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The Triple Threat: Phase II
October, 2009

A sequel to "Planning for the Strategic Triple Threat," January 2009
from John F. Dini's blog, Awake at 2 O'clock in the Morning?

Okay, I'm stepping away from the sales compensation series for a day, and admitting something to everyone.

I've been writing the blogs on sales comp in order to duck the one I didn't want to write. I am by nature a relationship-oriented person. I like people, and I want them to like me. I've been watching my clients struggle with this economy for what seems like forever. They all desperately want this damn recession to end, and so do I.

I don't like to be the bearer of bad news, but I don't think most of us are going to be very thrilled with 2010. My January posting on Planning for the Strategic Triple Threat was discussed by hundreds of business owners in The Alternative Board® around the country, and re-posted in places that eventually came back to me from surprisingly far afield. We are now entering Phase 2 of the triple threat, the slow recovery.

Last week I attended a presentation by John V. Duca PhD, Vice President of the Dallas Federal Reserve Bank, and another by Joseph Stiglitz PhD, the author and Nobel winning economist. Neither one said anything that I hadn't already read or figured out, but nothing in either speech made me very happy.

1. What Underlies the "Recovery?"

I am going to be succinct in delivering the facts. Some are from the lectures and others from my own research. They speak for themselves.

- Economic growth is projected to be positive again in the third quarter, by a fraction of a percent. This would mark the "end" of the recession.
- Bank lending spreads are at 1930's levels. (Any of my clients who have gotten their credit lines renewed in the last 6 months will attest to that.)

- Unemployment is at 9.8% of the working population. The U-6 measure of unemployment, which includes those who have given up looking and who are employed part-time but still seeking a full time job, is at 17%.
- Bank failures in 2009 are right at 100. That will probably double in 2010.
- The household savings rate spiked to almost 7% in May, and continues in the mid 4% range, even against strong equity indices.
- The total number of home mortgages that have been refinanced or principle-adjusted through government relief programs in the last 2 years is less than the average month's new foreclosures.
- Except for non-conforming jumbo mortgages, the US Treasury, via Freddie-Mac, Fannie-Mae or FHA, is currently underwriting 100% of the homes sold in the US.
- Commercial property mortgages on bank's balance sheets are still exempt from mark to market, disguising the real state of those banks for the moment.
- The FDIC is bankrupt
- $400 billion of the $800 billion stimulus will disappear without a trace
- Asia has emerged from the recession. South America barely felt it. Neither is waiting for us to start spending again to move forward with their economic plans. Enjoy the Olympics in Rio de Janeiro.
- The G-20 meeting in Pittsburgh tacitly accepted the need to move to a new world reserve currency from the US Dollar. Only the refusal of the host country to place it on the agenda kept it from being the major topic.
- We have tripled our current deficit, which we are funding by "printing" money.

I don't want to hold back, so I'll toss in a couple more things that are more observation than fact, and then move to a discussion of what we should be doing.

Our government is currently focused on health care reform. Regardless of what you think about the programs or proposals, two things are plain. One, "budget neutrality" however that is defined, will come only at a substantial increase in the costs of employment. Second, it will not include the looming explosion in Baby Boomer Medicare, which predates the "reform" and is therefore not included in the calculations.

Both of the speakers, when asked about different events in the future, had disturbingly identical responses. "I can't say. We are in uncharted territory."

The Domino theory in Vietnam was a crock, but right now we have so many things falling on each other that the metaphor seems appropriate.

2. What does it mean?

Let's look at the above facts in light of their effect on our businesses.

<u>Economic growth and unemployment</u>

The projections I've seen are for slow growth. Some say we will have a double dip recession: two quarters of replenishing inventories and the supply chain, followed by another slowing. That is the "W" shaped graph scenario.

Others say the recovery will be a “U.” Still others say an “upside down square root sign” meaning a long flat period. No one, absolutely no one, says we will have a “V” shaped recovery such as in the 90’s and 2002.

So growth will be slow, likely in the 1% to 1.5% range. Some, like Stiglitz, say we will face “3 to 5 years of Japanese style malaise.”

Employee productivity increases by an average 2.2% annually. It has been much greater with the layoffs and through the introduction of the PC, but 2.2% is the long term average. We are still adding about 1% to the working population annually; although that may rise due to delayed retirement by Boomers who have seen their savings shrink.

So we need around a 3.5% growth rate in GDP to absorb productivity increases and new entrants before we start shrinking the unemployment rolls. No one is predicting 3.5% growth in the next couple of years. In addition, we have to return all the employees on short hours or short pay before we hire anyone. Look for unemployment to stay this way for some time.

Consumer spending

As I pointed out in January, the explosion of credit led to a huge overbuilding of commercial space. More on that later, but the savings rate of all Americans has jumped from a negative 2% to about 5%. With consumer spending at 70% of the pre-recession GDP, that put almost 5% of the national economy out of circulation.

I learned a new term this week; “the paradox of thrift.” The more people save, the worse the economy becomes, and so the more people save. Add to that the 17% that can’t save because they don’t have enough for expenses already, and the consumer driven economy looks pretty grim.

The rising stock markets have pulled some of that money away from savings. I admit to not being clear on exactly how that’s figured. I think retirement account investment is savings, but direct investments are not, but I’m not sure. Either way, if we get a bump in interest rates and a slip in the markets, just watch how that savings rate spikes again. No one wants to be caught like they were last October.

Banking and Commercial Lending

It’s a good time to be a conservative, solvent banker with an underpinning of consumer deposits. You are borrowing from the Fed at essentially zero, and lending it out at the best spread you’ve ever seen.

The truth is, you need to make a lot of money because the FDIC just asked you to pay the next few years of your vastly higher deposit insurance premiums in advance. Ouch! The FDIC reserves didn’t even make it through a year of this mess. What happens when the next year is worse, and the FDIC has already borrowed through 2013? I'm betting on more special assessments, putting greater upward pressure on rate spreads. That slows business even more.

It could be worse. You could be one of the many (some say a majority) of banks whose balance sheets depend on commercial real estate mortgages. Office buildings and strip centers have low occupancy, and many of the rents are at discount. Here's what that would normally do.

As a banker, I value your building by its income stream, or capital return rate. If you are projected to generate $100K in rents at say, 85% occupancy, and I expect a 10% cap rate, then I would value your building at $1,000,000. You put in $200,000 (20%) and I will lend you the other $800,000.

At the end of 2009 I look at your results, and find that you were only 70% occupied, and did some discounting, so that rents actually came in at $62K. Now your building is worth $620,000 by my calculations.

So I reset the value on my books, look at your remaining mortgage balance of $775,000, and nicely ask you to come down to the office with a check for $155,000 to make up the difference. That's if I don't ask you to bring $279,000 so I have an 80% loan-to-value ratio again.

What? You don't have $155,000 (or $279,000) because your rents were down? No problem! Since TARP I no longer have to "mark to market" on my assets. So I can roll your financing for $775,000 on a $620,000 building because I judge, in my expert opinion, that over the life of the loan the asset will *someday* be worth as much as I have it on my books for. Neat, huh?

As Dr. Stiglitz said, there is seldom a *good* reason for markets with poor transparency to become even less transparent. Many banks will do this until their balance sheet becomes so unrealistic that they fold even though they are technically solvent under the current rules; thereby increasing the pressure on the FDIC.

Finance

By now, you are probably asking the same question millions of Americans have voiced, which is "Why don't the regulators do something about this?"

Short answer: Because there are 5 (count 'em, *five*) financial industry lobbyists in Washington DC for every Congressman.

Longer answer: Because our national legislature has lost any appetite for regulating the markets, (which just might be related to the short answer.) They will hold hearings on Merrill Lynch bonuses, slap a few people around, and move on.

Everyone (except those of us who are paying for it) is pretty comfortable with the current system. People in the financial industry get paid huge sums to take big risks with other people's money. If they succeed, their huge paychecks get even huger. If they fail, we socialize the losses. That means everyone shares.

The institutions that were deemed "too big to fail" were merged, so they became even bigger. Now they are "too big to fix." Where we used to let them crash, wiping out the debt holders and shareholders, now we "have to" save the mutual funds and union retirement funds, so we pay everyone off with tax dollars. Actually, we are paying it with your children's tax dollars.

If you were proud of not being one of the spendthrifts, of not running up your credit cards, of not hocking your house to buy big screen TVs, I have news. Your government decided to do it for you.

<u>The Deficit</u>

My Mom says "I know things are bad, but I live on Social Security and a few CDs. None of this really will affect me."

Perhaps, but it really affects us all. The deficit makes us less credit worthy as a country. A recent issue of The Economist compared the US Federal Reserve Bank's balance sheet to the Bank of Zimbabwe. Isn't that comforting?

Maybe we'll start getting emails from Fed employees, offering to transfer millions in frozen accounts if we just give them our bank account number. Oh… they already have our bank account numbers. Never mind.

The "Third World" is rapidly gaining. China has pretty much blown us out of Africa, as business goes. They are passing us in trade with Brazil, and the rest of South America is following. Their economy will grow at 6-7% this year, and that was in a recession. The developing world just passed the USA in total trading volume with China. We are now their second best market, and Europe is catching up fast.

China, Japan and the Middle East are acutely aware that they hold trillions of dollars in US debt; and that we are printing money to devalue our currency through inflation, making that debt worth less to them every day.

As long as they though they needed to lend us the money to buy their stuff, it was a price they had to pay. Now they are beginning to understand that they can get along without us. They will soon start to demand the risk premium that's appropriate for debt that will decline in value over its lifetime.

In 1981 I was factoring our receivables at 6 points over prime. The prime rate hit 18%. That meant my first 24% in gross margin went to pay financing costs, before any operating expenses. Our company was snatched up at a bargain basement price by a German supplier who could borrow at more reasonable rates.

Our creditors' big decision now is when do they want to step up and take the one-time hit? Money is a theoretical mechanism anyway. (Read "Greenback" by Jason Goodwin) Introducing a world trading currency would cause a huge fall in the dollar, but it would relieve their need to accept dollars, and the deflation risk that accompanies them, in the future.

For us, it means we start paying for our imports, especially oil, in a currency that has to be exchanged at whatever its current value is. We screamed about $4 a gallon. The Italian Lira buys gasoline at $4 a *quart*.

So how do we stop borrowing or printing money to pay our bills? It isn't going to be easy. Take the stimulus bill for an example. Why aren't we seeing the effect of an $800 billion infusion?

Because the first $400 billion disappeared. That's how much the state budgets were under water for 2009 and 2010. Most states are required to have a balanced budget. No revenues, no services. Despite the many political speeches about being frugal, budget cuts were only by a fraction of what was missing due to reduced income tax and sales tax collection.

I have a friend who is a legislator on the appropriations committee at the state level. They were apportioning the stimulus money as soon as it was passed. Ten billion for education? That's ten billion less that the state has to find. Fifteen billion for highway construction? One more highway we don't have to pay for.

So at least half of the stimulus money is going to *maintain* current spending levels. The biggest impact of the stimulus is that things aren't a lot *worse* than they are. The states have mostly avoided massive layoffs of their own.

My Mom will see her return on CDs go up and the COLAs on Social Security go away. Probably a wash. The rest of us won't be so lucky.

We can't stimulate the recovery by lowering interest rates, as is customary. Rates are at zero, so have no place to go. So the other choice is another stimulus bill. That means borrowing more. That means printing more money. You can probably see where this is going.

3. Why do I want to depress everyone?

Let me make this plain. This is NOT a political blog. Nothing I've said here places blame or points fingers. We are talking about gravity. It is what it is, and the effect is there whether you like it or not.

I’m not making any of this up. I’m not saying whether health care reform is right or wrong. I’m not trying to pin it on this administration, or the last administration, or Wall Street, or indolent Americans, or the Chinese. Facts are facts. It’s gravity.

I do think that the Fourth Estate plainly likes this administration more than the last, and is more favorable in its coverage. I do think that the media across the board avoids complex and difficult issues, and this problem is very complex. I do know, for a fact, that most folks don’t want to think about living though more of the same when it comes to 2009.

So when the talking heads tell you things are getting better, examine the information, not the delivery. Is losing “only” 500,000 more jobs actually an improvement? Is a positive GDP by itself enough to bet your next expansion on? Be very, very critical of what you see and hear.

Don’t ask me whether to buy or sell stocks. I have no clue. I’m taking the time to write this because I want my clients and other business owners to pay attention and to be ready. You are ready if you are running your business the best you can. You may say that you are doing that now, but you will need to do better.

4. What is a business owner to do?

Getting back to the basics is a hackneyed phrase, and like most over-used sayings, has lost much of its meaning. Here is what you can focus on.

Cash

Cash may be the only thing you have to fall back on if you hit a bump in the road. Your credit line is likely to be reduced, and may disappear. At the very least, it will be a lot more expensive than it was.

Do not pay down debt. Unless you fear a loan call because you are breaking covenants, continue paying today’s low-interest notes over their term. $100,000 in cash will make that $5,000 note payment for 20 months if you run into trouble.

Profits

Maintain profitability at all costs. It is the only way to generate more cash. You may want to take out the profits for tax purposes, but be prepared to lend them back.

It’s hard to keep up margins in a brutal pricing environment. You have no choice. Back in the inflationary 80’s we cancelled all catalogs and price sheets. Every one of our 5,000 SKUs were “call for price.” No one liked it, but we didn’t have a choice.

Many of our members are making the tough decision to give up the demanding, high volume-low margin customer. Whether you can afford to do that is dependent on your fixed vs. variable costs.. If you have high variable costs, especially if you are in a service industry, you may be better off without them.

Employees

If you decide to drop marginal business, drop those variable expenses *immediately*. Don't become a cheerleader for "we can replace it in time." You probably can't, and you are bleeding cash every day that you try.

It's cold, but if you lay off people the likelihood is that most of them won't be going very far. You can get them back if you need them.

The last 12 months have shown you who gets it and who doesn't. Every one of my clients admits that they have employees who acted like the recession was someone else's problem, or have found it a convenient excuse for underperforming. It's time for them to go, and seniority isn't a factor.

Every termination, whether voluntary or involuntary, is cause to reexamine job descriptions. You should have one of those WWII posters up, but this one says "Is this hire really necessary?" Can you split the job up? Can you do it with a part timer? Can you do it with TWO part timers? There are plenty of folks out there in that 17%.

If you haven't frozen wages, think about it now. Offer to share some profit instead. If there is an employment tax for health care, you will be sharing the burden instantly.

Purchases

Every purchase should provide a long term cost savings. Start downsizing vehicles at every opportunity. It really isn't a question of whether fuel will be vastly more expensive. It's only a question of how soon? By the time everyone else wakes up, small vehicles will be selling at a premium.

When your technology vendor says it is time to upgrade, demand to know what you will gain. "Faster" isn't a feature if the operator isn't currently at maximum capacity. The business world turned Vista down flat, and got away with it. Even Microsoft is learning that the customer has power.

Green is nice, but frankly it is a self-imposed competitive handicap to those who don't participate. If paying more for electricity that is supposedly wind-generated makes you feel good, that's great. If you can afford to be uncompetitive because your costs are higher, better still. (For the other guy)

My responsibilities are first to my family, second to my employees, and third to my clients. I feel a responsibility to the planet and humankind, but only after I've taken care of the first three. Short-sighted, I know. So shoot me.

By the way. At the risk of sounding like an investment advisor, I wouldn't buy commercial real estate just yet.

Sales

I'm finding that sales people are the worst when it comes to blaming the economy for their performance. That's why I started the series on compensation.

It's harder than it was. Just answering the phone isn't selling. Closing takes twice as long, collecting takes three times as long, and you have to beat off four competitors to get a reorder. So what's your point?

The tribes who eat well during lean times are the ones with the best hunters. If your hunters aren't getting the job done, you have to invest in better ones. This is the toughest place to suck it up. You can't afford to lose a single sale, so what do you do about the salespeople you have who aren't doing the job, but whose absence may cause more lost sales?

You can reduce your profits to add capacity until you can fire someone. You can fire them now and try to save as much as possible. You can reduce their compensation and let them quit, while preparing to cover their production. There is no painless way to do it.

A hard decision, but we are in the profession of hard decisions. It won't be the last one you make in the next couple of years.

All my blog postings, including the original "Triple Threat" post that was reprinted hundreds of times around the country, are available at www.Awakeat2oclock.com