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January 5, 2012

## Monthly Economic and Financial Update

Major headwinds continue to impact the economy. The potential for significant weakness in Europe and China along with destructive regulatory policies in the US have prevented a strong recovery.

However, even in the midst of the Great Depression, pouring money into the economy produced major gains in real growth and jobs. This is what happened from 1933 to 1937. In the midst of the Great Depression spending and growth averaged increases of roughly 10% a year. The unemployment rate went from 25% in 1933 to 14% in 1937. The turnaround occurred when Fed policy turned from highly restrictive to highly expansive.

Hence, Fed policy can create what appears to be a recovery in spite of serious negative forces. This past year the Fed increased bank reserves by more than 20%. This compares to an average annual increase of only 6% the prior

two years. So far problems in the banking system have muted the impact this policy has had on the pace of spending.

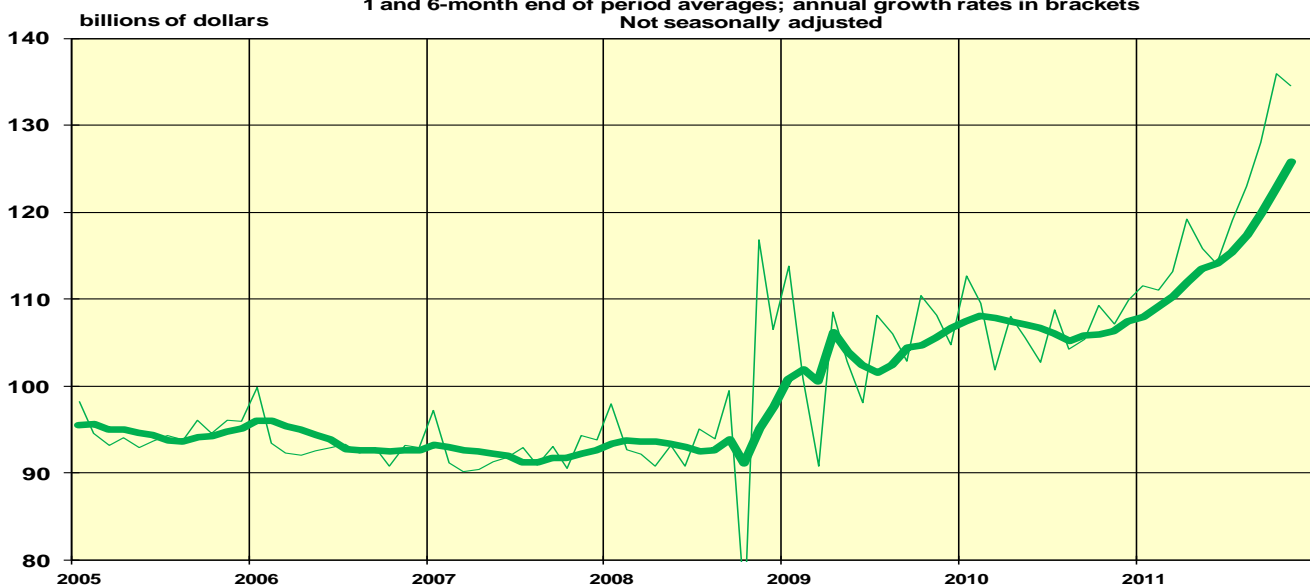
In recent months there have been tentative signs the banking sector is improving. If so, it's likely we'll soon see the impact of this substantial increase in bank reserves.

These signs may already be appearing in some of the more sensitive indicators. There has been a substantial reduction in housing inventories which increases the likelihood housing activity begin to recover this year.

In addition, a number of other sensitive indicators are showing signs of improvement. I expect these signs to continue. If they do, it raises the odds the economy will experience a faster pace of growth in the year ahead.

### Adjusted Bank Reserves less Excess Reserve

1 and 6-month end of period averages; annual growth rates in brackets  
Not seasonally adjusted



Source: Federal Reserve Bank of St. Louis; classicalprinciples.com; October 2011 estimate from partial data.

## Monetary Indicators

While monetary indicators remain somewhat mixed, they are tilting progressively more in the direction of stimulus.

Bank reserves, which are the raw ingredients of the money supply, have increased by more than 20% over the past year. Under normal conditions, an increase in bank reserves will work its way through the banking system and produce an increase in the money supply.

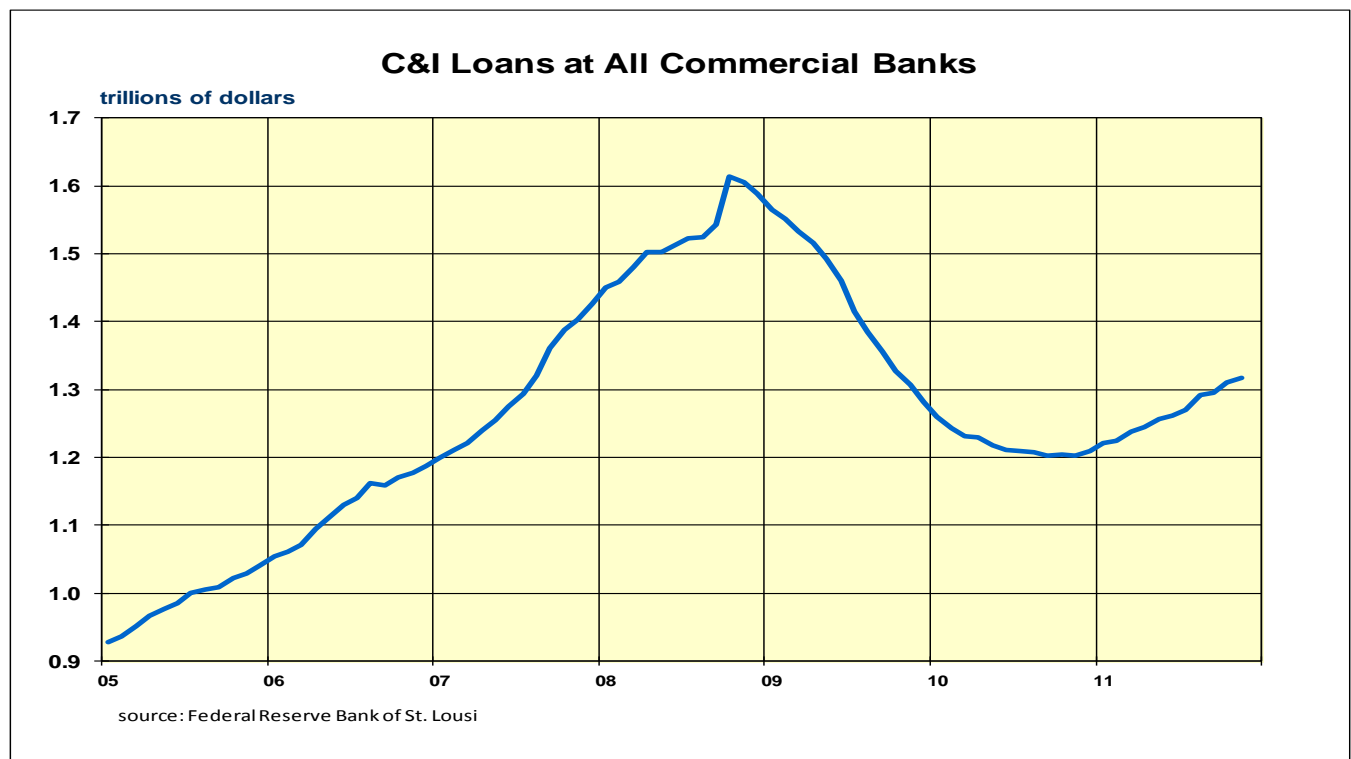
So far, the increase in bank reserves has lifted other monetary aggregates. M2 is up 10% and currency 9% this past year. The next step is for these increases to work their way into an increase in spending.

Through November, there was no evidence monetary stimulus had affected the pace of spending. Current dollar consumer spending was up less than a 4% annual rate in both the 3 and 6-month periods ending in November.

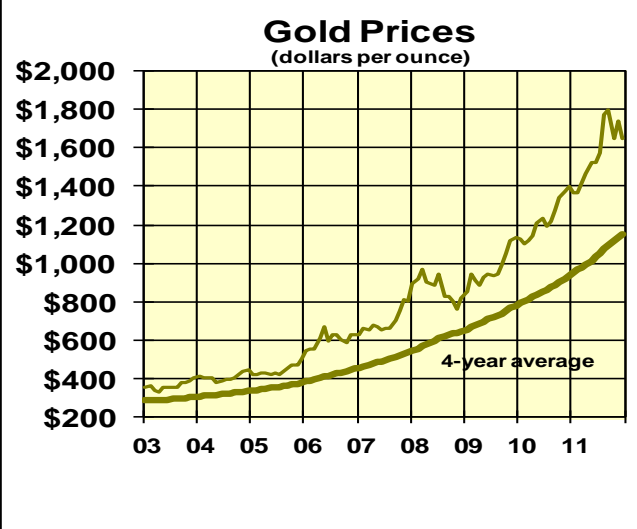
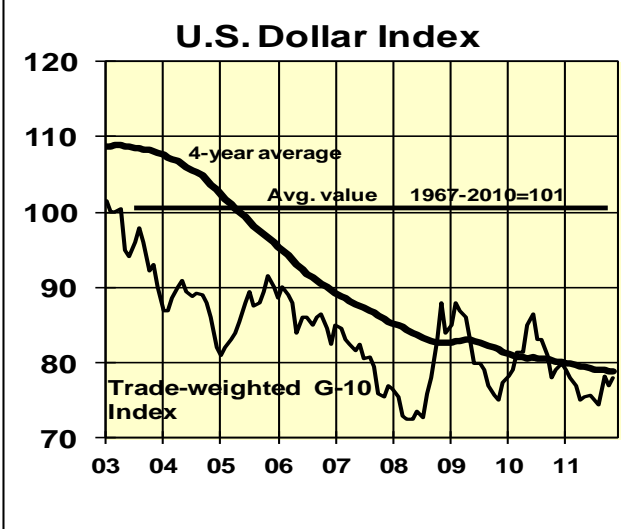
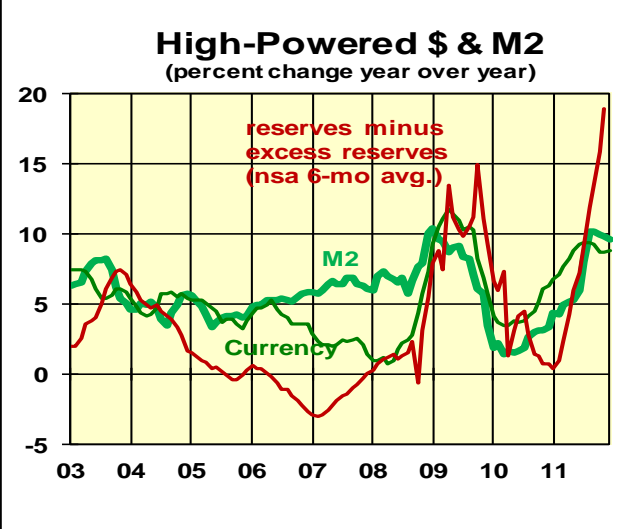
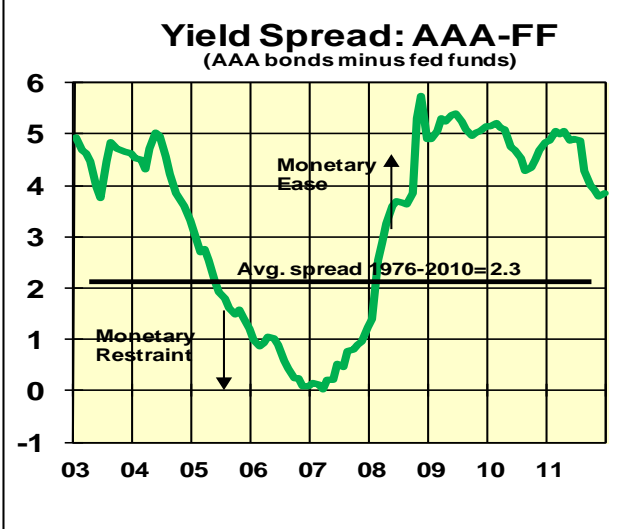
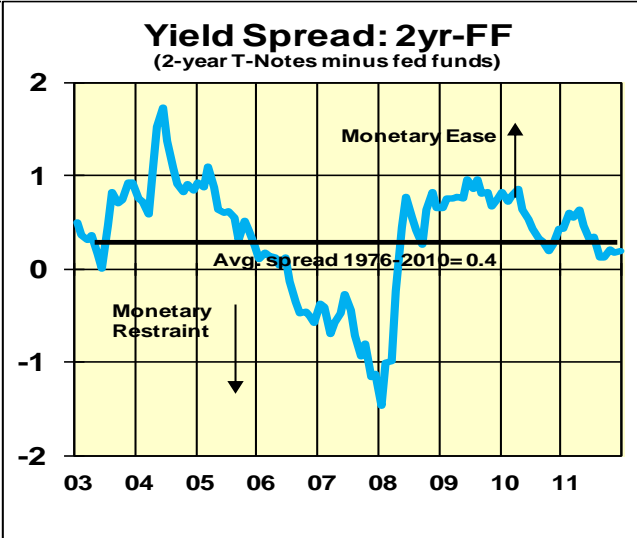
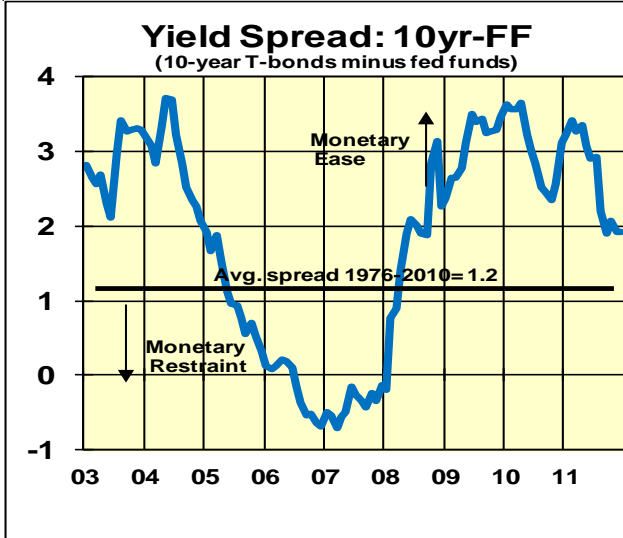
Institutional changes, such as the deleveraging of the banking system, have so far dampened the impact of money on spending. Even so, the combination of a substantial increase in money and signs of a pickup in bank loans raises the odds of a pickup in spending.

The acceleration in bank reserves over the past six months appears to be impacting banks. In the 6 months ending November, bank loans have increased at a 10% annual rate, while for loans and investments the rate is 5%.

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. While sensitive indicators remain mixed, they too are tilting in a more positive direction.



# MONETARY INDICATORS



## Sensitive Indicators

There is some evidence sensitive indicators are beginning to respond to the sharp increase in bank reserves. New orders for durable goods have been particularly strong. However, some of the strength may be due to more favorable tax depreciation terms in 2010.

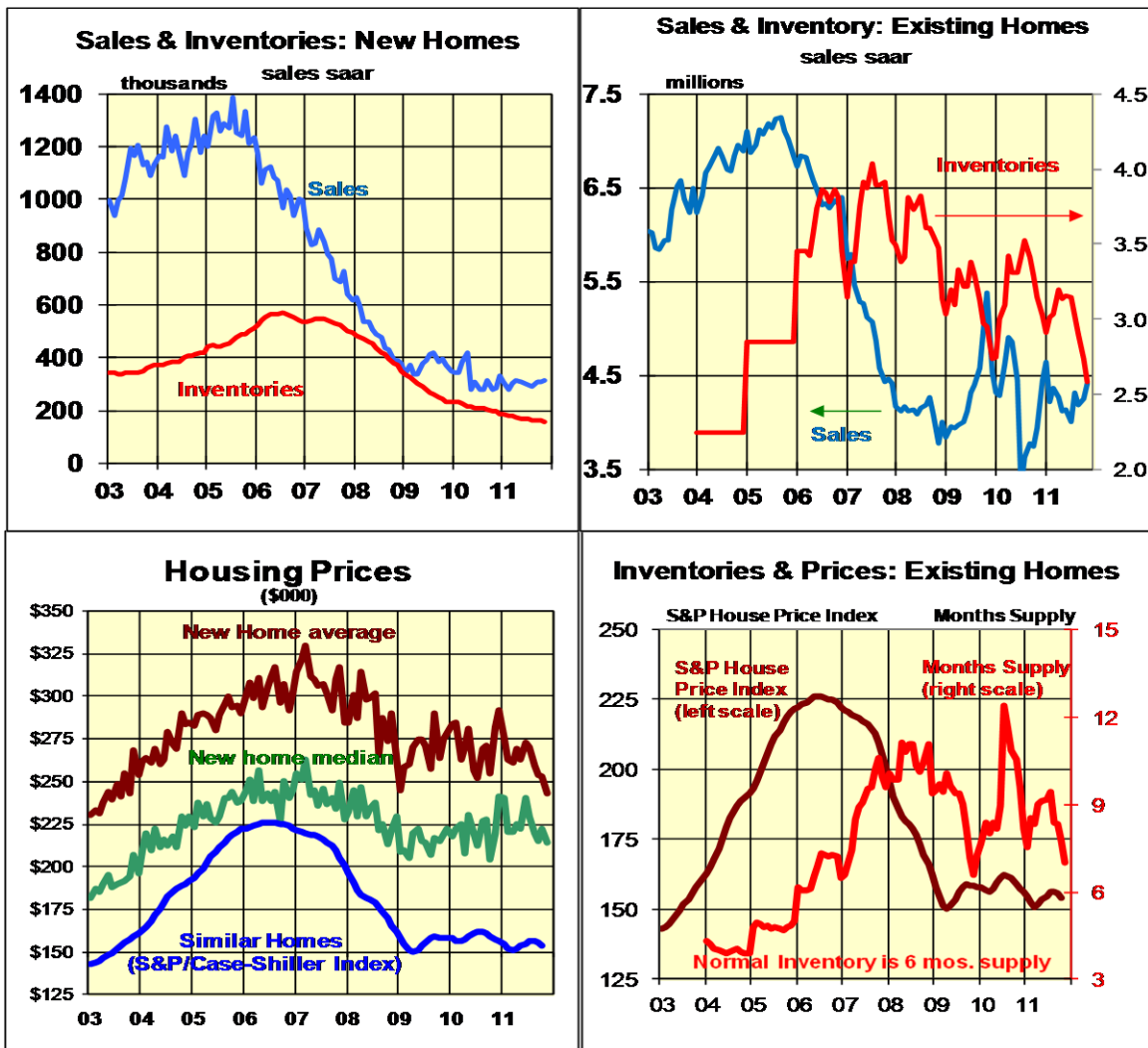
The ISM survey of manufacturers improved significantly in November and December, with the new orders component at a strong 57. The survey for service companies also improved, but only slightly.

Housing activity is also encouraging. Inventories of existing homes have declined to

pre-boom levels. After Lower inventories this year should lead to the first increase in home prices in three years.

Initial unemployment claims and stock prices also registered a fairly significant improvement in December. Other sensitive indicators such as commodity prices and new orders for semiconductors have not been as positive.

So far, the evidence regarding an increase in monetary stimulus remains tentative. However, the most recent signs have turned progressively more positive.



# SENSITIVE INDICATORS

**Raw Industrial Prices**



**Stock Prices**

S&P 500



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



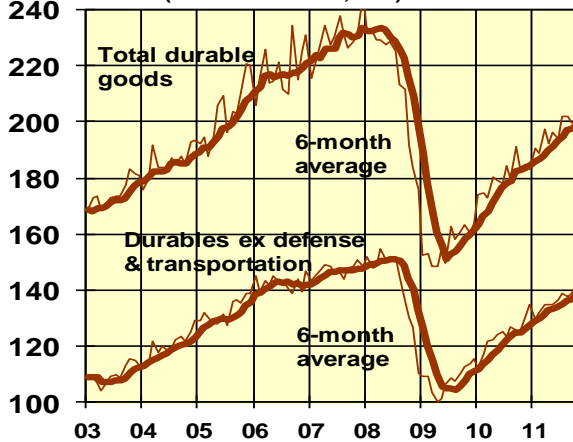
**Unemployment Claims**

(weekly claims)



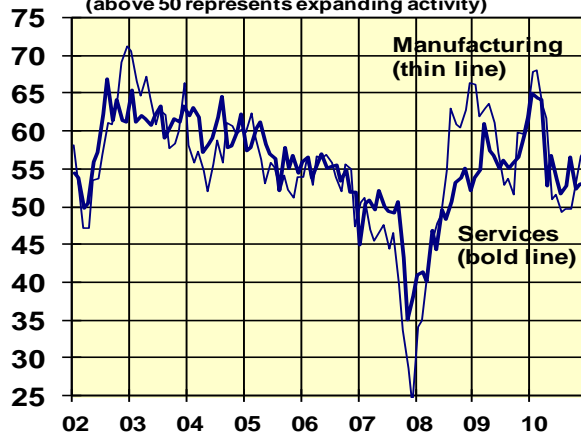
**New Orders**

(billions of dollars, saar)



**ISM: New Orders**

(above 50 represents expanding activity)

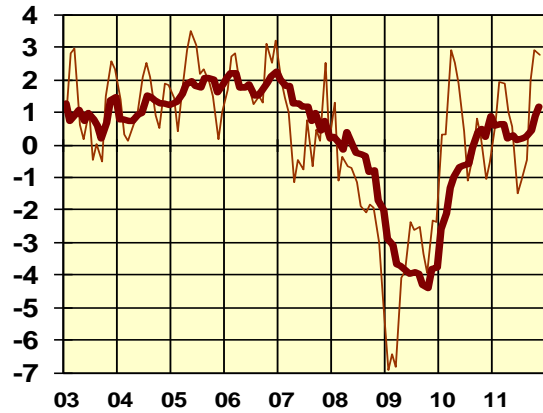


# ECONOMIC INDICATORS

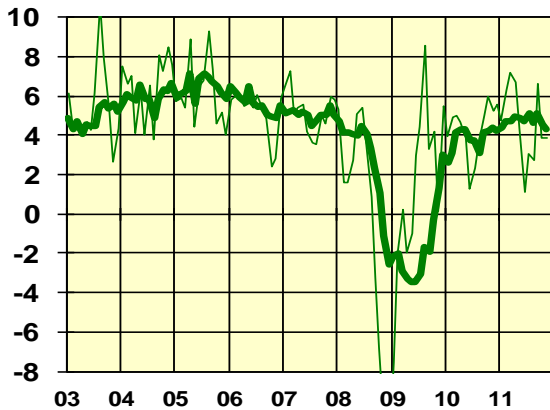
**Jobs: Payroll Data**  
(year over year percent change)



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



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



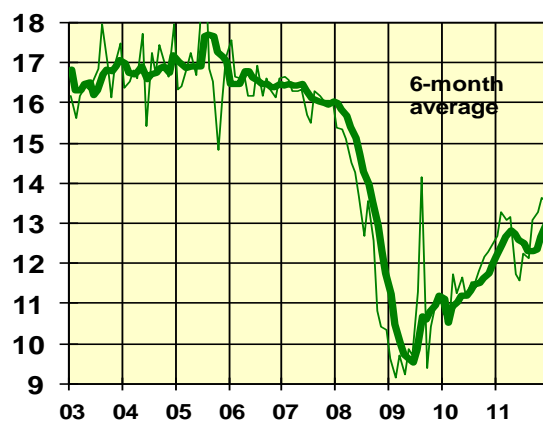
**Real Consumer Spending**  
(annual rates of change-- 3 months & 1 year)



**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, commodity prices have fallen and most show essentially no increase over the past year.

While commodity prices often lead inflation, they can also provide misleading signals as they did this past year. 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.

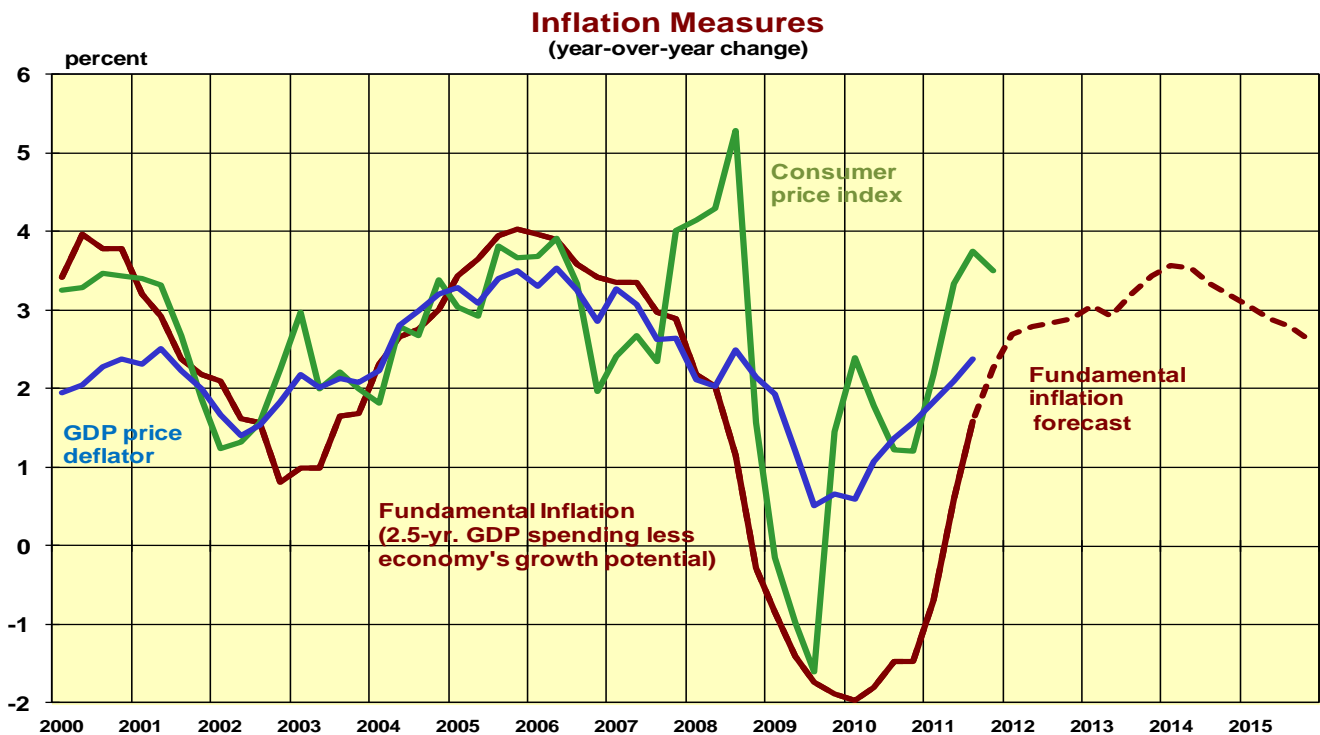
Over the past 2½ years, current dollar GDP has increased at just over a 4% annual rate. Given the mass of new regulatory burdens, the economy's potential growth is likely close to

only 2% a year. Hence, current dollar spending exceeds potential by just over 2%. This is the current underlying inflation rate. It is the rate inflation tends to gravitate towards.

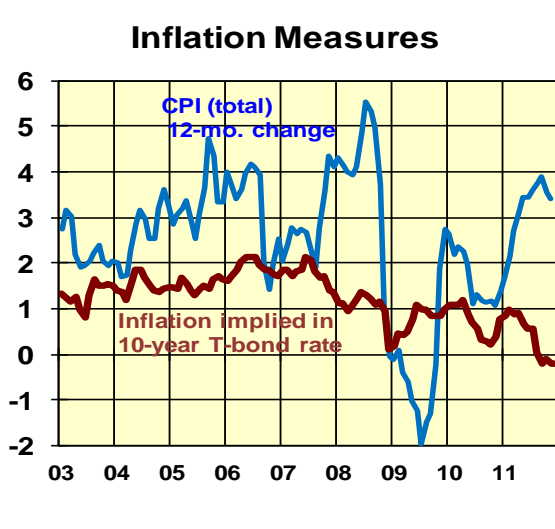
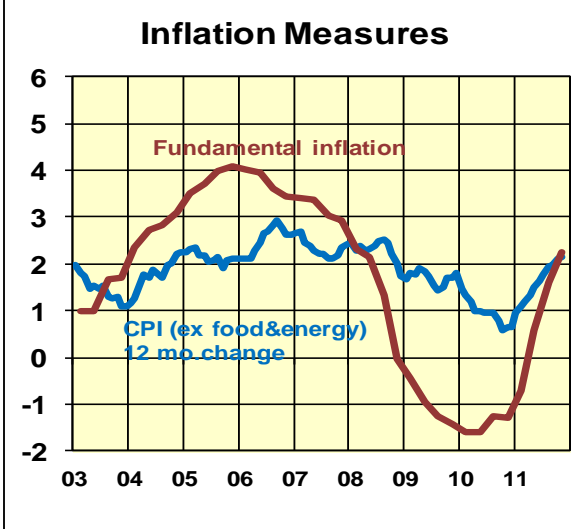
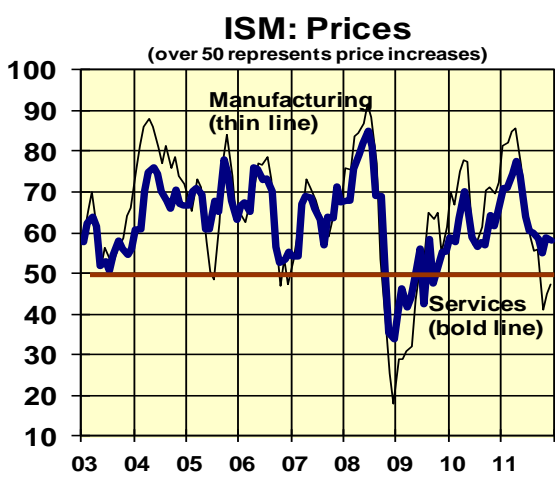
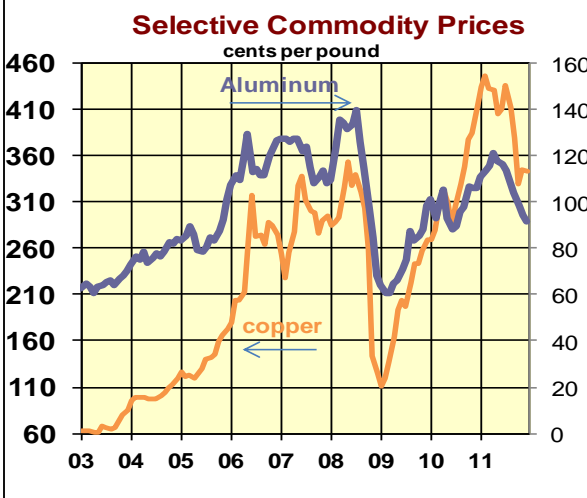
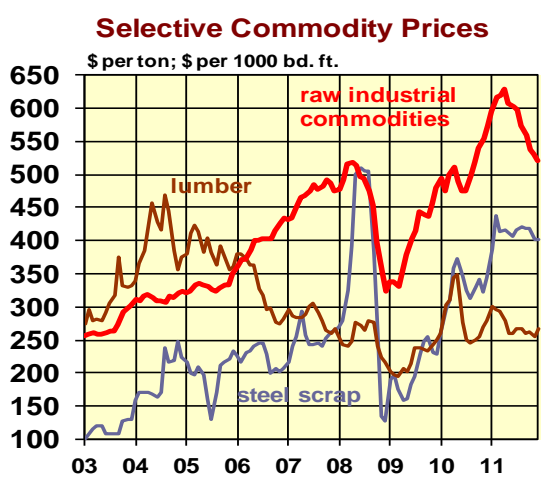
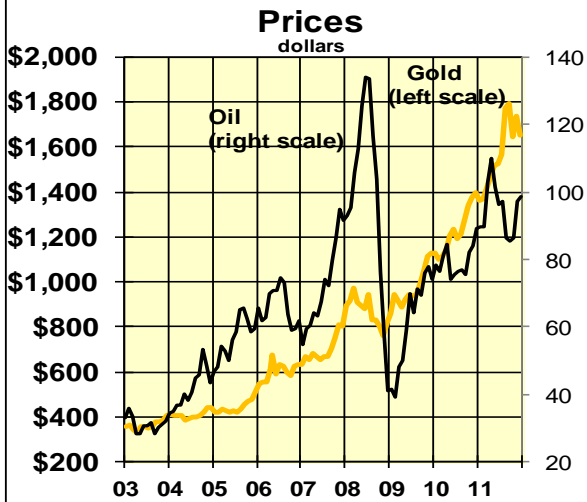
My forecast is for current dollar spending to increase by roughly 6% this coming year. If it does, the 2½-year pace of GDP would be close to 5% by the end of 2012. Subtracting 2% for potential growth points to an underlying inflation rate of roughly 3%

Beyond this coming year, inflation depends on many factors—Fed policy, the health of the banking system and the extent of any policy changes following the elections.

While inflation beyond this coming year is highly speculative, fundamental economic forces point to an inflation rate of 2%-3% in the year ahead.



# INFLATION INDICATORS



## Interest Rates

The Federal Reserve just announced it will reveal the interest rate forecasts of each of its key voting members. The move is an effort to shed more light on its monetary decisions.

Unfortunately, since the relationship between interest rates and monetary stimulus is often nonexistent, the latest move is meaningless. Every Fed member may have a perfect interest rate forecast for the coming year and it would not help anyone to assess the degree of monetary stimulus.

Let's say each Fed member were to forecast a fed funds rate between 0% and ¼%. If bank reserves available for loans and deposits keep growing by more than 20% and the banking system stops deleveraging, it would likely mean Fed policy was geared toward producing double-digit inflation.

Alternatively, if the banking system remains under extreme stress this coming year, a zero fed funds rate is likely to be consistent with monetary restraint. In short, an effort to explain the Fed's decision makers' forecasts of interest rates is as meaningless a guide to monetary policy as most of the Fed's other statements.

There is a potential for the Fed's sharp increase in bank reserves to produce a much sharper

increase in spending this year than my forecast suggests. However, sharp increases in bank reserves in the early 1990s failed to ignite a surge in spending. Then, as now, the banking system was stressed in response to the S&L crisis. This meant it could not transmit the sharp increase in reserves into a surge in spending.

No one can be certain what interest rate level is consistent with monetary stability. Institutional changes can be important. Outside influences such as costly regulations and developments abroad can also have an impact.

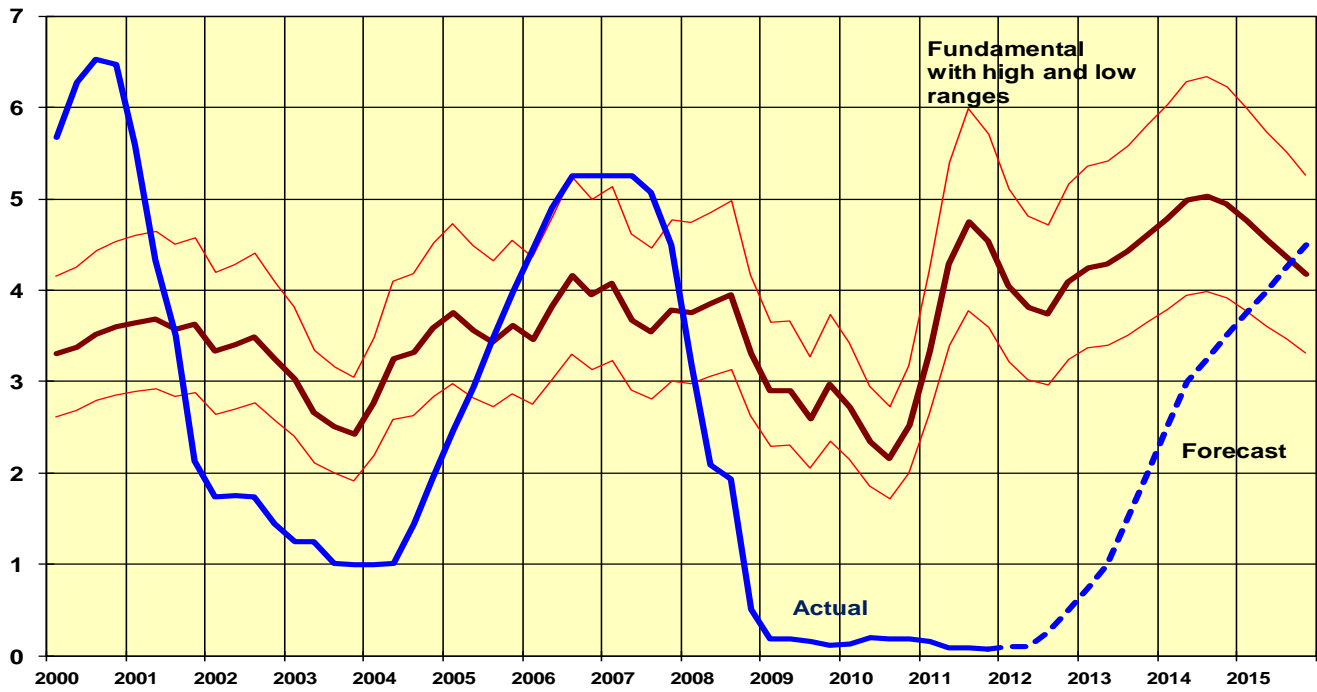
My approach is to begin by looking at bank reserves. The average annual increase in these reserves in 2009 and 2010 was 6%. Spending rose by roughly 4% this past year as other factors held it down.

If the banking system strengthens as it appears to be doing, it will likely help to transmit more of the increase in reserves to higher spending.

Recent signs of improvement in sensitive indicators raise the odds of an increase in both spending and growth this year. However, the weakness in stock prices and commodity prices cautions against expecting too strong a pickup in business activity.

### 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.

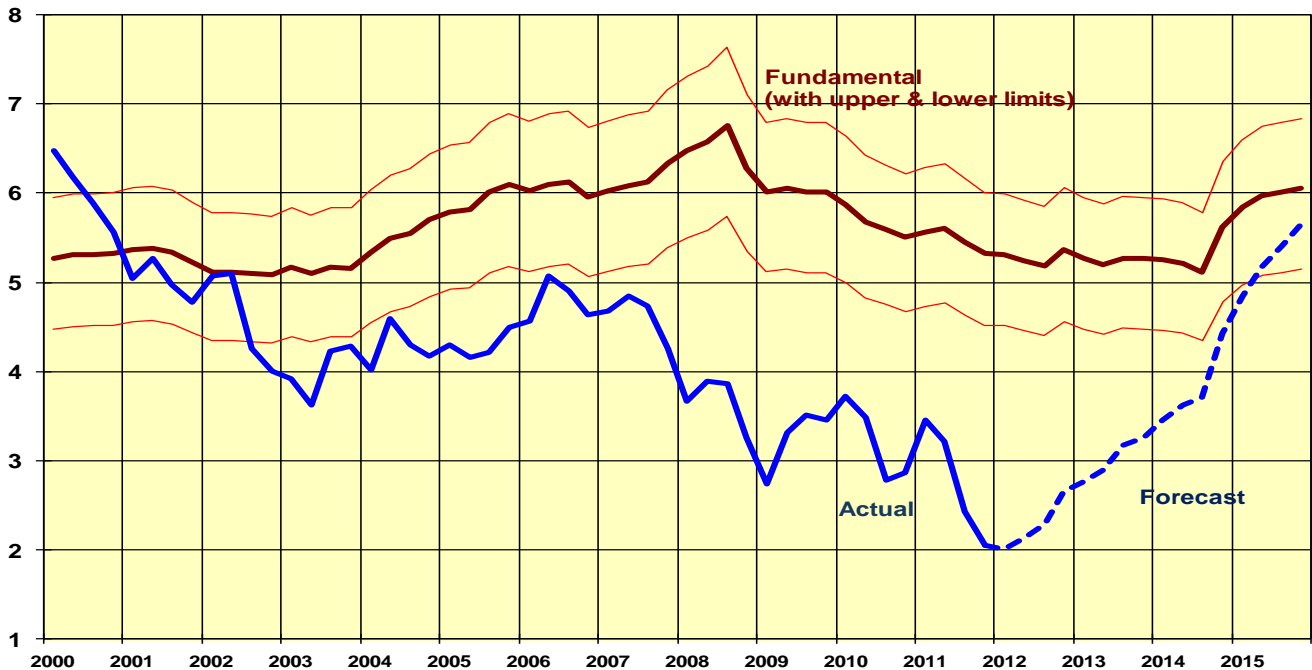
However, both short and longer-term interest rates are well below levels normally associated with the current inflation. Long-term rates have been held below normal levels by the Fed's policy of near-zero short-term rates.

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 among the first signs 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.

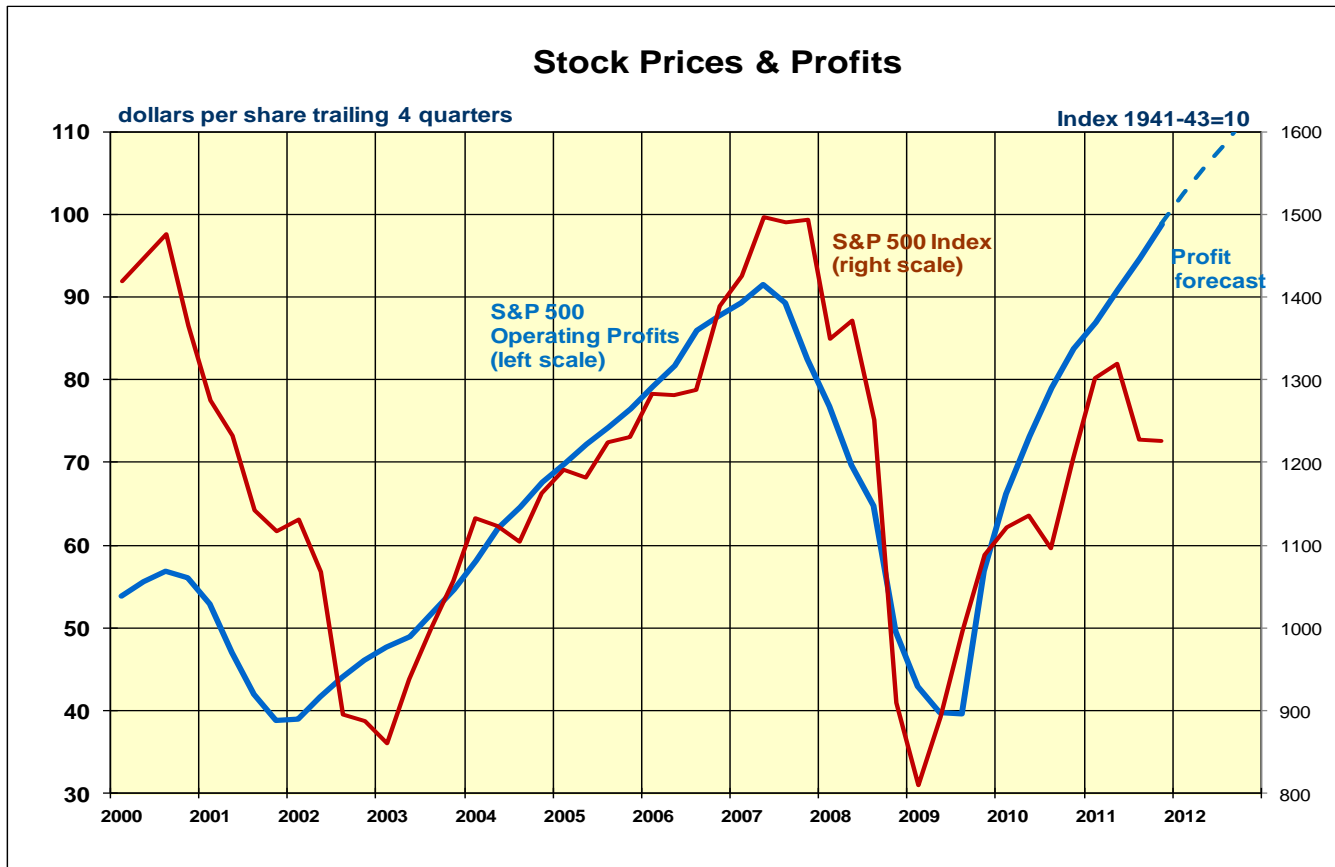
In the third quarter, S&P operating profits reached \$101 a share. With the S&P 500 index close to 1275, the price-earnings ratio amounts to 12.5. The earnings/price ratio for S&P companies is roughly 8% or twice the yield on AAA bonds. By almost all measures, stocks are selling well below fundamental value.

The chart below shows the relationship between operating profits and the S&P 500. To some extent the position today is the opposite

of what existed in 2000 and 2001. At that time investors had driven stock prices well above a more normal relationship to earnings.

In the past decade there have been two major declines in stock prices. Investors have become extremely pessimistic with respect to the future. If the economy improves as I expect it to, there is the likelihood of an explosive rise in stock prices.

Preliminary signs the sharp increase in bank reserves may be working through the banking system raises the odds a sharp rise in stock prices will come sooner rather than later.



1/5/2012	Actual			Forecast				YEARS				
	2011	2011	2011	2011	2012	2012	2012	2009	2010	2011	2012	2013
	I	II	III	IV	I	II	III					
GROSS DOMESTIC PRODUCT	14868	15013	15176	15376	15611	15838	16069	13939	14527	15108	15956	16885
%ch	3.1	4.0	4.4	5.4	6.2	5.9	6.0	-2.5	4.2	4.0	5.6	5.8
REAL GDP	13228	13272	13332	13435	13559	13671	13790	12703	13088	13316	13732	14173
%ch	0.4	1.3	1.8	3.1	3.8	3.4	3.5	-3.5	3.0	1.7	3.1	3.2
CHAIN PRICE INDEX	1.124	1.131	1.138	1.144	1.152	1.159	1.166	1.097	1.110	1.134	1.162	1.193
%ch	2.5	2.5	2.6	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	1.0	2.3	2.6	2.7	-0.3	1.6	3.2	2.4	3.0
FUND. INFLATION%ch	-0.7	0.6	1.6	2.3	2.7	2.8	2.8	-0.3	-1.8	-0.8	2.2	2.7
PRETAX PROFITS	1877	1891	1913	1907	1941	1978	2004	1455.7	1819.5	1897.0	1988.1	2131.3
%ch	34.7	2.9	4.8	-1.1	7.3	7.9	5.4	7.0	25.0	4.3	4.8	7.2
PRETAX PROFITS ADJ (1)	1876	1938	1970	1960	1996	2032	2058	1362.0	1800.1	1935.9	2042.0	2185.1
%ch	4.2	13.7	6.9	-2.1	7.6	7.4	5.4	9.1	32.2	7.5	5.5	7.0
AFTER-TAX PROFITS	1455	1470	1502	1482	1508	1541	1563	1183	1408	1477	1548	1661
%ch	39.8	4.3	8.8	-5.1	7.3	9.2	5.7	12.6	19.0	4.9	4.8	7.3
AFTER-TAX PROFITS ADJ(1)	1454	1517	1559	1534	1563	1595	1617	1089.6	1389.1	1516.0	1601.7	1714.3
%ch	0.4	18.5	11.4	-6.2	7.7	8.5	5.6	16.0	27.5	9.1	5.7	7.0
PERSONAL INCOME	12847	12955	12980	13044	13212	13404	13600	11930	12374	12957	13504	14291
%ch	8.8	3.4	0.8	4.4	5.2	5.9	6.0	-4.3	3.7	4.7	4.2	5.8
REAL DISPOSABLE INCOME	10183	10170	10122	10143	10217	10301	10383	9883	10062	10154	10341	10636
%ch	1.2	-0.5	-1.9	2.8	3.0	3.4	3.2	-2.3	1.8	0.9	1.8	2.8
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	140.8	140.9	141.1	141.3	139.9	139.1	139.3	141.2	142.1
%ch	1.5	0.0	0.2	3.3	0.3	0.6	0.5	-3.8	-0.6	0.2	1.4	0.6
UNEMPLOYMENT RATE	8.9	9.1	9.1	8.8	8.9	8.7	8.8	9.3	9.6	9.0	8.8	8.5
INDUSTRIAL PRODUCTION	92.8	92.9	94.3	94.8	96.1	97.2	98.3	85.5	90.1	91.3	97.8	103.0
%ch	4.9	0.6	6.2	2.0	5.7	4.4	4.8	-11.2	5.3	1.3	7.2	5.3
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.

1/5/2012	Actual			Forecast				Years					
	2011	2011	2011	2011	2012	2012	2012	2009	2010	2011	2012	2013	
<b>Monetary Aggregates quarterly:</b>	I	II	III	IV	I	II	III						
M2 %ch at annual rates	5.1	6.2	21.4	7.0	6.4	5.3	4.5	7.9	2.3	7.3	7.6	4.5	
Adj. Bank Reserves less excess reserves (billions of \$)	112	116	123	135				105	107	121			
<b>Interest Rates:</b>													
Baa Corp Bonds: Moody's	6.09	5.85		5.25	5.11	5.14	5.23	7.30	6.04	5.25	5.26	5.80	
Aaa Corp Bonds: Moody's	5.13	5.04		3.93	4.06	4.14	4.23	5.31	4.94	3.93	4.25	4.80	
<b>MORTGAGE RATES</b>	5.10	5.10	5.10	5.10	4.01	4.14	4.28	5.04	5.10	5.10	4.27	5.03	
<b>10-YR GOVT SECURITIES</b>	3.46	3.21	2.43	2.05	2.01	2.14	2.28	3.26	3.21	2.79	2.27	3.03	
<b>5-YR GOVT SECURITIES</b>	2.12	1.86	1.15	0.95	0.90	1.02	1.32	2.19	1.93	1.52	1.27	2.42	
<b>2-YR GOVT SECURITIES</b>	0.69	0.57	0.28	0.26	0.20	0.30	0.55	0.96	0.70	0.45	0.51	1.81	
<b>3-MONTH T-BILL</b>	0.13	0.05	0.03	0.02	0.34	0.34	0.49	0.16	0.13	0.06	0.48	1.55	
<b>FEDERAL FUNDS RATE</b>	0.16	0.09	0.08	0.07	0.10	0.10	0.25	0.16	0.18	0.10	0.24	1.31	
<b>3-MONTH LIBOR RATE</b>	0.31	0.26	0.30	0.48	0.45	0.45	0.60	0.69	0.34	0.34	0.59	1.66	
<b>BOND EQUIVALENT RATES:</b>													
FEDERAL FUNDS	0.16	0.09	0.08	0.07	0.10	0.10	0.25	0.16	0.18	0.10	0.24	1.32	
3-MONTH LIBOR	0.31	0.26	0.30	0.48	0.45	0.45	0.60	0.70	0.34	0.34	0.59	1.68	
3-MONTH T-BILL	0.14	0.05	0.03	0.02	0.35	0.35	0.50	0.16	0.14	0.06	0.48	1.58	
<b>STOCKS:</b>													
S&P 500	1303	1319	1228	1226	1279	1344	1406	947	1139	1269	1367	1646	
S&P 500 quarterly reported earnings	85.8	89.0	90.5	95.3	100.2	101.5	101.9	51.0	77.4	90.1	103.3	110.5	
S&P 500 p/e on reported earnings**	15.2	14.8	13.6	12.9	12.8	13.2	13.8	19.6	14.8	14.1	13.2	14.9	
S&P 500 quarterly operating earnings	90.2	99.4	101.2	104.6	105.0	112.5	112.9	56.9	83.8	98.9	112.4	116.4	
S&P 500 p/e on operating earnings**	14.4	13.3	12.1	11.7	12.2	11.9	12.4	16.7	13.6	12.8	12.2	14.1	
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	14.8	15.2	15.8	16.2	13.3	15.0	15.7	15.9	18.0	
*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													