THE DANA VIEWPOINT

FAR FROM NORMAL

March 12, 2012
Dow: 13,066

The jobs market added another 227,000 nonfarm payroll positions in February. That is the third consecutive month of 200,000 plus new jobs being created. Furthermore, the gain was broad based as business services added 82,000; health care 61,000; leisure and hospitality 44,000 and manufacturing 31,000. Construction was the only weak area shedding 13,000 jobs. The labor participation rate, the share of employable adults working, ticked up to 63.9%. A better number, but still at a twenty year low. The unemployment rate remained at 8.3%. The long-term unemployed (those without jobs for six months or more) is still over five million, which is 42.6% of all jobless workers. Economists say that if we can sustain the current rate of job creation, we will need two more years to get the unemployment rate under 7%. Ben Bernanke at the Fed is still concerned that the job market is *"far from normal."* As a result, you can expect the Fed to make no changes in their accommodative stance of near zero interest rates. Their goal is to control inflation while seeking lower unemployment.

Far From Normal II: CPI (Consumer Price Index) numbers are due to be reposted Friday (March 16). Government numbers currently indicate inflation is running at an annual rate of 2.8%. Somehow that doesn't seem to compute. The average price of a regular gallon of gas in the US today (March 12) is $3.80. This is up 52 cents from January (16%). Anyone who shops for groceries knows that prices are up and in some cases substantially (beef and milk). We have often talked about inflation being caused by too much money chasing too few goods. The main factor that drives this number is the velocity of the money supply. Over the past three years, the Fed has pumped an extraordinary amount of cash into bank reserves. However, the velocity of that money has remained low as banks have chosen to sit on that money. The Fed now pays interest on reserves held at the Federal Reserve Banks and banks have chosen to accept a low risk return on their reserves rather than risk those funds in an uncertain economy. Now with the economy showing signs of life, banks are starting to generate loans. Hence, the money is starting to move. According to bank analysts, banks are currently holding about $1.5 trillion in reserves. This is fifteen times more than they are required to hold. In normal times, banks will hold 1-2% over required reserves. Money as measured by M-2 (cash, checking accounts, savings accounts and money market funds) has been growing at a 10% per annum rate. Simple arithmetic indicates an inflation rate of 7.2% (10% M-2 growth minus 2.8% GDP growth). Now,

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however, the increase in bank lending will increase the M-2 number and inflation will increase to a higher level even if growth in GDP were to keep pace. This is the ultimate snowball effect. Every dollar loaned out adds more than a dollar to the money supply. A bank makes a loan to a company. The company deposits the loan in its bank. That bank now has increased reserves to expand their lending. This is called the multiplier. In normal times, the multiplier would range from 8-9. Every new dollar in the monetary base resulted in $8-$9 in the money supply. The multiplier has fallen to the 3-4 range since the economic turmoil. As the economy expands, the multiplier will return to more normal levels expanding the money supply and, inturn, the rate of inflation. The Fed is working on methods to drain the excess reserves from the system to reduce the risk of high inflation. The Fed and Congress have several options to reduce this risk. Congress can cut spending and/or raise taxes. The Fed could raise reserve requirements to reduce lending, and they could drain more money from the system. Any of these options are feasible while allowing the economy to continue to grow. We may have a new normal for a while. Some of this data was excerpted from an article by Steven Cunningham in the February 28 issue of *Investors Business Daily*.

Far From Normal III: The Chinese government last week announced that they are targeting only 7.5% growth for this year. The goal seems to be to rely on more domestic consumption and less on exports as the worldwide economy slows. A spokesperson made the following statements: "We will formulate and promulgate a guidance list for key products and services of strategic emerging industries." "We will promulgate and implement the plan for allocation of the productive forces and restructuring in key heavy industries." "We will formulate the list for encouraging the development of emerging industries and new business models in the service sector." Two things come to mind. One, growth will slow on its own due to the natural forces of supply and demand. Two, the government still wants to control the economic strings. A new normal in China.

One more note. Japan will lower its corporate tax rate next month leaving the US corporate tax rate the highest in the free world.

All in all, the economic news is improving and the big ship that is the economy is turning.

Random Thought for March 2012:

"However beautiful the strategy, you should occasionally look at the results."

Winston Churchill

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