



**Near-Zero Interest Rates For Years:
Can Economies Adjust?
January 11, 2012**

David Malpass
dmalpass@encimaglobal.com

212.876.4400

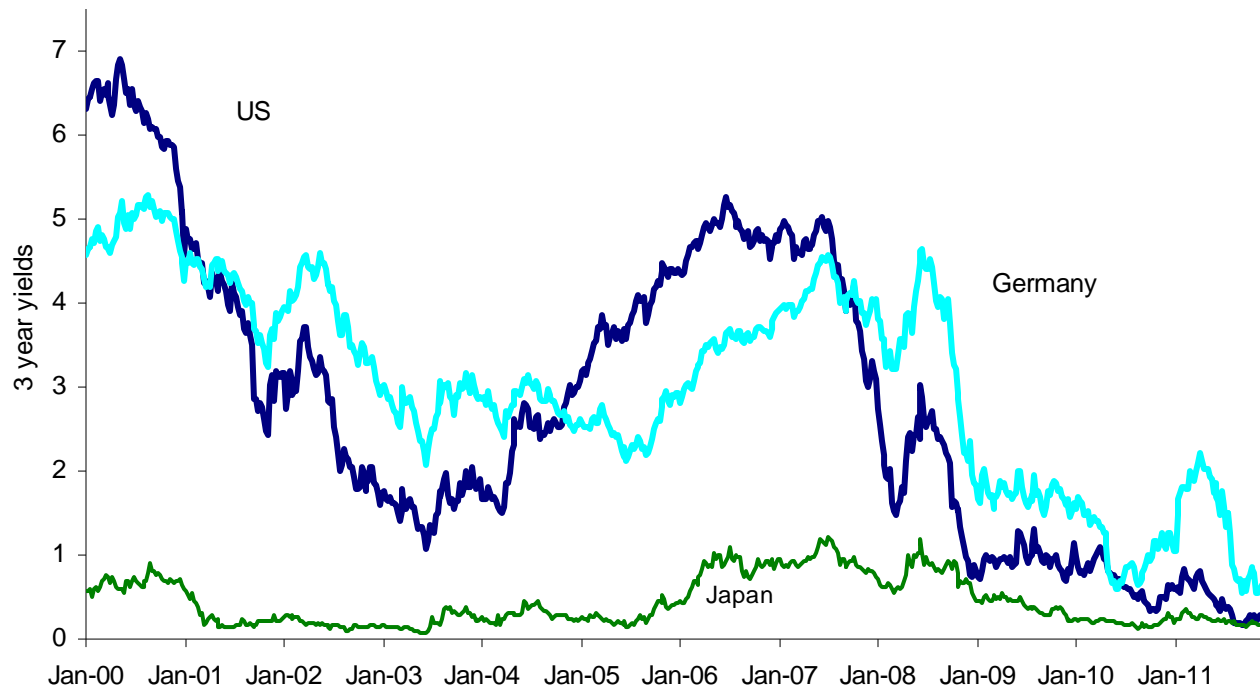
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2012 Outlook

- **With interest rates near zero in the U.S. and Japan and moving that way in Europe, we expect big short-term risk-on asset rallies on good news even if the end result turns out grim.**
 - **Equities gained in the fourth quarter as U.S. growth accelerated well above consensus and the ECB began making three-year loans to euro-zone banks. The issue is whether there will be much follow-through. Technicals are currently favorable, including the break-out in the Dow Transports and in the banking indices. However, we think the deterioration in Europe's periphery and weaker banks will limit the rally as markets restrict lending to the weakest links.**
 - **European leaders are focused on imposing tax-based austerity programs during recessions. We think this is a harmful plan that won't work. It doesn't address the banking crisis or the risk of a fire-sale. It delays solutions – kicking the can is causing recessions to spread.**
 - **We expect Europe to provide more funding through the IMF-led troika to Greece, Portugal, Hungary and others. However, the European banking system is too large for bailouts. The credit freeze is harming small European businesses and non-euro countries like Turkey and Czech as banks reduce assets. There's a strong first-mover advantage during a fire sale.**
 - **U.S. growth will probably slow materially in the first quarter from the fourth. The regulatory, tax and fiscal uncertainties discourage new investment and hiring. We expect the unemployment rate to rise above 8.5% and job growth in the household survey to slow from the fast August-November pace. Non-auto retailing will probably cool off.**
 - **While China faces a sharp decline in building in certain areas, it is loosening monetary policy and encouraging bank lending. As capital and labor exit the bubbles, we think the economy will flex into other projects, adding growth and averting a hard landing.**
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3 Year Yields Converging At Record Lows

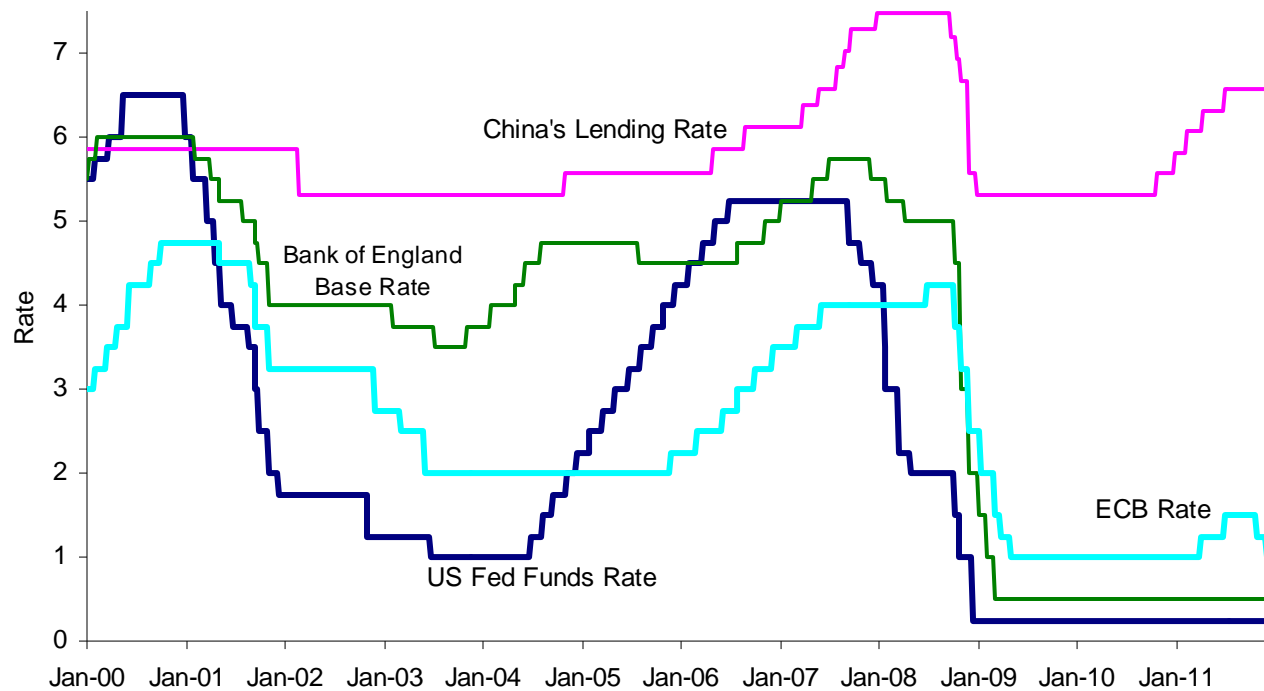
(U.S. at 0.36%, Germany 0.26%, Japan 0.16%; last obs. January 11, 2012)



Source: Bloomberg; Encima Global

Policy Rates Very Low; ECB and China Likely to Cut

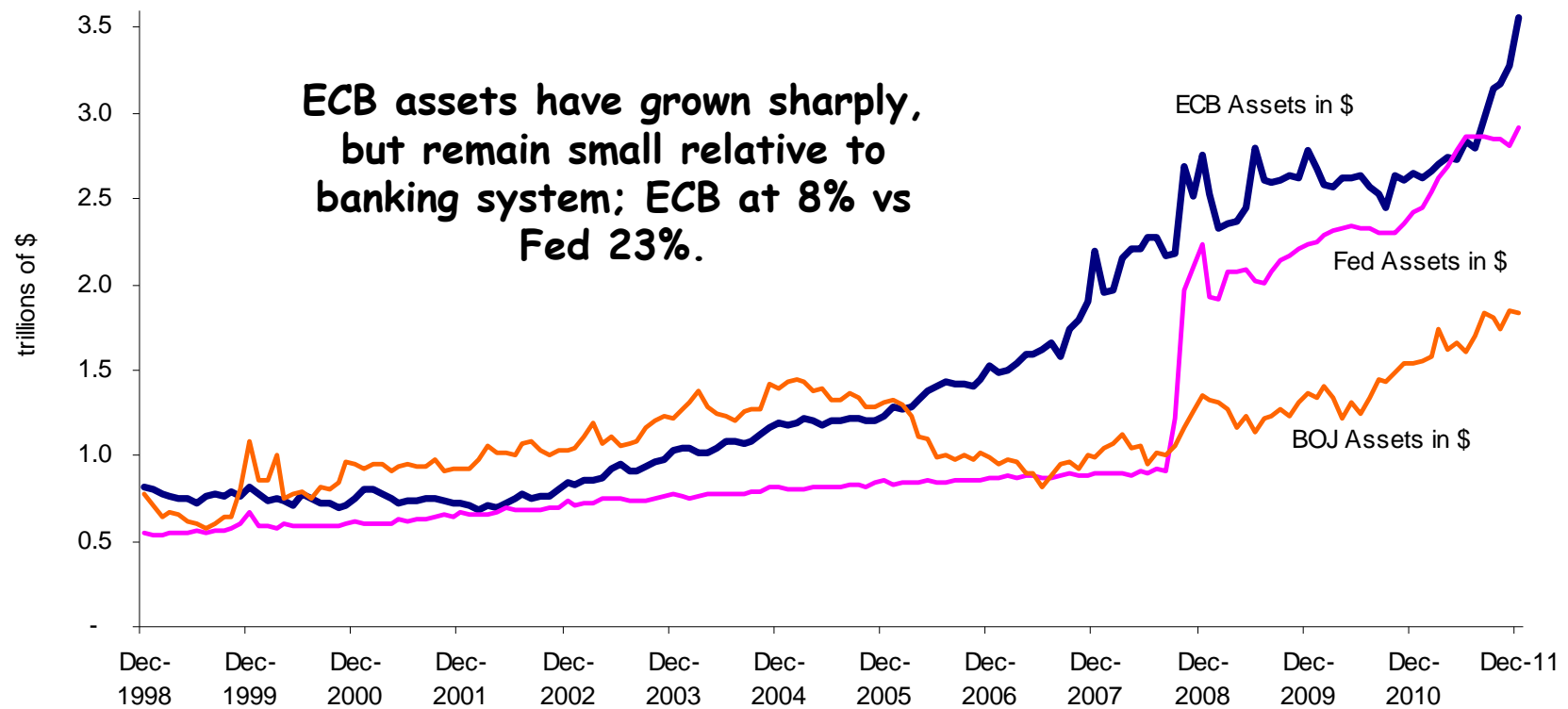
(last obs. January 10, 2012)



Source: Federal Reserve Board; ECB; Bank of England; Bank of China; Encima Global

ECB, Fed & BoJ Assets High

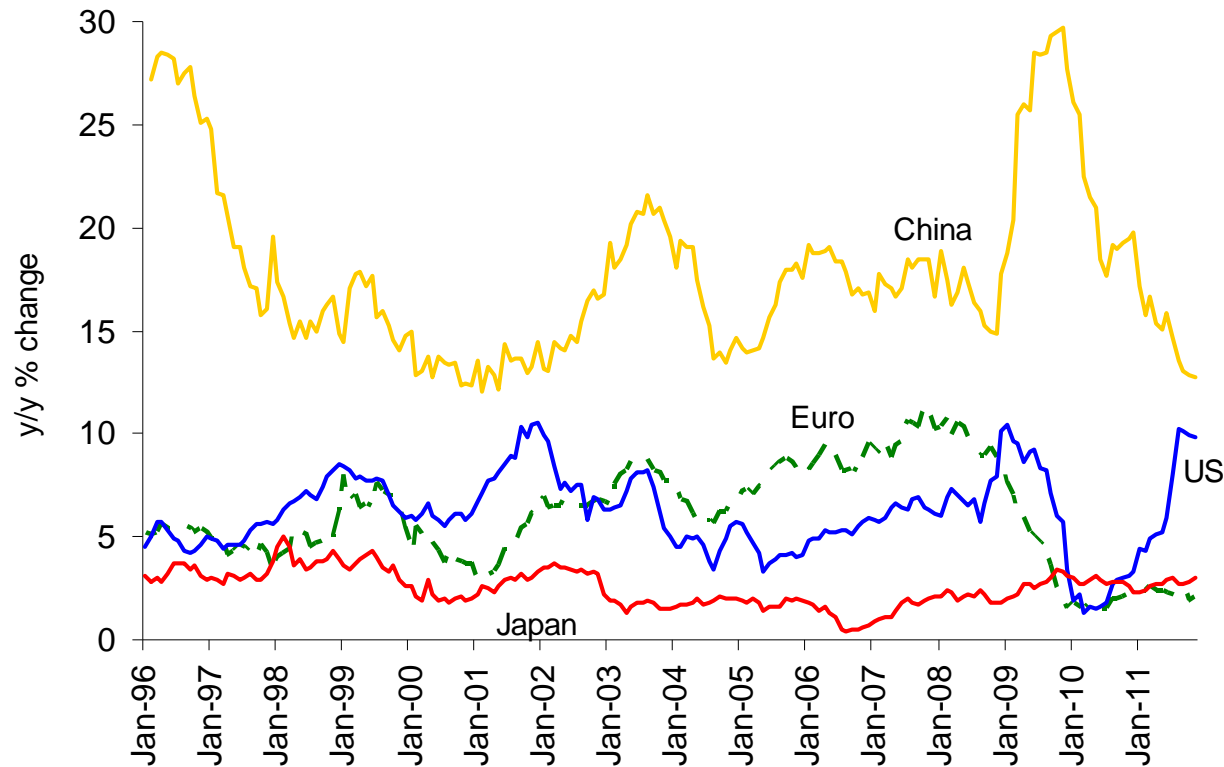
(last obs. December 2011)



Source: Federal Reserve; ECB; Bank of Japan; Encima Global

China's M2 grew after crisis while others shrank

(last obs. November 2011)



Source: Federal Reserve Board; ECB; Bank of China; Bank of Japan; Encima Global

Yen / US \$

(last obs. January 4, 2012)

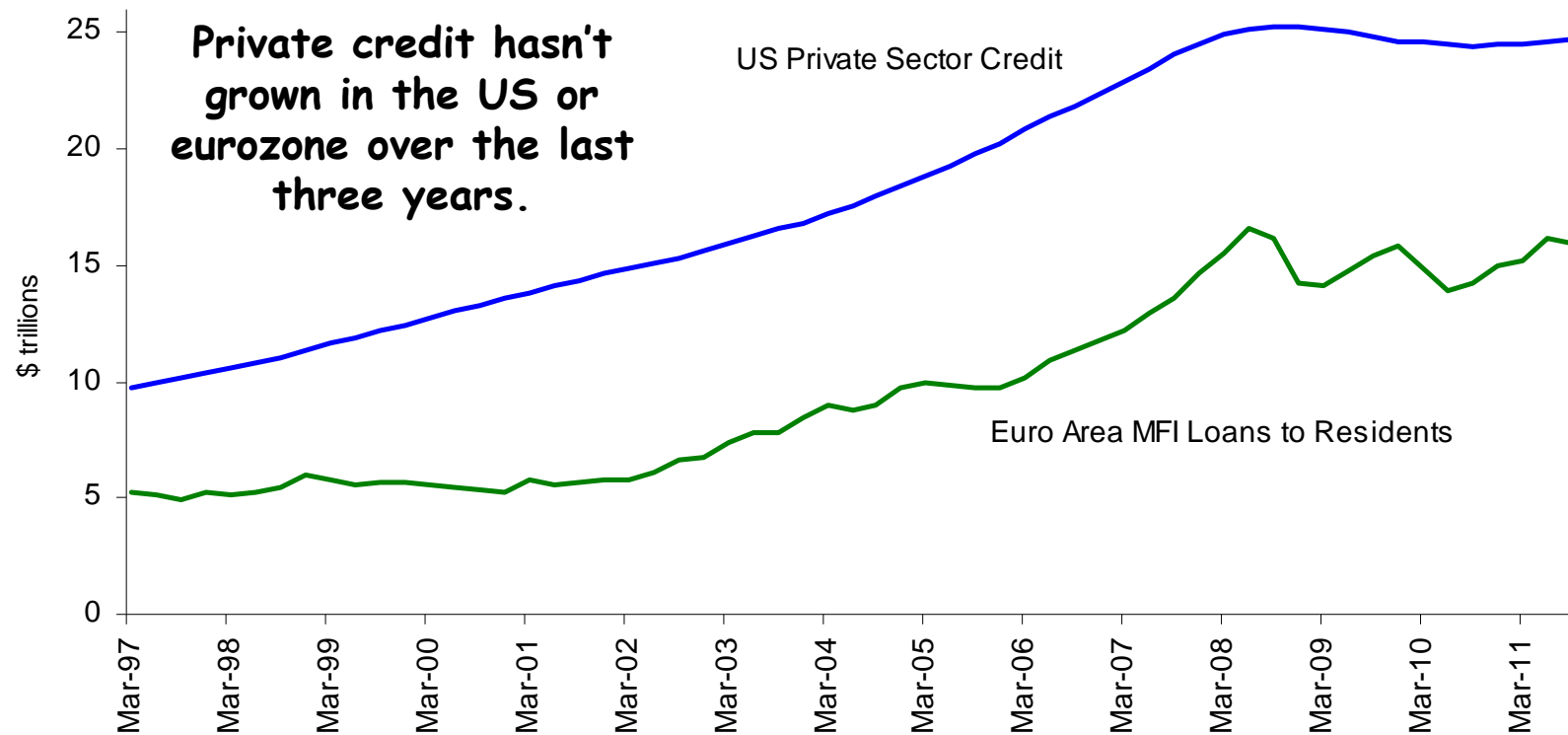


To encourage investment and jobs, Japan should copy Switzerland, putting a ceiling on the yen by promising unlimited buying of dollars at 85y/\$.

Source: Wall Street Journal; Encima Global

U.S. and Euro Zone Private Sector Credit

(last obs. Q3 2011, Euro area converted to dollars)

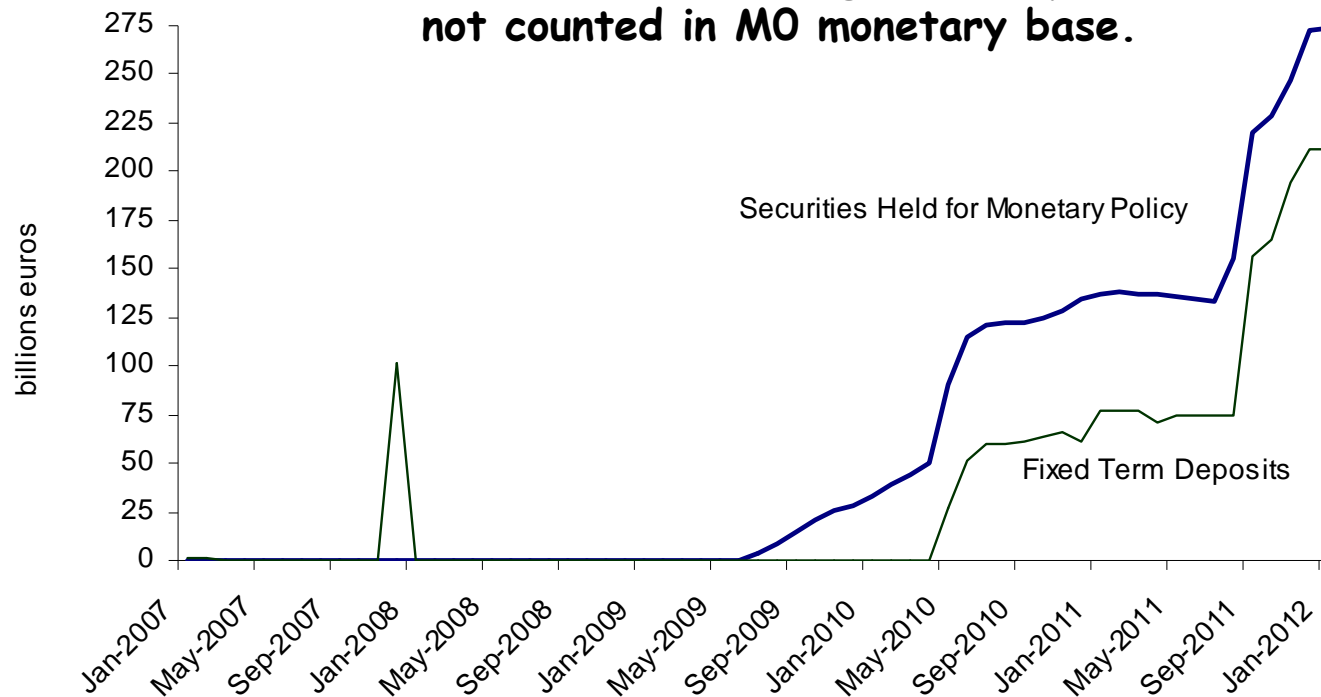


Source: Federal Reserve; ECB; Encima Global

ECB Sterilizing Bond Purchases Like Fed

(last obs. January 6, 2012)

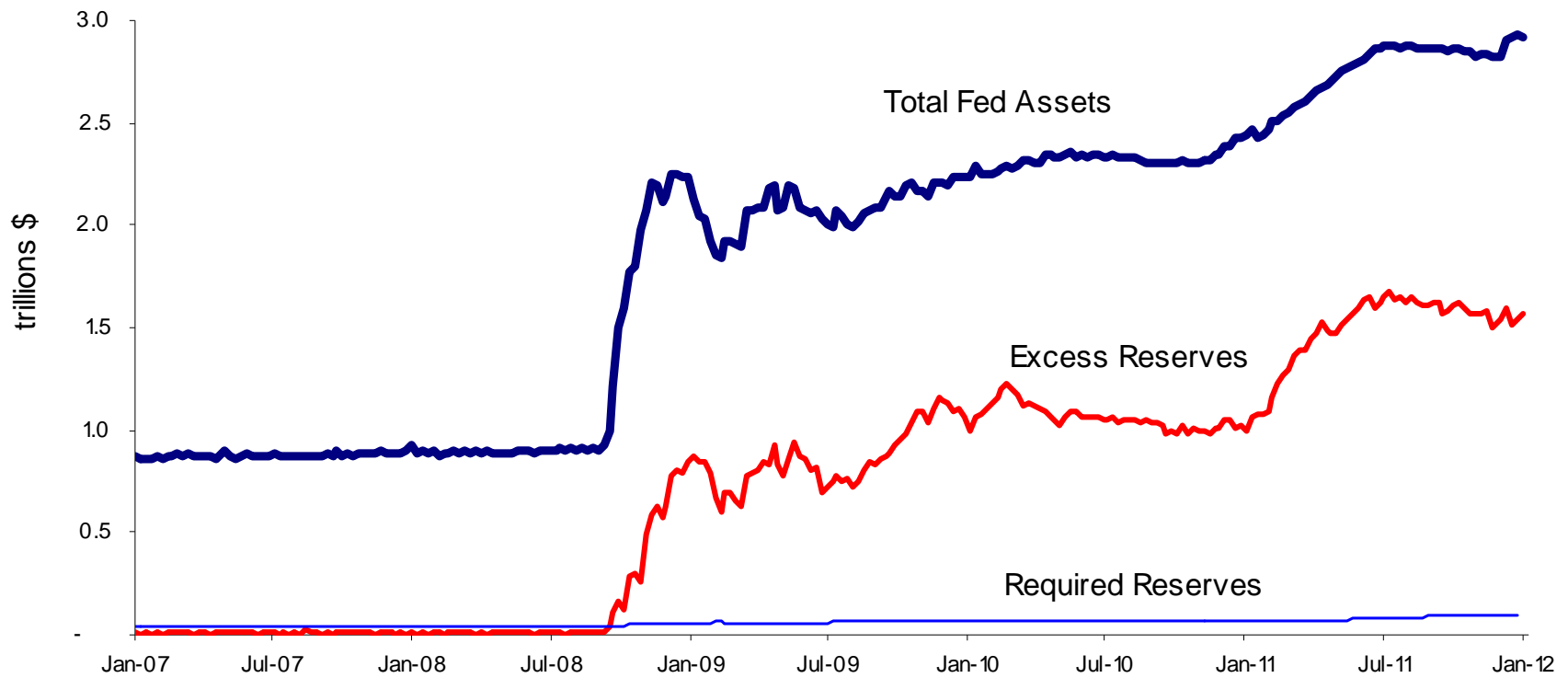
ECB bond purchases still small compared to Fed's QE1 or QE2. Fed sterilizes through excess reserves at 25bp, which count in M0. ECB sterilizes using term deposits, which are not counted in M0 monetary base.



Source: ECB; Encima Global

Fed Balance Sheet

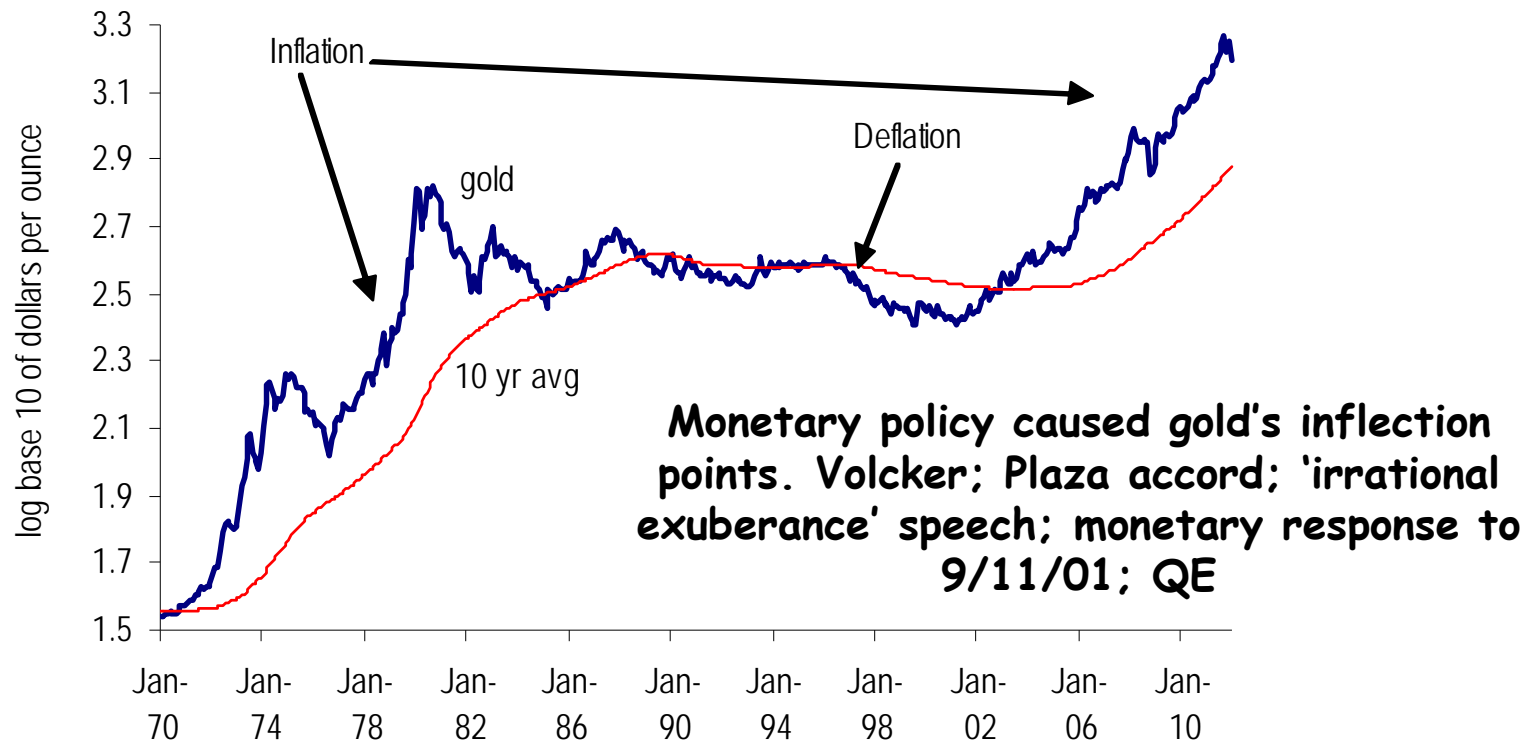
(last obs. January 4, 2012)



Source: Federal Reserve; Encima Global

Gold Prices in Log Terms

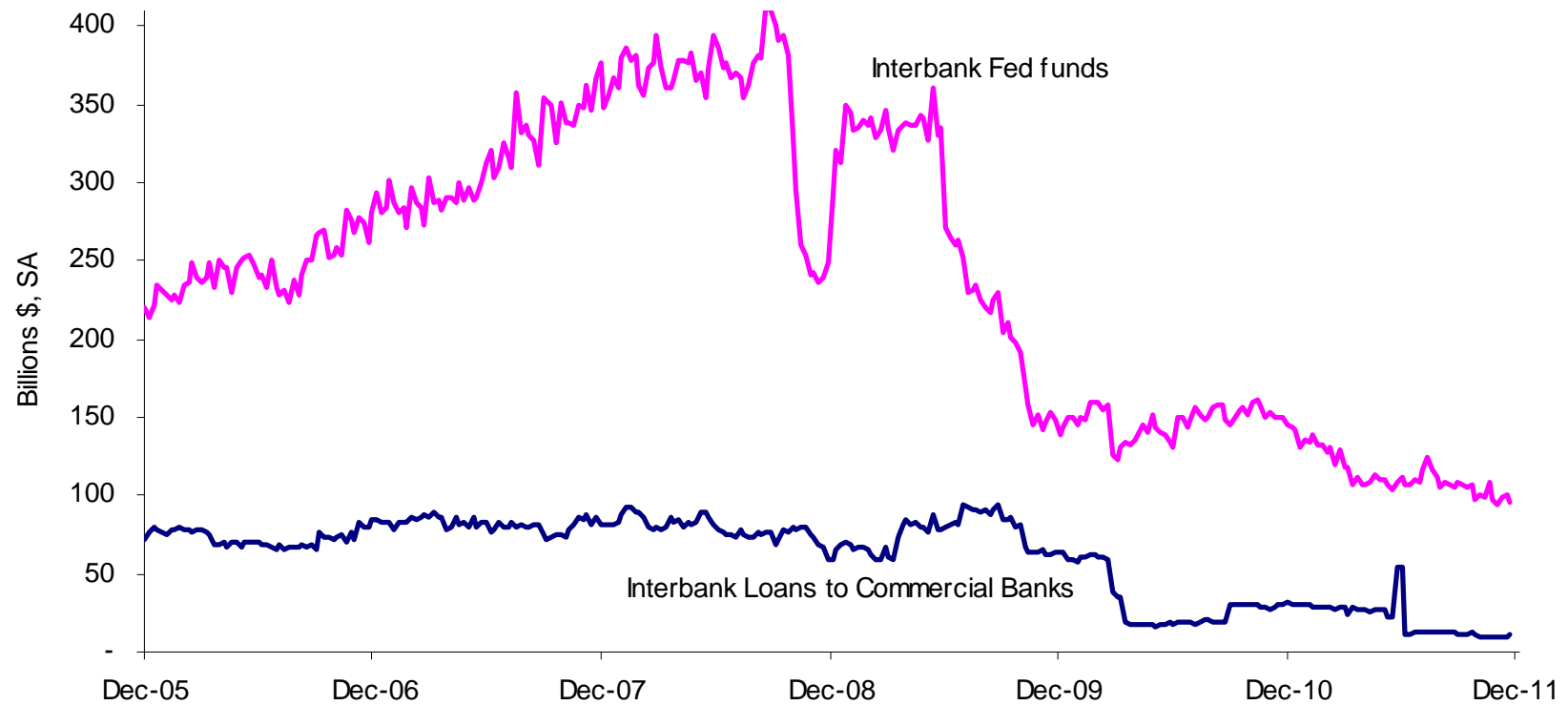
(\$ per gold ounce, last obs. December 28, 2011)



Source: Wall Street Journal; Encima Global

Interbank Lending

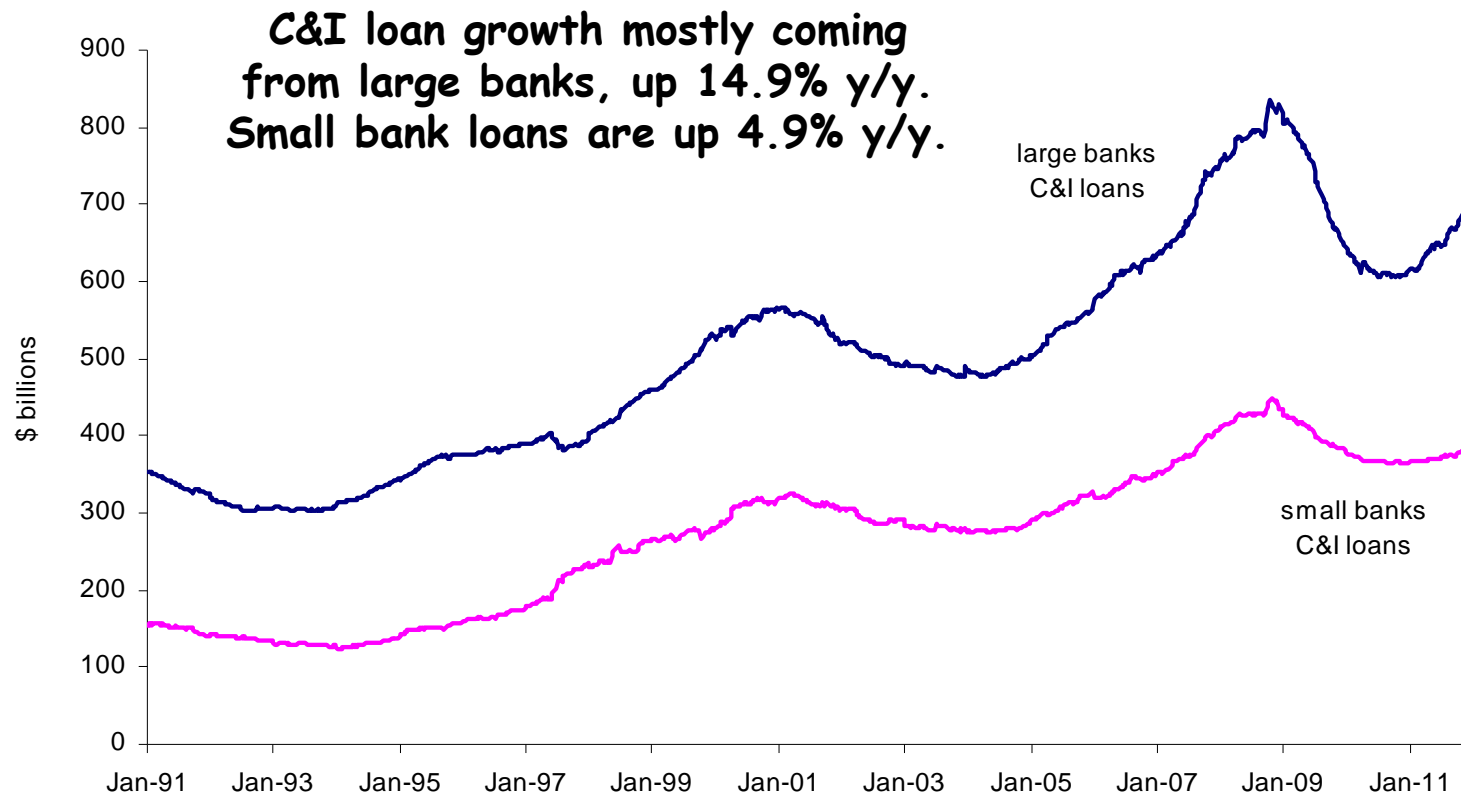
(last obs. December 23, 2011)



Source: Bureau of Economic Analysis; Encima Global

Commercial and Industrial Loans Rising Some

(last obs. December 28, 2011)



Source: Federal Reserve; Encima Global

Four Measures of Employment Growth

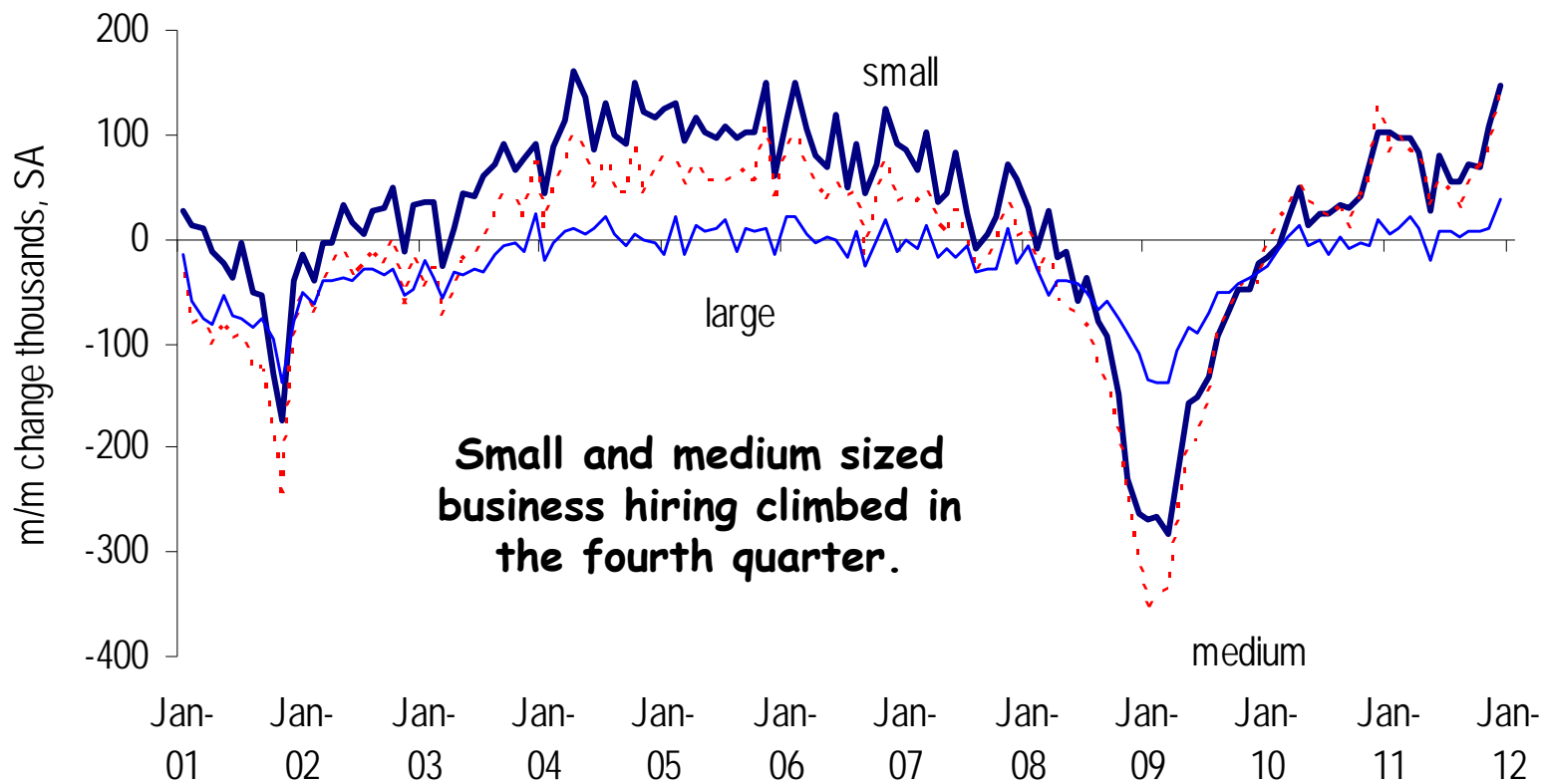
(last obs. December 2011)

	<u>ADP</u>	<u>Establishment Payrolls</u> <u>Private</u>	<u>Total</u>	<u>Households</u> <u>Pop Adj.</u>
January 2010	-50	-42	-39	770
February 2010	4	-21	-35	161
March 2010	49	144	192	167
April 2010	113	229	277	465
May 2010	42	48	458	30
June 2010	50	65	-192	-205
July 2010	31	93	-49	-2
August 2010	63	110	-59	195
September 2010	32	109	-29	2
October 2010	79	143	171	-275
November 2010	122	128	93	-138
December 2010	246	167	152	279
January 2011	190	94	68	582
February 2011	205	261	235	221
March 2011	203	219	194	213
April 2011	179	241	217	-136
May 2011	35	99	53	180
June 2011	144	75	20	-423
July 2011	107	173	127	65
August 2011	85	72	104	304
September 2011	130	220	210	353
October 2011	146	134	112	190
November 2011	204	120	100	317
December 2011	325	212	200	176

Source: Bureau of Labor Statistics; ADP; Encima Global

ADP Monthly Job Growth by Company Size

(last obs. December 2011)



Source: ADP; Encima Global

World Nominal \$ GDP Growth Slowing to 4%

(last obs. 2010, forecasts for 2012)

	2010	2011	2012
Nominal \$ GDP Growth			
United States (\$ 15.7T, 22% share)	4.2%	3.7%	4.0%
European Union (\$ 17.5T, 24%)	-0.7%	10.6%	-2.7%
Emerging and developing (\$ 27.2T, 37%)	18.9%	16.5%	8.2%
World (\$ 72.8T)	9.0%	11.3%	4.0%
Nominal \$ GDP Growth if euro breaks			
World (\$ 70.7T)			1.0%
European Union (assumes avg euro components = \$1.20)			-13.5%

Source: Encima Global; IMF

Equity Fundamentals Are Favorable

- **PE multiples are low and dividend yields high, especially compared to bond yields. U.S. earnings growth remains strong, and earnings for non-bank European corporations are growing.**
- **U.S. GDP growth beat expectations by a lot in the fourth quarter, with a positive spillover impact on Europe. China is beginning an easing process. Crude oil is up sharply from its October 4 low, in part reflecting the improvement in the global growth outlook since then.**
- **Ten-year bond yields are below 2%.**
- **New governments in Greece, Italy and Spain may be able to make a difference.**
- **However, we remain deeply concerned about elevated government spending in the U.S. and Europe and the need for sweeping structural reforms in regulatory, tax and monetary policies. We think government policy choices in the U.S. and Europe will be critical to markets.**

S&P 500 – Policies Have Big Impact on Valuation

(last obs. January 10, 2012)



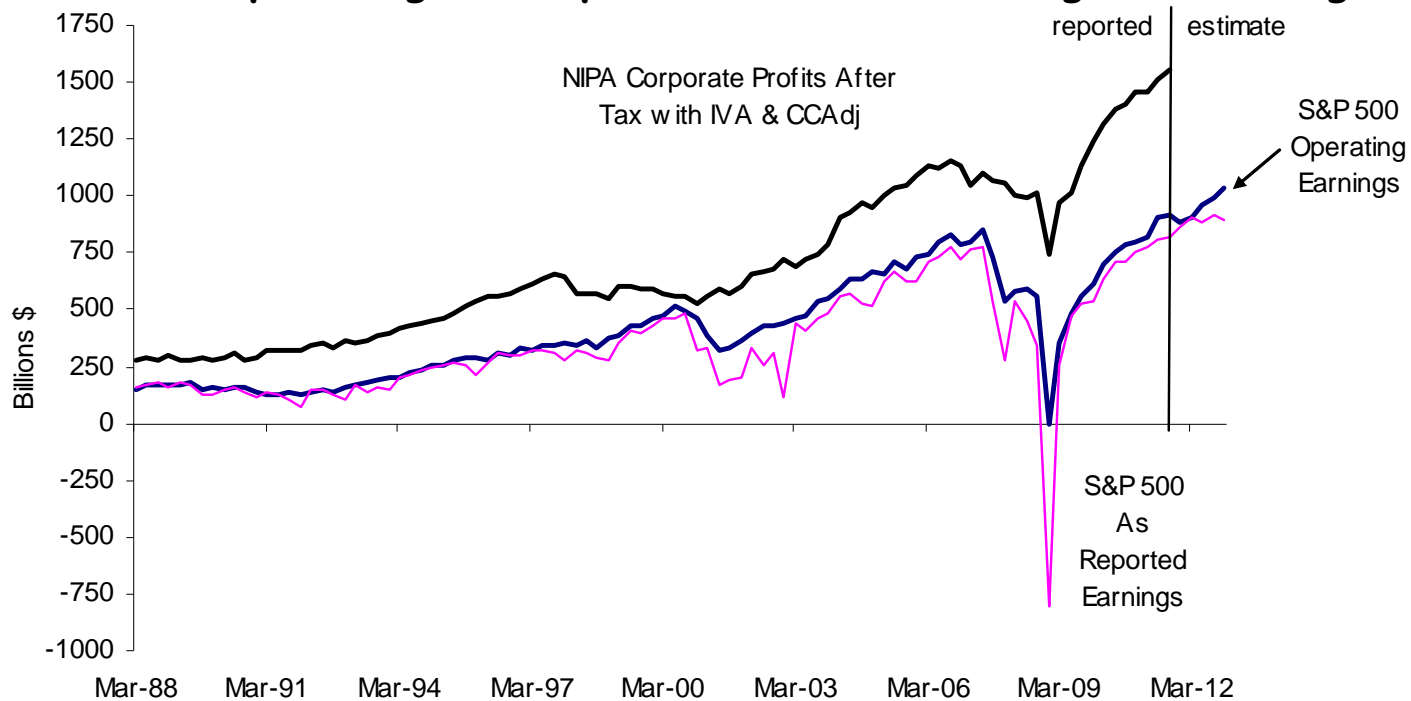
Source: Wall Street Journal; Encima Global

NIPA Corporate Profits and S&P Earnings

(after-tax SAAR, last obs. Q3 2011, S&P estimates through 2012)

S&P expects operating earnings to weaken slightly over the next two quarters, but then pick up again in the second half of 2012.

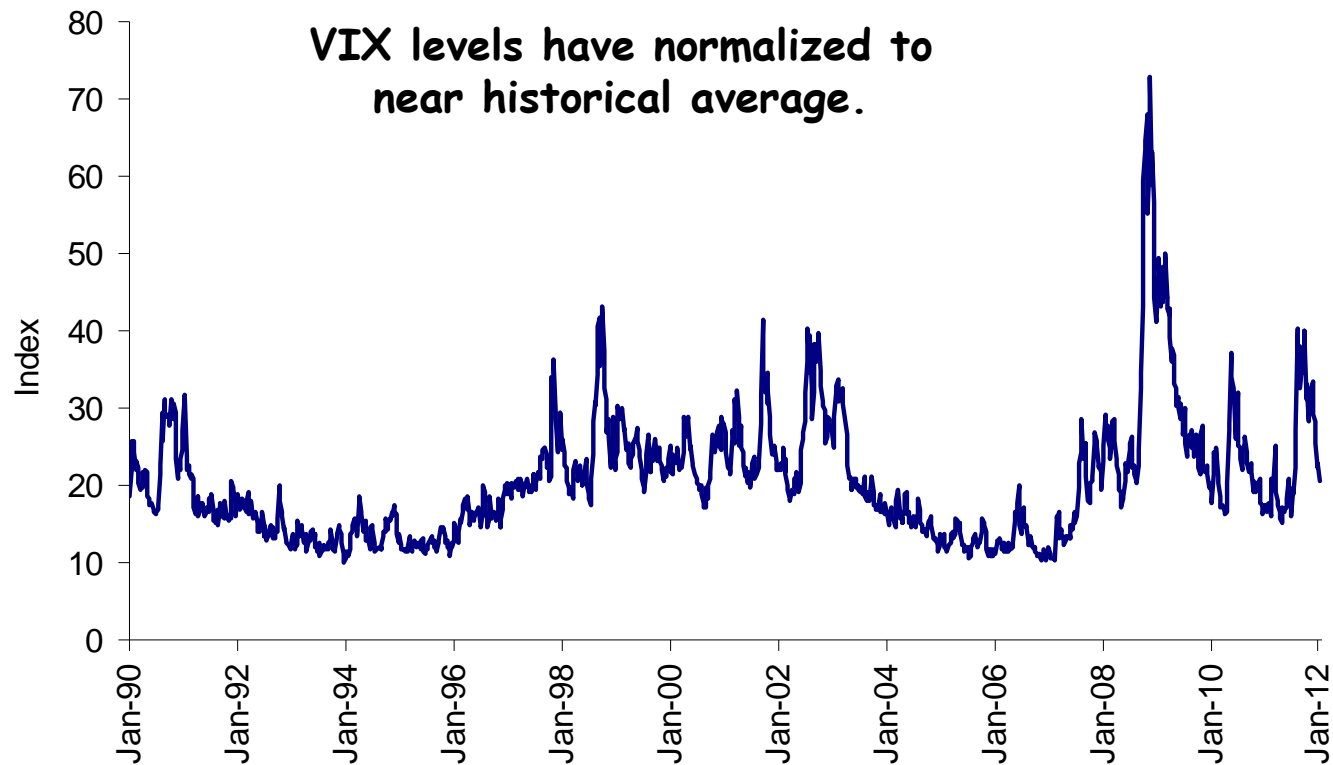
We think that reacceleration in earnings is possible only if Europe changes the policies that are causing debt contagion.



Source: Bureau of Economic Analysis; Standard and Poors'; Encima Global

VIX – Volatility index

(last obs. January 10, 2012)



Source: Wall Street Journal; Encima Global

U.S. and Europe Bank Statistics

(last obs. Q3 2011)

	<u>US</u>	<u>Euro Zone</u>
Total Bank Assets	\$ 12.5T	\$ 45.5T
Bank Loans to Non-Financial Corporations	\$ 1.3T	\$ 6.4T
Bonds Outstanding for Non-Financial Corp.	\$ 4.8T	\$ 1.2T
GDP 2011	\$ 15.2T	\$ 13.4T

Source: ECB; Encima Global

Assets of Euro Area Banking System

(billions of euros, last obs. November 2011)

	2011	<u>Jan</u>	<u>Jun</u>	<u>Nov</u>
Loans to Banks		5,526	5,502	6,137
Loans to Governments		1,218	1,153	1,144
Loans to Non-financial corporations		5,949	5,989	5,987
Loans to Households		5,182	5,266	5,242
Loans outside euro-zone		4,936	4,690	4,712
External assets		4,362	4,296	4,282
Other		4,921	4,845	5,899
Total		32,094	31,740	33,404

Source: ECB; Encima Global

Liabilities of Euro Area Banking System

(billions of euros, last obs. November 2011)

	2011	<u>Jan</u>	<u>Jun</u>	<u>Nov</u>
Deposits	10,473	10,656	10,725	10,725
Debt to Banks	5,799	5,692	6,188	6,188
Borrowed from Money market funds	631	608	607	607
Debt securities issued	4,860	4,903	4,941	4,941
External liabilities	4,230	3,973	3,976	3,976
Other liabilities	4,040	3,753	4,762	4,762
Capital and reserves	2,062	2,156	2,204	2,204
Total	32,094	31,740	33,404	33,404

Source: ECB; Encima Global

Selected Bank Ratios (higher leverage to lower)

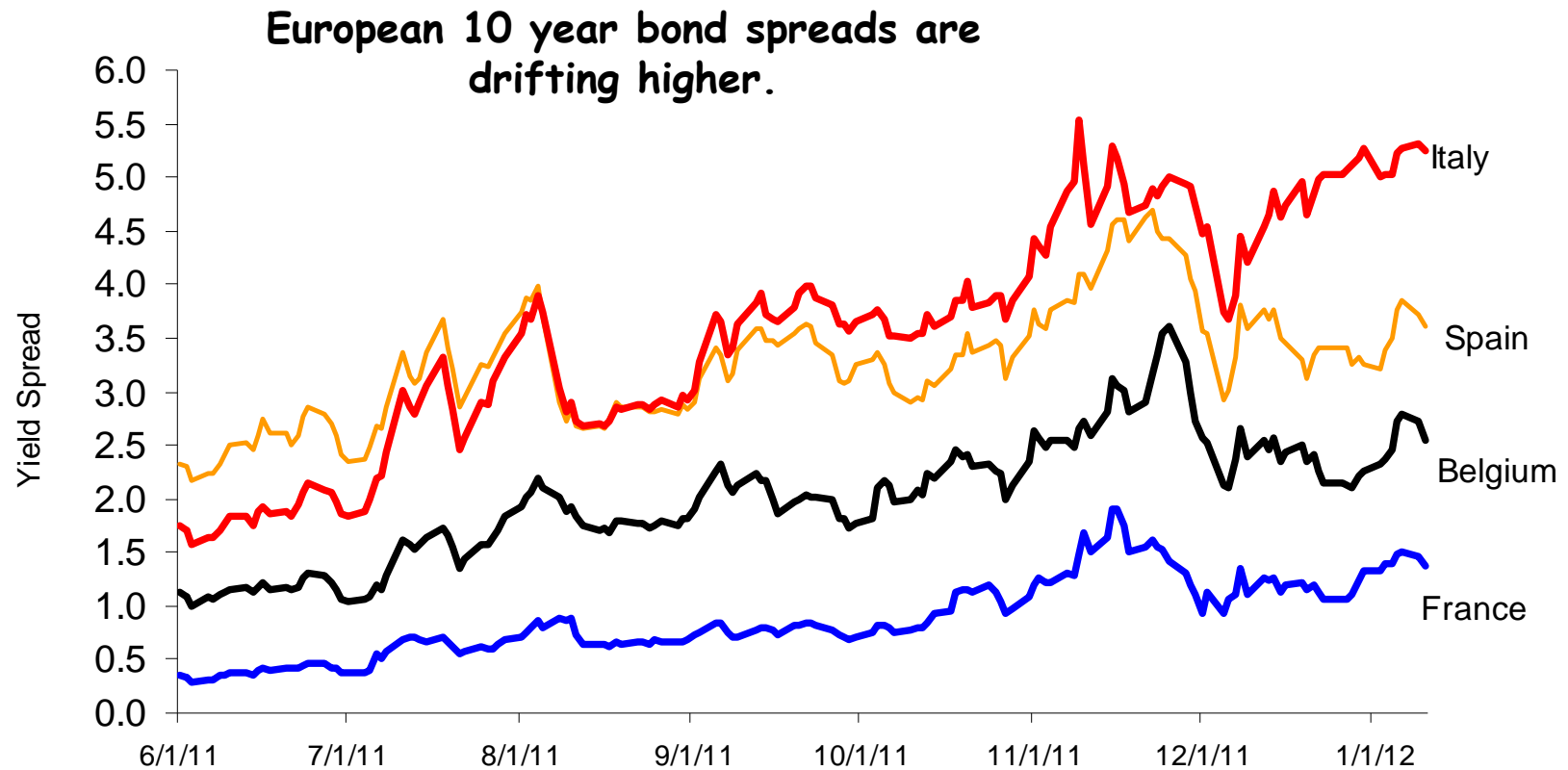
(\$ billions, last obs. December 2011)

	Assets	Liabilities	Equity capital	Market capital	debt/eq	MC/Equity
Deutsche Bank	2,572	2,504	68	34	37	0.5
Commerzbank	1,018	979	39	8	25	0.2
Barclays	2,354	2,255	98	32	23	0.3
BNP	2,697	2,581	116	46	22	0.4
Unicredit	929	862	68	15	13	0.2
JPM	2,117	1,941	176	116	11	0.7
GS	911	833	78	47	11	0.6
BAC	2,265	2,036	228	59	9	0.3

Source: Bloomberg

Selected European 10 Yr Yield Spreads

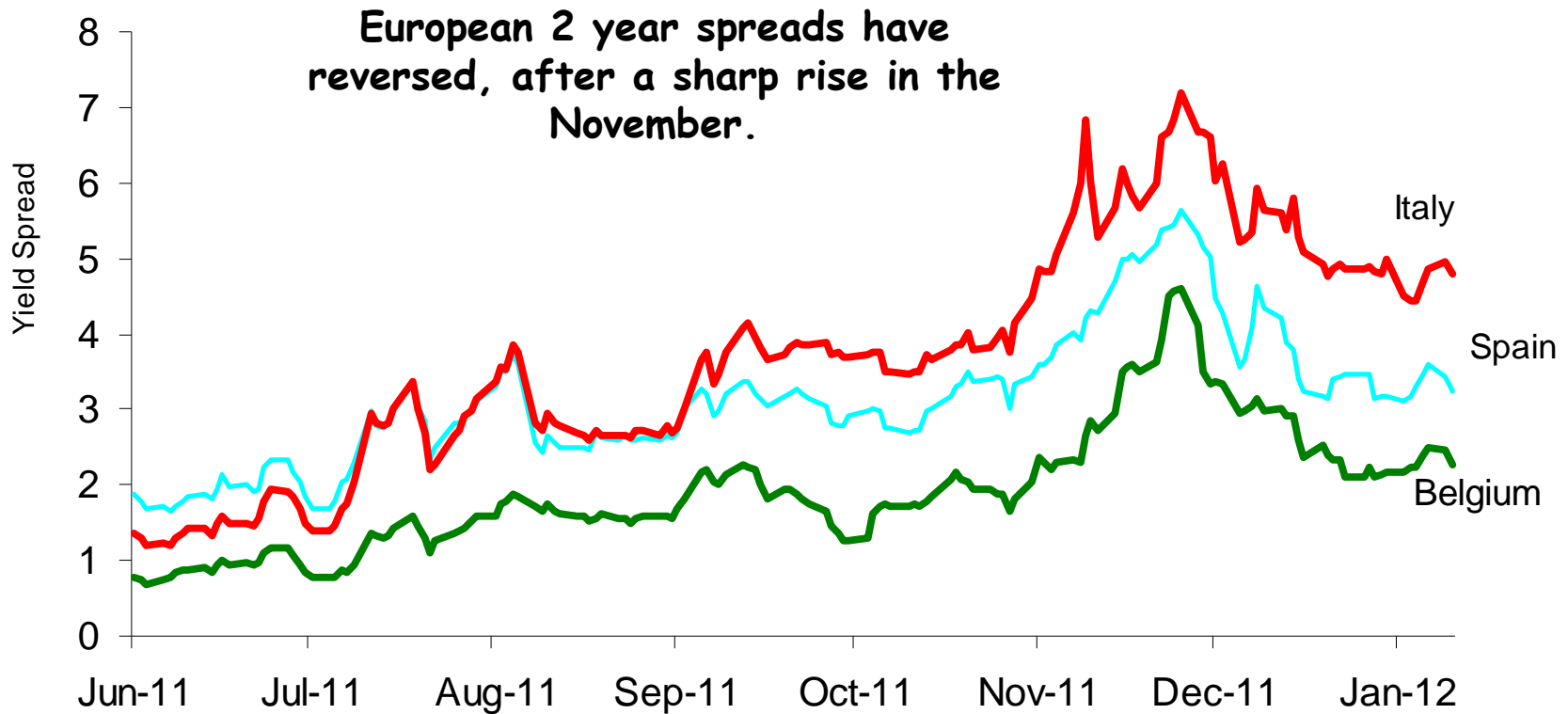
(last obs. January 10, 2012)



Source: Bloomberg; Encima Global

Selected European 2 Yr Yield Spreads

(last obs. January 10, 2012)



Source: Bloomberg; Encima Global

US \$ / Euro

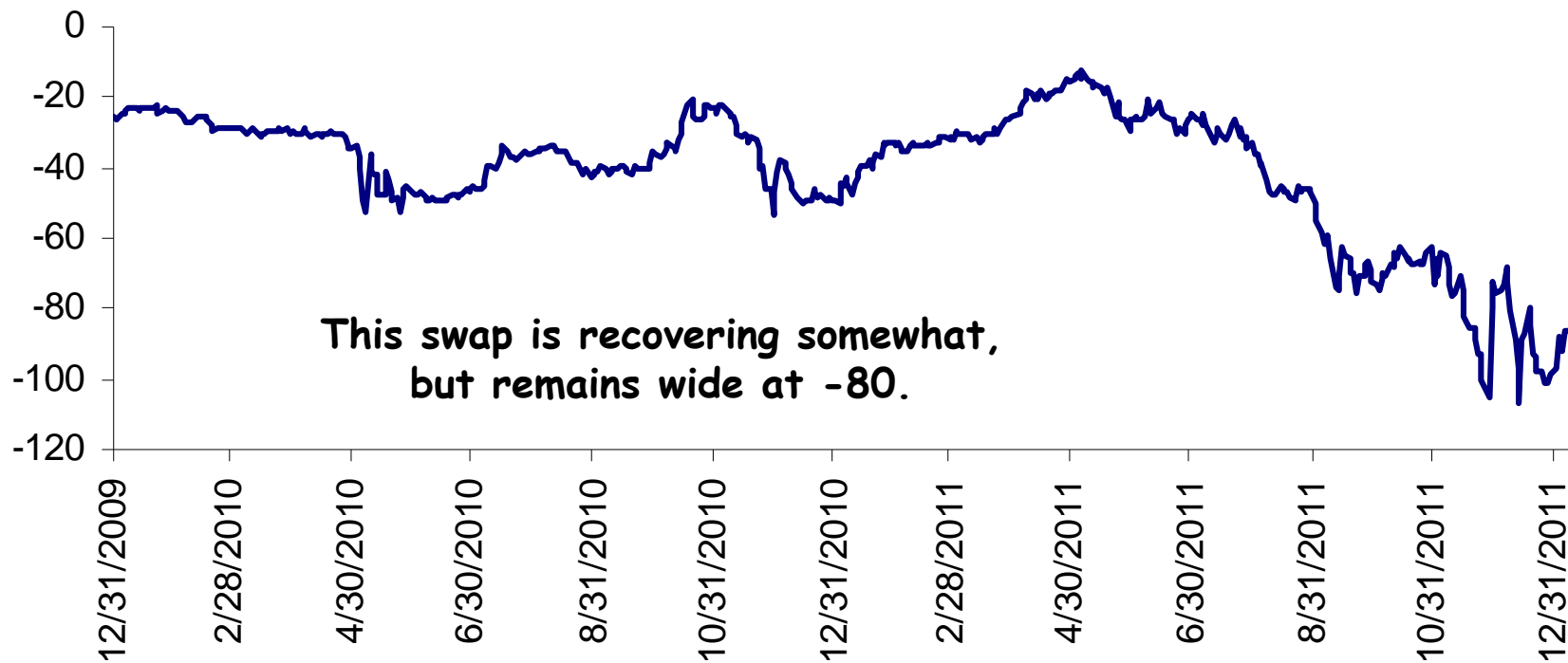
(last obs. January 4, 2012)



Source: Wall Street Journal; Encima Global

Euro Basis Swap 1 Year

(last obs. January 10, 2012)



Source: Bloomberg; Encima Global

3 Mo Euribor less OIS Spread

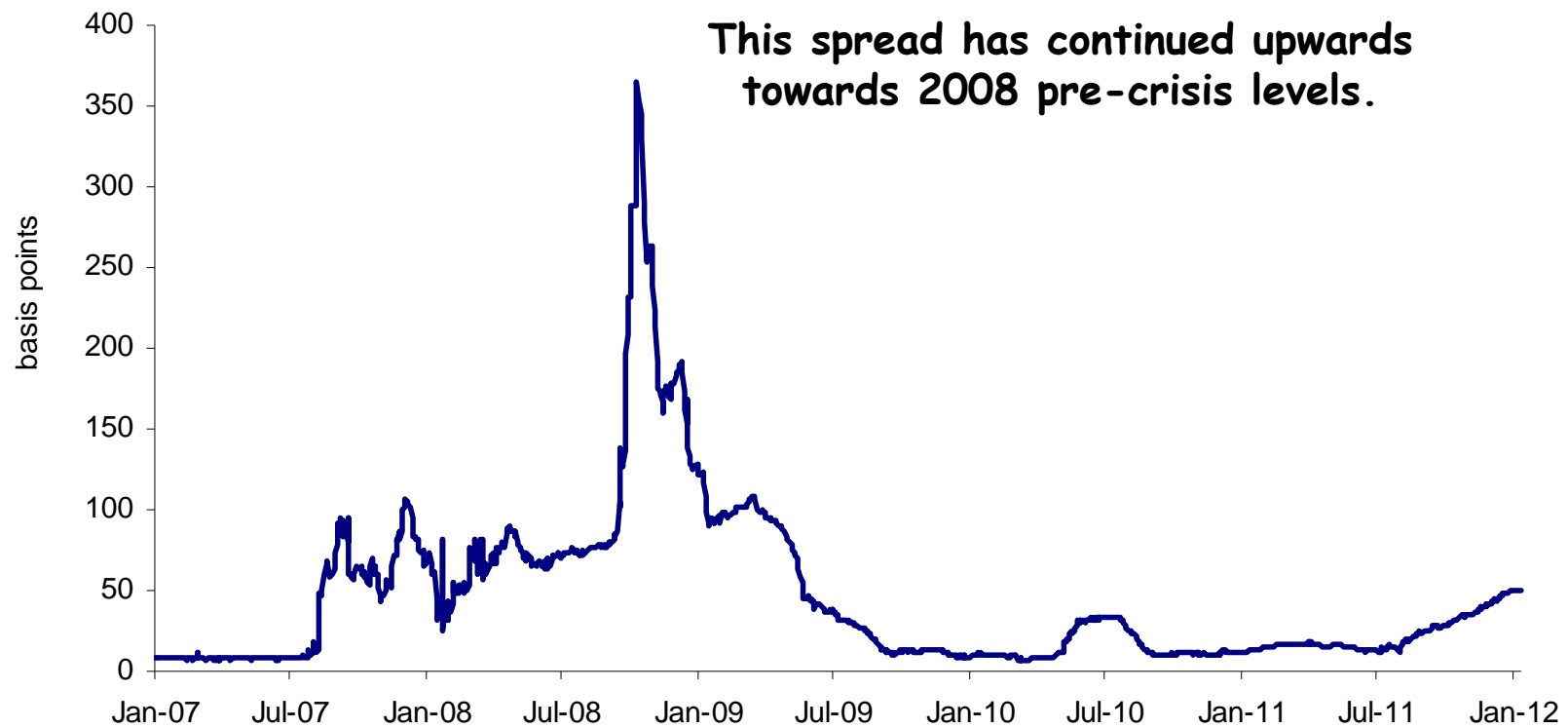
(last obs. January 10, 2012)



Source: Bloomberg; Encima Global

3 Mo Libor less OIS Spread

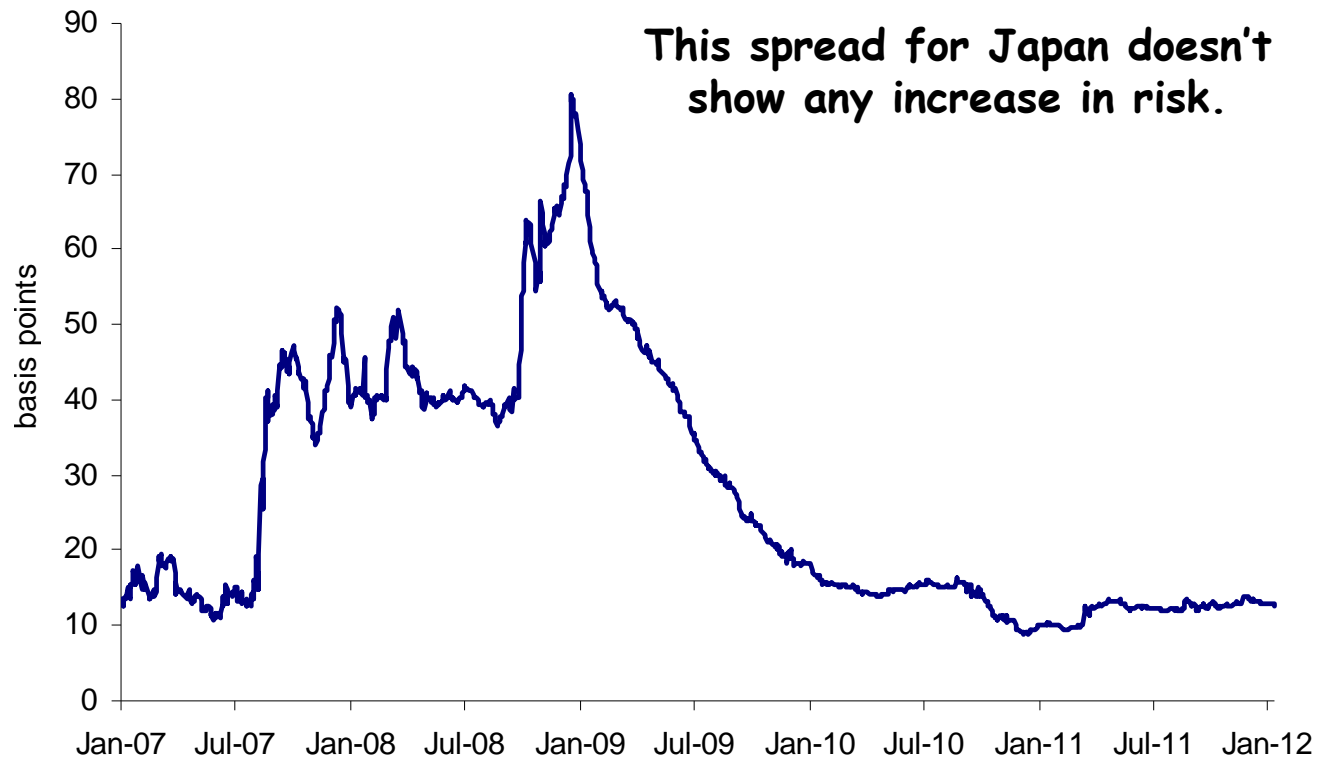
(last obs. January 10, 2012)



Source: Bloomberg; Encima Global

3 Mo Libor less OIS Spread for JPY

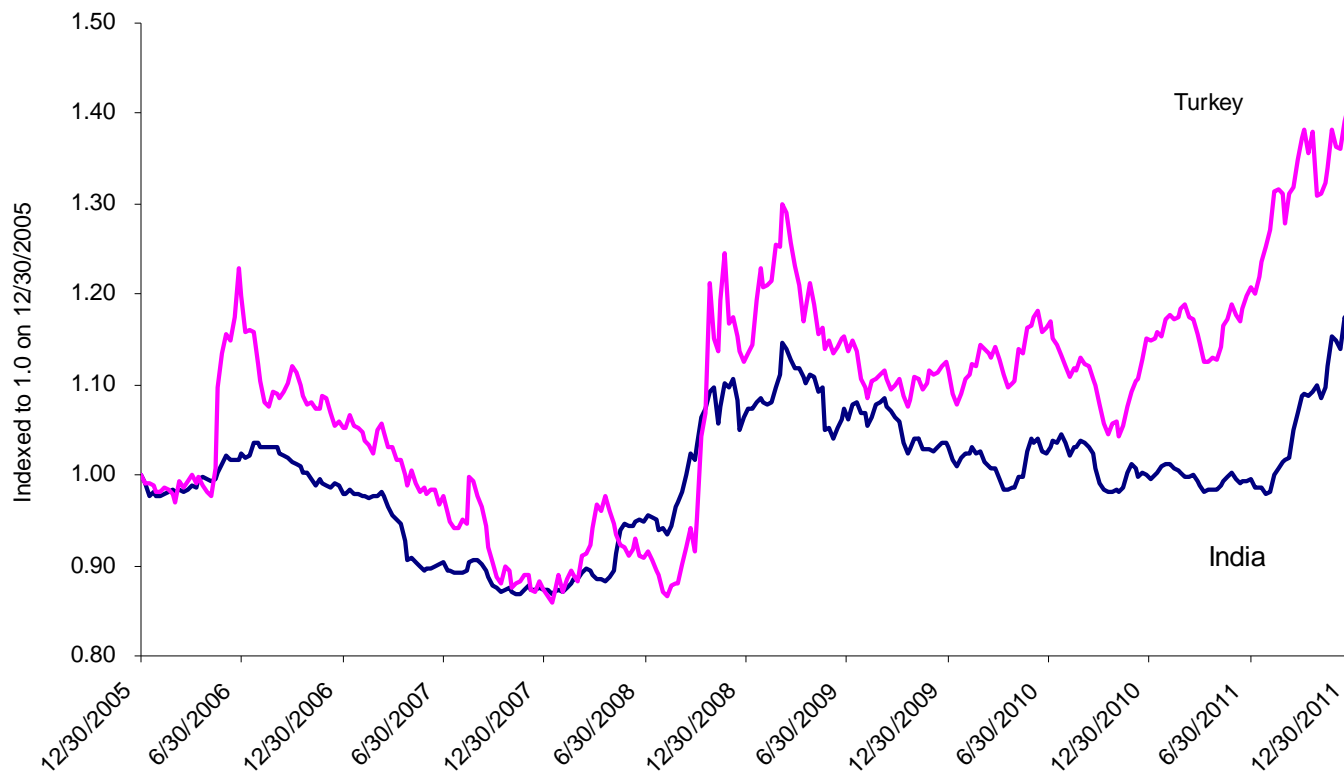
(last obs. January 10, 2012)



Source: Bloomberg; Encima Global

Turkey and India Currencies Weakening

(Indexed = 1.0 on 12/30/2005, last obs. January 10, 2012)



Source: Wall Street Journal; Encima Global



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