

## Monthly Economic and Financial Update

Preliminary numbers suggest that spending grew at a 5%-6% annual rate in the second quarter. With inflation close to 1%, it means that real growth was roughly in the vicinity of 4%-5%. Moreover, fairly strong numbers for new orders suggest that the economy will continue to expand in period immediately ahead.

The economic numbers tell us where the economy has been. Stock prices often tell us where investors expect the economy to go. One of the reasons that stock prices often respond positively or negatively in advance of the economy is because stock prices are more sensitive to monetary policy changes than the overall economy.

When monetary policy turns restrictive, one of the first areas to respond negatively is the stock market. There are a number of indications that suggest the Federal Reserve is once again embarking on a policy of monetary restraint. If so, it represents a problem for stocks as well as a threat to the recovery.

Given concerns over Fed policy, I continue to moderate my forecast for the pace of the recovery. The forecast still assumes that the Fed increases liquidity in the months ahead. Under this assumption, the recent decline in stock prices will be temporary. The economy will continue to recover well into next year. And, it will soon make sense to hold larger positions in stocks.

Nonetheless, the uncertainty surrounding Fed policy adds to the risk that these things will play out in a less favorable manner. As a result, for now I continue to favor a defensive position with respect stocks.

Up to this point, monetary policy has been the only factor helping to boost the economy. Congress has done a lot to discourage individuals from increasing output and restoring a healthy economy.

Government policies at the present time are as destructive to growth and prosperity as they have been at any time since the late 1970s. Even if Fed policy were more expansive, government policy changes would create problems for the economy.

The latest nail in the economy's coffin is the so-called "financial reform" legislation. If it passes the Senate, it will be the latest in a series of government moves that makes it difficult for the economy to experience any meaningful recovery

In a series of moves, Congress and the President have adopted policies that will increase the cost and reduce the availability of health care, credit and energy. In addition, we are now only 6 months away from tax increases that will further stifle growth and set back any meaningful recovery.

The economy faced a very similar set of destructive policies in the late 1970s. Those policies led to conditions that were referred to as an "economic malaise." The malaise resulted from misguided policies that threw sand into the gears of the American economy.

The malaise of the 1970s ended after the policies that created it were reversed. Our malaise will also end when the destructive policies that cause it are once again relegated to the dustbin of history.

## Monetary Indicators & the Monetary Process

Monetary indicators continue to provide mixed signals. Higher gold prices along with relatively large spreads between short and long-term interest rates point to an expansive monetary policy. However, most money supply measures along with the value of the dollar point to a potentially restrictive policy.

The single best indicator of Fed policy is adjusted bank reserves less excess reserves. Adjusted reserves represent the raw ingredients of the money supply. They are the first step in the process of creating money.

Bank reserves are completely under the control of the Federal Reserve. The monthly volatility shown in the chart below reflects two things. First, the Fed chooses to fix the price of credit (the fed funds rate) instead of the quantity of reserves in the system. Fixing the funds rate allows reserves to move erratically up and down. Second, the volatility reflects substantial monthly changes in excess reserves held by banks.

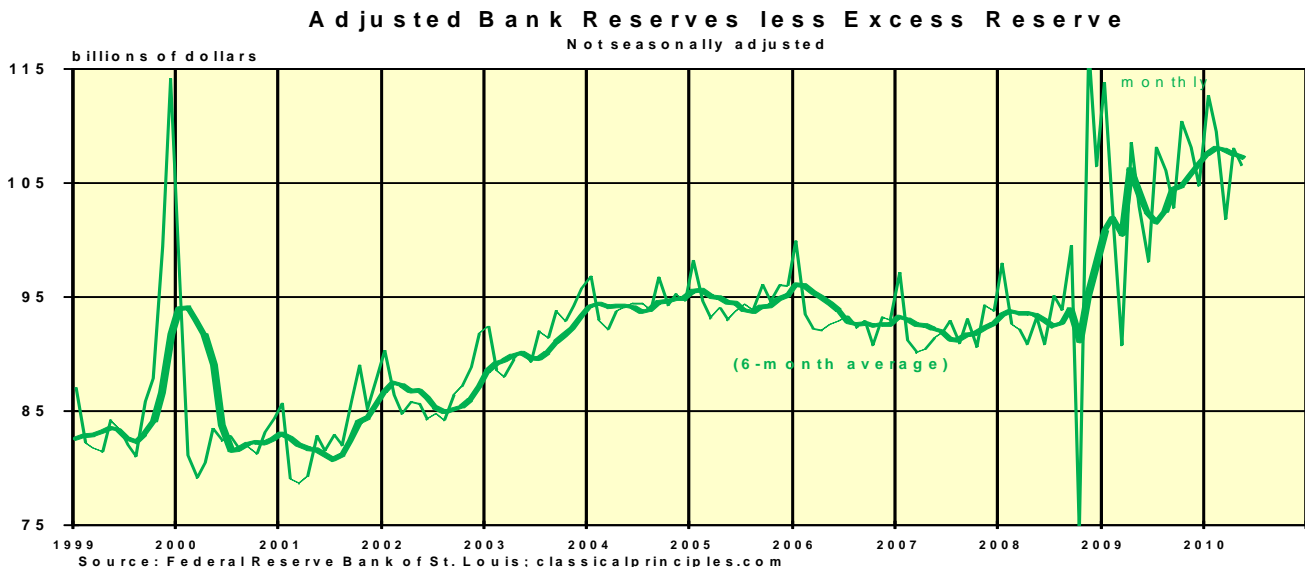
Although bank reserves adjusted for excess reserves are up about 10% from early last year, there has been only a modest increase in the year ending in May and no increase over the past 6-7 months.

As a result, most measures of the money supply show relatively low year-over-year growth rates. While I continue to expect the growth in bank reserves to resume, it's not at all certain this will occur. The recent lack of growth combined with declining stock prices raises the odds that the Fed is once again inadvertently tightening liquidity.

In early May I recommended adopting a defensive stock market strategy as a hedge against another liquidity squeeze. Developments over the past two months suggest that the odds of such a development have increased.

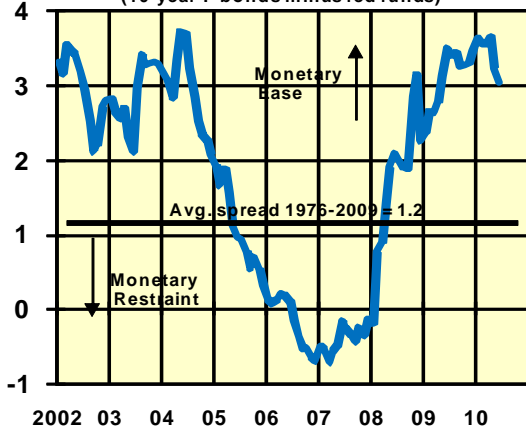
As evidence that the Fed is tightening liquidity has increased, I have moderated my forecast for the strength of the economic recovery. So long as the data on bank reserves point to a lack of liquidity, I will continue to pare back my forecast. It now points to spending increases closer to the 5% vicinity compared to 6% last month.

If monetary data show no increase in liquidity in the months ahead, the pace of the recovery in the latter part of this year is likely to be even slower.

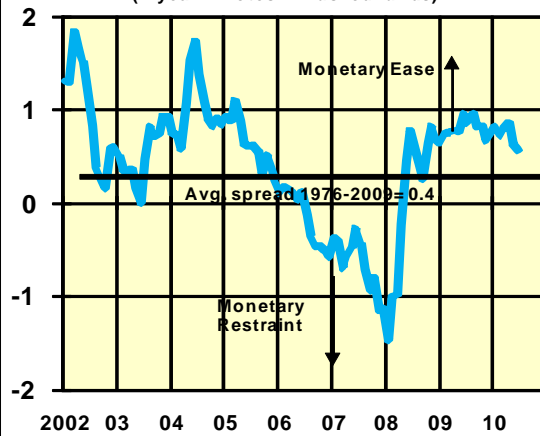


# MONETARY INDICATORS

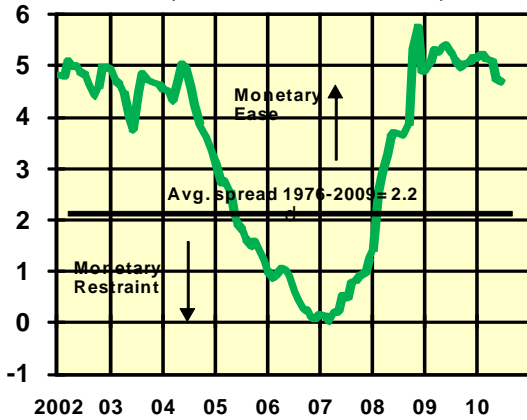
**Yield Spread: 10yr-FF**  
(10-year T-bonds minus fed funds)



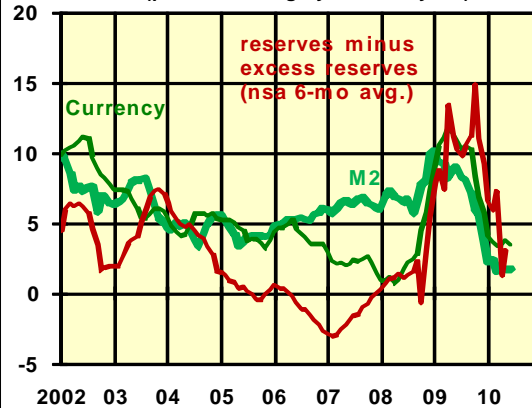
**Yield Spread: 2yr-FF**  
(2-year T-Notes minus fed funds)



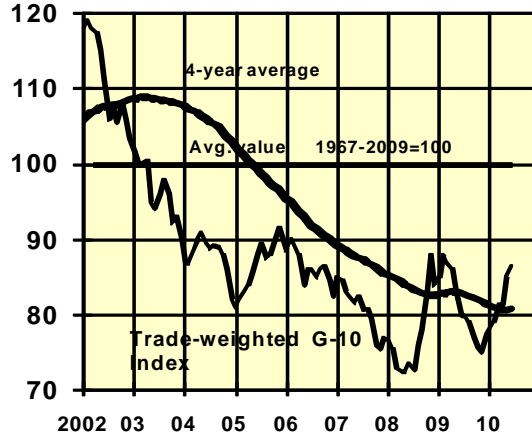
**Yield Spread: AAA-FF**  
(AAA bonds minus fed funds)



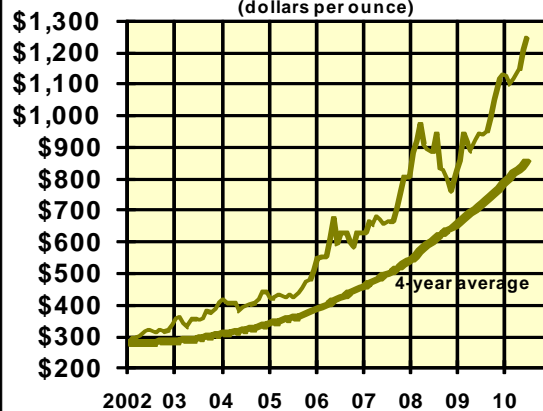
**High-Powered \$ & M2**  
(percent change year over year)



**U.S. Dollar Index**



**Gold Prices**  
(dollars per ounce)



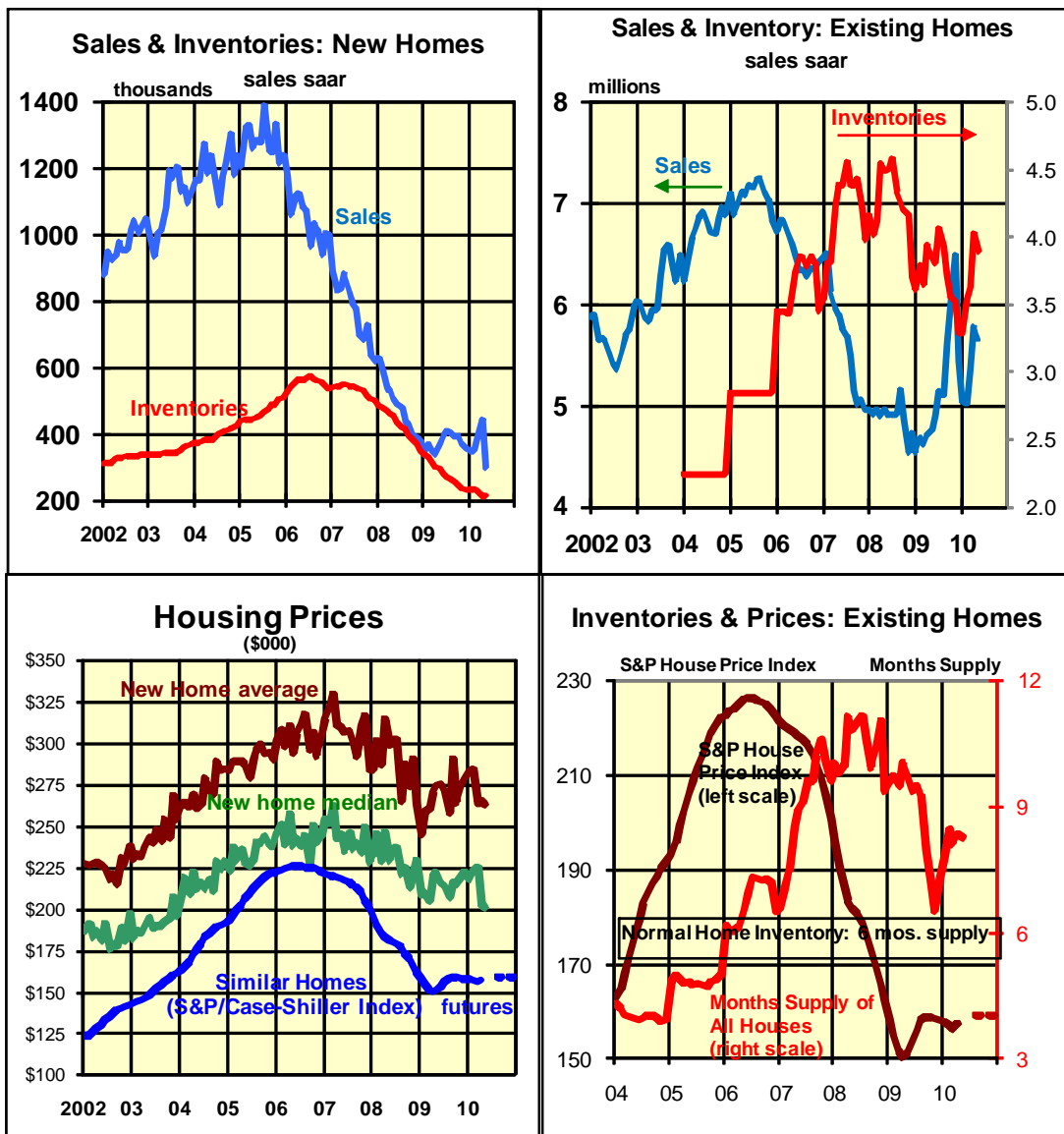
## Sensitive Indicators

Sensitive economic indicators continue to improve. This suggests that the momentum exists for a further expansion in business activity. While housing activity shows some modest improvement, existing home inventories remain too high for any meaningful near-term recovery in the housing market.

New orders through May were fairly strong in all three of the charts on the next page. It's important to pay close attention to the ISM new order figures due at the beginning of July. If

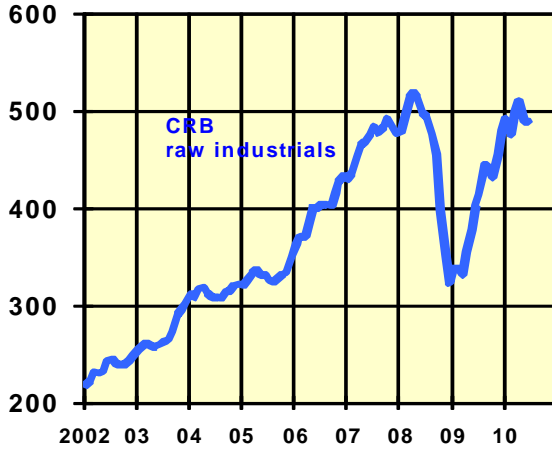
Fed policy is beginning to limit liquidity, the first signs of a slowdown are likely to appear in the ISM surveys of new orders.

The coincident indicator charts on page 5 show dramatic changes in business activity. These indicators reflect the strength in the economy during the early months of the year. However, some of the data, such as the employment reports are artificially high due to the hiring of census workers.

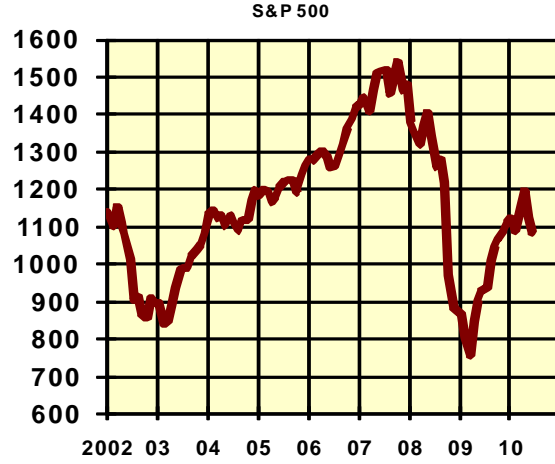


# SENSITIVE INDICATORS

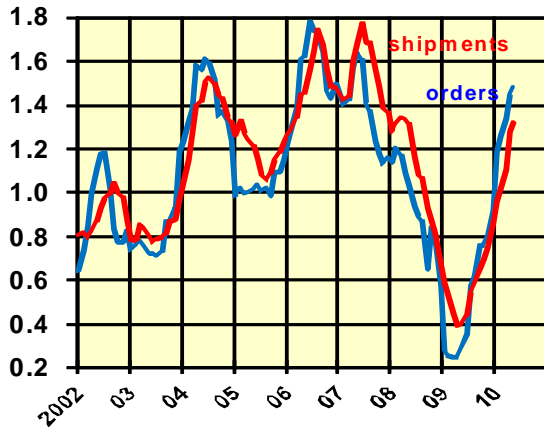
## Raw Industrial Prices



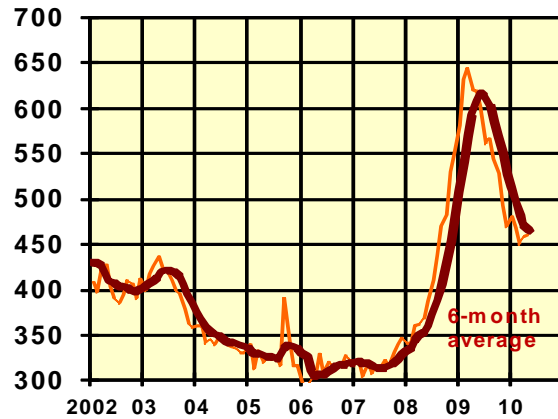
## Stock Prices



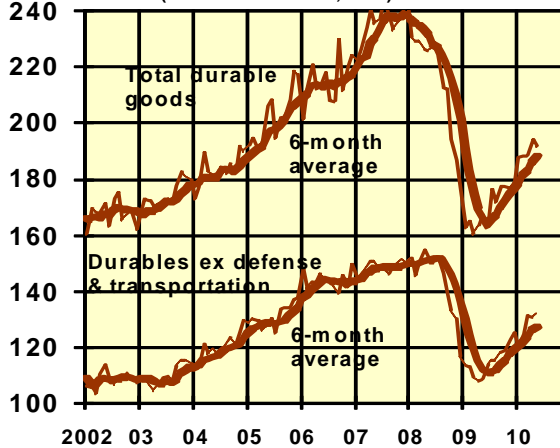
## Semiconductor: N. A. Orders and Shipments (billions of \$)



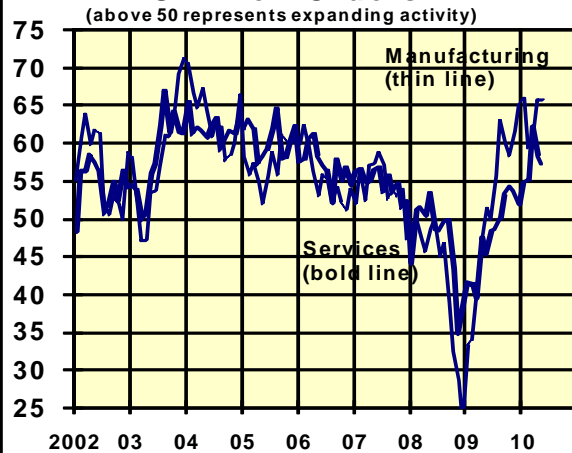
## Unemployment Claims (weekly claims)



## New Orders (billions of dollars, saar)

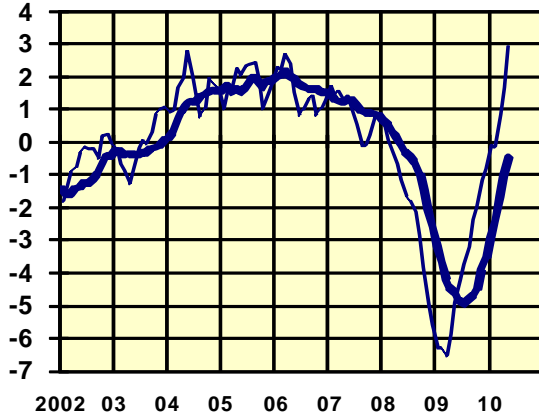


## ISM: New Orders

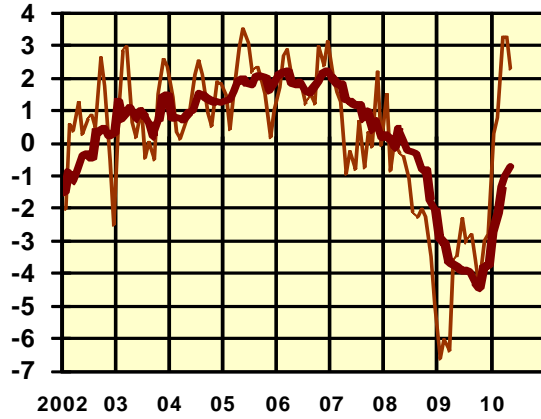


# ECONOMIC INDICATORS

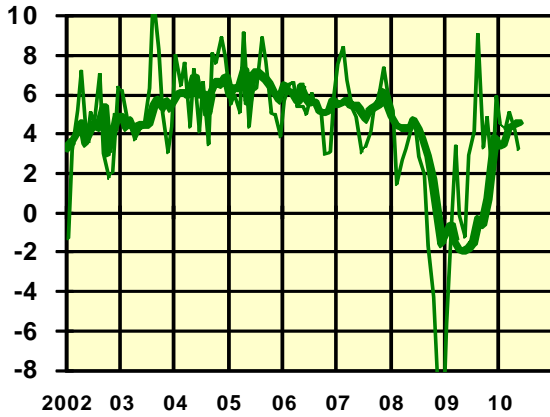
**Jobs: Payroll Data**  
(annual rates of change--3 months & 1 year)



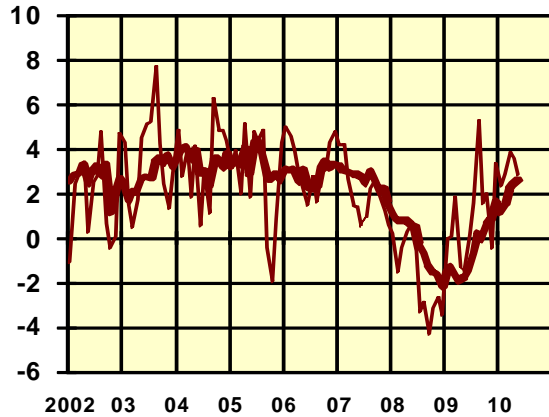
**Jobs: Household Data**  
(annual rates of change--3 months & 1 year)



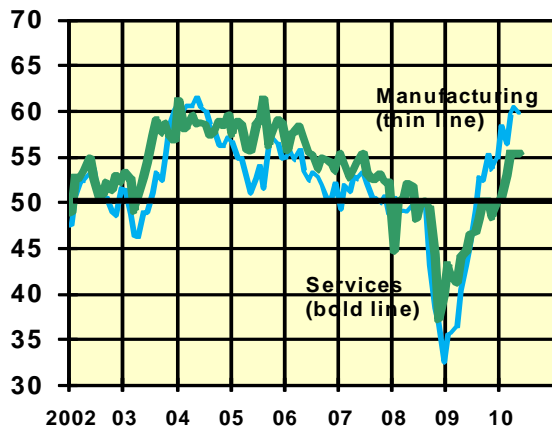
**Consumer Spending**  
(annual rates of change-- 3 months & 1 year)



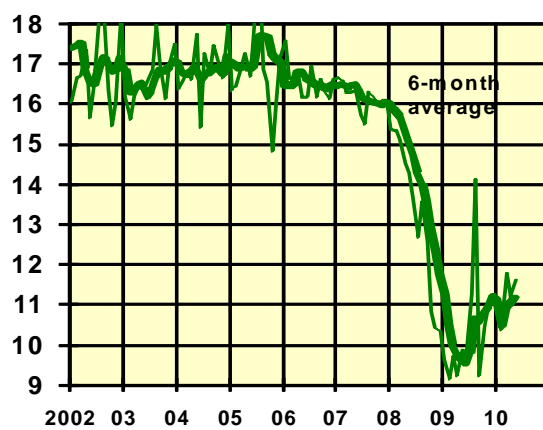
**Real Consumer Spending**  
(annual rates of change-- 3 months & 1 year)



**ISM: Composite**  
(over 50 represents expanding activity)



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



## Inflation Indicators

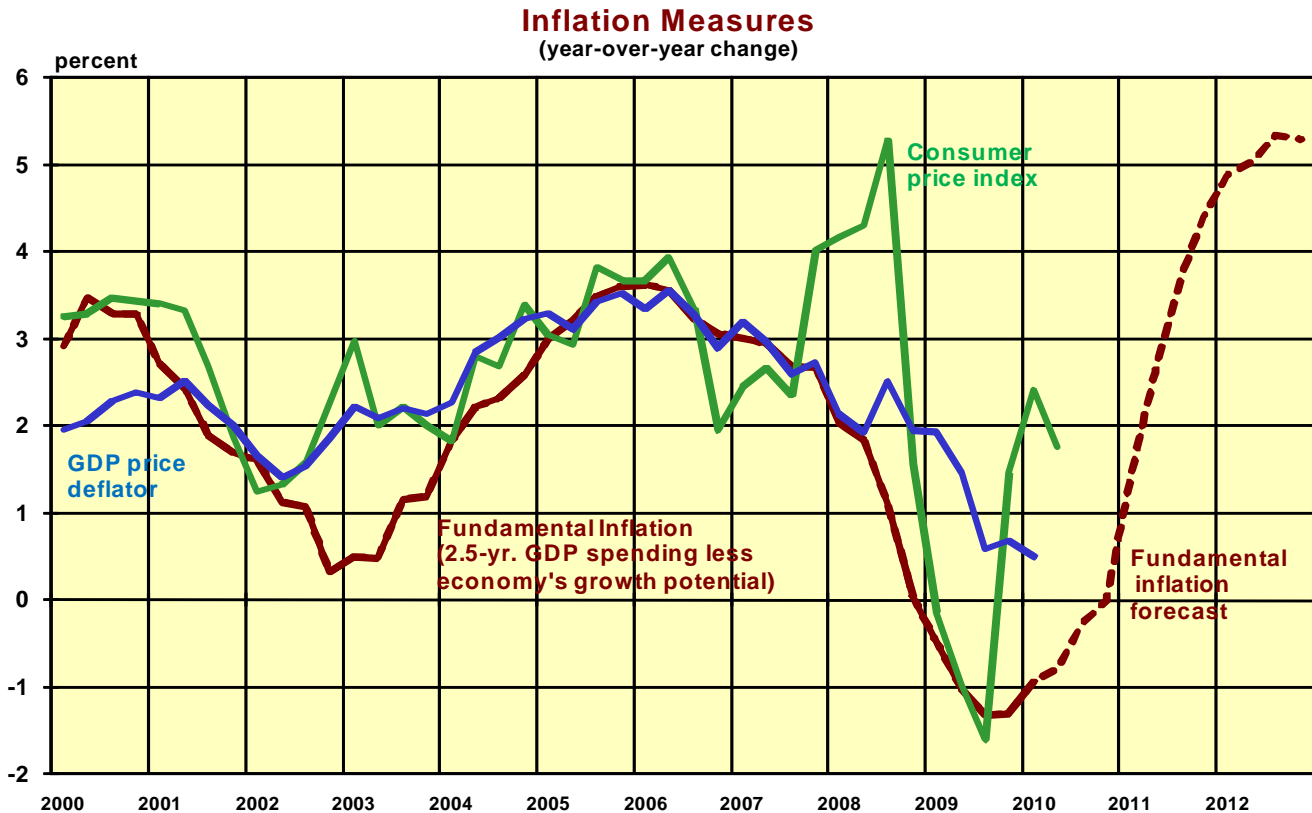
The recent revival in business activity has led to sharp increases in commodity prices. Commodity prices are far more volatile than more conventional inflation measures, which include a large component of more stable labor costs.

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%**.

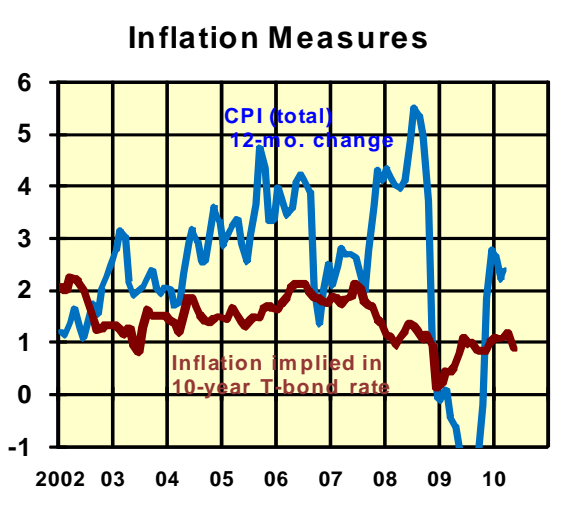
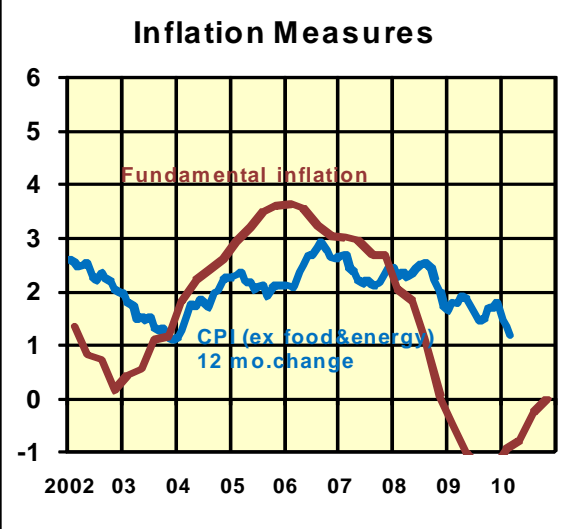
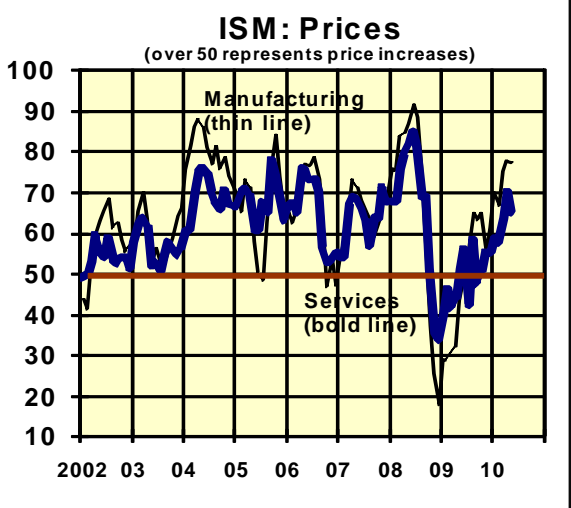
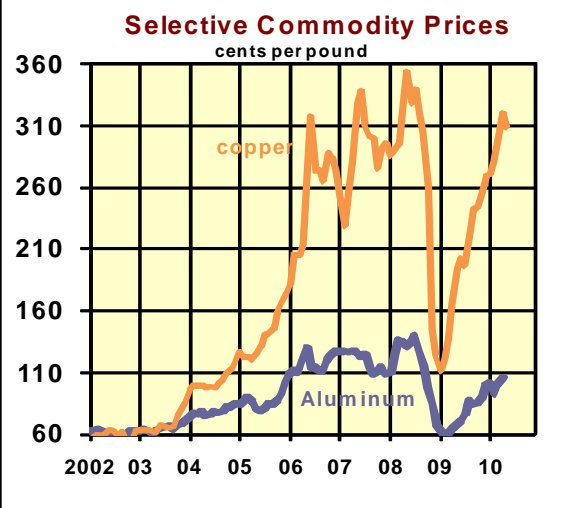
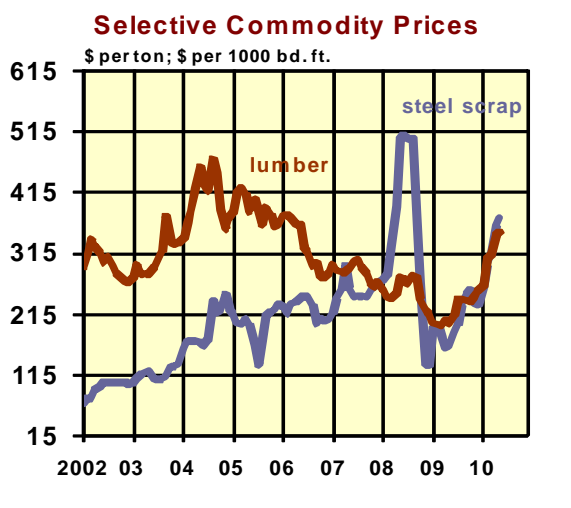
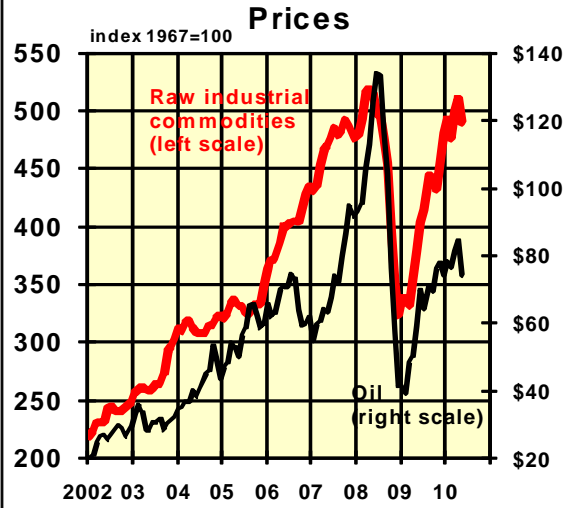
Given the weakness in spending over the past year, inflation is likely to remain subdued even as the economy recovers.

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.

If the slowdown in bank reserves leads to a slower pace of growth this summer and fall, commodity prices are likely to fall and the moderate inflation numbers seen so far this year will carry over into 2011.



# INFLATION INDICATORS



## Interest Rates

A combination of high unemployment and relatively subdued inflation puts pressure on the Fed to pursue an expansive monetary policy. Unfortunately, the Fed's operating procedure focuses on setting the fed funds rate instead of regulating the amount of bank reserves.

Increases in bank reserves tend to increase bank deposits. However, when these reserves are either held at the bank in the form of vault cash, held at the Fed or held as cash by individuals, it limits the creation of bank deposits.

As the chart on the following page shows, bank reserves after allowance for excess reserves (i.e. reserves that banks keep with the Fed) increased rapidly early last year. The increase helped boost bank deposits and liquidity. With the normal 6-9 month lag, the increase raised the pace of spending.

While the momentum from last year's increase in liquidity continued to boost spending in the first half of this year, the increase in liquidity has begun to subside. Over the course of the past year bank reserves less excess reserves are up only about 3%-4%. Moreover, there has been no increase in the 10 months ending in May.

When liquidity begins to dry up, the effects tend to appear first in financial markets in the form of weaker stock prices. The downward move in stock prices over the past two months is consistent with a shortage in liquidity.

A shortfall in liquidity is also typically accompanied by a smaller spread between short and long-term interest rates. Although spreads have narrowed in recent months (see chart on page 3), they remain above their cyclical averages.

The interest rate spread at the current time may be distorted due to a combination of factors, including the record low short-term rates.

In any event, if the relatively flat trend in liquidity were to continue through this summer, we are likely to see further weakness in stock prices. This would be followed by a significant slowdown in the economy within the next 3-6 months.

Also, if there is a lack of liquidity, we could expect some weakening in commodity prices and other sensitive leading indicators within the next few months.

It would probably not be until later in the year before the impact would spread to the rest of the economy leading to either a slowdown or another downturn.

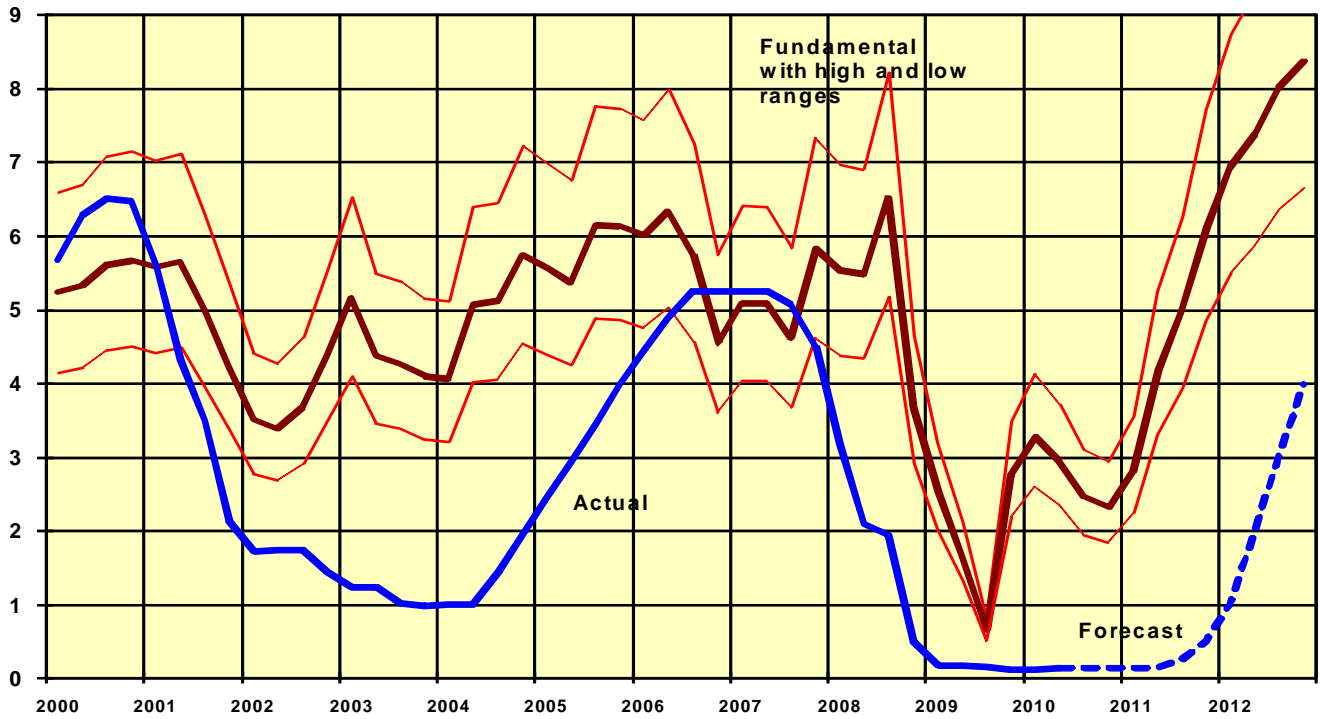
For purposes of the current forecast, my assumption continues to be that the Fed will increase the amount of bank reserves over and above the level of excess reserves. This would mean that the recovery remains intact.

No one (not even Fed members) knows the future course the Fed will take. Since Fed members don't pay attention to reserves in the system, they appear unaware of what is happening in this area.

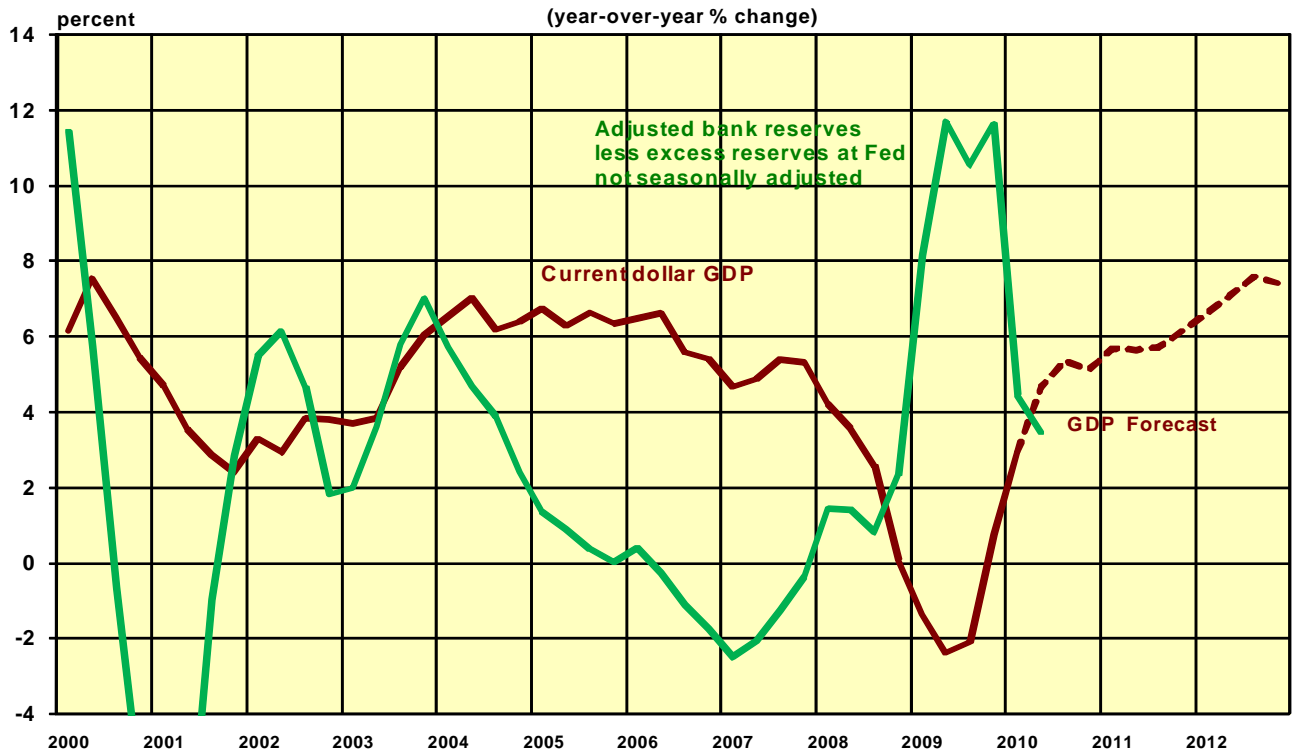
We will have more information on liquidity when the Fed releases the data for June. Those data will either provide greater confidence that the Fed is increasing liquidity, or it will increase the anxiety associated with potential problems in financial markets and the economy.

In response to the lack of growth in liquidity, I have reduced my forecast for spending growth to roughly a 5% annual rate in the latter part of this year. Without a sharp pick up in spending, the Fed is likely to keep the fed funds target unchanged through the first half of next year.

**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**

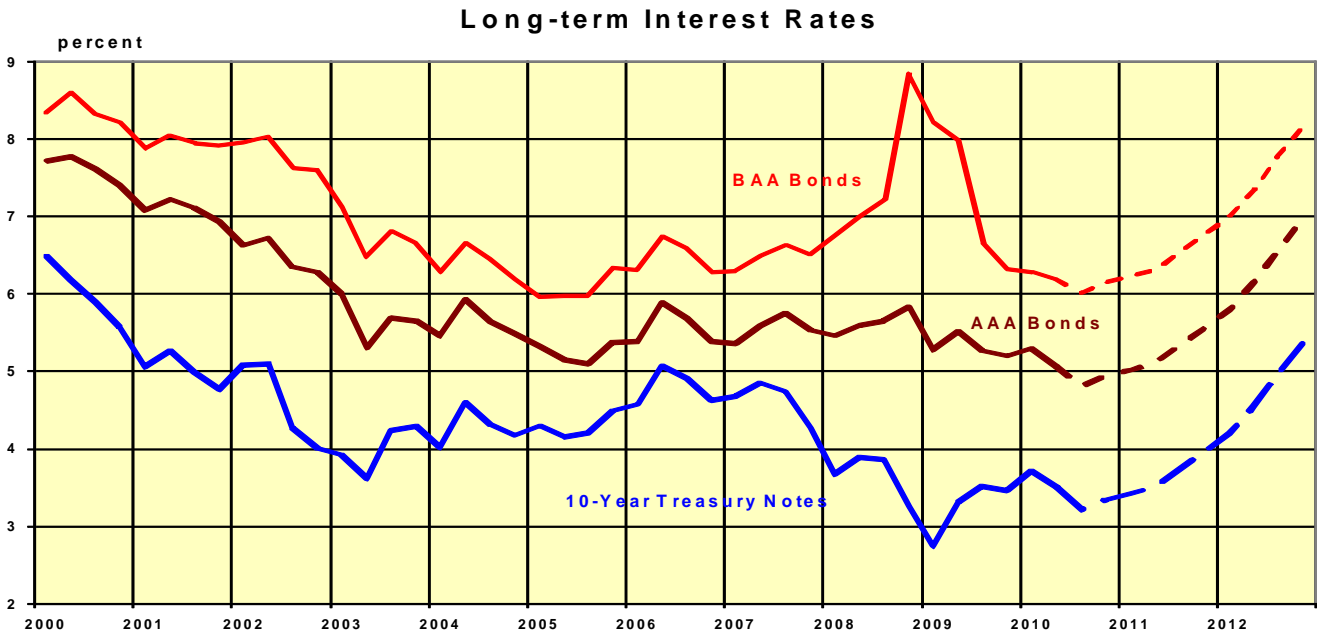
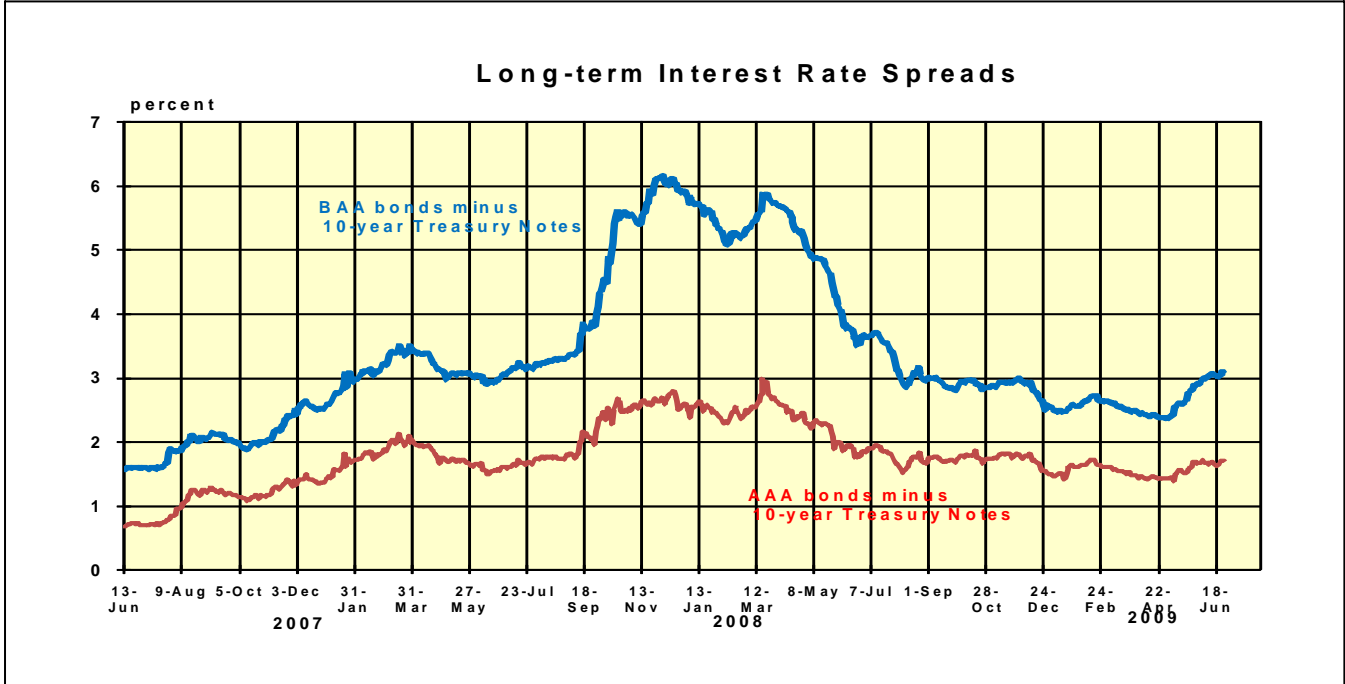


## LONG-TERM INTEREST RATES

The chart immediately below shows the spread between interest rates on corporate bonds and the long-term Treasury notes. Higher spreads tend to be associated with higher levels of uncertainty.

The recent increase in these spreads is another reason to suspect that liquidity is drying up.

The odds still favor a moderate increase in growth and spending in the latter half of this year. However, the possibility of a further shift toward monetary restraint would produce a different outlook. If the Fed continues to shift toward further restraint, all interest rates would remain low for a more extended period of time than shown in the current forecast.



## STOCK PRICES

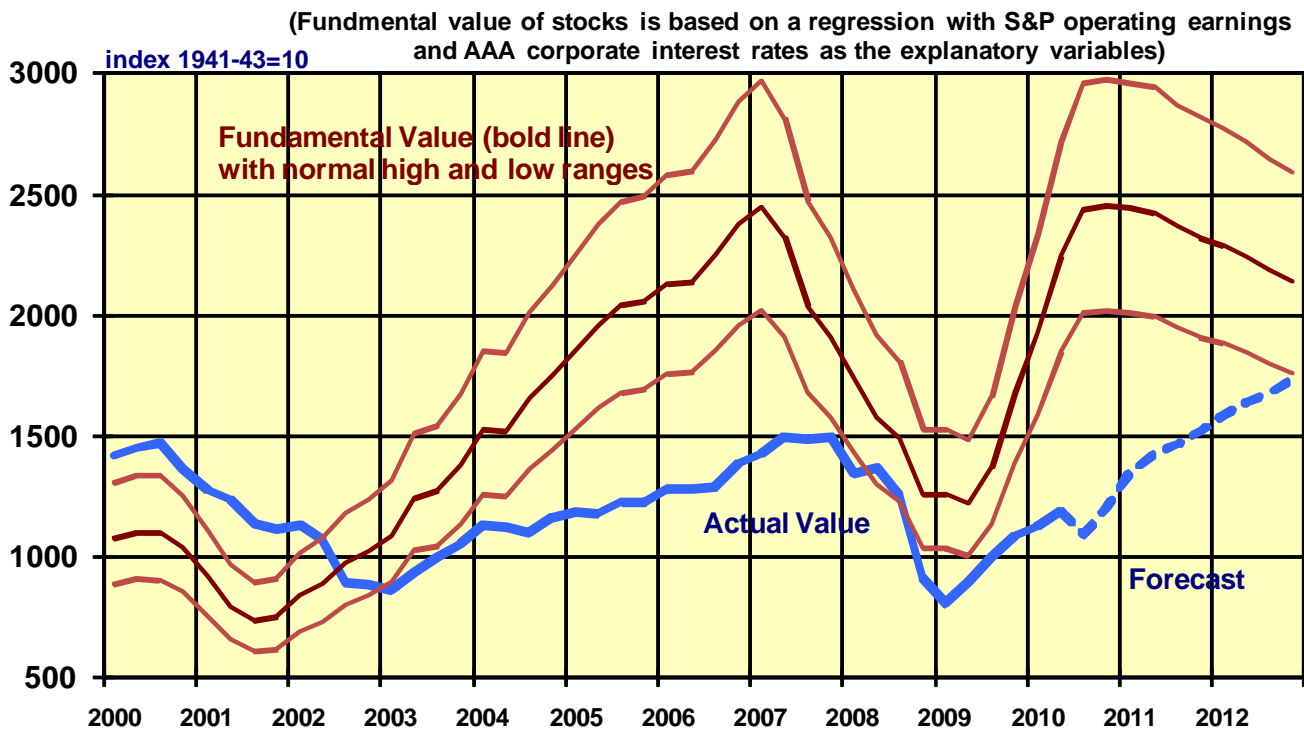
Strong profits and low interest rates mean that the fundamental value of stocks is far higher than the actual values. Even so, investors are understandably concerned about a number of factors.

Monetary restraint can send stock prices down even when other government policies are constructive. If other policies are destructive the potential for weaker stock prices is that much greater.

The upturn in future stock prices shown in the chart below is based primarily on the assumption that Fed policy expands in the months ahead. This would provide a boost to stock prices.

However, until there is either more reliable insight into the Fed's next move or some evidence of a positive shift in investor psychology, my inclination is to continue to avoid stocks.

### Stock Prices: S&P 500



6/29/2010	<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	14592	14808	15006	15190	15419	15646	14441	14256	14899	15762	16893
%ch	2.6	6.1	3.9	6.0	5.4	5.0	6.1	6.0	2.6	-1.3	4.5	5.8	7.2
REAL GDP	12973	13150	13239	13412	13554	13679	13793	13865	13312	12987	13471	13906	14268
%ch	2.2	5.6	2.7	5.3	4.3	3.7	3.4	2.1	0.4	-2.4	3.7	3.2	2.6
CHAIN PRICE INDEX	1.098	1.099	1.102	1.104	1.107	1.111	1.118	1.129	1.085	1.097	1.106	1.134	1.186
%ch	0.4	0.5	1.1	0.7	1.1	1.3	2.8	3.9	2.1	1.2	0.8	2.6	4.6
CPI- ALL URBAN%ch	3.7	2.6	1.5	-0.8	0.8	1.0	2.5	3.6	3.8	-0.3	1.5	2.3	4.8
FUND. INFLATION%ch	-1.3	-1.3	-0.9	-0.8	-0.4	-0.2	1.3	2.4	2.3	-0.1	-1.1	0.8	4.4
PRETAX PROFITS	1495	1632	1847	1775	1815	1839	1827	1828	1462.8	1427.7	1818.9	1833.2	1936.4
%ch	56.3	42.0	64.1	-14.7	9.2	5.3	-2.5	0.3	-17.6	-2.4	27.4	0.8	5.6
PRETAX PROFITS ADJ (1)	1359	1468	1585	1562	1577	1613	1595	1599	1360.4	1308.9	1584.0	1603.0	1706.5
%ch	50.7	36.0	35.9	-5.6	3.9	9.4	-4.4	1.1	-11.8	-3.8	21.0	1.2	6.5
AFTER-TAX PROFITS	1174	1270	1424	1385	1421	1430	1420	1425	1171	1113	1415	1427	1505
%ch	68.0	37.0	58.0	-10.5	10.7	2.6	-2.8	1.4	-11.5	-4.9	27.1	0.9	5.4
AFTER-TAX PROFITS ADJ(1)	1038	1106	1161	1172	1183	1204	1188	1196	1068.2	994.2	1179.9	1197.1	1274.7
%ch	61.6	28.8	21.7	3.6	3.9	7.4	-5.2	2.7	-2.0	-6.9	18.7	1.5	6.5
PERSONAL INCOME	12005	12069	12187	12367	12532	12686	12876	13066	12239	12019	12443	13163	14108
%ch	-1.4	2.2	3.9	6.0	5.4	5.0	6.1	6.0	2.9	-1.8	3.5	5.8	7.2
REAL DISPOSABLE INCOME	9984	9985	10037	10203	10319	10421	10516	10579	9911	9993	10245	10604	10856
%ch	-3.6	0.0	2.1	6.8	4.6	4.0	3.7	2.4	0.5	0.8	2.5	3.5	2.4
PRODUCTIVITY	1.498	1.521	1.532	1.542	1.551	1.560	1.565	1.570	1.429	1.483	1.546	1.572	1.593
%ch	7.8	6.3	2.8	2.6	2.4	2.3	1.4	1.2	2.1	3.7	4.2	1.7	1.3
CIVILIAN EMPLOYMENT	139.3	138.1	138.6	139.0	139.4	139.9	140.2	140.4	145.4	139.9	139.2	139.6	141.3
%ch	-3.2	-3.4	1.4	1.2	1.0	1.5	0.7	0.6	-0.5	-3.8	-0.5	0.3	1.2
UNEMPLOYMENT RATE	9.6	10.0	9.7	9.8	9.7	9.2	9.4	9.5	5.8	9.3	9.6	9.6	9.9
INDUSTRIAL PRODUCTION	87.6	89.1	90.6	92.4	92.4	92.4	92.4	92.4	96.7	87.7	92.0	92.4	98.0
%ch	8.3	6.9	6.9	8.2	0.0	0.0	0.0	0.0	-3.3	-9.3	4.8	0.5	6.0
LIGHT VEHICLE SALES (2)	11.5	10.9	11.0	12.5	12.7	12.6	12.3	11.6	13.2	10.4	12.2	12.5	11.8
Domestic	6.4	5.7	5.7	6.8	6.9	6.8	6.6	5.8	6.8	5.5	6.6	6.8	6.1
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.

(2) Millions at seasonally adjusted annual rates.

6/29/2010	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	5.3	6.3	7.1	7.8	3.9	6.3	6.8
Adj. Bank Reserves (billions of \$)	895	1146	1218	1151					94	233	968	1185		
less excess reserves at Fed	103	106	106	108	110	112	116		92	94	103	109		
Interest Rates:														
Baa Corp Bonds: Moody's	6.66	6.33	6.29	6.18	6.01	6.14	6.22	6.31	6.48	7.45	7.30	6.11	6.46	7.57
Aaa Corp Bonds: Moody's	5.27	5.20	5.29	5.05	4.81	4.94	5.02	5.11	5.56	5.64	5.31	4.93	5.26	6.37
MORTGAGE RATES	5.16	4.92	5.10	5.20	4.91	5.04	5.22	5.31	6.34	6.04	5.04	5.06	5.51	6.77
10-YR GOVT SECURITIES	3.52	3.46	3.72	3.50	3.21	3.34	3.42	3.51	4.63	3.67	3.26	3.44	3.66	4.77
5-YR GOVT SECURITIES	2.47	2.30	2.42	2.25	1.88	2.09	2.16	2.43	4.43	2.80	2.19	2.16	2.50	4.23
2-YR GOVT SECURITIES	1.03	0.87	0.92	1.00	1.15	1.25	1.30	1.35	4.36	2.00	0.96	1.08	1.45	3.70
3-MONTH T-BILL	0.17	0.07	0.10	0.25	0.35	0.39	0.39	0.39	4.41	1.46	0.16	0.27	0.50	2.74
FEDERAL FUNDS RATE	0.16	0.12	0.13	0.15	0.15	0.15	0.15	0.15	5.02	1.93	0.16	0.15	0.26	2.50
3-MONTH LIBOR RATE	0.41	0.27	0.26	0.50	0.50	0.50	0.50	0.50	5.30	2.91	0.69	0.44	0.61	2.85
BOND EQUIVALENT RATES:														
FEDERAL FUNDS	0.16	0.12	0.13	0.15	0.15	0.15	0.15	0.15	5.15	1.95	0.16	0.15	0.26	2.54
3-MONTH LIBOR	0.41	0.27	0.26	0.50	0.50	0.50	0.50	0.50	5.44	2.95	0.70	0.44	0.61	2.90
3-MONTH T-BILL	0.17	0.07	0.10	0.25	0.36	0.40	0.40	0.40	4.52	1.49	0.16	0.28	0.51	2.80
STOCKS:														
S&P 500	997	1089	1122	1185	1091	1204	1344	1425	1477	1221	947	1150	1438	1660
S&P 500 quarterly reported earning	59.0	60.7	69.5	70.1	70.8	66.1	71.1	71.6	66.2	14.9	51.0	69.1	70.2	74.7
S&P 500 p/e on reported earnings**	16.9	17.9	16.1	16.9	15.4	18.2	18.9	19.9	26.5	17.7	19.6	16.7	20.5	22.3
S&P 500 quarterly operating earnin	63.1	68.6	77.5	90.6	95.2	82.8	83.3	92.5	82.5	49.5	56.9	86.5	88.8	92.5
S&P 500 p/e on operating earnings <sup>d</sup>	15.8	15.9	14.5	13.1	11.5	14.5	16.1	15.4	17.9	24.7	16.7	13.3	16.2	17.9
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 <sup>d</sup>	13.9	14.9	15.2	15.8	14.3	15.5	17.1	17.8	23.5	18.3	13.3	15.2	17.8	19.3

\*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)