Economic Chartbook
October 2011

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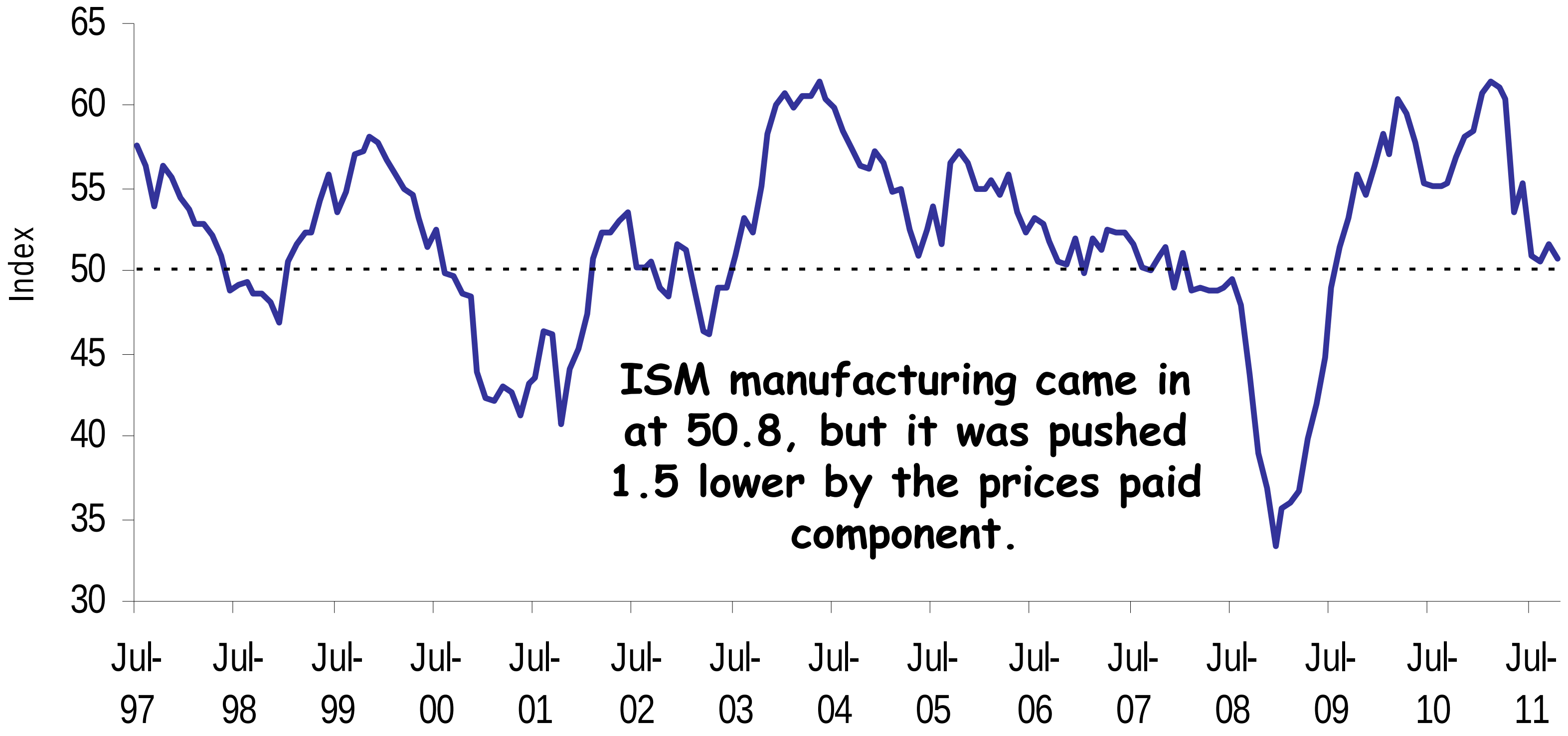
Overview

- August and September U.S. data improved after Japan-related disruptions in the second quarter. However, we expect weakness in coming quarters due to the sharp U.S. fiscal and monetary policy deterioration and the many weaknesses in Europe's debt crisis policies.
- Confirming the U.S. drag: very weak income growth; a U.S. budget policy impasse that is likely to keep blocking tax reform and spending restraint; the regulatory problems facing banks, housing and mortgages; and the Fed's anti-growth near-zero rate policy. Confidence and animal spirits remain low.
- Under current policies, we expect southern Europe's recession to deepen, northern Europe to fall into recession and the U.S. to enter a shallow recession in 2012. S&P 500 earnings may stay under $100 in 2012, showing little or no growth from 2011.
- We don't agree with many of the more deeply negative views. That economies are destined to grow slowly after a deep financial crisis due to deleveraging. That the U.S. is already in a recession. That the euro has to break up. That China will slow hard to 5%. That we're heading for a Lehman crisis or a Japan-style deflation. That the Fed printed money, the dollar will crash, and fast inflation is just around the corner. The most likely outcome is slower growth and increasing European debt problems until policies change in 2012.

ISM Manufacturing

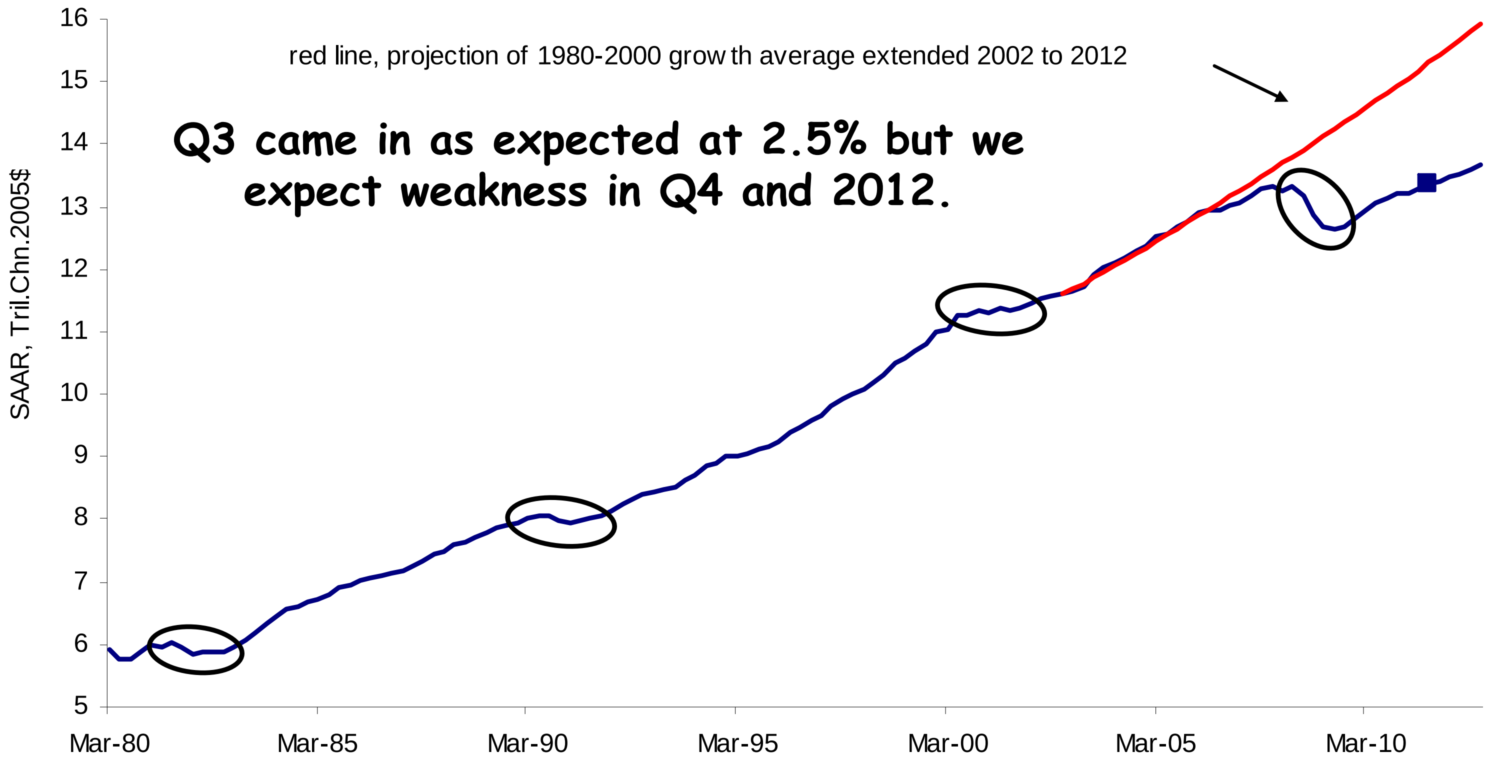
(last obs. October 2011)



Source: Institute for Supply Management; Encima Global

Real GDP Growing Slowly From a Low Base

(last obs. blue square Q3 2011, projected to Q4 2012)

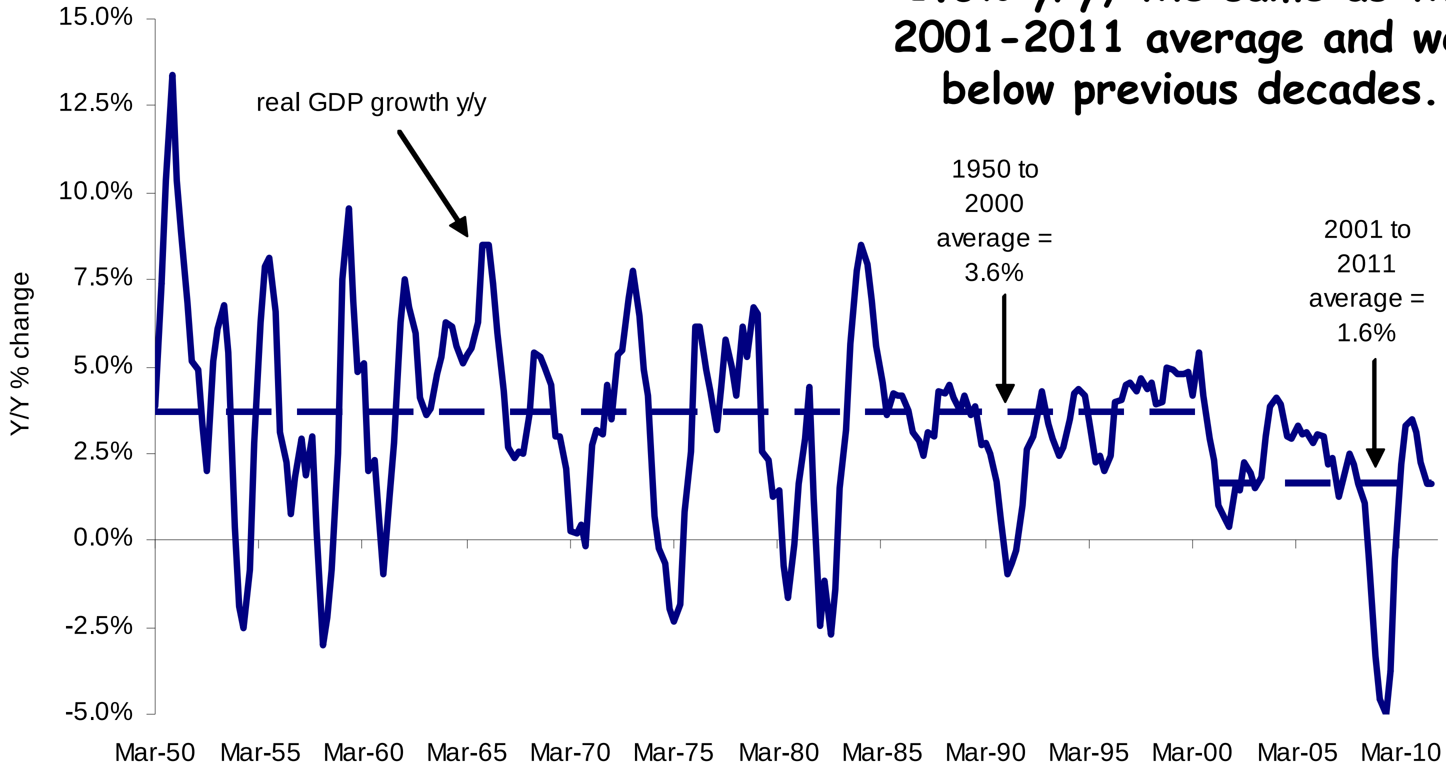


Source: Bureau of Economic Analysis; Encima Global

Real GDP y/y

(last obs. Q3 2011)

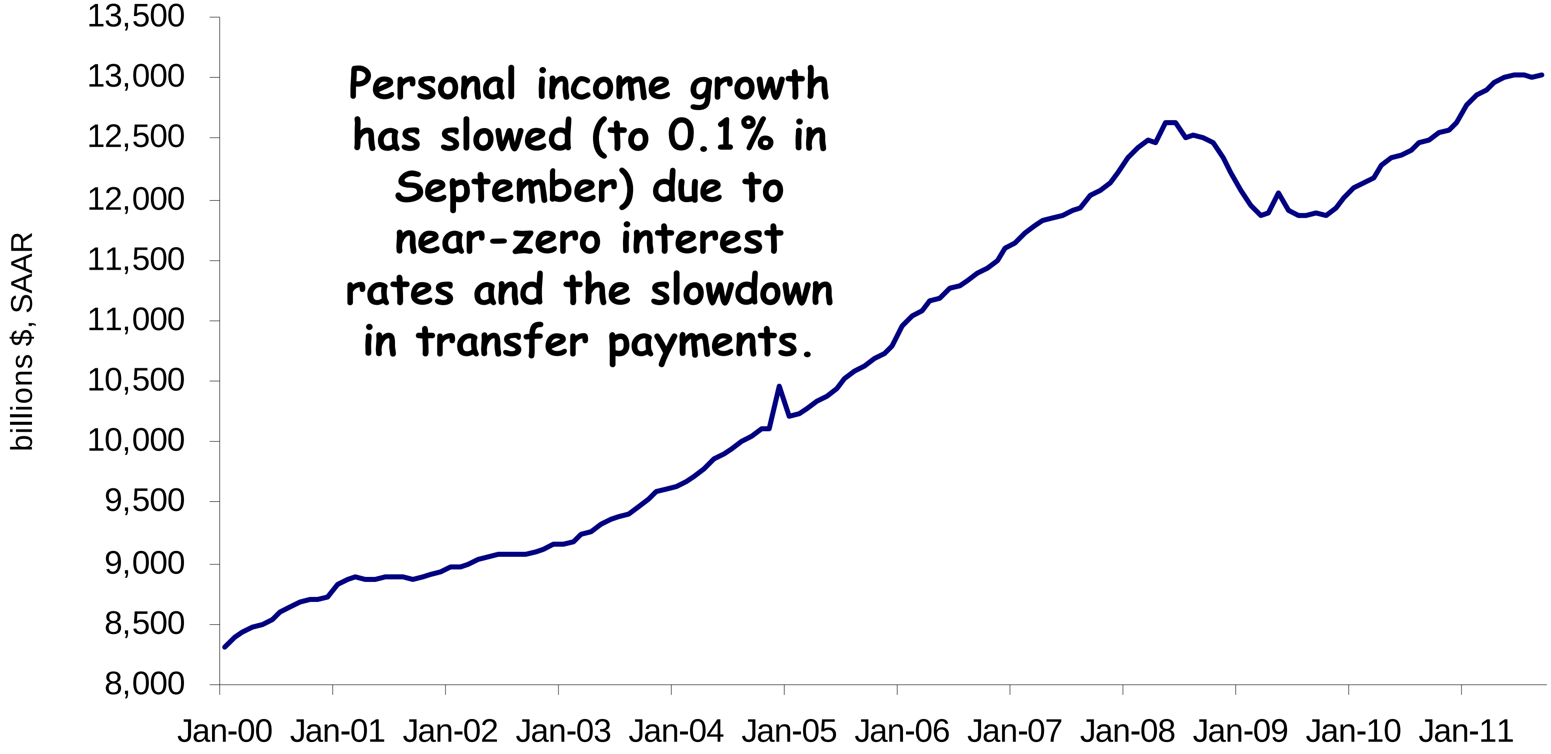
Growth has remained slow at 1.6% y/y, the same as the 2001-2011 average and well below previous decades.



Source: Bureau of Economic Analysis; Encima Global

Personal Income: Growing Slowly from Low Base

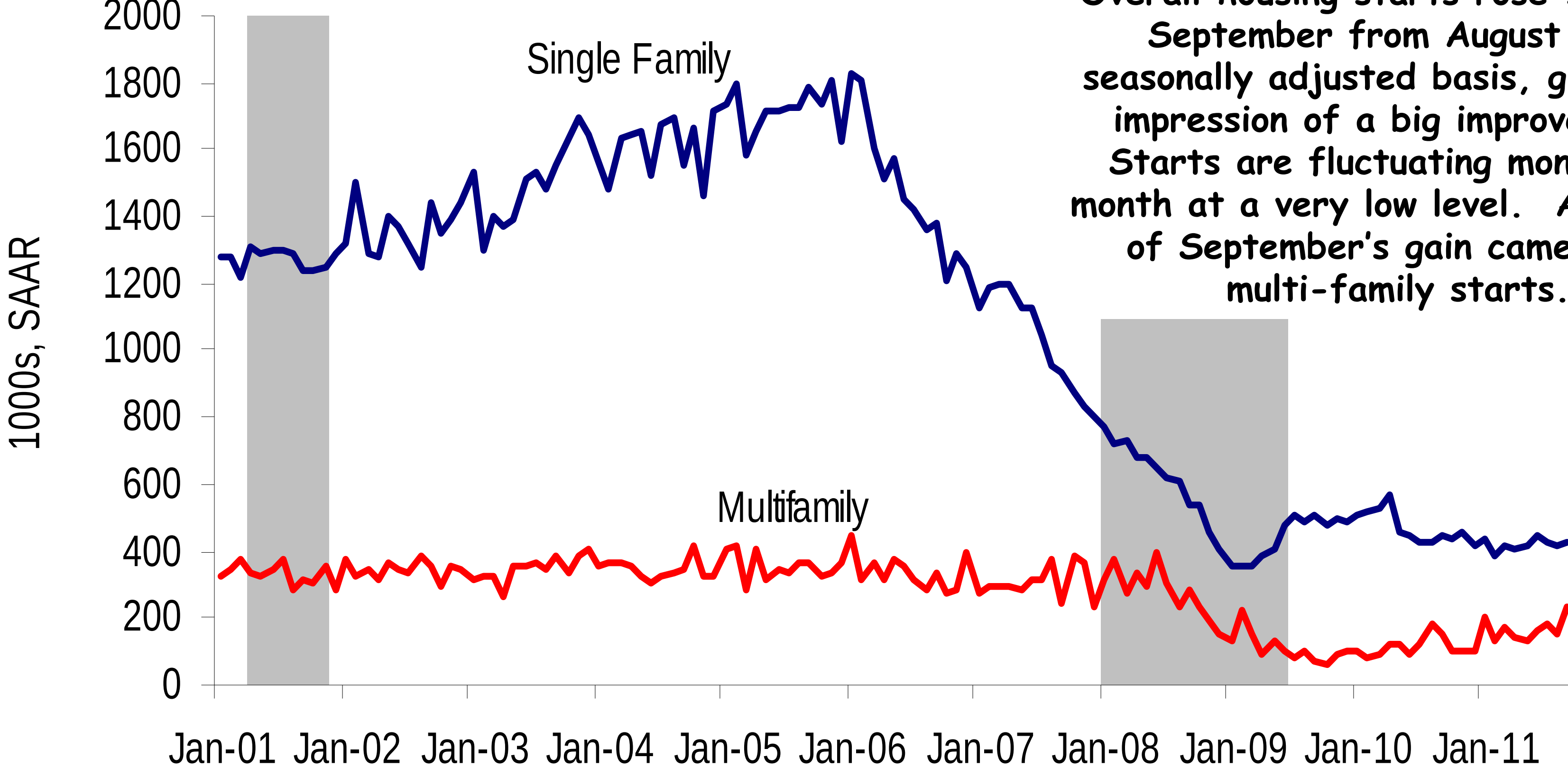
(last obs. September 2011)



Source: Bureau of Economic Analysis; Encima Global

Housing Starts Still Weak

(last obs. September 2011)



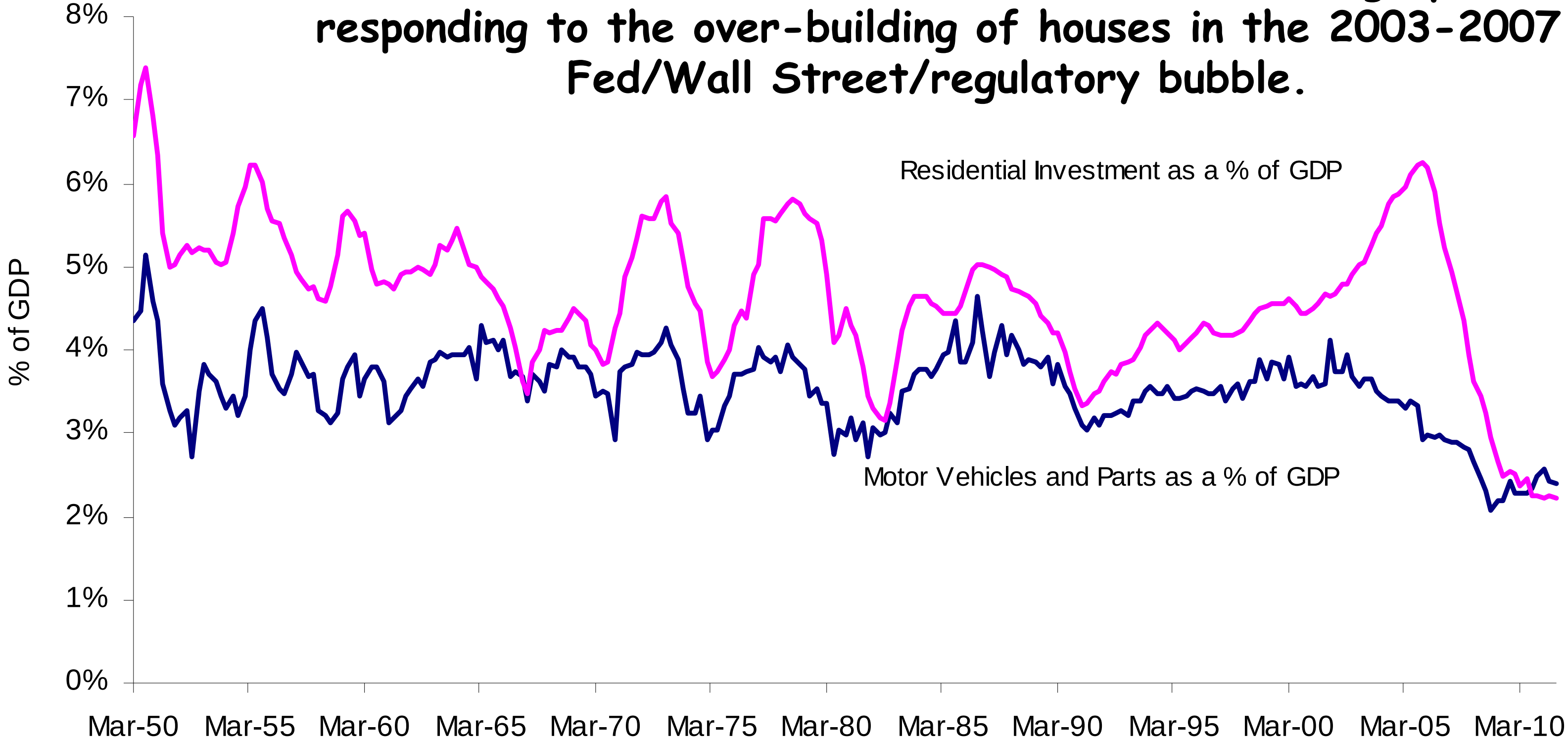
Overall housing starts rose 15.0% in September from August on a seasonally adjusted basis, giving the impression of a big improvement. Starts are fluctuating month-to-month at a very low level. Almost all of September's gain came from multi-family starts.

Source: Census Bureau; Encima Global

Motor Vehicles and Housing as a % of GDP

(last obs. Q3 2011)

Motor vehicles are now a bigger % of GDP than housing. This is the first clear cross-over since WWII, in large part responding to the over-building of houses in the 2003-2007 Fed/Wall Street/regulatory bubble.



Source: Bureau of Economic Analysis; Encima Global

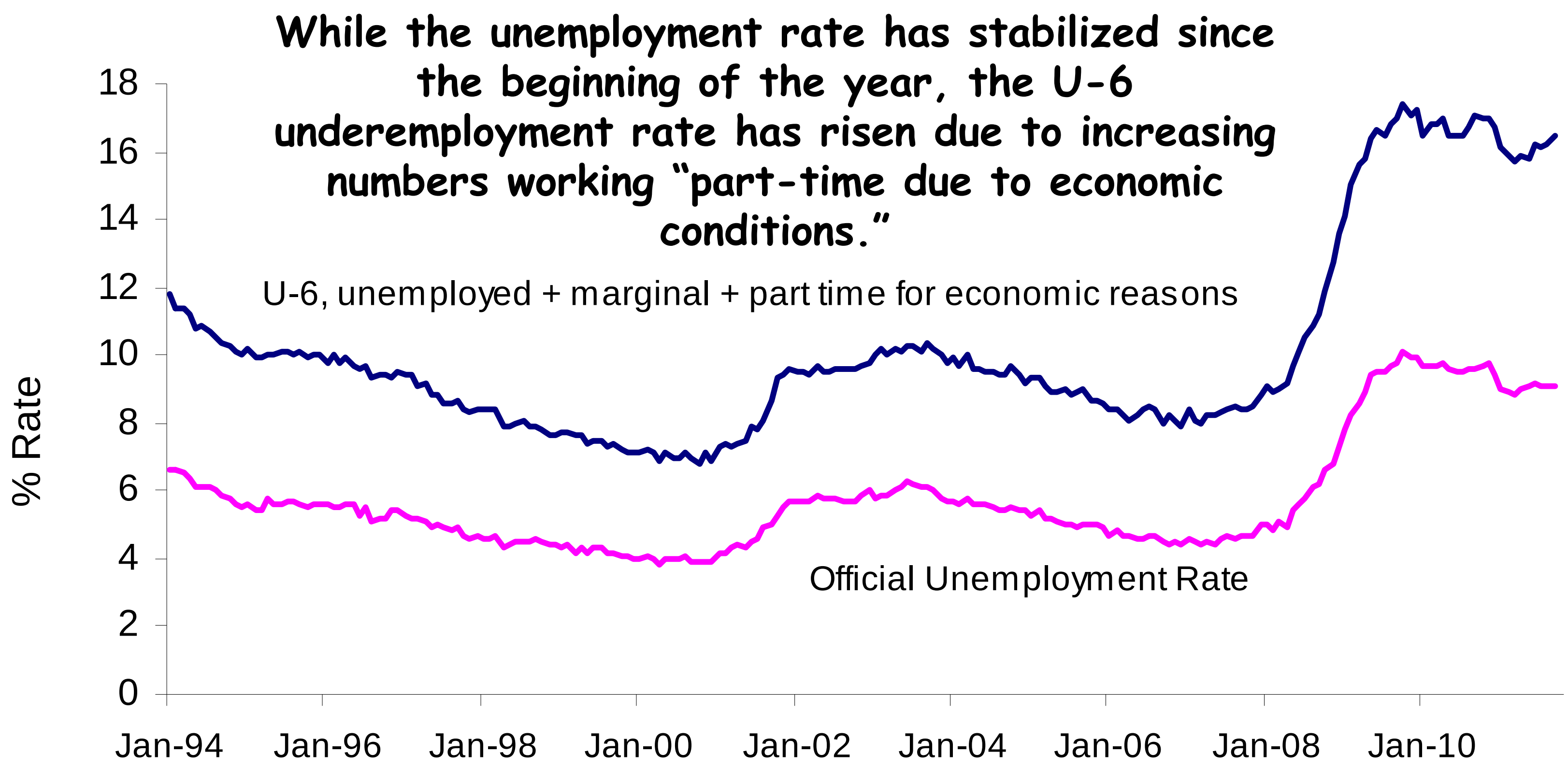
Headline and Core Consumer Price Index Y/Y

(last obs. September 2011)

Source: Bureau of Labor Statistics; Encima Global

Unemployment and Underemployment Rates

(last obs. September 2011, unemployment 9.1%, underemployment 16.5%)



Source: Bureau of Labor Statistics; Encima Global

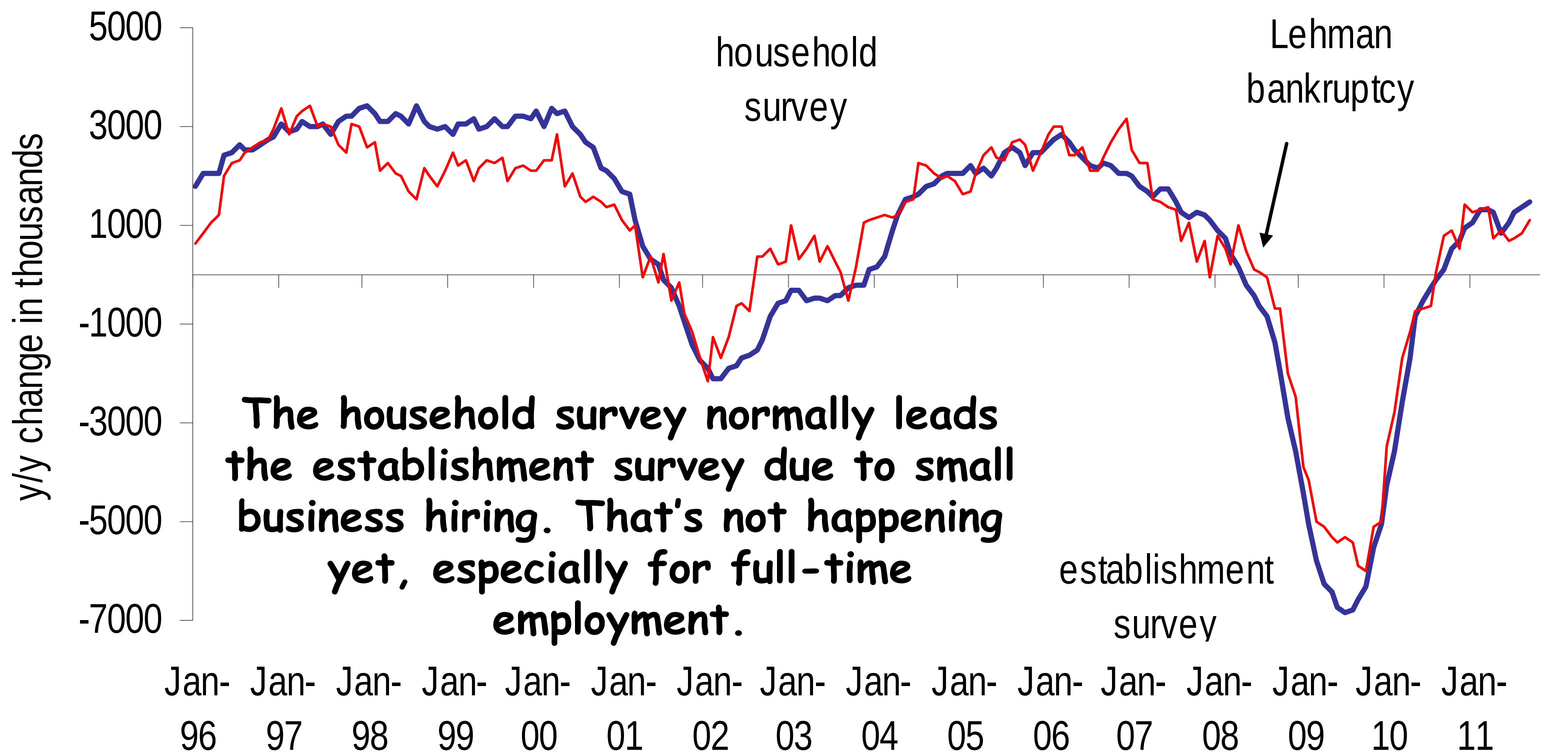
Misery Index

(last obs. September 2011)

Source: Bureau of Labor Statistics; Encima Global

Annual Employment Growth

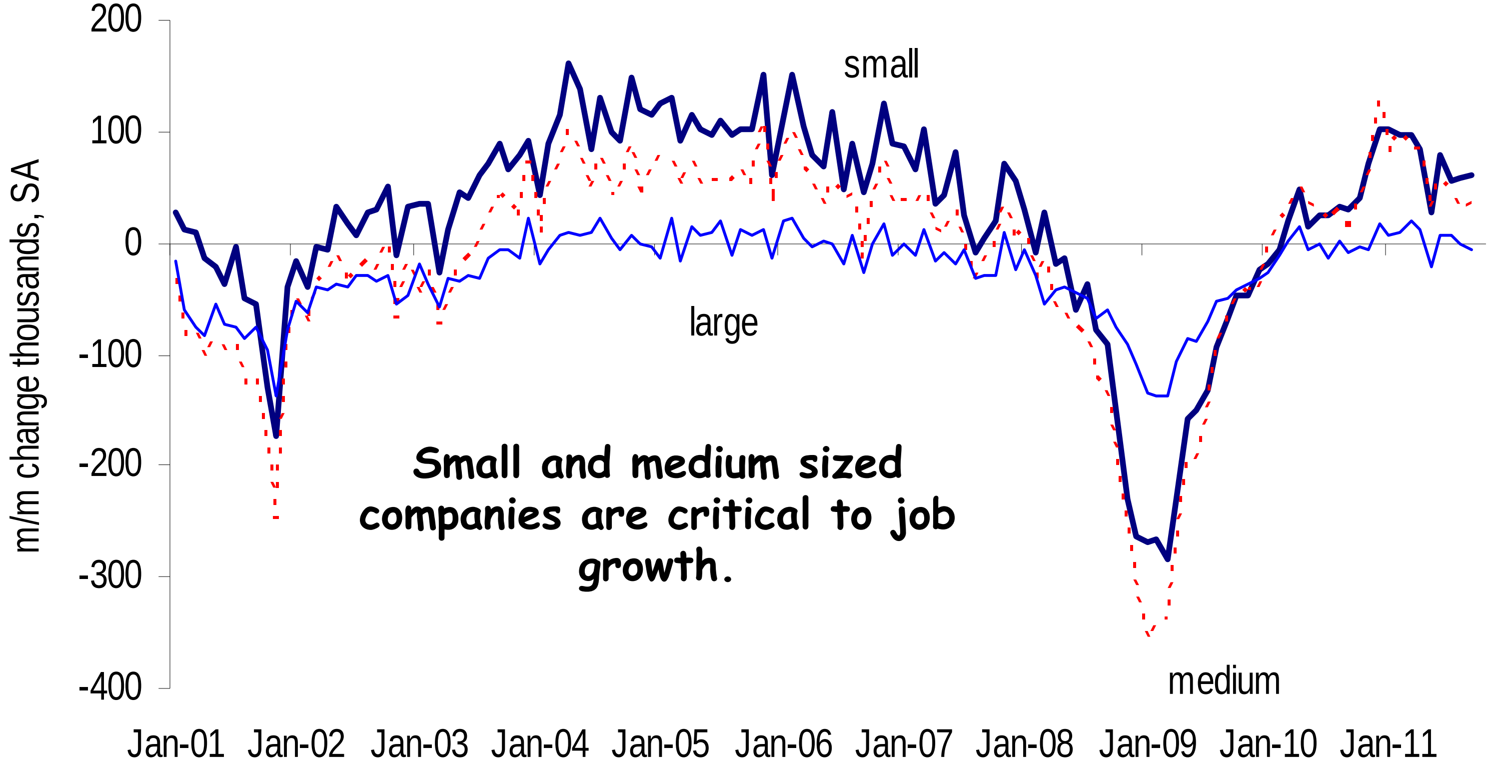
(last obs. September 2011)



Source: Bureau of Labor Statistics; Encima Global

ADP Jobs Monthly Jobs Growth by Company Size

(last obs. September 2011)



Source: Automatic Data Processing: Encima Global

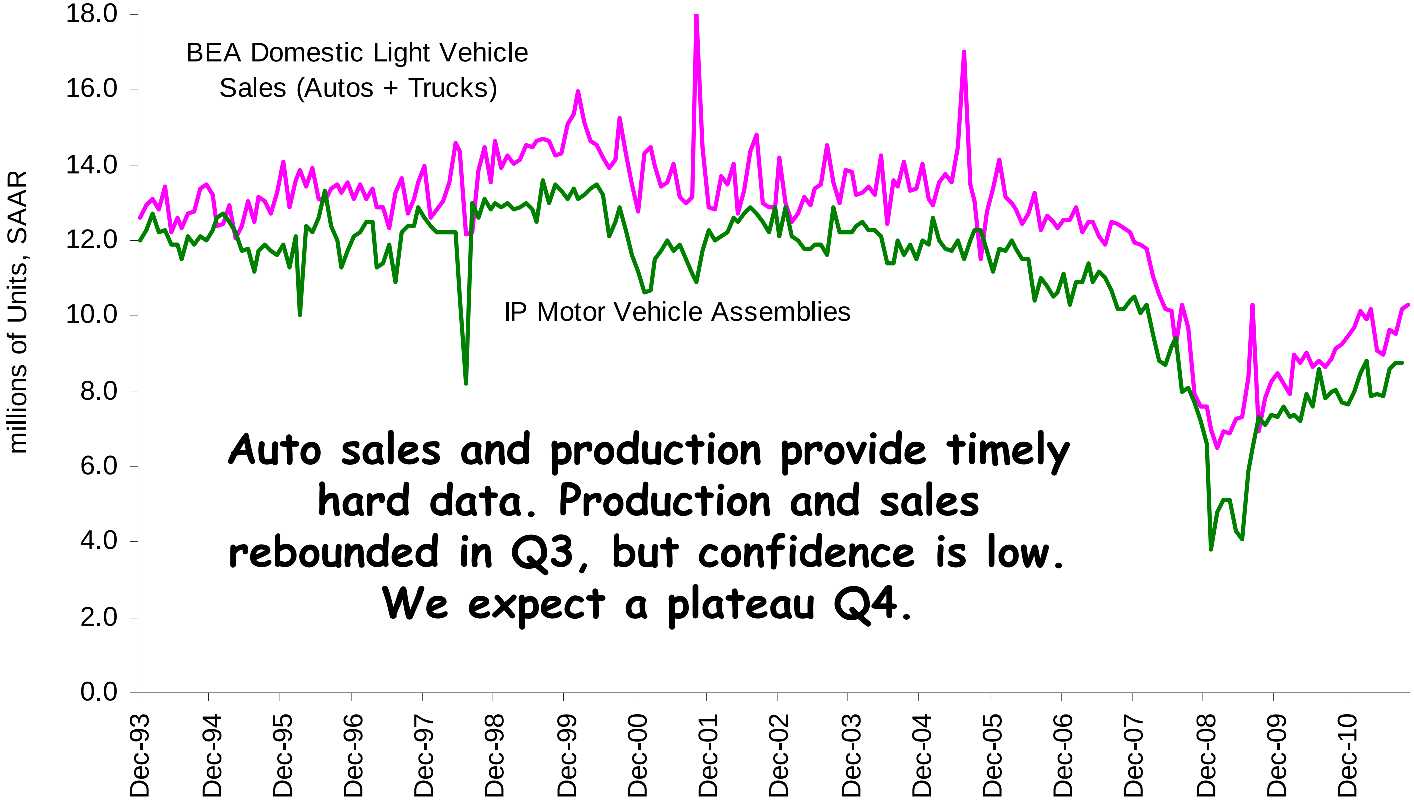
Initial Jobless Claims Showing Expansion Underway

(last obs. October 22, 2011)

Source: Department of Labor: Encima Global

Auto Sales and Production

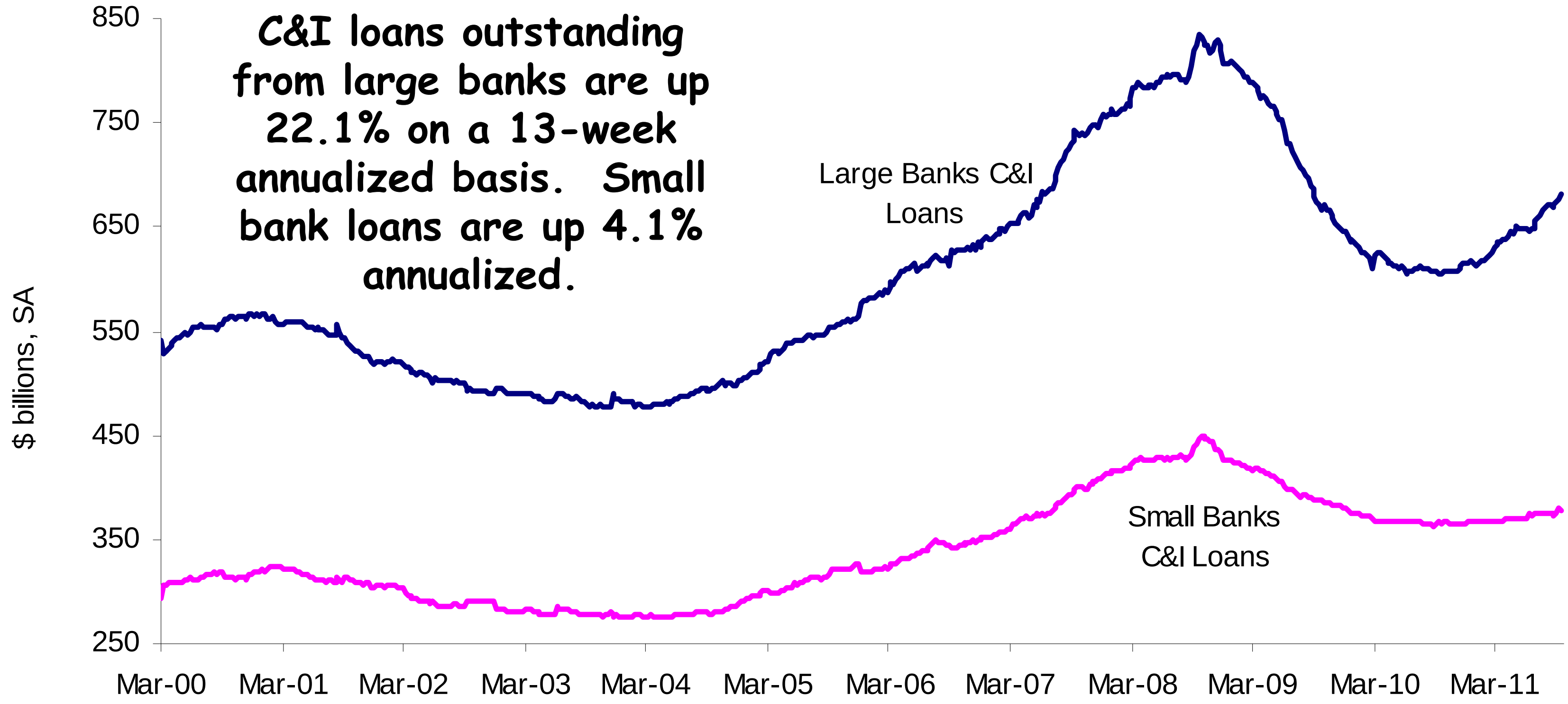
(last obs. September 2011, sales estimate for October 2011)



Source: BEA; Federal Reserve; Encima Global

Commercial and Industrial Loans Rising Some

(last obs. October 19, 2011)

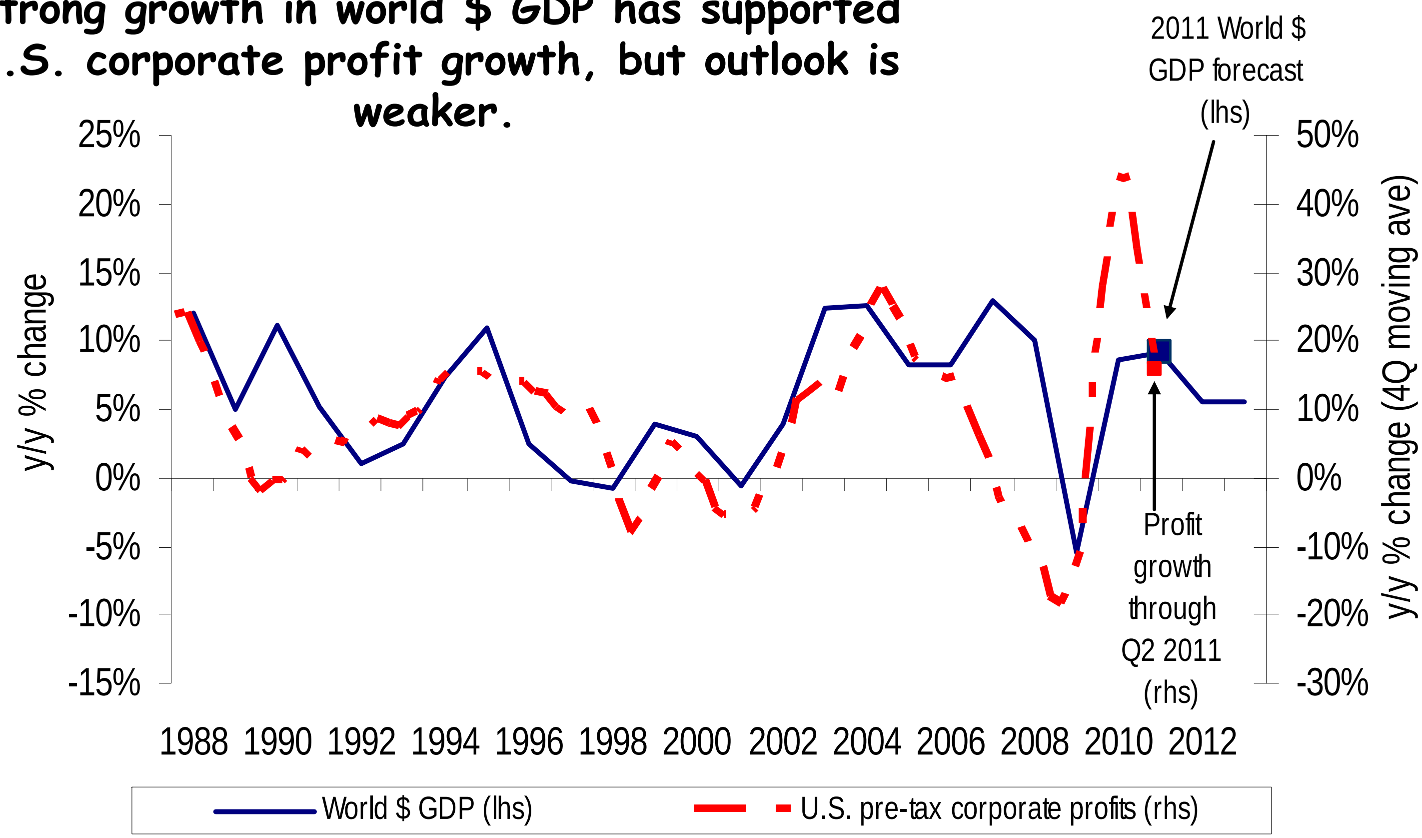


Source: Federal Reserve; Encima Global

U.S. Corporate Profits Grow with World $ GDP

(last obs. Q2 2011 for NIPA corporate profits, IMF forecasts for $ GDP to 2013)

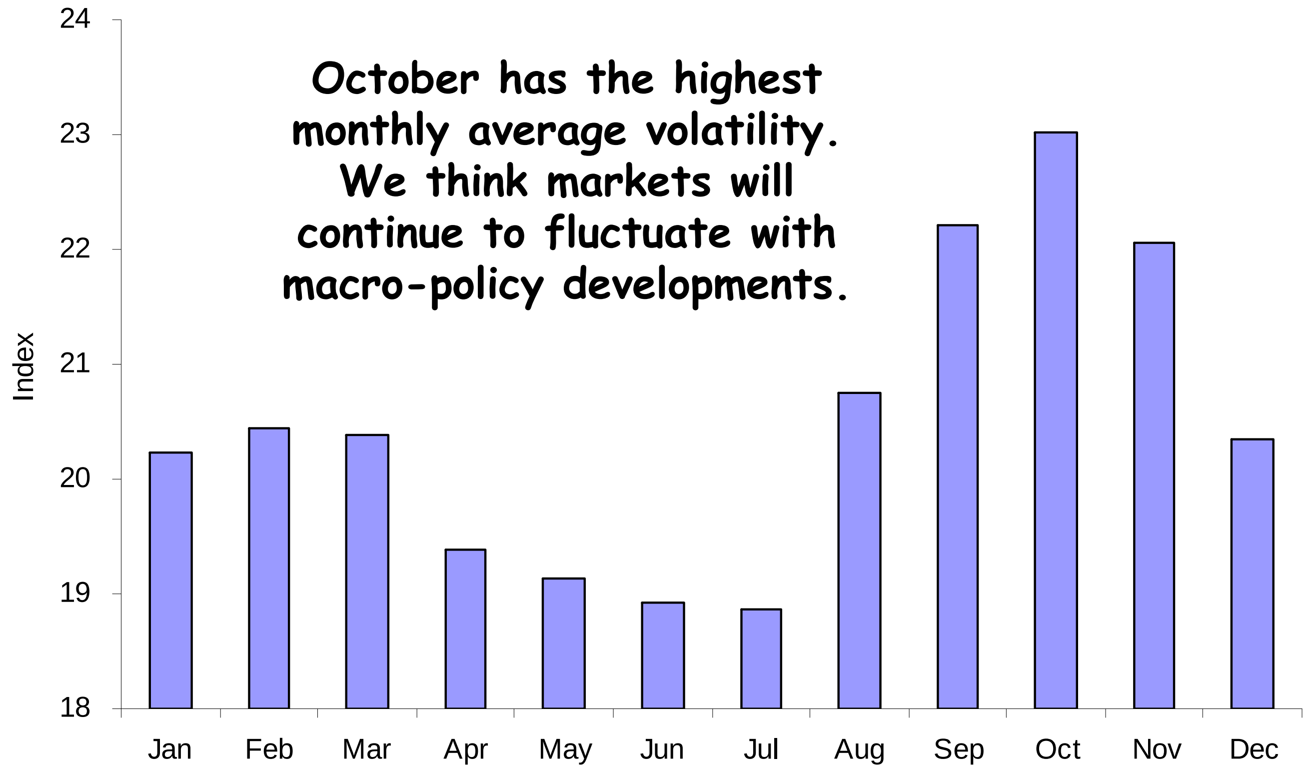
Strong growth in world $ GDP has supported U.S. corporate profit growth, but outlook is weaker.



Source: Bureau of Economic Analysis; IMF; Encima Global

VIX Monthly Averages

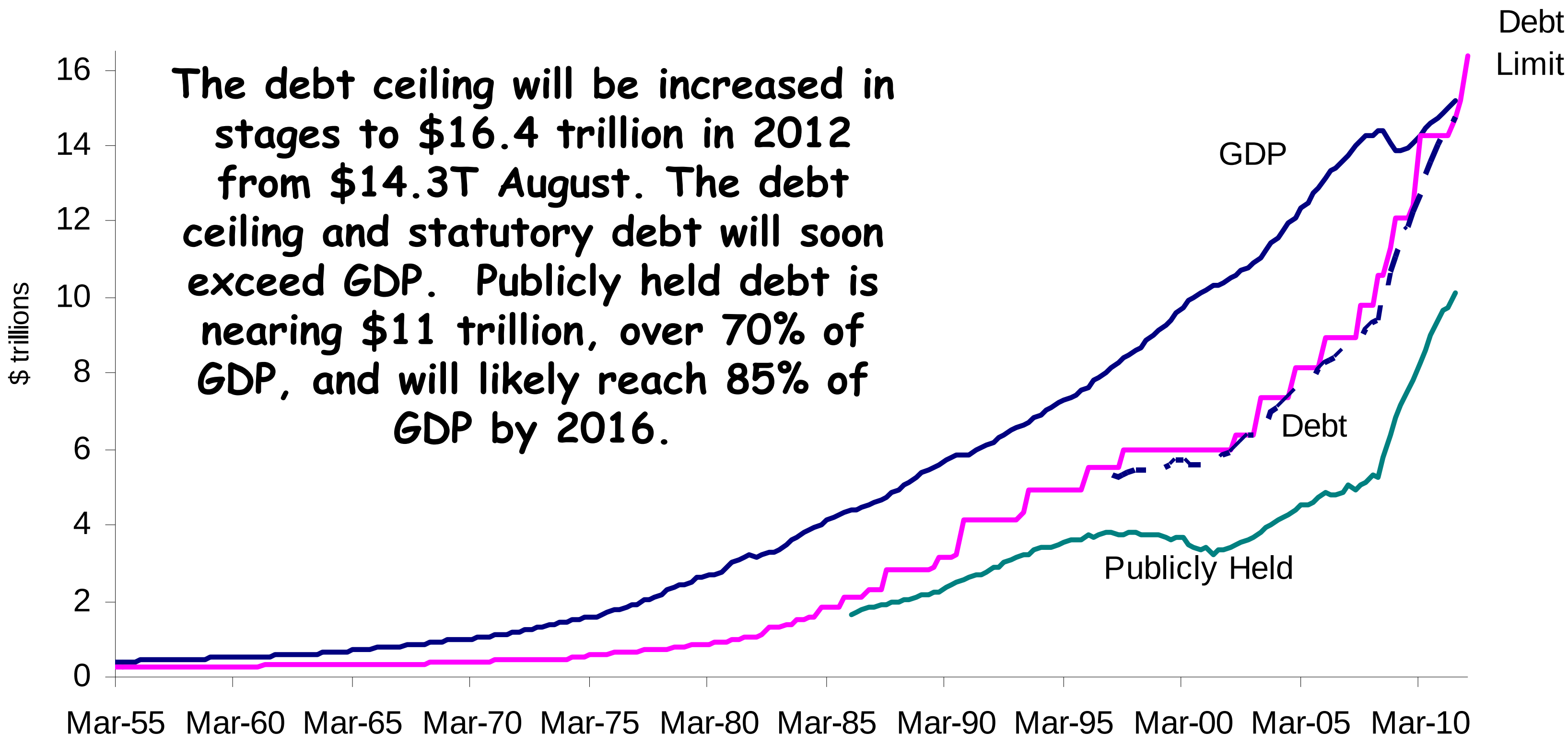
(data from 1990 to 2011)



Source: Wall Street Journal; Encima Global

Publicly Held Debt Reaching 70% of GDP

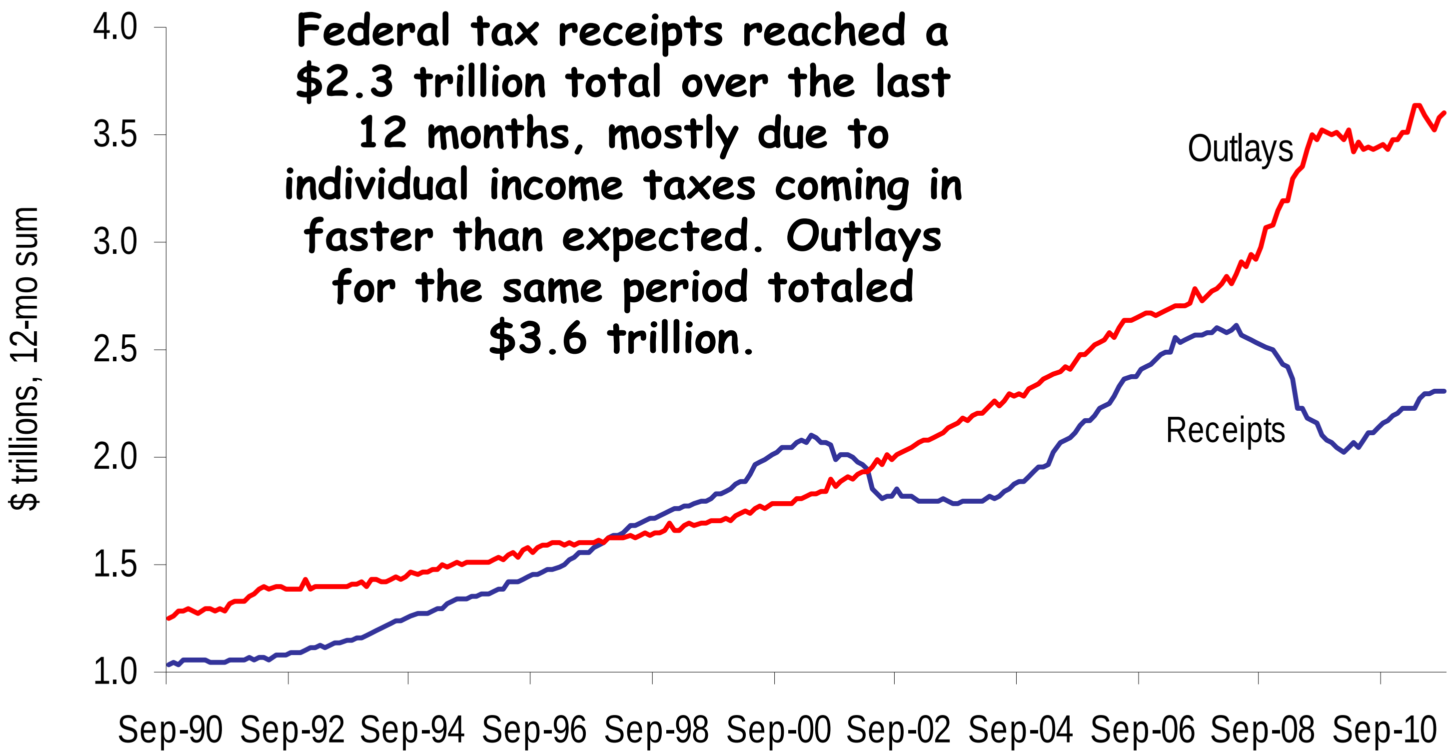
(last obs. Q3 2011, Q1 2012 for debt limit)



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

Level of Federal Receipts and Outlays ($ trillions)

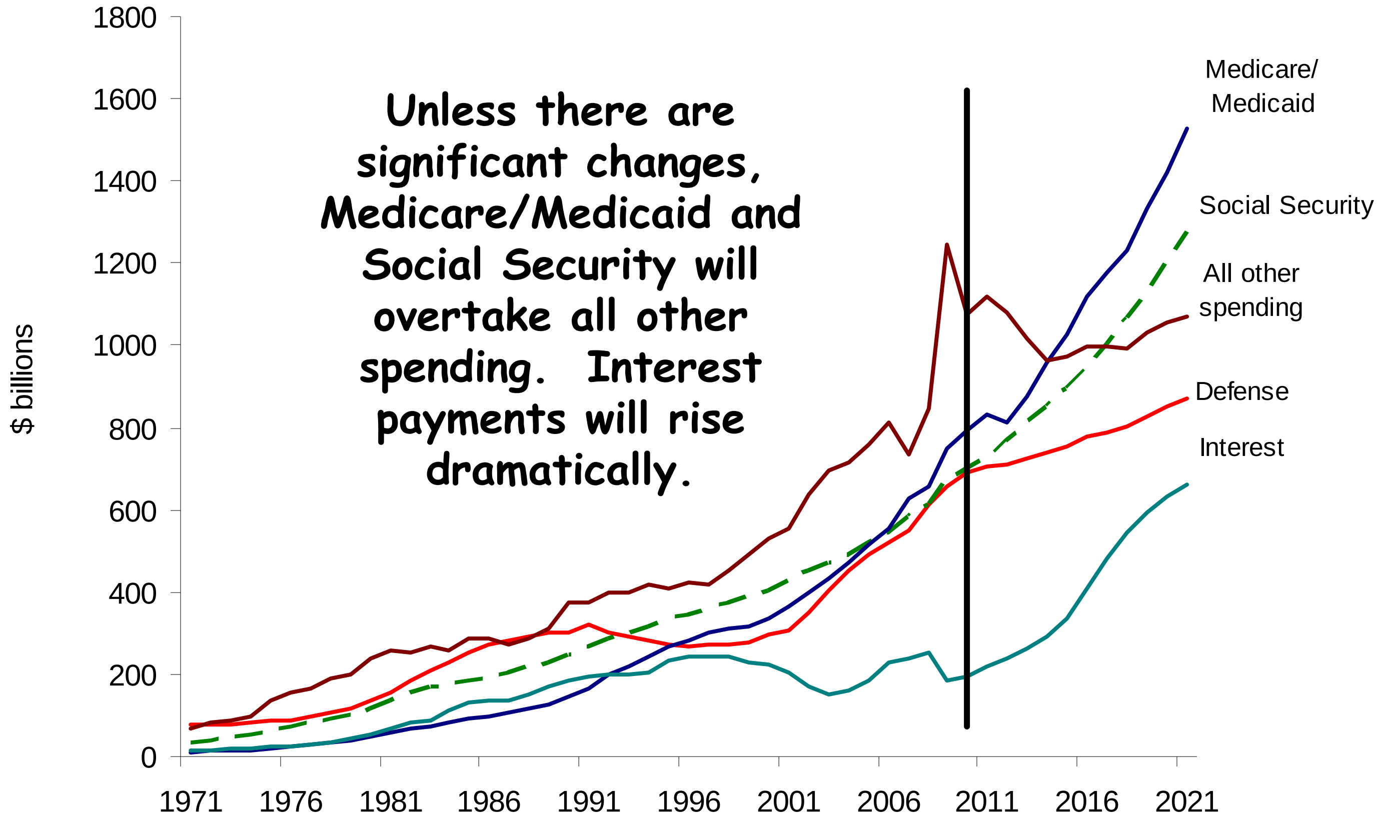
(last obs. September 2011)



Source: U.S. Treasury: Encima Global

Level of Federal Spending by Major Category

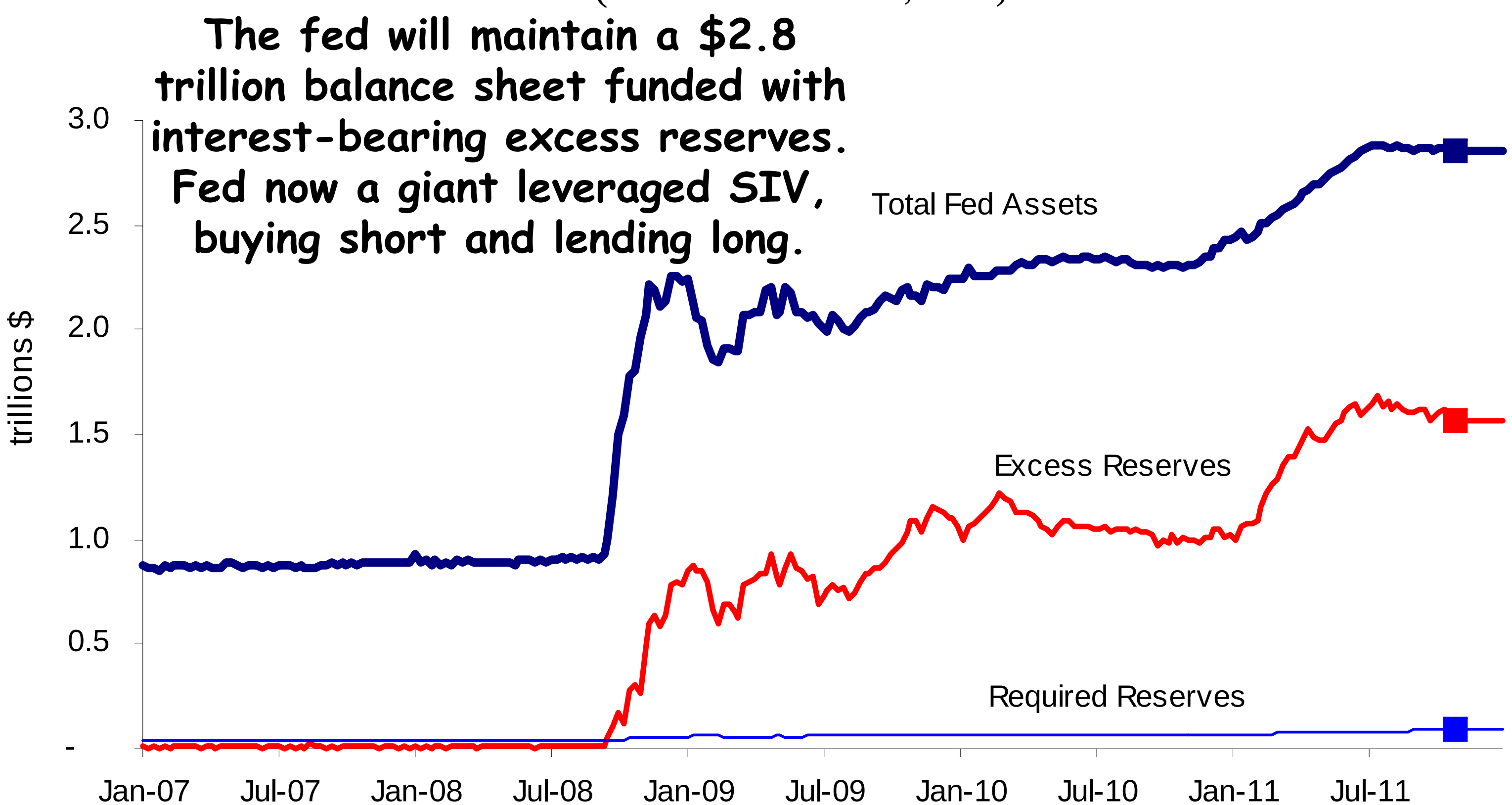
(last obs. 2010, projected to 2021)



Source: CBO: Encima Global

Fed 'Sterilized' QE2 Through 25bp rate and Credit Rationing -- 'Pushing on a String'

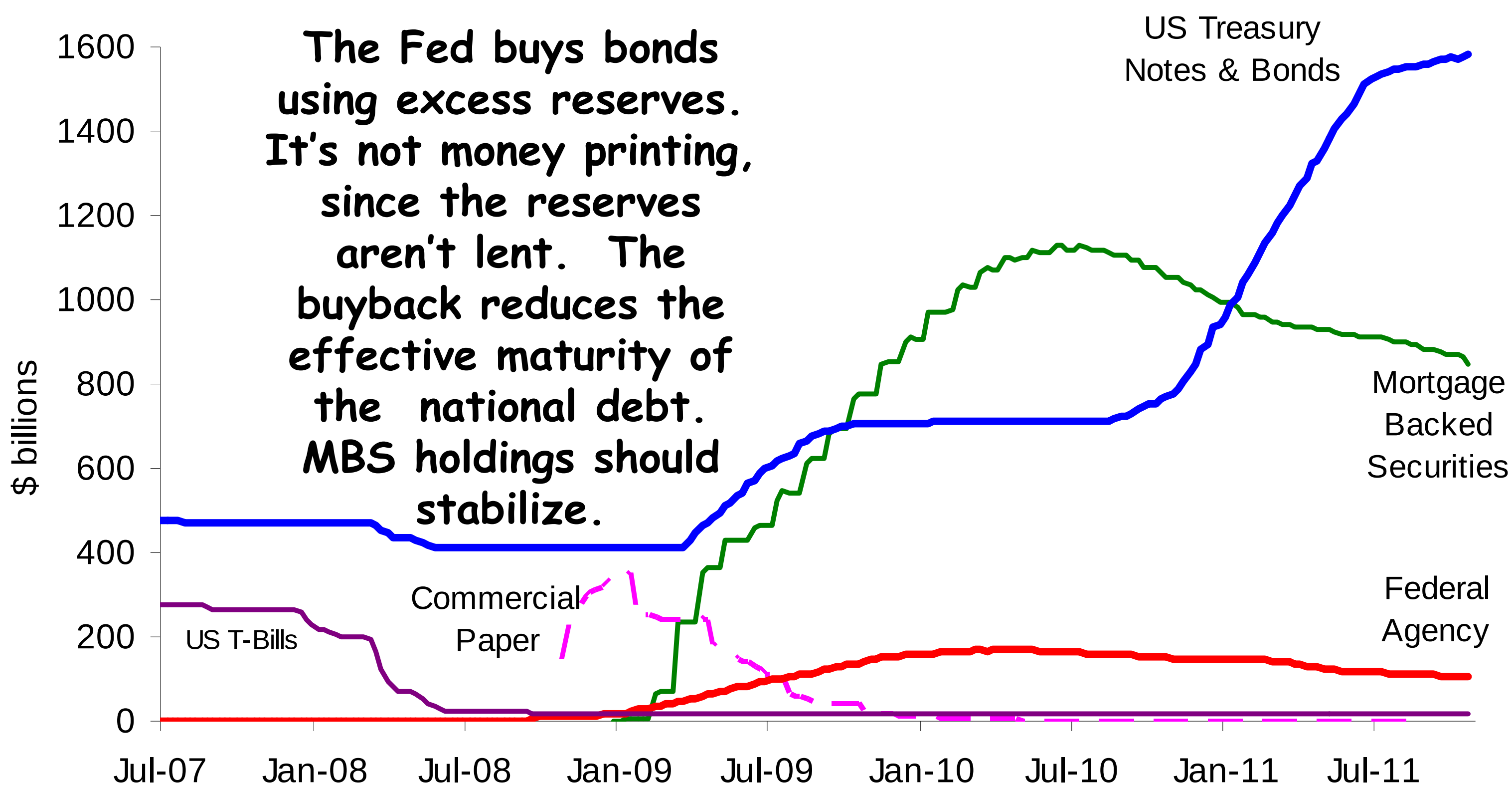
(last obs. October 26, 2011)



Source: Federal Reserve: Encima Global

Fed Assets

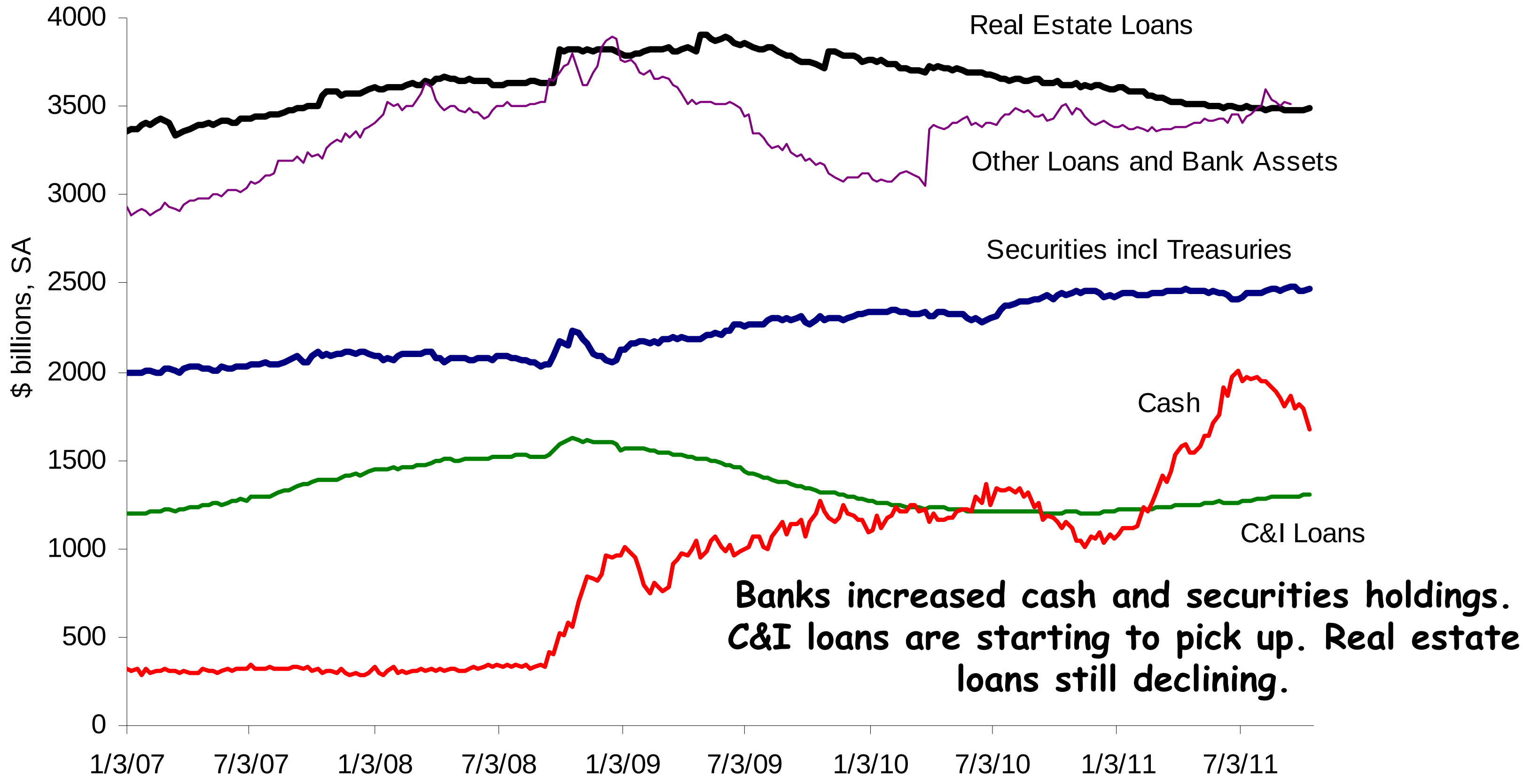
(last obs. October 26, 2011)



Source: Federal Reserve: Encima Global

Bank Assets: Cash Has Risen Sharply Due to QE2

(last obs. October 12, 2011)

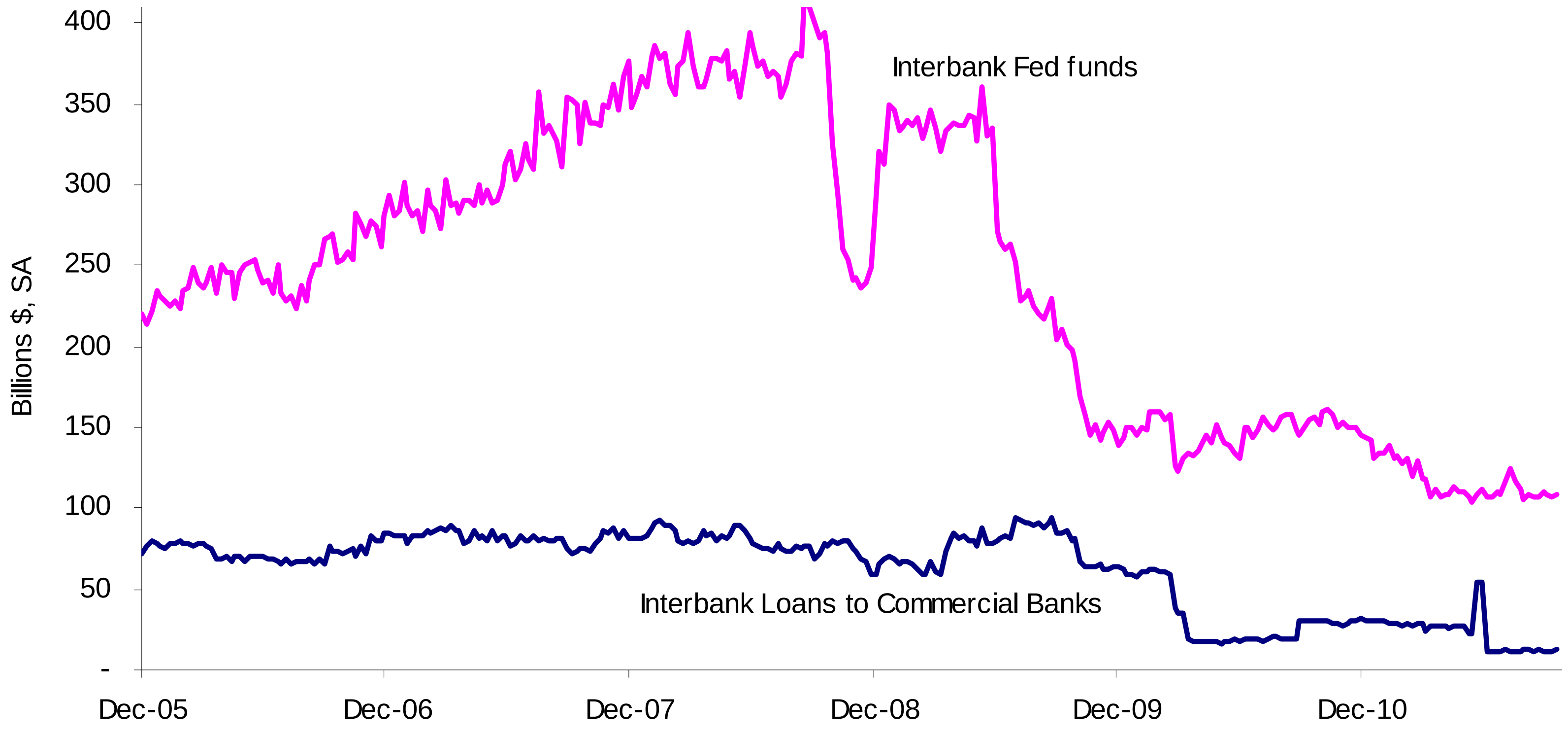


Source: Federal Reserve: Encima Global

Interbank Lending Under Pressure From Zero Rates

(last obs. October 21, 2011)

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



Source: Federal Reserve; Encima Global

10 Year U.S. Treasury Yield Too Low

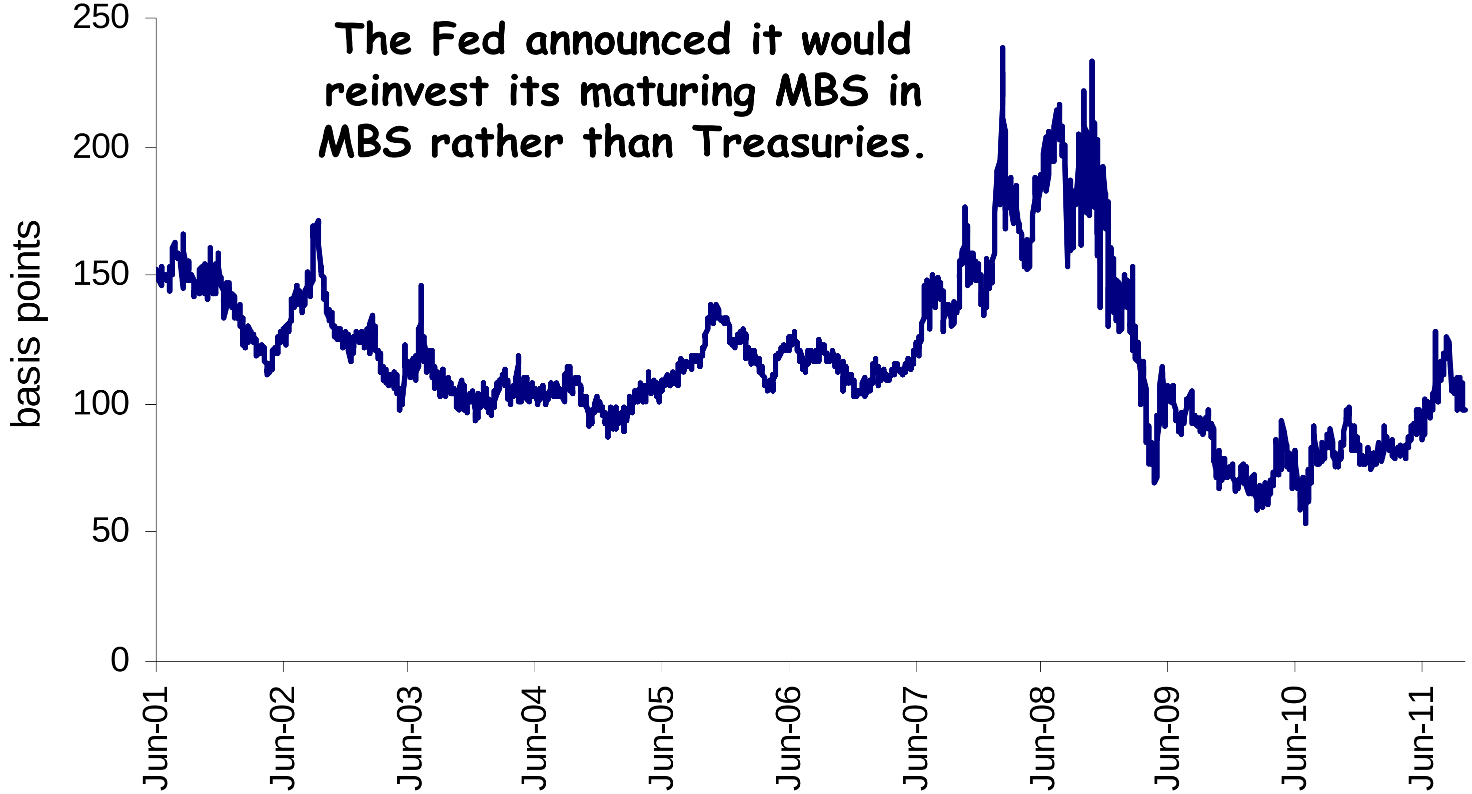
(last obs. October 31, 2011)

Investors have been buying bonds to protect against deflation and gold to protect against inflation (the barbell trade). This leaves less capital for growth. We think both bonds and gold are in a bubble that will pop if better policies emerge.

Source: Federal Reserve Board; Encima Global

MBS Yield less 10 Yr U.S. Treasury Yields

(last obs. October 31, 2011)



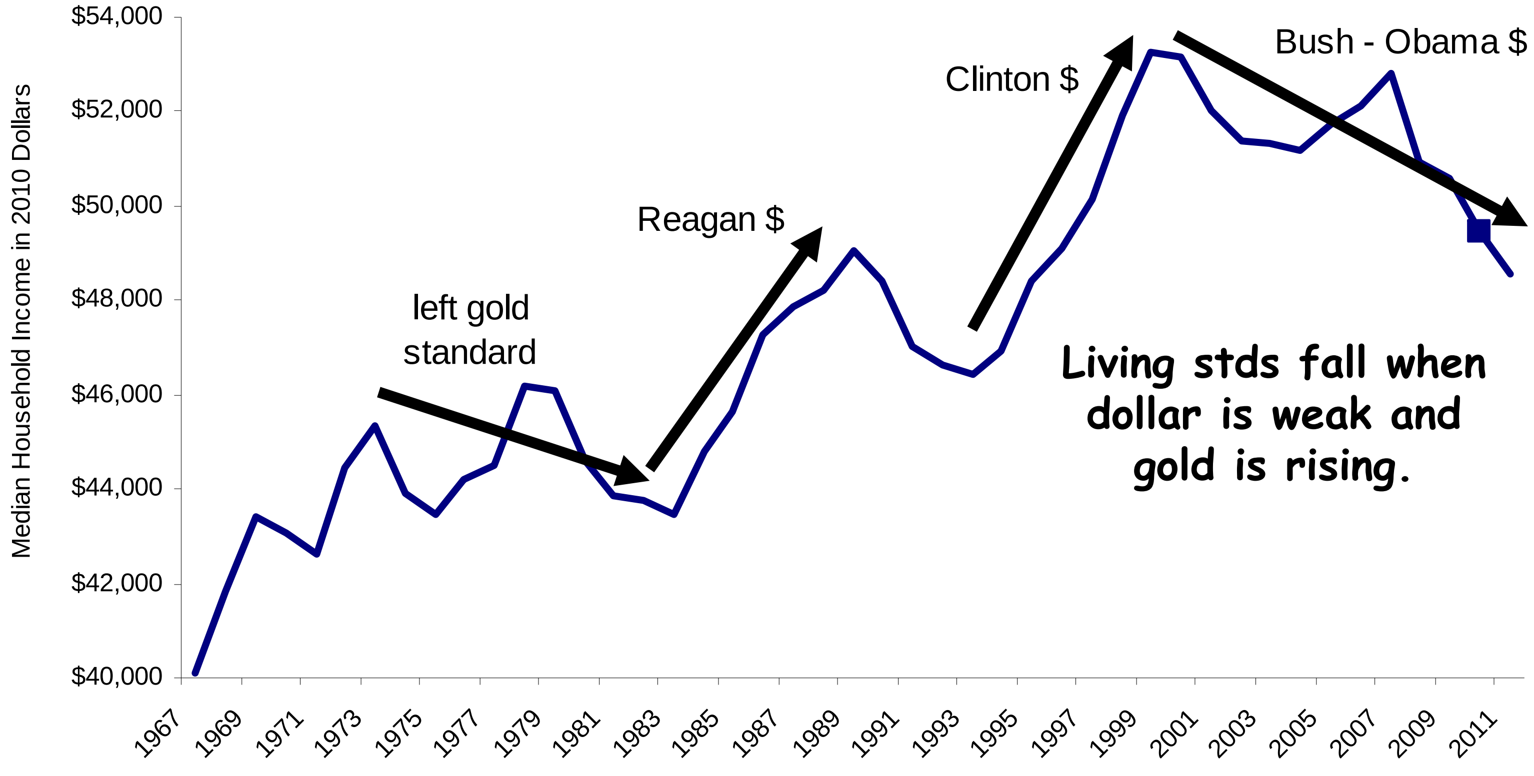
Source: U.S. Treasury: Encima Global

'Strong and Stable' $ Would Help Living Stds

- In the late 1990s, the dollar was strengthening from a strong level. This drew capital to the U.S. but caused asset bubbles and harmful deflation in many countries from 1997-2002. Real interest rates were high and gold fell to $250 per ounce.
- Like the 1970s, the 2000s and 2010s suffered from a weakening dollar which hurt living standards and pushed capital abroad. Real interest rates were low and gold rose sharply.
- In most countries, central banks are responsible for the value of their currency (by controlling supply). The Federal Reserve, working with Treasury, should state a preference for a strong and stable dollar and incorporate that goal into monetary policy, ending the weak-dollar policy.

Median Household Income Falling

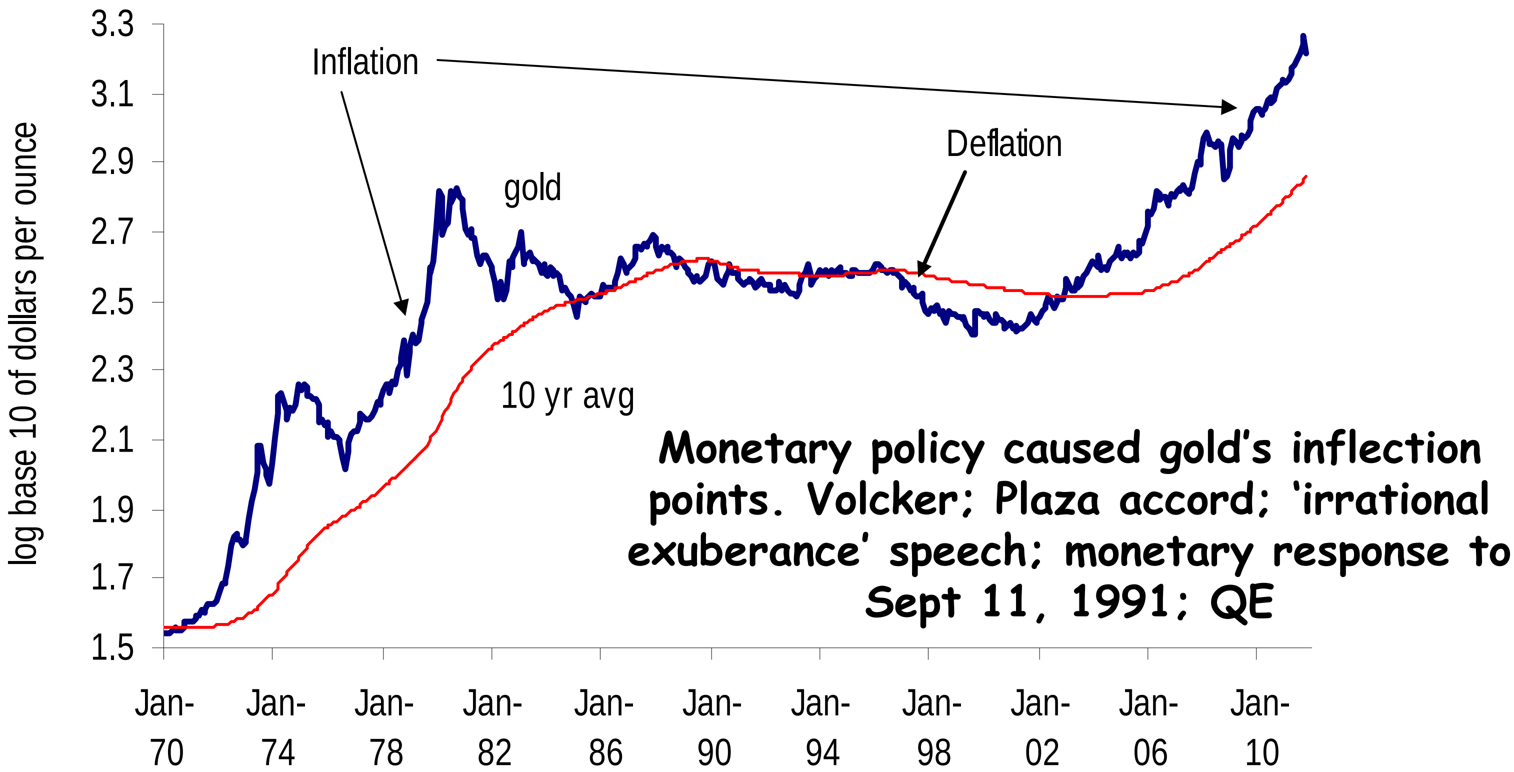
(inflation adjusted 2010 $, last obs. 2010, forecast for 2011)



Source: Census Bureau; Encima Global

Gold Prices in Log Terms

($ per gold ounce, last obs. October 2011)

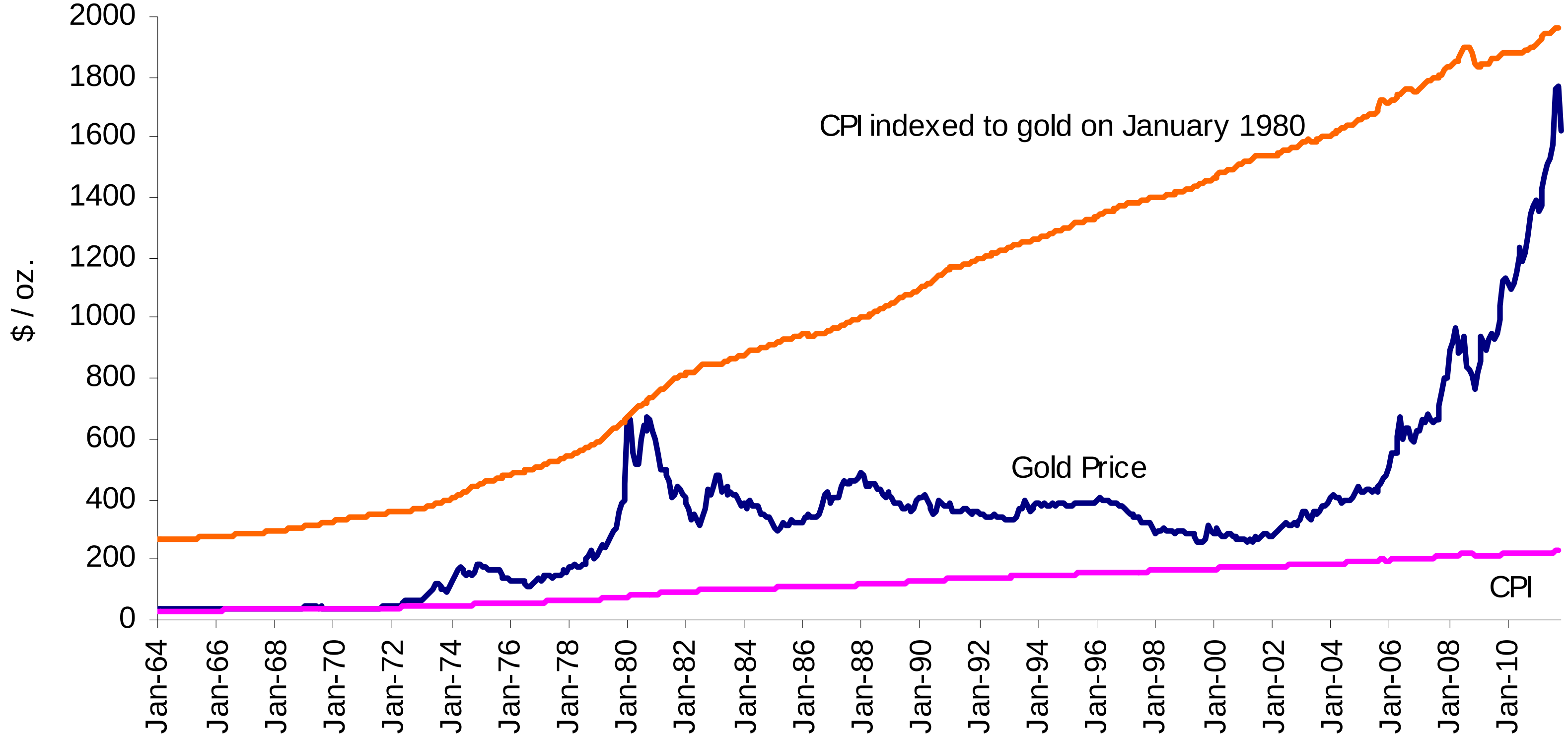


Source: Wall Street Journal; Encima Global

Gold Prices Very High In Real Terms; Like 1980

(last obs. September 2011)

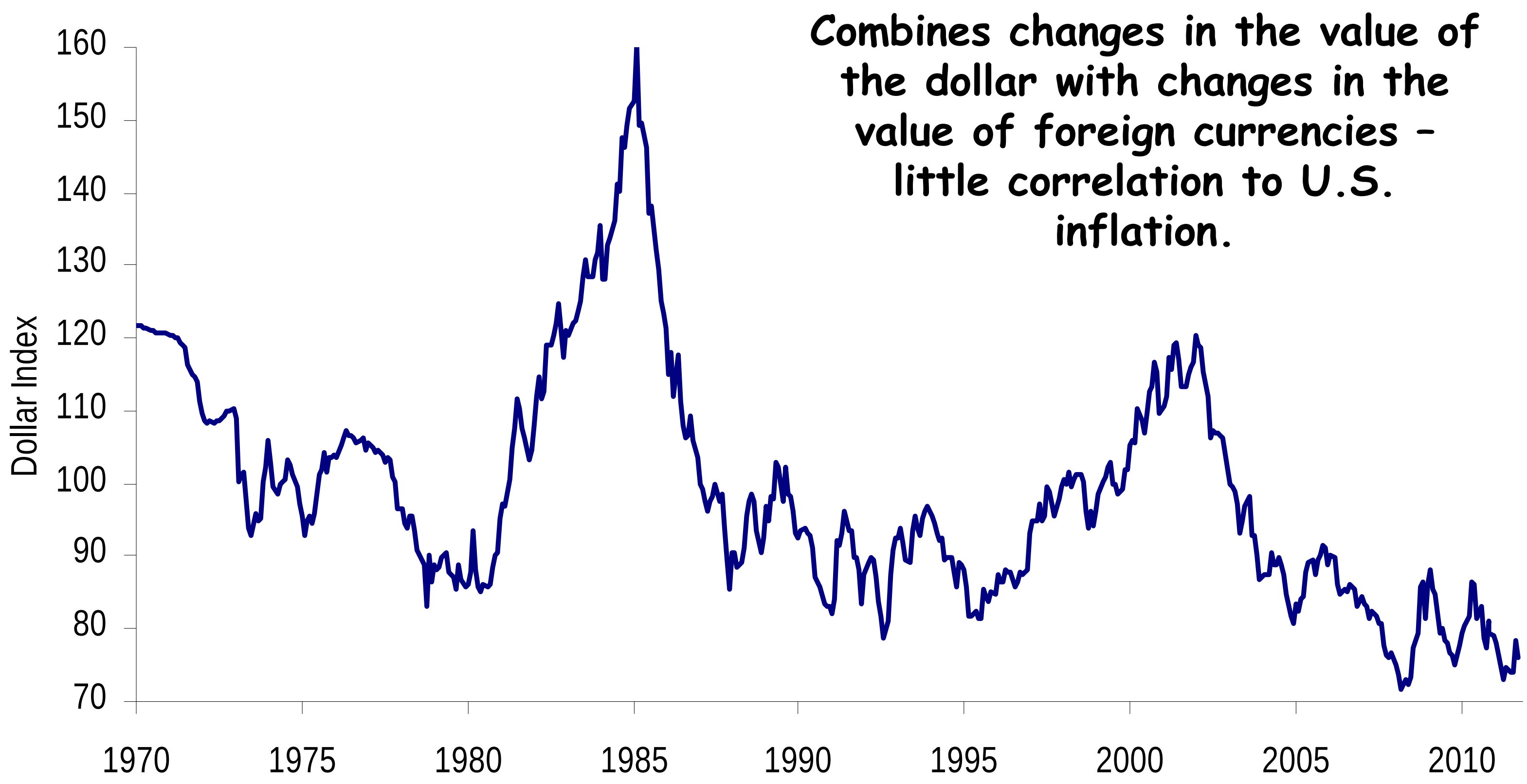
Neither the Fed nor ECB are causing the expansion of credit needed to justify high gold prices. If banks begin lending wildly as in the 1970s and 2000s, then inflation risks will support high gold prices.



Source: Wall Street Journal; Bureau of Labor Statistics; Encima Global

DXY – Trade-Weighted Dollar Index

(last obs. October 31, 2011)

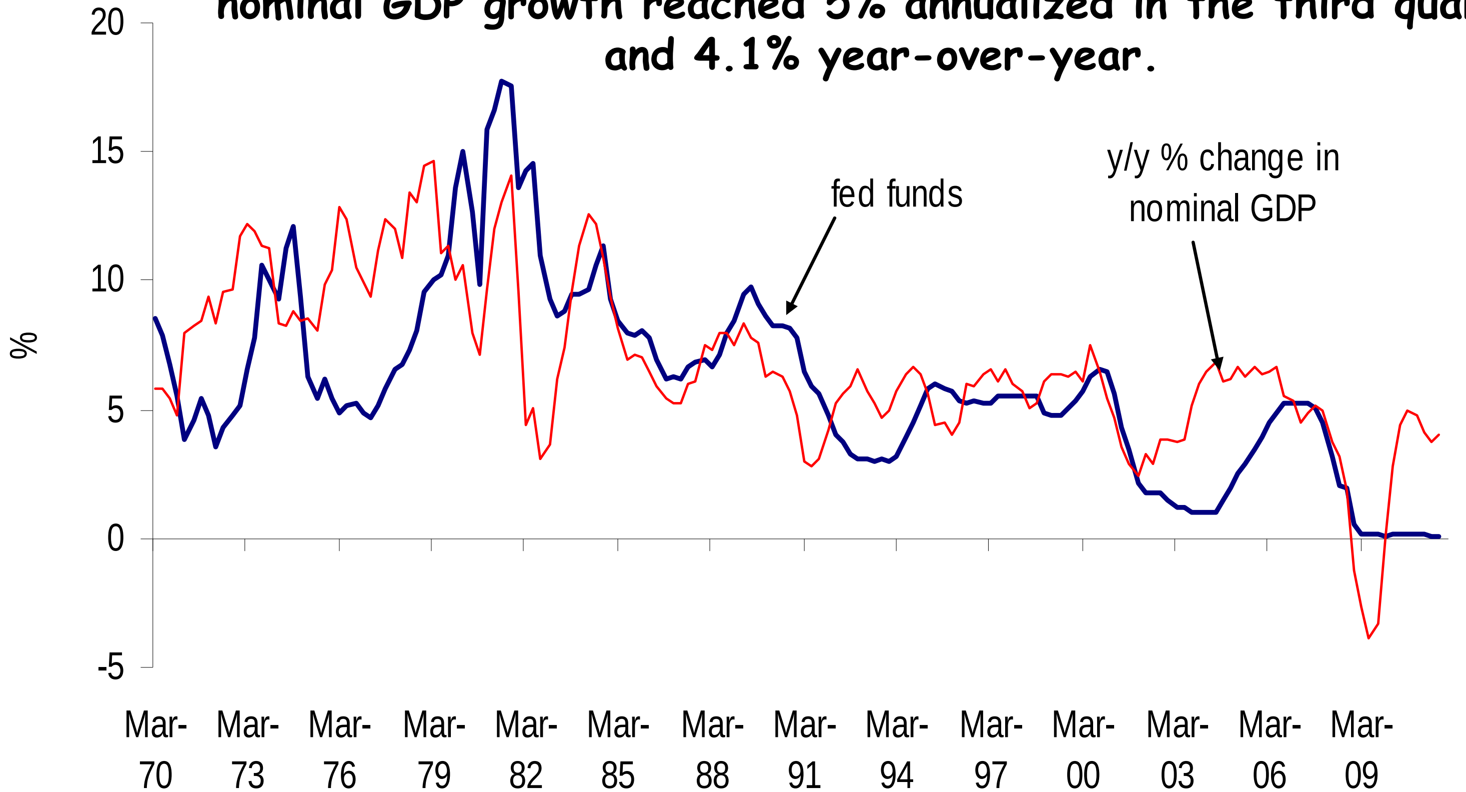


Source: Bloomberg; Encima Global

Fed Funds and Nominal GDP

(last obs. Q3 2011)

The Fed's near-zero interest rate and asset purchases are not appropriate policies, especially at this point in an expansion -- nominal GDP growth reached 5% annualized in the third quarter and 4.1% year-over-year.



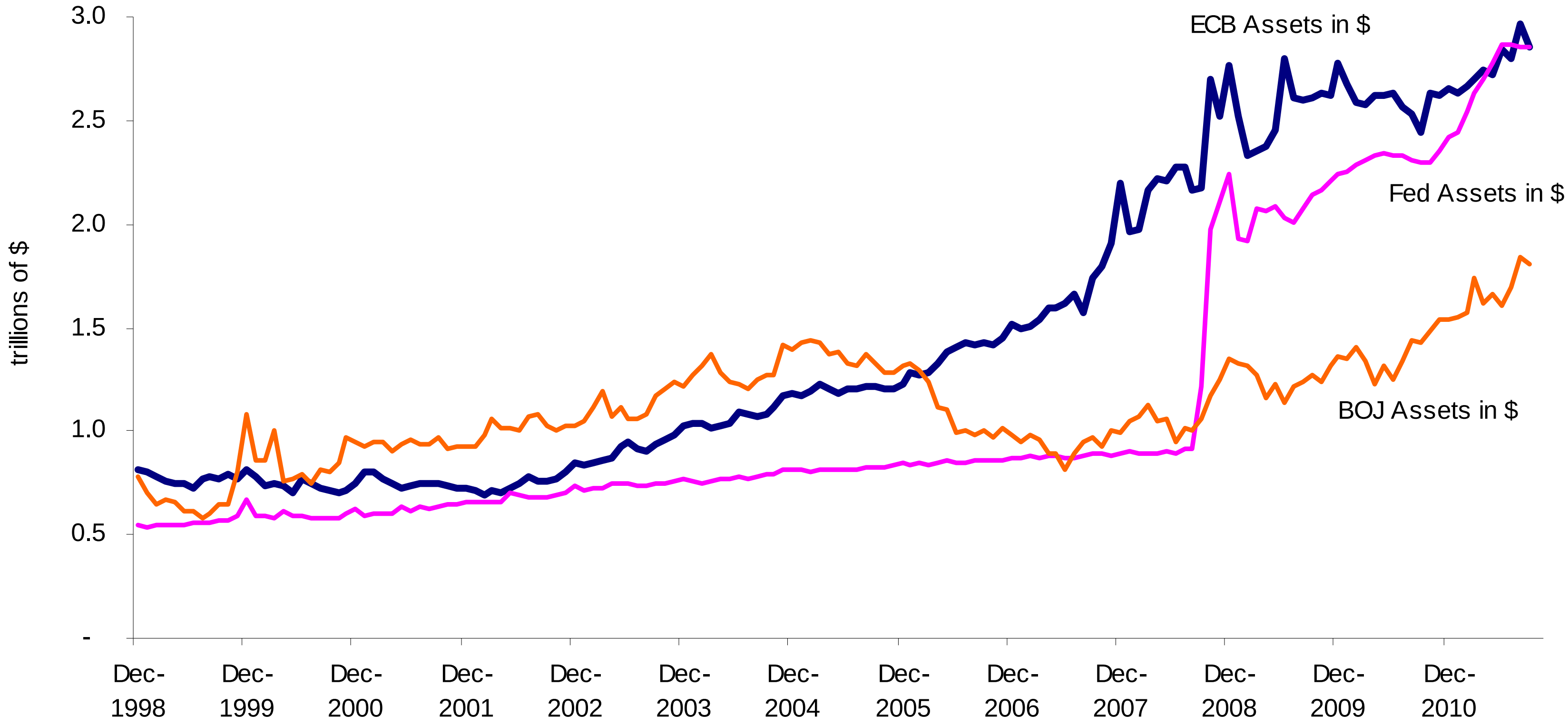
Source: Wall Street Journal; Bureau of Economic Analysis; Encima Global

Europe

- **The new set of agreements is more of a "puffer fish" approach than a 'going all-in' bazooka. Europe is making the most of limited resources, hoping the comprehensiveness of the agreements will scare pessimists and restart investment in European bank and sovereign bonds. But the ECB won't be expanding its bond purchases; there are no broad new guarantee authorities for bank liabilities along the lines of the 2008 FDIC guarantees for new U.S. bank debt; and many banks are likely to be forced to apply mark-to-market more aggressively, to reduce their leverage ratios, and/or to increase equity capital.**
- **The surprise announcement of a Greek referendum and the MF Global bankruptcy add to the already-existing selling pressure on European banks and bonds. 1) The bank deleveraging process. 2) Questions about the value of CDS hedges when a 50% haircut doesn't trigger CDS coverage. 3) Europe recently decided to apply mark-to-market more rigorously, accelerating the downward valuation process. 4) The liquidation of MF Global assets. 5) There's direct contagion to Italy and other countries. A 50% hard-to-hedge haircut for Greece lowers the value of other sovereigns. There's also moral hazard the undercuts structural reforms.**
- **We don't think the October agreements will stop the contagion or cause growth to resume. Europe will probably have to do something more to offset the negative from the referendum risk. The Greek or Italian governments might fall, but that won't improve the situation. Germany has ruled out sizeable ECB bond purchases. European governments might guarantee bank liabilities so banks could finance and hold their assets. The IMF and China will be brought into the discussion at the early November G20 meeting, but neither wants to take risk unless Germany insures it. Next move is Germany's.**

Federal Reserve; ECB; Bank of Japan Assets

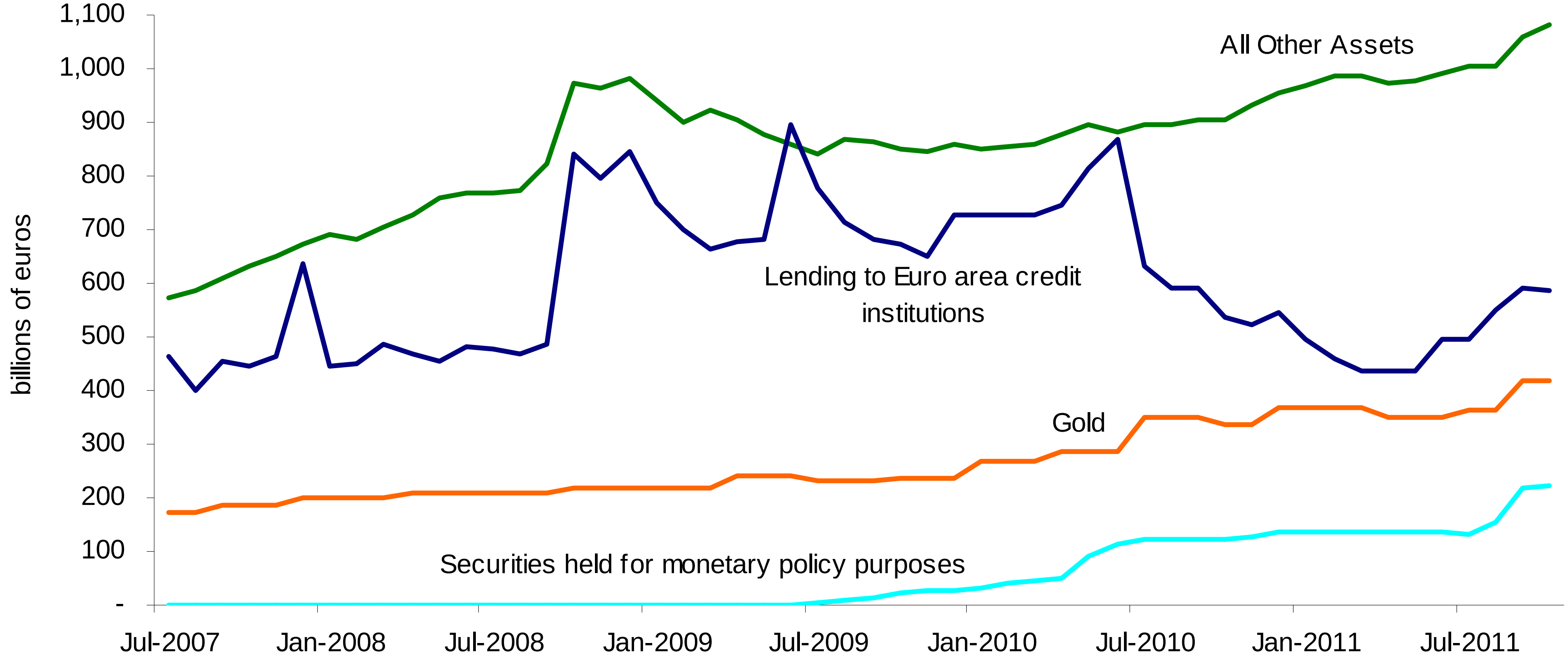
(last obs. September 2011)



ECB Balance Sheet

(last obs. October 21, 2011)

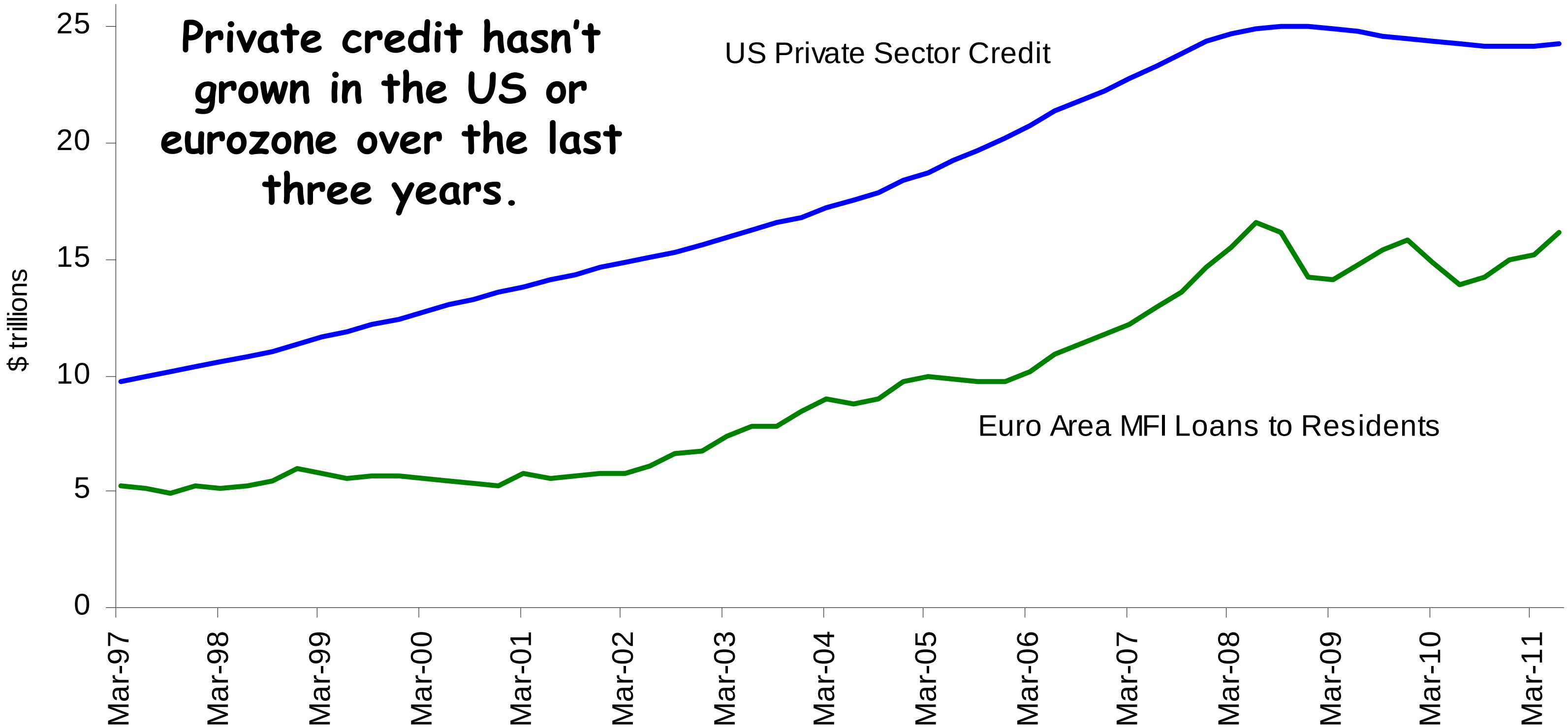
The ECB has expanded less rapidly than the Fed, buying Greek, Italian and other bonds for 'monetary policy purpose' with yields over 5%.



Source: ECB; Encima Global

U.S. and Euro Zone Private Sector Credit

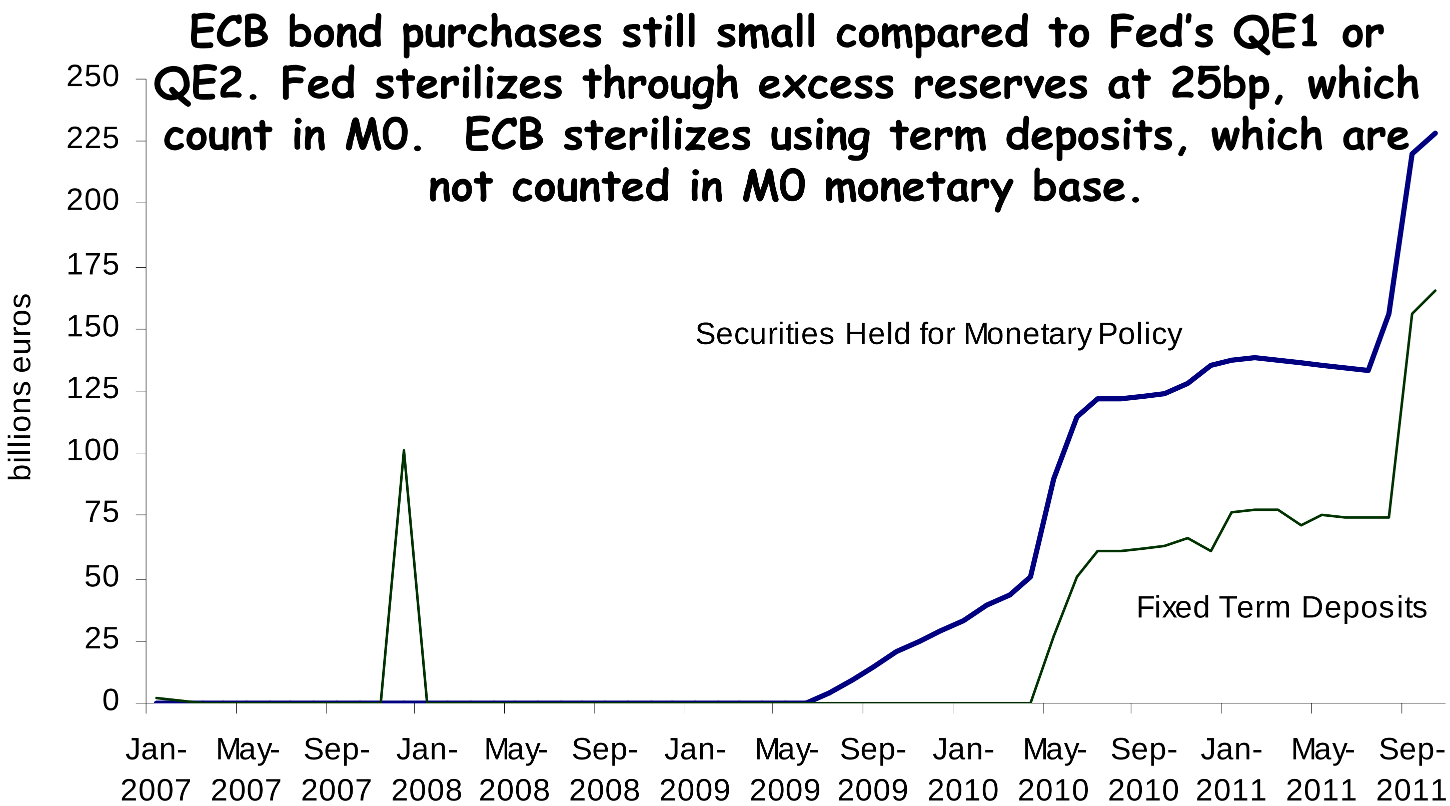
(last obs. Q2 2011, Euro area converted to dollars)



Source: Federal Reserve; ECB; Encima Global

ECB Sterilizing Bond Purchases

(last obs. October 21, 2011)



Source: ECB; Encima Global

USD / Euro Exchange Rate

(last obs. October 31, 2011)

Source: Bloomberg; Encima Global

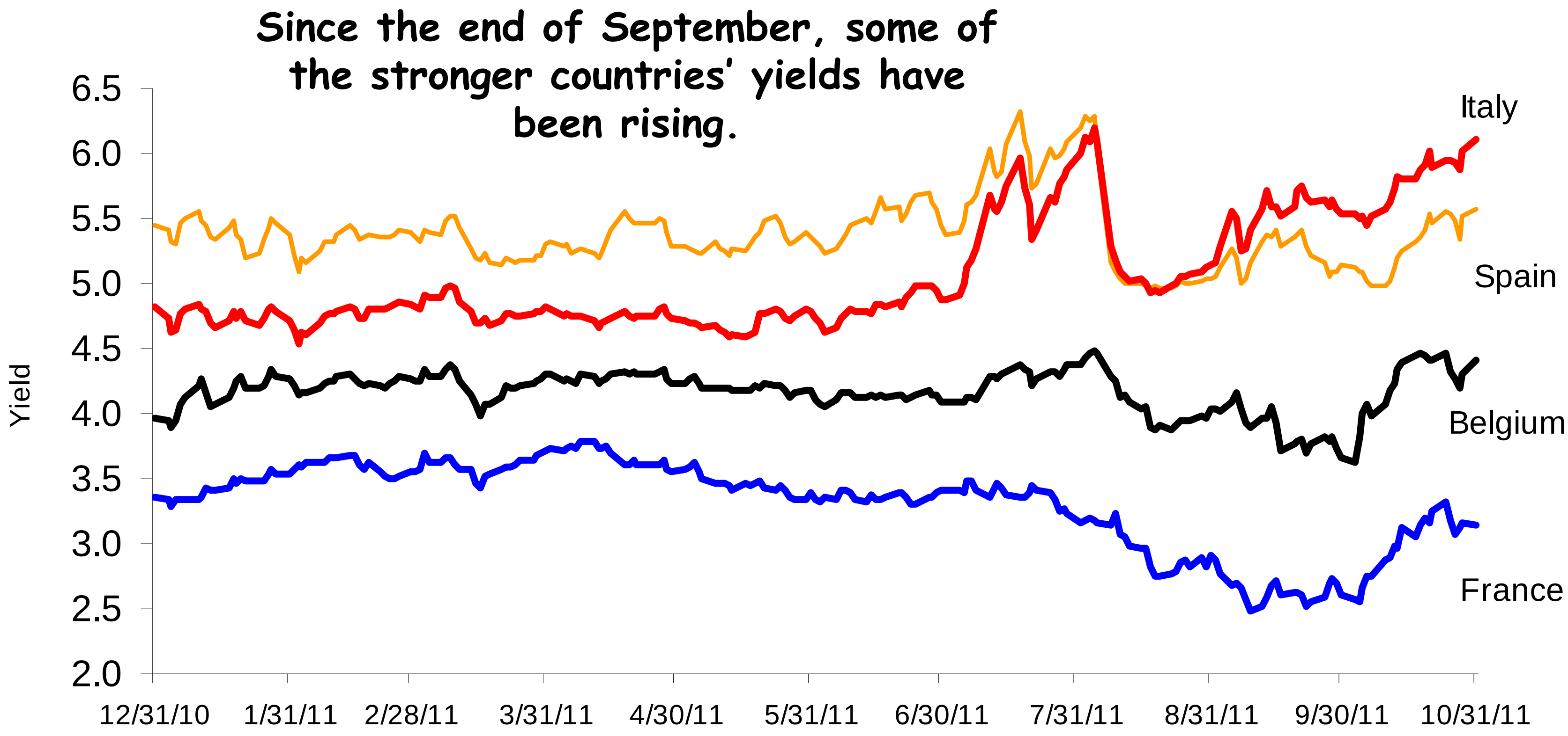
EURIBOR - OIS Spread

(last obs. October 31, 2011)

Source: Bloomberg; Encima Global

Selected European 10 Yr Yields

(last obs. October 31, 2011)



Source: Bloomberg; Encima Global

Selected European 10 Yr Yields

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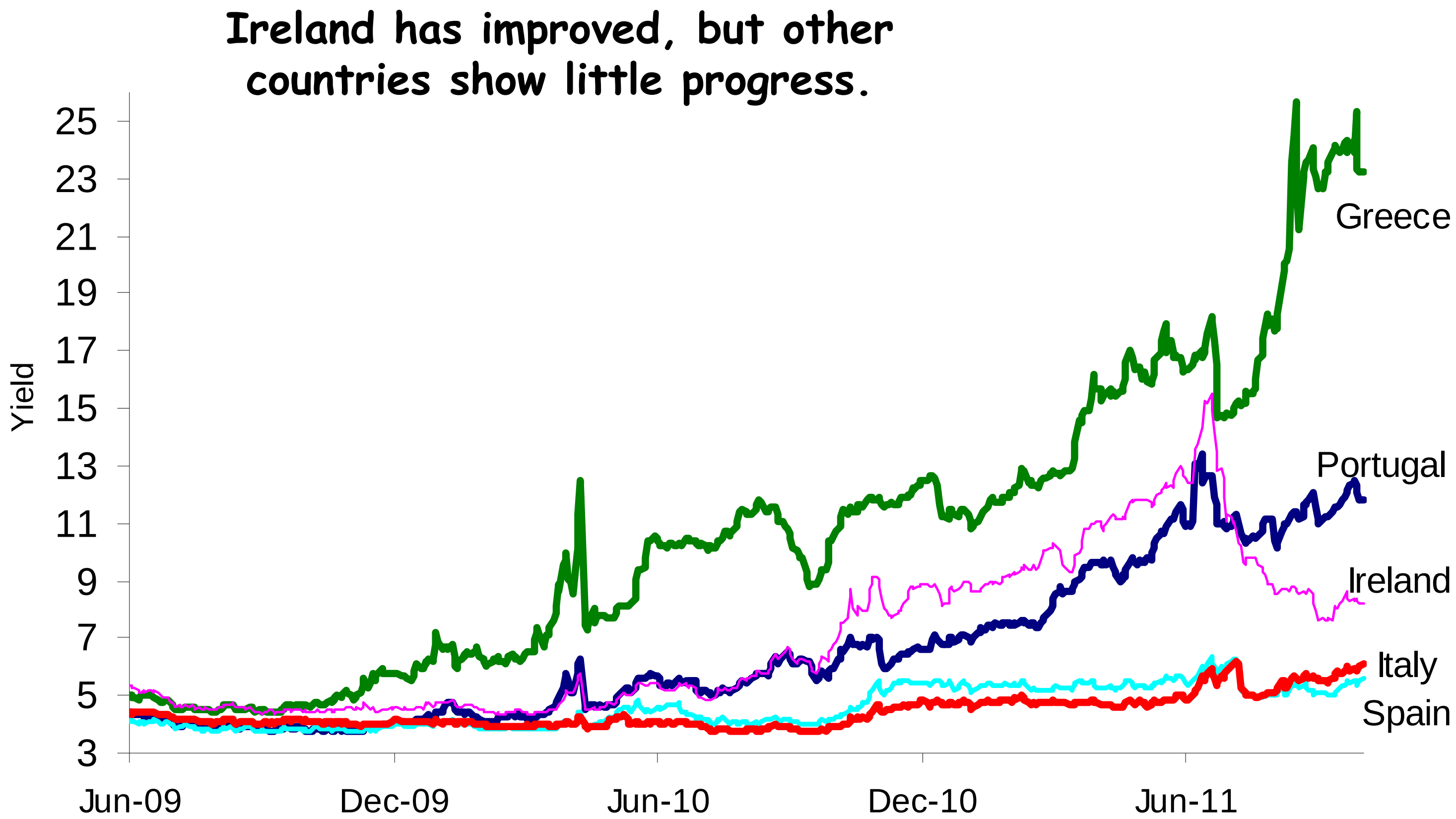
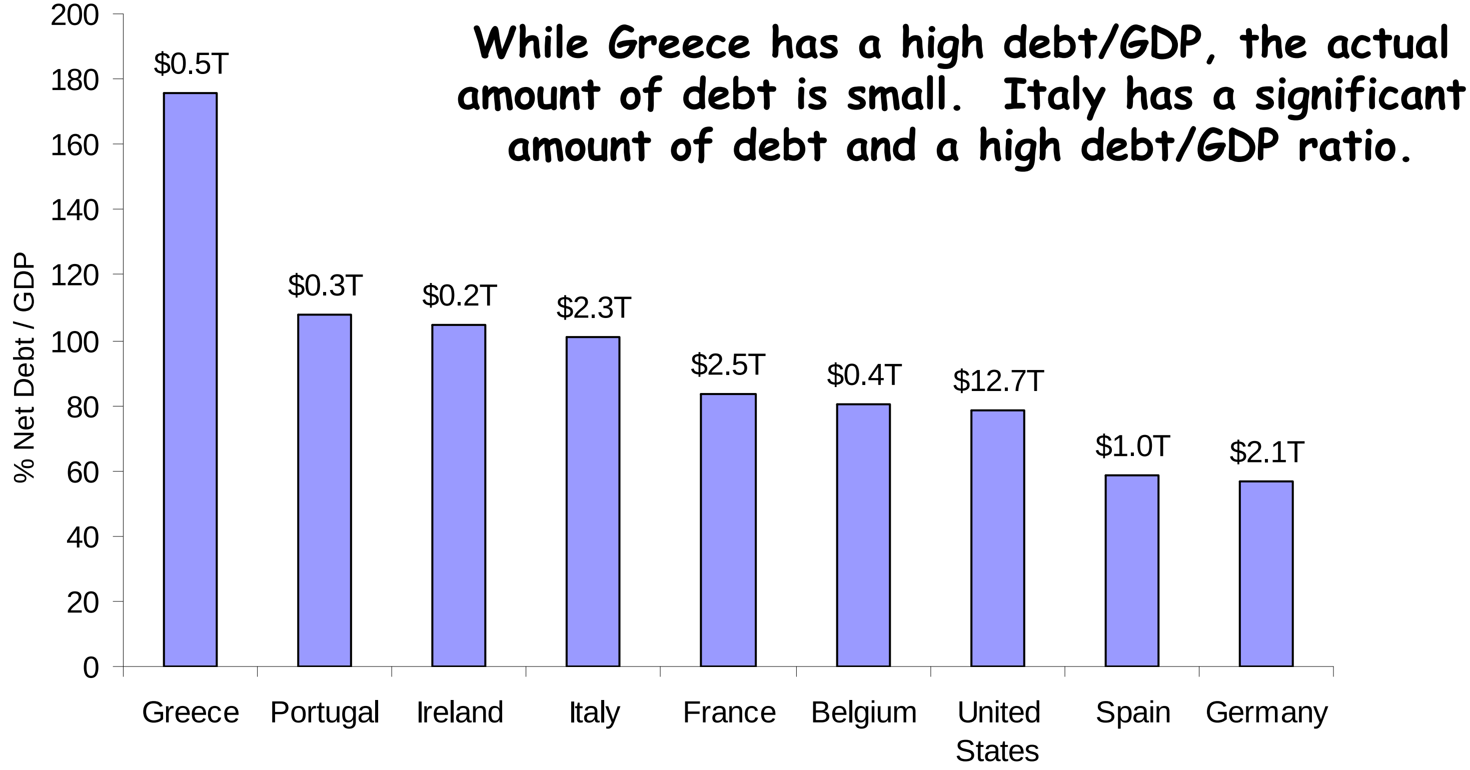


Source: Bloomberg; Encima Global

Net Debt / GDP

(General govt incl state and local; nets out intra-govt debt; IMF projections for 2012)



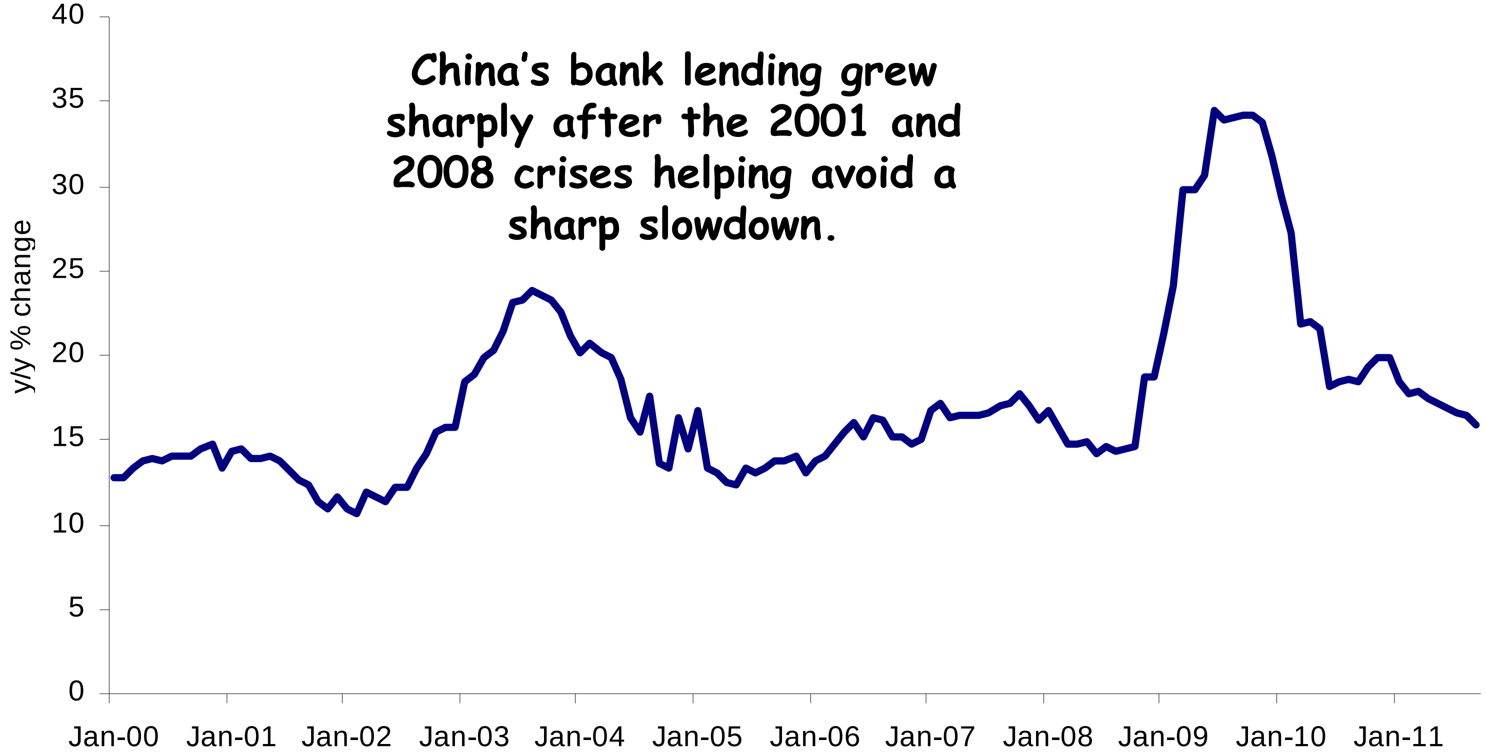
Source: IMF; Encima Global

Contrast in Global Monetary Policy

- **With near-zero interest rates, 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 forced increases in bank capital, aggressive mark-to-market, regulatory scrutiny.)**
- **U.S. and European regulators are still pressing for capital injections, arbitrary capital premiums, capital penalties for too-big-to-fail institutions, and divisive Basel III capital standards. We expect a shift in activity toward non-bank financial innovation. One loser during the transition – new and small businesses that depended on relationship banking.**

China's Countercyclical Bank Lending Policy

(last obs. September 2011)



Source: Bloomberg; Encima Global