

Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent • Objective • Original

March 2010

1731 North Marcey, Chicago IL 60614

www.biancoresearch.com

Special Report

March 2010

Market Outlook

March 11, 2010 Conference Call
(This transcript has been edited)

James A. Bianco, President, Bianco Research:
Good morning, everybody. This is Jim Bianco. Welcome to our Conference Call.

Summary/Conclusion

Today's topic is "Market Outlook." The reason I called it this is because there are about four or five different things that I want to try and touch upon, that we've been discussing in the last couple of months and I think are important issues.

They are core inflation and why we think that there might be an unexpected surprise coming with core inflation. And, within that, we'll touch a little bit on housing and REITs, and talk about the deficit and deleveraging, or the lack thereof of deleveraging. And that will lead us into a little bit of a discussion of why, I think, we're having a sovereign debt crisis.

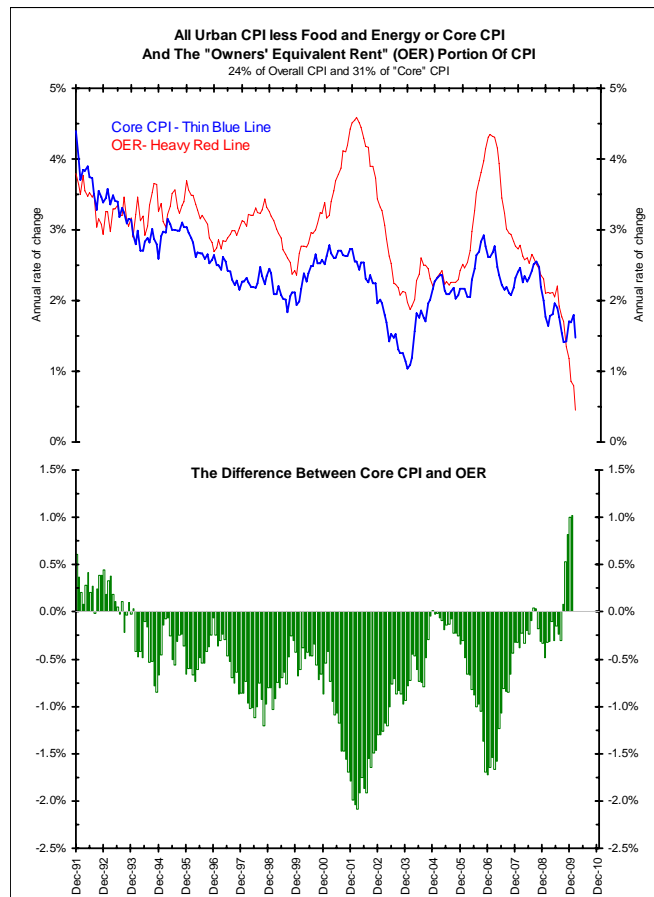
And then, lastly, I want to finish up with earnings and talk a little bit about the effect that the financial sector is having on earnings in terms of the market.

So, with that, let's turn to Page 2 of the handout – "Is There a Core Inflation Problem?"

This is a case that we've been making for a couple of months now, that there very well might be a core inflation problem unfolding. I know that this is a controversial call, as not many people think this way. But let me run through it one more time.

Is There A Core Inflation Problem?

On the chart on Page 2, the blue line is core CPI. The red line is owner's equivalent rent, or OER. As the headline of the chart says, in the top panel, 31% of core inflation is owners' equivalent rent, so it's roughly around a third.



You'll notice that the red line is collapsing.

The green bars on the second panel below show the difference between core inflation and OER. Normally, OER runs at a higher rate than overall core inflation, and that is signified by the negative bars. But, now, the positive bars are showing that core inflation is actually now higher than its biggest component – owners' equivalent rent.

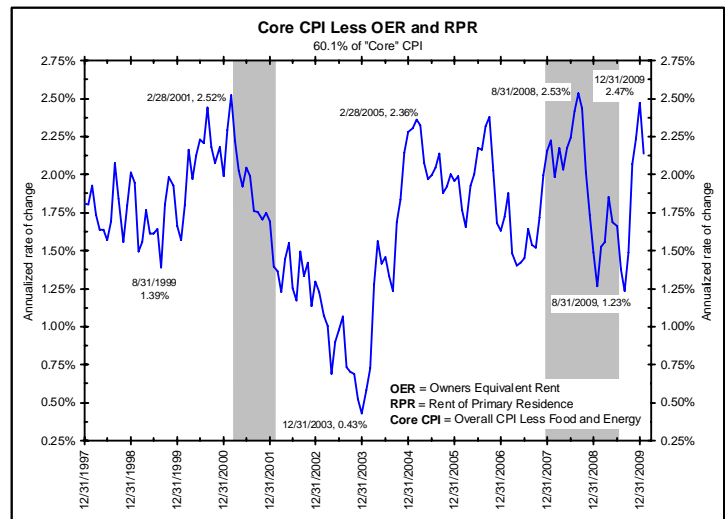
One of the reasons that you're seeing core inflation being held at bay is because owners' equivalent rent has been falling apart. And if you actually were to take a look on Page 3, going to the next page, there's a table in the upper right corner, and on that table, we highlight owners' equivalent rent.

There's another measure that's very similar to it, which is called rent of primary residences. This uses the same series as owner's equivalent rent. Owners' equivalent rent is a survey of rental units. They put the data into an econometric model, from which they calculate housing inflation, how much of your house's appreciation was due to inflation versus how much was due to, say, real growth or real appreciation beyond inflation.

So they use the survey in an econometric model. They use the same data in a different econometric model to calculate rent inflation -- so if you are a renter, how much of your increase in rent is due to inflation as opposed to supply/demand characteristics that the landlord can just get away with more. That's another 6% or so of overall inflation. And it's another 9% or so of core CPI.

Housing's Effect On Core Inflation Larger Than Thought

The chart on the bottom left, on Page 3, shows those two series – in blue, rents of primary residence and, in red, owners' equivalent rent. You'll see that both of them have been declining.



You'll see that what we've done is that we've recalculated core CPI less owners' equivalent rent and RPR. And you'll see that core CPI less those two measures is running near the highs that we've seen in the last 12 years. As a matter of fact, December's number – 2.47% – was just a couple of tenths off of a 12-year high in this measure.

Now, I do this because I'm not saying that this is the proper measure. I'm not trying to say, "Let's strip out more." I just wanted to highlight that, away from rents of primary residences and away from owners' equivalent rent, the underlying trend of core CPI is problematic for a Federal Reserve that is at 0%. And if you believe Charlie Evans as he spoke at the NABE Conference earlier this week and has made some headlines, they are going to stay at zero for many, many more months.

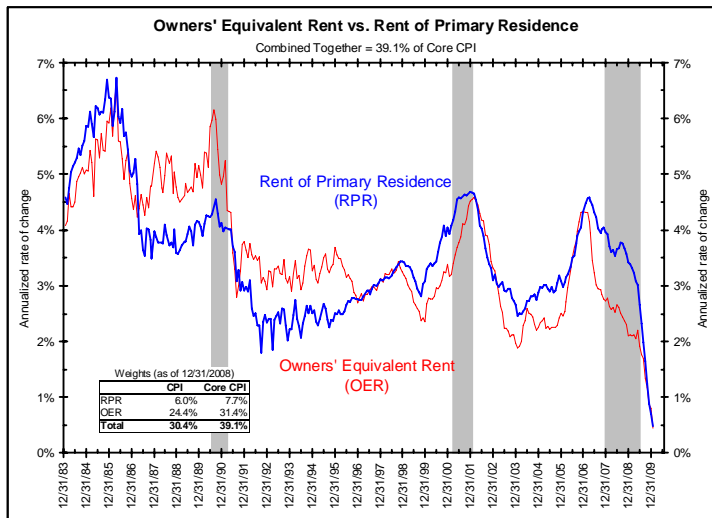
2.5% is not a big deal unless the funds rate is at 0%, and you have \$1 trillion of excess reserves. Then this, I believe, becomes problematic for the Federal Reserve should these numbers stay very high.

Now this is going to get no play in the marketplace unless or until the core measures of CPI start moving higher overall. Now, how do core measures of CPI start moving higher? That's if owners' equivalent rent and RPR bottom out, and that big decline that we saw with them stops going down.

The Anatomy Of A Housing Bottom

Starting on the chart on Page 4, I want to make a simple case for you of why we might be seeing the beginnings of those things at least running their course right now.

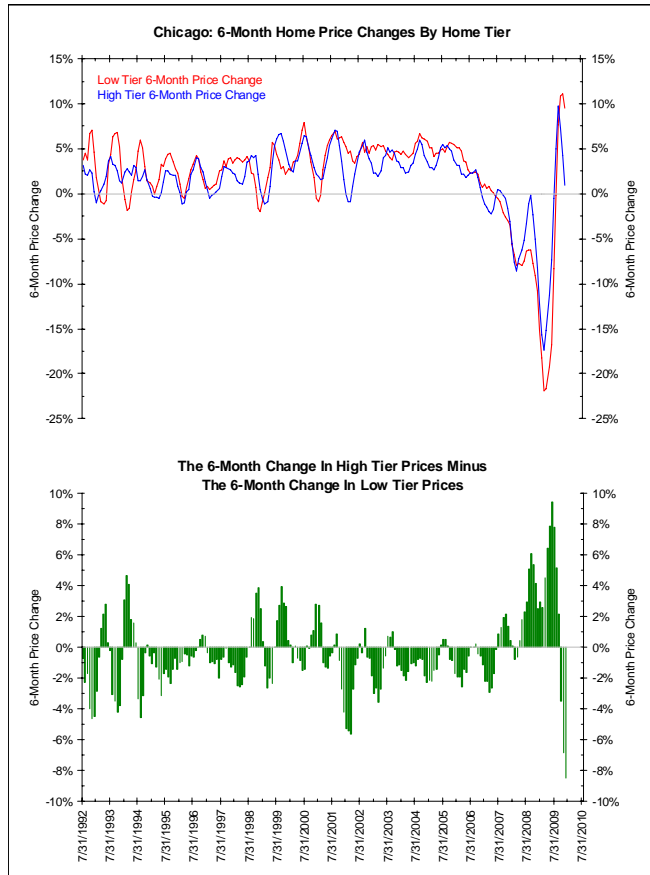
This chart here on Page 4 comes from a piece that we did last week in looking at the anatomy of a housing bottom. The conclusion in this piece was that the Case-Shiller 10 is an index of 10 cities' existing home sales. Case-Shiller breaks down



The little table on the chart shows that the two together – same series, two different econometric models – are almost 40% of core inflation. That's 40% of core inflation that measures rent.

So if you look at the chart on the lower right, what happens if we take these two measures out of core CPI?

those numbers by low-tier price houses, middle-tier price houses, and high-tier price houses.



They don't offer that in a national index; they just offer it in a city-by-city index. So we looked at the city-by-city numbers. We tried, by the way, to put together a national index, but there's not enough data to do that. So we left the analysis at city-by-city.

On this chart here, on Page 4, we use here Chicago as an example. On the next page – Page 5 – I'll show you in a second that we use Boston and San Diego. So I tried to pick different regions of the country.

Housing – A Low-Tier Boom

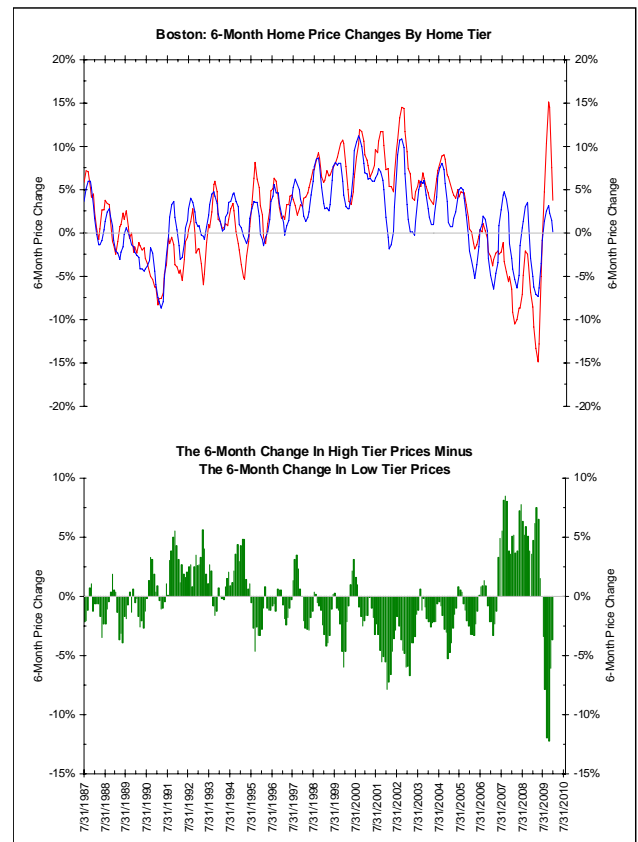
The red line on the chart is the year-over-year change in low-tier house prices. The blue line on the chart is the year-over-year change in high-tier house prices. You can go through the original report, which is linked on Page 4, and it will show you what the price levels are. But it's basically a median and one standard deviation move off of whatever the median house price is in that particular market. So it's all different levels for what are low- and high-tier. But it's just one standard deviation off of the mean or median in those markets.

The bars below show the difference between low-tier house price appreciation and high-tier house

price appreciation. And it's on a six-month basis. Six months, half a year helps to eliminate whatever seasonal effects there might be in the market. That's why we pick six months.

And what you'll see on this chart on Page 4 are big negatives, meaning that higher-tiered house prices – the expensive houses – are not appreciating as fast as the lower-tiered house prices. Lower-tiered prices – those home prices that are one standard deviation below average – are doing much better, and not only in the Chicago market.

If you go to Page 5, the chart on the left shows the Boston market. And you could see that the same thing is happening in the Boston market, that low-tier house prices are doing very well.

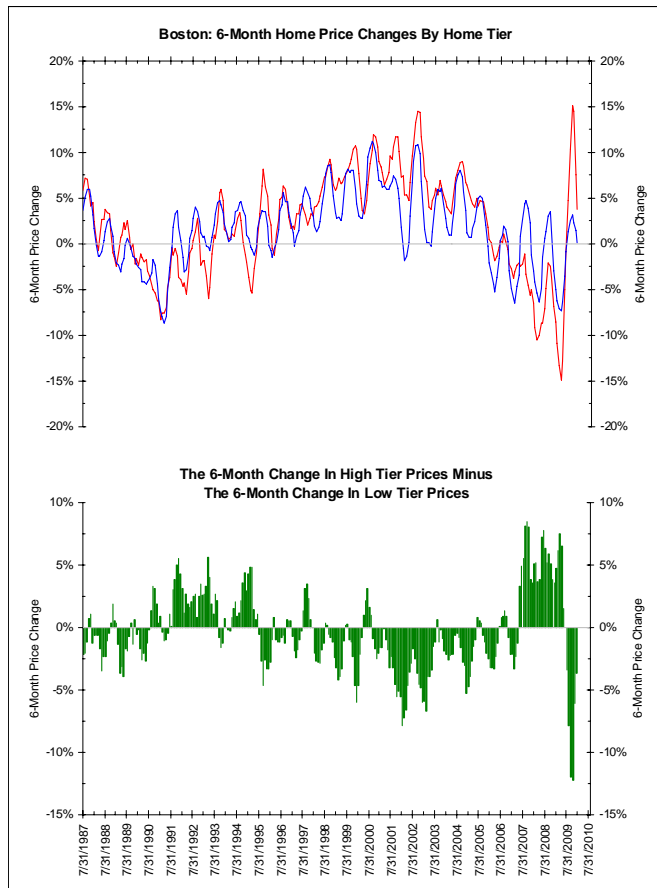


And if you go to the right on Page 5, it shows San Diego. And it shows the same thing – that, in San Diego, the low-tier house prices are appreciating at almost 11% or 12% over the last year where upper-tier home prices are barely up by 1% or 2% for a 10-percentage point outperformance.

Why is this happening?

The First-Time Homebuyers Tax Credit originally started in September of '08 as a tax credit that you had to pay back to the government. By February of last year, they spun it into an \$8,000 tax credit, that, if you're a first-time homebuyer, then you get \$8,000 to apply to your down payment or to whatever else

you need. It kicked in around April. And, since then, we've seen dramatic outperformance of lower-priced homes relative to higher-priced home.



That First-Time Homebuyers Tax Credit was extended in November. And we've argued that a lot of people have been looking at Case-Shiller and have been making the case that those indices bottomed out, and maybe the worst is behind us in home prices.

The conclusion that we came up with is that we don't know. It looks like this homebuyer tax credit, for which almost 1.5 million have applied by now – a million and a half first-time homebuyers in the last year have applied for this \$8,000 tax credit. I don't know how many have gotten it, but that is how many have applied for it so far – has been really putting a big support on lower-tiered homes.

Lower-tiered homes traded more volume than the upper-tiered homes. And that could account for much of the bottoming in home prices.

The first-time tax credit expires on April 30 unless it is again extended, which there is a reasonable chance that it might be. But, for the moment, it's on nobody's radar screen that the homebuyer tax credit could again get extended.

The First-Time Homebuyers Tax Credit, we have argued, has helped to serve in depressing rents,

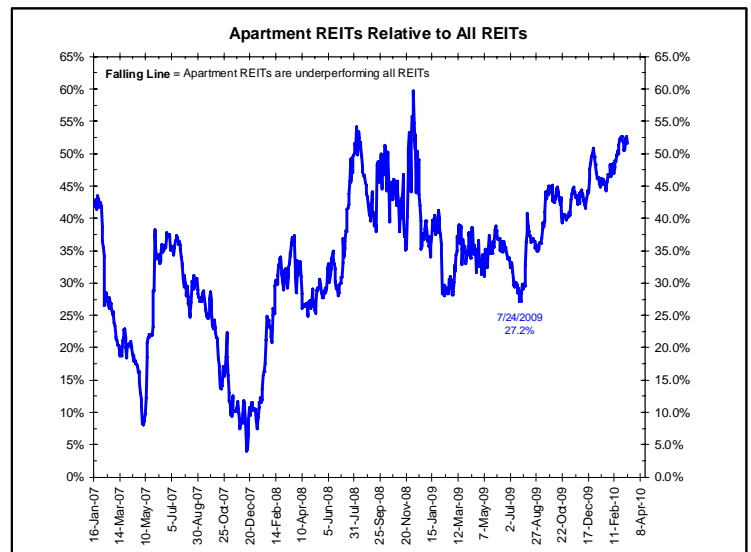
which is why we've seen OER and RPR collapsing. Where do first-time homebuyers live? They rent or live with their parents; but, mainly, they rent. And now that they're given an \$8,000 tax credit to go and buy a \$120,000 home, which might be a condo, they are jumping at that opportunity to do exactly that. And by jumping at that opportunity to do exactly that, they've been reducing the demand for rents, which is why rentals have been falling, and you've seen the dramatic home price outperformance.

Now, if the tax credit expires, then what we suspect that you would see is a reversion to the mean that lower-tiered home prices would converge back with upper-tiered home prices. I would guess that would mean lower-tiered home prices' appreciation would fall, not that upper-tiered home prices would gain. There is nothing for upper-tiered home prices.

There are some first-time homebuyers that are buying into the upper tier but not that many. And that should also slow down the migration from renting to first-time homebuyers, which should increase the demand for rental units.

Apartment REITs Outperforming

So if you go to Page 6 – and this is something that we've talked about for a number of years – it shows apartment REITs relative to all REITs. Apartment REITs bottomed on July 24, as we mark on the chart. The scale on the chart is the Bloomberg Apartment REIT Index. We highlighted this in a report in January, relative to the Bloomberg Apartment REIT Index, and it's just the two indexes divided by one another.



But, since July, you've seen a general up-trend in this chart, meaning that apartment REITs have been outperforming all REITs. They've been doing better than everything else, suggesting that the marketplace sees maybe an end to this collapse in rentals coming soon.

We have shown in reports of the past that the lead-time on this is around six months. Around six months puts you around February-March, which is where we are right now, suggesting that you could see a turnaround, at least, in actual rents.

So CPI less rents, which is 40% when you consider RPR and OER, is really pretty sticky for a 0% inflation environment. What has been holding down the overall index is that 40% of that index is collapsing. Maybe we're starting to see, with the First-Time Homebuyers Tax Credit due to expire April 30, with the relative outperformance of apartment REITS, which we've shown in the past, leads by six months -- we might start seeing the bottoming of that 40% of core inflation. If we see a bottoming of that 40% of core inflation, then you should see a snapback coming up in the next several months into the summer, maybe early fall, in core inflation.

Yes, maybe it bounces back to 2.5% or 3%. That's not necessarily, by itself, a terrible number. But if you combine that with a zero funds rate, that the Federal Reserve wants to stay at 0% and wants to be very slow and very deliberate with their exit strategy, then what is the one thing that must remain constant for this to happen? Inflation must remain behaved.

The Federal Reserve defines inflation as core inflation. So \$100 oil shoving up the headline index is not going to do anything for changing Federal Reserve policy. But core inflation could. And this is a way that we could get a problematic 2.5% inflation environment in a 0% funds rate.

Like I said, if the funds rate were 2% or 2.5%, then this wouldn't be an issue. Moving to 2.5% or 3% of core inflation is not a big deal. But when the funds rate is 0%, and they want to stay there until 2011 or 2012, as I think some members would like to do, then that becomes very problematic.

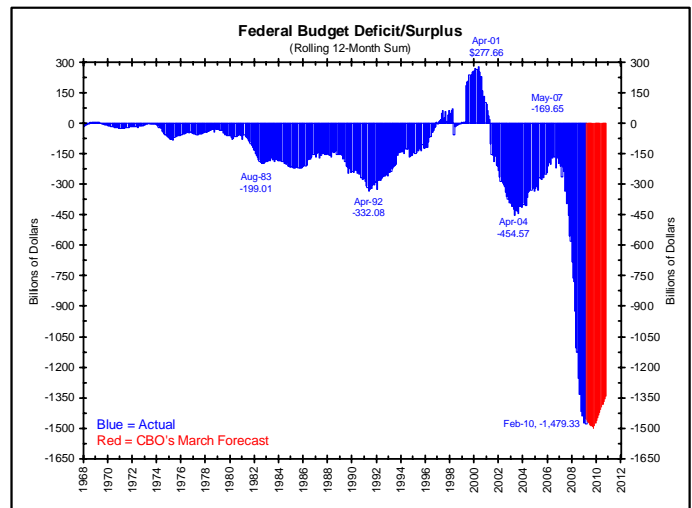
The Deficit Hits \$1.5 Trillion

OK, Page 7 – changing a little bit, remember market outlook? Changing a little bit here, I want to talk a little bit about financing a little bit.

The deficit – yesterday, the February deficit numbers were reported at \$220 billion for the month of February. Those of us old enough will remember David Stockman's line, "Two-hundred billion dollars, as far as the eye can see." Well, now we're getting that in one month.

Overall, as the chart here on Page 7 shows in blue, by February, the year-over-year deficit was almost \$1.5 trillion; it was \$1.479 trillion to be exact. The CBO's March forecast, which came out last week, projects that the deficit was going to, this fiscal year, hit \$1.5 trillion; and then, by next fiscal year, go to

\$1.3 trillion. That's what the red is – the projections by the CBO's estimate, which was announced last week.



The fiscal year ends in September. So I guess that what they're trying to say is that we are now at the worst possible point in the deficit as we move forward from here. That's a pretty heady call to say that that parabolic move is now done, and that we're going to reverse and go the other way, considering that the CBO has had a terrible record at predicting the deficit in the past.

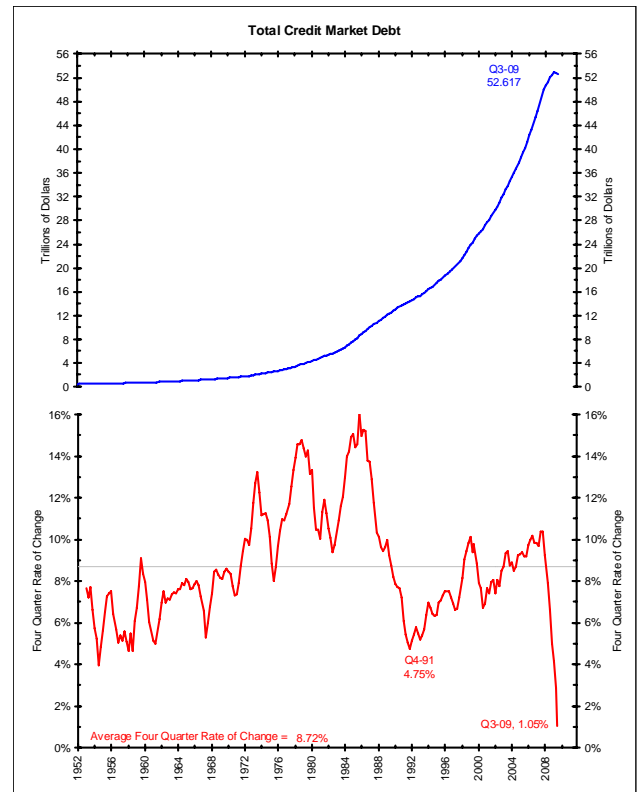
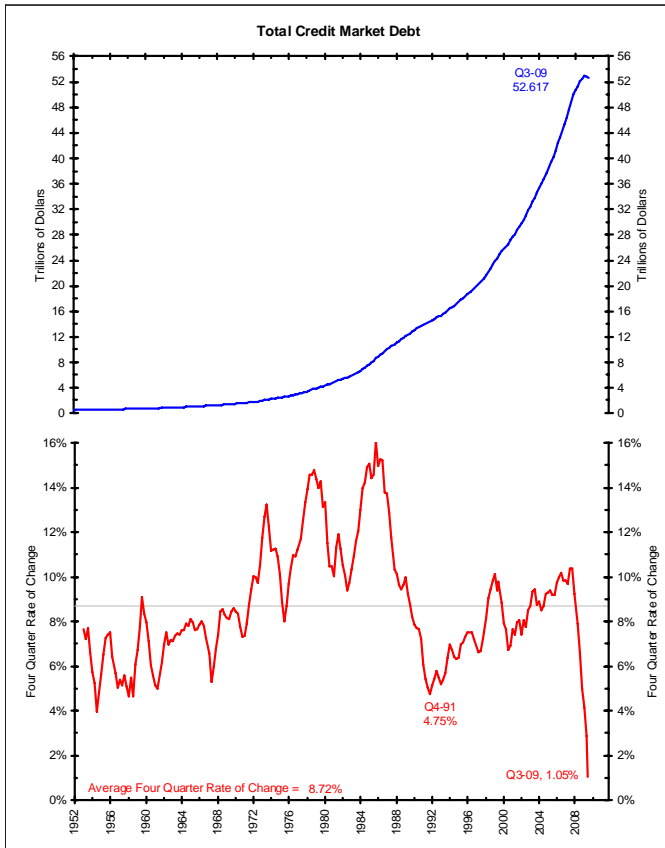
So it looks like it's a fair bet that that \$1.5-trillion estimate by yearend is probably going to have to get revised to worse as we move forward from here. This was especially evident if you saw what happened in Congress in the last two weeks, when Senator Jim Bunning tried to hold up the extension of unemployment insurance and some federal workers. He wasn't against the bill but was just asking how we are going to pay for it, because we were just going to pass the bill that was going to add to the deficit, and he was just roundly skewered over that. In other words, we are not in a mentality right now to be thinking about the deficit. We are still in a mentality to be spending money.

Total Credit Market Debt, What Deleveraging?

And that brings us to the chart on Page 8. That spending money is, I think, something important to understand about what has been happening in the credit crisis. And I have talked about these charts before and have said that the first half of the credit crisis was that we borrowed too much money in the private sector.

The first chart on Page 8 basically shows total credit market debt. The total credit market debt as of the end of Q3 is \$52.6 trillion. I might add that this data is from the Federal Reserve Flow of Funds. Q4's data is out later today. This afternoon or tomorrow, we will have these charts updated from Q4. I'll

include them in *News Clips* in the next day or two, in next week's *Charts of the Week* – some of these charts – so you can see what the updates are for Q4.



Financial Debt Is The Bulk Of Private Debt Deleveraging

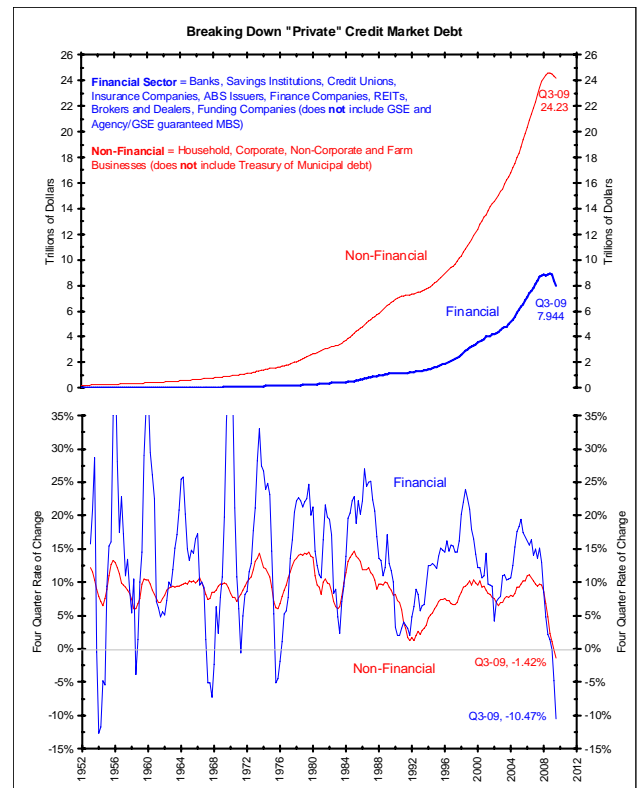
If we go to the chart on Page 10, it further breaks down private sector debt. It breaks down into non-financial debt and financial debt.

The year-over-year change as of Q3 was 1%. There was no deleveraging during the financial crisis. Yes, we had the slowest growth rate that we've ever had, but we're still adding debt; we're just adding it at a slower rate.

But if you break that down and go to the chart on Page Nine, then you'll see that what we have done is that we've been deleveraging the private sector.

Private Debt Deleveraging

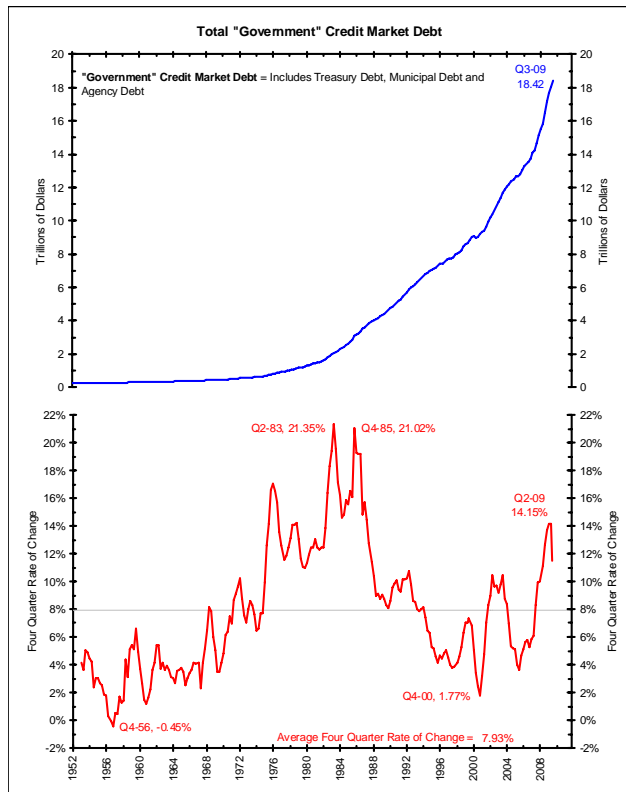
The chart on Page 9 shows you private credit market debt, which is at \$34 trillion. That has contracted for the first time year-over-year through Q3, at 3%.



Non-financial debt did contract at 1.4% versus the same levels a year ago. Financial debt really contracted quite a bit. But we know this because of Lehman, because of Bear, because of all of the problems that the financial sector has had – the brokerage community deleveraging. So we saw a traumatic deleveraging in the financial sector.

Government Debt Re-leveraging

However, taking up that slack is the chart on Page 11. And the chart on Page 11 shows government re-leveraging.



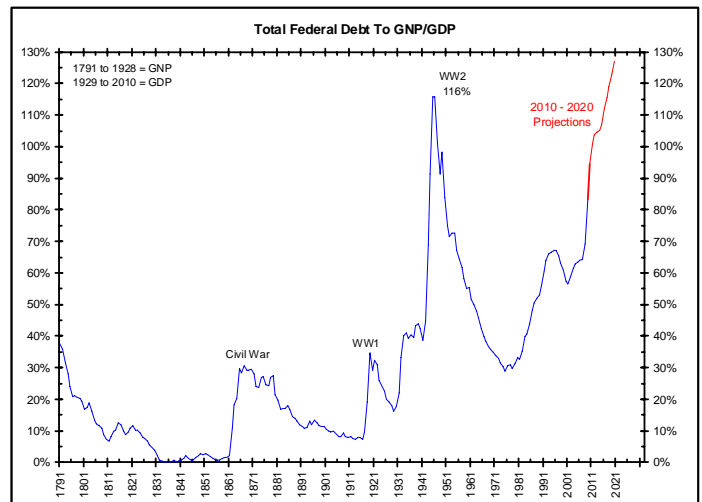
The government has been borrowing more money. And you've seen that their year-over-year change numbers have jumped quite a bit. Even though they've come down just a hair, they're still running at around 12% or so.

Debt-to-GDP Ratios and Projections

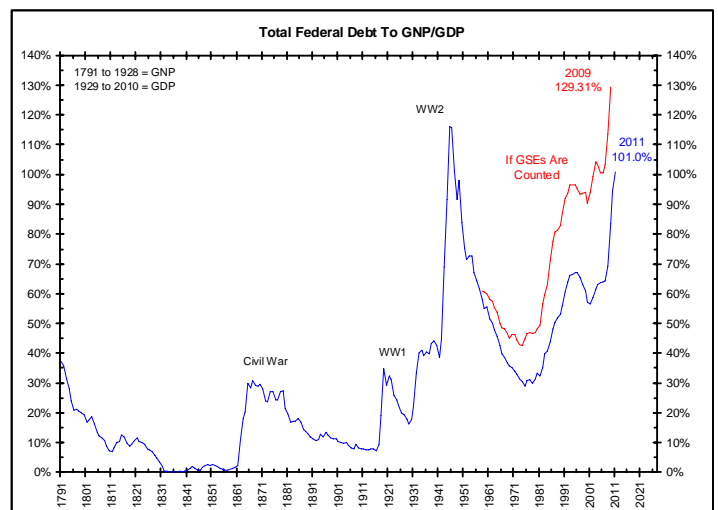
And if you go to Page 12, the first chart is one that we use frequently. Around 1976, for the bicentennial, the Commerce Department published a bunch of statistics on the United States going back to the Revolutionary War. And we were able to derive from those statistics a debt-to-GDP ratio going back to 1791. We are currently around 85%. And, in red, we show the projections that we have for debt between 2010 and 2020 using the CBO's projections. And we would get to around 125% to 130%. This is just on Treasury borrowings alone.

And, finally, in looking at the chart on the lower right, on Page 12, there is some question about what is the

definition of federal debt. If you count the GSEs, we already are at 130% on GSEs. Debt-to-GDP is the highest that it's been in the history of this country.



As of a couple of years ago, we took out the World War II high. And it's going to exceed 100% by 2011. Those estimates tend to be fairly accurate unless there's another financial crisis, in which case they go higher.



For my career – and I started in this business in 1984, so I'm in my twenty-sixth year of my career – I have restlessly heard people say that this country borrows too much money, and we are on the precipice of disaster. But that disaster never quite comes. More reasoned arguments have been that that disaster is always about 10, 20, or 30 years away, and at the sustainable path that we're going, we're going to get there.

What happened during the financial crisis – and Ken Rogoff and Carmen Reinhart have talked about this in their book *This Time is Different* – is that the governments of the world, especially the developed countries' governments, have stepped in, guaranteed everything, and borrowed like crazy. So

the possibility that our borrowing too much was going to be a problem in 10 or 20 years is now a problem in three or maybe five years, or maybe even less than three years. We are accelerating that problem forward. This is because what we did to stop the credit crisis was to have governments guarantee everything and borrow sums of money that we don't quite have a handle on. And this is the second half of the crisis – how do we deal with all of this government borrowing?

Willem Buiter, Chief Economist of Citibank, had an interesting quote in the *FT* today. It was in the El-Erian op-ed in the *FT*, which is the first block in today's *New Clips*.

Buiter said that, up until two years ago, GDP was being created by countries that had a deficit of more than 10% of their GDP, about 5% or less.

Let me restate that. If you look at all of the countries that had a deficit-to-GDP ratio of 10% or more, they accounted for only about 5% of the world's production – or less. And almost all of those countries were emerging-market countries. 10% deficit to GDP or more was producing about 5% of world economic activity. Today, it's 40%, a number we have never quite seen before because it's developed countries – EU, US – that have been borrowing at sums that we don't understand in order to prevent a financial crisis.

Another statistic that I have been using quite a bit is that Fannie and Freddie have been nationalized or put in conservatorship in September of '08. We have collectively lent them – the government -- \$112 billion. They want to borrow another \$20 billion. The CBO estimates by 2020, the total amount of money that they're going to borrow is going to be \$390 billion.

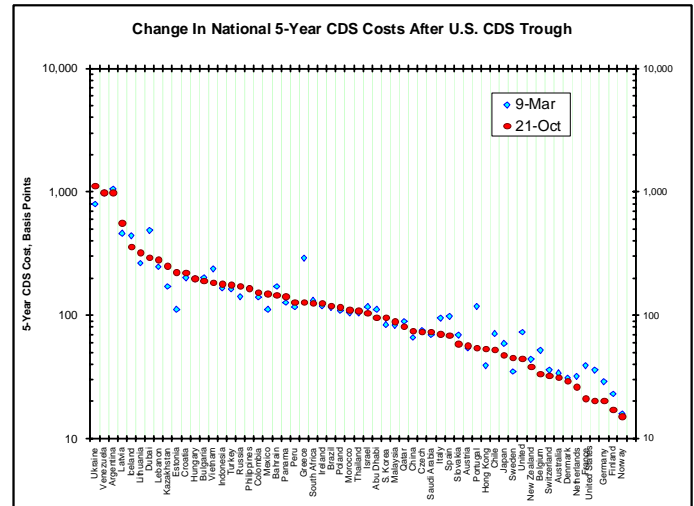
Laurie Goodman at Amherst Securities has put the number at \$450 billion. That was before they started buying delinquent mortgages out of existing private mortgage pools. And that number could go much higher. And I have argued that, if you want to put this in a different context, from September 2008 forward, we will probably spend more on Fannie and Freddie than we will on the Iraq and Afghanistan wars combined. Yet that doesn't seem to generate the type of emotion that the wars have, and for good reason. Nevertheless, the amount of money we're spending on these things is the same.

Usually those that complain about the war point to the amount of money being spent as one of their top three reasons, if not the top reason for being against it. Yet they don't seem to get that agitated about Fannie and Freddie borrowing even more sums of money; maybe they should at that point because this is where the unsustainable level is. This is the

second half of the credit crisis that we have been worried about.

Sovereign CDS

I'm going to jump us a little bit out of order on our charts to Page 15 in the chart book. This is the "Sovereign CDS" chart that we use quite a bit.



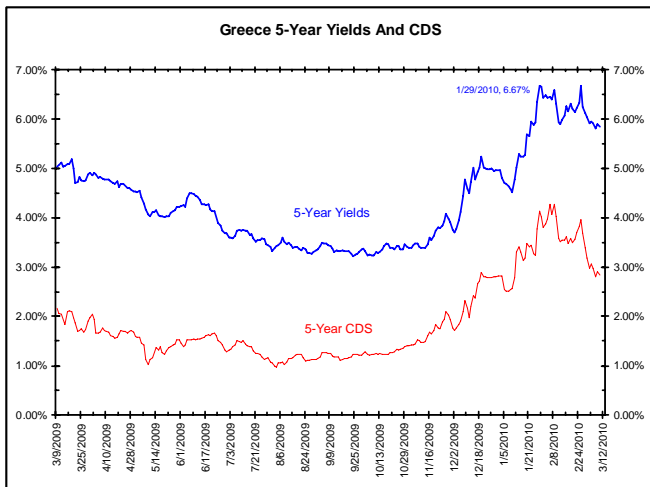
The red dots on the chart are October 21. The blue diamonds are the latest plot that we have, which was March 9, two days ago. Most of the blue diamonds remain above the red dots, which means that most sovereign CDS rates are above the levels that they were on October 21. It seems like, around October 21, all sovereign CDS rates bottomed.

I argued on the conference call that this is a good measure of risk. The politicians in Europe, especially Greece, want to make you believe that this is a secret cabal of hedge funds conspiring against Greece and nothing more than that.

However, the data says that it's the opposite. The data says that what is happening is that most CDS rates worldwide are moving much higher or lower in unison. This is just sovereign debts. But, if you want, you can add into that as well the municipal debts of New York, California, and Illinois, too.

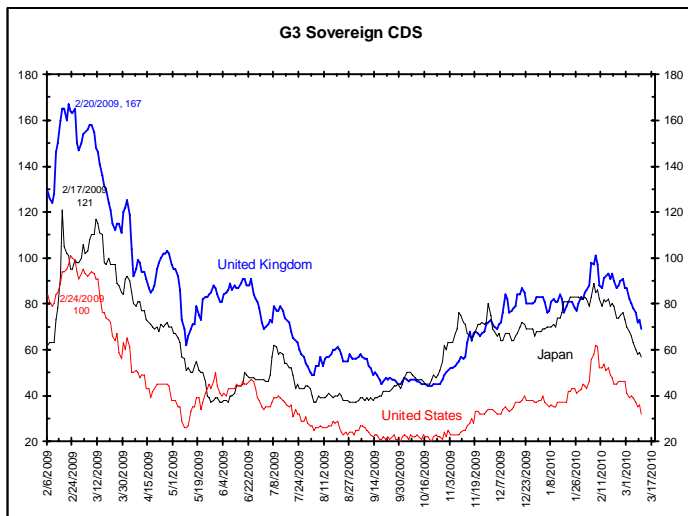
CDS Rates Coming Down

The next chart on Page 16, in the top left, basically shows the five-year yield on Greece's debt. And it shows five-year CDS. These moved the same. These pretty much moved the same. There is nothing unusual about CDSs relative to yields unless you want to make the case that the government yields are following the CDSs.



Well, remember that it's all 57 countries that this is happening in right now. And they all seem to move up and down together as far as where they've been going right now.

If you look at the chart on the right, on Page 16, here are the Big Three – the G3 – the U.S., the UK, and Japan. You could see that right around October 21, if you roughly find that date on the chart, they all started moving higher. They all started moving higher until around the middle of February. And then, recently, in the last couple of weeks, they all started moving lower.



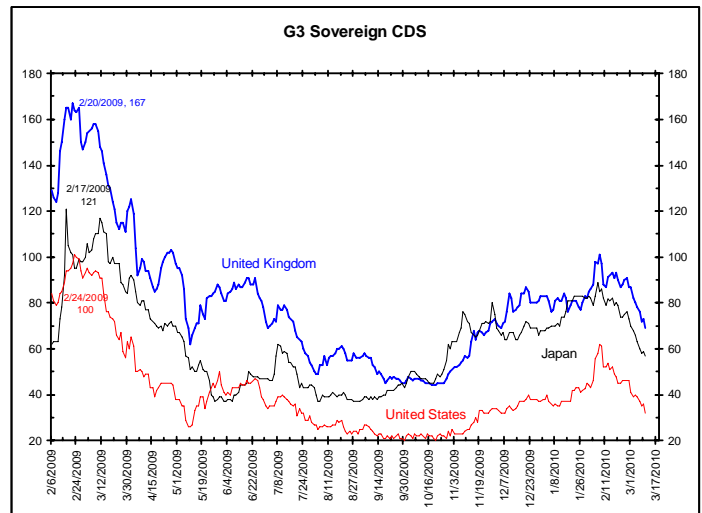
This, to me, says that this is a more systemic problem, that the world is worried about government borrowing. I have argued that this problem goes away in five seconds. Stop borrowing money. Governments, stop borrowing money. Stop expanding government welfare. Stop with the bailouts and the guarantees.

Governments of the world have said that they will do anything, including derivatives, to try to hide the truth. They'll do anything except stop borrowing money. And when somebody like Bunning says, "How are we going to pay for this," he's roundly

derided for even asking the question. Remember that he wasn't even against the idea of extending the unemployment; he was just asking how we are going to pay for this, or are we just going to add it to the deficit.

So this is a much bigger problem. This is the second half of the credit crisis – how do we get out of this crisis? And I think this problem will be with us for a while. It ebbs and flows. It flowed higher during Dubai; and then Abu Dhabi bailed them out, and it ebbed. It flowed higher during Greece. And now everybody believes that the EU is going to bail them out, and now it's starting to ebb. It will probably flow again at some point in the future.

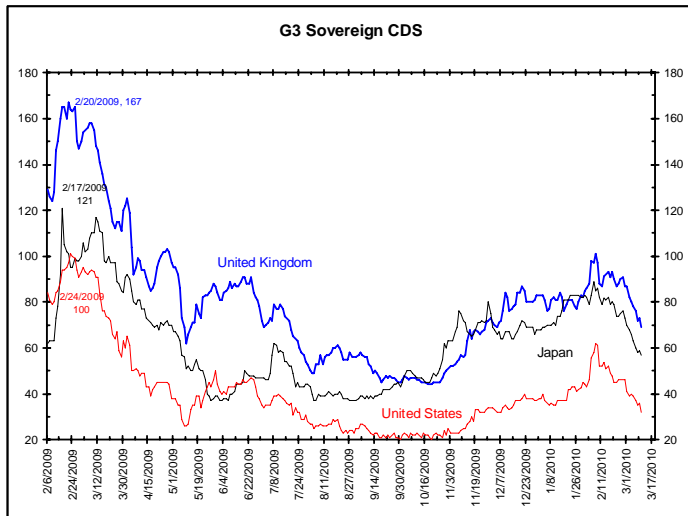
Whether or not it comes out of Greece or Dubai -- or if it comes out of Portugal, California, Spain, or Illinois, or it comes from some other source that we haven't yet figured out -- I still suggest to you that it will flow at some point along the way, too. And what will ultimately end this is going to be when governments get a handle on their spending. And, like I've said, when they will do almost anything but try and get a handle on their spending.



S&P Operating Earnings

All right, in the last set of charts, I wanted to just highlight one more issue, as well, and that's earnings.

The chart on Page 13 – "S&P Operating Earnings" – shows, in red, trailing 12-month operating earnings on an earnings-per-share basis for the S&P. It is at \$64.44 through the end of March on a rolling 12-month basis. You could divide that number by 1143, which is where the S&P is right now, and what you'll come up with is the current PE ratio on an operating basis.



The blue line shows the 12-month forward estimates of earnings one year ago, so what the consensus perceived that earnings were going to be. This is bottom-up. It comes from Bloomberg. And a year ago, they thought that the current earnings numbers would be somewhere around \$80 as opposed to \$62. They currently think that, in one year, it will be about \$93 per Bloomberg's bottom-up estimate.

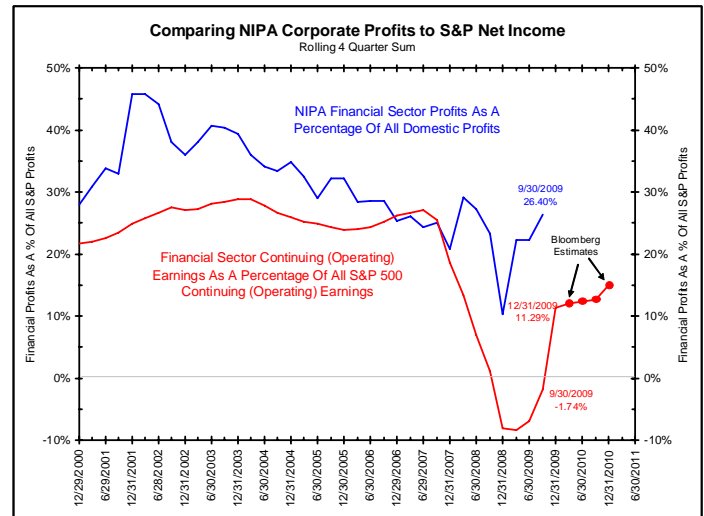
I might add that the difference between the operating earnings and the blue line, the estimates, is the widest ever seen in the history of compiling estimated earnings. Wall Street has never been worse at predicting earnings.

And it seems like a lot of the argument about earnings has been around this idea of, "Well, earnings are going to be \$80 or \$90 next year, so, therefore, 1150 on the S&P is cheap." Well, if they are \$90 next year, then it will be cheap. But they've done a horrible job of trying to predict earnings, now more so than ever.

The Curve – Is Anything More Important To S&P Earnings?

I would argue that one of the reasons that they're doing a bad job at earnings is shown on the charts on Page 14.

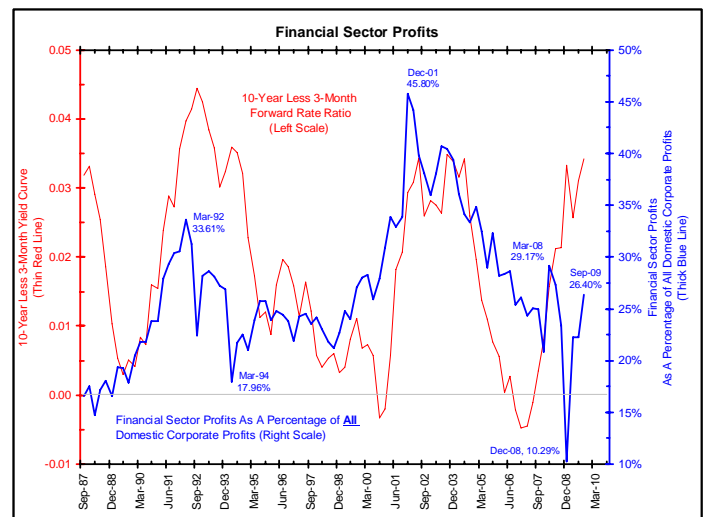
The top left chart is one that we use quite frequently. The red line is the yield curve. The blue line is financial sector profits as a percentage of all domestic corporate profits. The data is current only through September.



Next week, the National Income and Product Accounts – this is where it comes from – NIPA – will update the fourth-quarter data. I suspect that you'll see a big jump in this data, as well.

I have argued that 30% to 40% of earnings of all of corporate America's profitability comes from the financial sector. And as the red line on this chart shows, what drives the financial sector's profitability is the shape of the yield curve.

A couple of people have asked me the question, "Well, if you look at the S&P 500, it's not nearly that high. That's true. The red line on the bottom chart on Page 14 shows financial sector earnings – continuing or operating earnings – as a percentage of all earnings on the S&P 500. As of the fourth quarter, only around 11% of the S&P 500's earnings were made up by the financial sector versus the NIPA number, which was somewhere around 26%.



I might add that the NIPA number was from Q3 to Q4. And I've marked those, and we went from -1%, meaning that, over the previous 12 months, the financial sector was still at a loss, to +11%, a

gigantic jump. So I suspect that we'll see a big jump in the NIPA numbers when we get them in a couple of weeks. And then there are the Bloomberg estimates.

Why are the S&P numbers so much lower? It is because they estimate just the financial sector. GEs --GCAP, Ford credit, Caterpillar credit -- just to name three off of the top of my head -- are not included in the S&P numbers because those companies are not financial companies. Those are, however, included in the NIPA numbers.

All of the hedge funds with the exception of Fortress, a publicly traded company, are all privately traded. All of the billions of dollars that the zillions of hedge fund managers make are not counted in corporate earnings in the S&P 500. But they are counted or estimated in the NIPA numbers. That is why financial sector earnings are so much higher. The big, steep yield curve is the driver of a lot of the corporate earnings that we've seen.

My argument here is the quality of the earnings. It's not that the earnings are not bad, but they are being driven by the steep yield curve. And as long as the yield curve stays very, very steep, you will see the financial sector continue to make good money. We will continue to see gnashing of teeth about Goldman Sachs' bonuses because they get to borrow at zero and finance a \$1 trillion-plus portfolio at something greater than zero, and they get to make a lot of money for themselves.

But if we see a bottoming of rental prices and a turnaround in the OER and rents of primary residence, and a bump-up in the core inflation numbers, then that could be very problematic at that point for the Federal Reserve to stay at zero. We might start to see them get a little more aggressive with the exit strategy. And a flattening of the yield curve will probably go to hurt corporate earnings to a degree that nothing else has hurt corporate earnings in the past.

I would argue that corporate earnings -- this whole idea that the S&P is cheap because we suspect \$80 or \$90 off of the S&P -- a large part of that is coming from financials, either the 79 companies of the S&P that are actually in the financial index, or those companies that have credit subsidiaries that are not in the financial index that are making them lots of money, or those companies that rely on the financial sector to buy products from them. Where would Cisco be if they lost all of their financial sector customers in terms of the purchases of routers?

Conclusion

One last thought about this --

I'll jump us back to Page 2 just to highlight this point. Right when Bernanke came into office in 2006 -- the

blue line is core CPI -- we had a jump-up in core inflation to nearly 3%. It was driven by a gigantic rise in OER to nearly 4%.

At that point, when the inflation numbers were getting to be problematic, remember that the Federal Reserve was raising rates a quarter of a percent at every meeting, and they were very close to winding down, and people were saying, "Wait a minute. You can't wind down because the inflation numbers are starting to move higher."

And a lot of Federal Reserve governors came out and gave speeches in trying to say, "Yeah, but it's all about this core inflation number." Believe me, they all know this. It's all about core inflation driving this higher so, therefore, it doesn't count.

And they were blasted in the press because, in 2003, when the core inflation numbers were being driven lower by OER, they never gave speeches saying, "Hey, these core numbers are being distorted downward." No, they cut the funds rate to 1% and said that they would stay there a considerable period. And, now, Greenspan's reputation has been trashed because they were too easy during that period. So when the core numbers are being driven down by OER, they never give speeches saying that that's a problem; they give speeches only when it's going up.

Bernanke settled that argument in 2006, early into his tenure-ship. And he said, "No, we're going to do this. We're not going to pick core inflation apart, to death." Remember he's an inflation targeter, and he would like to target core inflation. So if the core CPI number goes up, then he has stated -- not all of this was pre-crisis, but he did state that he would just follow that number and not try to rationalize it away.

So if we get a rise in core inflation, then I suspect that there will be some of that mentality at the Federal Reserve. Look, we didn't rationalize it down when we were holding the funds rate at zero for an extended period of time. But if we see a turnaround in OER, then we can't turn around and start trying to rationalize it back onto the upside.

OK, so those are the four market updates.

There is the inflation argument with housing in there, and apartment rents outperforming all rents.

The deficit is growing big.

The deleveraging -- there hasn't been any real deleveraging. What we've had is a private sector -- largely financial sector -- deleveraging. But we've had governments guaranteeing and borrowing money at sums that we've never seen before, to the point where we're now into the second part of the credit crisis.

Do governments take their feet off of the gas, if you will, when it comes to borrowing money? Everything suggests, no, they won't. They'll pass austerity programs in Greece.

The question is, when the crisis dies down and no one is looking, will they pass other laws, basically adding the spending back later on? That is what I suspect they will do when everybody stops paying attention to them.

We will still have these problems as we move forward from here until, unfortunately, we get to some kind of a crisis.

Lastly, Carmen Reinhart and Ken Rogoff have suggested that, when debt-to-GDP levels get above 90% – and that's overall debt to GDP levels – I know that the CBO tries to use some measure called "debt held by the public," which is only 50% of so, much lower than the overall number – countries' economies seem to struggle with growth.

When you seem to get deficit-to-GDP numbers greater than 10%, you see growth numbers struggle in those countries. 40% of world production now comes from countries that have deficit-to-GDP numbers greater than 10%. We have never been anywhere near these kinds of numbers. That was less than 5% even three years ago.

So this is the second half of the problem –

Can we exit from Fannie and Freddie?

Can we exit from the First-Time Homebuyers Tax Credit?

Can the Federal Reserve stop purchasing mortgage securities?

Can all of the government involvement in the markets and the economies go away without the economies falling apart?

If you are of the opinion that, once we take away the First-Time Homebuyers Tax Credit, once the Federal Reserve stops buying mortgages, then the home price market is going to struggle, then we're faced with a bad choice. Do the governments of the world say, "Let these markets kind of sort out their equilibrium," or do they crank up the borrowing machine all over again to try and desperately support them at current levels? And the world, at least by CDS rates, is saying, "I think that we've borrowed too much money. We've got to look to be going the other way, not trying to add more money."

So those are kind of the topics.

Oh, yes, of course, and the last topic was a lot of the earnings that were seeing in companies right now are being driven by the financial sector. I think that is an underappreciated statistic when it comes to looking at the financial sector. And, because of that,

I think that people don't appreciate what could very well happen to earnings if we get to a point in the earnings cycle where the Federal Reserve starts raising rates, and the yield curve starts to flatten. It could have a very devastating effect, I think, for a lot of people when it comes to these numbers.

Questions & Answers

With that, let me stop and turn us to asking questions.

Remember that we take questions on a first name-only basis. I know who you are from all of this technology, and that is all that really matters. We feel that, by keeping you somewhat anonymous, it allows you to more freely speak your mind as I do my very best to answer you.

So let me start off with some of the questions that are coming in via email.

Jeff writes:

What if CDS means nothing other than a measure of fear and discomfort expressed by sophisticated financial players, like the concept of the VIX or a poll of investor management bullishness and, thus, the meaning means nothing, just day-trading noise that gives writers and TV commentators something to do everyday?

El-Erian brings up a point which you have expressed multiple times – those who consider the Greece problem to be an isolated incident are those who blame evil speculators for the reason behind exploding CDS rates. CDS costs across the majority of the world are still higher than they were on October 21. For this test to truly be behind us, we would need to see the blue diamonds fall materially.

OK, as far as that question goes, you're right in that there is a lot of noise in the CDS Market. That is why I try to separate the noise by looking at all of the markets over the last several months as opposed to hyperventilating about the Greece chart, which is what the Greece Finance Minister likes to do, and blame evil speculators.

If it were just Greece shooting up out of sight, then we might have a case. In fact, there was more of a case to be made for that last November because we were early on in the widening of CDSs, and then Dubai exploded higher. And you could argue that this was a speculative run on Dubai. But now there is something more to it. It's everything. It's California.

And so you're right. It is kind of like the VIX, and it is kind of like investor bullishness in that, if you kind of look at it from day to day, week to week, then what you could wind up doing is just getting buried in the noise. But if you step backward and look at it in the

larger context, then I think it will tell us something more meaningful about the market.

And then, finally, if you look at the chart that we have on Page 16 – which I've brought up again on the webcast – I show the five-year yield and show the CDS for Greece on the five-year. It's the same image, the same pattern. Yeah, the scale is a little bit different, but they go up together and go down together.

So I could have put together a chart of five-year government yields across a bunch of different countries. I think it would yield exactly the same result. It would just be a little bit more difficult to discern that because they're not all on the same scale, whereas CDS rates are all on the same scale among sovereign countries. And you could compare them kind of the way that we compare them, at least better than you can compare a bunch of five-year yields because they would all be in different currencies and would all have different stipulations, where this is a little bit more of a generic standard.

So, yes, I agree with the idea that you can really get lost in the noise of CDSs. But that is why I have tried to look at a broad majority of them, bigger picture. And that is why I reject the idea that it is about speculators.

The next question comes in from **Evan**:

With rental vacancies at an all-time high, why would we expect rents to increase with the expiration of First-time Homebuyers Tax Credit? Wouldn't this just be hitting existing home prices, which would negatively affect as the rents of households compare the price of rent to the price of buying a home?

Yes, that is why I was careful in my words that I suspect that what we will initially see is OER stop collapsing, rents of primary will stop collapsing. And that is what will, at least at that point, provide some kind of support for the housing market. And that is where, I think, we will get a positive, at least, in terms of where inflation will go.

I'm trying to bring up the chart right now for those of you that are on the webcast.

So I think that what we are really looking at here is basically just that they would stop going down. If you look at the chart, they have been collapsing a lot. And that is all that it is.

I finally brought up the chart on the webcast after fumbling around a little bit with it.

But they are in a very, very steep decline, those charts. And that's all that it would take, at least to see core inflation move higher.

Yeah, later on, we could start to see maybe rents get a little bit sticky and start moving higher. In other words, that mass migration of first-time homebuyers slows down quite a bit. But, at least for right now, I'm trying to argue the default, that the big decline that we've seen in rents that has been holding down CPI might be very, very close to ending, as well.

The next question comes from **Brett**:

How many companies have significant financial subsidiaries – 79 S&P financial companies? How many entities does NIPA encompass?

The National Income and Product Accounts – or NIPA – encompasses all corporations in America, both private corporations and publicly traded corporations. They do modeling based on available information, whether it's tax information or available public information, to try and make estimates as to overall profitability broken down by financial to non-financial.

With the financial, they look at it on a company-by-company basis. GE Capital is a company. That gets qualified, as I understand it, as a financial company in the NIPA numbers. GE Capital is not a separate publicly traded company; it is a subsidiary of GE, which is in the industrial group. So the profitability of GE Capital gets counted toward an industrial company in the S&P 500.

The 79 companies of the S&P Financial Index are what make up that measure. That is at least how NIPA does it. That is why their numbers are much higher. And the takeaway from that is that the financial sector creates a lot more profitability of corporate America than almost any other sector out there.

What is the name on the new Shea Stadium? It is Citi Field. That's not unusual. It's a financial services company. Financial services have the money.

If I could be so blunt, maybe that's why we're in the business, because this is where you can make a good, decent living, and we're not designing cars or in other businesses. Maybe the only thing that would compete with financial services is some kind of a technology firm almost at this point.

So that's where the takeaway is. Financial services make a lot of corporate profitability. And as the chart shows on Page 14, which I brought up on the webcast, a lot of that profitability right now is being driven by the shape of the yield curve, and we have an all-time steepness in the yield curve.

David writes:

Are you saying that OAR is going to bottom, potentially causing core inflation measures to

increase, which would put pressure on the Fed's QE policy?

Howard put out a piece recently saying the TIPS Market is underpricing inflation risks. TIPS are not cheap. Doesn't this imply that some degree of higher inflation is already priced in the yields, both nominal and real?

Yes, let me square away those two.

TIPS often overprice. So you often overpay for the insurance of TIPS because those that want the insurance of TIPS will pay up for it. So to say that TIPS overprices is not necessarily a shock because that happens often.

What is not being anticipated in these markets is unexpected inflation. I believe that what you are going to see with these CPI core numbers is unexpected core inflation. That is what moves monetary policy, is unexpected core inflation.

How much of that will be factored into the TIPS Market? It's hard to say. Howard and I have also talked a lot about -- in fact, Howard put out a piece on this a couple of days ago -- that you could go through the gasoline charts and the crude oil charts, and the TIPS Market seems to kind of bounce up and down with crude oil or gasoline prices, but, longer-term, it should not have that high degree of correlation. It overstates the importance of crude oil and gasoline.

We could say that until we're blue in the face, and we could show the statistics, but that's the way that that market trades. So what happens if we get higher unanticipated core inflation?

It depends on what crude oil is going to do. If crude oil is on its way to \$100, then TIPS breakevens are going to widen. If we get higher unanticipated core inflation, and crude oil is on its way to \$50, then TIPS breakevens are going to narrow in that environment. They're not going to pay any attention -- at least not the TIPS breakevens -- to the widening core inflation.

Bernanke has repeatedly said that all that he cares about is core inflation. When you look at headline inflation, there is that energy component, that food component. Those prices are all over the place. That's a lot of noise when it comes to inflation. It's interesting, but we don't set policy on it. But the TIPS Market is based on headline CPI NSA. So that matters quite a bit to it.

The next question is from **Beau**. He writes:

As the Fed raises rates, the Financial Sector earnings will soften. But how much of this will be compensated by earnings increased due to other sectors and demands from other global markets?

It would be nice to think that there would be a nice, seamless handoff, that we have this very steep yield curve, and the financial sector is making huge sums of money. And then, as all of the non-financial companies of the world start making a lot of money, we start flattening the curve, squeezing the financial sector, and the industrial companies and the material companies, and the technology companies kind of take up the slack for the loss of the financial sector.

Unfortunately, in the real world, I don't think that it's going to work that way. The Federal Reserve is going to have to anticipate, and they are going to have to raise rates in anticipation of inflation, not in the realization that these non-financial companies are making a lot of money relative to financial companies.

The handoff won't be that seamless; it almost never is. And I suspect that we will see something more of the same again.

Finally, let me take one last question here, as I try to keep this limited to about an hour.

I will interject right here that we will release the transcript on Monday. If any other questions come in, as well as some other questions that I won't get to for a minute, then we will include all of them in the transcript of the conference call on Monday.

So let me take the last question, which is from **Brian**:

What is your take on what happens when the Fed stops buying MBS? I know that they still have room for \$175 billion more, but what step do they take to watch what happens to the Market? And do they come back if the Market doesn't like it?

There are a couple of interesting points about this MBS thing. As I see it, there is going to be a transition with the MBS Market. The Federal Reserve should stop at the end of this month, as they have committed to stopping.

But the Treasury does have a bit of authority to buy MBS. And Fannie and Freddie are going to continue to purchase delinquent mortgages out of MBSs, as well. So there will be some kind of a transition between the Treasury's ability to purchase MBS and the Fannie and Freddie's ability to purchase MBS, though not at the degree that the Fed has. But we're not going to go to zero on April 1. It will be something much less on our way to a much lower number.

A lot of people have asked the question, "What is going to happen to mortgage spreads?"

There are two ways in which you can answer this.

You can take kind of the Wall Street consensus of, "Well, it's not going to be that big of a deal. Mortgage spreads are going to widen 25 basis points, maybe 15 basis points. Everybody knows what is going to happen on April 1. It's priced into the market. It's not going to be that big of a deal."

That's a reasonable argument. However, in my travels, I meet a large number of mortgage trades that say that the Federal Reserve will stop on April 1 for a while, and then things will get kind of hairy, and they will be forced back into the market. And this suggests that maybe a stop is not as priced in as we think, that a pause for a while is priced in, but not necessarily a stop in the market.

In that case, if the Federal Reserve is really insistent on stopping when the market thinks that there is a pause, then you could see a bigger backup in yields.

The bottom line is that we've never done this before. We've never had the government print \$1 trillion, and buy and basically dominate a major sector of the fixed-income market -- the largest sector of the fixed-income market -- and then summarily stop. There has to be some kind of an effect. Otherwise, the Mortgage Purchase Program was useless to begin with.

I would suspect that you're going to see spreads widen more toward the higher end of what Wall Street thinks -- 25 basis if not more. And then we'll have to see how much of the mortgage market is thinking that it's more of a pause as opposed to a stop.

Right now, I think that a lot of mortgage players think that it's a pause. They're going to stop for a while, things will get ugly, and they're going to be forced

back into the market. Just like a lot of mortgage players and a lot of non-mortgage think, "You watch. At the second half of April, they're going to extend the Homebuyers Tax Credit. Just like they did in October when it was due to expire in October, at the very last minute, they pushed to extend that, too." They're afraid to let these markets alone, by themselves, and that means more government spending down the line.

We'll have to see about the First-Time Homebuyers Tax Credit when we get to the second half of April, if there is a real push at that point to extend it for yet a fourth time, as we have already extended it three other times in the past.

I would lean on that, with the MBS market, you will see the widening more toward the larger end of the range. And the big question is going to be, "If things get a little bit wobbly, then does the Federal Reserve go weak-kneed and want to jump right back into the market again?" And we will have to wait and see whether that happens.

All right, let me stop there because we are at one hour now on the call.

Let me thank everybody for joining us on the call. If there are any other questions, I will get to those when I can and will include those in the transcript.

We will see you at our next conference call in a couple of weeks.

Thanks, and enjoy the NCAA Tournament next week.

Bye-bye.

END

Bianco Research L.L.C.

1731 North Marcey, 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

Chicago Sales Office

James L. Perry james.perry@arborresearch.com

Phone (847) 304-1560 Fax (847) 304-1595

Geneva Sales Office

Rich Kleinbauer rich.kleinbauer@arborresearch.com

Phone (41) 22 365-1850

Far East Sales Office

Robert Reynolds robert.reynolds@arborresearch.com

Phone (847) 756-3680 Fax (435) 647-3073

Copyright © 2010 Bianco Research, L.L.C.

This message is intended only for the personal and confidential use of the designated recipient(s) 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.