

Robert Genetski

February 3, 2008

Monthly Economic and Financial Update

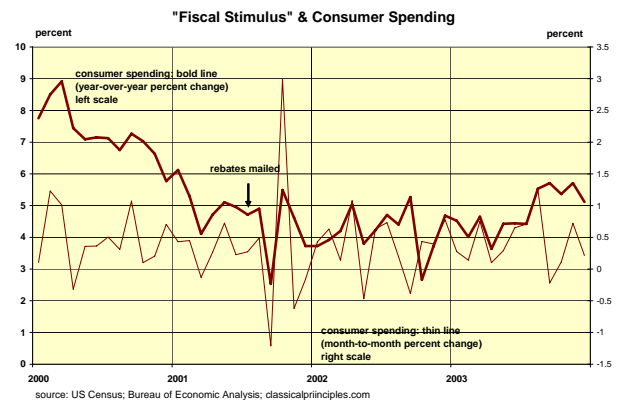
By cutting the fed funds rate by a total of 1¼ points in just over a week, Fed policy has likely completed the shift from restraint to expansion. Although it will be several weeks before new monetary numbers will become available, it appears that the Fed has done enough (perhaps more than enough) to increase the pace of spending later this year.

Monetary policy had been moderately restrictive up until last summer. Amid financial turmoil, credit markets froze. Early efforts by the Fed to shift money around rather than increase the supply created further problems for the financial system and for the economy.

The Fed once again seemed surprised to find that it had the ability to slow the pace of spending. Slowing the pace of spending in an election year is not very popular among politicians. In fact, the prospect of a recession was so threatening, it had the effect of bringing both political parties together in a knee-jerk reaction to do something.

I spend relatively little time discussing fiscal stimulus. The idea that you stimulate spending by borrowing money from one group and giving to another has never made sense. Nor has there ever been any evidence to support the view. This is one of those urban legends that economists repeated so often that they assumed it was true. The only time shifting funds around *appears* to increase spending is when the Fed happens to be creating more money. Without the Fed, there is no stimulus.

The accompanying chart shows the experience with rebates in mid-2001. Other than the shock and recovery from 9/11, the rebates had no impact on spending patterns. For a similar view on the effectiveness of fiscal stimulus see: <http://www.heritage.org/Research/Economy/wm1776.cfm>.



H.L. Mencken referred to elections as “a sort of advance auction sale of stolen goods.” Politicians in both parties seem to be falling over each other in an effort to validate Mencken’s view.

While concern over a potential recession has led to all sorts of political nonsense, it may also highlight a mechanism by which the economy will be able to avoid future problems. Up to now there appeared to be little hope of avoiding higher tax rates. However, the recent panic in Washington has led policymakers to consider a swift change in policy. The moment politicians noticed that the economy (and their re-election) could be in trouble they changed positions. While some aspects of the knee-jerk reaction may be harmful, the reversal underscores a key point. Policymakers will respond quickly to perceived shocks to the system.

If, as I suspect, financial markets begin to melt down at the prospect of a sharp increase in tax rates, those committed to ending the Bush tax cuts might well be among the first to abandon their positions. Politicians who lack principles can have a positive impact when the principles they profess to have are destructive. The latest flip flops in Washington suggest that turmoil in financial markets holds the potential for a radical shift in legislative priorities.

Monetary Indicators

The Fed reported that during the first two weeks of January bank reserves moved sharply higher. While bi-weekly data on bank reserves are not always related to monthly averages, the latest numbers are probably on target. If so, it means that the Fed had already shifted its policy before the latest round of interest rate cuts.

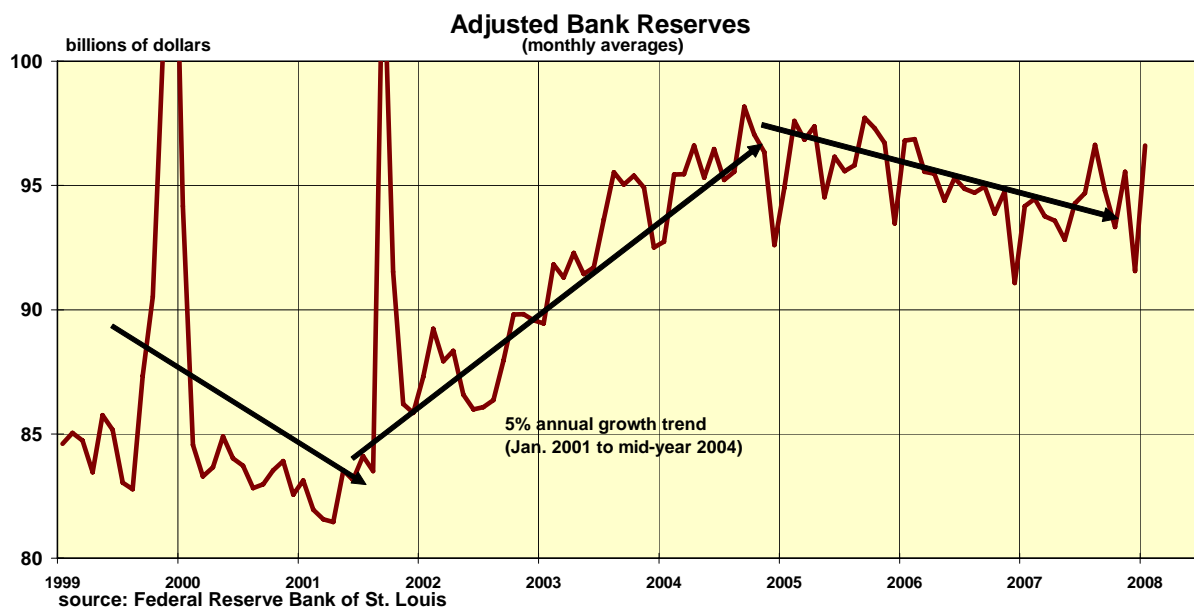
Yield curves have yet to confirm the move to an expansive policy. The spread between fed funds rate and Moody's AAA corporate bond rate is now close to consistent with the average spread over the business cycle. As such, it suggests that monetary policy is neutral. The spread for 2-year Treasury Notes is consistent with significant monetary restraint, while the spread for the 10-year is somewhere between the two extremes (see charts on next page). The extreme lows in the 2-year rate reflect the current consensus that rate cuts will continue.

Treasury rates in general remain lower than normal due to concerns over the stability of the financial system. By the same reasoning, corporate rates are higher than they would be without this concern.

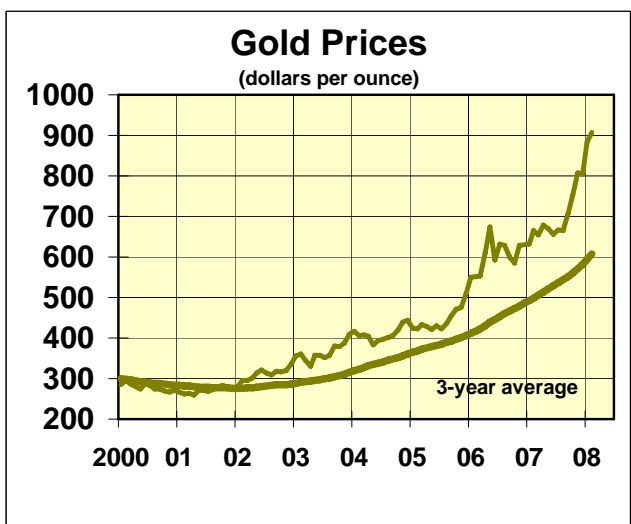
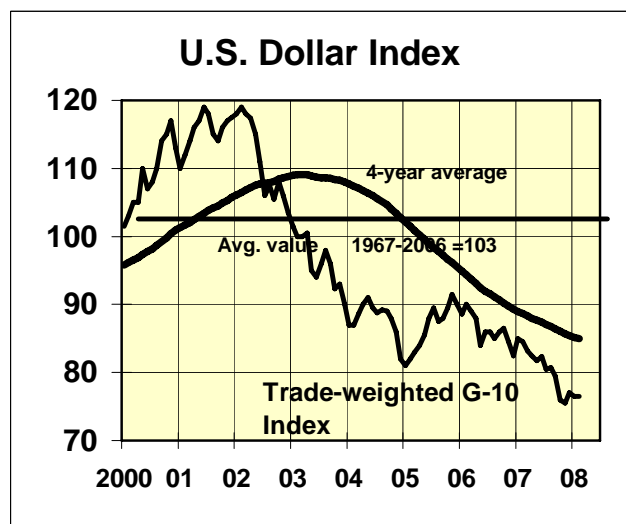
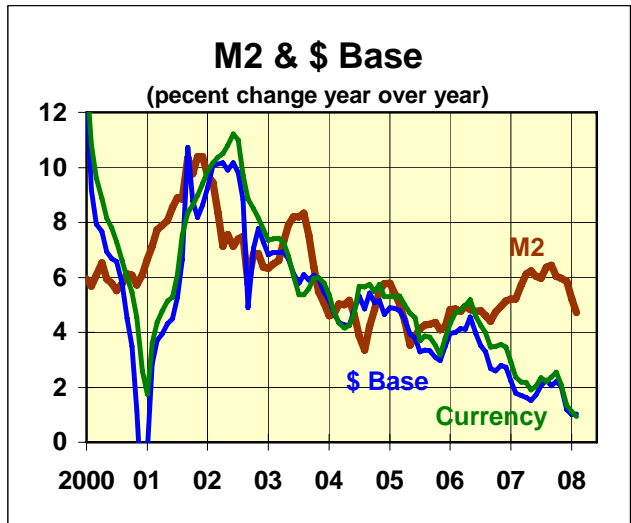
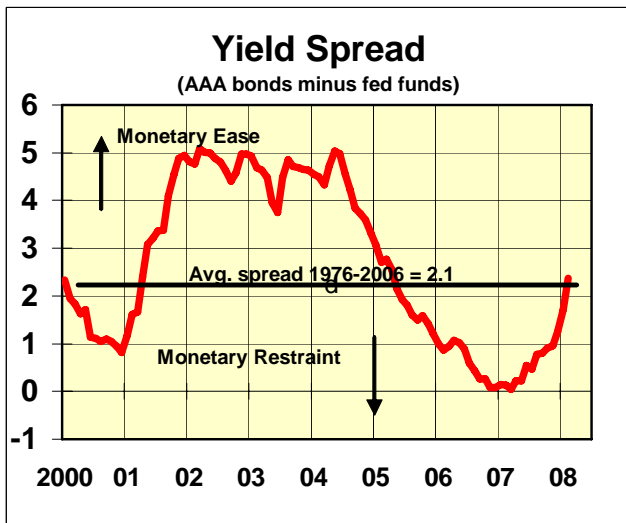
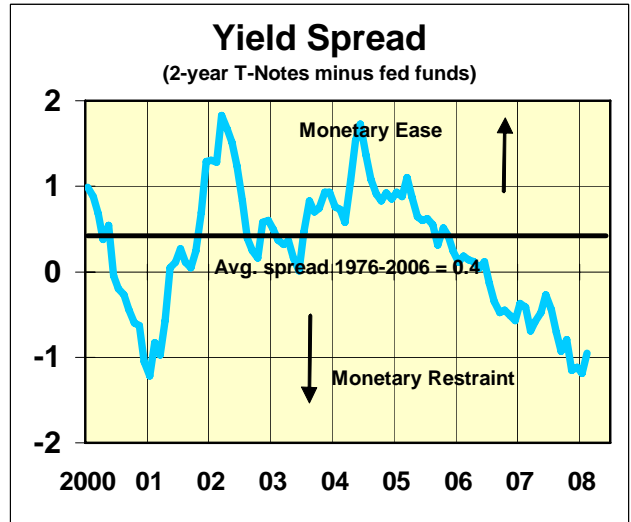
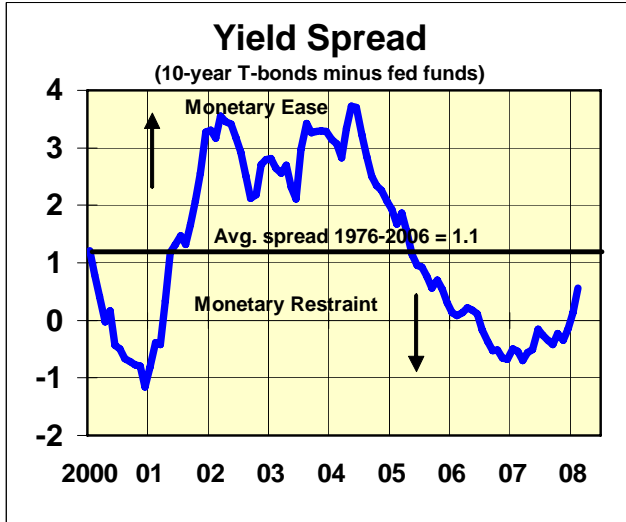
Gold prices and the value of the dollar continue to paint a completely different picture of

monetary policy. Each behaves as if monetary policy has been highly expansive. However, both indicators are highly suspect. Neither correctly anticipated either the slowdown in spending in recent months or the strains in the financial system. Moves in these indicators appear to be dominated by forces other than monetary policy. It's also conceivable that these markets simply looked beyond the shift toward monetary restraint and anticipated that any such period of restraint would be short-lived. While this is possible, it makes little sense to worry about excessive stimulus and excessive restraint at the same time.

Monetary policy is in the process of shifting toward stimulus. The latest figures suggest that the Fed may have already begun the process before its recent 1¼ point cut in rates. It often takes 6-9 months for spending to accelerate following a shift in policy. There is some evidence that the lead time can be shorter amid more dramatic policy changes, such as have recently occurred. In any event, the latest shift in policy should produce rapid increases in spending in the later half of this year, if not sooner.



MONETARY INDICATORS



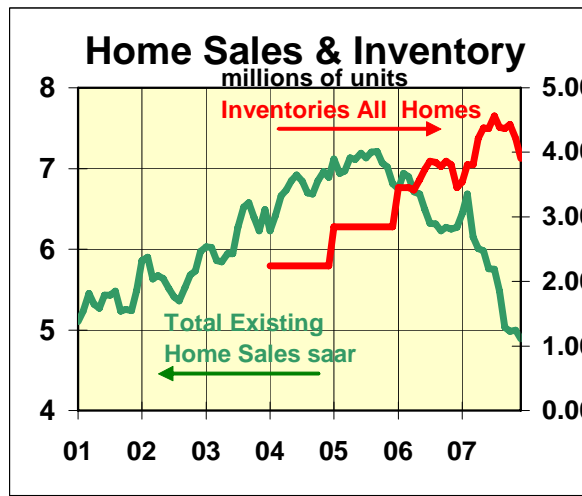
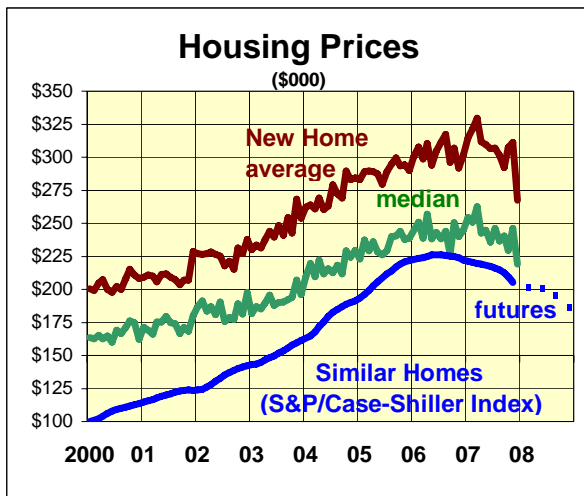
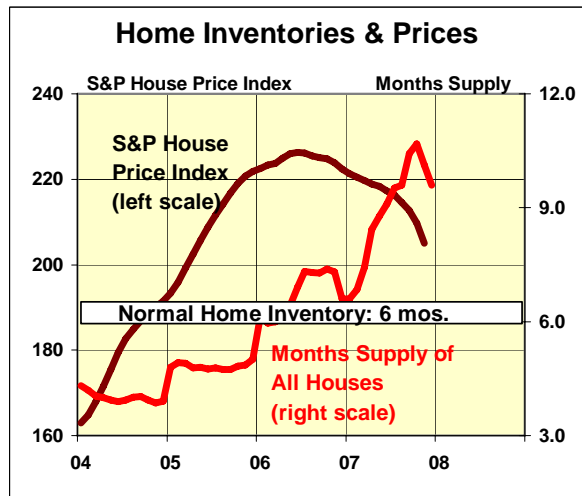
Sensitive Indicators

The depression in housing activity continues. Housing prices are down 10% from their peak and future markets anticipate another 10% decline over the next year. A 20% decline in housing prices wipes out the equity for most homes bought in 2004-05. The financial implications of this adjustment are significant. There were 14 million homes sold during these years at an average price of \$300,000. It's likely that the price decline *so far* has reduced equity needed to qualify for refinancing by over \$½ trillion. This creates problems for homeowners as well as their banks.

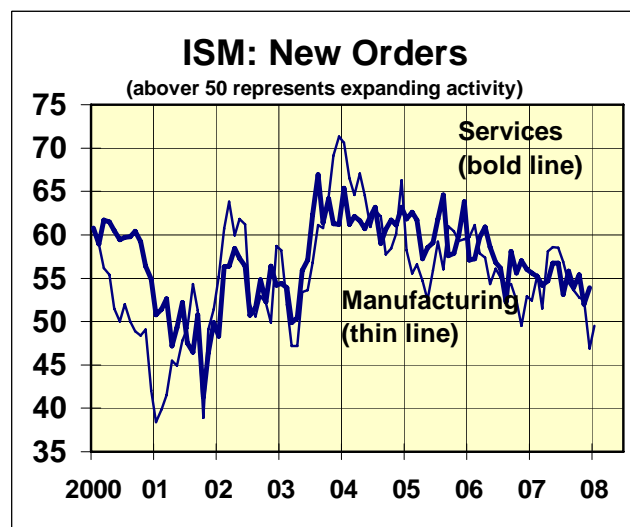
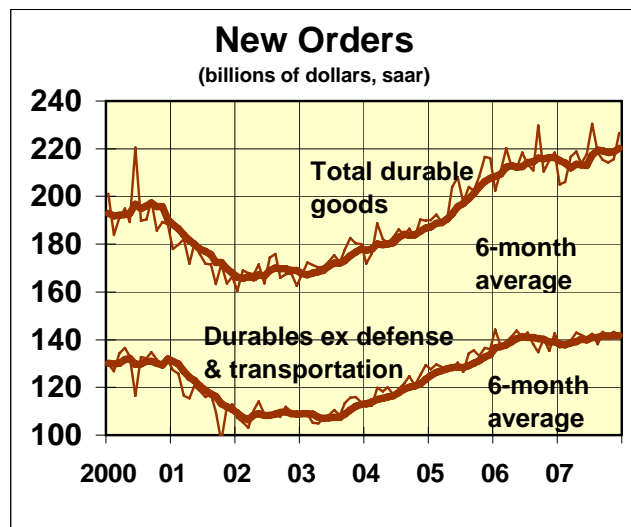
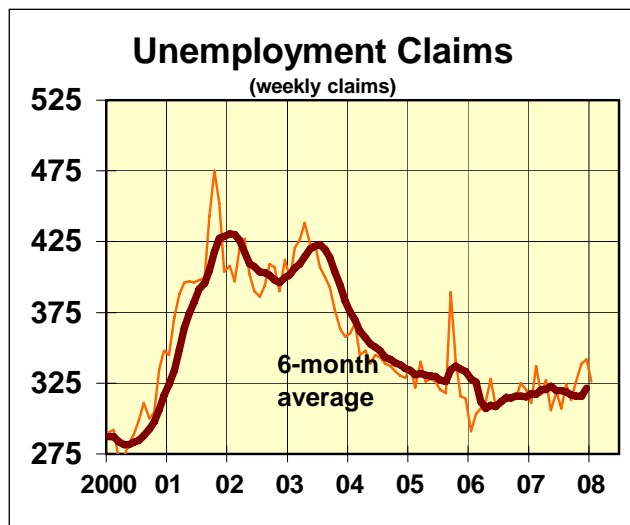
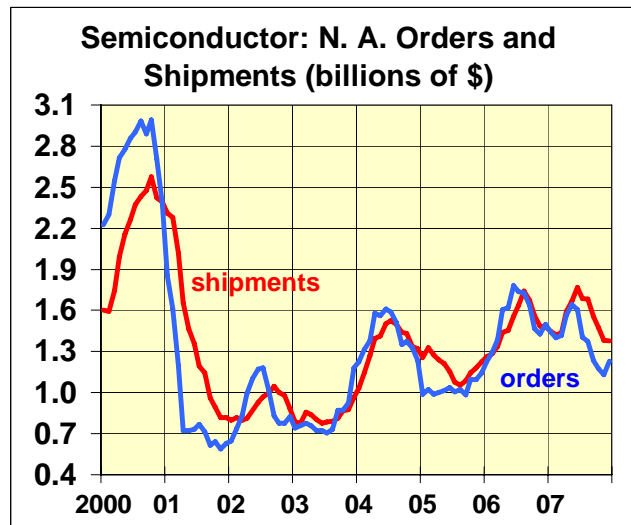
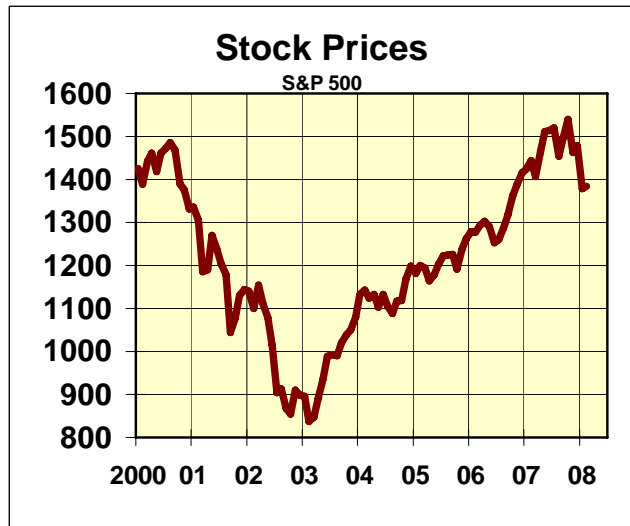
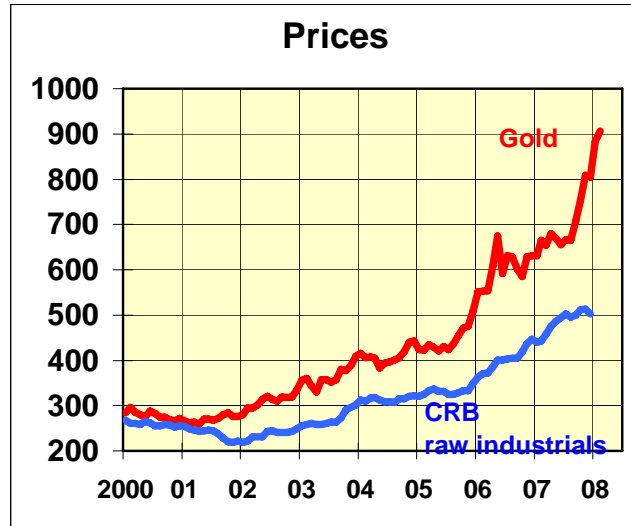
As housing prices decline, new home construction plummets. After rising sharply, home inventories have now begun to fall.

There is much pain ahead and little hope for a near-term recovery for housing. In spite of serious housing-related problems, economic fundamentals remain strong. With monetary policy shifting to stimulus, the likelihood of a recession has declined.

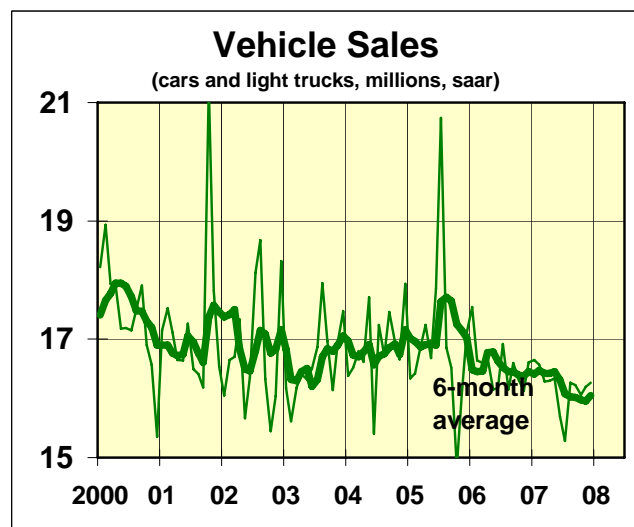
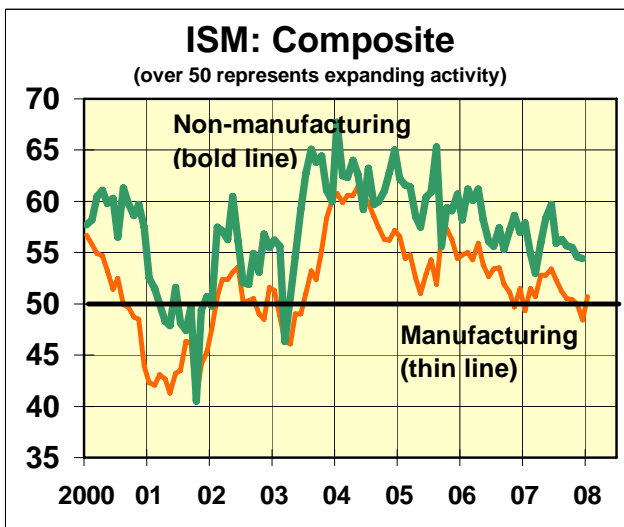
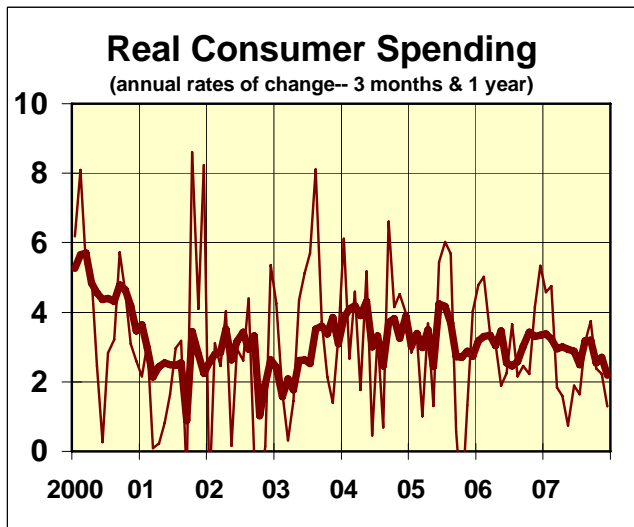
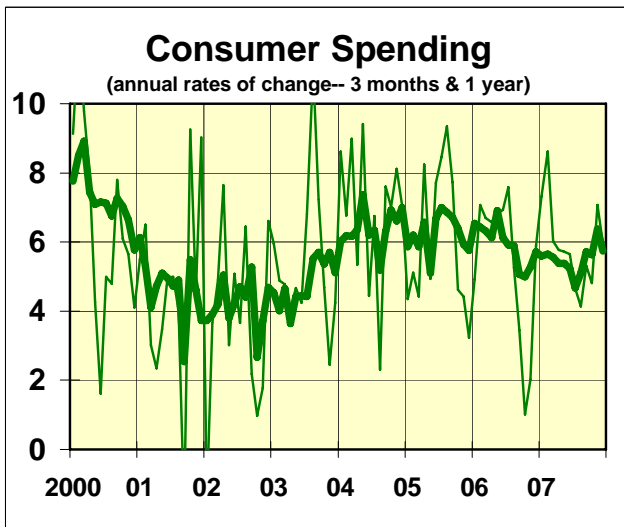
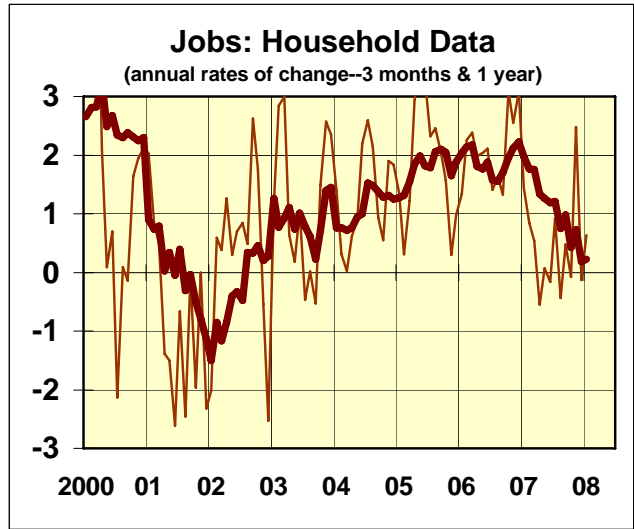
In addition to housing activity, stock prices, new orders and initial unemployment claims are all signaling some weakness ahead. As for coincident indicators (page 6), almost all now reflect the slowdown suggested by prior monetary restraint. Within the next 2-3 months some of the sensitive indicators should begin to signal an upcoming recovery in business activity.



SENSITIVE INDICATORS



ECONOMIC INDICATORS



Inflation Indicators

Energy prices continue to play havoc with inflation. The year-over-year CPI jumped to just over 4% in November and December, while the core inflation rate moved up to just below 2½%. Moreover, the ISM survey of manufacturers shows that inflationary pressures intensified in January.

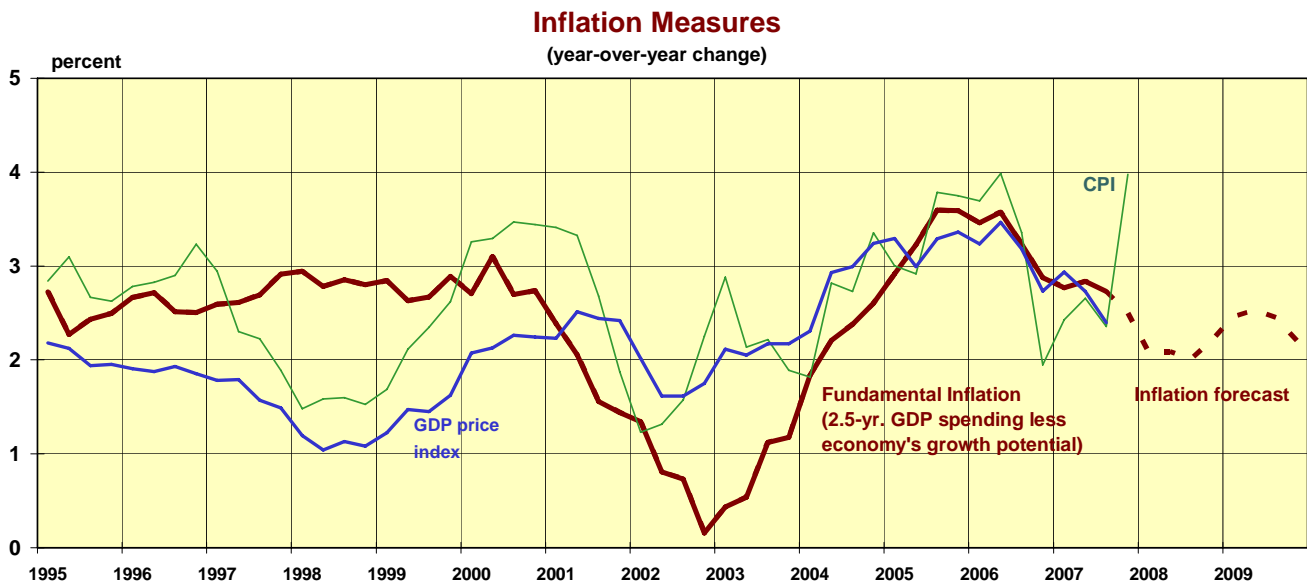
The fundamental or underlying inflation rate is shown by the bold line in the chart below. It represents the excess of spending over potential growth. During the past 2½ years current dollar spending (GDP) has increased at a 5½% annual rate. In last month's annual long-term report, I indicated that potential growth appeared to be close to 3%. Productivity data suggest that trends have been about ½% a year less than my analysis had suggested. This means that potential growth

may be ½% less, and underlying inflation ½% more than I had previously indicated.

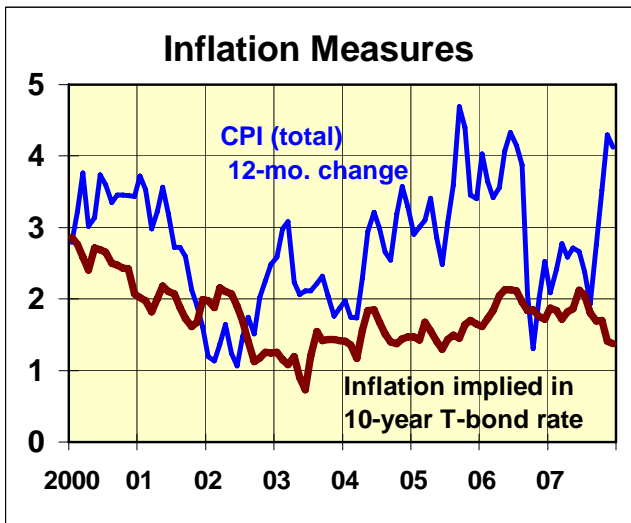
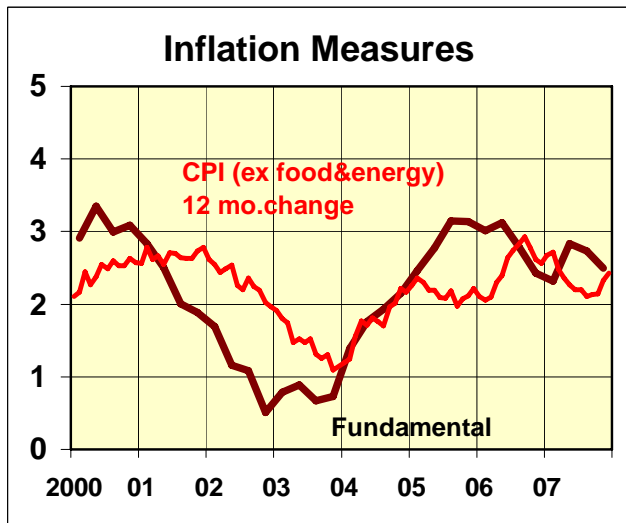
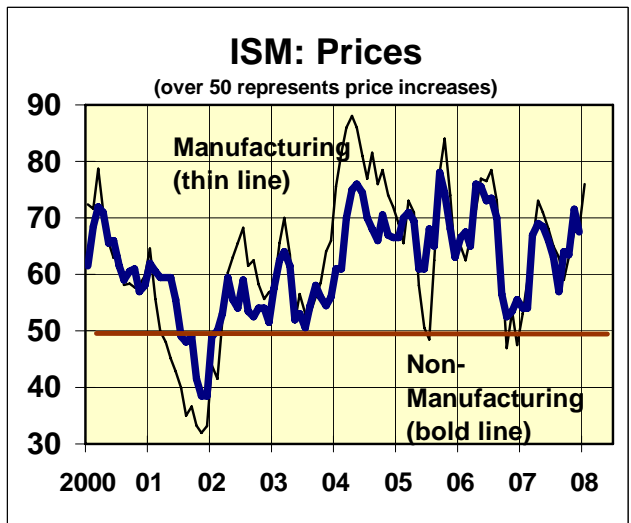
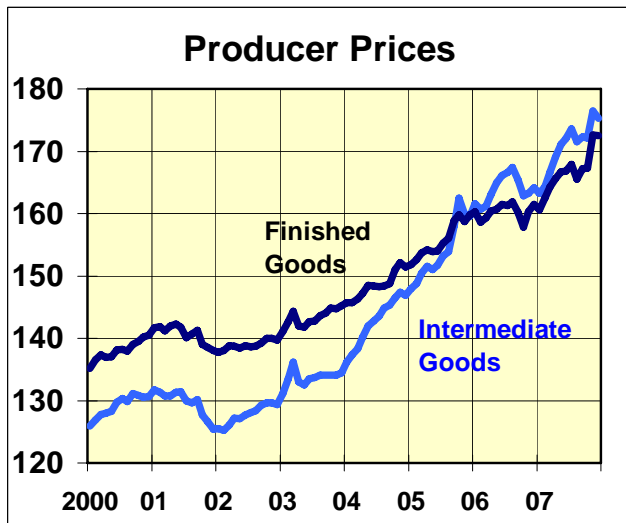
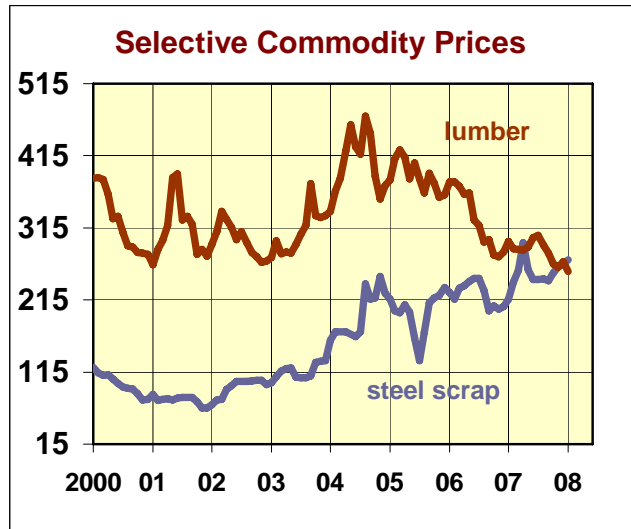
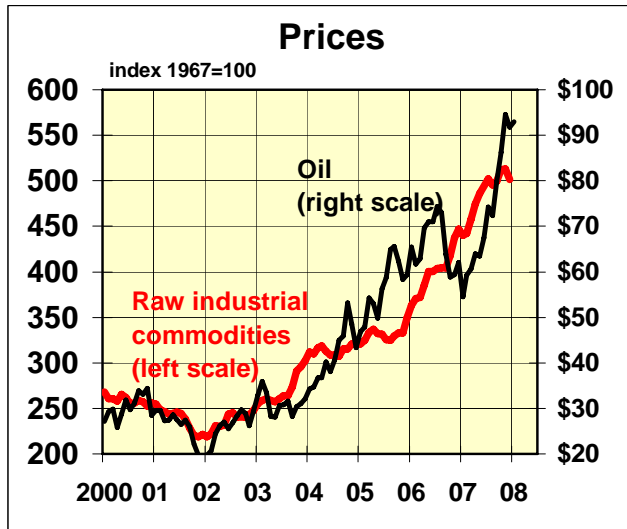
Subtracting 3% potential growth from the 5½% spending pace yields an underlying inflation rate of 2½%, or close to the current core rate.

With relatively weak spending expected in the first half of this year, the 2½-year spending pace is forecast to decline to 5%. This would lower the fundamental inflation rate to 2%. However, monetary stimulus is expected to send spending up sharply in the later half of the year.

The forecast assumes that the Fed responds relatively quickly to signs that spending is moving ahead rapidly. This response would serve to keep inflationary pressures in the 2%-2½% vicinity over the next few years.



INFLATION INDICATORS



Interest Rate

*The charts on the following pages place developments in financial markets in perspective. The middle line in the interest rate chart shows an estimate of the **fundamental** interest rate. The boundary lines above and below the fundamental show where two-thirds of all the historical observations have occurred. The **fundamental** rate represents an underlying interest rate that is consistent with economic fundamentals. These fundamentals include inflation and the real rate of interest. Rates may lie above or below the fundamental due to either Fed policy or market psychology.*

The fed funds rate is a key interest rate since the Fed uses this rate to conduct its monetary

policy. The Fed's manipulation of the fed funds rate relative to that rate's fundamental serves to influence changes in the growth rate of the money supply.

*Whenever the Fed raises the actual fed funds rate **relative to** the fundamental, it tends to slow the growth in the money supply. Whenever the Fed lowers the actual fed funds rate **relative to** the fundamental, it tends to increase the growth in the money supply. Both the level of fed funds and the rate of change relative to the fundamental can impact monetary stimulus. The lower chart shows the percent change in current dollar spending, which is primarily influenced by Fed policy.*

As the charts on the following page indicate, it took an unusually long time for the Fed's stimulus (2001-04) to lift the pace of spending. The attack on 9/11 may have had something to do with the failure of spending to rise as much as the growth in money would have suggested.

Once the extra money was in the system, it then took an unusually long time to slow the pace of spending. The excess money that had entered the economy was apparently capable of maintaining a strong spending pace longer than would normally have been expected.

There is still some debate over the extent of the current slowdown in spending. During the spring and summer quarters, current dollar GDP rose at a rapid 6% annual rate. In the fourth quarter the rate slowed to 3%. On a year-over-year basis, current dollar spending increased by roughly 5%. This is at the upper end of the 4%-5% pace indicated by monetary indicators.

Recent commentary and forecasts anticipate further cuts in the fed funds rate. While I doubt that this will occur, you never know how the Fed

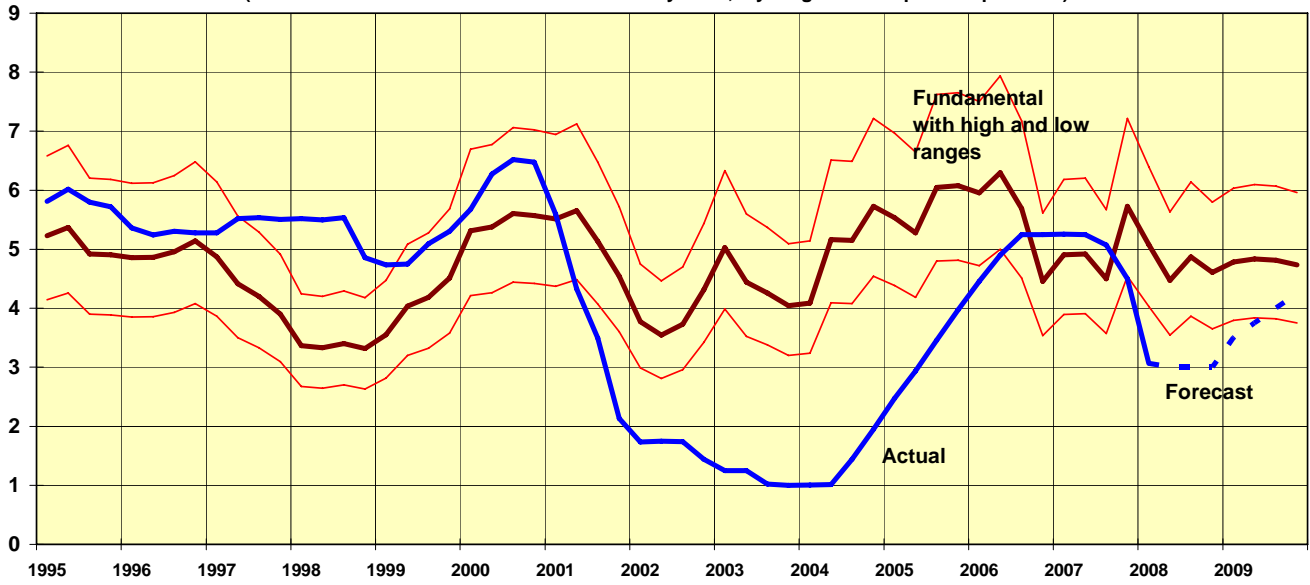
will react. Last year I had expected the Fed to cut rates in the spring or summer. They waited until late summer. When they did cut, it was initially too slow. Now that they are cutting, I suspect they may be too aggressive.

One of the reasons for the Fed's panic relates to obvious concerns over the financial system. Another relates to their shock over the slowdown. Their models failed to predict it. The same models now tell them that the decline in housing and stock prices will lead to a much weaker economy this spring and summer. They are likely to be surprised once again when business activity this summer is stronger than they expect.

I continue to believe that the appropriate fed funds rate is closer to 4% than 3%. As a result, I suspect the Fed is once again in the process of overshooting an appropriate target. If so, the latest round of cuts is a prelude to more volatility and higher interest rates later this year or in 2009.

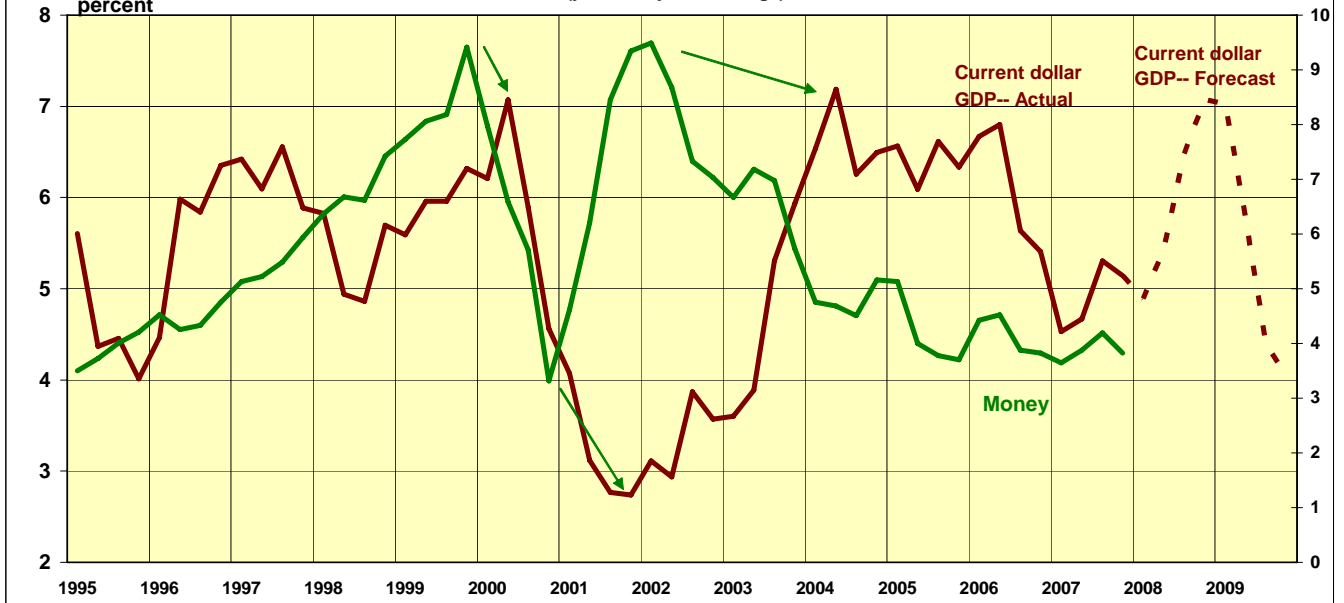
Fed Funds Rate

(fundamental based real after-tax rate currently 1.0%, 1-yr avg. inflation plus tax premium)



Current Dollar Spending (GDP) & Money (M2, \$Base average)

(year-over-year % change)



LONG-TERM INTEREST RATES

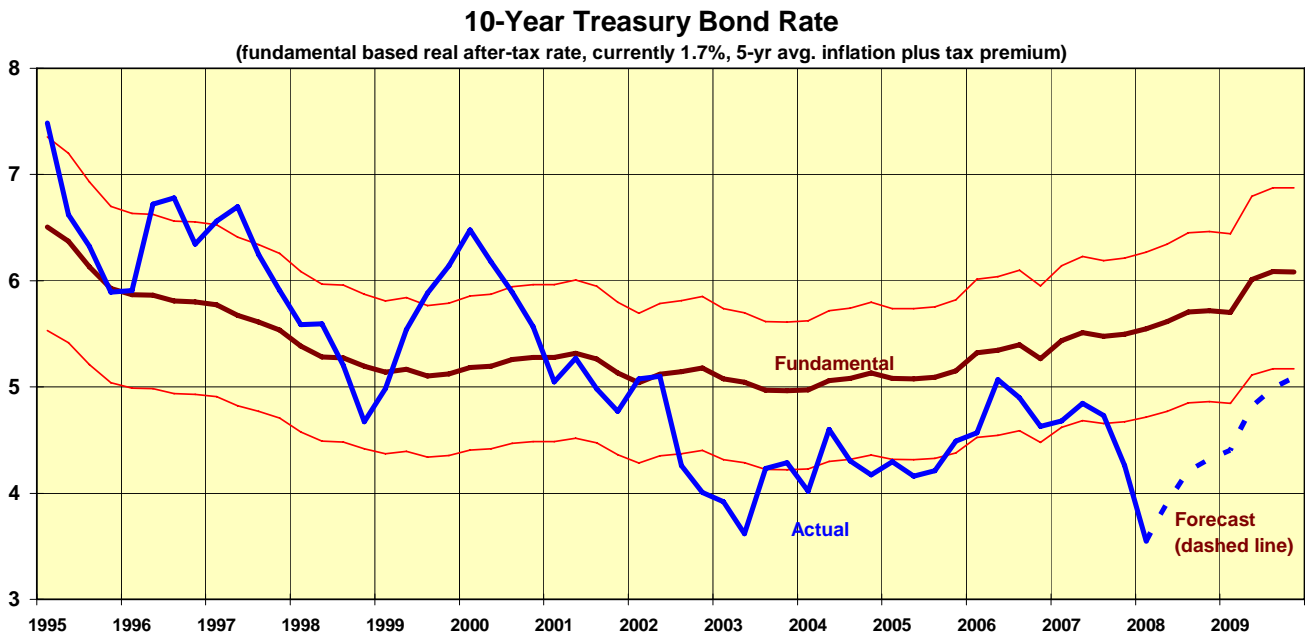
The yield on 10-year Treasury Notes has dropped to just over 3½% amid a rush to the safe haven of government securities. The decline continues to bring rates well below my estimate of their fundamental value.

The difference between the Treasury's inflation protected securities (TIPS) and more traditional Treasury Notes provides an independent measure of future inflationary expectations. Currently, that difference amounts to roughly 2¼ percentage points. This suggests that long-term inflationary expectations are roughly 2¼% and that long-term real after-tax interest rates are artificially low. Real rates tend to fall when

economic conditions become depressed and the Fed drives short-term rates down.

After taxes and inflation, holders of fixed-income securities have negative returns. This won't continue. Rates will move higher and when they do, they are likely to move quickly.

With long-term interest rates well below their fundamentals, this is an ideal time to borrow money. Odds are very high that interest rates will increase later this year. Such increases, when they occur are likely to be fairly large.



STOCK PRICES

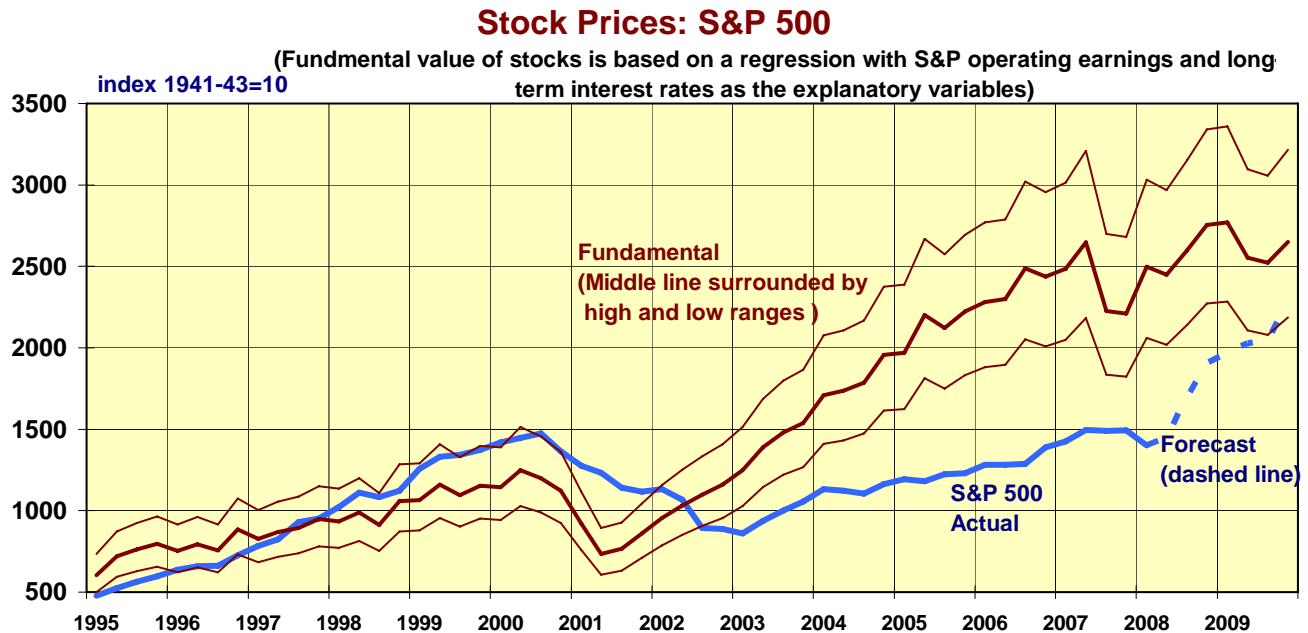
Steep losses among financial companies have produced significant uncertainty regarding the strength of corporate profits. While there have been (and will continue to be) significant write-offs associated with the crash in housing prices, operating earnings remain solid.

In the third quarter, S&P 500 operating earnings came in at \$20.87. For the fourth quarter the numbers are again being dragged down by the financial sector. Estimates of fourth quarter profits for non-financial firms show increases of 15% from the previous year. While there are problems with profits, they appear to be concentrated in the financial sector.

The current weakness in profits serves to reduce my estimate of the fundamental value of

stocks. At the same time, lower interest rates raises that value. Taking both of these factors into consideration, with S&P 500 index near 1400, my analysis shows that the index is undervalued by 40%-50%. As interest rates increase later this year or next, the negative impact of higher rates will be offset by a stronger economy and stronger profits.

Bottom line—stocks remain extremely undervalued. Since stock prices tend to reflect conditions roughly six months into the future, the current decline in the bull market should soon give way to anticipation of a pickup in both the economy and profits.



1/30/2008

	<u>Actual</u>			<u>Forecast</u>					<u>YEARS</u>				
	2007 II	2007 III	2007 IV	2008 I	2008 II	2008 III	2008 IV	2009 I	2005	2006	2007	2008	2009
GROSS DOMESTIC PRODUCT	13769	13971	14081	14214	14384	14650	14937	15152	12434	13195	13843	14546	15395
%ch	6.6	6.0	3.2	3.8	4.9	7.6	8.1	5.9	6.4	6.1	4.9	5.1	5.8
REAL GDP	11520	11659	11677	11734	11821	11989	12166	12275	11004	11319	11567	11927	12369
%ch	3.8	4.9	0.6	2.0	3.0	5.8	6.0	3.6	3.1	2.9	2.2	3.1	3.7
CHAIN PRICE INDEX	1.195	1.198	1.206	1.212	1.217	1.223	1.229	1.236	1.130	1.166	1.197	1.220	1.246
%ch	2.6	1.0	2.6	1.9	1.9	1.8	2.0	2.3	3.2	3.2	2.7	2.0	2.1
CPI- ALL URBAN%ch	6.0	1.9	4.3	2.3	2.3	2.2	2.4	2.7	3.4	3.2	2.9	2.8	2.5
FUND. INFLATION%ch	2.8	2.7	2.5	2.1	2.1	2.0	2.2	2.5	2.8	3.6	2.9	2.3	2.3
PRETAX PROFITS	1932	1880	1887	1868	1853	1980	2036	2048	1579.6	1805.8	1878.5	1934.5	2073.6
%ch	28.0	-10.3	1.5	-3.9	-3.1	30.3	11.8	2.3	31.1	14.3	4.0	3.0	7.2
PRETAX PROFITS ADJ (1)	1642	1622	1603	1587	1571	1698	1754	1766	1372.8	1553.7	1603.8	1652.5	1791.6
%ch	26.8	-4.9	-4.6	-4.0	-4.0	36.6	13.7	2.7	11.5	13.2	3.2	3.0	8.4
AFTER-TAX PROFITS	1441	1410	1413	1399	1388	1478	1518	1526	1187	1352	1407	1446	1544
%ch	25.0	-8.4	0.9	-3.9	-3.1	28.6	11.1	2.1	32.2	13.9	4.1	2.8	6.8
AFTER-TAX PROFITS ADJ(1)	1152	1153	1130	1118	1106	1196	1235	1244	1186.7	1099.8	1132.4	1163.9	1261.8
%ch	22.5	0.1	-7.7	-4.0	-4.4	37.1	13.7	2.7	28.4	-7.3	3.0	2.8	8.4
PERSONAL INCOME	11577	11747	11839	11952	12095	12318	12559	12741	10301	10983	11658	12231	12945
%ch	3.8	6.0	3.2	3.8	4.9	7.6	8.1	5.9	5.9	6.6	6.1	4.9	5.8
REAL DISPOSABLE INCOME	8607	8703	8679	8713	8768	8884	9007	9079	8148	8397	8653	8843	9136
%ch	-0.8	4.5	-1.1	1.6	2.6	5.4	5.6	3.2	1.7	3.1	3.0	2.2	3.3
PRODUCTIVITY	1.366	1.387	1.389	1.398	1.407	1.418	1.429	1.439	1.341	1.354	1.375	1.413	1.452
%ch	2.2	2.0	0.7	2.5	2.6	3.1	3.2	2.8	1.9	1.0	1.6	2.7	2.8
CIVILIAN EMPLOYMENT	145.9	146.0	146.3	146.4	146.6	146.8	147.0	147.3	141.7	144.4	146.0	146.7	147.7
%ch	-0.2	0.3	0.7	0.4	0.4	0.6	0.6	0.7	1.8	1.9	1.1	0.5	0.7
UNEMPLOYMENT RATE	4.5	4.7	4.8	4.8	5.0	5.0	5.0	4.9	5.1	4.6	4.6	5.0	4.8
INDUSTRIAL PRODUCTION	1.132	1.142	1.139	1.131	1.128	1.141	1.171	1.188	1.069	1.112	1.134	1.143	1.199
%ch	3.6	3.5	-0.9	-2.9	-1.0	4.8	11.0	5.9	3.2	4.0	1.9	0.8	5.0
LIGHT VEHICLE SALES (2)	16.1	15.9	16.2	16.2	16.3	16.5	16.7	16.8	17.0	16.5	16.2	16.4	16.8
Domestic	7.7	7.3	7.8	7.6	7.7	7.7	7.9	7.9	7.6	7.8	7.6	7.7	7.9
Imports	8.4	8.6	8.4	8.6	8.6	8.8	8.8	8.9	9.3	8.8	8.6	8.7	8.9

(1) Profits adjusted for capital consumption and inventory adjustment; 4th quarter 2007 are estimates.

(2) Millions at seasonally adjusted annual rates

	Actual			Forecast					Years				
	2007	2007	2007	2008	2008	2008	2008	2009	2005	2006	2007	2008	2009
Monetary Aggregates quarterly:	II	III	IV	I	II	III	IV	I					
M2 %ch at annual rates	6.2	4.8	5.4	6.5	6.7	6.8	5.8	4.7	4.4	4.8	5.9	6.1	5.1
Mg %ch at annual rates	3.3	3.8	5.3	6.5	6.7	6.8	5.8	4.7	5.1	3.8	3.2	5.6	5.4
Adj. Bank Reserves	-1.5	-3.5	-2.6	17.2	8.5	4.1	4.1	3.7	-0.4	-0.8	-1.2	4.9	4.2
Interest Rates:													
Baa Corp Bonds: Moody's	6.49	6.63	6.51	6.15	6.29	6.39	6.32	6.40	6.06	6.48	6.48	6.29	6.80
Aaa Corp Bonds: Moody's	5.58	5.75		5.15	5.29	5.44	5.42	5.50	5.24	5.59	5.56	5.32	5.90
MORTGAGE RATES	6.37	6.55	6.23	6.15	6.19	6.34	6.32	6.30	5.87	6.41	6.34	6.25	6.55
10-YR GOVT SECURITIES	4.85	4.73	4.26	3.55	3.89	4.14	4.22	4.30	4.29	4.79	4.63	3.95	4.70
5-YR GOVT SECURITIES	4.76	4.50	3.79	2.90	3.44	3.62	3.71	3.92	4.05	4.75	4.43	3.42	4.33
2-YR GOVT SECURITIES	4.81	4.38	3.48	2.26	3.00	3.10	3.20	3.55	3.85	4.82	4.36	2.89	3.96
3-MONTH T-BILL	4.76	4.39	3.51	2.36	2.50	2.70	2.90	3.50	3.15	4.72	4.41	2.62	3.88
FEDERAL FUNDS RATE	5.25	5.07	4.50	3.06	3.00	3.00	3.00	3.50	3.21	4.96	5.02	3.02	3.88
3-MONTH LIBOR RATE	5.36	5.45	5.03	3.76	3.50	3.30	3.30	3.80	3.56	5.19	5.30	3.47	4.18
BOND EQUIVALENT RATES:													
FEDERAL FUNDS	5.39	5.20	4.60	3.11	3.05	3.05	3.05	3.56	3.27	5.09	5.15	3.06	3.95
3-MONTH LIBOR	5.50	5.60	5.16	3.83	3.56	3.35	3.35	3.87	3.62	5.33	5.44	3.53	4.26
3-MONTH T-BILL	4.88	4.50	3.59	2.41	2.55	2.76	2.96	3.58	3.22	4.85	4.52	2.67	3.97
STOCKS:													
S&P 500	1496	1491	1494	1400	1448	1698	1905	1970	1207	1311	1477	1613	2080
S&P 500 quarterly reported earnings*	87.5	60.6	68.8	75.1	80.0	86.9	83.2	83.5	69.9	81.5	75.6	81.3	88.2
S&P 500 p/e on reported earnings**	17.1	24.6	21.7	18.6	18.1	19.5	22.9	23.6	17.3	16.1	20.0	19.8	23.6
S&P 500 quarterly operating earnings	96.2	83.5	80.1	83.4	84.3	90.7	95.6	96.8	76.5	87.7	87.3	88.5	96.3
S&P 500 p/e on operating earnings**	15.5	17.9	18.7	16.8	17.2	18.7	19.9	20.4	15.8	14.9	16.9	18.2	21.6
S&P 500 underlying earnings***	61.0	62.0	63.0	64.0	65.0	66.0	67.1	68.1	54.2	57.7	61.5	65.5	69.8
S&P 500 p/e on underlying earnings***	24.5	24.1	23.7	21.9	22.3	25.7	28.4	28.9	22.3	22.7	24.0	24.6	29.8

Fourth quarter 2007 profits are estimates.

*annualized.

**current quarterly stock price divided by annualized current quarter reported earnings.

***reported earnings based on a 6.5% growth rate

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