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To: Undisclosed recipients;;

Subject: Eye on the Market, November 4, 2010

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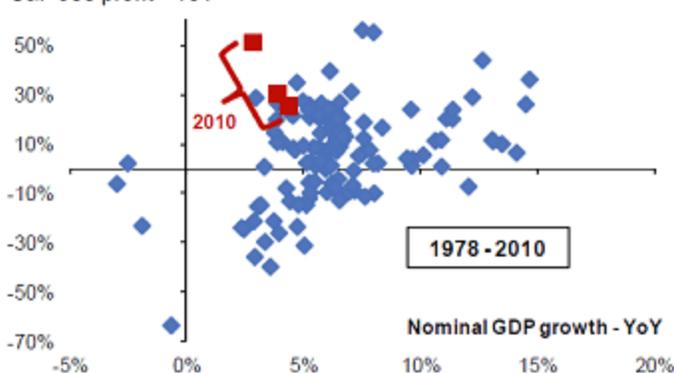
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Eye on the Market, November 4, 2010

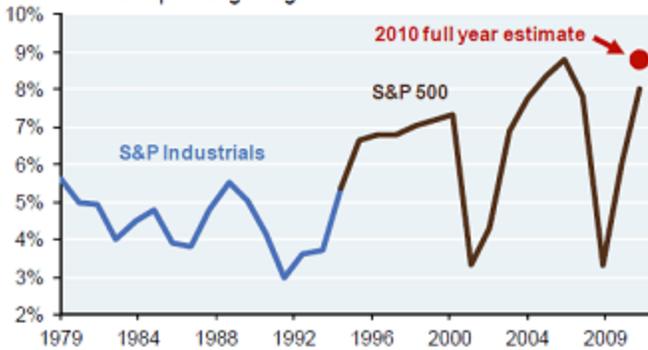
Topics: The most surprising news of the week: was it S&P profits, QE2, commodities or the elections? And Weimar, revisited

While QE2 and election results have been well telegraphed for weeks, strength of profits and margins in the face of weak growth continues to surprise. As shown in the first chart, U.S. companies are generating strong profits growth at a time of weak GDP growth (red dots). When growth is this weak, profits are often *declining*. Furthermore, margins continue to hover around historical peaks. Rising commodity prices may hurt some sectors (e.g., apparel, electrical equipment, low-margin consumer staples, furniture, machinery, airlines, waste management), but in aggregate, energy and industrial commodities only represent 7% of total corporate input costs for the median industry. A lot will depend on the balance between rising commodity prices and rising demand.

Profit growth outpacing GDP growth
S&P 500 profit - YoY

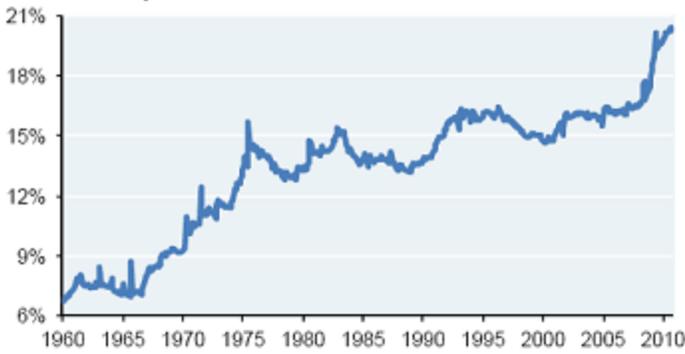


Profit margins near historical highs
S&P 500 Net Operating Margin



These profit results reflect stronger demand outside the U.S. where 30% of S&P revenues are earned, and aggressive steps taken to control supplier and inventory costs. **But there are Achilles heels in these results as well.** Declines in labor costs account for a lot of the margin improvement, and what appears to be holding middle class consumers together is an all-time high in government transfers to individuals. While consumption is skewed to higher income households, government transfers are playing a large role, and are not sustainable indefinitely (see page 3).

Government transfers to households
Percent of disposable income



Source: Bureau of Economic Analysis.

Corporate cash balances at their highest levels
Nonfinancial corporate liquid assets / tangible assets



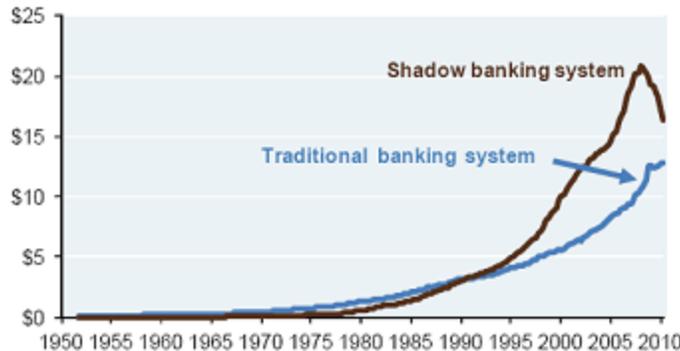
Source: Federal Reserve - Flow of Funds.

During the last 3 recessions, housing led the way out, followed by commercial property. That's not going to happen now, given oversupply in both sectors. A stronger economic recovery would need to be led by profits. CEOs certainly have the ammunition to do it; check out corporate cash balances (above). But will they?

While CEOs have the ammunition, weak demand is probably what's holding them back, rather than politics (EPA regulations, healthcare, cap & trade, unionization rules). We would be surprised if the Republican takeover of the House turned out to be an inflection point in the economy. Given low valuations (13x P/E) and margin trends shown above, we're comfortable with the equities we hold, spread across traditional active equity managers, exchange-traded funds, private equity, long-short hedge funds and event-driven managers. Our portfolios are modestly less reliant on equities than in prior recoveries, for reasons we have discussed in prior weeks.

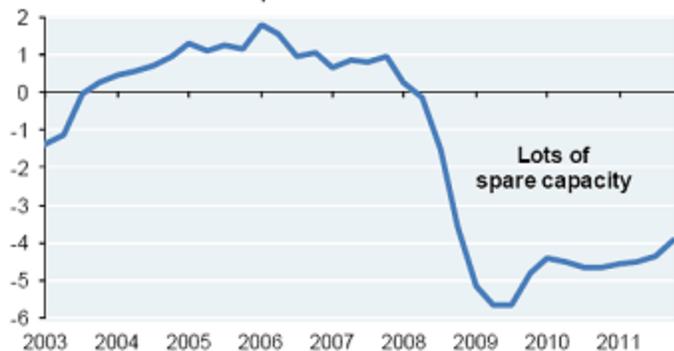
ON QE2: We understand why the Fed is trying (QE2 = another \$900 bn in Treasury purchases by June 2011). The shadow banking system is fading more than traditional banks are growing; fiscal policy will be tighter after the elections; and the so-called "output gap" estimates a lot of unused capacity in the U.S. economy (suggesting that inflation risk is remote).

Traditional banking system vs Shadow banking system
Trillions



Source: Federal Reserve Board Flow of Funds, as of Q2 2010.

US "output gap": a measure of spare capacity
Percent, GDP relative to potential GDP



Source: J.P. Morgan Securities LLC.

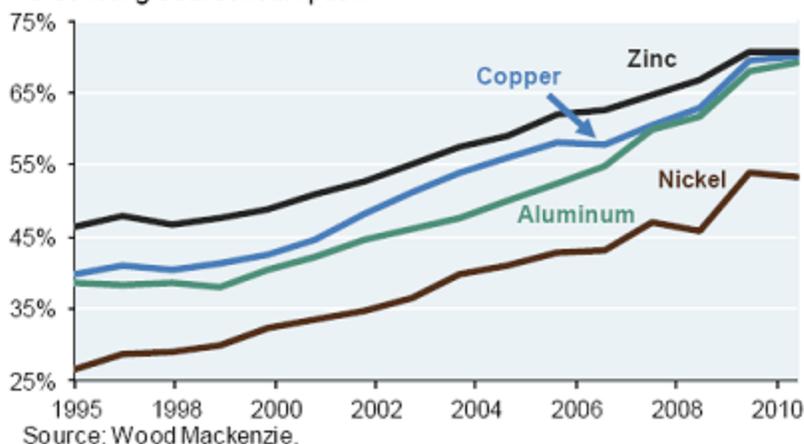
But while QE2 may be positive for financial assets, its long-term consequences are not well understood, which was the subject of last week's EoTM (*St Crispin's Day*, Oct 29). Even in the short term, there are risks; a weak dollar policy will likely hurt before it feels better, as the US has the **highest ratio of consumer spending-to-exports of the 20 largest economies**. In the end, Bernanke's Op-Ed today in the Washington Post makes it clearer than ever than **degrading the value of cash and bonds and directly influencing equity markets is his goal**. We have no doubt he will succeed, in the short run, although history shows life is not nearly as simple as the transmission mechanism Bernanke lays out.

Central banks purchasing massive amounts of government bonds is an infrequent thing. It's not *completely* untested in the US, which engaged in QE during the Great Depression. However, **a look at this period yields more questions than answers**. While Depression-era QE did not result in inflation, it amounted to 7% of GDP in 1933-36 after real output declined by 25%. In the current era, the Fed's Treasury and MBS purchases are 18% of GDP after an output decline of only 4%. **So, we're getting well more than twice the QE after a collapse that's 6 times less severe**. We take Bernanke at his word that "*we have much less experience in judging the economic effects of this policy instrument*".

The mother of all QE experiments gone wrong is the **Weimar Republic**. Fortunately, the differences outweighed the similarities compared to today's era (see appendix on page 4). However, the current experiment is not over yet; we expect QE3 and QE4 to follow if US growth and unemployment do not improve markedly.

One of the investment implications of QE2 and beyond: maintain commodity positions. Easier U.S. monetary policy is absorbed by emerging economies that would "rather fight than switch" (continue to print their own currency and buy dollars in order to prevent currencies from appreciating), leading to lower interest rates and higher growth in those countries. And since these countries make up an increasingly large component of commodity demand (see chart below), we intend to maintain our commodity allocations for now. Our preferred exposures: **gold, copper, oil and platinum**. As for agriculture, so far this year, corn, wheat, soybeans, sugar and pork bellies are up 20%-40%. As mentioned last week, the lower 2 quintiles in the US spend 30%-60% of their after-tax income on food and energy, which is another flaw in the QE2 ointment.

Commodity usage in the developing world
Percent of global consumption

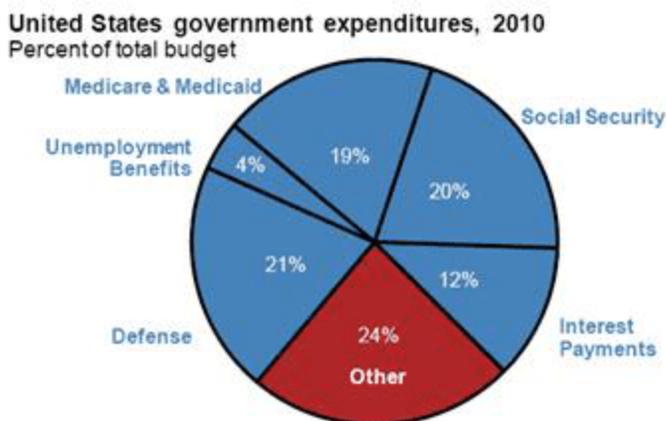


On the elections: what exactly does "End Big Government" mean?

With “Big Government” as apparently out of favor as Crocs, Palm Pilots and Windows Vista, let’s look at what this might mean. The pie chart shows 2010 government expenditures; 76% are made up of mandatory entitlements and interest, and defense. The red slice is everything else (discretionary spending, and the cost of administering the mandatory programs). Let’s assume the *entire* “Other” slice were eliminated; we would still have a budget deficit of 3.5% of GDP. So...“ending big government” either means:

- * Deep cuts in the narrow slice of spending that is still discretionary and unrelated to administering mandatory programs, or
- * A serious dent in defense and/or entitlement spending, or
- * A bipartisan plan to foster consistent real GDP growth of 4%-5%, which would reduce the deficit, or
- * Nothing; the Republican pledge is simply to cut \$100 billion, which is not a game-changer

Reading quotes from both sides, I get the sense that post-election polarization will be worse rather than better, increasing from its all-time high in a chart we have been showing for over a year now. The first 3 bullet points are therefore less likely.

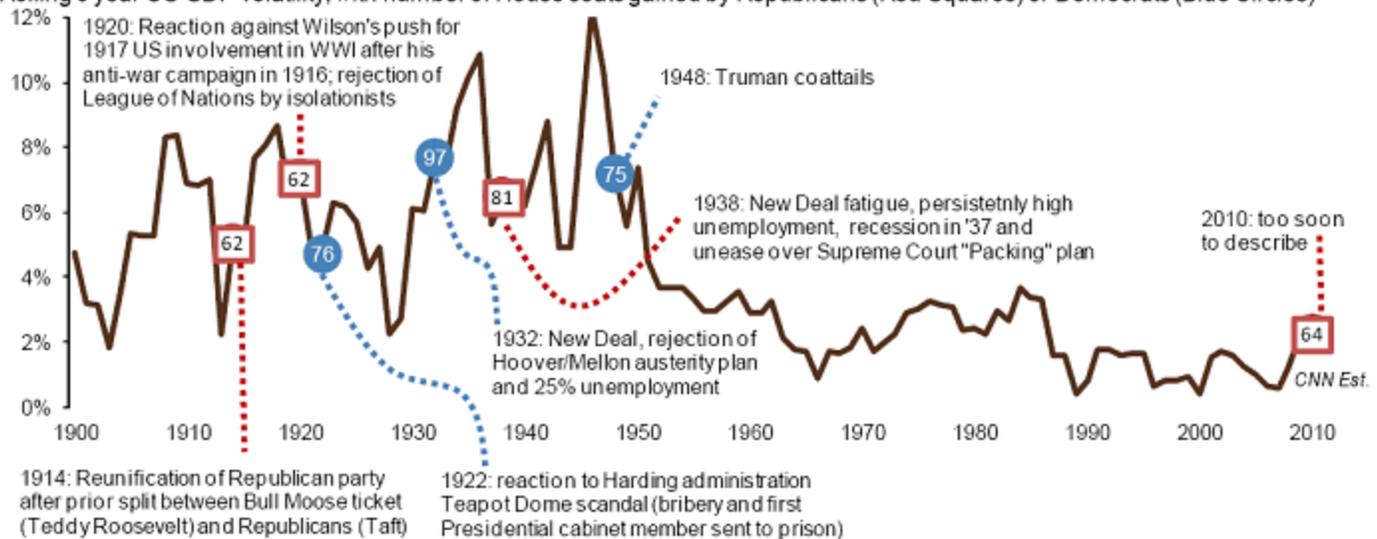


Source: Department of the Treasury. Data as of September 2010.



As for the seismic swing in the House, a 60+ seat shift hasn’t happened since 1948 when Truman won the Presidency. **But such electoral shifts happened 5 times between 1914 and 1938, a period of much greater economic volatility** (see chart below; the line plots the volatility of US GDP). Maybe we should get used to this.

House of Representatives swings greater than 60 seats was a common feature of the volatile pre-war US
 Rolling 5 year US GDP volatility, with number of House seats gained by Republicans (Red Squares) or Democrats (Blue Circles)



Michael Cembalest

Chief Investment Officer

[Appendix]

The Weimar Republic: hyperinflation, history and hyperbole

Let's start with the bad historical parallel: the U.S. Federal Reserve is now buying a lot of Treasury bonds. Our estimates show that the Fed will end up financing 94% of a very large U.S. budget deficit next year. Isn't this what happened in Germany in the 1920s? Yes, narrowly, but no on a broader basis. To begin, we add up all the U.S. Treasury bonds that are now owned by "non-economic holders". That would include two primary purchasers:

* The US Federal Reserve (QE1+QE2)

* Foreign Central Banks (Treasures purchased as a by-product of efforts to keep currencies cheaper than their natural equilibrium). Inflationary pressure may one day render this strategy too risky to maintain.

The result: 53% of all Treasuries are held by non-economic, non-private sector investors. Now let's plot that number in the context of another episode of Treasury bills acquired by a Central Bank: the Reichsbank, circa 1922. That's the first chart below. We know how that turned out (bad).

But there are some important and obvious differences to keep in mind. Annual German war reparations payments from 1919 to 1922 were almost 10% of GDP. To put such massive payment obligations in context, they represented a doubling of the entire pre-war German tax burden. With the threat of Allied sanctions on one side and an impossible doubling of the tax burden on the other, it's not surprising the Reichsbank decided to print their way out. As a result, by the middle of 1922, the monetary base, wholesale prices and the exchange rate all exploded. It was all downhill from there.

So we do not believe the U.S. is headed for hyperinflation. **But that's not the same thing as saying that the exit strategies for the Fed and for foreign Central banks are well-mapped out, properly understood or benign.** We expect the shadow of monetary exit uncertainty to hang over financial markets, depressing P/E multiples and resulting in defensive cash balances held by households and corporations, in spite of Federal Reserve efforts to evaporate the real value of their savings.

Monetization of Weimar era government debt
Percent of Treasury bills held by Reichsbank



The onset of Hyper-inflation
Index, 1921 = 1



Source: "The German Inflation, 1914-1923: causes and effects in international perspective", CL Holtfrerich, Walter de Gruyter GmbH & Co.

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