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December 6, 2011

## Monthly Economic and Financial Update

### Gingrich's New Contract—Great News!

Gingrich's 21<sup>st</sup> Century Contract with American represents a detailed framework of plans for transforming the US economy. If adopted, there would be a greater shift in US economic policies in the direction of classical principles than at any time in modern history.

For starters, the Contract proposes to eliminate the tax on capital gains, reduce the individual tax rate to an optional maximum of 15%, lower the corporate tax rate to 12.5% and eliminate the death tax.

In terms of regulations the Contract pledges to repeal Obamacare, Dodd-Frank and Sarbanes-Oxley, while replacing the EPA with an Environmental Solutions Agency.

With respect to Social Security, Medicare and Medicaid, Newt's Contract describes solutions that provide individuals with the freedom to choose market-oriented health and retirement plans designed to dramatically increase savings and wealth.

In terms of the Fed, the Contract proposes to make price stability the sole objective of Fed policy.

Gingrich's Contract provides the basis for a resurgence of growth and prosperity. It is the precise formula needed for ushering in an extended period of rapid growth and prosperity. I urge everyone to read both the Contract's legislative proposals and the discussion of entitlement reforms <http://bit.ly/o8bdA3>.

If Gingrich were to be elected President and have the support of Congress, his program would ignite the most explosive rally imaginable, first in the stock market and then in the economy.

### Monetary Stimulus to Boost Spending

European leaders continue to struggle with how to both solve their debt issues and stimulate growth. The Obama Administration is struggling with the same issues. Neither has found the solution.

Both EU leaders and the Obama Administration reject classical principles. They base their solutions on Keynesian principles. Keynesians believe growth is associated more with government action than with the interplay of individuals responding to market forces.

As frustration with the pace of the recovery increases, both European and the US leaders will lean on their respective central banks to create more money to artificially boost spending.

The head of Europe's central bank (ECB) indicated that the bank would step up its efforts (i.e. buy more debt) if euro-area governments were to adopt a closer fiscal union. This suggests the formula for resolving Europe's debt crisis will involve a combination of cuts in government spending, increases in tax rates and bank capital ratios and the creation of more Euros.

A similar situation is at work in the US. This year the Fed has already provided a substantial increase in the raw ingredients of money. In spite of numerous regulatory burdens undermining growth, at least some of the recent increase in money should work its way into spending this coming year.

While the economic news is mixed, I have increased my forecast for the pace of spending to 6% in the year ahead. Given a substantial amount of unemployed resources, real growth should increase to 3%-4%.

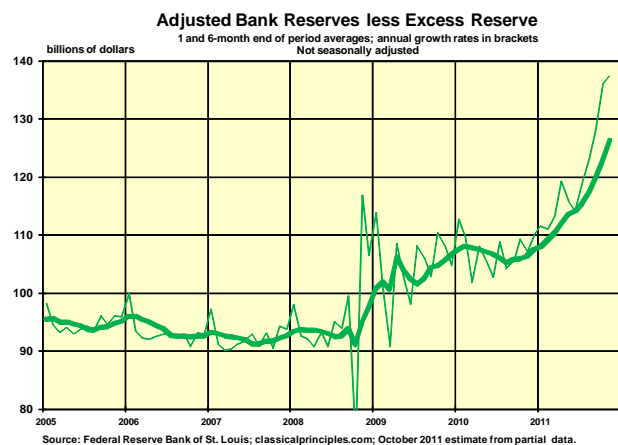
## Monetary Indicators

Bank reserves represent the first step in the monetary process. They are completely under the control of the Federal Reserve and provide the main impetus for increasing the money supply.

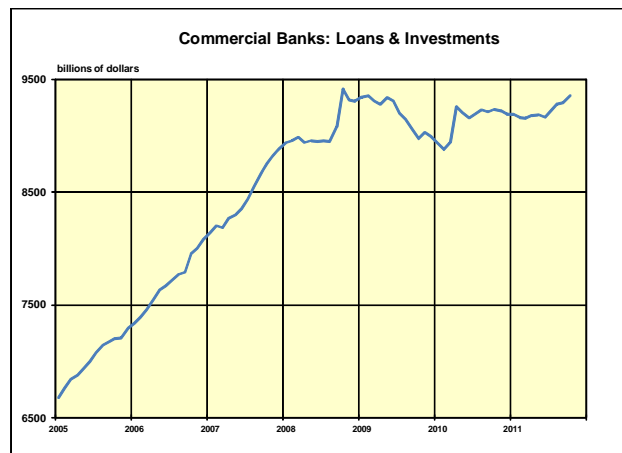
Under normal conditions, an increase in bank reserves will work its way through the banking system and produce an increase in the money supply. The increase in money will then work its way through the economy producing an increase in spending.

Institutional changes, such as unusual leveraging or deleveraging in the banking system can affect the relationship between the Fed's creation of reserves and the money supply. In recent years, as banks deleverage by limiting loans and investments, bank reserves have grown much faster than either the money supply or spending.

The chart below shows how the Fed has aggressively increased bank reserves this year, and particularly during the past 6 months.



In spite of this increase, loans and investments at all commercial banks have grown by only about 2% this year. The disparity indicates the transmission mechanism from reserves to money has been short-circuited.



Monetary policy doesn't occur in a vacuum. If the Fed is aggressively increasing liquidity and if the increase will boost spending, it should impact sensitive indicators in a predictable pattern. At this point, the indicators are mixed.

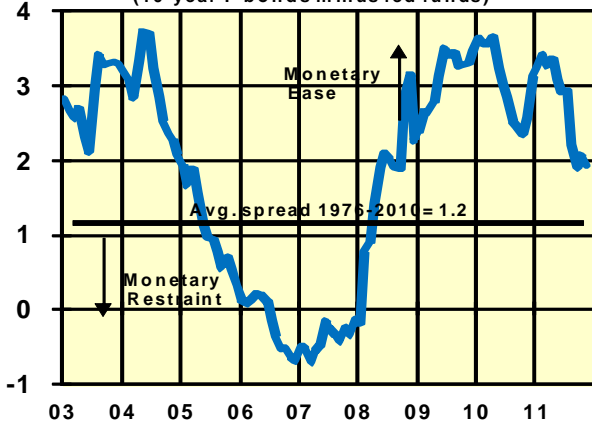
The spread between short and long-term interest rates usually increases when the Fed creates more money. This year, yield spreads have actually declined. Alternative money measures (currency and M2) have increased, but at a much slower pace than the increase in reserves. Mixed signals extend to sensitive indicators where raw material prices are down and stock prices unchanged.

The mixed monetary signals suggest the current period is unique. Significant increases in regulatory burdens represent a major institutional change that has disrupted the normal monetary transmission mechanism.

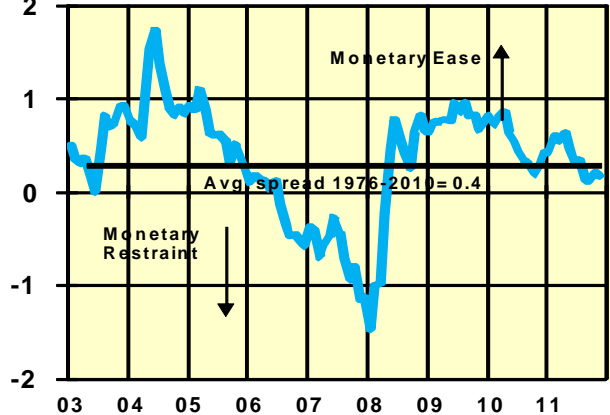
Current changes in institutional factors make it difficult to trace the impact of changes in reserves on the future pace of spending. Even so, the magnitude of the increase in these reserves has become so large that it has raised the odds of an increase in the pace of spending in the year ahead.

# MONETARY INDICATORS

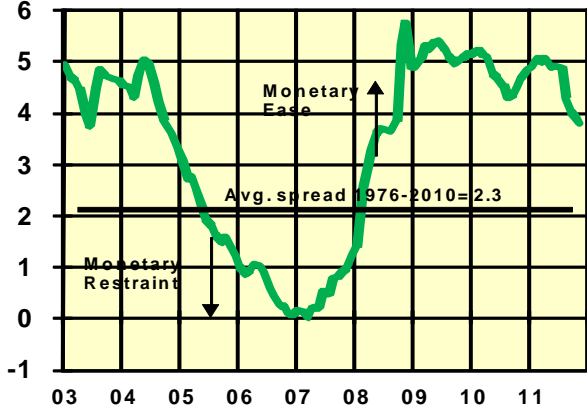
**Yield Spread: 10yr-FF**  
(10-year T-bonds minus fed funds)



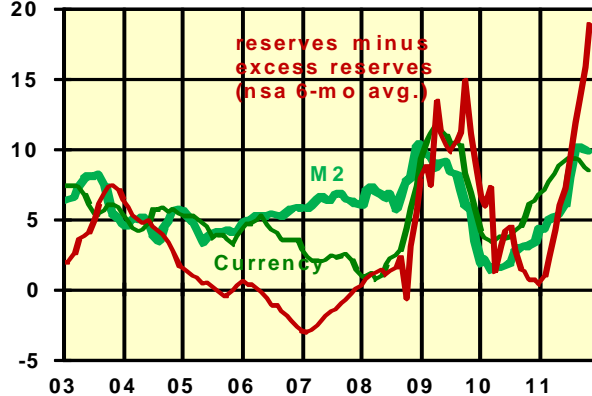
**Yield Spread: 2yr-FF**  
(2-year T-Notes minus fed funds)



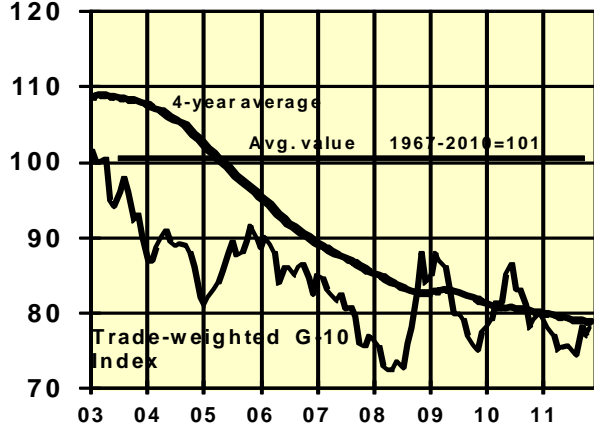
**Yield Spread: AAA-FF**  
(AAA bonds minus fed funds)



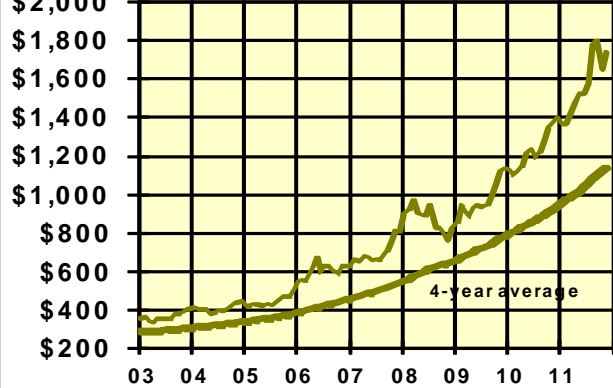
**High-Powered \$ & M2**  
(percent change year over year)



**U.S. Dollar Index**



**Gold Prices**  
(dollars per ounce)



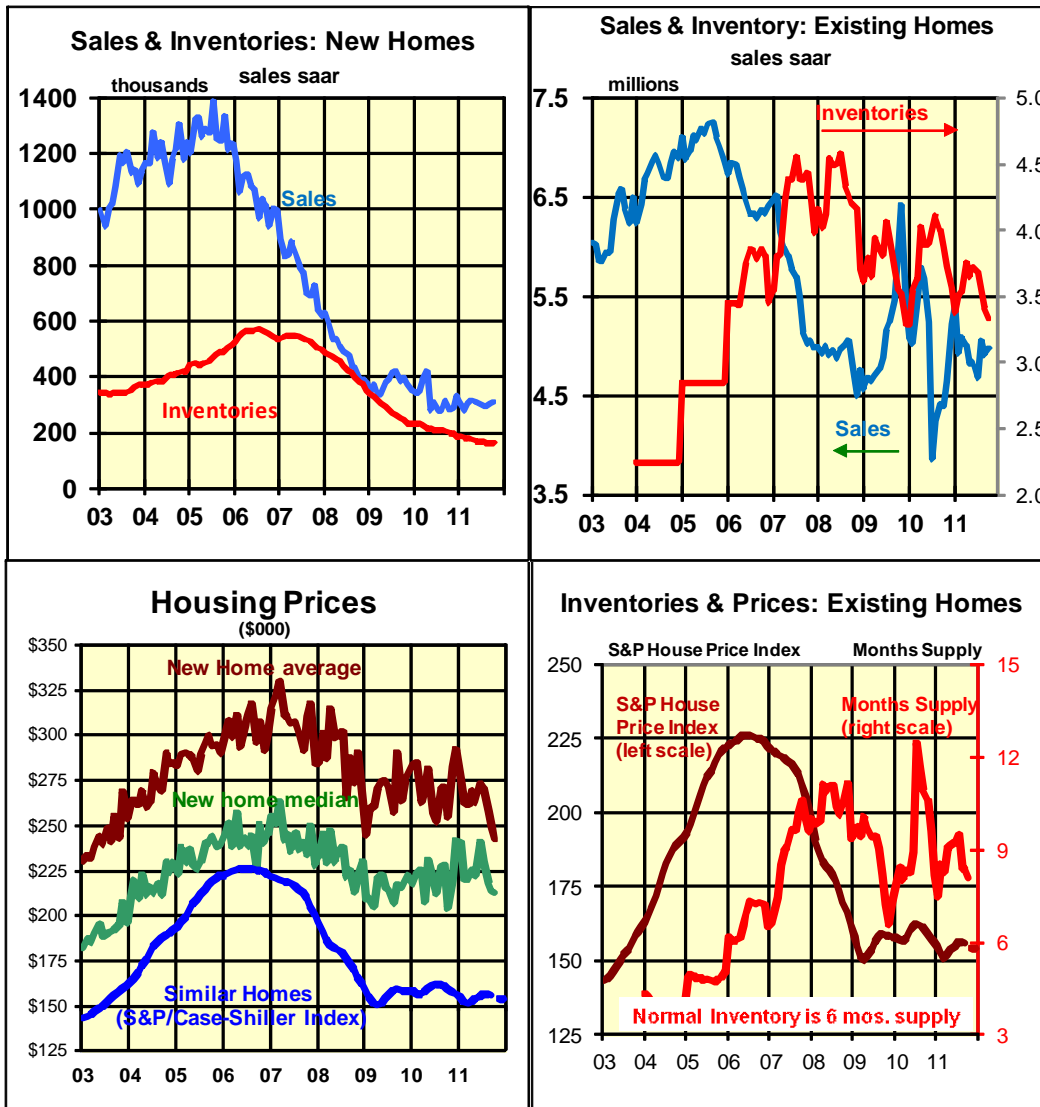
## Sensitive Indicators

So far, there is little evidence sensitive indicators are responding to the sharp increase in bank reserves. While new orders for durable goods are strong, ISM surveys are mixed. The new order components in early November were positive, but other components such as order backlogs are negative.

Stock prices remain erratic and have yet to respond as they normally would to a sharp increase in liquidity. Other sensitive indicators

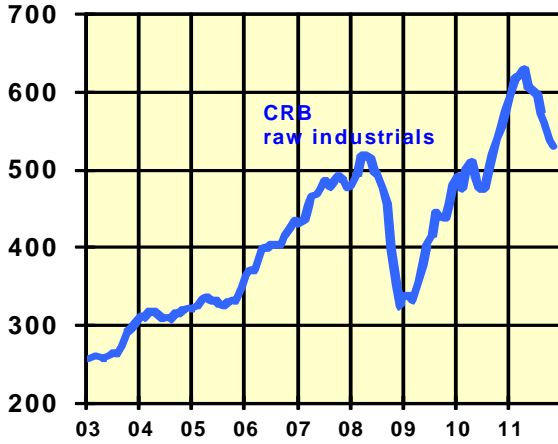
such as commodity prices and new orders for semiconductors have recently moved sharply lower.

So far, in terms of sensitive indicators, the evidence regarding an increase in monetary stimulus remains mixed. Even so, the magnitude of recent increases in bank reserves has been so great that it should help to sustain a stronger pace of spending.



# SENSITIVE INDICATORS

### Raw Industrial Prices

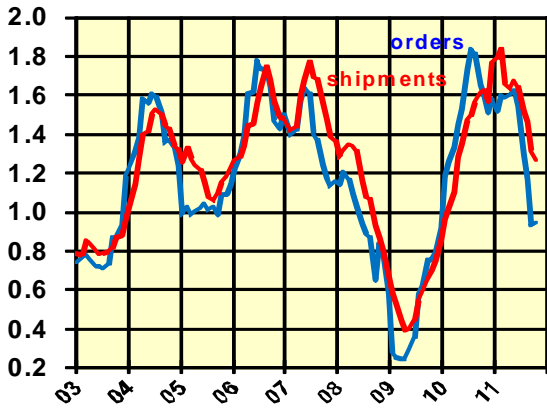


### Stock Prices

S&P 500

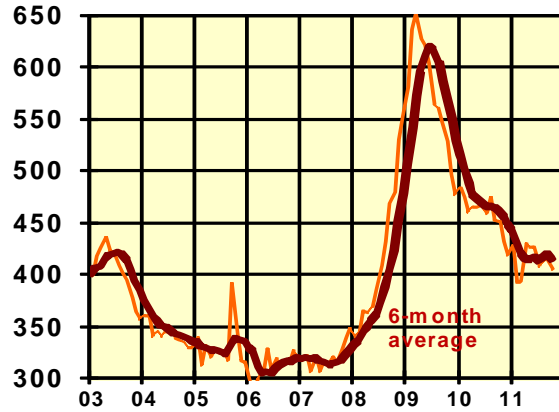


### Semiconductor: N. A. Orders and Shipments (billions of \$)



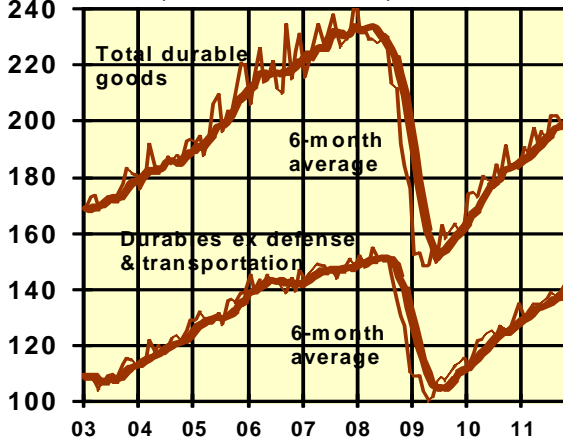
### Unemployment Claims

(weekly claims)



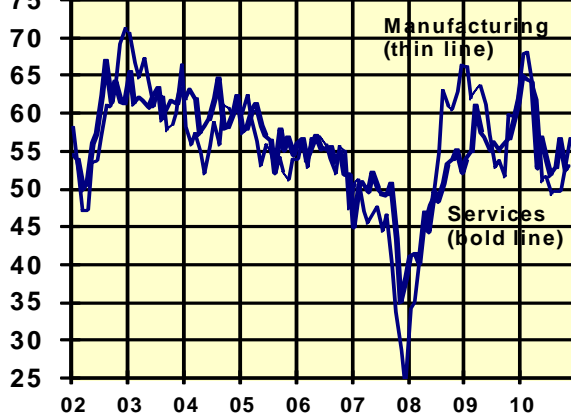
### New Orders

(billions of dollars, saar)



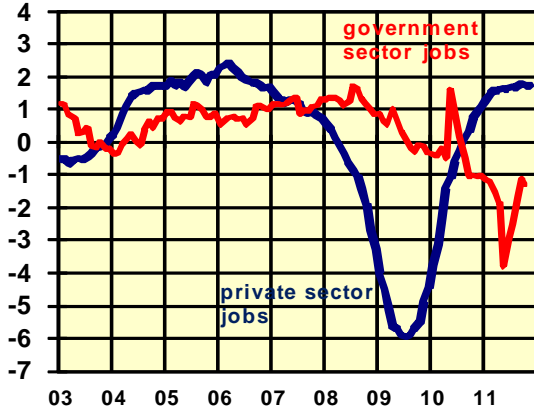
### ISM: New Orders

(above 50 represents expanding activity)

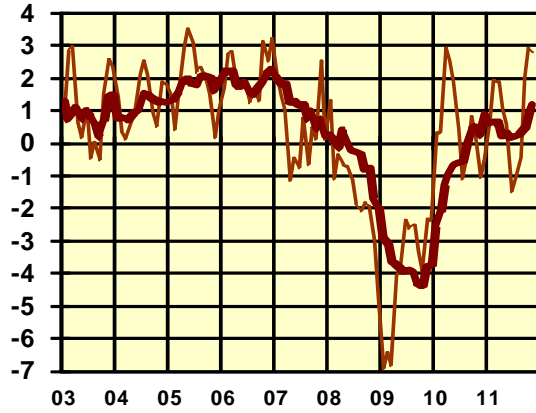


# ECONOMIC INDICATORS

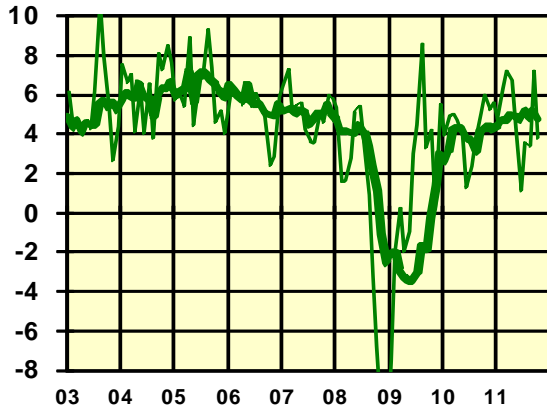
**Jobs: Payroll Data**  
(year over year percent change)



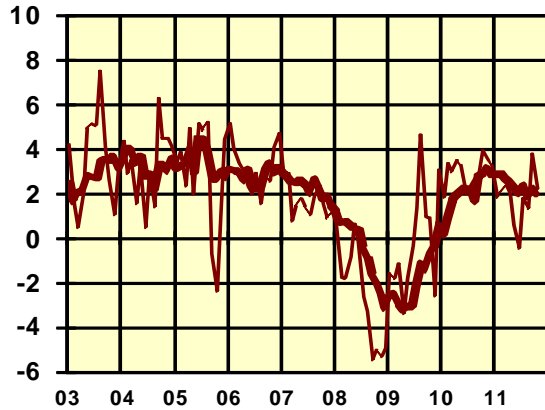
**Jobs: Household Data**  
(annual rates of change--3 months & 1 year)



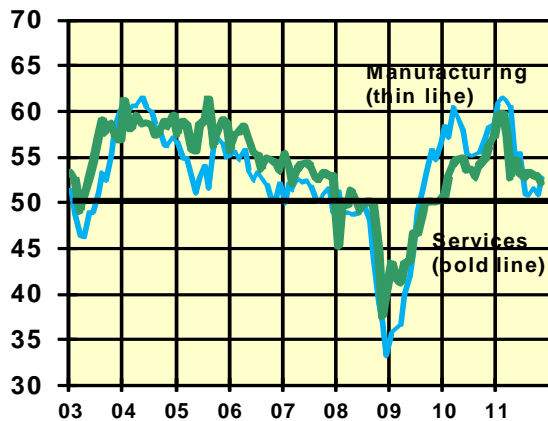
**Consumer Spending**  
(annual rates of change-- 3 months & 1 year)



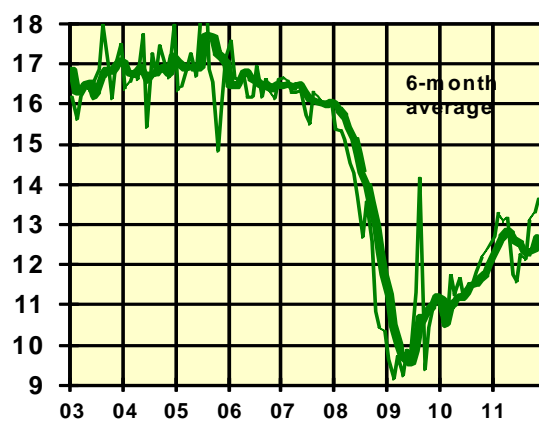
**Real Consumer Spending**  
(annual rates of change-- 3 months & 1 year)



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



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



## Inflation Indicators

A sharp increase in commodity prices earlier in the year sent most year-over-year inflation numbers sharply higher. Since then, most commodity prices have fallen and show essentially no increase over the past year. The underlying rate of inflation is not determined by commodity prices.

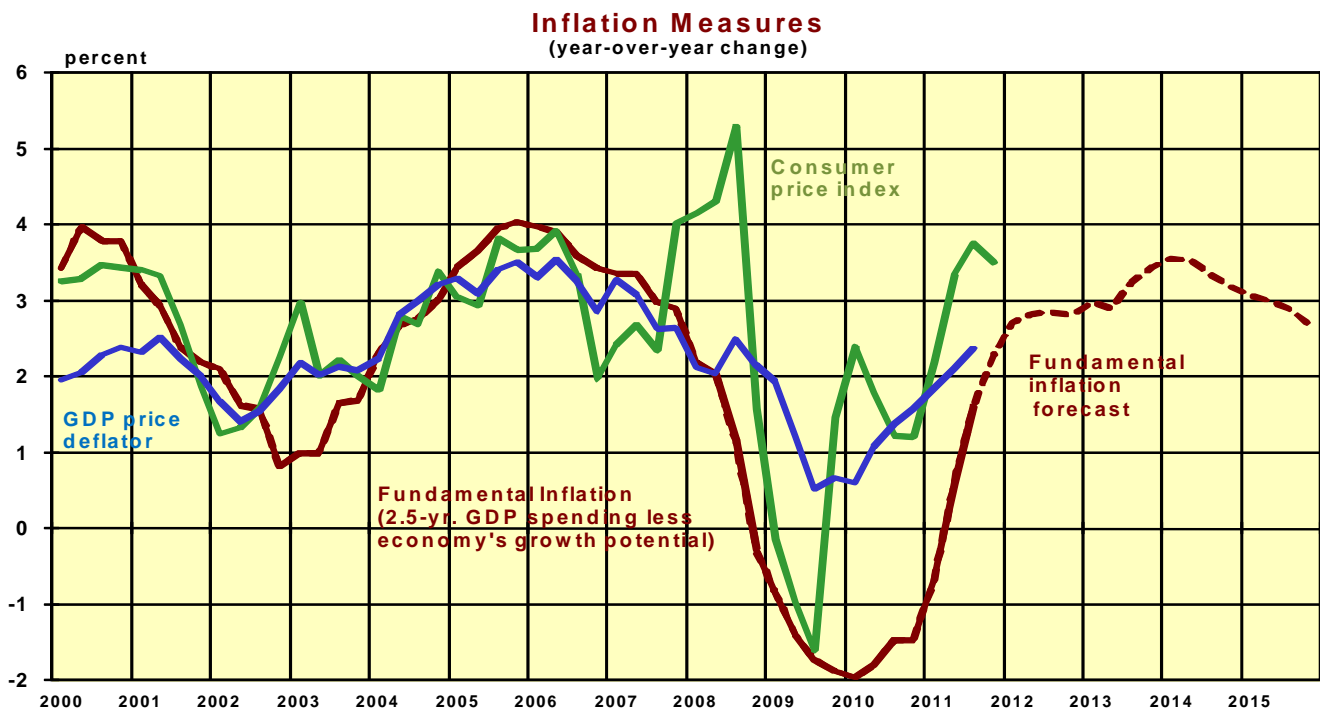
Underlying Inflation reflects the extent to which current dollar spending (GDP) exceeds the economy's ability to create goods and services. Over time, inflation tends to gravitate toward this underlying rate.

Over the past 2½ years, current dollar GDP has increased at just over a 4% annual rate. Given the mass of new regulatory burdens, the economy's potential growth is likely close to 2% a year. Hence, current dollar spending exceeds potential by just over 2%. This is the current underlying inflation rate.

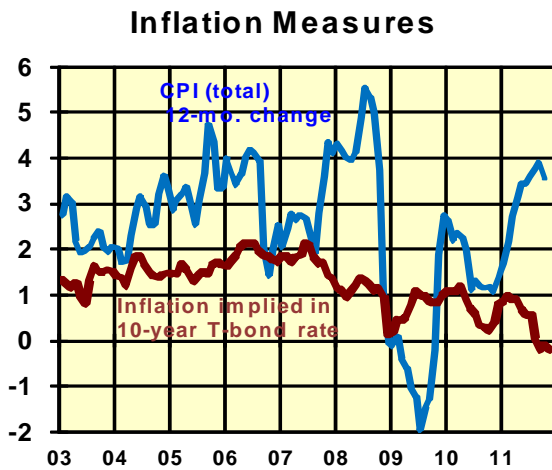
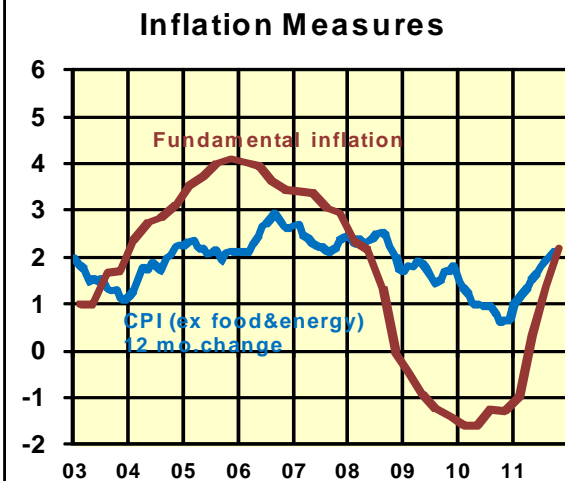
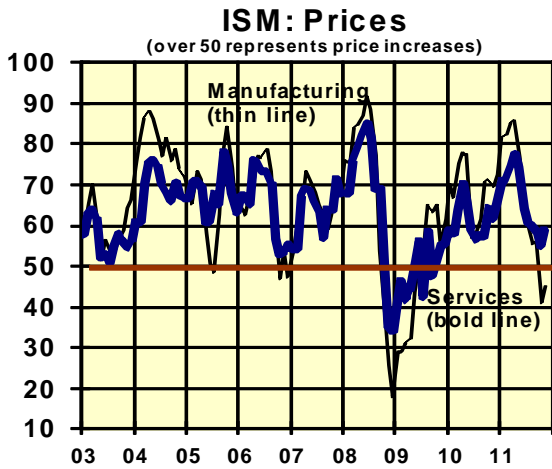
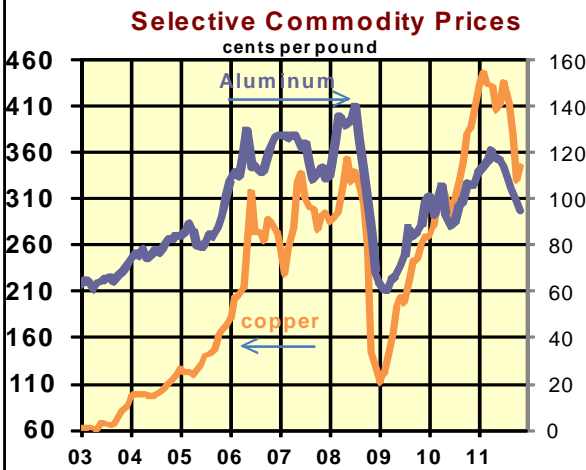
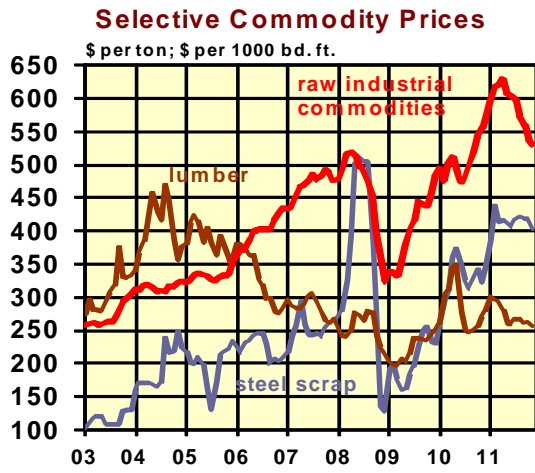
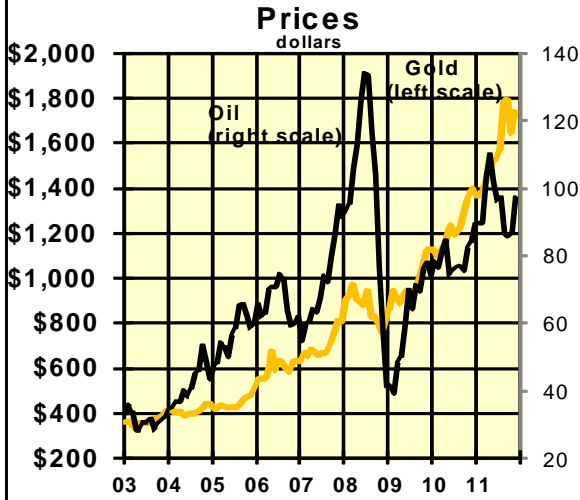
My forecast is for current dollar spending to increase by roughly 6% this coming year. If it does, the 2½-year pace of GDP would be close to 5% by the end of 2012. Subtracting 2% for potential growth indicates an underlying inflation rate of roughly 3%.

Inflation cannot move much above the 4% vicinity for any extended period unless current dollar spending increases faster than 6% a year or the economy's potential growth moves much below the 2% vicinity.

These factors suggest the odds are fairly high that inflation will remain in the 2%-3% vicinity for the coming year. If the recent rapid increase in bank reserves continues, both spending and inflation beyond next year are likely to move considerably higher.



# INFLATION INDICATORS



## Interest Rates

The Federal Reserve has chosen to regulate the supply of bank reserves indirectly by setting a target for the fed funds interest rate. The current target is between zero and 0.25%.

Fed members insist they intend to keep the fed funds target close to zero until at least the spring of 2013. If the pace of spending remains close to a 4% rate, the Fed will likely realize its intention. However, the Fed's assessment of the appropriate interest rate is often wrong.

In the early part of the past decade the Fed consistently kept interest rates too low. The result was an unhealthy speculative spending boom. Beginning in 2005 until the fall of 2008 the opposite occurred. The Fed overestimated the interest rate needed to restore liquidity to a rapidly weakening economy. As a result, the Fed inadvertently drained bank reserves in the midst of a credit crunch.

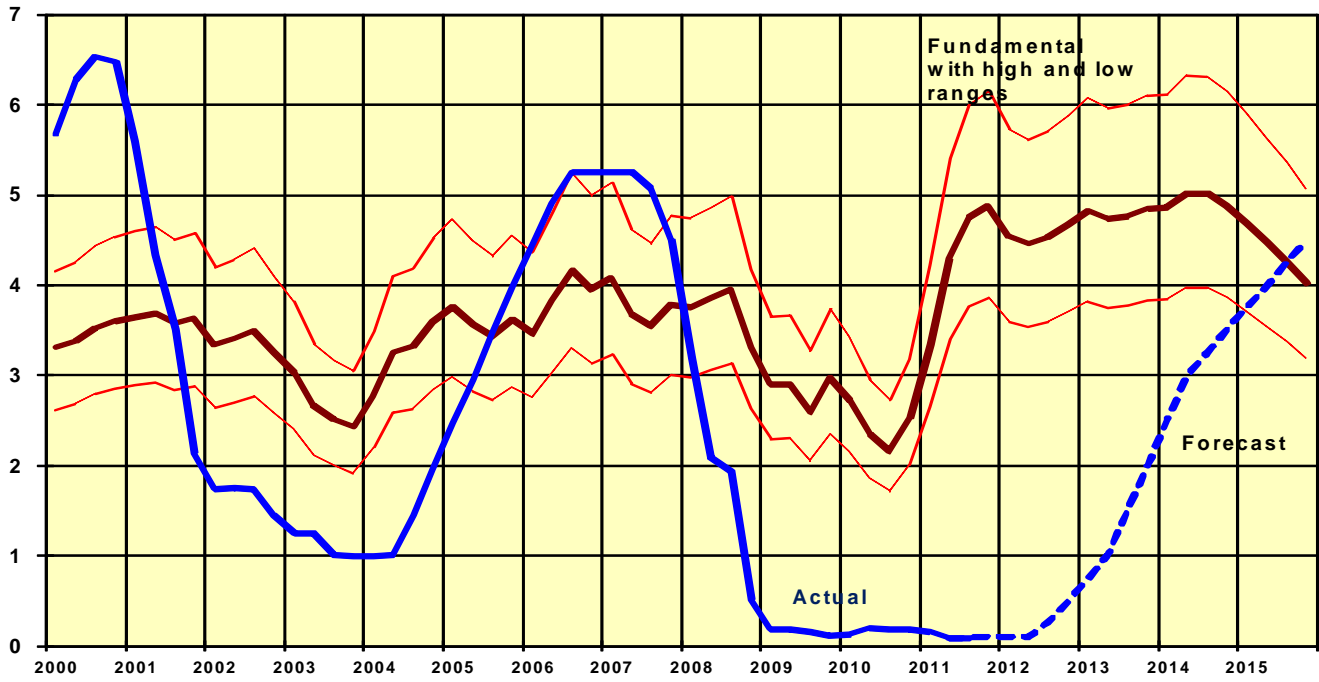
No one can be certain what interest rate level is consistent with monetary stability. However, given the recent rapid increase in bank reserves it appears likely the Fed will once again end up providing too much liquidity to maintain price stability.

If the Fed decides to keep its target fed funds rate close to zero while the pace of spending improves, it would have to add progressively more reserves to maintain its interest rate target. This, in turn, would produce a progressively faster rate of spending and much higher inflation.

If the banking system strengthens and the economy's spending pace improves (as I suspect it will), the Fed is likely to abandon its low interest rate policy sooner than it intends. Even so, it is unlikely to raise interest rates rapidly enough to prevent further increases in spending along with higher inflation rates.

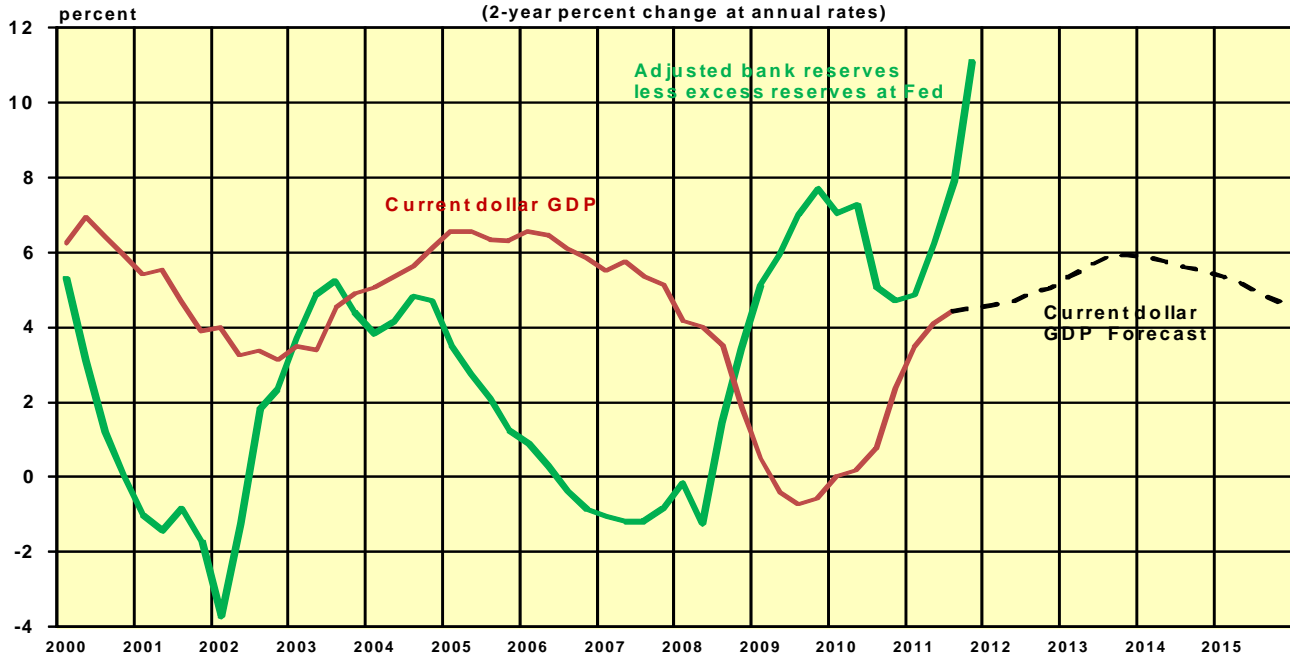
### Fed Funds Interest Rate

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



### Money & Spending

(2-year percent change at annual rates)



## 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 odds of any significant near-term increase in long-term interest rates appear fairly low.

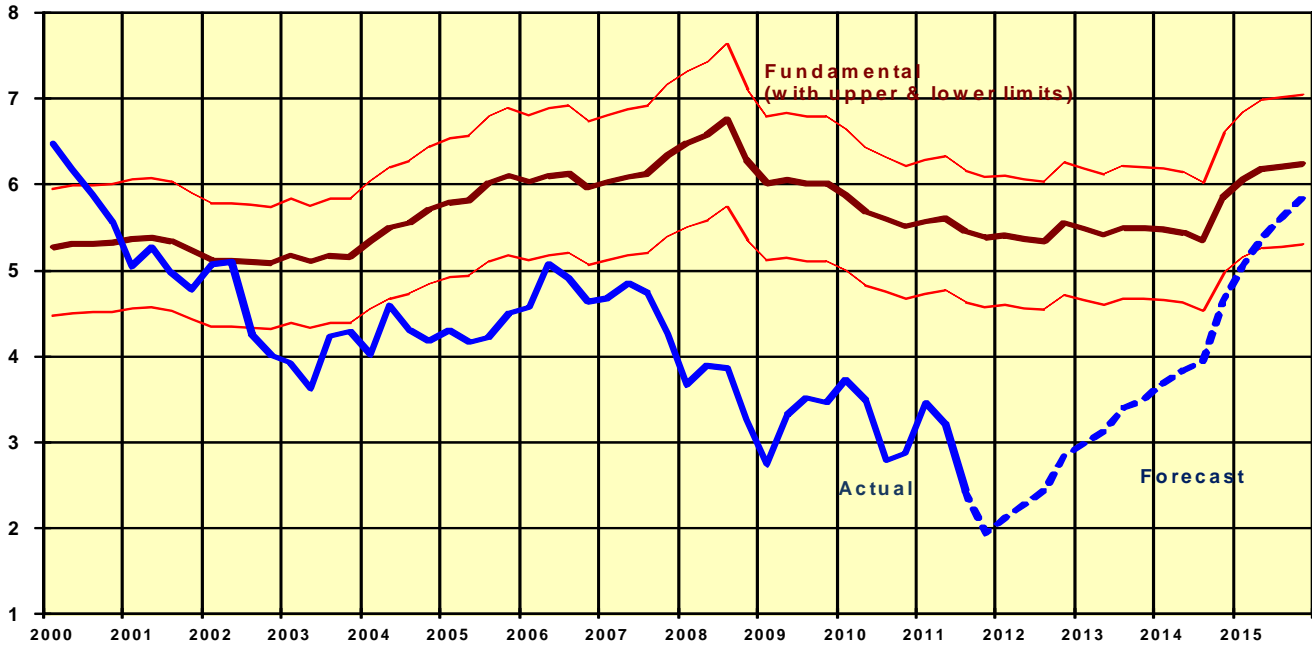
However, both short and longer-term interest rates are well below levels normally associated with the current inflation. Long-term rates have been held below normal levels by the Fed's policy of near-zero short-term rates.

The longer interest rates remain below levels associated with economic fundamentals, the

more dramatic the increases are likely to be when those rates begin to move higher.

An increase in stock prices is likely to be the first sign the pace of spending will be moving higher. Increases in other sensitive indicators such as new orders and commodity prices would provide further evidence that conditions are changing. The final sign would be an increase in the pace of consumer spending. As each of these signs occur they are likely to send longer-term rates sharply higher.

**10-Year Treasury Bond Rates: Actual & Fundamental**  
 (Fundamental is 1.4% real rate; 5-year inflation average cpi, gdp deflator; 25% marginal tax rate)



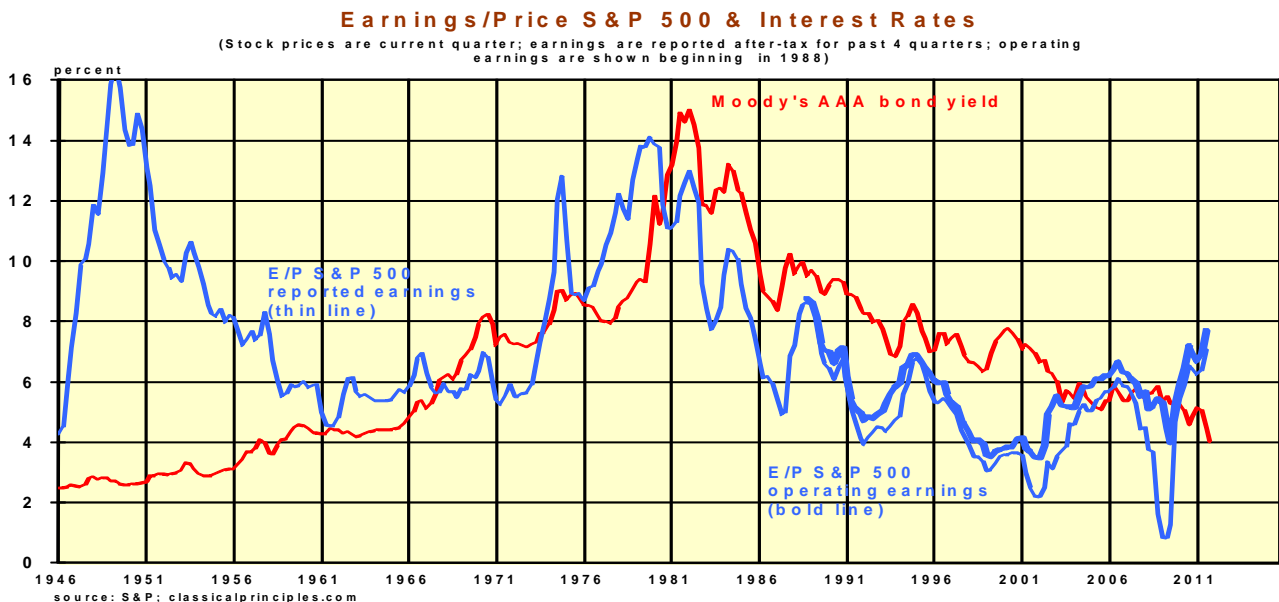
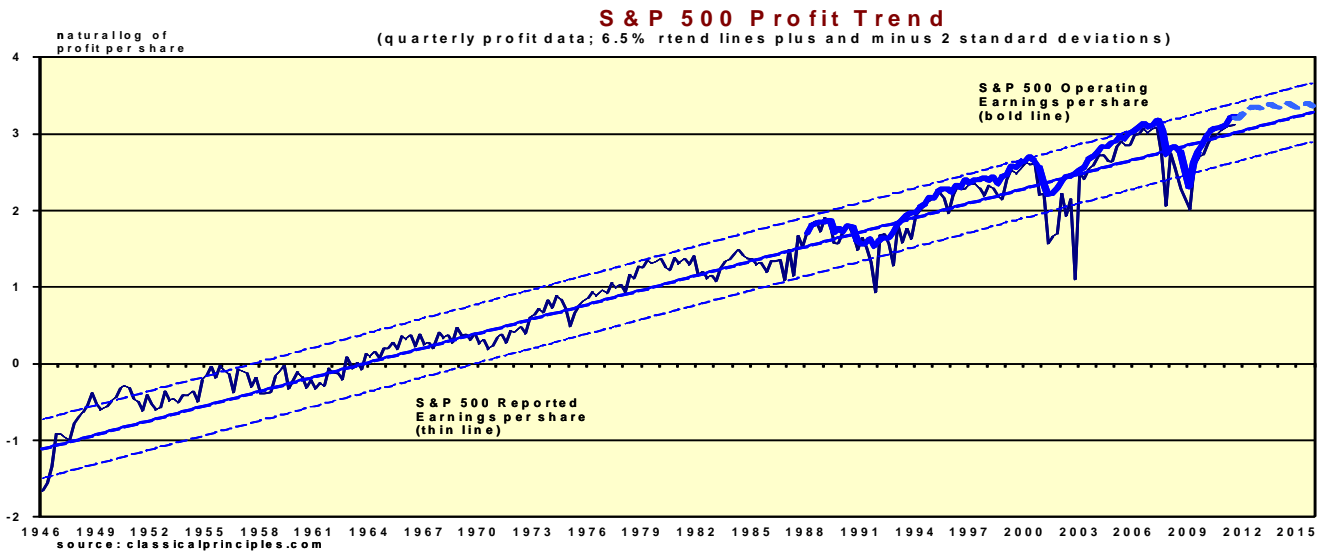
## STOCK PRICES

Stock prices continued to move without a clear sense of direction. In contrast to the lack of any trend in stock prices, corporate profits continue to improve.

In the third quarter, S&P operating profits reached \$101 a share. With the S&P 500 index at 1265, the price-earnings ratio amounts to 12.5. The earnings/price ratio for S&P companies is roughly 8% or twice the yield on AAA bonds. By almost all measures, stocks are selling well below fundamental value.

If the sharp increase in bank reserves begins to work its way through the banking system and into the economy, stock prices should be one of the first areas to move sharply higher.

As noted above, the sharp increase in bank reserves has raised the odds of an increase in the pace of spending. This, in turn, increases the odds stock prices will soon be moving higher.



12/6/2011	<u>Actual</u>			<u>Forecast</u>				<u>YEARS</u>				
	<u>2011</u>	<u>2011</u>	<u>2011</u>	<u>2011</u>	<u>2012</u>	<u>2012</u>	<u>2012</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
	I	II	III	IV	I	II	III					
GROSS DOMESTIC PRODUCT	14868	15013	15181	15381	15615	15847	16068	13939	14527	15111	15951	16877
%ch	3.1	4.0	4.6	5.4	6.2	6.1	5.7	-2.5	4.2	4.0	5.6	5.8
REAL GDP	13228	13272	13338	13440	13564	13679	13790	12703	13088	13319	13729	14172
%ch	0.4	1.3	2.0	3.1	3.7	3.4	3.3	-3.5	3.0	1.8	3.1	3.2
CHAIN PRICE INDEX	1.124	1.131	1.138	1.144	1.151	1.159	1.166	1.097	1.110	1.134	1.162	1.192
%ch	2.5	2.5	2.5	2.3	2.5	2.6	2.4	1.1	1.2	2.2	2.5	2.6
CPI- ALL URBAN%ch	5.2	4.1	3.1	2.1	2.3	2.6	2.7	-0.3	1.6	3.2	2.6	2.9
FUND. INFLATION%ch	-0.7	0.6	1.6	2.3	2.7	2.8	2.8	-0.3	-1.8	-0.8	2.3	2.7
PRETAX PROFITS	1877	1891	1851	1871	1908	1938	1959	1455.7	1819.5	1872.4	1947.3	2087.9
%ch	34.7	2.9	-8.2	4.6	8.1	6.4	4.4	7.0	25.0	2.9	4.0	7.2
PRETAX PROFITS ADJ (1)	1876	1938	1918	1947	1980	2011	2031	1362.0	1800.1	1919.7	2019.9	2160.7
%ch	4.2	13.7	-4.0	6.1	6.9	6.6	4.0	9.1	32.2	6.6	5.2	7.0
AFTER-TAX PROFITS	1455	1470	1422	1441	1469	1494	1508	1183	1408	1447	1500	1610
%ch	39.8	4.3	-12.6	5.7	8.0	6.9	3.9	12.6	19.0	2.7	3.7	7.3
AFTER-TAX PROFITS ADJ(1)	1454	1517	1489	1517	1541	1567	1581	1089.6	1389.1	1494.3	1572.7	1682.4
%ch	0.4	18.5	-7.2	7.7	6.5	7.1	3.5	16.0	27.5	7.6	5.3	7.0
PERSONAL INCOME	12847	12955	12975	13115	13283	13481	13669	11930	12374	12973	13569	14357
%ch	8.8	3.4	0.6	4.4	5.2	6.1	5.7	-4.3	3.7	4.8	4.6	5.8
REAL DISPOSABLE INCOME	10183	10170	10117	10163	10236	10323	10399	9883	10062	10158	10355	10651
%ch	1.2	-0.5	-2.1	1.8	2.9	3.4	3.0	-2.3	1.8	1.0	1.9	2.9
PRODUCTIVITY	1.105	1.105	1.111	1.114	1.118	1.121	1.125	1.055	1.098	1.109	1.123	1.140
%ch	-0.6	-0.1	2.3	1.3	1.3	1.3	1.3	2.3	4.1	0.9	1.3	1.5
CIVILIAN EMPLOYMENT	139.6	139.6	139.6	139.8	139.9	140.1	140.2	139.9	139.1	139.3	140.1	141.0
%ch	1.5	0.0	0.2	0.3	0.3	0.6	0.5	-3.8	-0.6	0.2	0.6	0.6
UNEMPLOYMENT RATE	8.9	9.1	9.1	9.4	9.5	9.3	9.4	9.3	9.6	9.1	9.4	9.1
INDUSTRIAL PRODUCTION	92.8	92.9	94.1	95.1	96.4	97.5	98.5	85.5	90.1	91.3	98.0	103.2
%ch	4.9	0.4	5.3	4.3	5.7	4.7	4.3	-11.2	5.3	1.3	7.4	5.4
LIGHT VEHICLE SALES (2)	13.0	12.2	12.5	12.7	13.0	13.2	13.4	10.4	11.6	12.1	13.3	13.5
Domestic	6.6	6.0	5.8	6.4	6.7	6.8	6.9	5.5	5.8	6.0	6.9	7.0
Imports	6.5	6.1	6.7	6.4	6.3	6.4	6.5	4.9	5.8	6.1	6.4	6.6

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

(2) Millions at seasonally adjusted annual rates.

12/6/2011	Actual			Forecast				Years					
	2011	2011	2011	2011	2012	2012	2012	2009	2010	2011	2012	2013	
Monetary Aggregates quarterly:	I	II	III	IV	I	II	III						
M2 %ch at annual rates	5.1	6.2	21.9	7.1	6.5	5.5	4.6	7.9	2.3	7.4	7.8	4.4	
Adj. Bank Reserves less excess reserves (billions of \$)	112	116	123	133				105	107	121			
Interest Rates:													
Baa Corp Bonds: Moody's	6.09	5.85	5.46	5.11	5.14	5.18	5.27	7.30	6.04	5.29	5.30	5.82	
Aaa Corp Bonds: Moody's	5.13	5.04	4.46	4.01	4.09	4.18	4.27	5.31	4.94	4.24	4.28	4.82	
MORTGAGE RATES	5.10	5.10	5.10	3.90	4.04	4.18	4.32	5.04	5.10	4.80	4.31	5.05	
10-YR GOVT SECURITIES	3.46	3.21	2.43	2.00	2.04	2.18	2.32	3.26	3.21	2.77	2.31	3.05	
5-YR GOVT SECURITIES	2.12	1.86	1.15	0.90	0.92	1.04	1.34	2.19	1.93	1.51	1.29	2.43	
2-YR GOVT SECURITIES	0.69	0.57	0.28	0.20	0.20	0.30	0.55	0.96	0.70	0.44	0.51	1.81	
3-MONTH T-BILL	0.13	0.05	0.03	0.34	0.34	0.34	0.49	0.16	0.13	0.14	0.48	1.55	
FEDERAL FUNDS RATE	0.16	0.09	0.08	0.10	0.10	0.10	0.25	0.16	0.18	0.11	0.24	1.31	
3-MONTH LIBOR RATE	0.31	0.26	0.30	0.45	0.45	0.45	0.60	0.69	0.34	0.33	0.59	1.66	
BOND EQUIVALENT RATES:													
FEDERAL FUNDS	0.16	0.09	0.08	0.10	0.10	0.10	0.25	0.16	0.18	0.11	0.24	1.32	
3-MONTH LIBOR	0.31	0.26	0.30	0.45	0.45	0.45	0.60	0.70	0.34	0.33	0.59	1.68	
3-MONTH T-BILL	0.14	0.05	0.03	0.35	0.35	0.35	0.50	0.16	0.14	0.14	0.48	1.58	
STOCKS:													
S&P 500	1303	1319	1228	1102	1267	1331	1393	947	1139	1238	1356	1639	
S&P 500 quarterly reported earnings	85.8	89.0	90.9	94.3	98.9	99.9	104.5	51.0	77.4	90.0	102.7	109.9	
S&P 500 p/e on reported earnings**	15.2	14.8	13.5	11.7	12.8	13.3	13.3	19.6	14.8	13.8	13.2	14.9	
S&P 500 quarterly operating earnings	90.2	99.4	101.5	103.6	103.6	110.7	115.8	56.9	83.8	98.7	111.9	115.7	
S&P 500 p/e on operating earnings**	14.4	13.3	12.1	10.6	12.2	12.0	12.0	16.7	13.6	12.5	12.1	14.2	
S&P 500 underlying earnings***	78.8	80.1	81.3	82.6	83.9	85.3	86.6	71.2	75.8	80.7	85.9	91.5	
S&P 500 p/e on underlying earnings	16.5	16.5	15.1	13.3	15.1	15.6	16.1	13.3	15.0	15.4	15.8	17.9	

\*annualized.

\*\*\*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