

Growth Now, But Threats Rising

The economy has strengthened as expected since mid-2010, helped by pent-up demand especially for autos. **We expect 4% real growth in the first quarter but with a subsequent letdown as pent up demand is met.** Confidence will suffer as price increases weigh, the Fed stops its asset purchases, state and local cutbacks take hold, and many workers hit the 99 week cut-off of unemployment benefits – 3.6 million will stop getting checks in 2011 with only a portion finding jobs. While equity markets have bought the dips caused by problems in the Mideast, oil, eurozone debt, and China’s tightening, **we think the obstacles to growth outweigh the engines given the lack of structural reform.**

- The combination of a strong stock market, falling jobless claims and mild inflation give the impression of a normal expansion. However, we note unprecedented macro conditions -- the 0% Fed funds rate, the 0.75% two-year Treasury rate (post-1977 average is 6.3%), Fed assets nearly quadrupling to \$3 trillion, and a \$1.6 trillion fiscal deficit, over 10% of GDP. Transfer payments are still over 18% of personal income.

Fed Funds Rate (last obs. February 22, 2011)



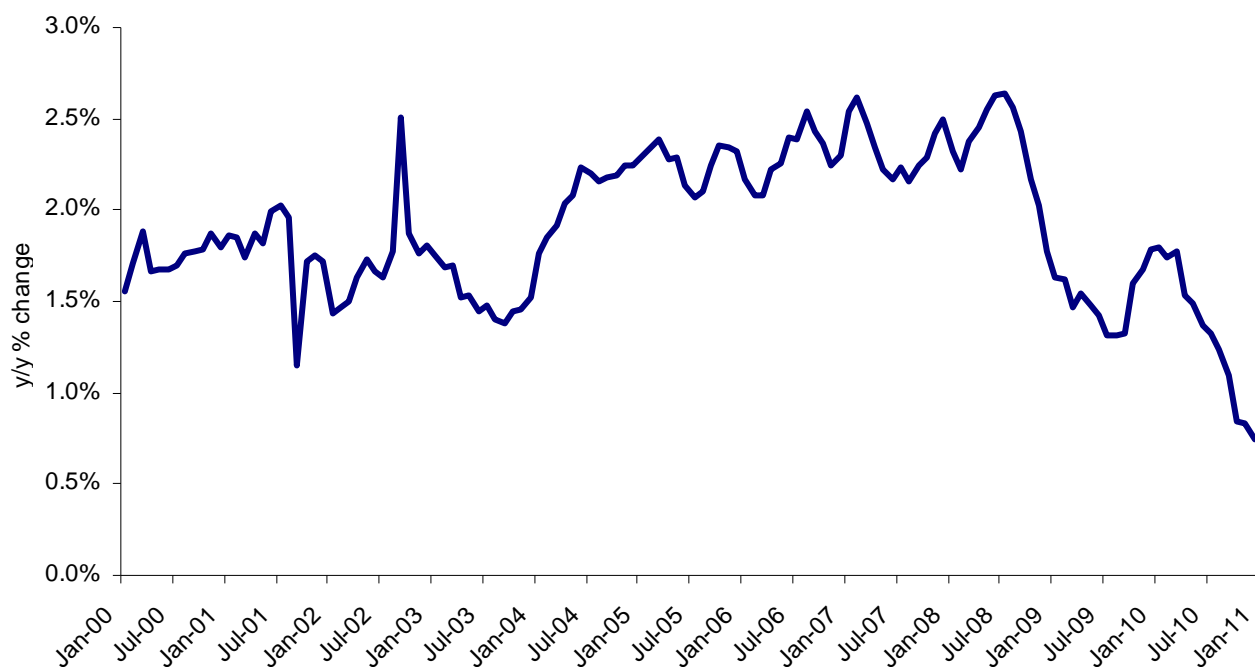
Source: Federal Reserve; Encima Global

- Nowhere in financial history other than Japan’s 20-year malaise have these macro conditions occurred, and Japan’s experience is distinct from ours in that the yen was strengthening and the national debt was mostly financed internally. **We think the U.S. is doing better than Japan at kicking the can down the road (i.e. papering over**

the problems) but is increasingly at risk from the level of federal debt, its short effective maturity, and the economic distortions from the emergency Fed policies still in place.

- As in 2003-2006, we think the Fed is botching monetary policy in a way that distorts the economy and will reduce future growth. Last decade, the Fed kept the Fed funds rate too low (at 1% in 2003, then limited 0.25% hikes starting in 2004). It mistakenly thought there was a deflation problem and then argued that inflation would moderate when it was actually rising. The result was a huge outflow of American capital to foreign countries due to the weakening dollar; and excess house construction due in part to artificially low mortgage rates. The core PCE deflator rose from 2003-2008, exceeding the Fed's 2% ceiling for 18 quarters in a row.

Core PCE Deflator Y/Y (last obs. December 2010)



Source: Bureau of Economic Analysis; Encima Global

- In the 2003 expansion, the economy was able to grow despite inflation. At first the weaker dollar was a plus, reversing the overly strong Clinton-Rubin king dollar that had pushed gold and commodities to historic lows. The 2003 tax cut was a pro-growth reduction in top marginal rates, a contrast with this cycles repeated consumption oriented rebates. **We don't expect the current expansion to last as long as the 2003 expansion.**
- In January data, CPI and PPI inflation came in above expectations on both overall and core measures. Headline CPI rose 0.4% in both December and January, reflecting the rising cost of energy and food. Six-month annualized CPI inflation is at 3.2%. Because monthly inflation was very low between February and June of 2010 – 0,0,0,

neg 0.1 and neg 0.2 -- headline inflation is set to jump in coming months on a year-over-year basis. For example, if CPI continues at 0.4% per month through June, year-over-year inflation would rise to 3.9% from the current 1.6% year-over-year rate.

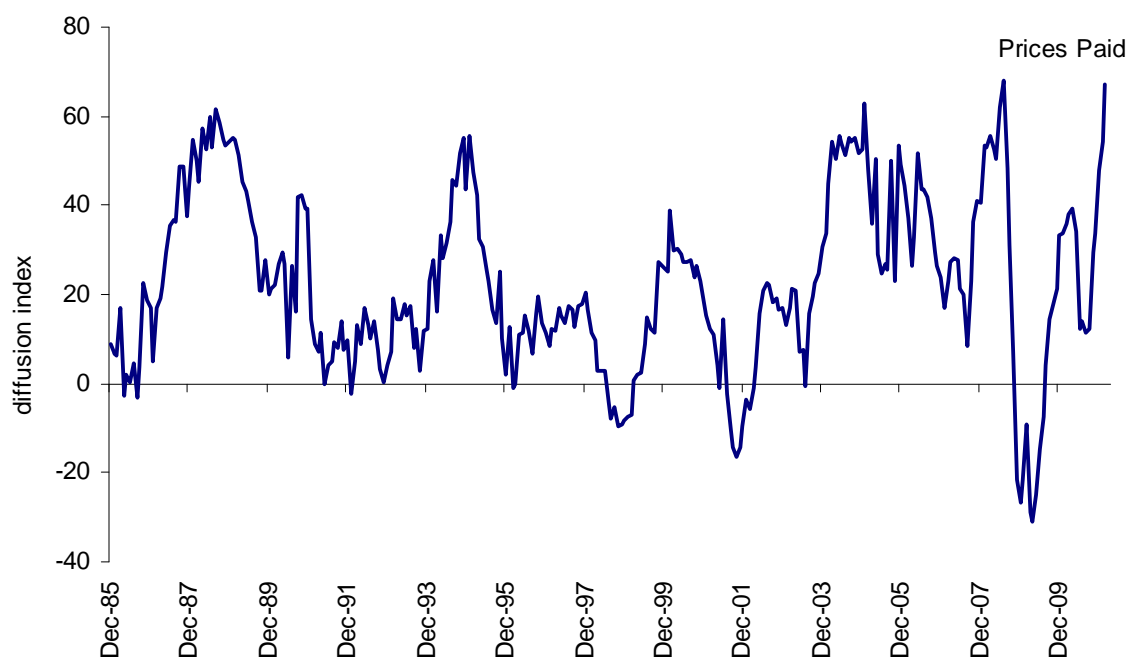
Inflation – CPI Y/Y (last obs. January 2011)



Source: Bureau of Labor Statistics; Encima Global

- The Philly Fed index showed flat orders (up 0.1 from January) and little evidence of pricing power (prices received up 3.9 in February). This is a sharp contrast with prices paid (up 12.9 in February).

Philly Fed Prices Paid (last obs. February 2011)



Source: Federal Reserve Bank of Philadelphia; Encima Global

- Many commodity prices are moving higher, adding to inflation. Oil prices are at their highest level since their 2008 weak dollar crisis that pushed oil above \$140 per barrel.

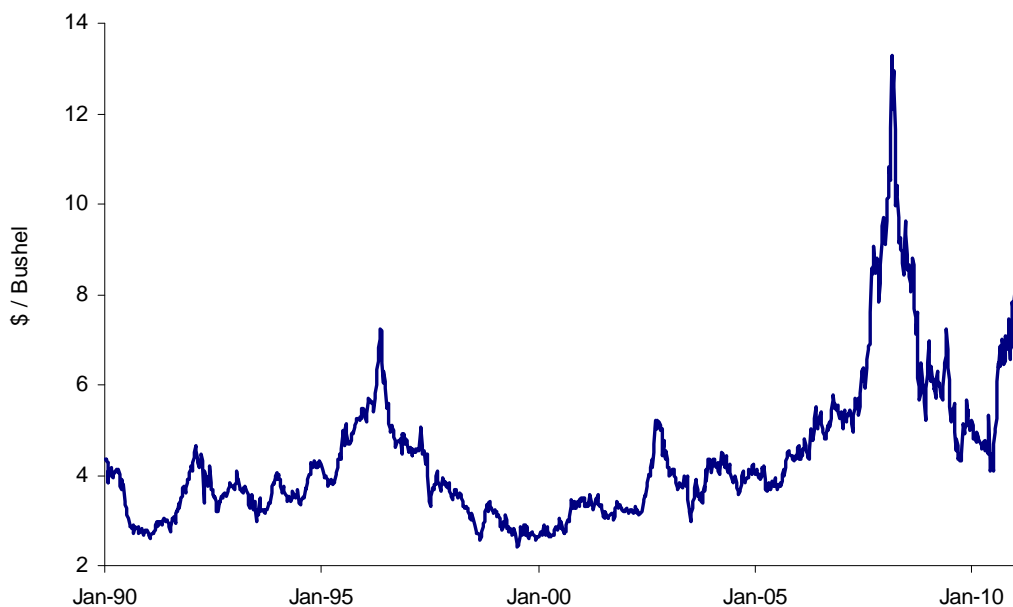
Oil Prices (last obs. February 22, 2011)



Source: Wall Street Journal; Encima Global

- Wheat prices recently topped \$9 per bushel.

Wheat Prices (last obs. February 22, 2011)



Source: Wall Street Journal; Encima Global

- Core CPI rose 0.2% in January, the highest since 0.2% in October 2009, bringing the year-over-year reading to 1%. Housing has a 48.5% weighting in the core index and is being held down by plentiful supply, keeping core inflation tame despite inflation in healthcare, education and other essentials.

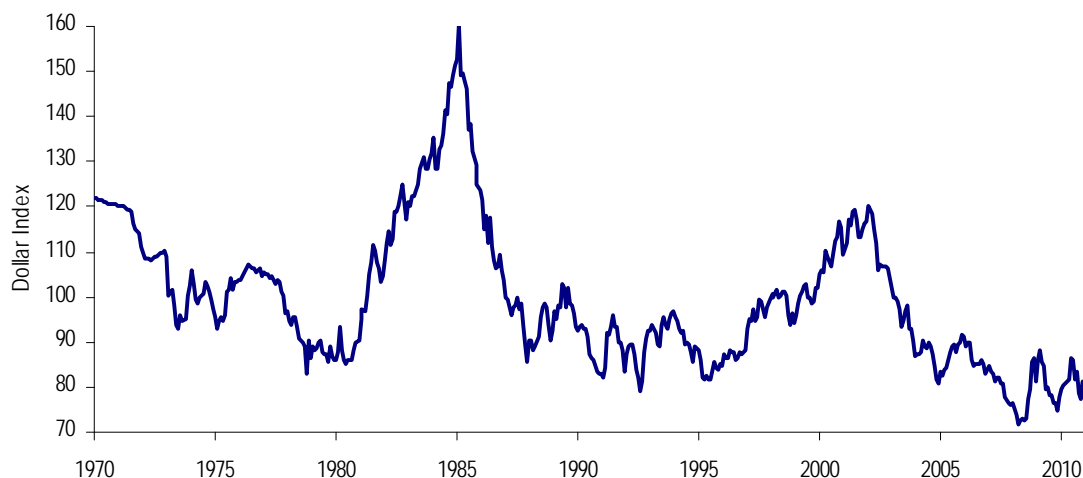
Core CPI Y/Y (last obs. January 2011)



Source: Bureau of Labor Statistics; Encima Global

- The dollar index remains near its all-time lows even as the euro-zone suffers a debt crisis and Japan and the UK shrink (Q4 down 1.2% and 2% respectively annualized).

DXY - Dollar Index (last obs. February 22, 2011)



Source: Bloomberg; Encima Global

- The dollar is even weaker relative to commodities and gold, a dependable precursor of a strong inflationary trend.

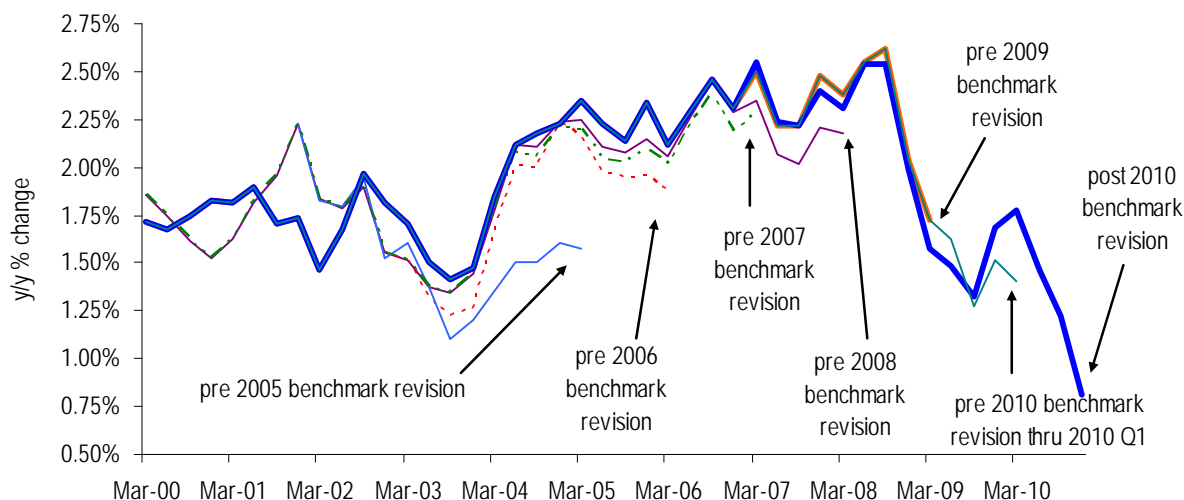
Gold Prices in log base 10 (last obs. February 22, 2011)



Source: Wall Street Journal; Encima Global

- The core PCE deflator, the Fed's preferred measure, is one of the most deeply lagging indicators. It is subject to large benchmark revisions (normally made in July). The system allows current inflation readings to decline even as revised inflation readings are elevated.

Core PCE Deflator (last obs. Q4 2010)



Source: Bureau of Economic Analysis; Encima Global

Bottom Line: We think ultra-loose fiscal and monetary policy do not provide a sound basis for structural improvement in the U.S. economy and are creating lasting inflation and debt problems. Pent-up demand has been sustaining the economy, but will not be able to maintain current growth.

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