

Robert Genetski

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Long Term Economic & Financial Outlook

Executive Summary

Throughout much of the world, the adoption of classical economic policies is contributing to an economic boom. The successful application of low-tax, free-market policies is producing the greatest economic transformation in history. As global growth soars ahead at rates of 5% or more, hundreds of millions of people emerge from conditions of abject poverty.

In the US, the 2003 tax cuts have enabled the economy to perform extremely well in the face of numerous obstacles. The wealth-creating impact of low tax rates is likely to continue through 2010. In addition, monetary policy is in the process of shifting from restraint to stimulus. While the delayed impact of monetary restraint could produce some weakness early this year, the pace of business activity is likely to improve significantly as the year unfolds. For the next three years US economic policies should produce strong growth with relatively low inflation.

While the world is moving inexorably in the direction of classical principles, in the US there are mounting pressures to move policies in the opposite direction. The movement toward reducing trade barriers has stalled; a crackdown on illegal immigrants threatens the free flow of workers; and Congress ended the year with legislation that attempts to solve energy problems through edicts rather than relying on market forces. Allocating resources through political edicts is a throwback to the economics of socialism. After obvious failures, socialism has been discarded throughout most of the world. It's ironic and disturbing to see it creeping back into US policy.

Neither political party has distinguished itself in terms of pursuing classical principles. Democrats vow to raise tax rates while Republicans vow to limit immigration. Each policy threatens future growth. In terms of the Presidential aspirants, none of the Democrats and only a few of the Republicans appear to understand the importance of classical principles in promoting economic growth.

While US economic trends should remain generally positive for the next 2-3 years, the outlook beyond appears less sanguine. Two major developments threaten to slow growth and increase inflation in the decade ahead. The first is the threat of higher tax rates. Current tax rates expire in three years and only a change in existing legislation can avoid damaging tax hikes.

Second, demographics point to little growth in the US workforce age population. This occurs at the same time that baby boomers retire in droves. Since Social Security and Medicare payments for retirees come from payroll taxes, the shortfall will produce pressure for some combination of major cuts in retirement benefits and increases in payroll taxes

There are viable policies that can dramatically improve longer-term US economic prospects—policies that would make it unnecessary to raise tax rates or cut benefits; policies that would enable the US to maintain its position as the world's leading economy. The key question surrounding the longer-term outlook is the extent to which the US will adopt such policies in time to prevent a period of slow growth and economic stagnation.

Introduction

A long-term perspective on the economy and financial markets is a useful way to place current developments in historical perspective. This report consists of two parts: the first deals with economic issues of growth and inflation; the second with financial markets.

The section on the economy focuses on those factors that determine growth and inflation. Over two centuries ago, classical economists discovered that the key to economic prosperity consists of providing individuals with the right environment for creating wealth. That environment includes only four things—low tax rates, free markets, protection of individual property rights and a stable currency for transacting business. These are the four key classical principles for achieving economic success. The economic section explores how these principles have contributed to growth and prosperity and how they provide a basis for assessing the likely course of the economy in the years ahead. The section on financial markets uses the economic analysis as a background in assessing the current state of financial markets and likely developments in the years ahead.

Placing current developments in perspective is the first step in distinguishing normal short-term fluctuations in financial markets from more substantive longer-term shifts. Furthermore, it's important to be able to identify when shocks to the system or policy changes are significant enough to alter longer-term trends. Assessing such changes in the context of longer-term developments can help in assessing the implications for financial markets.

Economic Trends: Growth & Inflation

During the past quarter century, developments in technology and telecommunications, along with the spread of democracy, have helped to promote the adoption of classical principles. The computer chip has helped quantify the benefits of low-tax, free-market, non-inflationary policies, while the collapse of communism has made the importance of property rights self-evident. Advances in telecommunications have made research pertaining to these policies widely available. And the rapid spread of democracy has led competent policymakers to implement these policies and fulfill people's expectations for ever higher living standards.

Trends in Classical Policies Outside of the US

The march toward classical principles outside the US began after World War II when policies based on those principles helped both Japan and Germany rebuild their economies. In the 60s and 70s, the movement spread to parts of Asia where Hong Kong, Taiwan and Singapore successfully adopted classical policies. Since 1980, the two countries showing the most dramatic improvement in applying these principles have been China and India. The application of classical policies by the world's two most populated countries has enabled China and India to surpass Japan as the second and third most powerful economies in the world.

China's transformation began earlier than in India. China's leaders studied classical economic writers extensively in the 1970s. They experimented with free markets and property rights in farming. Following a spectacular increase in agricultural production, China's policymakers decided to make classical principles the basis for the country's longer-term economic development. Recognizing the potential for rapid change to create social instability, Chinese leaders have pursued a measured approach to shifting from a state-controlled economy to one that would be directed by free markets.

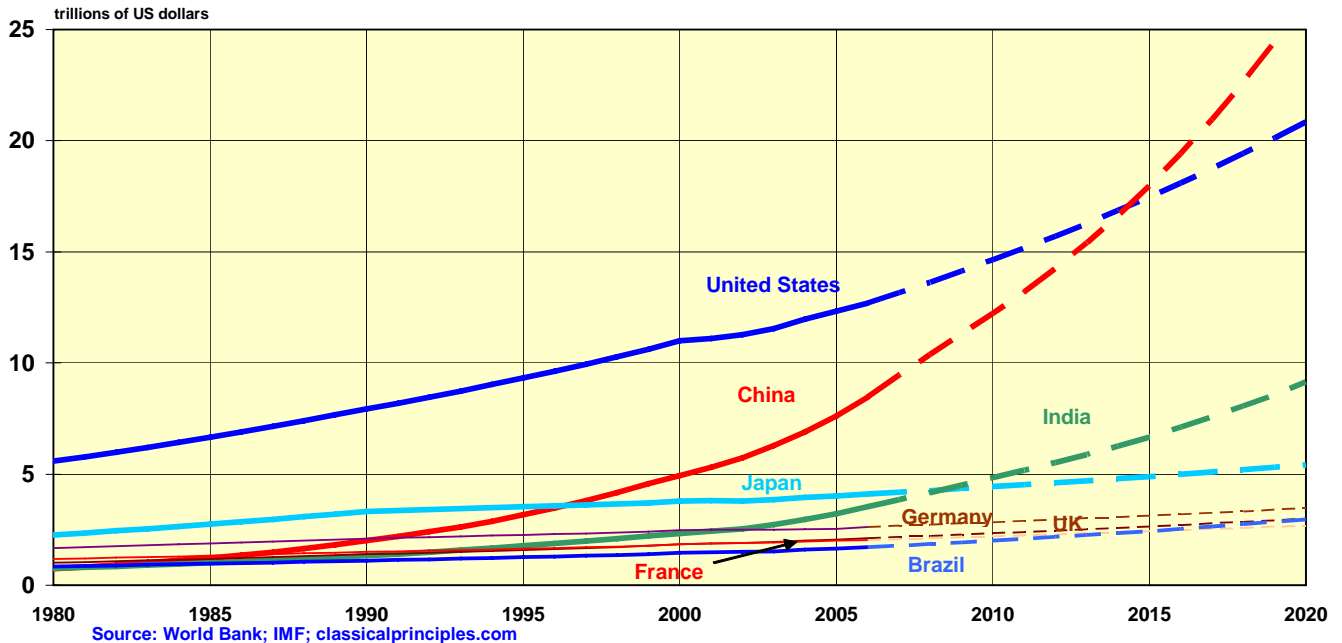
Gradually over the past quarter century China has shifted production from state-owned and operated companies to private companies. Recent estimates indicate that close to 80% of China's Gross Domestic Product (GDP) now comes from private companies.

As with most developing countries, China has tax rates that are relatively high compared with the rest of the world. There is a 17% VAT, a 33% tax on corporations and a tax schedule for individuals that goes up to 45%. However, China has a history of tax breaks and tax evasion that makes effective tax rates much lower than the tax schedules indicate. China's tax receipts as a share of GDP were as low as 14% in 2001. In 2005 they rose to 17%. Inclusive of social security taxes, China's share in 2005 rises to 20%. This compares to 26%-29% for other developing countries and 37%-41% for developed countries.

China's tax share of GDP has increased in spite of lowering tax rates for individuals through larger deductions in recent years. Rapid growth and increased enforcement account for the country's recent sharp rise in its tax share of GDP. Following its entry in the World Trade Organization, China committed to further reducing its tariffs and deregulating its economy and capital markets. On balance, China continues to make substantial progress in moving its economic policies in the direction of classical principles. Following China's lead, India has also shifted policies dramatically in the direction of free markets and less regulation. This past year India became the third most powerful economy in the world as its output surpassed that of Japan.

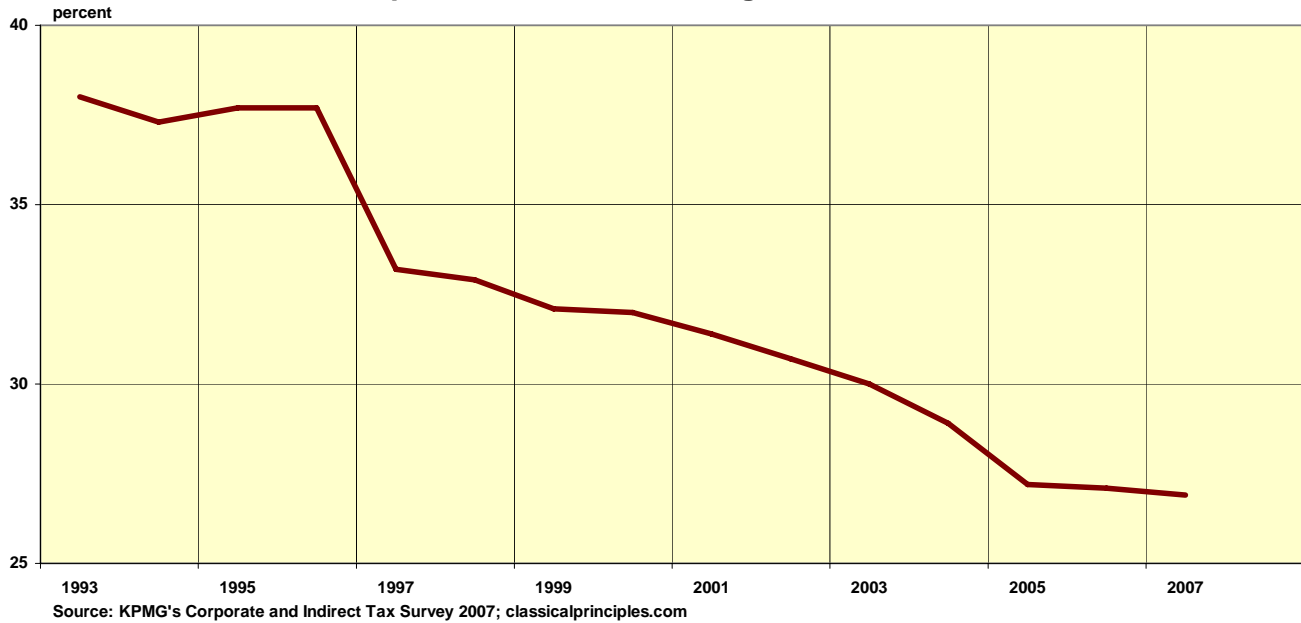
The following chart shows the relative size of each major economy based on the purchasing power of each country's currency. Data on relative size are not always definitive. In 2005 the World Bank increased its estimate of China's GDP by almost 20%. More recently, the Bank decided it had overestimated China's size by 40%. The figures in the chart below represent an average of the latest estimates from both the World Bank and the International Monetary Fund. Regardless of the measure used, China is clearly the second most powerful economy in the world in terms of economic output. Moreover, as US growth slows in the decade ahead, the gap between the US and China will continue to shrink. It's highly likely that within the next decade, China will replace the US as the most powerful economy in the world.

GDP--Major Countries-(Based on Purchasing Power Parity)

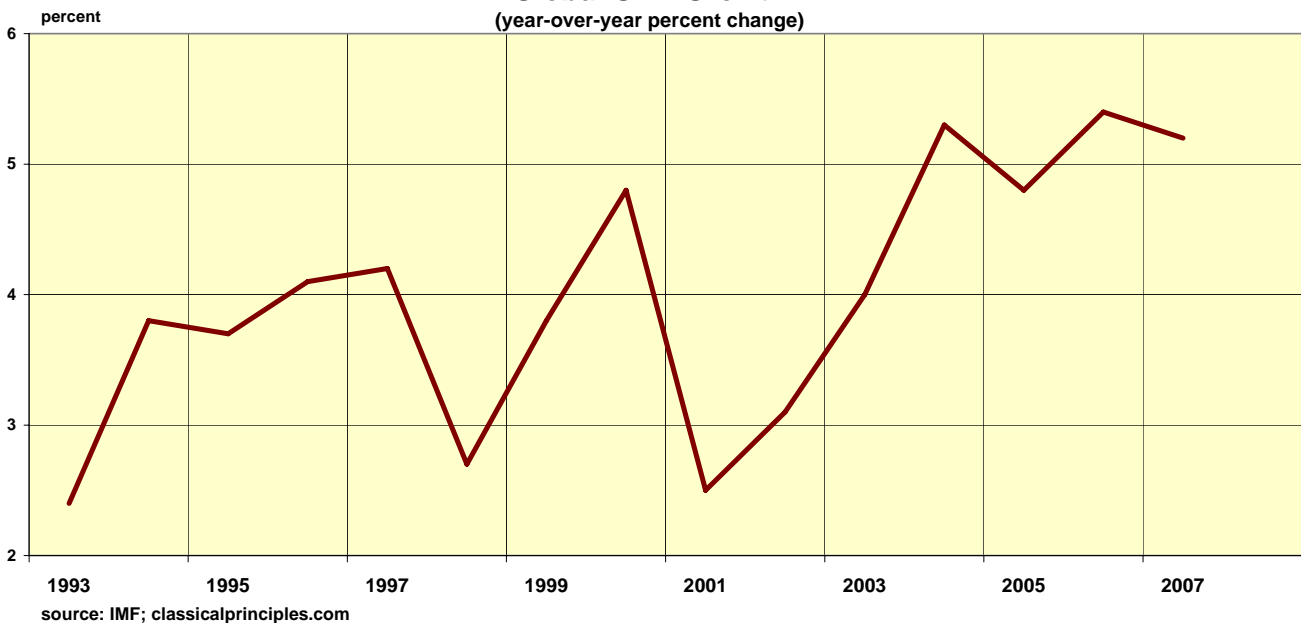


Throughout the world, the movement toward classical principles remains strong. Taxes and trade barriers are falling and markets are being deregulated. As a consequence, there has been explosive growth throughout the world. While moves against classical principles can still be found in certain countries, such moves are the exception rather than the rule.

Corporate Tax Rates: Average All Countries



Global GDP Growth
(year-over-year percent change)



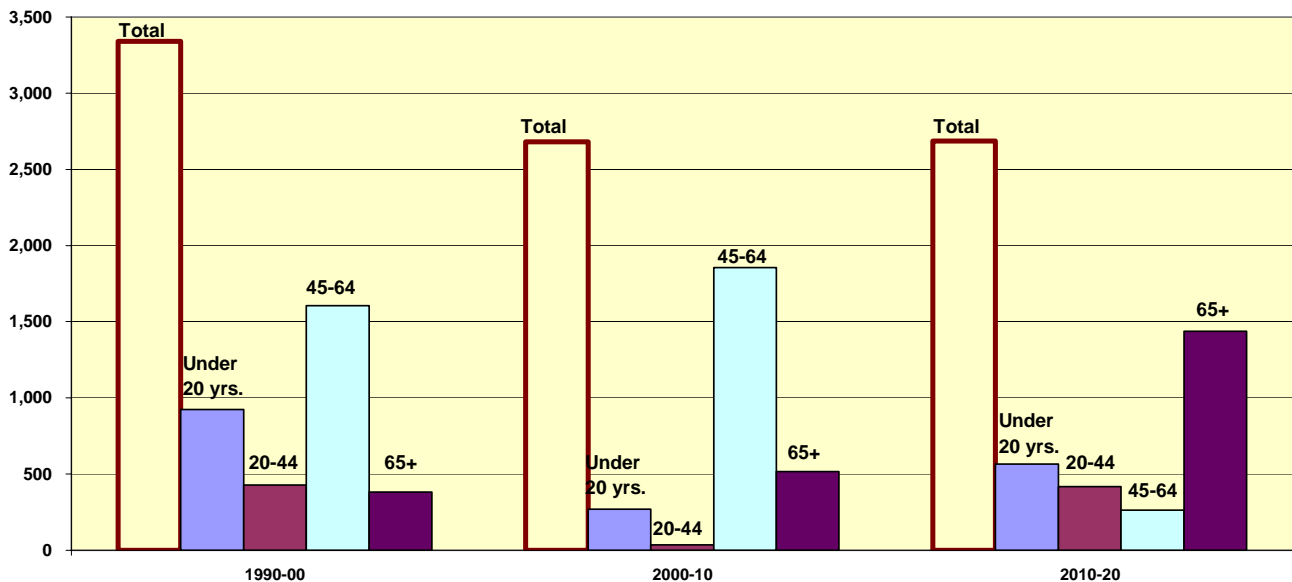
Outlook for Real Growth in the US

Economic growth consists of two components—changes in productivity and changes in hours worked. Productivity is the key component of growth. A country’s productivity determines the living standards of its people. Increases in productivity determine the extent to which people experience an increase in living standards. Total hours worked often depend heavily on demographics—specifically, the growth in the working age population. Combining productivity growth with the change in hours worked provides an estimate for potential real growth or the amount of additional goods and services a country is able to produce each year.

Demographics and Hours Worked

The age composition of the US is undergoing a dramatic change. The following chart highlights these changes. In the 1990s the working age population (roughly ages 20-64) grew at an annual rate of 1.3% a year. Hours worked were estimated to have grown at 1.7% a year. This means that of the 4% a year average growth during the 1990s, more people working more hours accounted for roughly 1½ percentage points. From 2000-10, the growth in the working age population slowed to roughly 1% a year. From 2010-20 there will be a sharp slowdown in the growth of the working age population to only 0.4% a year. Hence, hours worked are likely to grow by roughly ½% or less each year. This means that additional hours worked will go from adding 1½% a year to real growth as occurred in the 1990s to adding only about ½% to growth from 2010-20. Real growth in the years ahead will depend mainly on the rate of growth in productivity.

US Population Change: Key Ages
(thousands of people per year)



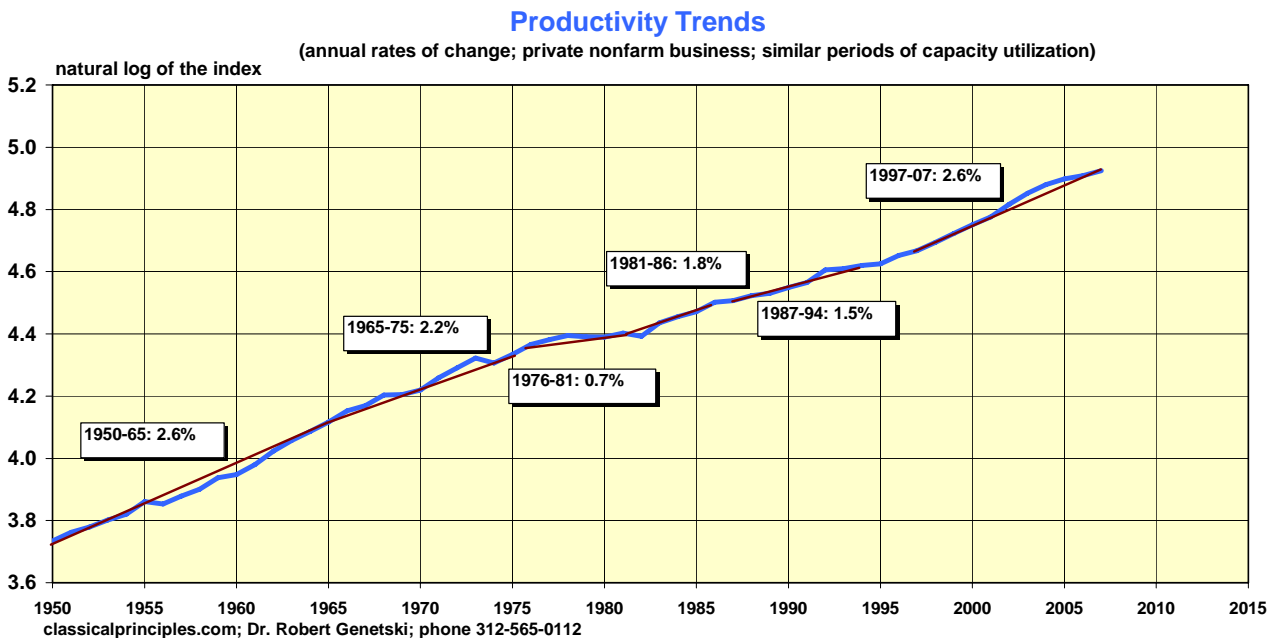
Some employment figures show that jobs grew at an average of 1% a year from 2000-07, consistent with the growth in the working age population. Other data, such as figures for total hours worked and payroll employment, show little to no growth during the first 7 years of this decade. It’s highly doubtful that with the working age population growing at roughly 1% a year, that there has been little change in hours worked in 7 years. What has likely happened is that structural changes in the economy have made it more difficult to collect reliable statistics. In all likelihood, hours worked are increasing by close to 1% this decade, but not all data are capturing the increase.

US Productivity Performance

Of all the major *developed* countries in the world, the US has been the most aggressive in pursuing classical economic policies over the past ¼ century. As a result, US productivity performance has surpassed that of all other developed countries.

For the last half of the 20th Century real growth in the US averaged 3½% a year. Productivity data showed increases averaging 2% a year (the remainder came from more people working more hours). Productivity gains of 2% a year provide for a doubling of living standards every 35 years. Measuring productivity can be difficult. Errors in calculating output or the number of hours worked can produce misleading productivity numbers. Also, productivity tends to be cyclical. When spending slows, output tends to slow by more than hours worked leading to below average productivity growth. The opposite tends to occur when spending increases at above average rates. To determine the underlying productivity trend, it's important to adjust for cyclical factors.

The chart below adjusts for cyclical moves by showing actual US productivity as well as trends between similar periods of employment and capacity utilization. The numbers show productivity trends moved above and below the 2% average for extended periods of time. From 1950-65 the productivity trend was 2.6% a year, well above the average. This corresponded to a period that was widely recognized as one of strong growth and prosperity. From 1965 to 1981 productivity growth slowed. The worst of the slowdown occurred in 1976-81 when productivity growth averaged only 0.7% a year. This latter period is associated with the worst economic performance of the past ½ century.



From 1981-86 the productivity trend improved dramatically. There was a slight slowing from roughly the mid-80s to the mid-90s. Beginning in 1997 (the year the capital gains tax was reduced from 28% to 20%) productivity trends once again improved. Productivity data showed average growth of just over 2½% from 1997-2007. Since hours worked reportedly grew by only a bit over ½% a year, real growth for the past 10 years is reported to have increased by roughly 3% a year. It's possible that both productivity and hours worked have grown faster than these data suggest. The difficulty of accurately capturing the contribution of smaller businesses may understate real growth. However, even if the data are correct, productivity growth of 2.6% a year for the past 10 years matches the strongest performance in the history of the US economy.

Correctly measuring changes in productivity and hours worked is important for correctly estimating how fast the economy can grow. And, correctly calculating growth is important in determining inflation and interest rates. Last year's analysis concluded that both productivity and real growth trends were stronger than current data suggest. While there are reasons to suspect that reported numbers understate potential for US growth, the analysis presented here takes the numbers at face value. The alternative would be to simply make up stronger numbers. Hence, the analysis assumes that the reported numbers are reasonably accurate and uses them as the basis for determining future economic performance. This approach leads to the conclusion that the underlying growth trend for the US is slower (and that underlying inflation trend is greater) than was indicated in last year's report.

Factors Influencing Productivity Growth

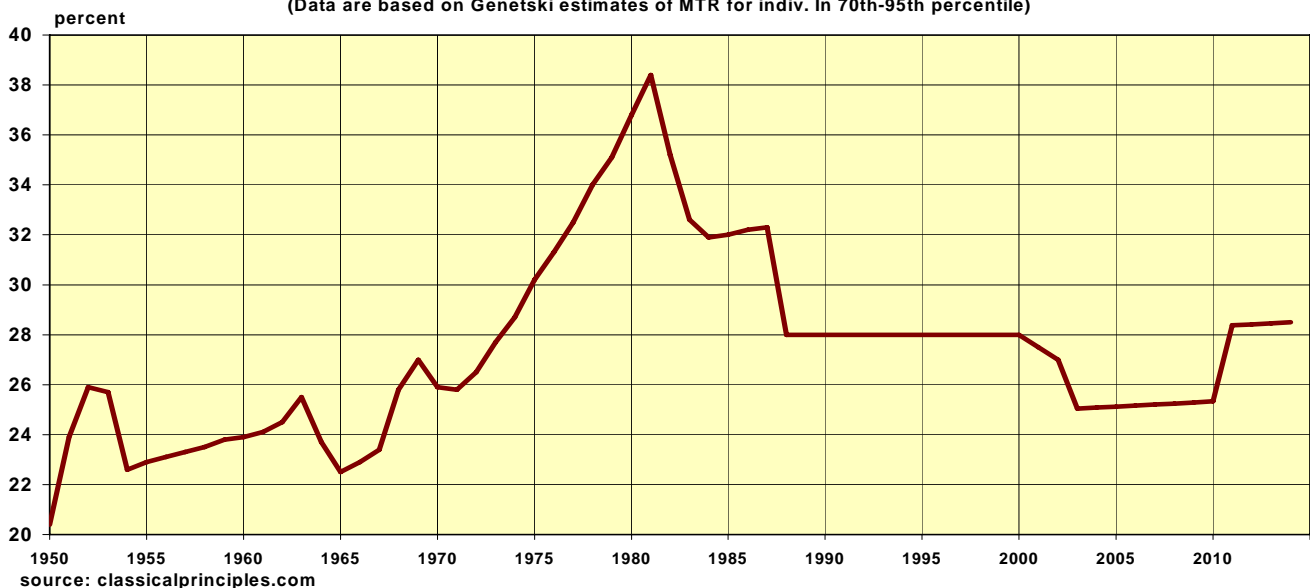
From a classical perspective, productivity performance depends on tax rates, free markets, property rights and inflation. While each of these factors is important, there is compelling evidence that for the US economy, changes in tax rates have often been the dominant force affecting productivity performance.

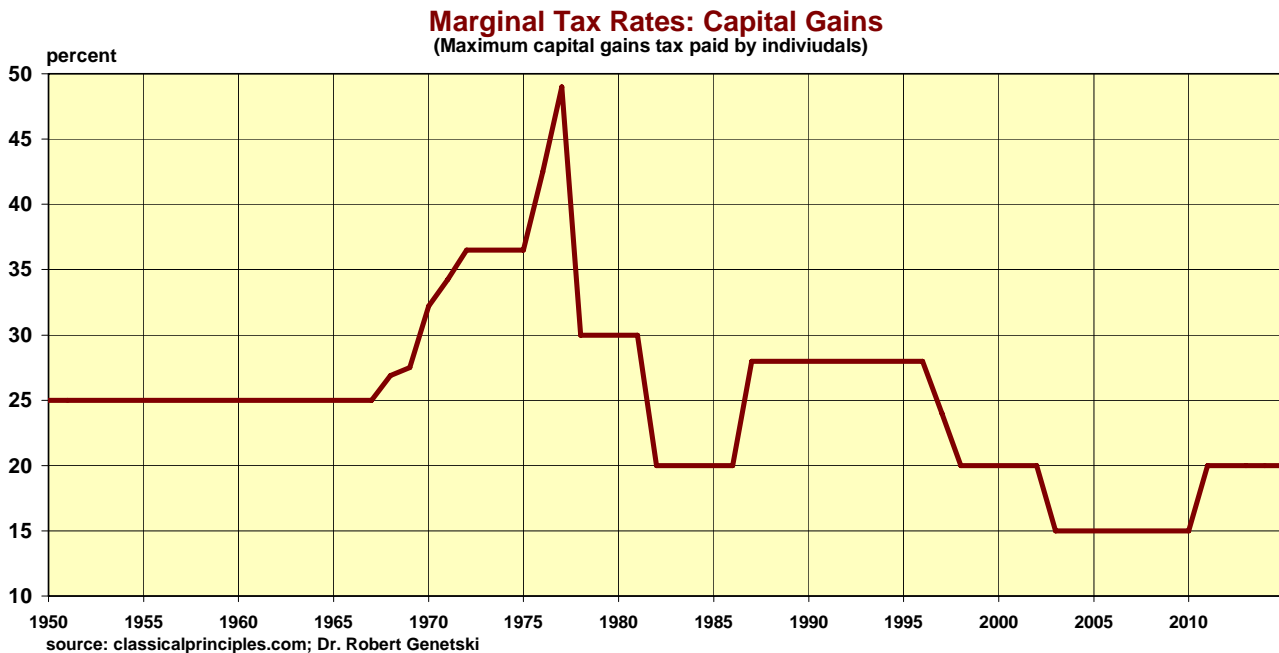
The idea that tax rates affect economic performance is straightforward—when you tax something, you get less of it. Taxing income at higher rates discourages people from acting in such a way as to produce more income. Moreover, different types of taxes can be more or less damaging to growth. The most damaging taxes are marginal tax rates. These are taxes on the creation of *additional* income. Taxing additional income takes some of the incentive away from creating additional income. The key tax rates that hold the potential to affect income growth are marginal tax rates on income and capital gains.

The following charts show these key tax rates for the US beginning in 1950 and extending out to 2015. Looking back at the productivity trends shown on page 8, it's apparent that during every period when US productivity trends deteriorated, one or both of these key marginal tax rates were *increasing*. In contrast, during every period when productivity trends were improving, marginal tax rates were falling. The evidence strongly supports the classical principle that higher marginal tax rates hamper productivity and produce disappointing economic performance. Tax rates beyond 2008 are based on current legislation. In 2011 the current tax rates are set to expire. If the scheduled increases occur, productivity growth will slow, ushering in a period of economic stagnation.

Effective Marginal Tax Rates: Individuals

(Data are based on Genetski estimates of MTR for indiv. In 70th-95th percentile)





Federal Spending & Regulation

Aside from tax policy, government spending and regulation can impact productivity trends. Extensive research shows that government spending tends to be half as efficient as spending in the private sector. Hence, sharp increases in government spending will tend to produce an inefficient allocation of resources and thereby depress growth. In addition, rapid increases in government spending reduce the real value of wages and salaries as government services take the place of higher wages and salaries. In a similar manner, regulations can impose huge costs on the private, productive sector. The most comprehensive study of the cost of complying with federal regulations (Hopkins' study) estimates this cost at well over \$1 trillion a year. As with government spending, regulatory expenses reduce workers' incomes. Productivity gains that would have increased workers' incomes go instead to pay for the increased burden imposed by regulations.

After significant gains in government spending in the early part of the decade, there is evidence that the pace slowed in 2007. Government spending increased at an annual rate of 7%-8% between 2003 and 2006. For 2007 the increase was just under 3%. Based on the budget for 2008, spending increases should remain close to the 3%-4% vicinity. Vetoes by President Bush and Republicans in the Senate have been successful at slowing attempts to expand government programs. Unfortunately, there is little evidence of any significant control over regulatory programs. Hence, some of the gains from slower growth in government spending are being offset by ongoing efforts to extend government regulations.

Future Productivity Trends

The future productivity trend will depend on the extent to which policymakers move toward or away from classical policies. There have already been moves to disrupt the flow of capital and labor to the US. Responding to demands from their constituency, politicians effectively told foreigners that we didn't want them purchasing any US asset remotely related to homeland security. The Dubai Ports incident discouraged foreign investment, thereby serving to erode the value of the dollar in terms of foreign currencies. There has also been a significant move to discourage undocumented (illegal) workers from working. Discouraging the flow of foreign capital and the flow of much-needed workers runs counter to classical free market principles. The assumed benefits to disrupting these flows are non-existent. The costs are significant.

While the movement toward reducing trade barriers appears to have stalled, there appears to be growing discomfort in both political parties over trade. This discomfort comes at a time when job growth has been strong. Should the economy slow and job growth stall, the pressure for protectionist policies is likely to become even more intense. Next to the scheduled rise in tax rates in 2011, protectionist policies represent the most serious threat to future productivity gains.

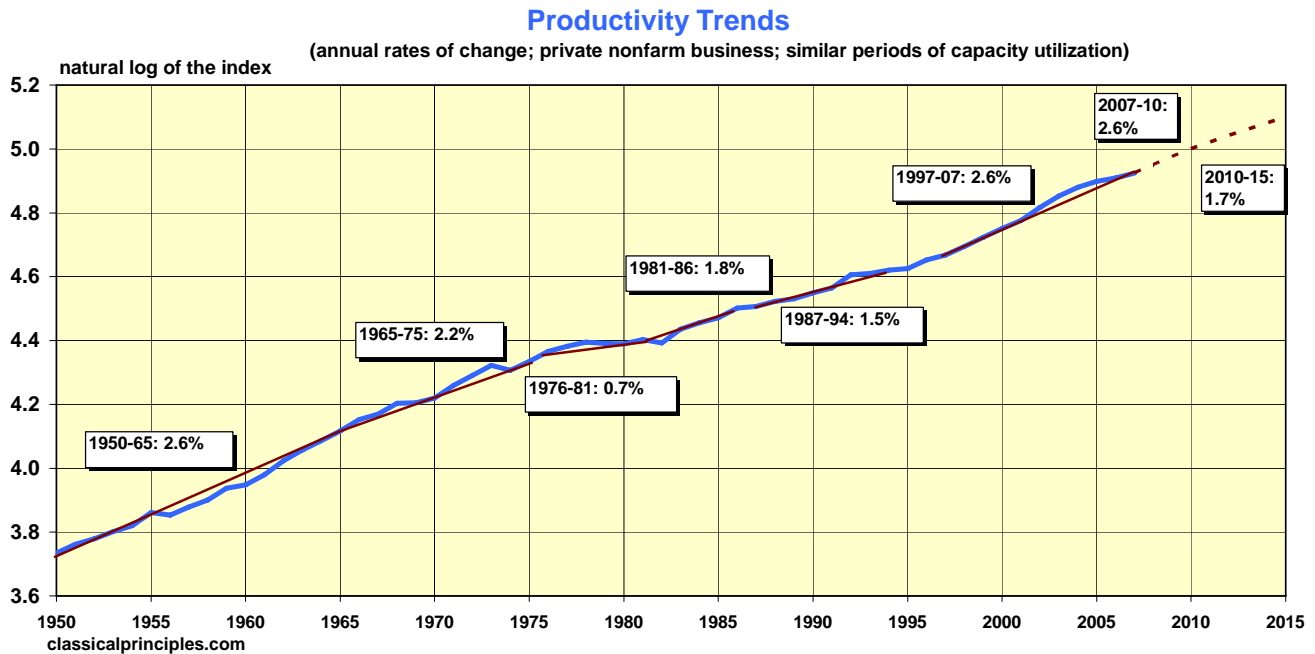
In assessing the growth path over the next five years, various assumptions have to be made. Tax rates, government spending, trade policies and the extent to which politicians abandon free markets are all factors that will affect productivity. In terms of tax rates, the odds of maintaining current rates through 2010 are encouraging. Only 41 Senators can filibuster any attempt to change legislation and raise tax rates. This suggests that for the next three years it will be difficult to pass any significant tax increase.

For the same reason that it will be difficult to raise tax rates during the next three years, it will be difficult to prevent tax rates from increasing in 2011. Since tax rates increase under existing legislation, it will likely take 60 Senators to vote to maintain current tax rates. All the Democrat Presidential contenders have promised to raise tax rates. Even among Republican Presidential aspirants, there are only three candidates that have consistently favored cutting tax rates—Rudy Giuliani, Fred Thompson and Ron Paul. Senator McCain and Mitt Romney both opposed the Bush tax cuts in 2003. Although he claims to be a tax cutter, Mike Huckabee worked hard to raise taxes while Governor of Arkansas. Governor Huckabee is also a leading proponent of keeping Mexican workers out of the US. From a seemingly overflowing number of Presidential aspirants, there are relatively few who seem to understand and vigorously advocate classical principles.

Even before the 2008 elections, government policy appears to be shifting in a troubling direction. A monumental energy bill dictates massive increases in ethanol production along with extensive mandates regarding fuel efficiency standards. These moves provide a significant departure from classical principles by substituting political dictates for market forces. In so doing, the legislation guarantees that resources will be misallocated and productivity will suffer. It's difficult to quantify the extent to which this legislation will slow productivity. There would be no damage if markets respond to higher energy prices by matching or exceeding efficiency standards. In that case, dictates are superfluous. If the edicts are effective in shifting resources well beyond the pressures of market forces, the costs will be significant. Dictates regarding the massive expansion of ethanol production are so extensive that they will almost certainly damage future productivity.

The forecast for productivity growth shown in the chart below assumes that current tax rates extend through 2010 and that the wealth-creating benefits of these cuts maintains productivity growth at 2.6% a year. Beginning in 2011, at least some of the currently scheduled tax hikes are assumed to take place. Tax hikes (along with continued government efforts to dictate the flow of resources), slow productivity growth to less than 2% a year.

Any specific forecast for productivity performance several years from now is highly speculative. It's always possible that the public will insist on politicians who recognize the importance of low tax rates and free markets in promoting economic efficiency. However, at this point in time the paucity of even Presidential contenders who are committed to maintaining this course is not encouraging. It suggests that the public may have to experience the negative impact of higher taxes and misallocated resources first hand before realizing the damage they can do.



Real Growth 3% through 2010, 2% beyond 2010

Two factors are likely to slow the growth potential in the US economy beyond 2010. A likely increase in tax rates in 2011 will slow the growth in productivity. Furthermore, demographic changes mean that the growth in the working age population will slow to less than ½% a year. This combination produces a relatively sluggish economy with potential real growth of only about 2% a year. The slowdown in the growth of the workforce will come amid rapid growth in the population over 65 years of age. Since Social Security and Medicare payments depend on the incomes of workers, there will be significant pressure on politicians to cut benefits and raise taxes over and above the increases already scheduled. Efforts to raise payroll taxes to help support the surge in retirees would be self-destructive. It would mean a further reduction in productivity gains, making it even more difficult for government to keep its commitments.

Solutions to Maintaining Rapid Growth

It's easy to become discouraged over the prospects for longer-term growth in the US. Similar pressures in Japan and Western Europe led to economic stagnation. Such stagnation is not inevitable. There are viable solutions to all problems facing the US. A solution to the slowdown in the workforce population is obvious. The US has a shortage of workers. Mexico has a surplus of workers. Permits to work in the US should be readily available to all healthy, law-abiding Mexicans who want them. The permits can be renewable so long as these workers maintain steady employment and continue to obey all laws. If politicians continue to reject the privatization of Social Security, importing workers becomes the only remaining viable solution to providing government payments to retiring baby boomers. Instead of building fences on the border with Mexico, the US should be building welcome centers. It's also likely that the reality of sharp cuts in retirement benefits will make the public so aware of current system's failure that privatization becomes a viable option.

Maintaining strong productivity growth involves maximizing the incentives for investors and workers to create wealth. Increasing marginal tax rates is the equivalent of economic suicide. Rather than being increased, they should be cut or even eliminated. An articulate leader can capture the public's imagination and shift the focus to policies that will promote future growth instead of hindering it. However, until such a figure emerges, it appears that the public will have to experience the negative impact of a slower pace of growth before there is sufficient support for the necessary policy changes.

The Outlook for Money, Spending & Inflation

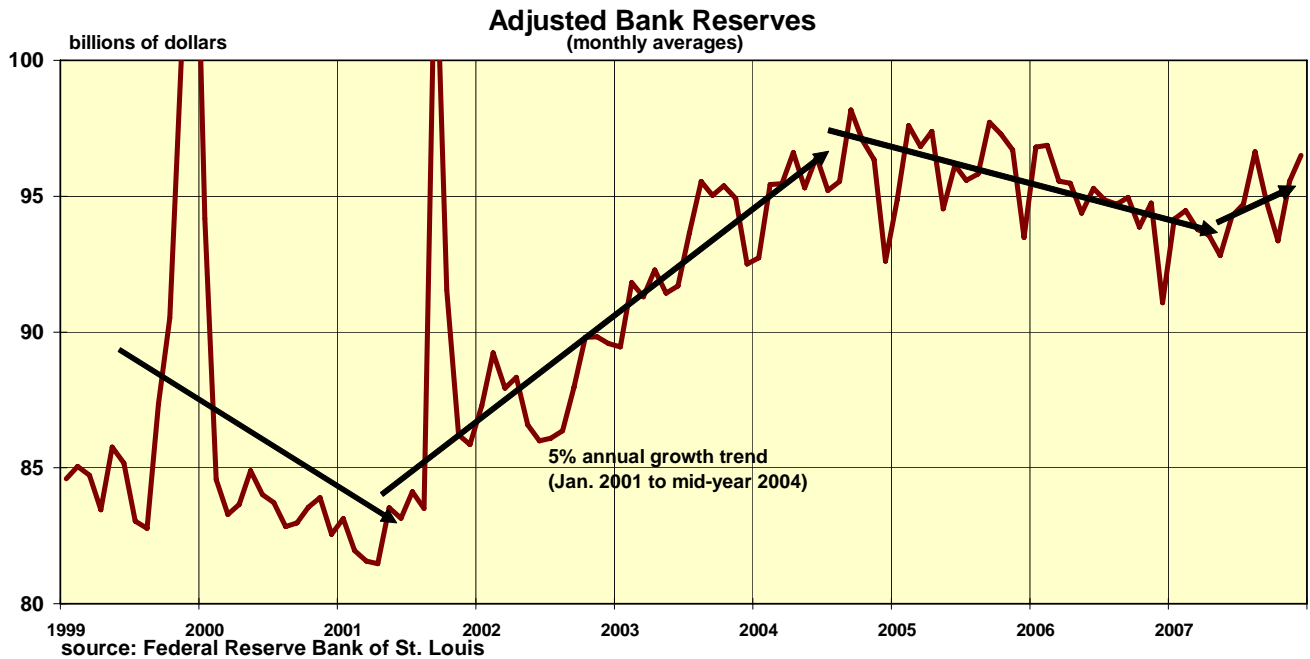
Tax rates, free markets and property rights all contribute to an economy's potential growth trend. In any particular year, short-term changes in spending will cause the economy to grow faster or slower than its underlying growth trend. Such changes in spending from one year to the next result primarily from changes in monetary policy. When the Federal Reserve expands the money supply rapidly, spending subsequently soars. When it creates too little money, spending eventually slows.

When productivity is strong, the monetary authorities have more leeway to create money since more of the spending goes to real growth and less to inflation. In addition, when productivity is strong, minor mistakes by the Federal Reserve will simply slow the economy and not drive it into recession. When productivity slows, the Fed's job is far more difficult. Political pressure from slow growth tends to create pressure on the Federal Reserve to create more money. The additional money tends to produce higher inflation. If the economy's growth rate slows, it has implications for monetary policy, spending, inflation and for financial markets.

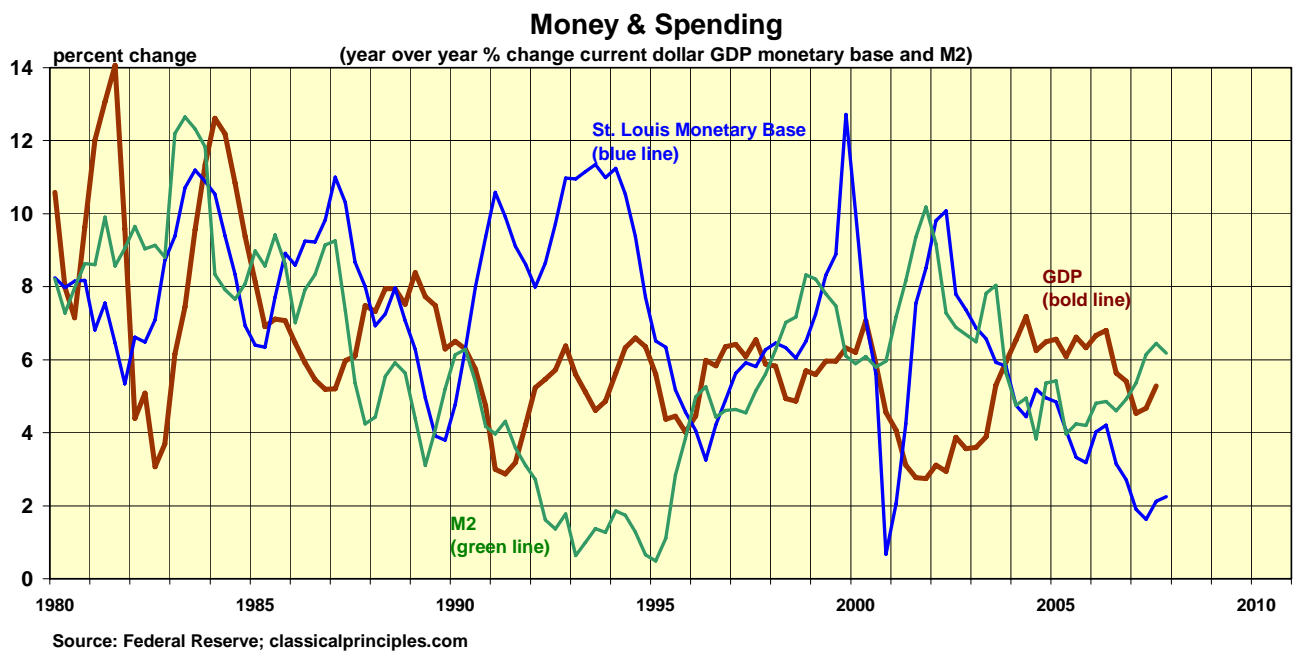
In addition to the economy's growth path, it's important to determine how much money the Fed is creating. There are many ways to assess Fed policy. No single approach is without its limitations. The most useful approach is to assess the information from various monetary indicators to determine if a pattern emerges.

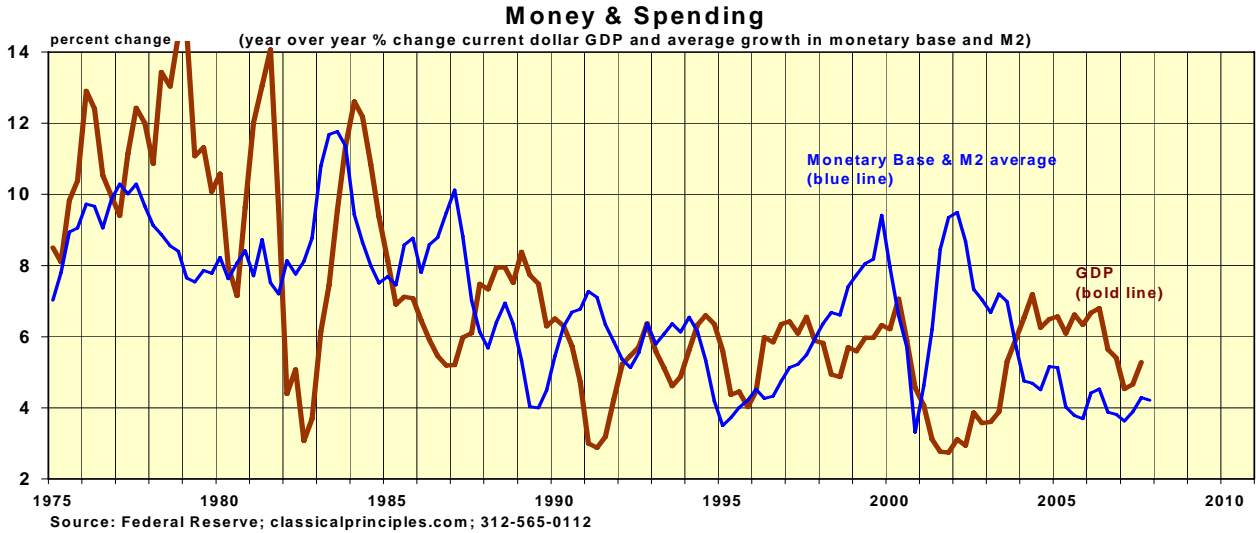
The first step in the monetary process involves the creation of bank reserves. The following chart shows the recent behavior of these reserves. It shows the decline in reserves associated with the Fed's efforts to slow the creation of money in 2005 and 2006. It also shows the recent impact of the Fed's shift to a lower fed funds target.

Bank reserves represent the first step in the money creation process. These reserves have tended to grow several percentage points slower than most other measures of money. They also tend to grow several percentage points slower than increases in current dollar spending. While no single measure of the money supply has a perfect record of forecasting future spending, it's often helpful to begin an analysis of money by viewing the behavior of bank reserves. The changes in these reserves provided an early indication of the 2001 recession, the recovery in spending from 2002-06 and the recent slowdown in the spending pace to the 5% vicinity.



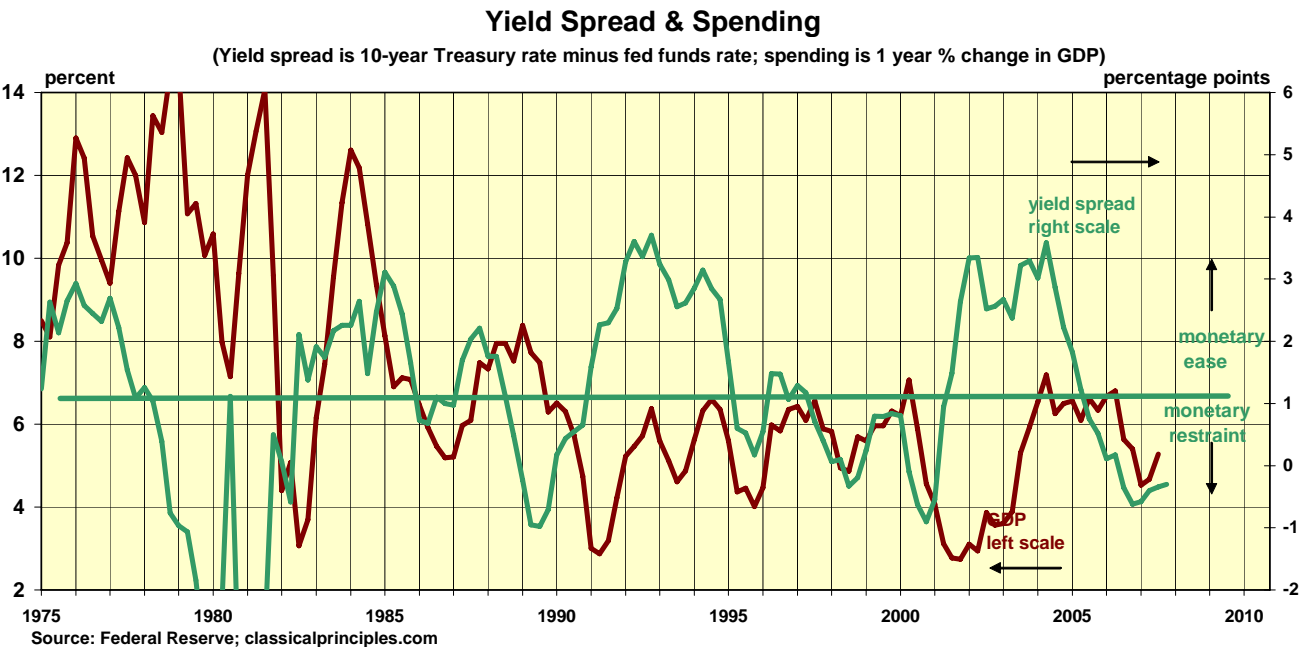
In addition to bank reserves, the monetary base (bank reserves plus currency) and M2 have also been helpful in assessing the thrust of monetary policy. The first chart shows how the base and M2 have often moved in different directions relative to current dollar spending. What has happened is that periods of monetary restraint (indicated by a slowdown in the monetary base) tend to raise interest rates. Higher rates lead people to shift money assets out of demand deposits and into time deposits and money market funds. This shift artificially boosts the M2 measure of money, which includes these deposits. The second chart shows how averaging these two measures tends to produce a closer approximation to future spending than either of the individual measures.





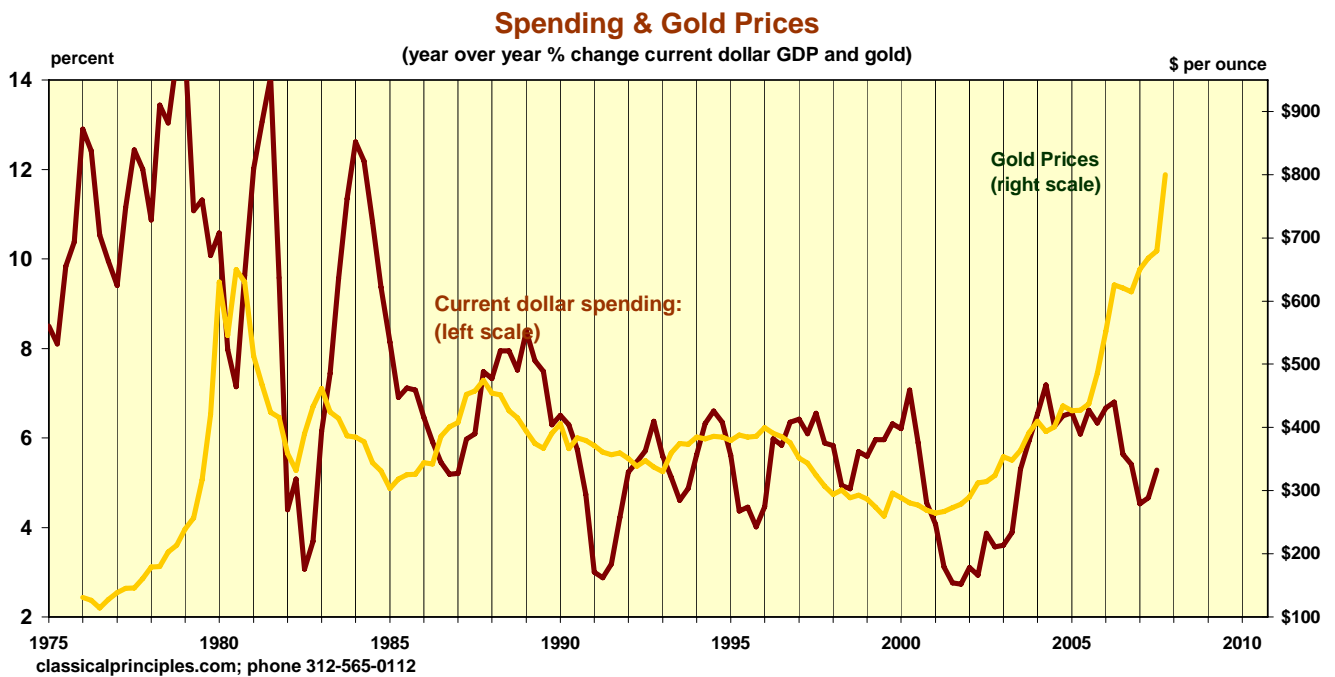
Although the yearly data are often several percentage points from subsequent changes in spending, the differences are made up over time. For example, the large excess in money over spending from the late 1990s and early 2000s was offset by excesses of spending over money in the mid-1990s and in recent years. Over extended periods of time, the cumulative difference between this rough approximation of money growth and the growth in current dollar spending has been less than one percentage point.

The relatively large gaps between traditional measures of money and subsequent changes in spending make it advisable to look to other indicators of monetary policy to determine the extent to which Fed policy has been restrictive or expansive. The following charts show alternative measures of monetary policy. The first shows the relationship between spending and the yield spread. The next shows the relationship between spending and gold prices and then spending and the US dollar.



Yield spreads have tended to widen when the Fed's monetary policy has been expansive and narrow or turn inverted when policy turns restrictive. When the spread between the rate on 10-year Treasury Notes and the fed funds rate has gone below its average of 1.1 percentage points (the solid green line), there has been a strong tendency for the spending pace to slow. The yield spread relationship complements the money relationship shown previously. While neither measure is perfect, there is a fairly reliable tendency for subsequent changes in spending to move in the direction shown by the various monetary indicators.

The price of gold and the value of the dollar are other potential indicators of Fed policy. When the Fed creates too much money, there is a tendency for the price of gold to rise in anticipation of a rapid increase in spending followed by a rapid rise in inflation. The creation of excess dollars can also lead to a weaker dollar.



While gold prices provided some guidance to the pace of spending and inflation during the 1980s and 90s, they were lagging indicators during the explosive rise in spending in the late 1970s. At that time, current dollar spending had been increasing at double-digit rates for several years before gold prices rose. The failure of gold to *anticipate* the most expansive monetary policy of the past half century suggests that it hasn't been as reliable as other monetary indicators.

The same is true for the value of the dollar. In 1975 current dollar spending soared at double-digit rates. In spite of this sure sign that inflation was heading higher, the value of the dollar actually moved higher. Hence, there are reasons to be cautious when using either gold prices or the value of the dollar as a guide to interpreting Fed policy.

Trade-Weighted Value of US Dollar in G10 Countries

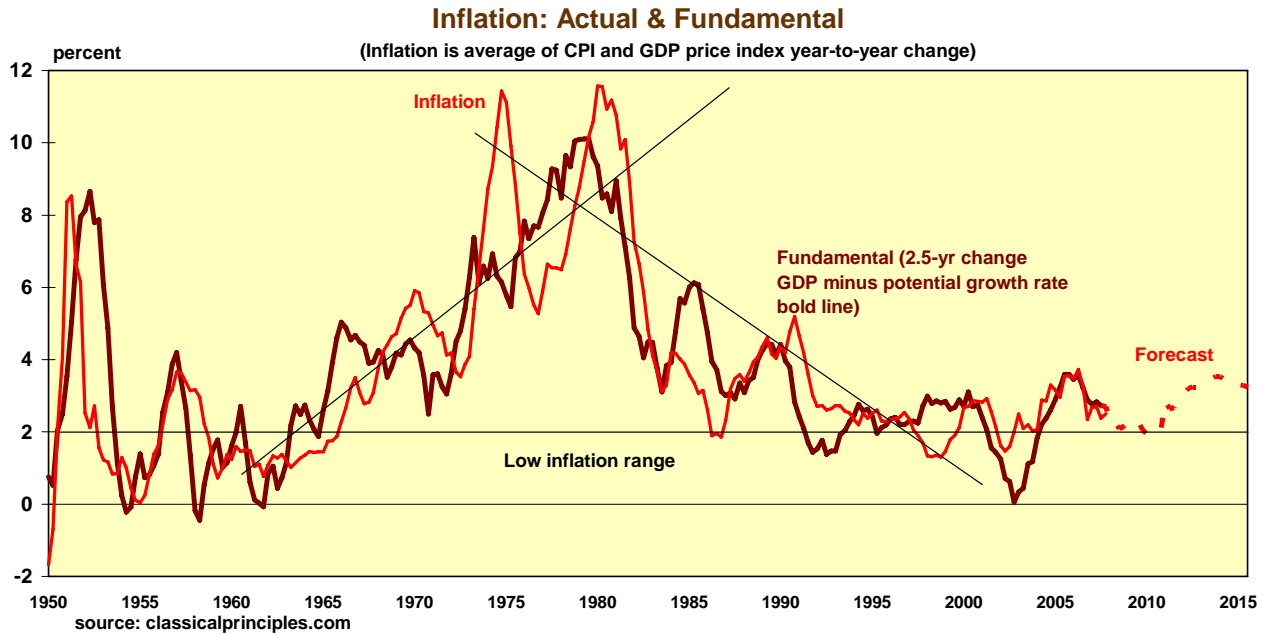


From 2003 to the middle of 2006 the average annual spending pace was 6%-7%. For the past two years it has averaged 5%-6%. This slowdown in spending is consistent with the slowdown predicted by the monetary indicators. Last year, the monetary indicators suggested that the spending pace would slow to 4%-5% in 2007. In the year ending with the third quarter, the spending pace was 5.3%, slightly above the predicted range. In contrast, gold prices have suggested that monetary policy has been expansive in 2005-06. If so, it's difficult to imagine why the pace of spending would actually slow for the 2006-07 period. For the year ahead, the more reliable monetary indicators continue to suggest that the pace of spending will be roughly in the 5% vicinity.

Inflation

One reason to focus on monetary policy is to determine whether spending, and therefore business conditions, are likely to be stronger or weaker in the period ahead. A second reason is to anticipate the rate of inflation. Inflation results when increases in spending exceed the economy's ability to supply goods and services. The section on productivity concluded that the economy was capable of increasing goods and services by roughly 3% a year. If spending increases by 5% over a 2-3 year period, the fundamental or underlying inflation rate will be 2%. The reason that it often takes 2-3 years of spending to change inflation is because many prices involve contracts that extend for beyond a year and cannot be changed quickly.

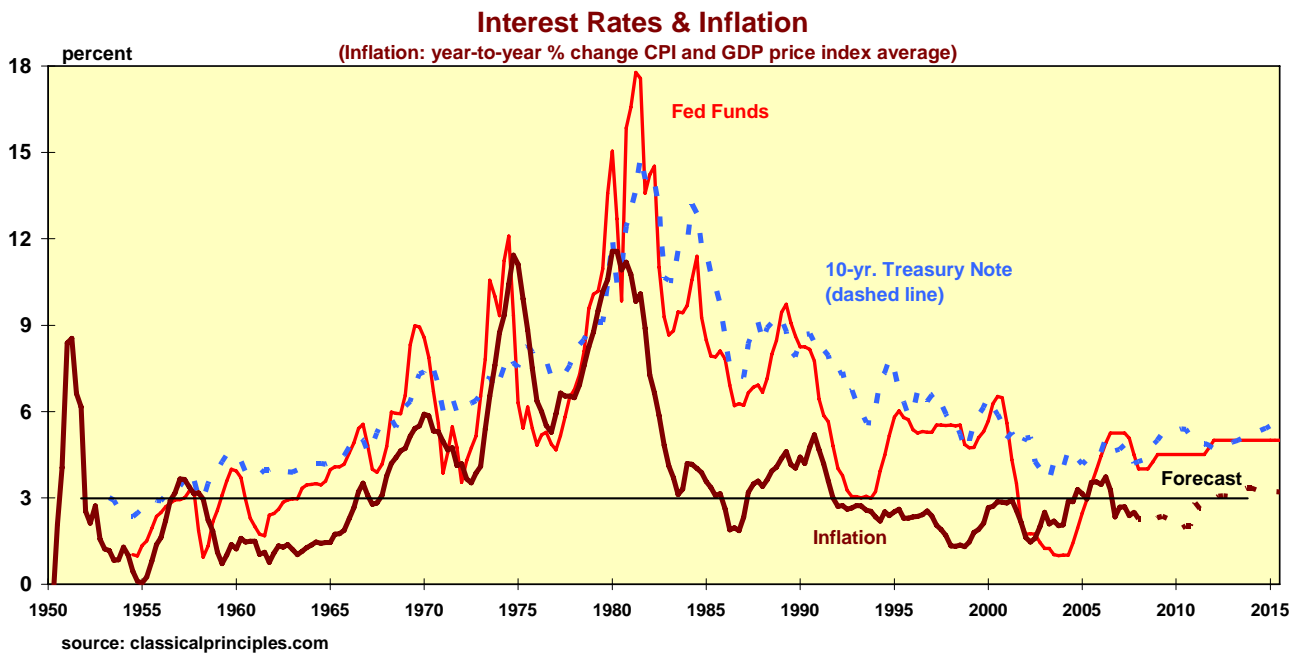
The next chart shows fundamental inflation as the amount by which the annualized spending pace over a 2-3 year period exceeds the economy's ability to supply goods and services. The 2-3 year pace of spending peaked at 6.6% in the last half of 2005. This spending pace was roughly 3½-percentage points above the estimate of the economy's potential and therefore pointed to an underlying inflation of 3½% for 2006. For the 2-3 years ending in 2007, the average spending pace has slowed to roughly 5½%. This suggests that the underlying inflation rate has slowed to roughly 2½%. For the year ahead current dollar spending is forecast to increase by roughly 5½%. If so, it would keep the 2½-year spending pace at 5½% and keep the underlying inflation rate close to the 2½% vicinity. The assumption that the real growth rate will slow to 2% beyond 2010 would place pressure on the Fed to create more money, thereby leading to higher inflation.



Financial Trends: Interest Rates & Stock Prices

Interest Rates

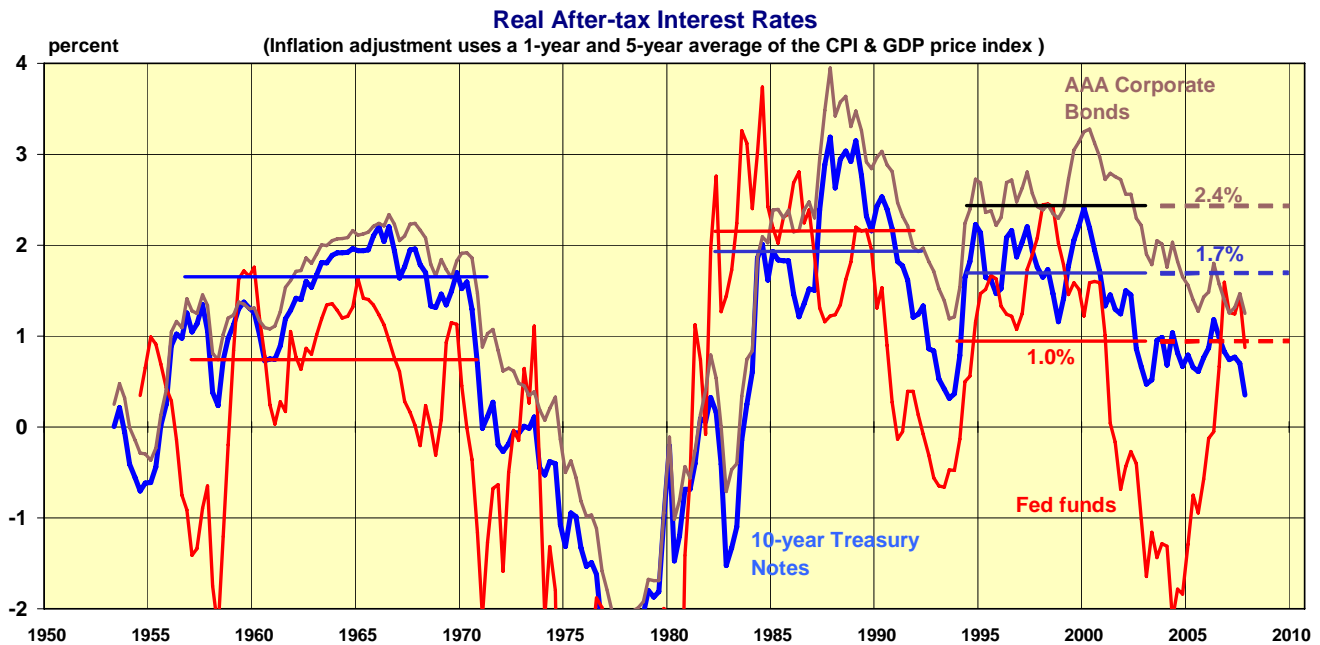
The most important factor affecting interest rates is the expected rate of inflation. As inflation declined over the past two decades, interest rates followed. As inflation declined to rates that existed in the 50s and 60s, interest rates gradually moved back to the rates that prevailed during that period. Interest rates consist of three key components—a real after-tax rate, a rate reflecting inflationary expectations and a tax premium. The chart below indicates that inflation has been the dominant force affecting major moves in interest rates.



Once inflation and taxes are taken into account, what remains is the real after-tax interest rate. This is generally a fairly low rate and is influenced by a number of different factors. One of the most significant is the productivity trend. When productivity is strong, entrepreneurs are willing and able to pay higher real after-tax rates to participate in highly productive investments. When productivity gains are low, as they were in the late 70s, investment returns tend to be low and entrepreneurs are unwilling and unable to pay high real rates for their ventures.

Another factor affecting real after-tax rates is monetary policy. During periods when monetary policy is restrictive (such as during the 1980s), real interest rates tend to be higher than average. When monetary policy is expansive (such as during the 2001-04 period), real rates tend to be lower than average. Real after tax rates were extremely low during the expansive phase of the most recent monetary cycle. As monetary policy turned less accommodative, the real after-tax fed funds rate rose well above its average. In contrast, the real after-tax rate for 10-year Treasury Notes remains well below its average.

Determining a reasonable real after-tax interest rate is difficult due to the competing forces that influence these rates. During a more normal period in the past (such as the 1960s), the average real after-tax rate for fed funds was 3/4%, while the comparable rate for 10-year Treasury Notes was 1.7%. During the 1970s, easy money and rapid inflation led to abnormally low real rates of interest. The opposite situation occurred in the 1980s, when tight money and falling inflation led to abnormally high real rates. During the 1990s real rates returned to more normal levels. With reasonably strong productivity trends through the end of this decade, it's reasonable to expect that real after tax rates on 10-year Treasury Notes will be close to the 1.7% level of the 1990s. For fed funds, the real after tax rate should be closer to a normal spread of roughly 70 basis points below the 10-year, which would put it at 1.0%. Rates on AAA corporate bonds have been roughly 70 basis points above those on the 10-year Treasury.

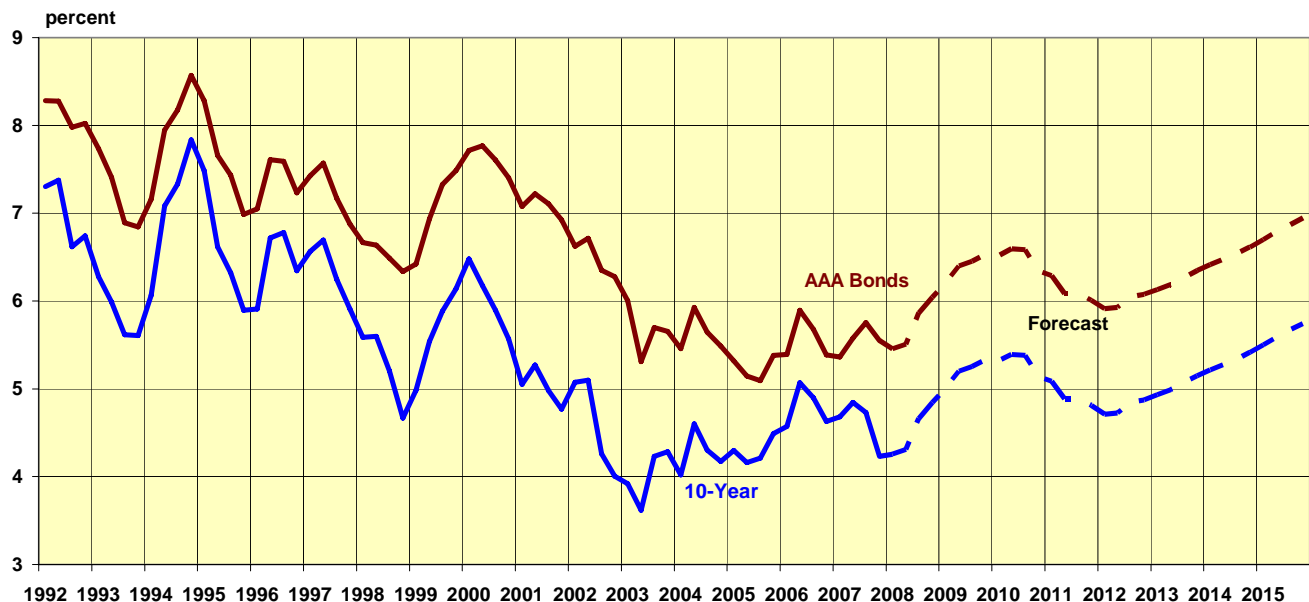


Given this analysis, we can calculate the normal level of interest rates if expected inflation were to settle in at 2½%. For fed funds, a 2½% inflation expectation plus a 1% real after tax rate produces an after tax rate of just over 3½%. If the tax premium is 25%, a normal fed funds rate would be just over 4½%. For 10-year Treasury Notes a real rate of 1.7% plus expected inflation of 2½% would place the real after tax rate at 4.2%. The normal pretax rate in this case would be just over 5½%.

While this analysis has served reasonably well in anticipating short-term rates, the analysis has not served as well with respect to longer-term rates. Even before the recent flight to the safety of Treasury securities, rates on long-term Treasury securities were lower than this analysis suggests. The current 10-year Treasury rate of 4% suggests that inflation expectations are either very low (1.3%), or that the real after-tax rate is below 1%. As the chart on the previous page shows, government securities are not the only ones with relatively low real rates. Real rates on AAA corporate bonds are also well below normal levels. The current generally depressed level of real after-tax rates is consistent with a monetary policy that is overly restrictive. In this case, the extremely low real rates may reflect expectations that growth will be very slow.

From a longer-term perspective it appears that a fed funds rate of roughly 4½% is consistent with an underlying inflation rate of 2½%. Barring some dramatic change in inflation expectations, the fed funds rate should remain in the 4%-5% vicinity in the years immediately ahead. As for longer-term rates, they appear unusually low at the current time. With more normal real rates and inflation expectations of roughly 2½%, the coming years should see yields on 10-year Treasury Notes and AAA corporate bonds that are well above the current depressed levels.

Long-term Interest Rates: Moody's AAA & 10-Year Treasury-Note



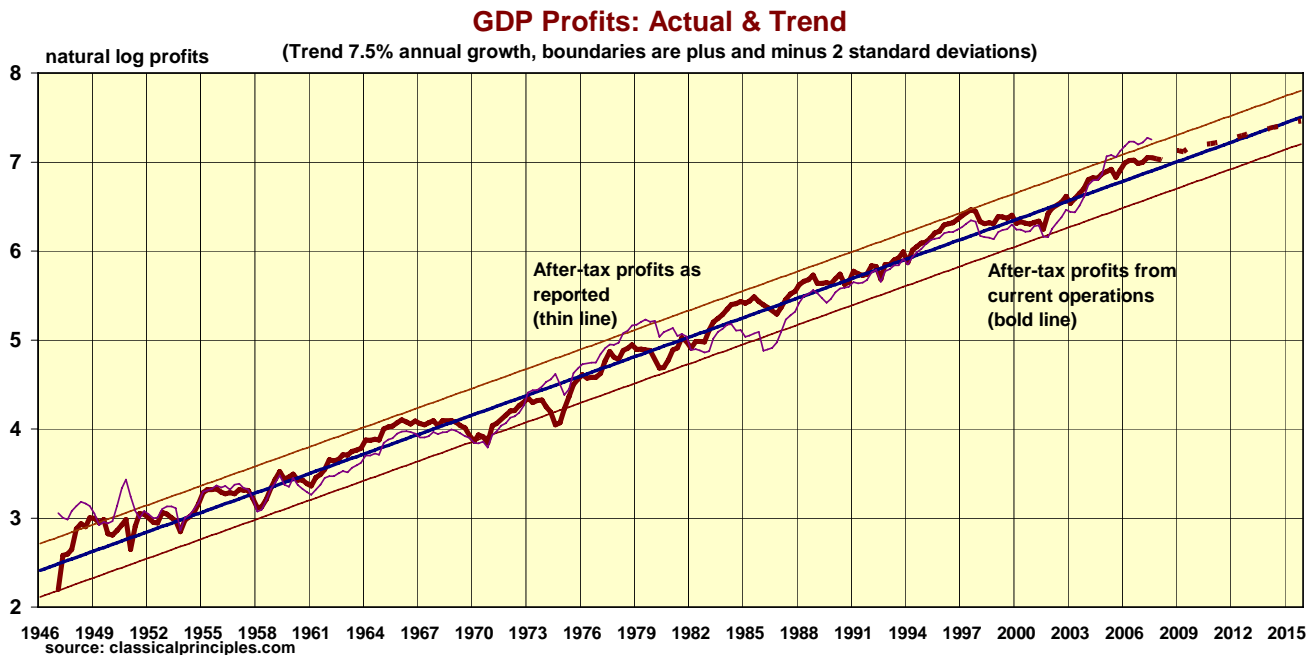
Beyond 2010, if growth slows and inflation rises, the increase in longer-term interest rates is likely to be greater. Although a slowdown in productivity growth would tend to lower the real after tax portion of interest rates, higher taxes and inflation would more than offset this factor. The end result would be a strong potential for higher interest rates.

Stock Prices

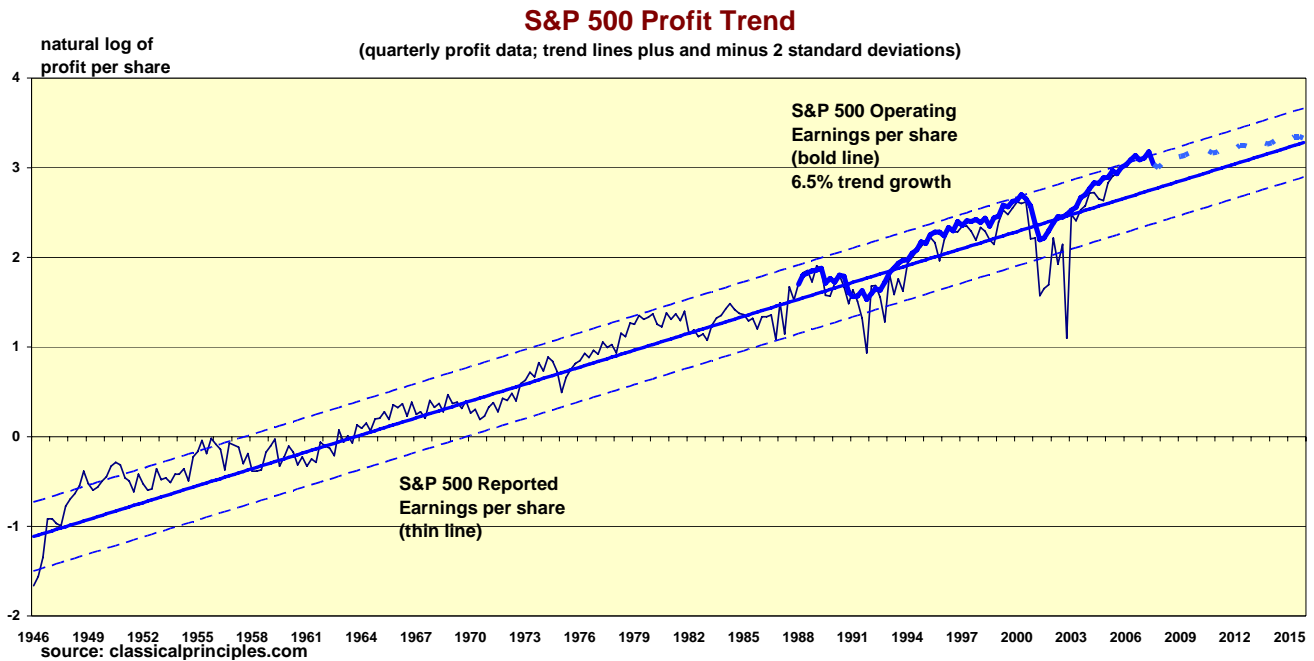
There are three main factors that affect the value of stocks—earnings, interest rates and risk. Assessing a reasonable value for stock prices entails reasonable assumptions for each of these variables.

Profits

Profits represent the most important factor contributing to the value of stocks. Over long periods of time, stock prices move in response to earnings. Hence, the first step in establishing a value for stocks is to determine the likely course of corporate earnings. The chart below shows the long-term trend for after-tax corporate profits in the US economy. It shows that profits have consistently grown at a 7½% annual rate since the end of World War II. Profits have held up extremely well in recent years amid a difficult economic environment. Recent tax cuts and the accompanying productivity improvements continue to provide a healthy environment for increases in corporate profits. Even so, profits are currently above their normal share of GDP. The forecast assumes that growth in corporate profits will slow over the course of the next few years bringing them back to their longer-term trend.



Where corporate profits for the entire economy have an annual long-term growth trend of 7½%, the companies in the S&P 500 stock index have a somewhat lower 6½% trend. As for the overall economy, profits for the S&P 500 companies have been above the trend line in recent years. The forecast assumes that profit growth for the S&P 500 companies also returns to its longer-term trend. This suggests that profits will be growing slightly below their longer-term growth trends.



The chart below shows the long-term relationship between the S&P 500 stock price index and earnings for the companies in the index. Earnings are multiplied by a price-earnings ratio of 17, which is the average over the entire period. Natural logs are used so that percentage changes over long periods appear consistent. Based on an average PE ratio, the S&P 500 is appropriately valued. However, stocks compete with fixed income instruments. Using an average PE ratio to value stocks makes sense if interest rates are the same today as they were over the historical period. During the time period 1955-2007, when the PE ratio averaged 17, the average rate on 10-year Treasury Notes was 6.6% and on Moody's AAA corporate bonds it was 8.3%.

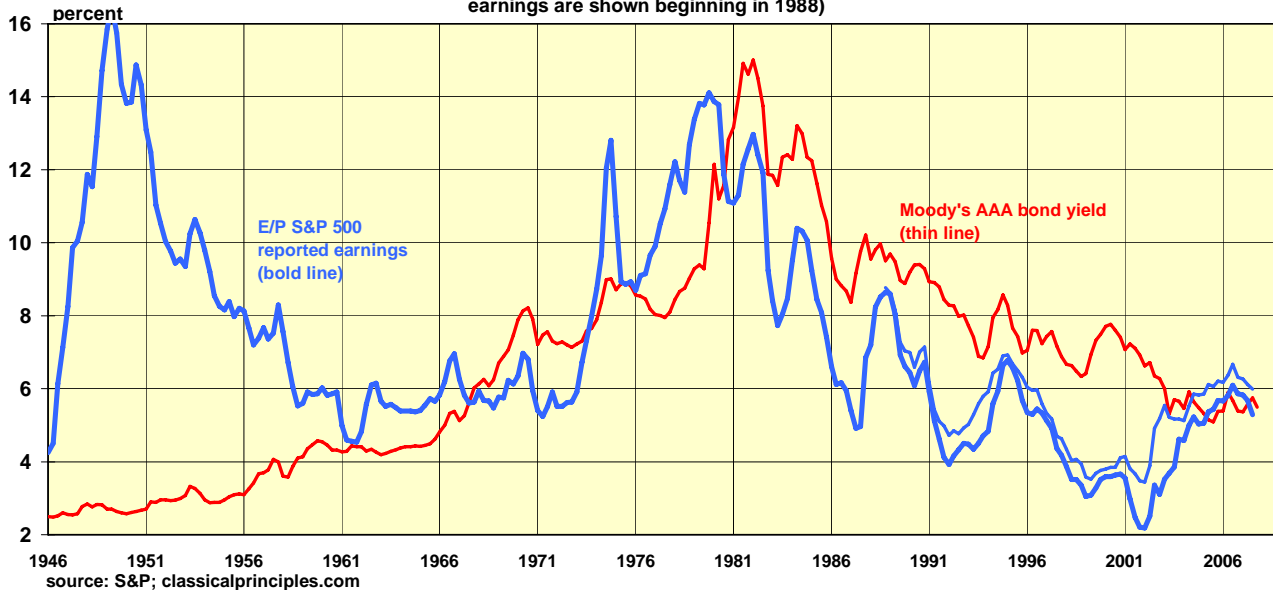


The relationship between profits and stock prices essentially captures the popular concept of a price/earnings (PE) ratio. A more practical tool than the PE ratio is its inverse—the earnings/price ratio (EP). The EP ratio is helpful for comparing the returns paid to stockholders with those paid to holders of fixed income assets. The chart below compares these returns. During most normal periods, the returns to bondholders (i.e. rate of interest) are greater than those to stockholders (i.e. the EP ratio). The reason for this is that over time stockholders can usually count on the growth in profits to increase their returns. In contrast, returns to bondholders are fixed.

Recently, in spite of rising profits and higher stock prices, the earnings yield on stocks has actually been above the bonds. This is a highly unusual situation. It existed in the late 40s and early 50s when memories of the Depression were still fresh. It also existed in the late 70s, when economic policies moved away from classical principles leading to economic stagnation. A relatively high earnings yield means that stocks are out of favor, and there is a large risk premium associated with holding them.

Earnings/Price S&P 500 & Interest Rates

(Stock prices are current quarter; earnings are reported after-tax for past 4 quarters; operating earnings are shown beginning in 1988)

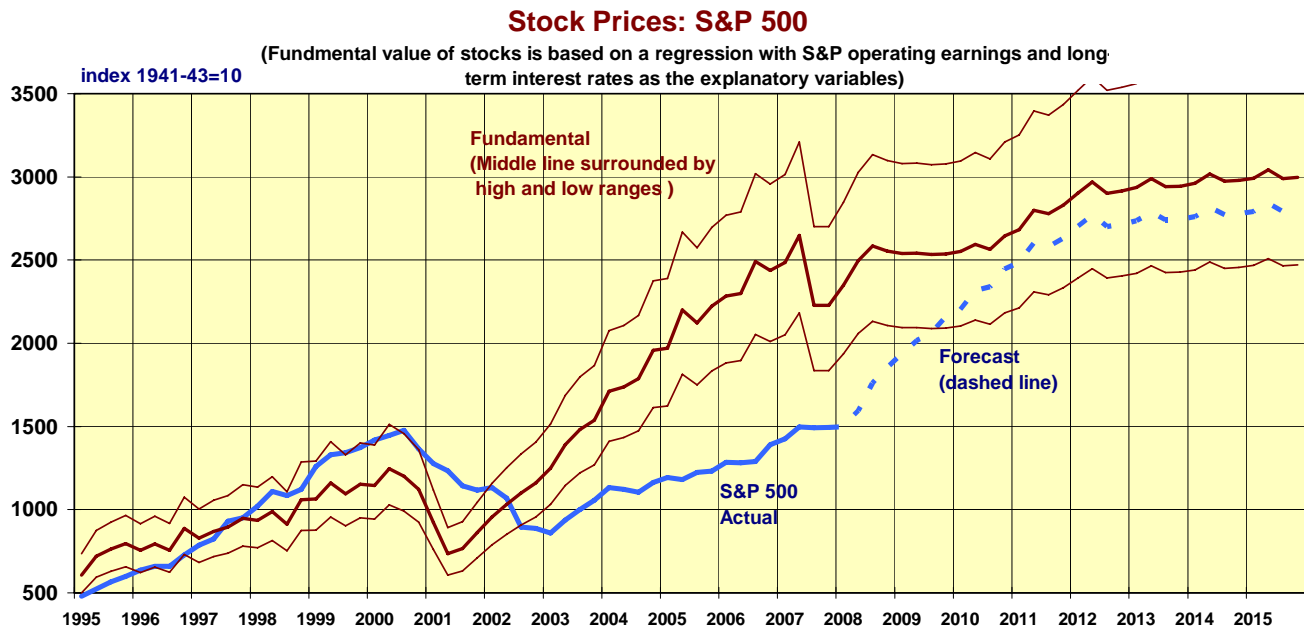


The large risk premium on stocks is probably associated with the 40% drop in stock prices at the beginning of this decade. Over time, memories of that decline will fade. Profits will grow. Bondholders, who in recent years have often suffered from negative real returns, will eventually demand and receive higher returns. By the same token, the relatively high returns to stockholders will gradually return stocks to their favored status over fixed-income assets.

In the context of history, the unusually large risk premium currently associated with holding stocks does not appear reasonable. There will always be risks associated with business and investments. Those risks are far greater when economic policies move dramatically away from classical principles and when monetary policies are overly restrictive. With policies remaining positive for at least the next 1-3 years, and with monetary policy shifting away from restraint, the risk associated with owning stocks should be far lower than indicated by current stock prices.

Forecasting Stock Prices

Forecasting stock prices begins with a forecast of profits and interest rates. A regression analysis relates stock prices to both the profit and interest rate projections noted earlier. The *fundamental* stock price represents the best estimate of stock prices given historical profit and interest rates for the relevant time period. The difference between the actual stock price and the fundamental in the chart below represents the risk premium associated with holding stocks. When actual prices are above the fundamental, it indicates that the risk premium is less than average. When prices are below the fundamental, investors perceive a greater than average risk to holding stocks.



Over the past 5 years, the S&P 500 Index rose by 70%. Including dividends, these stocks had a total return of 84% (a 13% annual rate of increase). In spite of these seemingly strong numbers, the S&P index spent the past 5 years simply restoring the losses incurred at the beginning of the decade. The increase in stock prices during the past five years was far below what might have been expected from soaring profits, which more than doubled and which ended the past year 40% above previous highs.

Over the next 2-3 years, as monetary policy shifts from restraint to stimulus, stock prices should rise at above-average rates. If tax rates rise as scheduled in 2011, stocks will lose some of their luster. However, to the extent that US companies are able to reap the benefits of rapid global growth, they should be able to continue to reward their owners with returns that are commensurate with the risks of ownership. Over extended periods of time, stocks have been and should continue to be the highest yielding asset in anyone's portfolio.

Conclusion

The widespread application of classical policies throughout the world has led to an unprecedented acceleration in growth and prosperity. At present, the US leads the rest of the world in adopting low-tax, free market policies that have contributed so much to the global boom.

For the immediate future, the odds for rapid growth and relatively low inflation in the US appear relatively high. Unfortunately, so do the odds for a setback at the turn of the decade. Significant pressures are emerging that will challenge US world leadership. Xenophobic reactions to foreign investment and immigrants already pose a threat to the free flow of trade and workers. New energy legislation relies on political edicts to direct resources—a clear throw-back to destructive socialist policies. Meanwhile, scheduled tax hikes and challenging demographic trends present major hurdles to ongoing US prosperity.

Up to now, efforts to forestall the Social Security crisis through privatization have failed. As the problems associated with Social Security become progressively more obvious and more painful, the public is likely to turn to solutions that were previously viewed as untenable. Similar reasoning applies to tax policy. Ideally, politicians will vote to retain current tax rates before they expire, thereby avoiding the damage from higher rates. However, if tax rates do increase, the negative impact will be so quick and so damaging that it's likely to deal a lethal blow to those politicians who allow it to happen.

When faced with destructive economic policies, the American public has often been able to sense the appropriate course of action. At times, such as during the late 1970s, the public gets it wrong. Destructive policies lead to poor economic performance. In response, the public recognizes the mistake and changes course.

America is the world's first and greatest democracy. One of our greatest strengths has been a unique ability to change course and deal effectively with challenges. Upcoming challenges will test both the public and our political leaders. The initial reaction to such challenges has not been encouraging. At this point it appears likely that the challenges will have to produce problems before those problems are addressed.

Even so, the American public tends to possess a unique sense of understanding of what constitutes sound policies. As challenges become progressively more apparent, the public is likely to turn to its classical roots for solutions. In so doing, it's likely that those challenges will turn into opportunities for reforms—reforms that can enable the US to show it has the ability to continue to lead the greatest global transformation in history.

1/2/2008	<u>Actual</u> 2007	<u>Forecast</u> 2008	2009	2010	2011	2012	Average 2007-2012
GROSS DOMESTIC PRODUCT	13859	14579	15336	16045	16812	17722	
%ch	5.0	5.2	5.2	4.6	4.8	5.4	5.0
REAL GDP	11581	11947	12324	12667	12987	13340	
%ch	2.3	3.2	3.2	2.8	2.5	2.7	2.9
CHAIN PRICE INDEX	1.197	1.221	1.246	1.269	1.297	1.332	
%ch	2.7	2.0	2.0	1.8	2.2	2.7	2.2
CPI- ALL URBAN	2.072	2.128	2.180	2.229	2.288	2.359	
%ch	2.8	2.7	2.4	2.2	2.6	3.1	2.6
PRETAX PROFITS ADJ (1)	1606	1656	1785	1866	1950	2051	
%ch	3.3	3.2	7.8	4.5	4.5	5.2	5.0
AFTER-TAX PROFITS ADJ(1)	1134	1167	1257	1314	1373	1445	
%ch	3.1	2.9	7.8	4.5	4.5	5.2	5.0
PRODUCTIVITY	1.38	1.41	1.45	1.49	1.52	1.55	
%ch	1.6	2.8	2.7	2.6	2.1	1.9	2.4
UNEMPLOYMENT RATE	4.6	5.0	4.8	4.7	4.7	4.7	4.7
Potential Real GDP	11724	12076	12438	12811	13115	13378	2.7
Actual as a percent of Potential	98.8%	98.9%	99.1%	98.9%	99.0%	99.7%	99.5%
M2 %ch at annual rates	6.0	5.5	4.7	4.7	5.0	5.3	5.0
Mg %ch at annual rates	3.2	5.2	4.8	4.7	4.8	5.4	4.7
MORTGAGE RATES	6.5	6.8	7.0	7.0	6.6	6.5	6.8
10-YR GOVT SECURITIES	4.6	4.5	5.2	5.3	4.9	4.8	4.9
2-YR GOVT SECURITIES	4.5	3.9	4.6	4.6	4.7	5.1	4.6
PRIME RATE	8.0	7.1	7.5	7.5	7.6	8.0	7.5
FEDERAL FUNDS RATE	5.0	4.1	4.5	4.5	4.6	5.0	4.5
STOCKS:							
S&P 500	1477	1676	2044	2326	2573	2722	13.0
S&P 500 operating earnings/share	87.5	90.8	98.2	100.8	103.1	106.5	4.9
S&P 500 p/e	19.7	19.7	22.4	24.4	25.8	25.9	23.6

(1) Profits adjusted to exclude inventory profits and to allow for depreciation at replacement cost

Data for GDP are in billions of dollars