

Monthly Economic and Financial Update

Just when you thought it was safe to go back into the water, here come the sharks. Let's start with some good news. As the charts on economy show, business activity is picking up nicely. The economy is growing. New orders are soaring and profits are strong.

All this is to be expected. The acceleration in the pace of business activity follows the Fed's shift to an expansive monetary policy this past year. Following a normal 6-9 month lag, spending has recovered.

In spite of the recovery, stock prices have wavered over the past two weeks before today's sharp decline.

Commentators attribute the weakness in stocks to problems in Greece. Problems in Greece should be simply problems for Greece.

Unfortunately, the European Union, the IMF and (according to some reports the Obama Administration) have committed to helping Greece try and close its deficit.

The appropriate solution is to let Greece default. Even with the announced aid, Greek workers are resorting with strikes and other destructive activity. The more civil disobedience leads to foreign assistance, the more likely it is that government workers in other countries will resort to similar tactics.

Greece is not a problem for the US. Greece is may be doing us a favor. It is showing us what lies ahead for governments that spend money in a way that makes drunken sailors look responsible.

The Greek problem will be solved by Greece cutting its spending. The only issue is the extent to which it can postpone some of the painful cuts while others loan it the funds to

plug the gap. There is no way the US should be a party to this negotiation.

While it's tempting to blame the problems in Greece for today's weakness in US markets, I doubt that the two are related.

My guess is that the latest decline in stock prices is a temporary setback. The stock market section on page 12 explains some of the factors that led me to suggest that stocks were vulnerable to a setback.

There is a chance that the decline in stock prices could be more than temporary. In spite of all the good news on the economy, the Fed may once again be losing control over liquidity.

The monetary indicators section on page 2 discusses some of the issues surrounding this possibility. If liquidity does become tighter, the first place it is likely to show up is in the equity markets. The uncertainty associated with this potential development was a factor in my suggesting a reduction in equities.

For now, the positive economic momentum should continue. Even if monetary policy turns more restrictive, it will take a while for the impact to work its way through the economy.

My current forecast assumes that the monetary policy remains expansive. Under this assumption, the decline in stock prices will be temporary and the economy will continue to recover well into next year.

Nonetheless, the uncertainty surrounding Fed policy adds to the potential for things to play out in a less favorable manner. As a result, I would recommend that stock positions remain closer to neutral than to maximum exposure.

Monetary Indicators & the Monetary Process

Monetary indicators are giving off mixed signals. Interest rate spreads and gold prices point to an expansive policy. However, bank reserves and certain monetary aggregates hint that policy may be turning restrictive.

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.

Bank reserves are completely under the control of the Fed. The monthly volatility reflects the fact that the Fed chooses to fix the fed funds rate instead of the quantity of reserves in the system. The volatility also reflects substantial changes in excess reserves held by banks.

The sharp drop in March for bank reserves available for loans and investments is a concern. Economic data show that the

economy is beginning to move ahead at a rapid pace. If the Fed were to tighten liquidity at this point, it would play havoc with financial markets.

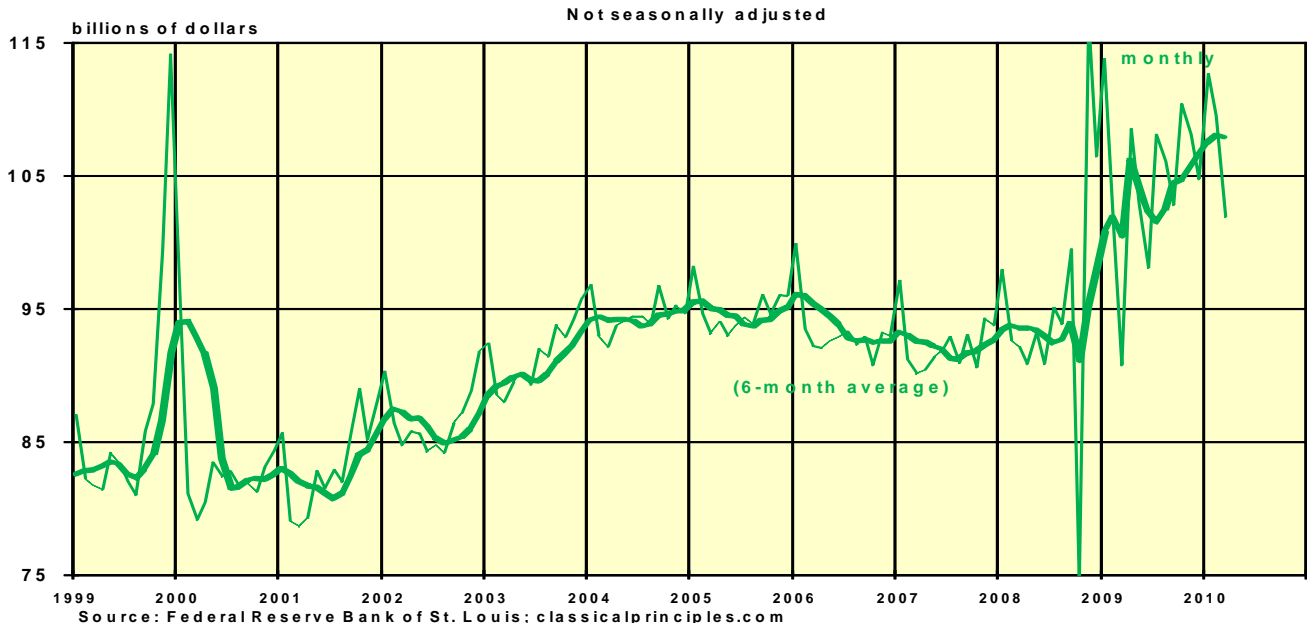
It will be at least another week before we will know what the Fed did in April. Given the extreme monthly volatility, it's as likely that reserves moved sharply higher as it is that they moved even lower.

Whenever there are mixed signals regarding monetary policy it's often helpful to look at other measures. However, the charts on the following page indicate that there is no preponderance of evidence one way or the other.

Without a strong conviction regarding the amount of liquidity in the system it's difficult to have a high degree of confidence in the future path of the business activity.

The current uncertainty with regard to monetary policy has led me to moderate the forecast for the pace of spending later this year.

Adjusted Bank Reserves less Excess Reserve



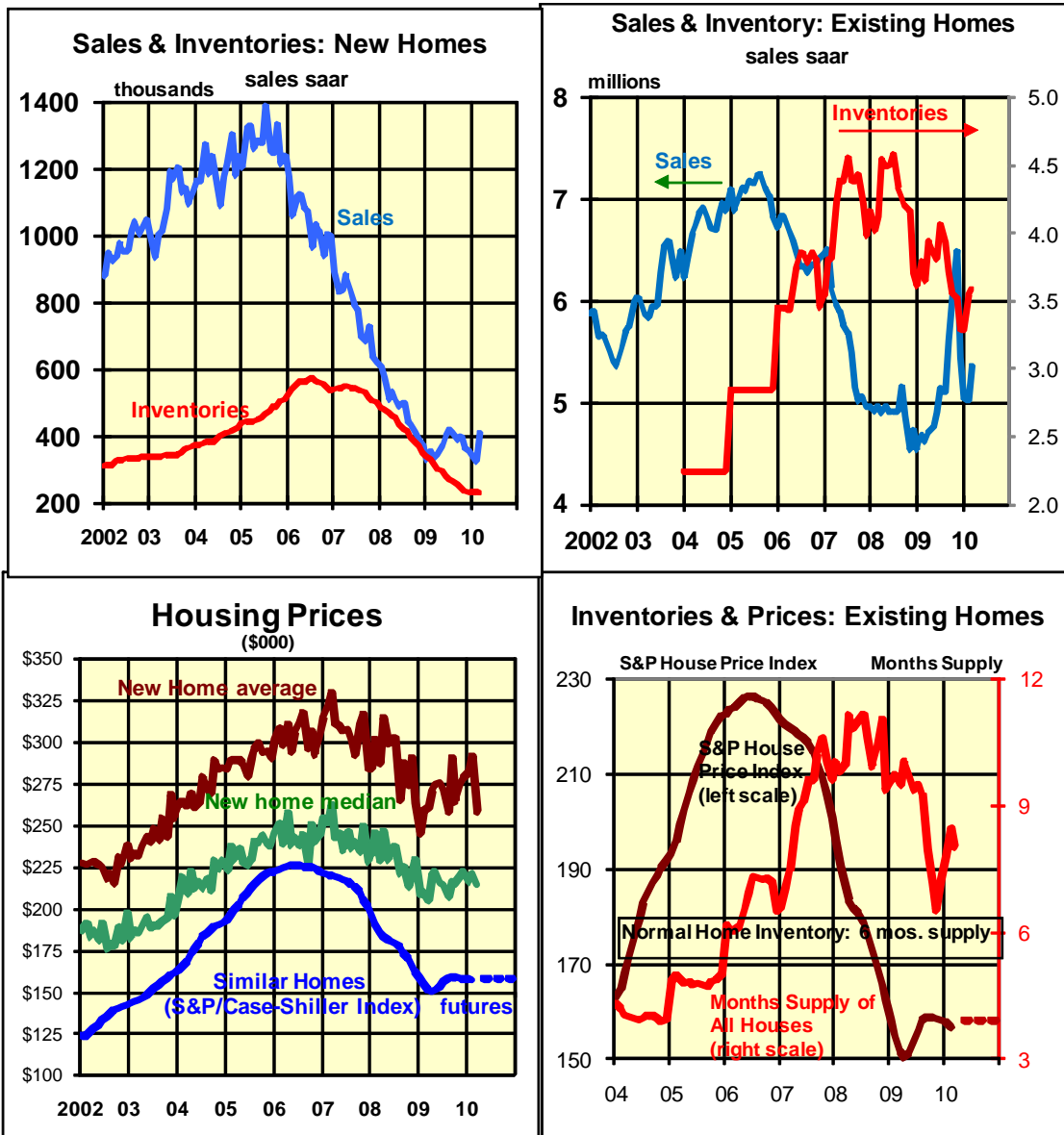
Sensitive Indicators

Sensitive economic indicators continue to improve. Housing sales are experiencing a modest recovery and inventories are well off their peaks.

New orders are strong in all three of the charts on the next page. The gain in new orders

points to further upward momentum in the economy in the months ahead.

The coincident indicator charts on page 5 show dramatic changes in business activity. Employment, spending, real spending and other indicators are all sharply higher in recent months.



SENSITIVE INDICATORS

Raw Industrial Prices

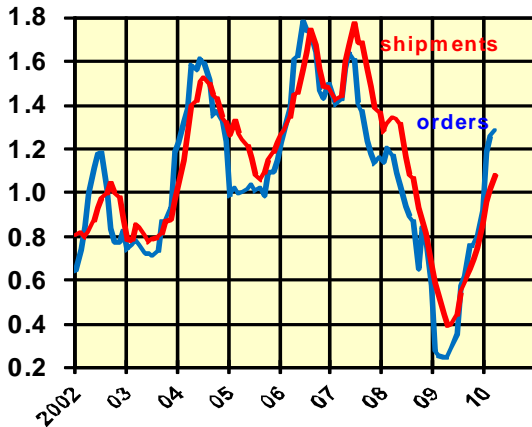


Stock Prices

S&P 500

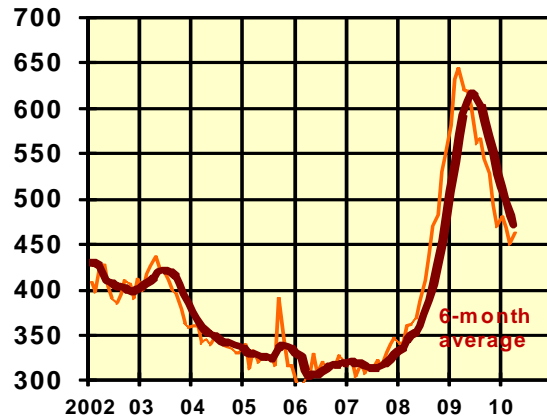


Semiconductor: N. A. Orders and Shipments (billions of \$)



Unemployment Claims

(weekly claims)



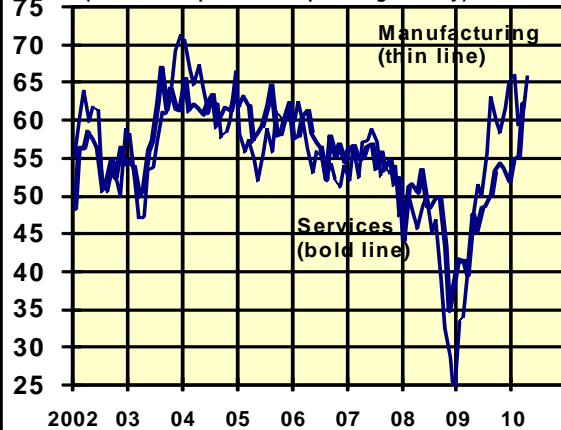
New Orders

(billions of dollars, saar)

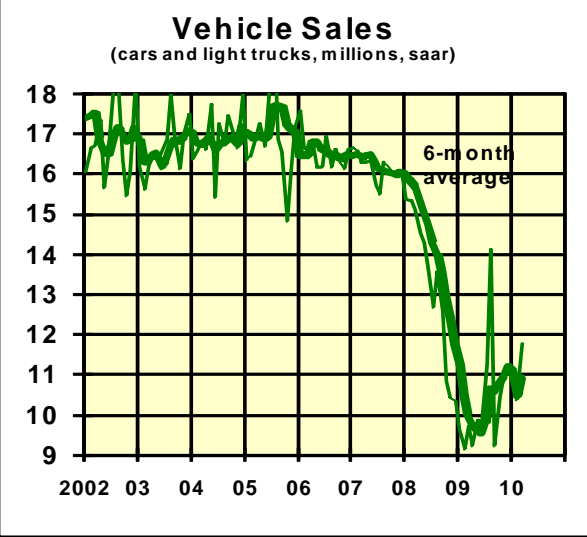
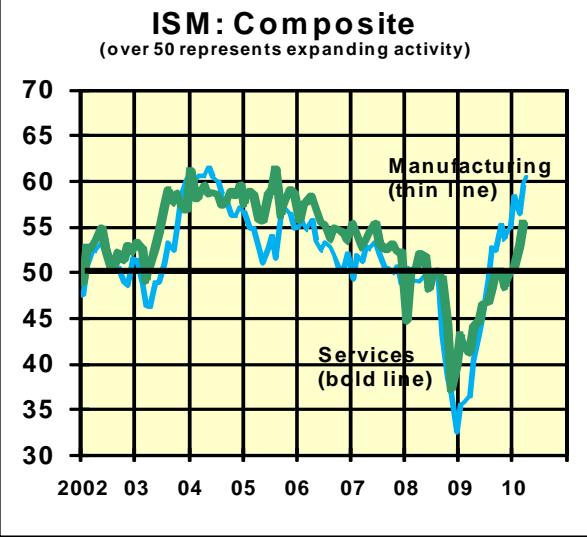
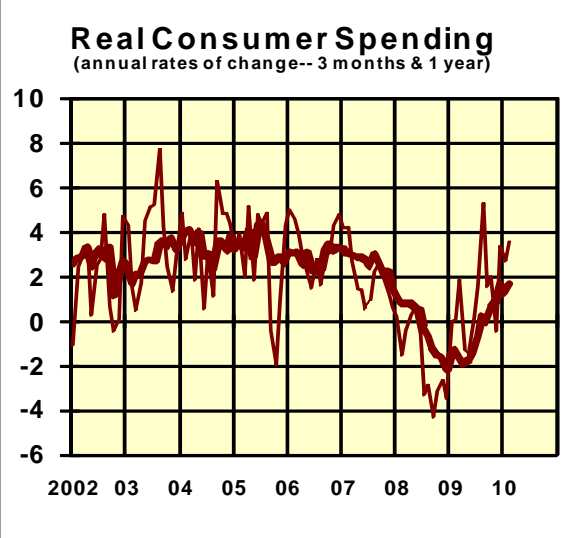
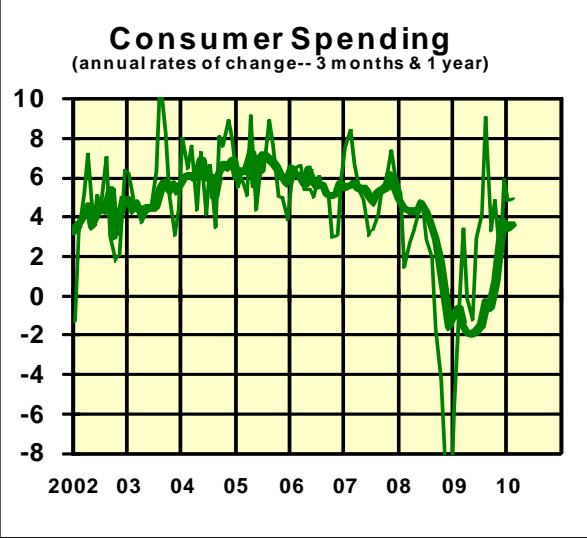
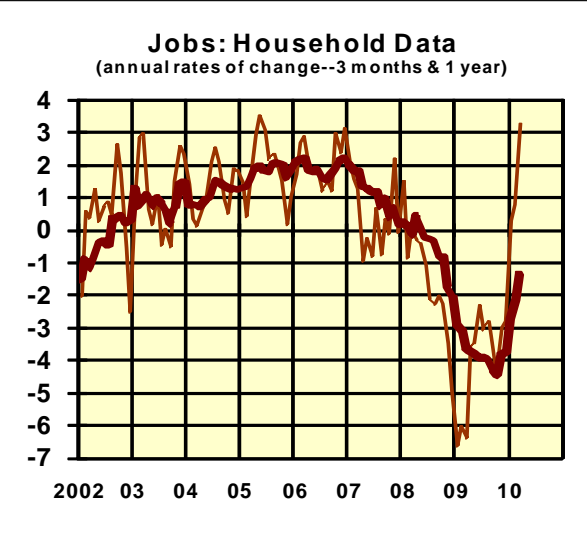


ISM: New Orders

(above 50 represents expanding activity)



ECONOMIC INDICATORS



Inflation Indicators

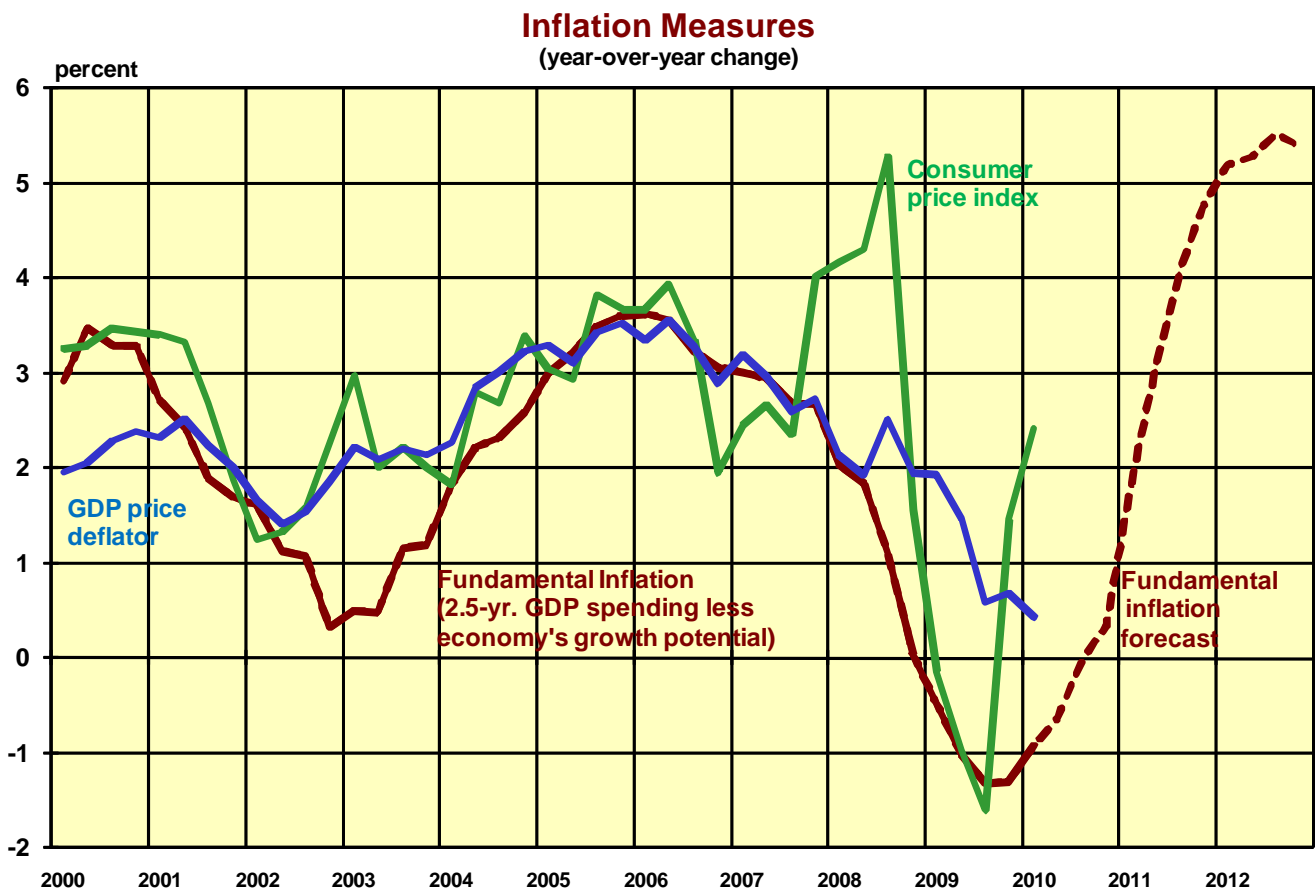
The recent revival in business activity has led to sharp increases in commodity prices. Commodity prices are far more volatile than more conventional inflation measures. Such measures include a large component of more stable labor costs.

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 just over 1% at an annual rate. Subtracting an underlying growth rate of

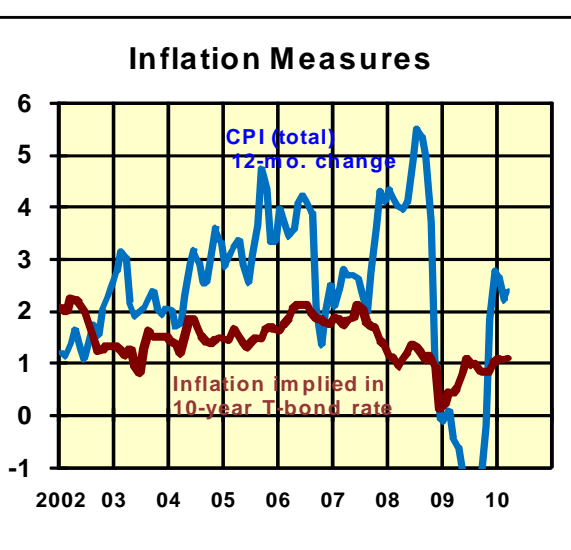
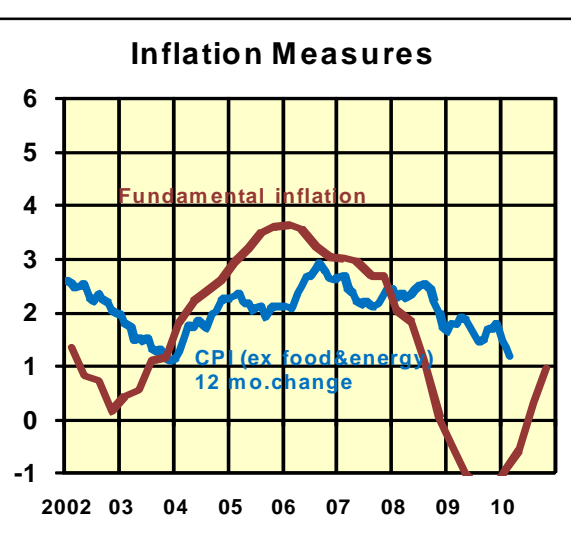
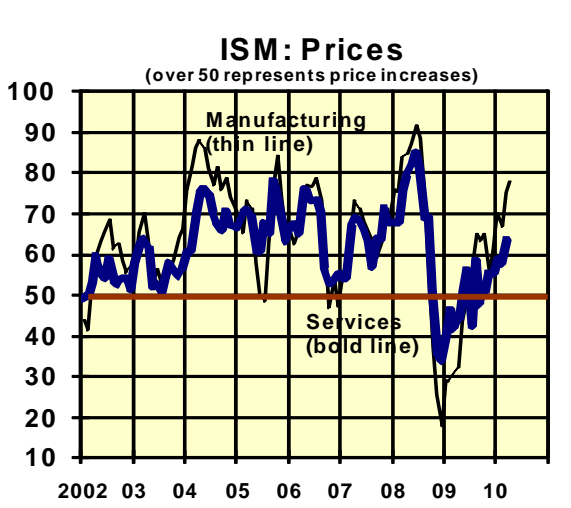
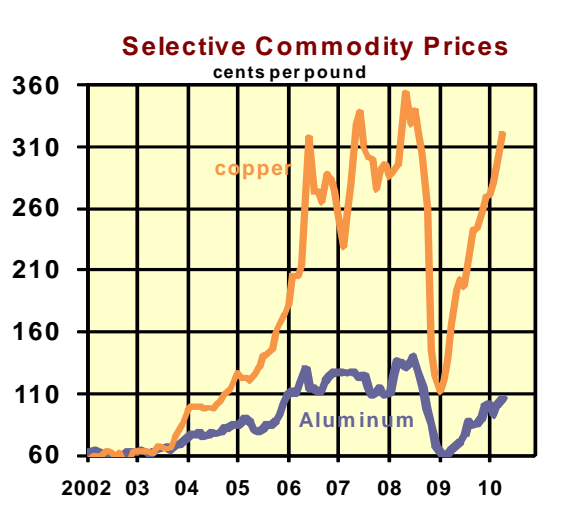
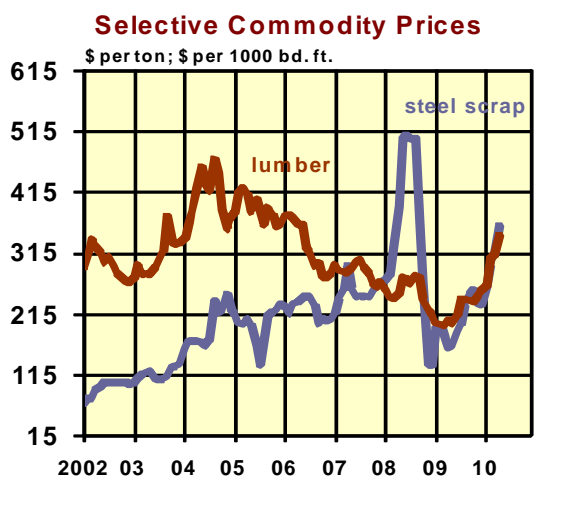
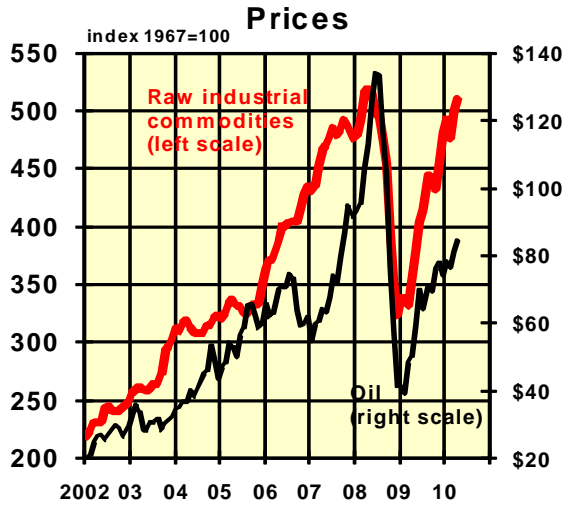
roughly 2½% yields an underlying inflation of *minus* 1½%.

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 increases works their 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.

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 excess reserves rose by \$116 billion and in March they declined by \$42 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. As a result, it is not certain that the Fed will continue to expand liquidity.

If the drop in reserves in March were to continue in April and May, we are likely to see the negative impact show up first in financial markets. It would take at least several more

months for the impact to begin to affect leading indicators and then the rest of the economy.

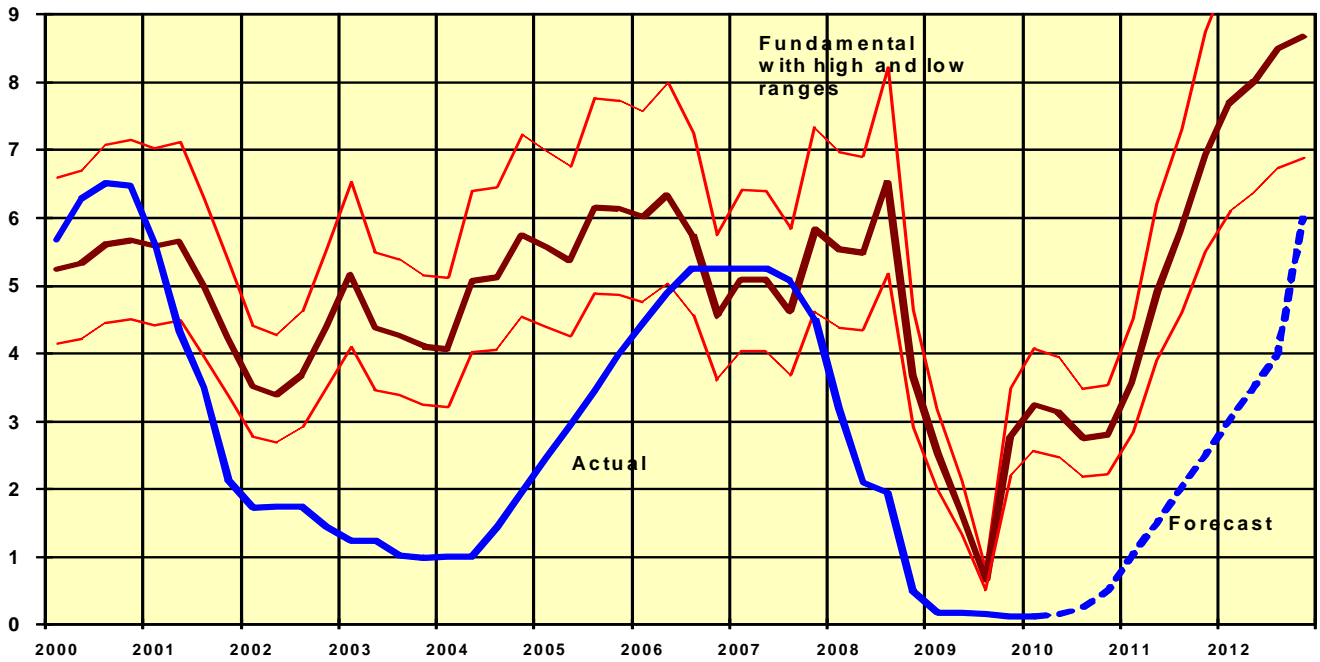
For purposes of the current forecast, my assumption continues to be that the Fed will increase the amount of bank reserves over and above the level of excess reserves.

In light of the uncertainty of the process I have moderated my assumption of the increase in liquidity. I'm now assuming that the increase in the year ahead is closer to 5%-8% instead of the previous range of 6%-10%. This is the reason for moderating the spending pace later this year.

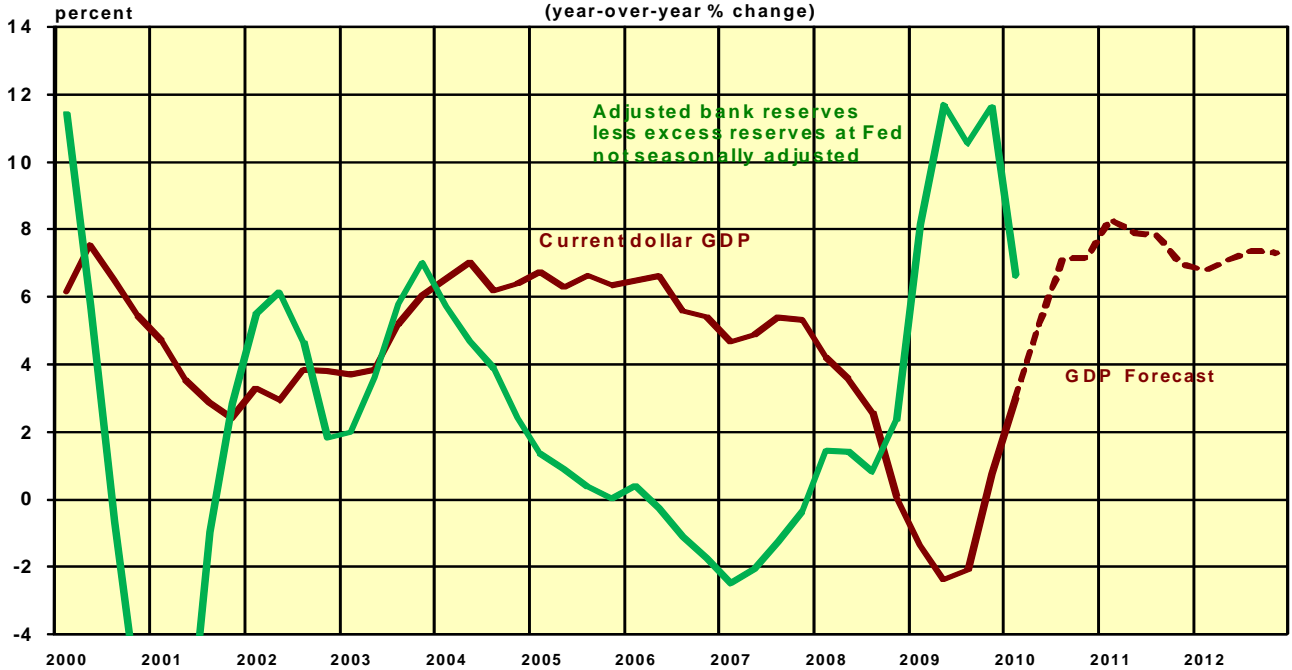
No one (not even Fed members) knows the future course the Fed will take. Since the Fed doesn't focus on reserves in the system, it is flying blind. It's difficult to have much faith in the course the economy will take when the pilots can't see what they're doing.

We will have more information on liquidity when the Fed releases the data for April. Those data will either provide greater confidence that the Fed is increasing liquidity along the lines suggested by my forecast, or it will increase the anxiety associated with potential problems in financial markets.

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

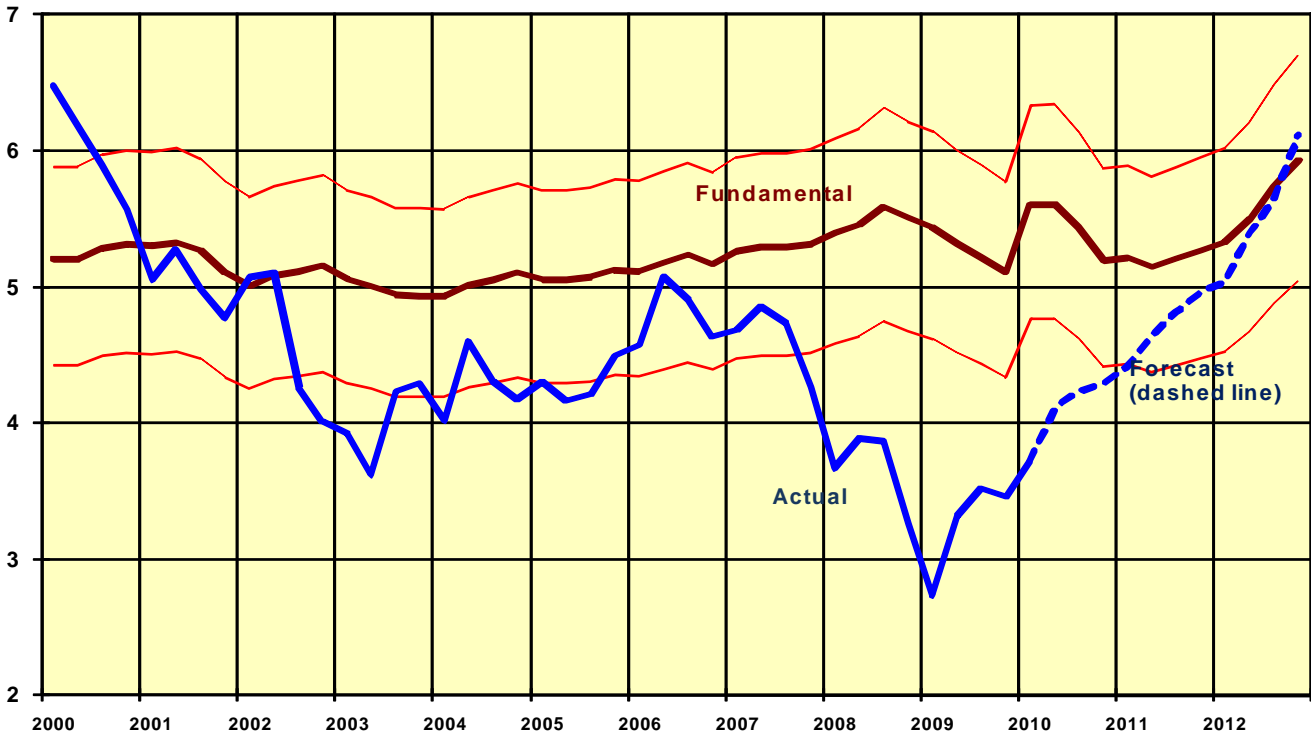
A lack of inflationary pressures combined with perceptions that the economy may still be struggling has produced extremely low interest rates. The artificially low fed funds rate is a key factor keeping long term rates at artificially low levels.

The near-term outlook for long-term interest rates depends on perceptions regarding the strength of business activity. The stronger the increase in business activity, the greater is the

likelihood that the Fed will consider raising the fed funds rate.

While, the odds still favor a further pick-up in the rate of growth, the possibility of a shift toward monetary restraint would produce a different outlook. If the Fed inadvertently shifts to restraint, all interest rates would remain low for a more extended period of time than shown in the current forecast.

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



STOCK PRICES

Fundamentals such as profits and interest rates remain favorable for stocks. So long as monetary policy remains expansive it should continue to help boost stock prices.

My recent recommendation to reduce equity holdings from maximum to neutral stems from two factors. One is the uncertainty over the current course of monetary policy. The second is based on technical factors.

There had been a number of disappointing technical developments in recent weeks. Trading volume tended to be higher when stock prices fell and lower when they increased. This tends to be a negative signal.

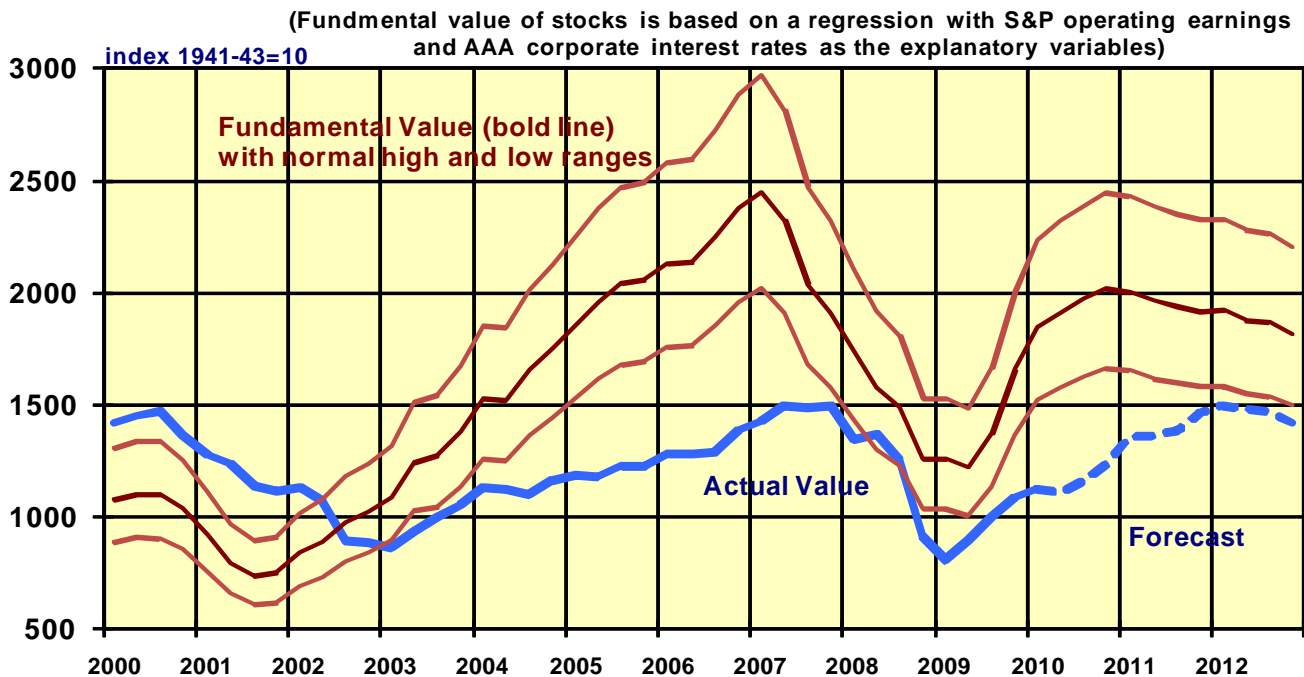
In addition, the market had registered significant gains over the past two months and peaking at a key resistance level (roughly 1220

for the S&P 500). It would be unusual if prices had continued to rise without some correction. Finally, a descending triangle pattern had formed.

These negative signals added to my concern that the Fed could conceivably be creating more problems for stocks with its monetary actions.

At the moment the market has fallen all the way from resistance to a key support level (1175 for the S&P 500). If the market rally's from this point, it will be a major positive sign. However, if it breaks through this support level, the decline in prices is likely to last for a while longer.

Stock Prices: S&P 500



5/4/2010	<u>Actual</u>			<u>Forecast</u>					<u>YEARS</u>				
	<u>2009</u>	<u>2009</u>	<u>2010</u>	<u>2010</u>	<u>2010</u>	<u>2010</u>	<u>2011</u>	<u>2011</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
	III	IV	I	II	III	IV	I	II					
GROSS DOMESTIC PRODUCT	14242	14454	14601	14866	15134	15398	15640	15875	14441	14256	15000	15980	16996
%ch	2.6	6.1	4.1	7.4	7.4	7.1	6.4	6.2	2.6	-1.3	5.2	6.5	6.4
REAL GDP	12973	13150	13255	13468	13663	13841	13947	14004	13312	12987	13557	14023	14221
%ch	2.2	5.6	3.2	6.6	5.9	5.3	3.1	1.6	0.4	-2.4	4.4	3.4	1.4
CHAIN PRICE INDEX	1.098	1.099	1.101	1.104	1.108	1.113	1.122	1.135	1.085	1.097	1.106	1.140	1.197
%ch	0.4	0.5	0.9	0.9	1.5	1.8	3.3	4.5	2.1	1.2	0.8	3.1	4.9
CPI- ALL URBAN%ch	3.7	2.6	1.5	0.4	1.2	1.5	3.0	4.2	3.8	-0.3	1.8	2.9	5.2
FUND. INFLATION%ch	-1.3	-1.3	-0.9	-0.6	0.0	0.3	1.8	3.0	2.3	-0.1	-1.0	1.3	4.8
PRETAX PROFITS	1495	1632	1575	1659	1665	1671	1672	1684	1462.8	1427.7	1642.4	1679.6	1764.8
%ch	56.3	42.0	-13.3	23.2	1.6	1.3	0.3	2.9	-17.6	-2.4	15.0	2.3	5.1
PRETAX PROFITS ADJ (1)	1359	1468	1424	1502	1512	1515	1517	1529	1360.4	1308.9	1488.1	1524.7	1609.9
%ch	50.7	36.0	-11.3	23.5	2.7	0.9	0.6	3.1	-11.8	-3.8	13.7	2.5	5.6
AFTER-TAX PROFITS	1174	1270	1233	1294	1300	1303	1305	1313	1171	1113	1282	1310	1375
%ch	68.0	37.0	-11.3	21.4	2.0	0.7	0.7	2.6	-11.5	-4.9	15.2	2.2	4.9
AFTER-TAX PROFITS ADJ(1)	1038	1106	1082	1136	1146	1147	1150	1158	1068.2	994.2	1128.1	1155.4	1219.9
%ch	61.6	28.8	-8.2	21.6	3.6	0.2	1.1	2.8	-2.0	-6.9	13.5	2.4	5.6
PERSONAL INCOME	12005	12098	12213	12434	12658	12879	13081	13278	12239	12026	12546	13366	14215
%ch	-1.4	3.1	3.9	7.4	7.4	7.1	6.4	6.2	2.9	-1.7	4.3	6.5	6.4
REAL DISPOSABLE INCOME	9984	10008	10009	10181	10336	10478	10566	10617	9911	9999	10251	10626	10752
%ch	-3.6	1.0	0.0	7.1	6.2	5.6	3.4	1.9	0.5	0.9	2.5	3.7	1.2
PRODUCTIVITY	1.498	1.523	1.532	1.542	1.552	1.562	1.568	1.572	1.429	1.484	1.547	1.574	1.592
%ch	7.8	6.9	2.2	2.8	2.7	2.6	1.4	1.1	2.1	3.8	4.3	1.8	1.1
CIVILIAN EMPLOYMENT	139.3	138.1	138.6	138.6	139.0	139.5	139.7	139.9	145.4	139.9	138.9	139.2	140.9
%ch	-3.2	-3.4	1.4	0.0	1.0	1.5	0.7	0.6	-0.5	-3.8	-0.7	0.2	1.2
UNEMPLOYMENT RATE	9.6	10.0	9.7	9.9	9.1	8.3	8.3	8.4	5.8	9.3	9.3	8.5	8.9
INDUSTRIAL PRODUCTION	0.979	0.996	1.014	1.033	1.050	1.063	1.065	1.059	1.088	0.982	1.040	1.053	1.025
%ch	6.4	7.1	7.6	7.7	6.4	5.2	0.7	-2.3	-2.2	-9.7	5.9	1.2	-2.7
LIGHT VEHICLE SALES (2)	11.5	10.9	11.0	12.5	12.7	12.6	12.3	12.4	13.2	10.4	12.2	12.5	12.3
Domestic	6.4	5.7	5.7	6.8	6.9	6.8	6.6	6.7	6.8	5.5	6.6	6.8	6.6
Imports	5.1	5.2	5.2	5.7	5.8	5.7	5.7	5.8	6.5	4.9	5.6	5.7	5.7

(1) Profits adjusted for capital consumption and inventory adjustment. First quarter profits are estimates.

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

5/4/2010	Actual			Forecast					Years					
	2009	2009	2010	2010	2010	2010	2011	2011	2007	2008	2009	2010	2011	2012
Monetary Aggregates quarterly:	III	IV	I	II	III	IV	I	II						
M2 %ch at annual rates	1.7	3.0	4.0	7.0	7.0	6.0	6.0	5.0	6.3	7.1	7.8	3.9	6.1	6.1
Adj. Bank Reserves (billions of \$)	895	1140							94	233	967	1215		
less excess reserves at Fed	103	106	108	112	114	116	120		92	94	103	112		
Interest Rates:														
Baa Corp Bonds: Moody's	6.66	6.33	6.29	6.41	6.83	7.04	7.16	7.39	6.48	7.45	7.30	6.64	7.46	8.29
Aaa Corp Bonds: Moody's	5.27	5.20	5.29	5.31	5.63	5.89	6.01	6.24	5.56	5.64	5.31	5.53	6.31	7.14
MORTGAGE RATES	5.16	4.92	5.10	5.51	5.73	5.99	6.21	6.44	6.34	6.04	5.04	5.58	6.56	7.54
10-YR GOVT SECURITIES	3.52	3.46	3.72	3.81	4.03	4.29	4.41	4.64	4.63	3.67	3.26	3.96	4.71	5.54
5-YR GOVT SECURITIES	2.47	2.30	2.42	2.40	2.34	2.75	3.08	3.67	4.43	2.80	2.19	2.48	3.77	5.43
2-YR GOVT SECURITIES	1.03	0.87	0.92	1.00	1.25	1.60	2.15	2.70	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	1.74	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	1.50	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	1.85	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	1.51	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	1.87	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	1.77	4.52	1.49	0.16	0.39	2.03	4.48
STOCKS:														
S&P 500	997	1089	1122	1198	1201	1235	1356	1364	1477	1221	947	1189	1394	1464
S&P 500 quarterly reported earning	59.0	61.4	64.1	67.4	67.9	63.7	68.2	68.6	66.2	14.9	51.2	65.8	67.4	71.1
S&P 500 p/e on reported earnings**	16.9	17.7	17.5	17.8	17.7	19.4	19.9	19.9	26.5	17.7	19.5	18.1	20.7	20.6
S&P 500 quarterly operating earnin	63.1	68.6	73.4	82.6	83.3	79.2	82.0	84.2	82.5	49.5	56.9	79.6	82.5	85.1
S&P 500 p/e on operating earnings ^d	15.8	15.9	15.3	14.5	14.4	15.6	16.5	16.2	17.9	24.7	16.7	14.9	16.9	17.2
S&P 500 underlying earnings***	71.7	72.8	74.0	75.2	76.4	77.6	78.8	80.0	62.7	66.8	71.1	75.8	80.7	85.9
S&P 500 p/e on underlying earning ^d	13.9	14.9	15.2	15.9	15.7	15.9	17.2	17.0	23.5	18.3	13.3	15.7	17.3	17.0

*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)