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Key Variable – U.S. Second Half Growth

We think several of the current macro worries will be resolved soon, most of them favorably,
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- The end of QE2 bond purchases should be benign, like Y2K, since QE2 was not money printing and didn't add to private sector credit. It didn't have a discernable impact on the economy or, in our view, financial markets (the equity rise in the second half of 2010 reflected growth in profits and GDP following the 2010 soft patch.) We disagree strongly with the flow view of the bond market in which the Fed's reduction in bond purchases will create a shortage of buyers. We're negative on bonds for other reasons – growth, inflation and low yields.

- The debt limit increase will get done one way or another. We expect ultra-loose fiscal policy to continue. The U.S. doesn't have any structural reform process under way yet, either at the federal level or in many of the states. One outcome of the debt limit fight could be fewer Republican seats in the 2012 election if they are labeled as irresponsible. We think that would be a market negative, especially if it points to Republicans losing control of the House.

- We addressed concerns about China's hard landing and the Greek debt situation in Friday's piece (Global Growth Outlook Still Intact). We agree that a Greek restructuring could, if botched, stop global growth -- for example, a euro country exiting the euro by converting euros into local currency would stop global growth because it would cause a devastating run on euro deposits in weaker countries. But there's no sign of the Greek crisis heading that way.

- The near-zero Fed funds rate is also a major worry and would be a key variable -- except the current Fed is dug in on this policy and unlikely to correct it regardless of higher growth and inflation rates. It is causing credit rationing, a weak dollar, high commodity prices and a giant transfer of growth capital out of the U.S. and from savers to debtors, so this particular Fed policy and the related weak-dollar policy would immediately be key variables if they came under review.

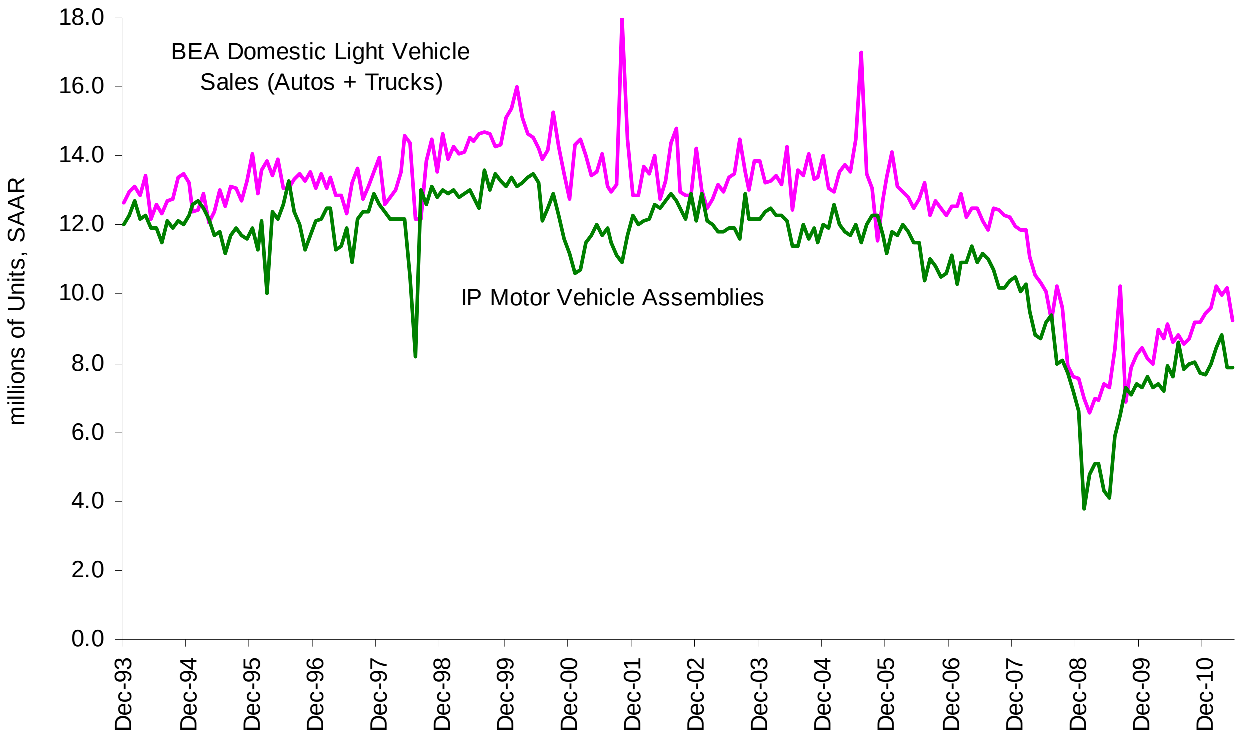
U.S. Growth A Key Variable

In contrast with the other worries, the debate over second-half U.S. growth will probably take several months to resolve and will be a key market variable during that sorting out process (as it was during the equity rally in the second half of 2010.) There will be a big difference in market performance if the U.S. records 2% growth in the second half (the new norm) or 3.5%

as we expect. Before discussing various forecasts, we should note that economists have not been good at making this type of forecast. For example, second half 2010 growth and inflation were still being underestimated into November when the Fed board approved QE2 based on worries about a deflationary double dip.

- We're maintaining our 3.5% second half forecast based on profit growth, top line sales growth projections, increased auto production, export growth (emerging markets are enjoying rising living standards and strong capital investment, partly from U.S. capital flight), some job growth, and pent-up demand for business investment and personal consumption.

Autos Sales and Production (last obs. May 2011)

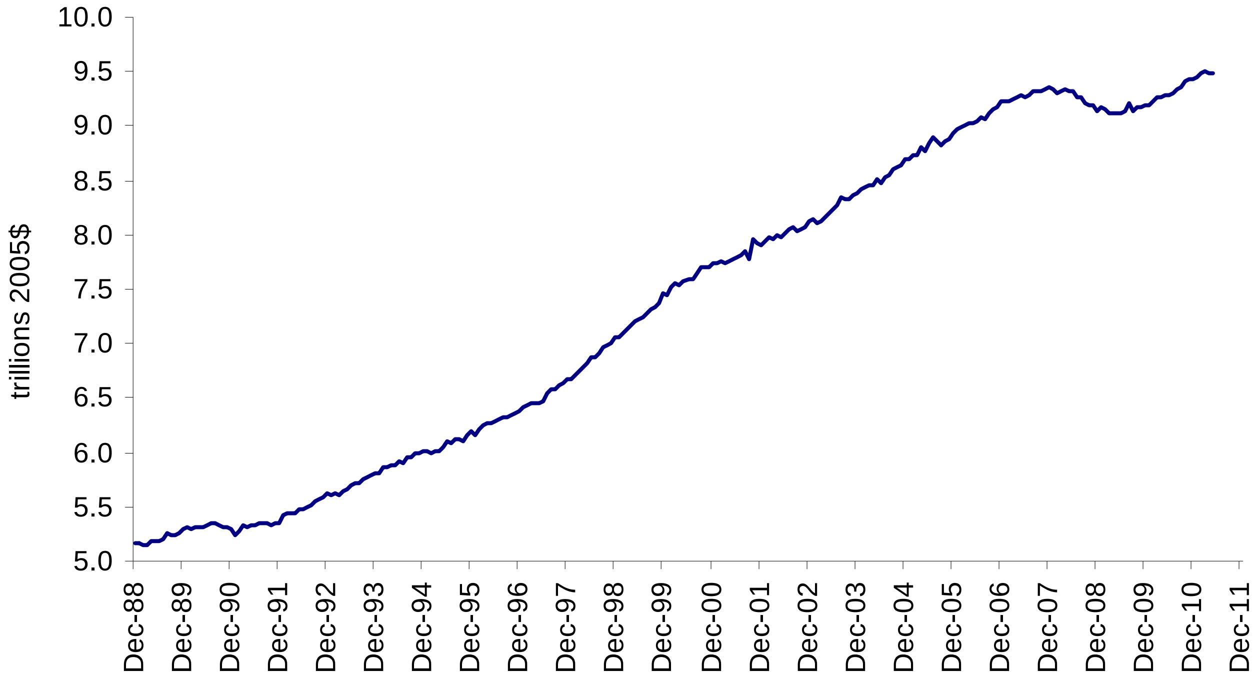


Source: Bureau of Economic Analysis; Federal Reserve Board; Encima Global

- The NYT ran a story Saturday saying "Forecasts for Growth Drop, Some Sharply." The article is based on Goldman and Macroeconomic Advisors lowering their Q2 forecasts to 2% two months ago from 4%. Our 1.8% Q2 real GDP forecast looks a bit on the low side given recent data – we'll be watching Japan's May industrial production data (due June 29) and U.S. June auto sales (due July 1) to make an adjustment.

- Personal consumption expenditures didn't grow in May from April in nominal terms due to the previously-reported weakness in auto sales. In real terms, they fell 0.1% from April. The weakness caused a few more downgrades of second quarter forecasts.

Real PCE (last obs. May 2011)



Source: Bureau of Economic Analysis; Encima Global

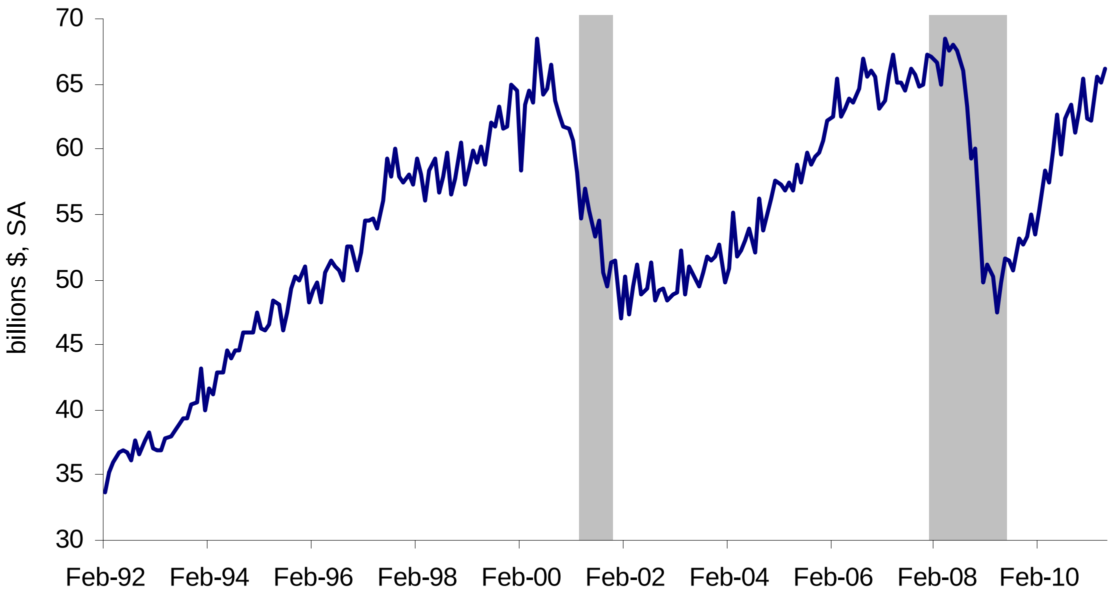
- Jobless claims were higher again last week. Weekly claims were our favorite indicator during the 2009 recovery and the 2010 soft patch. However, they are now at normal levels relative to the size of the labor force and probably not as useful as a leading indicator in 2011. We're more interested now in business investment and in small business job growth as measured by ADP and the BLS household survey. We think the rise in jobless claims solidly above 400,000 after the Japan production disruption may subside to an average 400,000 level in July and August as auto production ramps up.

Jobless Claims as a % of Total Employment (last obs. June 18, 2011)

Source: Bureau of Labor Statistics; Department of Labor; Encima Global

- U.S. durable goods orders were better than expected on Friday including capital goods orders (which affects Q3 GDP) and shipments (counted in Q2 GDP). Pent-up demand for business and consumer investment in durables is a key assumption in our second half outlook. (Note steepness of order rebound -- twice already in this expansion the three-month growth in cap goods orders has exceeded any three-month growth rates in the previous expansion.)

Nondefense Orders for Capital Goods ex Aircraft (last obs. May 2011)



Source: Census Bureau; Encima Global

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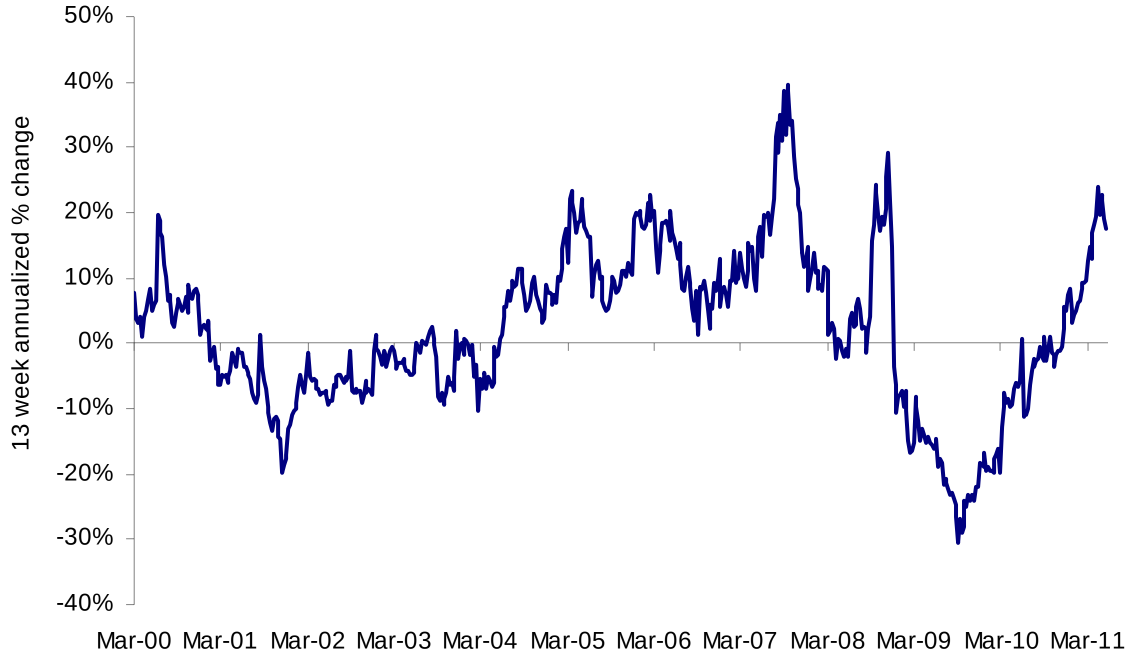
- We didn't get much out of Chairman Bernanke's press conference last week or the Fed's somewhat slower GDP growth forecasts. We think broad monetary policy (the combination of traditional monetary policy plus credit rationing) will remain relatively loose and note the rise in C&I loan balances at large banks (up at a 6.4% annual rate).

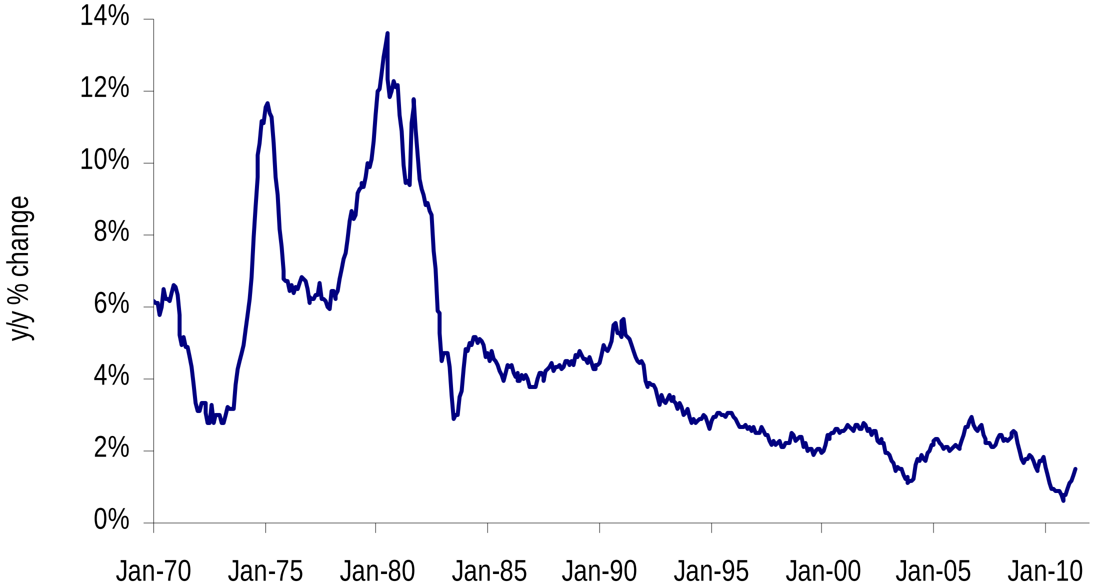
C&I Loans at Large Banks (last obs. June 15, 2011)



Source: Federal Reserve; Encima Global

- U.S. CPI inflation, now 3.6%, will likely peak in June at nearly 4% and then fall rapidly in the second half as lower gasoline prices and easier year-over-year comparisons take effect. Core CPI has risen to 1.5% year-over-year in May from the 0.6% yoy trough in October 2010. We think core will climb more through year-end but without forcing the Fed to change monetary policy. The core PCE deflator offers an even longer lag, so the Fed may be able to argue "moderating inflation" for years as it did in the 2004-2007 inflation bulge (which wasn't disclosed until the revisions were included.)

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



Source: Bureau of Labor Statistics; Encima Global

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