The Economy as 2012 Begins

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Conditions in 2012

- Debt/Banking Crisis in Europe continues
  -Expect more sovereign and bank downgrades.
  - Greece will default and eurozone will be restructured.
  - Massive bank bailout will be needed.
- Debt Crisis in Japan - $3 trillion rollover needed.
- Real Estate Crisis in China – prices and number of sales collapsing.
- U.S. – Election Year impacts events.
- More "money printing" will be done to handle all of these problems.

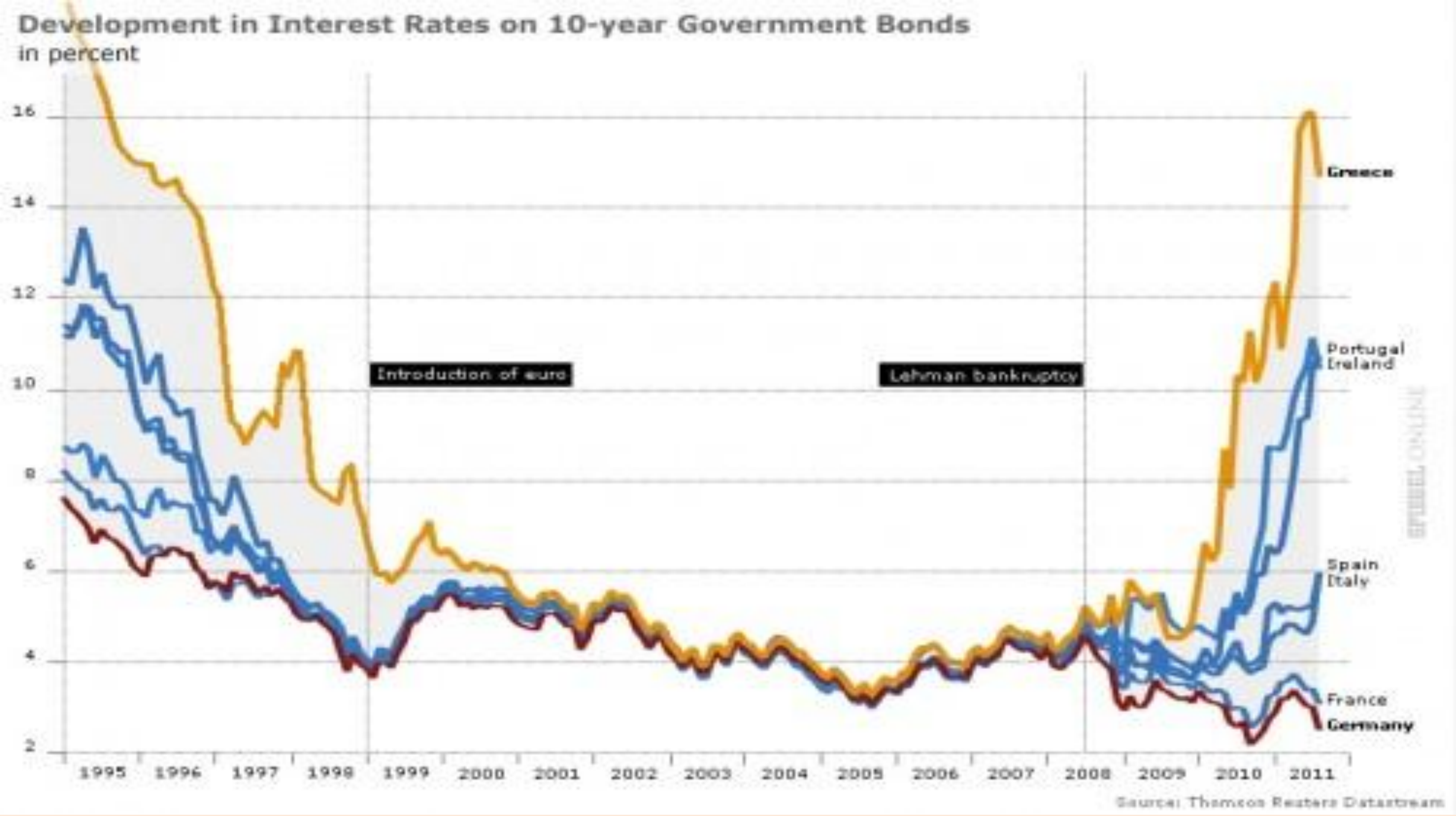
Current Conditions in EU

- Greece, Portugal and Hungary have junk ratings.
- LTRO – long-term lending to banks
  - banks borrow from ECB, buy sovereign debt of PIIGS, make money on spread.
  - can keep lower % assets for capital.
  - this is money printing
- EFSF (bailout fund) accused of buying its own bonds at auction on Nov 7th ; auction failed in Germany on 11/23, market demand for EU governments has remained low.

Current Conditions Overseas

- Greek 1-Year bond yields at 373%, 10-year yields around 35%.
- Greece and Italy now run by technocrats in transitional governments (elections in spring).
- 10 Year Yields: Italy 7.13%, Spain 5.71%, Portugal 13.25%, Ireland 8.13% (over 6% is dangerous)
- EU and Japan \$ cash starved (\$ swap facility started by Fed on Dec 5th).
- ECB interest rates 1.0%, UK engaging in QE2.

History of EU Country Borrowing Rates



Greek One-Year Bond Yields

Red arrow when last rescue plan announced.

Greek 10-Year Bond Yields

Red arrows are when rescue plans were announced.

Portuguese 10-Year Bond Yields

Red arrow when ECB started buying Portuguese bonds.

Italian 10-Year Bond Yields

Red arrow ECB/EU actions to drive yields down.

Spanish10-Year Bond Yields

Red arrow when ECB started buying Spanish bonds.

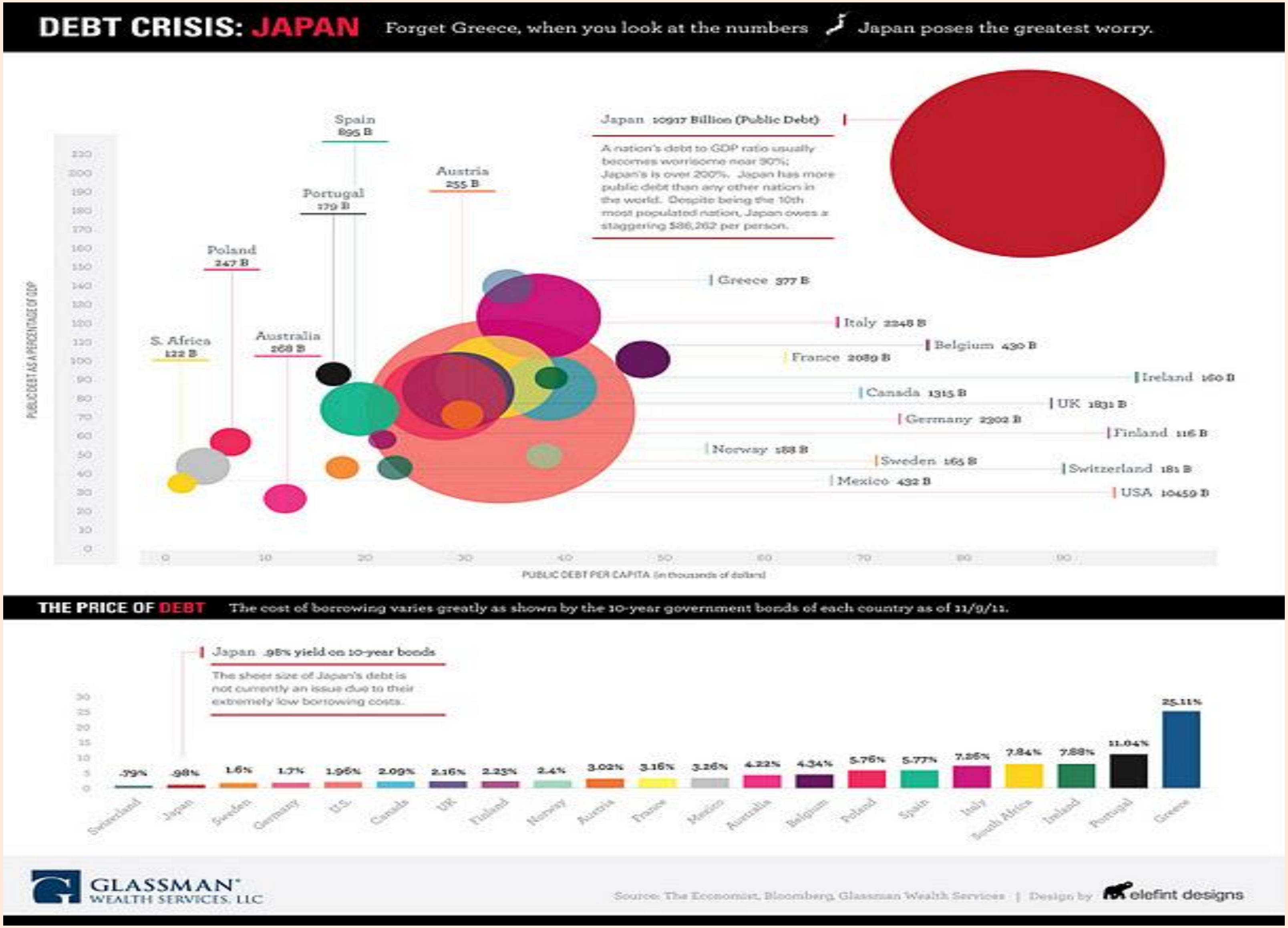
Change in Dollar Swap Lines

Demand coming from EU and Japan.

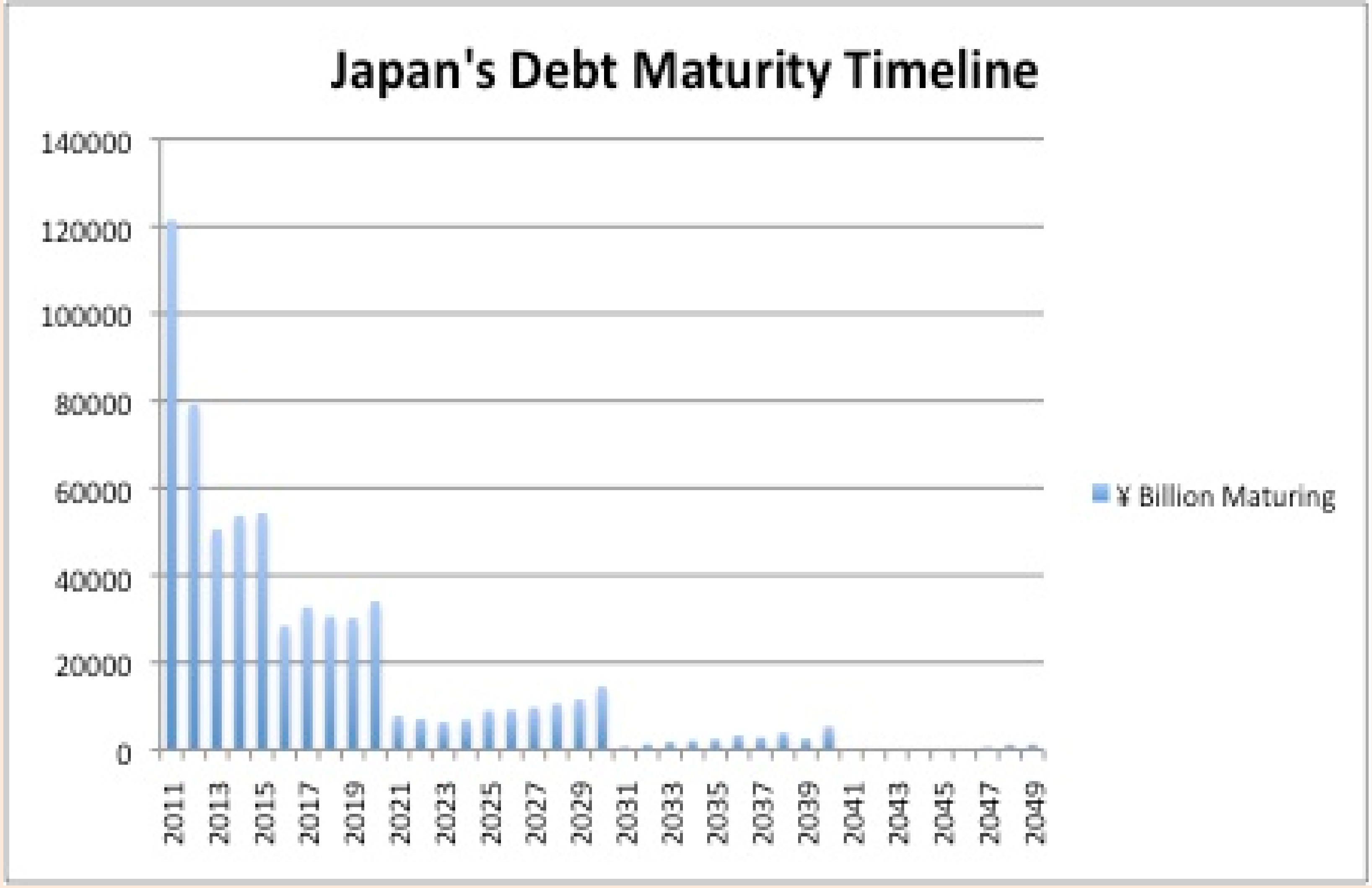
Problems in Japan

- Japan’s debt to GDP ratio is 229%, highest in the world (over 90% is a problem).
- Unlike the U.S., this has been mostly funded internally.
- After 2 decades of economic malaise and with a large number of retirees, savings rate is projected to turn negative.
- Huge amount of debt needs to be rolled over starting in 2012.

Debt by Country



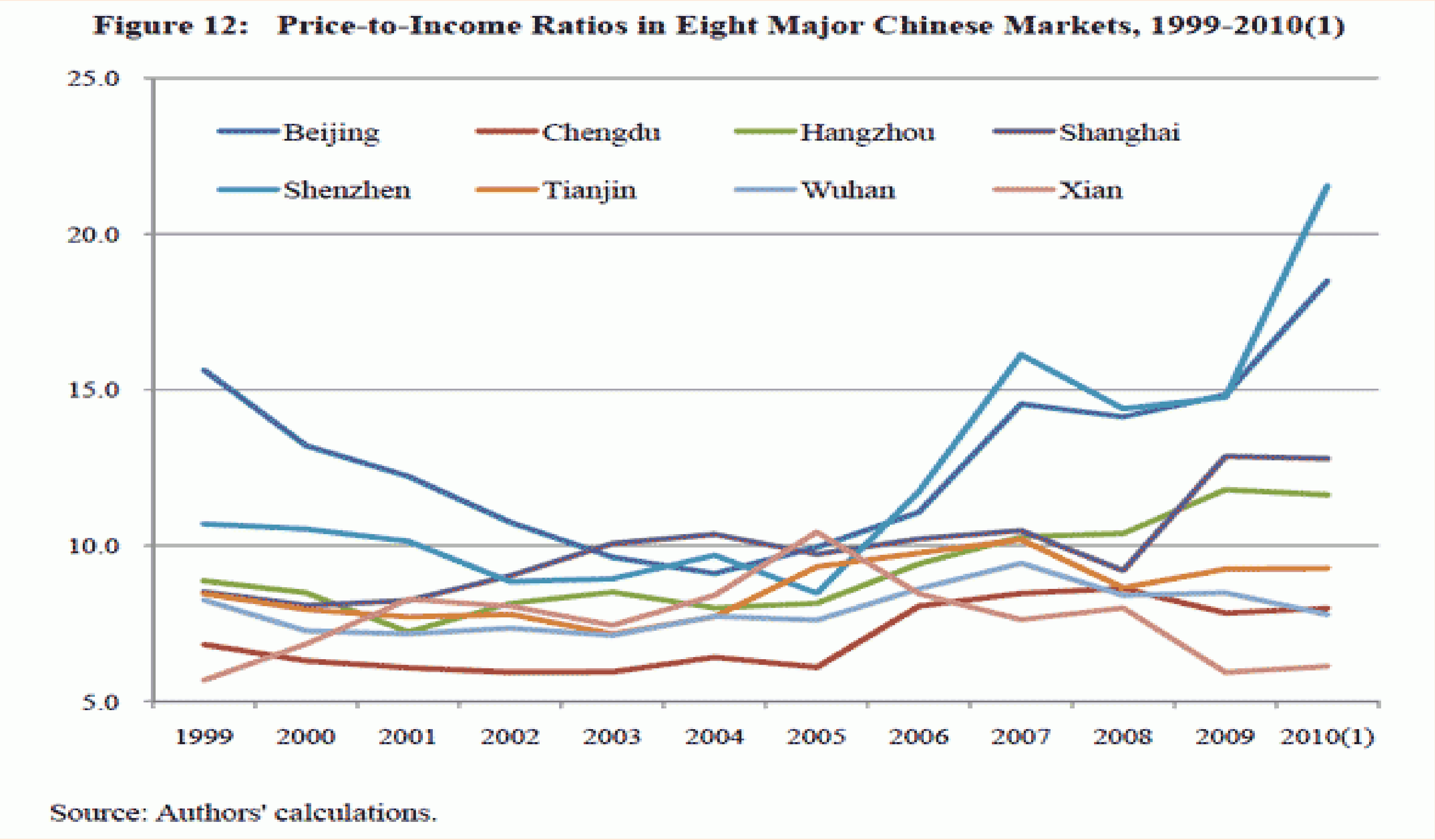
Japanese Debt Rollover



Problems in China

- Real estate bubble is considered one of the largest in history. Impacts global commodity prices.
- “Ghost” districts and even cities exist where no one lives. Investors own the apartments.
- Prices had sharp drops in Beijing at the end of 2011.
- Number of sales have been cut in half in a number of cities.

Ratio of Income to House Price in China



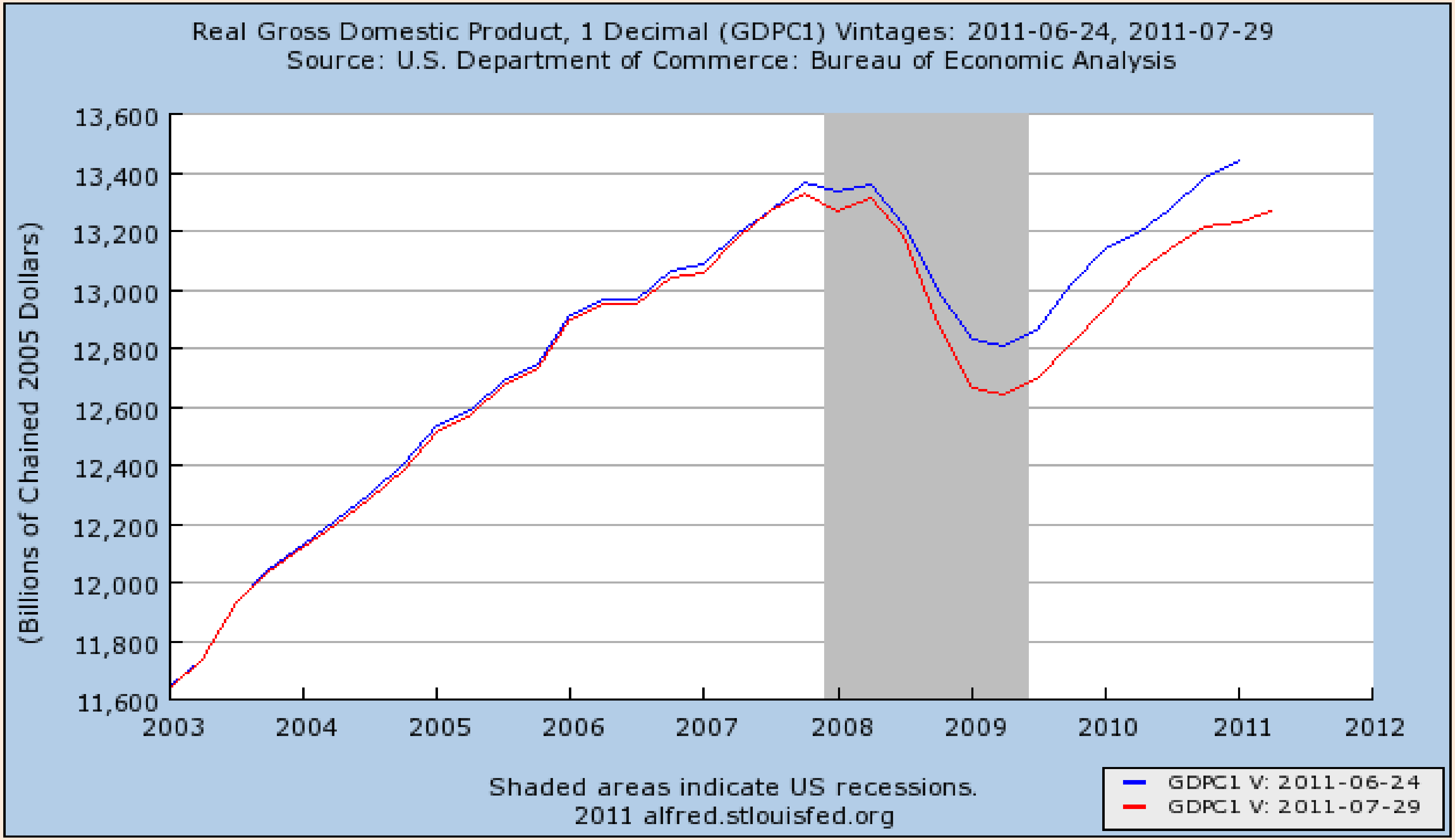
Current Conditions – U.S. Fiscal State

- National Debt: $15.2 trillion
  State and Local Debt $3.0 trillion
  Unfunded liabilities $117 trillion.
- Debt to GDP ratio >**100%** (actually much greater).
- Debt doesn't include Federal Reserve or Fannie Mae, Freddie Mac and FHA obligations.
- Debt Ceiling at $16.4 trillion (up to election). Obama asked for it to be raised over holidays.
- Federal budget deficit for 2012 at least $1.1 trillion. State/Local deficit $654 billion.
- 2011 Trade Deficit around $500 billion.

Official U.S. Economic Numbers

- GDP
  - Q3 up 1.8% (was 2.0%, 2.5%).
  - Q2 was 1.3%.
  - Expect downward revisions in future years.
- December Jobs Report
  -Unemployment 8.5% (9.6% more realistic).
  - 200,000 jobs created (42,000 were messengers), seasonal adj. problems.
- CPI Inflation for November 3.4% (ShadowStats around 11%).

This Year's GDP Revisions Compared to Last Year

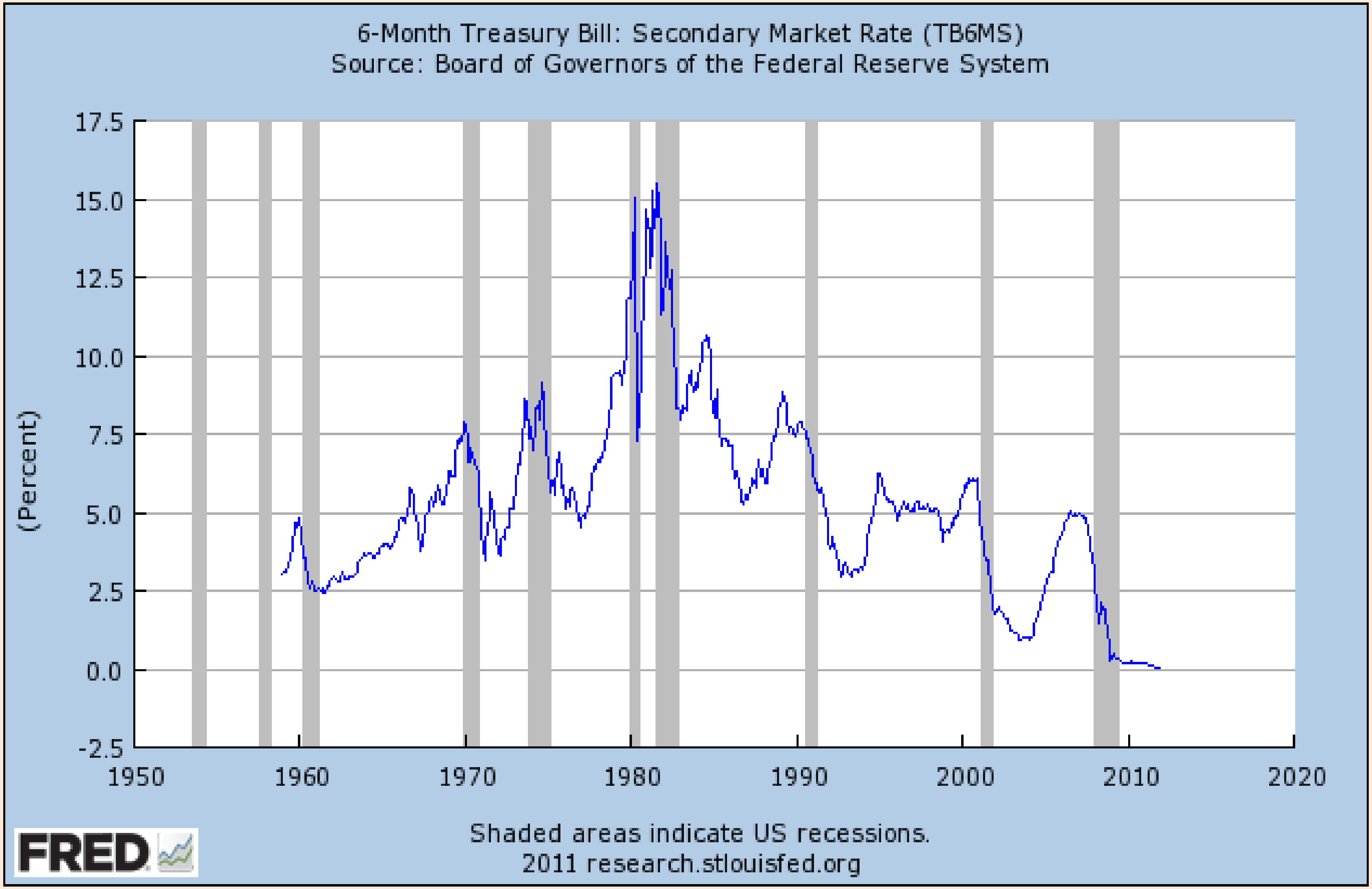


Blue line original numbers. Red line revised numbers.

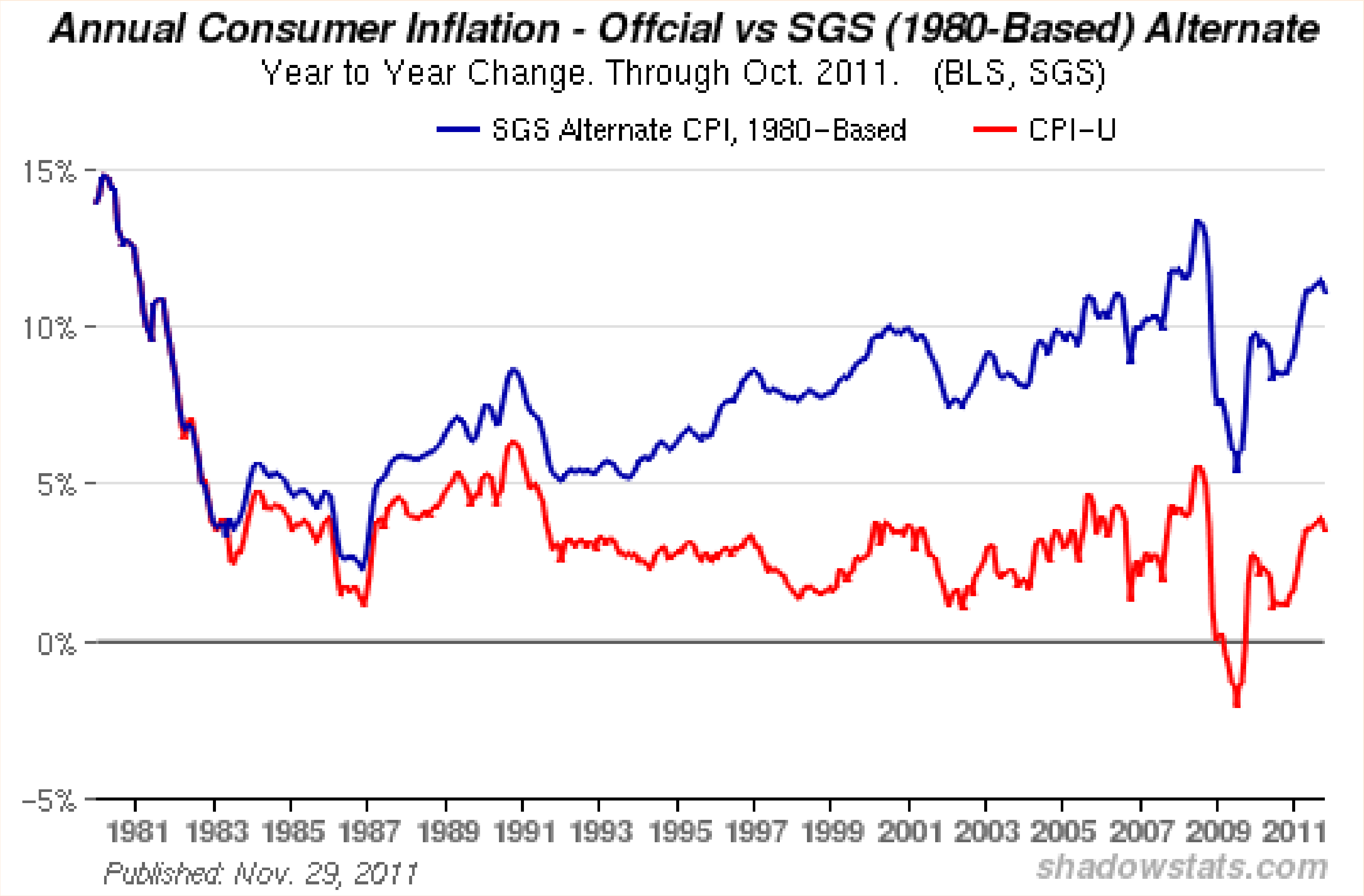
Current Conditions in U.S.

- Fed funds rate at Zero since Dec 2008.
  3-month, 6-month and 1-year close to zero.
- Fed still conducting Operation Twist.
- Real interest rates (adjusted for inflation) are between *minus* 8% and *minus*11%.
- Nominal 10-year rate has hit lowest in history.
- Monetary Base going horizontal.
- Fed Balance Sheet growing again (as it does during quantitative easing).

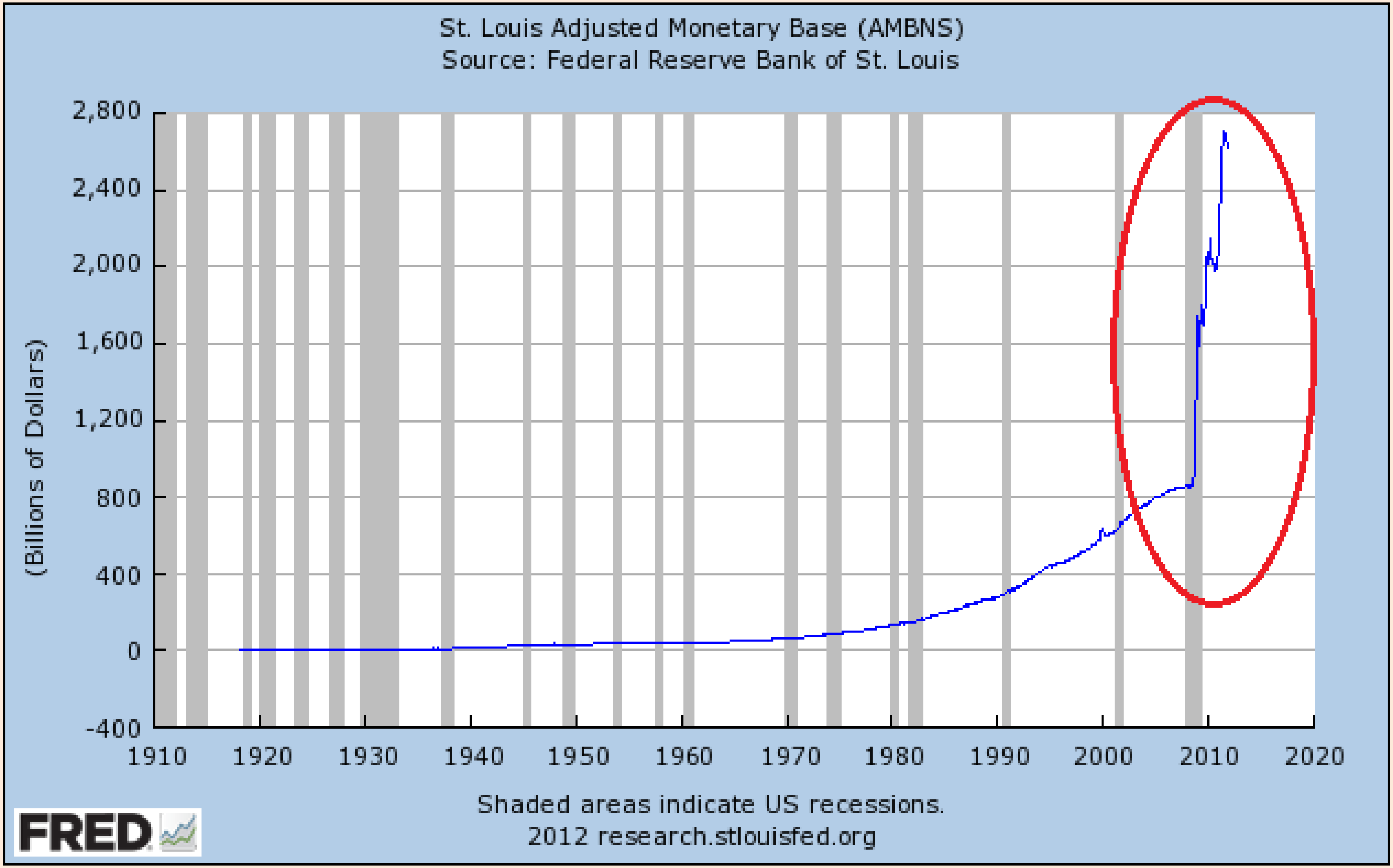
6-Month Treasuries



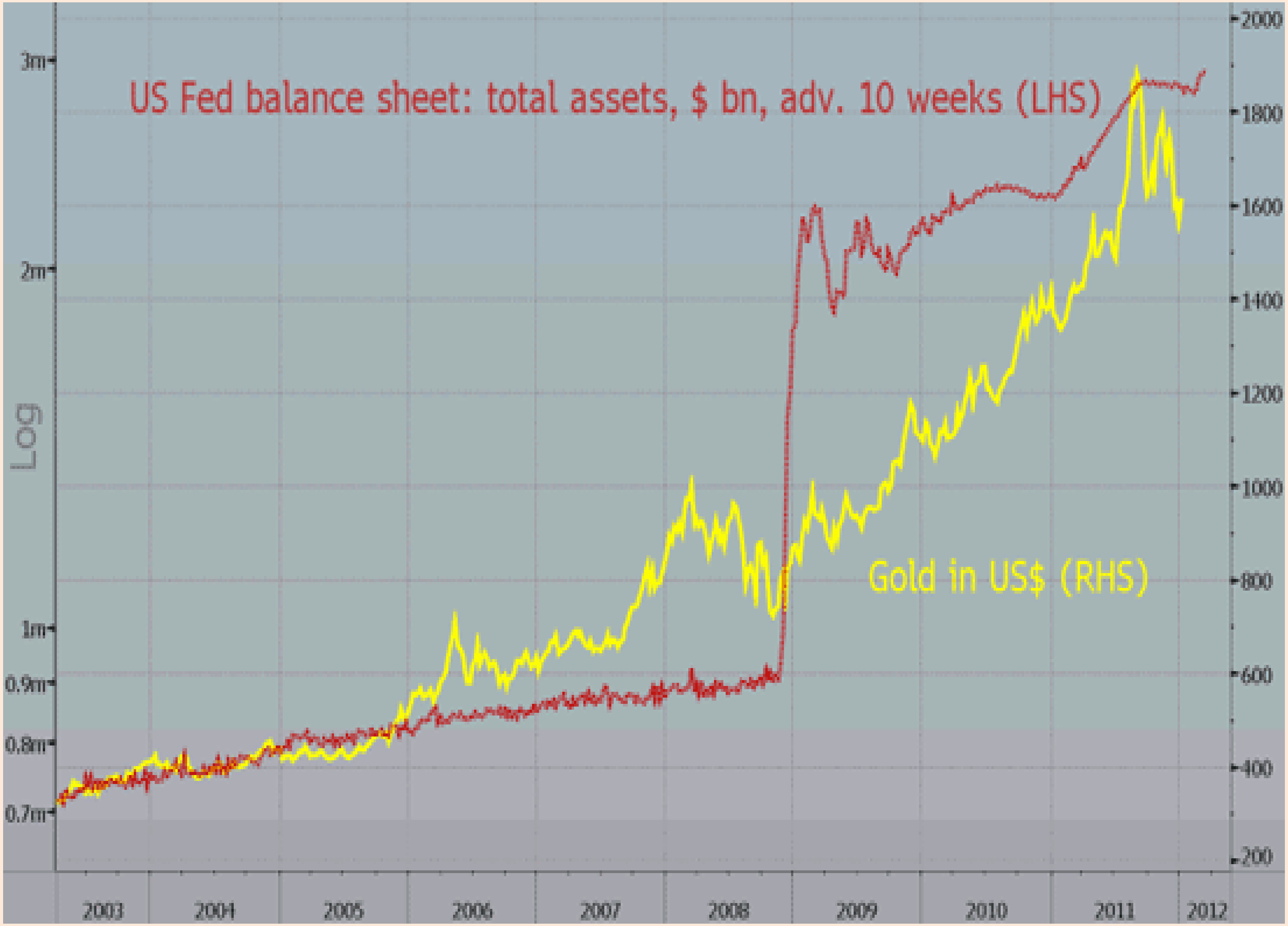
Shadowstats.com and Reported U.S. CPI



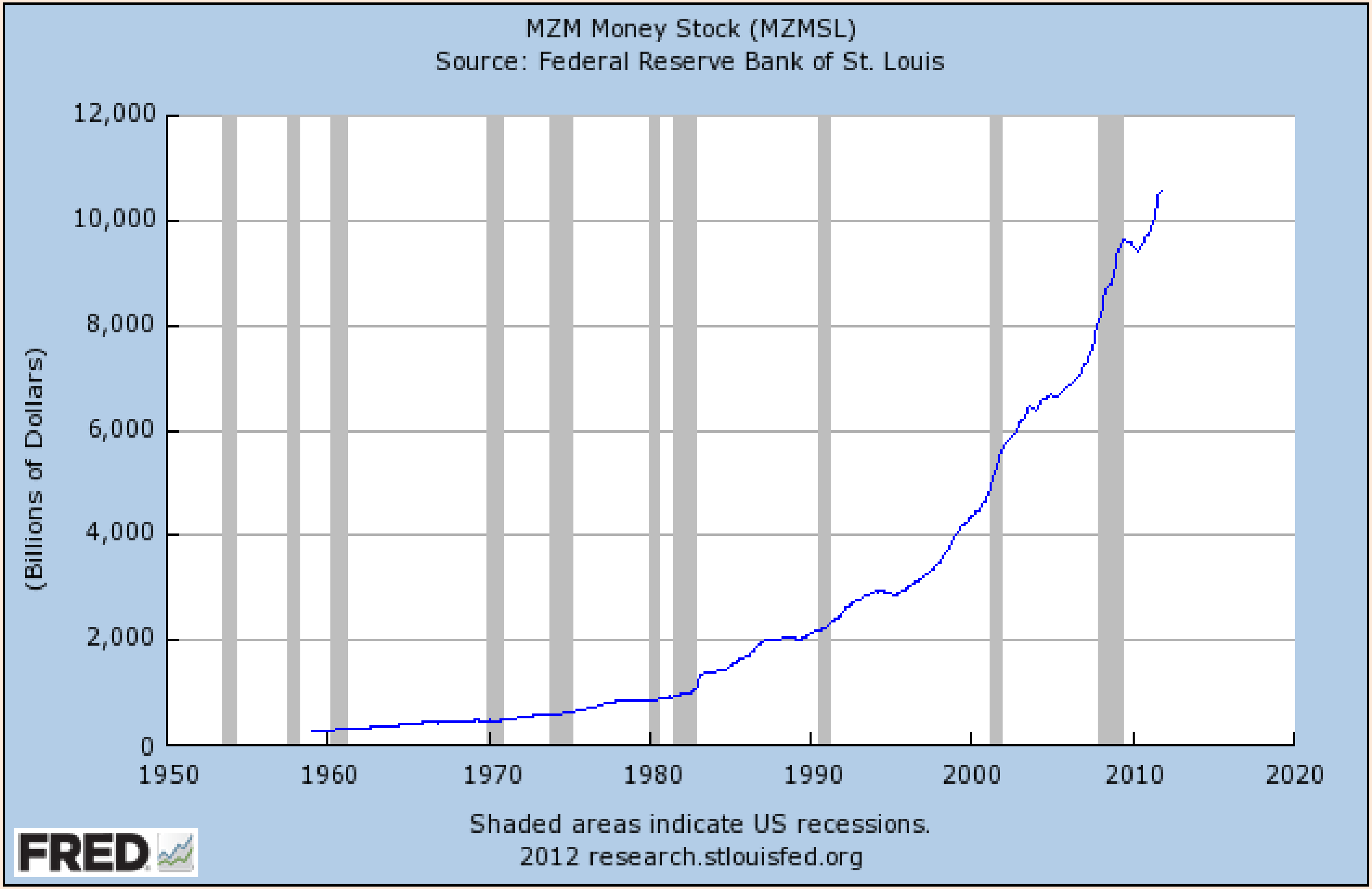
U.S. Monetary Base – Future Inflation



Fed Balance Sheet



MZM Money Supply



Various forms of cash.

Summary of 2012 Monetary Policy