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August 4, 2011

Monthly Economic and Financial Update

Removing the debt ceiling has solved the immediate problem of avoiding a disruptive government shutdown. However, the failure of Congress to address the nation's fiscal insolvency will promote serious future problems for the economy and financial markets.

Modest changes in the federal government's fiscal path can be helpful if both the economy and government are in decent shape. Modest changes are almost worthless given the extent of current problems.

The problem facing the US isn't a debt ceiling. The problem is a combination of government spending, EPA mandates, the fallout from Dodd-Frank burdens, and high costs and confusion stemming from health care legislation. The budget compromise does nothing to address any of these problems. It is a political, rather than an economic solution.

Details of the compromise (based on various CBO reports)

The budget compromise produced a cut of roughly 10% in discretionary spending in the 2012 budget. This is 2/3 of what the Ryan budget proposed. In addition, the compromise contains a Rube-Goldberg approach to cut \$1.2 trillion over the next ten years from "expected" future spending. (Another \$1 trillion in "cuts" is assumed to result from the winding down of spending on wars.)

None of these "cuts" are relevant in terms of the economic impact of the federal government on the health of the economy. Adding up ten-year totals makes the "cuts" appear significant. They are not. Federal spending over the next decade is projected to total more than \$50 trillion. Without the possible savings from wars, the budget compromise reduces the total to \$49 trillion.

Given the nation's expected revenue, the compromise will lead to a doubling in the nation's debt. Debt held by the public would go from \$10.3 trillion at the end of this fiscal year to \$20.6 trillion by 2021 (\$19.6 trillion without the war expenses).

The European economic model

In addition to the direct cost associated with government spending there are indirect costs. My calculations show the cost of complying with government edicts and mandates is currently close to \$2 trillion a year. The combination of mandated costs along with federal spending places the federal government share of the economy at roughly 40%. Adding state and local government spending brings the total government sector well above 50%.

The scope of government in the US is now comparable to what has been adopted in older European countries. This European economic model produces slow growth, high unemployment and, eventually, financial crises.

With increases in both government spending and regulatory burdens the US has adopted the European economic model. From an economic standpoint we are now the United States of Europe. This is the reason the US economy has struggled with growth and unemployment rates now comparable to those in Europe.

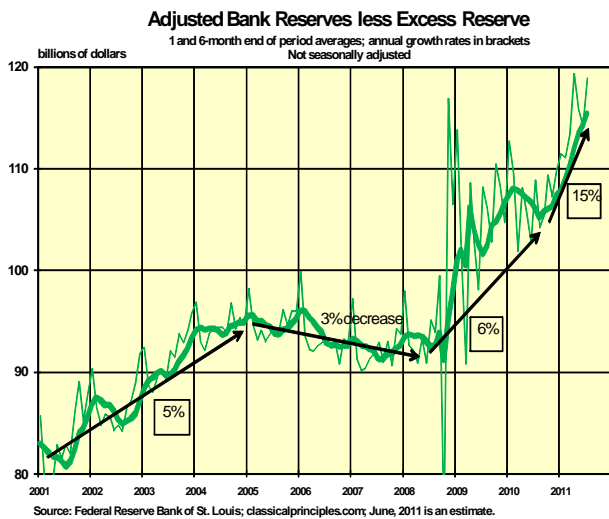
Having already adopted the European economic model, major policy changes will be necessary to restore the dynamic, high-growth economy the US once enjoyed. Next year's elections will determine if voters want to keep the current model or trade it in for something that runs better.

How Much Usable Money Has the Fed Created?

Beginning with the onset of the financial crisis in the fall of 2008 the Federal Reserve changed its operating procedures. It massively increased bank reserves; began paying banks to keep their reserves at the Fed; and pressured banks to raise their capital requirements.

In its own convoluted way the Fed has behaved at cross purposes. Increasing bank reserves boosts liquidity. However, paying banks to keep reserves with the Fed and having banks raise capital requirements reduces liquidity.

The following chart shows the pattern with respect to bank reserves other than those kept with the Fed. It shows how the Fed's has rapidly increased bank reserves even after allowing for bank reserves left with the Fed. I had been assuming the latest increase in these reserves would lead to a similar increase in current dollar spending later this year.

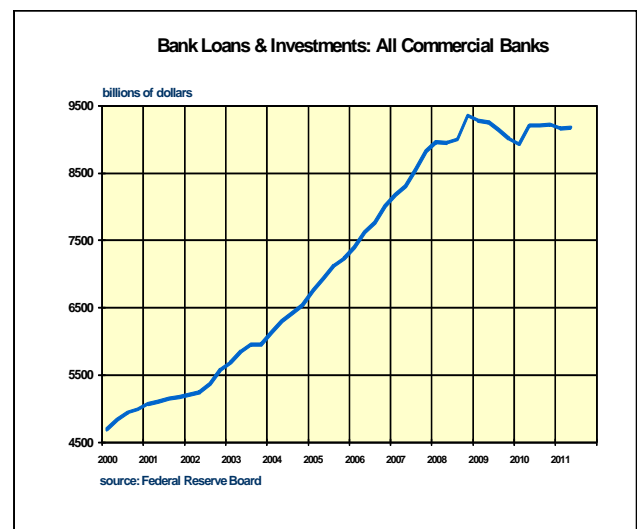


Mike Moebis, an expert on the banking system, agrees that bank reserves less excess reserves are a relevant measure of money or liquidity in the economy. However, he has indicated that overly aggressive regulators have required banks to increase their capital ratios. Banks have responded by reducing their assets. Maintaining capital while reducing assets produces higher capital to asset ratios.

Banks and other financial intermediaries provide the transmission mechanism that takes new bank reserves and turns those reserves into additional loans and deposits that allow the additional money to promote more spending.

When the banking system is healthy, it can very efficiently take reserves and convert them into money to facilitate more spending. When the system is under stress, it can short-circuit the process.

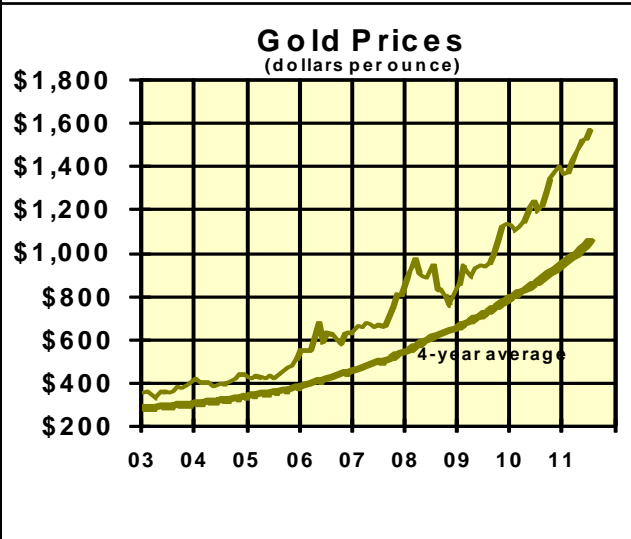
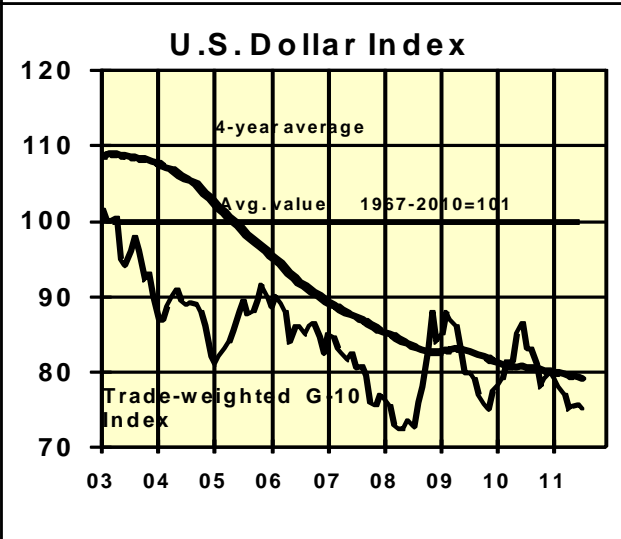
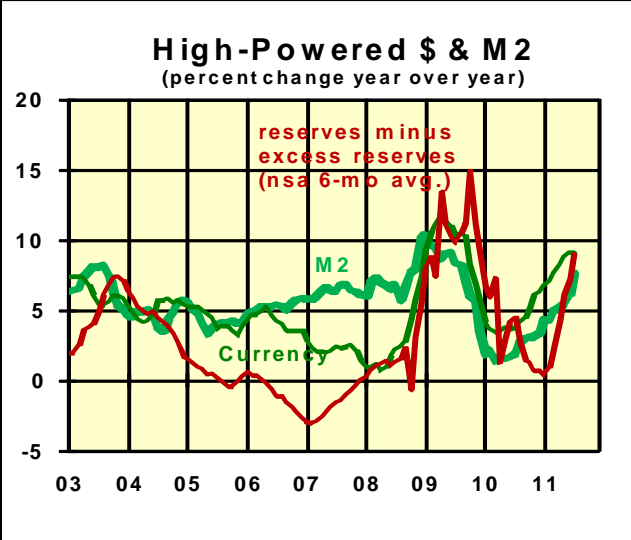
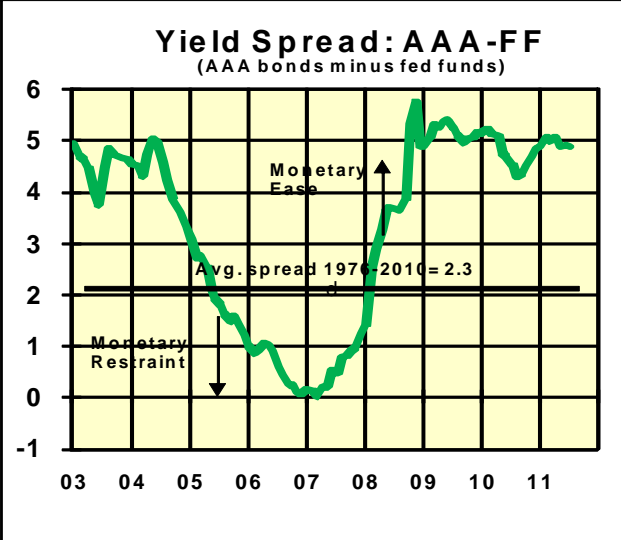
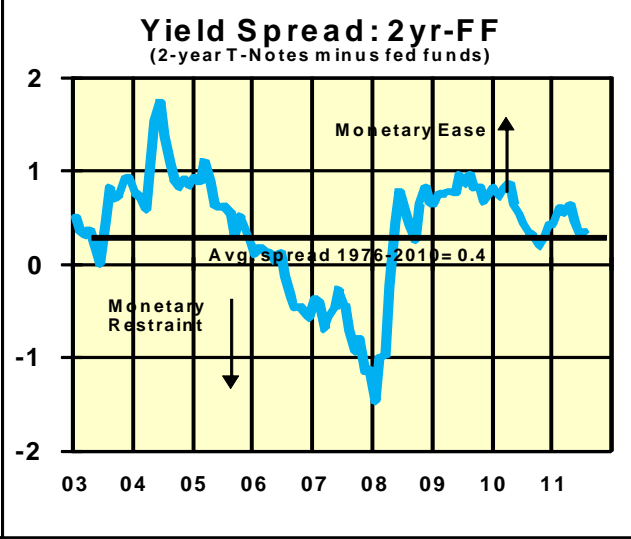
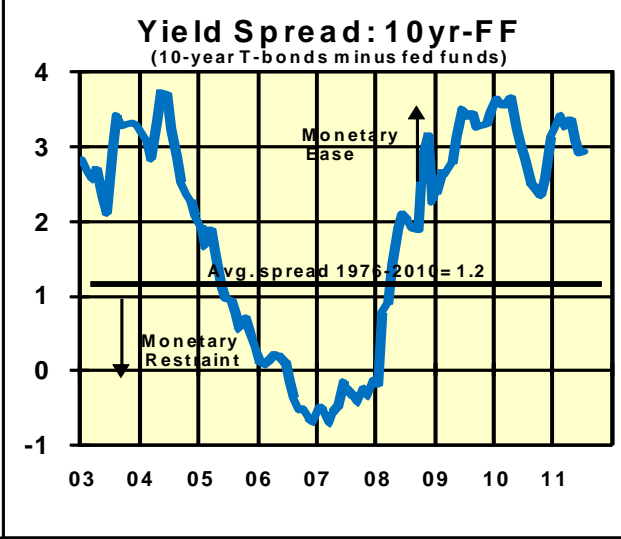
The next chart shows how loans and investments have failed to increase during the past two years. This is the opposite of the pattern in the previous period when rapid growth in loans and investments produced more spending than would have been expected based on changes in bank reserves alone.



As long as banks (particularly banks serving small businesses) are under stress, the transmission mechanism is also under stress.

The lack of growth in bank loans and investments appears to be providing a drag on the economy's ability to transfer reserves into current dollar spending. This helps to explain how current dollar spending can increase at a much slower rate than the increase in bank reserves.

MONETARY INDICATORS



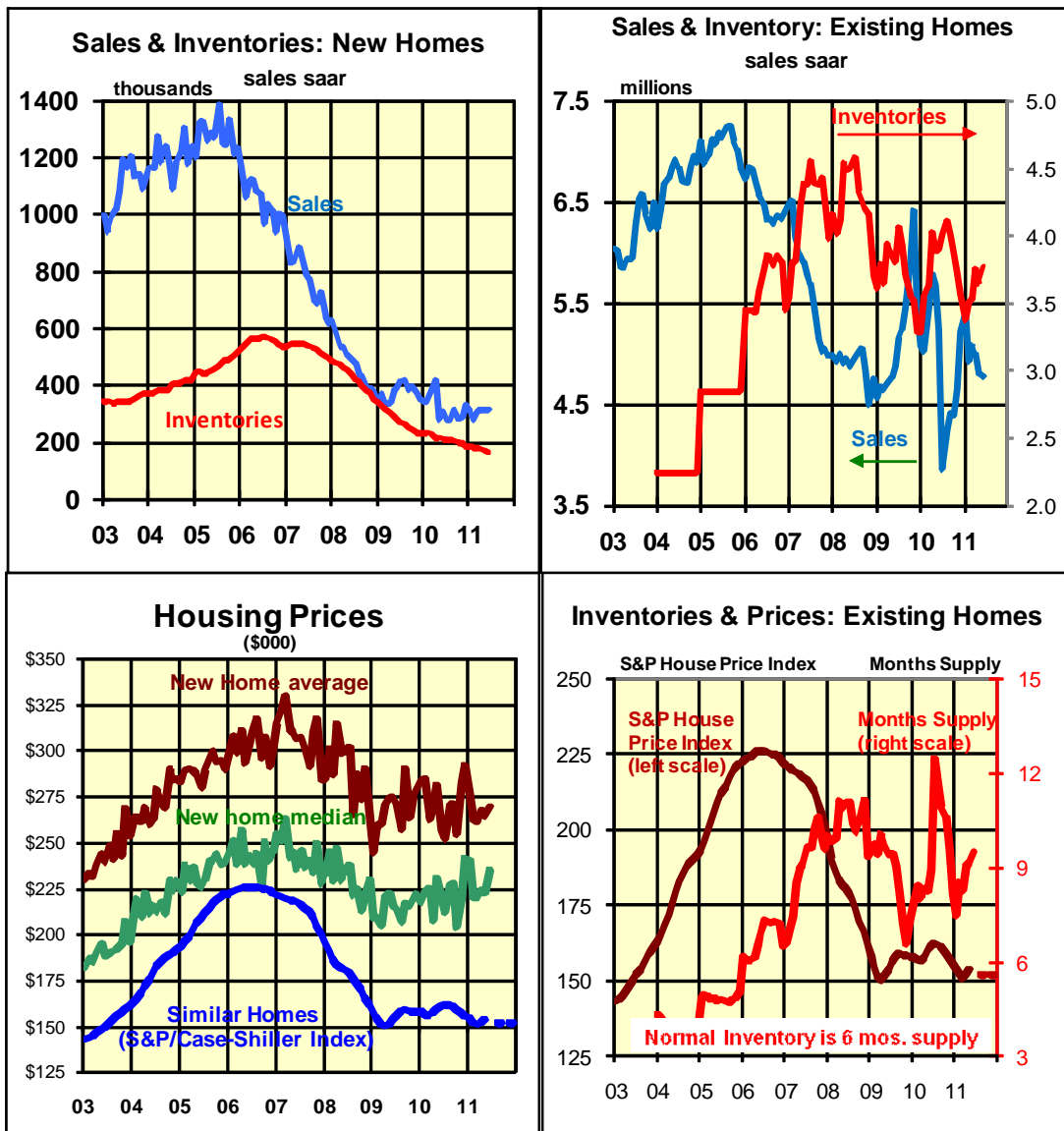
Sensitive Indicators

For the most part, sensitive economic indicators remain fairly weak. ISM surveys in early July were weaker for both manufacturing and service companies. The ISM new order components for early July indicate little, if any, expansion in the months immediately ahead.

In response to a weaker pace of economic growth, stock prices and industrial commodity

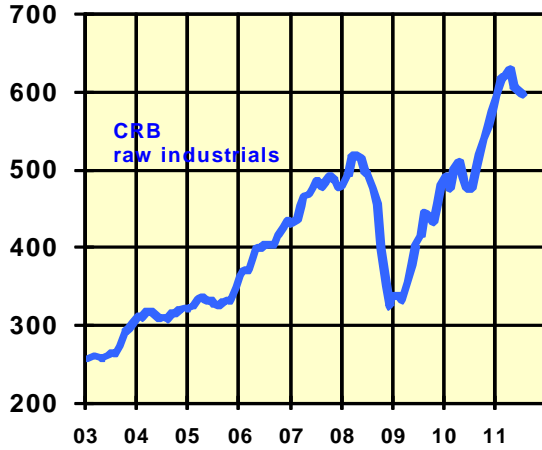
prices have also turned down. Housing activity appears to be fairly stable, albeit at a very low level.

Coincident indicators also reflect a substantial weakening in the pace of real economic activity in recent months.



SENSITIVE INDICATORS

Raw Industrial Prices

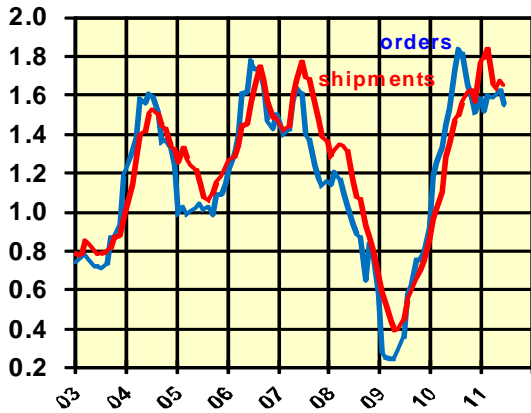


Stock Prices

S&P 500

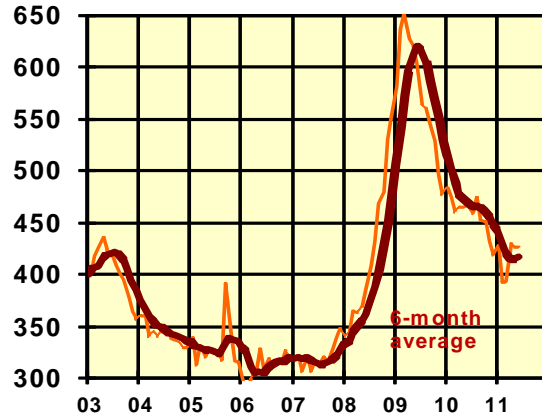


Semiconductor: N. A. Orders and Shipments (billions of \$)



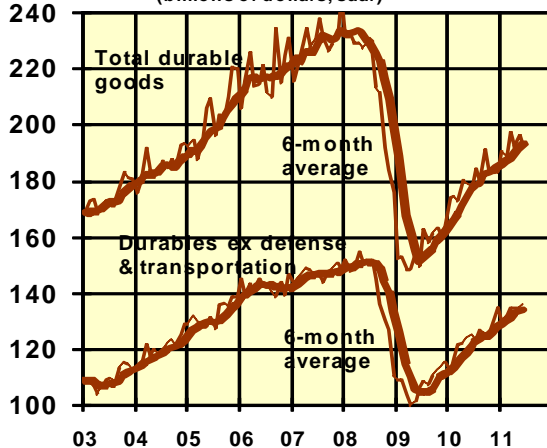
Unemployment Claims

(weekly claims)



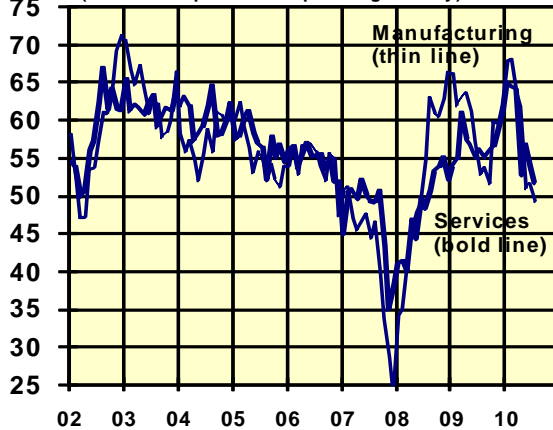
New Orders

(billions of dollars, saar)



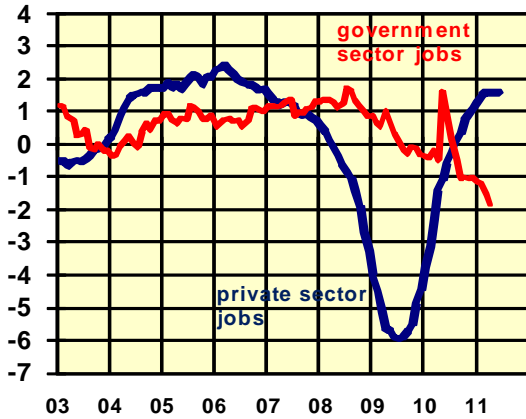
ISM: New Orders

(above 50 represents expanding activity)

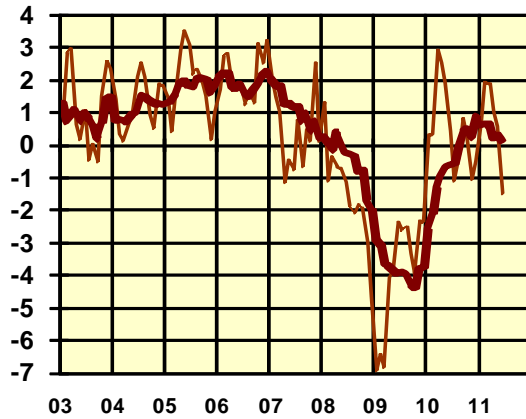


ECONOMIC INDICATORS

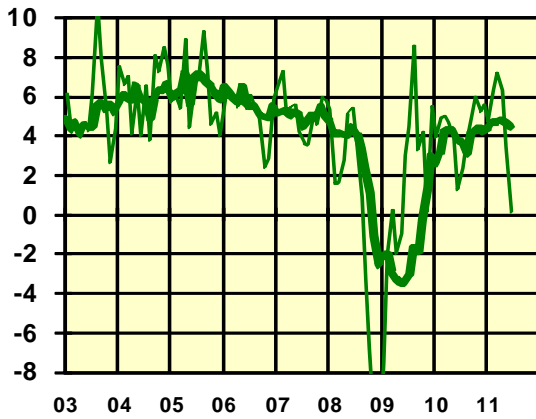
Jobs: Payroll Data
(year over year percent change)



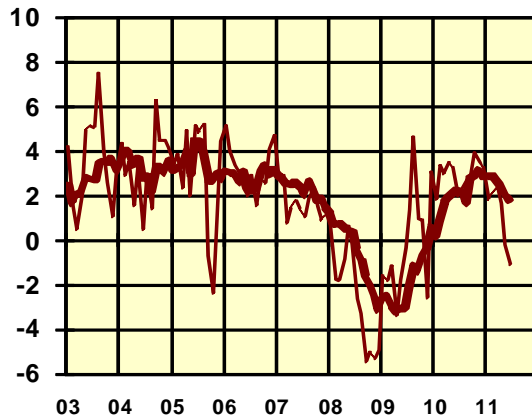
Jobs: Household Data
(annual rates of change--3 months & 1 year)



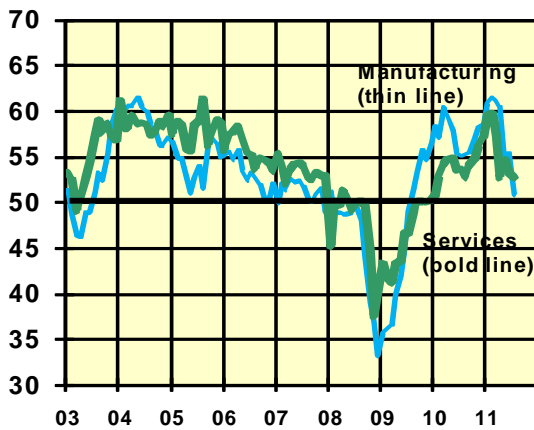
Consumer Spending
(annual rates of change-- 3 months & 1 year)



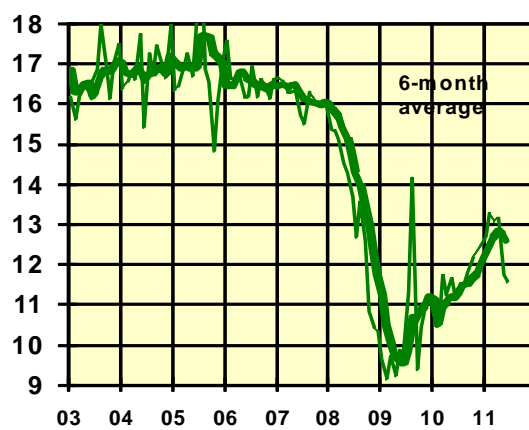
Real Consumer Spending
(annual rates of change-- 3 months & 1 year)



ISM: Composite
(over 50 represents expanding activity)



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



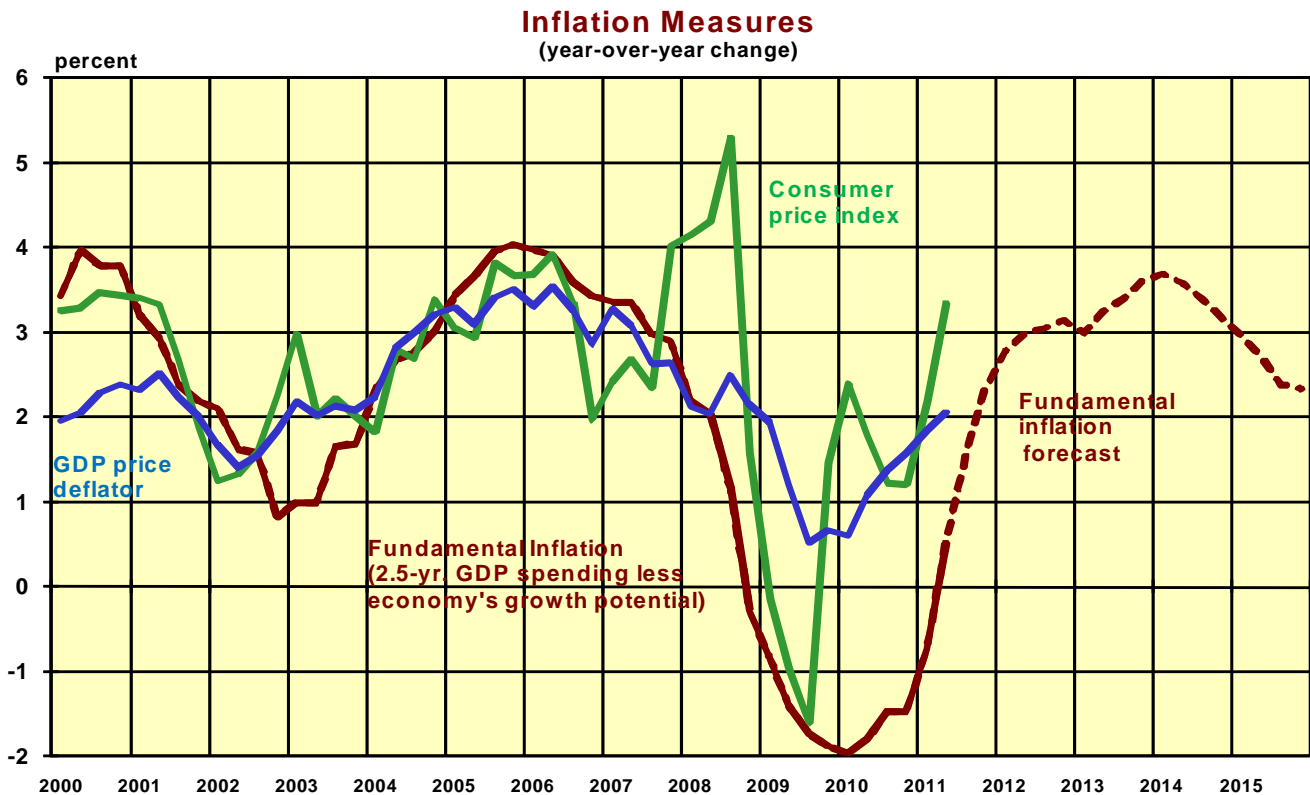
Inflation Indicators

A sharp increase in oil prices earlier in the year produced a spike in most measures of inflation. The spike sent inflation well above its fundamental or underlying pace. More recently, sensitive commodity prices have begun to decline.

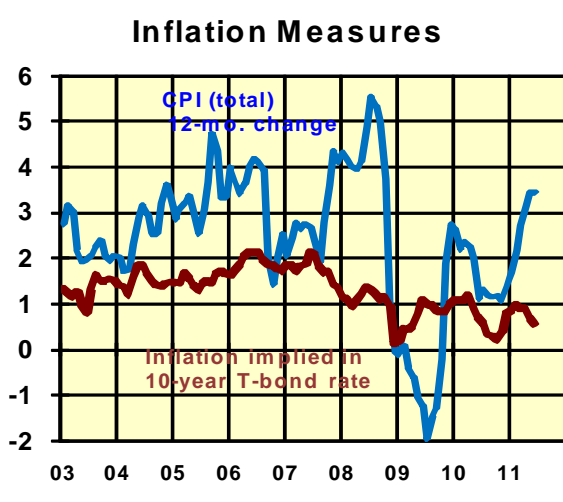
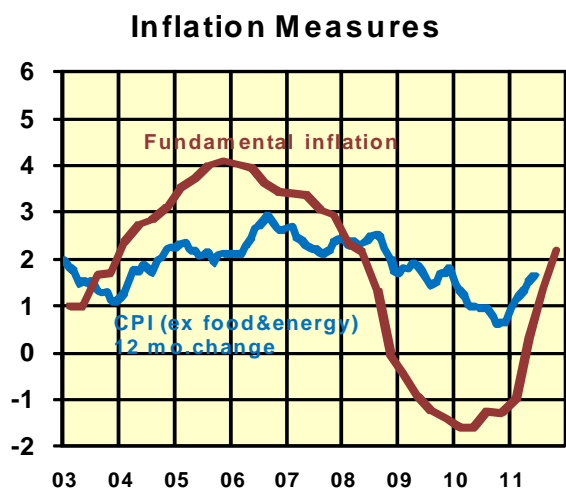
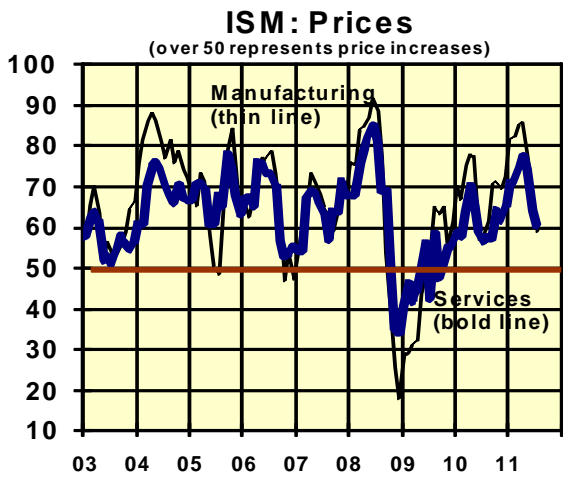
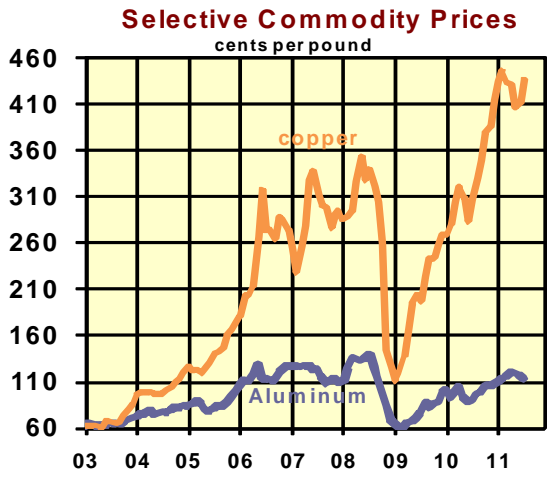
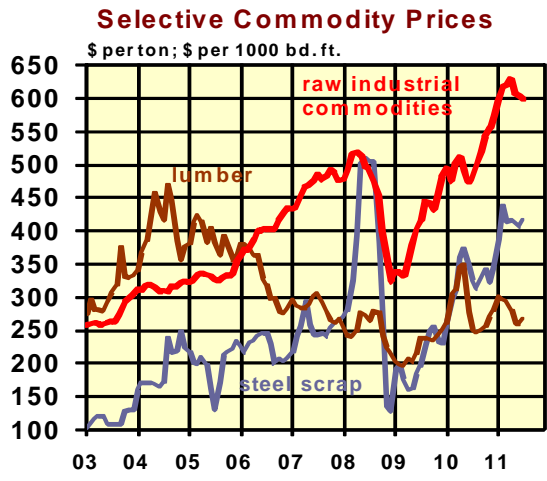
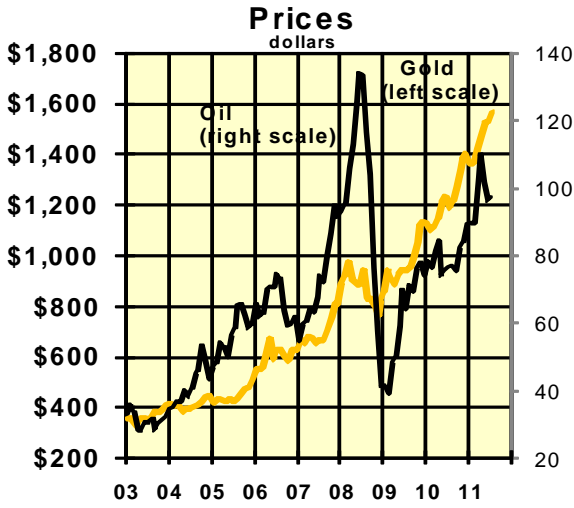
With mixed signals on inflation it's always helpful to reassess the economy's underlying inflation rate. This is rate inflation tends to gravitate toward over time. It's determined by the 2-3 year average change in current dollar spending (GDP), minus the economy's potential growth. The economy's underlying potential growth rate is currently probably somewhere in a range of 1%-2%.

Over the past 2 years, current dollar GDP increased at a 4% annual rate. Subtracting potential growth produces an underlying inflation of roughly 2%-3%. If the 4% currently dollar spending of the past two years continues, inflation can be expected to gravitate toward this range.

For inflation to move above the 2%-3% vicinity it would be necessary for current dollar spending to move higher than a 4% rate or for the economy's potential growth to move below the 1%-2% vicinity.



INFLATION INDICATORS



Interest Rates

In the late 1970s, the economy experienced sluggish growth while spending, inflation and interest rates soared. Recently, the economy has also experienced sluggish growth while spending, inflation and interest rates have been low.

The main difference between the two periods is the growth in current dollar spending. If the spending pace is weak, interest rates and inflation will remain weak. In order for interest rates and spending to increase it is necessary for the pace of current dollar spending to increase.

As noted earlier, the spending pace depends on the amount of bank reserves created by the Fed and transferred by the banking system into spending.

Interest rates have recently moved lower amid signs the economy remains very weak. So long as these signs continue, interest rates will stay at historically low levels.

Almost everyone, including those at the Fed, acknowledges that interest rates will have to increase substantially from their current historically low levels. The issue is timing.

If problems with the banking system keep the spending pace in the 4%-5% vicinity, it will be an extended period of time before interest rates begin to increase. The first indication of upcoming increases in interest rates will be an increase in the pace of current dollar spending.

While increasing the pace of current dollar spending would provide a short-term boost to spending, it would not solve the nation's problems. If the underlying growth rate is weak, increasing liquidity soon leads to more inflation and higher interest rates.

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. These were generally periods when the banking system was healthy. Banks were increasing their leverage and bank loans and deposits were increasing rapidly. Given these conditions, the financial system was able to produce more liquidity and more spending from a given amount of bank reserves.

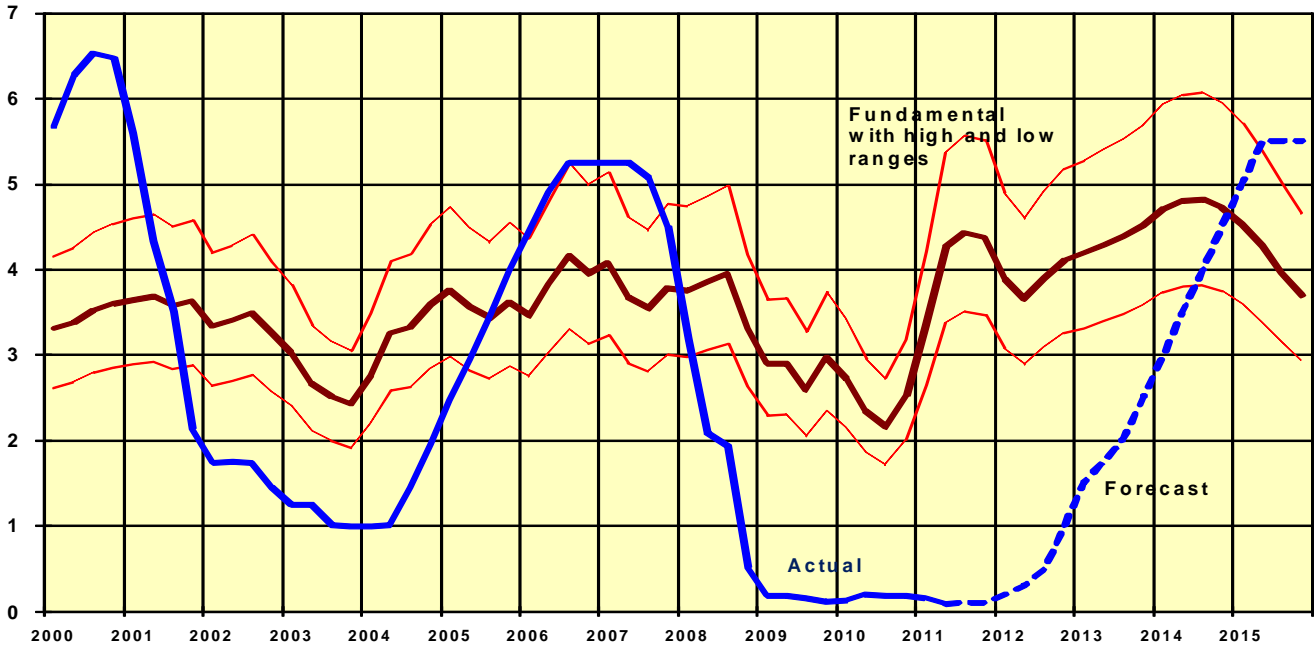
An exception to this relationship occurred during the early 1990s. This was a disruptive time for financial markets. The savings and loan crisis led to massive losses and many institutions were closed and consolidated. This reduced the potential for a normal multiple expansion of reserves into bank deposits. Such institutional factors can disrupt the transmission mechanism from reserves to spending.

This same potential disruption appears to be at work today amid serious dislocations among financial institutions.

While the average increase in bank reserves over the past year is in the 6%-7% vicinity, there has been essentially no growth in bank loans and investments. While these relationships are far from rigid, the recent pattern points to a pace of current dollar spending closer to 5%-6% than the higher pace suggested by the growth in bank reserves. If this turns out to be correct, the upturn in interest rates isn't likely to occur until the beginning of next year or even later.

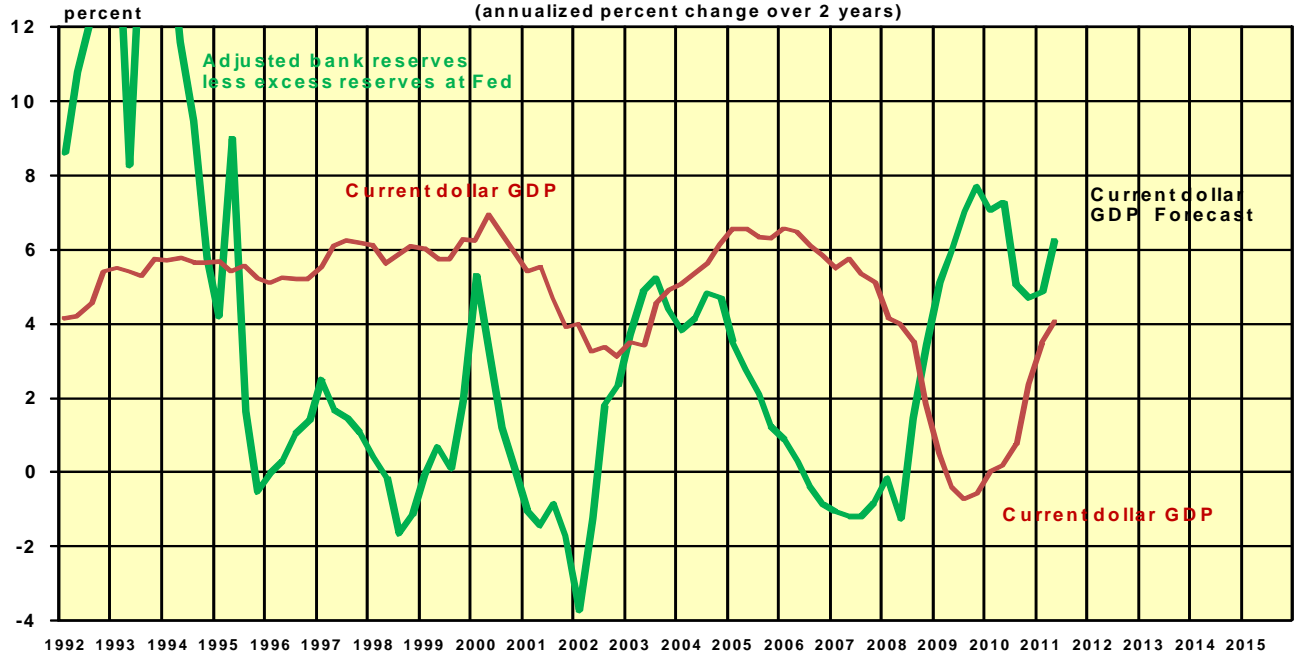
Fed Funds Interest Rate

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

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.

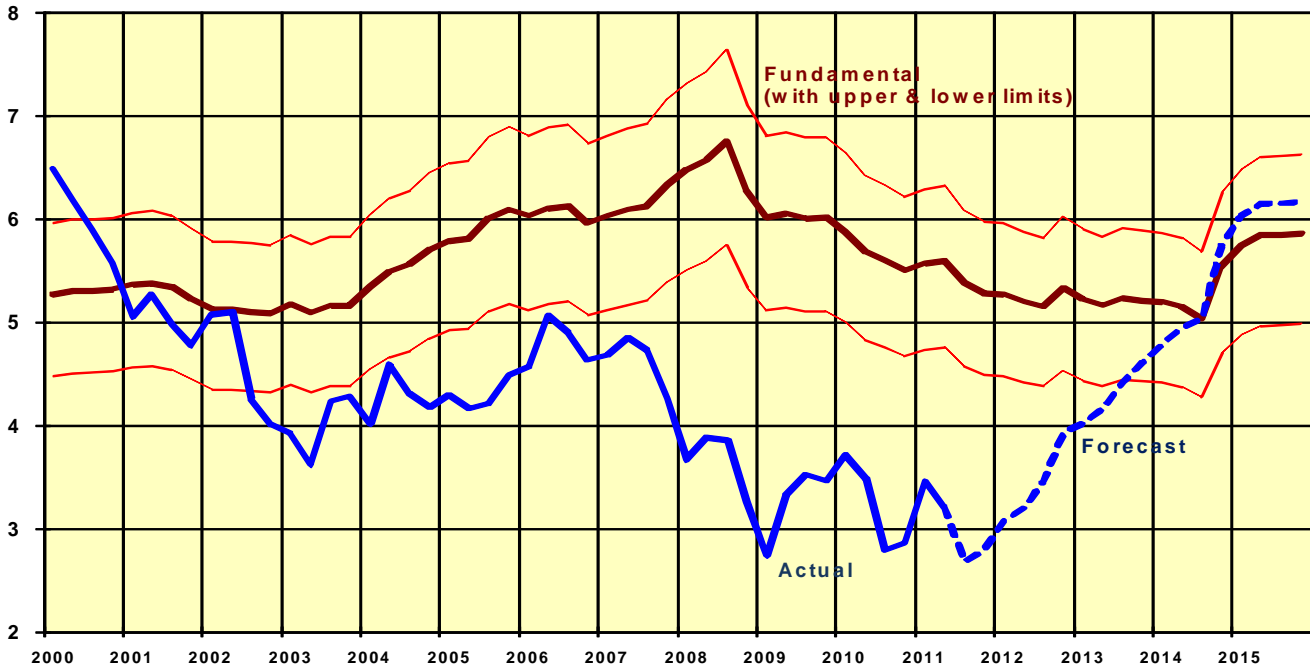
The timing of the increase will depend on the extent to which the banking system transforms the increase in bank reserves into liquidity. Efforts by banks to increase their capital ratios appear to have dampened the impact of these

reserves on the pace of spending. This is a temporary phenomenon.

A combination of an increase in bank capital ratios along with further increases in bank reserves will provide significant pressure to boost spending. When it does, it will mark the beginning of what is likely to be an extended increase in interest rates.

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. The significant burdens associated with ill-advised government policies have weakened the economy. Companies have responded to existing and potential government burdens by cutting workers and boosting earnings.

From the standpoint of profits, companies have built a substantial cushion with which to deal with potential future costs. At the moment, stocks remain significantly (44%) undervalued based on current profits and current interest rates.

As interest rates other costs facing companies increase, the fundamental value of stocks will decline. However, the substantial cushion created by an extraordinary risk premium means current prices discount a number of future adverse developments.

The bottom line for stocks is the underlying trend remains positive in spite of a number of challenges. As a consequence, any decision to sell stocks and adopt a defensive position should be a temporary stance capable of being quickly reversed.

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)



8/3/2011	<u>Actual</u>			<u>Forecast</u>				<u>YEARS</u>				
	<u>2010</u>	<u>2011</u>	<u>2011</u>	<u>2011</u>	<u>2011</u>	<u>2012</u>	<u>2012</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
	IV	I	II	III	IV	I	II					
GROSS DOMESTIC PRODUCT	14755	14868	15004	15187	15405	15628	15852	13939	14527	15116	15987	16995
%ch	4.2	3.1	3.7	5.0	5.9	5.9	5.9	-2.5	4.2	4.1	5.8	6.3
REAL GDP	13216	13228	13270	13365	13483	13597	13708	12703	13088	13337	13782	14290
%ch	2.3	0.4	1.3	2.9	3.6	3.4	3.3	-3.5	3.0	1.9	3.3	3.7
CHAIN PRICE INDEX	1.117	1.124	1.130	1.136	1.143	1.150	1.157	1.097	1.110	1.133	1.161	1.191
%ch	1.9	2.5	2.3	2.1	2.3	2.5	2.6	1.1	1.2	2.1	2.4	2.6
CPI- ALL URBAN%ch	2.6	5.2	4.1	1.8	2.5	2.7	2.8	-0.3	1.6	3.1	2.7	3.0
FUND. INFLATION%ch	-1.5	-0.7	0.5	1.6	2.3	2.7	2.8	-0.3	-1.8	-0.8	2.2	2.8
PRETAX PROFITS	1743	1877	1801	1838	1858	1888	1912	1455.7	1819.5	1843.5	1929.4	2079.3
%ch	-20.4	34.7	-15.3	8.5	4.3	6.8	5.0	7.0	25.0	1.3	4.7	7.8
PRETAX PROFITS ADJ (1)	1857	1876	1884	1906	1933	1960	1985	1362.0	1800.1	1899.9	2002.0	2152.1
%ch	5.4	4.2	1.7	4.6	5.9	5.7	5.3	9.1	32.2	5.5	5.4	7.5
AFTER-TAX PROFITS	1338	1455	1376	1408	1426	1448	1465	1183	1408	1416	1479	1596
%ch	-19.9	39.8	-19.9	9.5	5.1	6.3	5.0	12.6	19.0	0.6	4.5	7.9
AFTER-TAX PROFITS ADJ(1)	1453	1454	1460	1475	1501	1519	1539	1089.6	1389.1	1472.6	1552.0	1668.5
%ch	15.0	0.4	1.5	4.4	7.1	4.9	5.3	16.0	27.5	6.0	5.4	7.5
PERSONAL INCOME	12578	12830	12962	13120	13308	13501	13695	11930	12374	13055	13811	14682
%ch	4.1	8.3	4.2	5.0	5.9	5.9	5.9	-4.3	3.7	5.5	5.8	6.3
REAL DISPOSABLE INCOME	10152	10170	10189	10269	10355	10437	10517	9883	10062	10246	10568	10916
%ch	1.5	0.7	0.7	3.2	3.4	3.2	3.1	-2.3	1.8	1.8	3.1	3.3
PRODUCTIVITY	1.123	1.128	1.133	1.138	1.143	1.148	1.153	1.074	1.115	1.136	1.155	1.179
%ch	2.9	1.8	1.8	1.8	1.8	1.8	1.8	3.7	3.9	1.8	1.8	2.0
CIVILIAN EMPLOYMENT	139.1	139.6	139.6	139.8	140.0	140.3	140.5	139.9	139.1	139.3	140.6	141.4
%ch	-0.4	1.5	0.0	0.5	0.8	0.7	0.6	-3.8	-0.6	0.2	0.9	0.6
UNEMPLOYMENT RATE	9.6	8.9	9.1	9.2	9.0	8.9	8.9	9.3	9.6	9.1	9.0	9.0
INDUSTRIAL PRODUCTION	91.7	92.8	93.0	93.0	94.2	95.4	96.4	85.5	90.1	91.3	97.2	103.3
%ch	3.1	4.9	0.9	0.0	5.3	5.0	4.3	-11.2	5.3	1.3	6.5	6.3
LIGHT VEHICLE SALES (2)	12.3	13.0	12.2	12.5	12.7	13.0	13.2	10.4	11.6	12.1	13.2	13.5
Domestic	6.0	6.6	6.0	6.3	6.5	6.7	6.8	5.5	5.8	6.0	6.9	7.0
Imports	6.4	6.5	6.1	6.2	6.3	6.3	6.4	4.9	5.8	6.1	6.4	6.5

(1) Profits adjusted for capital consumption and inventory adjustment. Second quarter 2011 are estimates.

(2) Millions at seasonally adjusted annual rates.

8/3/2011	Actual			Forecast				Years					
	2010	2011	2011	2011	2011	2012	2012	2009	2010	2011	2012	2013	
Monetary Aggregates quarterly:	IV	I	II	III	IV	I	II						
M2 %ch at annual rates	5.9	5.1	6.6	6.7	6.9	6.2	5.2	7.9	2.3	5.6	5.9	4.3	
Adj. Bank Reserves less excess reserves (billions of \$)	109	112	116	120	123			105	107				
Interest Rates:													
Baa Corp Bonds: Moody's	5.91	6.09	5.85	5.14	5.22	5.49	5.58	7.30	6.04	5.40	5.78	6.66	
Aaa Corp Bonds: Moody's	4.86	5.13	5.04	4.18	4.25	4.51	4.59	5.31	4.94	4.49	4.79	5.66	
MORTGAGE RATES	5.10	5.10	5.10	4.58	4.70	5.11	5.24	5.04	5.10	4.87	5.45	6.36	
10-YR GOVT SECURITIES	2.86	3.46	3.21	2.68	2.80	3.11	3.24	3.26	3.21	3.04	3.45	4.36	
5-YR GOVT SECURITIES	1.49	2.12	1.86	1.74	1.95	2.25	2.37	2.19	1.93	1.92	2.58	3.75	
2-YR GOVT SECURITIES	0.48	0.69	0.57	0.80	1.10	1.40	1.50	0.96	0.70	0.79	1.70	3.14	
3-MONTH T-BILL	0.14	0.13	0.05	0.34	0.34	0.44	0.54	0.16	0.13	0.22	0.74	2.18	
FEDERAL FUNDS RATE	0.19	0.16	0.09	0.10	0.10	0.20	0.30	0.16	0.18	0.11	0.50	1.94	
3-MONTH LIBOR RATE	0.29	0.31	0.26	0.45	0.45	0.55	0.65	0.69	0.34	0.37	0.85	2.29	
BOND EQUIVALENT RATES:													
FEDERAL FUNDS	0.19	0.16	0.09	0.10	0.10	0.20	0.30	0.16	0.18	0.11	0.50	1.96	
3-MONTH LIBOR	0.29	0.31	0.26	0.45	0.45	0.55	0.65	0.70	0.34	0.37	0.85	2.31	
3-MONTH T-BILL	0.14	0.14	0.05	0.35	0.35	0.45	0.55	0.16	0.14	0.22	0.75	2.22	
STOCKS:													
S&P 500	1204	1303	1319	1299	1318	1355	1395	947	1139	1310	1442	1722	
S&P 500 quarterly reported earnings	82.7	85.8	82.9	82.1	85.4	89.6	87.4	51.0	77.4	84.1	88.6	95.2	
S&P 500 p/e on reported earnings**	14.6	15.2	15.9	15.8	15.4	15.1	16.0	19.6	14.8	15.6	16.3	18.1	
S&P 500 quarterly operating earnings	87.7	90.2	96.0	98.7	98.6	102.3	109.2	56.9	83.8	95.9	109.1	113.3	
S&P 500 p/e on operating earnings**	13.7	14.4	13.7	13.2	13.4	13.2	12.8	16.7	13.6	13.7	13.2	15.2	
S&P 500 underlying earnings***	77.6	78.8	80.1	81.3	82.6	83.9	85.3	71.2	75.8	80.7	85.9	91.5	
S&P 500 p/e on underlying earnings	15.5	16.5	16.5	16.0	16.0	16.1	16.4	13.3	15.0	16.2	16.8	18.8	

*annualized.

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***reported earnings based on a 6.5% growth rate. Second quarter 2011 earnings are estimates.

****price earnings based on reported earnings trend (6.5% growth) for the current quarter

MN means the number is not meaningful