

## Monthly Economic and Financial Update

Economic reports indicate that the pace of business activity has slowed. Current dollar GDP slowed to just over a 4% annual rate between the first and second quarters. In June, consumer spending and personal income showed no change from May.

With Fed policy turning less accommodative, some slowdown in activity was likely to occur. Even so, the economy seldom moves smoothly one direction. Even if it did, reported numbers often provide misleading information. They are rough estimates based on limited data.

The ISM surveys of purchasing managers provide some of the more reliable information on business activity. July numbers show that both the economy and new orders continue to increase, albeit at a slower pace than earlier in the year. This suggests that the reported pause in spending in June was an aberration.

While Fed policy continues to show no change in liquidity through June, the relationship between liquidity and spending can be fairly loose. Since the slowdown in recent months appears greater than anticipated, it would not be surprising for business activity to show some modest signs of improvement in the months ahead.

Even so, my concerns over Fed policy have led me to reduce my estimate for current dollar GDP growth to a 5% annual rate for the coming 6-9 months. As in the past, I continue to expect that sooner or later Fed members will adjust policy to improve liquidity. For the sake of the recovery, they should figure it out sooner rather than later.

Regardless of what the Fed does and when it does it, Congress has placed significant

barriers in the way of any meaningful recovery. Extensive estimates of the cost of its recent legislative initiatives are now available.

Health Care legislation has a price tag estimated at \$2.7 *trillion* over the next nine years. The estimates are based almost entirely on Congressional Budget Office data. Most of the expenditure is for organization, processing and enforcement. These are all things that politicians apparently believe are essential in a government-run health system.

A detailed analysis of the Financial Reform legislation suggests that it will cost over \$1.5 *trillion* during the next five years. The cost estimate is based on experience with Sarbanes-Oxley (SOX), which had five-year costs of over \$50 billion. Financial Reform bill is over 30 times the magnitude of SOX.

Both of these bills will create work for accountants, lawyers, programmers and government employees. The estimated annual cost of both of these measures amounts to roughly \$1,500 per worker. For the years covered by the estimates, the total cost per worker amounts to roughly \$13,000. This is the amount by which workers' take home pay will be reduced to pay for the massive expansion of government.

Polling data suggest that there is significant opposition to the current policy direction. Most voters seem to recognize the implication this legislation has their individual freedom of choice and for their pocketbooks. The fall elections will go a long way toward determining the extent to which these recent policy changes will be implemented.

## Monetary Indicators & the Monetary Process

While monetary indicators remain somewhat mixed, they continue to suggest that policy is becoming progressively less accommodative.

At this time, the single best indicator of Fed policy is adjusted bank reserves less excess reserves (shown in the chart below). Adjusted reserves represent the raw ingredients of the money supply. They are the first step in the process of creating money and are the basis for expanding loans, investments and bank deposits.

This measure of liquidity rose by about 12% in the early part of last year. The increase in liquidity led to a sharp rise in stock prices. After the normal lag, the extra liquidity led to an increase in spending and the start of an economic recovery.

After that initial burst of monetary stimulus, there has been little additional liquidity. Financial markets appear to be reacting to a shift from a more accommodative to a less accommodative policy.

In addition to some weakness in stock prices, yield spreads have begun to narrow and the pace of economic activity appears to be slowing.

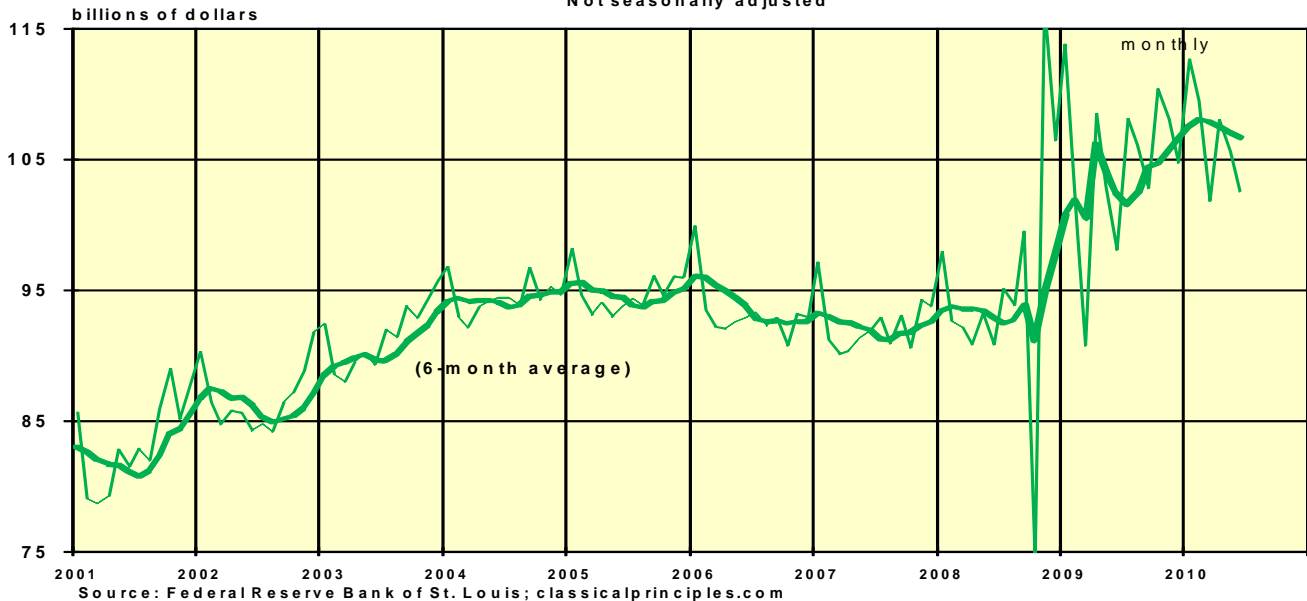
While I expect the growth in bank reserves to resume, it's not at all certain this will occur. The recent lack of growth combined with declining stock prices raises the odds that the Fed could once again inadvertently tighten liquidity.

If this measure of liquidity shows no increase in the months ahead, the pace of the recovery in the latter part of this year is likely to be even slower than recent numbers would suggest. If the measure continues to decline, it's likely to produce a decline in business activity.

My assumption continues to be that the Fed reverses the recent decline in liquidity. So far, that assumption has been wrong. However, the pressure from an economic slowdown and high unemployment may force the Fed to renewed action.

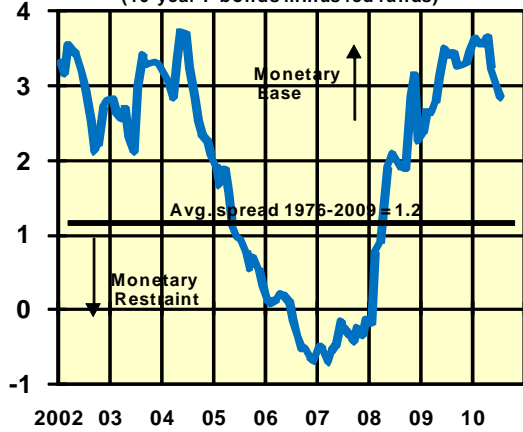
**Adjusted Bank Reserves less Excess Reserve**

Not seasonally adjusted

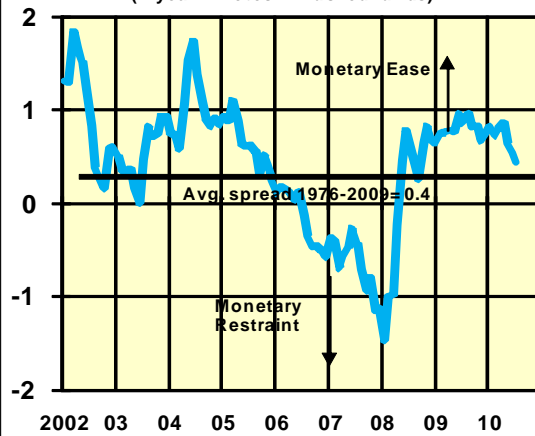


# MONETARY INDICATORS

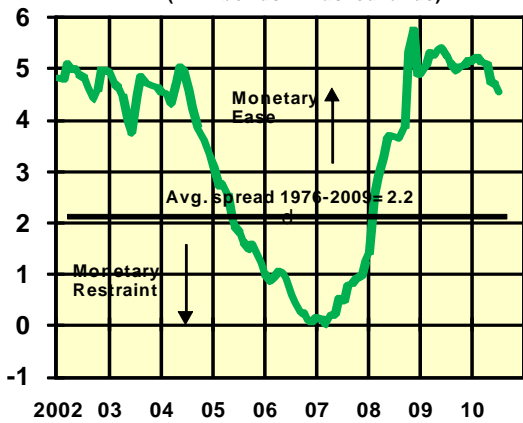
**Yield Spread: 10yr-FF**  
(10-year T-bonds minus fed funds)



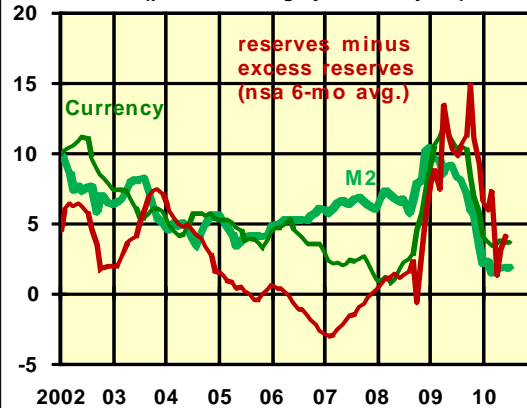
**Yield Spread: 2yr-FF**  
(2-year T-Notes minus fed funds)



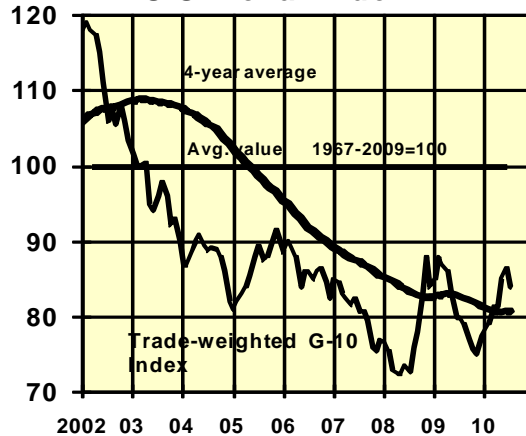
**Yield Spread: AAA-FF**  
(AAA bonds minus fed funds)



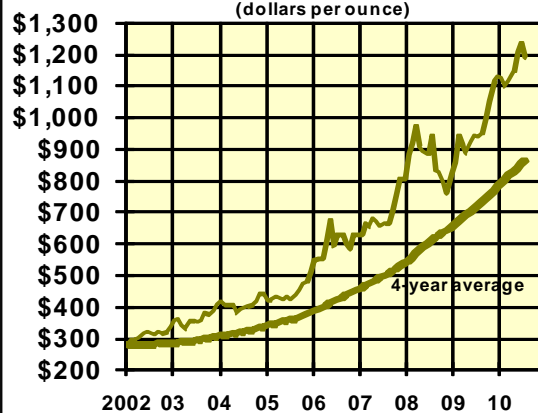
**High-Powered \$ & M2**  
(percent change year over year)



**U.S. Dollar Index**



**Gold Prices**  
(dollars per ounce)



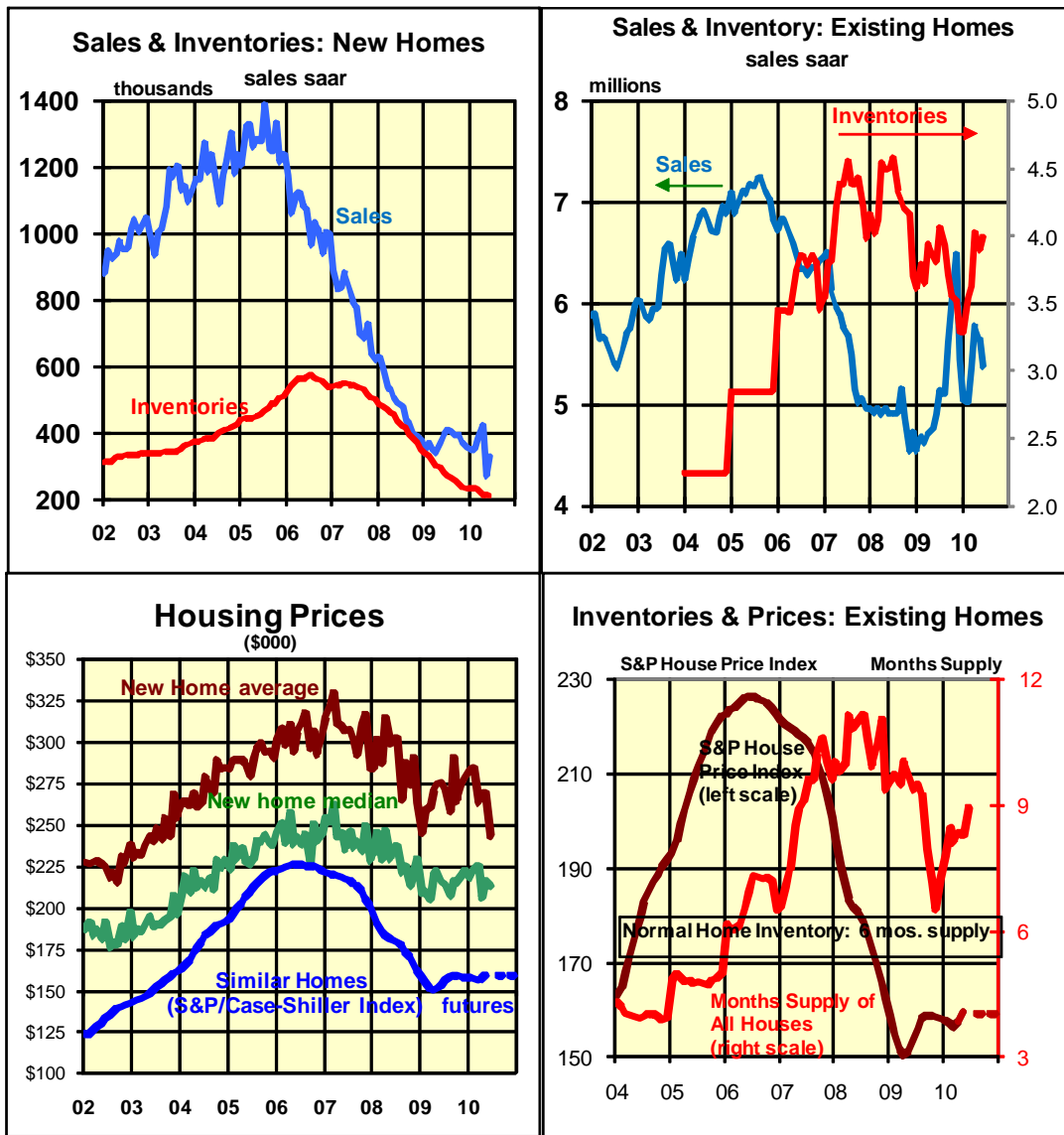
## Sensitive Indicators

Sensitive indicators of economic activity have turned in a mixed performance in recent months. Housing activity remains hostage to the overhang of existing home inventories. Inventories of existing homes are well above levels that would produce a significant improvement in the housing market.

The new orders components to the ISM surveys have eased in recent months. Although the surveys still point to growth, the pace is below the order level from earlier in the year.

Some sensitive indicators (new orders for durable goods and semiconductor orders) continue to show strength. However, these data tend to lag the ISM surveys. Hence, the information may be a bit outdated.

On balance, sensitive indicators have begun to issue tentative warnings that the pace of expansion will be remain relatively sluggish.

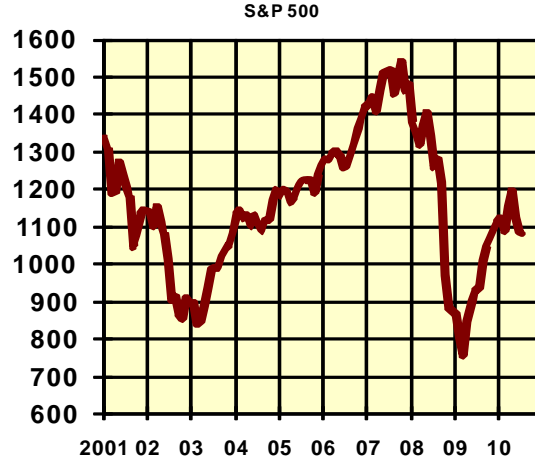


# SENSITIVE INDICATORS

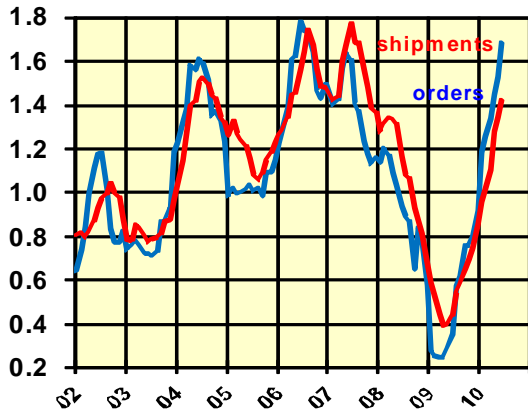
## Raw Industrial Prices



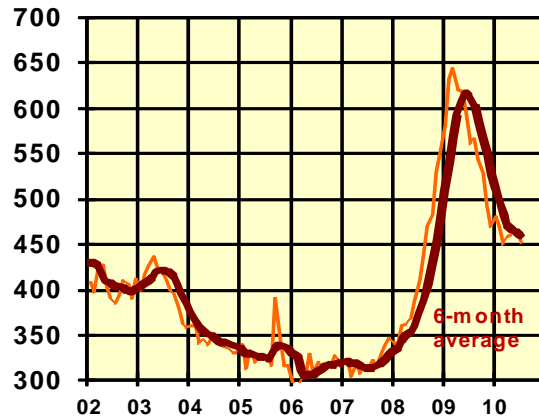
## Stock Prices



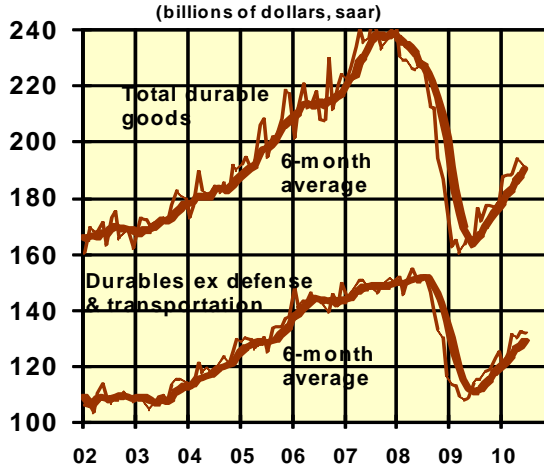
## Semiconductor: N. A. Orders and Shipments (billions of \$)



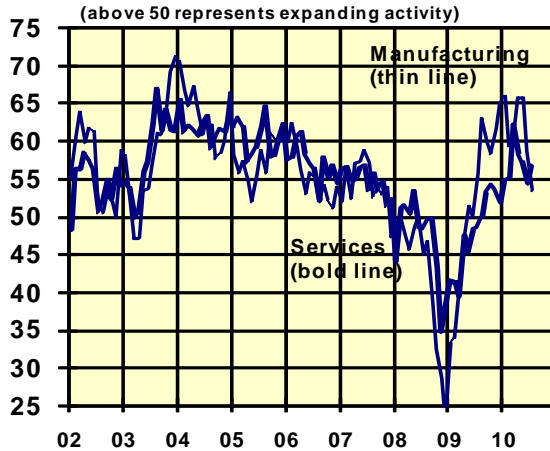
## Unemployment Claims (weekly claims)



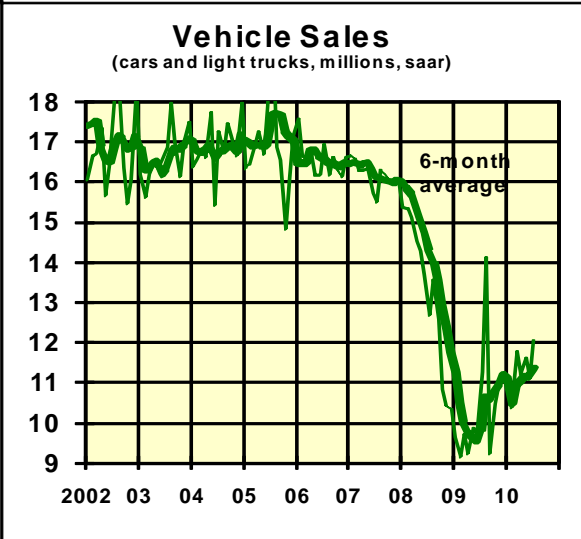
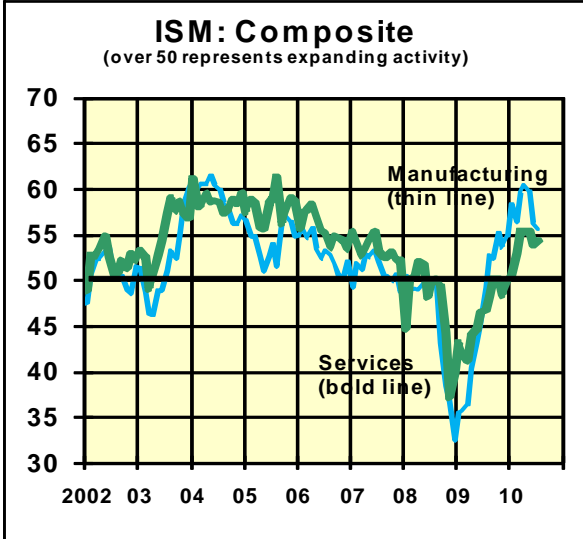
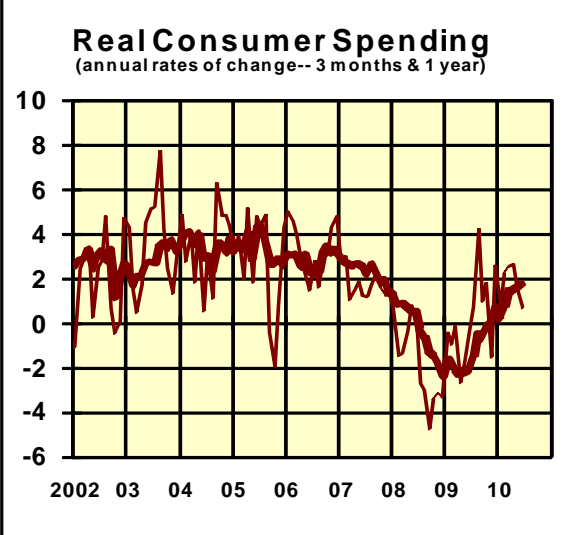
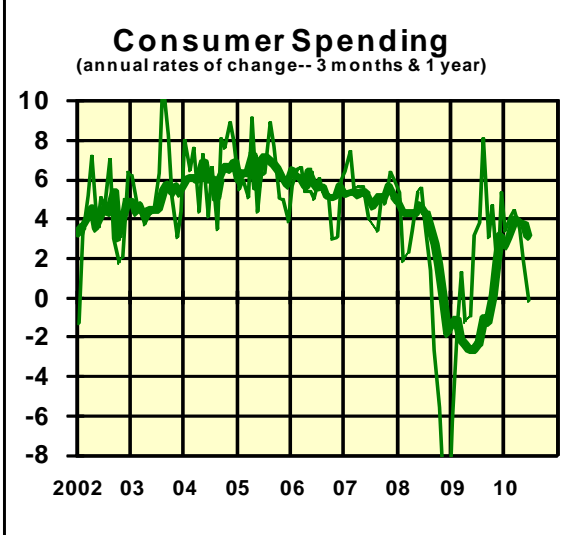
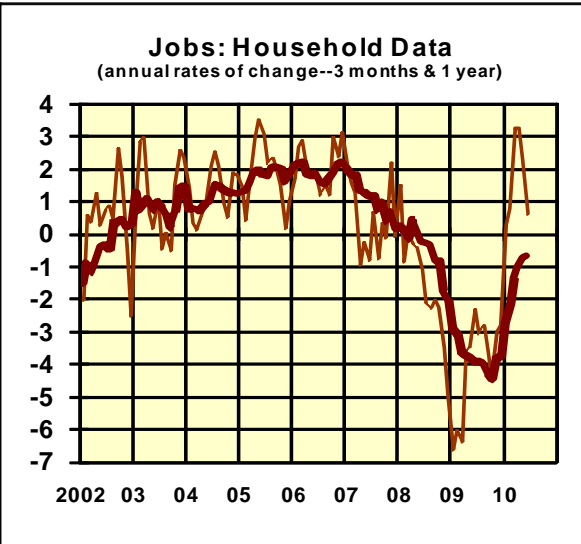
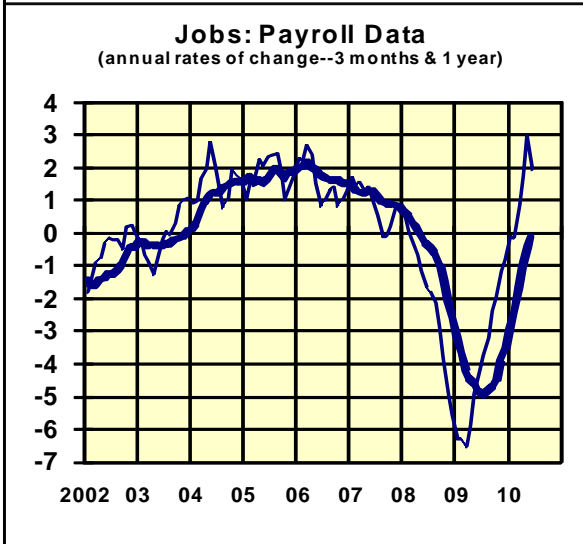
## New Orders (billions of dollars, saar)



## ISM: New Orders (above 50 represents expanding activity)



# ECONOMIC INDICATORS



## Inflation Indicators

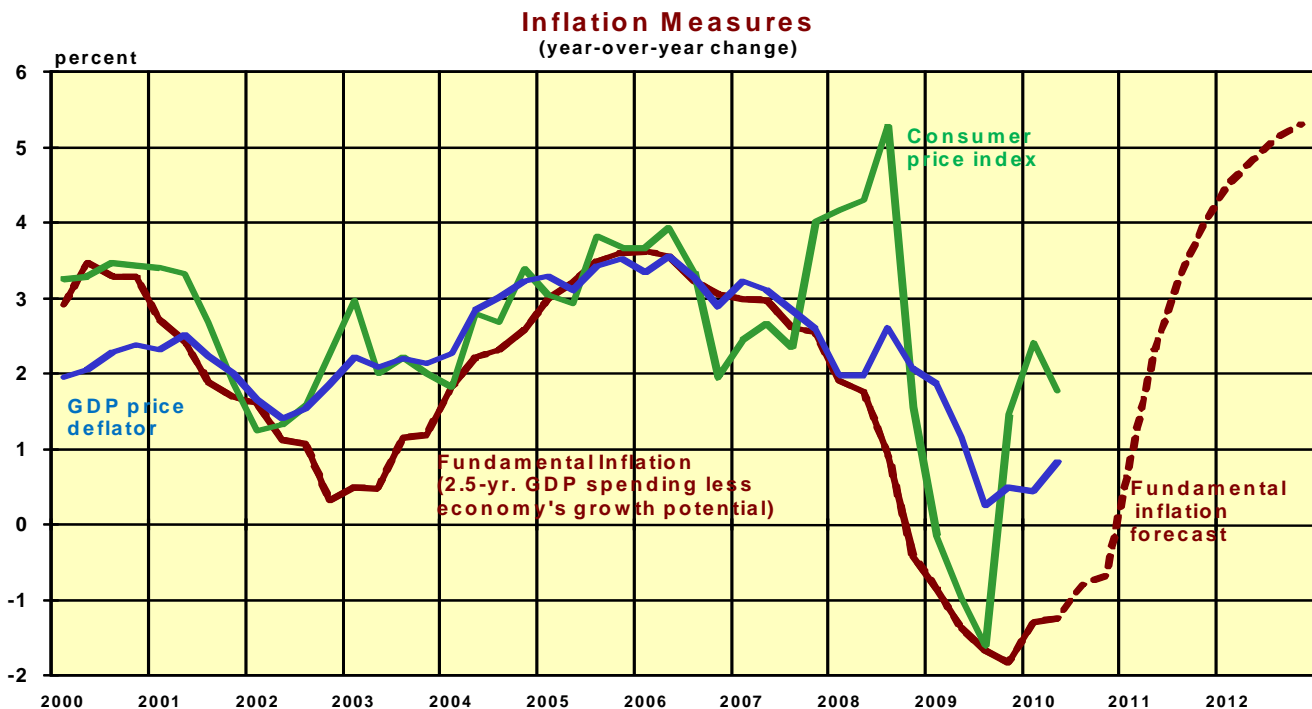
The *underlying* inflation rate is determined by the rate of current dollar spending over a 2-3 year period minus the economy's underlying growth rate. Over the past 2½ years current-dollar spending (GDP) has averaged a bit less than 1% at an annual rate. Subtracting an underlying growth rate of roughly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

The use of this technique suggested that the surge in commodity prices earlier this year would not raise the overall inflation rate. In fact, the CPI both with and without the effect of energy and food prices was only 1% in June from a year ago.

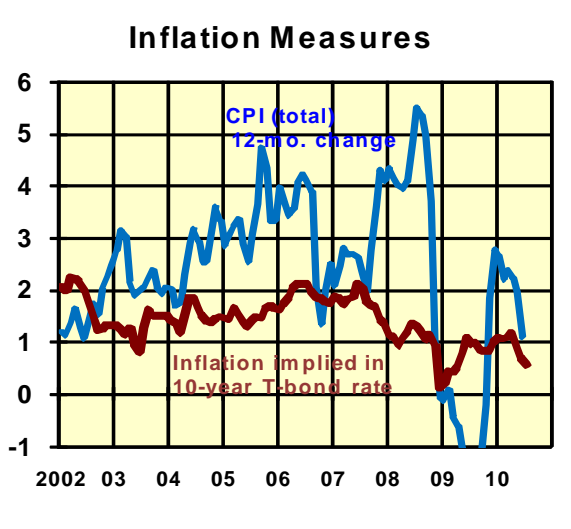
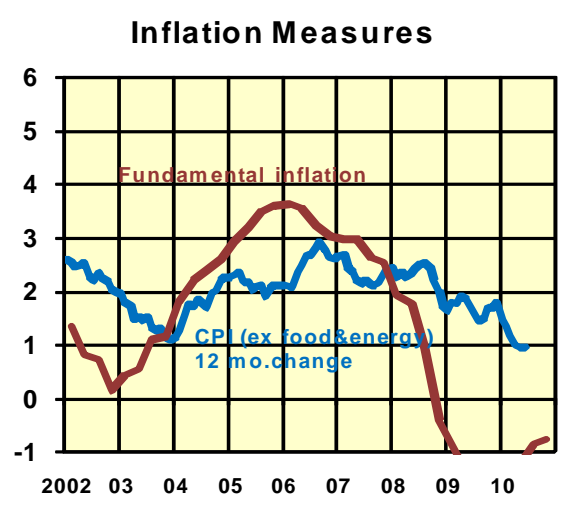
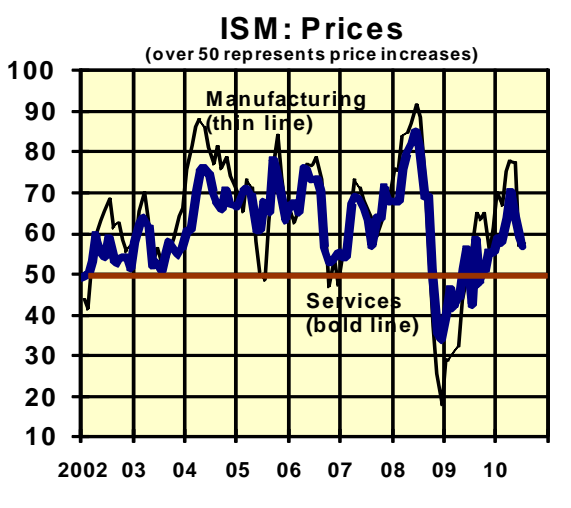
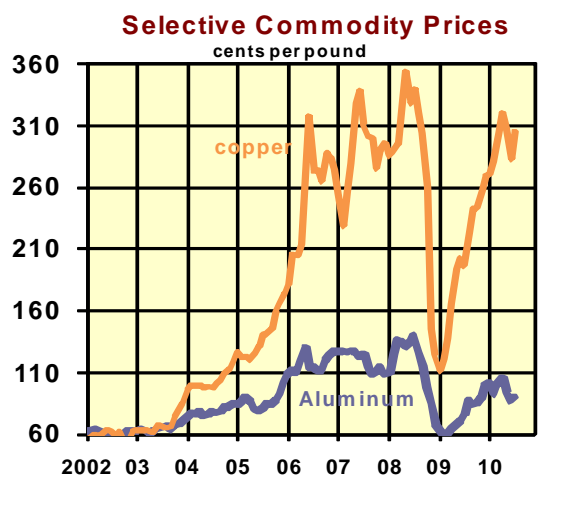
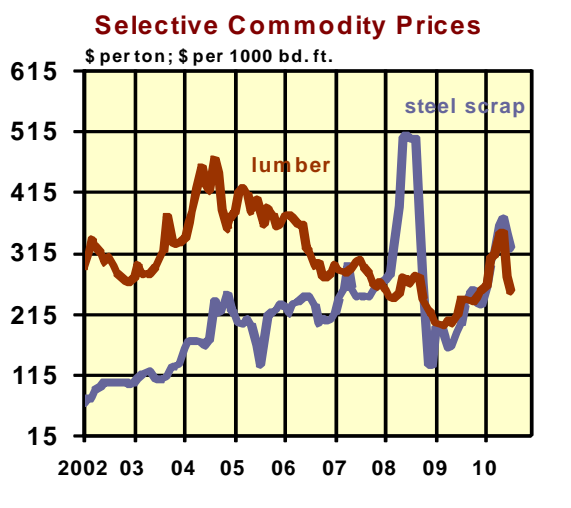
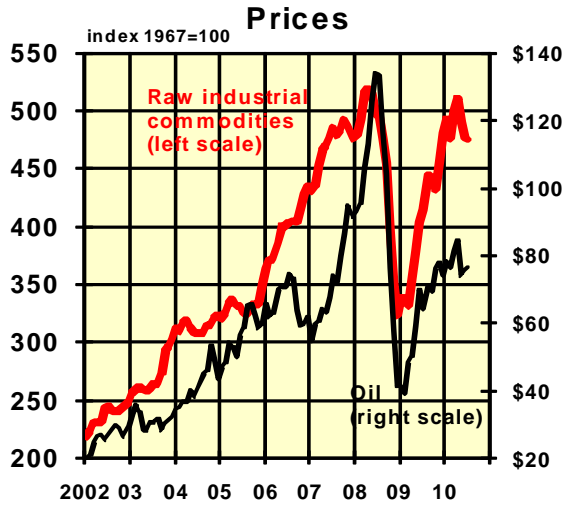
The 2½-year average of current dollar spending should begin to increase in the next few

quarters as slow and even negative quarterly changes drop off. Even moderate increases in current dollar spending in the upcoming quarters should allow the average to rise to 3%-4% by next year. This would place the underlying inflation rates back in the 1%-2% vicinity.

In short, we are likely to see relatively low inflation rates for at least the next year. Moreover, if the slowdown in bank reserves continues and leads to a slower pace of spending this fall and winter, the current modest inflation environment would continue for a more extended period of time than shown in the chart below.



# INFLATION INDICATORS



## Interest Rates

A sluggish recovery 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 in the economy.

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

As the chart on the next page shows, the relationship between bank reserves and current dollar spending is fairly loose, particularly on the basis of yearly percent changes.

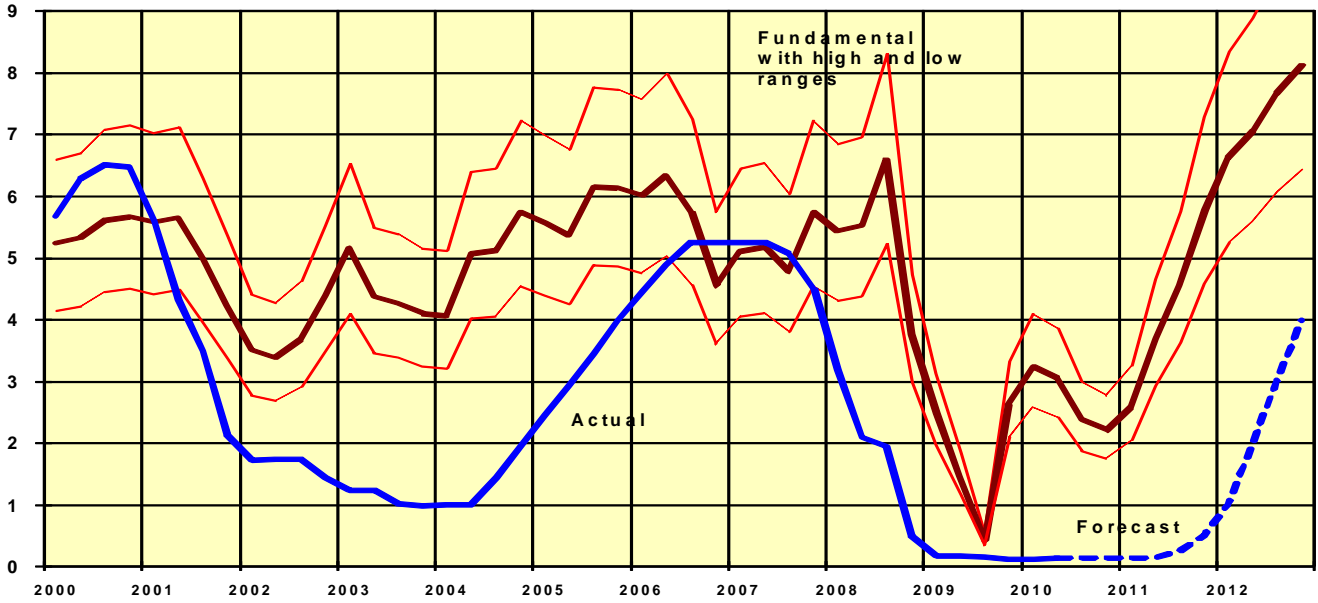
Current dollar spending tends to increase about 2 percentage points faster than the increase in bank reserves over an extended period of time. If the relatively flat trend in liquidity were to continue into the fall, it would eventually be consistent with increases in current dollar spending of roughly 2% a year.

If the Fed were to allow the more recent decline in liquidity to continue, current dollar spending would likely be even slower. In this case the economy would be in danger of slipping into another recession.

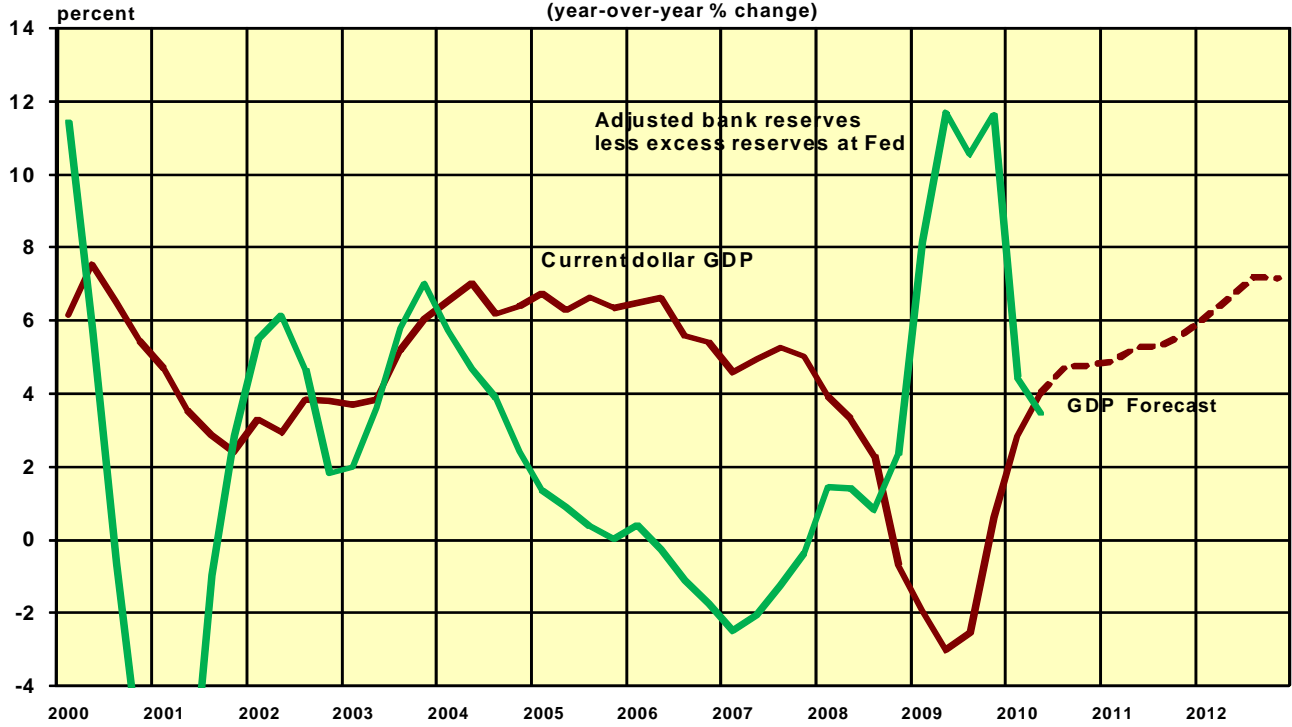
No one knows the future course the Fed will take. Since Fed members chose to ignore the amount of bank reserves in the system, they appear unaware of what is happening in this area. While I continue to assume that the Fed will somehow find a way to boost reserves, I don't really know if this will be the case.

Regardless of what the Fed ends of doing, the lag between Fed action and its effect on the economy provides some advance warning of what lies ahead. That lag now suggests that the economy should experience only modest growth for the balance of the year. This raises the odds that interest rates will stay at historically low levels for at least the next 6-9 months.

**Fed Funds Rate**  
 (fundamental based real after-tax rate currently 1.0%, 1-yr avg. inflation plus tax premium)



**Money & Spending**  
 (year-over-year % change)



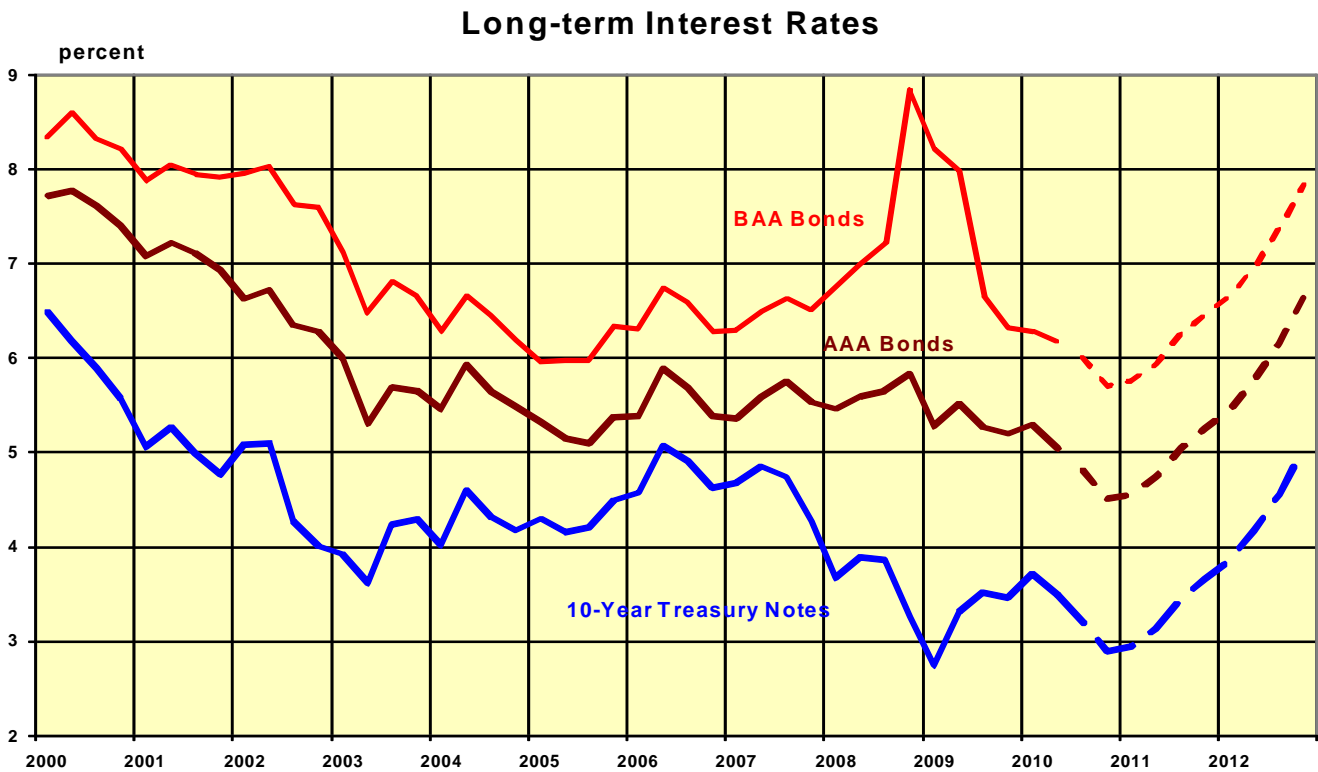
## LONG-TERM INTEREST RATES

With liquidity drying up and business activity slowing, inflationary expectations and long-term interest rates have moved lower. Unless there is an abrupt change in Fed policy, the odds are that long-term interest rates will remain at historically low levels.

Any upturn in long-term interest rates will first depend on a shift in Fed policy toward stimulus.

Second, it will depend on a subsequent shift to a faster pace of spending.

Eventually, the Fed will get around to increasing liquidity. At this point there is no clue as to when there will be a shift toward a more accommodative policy. The upturn in long-term interest rates projected to begin next year is based on speculation that the shift in Fed policy occurs before the end of this year.



## STOCK PRICES

Strong profits and low interest rates mean that the fundamental value of stocks is far higher than their actual value. In spite of being undervalued, stocks can suffer if monetary policy turns less accommodative.

The recent weakness in stock prices may well be related to a less accommodative policy. Aside from shifts in monetary policy, market psychology can also temporarily send stock prices higher or lower.

The market's internal technical indicators have recently shifted in a more positive direction. This shift in technical indicators suggests that stock prices may be poised for further gains. At this point it's uncertain whether the shift in technical indicators signals some advance

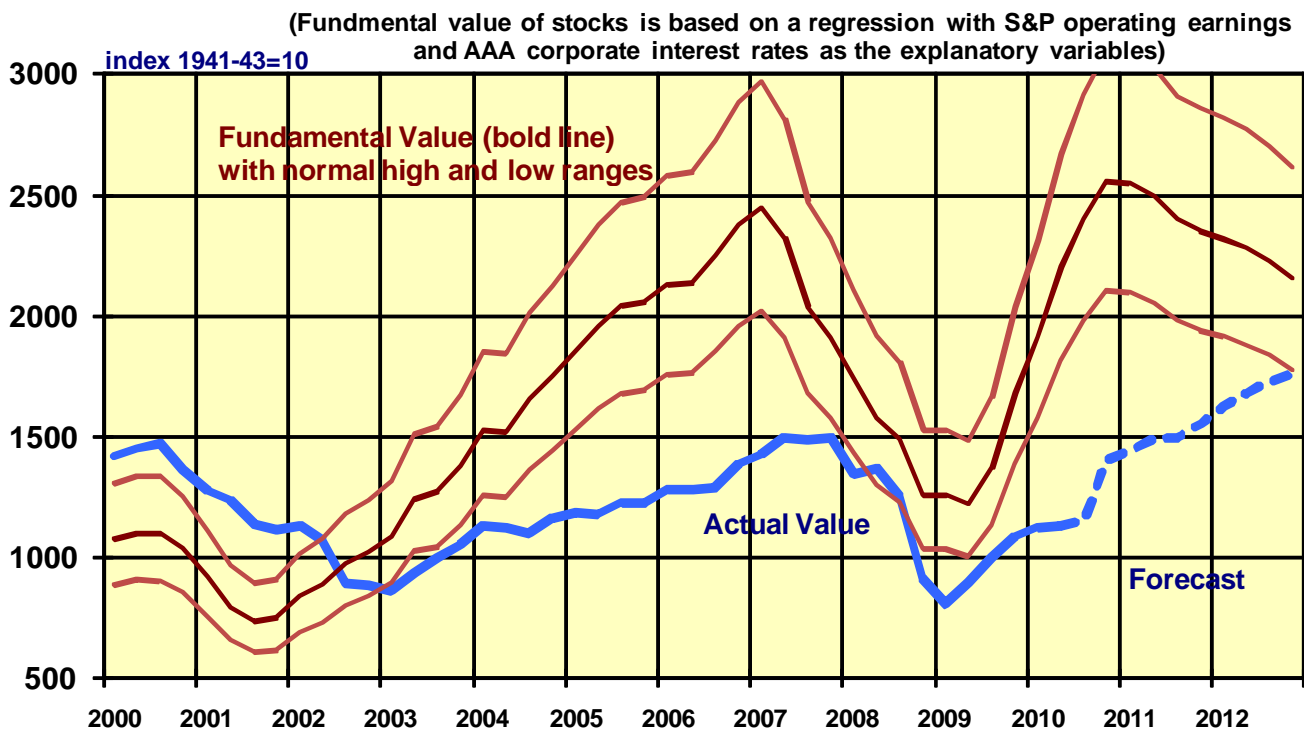
change in monetary policy, an expectation of a change in governmental policies or simply a false signal.

Given the extreme undervalued nature of stocks, my preference is to remain invested so long as technical indicators are positive and to cut any losses when they turn negative.

The upturn in stock prices shown in the chart below is based primarily on the assumption that investor psychology moves in anticipation of a near-term positive shift in Fed policy

If Fed policy were to remain restrictive it's likely that the recent positive shift in investor psychology would be short lived. Such a development would likely produce a renewed weakness in stock prices.

### Stock Prices: S&P 500



8/3/2010	<u>Actual</u>			<u>Forecast</u>				<u>YEARS</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>
	IV	I	II	III	IV	I	II					
GROSS DOMESTIC PRODUCT	14277	14446	14598	14781	14956	15148	15364	14369	14119	14695	15467	16514
%ch	4.7	4.8	4.3	5.1	4.8	5.2	5.8	2.2	-1.7	4.1	5.3	6.8
REAL GDP	13019	13139	13217	13361	13496	13598	13672	13229	12881	13303	13710	14078
%ch	5.0	3.7	2.4	4.5	4.1	3.0	2.2	0.0	-2.6	3.3	3.1	2.7
CHAIN PRICE INDEX	1.097	1.100	1.105	1.106	1.108	1.114	1.124	1.086	1.096	1.105	1.129	1.175
%ch	-0.2	1.0	1.8	0.7	0.7	2.2	3.6	2.2	0.9	0.8	2.2	4.1
CPI- ALL URBAN%ch	2.6	1.5	-0.7	0.4	0.4	1.9	3.3	3.8	-0.3	1.4	1.8	4.3
FUND. INFLATION%ch	-1.8	-1.3	-1.2	-0.8	-0.8	0.7	2.1	2.2	-0.4	-1.5	0.3	3.9
PRETAX PROFITS	1548	1773	1678	1712	1742	1727	1722	1333.2	1316.7	1726.1	1727.4	1819.5
%ch	63.6	71.9	-19.8	8.3	7.2	-3.5	-1.0	-23.3	-1.2	31.1	0.1	5.3
PRETAX PROFITS ADJ (1)	1418	1567	1510	1524	1564	1544	1542	1262.8	1258.0	1541.2	1546.3	1638.6
%ch	42.7	48.9	-13.8	4.0	10.8	-5.0	-0.6	-16.4	-0.4	22.5	0.3	6.0
AFTER-TAX PROFITS	1229	1370	1350	1370	1381	1368	1373	1025	1062	1368	1373	1445
%ch	48.5	54.1	-5.6	6.0	3.2	-3.7	1.6	-20.7	3.6	28.8	0.4	5.2
AFTER-TAX PROFITS ADJ(1)	1099	1163	1182	1183	1203	1185	1193	954.4	1003.1	1182.7	1192.0	1263.7
%ch	23.9	25.5	6.5	0.3	7.0	-5.8	2.7	-10.4	5.1	17.9	0.8	6.0
PERSONAL INCOME	12239	12362	12486	12642	12792	12956	13141	12391	12175	12570	13229	14125
%ch	2.5	4.1	4.1	5.1	4.8	5.2	5.8	4.0	-1.7	3.2	5.2	6.8
REAL DISPOSABLE INCOME	10080	10122	10231	10351	10463	10549	10614	10043	10100	10292	10638	10900
%ch	0.0	1.7	4.4	4.8	4.4	3.3	2.5	1.7	0.6	1.9	3.4	2.5
PRODUCTIVITY	1.521	1.532	1.540	1.549	1.558	1.563	1.568	1.429	1.483	1.545	1.571	1.591
%ch	6.3	2.8	2.1	2.4	2.4	1.4	1.2	2.1	3.7	4.1	1.7	1.3
CIVILIAN EMPLOYMENT	138.1	138.6	139.3	139.7	140.2	140.4	140.7	145.4	139.9	139.5	139.9	141.6
%ch	-3.4	1.4	2.0	1.0	1.5	0.7	0.6	-0.5	-3.8	-0.3	0.3	1.2
UNEMPLOYMENT RATE	10.0	9.7	9.7	9.6	9.1	9.3	9.4	5.8	9.3	9.5	9.5	9.9
INDUSTRIAL PRODUCTION	89.1	90.6	92.1	92.4	92.4	92.4	92.4	96.7	87.7	91.9	92.3	98.1
%ch	6.9	7.1	6.5	1.5	0.0	0.0	0.0	-3.3	-9.3	4.7	0.5	6.3
LIGHT VEHICLE SALES (2)	10.9	11.0	11.3	12.4	12.2	11.8	11.6	13.2	10.4	11.7	11.9	11.6
Domestic	5.7	5.7	5.6	6.6	6.5	6.2	5.8	6.8	5.5	6.1	6.2	5.9
Imports	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. Second quarter data are estimates.

(2) Millions at seasonally adjusted annual rates.

8/3/2010	Actual			Forecast				Years					
	2009	2010	2010	2010	2010	2011	2011	2007	2008	2009	2010	2011	2012
Monetary Aggregates quarterly:	IV	I	II	III	IV	I	II						
M2 %ch at annual rates	3.0	4.0	7.0	7.0	6.0	6.0	4.9	6.3	7.1	7.8	2.6	5.7	6.5
Adj. Bank Reserves (billions of \$)	1146	1218	1151					94	233	968	1185		
less excess reserves at Fed	106	106	108	105	112	116	120	92	94	103	108		
Interest Rates:													
Baa Corp Bonds: Moody's	6.33	6.29	6.18	6.00	5.68	5.73	5.90	6.48	7.45	7.30	5.95	6.05	7.09
Aaa Corp Bonds: Moody's	5.20	5.29	4.99	4.80	4.48	4.53	4.70	5.56	5.64	5.31	4.76	4.85	5.89
MORTGAGE RATES	4.92	5.10	5.10	4.90	4.58	4.73	4.90	6.34	6.04	5.04	4.92	5.10	6.29
10-YR GOVT SECURITIES	3.46	3.72	3.49	3.20	2.88	2.93	3.10	4.63	3.67	3.26	3.32	3.25	4.29
5-YR GOVT SECURITIES	2.30	2.42	2.25	1.87	1.87	1.92	2.22	4.43	2.80	2.19	2.10	2.30	4.00
2-YR GOVT SECURITIES	0.87	0.92	0.87	1.15	1.25	1.30	1.35	4.36	2.00	0.96	1.05	1.45	3.70
3-MONTH T-BILL	0.07	0.10	0.14	0.35	0.39	0.39	0.39	4.41	1.46	0.16	0.25	0.50	2.74
FEDERAL FUNDS RATE	0.12	0.13	0.19	0.15	0.15	0.15	0.15	5.02	1.93	0.16	0.16	0.26	2.50
3-MONTH LIBOR RATE	0.27	0.26	0.44	0.50	0.50	0.50	0.50	5.30	2.91	0.69	0.42	0.61	2.85
BOND EQUIVALENT RATES:													
FEDERAL FUNDS	0.12	0.13	0.19	0.15	0.15	0.15	0.15	5.15	1.95	0.16	0.16	0.26	2.54
3-MONTH LIBOR	0.27	0.26	0.44	0.50	0.50	0.50	0.50	5.44	2.95	0.70	0.42	0.61	2.90
3-MONTH T-BILL	0.07	0.10	0.15	0.36	0.40	0.40	0.40	4.52	1.49	0.16	0.25	0.51	2.80
STOCKS:													
S&P 500	1089	1122	1135	1151	1404	1445	1493	1477	1221	947	1203	1498	1697
S&P 500 quarterly reported earning	60.7	69.9	71.0	71.1	66.5	71.2	71.7	66.2	14.9	51.0	69.6	70.2	74.4
S&P 500 p/e on reported earnings**	17.9	16.0	16.0	16.2	21.1	20.3	20.8	26.5	17.7	19.6	17.3	21.4	22.8
S&P 500 quarterly operating earnin	68.6	77.5	87.9	91.8	83.1	83.0	88.8	82.5	49.5	56.9	85.1	86.7	90.0
S&P 500 p/e on operating earnings <sup>d</sup>	15.9	14.5	12.9	12.5	16.9	17.4	16.8	17.9	24.7	16.7	14.1	17.3	18.9
S&P 500 underlying earnings***	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:	14.9	15.2	15.1	15.1	18.1	18.3	18.6	23.5	18.3	13.3	15.9	18.6	19.7
*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)													
Second quarter earnings are estimates.													