



# **Economic Chartbook**

## **July 2011**

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Please read the important disclosure information in the Addendum section of this presentation.

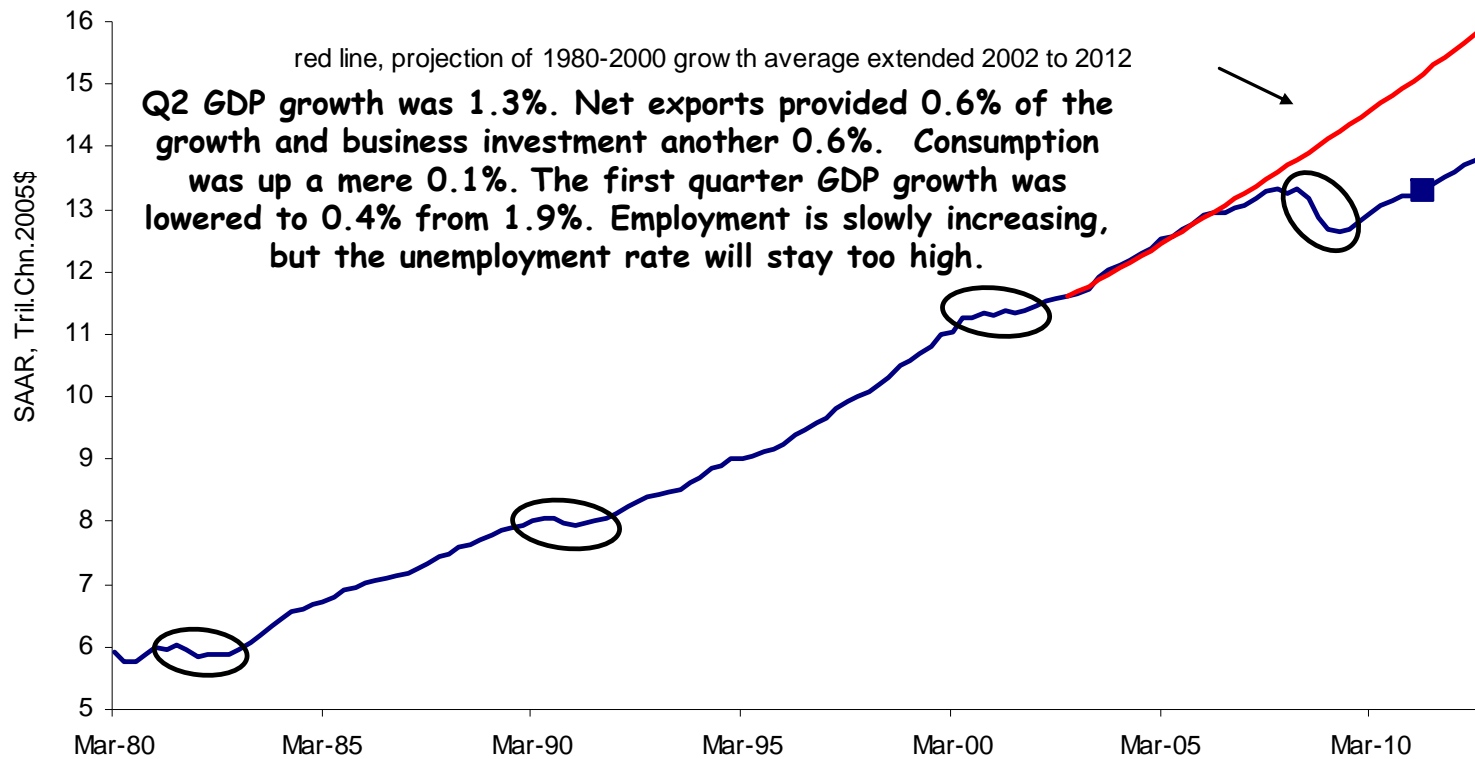
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## Economic Outlook

- **Most of the economic and policy news has been negative. First half growth was way below the “new norm” of 2% and the second half has started weak. We expect somewhat faster growth in the third quarter (2%) than the second (1.3%) based on auto production, business investment and exports.**
- **Jobless claims fell below 400,000. Corporate profits have been strong and expectations for second half profits continue to increase, not decrease, based on both top line growth, cost cutting and earnings abroad. China's hard landing hasn't materialized, with 9.5% growth in the second quarter despite the production crash in Japan and the U.S. weakness.**
- **U.S. bank lending is finally rising -- at a 5.4% annualized rate over the last 13 weeks with M2 growth accelerating sharply in the same period.**

# Real GDP Growing From a Low Base

(last obs. blue square Q2 2011, projected to Q4 2012)



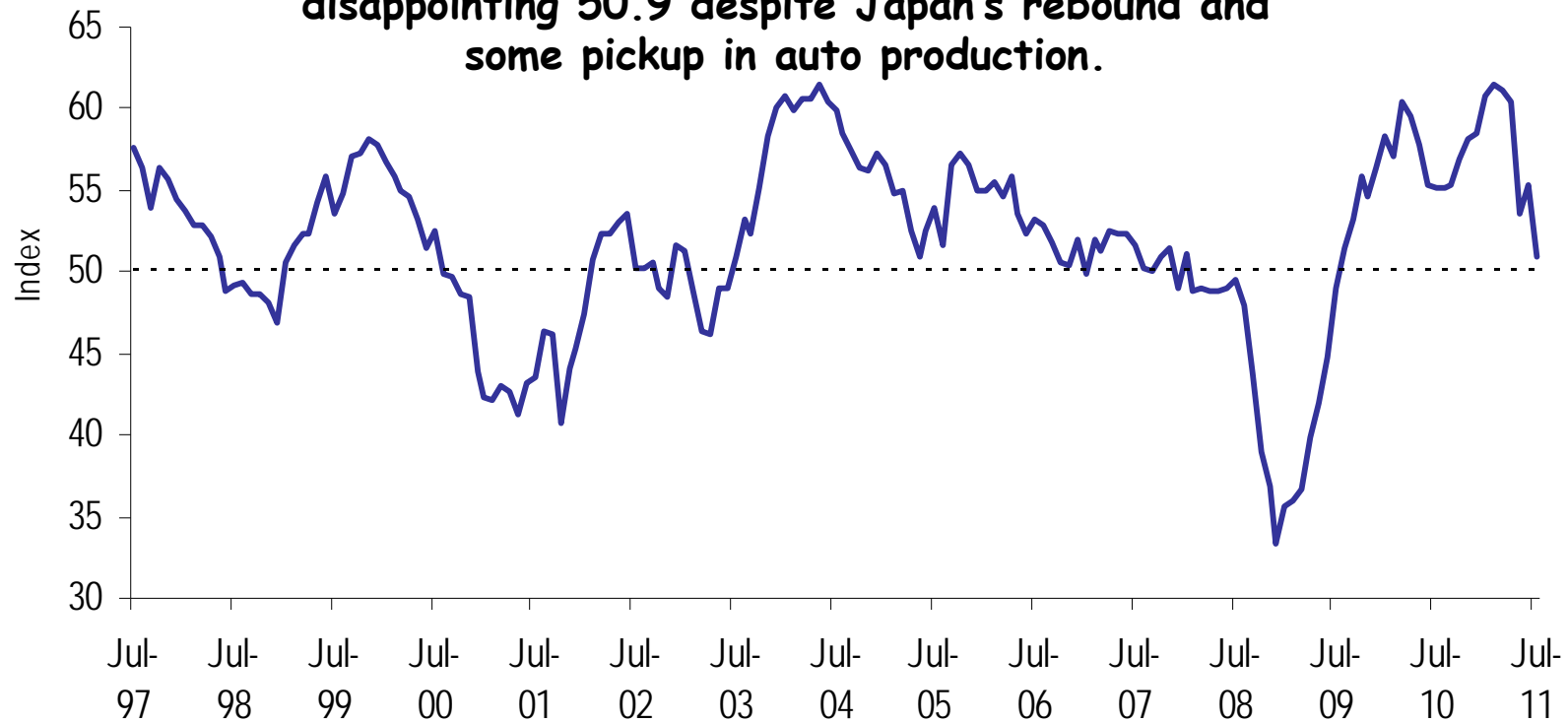
Source: Bureau of Economic Analysis; Encima Global



# ISM Manufacturing

(last obs. July 2011)

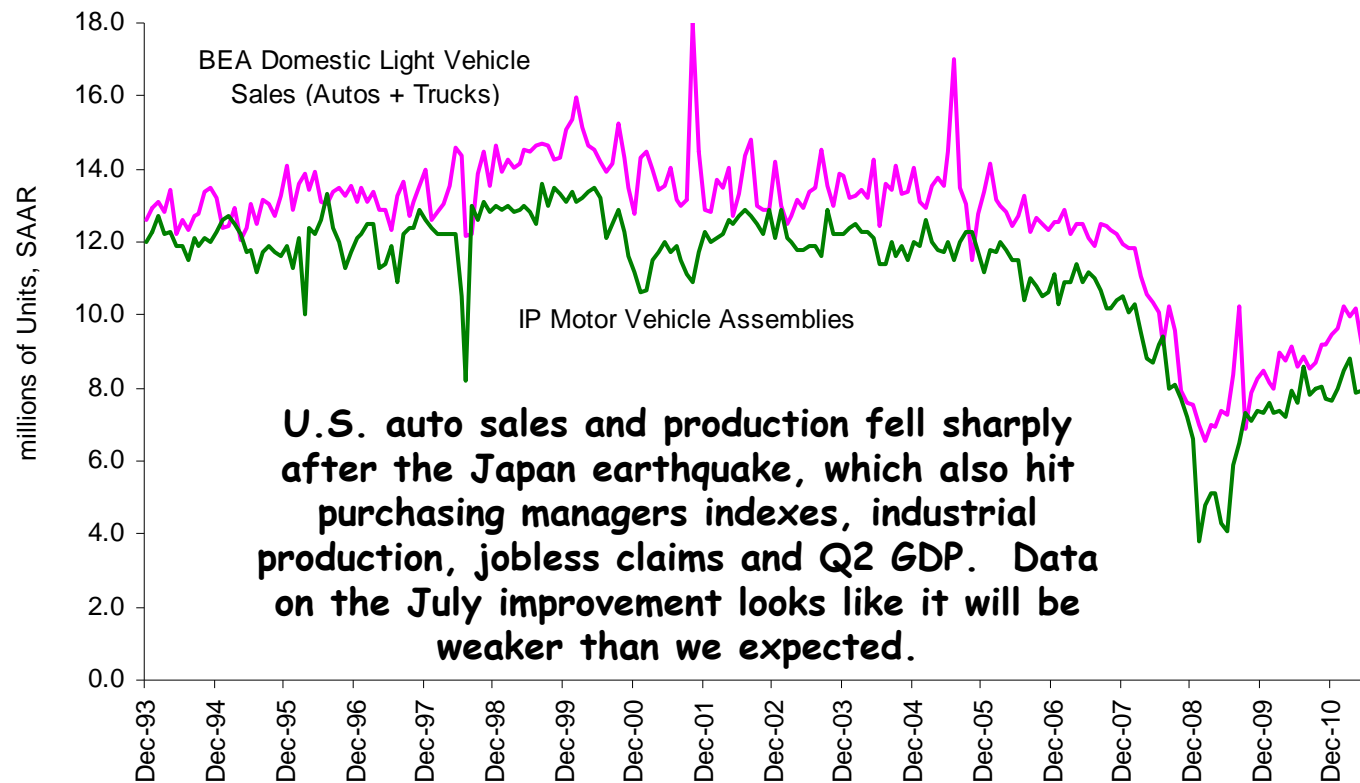
**ISM manufacturing for July fell to a disappointing 50.9 despite Japan's rebound and some pickup in auto production.**



Source: Institute for Supply Management; Encima Global

# Auto Sales and Production Rising

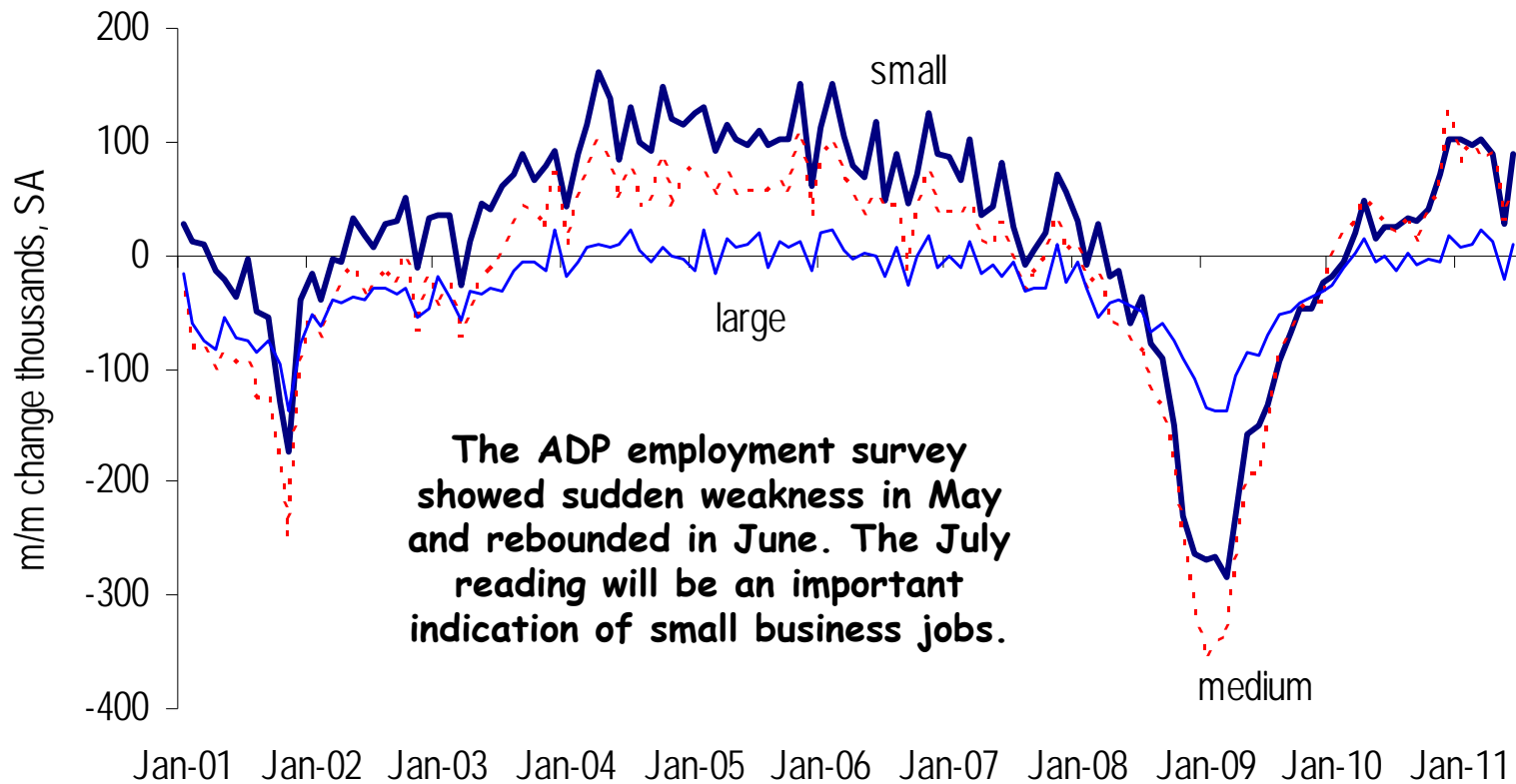
(last obs. June 2011, sales est. to July 2011)



Source: Federal Reserve; Bureau of Economic Analysis; Encima Global

# ADP Jobs Survey by Company Size

(last obs. June 2011)

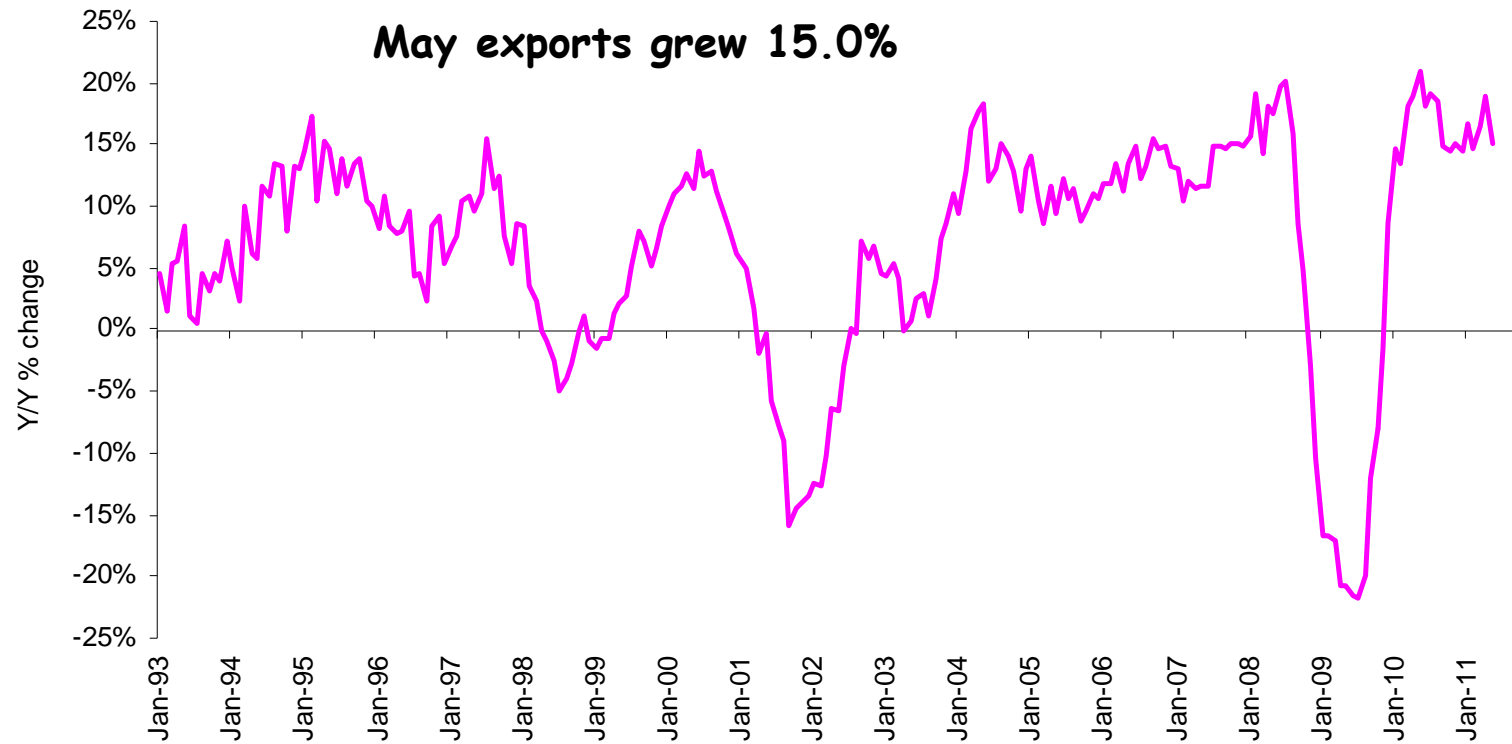


**The ADP employment survey showed sudden weakness in May and rebounded in June. The July reading will be an important indication of small business jobs.**

Source: ADP; Encima Global

# U.S. Export Growth

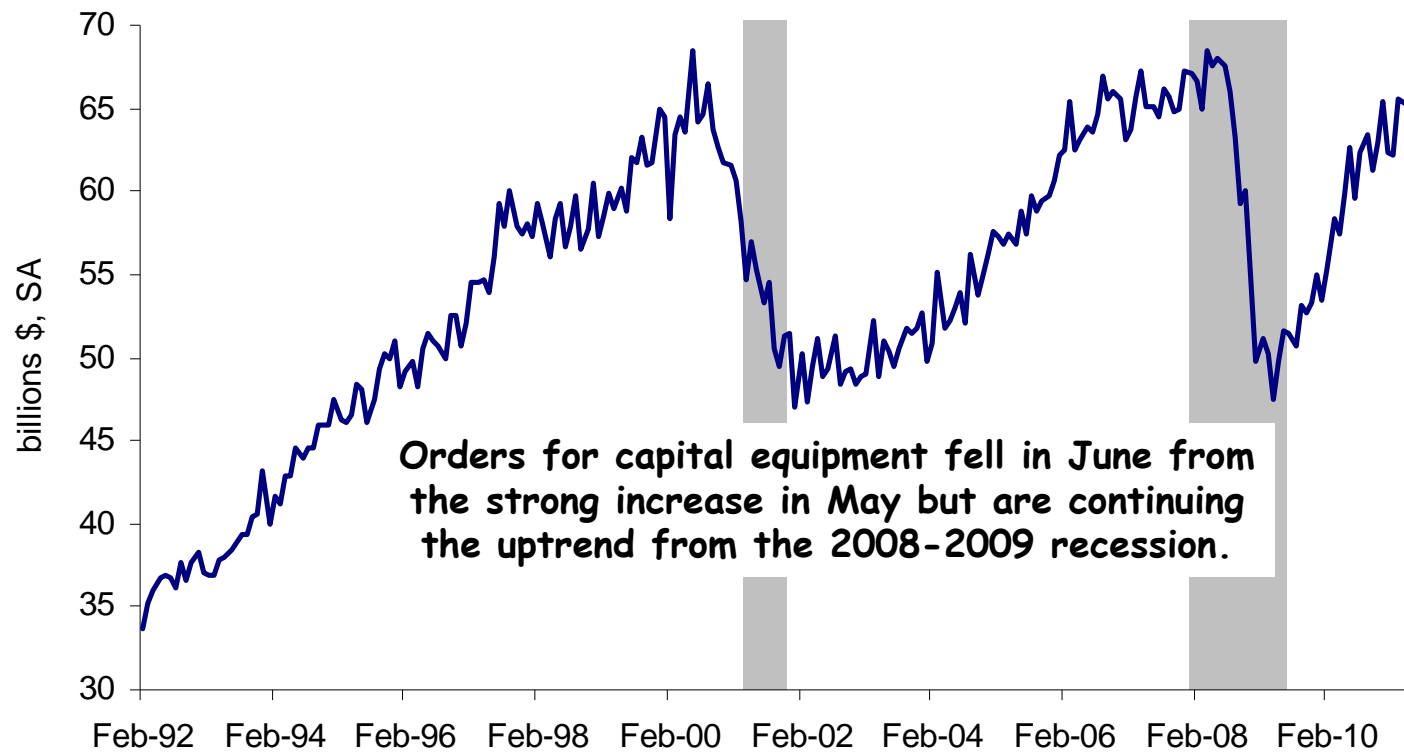
(year-over-year, last obs. May 2011)



Source: Bureau of Census; Encima Global

## Nondefense New Orders for Capital Goods ex Aircraft

(last obs. June 2011)

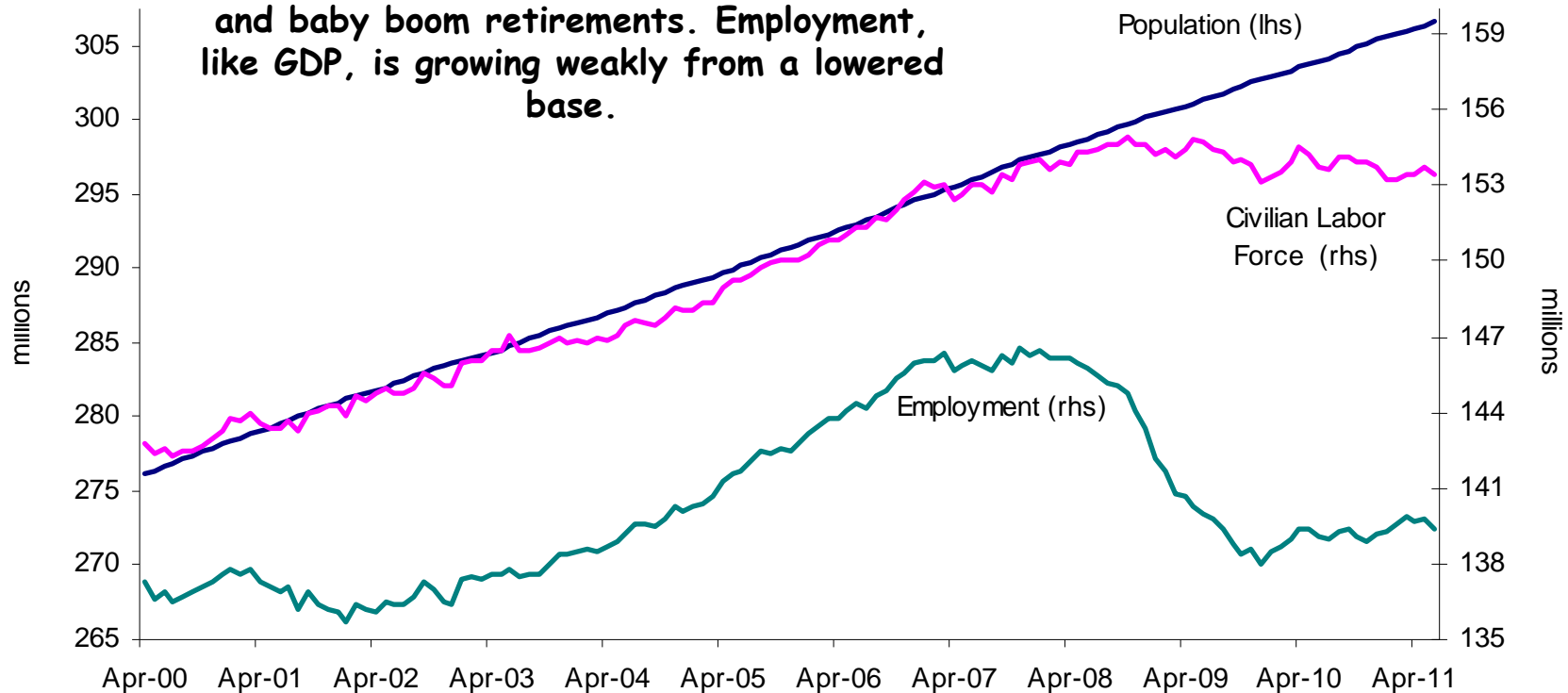


Source: Census Bureau; Encima Global

# Population, Labor Force and Employment

(last obs. June 2011)

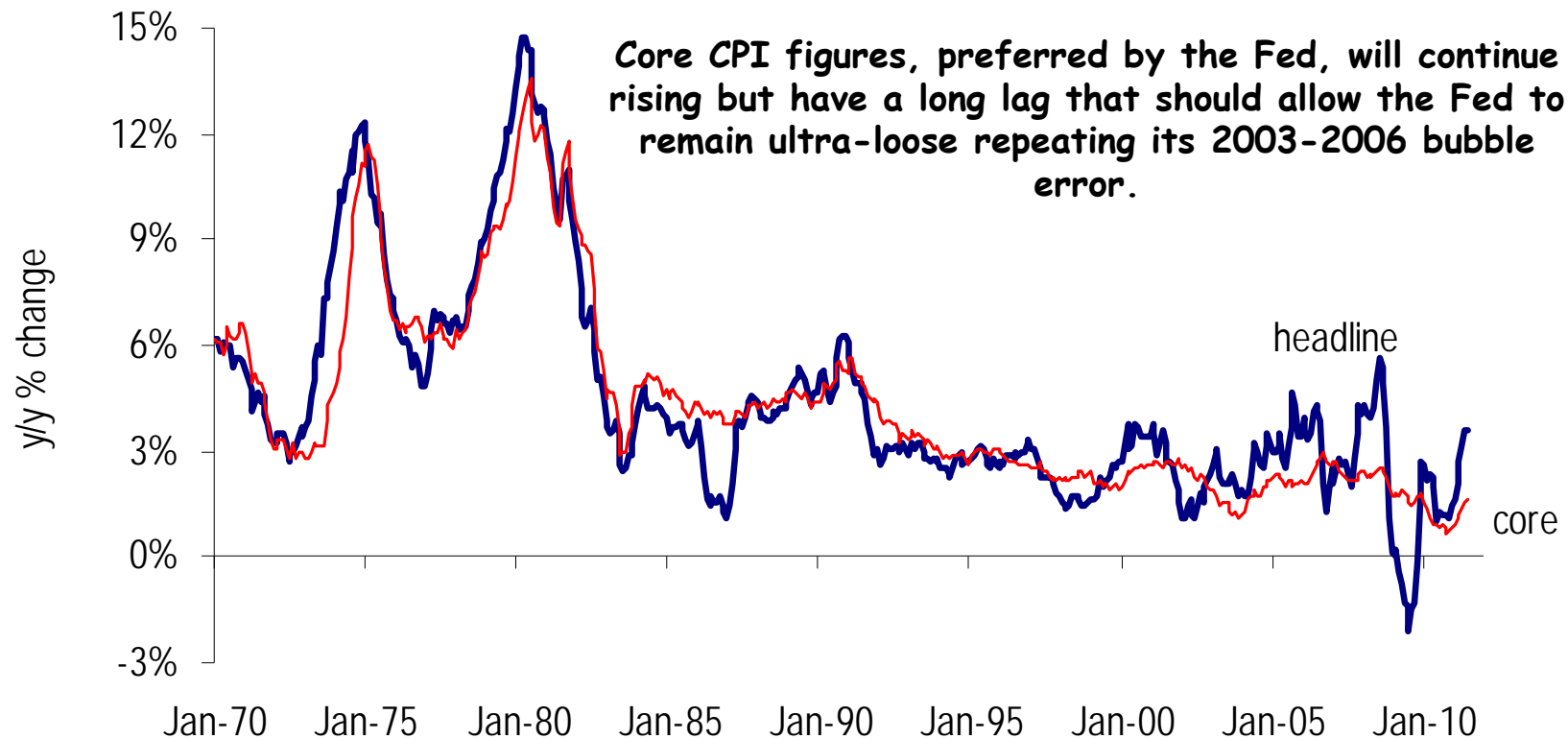
The civilian labor force has shrunk, reflecting the difficult employment situation and baby boom retirements. Employment, like GDP, is growing weakly from a lowered base.



Source: Bureau of Labor Statistics; Encima Global

# Headline and Core Consumer Price Index Y/Y

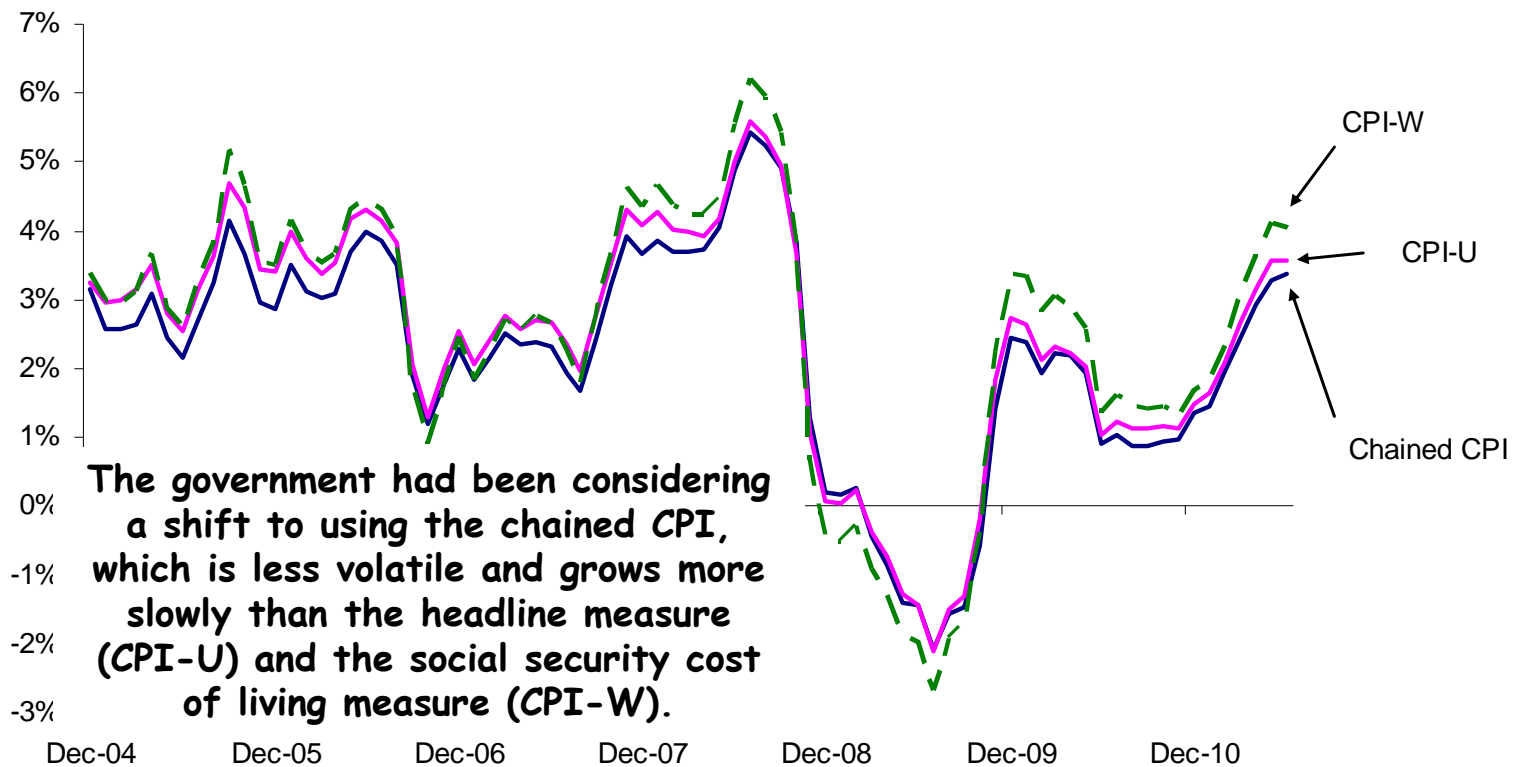
(last obs. June 2011)



Source: Bureau of Labor Statistics; Encima Global

# Consumer Price Index Variations

(last obs. June 2011)



Source: Bureau of Labor Statistics; Encima Global

# Gold high, dollar low, pointing to rise in other prices

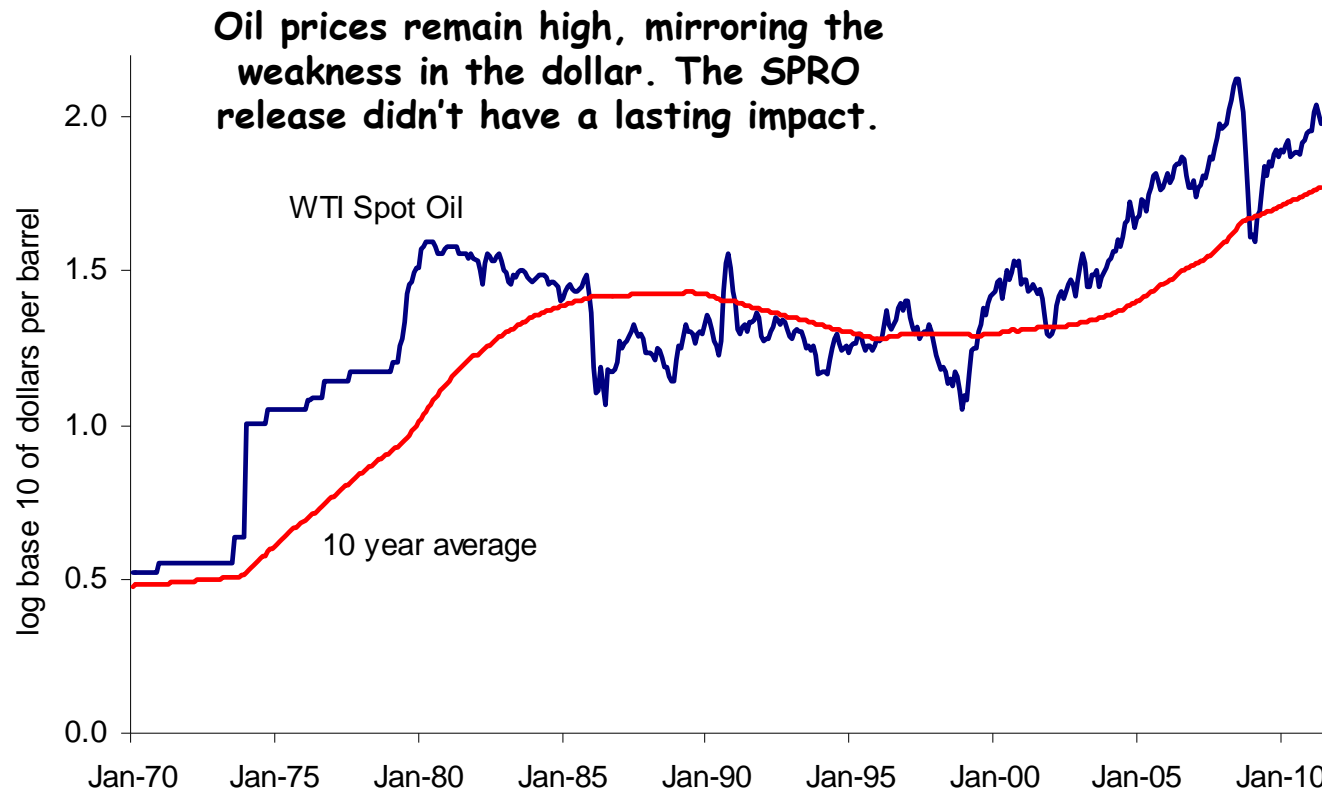
(last obs. July 29, 2011)



Source: Wall Street Journal; Encima Global

# High oil prices reflect dollar's weak value

(log scale, last obs. July 29, 2011)



Source: Wall Street Journal; Encima Global

# DXY – Dollar Index

(last obs. July 29, 2011)

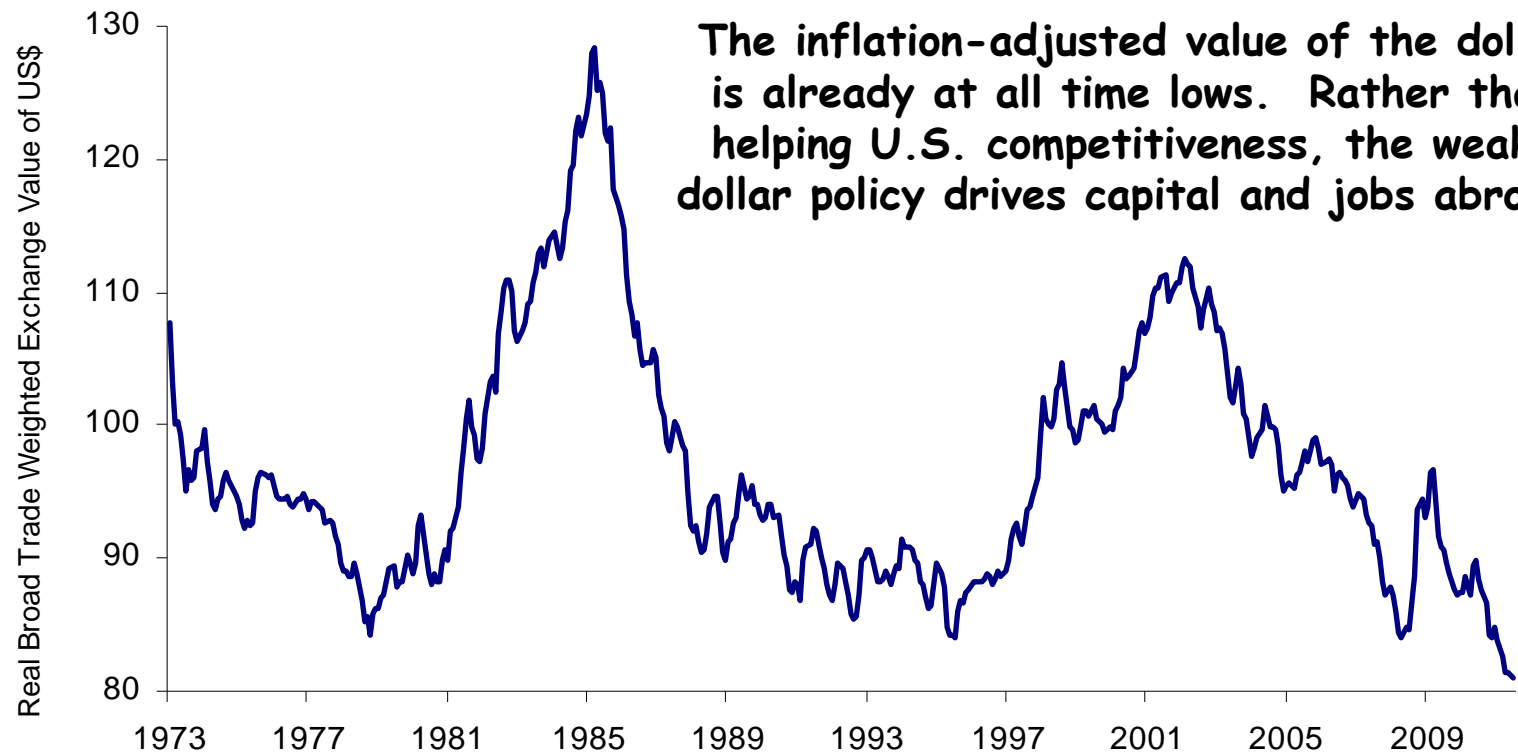
**The Fed is giving no confidence about the future value of the dollar, leaving market dynamics to trend-following and momentum and hurting U.S. investment fundamentals. Bernanke's dovish policy and the lack of traction for federal spending hawks provide no floor to the value of the dollar, which we expect to sink to all-time lows.**



Source: Bloomberg; Encima Global

# Record Low for 'Real' Value of \$

(last obs. June 2011, estimated for July 2011)



**The inflation-adjusted value of the dollar is already at all time lows. Rather than helping U.S. competitiveness, the weak-dollar policy drives capital and jobs abroad.**

Source: Federal Reserve; Encima Global

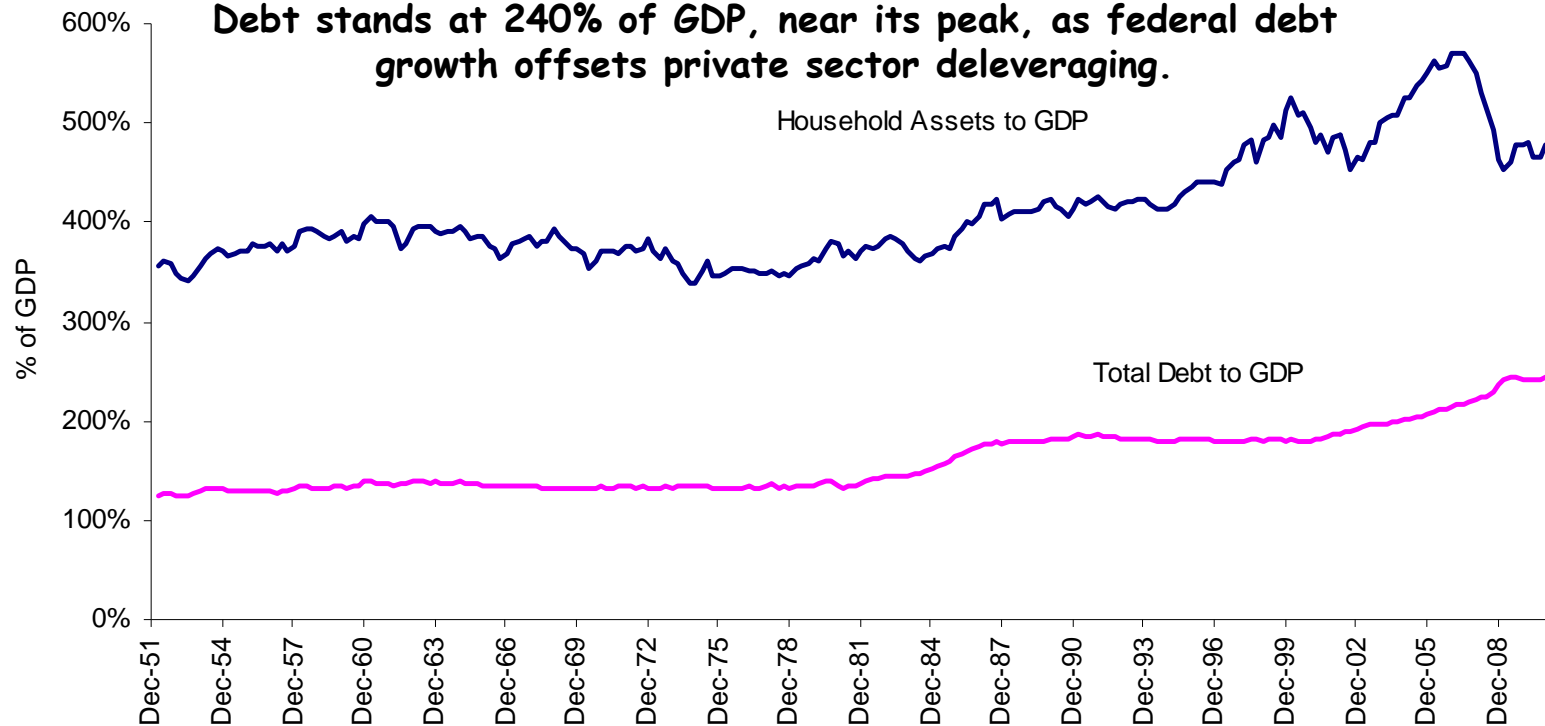
## Problems Under the Rug

- **The basic U.S. policy has been to kick the can hard down the road. Contrasting with most of the rest of the world, the U.S. government has allowed unrestrained spending and mandates, with true belt-tightening still years off.**
- **The Federal Reserve has bought back longer-maturity debt and maintained near-zero interest rates, which hold down government and corporate borrowing costs at the expense of savers.**
- **China has slowed on the margin while maintaining substantial top-down control. Like the Latin debt crisis, Europe's losses on excess debt will be spread out over several years.**
- **Many of these policies are suboptimal or even harmful, but can-kicking and the expansion of low-yield sovereign debt will probably leave economic and market trends intact and leave room for an improvement in near-term expectations.**

# U.S. Household Assets \$72 Trillion; Total Debt \$36T

(last obs. Q1 2011)

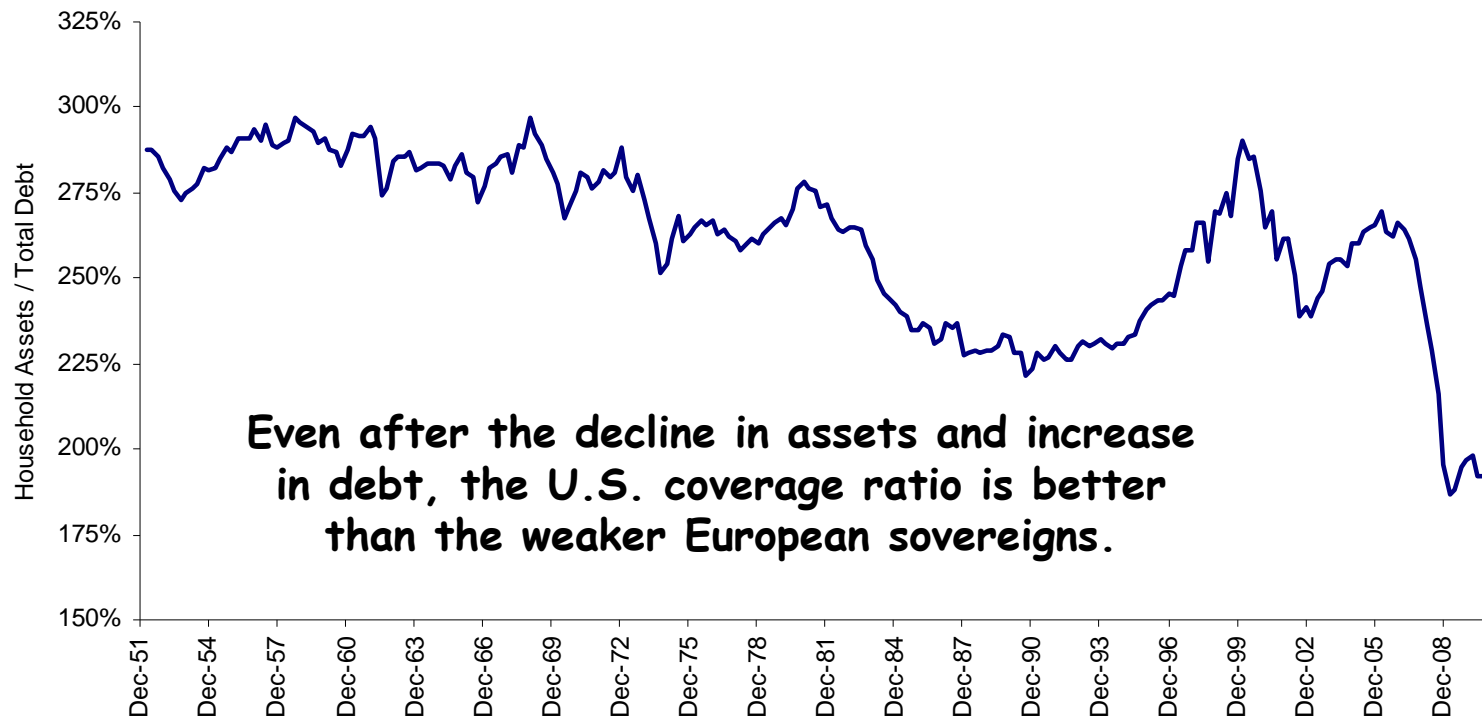
**U.S. household assets are double the total non-financial debt, allowing years of losses and dissipation before a tipping point. Debt stands at 240% of GDP, near its peak, as federal debt growth offsets private sector deleveraging.**



Source: Federal Reserve; BEA; Encima Global

# Household Assets / Total Debt

(last obs. Q1 2011)

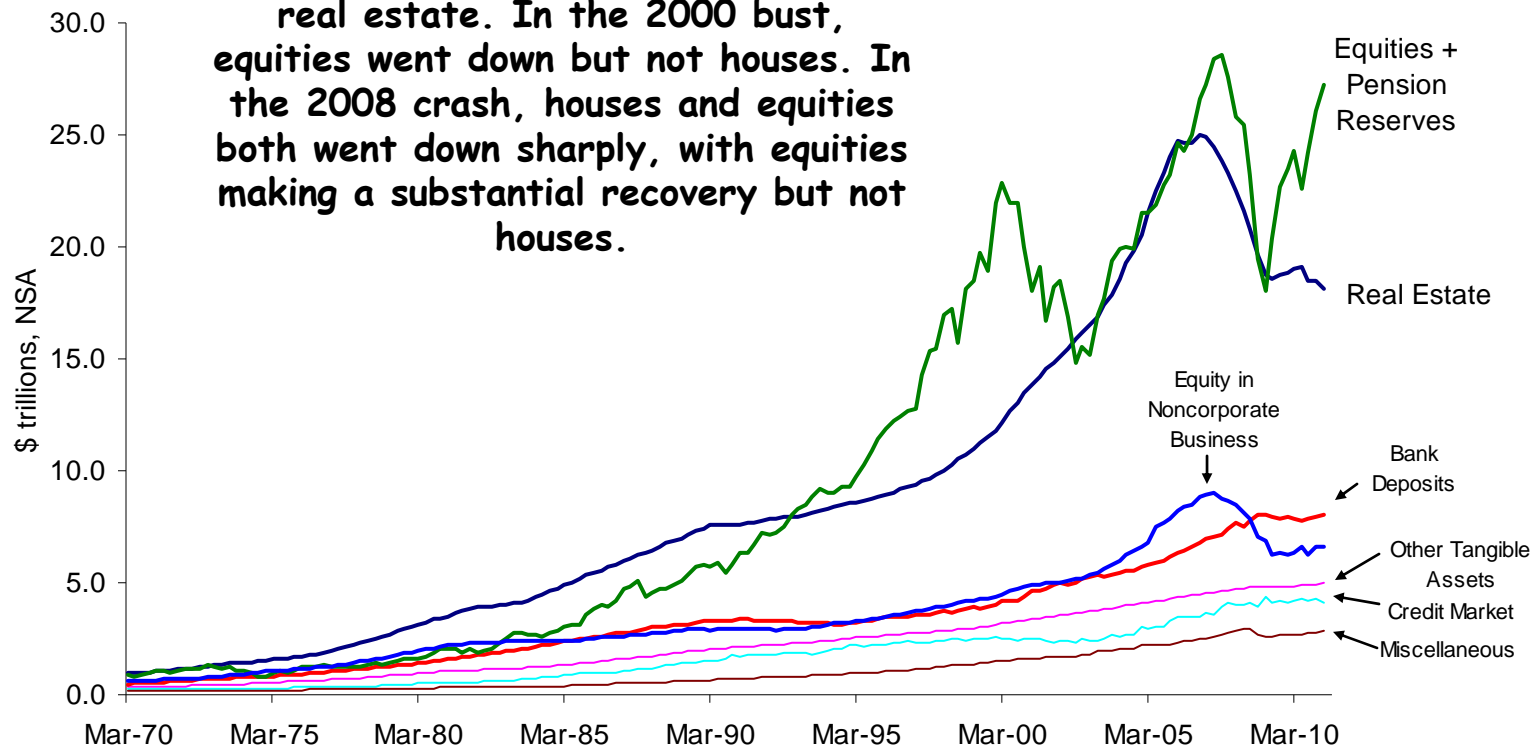


Source: Federal Reserve: Flow of Funds; Encima Global

# Household Assets

(last obs. Q1 2011)

**Most household assets are equities or real estate. In the 2000 bust, equities went down but not houses. In the 2008 crash, houses and equities both went down sharply, with equities making a substantial recovery but not houses.**



Source: Federal Reserve: Flow of Funds; Encima Global

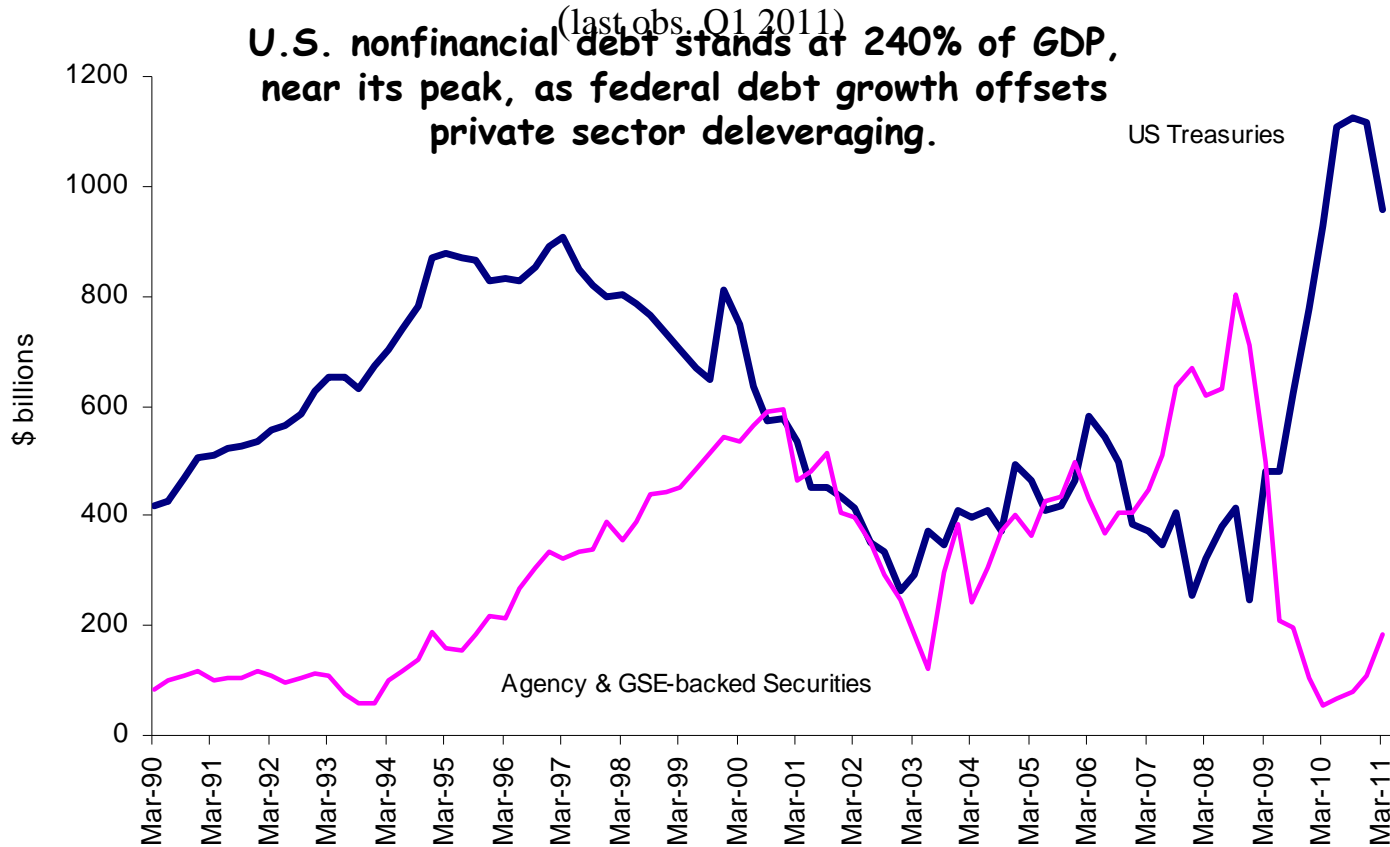
# Total Household Assets

(last obs. March 31, 2011)

	2011 Q1	2010 Q4	Yr/Yr % chg	Yr/Yr % chg
	(\$ trill)	(\$ trill)	2011 Q1	2010 Q1
<b>Total assets</b>	\$71.9	\$71.1	3.9%	9.0%
Tangible assets	\$23.1	\$23.4	-3.2%	1.2%
Real Estate	\$18.1	\$18.5	-4.7%	1.3%
Other tangible assets	\$5.0	\$4.9	2.5%	1.2%
Financial assets	\$48.8	\$47.7	7.6%	13.5%
Checkable deposits & money funds	\$1.5	\$1.5	0.1%	-20.9%
Time and savings deposits	\$6.5	\$6.5	2.7%	3.6%
Credit market instruments	\$4.1	\$4.3	-1.0%	-5.5%
Equities (direct)	\$8.8	\$8.2	14.5%	52.5%
Mutual funds	\$5.1	\$4.7	15.9%	39.5%
Pension reserves/life insurance	\$14.7	\$14.4	8.7%	22.3%
Equity in unincorporated business	\$6.6	\$6.6	4.2%	-8.0%
Other financial assets	\$1.5	\$1.5	4.6%	2.7%

Source: Federal Reserve: Flow of Funds; Encima Global

# U.S. Households Adjusted to Fed QE2 Buying by Reducing Treasury Holdings



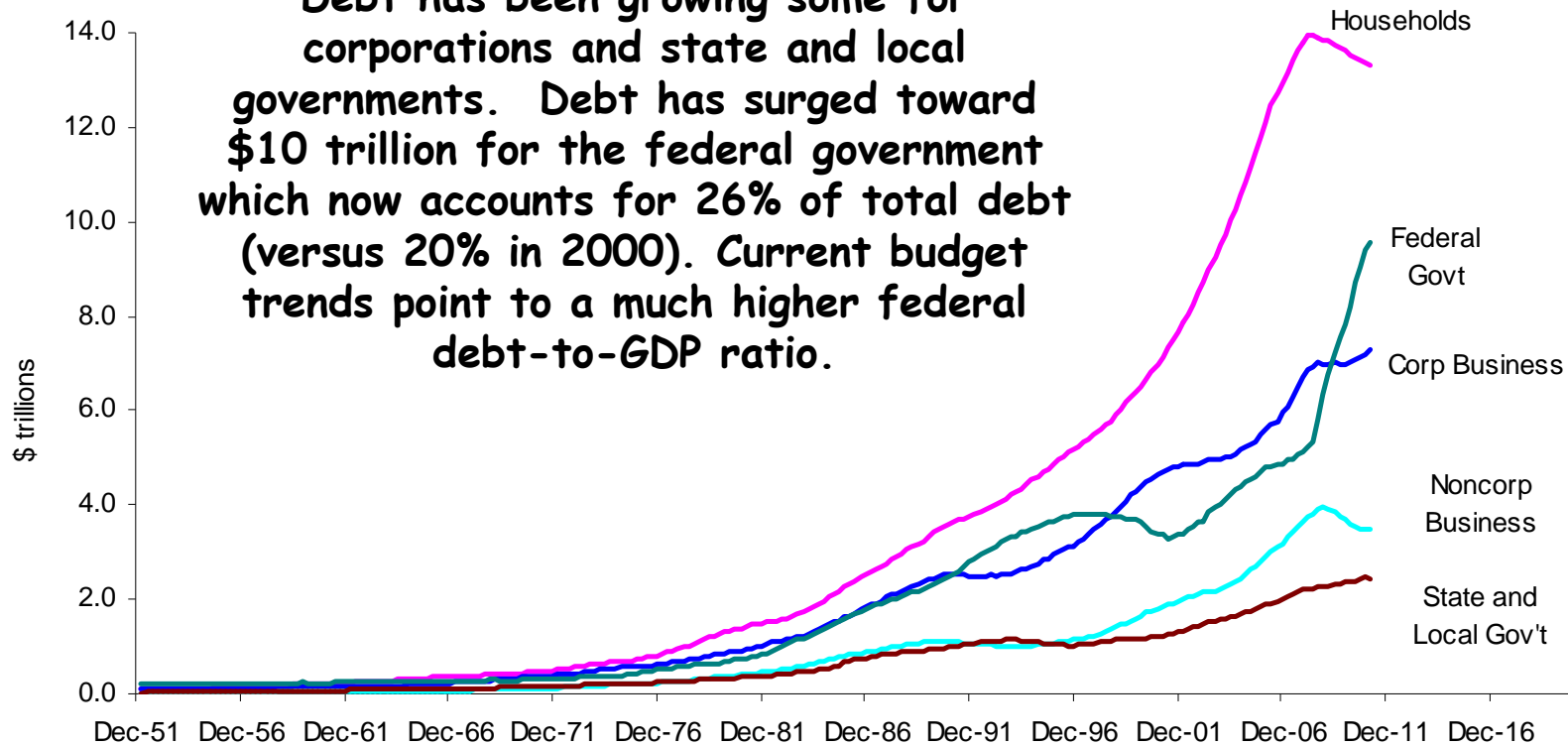
Source: Federal Reserve; Encima Global

# U.S. Debt By Sector

(last obs. Q1 2011)

Debt levels have been declining some for households and unincorporated businesses.

Debt has been growing some for corporations and state and local governments. Debt has surged toward \$10 trillion for the federal government which now accounts for 26% of total debt (versus 20% in 2000). Current budget trends point to a much higher federal debt-to-GDP ratio.



Source: Federal Reserve: Flow of Funds; Encima Global

## Domestic Nonfinancial Debt

(last obs. March 31, 2011)

	2011 Q1	2010 Q4	Yr/Yr % chg	Yr/Yr % chg
	(\$ trill)	(\$ trill)	2011 Q1	2010 Q1
<b>Domestic Nonfinancial Sectors</b>	\$ 36.3	\$ 36.1	3.9%	2.9%
<b>Households</b>	\$ 13.3	\$ 13.4	-1.7%	-1.9%
<b>Corporate Business</b>	\$ 7.3	\$ 7.2	4.2%	0.3%
<b>Noncorporate Business</b>	\$ 3.5	\$ 3.5	-3.4%	-8.8%
<b>State &amp; Local Govts</b>	\$ 2.4	\$ 2.5	2.2%	4.9%
<b>Federal Government</b>	\$ 9.6	\$ 9.4	16.5%	21.3%
<b>of which Fed Holds</b>	\$ 1.3	\$ 1.0	72.6%	57.8%
as of June \$1.54 trillion				
<b>memo:</b>				
Federal Govt Trust Funds	\$ 4.6			
of which Soc Sec	\$ 2.6			

Not counting government spending promises or future losses on GSEs

Source: Federal Reserve: Flow of Funds; Encima Global

## Mortgage Holders (Residential and Commercial)

(last obs. March 31, 2011)

	2011 Q1 (\$ trill)	2010 Q4 (\$ trill)	Yr/Yr % chg 2011 Q1
<b>Total Mortgages</b>	\$ 13.7	\$ 13.8	-3.0%
<b>Commercial Banking</b>	\$ 3.6	\$ 3.7	-5.6%
<b>Government Sponsored Enterprises</b>	\$ 5.1	\$ 5.0	-1.0%
consolidated mortgage trusts	\$ 4.3	\$ 4.2	-4.4%
<b>Agency mortgage pools</b>	\$ 1.2	\$ 1.1	21.1%
<b>ABS Issuers</b>	\$ 1.8	\$ 1.9	-12.6%
<b>Other Financial Institutions</b>	\$ 1.6	\$ 1.7	-5.2%
<b>Other</b>	\$ 0.4	\$ 0.4	-2.7%

**GSE consolidated trusts (conventional MBS) are the holders of about a third of all mortgage debt. Bank holdings have declined while Ginnie Mae mortgage pools grew 21% yoy.**

Source: Federal Reserve: Flow of Funds; Encima Global

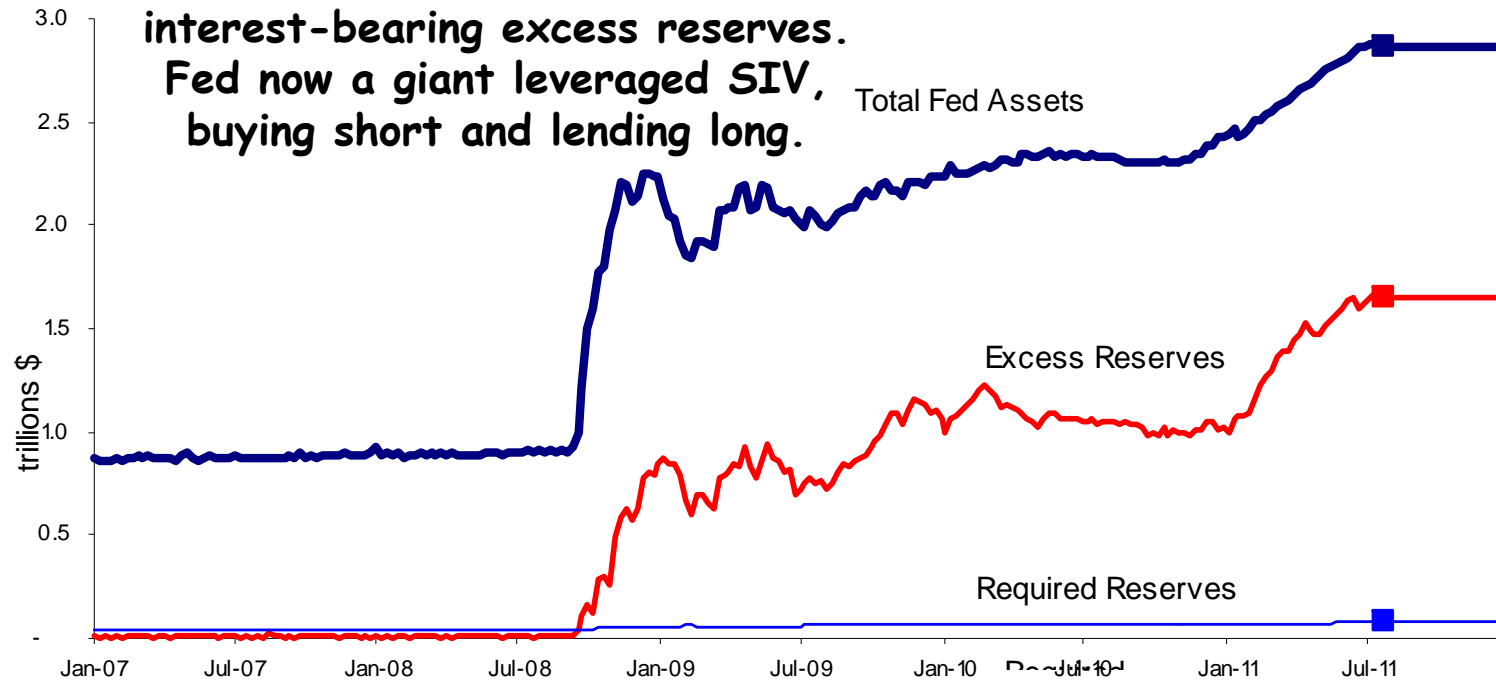
## QE2 To End Like Y2K

- **QE2's impact on the economy, markets and inflation was exaggerated. QE2 wasn't money printing and wasn't very powerful. To achieve its balance sheet expansion, the Fed pays an above-market interest rate to commercial banks for extra deposits at the Fed. The result was a rise in excess commercial bank reserves equivalent to the Fed's balance sheet expansion and little transmission from QE2 to private sector credit growth or the economy.**
- **The commodity spike and the squeeze on Treasury bonds got overdone in part due to the view that the Fed's QE2 was a new form of money printing that would create a near-term crisis. QE2 has caused substantial distortion in credit markets and artificially depressed the dollar, but we don't think this creates the near-term crisis that's assumed in high gold and commodity prices and low Treasury bond yields.**
- **Other damage from QE2: expansion of the Fed's role and power in the economy (over \$100 billion in annual profits); a precedent for the Fed to buy assets whenever the economy weakens; risk that future Fed's will buy non-Treasury assets.**

# Excess Reserves Rose – Fed ‘Pushing on a String’

(last obs. July 27, 2011)

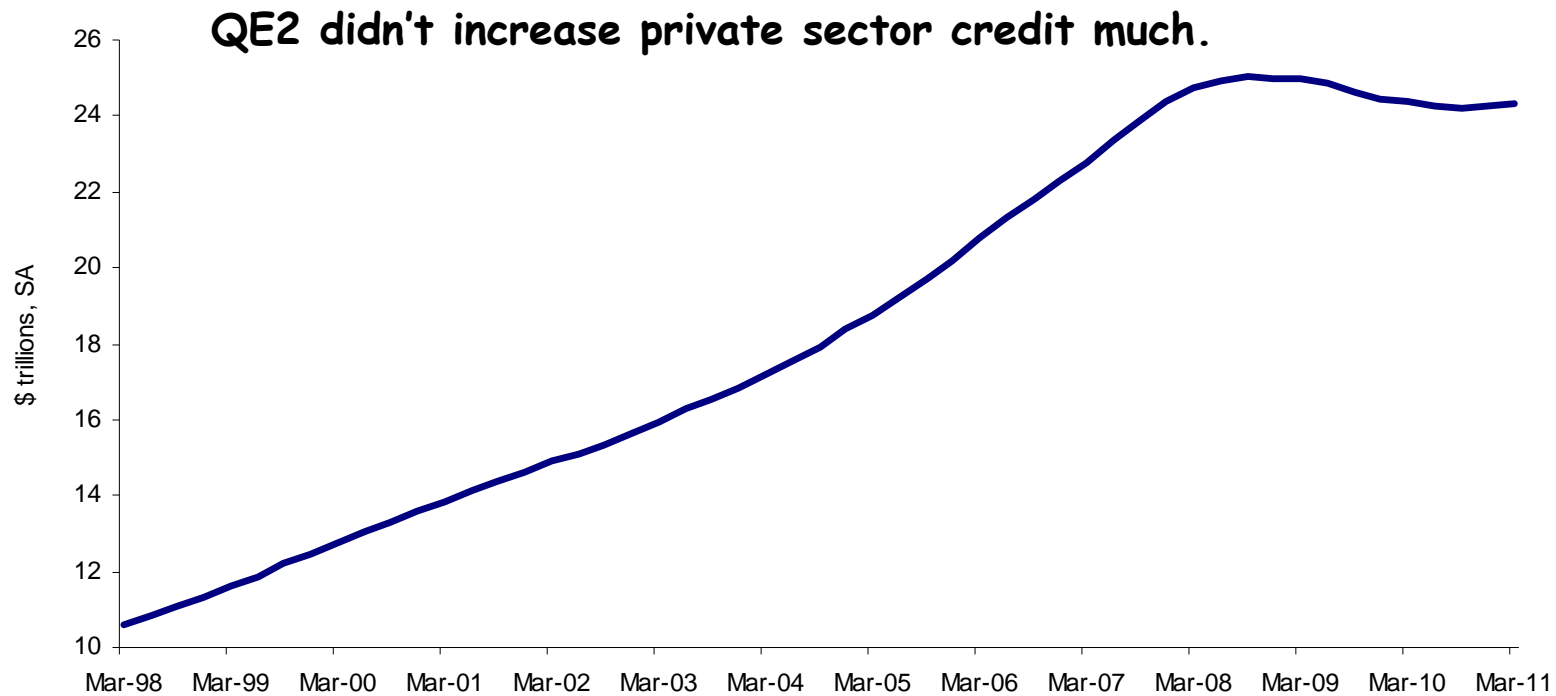
**The fed will maintain a \$2.9 trillion balance sheet funded with interest-bearing excess reserves. Fed now a giant leveraged SIV, buying short and lending long.**



Source: Federal Reserve: Encima Global

# Little Growth in U.S. Private Sector Credit

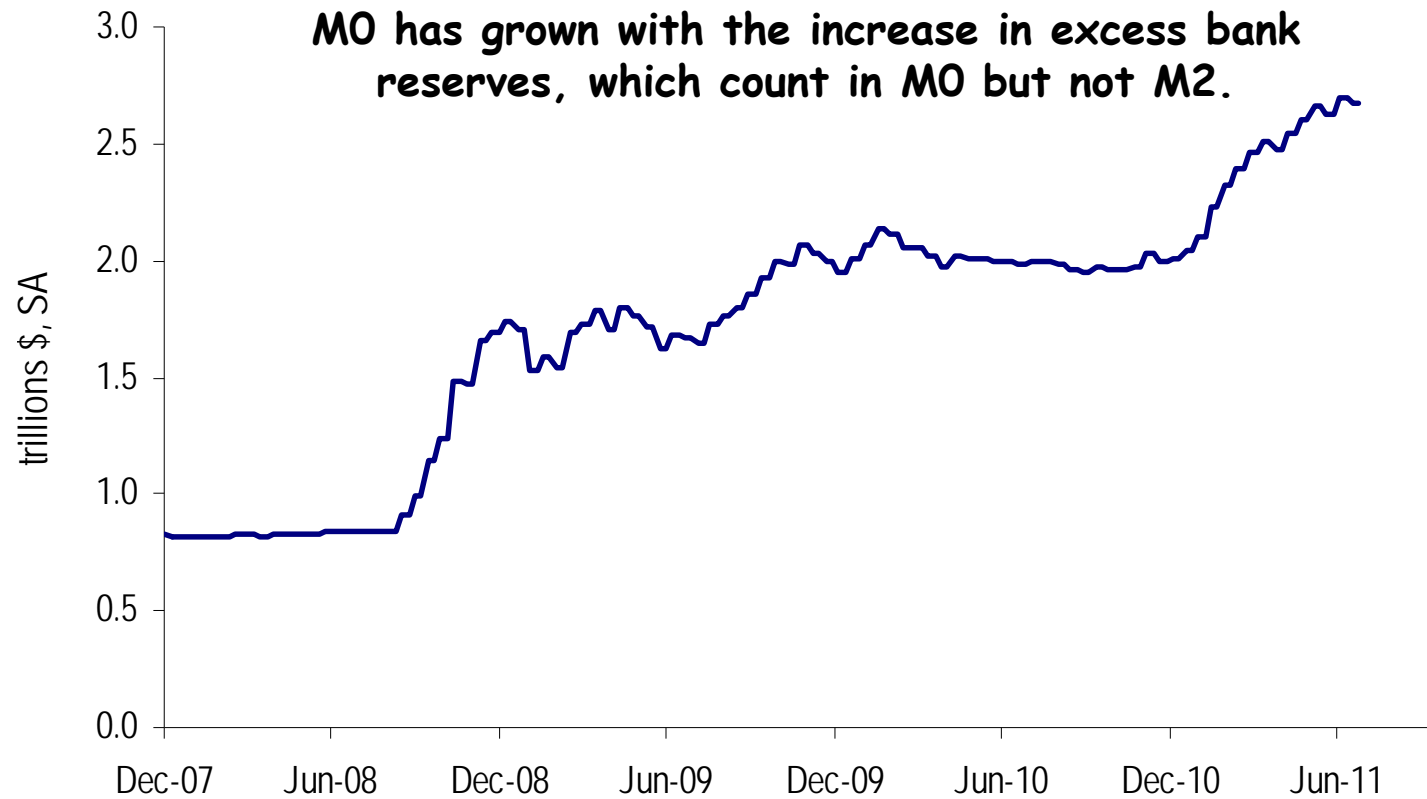
(last obs. Q1 2011)



Source: Federal Reserve; Encima Global

# M0

(last obs. July 25, 2011)



Source: Federal Reserve; Encima Global

## M2 13 Week change annualized basis

(last obs. July 18, 2011)

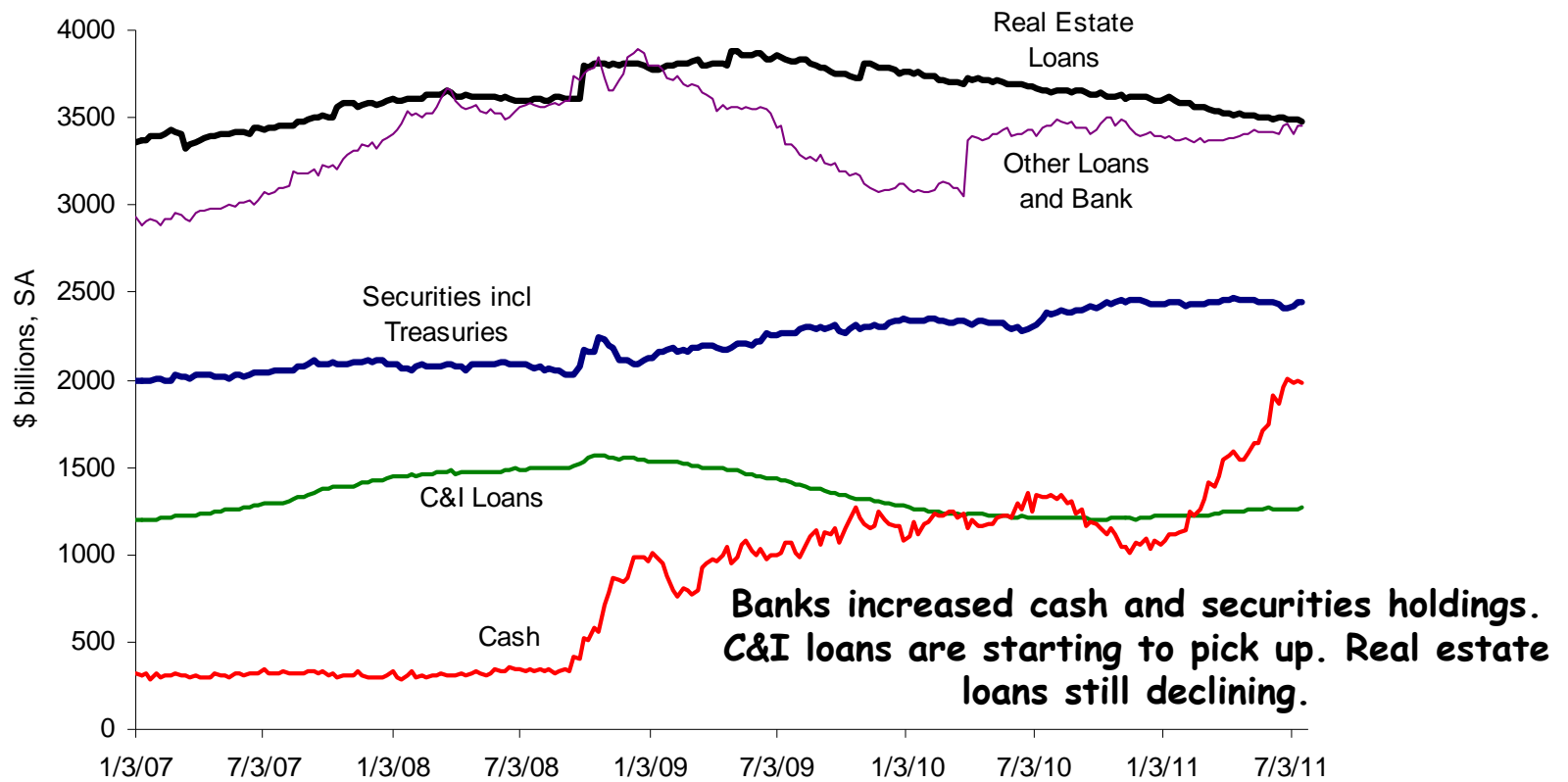
**M2 growth was weak during QE2 but jumped to 15.8% on a 13 wk annualized basis in the most recent week. Bank deposits have increased as the fear of default has grown.**



Source: Federal Reserve: Encima Global

# Bank Assets – Cash Includes Excess Reserves at Fed

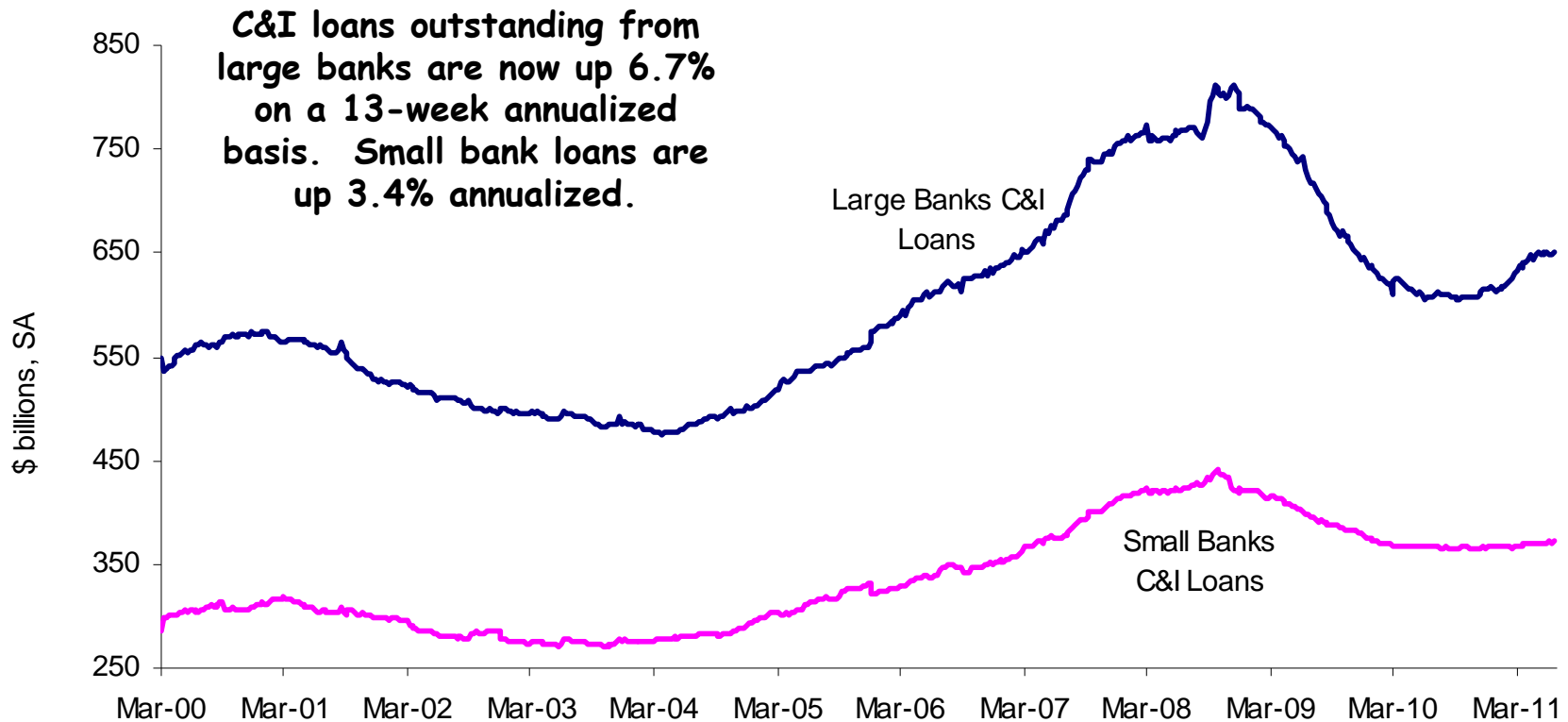
(last obs. July 20, 2011)



Source: Federal Reserve: Encima Global

# Commercial and Industrial Loans Beginning to Rise

(last obs. July 20, 2011)

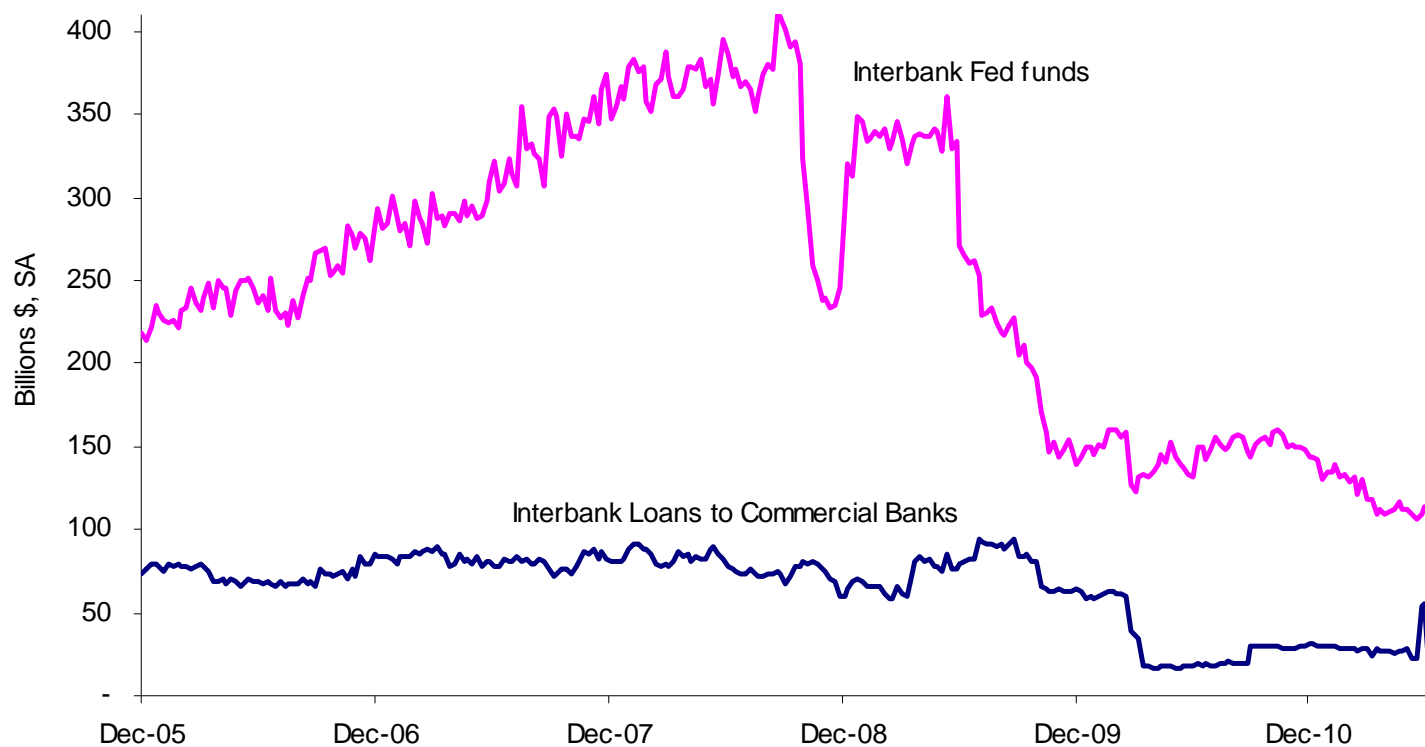


Source: Federal Reserve; Encima Global

# Interbank Loans – through Fed Funds and direct

(last obs. July 22, 2011)

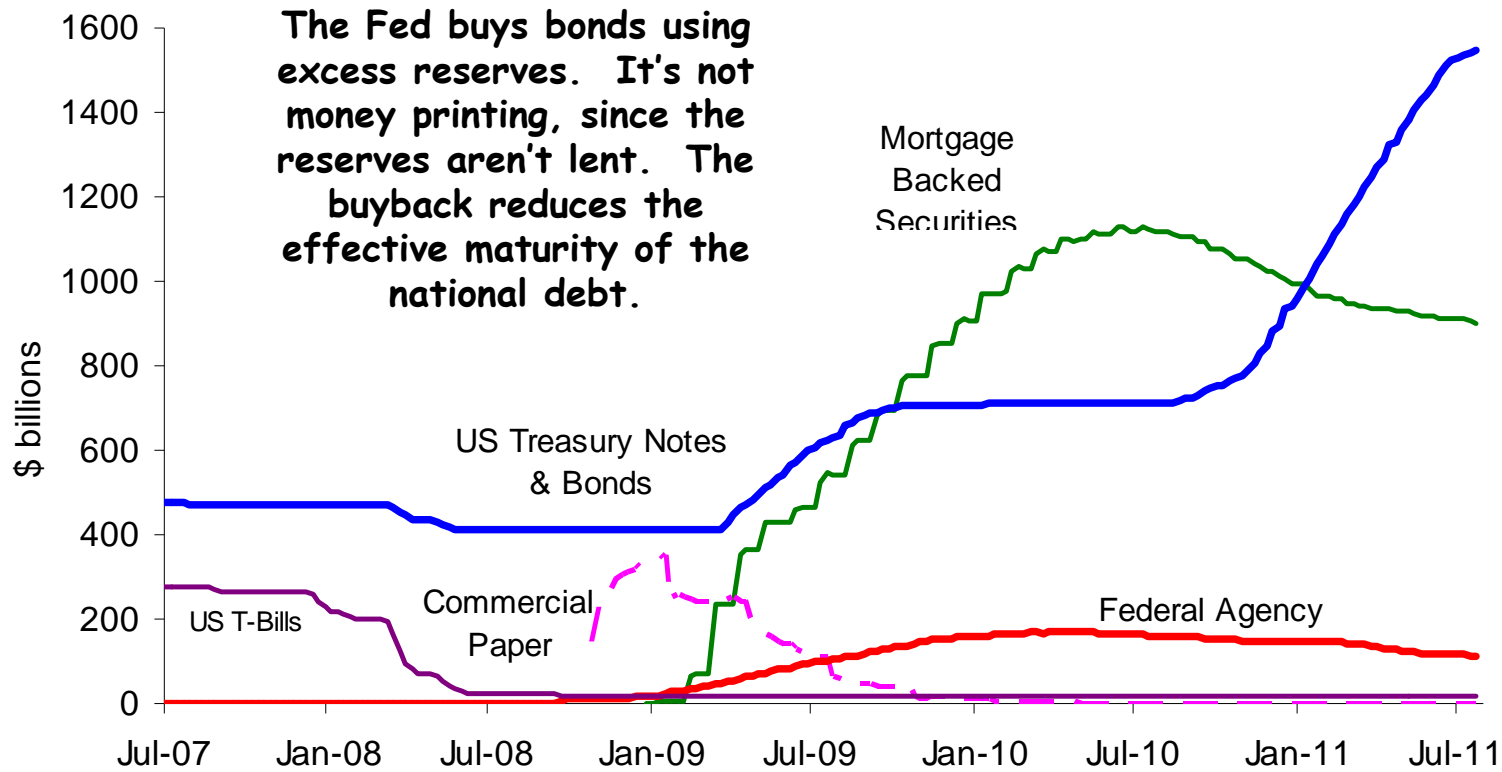
**Interbank lending has fallen significantly since the Fed Funds rate has been held near zero.**



Source: Federal Reserve; Encima Global

# Fed Balance Sheet

(last obs. July 27, 2011)

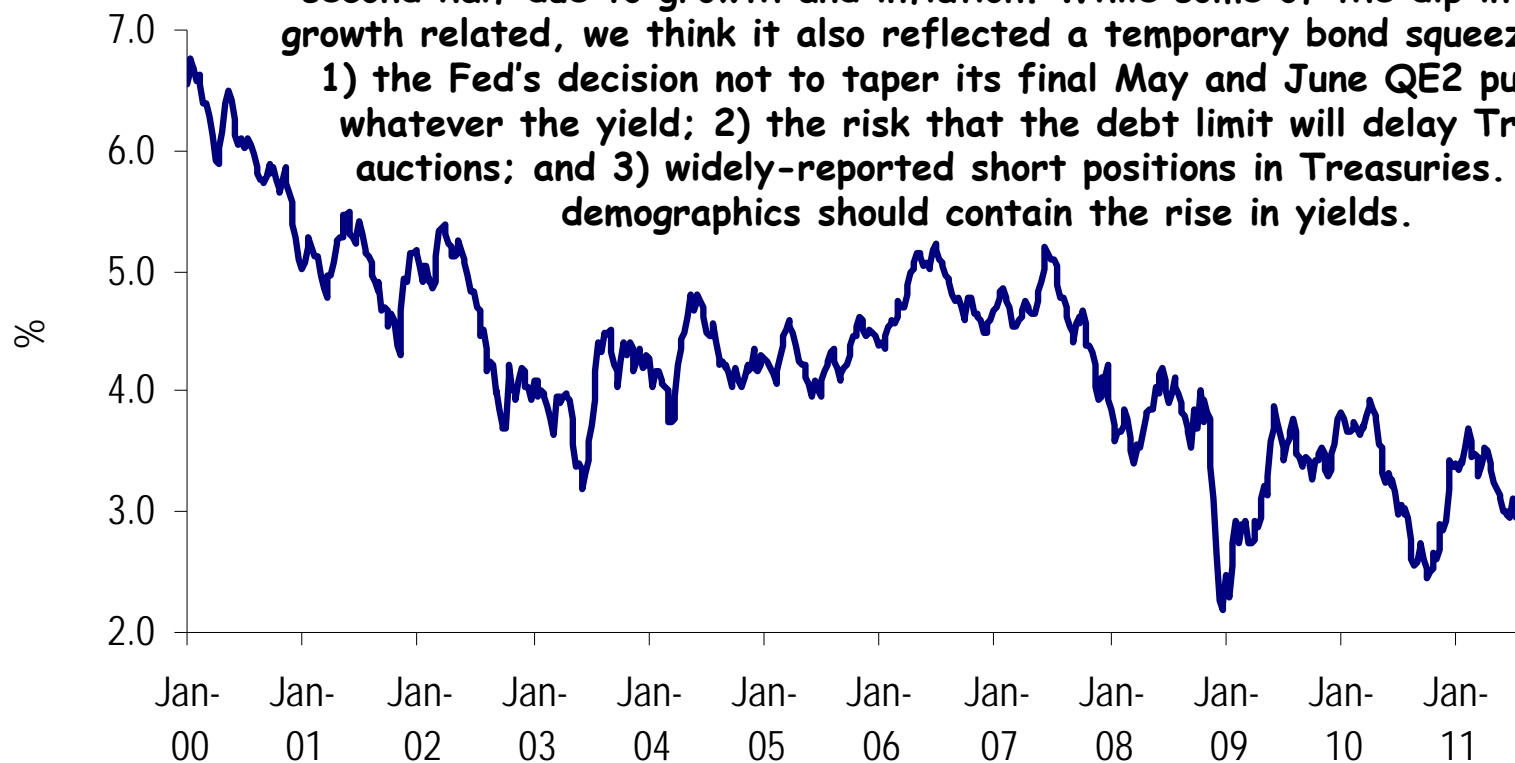


Source: Federal Reserve: Encima Global

# 10 Year Treasury Yield To Rise In Second Half

(last obs. August 1, 2011)

Bond yields declined from February to July but should go higher in the second half due to growth and inflation. While some of the dip in yields is growth related, we think it also reflected 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) the risk that the debt limit will delay Treasury auctions; and 3) widely-reported short positions in Treasuries. Aging demographics should contain the rise in yields.



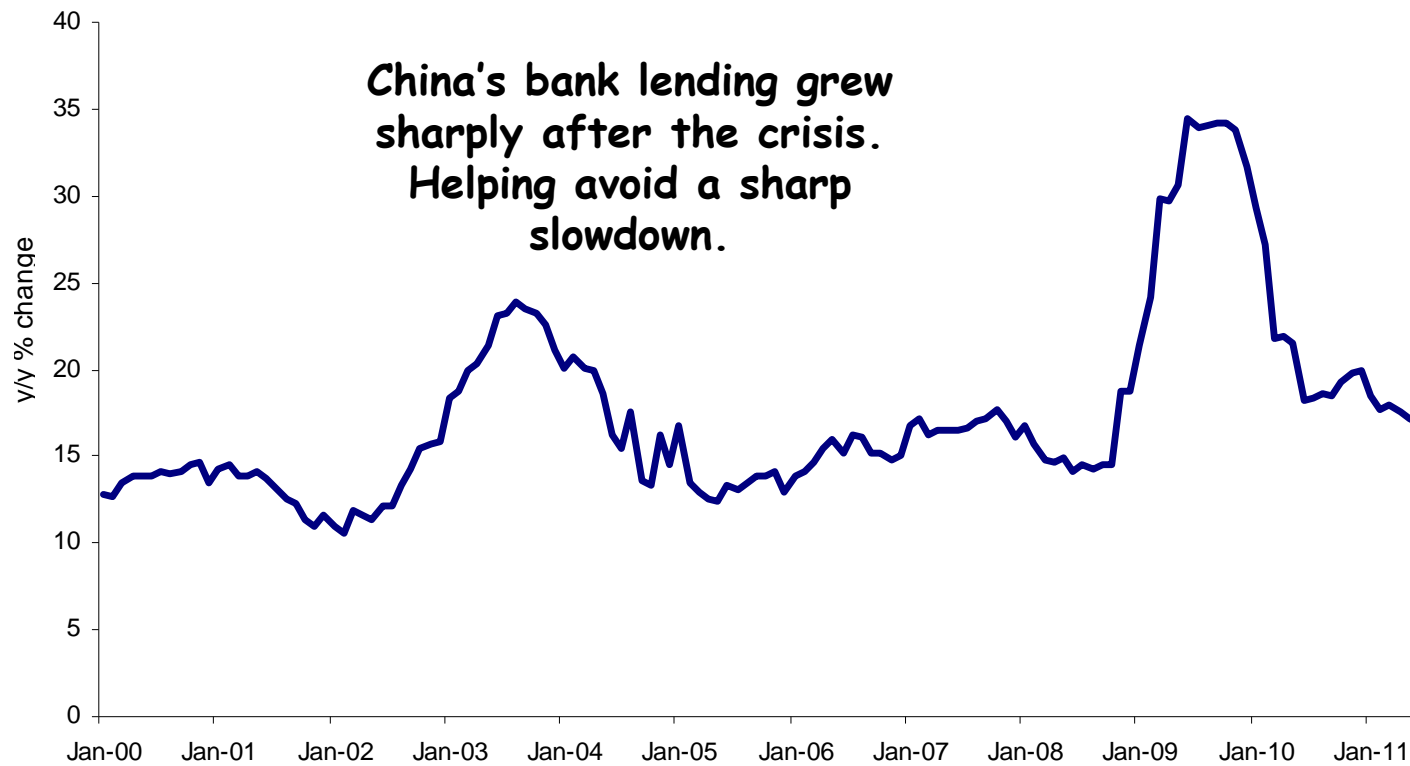
Source: Federal Reserve; Encima Global

## Evolution of Global Monetary Policy

- **The near-zero Fed funds rate is too low to impact monetary policy and is harmful because it distorts short-term credit markets and subsidizes the government, banks and big corporations at the expense of savers.**
- **U.S. monetary policy is now primarily based on regulatory rationing of credit rather than price-based allocation. China practices counter-cyclical credit rationing (restrict lending during booms, allow lending after a bust.) The U.S. practices pro-cyclical credit policy (few controls during boom, heavy controls after busts including increased bank capital, aggressive mark-to-market, lawsuits, regulatory scrutiny.)**
- **Rather than QE3, we expect some regulatory easing, allowing existing bank capital to fund more mortgages, commercial loans and securitizations.**
- **With global liquidity now massive, Basel III standards will get lip service but won't stop global loan growth. Many banks will lend more aggressively.**

# China Bank Lending

(last obs. June 2011)



Source: Bloomberg; Encima Global

## China's M2 / GDP

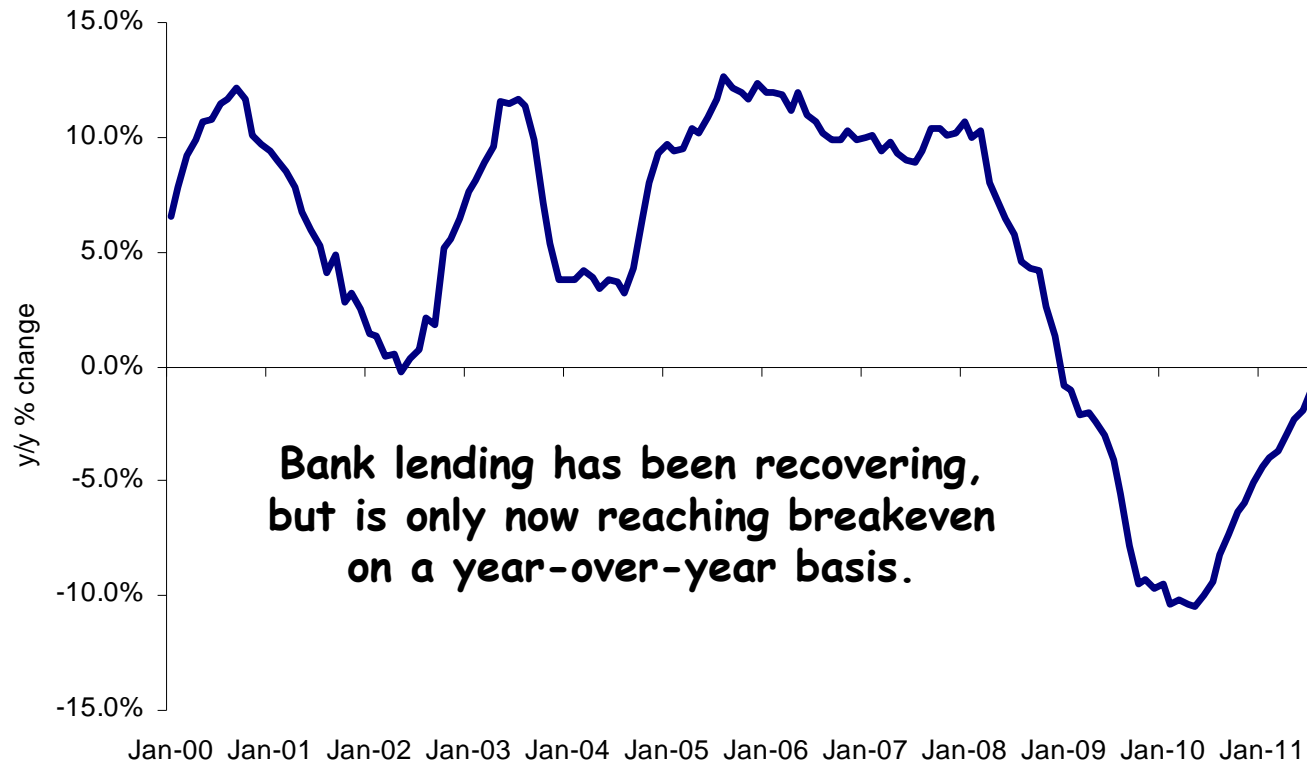
(last obs. Q2 2011)



Source: China National Bureau; People's Bank of China; Encima Global

# US Bank Lending

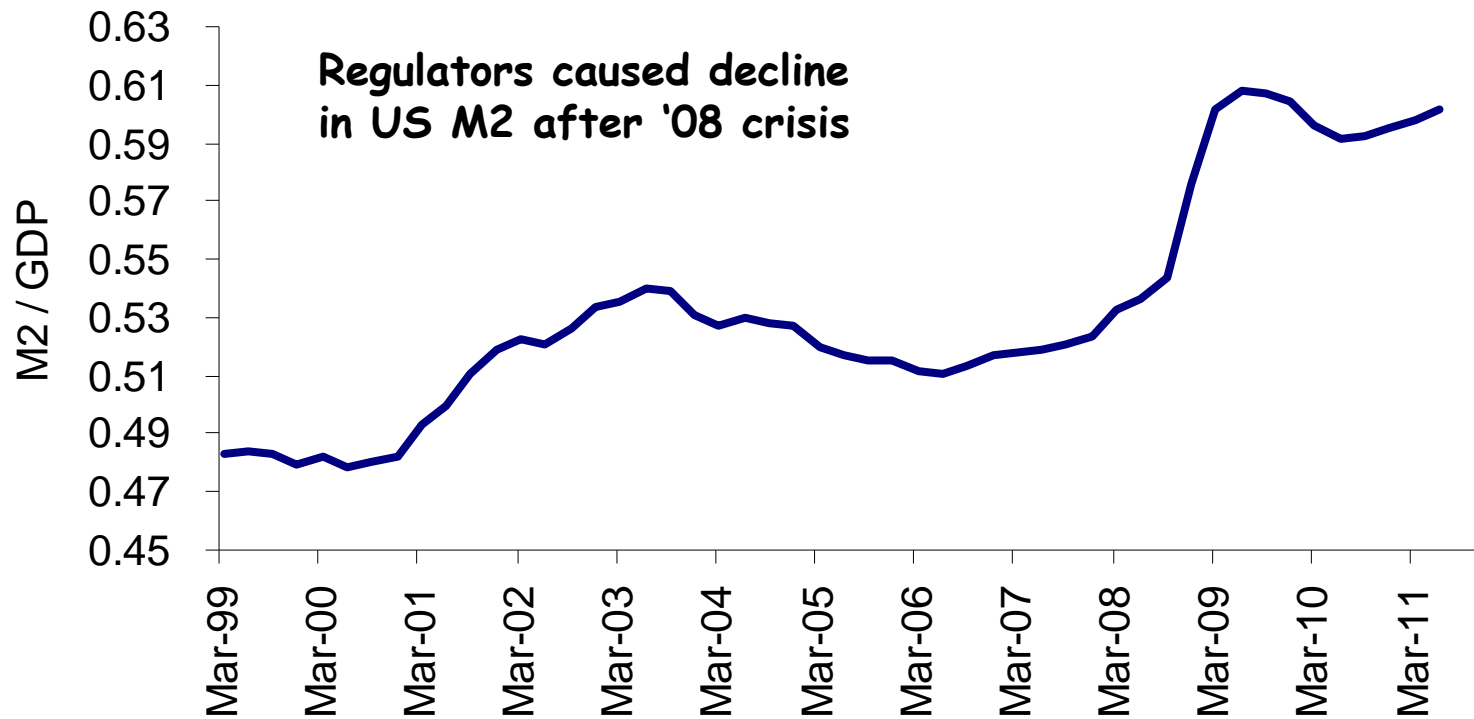
(last obs. June 2011, estimate for July 2011)



Source: Federal Reserve; Encima Global

## US M2 / GDP

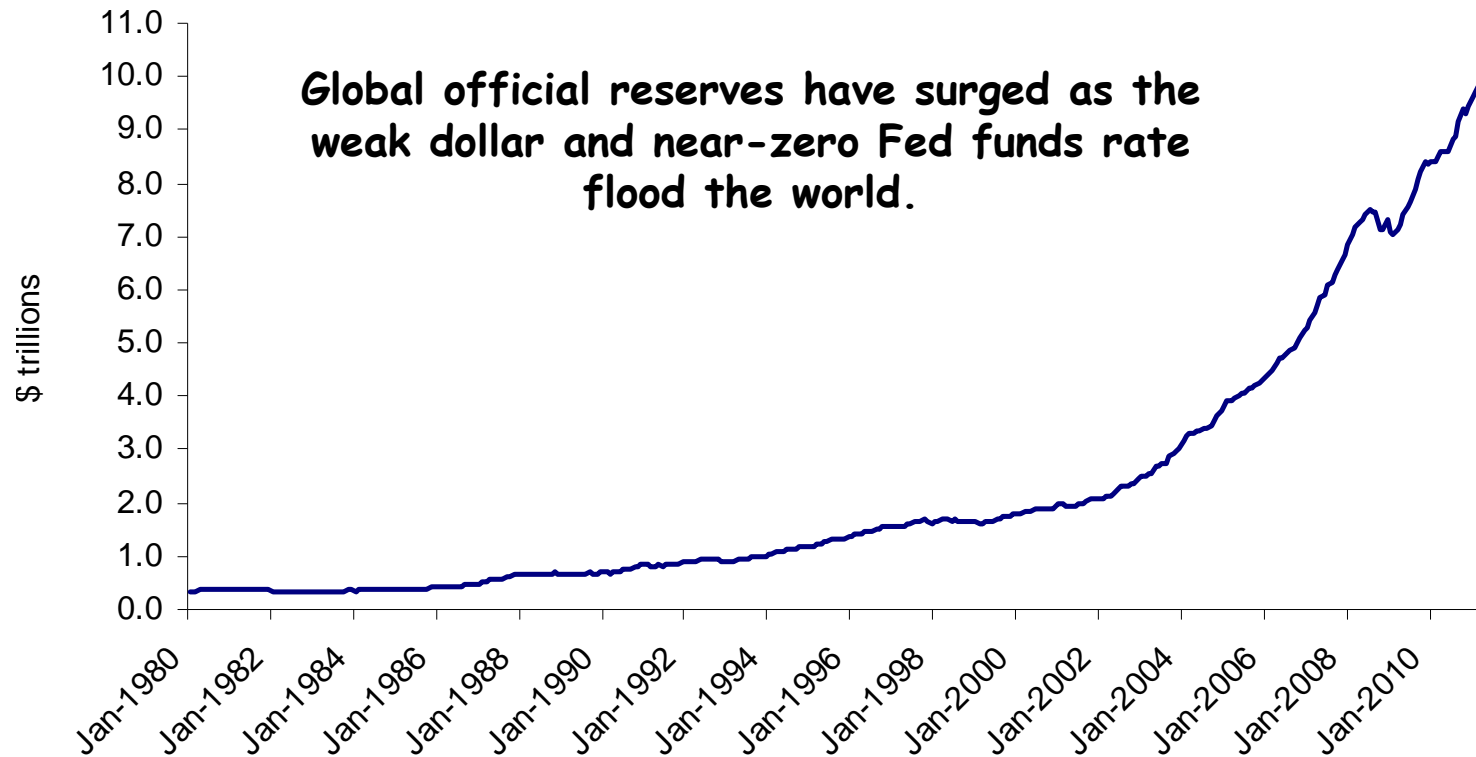
(last obs. Q1 2011)



Source: Federal Reserve; BEA; Encima Global

# The U.S. Credit Pump: Global Official Reserves

(not counting gold holdings and U.S. reserves; last obs. April 2011)

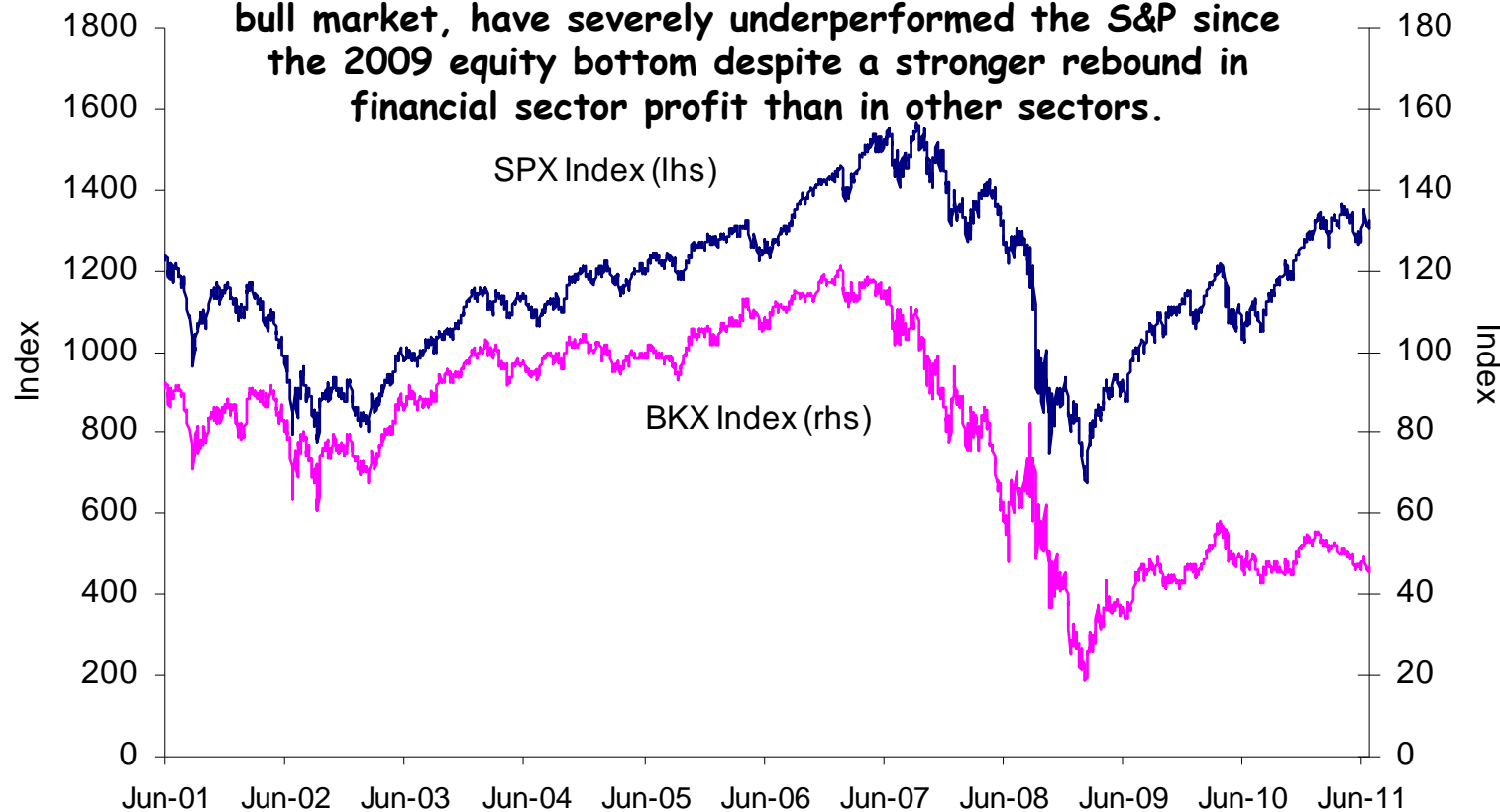


Source: IMF; Encima Global

# Bank Stocks vs. Overall Market

(last obs. July 21, 2011)

**Equity prices for banks, normally an important leader in a bull market, have severely underperformed the S&P since the 2009 equity bottom despite a stronger rebound in financial sector profit than in other sectors.**



Source: Bloomberg; Encima Global

# Bank Equity Capital Expensive – 2.4 Times the Cost of Debt Capital

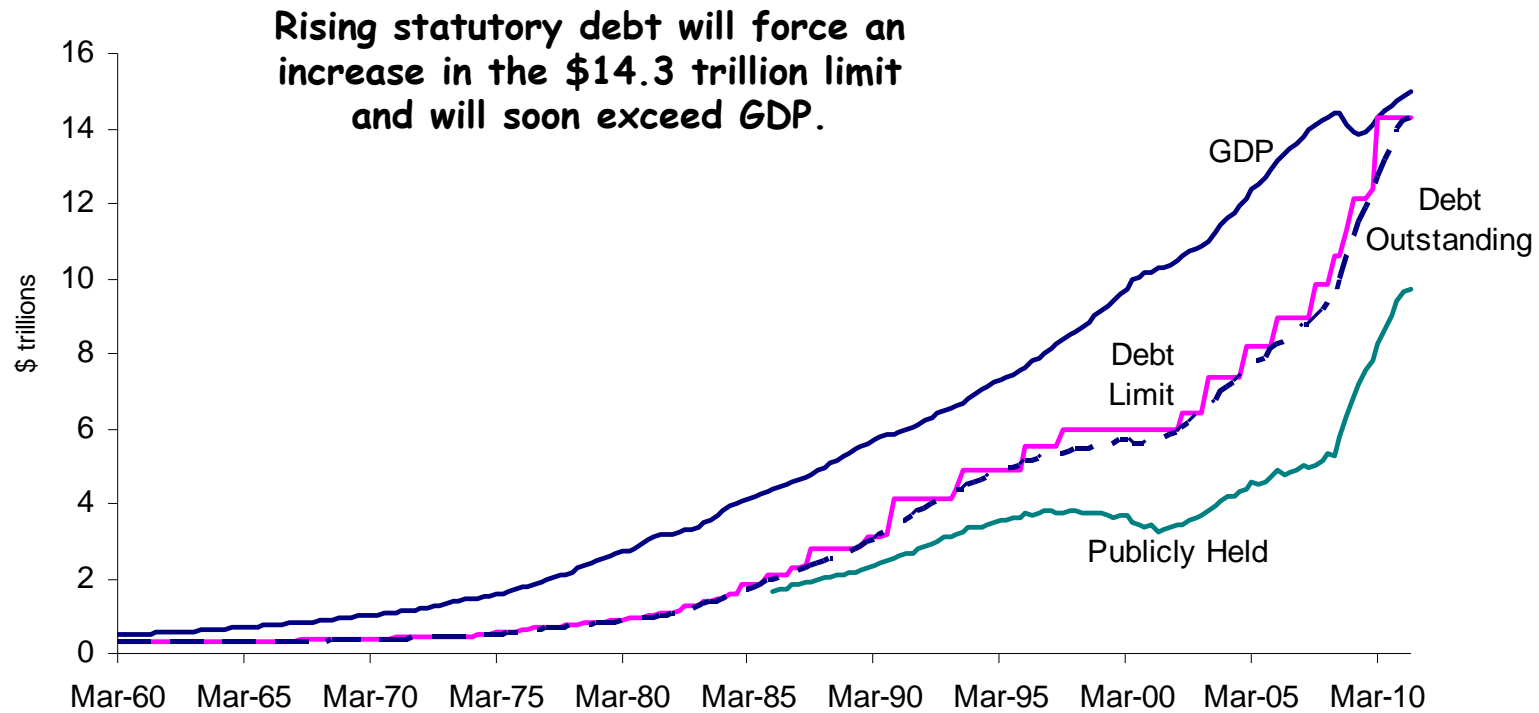
(last obs. July 21, 2011)



Source: Bloomberg; Dow Jones; Encima Global

# Publicly Held Debt Reaching 70% of GDP

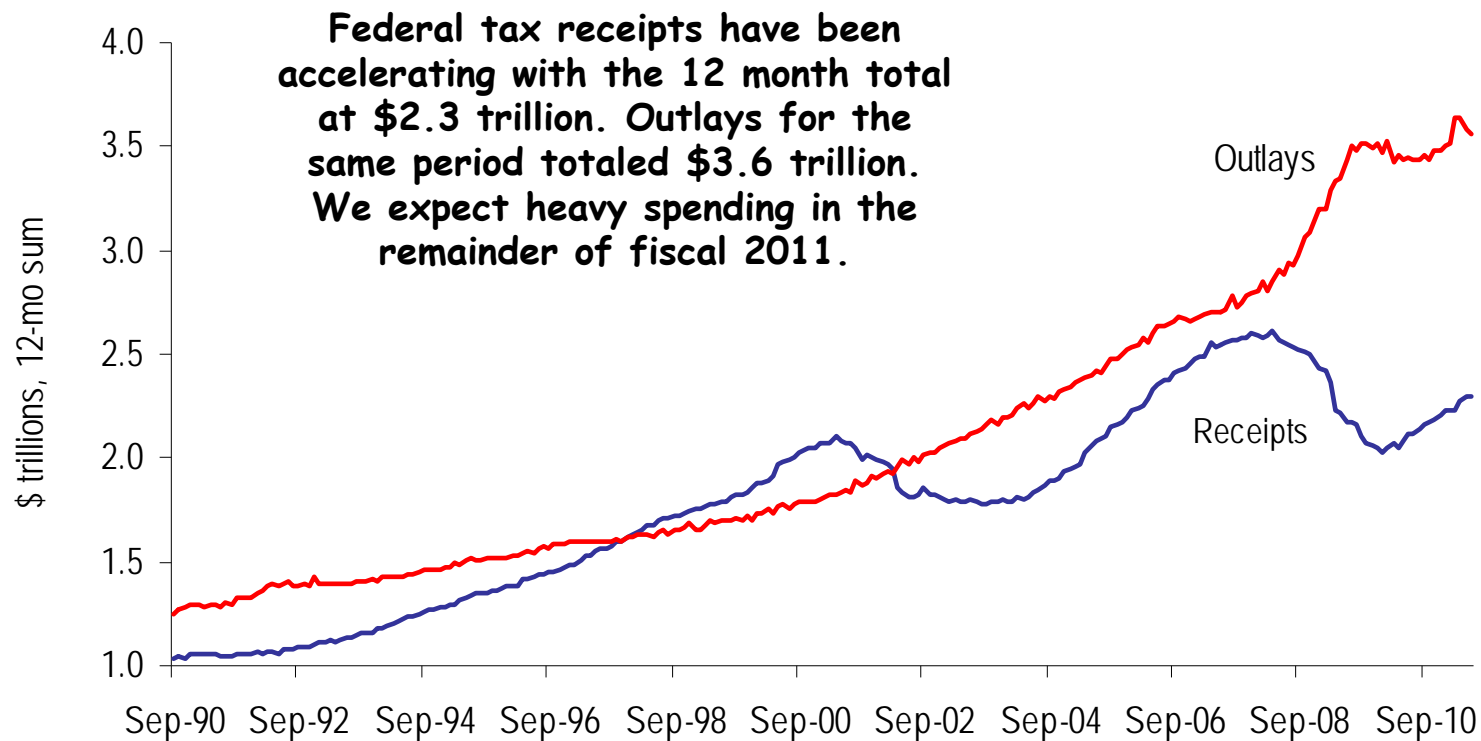
(last obs. Q2 2011)



Source: Bureau of Economic Analysis; U.S. Treasury; Encima Global

# Federal Receipts and Outlays

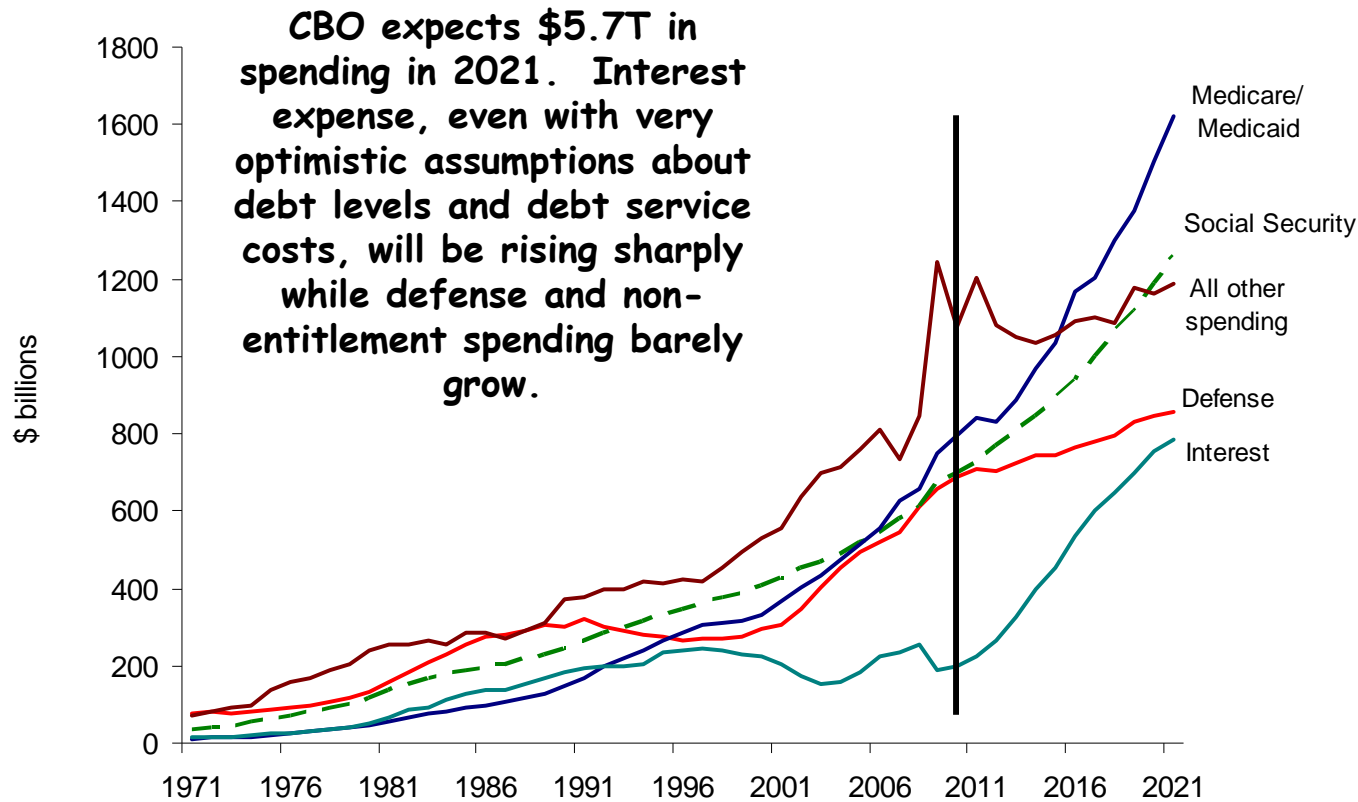
(last obs. June 2011)



Source: U.S. Treasury; Encima Global

# No Control on Federal Spending

(last obs. 2010, CBO projection to 2021)



Source: CBO; Encima Global

## Budget Variations

	FY 2012			FY 2012 - 2021		
	Outlays (\$ trillions)	Deficit (\$ trillions)	Debt per GDP	Outlays (\$ trillions)	Deficit (\$ trillions)	Debt per GDP
CBO March Baseline	3.6	-1.1	73.4%	45.8	-6.7	75.6%
CBO Alternative Baseline*	3.6	-1.1	74.5%	46.1	-12.6	101.3%
White House Re-Estimated	3.7	-1.2	74.3%	46.2	-9.5	87.4%
Ryan Budget	3.5	-1.0	72.8%	40.0	-5.1	67.5%
Debt Limit Deal?*	3.6	-1.1	74.5%	44.1	-10.5	95.0%

\* The two lines marked with an asterisk assume current tax rates are extended, i.e. no tax increase for AMT, Bush rates, subsidy reduction

**We don't think the deal on the debt limit increase will have much impact on spending or debt. They are arguing over \$2.4 trillion in spending over ten years. In rough terms that would mean at best agreeing to slow the compound annual growth rate in spending from 5% to 4% -- after accepting the elevated starting point for spending. We think the CBO March alternative baseline is the most plausible under the current political trajectory leaving marketable debt-to-GDP over 100% in 2021 (should be 50% or less to allow the private sector to increase median per capita living standards.) If there's an agreement on \$2.4 trillion in spending cuts in the debt limit deal, the CBO scoring of the ten-year outlook, based on rosy assumptions, might look something like the bottom line on the table.**

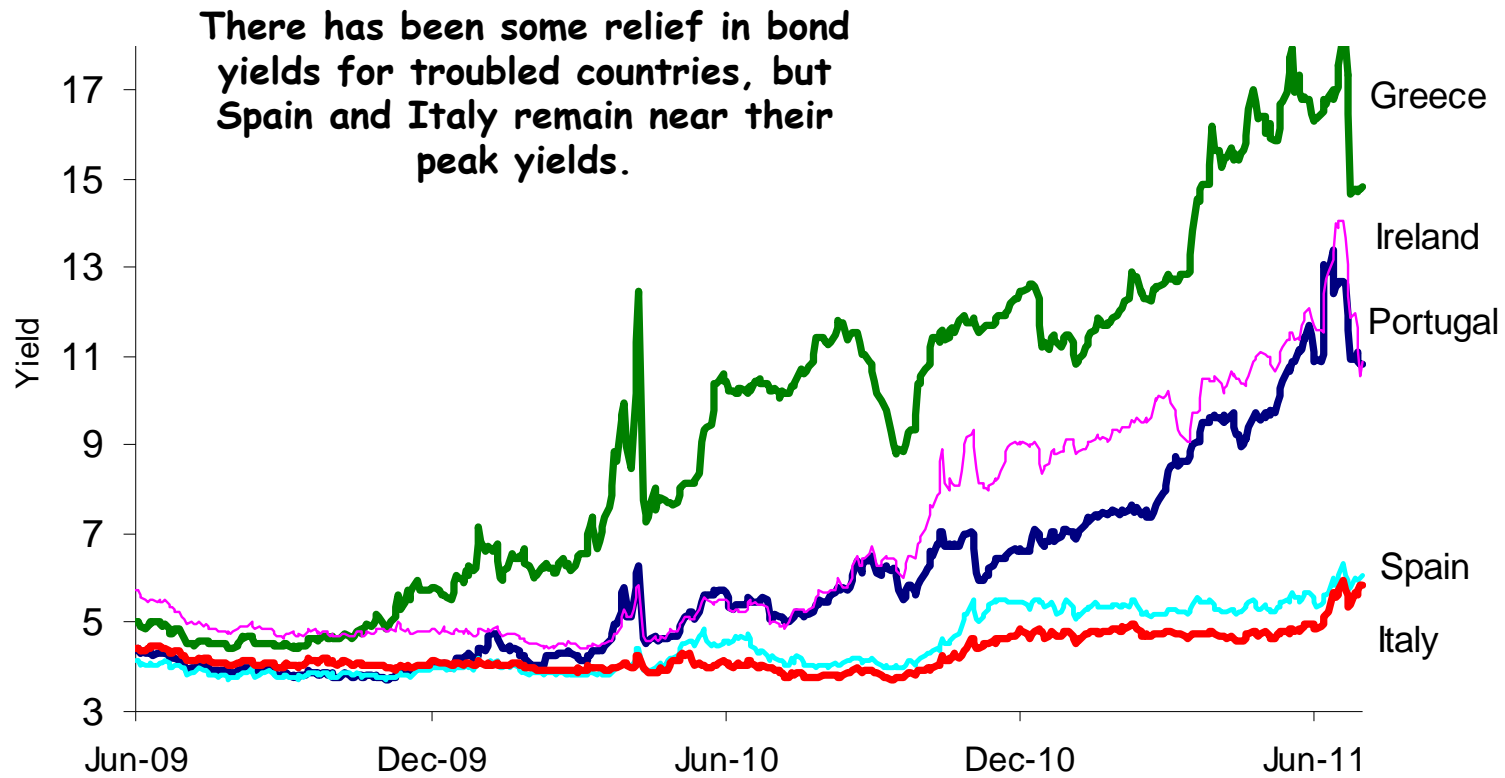
Source: CBO; House Budget Committee; Encima Global

## European Debt Crisis

- **A reimposition of local currencies by a euro country would be catastrophic but there's no movement in that direction. On the positive side, market-oriented structural reforms in southern Europe, if extensive, would improve the growth outlook.**
- **The debt restructuring process underway involves the injection of public sector funds through the IMF and EU and the sharing of remaining losses. The losses aren't large relative to the economies and banking systems of northern Europe.**
- **Several countries will restructure debts over time (e.g. Portugal.) The menu of bank options will vary country to country. As in the Latin crisis, delay in Europe is necessary for political reasons and to reduce and postpone bank losses. It causes extra payments to creditors and hurts new investment in all the peripherals including Spain and Italy.**

# Select European 10 Yr Yields

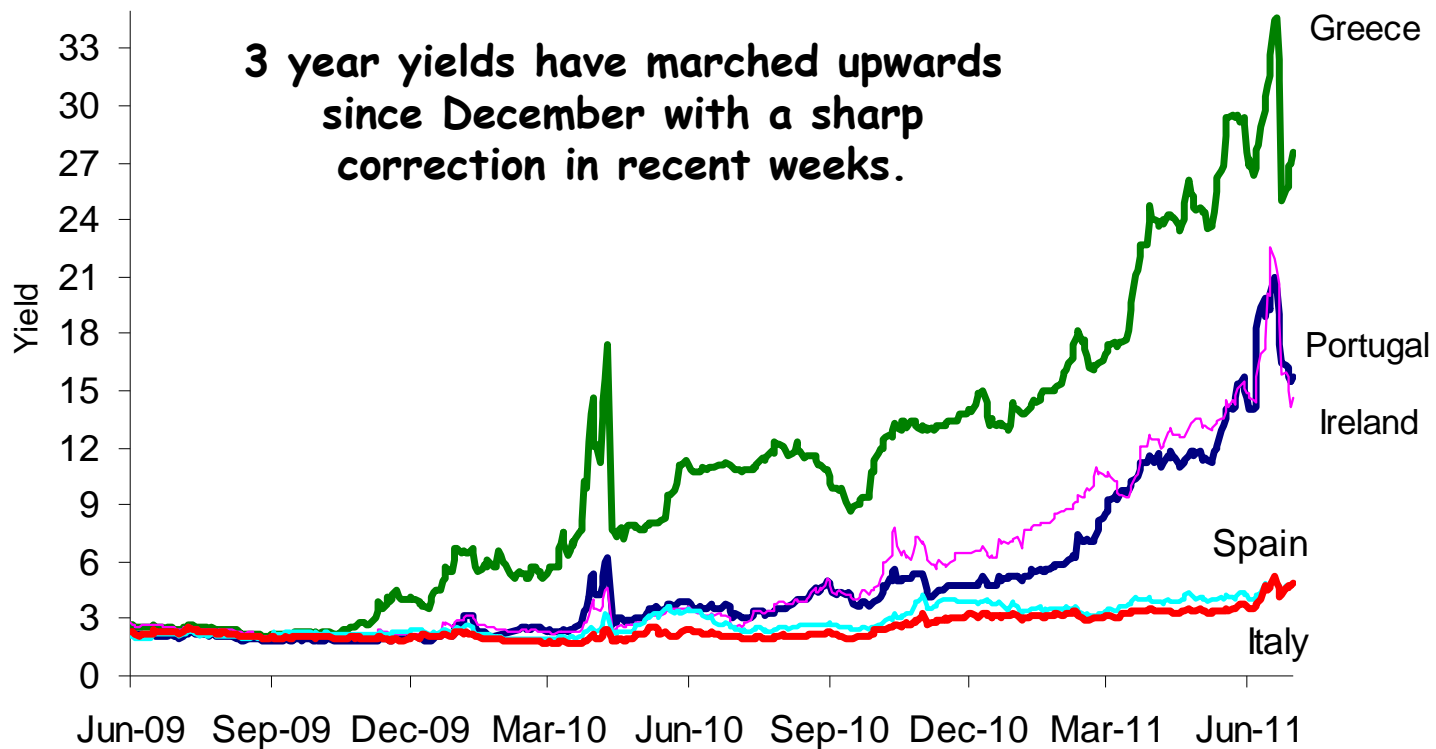
(last obs. July 29, 2011)



Source: Bloomberg; Encima Global

# Select European 3 Yr Yields

(last obs. July 29, 2011)



Source: Bloomberg; Encima Global

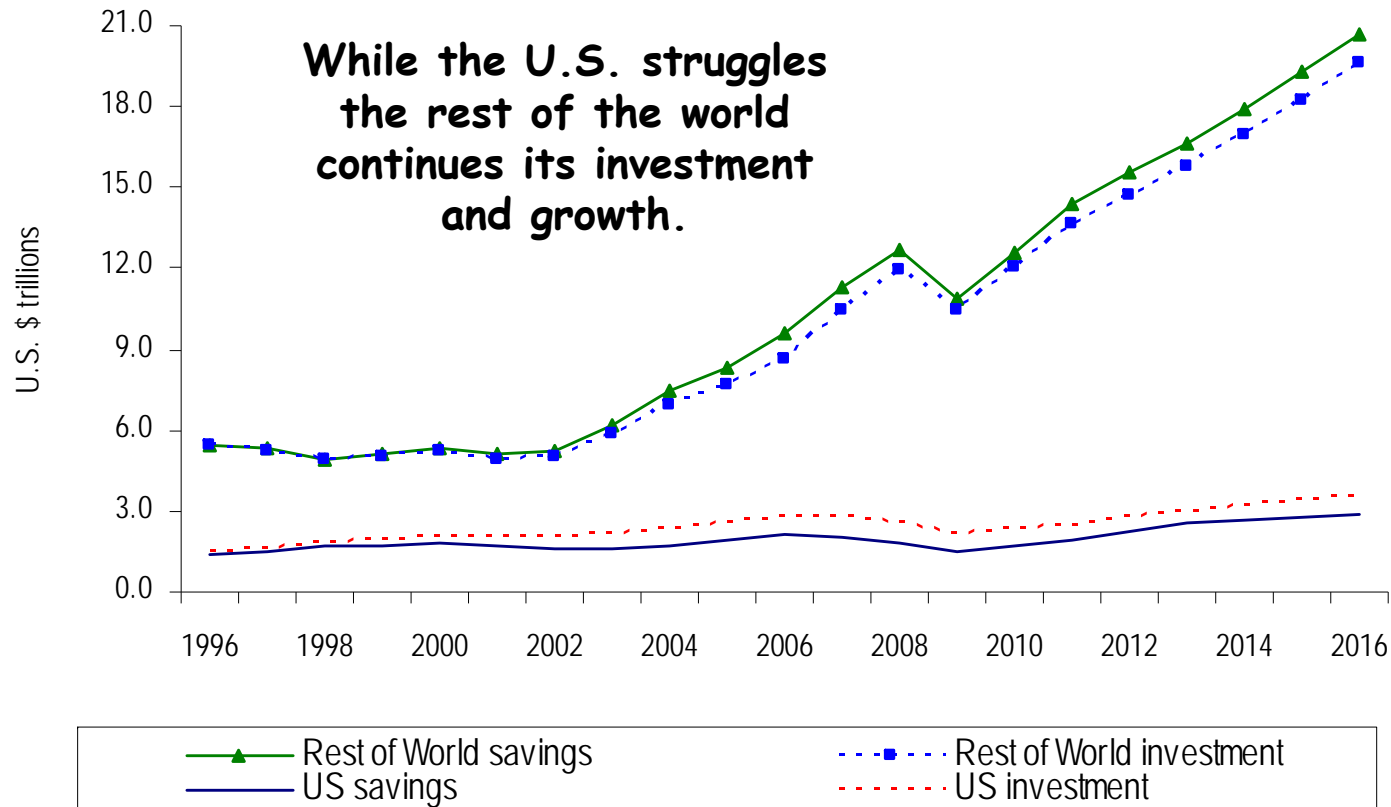
# Transformations

**Vital market-oriented structural reforms are transforming globe**

- **Creation of sound money like euro, yuan, real, rupee, T-lira to provide safety against weakening dollar**
- **Internet; information for farmers, geneticists, innovators; Google, Facebook**
- **Privatizations like Petrobras; ownership of trucking, telecom**
- **Personal retirement accounts and defined contribution plans**
- **Private property and title to it**
- **Long local currency yield curves and entry of foreign banks are allowing globalization of financial intermediation**
- **Market-based pricing – still more to go**
- **In the U.S., state-driven structural reforms -- privatizations, tort reform, defined contribution plans**

# Investment Outside U.S. Growing Fast

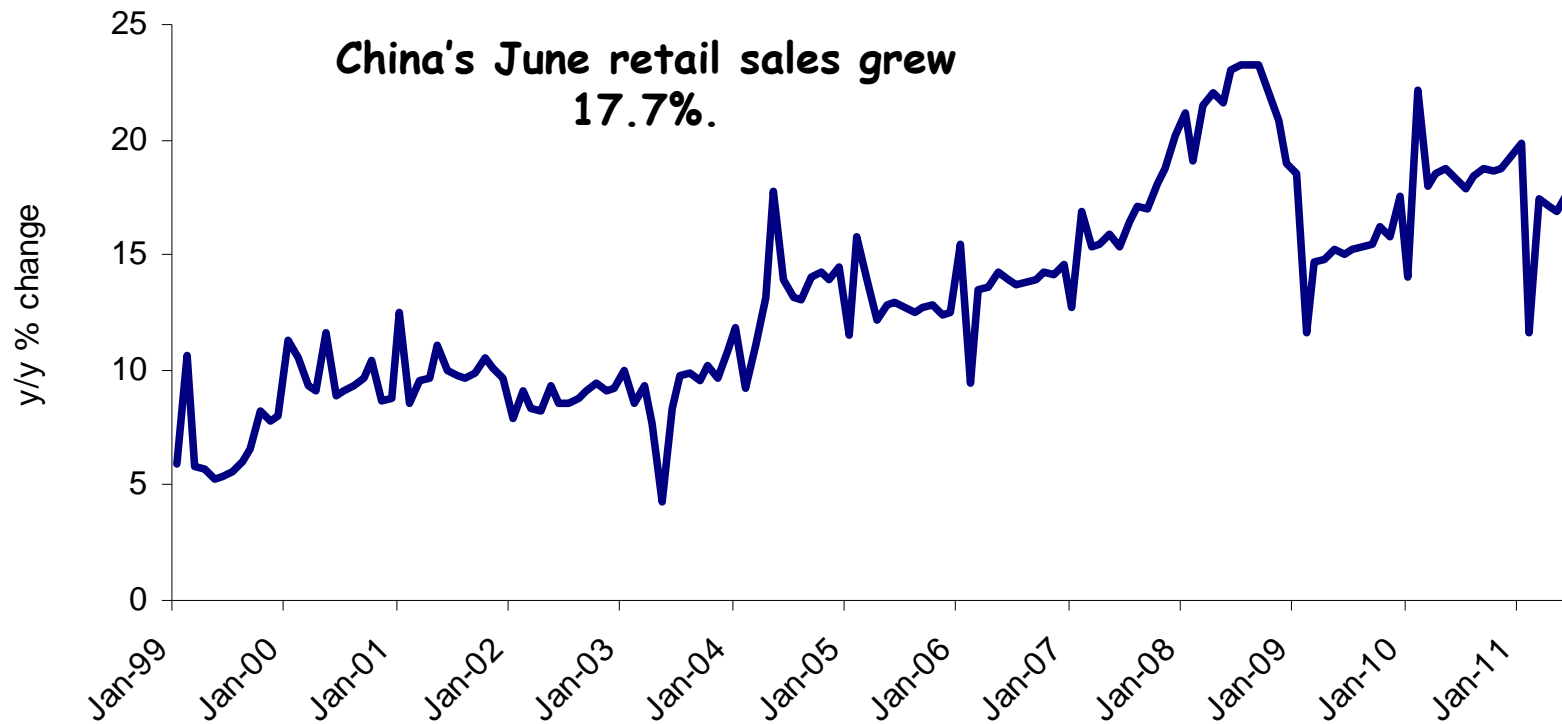
(last obs. 2010)



Source: IMF; Encima Global

# China's Retail Sales Y/Y

(last obs. June 2011)

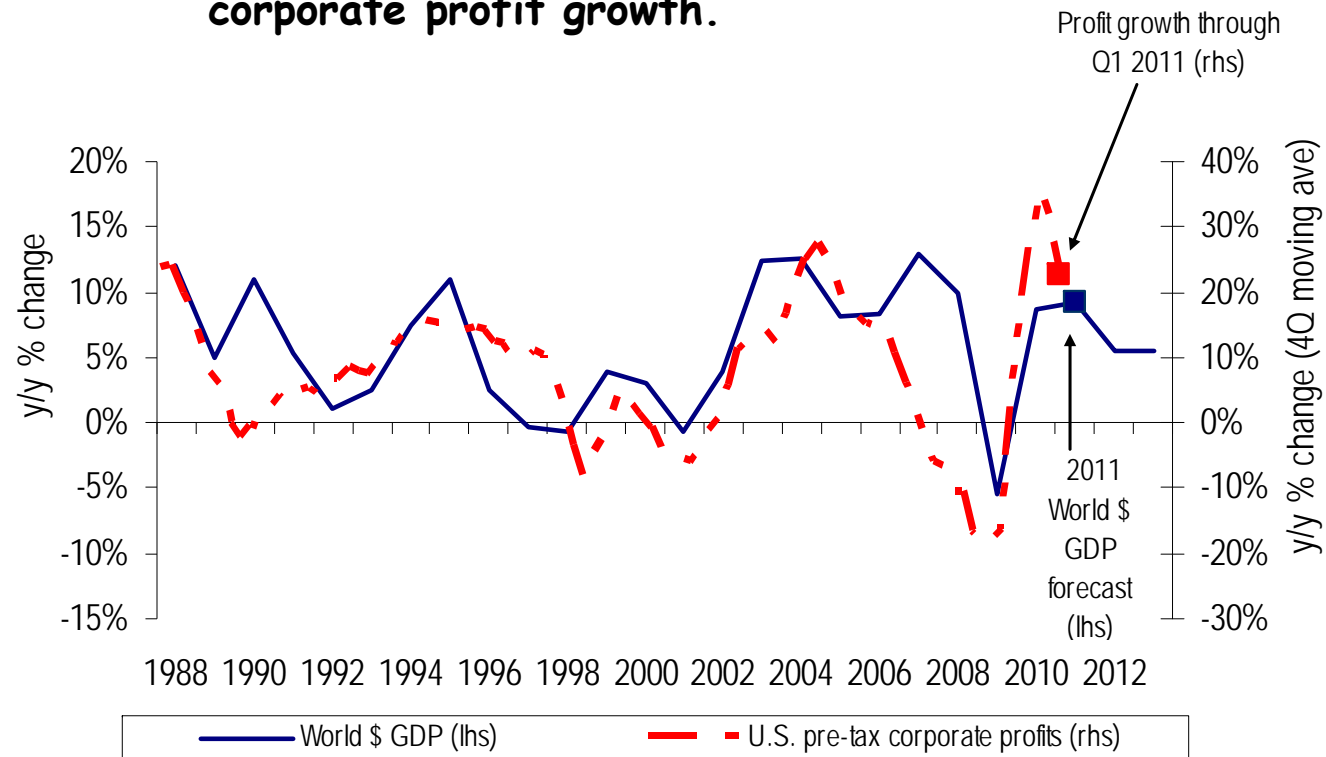


Source: Bloomberg; Encima Global

# U.S. Corporate Profit Growth and World \$ GDP

(last obs. Q1 2011 for NIPA corporate profits, IMF forecasts for \$ GDP to 2013)

**Strong growth in world \$ GDP supporting U.S. corporate profit growth.**



Source: Bureau of Economic Analysis; IMF; Encima Global

## The World In 2016

- **U.S. debt-to-GDP ratio 85% (now 65%) but no tipping point.**
  - **Weak-dollar policy continues; credit pump transfers U.S. capital and investment abroad.**
  - **U.S. share of world GDP falls; U.S. share of world investment falls much more.**
  - **Fed funds higher; bullish as it happens; M2 growth will soar as borrowers seek loans.**
  - **Treasury yield curve inverts over time (like in 2000 and 2006).**
  - **Housing starts double to 800,000; major internet-sized invention**
  - **Dollar weaker, gold and commodities somewhat higher; inflation averages 3.5% yoy.**
  - **Yuan strengthens 5% per year reaching 5 per dollar (currently 6.5).**
  - **European growth shifts north; southern Europe still in euro but decrepit and waiting strong leaders.**
  - **Non-bank financial services much larger and more innovative; non-U.S. earnings grow as share of U.S. corporate earnings.**
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