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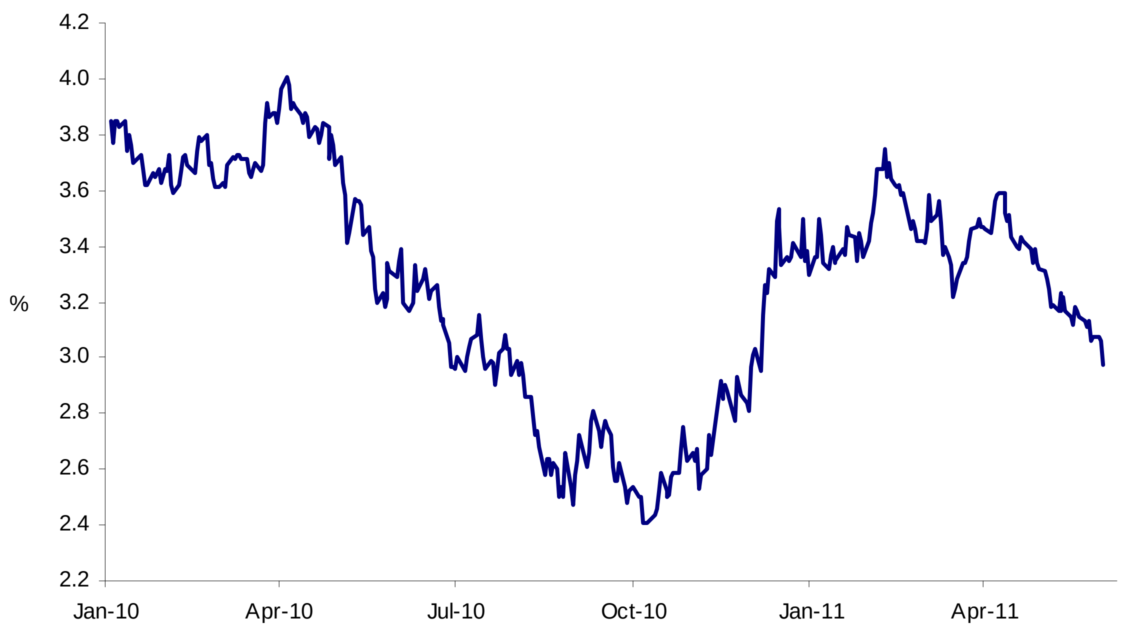
Substantial 2011 Soft Patch; Lowering Second Qtr GDP but Not Second Half

Economic data keeps weakening and the ten-year Treasury yield has fallen below 3% as it did during 2010's worries about a double-dip recession. While some of the dip in yields is growth related, we think it also reflects a temporary bond squeeze due to:1) the Fed's decision not to taper its final May and June QE2 purchases whatever the yield; 2) worries that the debt limit will curtail Treasury auctions; and 3) Pimco's widely-reported short position in Treasuries.

10 Year U.S. Treasury Yield (last obs. June 1, 2011)

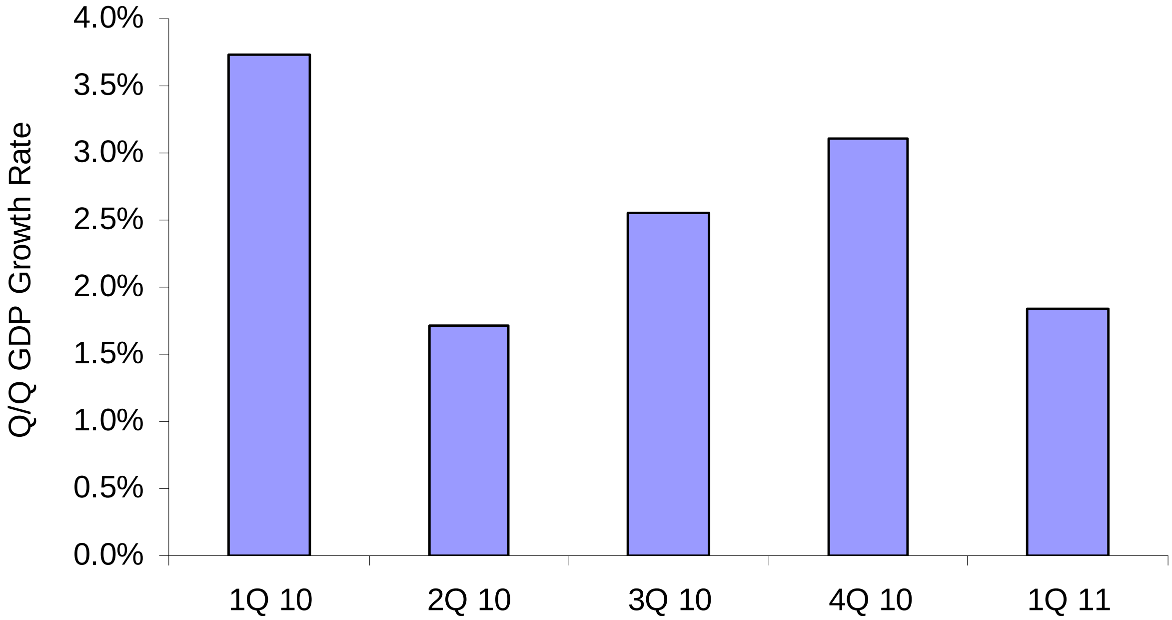


Source: Bloomberg; Encima Global

- The 2011 U.S. economic slowdown is worse than we expected and will probably be as substantial as the 2010 soft patch. Growth has slowed from 3.1% in the fourth quarter of 2010 to 1.8% in the first quarter and perhaps also 1.8% in the second quarter, held down by weak auto production (our Q2 forecast had been 3.0%.)

- In the 2010 soft patch, growth fell from 5% in the fourth quarter of 2009 to 3.7% in the first quarter of 2010 and 1.7% in the second quarter, in part due to caution on inventories, before picking up to 2.6% in the third quarter and 3.1% in the fourth.

GDP Q/Q (last obs. Q1 2011)



Source: Bureau of Economic Analysis; Encima Global

- After the first-half 2011 soft patch, we still look for 3.5% real growth in the second half of 2011 and don't think equities will suffer as big a hit as in 2010 (when the S&P fell 16% -- from 1217 in late April 2010 to 1023 in early July 2010.) The S&P fell 7% peak to trough in the February-March decline and, from a higher level, 4.3% in the May selloff.

S&P 500 (last obs. June 1, 2011)

Source: Bloomberg; Encima Global

We think equities face a more defined set of problems in 2011 than 2010 and will be better able to see through this year's slowdown.

- The 2010 problems were more open ended including scary daily pictures of the underwater oil spill, widely publicized double-dip recession worries that extended to the Fed, the scheduled year-end mega-tax increase and uncertainty about whether Germany would organize a bailout for Greece to keep it in the euro.

- In contrast, the current wall of worry, while tall, has a known timeframe for problems – the end of QE2 on June 30, the debt limit problem in July and August, Greece's next bailout tranches, and the relatively limited tax increases currently scheduled for December.

- In the longer term, equities have to deal with deeper concerns about average U.S. GDP and profit growth -- whether the 'new norm' is 2%, which we think is unsustainable even in the near term, or something like the 2.8% average growth we expect (and think would be enough to kick the national debt problems down the road hard enough to pass them on to future Administrations.)