Robert Genetski February 2, 2010

Monthly Economic and Financial Update

The pace of business activity improved going into the fourth quarter of the year with current dollar spending advancing at just over a 6% annual rate. This was the fastest increase in current dollar spending in almost four years.

The increase in spending tends to confirm the fact that the Federal Reserve had loosened monetary policy earlier in 2009. The lagged impact of this easing became apparent toward the end of the year and has continued into this year.

The challenge at this point is to interpret recent monetary developments. These developments determine the extent to which current dollar spending will continue to improve this summer and fall.

My analysis indicates that the Fed has remained expansive through the end of the year and into January. Looking ahead, the odds are that the expansive policy will continue.

Nonetheless, the monetary outlook remains in a state of flux. Fed policy moves have been so massive and so erratic that they provide concern regarding future changes. There is little indication that those at the Fed have any more understanding of the impact of its actions today than it did in 2008. At that time they inadvertently turned restrictive when they thought they were expansive.

Although the Fed won't deliberately reduce liquidity by raising the fed funds rate any time soon, its operating procedures often produce abrupt, unintended shifts in liquidity. The monetary indicators section discusses some of these concerns.

The Administration's budget plans continue to rely on government to create prosperity. Plans for the future rely on government to boost the economy through a combination of tax credits for jobs, assistance to small business, and aid for research and development in specific areas. Tax hikes are planned for those earning over $250,000 in income, for those of all incomes who pay earn interest or dividends or who pay capital gains taxes. There will also be higher taxes banks and for anyone who uses energy.

These policies are based on two assumptions. The first is that government experts make better decisions on allocating resources than those made by market forces. The second is that those who are successful and those who choose to save their money can afford to face higher taxes without the extra expense damaging the economy.

Policies based on these assumptions not only fail to use common sense, they have a proven historical record of failure. While those with assets and unique skills are able to cope (and sometimes even prosper) amid such programs, those without unique skills tend to suffer. This is what happened in the 1930s and the 1970s amid similar attempts to have government allocate resources while taxing prudent behavior.

The election of Scott Brown in Massachusetts has changed the political landscape. His election appears to have euthanized the current health care bill.

Brown's victory suggests that this year's elections will be a referendum on the future direction of policy. Ideally, the public will have a clear choice—continue to grow government at the expense of the private sector or reverse the current trend. The outcome of that choice will determine whether the US maintains its status as the most successful economy in the world, or joins the subpar performance that accompanies a heavy reliance on government to create prosperity.

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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 securities. It then pays for these securities 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. The funds from the resulting loans and investments are then re-deposited into banks. This process results in a multiple expansion of money and credit in the economy.

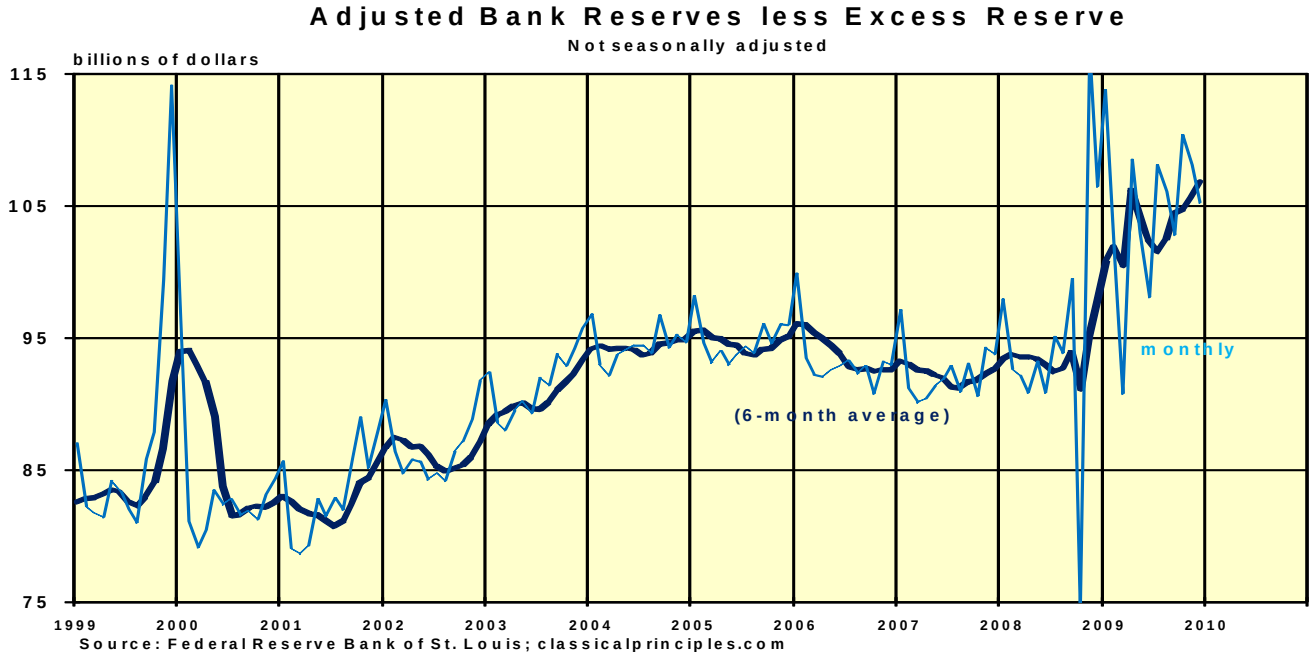
The monetary process can be short-circuited if funds leave the banking system. This happens when either banks or the public decides to hold more of their monetary assets in the form of currency as opposed to bank deposits.

When banks hold more reserves with the Fed than the Fed requires, these excess reserves are not used for loans and investment. Hence, it short-circuits the monetary expansion process.

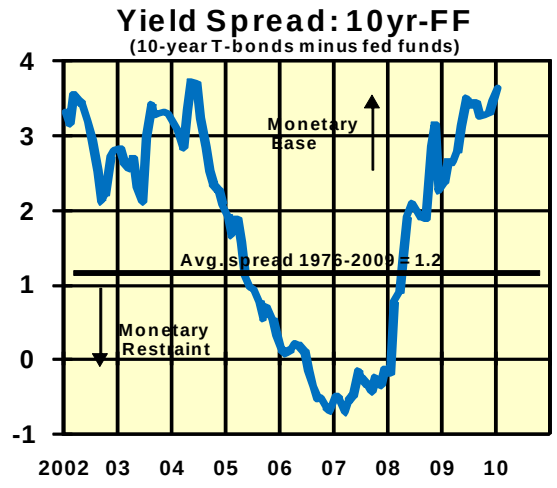
The chart below shows the monthly data along with a 6-month moving average of bank reserves minus excess reserves. The data are not adjusted for seasonal variations because the unadjusted data appear to be more stable than those that are seasonally adjusted. Even with the more stable unadjusted data, the last two months of 2009 are down from the peaks of the previous year. Other monetary measures (M2, currency) also show some year-over-year slowdown.

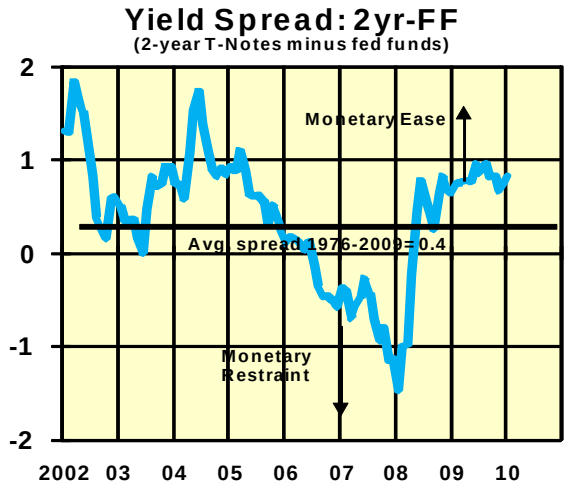
The extreme monthly swings make it challenging to determine future trends. For now, the best approach may be to look at the 6-month average. Doing so suggests that the Fed has increased the amount of reserves in the banking system by roughly 10% through the end of last year. Interest rate spreads tend to confirm this trend.

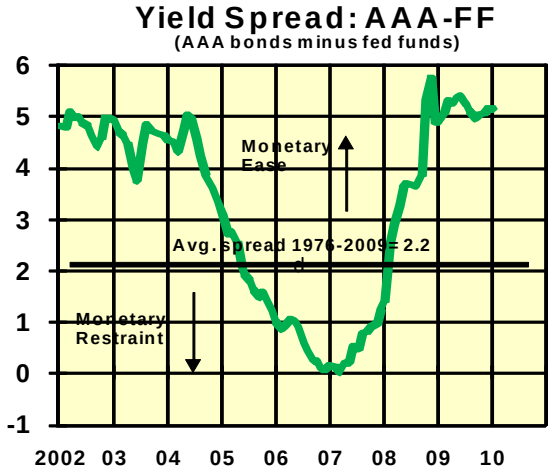
As the accumulation of these reserves work their way through the economy they should boost spending. So long as they continue to grow at double-digit rates, spending is also likely to increase at close to double-digit rates.

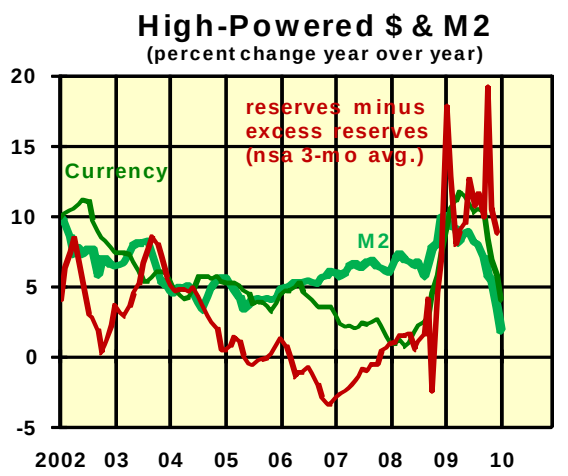


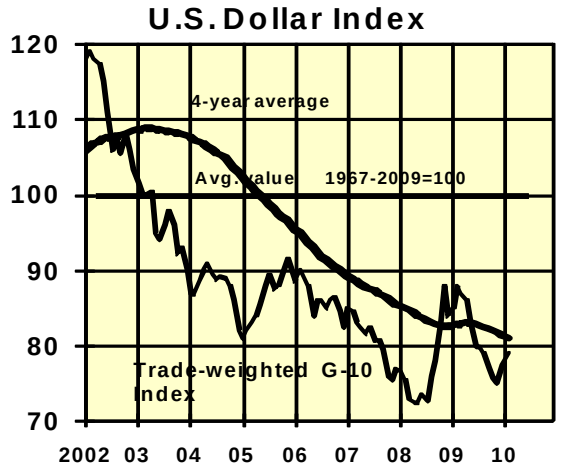
MONETARY INDICATORS

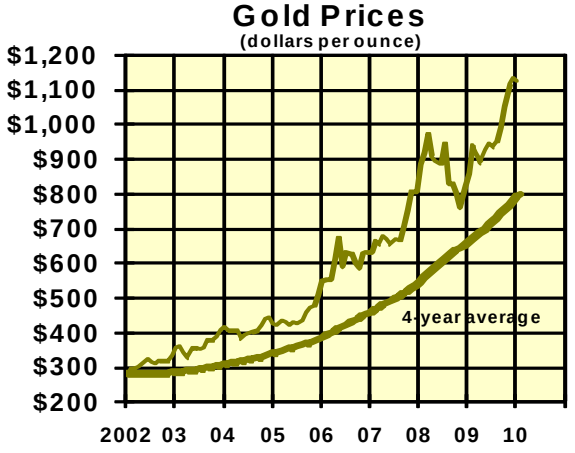










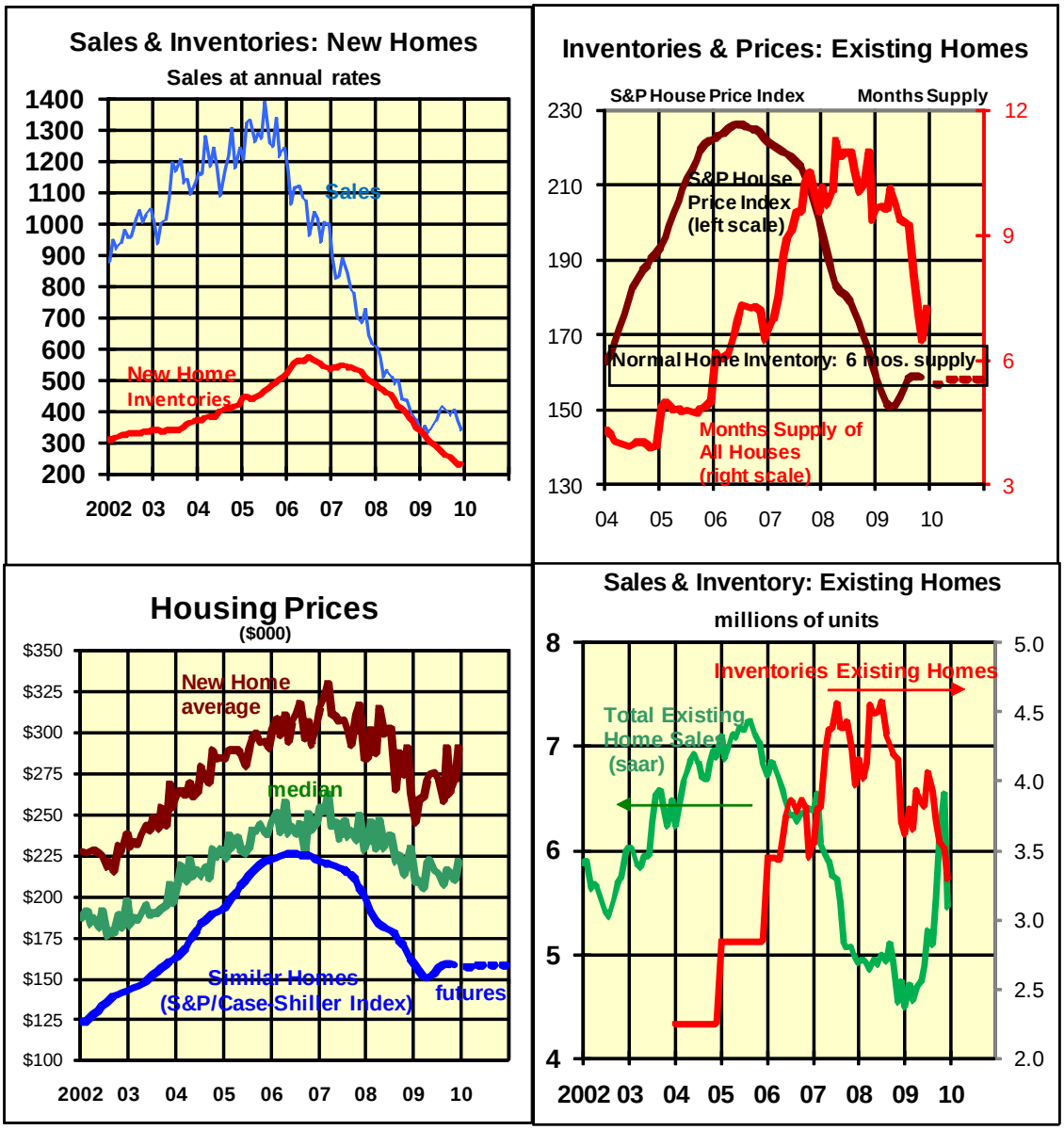


Sensitive Indicators

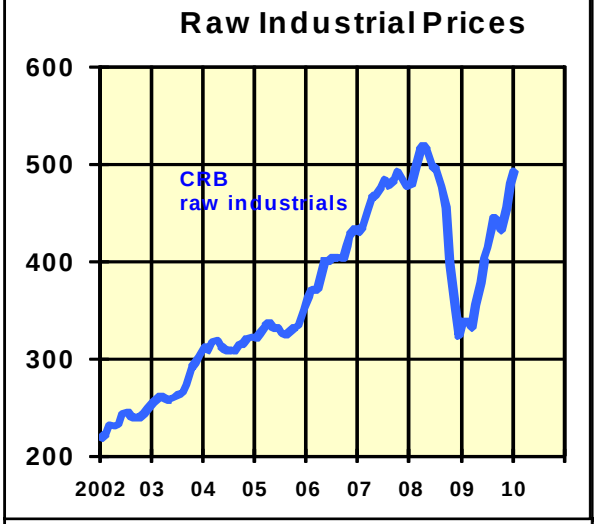
There are two encouraging developments regarding sensitive economic indicators. As the charts below show, home inventories have moved sharply lower. Inventories of existing homes fell to 3.3 million units at the end of December while inventories of new homes fell to the lowest level in almost 40 years.

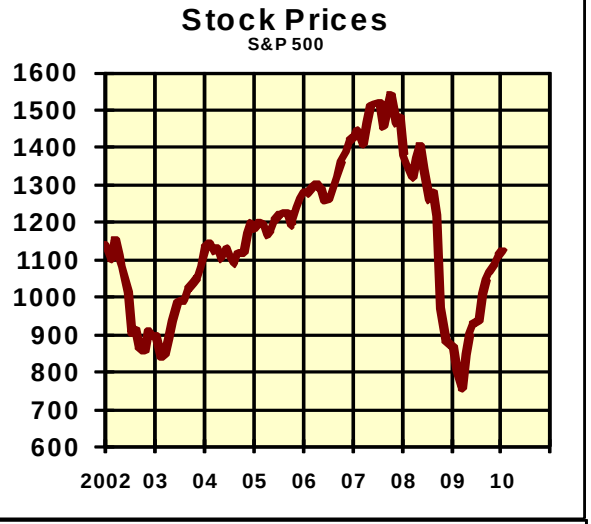
Another bright spot is new orders. The ISM survey of manufacturers indicates that new orders for January were at the fastest pace in almost 6 years.

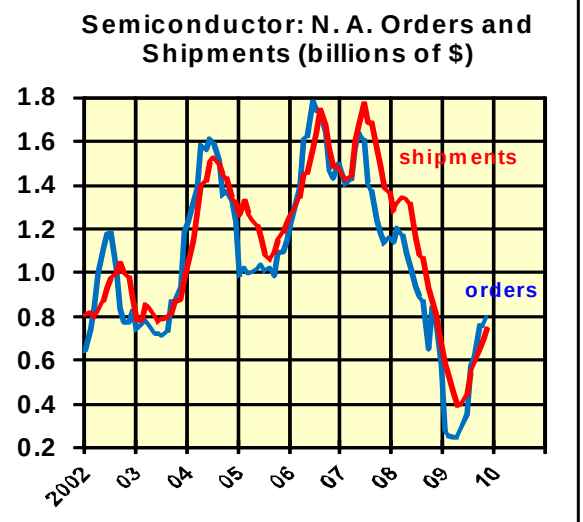
While other indicators show more modest gains, by almost all indications business activity continues to improve. With the gains in money noted above, the signs of further improvement are likely in the months ahead.

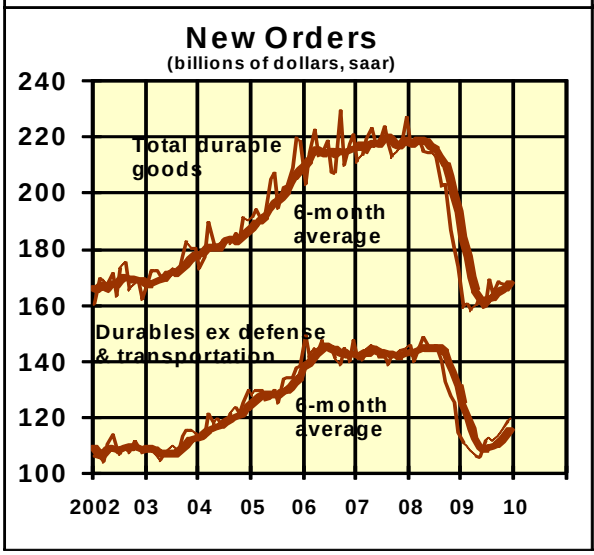


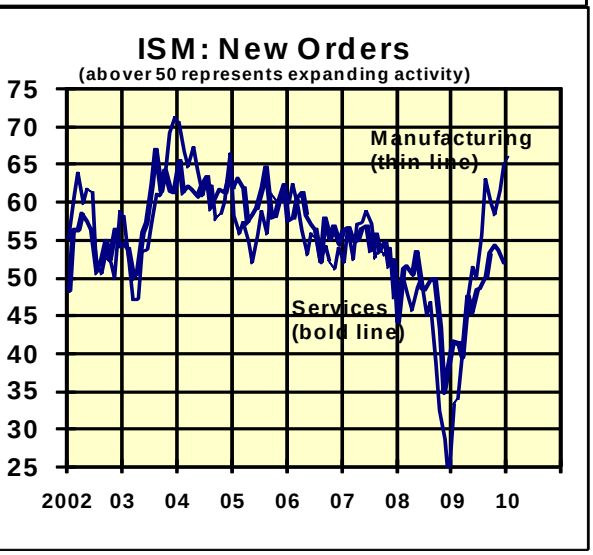
SENSITIVE INDICATORS



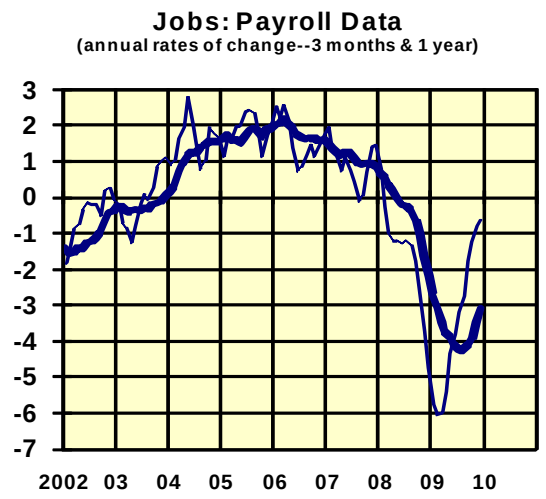


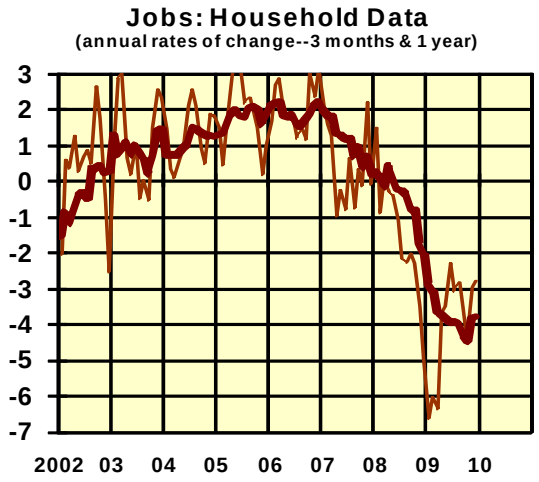


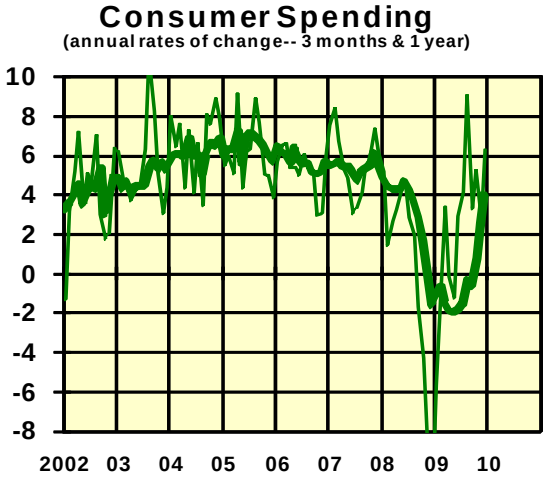


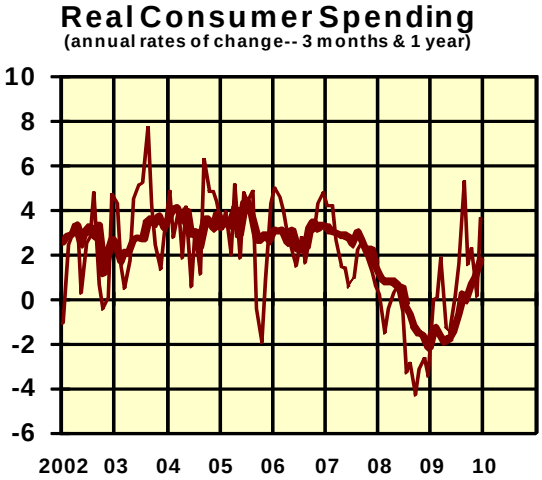


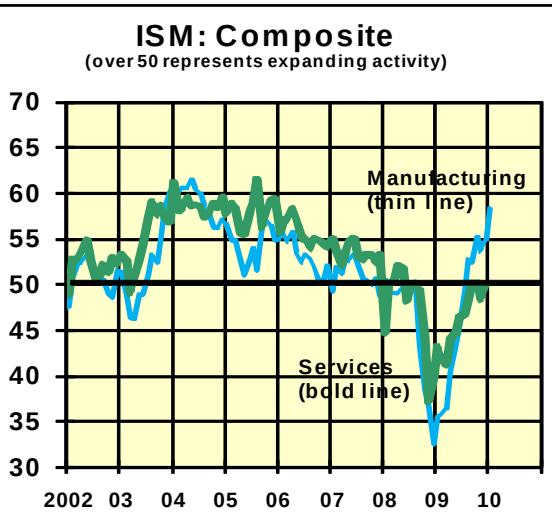
ECONOMIC INDICATORS

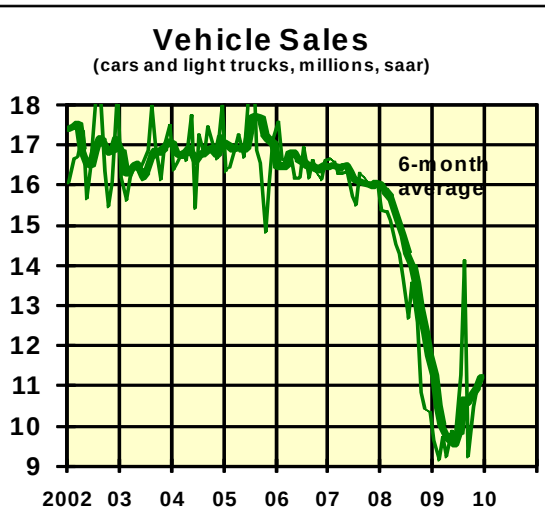












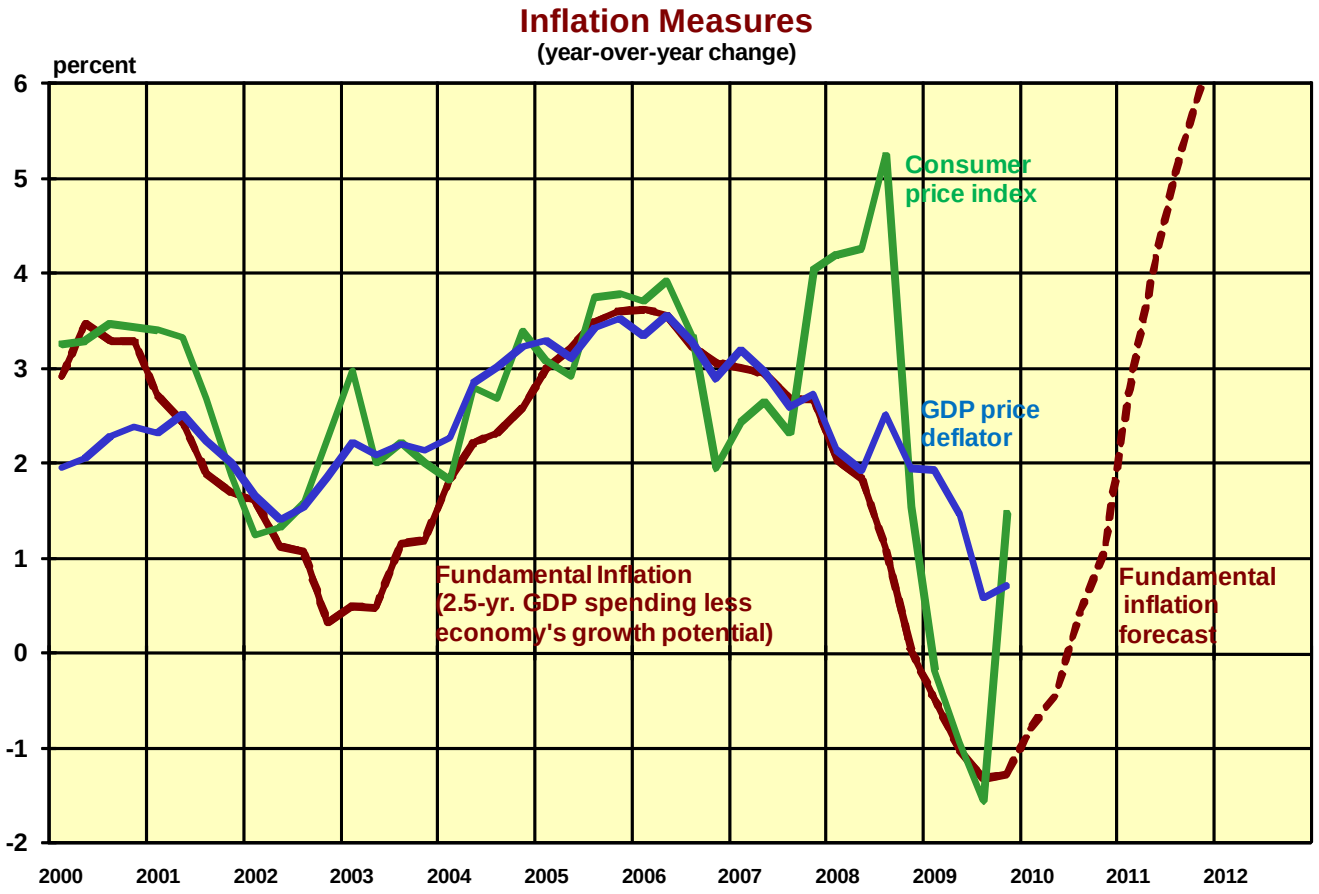
Inflation Indicators

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

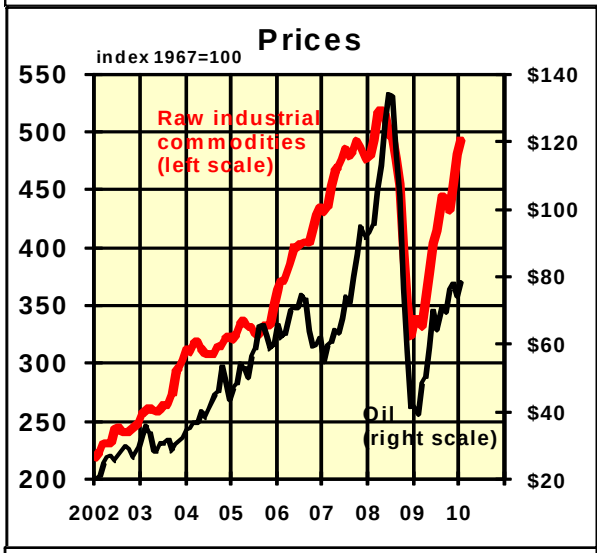
The country's *underlying* inflation is determined by the rate of spending over a 2-3 year period minus the economy's underlying growth rate. Over the past 2½ years current-dollar spending (GDP) has averaged roughly 1½% at an annual rate. Subtracting an underlying growth rate of roughly 2½% yields an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

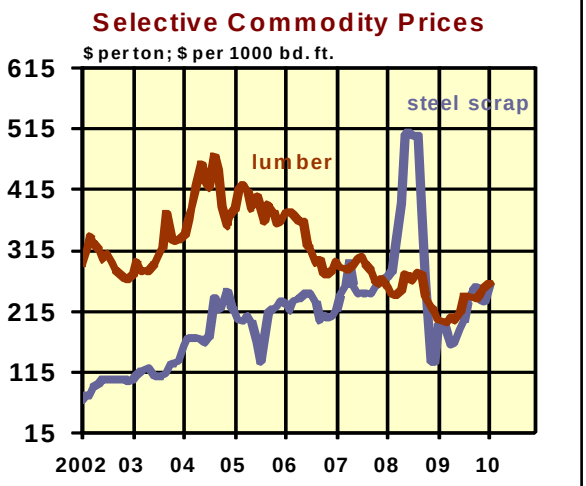
Given the weakness in spending over the past year, it will take another year for even a relatively sharp pick-up in spending to produce a significant increase in inflation.

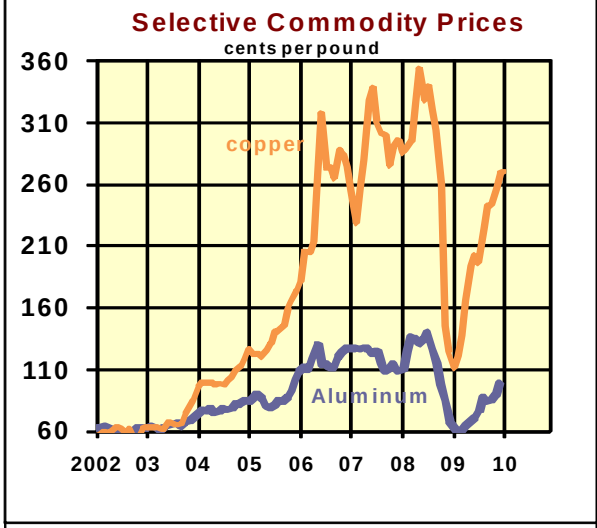
As the chart below shows, inflation tends to gravitate to the fundamental level dictated by spending and real growth. This suggests that the recent burst of price increases (shown in the charts on the following page) is temporary. Any sustained rise in inflation is at least a year away.

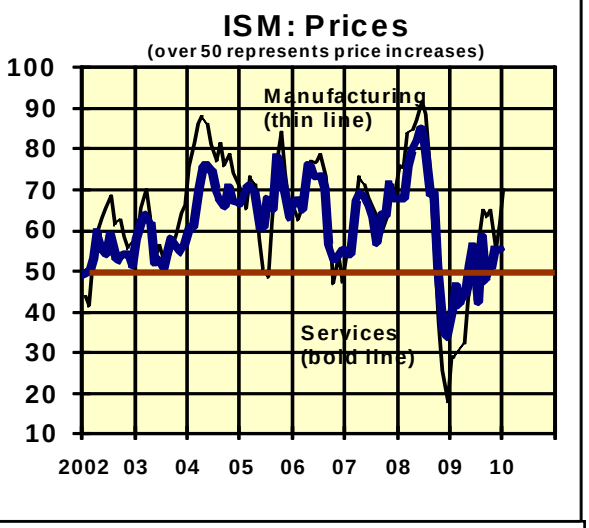


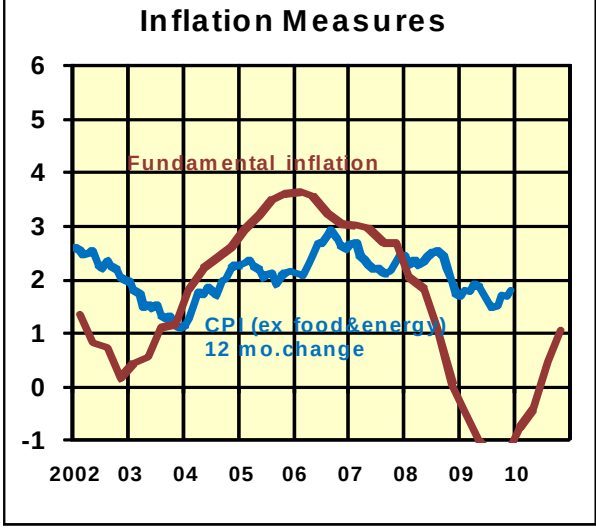
INFLATION INDICATORS

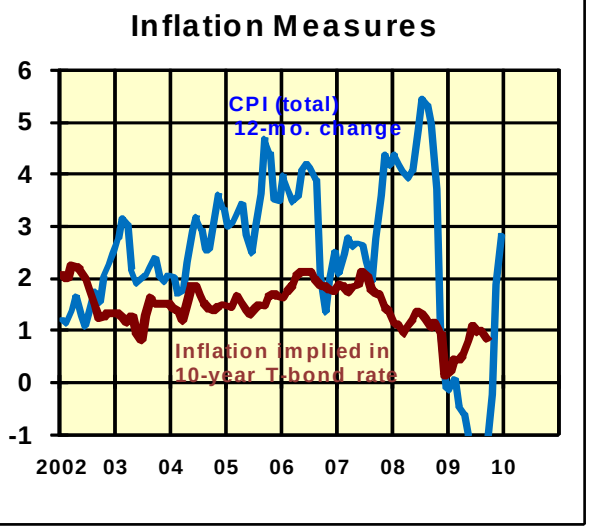












Interest Rates

A combination of high unemployment and relatively subdued inflation will cause the Federal Reserve to want to pursue an expansive monetary policy. The Fed's operating procedure involves keeping the fed funds rate at the current artificially low level.

As shown above, this operating procedure can produce wild swings in bank reserves that can have unintended consequences. Assuming that, on balance, the erratic changes produce more bank reserves, the recent increase in the pace of spending should continue into the spring and summer.

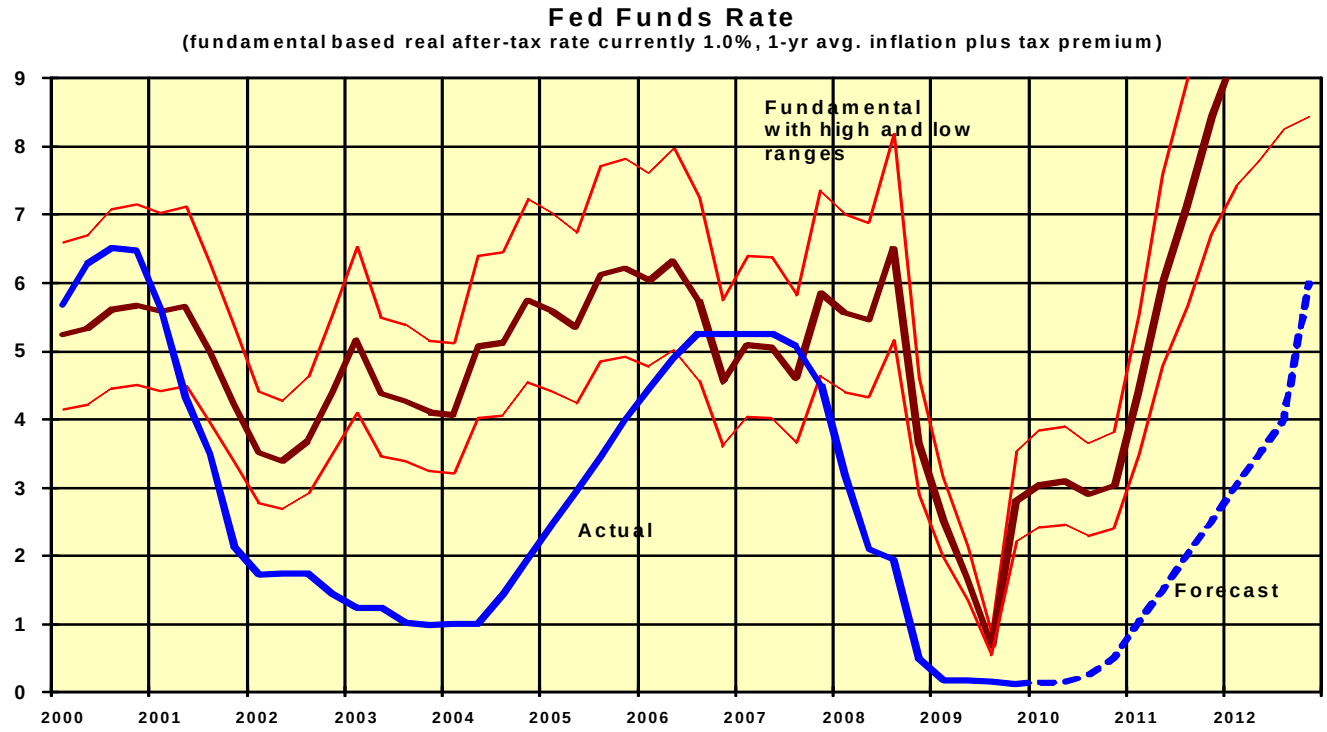
Even if the economy recovers at a relatively brisk pace, it is unlikely that companies will quickly add more workers. Potential increases in taxes and other costs mean that businesses will continue to rebuild profits while limiting their payroll expense.

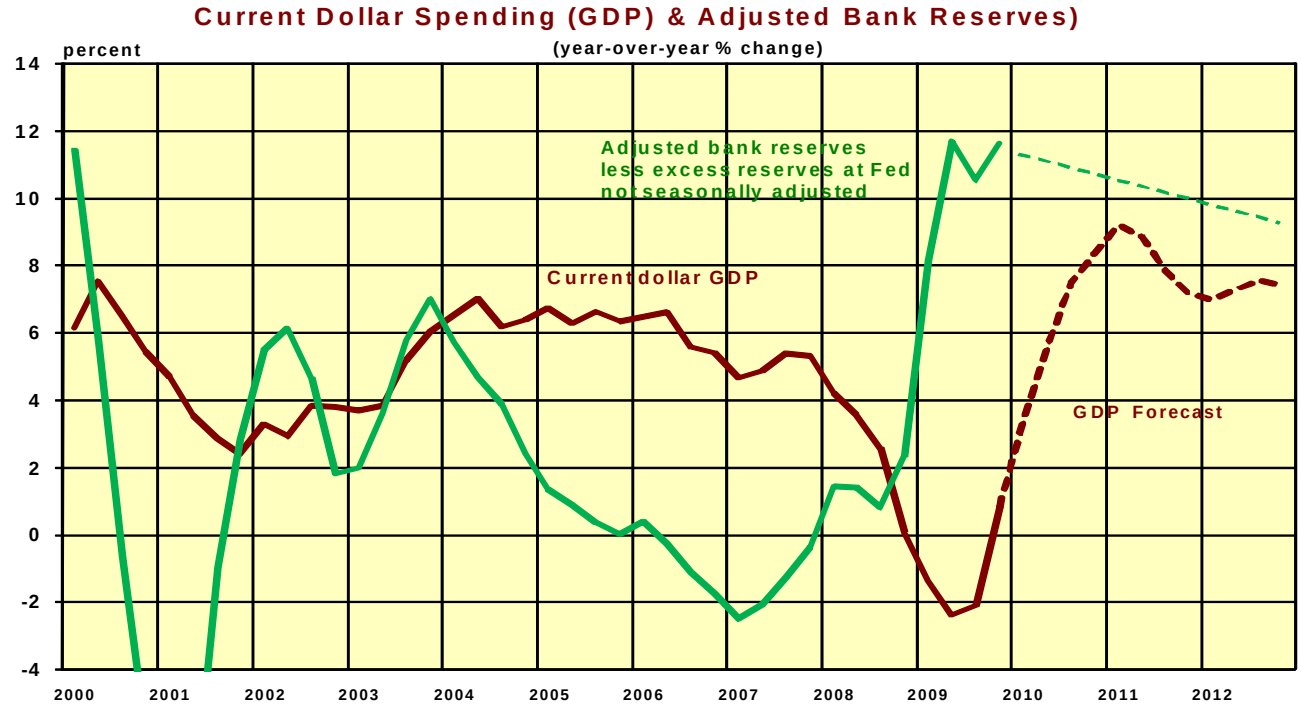
Under normal conditions, keeping the fed funds rate close to zero while spending increases rapidly would lead to a sharp increase in bank reserves.

These are not normal times. During the past year, the monthly change in excess reserves that banks hold at the Federal Reserve has ranged from a decrease of $155 billion to an increase of $134 billion. This means that in any one month there is the potential for a significant shift in the amount of reserves used for loans and investments.

My current assumption is that the Fed will continue to increase the amount of bank reserves over and above the amount of excess reserves by somewhere between 6%-10% in the year ahead. As a result, monetary policy would remain sufficiently expansive to lead to progressively more rapid spending in the summer and fall of the coming year.

However, the extreme monthly volatility in bank reserves has the potential to disrupt both financial markets and the economy. As a result, these numbers must be monitored closely to see if my assumption regarding their future direction remains valid.


Fed Funds Rate
(fundamental based real after-tax rate currently 1.0%, 1-yr avg. inflation plus tax premium)
Fundamental with high and low ranges
Actual
Forecast
9
8
7
6
5
4
3
2
1
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012


Current Dollar Spending (GDP) & Adjusted Bank Reserves)
percent
(year-over-year % change)
Adjusted bank reserves less excess reserves at Fed not seasonally adjusted
Current dollar GDP
GDP Forecast
14
12
10
8
6
4
2
0
-2
-4
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

LONG-TERM INTEREST RATES

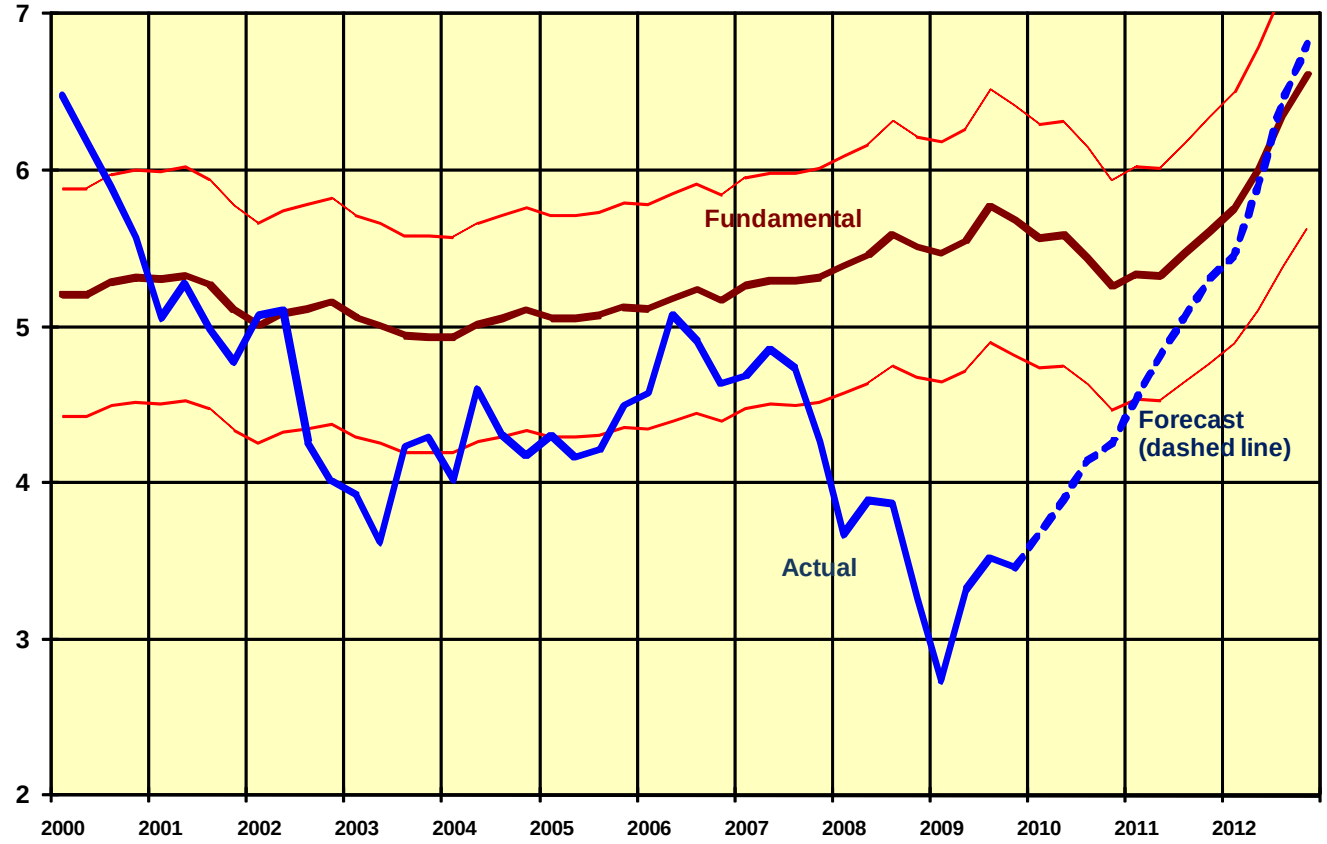
The near-term outlook for long-term interest rates depends on perceptions regarding future inflation. Near term, those perceptions depend on the strength of business activity. The stronger the increase in business activity, the greater the likelihood of shift in the Fed's interest rate target.

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

However, so long as monetary policy remains expansive, the odds favor a further pick-up in the rate of growth. Once the consensus shifts to expectations of more rapid growth, it will lead to an abrupt increase in long-term rates.

10-Year Treasury Bond Rate

(fundamental based real after-tax rate, currently 1.7%, 5-yr avg. inflation plus tax premium)



STOCK PRICES

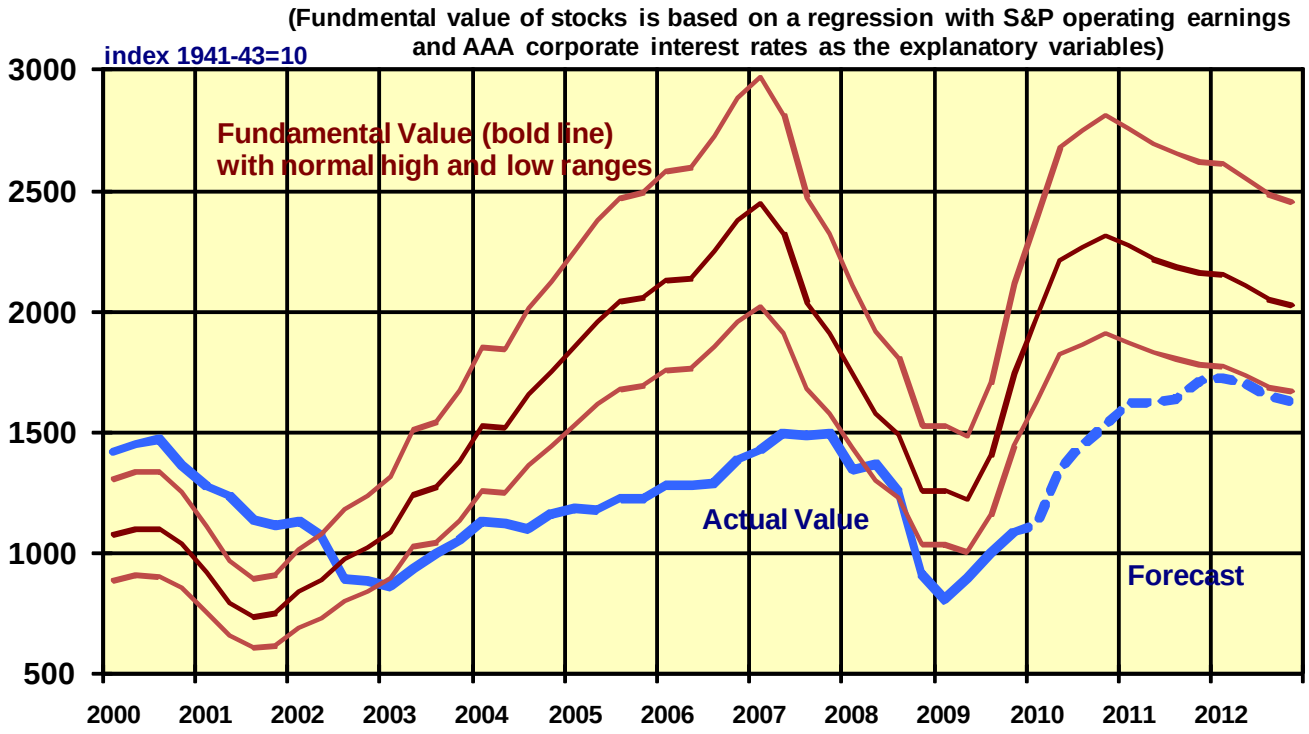
While fundamentals such as profits and interest rates remain favorable, there have recently been some disturbing trends with respect to the market's performance. These developments have led me to suggest a defensive position with respect to stocks.

I do not anticipate remaining defensive for very long. However, given the potential for the Fed to misjudge the amount of reserves in the system, it's conceivable that there could be more than a short-term dip in stock prices. The recent deterioration in technical indicators could be the first sign of an extended downturn.

While it's never possible to have a high degree of confidence in where the stock market is headed, my assessment of current conditions is that the risks of at least a mild downturn have increased.

Whatever the case, my intention is to watch both the market's technical performance along with the behavior of reserves to decide when to move back into the market. One of the deciding factors will be the extent to which the Fed is continues to provide sufficient liquidity to maintain a pick-up in spending. So long as it does, any weakness in the market is likely to be relative short-lived.

Stock Prices: S&P 500



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	Actual			Forecast					YEARS				
	2009 II	2009 III	2009 IV	2010 I	2010 II	2010 III	2010 IV	2011 I	2007	2008	2009	2010	2011
GROSS DOMESTIC PRODUCT	14151	14242	14463	14652	14937	15304	15672	16000	14078	14441	14259	15141	16389
%ch	-0.8	2.6	6.4	5.3	8.0	10.2	10.0	8.6	5.1	2.6	-1.3	6.2	8.2
REAL GDP	12902	12973	13155	13320	13545	13817	14066	14216	13254	13312	12989	13687	14274
%ch	-0.7	2.2	5.7	5.1	6.9	8.3	7.4	4.3	2.1	0.4	-2.4	5.4	4.3
CHAIN PRICE INDEX	1.097	1.098	1.099	1.100	1.103	1.108	1.115	1.127	1.062	1.085	1.098	1.107	1.150
%ch	0.0	0.4	0.6	0.2	1.0	1.9	2.6	4.3	2.9	2.1	1.2	0.8	3.9
CPI- ALL URBAN%ch	1.3	3.6	3.4	0.7	0.5	1.6	2.3	4.0	2.9	3.8	-0.3	1.8	3.7
FUND. INFLATION%ch	-1.0	-1.3	-1.3	-0.8	-0.5	0.4	1.1	2.8	3.1	2.3	-0.1	-1.0	2.1
PRETAX PROFITS	1337	1495	1481	1531	1599	1611	1611	1637	1774.4	1462.8	1389.9	1587.9	1644.2
%ch	32.4	56.3	-3.7	14.1	19.0	3.0	0.1	6.5	-2.7	-17.6	-5.0	14.2	3.5
PRETAX PROFITS ADJ (1)	1227	1359	1358	1401	1472	1483	1484	1509	1541.7	1360.4	1281.4	1460.0	1516.6
%ch	15.7	50.7	-0.4	13.4	22.0	2.8	0.4	6.9	-4.1	-11.8	-5.8	13.9	3.9
AFTER-TAX PROFITS	1031	1174	1171	1201	1249	1263	1264	1282	1323	1171	1088	1244	1288
%ch	24.5	68.0	-1.0	10.5	17.3	4.5	0.3	5.7	-2.0	-11.5	-7.0	14.4	3.5
AFTER-TAX PROFITS ADJ(1)	921	1038	1048	1071	1123	1135	1137	1154	1090.2	1068.2	979.7	1116.5	1160.2
%ch	3.6	61.6	3.9	9.1	20.9	4.4	0.6	6.2	-4.0	-2.0	-8.3	14.0	3.9
PERSONAL INCOME	12049	12084	12272	12432	12673	12985	13297	13575	11894	12239	12089	12847	13905
%ch	3.3	1.2	6.4	5.3	8.0	10.2	10.0	8.6	5.6	2.9	-1.2	6.3	8.2
REAL DISPOSABLE INCOME	10078	10042	10115	10229	10415	10631	10830	10954	9861	9911	10040	10526	11000
%ch	6.2	-1.4	2.9	4.6	7.4	8.6	7.7	4.6	2.2	0.5	1.3	4.8	4.5
PRODUCTIVITY	1.456	1.485	1.496	1.506	1.516	1.528	1.539	1.545	1.401	1.426	1.467	1.522	1.551
%ch	6.9	8.1	3.1	2.5	2.9	3.1	3.0	1.6	1.9	1.8	2.9	3.7	1.9
CIVILIAN EMPLOYMENT	140.5	139.3	138.1	138.0	138.0	138.3	138.8	139.1	146.0	145.4	139.9	138.3	138.5
%ch	-3.1	-3.2	-3.4	-0.5	0.0	1.0	1.5	0.7	1.1	-0.5	-3.8	-1.2	0.2
UNEMPLOYMENT RATE	9.3	9.6	10.0	10.2	9.9	9.1	8.3	8.3	4.6	5.8	9.3	9.4	8.5
INDUSTRIAL PRODUCTION	0.964	0.980	0.997	1.018	1.039	1.067	1.093	1.102	1.113	1.088	0.983	1.054	1.075
%ch	-10.2	7.0	7.0	8.7	8.5	11.5	9.7	3.4	1.5	-2.2	-9.7	7.3	2.0
LIGHT VEHICLE SALES (2)	9.6	11.5	10.9	11.8	12.7	12.9	12.9	12.7	16.2	13.2	10.4	12.6	12.8
Domestic	4.9	6.4	5.7	6.2	6.9	7.1	7.0	6.9	7.6	6.8	5.5	6.8	7.0
Imports	4.7	5.1	5.2	5.6	5.8	5.9	5.9	5.8	8.6	6.5	4.9	5.8	5.8

(1) Profits adjusted for capital consumption and inventory adjustment. 4th quarter 2009 profits are estimates.
(2) Millions at seasonally adjusted annual rates

2/1/2010

	Actual			Forecast					Years					
	2009	2009	2009	2010	2010	2010	2010	2011	2006	2007	2008	2009	2010	2011
Monetary Aggregates quarerly:	II	III	IV	I	II	III	IV	I						
M2 %ch at annual rates	2.7	1.6	3.0	4.0	7.0	7.0	6.0	6.0	5.3	6.3	7.1	7.3	4.1	6.3
Adj. Bank Reserves (billions of $)	1011	895	1140						95	94	233	967	1160	
less excess reserves at Fed	104	103	106	110	112	114	116	120	94	92	94	103	113	
Interest Rates:														
Baa Corp Bonds: Moody's	7.98	6.66	6.33	6.57	6.74	6.94	7.00	7.28	6.48	6.48	7.45	7.30	6.81	7.68
Aaa Corp Bonds: Moody's	5.51		5.20	5.47	5.49	5.74	5.85	6.13	5.59	5.56	5.64	5.31	5.64	6.53
MORTGAGE RATES	5.03	5.16	4.92	5.67	5.89	6.14	6.25	6.53	6.41	6.34	6.04	5.04	5.99	6.93
10-YR GOVT SECURITIES	3.31	3.52	3.46	3.67	3.89	4.14	4.25	4.53	4.79	4.63	3.67	3.26	3.99	4.93
5-YR GOVT SECURITIES	2.23	2.47	2.30	2.36	2.39	2.79	3.13	2.62	4.75	4.43	2.80	2.19	2.67	3.34
2-YR GOVT SECURITIES	1.01	1.03	0.87	1.65	1.90	2.05	2.40	1.10	4.82	4.36	2.00	0.96	2.00	1.85
3-MONTH T-BILL	0.18	0.17	0.07	0.15	0.25	0.45	0.74	1.24	4.72	4.41	1.46	0.16	0.40	1.99
FEDERAL FUNDS RATE	0.18	0.16	0.12	0.15	0.15	0.25	0.50	1.00	4.96	5.02	1.93	0.16	0.26	1.75
3-MONTH LIBOR RATE	0.85	0.41	0.27	0.65	0.50	0.60	0.85	1.35	5.19	5.30	2.91	0.69	0.65	2.10
BOND EQUIVALENT RATES:														
FEDERAL FUNDS	0.18	0.16	0.12	0.15	0.15	0.25	0.50	1.01	5.09	5.15	1.95	0.16	0.26	1.77
3-MONTH LIBOR	0.85	0.41	0.27	0.65	0.50	0.60	0.85	1.36	5.33	5.44	2.95	0.70	0.65	2.12
3-MONTH T-BILL	0.18	0.17	0.07	0.15	0.25	0.46	0.75	1.26	4.85	4.52	1.49	0.16	0.40	2.03
STOCKS:														
S&P 500	892	997	1089	1121	1346	1452	1530	1622	1311	1477	1221	947	1362	1647
S&P 500 quarterly reported earnings*	54.0	59.0	72.7	74.3	77.9	78.8	78.9	80.1	81.5	66.2	14.9	54.0	77.5	80.5
S&P 500 p/e on reported earnings**	16.5	16.9	15.0	15.1	17.3	18.4	19.4	20.2	16.1	26.5	17.7	18.8	17.5	20.5
S&P 500 quarterly operating earnings	55.2	63.1	73.5	82.2	92.3	92.9	87.7	92.6	87.7	82.5	49.5	58.1	88.8	93.2
S&P 500 p/e on operating earnings**	16.2	15.8	14.8	13.6	14.6	15.6	17.5	17.5	14.9	17.9	24.7	16.3	15.3	17.7
S&P 500 underlying earnings***	70.6	71.7	72.8	74.0	75.2	76.4	77.6	78.8	58.9	62.7	66.8	71.1	75.8	80.7
S&P 500 p/e on underlying earnings****	12.6	13.9	14.9	15.2	17.9	19.0	19.7	20.6	22.3	23.5	18.3	13.3	18.0	20.4

***annualized.**

****current quarterly stock price divided by annualized current quarter reported earnings. 4th 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)