# Economic Outlook:
# Fed Expansion vs. Tax Hikes
## October 19, 2010

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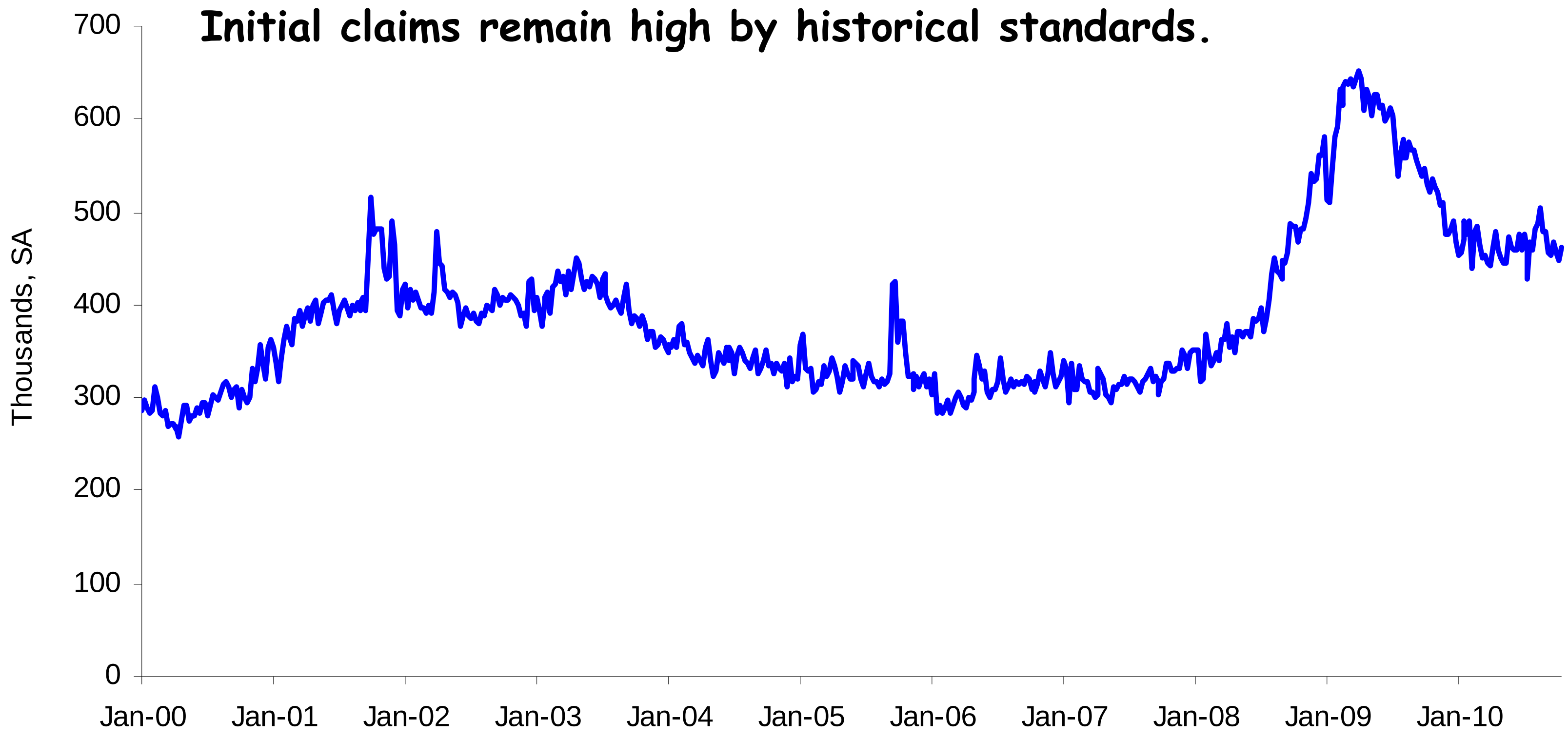
# Sluggish Recovery

- **We think the U.S. economy has resumed a sluggish recovery after hitting extra strong head winds in the second quarter. Those included the discouragement over the Gulf oil spill, Europe's debt crisis, and the legislative shocks on health care, the tax risk (given no congressional budget), and sprawling, ill-defined financial regulation.**
- **The head winds are still strong -- rising prices for manufacturers; the expansion of federal spending and power; the centralization of key financial decision making in Washington regulators impeding small business; and the burden from complex, changing regulations in health care, environment, and labor.**
- **Even so, we expect a gradually strengthening recovery in the remainder of 2010 and into 2011 – moderate growth from a low base. We note pent-up demand (especially for autos), foreign growth, idle cash, and the short-term stimulus from the absorption of debt into the federal government (through subsidies to states, auto bailout, the mortgage bailout process, transfer payments, etc.)**

# Initial Unemployment Claims

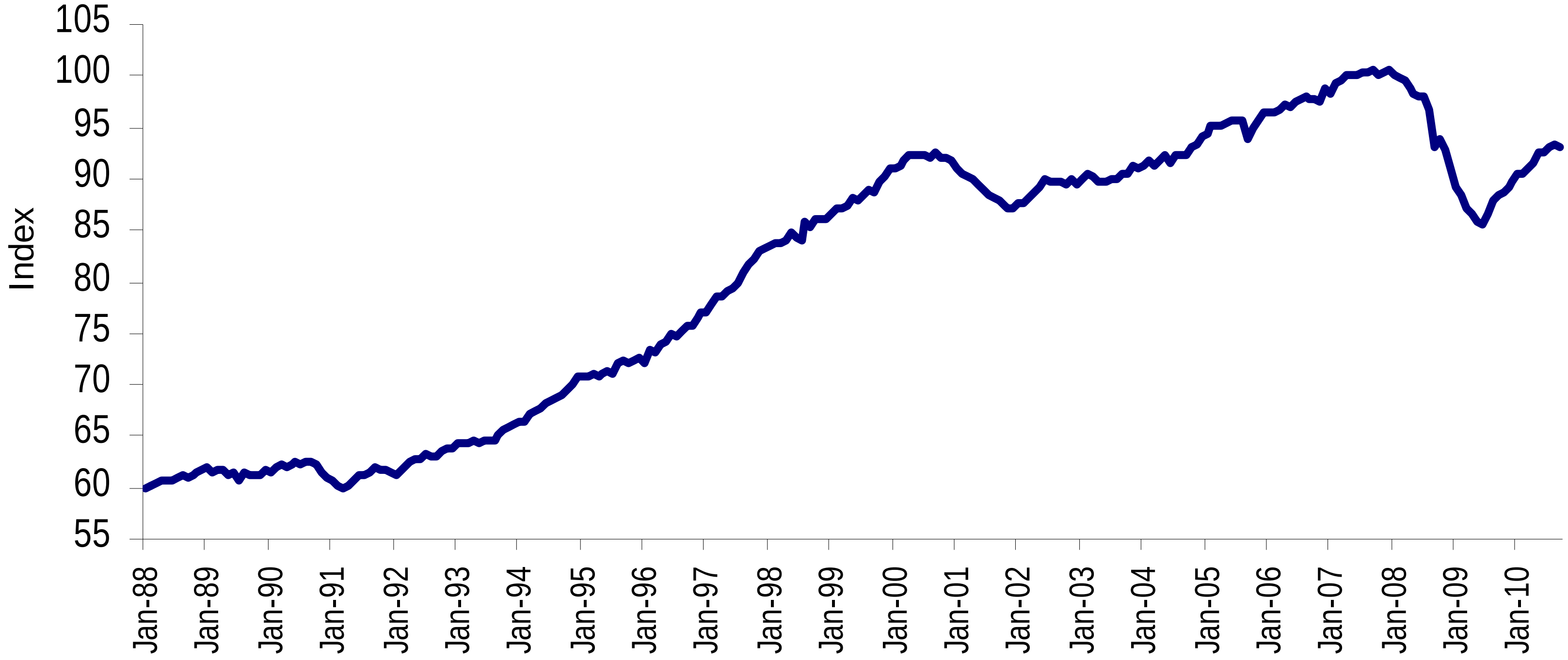
(last obs. October 9, 2010)




Source: Bureau of Labor Statistics; Encima Global

# Industrial Production

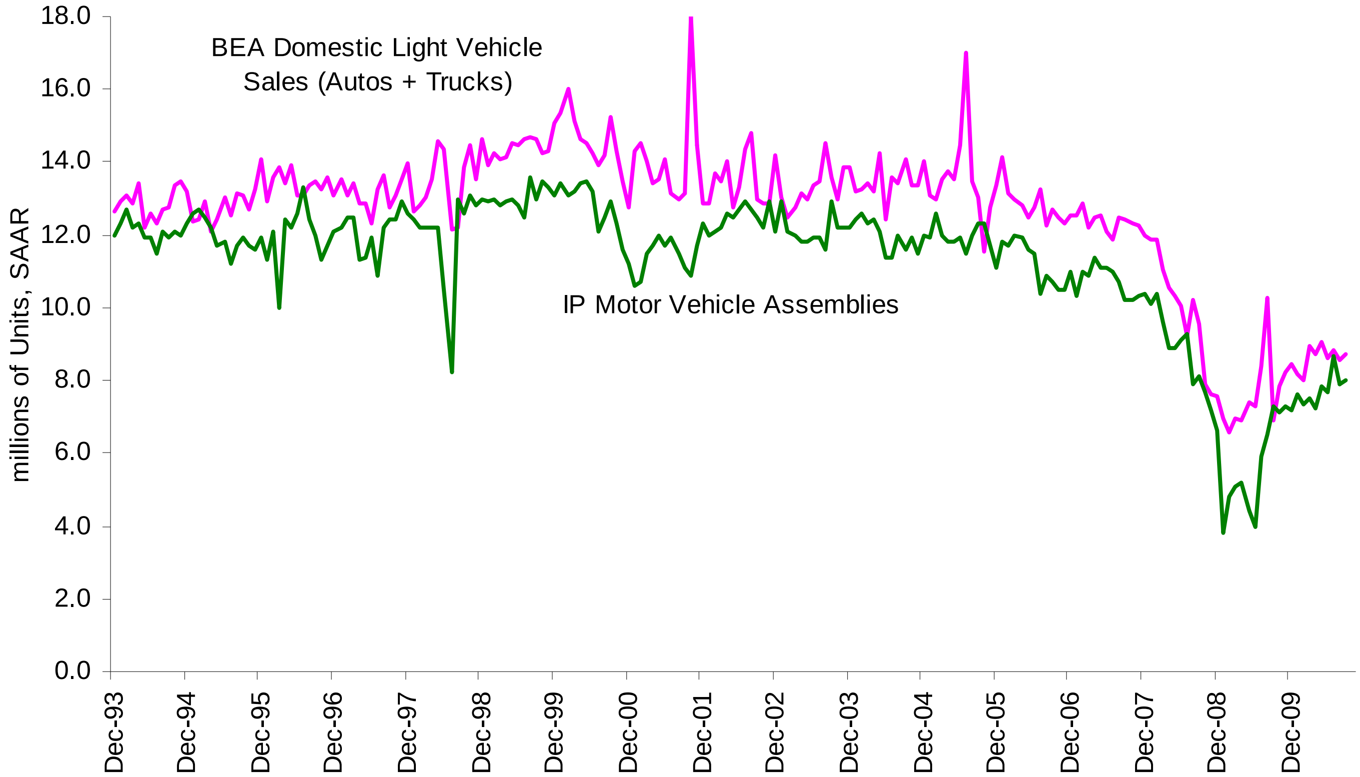
(last obs. September 2010)




Source: Federal Reserve; Encima Global

# Auto Sales and Production Below Replacement Rate

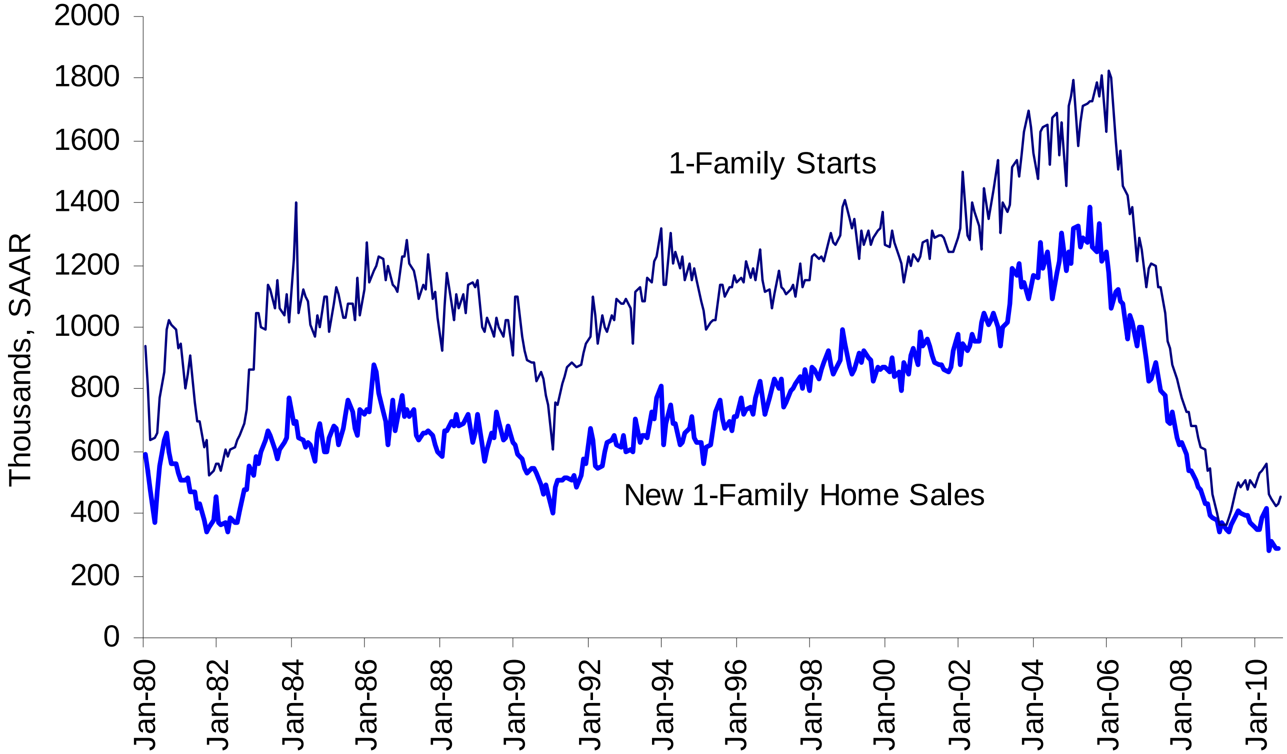
(last obs. September 2010)




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

# New Single Family Home Sales and Starts

(last obs. starts September 2010; sales August 2010)



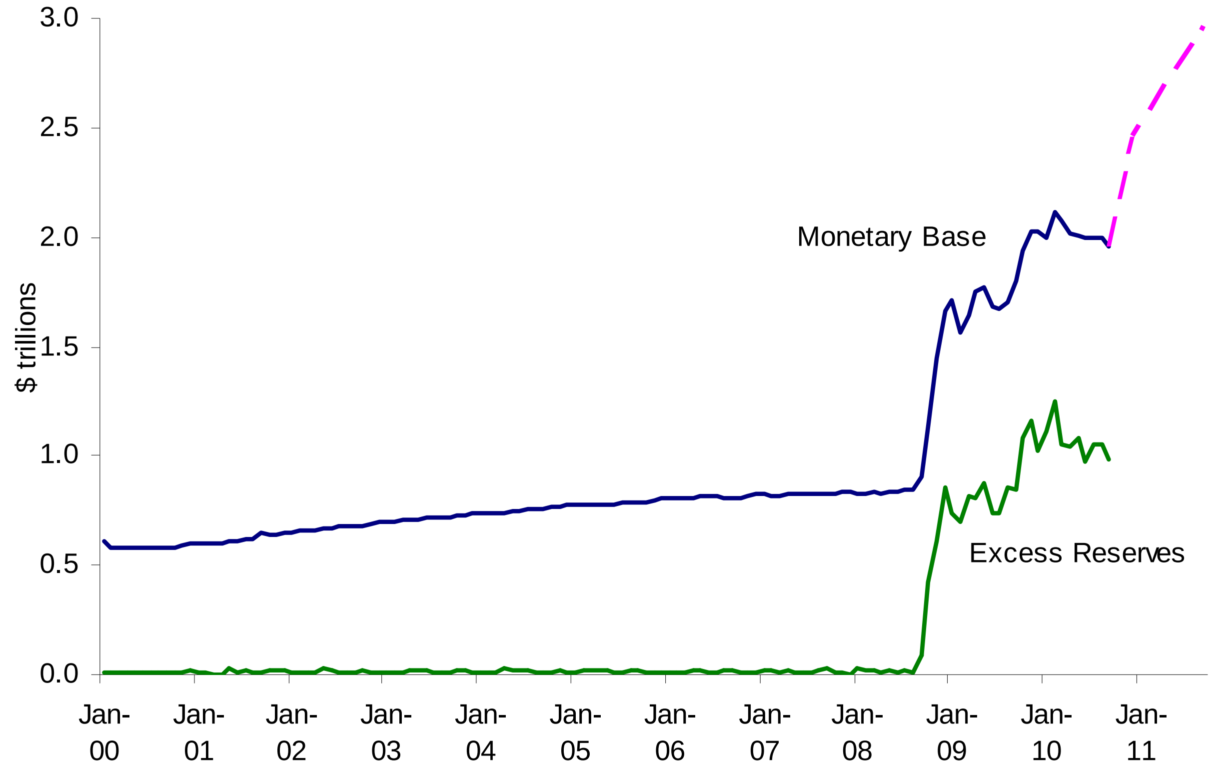

Source: Census Bureau; Encima Global

# Rapid Fed Expansion

- **We expect the Fed to restart its purchase of Treasury notes, perhaps as soon as December.**
- **We don't think this will have much impact on growth or bank lending – credit is being rationed by regulatory policy rather than price, as reflected in the trillion dollars in excess bank reserves. Like Japan's ineffective quantitative easing, Fed purchases will mostly affect the price of the purchased asset.**
- **In the U.S., capital allocation is increasingly being determined by governments, regulators and big corporations, a distinct new negative. Leverage is shifting rapidly from the U.S. private sector to the federal government and Fed where borrowing costs are low. In the short-run, this has been stabilizing.**

# Monetary Base after more QE

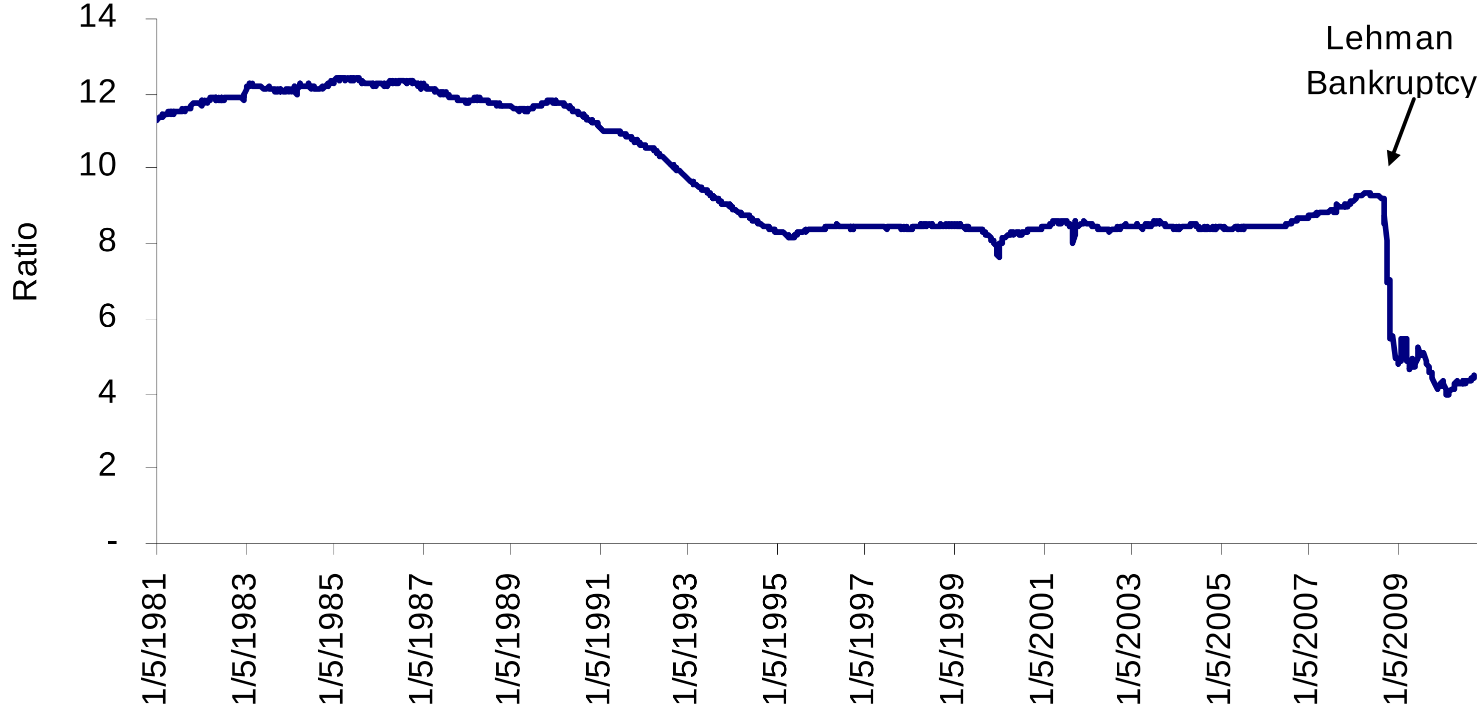
(last obs. October 6, 2010)




Source: Federal Reserve; Encima Global

# M2 / M0: Fed is pushing on a string

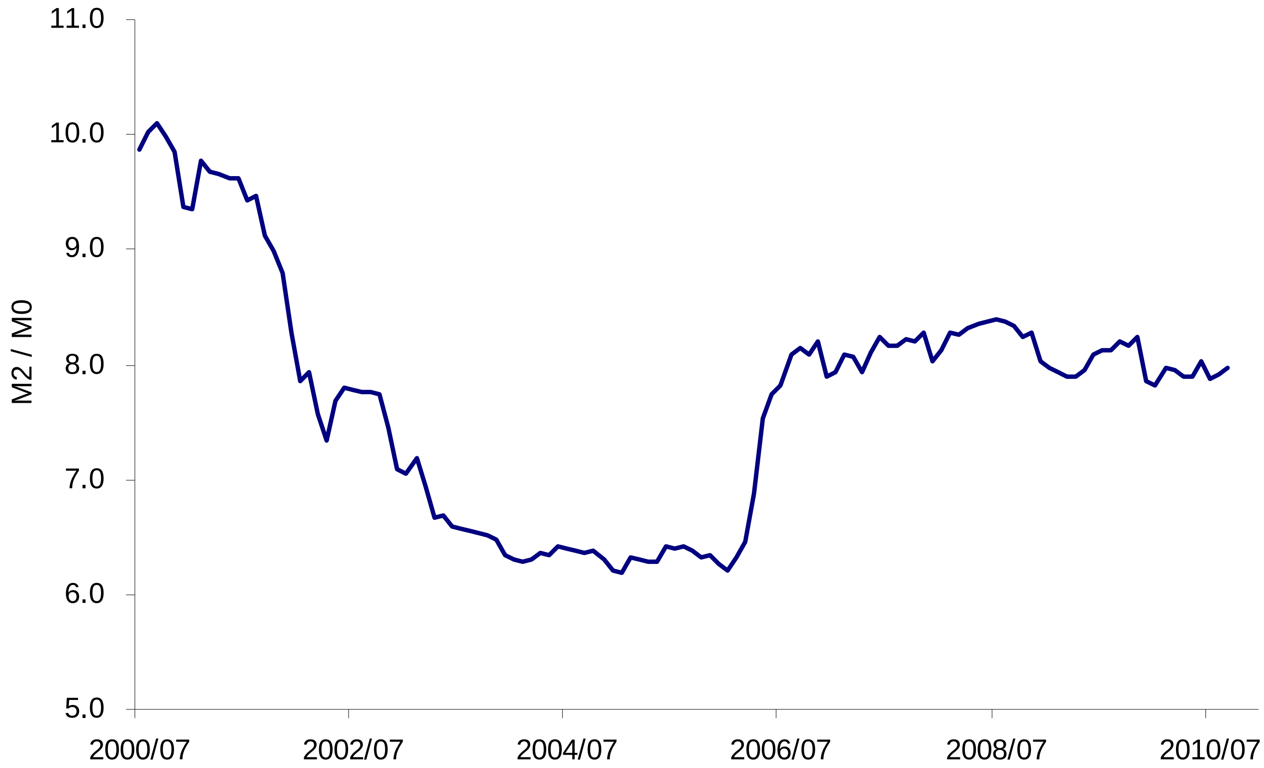
(last obs. October 4, 2010)




Source: Federal Reserve; Encima Global

# Japan M2 / M0: Pushing on a string

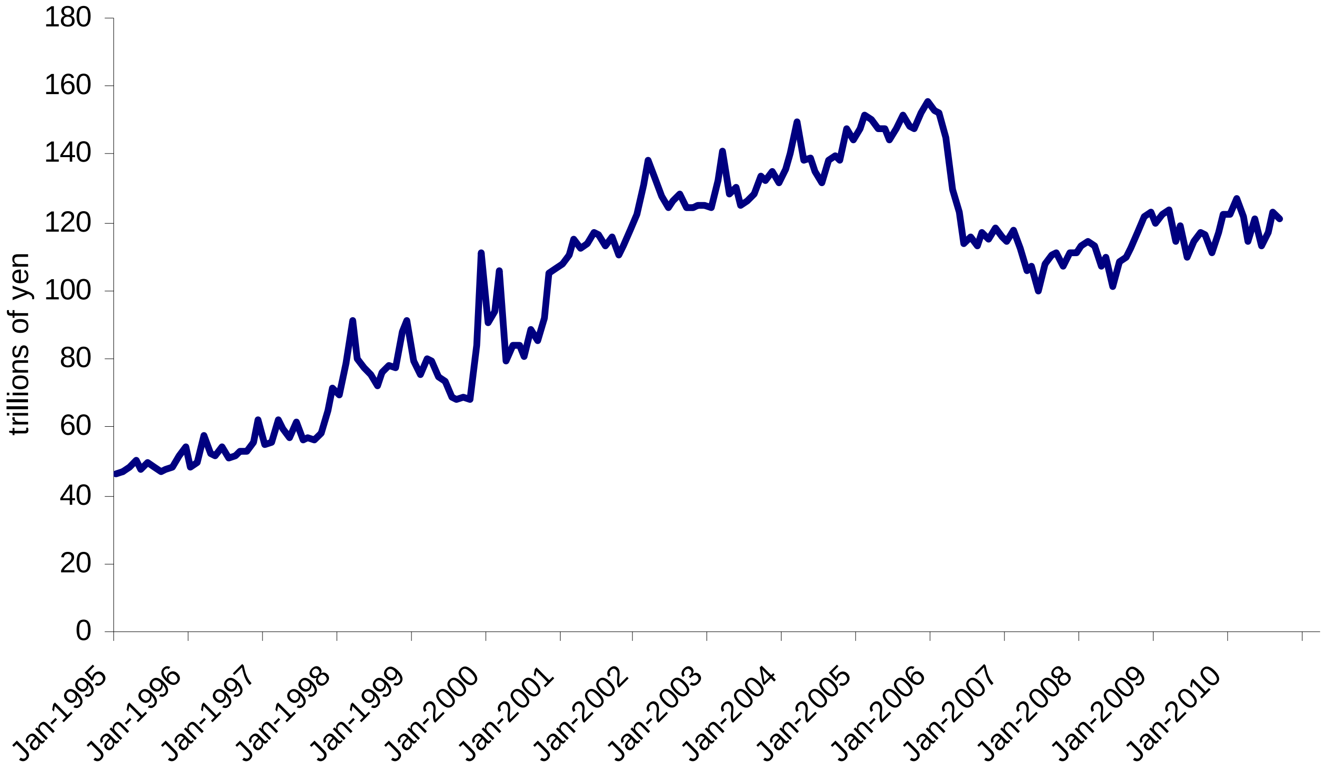
(last obs. September 2010)




Source: Bank of Japan; Encima Global

# Bank of Japan Total Assets

(last obs. September 2010)




Source: Bank of Japan; Encima Global

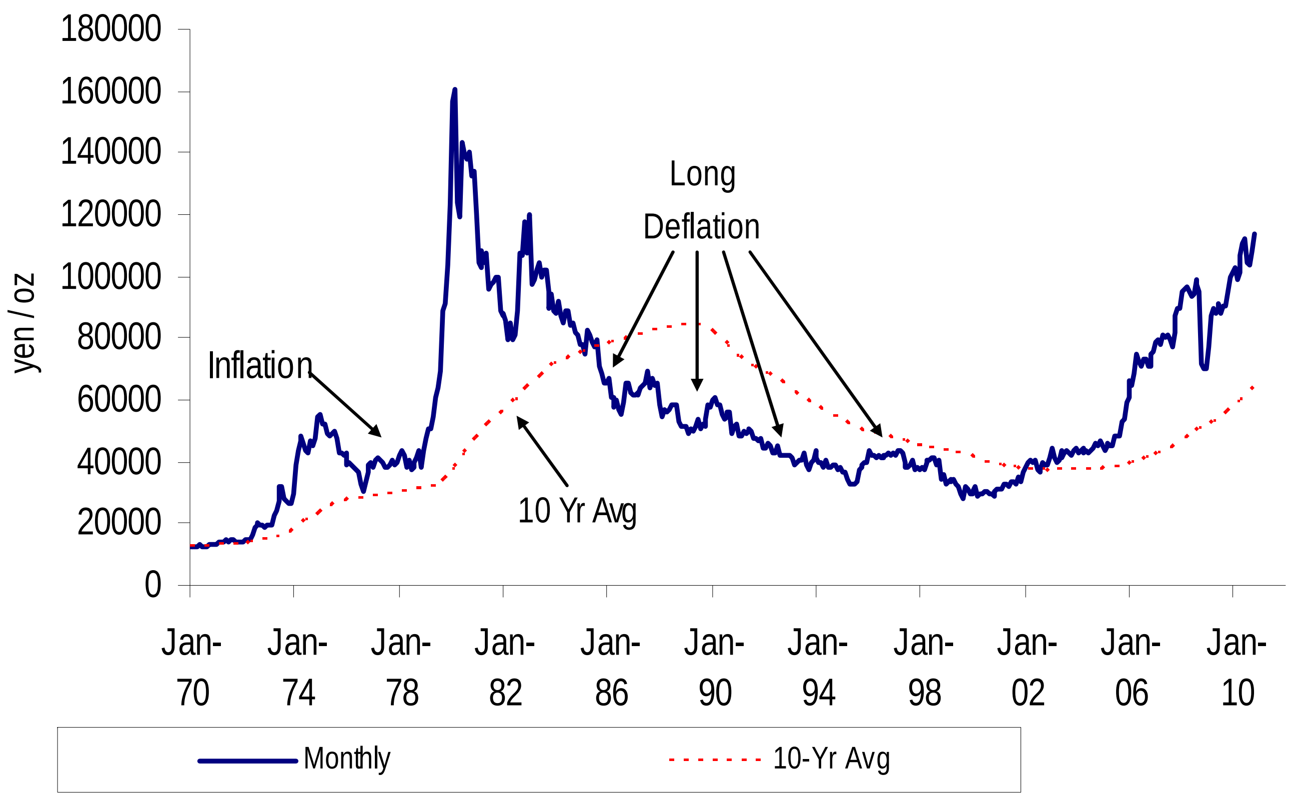
# Bank of Japan Core CPI y/y

(last obs. August 2010)


Source: Bloomberg; Encima Global

# Gold Price in Yen

(last obs. October 18, 2010)




Source: WSJ; Federal Reserve ; Encima Global

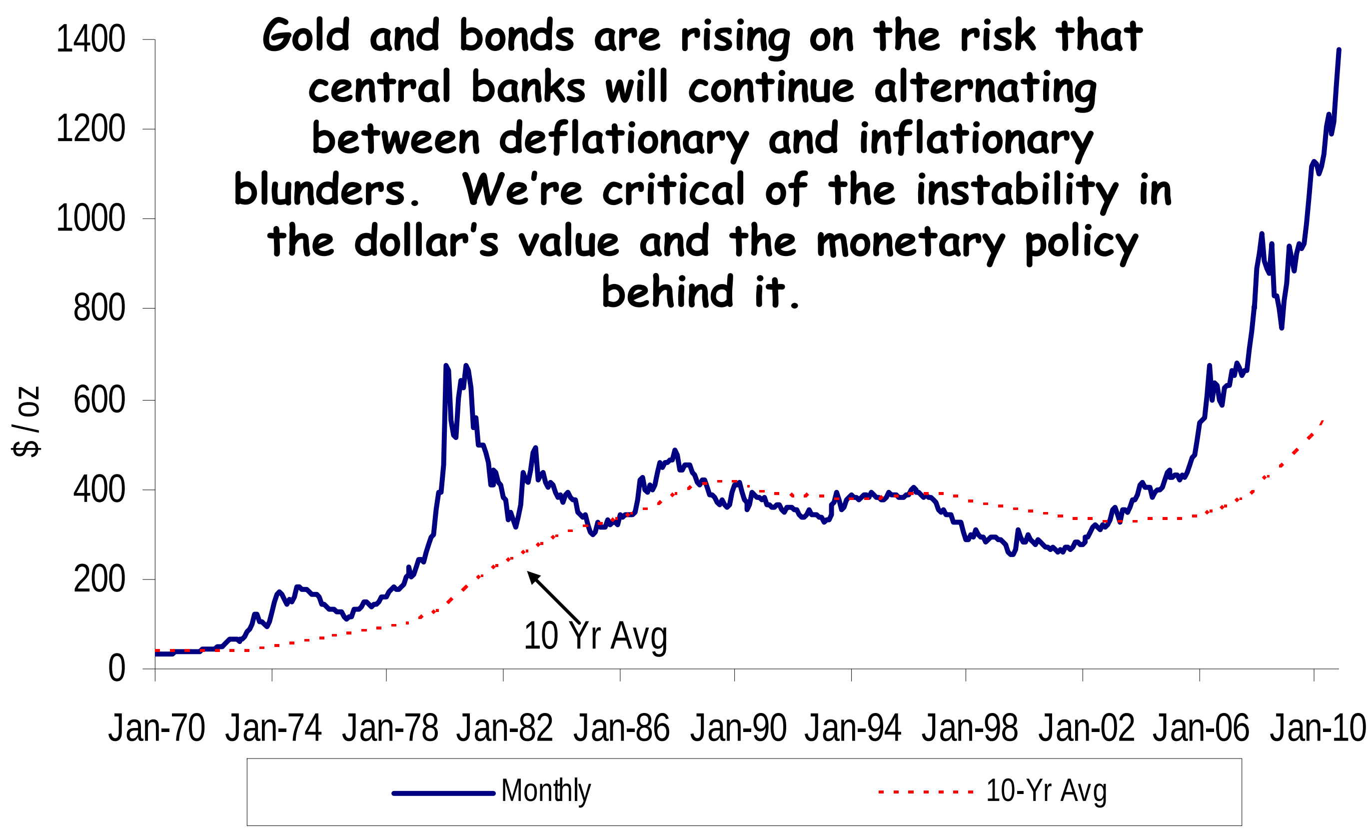
# Deflation Fear: 10 Year Treasury Yield Low

(last obs. October 18, 2010)


Source: Federal Reserve Board; Encima Global

# Inflation Fear: Gold Prices Hitting New Highs

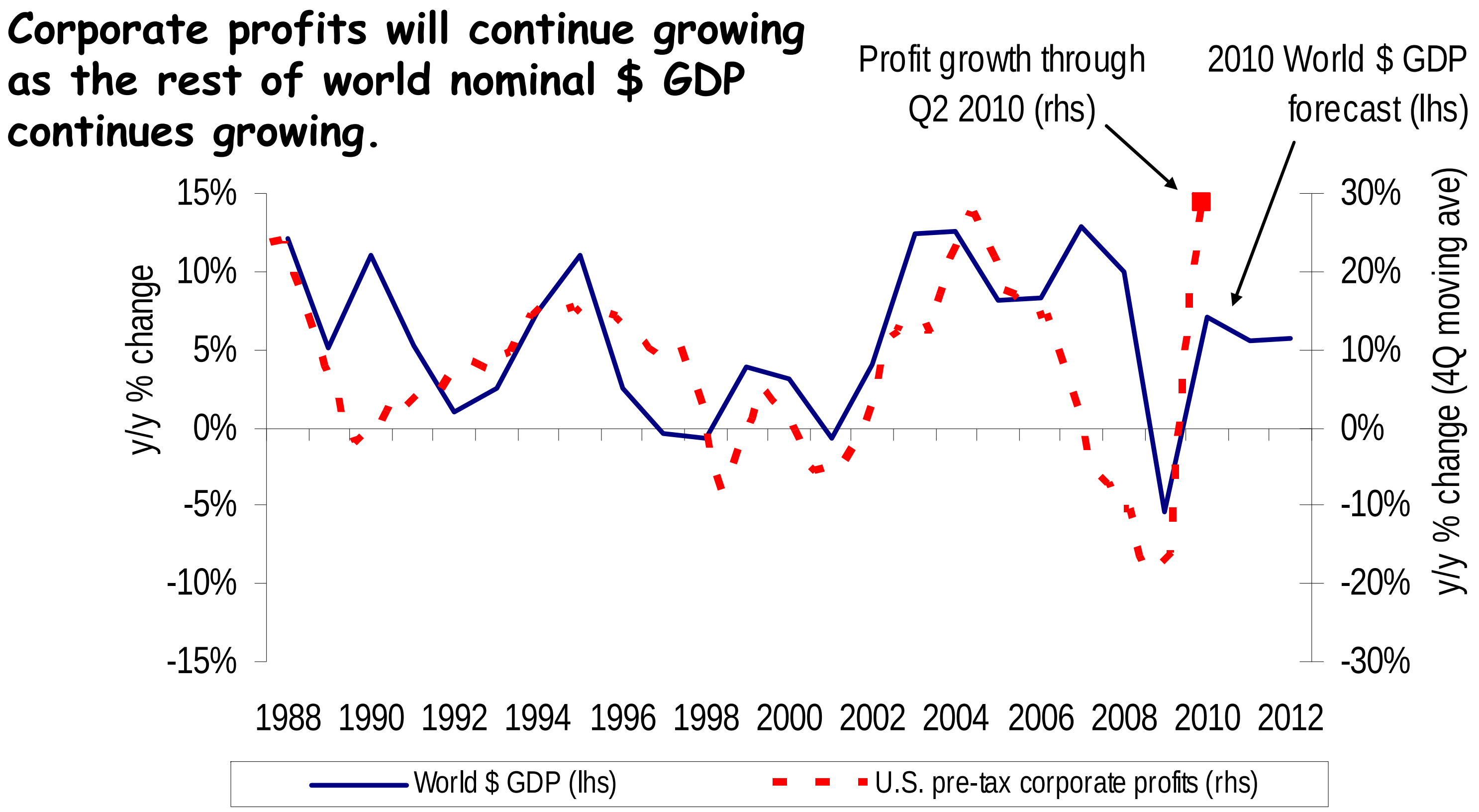
(last obs. October 18, 2010)




Source: Wall Street Journal; Encima Global

# World Nominal $ GDP and US NIPA Corporate Profits

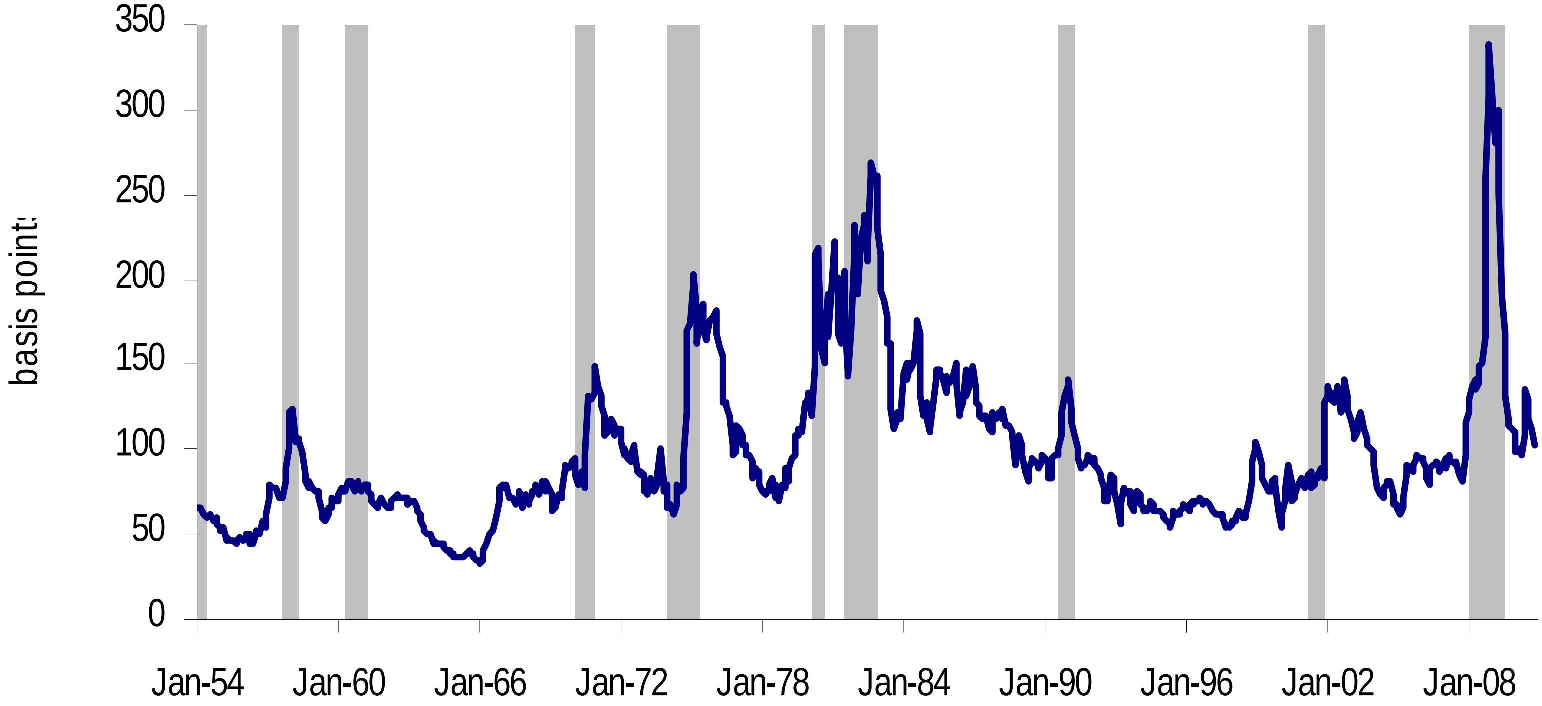
(last obs. Q2 2010)




Source: IMF; Bureau of Economic Analysis; Encima Global

# Baa – Aaa

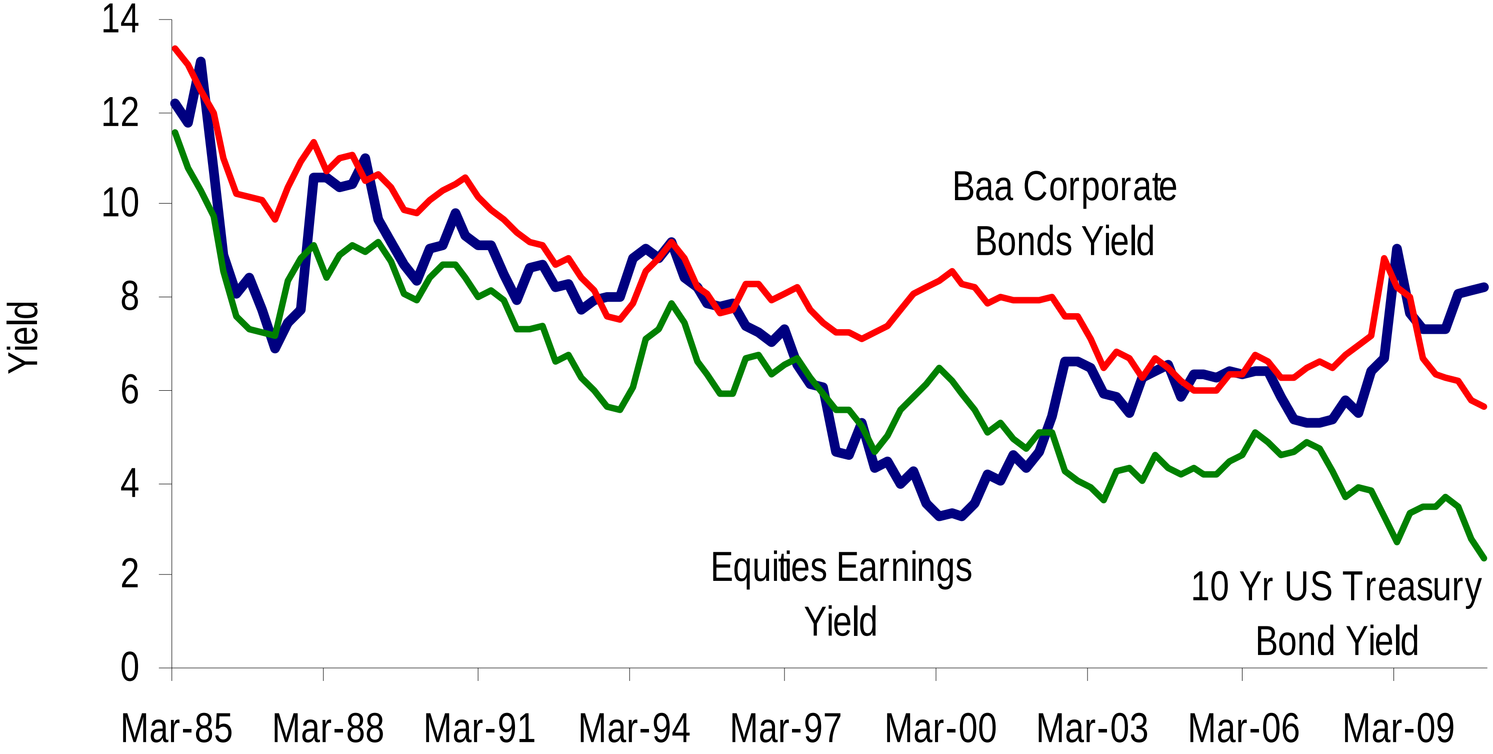
(last obs. October 18, 2010)




Source: Federal Reserve; Encima Global

# Yields for Bonds and Equities

(last obs. October 14, 2010)



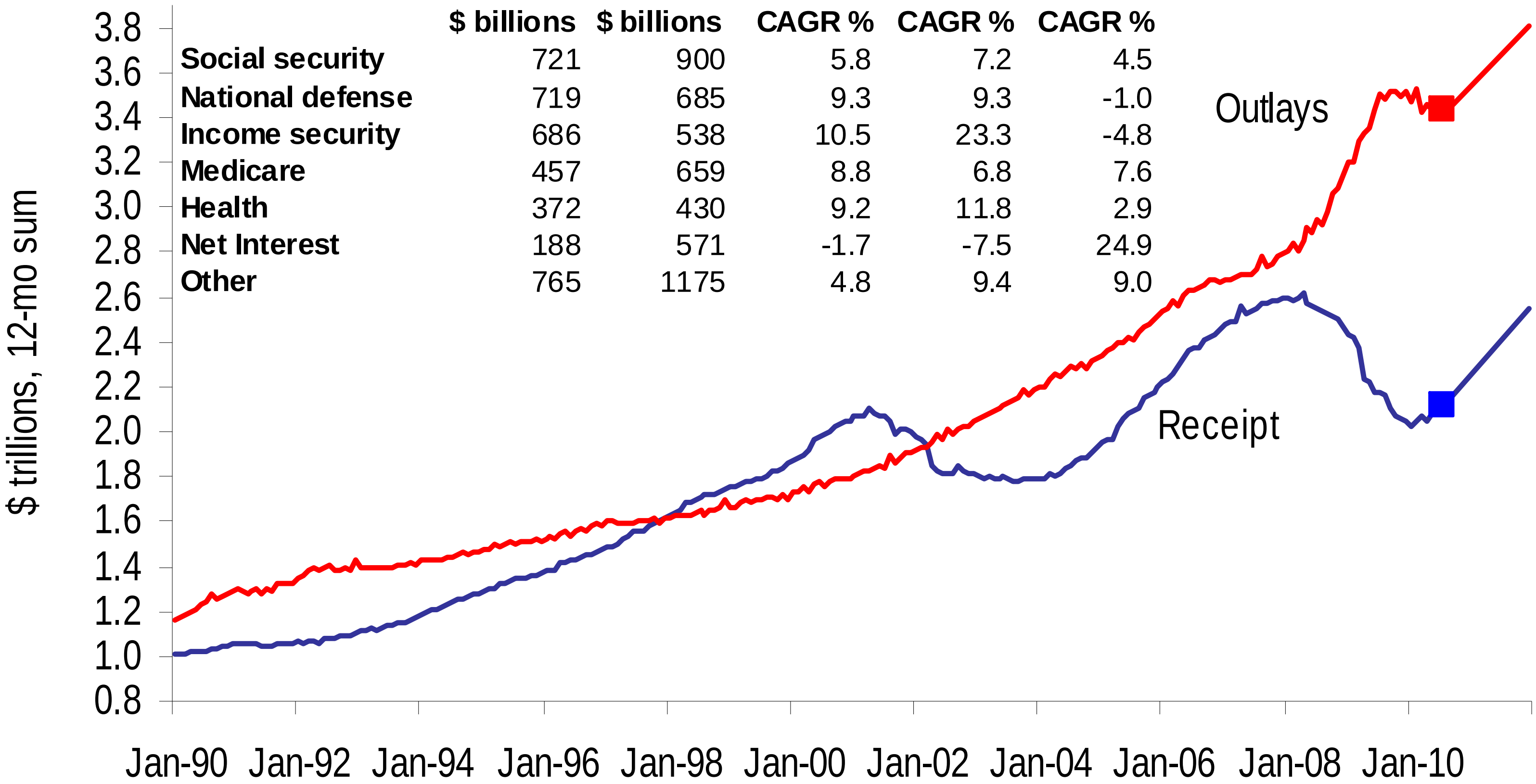

Source: Federal Reserve; Encima Global

# Get Ready for Tax Chaos

- **We think an expiration of the Bush tax cuts is more likely than an extension. If so, it's unlikely that Congress will be able to quickly reverse expirations given the divided Congress, legislative procedures, the President's views, and the big deficit impact under CBO scoring rules (which explicitly ignore the positive impact of lower tax rates on economic growth).**
- **We think the resulting tax chaos that would emerge in December and extend into 2011 will be a major negative for both the U.S. economy and markets, with several aspects not yet fully priced in.**
- **While Congress might still act in December, the legislative obstacles are high -- need 60 sitting Senators to vote for a much bigger tax-cut-related fiscal deficit even though there's no agreement between the two parties on tax policy. The prospect of Fed quantitative easing gives Congress a timely excuse for inaction.**

# Federal Government Receipts and Outlays

(last obs. September 2010, CBO and OMB forecasts)




| | 2010 estimate $ billions | 2015 estimate $ billions | 2000 to 2010 CAGR % | 2007 to 2010 CAGR % | 2010 to 2015 CAGR % |
|---|---|---|---|---|---|
| **Social security** | 721 | 900 | 5.8 | 7.2 | 4.5 |
| **National defense** | 719 | 685 | 9.3 | 9.3 | -1.0 |
| **Income security** | 686 | 538 | 10.5 | 23.3 | -4.8 |
| **Medicare** | 457 | 659 | 8.8 | 6.8 | 7.6 |
| **Health** | 372 | 430 | 9.2 | 11.8 | 2.9 |
| **Net Interest** | 188 | 571 | -1.7 | -7.5 | 24.9 |
| **Other** | 765 | 1175 | 4.8 | 9.4 | 9.0 |

Source: US Treasury; CBO; OMB; Encima Global