



**Strategas Research Partners, LLC**

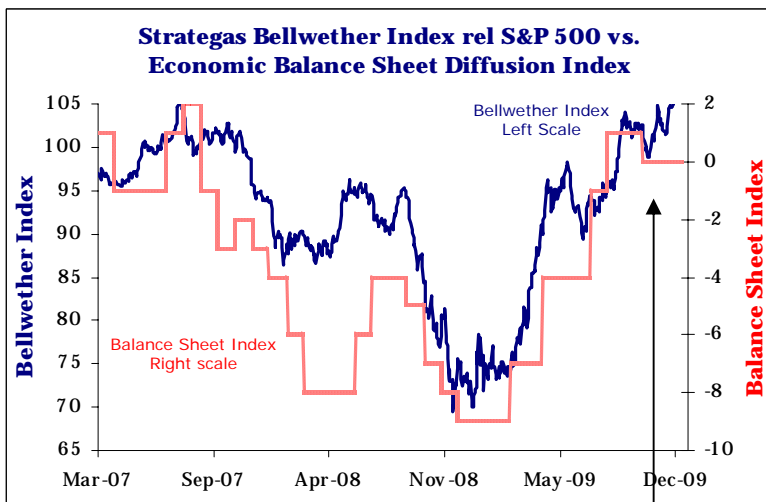
Don Rissmiller (212) 906-0134 drissmiller@strategasrp.com  
 Tiffany Smith (646) 292-7910 tsmith@strategasrp.com  
 Mary Catherine Sinclair (212) 897-6386 mcsinclair@strategasrp.com

## KEY ECONOMIC THEMES FOR 2010

- 1) Transition: Recession => Recovery => Expansion
- 2) Reflation (2009) => Goldilocks (2010-11) => Inflation (2012+)
- 3) Binding Constraints: Saving must equal Investment
- 4) Debt/GDP must go sideways as a definition of fiscal sustainability
- 5) Exit Strategies Matter: Fiscal, Monetary & Regulatory
- 6) China currency peg as the lynchpin in global imbalances

### 1) Recession => Recovery (we are here) => Expansion

The primary tension in the economic data, in our view, remains sorting out the cyclical and secular trends. While there remains a number of structural problems for the next expansion (still-elevated mortgage debt, demographics, etc), the bulk of the data are still pointing to a cyclical recovery as we start 2010. The rise in the U.S. mfg PMI to 55.9% in December (a new high), with strength in the new orders and employment components, reinforces this view.



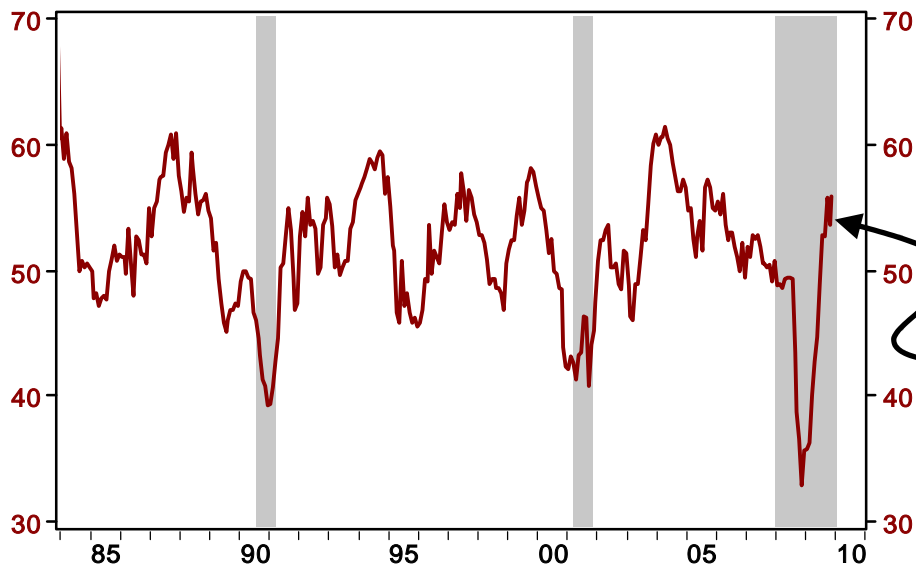
<b>STRATEGAS ECONOMIC BALANCE SHEET</b>		
<u>Assets</u>	<u>Neutral</u>	<u>Liabilities</u>
Interest Rate Env	Price Inflation	Nonres Constr
Manuf'ing	Wage Inflation	Budget Deficit
Capex Eqp	Housing	Trade Deficit
	Consumer Conf.	
	Business Conf.	
	Cons. Spend	
	Employment	
	Credit Environ	

The market appears to be anticipating continued improvements in the economic data – which, as we see it, is essentially a bet on employment and capital spending. We feel this is an appropriate bet at this stage of the business cycle.

## DECEMBER MFG PMI BOUNCE CONTINUES PACKAGE OF STRONGER CYCLICAL DATA

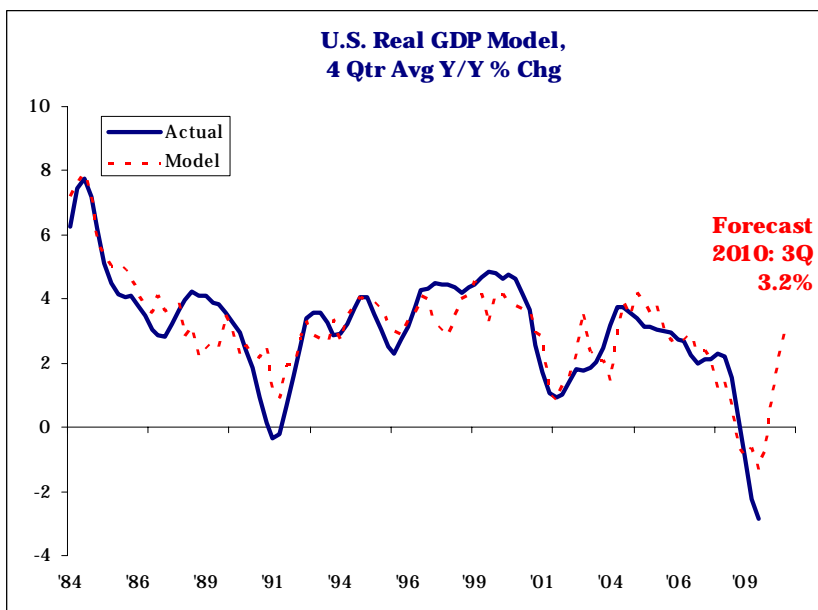
ISM Manufacturing: PMI Composite Index

SA, 50+ = Increasing



While construction spending dipped -0.6% m/m in November, the mfg PMI made a new high in December, indicating that the cyclical bounce appears intact as we begin 2010.

## REAL GDP MODEL POINTING TO CONTINUED RECOVERY, EVEN IF PROBLEMS REMAIN FOR THE NEXT EXPANSION.



Strategas' model of GDP, based on price shocks, labor's share of income, consumer asset growth, debt service burdens, and M2 is pointing to a significant rebound to roughly 3% real GDP as we move through 2010.

Model Equation:  $GDP\ Y/Y = 1.6 - 0.4 \times [CPI - GDP\ Deflator\ Y/Y] - 0.3 \times [Corp\ Compensation - Corp\ GDP\ Y/Y] + 0.1 \times Consumer\ Assets\ Y/Y - 1.3 \times Debt\ Service\ Obligations + 0.2 \times Real\ M2\ Y/Y$ .  
All right-hand side variables are lagged 4 quarters, estimated 1984-2009 with an R<sup>2</sup> of 75%.

## Recession => Recovery => Expansion

### Reflation (2009) => Goldilocks (2010-11) => Inflation (2012+)

With the change in Administration in the U.S., our description of 2009 is that – starting in earnest in March – the government plan became one that switched from programs that were aimed at fixing the problems in the economy (TARP, etc) to plans that were aimed at putting floors in key sectors such as Financials, the Consumer, and Housing. Each problem was addressed by a different government agency, **but the strategy was similar: if the problem was too big to solve quickly, at least we could fail slowly, ie, kick the can down the road, and allow the business cycle to play out near-term.** Making the transition from *recession* to *recovery* was, after all, easier than jumping from recession immediately to *expansion*.

In 2009, FASB offered discretion on mark-to-market accounting, and having bought time, the FDIC began to take banks over in an orderly fashion. The Treasury sent checks to consumers, so any quick adjustment in saving & spending behavior was checked. The housing imbalance was a harder issue to address, given the magnitude of the problem, but the agency with the most money (the Fed) bought \$1 trillion of mortgage securities, which in conjunction with the homebuyer tax credit and foreclosure relief has caused home sales, and even more importantly home prices, to go sideways.

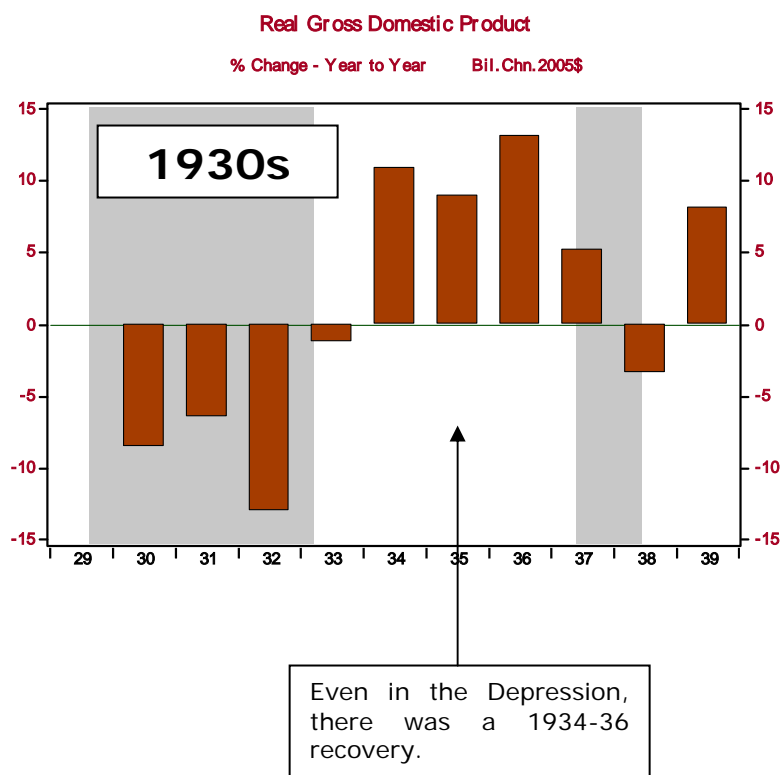
With this kick-the-can strategy, however, investors now appear to be fearing new bubbles in the global economy. This is especially relevant since this same government strategy is likely to be applied to any future problems – there are still large problems that we may attempt to stabilize, rather than fix: nonresidential construction, developed economy budget deficits, etc.

However, while this government strategy causes long-term structural problems to persist, a good amount of control is gained over the economy near-term. To be sure, exit strategies will likely be the key story for 2010. Starting with the State of the Union address, Strategas' Washington team expects the Administration to intensify the rhetoric about bringing deficits down (though additional “jobs-based” stimulus is still likely). The Fed also has tested new tools such as reverse repos, and has discussed paying interest on reserves and other novel ideas (eg, selling bonds) as ways to manage the excess reserves it has created. As we've written previously, **the government plans still appear to be aimed at inflating balloons (that can be deflated slowly), not bubbles (which have to pop).**

These plans may ultimately prove ineffective, or may be insufficient. But if there is a policy mistake as we start the 2010s, the intent appears to be to fail in slow motion. **A grudging, government-led Goldilocks 2.0 environment, characterized by decent real GDP growth, yet restrained nominal GDP, could persist for several years as the economic recovery takes shape.** There will likely be an enormous amount of overhang still present on the next economic *expansion*, but the cyclical *recovery* is step one.

The easiest way out is probably a slow loss of wealth through inflation, versus a sharp adjustment. Debt payments and entitlements, for instance, guarantee a certain string of dollar payments – they don't guarantee what those dollars buy. We're likely to choose the problem we've seen before (Inflation), vs. Deflation (which is hard to fix) or Goldilocks (which is unlikely to last long-term). It's hard to see policymakers executing a perfect exit strategy, and the temptation will be to keep policy too easy for too long.

## EVEN IN THE 1930's, WHEN THE GOVT SPENT MONEY IT "WORKED"

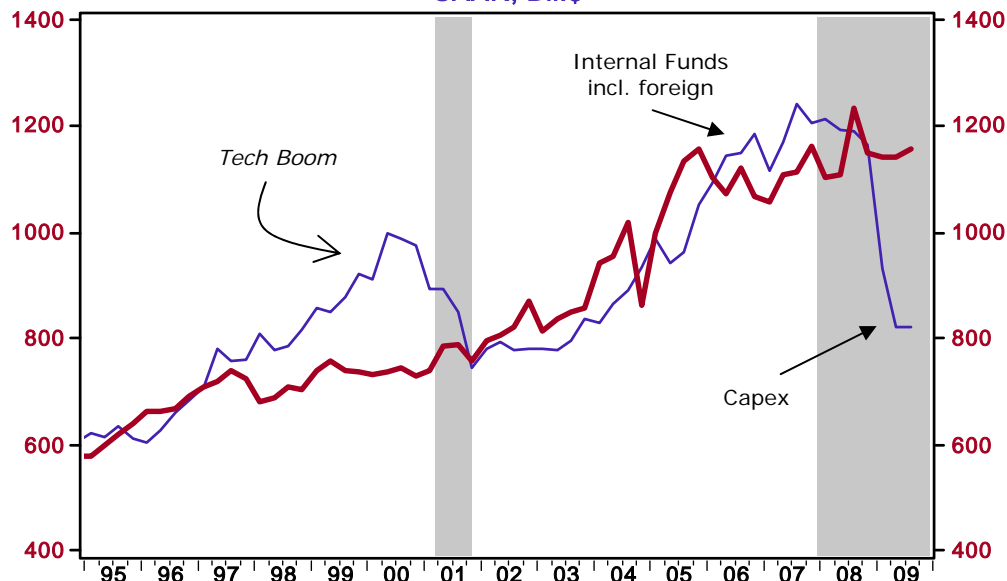


Construction and housing in the U.S. may indeed be forming an "L", but that's better than recent performance (with a lot of government help), and there are still lagging sectors (eg, nonresidential construction). But there are sectors which are seeing legitimate "V" shaped bounces – manufacturing is key among them. Additional government stimulus in 2010 (2/3 of the stimulus already authorized has yet to be spent) offers a tailwind to start the year.

## PLENTY OF CORPORATE SAVING (PROFITS) AS FUEL NOW. LIKELY A STRONG 2010 CAPEX EQP STORY.

Nonfin. Corporate Business: Total Internal Funds + IVA  
SAAR, Bil.\$

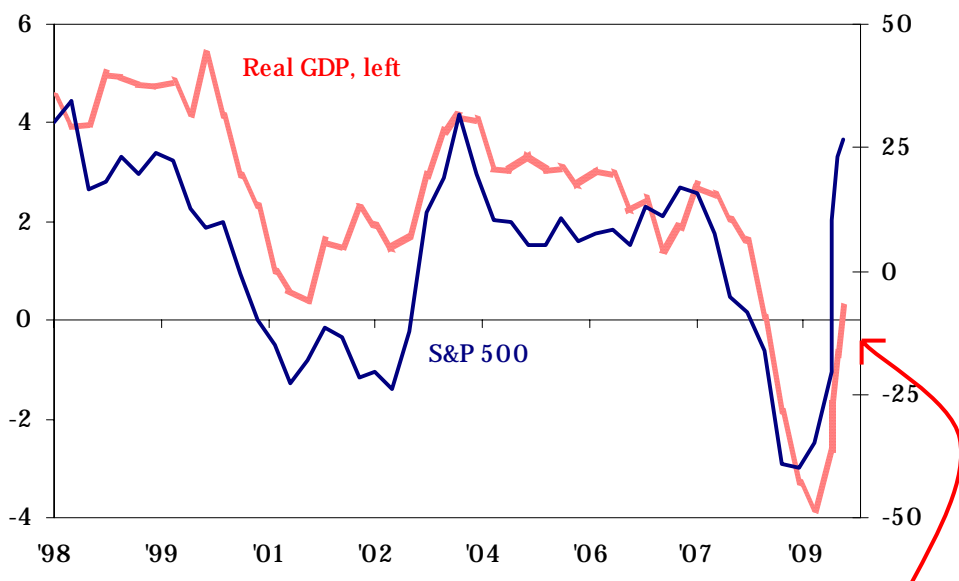
Nonfinancial Corporate Business: Capital Expenditures  
SAAR, Bil.\$



In addition to govt stimulus, nonfinancial corporations appear to have a substantial ability to spend – corporate cash flows have fallen slightly, but capex has been cut much more dramatically. The story in the late 1990s was the large “financing gap” as there was a tech capex boom – we’re now in the reverse situation!

## WITH EXPECTATIONS RISING, EMPLOYMENT NEEDS TO IMPROVE (WE THINK THAT’S A GOOD CYCLICAL BET NOW) ..

Real GDP vs. S&P 500  
(Y/Y Pct Chg)



The rise in consumer expectations has paralleled the rise in the stock market since 1Q of 2009. Both now appear dependent on the economy following through: reflation in assets now has to turn into income for the economy. We continue to believe this is a good cyclical bet in 2010, as the labor market bottoms.

**EMPLOYMENT = INCOME = SPENDING = 71% OF U.S. GDP**

An Inventory Bounce Is the Story Short-Term,  
 But Then the Consumer & Capex Need to Kick In.

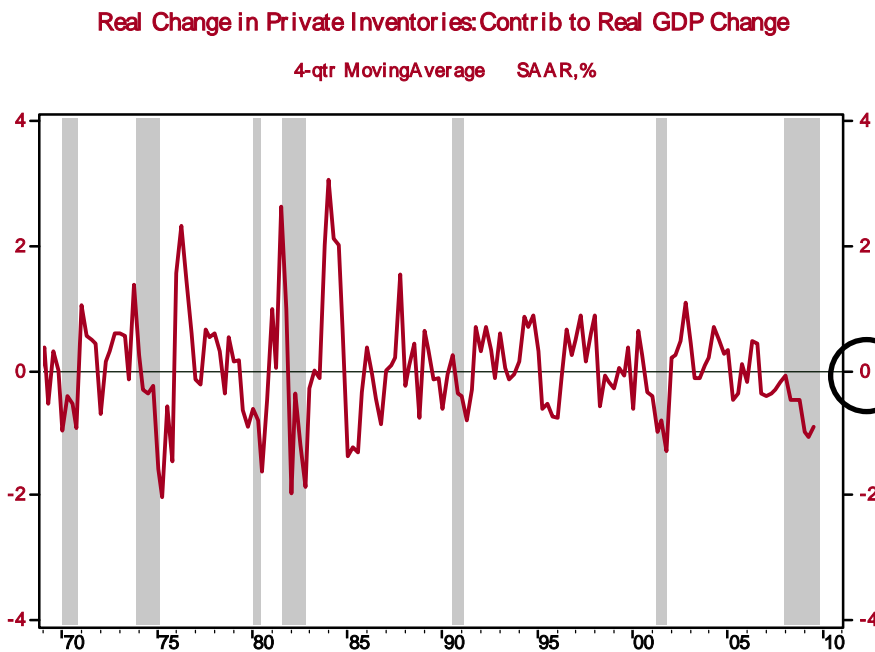
(Corporations now need to spend *their* saving on Jobs and Equipment).

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009 e</u>	<u>2010 e</u>	<u>2011 e</u>
<b>REAL GDP 4q/4q %</b>	<b>2.5</b>	<b>2.5</b>	<b>-1.8</b>	<b>-0.3</b>	<b>2.9</b>	<b>3.7</b>
<b><u>Contributions</u></b>						
Consumer Spending	2.3	1.4	-1.2	0.9	2.0	3.0
Capex Eqp	0.5	0.3	-0.8	-0.8	0.8	1.3
Nonres Constr	0.4	0.6	0.1	-1.0	-0.5	-0.5
Housing	-1.0	-1.0	-0.8	-0.3	0.3	0.4
Inventories	-0.4	-0.2	-0.5	-0.3	0.6	0.0
Trade	0.4	1.0	0.8	0.7	-0.8	-0.5
Govt	0.3	0.5	0.6	0.5	0.5	0.0



Inventory Bounce in the GDP Math: GDP is a Flow (like Income),  
 Not a Stock (like Wealth).

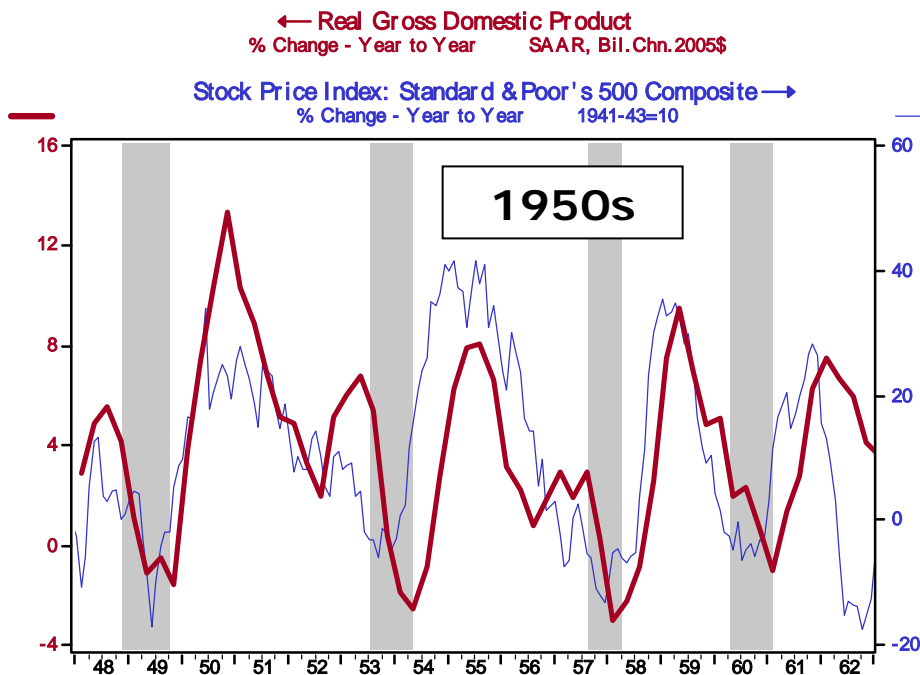
**GDP = FINAL SALES + (CHANGE IN INVENTORIES)**



Bottom line, real GDP Growth depends on the “Change in the Change” in Inventories short-term.

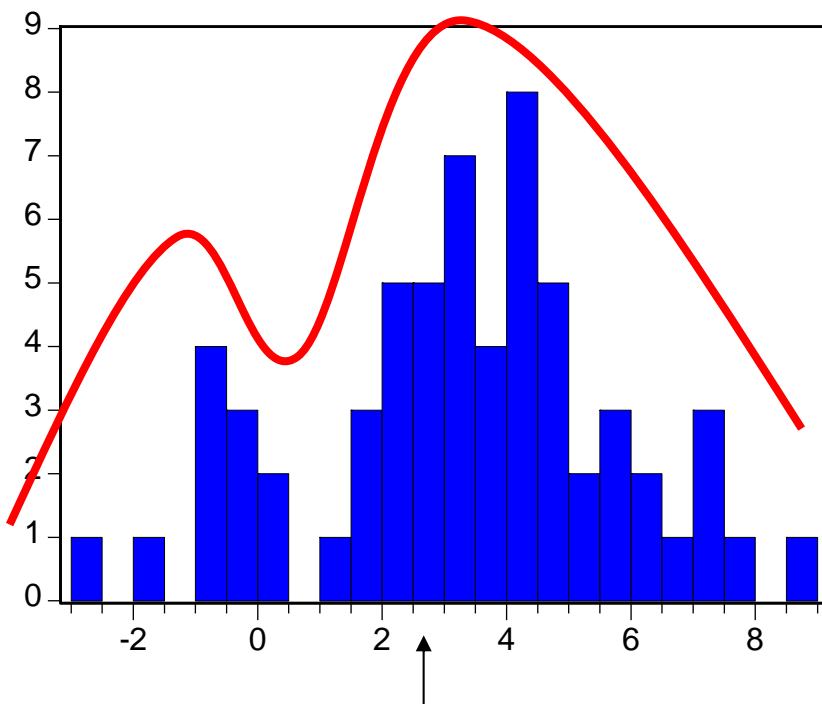
Sharp spikes around recessions, but generally trends around zero. Not a driver of growth alone long-term.

## DEVELOPING QUESTION GOING FORWARD IS PROBABLY WHETHER WE WILL NOW SEE “SHORT” U.S. EXPANSIONS (LIKE THE 1950s).



Since we are seeing a cyclical recovery, the developing question going forward will likely turn from *recession* to *recovery* to *expansion*. There are historical periods in which recessions were much more common (eg, the 1950s). Our concern is that if we see a slower trend growth rate in the U.S. economy, we will be perpetually closer to the recession condition of negative growth.

U.S. Real GDP Growth Y/Y % 1947-2009



Historically, the U.S. economy has tended to either be expanding around potential growth (3%), or in a recession (-1%). **A “flat” economy has generally been unstable.** If potential growth in the next expansion will be slower (as we believe), we will be starting out closer to the “flat” economy – it may therefore be harder for economic growth to slow without tipping into recession (“mid-cycle slowdowns” could become more rare).

↑  
*Slower trend growth would push this “hump” in the distribution to the left in the next expansion.*

**REFLATION (2009) => GOLDDILOCKS (2010-11) => INFLATION (2012+)**

## WHAT'S THE WAY OUT? GOLD AND GOLDDILOCKS 2.0

While recent Fed speak and economic data appear to have reinforced investors' intent to simultaneously 1) do the reflation trade (helping stocks and commodities) and 2) do the carry trade (helping bonds), we continue to find it hard to believe that commodities, bonds, and stocks can all be giving correct signals on underlying economic fundamentals. Precious metals (eg, gold) should work when there's significant uncertainty about inflation/deflation (eg, the policy mistakes in the 1930s and the 1970s) – this variance in inflation would likely be bad for stock market *multiples*.

Bonds would work if we were looking at a deflationary bust – but then corporate *earnings* would suffer. **Given that stock prices are a function of earnings (E) and multiples (P/E), there appears to be a considerable contradiction developing that could assert itself as the liquidity driving the market fades.**

Given that governments around the world (U.S., China) appear to be intent on providing economic support short-term, however, investors are likely **pursuing a “barbell” strategy of buying both those assets that would work if there's a policy mistake (eg, gold) as well as the “stick-the-landing” plays – ie, Goldilocks 2.0.** Investors are unwilling to fight the Fed, the federal government, and the China currency peg, but they are also unwilling to go without some insurance against policy-gone-awry.

The key, then, remains to watch for signs that the “kick the can down the road” policy is coming to an end – Strategas' Strategy Team has listed 7 inflection points worth monitoring to know when the bill is indeed coming due. Currently, it's worth noting that none of these items are flashing red lights.

### **We're Bullish Until... (Bearish Inflection Points Worth Monitoring)**

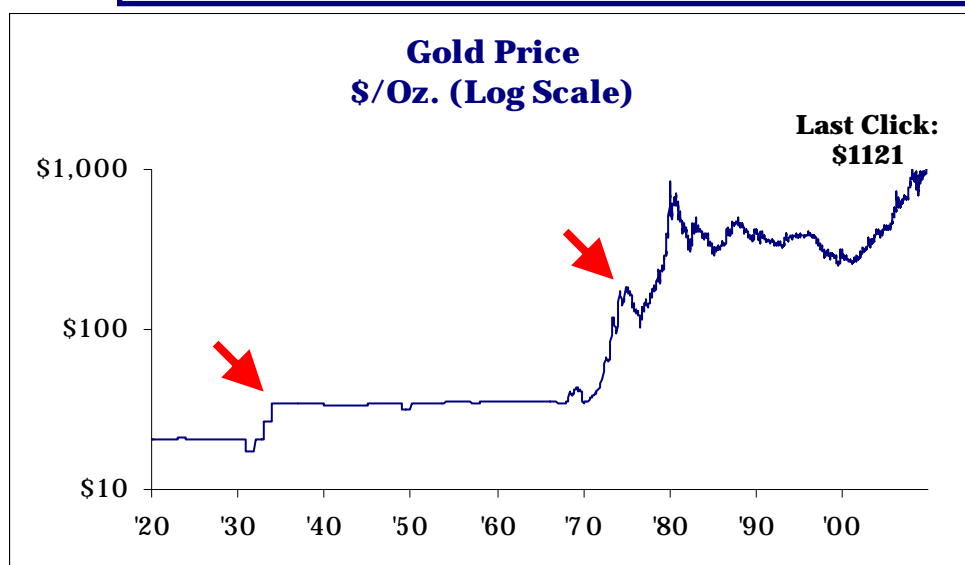
1. A poorly subscribed Treasury auction signals reduced appetite for U.S. debt.
2. 10-year yields break out above long-term down-trend.
3. Increased anxiety over significant tax increases to close the structural deficit gap takes hold.
4. Holiday sales come in below expectations with income under pressure as government transfers fade.
5. Commodity price inflation prompts China to slow economic growth (again).
6. Mortgage rates push above 6.0% in 2010.
7. Signs of protectionism creep into global policy.

## GOLD AND GOLDBLOCKS 2.0 Contd

**Policy is too Cold** (eg, 1937) – Gold works, Bonds work

**Policy is too Hot** (“Blowoff Top”) – Gold works, Stocks work

**Policy is Just Right** – Goldilocks; Stocks & Bonds work



Investors appear to be looking for trades that can hedge against a wide variety of outcomes, and gold in particular “worked” in both the 1930s and 1970s – ie, it functioned as a hedge against the variance in inflation generally.

### THE “STICK THE LANDING” SCENARIO IS PROBABLY UNREALISTIC LONG-TERM

Consider the sequence of events that would be necessary to see “Goldilocks” trades work out:

- 1) Real GDP has to rebound enough to validate expectations of a sustainable recovery, but not so much that we get a “V”-shaped recovery and a quick peak in the unemployment rate.
- 2) Nominal GDP has to rebound enough to keep marginal companies in business, but not so much that interest rates rise.
- 3) The dollar has to continue to decline, but not so much that there’s a loss of faith in the reserve currency.
- 4) Commodity pressures continue upward, but not so much that energy prices push the economy back into recession.
- 5) The budget deficit concerns have to fade, but without tax increases or spending cuts large enough to injure the nascent economic recovery.

## REFLATION (2009) => GOLDBLOCKS (2010-11) => INFLATION (2012+)

Eventually, we need both monetary and fiscal policy to normalize, especially as growth appears to be picking up in a synchronized fashion around the globe. The end game is that interest rates, taxes, and spending need to be set so that Saving and Investment balance.

### THE FUNDING OF U.S. INVESTMENT (Bil \$ SAAR)

	<u>2008:2Q</u>	<u>2008:3Q</u>	<u>2008:4Q</u>	<u>2009:1Q</u>	<u>2009:2Q</u>	<u>2009:3Q</u>	<u>Future?</u>
Personal Saving	374.4	235.7	409.2	403.1	595.7	495.0	600
Undistributed Corp Profits	392.6	473.2	230.5	294.2	364.5	488.0	400
Government Saving	-822.5	-724.8	-730.2	-1005.7	-1293.5	-1342.0	-1000
Foreign Saving	756.4	725.5	625.1	412.6	392.5	428.4	800
Statistical discrepancy	126.7	68.3	139.4	185.4	161.7	163.2	0
Net domestic investment	824.6	789.6	650.0	306.7	218.0	229.7	800

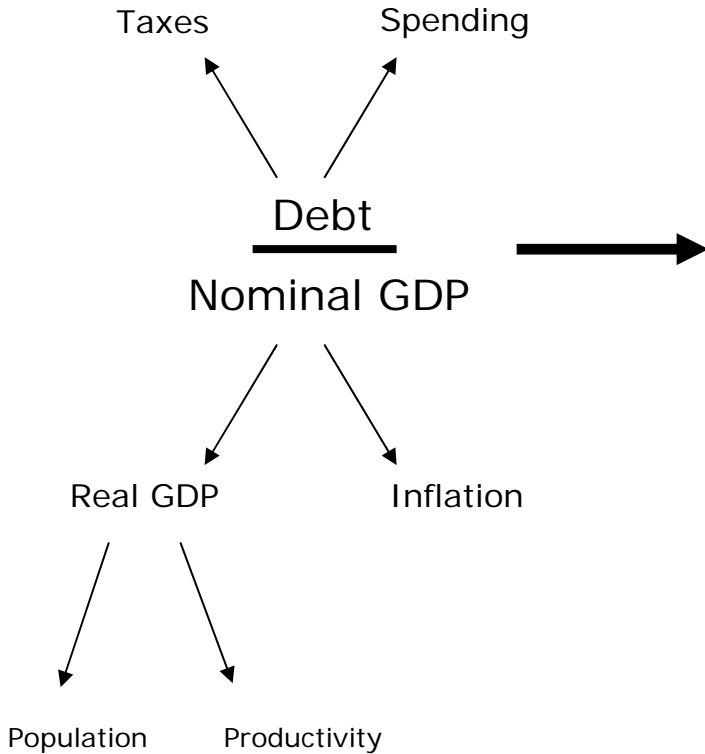
Source: Bureau of Economic Analysis

Government support – which helps push the structural economic problems out of recovery and into expansion, and stabilize the economy near-term – can last until we encounter a problem with deficits (ie, problems with govt funding). Investment has to be funded by 1 of 4 sources: 1) personal saving, 2) corporate saving, 3) government saving, or 4) foreign saving. With investment weak, there's room for government *dis*-saving to help solve the problem now (but not indefinitely).

As the U.S. approaches a debt-to-GDP ratio of 100%, we have the following choices:

- **Increase taxes:** politically hard to do, but probably an end-game.
- **Cut spending:** again politically hard to do (as the state examples of CA and NJ demonstrate).
- **Bank on faster trend growth:** this would require either faster workforce growth (eg, changing immigration policy), or a productivity gain (technology bailing out the economy).
- **Inflate out of the problem:** “Sherlock Holmes” logic: when all other options have been eliminated, the one that remains (however improbable) is the answer.

## U.S. DEBT/GDP MUST GO SIDeways AS A DEFINITION OF FISCAL SUSTAINABILITY



This ratio needs to go sideways long-term as a definition of fiscal sustainability (otherwise, interest costs would eventually consumer the entire federal budget). We continue to believe that we are setting up for a transition from reflation (2009) to “goldilocks” (2010-11, as we force a real GDP bounce in a restrained nominal GDP environment) to eventual inflation (2012+).

Taking a simple look at the U.S. debt situation, any interest rate much above 7% reaches the 100% of GDP “danger” level pretty quickly, and anything above a 4% interest rate eventually trends in that direction. **Basically, we cannot pay more in interest than trend nominal growth** – which we’re still pegging at roughly 2% real GDP and 2% inflation – for an extended period of time. There is certainly a role for borrowing, and when the government is the only sector with access to funds, there is a large role for intervention to help address problems in the markets. But it’s hard to call ever increasing debt a long-run solution to fiscal problems, as the Japan experience of the last decade has demonstrated. **Of course, if inflation rises longer-term, then the trend nominal GDP (PY) growth rate will be higher – this is likely to prove awfully tempting for policymakers as a “way out”.**

## EVEN IF THE FED IS LATE, COULD STILL TIGHTEN MORE CREATIVELY THAN THE CONSENSUS EXPECTS IN 2010

- 5 THINGS TO WATCH FOR: 1) PAYING INTEREST ON RESERVES,  
2) REVERSE REPOS, 3) TREASURY SELLING BILLS, 4) FED TERM DEPOSITS,  
5) OPEN-MARKET SELLING OF SECURITIES

“Even if our balance sheet stays large for a while, we have two broad means of tightening monetary policy at the appropriate time: **paying interest on reserves and taking various actions that reduce the stock of reserves**. We could use either of these approaches alone; however, to ensure effectiveness, we would likely use both in combination ... Considerable international experience suggests that paying interest on reserves effectively manages short-term market rates. ...

The problem can [also] be addressed by supplementing payment of interest on reserves with steps to reduce reserves and drain excess liquidity – the second means of tightening monetary policy. Here are four options for doing this.

First, the Federal Reserve could drain bank reserves and reduce the excess liquidity at other institutions by arranging **large-scale reverse repurchase agreements**.

Second the **Treasury could sell bills and deposit the proceeds with the Federal Reserve**...

Third ... we can offer **term deposits to banks**...

Fourth, if necessary, the Fed could reduce reserves by **selling a portion of its holdings of long-term securities into the open market**.”

*Fed Chairman Bernanke, WSJ Op-Ed, 7/21/2009*

**At a very basic level, what we can be certain about is that the Fed will have to be creative with policy as the fed funds rate rises (we believe in 2010), just as they were creative with policy on the way down.** There remains a large asymmetry between Fed easing and tightening – with Fed tightening requiring much more time to prepare the market (easing is like the “cold water”, you turn it on quickly. Tightening is like the “hot water”, you turn it on slowly). In this light, what we are seeing are the early steps in an extended articulation of what will be the Fed’s eventual exit strategy. While the fiscal exit strategy appears aimed at avoiding 1937 and “kicking the can down the road”, monetary policymakers appear set to attempt a creative exit – we still view Chairman Bernanke’s July WSJ editorial as the game-plan for an eventual exit.

# CAN HAVE EITHER A CURRENCY PEG OR A MONETARY POLICY: CHINA IMPORTING EASY FED MONETARY POLICY

