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Second Half Lift Off With U.S. Alone on Weak Monetary Policy?

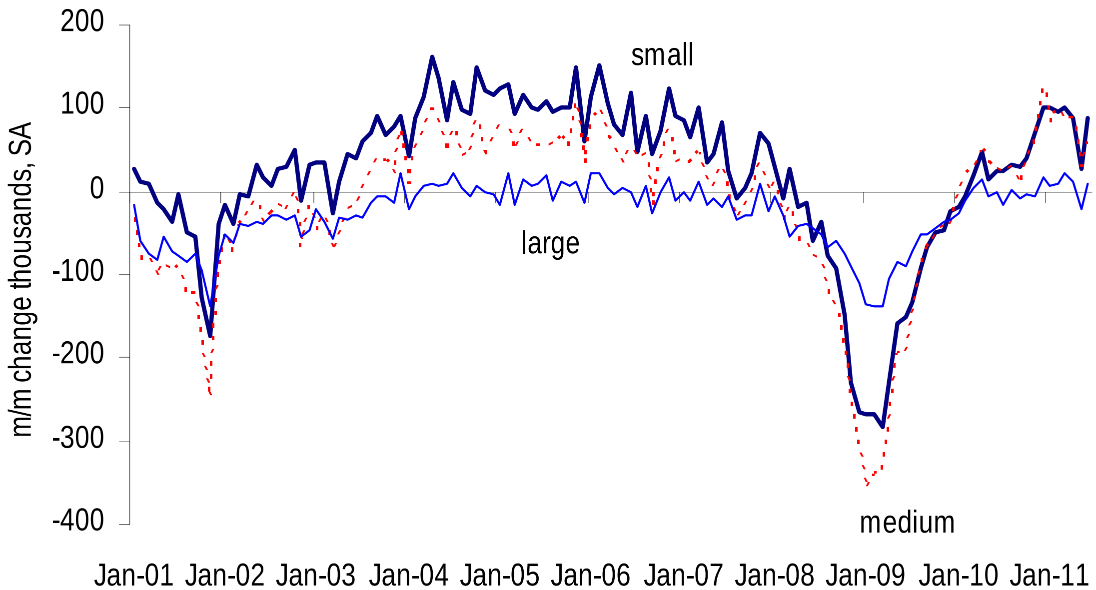
We're maintaining our 3.5% second half growth assumption, a marked acceleration from the 1.8% growth we expect for the second quarter.

- There's a chance of a stronger burst once the debt limit increase gets done, drawing on pent-up demand and an overflowing punch-bowl of high-powered central bank liquidity around the world (now at a record $10.1 trillion.) See discussion of this in today's client conference call "Why Constructive? Engines of Growth During Malaise."

- U.S. bank lending and money supply growth have picked up markedly in recent weeks. The latest stock market jump and gasoline price slump will cause talk of the wealth effect and added purchasing power (though we think the Japan rebound is more important.)

- Today's ADP data showed a stronger-than expected 157,000 in private sector job growth in June. Small businesses added 88,000 net, medium-sized 59,000 and large businesses 10,000.

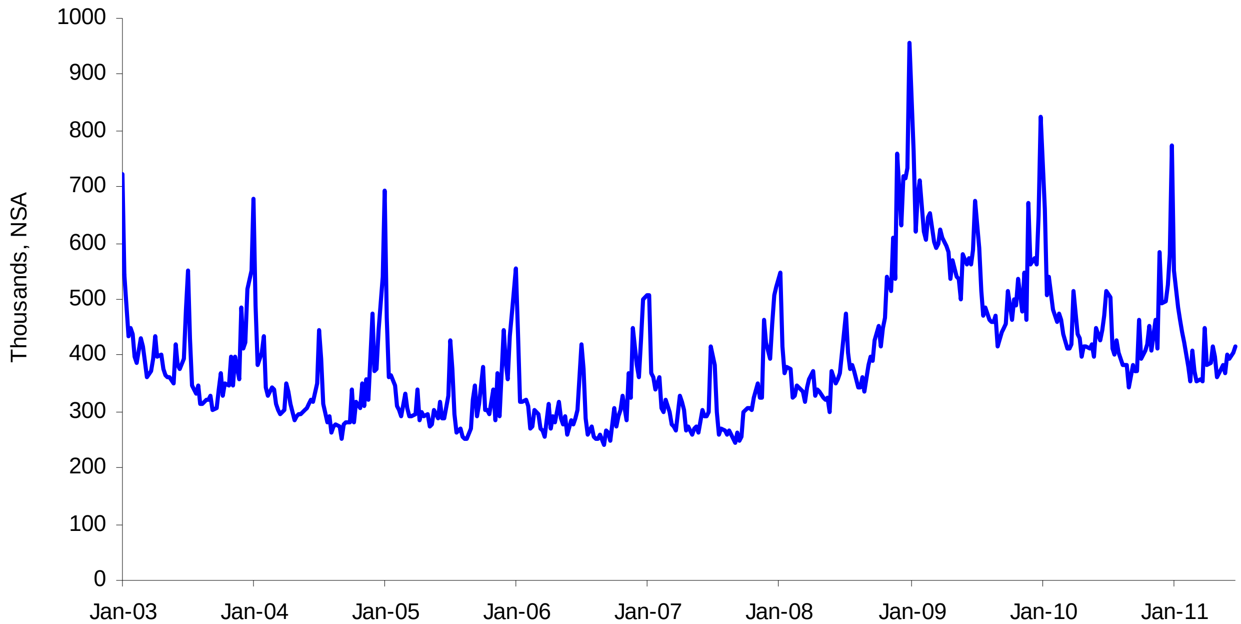
ADP Monthly Jobs Growth by Company Size (last obs. June 2011)



Source: ADP; Encima Global

- Today's initial jobless claims were relatively steady at 418,000. The data was for the week ended July 2. We think jobless claims will go down some with the data released July 14 because the auto sector may have fewer-than normal post-July 4 shutdowns (having shutdown in April and May). The seasonal adjustment assumptions are very strong in the remainder of July based on regular post-July 4 shutdowns in previous years which employers feed directly into jobless benefits on behalf of unions, so seasonally-adjusted claims will go down unless there are a lot of auto layoffs.

Initial Jobless Claims Not Seasonally Adjusted (last obs. July 2, 2011)



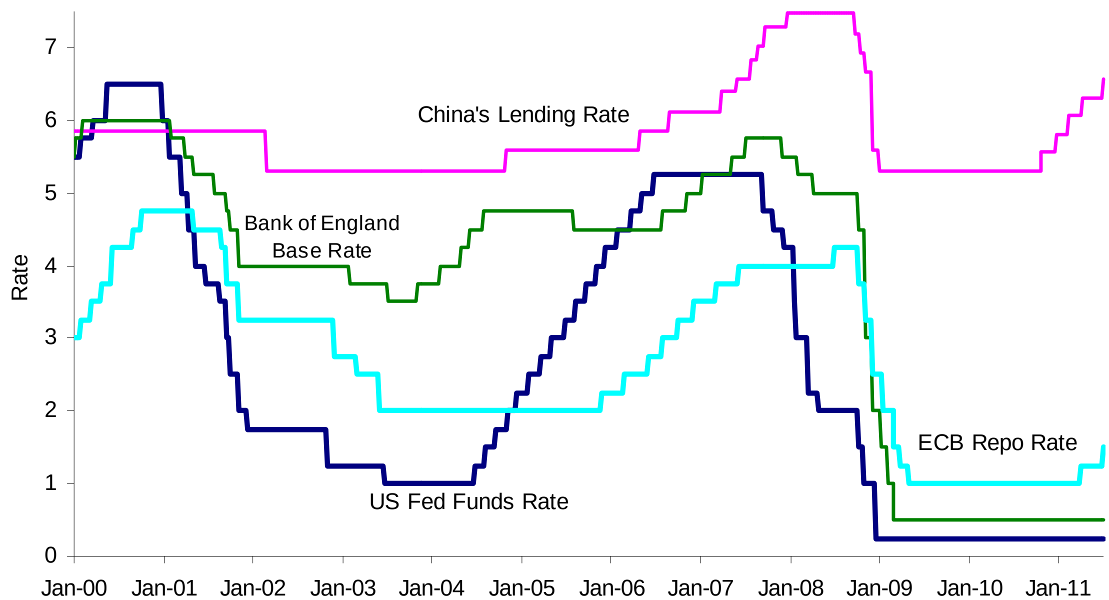
Source: Department of Labor; Encima Global

- We think the 2011 soft patch was about half as big as the 2010 soft patch. The peak to trough 2011 equity loss, at 8% for the S&P, has been about half the 2010 setback. With P/E multiples low and prospects for corporate profit growth good, we expect further equity gains as investments shift toward equity from bonds, especially after the debt limit increase.

U.S. Alone on Weak Monetary Policy

The ECB raised its rate to 1.5% today from 1.25%, following China's fifth hike yesterday to 6.56% for its one-year lending rate. Trichet said he expected more ECB hikes – we think the ECB rate should reach 2.5% by year-end. China may pause to see the results of previous hikes and the hoped-for peak in CPI inflation at about 6%, but the PBOC may have to go higher later in the year if commodity prices stay high.

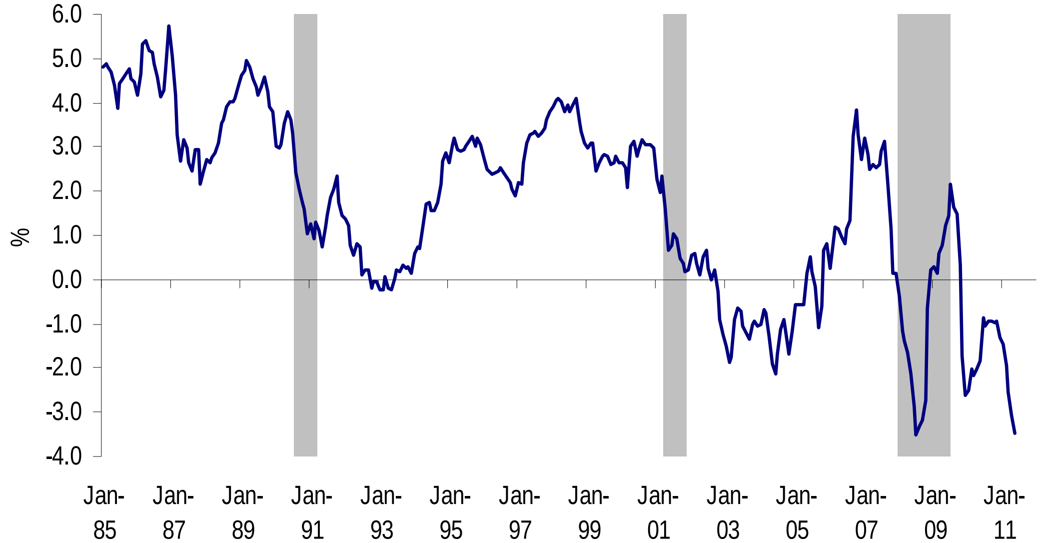
Policy Rates around the World (last obs. July 7, 2011)



Source: Bloomberg; Encima Global

- Meanwhile, the Federal Reserve stands alone imposing a near-zero Fed funds rate years after the crisis. We think the Fed will say and do nothing on monetary policy while the debt limit is still being worked out, but will have to send less dovish signals after the debt limit is raised and second half growth forecasts rise.

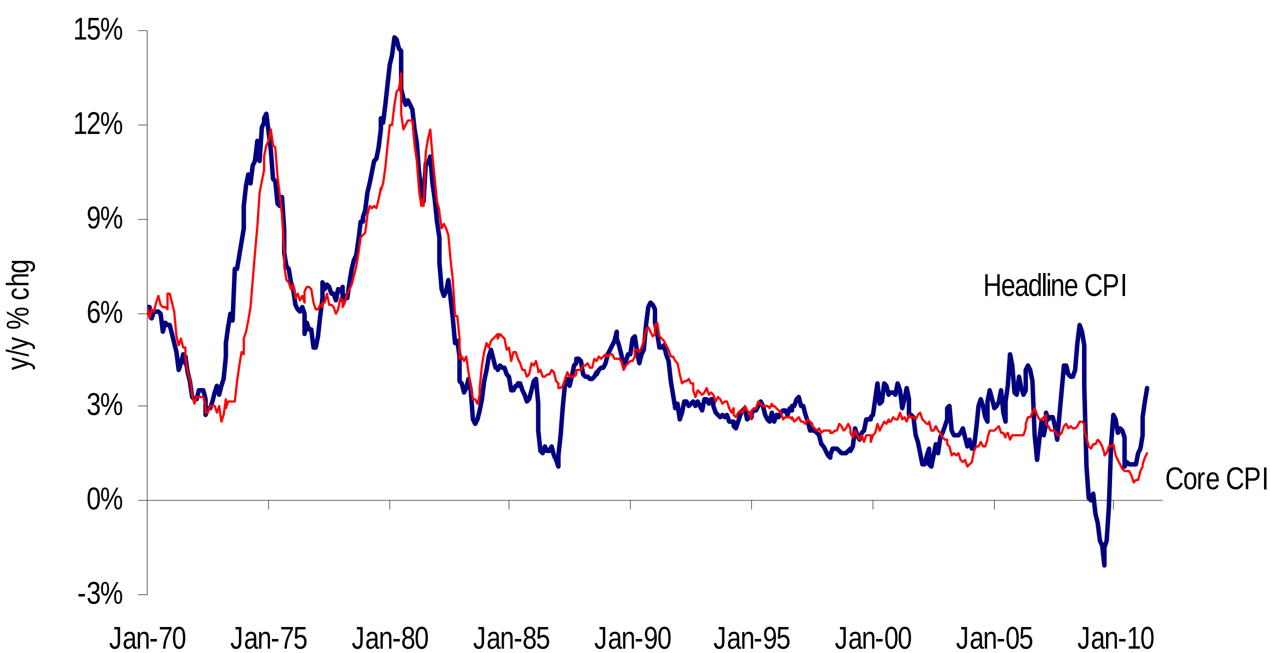
Negative Real Fed Funds Rate (using headline CPI, last obs. May 2011)



Source: Federal Reserve; Bureau of Labor Statistics; Encima Global

- Inflation data for June is due July 15. We expect headline CPI to rise to 3.8% year-over-year from 3.6% in May (assumes a 0% mom change due to gasoline price decline). We think this will be the peak for headline CPI through year-end. Core CPI should continue rising from the 1.5% year-over-year rate recorded for May.

Headline and Core CPI y/y (last obs. May 2011)



Source: Bureau of Labor Statistics; Encima Global

The Fed has many signals it could send if it wanted to move off its ultra-dovish position:

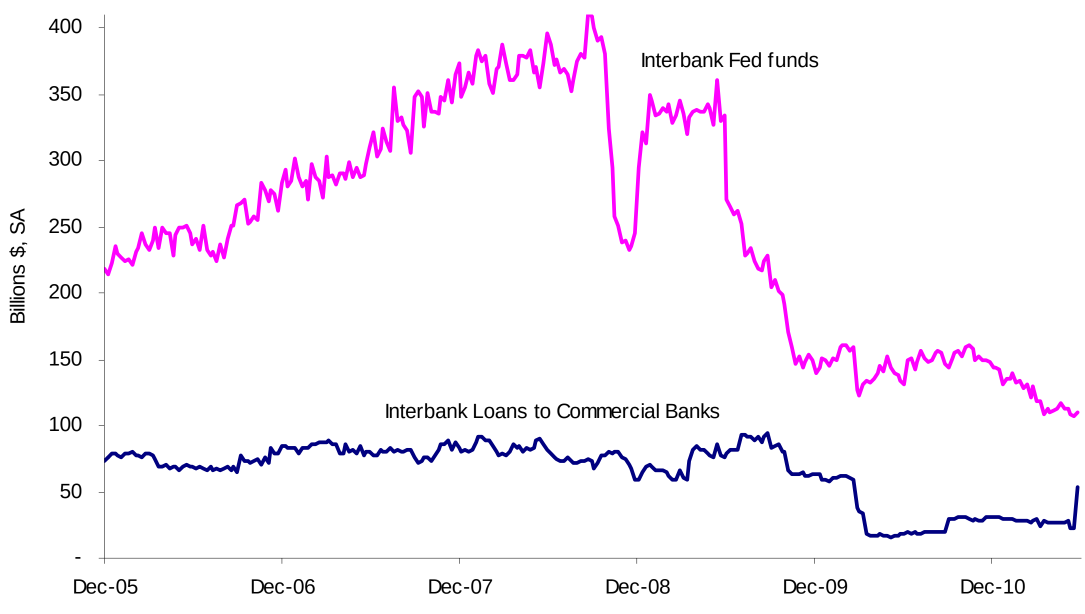
- Concern over inflation. So far, Chairman Bernanke has emphasized the transitory/temporary nature of the spike in inflation, but with oil prices nearing $100 per barrel despite the SPRO release, he has an opportunity to express concern.

- Recognition that the growth environment is looking up again. The Fed lowered its 2011 growth forecast to 2.8% after the June 22 FOMC meeting, probably marking the end of the downgrades.

- Abandonment of QE3 as a tool. The Fed's own studies are showing that QE2 was ineffective as did Japanese studies of its own "pushing on a string" exercise in futility. It's an easy step for the Fed to voice questions about QE2 as a signal that its taking QE3 fully out of the tool box. This would have the added benefit of strengthening the dollar a bit and heading off the bulge in commodity prices that will come if growth expectations go back up.

- Outright discussion of the need to move above the zero bound in order to allow markets to start working again. For example, the Fed could begin discussing the problems in the interbank market, where volumes have dried up. Stanford professor Ronald McKinnon has documented the damage to small banks from the paralysis in the interbank market.

Interbank Lending volumes: Direct and Fed Funds (last obs. June 24, 2011)



Source: Federal Reserve; Bureau of Labor Statistics; Encima Global