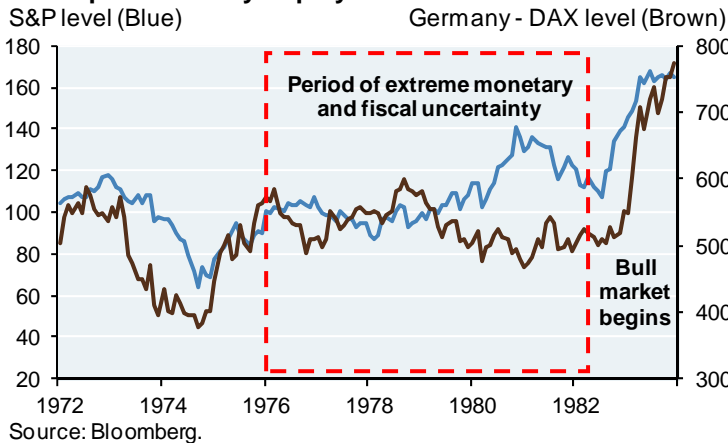


Topic: US economic/profits watch; the latest idea to save Europe (repo markets); Brazil; the Gospel according to Paul

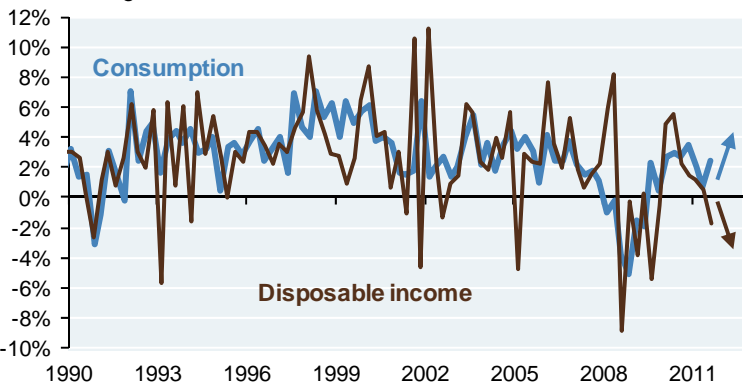
Equity markets have just been through something that has only occurred a handful of times over the last 80 years: a 15% selloff and recovery in the span of 3 months¹. As we noted a few weeks ago, technical factors² indicated that there was extreme pessimism regarding US and Chinese growth, and the European debt crisis. All it took were modest improvements in the US and China economic outlook and ambiguous plans out of Europe to drive markets higher. Where do we go from here? Sideways, most likely, with more volatility to come. The first chart below is a proxy for the environment we think we are in. In the wake of the 1970's recession, US and German equity markets collapsed, then rallied back sharply by the end of 1976. Afterwards, during a period of extreme monetary and fiscal policy uncertainty, markets went sideways for years until the smoke cleared, setting the stage for the next bull market. **Lessons learned** during the prior period: don't sell when valuations are very low and pessimism is extremely high; look for opportunities to add yield through high-dividend stocks, and credit; be prepared to shift to a more aggressive portfolio only when macroeconomics fade in importance relative to the profit cycle. On the latter point, we think we are not there yet; 2012 looks like another year in which macro will trump micro, as it has for the last 3 years.

1970s post-recovery equity market wilderness



Consumers spend by drawing down savings (again)

QoQ change, real, annualized, sa

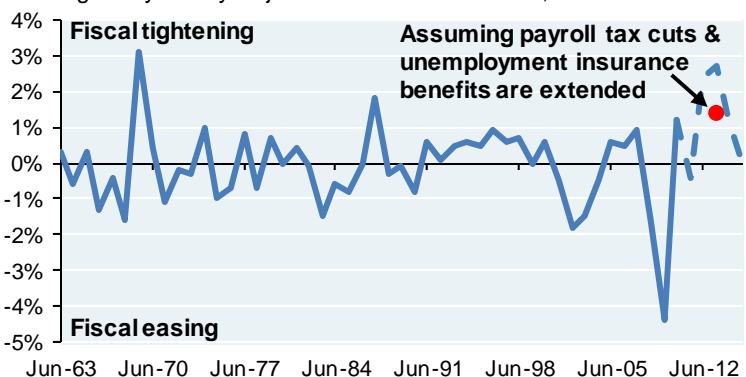


US economic growth and profits outlook: better than very low expectations as 2011 comes to a close

- Consumer spending has held up better than expected. However, this is due more to a decline in the savings rate than to improvements in disposable income (see second chart). This can go on for a quarter or two, but there's a limit to which the savings ratio can serve as a buffer against stagnation in household income.
- Commercial construction, capital goods shipments, light truck vehicle sales and other capital spending have generally been exceeding expectations. Regional business surveys have also been improving this month.
- As things stand now, the papal infallibility of the Economic Cycle Research Institute may be at risk, given their prediction of an unavoidable recession: *"You haven't seen anything yet. It's going to get a lot worse."* Our expectations have been for roughly 2% US growth: lower than the 3% consensus view that prevailed during Spring 2011 (in part due to the housing drag), but better than the recession which was priced in during September and early October.
- The big question revolves around the Committee on Deficit Reduction. The Fed's recommended solution is more fiscal stimulus now in exchange for substantial tax and entitlement changes in the future. Either way, the private sector will have to overcome fiscal tightening in 2012. The only question is whether the austerity burden will be moderate (e.g., if payroll tax cuts are extended), or very large (see chart).
- **Profits update:** another quarter of profits growth, this time to an all-time high. After the recent rally, the S&P is priced at 11.5x-12x 2012 earnings. The Achilles Heel remains the reliance of profits on a 50-year low in labor compensation to revenues, which is why profits should not command the same multiples they did in the past.

US faces large fiscal adjustment in 2012

Change in cyclically-adjusted federal fiscal deficit, Percent of GDP



¹ Years in which this happened to the S&P 500: 1930-1933, 1938, 2001, 2002, 2009 and now 2011.

² Short interest in S&P 500 ETFs, speculative long positions on S&P futures, bullish sentiment ratios, hedge fund surveys, etc.

Topic: US economic/profits watch; the latest idea to save Europe (repo markets); Brazil; the Gospel according to Paul

- **China** does not appear to be tilting into recession: growth in industrial value-added picked up in September vs August, as did cement production and steel demand. Consumption remains solid: spending measured by the urban household survey picked up in Q3 vs Q2. The October manufacturing business survey that we follow moved above 50 after spending 3 months below 50; new orders improved as well. Monetary policy is unlikely to change soon, but with money supply growth running below target and core inflation decelerating, chances are that if the Central Bank does move it will be in the direction of easing.

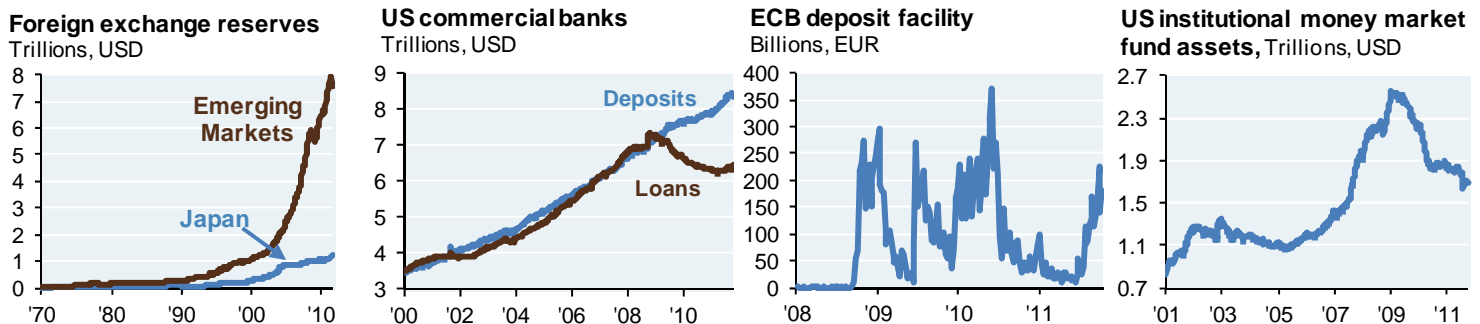
The Jackrabbit solution: using repo markets to save southern Europe

The European Union has been working on ideas to leverage its 440 billion Euro backstop (EFSF) into something bigger. Why? First, roughly 150 billion has already been spent/committed, or is needed for bank recapitalization. Second, funding needs for Spain and Italy over the next couple of years are 2x-3x what's left. I will not go into the intestinal details of the so-called "Monoline Solution" or the "Special Purpose Vehicle Solution" other than to say that they probably require the following:

- That France does not get downgraded below AAA, which could short-circuit the entire mechanism
- That Europe finds sufficient appetite for unorthodox long-term sovereign bonds with first-loss protection
- That a special purpose vehicle will be able to issue subordinated debt rated no higher than Italy itself

While these conditions might be achievable, they are far from certain. As a result, behind the scenes, our understanding is that Europe is looking for another way to draw in private capital. The idea of repo is interesting, since it tries to make good use of the rise in precautionary savings by companies, households and central banks that the European mess itself has prompted.

To make this simple, if you need to borrow a lot of money, you would first figure out who has a lot of it. In today's world, there are massive pools of cash struggling to find credit-worthy entities to lend to. A proxy for this is the quartet of charts below: the accumulation of reserves by EM and Japanese central banks; the surplus of deposits over loans in the US commercial banking system; the money that European banks leave on deposit at the ECB; and the pool of savings in US money market funds. There are others, but these tell the story: there's a lot of cash looking for a home as the money multiplier collapses.



Sources: Federal Reserve Board, ECB, Investment Company Institute, Japan Ministry of Finance, IFS, J.P. Morgan Securities LLC

The good news, in theory. These pools of capital participate in "repo markets", which are short-term collateralized lending facilities³. The size of this market in Europe is at least 6 trillion Euros, more than enough in principle to provide leverage to the EFSF so that it could buy Italian and Spanish government bonds, pledge them, and then buy more. The EFSF would not need to borrow at the current 5%-7% repo haircuts applied to Italian debt (up to 15% for longer maturities). Even if the EFSF had to borrow at haircuts of say, 30%, it could still on paper create a trillion Euro backstop facility. Cash providers would presumably take the risk of lending against Italian government bonds given these larger haircuts, and given the ability to exit if they don't like the way things are going. Repo investors could earn more than the 0.75% they get paid by the ECB, and more than the 0.90% they earn in the unsecured overnight interbank lending market. Debt crisis solved?

The obvious problem: repo market lenders are like Jackrabbits, in that they flee at the first sign of trouble. That's what they *should* do, since they are looking for a marketplace with very little return (generally below Libor) in exchange for taking very little risk. We have no way of knowing if larger-than-normal lending haircuts would reduce their jackrabbit nature. What we do know is that in the fall of 2008⁴, and more recently in Europe, the rapid flight of repo lenders played a role in accelerating a debt crisis. High-velocity repo lenders might need upfront reassurance that the ECB would step into their shoes if there were a sudden and collective repo financing meltdown.



³ There is a ton of detail on which entities would serve as repo collateral agent (LCH, Eurex, etc); how FX risk would be hedged by non-Euro participants; bilateral repo vs tri-party repo; etc. Most of this is not germane right now as to whether the idea would work or not.

⁴ Example: from June 2007 to the end of 2008, haircuts on AA and AAA asset backed securities rose from 1.8% to 18%. Haircuts on Irish debt were as high as 80% in the summer of 2011, compared to pre-crisis levels of 2%-4% for EU AAA sovereign paper.

Topic: US economic/profits watch; the latest idea to save Europe (repo markets); Brazil; the Gospel according to Paul

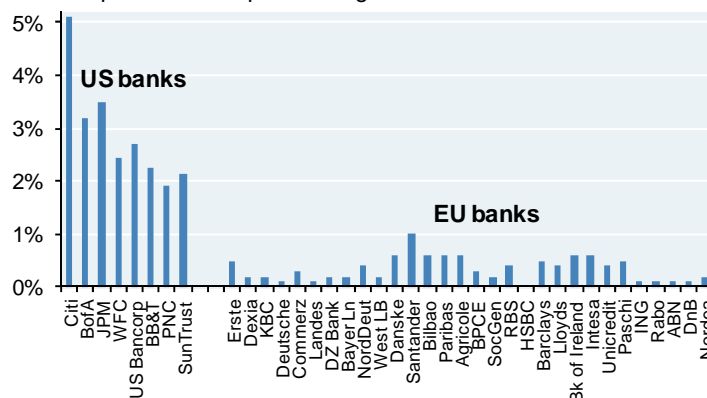
The less obvious problem: if the EU succeeds in creating a large-haircut lending product, what impact will that have on the rest of the repo markets? In other words, why would people keep financing French debt with a 5% haircut when you could lend against Italian debt with a 30% haircut? There could be unintended distortions in the rest of the repo markets which worsen financing conditions at a time when European banks are already shrinking their balance sheets.

An even less obvious problem: at some point, markets may refocus on the sand-bagging of bank capital adequacy stress tests, and insist that the EU explain more about its intended backstop for bank debt. Comparison of the week: the chart below shows the level of provisions on performing credit loans by US and European banks. If a recession takes place in Europe (the latest business surveys out of Germany were very weak), worsening conditions for banks could complicate the repo solution by increasing the amount of money sovereigns might need to fix them.

Bottom line: we find the repo idea interesting, as it appears to sidestep some problems inherent in the other approaches. Any subordinated capital from the IMF or China would help as well, since it too could be leveraged. However, using a liquidity-focused, hyper-skittish investor base to solve a problem that longer term debt markets do not want to solve is complicated, if not counter-intuitive. This is particularly true for pools of capital outside European banks (state and local U.S. governments, mutual funds, custodial managers, etc) which typically only lend against the highest quality collateral in the tri-party repo system. **We will need a lot more detail from repo participants before considering this a viable solution.** Meanwhile, Greece continues to disintegrate both economically and politically, the Irish miracle is fading with a first half relapse in GNP, and the EU region is heading for recession and credit contraction.

L'espoir est eternal

Loan loss provisions on performing credit loans



Source: European Banking Authority, US 10-Ks. Data as of December 2010.

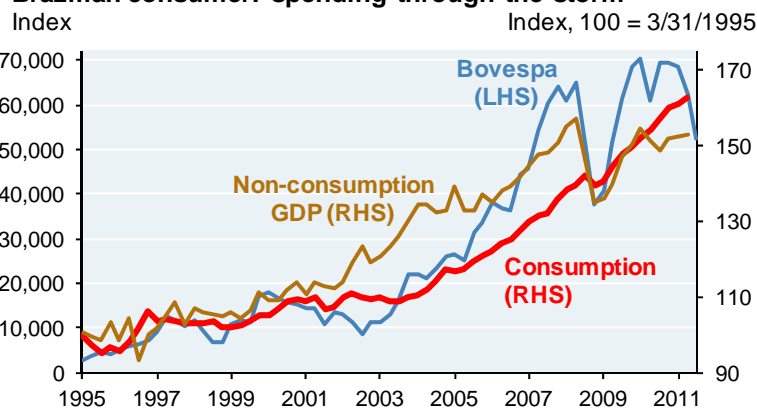
The EMU is still an emu (see last week's EoTM).

Stay focused on the steady pace of rising consumption in emerging economies, like Brazil

As described on page 1, we believe markets are in for an extended period of volatility given the global macro-economic landscape. There are not a lot of places to hide regarding interim valuations. But in the long run, we expect investments in companies with improving earnings fundamentals to pay off. One example: **consider the steady advance of Brazilian consumption**, compared to the rest of the Brazilian economy, and the Bovespa itself, both of which have been much more volatile.

One of our managers is dedicated to this strategy, having made acquisitions in car rentals, men's apparel targeting the middle class, food processing and distribution, etc. These companies were acquired at 6x-8x cash flow, and have generated earnings growth at twice the level of the Bovespa over the last year. The manager's pipeline is heavily focused on consumer goods, retailing and education. Investments in private companies entail a substantial sacrifice of liquidity; reserving illiquid portfolio capacity for developing country consumer plays seems like a good place to deploy it. With the run rate of Brazilian IPO's at around one third of their 2007-2010 pace, private equity investors are able to command better terms and conditions given a bit more capital scarcity.

Brazilian consumer: spending through the storm



Source: Fundação Instituto Brasileiro de Geografia e Estatística, Haver.

One more thing: the Fed's zero interest rate policy plays a role here as well. The Brazilian *Real* has been on a wild ride over the last few years, rising from 40 cents to 65 cents twice (2005-2008 and 2009-2011). With Brazilian interest rates still among the highest in the world, and easy Fed policy until 2017, we expect the *Real* to remain at the upper end of this range, putting further pressure on exports, and adding fuel to consumer incomes. Unemployment has fallen in half since 2004; according to the Brazilian Ministry of Finance, Brazil's middle class rose from 65 million people in 2003 to 95 million people in 2009.

Topic: US economic/profits watch; the latest idea to save Europe (repo markets); Brazil; the Gospel according to Paul

The Gospel according to Paul: the impact of high-risk, government sponsored lending

Former Fed Chairman Paul Volcker remains a powerful and influential voice as it relates to the U.S. financial system. His views on the activities of banks and broker-dealers are well-known. However, I wonder if people are equally familiar with his views on the impact of high-risk government sponsored lending, as reported recently in the Times⁵:

“We simply should not countenance a residential mortgage market, the largest part of our capital market, dominated by so-called government-sponsored enterprises,” Mr. Volcker said in his speech. “The financial breakdown was in fact triggered by extremely lax, government-tolerated underwriting standards, an important ingredient in the housing bubble.” While he acknowledges that we cannot eliminate Fannie and Freddie anytime soon, “it is important that planning proceed now on the assumption that government-sponsored enterprises will no longer be a part of the structure of the market,” he said

“This is an opportunity to get rid of institutions that shouldn’t exist. You ought to be either public or private; don’t mix up private profit-making opportunities with an institution that is going to be protected by the government but not controlled by it.”

“If the government wants to guarantee mortgages for certain low-income people, O.K., but I wouldn’t do much of it,” Mr. Volcker said. “A public agency intervening in the mortgage market in a limited way doesn’t bother me. But if you want to subsidize the mortgage market, do it more directly than hiding it in a quasi-private institution.”

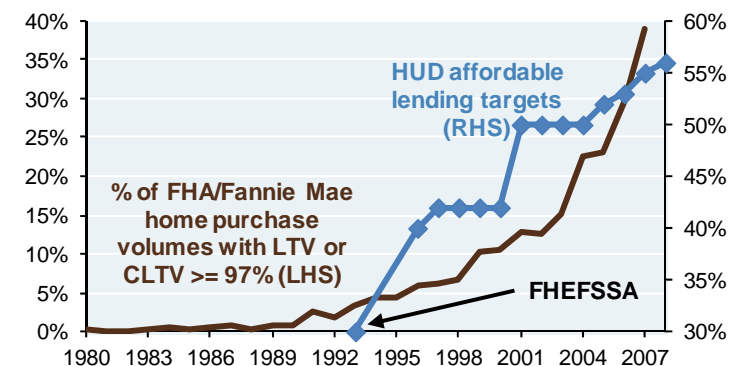
I find this chart useful in the context of Volcker’s comments. It looks at one of the origins of the housing crisis: the growth of high LTV loans, a source of eventual distress to taxpayers and homeowners. In the early 1990’s, to maintain its charter and not be privatized, the US Agencies partnered with Congress and the Department of Housing and Urban Development and agreed to Affordable Housing targets. (FHEFSSA, ironically enough, stands for Federal Housing Enterprises Financial Safety and Soundness Act). From that point going forward, Fannie Mae and FHA competed to see how many affordable loans they could underwrite. In 2002, Fannie Mae’s CEO proclaimed that it was running “*neck and neck*” with the Federal Housing Administration as the chief source of public funding for housing. Other illustrative quotes: “*The government is our only competitor*”, and “*Our company is overwhelmingly an affordable housing company*”⁶.

The affordable housing targets started at 30%, but their “free lunch” nature was irresistible: Congress raised them 3 more times to please constituents. A year or two after each increase, GSE-guaranteed high LTV loans (loan to values $\geq 97\%$) rose sharply, and the rest, as they say, is history. Decades of underwriting discipline by both GSEs and commercial banks went out the window. In an effort to promote affordable housing, its adherents arguably ended up exhausting several generations of housing subsidies in a few short years. As the debate about what went wrong and what to do continues, it’s worth keeping this history in mind: good underwriting is the best foundation for a viable housing market, and the unintended consequences of seemingly benign public policy can never be under-analyzed.

Michael Cembalest
Chief Investment Officer

A look back at the origins of the housing crisis

Percent of annual loan volume



Source: FHA, HUD, American Enterprise Institute.

EFSF European Financial Stability Facility;
LTV Loan to value
EMU European Monetary Union
HUD Housing and Urban Development
IPO Initial Public Offering

ECB European Central Bank
LCH London Clearing House
IMF International Monetary Fund
FHA Federal Housing Authority
GSE Government sponsored enterprise

⁵ “How Mr. Volcker Would Fix It”, New York Times, October 22, 2011

⁶ As reported by Realty Times, March 2002, and National Mortgage News, April 2002.

Topic: US economic/profits watch; the latest idea to save Europe (repo markets); Brazil; the Gospel according to Paul

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