LAFFER ASSOCIATES
Supply-Side Investment Research
July 07, 2010

WEEKLY COMMENTARY AND ECONOMIC CHARTBOOK HIGHLIGHTS

The Laffer Associates Economic Chartbook provides a monthly snapshot of how we view the world from a supply-side perspective. It provides a clear and concise resource for examining the state of the economy through a series of carefully crafted displays. Our weekly commentary calls attention to those factors that are currently driving markets and influencing asset values around the globe.

Friends,

The handwringing from the Keynesians has begun again as the election season approaches. Despite unprecedented stimulus ($3.6 trillion) including bailouts, Fed intervention and eye popping money supply growth, the unemployment rate remains well above administration forecasts and near post war highs, GDP growth is slowing, the market is in the midst of its largest correction since March 2009 (see chart) and voters are growing more disaffected by the day. One would think it might be time for Washington to seriously re-evaluate its economic policies.

Nope. Instead, there is a growing chorus calling for the U.S. to pass more stimuli—a lot more—lest the U.S. fall into another Great Depression. This is no better than bloodletting centuries ago, if one pint of blood didn't cure the patient, they took two pints, if two pints didn't cure the patient (it didn't), they took three pints. There is only one reason they haven't announced another stimulus program: those pesky voters! If we see more spending legislation passed, either before or after the election, expect markets to react poorly.

If economic numbers don't improve, we could also see the Federal Reserve re-open temporary liquidity facilities vis-á-vis the TAF and the MBS purchase program, both of which expired earlier this year. Because states and localities still face growing budgetary problems, we believe that the federal government's likely response will be to borrow more money in order to send it to the states. Due to the already large deficits and a potential weakening in demand for more and more U.S. government debt, the Fed may end up monetizing this new debt. From the federal government and Federal Reserve's perspective, monetary stimulus is advantageous because it raises fewer red flags in the investment community while simultaneously increasing federal government power over state policies.

An alternative path is for states and localities to directly issue additional state and local bonds—because state and local debt issuance faces greater restrictions, however, this policy may be more difficult to follow. Just like it did with MBS purchases in 2009 and early 2010, monetizing this increased debt would require the Federal Reserve to follow the unprecedented policy of directly purchasing the state and local municipal bonds and Build America Bonds—whose yields have risen lately on the back of increased risk (see chart).

With FY 2011 beginning last week in most states, it's disheartening, but not surprising, to see that many of the most troubled state budgets from the past few years have only worsened—and this coming off of a record fiscal year in net legislated tax changes (see chart). We know New Jersey has a fiscally conservative leader in Gov. Chris Christie, but are the politicians in the other troubled states like Illinois, New York, and California, going to be as effective? CDS spreads in Illinois have widened to their largest levels ever over the past few months (see chart). Should debt fears escalate further at the regional level, the recent euro induced dollar rally will wane. This will not be good for containing higher inflation and higher interest rates.

As a follow up to our bullish piece on Poland[1], the market has reacted favorably to the Polish election of Bronislaw Komorowski over the weekend. The zloty has gained just over 2% against the dollar and 1.5% against the EUR (see chart), and ETFs tracking the MSCI Poland index have gained over 6% since last Friday. Komorowski's election will pave the wave for further pro-growth reforms in Poland as it puts the more fiscally conservative Civic Platform (PO) party in charge of Parliament, the Prime Minister's office and the Presidency.

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[1] Thomas F. Landstreet and Jared DeSoto, "Poland: Not a Joke Anymore", *Laffer Associates,* March 04, 2010.

S&P 500: Nominal vs. Real Price Appreciation
(monthly, semi-log, Jan-66=100, through 07-07-10)

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Build America and GO Municipal Bond Yield Spreads to 10-Year Treasuries

(daily, percent, through 07-07-10)

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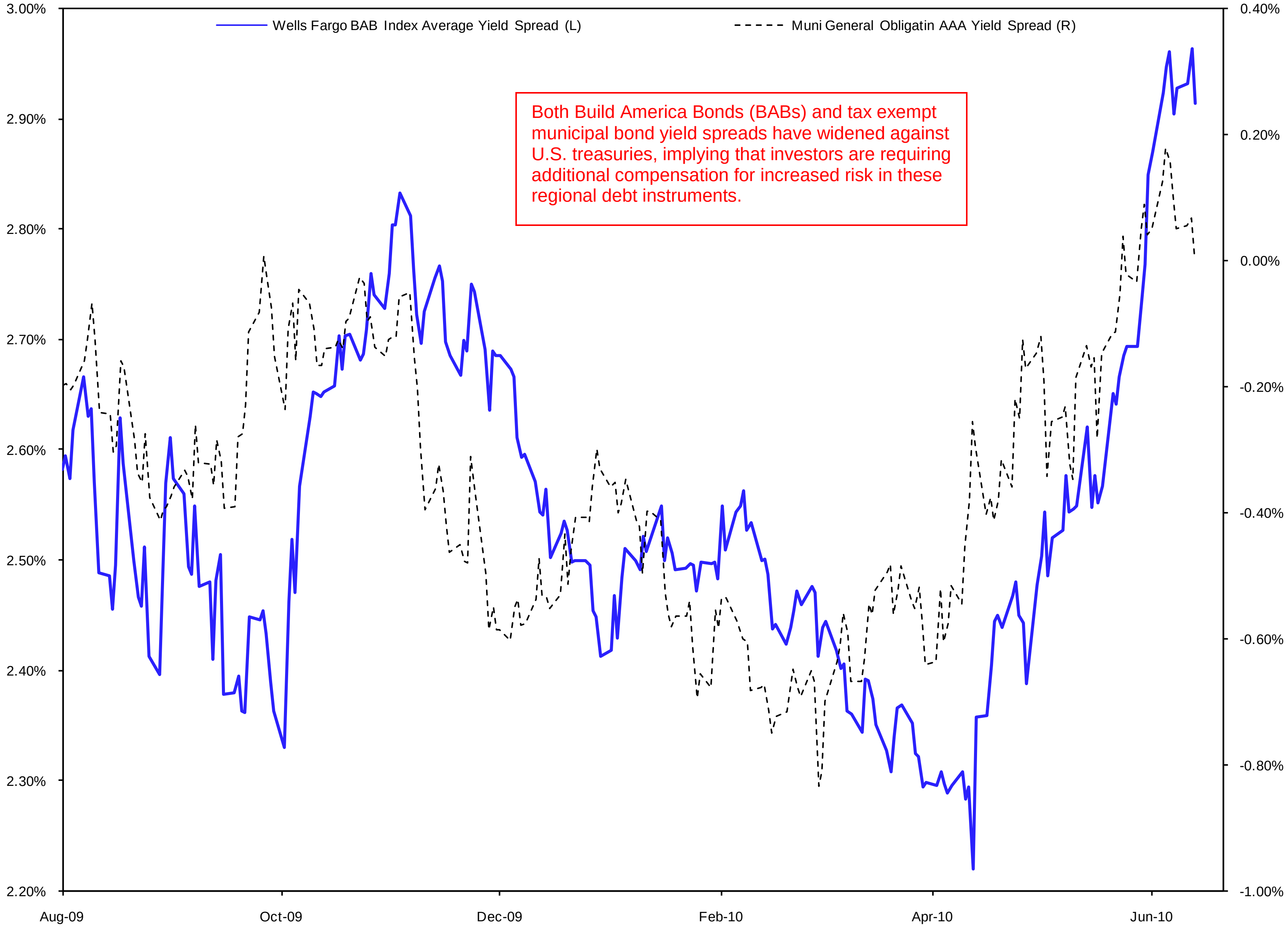

Net State Legislated Tax Changes as a % of Previous Year Tax Collections (and in $billions)
(annual, estimated through FY-11)

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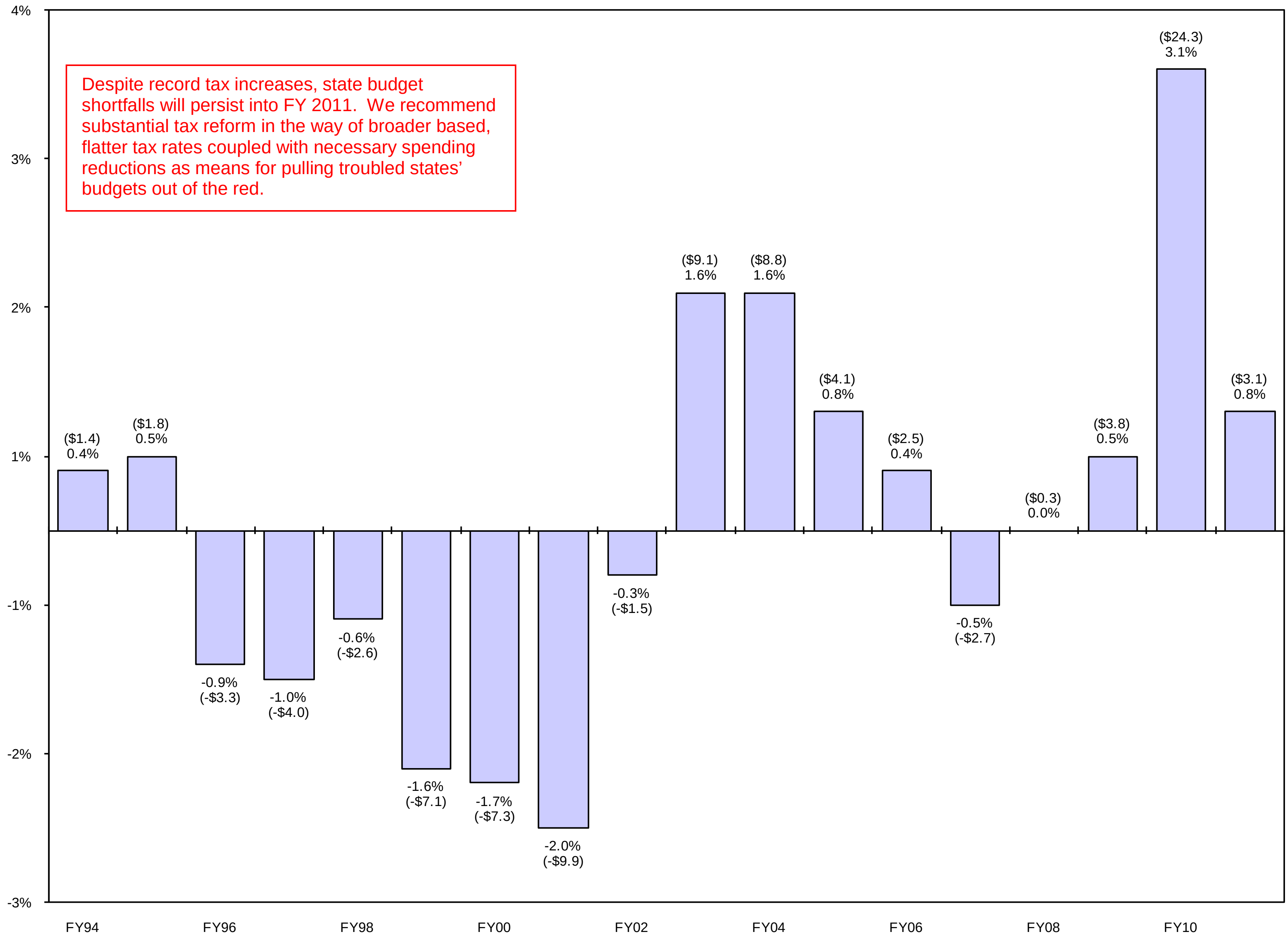

Illinois State Credit Default Swap Spread
(daily, basis points, through 07-07-10)

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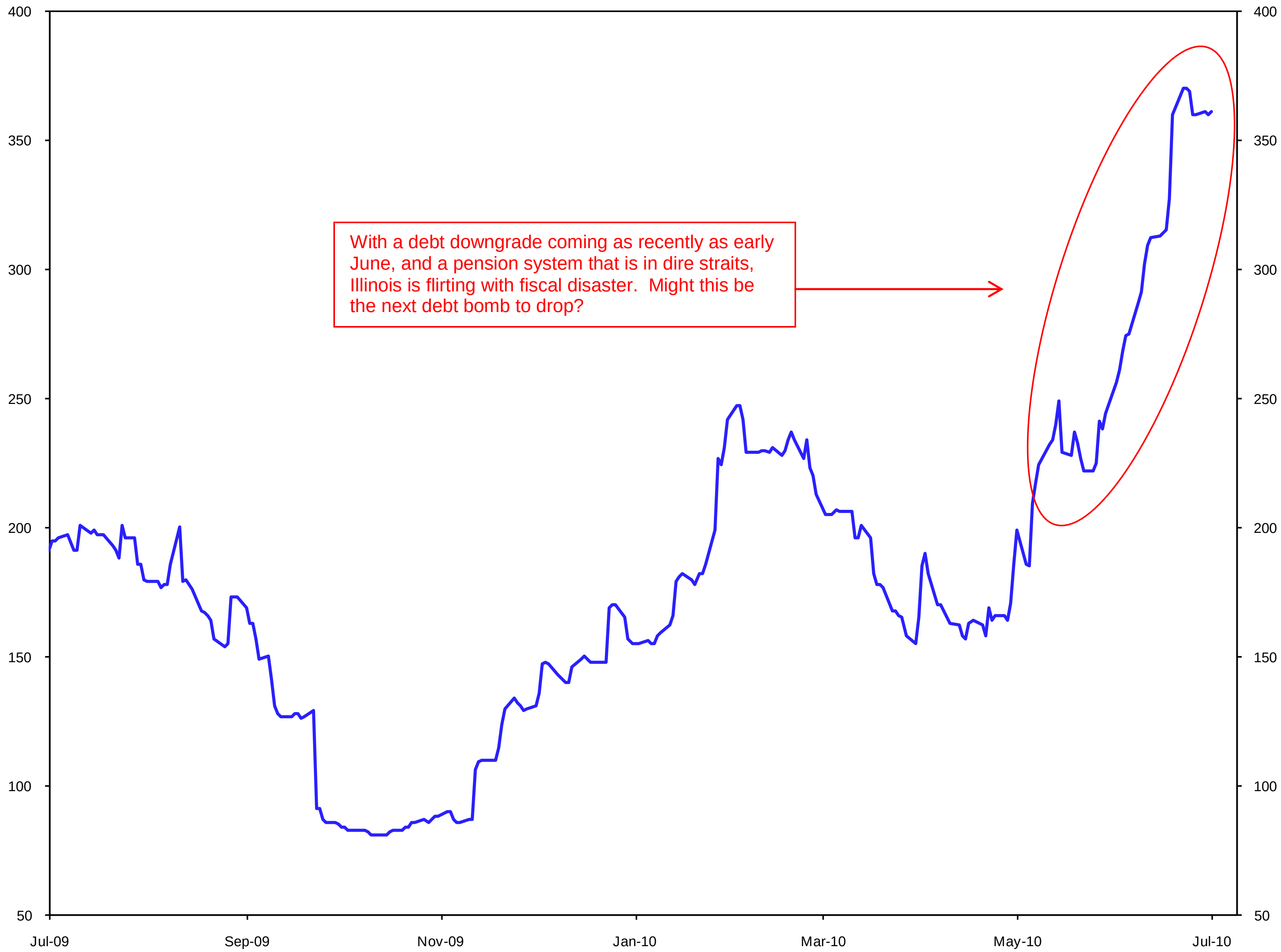

Zloty Exchange Rates: PLN/USD and PLN/EUR
(daily, 07-07-09=100, through 07-07-10)

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