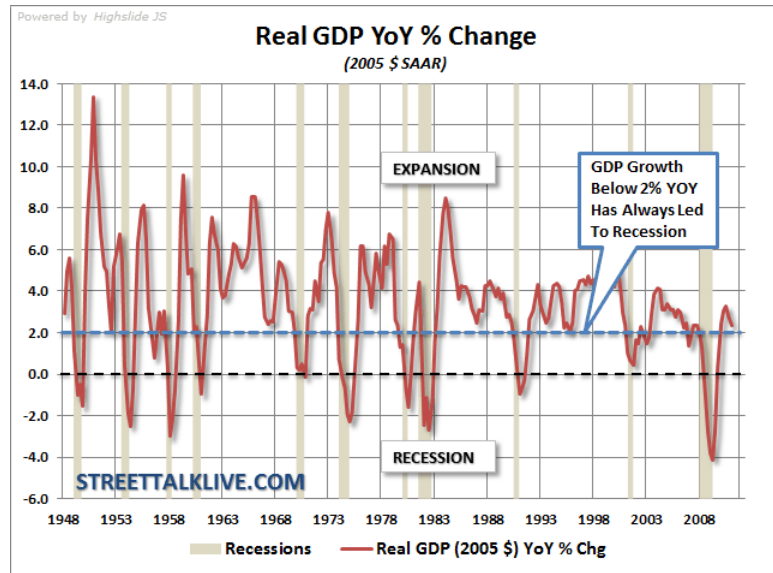


## Economy

Referring to the chart at right, economist David Rosenberg at Gluskin Sheff notes that since WWII economic growth below 2% has always led to a recession. He has not gotten much of a reception for that remark but the newly revised GDP figures were much weaker than previously thought.

Now, this chart is a little out of date. GDP (gross domestic product, the measure of US economic growth) was revised sharply downward today. 4Q/2010 was revised down from 3.1% to 2.3% and 1Q/2011 from 1.9% to 0.4%! I can't ever remember having seen such large revisions.



Clearly, the growth in 2009, oddly anemic as it was coming out of recession when growth is usually very strong, was a peak. It was an unusually weak growth peak, by far the lowest in the past 65 years.

Rosenberg also notes that fairly close recessions are not uncommon. They occurred in 1980 & 1982, 1970 & 1974, 1958 & 1961, 1950 & 1954. I am not predicting a recession, just pointing out the recent peak and trend. My guess is that growth will stay around 1%-2% for another few quarters.

## Household Debt

Debt is a major reason growth is so low. Look at a chart of household debt since 1952. **The first jump in household debt is post WWII** Little debt had been taken on during the Depression or while GIs were overseas. Now they were borrowing to buy houses.

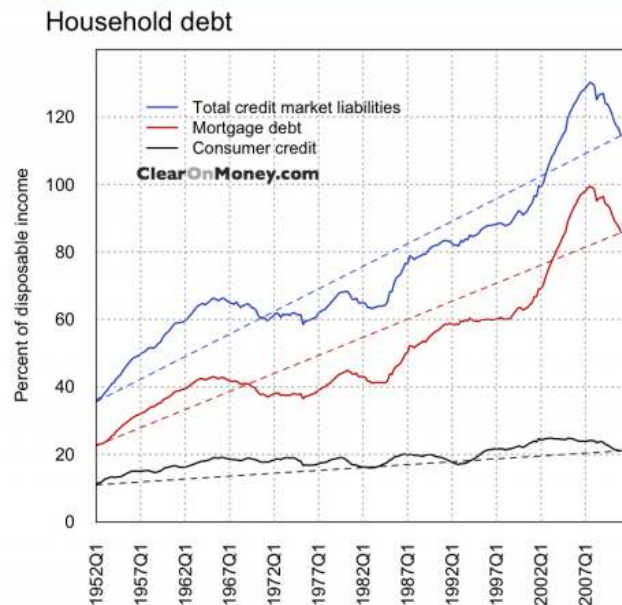
**From 1982-2000 debt accumulation jumped** as extremely high interest rates came down.

**Household debt exploded 2000-07. In 7 years household debt grew in percentage terms by as much as in the previous 38 years!**

**Since 2007** – Like a climbing stunt plane that loses its power, the fall has been as fast as the climb. This is the norm in explosions of this type, whether debt or stock prices.

Returning to sustainable levels of debt will take several years at least. It is not the trend line to which households must return but the more sustainable levels of debt. That means declining from the current 117% to more like 60%-70%. Better economic growth would help pay off debts earlier.

So would a change in American attitudes toward debt and the need for stuff. That is happening slowly.



## Employment

It is mainly the crummy job market that has kept the repayment of household debt so slow nationally.

According to USA Today, working from Bureau of Labor Statistics (BLS) data, "Only 45.4% of Americans had jobs in 2010, the lowest rate since 1983 and down from a peak of 49.3% in 2000. Last year, just 66.8% of men had jobs, the lowest on record." [www.usatoday.com/money/economy/employment/2011-04-13-more-americans-leave-labor-force](http://www.usatoday.com/money/economy/employment/2011-04-13-more-americans-leave-labor-force)

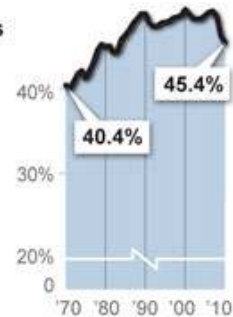
Families with one or no wage-earners are struggling heroically to keep out of bankruptcy. I have all the sympathy in the world for them. A long time ago, I was in a similar situation and today I have several friends whose retirement came much sooner than they had planned and whose assets had just declined.

Not even in the bad recessions of 1974 and 1982 did workforce participation dip so low. And as you can see in the bottom chart, for men it has been declining for 60 years.

This is what makes things so difficult. Job losses in recent decades have been increasingly not due to temporary fluctuations in the economy but shifting jobs overseas, as I showed last month. The retirement of Baby Boomers is now also adding to the decline, though some of them have gone back to work at WalMart.

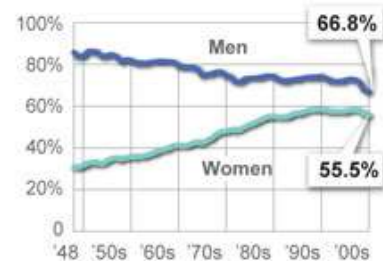
### U.S. workers

The share of the population working is at its lowest point since 1983.



### Women, men in labor force

Share of population employed, 20 and older:



Sources: USA TODAY; Bureau of Economic Analysis; Bureau of Labor Statistics

By Julie Snider, USA TODAY

## Why Government Badly Needs Economic Growth

At first look, Heritage Foundation's title for this chart seems to tell the whole story. Certainly the increase in spending under the last two presidents has been spectacular.

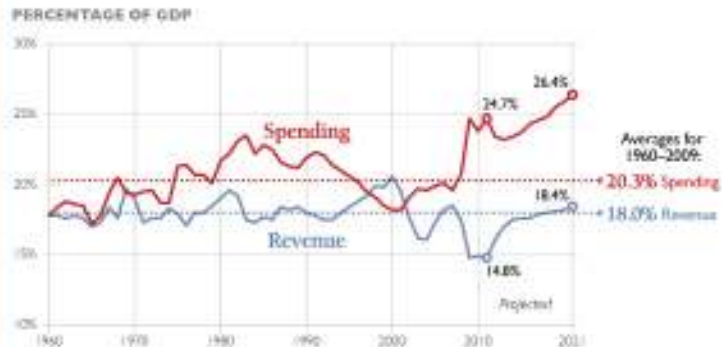
But on closer inspection, there is another lesson – the effect of economic growth on taxes and spending as a percent of the economy. Let me show you why stronger growth solves much of our deficit problem.

**Look at the blue revenue (tax) line.** A little analysis will show that changes in economic prosperity, or lack of it, have a great deal to do with tax revenues.

In fact, it is remarkable how small the range of taxes as a % of the economy has been despite all the major changes in tax law over the last fifty years.

### Runaway Spending, Not Inadequate Tax Revenue, Is Responsible for Future Deficits

The main driver behind long-term deficits is government spending—not low revenues. While revenue will surpass its historical average of 18.0 percent of GDP by 2021, spending will shoot past its historical average of 20.3 percent, reaching 26.4 percent in the same year.



Source: Heritage Foundation calculations based on Congressional Budget Office data.

Federal Spending Chart 11 • 2011 Budget Chart Book [heritage.org](http://heritage.org)

Significant deviations in tax revenue are very much related to significant changes in economic prosperity. To show that let me go through the 3 main periods on the chart.

1960-1995 federal tax revenue stayed pretty close to 18% of GDP (the size of the economy). Usually, the variation was only a percent or two.

In the mid 1990s with a booming economy tax revenue increased to 20% of the economy. In 2000, when the dot.com party ended and the country went into a recession it dropped hard to 16%. With the recovery it went back to the normal 18%. But, after 2007, as the economy started to falter again, it started down. Federal tax revenue dropped dramatically since 2007 to 14.8% where it remains today. No one reduced tax rates. No taxes were repealed. The drop was entirely due to a slowing economy.

Lesson 1 – the most important thing you can do for TAX REVENUES is to promote economic prosperity.

**Now, look at the red (spending) line.** Ignore the post-2011 section to the far right of the chart. That is just the Heritage Foundation's projection.

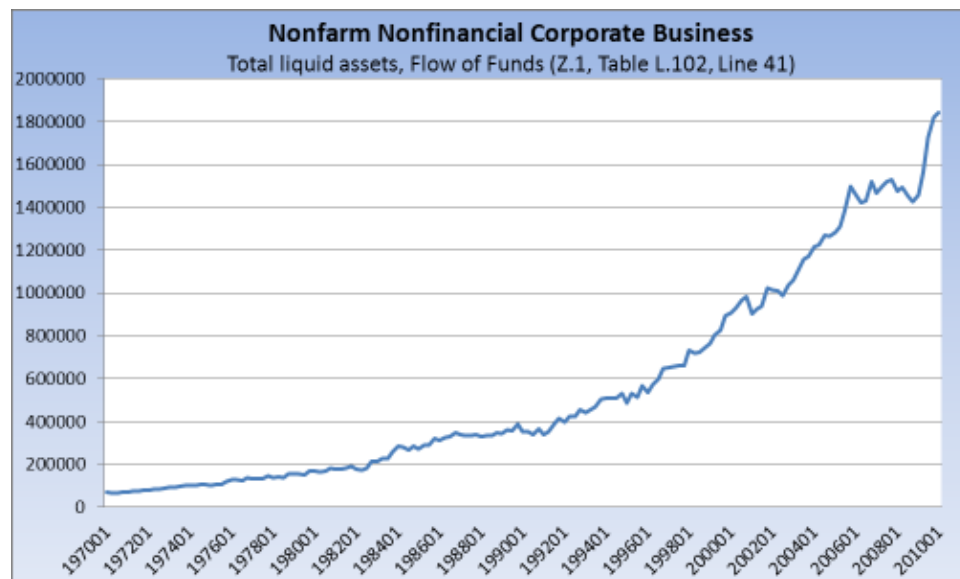
Federal spending as a % of the economy has been going up since 1960 with one very large exception – the period of strong decline from 1982 – 2000. Spending was not dropping, but it was dropping as a % of a rapidly growing economy. That was because as interest rates dropped from their peaks in the high teens in 1982 to low single digits in 2000 the economy grew enormously.

So, since both tax revenue and spending as a percentage of the economy depend greatly on economic health, downturns in the economy make for large gaps between revenue and spending, i.e. budget deficits.

Lesson 2 – by far, the most important thing you can do to reduce SPENDING as a % of the economy is to promote economic prosperity.

### **Corporate Cash / Lack of Investment**

Why are businesses not spending on hiring and on new plants and equipment? It's not because they lack the cash. Corporate cash is at record levels.



<http://www.businessinsider.com/heres-the-real-reason-companies-arent-spending-their-mountains-of-cash-2010-7>

The main obstacles, according to the National Federation of Independent Business (NFIB)'s "Single Biggest Problem" table in May are in the table below.

### SINGLE MOST IMPORTANT PROBLEM

#### SINGLE MOST IMPORTANT PROBLEM

May 2010

Problem	Current	One Year Ago	Survey High	Survey Low
Taxes	22	19	32	8
Inflation	4	3	41	0
Poor Sales	30	30	34	2
Fin. & Interest Rates	3	5	37	1
Cost of Labor	4	4	9	2
Govt. Reqs. & Red Tape	13	13	27	4
Comp. From Large Bus.	6	6	14	4
Quality of Labor	4	4	24	3
Cost/Avail. of Insurance	9	8	29	4
Other	5	8	31	1

In other words, they perceive their problems as low sales, high taxes and high regulation.

Government can affect the last two items directly. But, don't count on lower taxes or lower regulation.

That leaves lower sales and as long as people continue to dig out from under their homes and credit card debt sales will be historically slow.

But, when I listen to big business I hear an underlying tone of uncertainty. Candidate Obama promised change in Washington but to corporate CEOs the amount of change is very unsettling, though obviously much of the change started before he took office.

<http://www.businessinsider.com/heres-the-real-reason-companies-arent-spending-their-mountains-of-cash-2010-7>

Uncertainty is about as high as it can get. It is very likely to come down from here. On the other hand, we have a big election in a year. To the extent uncertainty decreases, CEOs will feel freer to spend.

### **Making Money**

So, to the big subject – how do we make money in this environment? First, let me point to the fact that corporate borrowing has picked up. That's partly due to record low interest rates but also due to the fuel of sizeable corporate cash will start to be burned as uncertainty calms down some, leading to growth.

Also, while some are predicting a second recession, I think 1Q/2011 was depressed by the triple whammy in Japan more than people think. In fact, Japanese stocks are picking up again quite nicely. I think the first quarter of 2011 could be the low point for the US recovery.

The stock market, for all the poor economic news, is actually higher for the year and not on a bad pace. Asian markets, struggling the last year, have just started to turn up in spite of the bad news in Europe and the US. I intend to put more money to work there. I have been avoiding them as they declined under the pressures of rising inflation and interest rates.

The whole world is unlikely to stop growing altogether. The worst of things is likely behind us. Stocks are moderately priced, not overpriced. And, as growth slowly ramps up again, corporate profits and therefore stock prices should rise faster.

Our gold has appreciated nicely. Commodity prices have come down some, giving us better entry points and we are very lightly invested there.

Our bond funds are doing fairly well and should continue as long as growth is tame, though a US credit downgrade certainly won't help.

Asia may be able to start lowering rates again. If that is the case emerging market bonds should continue to shine. We have some funds directly invested there and many of our more general bond funds have increased their holdings of emerging market bonds.

While a slowing US, a Europe in turmoil and emerging markets facing inflation and high interest rates have been the story, I think we are the point of maximum drama in this recovery. I look forward to continuing to make money.

Thanks for your support. This newsletter will be posted on [www.CornerstoneInvestment.com](http://www.CornerstoneInvestment.com). Please check out my daily blog on investments at the same address!

Dave Hoshour