

Rebuilding Confidence

Equities have been gyrating under the combined confusion from the uninspiring debt limit deal, the S&P downgrade, Europe's slow-motion bailout and the disastrously gold inflating FOMC statement threatening two more years of near-zero rates and the use of "the range of policy tools available to promote a stronger economic recovery."

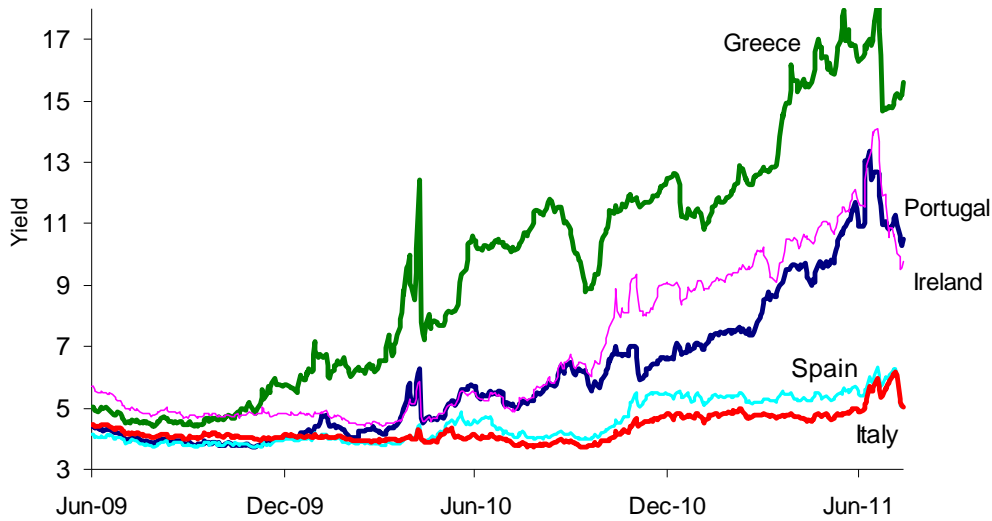
Gold Prices (last obs. August 11, 2011)



Source: Wall Street Journal; Encima Global

We emphasize the importance of the progress in Europe. It's gotten lost in the U.S. downgrade and the market turmoil. The ECB started purchasing Italian and Spanish bonds on Monday, a parallel to the Fed's critical MBS purchases in 2008-2009. Italy's 10-year yield fell briefly below 5% this morning for the first time in over a month. There is German and French cooperation on parliamentary approvals of the EFSF expansion and a European focus on rules to restrain momentum selling strategies. If Europe creates a parallel mechanism to the ECB bond buying (like an expanded EFSF) that can issue euro-zone bonds to buy higher-yielding sovereign bonds, we think it will stop the contagion spiral – though GDP growth will still require growth oriented structural reforms.

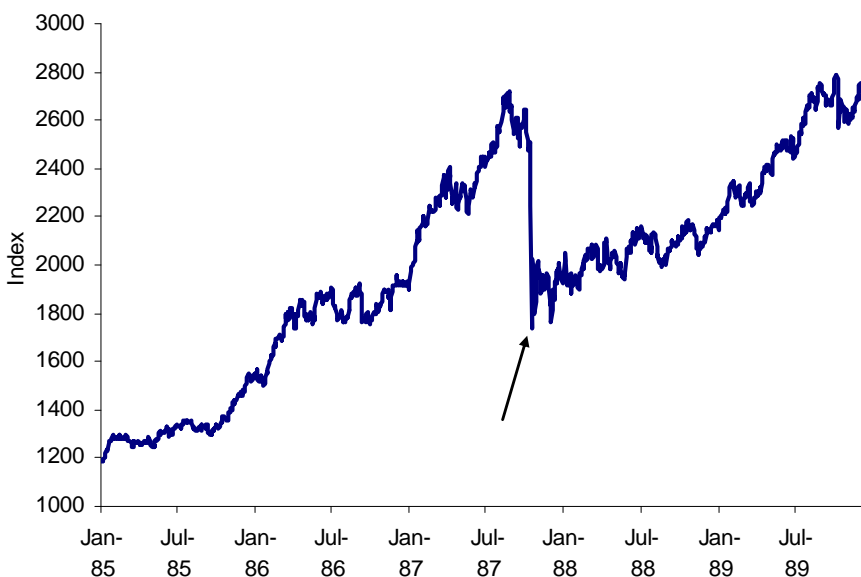
Select European Yields (last obs. August 11, 2011)



Source: Bloomberg; Encima Global

We think it's more like the 1987 equity crash than the 2008 crash. In the current turmoil, there's no equivalent to the Lehman bankruptcy filing (that immediately paralyzed interbank and commercial paper markets worldwide) or the federal takeovers of AIG, Fannie and Freddie. Though several of the market problems operating in 2008 and 2009 haven't been fixed – naked non-transparent CDS, momentum-driven bond ratings and regulatory capital requirements, the weak dollar policy -- central banks have much more powerful tools and facilities to deal with bank funding problems than in 2008.

Dow Jones Industrial Average (1985 to 1989)



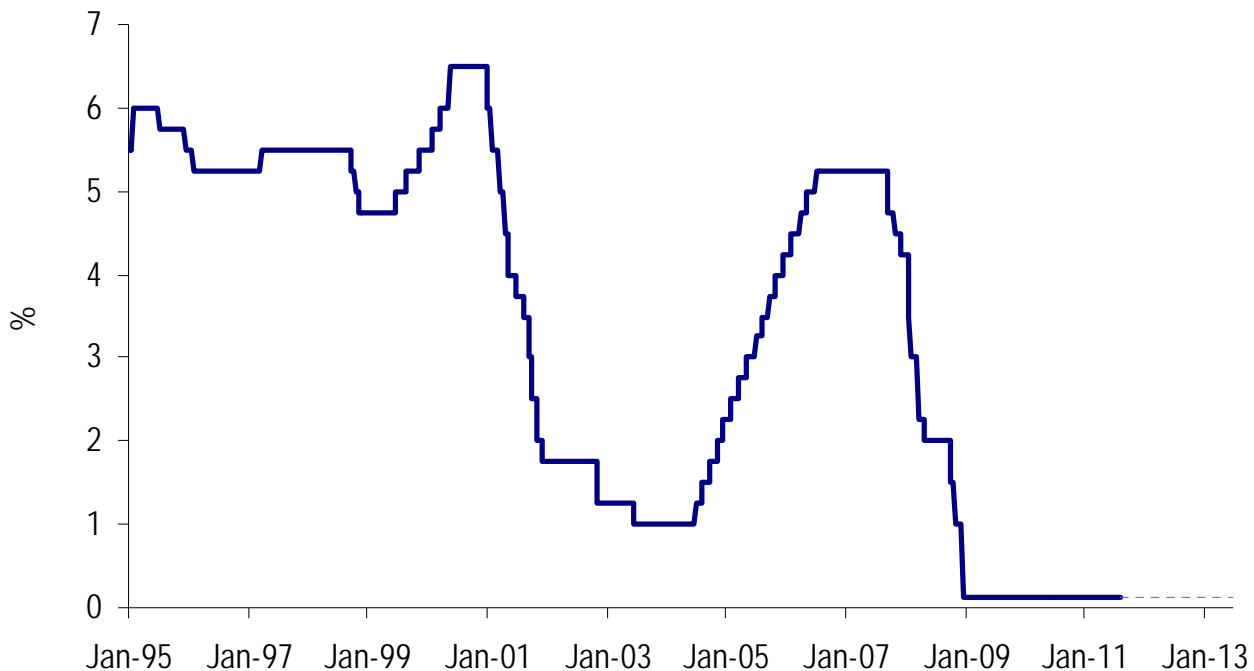
Source: Bloomberg; Encima Global

We expect reasonable growth in the second half based on auto production, corporate profits, growth abroad, business investment and some job growth. Today's jobless claims declined to 395,000 in line with our expectations. July auto sales were solid. The July jobs report showed wage gains that point to a pick up in personal income. We think Japan's catastrophe slowed second quarter global growth substantially. We expect some of Japan's rebound to spread into second half global growth. China's July import and export data were strong. We're maintaining our 2% third quarter U.S. GDP forecast with a further strengthening in the fourth quarter to 3.5%.

We note the negative sentiment in 2010 at the end of the soft patch, with widespread forecasts of a double dip recession. We think growth and corporate profits drove the subsequent equity market surge – though the Fed claimed it as a QE2 success but not the commodity surge or the CPI bulge.

The Fed's dangling of QE3 on Tuesday was a distinct negative. It locks the Fed into negative real interest rates for two more years harming growth, savings and investment. To the extent that it flattens the yield curve (we're skeptics on that), it will hurt bank profitability at a time when it is most critical.

Fed Funds Rate Target (last obs. August 11, 2011)



Source: Federal Reserve; Encima Global

The FOMC statement highlighted the risk of deflation (Bernanke’s permanent concern despite the 3.6% CPI inflation rate) and, simultaneously, the risk of inflation from an inflated Fed balance sheet and near-zero rates. It pushes investors into the anti-growth “barbell trade.” Investors have to buy bonds to protect against deflation and gold to protect against inflation, leaving less capital for growth. We think both bonds and gold are in a massive bubble if policy improves or fear abates.

U.S. Treasury 10 Yr bond yields (last obs. August 11, 2011)



Source: Wall Street Journal; Encima Global

Amid market turmoil, we think government actions will be important in rebuilding confidence and animal spirits. Uncertainty over dilution from regulatory capitalization levies is weighing heavily on banks and lending. We think any Administration proposals on clearer bank regulation, spending cuts or growth-oriented tax reform would be well received by markets. Absent presidential leadership, gridlock puts the U.S. at a disadvantage to parliamentary systems more able to cut spending and improve regulation.

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