January 5, 2006

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THE FEDERAL RESERVE: CONTINUED RESTRICTIVE MONETARY POLICY AND ITS FALLOUT

Prelude…
The Fed's Policy concerning the Specter of Inflation

Most of the inflation we have been experiencing is coming from a single source: energy. The Federal Reserve policy is most effective in curtailing demand side inflation – not supply side. Demand side inflation has been increasingly been suppressed due to rise of competitive pressures throughout the economy. As we have argued, this is the essence of the New Paradigm – increasing competition in markets eliminates the price power of firms. When inflation comes from supply-side shocks, marked by OPEC price increases, a recartelized domestic oil industry and an anti-growth environmental lobby, the Fed's weapons become ineffective and in fact cause extensive collateral damage, as we will discuss below.

Beyond the issue with OPEC's pressuring global prices upward, a major cause of the explosion in energy prices in the past two years is the fact that the domestic energy industry has not increased capacity because it is not in their best interest to do so in terms of their profit picture. A second problem is the very powerful and extensive environmental group. Its antigrowth policies have resulted in a virtual shutdown in the nuclear power industry and the halting of any expansion in the production and refining capacity of the American oil industry. Even in the area of coal and renewable resources such as wind and solar power, environmental roadblocks are more the rule than the exception. Inflationary pressures, caused by energy shortages, cannot be managed through the use of monetary policy by the Fed.

It has to be made very clear that the policies and decisions of the Department of Justice and the Federal Trade Commission allowed the American oil industry to recartelize over the past fifteen years. This has to be rectified and competition must be reintroduced into the American oil industry. On the environmental front, we must move from the current "Chicken Little" policy of the sky is falling, to a more rational approach to protecting the environment. It must be noted that much of OPEC's current power would be absent if it were not for the recartelization of the American oil industry and the outdated and obstructionist attitude and quasi-scientific stance of the environmental lobby. Until this is accomplished, the American consumer will continue to be suffer from high energy costs and Fed induced high-interest rates. Short of a Federal Reserve induced economic collapse (a la 2000), their policy of pressuring interest rates upward are of no avail, given the current structure of the domestic energy industry and the environmental obstructionist policies.

Please note that this is not to ignore that strong growth in the U.S. economy and China, for example, have put upward pressure on global oil prices, but again, the primary cause for the huge spike in energy prices is coming from the supply side…

As we move on, we'd like you to consider the following two questions:

1) Who is benefiting from the Fed's policy of pushing up the federal funds rate?

2) Who is hurt by the Fed's policy?

The answer to these questions will be addressed…

The Killing Fields: Weak links in an otherwise strong economy…

Introduction/Overview

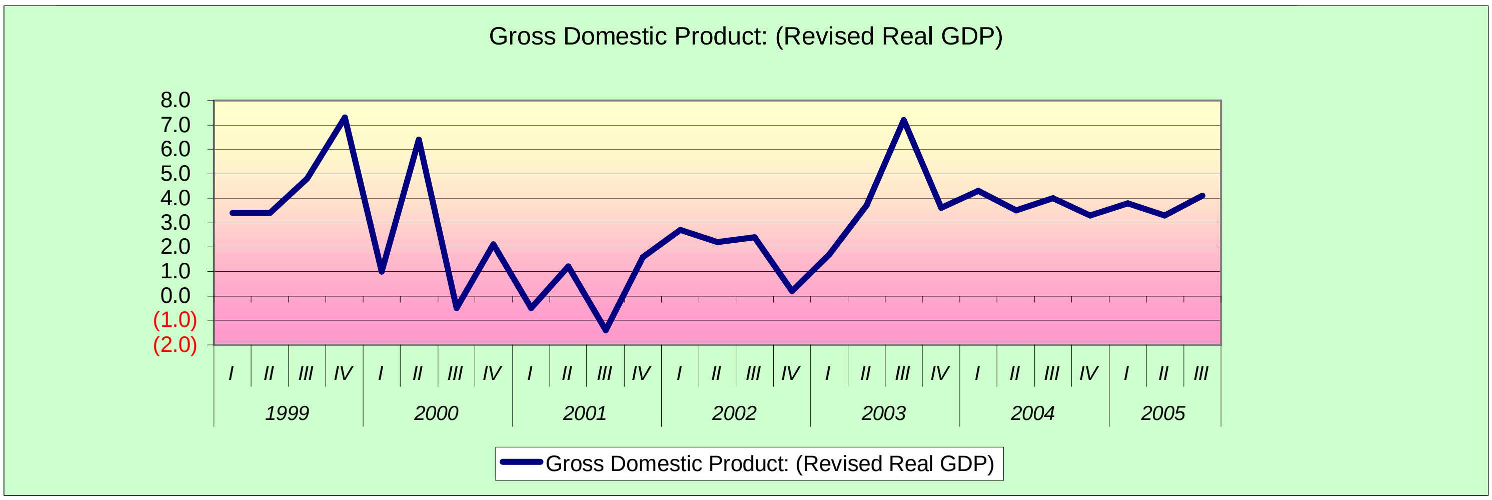
As you can tell by the following illustration, the U.S. economy destabilized late in 1999 and collapsed in 2000. Beginning in the fourth quarter of 2001, the economy has been humming along strongly as it enters the fifth year of its expansion.

What Recession? The ongoing debate as to when/if there indeed was a recession at all

(Webster's Dictionary) RECESSION : A period during which economic activity, as measured by gross domestic product, declines for at least two quarters in a row in a specific country. If the decline is severe and long, such as greater than ten percent, it may be termed a depression.

Bureau of Economic Analysis (BEA)
Table 1.1.1. Percent Change From Preceding Period in Real Gross Domestic Product
[Percent] Seasonally adjusted at annual rates
Today is: 12/26/05 Last Revised on December 21, 2005 Next Release Date January 27, 2006

	1999				2000				2001				2002				2003				2004				2005		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
Gross Domestic Product : (Revised Real GDP)	3.4	3.4	4.8	7.3	1.0	6.4	(0.5)	2.1	(0.5)	1.2	(1.4)	1.6	2.7	2.2	2.4	0.2	1.7	3.7	7.2	3.6	4.3	3.5	4.0	3.3	3.8	3.3	4.1



The steady strength in the economy is reflected in solid job growth and an unemployment rate running around 5%.

[*Department of Labor, Bureau of Labor Statistics: December 26, 2005*]

Labor Force Statistics from the Current Population Survey (Household Survey)

1 Month Net Change

Series Id: LNS12000000
Seasonal Adjusted
Series title: (Seas) Employment Level
Labor force status: Employed
Type of data: Number in thousands
Age: 16 years and over

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2001	157	(184)	212	(507)	(194)	(216)	200	(825)	592	(457)	(160)	(189)	(1,571)
2002	(350)	692	(174)	(83)	421	(125)	5	305	576	(294)	(505)	(111)	357
2003	1,029	(64)	86	177	(76)	223	(264)	82	26	403	435	(48)	2,009
2004	72	(147)	74	237	201	312	481	19	(131)	300	466	(137)	1,747
2005	85	(97)	357	598	376	163	438	373	(17)	214	(52)		2,438

Net Job Gain / (Loss) 2001 - 2005 4,980

Change in Payroll Employment (Payroll Survey)

1 Month Net Change

Series Id: CES0000000001
Seasonally Adjusted
Super Sector: Total nonfarm
Industry: Total nonfarm
NAICS Code: N/A
Data Type: ALL EMPLOYEES, THOUS

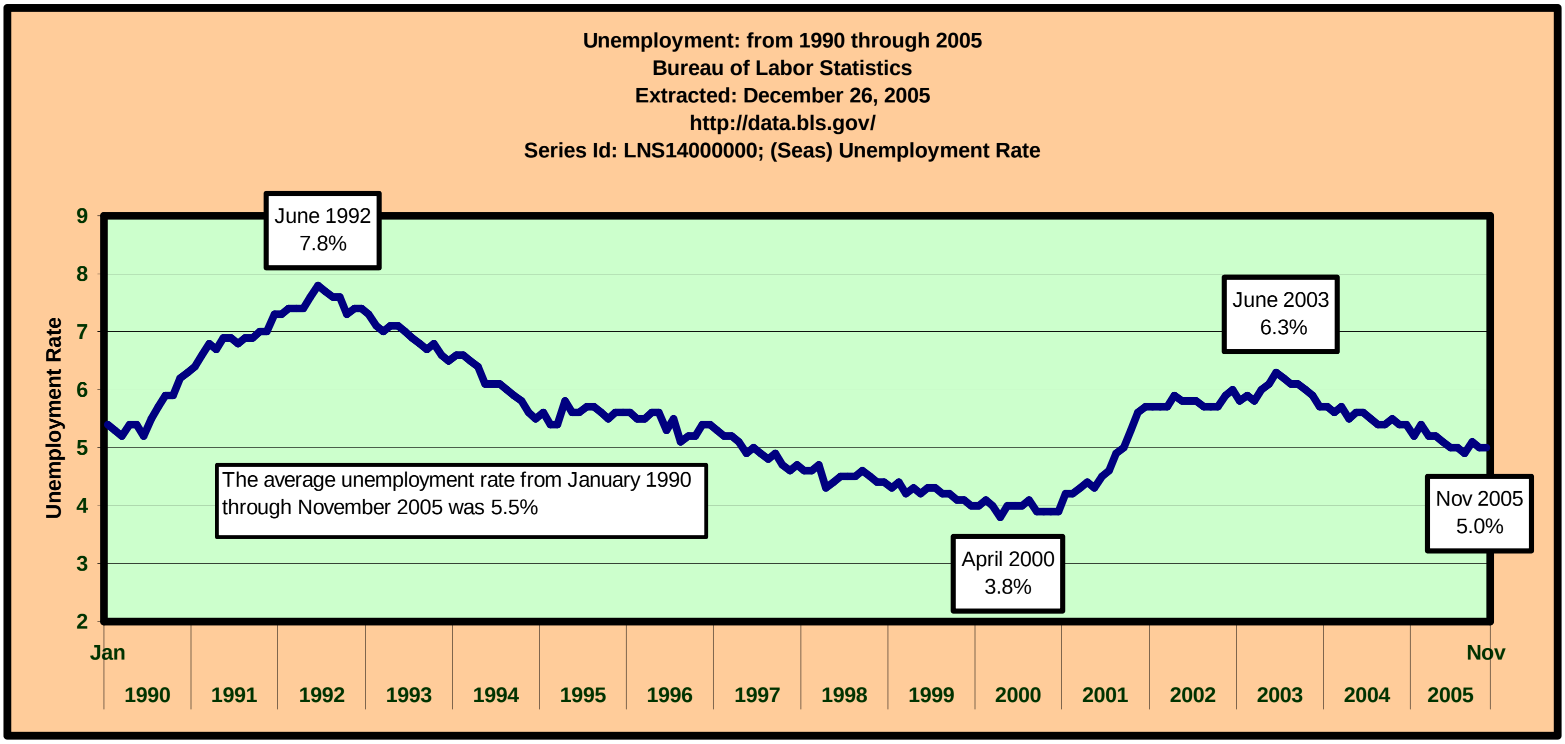
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2001	(30)	92	(35)	(297)	(27)	(158)	(88)	(138)	(254)	(377)	(293)	(174)	(1,779)
2002	(124)	(103)	(37)	(106)	(9)	51	(100)	18	(45)	59	6	(154)	(544)
2003	86	(122)	(218)	(54)	(26)	27	3	2	94	123	96	83	94
2004	117	94	320	337	250	106	83	188	130	282	132	155	2,194
2005	124	300	122	292	126	175	277	148	17	44	215		1,840

Net Job Gain / (Loss) 2001 - 2005 1,805

Net Difference 3,175

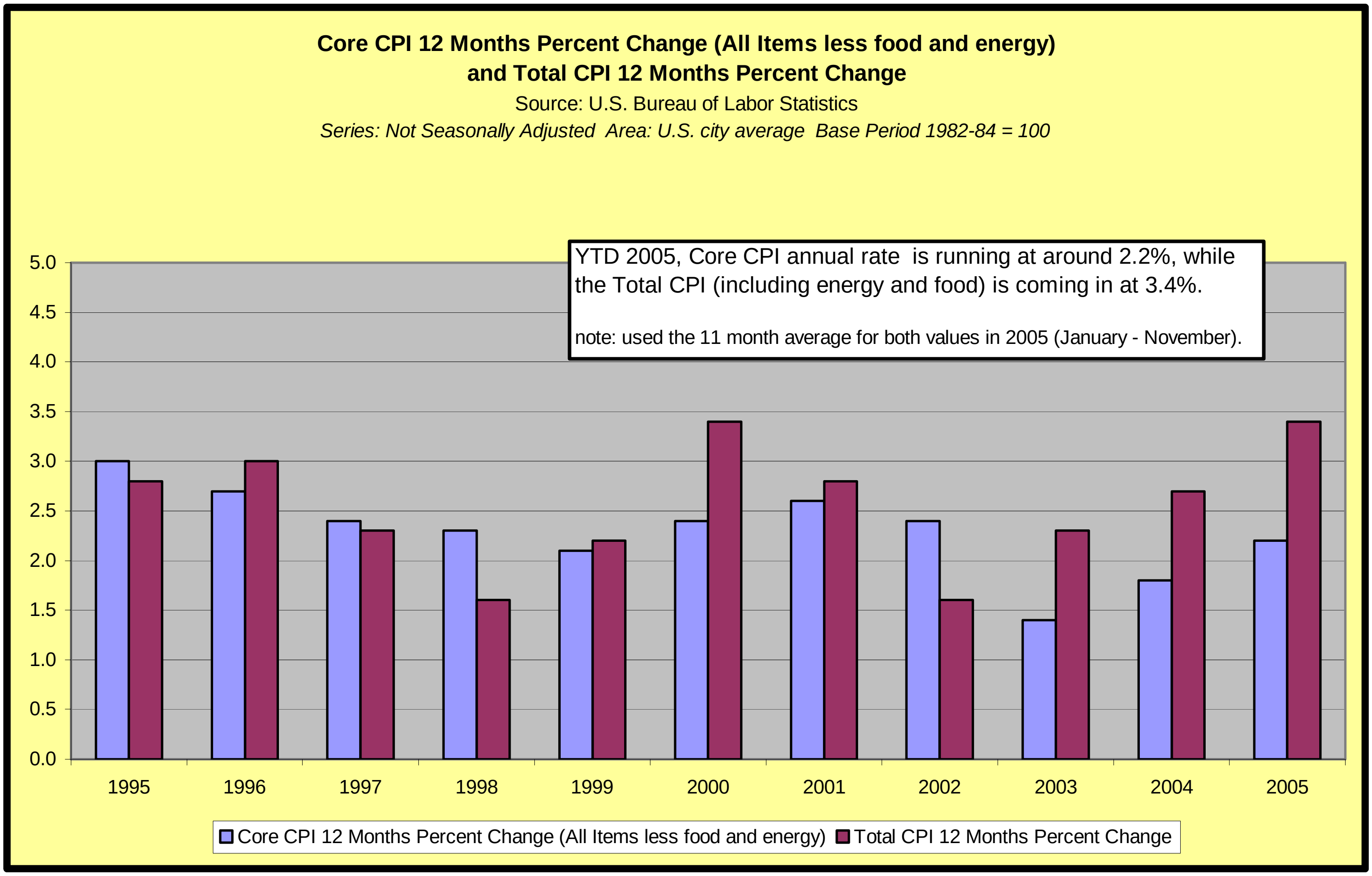
According to BLS data, from December 2003, through November 2005, the economy has added around 4 million jobs (4.1 million in the Population Survey; and 4.1 million in the Payroll Survey).

Job growth from 2001 (two surveys)



This economic growth has sustained itself in spite of two consecutive record hurricane seasons, including 2005 with well in excess of $100 billion in losses due to Katrina alone (http://www.ncdc.noaa.gov/oa/climate/research/2005/hurricanes05.html) and the cost of the ongoing wars on Terror, in Iraq and Afghanistan (http://www.house.gov/appropriations_democrats/pdf/iraq-funding-timeline-6-15-2005.pdf).

There has been little inflation, other than that caused by the recartelization of the oil industry, despite the prolonged expansion in the economy.



The Weak Links…

- **Restructuring (Auto and Education)**
- **Energy Costs**
- **Rising Mortgage Interest Rates**
- **Trade Deficit**

Restructuring…

A painfully familiar aspect of restructuring: AUTO INDUSTRY

Some argue that the American auto industry is at best dying and at worst already dead. This may seem like the case if you live in places like Southeastern Michigan, but if you are living in the Southeastern U.S., where the auto industry is migrating, you are experiencing a boom. Some emphasize outsourcing and plant closings occurring in the more northerly latitudes, but south of the Mason-Dixon Line, in sourcing is the norm – where new plants are opening.

See Hyundai in Alabama (http://www.hyundaiusa.com/abouthyundai/usinvestment/usinvestment.aspx)

Southern Hospitality - automotive industry relocating to the South http://www.findarticles.com/p/articles/mi_m3165/is_2002_August_1/ai_90091366/print

Southeast's Auto Industry Climbs into the Driver's Seat http://www.frbatlanta.org/invoke.cfm?objectid=FF0566BA-5056-9F06-99814EF979B2CB50&method=display

While this relocation is going on, in terms of geography, there is just as dramatic a shift occurring in market share. Back in 1950, the hey-day of the Big Three as the dominant players in the auto market of the U.S., their market share was between 90 and 95 percent. Imports comprised most of the remaining portion with the exception of a few dying brands, including Studebaker, Packard, Checker… Now, a generous estimate is that those same Big Three have between a 50 and 55% market share, with the rest going to transplants and imports. In addition, in 1950 the market was the United States – it is now defined as the NAFTA (North American Free Trade Area).

An interesting thing to note here is that around 80% of the vehicle sales in the U.S. auto market are homegrown: Traditional Big Three (GM, Ford and DaimlerChrysler) 55%; Transplants (foreign brands producing and selling those products here) 25%; Imports 20%. http://www.morgancom.com/automotivenews.htm

Between 1961 and 2003, the U.S. share of global vehicle production went from 44% to 20%

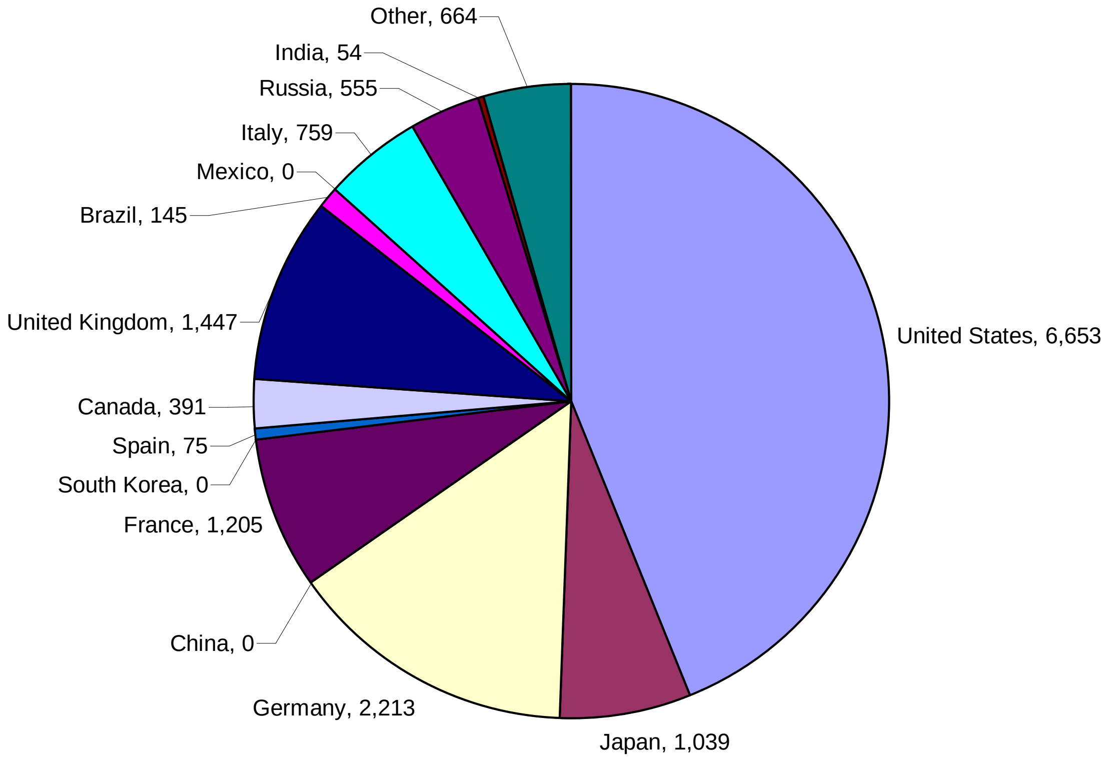
Global Vehicle Production 1961

(Total Passenger Cars and Commercial Vehicles)

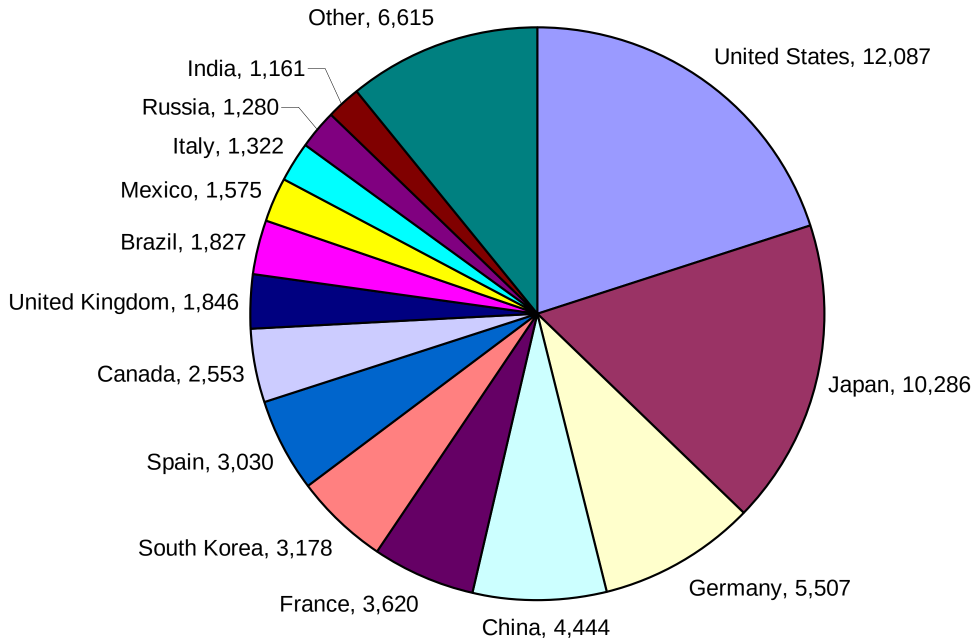
U.S. Bureau of Transportation Statistics

http://www.bts.gov/publications/national_transportation_statistics/2005/html/table_01_22.html

in thousands of vehicles (total = 15,200)



Global Vehicle Production 2003
(Total Passenger Cars and Commercial Vehicles)
U.S. Bureau of Transportation Statistics
http://www.bts.gov/publications/national_transportation_statistics/2005/html/table_01_22.html
in thousands of vehicles (total = 60,331)



As is chronicled in this newsletter and elsewhere, the major problem causing this dramatic restructuring has been linked to high labor costs and compensation packages in the Big Three. The differences between total labor compensation in the traditional Big Three and the foreign transplants in the auto industry…or, where the ***killing fields*** lie in the domestic auto industry...

In the U.S. domestic auto market, the hourly compensation (including benefits) for workers at the three traditional nameplates is estimated at $65/hour or $130,000 per year, while a similar estimate for the transplants is about $30/hour or $60,000 per year. According to the U.S. International Trade Administration, in terms of the wage portion of auto workers total compensation package:

"Auto manufacturing remains one of the economy's best paying industries. Production workers' average hourly earnings reached $29.05 (excluding benefits) in 2004. Wages were 80% greater than the national average for all manufacturing industries."

Again, the bulk of the difference between the Big Three autoworker and that of the transplant autoworker is mostly in the area of non-wage compensation (including such things as health care and pension benefits).

"After Delphi filed for bankruptcy, its chairman and CEO, Robert "Steve" Miller, said that the company needs to get rid of a "substantial" number of its North American operations and reduce its 51,000-member workforce. He wants the UAW to agree to concessions that would reduce members' average wage-and-benefit packages from about $65 an hour to about $20 or $25 an hour. Of that total compensation package, the hourly wage alone would drop from $27 to $10 if Miller has his way."
http://knowledge.wharton.upenn.edu/article/1301.cfm

"With wages as low as fifty cents an hour in China, compared to $21 an hour in the United States. and $2 an hour in Mexico, low labor costs are also a draw for U.S. suppliers to set up facilities in China, especially for certain labor intensive products. China's low tooling costs, low energy costs and its currency rate are additional incentives for producing and exporting from there."
(U.S. – China Automotive Parts Industry Overview)
http://www.ita.doc.gov/td/auto/US-ChinaPartsOverview.pdf

"What all those disparate groups of workers have in common is they work for companies that once were monopoly powers," said Dana Johnson, chief economist for Comerica Bank Inc.

"That era is gone for those companies. No more monopoly profits and, in many cases, no profits at the moment. Many unions and Michigan workers are operating under a compensation structure based on a market reality that no longer exists. It's the painful new reality."

http://www.detnews.com/apps/pbcs.dll/article?AID=/20051201/METRO/512010366

One aspect of restructuring you are perhaps not so familiar with:

EDUCATION

While it is evident that restructuring is in full swing in the auto industry, we've also found equally fundamental restructuring occurring in education – especially at the college level.

Most people are familiar with the encroachment of community colleges into higher education. Compared to years ago, a large portion of students take their first two years at community colleges, before completing their four-year programs. An even more profound change going on is the very rapid growth in online education.

From the US Dept of Education and US Census Bureau…

For the past few years, the increase in total online enrollment has exceeded the increase in all college enrollment – this means that not only is onground (face-to-face) education playing a declining role relative to online education, but its absolute numbers have fallen as well.

Between the 1997-1998 school years and 2000-2001 school years, distance-learning enrollments grew by 1,416,000 students, or 85% (from 1,661,000 to 3,077,000). In contrast, according to US Census Bureau data, from 1997 – 2000 total postsecondary enrollments (both distance and onground) only grew by 811,000 (from 14.502 million to 15.313 million).

1997-1998 (NCES)
http://nces.ed.gov/surveys/peqis/publications/2000013/

2000-2001 (NCES)
http://nces.ed.gov/surveys/peqis/publications/2003017/tables.asp#fig

1997 – 2000 (Census)
http://www.census.gov/prod/2004pubs/03statab/educ.pdf

>State University of New York<

In 2003, SUNY had 53,000 students enrolled online, with a total enrollment of 403,000.
http://www.suny.edu/SUNYNews/News.cfm?filname=2005-05-28SLNHighEnrollment.htm

By 2005, the online enrollment grew to 86,500, with a total enrollment of 413,500.
http://www.suny.edu/About_SUNY/SUNYFastFactsDesc.cfm

>University of Maryland<

(May 6, 2005) Gerald A. Heeger, 62, has been head of the University of Maryland University College since 1999. During his tenure, online enrollment grew from 20,000 students to nearly 125,000.
http://www.umucreview.com/index.php?name=PNphpBB2&file=viewtopic&t=37

Online education often is accompanied by extensive discounting of tuition rates; this reflects what has also been the case in the auto industry – competition has driven down the price of these goods/services to the consumer.

ENERGY COSTS

As we spelled out in a previous issue of this newsletter and referenced in the prelude, the recartelization of the American oil industry and environmental resistance have kept the energy industry being able to develop and expand to meet the needs of consumers. American businesses and households have been trapped in a virtual ***killing field*** of high-energy costs; with little hope of any relief in the near term. While critics lump the U.S. and China together as the primary polluters

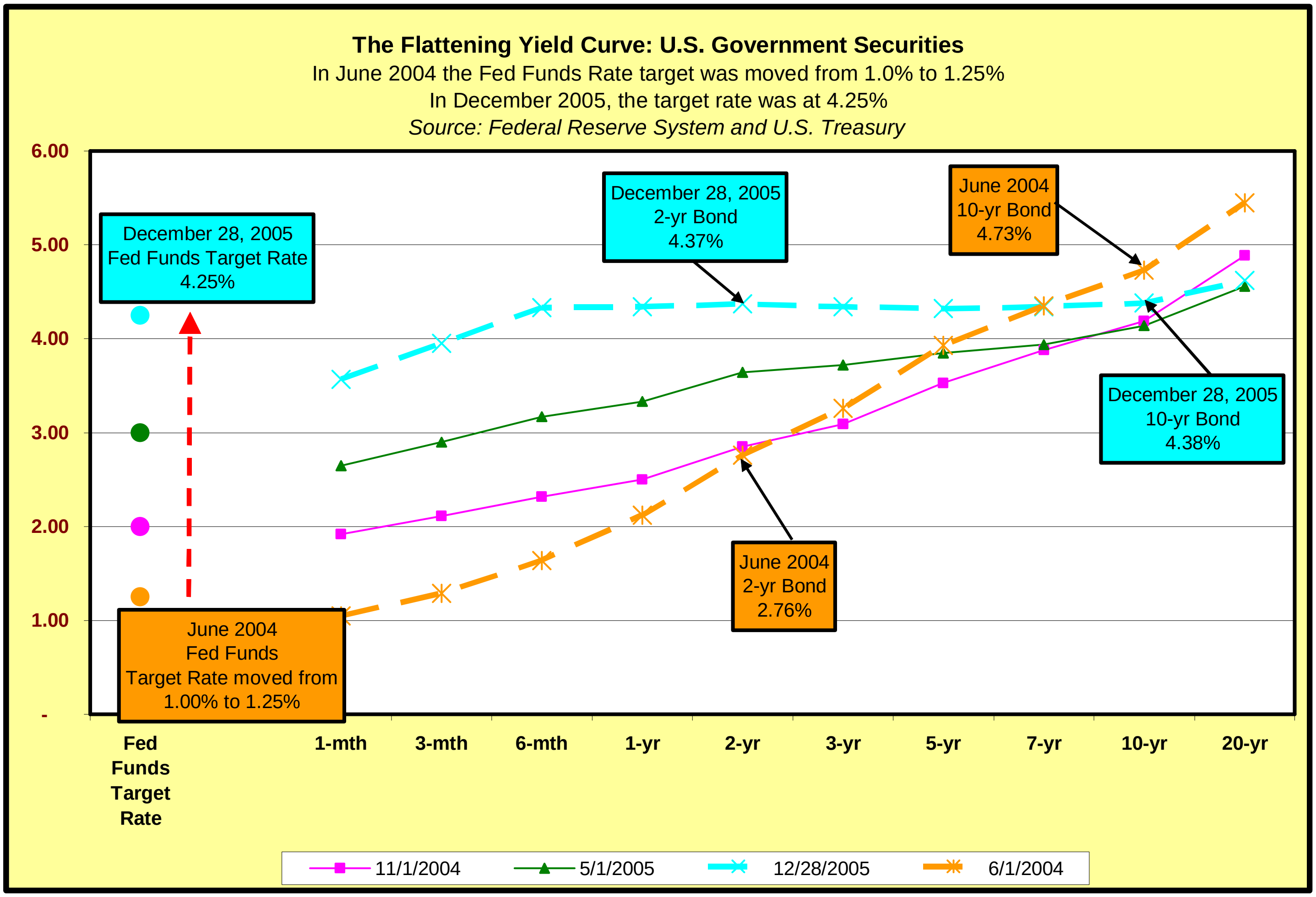
of the global environment, France has been noted as the poster child for all that is right in terms of energy conservation. The truth is that France has chosen to rely on nuclear energy for much of its electrical production.
http://byrned.faculty.udmercy.edu/2004%20Volume,%20Issue%203/Newsletter%20Volume%202004%20Issue%203.htm

RISING MORTGAGE INTEREST RATES

In addition to the rising energy costs and insecurity in the labor markets, households are now facing an additional burden of rising interest rates, affecting their mortgages. As short-term rates are driven up by the Federal Reserve actions in the Federal Funds rates, it influences other short-term interest rates to rise as well.

In the area of variable rate mortgages (ARMs), the Fed's actions are gradually triggering the adjustment clauses in these mortgages. This increases the monthly payments, reducing further the disposable income available to purchase other goods and services and also reduces the cushion protecting homeowners from defaulting on mortgages.

The second area of concern is the rise in fixed rate mortgages, both for new homebuyers and those attempting to refinance from variable to fixed rates. The real question is are these short-term rates of interest, and some longer term rates of interest like 15 and 30 year fixed rates, higher because of real supply and demand factors in the market, or because of the Fed's actions.

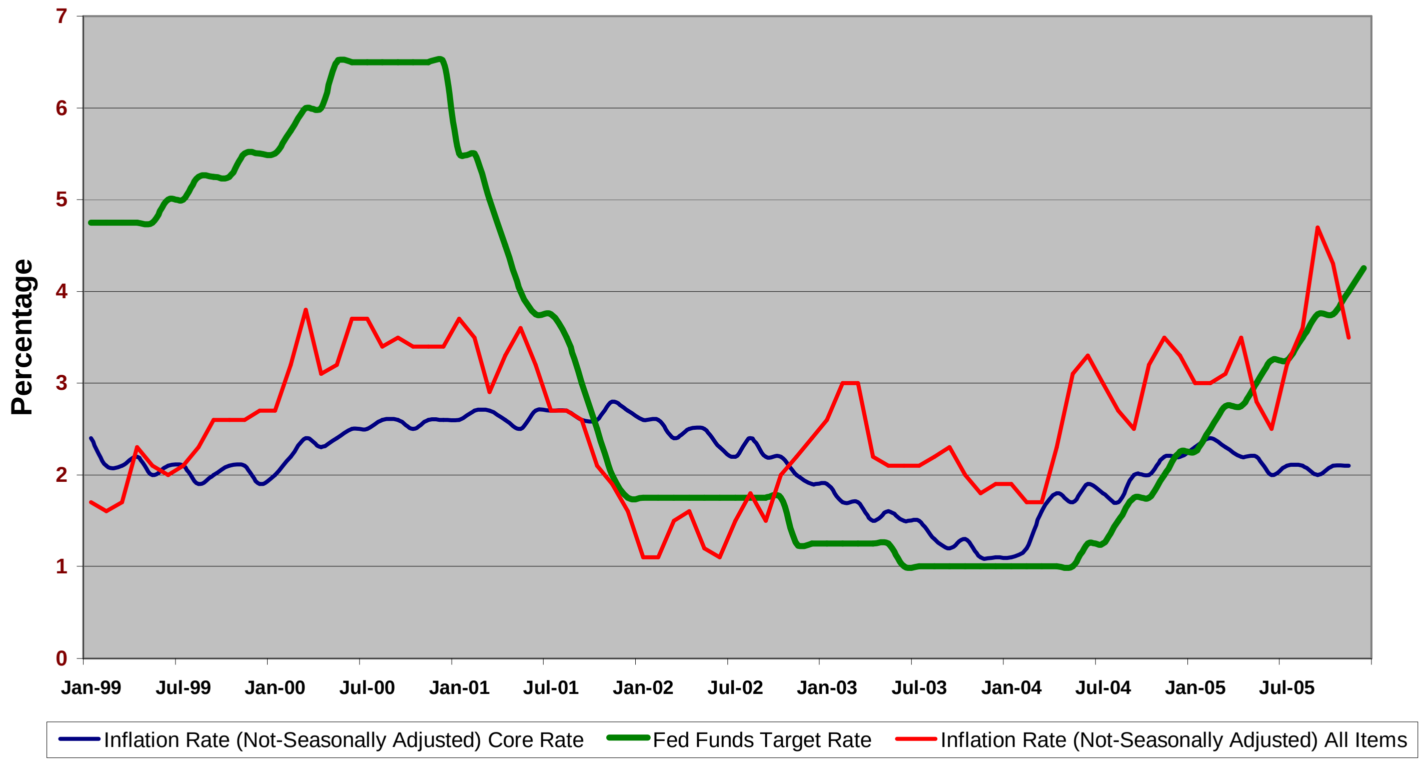


Yield curve data…
http://www.treas.gov/offices/domestic-finance/debt-management/interest-rate/yield.shtml

Déjà vu with the Fed policy of tightening *(wrong then; wrong now)*

Recall that the Fed, once before in 1998 and 1999, became obsessed with the fear of serious inflation reasserting itself. This policy of restraint by the Fed added to the heavily depressing weight of the rise in the federal surplus and the rise in the trade deficit. As discussed in previous articles and supported by data from the U.S. Bureau of Economic Analysis, these actions caused a collapse in the economy in 2000, where the growth rate fell from 7.3% in the fourth quarter of 1999 to a -0.5% in the third quarter of 2000 (not 2001).

Fed Funds Target Rate: Federal Reserve Board of Governors
Inflation (Core Rate and All Items) 12 Months Percent Change: Bureau of Labor Statistics
Not Seasonally Adjusted U.S. city average
All items less food and energy
Base Period: 1982-84=100



The preceding chart illustrates that the core rate of inflation has been relatively flat (tame) for the past several years. **The volatility has shown up primarily in energy** and food – to a lesser extent.

What's the difference now?

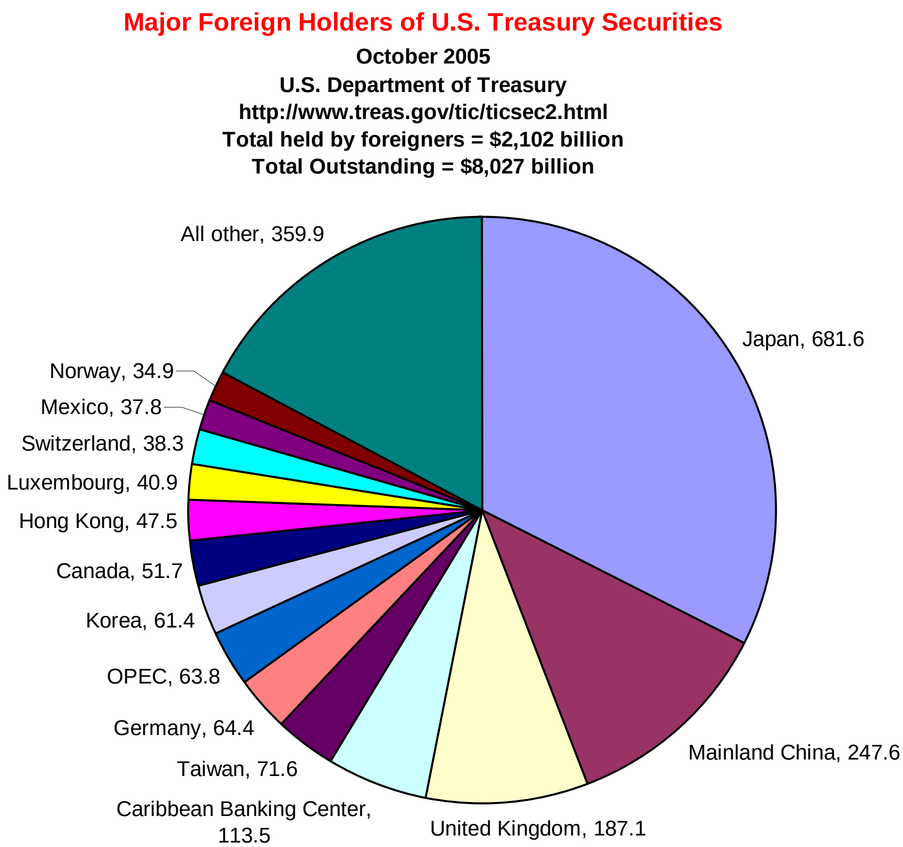
In a negative sense, much higher energy costs and mortgage interest costs are clobbering households, with no immediate end in sight. The household financial health is being further damaged by the acceleration of job losses and compensation cuts in the auto industry. The trade deficit is still large, if not higher than what is was in 1999. Yet, the growth in real GDP and jobs continues to show great strength…why? Instead of huge and growing federal budget surplus, a significantly large deficit exists in that budget as a result of significant tax cuts a few years back. Remember that taxes depress, government spending stimulates…a federal government deficit means stimulation of the economy in all schools of thought. So despite the call for tax increases to reduce the deficit and Congress's unpopular attempts to cut back on government spending, if it were not for that significant federal budget deficit, the economy would have experienced another collapse, similar to what occurred in 2000.

…the last weak link in our discussion

TRADE DEFICIT

Again, as pointed out previously in this newsletter, a large trade deficit has both good and bad sides to it. On the good side, since we are importing more than exporting, we can consume and accumulate capital at a rate beyond what our domestic production possibilities would otherwise allow. On the flipside, since imports depress and exports stimulate, a trade deficit depresses the economy. Of course, this means that it is anti-inflationary in its impact. A second problem is that we have to finance the trade deficit, primarily by borrowing from the rest of the world; hence, our international debtor status is increasing in order to finance this large trade deficit. This international financing of our deficit reflects itself in the increasing amount of debt and equity claims of our economy owned by foreign interests – both private and public.

Who owns U.S. securities…???



Report on Foreign Portfolio Holdings of U.S. Securities
as of June 30, 2004
U.S. Department of Treasury, Federal Reserve Bank of New York and the Board of Governors of the Federal Reserve System (June 2005)
http://www.treas.gov/tic/shl2004r.pdf

2. Value of foreign-owned U.S. long-term securities and share of the total outstanding, by asset class, as of survey dates

Billions of dollars except as noted

Type of security	Dec. 1978	Dec. 1984	Dec. 1989	Dec. 1994	Mar. 2000	June 2002	June 2003	June 2004
Equity								
Total outstanding[1]	1,024	2,131	4,638	7,767	24,703	17,904	17,941	20,779
Foreign-owned	48	105	275	398	1,709	1,395	1,564	1,904
Percent foreign-owned	4.7	4.9	5.9	5.1	6.9	7.8	8.7	9.2
Marketable U.S. Treasury								
Total outstanding[2]	326	873	1,515	2,392	2,508	2,230	2,451	2,809
Foreign-owned	39	118	333	464	884	908	1,116	1,462
Percent foreign-owned	12.0	13.5	22.0	19.4	35.2	40.7	45.5	52.0
U.S. government agency								
Total outstanding[3]	180	507	1,167	1,982	3,575	4,830	5,199	5,960
Foreign-owned	5	13	48	107	261	492	586	623
Percent foreign-owned	2.8	2.6	4.1	5.4	7.3	10.2	11.3	10.5
Corporate and other debt								
Total outstanding[4]	715	1,305	2,599	3,556	5,713	7,205	7,852	8,384
Foreign owned	7	32	191	276	703	1,130	1,236	1,429
Percent foreign-owned	1.0	2.5	7.3	7.8	12.3	15.7	15.7	17.0
Total U.S. long-term securities								
Total outstanding	2,218	4,682	9,904	15,700	36,583	32,169	33,443	37,932
Foreign-owned	99	268	847	1,244	3,558	3,926	4,503	5,418
Percent foreign-owned	4.4	5.7	8.6	7.9	9.7	12.2	13.5	14.3

n.a. Not available.

1. Source: Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States,* Table L213, row 1, minus Table L213, row 3, plus Table L214, row 1, plus Table L206, row 1.

2. Source: Bureau of the Public Debt Table 1 *Summary of Public Debt Summary of Treasury Securities Outstanding*, Total marketable held by the public less Bills.

3. Source: Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States,* Table L210, row 1, less the amount of this figure determined by staff research to represent short term securities (approximately $300 billion as of June 30, 2004). U.S. government agency securities include all securities issued by federally sponsored agencies and corporations, as well as all securities guaranteed by the Government National Mortgage Association (GNMA).

4. Source: Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States,* Table L212, row 1, less Table L212, row 3, plus Table L211, row 1, less Table L211, row 3.

4. Value of foreign holdings of U.S. securities, by major investing country, June 30, 2004

Billions of dollars except as noted

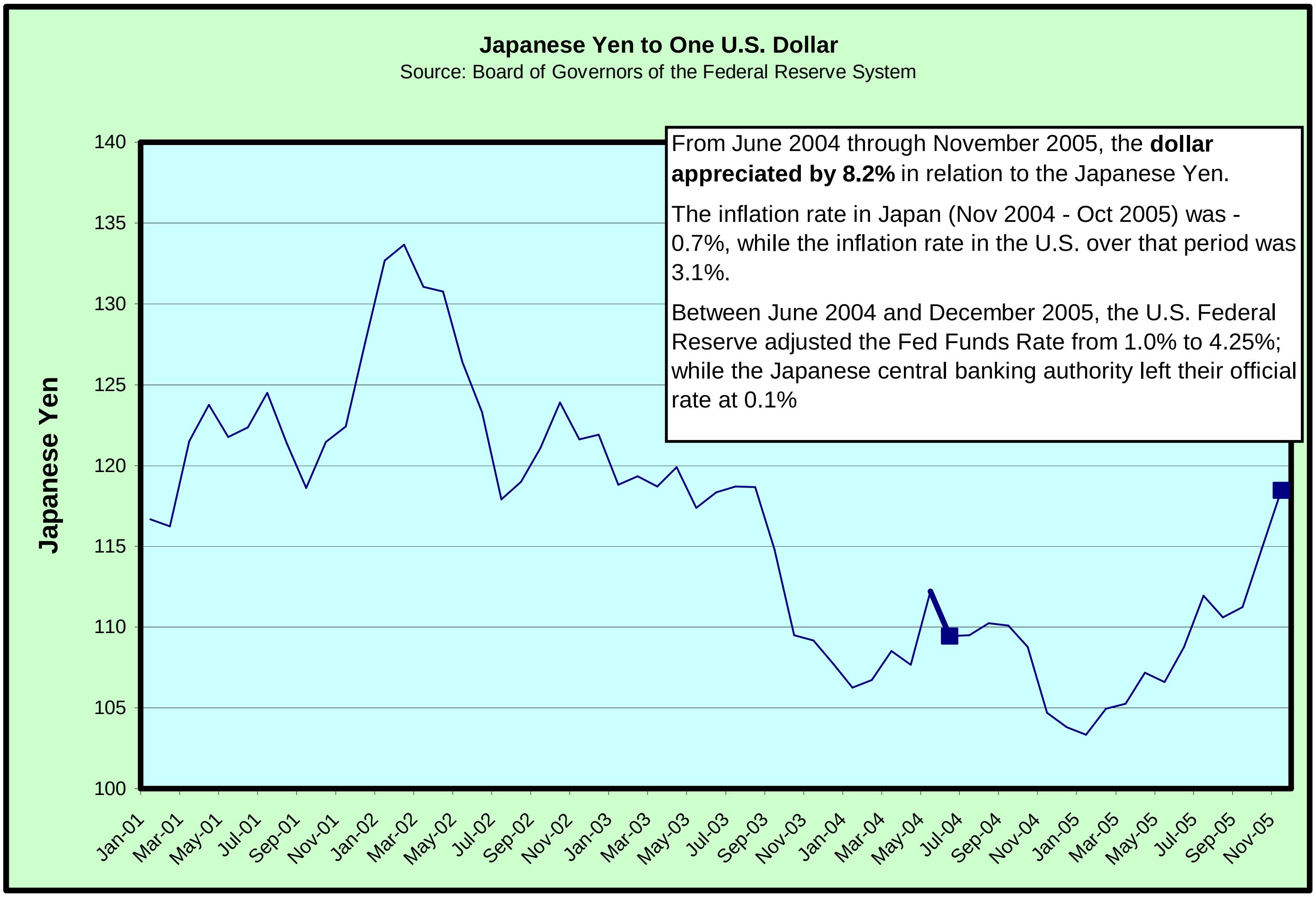
Country or category	Total	Equity	Debt		
			Total	Long-term	Short-term
Japan	1,019	162	857	736	121
United Kingdom	488	250	238	221	16
Luxembourg	392	130	262	230	31
Cayman Islands	376	115	261	230	31
China, P.R.	341	3	338	320	18
Belgium	308	18	290	285	5
Canada	291	210	81	67	15
Netherlands	203	127	76	70	6
Switzerland	199	120	79	68	11
Germany	190	76	115	107	8
Country unknown	224	3	221	218	3
Rest of world	1,976	691	1,286	962	323
Total	**6,006**	**1,904**	**4,102**	**3,515**	**588**

It's not just U.S. government securities that are owned, but foreign interests own a substantial portion of equity interests in American firms. Of much recent interest, is our continued trade deficit with China. As pointed out in previous articles, much of this is due to the Chinese decision to peg their currency (yuan) at a rate of $0.125 per yuan, instead of the near equilibrium of $0.50 per yuan. This means that Wal-Mart, for example, now pays $125 for a large, flat-screen plasma TV that using the near equilibrium exchange rate from a few years ago would have cost $500. It also means that the cost of the U.S. dollar to the Chinese has risen from 2 yuan per dollar to 8 yuan per dollar. Thus a U.S. made tractor costing $20,000 would have cost the Chinese 40,000 yuan a few years back, now costs them 160,000 yuan.

Does this clear up any confusion on why we have a trade deficit with China?

A more general cause of the trade deficit with the rest of the world has been due by an upward trend, over the past several years, in value of the dollar in the foreign exchange markets…this is due to the fact that foreign capital flows in to the U.S., demanding dollars at a greater rate than capital flowing out of the U.S. that supplies dollars. This shortage of dollars causes the foreign exchange price of the dollar to rise, which is equivalent to saying that the dollar price of foreign exchange is falling. This leads to pressure for the dollar to appreciate or in the vernacular of the press – to strengthen against foreign currencies. This in turn, results in foreign goods becoming cheaper to us and our goods becoming more expensive to the rest of the world. This is all reflected in the rise of our trade deficit to the rest of the world over the past several years.

There is a basic issue in question here…has the Fed policy of maintaining relatively high short-term rates in the U.S., in order to combat what they see as the potential and significant rise in inflation, triggered the net increase in capital flows into the U.S. If this were in fact the case, then it would be the culprit in causing our persistent and large trade deficit. Note, that even though the Fed's efforts are mostly manifested in the short-term end of the market (and intermediate and long-term interest rates do not always reflect the Fed's policies), the trade deficit nevertheless does have a depressing effect on the economy, and is anti-inflationary in nature.

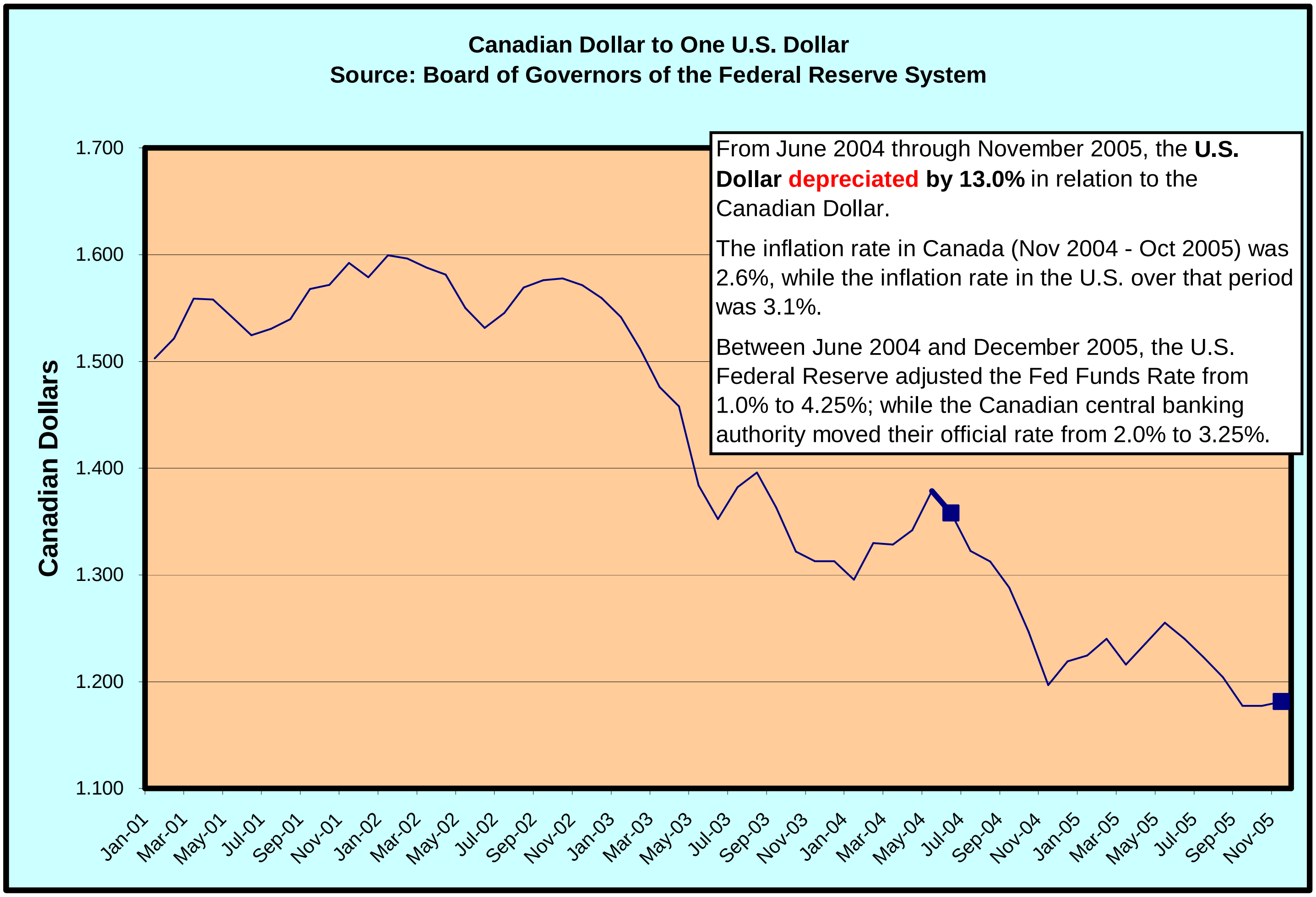


In terms of purchasing power parity, the U.S. dollar should have depreciated against the yen since June 2004 (and well before).

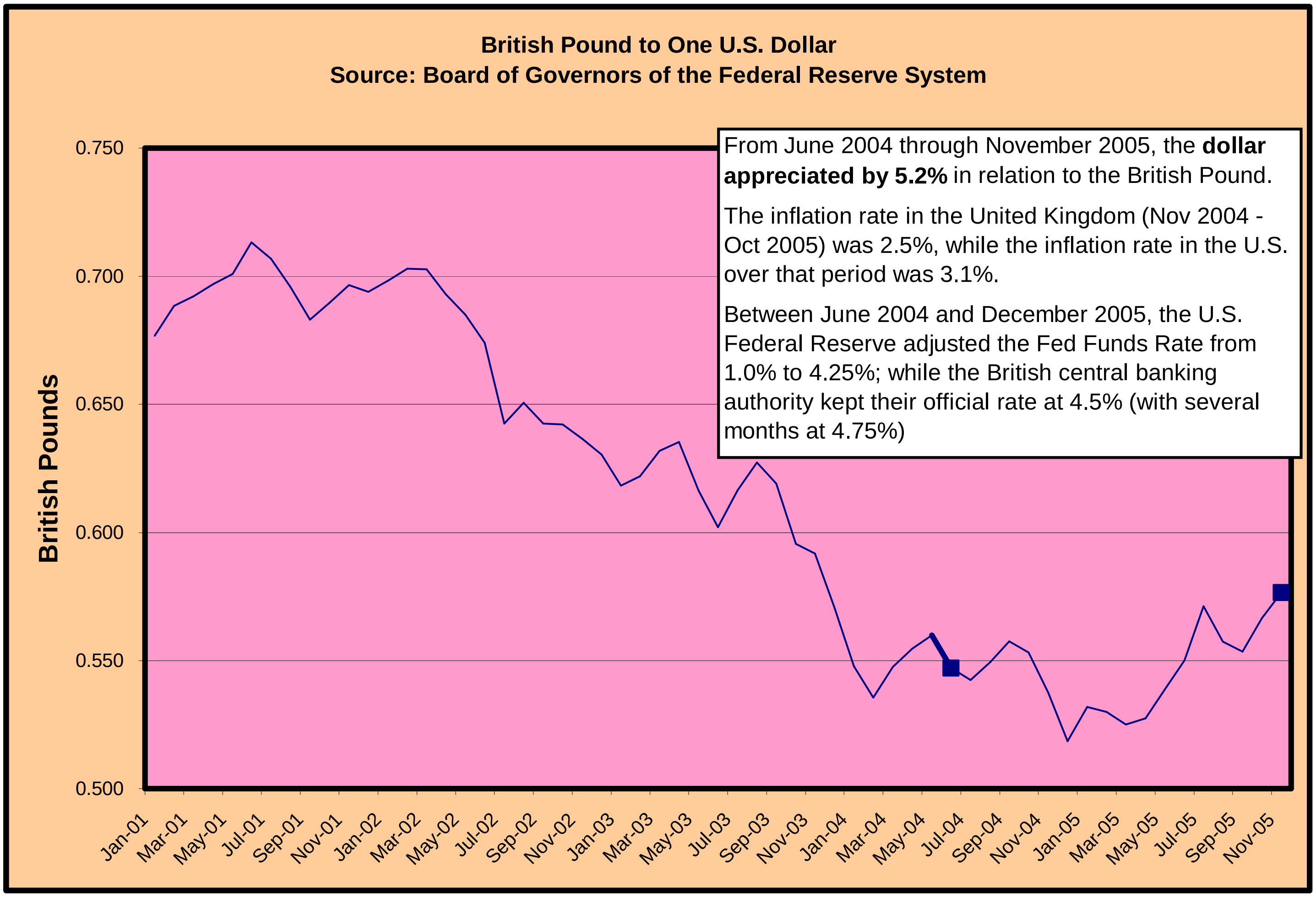
Reflected in their policy of maintaining a "cheaper" yen, the Japanese central bank has had to acquire U.S. securities and so doing, the dollar has appreciated; this in turn, makes it difficult for the U.S. to export to Japan.

While this is a much less formal type of intervention by the Japanese, it achieves the same as the Chinese pegging of the yuan – their currency depreciates.

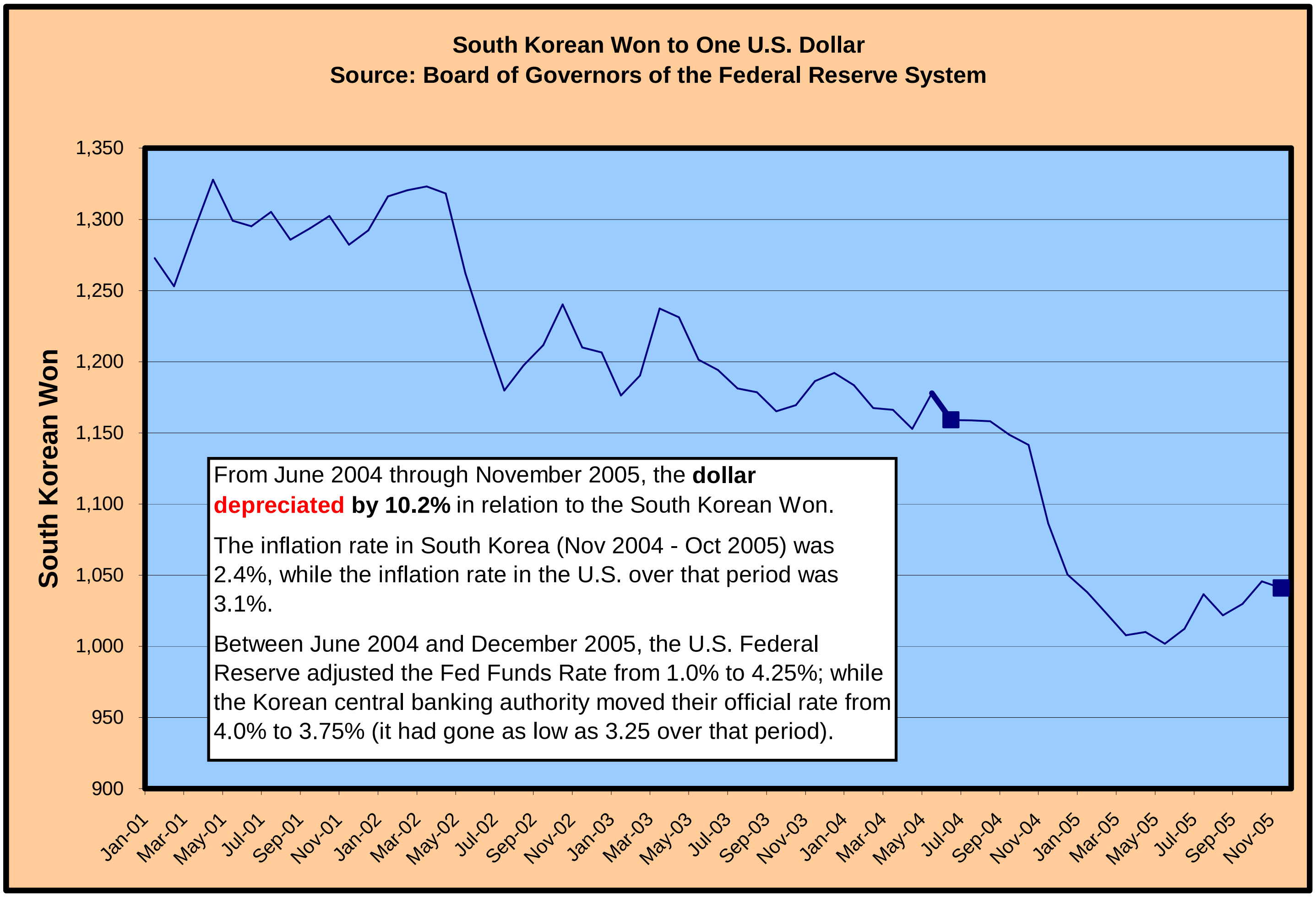
In the last analysis, the Federal Reserve monetary policy of pressuring federal funds rate upward in an attempt to slow the economy (fear of inflation), is promoting and prolonging the massive trade deficit – again, a trade deficit depresses the economy.



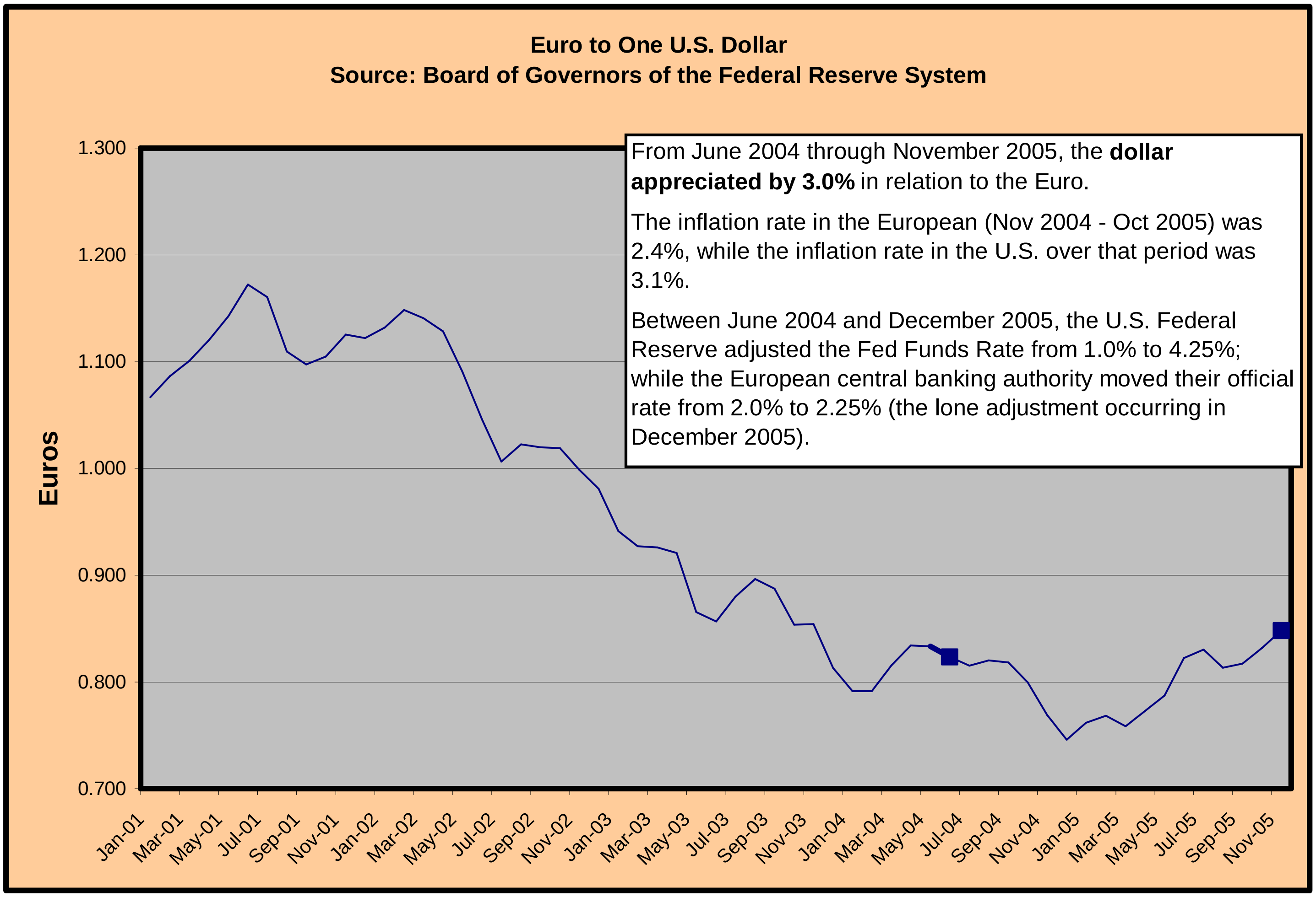
The U.S. dollar relationship with to the Canadian dollar is more reflective of what one might be expected in a free market. However, remember to keep in mind that the U.S. imports a good deal of energy products from Canada (petroleum and electricity).



The recent appreciation of the U.S. dollar versus the British pound is one of the results of the Federal Reserve's restrictive policy of driving up interest rates relative to the United Kingdom.



The recent depreciation of the U.S. dollar in relation to the South Korean won is to be expected as a result of the Korean monetary authority pursuing a less restrictive monetary policy (the central bank lowering their controlled interest rate)



Reluctance on the part of the European Union to raise interest rates until very recently helps to account for the appreciation of the U.S. dollar compared to Europe's euro.

And now we can answer the questions….who is benefiting from the Fed's policy?

- Other nations, desirous of running trade surpluses
- Foreign interests that own both public and private U.S. short-term securities

- Financial services industry involved in residential mortgage financing: Rising short-term rates and longer-term fixed mortgages rising without justification in relation to long term government bond rates

Who is hurt by the Fed's policy?

- Households, hurt by higher interest rates in mortgages
- American businesses that are unable to export because of the strong dollar
- Labor, by job losses due to inability to export (overwhelmed by the rising tide of cheaper imports)

In short, government policies do make winners and losers.

For some of the above issues we have covered in past newsletters we touched briefly on the theoretical framework for the analysis. The heart of understanding these issues is to understand microeconomic theory. To many, this is the boring part of economics, especially the theory of income distribution. We would like to give you some additional facts that may startle you, but we hope will whet your appetite for an initial introduction and more elaborate discussion of the topic of income distribution in the next issue.

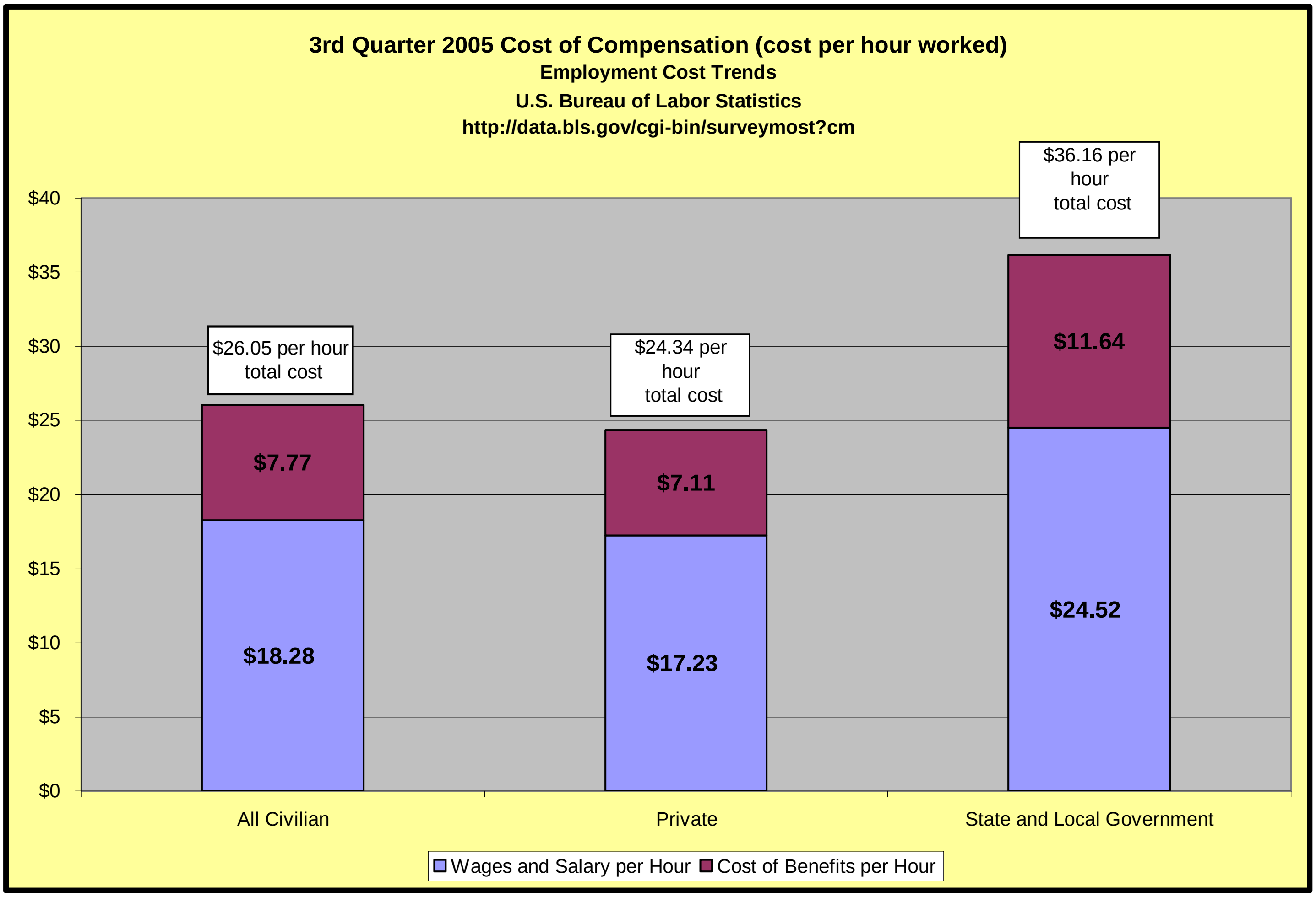
For example, the only way to understand the massive restructuring going on throughout several industries, such as the auto industry is to understand the difference in total compensation between a typical worker at GM and that of a retail worker at Wal-Mart, for example. The difference is what economists call economic rent, or surplus reward. The common portion of the compensation package is what the worker must be paid to bid them away from their next best *competitive* alternative – that is the opportunity cost. In terms of opportunity cost, these two workers would receive fairly similar compensation. The difference, or the large economic rent (surplus reward) received by the autoworker is due to the past market power of the original Big Three firms…it was an oligopoly, dominated by General Motors. Labor costs could be passed on to the car buyers in the form of higher prices with some degree of ease. Those days are gone my friends. The American auto industry has been and will continue to be in a tumultuous struggle for market share with foreign transplants having a huge competitive edge. On the other hand, your typical retail worker from Wal-mart, for example, has labored in an industry that has always been extremely competitive.

As competition increases in markets, the income of resources will shrink toward the resource's opportunity cost, thus eliminating the surplus reward called economic rent. The autoworker located in Mississippi or Kentucky receives around half of the compensation package of their counterparts in the Midwest. The latter portion of the auto industry is being gradually being downsized by the inability of their employers to compete in the marketplace. It is problems like this that we hope to shed some light on as the American economy undergoes restructuring. Our journey in this newsletter is not an easy one, but it will be well worth it.

More to follow on income distribution in the next issue

Did you know…?

Breakdown on employee compensation (from BLS)



Union membership Percentages…

1983 = 20.1% of workers
2004 = 12.5% of workers

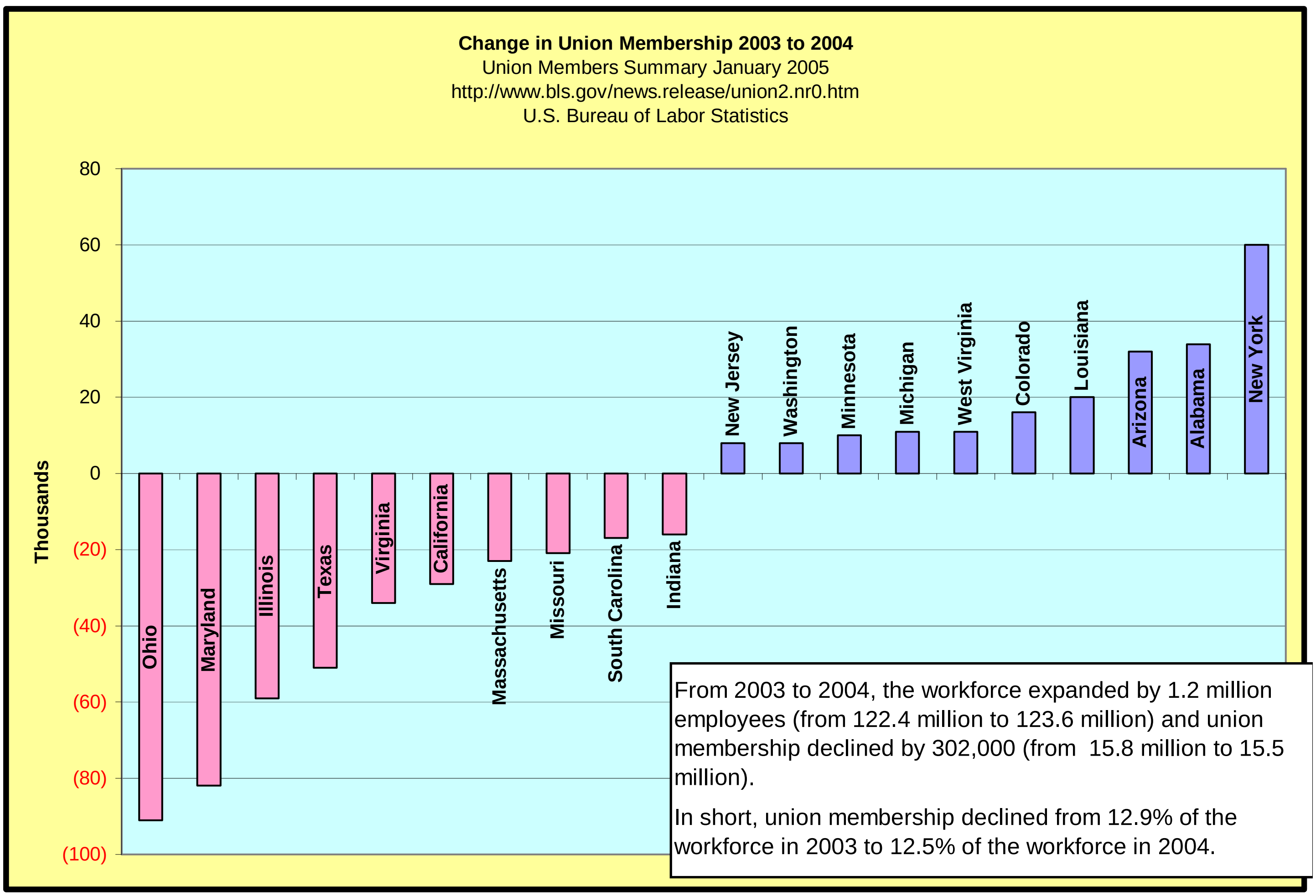
From the U.S. Bureau of Labor Statistics
http://www.bls.gov/news.release/union2.nr0.htm

UNION MEMBERS IN 2004

In 2004, 12.5 percent of wage and salary workers were union members, down from 12.9 percent in 2003, the U.S. Department of Labor's Bureau of Labor Statistics reported today. The union membership rate has steadily declined from a high of 20.1 percent in 1983, the first year for which comparable union data are available. Some highlights from the 2004 data are:

--About 36 percent of government workers were union members in 2004, compared with about 8 percent of workers in private-sector industries.

--Two occupational groups--education, training, and library occupations and protective service occupations--had the highest unionization rates in 2004, at about 37 percent each. Protective service occupations include fire fighters and police officers.



Current Statistics (1-05-2006)

The Employment Picture

Unemployment Rate ({5.1% Sep}…{5.0% Oct})…**{5.0% Nov}**

Nonfarm payroll employment grew by 215,000 in November, and the unemployment rate was unchanged at 5.0 percent, the Bureau of Labor Statistics of the U.S. Department of Labor reported today. Over the month, job growth was widespread, with large gains in construction and food services.

Industry Payroll Employment (Establishment Survey Data)
Total nonfarm payroll employment rose by 215,000 to 134.3 million in November. This followed 2 months of little growth in employment, due in part to the direct and indirect effects of hurricanes that struck the Gulf Coast. During the first 8 months of the year, payroll employment grew by an average of 196,000 per month.

Unemployment (Household Survey Data)
Total employment, 142.6 million, and the civilian labor force, 150.2 million, were little changed in November. The employment-population ratio also was little changed over the month at 62.8 percent, and the labor force participation rate held at 66.1 percent.

News Release - http://www.bls.gov/news.release/empsit.nr0.htm

Jobless Claims

(4-wk rolling average: 324,750 Dec-17, to 326,000 Dec-24, to 316,750 Dec-31)

In the week ending Dec. 31, the advance figure for seasonally adjusted initial claims was 291,000, a decrease of 35,000 from the previous week's revised figure of 326,000. The 4-week moving average was 316,750, a decrease of

9,250 from the previous week's revised average of 326,000.

For 2001, the average weekly initial jobless claims were running around 405,000; thus far, in 2005 (with the exception of the anomaly caused by Hurricanes Katrina and Rita), the average has been in the 325,000 range.

News Release - http://www.dol.gov/opa/media/press/eta/ui/current.htm

GDP (3rd Quarter 2005 Real GDP: 4.1%)

Real gross domestic product -- the output of goods and services produced by labor and property located in the United States -- **increased at an annual rate of 4.1 percent in the third quarter of 2005**, according to advance estimates released by the Bureau of Economic Analysis. In the second quarter, real GDP increased 3.3 percent.

❖ ***3rd Quarter 2006 is the sixteenth consecutive quarter of economic expansion***

The major contributors to the increase in real GDP in the third quarter were:

from Table 2.--Contributions to Percent Change in Real Gross Domestic Product

Personal Consumption Expenditures (PCE) 2.86%
(Durable Goods 0.76% (*Motor Vehicles and parts 0.45%);* Nondurable Goods 0.73%; Services 1.36% change from 2nd Quarter)

Gross private domestic investment: 0.87%
(Fixed Investment 1.31%; Change in Private Inventories -0.43%)

Net Exports (Exports – Imports): -0.12%
An increase in Exports contributed 0.26% were more than offset by increasing Imports which accounted for a -0.38% change.

Government Spending (Government consumption expenditures and gross investment): 0.54%
Federal increasing 0.52% and State and Local increasing by 0.03%

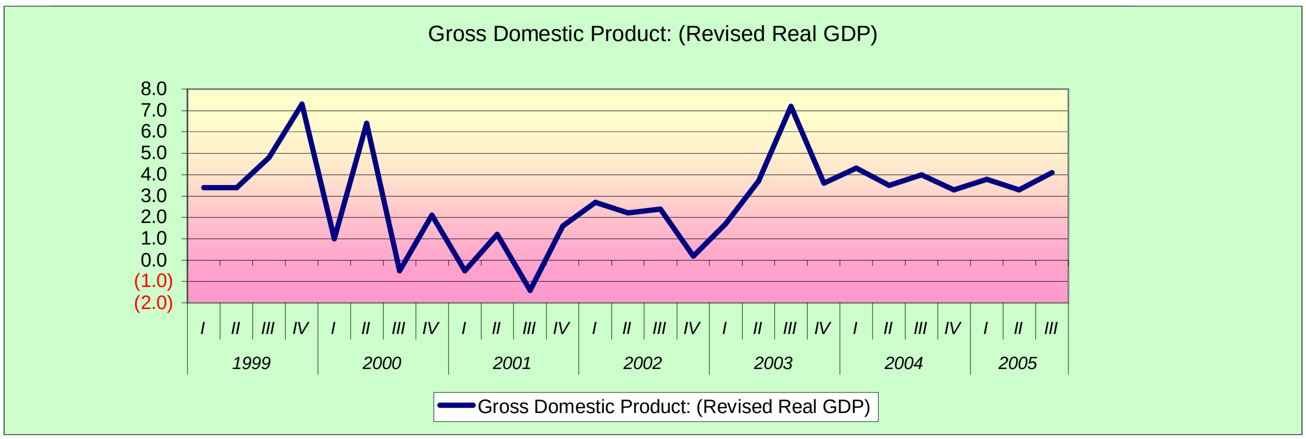
News Release - http://bea.gov/bea/newsrelarchive/2005/gdp305f.htm

What Recession? **The ongoing debate as to when/if there indeed was a recession at all**

(Webster's Dictionary) RECESSION : A period during which economic activity, as measured by gross domestic product, declines for at least two quarters in a row in a specific country. If the decline is severe and long, such as greater than ten percent, it may be termed a depression.

Bureau of Economic Analysis (BEA)
Table 1.1.1. Percent Change From Preceding Period in Real Gross Domestic Product
[Percent] Seasonally adjusted at annual rates
Today is: 12/26/05 Last Revised on December 21, 2005 Next Release Date January 27, 2006

	1999				2000				2001				2002				2003				2004				2005		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
***Gross Domestic Product*:** (Revised Real GDP)	3.4	3.4	4.8	7.3	1.0	6.4	(0.5)	2.1	(0.5)	1.2	(1.4)	1.6	2.7	2.2	2.4	0.2	1.7	3.7	7.2	3.6	4.3	3.5	4.0	3.3	3.8	3.3	4.1



Leading Indicators

According to figures released by the Conference Board on December 22, 2005, seven of the ten indicators that make up the leading index increased in November. The Conference Board announced that the U.S. leading index increased 0.5 percent, the coincident index increased 0.2 percent and the lagging index increased 0.6 percent in November.

The leading index now stands at 138.8 (1996=100). Based on revised data, this index increased 1.0 percent in October and decreased 0.7 percent in September. During the six-month span through November, the leading index increased 1.7 percent, with eight out of ten components advancing (diffusion index, six-month span equals eighty percent).

Next release – January 23, at 10:00 AM ET

News Release - http://www.conference-board.org/economics/bci/pressRelease_output.cfm?cid=1

Construction (put in place) (November 0.2% above October)

The U.S. Census Bureau of the Department of Commerce announced today that construction spending during November 2005 was estimated at a seasonally adjusted annual rate of $1,146.4 billion, 0.2 percent (±1.4%)* above the revised October estimate of $1,144.2 billion. The November figure is 7.8 percent (±2.4%) above the November 2004 estimate of $1,063.4 billion.

During the first 11 months of this year, construction spending amounted to $1,031.2 billion, 9 percent (±1.6%) above the $946.3 billion for the same period in 2004.

Next release – December 2005 data will be released on February 1, 2006 at 10:00 A.M. EDT.

News Release - http://www.census.gov/const/C30/release.pdf

New Housing Starts (November 5.3% above October)

Privately-owned housing starts in November were at a seasonally adjusted annual rate of 2,123,000. This is 5.3 percent (±7.7%)* above the revised October estimate of 2,017,000 and is 17.5 percent (±6.8%) above the November 2004 rate of 1,807,000.

Single-family housing starts in November 2005 were at a rate of 1,808,000; this is 4.8 percent (±8.3%)* above the October figure of 1,725,000. The November rate for units in buildings with five units or more was 277,000.

Next release (for December) – January 19, 2006 at 8:30 A.M. EDT

News Release - http://www.census.gov/indicator/www/newresconst.pdf

New Residential Sales (November 11.0% below October)

Sales of new one-family houses in November 2005 were at a seasonally adjusted annual rate of 1,245,000, according to estimates released jointly today by the U.S. Census Bureau and the Department of Housing and Urban Development. This is 11.3 percent (±8.9%) below the revised October rate of 1,404,000, but is 6.0 percent (±13.8%)* above the November 2004 estimate of 1,175,000.

The median sales price of new houses sold in November 2005 was $225,200; the average sales price was $283,300. The seasonally adjusted estimate of new houses for sale at the end of November was 503,000. This represents a supply of 4.9 months at the current sales rate.

Next release (for December) – January 27, 2006 at 10:00 A.M. EDT.

News Release - http://www.census.gov/const/newressales.pdf

Durable Goods (November increased 2.5% over October)

Summary

New orders for manufactured goods in November increased $10.1 billion or 2.5 percent to $407.7 billion, the U.S. Census Bureau reported today. This was at the highest level since the series was first stated on a NAICS basis in 1992 and followed a 1.7 percent October increase. Shipments, up six of the last seven months, increased $0.9 billion or 0.2 percent to $397.0 billion. This was at the highest level since the series began and followed a 0.7 percent October increase. Unfilled orders, up seven consecutive months, increased $18.1 billion or 3.0 percent to $621.4 billion. This was at the highest level since the series began and followed a 1.4 percent October increase. Inventories, up five of the last six months, increased $0.7 billion or 0.2 percent to $467.1 billion. This followed a 0.6 percent October increase.

New Orders for manufactured durable goods in November, up three of the last four months, increased $9.3 billion or 4.4 percent to $223.1 billion, unchanged from the previously published increase.

New orders for manufactured nondurable goods increased $0.8 billion or 0.4 percent to $184.6 billion.

Shipments of manufactured durable goods in November, up three of the last four months, increased $0.1 billion to $212.4 billion, revised from the previously published 0.2 percent decrease. This was at the highest level since the series began and followed a 1.2 percent October increase.

Shipments of manufactured nondurable goods, up four of the last five months, increased $0.8 billion or 0.4 percent to $184.6 billion.

Unfilled orders for manufactured durable goods in November, up seven consecutive months, increased $18.1 billion or 3.0 percent to $621.4 billion, revised from the previously published 3.1 percent increase. This was at the highest level since the series began and followed a 1.4 percent October increase.

Inventories of manufactured durable goods in November, up four of the last five months, increased $1.5 billion or 0.5 percent to $285.2 billion, unchanged from the previously published increase. This followed a 0.5 percent October increase.

Inventories of manufactured nondurable goods, down following two consecutive monthly increases, decreased $0.8 billion or 0.4 percent to $181.9 billion.

Note: All figures in text are in seasonally adjusted current dollars.

Next release (for December) – January 26, 2005 at 8:30 A.M. EDT.

News Release - http://www.census.gov/indicator/www/m3/

Capital Goods Industries (November):

Capital Goods Industries
Nondefense new orders for capital goods in November increased $14.1 billion or 19.6 percent to $85.9 billion.

Defense new orders for capital goods in November decreased $2.6 billion or 26.6 percent to $7.2 billion.

Next release (for December) – January 26, 2005 at 8:30 A.M. EDT.

News Release - http://www.census.gov/indicator/www/m3/adv/

Current Account Balance (Trade Balance)

The Current Account Balance consists of the Trade Balance (Net Exports (Exports less Imports) of Goods and Services), the Income Balance (Income Receipts and Income Payments), and net Unilateral Current Transfers. The Department of Commerce publishes the Current Account Balance data on quarterly basis.

The U.S. Current Account Balance 2003 – $530.7 billion

The U.S. Current Account Balance 2004 – $665.9 billion

The U.S. Trade Balance 2003 – $496.5 billion

The U.S. Trade Balance 2004 – $617.1 billion

The U.S. Census Bureau and the U.S. Bureau of Economic Analysis, through the Department of Commerce, announced today that total October exports of $107.5 billion and imports of $176.4 billion resulted in a goods and services deficit of $68.9 billion, $2.9 billion more than the $66.0 billion in September, revised. October exports were $1.8 billion more than September exports of $105.8 billion. October imports were $4.7 billion more than September imports of $171.8 billion.

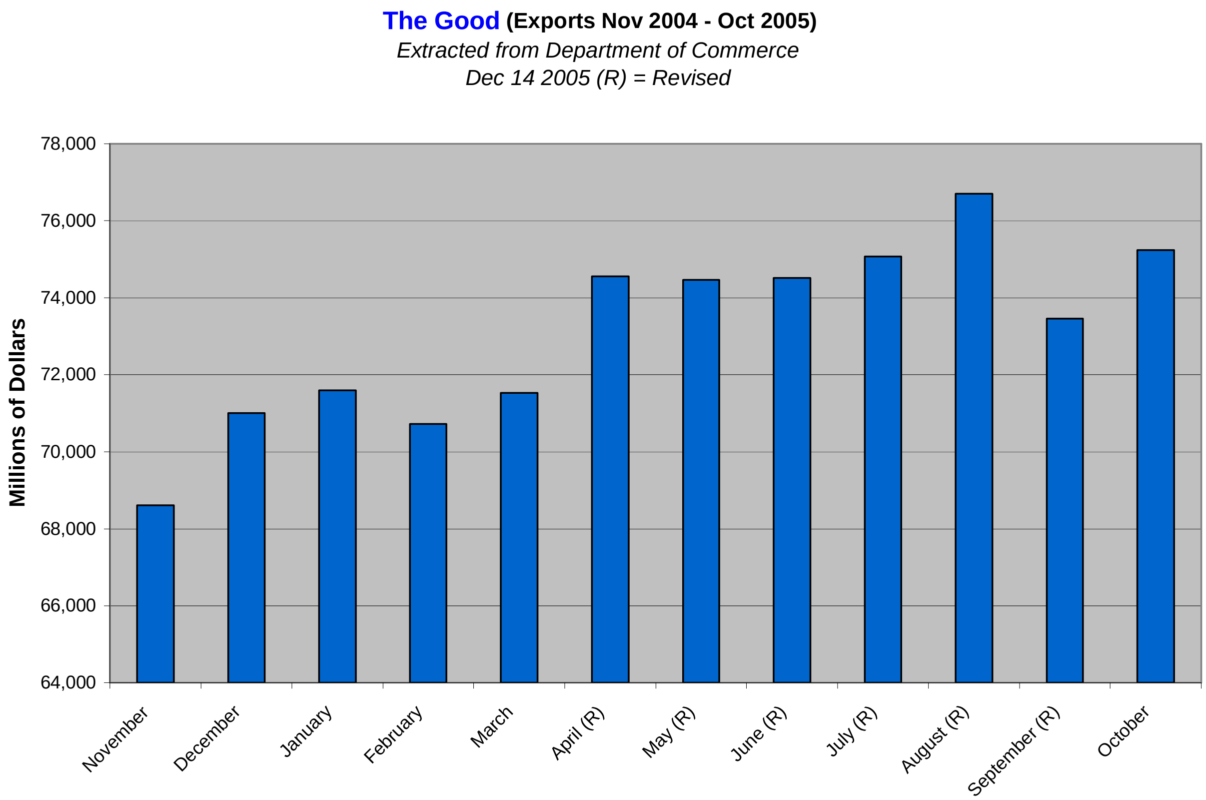
In October, the goods deficit increased $2.6 billion from September to $73.9 billion, and the services surplus decreased $0.3 billion to $5.0 billion. Exports of goods increased $1.8 billion to $75.2 billion, and imports of goods increased $4.3

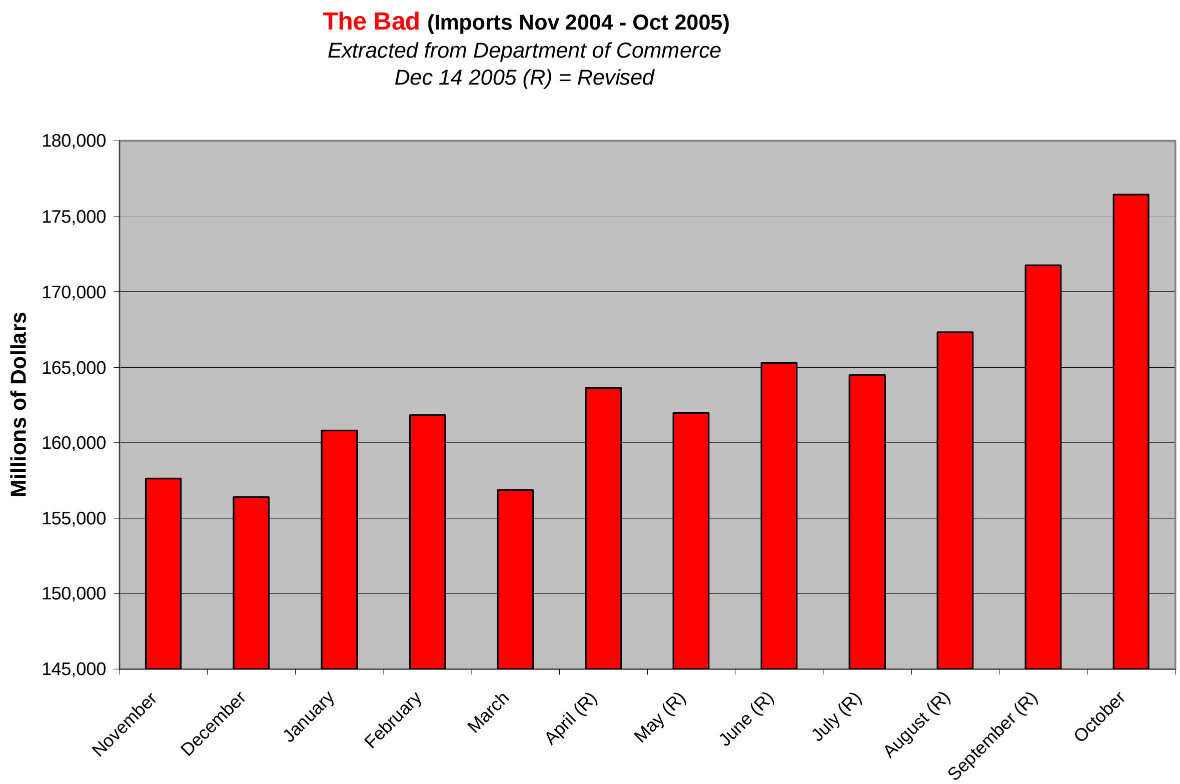
billion to $149.1 billion. Exports of services were virtually unchanged at $32.3 billion, and imports of services increased $0.3 billion to $27.3 billion.

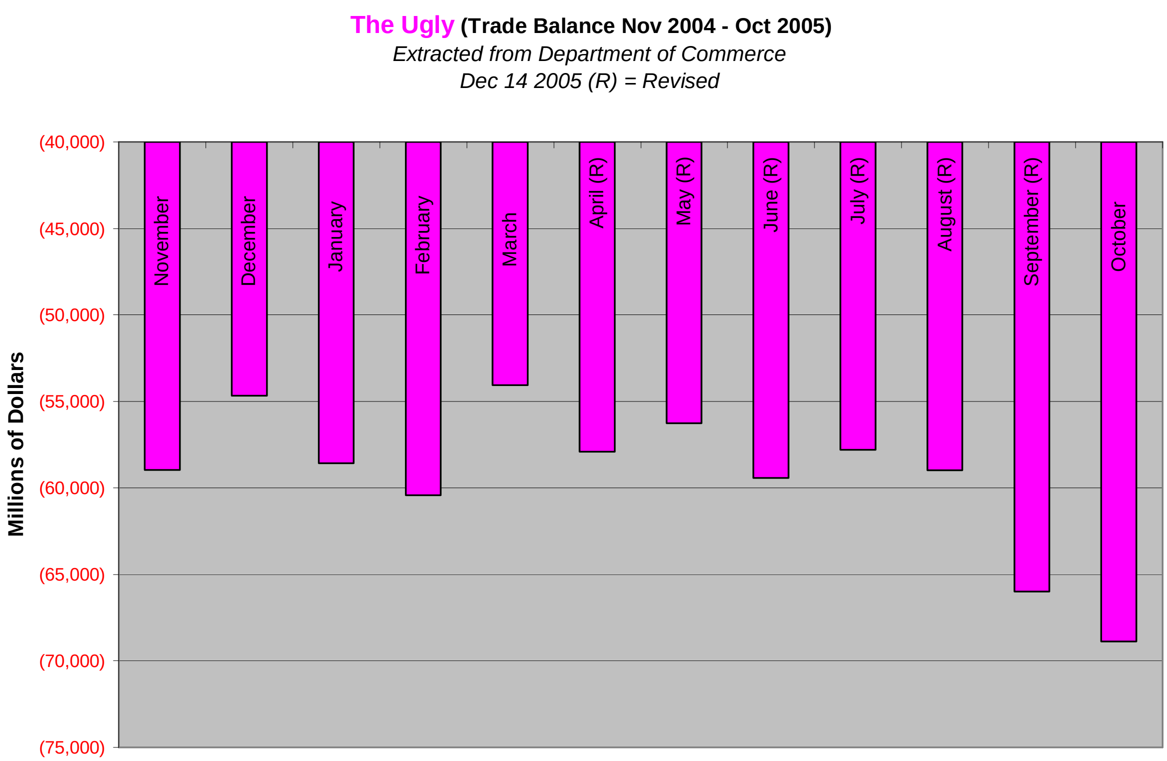
In October, the goods and services deficit was up $13.3 billion from October 2004. Exports were up $9.0 billion, or 9.2 percent, and imports were up $22.3 billion, or 14.5 percent.

Next release (for November) – January 2006

News Release - http://www.bea.gov/bea/newsrelarchive/2005/trad1005.htm




The Bad (Imports Nov 2004 - Oct 2005)
Extracted from Department of Commerce
Dec 14 2005 (R) = Revised
Millions of Dollars
180,000
175,000
170,000
165,000
160,000
155,000
150,000
145,000
November
December
January
February
March
April (R)
May (R)
June (R)
July (R)
August (R)
September (R)
October


The Ugly (Trade Balance Nov 2004 - Oct 2005)
Extracted from Department of Commerce
Dec 14 2005 (R) = Revised
Millions of Dollars
(40,000)
(45,000)
(50,000)
(55,000)
(60,000)
(65,000)
(70,000)
(75,000)
November
December
January
February
March
April (R)
May (R)
June (R)
July (R)
August (R)
September (R)
October

CPI -0.8% (November) / PPI - 0.7% (November) (Seasonally adjusted)

CPI – The Consumer Price Index for All Urban Consumers (CPI-U) *decreased 0.8 percent in November*, before seasonal adjustment, the Bureau of Labor Statistics of the U.S. Department of Labor reported today. The November level of 197.6 (1982-84=100) was 3.5 percent higher than in November 2004.

On a seasonally adjusted basis, the CPI-U decreased 0.6 percent in November, its largest decline since a 0.9 drop in July 1949. The index for energy declined for the second consecutive month, down a record 8.0 percent in November. Within energy, a 15.2 percent decrease in the index for petroleum-based energy more than offset a 2.1 percent increase in the index for energy services.

The index for all items less food and energy rose 0.2 percent in November, the same as in October, after registering increases of 0.1 percent in each of the preceding five months.

Next release (for December) – January 18, 2006, at 8:30 A.M. (EDT)

News Release - http://www.bls.gov/news.release/cpi.nr0.htm

PPI – The Producer Price Index for Finished Goods *declined 0.7 percent in November*, seasonally adjusted, the Bureau of Labor Statistics of the U.S. Department of Labor reported today. This decrease followed a *0.7 percent rise in October* and a 1.9-percent gain in September.

Among finished goods, the index for energy goods decreased -4.0 percent in November, following a 4.1 percent increase in the previous month. By contrast, prices for finished goods other than foods and energy increased 0.1 percent, after decreasing 0.3 percent in the preceding month.

Next release (for December) – January 13, 2006 at 8:30 A.M. EDT

News Release - http://www.bls.gov/news.release/ppi.nr0.htm

Productivity, Compensation and **Unit Labor Cost** (Seasonally Adjusted)

The Bureau of Labor Statistics of the U.S. Department of Labor reported revised **productivity** data on December 6, 2005--as measured by output per hour of all persons--for the third quarter of 2005. The seasonally adjusted annual rates of productivity growth in the third quarter were:

5.4 percent in the business sector and
4.7 percent in the nonfarm business sector

Hourly compensation in the business sector increased 4.2 percent during the third quarter of 2005, following a decline of 0.1 percent in the second quarter (as revised).

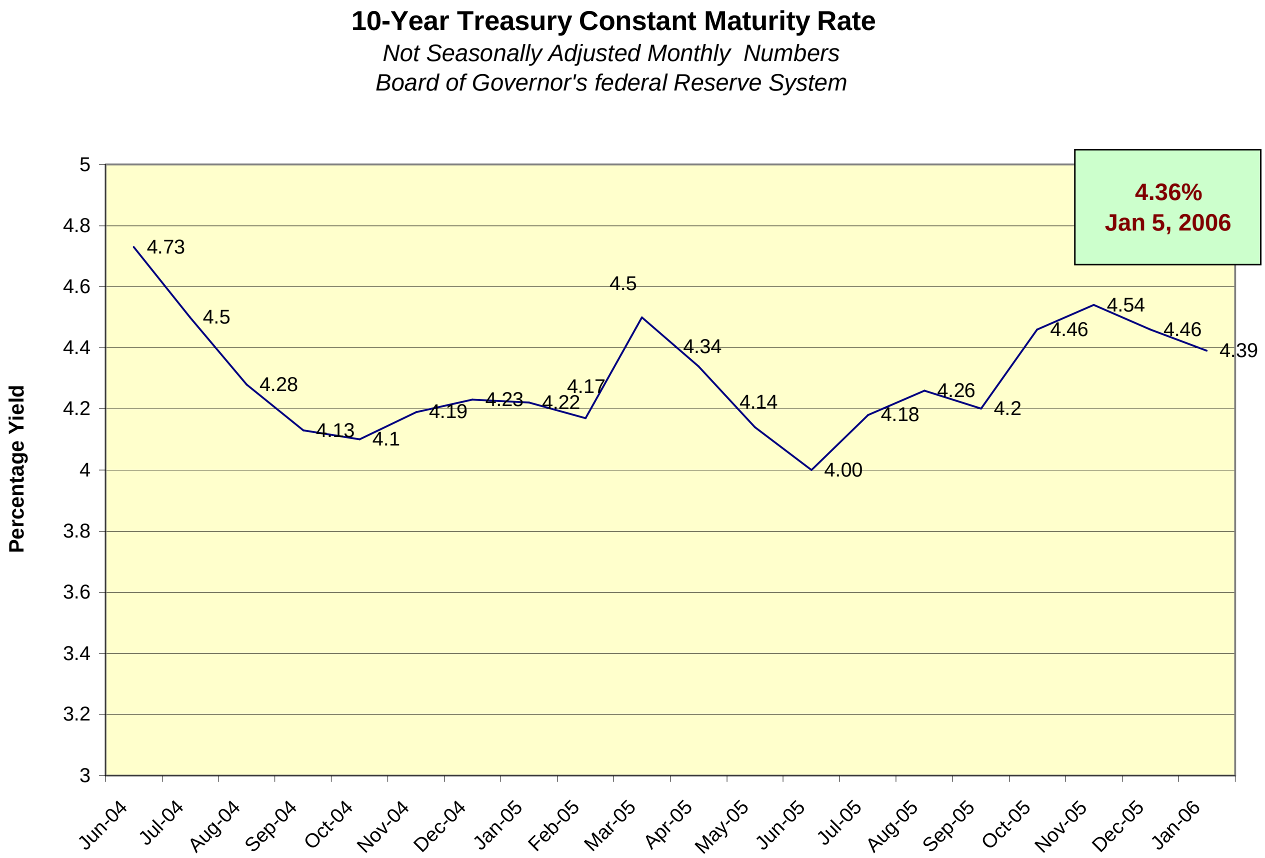
Unit labor costs fell 1.1 percent in the third quarter of 2005 following a decline of 0.9 percent one quarter earlier.

Next Release (for 4th Quarter and annual 2005) – February 2, 2006 at 8:30 A.M. EDT

News Release - http://www.bls.gov/news.release/prod2.nr0.htm

10-year U.S. Government Bond Rate

The 10-year Maturity U.S. Government Security continues to remain trading at a relatively low rate.


10-Year Treasury Constant Maturity Rate
Not Seasonally Adjusted Monthly Numbers
Board of Governor's federal Reserve System
4.36%
Jan 5, 2006
Percentage Yield
5
4.8
4.6
4.4
4.2
4
3.8
3.6
3.4
3.2
3
4.73
4.5
4.28
4.13
4.1
4.19
4.23
4.22
4.17
4.5
4.34
4.14
4.00
4.18
4.26
4.2
4.46
4.54
4.46
4.39
Jun-04
Jul-04
Aug-04
Sep-04
Oct-04
Nov-04
Dec-04
Jan-05
Feb-05
Mar-05
Apr-05
May-05
Jun-05
Jul-05
Aug-05
Sep-05
Oct-05
Nov-05
Dec-05
Jan-06