

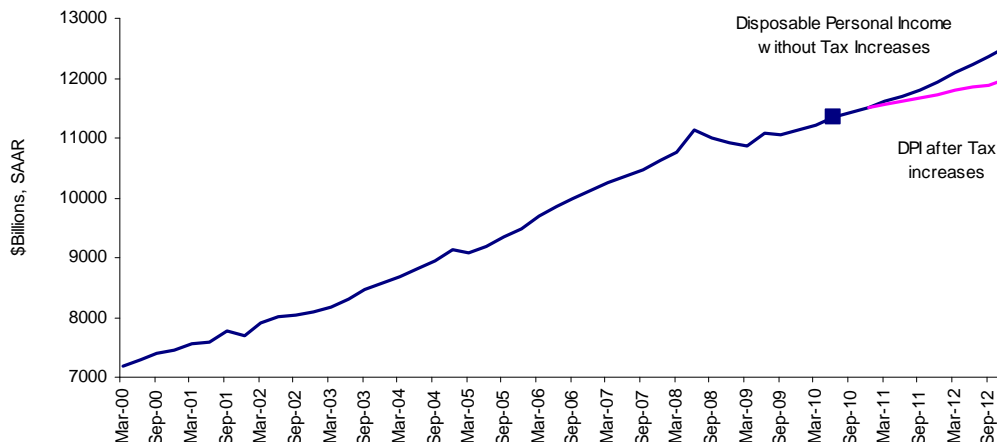
October 29, 2010

Big Tax Increase: Neg Q1 GDP?

We don't think markets or consensus economic forecasts have fully appreciated the size, likelihood and destructiveness of the coming tax increase.

- The focus is still on quantitative easing (ineffective, hyped and more than priced in) and Republican gains in Congress (large, but probably can't stop the tax increase). **By December, we think focus will have shifted almost totally to the haymaker tax hike coming down the pike.**
- A client told us yesterday that we are the only one of their mostly bullish thirty contacts harping on the tax increase (eg Get Ready for Tax Chaos on October 14). The argument is that even if the increase goes through it will be reversed retroactively in 2011. (Our view: maybe some reversal by mid-year, but most increased tax payments will already have been made in the first half.)
- One outside survey of investors taken earlier this week found **over half expect all of the Bush tax cuts to be extended**, while only a quarter think Obama will move to the center. Our view: **the Bush cuts can only be extended if Obama makes a major move to the center, which is unlikely.** We think 25% is optimistic both for an Obama switch and a tax cut.
- Though not in the press yet, **major New York brokerages have begun plans to pay bonuses in December** rather than the normal January cycle in order to beat the tax hike. We expect some deferred compensation plans to be unwound. With the gift tax at "only" 35%, some large estates of the elderly will make taxable gifts in December to avoid future estate taxes.

Disposable Personal Income (last obs. Q2 2010, forecast to Q4 2012)

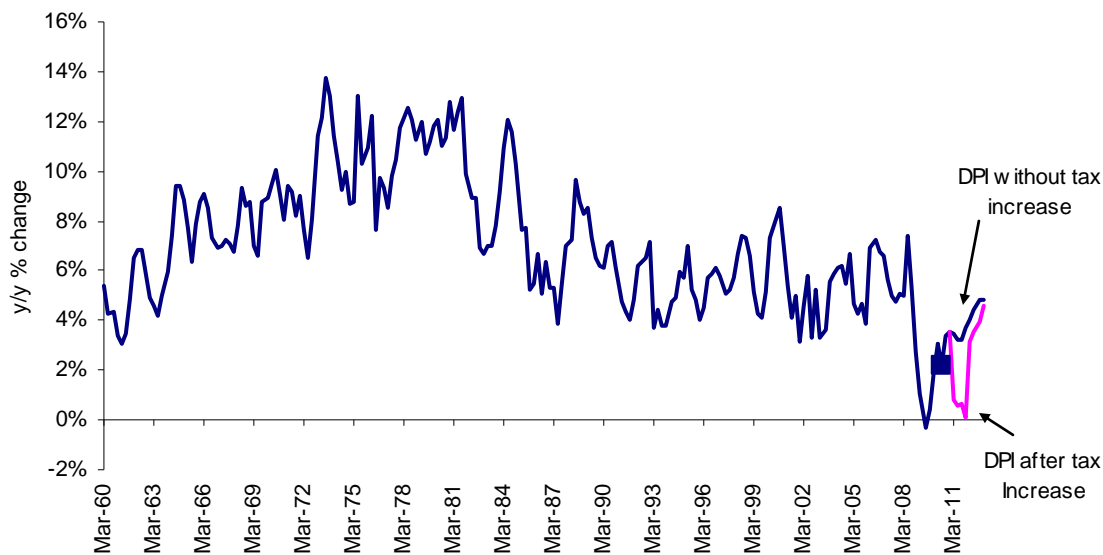


Source: Bureau of Economic Analysis; Encima Global

Economic Impact

- **We're raising our estimate of fourth quarter GDP to 3.5%** (was 3%) based on a timing shift in income, our expectation of a good Christmas season, pentup demand, the gradual improvement in the labor environment and strong corporate profits. **We'll be lowering our first quarter estimates** by a larger factor to take account of the tax increase.
- Disposable personal income won't grow in 2011 if the tax increase isn't reversed, but reversing it means having the two parties reach agreement.

Disposable Personal Income Y/Y (last obs. Q2 2010, forecast to Q4 2012)



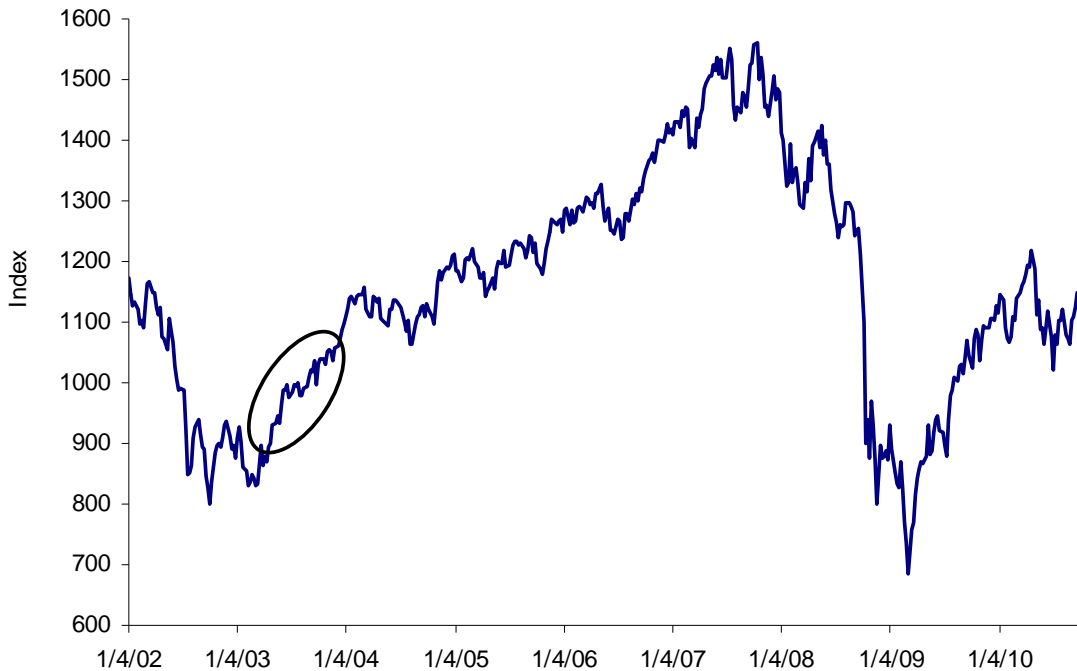
Source: Bureau of Economic Analysis; Encima Global

Equity Impact

From an equity standpoint, the tax increase reduces asset values directly (by increasing the tax on dividends and capital gains); reduces expected earnings from the supply-side (the increase in top marginal rates reduces national output); and reduces expected earnings from the demand-side (the increase in overall taxes decreases consumption).

- Adding to the burden on equity gains (which have been linked to the dollar in trading patterns since 2003), we think the new Congress will be more dollar-favorable than the old one. It will try to cut spending; it may object to the Fed's asset purchases; several likely new members openly support a stable or stronger dollar; and it may be unable to stop the tax increase which markets may at first take as dollar-favorable fiscal austerity.
- When the details of the Bush 2003 tax cut came out in the spring, equities began lifting off. GDP growth in the third quarter of 2003 was 6.9%. Some of this will reverse if the tax cuts expire.

S&P 500 (last obs. October 28, 2010)



Source: Wall Street Journal; Encima Global

Election/Lame Duck Update

The November 2 election will see a change in the composition of the Congress, but not much change in likely outcomes for the next year's legislative agenda.

- Our estimate is that Republicans will gain approximately 45 new House seats (result 223 R, 212 D), regaining the majority, and five new Senate seats for the GOP (result 46 R, 54 D) This is fewer Republican gains than current consensus.
- Millions of voters have already cast their votes. Early voting, absentee voting and mail voting (eg Washington state) mean that it is more difficult than ever to significantly alter outcomes with a last-week blast of commercials.

We believe that the lame duck session will do almost nothing except pass a Continuing Resolution or Omnibus Appropriations Bill to continue government spending into 2011 and leave the rest to the 112th Congress.

- Broad tax increase. The CBO estimate is \$6 trillion over ten years. There are 69 Bush provisions alone. \$2 trillion of the \$2.7 trillion from Bush is for family incomes below \$250,000. There are another \$3.3 trillion in non-Bush tax provisions including the alternative minimum tax and extensions of the R&D credit, ethanol credit, alternative energy credits and so on.

- High hurdle. To stop the tax increase in the lame duck, Congress needs 60 votes in the current, heavily Democratic Senate, and the President, to approve a complicated tax cut that can pass the House even though it increases the deficit. It's a very high hurdle.
- Hard to reverse. To reverse the tax increase in 2011, a likely Republican House would have to pass a bill acceptable to a Democratic Senate majority and President Obama. The bill would increase the deficit, especially if retroactive. We expect a complex House-Senate-President negotiation on a detailed "tax reform" extending into the middle of 2011. **In the meantime, markets and the economy will need to operate as if the tax increase is permanent.**
- **This leaves many tax issues completely up in the air including the alternative minimum tax, the estate tax, the R&D tax credits, solar and wind credits, Build America Bonds, the tax rate on dividends, and the more than 20% cut in Medicare reimbursements to doctors.**
- If there's an effort at a partial fix – say AMT, the "Doc Fix" for Medicare and the R&D credit -- the parliamentary reality on the Senate floor would kick in with arguments for the extension of the Bush tax cuts. We believe that the tax fight is unavoidable and that the Senate will have a very difficult time between Dec. 3 and Dec. 23 finding a 60 vote majority for much of a package, especially given the deficit scoring impact.

Meanwhile, the lame duck will also feature hearings on the mortgage mess, the expanding federal debt and the charges against Reps. Charles Rangel and Maxine Waters. In addition, the deficit reduction commission may focus more attention on deficit reduction, further complicating the lame duck session.

Notes: This email and attachment are confidential and intended solely for the use of the individual to whom they are addressed. Encima Global LLC does not accept liability for the content, or for the consequences of any actions taken on the basis of the information provided. The information is not necessarily complete, and we make no warranty as to its accuracy.