



Tax Hike and Fed QE: Will Washington Reverse These Blunders?

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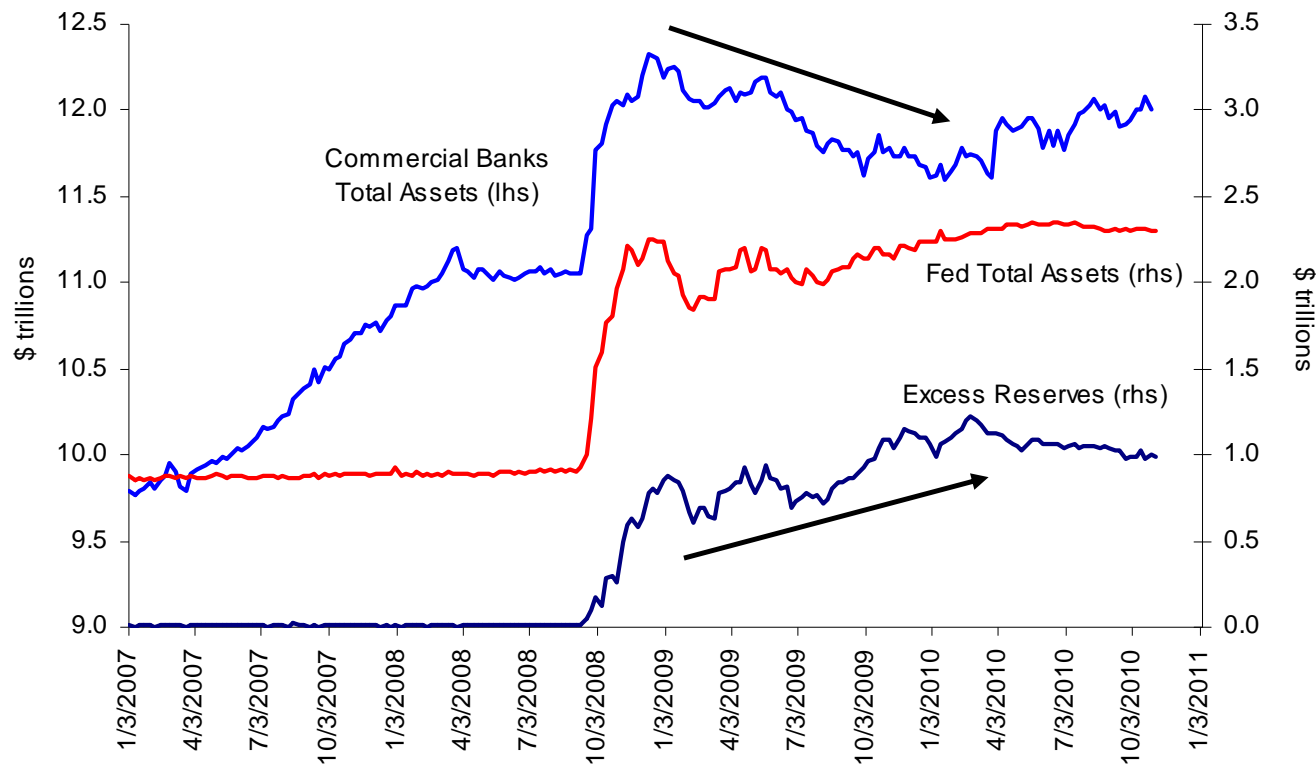
Fed Expansion Won't Cause Growth

- **The Fed funds target is 0% to 0.25% with an average \$75 billion per month in net balance sheet expansion offered through June, nearly as large as the fiscal deficit. Gross Treasury purchases will reach \$110 billion per month.**
- **This won't have much impact on growth or bank lending – credit is being rationed by regulatory policy rather than price. Like Japan's ineffective QE, Fed purchases will mostly affect the price of the purchased asset while it is being purchased.**
- **The current Fed policy is costly. The near-zero fed funds rate hurts savers and distorts capital flows. Capital allocation is increasingly being determined by governments, regulators and big corporations, a distinct new negative.**

In QE1, Reserves Rose, Commercial Bank Assets Fell

(last obs. November 3, 2010)

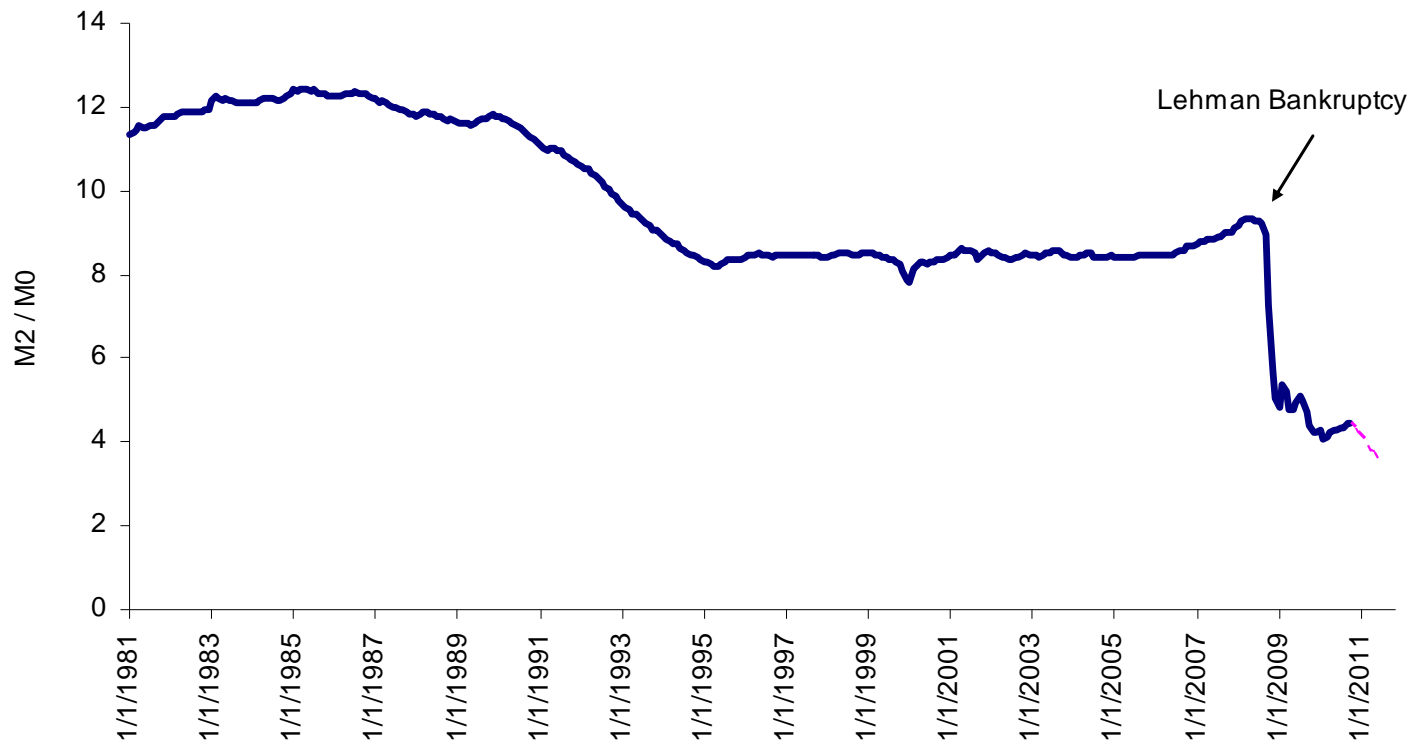
Most of the Fed's new asset purchases will be financed by excess reserves causing no throughput, 'pushing on a string', no implied growth in bank lending.



Source: Federal Reserve; Encima Global

M2/M0 to fall again as Fed pushes harder on string

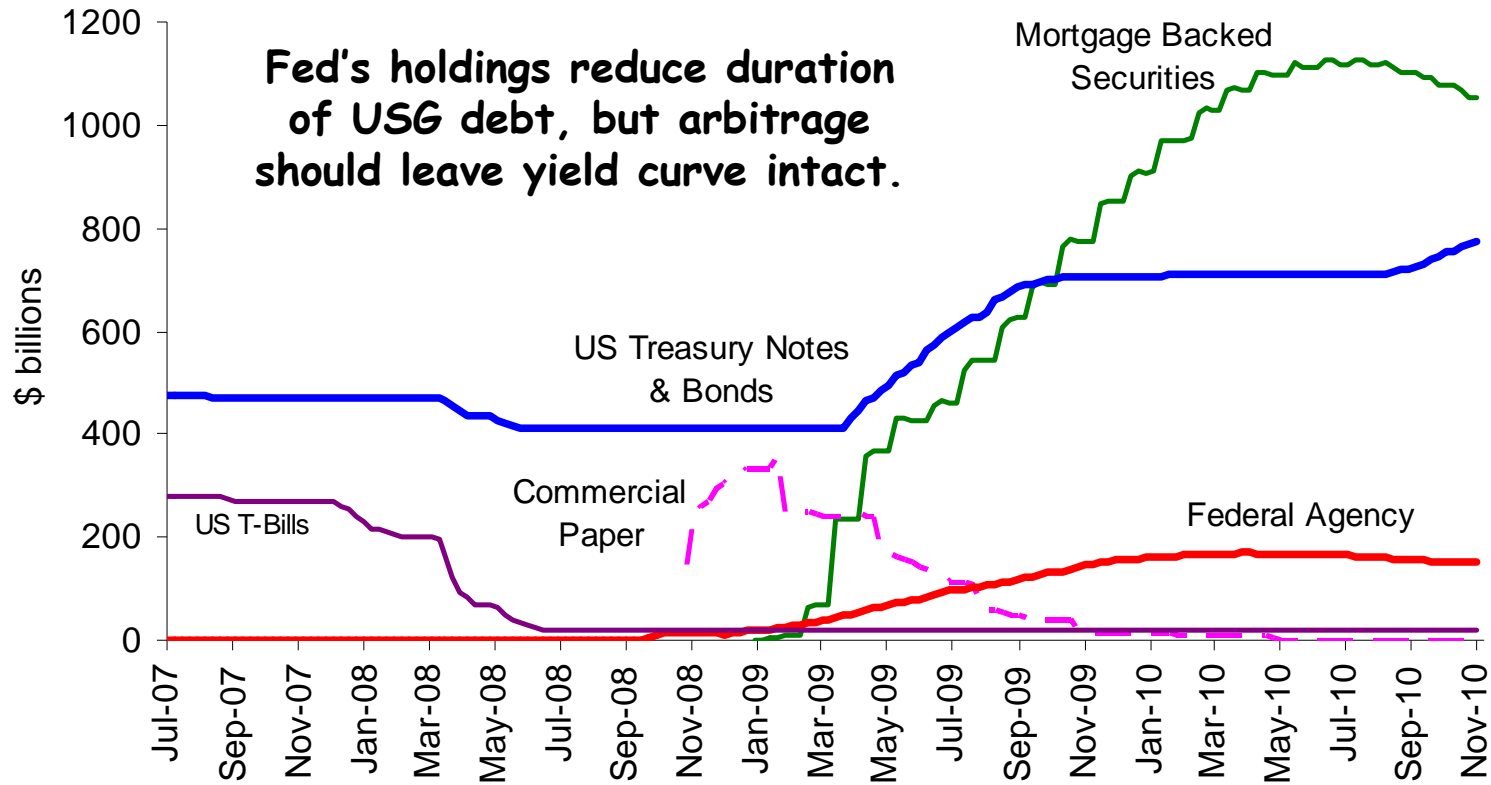
(last obs. October 25, 2010)



Source: Federal Reserve; Encima Global

Fed Assets Now Long-term

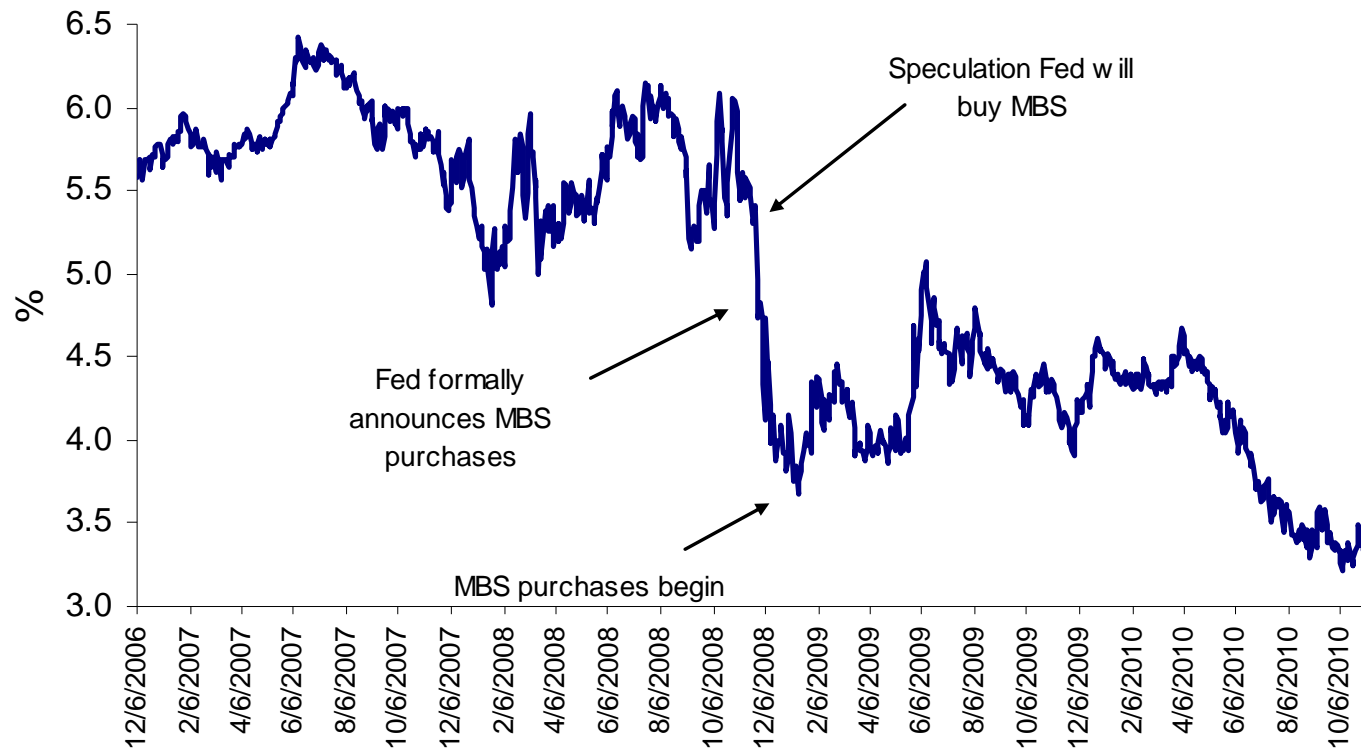
(last obs. November 3, 2010)



Source: Federal Reserve; Encima Global

MBS Yield in QE1; Fed Purchases Marked Bottom

(last obs. November 9, 2010)



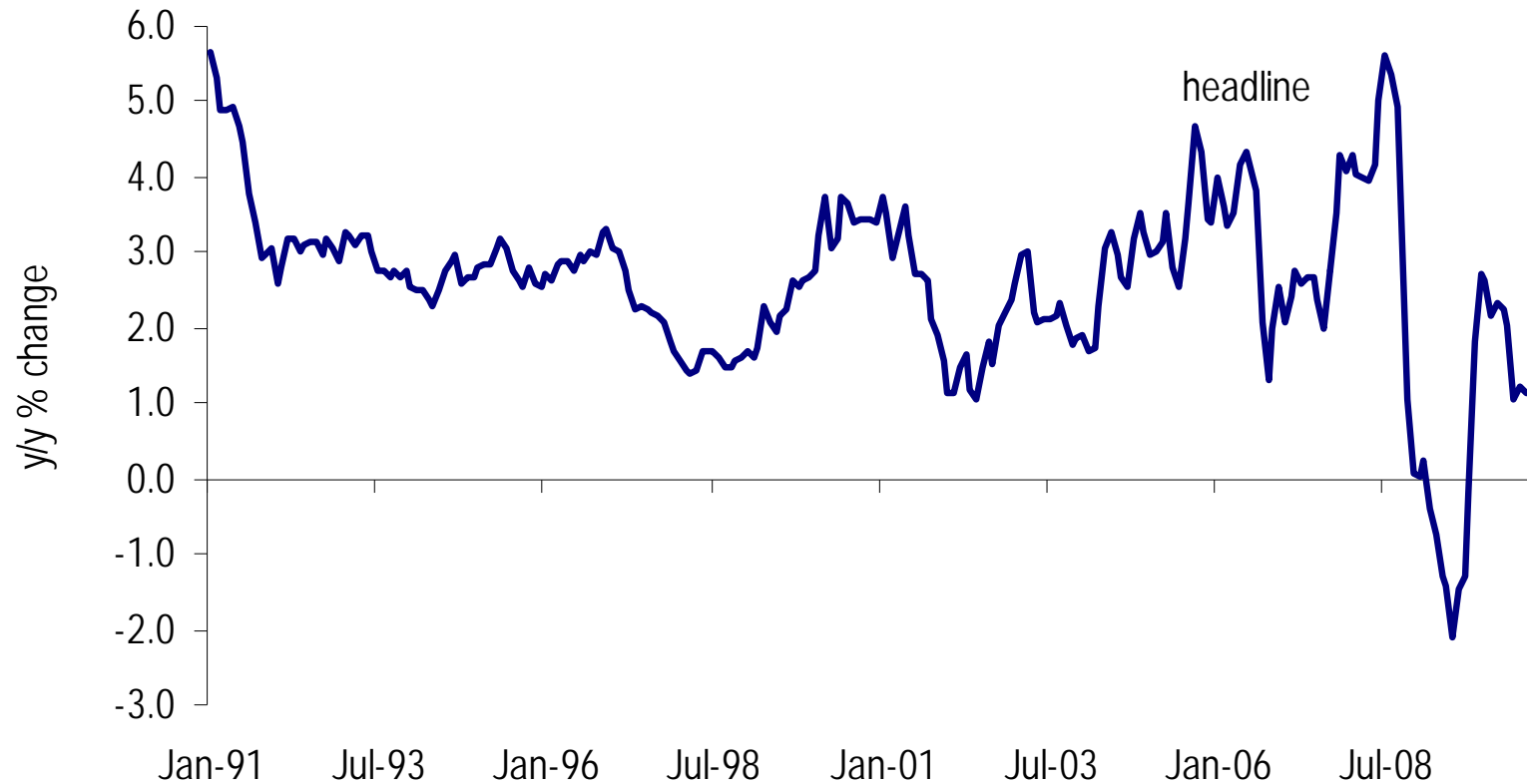
Source: Bloomberg; Encima Global

Fed Causing Asset Bubbles – Not a New Problem

- Extract from *Fed's Moment of Weakness*: Malpass WSJ 9/25/02
- “Three major debates over monetary policy are in full swing -- how to combat deflation, the central bank's role in controlling asset-price extremes, and the proper response to fiscal deficits.
- “At the moment (2002) the debates are headed in the wrong direction. They don't offer an explanation for the deflation of the 1990s, let alone a policy bridge to price stability, economic growth and tax reform in the 2000s.
- “Fed Chairman Alan Greenspan explained at an Aug. 30 (2002) speech in Jackson Hole, Wyo., that the Fed can't anticipate bubbles and can only hope to soften the blow when they pop.
- “Mr. Greenspan is letting himself off the hook here. Instead of the tight-money, strong-dollar response to "irrational exuberance" in the late 1990s, a Fed commitment to currency stability and proper regulation would have allowed market forces to operate better, softening the boom.
- “The momentum-based capital inflow to the U.S. would have been smaller. The result would have been less of a U.S. boom, but also less of a bust and a better economy going forward. Global growth would have been more balanced.”

Big Swings in U.S. Consumer Price Inflation

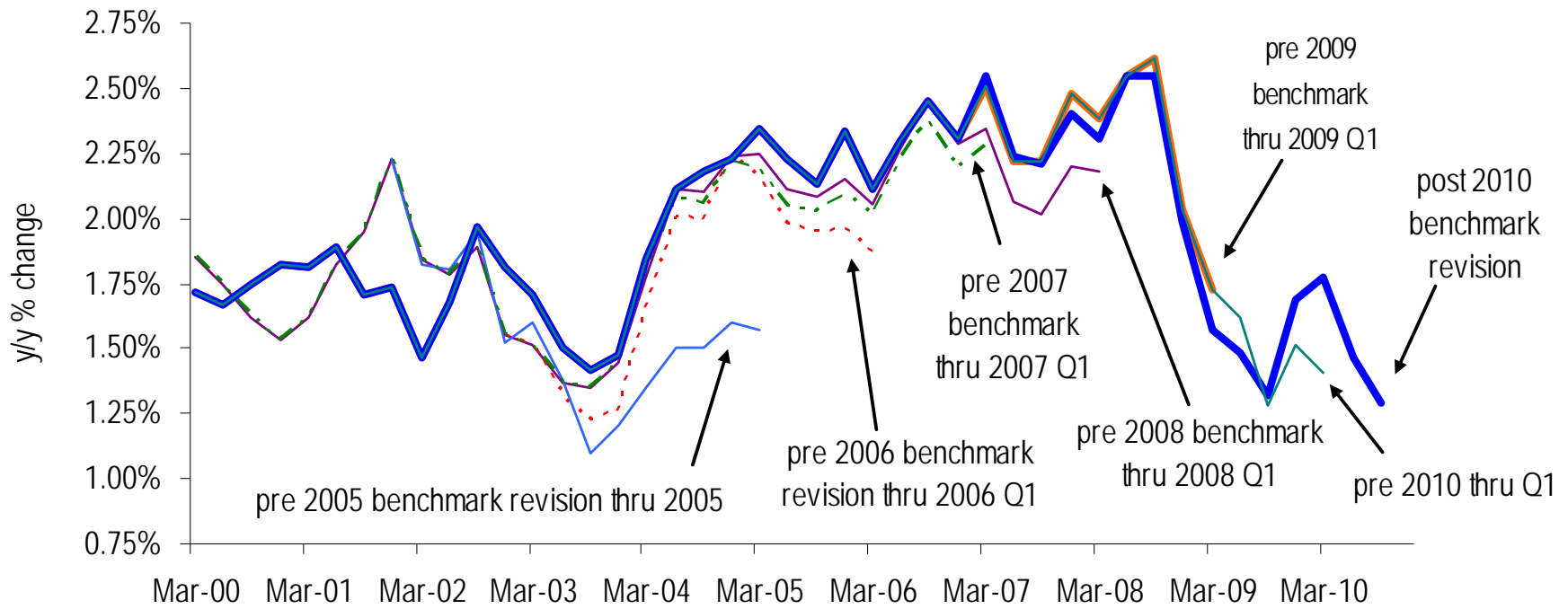
(last obs. September 2010)



Source: Bureau of Labor Statistics; Encima Global

Core PCE Deflator “Moderates” Until Revisions

(last obs. September 2010)



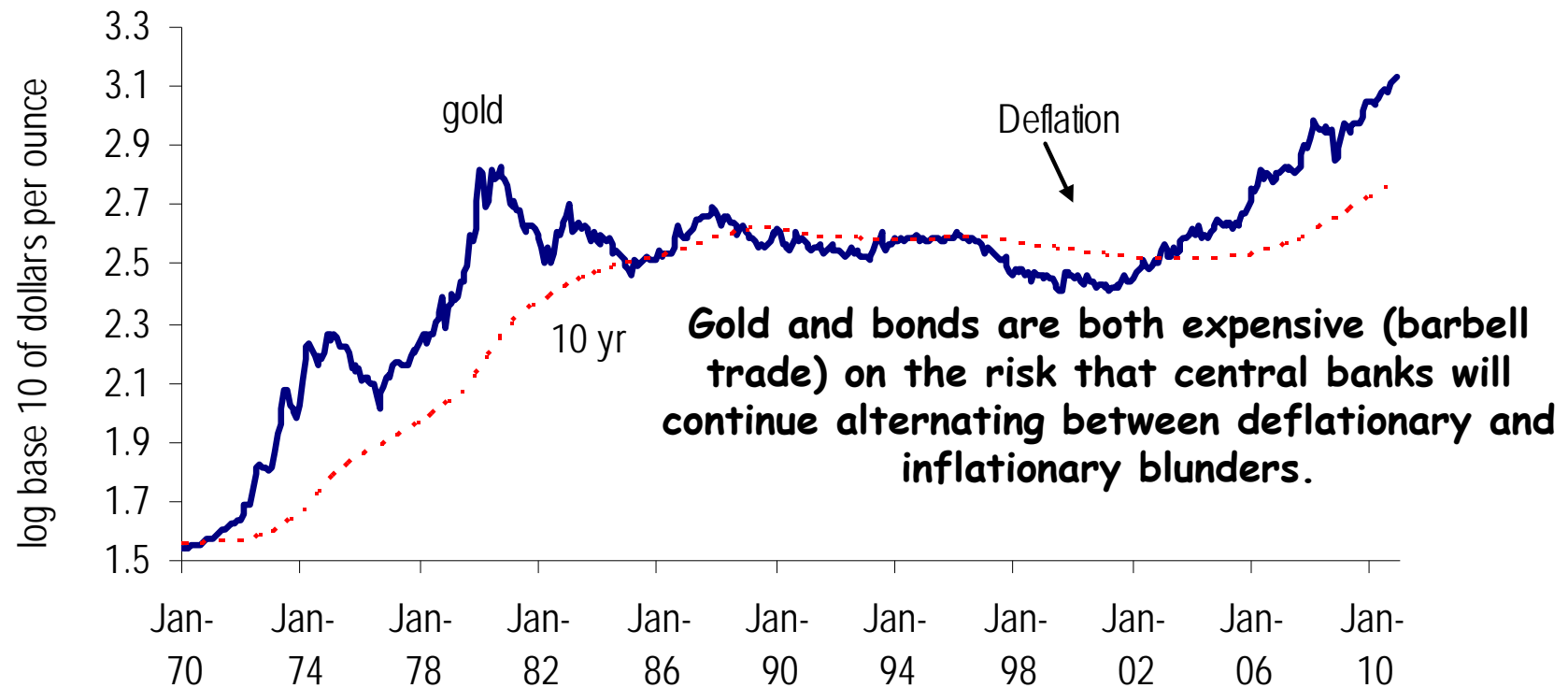
Source: Bureau of Economic Analysis; Encima Global

Gold As International Reference Point

- **“The G20 should complement this growth recovery program with a plan to build a cooperative monetary system that reflects emerging economic conditions... The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values.” *Robert Zoellick, 11/8/10 FT***

Inflation Fear: Gold Prices Hitting New Highs

(log scale; last obs. November 9, 2010)



Source: Wall Street Journal; Encima Global

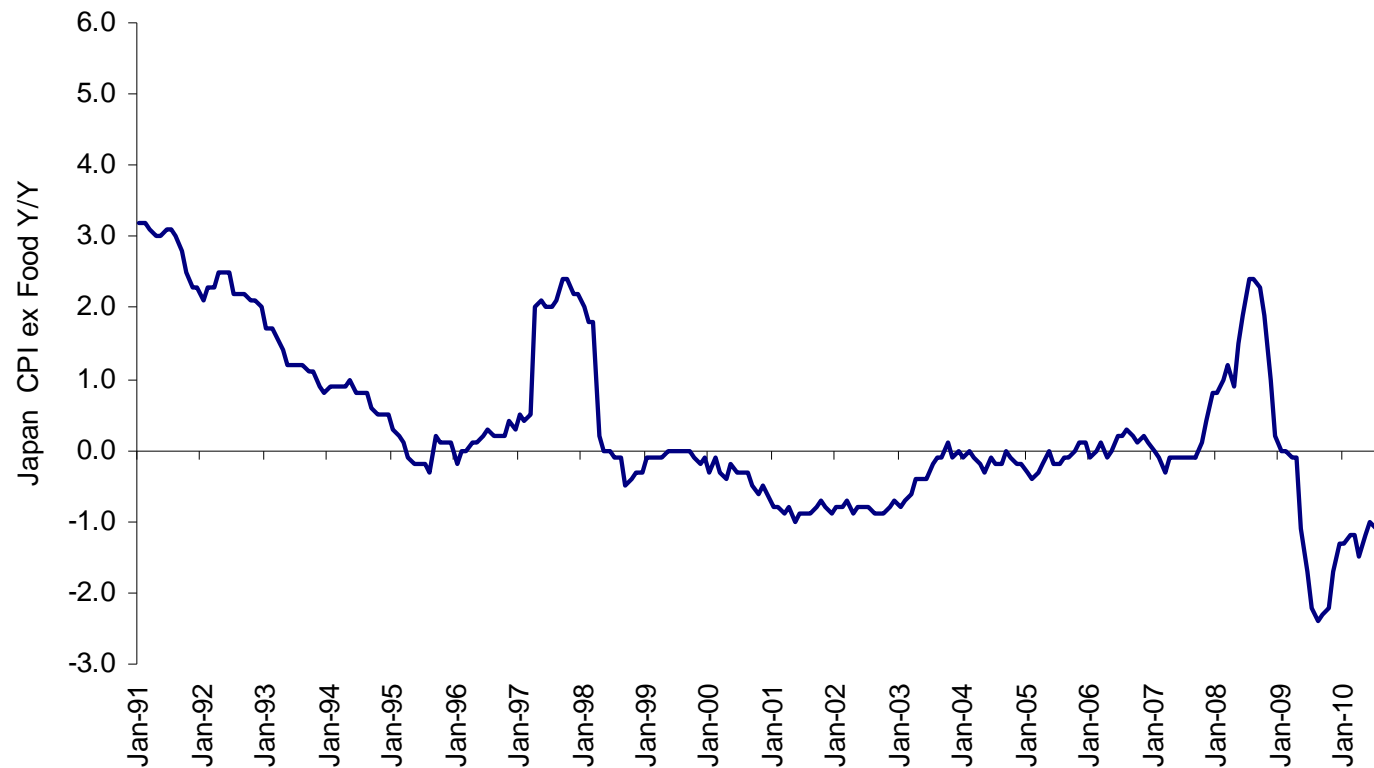
U.S. Not At Risk of Japan Deflation

- The BOJ QE was roughly 15% of GDP, slower than the Fed's QE but about the same size.
- However, Japan had suffered over a decade of strong-yen deflation before undertaking quantitative easing.
- Japan's CPI was zero or negative before and during the QE.
- Japan's banks hampered by very low, often negative nominal GDP prior to QE. (Pre-2008, weakest U.S. yoy nominal growth was 2.4% in 2001. Since crisis, nominal GDP was -3% in Q2 of 2009, already 4.4% yoy in Q3 of 2010.)
- Japan's asset purchases consisted of short-term repos.

Japan Suffered Clear Deflation Before QE

Ex-food CPI y/y

(last obs. September 2010)



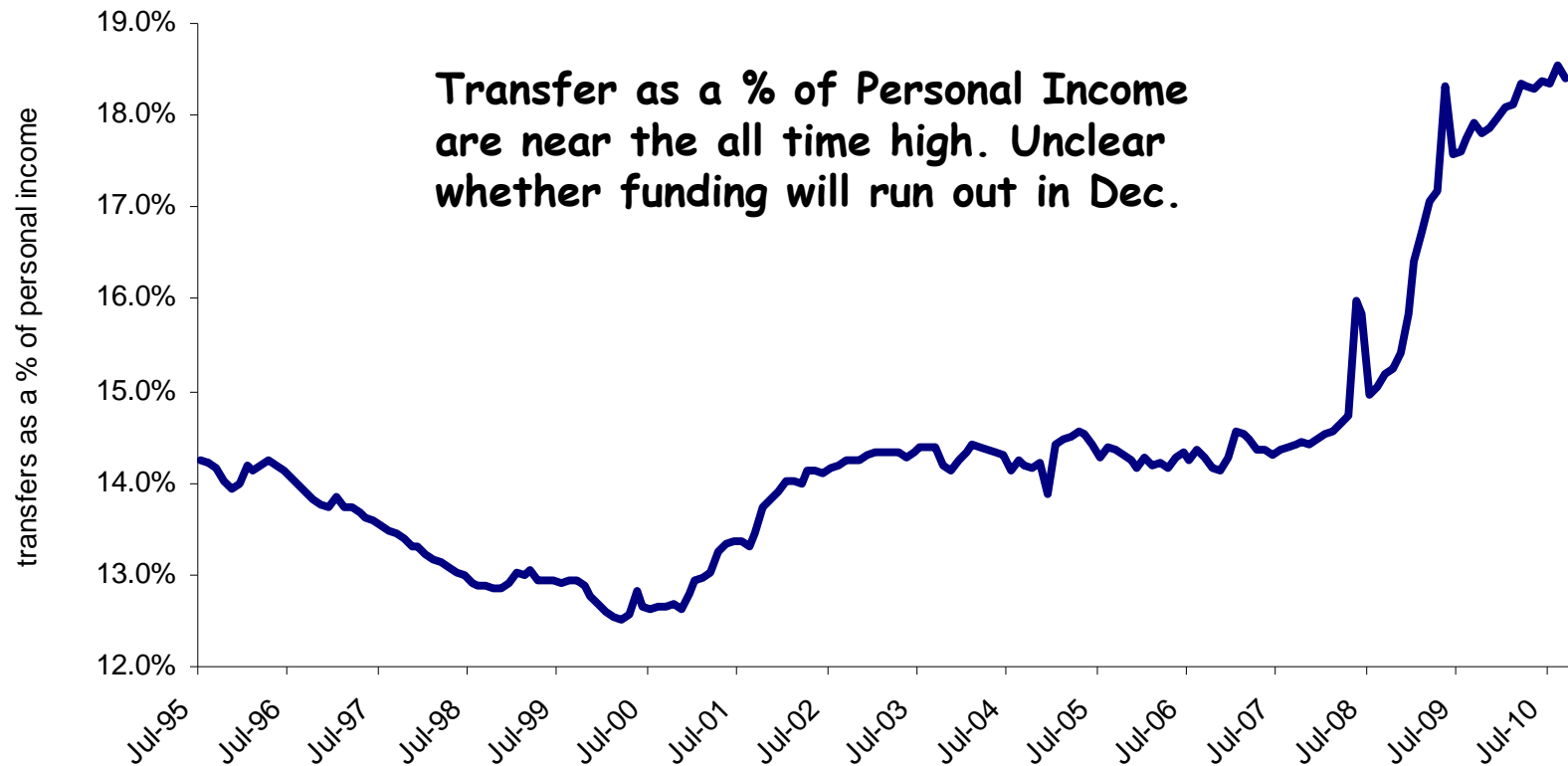
Source: Bloomberg; Encima Global

Get Ready for Tax Chaos

- **We think there's a substantial risk that Congress will not agree on tax extensions in the lame duck, allowing many tax rates to go up on January 1. If so, it's unlikely that Congress will be able to quickly reverse expirations given the divided Congress, legislative procedures, the President's views, and the big deficit impact under CBO scoring rules (which explicitly ignore the positive impact of lower tax rates on economic growth).**
- **We think the resulting tax chaos that would emerge in December and extend into 2011 will be a major negative for both the U.S. economy and markets, with several aspects not yet fully priced in.**
- **While Congress might still act in December, the legislative obstacles are high -- need 60 sitting Senators to vote for a much bigger tax-cut-related fiscal deficit even though there's no agreement between the two parties on tax policy.**

Transfers as % of Personal Income

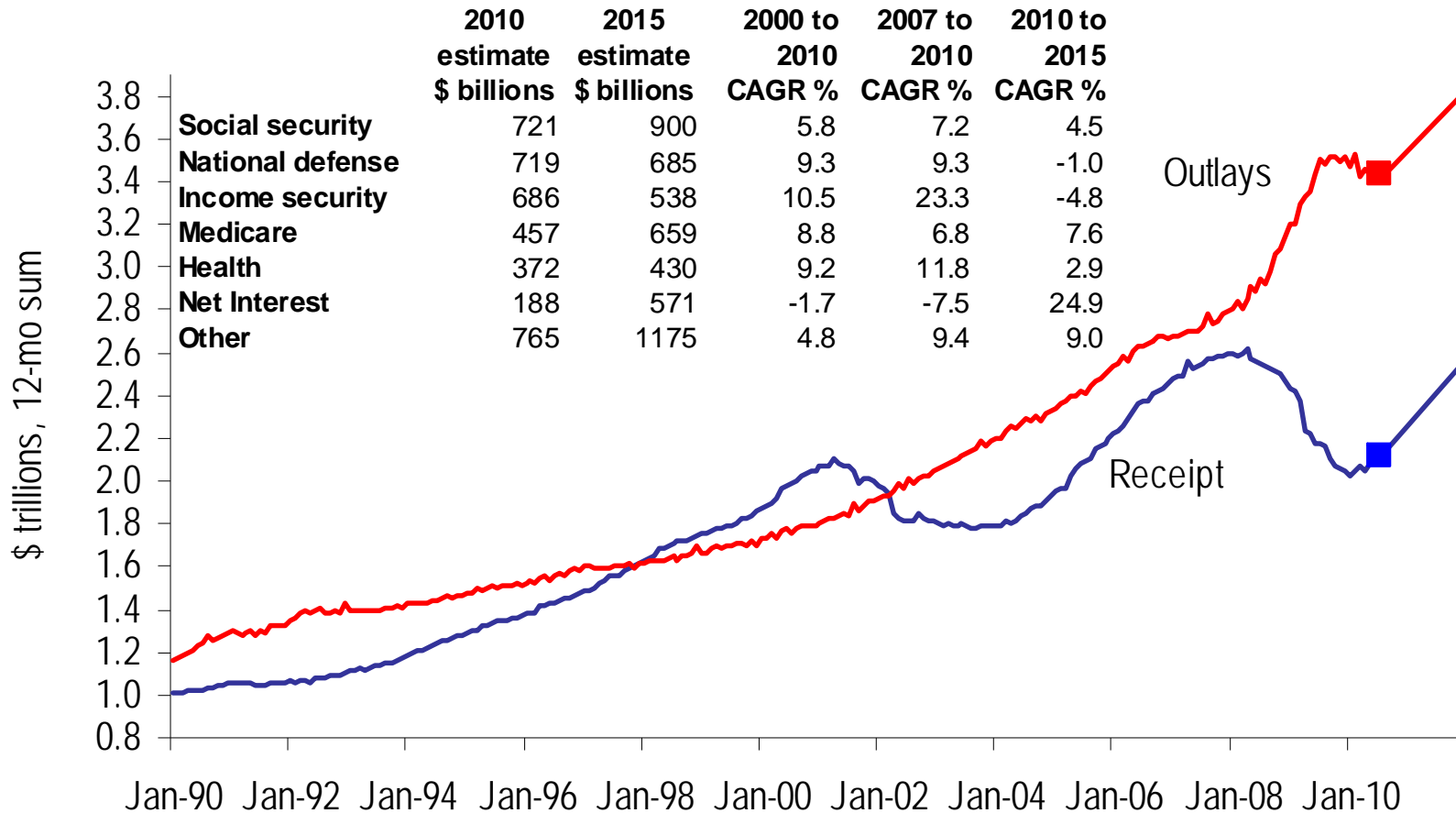
(last obs. September 2010)



Source: Bureau of Economic Analysis; Encima Global

Federal Government Receipts and Outlays

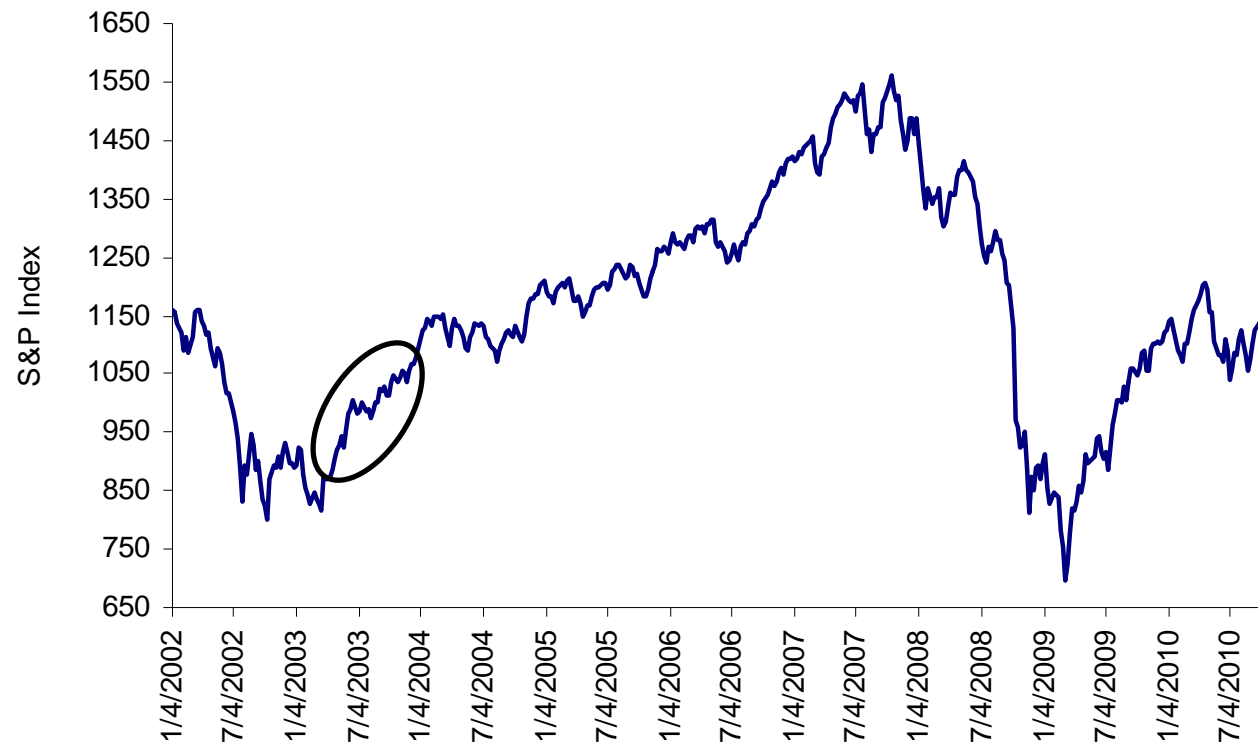
(last obs. September 2010, CBO and OMB forecasts)



Source: US Treasury; CBO; OMB; Encima Global

Taxes Impact Asset Values – Bush Cuts Added In ‘03

(last obs. November 9, 2010)



Source: Wall Street Journal; Encima Global

Favorable News Priced into Markets

- **We think markets have been too optimistic about quantitative easing and taxes.**
- **The Fed's asset purchase plan distorted the bond market, pushing yields artificially low and contributed to higher equity prices (along with improving growth, earnings and election.)**
- **The scheduled tax increases are unusually harmful to growth and equities and will be hard to reverse both in the lame duck and in 2011.**
- **Winding down QE will disappoint markets but not have much impact on growth. The Fed isn't creating extra credit and a wind-down wouldn't reduce credit. Dollar would strengthen, weakening equities at first.**

Baa Yields Low Now; In '78 Yields Increased Late

(last obs. November 8, 2010)



Source: Federal Reserve; Encima Global

In '77-'79, Equities Volatile as Inflation Risks Rose

(1970 to 1985)



Source: Wall Street Journal; Encima Global



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