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September 6, 2011

## Monthly Economic and Financial Update

President Obama plans to speak before a joint session of Congress on Thursday to present his “new plan for jobs.” The President’s new program will be based on the same economic theory as his previous jobs programs.

Both the President and his advisors subscribe to Keynesian economic theory. This is the theory used by FDR in the 1930s. After massive increases in government spending, the unemployment rate in 1939 stayed above 17%.

Keynesian theory assumes government can increase demand by increasing government spending, lowering interest rates and boosting public confidence. Look for the President will pull all these misguided levers without hitting the jackpot.

The approach fails because government has to pay for either more spending and tax cuts by borrowing from a limited supply of credit. This means some who need that credit for vital economic purposes will find the credit isn’t available. In order for either government spending or tax cuts to help the economy they have to provide sufficient benefits to offset the damage government does from reducing available credit.

A jobs program would be more effective if government would cut wasteful government spending. This would enable the government to reduce its borrowing, and hence free up credit for the rest of the economy.

In what he will apparently claim is an innovative plan, the President is likely to propose the creation of a new “infrastructure bank” to finance major construction projects. As with all other government spending, the plan would involve redirecting credit from the private sector to government chosen projects. It would kill jobs rather than create them.

The President will also attempt to redefine himself as a tax cutter. He will reportedly

propose middle class tax cuts while claiming Republicans only want tax cuts for the rich.

One tax cut the President will propose isn’t a cut at all. Rather, it would keep the payroll tax where at current levels. Republicans should accept this proposal steadfastly insisting its spending that is too high, not taxes.

Temporary tax cuts, such as President Bush’s tax rebates are outright harmful. Instead of encouraging more production, they involve redirecting funds from credit markets to people’s pockets. Cutting off funds for productive businesses and turning them over to others does more harm than good.

The President is also likely to talk about his suspension of EPA rules. This is a positive move. It helps to avoid serious economic problems prior to the next election. The President has promised to reassess this positive decision once the election is over.

Bernanke will also speak this week. He is likely to announce some major new monetary action. Whatever action the Fed comes up with it will have to begin by compensating for the most recent monkey wrench the Administration through into the economy’s gears.

This past week the Administration announced it would sue the nation’s largest banks over sales of mortgages to Fannie and Freddie. If successful, the suit would remove an estimated \$40 billion of bank capital, supporting roughly \$400 billion of loans and deposits. Just the threat of these losses will remove liquidity from the system at a time when it may be badly needed.

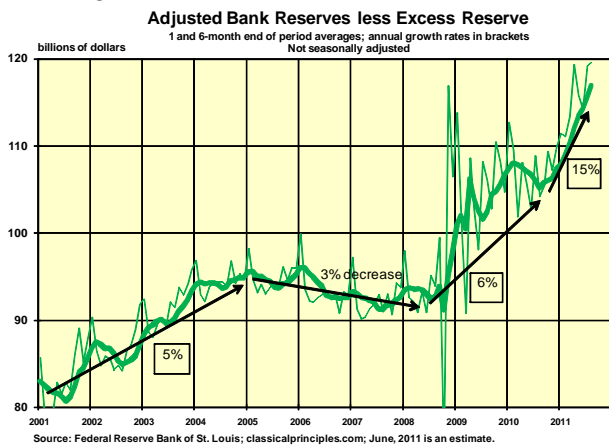
While the President and Fed Chairman will attempt to boost confidence, their misguided instincts continue to undermine efforts to restore the growth and stability to an economy badly in need of both.

## How Much 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 has rapidly increased bank reserves this year, even after allowing for bank reserves left with the Fed.



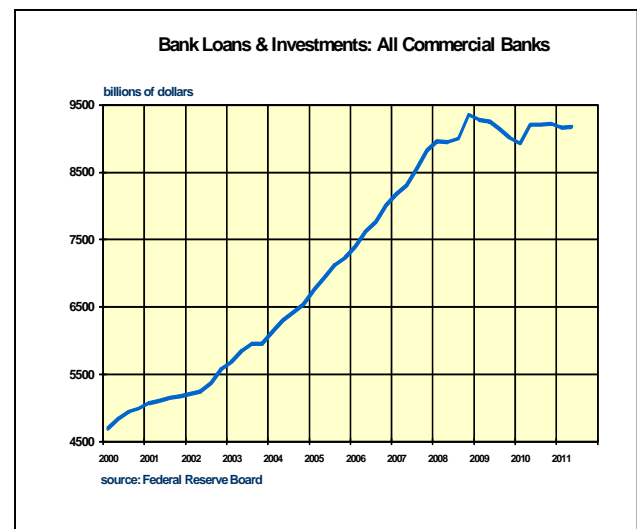
My friend Mike Moebis, an expert on the banking system, points out that overly aggressive regulators have required banks to increase their capital ratios. Banks have responded by reducing their assets. Maintaining capital while reducing assets produces higher capital to asset ratios, which pleases regulators.

However, banks and other financial intermediaries provide the transmission mechanism. They take the Fed's newly-created bank reserves and turn them into loans and deposits. This, in turn, serves to boost current dollar 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 tends to 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 are under stress, the transmission mechanism is also under stress.

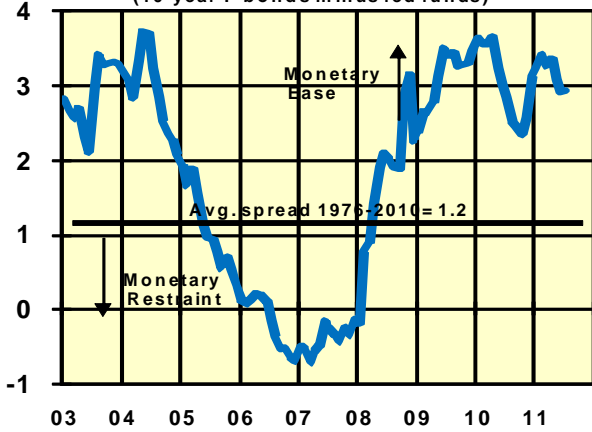


The lack of growth in bank loans and investments appears to be providing a drag on the economy's ability to transfer reserves into current dollar spending. This helps to explain how current dollar spending can increase at a much slower rate than the increase in bank reserves.

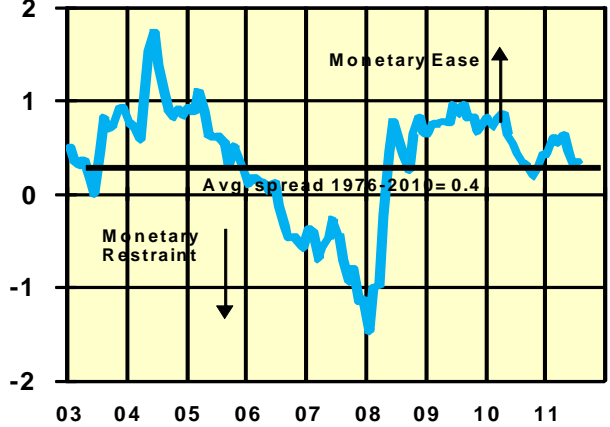
By suing major banks for tens of billions of dollars, the Administration does further damage to those banks. This also does further damage to the mechanism transferring reserves to spending. It is difficult to quantify the magnitude by which these damaging actions can impact spending. However, the moves do have the potential to continue to hold the growth in spending well below a pace based on bank reserves alone.

# MONETARY INDICATORS

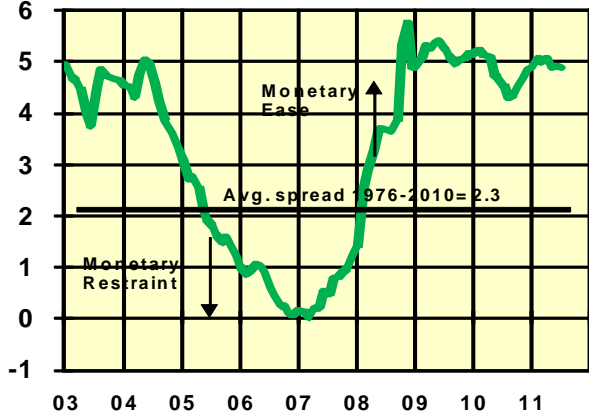
**Yield Spread: 10yr-FF**  
(10-year T-bonds minus fed funds)



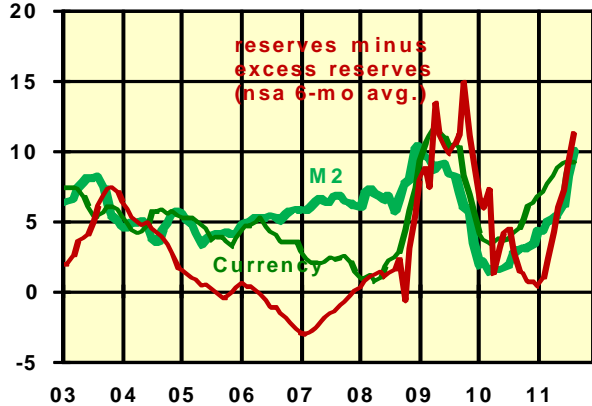
**Yield Spread: 2yr-FF**  
(2-year T-Notes minus fed funds)



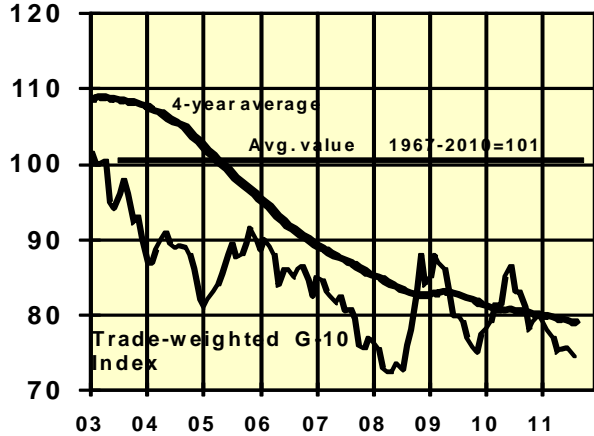
**Yield Spread: AAA-FF**  
(AAA bonds minus fed funds)



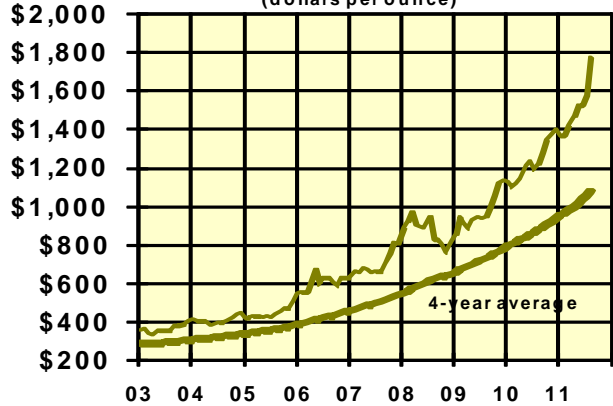
**High-Powered \$ & M2**  
(percent change year over year)



**U.S. Dollar Index**



**Gold Prices**  
(dollars per ounce)



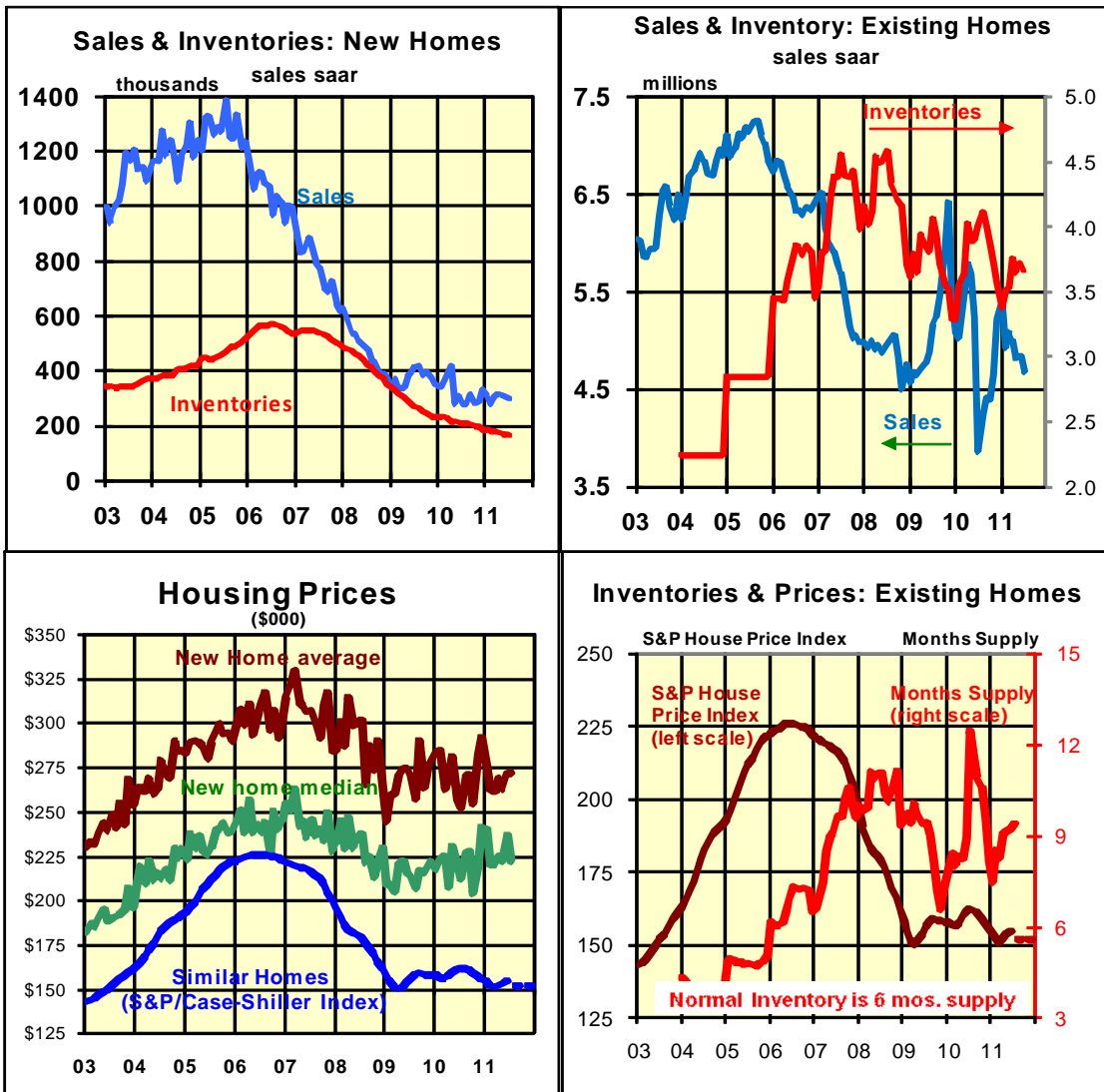
## Sensitive Indicators

With the exception of new orders for durable goods, sensitive indicators point to a slower pace of activity in the months ahead. The ISM new order components for early August indicate a continuation of relatively sluggish economic growth in the months immediately ahead.

Stock prices, new orders for semi-conductors, and raw materials prices all point to a slowdown in activity.

Housing activity remains hostage to a large amount of unsold homes. This will continue to create problems for this sector in the period ahead.

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



# SENSITIVE INDICATORS

### Raw Industrial Prices

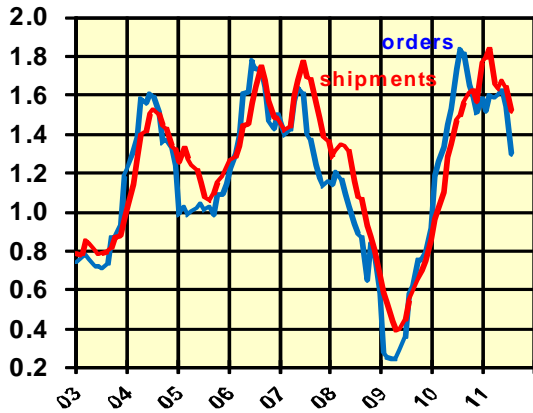


### Stock Prices

S&P 500

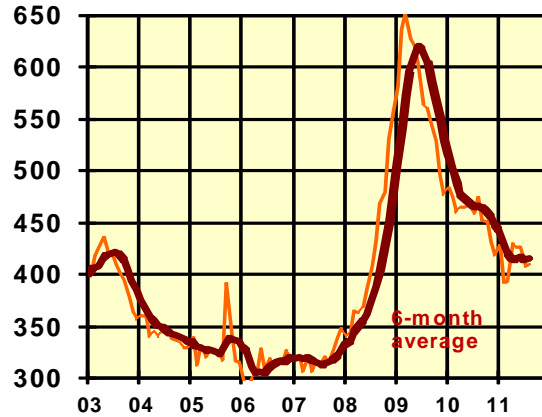


### Semiconductor: N. A. Orders and Shipments (billions of \$)



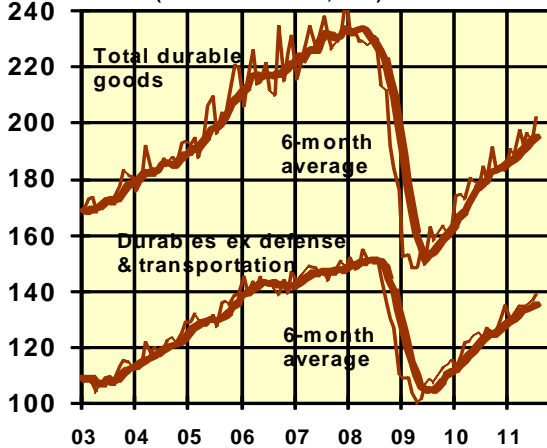
### Unemployment Claims

(weekly claims)



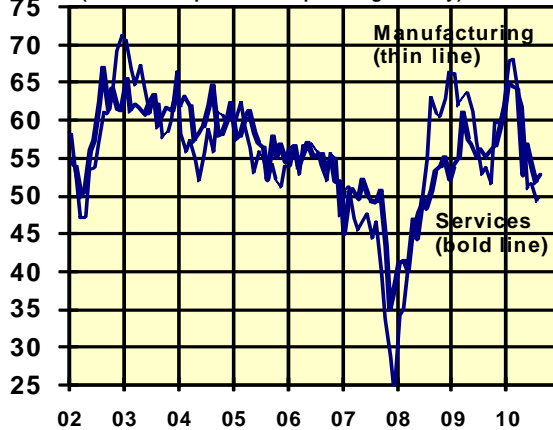
### New Orders

(billions of dollars, saar)



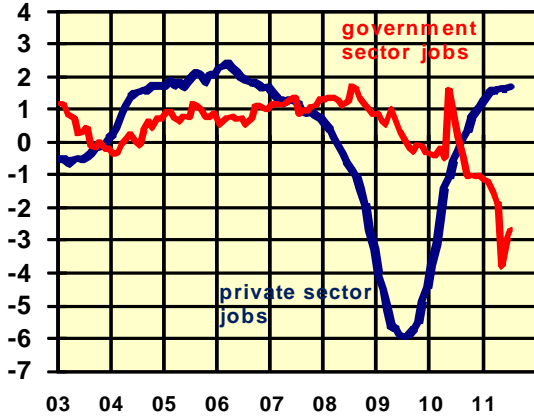
### ISM: New Orders

(above 50 represents expanding activity)

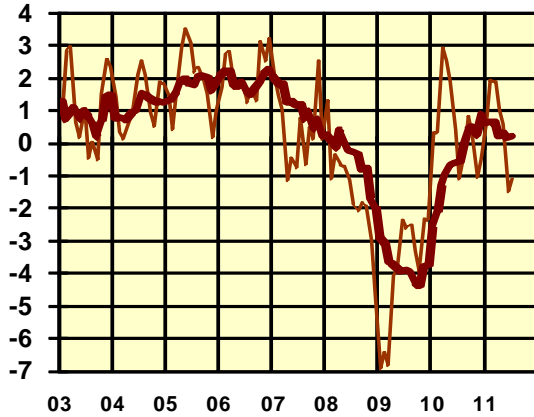


# ECONOMIC INDICATORS

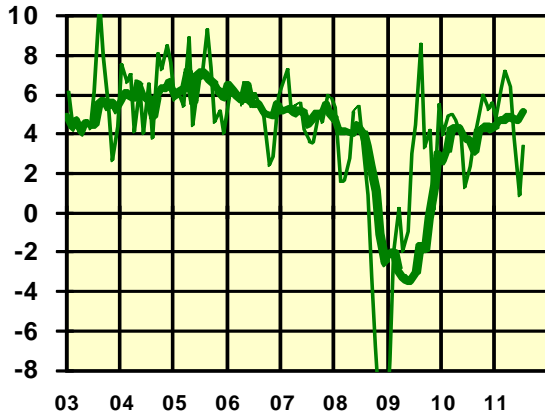
**Jobs: Payroll Data**  
(year over year percent change)



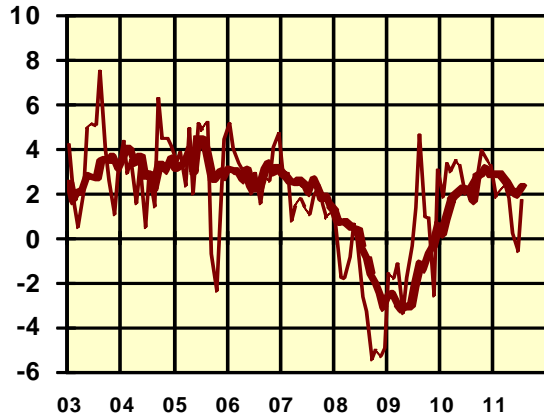
**Jobs: Household Data**  
(annual rates of change--3 months & 1 year)



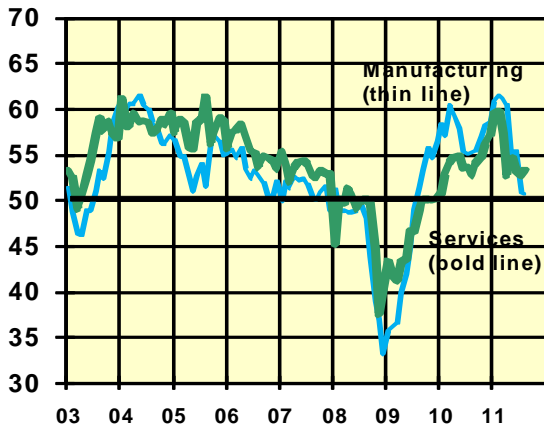
**Consumer Spending**  
(annual rates of change-- 3 months & 1 year)



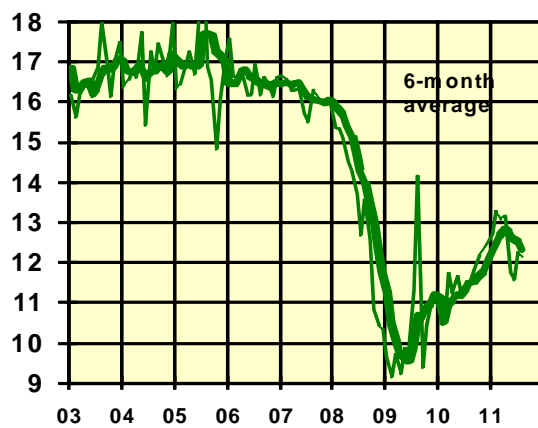
**Real Consumer Spending**  
(annual rates of change-- 3 months & 1 year)



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



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



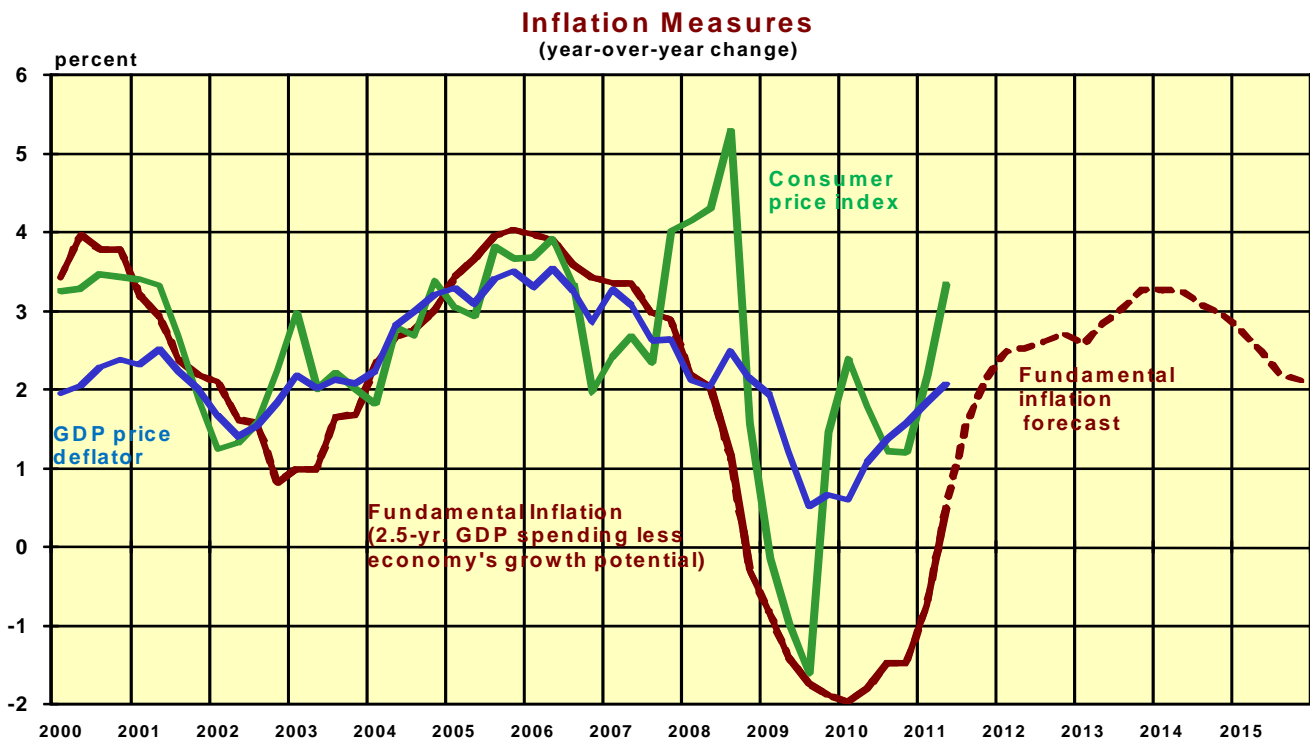
## Inflation Indicators

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, including oil, have declined.

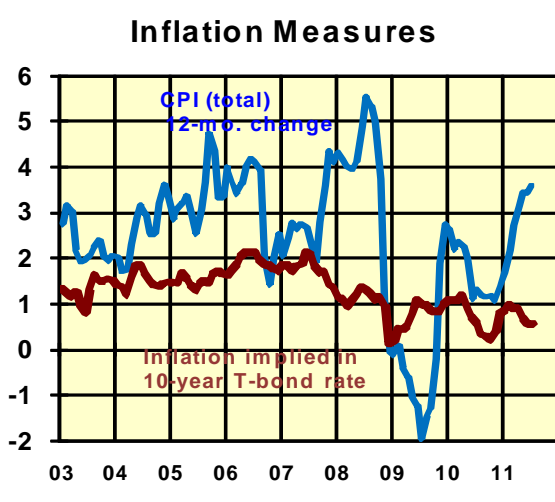
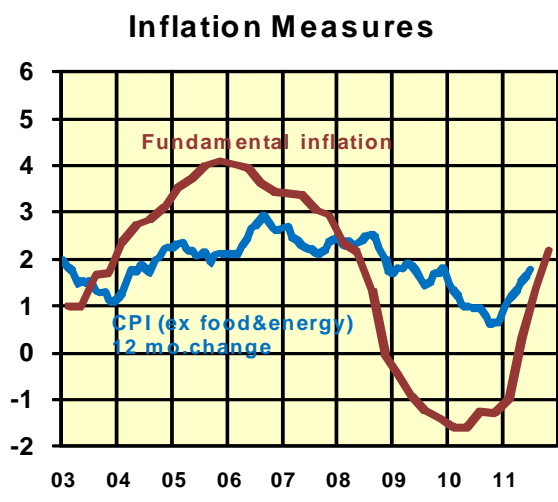
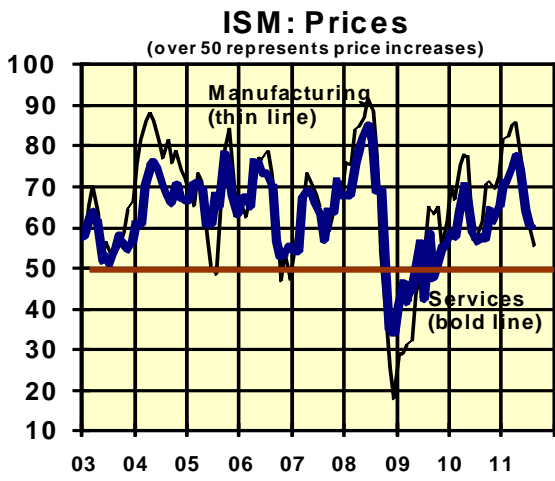
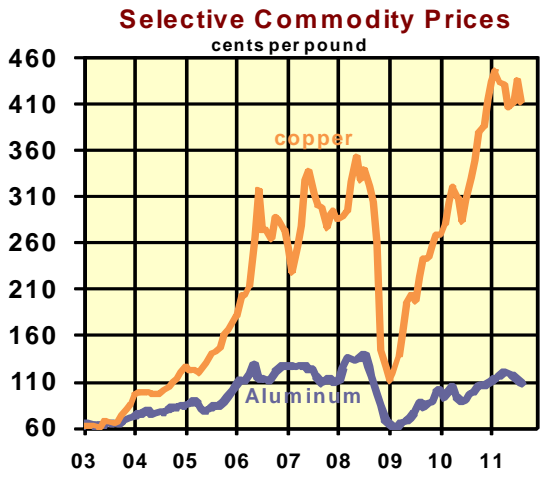
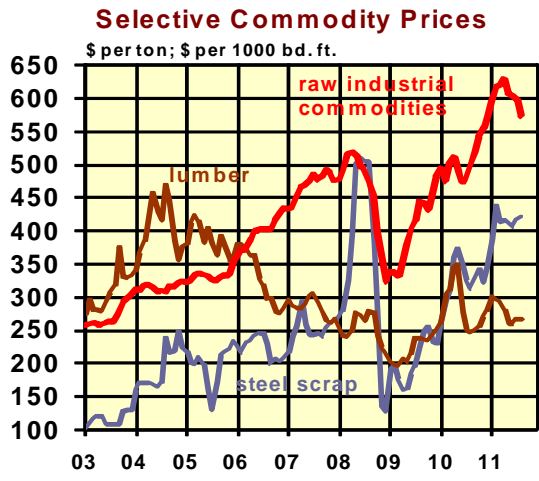
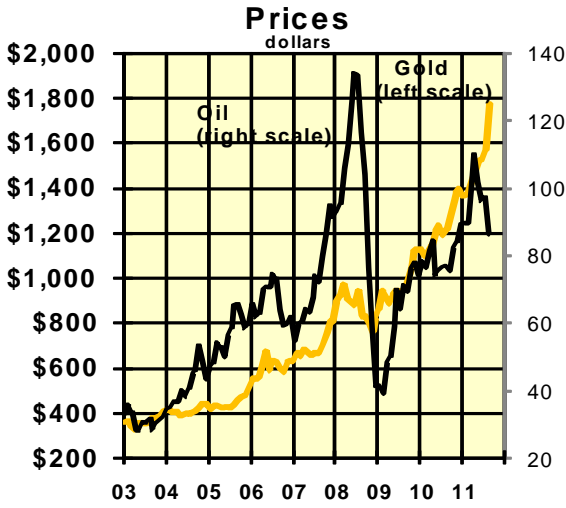
With mixed signals on inflation it's always helpful to reassess the economy's underlying inflation rate. This is rate inflation tends to gravitate toward over time. It's determined by the 2-3 year average change in current dollar spending (GDP), minus the economy's potential growth. The economy's underlying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

The Federal Reserve bases its monetary policy on Keynesian economic theory. Instead of concentrating on the amount of money or liquidity in the economy, its focus is on interest rates and promoting confidence.

The Fed's announced intention to keep interest rates low for at least the next two years reflects its Keynesian approach. The announcement does nothing to change monetary policy since no one expected any change in rates for at least the next six months. Hence, the purpose of the announcement was an attempt to boost confidence by attempting to reassure people interest rates would not increase.

Keynesian theory views confidence as an independent force that can alter economic conditions. The alternative classical position views confidence as a consequence rather than a cause of economic conditions.

Attempting to manipulate confidence has often led policymakers to misjudge the reasons for a weak economy. Policymakers should focus on identifying and correcting the fundamental cause of weak economic conditions. Once the causes are identified and addressed, jobs and wages will improve thereby restoring confidence.

When government policies place tax and regulatory barriers in the way of increasing output, it undermines economic growth. Suing banks and seeking to remove \$40 billion from bank capital, represents another potential job killer that interestingly appears on the eve of a new plan that promises to create jobs.

Given their Keynesian backgrounds, it's more likely policymakers will continue to fiddle with all

types of new policies. With respect to the Fed, they might decide to stop paying banks interest on reserves left with the Fed. Had the Fed done so three years ago, it could have restored liquidity without increasing the size of its portfolio by 10-20 times.

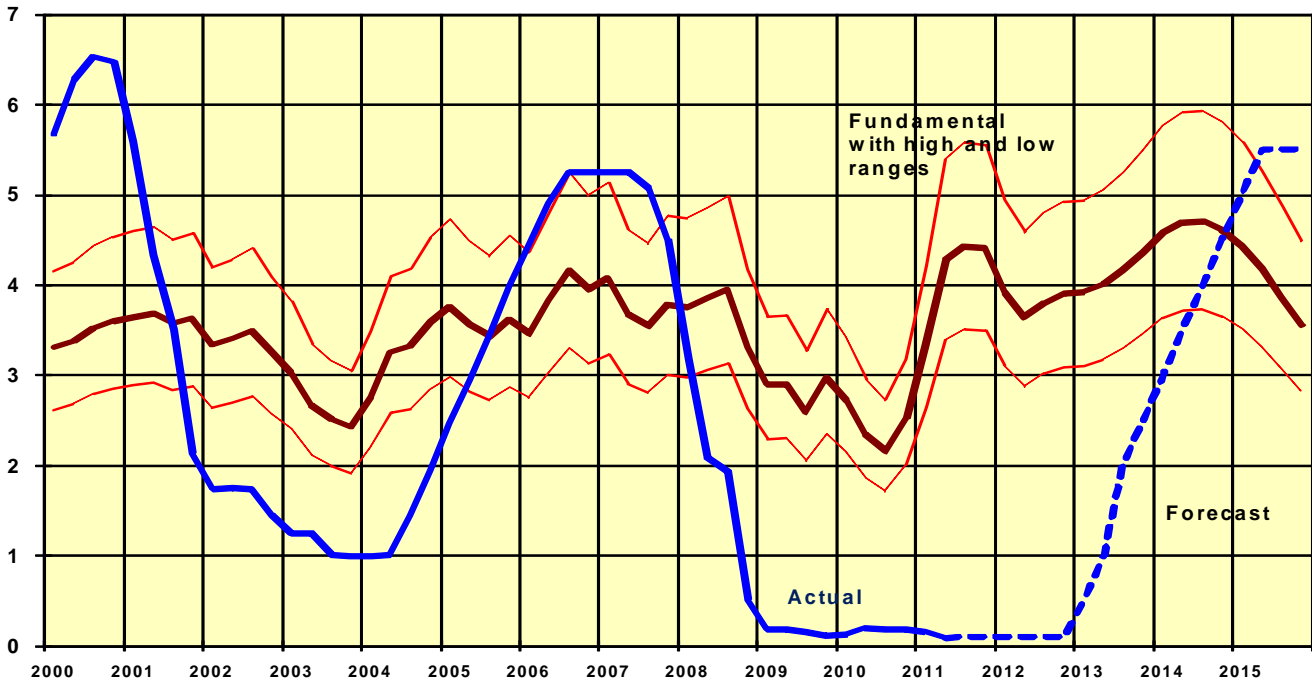
At this point, with more than \$1.6 trillion dollars of excess bank reserves held at the Fed, attempts to get banks to put those reserves into loans and deposits could lead to either an explosive increase in liquidity, or too little liquidity. The latter would occur if the Fed were to offset the reduction in excess reserves by selling off its portfolio too rapidly. Given the Fed's difficulty in producing a stable amount of liquidity over the past three years, the odds are fairly high the Fed will have difficulty reversing its convoluted process for managing the money supply.

The Fed's task is made even more difficult due to both its insistence on raising bank capital requirements and the Administration's latest suit against the largest banks. Forcing banks to shrink their balance sheets (so bank capital is a larger portion of assets) or suing banks to directly eliminate their capital are both moves that reduce liquidity, the availability of credit and, hence, the pace of spending.

**While forecasting the future pace of spending is never easy, the multitude of distortions to the financial system by both the Administration and the Fed has made it more difficult than ever to have a high degree of confidence in the future pace of spending.**

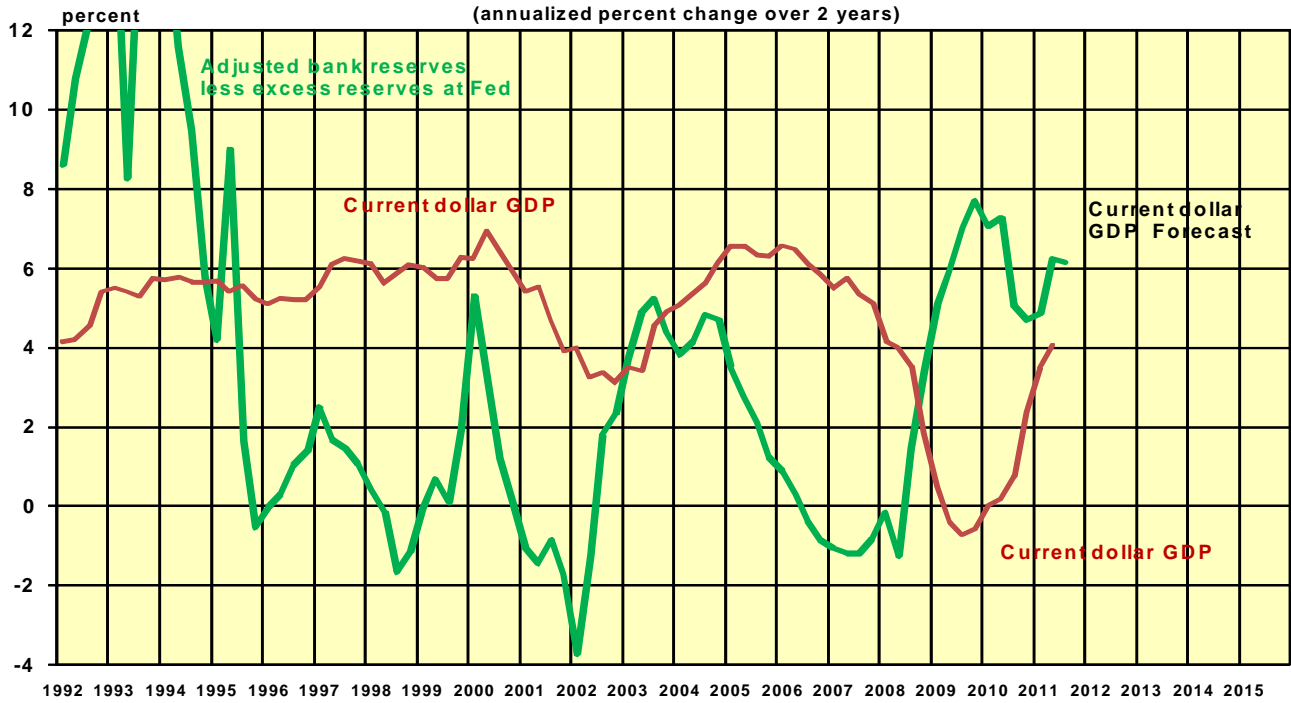
### Fed Funds Interest Rate

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

With the Fed indicating its intent to hold short-term interest rates low until at least the spring of 2013, the risks of a near-term increase in long-term interest rates have declined.

Also, the possibility of a liquidity squeeze associated with actions from both the Fed and the Administration, raise the potential for an extended period of weak spending and lower interest rates.

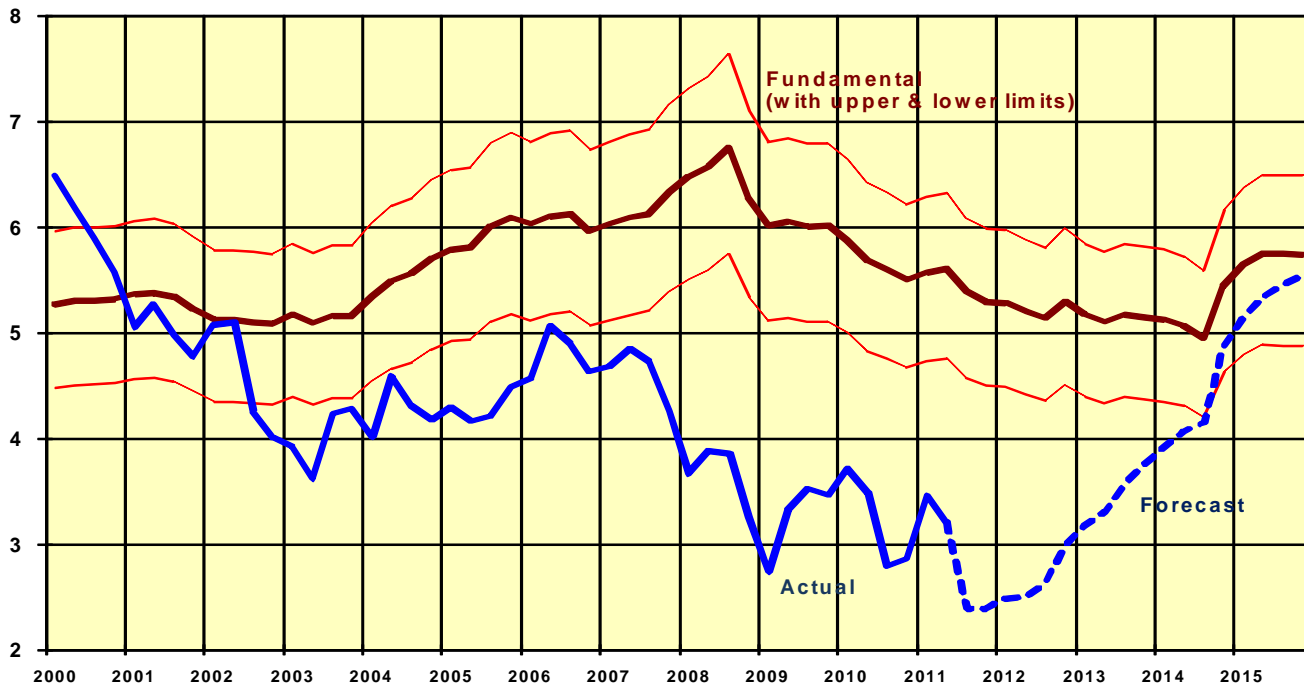
In contrast, a move by the Fed to stop paying banks interest on reserves opens up the possibility of an explosive increase in liquidity. This would occur if banks were to draw down their deposits with the Fed and the Fed failed to

reduce their holdings of securities to offset the flood of reserves into the banking system.

The ongoing hyperactivity on the part of both the Fed and the Administration create the potential for sharp changes in economic conditions in either direction.

The chart below, as the rest of the forecast, is merely suggestive a wide range of possibilities stemming from confused policymakers. In spite of potential for dramatic changes in either direction, **with long-term interest rates near historically low levels, there is a greater potential that rates will go up than down.**

**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

Erratic changes in stock prices reflect the confusion associated with erratic policy moves. One day EPA rules are causing utilities to close their plants; the next day they have a temporary reprieve. One day the Fed defines interest rate stability as lasting six months, the next day the policy is extended to two years. When the President and Fed Chairman speak this week, they will likely reveal a new set of policies.

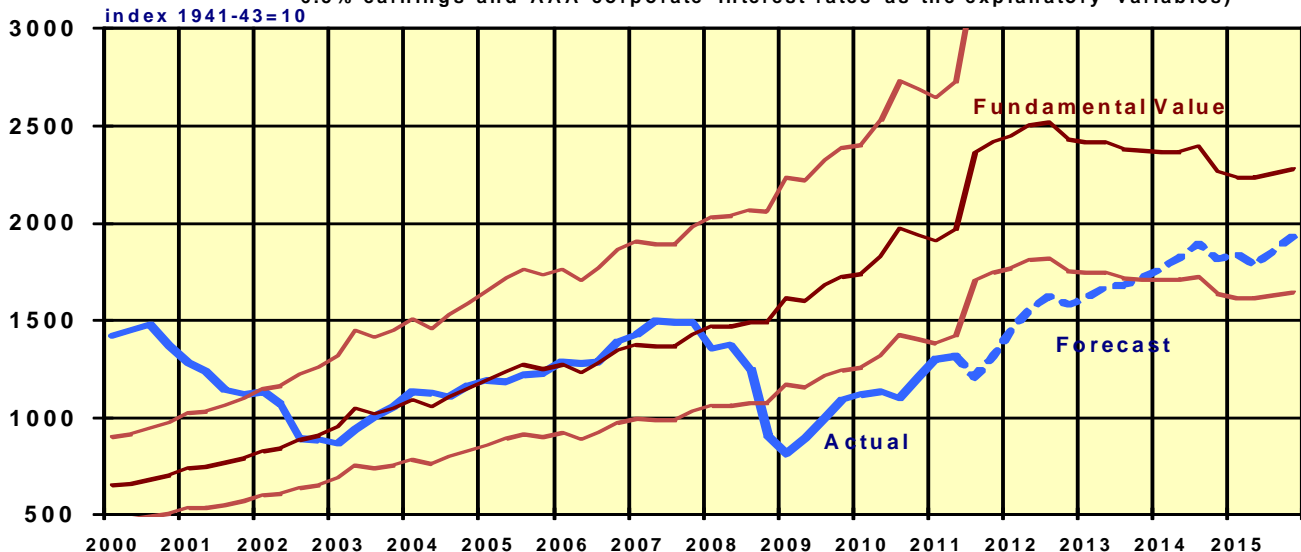
Companies have responded to erratic policy changes by cutting costs and boosting profits. **Profits are at a record share of the economy and the earnings yield on the S&P 500 is now roughly 8%. This is almost twice the rate on AAA bonds. Stocks are currently selling for roughly half their fundamental value. It won't take much in the way of a positive change to send stock prices sharply higher.**

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)



9/6/2011	<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	14997	15180	15343	15551	15756	13939	14527	15097	15890	16912
%ch	4.2	3.1	3.5	5.0	4.4	5.5	5.4	-2.5	4.2	3.9	5.3	6.4
REAL GDP	13216	13228	13261	13356	13431	13538	13641	12703	13088	13319	13720	14277
%ch	2.3	0.4	1.0	2.9	2.3	3.2	3.1	-3.5	3.0	1.8	3.0	4.1
CHAIN PRICE INDEX	1.117	1.124	1.131	1.136	1.142	1.149	1.155	1.097	1.110	1.133	1.159	1.186
%ch	1.9	2.5	2.4	2.1	2.1	2.3	2.3	1.1	1.2	2.1	2.2	2.4
CPI- ALL URBAN%ch	2.6	5.2	4.1	2.3	1.9	2.1	2.3	-0.3	1.6	3.1	2.3	2.7
FUND. INFLATION%ch	-1.5	-0.7	0.5	1.6	2.1	2.5	2.5	-0.3	-1.8	-0.8	2.1	2.5
PRETAX PROFITS	1743	1877	1886	1850	1866	1899	1925	1455.7	1819.5	1869.7	1938.7	2091.4
%ch	-20.4	34.7	1.9	-7.4	3.5	7.3	5.7	7.0	25.0	2.8	3.7	7.9
PRETAX PROFITS ADJ (1)	1857	1876	1934	1918	1941	1970	1999	1362.0	1800.1	1917.3	2011.3	2164.2
%ch	5.4	4.2	12.8	-3.3	5.1	6.1	5.9	9.1	32.2	6.5	4.9	7.6
AFTER-TAX PROFITS	1338	1455	1467	1421	1437	1462	1484	1183	1408	1445	1494	1612
%ch	-19.9	39.8	3.3	-11.8	4.6	7.2	6.1	12.6	19.0	2.6	3.4	8.0
AFTER-TAX PROFITS ADJ(1)	1453	1454	1514	1489	1513	1534	1558	1089.6	1389.1	1492.5	1566.2	1685.2
%ch	15.0	0.4	17.6	-6.6	6.6	5.7	6.4	16.0	27.5	7.4	4.9	7.6
PERSONAL INCOME	12578	12847	12995	13154	13295	13475	13653	11930	12374	13073	13769	14654
%ch	4.1	8.8	4.7	5.0	4.4	5.5	5.4	-4.3	3.7	5.6	5.3	6.4
REAL DISPOSABLE INCOME	10152	10183	10208	10251	10300	10388	10467	9883	10062	10236	10521	10909
%ch	1.5	1.2	1.0	1.7	2.0	3.4	3.1	-2.3	1.8	1.7	2.8	3.7
PRODUCTIVITY	1.107	1.105	1.103	1.108	1.113	1.118	1.122	1.055	1.098	1.107	1.125	1.148
%ch	2.2	-0.6	-0.7	1.8	1.8	1.8	1.8	2.3	4.1	0.8	1.6	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	93.6	94.6	95.5	85.5	90.1	91.3	96.4	103.2
%ch	3.1	4.9	1.0	5.9	2.5	4.6	3.8	-11.2	5.3	1.3	5.6	7.1
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.

(2) Millions at seasonally adjusted annual rates.

9/6/2011	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	4.4
Adj. Bank Reserves less excess reserves (billions of \$)	109	112	116	119	123			105	107			
Interest Rates:												
Baa Corp Bonds: Moody's	5.91	6.09	5.85	5.40	5.30	5.22	5.09	7.30	6.04	5.52	5.15	5.73
Aaa Corp Bonds: Moody's	4.86	5.13	5.04	4.30	4.20	4.17	4.09	5.31	4.94	4.51	4.14	4.73
MORTGAGE RATES	5.10	5.10	5.10	4.30	4.30	4.47	4.49	5.04	5.10	4.70	4.64	5.43
10-YR GOVT SECURITIES	2.86	3.46	3.21	2.40	2.40	2.47	2.49	3.26	3.21	2.87	2.64	3.43
5-YR GOVT SECURITIES	1.49	2.12	1.86	1.13	1.10	1.14	1.19	2.19	1.93	1.55	1.38	2.71
2-YR GOVT SECURITIES	0.48	0.69	0.57	0.25	0.20	0.20	0.30	0.96	0.70	0.43	0.38	2.00
3-MONTH T-BILL	0.14	0.13	0.05	0.34	0.34	0.34	0.34	0.16	0.13	0.22	0.34	1.74
FEDERAL FUNDS RATE	0.19	0.16	0.09	0.10	0.10	0.10	0.10	0.16	0.18	0.11	0.10	1.50
3-MONTH LIBOR RATE	0.29	0.31	0.26	0.45	0.45	0.45	0.45	0.69	0.34	0.37	0.45	1.85
BOND EQUIVALENT RATES:												
FEDERAL FUNDS	0.19	0.16	0.09	0.10	0.10	0.10	0.10	0.16	0.18	0.11	0.10	1.51
3-MONTH LIBOR	0.29	0.31	0.26	0.45	0.45	0.45	0.45	0.70	0.34	0.37	0.45	1.87
3-MONTH T-BILL	0.14	0.14	0.05	0.35	0.35	0.35	0.35	0.16	0.14	0.22	0.35	1.77
STOCKS:												
S&P 500	1204	1303	1319	1060	1186	1338	1463	947	1139	1217	1493	1676
S&P 500 quarterly reported earnings	82.7	85.8	89.1	82.9	86.1	90.5	91.7	51.0	77.4	86.0	90.2	97.0
S&P 500 p/e on reported earnings**	14.6	15.2	14.8	12.8	13.8	14.8	16.0	19.6	14.8	14.1	16.6	17.3
S&P 500 quarterly operating earnings	87.7	90.2	99.4	99.5	99.3	103.2	110.2	56.9	83.8	97.1	109.9	114.3
S&P 500 p/e on operating earnings**	13.7	14.4	13.3	10.7	11.9	13.0	13.3	16.7	13.6	12.5	13.6	14.7
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	13.0	14.4	15.9	17.2	13.3	15.0	15.1	17.4	18.3

\*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