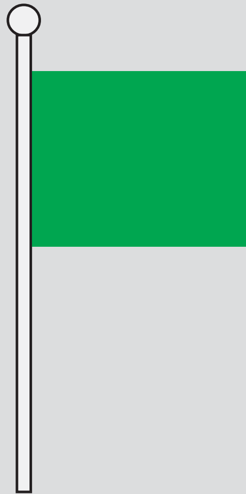
The Financial Research Center, Inc.

Money Forecast Letter



I confess that I had been thinking of taking my yellow flag out of mothballs, but recent events have led me to put it back in the drawer.

MARCH, 2010

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Holliston, Massachusetts - February 17, 2010

I confess that I had been thinking of taking my yellow flag out of mothballs, but recent events have led me to put it back in the drawer.

It has been fashionable in the popular press to bash the U.S. economic recovery. Whether the criticism was coming from the right or the left the message has been the same these past few months. Most self proclaimed experts first tried making a splash by predicting that the U.S. was headed for another Great Depression. When Ben Bernanke proved more than capable of steering the economy through the roughest waters any Fed Chairman has faced since Paul Volcker held the job some thirty years ago, the media quickly lined up to pronounce that any recovery would be both anemic and temporary.

While these modern day Chicken Littles have been watching the horizon for signs of economic calamity I have been busy

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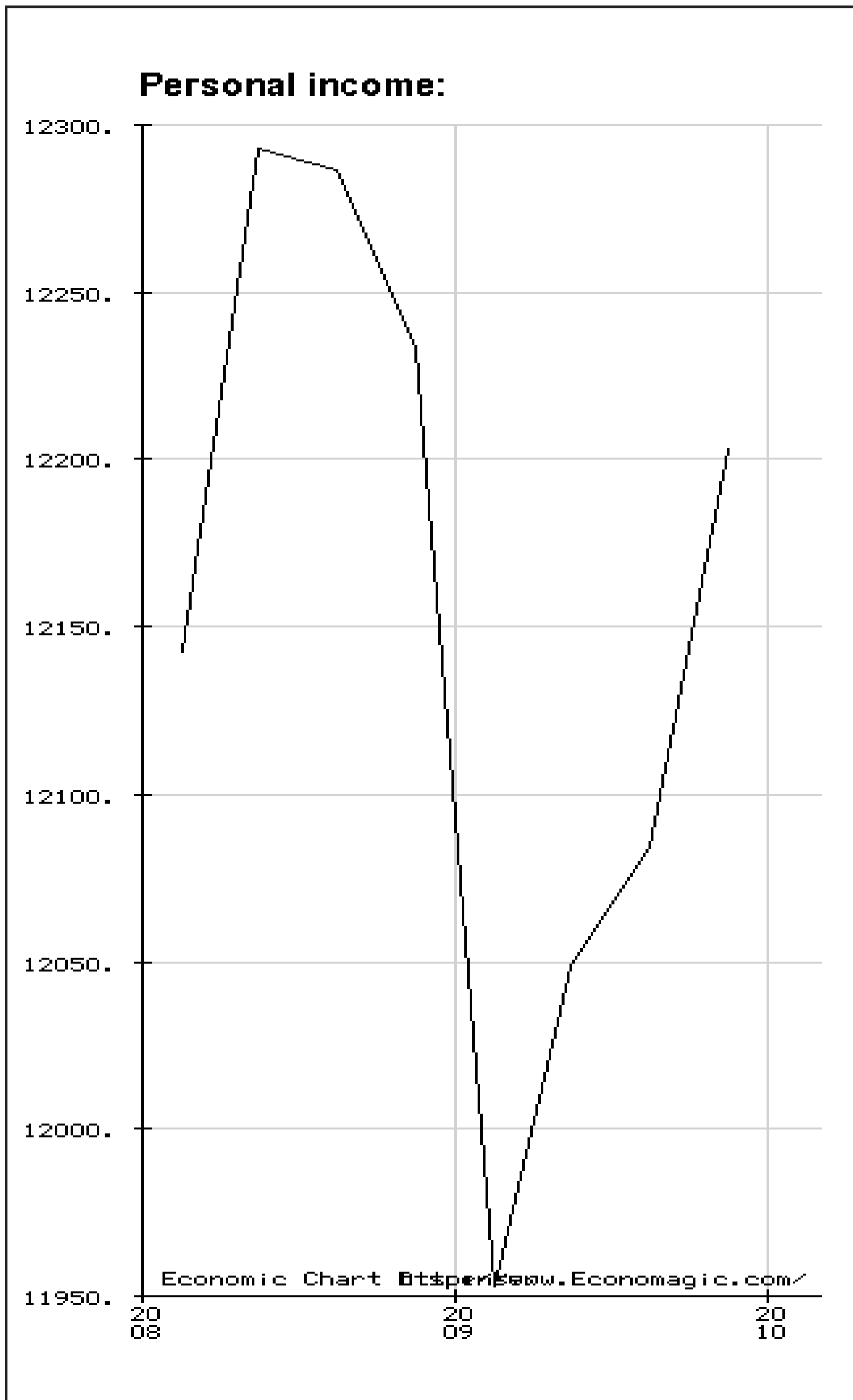
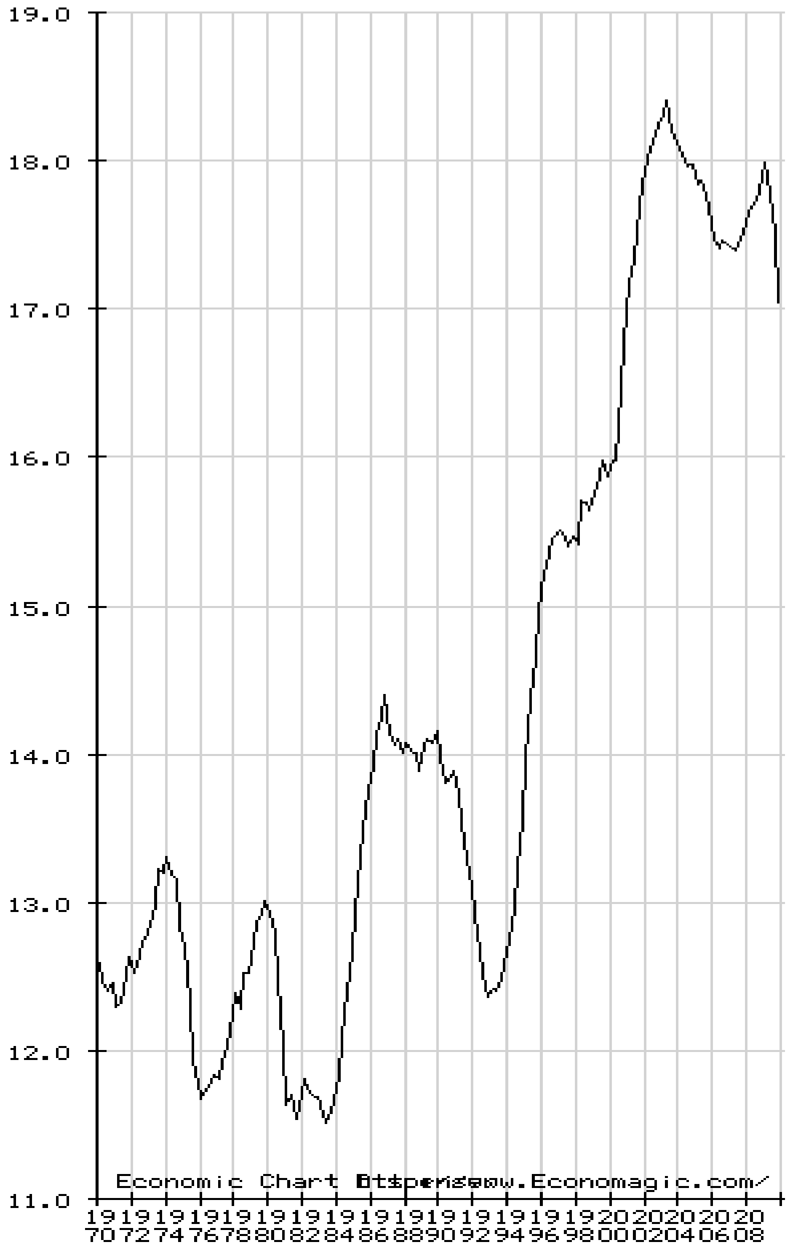

Personal income:
12300.
12250.
12200.
12150.
12100.
12050.
12000.
11950.
Economic Chart
www.Economagic.com/
20
08
20
09
20
10

looking elsewhere. Namely at the efforts of a few powerful Congressmen and Senators who believed the recent economic downturn and the accompanying financial panic provided them with the unique opportunity to completely rewrite the financial rules and regulations under which our free market system would operate.

Long time readers know that I have long attempted to keep personal feelings out of my monthly forecasts. The opinions expressed here are the result of unbiased analysis. I have likened it to the process of a cow producing milk. She roams the fields eating her grass, digesting it and producing milk. I spend a great deal of time researching events, some that are widely reported and others that most people never hear about. I then digest all this information and produce conclusions on what it will mean for the future. There is no agenda here - no desired outcomes that color my thinking.

Because this is the way I approach the task of predicting what is coming in money and the economy there are many times when I find myself out ahead of most people. I process so much information and begin to see what is coming so clearly that it appears to me that it must happen almost immediately. For this reason I always warn readers that what I say is probably going to happen later than I think, but happen it will.

I have been watching the Congress for months now as they attempt to "reform" the

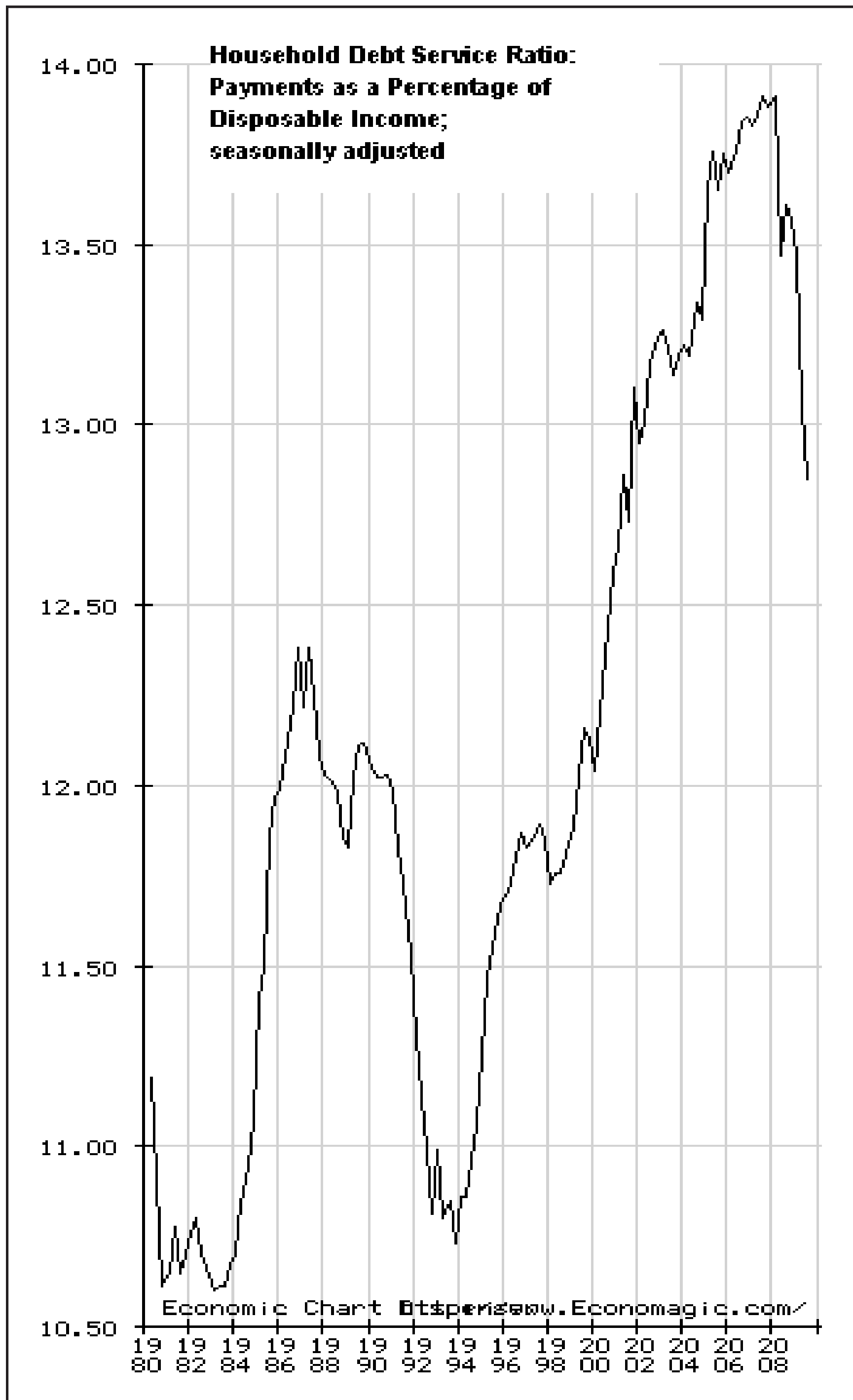

Consumer Credit Outstanding as a Persentage of GDP
19.0
18.0
17.0
16.0
15.0
14.0
13.0
12.0
11.0
Economic Chart Dispenser www.Economagic.com/
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008

financial industry. I need not remind you that the politicians in Washington, D.C. have a very different idea of what reform means than you and I might.

For them all reforms are seen through the prism of what is best for their reelection campaign. When Evan Bayh recently announced that he would not be seeking reelection to his Indiana Senate seat he made mention that it was now a seemingly full time job to raise money for elections. He lamented the passing of the good old days - back when his father was a senator - when you could run for reelection for two years and govern for four. Today the campaign never stops.

Because of this the Congress spends a great deal of time listening to two groups of people: Washington lobbyists and pollsters. The first facilitate a trade of cash for influence, the second provide guidance on what policies will prove most helpful in the campaign. Neither is likely to be a good source of ideas that produce sound legislation.

For months now I have watched as bill after bill was crafted by these politicians. Whether it was for healthcare, financial reform or environmental protection the theme has been the same. Pander to the populist instincts of the voters and try not to include anything in the legislation that would slow the flow of cash into the campaign coffers.

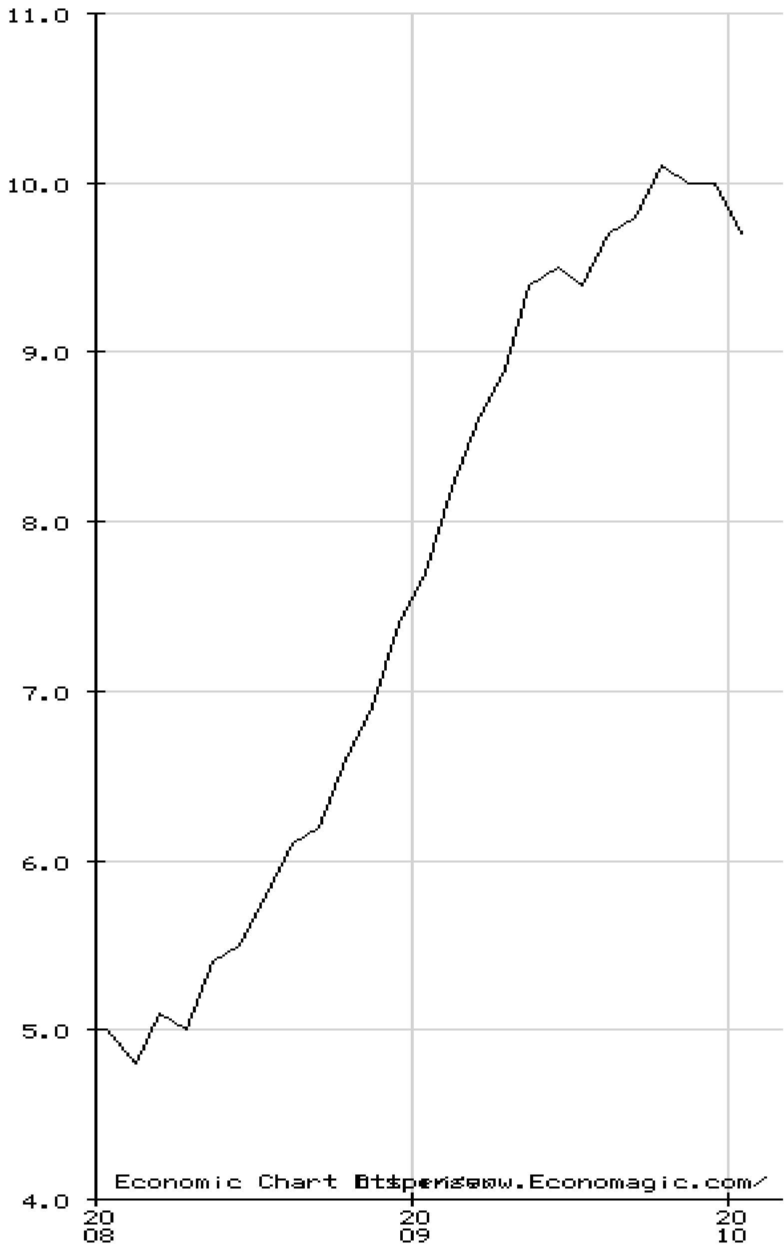

Household Debt Service Ratio:
Payments as a Percentage of
Disposable Income;
seasonally adjusted
14.00
13.50
13.00
12.50
12.00
11.50
11.00
10.50
Economic Chart Dispenser www.Economagic.com/
19 80
19 82
19 84
19 86
19 88
19 90
19 92
19 94
19 96
19 98
20 00
20 02
20 04
20 06
20 08

The result has been some truly dreadful efforts at reform. The House has passed legislation that claims to reform the financial industry, but is really just a collection of long standing desires on the part of Populists from both sides of the aisle to gain greater control over America's banks and thus have easier access to the money these large financial institutions control.

At the heart of this legislation is the idea that some institutions are "too big to fail" and are thus deserving of a special relationship with the government. The deal is Congress will backstop all potential losses (despite the moral hazard which that entails) and the banks promise to allow the politicians a say into who gets the money that the banks loan out and who gets the profits that result.

The same types of arrangements could be seen in the healthcare and cap and trade legislation wending their way through both houses of Congress. The major players in the private sector were presented with a Hobson's choice. Sign onto the legislation and pledge money to fund the new reality or get nothing when the government took over. This is why you saw major insurers volunteer their support for a plan that would surely be against their best interests. It is also why you saw ads produced by oil companies touting the advantages of a future without oil.

As I said, I have been following this story quite closely for a while and have been hoping that the moderate Democrats in the House would have sufficient numbers to influence the

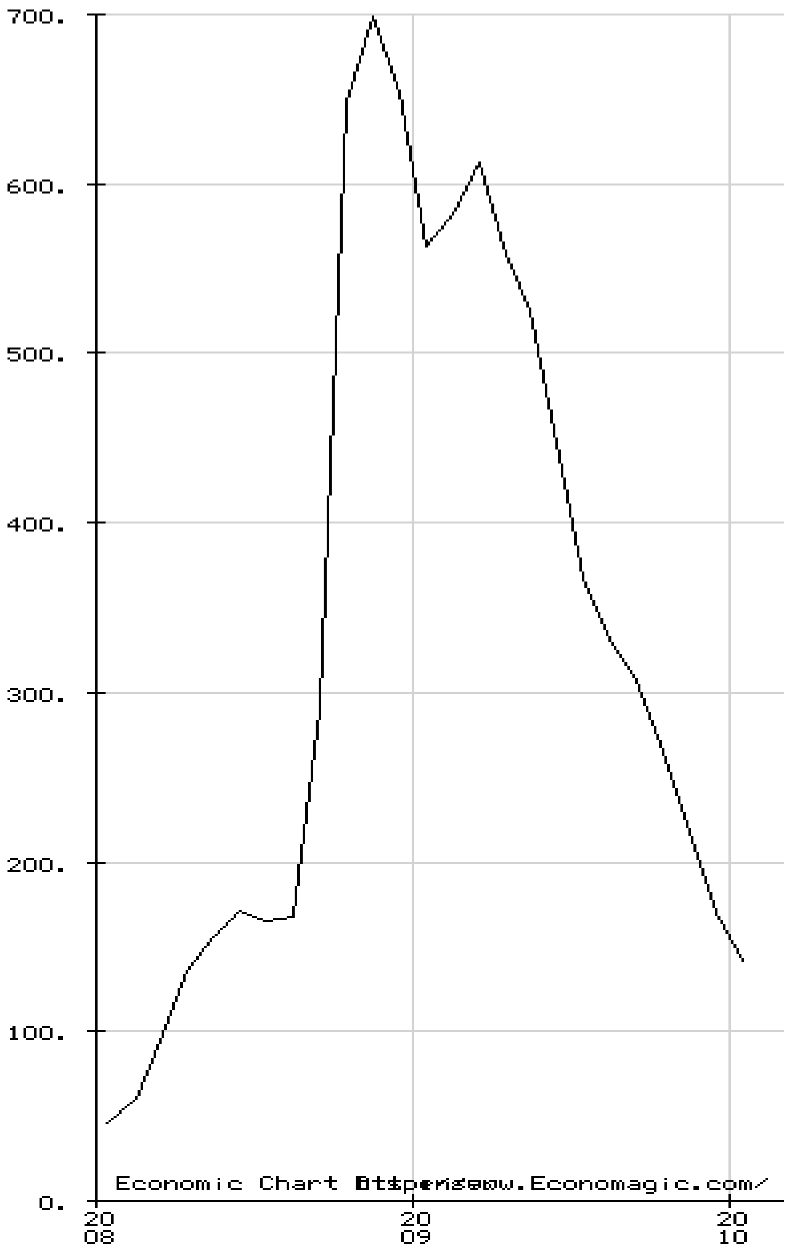

Civilian Unemployment
11.0
10.0
9.0
8.0
7.0
6.0
5.0
4.0
Economic Chart
Economagic.com/
20
08
20
09
20
10

process. It was my belief that the looming congressional elections this fall would force Congress to resist the temptation to craft bills that satisfied their desire to grab more power while ignoring the very real long term damage that these new laws would have on the economy.

Last month I voiced my concern that, while this economy was indeed recovering, there was still a very real chance that the self proclaimed liberals who controlled the levers of power in the House, Senate and White House were in a position to force though legislation which would prove quite harmful to the country's short term and long term economic health.

In many instances the long term damage would be much worse than the immediate consequences. In the case of the healthcare bill, the promised savings would most certainly fail to material in the short run, but in the long run - perhaps ten years from now, the changes made to the system would result in the collapse of the private market for health insurance. In the case of the financial reforms the long term damage may have taken even longer to become apparent. Many of the changes being contemplated, such as the institutionalization of the concept of "too big to fail" might not produce disastrous consequences until the next time the country faced a financial crisis similar to the one we have just survived.

Senator Scott Brown's election means that we as a country have bought more time.

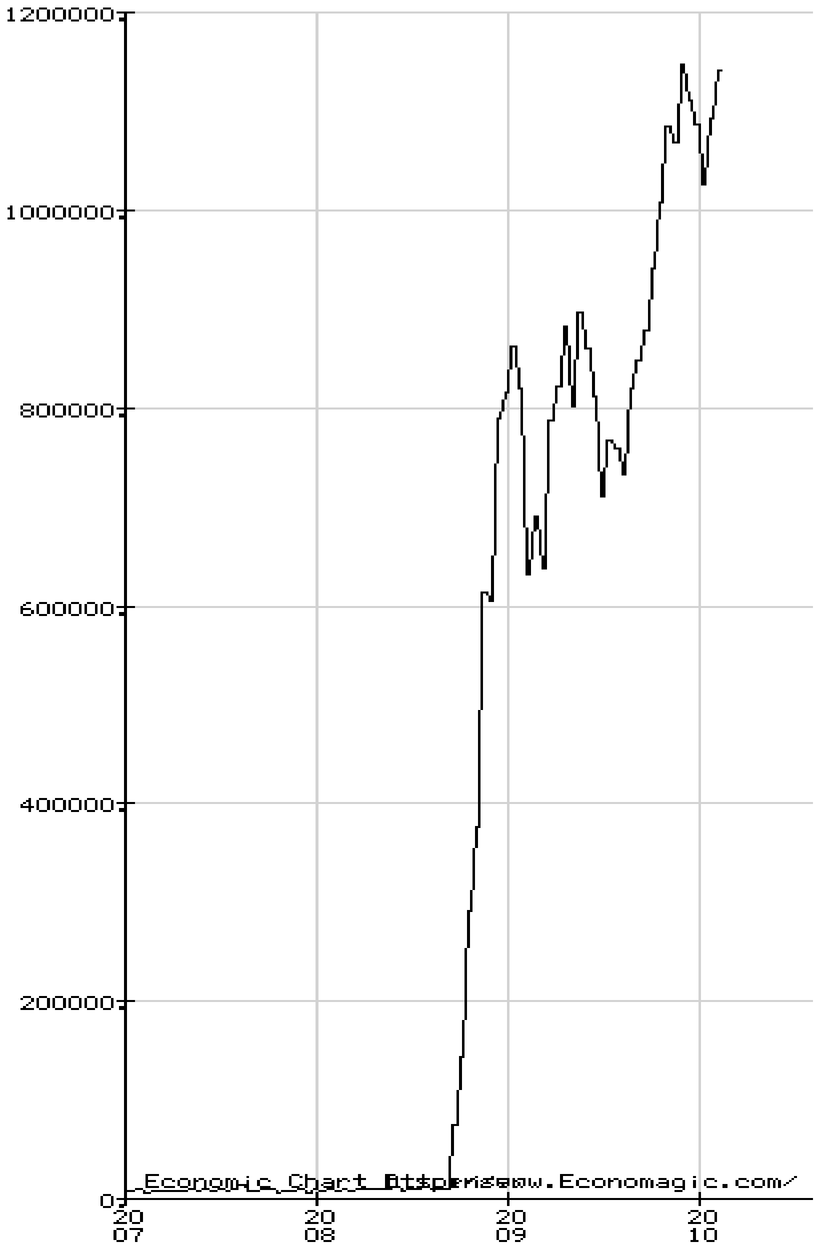

Total Borrowings of Depository Institutions from the Federal reserve: Billions of Dollars; not seasonally adjusted
700.
600.
500.
400.
300.
200.
100.
0.
20
08
20
09
20
10
Economic Chart
www.Economagic.com/

The election of Scott Brown, a moderate Republican from Massachusetts, to the seat held by the late Senator Kennedy has changed the balance of power just enough so that the more damaging pieces of legislations have been stopped in their tracks. Had Brown lost that race I would likely be flying a yellow flag on the cover this month. While presence of 41 Republicans in the Senate does not guarantee that the reworked legislation will be good for the country, it does mean that it is likely that it will not be really, really bad.

The time is coming when Congress must do what is right, not just what is most pleasing to those who have been holding the reins of power in this country for the past year. The recent appearance by Paul Volcker before the Senate Committee on Banking, Housing and Urban Affairs is a very good sign that the White House has come to realize that voters are paying attention.

Paul Volcker has forgotten more things about the way America's banking system should be set up and regulated than most people on the planet could ever hope to learn.

That is especially true when the people we are speaking about are members of Congress. President Obama, despite his public position that the election of Scott Brown meant nothing, asked the Senate committee to stop everything for a few hours and take testimony from Mr. Volcker on the importance of once again differentiating between banks and

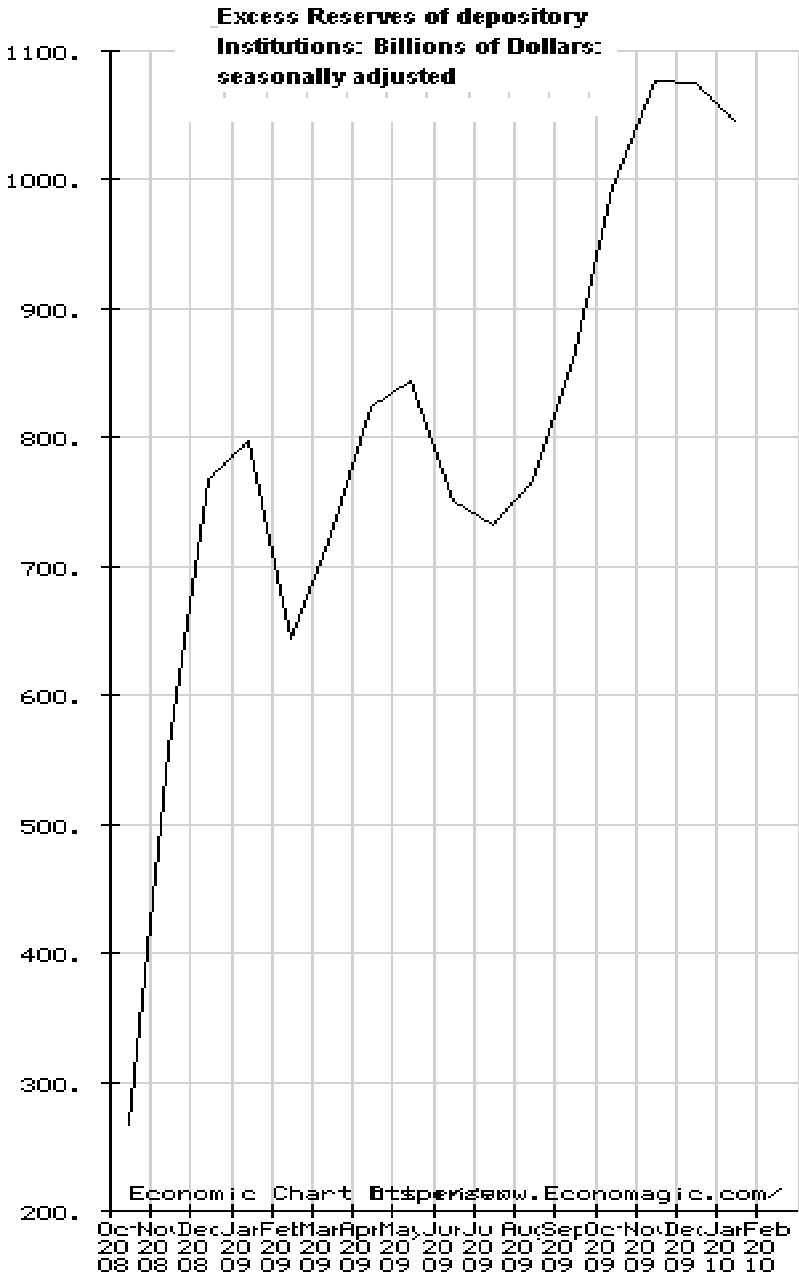

Reserves of Depository Institutions
1200000
1000000
800000
600000
400000
200000
0
20
07
20
08
20
09
20
10
Economic Chart Dispenser http://www.Economagic.com/

investment houses.

His proposal to end the implicit government guarantee to bailout any bank that gets in trouble after making poor investments with deposits guaranteed by the government was met with more than a bit of resistance on Capitol Hill. Not because these Senators thought his ideas were without merit, but mostly because it would mean they would need to scrap their approach to financial reform and start from scratch. The popular media couldn't wait to pronounce this so-called Volcker rule dead on arrival. That's because most of them don't know the difference between Glass-Steagall and a glass of milk. I am not concerned that the members of the banking committee initially seem cool to the idea. The great 19th century French writer Victor Hugo said it best: "Nothing is as powerful as an idea whose time has come".

The time has come for Washington to tame its profligate ways and it is time for Wall Street banks to stop making enormously risky investments because they feel any loses will be covered by taxpayer funded bailouts. Paul Volcker knows that. I suspect that many people in Congress and the White House know this as well. The voters of Massachusetts - of all places - not only know this, they have sent a man down to Washington who vowed to do something about it.

Change is coming to Washington – those who claim to be ahead of the news curve just haven't figured it out yet. My advice is to prepare yourself for this coming change.

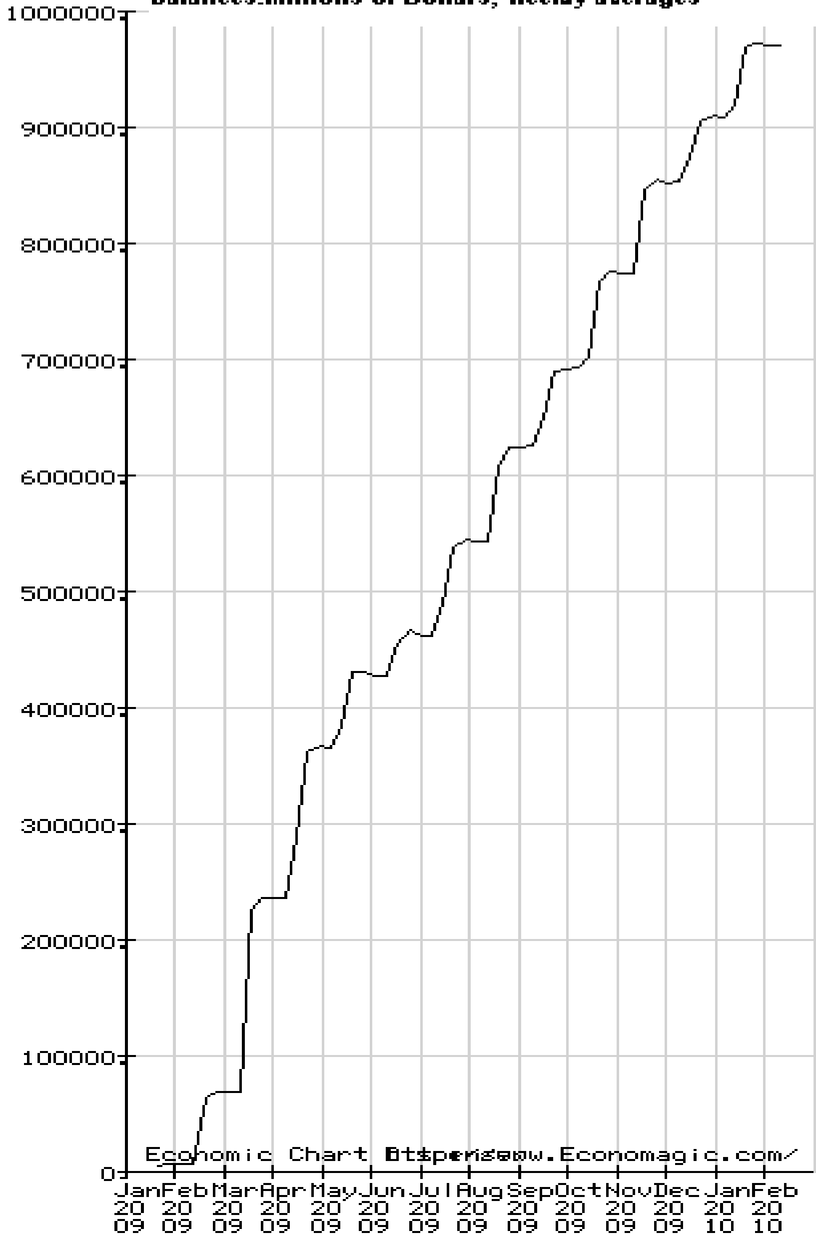

Excess Reserves of depository Institutions: Billions of Dollars: seasonally adjusted
1100.
1000.
900.
800.
700.
600.
500.
400.
300.
200.
Economic Chart Dispenser www.Economagic.com/
Oct 2008
Nov 2008
Dec 2008
Jan 2009
Feb 2009
Mar 2009
Apr 2009
May 2009
Jun 2009
Jul 2009
Aug 2009
Sep 2009
Oct 2009
Nov 2009
Dec 2009
Jan 2010
Feb 2010

It’s substantial enough to keep our green flag flying when nearly everyone else is still wringing their hands over an economy they wrongly perceive to be growing weaker.

Since before this recovery began it has been the default position that it would be a jobless recovery because the consumer, out of work and in debt up to their collective eyeballs would have no money to spend and thus there would be no need to produce goods for them.

The chart on page two makes it abundantly clear that this assumption is proving to be dead wrong. Personal income has been moving smartly higher for almost a year now. It will shortly be higher than the previous peak that came back in 2008. When you combine this rebound in incomes with the move on the part of consumers to reduce their level of debt you get the results shown on pages four and six. The first chart shows consumer credit outstanding as a percentage of GDP. Clearly debt levels have grown too high over the past two decades. Just as clear is the trend to reduce this over-leveraged situation. Keep in mind that this chart reflects two things: debt levels and recent GDP growth. It is not necessary for debt to be liquidated to keep this line moving back down to its long-term level of between 12% and 13%. A growing economy will help drive this number back into a more normal range.

The chart on page six shows that rising incomes and falling debt levels are quickly helping more and more households escape the prospects of not being able to pay their bills.

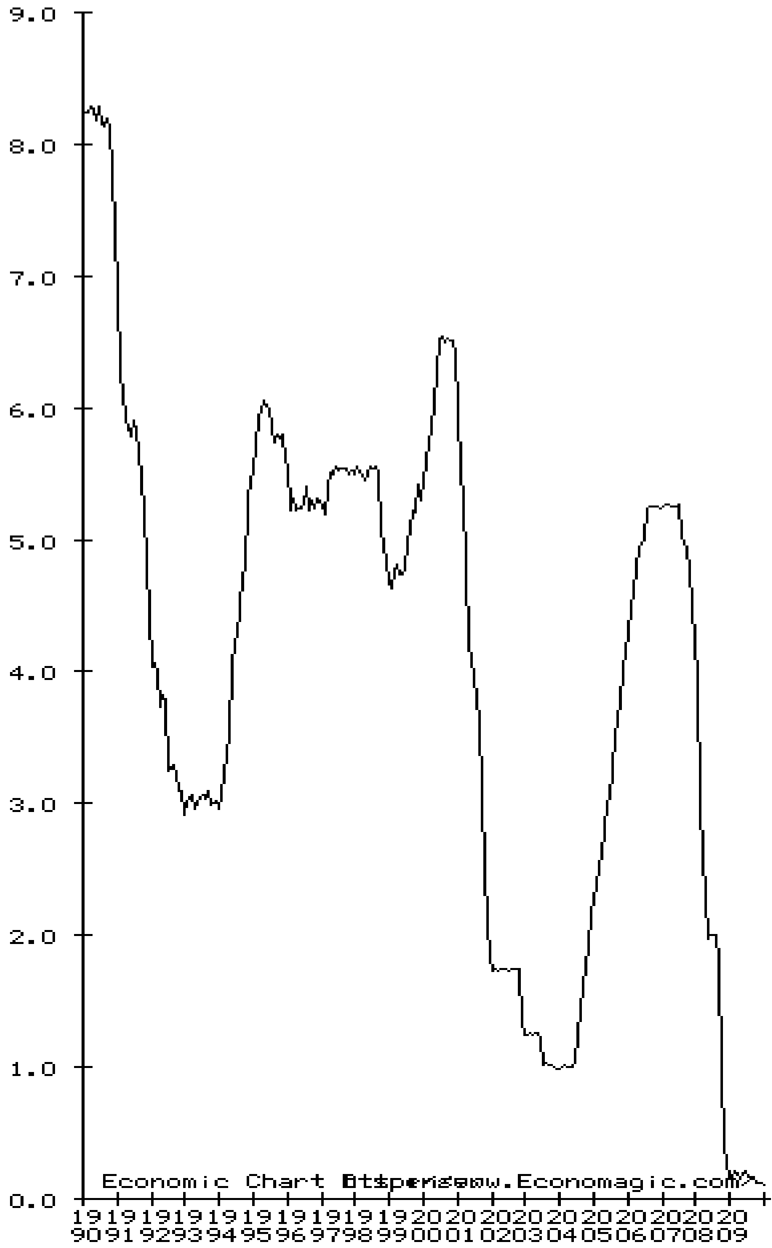

Mortgae-backed Securities: Factors Supplying Reserve Balances:Millions of Dollars, weekly averages
1000000
900000
800000
700000
600000
500000
400000
300000
200000
100000
0
Jan 2009
Feb 2009
Mar 2009
Apr 2009
May 2009
Jun 2009
Jul 2009
Aug 2009
Sep 2009
Oct 2009
Nov 2009
Dec 2009
Jan 2010
Feb 2010
Economic Chart
http://www.Economagic.com/

Household debt includes not just consumer debt but also mortgages. If this trend continues, and I see no reason why it won't, it suggests that the concern that 5.5 million home mortgages will default in the coming two years is too pessimistic. Lower debt levels combined with declining joblessness (page 8) suggests that the American consumer is well on the way back to good financial health. This trend is being ignored by those who are waiting for this economy to resume its decline. Forget all the talk of consumers needing ten more years to heal their balance sheets. These charts suggest that it may take less than 2 years to regain the healthy levels of years past.

All Of This Good News Is Not Being Lost On Ben Bernanke

Shortly after winning confirmation to a second term, Ben Bernanke got right to work on his next important task - namely the gradual unwinding of all the steps taken to assure a fully functioning credit market after the financial panic of 2008. There is no doubt that the panic has long since subsided. The chart on page 10 shows how much banks came to depend on the Fed for funds once the panic began back in '08 and how they no longer need to run to the Fed to make ends meet.

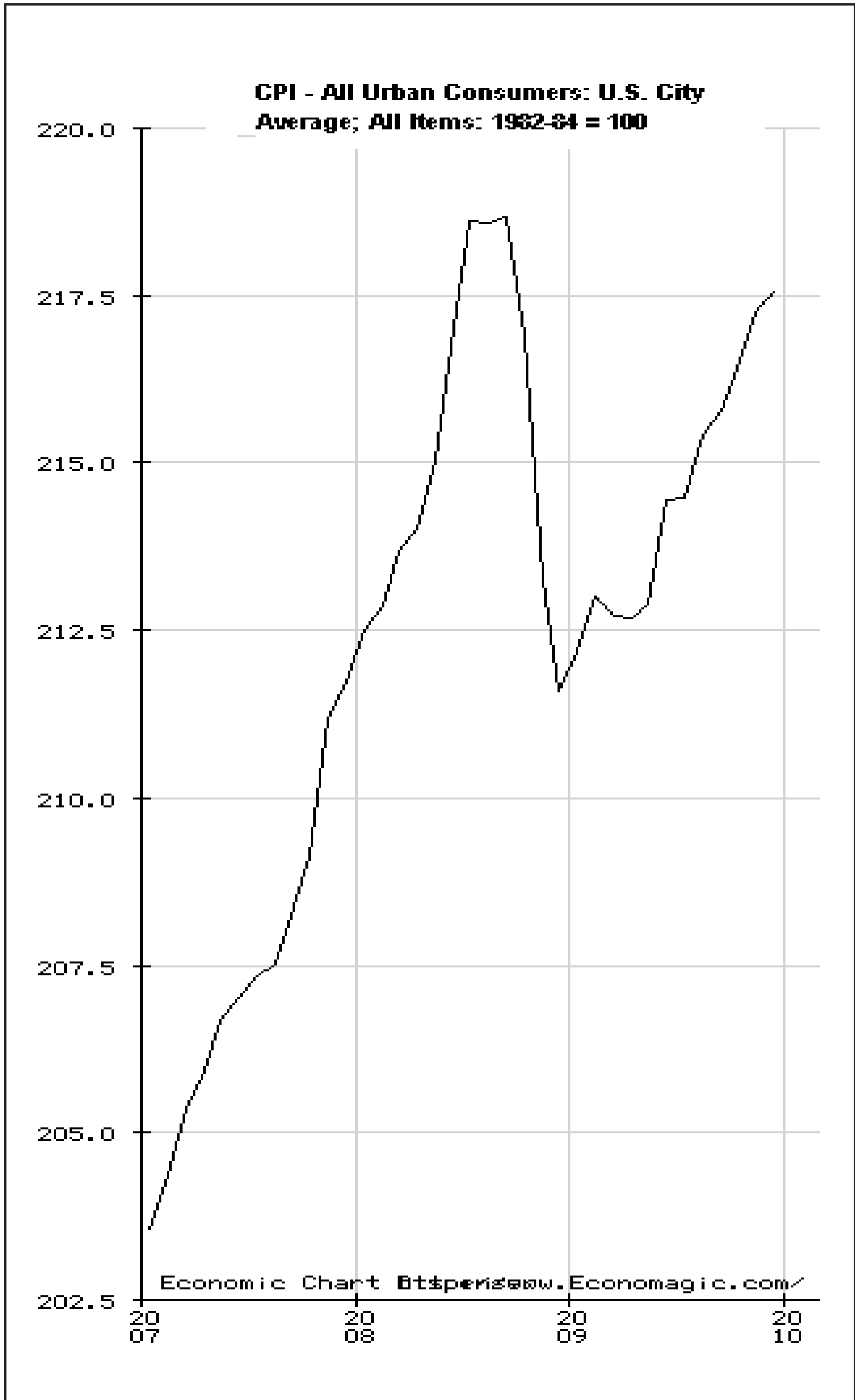
But the end of the panic is only part of this story. The Fed has used its nearly limitless resources to keep the economy from imploding and now all those purchased assets need to


Effective Federal Funds Rate: Percent
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Economic Chart
Economagic.com
1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009

be returned to the private sector. The chart on page 12 gives you a clear understanding of just how much money we are talking about here. The banks usually only want to keep enough reserves at the Fed to cover what is required by law. But that changed after the financial panic began. The Fed flooded the banks with money to make sure they would have enough to quell any bank runs and thus restored confidence in the system. All this money became what is known as Excess Reserves, cash available to the banks, but not legally required to be held at the Fed (page 14). When bank runs failed to materialize the Fed began to pull that money back.

But the problems in the real estate markets forced the federal government to facilitate several buyouts of unhealthy firms by more healthy firms. Among this was the arranged marriage between JP Morgan Chase and Bear Stearns. The only way the merger could be made to work was for the government to buy up much of the illiquid mortgage backed securities that were weighing down the balance sheets of Bear Stearns. Enter the Fed. It began a program of purchasing these toxic assets (page 16). When all was said and done they bought up nearly one trillion dollars of these investments.

But the Fed now has a problem. They are not willing to part with these assets yet because real estate prices are still low and throwing these mortgage-backed assets back out into the market all at once would do great damage. So the Fed has decided it will hold onto them. The drawback is that


CPI - All Urban Consumers: U.S. City
Average; All Items: 1982-84 = 100
220.0
217.5
215.0
212.5
210.0
207.5
205.0
202.5
Economic Chart
www.Economagic.com/
2007
2008
2009
2010

these assets, while illiquid, provide the raw materials that banks need to expand loan activity.

The fear is that once the economy gets rolling again banks will use these reserves to expand loans and thus the money supply at a pace which the Fed believes will be inflationary in the long run. The sheer level of reserves (we are talking about a trillion dollars here) means that the Fed can't do what it usually does – drain a little money out of the system and force the Fed Funds Rate up. So Ben Bernanke has announced that he will use two other tools now at his disposal. The first is to pay interest on the reserves parked at the Fed. This will entice banks to keep the money there rather than lend it out. The second tool is to force banks to enter into agreements whereby the Fed locks the money up at the Fed, preventing the banks from accessing it and using it to make loans.

The details of how this will be done is not as important as the message from the Fed that it is well aware that these excess reserves can one day pose a threat to price stability. The most damning charge made against the Fed under Alan Greenspan was that the Fed kept credit too loose for too long. That led to the speculative bubble in real estate which is the root cause of nearly all that has transpired since.

Ben Bernanke, by making public his plans on how to prevent another era of too loose money, is sending a signal that he gets it. The Fed will not allow another speculative bubble to

return the U.S. to the destructive boom and bust cycle ushered in under Alan Greenspan.

Investors, after initially voicing concern that the Fed might prematurely kill the recovery, have begun to appreciate the Fed's ability to address the issue before it could become a problem. Trust that Bernanke has a grasp of the issues and is willing to act in a timely manner will provide confidence in this economy going forward. As the economy continues to grow it will allow the Fed to begin to sell these mortgage-backed securities into the marketplace. As that happens you will see the excess reserves begin to decline.

Just as there are those who don't understand the nature of these reserves and thought that their presence must be inflationary, so too will there be those who see those reserves start to fall and think it will be deflationary. Don't be fooled by these people. Ben Bernanke has proven himself a master at using these reserves to see the country through the bad times, he will have no problem overseeing their elimination without causing the economy to suffer as a result.

- Adrian Van Eck

ADRIAN VAN ECK EXPLAINS WHY HE OFFERS HOTLINES

*In the summer of 1990 , Adrian finished
His monthly Money Forecast Letter,
Put it in the mail and flew off to
Washington, D.C. for an appointment.*

Adrian was in the office of the Secretary of Treasury when an aide rushed in and breathlessly announced that Iraqi armor and troops had just crossed the border of Kuwait. Needless to say, the planned meeting was cancelled, as first President George Bush summoned his cabinet officers to an emergency meeting at the White House.

The economy was suddenly turning upside down and Adrian wished he had a way to communicate with his readers. On the flight back to Boston, he decided it was time to supplement the in-depth analysis and forecasts in his monthly letter with a time-value weekly hotline.

At first he provided a voice message. That proved impractical and it was soon replaced by a fax version. More recently he added an E-Mail version, which is today the choice of 5 out of 6 hotline subscribers.

If you do not yet take Adrian's hotline on Money and the Economy, please turn over and sign up now.

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