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Attachments: 5-03-10_-_EOTM_-_Tale_of_Three_Cities.pdf

Inline-Images: image005.png; image006.png; image007.png; image008.png

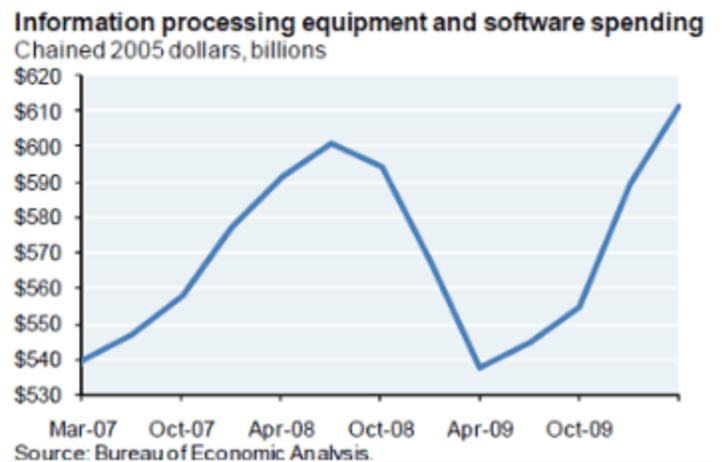
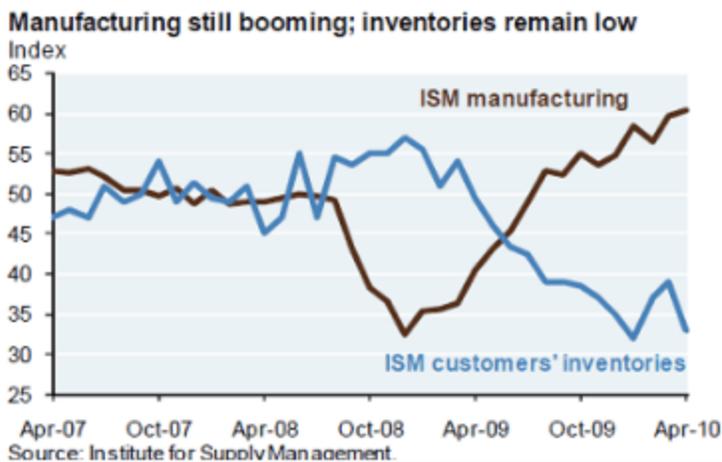
Eye on the Market, May 3, 2010 (the attached PDF of this email is much easier to read)

Topics: A tale of three cities (the US, Europe and China)

So far, the year is shaping up as we had described it back in January: a mix of business cycle improvements, and damage from shrapnel left over from the global recession. Our portfolios are tilted heavily towards U.S. large and mid cap equities, event-driven and credit-oriented hedge funds, emerging markets currencies, and opportunities in corporate credit where 2007 is not priced in all over again. Our under-weights include Europe, long-duration government and municipal bonds, and traditional buyout exposure. We are rebuilding positions in both commercial real estate and Japan (for the short term only), which we scaled back on in 2007. Here are some charts we discussed at our investment meeting this morning.

Generally good news in the U.S.

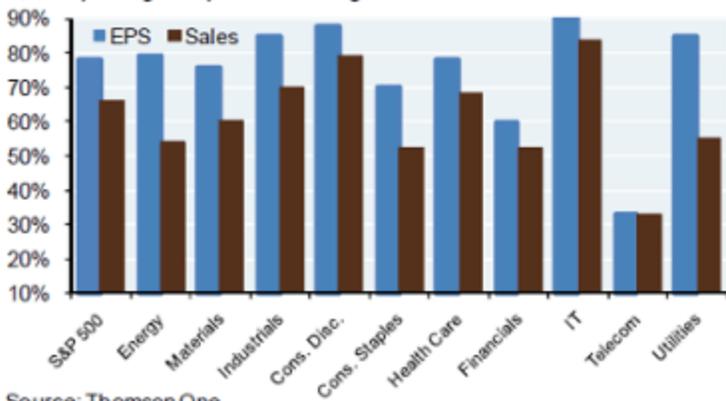
Today's ISM report on manufacturing shows a continued strong rebound, combined with the perception by manufacturers that inventories are still quite lean (chart, left). This suggests future production and employment gains, with potential multiplier benefits for an economy that sorely needs them. The tech replacement cycle is another bright spot, with equipment and software spending breaching the prior cycle peak (overall capital spending remains 15% below peak levels). On the flip side, we are still bearish on just about everything that has to do with housing, which was still a drag on Q1 GDP.



On U.S. corporate profits, the news continues to be positive. With 2/3 of companies reporting, both earnings and revenues have exceeded expectations across most sectors (not just better results from financials reducing quarterly loan loss provisions). As is typically the case in the earliest stages of a recovery, analysts have been behind the curve, revising up earnings expectations for 2010 and 2011 (they will likely become way too optimistic later). U.S. equities look to be trading at a 14.5 P/E multiple, which we consider reasonable given low inflation. We're curbing our enthusiasm here, since the cost of monetary and fiscal stimulus withdrawal has yet to be quantified for purposes of valuing future earnings.

Positive surprises by sector

% of reporting companies beating estimates



Forward 500 earnings estimates on the rise

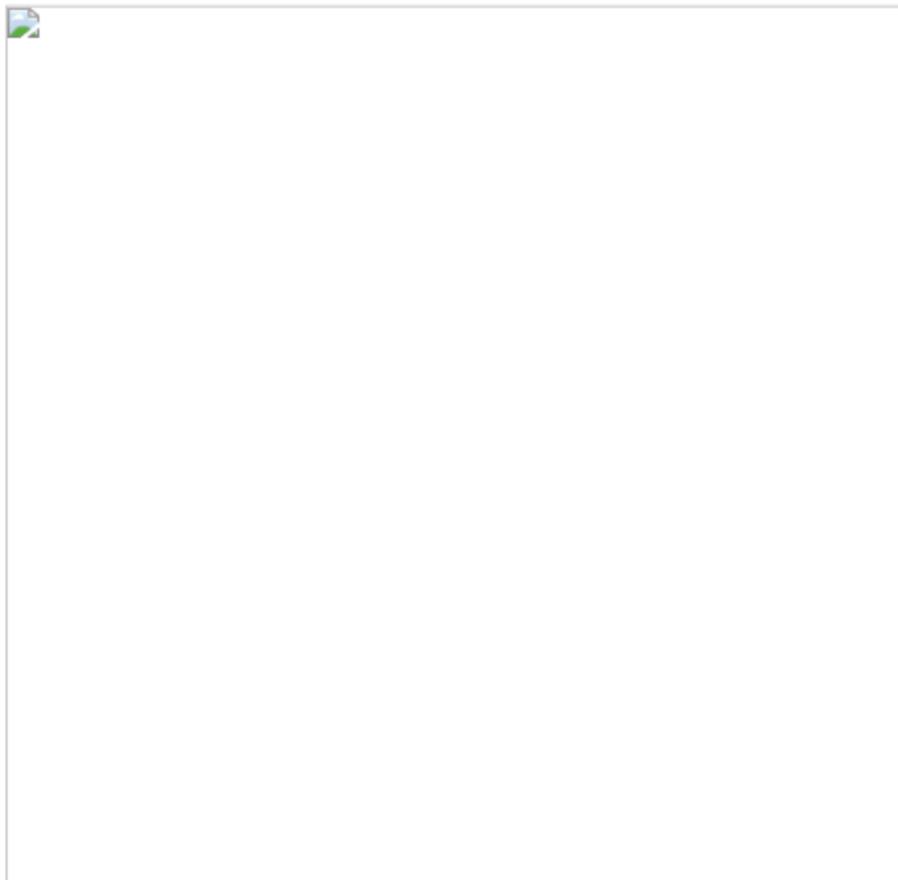
Earnings per share



I had some charts on Fannie Mae, OFHEO, the quadrupling of homes bought for speculative purposes from 1994-2004, Alt A loans, mortgage insurance, the doubling of household mortgage debt to income, and the collective Freudian id of the legislature and general public expressed through Congressional hearings. But the lack of space and common sense suggest they be postponed to another day.

Prometheus Bound

As punishment for giving fire to mortals, Zeus condemns Prometheus to be chained to a rock, and to have his immortal liver eaten daily by an eagle. It brings to mind the austerity program planned for Greece. No need to go through the details; it suffices to say that it's the most austere adjustment an OECD country has subjected itself to in 50 years in the absence of a falling currency, a rebound in GDP growth (a) and an open economy. We created the chart below to pull together four variables we've discussed before, showing that Greece is effectively in **No Man's Land**. I promise, this is my last chart in 4 dimensions.



So while the total Eurozone-IMF package of EUR 110 bn was 6x larger than the one discussed just a few weeks ago, here are some glass-half-empty observations:

- * Greece's ability to absorb the lion's share of the adjustment solely through 15%-20% declines in wages and prices is untested, and **implausible**. Changes to retirement ages and increased privatization make sense, but their contributions to competitiveness are very small in the short run. Note that in Greece's prior adjustment (1989-94), the Drachma fell 50%.
- * We could have included the U.S. from 1985 to 1995, when the trade-weighted dollar fell 30%, or the British Pound in 1931, which devalued by 20% after the UK abandoned the Gold Standard. Of the countries using gold as a monetary anchor in 1931, none remained a decade later. The sooner a country regained its own monetary policy, the faster it recovered (b).
- * The bailout does little to answer questions on Ireland, Spain and Portugal; is the new "safe zone" having a line of credit that takes you out of the capital markets for 3 years? Their public sector debt burdens are not as bad as Greece, but they suffer from some of the same (or larger) corporate debt burdens and productivity gaps vs core Europe.
- * History is not kind to bailouts ending contagion. The 1982 Mexico bailout did not stop the spread to Brazil, Venezuela and Argentina, and the IMF rescue package for Thailand in October 1997 did little to stop the spread to Indonesia and Korea.
- * It's hard to keep track of all the EMU pillars being discarded at once (no bailouts, changes to ECB collateral rules, Eurozone rating agency). Will ECB purchases of sovereign bonds be next? The Fed and Bank of England have done this in spades; but **Europe is different**. German Constitutional Court rulings in 1993 asserted powers to review ways in which European institutions might be exceeding rights conferred to them. Furthermore, the US and UK do not have to grapple with a history of monetization of government debt as a contributor to military, economic and social disaster (1923). That may be why Merkel remarked last month that "Europe is not only a community of peace, it is a community of stability".

China starts paying the piper

Here's the best anecdote describing what's happening in China right now: the Beijing land ministry voided a land auction since the winning bid **exceeded the maximum allowable amount**. Around the same time, China increased the borrowing rate on investment properties from 4.2% to 6.5%. I would make a list of all the ways in which China is tightening monetary policy, but I am committed to keeping the EoTM to 3 pages (property consumption taxes may be next). As shown below, China and Asia more broadly are rebounding strongly from the global recession, but are much closer to full capacity, with China having poured in even more stimulus/GDP than the U.S. We expect Asian (and in particular Chinese) equity markets to trade sideways for some time, until the multi-tentacled stimulus programs are withdrawn. We're working on investments designed to benefit from continued urbanization and the growth of the middle class, but in ways that are less linked to Shenzhen and Shanghai equity markets. More on that sometime next week.



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Notes

OECD = Organization for Economic Cooperation and Development; EMU = European Monetary Union; ECB = European Central Bank; IMF = International Monetary Fund; ISM = Institute for Supply Management; OFHEO = Office of Federal Housing Enterprise Oversight

(a) The chart assumes 0% GDP growth for 2010-2014, which is what the IMF-Greek Finance Ministry announced as a target. This assumption may be optimistic; Latvian GDP recently shrunk by 20% in the absence of a currency adjustment, and unemployment doubled.

(b) Ben Bernanke, "Money, Gold and the Great Depression", Washington and Lee University, March 2, 2004.

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