



ECONOMIC OUTLOOK

bounty management
unique investment insight

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AS THE FED ENDS ROUND 2 OF QUANTITATIVE EASING WILL THEY EASE ON DOWN THE ROAD?

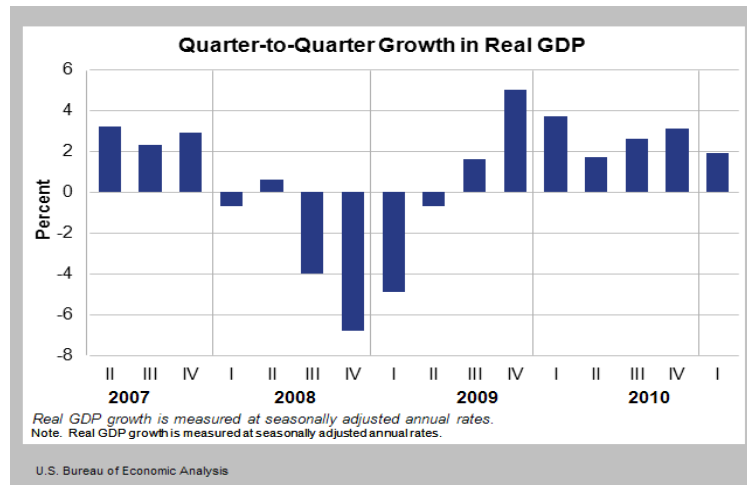
As we enter the third quarter of 2011, the global economy continues to struggle with the European Union sovereign debt crisis, the ongoing “Arab Spring” uprisings in the Middle East, and loose monetary policy in the U.S. Not a lot has changed since the last update. The U.S. economy remains stuck in neutral with anemic growth as the government winds down the quantitative easing (i.e., the purchase of government securities) that was intended to stabilize the economy and propel the U.S. towards recovery and growth. Unfortunately, with high unemployment, depressed real estate, and higher costs of essential goods, consumers, according to the Dallas Fed, are “shocked away from non-essential spending.” Exiting the easing stage will be difficult: the Federal Reserve has not committed to buying additional assets although they will continue to purchase mortgages, keeping the balance sheet steady at a bloated \$3 trillion. Asia and emerging markets continue to grow, but at a slower pace, with underlying inflation in food, energy, and raw materials. The Fed conceded in their June meeting that they will consider additional monetary stimulus if economic growth is slow and unemployment remains high. After the economic reality of slower growth sets in, we see another round of easing sometime down the road.

Domestic economy

During the past two and one-half years, the U.S. accumulated over \$6.5 trillion in debt and added only \$200 billion in GDP. This is not a good return on investment. Total debt will surpass the GDP of the U.S. for the first time since WWII. The U.S. total deficit for 2011 is projected to be about \$1.4 trillion. Approximately 40% of spending at the government level is now borrowed. The stimulus to the states (\$480 billion to date) ended in June and accounts for 30% of states’ budgets. The government currently employs 22.5 million workers vs. 8.7 million in 1960. Manufacturing in the U.S. currently employs 11.5 million workers vs. 15 million in 1960.

The new stimulus proposals may include employee payroll tax breaks, overseas earnings repatriation (never proven to add jobs), capital expenditure tax breaks, and tax credits for new jobs. Releasing the strategic oil supply to lower gas prices was a short-term tool to put disposable income into consumers’ pockets. More quantitative easing seems inevitable since the Fed has bought over 83% of the \$589 billion of net issuance of U.S. Treasuries from November 2010 to March 2011. The Fed has lowered growth projections for 2011 in both April and June with the latest revision down from 2.9% to 2.7%. GDP estimates continue to be lowered every quarter: 1st quarter GDP was 1.9% vs. the consensus of 2.5% to 3% and our forecast of 2%. We see third quarter 2011 GDP at 2% and 2 % for 2011 as a whole. During a typical post recession

recovery, we would expect growth of 3% to 4.5%. As depicted in the chart below, GDP initially rose primarily due to inventory rebuilding and government support, but has since sputtered:



Unemployment

Persistent high unemployment at 9.2% continues to be a key part of the slow recovery. Small businesses, the largest growth creator, are still not hiring and sales are slow. With over 7 million jobs lost since the beginning of the recession, employment is still growing weakly, averaging 171,000 in the second quarter. Analysts expected a job increase of 105,000 workers in June, but only 18,000 jobs were added. There are 8.5 million involuntary part-time workers, those working part-time because their hours were cut or they could not find a full-time job. Real weekly earnings adjusted for CPI are below 1970 levels.

The consumer

Consumer spending in the first half of 2011 stagnated as employment prospects dimmed and rising inflation caused Americans to cut back. Close to 20% of income comes from the government in the form of unemployment compensation, disability, and social security payments. By the end of the year, many of these payments may be cut and this will hurt spending unless there is job growth to compensate. Retail sales overall were flat in the second quarter and auto sales have leveled off. Hourly earnings are up 1.9% y/y while inflation increased 3.7% y/y in May. Energy, food and healthcare costs all rose. It is unlikely that consumer spending, historically two-thirds of GDP, will be a factor for growth in 2011.

Real estate

Real estate has yet to find a bottom. Existing home sales slid another 3.8% from April and are down 4.6% y/y. The National Association of Home Builders said that builder confidence has waned even further with economic growth stalling, foreclosures continuing to hit the market, and the cost of building a home rising. Meanwhile, potential new-home buyers are being constrained by difficulty selling their existing homes, stringent lending requirements, and general uncertainty about the economy. Economic growth must pick up in order for housing to get back on track.

Manufacturing and trade

Corporations have been boosting profits although profit margins continue to be under pressure. Business spending and exports have both been positive. With high prices for commodities, agricultural and oil & gas producing states are faring better than average. A weaker dollar and rising costs in developing markets have benefitted the U.S. with manufacturing jobs up 1.4% y/y in May. Some companies have even moved from China back to the U.S. GE moved production of water heaters citing rising shipping and production costs. World trade in April was down 2.4%, the first time it has been negative since 2009.

World Economies

Japan: The Japanese earthquake, tsunami, and nuclear meltdown brought an economy that was already deflating to a worst case scenario. GDP contracted at a rate of -5.2%. Consumer spending, capital expenditures, and exports were all negative. March was horrible: the purchasing managers index (PMI) was 41.4 vs. 52.9 in February; service sector activity was the worst in 22 years; retail sales were down 8.5% y/y. Auto exports fell off a cliff down 68% y/y. With 14 nuclear power plants shut down, power shortages are forecast through the summer. More monetary easing is needed, but the government debt / GDP is already over 200% and the social security pension fund is now selling government bonds to fund payments. Our 2011 forecast is below consensus at -4% to -5% for the year.

Europe: The northern European countries (e.g., Germany and The Netherlands) continue to outperform the rest of the EU and skew GDP. The UK is sliding into stagnation as GDP remains sluggish. The PIIGS (Portugal, Italy, Ireland, Greece, and Spain) are weak. Banks across the EU hold each others' risky debt obligations and the European Central Bank (ECB) holds \$480 billion of toxic debt itself.

The EU dilemma with Greece is similar to our own crisis in 2008 – if Greece defaults then the remaining PIIGS may follow. Greece is the weakest with 1st quarter GDP -5.5% y/y. The 2011 deficit is still 10.6% of GDP with the 2 yr bond at 28%, so financing is limited. New bailouts may be in the range of \$175 to \$210 billion if approved by the voters. Default in some form is almost a certainty – how to achieve this without hurting banks across Europe is the question. Ireland is almost as bad as Greece. The unemployment rate is close to 20%, the 10 year bond is above 12%, and bank failures have cost \$70 billion Euros, equal to 40% of GDP. Portugal was bailed out to the tune of \$129 billion in the 1st quarter, the 10 yr bond is above 11%, and Moody's cut the debt rating to junk status. If Greece goes under, Ireland and Portugal are next.

Emerging Markets: Growth in developing nations is very strong, but slowing. China is growing fast (2Q GDP +9.5%) even though the government has raised rates in five of the last eight months. In June, consumer prices were up 6.4% y/y and food prices 14.4% y/y adding to the worry over accelerating inflation. China bought 540,000 tons of corn from the U.S. in July after the USDA forecast purchases of 500,000 tons for the entire year. Part of the rate increase is intended to cool the economy and the housing market in particular since it accounts for half of Chinese GDP by some estimates. Commercial and residential property sales were up 24% in the 1st half of 2011. Power consumption in May rose +12% y/y and oil imports were up +8% y/y. Retail sales are slowing, but still up 16.9% y/y. The consumer is only a disappointing 34% of GDP. Foreign exchange reserves are over \$3 trillion and provide many options such as the recent \$463 billion program to bail out local government loans similar to our Troubled Asset Relief Program.

The Indian economy has slowed, although 1st quarter GDP was up 7.8% y/y as exports rose 44% y/y. Food inflation of 9% has hurt the consumer. May industrial production slowed to +4.4% y/y. In Brazil, GDP is still growing nicely on credit expansion, but bad consumer loans are a concern. Russia & the Middle East are benefiting from higher oil prices, but interest rates are up. Russian GDP is growing at about 7%. Other South American and South Asian countries are growing in the range of 4% to 7%. Our forecast for 2011 GDP growth is about 1.5% for the Euro zone. The International Monetary Fund sees global growth at 4.4% for 2011 (already revised down). Our forecast for world growth would be 1.5% to 2% based on Europe, U.S., and especially Japan (75% of world economy among them) worse than expected.

Investment Expectations

The markets have been difficult for the past few years as the financial crisis led to extraordinary measures by governments to try to prevent a collapse and restore confidence. Many investors were in shock and continued to hold too much in cash, were too negative and unable to step in to hedge against a loss of purchasing power and a debasing fiat (paper-based) currency.

Energy still looks attractive as global demand continues to press against spare supply. The U.S. Energy Information Administration (EIA) recently published that 2011 demand would increase +1.7 million barrels per day (mbpd) or + 2%. Chinese demand is forecast at a 4% to 5% annual increase for the next few years. The floor on prices is probably around \$85 even if demand wanes with a softer economy. The demand for gold continued to outpace supply. In the first quarter alone, China bought 93.5 tons, Mexico 109 tons, and Russia 32.8 tons. The S&P 500 in gold terms has deflated 85% since 2000.

We believe that bonds are still over-valued with rates near 0% for 90 day treasuries and below 0.4% for two year notes. We wonder who will buy our deficit bonds especially after the U.S. government steps away from the bidding with the end of quantitative easing. Some of the larger purchasers of treasuries may also slow their buying. Finally, the Japanese may have to sell treasuries to fund reconstruction and social security.

On the equity side, investors are clinging to any positive news among all the negative economic data. We think there may be a correction due to credit worries, economic disappointments in the 2nd and 3rd quarters, and earnings concerns due to lower margins and lower than expected volumes. The harder, real assets such as chemicals, energy, gold, manufacturing, and rails will continue to do relatively well over time despite periods of volatility. Financial stocks continued weaker, a concern since this indicates that investors are wary of remaining mortgage, derivative, and off-balance sheet liabilities. The best groups are those benefiting from easing since August 2010: energy, basic materials, industrials, and healthcare. The worst areas include financials, staples, technology, and utilities. Dividends are imperative since cash yields little. If the economy continues to struggle, we expect the government to return to more quantitative easing as there are few options left. Expect more struggles. We remain vigilant as always.

June 30, 2011

DJIA: 12,414.34

S+P 500: 1,320.64

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

We believe that:

- Global macroeconomic analysis of world-wide trends is valuable
- Security and sector selection are a key part of investing
- Unique business models and good management teams generate better returns
- A valuation discipline can help avoid mistakes

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at <http://www.bountymanagement.com>.

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