David Malpass
with Wing Chow
212-876-4400
dmalpass@encimaglobal.com
October 31, 2011

Outlook: U.S. and Europe To Slow

Last week's Europe developments got a good reception from equities but not from European bond markets where yields have continued rising in the periphery as growth and fiscal expectations deteriorate. Separately, U.S. third quarter growth was in line with our 2.5% expectation, but **we don't think growth in GDP or corporate earnings will be able to hold up in coming quarters under current policies.**

- While some August and September U.S. data improved from Japan-related weakness in the second quarter, **we don't think data yet reflects the negative inflection point in August from the sharp U.S. fiscal and monetary policy deterioration and the many setbacks in Europe's debt crisis policies.**

- More recent developments have confirmed the U.S. drags: very weak income growth; a U.S. budget policy impasse that is likely to keep blocking tax reform and spending restraint; another weak mortgage refinancing program; the regulatory onslaught against banks; and the Fed's anti-growth Operation Twist (buying long-term Treasuries at peak prices with the effective maturity of the national debt already short.) Consumer and business confidence have remained low. Job growth and hours worked have remained weak, though they tend to lag.

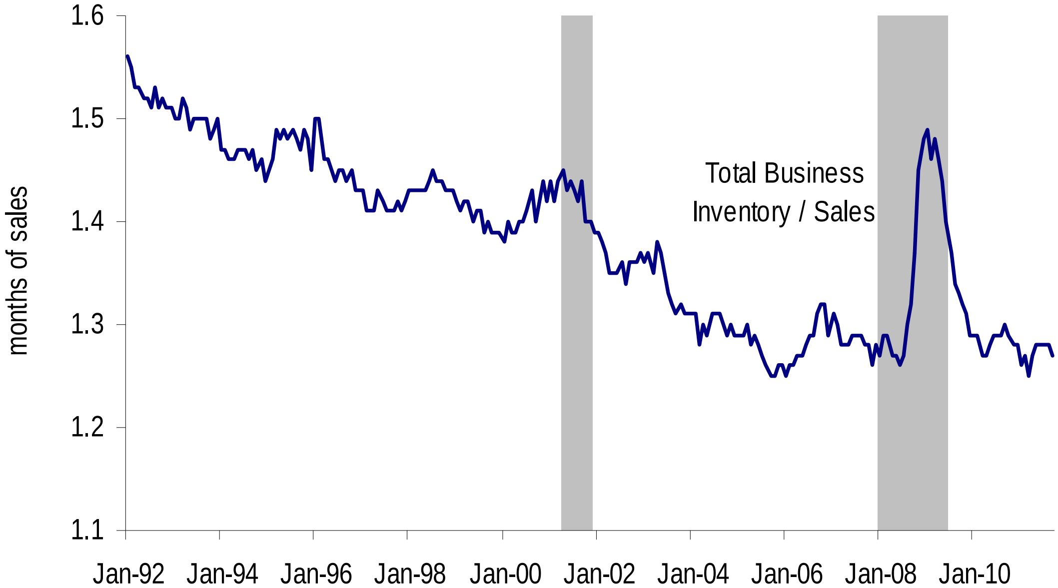
- Europe's summits stopped the October crisis, but haven't solved the underlying problems. France's spread to bunds is widening again. Italy's 5-year euro yield rose to a record high 5.9% today, responding to internal dissension over structural reforms and dependence on Berlusconi. We note other weak points in Europe's latest plan, including the German high court's October 28 injunction limiting ESFS operations, China's trade demands, Spain's worsening fiscal condition, heavy 2012 debt rollovers in the periphery, no sign that the ECB will help on Thursday with a rate cut or stepped up bond buying (see Trichet's "I told them so" interview this morning), the unworkability of the bank recapitalization plan, and the clear risk that the proposed debt forgiveness terms for Greece will undercut structural reforms in other countries. Regarding Greece, the debt restructuring leaves a heavy burden since Greece's large debts to the ECB and IMF aren't reduced and some of the debt haircut hits Greek pension funds and banks. Papandreou's majority is tenuous.

Outlook

On the positive side, the equity market's October surge, earnings growth and the recent tightening in credit spreads argue that GDP is still growing (equities began falling in 2000 and 2007 just before recessions began.) It looks like October auto sales gained some from September and auto production plans are holding up in Q4.

- Many companies are preparing for a decent Christmas season. Third quarter GDP data showed continued growth in consumption and a negative inventory contribution, which should help fourth quarter growth.

Inventory / Sales Ratio (last obs. August 2011, estimated for September 2011)



Source: Census Bureau; Encima Global

- At 402,000, jobless claims aren't sending a clear signal – they normally rise before a recession. Compared to the size of the labor force, the level of claims is consistent with employment growth in early phases of past expansions, and we're expecting some improvement in job growth in coming months.

Initial Claims as a % of Employment (last obs. October 22, 2011)

Source: Bureau of Economic Analysis; Encima Global

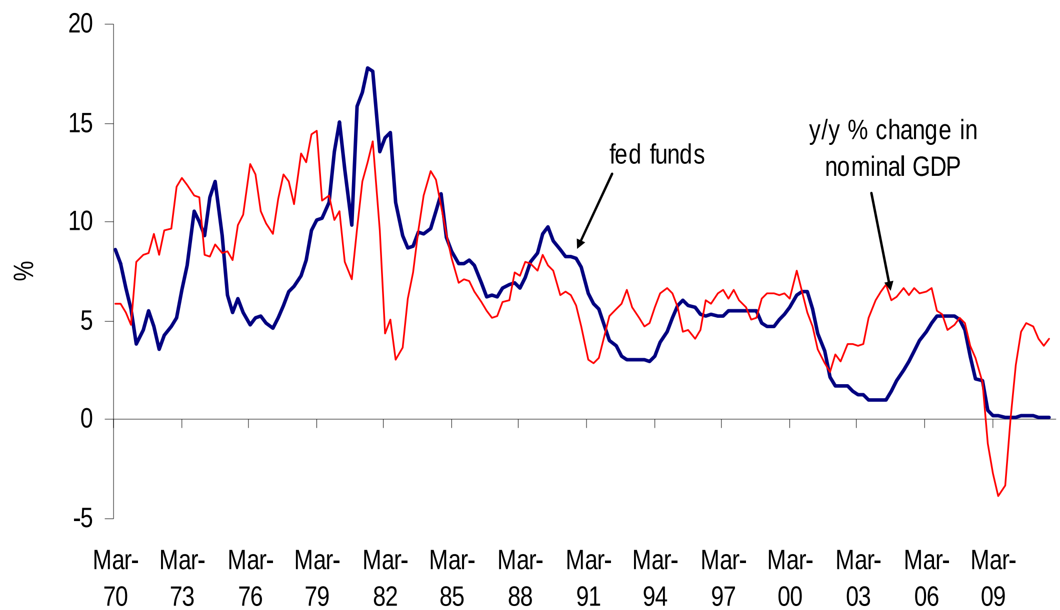
- We don't agree with the more deeply negative views that the consumer is tapped out or that economies are destined to grow slowly after a deep financial crisis due to deleveraging -- economies are flexible and credit growth isn't as critical to GDP growth as it's made out to be. We also don't agree with the view that the Fed printed so much money that the dollar will crash or that fast inflation is just around the corner.

On the negative side, federal policies on spending, taxes, interest rates and regulations have created massive friction in the economy, hurting confidence and slowing growth. We think these problems will continue in the fourth quarter and may get worse.

- On the fiscal side, the Super committee is unlikely to make progress on spending restraint. Legislative fights are likely over the stop-gap spending bills and extending the 99 week federal unemployment insurance and 2% cut in the payroll tax. The next debt limit increase is approaching fast (early 2013) with another bond rating downgrade likely before then under current policies.

- We think the Fed's near-zero interest rate and asset purchases are not appropriate policies, especially not at this point in an expansion -- nominal GDP growth reached 4.1% year-over-year in the third quarter (5% QoQ annualized), a divergence from nominal GDP that has only occurred in the 1970s and the early 2000s, with grim consequences.

Fed Funds and Nominal GDP Y/Y (last obs. Q3 2011)



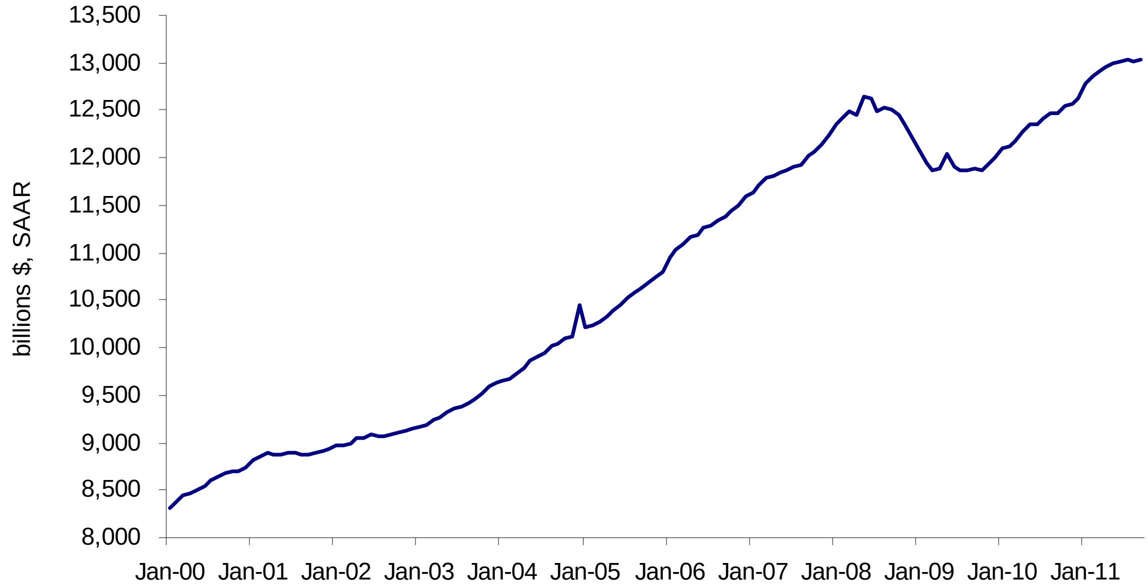
Source: Bureau of Economic Analysis; Encima Global

Recent Data

- With many people exhausting their 99-week unemployment insurance checks, personal income growth has all but stopped, gaining only 0.1% in September after a

-0.1% decline in August. In the third quarter, personal income gained 0.1%. Wages and salaries (51% of PI) added 0.5% while transfer payments (18% of PI) fell 1.1%.

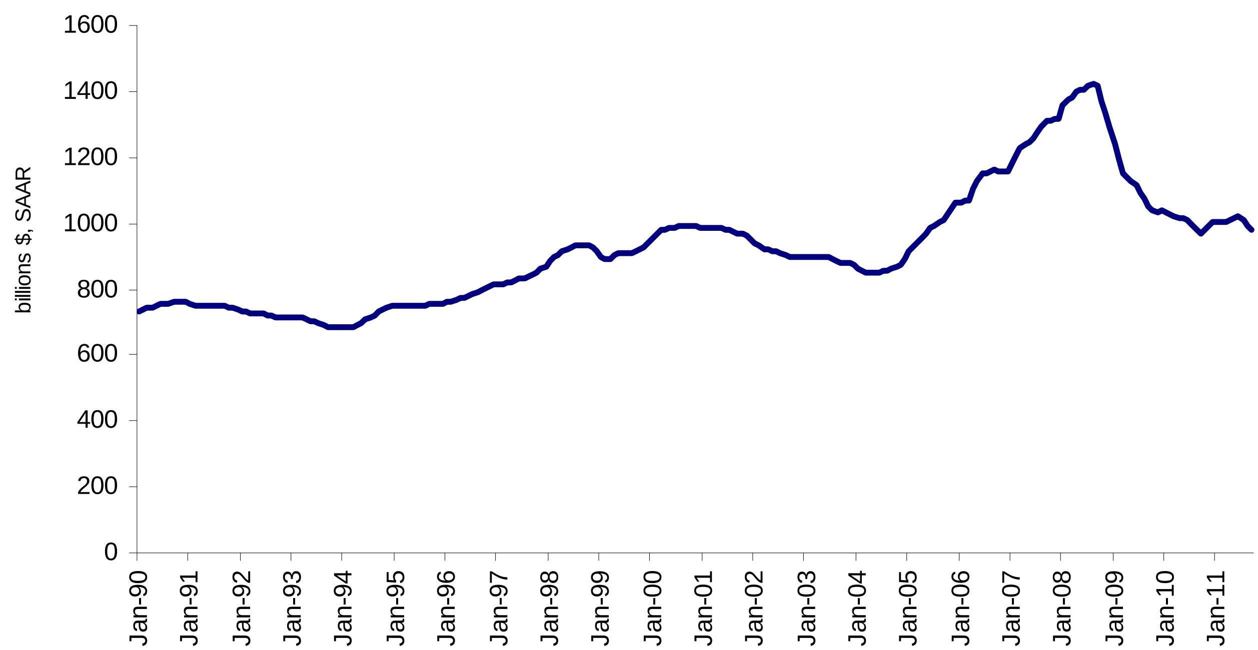
Personal Income (last obs. September 2011)



Source: Bureau of Economic Analysis; Encima Global

- Interest income (7.5% of PI) fell 4% in Q3 or $40 billion due to near-zero rates. .

Interest Income (last obs. September 2011)

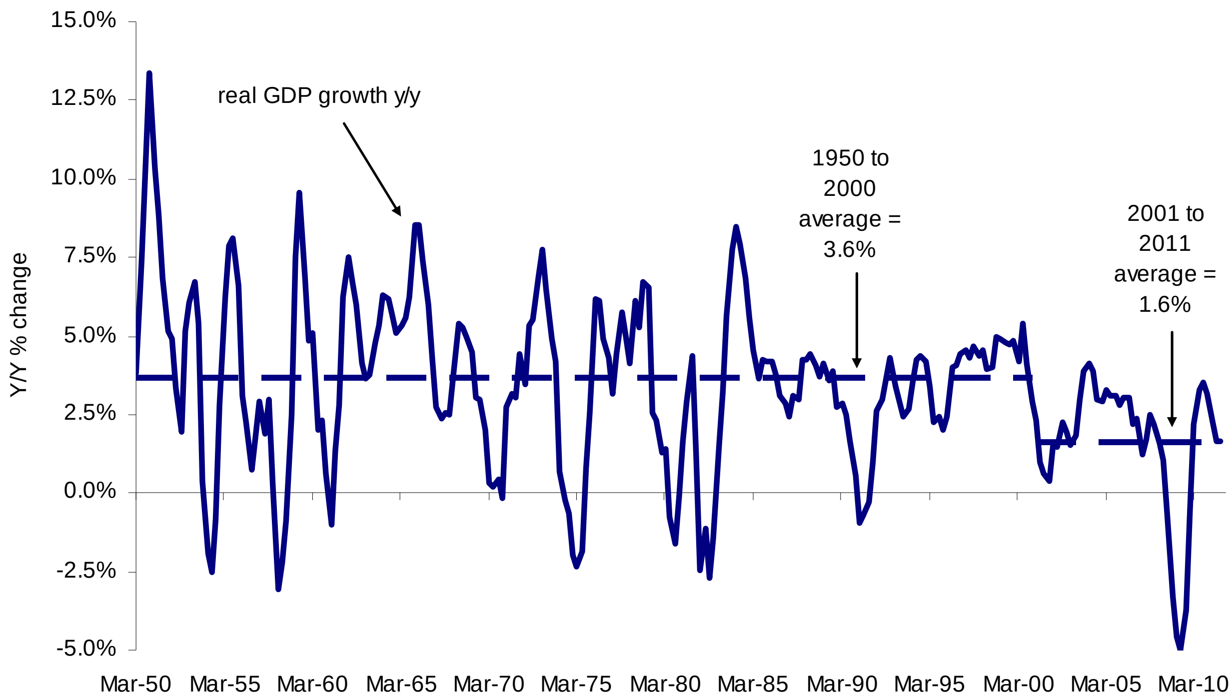


Source: Bureau of Economic Analysis; Encima Global

- U.S. third quarter real GDP growth was in line with our 2.5% expectation, up from 1.3% in Q2 and 0.4% in Q1 (quarter over quarter annualized). Sentiment got overly negative in July about a double dip recession and systemic risk. We expected the third quarter GDP improvement based on auto production recovering from the Japan supply disruptions, QE2 ending without much disruption, the debt problems in the U.S. and Europe getting pushed into 2012, and China avoiding a hard landing (see Look Past Wall of Worry To Stronger Second Half Growth on July 20.)

- On a year-over-year basis, real GDP was up a weak 1.6% in the third quarter, the same as the 2001-2011 average (and well below previous decades.)

Real GDP Y/Y (last obs. Q3 2011)



Source: Bureau of Economic Analysis; Encima Global

- Looking forward, we expect a slowdown based on the negative inflection point in policy. We lowered our Q4 GDP forecast to 1% on October 7 on the view that hiring and business investment will weaken and autos won't add nearly as much in Q4 as in Q3. There's a lot of data coming out this week and we may have to raise the fourth quarter forecast while still looking for a shallow recession in 2012 in the U.S. and northern Europe as the recession in southern Europe deepens and China slows toward 8% growth.