

Fear During a Recession

by [Gary North](#)

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January is a hangover month, in every sense. In January, the holiday bills start coming due.

Recessions are the hangovers of economic booms fueled by central banks' fiat money.

After a long boom, almost no one remembers the degree of fear that strikes non-government employees during a major recession, when they see their investments shrink in value, their career opportunities shrink, and their commissions – for those people on commission – cut by half. They pay their monthly bills by withdrawing savings or by borrowing.

Today, at the tail end of a five-year recovery, Americans are already paying their monthly bills by drawing down their savings or by borrowing.

BAD MEMORIES

Bad memories fade. We remember the good times. This is one of humanity's greatest blessings.

When it comes to recessions, this is a liability. Senior-level decision-makers today in every field have no memory of how terrifying a recession is for senior business managers: falling sales, enormous payrolls to meet, and enormous corporate debts that must be funded. Red ink is everywhere. Stock options become worthless. Senior managers are paid mostly by stock options.

Senior managers did remember back in 1981. There had been three recessions: in 1970–71, 1975, and 1980. Recessions were a common occurrence in that ten-year period. Managers had experience with them.

So had investors. The Dow Jones Industrial Average had peaked in early February, 1966, at just under 1,000. It had briefly gone above 1,000 inter-day. The Dow had yet to reach that 1966 level again in 1981. It fell to 777 the next year.

Then, for almost a decade, it was boom time. The Reagan boom began in 1982. Not until 1991 did the nation suffer a recession. That was 16 years ago.

An even longer boom began in 1991, but not strong enough to save Bush's Presidency.

You don't remember the details, do you?

Neither does your boss if you work for a Fortune 500 company. Your boss was just a hot prospect in 1991 – a comer. He may have been in a different company, even a different industry, in 1991.

The 2001 recession is also barely remembered. It inflicted too little pain. This is because Greenspan's Federal Reserve had been pumping in money and cutting interest rates for at least seven months when the recession began in March. It was over by November.

The Nasdaq had been in freefall for over a year by March, 2001, the month the recession began, as we were told officially in 2002. The S&P 500 was at 1100, down from 1550 in early 2000. It recovered that summer; then it fell to 950 later in the year. It recovered again; then it fell below 800 in the second half of 2002.

That was bad news for owners of individual stocks, but their numbers were small: about 20% of American families.

It was bad news for pension fund managers, but most pension fund investors keep contributing.

It was bad news for senior managers in American companies. Their companies' pension fund obligations continued to rise. The 15% to 17%

per year gains in their funds' stock holdings had reversed, but the day of reckoning for most corporate pensions was at least a decade away. Senior managers would be in retirement by then.

In February, 1991, the United States won a war in Iraq in one month. The army did not stick around. The voters trusted President Bush in March, 1991. His popularity ratings were sky high, scaring off Mario Cuomo and other big-name Democrat contenders, leaving only some guy from Arkansas at the head of the pack. Yet Bush lost his bid for re-election in 1992. That's how fast things changed. "It's the economy, stupid," was the Clinton camp's slogan.

It surely was.

Today, we are losing a war in Iraq. It is clear that there is no way out with honor. It is a quagmire. Iraq is moving into a civil war. The Republicans don't know what to do. The Democrats don't know what to do. The public has lost confidence in Bush, yet the economy seems to be booming. What will happen to public confidence in his leadership during a recession? We have a new Federal Reserve Chairman, who has yet to be tested under fire. Congress has just changed hands.

There is no recession-tested leadership. Yet a recession looms.

The U.S. trade deficit (current account) is approaching \$850 billion a year. Nothing in man's history rivals this level of deficit. The largest economy on earth can no longer compete with the rest of the world except in one area: the issuing of IOUs. Here, we are the grand masters. This has been the pattern since the 1991 recession.

The savings rate of private households in some recent fiscal quarters has gone negative. We have the lowest personal savings rate of any large economy.

We are dependent on Chinese imports for our goods on shelves in Wal-Mart, Target, and the other large retailers of consumer goods. These imports have kept down the rate of price inflation. We are being subsidized by the mercantilistic export policies of Asian nations, whose central banks fund the operation by expanding their currencies. When they stop inflating, they will have a recession like nothing seen in Asia in history. The last time it happened – the 1930s – Asia was agricultural.

In a recession, Asians will cut prices even lower to keep workers at work. The Zorro-masked yellow smiley face in the Wal-Mart ads will still be slashing prices and smiling. Meanwhile, American manufacturing will be slashing payrolls and screaming.

The Institute for Supply Management on December 1 issued its monthly report on American manufacturing. The index fell in November to 49.5. Anything below 50 is a mark of contraction. This was the first time in 41 months that this index had turned negative. For American manufacturing, the recession is here.

It is time to start hunkering down. As the radio ads on the kids' shows said in my youth, "Be the first on your block!"

THE ONLY THING WE HAVE TO FEAR. . . .

If you are male, married, white, and on salary, you probably won't get fired. The unemployment rate will rise. It could conceivably double. But for white, married, salaried men, the unemployment figure will not go double-digit. You won't get a raise. You won't get a promotion. But you probably won't get fired. That's the good news.

The bad news is that you can't be sure. People do get fired. If your position in your department is marginal, you're not immune to the axe. There is always some hot shot looking for your job. If he is single and can work for less, you're in trouble. He may live in India.

If you provide a service that involves the production of digits, you're at risk. If your company sells into an international market, you're at risk. If your division is marginal, you're at risk.

What gets hammered in a recession is commodities. They are at the bottom of the supply chain. They are price competitive. There is usually a cheaper commodity that can be substituted. In November, 2001, the month in which the most recent recession ended, the Commodity Research Bureau's index bottomed at 180. Today, it's over 340.

If you are a commodity, expect trouble. If what you do for a living, others can do almost as well, and if they are in a position to cut their price, you're in trouble.

One thing is certain: If you are on salary, you will become a net liability

for your company. You are a fixed expense. Meanwhile, corporate revenues will fall.

If you are on commission, the 16 fat years are about to end. For you, the news is bad . . . unless you work for an auction firm specializing in liquidating bankrupt companies.

The worst thing about a recession for most Americans is the ticking of the debt meter. It doesn't stop ticking just because the economy is in recession. It ticks louder.

People freeze up when they get scared. They put off making purchases. They cut expenses. But there are limits to what they can do. They live so close to the edge of their budgets that there is not much fat to cut in relation to disposable, after-tax income. The debt meter ticks.

This is why the auto industry is always hit hard in recessions. People can forego buying a new car.

Consider the American-owned car industry today. Ford and GM are experiencing huge losses. Chrysler joined with Daimler. We are in a boom.

The housing market has turned people's homes into ATMs. People borrow their homes' equity. But this process has begun to slow down. When equity begins to shrink in the next recession because of falling home prices, it will dawn on a growing number of Americans that they have been eating their seed corn.

What is really scary in the housing market in a recession is the increase in illiquidity. People refuse to face reality: Their real estate is worth less than before. When they decide to sell, they hold out for last year's price. They sit. They grow fearful. They still sit. Then they grow panicky. Eventually, they are forced to move: a lost job, a transfer, a foreclosure, or something that leaves them without recourse. They may walk away from the house.

They lose their credit rating when they do.

I bought my home in a foreclosure in 2005. I got a very good price.

The number of foreclosures is already over a million a year, up from

650,000 a year ago.

The "wealth effect" – spending more when you feel richer – has been fueled by rising prices on housing. This is about to end, all over the country, but especially in coastal cities.

I feel sorry for people in the early years of their careers. They have just bought their first homes. They have not faced a recession. They think that household budgets, while tight, will get looser as they get older. Ah, youth! They will soon have a rendezvous with reality.

WHEN NOTHING SEEMS TO WORK

In recessions, fear grips consumers. They start looking for ways to cut back on spending. If your services are marginal in their budgets, you're in trouble. If consumers say, "I can do without this," you're in big trouble.

Not everything marginal gets cut. Some things are seen as cheap luxuries. People may buy a candy bar instead of going out to lunch. Warren Buffett bought See's Candies. He knew what he was doing. People may rent a video instead of going to a movie. Nobody moves from three-martini lunches to brown bag lunches in one fell swoop. People should, but they don't. They resist being perceived as failures, as being desperate. They have their status to maintain.

Anything addictive or near-addictive tends to hold its market in a recession. Alcohol, cigarettes, and sugar products don't face collapsing markets. Bad habits are hard to break.

Companies cut back on advertising because revenues fail to pay for the ads. This leaves undefended territory in the market which can be exploited by companies that have deep pockets. For those few firms that remain aggressive, a recession allows them an opportunity to increase market share.

If you think Wal-Mart is a tough competitor today, wait until the recession is six months old.

It is the feeling of having hit a brick wall that is so discouraging in a recession. People refuse to buy from you, no matter what you do. If you are marginal in their present situation, you can't lower your price low

enough to get them to buy. You and your product are no longer in their budget.

If you are a brain surgeon, you will do fine. People don't schedule brain surgery based on the business cycle. If you are a dentist, you are in trouble. People can put off getting their teeth cleaned.

Because recessions have been infrequent for so long, and because business owners who are not facing Asian competition are not familiar with the effects of consumer resistance, the next recession will come as a shock to business decision-makers. They will see red ink flow because of fixed expenses and falling revenues.

Businesses that do not have a line of credit, guaranteed in writing, from a local bank may not survive. That is what happened two decades ago in Texas during the savings & loan crisis, which piggy-backed on the oil patch crisis that began in 1980. Small businesses that had enjoyed informal lines of credit saw these lines severed when their local banks were bought out by national banks, and new managers took over locally. "Never heard of you," was the refrain. "Your rolling credit is not being renewed. Pay up." They couldn't.

You may think your employer is solid. Yet we have just been through a period of rising corporate debt like no other in history. The borrowed money was used to fund mergers and acquisitions, as is common at the tail end of every boom. The money was also used to buy back corporate shares, thereby raising share prices, thereby making senior executives rich through their stock options. The debt meter will keep ticking.

WHAT IS YOUR FALL-BACK POSITION?

You probably will not be fired. You received a Christmas bonus – maybe. Don't expect a big one next Christmas.

What major moves are you planning over the next two years? Re-think them.

If you have your capital invested in equities, re-think your position.

If you plan to retire, re-think this decision.

If you plan to expand your business, wait. Put the expansion money in

reserve in a near-cash asset. You will get more bang for your buck a year into the recession.

The old rule of having enough money in the bank to cover payments for six months' bills is a very good rule. Extend this to 12 months.

The problem is, almost no business can afford to do this. The bills are many, profit margins are low, and reserves are minimal. If your business requires a rolling line of credit, lock it in now. Get this in writing. Pay an interest premium if you must.

My next-door neighbor is an independent contractor. He does cement work. He does very nice work. He has no marketing plan that I can see. I offered to help him develop an advertising program a year ago, for free. He never contacted me about this. He is a typical small businessman. He is uninterested in advertising. That is why most small businesses remain small.

His services are marginal. Nobody really needs them. He is not a plumber. When people are feeling no pain, they upgrade their yards. A few of them call him. But when people are feeling pain, they won't call him. Nobody needs a new patio.

My guess is that a year from now, he will be forced to put his home up for sale. I could be wrong. Maybe he has marketing skills I don't recognize. Or maybe he can liquidate his business and get a job as a laborer. Or maybe the town I live in will continue to boom. A lot of people are moving in. But for people like him in most regions, a recession is a disaster, not an annoyance.

Have you made an honest assessment of your position in a falling economy? Have you got some sense of how marginal you are in today's economy? If this economy heads as far south as it did in 1991, what will your income/outgo position be?

If you work for the government, you're safe. If you are in a business that helps people deal with emergencies that cannot be postponed, you're safe. But most people are not in this position.

CONCLUSION

Recessions are hard times for businesses. People in good times think

they have done all they can when they hedge their investment portfolio against falling demand. But the fact is, what threatens most people is not a fall in their investments, since they have so few investments. What threatens them most is the loss of a job or the sidetracking of a career.

You may need reserves to draw down in a recession. This means that you will need ready cash. If you have to sell something in order to get access to cash, you're in big trouble if that is your only reserve. Others will be selling, too.

High liquidity requires three things: (1) a rapid sale without offering a discount; (2) a rapid sale without advertising expenses; (3) rapid sale without offering a commission to a middleman.



Could you live for six months on your liquid reserves? If not, it's time to sell some less liquid assets in order to increase your liquidity.

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