

January 14, 2011

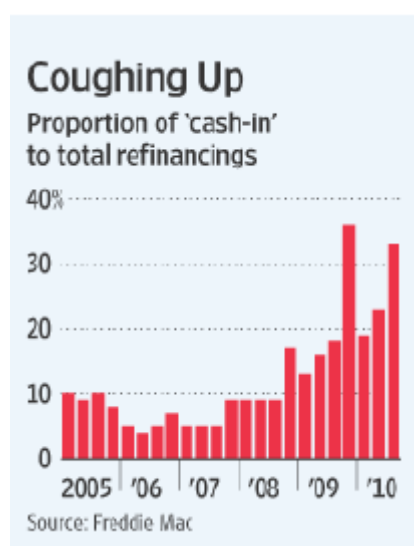
“The aggressiveness of our accommodative policy may soon backfire on us if we don’t begin to gradually reverse course.”

- Philadelphia Fed President, CHARLES PROSSER, referring to the Federal Reserve’s government bond buying program.

POINTS TO PONDER

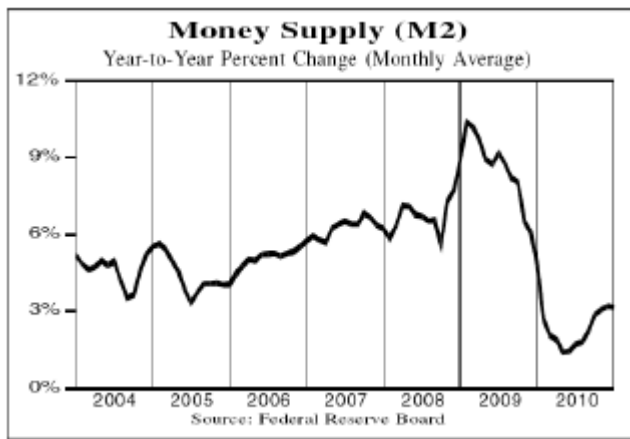
1. A few years ago, the US economy was artificially stimulated by hundreds of billions of home equity withdrawals, the infamous “house as ATM” phenomenon. Indicating how radically consumer behavior has changed, roughly one-third of current refinancings are so-called “cash-in refi’s” where mortgage balances are actually reduced.

2. Credit Suisse strategist Doug Cliggott has observed that in each of the last two quarters of 2010 stocks gained 10%. To demonstrate how remarkable this is, only 16 quarters in the last 30 years have registered double-digit increases.



3. A recent article in *The Economist* cited another chink in the once sacred efficient market hypothesis. It discussed numerous studies showing a “momentum effect” where the strongest stocks of the past year collectively outperform in the next 12 months. Three to five years out, however, this phenomenon tends to dramatically invert.

4. Numerous past EVAs have focused on the collapse of money velocity in the US. In addition to this, the money supply itself remains extremely subdued. Both of these vital factors argue against any meaningful inflation acceleration.



5. Another recurring *EVA* theme has been the understating of the US savings rate, and the same questionable accounting may apply to our trade deficit. According to a recent *Wall Street Journal* article, balance of trade number-crunching assumes that a good's entire value is attributable to the final exporting country, even if it provides nominal content.

6. Illustrating this distortion, although Apple's iPhone is shipped from China, just \$6.50 of its \$179 wholesale price is sourced there. The iPhone alone supposedly contributed \$2 billion to the 2009 US trade shortfall with China notwithstanding that, based on the actual cost of assembly, the addition to the bilateral deficit was just \$73 million.

7. The cumulative inflation increase since January 2007 in developing countries versus Europe and the US is already sizable. In addition to threatening the global recovery, the 6% drops early this year in Indian and Indonesian stocks are being attributed to inflation pressures.

Consumer price indices
% change since Jan 2007



* Federal Reserve Bank of Cleveland

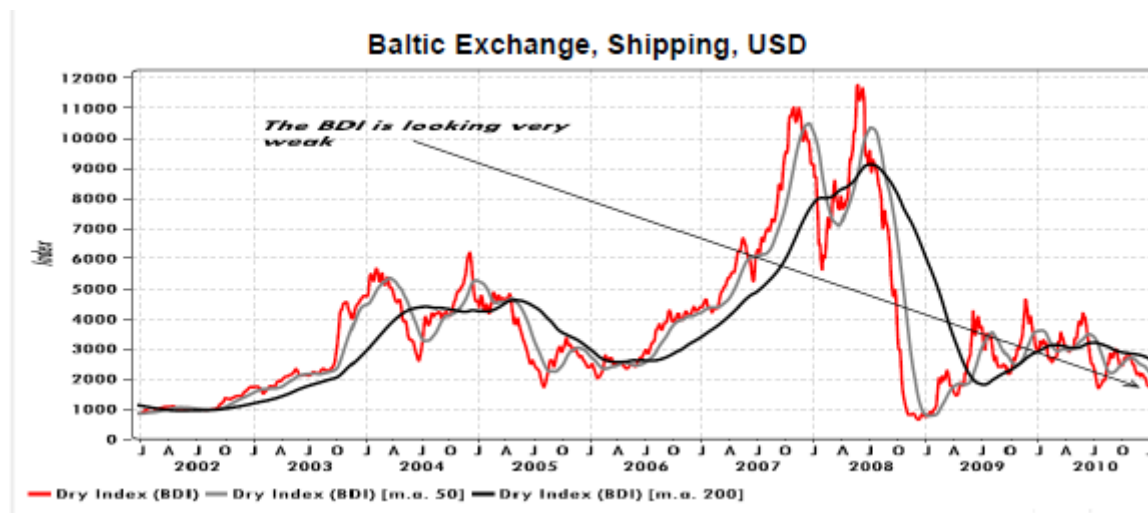
Source: Thomson Reuters Datastream

8. An epic event occurred last week when the cost of insuring against government bond defaults in Western Europe exceeded that of buying protection on sovereign debt from Eastern Europe, Africa, and the Middle East.

9. California's share of the nation's population soared from 2.5% in 1910 to 12% by 1990. Yet,

possibly due to its notoriously high tax structure, over the last two decades its population actually shrank, with two million Californians leaving the Golden State.

10. One of the odder developments of the recent commodity price surge has been the pronounced drop-off in the Baltic Dry Index. This measure tracks shipping costs and activity for most bulk goods and it is generally closely correlated with commodity prices.



11. The Japanese yen remains almost inexplicably near an all-time high versus the US dollar despite Japan's continued pursuit of fiscal policies that recently prompted the *Wall Street Journal* to refer to it as the Italy of Asia. Its fiscal 2011 budget projects that debt service costs will consume over 50% of all tax revenue even with very low interest rates.

12. After initial euphoria over the recent ADP payroll survey, a definite letdown occurred last week when the government's official unemployment report showed the addition of just 100,000 new jobs versus expectations of 150,000. However, October and November hirings were revised up by a combined 70,000.

13. *The Economist* recently noted that China is dealing with a situation that could be known as "profitless prosperity." Despite revenue growth approaching 40% over the prior year, profit margins continue to contract. This is the antithesis of the situation seen in the US where top-line growth has been modest but profits have soared.



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