

April 15, 2011

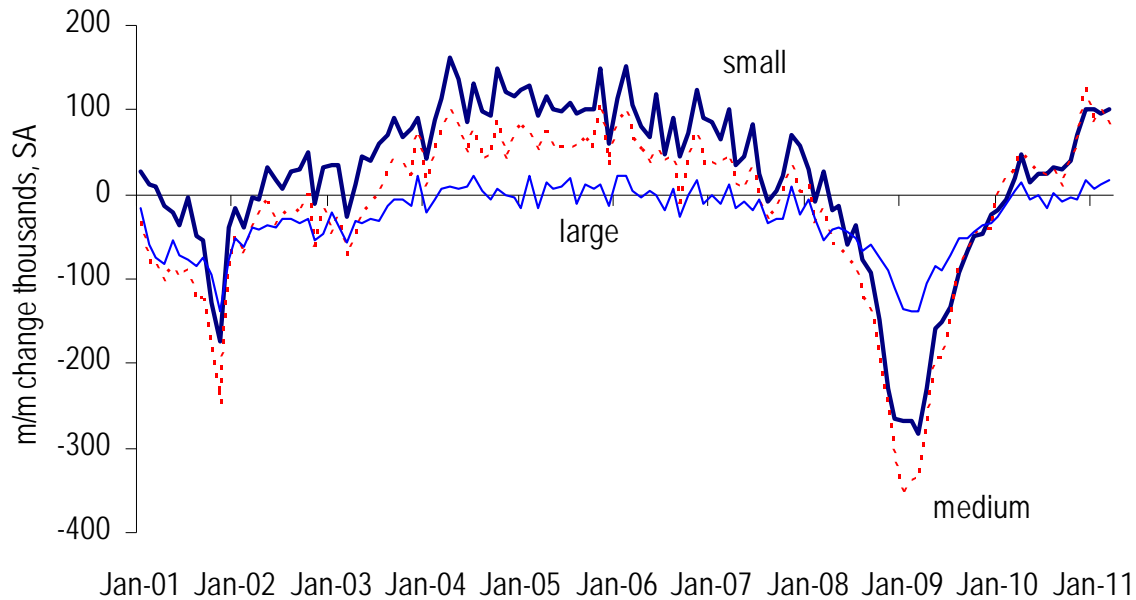
Tall Wall of Worry; Good Second-Half Outlook

The basic U.S. policy has been to kick the can hard down the road.

- Contrasting with most of the rest of the world, the U.S. government has been practicing belt-loosening (increased federal deficits and mandates) rather than belt-tightening. This has been supported by the Federal Reserve's massive debt buy-backs and the maintenance of near-zero interest rates, which hold down government and corporate borrowing costs.
- It's a harmful policy that bothers nearly everyone. Small businesses won't hire during uncertainty. Savers don't like the low interest rates. Banks don't like the regulators' system of credit rationing. The Fed has complained loudly about fiscal policy. The buildup of debt on future generations is despised. **But can-kicking will probably leave economic and market trends intact -- we think it will allow an expansion past the 2012 presidential election.**
- An influential and cautious market pundit put the negative case this way today: "With the fiscal and monetary stabilizers soon to be taken off, I remain less optimistic that the economy can deliver smooth and self-sustaining growth without government assistance." We don't agree -- we think loose fiscal and monetary policy have been harmful but will continue. There are also worries about inflation, high oil, a U.S. double dip (Feldstein this morning), the dollar, the debt limit increase and China's slowdown. **We think this large basket of worries means there's room for a solid improvement in expectations.**
- In March, we lowered our first quarter GDP forecast to 2.2%. We look for 3%-3.5% GDP growth in subsequent quarters (a moderate expansion.) We think job growth and business investment will be good signposts. (In 2009 and 2010, we emphasized rising auto sales and the decline in jobless claims, which were good measures of the on-and-off strength of the recovery but won't be as useful in 2011; see Not Another Soft Patch, March 29, 2011.)

- Despite the first quarter letdown in GDP, job growth picked up. The household survey found over one million jobs in the first quarter, while ADP finally began to show job growth for small and medium-sized businesses.

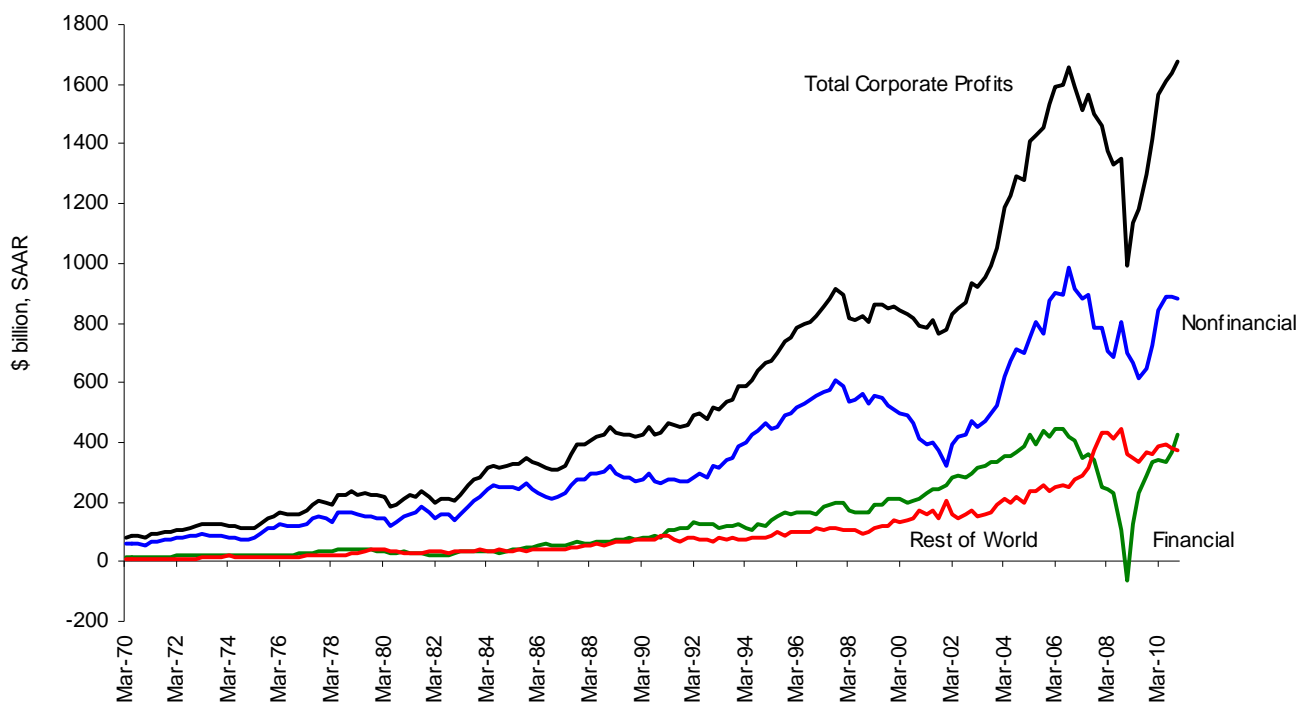
ADP Monthly Jobs Growth by Company Size (last obs. March 2011)



Source: Federal Reserve; Encima Global

- We're constructive on profits and equities in the second half of 2011 once markets can see through some of the current negatives.** Overall corporate profits rose to a new peak at \$1.68 trillion annualized in the fourth quarter of 2010. In the fourth quarter, U.S. nonfinancial corporations earned \$879 billion (on a seasonally adjusted annualized basis). U.S. financials earned \$427 billion. U.S. corporate profits earned outside the U.S. were \$373 billion, up almost 50% from the previous peak in corporate profits in the third quarter of 2006 peak (while profits earned in the U.S. are still 7% below the 2006 peak.) We expect strong corporate profit increases in 2011, helped by growth abroad, productivity gains and stronger capital spending in the U.S.

Corporate Profits Before Taxes (NIPA, with IVA and CCAdj, last obs. Q4 2010)



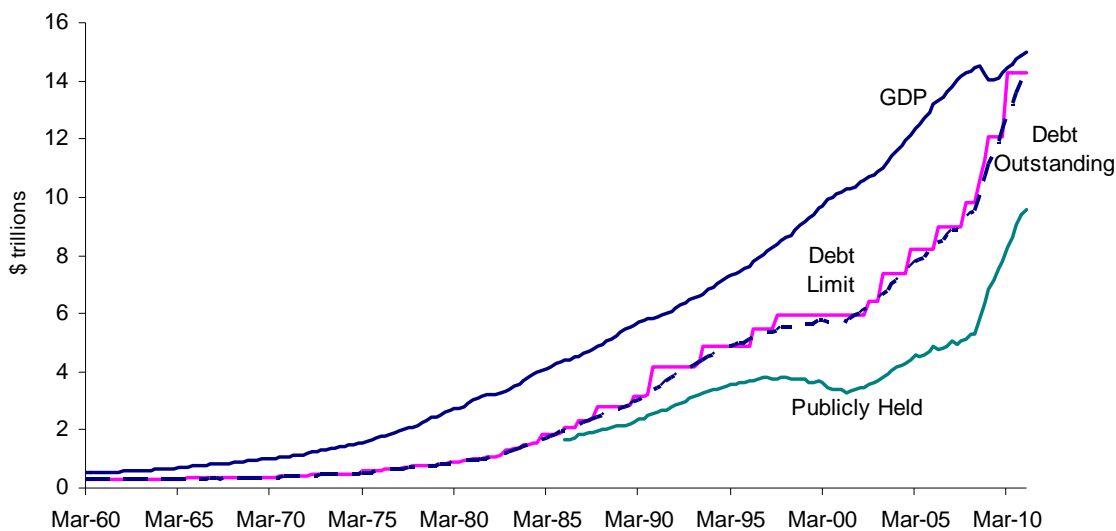
Source: Bureau of Economic Analysis; Encima Global

Little Change in Macro Policy

We think the economy would grow better without super-loose fiscal and monetary policy, but we expect them to continue, causing the 2009-2010 momentum to resume. At some point, market trends based on excess dollar liquidity and momentum— high commodities, strong foreign currencies, corporate boom, emerging market outperformance – become bubbles due to the market distortions. But for now, we think we're in the bubble building phase rather than the bubble popping phase. The VIX volatility index is at an already-low 16, a level of confidence achieved in 2003 on the way to a VIX of 10 in 2005 even as the federal deficit soared and the Fed limited its rate hikes.

- On the fiscal front, we don't think the debt limit problem will stop the expansion. Generous Washington deals were cut in the December 2010 tax cuts (every lobbyist and interest group got something) and on the just-passed FY2011 spending bill (almost no reduction in expected FY11 spending and only small reductions for FY12). We expect similar dynamics on the increase in the \$14.3 trillion debt limit in June, where the Administration holds most of the cards in terms of: 1) logic (the money's already been spent), 2) public attitude (don't risk a default) and 3) communications during a cliff-hanger. The end result will likely be a contentious debt limit increase and then a stalemate through the 2012 election. We don't expect major structural spending cuts, tax reform or a meaningful House-Senate budget resolution until at least 2013 (though the large tax increase scheduled for the beginning of 2013 will become an issue in late 2012.)

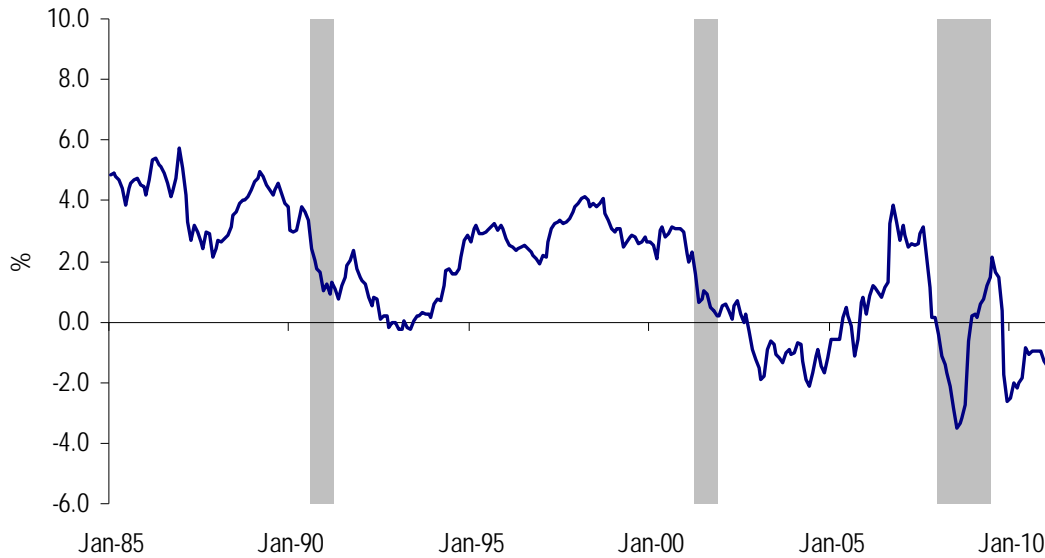
Federal Debt Limit and GDP (last obs. Q4 2010, estimated for Q1 2011)



Source: U.S. Treasury; Bureau of Economic Analysis; Encima Global

- On monetary policy, we expect the Fed to complete its QE2 purchases but promise markets that it will pursue aggressive monetary accommodation (see Fed Exit Strategies on April 1, 2011.) We think the Fed funds rate is more important to monetary policy than QE2 and will be kept near zero for a considerable time. Strong job growth might push the Fed to raise the Fed funds rate earlier than current market expectations. But this would still leave the Fed way behind the curve in terms of a neutral interest rate policy (as in 2004 and 2005 when the Fed was hiking rates but not actually tightening monetary policy because it was not closing the gap with a neutral Fed funds rate.)

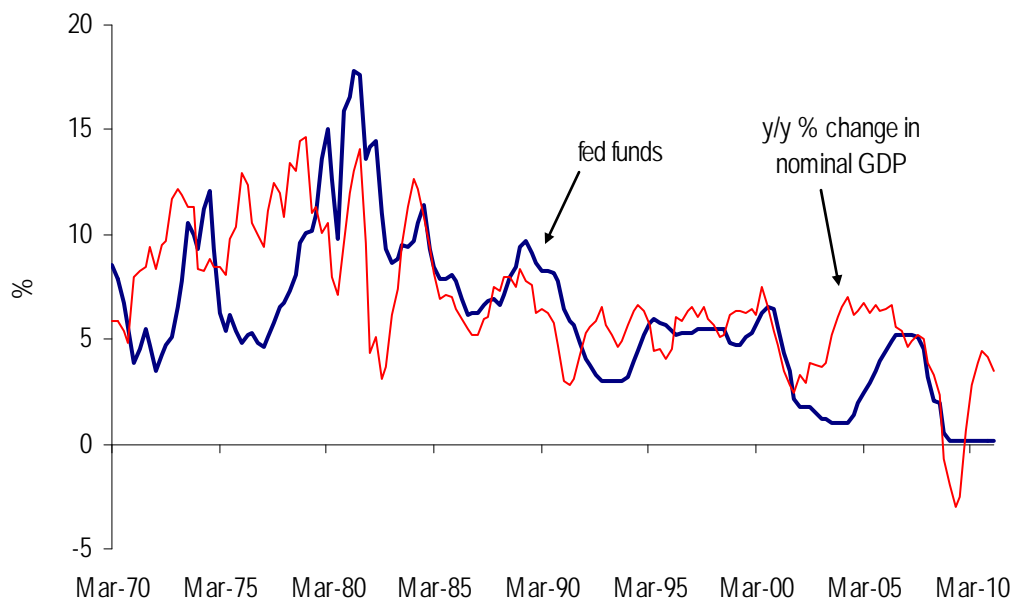
Real Fed Funds Rate (using headline CPI, last obs. March 2011)



Source: Federal Reserve; Bureau of Labor Statistics; Encima Global

- We expect the Fed funds rate to stay well below nominal GDP growth for several years (as in the 2003-2007 bubble-building era.)

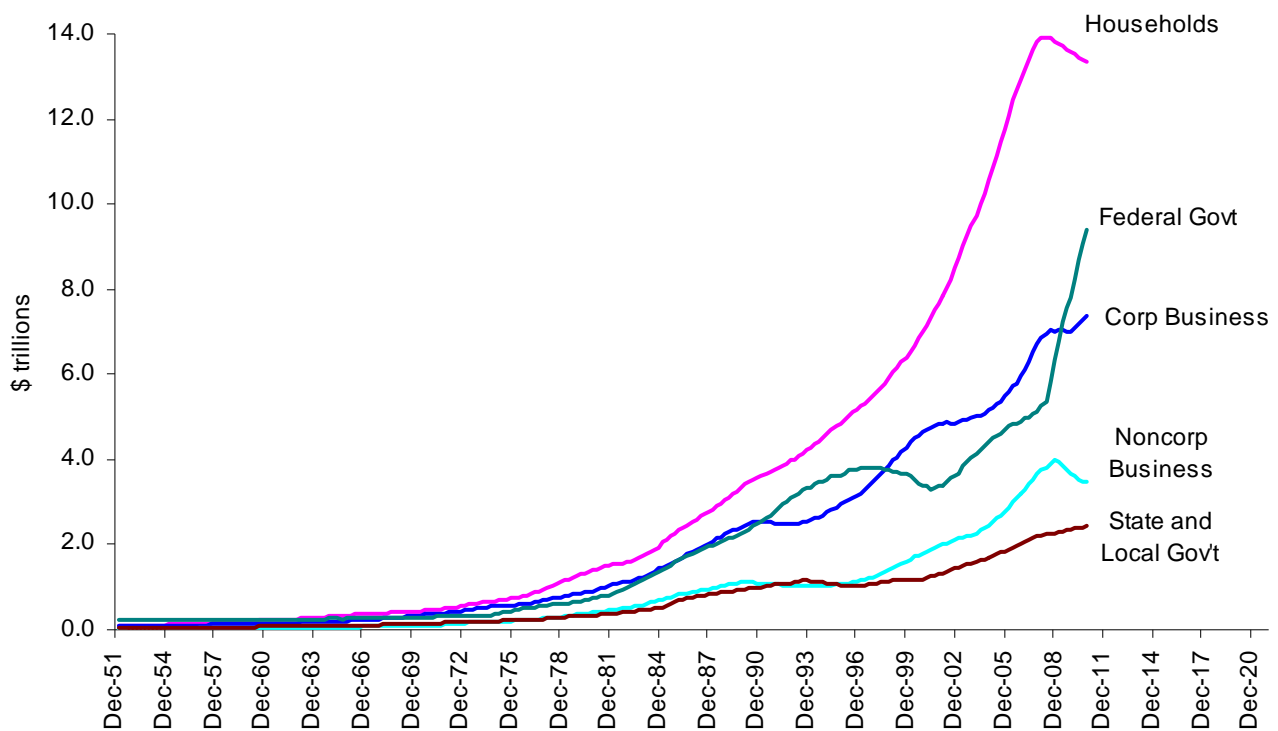
Fed Funds and GDP Y/Y (last obs. Q4 2010, estimated for Q1 2011)



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

- Controversial in the current expansion is the rapidly changing composition of U.S. debt. The federal government has drastically expanded its borrowing, but at very low interest rates (we think artificially low.) Though not as rapidly, corporations are also expanding their debt. In contrast, households and non-corporate businesses have seen their debt contract through the fourth quarter of 2010 (the latest data available from the Federal Reserve's flow of funds surveys.) In total, U.S. debt stood at \$36.2 trillion in December, up 4.8% from December 2009 (and up 14.5% from December 2007 when 'deleveraging' started.) We think this consolidation of U.S. debt in the federal government, part of the kick-the-can-hard process, has been stimulative in the short-run and will continue in 2011 and 2012 (with federal debt expected to grow another \$2.5 trillion.)

Sector Debt (last obs. Q4 2010)



Source: Federal Reserve; Encima Global

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