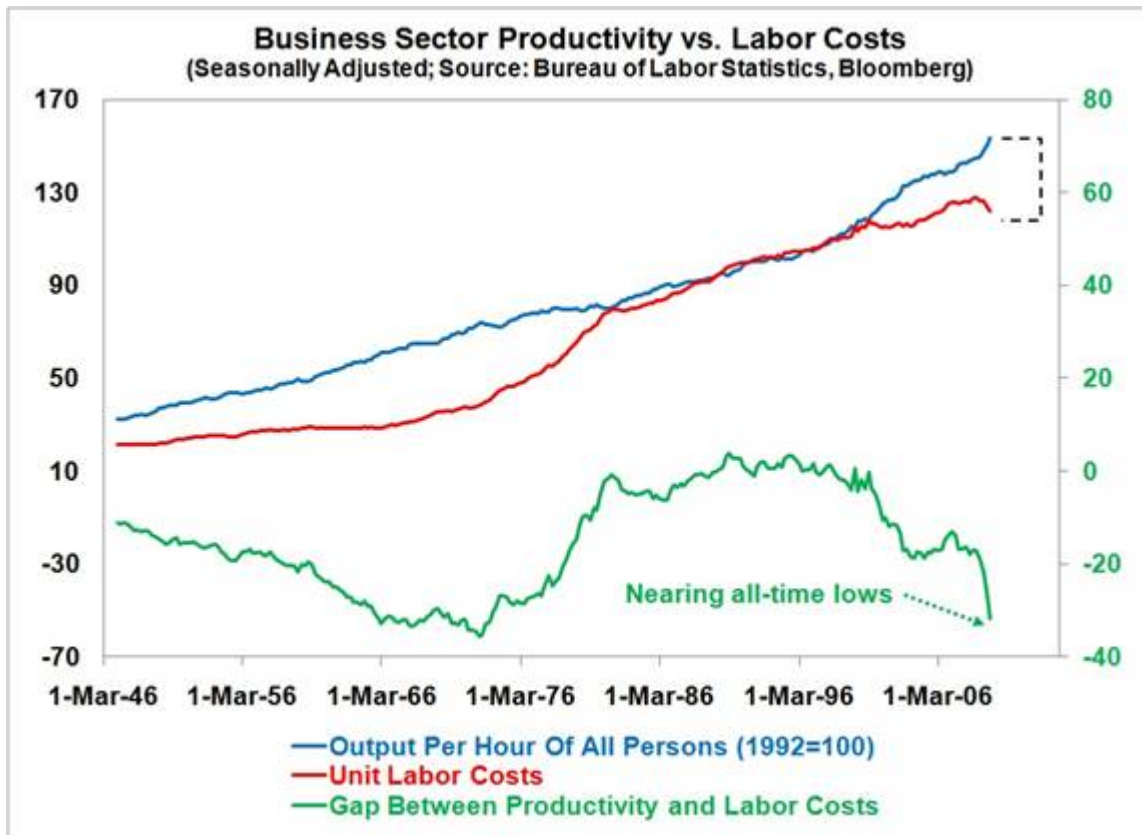


# Not Sustainable

BY MICHAEL PANZNER | march 4, 2010

Repeating a familiar pattern, U.S. nonfarm productivity surged in the fourth quarter as unit labor costs fell, indicating that businesses are making the most of a weak jobs market and squeezing more profit out of each worker.

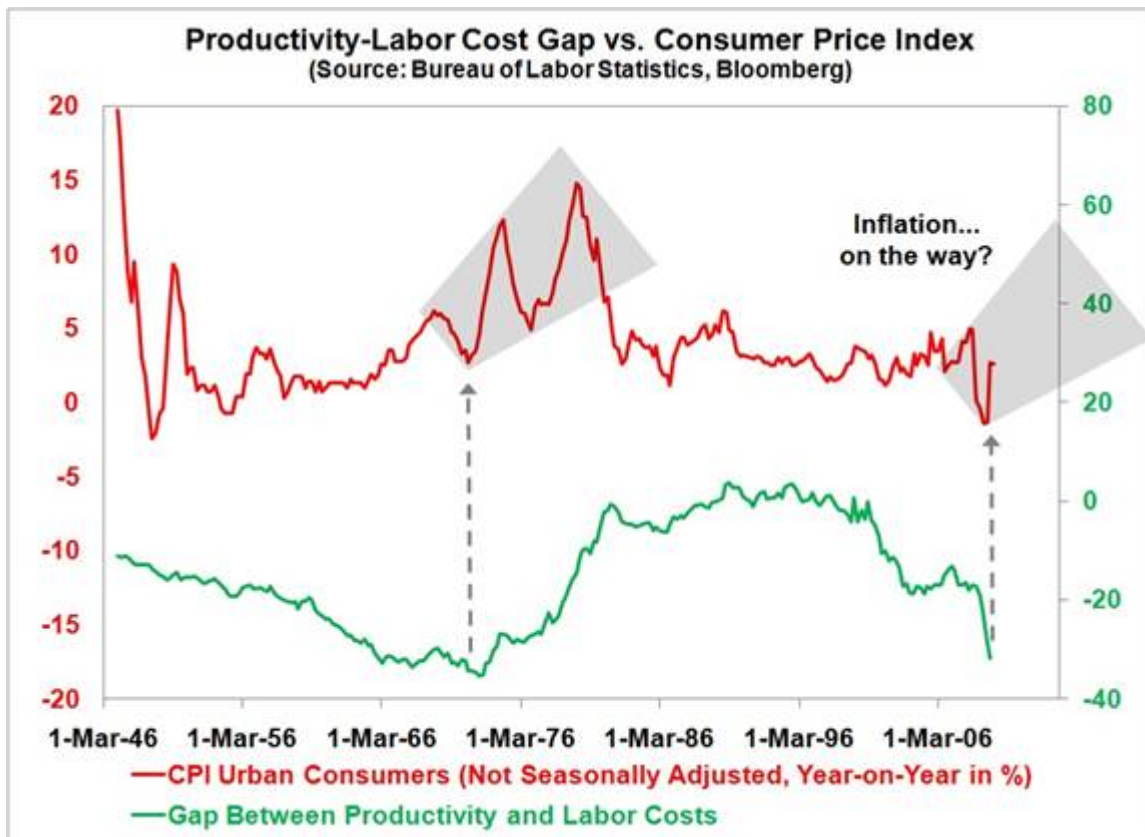


Not surprisingly, many economists viewed the report as a positive sign. If companies keep earning more money, the logic goes, then the economy's return to growth won't be far behind.

But is that the most likely outcome? Isn't it also possible that if hiring remains soft, a critical mass of those who are still employed -- especially those with a union standing behind them -- will say "that's enough!" and demand more money and benefits from their employers?

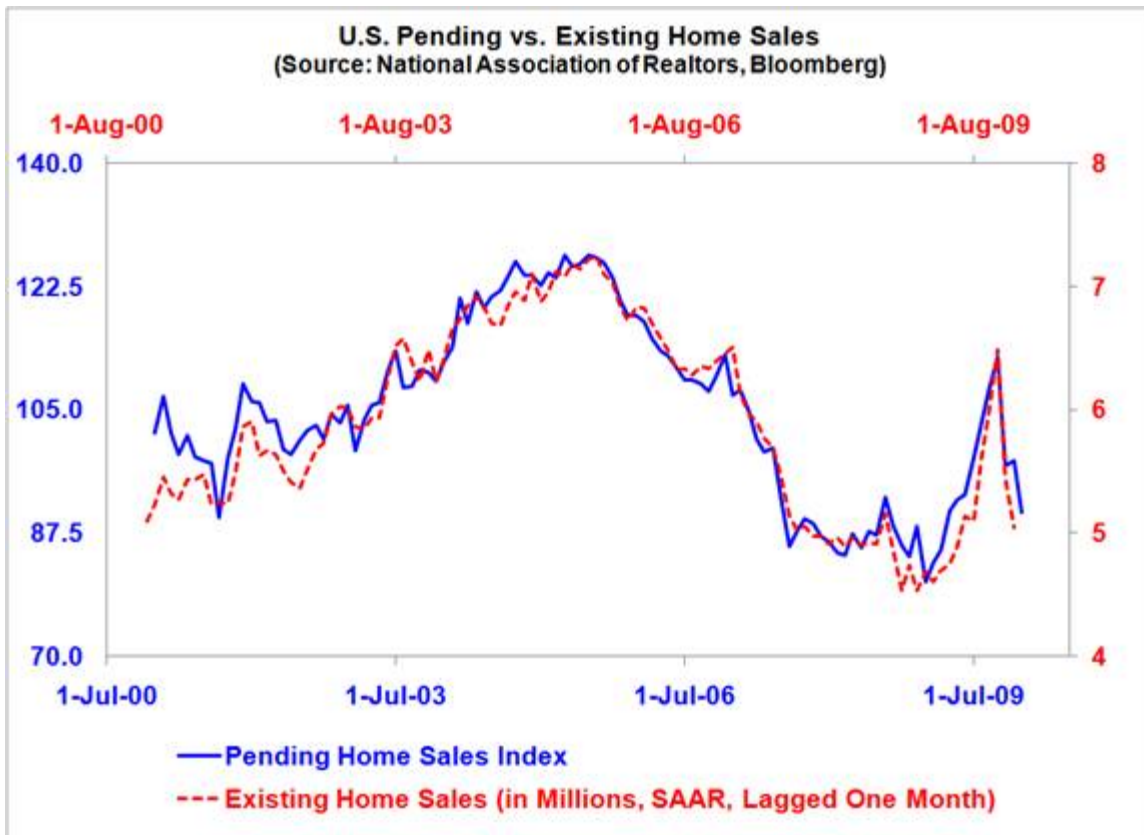
If so, that could set the stage for a period when wages and prices rise *despite* weakness in the overall economy.

Interestingly enough, if you look back at the history of the relationship between productivity and labor costs, the last time we saw a gap between the two as wide as it is now was -- you guessed it -- in the 1970s, before the Great Stagflation.

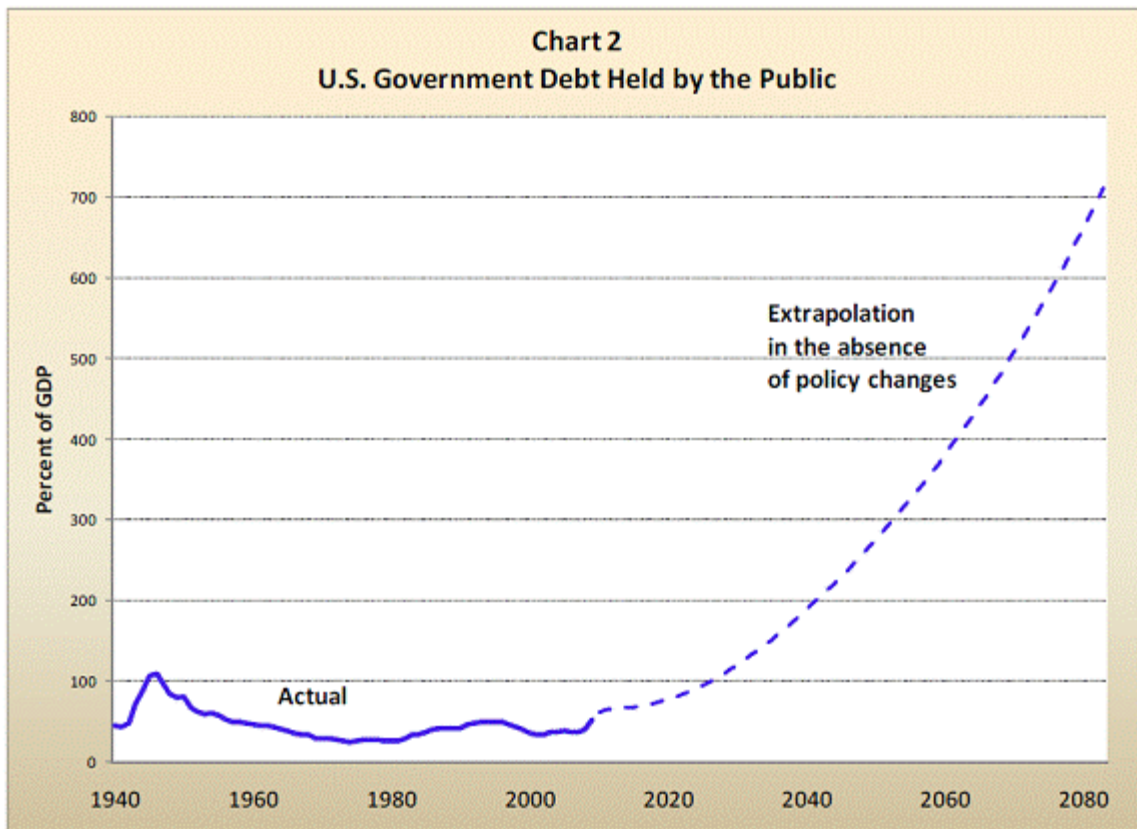


Although it is too soon to say whether this aspect of our economic history is about to repeat itself, today's allegedly good news from the Labor Department may not be all that it seems.

One area where history *does* seem to be repeating itself is in the real estate market. Although many economists keep talking about a rebound in housing, the latest data from the National Association of Realtors is anything but positive. According to the NAR, its pending home sales index, which tracks the number of home resales under contract, fell a worse-than-expected 7.6% in January. Since most pending home sales have traditionally become actual home sales one or two months later, today's report doesn't bode well for the immediate period ahead.

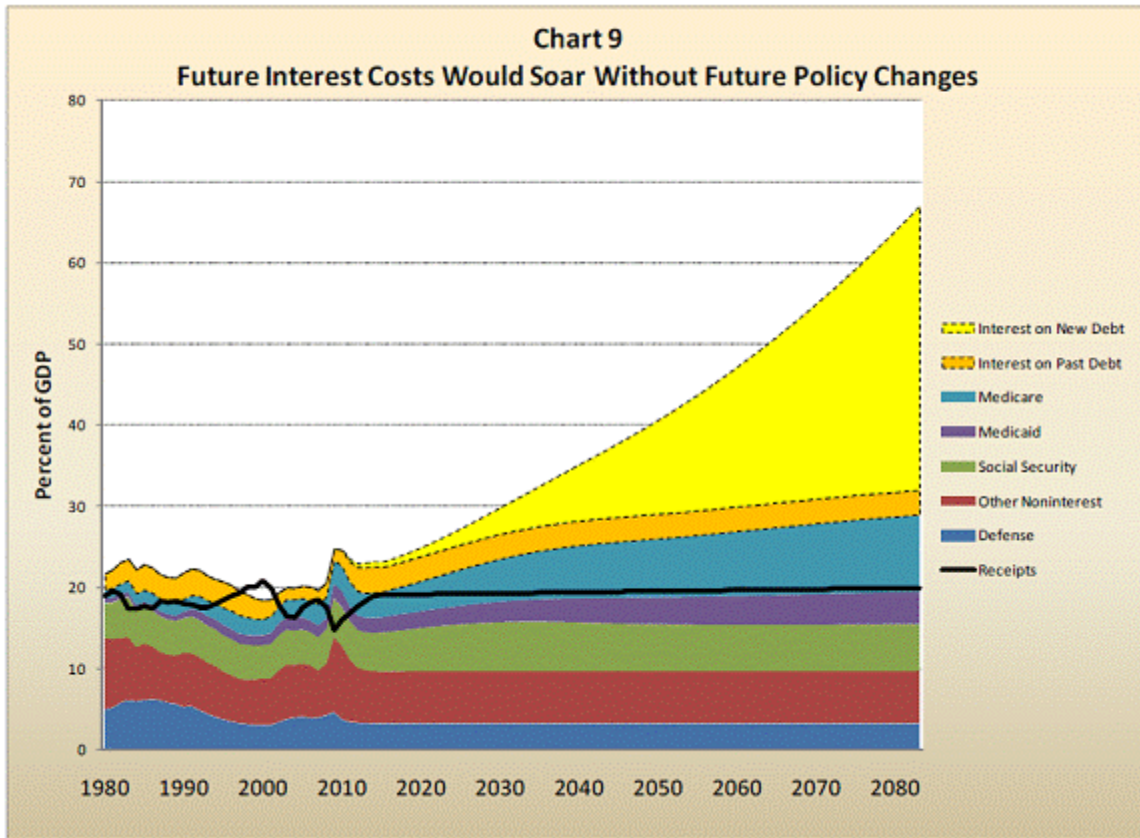


Of course, the problems we face beyond that point are nothing to sneeze at. In its “2009 Financial Report of the United States,” the Treasury Department provided data and graphs that should be labeled “for mature audiences only.” One example includes a parabolic curve detailing just how high publicly-held government debt as a share of gross domestic product (GDP) will go if things carry on as they are. In what some might call the understatement of the year, the report notes that “as currently structured, the Government's fiscal path cannot be sustained indefinitely and would, over time, dramatically increase the Government's budget deficit and debt.”



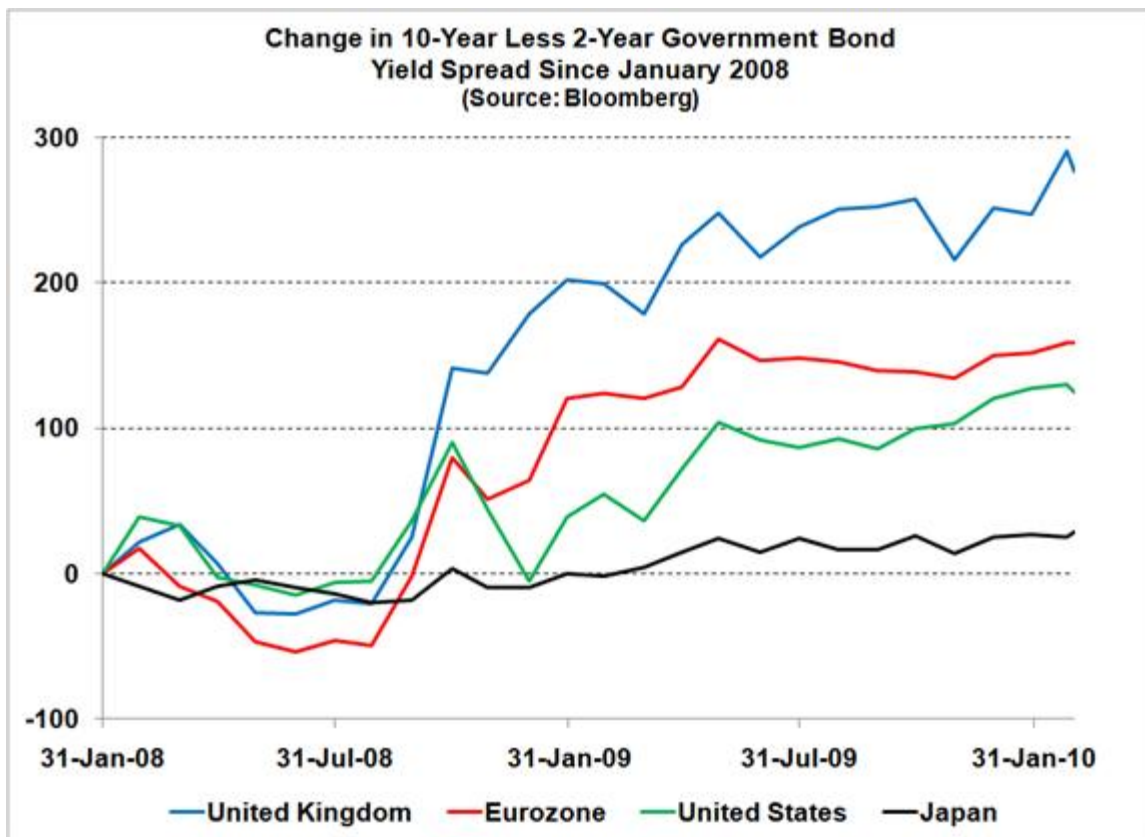
(Source: <http://www.gao.gov/financial/fy2009/09frusg.pdf>)

Another, more colorful chart reveals the alarming impact that rapidly rising interest costs will have on the federal budget as time goes on, assuming policies remain on the current track. According to the Treasury, “net interest expressed as a share of GDP is estimated to rise from 1.3 percent in 2009 to 10 percent in 2040 and to 35 percent in 2080. Because interest expenses grow, the total deficit and debt held by the public grow much more rapidly than does the primary deficit.” Again, the report notes, “these estimates illustrate that current policies are not sustainable.”



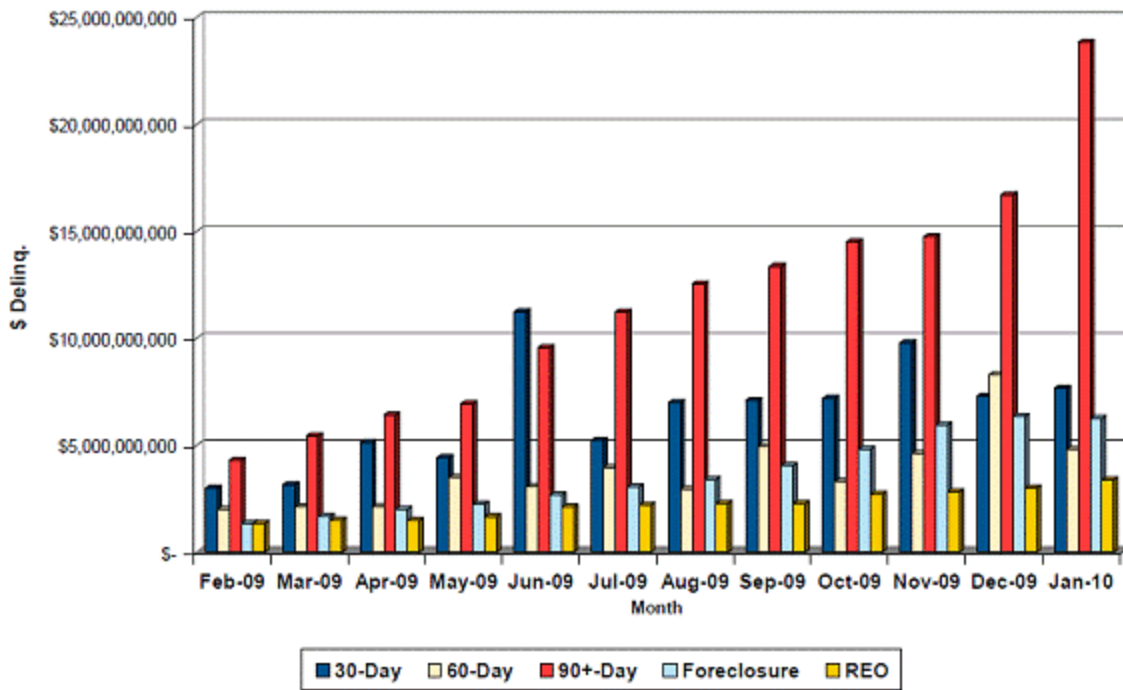
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Although equity traders could probably care less about such things, bond investors seem to be paying a bit of attention. In the U.S. and in other parts of the world where governments have decided that rapidly rising deficits and dramatic increases in borrowing don't really matter in the short run, yield curves continue to widen out, reflecting, among other things, worries about future inflation and the ability of governments to manage their finances in the long run. While some bullish economists have suggested that rising long rates relative to short rates is a sign that things are improving, that seems to be nothing more than wishful thinking.

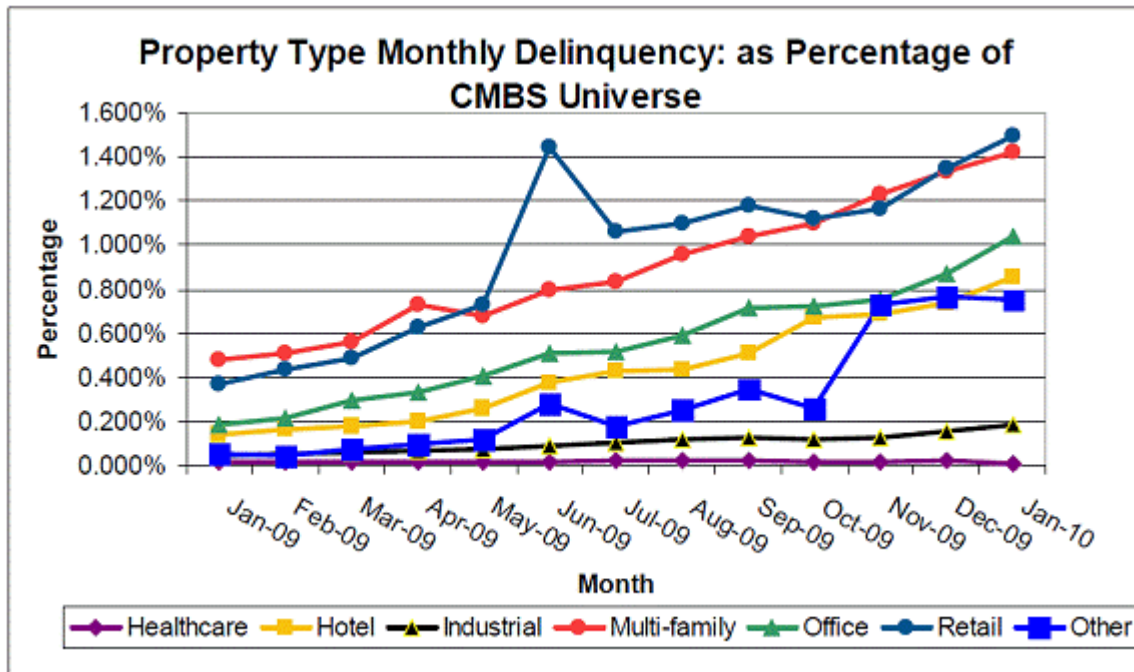


Speaking of wishful thinking, it appears that those “savvy” investors who, according to reports last quarter and earlier this year,” were swooping in to buy beaten-down commercial real estate with the view that the fundamentals couldn’t get any worse may have been somewhat premature. The following two graphs from Realpoint Research’s latest [“Monthly Delinquency Report.”](#) which reveal that the number of basket-case debtors is increasing and that virtually every segment of the CRE sector is under pressure, offer little in the way of hope that a turnaround is near.

Chart 6 – Monthly Delinquency Categories (source: Realpoint)



(Source: <https://www.realpoint.com/>)



(Source: <https://www.realpoint.com/>)

Stocks ended higher, aided by short-covering ahead of tomorrow’s employment report and hopes that Greece’s sovereign debt problems will remain contained.

At the close, the Dow Jones Industrial Average rose 47.38, or 0.5%, to 10,444.14. The S&P 500 Index climbed 4.18, or 0.4%, to 1,122.97. The Nasdaq Composite Index tacked on 11.63, or 0.5%, to 2,292.32.

April gold futures fell \$10.20 to \$1,133.10/oz., while the U.S. Dollar index jumped 0.7%. Ten-year Treasury yields shed 2 basis points to 3.60%, while April WTI crude oil futures slid \$0.66 to \$80.21/bbl.

*Michael Panzner*

Author, *When Giants Fall* and *Financial Armageddon*

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