Recession? It may be here already

ARTVILLE

BY GEORGE WITTERSCHEIN/ CONTRIBUTING EDITOR

Who better to tell us whether we're in a recession or not than an economic consultant? We asked Gary Shilling, and here's what he had to say:

Landscape Management: Our readers are sending us mixed signals about whether they see the landscape industry in recession or not. You're convinced that if we aren't in one already, the United States economy will be in recession soon? That's a pretty bold statement.

Shilling: Several things lead me to believe we're already in one. If you look around, you've got all the classic signs of a recession.

✔ ***Inventories are out of control.*** That's always the first primary cause of a recession. Despite our progress into more of a low-inventory service economy, the role of inventories in recessions is still a major one. As a matter of fact, in the last two recessions, inventories accounted for an increasing share of the decline in real GDP (i.e. the total economy).

✔ ***Confidence is declining.*** There's been a collapse in consumer confidence, CEO confidence and small business confidence.

✔ ***Productivity growth problems.*** Productivity growth declined in the fourth quarter. I'm a long-term bull on productivity, but in the short-run, when you get the disruptive effects of companies cutting down on business activity, productivity suffers and labor costs rise. In the fourth quarter, unit labor costs were up 4.1% annualized while productivity was up 2.4%. This is the reverse of what we had been seeing when the economy was booming.

✔ ***Capital spending is starting to ease off.*** "New tech" has found they don't live in their own world. They can't prosper by taking in each other's laundry. They've got to sell their wares, ultimately, to consumers and to "old tech." So "new tech" finds itself getting pulled down as well. As profits decline and capacity grows, capital spending gets cut back, and that hurts productivity.

These are all classic signs of a recession. When you look behind the signs for causes, you find many economic forces in place that tend to cause recession, like:

✔ ***The delayed effects of the Federal Reserve tightening.*** It takes a year for the effect of the Federal Reserve tightening interest rates to work through the system. The last tightening — one-half of a per-

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centage point — occurred in May of 2000, so we have a while yet before we get past that event and into the salutary effects of the Fed's recent easing of interest rates.

Less lending. About a year ago, the Fed told banks, "you're being too easy on loans," so the banks cut back on lending. Now that they're starting to see loan losses, they're really getting stringent. A recent Fed report shows a huge increase in the number of banks cutting back on credit availability, and a huge decline in loan demand. People who need loans are being hung out to dry because banks have gotten some big loan losses and others don't want to borrow.

✔ ***Energy cost increases.*** These take about a year to work through the system, too. Outside of California, utilities that generate electricity with, say, natural gas, typically have a combination buying philosophy that includes a mixture of long-term contracts and buying on-the-spot markets. As those long-term contracts run out, the utilities are renewing at higher prices and passing those right through to consumers. That means we'll get a delayed effect from the increase in natural gas prices.

✔ ***Uncertainty in Washington.*** We've got a split Congress, a president with no mandate, and, while there's talk of a quick tax cut retroactive to the first of the year, tax cuts are traditionally delayed in Congress to the point where it's too late for them to help a recession (the cuts may in fact help the recovery because Congress probably won't get them in place until the recession is virtually over). This tax cut will face an especially difficult time because we have such a divided Congress. The earliest they say they could act is by the middle of the year, and I think we should add another three months to that because of the lack of a mandate. Since the recession probably won't run much beyond the end of this year, we shouldn't expect the proposed tax cuts to ward it off.

✔ ***The stock market is still overblown.*** We've got over a 100 price-to-earnings ratio on the NASDAQ (many times higher than historic norms, suggesting that many of those stocks are still wildly overpriced and headed for some serious correction), and the real vulnerability now is in profits. Profits are getting squeezed by the combination of unit labor costs going up, the prospect of weakening volume and the fact that few businesses have any pricing power (and consequently will experience price declines as the economy weakens.)

Lower profits mean disappointments, disappointments mean lower stock prices and lower stock prices mean that consumers who have been spending from stock appreciation instead of from savings will lose confidence and spend less. LM

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Landscape Management: *If we're going to be in a recession through the end of the year, what should people in a business like landscaping do?*

Shilling: Cut back spending that isn't absolutely essential. Shed employees while there's still a relatively tight labor market in which they can find jobs. Unemployment is what we call a "lagging series." It's only when we are well into a recession that business gets around to cutting payrolls, so beat the competition to the punch and cut back on your payrolls while your people can still find jobs and you're not going to feel upset that you're throwing them out when they have no place to go.

Also, build a fortress-like balance sheet. Look at what is essential in your business and what isn't. We've had so many "McMansions" (a derisory term for large, showy homes built in recent years as a spillover from Wall Street money), and my forecast is that they'll go the way of all flesh. There was a lot of work for landscape professionals on those lots, and those kinds of contracts will fade fast.

If I were a landscape professional, I'd be looking for more basic kinds of things, maybe "small luxuries." When times are tough, people still want to treat themselves. They might opt to have a seasonal flower bed installed as opposed to a bigger landscape job.

If you can do these "small luxuries" in volume, you can still make some money.

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