

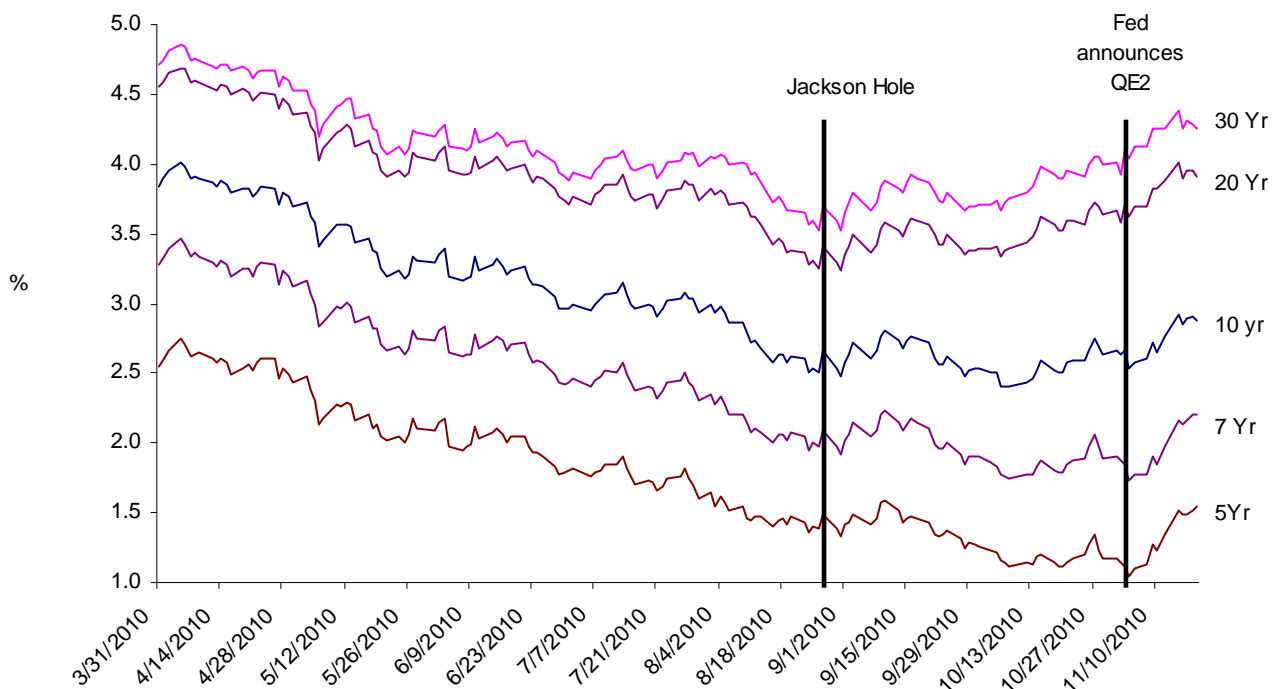
Looking Toward a Volatile December from QE and Taxes

We reiterate our near-term caution on equities on the view that markets are overestimating the effect and ultimate amount of Fed asset purchases and underestimating the year-end tax problem (see Good News Priced In, 10/26/10 and Impact of Higher Tax Rates, 11/1/10.) We think gold, commodities, bonds and stocks were all pumped up by the idea that quantitative easing would provide lasting benefits and that Congress would surely extend current tax laws. We are constructive on fourth quarter growth, corporate earnings and the near-term Irish situation, but think taxes and QE will be the bigger story in December.

We don't think QE provides lasting benefits in situations where banks are constrained by regulators rather than reserve requirements.

- It doesn't create new money or promise any improvement in the worsening bank regulatory paralysis. As expected, the market's reaction related to the Fed's November bond purchases was to buy the rumor, sell the news, earning a profit by getting ahead of the Fed using the same pattern that prevailed with the Fed's January 2009 MBS purchases (see Tax Cut Plus QE2 – Both in Doubt 11/10/10.)

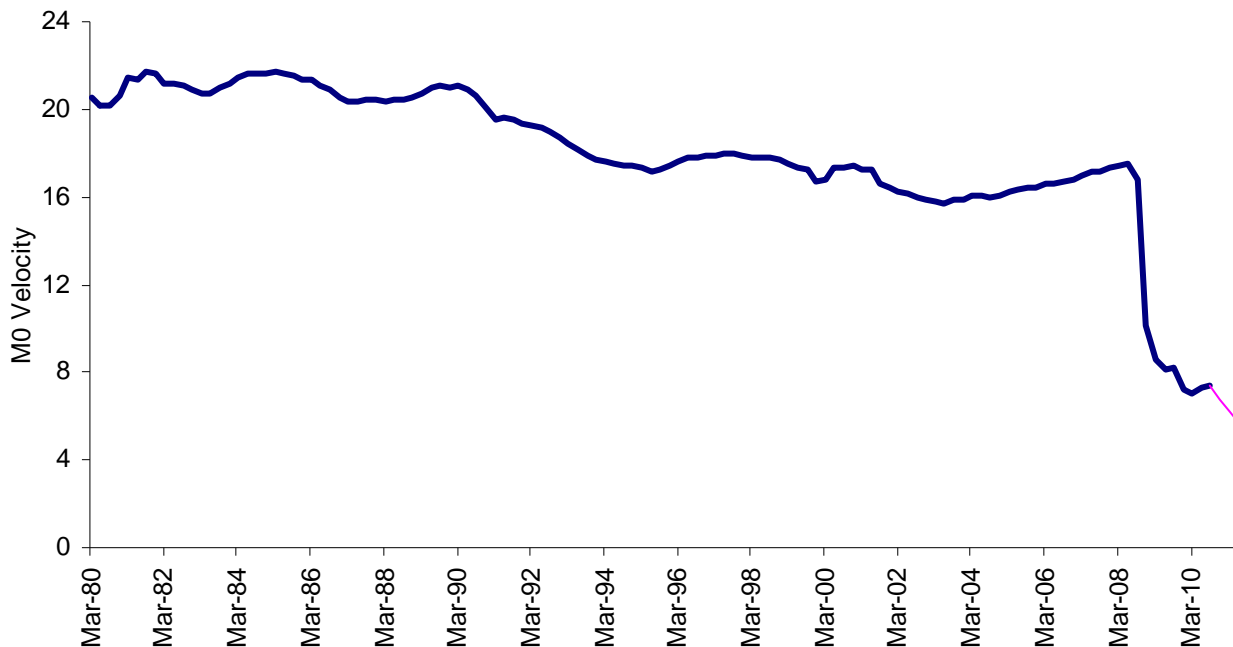
U.S. Treasury Yields various maturities (last obs. November 19, 2010)



Source: Federal Reserve; Encima Global

- Expanding the Fed's balance sheet adds to exit risks. The Fed has a very small equity cushion, so the larger the Fed's balance sheet, the more unstable the system. A small upturn in the velocity of M0 will cause a big increase in nominal GDP and the neutral Fed funds rate. In effect, it's a long lever.

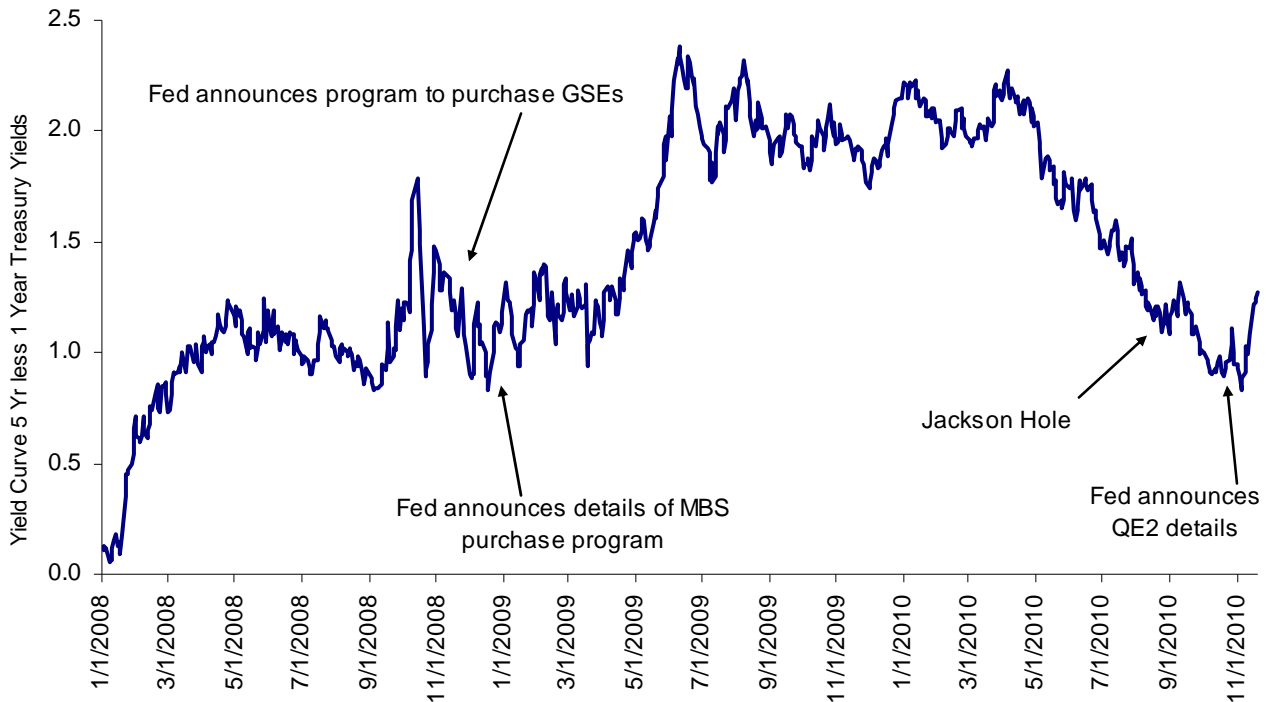
M0 Velocity (last obs. Q3 2010, projected to Q2 2011)



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

- In particular, academic concerns now point to the Fed concentrating too much on the tail risk from deflation and not enough on the tail risk from inflation. The Fed's operational plan seems to be to hold its large balance sheet for a long while, funding it with excess reserves. The problem is that, once growth starts, banks will have a large opportunity cost from investing in excess reserves, so the Fed may find itself losing principal as bond yields go up and simultaneously facing a sharp decline in profits or even a loss if the interest rate on excess reserves goes above the locked-in yield on the Fed's huge portfolio of long-maturity assets.
- Through QE, the government is taking on duration risk (funding long-term assets with overnight debt). We're skeptical that this can flatten the yield curve in a sustainable way since taxpayers still ultimately bear the risk. To the extent the government takes that risk, taxpayers should take less.
- We note the market's tendency to steepen the yield curve except when the Fed is making new asset purchase commitments.

Yield Curve 5 Year less 1 Year U.S. Treasury (last obs. November 19, 2010)



Source: Federal Reserve; Encima Global

Tax Cut Very Hard To Pass

We've emphasized in several pieces the degree of difficulty in extending tax provisions during the lame duck session. For now, both sides in Washington say they are working toward a deal and hope to find one by year end. That makes sense from a communications standpoint – neither side wants to take the blame for lack of effort if withholding rates go up on January 1.

However, the reality is that very little progress has been made in compromising on the nearly one hundred tax extensions:

- Last week, Republicans delayed until after Thanksgiving a meeting with the President to discuss taxes. The House vote against the unemployment extension shows the difficulty of passing any legislation that increases the projected deficit.
- The initial tax votes will be time consuming and polarizing. In early December, the Democrats plan to propose an extension of the middle-class cuts – which will be portrayed by opponents as a tax increase on small businesses. Some Democrats up for election in 2012 have already said they will have trouble supporting a bill that leaves small businesses facing higher tax rates. The Republicans then plan to propose an

extension of all the tax cuts – which will be portrayed as a budget buster. Neither proposal will get anywhere near the required 60 votes.

- The proposed extensions score poorly, meaning the planned compromise – a two-year extension of all provisions– has several problems. It will be scored as a giant tax cut (\$700-\$800 billion, same range as the 2009 fiscal stimulus bill) at a time when the public is looking for deficit reduction. One variation under discussion would separate small business income (to be taxed at existing rates) from high W2 income earners (to be taxed at a higher rate.) This would still score badly.
- Almost any bill will be thick, complicated, assembled by the sitting Finance Committee Democrats, and filled with hold-your-nose provisions that look a lot like the earmarks many members have vowed to oppose (subsidies for ethanol, wind, solar and a host of other special interests.)
- From a market standpoint, there's an added complication. If there is a deal, it probably won't be achieved until late December. A tax increase would be so harmful that markets will need to take precautions starting in December to value stocks, bonds and the dollar as if there might be a giant tax increase. Adding to the valuation challenge, our view is that it will be even harder to pass tax cuts in 2011 than in 2010 given the makeup of the new House and Senate. If the lame duck looks to be unsuccessful in extending current tax rates, markets will need to price assets on the assumption that the January 1 tax increase may be permanent – good for bonds and initially for the dollar, bad for equities and commodities.

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