

AN ECONOMIST'S PERSPECTIVE

Navigating the bond market amidst Federal Reserve manipulation, political disarray, and an ongoing post-bubble economic adjustment

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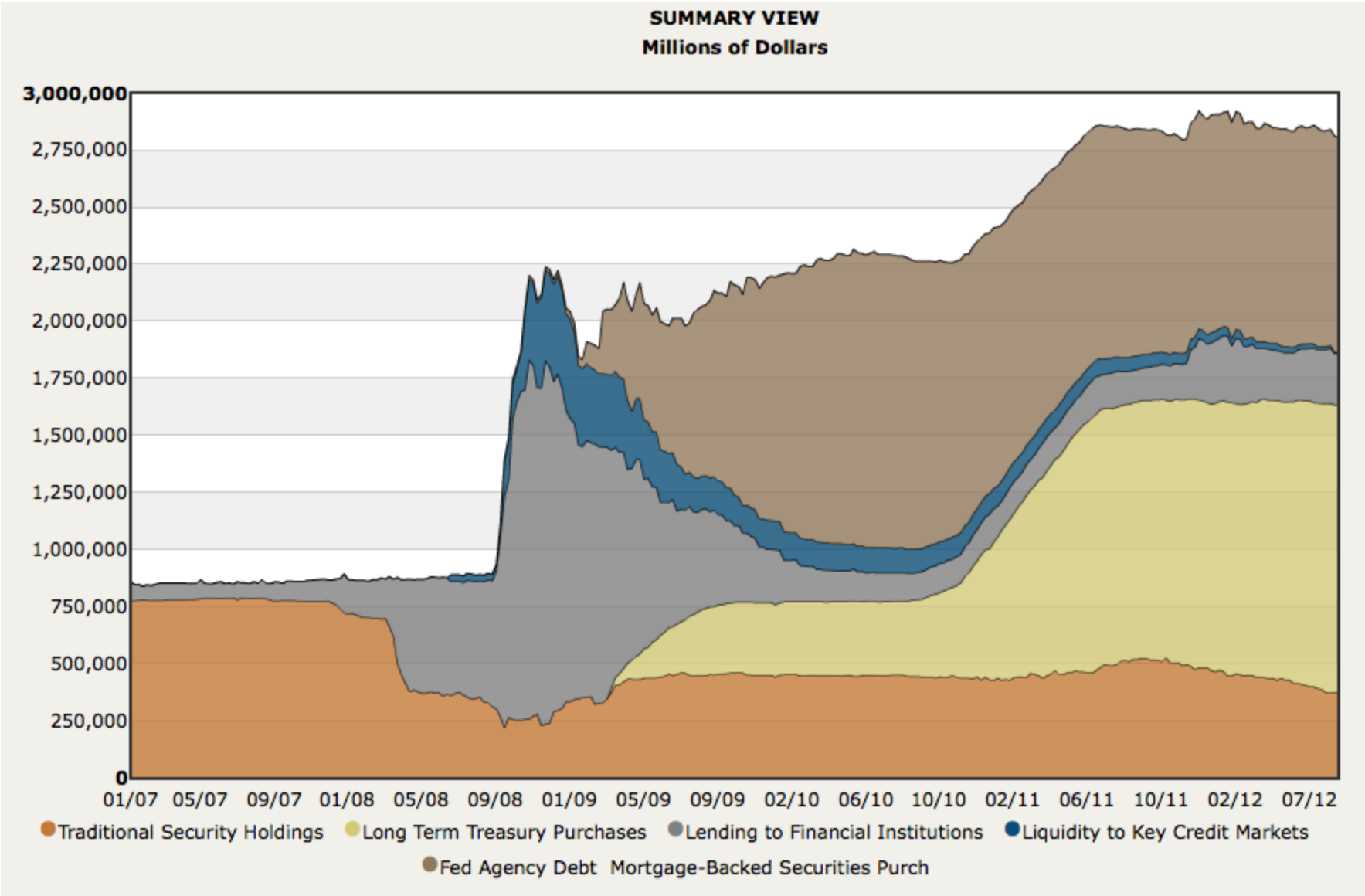


- The FOMC on September 13 announced a \$40B per month program of MBS purchases in addition to continuation of Operation Twist.
- Also, as widely expected, forward guidance for continuation of the prevailing 0-0.25% Fed funds target was extended from a previous “late 2014” to “mid-2015”.
- Even more importantly, the FOMC stated that “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.”
- So, if the economy does not pick up noticeably in the months ahead, the message is that MBS purchases will continue, and other balance sheet expanding purchases as well as potentially other actions will occur. All this is consistent with the forward-looking portion of the September 13 policy statement, where the wording was changed to read “The Committee is concerned that, without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions.” This compares to the August 1 phrasing that “The Committee expects economic growth to remain moderate over coming quarters and then to pick up very gradually.”
- MFR’s view remains that at this stage monetary policy moves such as those announced on September 13 are for the most part a political/market sideshow and will have little if any impact on economic activity. With interest rates at rock-bottom and liquidity abundant, the Fed is pushing on the proverbial string, and has been for a while. Manipulating and distorting markets is not going to accomplish anything lasting or meaningful, and to the contrary is retarding the adjustment process that the economy must go through in order to set the stage for sustained growth down the road.

Weak Economic Activity & Central Bank Manipulation Pushes Interest Rates to Extreme Lows



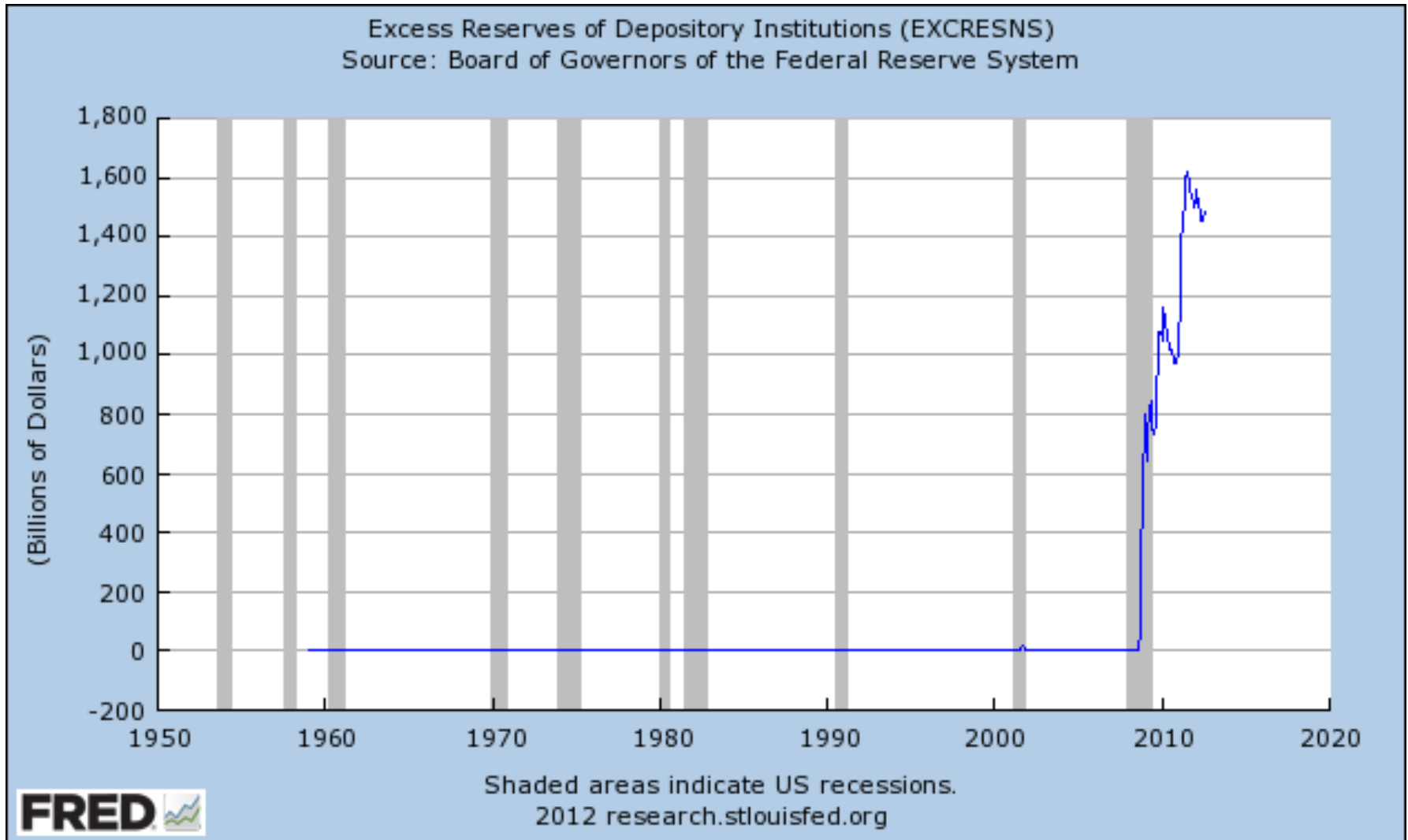
The Fed's Balance Sheet: A Brave New World



Monetary Easing versus Blockage



Source: Author.



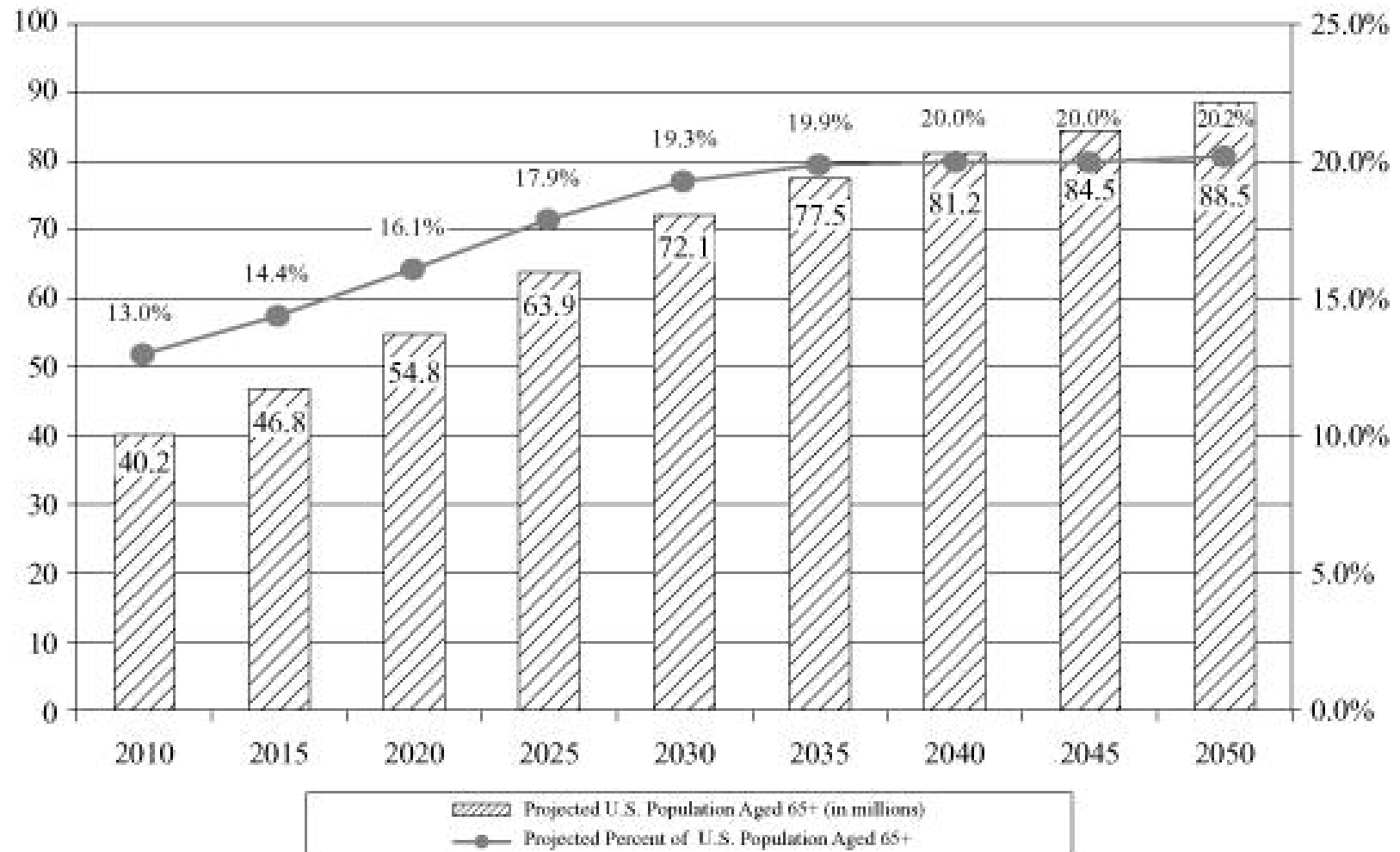
The January 1, 2013 Fiscal Cliff

- Under current law, the U.S. will suffer fiscal drag of unprecedented size at the beginning of 2013. The main elements of this are scheduled expiration of the Bush era tax cuts (a little under 2% of GDP), expiration of the 2010-11 payroll tax cut (about 0.7%), a budget sequester due to the failed Super Committee deliberations (0.6%), expiration of emergency unemployment benefits (0.3%), expiration of investment tax incentives (0.2%), and various healthcare related items (0.3%).
- Measured on a calendar year basis, the total amount of fiscal tightening potentially facing the economy appears to be close to 4% of GDP. Even using a conservative estimate of the multiplier effect on GDP, tightening of this magnitude would guarantee recession in 2013.
- At this stage, it appears that it will either be up to a lame-duck session of Congress (and possibly a lame-duck President) to find a way to reduce the fiscal hit that would otherwise occur on January 1, or things might slide until sometime in the first quarter when a new Congress and whomever is elected President would presumably hash things out retroactively to January 1. Further complicating matters is that the debt ceiling will be back in play probably soon after the election as well.
- Like most other analysts, we are assuming that sanity will prevail and that the ultimate fiscal tightening that occurs in 2013 will be considerably smaller than what would take place if nothing were to be done.
- The most plausible range is from about -0.4% of GDP (if there is an agreement to finesse things in order to almost completely preserve the status quo for another fiscal year), to roughly -2.0% of GDP.

More on the Fiscal Cliff

- At this stage, we think it is basically 50-50 whether things get resolved before January 1 (temporarily at least) or if the cliff is dealt with retroactively by the new Congress and possibly a new President.
- If things slip into Q1, the biggest questions will surround the debt ceiling (which will be back in play then) and the Bush tax cuts. Any deal that is made regarding the tax cuts at that stage is likely to cover the entire year rather than be a short-term extension of the status quo. Whether the cuts are extended in their entirety, without the upper rate category, or with a modified upper rate category would probably depend on the election results and the balance of political power. The entire top bracket reduction is worth about 30% of the total impact of the tax cuts (roughly \$65B of \$220B).
- A deal retroactive to January 1 would result in a lumpy economic impact (higher taxes / lower growth at the start of the year, then a correction of that when the IRS gets withholding tables sorted out, etc.). Sequestration is another item that must be dealt with, as the status quo is that it will take roughly \$75B out of spending over the initial nine months of the calendar year.
- We think that the fiscal tightening will ultimately be in the range of 1%-2% of nominal GDP, assuming that the debt ceiling is raised as it needs to be without any further spending cuts being part of the deal to do so.
- It is one big mess, basically, and until the election it is very murky. And, there are dozens of permutations of the above scenarios that are possible, so it is really tough to sketch all this out in any sort of reliable manner.

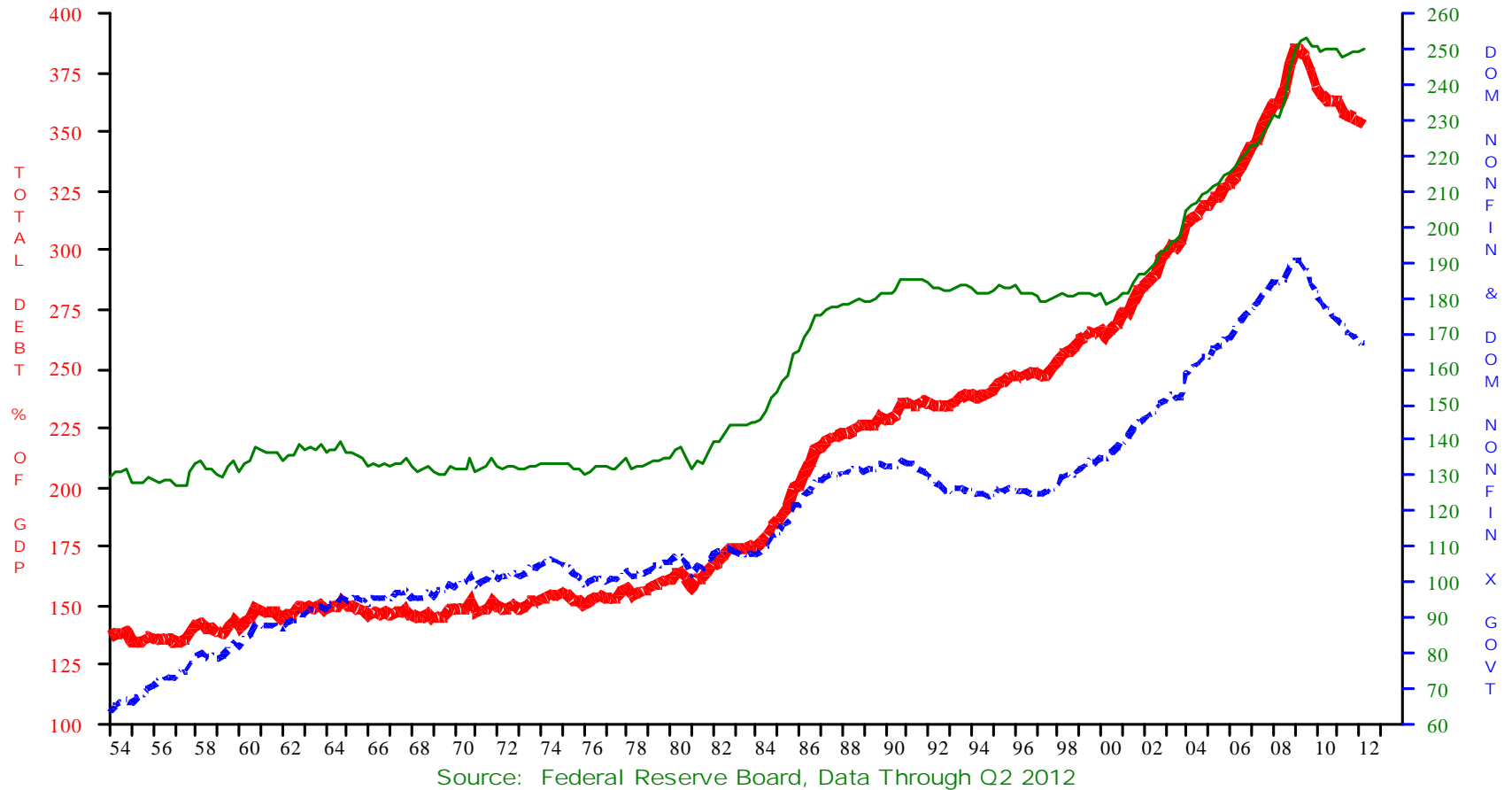
AGING BABY-BOOMERS WILL PUT INCREASED BURDEN ON ENTITLEMENT PROGRAMS – EXISTING BENEFIT LEVELS, COSTS, AND METHODS OF FINANCING ARE UNSUSTAINABLE



Source: U.S. Census Bureau

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U.S. CREDIT MARKET DEBT AS % OF GDP: EVEN AFTER STRIPPING OUT FINANCIAL SECTOR AND FEDERAL GOVERNMENT, THE OVERHANG IS HUGE



- TOTAL CREDIT MARKET DEBT AS % OF GDP (LHS)
- DOMESTIC NONFINANCIAL DEBT AS % OF GDP (RHS)
- - DOMESTIC NONFINANCIAL DEBT EXCLUDING FEDERAL GOVT AS % OF GDP (RHS)

Demographic Realities Create Fiscal Policy Imperatives

Given the aging of the population and rising costs for health care, attaining a sustainable federal budget will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

--Raise federal revenues significantly above their historical average share of GDP;

--Make major changes to the benefits provided for Americans when they become older; or

--Substantially reduce the role of the rest of the federal government relative to the size of the economy.

The most likely eventual outcome is some combination of all three of the above. The political, social, and economic fallout from the battle over how this will occur promises to be substantial.

Post-Bubble Deleveraging Continues

- Correction of past excess is providing a substantial countervailing force to upside cyclical influences.
- This will keep growth weak and erratic, and makes the economy more vulnerable to shocks.
- Moreover, demographic realities will require a significant reduction in benefit levels offered by entitlement programs and other government efforts.
- As this is anticipated, individuals will save more of current income in order to fill the gaps and help to provide for retirement, medical care, etc.

U.S. Economic Forecast Summary

	2012:Q3	2012:Q4	2013:Q1	2013:Q2	2013:Q3	2011 q4/q4	2012 q4/q4	2013 q4/q4
Real GDP q/q annualized	+1.4%	+1.2%	+1.6%	+1.8%	+1.8%	+2.0%	+1.5%	+1.7%
Final Demand q/q annualized	+1.4%	+1.2%	+1.8%	+1.8%	+1.8%	+1.7%	+1.7%	+1.8%
Consumer Sp. q/q annualized	+1.6%	+1.5%	+1.7%	+1.7%	+1.9%	+1.9%	+1.7%	+1.8%
Capital Spending q/q annualized	+2.4%	+3.5%	+4.6%	+7.3%	+2.9%	+10.2%	+4.2%	+4.8%
CPI q/q annualized	+1.5%	+1.8%	+1.6%	+1.6%	+1.6%	+3.3%	+1.6%	+1.6%
Core CPI q/q annualized	+1.8%	+1.7%	+1.6%	+1.6%	+1.6%	+2.2%	+2.1%	+1.6%
Housing Starts (000's, saar)	750	755	760	755	760	612 Ann Avg	739 Ann Avg	759 Ann Avg
Light Vehicle Sales (mlns, saar)	14.5	14.4	14.3	14.3	14.4	12.7 Ann Avg	14.3 Ann Avg	14.4 Ann Avg
Unemployment Rate	8.1%	8.0%	8.1%	8.1%	8.1%	8.9% Ann Avg	8.1% Ann Avg	8.1% Ann Avg

- **No changes in the fundamental outlook: Major fiscal imbalances remain unresolved both in the U.S. and abroad, and economies continue to struggle under the weight of the post-bubble correction. Our forecast of Q4/Q4 real GDP growth is 1.5% for this year and 1.7% in 2013, which is below consensus and under the FOMC's central tendency forecast of 1.7%-2.0% for this year and 2.5%-3.0% for next.**
- **Moreover, we still view downside risks to our forecast as being greater than upside risks. Our assessment of a 50% chance that the U.S. economy will be in recession within the next 12 months is about double the odds placed on this occurrence by the median response to the monthly Bloomberg survey of economists.**
- **Although the dollar's role as the global reserve currency affords the United States time to get its house in order, at some stage after the coming election it will be necessary for politicians to agree on a set of measures that put the nation's fiscal position on a clearly defined, sustainable path.**
- **Doing so will require a viable political middle ground, as it will inevitably create considerable pain as entitlement programs are redefined so that they are affordable as baby-boomers age.**
- **Until fiscal policy is adjusted in a bipartisan manner, economic, financial, political and social stability are by no means assured.**

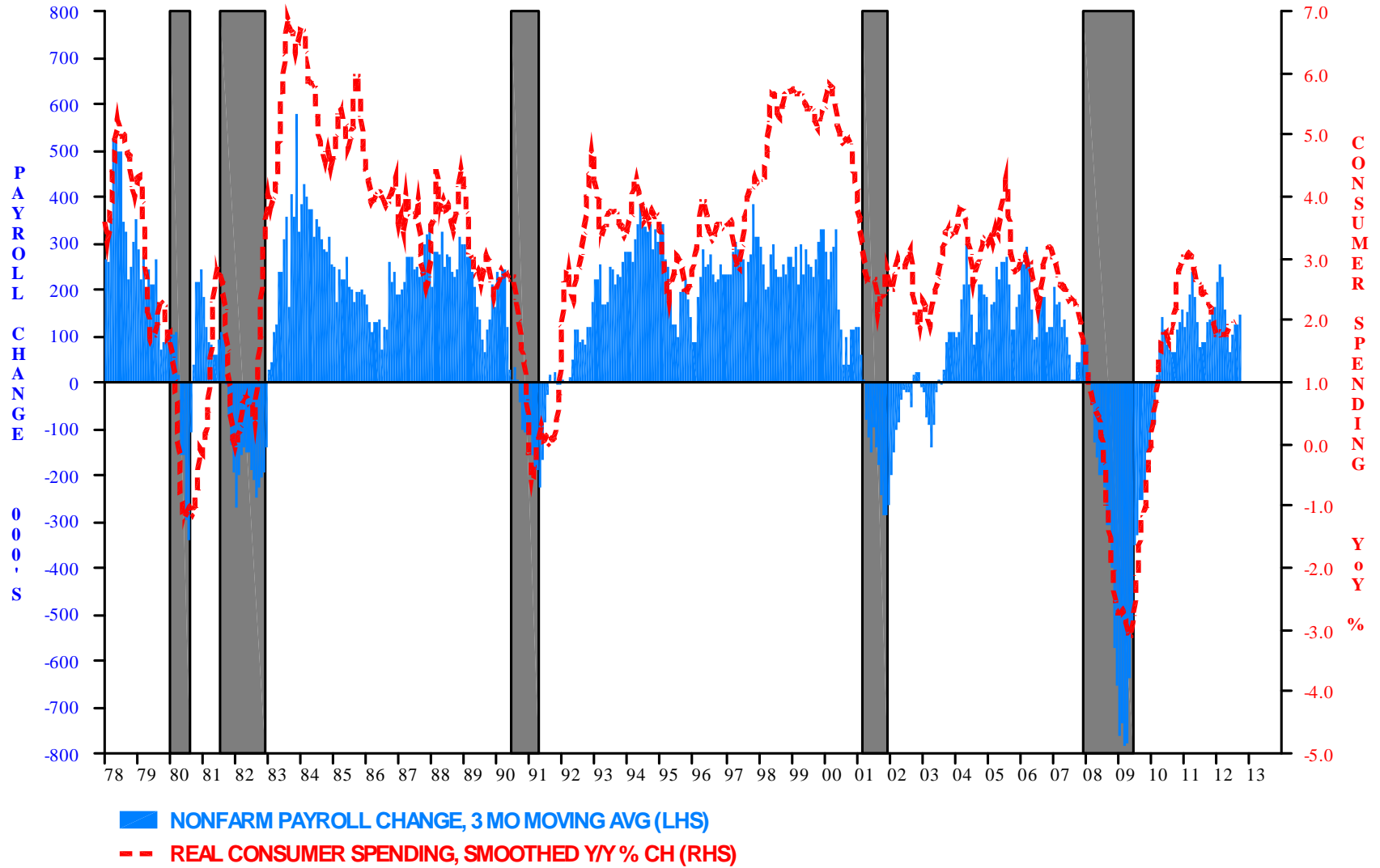
The Labor Market is Key to the Near-Term Growth Outlook

Payroll employment data have been erratic this year, at least in part owing to an unusually warm winter, associated seasonal adjustment distortions, and then a later correction of above-trend results as the weather and seasonal adjustment boost faded.

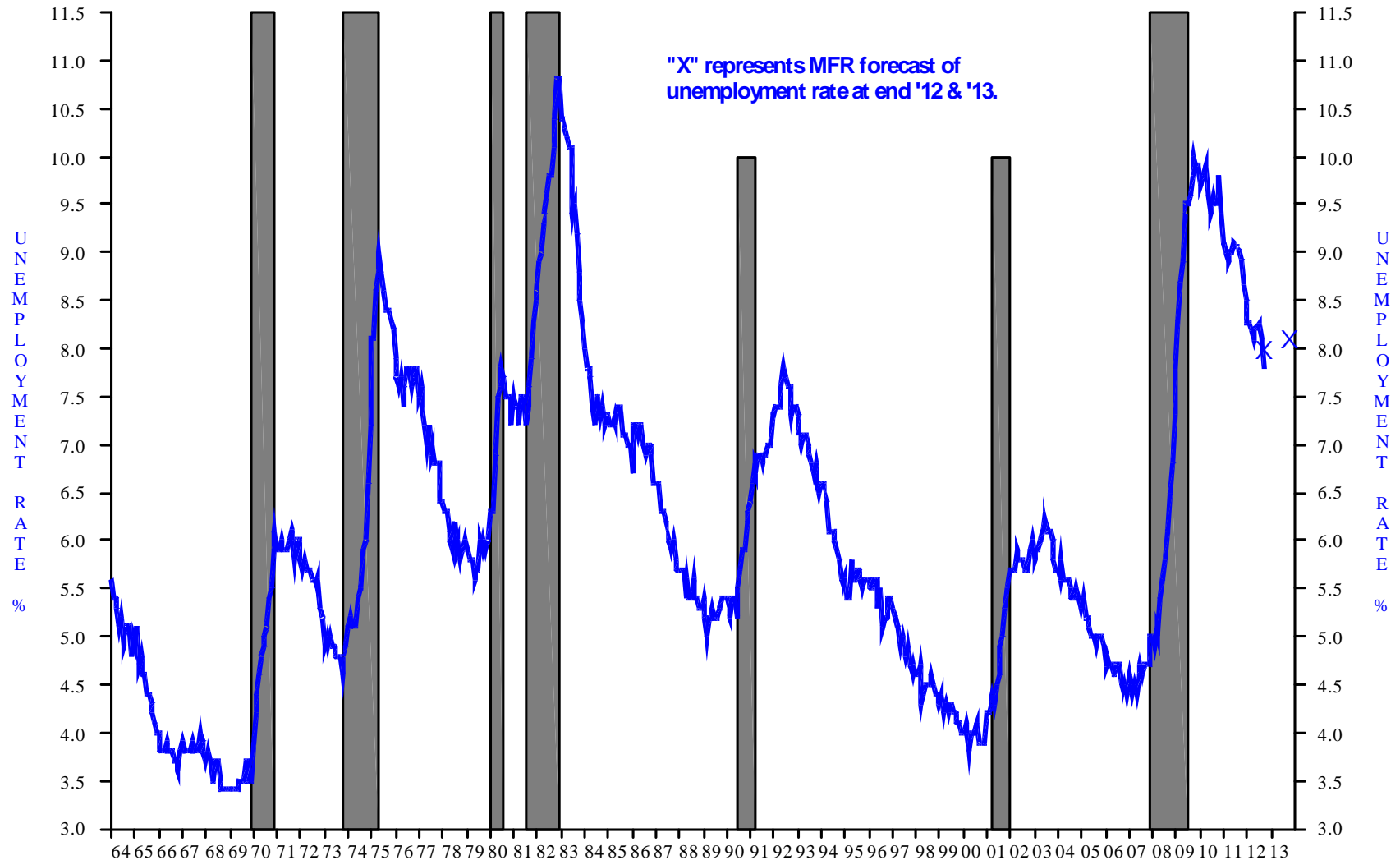
The key question now is where job growth settles down (assuming it actually does find a reasonably stable pace) now that statistical distortions seem to be behind us.

Given global events, recent evidence that new orders in the manufacturing and non-manufacturing sectors are softening considerably, and enormous uncertainties related to U.S. fiscal policy, we believe that job growth is going to be soggy in the coming months.

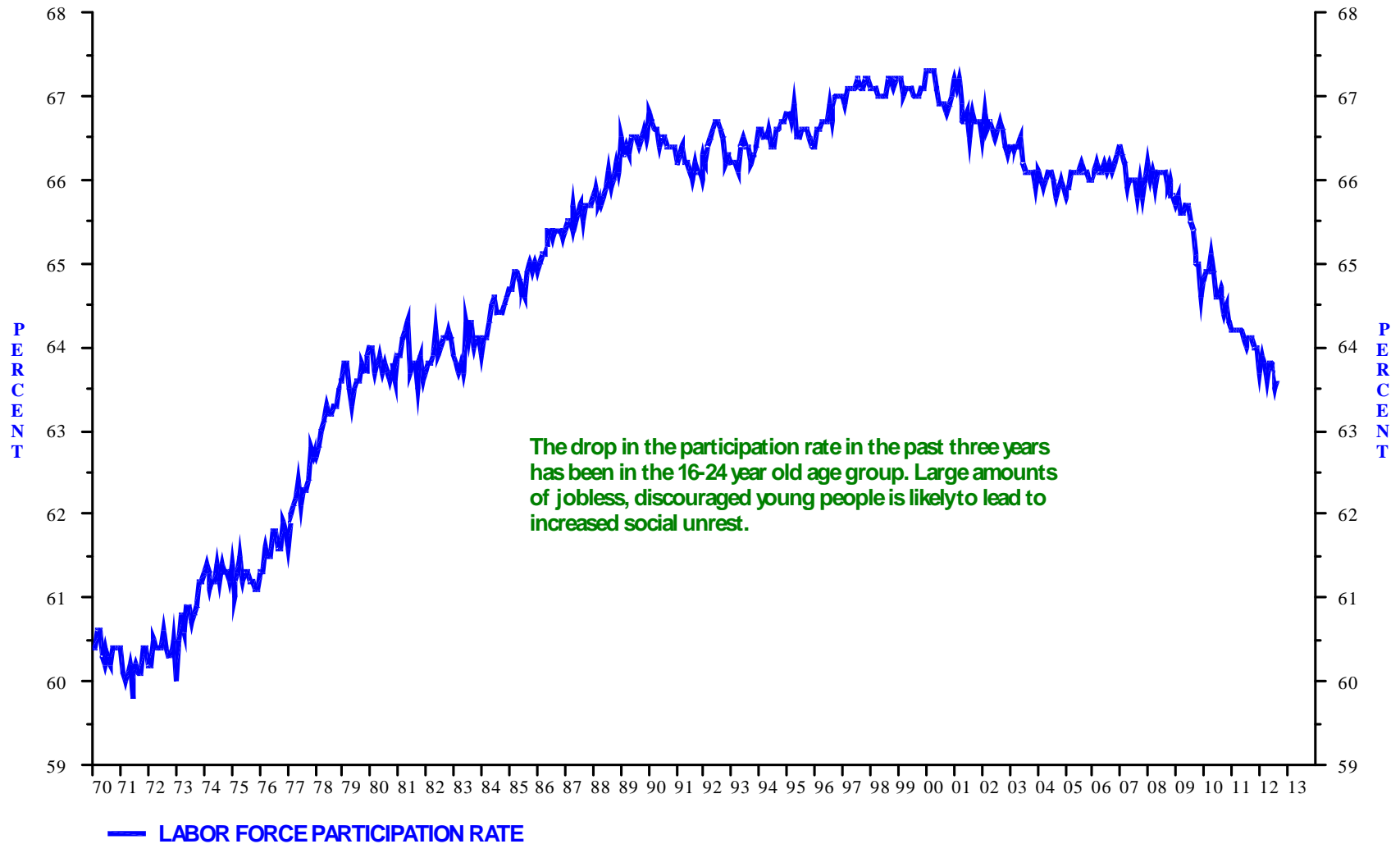
IF PAYROLL GAINS REMAIN WEAK, DON'T EXPECT AN IMPROVEMENT IN CONSUMER SPENDING GROWTH



JOB GROWTH UNLIKELY TO BE SUFFICIENT TO REDUCE UNEMPLOYMENT RATE;
AND, SHOULD LABOR FORCE PARTICIPATION BEGIN TO RECOVER, UNEMPLOYMENT RATE COULD RISE



LABOR FORCE PARTICIPATION RATE HAS PLUNGED -- DROP CONCENTRATED IN THE YOUNG, UNEMPLOYMENT RATE WOULD BE ABOUT 3PP HIGHER IF PARTICIPATION WERE AT 2009 RATE



Labor Market Carnage Was Unprecedented in Post-War Era; The Road Back is a Long One

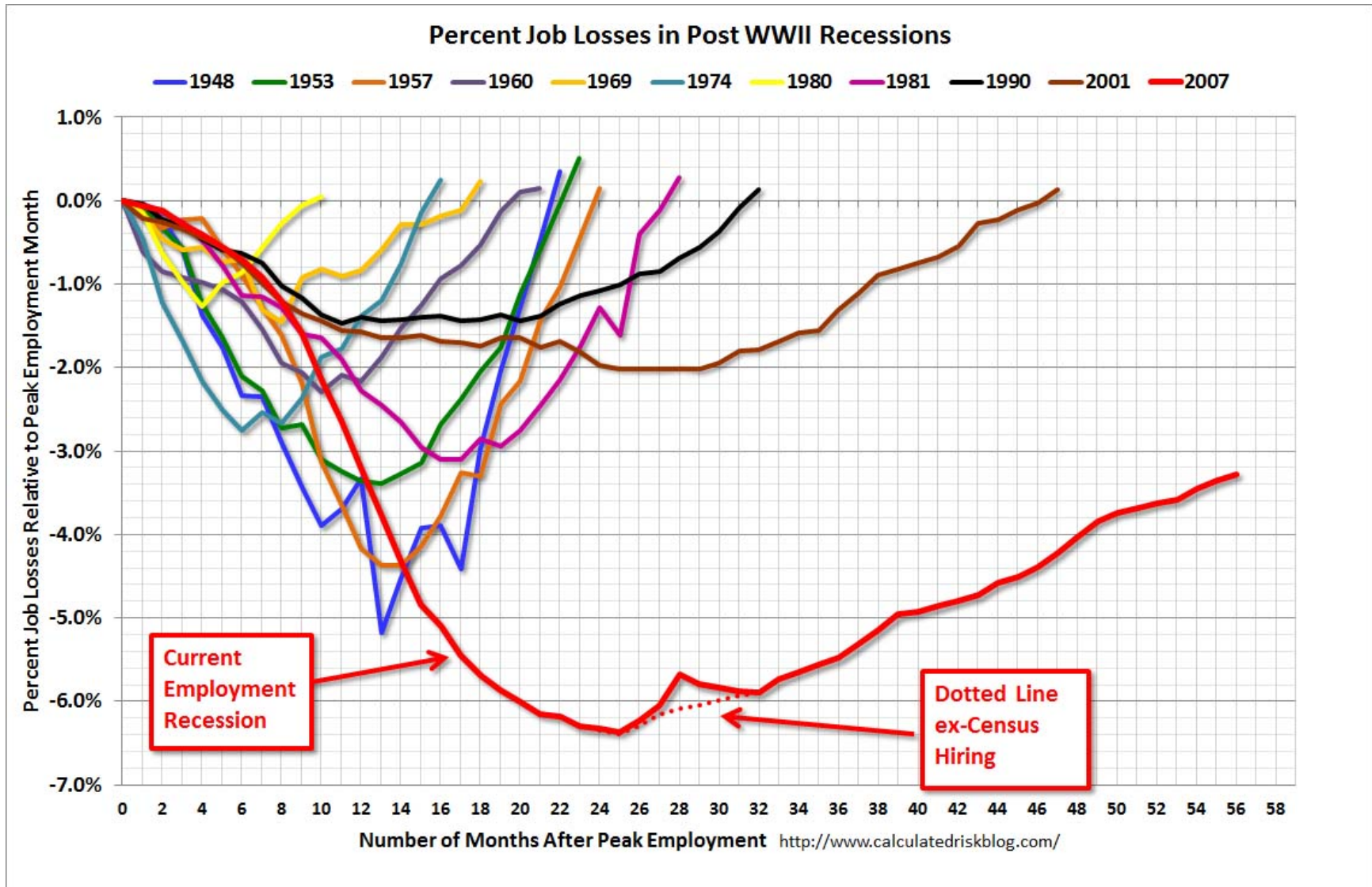
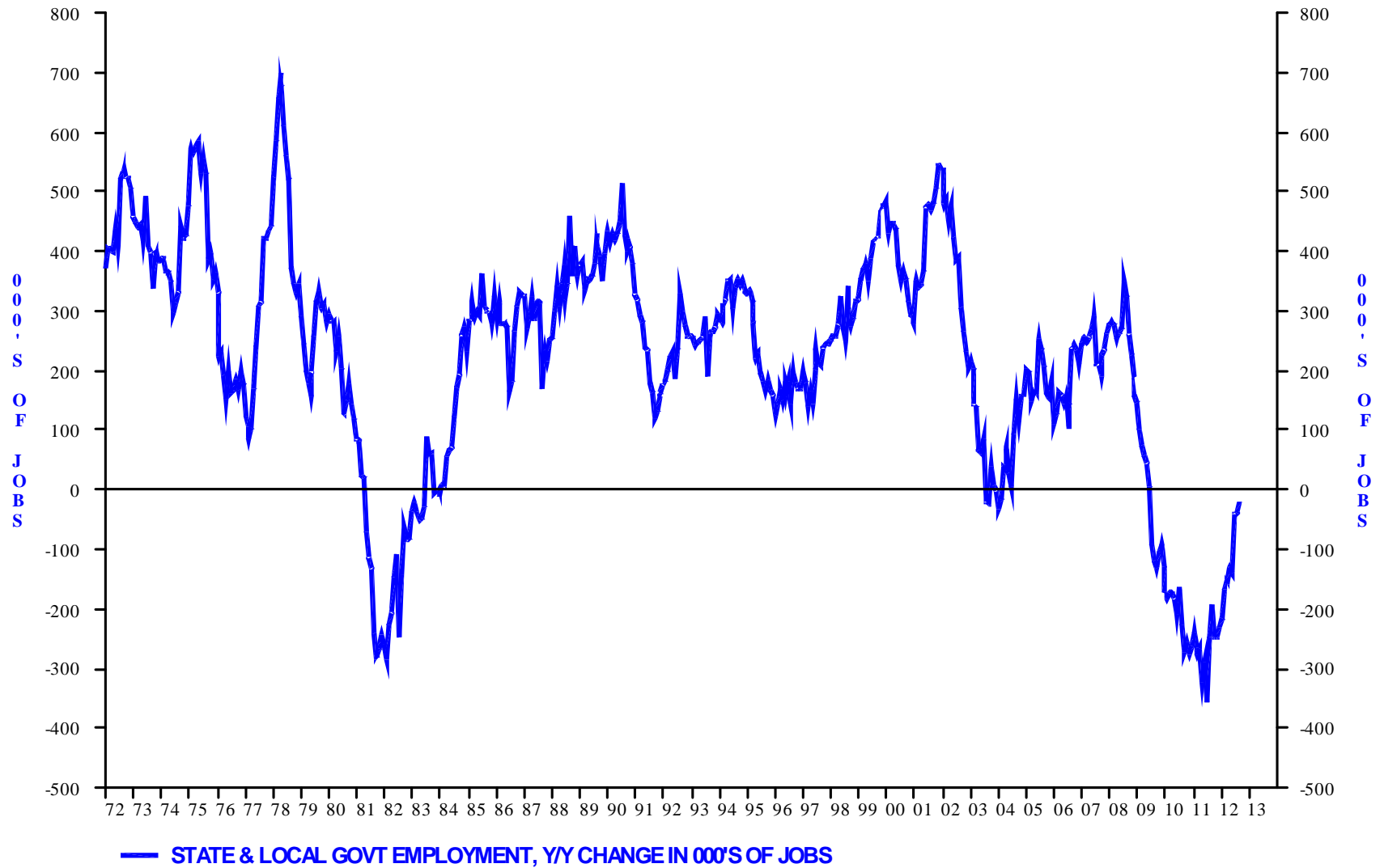


Chart Courtesy of Calculated Risk Finance & Economics

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STATE & LOCAL JOB LOSSES MUCH LESS OF A NEGATIVE AFTER EARLIER SHARP REDUCTIONS



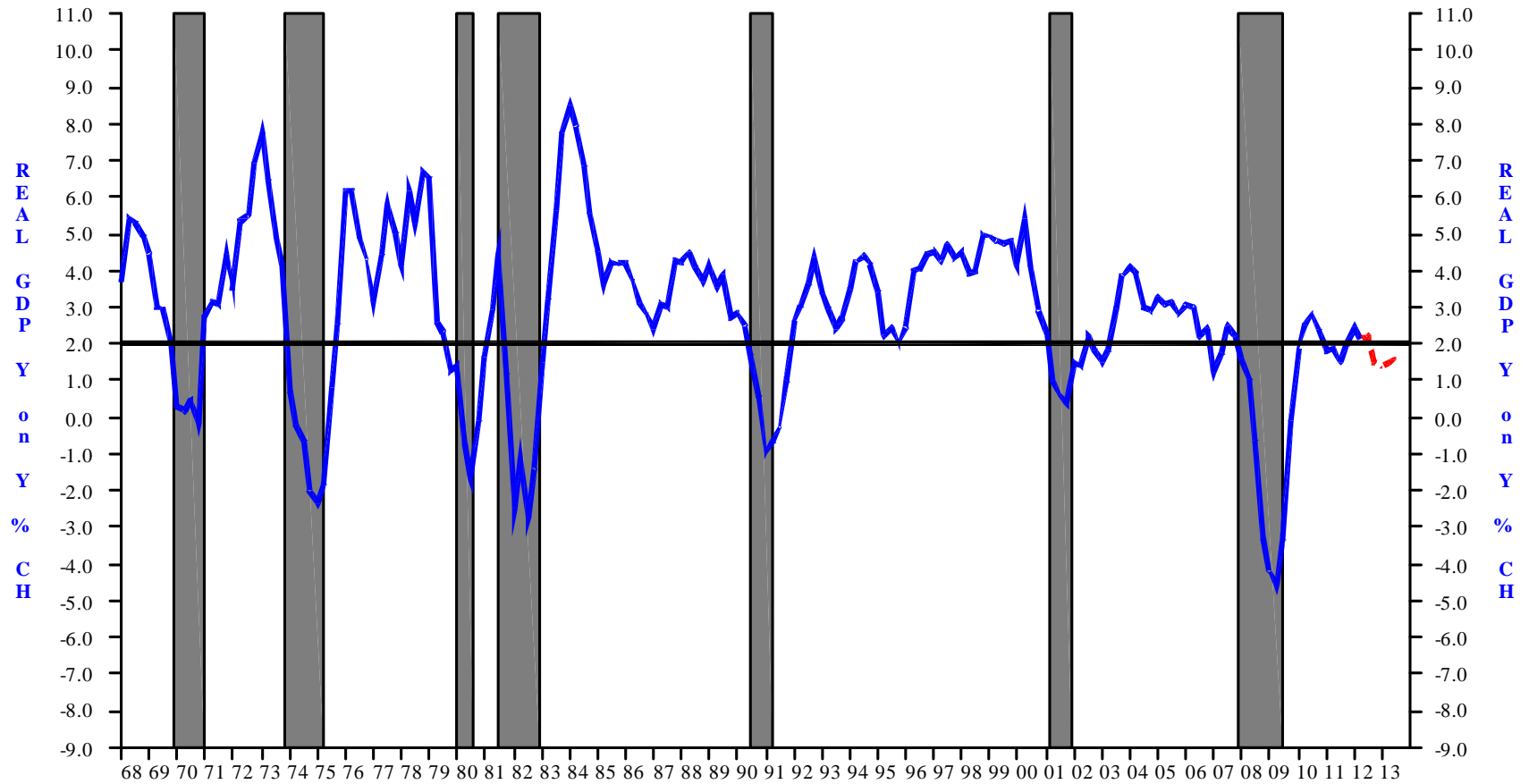
Most Other Data Also Points to Very Slow Growth

We believe that much of this is fundamental in nature, although it is likely that some of the weakness has been exaggerated to varying degrees due to payback from outsized gains during the winter.

Nonetheless, most of the weakness has been greater than ought to have been the case if it were simply a matter of payback.

This indicates a weakening of underlying economic activity, likely a product of spillover from Europe's woes and a waning of the supportive influence of U.S. fiscal and monetary policy (particularly on a rate of change basis).

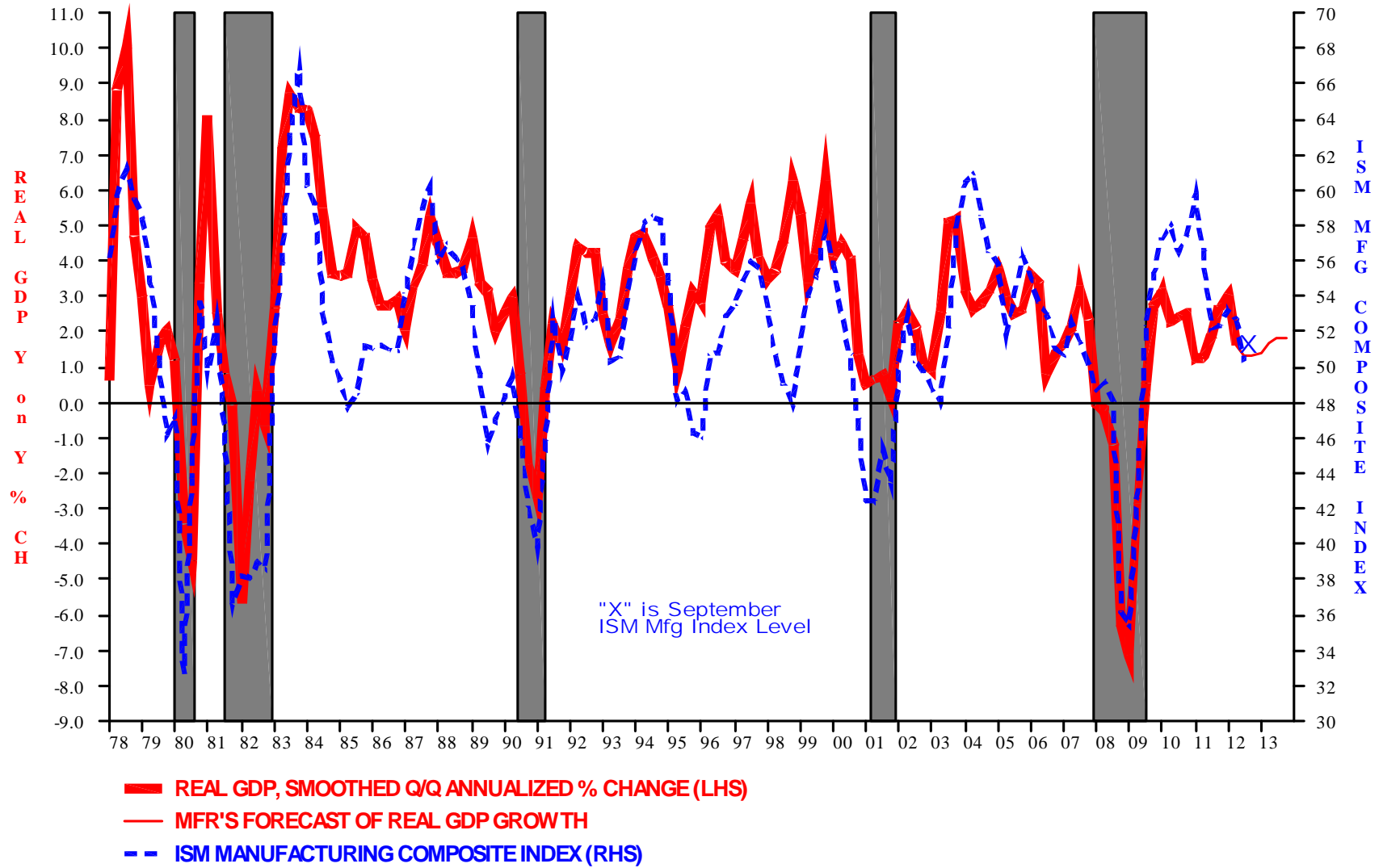
MAJOR DOWNSIDE RISK: ARE WE NEARING "STALL SPEED"?
 RECESSIONS HAVE OFTEN OCCURRED WHEN Y/Y REAL GDP GROWTH SLOWS TO UNDER 2%



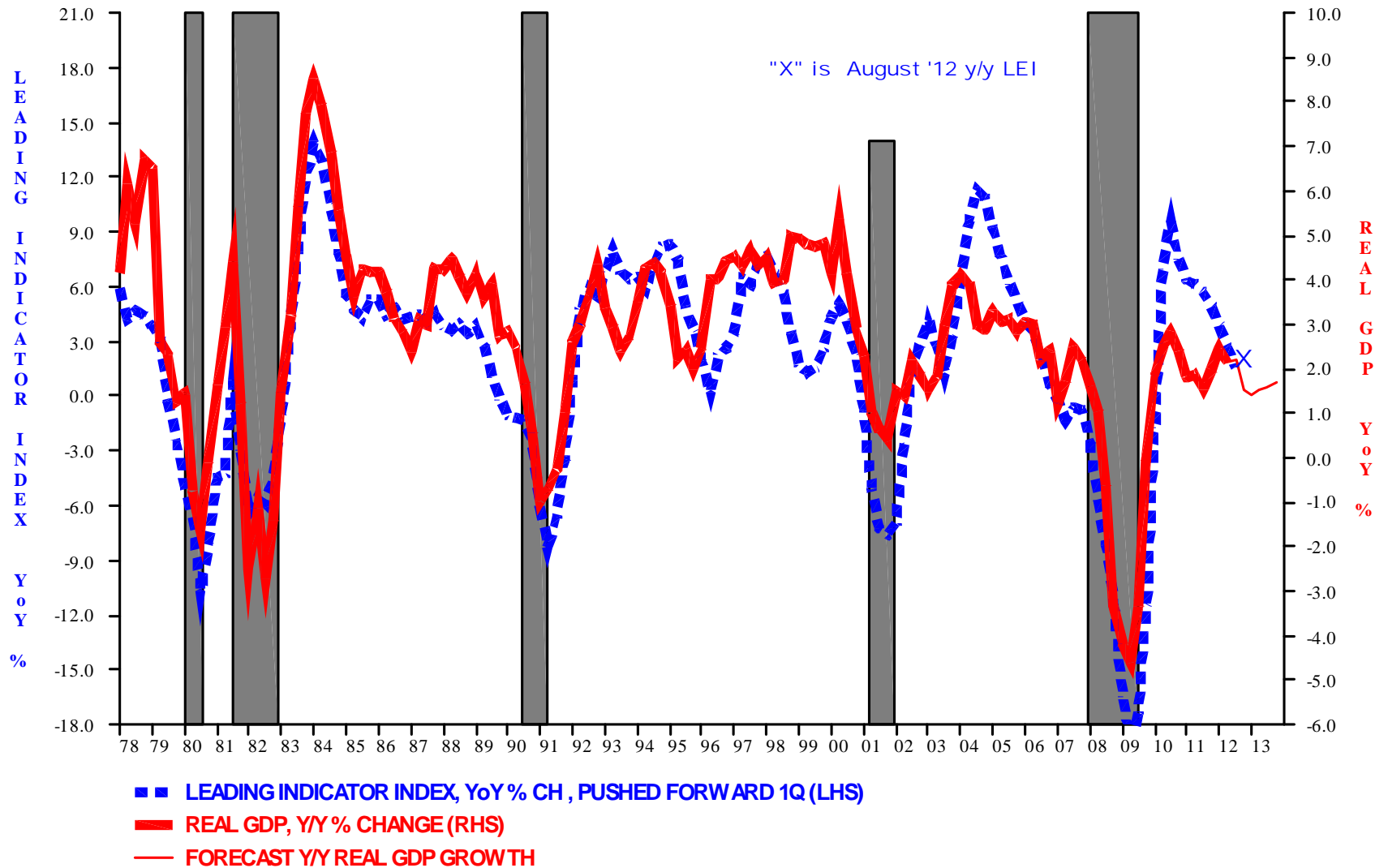
BEAR IN MIND, HOWEVER, THAT GDP DATA ARE SUBJECT TO SIGNIFICANT REVISION, AND THEREFORE THIS IS ONLY A VERY TENTATIVE SIGNAL.

- REAL GDP, Y/Y % CHANGE
- - MFR'S FORECAST OF REAL GDP GROWTH

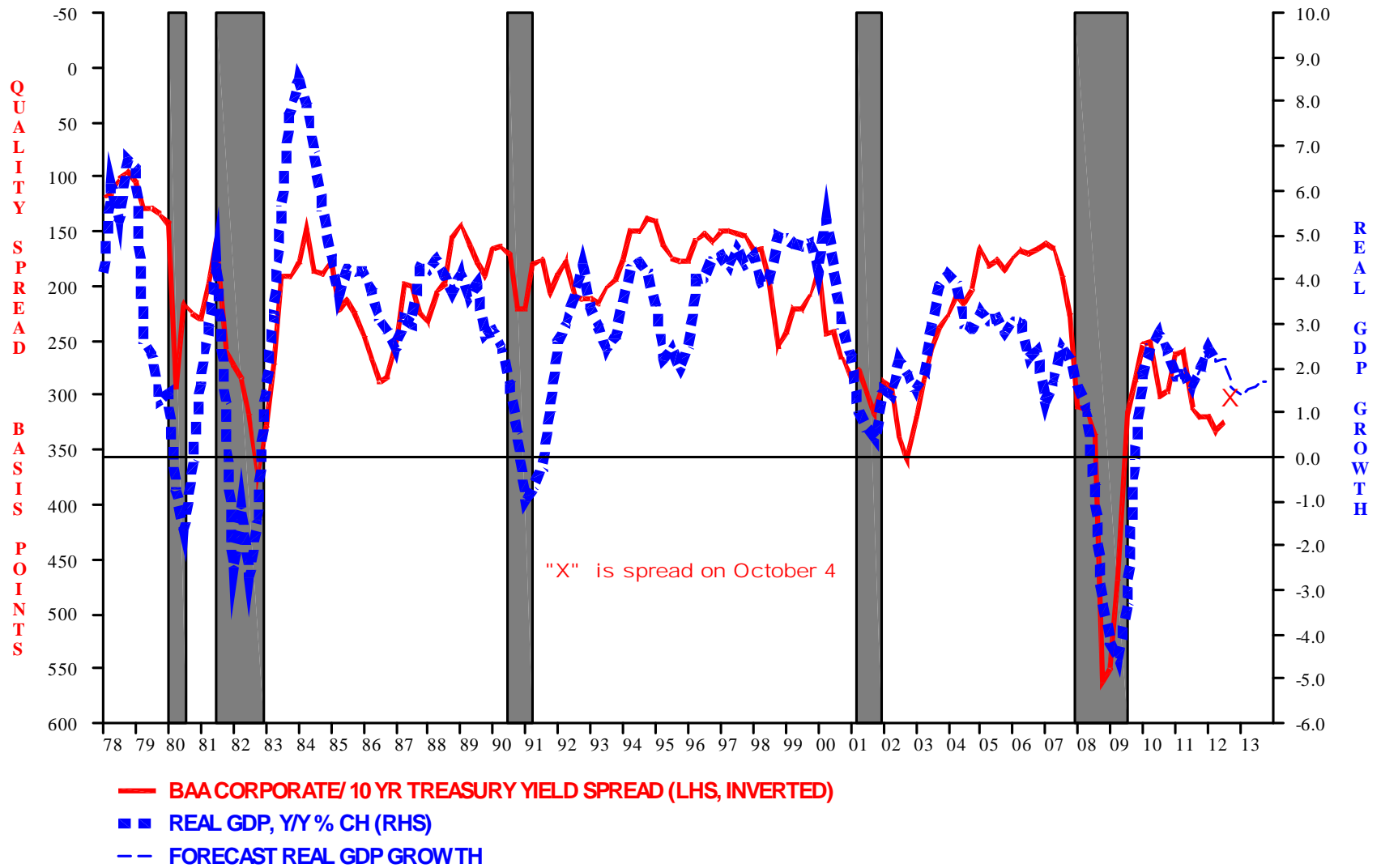
ISM MANUFACTURING INDEX CONSISTENT WITH WEAK ECONOMIC GROWTH



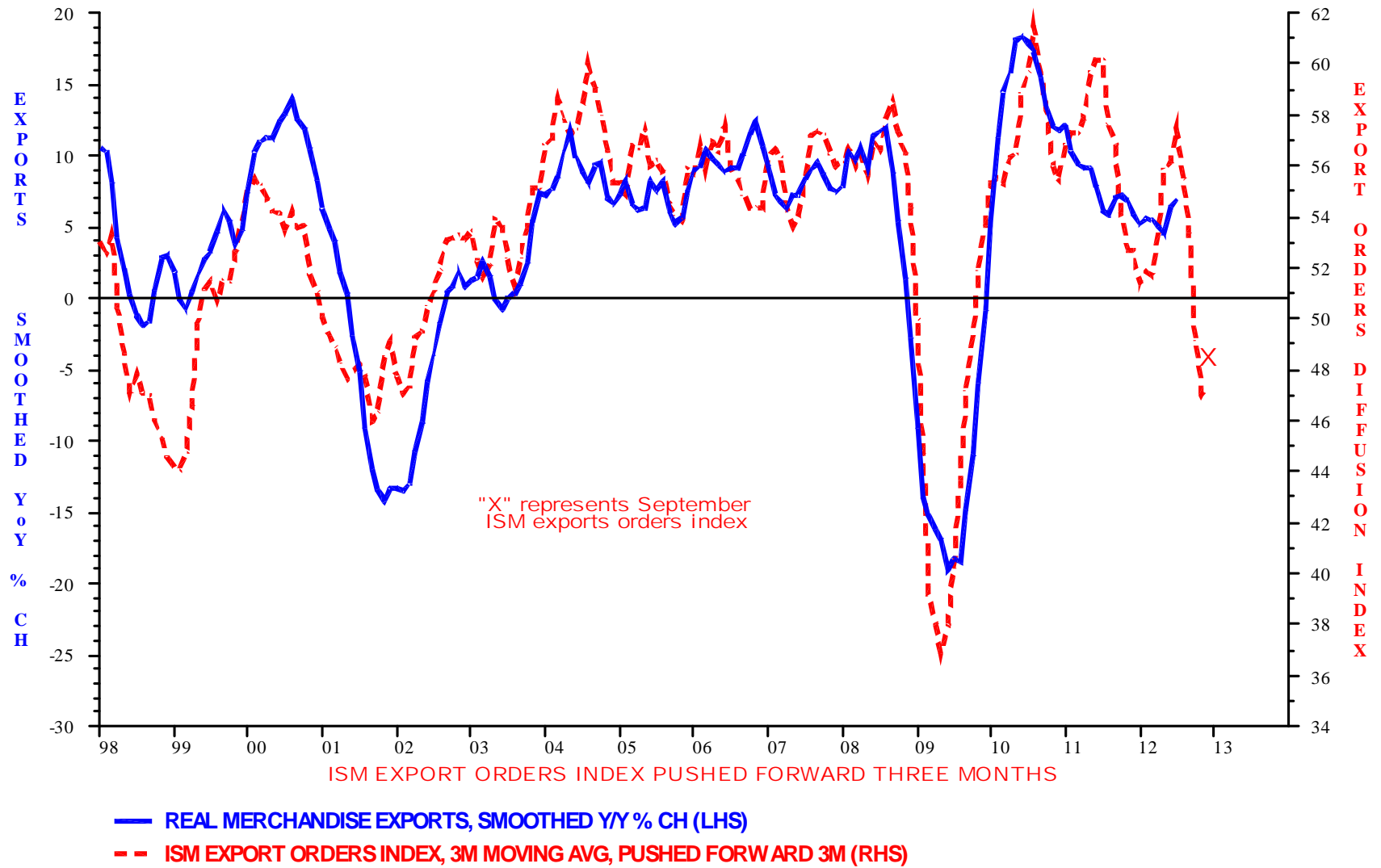
LEI POINTS TO SLUGGISH GDP GROWTH



BAA CORP / 10Y TSY SPREAD CONSISTENT WITH VERY WEAK GROWTH



COLLAPSE IN ISM EXPORT ORDERS INDEX, IF SUSTAINED, IS A VERY BAD SIGNAL FOR EXPORTS

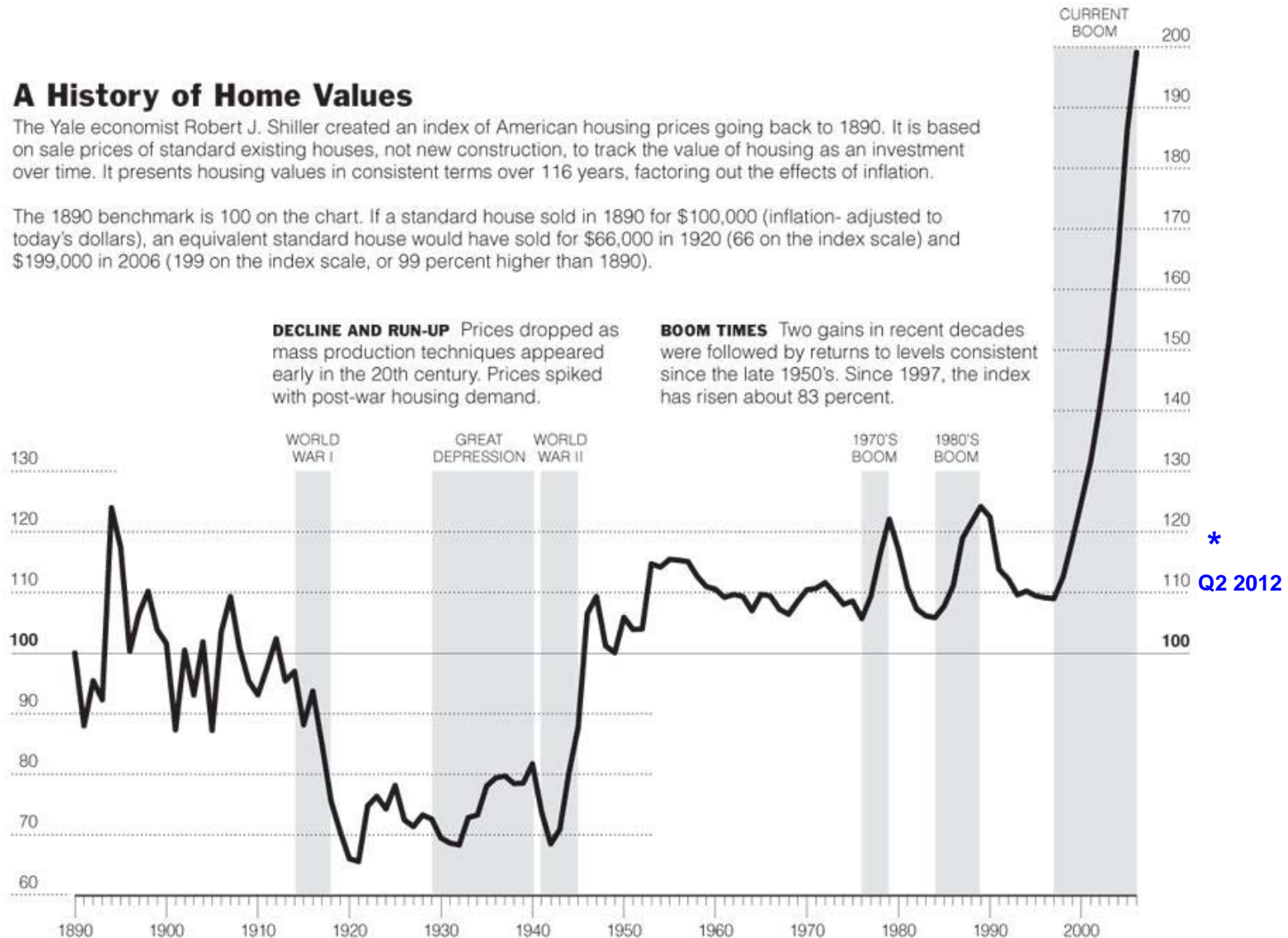


The Housing Bubble Was Unprecedented

A History of Home Values

The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

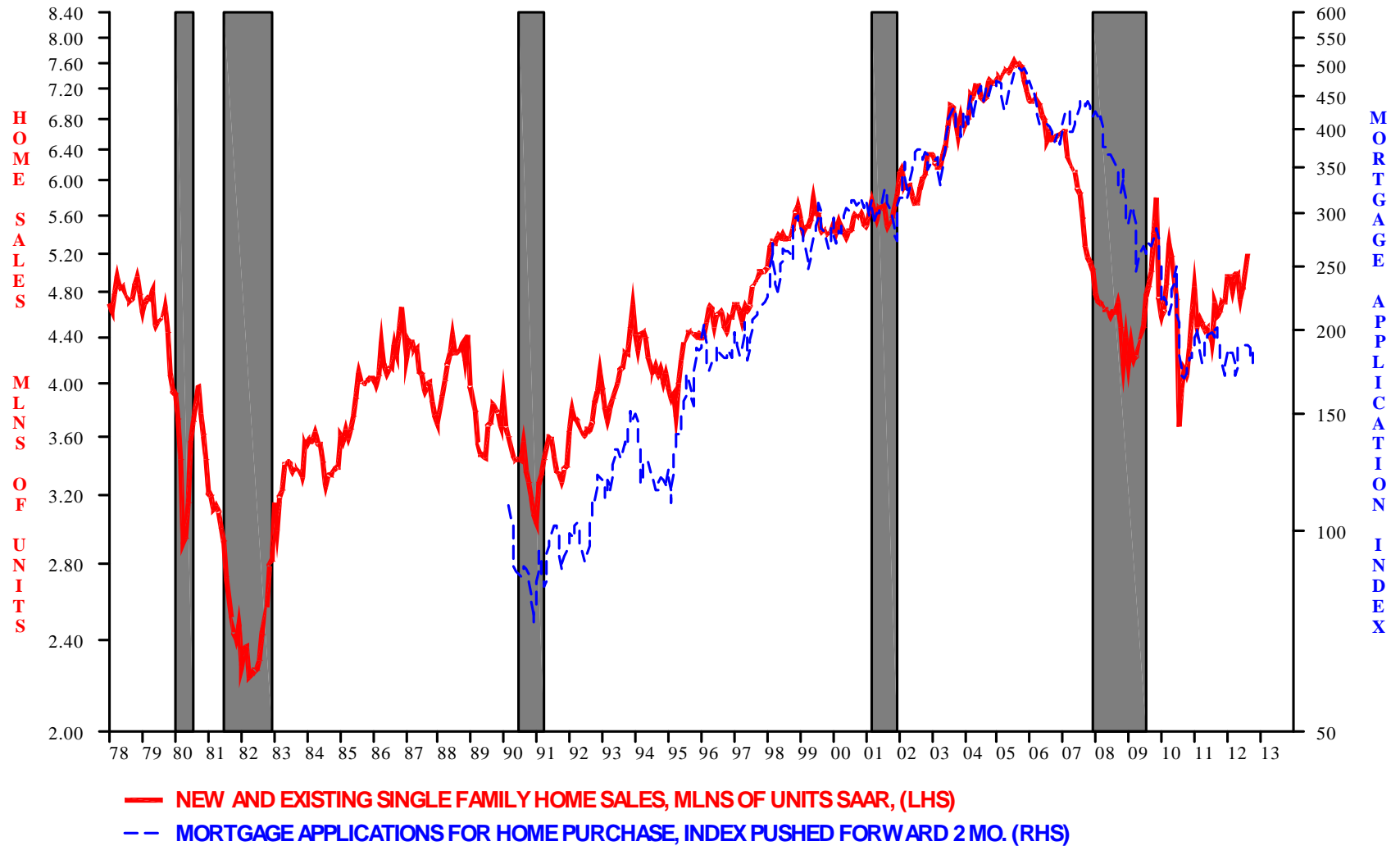
The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for \$100,000 (inflation-adjusted to today's dollars), an equivalent standard house would have sold for \$66,000 in 1920 (66 on the index scale) and \$199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).



Source: "Irrational Exuberance," 2nd Edition, 2006, by Robert J. Shiller

Bill Marsh/The New York Times

GAINS IN HOME SALES CENTERED IN EXISTING CATEGORY; WITH MORTGAGE APPLICATIONS FLAT, THIS POINTS TO SPECULATIVE DEMAND, NOT OWNER-OCCUPIERS

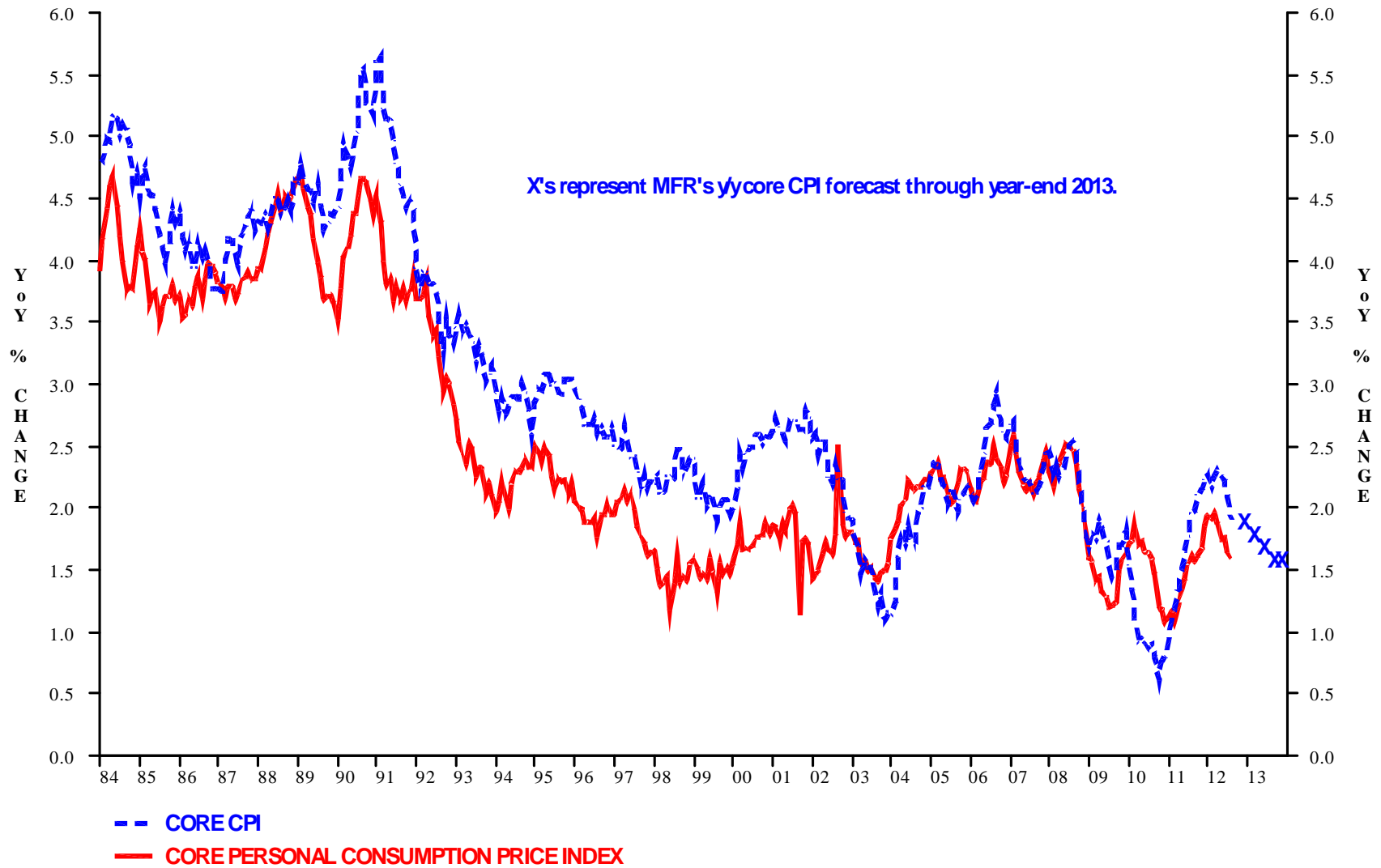


Disinflation to be Dominant in Coming Quarters

- Copious spare capacity has kept core inflation under wraps, and we do not expect upside problems within the medium term.
- Headline measures outpaced core measures in 2011 due to increases in energy and food costs.
- We look for core inflation to recede, and for headline and core inflation to be closer aligned.
- Longer term inflation picture is clouded by debt morass and the consequent temptation for policymakers to try to use inflation as a means of reducing the burden of debt.

	<i>2012:Q3</i>	<i>2012:Q4</i>	<i>2013:Q1</i>	<i>2013:Q2</i>	<i>2013:Q3</i>	<i>2011 q4/q4</i>	<i>2012 q4/q4</i>	<i>2013 q4/q4</i>
CPI q/q annualized	+1.5%	+1.8%	+1.6%	+1.6%	+1.6%	+3.3%	+1.6%	+1.6%
Core CPI q/q annualized	+1.8%	+1.7%	+1.6%	+1.6%	+1.6%	+2.2%	+2.1%	+1.6%

WE BELIEVE THAT CORE INFLATION HAS PEAKED MEASURED ON Y/Y BASIS



MFR Forecast of Fed Funds Target, 2-Year, 10-Year & 30-Year Treasuries (End-of-Quarter Basis)

	-----Actual-----				-----Forecast-----				
	<u>4Q'11</u>	<u>1Q'12</u>	<u>2Q'12</u>	<u>3Q'12</u>	<u>4Q'12</u>	<u>1Q'13</u>	<u>2Q'13</u>	<u>3Q'13</u>	<u>4Q'13</u>
FF	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
2s	0.24	0.33	0.30	0.23	0.25	0.25	0.30	0.40	0.50
10s	1.88	2.21	1.65	1.63	1.50	1.45	1.60	1.75	1.90
30s	2.89	3.34	2.75	2.82	2.65	2.50	2.65	2.80	3.00
2s-FF	12	21	18	10	13	13	18	28	38
10s-FF	175	209	152	150	138	133	148	163	178
10s-2s	164	188	135	140	125	120	130	135	140
30s-10s	101	113	110	119	115	105	105	105	110

(Spreads to Fed Funds are calculated against mid-point of Fed Funds target range.)

Wrap-Up

- **Economy to grow very slowly as post-bubble correction continues and households anticipate lower government spending and higher taxes.**
- **Monetary policy to remain highly accommodative, but at this stage it is basically pushing on a string.**
- **Political dysfunction must be overcome in order to put fiscal policy on a sustainable path.**
- **Doing so will create pain, but doing nothing or not enough will ultimately be even more painful.**
- **The big question, therefore, is whether our splintered, special-interest beholden political system is capable of implementing the necessary changes, or if it will take devastating economic and/or social disruption to spur action.**

MFR – Who We Are

GLOBAL ECONOMIC CONSULTING

Maria Fiorini Ramirez, Inc. (“MFR”) was founded in 1992 to provide *independent* economic consulting and market analysis to financial institutions and corporations around the world. MFR is widely known for its accurate appraisals of U.S. and international economic conditions, central bank policy, political trends, and the effects of these influences on global financial markets. Our forecasts have been repeatedly cited by national publications for their consistent accuracy.

MFR’s clients have access to our staff of experienced economists and strategists, and we encourage such interaction. Our research is distributed on a daily basis via e-mail, on Bloomberg, and through our website (www.mfr.com).

BROKER/DEALER

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