

**December 22, 2010**

# 2011 Global Outlook and Forecasts

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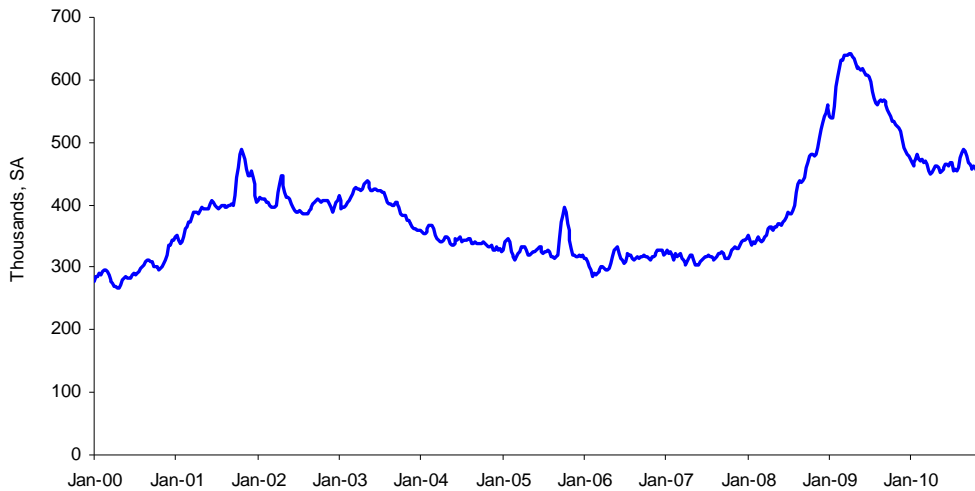
We expect 2011 to be a year of course corrections as countries deal with problems caused by the emergency responses to the 2008 crisis. Many of our 2010 themes should continue into 2011:

- Moderate U.S. recovery from a low base with neither a V nor a double dip; structural headwinds from the massive weak-dollar transfer of U.S. capital and know-how abroad and the burden from sprawling new regulations in health care, environment, financial services and labor.
- Above-consensus U.S. consumption growth driven by pent-up demand more dependent on jobs than on debt burdens, savings or the wealth effect;
- Structural changes -- spending cuts, labor mobility, currency policy, tax code -- will be a key variable in country outperformance; the U.S. was one of the structural laggards in 2010, though there was a sudden improvement on the federal spending outlook in December making U.S. federal spending policy a key variable in the dollar and commodity prices;
- Emerging markets growing fast, with China again avoiding a hard landing;
- The rolling debt crisis will continue, hitting U.S. states and municipalities hard. But it shouldn't have much impact on the U.S. outlook because muni debt won't infect other debt markets much and banks aren't very exposed. The muni market is individual rather than commoditized, short-selling is hard and city debt will consolidate into state issuance;
- We expect debt issuance to further consolidate through big issuers (U.S. Treasury, Germany, big corporations). In the short-run this is stabilizing; but it biases the capital allocation process toward governments and big corporations.

In the U.S., we think jobless claims and auto sales will be good indicators of the ongoing acceleration in the economy. We maintain our 3% real GDP forecast for the fourth quarter of 2010 and look for 3%-3.5% growth in 2011.

- Weakness in small business hiring remains a dampener on growth and is reflected in still-elevated jobless claims. If jobless claims break meaningfully below 400,000 in the first quarter of 2011 signaling quicker rehiring, we'll raise our expectations for auto sales and real GDP.

## Initial Unemployment Claims – 4 Week Average (last obs. December 11, 2010)

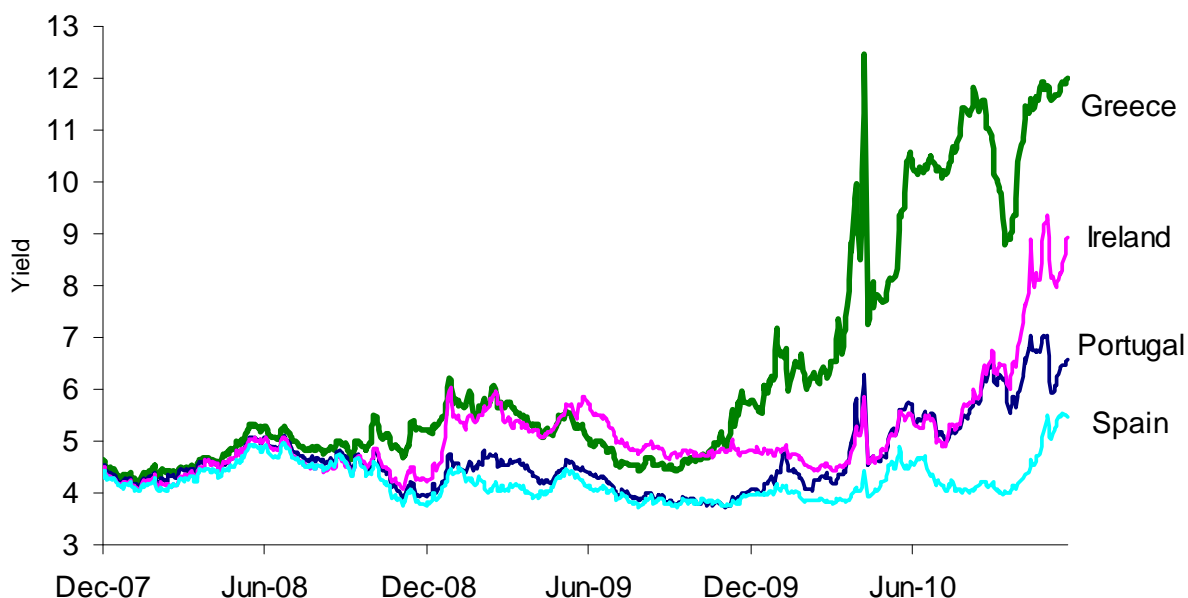


Source: Bureau of Labor Statistics; Encima Global

In the European Union, we think the stronger countries can continue participating in the global recovery without suffering too much drag from the weaker countries.

- We expect the high-yield countries in Europe to remain reactive to the debt crisis rather than proactive. This is a continuation of 2010 and points toward a Greek debt restructuring (we think non-traumatic). Due to Spain's heavy issuance calendar and the exposure of European banks to Spain, we expect some form of EU protection or bailout for Spain later in the year, without too much global impact.

## Select European Yields (last obs. December 22, 2010)

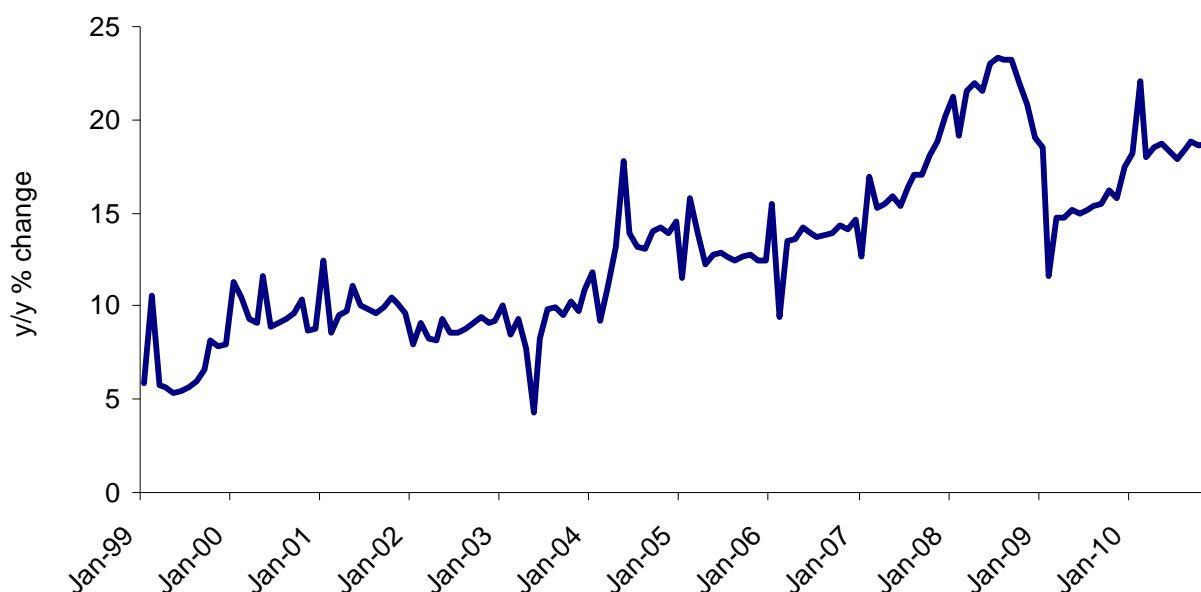


Source: Bloomberg; Encima Global

In Asia, we expect continued fast growth in China, India, and much of emerging Asia, with Japan participating more.

- Heavy capital inflows from the U.S. should continue as the U.S. dollar weakens steadily against the yuan and other Asian currencies even if the dollar strengthens against the euro and yen (as we expect in the event of federal spending cuts);
- China can delay the inflation problems using its standard techniques – higher reserve requirements, imports to meet shortages, commodity acquisitions worldwide, price controls, export controls, etc. Real growth will probably be slower than 2010's 11%, but still very fast as domestic consumption continues rising.

### China's Nominal Retail Sales Growth (year-over-year, last obs. November 2010)



Source: Bloomberg; Encima Global

### Other Predictions for 2011

- U.S. nominal growth rises. Currently 4.5% year-over-year, it may top 5.5% for the first time since 2006, but with unemployment still above 9%, double the 4.5% rate in 2006;
- Fed winds down. No QE3, no purchase of muni bonds or any other type of assets. Possible reduction in Fed's \$75 billion per month purchases of Treasury bonds in response to two FOMC dissenters (Fisher and Plosser) and falling jobless claims;
- Around May, an increase in the \$14.3 trillion federal debt limit, with medium-sized fiscal restraint attached, enough to strengthen the dollar some and push commodity prices down at least temporarily;

- Though U.S. policies are risky – very short federal debt maturity, Fed's QE2, weak dollar and high gold price, federal mortgage mess, temporary tax code -- we don't expect a full-blown dollar or federal debt crisis or a generalized commodity panic. Bond and currency vigilantes will hit smaller, weaker debtors first.
- Rolling debt crisis: Europe won't issue euro-wide bonds, instead muddling through one country crisis at a time; big rise in U.S. muni defaults and restructurings, but without much contagion to Treasuries or corporate debt and only negligible impact on U.S. GDP;
- Central banks provided plentiful liquidity in 2010 (though U.S regulators maintained the credit crunch on small businesses). Lending growth by foreign banks should slow some in 2011 as China and other emerging markets respond to inflation problems and excess liquidity and Europe reassesses its stress tests.
- Markets in 2011: most world equities higher; U.S. equities outperform, though not by as much as in 2010. Assuming U.S. spending restraint and Fed wind-down, dollar strengthens some, gold and oil weaken, and Treasury yields move only slightly higher.

### Key U.S. Upside Variables

- The amount of U.S. federal spending cuts in the March 2011 continuing resolution and in the May increase in the debt limit. If the spending cuts are large or actually slow the long-term spending path, we think the dollar will strengthen materially and commodity prices fall. For now, the consensus has priced in only small reductions in the bloated FY2010 spending levels and little in the way of long-term spending restraint. We emphasize the wide range of settling points for the dollar and commodity prices after such a large devaluation.
- Similarly, an early Fed wind-down of QE2 would trigger substantial dollar strength, break the commodity price uptrend and cause greater investment of global capital in the U.S. We think unemployment would fall faster than consensus, as it did in the strengthening-dollar 1990s.
- U.S. bank regulatory policy. Banks already have over \$1 trillion in excess reserves deposited at the Fed, with the Fed in the process of borrowing another \$600 billion from them to buy Treasury bonds. If Washington's bank regulators were to change their policies in a way that encouraged the banks to lend some of this excess, it would bring faster job growth and small business growth. It would also lead to materially higher bond yields and an increase in the Fed interest rate paid on excess bank reserves.

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