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Independent · Objective · Original

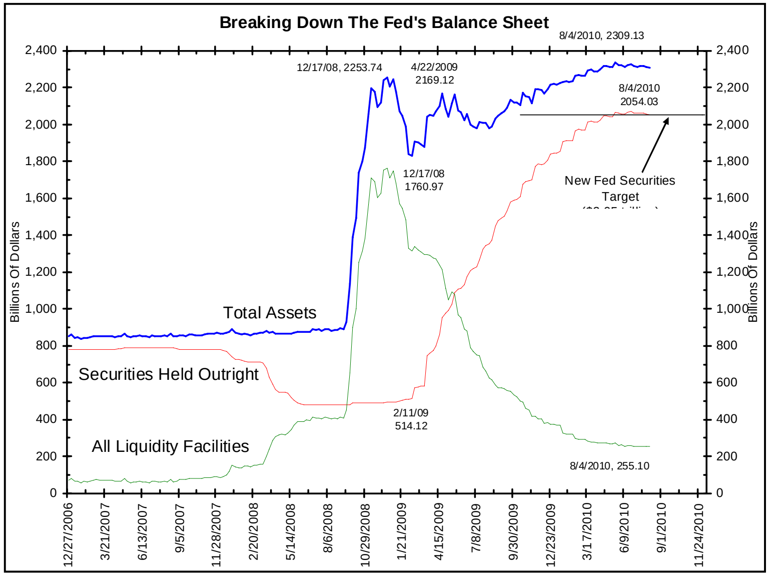
Earnings, QE2 and The Markets

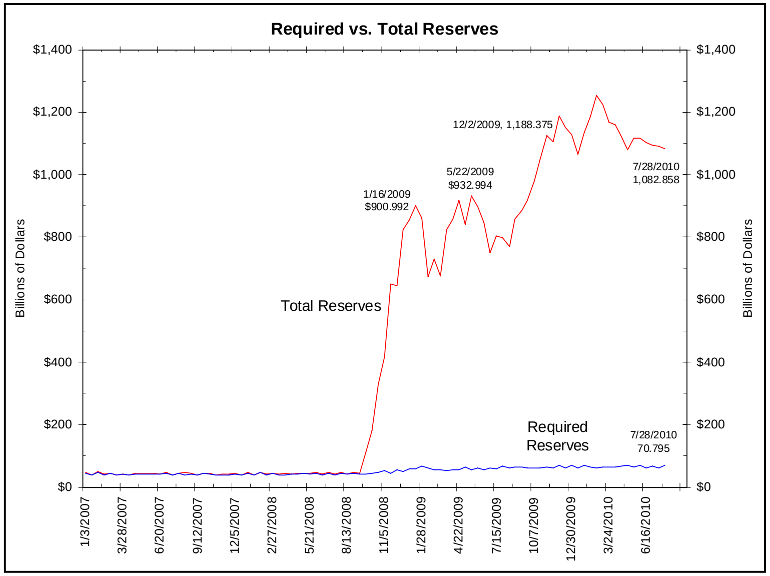
Conference Call Handout

August 12, 2010

Long-Term Interest Rates - 1900 to 2009

QE 1A





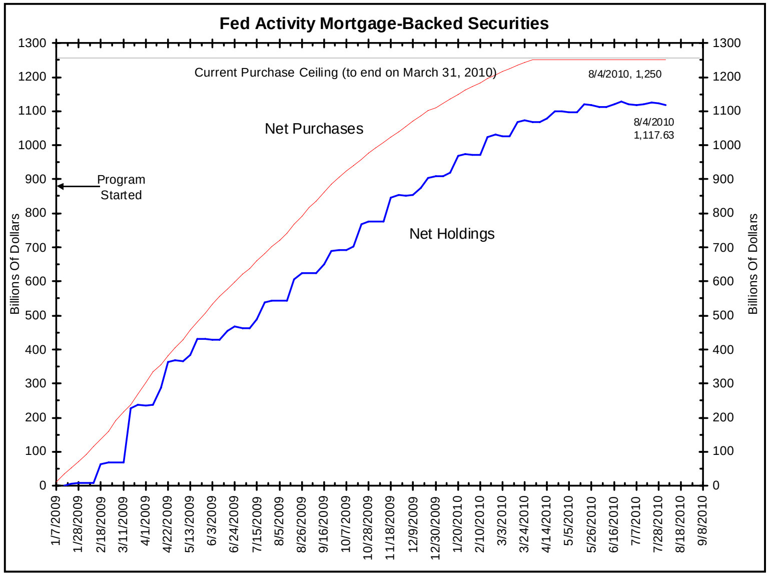
From **[Newsclips/Daily Market Commentary]**

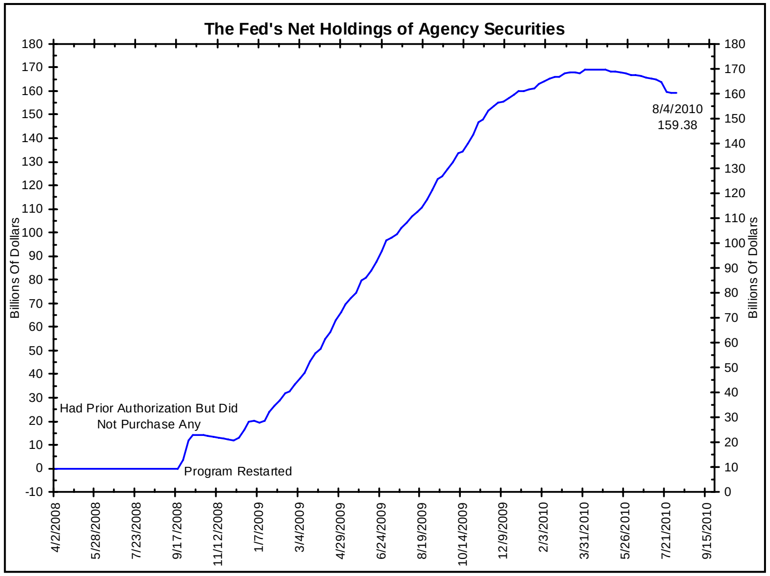
When the Federal Reserve buys agencies or MBS, it pays for them by crediting a bank's reserve account. In other words, it creates or "prints" the money. When that security matures or is paid off, that money disappears.

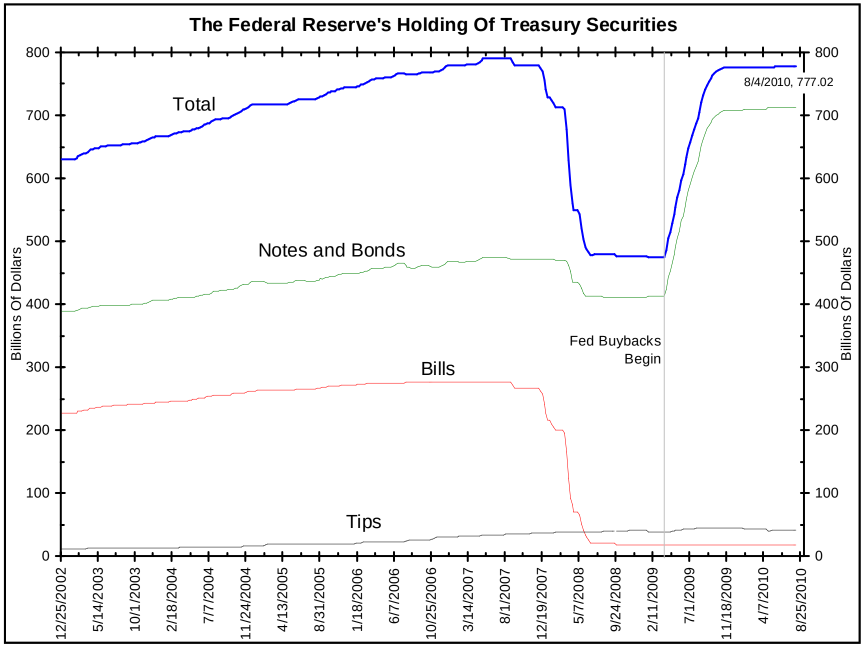
When that money disappears, the amount of securities the Federal Reserve holds goes down (red line) and thus takes the size of its balance sheet lower (blue line). So, the Federal Reserve announced yesterday that it will hold the level of securities at current levels around $2.05 trillion (black line).

Some have argued that a decline in the Federal Reserve's balance sheet is a defacto tightening. It is true that letting securities mature and allowing this money to disappear will result in a lower level of bank reserves, which are part of the Federal Reserve's balance sheet. But is this really a tightening?
As the next chart shows, the banking system only requires $71 billion in reserves, yet the Federal Reserve's "money printing" has resulted in over $1 trillion in reserves. If the Federal Reserve let total reserves fall to $900 billion or $800 billion, is this really a tightening? We would argue it is not until it gets under $71 billion. So, we don't completely understand this argument.

The Fed’s Holdings Of Government Securities







Big Owners Of Government Securities

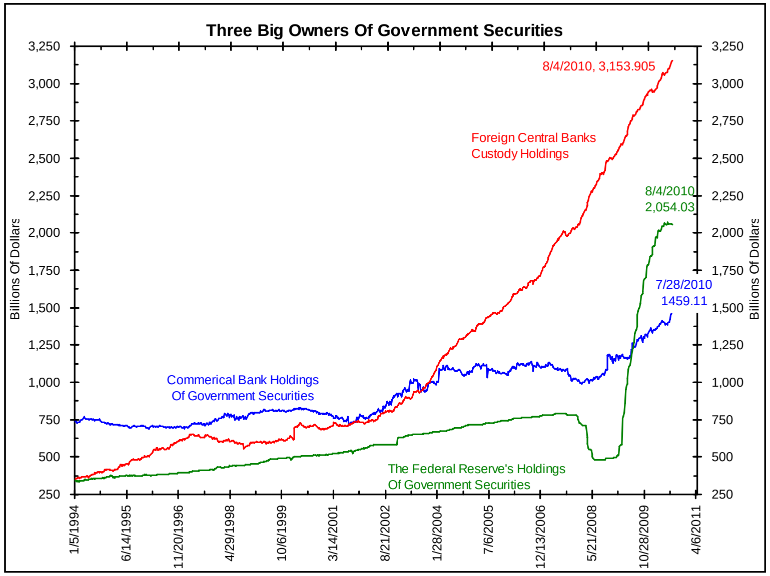
From Our **Newsclips/Daily Commentary**

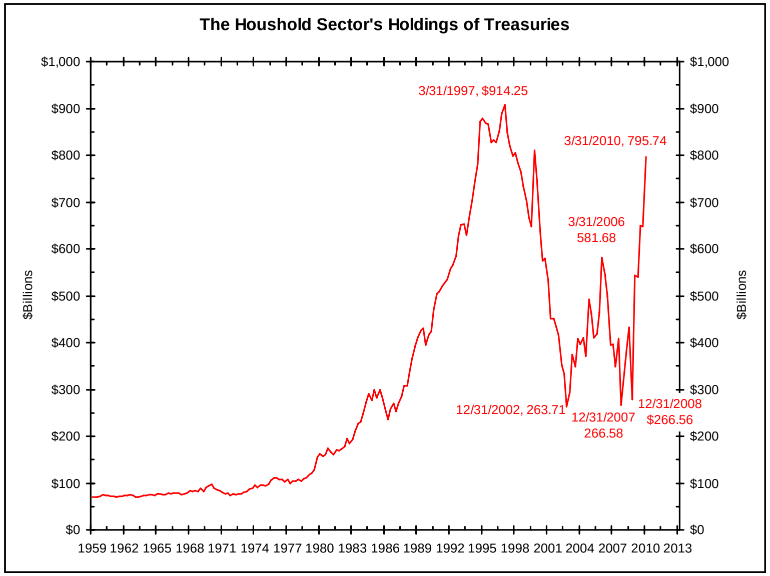
The chart to the lower right is from the Federal Reserve's flow-of-funds report. Households have been large quarterly buyers and their overall holdings have grown by over half-a-trillion in the last five quarters. But who are households?

To be clear, the "household sector" is misnamed. It is the residual account with a fancy name. So given this, what does it mean when the residual account soars? We would suggest that it means there is a measurement problem. In this case, the Federal Reserve cannot "find" the buyers of Treasuries thanks to the exploding deficit. They correctly assume that the buyer exists (otherwise the market would not exist) and therefore place the "missing" $500 billion in buying in the residual account. Since this account is called the "household sector", we all assume that "mom and pop" bought nearly $500 billion of Treasuries.

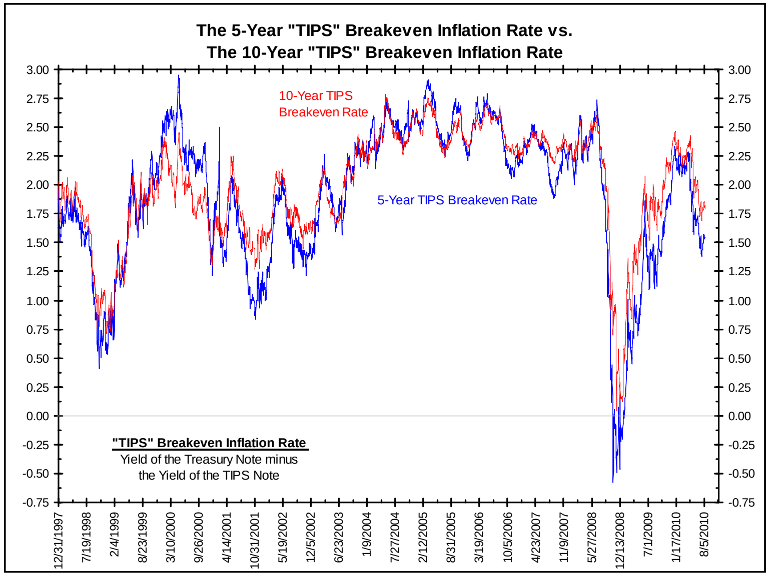
If it was "mom and pop" we would expect to see similar booming numbers from the mutual fund industry. However, mutual funds are net sellers of Treasuries.

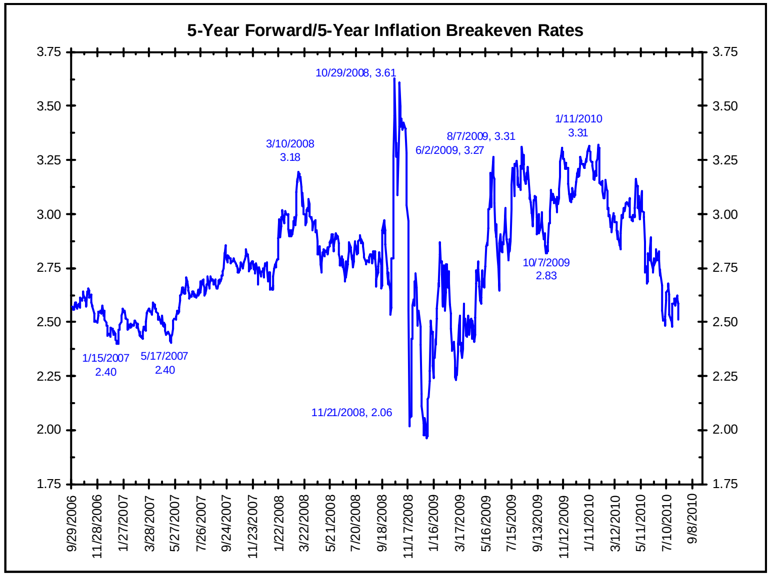
Our guess is the domestic buyer is a leverage carry trader, a mutual fund, a brokerage subsidiary or other group that does not have a category and gets "dumped" into the default category of "households."

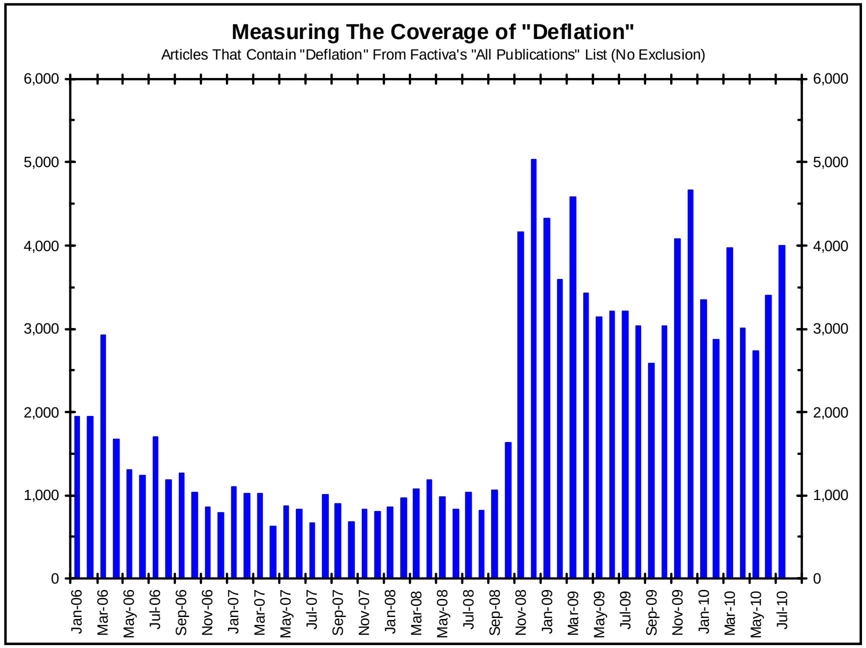




Should We Worry About Deflation?





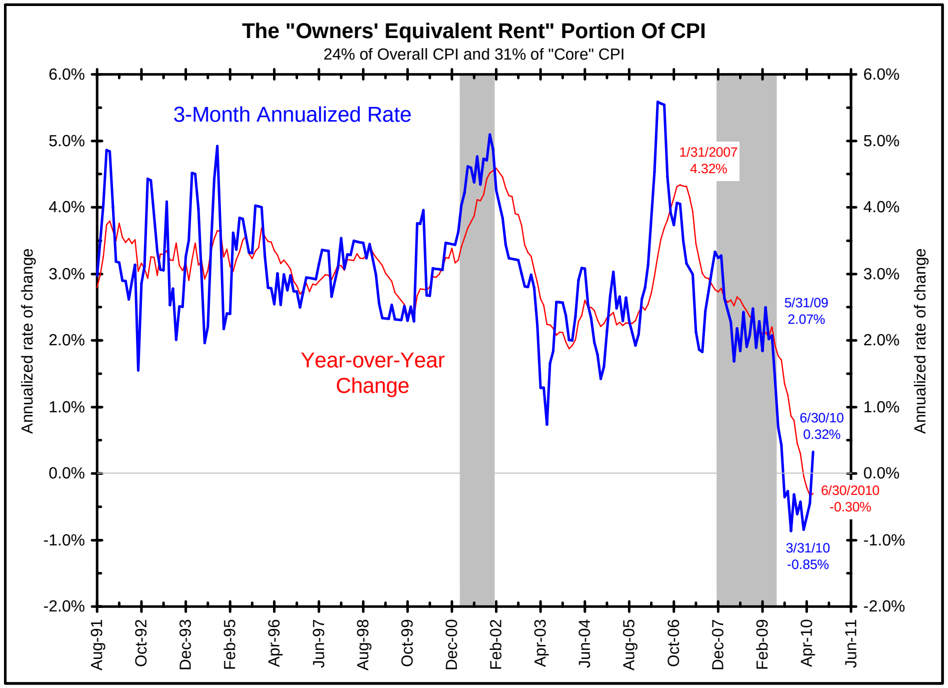


Owners' Equivalent Rent: An Update

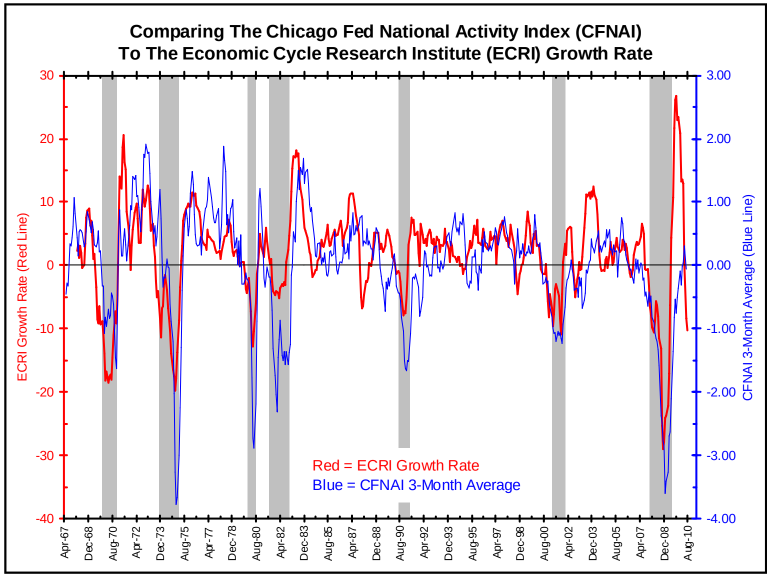
From Our Latest **Inflation Watch**

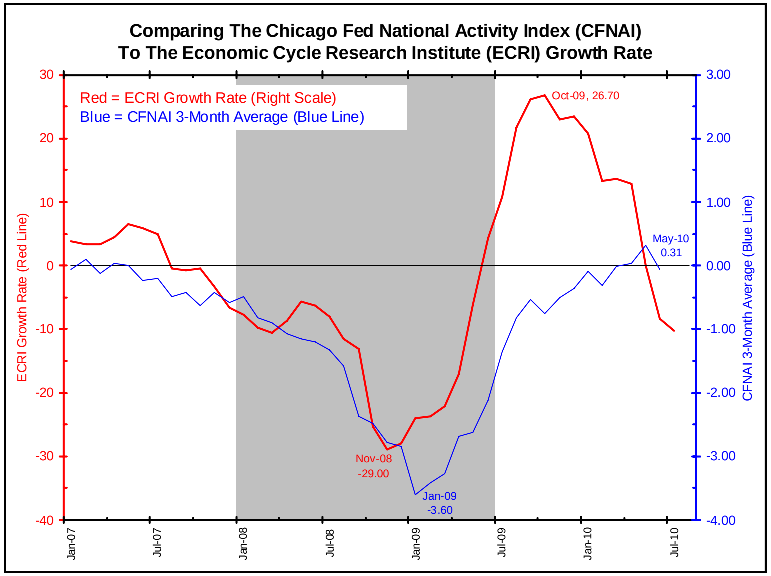
While no equivalent measure for rents exists, anecdotal information highlighted in our NewsClips product suggests that as home purchases have declined, demand for renting has increased. Since OER is based on rents, we would expect this increased demand to begin to push up rental prices. As the next chart shows, it has.

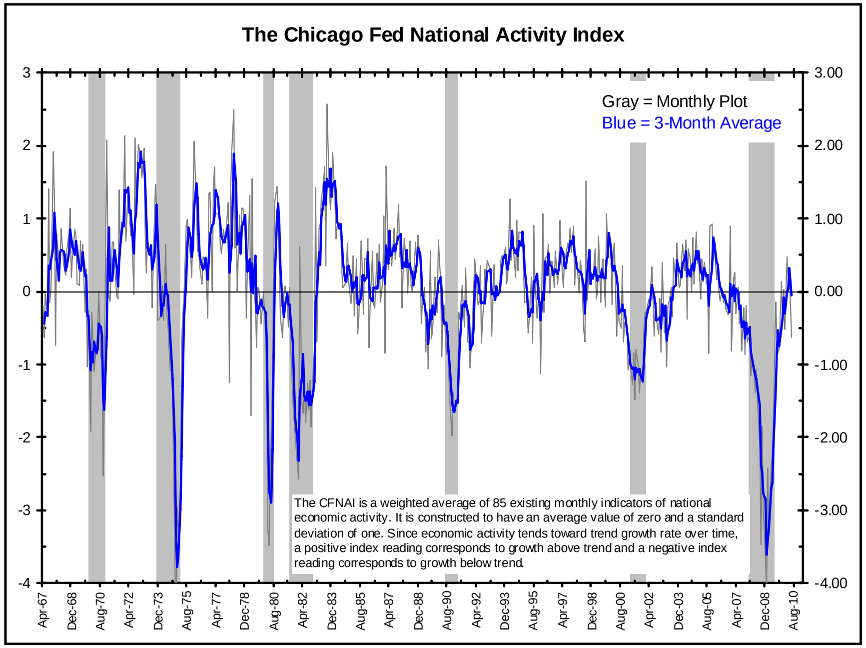
The red line in the chart on the right shows the 12-month annualized OER growth rate is still declining. The blue line shows the 3-month annualized growth rate. Over this shorter time frame, OER has turned higher as we would expect with sharply declining home purchases.



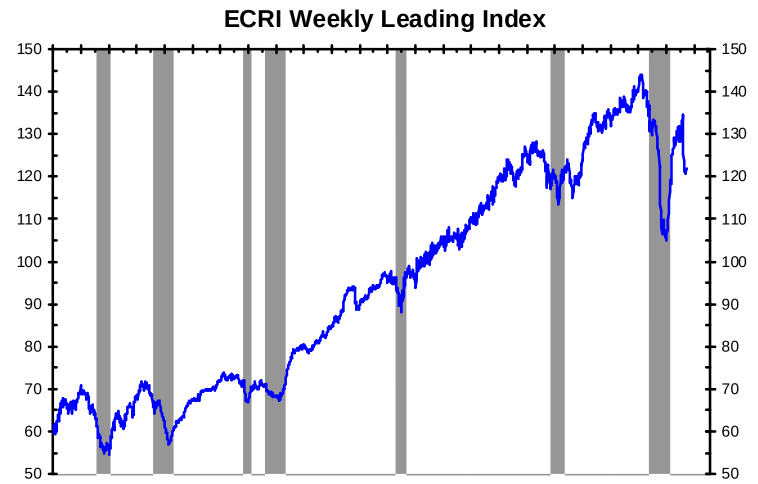
Economic Indicators That Lead vs. Coincident

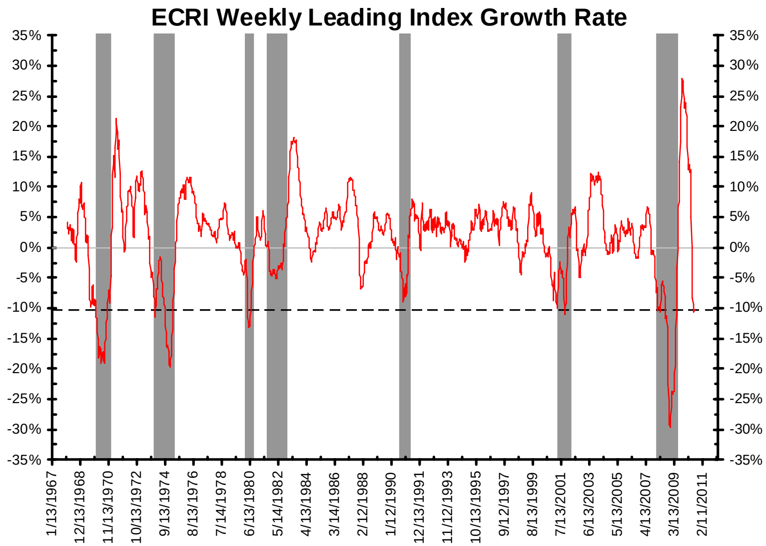






ECRI – Slowdown or Double Dip?





From **Newsclips/Daily Market Commentary**

How Is It Constructed?

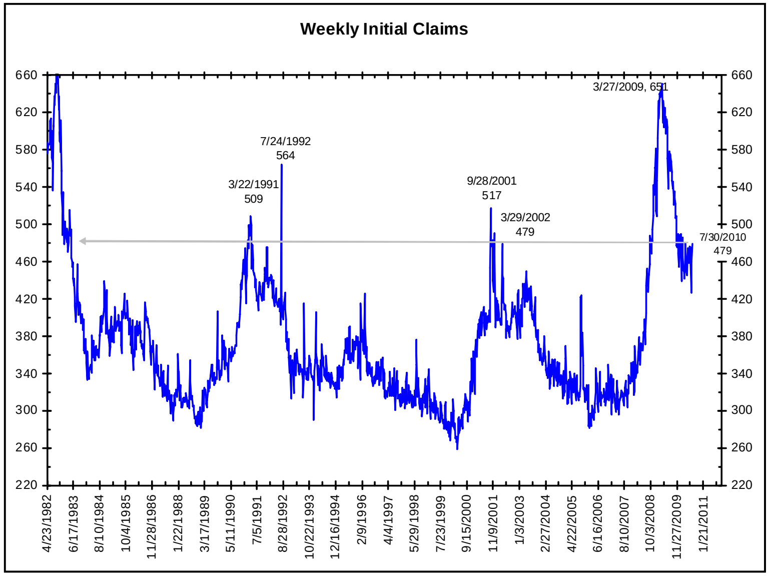
The ECRI keeps the exact construction of the index proprietary. That said, we believe it uses seven components in its computations. They include:

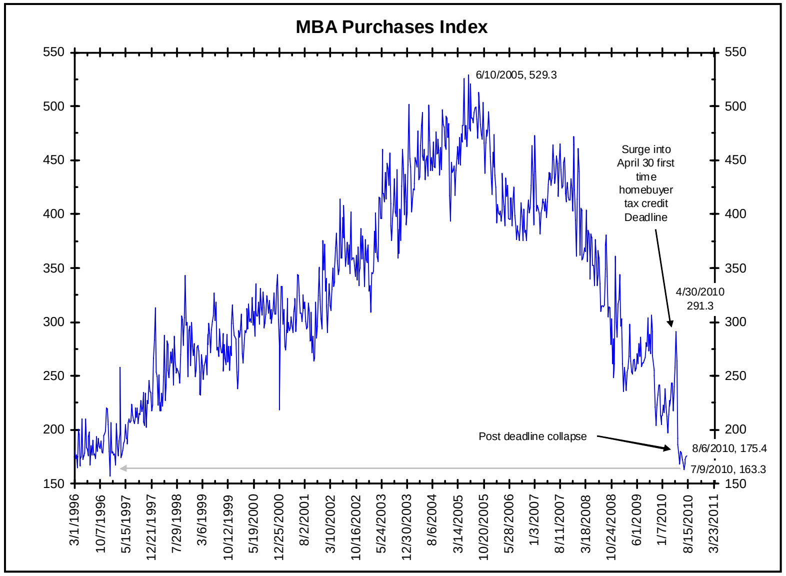
- •The Mortgage Bankers Association's home purchase index
- •Weekly Money Supply (Growth rate of M2 plus Long-Term Household Mutual Funds)
- •JOC-ECRI Industrial Price Index, Growth Rate
- •Initial jobless claims
- •Corporate Yield Spreads
- •Corporate Bond Quality Spreads
- •NYSE Composite Stock Price Index

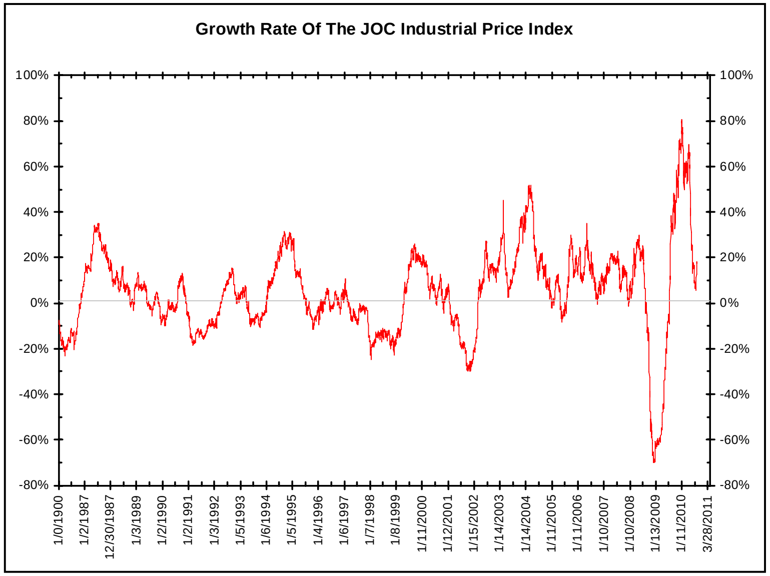
From **Newsclips/Daily Market Commentary**

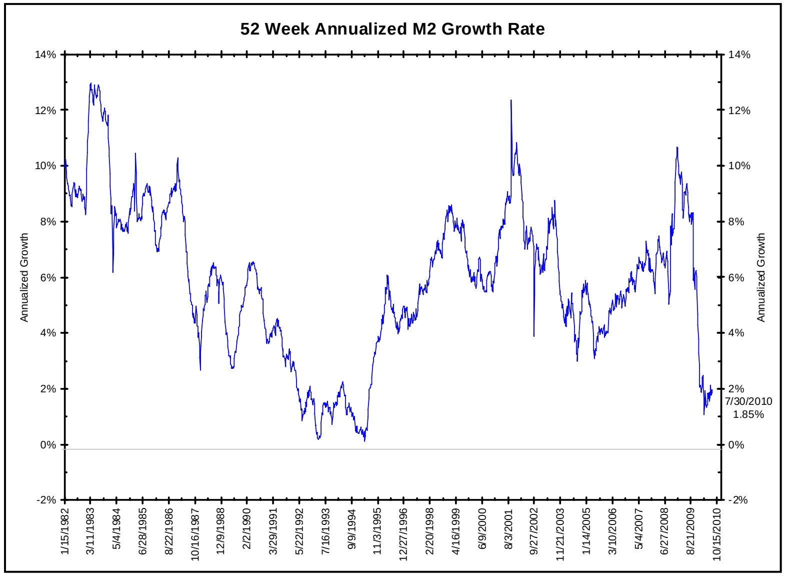
The ECRI Leading Index has been published every Friday for decades and offers a real-time prediction about the economy. Last Friday (July 16) its rate of change (bottom panel) was -9.8%. Note the dashed line on the chart. In the last 40 years, every reading this low has occurred during a recession. **Unlike the stock market, which Paul Samuelson said predicted 9 of the last 5 recessions, a rate of change in the ECRI index of -9.8% or lower has predicted 6 of the last 6 recessions. So, is the current reading telling us the double-dip recession has begun or is this time different?**

Economic Indicators That <u>Lead</u>

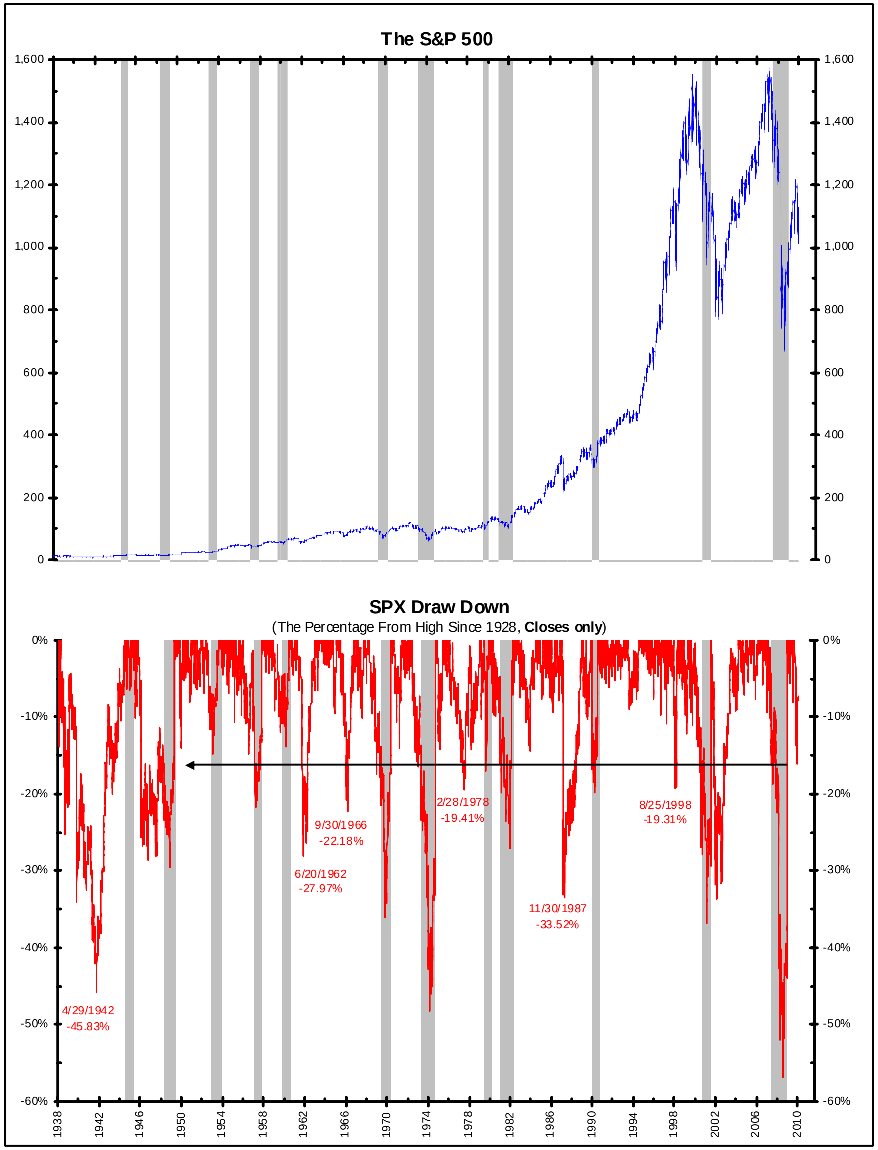








Do Stocks Predict Recessions?



Since 1938 the stock market has had a 15% decline immediately following a recession 15 times.

- Total = 15
- 9 of those 15 times the decline of 15% signaled another recession
- 6 of those 15 times no secondary recession ever materialized
- 2 times (1955, 1961) a secondary recession occurred without a 15% decline in stocks

Explaining Company Guidance

From Our **Newsclips/Daily Commentary**

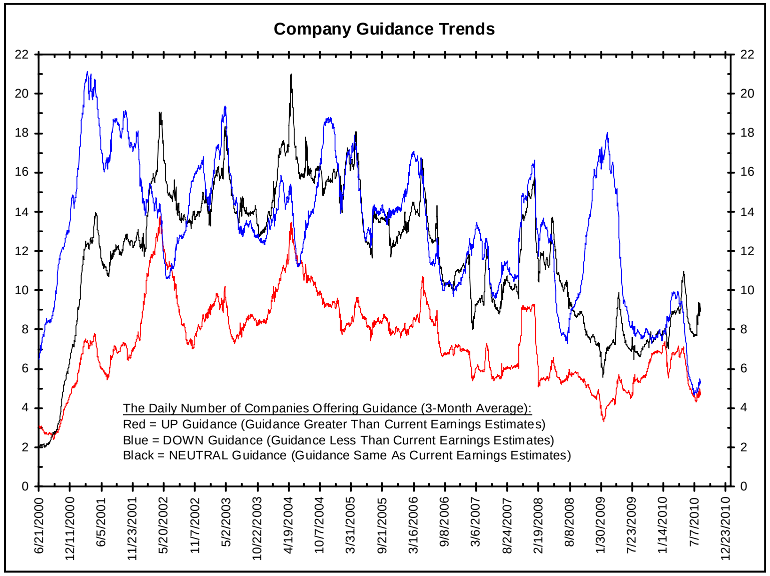
The current earnings season started July 12 with Alcoa's release. While many understand that the current quarter's earnings are somewhat gamed and therefore useless, company guidance is taken seriously. The current quarter's guidance has received a lot of attention because of the sheer number of companies that are guiding earnings estimates higher. Many believe this constitutes a leading indicator of the economy and is therefore a positive indicator of good things to come. Is this true?

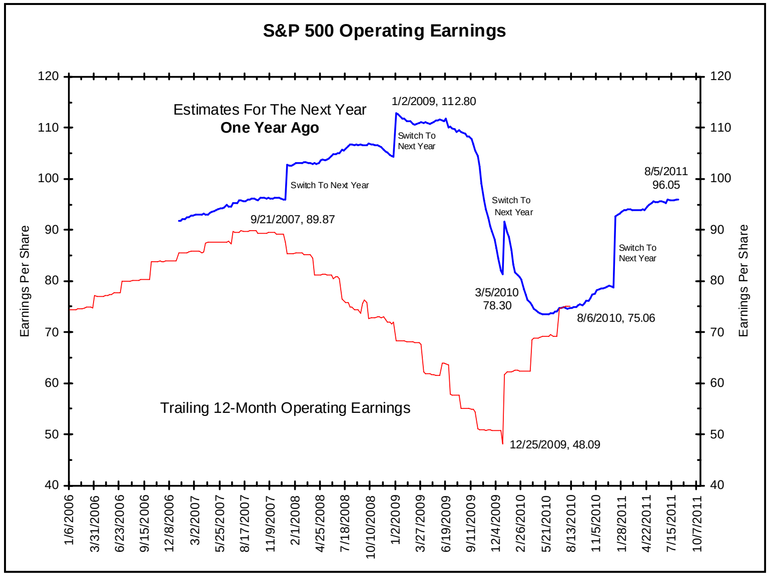
Company Guidance Index

The chart to the right plots a 3-month average of company guidance. We chose a 3-month period here and throughout this report because companies report quarterly and typically use these quarterly reports to offer guidance.

The red line shows UP guidance, companies that offer earnings guidance greater than the current consensus estimate. The blue line shows DOWN guidance, companies that offer earnings guidance less than the current consensus estimate. Finally, the black line shows NEUTRAL guidance, companies that offer guidance the same as the current estimate.

The sharp-eyed reader will note that the UP guidance (red) line is almost always below both the DOWN guidance (blue) line and the NEUTRAL guidance (black) line. This means the majority of guidance is either neutral or down. This is not surprising given the next chart. It shows current operating earnings (red) versus estimates for one year later (blue). Analysts are ***always*** too optimistic on future earnings, making it nearly impossible for a company to offer higher guidance than analysts' estimates.



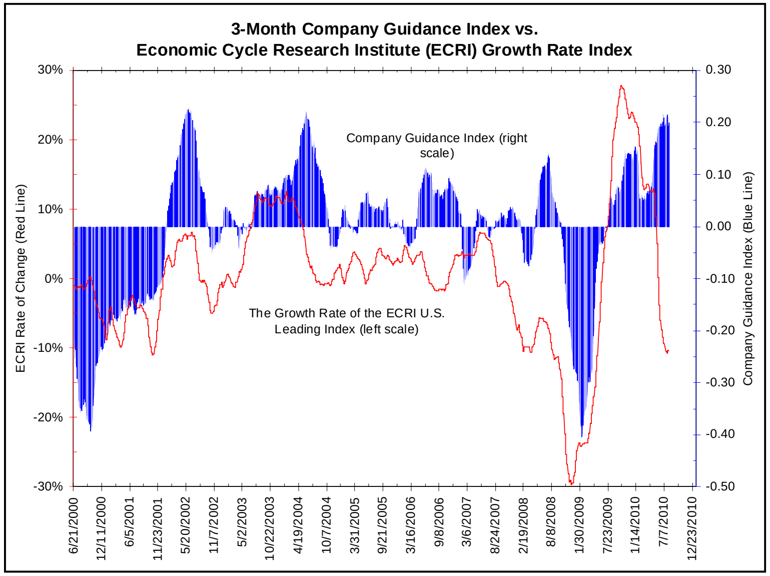


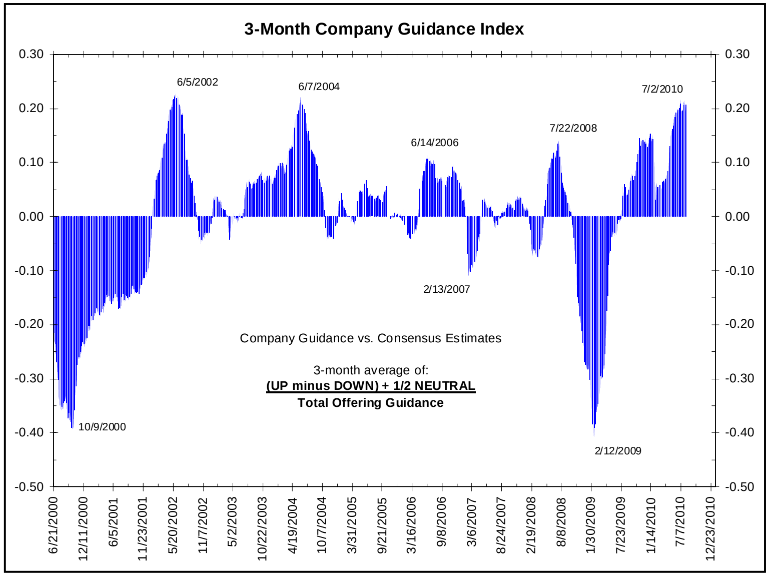
Does Company Guidance LEAD The Economy?

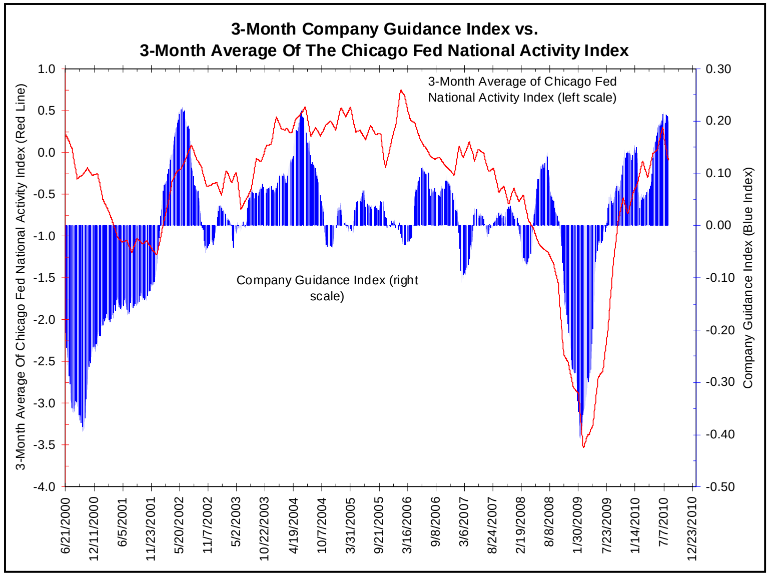
From Our **[Newsclips/Daily Commentary]**

When looking at these numbers, relative levels of guidance may be more revealing than absolute levels. To this extent, we constructed the index below. It plots the number of companies offering UP guidance minus those offering DOWN guidance plus 1/2 the number of companies offering NEUTRAL guidance divided by the total number of companies offering guidance. NEUTRAL guidance gets a 1/2 weighting because affirming what is expected is not as important as offering guidance that differs from expectations (UP or DOWN).

Without running a statistical analysis, it is clear that the ECRI turns ahead of the Company Guidance Index (top right chart). In other words, the ECRI leads the economy and the Company Guidance Index. It is also clear that the CFNAI runs coincident with the Company Guidance Index (bottom right chart). Both turn up and down together and often reach multi-year extremes at the same time. In other words, the CFNAI is coincident with the economy and the Company Guidance Index.





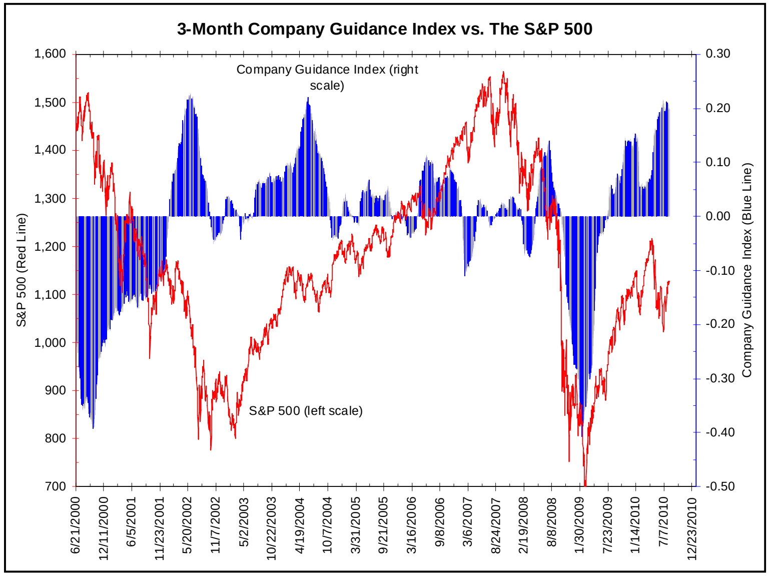


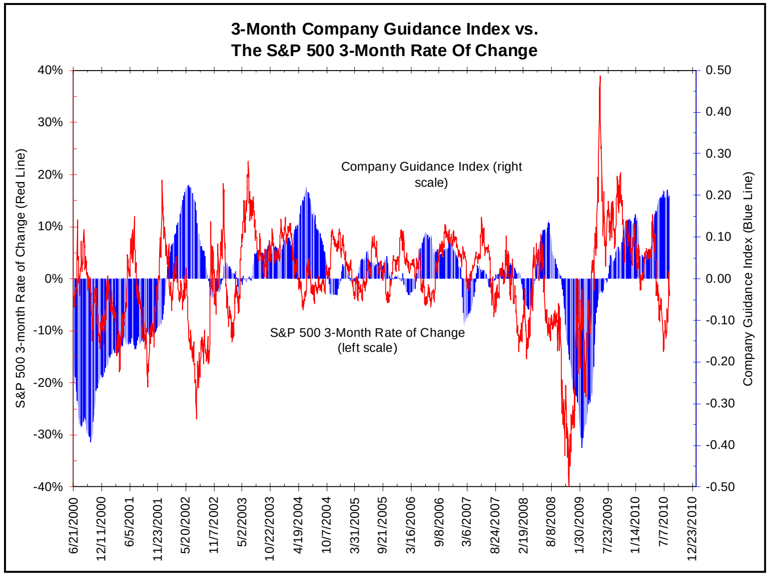
From Our [Newsclips/Daily Commentary]

Conclusion

The current dilemma is that economic statistics that are *coincident* or *lagging* the current pace of the economy show everything is “so-so”. Economic indicators such as the ECRI that generally tell us where the economy is going are flashing warning signals. Many strategists are ignoring this debate, preferring to cite the *relative* improvement in company guidance as a signal that the economy is doing well. However, as we show here, this is not a leading indicator of the economy. It is, at best, a coincident indicator of economic activity. In other words, company guidance does not tell us where the economy is going. Rather, it tells us where the economy is now or has just been in the recent past.

Finally, how does company guidance measure against the stock market? See the next two charts. If anyone can see a pattern, let us know. We are not surprised by this lack of correlation because many more things than company guidance (or forecasts) drive stock prices, [especially in recent years].





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