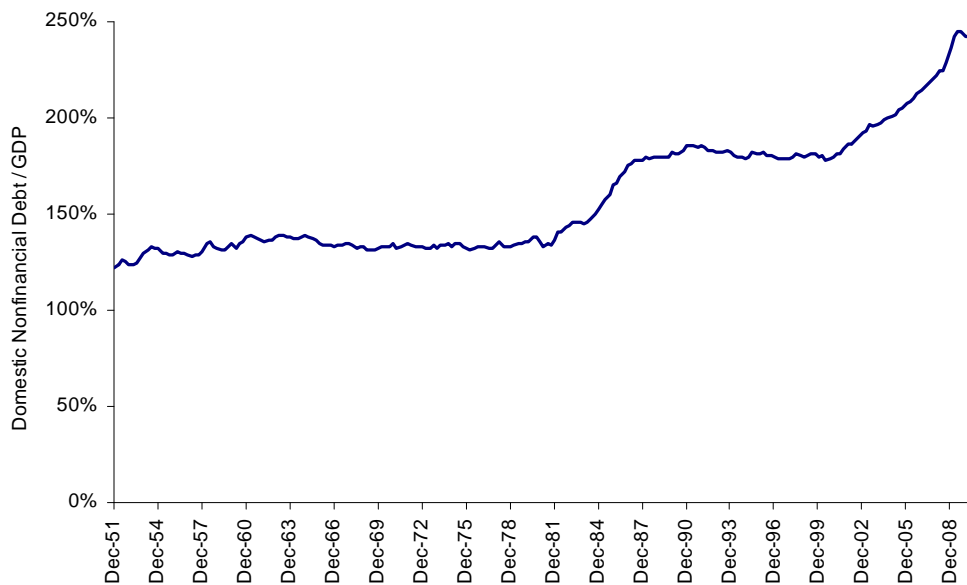


US Debt and Asset Picture

We expect moderate U.S. growth in 2011, somewhat faster than 2010 but still held back by the expansion of federal debt and the difficulty in sorting out debt with interest rates near zero.

- Despite current private sector deleveraging, overall U.S. debt levels are near their peak due to the burst in federal debt. At \$35.8 trillion, total U.S. nonfinancial debt stands at 243% of GDP in the Federal Reserve's most recent flow of funds data.

Total U.S. Nonfinancial Debt / GDP (last obs. Q3 2010)

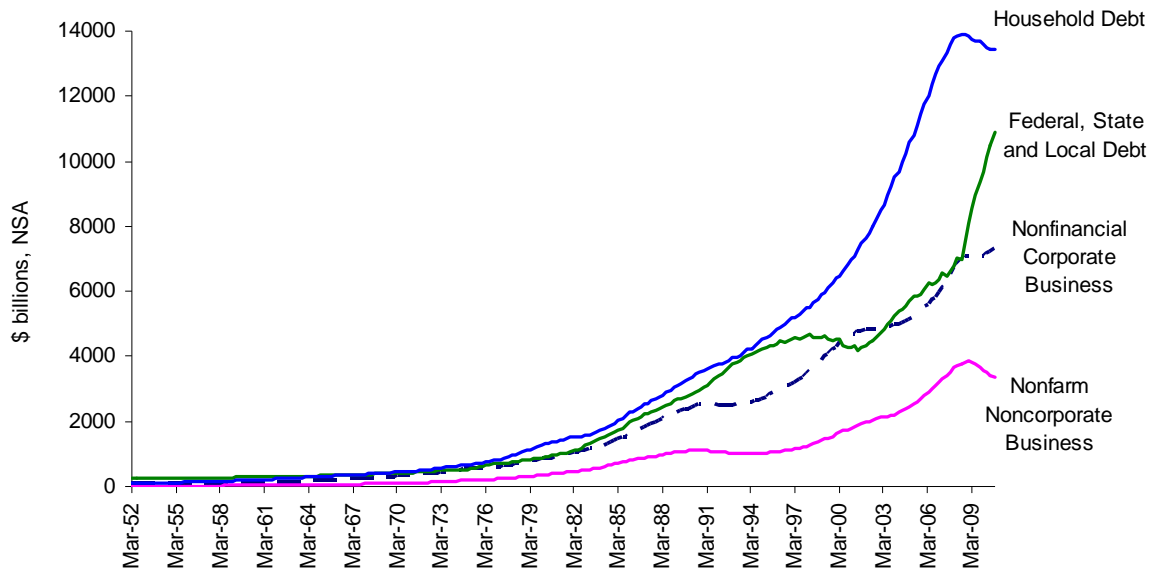


Source: Federal Reserve; Encima Global

- The housing situation, foreclosures and mortgages remain in bad condition, which reduces labor mobility. We expect an improvement in some parts of the country in 2011, but mortgage rates are rising and Washington hasn't been able to resolve the conflicts between property owners, first and second mortgage holders and the legal system.
- Excess debt and over-spending at the state and municipal level will pit pensioners against creditors against current government services. This will take a long time to resolve through courts, elections and attrition. In similar circumstances, Greece is considering the need for partial debt forgiveness. Southern Europe's debt problems still have a long way to go, with U.S. state and local problems just beginning.

- Debt has been accumulating for the federal government and big business.

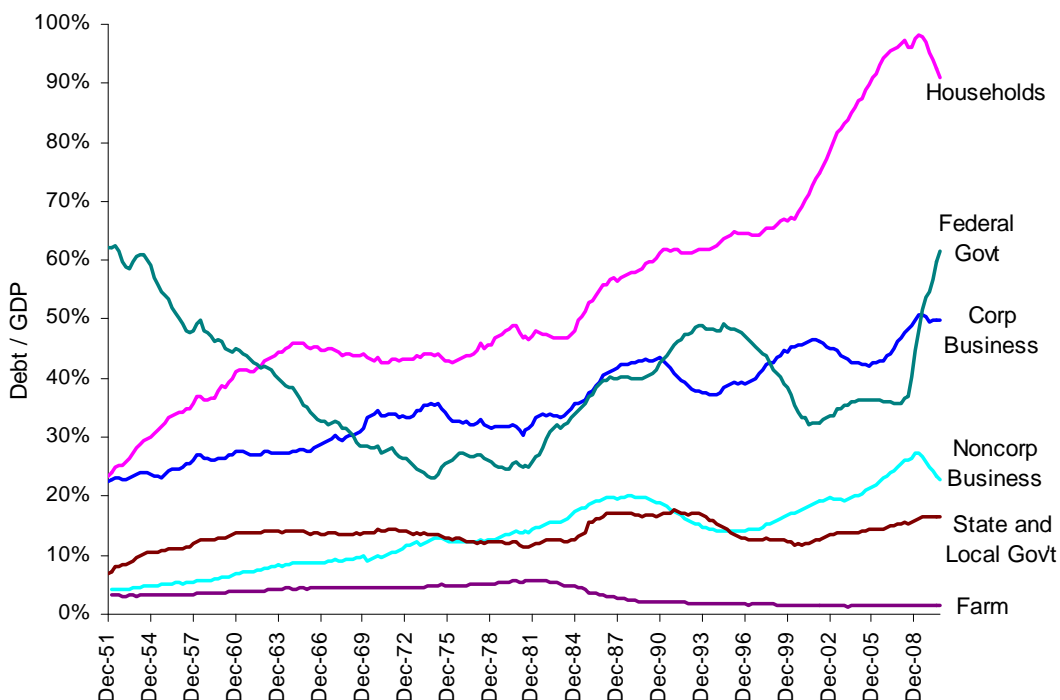
Gov't, Corporate and Noncorporate Business Debt Outstanding (last obs. Q3 2010)



Source: Federal Reserve; Encima Global

- Through the third quarter of 2010, households and small businesses saw their debt shrinking. In contrast, federal government debt has jumped to over 60% of GDP.

Total U.S. Nonfinancial Debt / GDP (last obs. Q3 2010)



Source: Federal Reserve; Encima Global

- In more recent months, small businesses have been getting some oxygen, but many debtors are still underwater – homeowners, small and medium sized businesses, states and municipalities. Unless growth speeds up markedly, many will be unable to maintain debt service. It will take more time in 2011 and 2012 to see how far these debt problems really extend and how severe their drag on growth.
- Overall debt is \$35.8 trillion. Of that, the marketable debt of the federal government is \$9 trillion. It grows with the fiscal deficit. In addition, the federal government also owes trust fund accounts \$4.6 trillion, which are expected to grow about \$300 billion per year. The Federal Reserve’s holdings of Treasury debt increased from \$800 billion in September to \$1 trillion in December. Though the Fed will likely hold it for years, the debt is still considered ‘marketable’ and part of the “debt held by the public.”

Credit Market Debt Outstanding (last obs. Q3 2010)

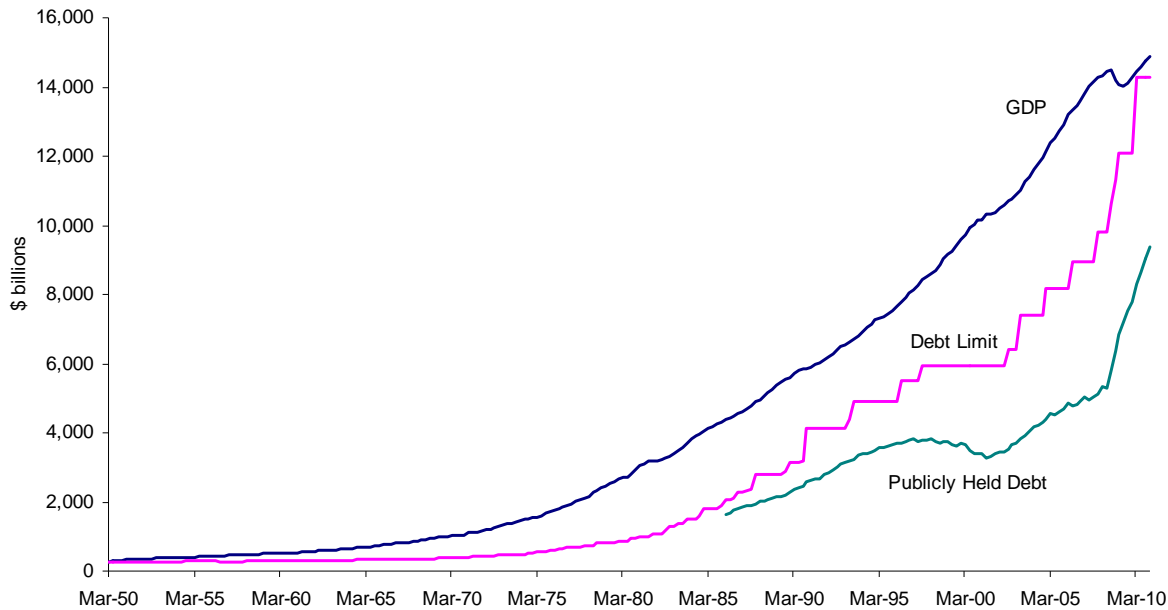
	2010 Q3	2010 Q2	Yr/Yr % chg	Yr/Yr % chg	Yr/Yr % chg
	(\$ trill)	(\$ trill)	2010 Q3	2009 Q3	2008 Q3
Domestic Nonfinancial Sectors	\$ 35.8	\$ 35.3	3.7%	4.3%	6.5%
Households	\$ 13.4	\$ 13.5	-1.8%	-1.7%	2.2%
Nonfinancial Corporate Bus	\$ 7.3	\$ 7.2	3.4%	0.3%	8.3%
Noncorporate Business	\$ 3.4	\$ 3.4	-7.5%	-4.8%	8.7%
Farm Business	\$ 0.2	\$ 0.2	0.3%	0.6%	2.2%
State & Local Govts	\$ 2.4	\$ 2.4	3.3%	3.7%	4.4%
Federal Government	\$ 9.0	\$ 8.6	19.5%	30.1%	15.3%
of which Fed Holds	\$ 0.8	\$ 0.8	5.5%	61.4%	-38.9%
as of Q4 \$1.01 trillion					
memo:					
Federal Govt Trust Funds	\$ 4.6				
of which Soc Sec	\$ 2.6				

There are unrecognized losses in Fannie Mae, Freddie Mac, Ex-Im Bank, etc.

Source: Federal Reserve; OMB; Encima Global

- At \$14.3 trillion, the statutory debt limit is approaching 100% of U.S. nominal GDP. Statutory debt grows by the combination of the fiscal deficit (which causes an increase in marketable debt) plus the increase in the holdings of trust funds. The statutory debt itself is now over \$14 trillion. It will exceed GDP by the second half of 2011, forcing a large increase (or series of smaller increases) in the statutory debt limit.

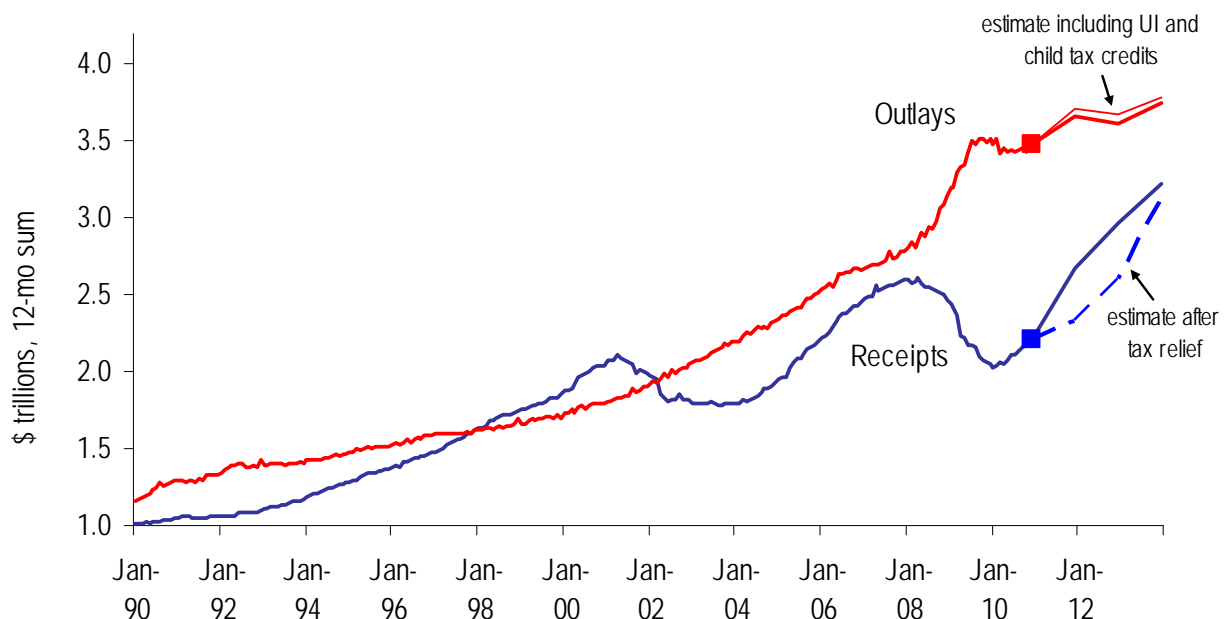
National Debt Limit at \$14.3T is Approaching GDP (last obs. Q4 2010, GDP est.)



Source: Federal Reserve; BEA; US Treasury; Encima Global

- Outlays are expected to remain high, with record transfer payments. Receipts will stay lower, leaving an expected deficit of over \$1.3 trillion. The December two-year extension of the Bush tax rates will be included in new CBO deficit projections, but the baseline used in federal budgeting will understate subsequent deficits by assuming that the Bush rates (and other tax rate extensions like the research and development tax credit) expire at the end of 2012 with no negative impact on GDP growth.

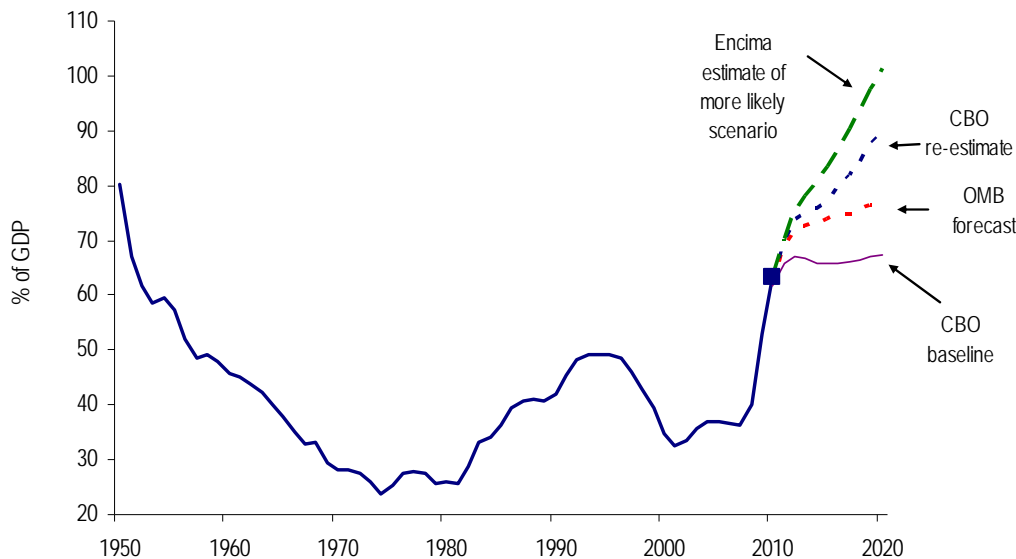
Federal Gov't Receipts and Outlays (last obs. Dec 2010, CBO forecast to 2013)



Source: CBO; US Treasury; Encima Global

- Previous CBO baseline estimates had the debt flattening out at about 65% of GDP. The White House FY2011 budget put the 2020 debt at 77% of GDP. CBO re-estimated that budget at 90% marketable debt-to-GDP. New forecasts in the FY2012 budget due in February will show substantially higher debt levels factoring in the late 2010 spending binge and disappointing tax receipts. The new forecasts will again make the misleading assumption that tax rates can go up massively (this time in January 2013) with no impact on GDP growth. This leaves a substantial systematic understatement of the likely deficit and debt – either tax rates rise and hurt growth and receipts or current tax rates are extended and tax receipts are materially below the baseline forecast.

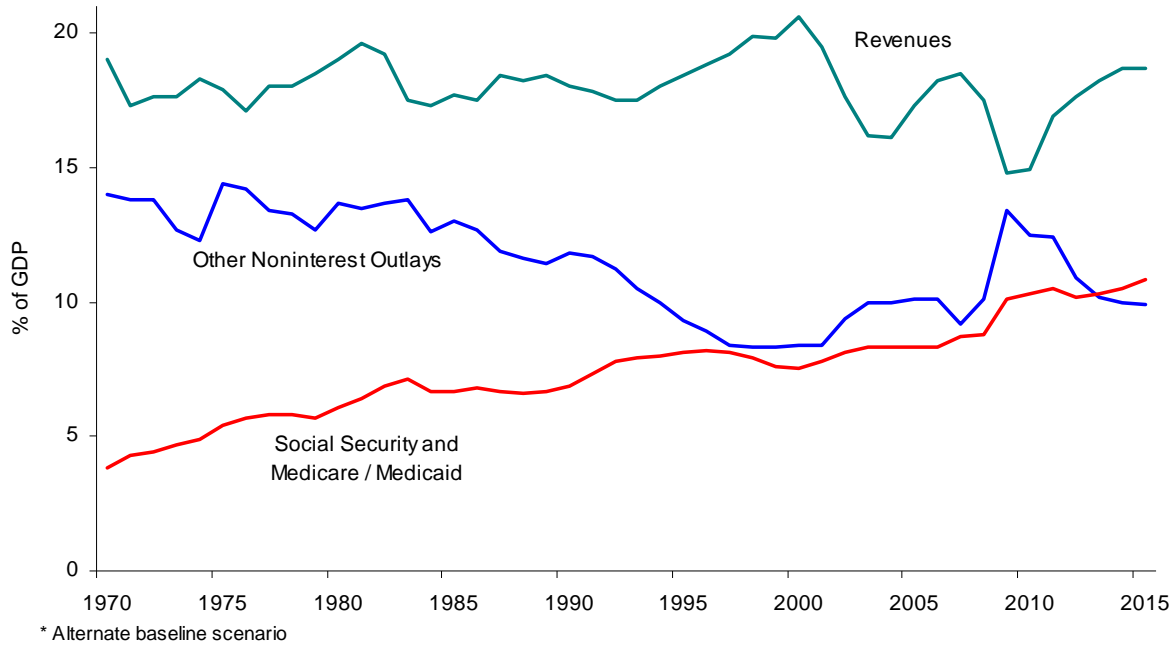
Marketable Federal Gov't Debt as a % of GDP (last obs. 2010, forecasts to 2020)



Source: CBO; OMB; Encima Global

- The debt to GDP ratio fell in the late 1990s as the federal government moved into fiscal surplus. A previous graph shows the stability of the statutory debt limit in those years. The two graphs below show some of the causes -- strong tax receipts related to the high-tech stock market boom, a decline (mostly defense-related) in noninterest outlays per GDP, and a brief demography-related period of very slow growth in entitlement spending. We don't think any of those factors will repeat in the next few years, leaving the fiscal deficit large and all debt measures -- statutory debt, the statutory debt limit, marketable debt and the marketable debt-to-GDP ratio -- increasing substantially.

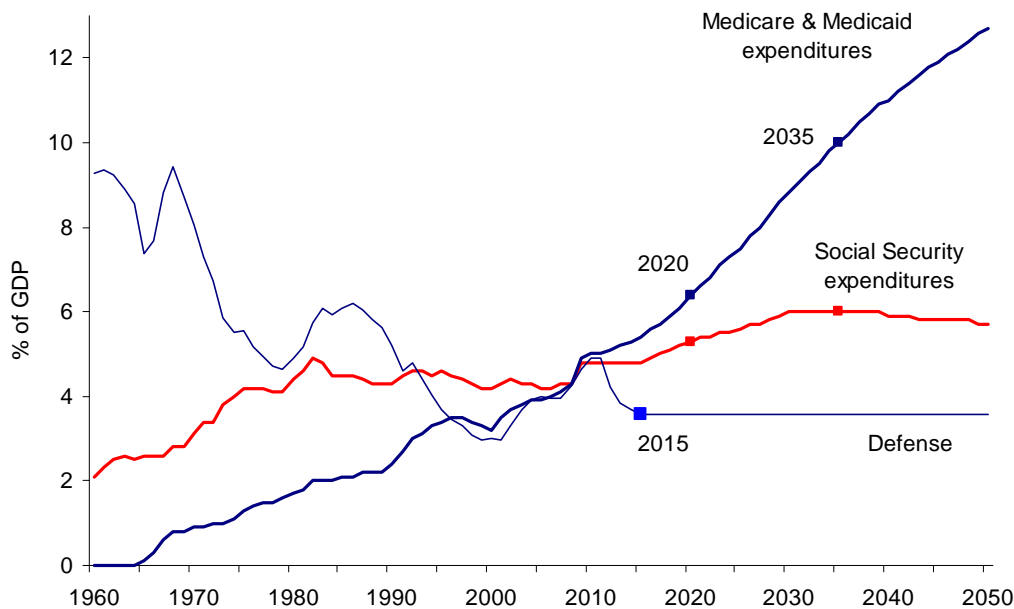
Outlays and Revenues as a % of GDP (last obs. 2010, forecasts to 2015)



Source: CBO; Encima Global

- The Administration's FY2011 budget had defense spending declining sharply relative to GDP through 2015 after a sharp decline in the 1990s. Future budgets will contend with fast growth in medical spending and the need to beef up defense spending.

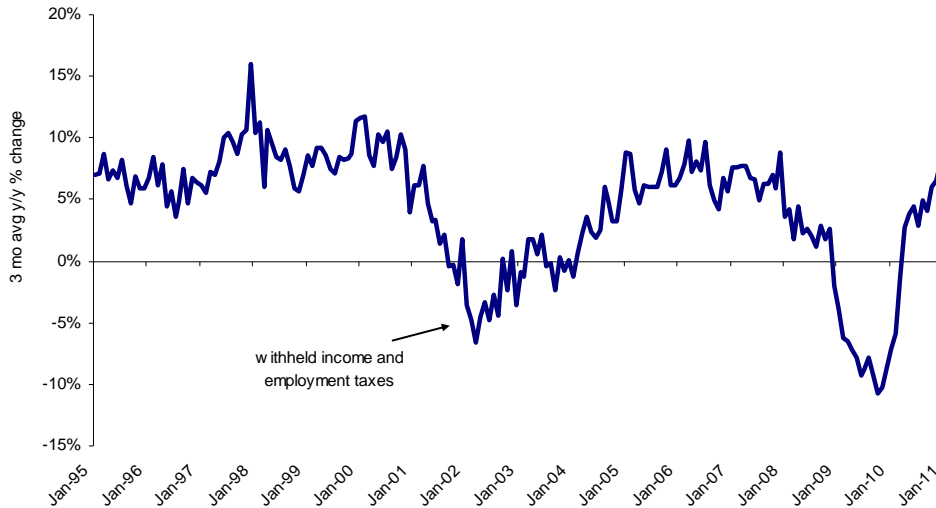
Social Security and Medicare / Medicaid Expenditures (last obs. 2010, CBO projections with defense extended to 2020)



Source: CBO; OMB; Encima Global

- Treasury's withholding tax data is showing a strong 8% gain in the fourth quarter of 2010 from the fourth quarter of 2009, but not enough recovery to materially reduce the fiscal deficit expectations. .

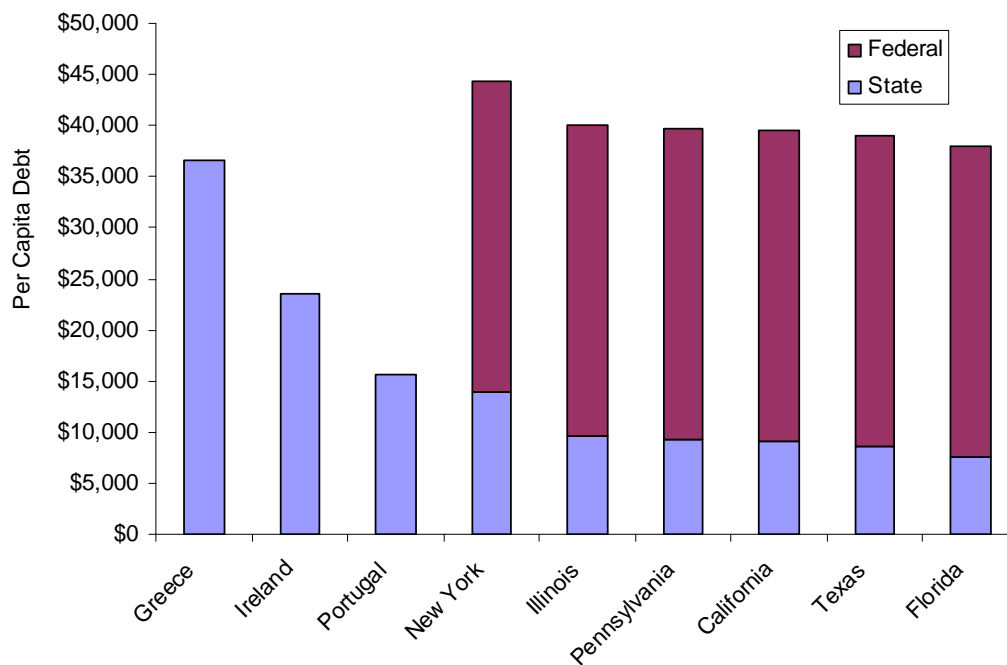
Federal Withheld Income and Employment Taxes (last obs. December 2010)



Source: U.S. Treasury; Encima Global

- The U.S. per capita debt burden was above those in Europe in 2009.

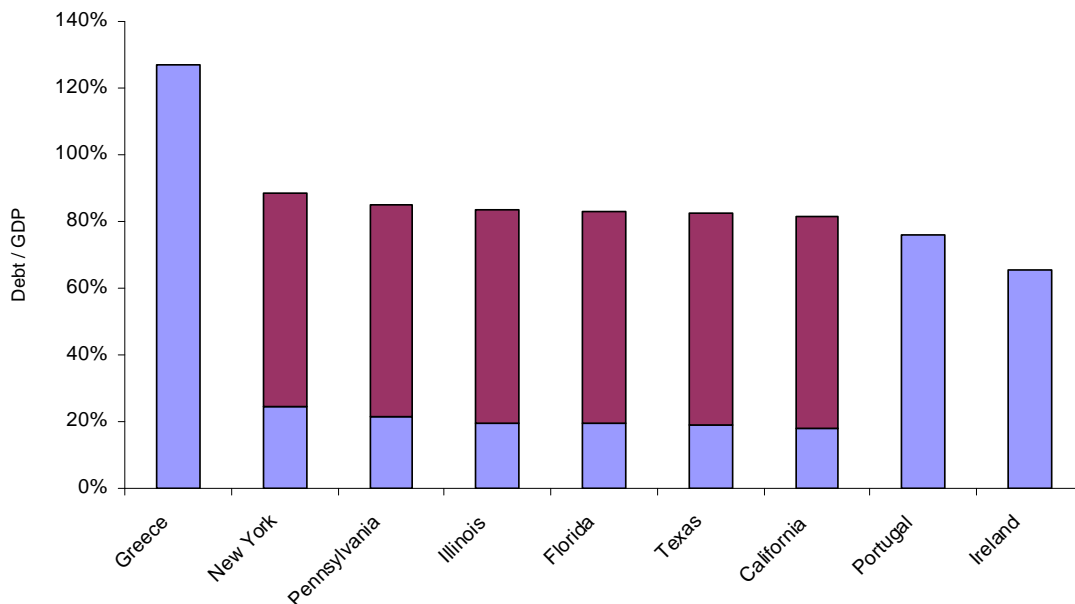
Per Capita Debt (last obs. 2008 for states, 2009 for EU)



Source: BEA; IMF; Wikipedia; Encima Global

- However, even in 2009, Greece's debt-to-GDP ratio was above U.S. levels, with Ireland and Portugal almost as heavily indebted as the U.S. This didn't count the big fiscal deficits since then, the upward restatement of Greece's debt and Ireland's assumption of bank debt.

Debt / GDP including U.S., State and Local (last obs. 2008 for states, 2009 for EU)



Source: Federal Reserve; Encima Global

- While much attention has been focused on the U.S. entitlement problem and the underfunding of the social security and Medicare trust funds, we think it is clearer to think of all government programs as a commitment of future spending, whether accounted for as an entitlement (like Medicare) or as discretionary spending (like defense.)
- In evaluating the U.S. debt problem versus other countries, we put emphasis on the current debt burden relative to GDP, its expected growth, and the nation's offsetting assets. On that basis, we think the U.S. is in a less precarious debt position than several European countries or the double-dip crisis view of the U.S. outlook. However, federal spending and debt are growing so fast from a very high level that they are already clouding the U.S. outlook.
- As the 2010 economic acceleration and government debt buildup become clearer, we think global policies will shift further toward fiscal and monetary restraint. If this also occurs in the U.S., 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 and toward the U.S. and non-commodity emerging markets.

Household Assets

As discussed in our pieces on the Fed's flow of funds data, third quarter household net worth stood at \$54.9 trillion, up from the \$53.7 trillion in the second quarter. Net worth first reached this level in the second quarter of 2005. Peak net worth was \$65.7T in Q2 of 2007.

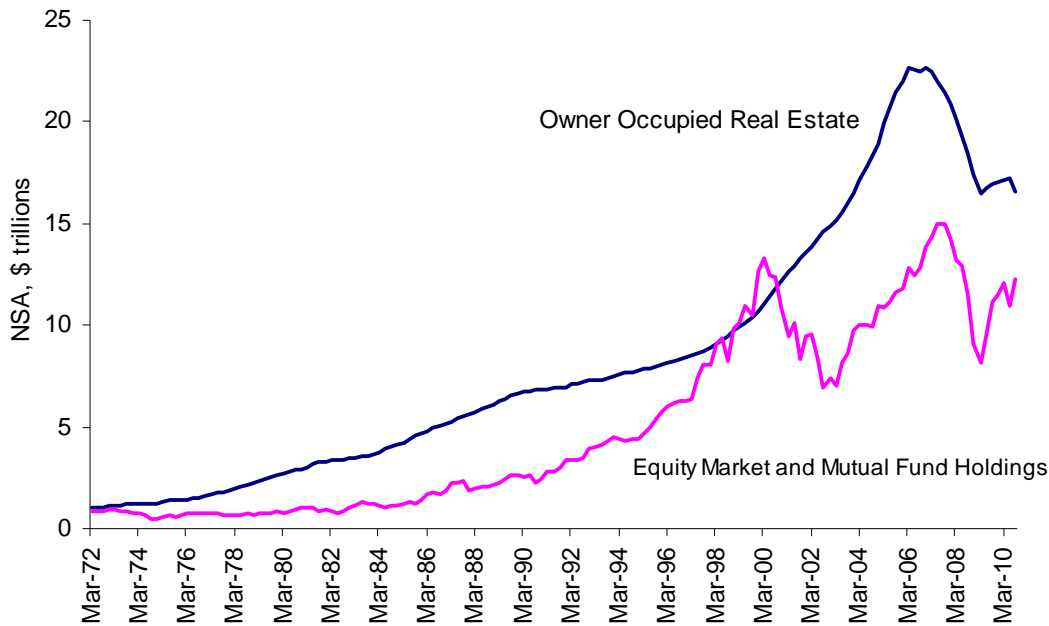
Household Balance Sheet (last obs. Q3 2010)

	2010 Q3 (\$ trill)	2010 Q2 (\$ trill)	Yr/Yr % chg 2010 Q3	Yr/Yr % chg 2009 Q3	Yr/Yr % chg 2008 Q3
Total assets	\$68.8	\$67.7	2.3%	-5.9%	-10.4%
Tangible assets	\$23.2	\$23.8	-1.3%	-8.0%	-10.8%
Real Estate	\$18.3	\$19.0	-2.1%	-9.8%	-13.6%
Other tangible assets	\$4.9	\$4.9	1.7%	-0.1%	3.9%
Financial assets	\$45.7	\$43.8	4.3%	-4.8%	-10.2%
Checkable deposits & money funds	\$1.3	\$1.3	-20.7%	6.0%	14.3%
Time and savings deposits	\$6.3	\$6.3	5.6%	-1.6%	5.7%
Credit market instruments	\$4.2	\$4.3	0.1%	1.4%	5.3%
Equities (direct)	\$7.8	\$6.9	9.5%	-4.9%	-26.9%
Mutual funds	\$4.4	\$4.0	11.5%	-0.1%	-15.5%
Pension reserves/life insurance	\$13.6	\$12.9	6.2%	-1.8%	-12.0%
Equity in unincorporated business	\$6.5	\$6.6	-1.4%	-16.8%	-11.2%
Other financial assets	\$1.5	\$1.5	4.7%	-17.4%	20.6%
Total Liabilities	\$13.9	\$13.9	-1.2%	-3.1%	3.0%
Mortgages	\$10.1	\$10.2	-2.6%	-1.6%	1.5%
Credit card	\$0.8	\$0.8	-9.8%	-8.2%	5.7%
Nonrevolving consumer credit	\$1.6	\$1.6	0.0%	-0.7%	2.2%
Other	\$1.4	\$1.4	16.0%	-13.6%	15.1%
Net worth	\$54.9	\$53.7	3.3%	-6.6%	-13.3%
Financial net worth (financial assets minus total liabilities)	\$31.7	\$29.9	6.9%	-5.5%	-15.3%

Source: Federal Reserve; Encima Global

- Household assets remain very liquid. With the U.S. household sector the world's biggest net creditor, near-zero interest rates are causing a major wealth transfer from household savers to net debtors, primarily the government.
- The assets of the household balance sheet are most affected by owner occupied real estate and equity market holdings. Equities have had a substantial recovery, but real estate has barely recovered from the bottom.

Equity Market Assets and Owner Occupied Real Estate (last obs. Q3 2010)



Source: Federal Reserve; Encima Global

- Our view is that fluctuations in household net worth are not as critical to future consumption and GDP growth as the labor environment -- jobs are most people's greatest asset. Untangling the surge in federal spending and the related debt balloon is a critical part of the labor environment. Thus, while U.S. debt levels are high, the key variable in 2011 is whether the growth in federal spending and debt can be slowed enough to stabilize.

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