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November 1, 2009

Monthly Economic and Financial Update

The odds that the economy will experience a liquidity squeeze have increased. Comments to the FDIC were overwhelmingly supportive of its proposal for banks to prepay the next 3 years of insurance premiums. Both the American Bankers Association and the Independent Community Bankers Association (ICBA) supported the proposal. The ICBA suggested shortening the period from 3 to 2 years.

Interestingly, the ABA agreed with the FDIC contention that banks have sufficient excess reserves to pay the premium without it having a negative impact on loans and liquidity. While there were a handful of comments pointing to a likely shortfall of liquidity, my comments were the only ones that spoke about the monetary implications of this move.

A Fed study has found that the excess reserves banks are holding at the Fed are not surplus funds. Rather, they are being held in response to a number of other factors. In order to raise the estimated \$45 billion to send to the FDIC, bankers will have to rearrange their balance sheets. This process involves reducing loans, further increasing excess reserves and cutting costs. Assuming the FDIC proposal goes into effect, it will reduce bank liquidity by \$45 billion by year end.

In September of 2008 the Treasury's decision to place itself senior to Fannie and Freddie preferred stockholders reduced bank capital by an estimated \$20 billion. The monetary effects of that decision produced a liquidity squeeze that sent stock prices plummeting.

The monetary effects of the FDIC decision are similar to an increase in reserve requirements. Required reserves are funds that banks must hold in the form of vault cash or deposits at the Federal Reserve. They are generally

considered a tax on bank deposits. A change in reserve requirements is a powerful tool for changing the multiple expansion of bank reserves. Hence, it's a tool that can be used to alter the amount of money in the system.

The FDIC special assessment is also a tax on bank deposits. In this sense, the FDIC proposal is similar to an increase in reserve requirements that drains \$45 billion from the system in the final two months of this year.

The Fed has the power to offset the monetary impact of the FDIC proposal. Unfortunately, the Fed tends to ignore bank reserves. Instead, it focuses all of its attention on the fed funds rate.

The Fed's approach to monetary policy is the main reason bank reserves declined in recent years. The decline in bank reserves is the main reason for the collapse in spending and depressed economic conditions.

There is no evidence that the Fed is even aware of the monetary impact of the FDIC proposal. I haven't found any mention of it in the Fed's Minutes. And, even if they are aware of it, there is no indication they have any intention of doing anything about it.

The recent decline in stock prices could be an indication that a liquidity squeeze is already underway. Banks will rearrange their balance sheets well before the end of December. If this plays out as I fear it might, the main negative impact on financial markets will occur between now and the end of the year. There would also be a lagged effect on the economy that carries over into the early part of next year.

None of this is inevitable. However, recent developments suggest that the risk these things will occur has increased.

Monetary Indicators & the Monetary Process

Bank reserves continue to provide a unique insight into monetary developments. Bank reserves are the first step in the monetary process. The Fed initiates the money-creation process by purchasing assets. It pays for these assets by crediting banks with new deposits at the Fed. These deposits are known as bank reserves.

Under normal conditions, banks will loan and invest the newly created reserves. These loans and investments are re-deposited into banks. This process results in a multiple expansion of money and credit in the economy.

This monetary process can be short-circuited if funds leave the banking system. This happens when either banks or the public decides to hold more of their monetary assets in the form of currency as opposed to bank deposits.

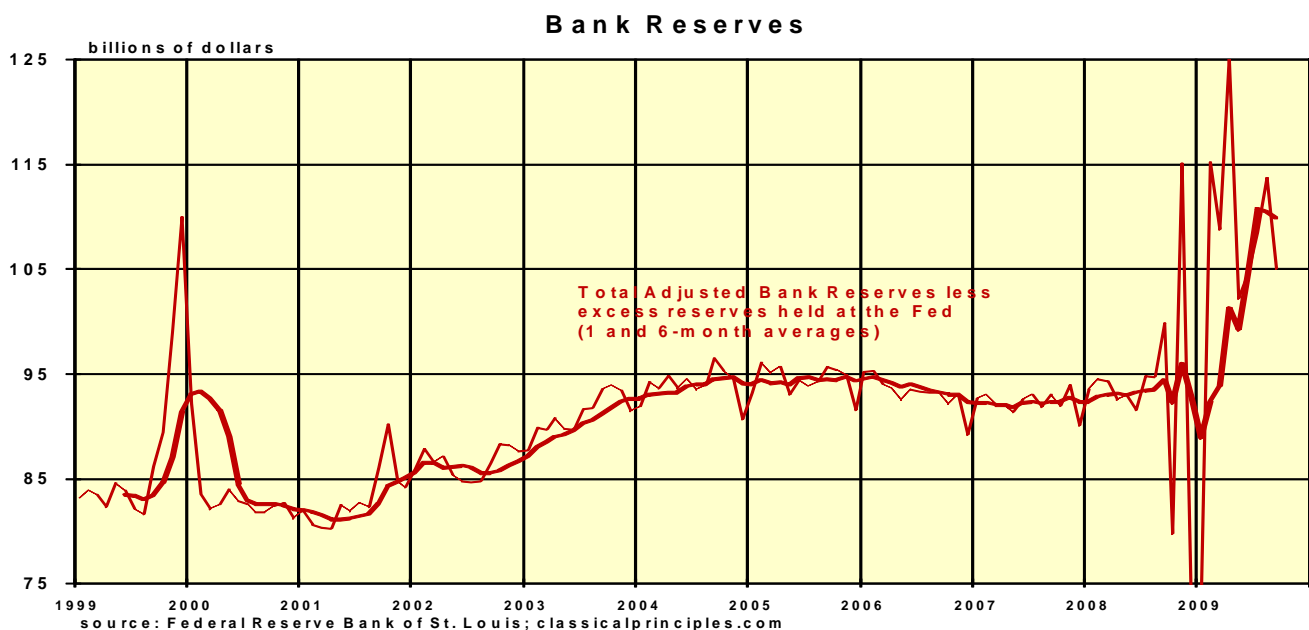
When banks hold more reserves with the Fed than the Fed requires, these excess reserves are not being used for loans and investment. Hence, it short-circuits the monetary expansion process. The FDIC Proposal is a tax on insured deposits. A tax increase on bank deposits is another way to short-circuit the monetary process.

In order to determine the impact of monetary policy on the economy it's important to adjust bank reserves for the amount funds that are being taken out of the banking system. This is why I have insisted on subtracting excess reserves from total reserves. The chart below shows bank reserves after this adjustment. It shows the erratic monthly shifts (thin line) as well as the 6-month average (bold line).

The erratic moves in bank reserves occur because the Fed chooses to target the fed funds rate and allow bank reserves to adjust to that target. The alternative approach would be to target reserves and let short-term interest rates adjust.

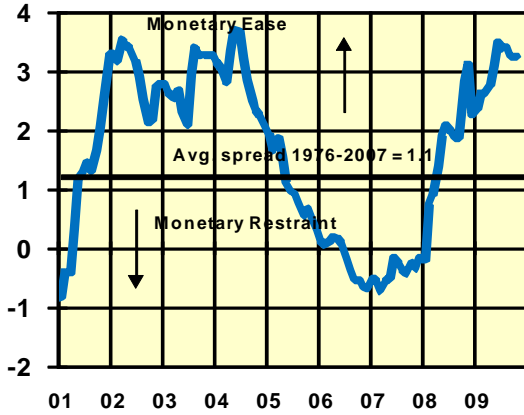
As the charts on the following pages show, financial markets began to improve in March, a month after this measure of liquidity began to increase. Some 6-9 months later, the first signs of an economic upturn began to appear.

The key monetary issue at the moment is the extent to which the proposal by the FDIC will dampen the monetary expansion and set back the recovery.

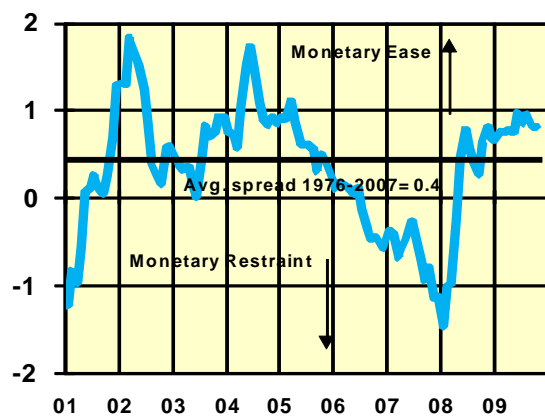


MONETARY INDICATORS

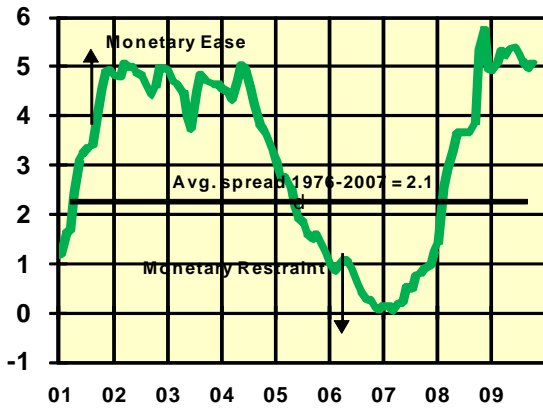
Yield Spread: 10yr-FF
(10-year T-bonds minus fed funds)



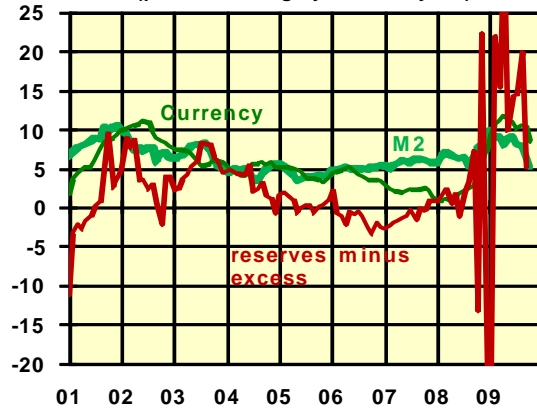
Yield Spread: 2yr-FF
(2-year T-Notes minus fed funds)



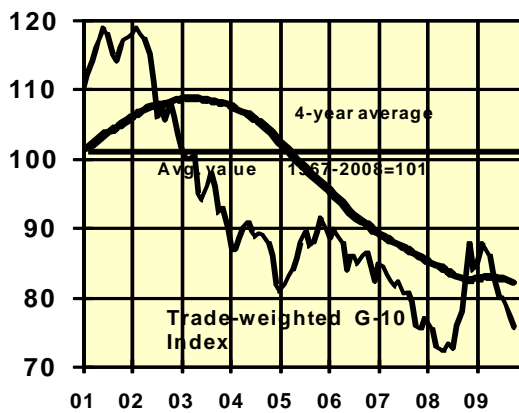
Yield Spread: AAA-FF
(AAA bonds minus fed funds)



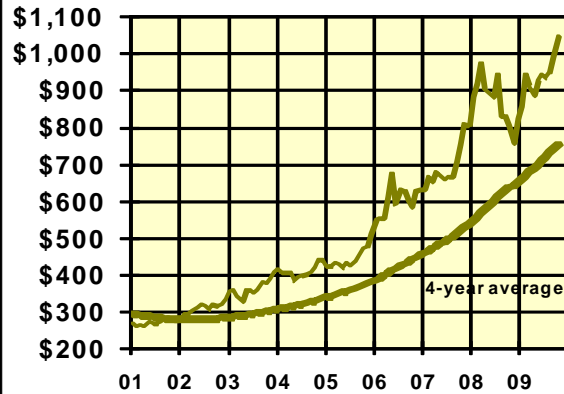
High-Powered \$ & M2
(percent change year over year)



U.S. Dollar Index



Gold Prices
(dollars per ounce)



Sensitive Indicators

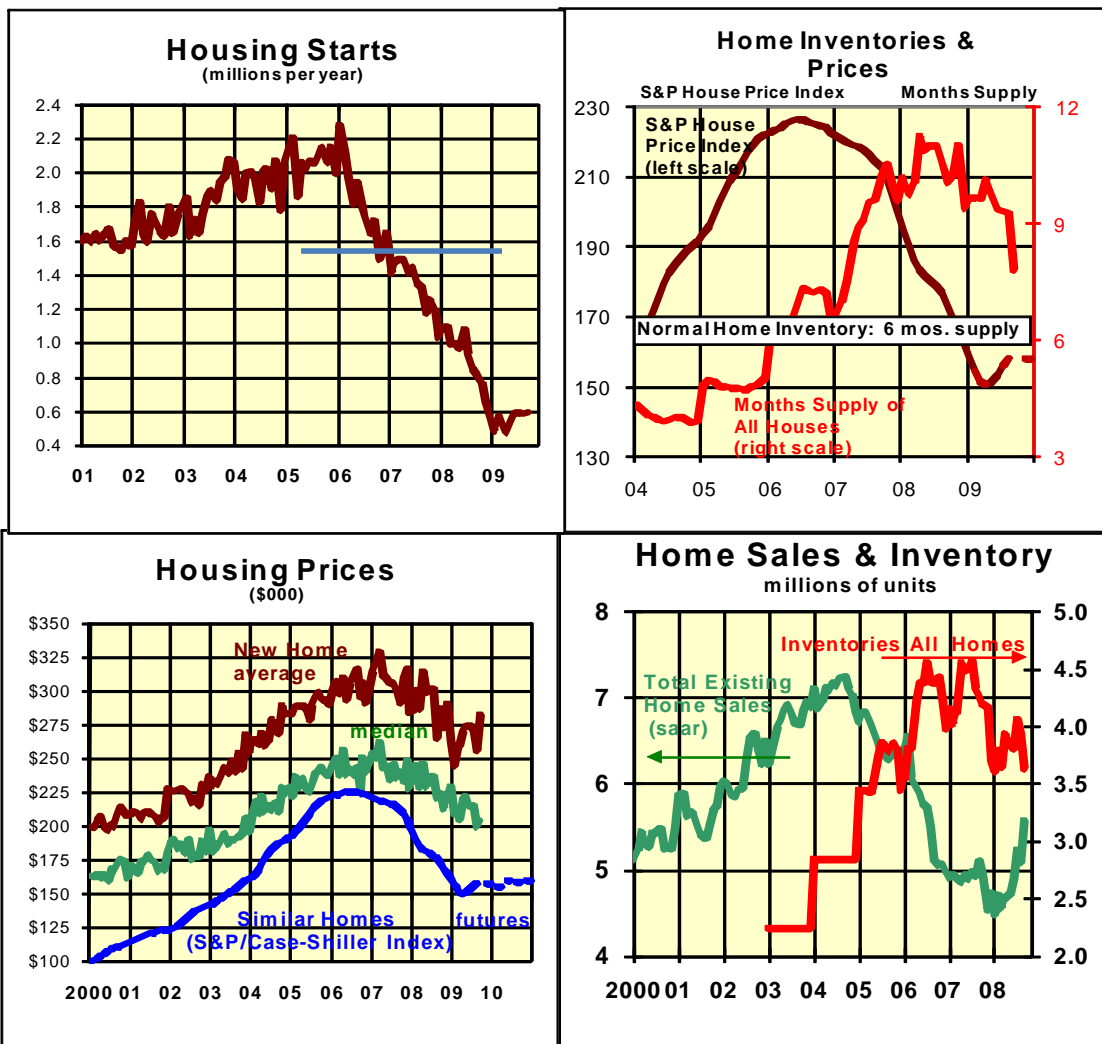
Sensitive indicators continue to recover from their lows. However, as the charts on this page and the next indicate, the recovery in many of the indicators has been subdued.

There are a few bright spots. The sharp decline in home inventories is encouraging. If the job picture improves and foreclosures slow, inventories would fall further and a genuine housing recovery would follow.

Another bright spot is orders for semiconductors. They have bounced back to roughly where they were a year ago.

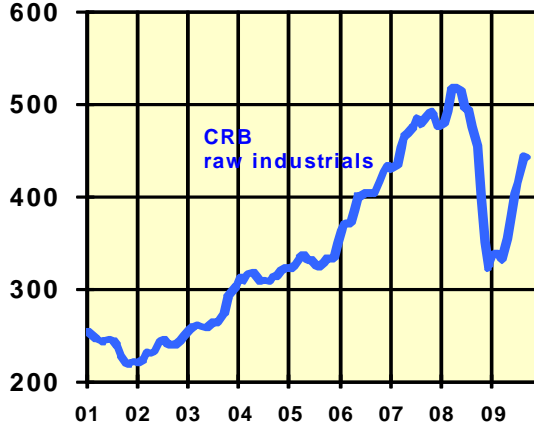
While other indicators have also recovered, the extent of the recovery leaves much to be desired. Durable goods orders remain depressed. The same is true for the decline in initial unemployment claims, stock prices and housing activity.

Coincident indicators are also relatively weak. An ongoing decline in jobs and subdued rate of consumer spending suggest that the recovery remains in low gear.

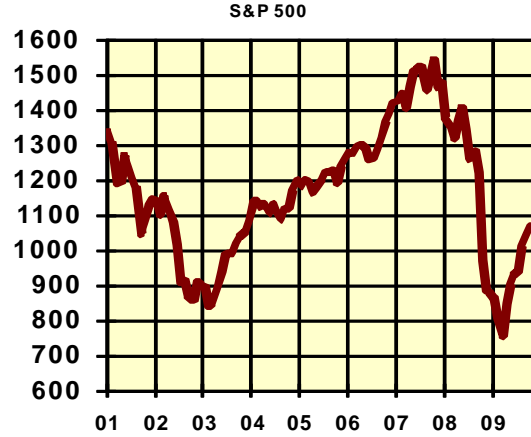


SENSITIVE INDICATORS

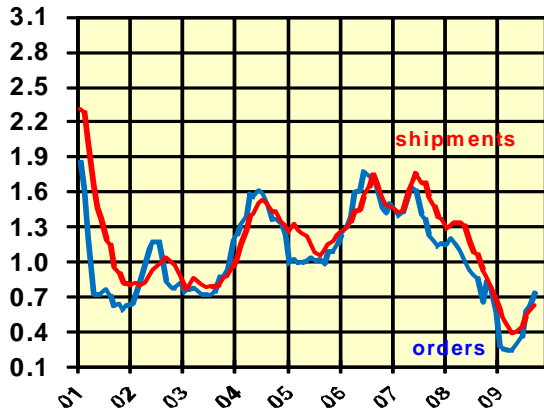
Raw Industrial Prices



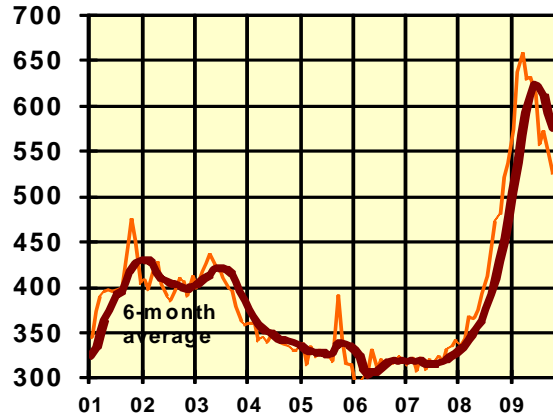
Stock Prices



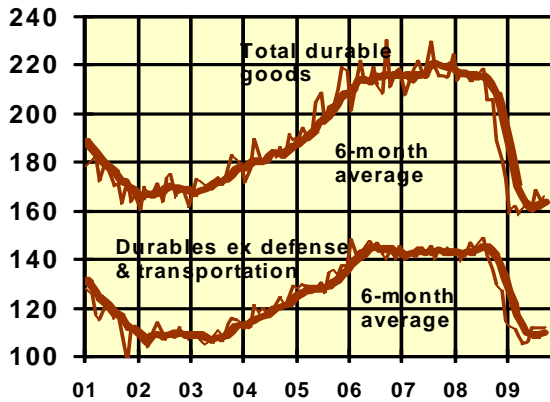
Semiconductor: N. A. Orders and Shipments (billions of \$)



Unemployment Claims
(weekly claims)



New Orders
(billions of dollars, saar)

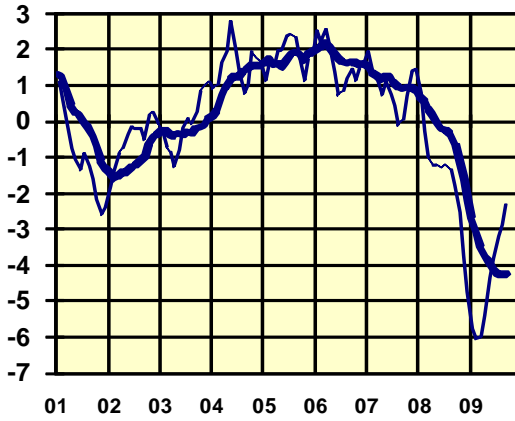


ISM: New Orders
(above 50 represents expanding activity)

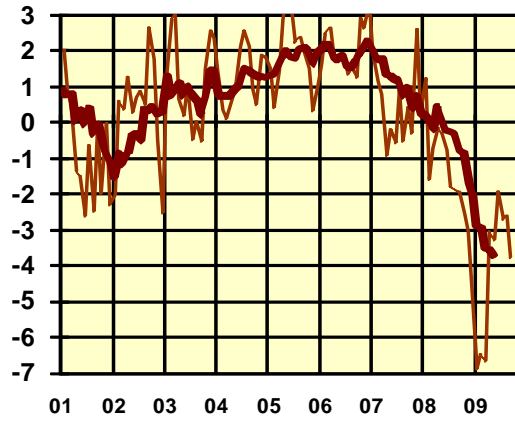


ECONOMIC INDICATORS

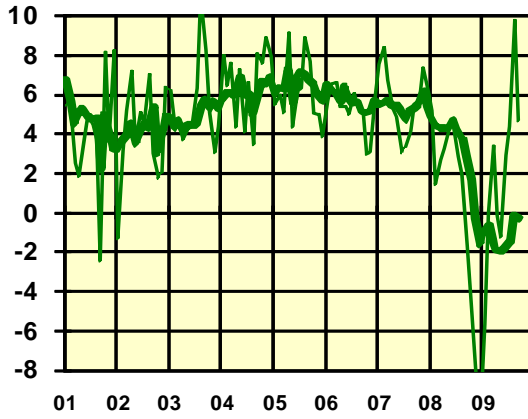
Jobs: Payroll Data
(annual rates of change--3 months & 1 year)



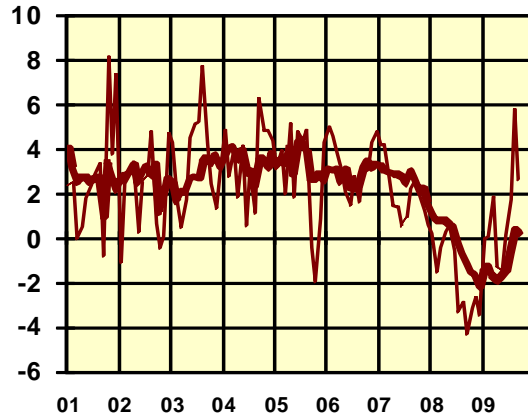
Jobs: Household Data
(annual rates of change--3 months & 1 year)



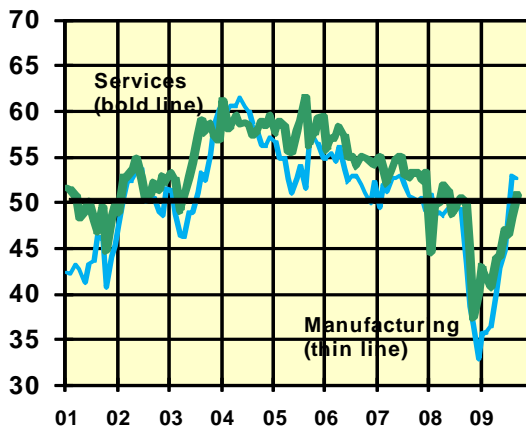
Consumer Spending
(annual rates of change-- 3 months & 1 year)



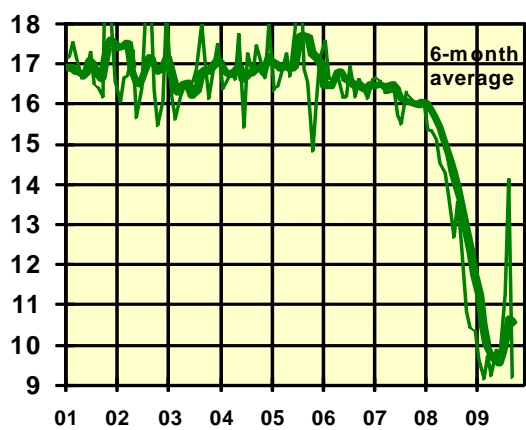
Real Consumer Spending
(annual rates of change-- 3 months & 1 year)



ISM: Composite
(over 50 represents expanding activity)



Vehicle Sales
(cars and light trucks, millions, saar)



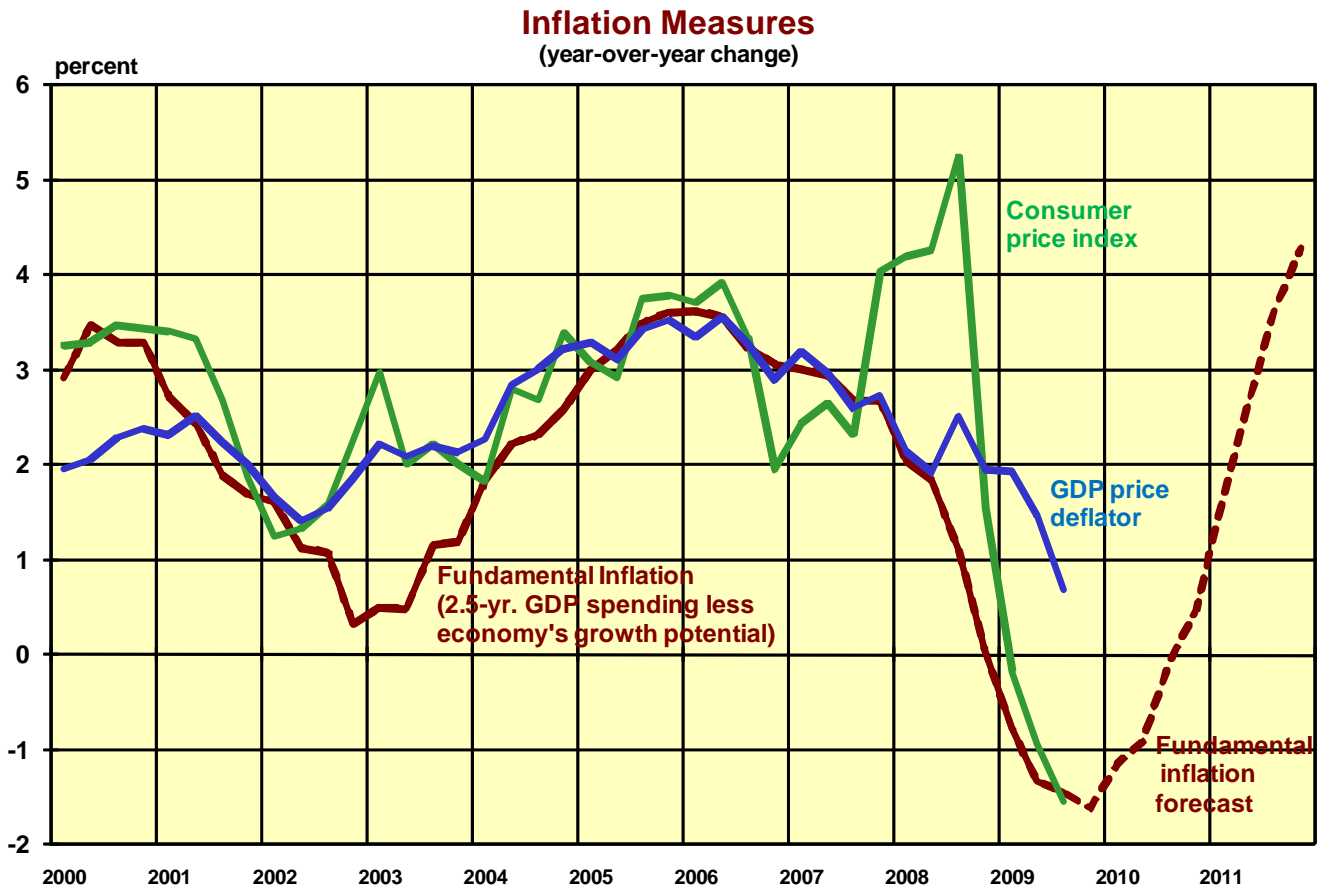
Inflation Indicators

Sharp changes in business activity can produce dramatic short-term changes in prices that mask the underlying inflationary pressures. The dramatic increase in prices going into the first half of last year was followed by an equally dramatic decline. Early signs of a revival in the economy have once again led to sharp increases in certain prices.

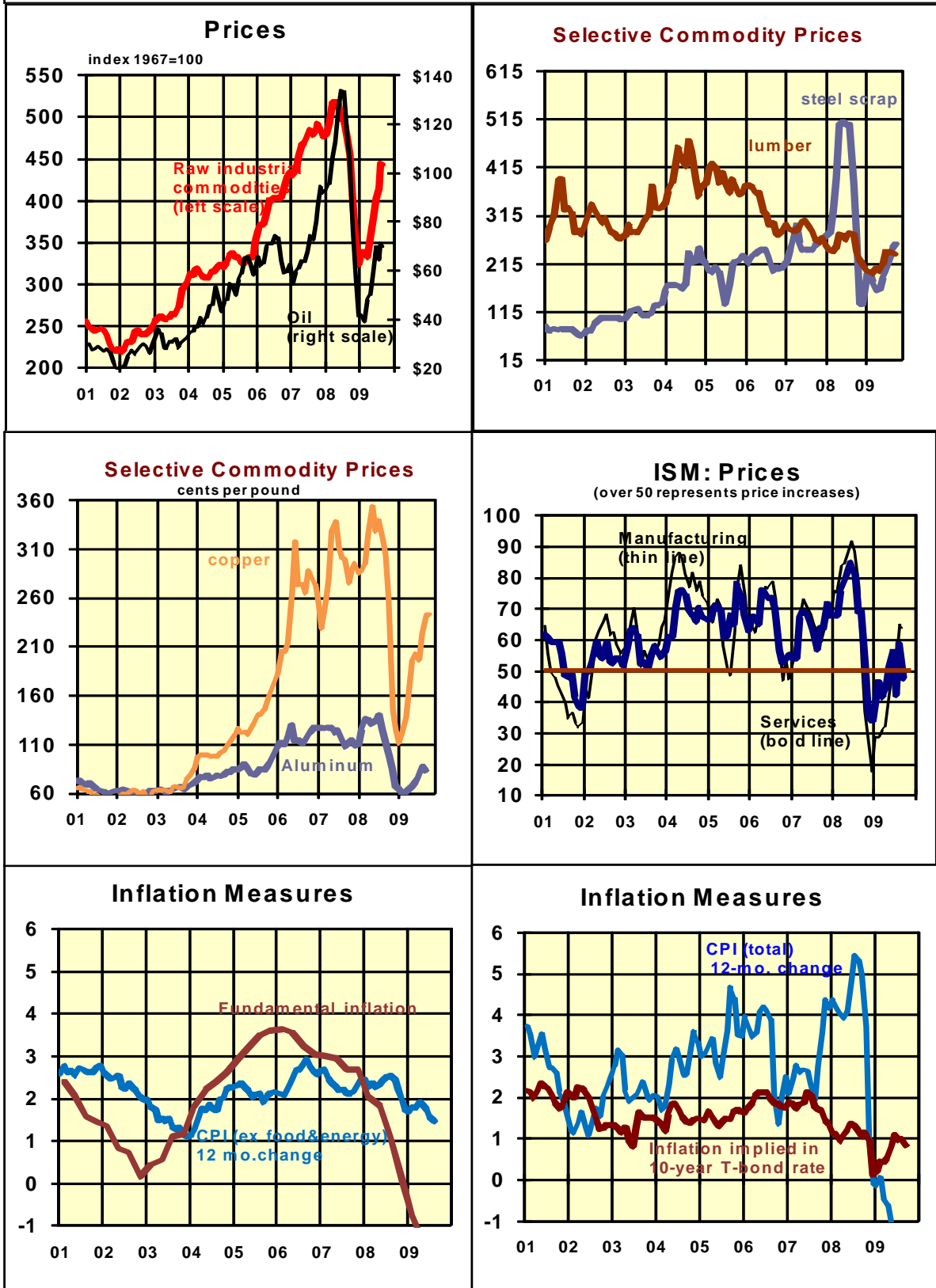
The country's *underlying* inflation is determined by the rate of spending over a 2-3 year period minus the economy's underlying growth rate. Over the past 2½ years current-dollar spending (GDP) has averaged roughly 1½% at an annual rate. Subtracting an underlying growth rate of roughly 2½% yields an underlying inflation of *minus 1%*.

Given the weakness in spending over the past year, it would take at least another year for even a relatively sharp pick-up in spending to produce a meaningful boost to inflation. Moreover, any delay in a strong recovery would hold inflation down for a longer period of time.

As the chart below shows, inflation tends to gravitate to the fundamental level dictated by spending and real growth. This suggests that the recent burst of price increases (shown in the charts on the following page) is temporary. Any sustained rise in inflation is at least a year away.



INFLATION INDICATORS



Interest Rates

A combination of high unemployment and subdued inflation is likely to cause the Federal Reserve to maintain the fed funds rate at an artificially low level for much of the next year.

Even if the economy recovers at a relatively brisk pace, it is unlikely that companies will quickly add more workers. Potential increases in costs mean that businesses will seek to rebuild profits while limiting payroll expense.

The main issue going forward is the extent to which the Fed will continue to increase liquidity. While the Fed has told us it intends to keep the fed funds rate close to zero, this doesn't provide the information necessary to interpret future policy. This is particularly true given the FDIC proposal to place a \$45 billion tax on bank deposits at the end of this year.

Since the Fed focuses its monetary decisions on the level of the fed funds rate, it has chosen not to provide meaningful information about the likely level of bank reserves. As a result, assessing future monetary policy developments involves speculating about the amount of bank reserves that happen to be associated with a fed funds rate that is close to zero.

There is no way I know of to determine the extent to which the Fed will allow the FDIC tax

on bank deposits to dampen the relationship between bank reserves and the money supply.

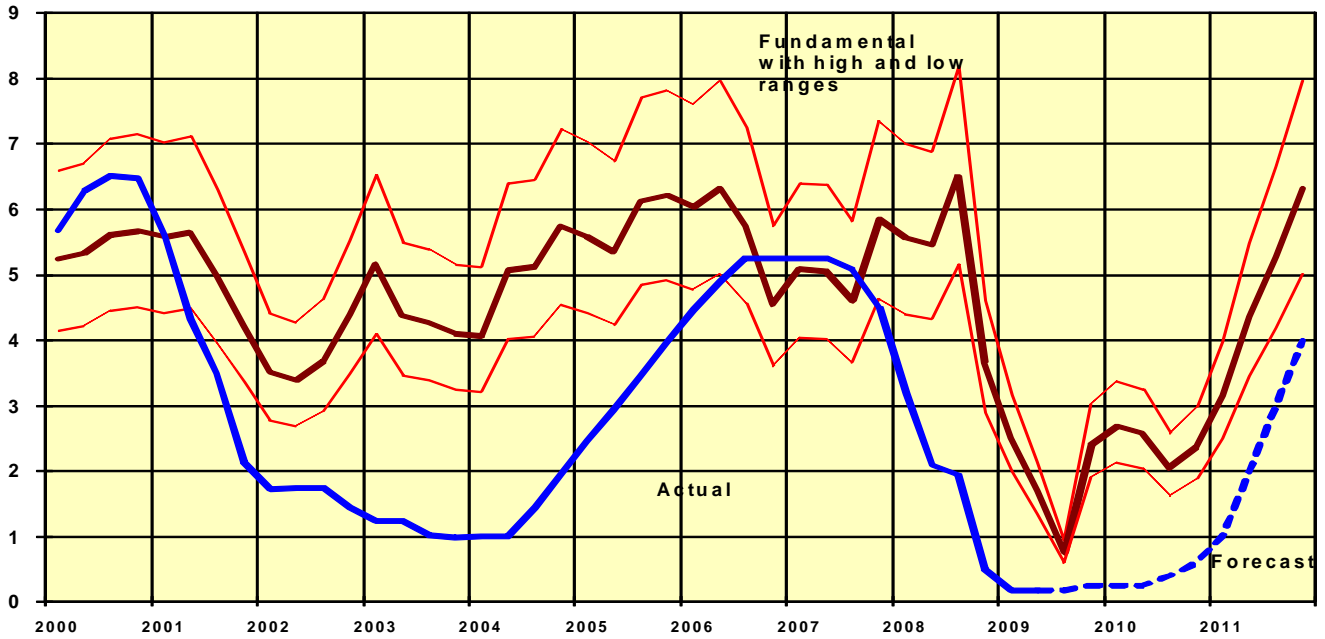
As the likelihood of the FDIC move has increased, I have continued to reduce my forecast for the growth in spending. My current assumption is that the monetary impact will slow the growth in current dollar spending to roughly 5% at year-end and into the first quarter.

The key unknowns are the amount of liquidity that comes out of the system due to the FDIC action and the Fed's response. The negative impact could easily be more or less than I have estimated.

Beyond the early part of next year, the forces of recovery should make a comeback. After prepaying the next three years of insurance premiums, banks have \$15 billion less in expenses each of the next three years. Hence, whatever liquidity is removed by this action will gradually be restored. As a result, the negative impact of this move will become less negative beginning next year. This gradual improvement in liquidity should then help the recovery to get back on track.

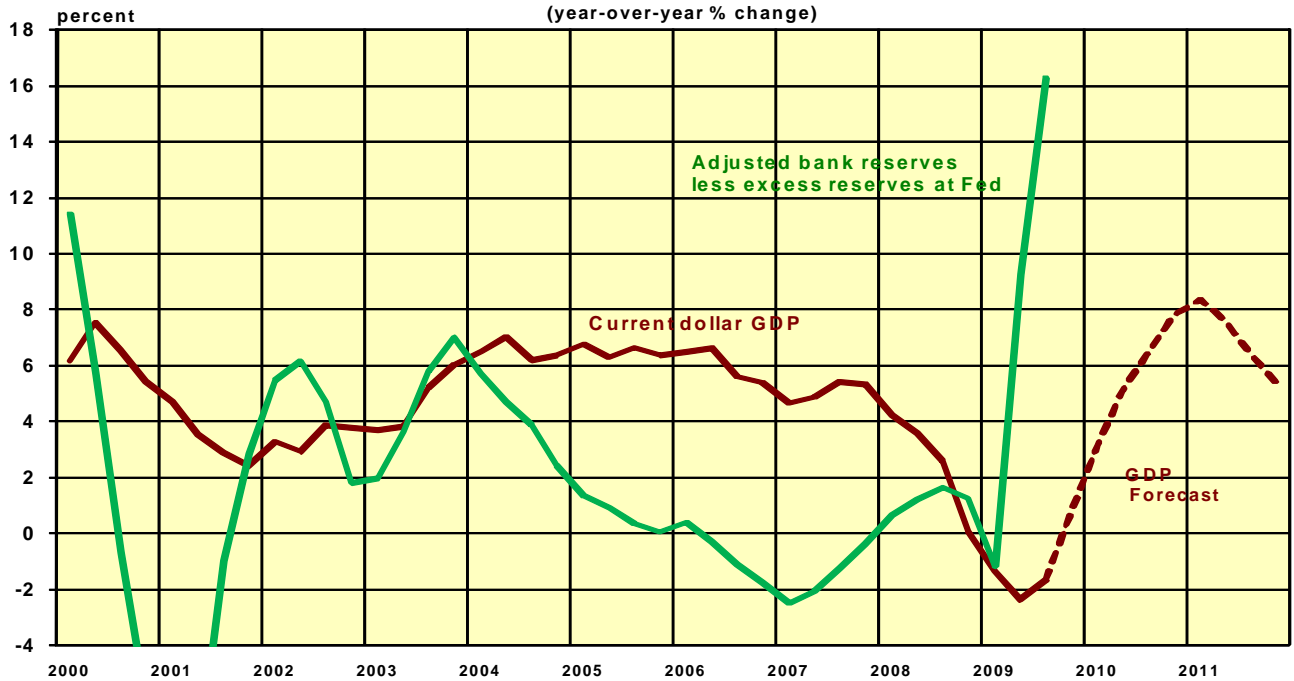
Fed Funds Rate

(fundamental based real after-tax rate currently 1.0%, 1-yr avg. inflation plus tax premium)



Current Dollar Spending (GDP) & Adjusted Bank Reserves)

(year-over-year % change)



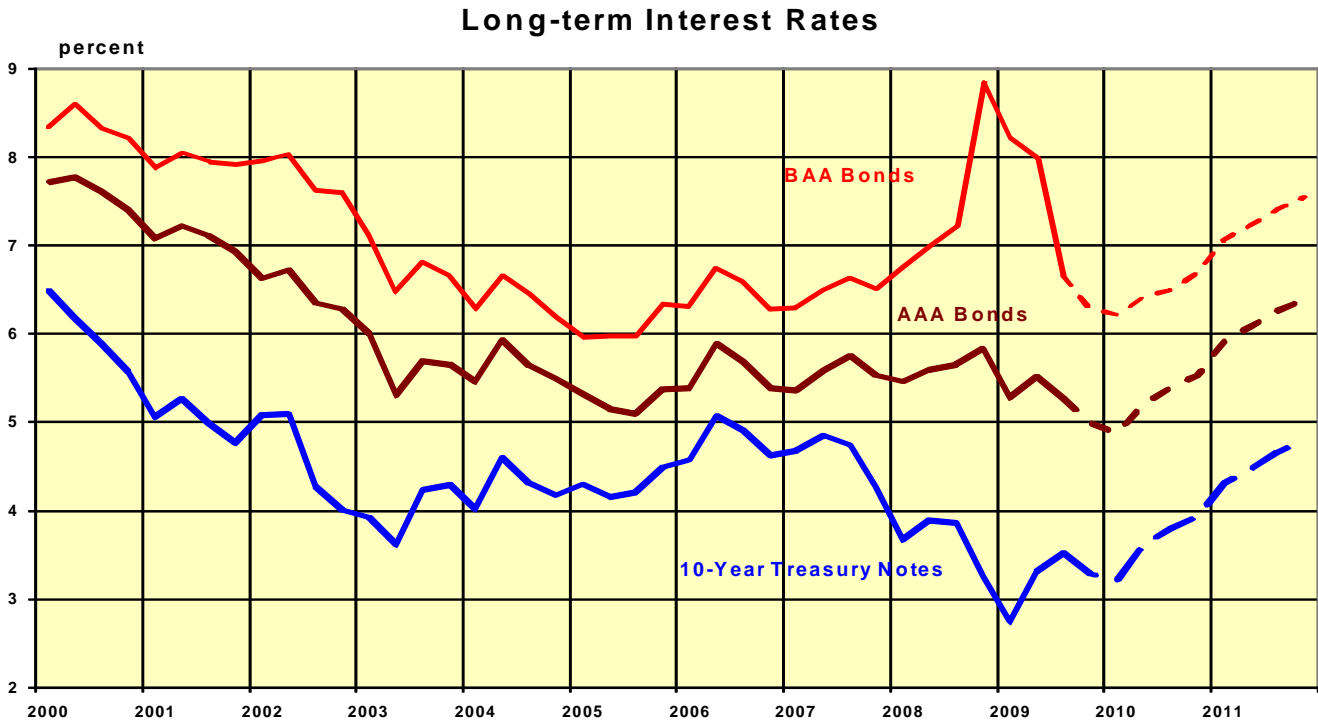
LONG-TERM INTEREST RATES

The near-term outlook for long-term interest rates depends on perceptions regarding the strength of spending. The longer-term outlook depends on perceptions regarding future inflation.

A lack of inflationary pressures combined with perceptions that the economy is struggling to recover has produced extremely low long-term interest rates.

If, as I suspect, the FDIC proposed tax increase postpones a more vigorous recovery, it will delay any increase in long-term interest rates.

As the chart below shows, I expect that a slower pace of activity in the months ahead will lead to lower long-term rates. However, once the initial negative impact has passed, I expect that a more vigorous pace of spending to resume. When it does, long-term interest rates are likely to head higher.



STOCK PRICES

A rebound in profits in the second and third quarters along with lower long-term interest rates raises the fundamental value of stocks. As with both the economy and long-term interest rates, the FDIC proposal has the potential to squeeze liquidity and temporarily set back the cyclical recovery in stock prices.

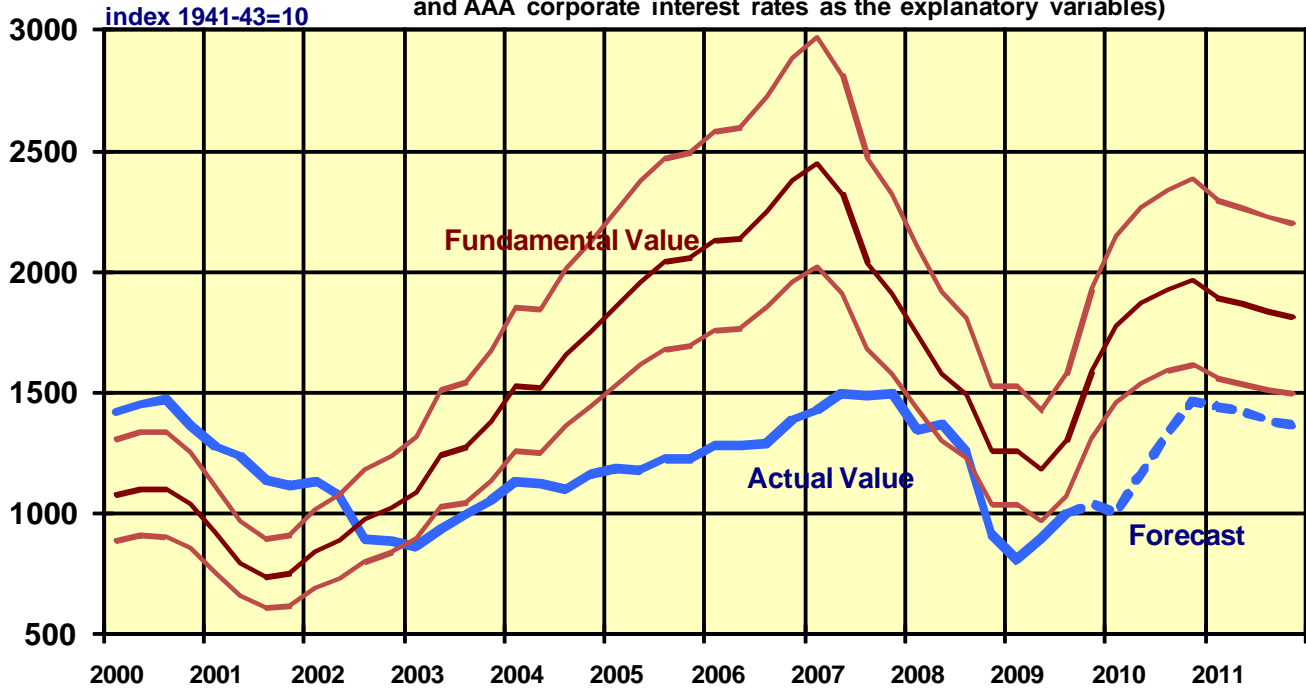
As with interest rates, the forecast for stock prices rests heavily on a key unknown—the

amount of liquidity in the economy after both the FDIC and the Fed are done doing their things.

My caution with respect to stocks reflects concern that neither the FDIC nor the Fed recognizes the potential for a liquidity squeeze and that neither will act responsibly to offset it.

Stock Prices: S&P 500

(Fundamental value of stocks is based on a regression with S&P operating earnings and AAA corporate interest rates as the explanatory variables)



11/1/2009

	Actual			Forecast					YEARS				
	2009 I	2009 II	2009 III	2009 IV	2010 I	2010 II	2010 III	2010 IV	2007	2008	2009	2010	2011
GROSS DOMESTIC PRODUCT	14178	14151	14302	14449	14623	14877	15223	15572	14078	14441	14270	15074	16110
%ch	-4.6	-0.8	4.3	4.2	4.9	7.2	9.6	9.5	5.1	2.6	-1.2	5.6	6.9
REAL GDP	12925	12902	13014	13137	13267	13480	13764	14032	13254	13312	12994	13636	14216
%ch	-6.4	-0.7	3.5	3.8	4.0	6.6	8.7	8.0	2.1	0.4	-2.4	4.9	4.3
CHAIN PRICE INDEX	1.097	1.097	1.099	1.100	1.102	1.104	1.106	1.110	1.062	1.085	1.098	1.106	1.134
%ch	1.9	0.0	0.8	0.4	0.8	0.6	0.9	1.5	2.9	2.1	1.2	0.7	2.6
CPI- ALL URBAN%ch	-2.4	1.3	3.6	0.9	0.3	0.1	1.1	1.7	2.9	3.8	-0.5	1.0	2.7
FUND. INFLATION%ch	-0.8	-1.3	-1.4	-1.6	-1.2	-0.9	-0.1	0.5	3.1	2.3	-0.2	-1.3	1.2
PRETAX PROFITS	1247	1337	1377	1436	1468	1533	1531	1540	1774.4	1462.8	1349.3	1517.8	1551.0
%ch	91.2	32.4	12.5	18.4	8.9	18.9	-0.5	2.6	-2.7	-17.6	-7.8	12.5	2.2
PRETAX PROFITS ADJ (1)	1183	1227	1290	1338	1375	1437	1436	1445	1541.7	1360.4	1259.2	1423.1	1456.1
%ch	22.8	15.7	22.4	15.6	11.5	19.3	-0.2	2.6	-4.1	-11.8	-7.4	13.0	2.3
AFTER-TAX PROFITS	976	1031	1091	1136	1150	1200	1204	1210	1323	1171	1059	1191	1217
%ch	85.2	24.5	25.5	17.4	5.0	18.5	1.5	1.9	-2.0	-11.5	-9.6	12.5	2.2
AFTER-TAX PROFITS ADJ(1)	912	921	1004	1037	1057	1104	1110	1115	1090.2	1068.2	968.6	1096.4	1122.4
%ch	5.5	3.6	41.6	13.8	7.8	18.9	2.2	1.8	-4.0	-2.0	-9.3	13.2	2.4
PERSONAL INCOME	11953	11972	11956	12080	12225	12438	12727	13019	11894	12239	11990	12602	13468
%ch	-8.9	0.6	-0.5	4.2	4.9	7.2	9.6	9.5	5.6	2.9	-2.0	5.1	6.9
REAL DISPOSABLE INCOME	9926	10020	9933	10014	10126	10301	10513	10712	9861	9911	9974	10413	10848
%ch	0.2	3.8	-3.4	3.3	4.5	7.1	8.5	7.8	2.2	0.5	0.6	4.4	4.2
PRODUCTIVITY	1.432	1.455	1.478	1.488	1.497	1.507	1.519	1.531	1.401	1.426	1.463	1.513	1.546
%ch	0.3	6.6	6.4	2.7	2.4	2.8	3.2	3.1	1.9	1.8	2.6	3.4	2.2
CIVILIAN EMPLOYMENT	141.6	140.6	139.5	139.2	139.0	139.0	139.3	139.9	146.0	145.4	140.2	139.3	139.6
%ch	-6.7	-2.8	-3.0	-1.0	-0.5	0.0	1.0	1.5	1.1	-0.5	-3.5	-0.7	0.2
UNEMPLOYMENT RATE	8.1	9.3	9.6	10.4	10.6	10.8	10.0	9.2	4.6	5.8	9.4	10.2	9.4
INDUSTRIAL PRODUCTION	0.990	0.964	0.976	0.990	1.006	1.025	1.055	1.082	1.113	1.088	0.980	1.042	1.063
%ch	-19.2	-10.2	5.2	5.9	6.4	7.6	12.3	11.0	1.5	-2.2	-9.9	6.3	2.1
LIGHT VEHICLE SALES (2)	9.5	9.6	11.5	10.9	11.8	12.7	12.9	12.9	16.2	13.2	10.4	12.6	12.8
Domestic	4.8	4.9	6.4	5.6	6.2	6.8	7.0	7.0	7.6	6.8	5.4	6.8	6.9
Imports	4.7	4.7	5.1	5.3	5.6	5.8	5.9	5.9	8.6	6.5	4.9	5.8	5.9

(1) Profits adjusted for capital consumption and inventory adjustment. All 3rd quarter 2009 profits are estimates.

(2) Millions at seasonally adjusted annual rates

11/1/2009

	Actual			Forecast					Years					
	2009	2009	2009	2009	2010	2010	2010	2010	2006	2007	2008	2009	2010	2011
Monetary Aggregates quarterly:	I	II	III	IV	I	II	III	IV						
M2 %ch at annual rates	13.1	2.8	0.1	3.0	4.0	7.0	7.0	6.0	5.0	5.8	6.9	7.8	5.8	5.8
Adj. Bank Reserves (billions of \$)	827	913	895	1100	1100				95	94	234	934	1100	
less excess reserves at Fed	92	102	109	112	114	116	118	120	94	92	93	104	117	124
Interest Rates:														
Baa Corp Bonds: Moody's	8.21	7.98	6.66	6.28	6.22	6.41	6.49	6.68	6.48	6.48	7.45	6.47	6.45	6.16
Aaa Corp Bonds: Moody's	5.27	5.51	5.27	4.98	4.87	5.21	5.39	5.53	5.59	5.56	5.64	5.12	5.25	6.16
MORTGAGE RATES	5.06	5.03	5.16	5.28	5.22	5.61	5.79	5.93	6.41	6.34	6.04	5.13	5.64	6.56
10-YR GOVT SECURITIES	2.74	3.31	3.52	3.28	3.22	3.61	3.79	3.93	4.79	4.63	3.67	3.21	3.64	4.56
5-YR GOVT SECURITIES	1.76	2.23	2.47	2.34	2.43	2.75	2.92	3.17	4.75	4.43	2.80	2.20	2.82	3.58
2-YR GOVT SECURITIES	0.91	1.01	1.03	0.40	1.65	1.90	2.05	2.40	4.82	4.36	2.00	0.84	2.00	2.60
3-MONTH T-BILL	0.23	0.18	0.17	0.15	0.15	0.25	0.45	0.74	4.72	4.41	1.46	0.18	0.40	2.74
FEDERAL FUNDS RATE	0.18	0.18	0.16	0.15	0.15	0.15	0.25	0.50	4.96	5.02	1.93	0.17	0.26	2.50
3-MONTH LIBOR RATE	1.24	0.85	0.41	0.45	0.65	0.50	0.60	0.85	5.19	5.30	2.91	0.74	0.65	2.85
BOND EQUIVALENT RATES:														
FEDERAL FUNDS	0.18	0.18	0.16	0.15	0.15	0.15	0.25	0.50	5.09	5.15	1.95	0.17	0.26	2.54
3-MONTH LIBOR	1.25	0.85	0.41	0.45	0.65	0.50	0.60	0.85	5.33	5.44	2.95	0.74	0.65	2.90
3-MONTH T-BILL	0.23	0.18	0.17	0.15	0.15	0.25	0.46	0.75	4.85	4.52	1.49	0.18	0.40	2.80
STOCKS:														
S&P 500	809	892	997	1035	1000	1165	1327	1463	1311	1477	1221	933	1239	1403
S&P 500 quarterly reported earnings*	30.1	54.0	58.0	70.8	72.2	75.4	75.8	76.1	81.5	66.2	14.9	53.2	74.8	76.6
S&P 500 p/e on reported earnings**	26.9	16.5	17.2	14.6	13.9	15.5	17.5	19.2	16.1	26.5	17.7	18.8	16.5	18.3
S&P 500 quarterly operating earnings	40.4	55.2	55.8	64.2	70.4	76.4	76.5	77.0	87.7	82.5	49.5	53.9	75.1	77.8
S&P 500 p/e on operating earnings**	20.0	16.2	17.9	16.1	14.2	15.2	17.4	19.0	14.9	17.9	24.7	17.3	16.5	18.0
S&P 500 underlying earnings***	69.5	70.6	71.7	72.8	74.0	75.2	76.4	77.6	58.9	62.7	66.8	71.1	75.8	80.7
S&P 500 p/e on underlying earnings***	11.6	12.6	13.9	14.2	13.5	15.5	17.4	18.9	22.3	23.5	18.3	13.1	16.3	17.4

*annualized.

**current quarterly stock price divided by annualized current quarter reported earnings. 3rd quarter 2009 earnings are estimates.

***reported earnings based on a 6.5% growth rate

****price earnings based on reported earnings trend (6.5% growth) for the current quarter

MN means the number is not meaningful (which tends to apply to most money numbers given the Fed's current operational approach)