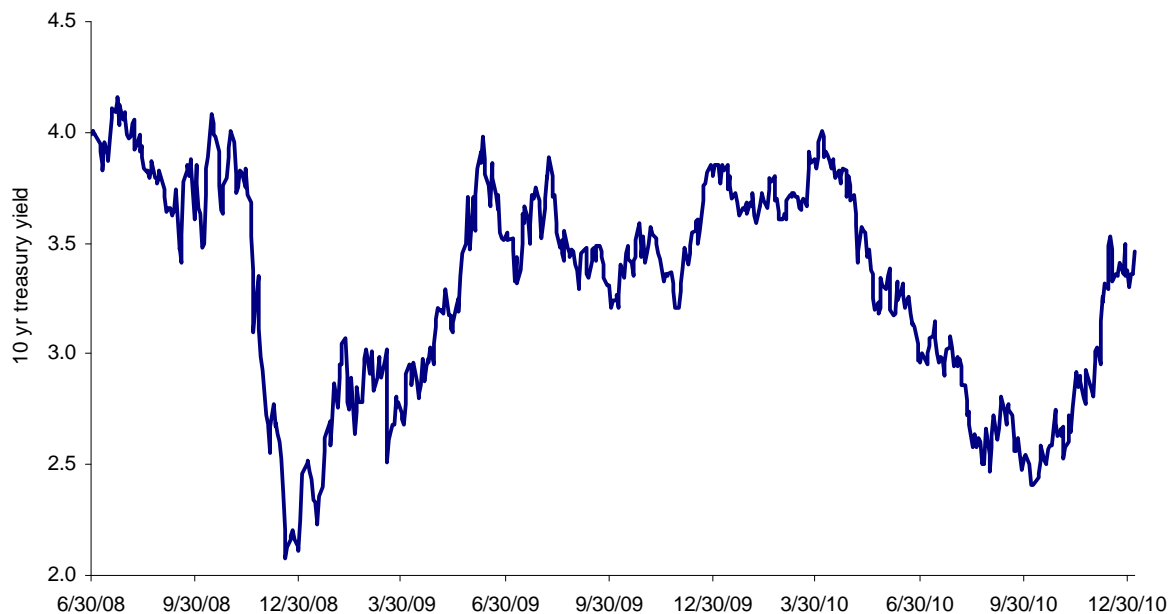


Strong Economic Data; Markets Doubt Monetary and Fiscal Restraint

Bond prices lost more than equities gained today after this week's strong economic data – ADP and ISM services today, auto sales yesterday, ISM manufacturing on Monday. The TIPS inflation spread has continued to rise over the last three months. We think markets are signaling that they have more concern about rising inflation than confidence in Washington's ability to carry out much-needed fiscal and monetary policy restraint.

10 Year US Treasury Bond Yield (last obs. January 5, 2011)



Source: Federal Reserve; Encima Global

- The minutes from the FOMC's December 14 meeting gave no indication that the Fed would take its foot off the gas pedal. The Fed's goal seems to be to cause nominal GDP to race. Our December 22 outlook piece predicted that we'd break through 5.5% nominal GDP growth yoy at some point in 2011 (currently 4.5%). That seemed aggressive at the time but already looks tame – 6% nominal GDP is coming into view. The 10-year Treasury yield (currently 3.5%) reached 4.5% back in 2004 when that expansion reached 6% nominal growth.
- As the economic acceleration becomes clearer, we think global policies will shift further toward fiscal and monetary restraint, including the U.S. If this pans out, it points to a stronger dollar, weaker commodity prices, lower U.S. bond yields after the latest run-up,

and a reallocation of equity investment away from commodities and materials, toward the U.S. and non-commodity emerging markets, and toward growth. This may happen in the first half of 2011 if the U.S. begins to make aggressive structural improvements.

- Key in triggering this regime shift is an early wind-down of QE2 and actual Congressional spending cuts. The market is justifiably skeptical of both. If they happen (our view), there will be a dramatic improvement in the global investment climate, especially for U.S. jobs and domestic companies. We note years of one-way investing away from the U.S. and toward commodities, which have lately benefited from ETFs, global unease, the Fed's irrational expansionism, and China's 2009-2010 bank lending spree.

Why Expect Any U.S. Monetary or Fiscal Restraint?

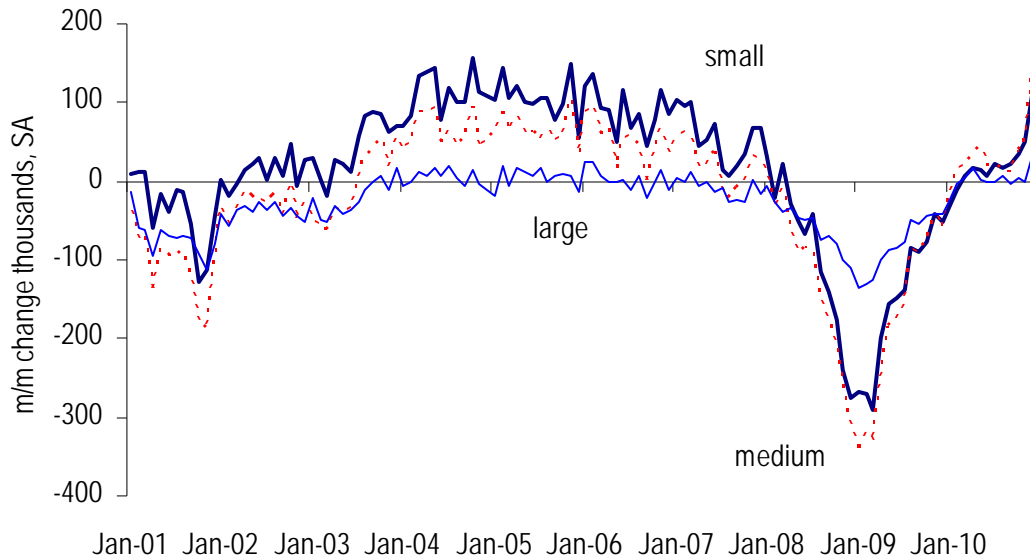
- Lots has changed since the FOMC's December 14 commitment to QE2. The evidence of U.S. economic acceleration is much clearer. Congress presided over blow-out spending late in December, which the Fed may take into account as fiscal stimulus. Evidence of inflation is mounting worldwide. The FOMC is risking two and possibly three dissents over QE2 at its January 26 meeting.
- On the fiscal side, Congress will have two concrete shots at fiscal restraint while still fresh off the November election. The March 4 continuing resolution now looks like it will be short-term and will push spending levels back to FY2008 rates. And the required debt limit increase in April or May is ideal for the House to force structural spending restraint on the Senate and the President if communicated well.

ADP Shows Leap in Jobs; ISM Data Shows Growth With Inflation

The ADP data released January 5 showed a gain of 297,000 private sector jobs in December versus a 100,000 consensus expectation. The ADP data is showing a break-out in job growth, which may reflect an awakening of small business.

- Over the last six months, the Labor Department's establishment survey has been stronger than ADP by roughly 56,000 per month, so some of the ADP surge may already have been reflected in the payroll data. Jobless claims have already dropped (though there may be retracement tomorrow). In the November data, the establishment survey was 42,000 below ADP, but even so, ADP and jobless claims data point to stronger job gains in Friday's release of the December jobs data than the 165,000 consensus.

ADP Job Gains by Firm Size (last obs. December 2010)



Source: ADP; Encima Global

- Most of the ADP job gains in all three size categories came from the services sector.

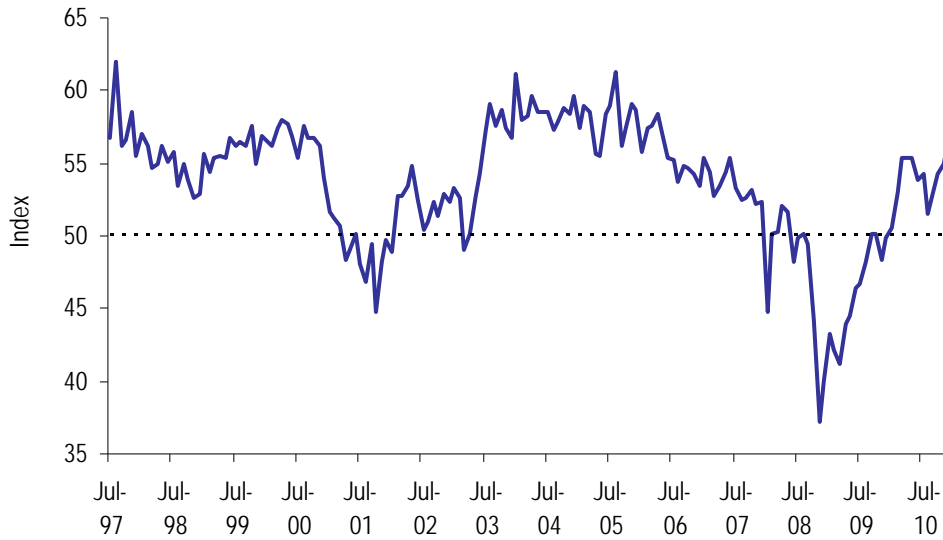
ADP Job Gains by Sector and Firm Size (last obs. December 2010)

| Size | Sector | | Total |
|--------------|------------|-----------|------------|
| | Services | Goods | |
| Small | 120 | -3 | 117 |
| Medium | 123 | 21 | 144 |
| Large | 27 | 9 | 36 |
| Total | 270 | 27 | 297 |

Source: ADP; Encima Global

- ISM non-manufacturing came in at 57.1 in December and has stayed above 50 since January 2010.

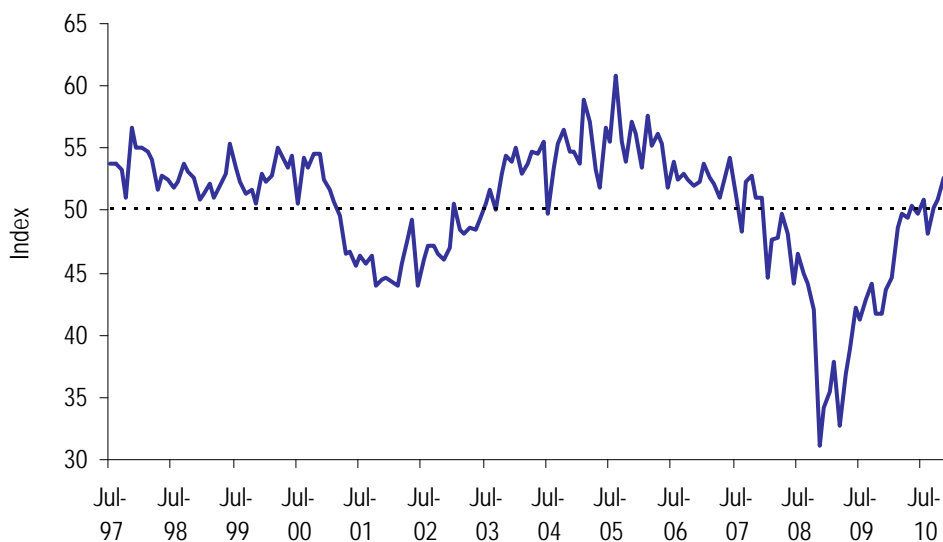
ISM Non-Manufacturing (last obs. December 2010)



Source: ISM; Encima Global

- ISM non-manufacturing employment declined to 50.5. It is not showing the improvement seen in initial claims and ADP. This may reflect the big-business nature of the ISM indices, whereas ADP and jobless claims both give more weight to small business hiring.

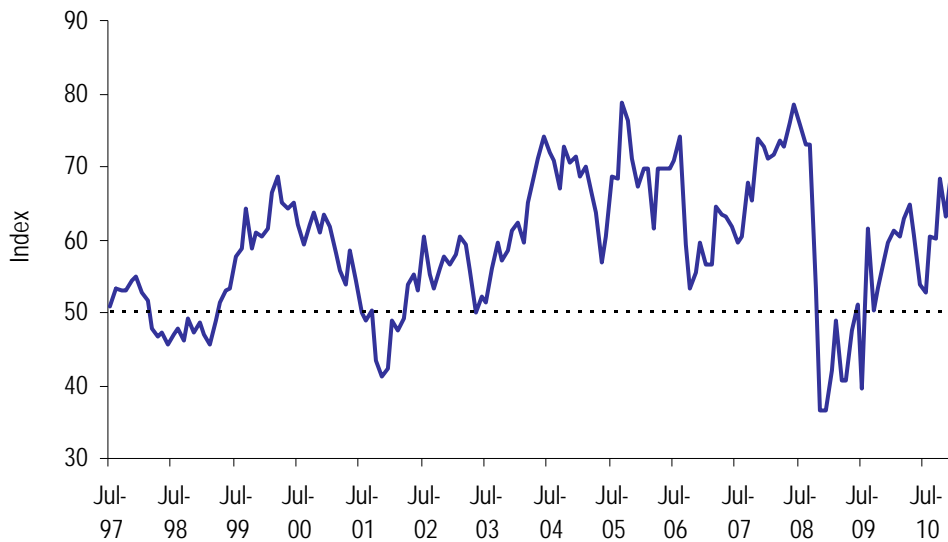
ISM Non-Manufacturing Employment (last obs. December 2010)



Source: ISM; Encima Global

- ISM nonmanufacturing prices rose to 70, a new high for this cycle.

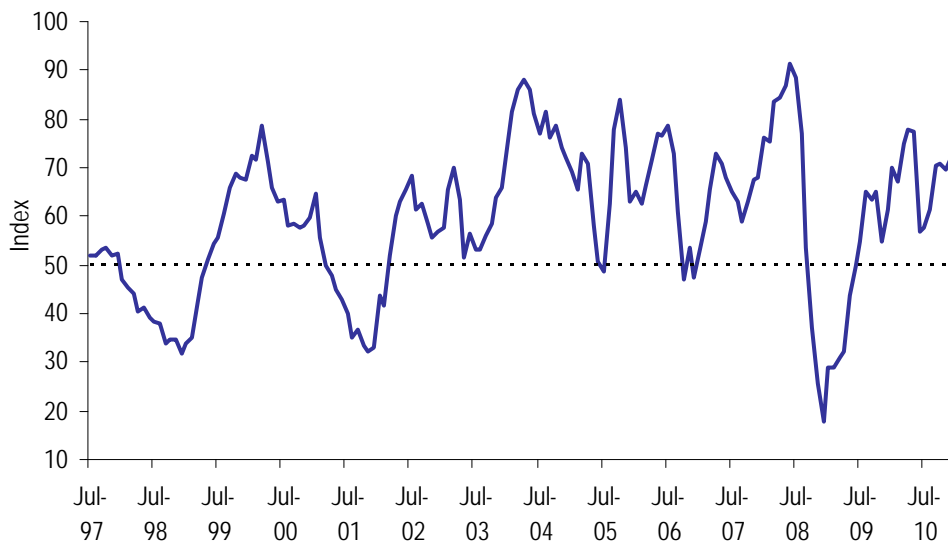
ISM Non-Manufacturing Prices (last obs. December 2010)



Source: ISM; Encima Global

- The ISM manufacturing prices remains elevated at 72.5.

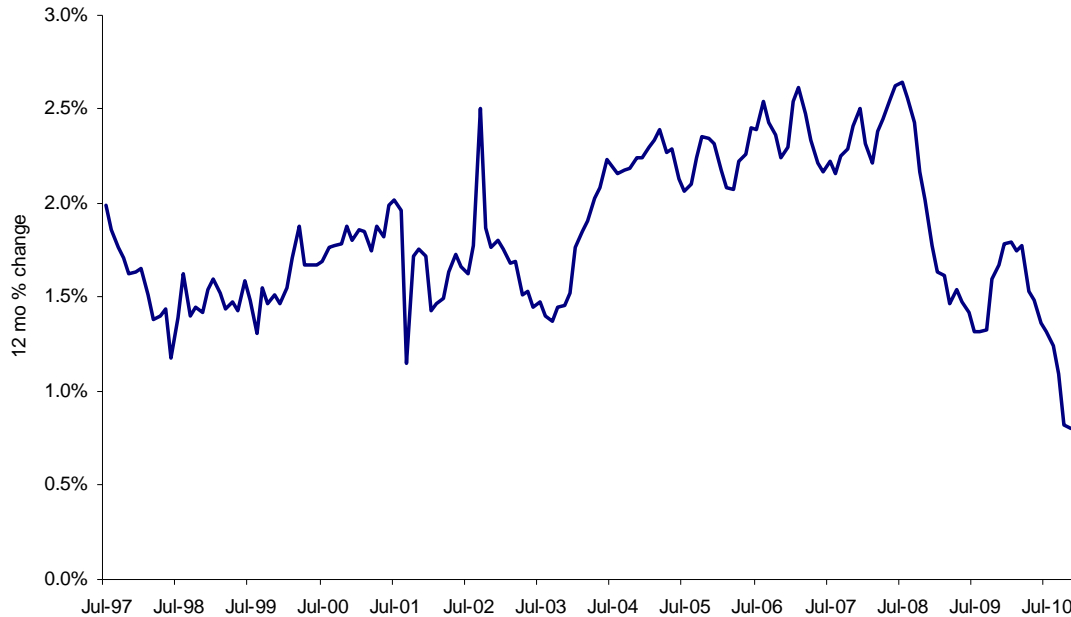
ISM Non-Manufacturing Prices (last obs. December 2010)



Source: ISM; Encima Global

- From 2003 to 2008 when the ISM prices indices stayed around 70, the core PCE deflator stayed well above 2% year-over-year.

Core PCE Deflator (year-over-year, last obs. November 2010)



Source: Bureau of Economic Analysis; Encima Global

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