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August 4, 2009

Monthly Economic and Financial Update

Recent fiscal and monetary policy developments will have a major impact on the economy and financial markets.

With respect to fiscal policy there has been a great deal of talk about only a relatively small amount of the \$700 billion fiscal stimulus money having been spent. Those who believe that fiscal stimulus helps the economy suggest that this is why the economy has remained weak.

The focus on the \$700 billion number is misplaced. In the current fiscal year federal spending is estimated to be up by over a trillion dollars—a 34% increase. This is aside from whatever part of the stimulus may not have been spent. Spending more than a trillion dollars in one year represents massive fiscal stimulus. Those who believe fiscal stimulus is effective must revert to a claim that is impossible either to prove or disprove—that things would have been even worse if the government had not spent all this money.

Classical economists do not believe that fiscal stimulus helps the economy. Rather, we believe it makes things worse. Government doesn't have any money. The only way it gets money to spend is either to tax or borrow the money from those who earned it.

When government taxes or borrows money, it cannot be spent by those who give it up. Hence, every dollar government spends is offset by a dollar that is not spent by the private sector. When the federal government borrows an extra trillion dollars to “stimulate” spending, it takes credit that is no longer available to fund spending elsewhere in the economy. When financing is no longer available, businesses have to cut production and lay off workers.

Increases in government spending do more than simply offset a dollar of stimulus for a dollar of restraint. Since government tends to spend money less efficiently than private individuals, government spending tends to make the economy weaker, not stronger.

Monetary policy is the second major influence on the outlook. Since the Federal Reserve began operating in 1914, recessions and recoveries have almost always been associated with its policy moves. The three worst economic downturns since the establishment of the Fed occurred in 1929-33, 1937-38 and 2007-09. Prior to all three of these major recessions, the Federal Reserve made policy decisions that reduced bank reserves. In doing so, it produced a highly restrictive monetary policy.

In spite of the damaging impact of increases in government spending, a Fed policy that increases bank reserves can boost spending. Such a policy produced rapid increases in spending along with an economic recovery from 1933-37.

In the current cycle, the Fed began to increase bank reserves last September. The potentially expansive effect of this move was temporarily delayed when banks kept excess reserves at the Fed instead of using them for loans or investments.

Beginning in February, bank reserves increased even after allowing for the excess reserves that banks held at the Fed. Over the past five months, this increase in liquidity has contained the steep decline in business activity. Given the typical 6-9 month lead time, the Fed's policy should boost spending and initiate a cyclical recovery beginning this summer. Recent data suggest that the timing of such an upturn in spending is on schedule.

Monetary Indicators

Bank reserves continue to provide a unique insight into monetary developments. Bank reserves are the first step in the monetary process. The Fed initiates the money-creation process by purchasing assets. It pays for these assets by crediting banks with new deposits at the Fed. These deposits are known as bank reserves.

Under normal conditions, banks will keep a small portion of the newly created reserves with the Fed to meet reserve requirements. The rest are used for loans and investments. When banks loan and invest their excess reserves it initiates a multiple expansion of credit through the banking system. This multiple expansion of credit boosts the money supply and, eventually, boosts spending. When banks keep excess reserves with the Fed, it mutes the multiple expansion of credit and limits the amount of monetary stimulus.

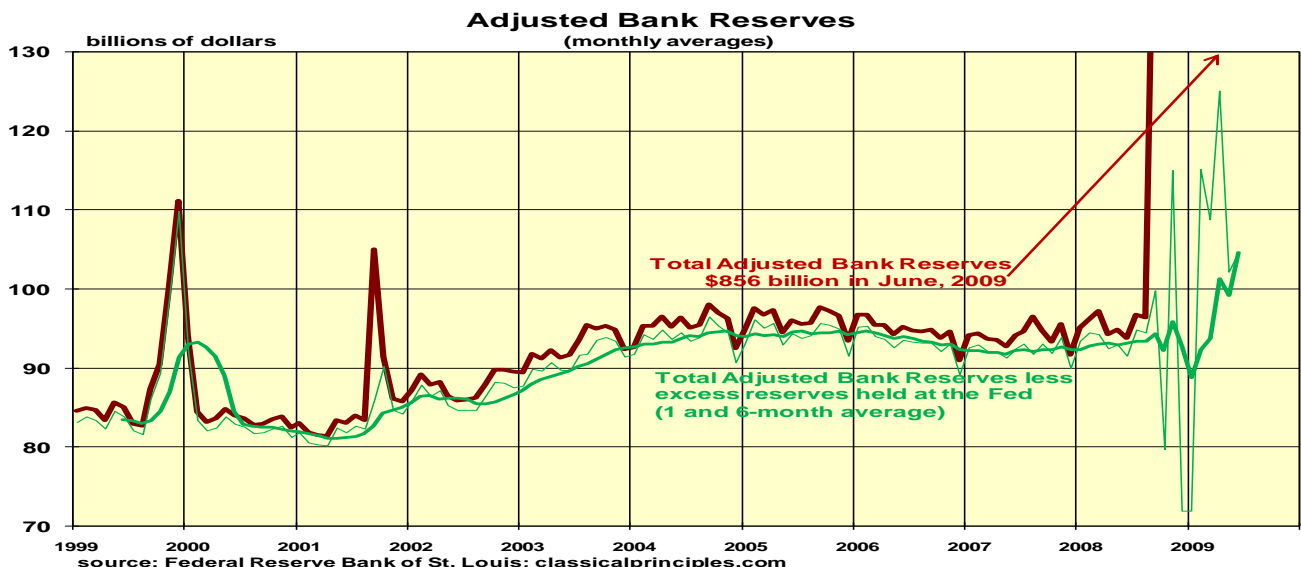
The light green line on chart below shows the St. Louis Fed monthly series of adjusted bank reserves *after* subtracting excess reserves that banks are keeping at the Fed. The bold line shows a six-month average. Beginning in February, there was an expansion in reserves even after allowing for the excess held at the

Fed. This is the basis for believing that liquidity began to improve beginning in February.

The upturn in stock prices that began in March and the easing of the downturn in recent months are consistent with an increase in liquidity.

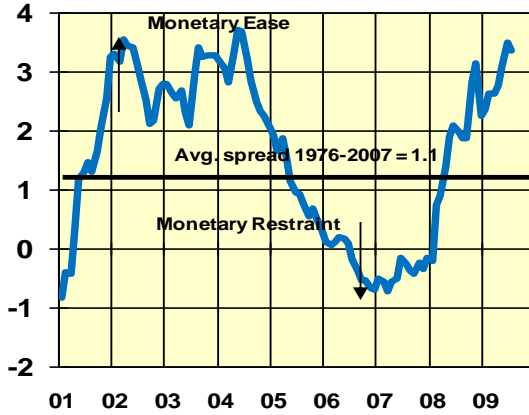
Although it is fairly clear that Fed policy has turned expansive in the months between February and June, the ongoing magnitude of monetary stimulus remains somewhat tentative. In setting policy, the Fed doesn't focus on bank reserves. Instead, it chooses a level for short-term interest rates and allows bank reserves to go wherever they end up going. This is why the behavior of bank reserves has been so erratic.

In addition to the monthly swings in bank reserves, banks are continually adjusting the amount excess reserves they hold at the Fed. In June, they reduced these excess reserves by \$93 billion. Without this reduction, monetary policy in June would have turned restrictive. While it's important to monitor the trend closely in the months ahead, for now it points to further gains in business activity in the months ahead.

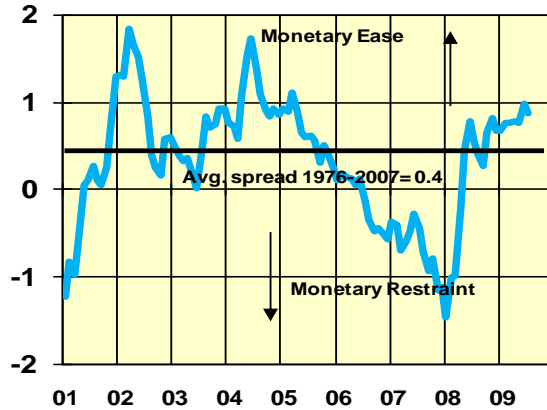


MONETARY INDICATORS

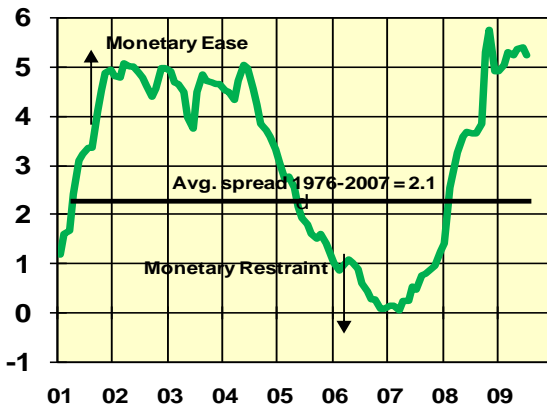
Yield Spread: 10yr-FF
(10-year T-bonds minus fed funds)



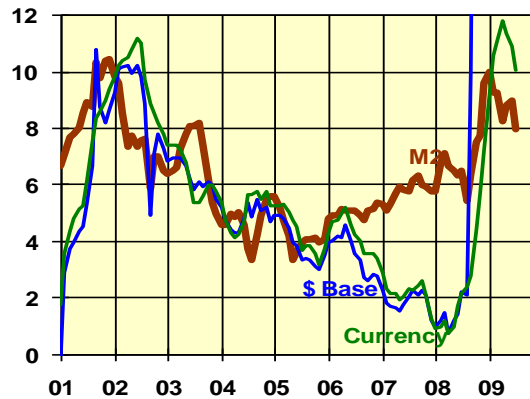
Yield Spread: 2yr-FF
(2-year T-Notes minus fed funds)



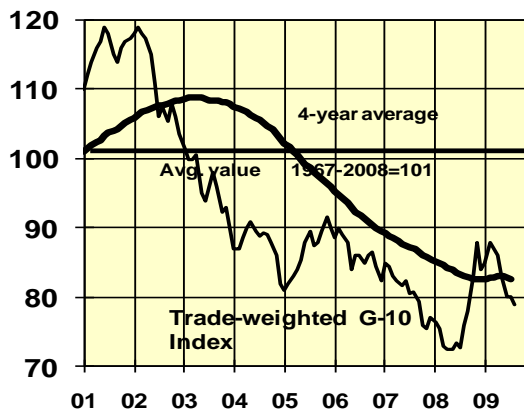
Yield Spread: AAA-FF
(AAA bonds minus fed funds)



M2 & \$ Base
(percent change year over year)



U.S. Dollar Index



Gold Prices
(dollars per ounce)

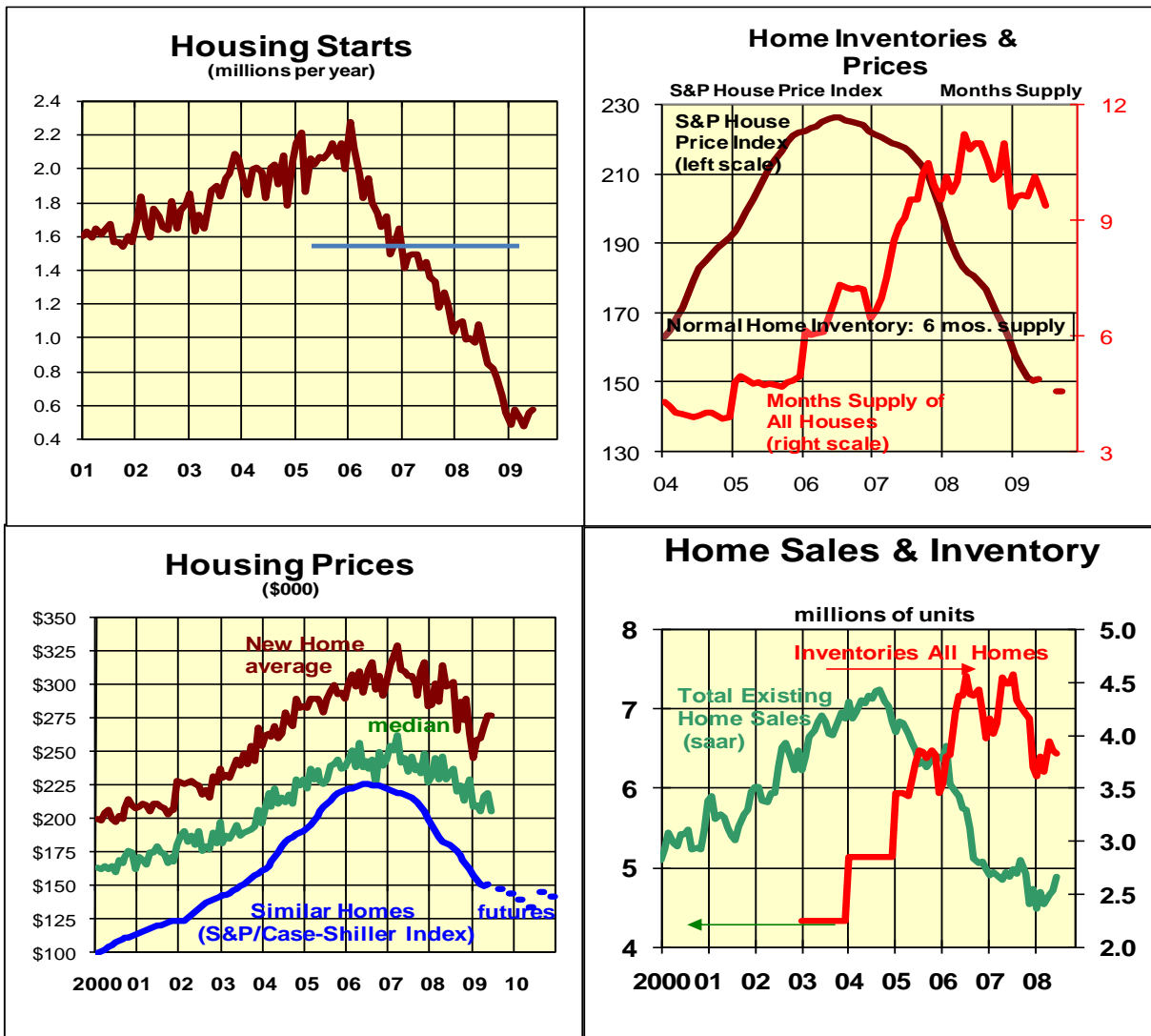


Sensitive Indicators

Housing activity tends to be the most sensitive of all leading indicators to a change in liquidity. As the charts below show, there has been a significant improvement in housing indicators. Housing sales are up since the beginning of the year and inventories are down substantially from their peak. The collapse in housing starts since 2007 has completely offset the prior speculative excess of homes. The current overhang of inventories is due to foreclosures associated with the recession. As the economy recovers, inventories should decline rapidly.

The sharp upturn in stock prices, raw material prices and the new orders component of the ISM surveys all suggest that an upturn in the economy is imminent.

The latest coincident indicators are also showing some improvement. The jump in auto sales in July along with a broad-based improvement in a various components of the ISM manufacturing survey provide further evidence of an upcoming positive move in business activity.



SENSITIVE INDICATORS

Raw Industrial Prices



Stock Prices

S&P 500



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



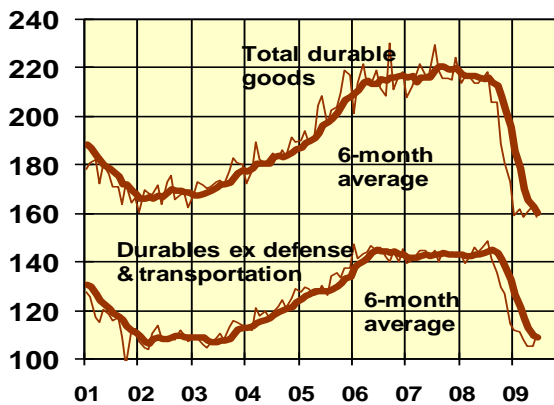
Unemployment Claims

(weekly claims)



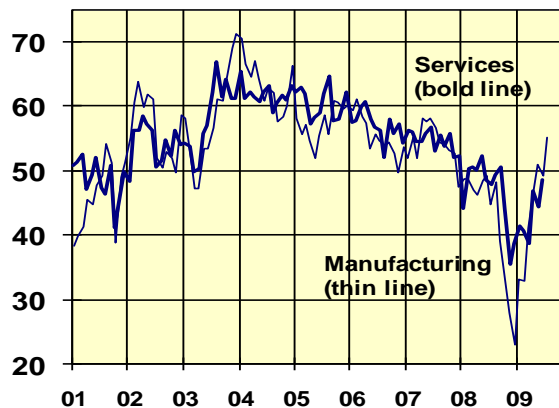
New Orders

(billions of dollars, saar)

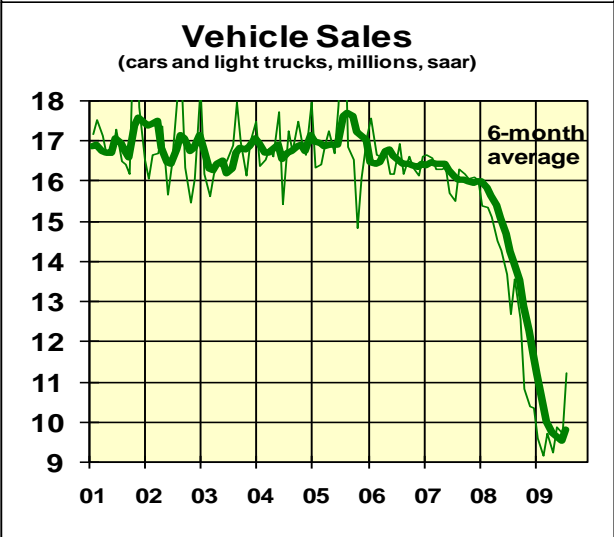
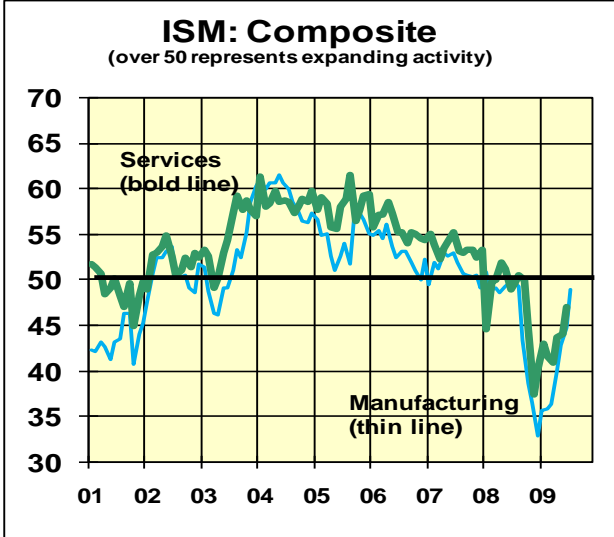
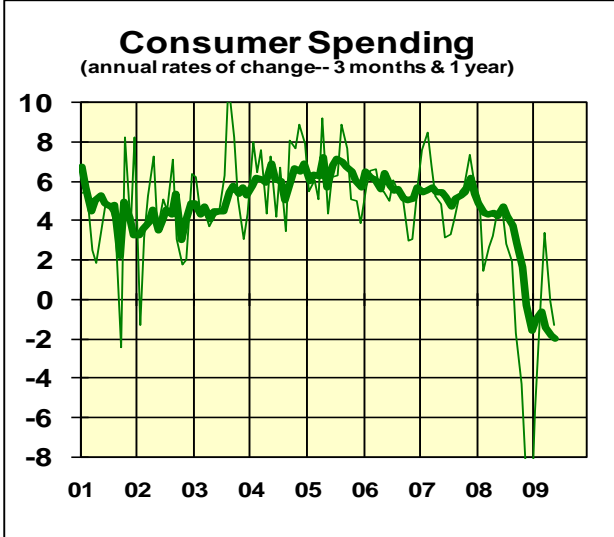
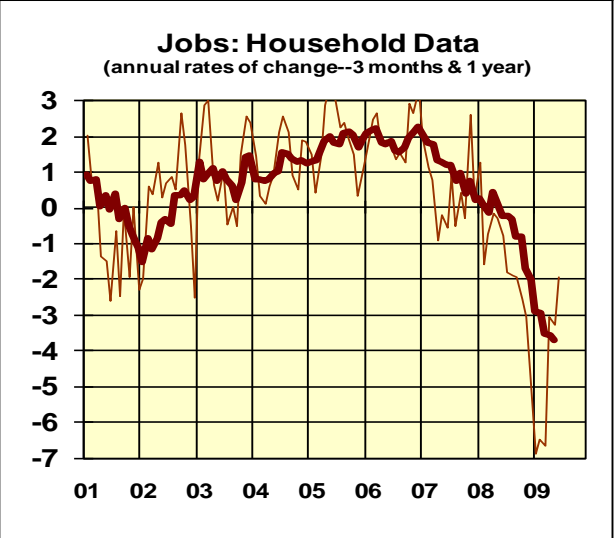


ISM: New Orders

(above 50 represents expanding activity)



ECONOMIC INDICATORS

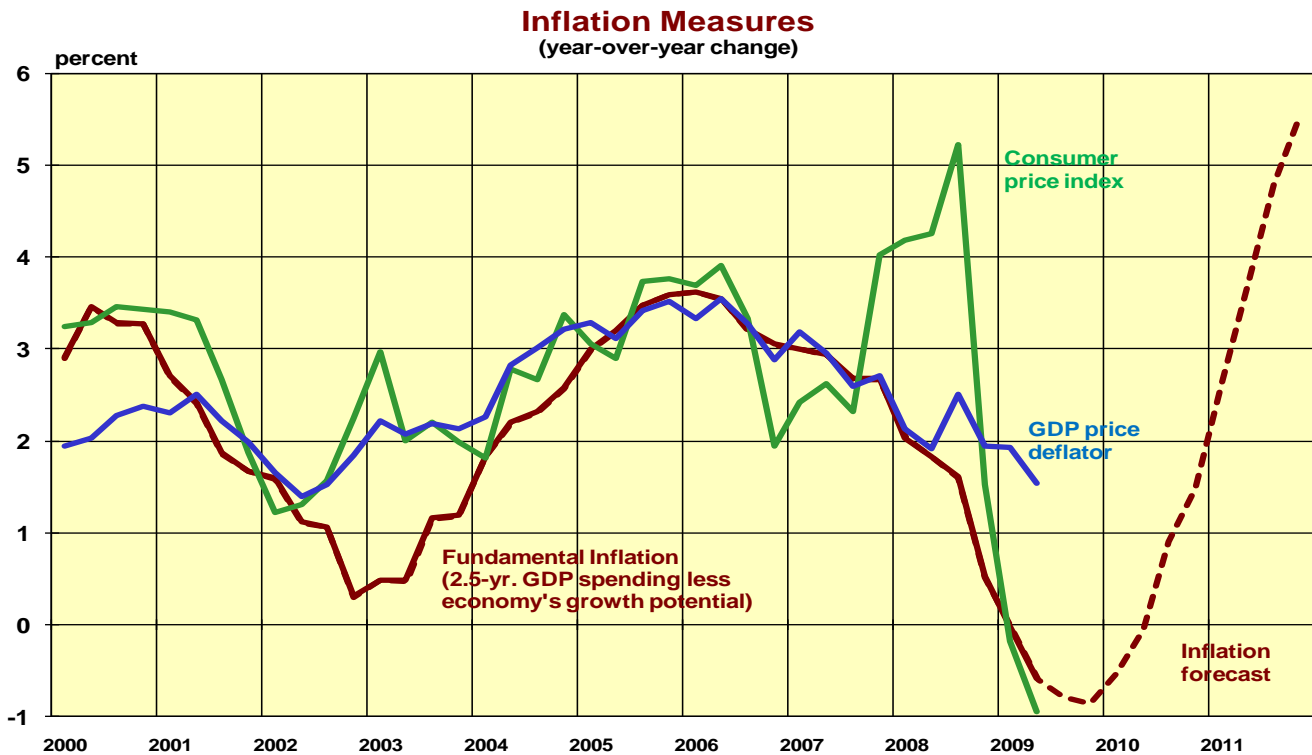


Inflation Indicators

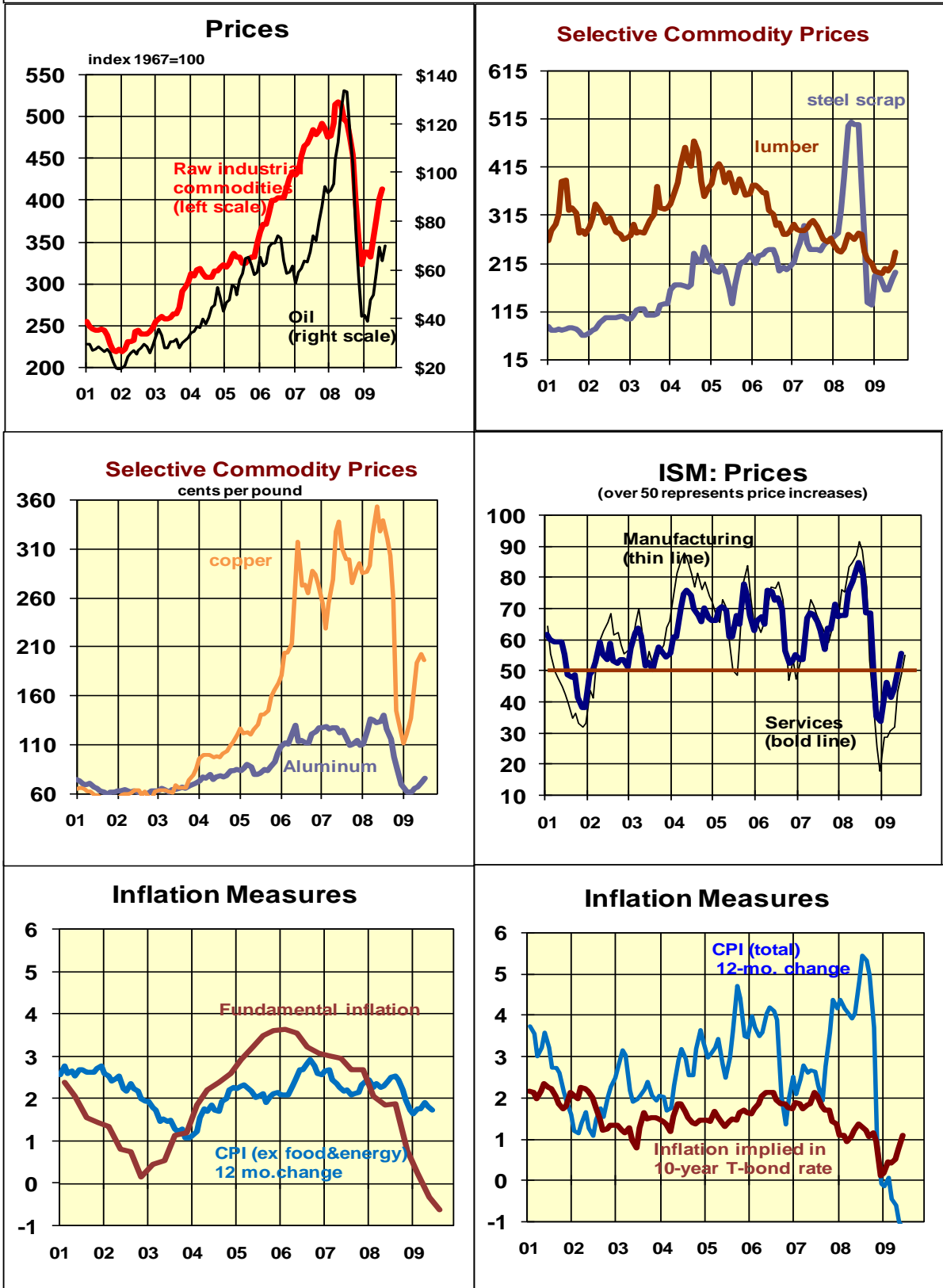
Dramatic changes in economic conditions have led to wide swings in various measures of inflation. These swings have made it difficult to assess underlying inflationary pressures.

The country's underlying inflation is determined by the rate of spending over a 2-3 year period minus the economy's underlying growth rate. Over the past 2½ years spending has averaged about 1½% at an annual rate. Subtracting an underlying growth rate of roughly 2½% yields an underlying inflation of close to *minus* 1%.

Sharp changes in business activity can produce dramatic short-term changes in prices. A month ago there were signs that certain sensitive commodity prices were weakening. This past month they are again advancing. Regardless of short-term moves, the recent weakness in spending suggests that the underlying inflationary trend will remain weak throughout this year. As spending recovers, the underlying inflationary trend will likely to move sharply higher.



INFLATION INDICATORS



Interest Rates

*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 in 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.*

A complex set of circumstances has recently made it more challenging to interpret monetary policy. On the surface, the explosive rise in bank reserves beginning last September should represent massive monetary stimulus. However, the behavior of banks and individuals can alter the magnitude of stimulus provided by bank reserves alone.

During the 1930s, banks and individuals chose to hold more currency relative to bank deposits. The increased demand for currency was the result of concerns over the safety of banks. Such action dampens the effect of bank reserves on the money supply since it mutes the multiple expansion of credit that occurs during more normal times.

The current situation is somewhat different from what occurred in the 1930s. Instead of banks building up cash in their vaults, they have chosen to hold significant amounts of excess reserves at the Federal Reserve. The Fed has encouraged banks to do this by paying them interest on those reserves. Although the interest rate is a relatively low 25 basis points, it's more than the nothing banks would earn if they simply kept the cash in their vaults.

Interestingly, none of the Federal Reserve officials discuss any of these factors. They either don't understand them or they believe they are not important. Instead they make the claim that their actions prevented a major collapse in the economy. As with the claim regarding fiscal stimulus, it is one that is impossible either to prove or disprove.

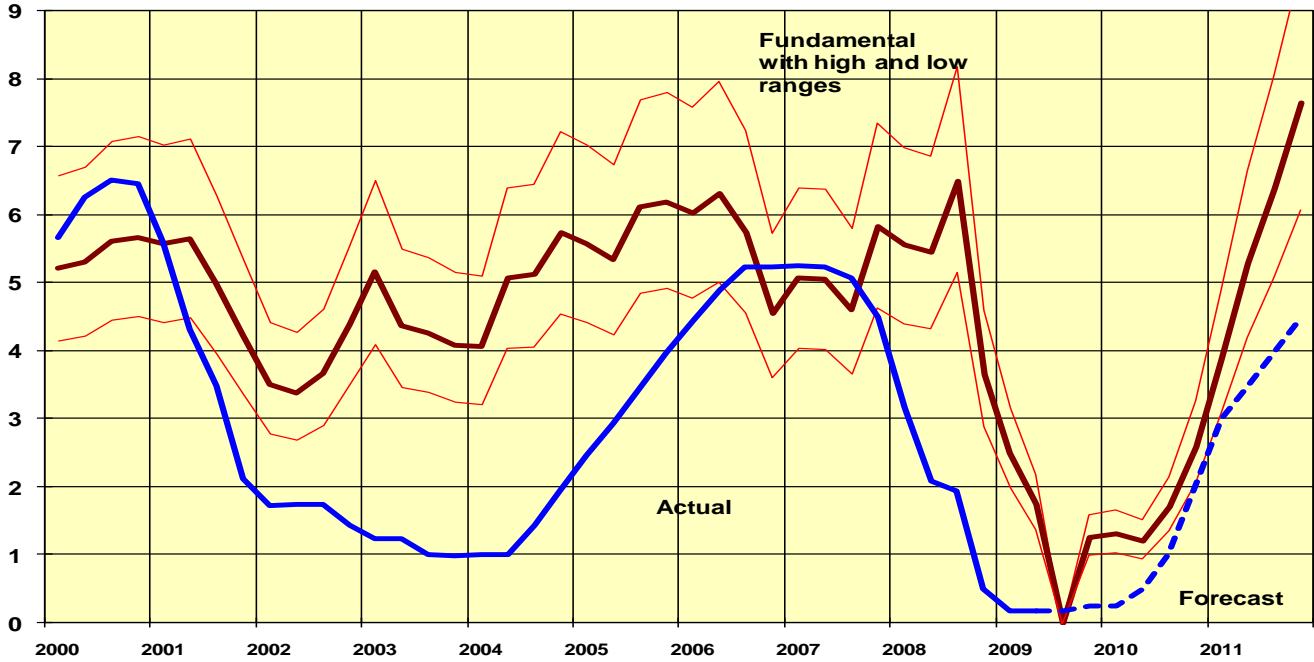
At the moment, all monetary indicators suggest that there has been an increase in liquidity in the economy. So long as this continues to be the case we are likely to see a significant rebound in spending in the year ahead.

As the recovery takes hold, there will be an increase in the demand for credit by businesses. Also, banks are likely to draw down their excess reserves at the Fed. All of this creates the potential for an explosive increase in spending.

Given the Fed's focus on interest rates, it's unlikely that they will raise the fed funds rate quickly enough to avoid the type of rapid increases in spending that will boost inflation.

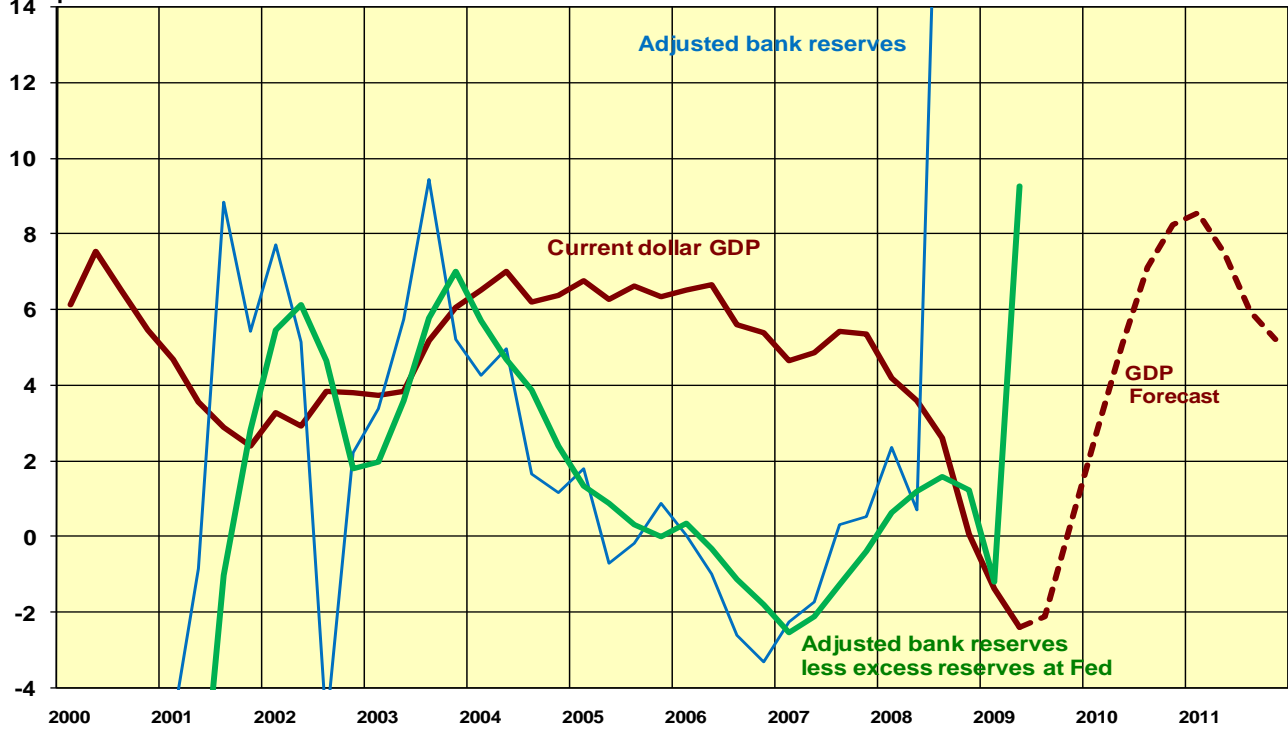
Fed Funds Rate

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



Current Dollar Spending (GDP) & Adjusted Bank Reserves

(year-over-year % change)



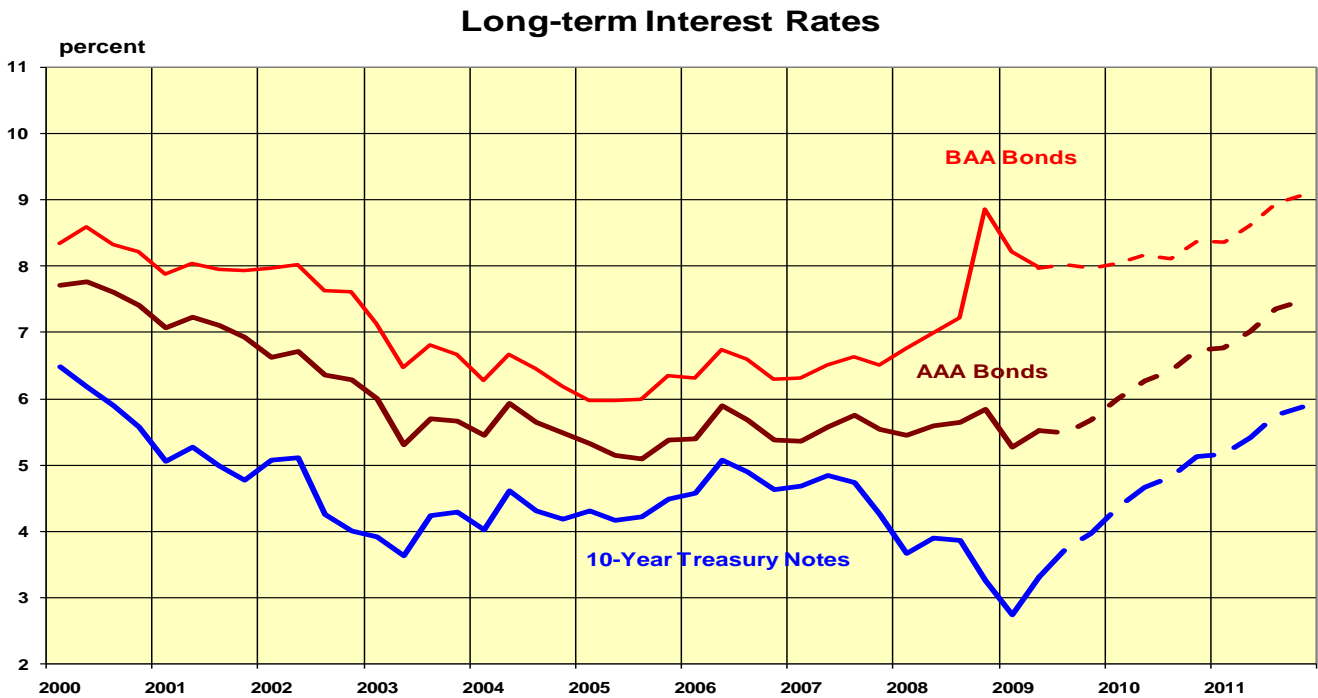
LONG-TERM INTEREST RATES

Long-term interest rates have remained remarkably stable for an extended period of time. Rates on Moody's AAA corporate bonds have now moved between 5%-6% for the past 6½ years.

The greater volatility in rates on long-term Treasury bonds and lower quality bonds reflects shifts in investor assessments of risks. Investors' perception of risks increased dramatically last year. This led to a flight away from lower quality bonds and into Treasury securities. A recent shift out of Treasuries and back into lower quality bonds reflects perceptions that risks have declined substantially.

The timing of the decline in risk is consistent with the increase in bank reserves (after allowing for the excess reserves held at the Fed). So long as these reserves continue to expand, perceptions regarding risk should continue to decline.

There is as yet no evidence that investors are demanding higher interest rates to compensate for a potential increase in inflation. However, as spending recovers in the year ahead, investors will become progressively more concerned over inflation. As this happens, all interest rates are likely to head higher.



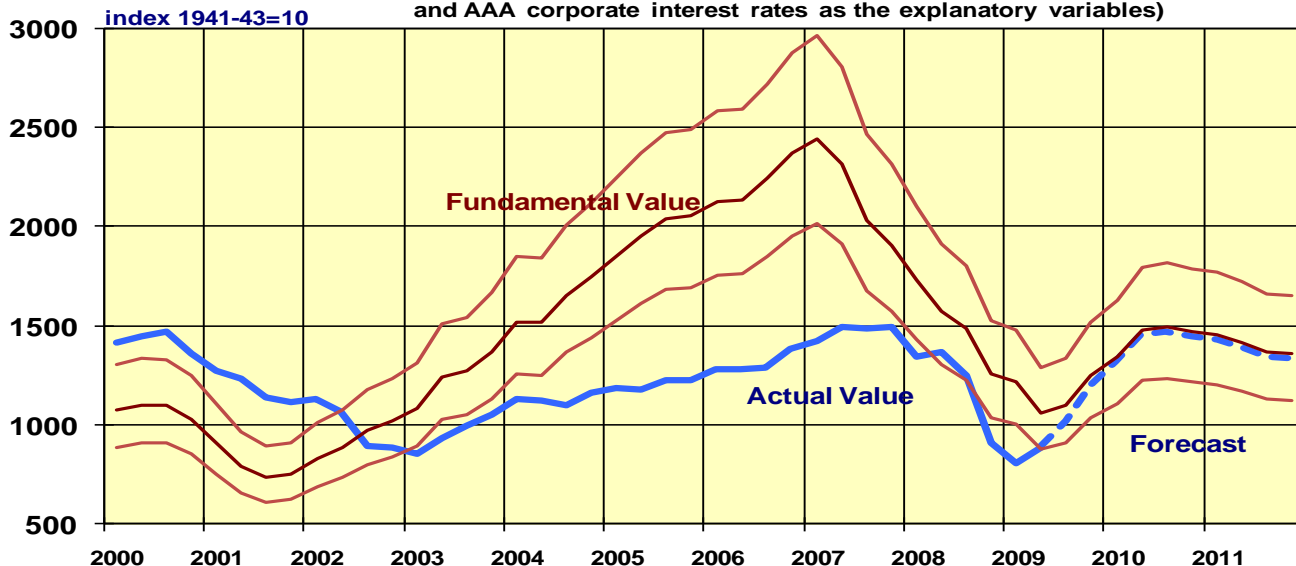
STOCK PRICES

Stock prices are subject to the uncertainties related to the Fed's monetary policy. The liquidity crunch of the past year that produced both a collapse in stock prices and the economy was due to serious monetary policy

mistakes. So long as there are sufficient bank reserves for new loans and investments, business activity will continue expand, profits will recover and the stock market will continue its cyclical recovery.

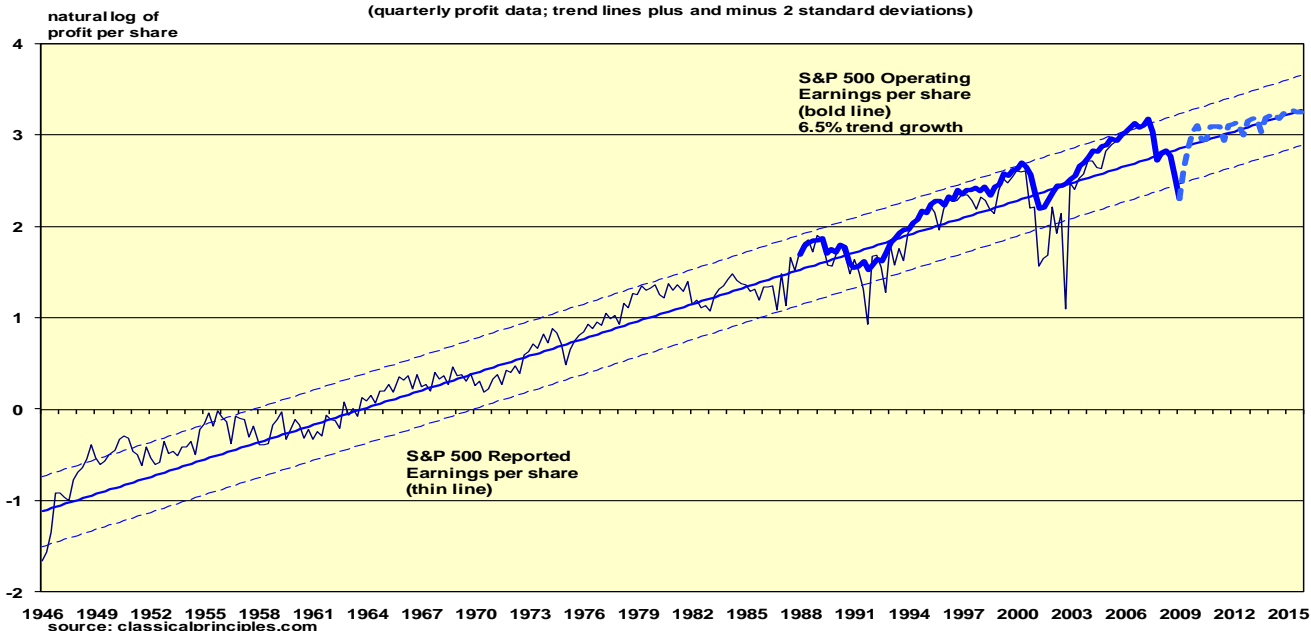
Stock Prices: S&P 500

(Fundamental value of stocks is based on a regression with S&P operating earnings and AAA corporate interest rates as the explanatory variables)



S&P 500 Profit Trend

(quarterly profit data; trend lines plus and minus 2 standard deviations)



source: classicalprinciples.com

8/4/2009

	<u>Actual</u>			<u>Forecast</u>					<u>YEARS</u>				
	2008 IV	2009 I	2009 II	2009 III	2009 IV	2010 I	2010 II	2010 III	2007	2008	2009	2010	2011
GROSS DOMESTIC PRODUCT	14347	14178	14150	14274	14457	14676	15013	15410	14078	14441	14265	15214	16351
%ch	-5.4	-4.6	-0.8	3.6	5.2	6.2	9.5	11.0	5.1	2.6	-1.2	6.7	7.5
REAL GDP	13142	12925	12892	13014	13192	13392	13670	13970	13254	13312	13006	13809	14340
%ch	-5.4	-6.4	-1.0	3.8	5.6	6.2	8.6	9.1	2.1	0.4	-2.3	6.2	3.8
CHAIN PRICE INDEX	1.092	1.097	1.097	1.096	1.096	1.095	1.098	1.103	1.062	1.085	1.096	1.102	1.141
%ch	0.1	1.9	0.2	-0.3	-0.3	0.0	1.0	1.9	2.9	2.1	1.1	0.5	3.6
CPI- ALL URBAN%ch	-8.3	-2.4	1.3	-0.6	-0.6	0.0	0.1	2.1	2.9	3.8	-1.1	0.3	3.7
FUND. INFLATION%ch	0.5	0.0	-0.6	-0.8	-0.8	-0.5	0.0	0.9	3.1	2.3	0.4	-0.5	2.2
PRETAX PROFITS	1060	1247	1253	1326	1363	1414	1483	1486	1774.4	1462.8	1297.0	1469.2	1512.4
%ch	-79.6	91.2	2.0	25.6	11.5	15.9	20.9	0.8	-2.7	-17.6	-11.3	13.3	2.9
PRETAX PROFITS ADJ (1)	1124	1183	1252	1294	1347	1390	1463	1464	1541.7	1360.4	1269.0	1447.4	1491.0
%ch	-64.4	22.8	25.8	14.0	17.2	13.5	22.6	0.3	-4.1	-11.8	-6.7	14.1	3.0
AFTER-TAX PROFITS	837	976	982	1050	1074	1111	1168	1171	1323	1171	1021	1157	1191
%ch	-81.3	85.2	2.6	30.6	9.5	14.3	22.1	1.1	-2.0	-11.5	-12.8	13.3	3.0
AFTER-TAX PROFITS ADJ(1)	900	912	982	1018	1058	1087	1148	1149	1090.2	1068.2	992.8	1134.9	1169.5
%ch	-62.4	5.5	34.3	15.5	16.7	11.3	24.3	0.4	-4.0	-2.0	-7.1	14.3	3.0
PERSONAL INCOME	12233	11982	12180	12287	12445	12633	12923	13264	11894	12239	12223	13096	14075
%ch	-1.7	-8.0	6.8	3.6	5.2	6.2	9.5	11.0	5.6	2.9	-0.1	7.1	7.5
REAL DISPOSABLE INCOME	9921	9948	9080	9172	9304	9445	9661	9869	9861	9911	9376	9751	10121
%ch	3.4	1.1	-30.6	4.1	5.9	6.2	9.5	8.9	2.2	0.5	-5.4	4.0	3.8
PRODUCTIVITY	1.415	1.421	1.425	1.432	1.441	1.450	1.460	1.470	1.371	1.409	1.430	1.465	1.490
%ch	-0.6	1.6	1.2	2.1	2.4	2.4	2.8	2.9	1.4	2.8	1.5	2.4	1.7
CIVILIAN EMPLOYMENT	144.0	141.6	140.6	140.2	140.4	140.7	141.0	141.3	146.0	145.4	140.7	141.2	141.5
%ch	-3.4	-6.7	-2.8	-1.0	0.5	0.7	0.9	1.0	1.1	-0.5	-3.2	0.3	0.2
UNEMPLOYMENT RATE	6.9	8.1	9.3	9.3	9.1	8.6	8.4	8.1	4.6	5.8	8.9	8.2	7.9
INDUSTRIAL PRODUCTION	1.045	0.991	0.960	0.974	0.997	1.023	1.053	1.086	1.113	1.088	0.981	1.068	1.090
%ch	-12.9	-19.1	-11.7	5.9	9.7	11.0	12.0	13.3	1.5	-2.2	-9.9	8.9	2.1
LIGHT VEHICLE SALES (2)	10.5	9.5	9.6	11.3	10.8	11.7	12.6	12.8	16.2	13.2	10.3	12.5	12.7
Domestic	5.4	4.8	4.9	6.2	5.6	6.1	6.8	6.9	7.6	6.8	5.4	6.7	6.8
Imports	5.1	4.7	4.7	5.1	5.3	5.6	5.8	5.9	8.6	6.5	4.9	5.8	5.9

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

(2) Millions at seasonally adjusted annual rates

8/4/2009

	Actual			Forecast					Years					
	2008	2009	2009	2009	2009	2010	2010	2010	2006	2007	2008	2009	2010	2011
Monetary Aggregates quarterly:	IV	I	II	III	IV	I	II	III						
M2 %ch at annual rates	15.1	13.5	2.6	4.0	8.0	8.0	7.0	7.0	5.0	5.8	6.9	9.0	8.5	6.3
Adj. Bank Reserves (billions of \$)	626	827	913	900	900	900	700	500	95	94	234	885	600	275
less excess reserves at Fed	94	92	102	105	110	113	116	125	94	92	93	102	120	130
Interest Rates:														
Baa Corp Bonds: Moody's	8.85	8.21	7.98	8.03	7.98	8.06	8.17	8.12	6.48	6.48	7.45	8.00	8.18	7.15
Aaa Corp Bonds: Moody's	5.84	5.27	5.51	5.48	5.68	6.01	6.27	6.42	5.59	5.56	5.64	5.56	6.36	7.15
MORTGAGE RATES	5.87	5.06	5.03	5.63	5.98	6.36	6.67	6.82	6.41	6.34	6.04	5.43	6.74	7.55
10-YR GOVT SECURITIES	3.25	2.74	3.31	3.73	3.98	4.36	4.67	4.82	4.79	4.63	3.67	3.44	4.74	5.55
5-YR GOVT SECURITIES	2.18	1.76	2.23	2.33	2.61	3.05	3.46	3.81	4.75	4.43	2.80	2.24	3.71	4.70
2-YR GOVT SECURITIES	1.21	0.91	1.01	0.93	1.25	1.75	2.25	2.80	4.82	4.36	2.00	1.03	2.68	3.85
3-MONTH T-BILL	0.39	0.23	0.18	0.18	0.25	0.25	0.50	1.00	4.72	4.41	1.46	0.21	0.94	3.75
FEDERAL FUNDS RATE	0.51	0.18	0.18	0.18	0.25	0.25	0.50	1.00	4.96	5.02	1.93	0.20	0.94	3.75
3-MONTH LIBOR RATE	2.72	1.24	0.85	1.18	1.25	1.25	1.50	2.00	5.19	5.30	2.91	1.13	1.94	4.75
BOND EQUIVALENT RATES:														
FEDERAL FUNDS	0.51	0.18	0.18	0.18	0.25	0.25	0.50	1.01	5.09	5.15	1.95	0.20	0.94	3.82
3-MONTH LIBOR	2.76	1.25	0.85	1.19	1.26	1.26	1.51	2.02	5.33	5.44	2.95	1.14	1.96	4.87
3-MONTH T-BILL	0.40	0.23	0.18	0.18	0.25	0.25	0.51	1.02	4.85	4.52	1.49	0.21	0.95	3.84
STOCKS:														
S&P 500	910	809	892	1185	1489	1750	1958	1981	1311	1477	1221	1094	1910	1867
S&P 500 quarterly reported earnings*	-93.0	30.1	54.5	42.5	57.9	59.5	62.8	62.9	81.5	66.2	14.9	46.2	62.1	64.0
S&P 500 p/e on reported earnings**	-9.8	26.9	16.4	27.9	25.7	29.4	31.2	31.5	16.1	26.5	17.7	24.2	30.7	29.2
S&P 500 quarterly operating earnings	-0.4	40.4	49.6	56.5	70.5	84.0	90.1	89.7	87.7	82.5	49.5	54.3	85.2	85.5
S&P 500 p/e on operating earnings**	NM	20.0	18.0	21.0	21.1	20.8	21.7	22.1	14.9	17.9	24.7	20.2	22.4	21.8
S&P 500 underlying earnings***	68.4	69.5	70.6	71.7	72.8	74.0	75.2	76.4	58.9	62.7	66.8	71.1	75.8	80.7
S&P 500 p/e on underlying earnings***	13.3	11.6	12.6	16.5	20.4	23.7	26.0	25.9	22.3	23.5	18.3	15.3	25.2	23.2

Second quarter 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

MN means the number is not meaningful (which tends to apply to most money numbers given the Fed's current operational approach)