Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent · Objective · Original

Trends Beginning 2011

Conference Call Handout

January 13, 2011

Long-Term Interest Rates - 1900 to 2010

Is QE2′s Purpose To Create A Stock Market Bubble?

In our early November conference call (Handout, Audio, Webcast) we talked extensively about QE2 and its real objective. Bernanke told us yesterday in an extraordinary Washington Post op-ed.

> This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. **Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.**

We say this op-ed is extraordinary because Bernanke's "virtuous stock market cycle" can also be described as a stock market bubble. To be clear, manipulating stock prices higher in hopes that stock prices alone will change beliefs (confidence) and behavior (spending) is a bubble. Bernanke did not say he is trying to ramp the economy higher and that will support higher valuations. This would not be a bubble.

In an interview before the FOMC meeting on Wednesday, Larry Meyer Said:

> **Erin Burnett**: This unemployment issue is the big issue. And now you have the Fed going about it by printing money and I know you said there is a risk it won't work, but what are the calculations they are running to get some sort of link, even if it is a derivative link between, "we print X amount of dollars in quantitative easing and Y happens to the unemployment rate" or is it really true that they have no clue?
>
> **Laurence Meyer**: First of all, here is how they would answer the question that you asked. It has nothing to do with printed money. It has nothing to do with the size of the balance sheet. It has nothing to do with the level of reserves. **The only thing you need to focus on is, "what happens to equity prices, what happens to the dollar, and what happens to borrowing costs?" That's what they're trying to do.** Now we know in normal times, and today too, that higher equity prices are good for aggregate demand. We know that the dollar falling increases our trade competitiveness. That's good for U.S. aggregate demand and lower borrowing costs should be as well. So take your mind off printing dollars and take your mind off the size of the balance sheet and reserves and just focus on the purpose of this. **The purpose of this is to improve financial conditions. If it doesn't, it won't work.**

I know no other way to describe it … Larry Meyer said the Fed's goal is to create another equity bubble to make people feel good so they go out and spend money. To be clear, Meyer said higher equity prices (or better financial conditions) will help the economy. He did **not** say that QE2 will boost the economy and justify higher valuations. Simply put Meyer's characterization that higher equity prices mean higher economic activity is a bubble!

The Latest On The Economy

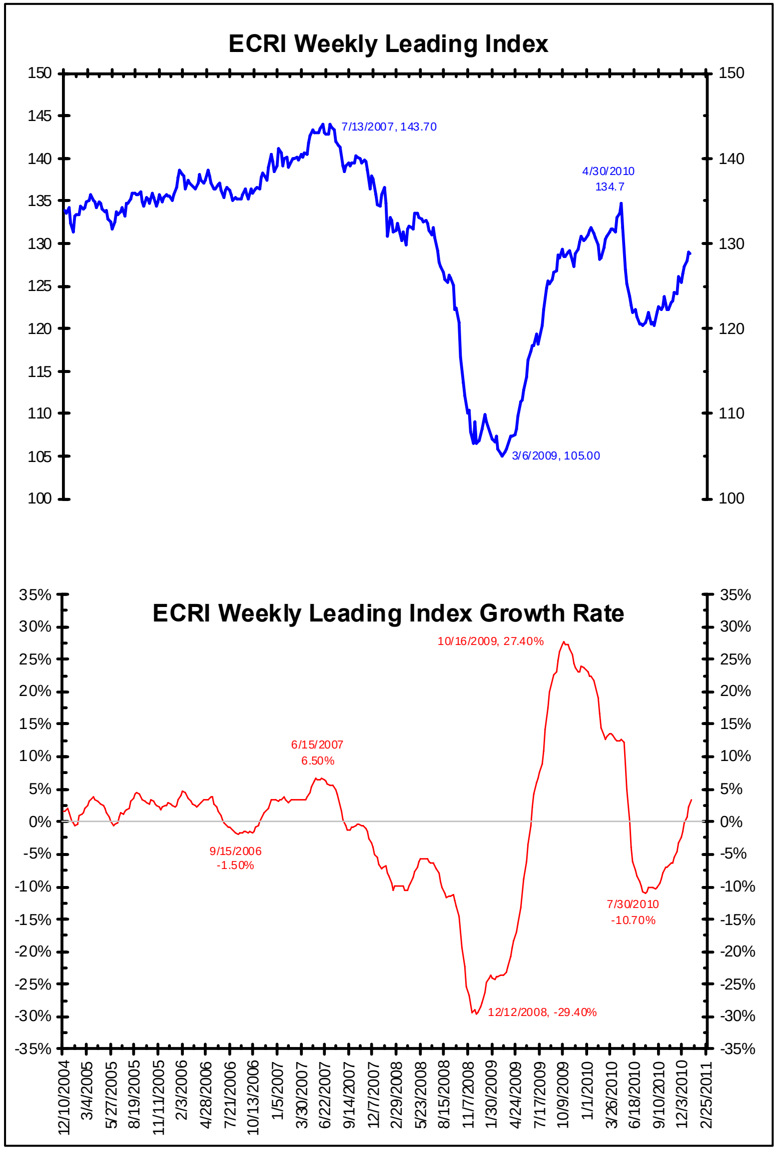
As the chart below shows, the ECRI has definitely improved.

Last summer the consensus was putting the odds of a double-dip at 33%. I was using this chart and saying it was closer to 50%. (For definitional purposes, I defined a double dip as 0% real GDP growth within two years of the end of the recession. Since the recession ended June 2009, that means 0% growth through Q2 2011 would qualify as a double-dip.)

No doubt the economy is weaker than a year ago (when we saw 5% real GDP growth in Q4 2009) and the latest reading of 2.6% in Q3 2010 is nothing to write home about. That said, a "double-dip" appears off the table for now.

What changed? How about QE2. The Fed is printing $600 billion and we have argued this help the stock market rise more than 20% since August 27 (Bernanke's Jackson Hole Speech where he said they were going to do QE2). This rise in stocks, which I have said has bubble characteristics, as explained [here](), is helping real growth and boost consumer confidence.

Will this economic growth last? As long as the Fed prints money, yes. When the Fed stop, I'm not optimistic.



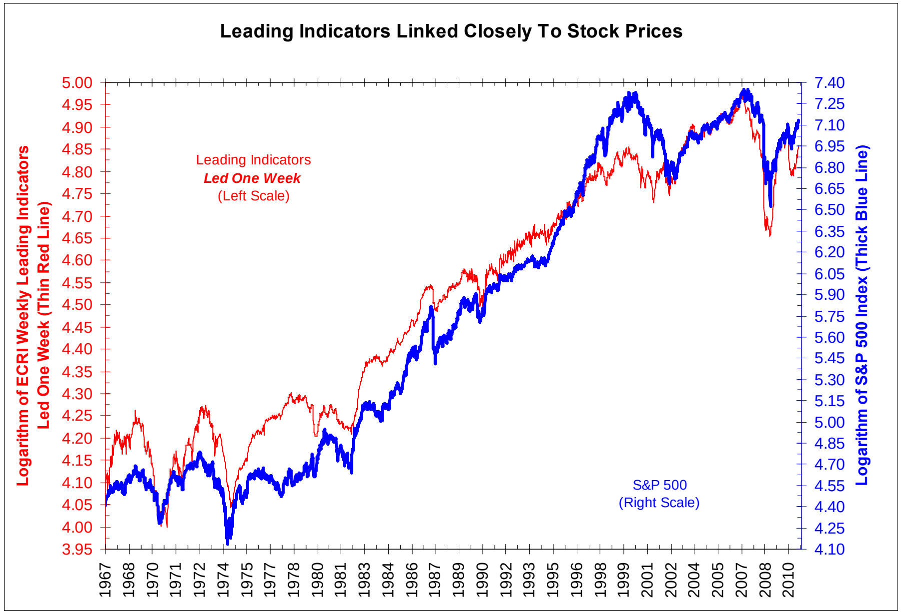
ECRI Weekly Index' Divergences Closing

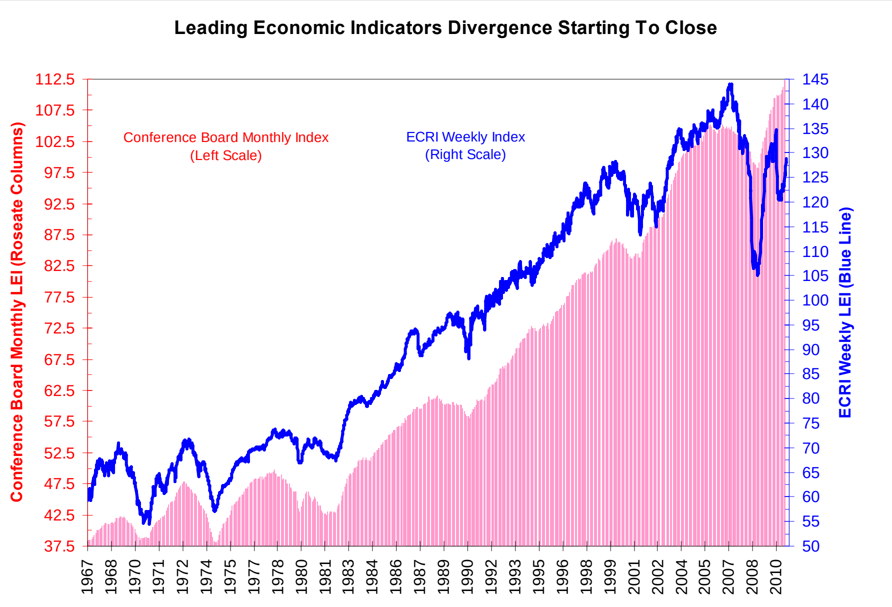
From A Recent **Market Fact**

We noted in June 2010 the ECRI Weekly index of leading economic indicators essentially was the S&P 500 lagged one week on a logarithmic basis (thin red and thick blue lines, respectively, left-hand chart). The r2 of this relationship has been 0.977 since January 1967.

We noted further in July 2010 how the divergence between the JOC-ECRI Weekly leading economic index and the Conference Board's monthly index (blue line and roseate columns, respectively, right-hand chart) could be explained by the drop in mortgage applications for new purchases following the removal of the first-time homebuyers' tax credit.

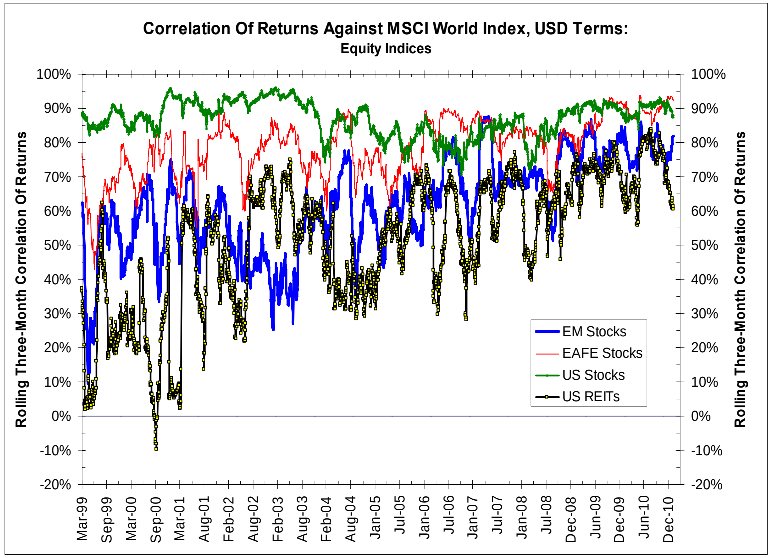
As the mortgage application index, which fell from 291.3 at the end of April 2010 to 172.1 at the time of that writing has rebounded to 199.8, (it had been at 473.7 in January 2006) we should expect the ECRI Weekly index to be moving back in the direction of the Conference Board index. It is doing so; however, the lingering torpor in the mortgage market will depress the ECRI index for the foreseeable future and will make this measure look unnaturally weak.





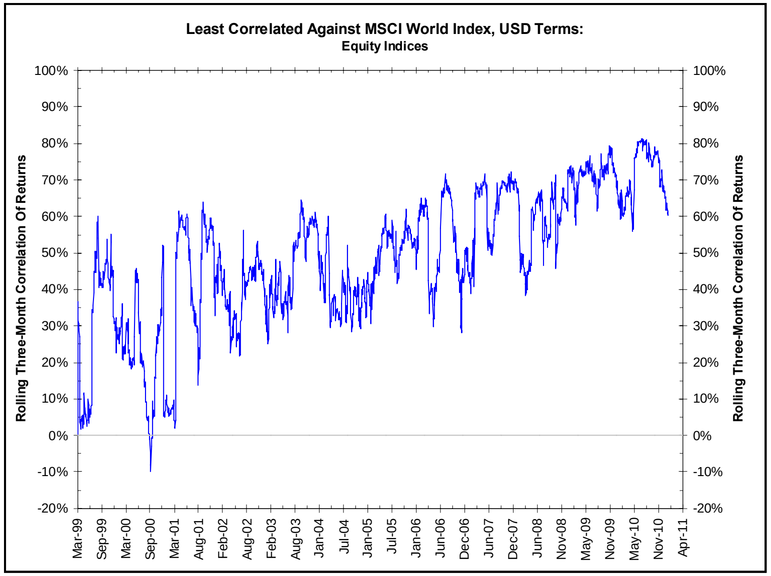
Asset Return Differentiation In QE2 Era - Equities

From A Recent **Market Fact**

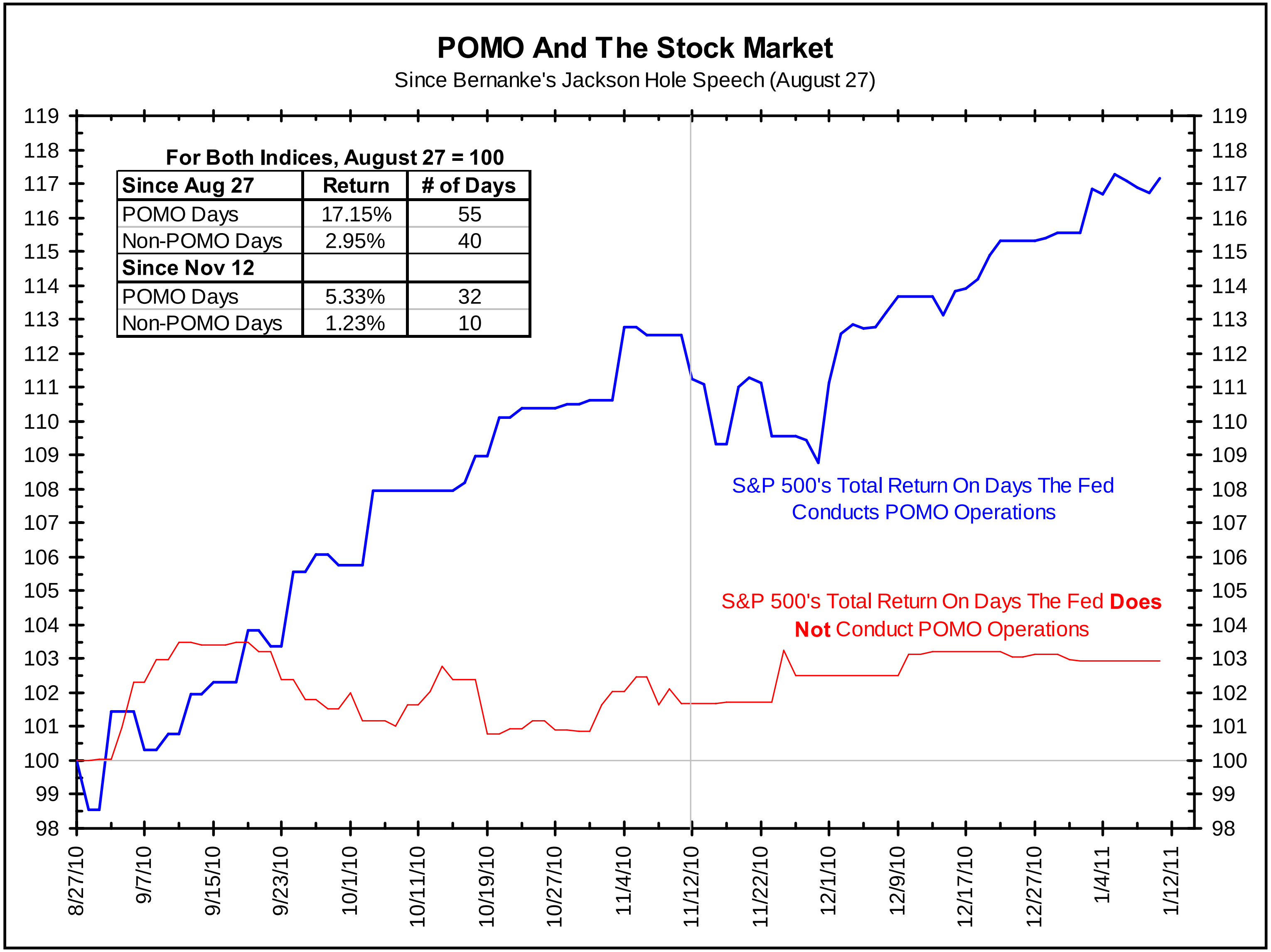


The correlation of returns for the equity indices (top chart) examined, the MSCI Emerging Markets, EAFE, U.S. and U.S. REITs, (blue, red, green and black lines, respectively, top chart) are diverging from each other. In particular, U.S. REITs are continuing to exhibit lower correlation of returns while that of EM stocks is rising.

The bottom chart plots the least correlated equity market from above.

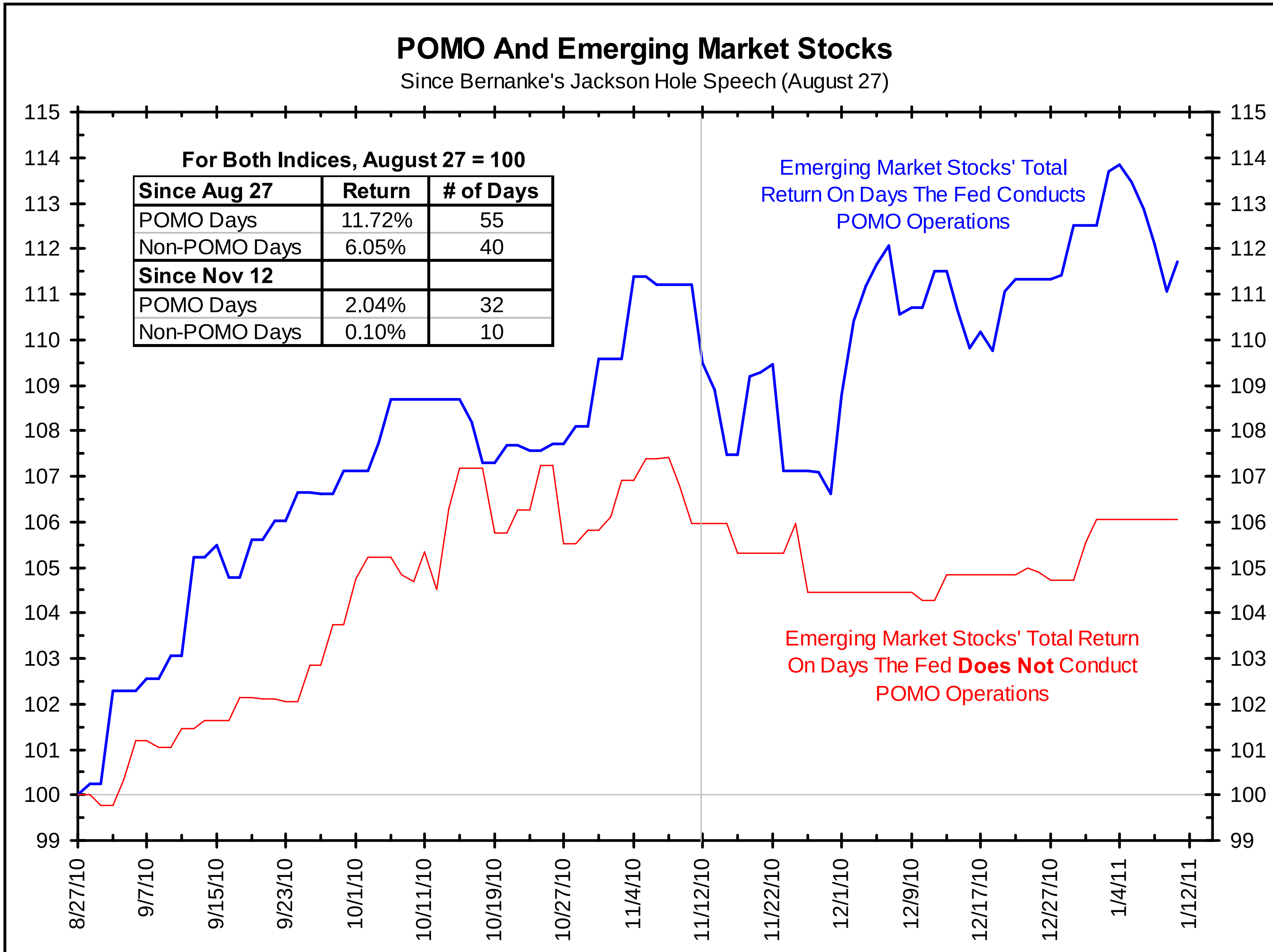


POMO And Stocks



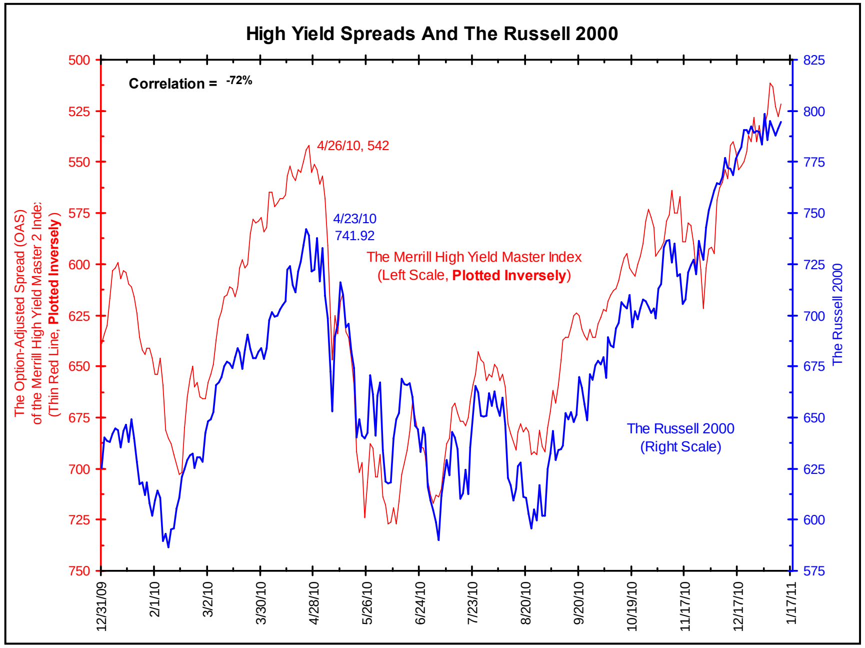
Since Aug 27	Return	# of Days
POMO Days	17.15%	55
Non-POMO Days	2.95%	40
Since Nov 12		
POMO Days	5.33%	32
Non-POMO Days	1.23%	10

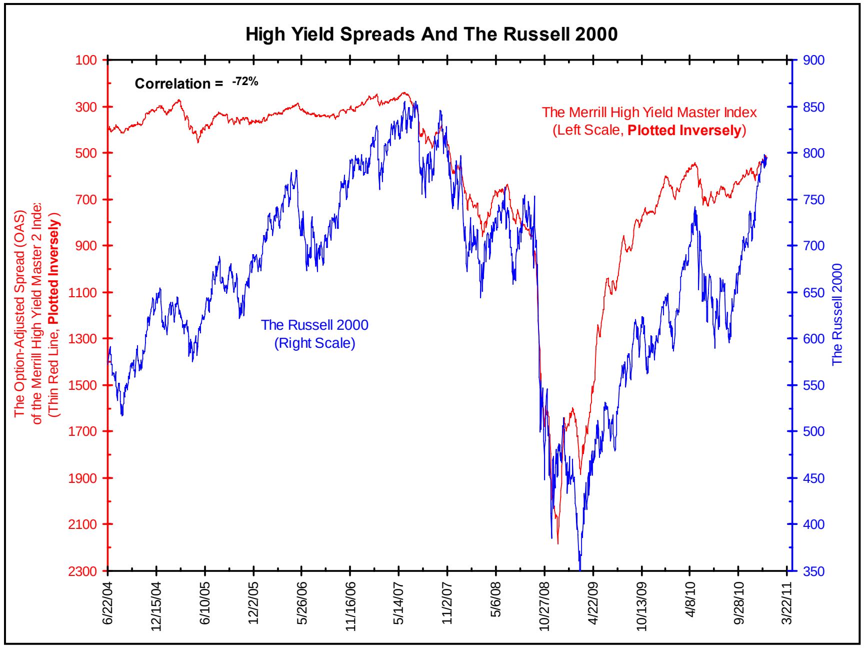
POMO And Emerging Markets



Since Aug 27	Return	# of Days
POMO Days	11.72%	55
Non-POMO Days	6.05%	40
Since Nov 12		
POMO Days	2.04%	32
Non-POMO Days	0.10%	10

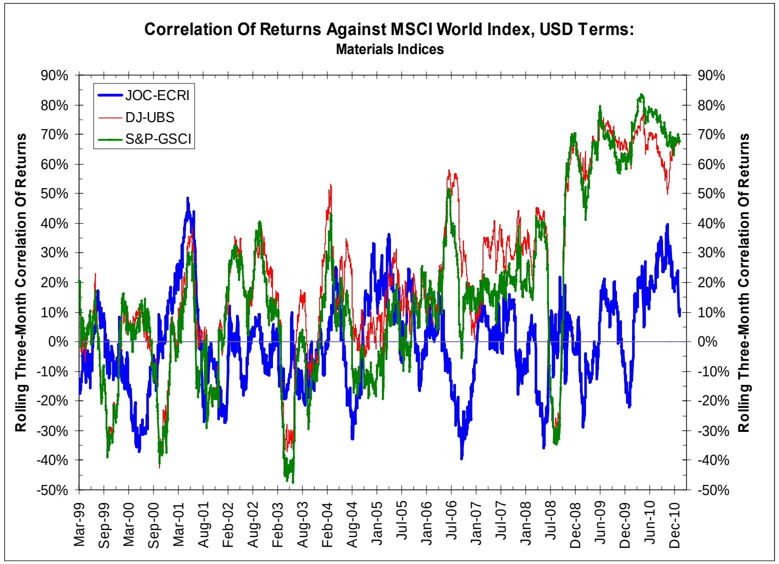
Stocks And Credit





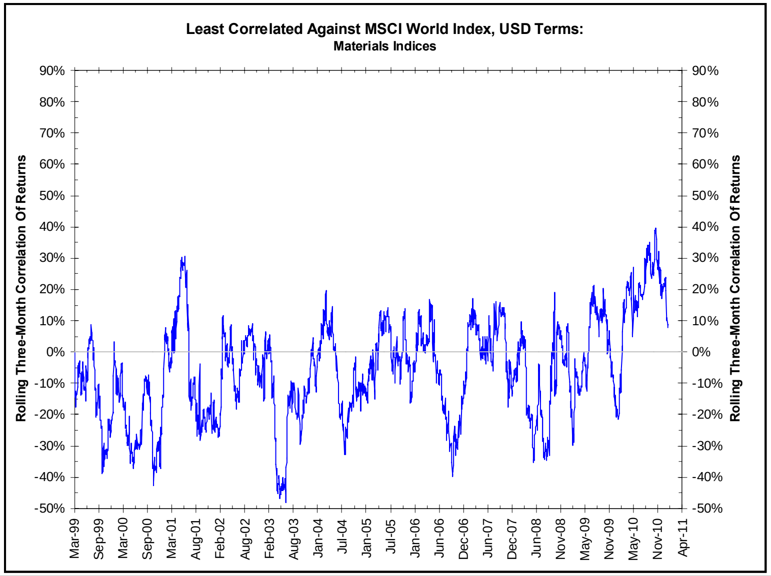
Asset Return Differentiation In QE2 Era - Commodities

From A Recent **Market Fact**

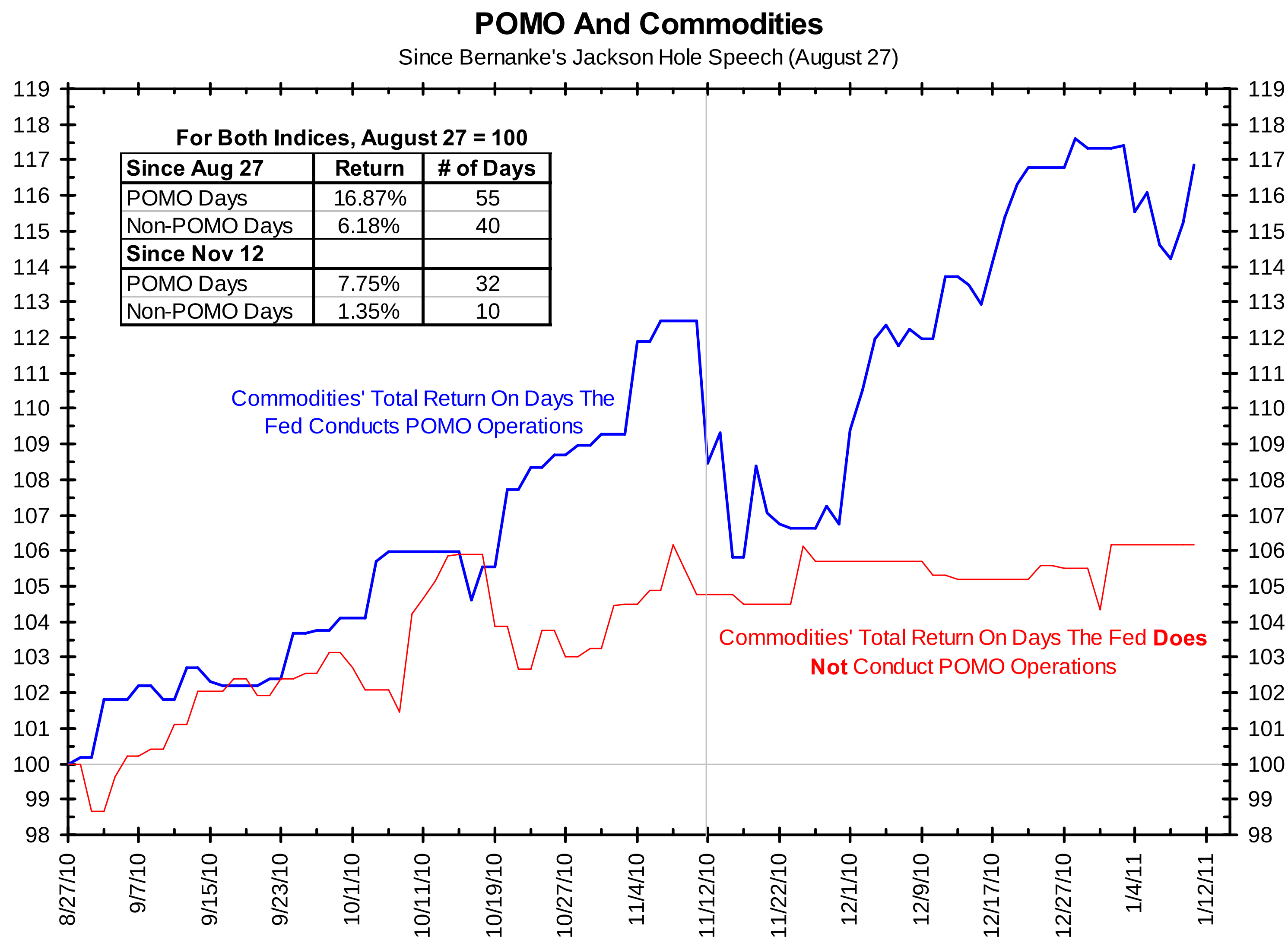


The S&P-GSCI and Dow Jones-UBS indices' correlation of returns (green and red lines, Top chart) have remained between 0.65 and 0.70 since mid-November, although on many days these links seem stronger. The non-traded JOC-ECRI index' correlation of price returns (blue line, top chart) has declined since mid-October.

The bottom chart plots the least correlated commodity Index from above.

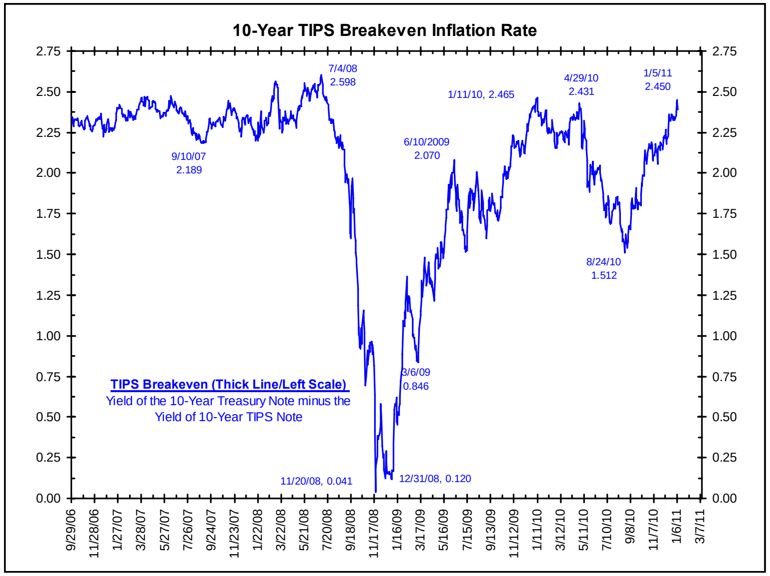


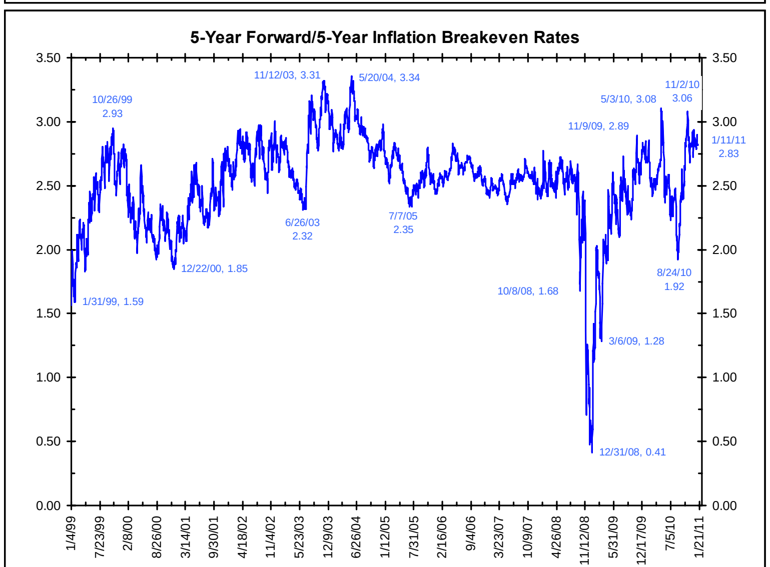
POMO And Commodities

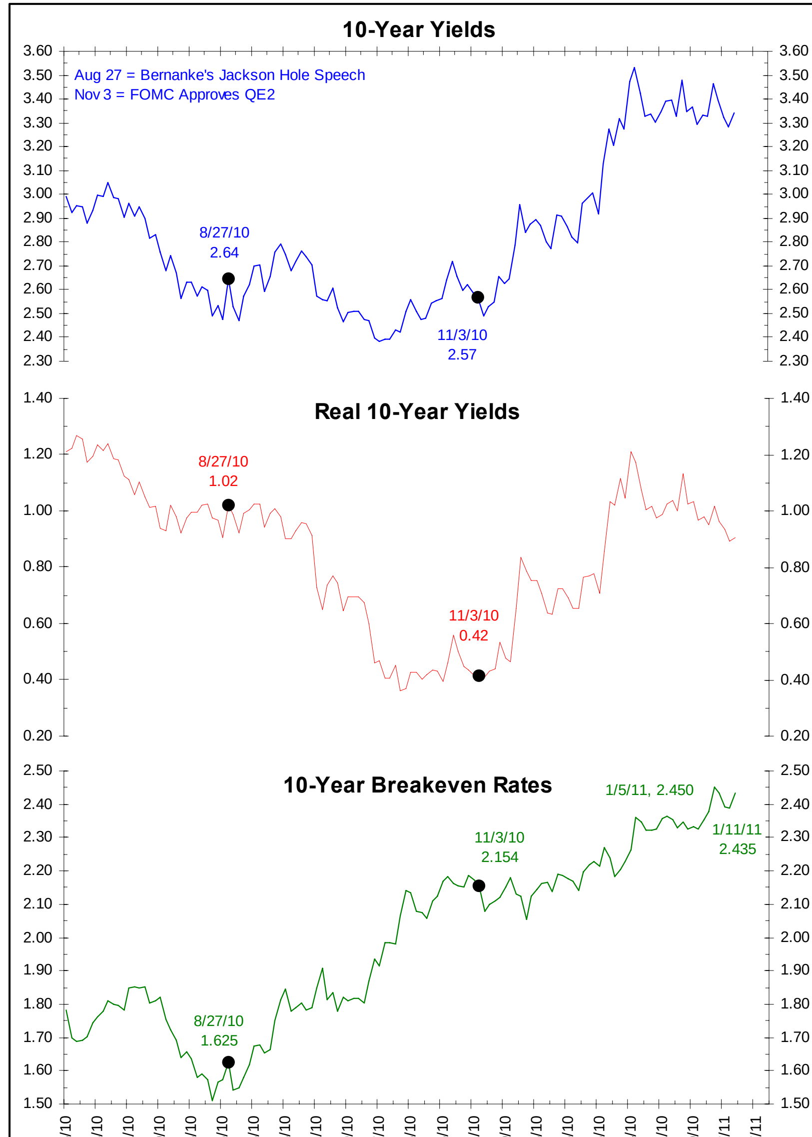


Since Aug 27	**Return**	**# of Days**
POMO Days	16.87%	55
Non-POMO Days	6.18%	40
Since Nov 12		
POMO Days	7.75%	32
Non-POMO Days	1.35%	10

Inflation Expectations





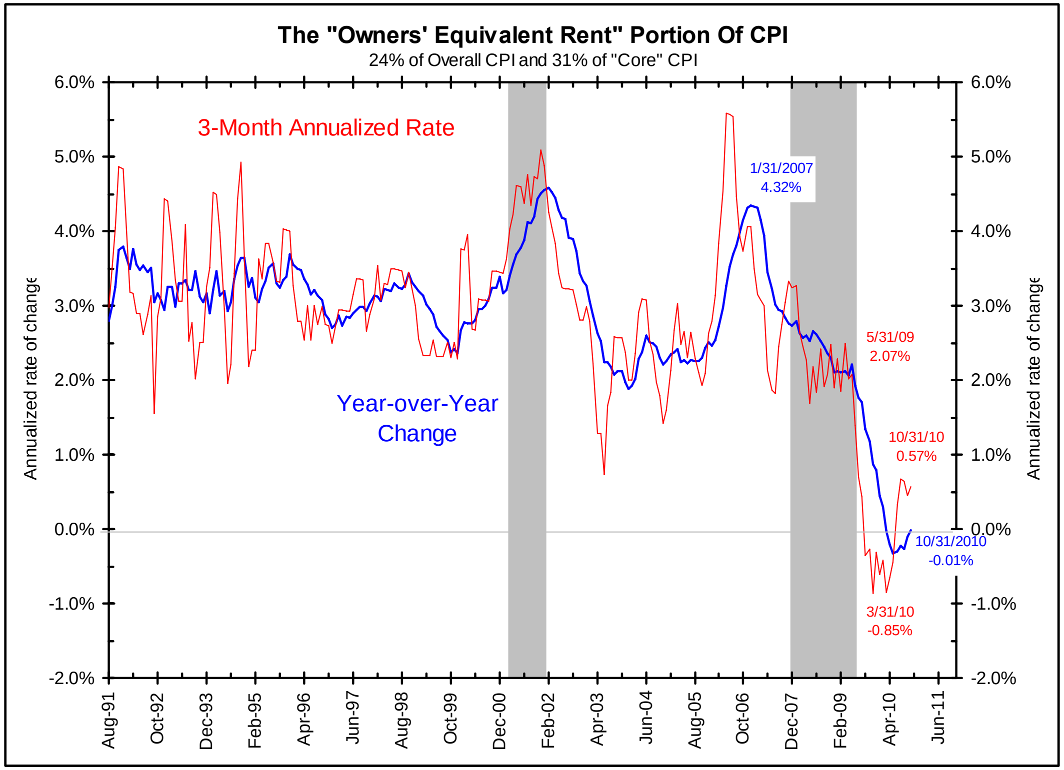


Owners' Equivalent Rent: An Update

From Our Recent **Inflation Watch** Update

Realpage.com – U.S. Apartment Rents Poised to Climb More Than 5 Percent in 2011

While apartment occupancy across the U.S. tightened enough to push rents up modestly during 2010, the stage is now set for a big bounce in pricing during 2011 according to projections from MPF Research, an industry leading market intelligence division of RealPage, Inc. Industry analysts at MPF are forecasting a 5.1 percent jump in rents. Combined with an increase of 0.8 percentage points anticipated in occupancy, the rising rents should increase revenues by 5.9 percent for apartment owners. "The past year was about rebuilding occupancy after job losses during the recession took the rate down to a record low at the end of 2009," said Greg Willett, vice president of research at MPF Research. "While rents have increased slightly, we're just now reaching the point where unit pricing can gain some real momentum in most individual metros." MPF Research's 4th quarter 2010 analysis showed U.S. apartment occupancy reaching 93.5 percent, up from 91.8 percent in late 2009. Effective rents climbed 2.5 percent during the past year, measuring change on a same-store basis. Monthly rents now average $1,029.



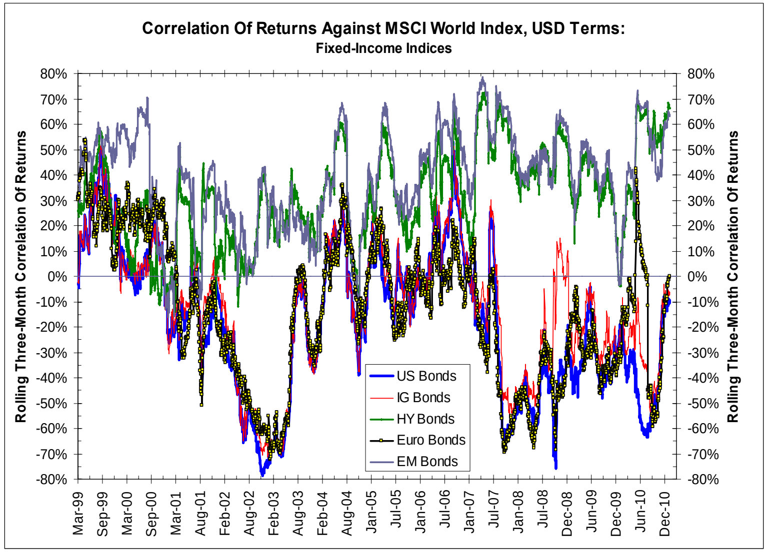
Asset Return Differentiation In QE2 Era – Fixed Income

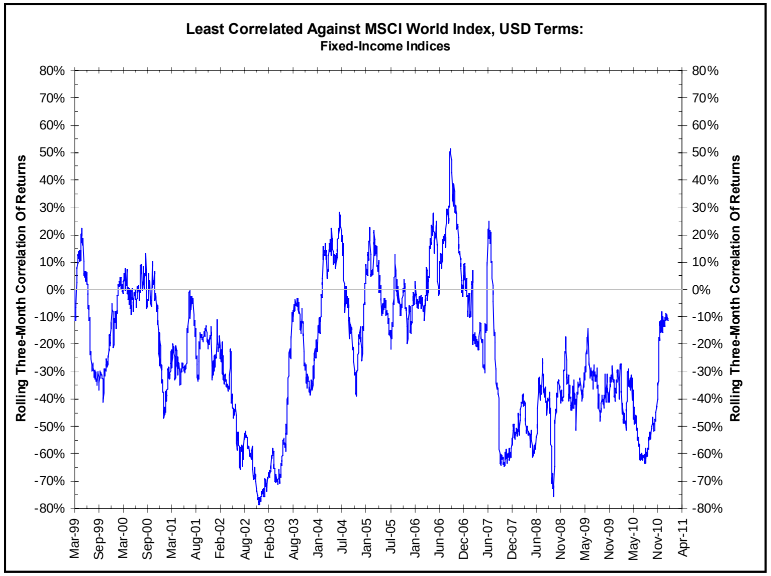
From A Recent **Market Fact**

All bond indices' correlations of returns have turned higher since August; those for EM and high-yield bonds (blue-gray and hatched green lines, respectively, top chart) are approaching their all-time highs, while those for Treasury, investment-grade and Pan-European sovereign bonds (blue, red and hatched black lines, respectively, top chart) are approaching zero from strongly negative levels.

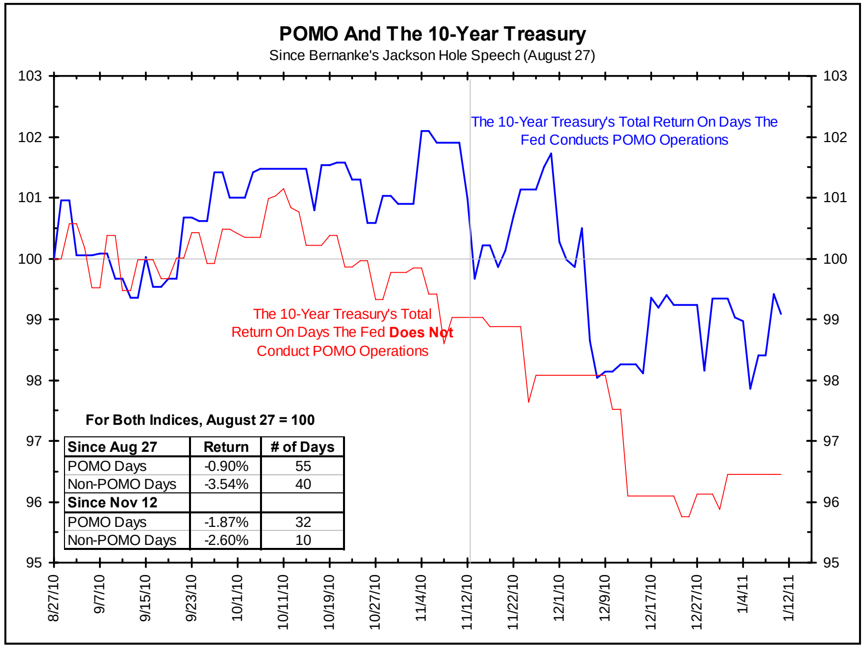
The bottom chart plots the least correlated fixed-income Index from above.

The "risk-off" trade has disappeared: Bonds that had rallied when stocks struggled now are staying stable or even rising as stocks rise. Eventually, the cycle will complete by bonds struggling as stocks rise in a manner similar to 2004-2007.

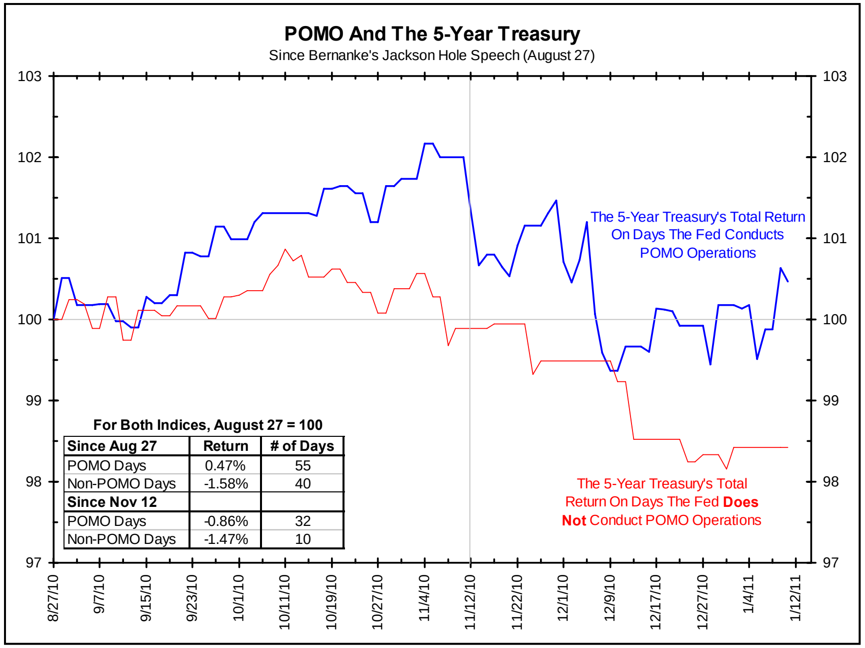




POMO And Bonds

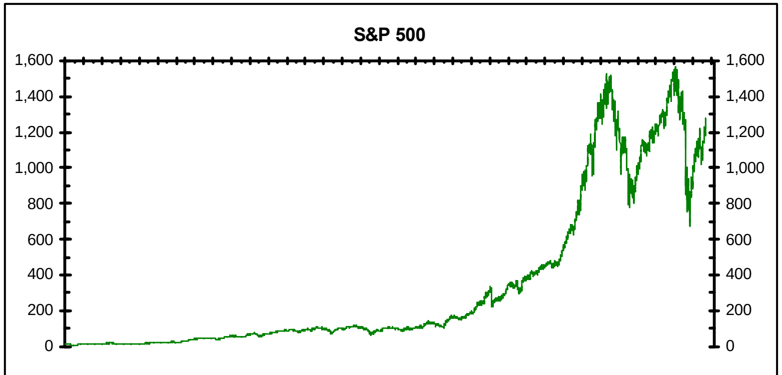


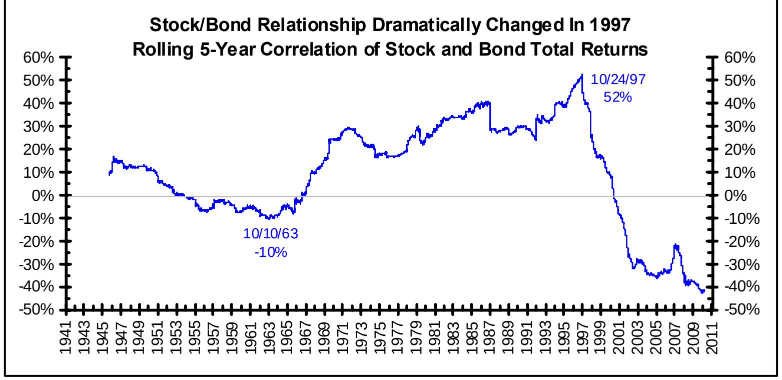
Since Aug 27	Return	# of Days
POMO Days	-0.90%	55
Non-POMO Days	-3.54%	40
Since Nov 12		
POMO Days	-1.87%	32
Non-POMO Days	-2.60%	10

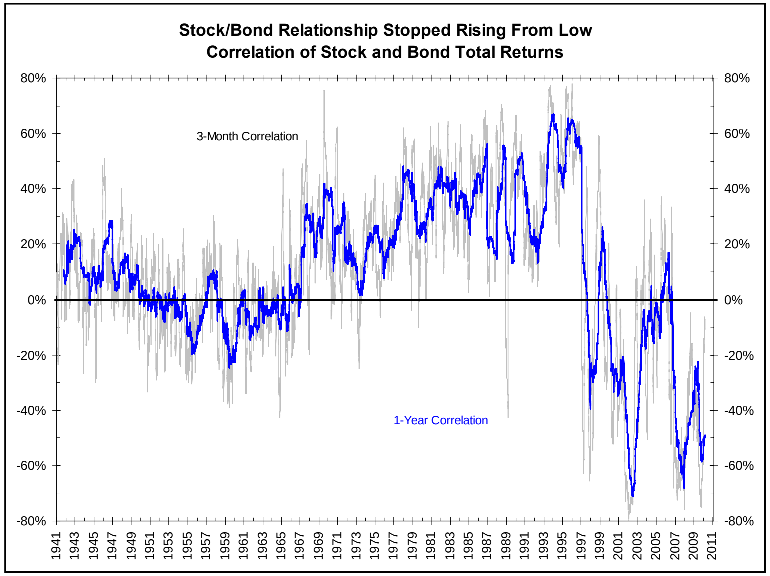


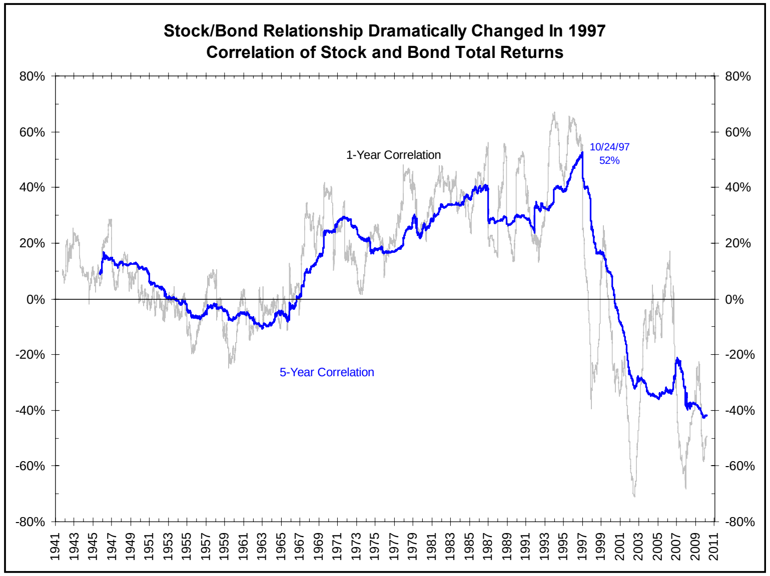
Since Aug 27	Return	# of Days
POMO Days	0.47%	55
Non-POMO Days	-1.58%	40
Since Nov 12		
POMO Days	-0.86%	32
Non-POMO Days	-1.47%	10

Has QE2 Affected The Stock/Bond Relationship?







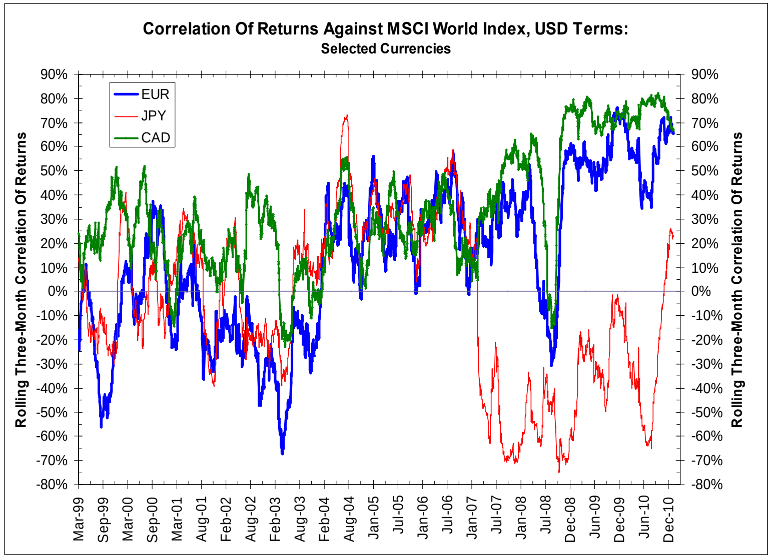


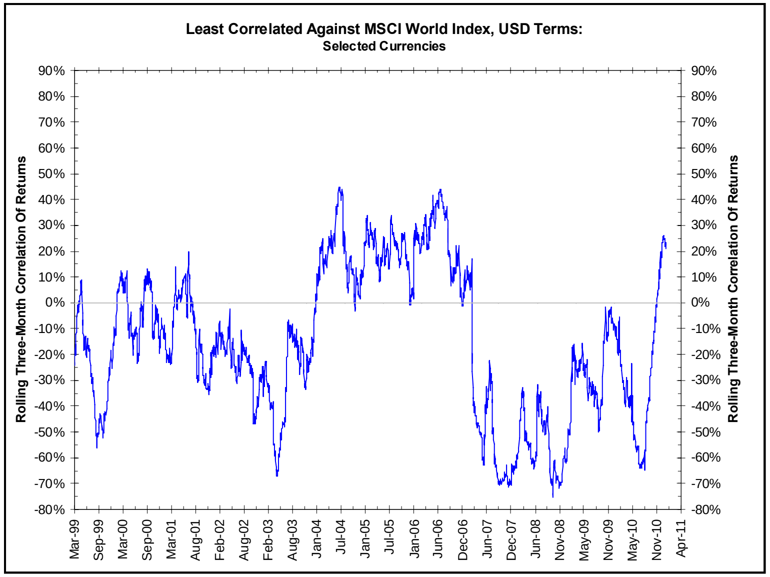
Asset Return Differentiation In QE2 Era - Currency

From A Recent **Market Fact**

The most notable aspect of currency markets' correlations of excess carry returns against the MSCI World Index has been the re-convergence of the yen (thin red line, top chart) to the euro and Canadian dollar (thick blue and hatched green lines, respectively, top chart). **Japan, as we suggest in October 2010, has found a way to cheapen the yen, much to the benefit of U.S. financial markets.**

The bottom chart plots the least correlated currency from above.

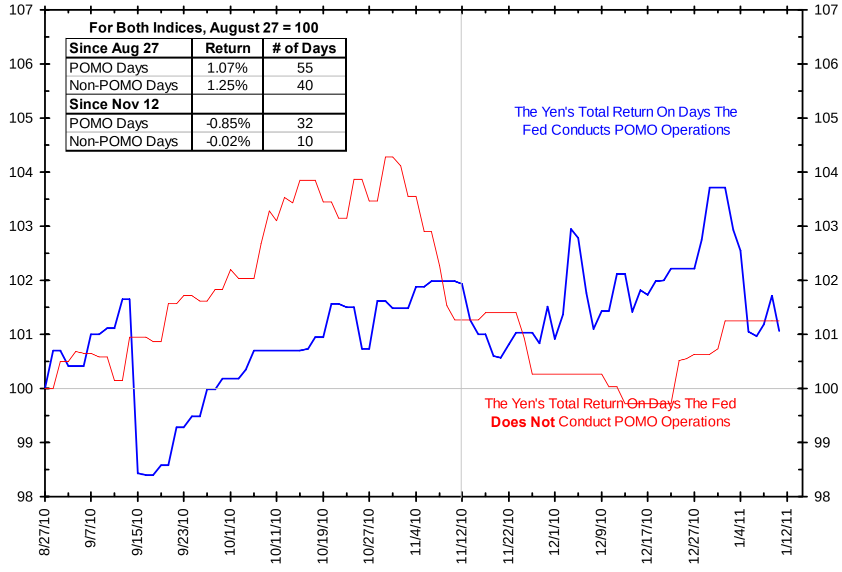




POMO And Currencies

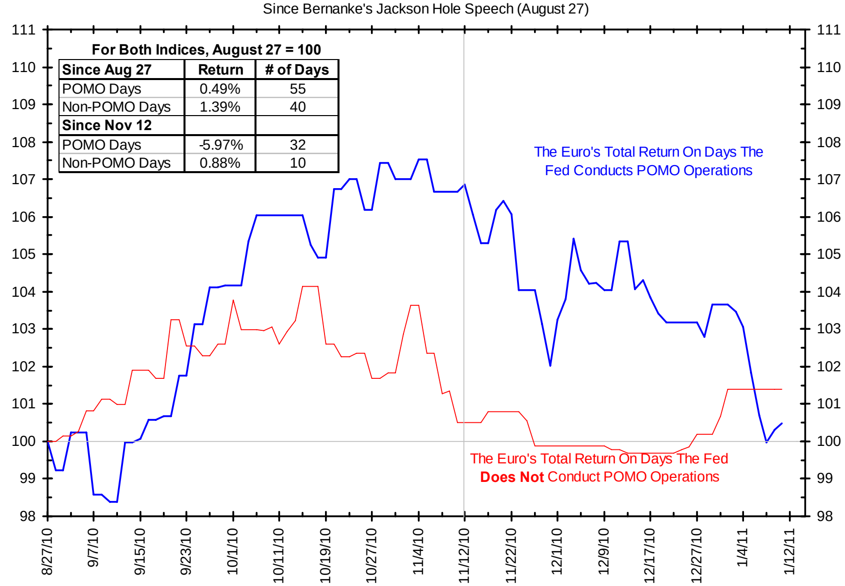
POMO And The Yen

Since Bernanke's Jackson Hole Speech (August 27)

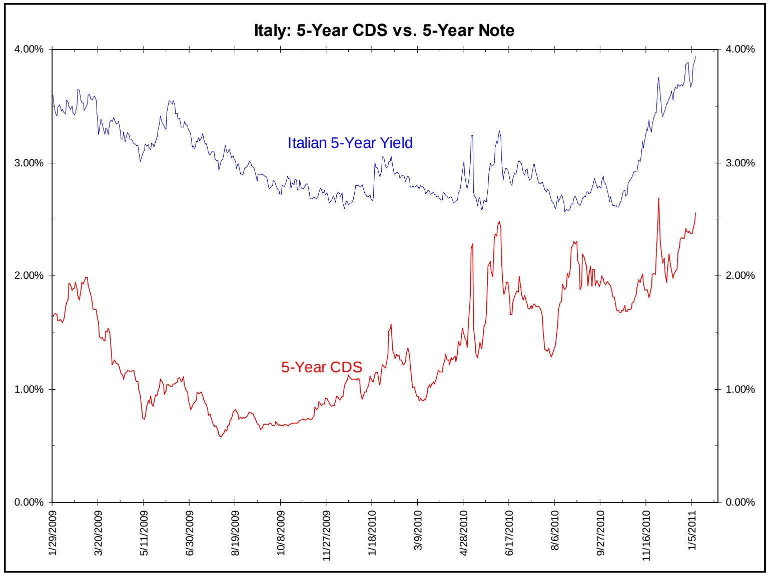


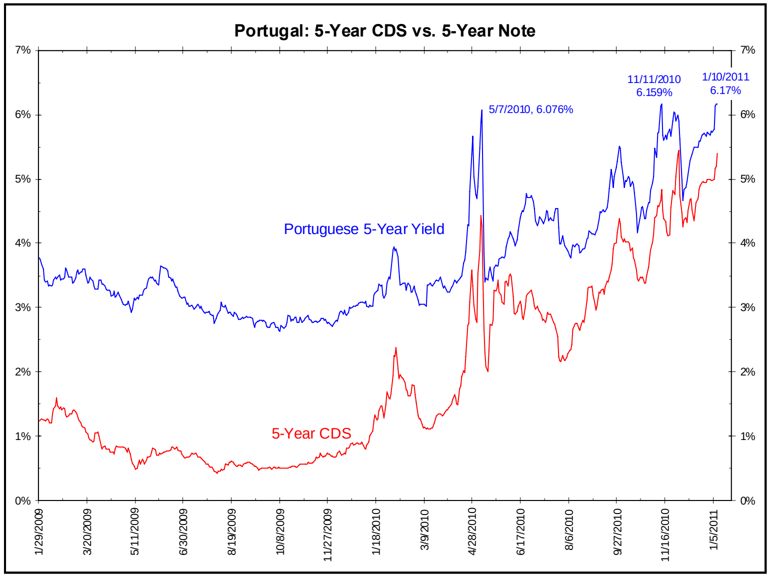
POMO And The Euro

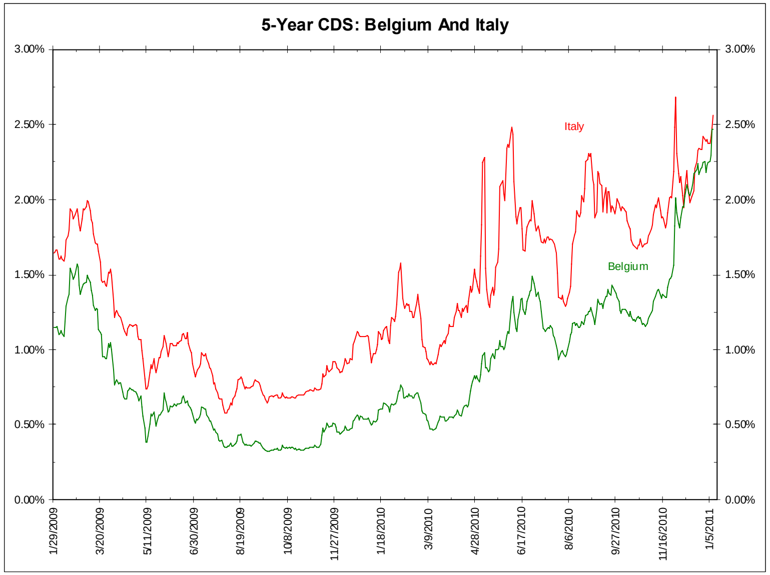
Since Bernanke's Jackson Hole Speech (August 27)

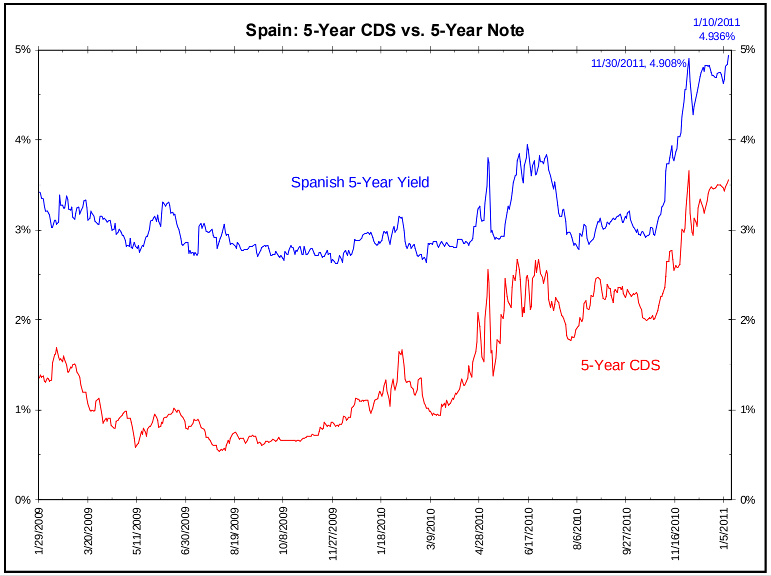


European Interest Rates And CDS

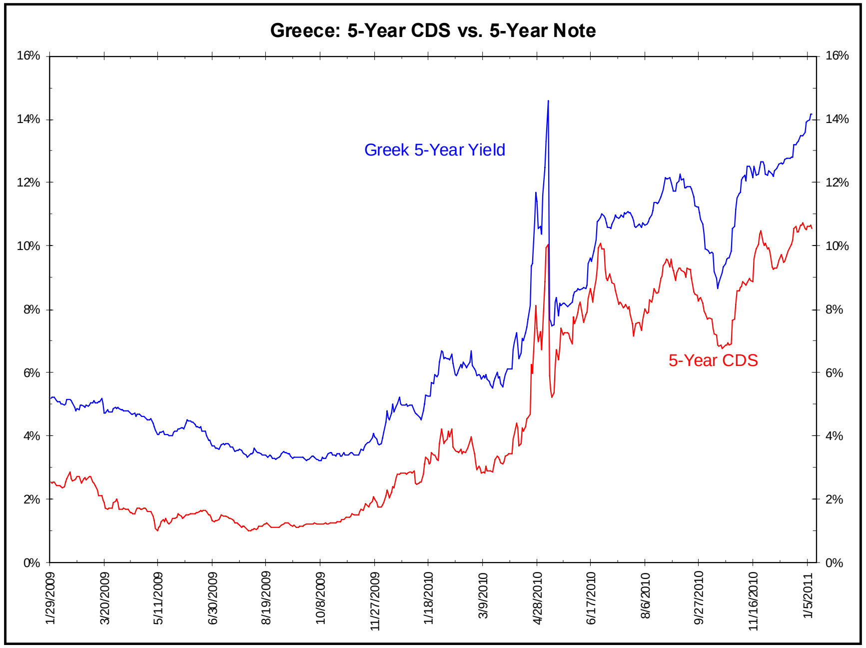


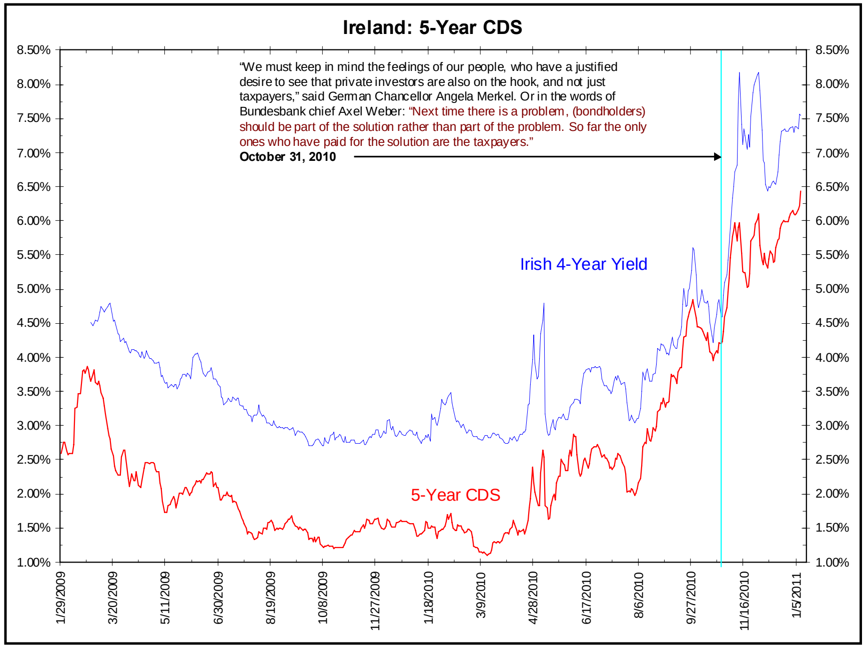






European Interest Rates And CDS - 2





Bianco Research L.L.C.

Clybourn Galleria
1731 N. Marcey Street
Suite 510
Chicago IL 60614

Phone: (847) 304-1511
Fax: (847) 304-1749
e-mail: research@biancoresearch.com
http://www.biancoresearch.com

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599
James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511
Howard L. Simons hsimons@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Ryan Malo rmalo@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 606-1872
Fritz Handler fritz.handler@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone: (847) 304-1560 Fax: (847) 304-1595
e-mail: inforequest@arborresearch.com
http://www.arborresearch.com

Domestic - For more information about Arbor Research & Trading and its services:

New York Sales Office
The Chrysler Building
405 Lexington Ave
New York, NY 10174
Edward T. McElwreath ed.mcelwreath@arborresearch.com
Phone (212) 867-5326 Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

London Sales Office
3rd Floor,4 Broadgate
London England EC2M 2QS
Phone 44-207-100-1051
Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com

International Sales
James L. Perry james.perry@arborresearch.com
Phone (847) 756-3510 Fax (847) 304-1595
Rich Kleinbauer rich.kleinbauer@arborresearch.com
Phone (41) 22 365-1850

Far East Sales
Robert Reynolds robert.reynolds@arborresearch.com
Phone (847) 756-3680 Fax (435) 647-3073

Copyright © 2011 Bianco Research, L.L.C.

This message is intended only for the personal and confidential use of the designated recipients named above. If you are not the intended recipient of this message you are hereby notified that any review, dissemination, distribution or copying of this message is strictly prohibited. This communication is for information purposes only and should not be regarded as an offer to sell or as a solicitation of an offer to buy any financial product, an official confirmation of any transaction, or as an official statement of Bianco Research LLC. Email transmission cannot be guaranteed to be secure or error-free. Therefore, we do not represent that this information is complete or accurate and it should not be relied upon as such. All information is subject to change without notice.