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May 4, 2011

Monthly Economic and Financial Update

During the first three months of the year Fed policy has turned dramatically more expansive. Bank reserves supporting loans and deposits increased by 10%. This amounts to more than a 40% annual rate increase.

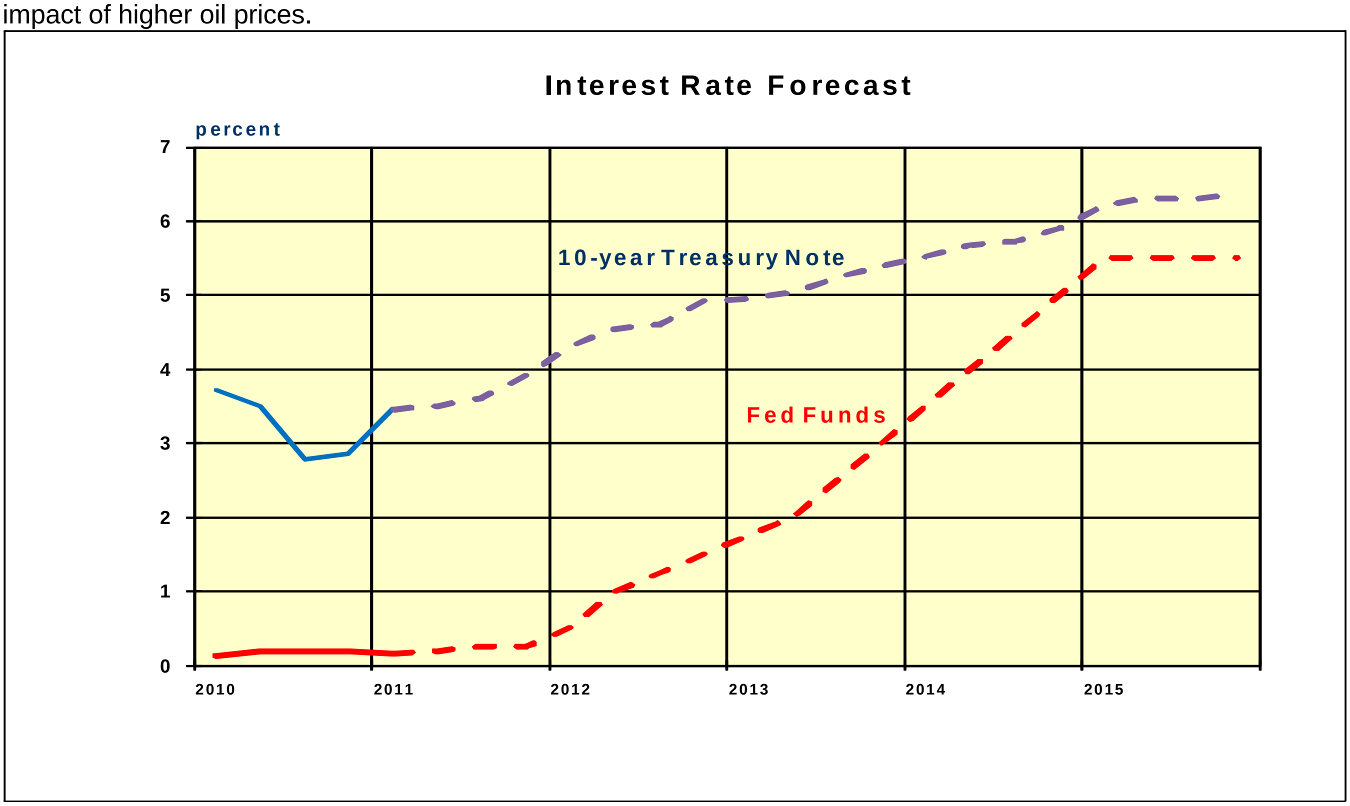
Monetary policy has become more expansive than during 2001-05. That was the period when even the Fed belatedly admitted it had created too much liquidity.

While there is always the possibility that some of the recent excess liquidity could be removed, Bernanke's statements provide little indication that the Fed would deliberately do so.

The latest moves by the Fed have important implications for the economy, inflation and interest rates. They suggest that the spending pace later this year will be strong, even with the disruptive impact of higher oil prices.

The potential weakness associated with higher oil prices in the months immediately ahead will be relatively short-lived. A strong pace of spending this summer will have some positive effects on production, spending and on the job market. However, the excessive creation of money means that inflationary pressures will increase, even if oil prices were to fall. It also means that whenever the Fed decides to mop up the excess liquidity, it will take significantly higher interest rates to stabilize spending and inflation.

My forecast has changed to reflect these developments. The particular path of rates shown in the chart below is highly speculative. Earlier, more aggressive moves toward restraint would limit the extent of the increase in interest rates. Less aggressive moves would produce higher interest rates.



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How Much Money Has the Fed Created?

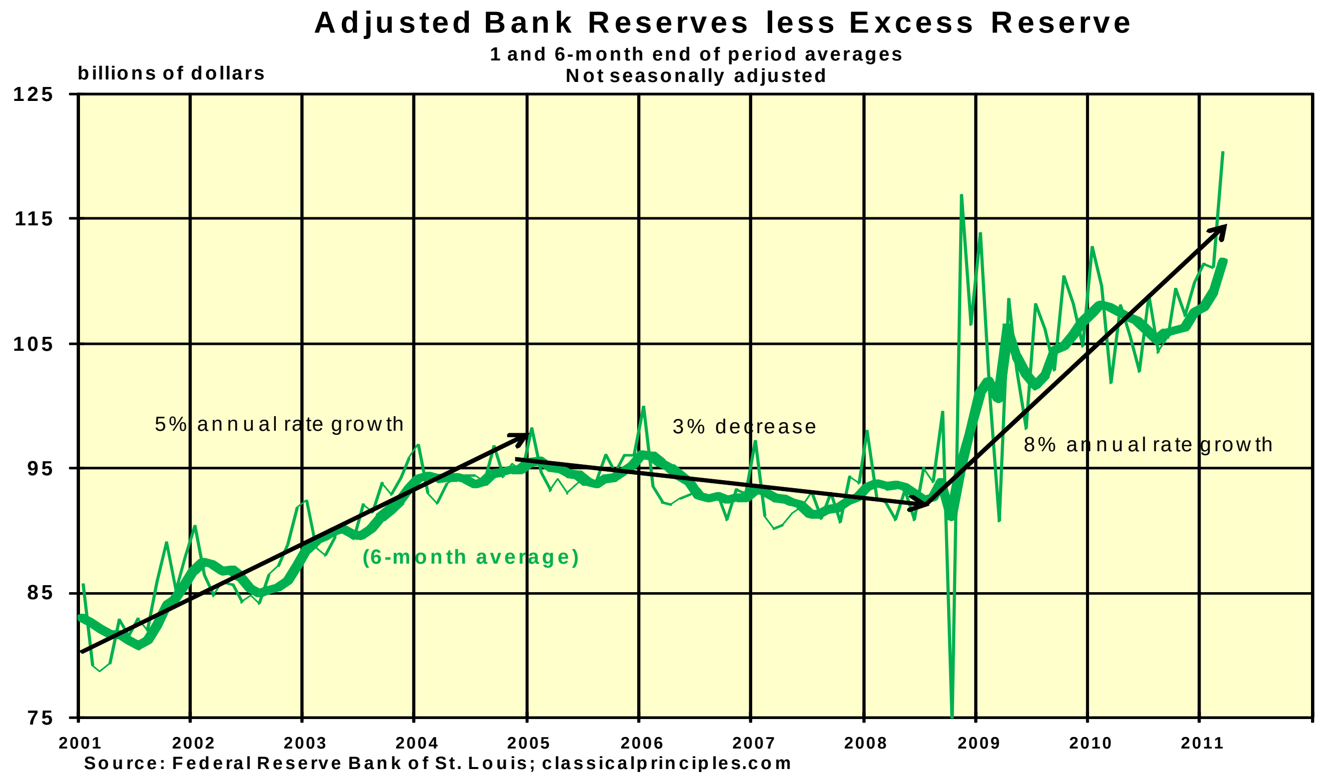
One of the greatest monetary puzzles of recent times has been why the tenfold increase in bank reserves in late 2008 did not produce a tenfold increase in spending. The answer is that most of those reserves remained at the Fed in the form of excess reserves.

The chart below shows the St. Louis Fed data on bank reserves adjusted for these excess reserves. From late 2008 until late last year the increase in bank reserves supporting loans and investments amounted to just over 5% at an annual rate. This increase has led to a faster growth rates in consumer spending and current dollar GDP, which have also averaged roughly 5%.

As the chart below shows, the Fed has recently increased substantially increased bank reserves in the economy. Unless the Fed does something to remove the latest surge in reserves, the pace of current dollar spending should accelerate substantially later this year.

Other monetary indicators have recently become more consistent in confirming a substantial increase in liquidity. Yield spreads are relatively wide and the more conventional money measures have also increased. In addition, commodity prices, including gold, have soared while the dollar has declined.

The recent jump in gold and commodity prices reflects the flood of new money injected into the economy. New money will lead to a sharp acceleration in spending later this year. Also, as the increase in liquidity becomes more apparent, interest rates should begin to move sharply higher.



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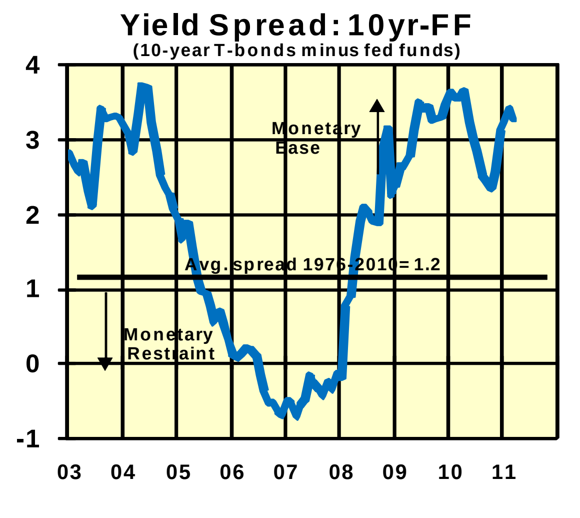
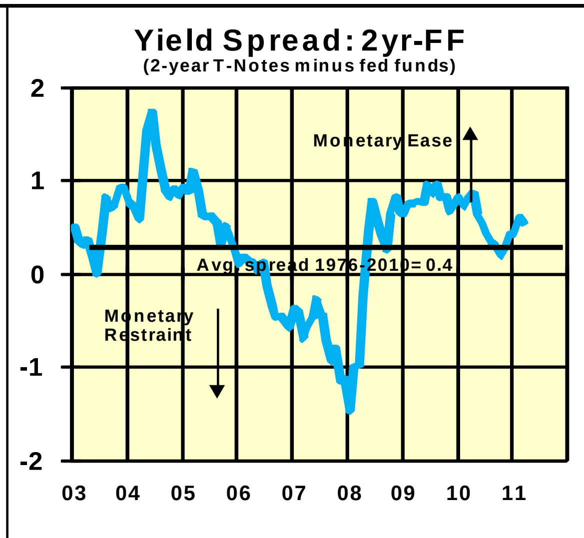
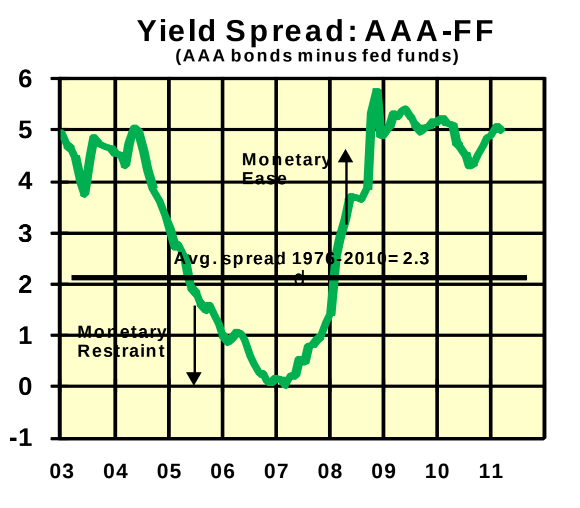
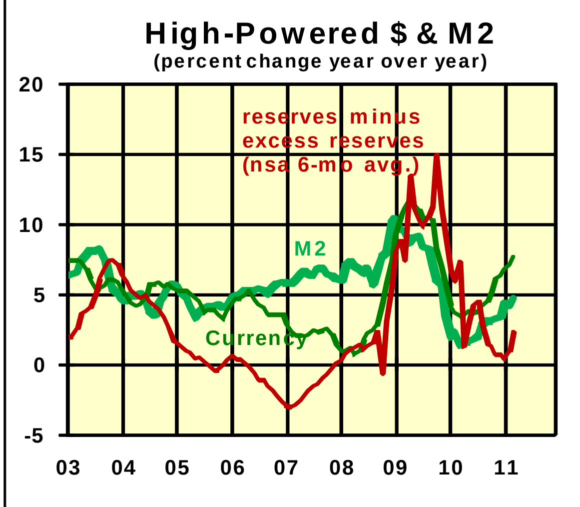
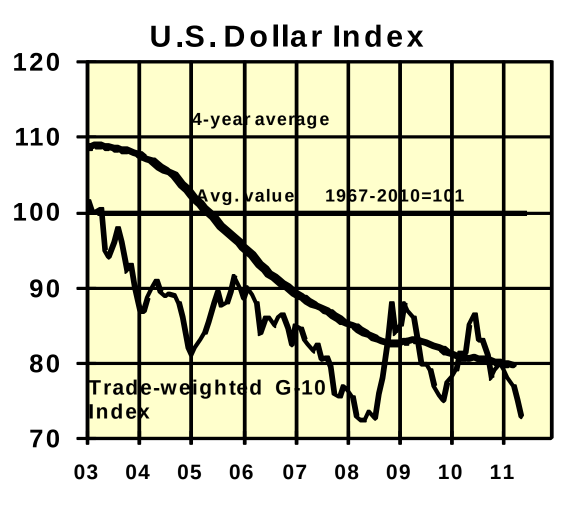
MONETARY INDICATORS

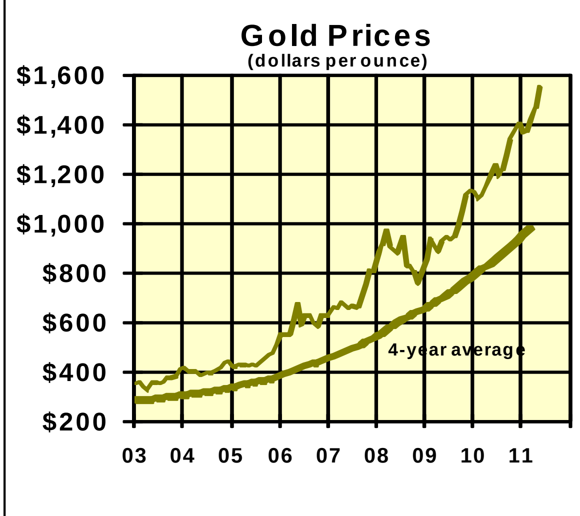












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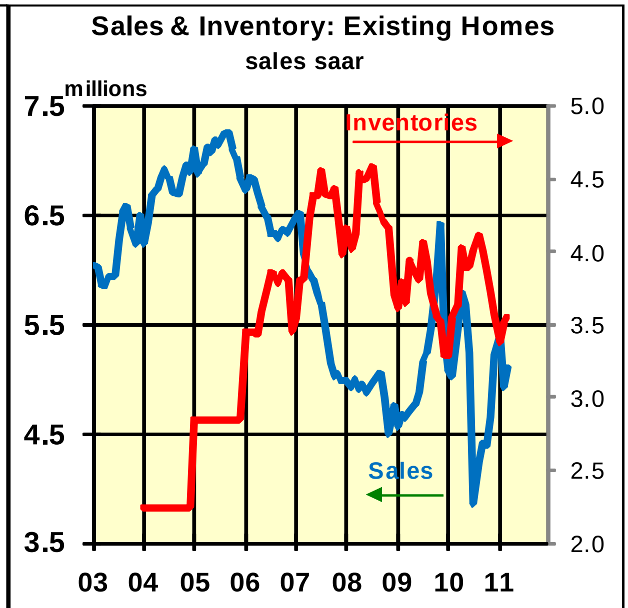
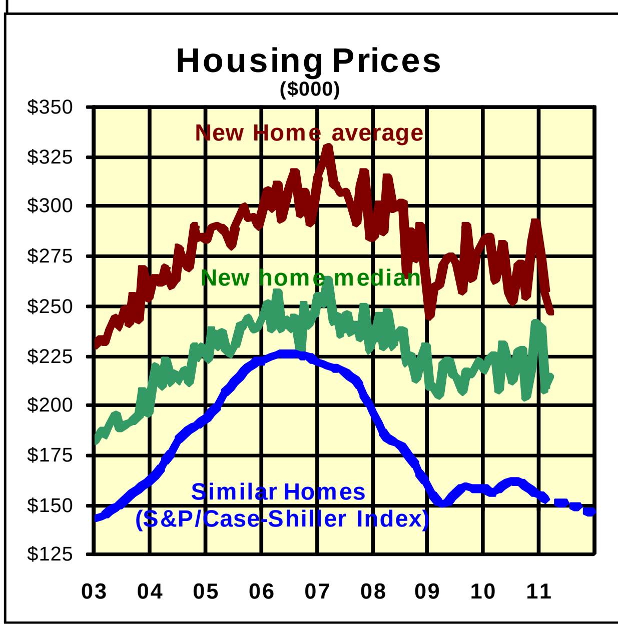
Sensitive Indicators

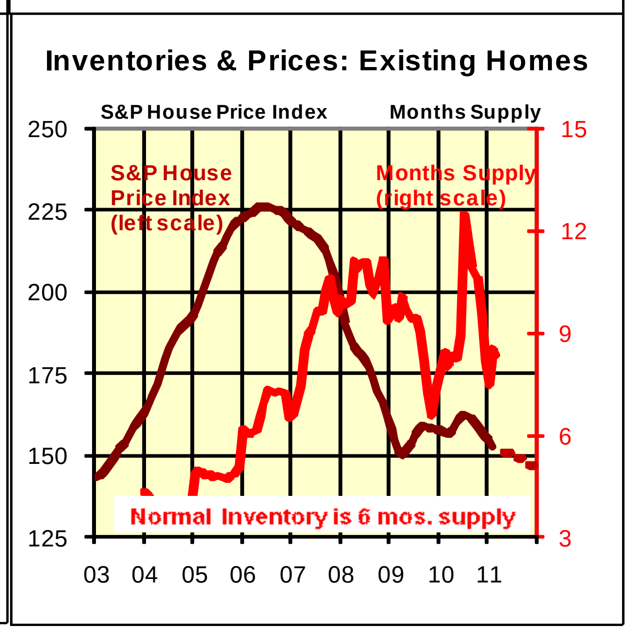
While most sensitive indicators continue to point to a moderate to strong pace of activity, the ISM surveys for service companies moved sharply lower in April. This slowdown, which can continue for a few more months, probably reflects the shift in spending patterns associated with sharply higher oil prices.

With the surge in bank reserves, any slowdown in spending should be short-lived. Other sensitive indicators remain relatively strong. While they may weaken in response to the disruption associated with higher oil prices, any such weakness should prove temporary.

Coincident economic indicators are also encouraging. Most show further improvement in recent months. As with the ISM survey, these indicators can be expected to show some temporary easing in the wake of higher oil prices.

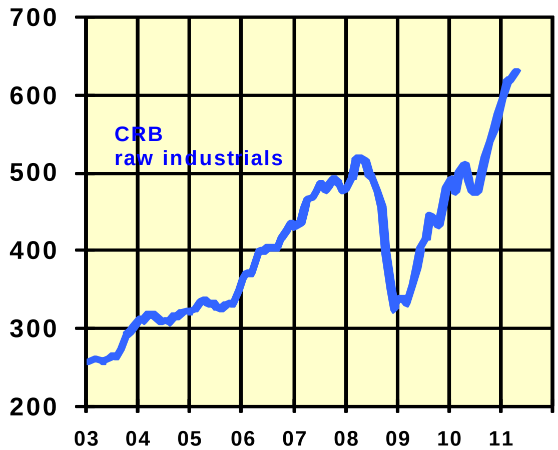






SENSITIVE INDICATORS

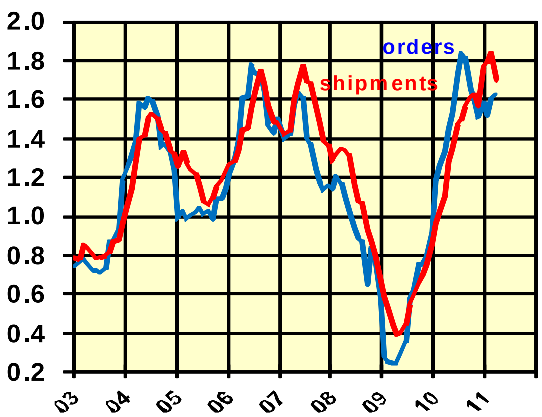
Raw Industrial Prices



Stock Prices

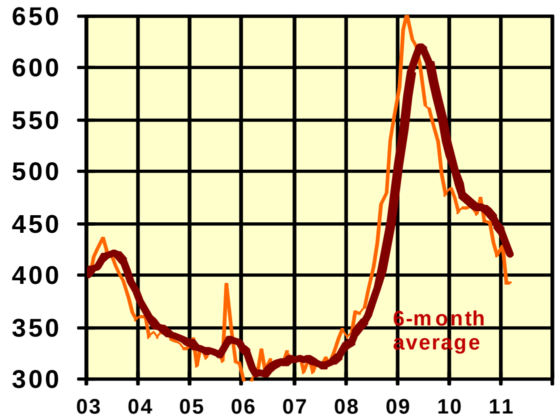
S&P 500

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



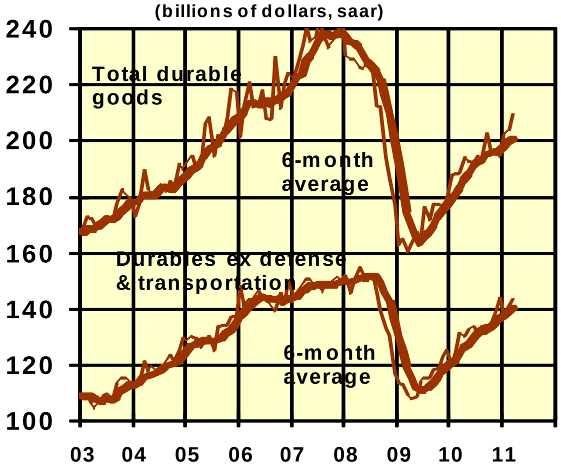
Unemployment Claims

(weekly claims)



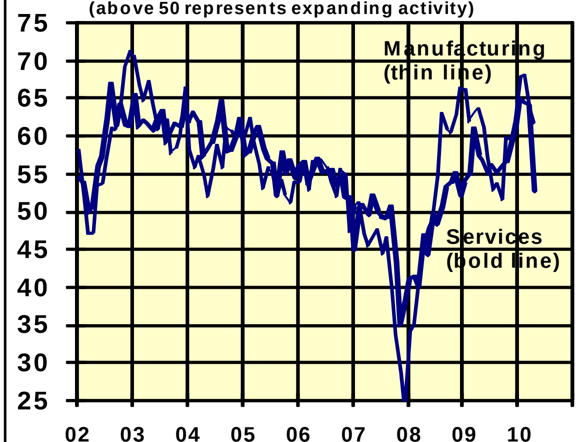
New Orders

(billions of dollars, saar)



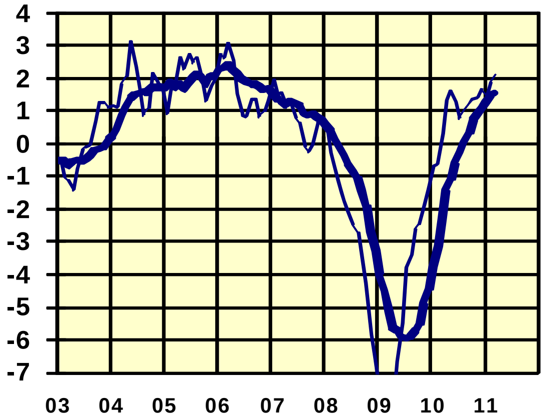
ISM: New Orders

(above 50 represents expanding activity)

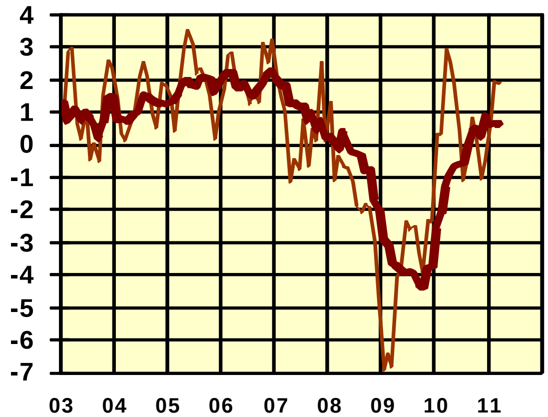


ECONOMIC INDICATORS

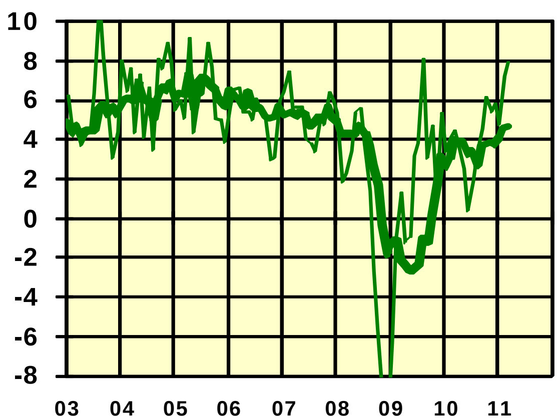
Private Jobs: Payroll Data
(annual rates of change--3 months & 1 year)



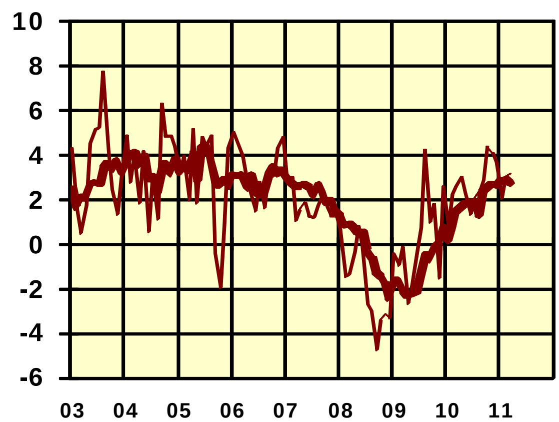
Jobs: Household Data
(annual rates of change--3 months & 1 year)



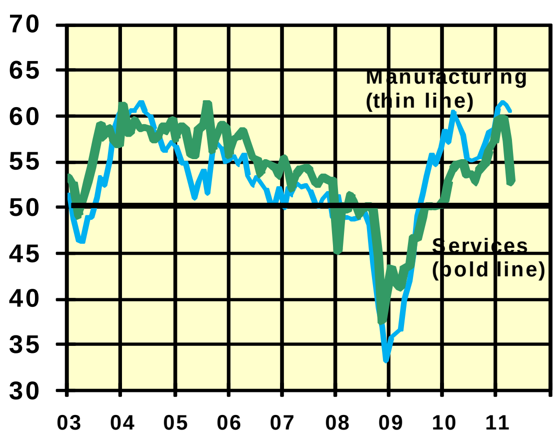
Consumer Spending
(annual rates of change-- 3 months & 1 year)



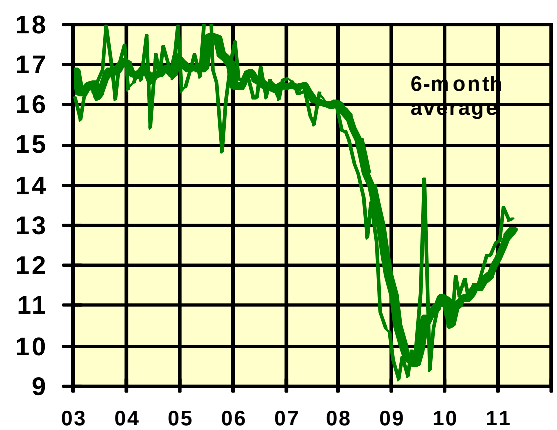
Real Consumer Spending
(annual rates of change-- 3 months & 1 year)



ISM: Composite
(over 50 represents expanding activity)



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



Inflation Indicators

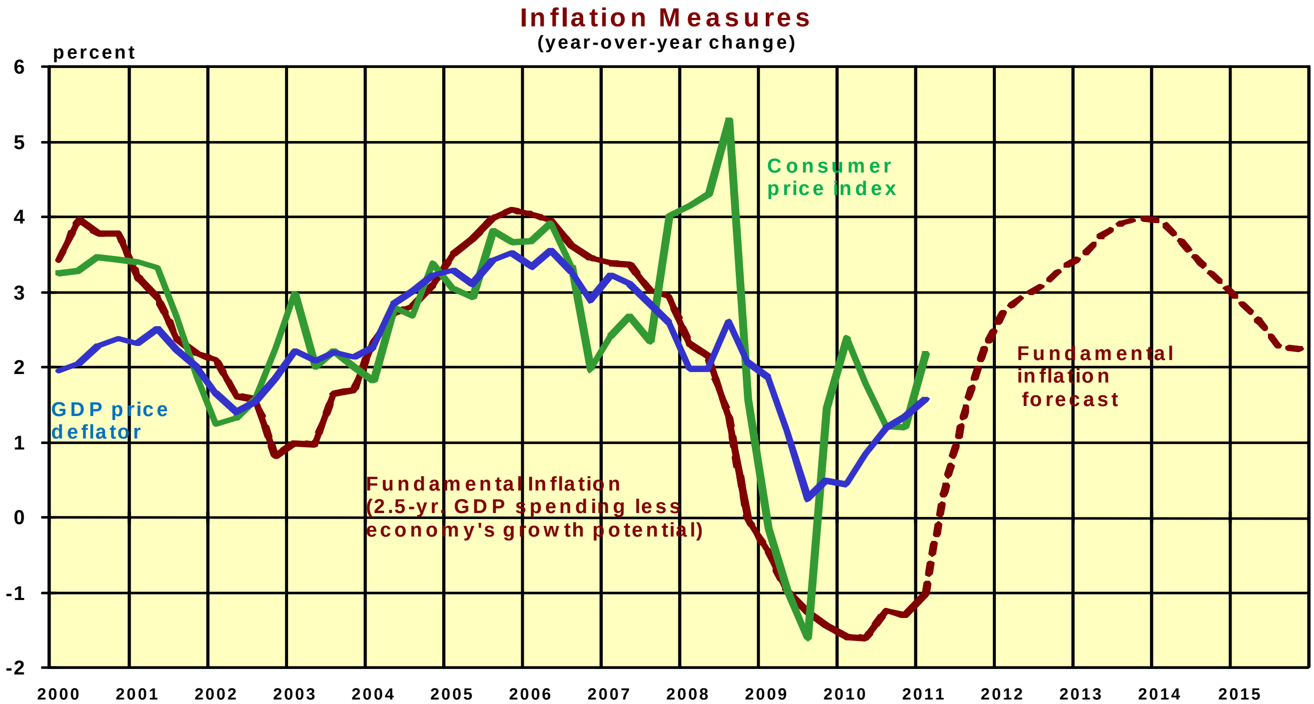
The substantial increase in bank reserves in a relatively short period has sent commodity prices soaring. The 10% increase in bank reserves (less excess reserves) was followed by a 10% decline in the value of the between December and the end of April. Gold prices rose by 10%, raw industrial commodity prices by 10% and oil prices by 20%.

Hence, Fed policy appears to explain most of the surge in commodity prices in recent months. The exception is oil, where roughly half of the prices increase is attributed to the Fed's monetary expansion and half to supply-side issues.

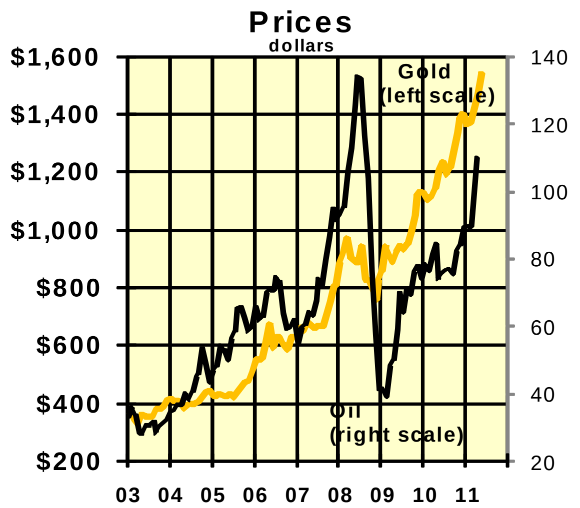
Seldom do we witness as clear a relationship between Fed policy and the reaction in the dollar and commodity markets. The current reaction is the opposite of what occurred in 2008. At that time the Fed was *reducing* the amount of bank reserves. This led to a sharp increase in the value of the dollar and a collapse in commodity prices.

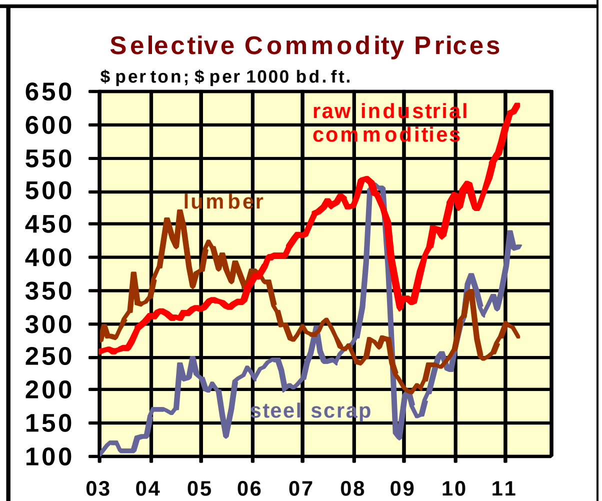
Amid all the monetary gyrations, it's interesting to note how inflation declined following the monetary restraint from 2005-08 and subsequent recession. Inflation has also returned with rebound in money and the economy.

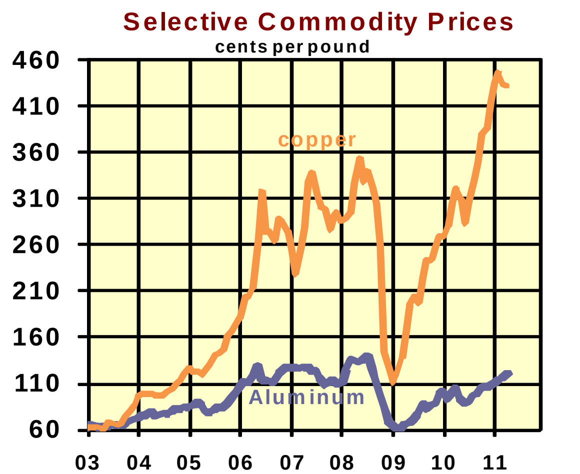
The underlying inflation rate is determined by the 2½-year average of current dollar spending (GDP), minus the economy's potential growth. Current Fed policy suggests that by the end of 2013 the 2-3 year average spending pace will be roughly 6%-7%. If so, it would raise the underlying inflation rate to roughly 4%.

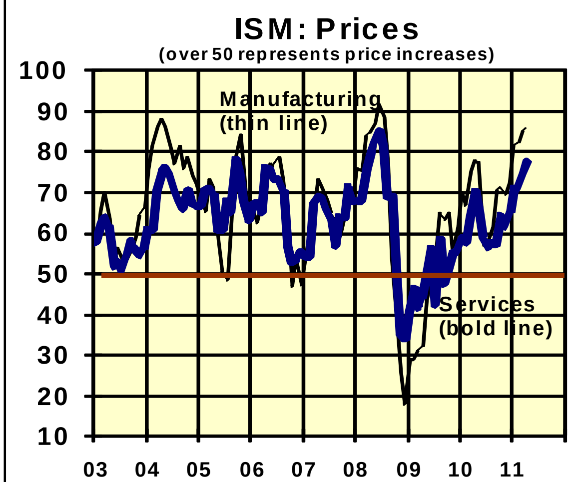


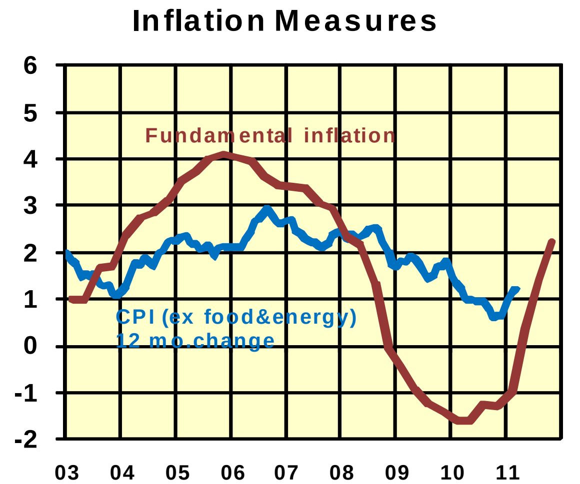
INFLATION INDICATORS

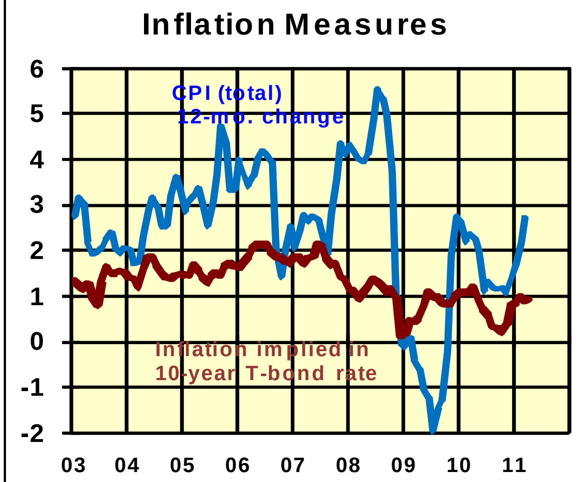












Interest Rates

Inflation rates of even 2%-3% point to interest rates that are much higher than today's rates. At its recent meeting the Fed acknowledged that interest rates would have to increase from their current historically low levels. However, the Fed also maintained that the current levels would remain "for and extended period."

This suggests that the recent explosive rise in bank reserves will continue. The longer it continues, the greater the pressure will be for a rapid increase in spending followed by higher inflation and higher interest rates.

The modest rise of a 3.7% annual rate for first quarter GDP probably gave the Fed some comfort that its highly expansive policy is appropriate. It is not.

Current dollar GDP growth can lag consumer spending. Recently, the growth in consumer spending has been at a rapid 7% annual rate. Averaging the two growth rates gives us roughly 5%, which is close to the previous growth in liquidity (bank reserves less excess reserves)

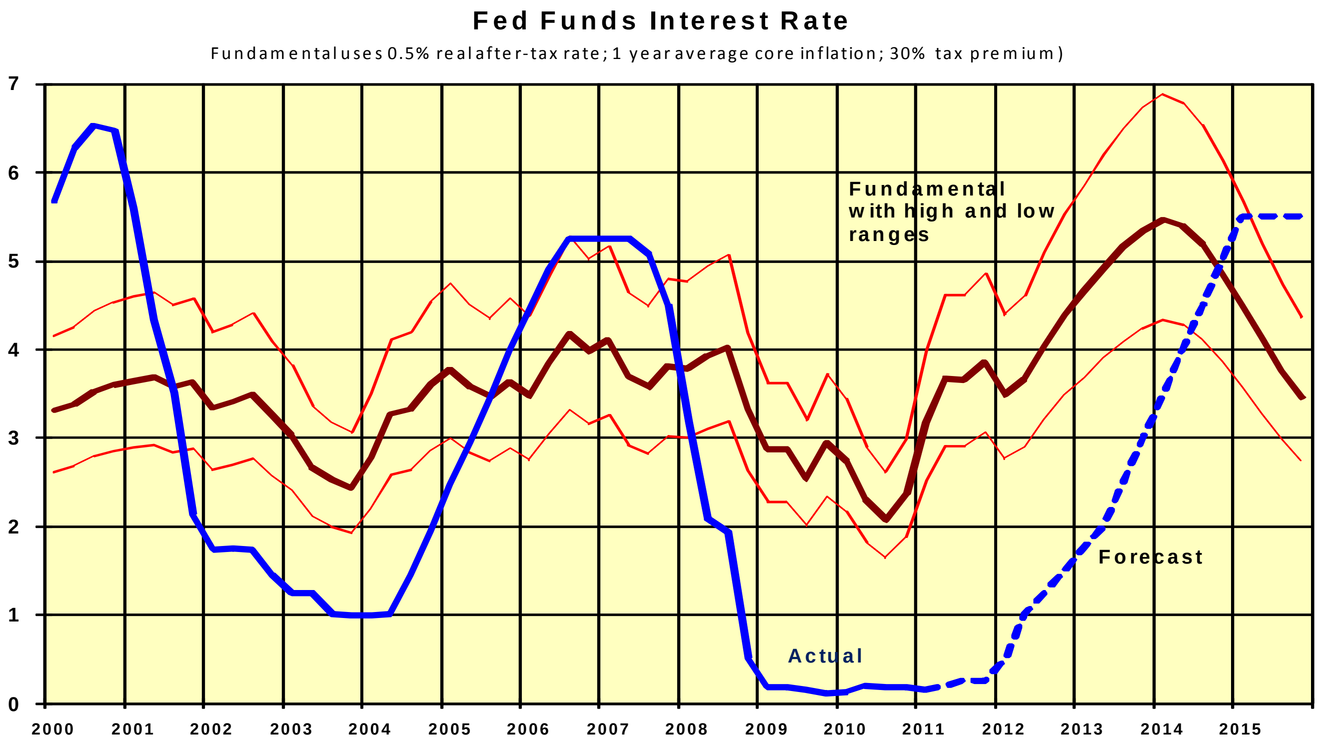
Bernanke has indicated that Fed policy won't change much during the current quarter. While monthly swings could reduce the impact of the recent surge, my expectation is that it's more likely than not that the Fed's rapid increase in reserves will continue.

What this means is that we should look for a rapid increase in the pace of current dollar spending this summer and through the remainder of the year. My guess is that the spending pace will be close to 7% by the fall.

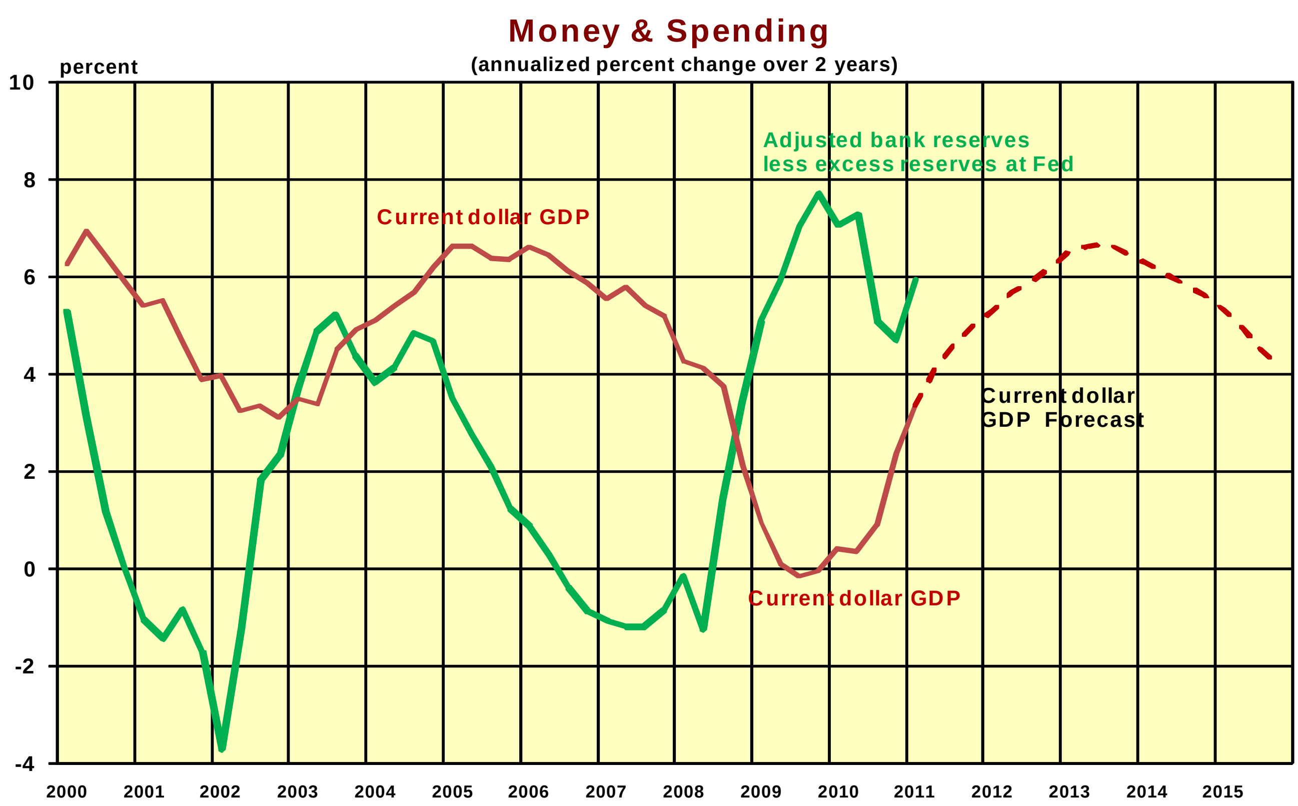
Speculating on the Fed's response to these developments in terms of adjusting the fed funds rate is challenging. Since the key is the amount of bank reserves, not the fed funds rate, there are a number of possibilities. One possibility is that the Fed gradually raises the fed funds rate inflation. This is the type of cautious behavior that has led to periods of rising inflation in the past.

Another possibility is that the Fed moves to increase the fed funds rate rapidly. An early, steep increase in fed funds is more likely to contain the increase in bank reserves and produce a peak in interest rates.

At this point it does not appear that the Fed will move to contain the increase in reserves. Rather, it favors a more gradual increase in fed funds. If so, the policy will lead to a more dramatic rise in interest rates beyond the current year.



Fed Funds Interest Rate
Fundamental uses 0.5% real after-tax rate; 1 year average core inflation; 30% tax premium)
Fundamental with high and low ranges
Forecast
Actual
7
6
5
4
3
2
1
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015



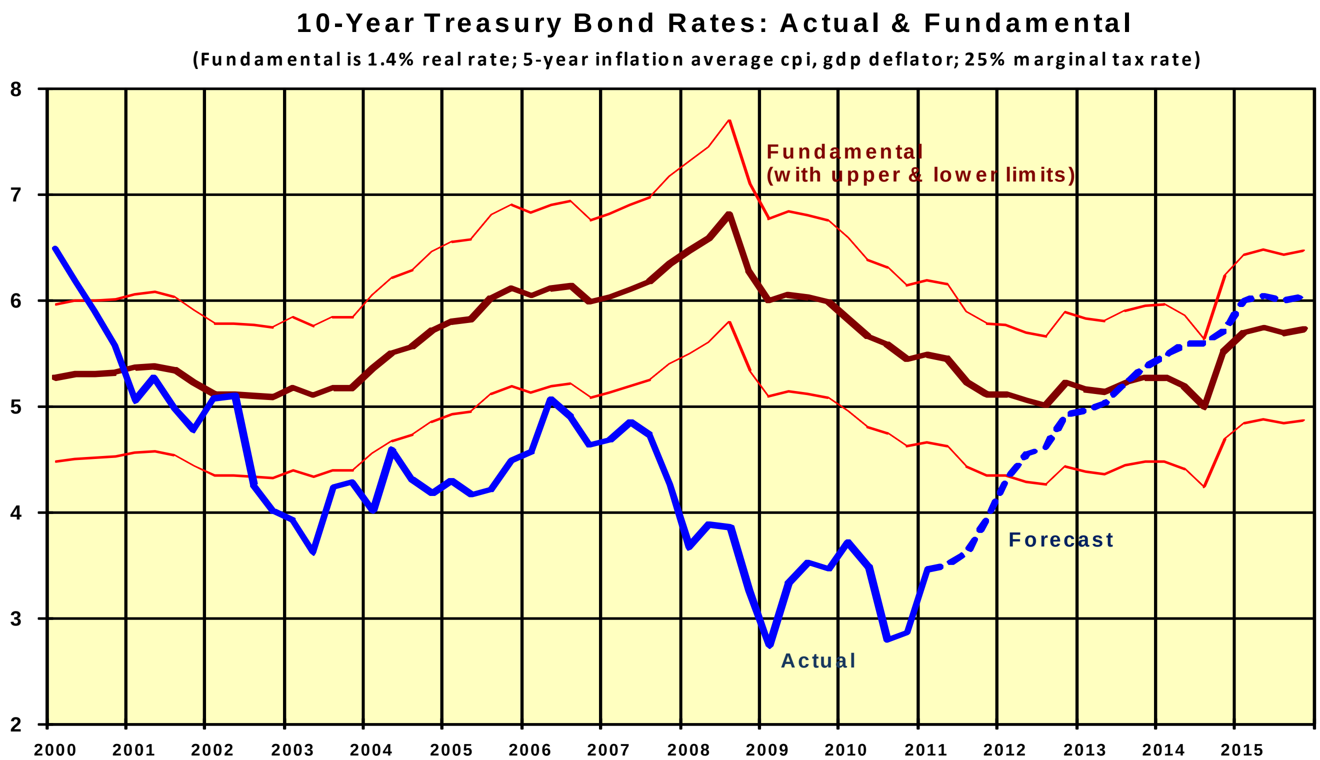
Money & Spending
(annualized percent change over 2 years)
percent
Adjusted bank reserves less excess reserves at Fed
Current dollar GDP
Current dollar GDP Forecast
Current dollar GDP
10
8
6
4
2
0
-2
-4
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015

LONG-TERM INTEREST RATES

By holding the fed funds rate close to zero, the Fed has created pressure to reduce all other interest rates. Once the Fed begins to increase the fed funds rate, there will also be a sharp increase in long-term rates.

As the recent increase in bank reserves works its way through the economy, it will become more apparent that interest rates are heading higher. The extent to which rates increase depends on Fed policy.

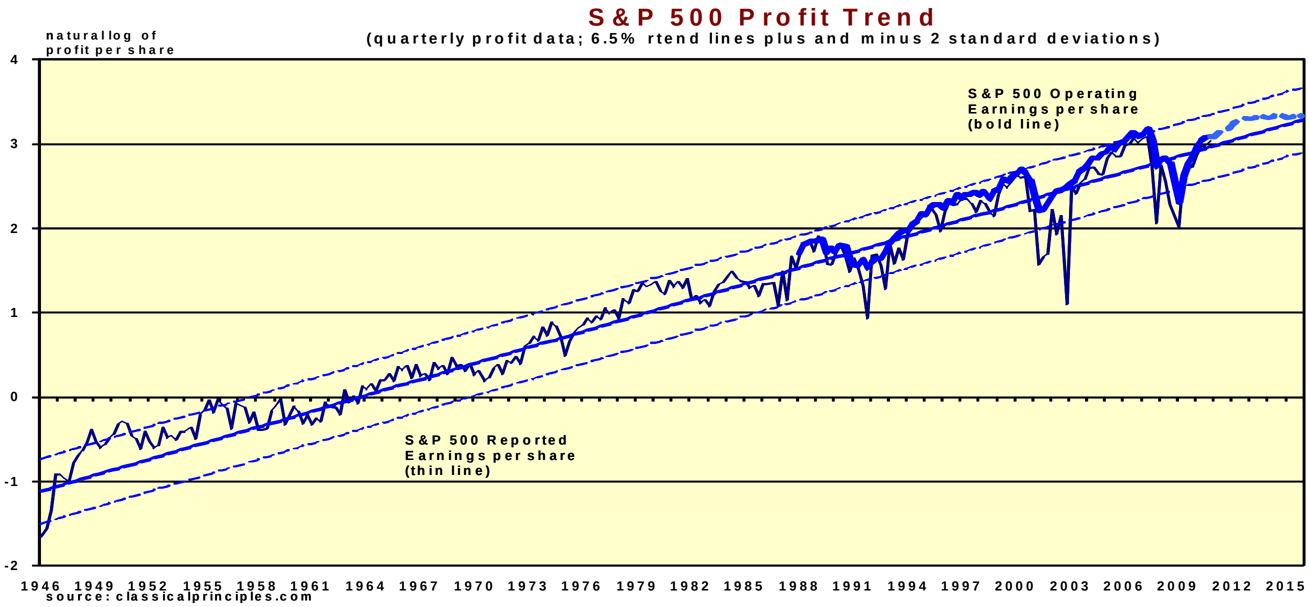
The potential for a sharp, sustained rise in long-term interest rates is so great that holding fixed-income securities represents a significant risk in the current environment.

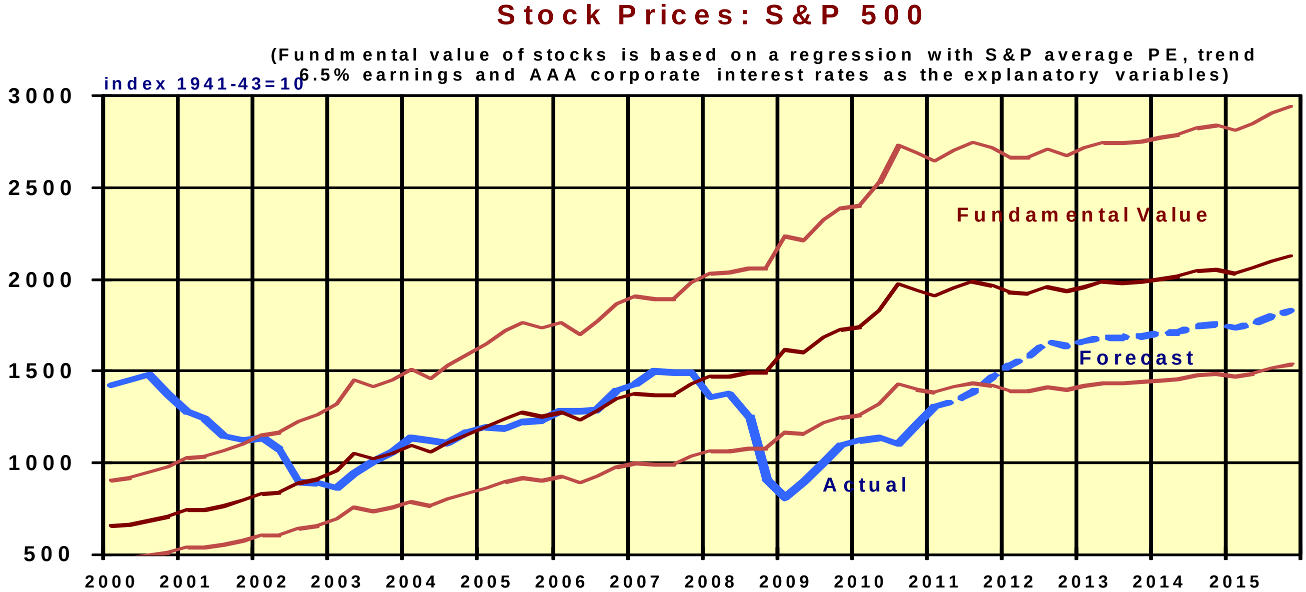


STOCK PRICES

Stock prices continue to move erratically higher. One of the factors supporting stocks is profits. With roughly 70% of the first quarter profit numbers already reported, it appears that operating profits will be up 14% or more from a year ago.

In spite of a significant amount of excess capacity, profits are above their long-term trend. As the pace of the recovery increases, profits should experience another year of double-digit increases in both 2011 and 2012. Higher interest rates will eventually reduce profitability. For now, my analysis shows that stock prices are roughly 30% undervalued and the outlook for further gains remains favorable.





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5/3/2011	Actual			Forecast				YEARS				
	2010 III	2010 IV	2011 I	2011 II	2011 III	2011 IV	2012 I	2008	2009	2010	2011	2012
GROSS DOMESTIC PRODUCT	14745	14871	15006	15207	15441	15734	16018	14369	14119	14660	15347	16402
%ch	4.6	3.5	3.7	5.4	6.3	7.8	7.4	2.2	-1.7	3.8	4.7	6.9
REAL GDP	13279	13381	13439	13525	13672	13875	14055	13229	12881	13248	13628	14257
%ch	2.6	3.1	1.7	2.6	4.4	6.1	5.3	0.0	-2.6	2.9	2.9	4.6
CHAIN PRICE INDEX	1.111	1.112	1.117	1.125	1.130	1.135	1.141	1.086	1.096	1.107	1.127	1.152
%ch	2.1	0.4	1.9	2.9	1.9	1.7	2.1	2.2	0.9	1.0	1.8	2.3
CPI- ALL URBAN%ch	1.4	2.6	5.2	1.6	1.6	2.4	2.7	3.8	-0.3	1.6	2.6	2.6
FUND. INFLATION%ch	-1.2	-1.3	-1.0	0.4	1.4	2.2	2.7	2.6	0.0	-1.5	-0.8	2.2
PRETAX PROFITS	1846	1797	1840	1844	1876	1905	1936	1333.2	1316.7	1801.1	1866.3	1976.7
%ch	13.5	-10.1	9.9	0.8	7.2	6.4	6.6	-23.3	-1.2	36.8	3.6	5.9
PRETAX PROFITS ADJ (1)	1640	1678	1678	1703	1724	1759	1787	1262.8	1258.0	1624.8	1716.2	1828.6
%ch	6.6	9.6	-0.1	6.1	5.1	8.3	6.5	-16.4	-0.4	29.2	5.6	6.6
AFTER-TAX PROFITS	1416	1369	1410	1408	1432	1455	1478	1025	1062	1384	1426	1508
%ch	10.1	-12.6	12.4	-0.7	7.2	6.4	6.5	-20.7	3.6	30.4	3.0	5.7
AFTER-TAX PROFITS ADJ(1)	1211	1250	1248	1267	1281	1308	1329	954.4	1003.1	1208.2	1275.9	1359.4
%ch	0.7	13.7	-0.8	6.3	4.4	9.0	6.4	-10.4	5.1	20.4	5.6	6.5
PERSONAL INCOME	12595	12724	12980	13153	13356	13609	13855	12391	12175	12547	13275	14187
%ch	2.5	4.1	8.3	5.4	6.3	7.8	7.4	4.0	-1.7	3.1	5.8	6.9
REAL DISPOSABLE INCOME	10277	10324	10399	10499	10620	10760	10884	10043	10100	10241	10570	11023
%ch	1.0	1.8	2.9	3.9	4.7	5.4	4.7	1.7	0.6	1.4	3.2	4.3
PRODUCTIVITY	1.115	1.122	1.125	1.131	1.137	1.143	1.149	1.036	1.074	1.115	1.134	1.158
%ch	2.3	2.6	1.0	2.2	2.2	2.2	2.2	1.0	3.7	3.8	1.7	2.2
CIVILIAN EMPLOYMENT	139.2	139.1	139.6	139.8	139.9	140.1	140.3	145.4	139.9	139.1	139.3	140.5
%ch	-0.2	-0.4	1.5	0.5	0.5	0.5	0.5	-0.5	-3.8	-0.6	0.2	0.9
UNEMPLOYMENT RATE	9.6	9.6	8.9	8.8	8.6	8.4	8.4	5.8	9.3	9.6	8.7	8.4
INDUSTRIAL PRODUCTION	91.0	91.7	93.1	94.5	96.4	98.9	101.1	96.3	85.5	90.1	91.3	103.2
%ch	6.7	3.1	6.1	6.3	8.4	10.7	9.1	-3.7	-11.2	5.3	1.4	13.0
LIGHT VEHICLE SALES (2)	11.6	12.4	13.1	12.7	12.4	12.7	13.0	13.2	10.4	11.6	12.1	13.2
Domestic	5.7	6.0	6.6	6.5	6.4	6.4	6.7	6.8	5.5	5.8	6.0	6.9
Imports	5.9	6.4	6.4	6.2	6.0	6.2	6.3	6.5	4.9	5.8	6.1	6.3

(1) Profits adjusted for capital consumption and inventory adjustment. First quarter profits are estimates.
(2) Millions at seasonally adjusted annual rates.

5/3/2011	Actual			Forecast				Years				
	2010	2010	2011	2011	2011	2011	2012	2008	2009	2010	2011	2012
Monetary Aggregates quarerly:	III	IV	I	II	III	IV	I					
M2 %ch at annual rates	4.6	5.7	4.4	5.6	6.1	6.3	5.6	7.1	7.9	2.3	5.1	5.4
Adj. Bank Reserves less excess reserves (billions of $)	106	109	114	117	119	121		95	105	107	118	
Interest Rates:												
Baa Corp Bonds: Moody's	5.78	5.91	6.09	6.04	6.08	6.34	6.69	7.45	7.30	6.04	6.15	6.92
Aaa Corp Bonds: Moody's	4.58	4.86	5.13	5.09	5.12	5.37	5.71	5.64	5.31	4.94	5.18	5.93
MORTGAGE RATES	5.10	5.10	5.10	5.24	5.52	5.82	6.31	6.04	5.04	5.10	5.42	6.59
10-YR GOVT SECURITIES	2.79	2.86	3.46	3.49	3.62	3.92	4.31	3.67	3.26	3.21	3.62	4.59
5-YR GOVT SECURITIES	1.55	1.49	2.12	2.10	2.28	2.58	3.00	2.80	2.19	1.93	2.27	3.43
2-YR GOVT SECURITIES	0.54	0.48	0.69	0.70	0.95	1.25	1.70	2.00	0.96	0.70	0.90	2.26
3-MONTH T-BILL	0.15	0.14	0.13	0.44	0.49	0.49	0.74	1.46	0.16	0.13	0.39	1.30
FEDERAL FUNDS RATE	0.19	0.19	0.16	0.20	0.25	0.25	0.50	1.93	0.16	0.18	0.21	1.06
3-MONTH LIBOR RATE	0.39	0.29	0.31	0.55	0.60	0.60	0.85	2.91	0.69	0.34	0.51	1.41
BOND EQUIVALENT RATES:												
FEDERAL FUNDS	0.19	0.19	0.16	0.20	0.25	0.25	0.50	1.95	0.16	0.18	0.21	1.07
3-MONTH LIBOR	0.39	0.29	0.31	0.55	0.60	0.60	0.85	2.95	0.70	0.34	0.52	1.42
3-MONTH T-BILL	0.16	0.14	0.14	0.45	0.50	0.50	0.75	1.49	0.16	0.14	0.39	1.33
STOCKS:												
S&P 500	1096	1204	1303	1363	1425	1464	1525	1221	947	1139	1389	1597
S&P 500 quarterly reported earnings	78.1	82.7	87.0	82.5	82.6	86.5	92.6	14.9	51.0	77.4	84.7	90.2
S&P 500 p/e on reported earnings**	14.0	14.6	15.0	16.5	17.3	16.9	16.5	17.7	19.6	14.8	16.4	17.7
S&P 500 quarterly operating earning	86.2	87.7	91.1	95.6	99.2	99.8	105.1	49.5	56.9	83.8	96.5	110.8
S&P 500 p/e on operating earnings*	12.7	13.7	14.3	14.3	14.4	14.7	14.5	24.7	16.7	13.6	14.4	14.4
S&P 500 underlying earnings***	76.4	77.6	78.8	80.1	81.3	82.6	83.9	66.8	71.2	75.8	80.7	85.9
S&P 500 p/e on underlying earnings	14.4	15.5	16.5	17.0	17.5	17.7	18.2	18.3	13.3	15.0	17.2	18.6

*annualized.
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***reported earnings based on a 6.5% growth rate. First quarter earnings are estimates.

****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)