Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Longbrake Letter*

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I. Recovery Progressing, Sustainability, Even Acceleration Likely, But Formidable Headwinds Still Prevail

While the recent performance of the stock market might lead one to suppose that the economy is picking up favorable momentum rapidly, a careful reading of data reports reveals a more mixed pattern. Yes, there is increasing cause for optimism but formidable weaknesses, particularly in housing, employment and state and local finances, remain deeply entrenched in the U.S. and will serve to slow the rate of acceleration. And, while expansion of emerging economies is helping the U.S. economy, worries abound about the potential consequences of escalating commodity prices and the overheating of those economies. In addition, all is quiet in Europe for the moment, but the sovereign debt crisis has not been resolved and could deteriorate at any time with potential severe consequences for global financial markets.

Suffice it to say that the Fed's large scale asset purchase (LSAP) program, which everyone but the Fed refers to as QE II (quantitative easing), and the additional federal tax and spending stimulus authorized in December, like a shot of adrenalin, have combined to give the economy an injection of high-powered stimulus. This in turn has crushed the pessimism of all but the most ardent gloom and doomers and has unleashed a bit of euphoria in financial markets. Rising confidence is a wonderful thing as it can become self-feeding and that is what is occurring now. Burgeoning confidence, however, becomes dangerous when it escalates into a mania and instigates outcomes that are out of sync with underlying economic fundamentals. When that occurs those outcomes become unsustainable. We are not anywhere

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close to the mania phase of the cycle by a long shot. Indeed, at this early point in the expansion part of the business cycle over-optimism can be helpful to the extent that it ignites a self-reinforcing virtuous circle that will lessen, and eventually reverse, the drag that the weak parts of the economy are still inflicting on growth.

Both fiscal and monetary policy stimulus are at maximum power right now, but by mid-year most of the benefits will be behind us. At that juncture one of two things can happen. As occurred last year, economic growth could slow because the economy is not yet healthy enough to withstand withdrawal of massive doses of government pump-priming. Or, and the outcome I now think is increasingly likely, healing in the private economy will have progressed to the point that expansion will continue on its own momentum with diminishing need of help from the government.

1. Good News

There is ***good and bad news*** embedded in this outlook. The ***good news*** is that a return to recession is highly unlikely. A new financial cataclysm is remote, although risks remain in Europe and emerging nations, particularly China, will have to work through the inflationary consequences of overheating economies. But, as the expansion progresses, employment will improve, consumer spending growth should approach normal rates, access to credit will get a little better, the threat of deflation will recede, although inflation phobes will continue to fret about the potential for runaway inflation, and even housing prices might finally find bottom and stabilize.

2. Bad News

However, the ***bad news*** is that a bit of good news and renewed optimism might well have the unfortunate consequence of reinforcing the natural tendency of policymakers and politicians to kick the can down the road in dealing forthrightly with exceedingly difficult policy issues. We know that massive debt leverage and a speculative mania in housing, commodities and financial derivatives brought the U.S. and global economies crashing down in 2008 and only extraordinary government intervention prevented a reoccurrence of the Great Depression. We also are well aware that public debt is soaring and that health and pension entitlement program promise more benefits over time than can be financed through reasonable tax levels.

3. Imbalances Are Significant and Growing — Political Will To Address Them Is Weakening

Now that global economies are expanding it is tempting to assume that all will be well; that the problems have been taken care of. However, ***deep-seated imbalances remain***, which were not resolved during the Great Recession. Indeed, some of these imbalances have worsened.

What is important to understand is that the mere existence of an imbalance does not mean that a correction is imminent. Indeed, the correction may take years to assert itself. Think back about how the housing bubble built over time and how long it took before it eventually burst. The housing bubble had many causes. All reinforced each other and collectively served to extend and amplify the bubble. A significant amplifier was group thinking which is always present in a speculative mania and always carries manias to seemingly irrational extremes.

It is also important to understand that since the Great Depression active government intervention in times of economic and financial crisis has been the rule, not the exception.

But there is a disturbing pattern in the historical record. Government, in its zeal to contain and limit the damage of a financial and economic crisis, has not permitted all of the imbalances that built up prior to the crisis to be rooted out. Thus, each new economic expansion starts with some of the problems of the previous expansion left unresolved. The disturbing pattern is that the magnitude of unresolved problems has grown over time. What this means is that each new expansion starts on a flimsier foundation. It also means that when the expansion cycle inevitably tops out and the next financial/economic crisis ensues, the crisis tends to be greater than the last one and the extent of government intervention required to avert the potential for collapse escalates as well.

I had thought for awhile that the severity of the recent crisis might mark the turning point in this vicious circle of escalation; that policymakers would accept the necessary pain and implement long-term remedial policies to address and reduce the size and extent of imbalances. But, as I watch the economic recovery unfold and the political process focus predominately on a limited set of short-term issues, my cynicism is growing that we do not yet understand what needs to be done. Thus, we seem doomed to yet another cycle, which could last for several years, but which will ultimately lead to yet another crisis, and to my way of thinking, a crisis that could surpass the recent one. Even if I am overly pessimistic in this view, by not addressing the imbalances discussed below, sooner than later, I believe improvement in the standard of living for Americans will be retarded and social and political consequences are possible.

There is one more point that is key to my assessment. Economic stability over time depends upon key economic phenomena maintaining a balance with each other. This is not a matter of exact precision that is reducible to equations. But, it is based on intuitive logic. For example, if we save too little and consume too much, this will limit investment and in time lack of investment will retard productivity and limit advances in the standard of living. Another example is that we can accelerate the rate of growth for a while by increasing debt, but as we do so we reduce our ability to withstand unexpected adverse shocks. We don't know the exact level of debt that will constitute an unstable imbalance, but we do know that more debt will take us closer to that point. And we know that if don't make people accountable for the consequences of their actions and let them transfer risk to others, then moral hazard will take hold and lead to unreasonable and dangerous risk taking.

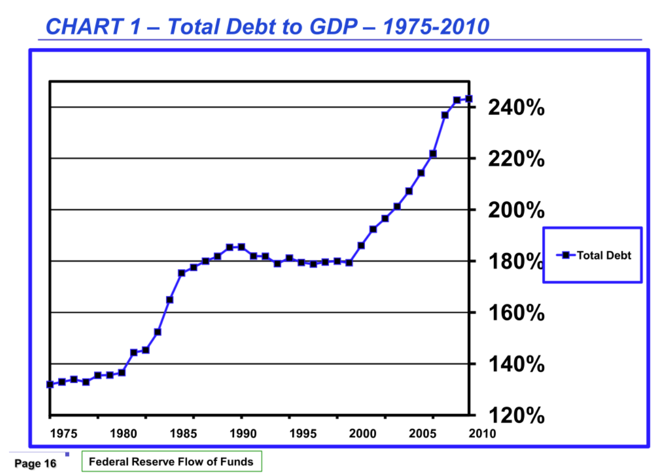
More examples could be cited and will be in what follows. However, the point is this. An economy that grows at its potential and maintains stability overtime must contain the tendency for imbalances to build up. And, if imbalances do occur, policies need to be crafted and pursued to diminish the threats they pose. Regrettably, this does not seem to be understood.

II. Imbalance - Debt Leverage

Massive expansion of consumer debt and an explosion in the amount of financial institution debt, much of it linked to mortgages, fueled the credit bubble that burst so dramatically in 2007-08. The virulence of the panic reflected the enormity of the excessive debt leveraging that built up during the bubble. Deleveraging has proceeded apace, but to prevent the possibility of economic collapse and the onset of a second Great Depression, governments intervened on an unprecedented scale.

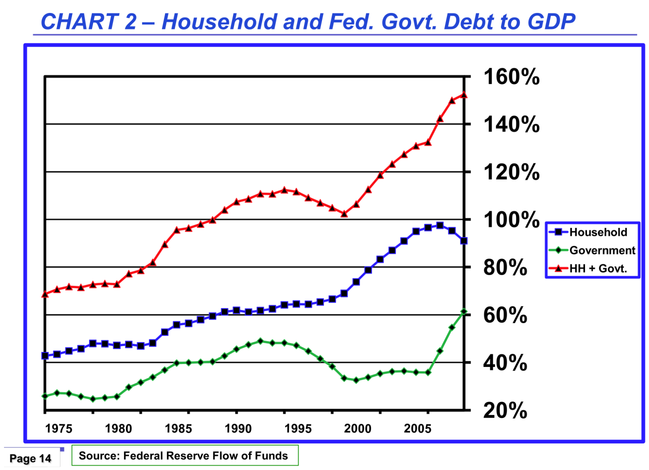
As a result, socialization of private debt in a large number of countries occurred on a massive scale. In some cases, governments simply assumed responsibility for private debt to avert default. That happened in Ireland where the government guaranteed all bank debt. It also happened in the United States in a more limited extent when the government agreed to guarantee all of Fannie Mae and Freddie Mac debt and mortgage backed securities. And, it happened indirectly through running up gigantic budget deficits to provide consumers with spending power lost to unemployment, underemployment and wage reductions.

The overall result is that the crisis was contained but little progress occurred in weaning the U.S. and many other economies from overreliance on debt. In the U.S. the total debt to GDP ratio peaked at 245.0% in the second quarter of 2009 and has only edged down slightly to 243.2% as of the third quarter of 2010. Between 1986 and 2001, this ratio was very stable, fluctuating little from an average level of about 180% (see **Chart 1**). We



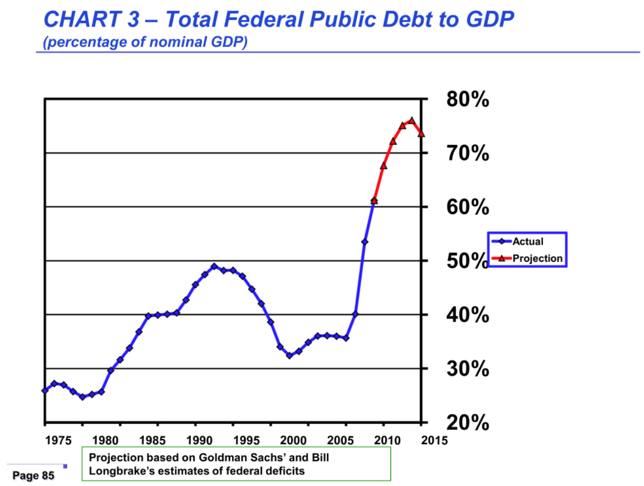
do not know exactly what level of total debt will precipitate a crisis, but we do know that the economy's flexibility to accommodate shocks diminishes as the amount of debt leverage increases. That truism is an inescapable conclusion of the 2007-2008 meltdown and massive household and financial markets deleveraging that characterized the crisis and its aftermath.

While household debt has fallen from 98% to 91% of GDP, after being relatively stable around 65% between 1986 and 2001, federal government debt has risen from 36% to 63% as of January 2011 (see **Chart 2**).



Carmen M. Reinhart and Kenneth Rogoff in their seminal treatise: ***This Time is Different: Eight Centuries of Financial Folly***, document that sovereign debt crises frequently follow financial market crises and tend to occur after public debt to GDP ratios reach levels of 70% or greater. The U.S. is nearing that zone and will cross the lower bound in 2012 (see **Chart 3**). Goldman Sachs (GS) constructed a statistical model that indicates that the probability of a sovereign debt crisis following a financial crisis within a ten-year period is about 30% in developed economies when the public debt to GDP ratio is 70% and the probability rises 2.5% for each 10% increase in the public debt to GDP ratio. The GS analysis implies that a sovereign debt crisis is unlikely in the U.S. The dollar's status as the global reserve currency probably reduces even that probability significantly. Nonetheless, the point should not be lost. A rising public debt to GDP ratio reduces a country's ability to respond forthrightly to a financial crisis. The U.S. is no exception. If the problem is not addressed, there simply will be considerably less ability to contain the next financial crisis, whenever it occurs.

Increasingly, it looks like the growing U.S. public debt problem will not



be addressed — probably not until the next crisis, which is likely not to occur for several years. How can I say this when House Republicans are likely to pass legislation to cut fiscal year 2011 government expenditures by $100 billion and President Obama's budget proposes spending cuts that will reduce federal spending by a cumulative $1.1 trillion over the next ten years? I say this because I believe no real political consensus has yet emerged that curtailment of the growth in public debt is an urgent matter. Serious effort to corral the debt requires much more than tinkering with discretionary spending. It requires overhauling the tax structure to broaden it and restructure many gigantic and inefficient loopholes, known as tax expenditures, such as the mortgage interest and state and local tax deductions, and it requires restructuring entitlement programs that currently promise larger benefits than can possibly be covered through tax revenues over time.

President Obama's Fiscal Commission, under the leadership of Erskine Bowles and Alan Simpson, provided a useful roadmap of what needs to be done and how it could be accomplished. A parallel effort sponsored by the Bipartisan Policy Center, under the leadership of Pete Domenici and Alice Rivlin, made similar proposals. The good news is that both efforts provided information and recommendations that will inform ongoing public debate. The bad news is that President Obama and the congressional leadership have chosen to ignore the "call to arms" and focus on the narrower issue of public spending.

Even the proposed spending cuts are likely to be whittled down. But, this will not occur without a dramatic confrontation over increasing the federal debt limit. In the meantime, encouraging economic news is likely and will help reduce the sense of urgency to address the public debt problem.

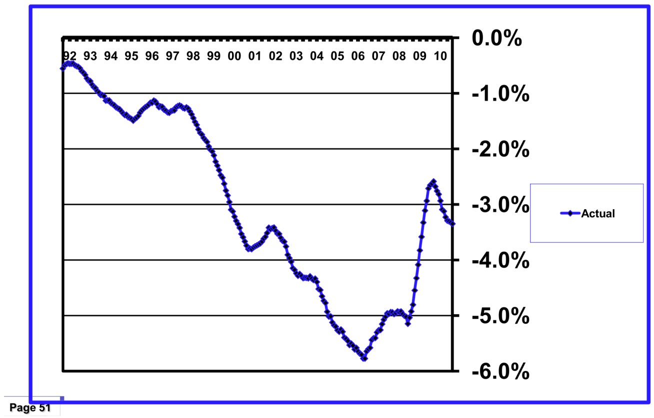
III. Imbalance — Currency Policies and Global Trade

Ideally, individual country trade surpluses or deficits in an open global economy remain small and adjustments in currency exchange rates occur to reduce the extent of imbalances. Unfortunately, however, it is often a matter of national interest to pursue trade and currency exchange rate policies that favor a country's economy. For example, China is deliberately maintaining a value of the yuan that prices its exports cheaply on world markets by pegging the value of the yuan to the dollar at too low a level. The Chinese policy is arguably forced by a need to create millions of jobs to absorb a massive migration of workers from rural to urban areas and in so doing maintain social and political stability. By holding its currency exchange rate at an artificially low level a country can cause production to switch to its shores and away from the country with the overvalued currency. Thus, it is also a way of accelerating economic growth for the country that manipulates its currency exchange rate.

Lest one is tempted to jump to the conclusion that all the blame falls to the country managing the value of its currency, trade surpluses can occur because of sustained competitive advantages that currency exchange rate adjustment cannot completely offset. For example, Germany has been a consistent trade surplus country and its currency, the euro, is not managed. Germany has an extremely strong and competitive manufacturing base which has benefited in recent years from significant labor reforms that have improved flexibility and cost competitiveness. The U.S., on the other hand, which, like Germany, does not mange the value of the dollar, pursues policies that systematically encourage consumption. The result of U.S. policies can be seen in **Chart 4**.

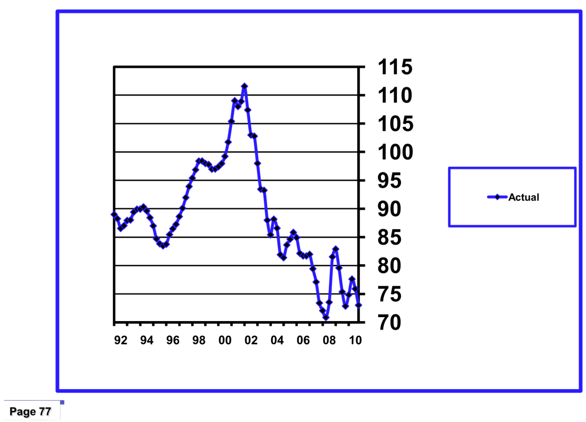
While the U.S. trade deficit has improved substantially in recent years, it remains at an unhealthy level exceeding 3% of GDP. The improvement since 2005 occurred in two waves. The initial improvement occurred following a substantial decline in the trade-weighted value of the dollar (see **Chart 5**).

CHART 4– TRADE DEFICIT (percent of nominal GDP)



The second wave began with the failure of Lehman Brothers and the collapse

CHART 5 – U.S. Dollar (Federal Reserve trade weighted index)



in global trade. Demand destruction occurred in the U.S. as consumption plummeted and imports simply declined by a much larger amount than exports. Because of the dollar's reserve currency status and because the dollar is viewed as a "safe harbor" by investors, the value of the dollar increased during the crisis. This subsequently contributed to an increase in the U.S. trade deficit as did a recovery in U.S. consumption and import activity. Curiously, there has been a significant negative correlation between inventory accumulation and import growth. Now that inventories are near long-term desired levels, the trade deficit appears to be stabilizing.

However, over time, even with the recent improvement, a sustained trade deficit at 3% of GDP will result in a steady and significant accumulation of dollars by other countries. While there are many variables that affect the dollar exchange rate with other currencies, over time a persistent large trade deficit will lead to a decline in the value of the dollar. It will also increase the probability of a dollar crisis

Countries with undervalued currencies will tend to run a trade surplus. Trade surpluses result in large financial flows into the trade surplus country. There are several consequences that follow. First, these financial flows do not just sit there; they are reinvested, often in financial assets but also in real assets. What this means is that the dollars used to pay for the net difference between U.S. exports and imports come back to the U.S., mostly in the form of purchases of U.S. Treasury securities, U.S. agency debt, mortgage-backed securities and other dollar-denominated securities. Some of it comes back through the purchase of ownership interests, real estate and other real assets. This activity impacts global financial markets, interest rates and credit spreads.

Second, the high rate of growth in trade surplus countries usually attracts additional financial inflows as investors scurry to reap returns from higher growth economies, particularly when risks are limited through currency pegging. This can easily morph into speculative activity.

Third, this in turn leads to the tendency of trade surplus economies to overheat. What this means is that aggregate demand grows faster, fueled by trade surplus financial flows, than can be accommodated through growth in supply and inflation breaks out. Dollar pegging can exacerbate this phenomenon by forcing the pegging country to expand its internal money supply. Thus, the Fed's stimulative quantitative easing monetary policy is transmitted directly to the pegging country. But, if the pegging country already has too much stimulus, this is tantamount to adding fuel to a raging fire. That is the situation China finds itself in currently. China's policy options at this juncture are limited. It could let the yuan appreciate at a faster pace against the dollar. There is, as yet, no indication that this is likely to happen. It can tighten monetary policy. On February 8 China raised the one-year lending rate for the third time in four months to 6.06%. While higher rates in theory should dampen lending activity, this is less likely to occur in China's managed economy. A more direct route is to limit lending to state enterprises. Another tool would be to impose capital controls to restrict inflows of "speculative" investment dollars. To the best of my knowledge, China has not opted to use this tool, but it has been used by other countries. Finally, China could simply allow inflation to spiral upwards. Inflation is already rising, but has not yet reached alarming levels. At the moment, wage increases, thanks to huge productivity gains are easily outstripping inflation, thus spending power for the bulk of Chinese workers is still increasing in spite of higher inflation.

How all of this plays out remains to be seen and it is not clear what course events are likely to take. What I can assert with certainty is that global trade and financial imbalances are large and growing. These imbalances are inherently unstable and as they grow larger the risks will also increase.

IV. Other Imbalances

There are other serious imbalances entrenched in the U.S. economy. They are of lesser import than those involving public debt and trade, but if left unattended will have cumulating deleterious effects on the U.S. economy over time. A partial, but not exhaustive, list includes policies that emphasize consumption over investment, policies that encourage financial speculation, and increasing wealth and income disparities.

1. Underinvestment in Infrastructure and Education

Underinvestment in infrastructure is ongoing and the lack of investment over time will diminish the ability of the U.S. economy to increase the standard of living through productivity growth. Underinvestment in education at the elementary and secondary level has been building for many years and may accelerate as state and local governments are forced to reduce spending to balance budgets during the current state and local fiscal crisis.

2. Wall Street Trading Focus

The Dodd-Frank Act, which is supposed to fix the regulatory deficiencies exposed by the speculative mania and subsequent bust, is unlikely to have any material impact for the better on Wall Street's focus on making money through trading financial instruments. Financial activity, unless it improves the efficiency of investment and production, adds no value to economic activity. While financial intermediation clearly serves a purpose and adds economic value, it is hard to see how the role of intermediation benefits to any material degree from trading in esoteric financial derivatives. At worst it truly is a casino, as some argue, which serves only to move wealth from one pocket to another but creates no lasting increase in wealth in the aggregate. The emphasis is on the word "lasting", because financial trading activity often fosters a speculative rise in the prices of financial assets, which for a period of time will appear to have increased measured financial wealth. The darker view is that the complexity of these financial derivatives and their opacity and lack of transparency convey an unfair competitive advantage to the traders; thus investors are playing a suckers game.

3. Growing Income and Wealth Disparities

Although no firm link has yet been established, there is circumstantial evidence that the acceleration in trading revenues and the Wall Street bonus/commission compensation structure that accompanies it may be contributing to growth in income and wealth disparities. If there is such a connection, then financial trading activity not only adds little value to the real economy, it may also be contributing to an erosion of the American social contract in the sense that financial opportunity is increasingly limited to fewer and fewer.

4. Too Big To Fail

In addition, Dodd-Frank seems to accept as a fait accompli the significant concentration of financial activity into fewer, larger financial institutions, thus entrenching a "too big to fail" policy. This has the potential benefit of limiting behaviors that could lead to destabilizing excesses. Also, the Financial Stability Oversight Council (FSOC) and expanded FDIC resolution authority will likely make crisis management more orderly and should limit the potential for matters to spin out of control because of legal obstacles as they did when Lehman Brothers failed and a jerry-rigged solution for AIG had to be stitched together. However, there is also a price to this kind of stability in terms of reduced risk taking and a tendency for an oligopoly of financial institutions to emerge that works with the government not just to limit risk taking but has the additional consequence of limiting competition.

The American financial system has been unique in the sense of supporting thousands of community-based and oriented financial institutions. While this system has lead to periodic spikes in the number of bank failures, it has had the virtue of assuring that grass-root needs are met by institutions that are local and knowledgeable about local needs. That is simply not the case when a handful of large financial institutions dominate the provision of financial services. Unfortunately, the number of community financial institutions continues to shrink. The regulatory and capital burdens inherent in Dodd-Frank, the accentuated risk-adverse nature of the current supervisory climate and the too big to fail policy bias all weigh against the on-going viability of community-based financial institutions. Thus, it seems more likely than not that the number of community financial institutions will continue to shrink and that concentration of financial resources in fewer, larger institutions will continue in tandem.

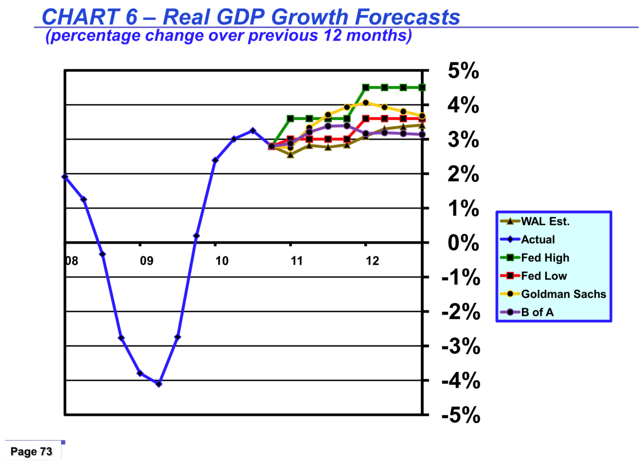
V. GDP Growth

Let me now turn to an update of key economic variables beginning with GDP growth.

1. Forecasts

In the wake of Congressional action in December to extend the Bush tax cuts and provide for additional stimulus in 2011 through approximately $120 billion in reduced payroll taxes and a one-year extension in extended unemployment benefits, most forecasters increased estimates of GDP growth (see **Chart 6**). Previously, the Federal Reserve's forecast seemed optimistic, but other forecasts have converged in the direction of the Fed forecast.

Goldman Sachs' forecast now falls in the middle of the Fed's forecast



range for both 2011 and 2012. Bank of America's forecast is also in the middle of the range for 2011 but at the lower end of the range in 2012. My forecast, labeled "WAL Est.", lags other forecasts in 2011, primarily because I am somewhat less optimistic about the degree of recovery in employment growth, but my forecast exceeds the Bank of America forecast in 2012.

Most forecasters agree that GDP growth will remain subdued compared to the early stage of typical cyclical expansions, but also agree that the rate growth is likely to accelerate gradually, even as the power of monetary and fiscal policy stimulus fades.

2. 2010 Q4 GDP

The "advance estimate" of fourth quarter GDP growth was 3.2% (see Table 1).

Estimates for both inventories and net exports look rather strange. These numbers also are subject to considerable revision between the "advance estimate" and the "final estimate". In recent quarters these two components of GDP have had a negative correlation of about .31.

The good news was the 3.04% contribution of consumption to GDP growth. Assuming that this estimate holds up after revisions, it is the

Table 1
2010 Fourth Quarter GDP Estimates

	Advance Estimate	Second Estimate	Final Estimate
Personal Consumption	3.04%		
Private Investment			
Nonresidential	.43%		
Residential	.08%		
Inventories	-3.70%		
Net Exports	3.44%		
Government	-.11%		
Total	**3.18%**		

strongest growth in consumption since prior to the Great Recession. Notwithstanding poor employment growth and lousy consumer confidence, it is a hopeful sign that consumers are spending more freely again. This is corroborated by a decline in the consumer saving rate from 6.2% in the second quarter of 2010 to 5.4% in the fourth quarter. There is additional evidence that the spending improvement was powered primarily by higher income consumers.

VI. Employment

1. Mysterious January Data

To say the least, the employment situation is confusing. The January Bureau of Labor Statistics (BLS) payroll survey revised payroll data for 2010 down to an average increase of 75,750 per month and added only 36,000 in January. However, the working age population is increasing about 157,000 per month. Given the current labor force participation rate of 64.2%, 101,000 workers need to be added to payrolls each month just to stay even with labor force growth.

Thus, the payroll report paints a discouraging picture of the labor market. However, the unemployment rate fell to 9.05%. Just two months ago it was 9.77%. If one were to stop there and not examine the data further, it would appear that the labor market is improving rapidly.

There are a number of plausible explanations for the differences. First, BLS updates the size of the eligible labor force each January, but it never revises historical data. These one-time adjustments can be very large. It was -185,000 in 2011; -205,000 in 2010; -296,000 in 2009 and -540,000 in 2008. The point is that there are annual discontinuities in the data series which decrease the comparability of December to January results.

Second, the number of reported unemployed persons decreased 1.2 million between November and January, but the employed labor force declined nearly 600,000 at the same time. Ordinarily, one would expect the employed labor force to increase, not decrease, when unemployment falls. A reasonable explanation for this conundrum is that discouraged workers are exiting the labor force, particularly those who have exhausted their maximum 99 weeks of unemployment benefits. If they are not looking for work, they are not counted as unemployed. The decline in the employed labor force seems outsized but is consistent with weak growth in payroll employment.

Third, one-month results from both the payroll and household surveys are subject to sampling error. This means that one should not place inordinate weight on a single month's numbers.

Fourth, we could blame that proverbial excuse for data that doesn't seem to make much sense — the weather (the survey was conducted during the week that a major snow storm clobbered the east coast).

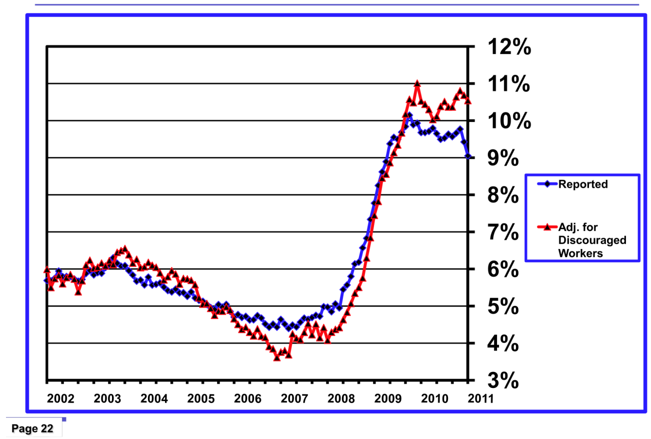
So, what is one to make of the employment data? Spending data and other reports of economic activity pretty strongly suggest that the labor market may be stronger than the official data indicate. If that is a correct interpretation, then employment growth should accelerate handsomely in coming months.

2. Shrinking Labor Force Participation Rate

Labor force participation was near its historical peak at 66.2% in January 2008 at the start of the Great Recession. Since then it has fallen precipitously to 64.2% in January 2011. Participation changes over time because of demographic changes and cultural considerations, such as greater entry of women into the labor force. Over shorter periods of time labor participation is also influenced by workers who exit the labor force during difficult times only to re-enter the labor force during good times.

For quite some time I have been doing statistical analysis that indicates that labor force participation has been declining gradually in recent years. The primary reasons are an aging workforce with a lower participation rate in the oldest cohorts and a declining participation rate among young workers, probably reflecting a larger proportion going to college. That statistical analysis suggests that demographic considerations accounted for a 0.5% decline in the participation rate since the start of the Great Recession and discouraged workers accounted for the remaining 1.5% decline. See **Chart 7**. If my statistical analysis is correct, there are currently approximately 2.3

CHART 7 – Reported Unemployment Rate & Adjusted for Discouraged Workers



million discouraged workers that would re-enter the labor force as the labor market improves. Adding back these workers to the ranks of the unemployed would raise the January unemployment rate from 9.0% to 10.5%.

However, Goldman Sachs (GS) recently published research that assigns a much larger share of the decline in the participation rate to demographic factors. GS expects the demographic decline in the participation rate to continue but simultaneously expects some discouraged workers to re-enter the labor force. GS expects this combination to result in an increase in the participation rate from 64.2% currently to 64.7% by the end of 2012. My forecast is slightly higher at 64.8%.

A steady, but gradual, decline in the labor force participation rate means that employment will grow more slowly in the future, but it will probably not affect the unemployment rate or, for that matter, other growth rates to any material extent. What it will affect, however, is the level of personal income, the level of retail sales and any other aggregate measures of household income and spending. This trend will matter in the following way. A 2% to 3% permanent decline in the labor participation rate means that household income, and probably spending as well, will be approximately 2% to 3% lower for the same population base. This is not good news for nominal tax collections that are geared to income or sales taxes.

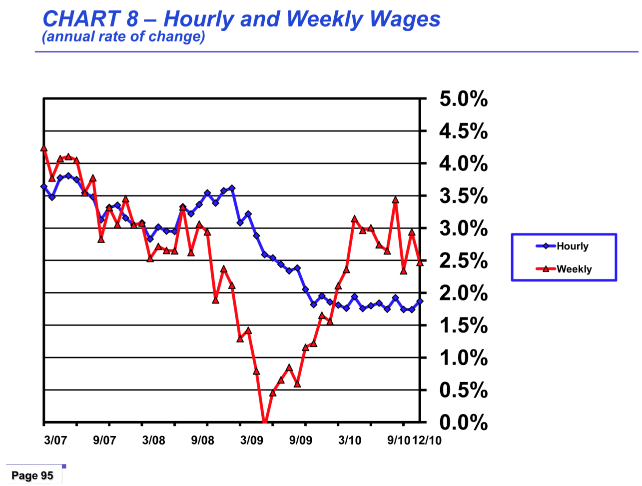
3. Structural Unemployment

Economists have been debating the extent to which the unemployment rate is overstated because a portion of workers are structurally unemployed. The reason this debate has some importance has to do with what level of measured unemployment would trigger inflationary wage pressures. Historically, the non-accelerating inflation rate of unemployment (NAIRU) was been approximately 5.0%. However, if structural unemployment is a significant factor, then a large number of unemployed workers will never find work and NAIRU is higher than 5.0%. Some have estimated that NAIRU may now be as high as 6.0%. However, if the unemployment rate is now falling because structurally impacted workers are leaving the labor force, then NAIRU has not gone up nearly as much as some argue.

In any event, even with the unemployment rate down to 9.0% there can be little argument that there are a lot of people who want to work who can't find a job. And, as long as that continues, there will be no upward pressure on wages and limited upward pressure on inflation.

4. Wage Growth

It appears that average hourly wage growth, which is an indicator of the intensity of excess labor supply relative to demand, has stabilized over the last year. **Chart 8** shows the annual rate of change in the hourly average



employee wage rate and the annual rate of change in weekly wages. The growth rate in average weekly wages adjusts for the average number of hours worked. The growth rate in weekly wage earnings is a measure of spending power of consumers. Weekly wages had grown since mid-2009 as average hours worked slowly increased, but now appear to be converging downward toward the growth rate in average hourly wages. Overall **Chart 8** tells a story of a very weak labor market that may be in the process of stabilizing.

In the long run, the more important of the two measures is growth in the average hourly wage rate. Average weekly hours fluctuate with the strength of the business cycle, fallings during recessions and rising when the economy is expanding. Early in the recovery phase of the business cycle, employers increase the number of hours worked by employees. But, as employers gain confidence in the sustainability of the expansion, they begin to hire additional workers. We may well be at the transition point. What that will mean is that the number of people hired will increase at a more rapid rate, which is what most, including myself, expect. It also means that the expansion in the number of hours worked per week will begin to flatten out and that is what has happened over the last several months. At that point, growth in the average hourly wage rate will become a more important indicator of the tightness of labor supply relative to demand.

The rate of growth in the average hourly wage rate is also a leading indicator of inflationary pressures. As long as it remains at a very low level there will be little to no upward pressure on inflation.

VII. Housing

While the rest of the economy is showing increasing signs of life, the housing sector is grinding along the bottom and appears to be a very long ways away from being a positive contributor to economic growth.

1. Housing Demand

The tax credit program stimulated demand for awhile, but since the program ended home prices have been declining again.

Homeownership continues to decline from a high of 69.0% of all households in the third quarter of 2006 to 66.5% in the fourth quarter of 2010. This amounts to a decrease of 2.8 million homeowner households. Many of these households are now renters, but some have doubled up. It is entirely possible that ownership could fall further, perhaps to as low as 64.4%, which was the average level that prevailed from 1965 through 1996. If that were to occur it would mean the loss of another 2.7 million households to homeownership.

New household formation has plummeted. In normal times household formation would be 1.1 to 1.2 million annually. It is far lower than that at the moment. As the economy improves and employment recovers, household formation rates will recover, but there is a good chance this will benefit the rental market, not the ownership market.

Survey data from Fannie Mae indicate no improvement in home buying intentions and a marked deterioration in attitudes about homes being a safe investment — only 64% view a home as a safe investment today versus 83%

in 2003.

And, if this were not enough, getting a home loan these days is nothing short of a major ordeal and close to impossible for those with poor credit scores. Access to credit is likely to become more, not less difficult, and more, not less, costly as the government increases guarantee fees on mortgages, raises down payment requirements and tightens underwriting and credit qualifying standards. This will help continue to depress single family housing demand and lower the homeownership rate.

2. Housing Supply — Vacancies

The Census Bureau's quarterly survey of housing unit vacancies indicates that the excess inventory of vacant single family homes remains stuck at about 700,000 units above the 1994-2000 average level (see **Chart 9**). However, rental vacancies have now declined for four consecutive quarters. The good news is that a slow healing process is underway. The bad news is that the improvement has bypassed ownership units — it is entirely concentrated in rental units.

Reflecting declining rental vacancies, there has been a modest firming in monthly rents over the last several months. There is little question that the changing structure of housing demand will favor rentals for many months to come. However, the rental and ownership markets are not discrete. Ownership units can easily be converted to rentals, a fact seemingly overlooked by those who think rents are poised to rise sharply. In fact, Fannie Mae data indicates that 55% of rental units are one to four units and only 45% are multi-family units.

Supply of single family residential homes is also being impacted by a high rate of foreclosures. Foreclosures are likely to remain at a high level for quite some time. Falling home prices could exacerbate matters. Zillow.com just reported that 27% of all mortgages, or 15.7 million, are underwater, which means that the amount owed on the mortgage is bigger than the price the house would fetch in the market. The comparable figure at the end of September was 23%, or 13.9 million mortgages.

3. Housing Prices

Weak demand for single family homes and a substantial excess supply mean only one thing — declining home prices. According to the Case-Shiller housing price index, housing prices have now declined for five consecutive months. Merrill Lynch expects home prices to decline 5% in 2011 and Fannie Mae forecasts a 3% to 5% decline. Most other forecasters expect roughly similar housing price declines during 2011.

However, there may be light at the end of the tunnel as most believe 2011 will mark the bottom for prices. That said, with private mortgage finance still largely non-existent and the government tightening standards and prices, it is hard to foresee very rapid improvement in the housing market, even after excess inventories are finally mopped up through the natural process of new household formation and, to a limited extent, intentional destruction of existing housing stock.

4. Potential Consequences of Falling Home Prices

There are three negative consequences of falling housing prices that could interfere with or limit acceleration in economic growth.

First, there will be no substantive increase in residential housing construction until excess inventory declines substantially and housing prices stabilize. This is not likely to occur until 2012 at the earliest.

Second, declining home prices mean that this component of consumer wealth will continue to shrink. The short-lived uptick in home prices and increasing stock prices boosted household wealth over the past year by about $1.7 trillion. It looks like stocks will need to do the heavy lifting in 2011 to offset the impact of declining home prices on consumer wealth. So far, all is well on that score. At the very least, depressed home prices will slow reacceleration in consumer spending and growth in GDP will progress more slowly compared to past early expansion phases of the business cycle.

Third, falling home prices means shrinking home equity for many homeowners and an expanding group of homeowners with negative equity — 27% according to Zillow.com at the end of 2010. This will have two consequences. First, the probability of defaults and foreclosures will rise and second, losses incurred by investors will increase.

But, investors are not likely to roll over and take the losses without a fight. The "robo-signing" media frenzy of last fall is far from over. Investors have filed lawsuits and state attorneys general are in the process of negotiating potentially large financial settlements with major mortgage servicing companies. Already Bank of America and other large servicers have reached multi-billion dollar settlements with Fannie Mae and Freddie Mac to limit losses stemming from demands to buyback mortgages with flawed underwriting that had been guaranteed by the Enterprises.

VIII. Will Inflation Turn Into Deflation?

1. Market Worry About Escalating Food and Commodity Prices

Market participants are once again worrying about an imminent outbreak in inflation. This time around the principal villain is rapidly rising food and commodity prices. A secondary villain is rental prices and owners equivalent rent. Let me say as emphatically as I possibly can — ***inflation is not a threat now and will not be for some time to come***.

First, commodity prices account for only a small fraction of the total cost of production. Second, there is scant evidence that much of the increase in commodities prices is passed through to finished goods. Third, statistical work by Goldman Sachs (GS) indicates that shocks in relative prices, such as increases in food, energy and commodities, do not pass through to core inflation. Fourth, inflation expectations are anchored. Fifth, growth rates in nominal wages are very low and stable and recent growth rates in real wage rates have been negative. Sixth, while rents have increased a bit as of late, the excess supply of single family homes coupled with the economics of falling housing prices and increasing rents will drive an increasing number of single family homes into the rental market, thus increasing rental supply and limiting further increases in rents. Seventh, statistical work by GS shows that the apparent correlation between inflation and the rental vacancy rate evaporates when the unemployment rate is included in the analysis.

Although the list of reasons why inflation will remain quiescent for an extended period of time is long and powerful, most refuse to believe the veracity of those reasons. That is because food, energy and commodity prices are highly visible. One is reminded every time he or she fills the car with a tank of gas. Those in manufacturing businesses are inordinately impacted by commodity prices. And, more generally, inflation is the bogey we know and have experienced; we have no similar experience with deflation. But, ask the Japanese about deflation — their emphatic advice is: never let it take hold. Japan continues in a deflationary trap and policymakers really don't know how to escape from it.

The Federal Reserve focuses on the core personal consumer expenditures (PCE) measure of inflation, which excludes food and energy prices. The Fed expects this measure to remain below 2.0% through 2013; in fact, the forecast range for 2013 is 1.1% to 2.0%. In its January 26, 2011 statement, the Federal Open Market Committee stated: "Although commodity prices have risen, longer-term inflation expectations have remained stable, and measures of underlying inflation have been trending downward." The Fed is not worried at all about inflation at this time, it is worried that measures of inflation have been trending downward.

While I have been concerned about the risk of deflation, the unfolding expansion, weak though it may be, seems likely to arrest the declining trend in the core rate of inflation before it reaches zero. Goldman Sachs and Bank of America both expect core inflation to stabilize near 0.5% over the next two years. Their forecasts are lower than the Fed's forecast and considerably lower than most others. However, I believe both have studied the facts well and that both have come to an informed conclusion which is more likely to be borne out by events than those who fear accelerating inflation.

IX. March Longbrake Letter

In March I plan to take you on an historical adventure based on the book, ***The Lords of Finance: The Bankers Who Broke the World*** by Liaquat Ahamed. The four lords of finance are: Montagu Norman, governor of the Bank of England; Hjalmar Schacht, head of the German Reichsbank; Emile Moreau, head of the Bank of France; and Benjamin Strong, president of the New York Federal Reserve Bank.

The book recounts the economic and political history of Europe and the United States from the late 1800's through the onset of World War II from a financial markets and monetary policy perspective. While it is an interesting tale that occurred before most of our lifetimes, it has much to say about what happens when significant economic and financial imbalances are not addressed or are addressed in the wrong way. In that sense the book is not just about what happened long ago, it is a cautionary tale for our own time.

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