Robert Genetski March 3, 2010

Monthly Economic and Financial Update

The pace of business activity continues to improve. Early trends show wages and salaries as well as real consumer spending increasing at roughly a 3% annual rate in January from their fourth quarter averages. This is above the 1%-2% rates of increase for these measures in the fourth quarter.

Fourth quarter real growth was at a strong 6% annual rate in spite of weak 1%-2% gains in wages and real consumer spending. One of the big contributors to the fourth quarter growth was a *change* in inventories amounting to $122 billion. Notably, inventories fell by $17 billion in the fourth quarter. Since this was less than the $139 billion drop the previous quarter, it counts as an addition to total output.

As real spending improves and wages increase, businesses will have to rebuild inventories. The combination of increases in real spending and wages combined with this rebuilding of inventories should produce fairly rapid rates of growth.

Evidence of a pickup in the pace of business activity is consistent with the delayed impact of the Federal Reserve's monetary policy. As noted in the next section, monetary policy this past year was expansive. Recent signs of an increase in spending reflect the lagged impact of that policy.

In terms of bank reserves, the Fed has maintained an expansive policy through January. This should be sufficient to boost the pace of spending going into this spring and summer.

Recent Fed statements indicate that they are likely to change their operating procedure. Instead of adjusting the fed funds rate, the Fed is considering operations based on the interest rate it pays banks for excess reserves (reserves banks keep at the Fed over and above what the Fed requires)

In January, the St. Louis Fed series on adjusted reserves was $1,159 billion. Although total reserves are ten times higher than they were two years ago, almost all of the increase is being held at the Fed in the form of excess reserves. Excess reserves were $1,046 billion in January. When banks hold excess reserves, the funds are not in the banking system and not being used for loans and investments or to boost the money supply.

Subtracting excess reserves from adjusted reserves provides a more useful measure of monetary policy. This measure shows that the Fed has increased bank reserves in the economy by roughly 8%-10% over the course of the past year. This increase was instrumental in providing the additional money that shifted the spending from declines a year ago to the recent 6% annual rate increases.

With reserves after allowance for excess reserves growing at 8%-10%, there are strong pressures for spending to accelerate to this vicinity. In the process, the additional money and spending should provide upward pressure on both stock prices and interest rates.

Monetary Indicators & the Monetary Process

The chart below shows the performance of adjusted bank reserves after allowance for excess reserves. The thin line shows monthly data, while the bold line shows a 6-month average.

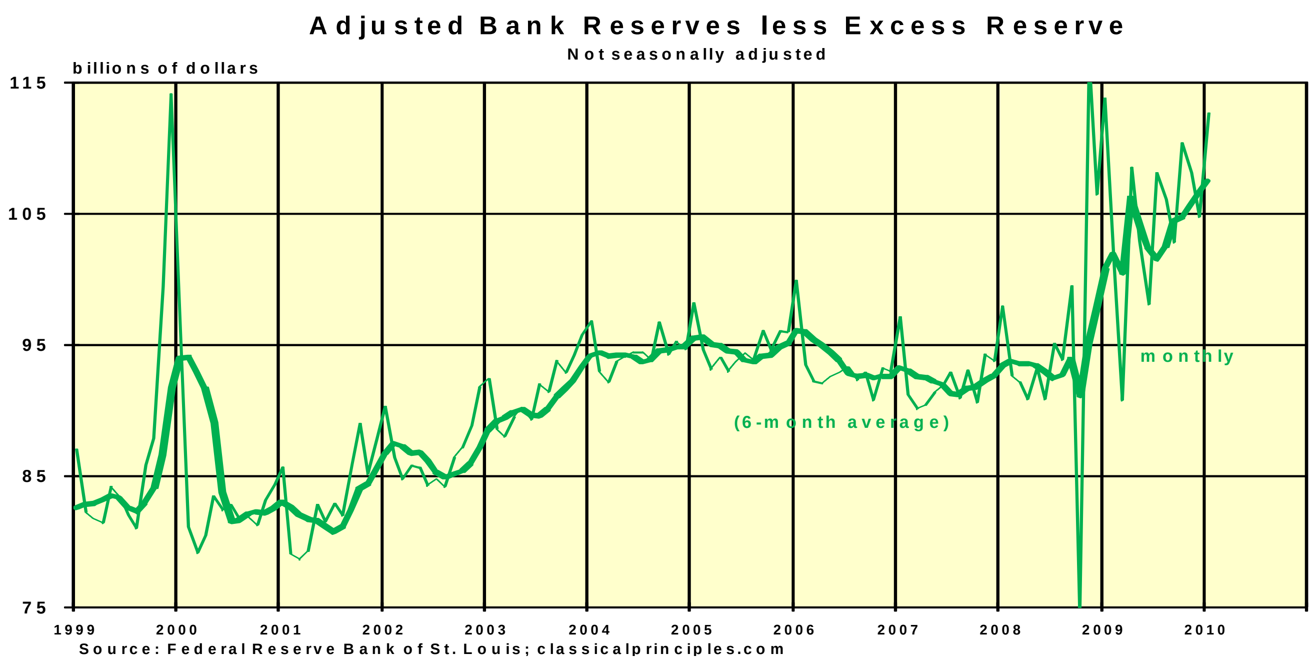
The data shown here are adjusted for changes in reserve requirements, but not for seasonal factors. When a series increases by tenfold, it makes no sense to apply seasonal factors generated from a much smaller series.

Due to the extreme monthly swings in this measure, it's helpful to view a 6-month average to determine the underlying trend. Amid extreme monthly volatility, the chart below shows that the trend has clearly been toward an increase in reserves that support loans and investments and boost the money supply.

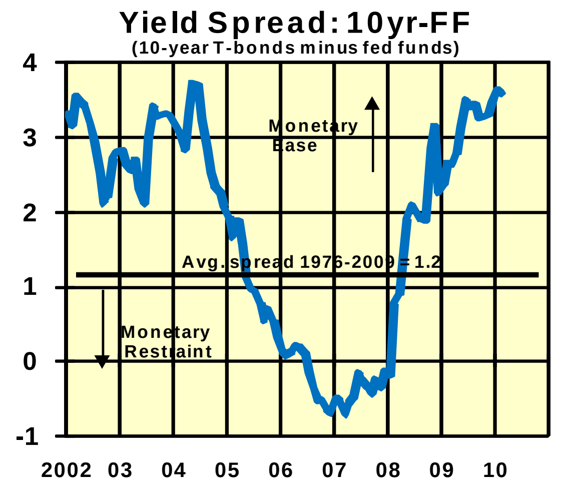
Most other monetary indicators confirm this ease in policy. Yield curves are wider than normal, which tends to signal a loose monetary policy. The widest spreads occur in the past two years as the Fed stopped reducing reserves and began increasing them.

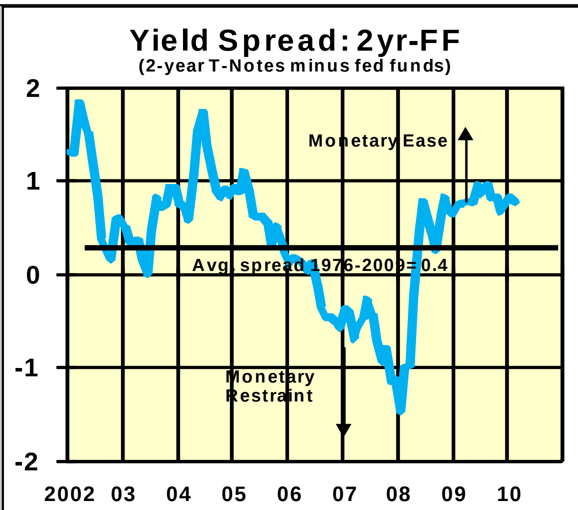
Other monetary measures are not as convincing. The popular M2 measure of money had been growing at an 8% rate, but has recently slowed to about a 2% year over year increase. Traditional money measures have been less reliable in gauging policy. This is likely due to the large number of institutional changes that have affected the financial system in recent years. Such changes alter consumers' preferences for holding different types of monetary assets.

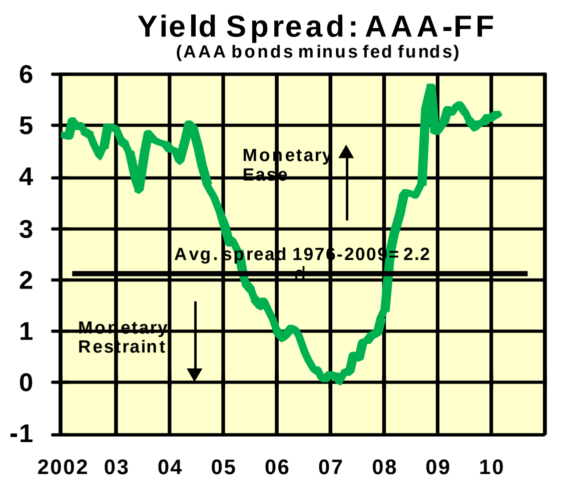
On balance, the evidence suggests that the Fed has been successful in reserving its highly restrictive policy. This reversal has led to a boost in spending. As the additional funds work their way through the economy, the pace of spending should continue to improve. This is the basis for forecasting a spending pace of 8%-10% later this year.

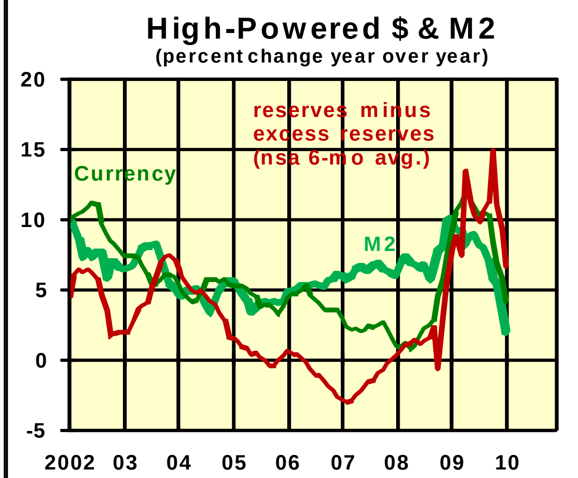


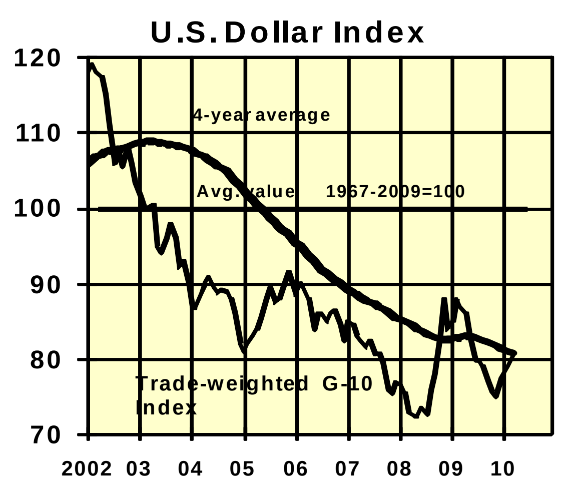
MONETARY INDICATORS

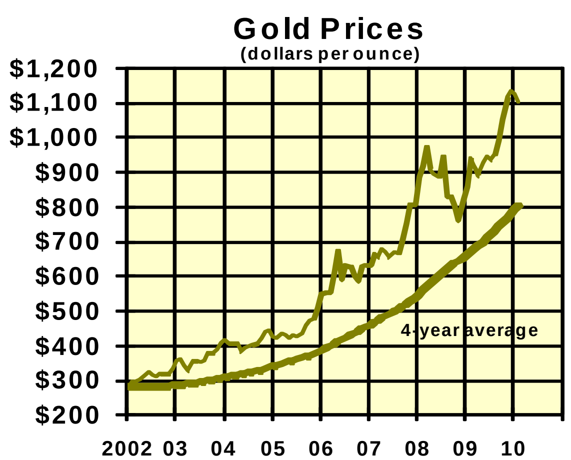










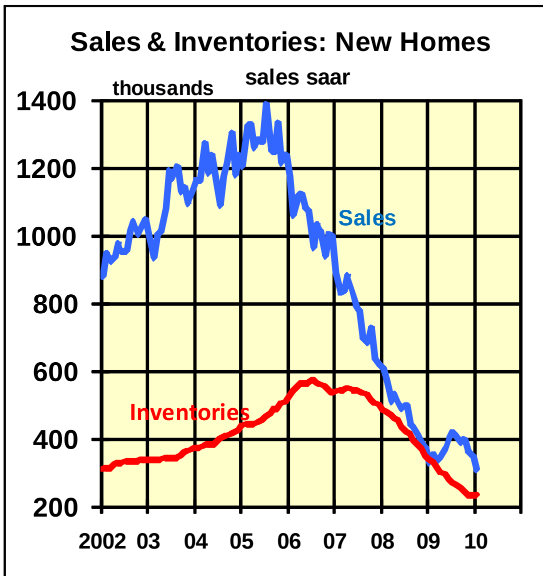


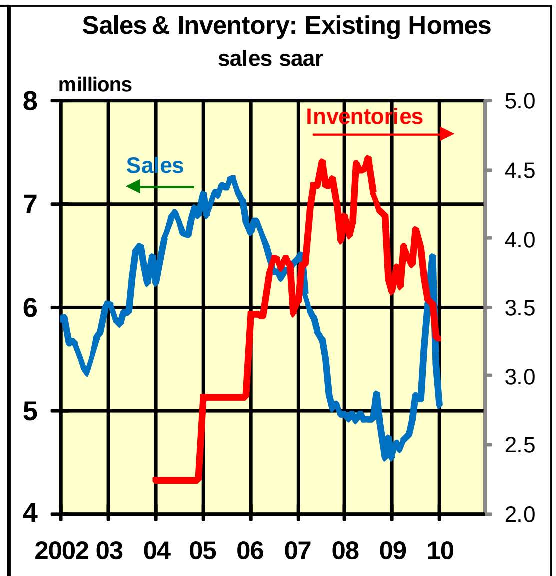
Sensitive Indicators

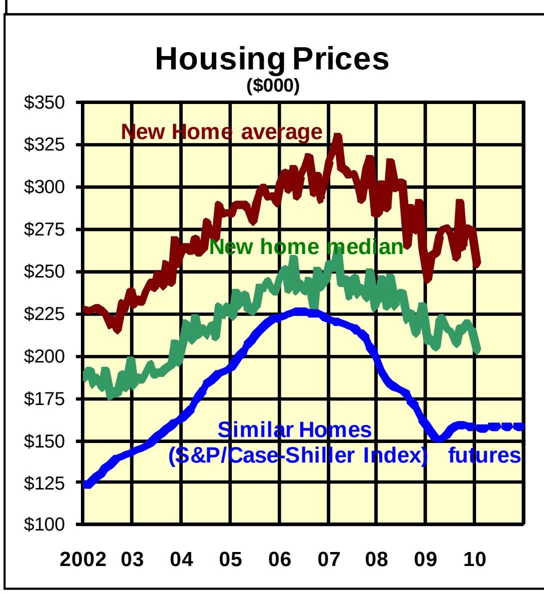
There are two encouraging developments regarding sensitive economic indicators. As the charts below show, home inventories have moved sharply lower. Inventories of existing homes fell to 3.2 million units at the end of January while inventories of new homes fell to the lowest level in almost 40 years.

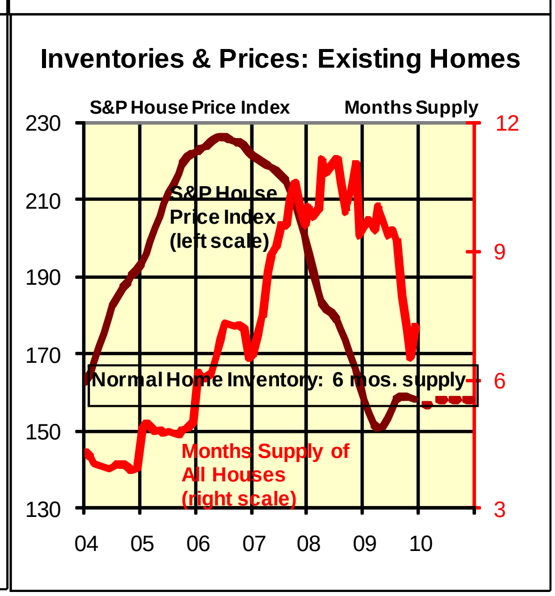
Another bright spot is new orders. The ISM surveys indicate that new orders for February remained strong. Orders for semiconductors are also rising rapidly.

While other indicators show more modest gains, by almost all indications business activity continue to improve. With the gains in money noted above, the odds are high that there will be further improvements in the period ahead.



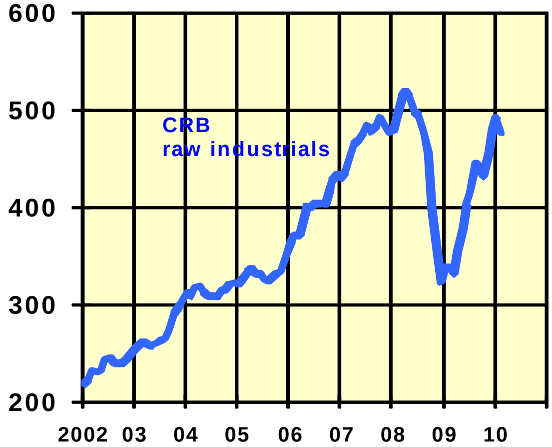






SENSITIVE INDICATORS

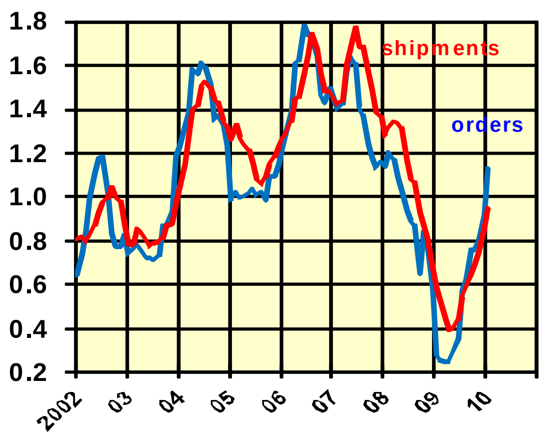
Raw Industrial Prices



Stock Prices

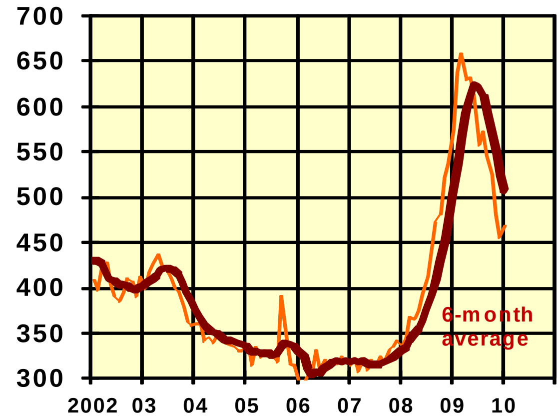
S&P 500

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



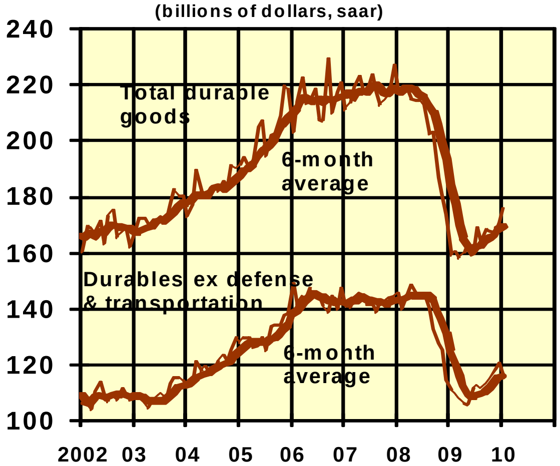
Unemployment Claims

(weekly claims)



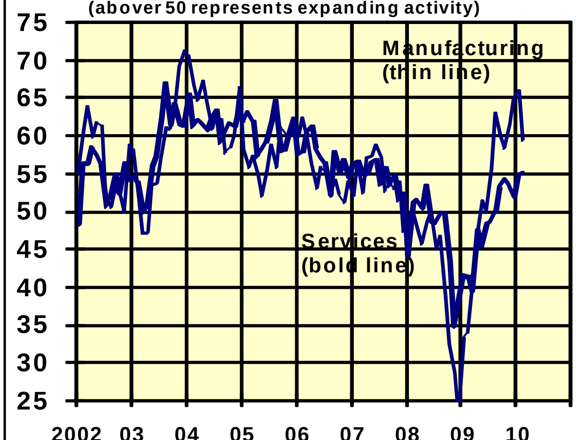
New Orders

(billions of dollars, saar)



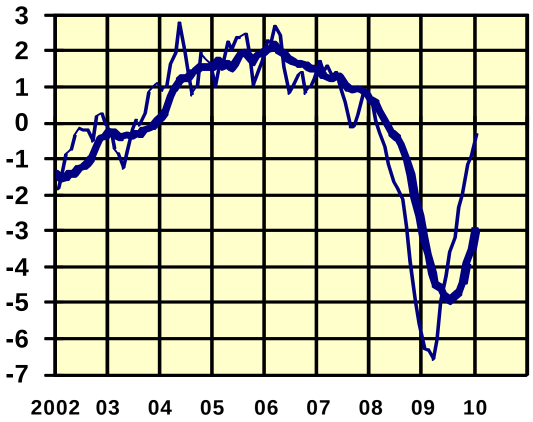
ISM: New Orders

(above 50 represents expanding activity)

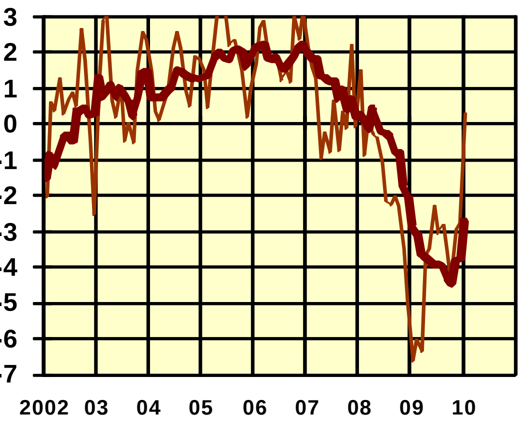


ECONOMIC INDICATORS

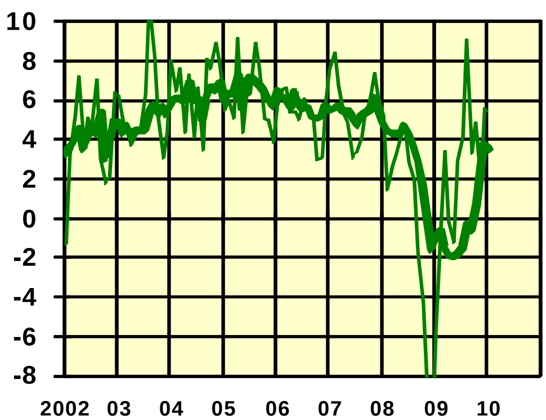
Jobs: Payroll Data
(annual rates of change--3 months & 1 year)



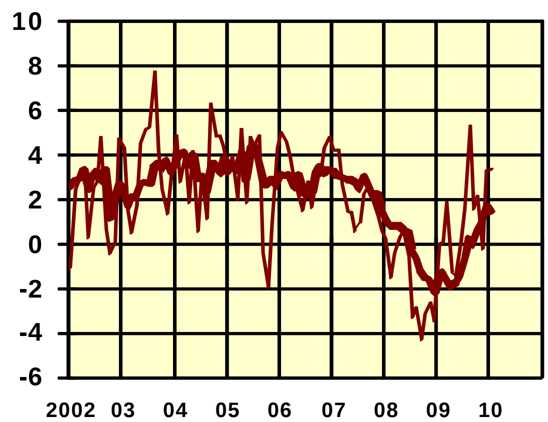
Jobs: Household Data
(annual rates of change--3 months & 1 year)



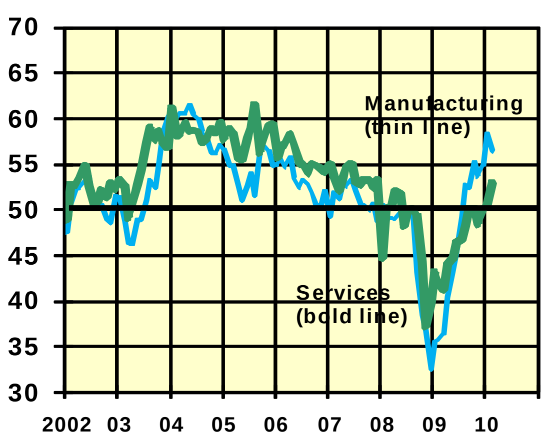
Consumer Spending
(annual rates of change-- 3 months & 1 year)



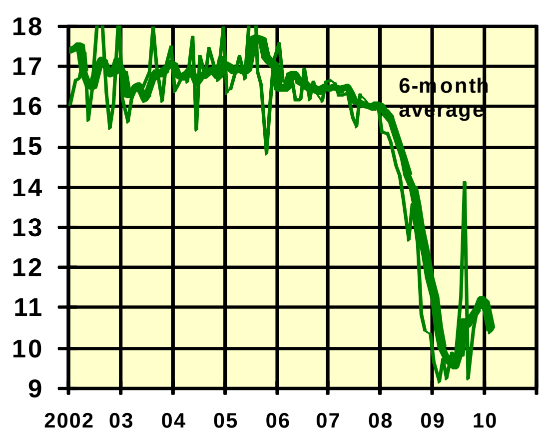
Real Consumer Spending
(annual rates of change-- 3 months & 1 year)



ISM: Composite
(over 50 represents expanding activity)



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



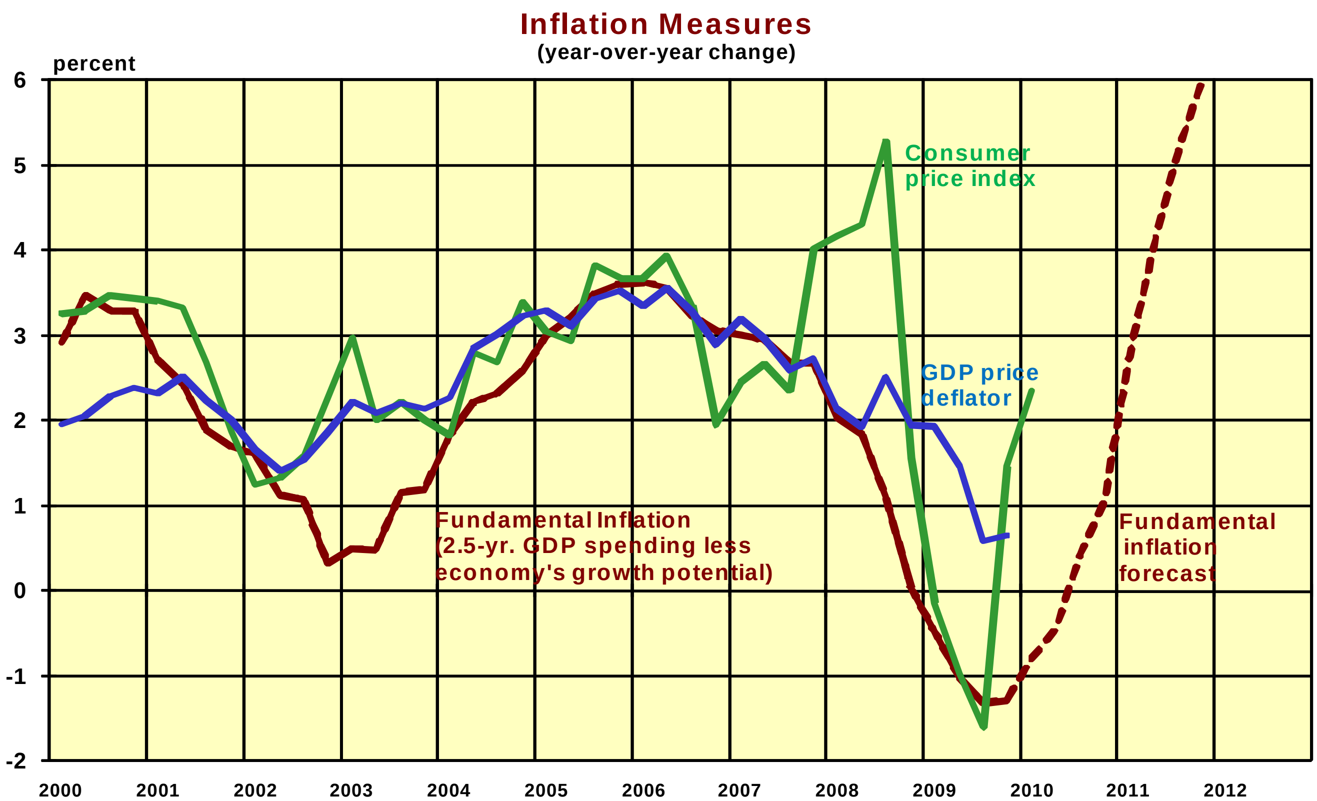
Inflation Indicators

Sharp changes in business activity can produce dramatic short-term changes in prices that mask 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.

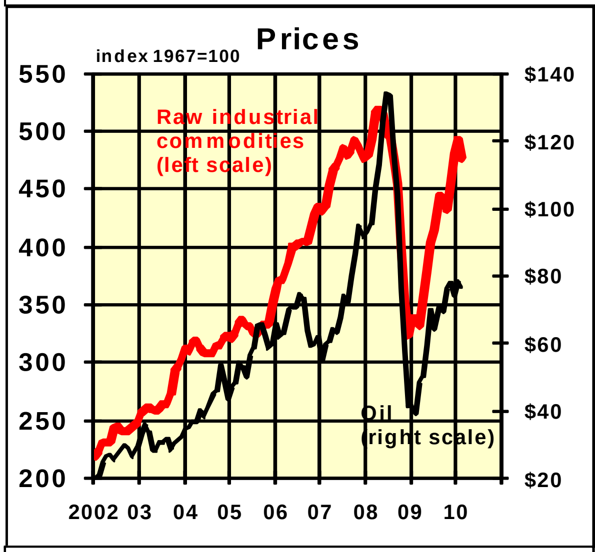
The country's *underlying* inflation is determined by the rate of spending over a 2-3 year period minus the economy's underlying growth rate. Over the past 2½ years current-dollar spending (GDP) has averaged roughly 1½% at an annual rate. Subtracting an underlying growth rate of roughly 2½% yields an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

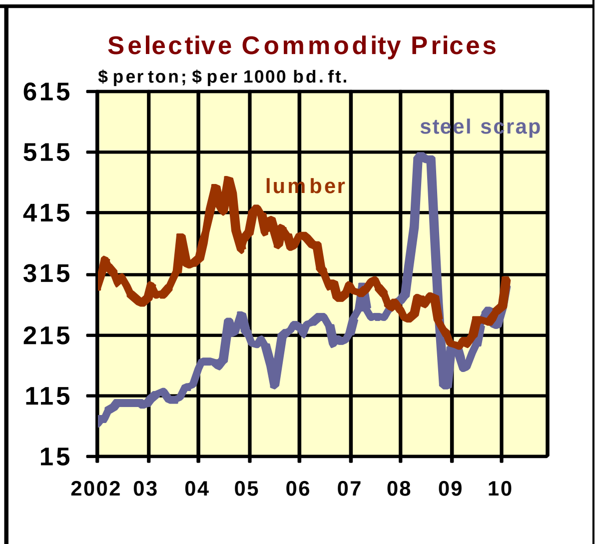
Given the weakness in spending over the past year, it will take another year for even a relatively sharp pick-up in spending to produce a significant increase in inflation.

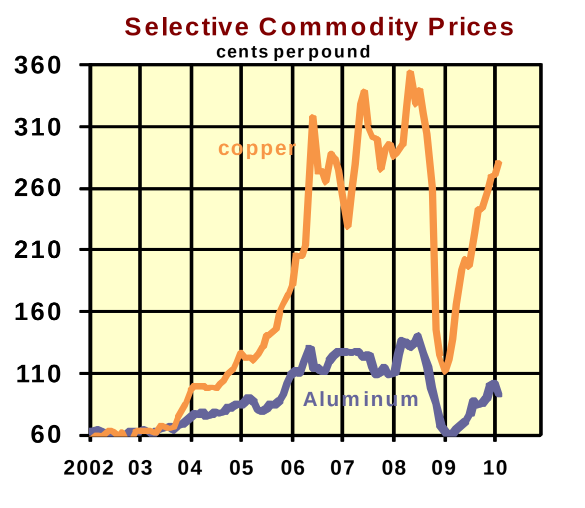
As the chart below shows, inflation tends to gravitate to the fundamental level dictated by spending and real growth. This suggests that the recent burst of price increases (shown in the charts on the following page) is temporary. Any sustained rise in inflation is likely to be at least a year away.

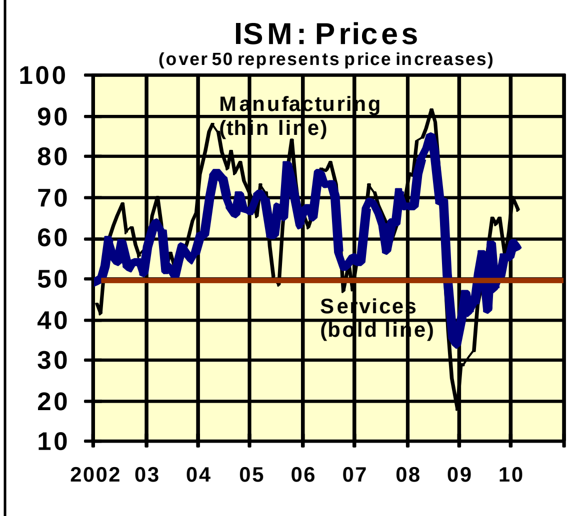


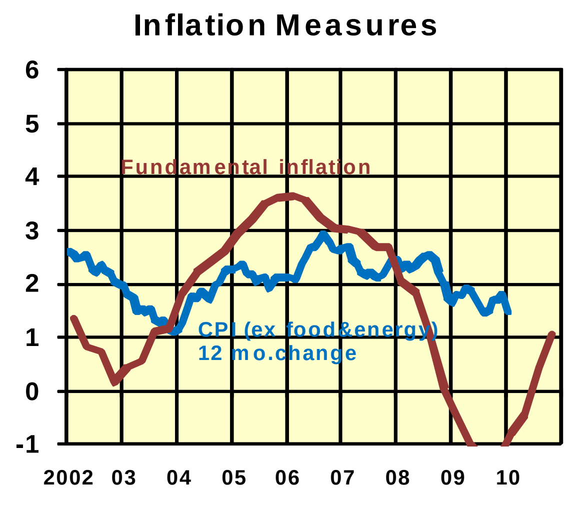
INFLATION INDICATORS

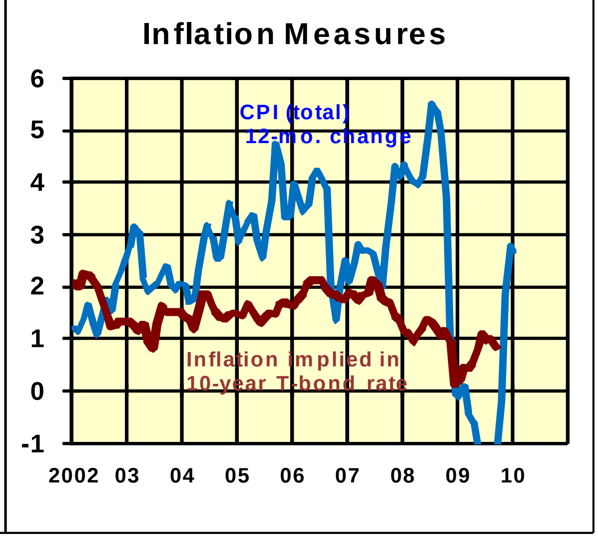












Interest Rates

A combination of high unemployment and relatively subdued inflation will put pressure on the Fed to pursue an expansive monetary policy. The Fed's operating procedure involves keeping short-term interest rates close to their current artificially low level.

Through January, the Fed has produced sufficient reserves to promote further increases in spending through late spring and early summer.

Even if the economy recovers at a relatively brisk pace, it's 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.

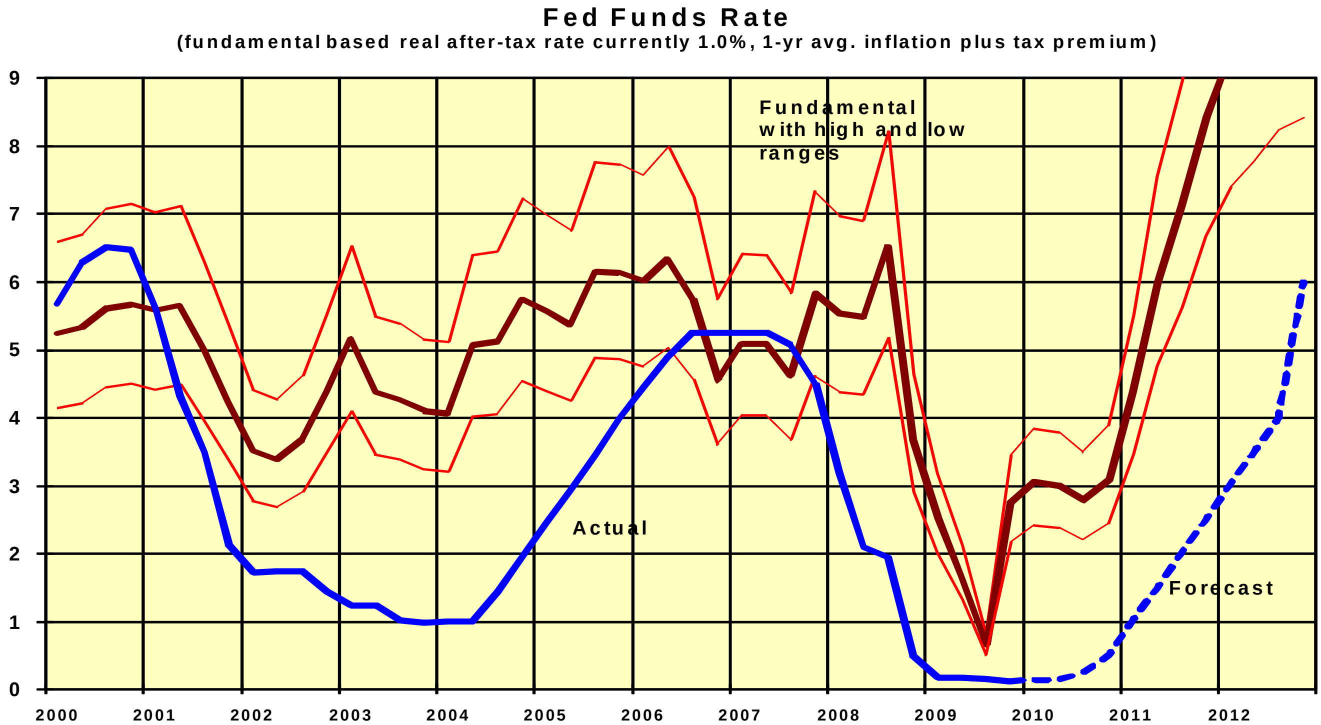
Under normal conditions, keeping short-term interest rates close to zero while spending increases rapidly would lead to a sharp increase in bank reserves.

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 available for loans and investments.

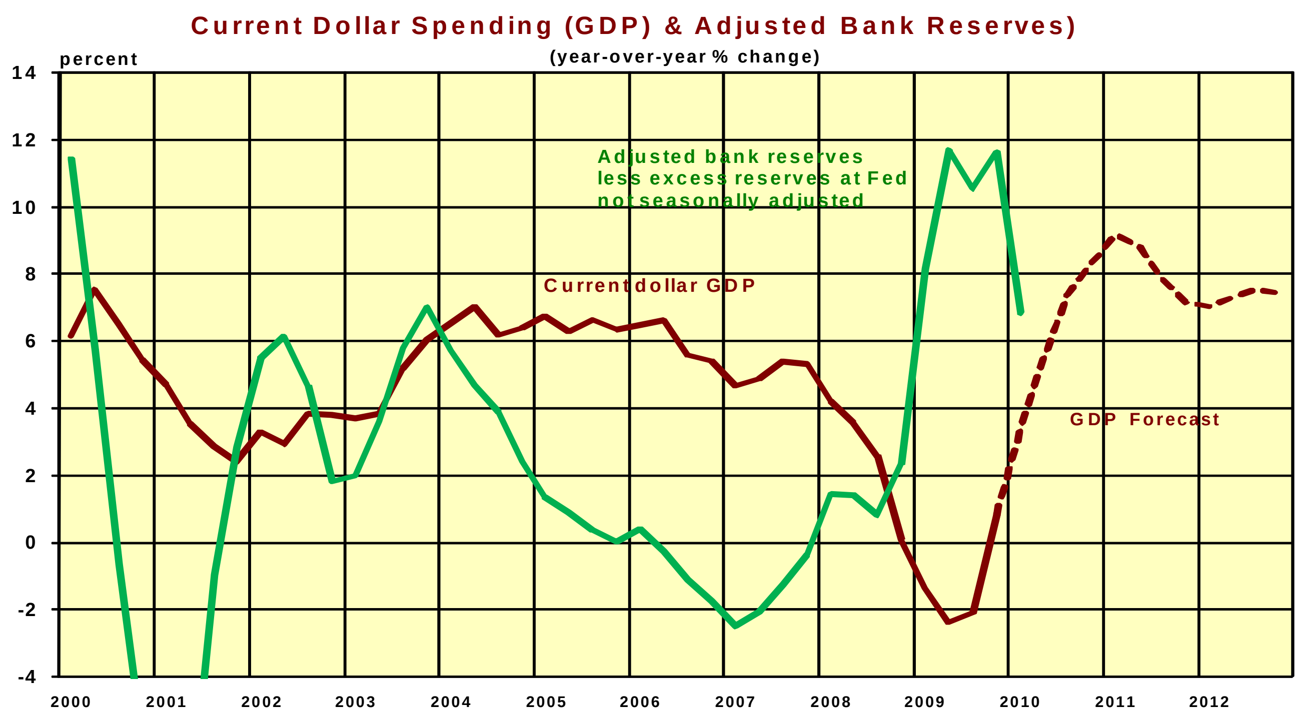
My current assumption is that the Fed will continue to increase the amount of bank reserves over and above the level of excess reserves by somewhere between 6%-10% in the year ahead. As spending picks up, short-term interest rates would naturally rise at the same time. However, political pressure will make it difficult for the Fed to raise rates quickly enough to prevent a highly expansive policy.

My assumption is that monetary policy will remain sufficiently expansive to lead to progressively more rapid spending late this year and into next.

There is one caveat. The extreme monthly volatility in both bank reserves and excess reserves can lead to unintended changes in liquidity. Such changes can 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
0
1
2
3
4
5
6
7
8
9
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012



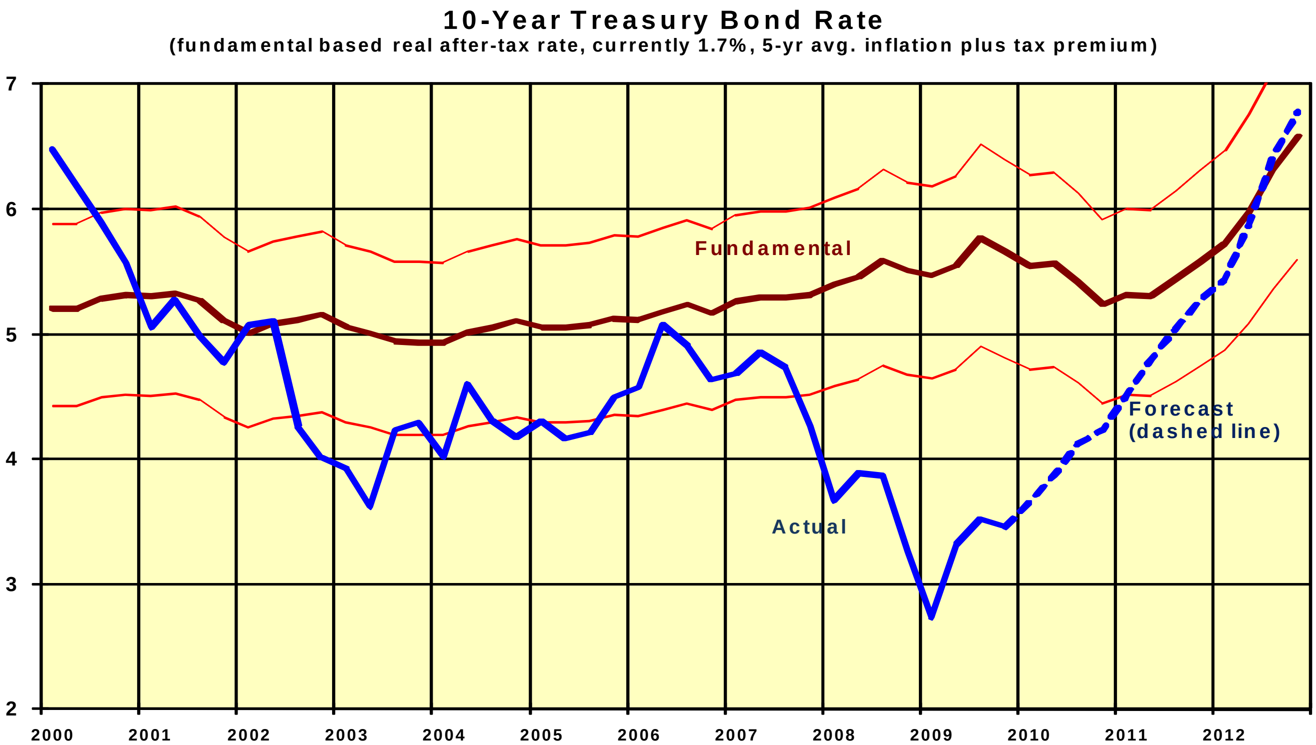
Current Dollar Spending (GDP) & Adjusted Bank Reserves)
percent
(year-over-year % change)
Adjusted bank reserves
less excess reserves at Fed
not seasonally adjusted
Current dollar GDP
GDP Forecast
14
12
10
8
6
4
2
0
-2
-4
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

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. .

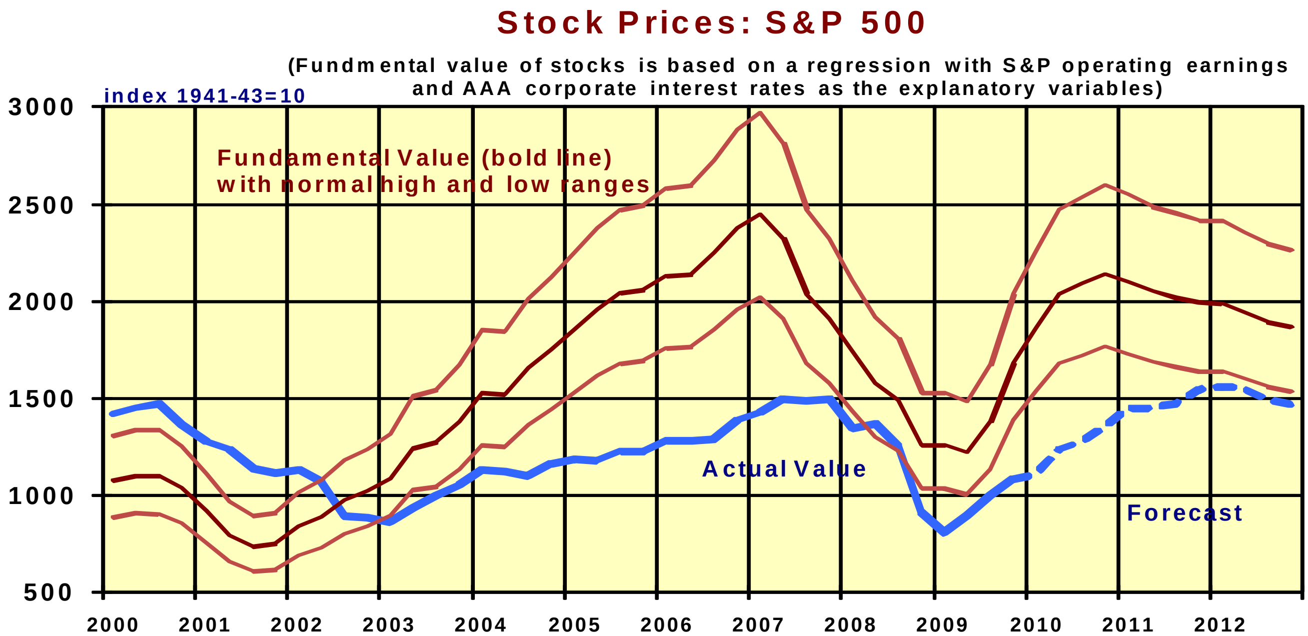
However, so long as monetary policy remains expansive, the odds favor a further pick-up in the rate of growth. Once the consensus shifts to expectations of more rapid growth, it should lead to a significant, abrupt increase in long-term rates.

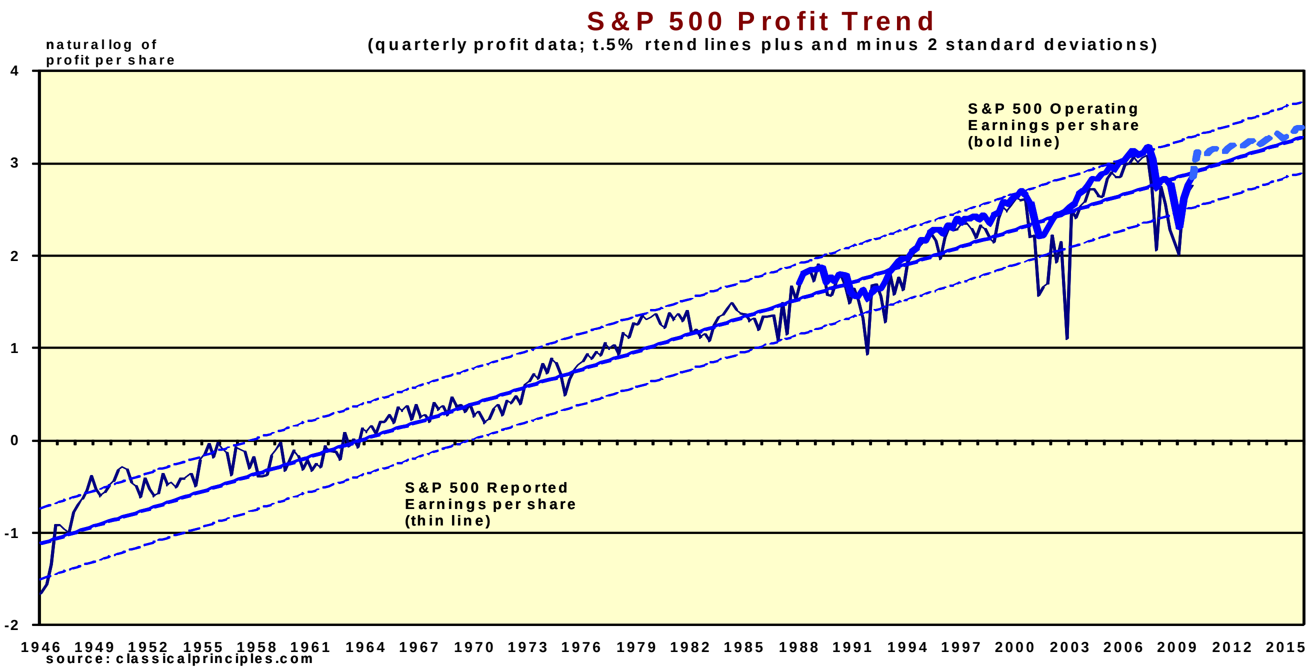


STOCK PRICES

Fundamentals such as profits and interest rates remain favorable for stocks. In addition, monetary policy has remained expansive through January. The combination of an expansive monetary policy, increasing profits and low interest rates bodes well for further increases in stock prices.

If, as I suspect, the economy continues to improve during the spring and summer, it should help to restore confidence in the market. In addition, the recent improvement in technical indicators confirms the likelihood of further upward momentum.





3/1/2010

	Actual			Forecast					YEARS				
	2009 II	2009 III	2009 IV	2010 I	2010 II	2010 III	2010 IV	2011 I	2008	2009	2010	2011	2012
GROSS DOMESTIC PRODUCT	14151	14242	14462	14648	14930	15298	15665	15988	14441	14258	15135	16381	17579
%ch	-0.8	2.6	6.3	5.3	7.9	10.2	9.9	8.5	2.6	-1.3	6.2	8.2	7.3
REAL GDP	12902	12973	13161	13324	13548	13821	14070	14217	13312	12990	13691	14280	14437
%ch	-0.7	2.2	5.9	5.1	6.9	8.3	7.4	4.3	0.4	-2.4	5.4	4.3	1.1
CHAIN PRICE INDEX	1.097	1.098	1.099	1.099	1.102	1.107	1.114	1.126	1.085	1.097	1.106	1.149	1.220
%ch	0.0	0.4	0.4	0.2	1.0	1.9	2.5	4.3	2.1	1.2	0.8	3.9	6.2
CPI- ALL URBAN%ch	1.9	3.7	2.6	1.2	0.5	1.6	2.2	4.0	3.8	-0.3	1.8	3.7	6.4
FUND. INFLATION%ch	-1.0	-1.3	-1.3	-0.8	-0.5	0.4	1.0	2.8	2.3	-0.1	-1.0	2.1	6.1
PRETAX PROFITS	1337	1495	1481	1530	1598	1610	1611	1636	1462.8	1389.9	1587.4	1643.4	1742.5
%ch	32.4	56.3	-3.7	14.1	19.0	3.0	0.1	6.4	-17.6	-5.0	14.2	3.5	6.0
PRETAX PROFITS ADJ (1)	1227	1359	1358	1401	1472	1482	1483	1508	1360.4	1281.4	1459.4	1515.8	1614.9
%ch	15.7	50.7	-0.4	13.3	21.9	2.8	0.3	6.8	-11.8	-5.8	13.9	3.9	6.5
AFTER-TAX PROFITS	1031	1174	1171	1200	1249	1263	1264	1281	1171	1088	1244	1287	1363
%ch	24.5	68.0	-1.0	10.4	17.2	4.5	0.3	5.6	-11.5	-7.0	14.3	3.5	5.9
AFTER-TAX PROFITS ADJ(1)	921	1038	1048	1071	1123	1135	1136	1153	1068.2	979.6	1116.0	1159.6	1235.6
%ch	3.6	61.6	3.8	9.1	20.8	4.4	0.6	6.0	-2.0	-8.3	13.9	3.9	6.6
PERSONAL INCOME	12049	12005	12190	12348	12585	12895	13204	13477	12239	12049	12758	13808	14818
%ch	3.3	-1.4	6.3	5.3	7.9	10.2	9.9	8.5	2.9	-1.5	5.9	8.2	7.3
REAL DISPOSABLE INCOME	10078	9984	10075	10176	10359	10575	10773	10893	9911	10016	10471	10943	11039
%ch	6.2	-3.6	3.7	4.1	7.4	8.6	7.7	4.6	0.5	1.1	4.5	4.5	0.9
PRODUCTIVITY	1.456	1.482	1.493	1.502	1.513	1.525	1.536	1.542	1.426	1.466	1.519	1.548	1.564
%ch	6.9	7.2	3.1	2.5	2.9	3.1	3.0	1.6	1.8	2.8	3.6	1.9	1.0
CIVILIAN EMPLOYMENT	140.5	139.3	138.1	138.0	138.0	138.3	138.8	139.1	145.4	139.9	138.3	138.5	140.2
%ch	-3.1	-3.2	-3.4	-0.5	0.0	1.0	1.5	0.7	-0.5	-3.8	-1.2	0.2	1.2
UNEMPLOYMENT RATE	9.3	9.6	10.0	10.2	9.9	9.1	8.3	8.3	5.8	9.3	9.4	8.5	8.9
INDUSTRIAL PRODUCTION	0.964	0.979	0.995	1.016	1.036	1.065	1.090	1.098	1.088	0.982	1.052	1.072	1.050
%ch	-10.2	6.4	6.7	8.6	8.4	11.5	9.7	3.3	-2.2	-9.7	7.1	2.0	-2.0
LIGHT VEHICLE SALES (2)	9.6	11.5	10.9	11.8	12.7	12.9	12.9	12.7	13.2	10.4	12.6	12.8	12.6
Domestic	4.9	6.4	5.7	6.2	6.9	7.1	7.0	6.9	6.8	5.5	6.8	7.0	6.8
Imports	4.7	5.1	5.2	5.6	5.8	5.9	5.9	5.8	6.5	4.9	5.8	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

3/1/2010

	Actual			Forecast					Years					
	2009	2009	2009	2010	2010	2010	2010	2011	2007	2008	2009	2010	2011	2012
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	6.3	7.1	7.3	4.1	6.3	7.0
Adj. Bank Reserves (billions of $)	1011	895	1140						94	233	967	1160		
less excess reserves at Fed	104	103	106	108	112	114	116	120	92	94	103	113		
Interest Rates:														
Baa Corp Bonds: Moody's	7.98	6.66	6.33	6.55	6.72	6.92	6.98	7.26	6.48	7.45	7.30	6.79	7.65	8.87
Aaa Corp Bonds: Moody's	5.51	5.27	5.20	5.45	5.47	5.72	5.83	6.11	5.56	5.64	5.31	5.62	6.50	7.72
MORTGAGE RATES	5.03	5.16	4.92	5.65	5.87	6.12	6.23	6.51	6.34	6.04	5.04	5.97	6.90	8.12
10-YR GOVT SECURITIES	3.31	3.52	3.46	3.65	3.87	4.12	4.23	4.51	4.63	3.67	3.26	3.97	4.90	6.12
5-YR GOVT SECURITIES	2.23	2.47	2.30	1.97	1.93	2.38	2.71	3.13	4.43	2.80	2.19	2.25	3.87	5.72
2-YR GOVT SECURITIES	1.01	1.03	0.87	0.90	1.00	1.25	1.60	2.15	4.36	2.00	0.96	1.19	2.94	5.33
3-MONTH T-BILL	0.18	0.17	0.07	0.15	0.25	0.45	0.74	1.24	4.41	1.46	0.16	0.40	1.99	4.37
FEDERAL FUNDS RATE	0.18	0.16	0.12	0.15	0.15	0.25	0.50	1.00	5.02	1.93	0.16	0.26	1.75	4.13
3-MONTH LIBOR RATE	0.85	0.41	0.27	0.65	0.50	0.60	0.85	1.35	5.30	2.91	0.69	0.65	2.10	4.48
BOND EQUIVALENT RATES:														
FEDERAL FUNDS	0.18	0.16	0.12	0.15	0.15	0.25	0.50	1.01	5.15	1.95	0.16	0.26	1.77	4.22
3-MONTH LIBOR	0.85	0.41	0.27	0.65	0.50	0.60	0.85	1.36	5.44	2.95	0.70	0.65	2.12	4.58
3-MONTH T-BILL	0.18	0.17	0.07	0.15	0.25	0.46	0.75	1.26	4.52	1.49	0.16	0.40	2.03	4.48
STOCKS:														
S&P 500	892	997	1089	1110	1234	1279	1355	1449	1477	1221	947	1245	1479	1515
S&P 500 quarterly reported earnings*	54.0	59.0	63.0	64.4	67.5	68.3	68.4	69.4	66.2	14.9	51.6	67.2	69.8	74.3
S&P 500 p/e on reported earnings**	16.5	16.9	17.3	17.2	18.3	18.7	19.8	20.9	26.5	17.7	19.4	18.5	21.2	20.4
S&P 500 quarterly operating earnings	55.2	63.1	69.0	77.0	85.9	85.9	82.8	86.9	82.5	49.5	57.0	82.9	87.1	90.8
S&P 500 p/e on operating earnings**	16.2	15.8	15.8	14.4	14.4	14.9	16.4	16.7	17.9	24.7	16.6	15.0	17.0	16.7
S&P 500 underlying earnings***	70.6	71.7	72.8	74.0	75.2	76.4	77.6	78.8	62.7	66.8	71.1	75.8	80.7	85.9
S&P 500 p/e on underlying earnings***	12.6	13.9	14.9	15.0	16.4	16.8	17.5	18.4	23.5	18.3	13.3	16.4	18.3	17.6

*annualized.

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

***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)