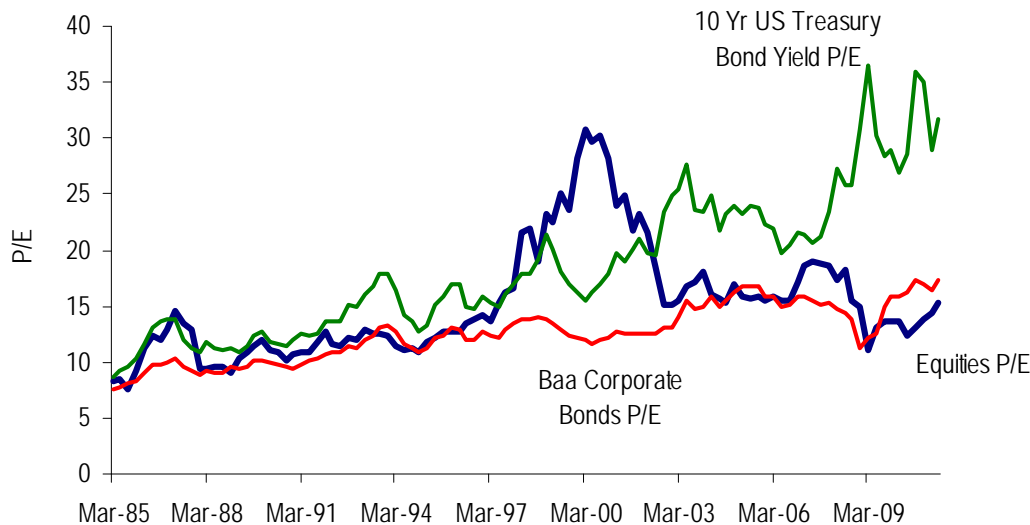


May 31, 2011

Near-Term Outlook

We note the attractiveness of global equities relative to bonds given strong profit growth (well above expectations each quarter) and extremely low bond yields. An ultra-loose global monetary policy is adding to the trillions in excess liquidity already outstanding – it's like having record flood-level liquidity with no sign the monsoons will end.

Equity, Corporate and Treasury Bond P/E (last obs. May 31, 2011)



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

We think there will be a shift from bonds to stocks once the world survives the end of QE2 and the debt limit increase; Germany and the IMF sweeten the Greek bailout; and 2012 profit growth comes into view. Adding to the bond-to-equity shift, we expect higher global inflation and think the latest China hard-landing scare -- about the fifth scare since Zhu Rongji's pivotal 1993 growth program -- will give way to still-strong GDP growth. We expect the S&P to push above its early-May intra-day peak of 1370 (versus today's 1345 close). We note a shift in seasonality for commodity price performance from unfavorable to favorable, which may soften the broad commodity-related deflation scare that hit markets in early May when gold and oil retreated from their highs.

- We expect somewhat stronger U.S. second half GDP growth based on gradually improving job growth, pentup demand for business investment and equity performance (one of the best leading indicators). Most of the weakness in recent data is related to

the U.S. auto production impact from Japan's earthquake -- including the weakness in IP in April (all due to autos), jobless claims (many due to early auto shutdowns which automatically feed claims without the union workers having to file), Chicago Fed and today's Chicago PMI. The sharp decline in the April and May Philly Fed indices were from a 29-year record high in March (pre Japan earthquake.)

- Consumption growth should strengthen some as newer workers benefit from the economy's transition away from baby-boom workers, easy auto loans, low interest rates and lower house prices (at the expense of existing home owners and small savers.) Helping sentiment, there should be a sigh of relief when the Fed's QE2 ends like Y2K without severe consequences and another one when the debt limit debate runs its course. Stronger production and sales of U.S.-built vehicles should add to second half growth as Japan manufacturing problems are solved or bypassed.
- We expect strong consumption growth in China, India and other emerging markets as millions of people each year move into the cash economy from subsistence living.
- GDP and consumption growth in northern Europe should be reasonable. Low unemployment rates are driving optimism – Germany announced today that its unemployment rate fell to 7% for May, the lowest since at least 1991 when Germany reunified.
- The legacy costs from the debt crises in southern Europe and Ireland, though expensive, shouldn't threaten the euro or the euro-zone financial system. Germany made clear in 2010 that it would take any steps to avoid this and has the means. The result is a protracted debtor/creditor/donor negotiation expected to last for years in which new money is injected (from the IMF, EU, public sector creditors and some private sector creditors) and eventually the remaining debt is restructured at a reduced net present value. (We think rumors of Greece leaving the euro are part of the negotiation but won't happen -- if any country using the euro were to convert to a local currency, it would be a huge new negative for Europe and the world financial system -- euro-denominated bank deposits in all but the strongest euro-zone countries would be withdrawn in a panic.)

In the longer-term, we share the deep concerns about U.S. federal spending, debt and competitiveness problems (like the tax code). Under the weak-dollar policy, capital is moving offshore, taking jobs and innovation with it. Federal, state and local governments have dramatically expanded their control over the economy, slowing expected growth to rates that won't allow sufficient job creation in many parts of the country. As a result, we expect the U.S. economy and financial markets to underperform many other countries until Washington corrects these problems. Even so, we think the outlook is for a continued decline of the U.S. relative to the rest of the world rather than a sharp new tipping point caused by bond and currency vigilantes.

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