

ON THE STREET by Dan Burrows (Author Archive)

Will 25% Unemployment Doom the Recovery?

DON'T POP THE champagne corks yet.

True, second-quarter earnings season, which began in earnest last week, has gotten off to a good start, with a number of big names blowing through Wall Street's estimates (notably, **Goldman Sachs (GS): 175.90*, -0.67, -0.37%**), **JPMorgan Chase (JPM): 43.66*, -0.69, -1.55%**) and **International Business Machines (IBM): 126.26*, +0.26, +0.20%**). Analysts at **Bank of America-Merrill Lynch (BAC): 15.88*, +0.11, +0.69%** proclaimed an end to the recession, unemployment claims dropped and even "Dr. Doom" -- New York University economist Nouriel Roubini -- said the worst is behind us.

But, according to some [portfolio managers](#) and financial advisors, persistently high -- even devastatingly high -- unemployment could easily derail the recovery and cause stocks to plunge.



"We are looking at the situation as the next Great Depression at our doorsteps," says Michael Rubino, chief executive of Rubino Financial Group, a wealth management firm in Troy, Mich. "We expect unemployment to reach Great Depression levels [of 25% at the peak] by 2011 or 2012. Boy, we hope we're wrong."

Let it sink in for a moment: 25% unemployment.

Rubino's view may be extreme, but there's no question that unemployment appears poised to remain very bad for quite some time. The Federal Reserve said last week it expects unemployment to hit 10% by the end of this year and edge down to only 9.7% for 2010. The most recent [survey](#) by The Wall Street Journal found that economists expect unemployment to hit 10% by year-end and stay there until June 2010.

At issue then is if there really is such a thing as a "jobless recovery" and whether the market has baked enough bad news and uncertainty into share prices. Rubino says it most certainly has not. "Consumers aren't spending, banks aren't lending and the housing market is doomed to mediocrity for at least another four or five years," he says.

Part of the problem? Baby boomers. "They're at an age where they are naturally going to spend less and save more especially if their jobs are at risk and their 401(k)s have been smashed," he says. Rubino sees the [Dow Jones Industrial Average](#) edging higher this year -- say to 9100 to 10300 -- but after that he expects it to fall off a cliff. "I don't see anything wrong with Dow 3000 to 3800 in 2010 or 2011."

John Lekas, CEO of Leader Capital Corp. of Portland, Ore., and [portfolio manager](#) of **Leader Short Term Bond Fund (LCCMX)**, isn't as bearish as Rubino, but he hardly paints a rosy picture. His technical and fundamental models forecast 15% unemployment and Dow 4200 by the time the economy bottoms out in first or second quarter of 2011. The reason? Companies need to shed debt, but as they refinance that debt, they'll be paying higher interest on it (since they'll be going down the yield curve where higher rates are charged to compensate for risk).

"If companies' cost of capital goes up, you're talking about billions in additional expenses," Lekas says. "Forget that revenue is stagnant or shrinking. That hurts earnings and puts dividends at risk." It also means that companies will be forced to slash jobs, creating a vicious cycle in which job losses lead to less spending thereby leading to further job cuts.

Charles de Vault, portfolio manager at International Value Advisors, a New York-based investment management firm, doesn't need unemployment to hit 15% or 25% to declare that this is a time for extreme caution. "Workers who have been unemployed for more than 15 weeks dwarfs what we saw in 1982, the last time we saw a vicious recession," de Vault says. "The average length of unemployment is even higher than it was in '82, and the speed at which it has increased is just unheard of."

Meanwhile, real hourly wages remain flat, and there are many more temporary workers now than there were 30 years ago -- a factor that skews today's numbers and makes them artificially prettier in comparison to those from the early '80s.

Like Lekas, de Vault thinks the bulk of corporate cost cutting is ahead of us (in other words, more job cuts) as growth remains "extremely anemic" over the next three to five years. He doesn't model for unemployment or market levels but doesn't foresee real economic recovery until that anemic growth phase has played itself out.

"It's nice to hear that the economy has stabilized but stabilization is not good enough to make up for the massive overcapacity in the economy," he says.

As gloomy as these bears may be, that doesn't mean all is lost for investors. Rubino and de Vault see lots of ups and

downs in the market, meaning active management could still allow investors to achieve positive, though not stellar, returns. "We think the recovery will look like a 'W' or even a 'WWW' for the next three to five years," says de Vault.

There is one happy thought amid all the gloom and doom forecasts of this group: Lekas' models call for a "fabulous bull market," running from 2012 to 2018.