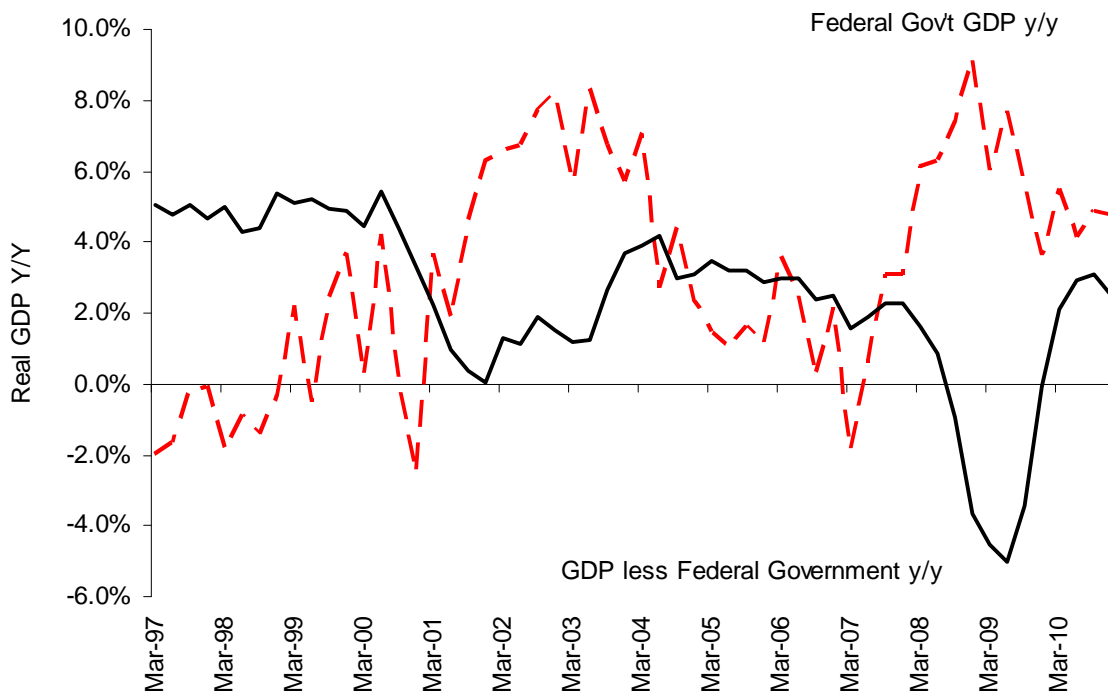


Only Small Budget Cuts Coming; Washington's Boom Goes On

After 4% growth in the first quarter, we expect a letdown in U.S. GDP growth to 3% in coming quarters as price increases begin to bite and pent-up demand, especially for autos, is met. Auto stocks have weakened materially. Capital equipment orders showed weakness in January, down 6.9% from December. News of high gasoline prices, fights over state spending, and turmoil in North Africa will have a dampening impact.

- **We disagree with the view that the spending cuts being discussed in Washington will further reduce GDP growth.** Ultra-loose fiscal and monetary policy is creating lasting inflation and debt problems. They don't provide sustained growth. Markets and the private sector are forward-looking, so Washington restraint would be a positive for growth and investment, not a negative. It's unlikely that Washington will cut spending decisively enough to improve the private sector growth path. The graph shows that federal government purchases (counted in GDP at cost) are still growing much faster than private sector output.

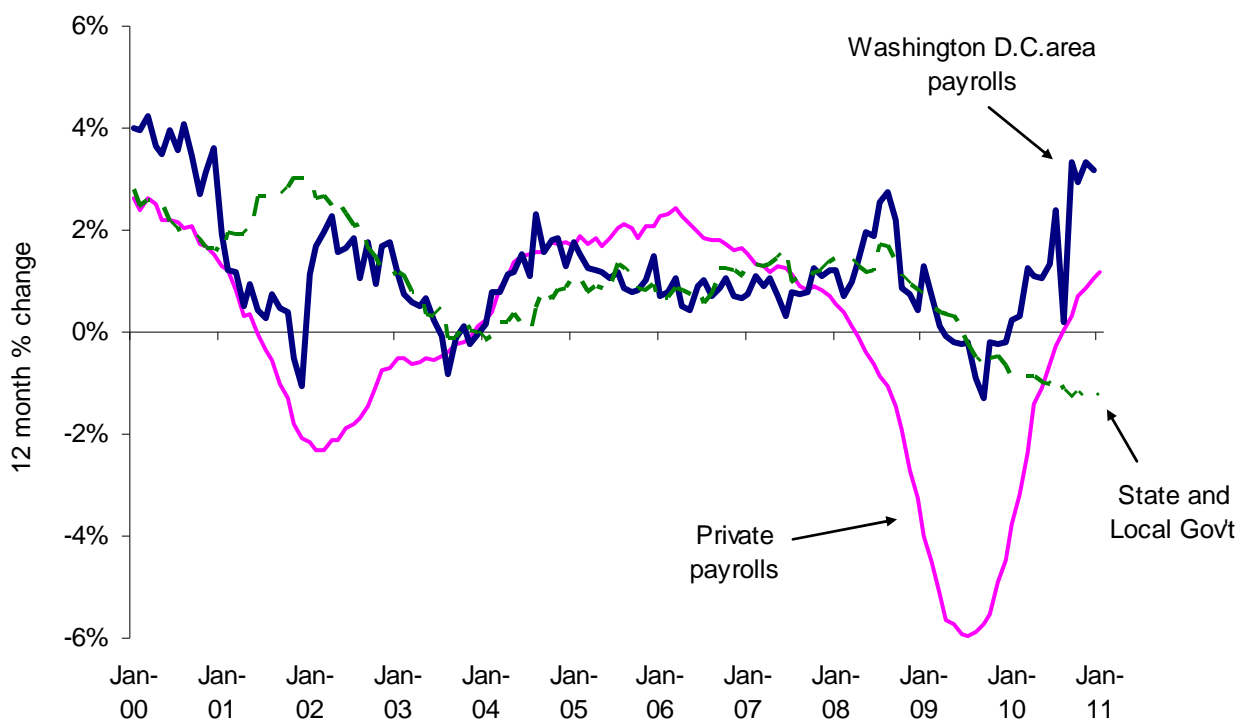
Private Sector Growth vs. Federal Growth (year-over-year, last obs. Q4 2010)



Source: Bureau of Economic Analysis; Encima Global

- Government agencies are preparing for a shutdown on March 4 when current spending legislation expires. The House has passed budget cuts, but the Senate is unlikely to agree and will probably get support from the public. We expect an eventual compromise, but without the much-needed structural reforms in federal spending programs that would add to U.S. growth prospects. Headlines will claim large budget cuts – both political parties have an interest in a large number -- but the cuts are from an elevated baseline and many of them are dependent on the scoring methodology. Many of the cuts will “score well” (meaning give the impression of big cuts) without actually reducing any jobs or contracts. Almost no programs will end.
- Jobs and income are growing faster in Washington DC than in other parts of the country. **Washington DC area payrolls have grown 3.2% in the last year. That’s the fastest rate since the Clinton boom and almost triple the 1.2% growth in nationwide private sector payrolls.** In contrast, state and local government payrolls fell 1.2% over the last year.

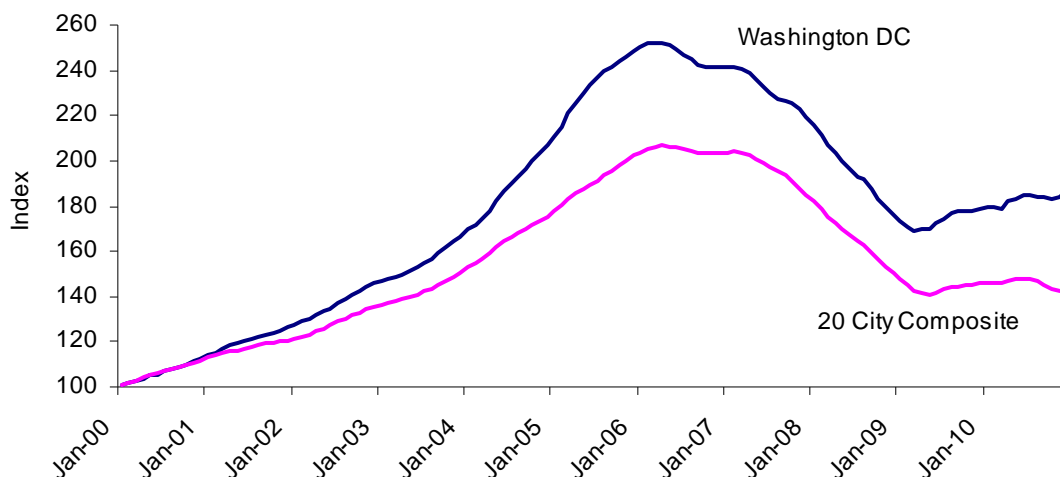
Payrolls Grow Faster In Washington DC (last obs. Jan 2011)



Source: Bureau of Labor Statistics; Encima Global

- Similarly, Washington’s residential and commercial real estate are substantially outperforming the national average. In the most recent Case-Shiller index, **Washington home prices showed a 4.0% increase in prices year-over-year versus a 2.4% decline for the 20-city average.**

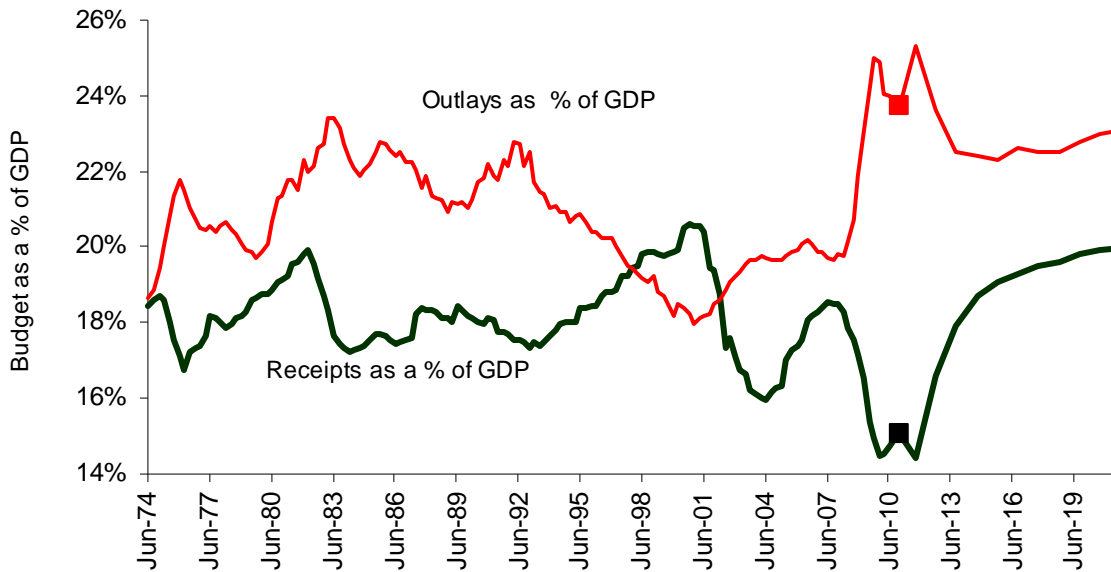
Case-Shiller Home Prices: Washington DC and 20 City Composite (last obs. December 2010)



Source: S&P/Case-Shiller; Encima Global

- We don’t think Washington will change spending trends very much. The regulatory expansion is likely to accelerate due to recent legislation -- there were thousands of pages of laws passed in the December lame-duck session alone. The Administration’s just-released budget projects debt at 107% of GDP in 2021 assuming major tax increases in 2013 and very fast GDP growth. Outlays are expected to remain above 22% of GDP for the next ten years. Receipts are projected to rise quickly and then stay consistently above 19% of GDP after 2015. While some spending cuts are likely, there’s no process on the drawing board to alter these fundamentals.

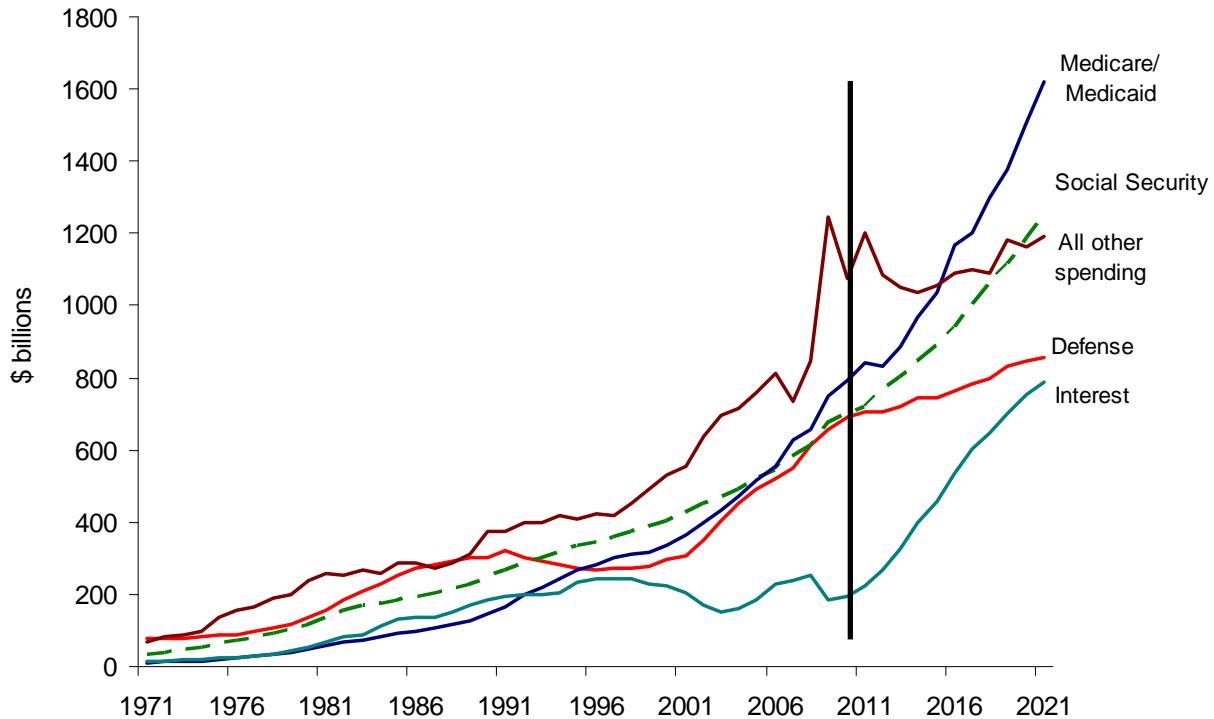
US Federal Gov't Receipts and Outlays as a % of GDP (last obs. 2010, OMB forecasts to 2011)



Source: OMB; Encima Global

- In OMB's budget, spending is projected to grow from \$3.8 trillion this year to \$5.7 trillion in FY2021.

Government Spending by Major Category (last obs. 2010, CBO proj to 2021)



Source: CBO; Encima Global

A normal expansion depends on small and new businesses hiring workers as their prospects for after-tax profit improves. Private sector credit normally grows. In contrast, this expansion has been characterized by pent-up demand from the very low 2009 trough, a massive increase in public sector credit, not private sector, and a channeling of new activity into the federal government, big companies and foreign countries.

- **By making many of the key economic and market decisions, Washington's role in the economy has grown substantially.** We think this phenomenon – Washington having a stepped-up impact on the economy, markets and sectors – is here to stay, reducing long-term private sector growth prospects but maintaining the boom for Washington DC.

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