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July 10, 2011

Monthly Economic and Financial Update

The slowdown in business activity this spring should soon be over. During the first six months of this year adjusted bank reserves increased at an annual rate of roughly 15%.

Once the Fed creates the raw ingredients for new money, the funds enter the banking system. This system provides the transmission mechanism between the creation of new money and an increase in current dollar spending.

If the financial system is relatively stable, new money tends to boost the pace of spending within 6-9 months. This would produce a pickup in spending by the July or September.

An unstable financial system can alter timing and the magnitude of the relationship between the increase in new money and the increase in spending can change.

Financial intermediaries faced many problems in recent years as a consequence of government policy mistakes.

The biggest mistake was the Fed's move to reduce bank reserves by 3% between 2005 and 2008. Prior to 2005, the Fed increased reserves by 5% a year. The increases created a speculative boom in spending. When the Fed reduced reserves by 3% it led to a collapse in spending that triggered numerous bankruptcies and failures among financial institutions.

A second key policy mistake was the decision in early September, 2008 to wipe out the value of Fannie and Freddie preferred stock. Since US banks held \$20 billion of the stock, the decision eliminated roughly \$20 billion of bank capital that supported roughly \$100 billion of loans and deposits.

Abruptly removing this capital sent banks scrambling to reduce assets in an effort to

restore more adequate capital ratios. Only after the financial system began to collapse did the Fed "rescue" the economy by replenishing bank reserves.

Various other policy mistakes by the FDIC and other regulators contributed to additional problems for financial intermediaries.

These problems haven't ended. Significant costs associated with last year's Dodd-Frank "reform" legislation created new burdens and hurdles for financial intermediaries. The Fed's insistence on raising bank capital requirements in a weak economy is the latest blow to financial intermediaries.

Weakening financial institutions has affected the transmission mechanism between money and spending. The Fed's response has been to massively increase in bank reserves, a move that disrupted the financial system.

The 15% rate of increase in bank reserves this year would normally produce an even faster increase in current dollar spending. The impact of the myriad of factors noted above can be expected to limit its impact on spending,

My expectation is that the ongoing dislocations in the financial system will reduce the impact of newly created reserves. Instead of a high double-digit pace, increases in spending are more likely to be closer to 6%-7% beginning later this year. However, if Fed policy remains as expansive as it has been, the spending pace would be expected to accelerate further in 2012.

How Much Money Has the Fed Created?

The Federal Reserve controls the nation's money supply. It does so by adjusting the amount of bank reserves in the economy. To measure bank reserves used for money it's necessary to adjust for both the reserves the Fed requires that banks hold and excess reserves. Excess reserves are those banks voluntarily keep on deposit with the Fed. Since these reserves are not used for deposits, it's important to subtract them to determine how much money (liquidity) is in the economy.

From late 2008 until late last year the increase in bank reserves supporting loans and investments amounted to roughly 6% at an annual rate. Growth in current dollar GDP has been roughly half this rate.

As the chart below shows, this year the Fed has increased bank reserves at roughly a 15% annual rate. Spending tends to respond to money with a lag. Hence, the recent increase in liquidity should boost spending later this year

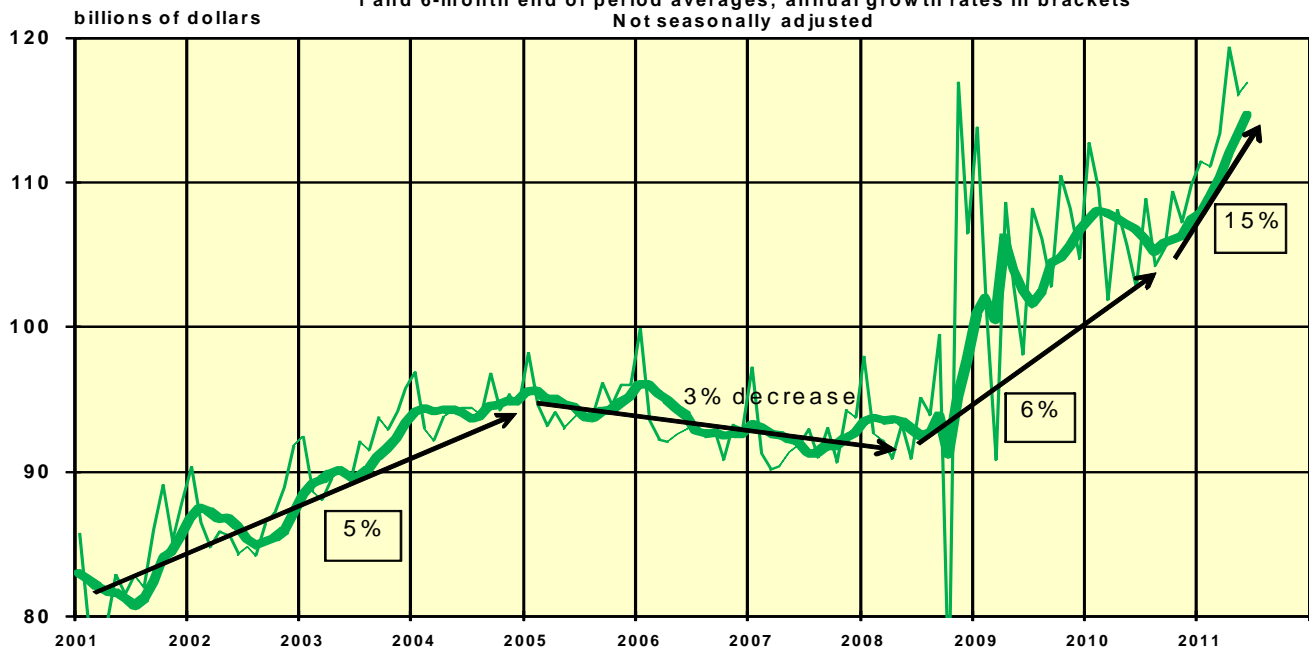
and into 2012. Ongoing problems with respect to financial intermediaries should continue to dampen the normal pace of spending.

Other monetary indicators have recently become more consistent in confirming an increase in liquidity. All of the money measures on the next page show year-to-year increases of 5%-10%. Also, the spread between short and long-term interest rates is relatively wide. Finally, a weak dollar and soaring prices for gold and other commodities tend to confirm that monetary policy has been fairly expansive.

The impact of the recent surge in bank reserves on spending can be muted by Fed efforts to raise bank capital requirements and by regulators insistence on conservative lending policies. Based on recent relationships the increase in reserves so far this year should be sufficient to boost current dollar spending somewhere in the vicinity of a 6%-7% rate later this year.

Adjusted Bank Reserves less Excess Reserve

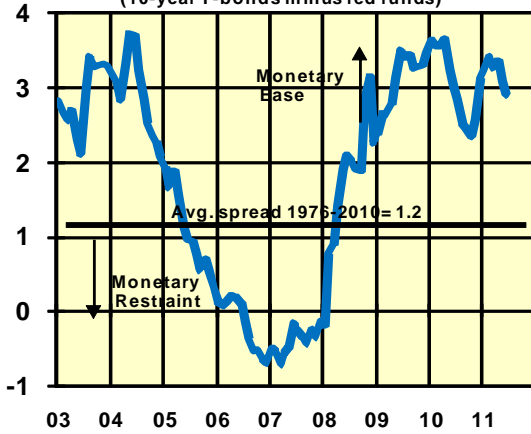
1 and 6-month end of period averages; annual growth rates in brackets
Not seasonally adjusted



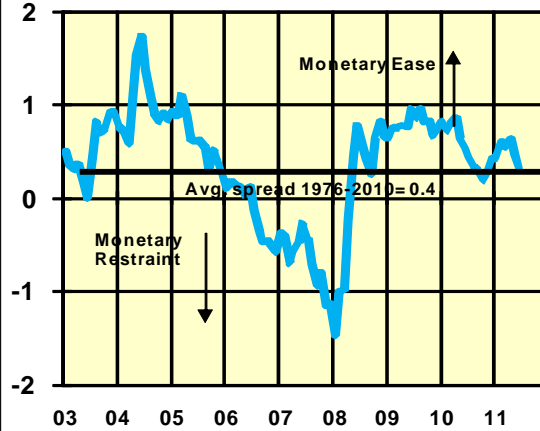
Source: Federal Reserve Bank of St. Louis; classicalprinciples.com; June, 2011 is an estimate.

MONETARY INDICATORS

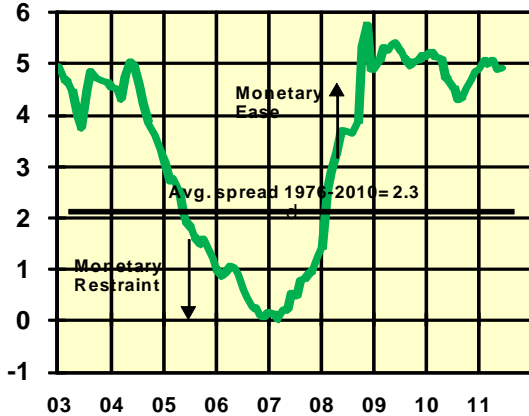
Yield Spread: 10yr-FF
(10-year T-bonds minus fed funds)



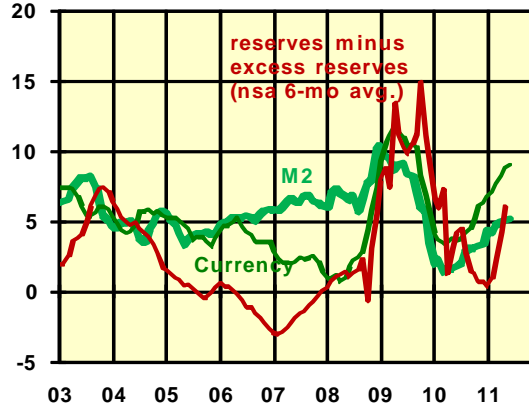
Yield Spread: 2yr-FF
(2-year T-Notes minus fed funds)



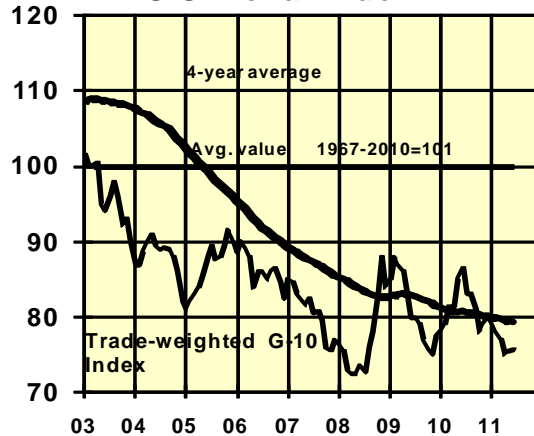
Yield Spread: AAA-FF
(AAA bonds minus fed funds)



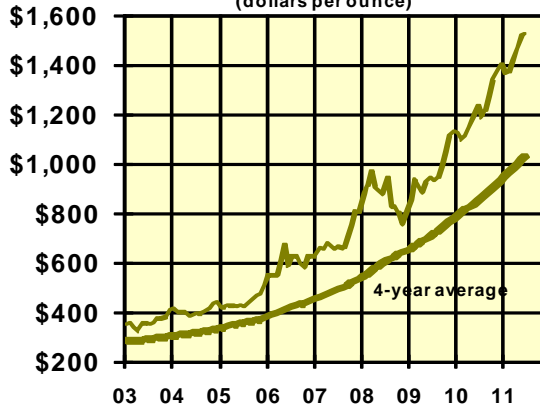
High-Powered \$ & M2
(percent change year over year)



U.S. Dollar Index



Gold Prices
(dollars per ounce)



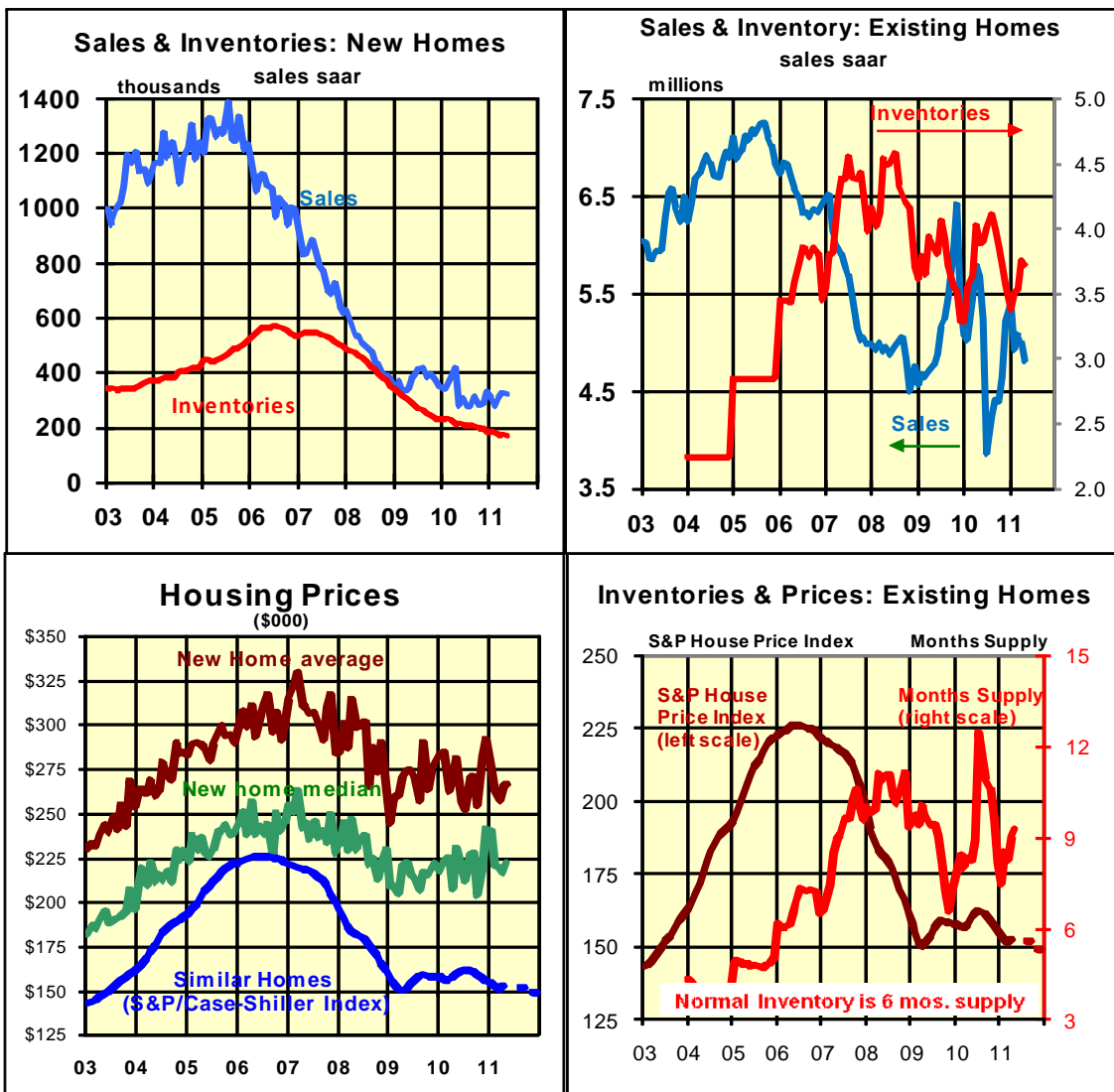
Sensitive Indicators

Special factors slowed the pace of business activity this past spring. A number of indicators reflect this weakness.

ISM surveys in early June continue to point to moderate growth. Initial unemployment claims have been elevated for the past three months and employment reports remain weak. Other

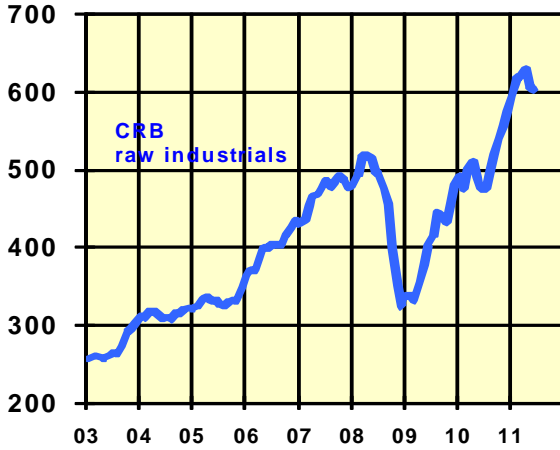
economic indicators remain sluggish through June.

The sharp increase in bank reserves during the first five months of the year is expected to increase the pace of spending by September at the latest. If it does, sensitive economic indicators should begin improving within the next month or two.



SENSITIVE INDICATORS

Raw Industrial Prices

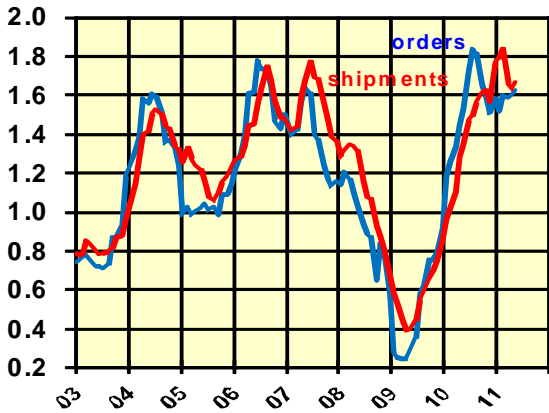


Stock Prices

S&P 500

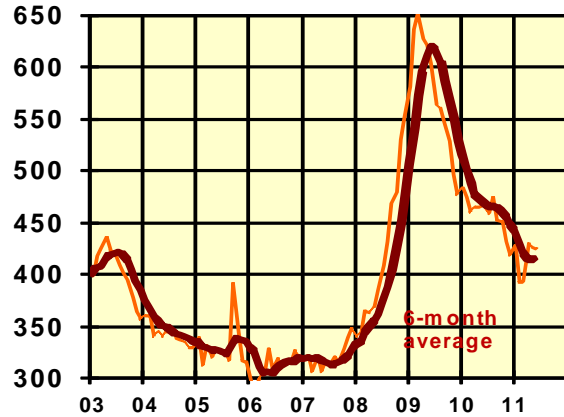


Semiconductor: N. A. Orders and Shipments (billions of \$)



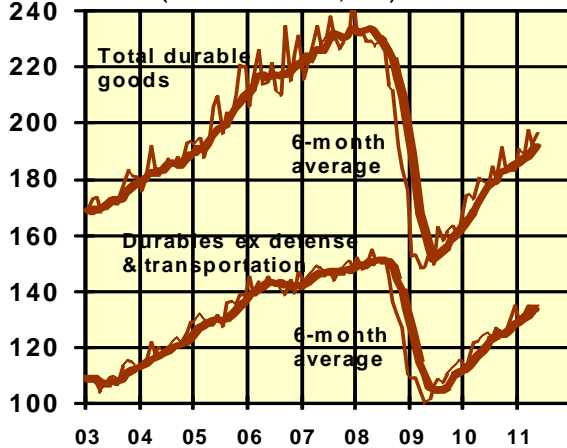
Unemployment Claims

(weekly claims)



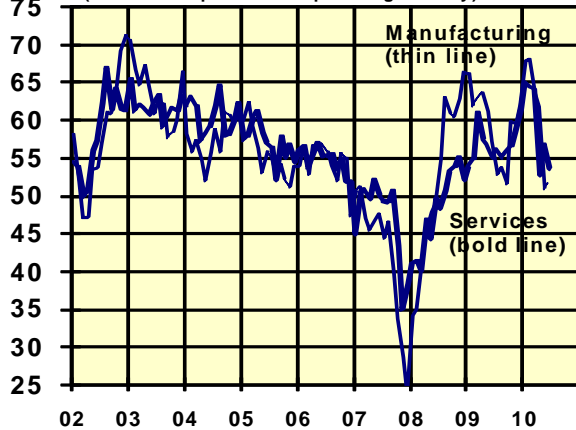
New Orders

(billions of dollars, saar)



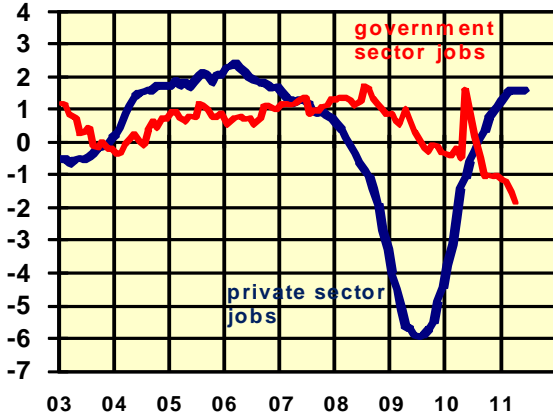
ISM: New Orders

(above 50 represents expanding activity)

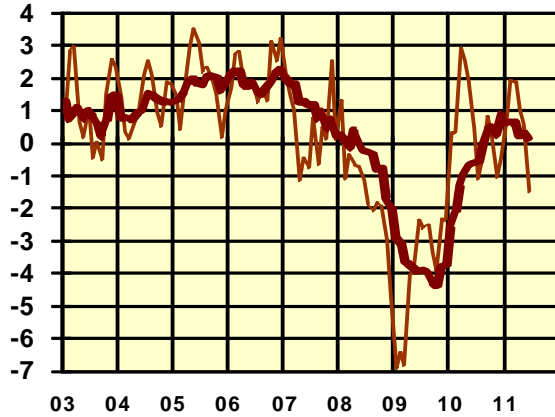


ECONOMIC INDICATORS

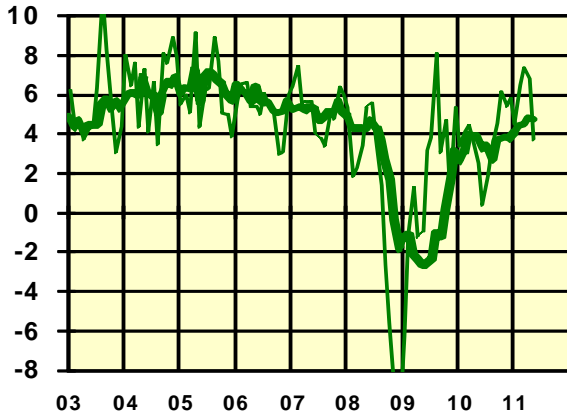
Jobs: Payroll Data
(year over year percent change)



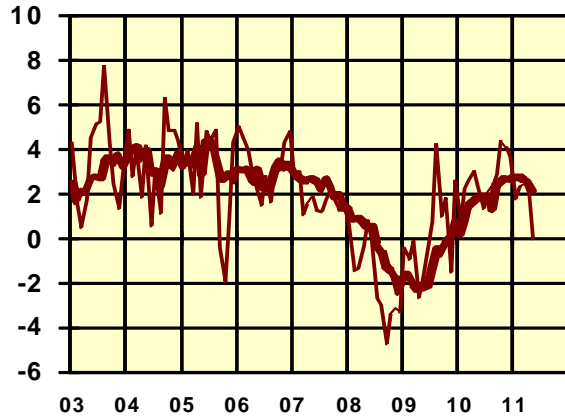
Jobs: Household Data
(annual rates of change--3 months & 1 year)



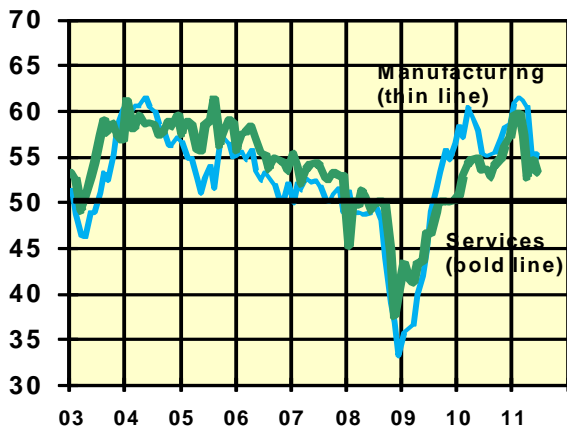
Consumer Spending
(annual rates of change-- 3 months & 1 year)



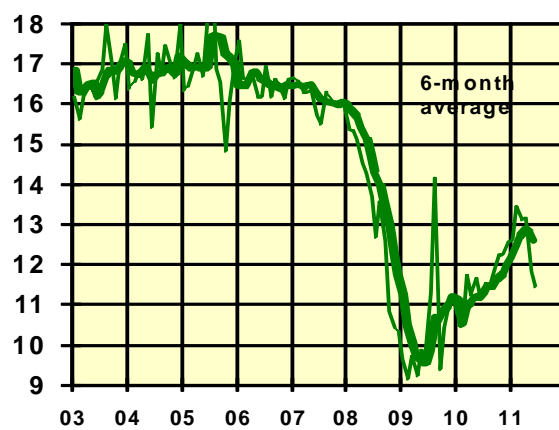
Real Consumer Spending
(annual rates of change-- 3 months & 1 year)



ISM: Composite
(over 50 represents expanding activity)



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



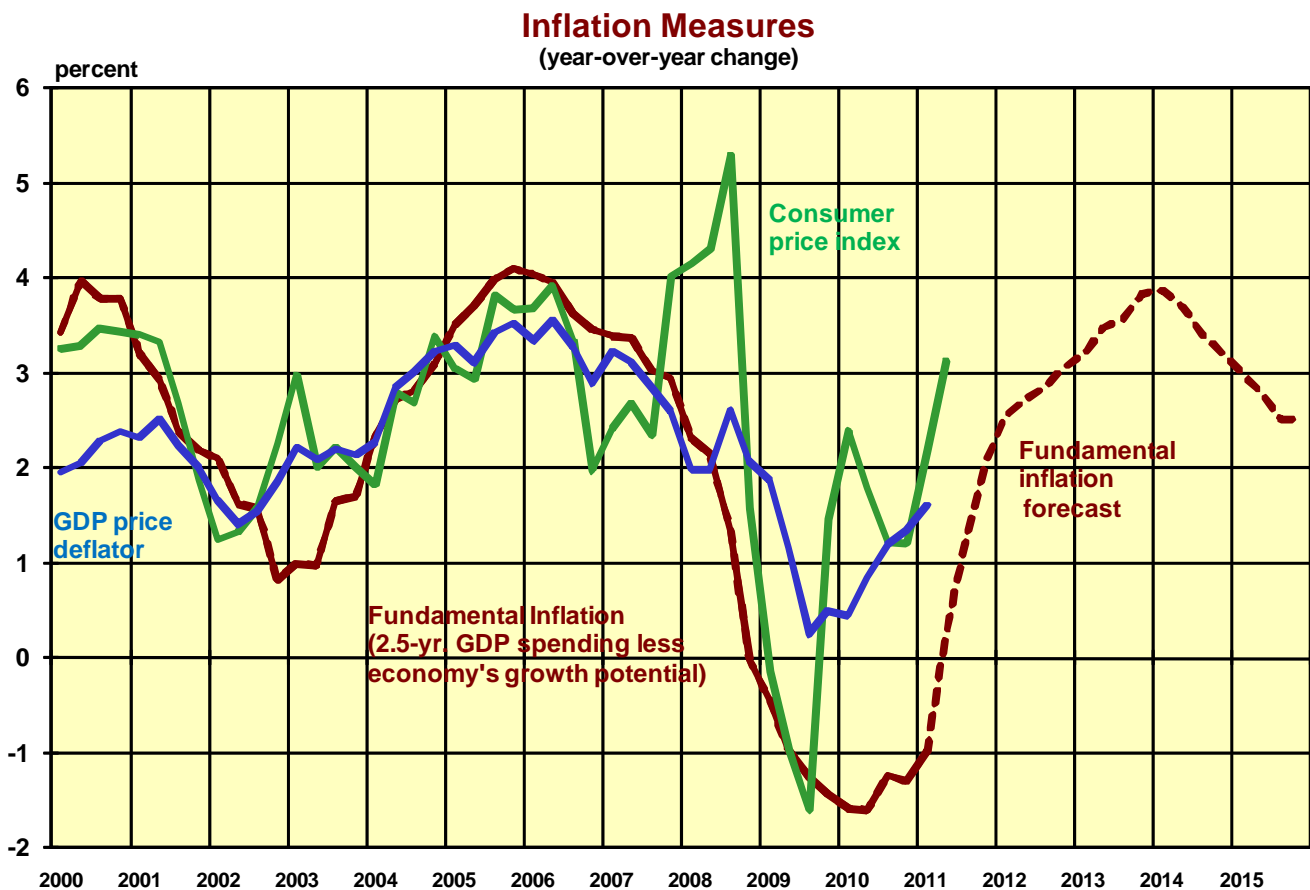
Inflation Indicators

In the first half of the year the dollar fell by 5% while the CRB index of industrial commodity prices rose by 5%. Gold prices rose by 9% and oil by 3%. The increase in prices came amid the sharp growth in bank reserves. Although spending remained relatively weak, the additional liquidity helped boost many sensitive prices.

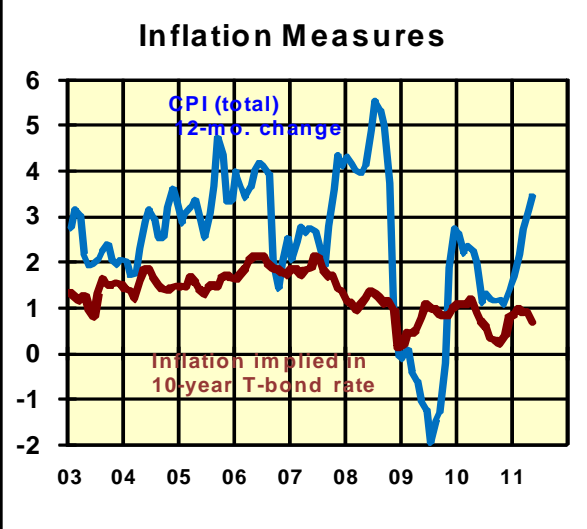
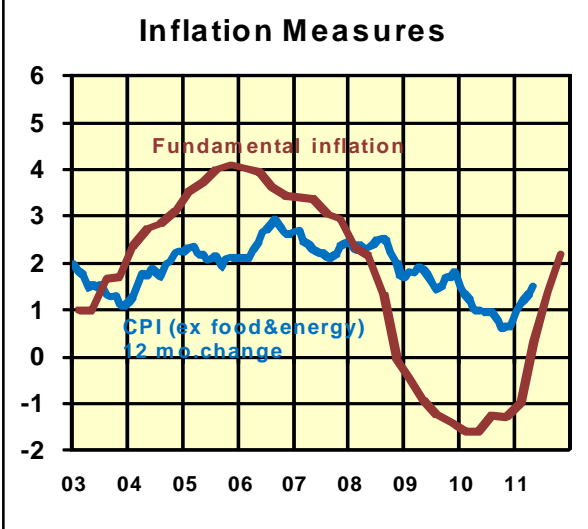
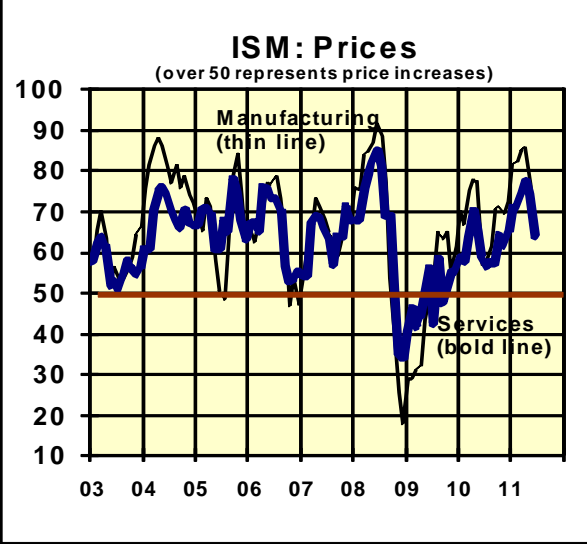
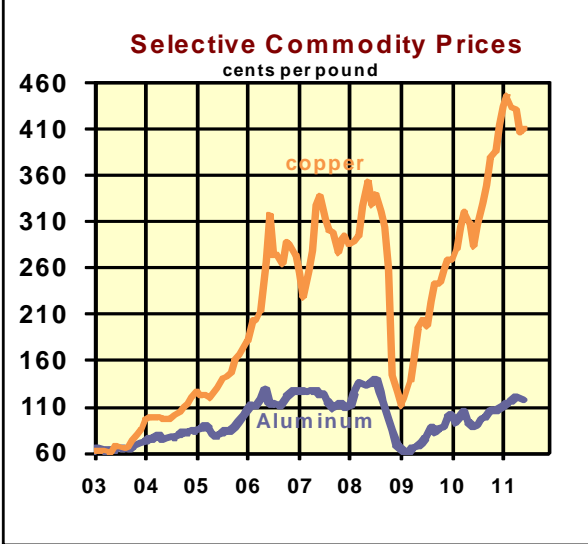
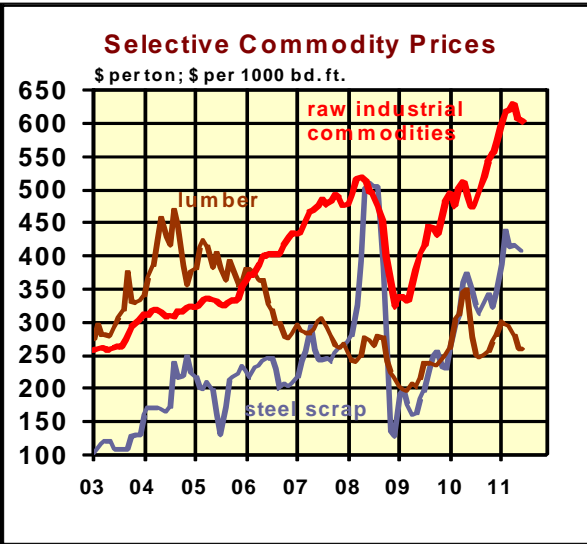
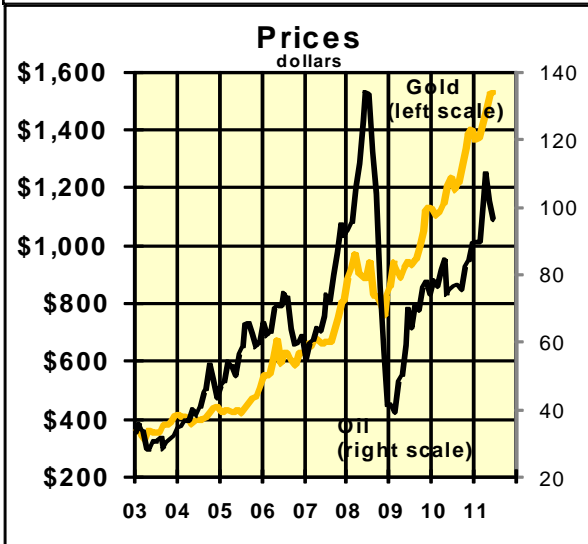
The sharp increase in oil prices earlier in the year produced a spike that sent most measures of inflation well above their fundamental or underlying trend. As the recent decrease in oil

prices works its way through the economy, reported inflation numbers should decline.

With mixed signals on inflation it's useful to assess the underlying inflation rate. This is rate inflation tends to gravitate toward. It's determined by the 2-3 year average change in current dollar spending (GDP), minus the economy's potential growth. If GDP were to continue at the 6%-7% rate suggested by recent Fed policy, it would raise the underlying inflation rate toward roughly 4% by the end of 2014.



INFLATION INDICATORS



Interest Rates

Inflation rates of even 2%-3% are consistent with 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 reiterated an expectation for current interest rate levels would remain "for an extended period."

Keeping the fed funds rate close to zero means the odds are high that the recent explosive rise in bank reserves will continue. The longer it does, the greater the pressure will be for an increase in spending followed by higher inflation and higher interest rates.

Recent signs that the pace of growth has slowed will only encourage the Fed to maintain an expansive policy.

As the chart on the following page shows, the pace of spending has been low relative to its normal relationship to adjusted bank reserves. For most of the past two decades increases in spending have been roughly two percentage points higher than the increase in adjusted bank reserves.

An exception to this relationship occurred during the early 1990s. This was a disruptive time for financial markets. The savings and loan crisis led to massive losses and many

institutions were closed and consolidated. In addition, the public's demand for currency grew rapidly. This reduced the potential for a normal multiple expansion of reserves into bank deposits. Such institutional factors can disrupt the transmission mechanism from money to spending.

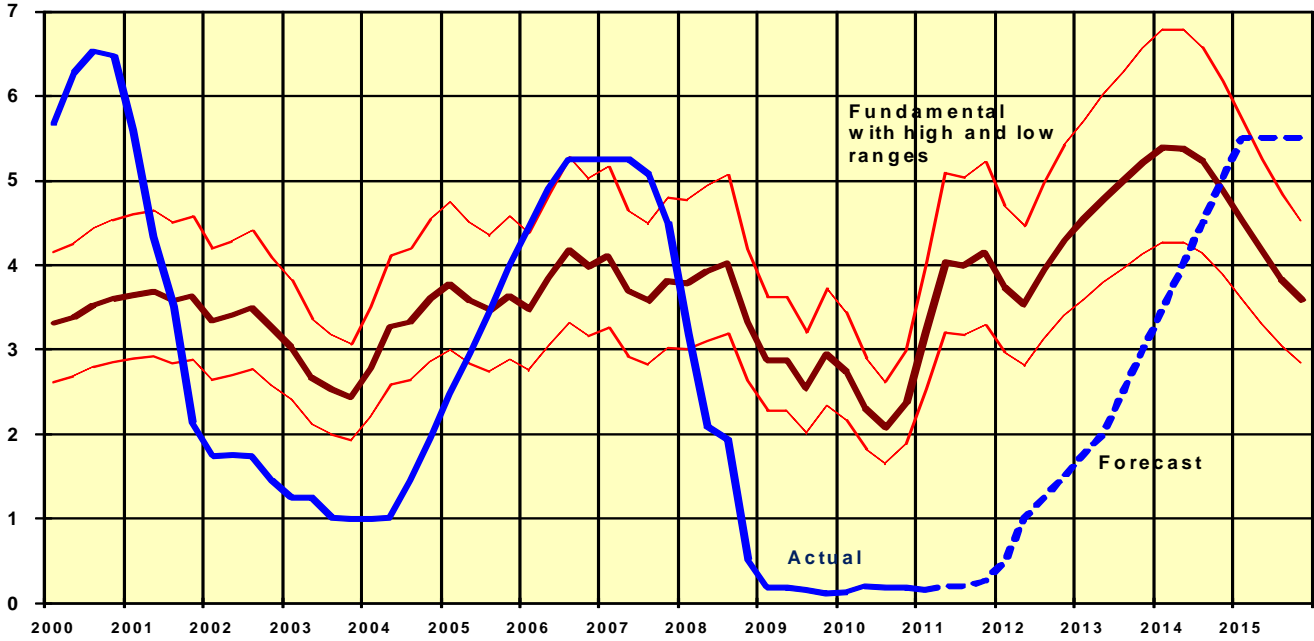
This same potential disruption appears to be at work today. Currency is once again growing rapidly and there are serious dislocations for financial institutions. These dislocations have served to disrupt the normal transmission mechanism from bank reserves to spending.

As noted earlier, recent patterns suggest that the spending pace associated with this year's 15% growth in bank reserves will be closer to 6%-7% than the much higher pace that would be expected under more normal conditions.

Regardless of the magnitude of such an adjustment, the Fed is still in the driver's seat. It can change bank reserves (or bank capital requirements) and any number of other things to produce more or less liquidity. Ongoing monitoring all these changes should help to determine the likelihood that the spending pace will accelerate as we head into 2012 and beyond.

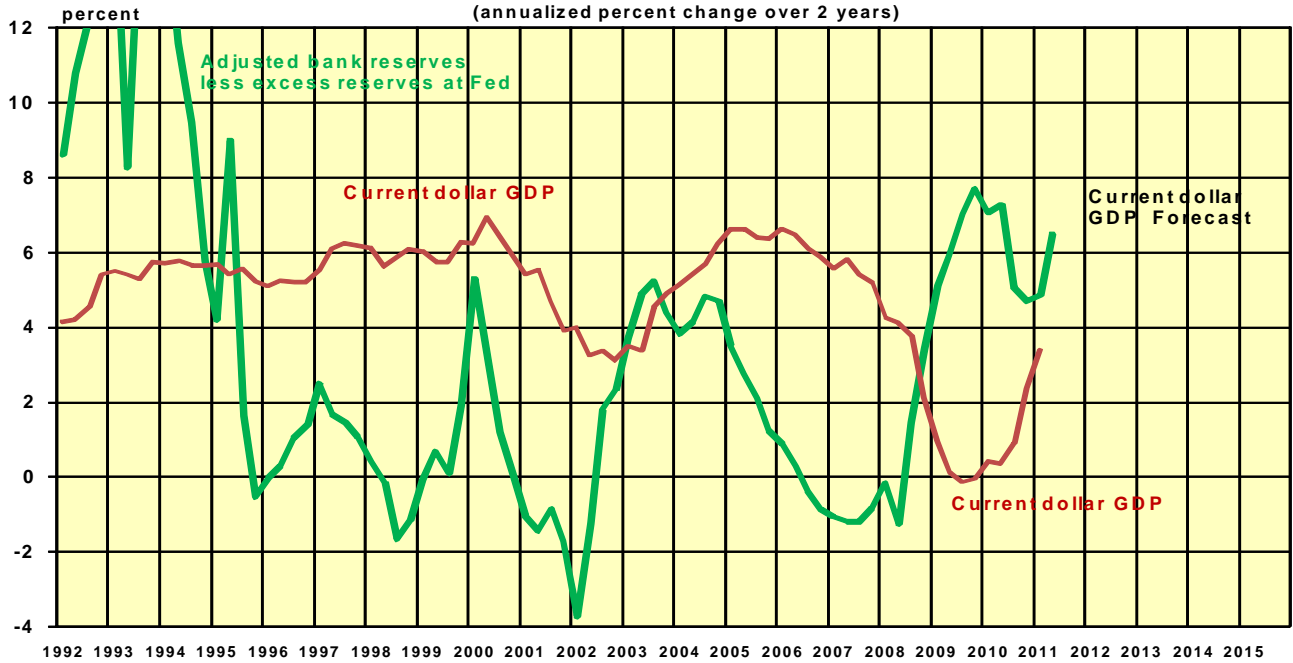
Fed Funds Interest Rate

Fundamental uses 0.5% real after-tax rate; 1 year average core inflation; 30% tax premium)



Money & Spending

(annualized percent change over 2 years)



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 financial markets anticipate that the Fed will increase the fed funds rate, all other interest rates will begin to move higher.

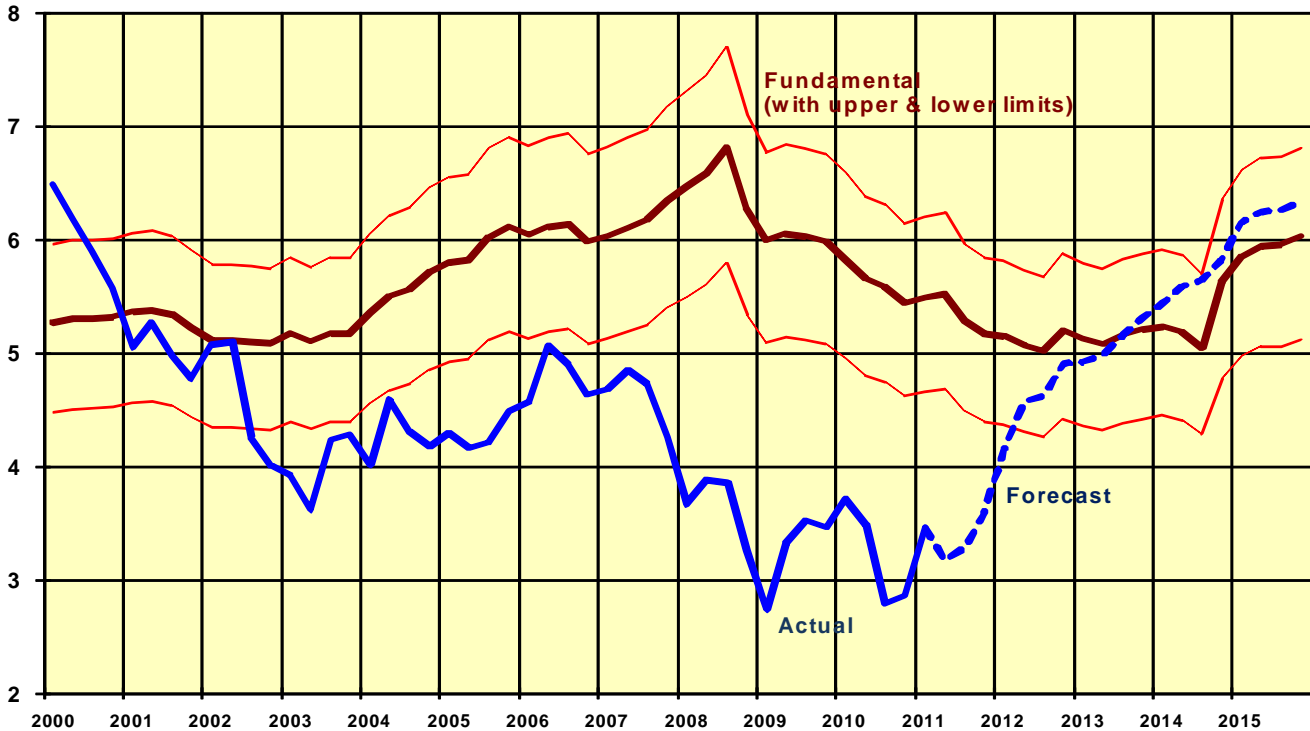
As the recent increase in bank reserves works its way through the economy, it should become

apparent that interest rates are heading higher. The extent to which rates increase depends on the timing of any change in Fed policy.

The potential for a sharp, sustained rise in long-term interest rates remains a very high likelihood. As such, holding fixed-income securities continues to represent a significant risk.

10-Year Treasury Bond Rates: Actual & Fundamental

(Fundamental is 1.4% real rate; 5-year inflation average cpi, gdp deflator; 25% marginal tax rate)



STOCK PRICES

Stock prices continue to behave erratically. A sharp downturn that began at the beginning of May appears to have ended. An equally sharp rebound has taken the key indexes back close to their highs for the year.

In spite of a sluggish economic recovery, corporate profits remain close to the highest share of the economy in over sixty years. My

analysis shows that stocks remain more than 30% undervalued.

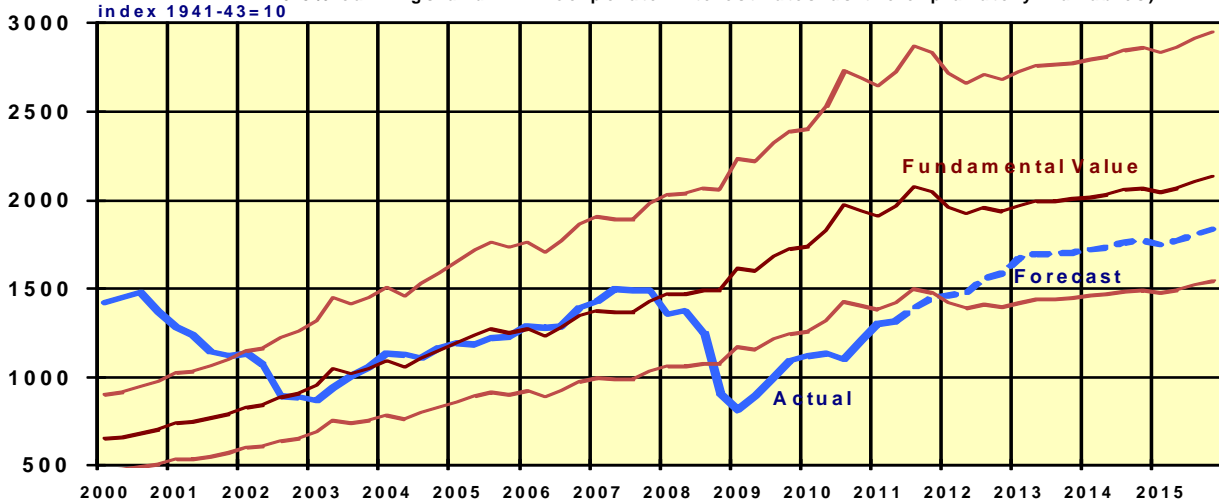
The likelihood of higher interest rates in the future is likely to reduce the fundamental value of stocks. However, the discounted value of stocks provides a large cushion for further significant gains.

After-tax Operating Profits Share of GDP



Stock Prices: S&P 500

(Fundamental value of stocks is based on a regression with S&P average PE, trend 6.5% earnings and AAA corporate interest rates as the explanatory variables)



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7/7/2011	<u>Actual</u>			<u>Forecast</u>				<u>YEARS</u>				
	<u>2010</u>	<u>2010</u>	<u>2011</u>	<u>2011</u>	<u>2011</u>	<u>2011</u>	<u>2012</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
	III	IV	I	II	III	IV	I					
GROSS DOMESTIC PRODUCT	14745	14871	15018	15164	15388	15659	15945	14369	14119	14660	15307	16311
%ch	4.6	3.5	4.0	3.9	6.0	7.2	7.5	2.2	-1.7	3.8	4.4	6.6
REAL GDP	13279	13381	13444	13468	13610	13800	13988	13229	12881	13248	13580	14188
%ch	2.6	3.1	1.9	0.7	4.3	5.7	5.6	0.0	-2.6	2.9	2.5	4.5
CHAIN PRICE INDEX	1.111	1.112	1.117	1.126	1.131	1.135	1.141	1.086	1.096	1.107	1.128	1.151
%ch	2.1	0.4	2.0	3.2	1.8	1.5	1.9	2.2	0.9	1.0	1.9	2.1
CPI- ALL URBAN%ch	1.4	2.6	5.2	3.2	1.5	2.2	2.5	3.8	-0.3	1.6	2.9	2.5
FUND. INFLATION%ch	-1.2	-1.3	-1.0	0.2	1.3	2.0	2.5	2.6	0.0	-1.5	-0.8	2.0
PRETAX PROFITS	1846	1797	1938	1851	1885	1916	1953	1333.2	1316.7	1801.1	1897.6	1987.7
%ch	13.5	-10.1	35.1	-16.7	7.6	6.8	7.8	-23.3	-1.2	36.8	5.4	4.7
PRETAX PROFITS ADJ (1)	1640	1678	1727	1710	1734	1770	1804	1262.8	1258.0	1624.8	1735.3	1839.6
%ch	6.6	9.6	12.1	-3.8	5.6	8.7	7.8	-16.4	-0.4	29.2	6.8	6.0
AFTER-TAX PROFITS	1416	1369	1476	1408	1433	1455	1480	1025	1062	1384	1443	1508
%ch	10.1	-12.6	35.2	-17.2	7.3	6.3	7.1	-20.7	3.6	30.4	4.3	4.5
AFTER-TAX PROFITS ADJ(1)	1211	1250	1266	1268	1282	1309	1332	954.4	1003.1	1208.2	1281.1	1359.5
%ch	0.7	13.7	5.1	0.6	4.5	8.9	7.0	-10.4	5.1	20.4	6.0	6.1
PERSONAL INCOME	12595	12701	12935	13029	13222	13454	13701	12391	12175	12541	13160	14015
%ch	2.5	3.4	7.6	2.9	6.0	7.2	7.5	4.0	-1.7	3.0	4.9	6.5
REAL DISPOSABLE INCOME	10277	10305	10328	10320	10436	10564	10693	10043	10100	10237	10412	10828
%ch	1.0	1.1	0.9	-0.3	4.6	5.0	5.0	1.7	0.6	1.4	1.7	4.0
PRODUCTIVITY	1.115	1.123	1.128	1.134	1.140	1.146	1.152	1.036	1.074	1.115	1.137	1.162
%ch	2.3	2.9	1.8	2.2	2.2	2.2	2.2	1.0	3.7	3.9	2.0	2.2
CIVILIAN EMPLOYMENT	139.2	139.1	139.6	139.8	140.0	140.3	140.6	145.4	139.9	139.1	139.3	140.9
%ch	-0.2	-0.4	1.5	0.5	0.8	0.8	0.7	-0.5	-3.8	-0.6	0.2	1.1
UNEMPLOYMENT RATE	9.6	9.6	8.9	9.0	8.8	8.6	8.5	5.8	9.3	9.6	8.8	8.6
INDUSTRIAL PRODUCTION	91.0	91.7	92.7	93.0	94.8	97.1	99.3	96.3	85.5	90.1	91.2	101.4
%ch	6.7	3.1	4.3	1.4	8.1	9.9	9.6	-3.7	-11.2	5.3	1.3	11.2
LIGHT VEHICLE SALES (2)	11.6	12.4	13.1	12.1	12.6	12.8	13.0	13.2	10.4	11.6	12.1	13.2
Domestic	5.7	6.0	6.6	6.1	6.4	6.5	6.7	6.8	5.5	5.8	6.0	6.9
Imports	5.9	6.4	6.4	6.1	6.2	6.3	6.3	6.5	4.9	5.8	6.1	6.4

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

(2) Millions at seasonally adjusted annual rates.

7/7/2011	Actual			Forecast				Years				
	2010	2011	2011	2011	2011	2012	2012	2008	2009	2010	2011	2012
Monetary Aggregates quarterly:	IV	I	II	III	IV	I	II					
M2 %ch at annual rates	5.7	4.4	5.4	6.4	6.6	5.8	4.6	7.1	7.9	2.3	5.1	5.4
Adj. Bank Reserves less excess reserves (billions of \$)	109	112	117	120	123			95	105	107		
Interest Rates:												
Baa Corp Bonds: Moody's	5.91	6.09	5.85	5.74	5.99	6.53	6.91	7.45	7.30	6.04	5.86	6.89
Aaa Corp Bonds: Moody's	4.86		5.04	4.78	5.02	5.55	5.92	5.64	5.31	4.94	4.95	5.90
MORTGAGE RATES	5.10	5.10	5.10	5.18	5.47	6.15	6.57	6.04	5.04	5.10	5.21	6.56
10-YR GOVT SECURITIES	2.86	3.46	3.21	3.28	3.57	4.15	4.57	3.67	3.26	3.21	3.38	4.56
5-YR GOVT SECURITIES	1.49	2.12	1.86	2.09	2.41	2.92	3.38	2.80	2.19	1.93	2.12	3.41
2-YR GOVT SECURITIES	0.48	0.69	0.57	0.90	1.25	1.70	2.20	2.00	0.96	0.70	0.85	2.26
3-MONTH T-BILL	0.14	0.13	0.05	0.44	0.49	0.74	1.24	1.46	0.16	0.13	0.28	1.30
FEDERAL FUNDS RATE	0.19	0.16	0.09	0.20	0.25	0.50	1.00	1.93	0.16	0.18	0.18	1.06
3-MONTH LIBOR RATE	0.29	0.31	0.26	0.55	0.60	0.85	1.35	2.91	0.69	0.34	0.43	1.41
BOND EQUIVALENT RATES:												
FEDERAL FUNDS	0.19	0.16	0.09	0.20	0.25	0.50	1.01	1.95	0.16	0.18	0.18	1.07
3-MONTH LIBOR	0.29	0.31	0.26	0.55	0.60	0.85	1.36	2.95	0.70	0.34	0.43	1.42
3-MONTH T-BILL	0.14	0.14	0.05	0.45	0.50	0.75	1.26	1.49	0.16	0.14	0.28	1.33
STOCKS:												
S&P 500	1204	1303	1319	1390	1447	1460	1468	1221	947	1139	1365	1517
S&P 500 quarterly reported earnings	82.7	85.8	82.6	82.7	86.6	90.3	87.9	14.9	51.0	77.4	84.4	89.6
S&P 500 p/e on reported earnings**	14.6	15.2	16.0	16.8	16.7	16.2	16.7	17.7	19.6	14.8	16.2	16.9
S&P 500 quarterly operating earnings	87.7	90.3	95.7	99.3	99.9	103.0	109.9	49.5	56.9	83.8	96.3	110.2
S&P 500 p/e on operating earnings**	13.7	14.4	13.8	14.0	14.5	14.2	13.4	24.7	16.7	13.6	14.2	13.8
S&P 500 underlying earnings***	77.6	78.8	80.1	81.3	82.6	83.9	85.3	66.8	71.2	75.8	80.7	85.9
S&P 500 p/e on underlying earnings	15.5	16.5	16.5	17.1	17.5	17.4	17.2	18.3	13.3	15.0	16.9	17.6

*annualized.

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***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)