



Economics Today January 9, 2012

The Federal Reserve/Monetary Policy

- Fed policy accommodative. Fed funds rate near zero through at least 2012.
- A one-in-three chance the economy stalls in 2012 and the Fed responds with a third asset acquisition program (QE3).
- Money supply growth slowed to 3.6% in past three months, but the big 9.6% yr/yr M2 jump (see link below to charts) should be enough to finance 4+% 2012 aggregate dollar demand (nominal dollar GDP) growth. Bank loans up in the past six months, paced by a rise in business loans.
- To better anchor market expectations and possibly increase its influence on the economy, the Fed will publish more detail regarding its outlook for interest rates, the economy and monetary policy following its policy meeting on January 25. Bernanke will explain the expanded data in a press conference. Longer run, greatly increased Fed transparency over the past decade has been a positive.
- Major fiscal policy change is unlikely this election year. The payroll tax cut and extended unemployment insurance may well continue through 2012. Pending automatic 2013 spending cuts and expiration of Bush tax cuts at year end 2012 will eventually force some action. The United States is still funding deficits at minimal interest rates – which could end abruptly someday. Recent better-than-expected economic data and a lower unemployment rate have political implications – if this continues, the economy becomes less of an issue and favors incumbents – voters have short memories.

The Economy/Inflation

- Aggregate dollar demand likely to rise 4% to 5% in 2012 vs. 4.2% in 2010 and 4% in 2011.
- The 31 month-old economic expansion should continue in 2012. Real GDP should grow 2% to 3% in 2012 (see table below) assuming better supply conditions than 2011 when the tsunami and high oil prices cut output/raised inflation. While there are significant risks to the downside - Europe, election-year fiscal uncertainty, \$100+ crude oil, wealth loss, the stretched consumer – the recession chance is one-in-three at most. Strongest sectors: business investment in structures and, especially, software/equipment; exports; and autos.
- Core personal consumption (PCE) price index should again rise 1% to 2% in 2012 vs. 1.5% in 2010 and 2011, but inflation risks are to the upside.
- Inflation news mixed: the core PCE price index was up a moderate 1.7% yr/yr in November. The CRB commodity price index has risen the past three weeks, but remains 4.3% below a year ago – but crude oil is up a sharp 15% yr/yr. The dollar has been strong in foreign currency markets the past five months. Inflation expectations have increased some, but remain moderate - the 10-year inflation forecast implied in inflation-protected Treasuries (TIPs) was 2.14% at Friday close, up from a low of 1.85% in late November.



Financial Markets

- The Fed's monetary policy is bullish for asset prices, i.e. the Fed maintaining negligible short-term interest rates that keep investors seeking higher returns in stocks, bonds, commodities and real estate - prices of gold, oil and, especially, bonds benefited over the past year. The weakest area was foreign stocks. The S&P 500 stock index was unchanged in 2011, providing a 2.1% total rate of return – higher on a taxable equivalent basis since dividends are taxed at a lower rate than interest income. Utilities, the most bond-like of stocks, were the best performing stock sector in 2011.
- Despite Uncle Sam borrowing a near record amount, the top investment in 2011 was, of all things, the 30-year Treasury bond. Tax-exempt bonds did very well, especially considering the fiscal problems of state and, especially, local governments.
- Stocks appear moderately undervalued vs. Baa bonds on a comparative yield basis (stock market barometer in chart link below).
- Based on trailing four quarter earnings, at Friday close the S&P 500 P/E was 13.2, cheap vs. a 19 average over the past 24 years. However, earnings (the E in the P/E) may fall short of expectations, especially since profit margins are at a record – probably unsustainable - high (see chart in link below). Importantly, earnings growth has slowed sharply.
- Robust dividend increases a support for stock prices and the S&P 500 dividend will reach a record high this quarter. The dollar dividend on the S&P 500 is up 30% from its August, 2009 low and 18.3% yr/yr despite deeply depressed bank dividends. Dividend paying stocks greatly outperformed non-dividend payers over the past year.
- Share buybacks also supporting stock prices – buybacks up 49% yr/yr in the third quarter!
- Credit quality yield spreads up a little (Bond Market Barometer in charts link below). On a comparative yield basis, tax-exempt bonds – despite their recent out performance - and Baa corporate bonds appear undervalued vs. U.S. Treasury securities.
- Long-term interest rates are at or near record lows, including mortgage rates. Refinancing will reduce debt burden for those who qualify.

	2011	2012				Annual Average		
	Q4	Q1	Q2	Q3	Q4	2010	2011	2012
Real GDP, % annual rate	3.5	2.0	2.3	2.8	2.8	3.0	1.8	2.4
Inflation, PCE % an. rate	1.2	1.6	1.7	1.7	1.8	1.8	2.5	1.8
Core inflation (ex food&energy)	1.3	1.4	1.5	1.5	1.6	1.4	1.5	1.6
10 Year Treasury bond (%)	2.05	2.00	2.10	2.20	2.35	3.22	2.80	2.16
Fed funds rate (%)	0.07	0.10	0.10	0.10	0.10	0.18	0.10	0.10
S&P 500 operating earnings(\$s)	24.31	24.65	26.35	27.10	28.15	83.77	97.02	106.25
S&P 500 op. earn. Yr/Yr % chg.	10.9	9.3	6.0	7.2	15.8	47.3	15.8	9.5
S&P 500 dividends (\$s)	7.28	7.00	7.20	7.25	7.50	22.74	26.43	28.95
S&P 500 dividend, Yr/Yr % chg.	20.5	13.6	10.9	11.5	3.0	1.5	16.2	9.5
S&P 500 Index (average)	1235.2	1295.0	1325.0	1355.0	1375.0	1138.1	1268.5	1337.50
S&P 500 Index, Yr/Yr % chg.	2.6	-0.8	0.5	11.6	11.3	20.5	11.5	5.4

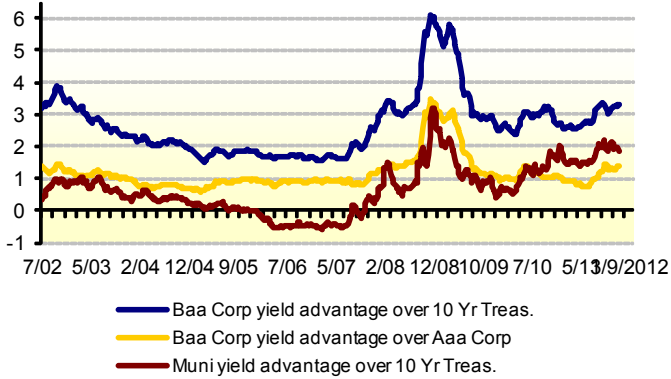


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Economics Today

Below are the charts that accompany the Economics Today commentary for January 9, 2012

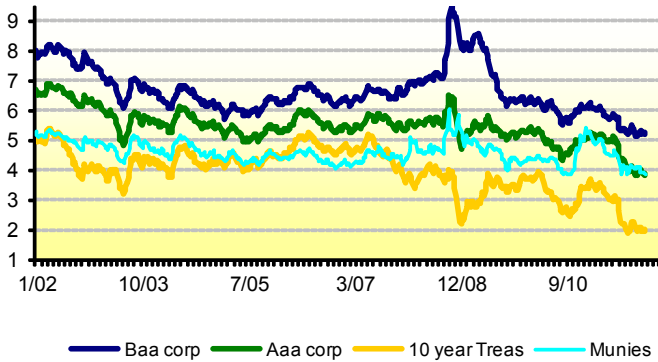
Bond market barometer (credit spreads) (%)



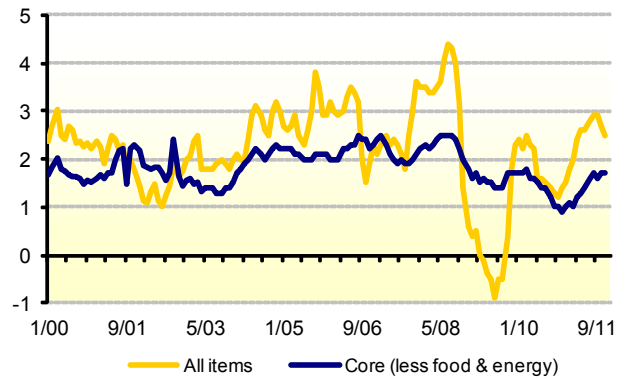
Mortgage rate at record low
30 yr conventional (%); Source: Freddie Mac



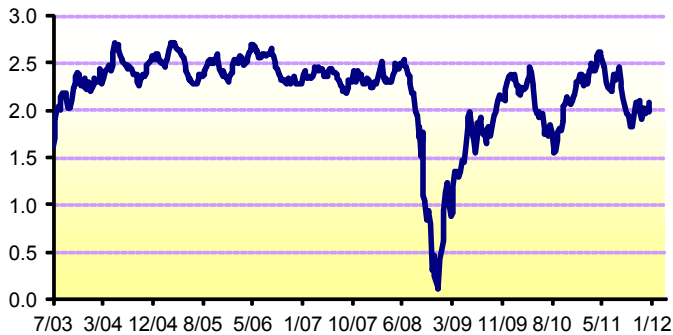
Bond yields (%), weekly averages



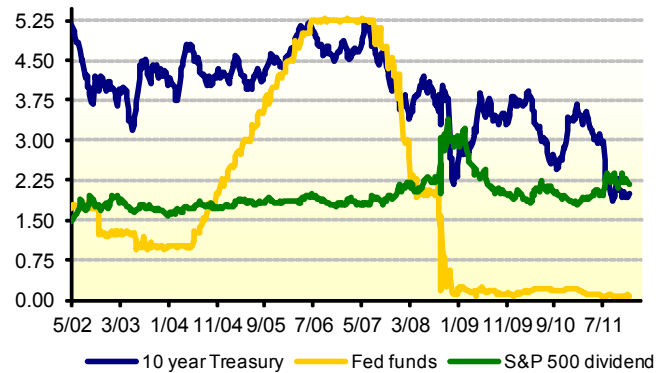
Core consumer inflation moderate. Personal Consum. Expenditure price index, % chg yr/yr



10 year annual inflation rate forecast implied in inflation-indexed 10 yr. Treas. Bonds (TIPs) yields, %



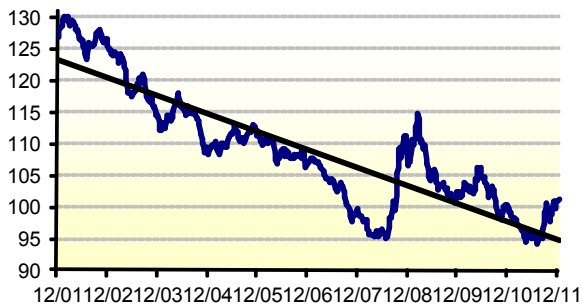
Interest rates (weekly avg.) & dividend yield, %



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Foreign exchange value of the \$ up in 2011, but has trended down 2.3% per yr. over last decade
Broad Index, Jan. 1997 = 100, wkly avg



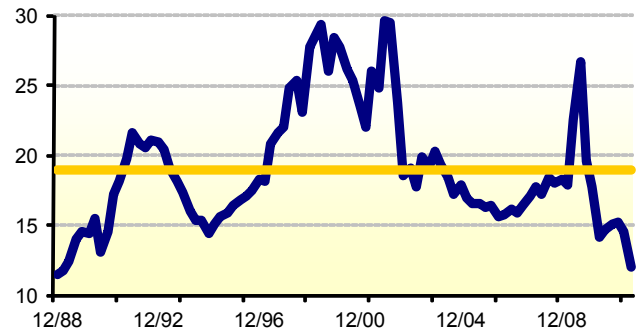
Rapid money supply growth may have peaked
M2, 4 week moving average, % chg. yr/yr



Personal savings rate declines again
Personal savings, % of disposable personal income



P/E ratio, end of quarter, S&P 500/operating earnings (last 4 quarters), end of 4Q 2011 est.



Gold, \$/ounce, Friday close



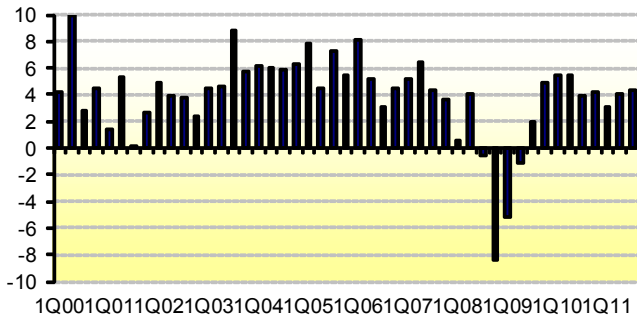
Commodity prices
CRB Futures index, Fri. close, 1967 = 100



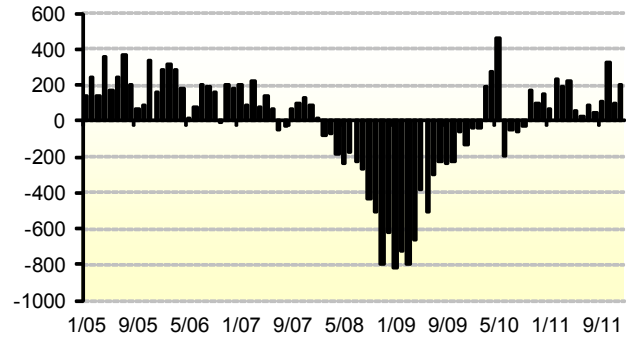
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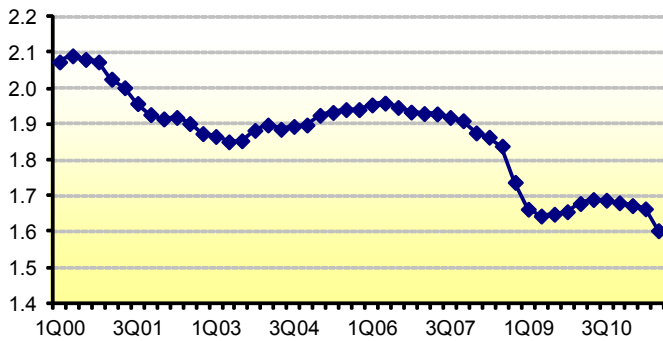
Aggregate \$ demand up moderately (3Q '11 prelim.)
GDP in current \$s, quarterly % change, annual rate



Non-farm payroll job growth picking up
Monthly chg., thousands



\$ of nominal GDP (aggregate \$ demand) per \$ of M2
(M2 velocity through 3rd Q 2011)



Unemployment rate declines



Rapid money supply growth may have peaked
M2, 4 week moving average, % chg. yr/yr



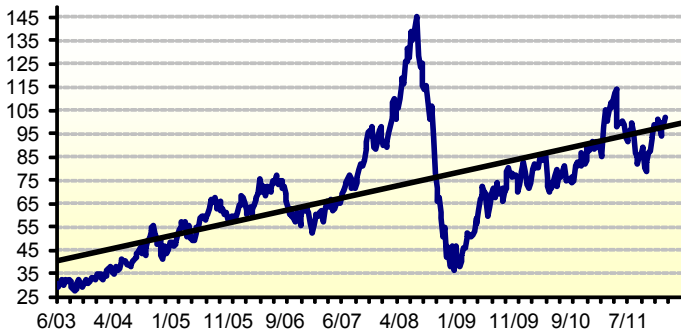
Wage growth weak for non-supervisory workers
Hourly Earnings, private industry, % chg. yr/yr



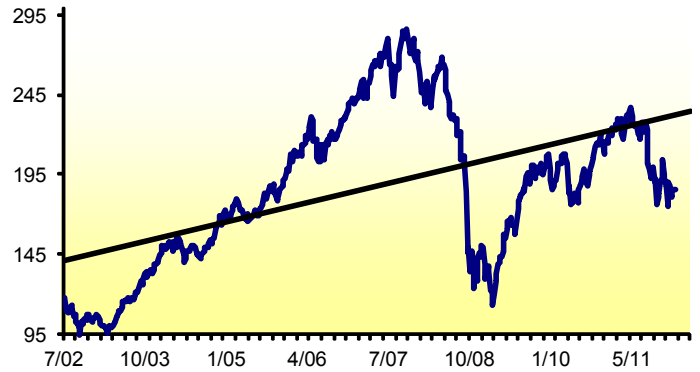
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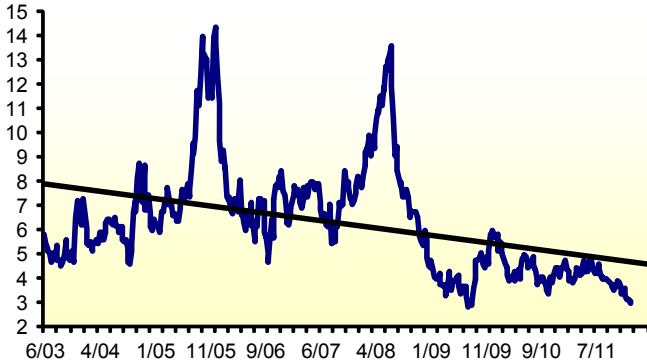
Crude oil, \$s per barrel, Fri. close



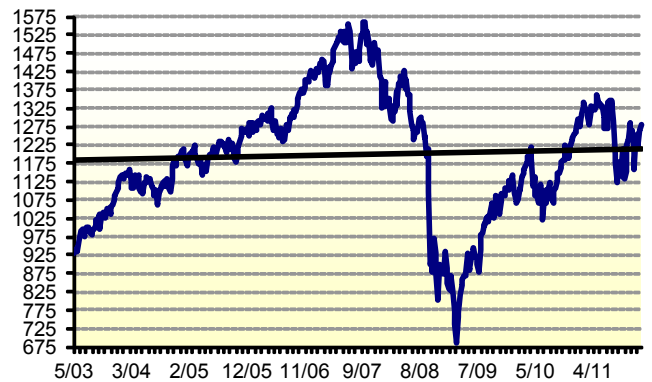
Dow Jones World Stock Index (less U.S.), Friday close



Natural gas, \$s/BTU, Friday close



S&P 500, Friday close



NASDAQ, Friday close

