Piscataqua Research, Inc.

The Consumer Press June, 2009 Update

Summary: In March, 2009, we wrote: "As we had suggested many times, the economy would be worse in 2009 than it was in 2008. It is."

Since March, the Obama administration's response to the economic mess has been a work in progress. We use the word "progress" loosely here. The Obama administration is ultimately making the economic problem worse.

We think that it has become increasingly obvious that the root of confidence is the word "con", as in the verb, to "con". Still, most people have not accepted that we are on a foolish path. Fewer have accepted that we need to pay the price to get onto a smart path.

Our work on economic cash flow indicates that the economy continues to slide downhill. In the short term, the Federal Reserve and the Treasury have succeeded in boosting nominal debt flow to create a semblance of positive economic activity.

Debt flow without income is not a recipe for continued economic success. Income based economies are much more boring. Who wants boring? How could one have crises and "animal spirits" without a Federal Reserve minting debt or a Treasury printing paper?

By

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This analysis brings our "Consumer Cash Flow", "Real Estate and Money Supply", and "The Interest Rate Conundrum" papers up-to-date.

The latest economic statistics show that consumers depended on new debt for 58% of their cash flow during 2008. The decrease in the percentage of cash flow derived from debt flow was substantial. In 2007, households depended on debt for nearly 81% of cash flow.

The decrease in debt flow in 2008 was the primary cause of the "improvement" in the relationship between debt flow and income flow. We have spent most of the last 6 months listening to politicians moan about the need to increase debt flow: i.e., the need to reverse the decline.

Chairman Bernanke told us the absolute truth about what our government is up to in a speech at Morehouse College: "Credit is the lifeblood of market economies…" Unfortunately, they have something wrong: profit is the lifeblood of market economies. Credit is the lifeblood of socialist economies; i.e. economies that do not generate enough profit and saving to support themselves.

We currently guess that consumers will use new debt for 58% of their cash flow in 2009. Though the Federal Reserve is working feverishly on debt flow, any success will only cause a worsening of this relationship. The long-term economic ramifications of this worsening would not be worth the smidgen of short-term improvement that it will bring.

For 2009, we guess that U.S. households will save about $75 billion for investment purposes. This amount compares to needing $105 billion in 2008 and $198 billion in 2007 for principal payments. In spite of the appearance of improvement on this measure, our current analysis indicates that U.S. households will exit 2009 in worse shape than they entered 2009.

In our March Press, we wrote: "We now expect that we will discover many similarities to 1931 as we progress through 2009." We have already found one important one. The Federal Reserve is discovering growing resistance to new debt: i.e., declining demand for new debt at any price.

This increasingly obvious fact is a central aspect of 1931. No matter what the Federal Reserve did in 1931, they could not generate new debt flow. The economy continued to wither.

Chairman Bernanke built his reputation on proving that 1931/1932 was a failure of the Federal Reserve as opposed to an efficient, rational response by households and businesses to an economic opportunity set. He has aggressively lowered interest rates – particularly mortgage rates - as our government uses financial incentives to try to overcome economic reality.

Our analysis indicates that mortgage rates will need to decline further during 2009. It is possible that 30-year mortgage rates will exit 2009 in the low 4%s. Our money supply work fascinates us.

Conclusion

In 2009, we have already recorded further economic deterioration caused directly by Obama administration choices. Our analysis of Obama administration's policies indicates that they will not work and will continue to worsen the economy. Read our comments on pages 5 and 6.

Chairman Bernanke will most likely have the honor of proving that his research is wrong. He might end up showing us how inflation and economic depression can combine to impoverish a once vibrant, wealthy country. He might show us how too much debt leads to deflation. Whatever he shows us, our analysis indicates that it will not be fun for America.

Consumer Cash Flow

In our paper, "Consumer Cash Flow", we developed a Sources and Uses of Cash Flow statement for U.S. households using the format for corporations. In the table below, we show the latest 2007 and 2008 results and our current wild guesses for 2009.

Statement of Household Cash Flow
($ Billions)

	Latest 2007	Latest 2008	Wild Guess 2009
Cash Flows from Operating Activities			
Personal Savings	57.4	192.7	420.9
Depreciation and Other Non-Cash Items	252.2	254.5	257.0
Net Cash provided by Operating Activities	**$309.6**	**$447.2**	**$677.9**
Cash Flows from Investing Activities			
Purchases of New Residential Property	(630.2)	(487.7)	(395.9)
Purchases of Savings Investments	(396.9)	(478.0)	(460.2)
Purchases of Other Investments	(138.5)	694.9	(41.0)
Net Cash used in Investing Activities	**$(1,165.6)**	**$(270.8)**	**$(897.0)**
Cash Flows from Financing Activities			
Repayments of Debt	(508.1)	(552.2)	(603.8)
Increases in Debt	1,363.0	606.7	920.9
Net Cash provided by Financing Activities	**$854.9**	**$54.5**	**$317.1**
Net Increase (Decrease) in Cash and Equivalents	**$(1.1)**	**$230.9**	**$98.0**
Cash and Equivalents at beginning of period	1,365.6	1,364.5	1,595.4
Cash and Equivalents at end of period	**$1,364.5**	**$1,595.4**	**$1,693.4**
Cash Flow from Debt	**1,363.0**	**606.7**	**920.9**
Total Cash Flow (Debt + Operating Cash)	**1,672.6**	**1,053.9**	**1,598.8**
Percentage Cash Flow from Debt	**81%**	**58%**	**58%**
Cash Flow Growth from the Prior Year	**-17%**	**-37%**	**52%**

In the context of whether households are gaining wealth, the level of household investment for the future is important. Our current WILD GUESS is that 2009 investment activities will increase 231% from 2008. We have already lowered our March wild guess by $100 billion!

In spite of the huge increase in 2009 compared to 2008, household investment should be less than 2000 nominally and less than 1994 after CPI changes! With a population that has increased 16% since 1994, 2009 household investment is still at extraordinarily low levels.

The "Statement of Sources and Uses of Cash Flow" documents households as a group are getting poorer. As far as we can tell, households in aggregate are going broke.

We caution you about interpreting the increase in Operating Activities cash positively. It does not change the underlying future. Of the estimated $228 billion increase, $138 billion comes from lower taxes; $60 billion comes from higher government transfer payments; and the rest from a $30 billion decline in personal outlays.

Mortgage Financing Environment

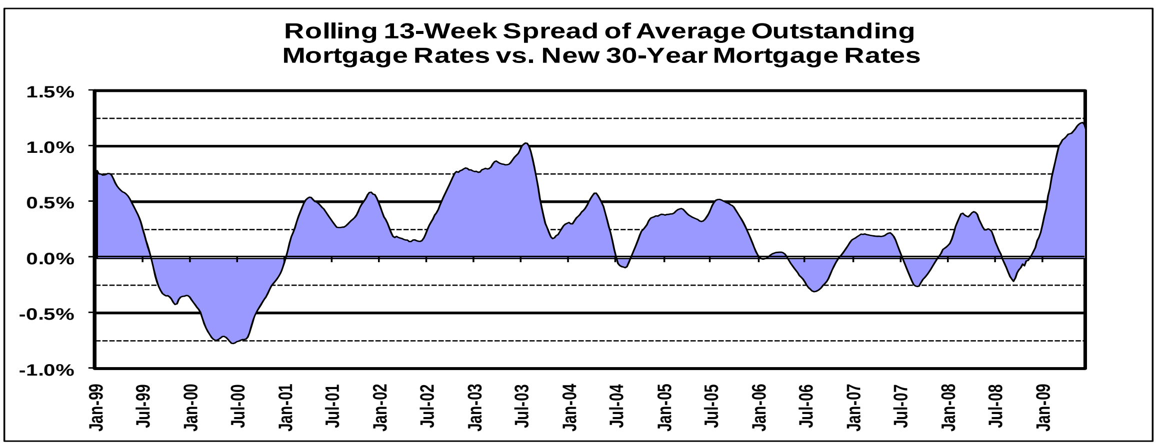
In June, 2007, we described the mortgage finance environment as a battle lost. It was an apt description. Since then, we have seen high delinquencies, high foreclosures, staggering mortgage write-offs, apparent panic at the Federal Reserve and Treasury, and the near bankruptcy of major financial institutions all over the world.

We have used the Battle of Kursk analogy many times to describe the mortgage battle. After Kursk, the Soviets had traded enough men and material with the Germans that the Germans could never recover. For the Germans, it would be a prolonged defensive battle with a guaranteed outcome. The only intelligent choice for the Germans after Kursk was to negotiate surrender.

For the Federal Reserve, 2007 was the point where the mortgage/housing game was over as a method for propping up the economy. Like the Germans, the Federal Reserve fought on. Now, the Fed is throwing America's future into the breach as it tries to stave off the inevitable.

2009/2010 is likely to be the final portion of this battle. The Fed has already forced Treasury and mortgage rates to levels where they provide few economic signals and mainly prop up household cash flow. Even at these low rates, household cash flow is insufficient for investment.

The chart below shows the relationship between the Freddie Mac mortgage rates and the average interest rates on existing mortgages. It shows the Fed has established a level of mortgage incentive unmatched even during the dark days of late 2002 and early 2003.



The impact on refinance applications is exactly what we expected: they soared. Interestingly, the Fed has not been able to replicate either the refinancing or purchase levels attained during 2003. In order to achieve the 2003 outcomes, the Fed probably needs to drive mortgage rates below 4.5%. As the Germans found, stripping the Western Front did not save the Eastern Front.

As we wrote in March: "The monetary system and the economy is on the verge of crack-up because U.S. households have excess debt levels and a lack of everyday liquidity. Without constant new debt flow, the structure will seize up."

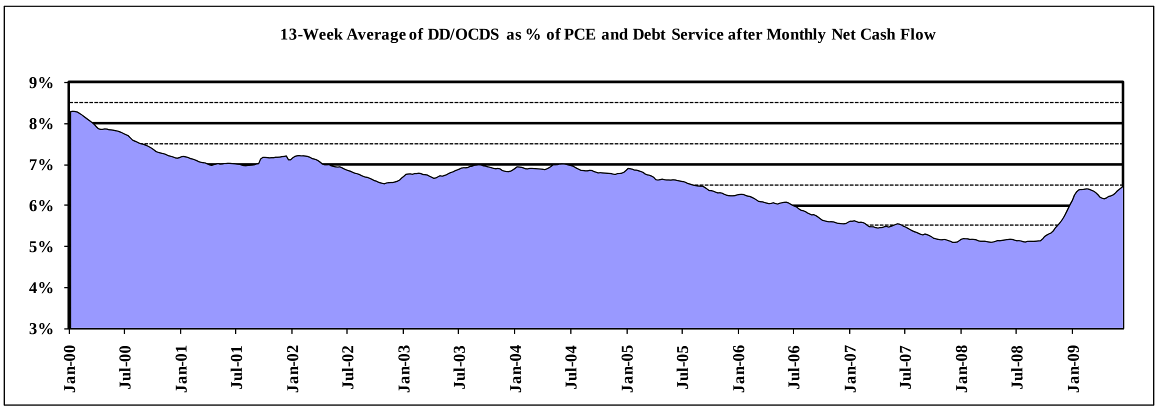
To date, the Fed has not failed our analysis. In the week after we wrote that, the Fed drove 30-year mortgage rates down about 0.25% for the next 10 weeks! The recent dramatic increase in mortgage rates will be an important test of economic fragility. We doubt that the mortgage rate increases will last because of their likely effect on household liquidity.

Household Liquidity

We analyze household liquidity needs in the context of the dollar level of economic activity shown in our Household Cash Flow model. We tie those needs to the available money balances shown in the Federal Reserve money supply accounts. Based on our Household Cash Flow analysis, we know that household liquidity is an economic trigger.

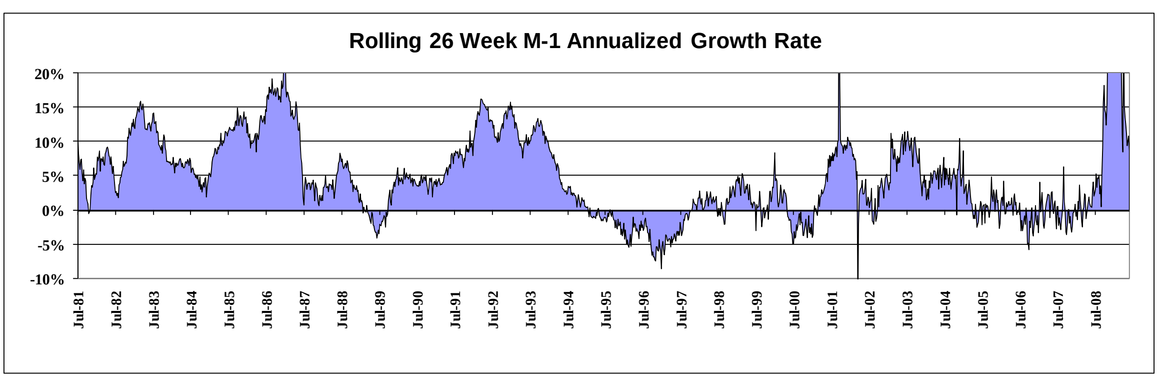
Household liquidity stabilized in early 2008. In late 2008, household liquidity soared in response to the credit slowdown. Since then, the Fed's aggressive mortgage strategy has allowed them to maintain household liquidity but has not led to a further improvement.

The chart below shows a one-month forward measure of all checkable deposits as a percentage of the annual household cash expenditures including household debt service adjusted for the expected monthly change from net cash flow.



As we stated in September, the takeover of the U.S. financial system engineered by the Federal Reserve and the Treasury during summer 2008 caused M-1 growth to reappear. We wrote: "M-1 should now grow. If M-1 growth had not changed, then the economy was headed for collapse. The U.S. was close to effective transactional illiquidity."

In March, we wrote: "As debt flow improves, we expect M-1 growth to decline dramatically. If liquidity again begins a slow downtrend, that will be a bad economic sign." As shown above, liquidity stopped improving but has not returned to its previous downtrend.



Our M-1 expectations have also proved accurate. As debt flow improved since March, M-1 growth declined. Unfortunately, we are not hopeful about liquidity.

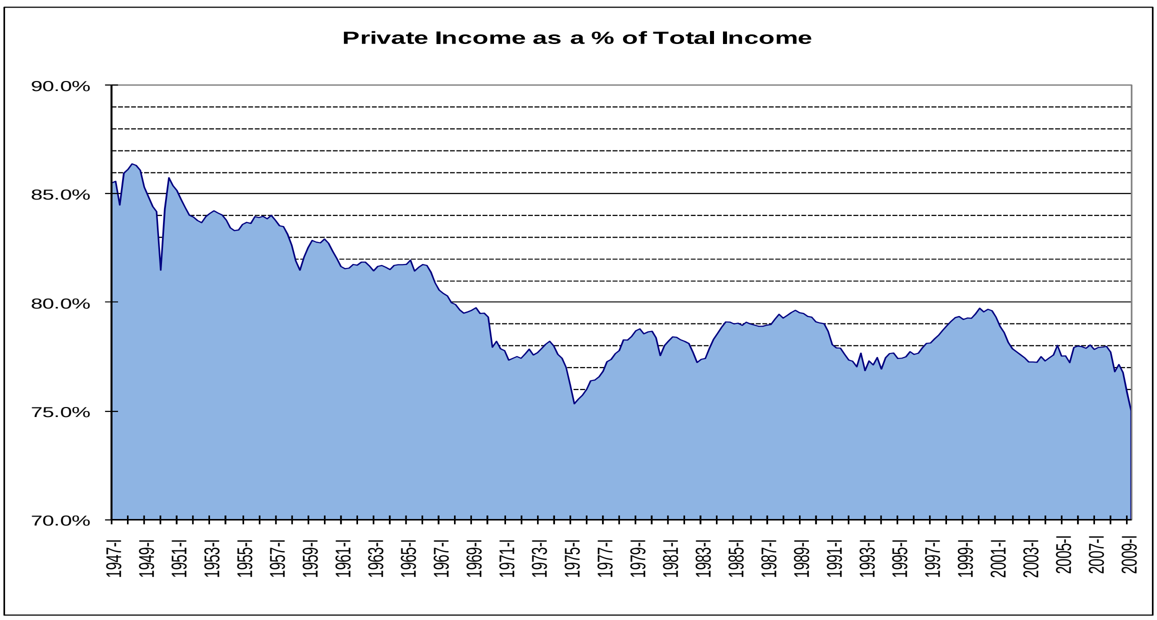
Government-Based Income

The starting point for our household cash flow analysis is the Personal Income statement created by the Bureau of Economic Analysis. It tells us how much cash we are "earning", but it does not tell us how much cash we are borrowing or acquiring through liquidating assets.

We built the Sources and Uses of Cash Flow statement for households to address this short-coming. We know that the cash flow statement is more important than the income statement. We also know that income-based cash flow is more important than debt-based cash flow. Stock analysts everywhere rely on cash flows as their primary analytical tool.

In our March report, we showed a chart with the historical quarterly level of Personal Income received from government transfers. Based on recent information, transfer payments are likely to exceed 16% of personal income during 2009 and will approach 17% by the end of 2009.

The chart below shows "Private Income" as a percent of "Total Income." In this measure, we evaluate the government's support of income. Private income excludes transfer payments and wages and benefits from governments. The governmental income categories tend to be very stable and even counter-cyclical as unemployment benefits increase during recessions.



This chart is interesting. It shows strong economic times are co-incident with Private Income in excess of 79% of total income during the last 40 years. It also shows poor economies are co-incident with Private Income below 78% of income.

In the 2nd Qtr, 2009, we will decline to 75% for the first time in the 62 year history. With Obama administration policies driving it below 75% in late 2009, we can be certain the Obama administration is bringing us change. Sadly, it appears that it is the wrong type of change!

The Obama administration/Democratic Congress is driving private income to new lows as a percent of income. Soon, households will expand their dependency on new debt flow to include a dependency on government distributed income. We suspect that government supported income growth will create as many problems as government enhanced debt flow has already created.

Government and the Economy

This section is philosophical. It starts a discussion about socialism and capitalism. It provides an interesting data point in determining the balance of socialism and capitalism in America.

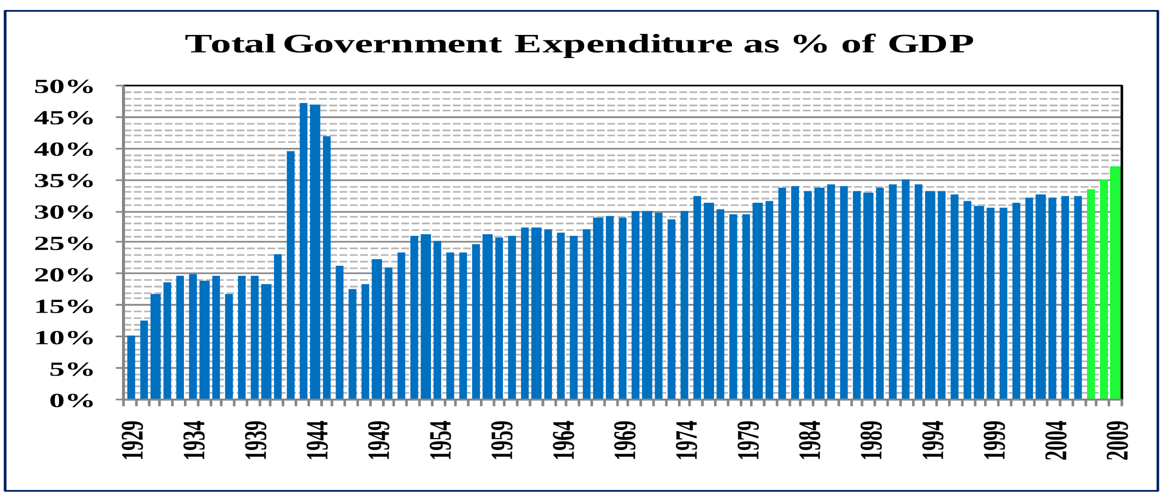
"Socialism" is defined on www.dictionary.com as "a theory or system of social organization that advocates the vesting of the ownership and control of the means of production and distribution, of capital, land, etc., in the community as a whole." Under Marx, "socialism" is the precursor to true collective ownership. Economically, collective ownership is a proven failure.

Under the Bush administration, "socialism" formally immigrated into the U.S. with collective ownership of a significant portion of the financial system. We have heard the excuses for government participation in the financial system, but the rationalizations do not change the facts.

The facts are simple: the U.S. Treasury and the Federal Reserve took physical control and effective ownership of substantial portions of the financial system during late 2008. The Treasury took control and ownership of Freddie Mac and Fannie Mae. The Federal Reserve took control of AIG. The Treasury invested in "perpetual preferred" equity with attached diluting warrants of a large swath of U.S. banks. The Treasury is now making investments in insurance companies and auto companies. It is what it is. It meets the definition of socialism.

Based on the above definition of socialism, George Bush brought socialism to the U.S and Barack Obama is extending the concept. Many blame Franklin Roosevelt for the largest increase in government control of the economy. The chart below surprisingly shows that Herbert Hoover was actually responsible for the biggest governmental increase in the economy.

The following chart shows the level of cash government expenditures as a percent of GDP. If America is turning more socialist, it will show an increase in government control of the GDP.



The green bars show what has happened since the election of the Democratic Congress in 2006. We are in the midst of the single biggest increase in government control of the economy since Truman or Hoover.

It is interesting there were few government deficits until government expenditures approached 30% of the economy. As governmental expenditures exceeded 30%, deficits expanded. When Clinton returned governmental expenditures to 30%, a balanced budget re-appeared.

Summary

Everything chronicled in our Consumer Crunch, Crush, and Press is directly related to falling household liquidity. With household liquidity at all time lows in early 2008; it stabilized. It increased in late 2008 and stopped increasing again in 2009.

Household liquidity is a key economic variable. If liquidity begins to decline again during late 2009/early 2010, it will signal a worsening economy. It would also signal that the Federal Reserve's use of the mortgage market to generate money is effectively finished as a predictable macro-economic control lever.

In March, we wrote: "With the effective government takeover of the banking system, we suspect that liquidity will probably fall no further. We expect to move toward the next step in the economic process."

In our view, the next step is the transition from a government-supported market economy to a government-supported economy. In such an economy, we can assume that the government will provide liquidity to the economy as it is needed. Effectively, the economy will operate forever on deficient liquidity, but it will not run out of necessary liquidity.

In March, we wrote: "…we did not yet realize that our new President would also include state and local governments in the transfer payment process. Not only are households broke, but the state and local governments supported by taxes and fees on broken households are also broke!"

We suggested that California, Florida and New York were potentially bankrupt. We also suggested that the Governors of these states would very much like the right to print money.

We have heard the Governor of California say that, unlike the U.S., he cannot print money to solve California's problems! We also understand that the Governor of New York is not sharing the stimulus transfers with local governments and the Governor of Florida is running for Senator. It seems nobody wants responsibility for this mess.

We think Gov. Schwarzenegger has it wrong. Printing money never solves problems. In fact, printing money creates more problems as it causes perverse economic rewards. Only those that benefit from government payments benefit from destruction of the currency.

We also wrote: "In our opinion, the Obama administration has made one economic mistake after another. A simple analysis of the stimulus package shows that it will not work."

We love the pie charts tracking how much of the Obama stimulus money has been distributed and how much has actually been spent. It is sad that America has been reduced to waiting for a tidal wave of government cash to save it. Government debt levels are rising at an unsustainable pace.

The cash flow statements do not lie. The path that our leadership has chosen will fail. Tax levels have reached economic resistance levels. Declining private income demonstrates that the economy is not functioning well. The "green shoots" of Bernanke's "recovering" economy are only the growth of Roubini's government "yellow weeds" taking over the economy.

The Obama administration is creating income dependency to complement the debt dependency created by the Federal Reserve. Income-constrained, debt-overloaded households cannot support future investment. Without household investment, U.S. households will become poorer.