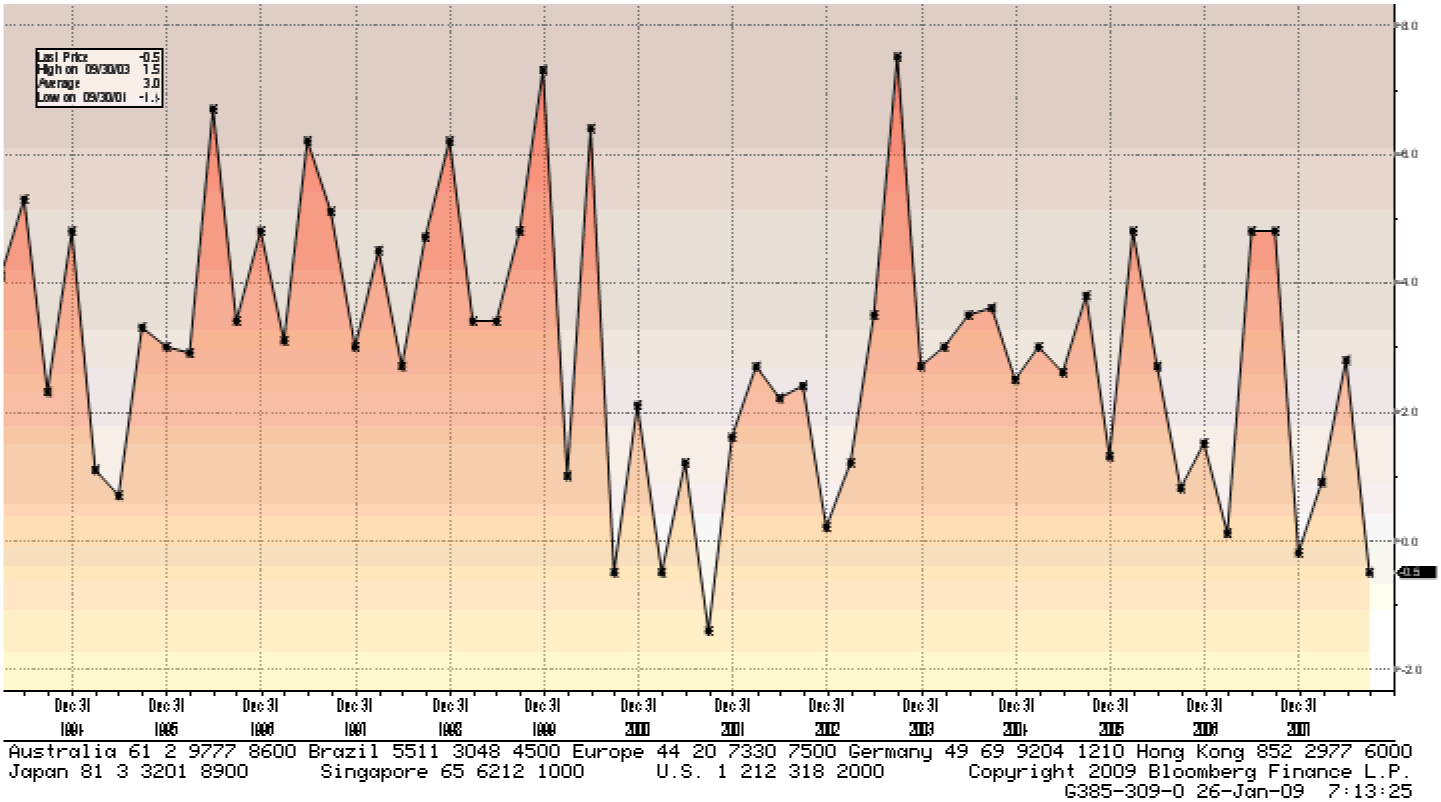
And so now I will say what the biggest risk of all is in my view. There is no doubt, whether it is in retrospect as most economists suggest or not, that (shhhhhhh…) we are in a Recession…Oh my Goodness, what an unpopular view—that the economy can actually shrink. And shrink it has, it is, and likely will continue to do. The question on my mind, as it has been over the past several months, is if we are going through a traditional Recession or a once-in-a –lifetime Depression? I have actually HOPED that Recession as the result of the unprecedented credit unwind would end up as just a nasty Recession at best. Sadly however, I feel that a Depression is either upon us, or soon will be upon us.

To be truthful or daring is important in markets and other parts of life. To be truthful, you must suck it up. To be daring is to avoid the bad news that is so obvious, but not at all too fun or exciting to focus on. There is no thought clearer in my mind, as I have stated many times over the past year, that we are in a Recession, or quite likely much worse. I hate to say this, as unpopular as it may seem (so what's new with what I write?), **WELCOME TO THE DEPRESSION**. For my reasoning, please read on.

Putting the Recession Question to Bed

GDP Estimates for the Q4 2008 are due to be released on Friday morning at 8:30 AM, with estimates coming in the -5.5% range, which follows a -0.5% number in the prior quarter. Many believe that the economy will turn in the second half of the year as the Obama Administration's Fiscal Stimulus Plan magically makes things "all better". I have to admit that I could not disagree more vehemently. We have seen these stimulus plans before, and dropping $500 checks into the mail has produced more savings, repayment of debt, but not a flow of steady consumption by consumers. Seriously, with weekly new claims for Unemployment Benefits now averaging over 500,000 per week and the economy losing 600,000 jobs per month, leverage still piled up on top of leverage, I think the odds of the economy being in growth by the end of 2009, and possibly before the end of 2010 is nothing more than a hope pipe-dream.

GDP Quarterly Change since 1994



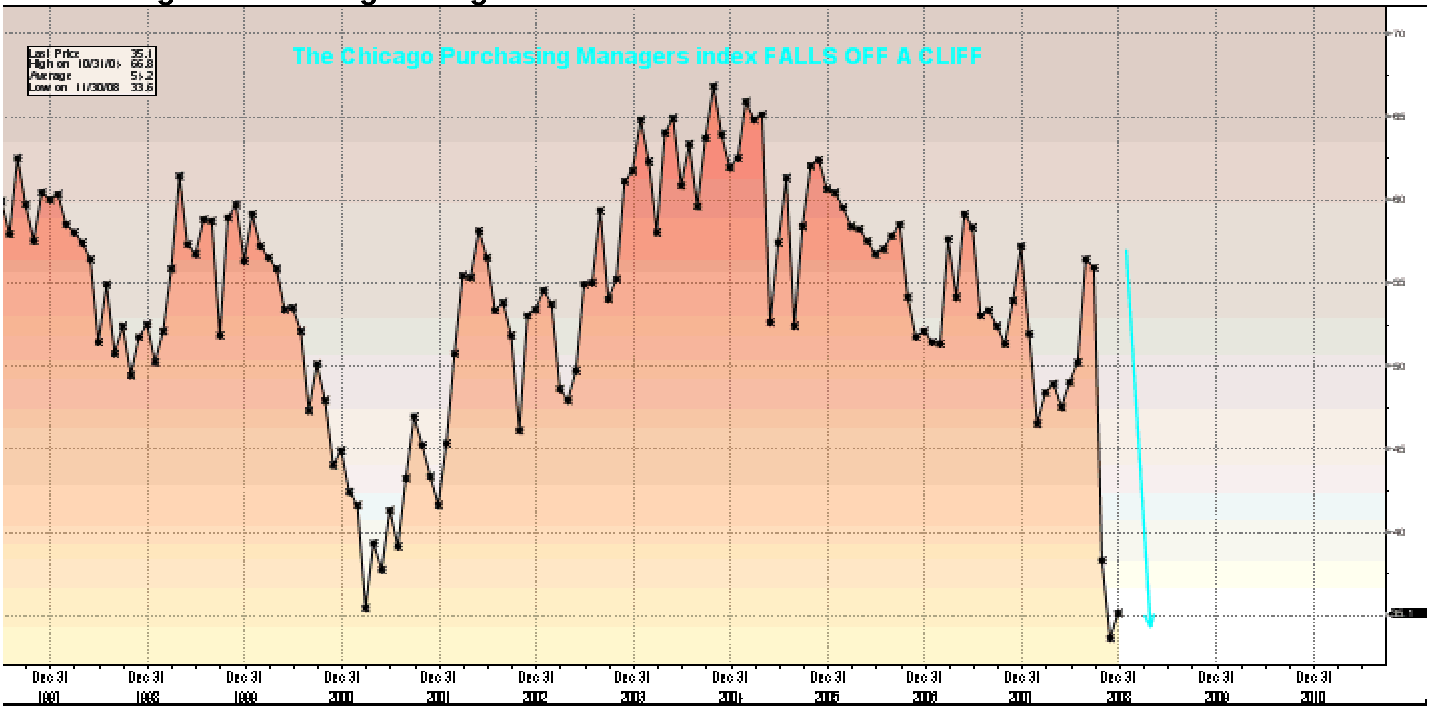
<u>Are We in a Economic Depression?</u>

From the Bloomberg definition at the outset of this piece, there are several criteria in order for an economy to be considered in a Depression:

- Massive decrease in business activity.
- Falling Prices.
- Reduced purchasing power.
- Excess of supply over demand.
- Rising unemployment.
- “Other” economic factors.

I would like to address these factors one by one in an attempt to determine if we actually have landed in an economic Depression, a depression that sadly may be global in nature.

The Chicago Purchasing Managers Index



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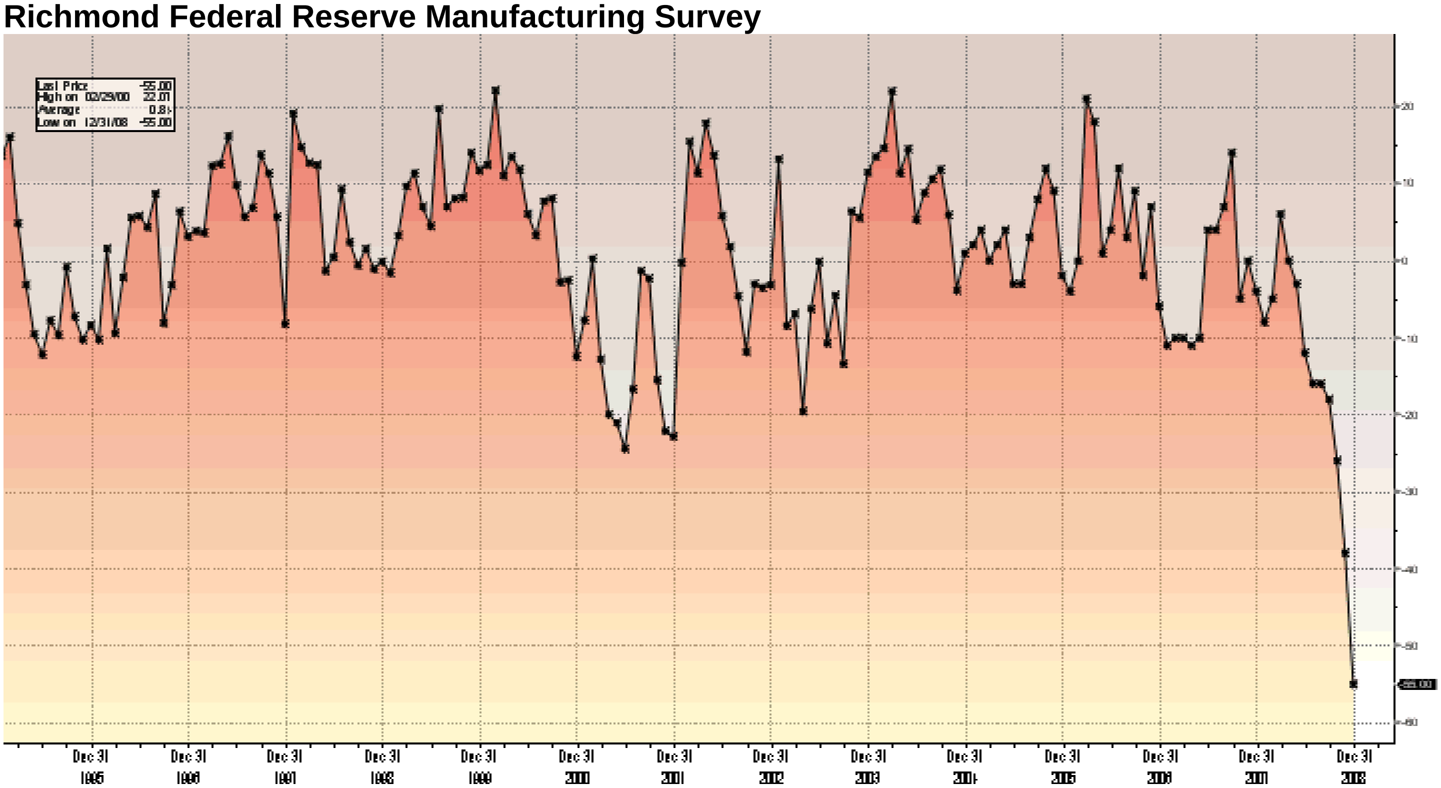
The Chicago Purchasing Managers index has fallen off a cliff. The index is a monthly, regional index of Midwestern manufacturing activity. An index reading below 50 (we are now at 35.1) means manufacturers are reporting deteriorating business conditions.

Richmond Federal Reserve Manufacturing Survey



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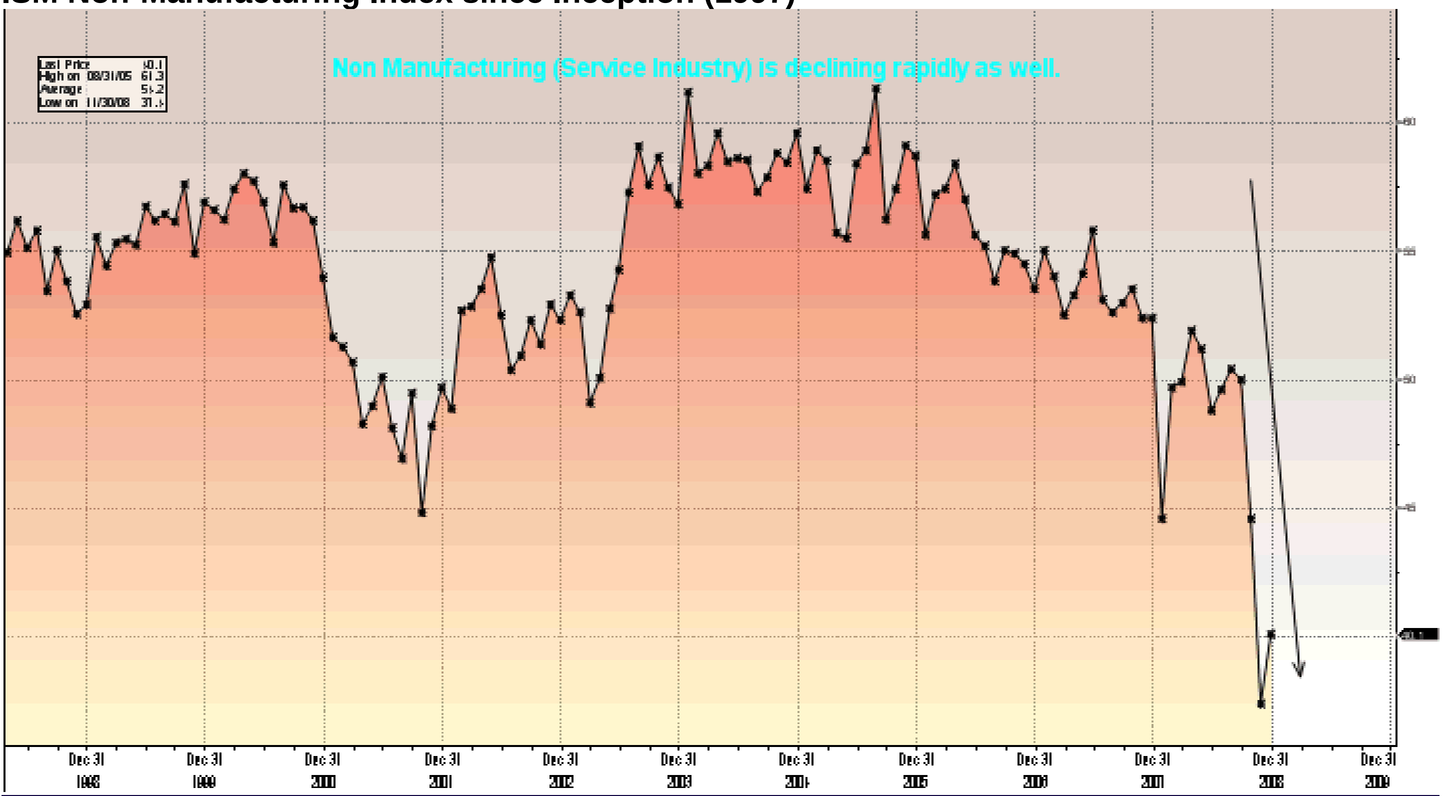
Just in case you would like to believe that the Chicago manufacturing number is a fluke, get a load of the chart above which covers states like Virginia and North Carolina.

Further, if you thought that only manufacturing was under attack, you may wish to reconsider. As the U.S. economy has become more of a service economy and less of a manufacturing economy, many have pointed to the ISM Non-Manufacturing Index for hope. Sadly, the service industry is suffering as well with the ISM Non-Manufacturing Index plummeting as well. It seems everywhere we turn, no matter what industry, no matter what country, the answer is the same--a **massive economic slowdown so pervasive that nothing seems to be able to stem the tide.**

ISM Non-Manufacturing Index since Inception (1997)



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What about falling prices? No matter where we turn, the prices of everything from equities worldwide, the prices of commodities (with the notable exception of gold), prices of esoteric securities cooked up by Wall Street, real estate, the answer is always, the same-FALLING PRICES. I could fill the next 5 pages with the gory details of falling prices, but anyone that opens their brokerage statement knows what I mean. It used to be said, “inflation in the things that we need and deflation in the things that we want,” but that saying is no longer apropos. Everything is falling in price, which is at best, deflationary, and at worst, signals the Depression we may very well be here.

Rising Unemployment—the Really Big Problem

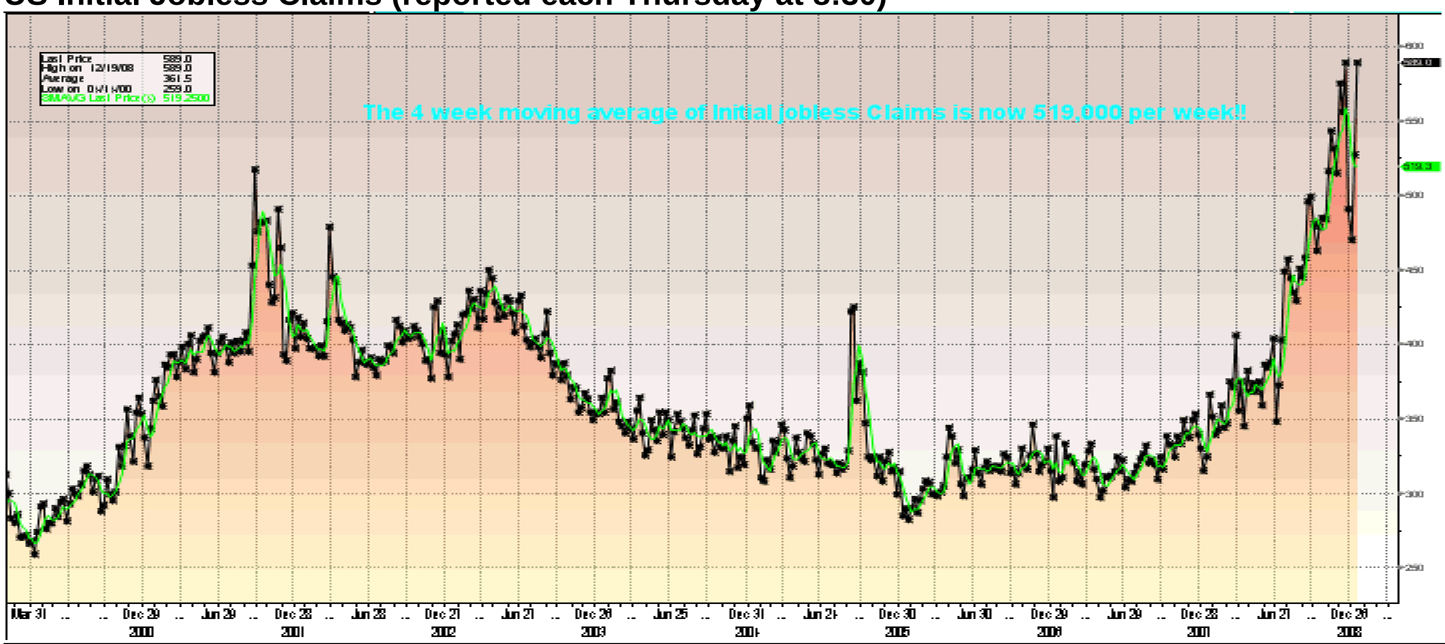
I chose to skip proving that there is excess supply over demand and the fact that reduced purchasing power, as it is painfully obvious. The charts above are quite simply the proof that these issues exist. The really big problem is that of unemployment. Like the old saying goes, “it is a Recession when your neighbor loses their job, but it is a Depression when you lose yours." As I write this, Caterpillar, the international leader in heavy equipment just announced an abysmal quarter (this is even more abysmal than their previous "pre-announcement") and that they were laying off 20,000 people. Many would like you to believe that this is a domestic issue, yet that is the furthest from the truth in my opinion.

Since much of CAT's business is conducted outside the U.S., it confirms my suspicions that the economic issue is indeed global and that anyone hanging their hats on an economic recovery due to a 1933-style infrastructure improvement had better take a look at CAT's news release. Just to give you a flavor for how far-reaching the unemployment situation is, I will provide a list (below) of companies that have recently announced job cuts and layoffs. The point I wish to make is that the companies making the announcements have a couple of things in common, namely they are global in nature, best of breed and industry leaders.

1. Caterpillar.
2. Kimberly-Clark
3. Pfizer
4. Royal Bank of Scotland
5. Home Depot
6. Harley Davidson
7. Philips International
8. Microsoft
9. Deere
10. Starbucks
11. Schlumberger
12. United Airlines
13. Xerox
14. Clear Channel
15. Union Pacific
16. Toyota
17. Rohm and Haas
18. Reebok.
19. Fiat.
20. Sony

Okay, are you depressed yet? If you think that list is scary, consider this: All of those companies have announced these layoffs since *last Thursday*. If you wanted the whole list, it could take up an entire book. To get a sense graphically of just how bad this has become, I will offer up a couple of rather sobering charts below.

US Initial Jobless Claims (reported each Thursday at 8:30)



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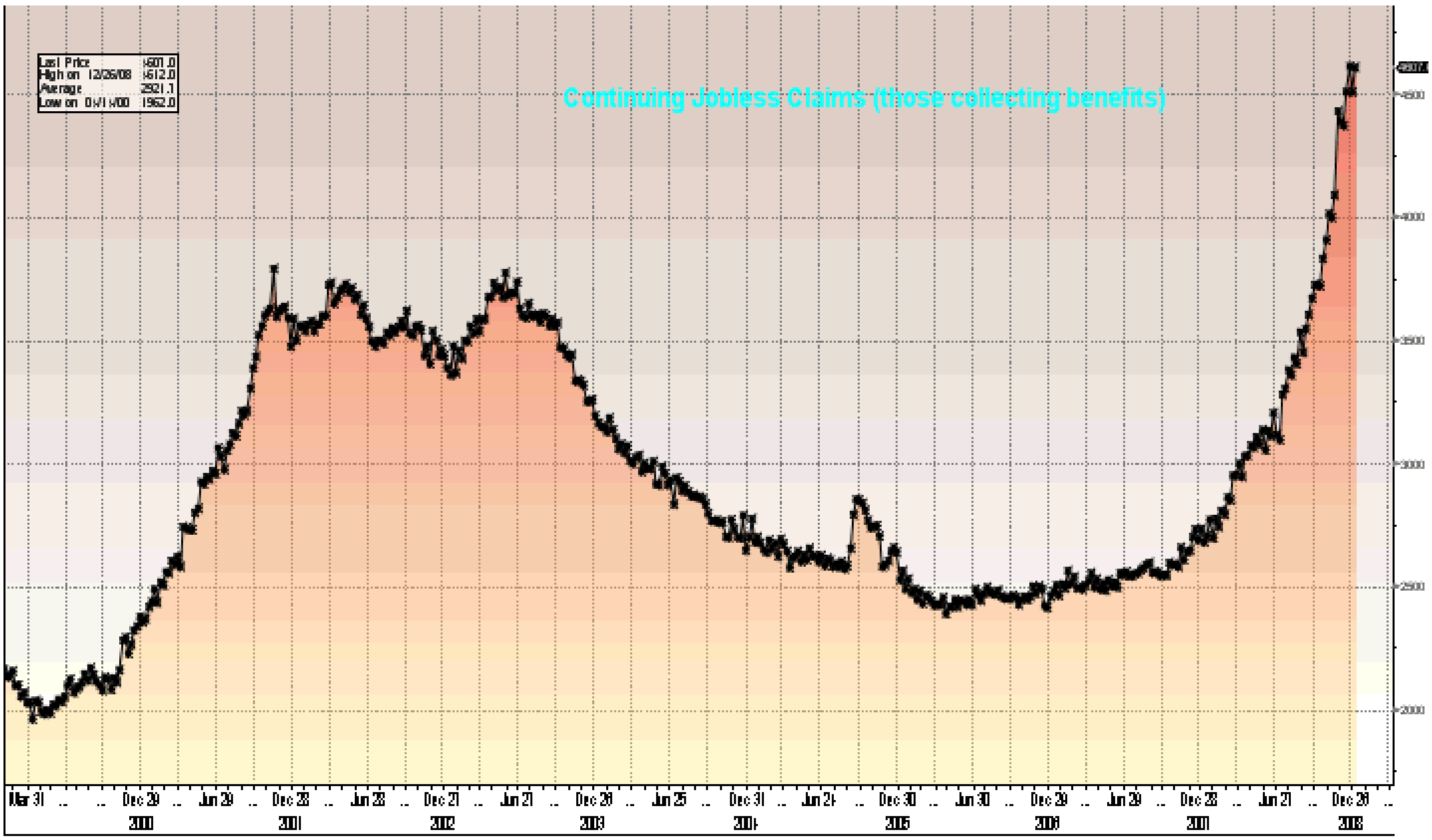
The difference between this cycle (Depression???) and past cycles is the persistence of the high numbers of laid off workers and the rather high absolute number. Sadly, I do not expect this trend to change for quite some time, with a terminal unemployment rate, depending on how it is reported (more on that below) of between 12-20%. Once again, Depression-like numbers.

U.S. Continuing Jobless Claims



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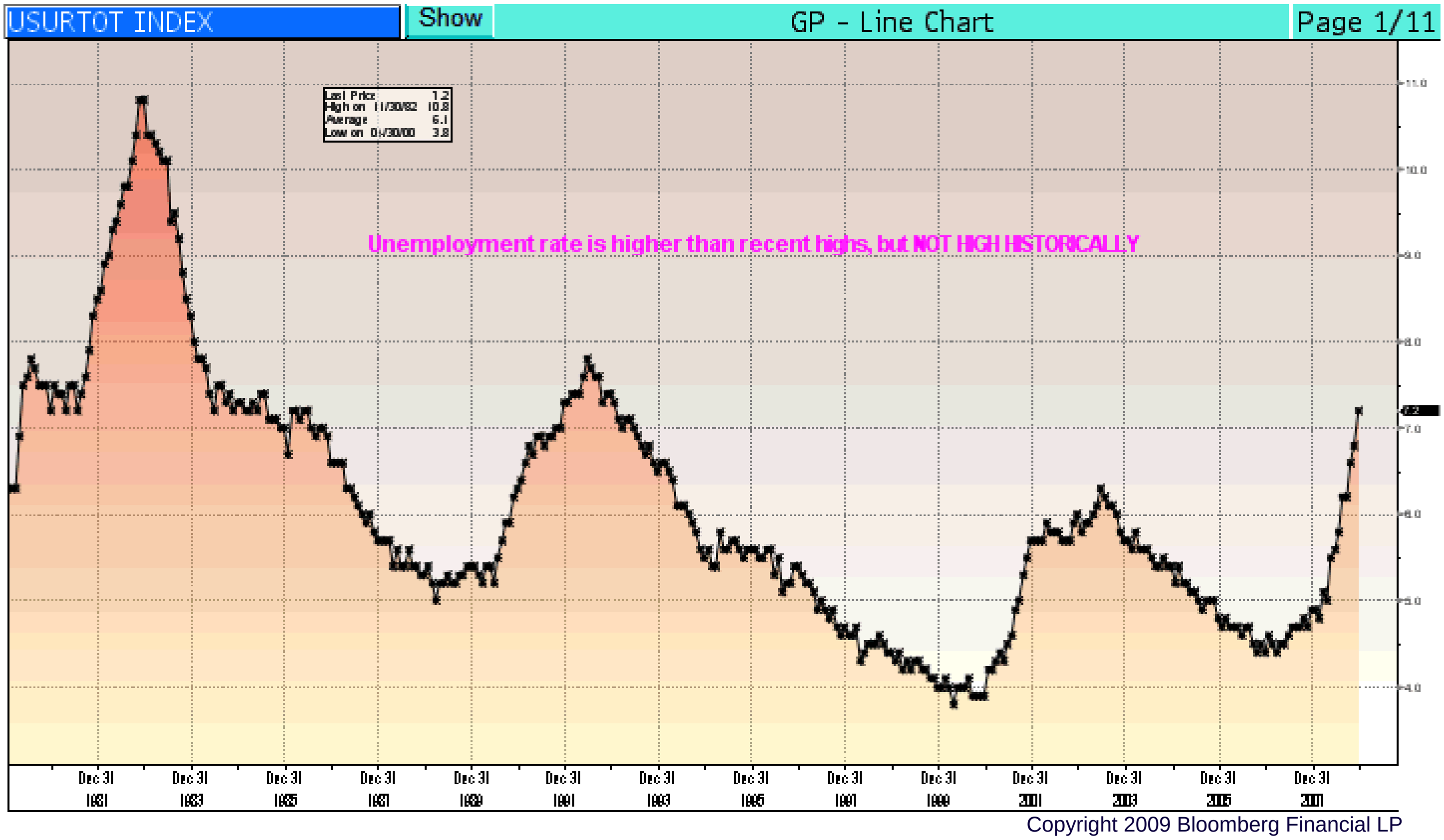
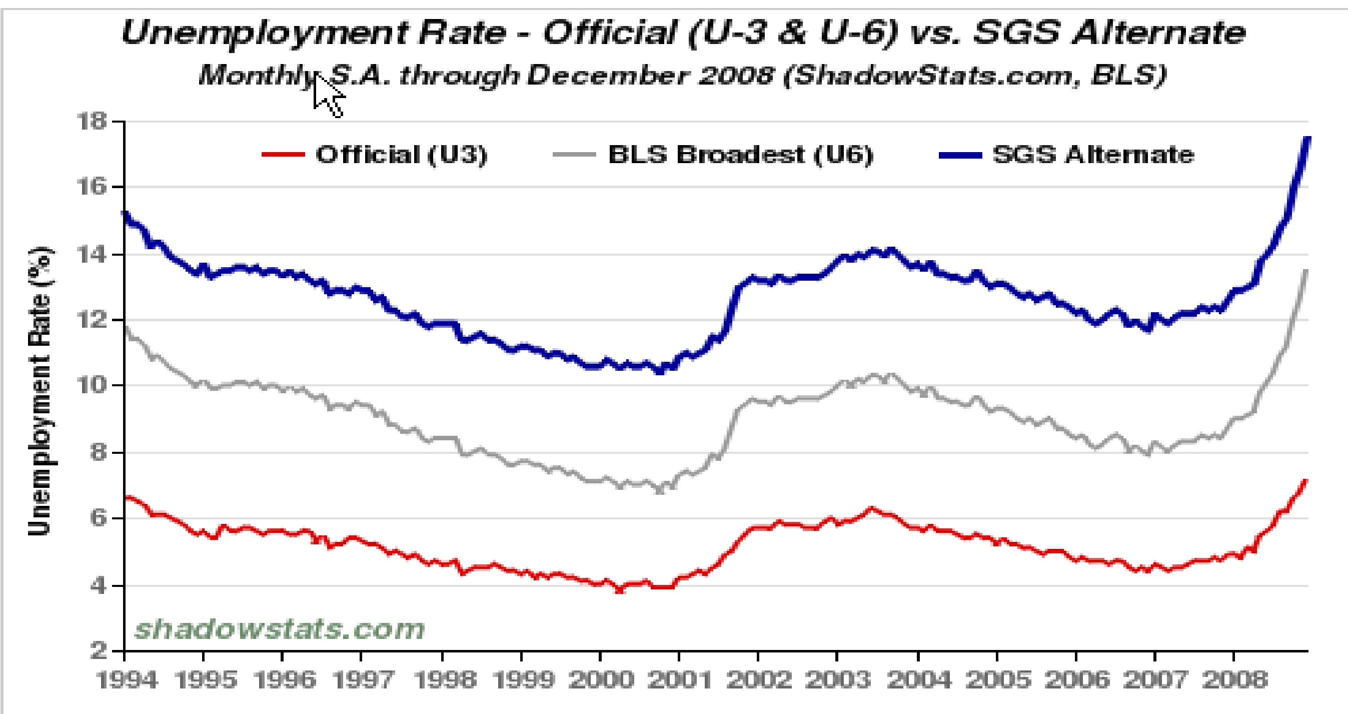
While the reported unemployment rate in the U.S. creeps up towards 7.5%, it is nowhere near the highs reported in the early 1980's, let alone the rates of prior Depressions. The $64 question is whether or not we can *trust* the numbers being reported out of Washington. As a cynic (no jeers please), I am unable to trust. Whether it is the flawed "Birth/Death Rate Model" that arbitrarily adds jobs via "hedonic adjustments", or other manipulations to the Unemployment Rate, the rate is nearly always understated. A recent study showed that when we add in "discouraged workers", or those that have given up looking for a new job and have run out of unemployment insurance, and then add part-time workers that are desirous of working full-time, the U.S. Unemployment Rate is closer to 13.5%. And the way the economy is behaving, with economic activity dropping off a cliff, the 13.5% number seems much more logical to me than 7.2%.



Unemployment Rate, Courtesy of Shadow Government Statistics



According to the data from John William's website, www.shadowstats.com, notice that the grey line includes the "discouraged workers" and we find the number at 13.5%. The main point I would wish to deliver here is that an economy built on so much leverage, deteriorating so quickly, no matter what the stimulus (bailouts, buyouts, TARP, Stimulus packages, quantitative easing, mortgage market manipulation, etc); the economic avalanche is upon us. And if you have ever witnessed an avalanche, there is no way to stop it.

In fact, with Ex-Fed Chairman Paul Volcker as President Obama's Economic Advisor, I would expect some tough times ahead. Mr. Volcker has a history as being a tough guy (recall he snuffed out double digit inflation in the early 1980's—I was there to see it and can tell you it wasn't fun) by raising short-term rates to near 20%, causing an ugly Recession, double digit unemployment and pain for all asset classes. The tough decisions that he made however, paid off with a 26 year bull market for Treasuries, which as I have mentioned of late, I believe is over. I believe he was chosen to make some tough decisions and recommendations that may cause a world of economic hurt, but a Darwinsitic approach that will produce better times ahead. Lastly, I believe the reason that Mr. Volcker was chosen and why we will have a young Treasury Secretary (Timothy Geithner), is that I believe Mr. Volcker will be behind the scenes orchestrating the moves.

In short, buckle your seatbelts. We continue to avoid credit, under-weight equities, and to batten down the hatches. Unfortunately, I believe the worst is yet to come.

Bennet Sedacca,

President

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