

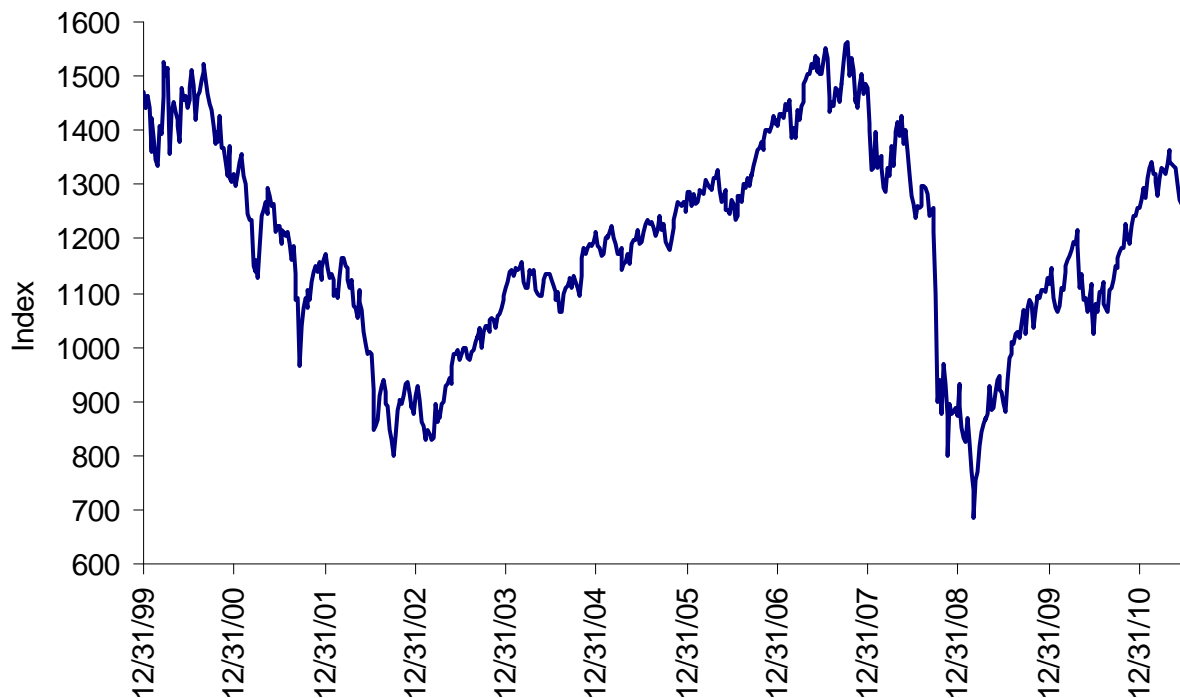
June 16, 2011

Thoughts on the Data and Market Sell-off

After a weak 1.8% first quarter and Q2 expectation, we expect the U.S. GDP growth rate to pick up to 3.5% in the second half due to profit growth, increased auto production, export growth, some job growth and pent-up demand for business investment and consumption.

- We think the equity market sell-off from the April peak (8% so far) will be less than in the 2010 soft patch (down 16% peak to trough intraday). In addition to growth concerns, the equity market is weighed down by four worries that we think should get resolved one way or another in the next couple of months – the end of QE2, the debt limit increase, China's landing (despite talk of a hard landing, China is set for over 9% growth in 2011) and the latest phase of the Greek debt crisis (all that matters to U.S. growth is that Greece not force a conversion of euros to drachmas). We think the oil price decline is bad for equities while the oil price is falling (since energy related stocks have been hammered) but should be good for equities once oil prices stabilize at a lower level.

S&P 500 Index (last obs. June 15, 2011)



Source: Wall Street Journal; Encima Global

- Headline CPI (at 3.6% yoy) should peak in June at nearly 4% and then fall back to 3% or below by early 2012 due to lower gasoline prices and easy comparables from 2010.

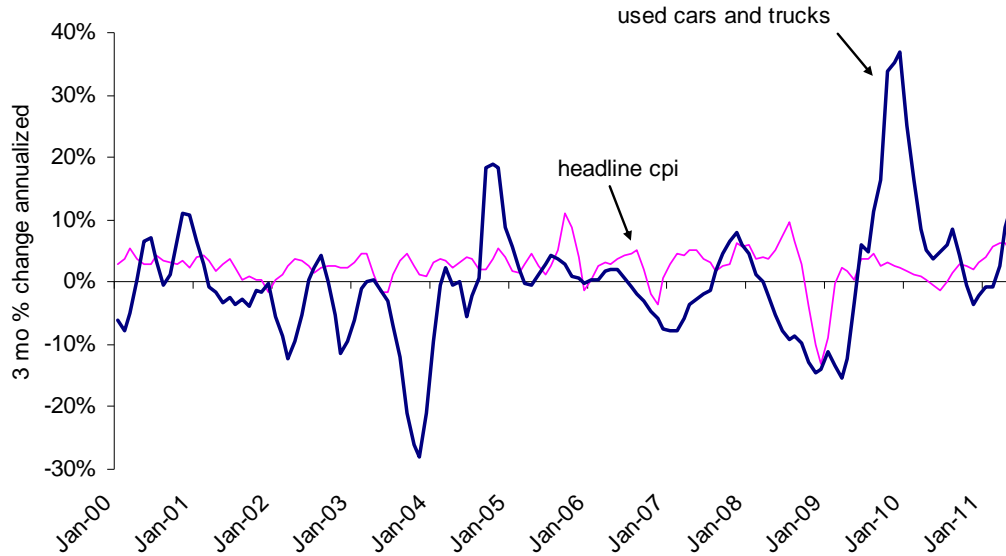
Consumer Price Index (last obs. May 2011)



Source: Bureau of Labor Statistics; Encima Global

- Core inflation is still being held down by weak housing and rental prices, so the Fed will want to keep the Fed funds rate very low due to high unemployment (9.1%) and under-employment (U6 rate is 15.8%).
- Used car price increases have been adding to overall inflation in recent months, pushed up by the disruption in auto production. Used car prices rose 1.1% in May alone and are up at a 12.9% annual rate in March-May. We think used car prices will soften once new car production picks up. The 2009-2010 spike in used car prices relates to the cash-for-clunkers federal subsidy program.

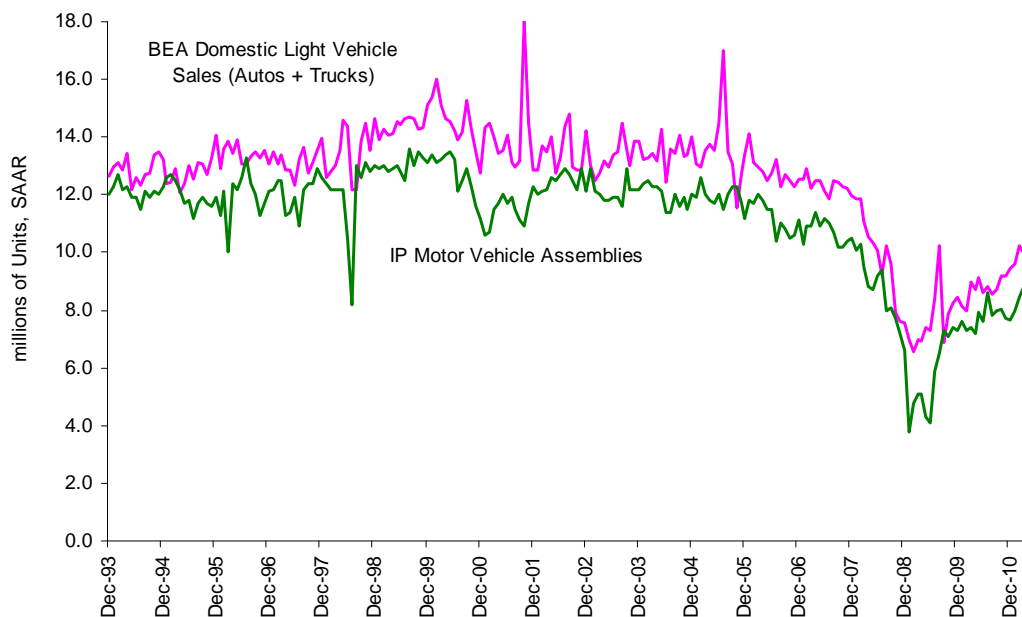
Headline CPI and Used Cars and Trucks CPI 3 mo % chg annualized (last obs. May 2011)



Source: Bureau of Labor Statistics; Encima Global

- Auto production remained weak in May due to the Japan disruptions. Vehicle assemblies were roughly 730,000 in March, then 660,000 in April and May. That's a reduction of 70,000 per month or 3,500 U.S.-made vehicles per production day since the disruptions from Japan's earthquake. Auto sales in May were weak in part due to fewer vehicles in the showroom and fewer incentives.

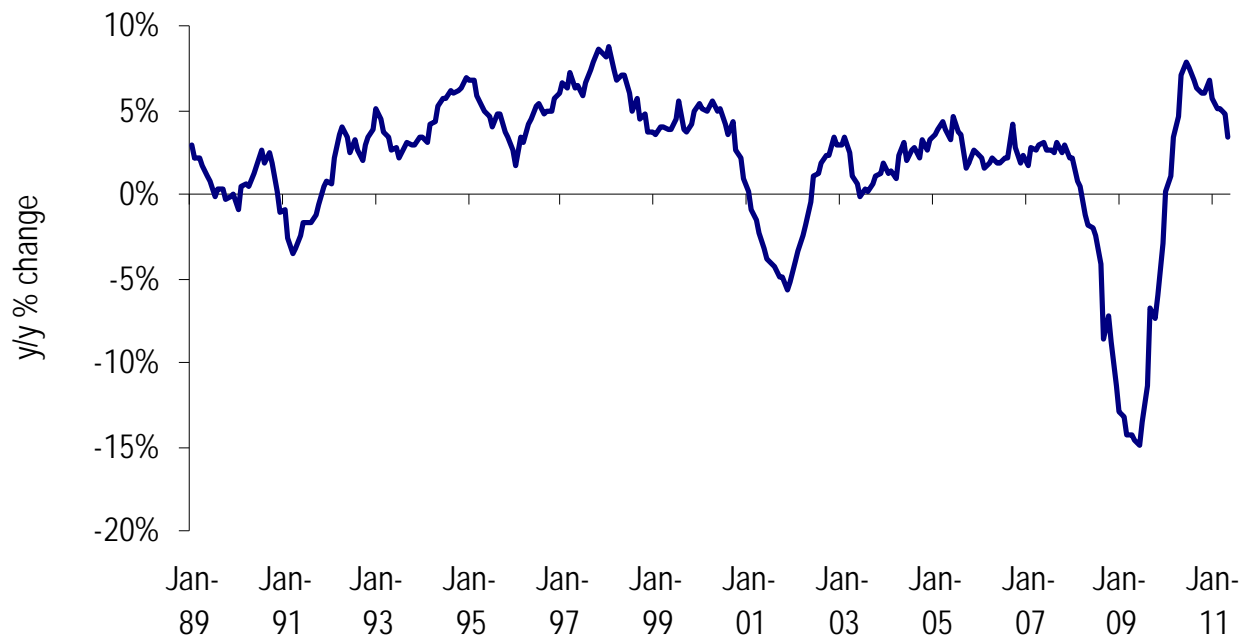
Auto Sales and Production (last obs. May 2011)



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

- Partly as a result of auto disruptions, overall industrial production rose just 0.1% in May after no increase in April. Growth in industrial production has slowed to 3.4% year-over-year. Even so, this is faster than most any 12 months from 2005-2008. Looking forward, we think the resumption of full vehicle production in June and July will restart the manufacturing recovery. The Empire State manufacturing index (a survey conducted by the Buffalo branch of the New York Federal Reserve) was weak, but participation in the survey is spotty and we don't put much weight in it as a predictor.

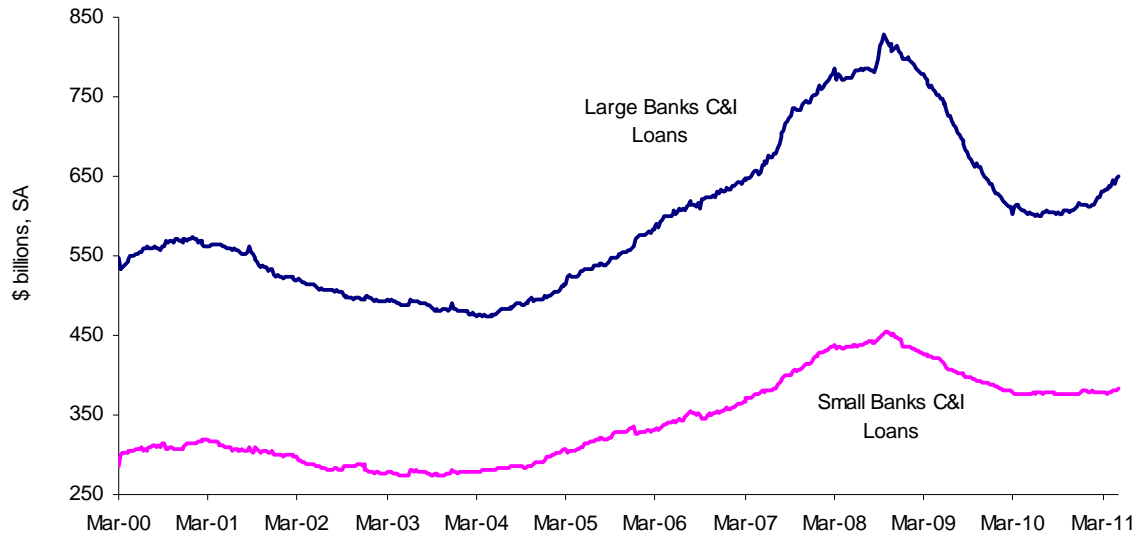
Industrial Production (last obs. May 2011)



Source: Federal Reserve; Encima Global

- Commercial and industrial loans outstanding for large banks continued to pick up in recent weeks, growing to \$649 billion as of June 1. That's a 22% annualized growth rate over the last 13 weeks. Small banks loans have grown at a 3.2% annualized rate, reaching \$382 billion.

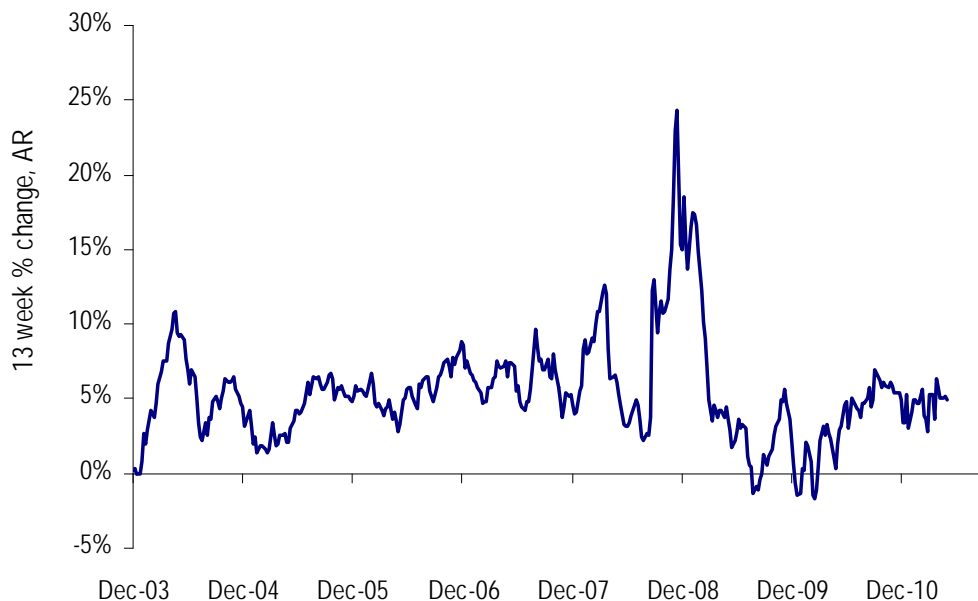
Small and Large Banks C&I Loans (last obs. June 1, 2011)



Source: Federal Reserve; Encima Global

- Over the last 13 weeks, the M2 money supply has grown at a 4.9% annualized rate. We disagree with the view that QE2 has been “adding liquidity” to markets and that ending QE2 will reduce liquidity or money supply growth. Throughout QE2, the Fed has been borrowing from banks to buy bonds. This leaves private sector credit unchanged. With bank lending finally picking up, we expect an uptick in private sector credit growth and in M2 and don’t think either will be affected by the end of QE2.

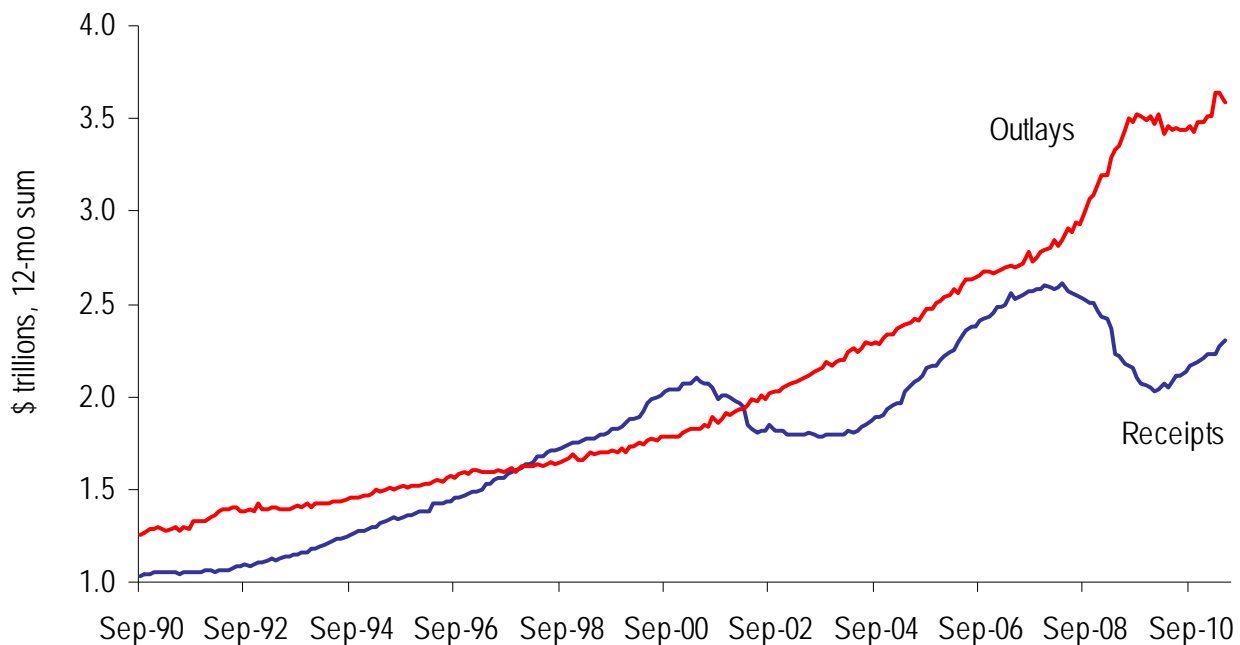
M2 13 week annualized % change (last obs. May 30, 2011)



Source: Federal Reserve; Encima Global

- Federal tax receipts were \$175 billion in the month of May, lifting the 12-month sum to \$2.3 trillion. Not bad, but still well below the 2008 peak. The growth rate in receipts has been accelerating – down 2% yoy in March, then up 18% yoy in April and 19% yoy in May. We think this shows more strength in the economy than the manufacturing-oriented data (like ISM, IP and auto sales, all weak, suggest.)
- Federal outlays were \$233 billion in May, putting the 12-month sum at \$3.6 trillion. The 12 month deficit was \$1.3 trillion in the 12 months through May, somewhat better (less) than expectations due to the climb in receipts. We expect heavy spending in the remainder of fiscal 2011 (which ends September 30), pushing the FY11 fiscal deficit to \$1.5 trillion or so.

Federal Govt Receipts and Outlays (last obs. May 2011)



Source: U.S. Treasury; Encima Global

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