



Economic Outlook

November 15, 2011

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

Cautious Outlook; U.S. Can't Decouple

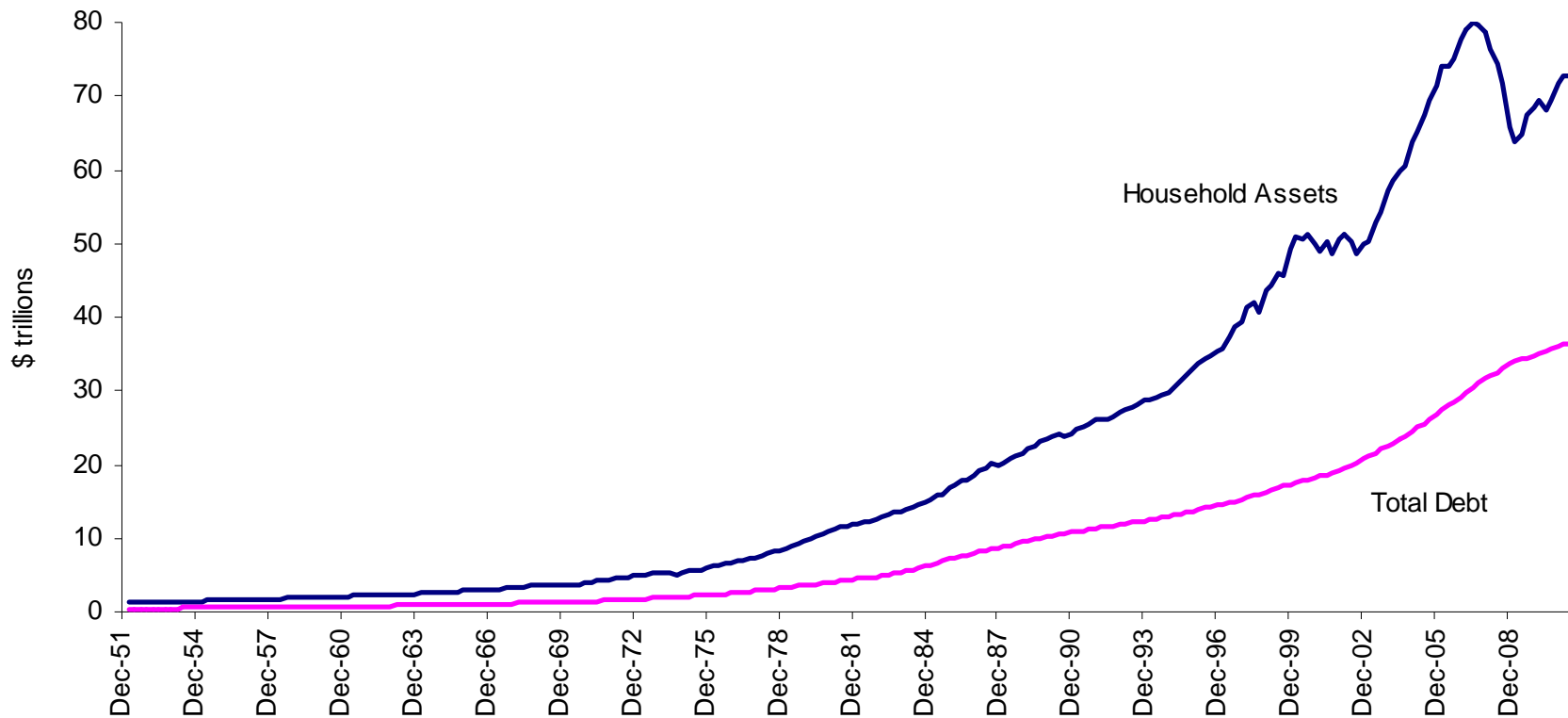
- **The deterioration in Europe's outlook, underway since August's failed Paris Summit, is accelerating. The ECB has firmly limited its role in a way that worsens the sell-off. The EFSF's role was limited by the Germany court ruling that EFSF commitments had to get Bundestag approval. And the negotiating dynamics over structural reforms give an incentive to debtors to withhold reforms in order to get bigger private sector haircuts and larger bailout packages.**
- **Europe's current plan won't last many more weeks because it doesn't address the burn rate for sovereigns or the burn-off of commercial bank liabilities.**
- **There is still the possibility (though unlikely) of a wholly new plan based on the ECB unfreezing sovereign credit markets and national governments working with regulators to sustain bank liabilities. Given Europe's low borrowing cost for long maturities, there is no reason for it to melt down over debt issues.**
- **However, under the current dynamics, the strong new leaders in Greece and Italy won't be able to reduce their burn rates, which are caused by deeper recessions, bigger fiscal deficits and reduced debt rollovers.**
- **European banks are burning off their private sector liabilities. The ECB will fill only part of that vacuum, with the rest coming from forced asset sales and equity capital (see Unicredito's announcement of a record loss today, with many more such surprise announcements yet to come for European banks.)**
- **Our base-case assumption is that German and the ECB will change course to keep all 17 in the euro. We think any country's departure (Slovenia or Greece are at immediate risk) would mark a new and even deeper deterioration than the one we've been describing.**

Disagree with Perma-Bears...

- **That economies are destined to grow slowly after a deep financial crisis due to deleveraging. Growth depends on policies.**
 - **That the U.S. is already in a recession (they said that in Aug '10 too.)**
 - **That the euro has to break up (though odds of that are increasing.)**
 - **That China will slow hard to 5%. It may slow below 9%, but banks are protected, bubble popping is common, and economy evolves.**
 - **That we're heading for a Lehman crisis or a Japan-style deflation.**
 - **That the Fed printed money, \$ will crash, and fast inflation is near.**
 - **The most likely outcome is slower growth and increasing European debt problems until policies change in 2012.**
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U.S. Household Assets Twice Total Debt

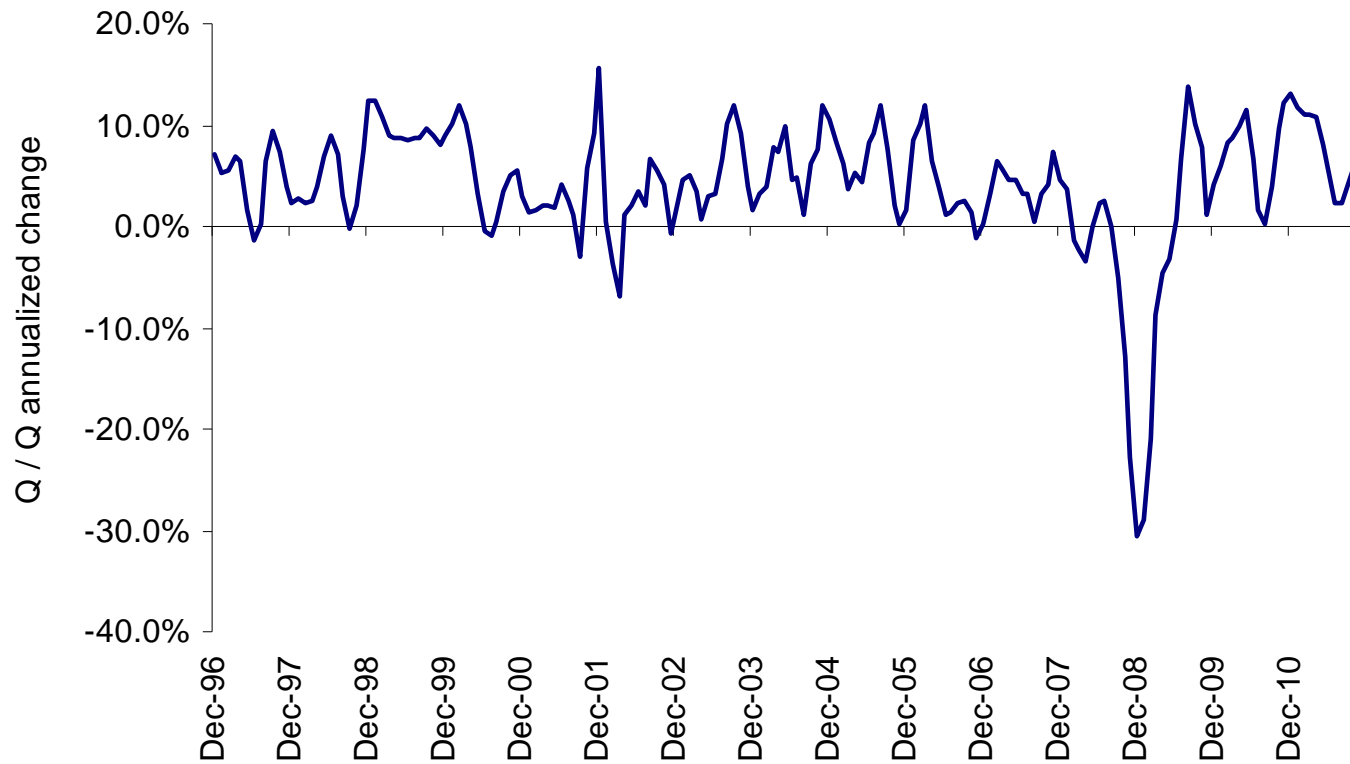
(last obs. Q2 2011, Assets \$72.6T, Total Debt \$36.5T)



Source: Federal Reserve: Flow of Funds; Encima Global

Retail Sales ex Food

(Q/Q annualized, last obs. October 2011)

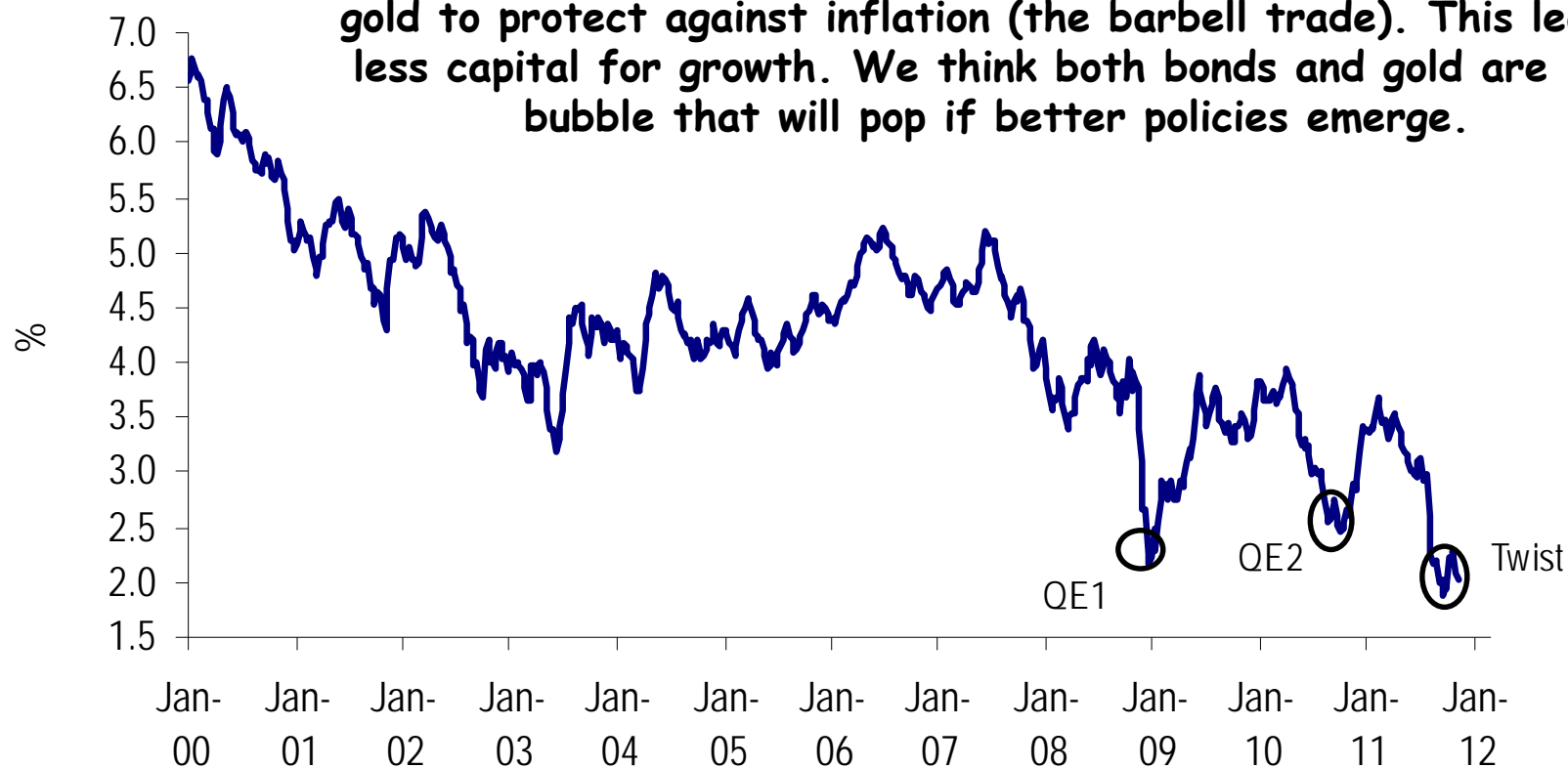


Source: Census Bureau; Encima Global

10 Year U.S. Treasury Yield Too Low

(last obs. November 15, 2011)

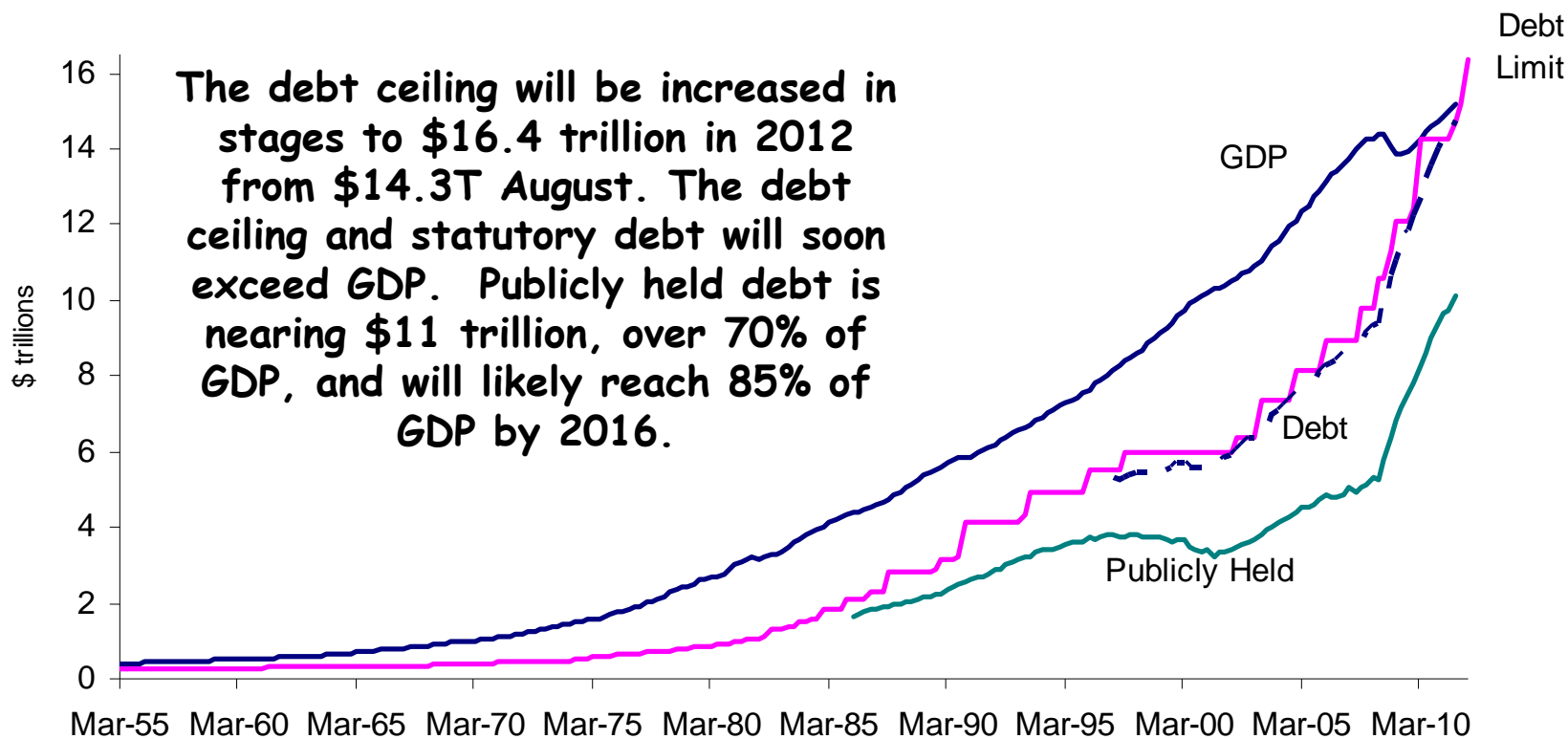
Investors have been buying bonds to protect against deflation and gold to protect against inflation (the barbell trade). This leaves less capital for growth. We think both bonds and gold are in a bubble that will pop if better policies emerge.



Source: Federal Reserve Board; Encima Global

Publicly Held Debt Reaching 70% of GDP

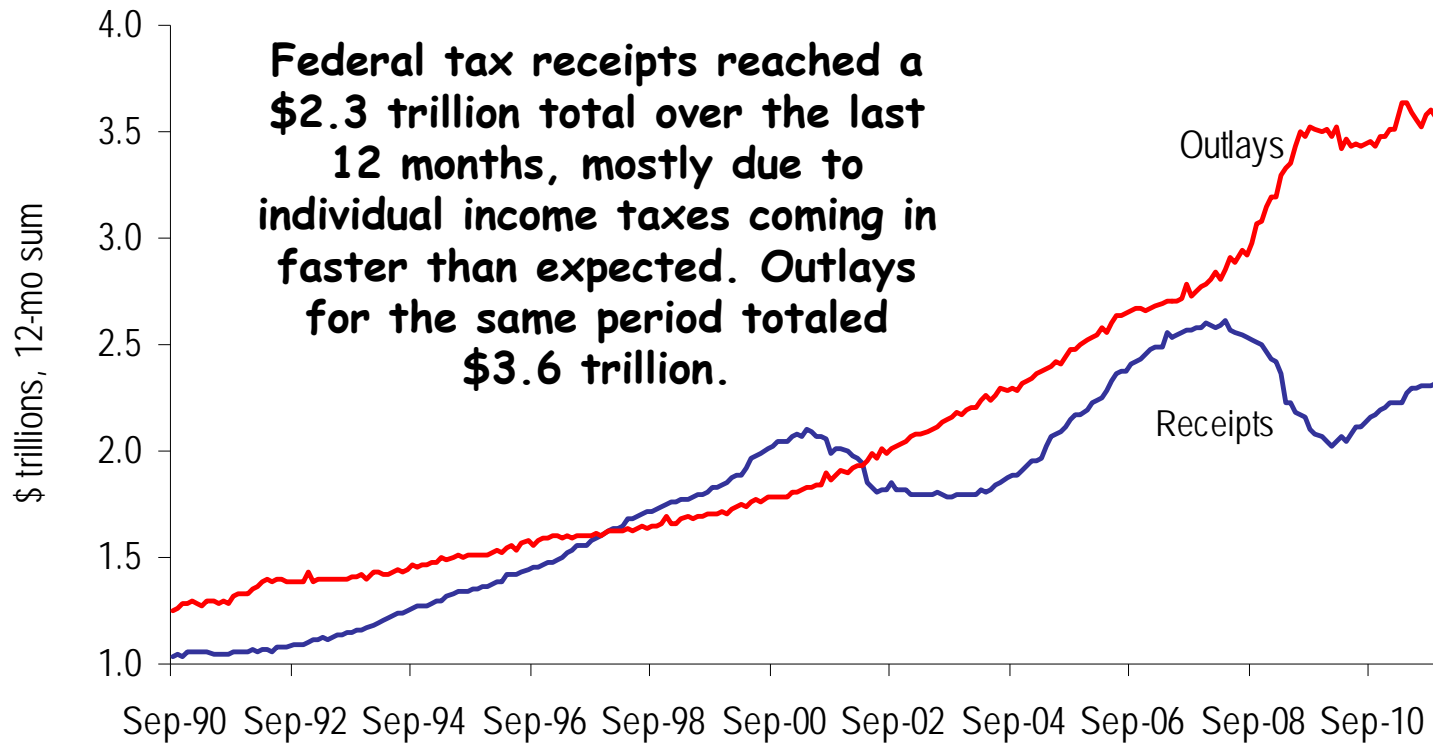
(last obs. Q3 2011, Q1 2012 for debt limit)



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

Level of Federal Receipts and Outlays (\$ trillions)

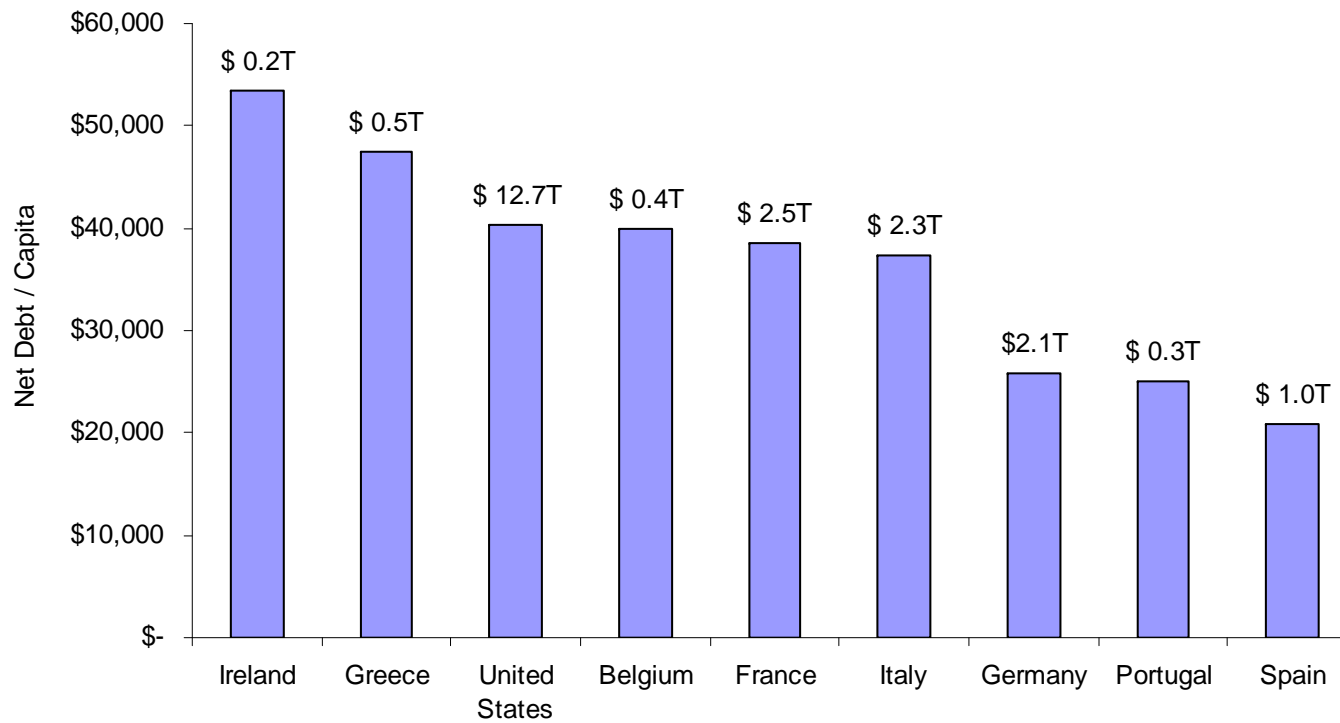
(last obs. October 2011)



Source: U.S. Treasury; Encima Global

U.S. and Europe Net Debt / Capita

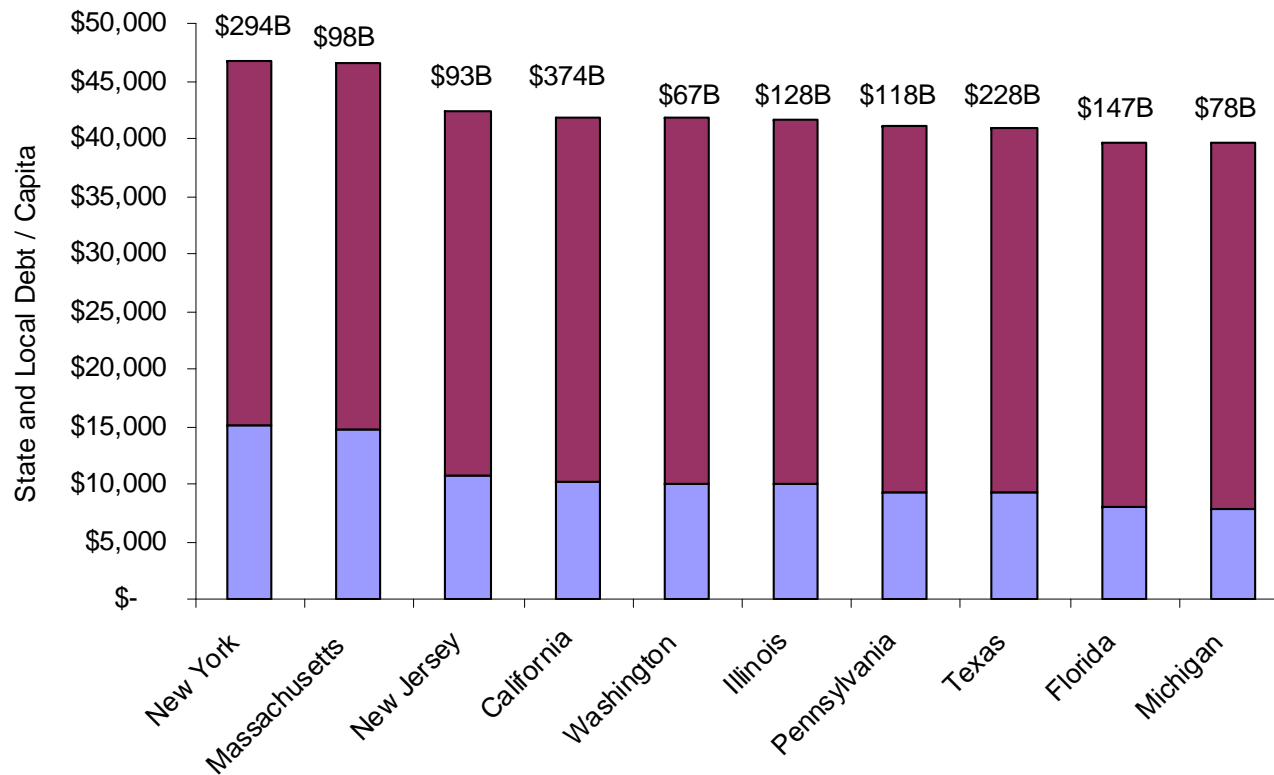
(General govt incl state and local; nets out intra-govt debt; IMF projections for 2012)



Source: IMF; Encima Global

State and Local Debt / Capita

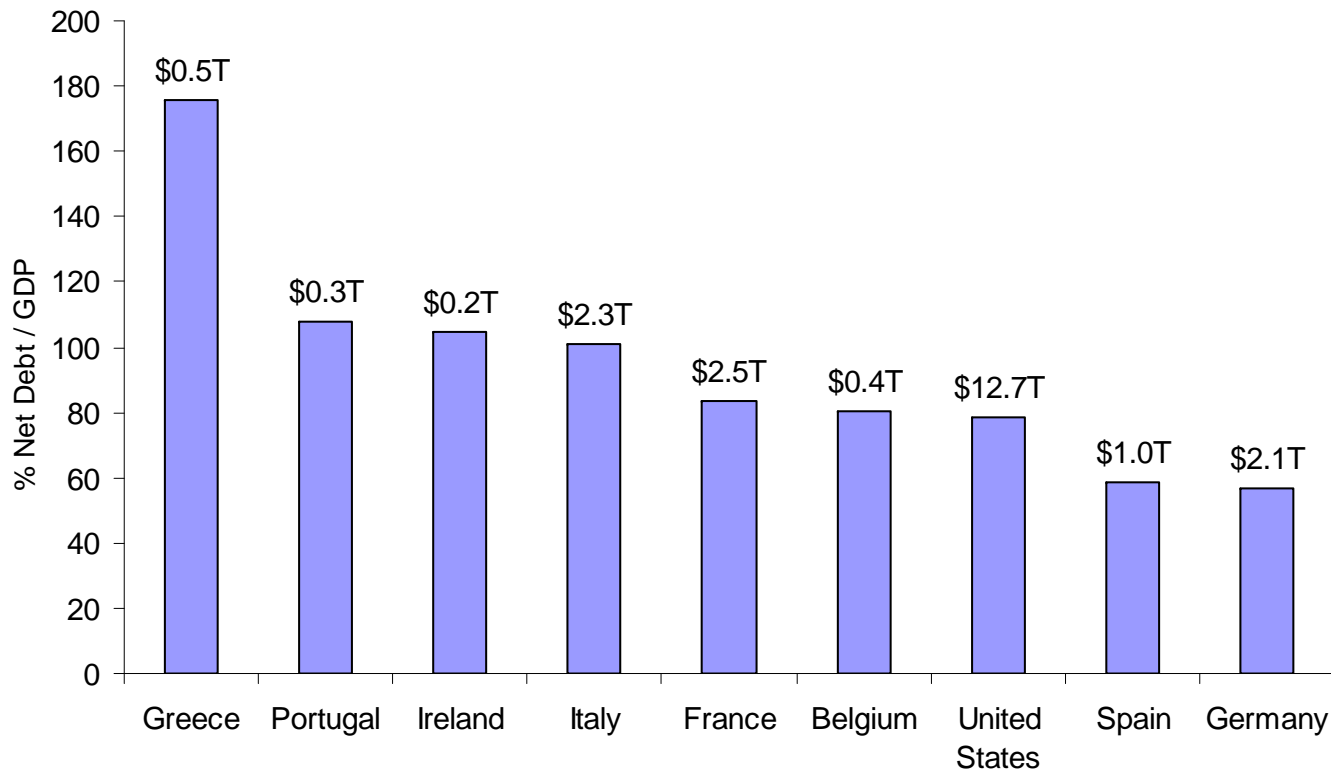
(labels show state and local debt using census bureau data for 2009;
bars total include net federal debt, adding \$36,000 per person in 2012)



Source: Census Bureau; U.S. Treasury; Encima Global

European Net Debt / GDP

(General govt; nets out intra-govt debt; IMF projections for 2012)

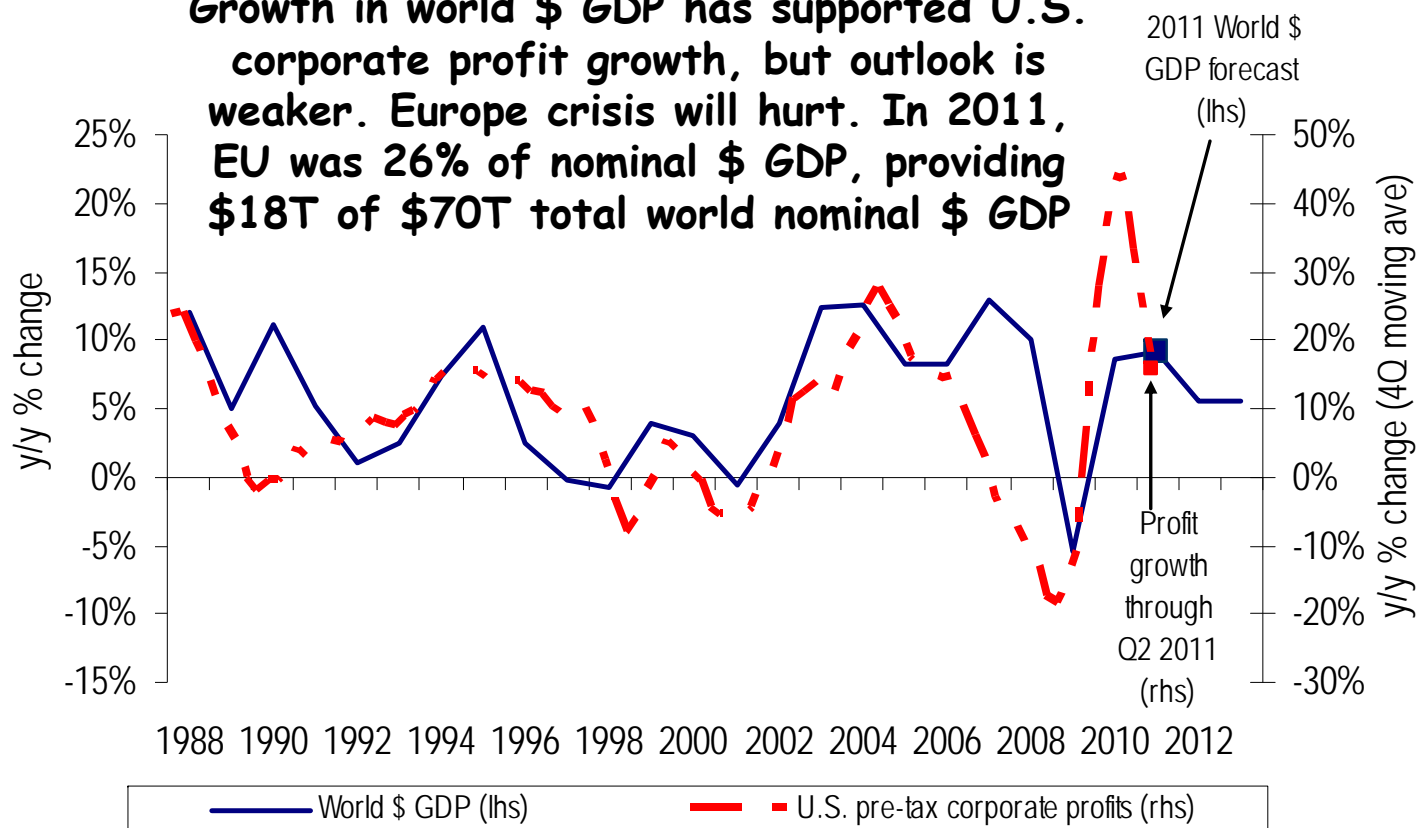


Source: IMF; Encima Global

U.S. Corporate Profits Grow with World \$ GDP

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

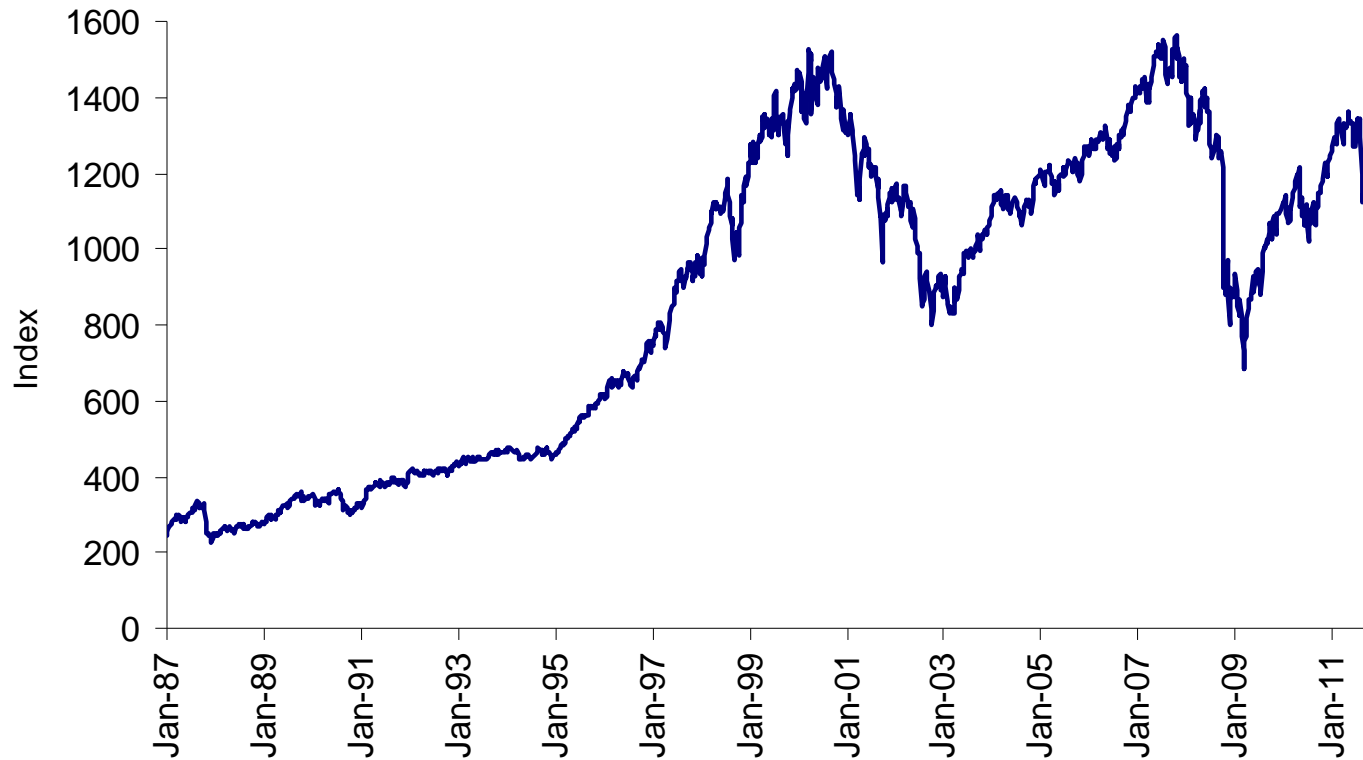
Growth in world \$ GDP has supported U.S. corporate profit growth, but outlook is weaker. Europe crisis will hurt. In 2011, EU was 26% of nominal \$ GDP, providing \$18T of \$70T total world nominal \$ GDP



Source: Bureau of Economic Analysis; IMF; Encima Global

S&P 500 – Policies Have Big Impact

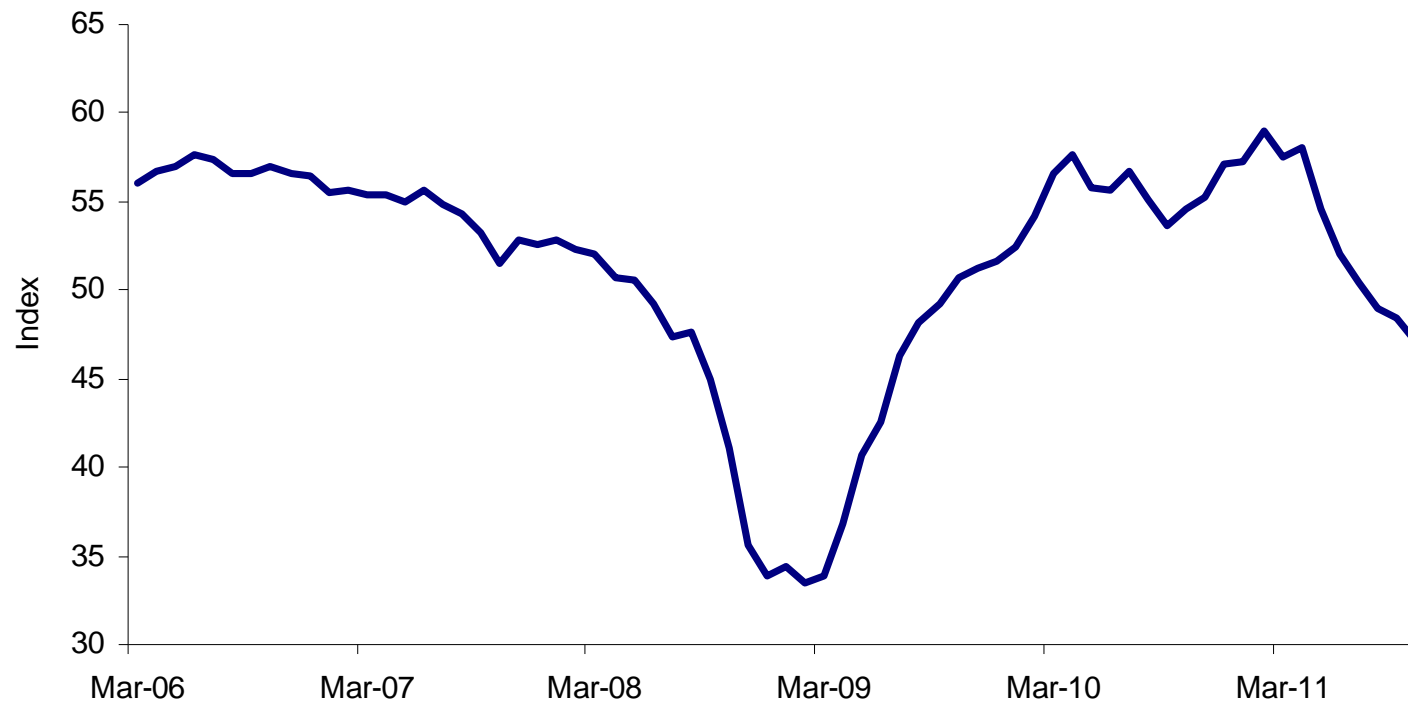
(last obs. November 14, 2011)



Source: Wall Street Journal; Encima Global

Eurozone Manufacturing PMI

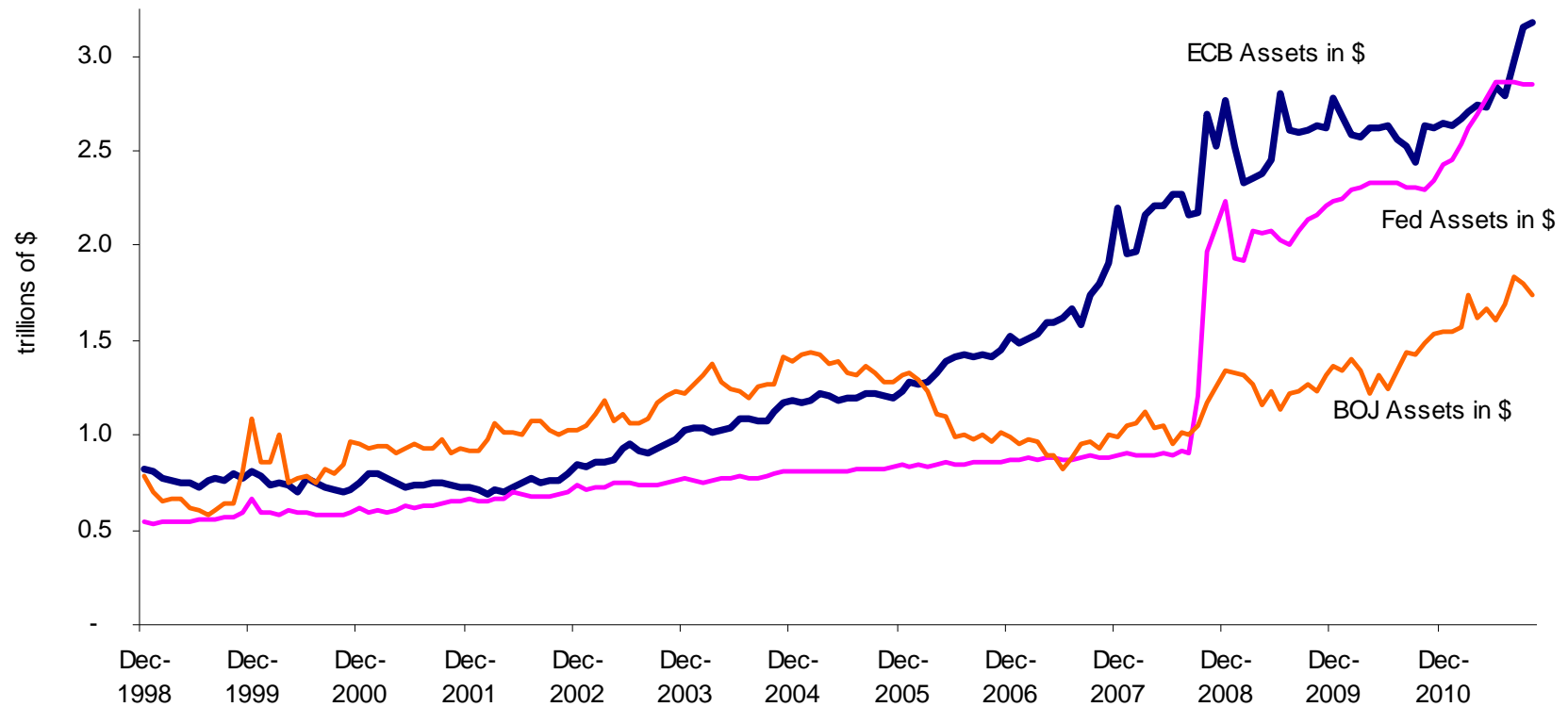
(last obs. October 2011, 47.1)



Source: Bloomberg; Encima Global

ECB, Federal Reserve & Bank of Japan Assets

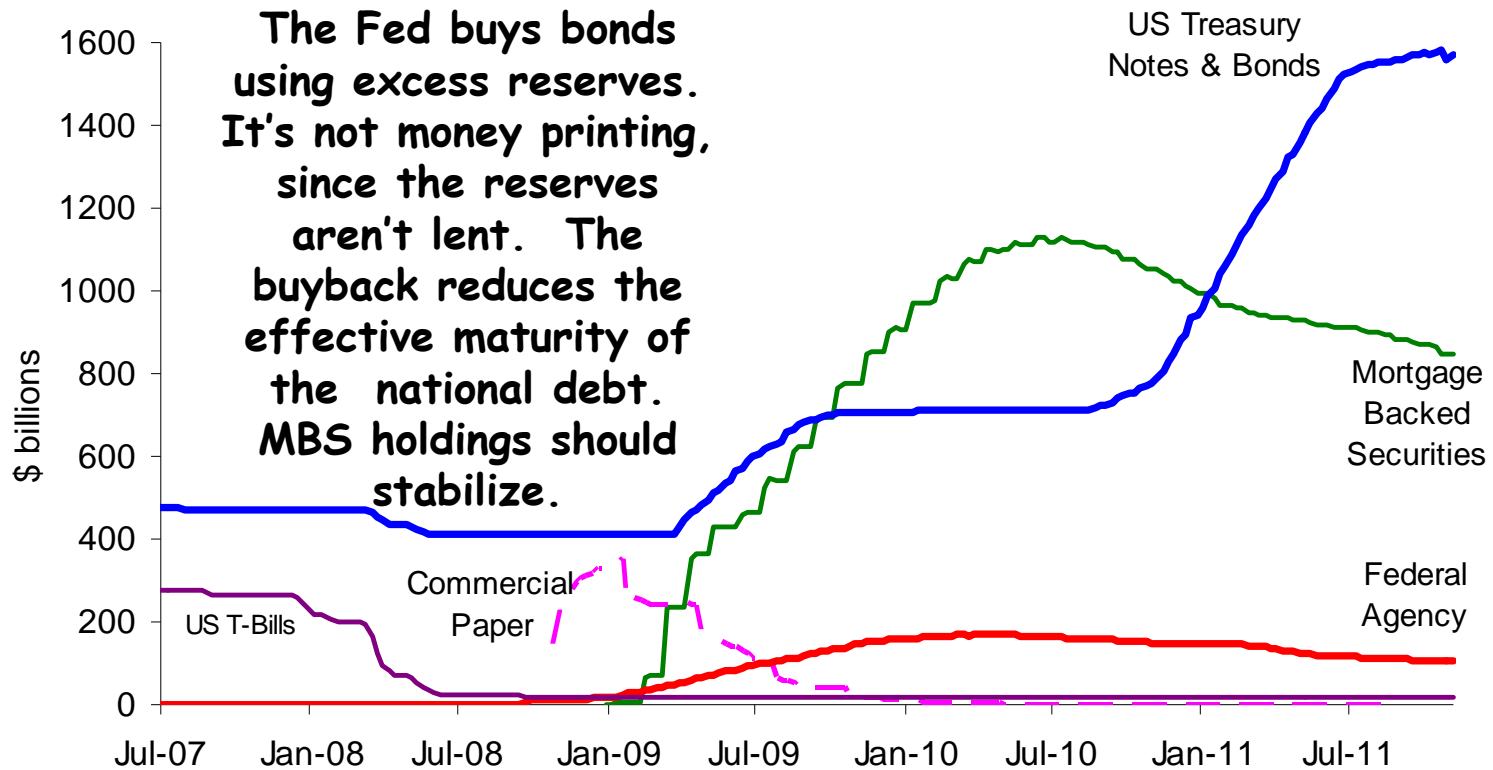
(last obs. October 2011)



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

Fed Assets

(last obs. November 9, 2011)

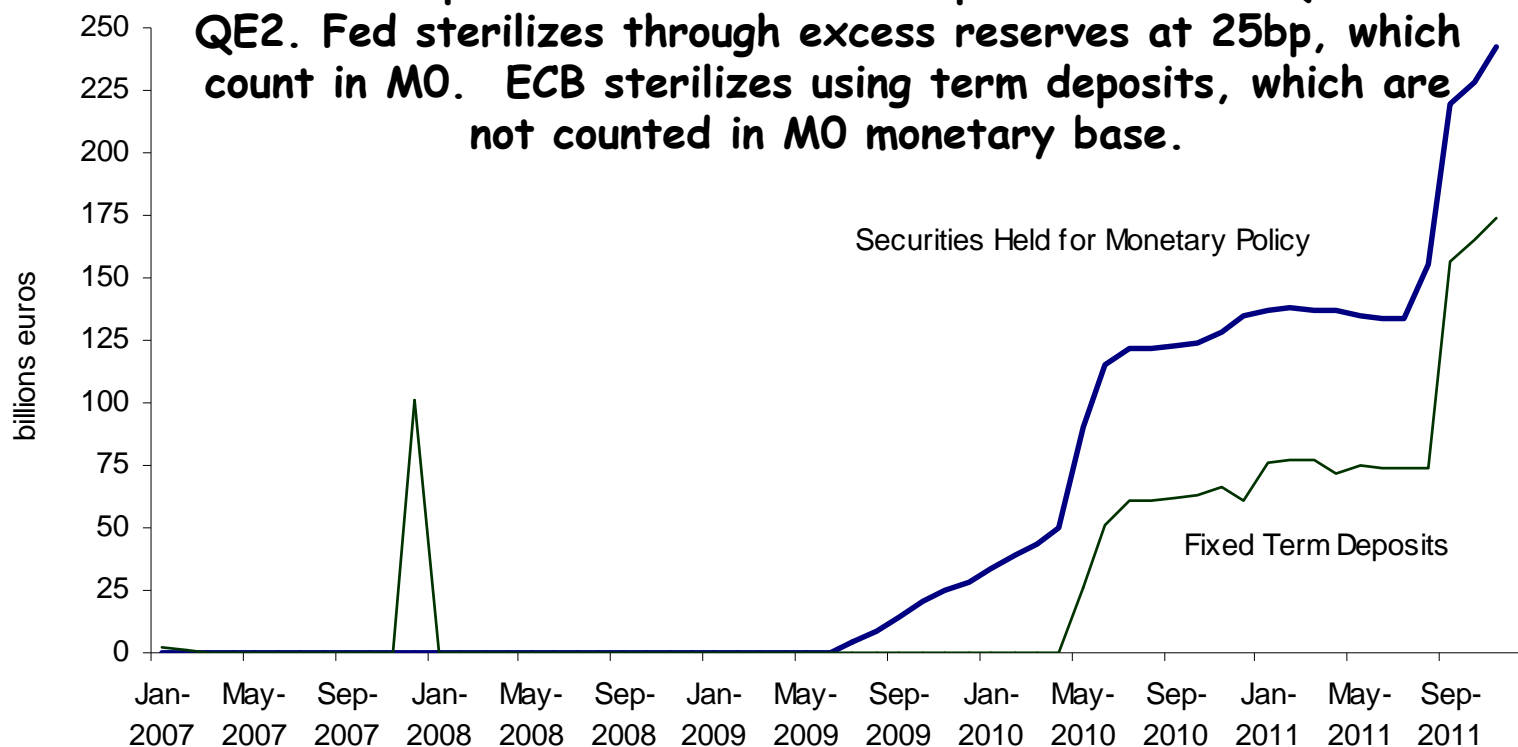


Source: Federal Reserve: Encima Global

ECB Sterilizing Bond Purchases Like Fed

(last obs. November 4, 2011)

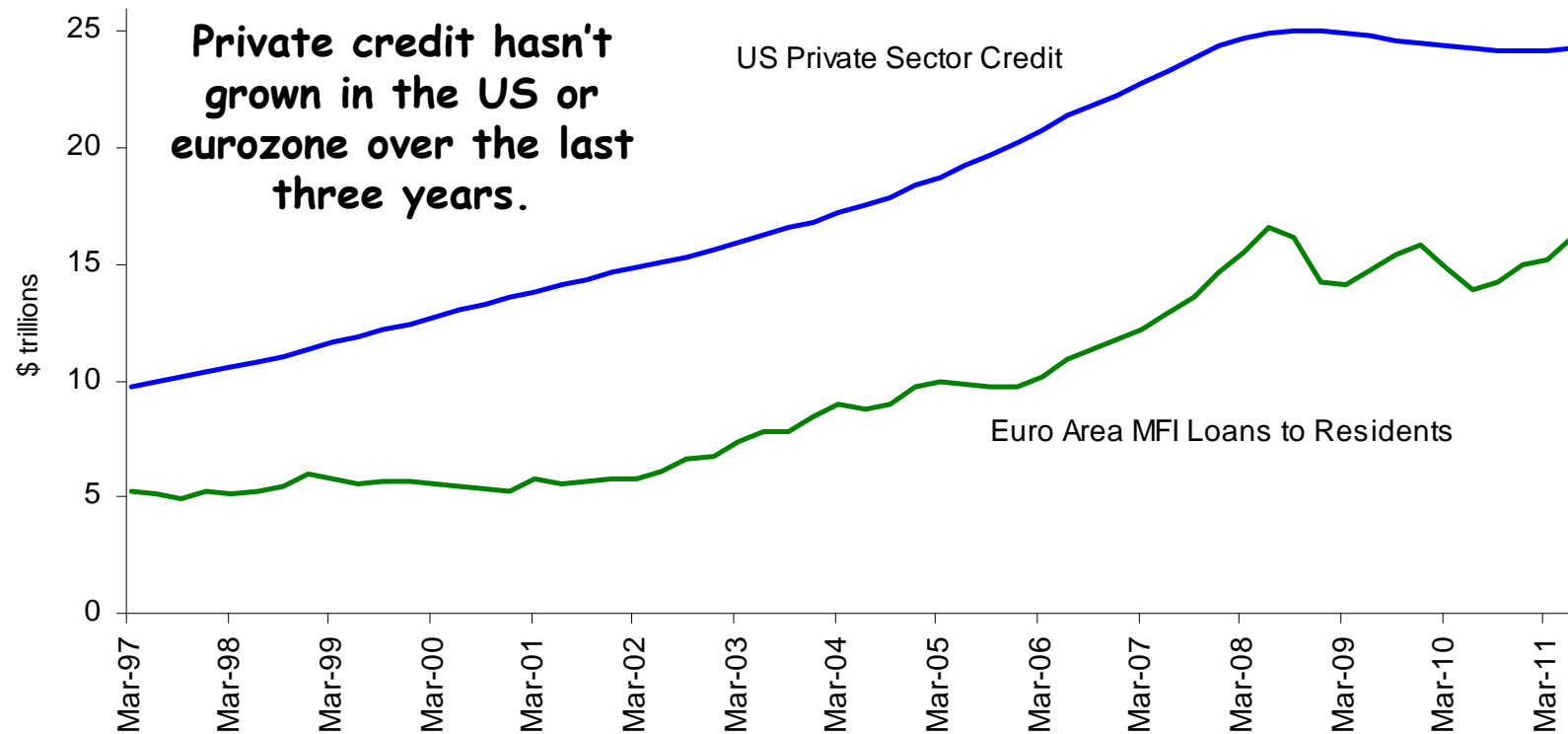
ECB bond purchases still small compared to Fed's QE1 or QE2. Fed sterilizes through excess reserves at 25bp, which count in M0. ECB sterilizes using term deposits, which are not counted in M0 monetary base.



Source: ECB; Encima Global

U.S. and Euro Zone Private Sector Credit

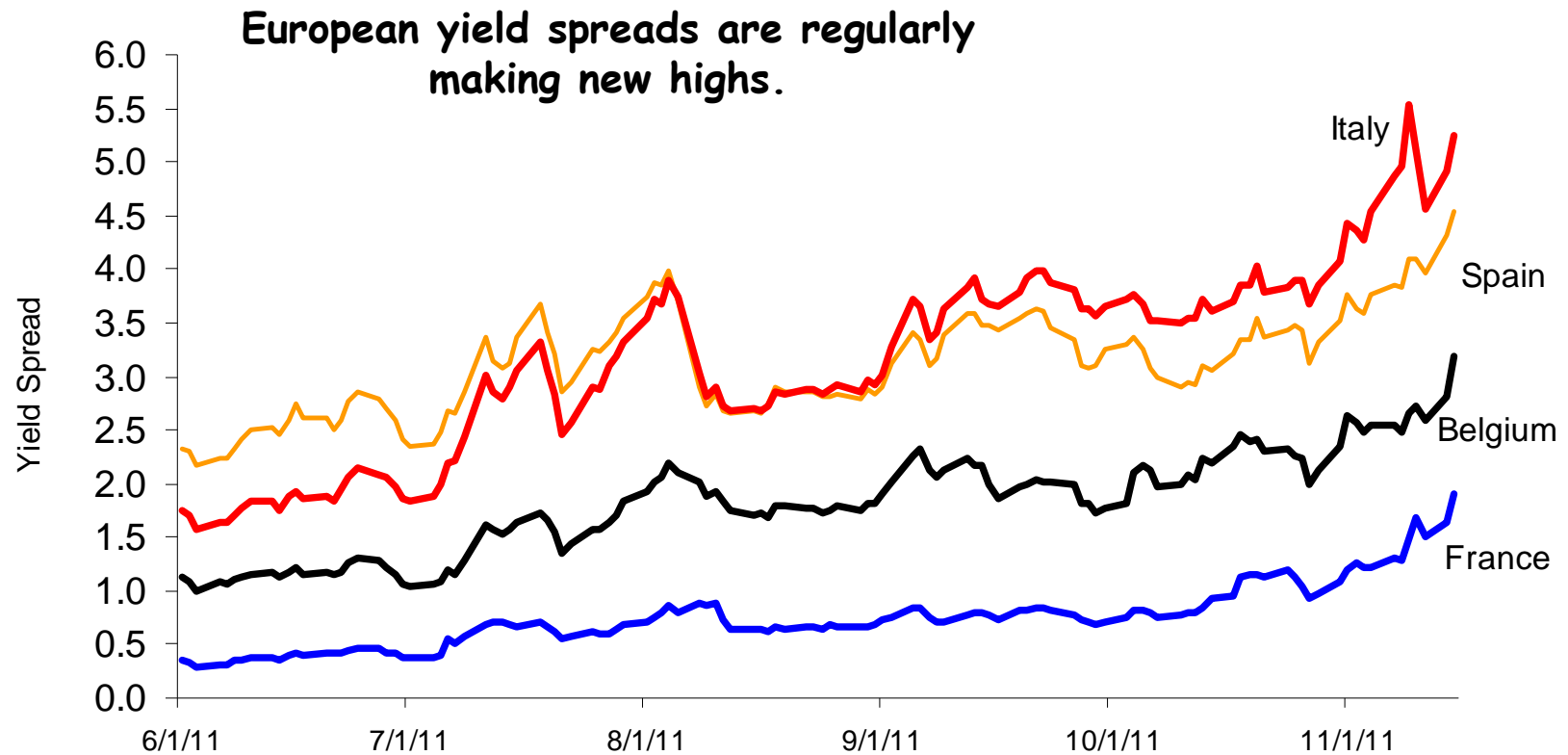
(last obs. Q2 2011, Euro area converted to dollars)



Source: Federal Reserve; ECB; Encima Global

Selected European 10 Yr Yield Spreads

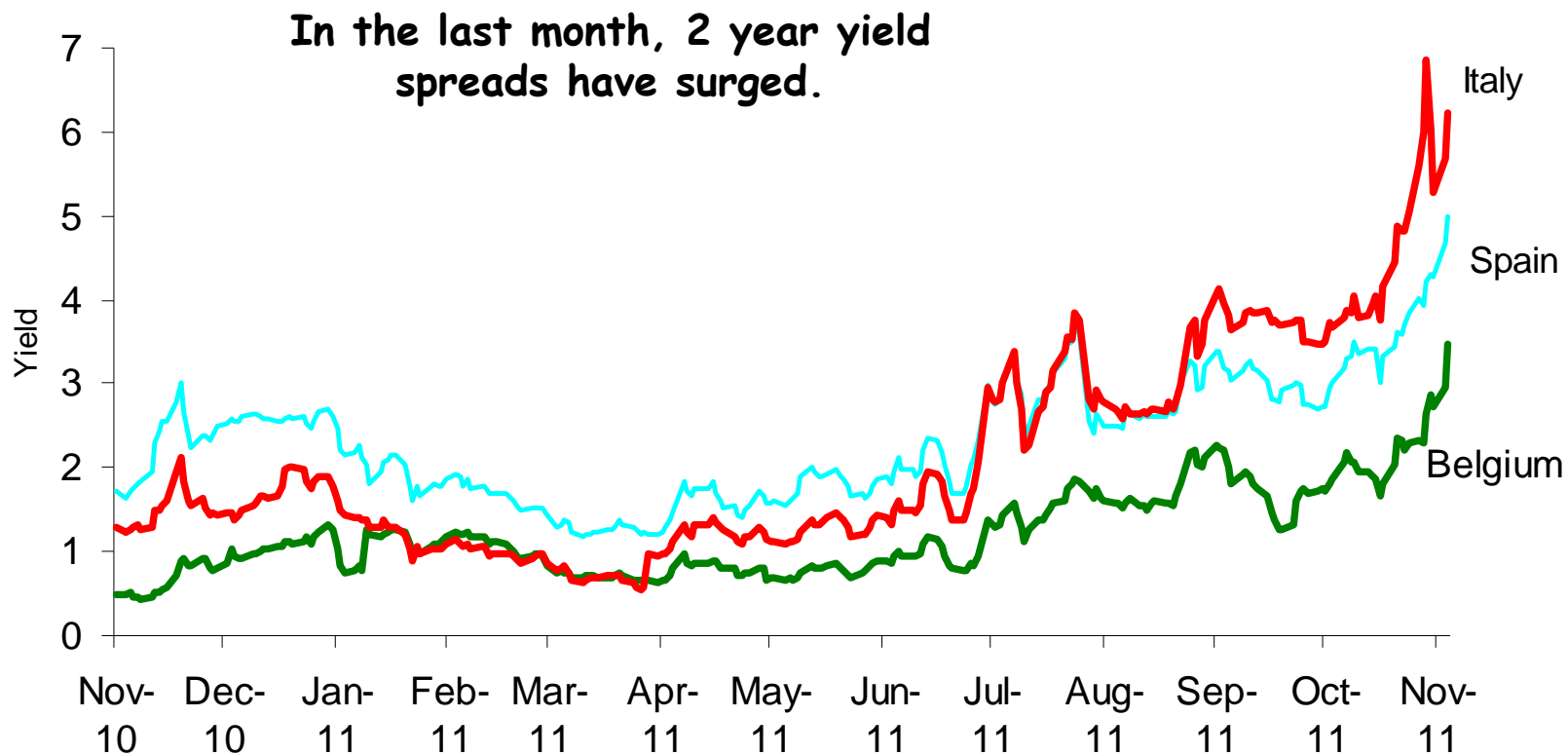
(last obs. November 15, 2011)



Source: Bloomberg; Encima Global

Selected European 2 Yr Yield Spreads

(last obs. November 15, 2011)



Source: Bloomberg; Encima Global

Europe: Five Selling Pressures

- **1) The bank deleveraging process. 2) The difficulty of hedging European assets against default because CDS hedges are not triggered by the 50% voluntary haircut in the Greek deal. 3) Europe recently decided to apply mark-to-market more rigorously, accelerating the downward valuation process. 4) The liquidation of MF Global assets, with related worries about margin financing. 5) There's direct contagion to Italy and other countries because a 50% hard-to-hedge haircut for Greece lowers the value of other sovereigns and it raises the question of whether countries should withhold debt payments and structural reforms until they negotiate their haircuts.**
- **The ECB says it won't expand its bond purchases (like Fed's MBS purchases). And there are no broad new guarantee authorities for bank liabilities along the lines of the 2008 FDIC guarantees for new U.S. bank debt. Result: roll-over mini-crises and forced asset sales.**

Slovenia Government Bond Price

(last obs. November 15, 2011)



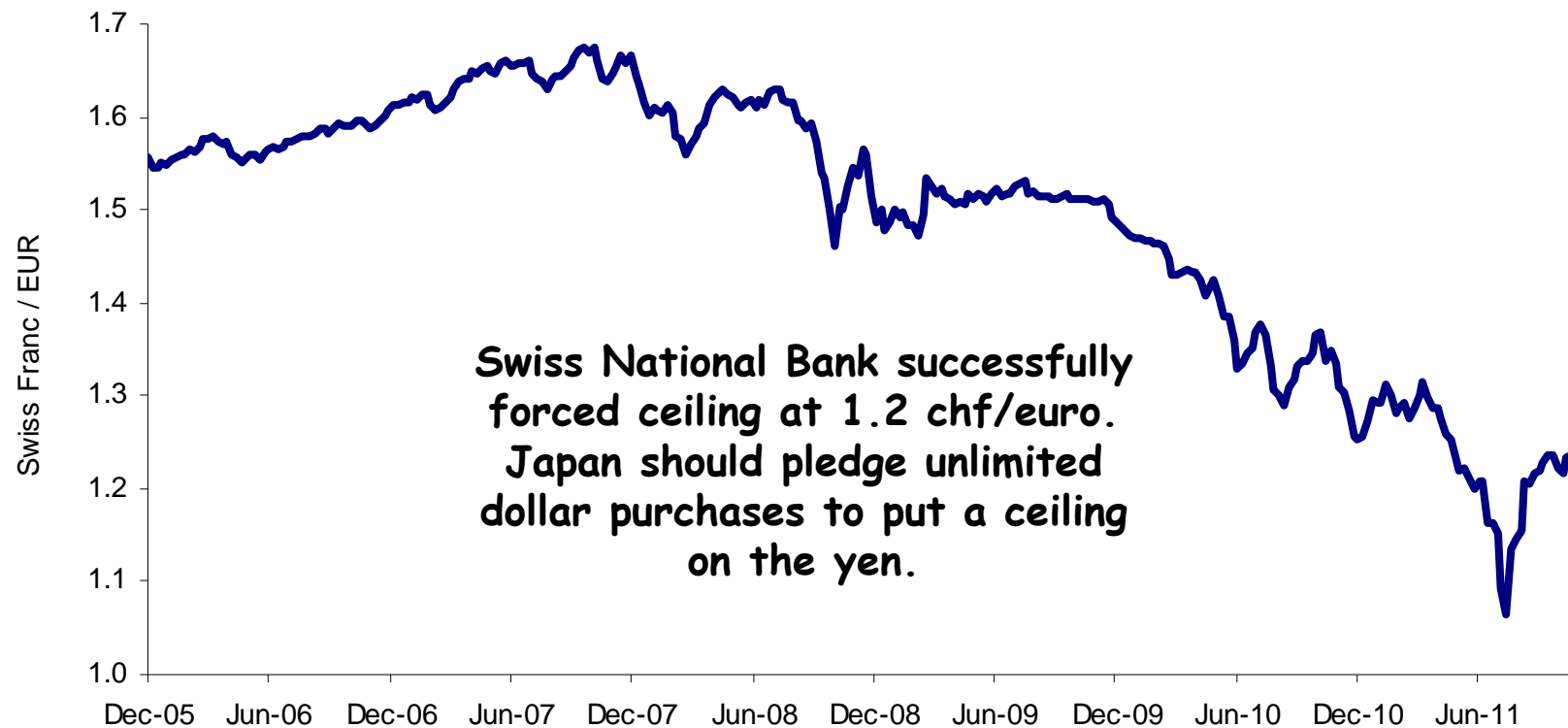
Source: Bloomberg; Encima Global

Global Regulatory Policy In Flux

- **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, mark-to-thin-markets, 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.**

Swiss Franc / Euro

(last obs. November 14, 2011)



Source: Wall Street Journal; Encima Global

Yen / US \$

(last obs. November 14, 2011)



Source: Wall Street Journal; Encima Global



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