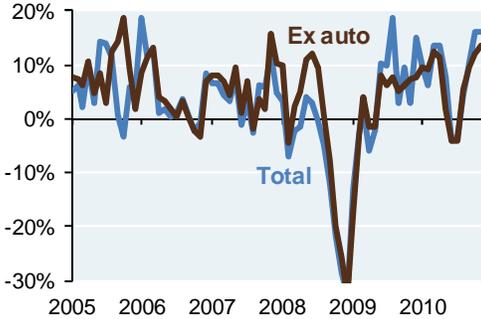


Topics: Happy Holidays and the Home Front

As the year comes to an end, the world's largest economic force is coming to life (US consumer). The November retail sales report was solid, and prior months were revised upwards. US consumer spending is tracking 4% growth in real terms, which should push Q4 GDP growth into the low 3's. Small business sentiment, which did not improve much in 2010, has finally trended upwards. Fiscal stimulus from proposed payroll tax reductions, as well as rising employment demand signaled by various surveys, should provide additional support for consumers. In Asia, after a slowdown in the early fall, exports are rising again in China, Korea and Taiwan, and regional manufacturing surveys point to more strength ahead. Global car sales hit a record high in November, driven by a whopping 30% increase in China since last May (the traffic on Hainan Island last week was terrible). Our investment portfolios have benefited as markets have priced in a lower risk of relapse.

Retail sales: what recession?

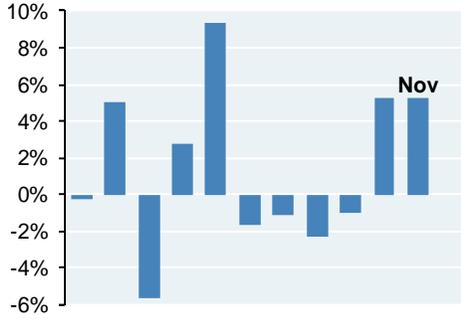
Percent change - QoQ, annualized



Source: Census Bureau.

EM Asia - Big 3 exports in 2010

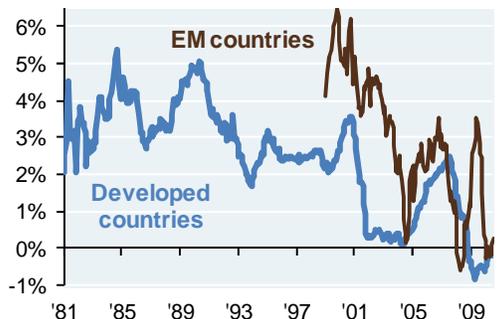
Percent - MoM in USD, China, Korea, Taiwan



Source: J. P. Morgan Securities LLC.

Cost of money = zero

Policy rates adjusted for inflation, percent



Source: J.P. Morgan Securities LLC.

As a word of caution, I would remind everyone (again) that this recovery has been stoked by a global monetary policy phenomenon that reduces the cost of money to zero (see chart). With that in mind, a recovery is not as unexpected as it might seem. The real trick will be to keep it going once the real cost of money returns to normal, with long-term bond yields going with them. In the emerging world, the tradeoff of employment gains versus inflation (in wages, prices and assets) is now more difficult. As for Europe, the Maginot Line that is now Spain is likely to be tested early next year, where there is almost no growth at all. Overall, the world's combined monetary and fiscal imbalances are still at an all-time high. More on all these topics in our 2011 Outlook on Jan 1.

We go through a lot of research as part of our investment process, but not all of it is investment-related. Here are two recent topics that might be of interest.

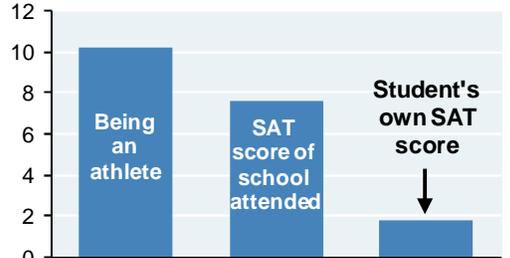
First topic: many families have children with **widely diverging levels of academic success** (mine included). It can be very hard to be the less-achieving student, particularly on report card day. So I was glad to come upon a study by a Princeton economist (and former Treasury official) showing that **SAT scores have almost no correlation at all to future earnings**. In the study, whether a student was an athlete mattered a lot more as a leading indicator. Furthermore, for an *average* student, college admissions have not become more difficult over time, as falling admissions rates are mostly a reflection of a rising number of applications per student. See sources below for more details.

Second topic: a recent study by the ZEW Center for European Economic Research looked at married couples in Germany, Australia and the UK. It revealed that marriages with "happiness gaps" are less likely to survive. That seems unremarkable. What was surprising is that **marriages in which wives were more unhappy were 15-25 times more likely to break up than when husbands were more unhappy**. For cohabitating couples, the asymmetry of wife unhappiness was even higher. The researchers did not make any assertions as to why this might be the case; I spoke to one of the authors, who said she is still trying to figure out why. She also said she was very happily married.

Have a very happy holiday season. For some of you, don't forget to help out at home.

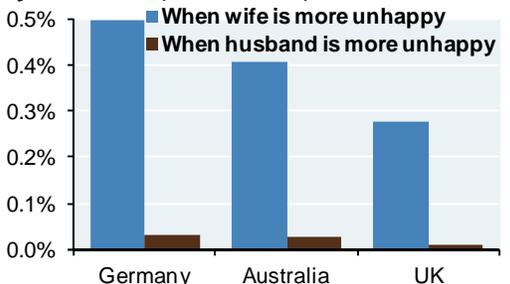
Michael Cembalest
Chief Investment Officer

Impact on an individual's future earnings from: Regression coefficient, %



Source: Dale and Krueger, Quarterly Journal of Economics.

Probability of breaking up in the next year, Breakup coefficient, percent



Source: Guven, Senik, & Stichnoth, Center for European Economic Research.

Topics: Happy Holidays and the Home Front**Sources and explanations**

“*Estimating the payoff to attending a more selective college: an application of selection on observables and unobservables*”, Stacy Dale and Alan Krueger, Harvard College, Massachusetts Institute of Technology, and Quarterly Journal of Economics, November 2002. The study was conducted using high school graduates from 1972; a more recent study was conducted by the authors, and yielded very similar results. By citing this paper, I am not trying to say that earnings are the only thing that matters in life. But under-achieving students may feel vulnerable these days, with articles in the press about how it’s harder to get into Bowdoin College in Maine than Princeton was in the 1970s. Letting them know that grades are not the primary determinant of their eventual ability to live on their own and be financially independent was reassuring, in our case.

Another thing to recognize: falling acceptance rates at many universities is more a reflection of a **rising number of applications** rather than of changing admissions standards. While standards may have tightened at Harvard and Stanford, the selectivity of most colleges has not changed much in recent decades. **“If you are the average student, you certainly should not be worrying about college admissions standards rising. It is really only students who are at or above the 90th percentile in aptitude and achievement who should think about college selectivity rising.”** [Professor Caroline Hoxby, director of the Economics of Education Program for the National Bureau of Economic Research; “*The Changing Selectivity of American Colleges*”, October 2009).

“*You Can’t Be Happier than Your Wife: Happiness Gaps and Divorce*”, Cahit Guven, Claudia Senik, and Holger Stichnoth, ZEW Zentrum für Europäische Wirtschaftsforschung (Center for European Economic Research), publication date pending.

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