

JOHN MAULDIN'S THOUGHTS FROM THE FRONTLINE THE STATISTICAL RECOVERY: PART 2

In this week's *Thoughts from the Frontline* John Mauldin looks at the statistical recovery. He focuses on recent unemployment and housing data and questions whether the numbers tell the full story. Delving a bit deeper leads to some interesting conclusions. He ends the letter with a round-up of the debate between some prominent economists on their forecasts for the market.

Enjoy the read.

A few weeks ago I first used the term "statistical recovery" to describe the nature of today's economic environment. Today we are going to further explore that concept, as it is important to have a real understanding of what is happening. This coming "recovery" is not going to feel like a typical one, and those expecting a "V"-shaped recovery are simply making projections from previous economic recoveries, which, based on the fundamentals, are not warranted. And of course, a few thoughts coming back from Maine are in order. There is a lot to cover, and this may take more than one letter.

But first, let me note to subscribers to Conversations with John Mauldin that we have posted my Conversation with George Friedman of Stratfor and will soon post a very interesting Conversation I had with John Burns (of John Burns Real Estate Consulting) and Rick Sharga of RealtyTrac. These may be the two most knowledgeable people on the [housing market](#) in the country. There is a lot of poorly informed speculation about the housing market, and I think this Conversation will help clear away a lot of the fog. PLUS, they both agreed to allow me to post their eye-opening PowerPoint stacks to Conversation subscribers (normally only available to their clients), so you get a very special bonus. And finally, David Galland of Casey Research is allowing me to post a most thought-provoking interview he did with Neil Howe. This is one of the best things I have run across in a long time. I do work on giving my Conversations subscribers good value.

George and I are going to be doing a regular quarterly Conversation called *Geopolitical Conversations with John Mauldin and George Friedman*. We believe that these new Conversations will help you better understand not only the global political landscape but also how it affects the financial umbrella that we are under. In this first Conversation, we talked about the "exogenous" risks to the markets (those from outside the markets themselves) posed by the geopolitical world.

We will offer this service, which will be priced separately, at some point in the near future. Now, here is the important part: [all current subscribers and anyone who subscribes now](#) will receive these Geopolitical Conversations free, as a thank you. (Current members can log in now.) If you have not yet subscribed, you can do so and receive a discount by clicking the link and typing in the code **JM47** to subscribe for \$149. This is a large discount from our regular price of \$199; plus, we are including the bonus Geopolitical Conversations that are worth \$59. And now, to the regular letter

The Statistical Recovery

The unemployment numbers came out last Friday, and Steve Liesman of CNBC did several interviews live from Leen's Lodge in Maine. I postponed an hour of fishing to be on air with Martin Barnes (of the Bank Credit Analyst) to comment on the numbers. Everyone seemed quite excited that the US lost "only" 247,000 jobs. However, it is still almost twice as large as a year ago, and at that time 128,000 lost jobs seemed pretty bleak. However, comparing it to the average of 692,000 lost jobs per month in the first quarter, those looking for good news immediately started talking about how a recovery is around the corner.



The unemployment numbers are some of the most seriously revised numbers in all of government data. The first monthly estimate is notoriously imprecise. Why people make investment decisions based on this release is beyond me. As I mention continuously, because of seasonal adjustment factors, the unemployment numbers understate job losses in a recession and also understate job gains in a recovery. About the most we can get from the current data is the broad trend. Admittedly, the trend is getting better, but we are still in a hole and no one has stopped digging.

What we can see is that we are down 6.7 million jobs since the beginning of 2008! We have roughly eliminated the job growth of the last five years. And that does not take into account the 150,000 new jobs that are needed each month just to maintain the employment rate because of the increase in population. It took 55 months once the 2001 recession was officially over to get back to the previous employment peak. That is 4.5 years, gentle reader, and we are further down now and faced with massive deleveraging. It is going to take a lot longer this time. Let's look at some of the reasons why.

I took a different tack in the CNBC interview. I pointed out that even though it is possible (likely?) we will see a positive number for GDP for the third quarter, it is not going to feel like a recovery for quite some time.

By the middle of next year (2010), when I think we will finally hit an unemployment bottom, we will be down close to 8 million jobs, wiping out all the jobs created since the middle of 2004. Unemployment is likely to be more than 10%, unless they keep playing games with the number.

A Recovery Statisticians Can Love

What I mean by that remark is that the unemployment number went down even though we lost 247,000 jobs. How can that be, you ask? Well, the government assumes that if you were not looking for a job within the last month, then you are not unemployed; therefore, on a statistical basis the number of people unemployed went down by 400,000. (There are 2.3 million such discouraged workers.) More in a minute on the problem that will cause down the road.

Assume that we will need 9 million jobs over the next five years (150,000 jobs a month for 60 months) and add the 8 million lost jobs. That means we have to add 17 million jobs in the next five years to get back to the 4.5% unemployment of 2007, let alone the under-4% we saw in 2000.

That means we need to grow employment by about 12% over the next five years. But it's worse than that. What is known as U-6 unemployment is over 16%. There are another approximately 8.8 million people who are either working part-time but want full-time jobs or are among the 2.3 million discouraged workers as mentioned above.

(The definition of U-6 unemployment from the BLS web site: "Marginally attached workers are persons who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the recent past. Discouraged workers, a subset of the marginally attached, have given a job-market related reason for not looking currently for a job. Persons employed part time for economic reasons are those who want and are available for full-time work but have had to settle for a part-time schedule."
<http://www.bls.gov/news.release/empsit.t12.htm>.)

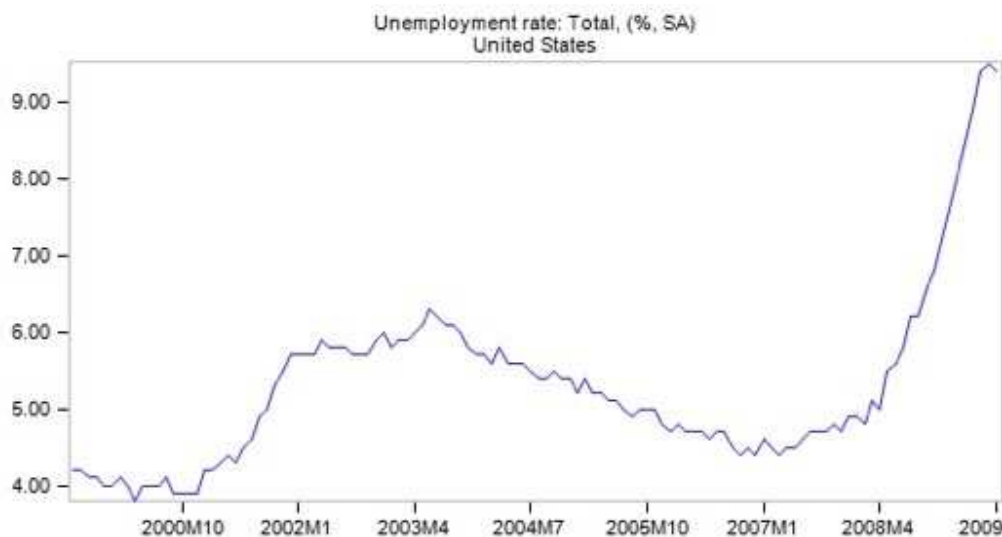
Let's make the assumption that the part-time workers want to go to full-time (which they say they do). Typically employers will increase the hours of part-time employees before adding new workers. That will be a major drag on potential job growth. It is the equivalent of creating at least 4 million jobs, except that no new jobs are created. Plus, those who want jobs but are not looking will come back into the market if jobs are available. That adds another 2 million. Now we are seeing the need for 23 million new jobs in five years, to get back to the "Old Normal."

That is an increase of 15% total employment from today's levels over the next five years. That type of jobs growth will only happen with significant economic growth. Normally, you should expect the economy to rebound to at least 3% trend GDP growth. That is what has happened historically. But we are not in the Old Normal. We are entering the era of the New Normal, where looking back at historical trends will prove to be misleading at best.

On average, and VERY roughly, you would think you would need a minimum of 15% real GDP growth over five years to get us back to what we think of as acceptable levels of unemployment. Actually you would need more, as productivity growth lessens the need for more workers. Oh, and add in the Boomer-generation workers who are not going to retire because they now cannot afford to.

(I think we will be lucky to have 10% real GDP growth in the next five years, for a host of structural reasons that we will be going into below and over the next few weeks.)

Unemployment will be rising for at least another two quarters and probably through the middle of next year. That should not surprise us too much, as unemployment kept rising for almost two years after the last recession, which many dubbed "the jobless recovery." The recession ended in 2001, but as the graph below shows, the unemployment rate rose until the middle of 2003.



We may have a "statistical recovery." The numbers may be positive for a variety of reasons only a statistician could love, but it is not going to feel like a recovery to the rest of us. Maybe that is why consumer confidence took another hit today, dropping to its lowest level since March, helping to drive the market down.

The economists at economy.com, who normally have a bullish tinge to their writing, said it succinctly: "Confidence will

struggle to gain ground in the months to come, as consumer budgets remain stretched. Little wage income, prospects for reduced bonus payments, reduced access to credit, and no capital gains are all constraining consumers' ability to meet their financial needs and recover from the sharp drops in wealth they have experienced. Many consumers are struggling to pay their debts. Supports are coming from reduced layoffs, equity market gains, and stimulus such as the cash for clunkers program, but that is proving inadequate to lift spirits so far. It will likely be some time before conditions turn enough for confidence to improve decisively. Key drivers of confidence include developments in the labor and housing markets and the path of energy and equity prices."

(My friend Bill Bonner described the Statistical Recovery as being just like a female impersonator. He is just like a real woman in every way, except for the essential ones.)

The consumer's sense of discomfort is shared in executive suites across the country. "Chief Executive Magazine's CEO Index, the nation's only monthly CEO Index, dropped to 63 in July, after showing gradual improvement. All components of the index are down, with Employment Confidence taking the largest hit...

"What's worse is that pessimism over employment is reaching new heights. The Employment Confidence Index declined 25 percent with 57 percent of CEOs expecting continued decrease in employment next quarter. Over 95 percent rate the current employment environment as bad—the highest level for 2009. Less than 5 percent think employment conditions are normal and virtually no one (0.4 percent) thinks they are good." (*The Bill King Report*)



A Few Thoughts on the Housing Market

Bill also sent me a link to a very interesting survey of the [real estate](#) market. Those in the real estate business will find this of value, although it makes for grim reading.

(<http://www.campbellsurveys.com/AgentSummaryReports/AgentSurveyReportSummary-June2009.pdf>)

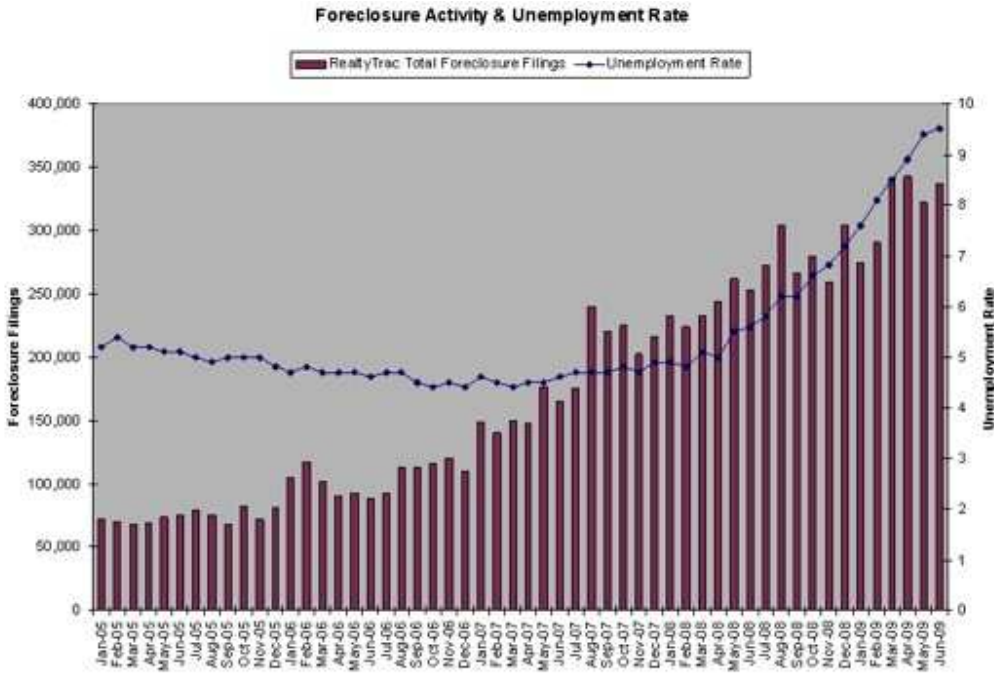
Three (of the sixteen) of their summary bullet points stood out:

- The market for home purchases can be divided into segments of 26% for damaged REO, 23% for move-in ready REO, 14% for short sales, and [only!] 36% for non-distressed properties. [REO means "real estate owned," typically by a bank as a result of a foreclosure.]
-
- 43% of homebuyers are first-time homebuyers, 29% are current homeowners (relocation or retirement homes), and another 29% are investors.
-
- **Only 31% of non-REO home sale listings are unforced or optional;** other major reasons for listings include financial stress (including short sales), long distance relocation, and divorce or estate sales.
-

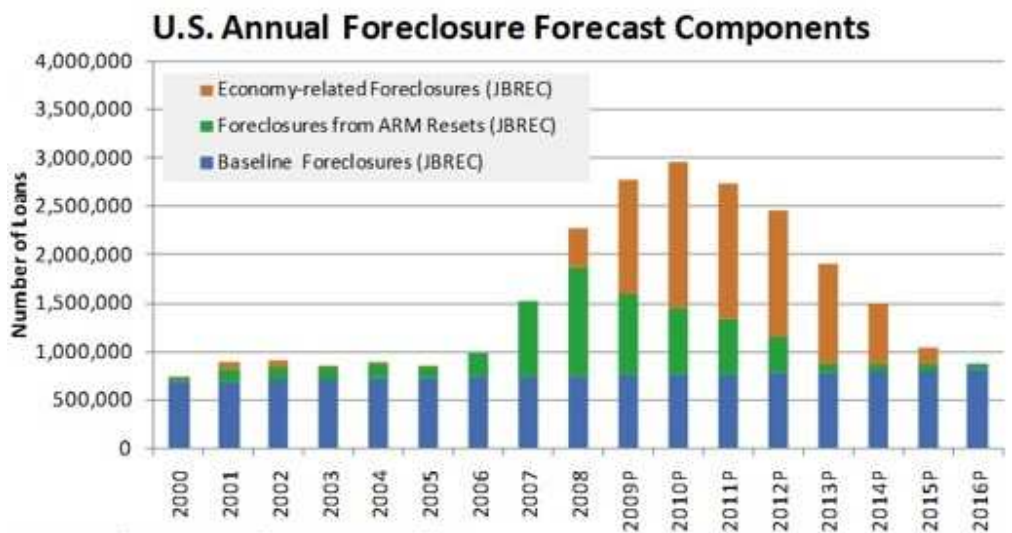
Think about that for a minute. Two-thirds of home sales are either foreclosures or banks taking a loss on the mortgage. Of the remaining 36%, only 10% are as a result of something we could call a normal selling process. And that is nationwide. There are lots of places where foreclosures are low. Reading this report anecdotally, there are large areas (California, Nevada, Arizona, Florida) where almost the only housing action is distressed or forced sales, that is, sales at a significant discount to original asking price.

Look at the chart below from Rick Sharga at RealtyTrac. Today we learned from them that foreclosures set a new monthly record of 360,149 properties that received a default or auction notice or were seized last month. One in 355 households got a filing, the highest monthly rate in RealtyTrac records. Many hard-hit areas have rates higher than 1 in 39 homes! Foreclosures are now running about six times higher than just four years ago.

And there is little relief in sight. There is typically about one foreclosure for every 6-10 jobs lost. It will be higher this cycle, as so many homebuyers are underwater on their mortgages and have little incentive to try and keep up payments while they are unemployed. Further, there are 500,000 REO-owned homes that are not on the market as of yet (what Sharga calls shadow inventory), and a wave of foreclosures will result from option ARMs and Alt-A loans resetting next year. Note: July's record numbers are not in the chart below.



John Burns gives us the next graph, which is an estimate of foreclosures for the coming years. (www.realestateconsulting.com)



Source: John Burns Real Estate Consulting

Notice that he estimates more foreclosures next year than this year, with very little relief until 2014! This does not bode well for housing prices, which are a big factor in consumer sentiment, which is a big factor in consumer spending.

It does mean that renters can find some very good deals, as there are now areas (like Phoenix) where it is cheaper to buy smaller homes than to rent. Remember the statistic above that first-time home buyers are 43% of the market and investors another 29%? Lower prices make housing more affordable, and with the government incentive programs for first-time buyers really working (for once), the lower end of the housing market may actually stabilize sooner than the overall market.

As I wrote almost two years ago, the housing market will not bottom before 2011 and maybe into 2012. We just built way too many homes in our exuberance; and with tightening lending standards (as there should be) the number of people who can qualify for a mortgage is down, although (again) falling prices make homes more affordable. The median price in California is down by 60%. (Although I saw today where Bill Gross bought a tear-down on the water in Newport Beach for \$23 million. That will help the average some.)

Homeowner vacancy rates are close to 3% of total homes, which is well over 2 million homes. Many of these are not yet on the market.

Retail sales were down in July. And that was with Cash for Clunkers in full force. The headlines said that economists were shocked. Really? Consumers are saving more, and actually paying down credit-card and bank debt. We will go into those details more next week, as it is getting close to time to hit the send button.

Some Thoughts from Maine

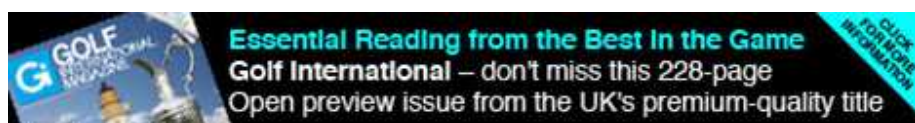
Last weekend I got to go to Leen's Lodge at Grand Lake Stream in Maine (www.leenslodge.com - *highly recommended*) to meet with 35 economics types and their friends. This is a very knowledgeable group, with a lot of well-known names. We fish in the morning, meet at a campsite for lunch (drink wine and eat what we caught), fish some more, go back to the lodge, eat a gourmet meal and drink some more wine, and then go on talking. This goes on for 2-3 days. I throw my diet to the wind, and pay for it over the next month, but it's worth it.

On Friday Steve Liesman and some local guides bring out their guitars and entertain, with a lot of loud, if somewhat off-key, singing from the crowd. (Liesman, by the way, really can play the guitar quite well.) On Saturday night we bet on the future of the markets and events - typically small amounts, and lots of side bets. This year I won five out of six side bets I made last year.

As usual, bets were all over the board. But a few interesting ones surfaced. David Kotok and George Friedman offered rather (for this crowd) large sums to take on all comers that Bernanke would not be reappointed. I took part of that offer, as did a number of others (for the record, the Fed economists at the meeting do not bet and were quite closed on the topic). I was surprised at the intensity of that debate. This is a well-informed crowd when it comes to Fed policy and actions, and if this question is (politely) contentious among friends in July of 2009, what will it be like in the latter part of the year, when Obama has to make the appointment (Bernanke's appointment is up in January of 2010)? And among those who do not get along? This could be a very noisy appointment process.

A few years ago (2006 and 2007), I was repeatedly told I was "too bearish." Now, my Muddle Through prediction was seen either as overly optimistic or the most likely scenario by a large number of attendees. The concerns about the credit markets are still quite strong, with many thinking we will be facing banking problems for years. There were more than a few who bet that Citibank will not be around in its current form by this time next year. (I did not take that bet.)

A number of participants saw a double-dip recession as a distinct possibility. I think it is a probability in 2011 as the Bush tax cuts expire. If Congress moves up the increase in taxes to 2010, which is what the House Democrats want, that recession could start in 2010.



Essential Reading from the Best in the Game
Golf International – don't miss this 228-page
Open preview issue from the UK's premium-quality title

Click for more information

Tulsa, Birthdays, Weddings, and Paul McCartney

Today is my mother's 92nd birthday, so I need to leave soon, as she eats early. The order of the day is Luby's Cafeteria. Interestingly, she had me when she was 32, and Tiffani is 32 and will have her first around Christmas. Other than her hearing, mother is still going strong, if a little more slowly, and shows no real signs of letting up. She is now bionic, with two new knees and hips over the last decade.

Next week I leave for Tulsa on Thursday to prepare to give away my daughter Amanda on Saturday to a nice young gentleman, Allen Porter. They (along with her twin sister Abigail) say they intend to move to Dallas after the first of the year, which will make Dad happy, as all the kids will be in the local area. A little golf on Friday morning with the new in-laws, parties, and so on. It should be a large wedding and a fun weekend. They have lots of friends, it seems. I do intend to write my letter as usual.

I also intend to be in the bar on Thursday night at the Hilton at 9:30-45, assuming Southwest is on time. If anyone cares to meet, feel free to drop by.

Thinking about Mother's birthday reminds me that I turn 60 on October 4. For whatever reason, it is not bothering me like 50 did. Maybe 60 is the new 45? Paul McCartney is now 66, and is on the road with what I am told is a very good show. I will find out Wednesday when he plays Dallas and I get to go to the new Cowboy Stadium to see him play. With most of his set scheduled to be Beatles tunes, I am really looking forward to being there. I got to see Eric Clapton last month. He is on top of his game. Maybe blowing through 60 is not all that bad.

Have a great week. I shall.

Your hoping I can avoid paying for another wedding for a few years analyst,

John Mauldin

Copyright 2006 John Mauldin. All Rights Reserved

Plexus. Independent Insight in an Uncertain World.

Tel: +27 (0) 21 970 2400 • Fax: +27 (0) 21 975 2248 • E-mail: info@plexus.co.za • Web: <http://www.plexus.co.za>

DISCLAIMER

This e-mail transmission contains confidential information that is the property of the sender and which is legally privileged. The information is intended only for the use of the addressee. If you are not the intended recipient, you are hereby notified that any disclosure, copying or distribution of the contents of this e-mail transmission, or the taking of any action in reliance thereon or pursuant thereto, is strictly prohibited. Should you have received this e-mail in error, please notify us immediately by telephone to arrange for the return of the documents comprising this transmission. In no event will Plexus Mauldin Alternative Investments (Pty) Limited, Plexus Asset Management (Pty) Limited or the sender of this e-mail be liable to any party for any direct, indirect, special or other consequential damages for any use of this e-mail, or on any other hyper-linked web site, including, without limitation, any lost profits, business interruption, loss of programs or other data on your information handling system or otherwise, even if we are expressly advised of the possibility of such damages.