THE ECONOMIC SITUATION

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Note: Cartoonist Robert Arial has generously allowed his cartoons to be used in the Economic Situation report.
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What to Expect from Quantitative Easing

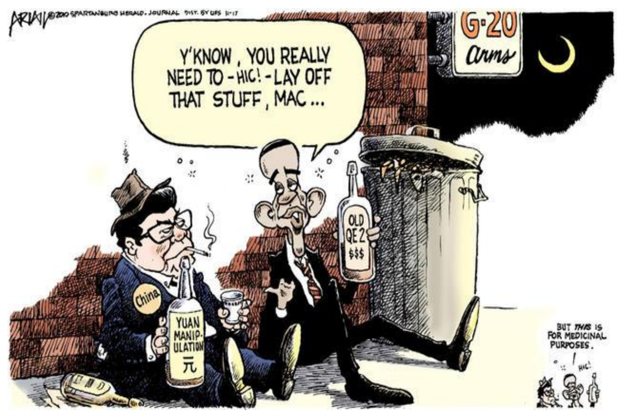
Mr. Bernanke's announced plan to inject $600 billion in new money into the economy across the next six months brought loud criticism from some of our key trading partners and lenders and reactions of shock from some who see the Fed as the protector of the wealth of the nation. Some of our trading partners and creditors saw the described domestic policy move as a disguised effort to devalue the dollar and thereby gain market share in world trade. Those holding vast amounts of dollar debt saw the move as a way to restructure loans by paying them off with printing press money and without their permission.

Upfront regarding the plan and apparently glad to defend it, Mr. Bernanke indicated that the Fed had an inflation target of 2% that it hoped to hit. At present we are experiencing 1% to 1.5%. Fear of deflation seems to be one of his more serious worries. Perhaps an unstated concern relates to the continued decline of housing prices and therefore housing related bankruptcies.

Another unstated goal might relate to giving retail sales an early nudge. If people truly believe that prices will be higher next year, they may shop early.

To get a handle on the implication for the economy, it may help to recall economist Irving Fisher's (1867-1947) equation of exchange: $MV = PQ$. In the equation, M measures the supply of money circulating in the economy; V stands for velocity and is a measure of how many times the supply of money turns over each year; P is the price level, a measure of inflation; and Q is the real quantity of goods and services produced annually. PQ can be thought of as the dollar value of GDP. In the simplest interpretation, increasing M by $600 billion through quantitative easing is linked to a larger value for PQ. But that larger value may result from a larger P—inflation, or some mixture of inflation and more goods. But there is another unknown in the equation, velocity. Since the onset of the Great Recession, velocity has fallen systematically month after month. Efforts by the Fed to provide larger reserves to the banking system have not been translated into loans and new private investment. For every increase in M, there has been a decrease in V. Nothing has happened to PQ. This new round of quantitative easing is another large effort to fire up credit expansion and inflation. If it did not work the first time, why might it work now? No one seems to be willing to offer an answer to this question.

While Mr. Fisher's equation suggests the intended result is clearly a mathematical possibility, we must remember that human beings form the transmission that connects the elements in the model. Banks may end up with more cash in the vault and reserves with the Fed, but those larger balances do not automatically increase the line of credit-worthy loan applicants in bank lobbies, especially when bank regulators are tightening loan standards. Optimism about the future and real action by real people will be necessary to get the equation of exchange to move from a theory to reality.



Until M becomes PQ, our trading partners have little to worry about. But the fact that reserves are larger leads to expectations about future currency conditions, and expectations do drive futures markets. As shown in Robert Arial's cartoon, Mr. Obama will continue being accused of doing exactly what he regularly accuses China's leadership of doing. Our government is intervening in financial markets in an attempt to reduce the value of our currency.

Ireland, Greece and Euro-zone survival

The Celtic Tiger, it seems, has its tail caught in the credit market meltdown. And it doesn't feel very good. News stories are full of bailouts with harsh conditions and new concerns about the next nation's demise and what to do. Will Portugal be next? Spain? Italy? What about Greece? Heaven help us, the U.S.? Each case has a separate fact situation, but it's all about debt and deficits. With Greece it is a history of overspending and welfare state expansions. More like Iceland's story than Greece's, Ireland's problems seem to have been driven by ambitious banks that expanded real estate lending and deposit taking well beyond the Emerald Isle.

Faced with the now typical defaults and customer panics, the banks called on government for help, and the government quickly responded with a carte blanche set of open-ended guarantees. When the books were finally tallied, the bank debt was more than even the government could swallow. Another round of Euro-zone bailouts has followed. Meanwhile, the debt stays on the books…, somewhere. And that is part of the problem. Shifting bad debt from one party to another doesn't really solve the basic problem. Restructuring the debt might.

But what's going on here? Why not let the unlucky or badly managed countries fail? It would not be the first time a country defaults. Market discipline could be the long-run best solution.

Think about the Euro-zone as a complicated Monopoly game where Euro member-players enjoy the game and create wealth in the process. Some country players are luckier than others. And some are more skilled at playing the game. In the game, players can borrow from each other and from the bank. But loans can be called when a player's finances look doubtful. With skill and luck, Germany has carefully bought Boardwalk and Park Place and now has three hotels on each property. The good Germans have money on their side of the table. Then there are less skilled and unlucky ones like Greece and Ireland. Ireland owns Baltic Avenue and Mediterranean and has three hotels on each, all paid for with borrowed money. But no one seems to land on Ireland's property, and the bank is thinking about calling the loan.

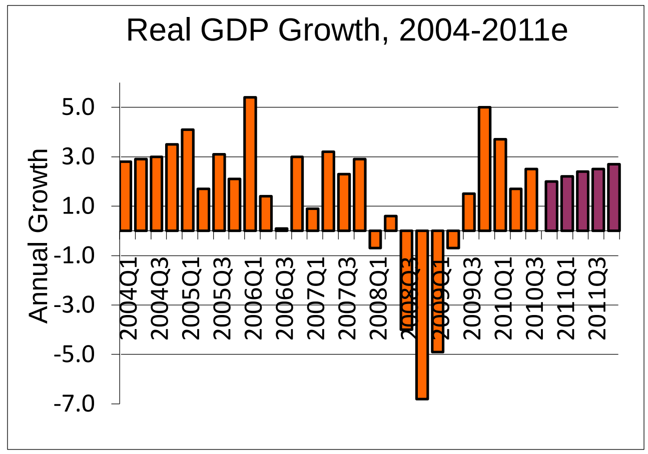
Suddenly Ireland lands on Boardwalk and can't pay up. What to do? Should Germany look the other way or accept an IOU? Should all the solvent players put money in a pool to lend to unlucky and less skilled players? But there is another option. Print money. Just give a few thousand to each player and the game goes on. But this Monopoly game is bit more complicated. There are other Monopoly games going on with other players. And the players at other boards lend across the various games. What happens in emergencies at one board can affect everyone else, no matter where they play.

If it appears the Euro players will just keep bailing out bad players till all the money is gone, players elsewhere will stop lending. And if the Euro players start printing more Euros in the hope of keeping their game going, fewer players elsewhere will be willing to hold Euros. Either way, the entire Euro-zone could go the way of the currency and collapse. Of course, if Ireland, Portugal, Spain, and then Italy hit the wall and receive no bailouts, the community would be reduced to a mixture of princes and paupers, which may be an accurate reflection of reality. Each country might go back to individual currencies and constitutions. And that might not be a bad idea. Maybe paupers will learn to be princes.

And maybe the Euro-zone members will recognize that it is possible to have one currency without having a bailout guarantee for nations that get in trouble, even when banks in each country are major holders of every country's debt.

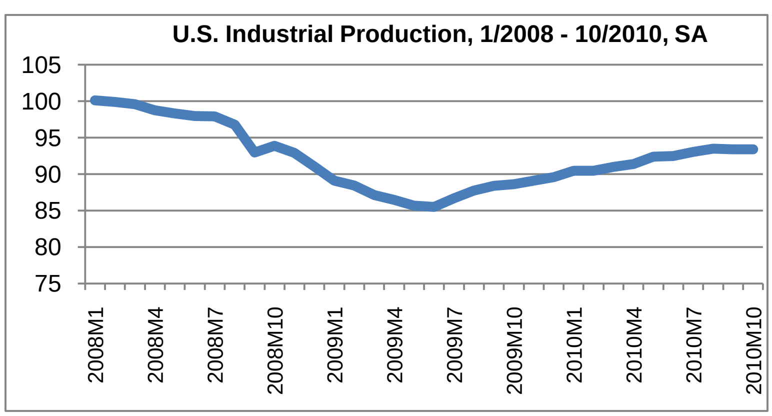
The Euro-zone problem is a problem about constraints and common-sense discipline, things that no spend-thrift country wants to deal with. We should know. The U.S. has its own version of Monopoly underway. We are just further back in line. We have ample time to get our house in order…, if we find the will to do so. The clock is ticking.

On Turning Corners and Looking Ahead.

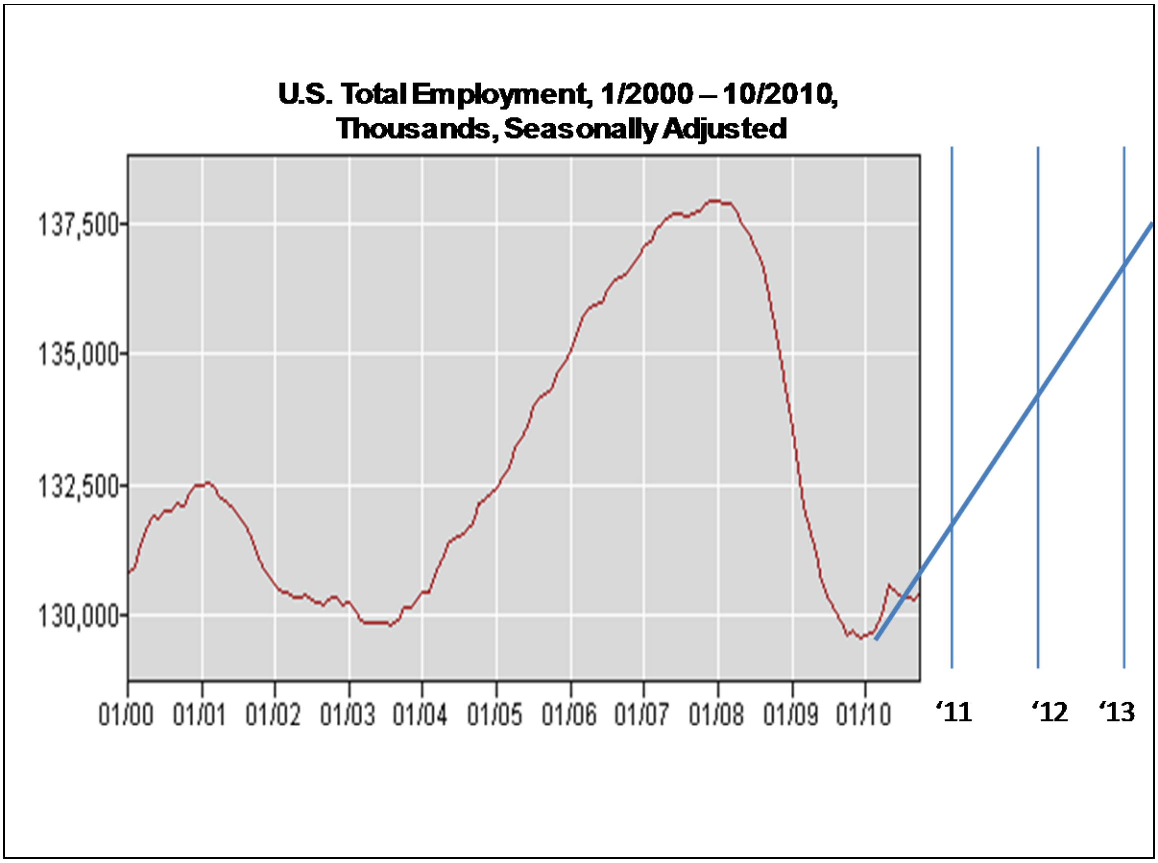


By many economic indicators, save one—the folks you know who are without work, the economy has turned some important corners. Incomes and retail sales are rising. Employment is growing, and even the unemployment situation has begun to improve. In the last 12 months some 101,000 workers have been added to the nation's payrolls. That's slim pickings, but the Commerce Department's second GDP estimate for 3Q2010 has the economy growing steady at 2.5%, but suggests the growth pace will fall to 2.0 percent in 4Q2010. These lower but positive numbers contain some of the effects of worn out programs for stimulating housing, auto sales, and state and local government support. Even so, we don't look a gift horse in the mouth. The numbers are in the black. I show the actual values here in orange. The purple estimates in the chart will never look that neat in real life, but do represent an expected growth trend. There is an alive and breathing economy out there.

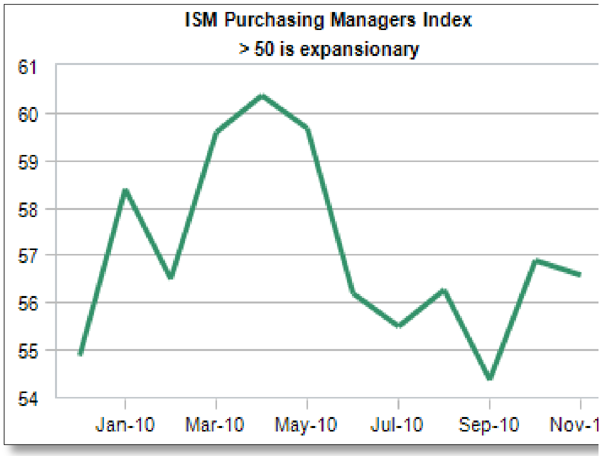
We can also see rays of sunshine in the Fed's Industrial Production index, which measures activity for the nation's factories, mines and utilities. Industrial production bottomed in June, 2009, the recession end point recognized by the National Bureau of Economic Research. The index value for January 2008, the recession's start, just happens to be conveniently set at 100. Led by autos, aircraft, electronics, and machinery, in October, the industrial economy was a little more than 5 percent away from recovery. Roughly speaking, we have a 95% full economy, and that's a lot!

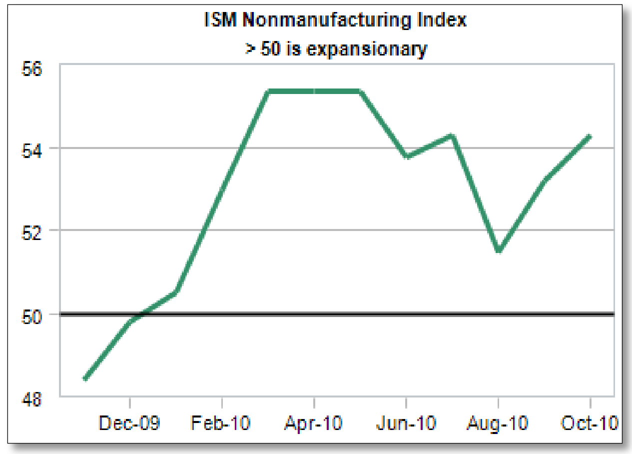


When we look at the count of those working, the data tell us that total employment bottomed in mid-2009 and has been heading slowly north on a bumpy road ever since. If we superimpose the most recent 2003-2007growth path on the current data, we see recovery at the December 2007 level would occur by 2Q2013. This is shown in the next chart. There will also be a larger number of people looking for work in 2Q2013, so the unemployment rate will higher than when the recession first started.



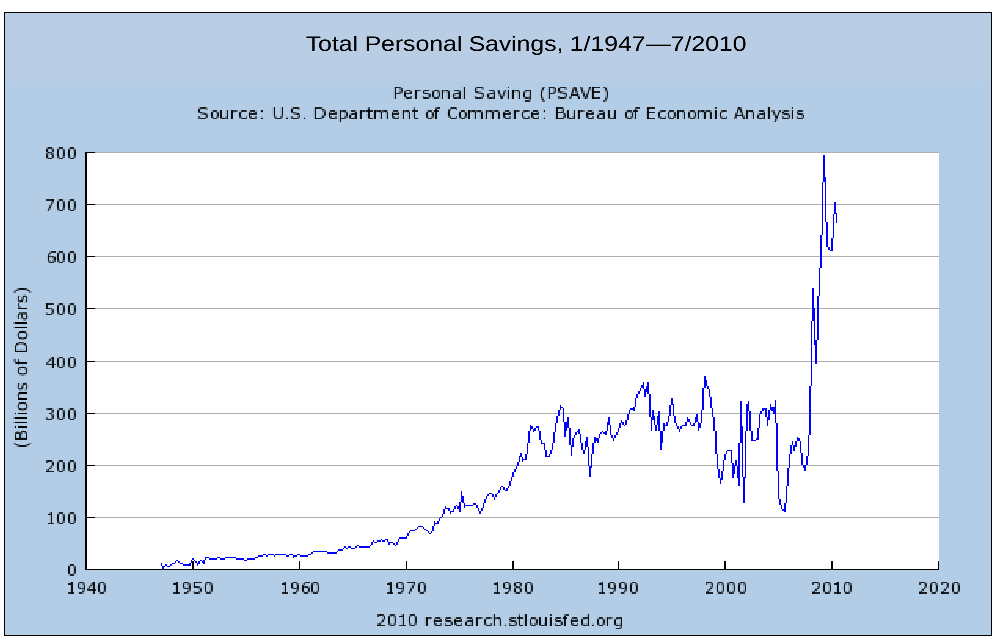
Evidence of another turning point is seen in the Institute of Supply Management's manufacturing index. With a value of 50 set as dead in the water and any greater value denoting growth, the index has rested above 50 since June 2009. As with employment, we see a bumpy path, but the path is positive and rising. The nonmanufacturing index, which accounts for the economy's remaining 75% activity, has been in growth (greater than 50) territory since January 2010.



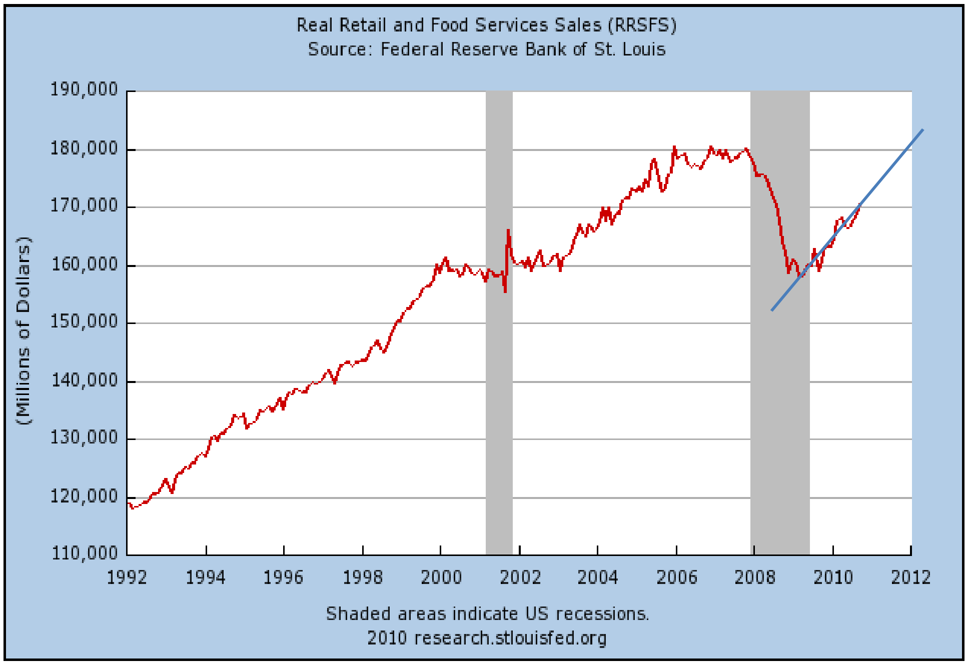


Weak Retail Sales Stand in the Way…, Maybe

"It's an evil wind that blows no good," so they say. The Great Recession reminded all but Washington that the time for paying down debt is long overdue. And even Washington has gotten the word. On the private side of the economy where no one can legally print money, Total Person Savings shot to the ceiling, which of course means that retail sales fell to the cellar. But even with high unemployment, consumers have become a bit more relaxed as employment picked up and incomes began to rise again.



With a bit more confidence, consumers have returned. Indeed, a projection of recent sales data shown in the next chart suggests that a recovery to pre-recession levels will be seen by early 2012.



Housing and Construction are Resting at Bottom

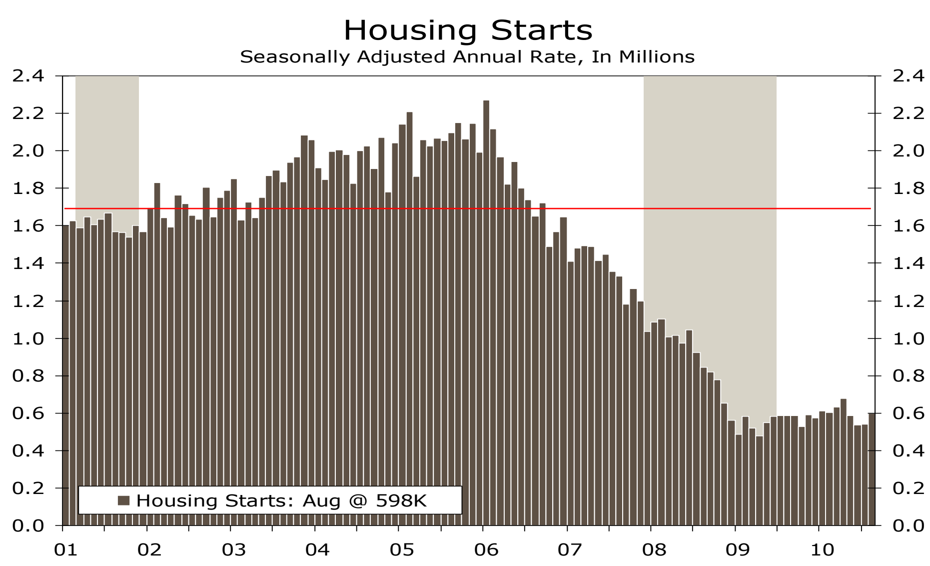
New York Fed president William Dudley estimates that there were three million excess housing units built during the boom before the bust, and most of them are still looking for occupants. This huge overhang, which amounts to about two years construction in normal times, weighs heavily on the recovery and makes it impossible for Washington fiscal and monetary policy to close the unemployment gap. As I see the situation, it is a matter of having almost two million construction workers counted among the 14 million unemployed. Put another way, some 14% of the unemployed directly came from the deflated housing bubble. The ranks include the highly skilled craftsmen and women as well as low-skill workers. Yes, we humans are adaptable creatures, but the easier adaptations come first. We are now 36 months into the recession and recovery, and construction is still in the cellar.

Thus far, Washington fiscal policy has been targeted on unemployment compensation, funds for state and local governments, and some infrastructure projects. Monetary policy has been geared toward reducing interest rates, building bank reserves, and inflating the economy. None of this can quickly bring employment to out-of-work dry wall specialists, plasterers, carpenters, and masons. Just to put a few dimensions on the problem, consider this: The October unemployment rate for Management, Professional and Related Occupations was 4.5%. The same rate for Service Occupations was 10.1%. The rate for Production, Transportation, and

Materials Moving Occupations was 11.0%. And the rate for Natural Resources, Construction, and Maintenance Occupations was 13.6%.

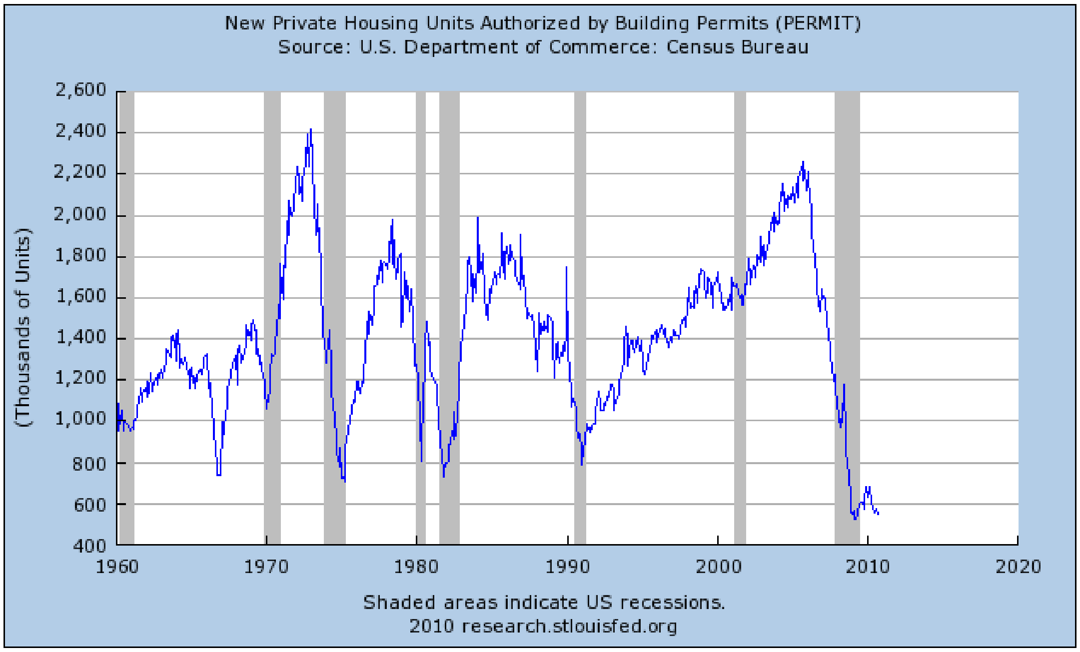
A Closer Look at Housing Starts

The housing construction excess is shown clearly in the next chart that was developed by Wells Fargo economics. I have placed a red line in the chart to mark the normal level of construction. The mountain of "too many houses" is easier to identify than to rectify.



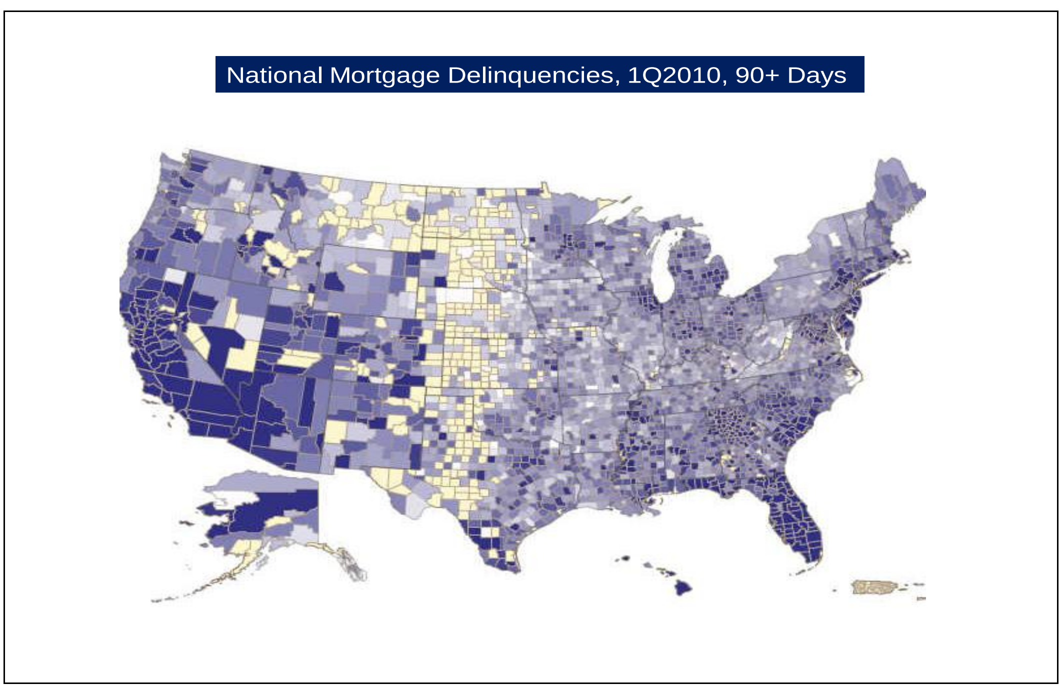
Wells Fargo Economics, 10/2010

A longer view of the housing is seen in the next chart, which at the current moment contains no apparent recovery pattern. Based on the 1990-2006 expansion, we might expect to see better times, meaning 1,600,000 units, in 2020.

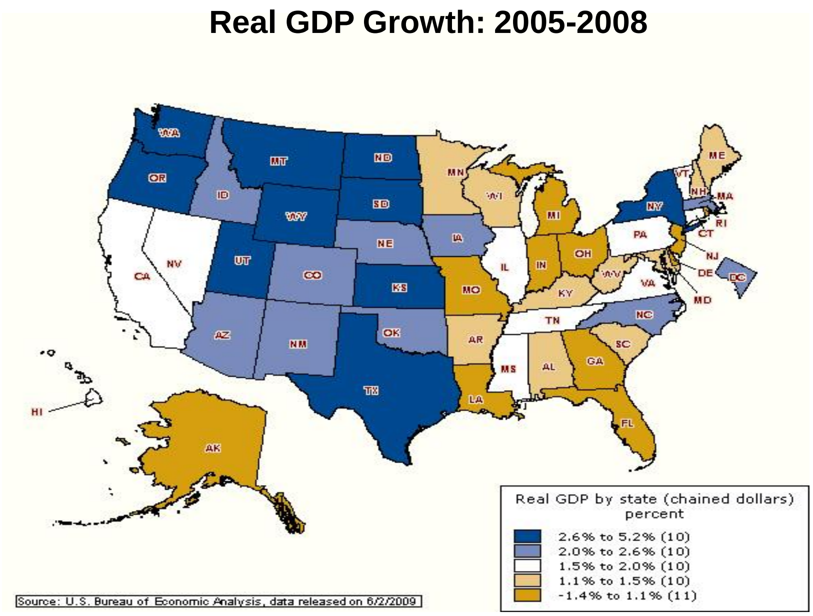


The Geography of the Problem

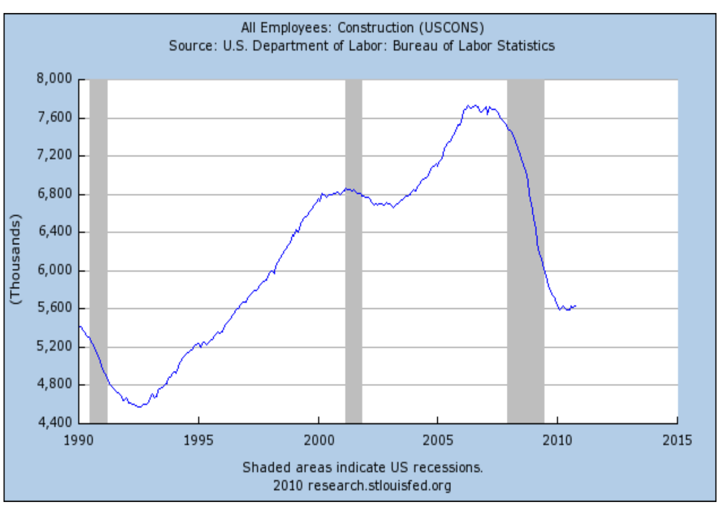
Bankruptcies, bank owned real estate, and delinquent mortgages, which are seen in the next chart, form the data counterpart of excess housing. The counties colored dark blue in the next chart identify regions that will continue to suffer the sub-prime blues. California, Nevada, Florida, and the Atlanta area in Georgia have a heavy dose of delinquencies. They also have a heavy dose of unemployed construction workers.



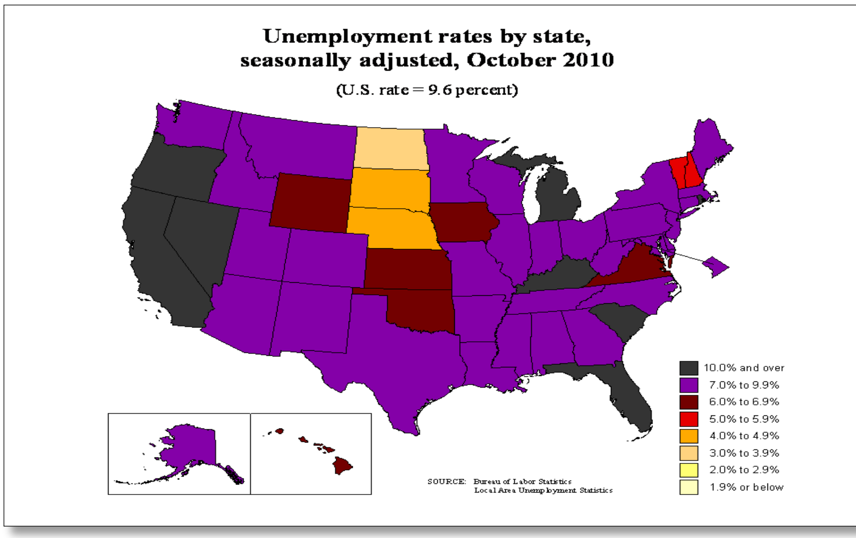
Another glance at the map identifies those states in the middle of the country that either missed out on the boom or somehow dodged the delinquency bullet. It turns out that those oil, coal, gas, and ethanol states were producing income even while other states were falling into recession. They are also states with higher educational attainment. We see the result in the next chart that shows state GDP growth for 2005-2008.



The overall construction employment problem is reflected in the next chart. Here we see the sharp decline that has just now hit bottom. Recall that employment bottomed out for the total workforce in June 2009. Compare the previous downturns seen in the chart. There is nothing like the current collapse.

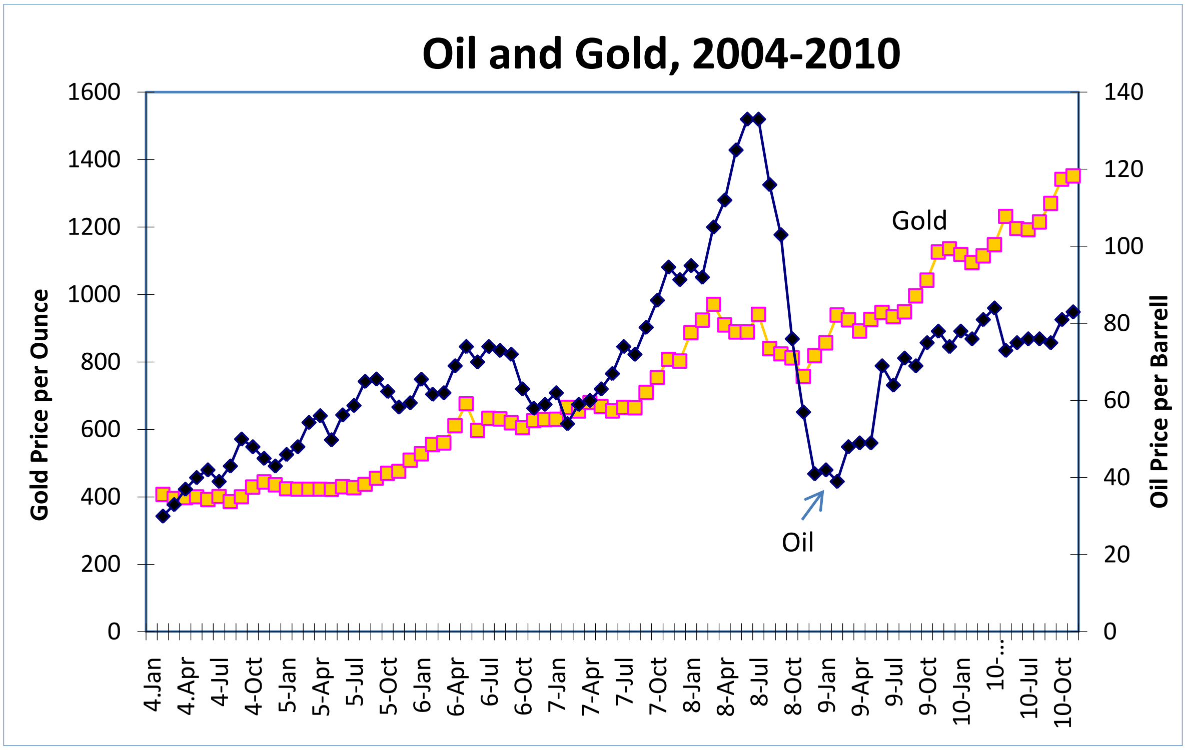


This and differences in state GDP growth seen earlier help to explain the variation in levels of unemployment observed across the states. As seen below, California, Oregon, Florida, South Carolina, Kentucky, and Michigan werw still members of the dreaded over-10% unemployment club in October 2010.



What about Oil? And Gold?

In the June Economic Situation report, I called attention to the upward bound prices of oil and gold and said we should look for $100 oil in the first half of 2011. The forecast was based on two things: 1) the relationship between the prices of oil and gold, which generally move together, and 2) a return to normal demand for oil with world recovery. We are now at $85 a barrel and holding. Meanwhile, prices for the two commodities have continued their upward trek with the price of oil continuing to be off its historic track, relative to oil. It is still my expectation that we will see $100 oil in the first half of 2011, but instead of basing this forecast primarily on a global recovery, which seems to have weakened lately, the promise is based partly on the Fed's commitment to inflation. Quantitative easing is in the wind, and commodity markets seem to sense it. In the chart below we see the relationship between the two prices, with the price of oil still off the historic track, relative to gold. We also observe a bit of acceleration in the price increases of the two commodities, which I believe relates to the announced quantitative easing.



Looking Ahead

With a new year on the horizon, it is time to look at what the GDP soothsayers are telling us and make a selection for the coming year. According to the Chinese lunar calendar, 2011 is the year of the rabbit. The rabbit is described as being generous, nervous about unusual disturbances, and therefore happiest when all is calm. This may be a tough year to be a rabbit.

But rabbits can also move quickly when frightened, and freeze stone still when trying to avoid attention. Stops and starts seem to be their recipe for survival. We may see some of that in the year ahead.

The range of 2011 GDP estimates shown in the chart below has narrowed in recent months. Notice that for the Obama Office of Management & Budget takes the prize for optimism, which is to be expected when putting forward a new budget that counts on growth to bring in revenues. And the Federal Reserve Board comes in second. The average forecast compiled by the National Association of Business Economists comes in third. From there, the variation narrows with Bank of America winning the prize for most pessimistic.

GDP Forecasts, 2010 & 2011

Organization	Date	2010	2011
OMB	7/2010	3.1%	4.0%
CBO	8/2010	3.0	2.1
BOA	9/2010	2.6	1.8
IMF	10/2010	2.6	2.3
Economist	11/2010	2.6	2.3
Economy.com	11/2010	2.7	2.7
FRB	11/2010	2.4-2.6	3.0-3.6
NBE	11/2010	2.7	3.2
Wachovia	11/2010	2.7	2.3

Not relying on models, but based on lots of reading and some thinking, I am inclined to look for another year like 2010, which means a GDP growth of 2.7%. I expect the national unemployment rate to stay above 9 percent until 4Q2011, and I expect CPI inflation to remain in the low one percent and a fraction. As indicated in the report, I expect to see $100 oil, a continuing slow construction economy, but with meaningful recovery in retail sales. On the political front, I expect to see meaningful action taken to reduce the nation's structural deficit with legislation in place that looks ahead and removes tax loopholes, increases age eligibility for Social Security benefits and makes Medicare a means tested benefit. And of course, I must advice the readers again that my mother loved me a lot. I tend to be optimistic.

Final Thoughts

We live in America. Be thankful. Our country is the third most populous nation in the world, and it is still one that people seek to enter. The U.S. is the only advanced economy with a growing population; we are relatively young. And the only large economy where 40% of the household earn $70,000 annually. But we are also a nation with a vast and growing body of regulations that limit flexibility and creativity. And we are a nation of debtors. We consume more than we produce, and that cannot continue.

A growing population provides a basis for a growing economy. Innovation and rising productivity add to the feast of plenty. But burdensome regulation subtracts, and debt burdens take away from investing in the future.

Can the American eagle still fly?

During our two stays in Washington, Dot and I became big fans of the Washington Zoo. The zoo was a regular stop when visitors came to see the sights. And that was often. Some of the animals there reminded me of my own life and work. I sometimes imagined that their cages were offices where they went to work each day. I recall the Tasmanian Devil had a corner office, one of the better ones in the zoo. I gathered that he was a member of the Senior Executive Service as I was. But the Devil was always to be seen running in a circle at a speed calculated, it seems, to be as fast as possible without falling down…, and getting nowhere. I sometimes wondered if my life looked that way to others.

The marvelous aviary was my favorite part of the zoo. Countless birds of many colors and plumes were to be seen. Among them, my favorite of favorites was a pair of bald eagles that occupied one of the largest cages in the zoo. It must have been three stories tall.

Invariably, I would find the eagles perched on the highest bar that formed the cage with their heads pushed out looking at what was going on around them. And what did they see? Hundreds, perhaps thousands, of free wild birds flying in the air around the cages and swooping down to feast on food that fell from the cages. The aviary was a feeding station.

I have no way of knowing what the eagles were thinking. But if eagles think about life, I believe they were thinking about freedom and wishing that they could soar to the heavens.

But having been cared for completely and fed regularly, would the eagles still be able to fly and feed themselves?

I still think about those eagles and wonder if they would or could swap security for freedom.