Alhambra Investment Partners

A-BOOK

Analysis Beyond The Headlines

Monthly Edition – September 19, 2012

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Miami – Coral Gables – West Palm Beach – Denver – Buffalo – Asheville – Omaha

A-BOOK TABLE OF CONTENTS

GDP ACCOUNTS

Q2 GDP +1.5%
Down from 2.0% in Q1

PCE +1.5%
Down from 2.4% in Q1

Non-Res Fix Inv +5.3%
Down from 7.5% in Q1

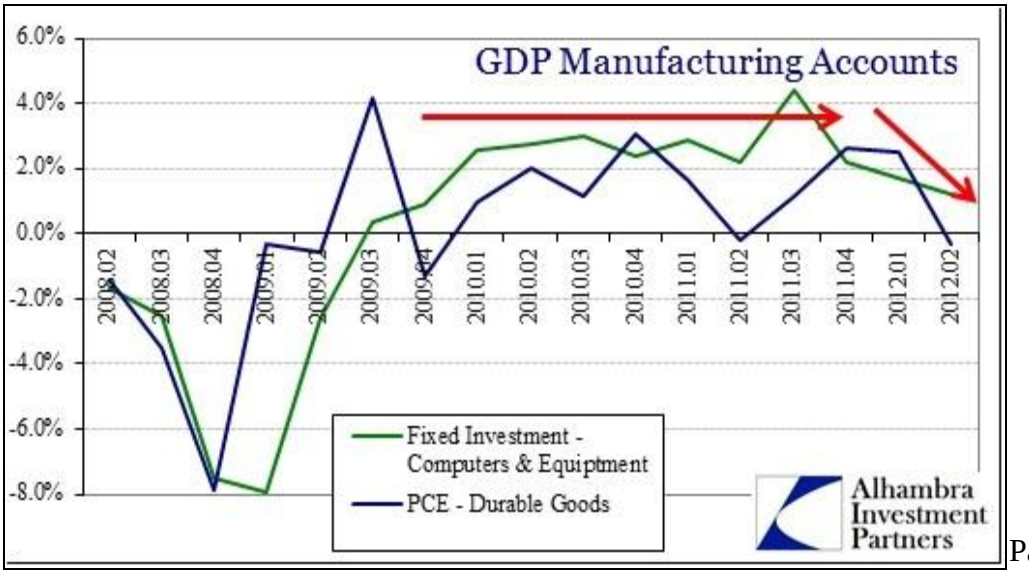
Real Final Sales +1.2%
Down from 2.4% in Q1

The first revision to GDP calculations showed a bit of an improvement over initial estimates. Accounting for nearly all the revision was the estimate for personal consumption expenditures on durable goods and imports, balanced slightly by a higher inflation estimate (0.08% vs. 0.07% initial). Compared to the initial estimate of declining spending on durable goods, the revisions brought this segment up to a flat quarter in Q2 over Q1 while imports were revised slightly lower (aligning with ancillary estimates of global trade levels).

Unchanged through these revisions is the trend in manufacturing throughout the US economy. While this Q2 data is now quite dated, we can extract the emergence of the weakening trend that is seen in so many of the data streams discussed below. Spending on manufactured items, whether by consumers or businesses, clearly ran into trouble transitioning out of the inventory bump from Q4 2011.

Some of that weak transitioning is certainly tied to corporate cash flows and profits. The August GDP release includes the BEA's estimates on profits and cash flows and, like Q1, "current production cash flow" fell again in Q2 (-$11.3bln Q2 vs. -$169.8bln Q1). Profits from current production were estimated to have increased by $10.4bln in Q2 vs. -$53.0bln in Q1, but those estimates include adjustments to inventory valuations and the BEA's estimate for "capital consumption" (the economic term for depreciation of real assets). There was a large change in the capital consumption adjustment in Q1 relating to the expiration of bonus depreciation claimed on corporate tax returns from 2011.

We can use "profits before tax" as an estimate of the profit picture absent any accounting and tax-related changes to capital consumption, and here it more closely resembles the cash flow picture (-$28.0bln Q2 vs. +$188.1bln Q1). Anecdotally, the decline in business and production profitability has been seen in earnings estimates and reports of individual companies and stock market estimations.



Next GDP release (final revisions to Q2 estimate) scheduled for September 27, 2012.

PAYROLLS & UNEMPLOYMENT

August NFP Payroll
+96,000 Total

July NFP revised lower
+141k from +163k

June NFP revised lower
+45k from +64k

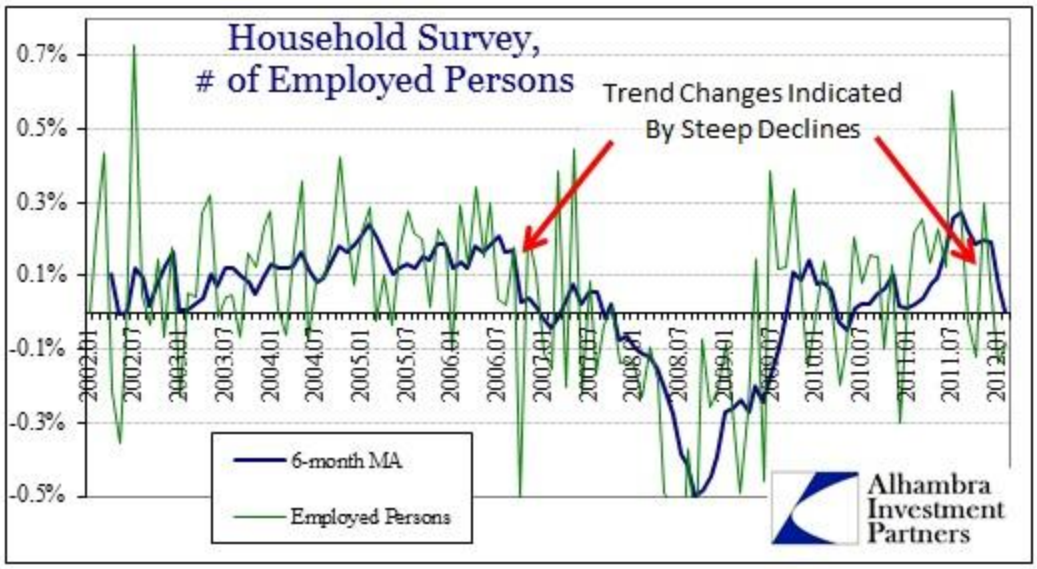
Headline Establishment survey of NFP payrolls for August 2012 surprised on the downside, coming in quite a bit lower than the +150,000 expectations; reversing July's "surprise". In addition, some of that July upside surprise was revised away, as was a large proportion of June's overall total (the headline for June NFP is now only +45k jobs). Inside the manufacturing sector, employment was estimated to have *declined by* 15,000, while employment in motor vehicles and parts fell by 8,000.

The headline rate of unemployment from the Household survey looked like a healthy drop to 8.1%, but, as is common knowledge in 2012, the decline was entirely attributed to people leaving the workforce. The BLS estimated that the overall civilian noninstitutional population rose by 212,000 in August, but the civilian labor force contracted by 368,000, bringing the participation rate to a *new recovery low* of 63.5% (well below the 64.1% participation rate of August 2011).

Inside the employment figures from the Household survey show a sharp contrast to the establishment survey for the second month running. While the Establishment survey estimated job gains of 96,000, the Household survey measured a *decline* in the number of employed workers of 119,000. That marked the second consecutive monthly decline in the Household survey (314,000 fewer employed workers for the summer) and the *fourth in the past six months* (see Chart below).

Over the fifteen months preceding those figures, there were only two monthly declines. The only other occurrence of four monthly declines as closely spaced (outside of the Great Recession in 2008 & 2009) was the second half of 2007 and the onset of the Great Recession. During the "boom"/recovery period between 2004 and the middle of 2007, the Household survey only registered a total of seven monthly declines out of 42 total months. The labor market is showing not just weakness, but extraordinary weakness that is not consistent with even "moderate" growth.

It is very likely, in our opinion, the stark change in trend in employment in this alternate series, in contrast to the more modest and adjusted Establishment survey, played an outsized role in the Federal Reserve's decision to implement ongoing monetary administration. Wage rates might also have played a role, particularly since average hours worked was largely unchanged except for a 0.2% decline in, as you might have guessed, manufacturing. The average hourly wage rate across all industries and sectors *declined* by $0.01/hour in August.



Next payroll report release scheduled for October 5, 2012.

INFLATION ACCOUNTS

August CPI
0.6% SA
0.6% NSA

August PPI
+1.7% Finished Goods
+1.1% Intermediate Goods
+5.8% Crude Goods

Inflation returned with a vengeance in August, registering a hefty increase after a period of subdued energy prices. Driven by asset prices across the commodity complex, gasoline prices surged in July by 9%. The BLS indicated that 80% of the move in the August CPI was due to gasoline prices alone. Despite drought conditions that continue to drive increases in the various prices of important foodstuffs, most of those increases have been limited to upstream in the supply chain. At the consumer level, the food index saw a rather modest rise of 0.2%.

At the producer level the inflation conditions altered more drastically than at the consumer level. The Finished Goods Index rose by a large 1.7% increase in August, after only a modest 0.3% rise in July. Energy prices rose by 6%; ex-food and ex-energy the PPI would have only registered a 0.2% increase.

Food prices in the supply chain have started to rise, as intermediate foodstuffs and feedstuffs rose by 2.4% in August, while crude stage foodstuffs and feedstuffs rose 4.6%. Crude energy prices rose by 9.6%.

Clearly, commodity price pressures are driving inflationary results, though mostly limited to the early stage production levels right now. Given recent history, however, it may only take a few months before this leaks up the supply chain. At this point there is duality or bifurcation taking place – the decline in manufacturing demand within the US and globally caused a massive retrenchment in commodity prices, only to be sharply resurrected by the anticipation of central bank action (at both the ECB & Fed).

Next CPI release scheduled for October 16, 2012.

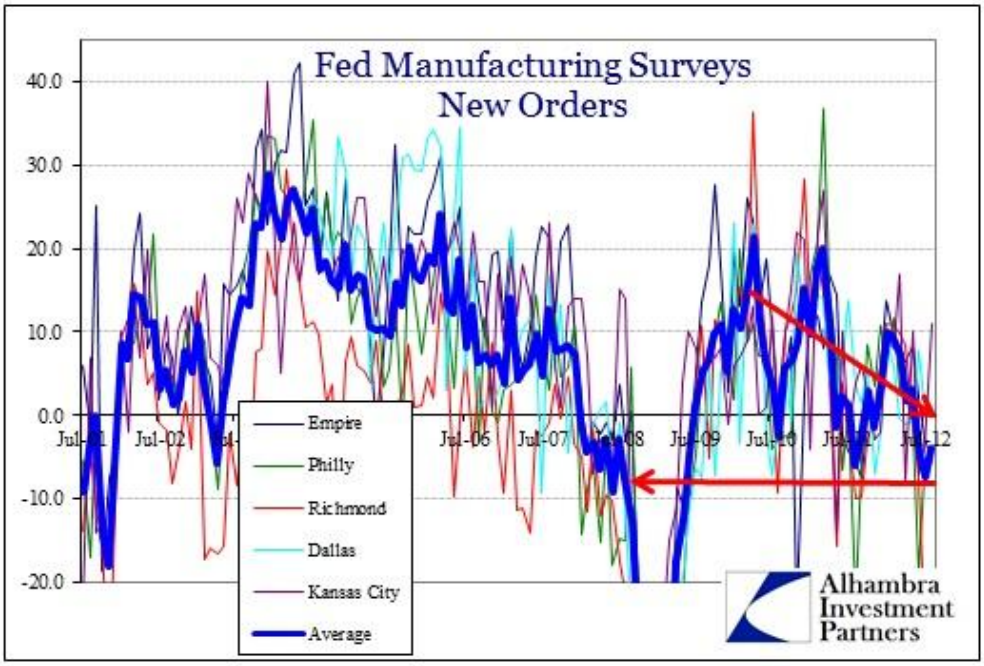
Next PPI release scheduled for October 12, 2012.

REGIONAL FED SURVEYS

	Overall Index	M/M Change	New Orders	Employment	Unfilled Orders
Empire	-5.9	Down 13.2	-5.5	16.5	-10.6
Philadelphia	-7.1	Up 5.8	-5.5	-8.6	-16.2
Richmond	-9.0	Up 8.3	-20	-5	-25
Dallas	6.4	Down 5.6	0.2	14.2	-9.2
Kansas City	8	Up 3	11	2	4

The pace of contraction moderated somewhat during August in the Philadelphia and Richmond surveys, but the Empire survey has now fallen dramatically as the trend of manufacturing continues to move lower. Even the Dallas survey fell more than anticipated, but at least continues to indicate moderate manufacturing growth.

New orders and the backlog of orders continue to move in the wrong direction and are the prime reasons that the headline diffusion indices continue to show mostly weak results. Current production levels accounted for much of the collapse in the Empire index, but survey respondents were asked additional questions about any change in plans over the course of 2012 so far. More than twice as many firms have signaled downward revisions to their expectations for hiring and capital expenditures than upward revisions.



Next Empire Fed release scheduled for September 17, 2012.
Next Philly Fed release scheduled for September 20, 2012.
Next Dallas Fed release scheduled for September 24, 2012.
Next Richmond Fed release scheduled for September 25, 2012.
Next KC Fed release scheduled for September 27, 2012.

ISM SURVEYS

ISM Manufacturing
August 49.6 -0.2

ISM Manufacturing – Since June, the ISM has remained below the magic 50 level for three consecutive months, falling to a new recovery low. The current output/production subcomponent fell dramatically to 47.2 from 51.3 in July, indicating that current output levels have contracted in August for the first time since *May 2009*. The New Orders subcomponent fell 0.9 to a very low 47.1, confirming the order trend seen in the regional Fed surveys. The only component registering a solid gain was the Prices category, ominously (given the potential inflation conditions) rising by 14.5 to 54.

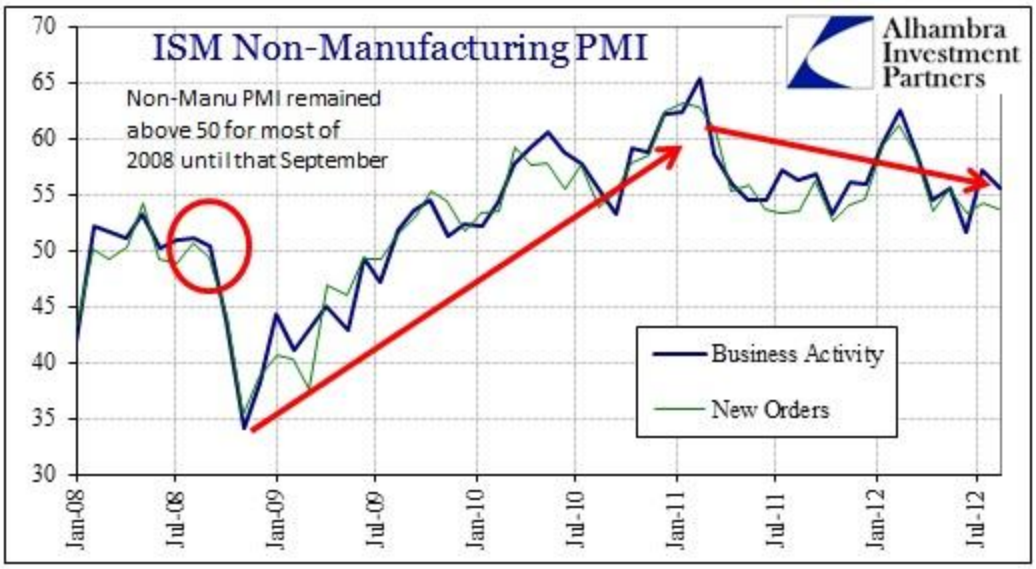
Of the 18 manufacturing industries, eight are reporting growth in August in the following order: Printing & Related Support Activities; Primary Metals; Food, Beverage & Tobacco Products; Petroleum & Coal Products; Apparel, Leather & Allied Products; Paper Products; Chemical Products; and Miscellaneous Manufacturing. The eight industries reporting contraction in August are: Textile Mills; Nonmetallic Mineral Products; Furniture & Related Products; Computer & Electronic Products; Electrical Equipment, Appliances & Components; Transportation Equipment; Fabricated Metal Products; and Machinery.

Next ISM Manufacturing Survey release scheduled for October 1, 2012.

ISM Non-Manufacturing
August 53.7 +1.1

ISM Non-Manufacturing – August results for the non-manufacturing sector were much better than manufacturing. Though both the business and new orders sub-indices fell in August, they remained at levels well above 50. There was improvement in employment and the backlog of orders, both segments rising above 50 in August. As with manufacturing, the Prices sub-index rose 9.4 to 64.3, indicating significant movement in prices.

Despite the general improvement in the various subcomponents, the overall index remains well below levels from earlier in 2012 and has been trending lower since early 2011. In the context of that overall performance (given a recovery peak level of 65.4) in the past three years and the behavior of the index in 2008, these subdued levels are consistent with *less than moderate* economic growth.



Next ISM Non-Manufacturing Survey release scheduled for October 3, 2012.

INDUSTRIAL PRODUCTION & CAPACITY UTILIZATION

August Industrial Production
+1.2%

Overall industrial output fell a stark 1.2% in August. Some of that decline in output was the result of Hurricane Isaac where precautionary shutdowns of rigs and drilling equipment contributed to the 1.8% decline in the output of mines. Even with the hurricane disruption, industrial activity was dramatically below expectations and cannot be explained by severe weather.

August Capacity Utilization
78.2%

The output of utilities fell by 3.6% in August, indicating output that was 4.7% *below* that of August 2011. Consumer industrial output fell 1.2%, largely as a result of a 2.9% decline in durable goods manufacturing (another confirmation of weakness in the manufacturing sector). Within the durable goods segment, overall output in the manufacture of automobiles fell a rather alarming 4.7% in the month. This was a trend we identified in the GDP report for the second quarter (August ABOOK) and points to a slowdown in end user markets for consumer and business vehicles.

Capacity utilization dropped along with industrial production, falling a full percent to 78.2%. The decline in utilization erases the entire gain seen in 2012, bringing the series back down to December 2011 levels.

Next Industrial Production and Capacity Utilization release scheduled for October 16, 2012.

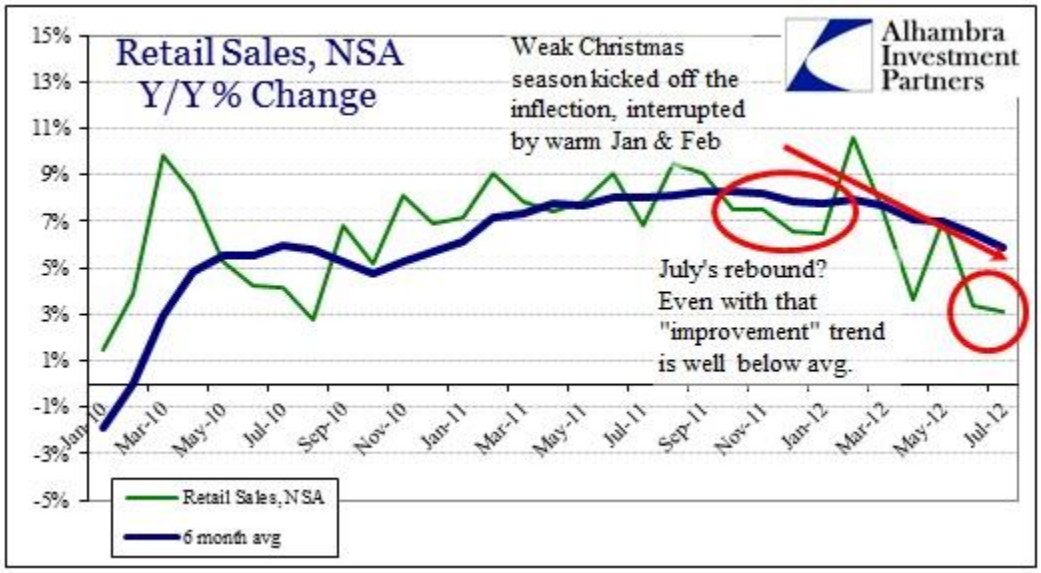
RETAIL SALES

August Retail Sales
+0.9%
x-Autos +0.8%

–0.3% Qtr-to-Qtr Change

The headline rise in retail sales figures belies the true picture of economic spending in the consumer segment. Nearly all of the headline increase was due to the 5.5% rise in sales of gasoline. Stripping out gasoline and auto sales, retail sales advanced only 0.1% in August. Sales at general merchandise stores fell 0.3%; food and beverage stores flat; non-store retailers (a segment that had performed very well recently) flat; clothing and accessory retailers -0.1%; and electronics and home appliance stores -1.4%. These retail results, with the exception of automobiles, align closely with the manufacturing and industrial production figures in the series discussed above.

The July "rebound" in retail sales was revised lower to +0.6%. July's results initially caused some discussion due to the unusual statistical/seasonal adjustments that seemed to have artificially boosted the monthly change. The problem lay with the movement of weekend shopping periods between June and July compared to the June/July period in 2011. Because there was one fewer weekend period in July 2012, the Commerce Dept.'s statistical adjustments accounted for the discrepancy by adding an unusually large seasonal "smoothing". Taking seasonal factors out of the equation by comparing year-over-year rates of change, the June/July period saw the weakest Y/Y change since August 2010. The August increase Y/Y, even including outsized gasoline sales, was still among the smallest in the past three years (chart below).

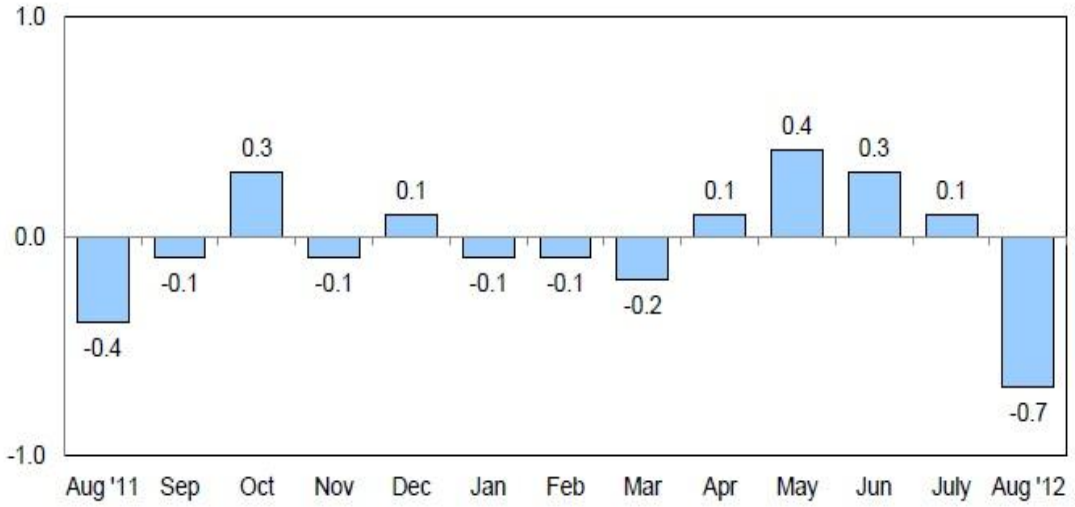


Next Retail Sales release scheduled for October 15, 2012.

PERSONAL INCOME & SPENDING

Personal income and spending accounts from the BEA surveys have been overtaken by recent data releases. The latest data from the BEA is for the month of July, showing a rebound in both income (+0.3%) and spending (+0.4%). The increase and rebound in real personal income in July was largely due to a flat estimate for inflation. That kind of subdued inflation pressure will not be present in the report for August.

Chart 1: Over-the-month percentage change in real average hourly earnings for all employees, seasonally adjusted, August 2011 – August 2012



As the Chart above shows, average hourly earnings, adjusted for estimated inflation, fell by 0.7% according to the BLS's August payroll report. As we have indicated in previous research releases and notes, the lack of consistent real income growth has been the major impediment to the recovery, and the decline in real incomes has been perhaps the largest contributor to the weakening trend in 2012 (along with a decline in business earnings and cash flow leading to declining demand for business investment). According to the BLS, real average hourly earnings have not grown at all year-over-year August 2011 to August 2012.

Worse than that, real average weekly earnings, the broadest measure of wage income growth in this series since it includes both wages and hours worked, stopped growing consistently in *October 2010*. Since late 2010, real average weekly earnings have declined a rather significant 1.3%. For production and manufacturing workers, the drop in weekly earnings is worse – down 2.1% since that October 2010 peak.

As consumer prices have picked up in August, the lack of real earnings or wage growth will adjust into the real economy as either a reduction in the savings rate, or a reduction in Personal Spending. In the July BEA release, the savings rate fell 0.1% to 4.2%. Despite the trough in inflationary pressures in the May – July period,

households were forced to dip slightly into savings just to maintain a slightly elevated spending pattern. We can infer and extrapolate from upstream indications and data that personal spending has been even weaker in August and going into September as inflation (energy and food prices in particular) has eroded purchasing power that has not been recycled back through expanding job growth.

Next Personal Income & Spending release scheduled for September 28, 2012.

CONSUMER CONFIDENCE

Gallup Economic Conditions Survey
-18

Conference Board Consumer Confidence
August 2012 60.6

Gallup's survey of consumer confidence rose 11 points in their latest weekly survey that Gallup attributes to Democrats and Independents responding to the Democratic convention. Whether or not other measures of confidence respond in the same way remains to be seen. The Conference Board's measure fell sharply in August as the tired combination of inflation pressure and weak to lower employment sapped its measures and survey results.

The Present Situation Index for the Conference Board measure remained at a very low level, largely unchanged from July at 45.8. The Expectations Index, however, fell a rather striking 8 points to 70.5. According to this survey, consumer confidence is now back at November 2011 levels, erasing all and more of the boost seen earlier in 2012. The Conference Board also found that expectations for business conditions and hiring in the near future both fell in August.

The Gallup survey is conducted weekly.
The next Conference Board survey release is scheduled for September 25, 2012.

CURRENT ACCOUNT & FOREIGN TRADE

Change in US Exports
-$1.9 billion June 2012

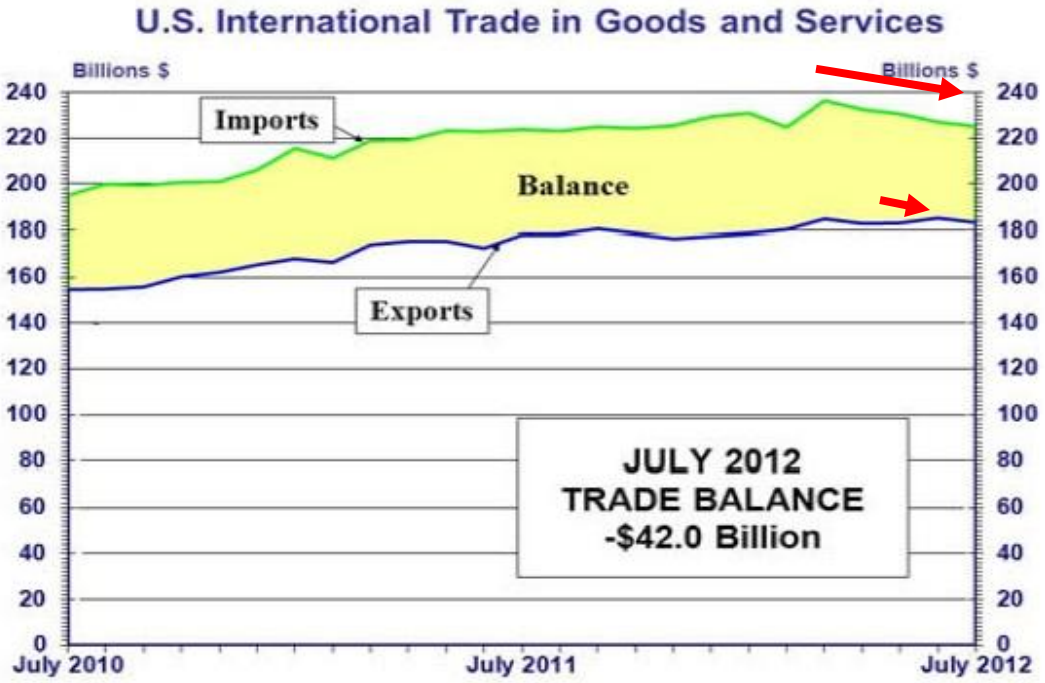
Change in US Imports
-$1.8 billion June 2012

US Merchandise Deficit
-$59.2 billion June 2012

Weakness in global trade and the domestic economy continue to show, though the figures on global trade and the current accounts are dated to June. Even though the lag exists and events have overtaken this series somewhat, the figures do show the trends that exist now forming in the last part of the Q1 and remaining throughout the second quarter.

The $57.3 billion merchandise deficit was the lowest deficit since December 2010. While this is technically positive in the GDP accounts, the indications are that domestic demand was tailing off. Some of the decline was due to lower energy prices leading to lower dollar volumes of imported materials, but the entire import decline is attributed to far more than energy price movements. Imports of consumer goods did increase in June, but a decline in the import of capital goods more than offset that as a measure of business demand for capital expenditures.

On the export side, nearly all of the decline in marginal export activity was in the industrial supplies and materials segment. Overall, the total trade deficit in May & June of $42 billion was lowest registered/estimated imbalance since the end of 2010. Moving forward, however, it is likely that the trade imbalance will rise again particularly into August and September with energy prices without any offset to export activity. Anecdotal indications as well as various foreign data series suggest that export demand and global trade have weakened not only with Europe but with Asia as well. For GDP accounts these trends will likely be a drag on third and fourth quarter statistics.



The next International Trade release is scheduled for October 11, 2012.
The next International Transactions release is scheduled for September 18, 2012.

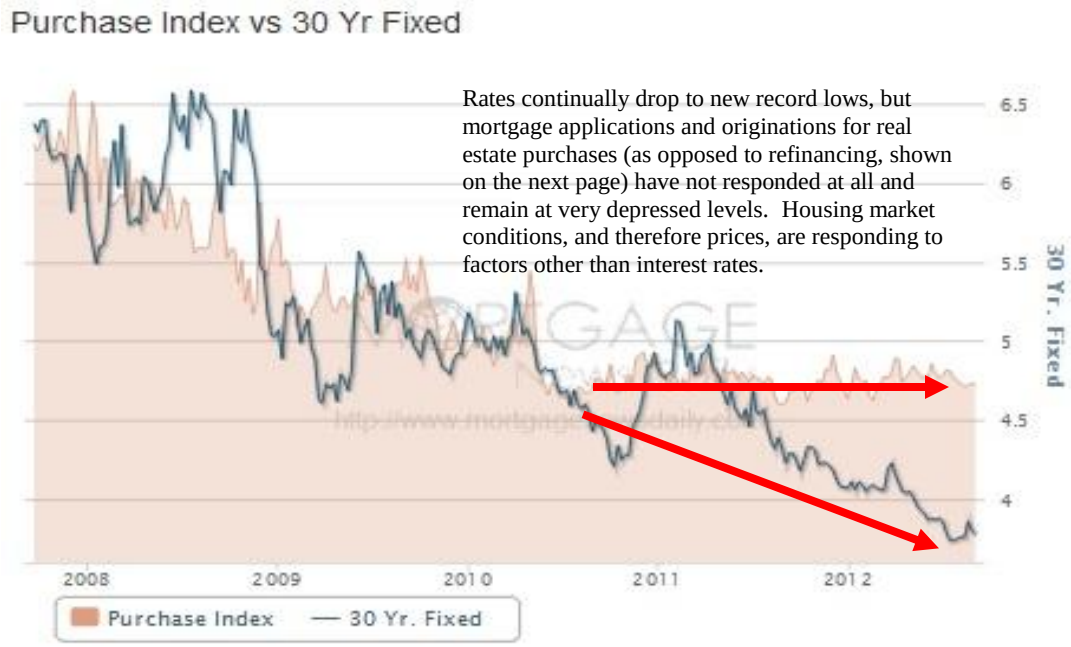
REAL ESTATE & HOUSING

The Federal Reserve continues to count on mortgages and housing-related financing as its primary monetary mechanism, as evidenced by the direct linkage between the Fed's MBS purchases with jobs (at least according to the central bank's theory). Ostensibly the FOMC would prefer a more direct link between monetary expansion and employment within the construction segment, the reality is that construction jobs continue to be largely unaffected by "stimulus", no matter how low interest rates have gone (see chart on the next page).

There continues to be a disconnect between the level of permitting, starts and eventual completions. In August, the level of permits issued for real estate

construction rose a rather robust 6.8% over July, and are up an astounding 29.5% over August 2011, including a 23% increase in permits for the all-important single family structures. That has translated into a 21.5% increase in starts, including a 17% rise in single family. However, completions have only grown 5.4% over August 2011, and even more striking completions for single family structures are *down 7.2%*.

While we should certainly expect permits to lead starts and completions by at least a few months, there is no good explanation for the dramatic difference between permitting and completions. This suggests a level of optimism in the construction industry that has yet to be fulfilled (outside of multi-family structure – completions in this segment are up 47% year-over-year). It also indicates that the housing market overall has yet to see any real, true rebound in any meaningful sense (which is one reason why the Fed is taking action).



In terms of financing, mortgages continue to be dominated by refinancing. Refinancing requests continue to make up 80% of all new applications and originations. While this is a mechanism for monetary stimulus to reach the general population (and was, arguably, the primary monetary channel in the past fifteen or so years), without a meaningful increase in house prices, home equity and refinancings will remain unavailable for the very people monetary policy professes to be trying to reach. That means that there needs to be meaningful mortgage expansion for the purchase of additional home units, but mortgages obtained for the purchase of houses has remained at a consistently low level (scraping along the bottom) since the middle of 2010 no matter how low interest rates have fallen (above chart).

Refinancing activity, as opposed to purchasing activity, has responded for the most part to movements in mortgage interest rates. How much more activity can be pulled out from real estate owners with positive equity and the willingness to add debt with uncertain inflation and employment conditions remains to be seen. The Federal Reserve is gambling that even lower rates will pull forward enough debt-financed activity to fill in the gaps in household income, and, if they are fully successful, restart the construction industry that has been in nothing short of continual depression.

We remain skeptical about the prospects for successful reconstruction of the construction industry or the dollar amount of new debt to replace lost wage income, let alone even offset additional inflationary pressures that have been created by just the anticipation of new monetary "stimulus". The state of the housing market has been most accurately described by Ben Bernanke himself as a broken transmission mechanism.

US CREDIT MARKETS

The focus for credit markets will undoubtedly be on the new Federal Reserve policy and how that will end up contributing to the macro-economic environment. The primary pathway will certainly be through credit markets as they adjust to the real implications of monetary expansion (attempted credit expansion and reach) and the perceptions of where the policy might impact.

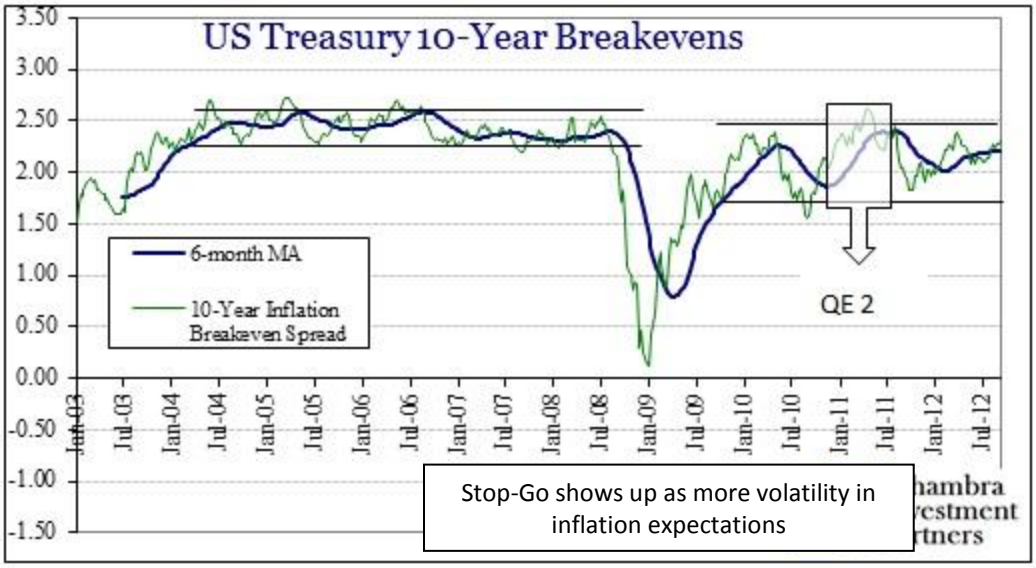
We have previous examples through the first iterations of these unconventional central bank measures to help us evaluate the pathology of credit reactions. Perhaps the biggest change between monetary efforts before September 2012 and after is the ongoing or potentially unlimited efforts by both the Federal Reserve and the ECB. The change to a more open-ended policy is obvious in the context of the previous interventions.

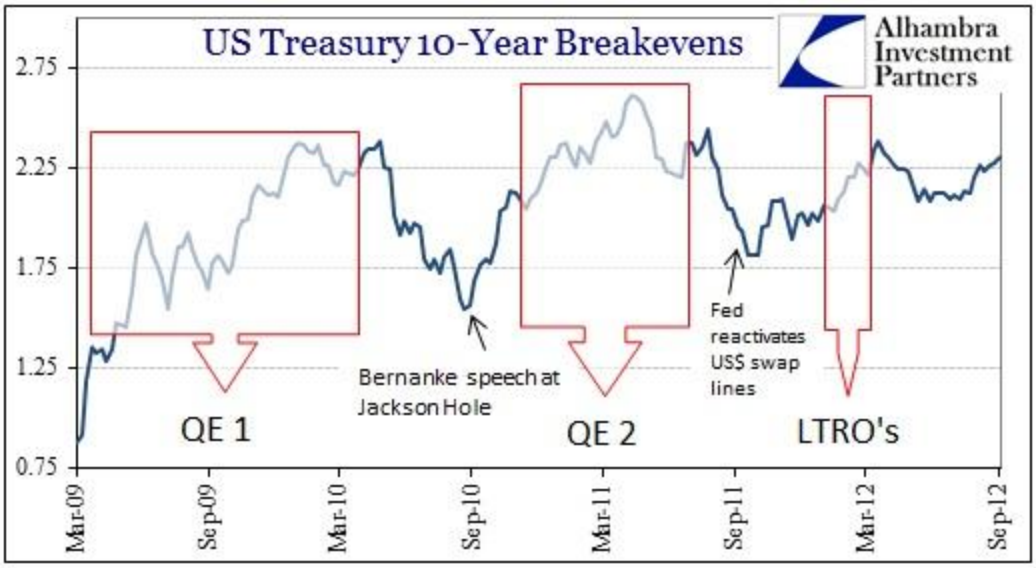
Much like the 1970's, monetary policy after 2008 has been "stop-go". The timescales have been more compressed (we have referred to this as mini-cycles in both monetary conditions and even macro-economic conditions). Mainstream economic theory posits a beneficial relationship between inflation expectations and economic expansion, with the operative focus on potential deflation over out-of-control inflation. As the chart below shows quite clearly, investor expectations of inflation respond just prior to monetary interventions, lasting throughout the period of policy intrusion.

Unfortunately for these central banks, once policy expansions end or wind down investor expectations simply return to their former trajectory. Part of this is certainly reactions to the explicit failure of macro conditions to respond as intended. We can infer from that that investors react to each policy intrusion with much optimism for success, only to be disappointed as each leaves no imprint on the general economic trajectory. In fact, that might be understating it since not only does the macro path fail to realize expectations for a full-fledged "recovery", but growth expectations continually disappoint to the downside.

Economists call this a muddle, but it is becoming increasingly clear that economic conditions are much worse than anticipated – likely explaining the rather drastic steps taken in seeming coordination by the Fed and the ECB. If these central banks have settled on measured policy operations as a plausible explanation for lack of measurable success (and this would conform to a more advanced interpretation of their "rational expectations theory"), eliminating the stop-go would be a logical step.

Central banks are now putting their strained faith into the idea that investors can be shaken out of this stop-go pace and will therefore be enticed into making allocation decisions based not on the anticipated end to central bank interventions, but to permanent conditions of monetary and balance sheet expansions. However, this might not produce the results intended (once again) as the inflation data shown in the previous section suggests. In other words, this seems to us as a tremendous gamble that any positive effects from eliminating stop-go will more than make up for the deleterious impacts of investor inflation expectations flowing through higher commodity prices.



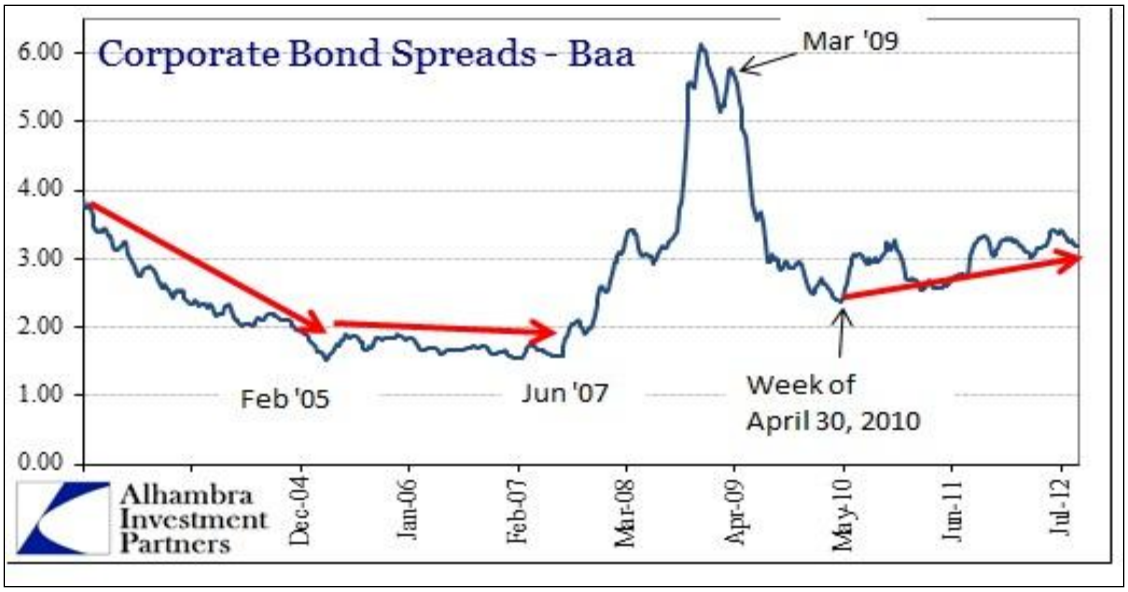


The credit markets themselves are less than impressed by intentional intrusions into inflation expectations. Nominal rates in the treasury markets at the short-end of the yield curve are for more focused on demand for dollar-denominated "quality" collateral, while the long end is captured by increasing indirect monetization of the national debt by the Fed. Therefore information content of interest rates in the treasury markets is compromised (as intended).

Alternative measures of interest rate information paint a very different picture of investor expectations for the general economy. Credit spreads between high yielding corporate debt and US treasuries show that default risks (the primary information content of corporate-UST spreads) have been signaling a dramatic break from historical patterns.

Typically during economic recoveries corporate spreads compress significantly in a very short timeframe, mostly as the fear of elevated default subsides to the point that over-reactions can be

reversed. Once the recovery becomes entrenched in expectations, corporate spreads further compress in a more measured and steady approach.



This is exactly what we saw coming out of the 2001 recession. Though that recession technically ended in late 2001, recession-like conditions persisted until almost 2003 (the original "jobless" recovery) as did the exasperating bear market in equities. The first appearance of the real recovery in late 2002 halted the decompression in corporate spreads and the retracement began while equity price found a temporary bottom. Spreads continued to fall as equities rallied into the growing acceptance of a sustainable (though artificial) economic "boom". Spread decompression continued all the way until June 2007 and the first real signs of financial and economic distress.

That script was largely being followed in the months after the Great Recession technically ended as well. Corporate spreads were rapidly decompressing off the worst days in March 2009, matching the rally in equity prices. At the end of April 2010, the first appearance of Greek/euro drama knocked spreads higher and equities into the "flash crash" as risk perceptions re-adjusted backward out of recovery-mode. Those risk perceptions lasted until Bernanke's Jackson Hole speech in late August 2010.

Since then, equities and corporate spreads have largely been on divergent paths. Rising spreads indicate steadily growing wariness over macro conditions, while equities have been indicating the exact opposite, rallying into each and every central bank intrusion. However, not only have corporate spreads been on a divergent path recently, they have not "normalized" to the historic pattern seen before the 2000's.

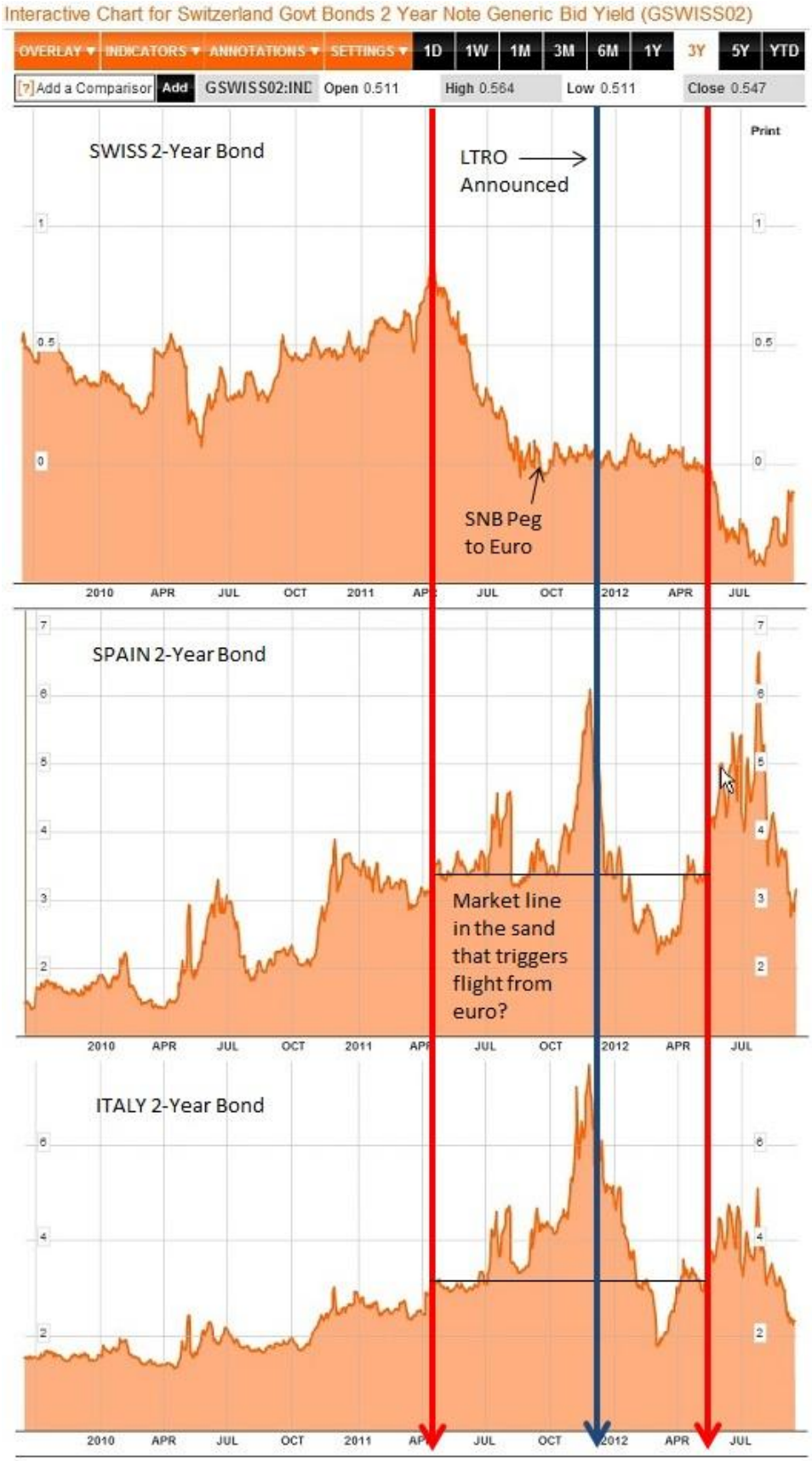
This is not the only divergence between bond prices and equity prices, but it does suggest that risk perceptions are not as "harmonized" as they once were, particularly in the decade plus since the asset bubbles and extraordinary interest rate regimes and unconventional monetary experiments. That suggests that equity prices arguably may have undergone a bit of paradigm shift with regard to discounting (or not discounting) default risks and macro considerations in favor of becoming more of a policy tool.

This potential imperviousness of credit markets to monetary manipulation beyond the stop-go nature of inflation expectations adds validation to the interpretation of weakening macro data and fears of re-recession in the United States. Stocks might be responding to central banks but little else is. There is little doubt that was a large consideration in the FOMC's September decision.

EUROPEAN CREDIT MARKETS

Despite constant intervention in European interbank and credit markets through SMP's and LTRO's, the ECB still has been unable to find a comprehensive liquidity solution that alleviates constant banking crisis. The ECB, like the Fed, has been unable to find a workaround or bypass to the "broken transmission mechanism" that would theoretically allow the central bank to offer a monetary element to the dramatic re-recession in Europe, particularly in the periphery. While the ECB first instituted its "sterilized" SMP plan in May 2010, like the Fed the ECB appears to be settling on the stop-go nature of previous interventions as a potential factor in appealing to a solution. Thus the promise of ongoing and unlimited bond purchases under the new SMP program.

(Continued Below)

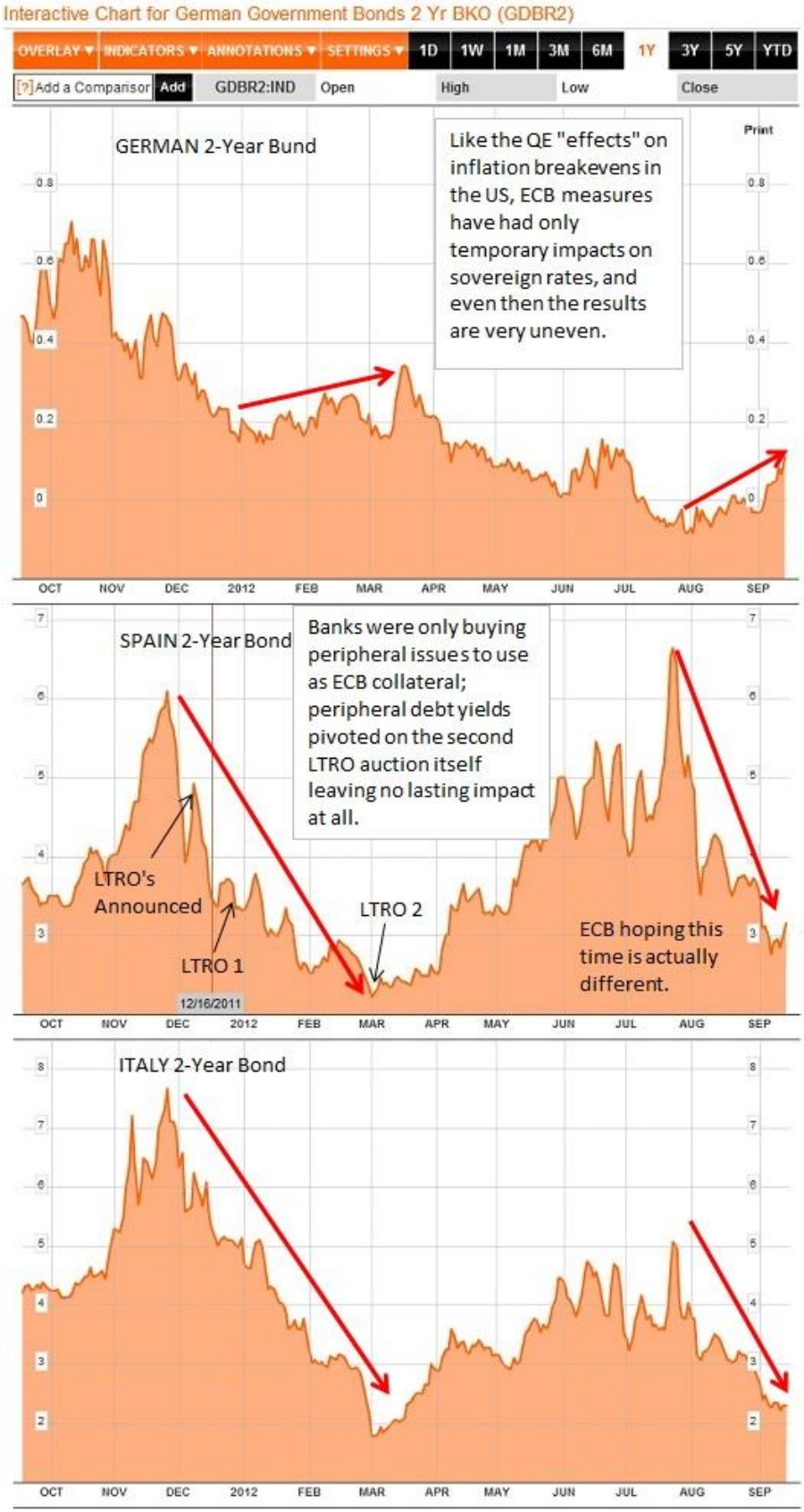


The primary problem in the European credit market has been, as much as the ECB will not admit as much, the common currency. Not only has the euro construction constrained the periphery's collective and individual abilities to alleviate entrenched economic imbalances, it offers another element of investor risk that the ECB has not anticipated.

Starting with the potential for Greece to exit the euro, peripheral countries have taken turns entering the "exit program" potential. In late 2011 as the European banking crisis turned serious, Italian and Spanish sovereign debt increasingly found little private sector appetite.

The ECB sought to address these concerns by supplementing the bank/central bank operational connections in the LTRO's. Promised extended liquidity provisions, banks in the peripheral countries bought peripheral sovereign debt solely to use as collateral for operational funding. Once the ECB operations ended selling pressures resumed in the various troubled sovereign markets.

As the Swiss 2-year exemplifies, the liquidity problem, and thus the sovereign debt problem, after April 2011 contained a very recognizable currency element. It wasn't the case that banks were hoarding money and not funding each other in the interbank markets so much as they were losing operational funding altogether as the various debt markets saw foreign



repatriation of euros. The primary destination of that euro disfavor was the Swiss franc. The simmering debt crisis in Europe had mutated into a general currency problem as faith in the euro has wavered over time.

Thus the LTRO's did very little toward diminishing actual liquidity conditions in Europe since it did nothing toward encouraging financial agents to hold euros. The Swiss National Bank was forced to intervene in September 2011 by pegging the franc to the euro, but, as the charts on the previous page show, the LTRO's had absolutely no impact on the flow of money out of the euro to Switzerland.

The failure of the LTRO's to engender a more lasting impact only added to the perceptions of currency risks in peripheral countries, particularly Spain. Retail depositors joined institutions in seeking other currencies and denominations as exchange risks did not abate as intended.

Seeking a means to bridge the divide between a potential reinstitution of national currencies, investors and financial agents have been willing to invest in other sovereigns at increasingly negative yields as a currency hedge. So much so that deposit flight in Spain in July seems to have broken the Swiss National Bank's ability to mitigate the inflow of money. The franc-euro peg had largely held the Swiss bond curve from plunging into the negative, but in mid-May 2012 the flow of money out of the euro and the desire to hedge potential currency shifts

changed the banking dynamic. Once the floodgates were opened banks in the periphery, having exhausted collateral options in the LTRO's (more on this below), had little alternative but to sell out sovereign bonds in their inventory. The spiral of debt sales due to diminishing liquidity eventually forced the ECB to first loosen collateral restrictions (along with the Bank of England) on June 22, followed by Mario Draghi's promise to save the currency at all costs. That eventually led to the latest version of the SMP.

In the bigger picture, however, the ECB is using bank liquidity to essentially offset deposit flight in the hope that liquidity will equate to reduced appetite for hedging currency risks. However, as we have seen throughout the two-plus years of continual crisis, none of this addresses the underlying sovereign problems – re-recession and government spending environments still geared to the conditions of the previous bubble period that no longer exist.

Clearly the ECB is betting that this time will be different and that SMP liquidity will have a more lasting impact than the LTRO's. There has been some noticeable movement in the "right" direction of various sovereign markets, but Target II imbalances continue to show deterioration in peripheral funding conditions (new record claims by the Bundesbank and liabilities at the Banco de Espana). Sovereign markets have retraced some of the panic moves of the summer, but remain elevated in the periphery despite all the promises; core and other denominated markets are still well-bid. It appears that bank liquidity does not fully substitute currency risks but can and does exhibit the same stop-go effects.

INTERBANK INDICATIONS

Bond purchases and liquidity measures have garnered nearly all the attention in each of the central bank measures announced recently. However, as has been the case since 2007, liquidity is far more dependent on collateral availability than direct liquidity injections. Nowhere is that more apparent than in Europe. The ECB has been loosening collateral restrictions since late June and have done so again in their most recent announcement of the SMP program.

The fact remains that unsecured funding markets have ceased to exist as a realistic means for operation funds. That is most apparent in the continued, though relatively minor, usage of dollar swaps between European banks, the ECB and the Federal Reserve Bank of New York.

As an example, troubled Spanish bank Bankia (now nationalized) appears to have exhausted financing options, forcing the Spanish government to auction €6 billion in bills and notes and then "inject" that cash into the FROB (Spain's mechanism for emergency bank funding). The FROB then "lent" cash to Bankia through a note operation that Bankia will then be able to use as its own collateral (only €4.5 billion after haircuts and covenants) with the ECB.

Beyond Bankia, there have also been anecdotal indications that various banks in Spain and elsewhere may be close to exhausting covered bond usage as ECB collateral. We have detailed some of this in other research notes, but in summary we have seen several large banks reduce or suspend the anticipated issuance of covered bonds due to the exhaustion of eligible credit assets.

UniCredit downsized a covered bond offering, while Santander and Societe Generale both canceled theirs.

Covered bonds have been an extremely important avenue for afflicted banks to "liquefy" their mortgage pools by carving out collateral that is readily acceptable. If banks in the periphery are finally coming up against the upper bound of covered bond issuance, that might explain much of the ECB's recent urgency (in addition to currency concerns and deposit flight).

Collateral conditions and European bank funding intersects global markets through London. As we saw so clearly in 2008, interbank conditions in London play an outsized role in asset prices and markets. Conventional wisdom still has not clearly defined the importance of collateral in the general funding conditions of the entire global system and the role collateral continues to play in the breakdown of global liquidity; and how that is centered in Europe.

The European banks continue to be an outsized presence in the global system, including the Eurodollar markets. That means that collateral problems and funding conditions for European banks will play a role in the transmission of liquidity shocks into the large system.

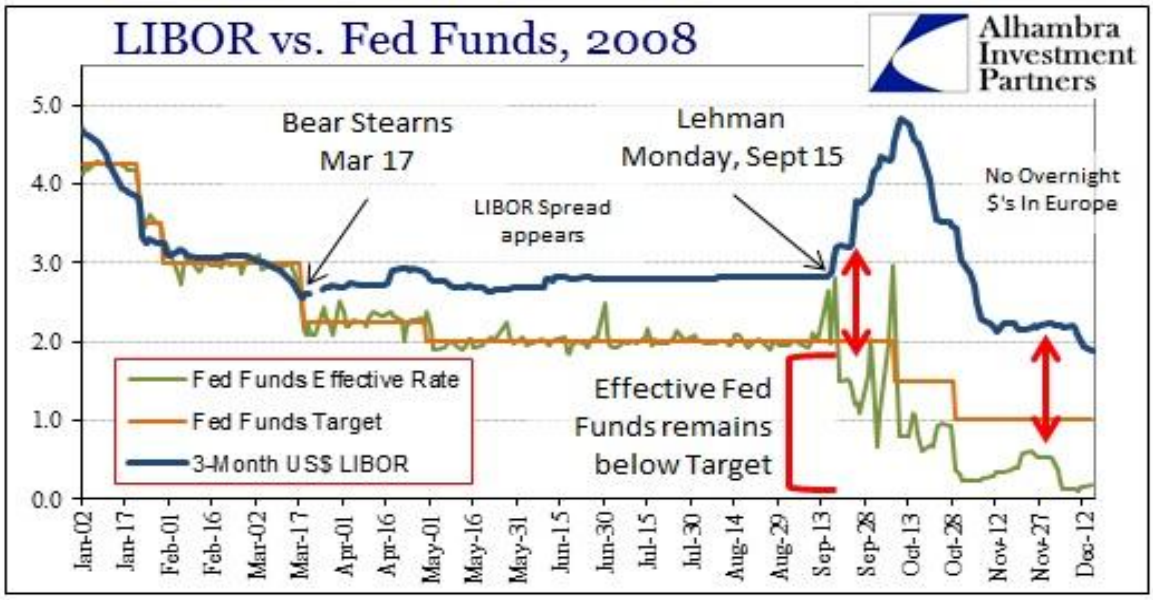
Starting in March 2008 after the failure of Bear Stearns, there appeared a premium for London-based overnight financing over the New York Fed funds equivalent. That indicated a slight stress in eurodollar financing over domestic conditions. Once Lehman Brothers failed on Monday, September 15, 2008, liquidity in London completely dried up, particularly in dollar terms. In contrast, outside of a few days where US$ in the US were hard to come by, the Fed funds effective rate fell far below the Fed target. That meant that dollars were largely plentiful in New York, but were unavailable at almost any cost in London. The 2008 panic was centered in London and European banks.

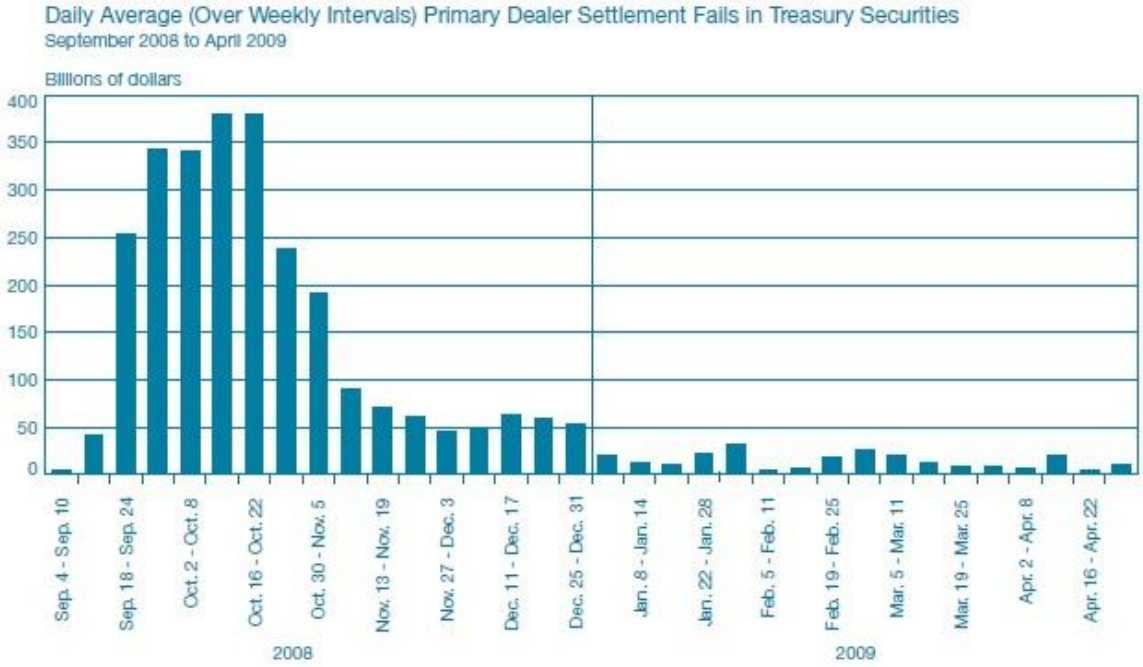
Perhaps more importantly, the collateral system of flowing dollars throughout the global banking conduits was largely inoperative because of the breakdown of US treasury collateral availability. In the scramble for liquidity after September 15, the inability of banks to finance through unsecured terms (LIBOR) led to a scramble for US treasury collateral, so much so that it led to a massive spike in repo failures. That meant the daisy chain of rehypothecation was completely imperiled as banks found themselves unable to maintain even minimal operational liquidity, and thus had to initiate margin calls and asset sales.

The US treasury responded by reopening several US treasury auctions to try to create new collateral but these efforts were largely ineffective because the auctions, counterintuitively, were unenthusiastically received by markets. In other words, utter chaos reigned in the system because no one had any real idea what to do under these constraints and it all traced back to the dual problem of collateral shortage and frozen unsecured wholesale money markets.

This becomes relevant to current conditions through the potential for the new ECB SMP to retain collateral and take it out of circulation. The ECB is making the conscious choice of propping up sovereign debt prices in exchange for collateral considerations, again, in the hope that bond price "stability" will lead to improving perceptions of currency risks. Given that collateral shortages have

continually been an unsolved problem lingering in the background of nearly every phase of this continual crisis, that just may be a tremendous gamble.





Source: Federal Reserve Bank of New York.

MONETARY POLICY NOTES

The big monetary event to note was the policy initiative and accompanying announcement following a 2 day Fed meeting on September 13th. The Fed extended its low (zero) interest rate policy into 2015 and established a quantitative easing program (QE3) where it will buy $40bln/month worth of agency and mortgage-backed bonds. Here are the important details from the accompanying Fed statement:

"To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee agreed today to increase policy accommodation by purchasing additional agency mortgage-backed securities at a pace of $40 billion per month. The Committee also will continue through the end of the year its program to extend the average maturity of its holdings of securities as announced in June, and it is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. These actions, which together will increase the Committee's holdings of longer-term securities by about $85 billion each month through the end of the year, should put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

The Committee will closely monitor incoming information on economic and financial developments in coming months. If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability. In determining the size, pace, and composition of its asset purchases, the Committee will, as always, take appropriate account of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. In particular, the Committee also decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015."

When dealing with a sound economic backdrop, Fed action can provide catalysts and headwinds. When dealing with an unbalanced or broken economy the Fed can buy time for the economy to heal. These Fed interventions, though, do not come without trade-offs. The consequences to intervention can be viewed as mis-pricings which lead to imbalances or mis-allocation of resources. For example, the construction boom did provide employment in the sector, but, alas, this was not sustainable, a result of mis-allocation of capital.

The Open Market Committee is obviously concerned about the state of growth in the economy. We take this to support our belief that the Fed is still worried about deflationary pressures stemming from the global contraction of credit. Bernanke is walking a fine line trying to balance these realities

with the fear of putting 1970's type inflationary pressures into the system. The Fed does not control the "real" economy; it is merely trying to support the troubled areas, too much credit in the system.
The following scenarios represent three possible paths for the economy. Without prior central bank support, the continuing crisis, a result of excess credit creation, would undoubtedly have been much more severe. But ironically, would likely have been shorter lived. The continued excessive support of the ailing economy masks the real risks; and, creates new ones as well.

- Deflation

The psychological interpretation of the Fed's move is that Ben Bernanke continues to fear deflation. A deflationary contraction would be negative for global asset prices and destroy capital already deployed at these higher price levels. In this scenario, we feel a bear market would emerge. This would be precipitated by the selling of assets in order to pay down calls on credit. Although the Fed policy lowers the likelihood of such a scenario, the day of reckoning (calls on credit) for excessive credit creation may come regardless.

- Muddle-Through

As the debt laden economy continues to experience below par performance, debts are being slowly paid down. At the same time, write-offs on bonds that aren't supported by current income are progressing. The Fed lends support. It buys time for this natural and potentially benign progression of deleveraging to occur. The economy slowly begins to improve. From the Fed's perspective, they not only prefer this scenario, but prefer for it to proceed at a higher price level. The scenario will likely include the transfer of assets from weaker to stronger entities. Any asset sale at a higher price level lowers the probability that debt write-offs occur. Fewer write-offs mean less loss of capital and less stress throughout the leveraged capital markets.

- Inflation

The Fed, today, thinks of new money creation as supportive of existing debt levels. But, the existing debt is large and the new money created in support has been large as well. The Fed, unfortunately, does not entirely control the path of these newly created, cheap funds. Some will flow to commodities such as oil; some will flow to the private sector in support of the subpar economy; some never leave the banking sector, which itself has been severely damaged by recent events. But, if and when the real economy picks up, it will demand funds from the banking world. The existence of so much newly created, cheap money is a stockpile of fuel that can cause the economy to rise and perhaps over-extend very quickly. In this scenario, the price of everything can rise very quickly. Prices can rise much faster than incomes and this can be very detrimental to sustainable growth. Additionally, new money flowing to just one area of the economy can be damaging as well. If the price of fuel and food rise, without income rising in kind, demand for other products will wane.
As our central bank struggles to find the right balance of policy to support but not overheat the economy, be aware of the latent pressure and potential consequences they have inserted into the equation. The Fed is large and powerful, but they are not necessarily working with precision instruments or reliable radar equipment. There will likely be negative consequences to their actions. Let's be aware of the possibilities and hope that the positive effects outweigh the negative.

EUROPE

EFA outperformance accelerated in August versus the S&P 500. It had made a tentative bottom in early June but the announcement of Draghi's bond buying plan was a catalyst for further gains. The plan is not a panacea by any means and we have doubts as to whether it will be effective in moving capital back to the periphery countries but it does indicate the ECB's commitment to saving the Euro project. With the German court having at least partially approved the ESM plan the next hurdle will be the negotiations over the banking union which we expect to take much longer than most market participants anticipate. European stocks in particular had become quite cheap so this short period of outperformance is not that surprising. Whether it can continue is another story however and we are not confident. As we've said in the past, Europe's problems are structural and cannot be solved by monetary policy. True recovery will only come when labor markets are liberalized and markets are given a more prominent role in the allocation of capital. That does not seem imminent.

Indeed the European economy appears to be accelerating to the downside. The Markit PMI for Europe came in at 46.3 for August down slightly from July's 46.5. The only country posting a PMI above 50 was again Ireland at 51.4. The German economy which has held up better than most in Europe is starting to feel the pinch. The inflow of capital from southern Europe has the potential to

create inflation while the export economy continues to contract. Certainly the capital inflow is creating distortions in the German economy and malinvestment to some degree seems a likely outcome. The ECB's efforts to redirect capital back to the periphery is as important for the future of the German economy as Spain and Italy.

In France, the mortgage lender Credit Immoblier de France, the country's second largest mortgage lender was bailed out. It wasn't a huge failure but it demonstrates that the debt issue in Europe is not contained in the periphery and is not a liquidity problem but one of solvency.

Another headwind for Europe is the recent strength of the Euro, particularly against the dollar.

It is amazing to see the Euro rising against anything with the future so uncertain and this may say more about the US dollar than it does about the appeal of the Euro. With the periphery in deflation a rising Euro is certainly not what is needed right now. The periphery economies are slowly rebalancing with current account deficits shrinking and export rising steadily if not spectacularly. A cheaper Euro is about the only thing that can accelerate the process since labor markets are inflexible.

EMERGING MARKETS

Emerging market stocks only recently joined the outperformance party:

That isn't surprising since to a large degree their future growth is a function of Chinese growth which seems to be less by the day. The resource economies such as Brazil have suffered as Chinese growth has stalled. China has announced additional stimulus spending for the next few years but they are still suffering from the hangover from their last stimulus binge. Export growth has obviously slowed due to Europe but imports actually contracted last month as well which is certainly no sign of growth. Even the official PMI for China is now under 50 and the Shanghai Composite continues to slide with no bounce in sight. Certainly China has the potential for more future growth and the changeover in leadership may have a positive long term impact if they shift to a more market oriented economy, but that is not something that is imminent.

Having said that, emerging market stocks may continue to outperform if QE3 has the same impact as its previous incarnations, which pushed capital into emerging markets, particularly in Asia. QE3 makes non dollar demoninated assets more attractive to the extent it weakens the dollar which is the most visible effect so far. Emerging market countries will try to offset the effects of the capital

inflow but past efforts have not been particularly effective. Hong Kong for instance, worried about a housing bubble, has tightened mortgage standards but that will just redirect the capital to another asset.

Brazil's economy has recently shown some signs of life with the government there much more aggressive than other countries in fighting a China related slowdown. Bank reserve requirements were recently lowered and the government also cut electricity rates. The recently announced stimulus package focuses on infrastructure ahead of the World Cup and Olympics. There have been some disappointments as well though, such as recent hike in import tariffs against a wide variety of goods. With the country still running a trade surplus this measure wasn't necessary and will likely just push prices higher.

Chile continues to weather the global slowdown better than almost any other country with growth looking close to 5% this year. The central bank has been on hold for 8 months and doesn't appear likely to make any moves absent a disruption to growth.

ASIA

In Asia, export dependent economies are slowing as China and Europe both slow. South Korea has cut rates recently and will likely cut again as growth estimates continue to fall and inflation hits a 12 year low. Retail sales are down 3 consecutive months. A stimulus package of $5.2 billion was recently unveiled with about half the package in the form of tax cuts. Exports were down over 7% in July and August. Singapore is also seeing a drop in exports with the most recent report showing a drop of 10.6% year over year. Exports to the EU dropped 28.7%. The central bank is expected to ease at the October meeting.

Despite all this bad news Asian stocks have generally performed pretty well and as stated above if QE3 forces capital into these countries as it has in the past, they are likely to continue outperforming the US market. In addition to the kick from QE3, most countries are actively easing monetary policy and many are enacting fiscal stimulus measures as well. Most of the Asian markets are reasonably priced with China the cheapest at around 7 times trailing earnings. Hong Kong also appears cheap at about 10 times.

Overall, foreign markets appear cheaper than the US but also face significant growth challenges. The onset of QE 3 increases the attractiveness of non US markets to the extent it weakens the dollar and encourages capital flows to ex-US markets. Emerging markets may be the better bet as the recent run up in European shares has likely run ahead of potential growth.

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