Economic Chartbook
September 2011

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Overview: Negative Policy Developments

Current policies suggest shallow recessions in 2012 and only weak S&P earnings growth

- **U.S. fiscal policy at impasse through at least Nov 2012, preventing structural reforms on spending, tax and regulatory policy; recent jobs approach by President Obama not likely to make progress or help; deficit forecasts worsening.**
- **U.S. monetary policy focused on extending near zero rates; harmful to savers, banks, small businesses, interbank markets and GDP growth, but holds down near-term financing costs for government and corporate borrowers.**

Policy developments have been negative in Europe.

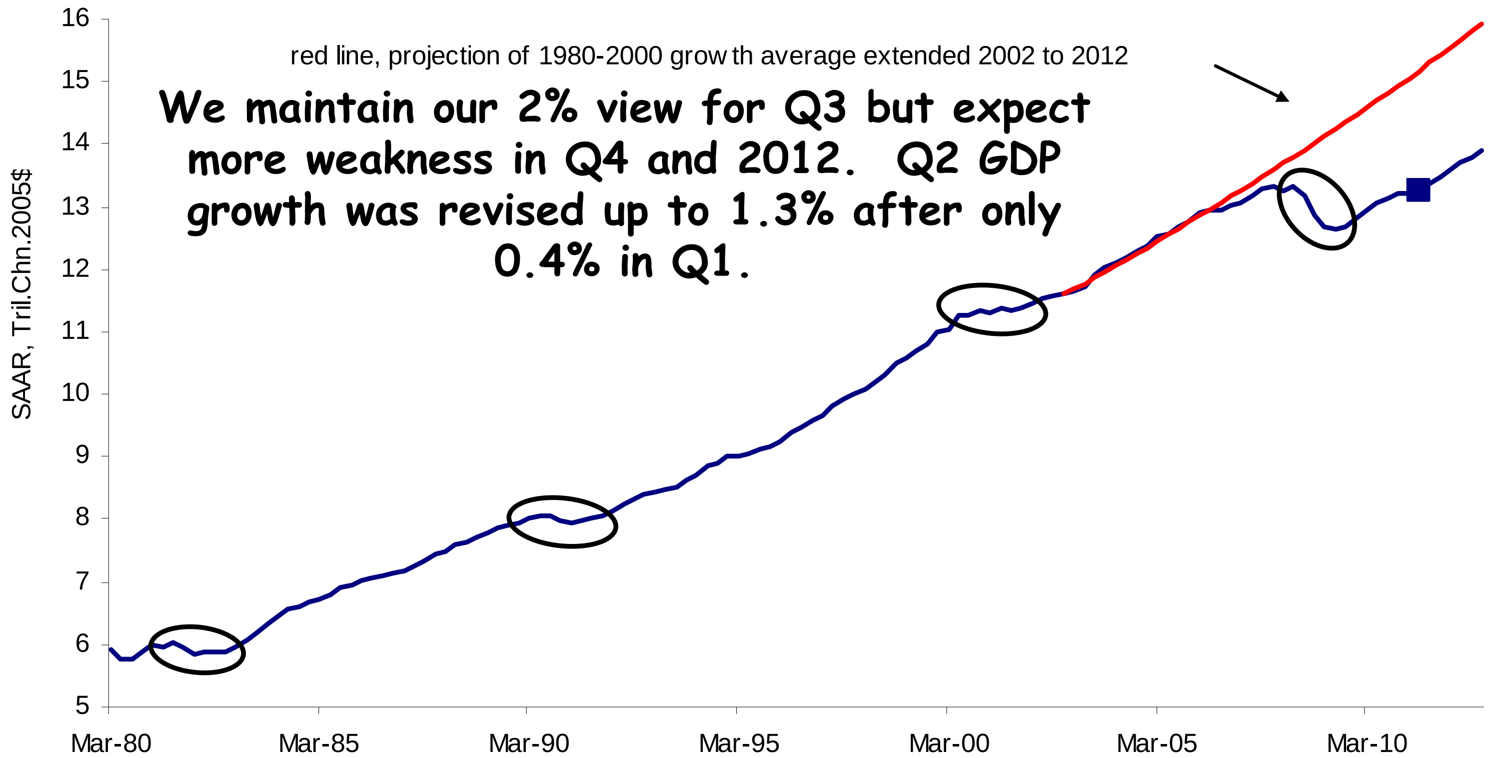
- **Expanded EFSF powers likely, but won't be enough; Germany not leading.**
- **Need to stop debt contagion in Italy; ECB won't buy enough bonds; bank capital adequate only if Germany makes clear that Italy and Spain are too big to fail**
- **Greece's cash flow worsening; expect only one more disbursement**

Policy breakthroughs possible to stop the deterioration:

- **Mortgage program in U.S. that cuts through litigation problem**
- **Relief on bank capitalization risk in U.S. or Europe (but G7 reiterated Basel 3)**
- **New programs needed in Europe: 1) MBS-style ECB debt purchases aimed at convergence; 2) government steps to help banks borrow; 3) switch from austerity to growth-oriented structural reform in Greece, Italy, elsewhere**

Real GDP Growing Slowly From a Low Base

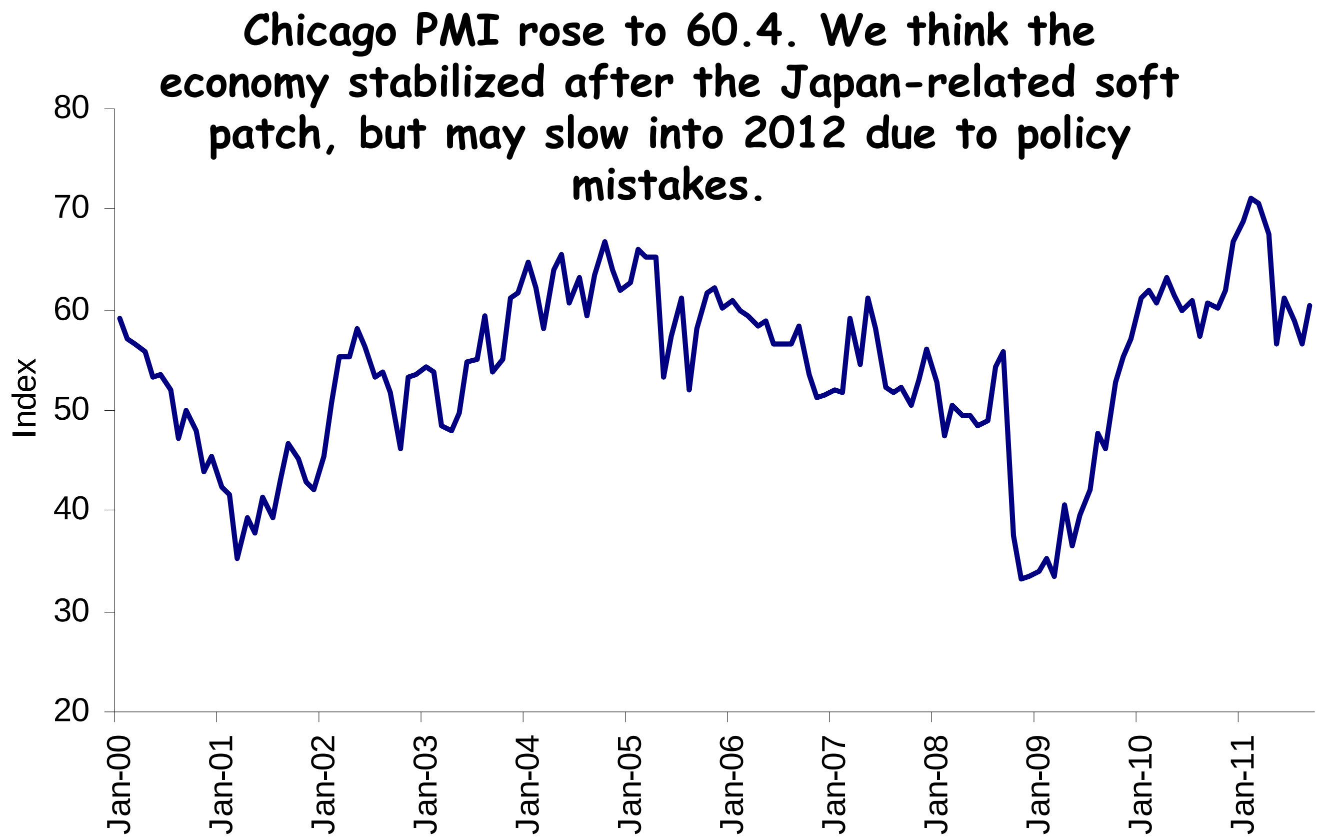
(last obs. blue square Q2 2011, projected to Q4 2012)



Source: Bureau of Economic Analysis; Encima Global

Chicago Purchasing Managers See Slow Growth

(last obs. September 2011)



Source: Kingsbury Int'l; Encima Global

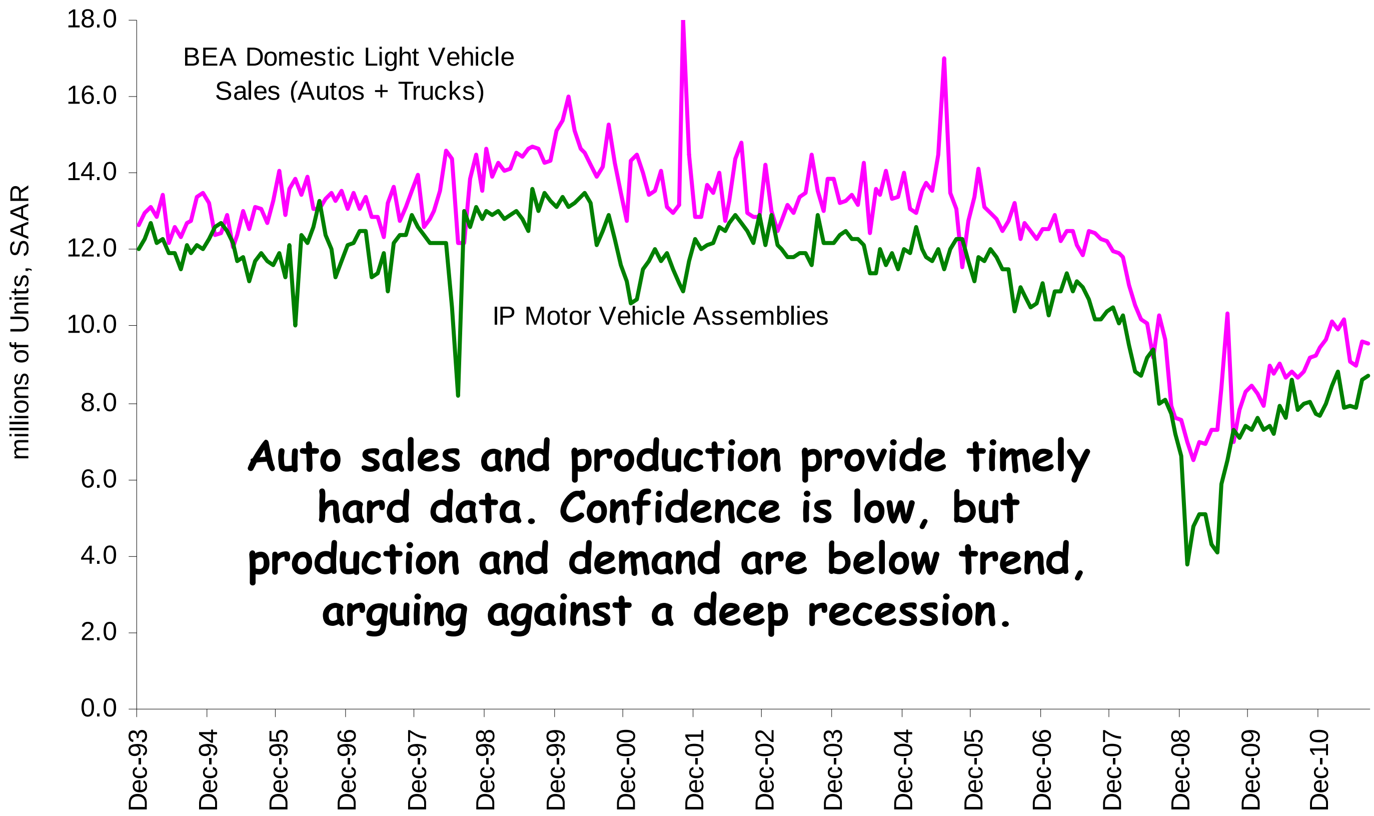
Initial Jobless Claims Showing Slow Growth

(last obs. September 24, 2011)

Source: Department of Labor: Encima Global

Auto Sales and Production

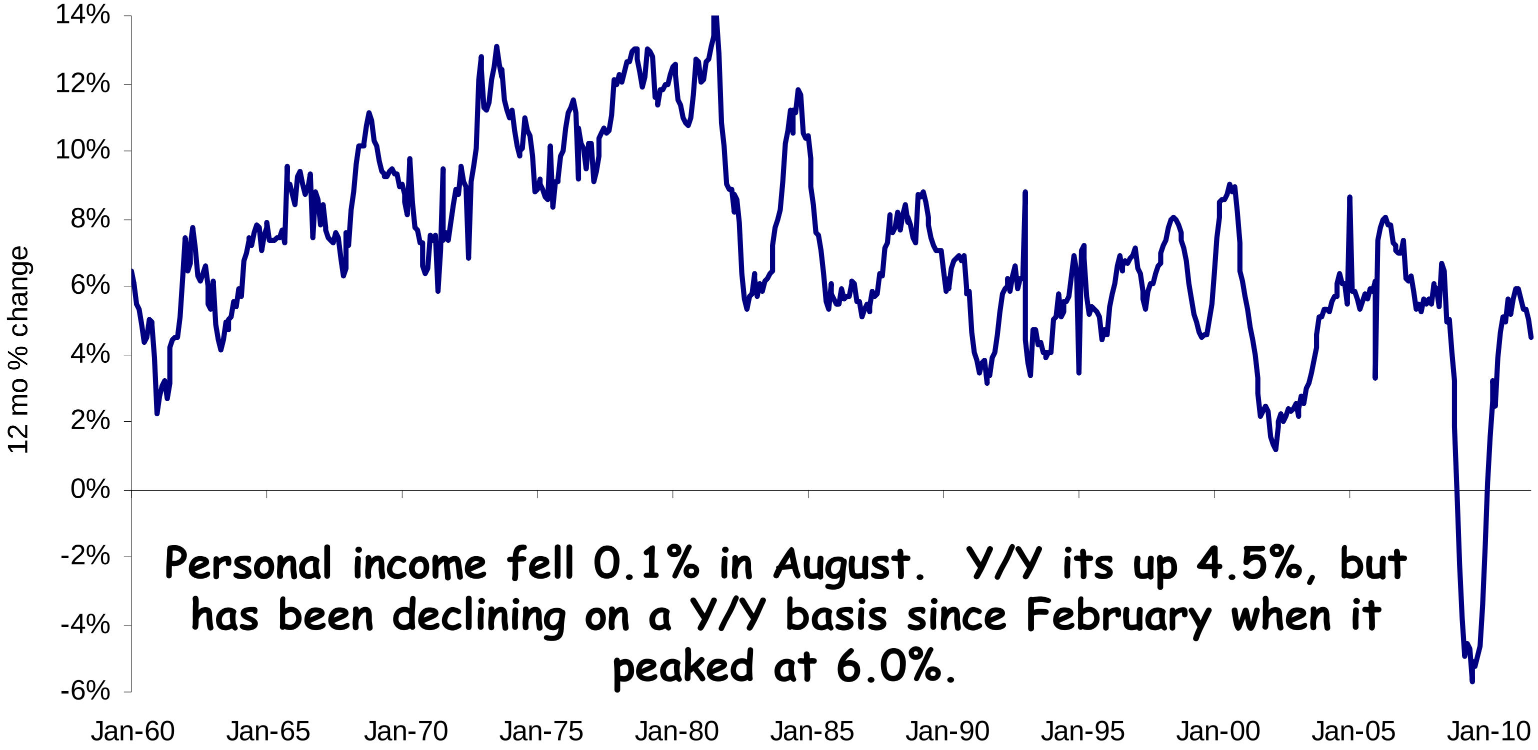
(last obs. August 2011, consensus sales forecast Sept. 9.6M)



Source: BEA; Federal Reserve; Encima Global

Personal Income Growth Slowing From Reduced Base

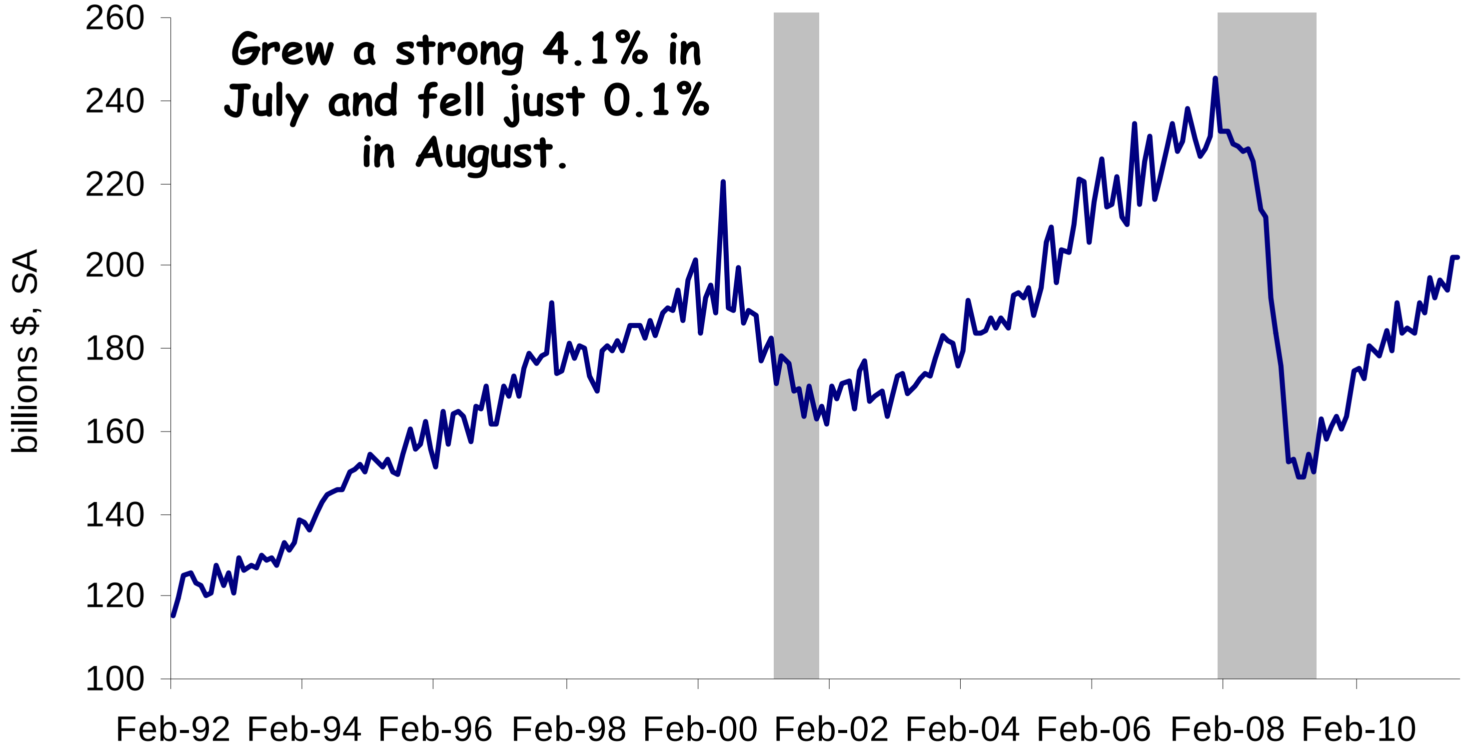
(last obs. August 2011)



Source: Bureau of Economic Analysis; Encima Global

Durable Goods Orders

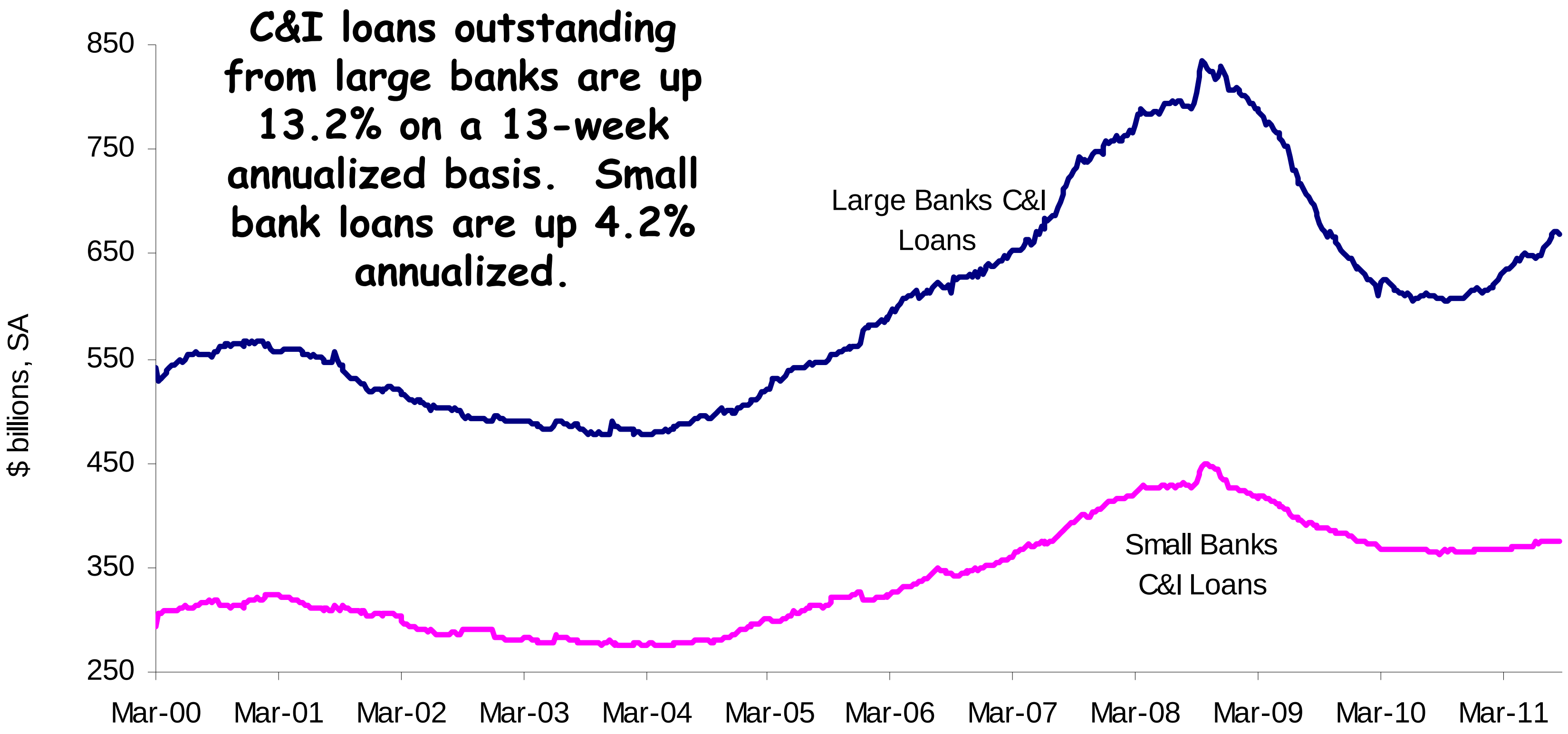
(last obs. August 2011)



Source: Bureau of Census; Encima Global

Commercial and Industrial Loans Rising Some

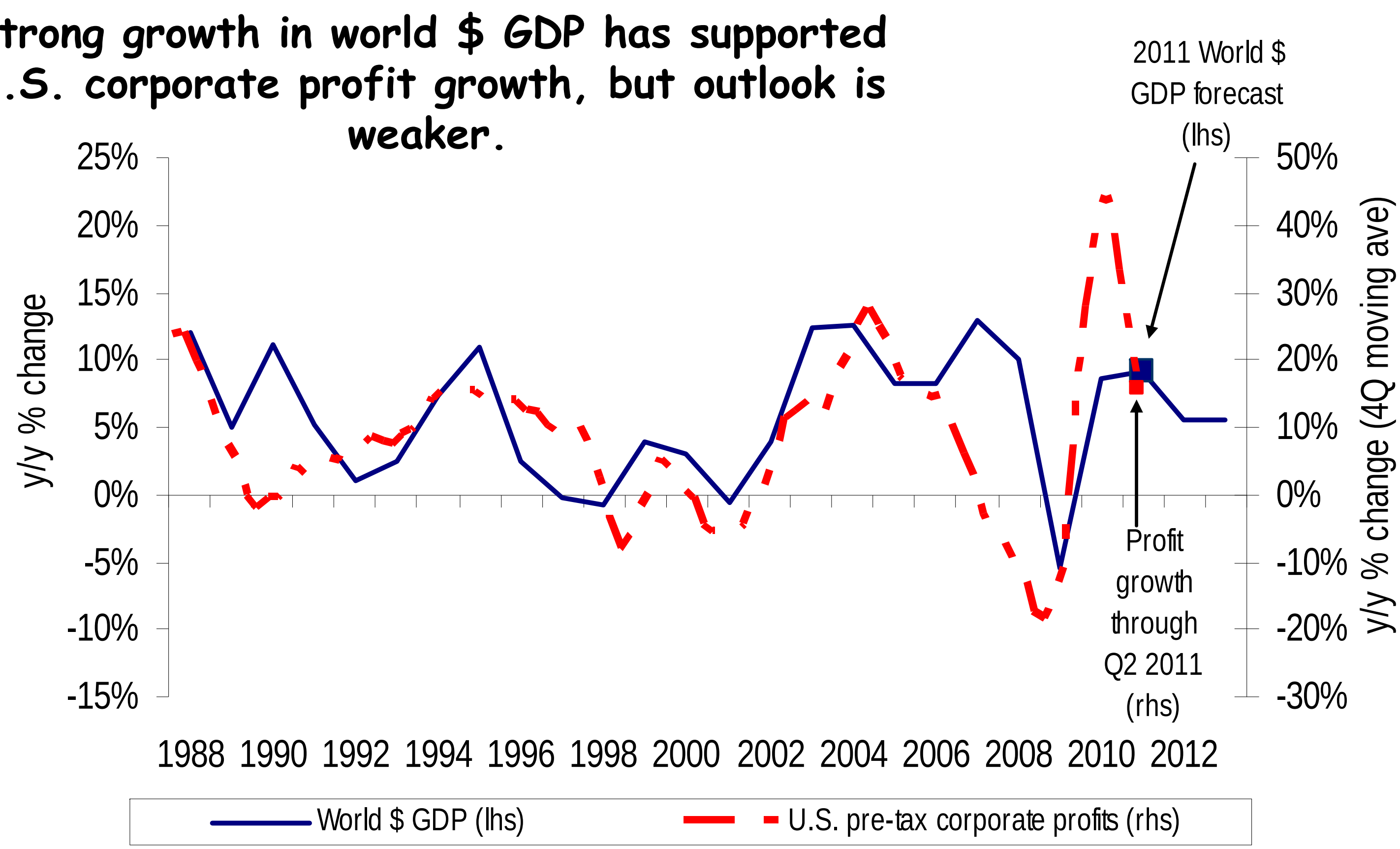
(last obs. September 14, 2011)



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)

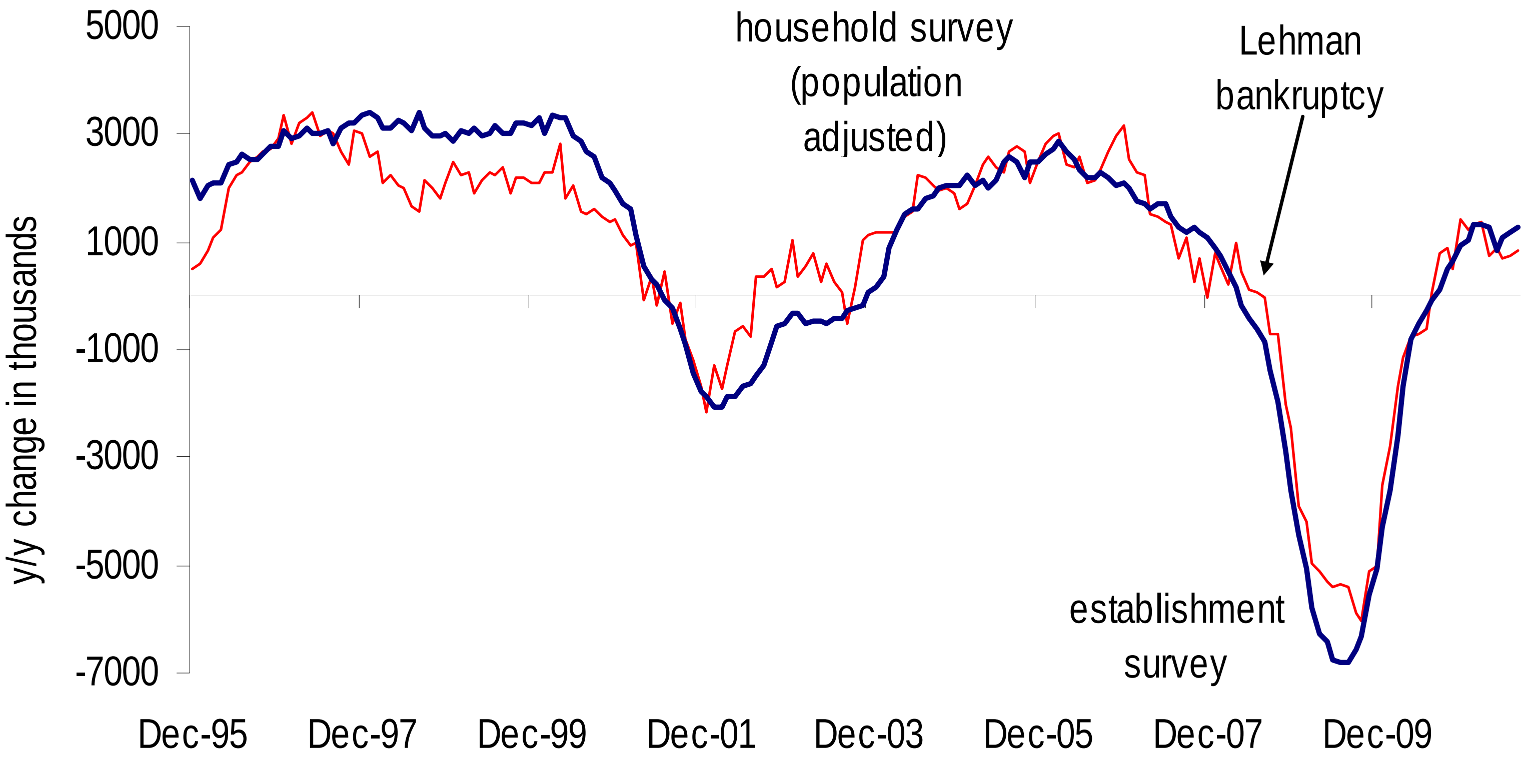


Source: Bureau of Economic Analysis; IMF; Encima Global

Annual Growth in Employment

(last obs. August 2011)

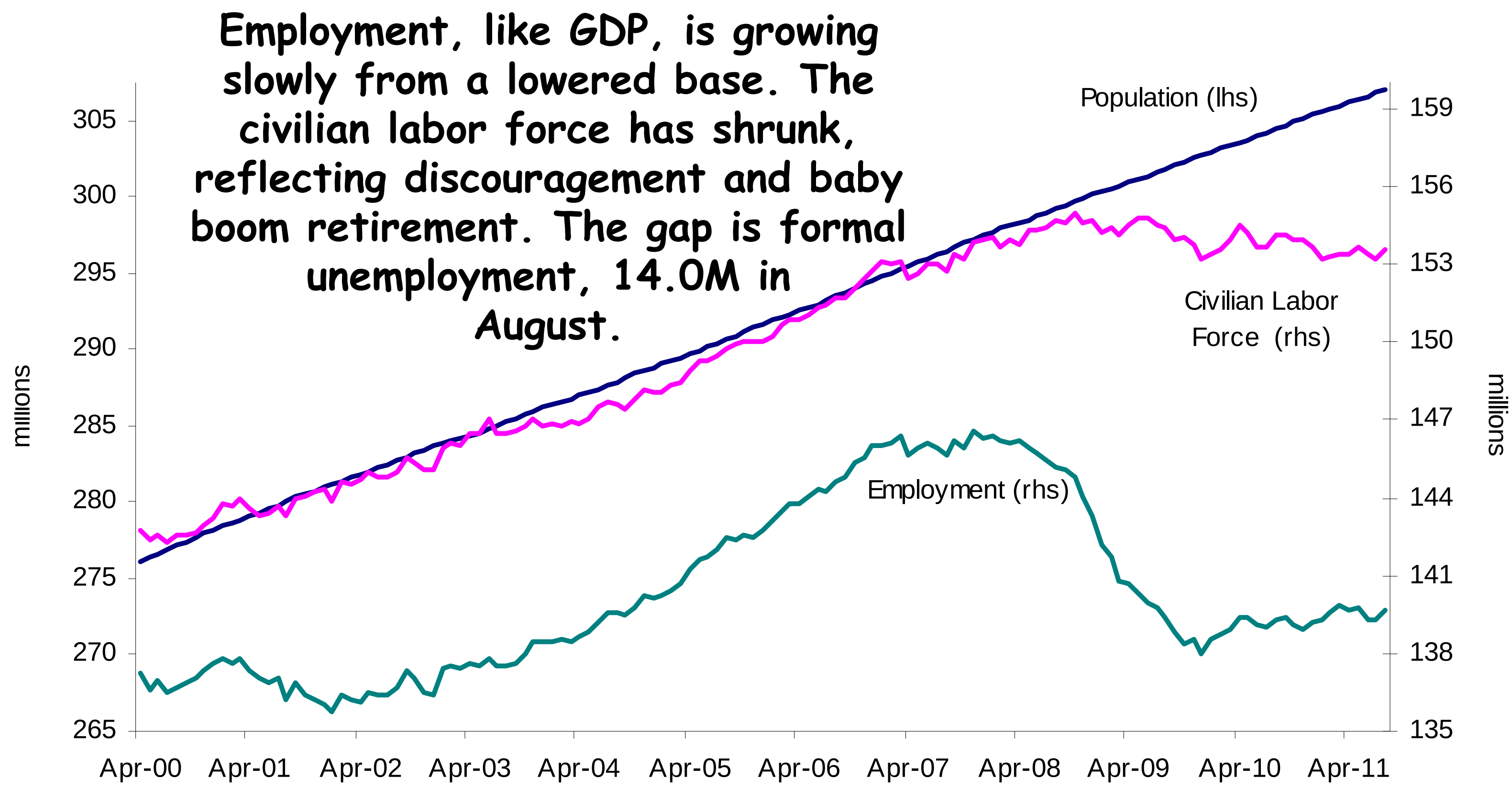
Monthly labor statistics show weak job growth.



Source: Bureau of Labor Statistics; Encima Global

Population, Labor Force and Employment

(last obs. August 2011)



Source: Bureau of Labor Statistics; Encima Global

Headline and Core Consumer Price Index Y/Y

(last obs. August 2011)

Source: Bureau of Labor Statistics; Encima Global

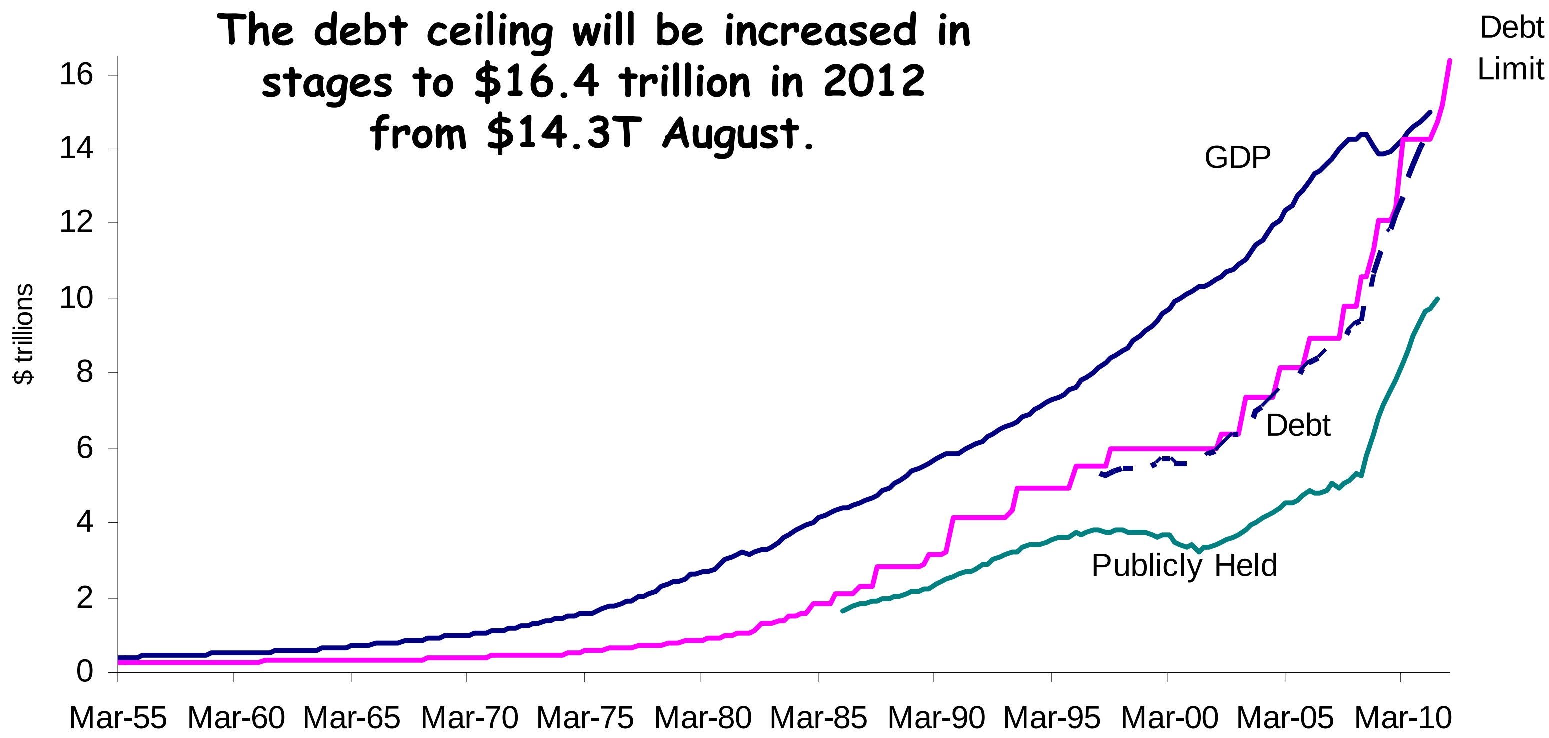
Misery Index

(last obs. August 2011)

Source: Bureau of Labor Statistics; Encima Global

Publicly Held Debt Reaching 70% of GDP

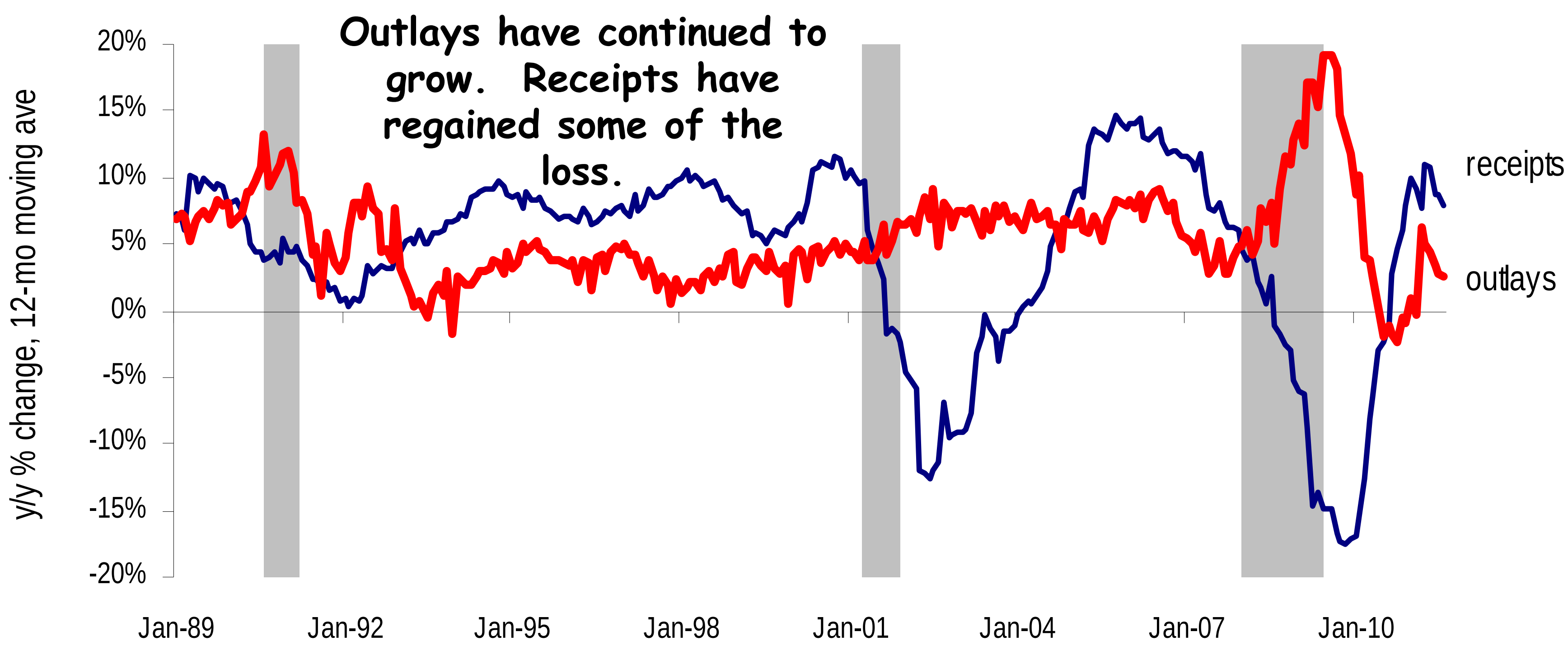
(last obs. Q3 2011, Q1 2012 for debt limit)



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

Growth in Federal Receipts and Outlays Y/Y

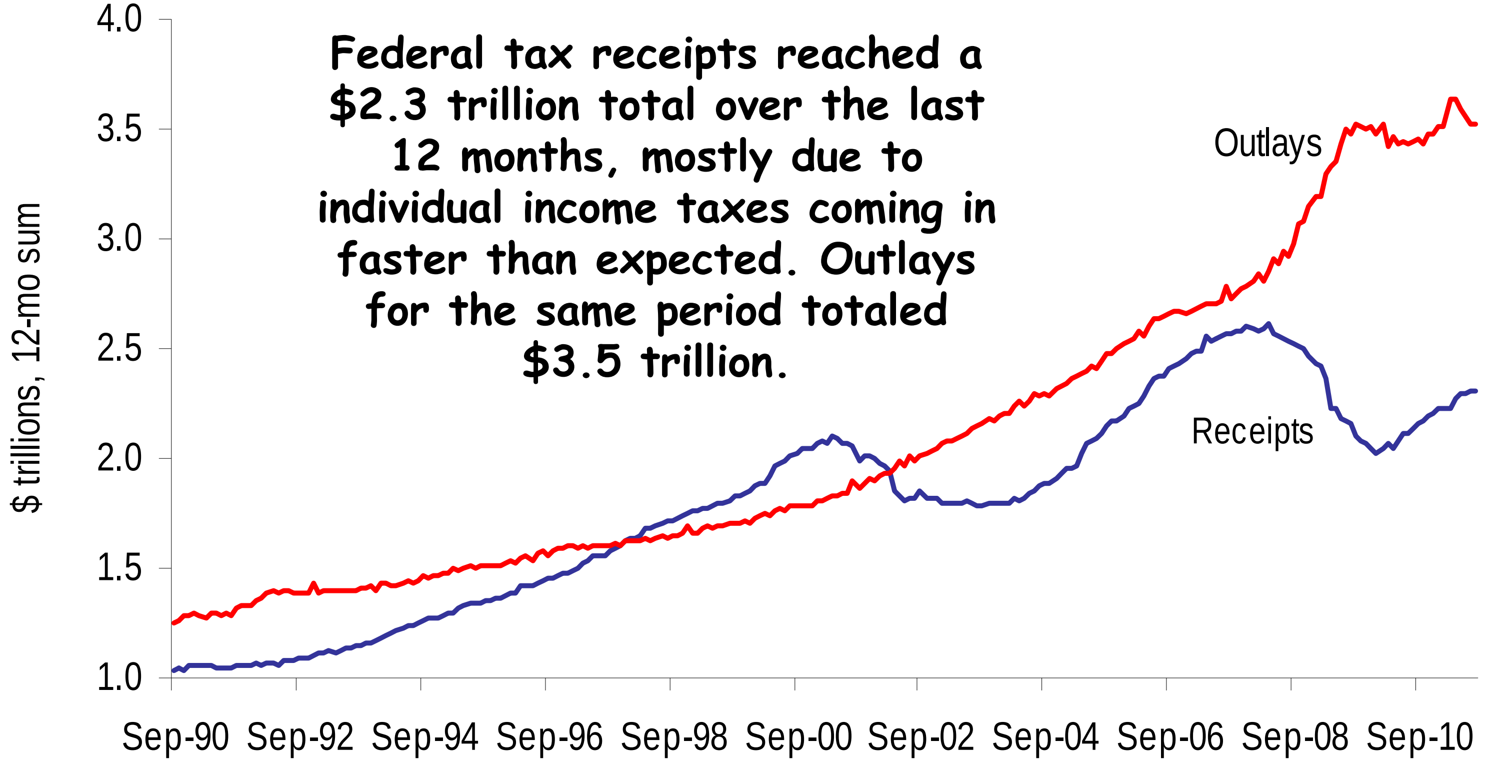
(last obs. August 2011)



Source: U.S. Treasury: Encima Global

Level of Federal Receipts and Outlays ($ trillions)

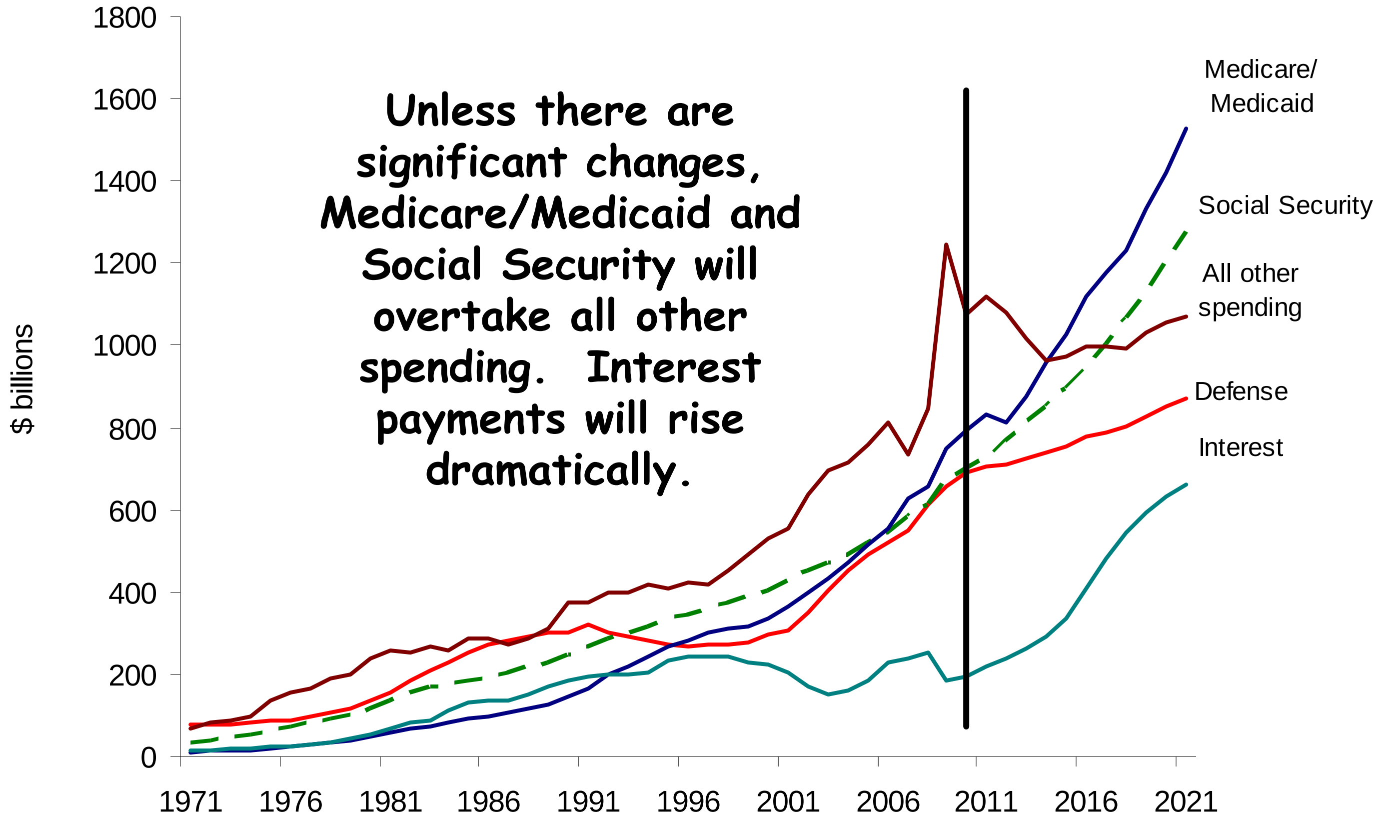
(last obs. August 2011)



Source: U.S. Treasury: Encima Global

Level of Federal Spending by Major Category

(last obs. 2010, projected to 2021)

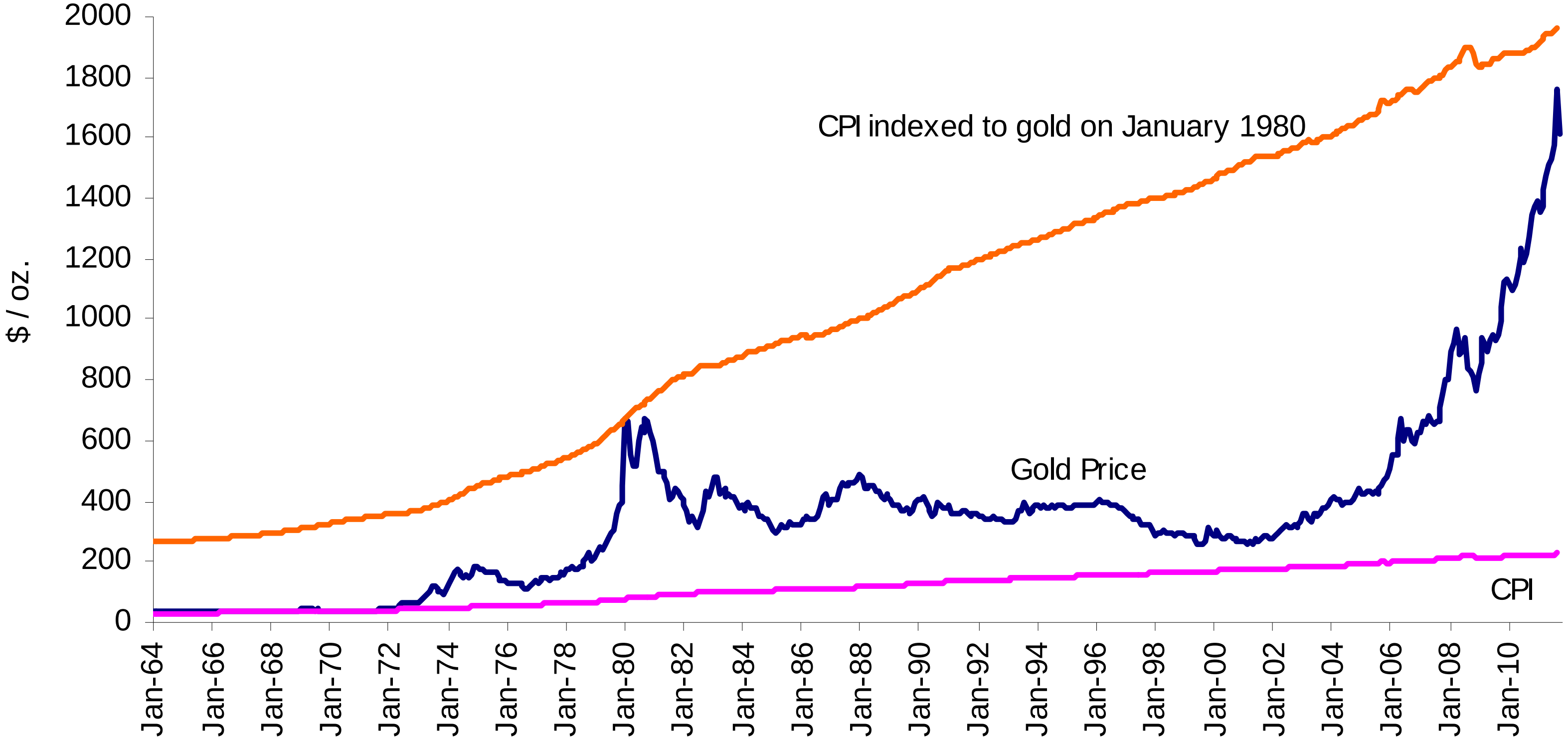


Source: CBO: Encima Global

Gold Prices Very High In Real Terms; Like 1980

(last obs. August 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

Operation Twist Ineffective

- The FOMC decided to buy $400 billion more in 6 to 30 year Treasury bonds, but will spread the purchases through June 2012. It will pay for them by selling Treasuries with maturities of up to 3 years. This will shorten the effective maturity of the U.S. national debt (the maturity of the consolidated Treasury and Fed holdings). Treasury has been gradually lengthening its issuance. If continued, this will counteract some of the Fed's purchases, especially since the Fed is buying slowly. In addition, as the Fed's mortgage backed securities mature (conventional MBS guaranteed by Fannie and Freddie), the Fed will switch to reinvesting its maturing MBS in MBS rather than Treasuries.
- The Fed's total assets and excess reserves will stay at current levels. In effect, the Fed is running a leveraged SIV (structured investment vehicle), borrowing short-term at 25 basis points to finance long-term bonds yielding more. This is very profitable for the Fed as long as interest rates stay low. The cost is born by savers earning negative real interest rates.
- We think QE2 and operation twist have hurt the U.S. growth outlook by hurting savers, weakening the dollar, distorted credit markets, creating the expectation of future Fed action and channeling capital toward the government and foreign borrowers.

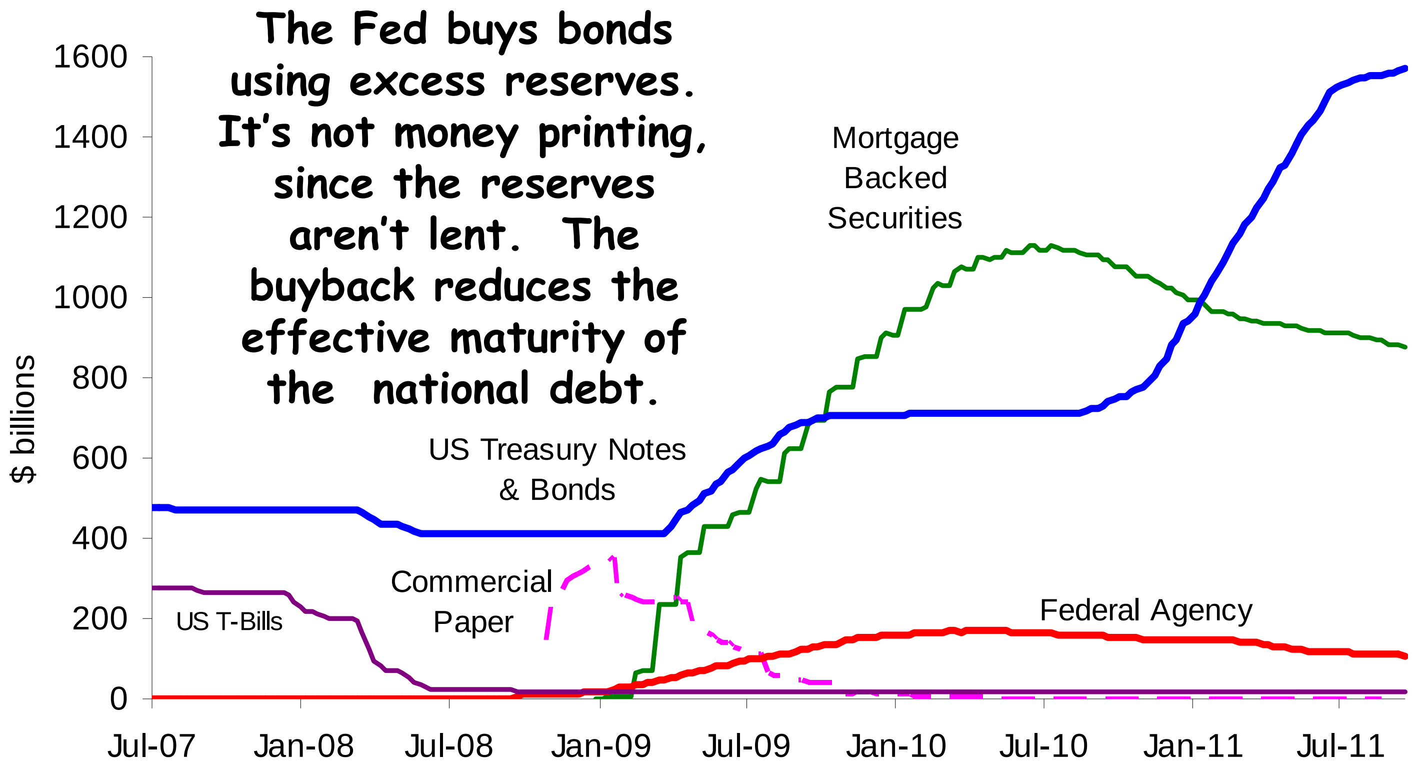
Fed 'Sterilized' QE2 Through 25bp rate and Credit Rationing -- 'Pushing on a String'

(last obs. September 21, 2011)

Source: Federal Reserve: Encima Global

Fed Assets

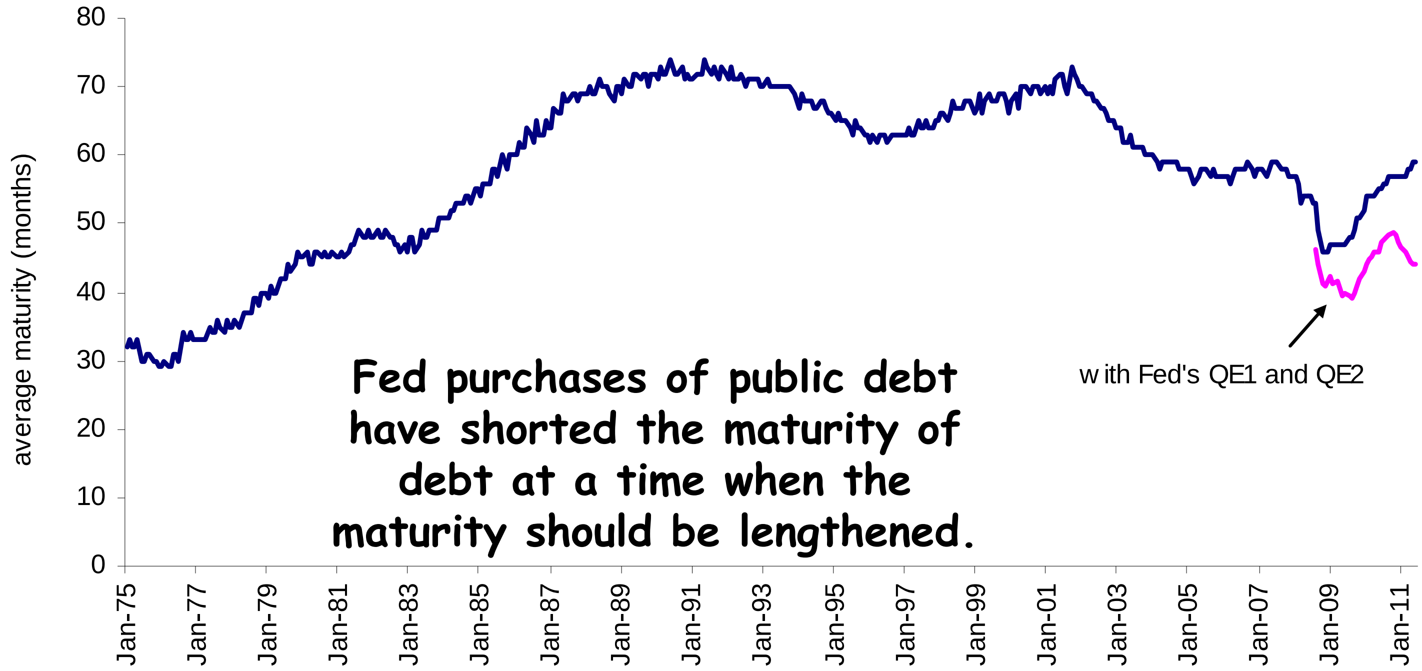
(last obs. September 21, 2011)



Source: Federal Reserve: Encima Global

Effective Maturity of Public Debt Getting Shorter

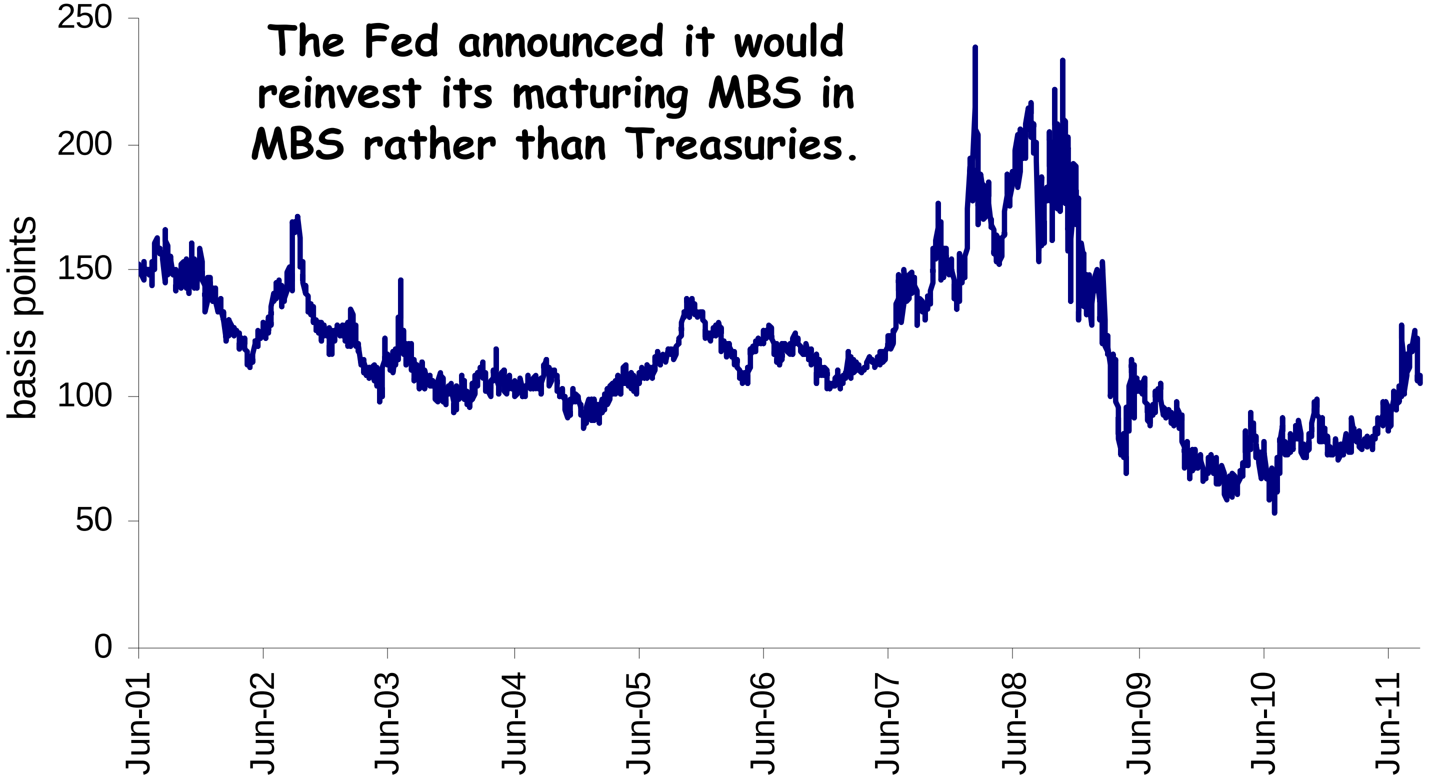
(last obs. June 2011)



Source: U.S. Treasury: Encima Global

MBS Yield less 10 Yr U.S. Treasury Yields

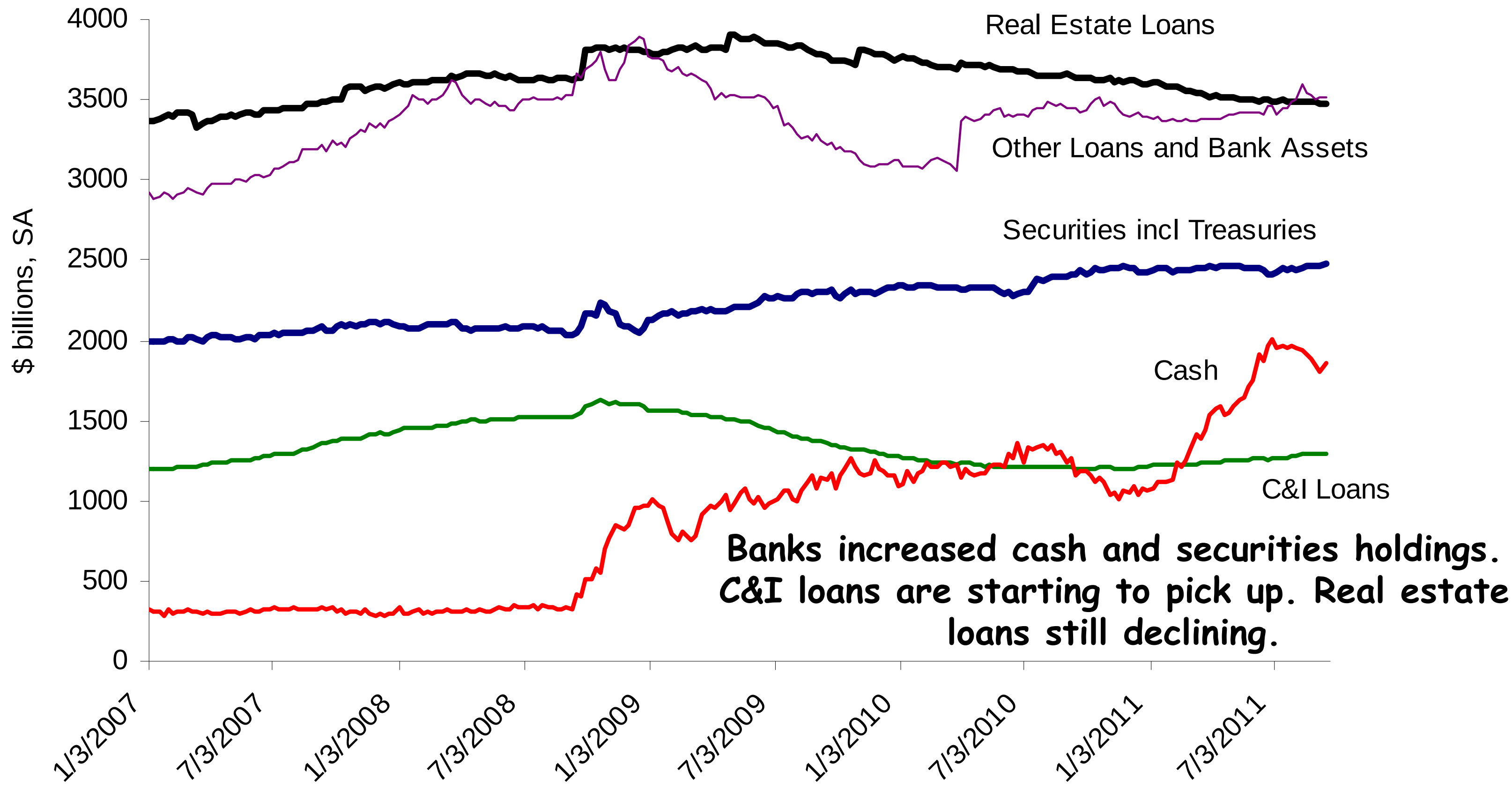
(last obs. September 28, 2011)



Source: U.S. Treasury: Encima Global

Bank Assets: Cash Has Risen Sharply Due to QE2

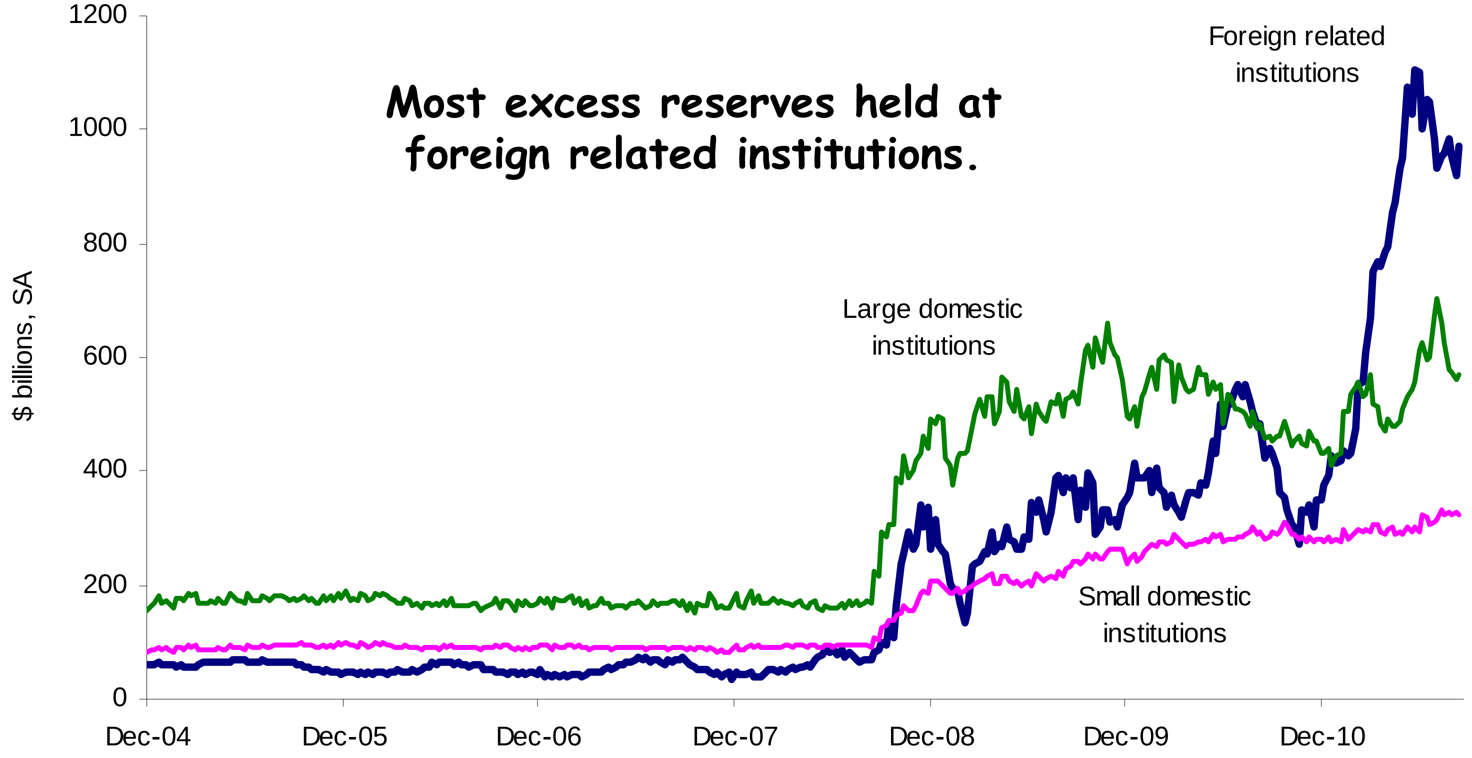
(last obs. September 14, 2011)



Source: Federal Reserve: Encima Global

Bank Cash by Type of Institution

(last obs. September 14, 2011)

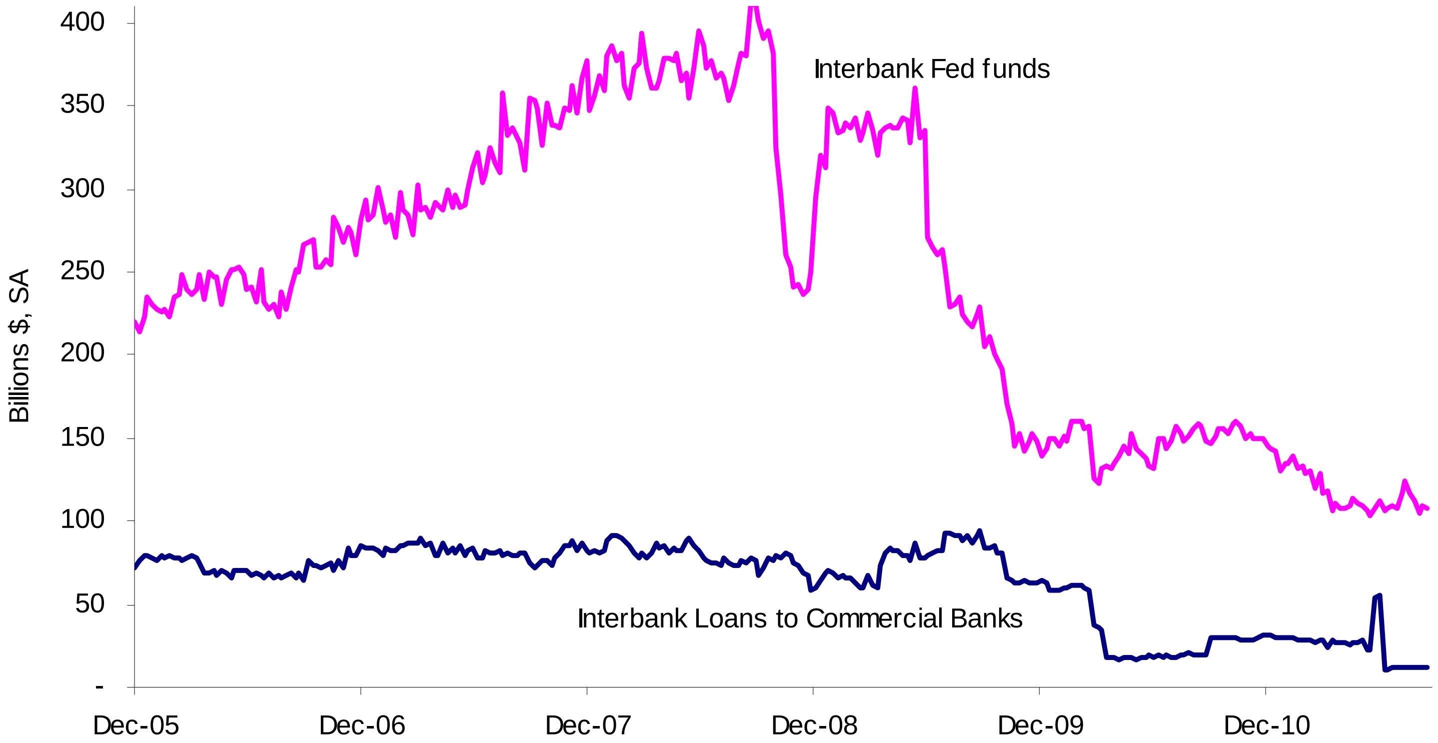


Source: Federal Reserve; Encima Global

Interbank Lending Under Pressure From Zero Rates

(last obs. September 16, 2011)

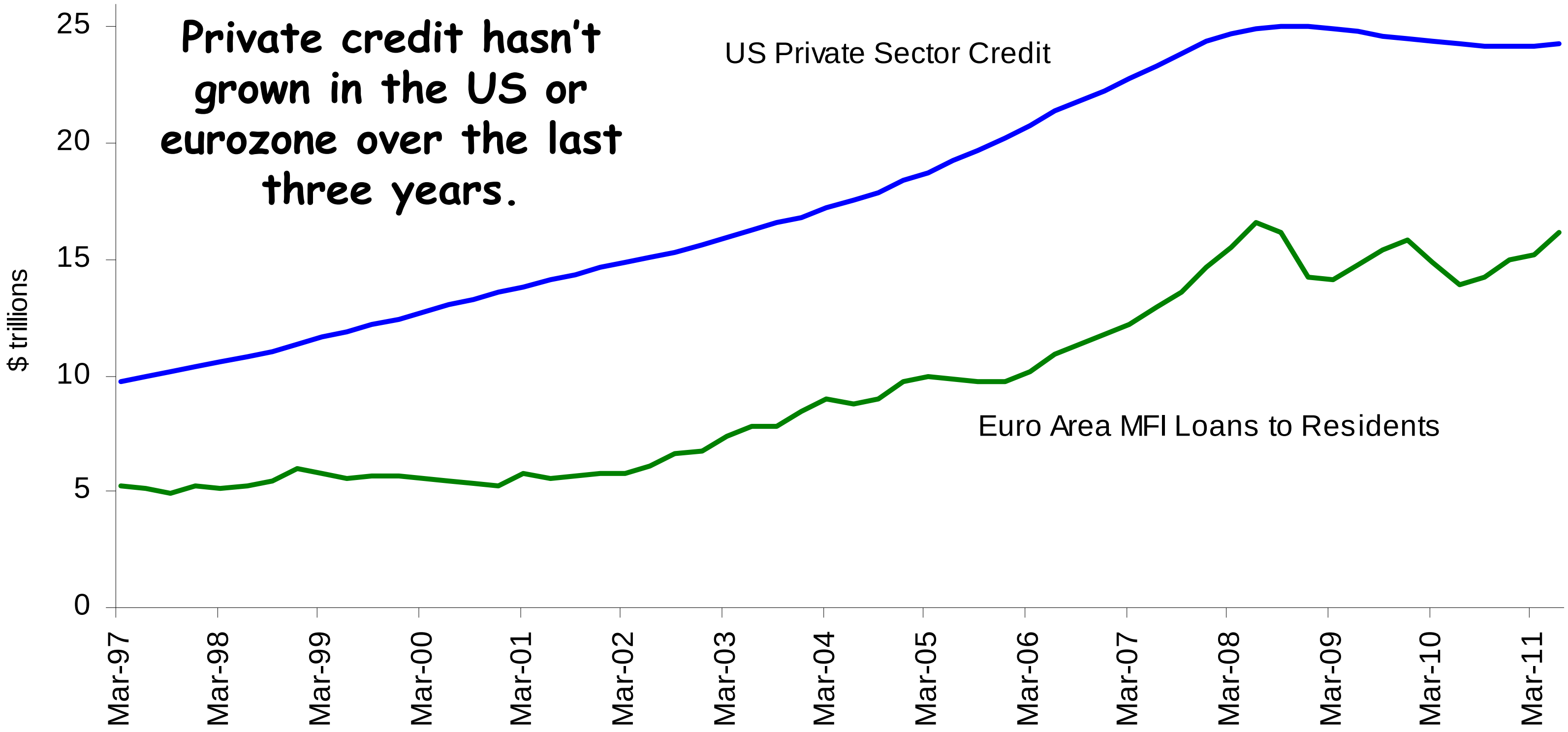
Interbank lending has fallen significantly since the Fed Funds rate has been held near zero.



Source: Federal Reserve; Encima Global

U.S. and Euro Zone Private Sector Credit

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

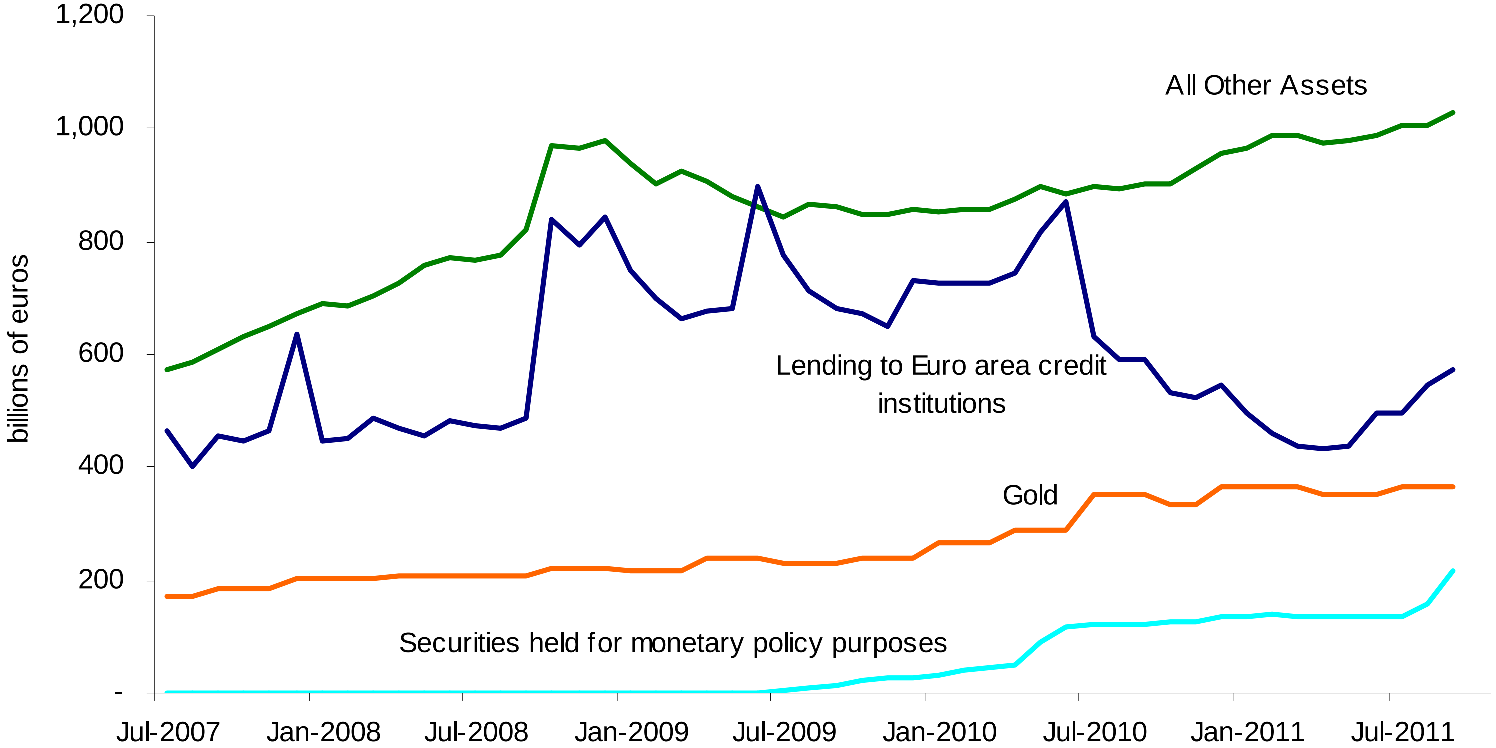


Source: Federal Reserve; ECB; Encima Global

ECB Balance Sheet

(last obs. September 23, 2011)

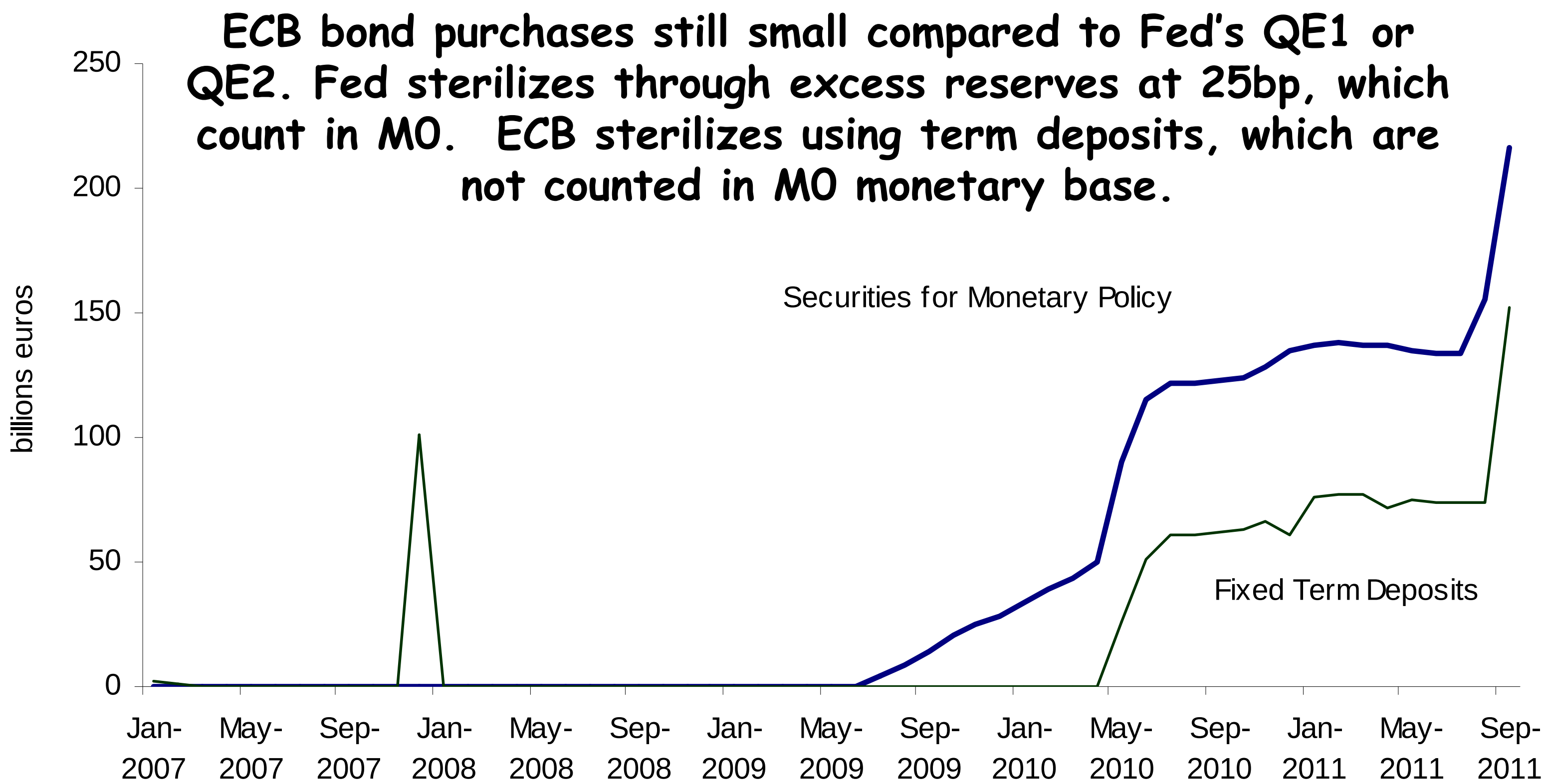
The ECB has expanded less rapidly than the Fed, buying Greek, Italian and other bonds for 'monetary policy purpose' with yields over 5%.



Source: ECB; Encima Global

ECB Sterilizing Bond Purchases

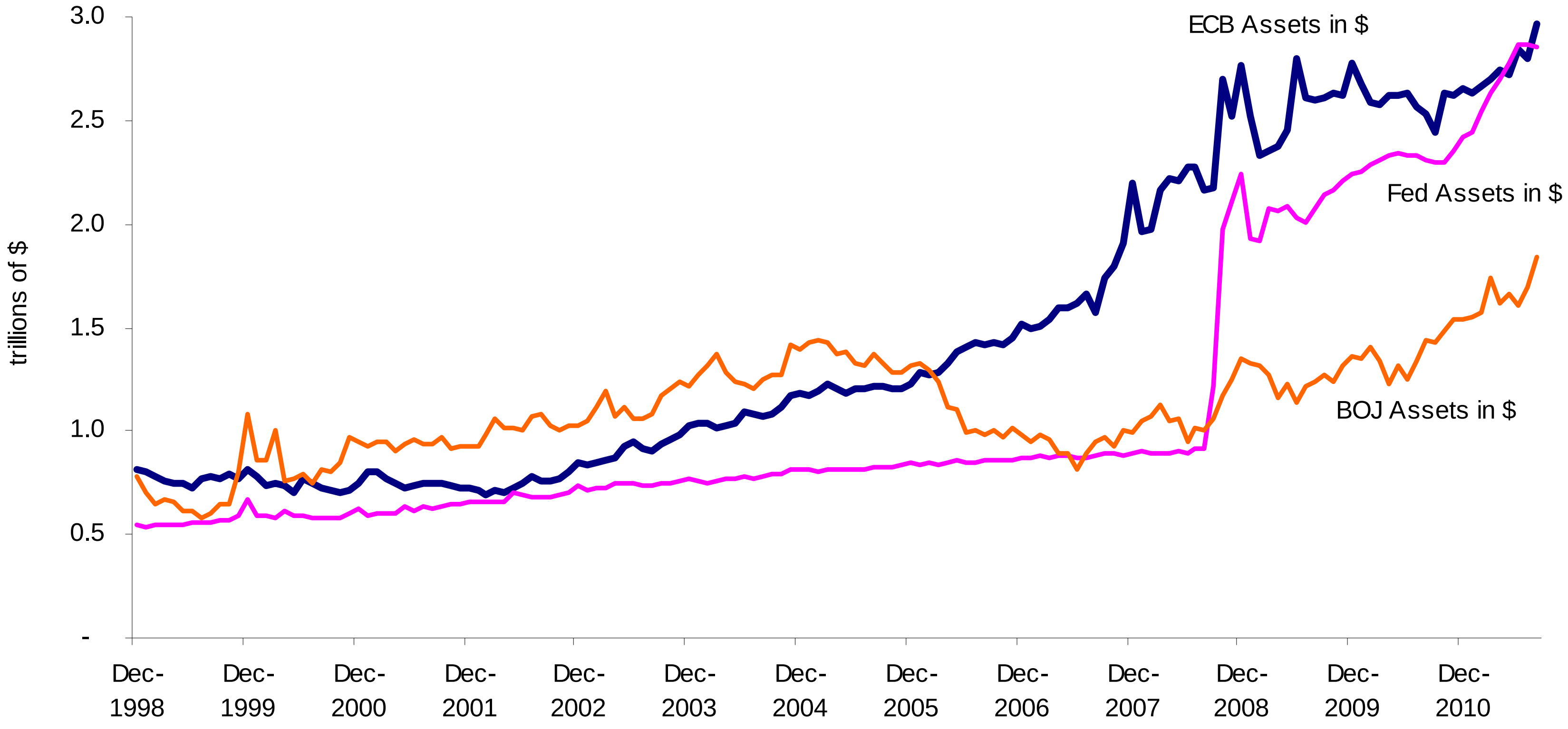
(last obs. September 23, 2011)



Source: ECB; Encima Global

Federal Reserve; ECB; Bank of Japan Assets

(last obs. August 2011)



Source: Federal Reserve; ECB; Bank of Japan; Encima Global

10 Year U.S. Treasury Yield Too Low

(last obs. September 30, 2011)

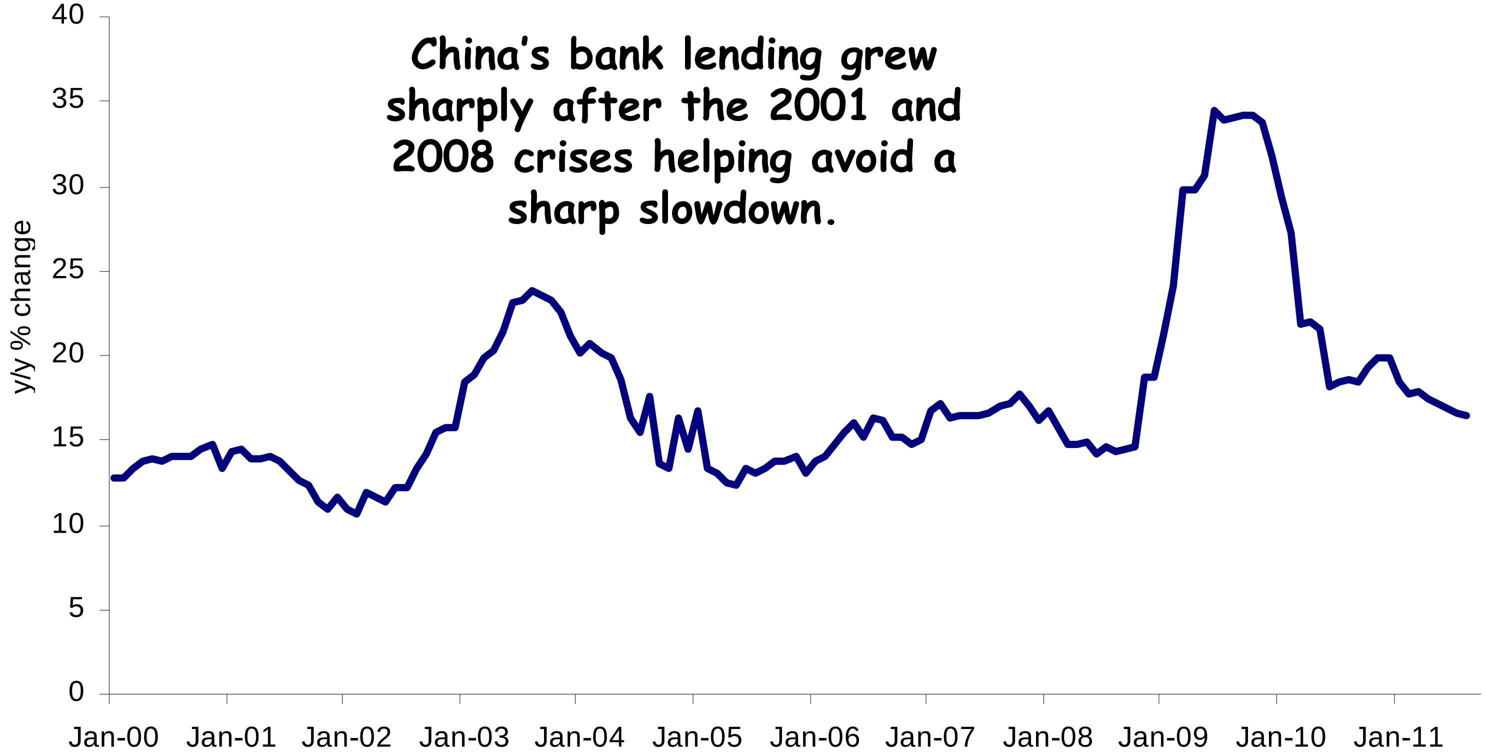
Source: Federal Reserve Board; Encima Global

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 still pressing for capital injections, arbitrary capital premiums, capital penalties for too-big-to-fail institutions, and divisive Basel III capital standards. We expect weaker financial institutions and more dynamism in non-bank financial innovation. One loser – small businesses that depend on relationship banking.

China's Countercyclical Bank Lending Policy

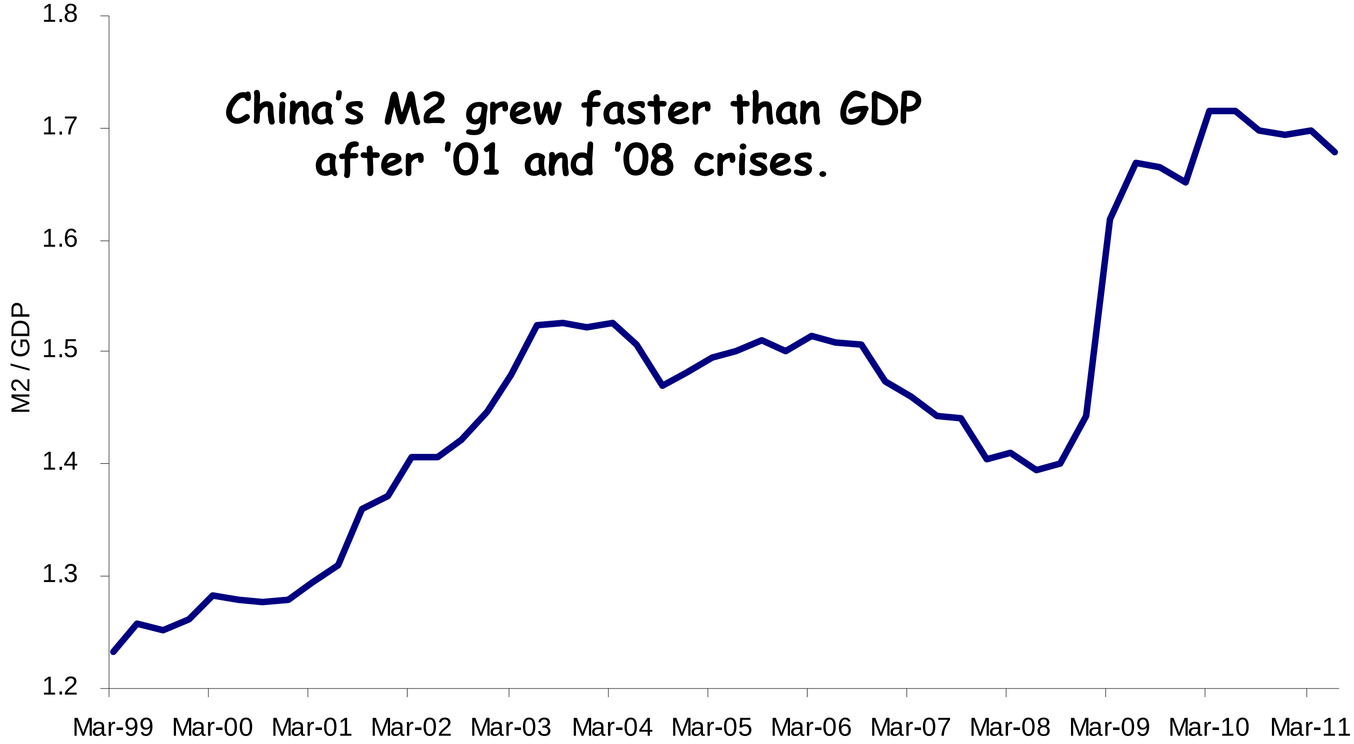
(last obs. August 2011)



Source: Bloomberg; Encima Global

China’s M2 / GDP

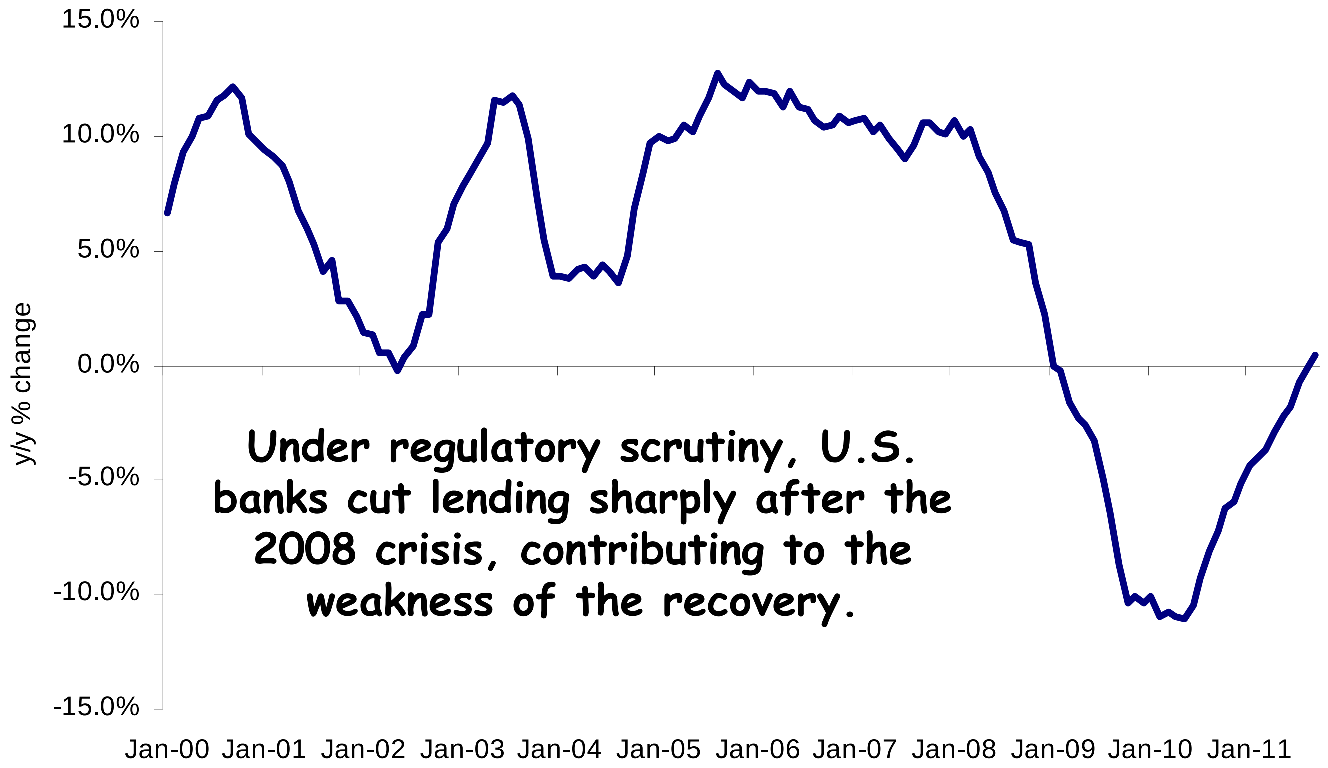
(last obs. Q2 2011)



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

US Pro-cyclical Bank Lending Policy

(last obs. August 2011, estimate September 2011)



Source: Federal Reserve; Encima Global

US M2 / GDP

(last obs. Q2 2011)

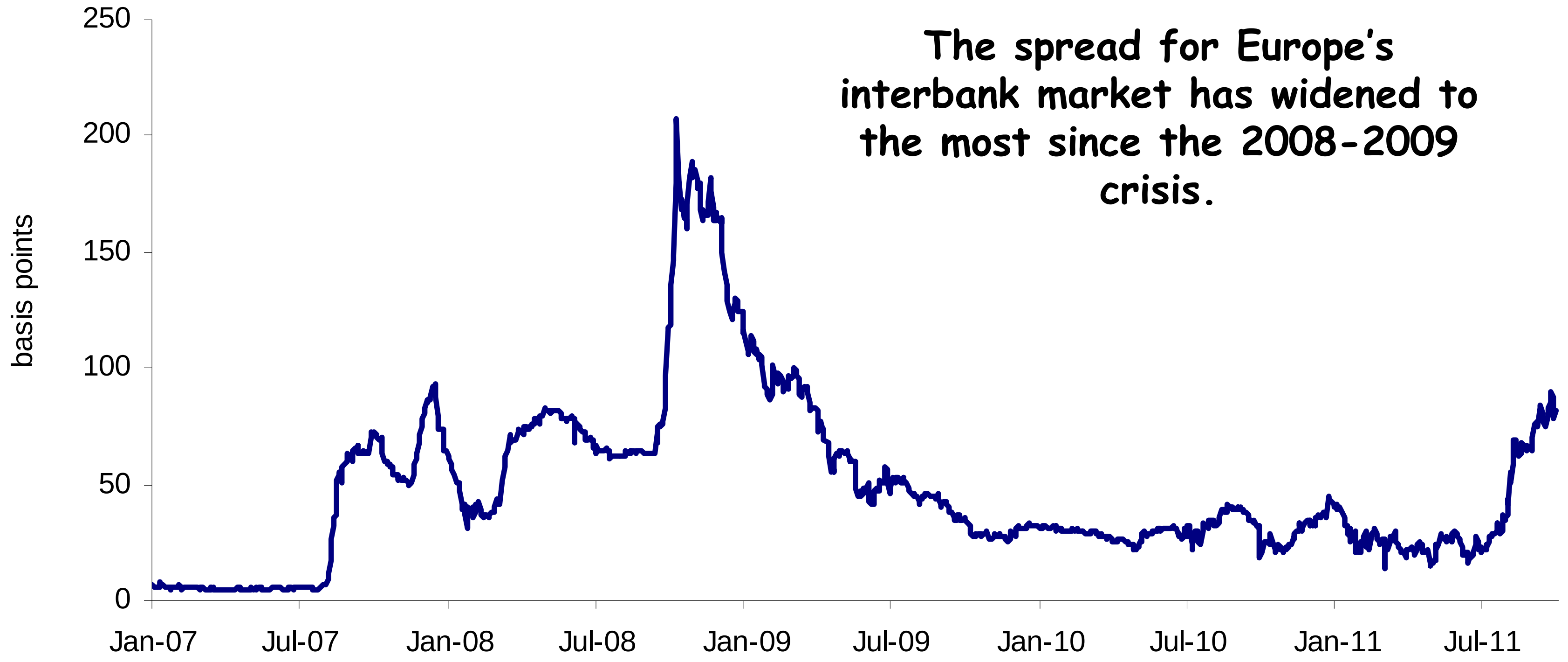
Source: Federal Reserve; BEA; Encima Global

Europe

- We think Europe's current policies point toward recession.
- We're skeptical that Europe will use leverage with its existing institutions or move fast enough to solve the contagion problem pushing Europe into recession.
- The ECB has the power to help (e.g. buy Italian bonds in size), but shows no sign of using it. For other European institutions, there are large legal and political obstacles to investing in sovereign bonds or in banks. We don't think structural reform efforts alone, even if they became energetic in Italy and Spain, would be enough to restore confidence.
- We don't think the EFSF will be able to lever up without a German constitutional amendment (which could not be achieved). Even if the EFSF could lever up, there hasn't been agreement on what it would do – whether inject capital into banks (a black hole in our view unless Italian and Spanish bond yields fall); or buy Italian and Spanish bonds (probably couldn't buy enough by itself.)
- With Greece's fiscal and economic outlook deteriorating rapidly, the July 21 agreement on 21% haircuts to private sector debt are too small. Many European banks are under-reserved regarding Greek debt. We think Greece will only get one more disbursement and will run out of cash later this year.

EURIBOR - OIS Spread Has Widened

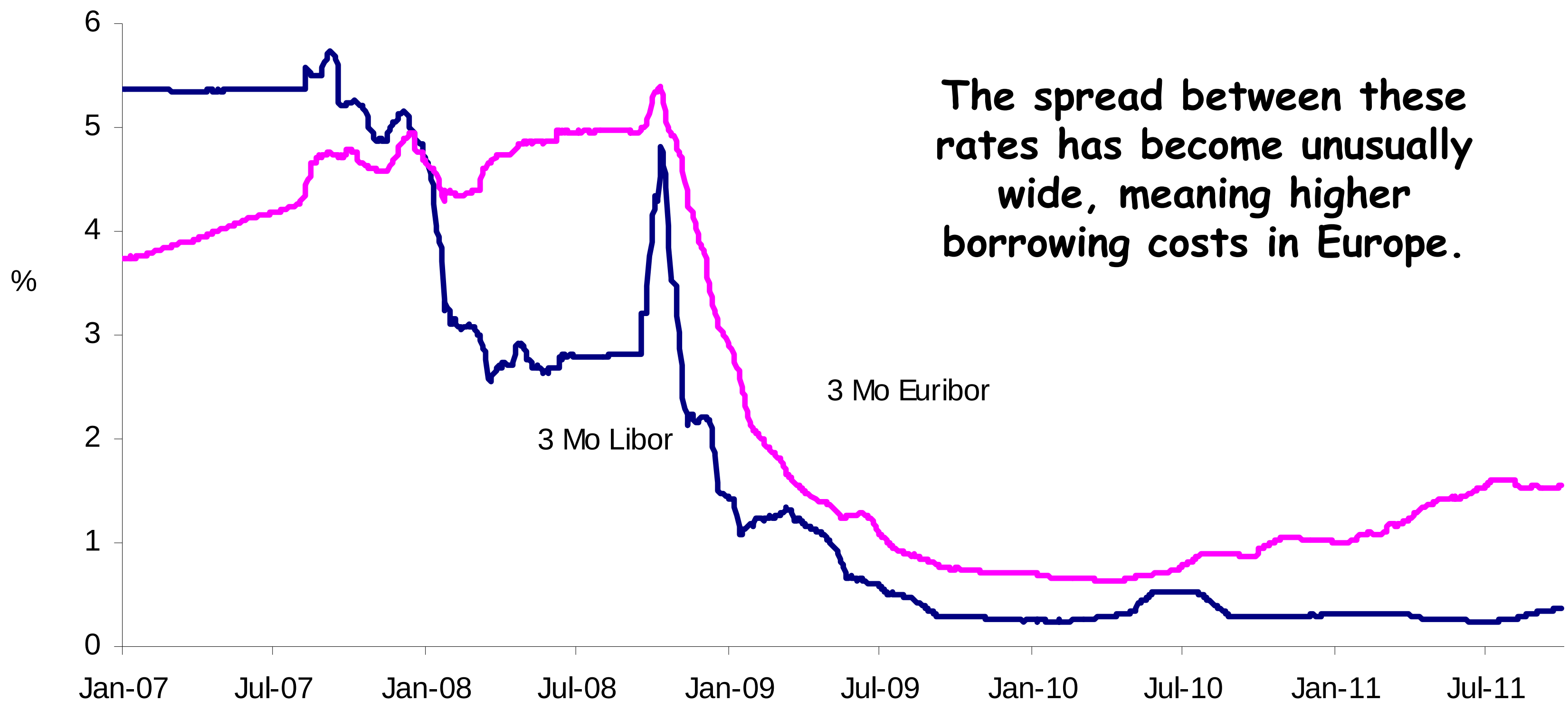
(last obs. September 30, 2011)



Source: Bloomberg; Encima Global

EURIBOR to LIBOR Spread

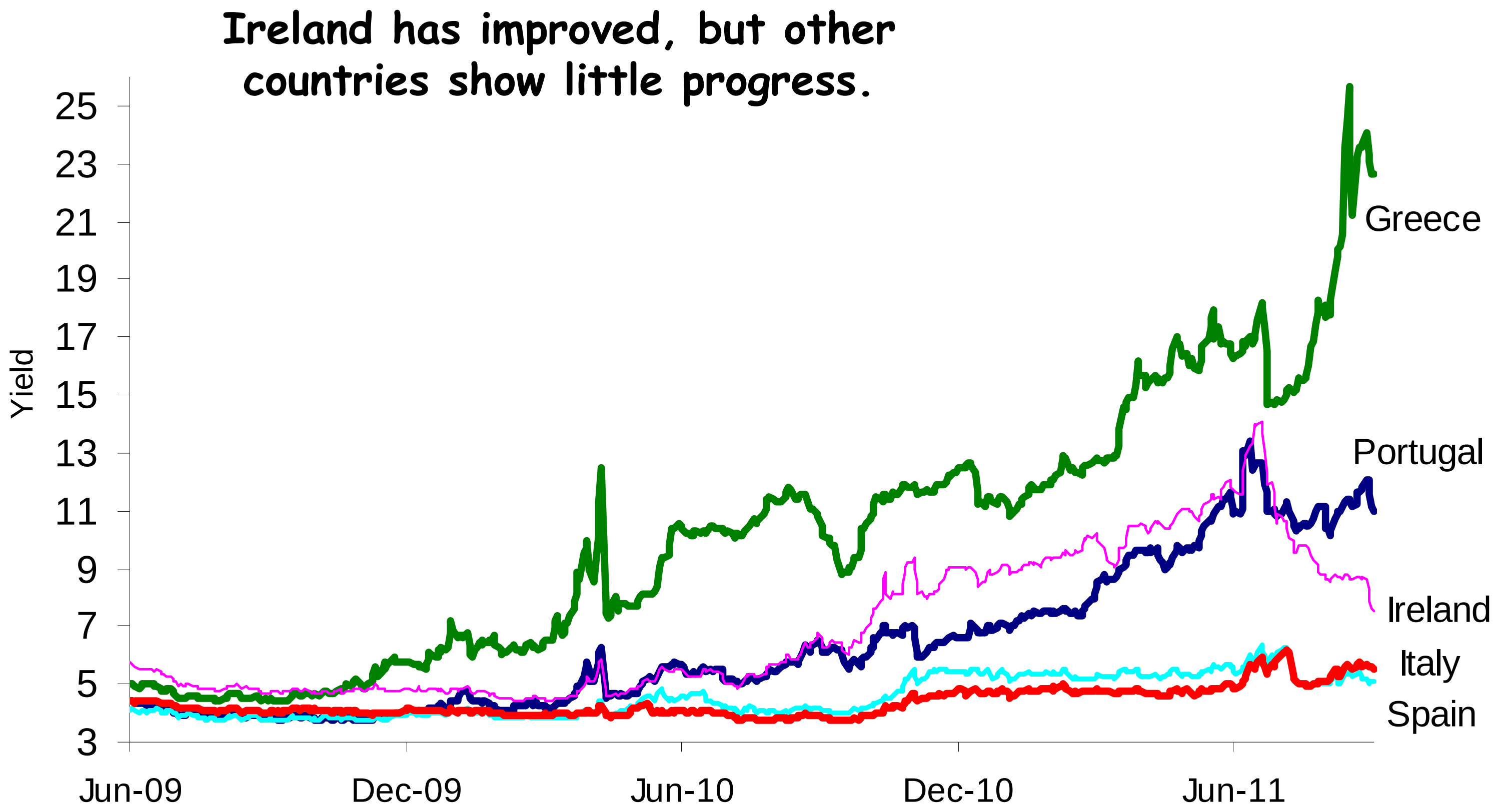
(last obs. September 30, 2011)



Source: Bloomberg; Encima Global

Selected European 10 Yr Yields

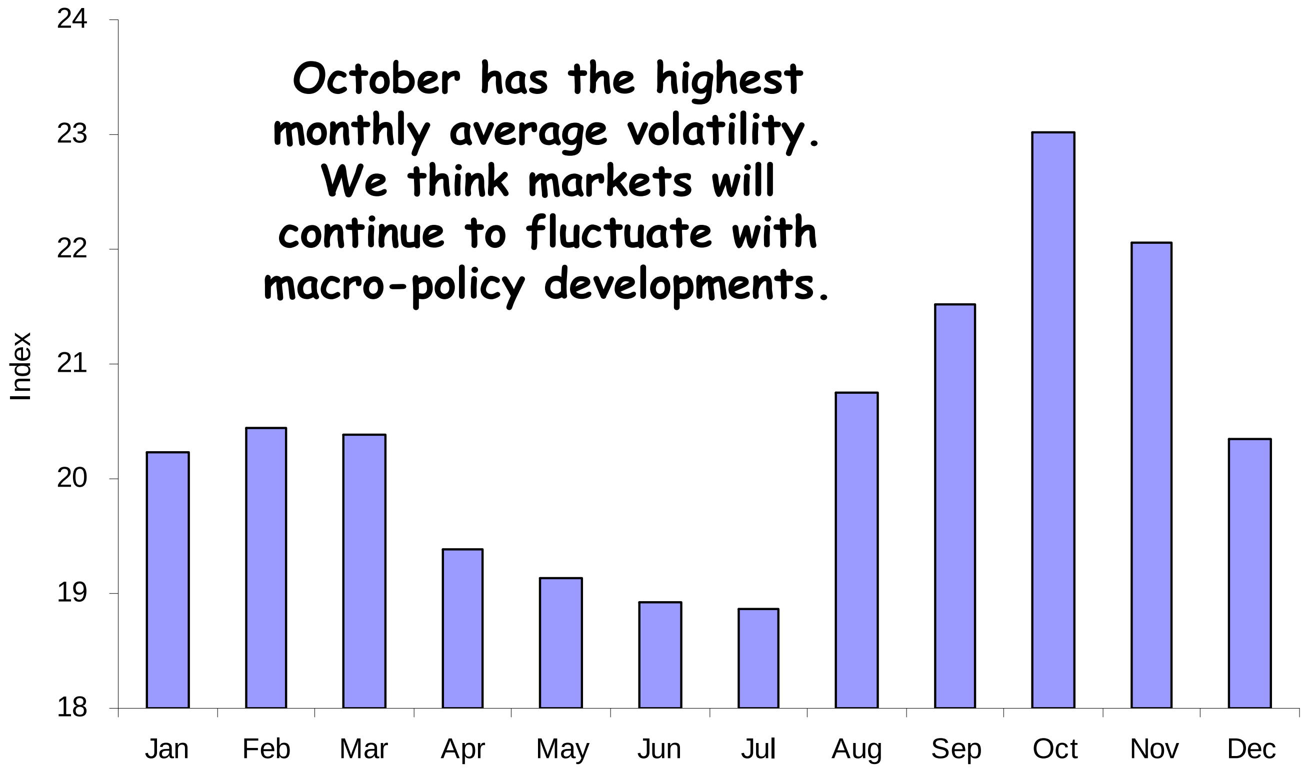
(last obs. September 30, 2011)



Source: Bloomberg; Encima Global

VIX Monthly Averages

(data from 1990 to 2011)



Source: Wall Street Journal; Encima Global