

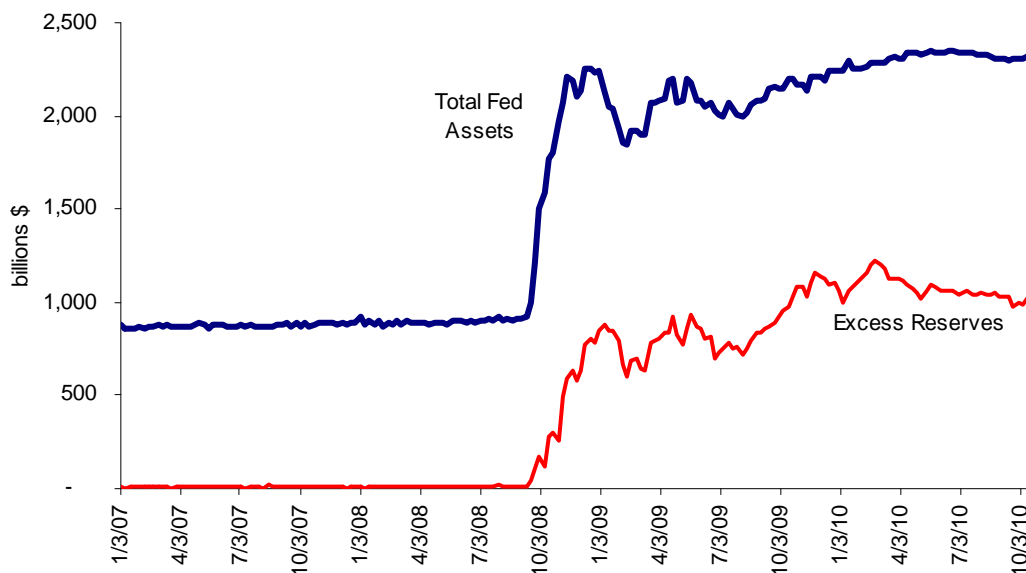
October 26, 2010

Good News Priced In, Cautious on Equities

We expect economic data to improve in coming weeks as Christmas approaches and auto sales continue to pick up. We don't think there was ever much risk of a double dip or deflation. Corporate earnings (now 25% foreign) should remain strong. Even so, **we're near-term cautious on equities on the view that markets have priced in the good economic news, have exaggerated the impact of Fed quantitative easing, and will suffer a bad tax outcome in December regardless of Republican gains.**

- Much-touted Fed plans to purchase Treasury notes have added substantially to equities, bonds and gold but will have little lasting economic impact. The Fed is paying banks 25 basis points for excess reserves (that's above the Treasury bill yield) and bank regulators are pursuing bank deleveraging, so we expect all of the Fed's new asset purchases to be financed by excess reserves (meaning no throughput to the economy as the Fed 'pushes on a string').

Fed Assets and Excess Reserves (last obs. October 20, 2010)

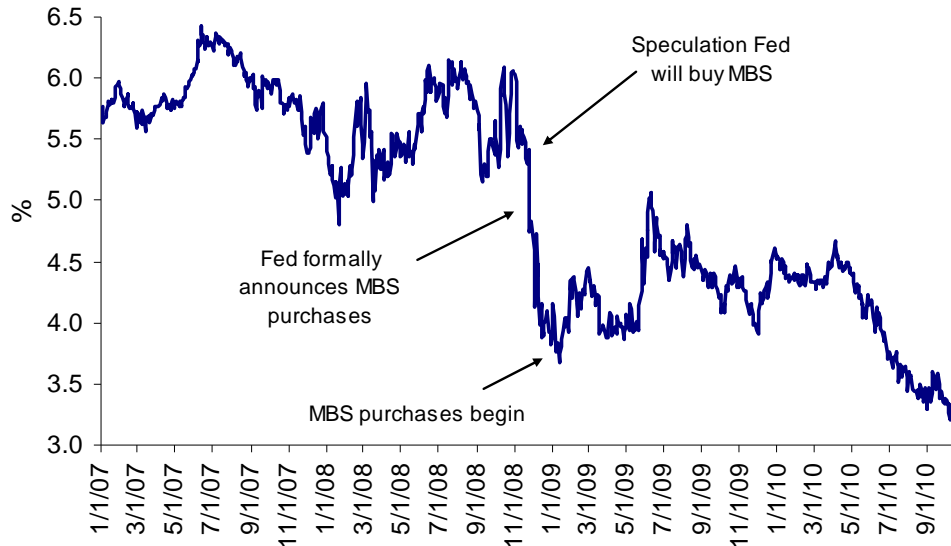


Source: Federal Reserve; Encima Global

- **We expect a buy-the-rumor, sell-the-news market reaction to Fed purchases similar to the 2009 QE episode. Yields fell sharply when the Fed hinted at**

purchases, but the start of actual Fed purchases early in 2009 marked a near-term low in yields.

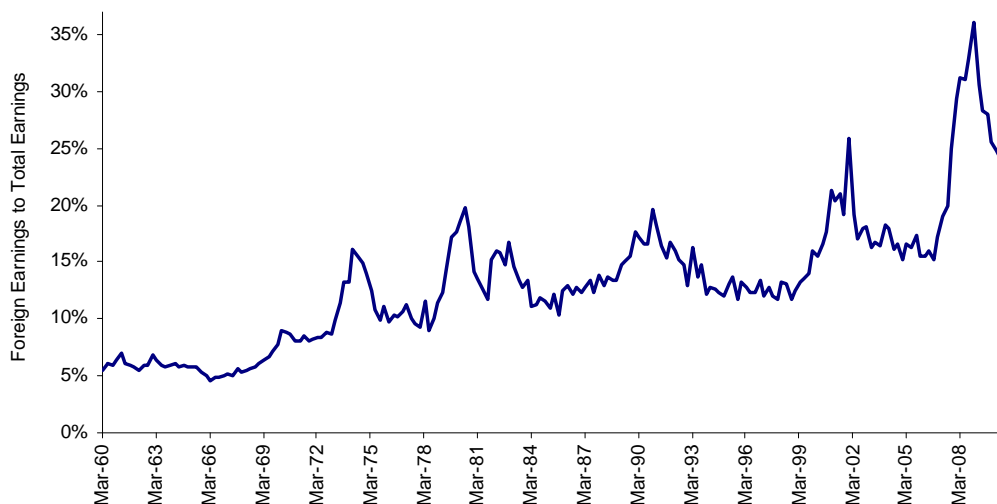
Conventional MBS yield (last obs. October 26, 2010)



Source: Bloomberg; Encima Global

- Dollar weakness related to Fed policy has helped nominal equity prices – but we think the dollar may recovery a bit as the election impact and the likely tax increase overshadow Fed asset purchases. Profits for big multinationals have been sensitive to the dollar, strengthened by low interest rates but also by foreign growth and favorable translation of foreign earnings, now 25% of total earnings.

Foreign Earnings to Total Earnings (last obs. Q2 2010)



Source: Bureau of Economic Analysis; Encima Global

We think most of the favorable news is priced into markets.

- Yields on Baa bonds are very low by historical standard, suggesting plentiful monetary liquidity and a bond bubble.

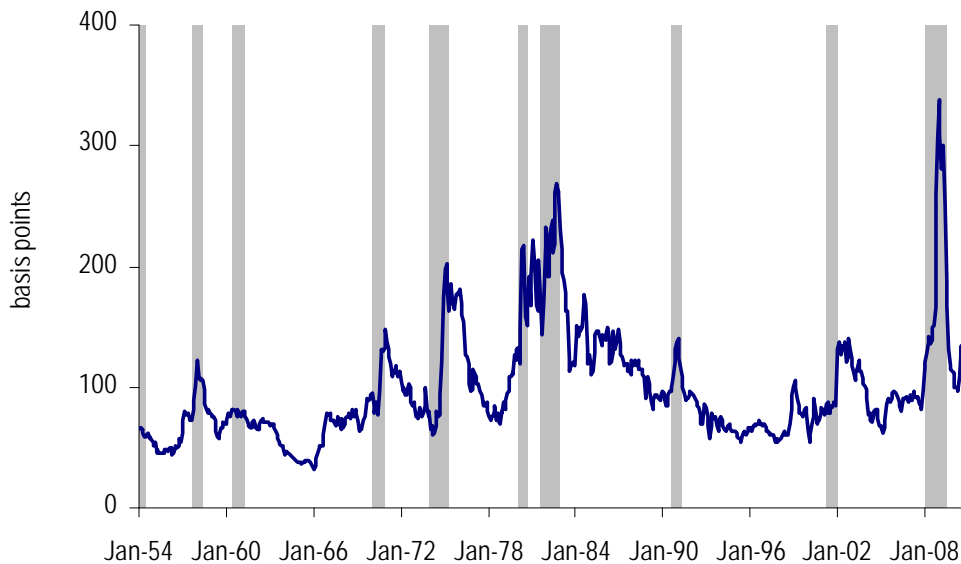
Baa yield (last obs. October 24, 2010)



Source: Federal Reserve Board; Encima Global

- The spread between Baa corporate bonds and AAA corporate bonds is low, showing little economic risk.

Baa minus Aaa yield (last obs. October 24, 2010)

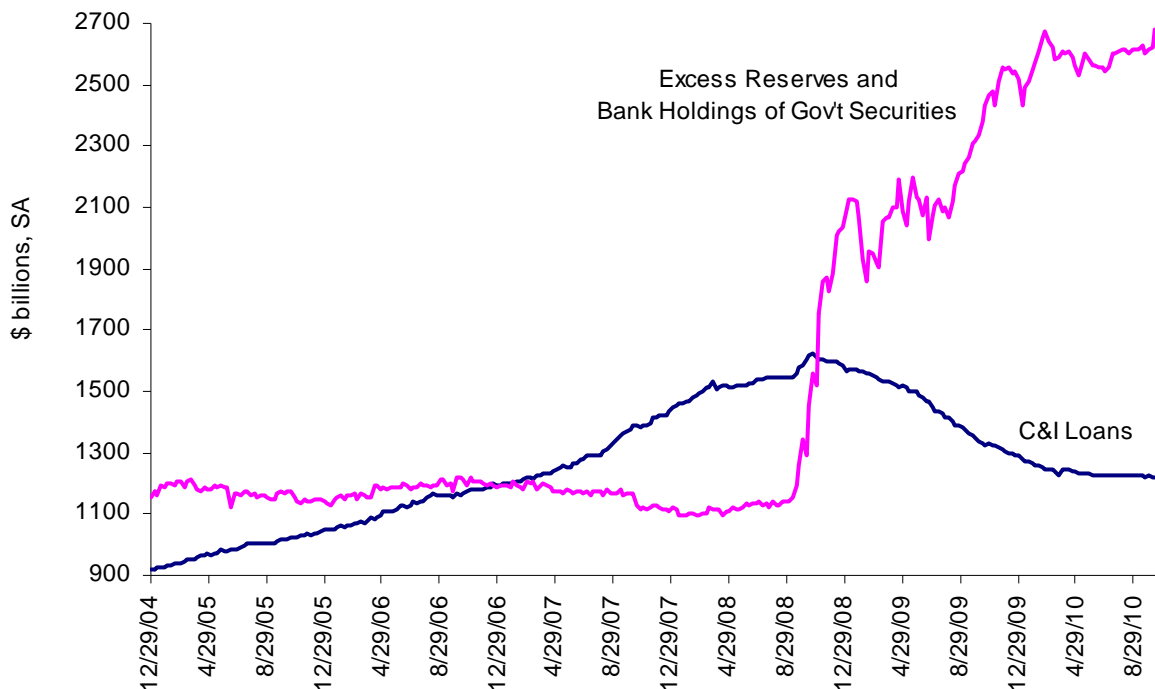


Source: Federal Reserve Board; Encima Global

We think markets are too optimistic about quantitative easing.

- Most of the Fed's new Treasury bond purchases are likely to be financed with deposits from commercial banks. As a result, there's no throughput into the economy. Bank assets are now 22% in combined Treasuries and excess Fed deposits and only 10% in commercial and industrial loans, a sharp de-risking since 2007 when the corresponding shares were 10% in Treasuries and the Fed and 13% in C&I loans (in 2007, banks also held more real estate assets).

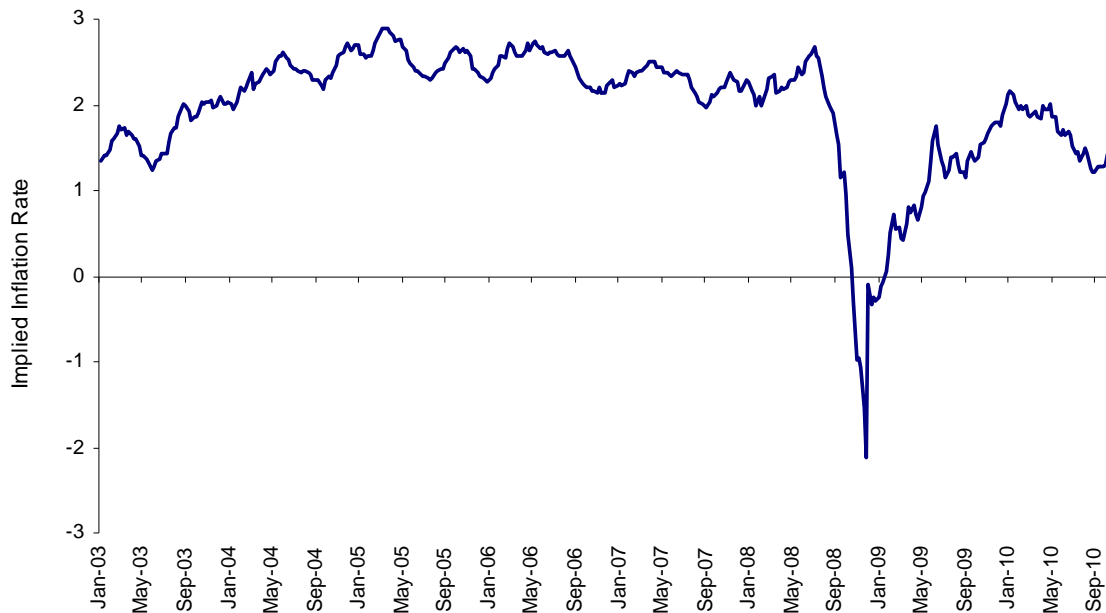
Banks C&I Loans, Govt Securities and Excess Reserves (last obs. Oct 13, 2010)



Source: Federal Reserve Board; Encima Global

- Inflation expectations are rising and show no sign of the deflation risk the Fed is citing to justify its proposed quantitative easing. The five-year TIP yield is now negative, showing an implied inflation expectation of well over 1% per year.

5 Yr Treasury Yield minus TIPS (last obs. October 26, 2010)

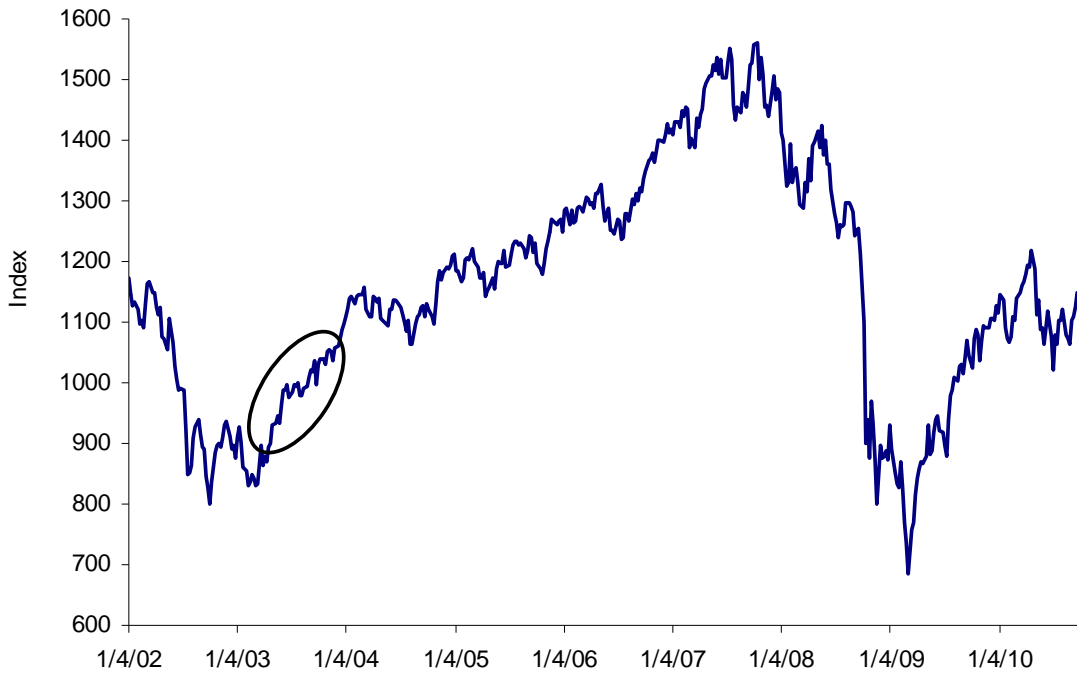


Source: Federal Reserve Board; Encima Global

We think markets are too optimistic about the election and taxes.

- We think Congress probably can't stop the impending tax increase. Unless 60 senators and the president agree by Christmas on specific tax cuts and the related deficit increase, then \$6 trillion in tax increases over 10 years kick in on January 1, the world's biggest-ever tax increase. The tax increase will be difficult to reverse (see Get Ready For Tax Chaos on October 14). Even if there's an agreement on a few tax cuts (for example, to maintain the 10% income tax bracket for lower wage earners), the tax increase for most of the economy will likely be large. The scheduled increases are unusually harmful for risk-taking ventures, higher earners and equities, possibly reversing the favorable equity market impact of the original tax cuts.

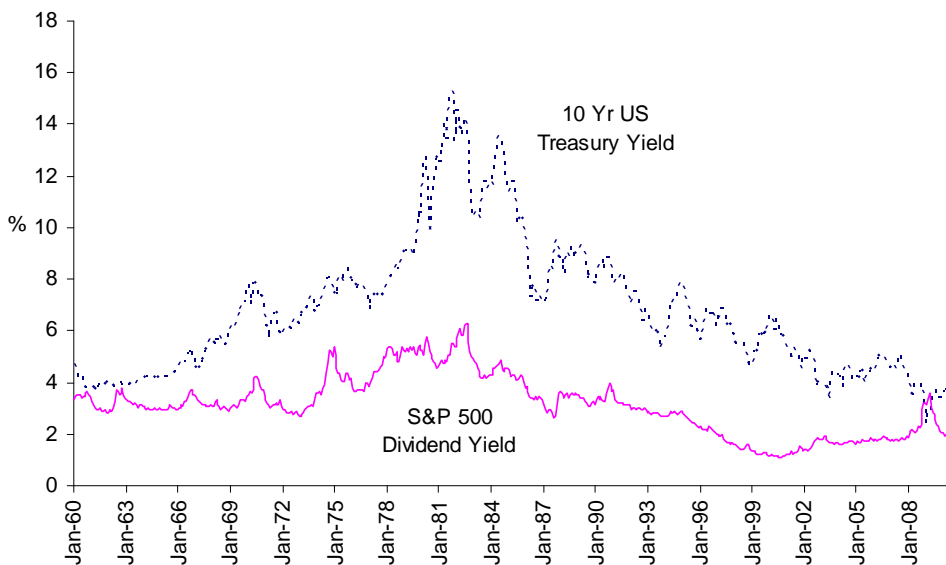
S&P 500 (last obs. October 26, 2010)



Source: Wall Street Journal; Encima Global

- From a valuation standpoint, bonds appear expensive relative to equities. The yield on Treasuries is nearing the yield on dividends, a major disconnect in relative value.

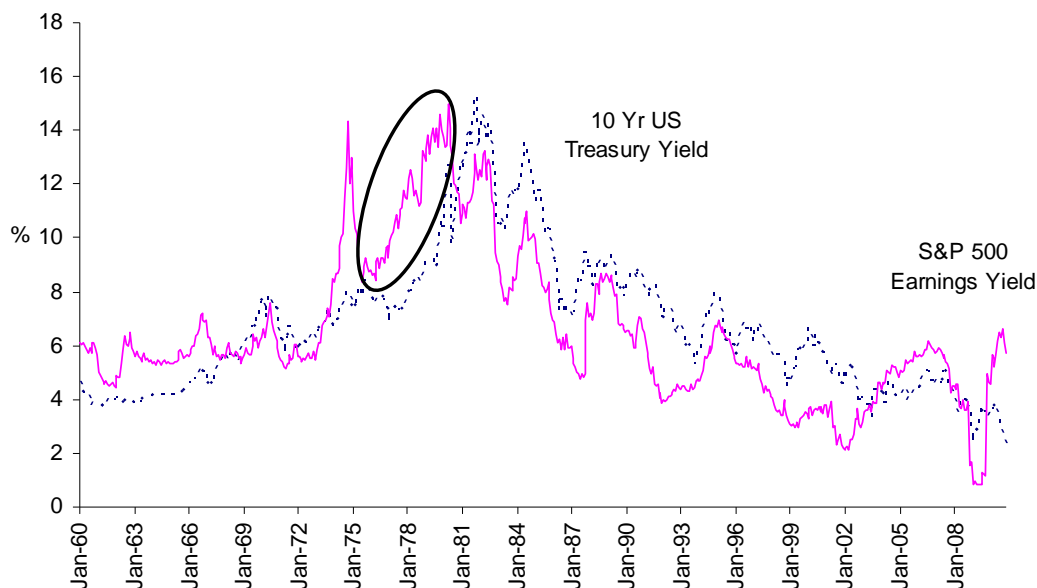
S&P Dividend Yield and 10 Yr US Treasury Yield (last obs. October 26, 2010)



Source: Federal Reserve Board; Standard and Poors; Encima Global

- The yield on Treasury bonds has normally been above the earnings yield on stocks (the inverse of the PE multiple) since the Volcker Fed. This is because bond coupons don't increase but corporate earnings often do. This relationship has recently reversed, arguing that equities are undervalued if inflation stays low along with bond yields; or that bonds are overvalued if inflation rises.
- We think Fed bond purchases have distorted the bond market, creating a bubble there, so the resolution of the equity-to-bond disconnect will be a bond sell-off. Note that the current S&P earnings yield is high (attractive) by the standards of the late 1990s and the Greenspan liquidity push of 2003-2005, but normal by the standards of the 1980s and 1960s and low (unattractive) compared to the 1970s. The bottom line is that stocks are attractive if inflation stays low but not attractive if inflation, bond yields and ultimately the Fed funds rate rise.

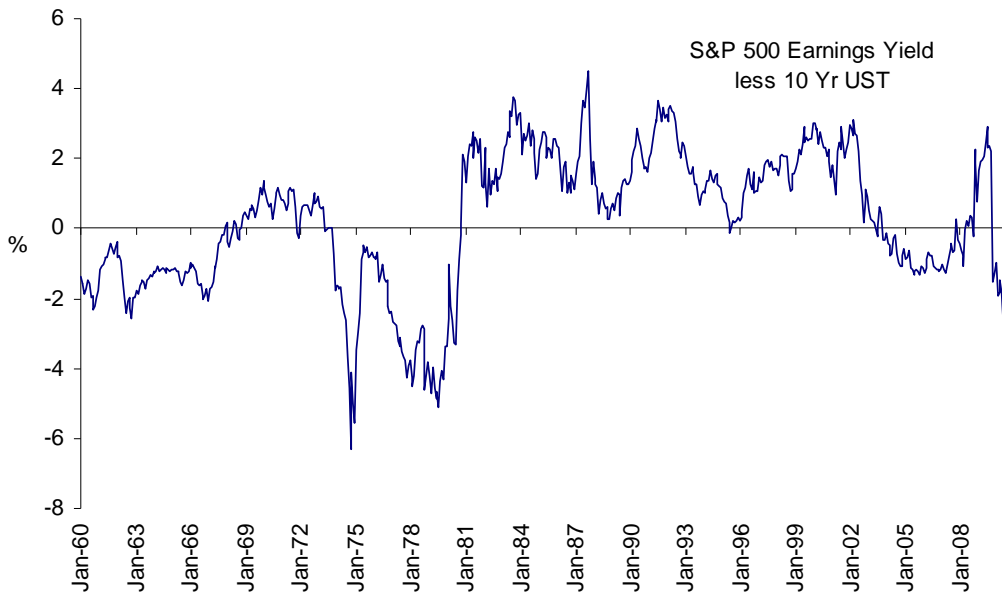
S&P Earnings Yield and 10 Yr US Treasury Yield (last obs. October 26, 2010)



Source: Federal Reserve Board; Standard and Poors'; Encima Global

- Relative value conditions like this occurred in 1978 when equity earnings yields began rising (P/E multiples began falling) before the bond market sell-off. Equity owners saw the inflation coming before bond owners. We think the eventual inflation risk in the current environment is high given the weak dollar, rising gold and Fed indifference and that equities are recognizing this risk in declining PE multiples.

S&P Earnings Yield less 10 Yr US Treasury Yield (last obs. October 26, 2010)



Source: Federal Reserve Board; Standard and Poors; Encima Global

- In 1978, the disconnect between equities and bonds was resolved by big declines in bond prices (rise in yields) and milder declines in nominal equity prices as the dollar continued its collapse.

S&P 500 (1970 to 1985)



Source: Wall Street Journal; Encima Global

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