

# Economic Forum of Palm Beach County January 2011

There IS a Light at the End of the Tunnel,  
But its Around the Bend

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## 2001–2010 Unprecedented Economic Turmoil in Post War History

- Reassessment of Economic and Monetary Fundamentals
- Revelations of Excesses and Weaknesses in our System

## Recent Post World War II Cycles

1978–1982: High Inflation, Major Increases in Interest Rates, Industrial Realignment

**Solution:** High Interest Rates, Extinguish Inflation, Lower Interest Rates Stimulate Growth

1990–1993: 1986 Tax Act Forces Nationwide Repricing of Real Estate, Major Decline in # of Banks and Bank Credit Quality

**Solution:** Major Decrease in Interest Rates, Steep Yield Curve Revive Banks and the Economy.

1998–2003: LTCM Failure, Russia Foreign Exchange Crisis, Plus Internet Bubble and 9/11 Severely Hamper Economy

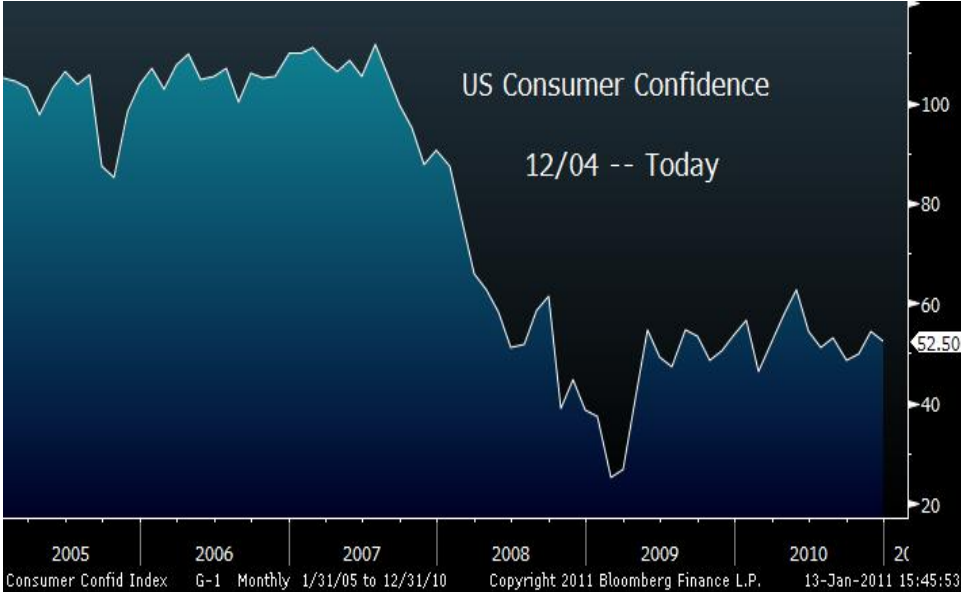
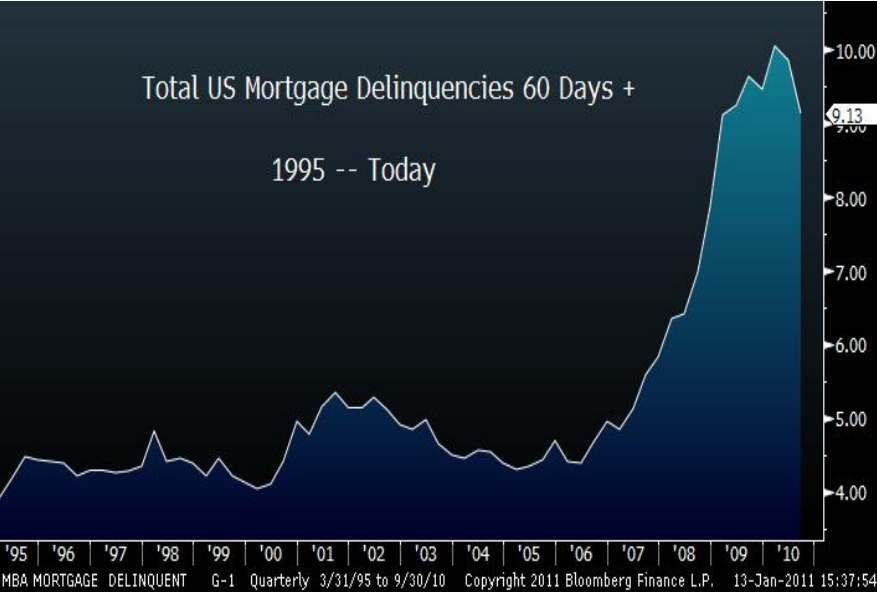
**Solution:** Major Decrease in Interest Rates Stabilizes Economy, Diverts Investment to Real Estate and Revives Economic Growth

2008–2011: Housing and Credit Bubble Pops, Hammering Economic Activity, Severely Deteriorating Bank Credit Quality and Pushing Down Asset Prices Around the World Threatening Deflation

**Solution:** 0% Short Term Interest Rates, Monetization of Debt Reverses Deflation, Generates Inflation and Revives Economic Activity (?!)

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## Where Has the Damage Been Done?



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## What Has Been Done to Limit the Damage or Revive Economic Activity?

### Fiscal Policy

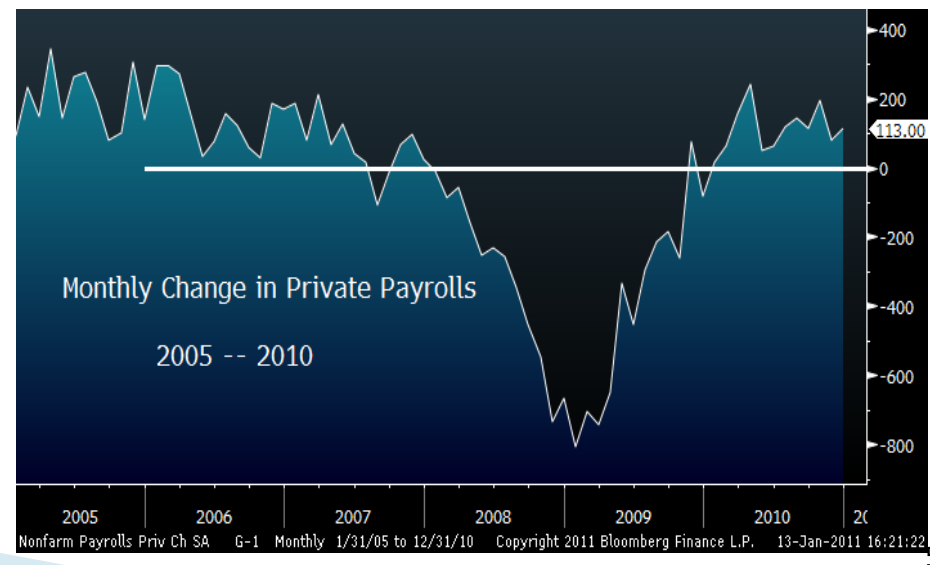
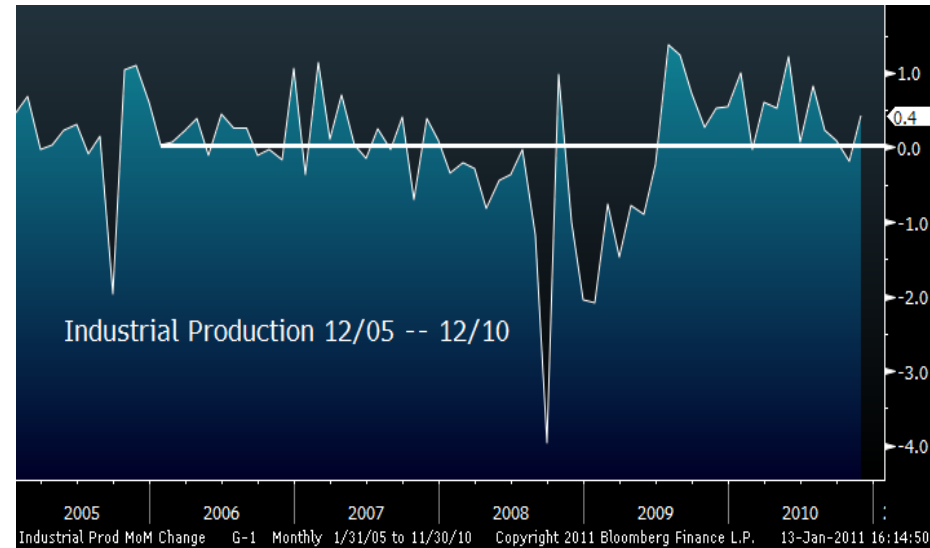
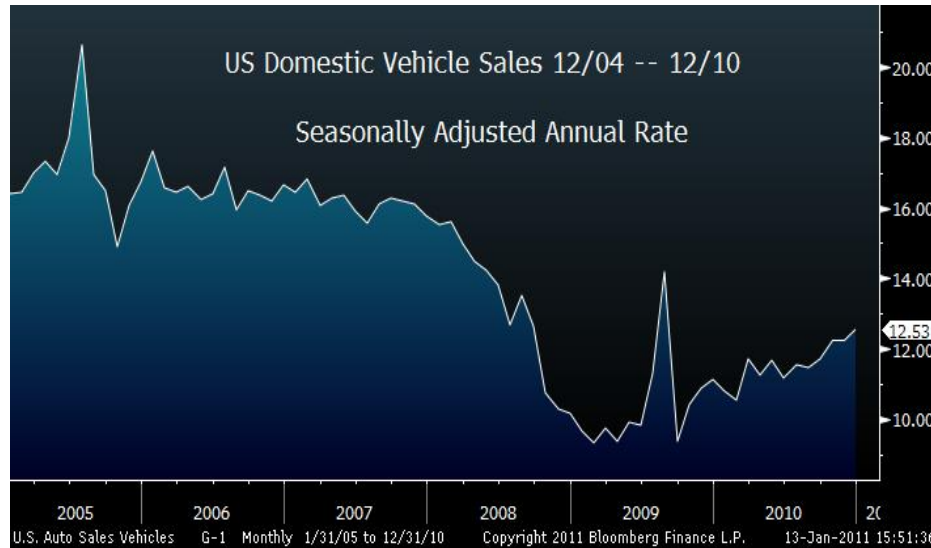
- February 2008: 168 Billion in Stimulus Checks From US Government- 500\$ per Family Average
- September 2008: TARP- Troubled Asset Repurchase Program
- January 2009: ARRA 785 Billion, 800 Billion, 1 Trillion(?)
- July 2009: Car Allowance Rebate System 4 Billion (Cash for Clunkers)
- March- July 2009: First Time Home Buyer Tax Credit 7-9 Billion
- January 2011: Postponement of Scheduled Expiration of Tax Rate Increases- (?)

### Monetary Policy

- December 2008- Fed Lowers Short Term Interest Rates to 0-¼%
- December 2008- Fed Promises to Purchase 1.7 Trillion in Mortgage, Treasury and Agency Securities (QE1)
- August 2010- Fed Begins to Reinvest Proceeds of P&I Payments
- September 2010- Fed Announces QEII- 600 Billion in Additional Treasury Purchases October 2010-June 2011

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## Effects of these Efforts: Fiscal Policy



# Effects of these Efforts

## Monetary Policy

### Federal Reserve Balance Sheet



Growth in the Federal Reserve Balance Sheet Leads to Corresponding Addition of Money in the US Economic System

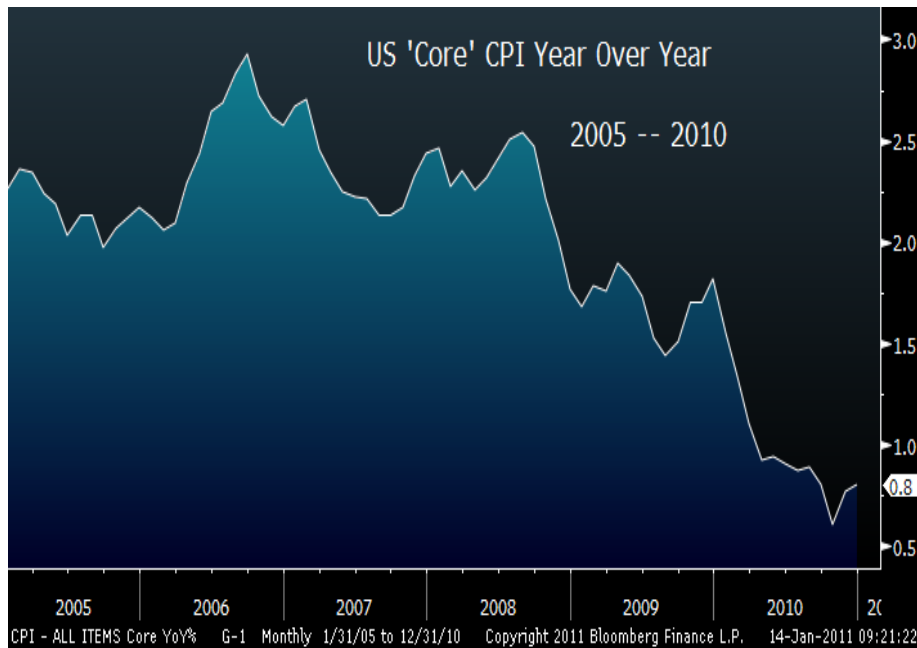
# Effects of these Efforts

## Monetary Policy

What is the Fed Trying to Do?

- Dual Mandate

### Stable Prices

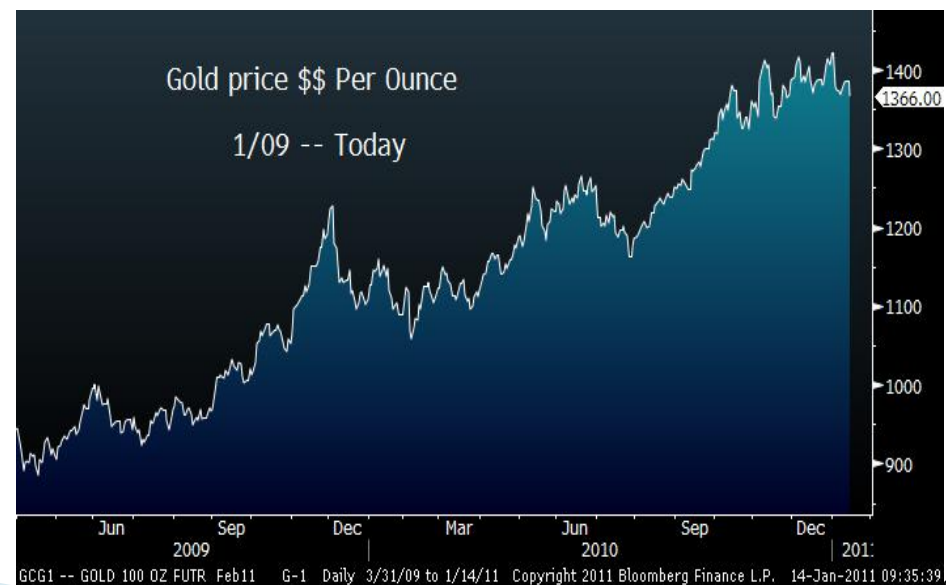
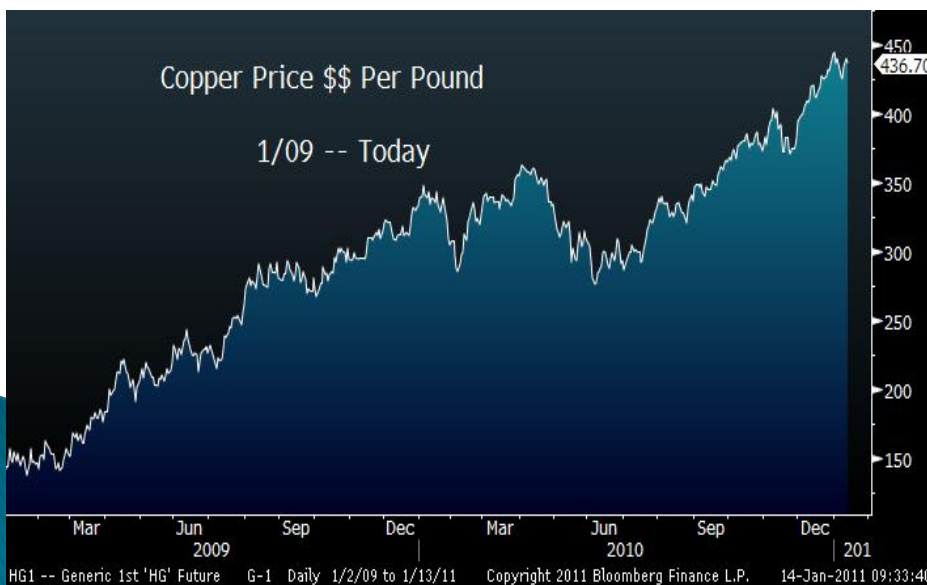
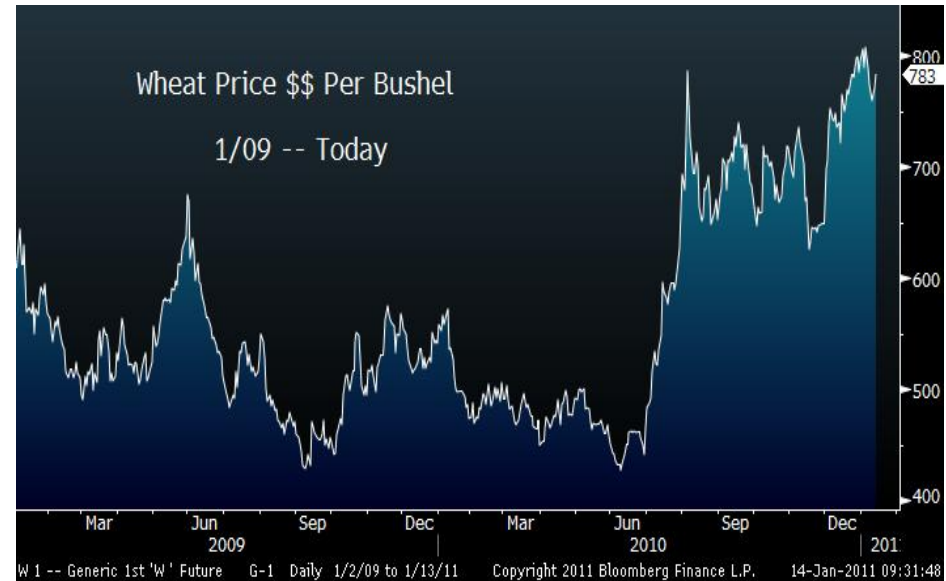
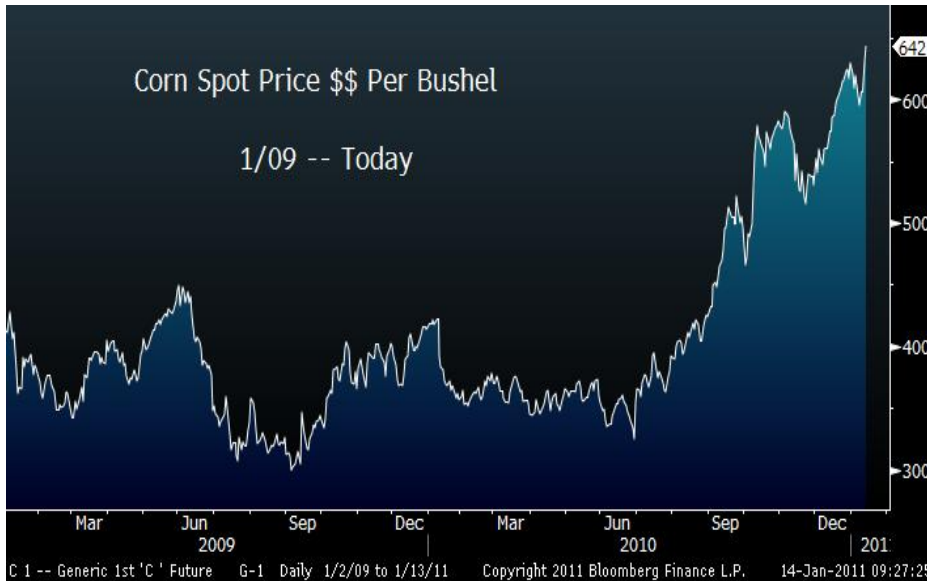


### Full Employment



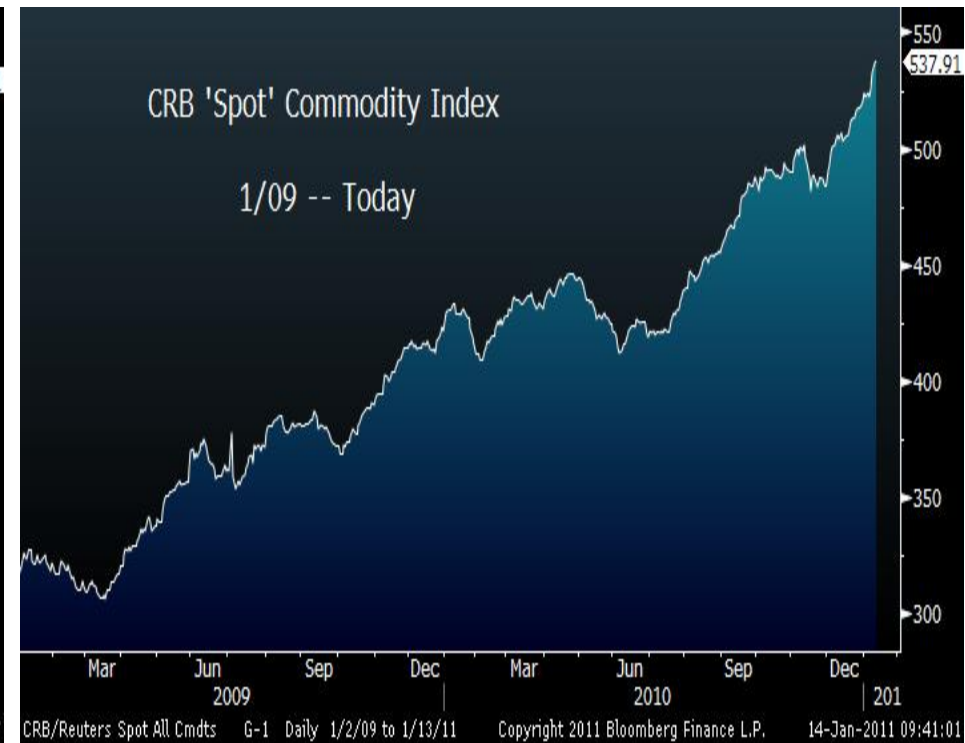
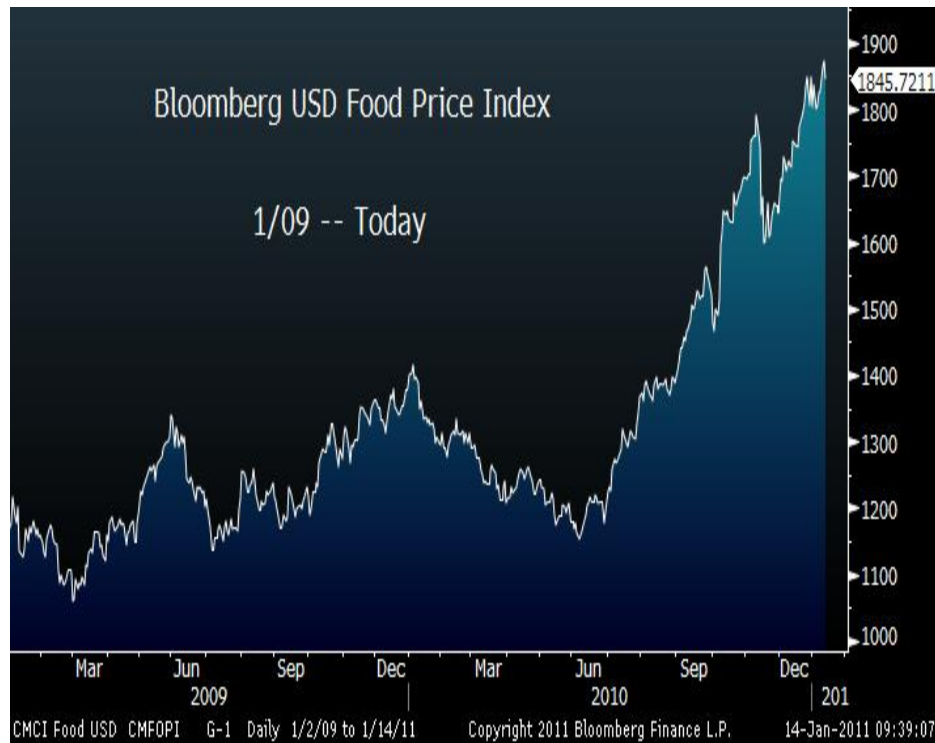
# Effects of these Efforts

## We Have Some Rising Prices



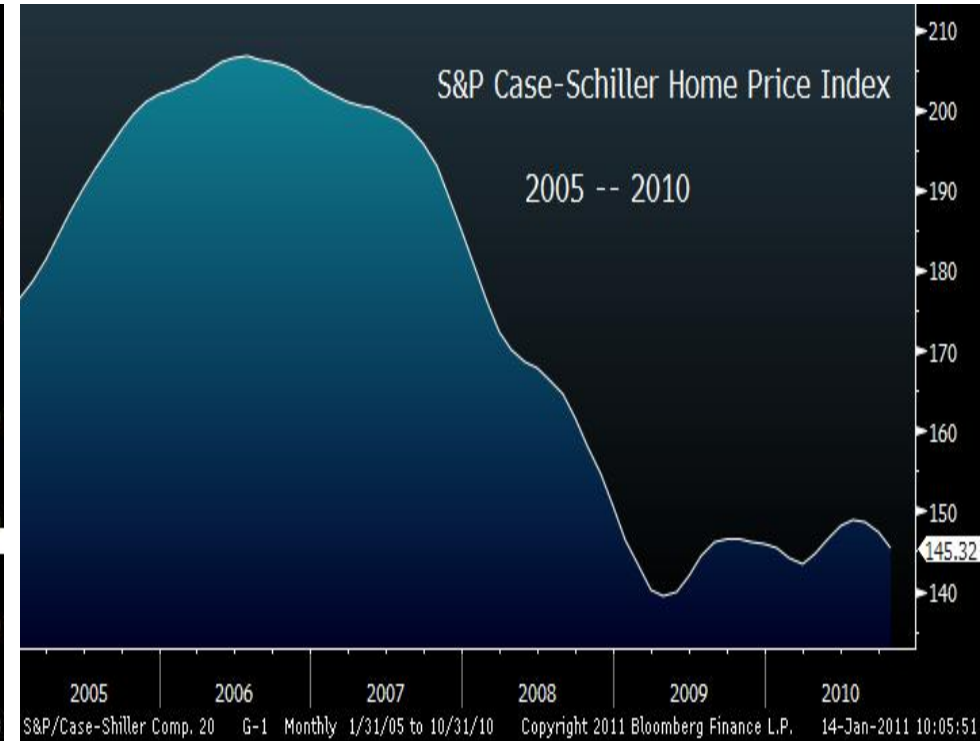
# Effects of these Efforts

And These Rising Prices are Spreading



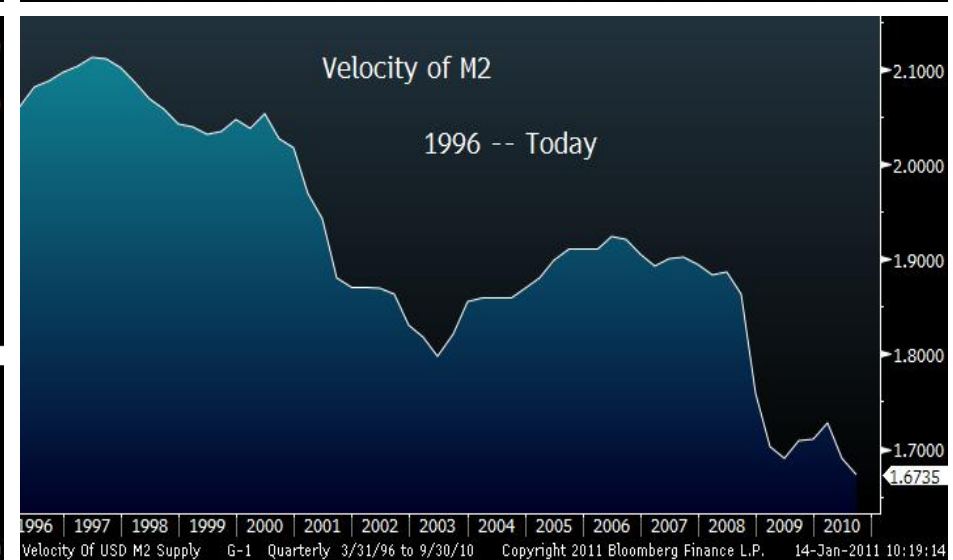
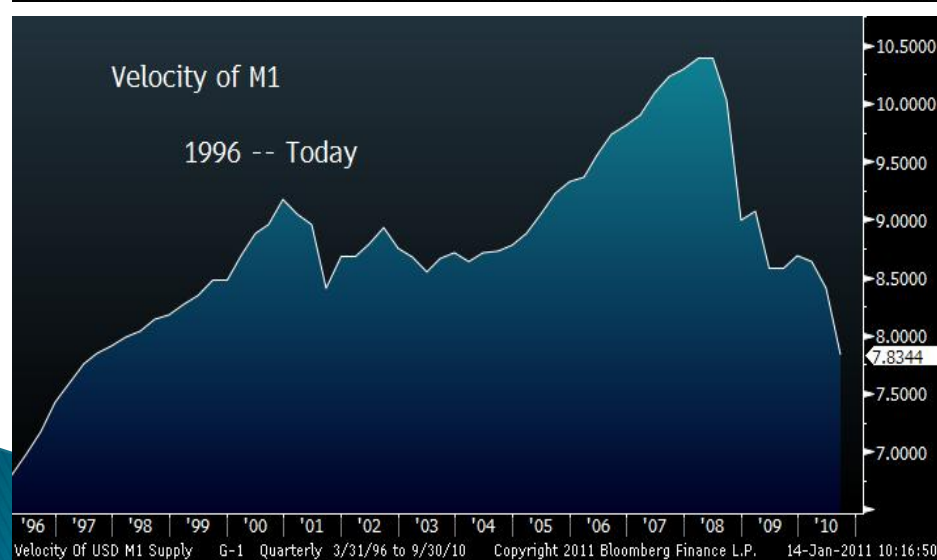
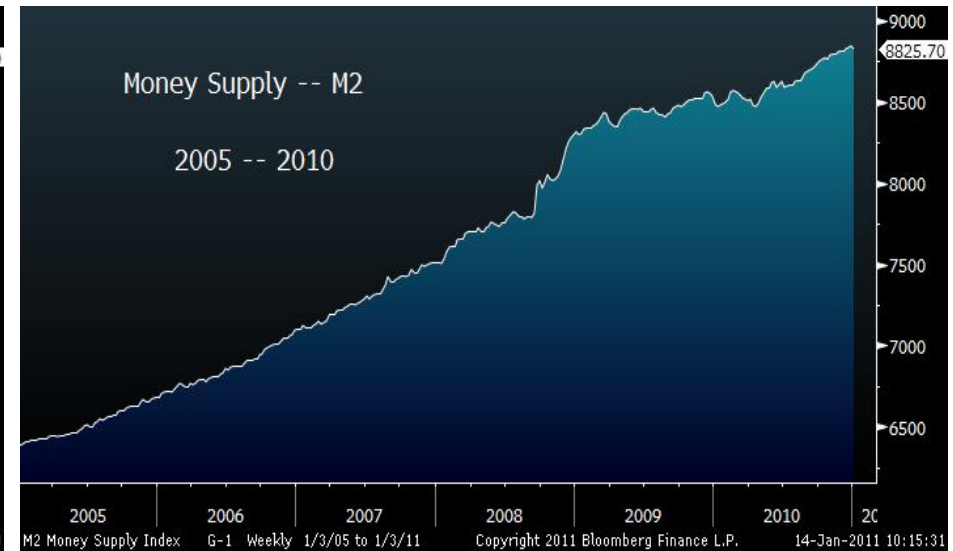
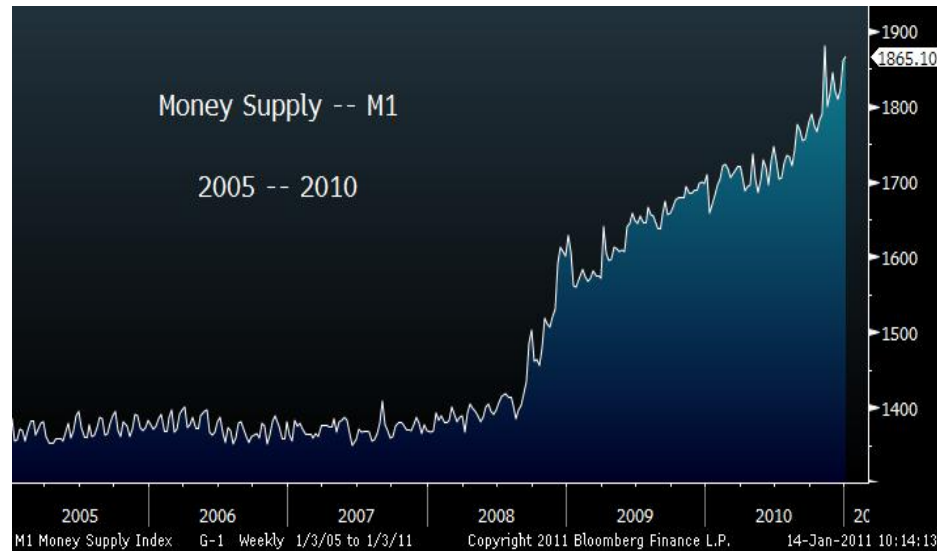
# Effects of these Efforts

## But Not Everywhere



# Effects of these Efforts

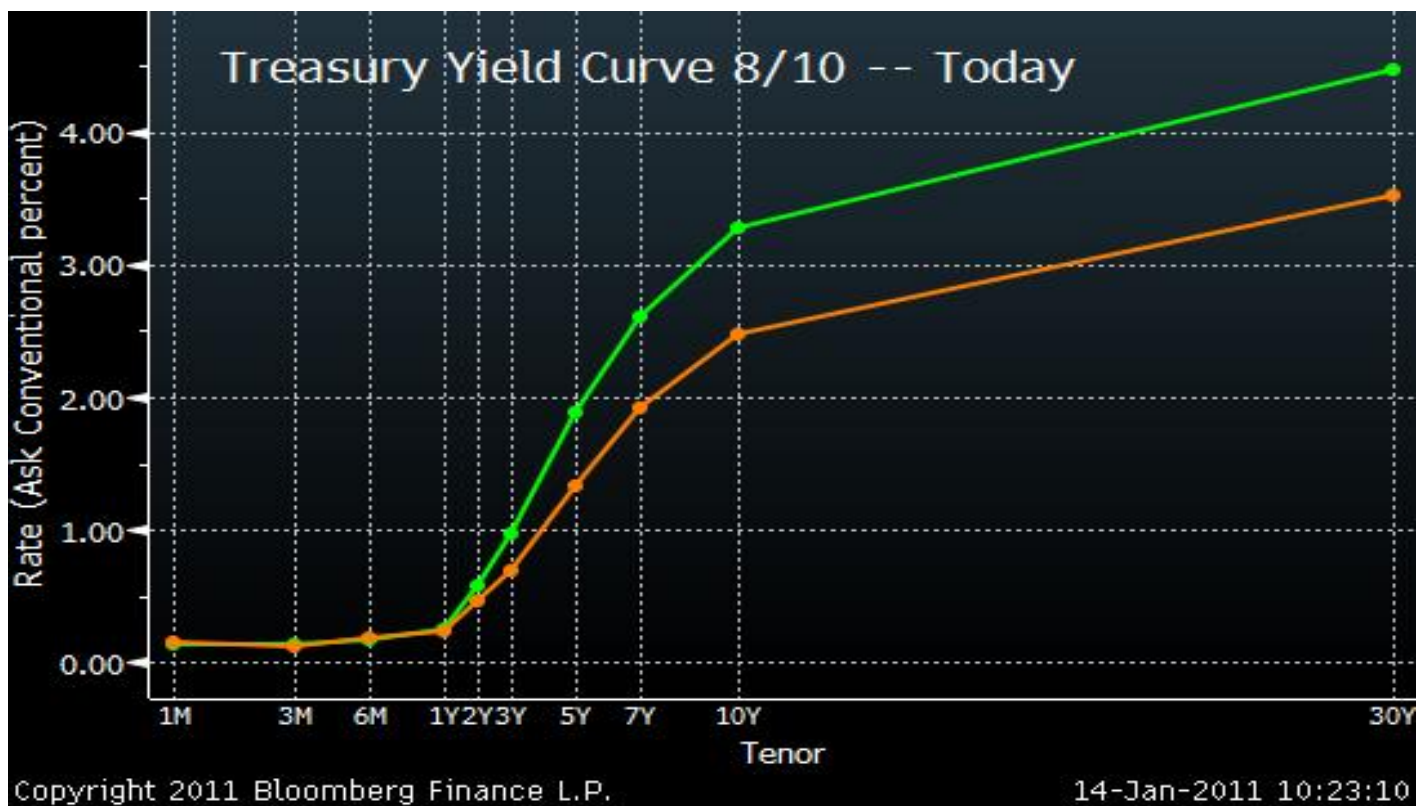
But the Fed is Having a Hard Time Getting the Money that is in the System to Work



Because of Sluggish Demand for Funding 11

# Effects of these Efforts

This Fed Combination Has Led To An Inevitable Result



And Given the Lagging Nature of Employment and Inflation, this WILL Continue

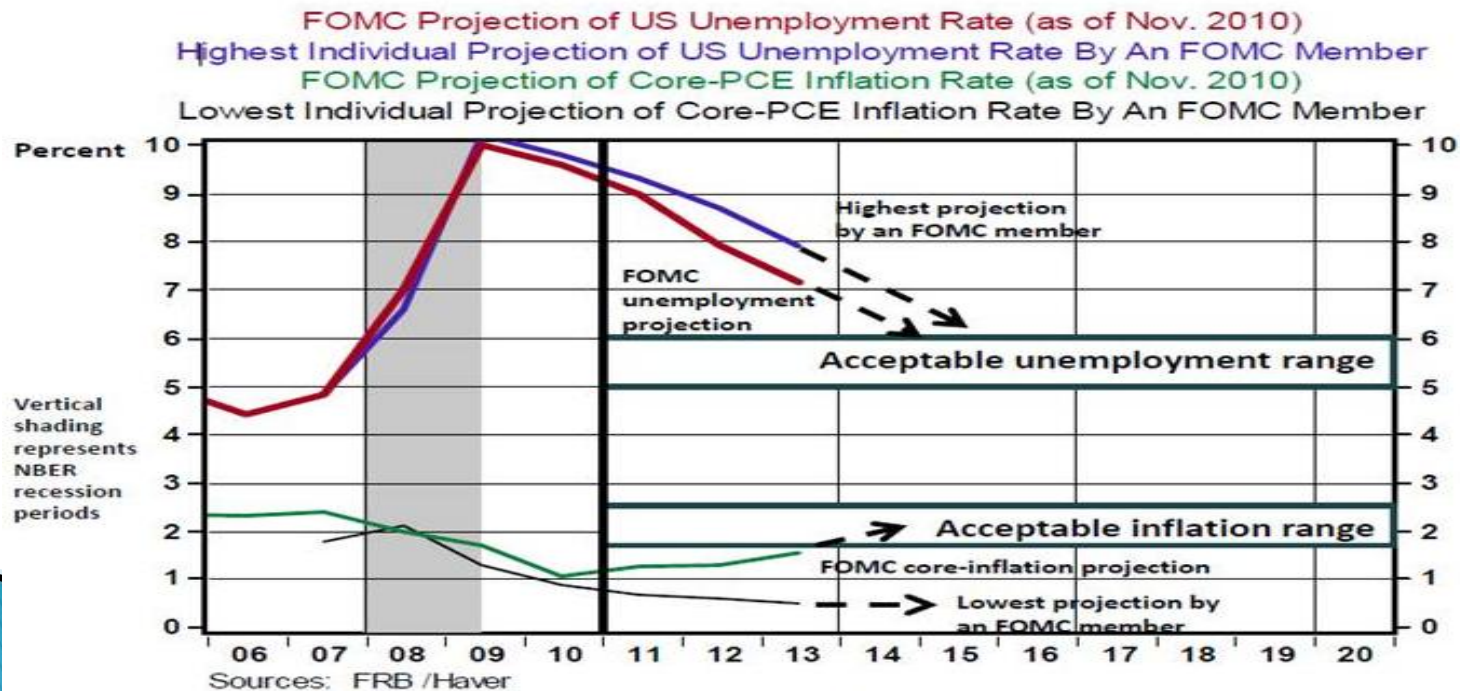
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Given the Dual Mandate and Current/Likely Future Economic Conditions the Fed will do Several Things:

- Complete QE II, Purchasing 600 Billion of Treasury Debt, Reinvesting ~250 Billion of their Cash
- Maintain Short Term Rates in the Current Range of 0-.25% For Most, If Not All of 2011

Because: Their Own Projections Show a VERY Slow Recovery

## Bernanke: Current Trajectory “Unacceptable”



Source: Federal Reserve Board; Projections for fourth quarter of 2010-13, as of Nov. 2010

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However, Several Changes are Occurring Independent of the Fed:

## Tax Policy

- Postponement of Scheduled Tax Increases
- Potential Restructuring of Corporate Tax Code

## Europe

- Continued Uncertainty Leading to Eventual Stability
- Increasing Inflation

## Emerging Markets

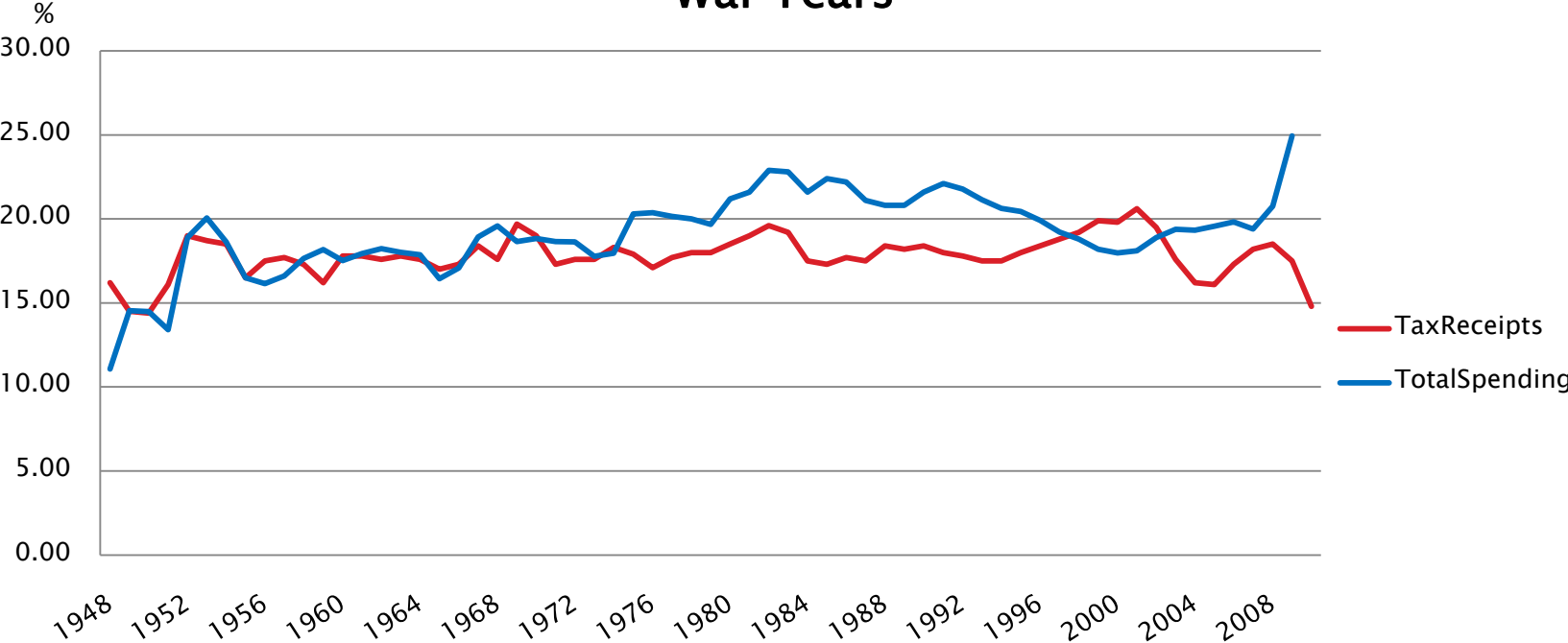
- Resumption of Strong Economic Growth
- Increasing Inflation
- Freer Trade– Outside the US

Standards of Living are About to Resume Rising Strongly Around the World

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## Tax Policy

### Taxes vs Expenditures as a Percentage of GDP in the Post War Years

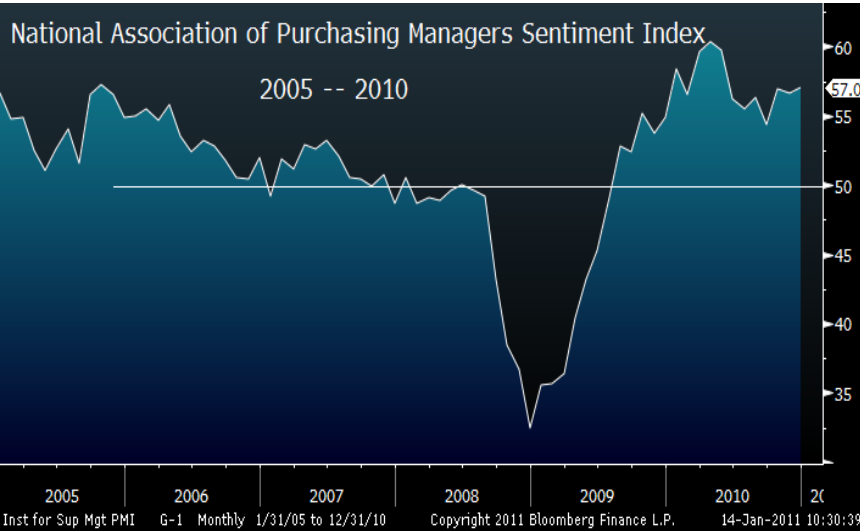


Spending Here is the Key, as the Smaller the Government Share of GDP, the Faster the Rest Of the Economy Grows

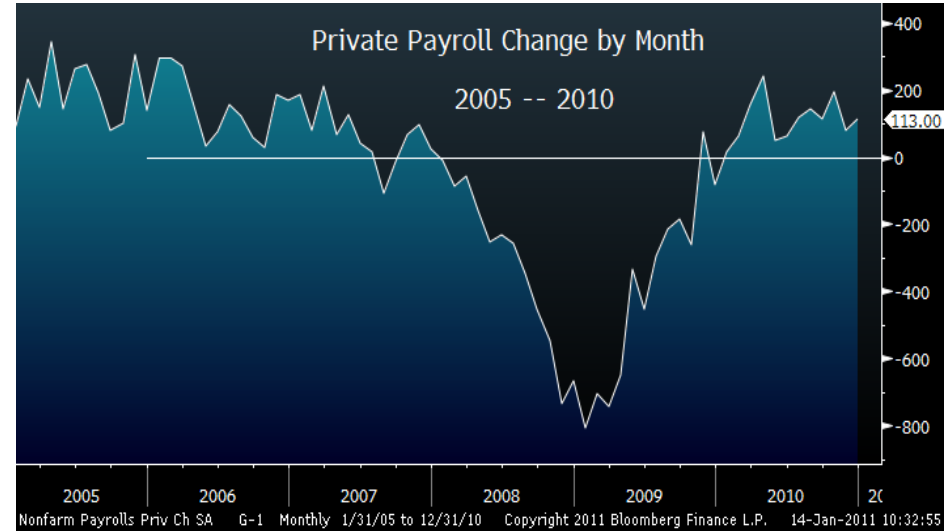
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## So Where is the Light?

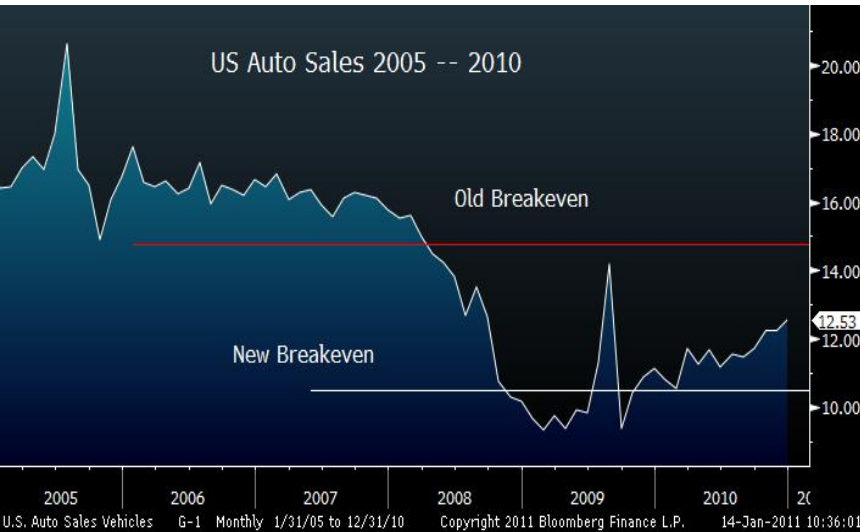
### In Sentiment



### In Employment



### In Auto Sales

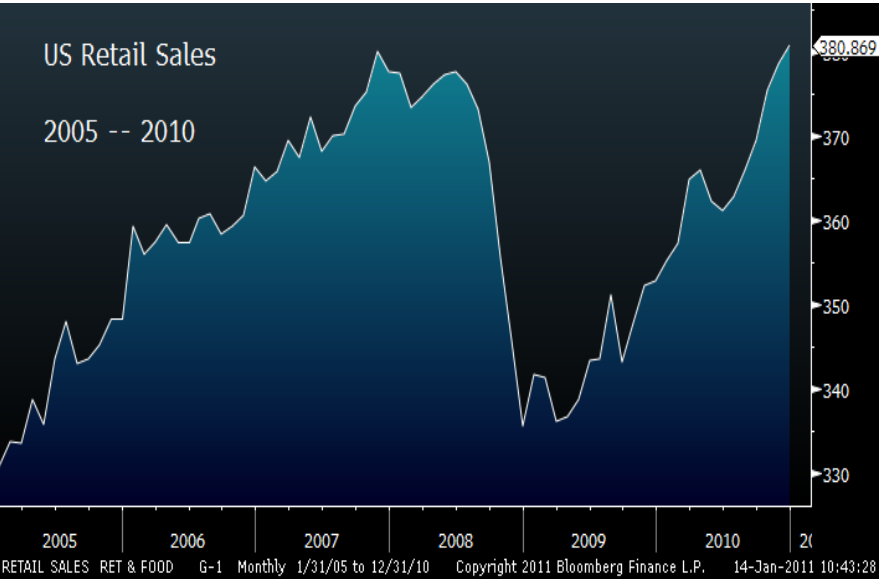


### In Debt Service



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### In Retail Sales



### In Capacity Utilization



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2011

## Good News and Strength Will Begin to Spread

- Lower Unemployment Insurance Claims
- Higher Non-Farm Payroll Growth
- Increases in Retail Sales
- Increases in Average Hourly Earnings
- Increases in Capacity Utilization
- Pricing Power Returns
- Increasing Income Tax Receipts for Federal Government

All this will Finally Lead to a Meaningful Drop in the Unemployment Rate and Inflation Rates of Roughly 2%

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## Risks to this Unfolding Improvement

### – State and Local Government Finances

- Excessive Overhead
- Pension and Health Care Costs
- Visible Financial Difficulties
- Capital Markets Access

### – Political Intervention

- Regulatory Burden
- Rising State Tax Rates

### – Higher Commodity Prices

- Energy
- Food



Inflation is not Just Rising Commodity Prices, But Increasing Wages and Pricing Power As Well

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## Risks to this Unfolding Improvement

- European Financial Situation
  - Bailed Out Greece, Ireland
  - Portugal, Spain?
  - Stability?
  
- Geopolitical
  - North Korea
  - Venezuela
  - Iran/Iraq/Afghanistan

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## How Does This Unfold in 2011?

- Fed Completes QE II
- Commodity Price Increases Work Their Way into Economy
- Unemployment Rate Rises, Then Begins to Fall
- Monthly Payroll Growth Crosses 200,000
- Automobile Sales Cross 13 Million Unit Annual Pace
- Hourly Earnings Increase at Over a 2% Rate
- Trade Deficit Narrows to Less than 30 Billion/Month
  
- Fed Maintains Short Term Rates @ 0– ¼ % Until Unemployment Falls Below 8%
- Inflation Works Through Commodity Prices, Service Economy, Wages and Finally to Commercial and Residential Real Estate
- Bank Profitability and Capital Adequacy is Restored Through Steep Yield Curve, Plentiful Deposits and Improving Credit Quality