Robert Genetski April 6, 2010

Monthly Economic and Financial Update

Recent developments suggest that the pace of business activity continues to improve. Economic data for March show significant gains in many areas.

The most encouraging news is in the area of new orders. The ISM surveys for both manufacturing and service companies show a sharp increase in new orders. This indicates that the improvement in the pace of activity will continue in the months ahead.

The improvement in the economy follows the shift in Fed policy. After several years of monetary restraint, the Fed shifted to an expansive policy somewhere between late 2008 and early last year.

There is a typical 6-9 month lag between a shift in monetary policy and a pickup in spending. The pickup in spending began right on schedule last summer when the economic downturn came to an end.

There is a great deal of confusion over the current state of Fed policy. Some believe that the increase in bank reserves of over a trillion dollars has flooded the system with new money. However, since excess reserves have also increased by over a trillion dollars, the amount of bank reserves being used to boost the money supply is far less than the numbers on bank reserves would suggest.

My estimates indicate that even after allowing for excess reserves, the Fed has increased the raw ingredients of money sufficiently to boost spending and produce a fairly brisk recovery.

For the six months ending in February my analysis suggests that Fed policy has become even more expansive. (See the section on monetary indicators on the next page.) As a result, the pace of spending should continue to improve well into the summer months.

The latest economic developments are consistent with this analysis. As the pace of business continues to improve, the Fed will want to begin reigning in its expansive policy.

The Fed's operating procedure involves raising short-term interest rate. Given the likelihood of a strong pace of spending, it normally would take a sharp increase in interest rates to slow the growth in money. Given political pressures, it's unlikely that the Fed will be able to raise rates rapidly enough to accomplish this task.

Although there are caveats, at this point it appears likely that a strong increase in spending will carry over into 2011.

While the increases in spending will be a welcome relief to the recent decreases, problems remain. Upcoming tax increases along with other significant moves away from classical economic principles will take their toll.

Following a brisk recovery later this year, the economy is likely to experience renewed inflationary pressures and a sharp increase in interest rates in 2011 and beyond.

Monetary Indicators & the Monetary Process

Monetary indicators were little changed this past month. They continue to point to an expansive policy that should continue to lift the pace of spending well into the summer months.

The single best indicator of Fed policy is adjusted bank reserves less excess reserves. Adjusted reserves represent the raw ingredients of the money supply and represent the first step in the process of creating money. Recent developments confirm that it's best to look at the not seasonally adjusted numbers, which are shown in the chart below.

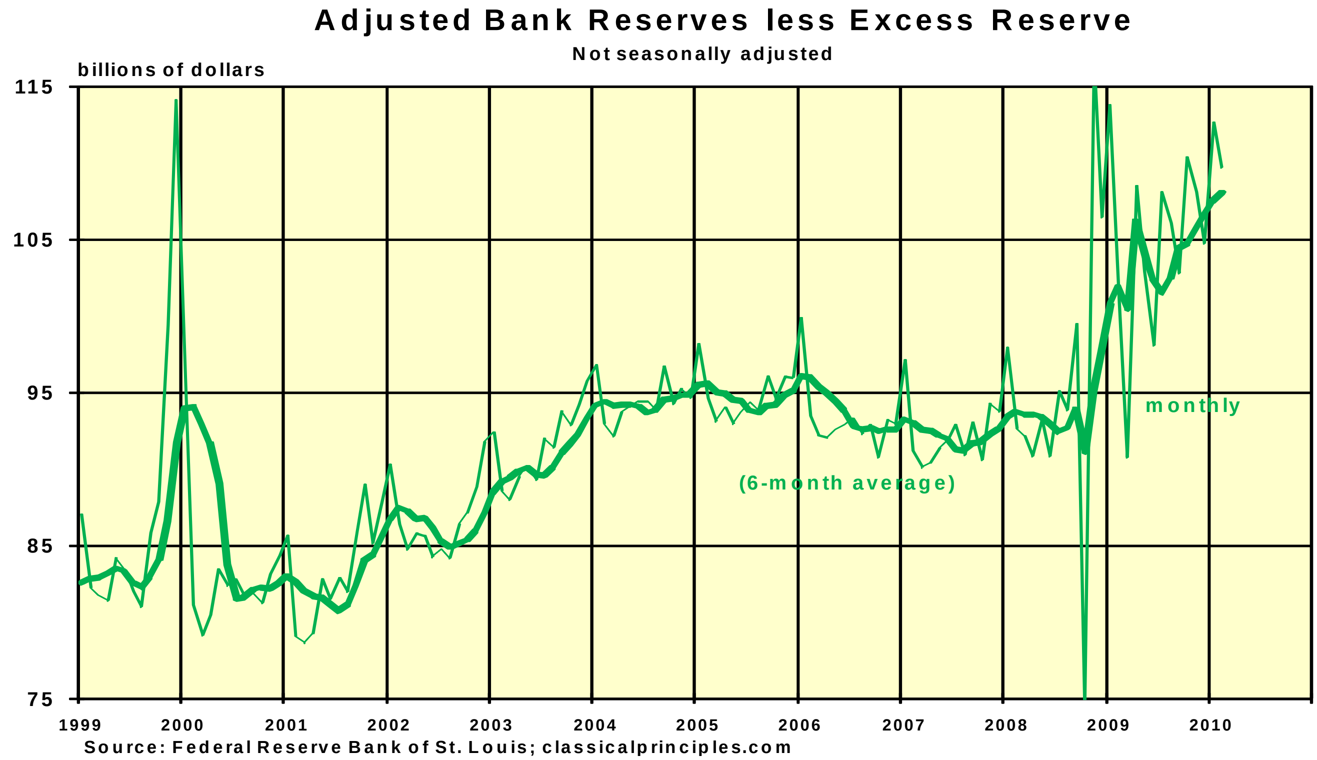
Volatile monthly moves also suggest that it's best to look at the 6-month moving average to determine the underlying trend. Through February, this smoothed trend is up 6% over the past year, but up at an 11% annual rate over the last six months.

Most other monetary indicators confirm this ease in policy. Yield curves are wider than normal, which tends to signal a loose monetary policy.

More traditional monetary aggregates point to a slowdown in monetary growth over the past year. Currency and the M2 measure of money have slowed to only about a 2% growth rate for both the past year and the past six months.

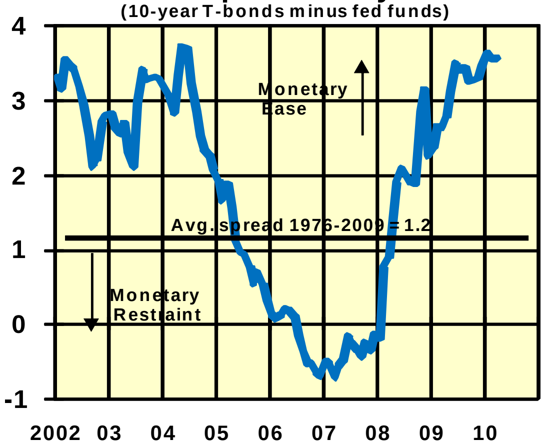
Traditional money measures can be a less reliable in gauging policy at times like the present when there are a large number of institutional changes occurring. My judgment is that the latest trends in the traditional money measures are more indicative of institutional changes than the thrust of the Fed's current policy.

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.

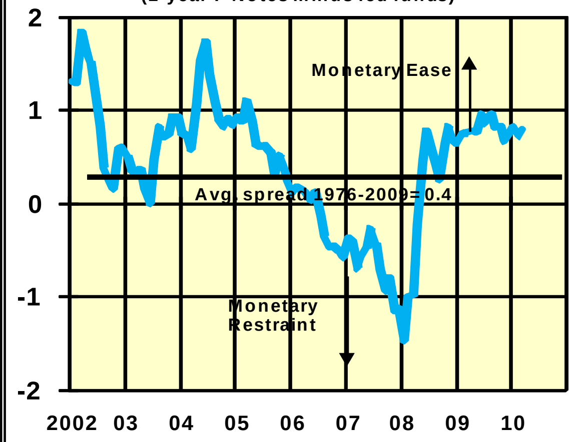


MONETARY INDICATORS

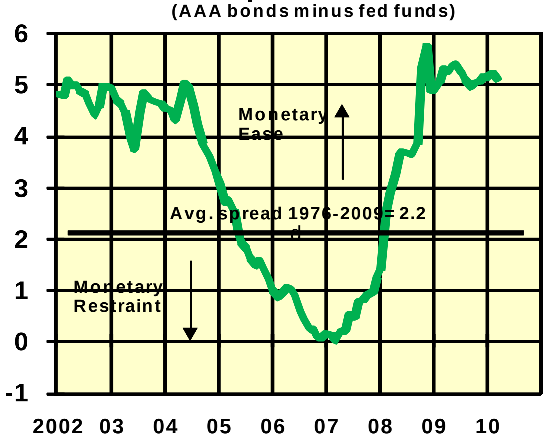
Yield Spread: 10yr-FF
(10-year T-bonds minus fed funds)



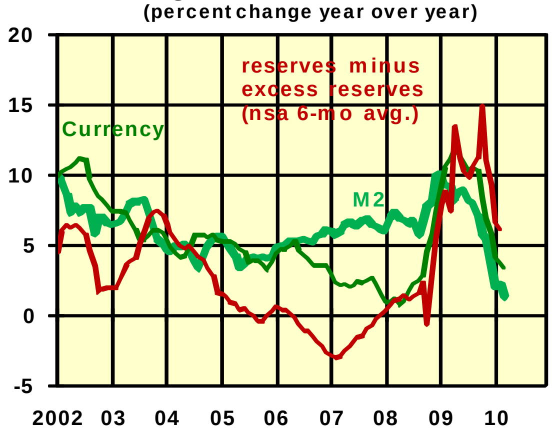
Yield Spread: 2yr-FF
(2-year T-Notes minus fed funds)



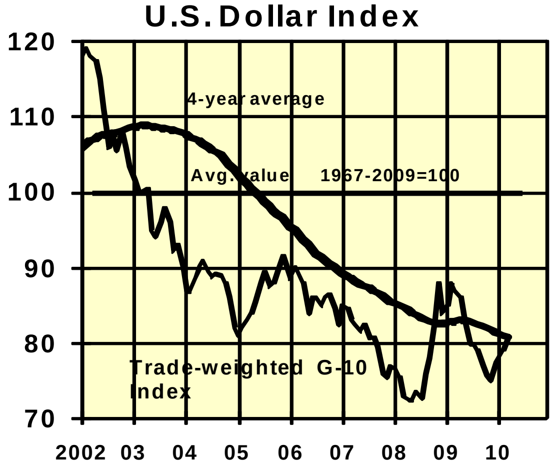
Yield Spread: AAA-FF
(AAA bonds minus fed funds)



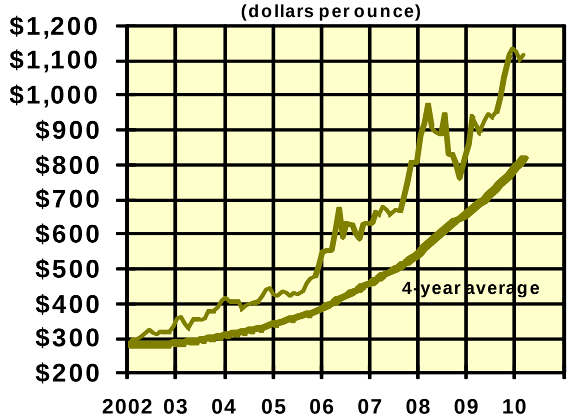
High-Powered $ & M2
(percent change year over year)



U.S. Dollar Index



Gold Prices
(dollars per ounce)

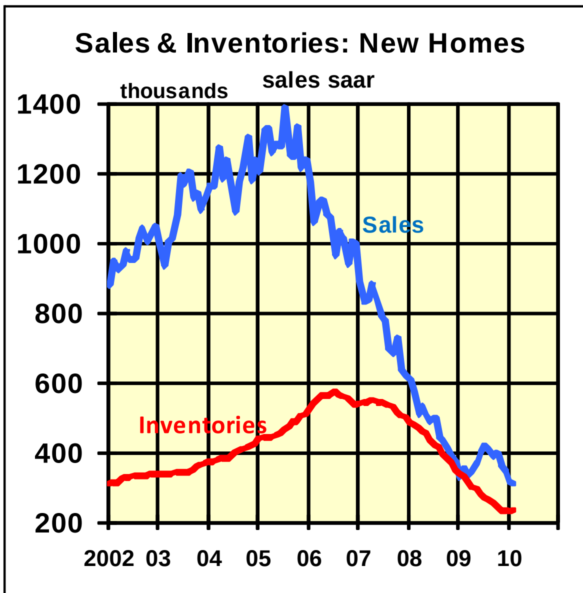


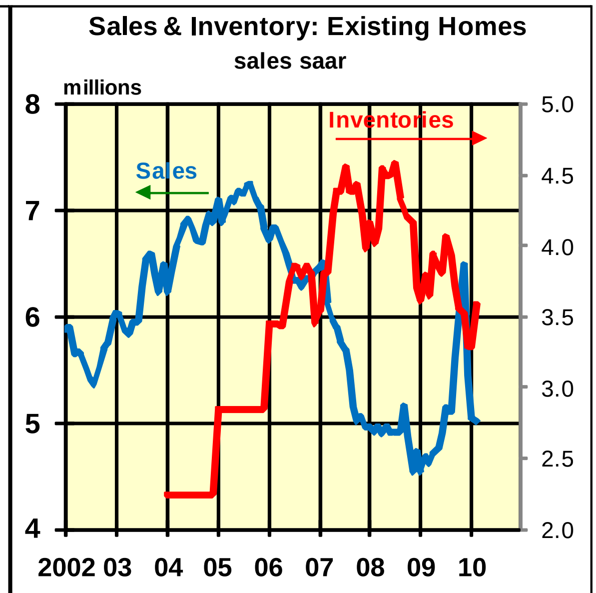
Sensitive Indicators

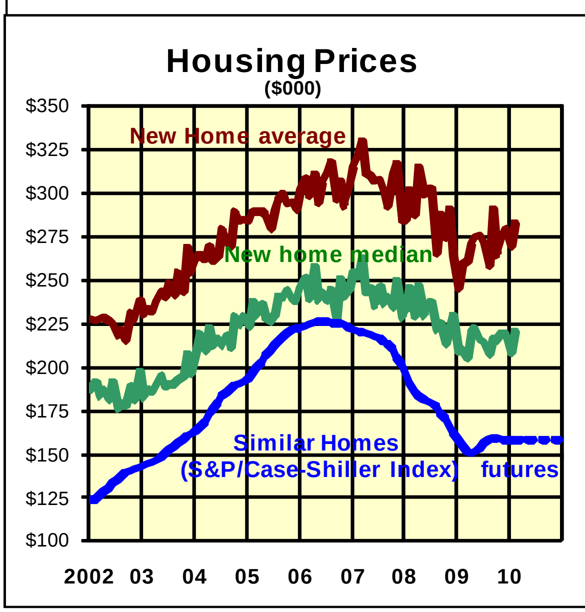
Sensitive economic indicators also continue to improve. While housing activity remains depressed, there has been substantial progress in reducing inventories. Once sales begin to improve, housing prices will again increase.

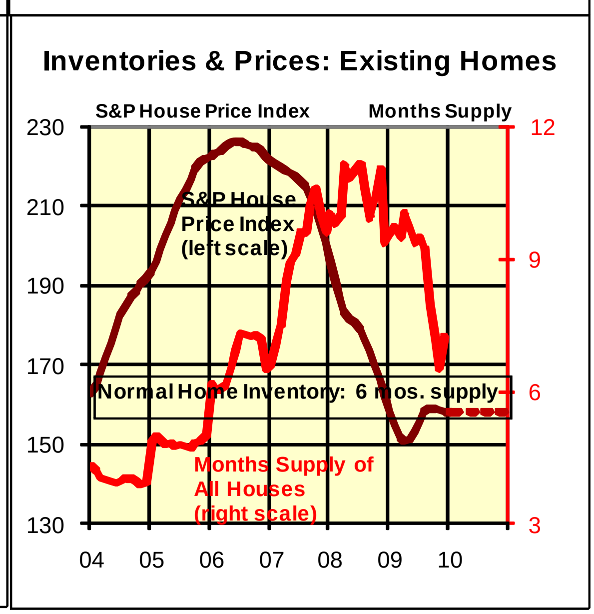
New orders are rising. The ISM surveys for early March point to strong new order activity. In addition, new orders for semiconductors are the highest in over two years. The new order performance is consistent with a further pickup in the pace of business activity in the months ahead.

Coincident indicators registered significant improvement in March as the ISM surveys, vehicle sales and employment data all moved sharply higher.



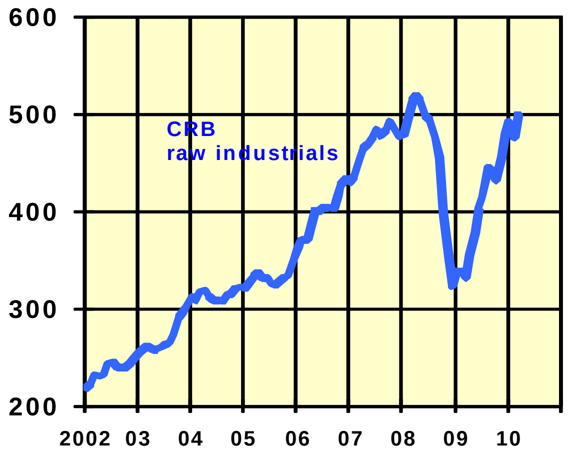






SENSITIVE INDICATORS

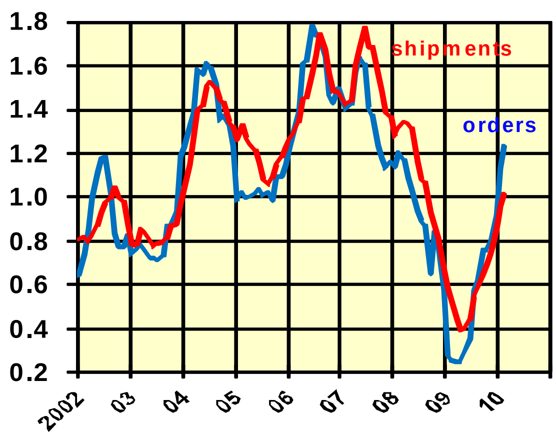
Raw Industrial Prices



Stock Prices

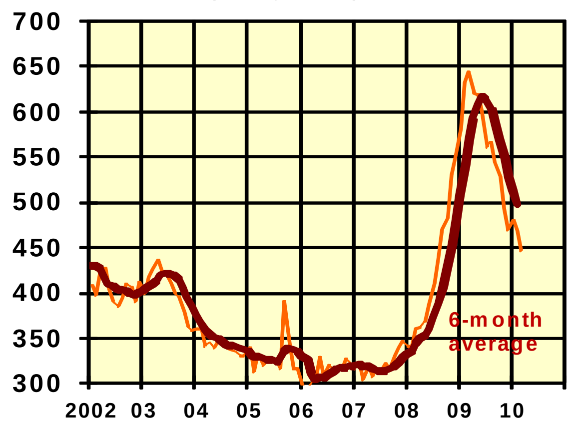
S&P 500

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



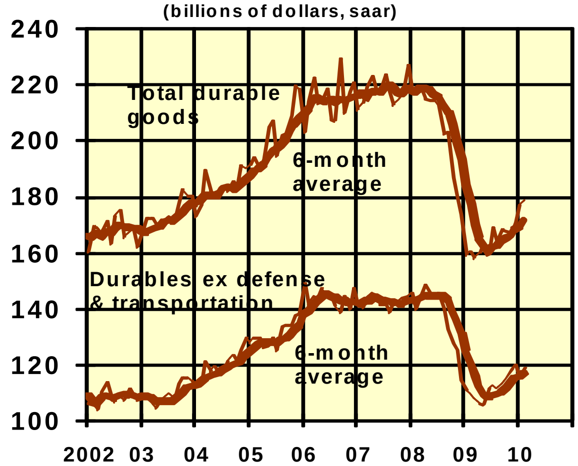
Unemployment Claims

(weekly claims)



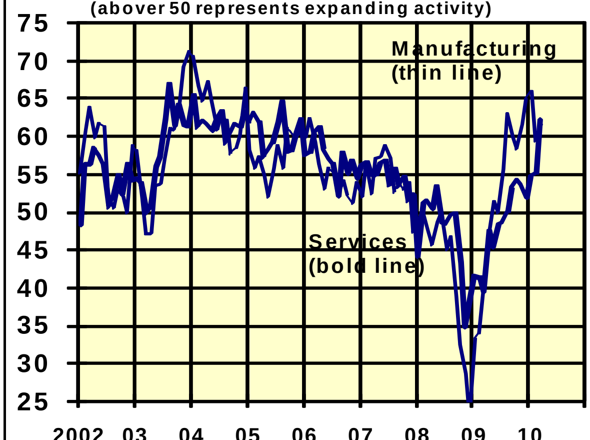
New Orders

(billions of dollars, saar)



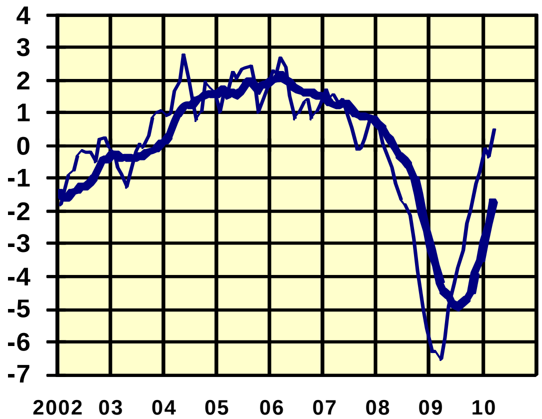
ISM: New Orders

(above 50 represents expanding activity)

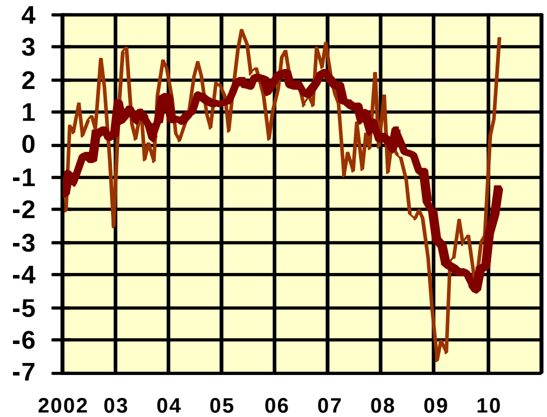


ECONOMIC INDICATORS

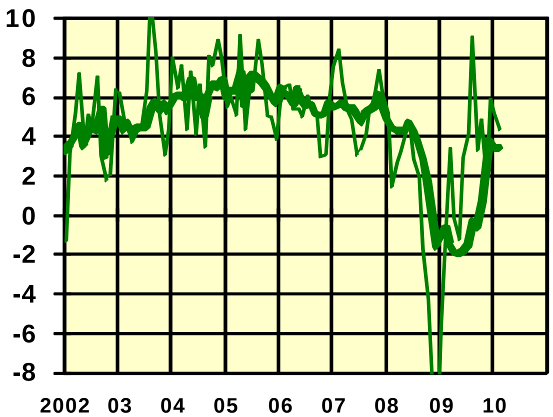
Jobs: Payroll Data
(annual rates of change--3 months & 1 year)



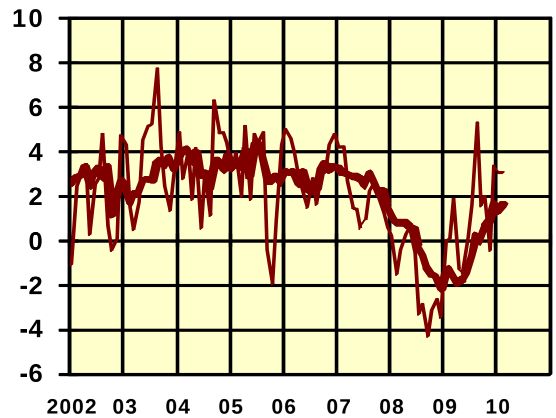
Jobs: Household Data
(annual rates of change--3 months & 1 year)



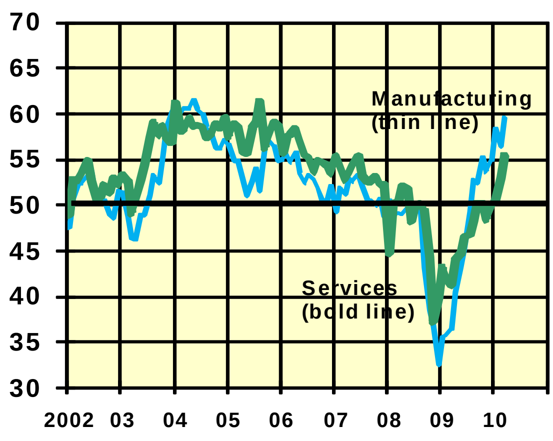
Consumer Spending
(annual rates of change-- 3 months & 1 year)



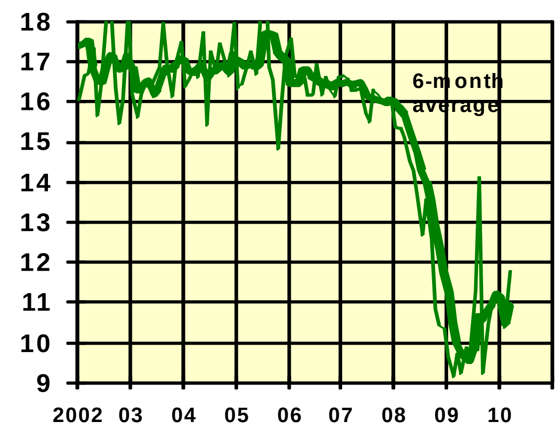
Real Consumer Spending
(annual rates of change-- 3 months & 1 year)



ISM: Composite
(over 50 represents expanding activity)



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



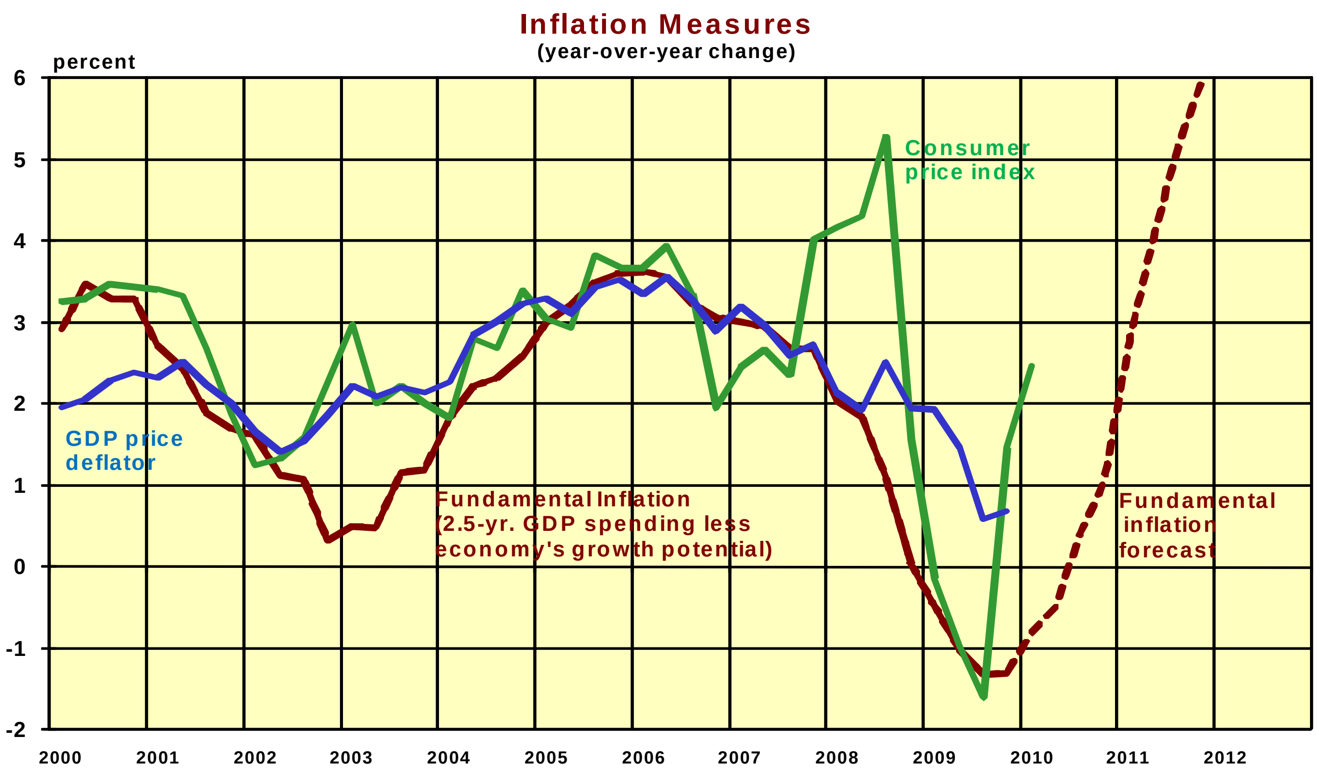
Inflation Indicators

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.

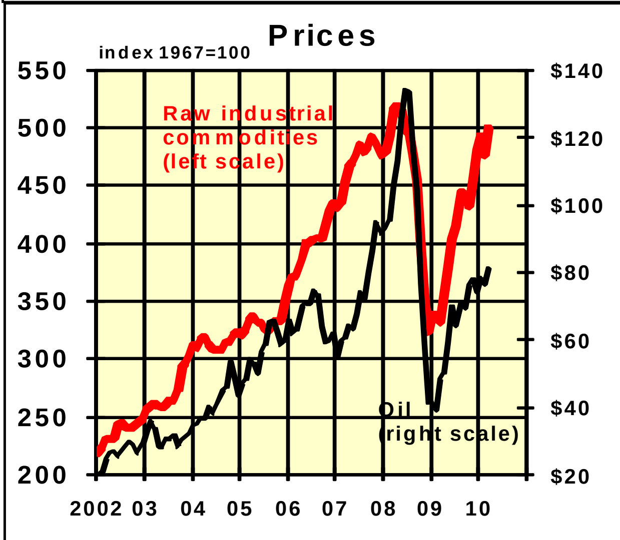
The country's *underlying* inflation is determined by the rate of spending over a 2-3 year period minus the economy's underlying growth rate. Over the past 2½ years current-dollar spending (GDP) has averaged roughly 1½% at an annual rate. Subtracting an underlying growth rate of roughly 2½% yields an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

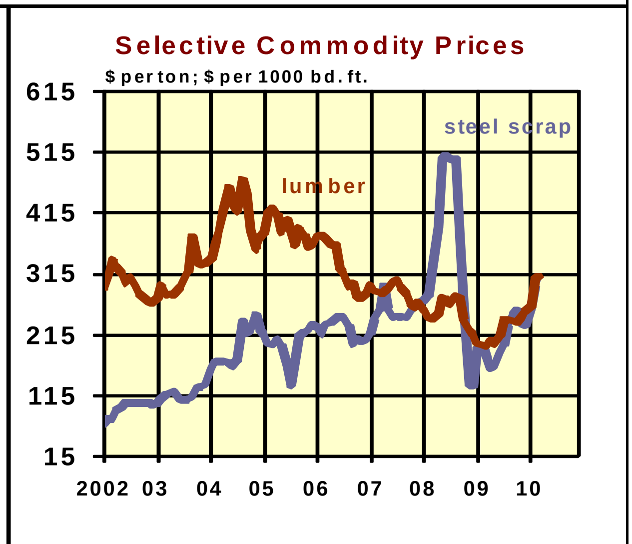
Given the weakness in spending over the past year, inflation is likely to remain subdued even as the economy recovers.

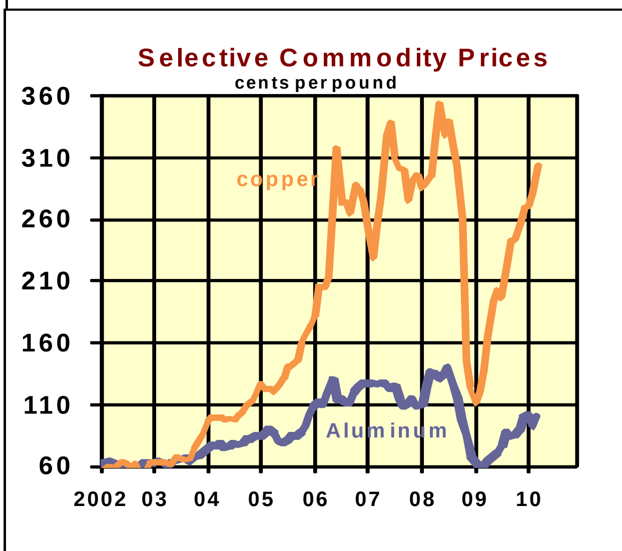
The recent burst of commodity price increases (shown in the charts on the following page) is the first sign of an upward move in prices. It is likely to take another year before the impact of these increase works its way into consumer prices.

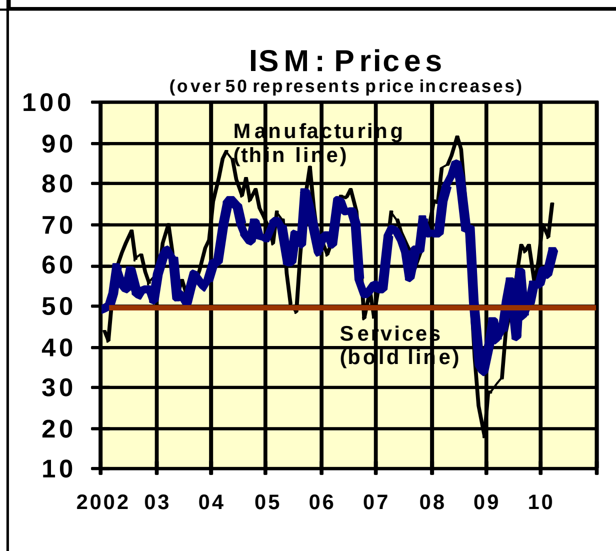


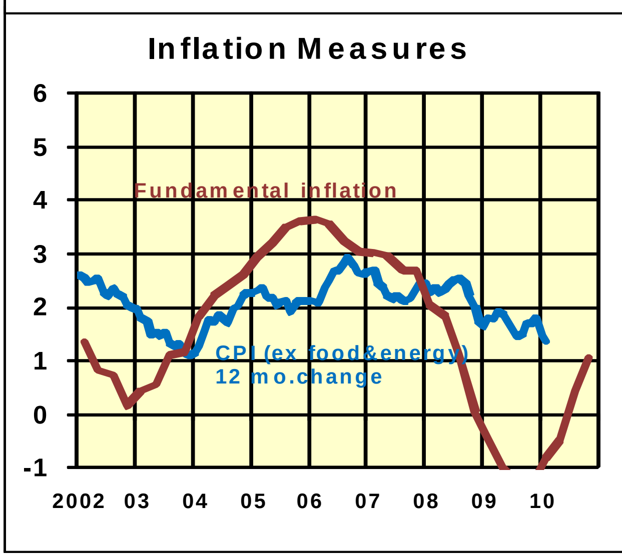
INFLATION INDICATORS

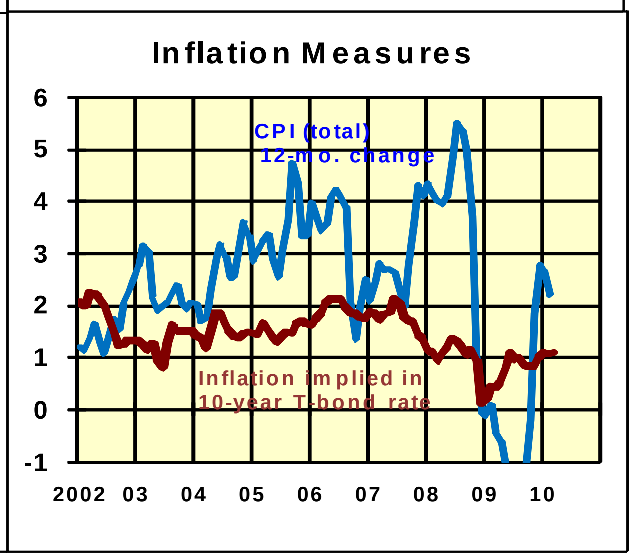












Interest Rates

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 February, the Fed has produced sufficient reserves to promote further increases in spending through summer and early fall.

Even if the economy recovers at a relatively brisk pace, it's unlikely that companies will quickly add more workers. In spite of signs of an increase in employment in March, potential increases in taxes and other costs mean that businesses will continue to rebuild profits while limiting their payroll expense.

Keeping short-term interest rates close to zero as the pace of spending increases would normally lead to a sharp increase in bank reserves.

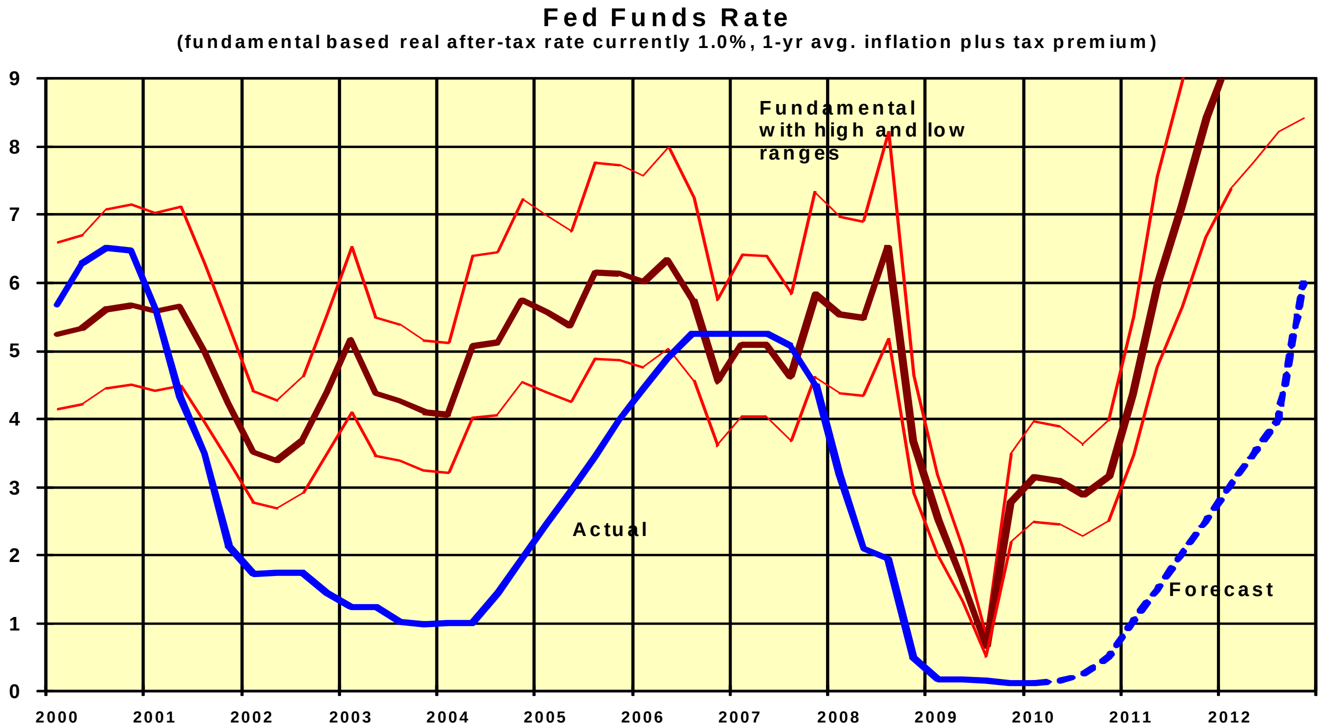
However, these are not normal times. During the past year, the monthly change in excess reserves that banks hold at the Federal Reserve has ranged from a decrease of $155 billion to an increase of $134 billion. In February alone, excess reserves rose by $116 billion.

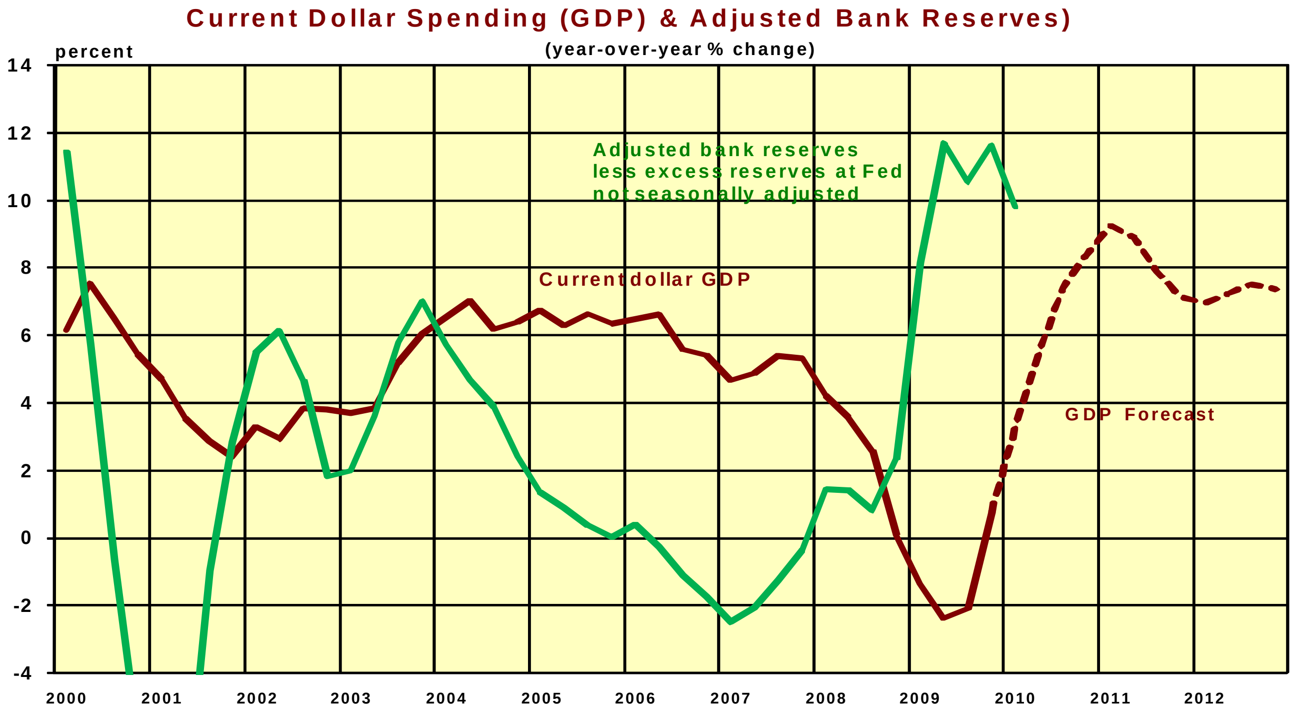
This means that in any one month there is the potential for a significant shift in the amount of reserves available for loans and investments.

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.

As a result, monetary policy is likely to 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 in either direction. 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
9
8
7
6
5
4
3
2
1
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

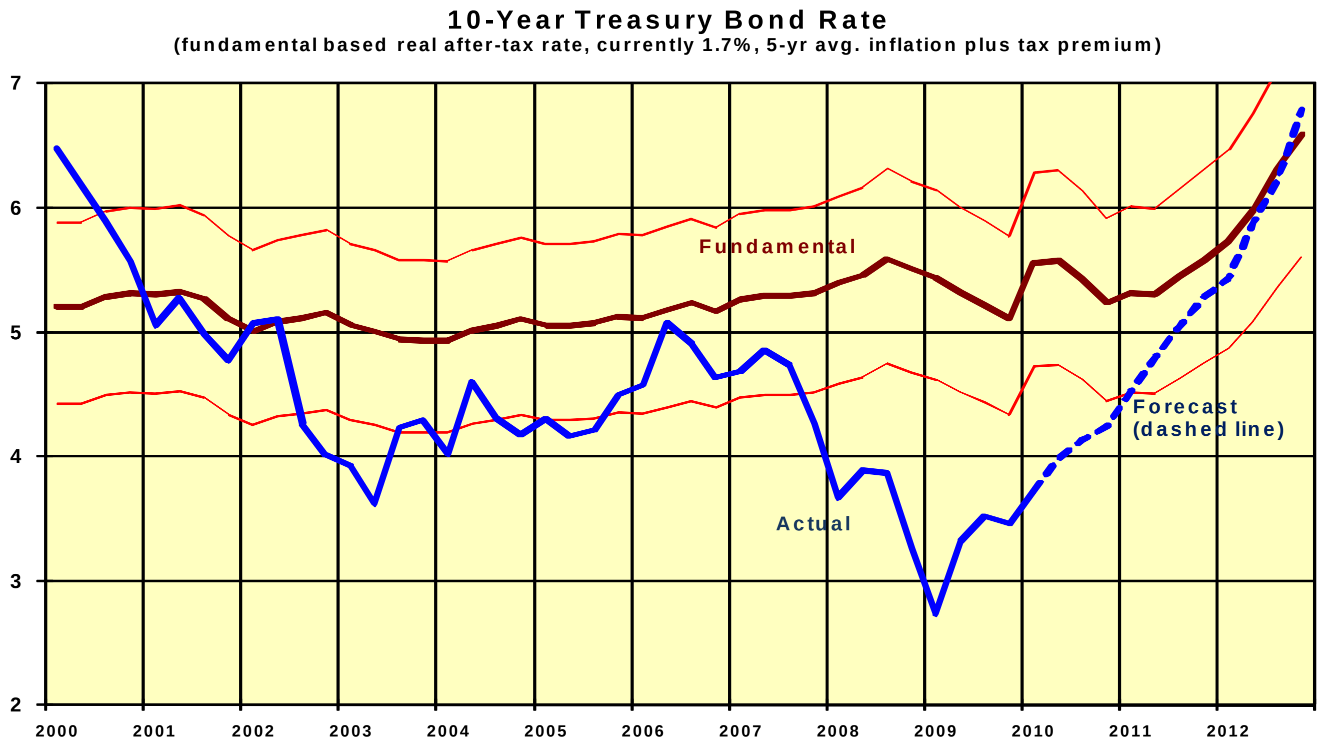

Current Dollar Spending (GDP) & Adjusted Bank Reserves)
percent
(year-over-year % change)
Adjusted bank reserves less excess reserves at Fed not seasonally adjusted
Current dollar GDP
GDP Forecast
14
12
10
8
6
4
2
0
-2
-4
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

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 may still be struggling has produced extremely low long-term interest rates. .

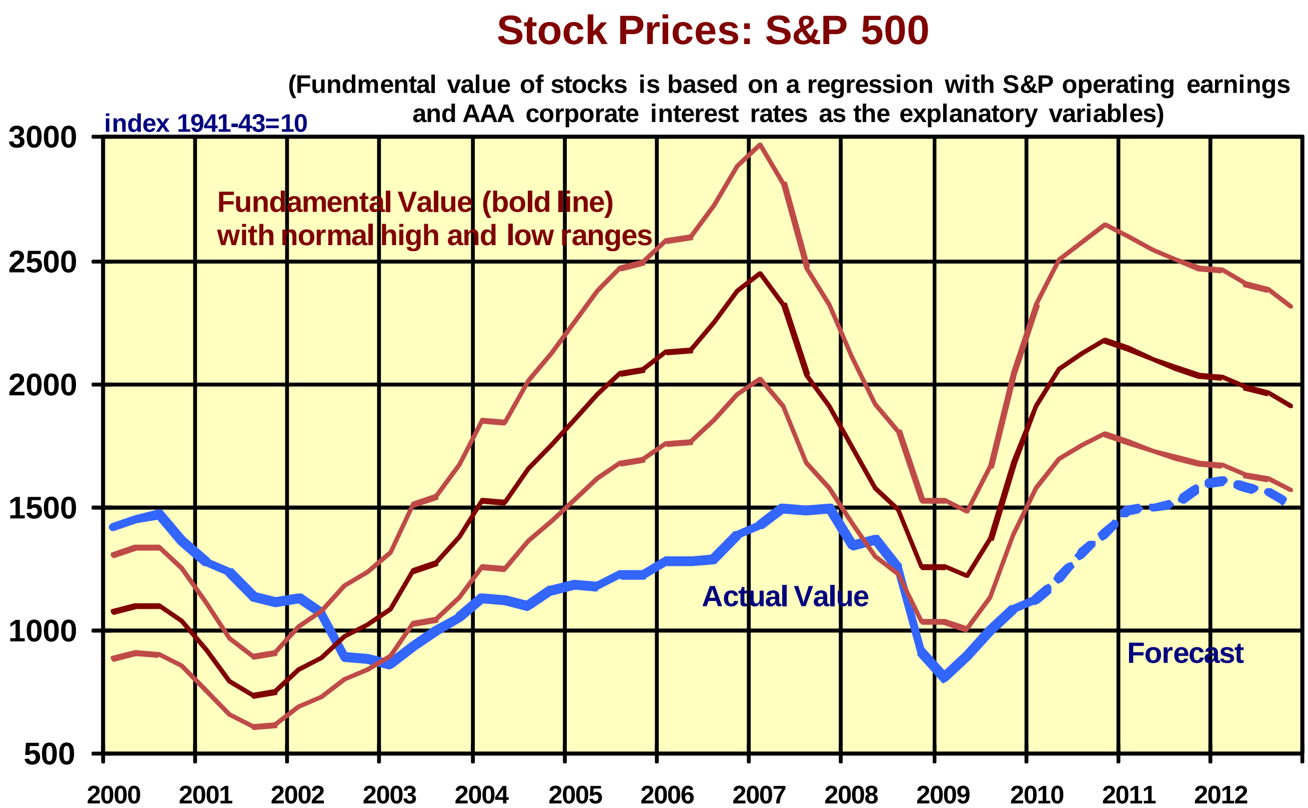
However, so long as monetary policy remains expansive, the odds favor a further pick-up in the rate of growth. Once the consensus shifts to expectations of more rapid growth, it should lead to a significant, abrupt increase in long-term rates.



STOCK PRICES

Fundamentals such as profits and interest rates remain favorable for stocks. In addition, monetary policy has remained expansive through February. 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 summer, it should help to restore confidence in the market and lead to still further gains in stock prices.



classicalprinciples.com

4/5/2010

	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	14454	14640	14923	15294	15666	15991	14441	14256	15131	16380	17569
%ch	-0.8	2.6	6.1	5.3	7.9	10.3	10.1	8.6	2.6	-1.3	6.1	8.3	7.3
REAL GDP	12902	12973	13150	13313	13538	13815	14068	14217	13312	12987	13683	14276	14426
%ch	-0.7	2.2	5.6	5.1	6.9	8.4	7.5	4.3	0.4	-2.4	5.4	4.3	1.1
CHAIN PRICE INDEX	1.097	1.098	1.099	1.100	1.102	1.108	1.115	1.126	1.085	1.097	1.106	1.149	1.220
%ch	0.0	0.4	0.5	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	1.7	0.5	1.6	2.2	4.0	3.8	-0.3	1.9	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	1632	1578	1664	1681	1698	1707	1462.8	1427.7	1655.3	1719.9	1822.7
%ch	32.4	56.3	42.0	-12.5	23.6	4.1	3.9	2.3	-17.6	-2.4	15.9	3.9	6.0
PRETAX PROFITS ADJ (1)	1227	1359	1468	1428	1507	1527	1542	1552	1360.4	1308.9	1501.1	1565.0	1667.7
%ch	15.7	50.7	36.0	-10.4	24.0	5.6	3.9	2.7	-11.8	-3.8	14.7	4.3	6.6
AFTER-TAX PROFITS	1031	1174	1270	1235	1298	1312	1323	1331	1171	1113	1292	1341	1419
%ch	24.5	68.0	37.0	-10.5	21.9	4.5	3.3	2.6	-11.5	-4.9	16.1	3.8	5.8
AFTER-TAX PROFITS ADJ(1)	921	1038	1106	1085	1141	1159	1167	1177	1068.2	994.2	1137.9	1186.0	1263.7
%ch	3.6	61.6	28.8	-7.3	22.1	6.4	3.1	3.2	-2.0	-6.9	14.5	4.2	6.6
PERSONAL INCOME	12049	12005	12098	12254	12490	12801	13112	13384	12239	12026	12664	13710	14705
%ch	3.3	-1.4	3.1	5.3	7.9	10.3	10.1	8.6	2.9	-1.7	5.3	8.3	7.3
REAL DISPOSABLE INCOME	10078	9984	10008	10097	10279	10497	10696	10817	9911	9999	10392	10864	10954
%ch	6.2	-3.6	1.0	3.6	7.4	8.7	7.8	4.6	0.5	0.9	3.9	4.5	0.8
PRODUCTIVITY	1.470	1.498	1.523	1.533	1.544	1.555	1.567	1.573	1.429	1.484	1.550	1.579	1.596
%ch	7.6	7.8	6.9	2.5	2.9	3.1	3.0	1.6	2.1	3.8	4.5	1.9	1.0
CIVILIAN EMPLOYMENT	140.5	139.3	138.1	138.6	138.6	139.0	139.5	139.7	145.4	139.9	138.9	139.2	140.9
%ch	-3.1	-3.2	-3.4	1.4	0.0	1.0	1.5	0.7	-0.5	-3.8	-0.7	0.2	1.2
UNEMPLOYMENT RATE	9.3	9.6	10.0	9.7	9.9	9.1	8.3	8.3	5.8	9.3	9.3	8.5	8.9
INDUSTRIAL PRODUCTION	0.964	0.979	0.995	1.010	1.031	1.060	1.085	1.094	1.088	0.982	1.047	1.068	1.045
%ch	-10.2	6.4	6.6	6.5	8.4	11.7	10.0	3.3	-2.2	-9.8	6.6	2.0	-2.2
LIGHT VEHICLE SALES (2)	9.6	11.5	10.9	11.0	12.5	12.7	12.6	12.3	13.2	10.4	12.2	12.5	12.3
Domestic	4.9	6.4	5.7	5.7	6.8	6.9	6.8	6.6	6.8	5.5	6.6	6.8	6.6
Imports	4.7	5.1	5.2	5.2	5.7	5.8	5.7	5.7	6.5	4.9	5.6	5.7	5.7

(1) Profits adjusted for capital consumption and inventory adjustment.

(2) Millions at seasonally adjusted annual rates. First quarter employment, unemployment rate and vehicle sales are actuals.

4/5/2010

	Actual			Forecast				Years					
	2009	2009	2010	2010	2010	2010	2011	2007	2008	2009	2010	2011	2012
Monetary Aggregates quarerly:	III	IV	I	II	III	IV	I						
M2 %ch at annual rates	1.6	3.0	4.0	7.0	7.0	6.0	6.0	6.3	7.1	7.3	4.2	6.4	6.9
Adj. Bank Reserves (billions of $)	895	1140						94	233	967	1215		
less excess reserves at Fed	103	106	111	112	114	116	120	92	94	103	113		
Interest Rates:													
Baa Corp Bonds: Moody's	6.66	6.33	6.29	6.92	7.02	7.09	7.27	6.48	7.45	7.30	6.83	7.66	8.82
Aaa Corp Bonds: Moody's	5.27	5.20	5.29	5.67	5.82	5.94	6.12	5.56	5.64	5.31	5.68	6.51	7.67
MORTGAGE RATES	5.16	4.92	5.10	6.07	6.22	6.34	6.52	6.34	6.04	5.04	5.93	6.91	8.07
10-YR GOVT SECURITIES	3.52	3.46	3.72	4.07	4.22	4.34	4.52	4.63	3.67	3.26	4.09	4.91	6.07
5-YR GOVT SECURITIES	2.47	2.30	2.42	2.04	2.44	2.77	3.13	4.43	2.80	2.19	2.42	3.87	5.70
2-YR GOVT SECURITIES	1.03	0.87	0.92	1.00	1.25	1.60	2.15	4.36	2.00	0.96	1.19	2.94	5.33
3-MONTH T-BILL	0.17	0.07	0.10	0.25	0.45	0.74	1.24	4.41	1.46	0.16	0.39	1.99	4.37
FEDERAL FUNDS RATE	0.16	0.12	0.13	0.15	0.25	0.50	1.00	5.02	1.93	0.16	0.26	1.75	4.13
3-MONTH LIBOR RATE	0.41	0.27	0.26	0.50	0.60	0.85	1.35	5.30	2.91	0.69	0.55	2.10	4.48
BOND EQUIVALENT RATES:													
FEDERAL FUNDS	0.16	0.12	0.13	0.15	0.25	0.50	1.01	5.15	1.95	0.16	0.26	1.77	4.22
3-MONTH LIBOR	0.41	0.27	0.26	0.50	0.60	0.85	1.36	5.44	2.95	0.70	0.55	2.12	4.58
3-MONTH T-BILL	0.17	0.07	0.10	0.25	0.46	0.75	1.26	4.52	1.49	0.16	0.39	2.03	4.48
STOCKS:													
S&P 500	997	1089	1122	1237	1291	1372	1493	1477	1221	947	1256	1522	1565
S&P 500 quarterly reported earnings*	59.0	61.4	60.3	63.4	64.4	64.9	65.4	66.2	14.9	51.2	63.2	65.9	70.2
S&P 500 p/e on reported earnings**	16.9	17.7	18.6	19.5	20.1	21.2	22.8	26.5	17.7	19.5	19.8	23.1	22.3
S&P 500 quarterly operating earnings	63.1	68.6	77.6	88.2	90.4	80.5	88.2	82.5	49.5	56.9	84.2	88.7	92.5
S&P 500 p/e on operating earnings**	15.8	15.9	14.4	14.0	14.3	17.1	16.9	17.9	24.7	16.7	14.9	17.2	16.9
S&P 500 underlying earnings***	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**	13.9	14.9	15.2	16.5	16.9	17.7	18.9	23.5	18.3	13.3	16.6	18.9	18.2

*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)