

August 3, 2011

Bond Yields Tanking More Than Economy

Treasury bond yields have fallen sharply and gold has hit another record this morning at \$1672 per ounce.

Gold Prices (last obs. August 3, 2011)

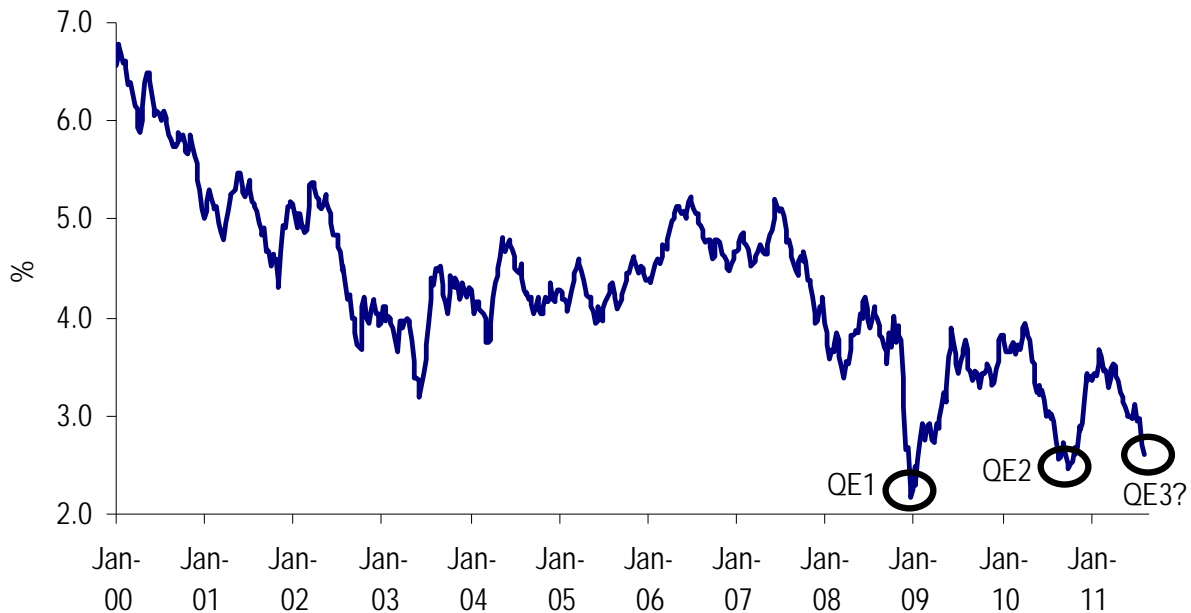


Source: Wall Street Journal; Encima Global

- We thought bond yields would rise after the debt limit increase because Treasury is preparing a slew of bond issuance, the near-term fiscal deficit is getting worse (as CBO's upcoming mid-session review will show), and super-loose U.S. fiscal and monetary policies remain entrenched. However, yields fell sharply, with **bond markets in the process of pricing in a deeper and longer soft patch or double dip than we expect.**
- Some Treasury bond buyers may be hoping to buy ahead of the Fed as they did very profitably before the Fed's QE1 MBS purchases and its QE2 Treasury bond purchases. We don't think this will work. At the August 9 FOMC meeting, we think the Fed will acknowledge economic weakness but will not open the door to QE3 even if job growth is weak on Friday. The latest GDP data shows **the ineffectiveness of QE2 – the more the Fed bought, the slower the economy.** GDP slowed from 3.8% in Q2 of 2010 to

2.5% in Q3, 2.3% in Q4 and 0.4% in Q1 of 2011. **Another major obstacle to QE3 is that the Fed would have to make the purchases very big to be credible.**

10 Year US Treasury Yield (last obs. August 3, 2011)

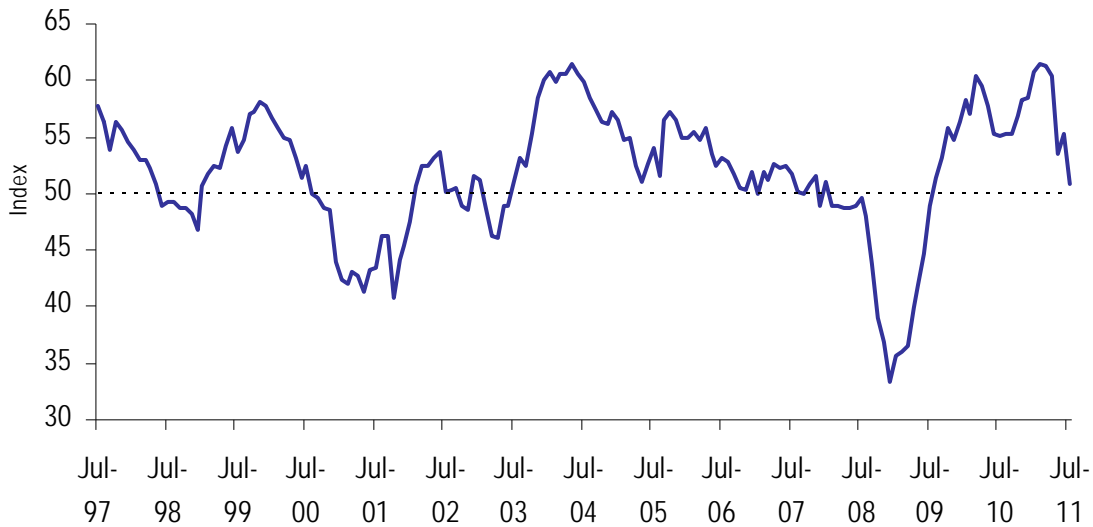


Source: Federal Reserve; Encima Global

We think the economy remains slow, but isn't tanking. First half GDP was revised down to a very weak 0.8% annual rate from the 1.9% expectation, making the 2011 soft patch worse than the 2010 soft patch. Yesterday's data confirmed that consumption and income remained weak in June, adding to the second quarter gloom from durable goods data.

- Monday's ISM softened to 50.9 for July triggering a deep equity sell-off and bond rally. The result, while weaker than expected, is consistent with 2.7% real GDP growth in Q3. (We lowered our forecast to 2.0% last week.)

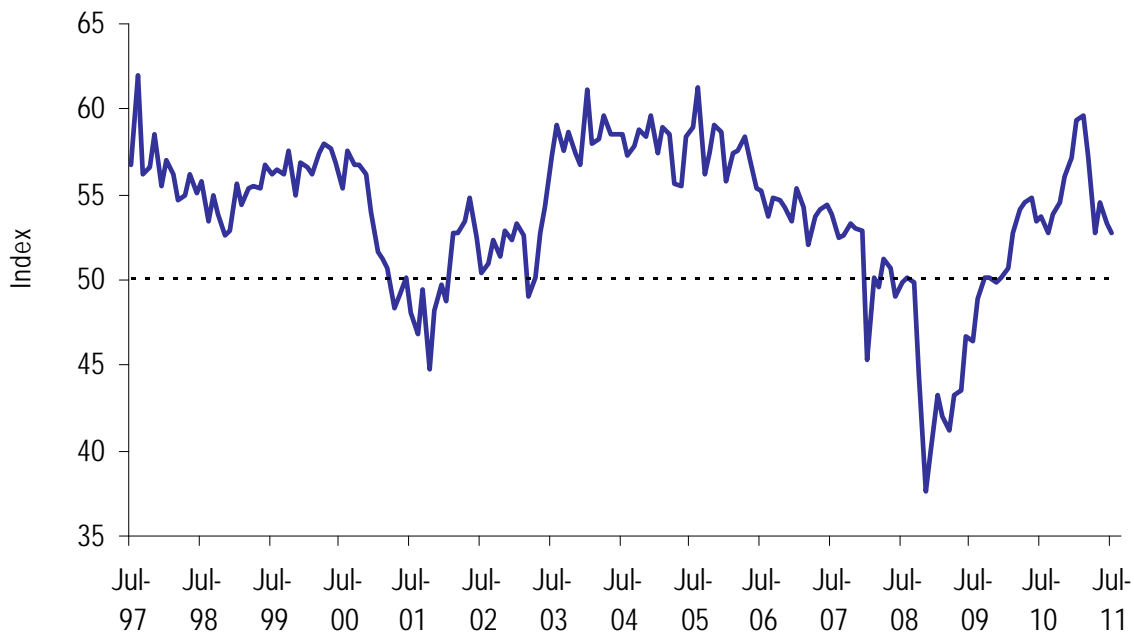
ISM Manufacturing Index (last obs. July 2011)



Source: ISM; Encima Global

- This morning's non-manufacturing ISM slowed to 52.7 in July from 53.3 in June, pointing to moderate growth but far below the V-shaped recovery that should occur under less interventionist federal policies given the depth of the 2008-2009 recession.

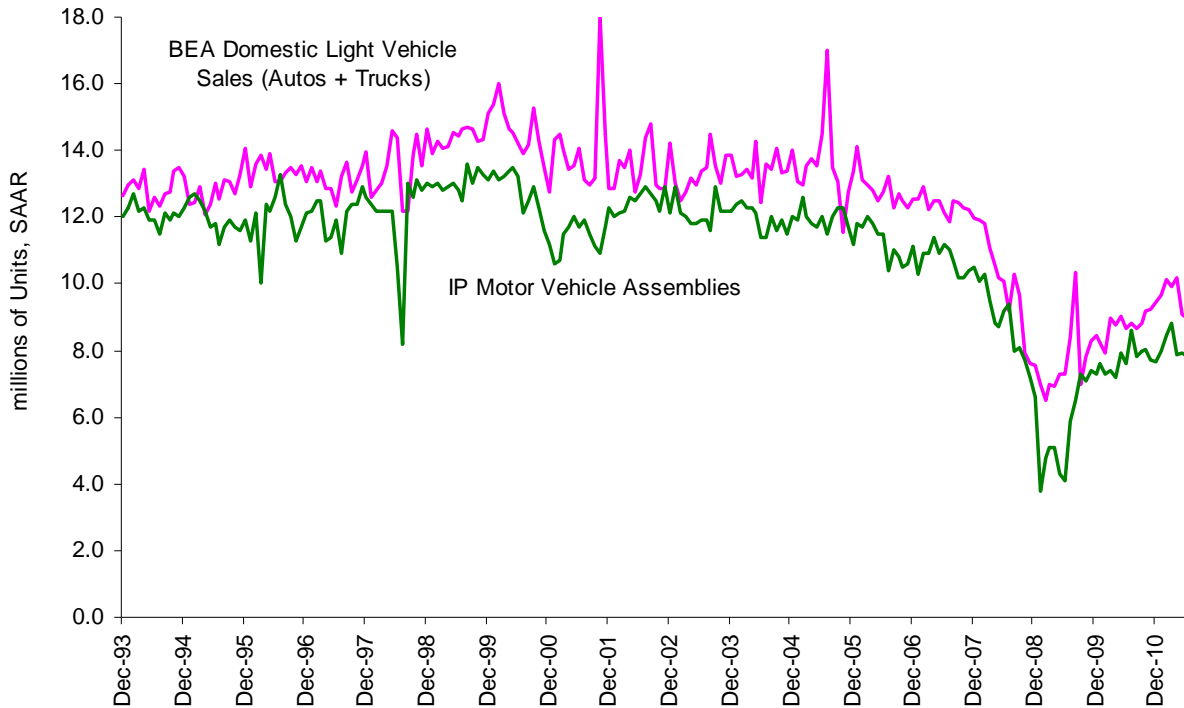
ISM Nonmanufacturing Index (last obs. July 2011)



Source: ISM; Encima Global

- On the positive side, July sales of domestically produced vehicles were stronger than expected and jobless claims have been coming down, both good indicators because they are hard data, not surveys or confidence measures.

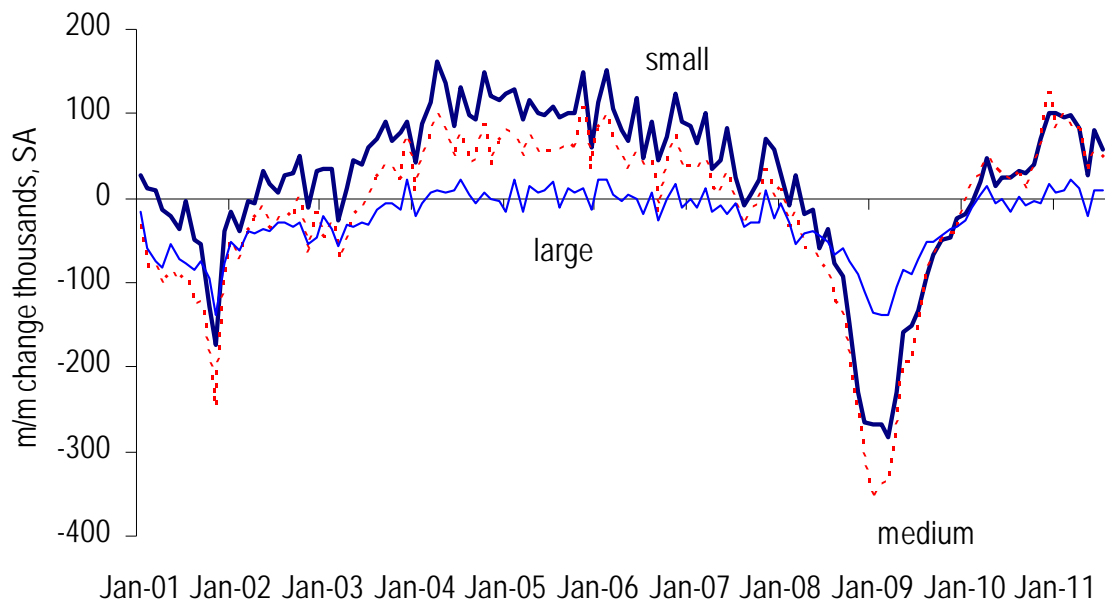
Auto Sales and Production (last obs. sales July 2011, production June 2011)



Source: BEA; Federal Reserve; Encima Global

- This morning's ADP data -- which picks up small business activity well and has been a good indicator of labor trends (though not the month-to-month variations in the Labor Department reports) -- showed private sector job gains of 114,000 jobs in July. June's strong gain was revised to a still strong 145,000 from 157,000. We stress that ADP results are based on actual data while the Labor Department data comes from surveys with much smaller sample sizes than ADP and suffers big subsequent revisions. In the July ADP report, the services sector matched the gains of the previous month at 121,000. The goods producing sector lost 7,000 jobs.

ADP Job Gains by Company Size (last obs. July 2011)



Source: ADP; Encima Global

We think markets are pricing in second half economic weakness more than the debt deal or QE3. This weakens equities, drives bond yields down and lifts gold, the harmful 2010 barbell asset allocation which reflects risks of instability or further monetary policy mistakes.

- The debt deal shows little sign of fiscal austerity. If it did, we think gold would fall. It also provides little chance that tax increases will emerge from the super committee and get passed by the House (though President Obama's reiteration yesterday of his preference for tax increases is a partial explanation for current financial market signals).
- If markets were pricing in QE3, the yield curve would steepen, not flatten. That was the pattern in 2010 when the yield curve flattened during the soft patch, then steepened as QE2 became a reality.

10 – 2 Year US Treasury Yield Curve Spread (last obs. August 3, 2011)



Source: Federal Reserve; Encima Global

- Our conclusion: the bond market is pricing in a double dip as it did in mid-2010. This is compounded by the shortage of bonds due to the debt limit fiasco. We think second half growth will not be as weak as bonds or equities have now priced in.

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