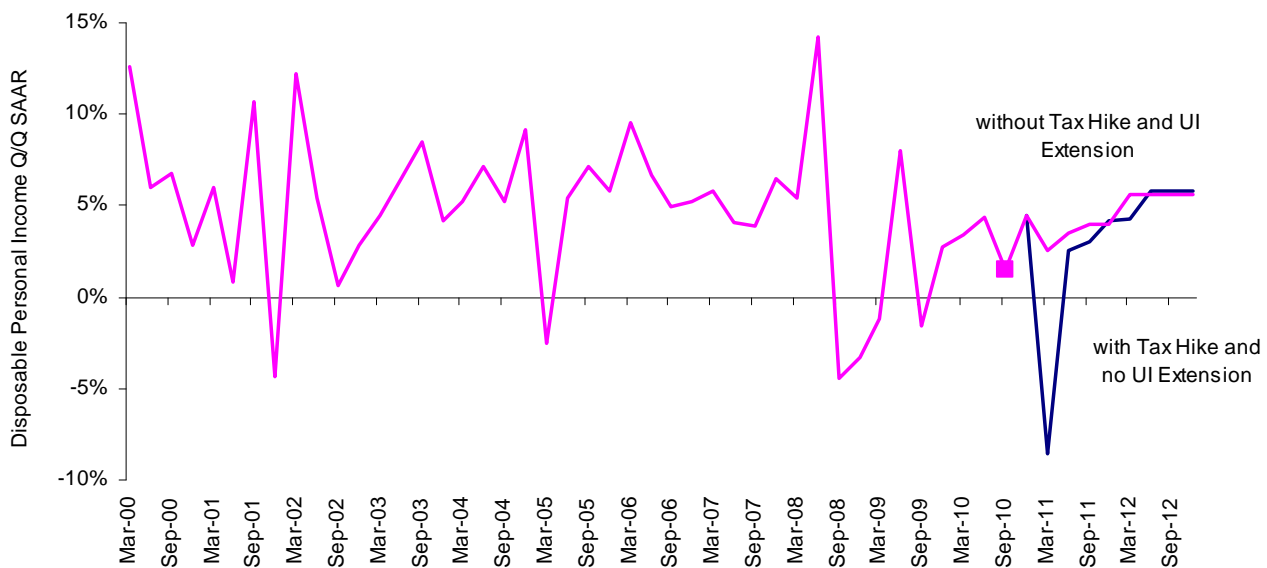


Tax Crisis Matters More Than European Debt

We think the December tax crisis in the U.S. will turn out to be more important for 2011 growth and markets than the rolling debt crisis in Europe.

Tax Update. It will be very hard for the Senate to get 60 votes behind any single tax proposal. We think there's still a material chance that Congress won't pass a tax bill, leaving after-tax income down sharply in the first quarter.

Disposable Personal Income Q/Q SAAR (last obs.Q3 2010, forecast to Q4 2012)



Source: Bureau of Economic Analysis; CBO; Encima Global

- In December, Congress will use its usual CBO/Joint Tax Committee scoring system, which builds in a large bias in favor of more taxes and more spending. Maintaining tax rates and subsidies at current levels will be scored as a huge increase in the fiscal deficit, with no positive impact on growth or asset prices. In effect, Congress is swimming against a 5 mph current in trying to hold down taxes using Washington's pro-tax scoring system.
- In addition, many of the individual tax provisions are as hard to justify as earmarks -- \$6 billion for ethanol as an example. While many members might vote for a larger deficit in order to provide a middle-class tax cut and a "growth-oriented tax cut for small businesses", it will be hard to get enough senators from either party to vote for a

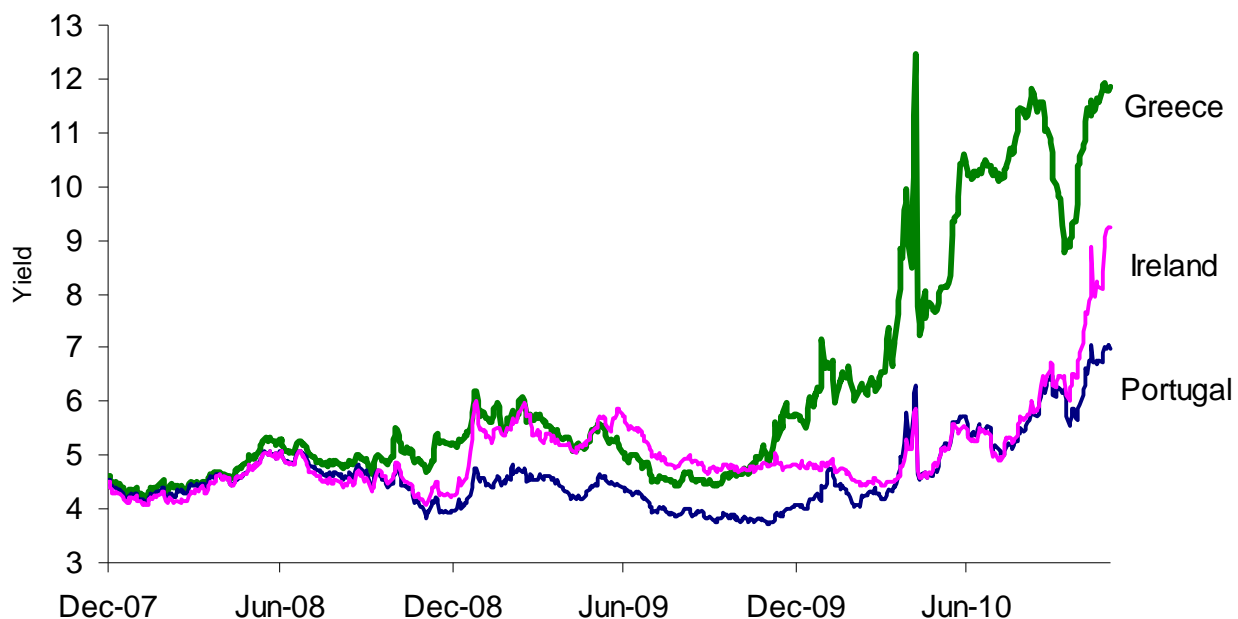
complex budget-buster filled with special interest provisions that most members won't have a chance to read. Even if the president moves hard toward the middle, getting 60 votes for another roughly \$700 billion stimulus bill will go down to the wire at Christmas.

Big Market Impact From Taxes. If Congress fails to pass a "massive tax cut" in December, we think it will be highly contractionary. The dollar will strengthen, Treasury bond yields fall, and equities fall especially outside the U.S. While recent market action has been blamed on Ireland and contagion, an additional explanation is that markets are beginning to recognize the possibility that Congress won't be able to pass a tax bill.

Eurozone Crisis. For the world outlook, we don't think the resolution of the European debt crisis matters as much as the tax crisis.

- The fight is over splitting the austerity between pensioners, sovereign bondholders, bank creditors, public sector workers, courtiers, home owners and other stakeholders. Almost all are based in Europe.
- A side battle is over which multi-national agency gets to control the situation (and add to its own power.) Over the weekend, the French made sure that the IMF (which France has always headed) will have wide discretion in deciding private sector haircuts.
- From a systemic standpoint, many countries have restructured their debts in the past, so there's no reason to think that a Greek debt restructuring (we're expecting one) will be traumatic. Volumes on European sovereigns are very thin, with pricing (and bond ratings) set more by the CDS market than country fundamentals (an echo of the momentum-driven U.S. pricing fiasco in 2007-2009.)

Select European 10-Year Yields (euro-denominated, last obs. November 30, 2010)



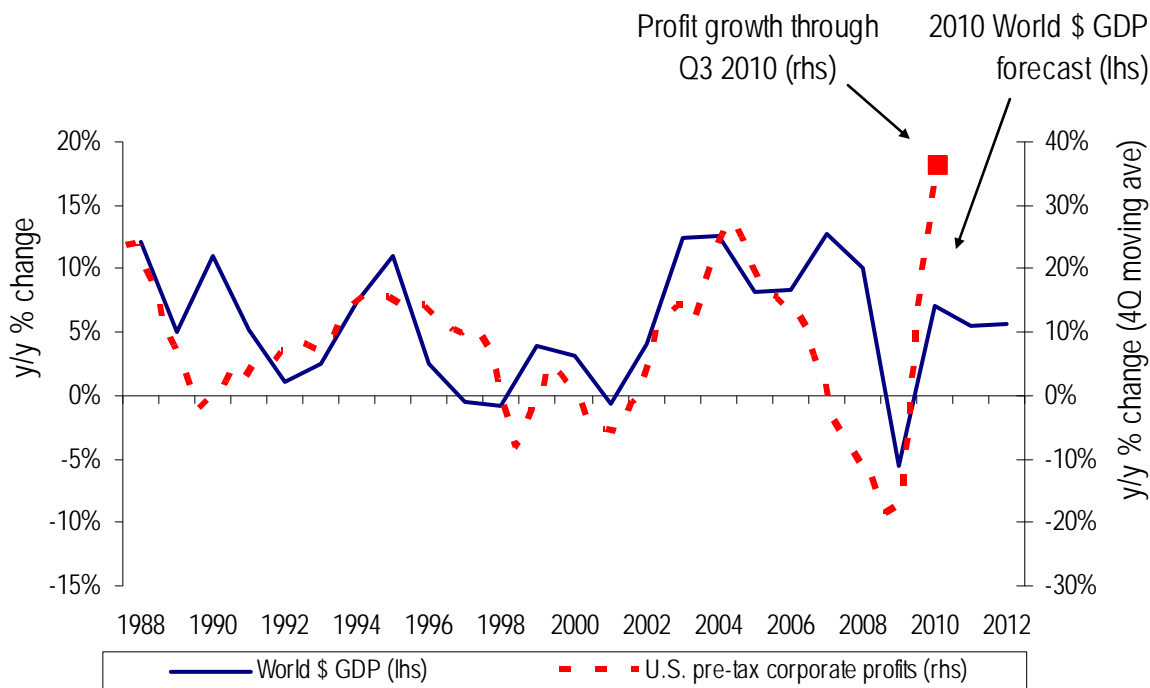
Source: Bloomberg; Encima Global

- Uncertainty about the outcome won't slow Europe's growth all that much. Investment will be diverted from weaker European countries to stronger ones, with net growth about the same. In April, the IMF's forecast for 2010 Euro-zone growth at 1%, with Germany at 1.2%. In October, the IMF's 2010 Euro-zone forecast, even after the global softpatch, is for 1.7% growth, with Germany at 3.3%.

We're not exactly arguing that a Portuguese debt crisis would be good for Germany.

- But from the standpoint of growth, allocating capital to profitable companies is critical. Along this line, we think the U.S. would have grown just as much in 2004-2007 if the Fed had provided a neutral (higher) Fed funds rate – fewer houses would have been built in Nevada, Arizona and California, and mortgage finance wouldn't have become such a big industry, but the dollar wouldn't have weakened as much, multi-nationals would have invested more in the U.S. and less abroad, and oil wouldn't have spiked as high.
- The Asia crisis was a severe blow to world dollar GDP and, as a result, to U.S. corporate earnings. Devaluations there knocked 50% off dollar GDP for Indonesia, Thailand, Malaysia and others. Critical in the Asia crisis was the IMF requirement that the countries devalue, not an option in Europe's debt crisis.

Corporate Profits and World Nominal \$ GDP (last obs.Q3 2010)



Source: Bureau of Economic Analysis; IMF; Encima Global

- Even assuming the euro falls quickly to \$1.15 (currently \$1.30, down from \$1.50 prior to the Greek crisis), Europe's debt crisis won't cause as much loss as the Asia crisis because the euro has a clear mandate for price stability.

Global GDP (\$ billions)

	2008	2009	2010	2011	2012
World	61,187	57,843	61,963	65,417	69,125
United States	14,369	14,119	14,624	15,157	15,825
Latin America	4,264	3,965	4,700	5,014	5,306
Developing Asia	7,436	7,876	9,136	10,174	11,257
Eurozone	13,616	12,484	12,067	12,187	12,520
World with pessimistic EUR exchange scenario			61,963	64,147	67,877
Y/Y Growth Rates		2009	2010	2011	2012
World		-5.5%	7.1%	5.6%	5.7%
United States		-1.7%	3.6%	3.6%	4.4%
Latin America		-7.0%	18.5%	6.7%	5.8%
Developing Asia		5.9%	16.0%	11.4%	10.6%
Eurozone		-8.3%	-3.3%	1.0%	2.7%
World with pessimistic EUR exchange scenario				3.5%	5.8%

Source: IMF; Encima Global

- Companies exposed to Ireland or over-exposed to southern Europe have probably already priced in most of the coming hit to earnings.
- The upside or downside for Europe depends on the structural reforms achieved during the crisis. Greece's IMF package centered on higher VAT taxes, with some spending cuts added in. Ireland is headed in a more pro-growth direction. It's unclear where Portugal and Spain will end up on this spectrum.

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