



June 14, 2010

Mixed economic news and uncertain investors drove the Dow to yet another jumpy week, with moves of 100 or more points on three of its five trading days. This time around, however, the Dow finished back above the 10,000-point threshold and both the S&P 500 and the NASDAQ followed it into the black.

The week began with Hungary's government further backtracking on statements about potential default that had spooked the market at the end of the previous week. Hungary's new government had taken the same tack to addressing its economic woes that had been adopted not only in Greece but by the new government in Britain and the Democrats in the United States: put the blame squarely on the shoulders of the previous administration. In this case, some believed that Hungary may have also been trying to get some wiggle room on the deal it made with the International Monetary Fund when it was bailed out to the tune of \$25 billion in 2008 on the condition that it lower its deficit to 3.8% of gross domestic product in 2010. As government spokesmen busily tried to clean up the mess, the euro zone's finance ministers convened in Luxembourg where the host nation's Prime Minister, Jean-Claude Juncker, succinctly summed up the brouhaha: "I do not see any problem at all with Hungary. I only see the problem that politicians from Hungary talk too much." While in Luxembourg, European finance ministers signed off on the details of the €440 billion (\$527 billion) in available loans that is the centerpiece of the recent bailout package. The European Central Bank,

	Key Market Data		
	Week ending...		
	6/11/10	6/4/10	Change
Dow Jones Industrial Average Index	10,211.07	9,931.97	+2.81%
S&P 500 Index	1,091.60	1,064.88	+2.51%
NASDAQ Composite Index	2,243.60	2,219.17	+1.10%
10-Year Treasury Note Rate	3.218%	3.197%	+0.021 pct. pts.
NYMEX Crude Future (Barrel)	\$73.78	\$71.51	+3.17%
Euro/U.S. Dollar	\$1.2094	\$1.1966	+\$0.0128

meanwhile, kept its benchmark interest rate at a record low 1% while assuring the availability of emergency loans for member countries.

Back in the U.S., Benjamin Bernanke, Chairman of the Federal Reserve, said the economy will be slow to recover and joblessness will be stubborn. "My best guess is that we'll have a continued recovery," he said, "but it won't feel terrific." Meanwhile the Fed reported that consumer borrowing rose 0.5% or \$954.8 billion in April to \$2.44 trillion, but also said the gain it had reported in March had been revised to a \$5.44 billion decline. The April increase, should it stand, will be only the second in the last fifteen months and is a good sign as economists look to consumer spending to lead the recovery.

The Fed also released its Beige Book, a snapshot of the state of the economy in one dozen Fed districts, and concluded that the recovery had at last spread to all twelve, though growth was modest and unemployment persistent. Even so, the last

time all of the Fed regions were in growth mode was back before the recession began in December 2007. Regarding unemployment, Harvard University economist Lawrence Katz estimated that the economy will need to generate 332,000 net new jobs for the next 45 months to make up for the positions lost in the last two years. The Commerce Department announced that wholesale inventories were up 0.4% in April and the ratio of inventories to sales – how long it would take to clear the shelves – fell to 1.13 months, its lowest mark since records began being kept in 1992. That was seen as a positive because if factories have to restock shelves, production will ramp up and companies may hire.

The Census Bureau said that the trade gap rose to its highest level in 16 months, widening to \$40.3 billion in April from a revised \$40 billion in March as exports fell 0.7% while imports were off 0.4%. The trade gap with China grew to \$19.3 billion from \$16.9 billion in March, and as a result Timothy Geithner, Secretary of the Treasury, renewed his call for China to let its currency float free of the dollar, telling the Senate Finance Committee, “The distortions caused by China’s exchange rate spread far beyond China’s borders and are an impediment to the global rebalancing we need.”

On Thursday, the House and Senate officially began work on reconciling the two versions of the financial overhaul bill with a 1,974 page “base text.” President Obama is pressuring Congress to merge the two versions of the bill before he heads for the Group of 20 summit in Toronto at the end of this month, with an eye to signing the bill into law on the Fourth of July (the cynical would say his speechwriters have probably already written a line or two about a new era of financial independence.) The idea is that if he goes to Toronto with the revised bill in hand, it would make it easier for him to lobby the other G-20 members to follow our lead and make headway on proposal for a global bank tax, for instance. And Paul

Volcker, Mr. Obama’s advisor and the former chairman of the Fed, said, “The United States will go from laggard to the head of the parade if we can get this legislation passed,” characterizing the bill as “a launching point for other countries.”

That may be wishful thinking, however, as the two bills total over 3,000 pages and have some glaring differences – not to mention the fact that the GOP will be loathe to give the president and his party such a high profile PR opportunity with midterm elections only five months away. The major differences are the Senate’s tougher plan to force banks to spin off their derivatives business (which the Obama administration opposes), as well as very different provisions for limiting the fees that banks can charge retailers for using credit cards and a ban on banks using their own money for proprietary trading (the so-called “Volcker Rule”).

The week ended on a down note when the Census Bureau also reported that retail sales fell unexpectedly in May, down 1.2% or \$362.5 billion after growing 0.6% in April. It was the first dip since September 2009 and was largely the result of a steep decline in the sale of building materials. Still, it was a sign of the stock market’s unpredictability that the market was nonetheless up on Friday after the report was released and the Thomson Reuters/University of Michigan poll of consumer confidence climbed to 75.5 in June from 73.6 in May.

The broader view

Despite the toll that the grim news from Greece has taken on the world’s stock markets over the past few months, it has had one positive effect: deficit reduction has become a hot topic.

Last week, there were plenty more warning words about the threat of top-heavy deficits, including some from Mr. Bernanke. Appearing before the House Budget Committee on Wednesday, he reprised a

theme that he has been drumming of late: the need to reduce our deficit, while also refusing to get dragged into the partisan fray. “The federal budget appears to be on an unsustainable path,” he said, while adding that the “exceptional increase” had been the key to the economic recovery, however sluggish it may have become. As for endorsing either the spending cuts favored by the Republicans or the tax increases endorsed by the Democrats, Bernanke said, “I’m trying to avoid taking sides on this because it’s really up to Congress to make those decisions.”

This past week the Congressional Budget Office (CBO) said that our annual deficit would be \$1.4 trillion this year, 9.4% of GDP. The CBO also estimated that our total debt was expected to grow from 53% of GDP in 2009 to 90% by 2020, during which time the deficit could increase by \$9 trillion. What does that mean? Net interest payments would quadruple to \$916 billion in 2020.

With those numbers and the crisis in Europe as a sobering background, the administration is wrestling over two very different approaches to addressing the deficit, with Keynesian economists saying that you need to keep spending to create the growth that will eventually lead to budget reduction, and other economists saying the time has come to stop spending, arguing that the \$787 billion in federal stimulus was not the economic cure-all it was billed to be. Right now, based on the job creation and employment benefit bills that are either stalled in Congress or being dramatically pared, the free spenders are losing the battle.



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And Bernanke was not alone. In Britain, the new Prime Minister David Cameron said his nation’s financial situation was “even worse than we thought,” adding that the effects of the decisions that have to be made “will stay with us for years, perhaps decades, to come.” Taking a shot at the “reckless” spending of the Labour government he unseated, he concluded, “Greece stands as a warning of what happens to countries that lose their credibility, or when governments pretend that difficult decisions can be avoided.” Naoto Kan, Japan’s new prime minister, also invoked Greece before saying, “Our finances could collapse if trust in national bonds is lost and our growing national debt is left alone.” And even Germany, one of Europe’s strongest economies, introduced an €80 billion austerity package to cut its deficit, hardly pleasing the Obama administration which has been enjoying sound European economies like Germany to spur consumer spending and boost the global recovery.

A look ahead

This week there will be updates on both the producer price index (PPI) and the consumer price index (CPI). There will also be releases on housing starts and building permits, industrial production and capacity utilization, and the Conference Board’s leading indicators, all against the backdrop of the Dow trying to stay above 10,000.

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