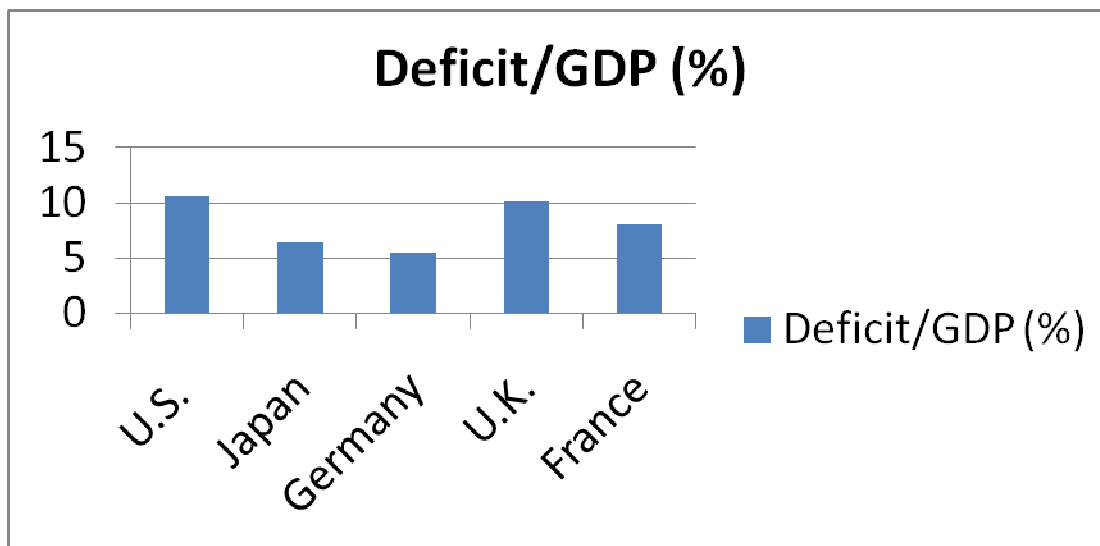




Perhaps the most significant debate facing U.S. economic policymakers is whether they should focus on unemployment or deficits. Paul Krugman, Nobel laureate, argues in the *New York Times* that the U.S. is in the “early stages of a third depression” because the U.S. and Europe are approaching a Japan-style deflationary trap. The real estate market continues to be fragile, unemployment is stubbornly high and governments are cutting spending. His policy prescription is more federal stimulus spending.

The alternative view, endorsed by the majority of G20 countries at their June meeting, is that governments should reduce their budget deficits and get their own fiscal houses in order. Government spending is viewed as a tax on productivity. Due to limits on capital availability, higher government spending effectively replaces private-sector spending which is the long-term source of job creation. In this view, the policy prescription is lower government spending. The federal deficit equaled 10.6% of GDP in 2010, higher than most G20 countries who have agreed to cut deficits in half by 2013. The following chart shows this relationship for several of the G20 countries. Who do you side with in this debate?



Breaking News

- **John Dugan, Comptroller of the Currency, announced that he will leave the OCC on August 14, the end of his term.**
- **Police in Venezuela arrested two individuals for spreading false rumors on Twitter about the nation’s banks. The government claims that they intended to destabilize the banking system. Officials have closed 12 Venezuelan banks since November 2009.**

- **Bank of America disclosed that it inappropriately hid \$10.7 billion in debt from its quarter-ending balance sheets in 2007-2009. It did so by classifying 6 short-term repo transactions known as ‘dollar rolls’ as sales when they were actually borrowings. The effect was to remove assets from the balance sheet and thus lower reported leverage. The bank claims the actions weren’t intentional and had no material effect on earnings. Earlier this year a bankruptcy-court examiner reported that Lehman Brothers moved \$50 billion of assets off its balance sheets in similar fashion. The SEC subsequently required several large institutions to review and report on their repo accounting.**
- **The FDIC closed four banks last Friday bringing total failures to 90 in 2010. In 2009, 140 banks failed. The four banks had combined assets of \$1.13 billion with the smallest, Ideal Federal Savings in Maryland, with just \$6.3 million. The estimated cost to the insurance fund is \$160 million.**

Deal of the Day

Would you buy these bonds? The state of Illinois has indicated it will soon offer \$900 million in Build America Bonds (BABs) maturing in 2035. The proceeds will be used to finance capital projects, including roads and bridges, and should create an estimated 20,000 jobs. BABs are taxable municipals which are attractive to qualifying issuers because the federal government pays 35% of the interest expense. Investors pay income taxes on all the interest received. These bonds are general obligations backed by the state’s full faith, credit and taxing authority.

Through the first 6 months of 2010, Illinois issued \$7.8 billion in new debt. In mid-June, it issued \$300 million of BABs maturing in 2035, also for capital projects, with the bonds priced to yield 7.1%. Moody’s subsequently lowered its ratings on Illinois bonds to A1 while Fitch lowered its ratings to A-. Even though long-term rates have fallen since June, the new bonds are expected to carry yields around 7.15%, or 3.4% more than a 30-year Treasury. Illinois has an estimated \$6 billion in unpaid bills from the last fiscal year and its projected deficit for fiscal 2011 is \$13 billion. The state also needs to make a \$3.7 billion payment to cover pension obligations and the Governor has proposed issuing bonds to cover this payment. It’s fascinating that these bonds still carry an investment grade rating.

Economic News

Concerned about job security, outstanding debts and the slow growth economy, many consumers are reducing borrowing. This past week, the Fed reported that individuals reduced non-mortgage debt by \$9.1 billion in May following a \$14.9 billion April drop. The consumer savings rate, in turn, increased to 4%, its highest level in the past 12 months. Consumer spending is a key driver of growth and any slowdown will dampen the magnitude and timing of a recovery. It appears that consumers now rely more on disposable income rather than asset values (home equity, pension & retirement savings) when making spending decisions.

Upcoming Events

- **2nd quarter earnings reports begin in earnest today. JPMorgan reports Thursday with Bank of America, Citigroup and GE reporting on Friday.**
- **The Census Bureau reports retail sales on Wednesday. Retail sales do not include spending on services but are widely viewed as a strong indicator of consumer spending.**