

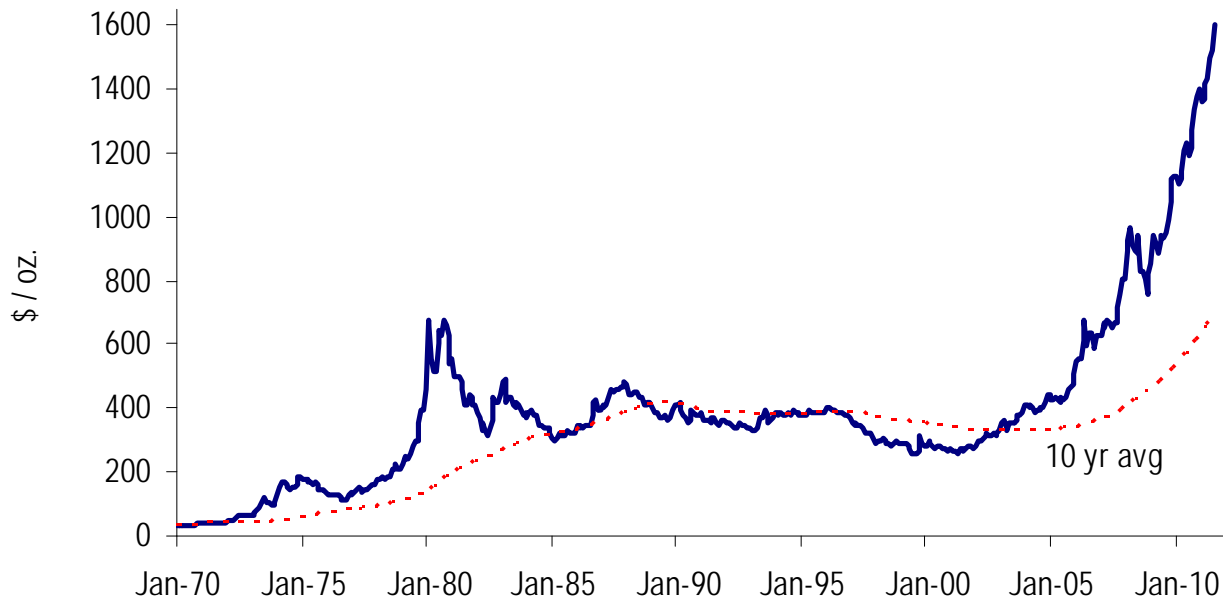
July 20, 2011

Outlook – Look Past Wall of Worry To Stronger Second Half Growth

Markets have been climbing a wall of worry that we think is gradually being resolved favorably -- including QE2 ending, the debt limit drama, China's soft patch and the European debt crisis (though this worry will linger for years.) We think U.S. second half GDP growth and corporate earnings will end up being the key market variables, favoring equities but not bonds.

- The Fed ended its QE2 bond buying with no impact on yields as other buyers stepped in. Some had feared a traumatic shortage of global buying power. Since the Fed wasn't printing money or having any positive impact on private sector credit, we think ending QE2 is a positive. Markets can resume more normal functions after the distortions from the Fed's large market interventions. However, the near-zero interest rate is severely damaging the interbank market and the short end of the credit curve. It signals a weak-dollar policy, driving the value of the dollar to new lows and gold prices to new highs, a forerunner to broader inflation (see WSJ 12/4/09 Near-Zero Rates Are Hurting the Economy.)

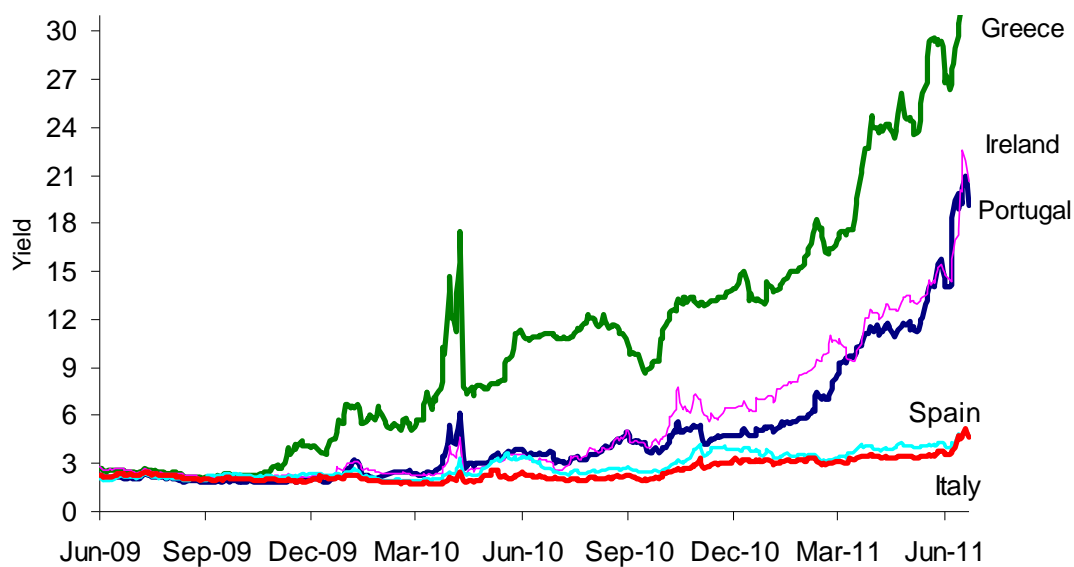
Gold Price (last obs. July 20, 2011)



Source: Wall Street Journal; Encima Global

- The U.S. debt limit will get resolved one way or another. We don't think there are big long-term risks, though an actual downgrade of the credit rating by Moody's or S&P, unlikely in our view, would be a costly negative surprise and another blow in the ongoing dissipation of national wealth and capital under the weak-dollar policy. **We don't think the Gang of Six plan is viable though some ideas in Simpson-Bowles will remain part of the budget debate in 2012 and especially 2013. As a debt limit deal, however, the Gang of Six plan is a non-starter politically given its net tax increases, continued long-term bias toward tax increases over spending cuts, and its likely complexity (hundreds of pages of yet unwritten legislative language.) We expect a smaller deal that doesn't do much to change the fiscal outlook -- probably at the last minute under the pressure of a White House orchestrated payments shutdown.**
- The European debt crisis will be bad for years, but we don't think there's all that much consequence for the world as long the euro stays intact. The money was lost years ago when financial markets lent injudiciously to Greek and Portuguese politicians. The sums aren't all that large by global standards (compared to TARP or high-tech losses in 2001 or Germany's net worth.) The issue is how to distribute the losses among bank shareholders, bond owners, non-transparent CDS buyers and sellers (a key battle), taxpayers in northern Europe, retired and active government workers expecting large pensions, and the private sector in the debtor countries. Spreading the losses on Irish banks is a different exercise because of the blanket guarantee of bank liabilities by the previous government. However, European Union borrowing costs are very low, so the losses aren't hard to finance and can be spread over decades. The long-term upside potential is whether Europe uses the crisis to deepen its market orientation and its checks and balances on excess government spending, still unclear.

Selected 3 Year European Yields (last obs. July 20, 2011)

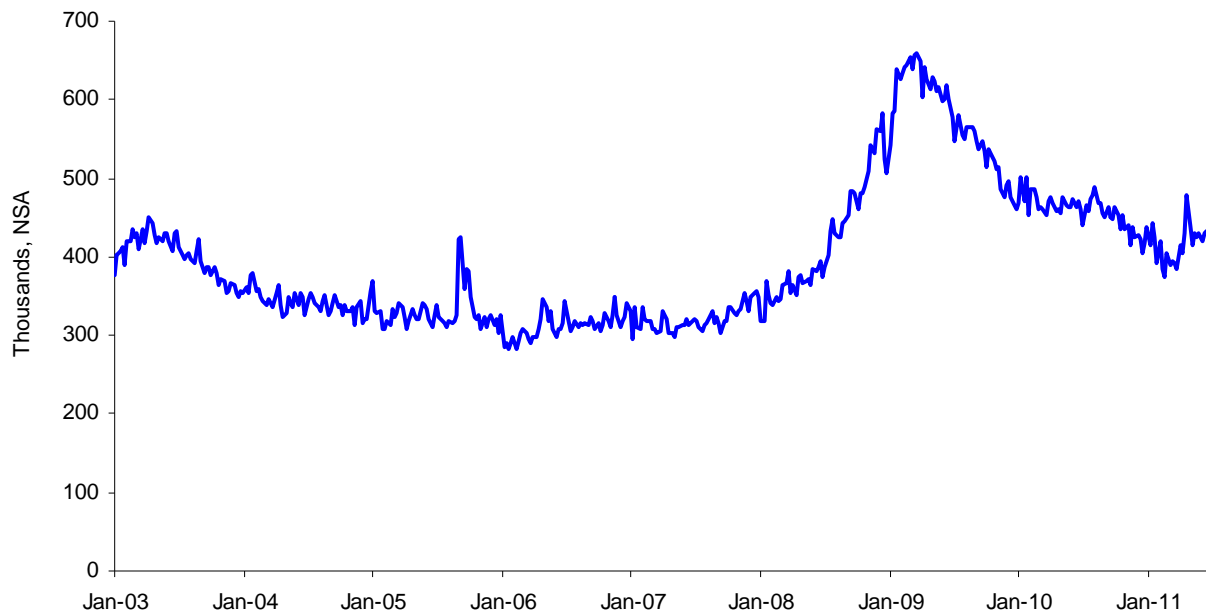


Source: Bloomberg; Encima Global

U.S. second half growth will be a key variable. There are residual negatives still being announced which we think relate to the second quarter soft patch, not prospects. For example, U.S. container lifts have weakened. China is reporting export weakness. The debt limit vitriol has hurt consumer sentiment, with non-Apple consumer electronics taking a hit.

- On the positive side (which we think will gain credibility once the debt limit is raised), corporate earnings are strong, with good forward visibility. U.S. auto production is recovering, with further gains likely as Japan's production goes through a V-shaped surge to make up for pent-up demand. Since housing starts are at rock bottom, there's room for strong sequential growth numbers like yesterday's 14.6% month-over-month growth. Jobless claims would have been under 400,000 last Thursday if not for the Minnesota government shutdown, now ended.

Initial Jobless Claims (last obs. July 9, 2011)



Source: Department of Labor; Encima Global

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