U.S. PORTFOLIO STRATEGY WEEKLY

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Overview: Unusually uncertain … in 2011

Robust earnings, strong European data and tentative signs of a pause in Chinese monetary policy tightening have improved the near-term outlook for capital markets. While Chinese and emerging market monetary policy tightening, European fiscal policy tightening and bank deleveraging are not complete, in the short term none of these factors seem likely to be acute enough to negatively impact U.S. capital markets unless the endogenous variable, U.S. growth, deteriorates. Our read of earnings season thus far supports our view that the equity and Treasury markets have extrapolated an outcome from the recent downtrend in macroeconomic data that is very unlikely in 2H10 (a substantial growth slowdown or even a double dip). Still, while 2Q10 earnings results are moving 2010 earnings estimates higher, there has been a small cut to 2011 estimates since July 1, perhaps reflecting policy headwinds from regulatory tightening (Dodd-Frank, Basel III, Affordable Care (Obama Care)) and fiscal tightening and the expiration of the Bush tax cuts. In other words, the bulk of the 'unusual uncertainty' relates to the 2011 outlook; we think that 2H10 is in better shape than the Treasury or equity markets would lead you to believe.

Overview: Tax policy & P/E multiples – on a collision course?

As the debate about the Bush-era tax cuts intensifies, one thing seems certain: The Obama administration will allow tax cuts for the wealthiest Americans to expire after 2010. As strategists, we thought we'd try to help investors by contributing our thoughts on the stock market impact of tax increases for top earners. We think it's reasonable to make the general observation that tax increases have gone hand-in-hand with a downward re-rating of equity valuations (read: higher earnings yields); however, we doubt one could easily conclude the end of the world is nigh, at least based on this single variable. The bottom line is there's enough of a relationship here to flesh out some thoughts about the impact of taxes (higher) on P/E multiples (lower) over the next couple of years. If the White House allows the tax cuts for top earners to expire, multiples could compress by at least another point (12x currently). The difference between 11x and 12x consensus earnings of roughly $96 for 2011 is 100 index points. Food for thought in the current political landscape.

VIEWS ON A PAGE

In December 2009, we expected a series of corrections and rallies in 1H10. The expansion in manufacturing and consumption has spread to the labor market; however, continued deleveraging and municipal finances have acted as a drag on growth. Additionally, the European debt crisis is threatening the banking system and the European recovery. These lingering deflationary forces have been at the core of two significant equity market corrections this year, and are likely to lead to a slower-than-expected normalization of Fed policy, in our view. As we look out into the 2H10 post-earnings season, we see policy normalization, optimistic earnings forecasts and fiscal tightening as hurdles for U.S. equities.

Our S&P 500 operating EPS forecasts are $76 (34% y/y) in 2010 and $80 (5% y/y) in 2011

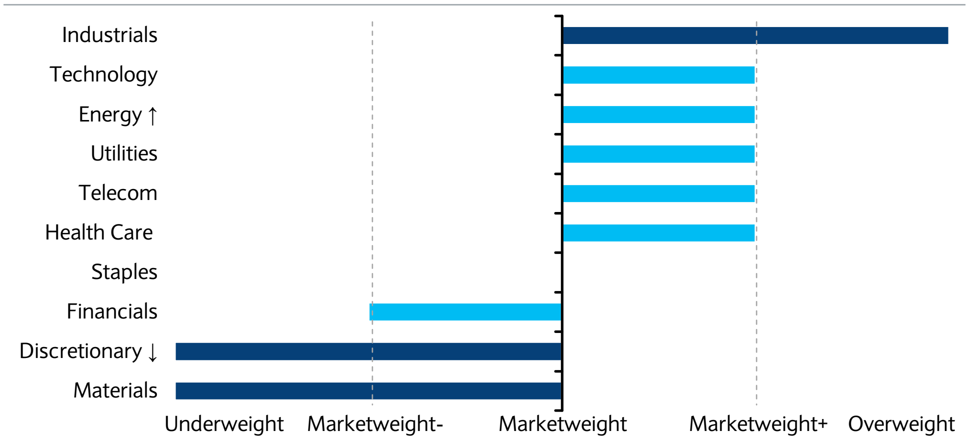
	Full-Year 2009a		Old Full-Year 2010e		New Full-Year 2010e		New Full-Year 2011e	
S&P 500	Level	y/y	Level	y/y	Level	y/y	Level	y/y
Operating EPS*	$57	15%	$71	25%	$76	34%	$80	5%
P/E	20x	7%	17x	-13%	16x	-6%	–	–
Index	1,115	23%	1,210	9%	1,210	9%	–	–

*Trailing four-quarter. Source: Barclays Capital

We want to make it clear we are positive on U.S. stocks at current levels. Equity valuations relative to investment-grade credit have improved to levels last reached in the late 1980s. We believe the equity market is assigning far too high a probability on double-dip scenarios, and would continue to accumulate stocks on corrections. Our year-end price target for the S&P 500 is 1,210, the product of $76 operating EPS and a 16x multiple. We think the near-term earnings outlook for the S&P 500 is positive, but we are less sanguine about post-earnings season as the prospect of fiscal tightening nears.

On a breakdown we would consider Utilities, Telecom and Health Care; on a breakthrough, we would favor Industrials, Technology and Energy.

We favor cheap to fair defensives and higher-quality cyclicals



Note: ↑/↓ = increases/decreases on 6/24/10 to ratings in place since 3/18/10 or earlier. Source: Barclays Capital

We would look at cheap to fair defensives such as Utilities, Telecom and Health Care, which we expect to continue outperforming if the overall market tone remains weak. Given the transition from the early to later stage of the cycle and the shift from consumption to investment, we're inclined to maintain our negative stance on Discretionary. Also, we would avoid segments geared to emerging markets and demand from the developing world (tighter monetary policy) like Materials, and favor sectors with a strong demand base across the major economies (easier monetary policy) such as Industrials, Technology and Energy.

OVERVIEW

Unusually uncertain … in 2011

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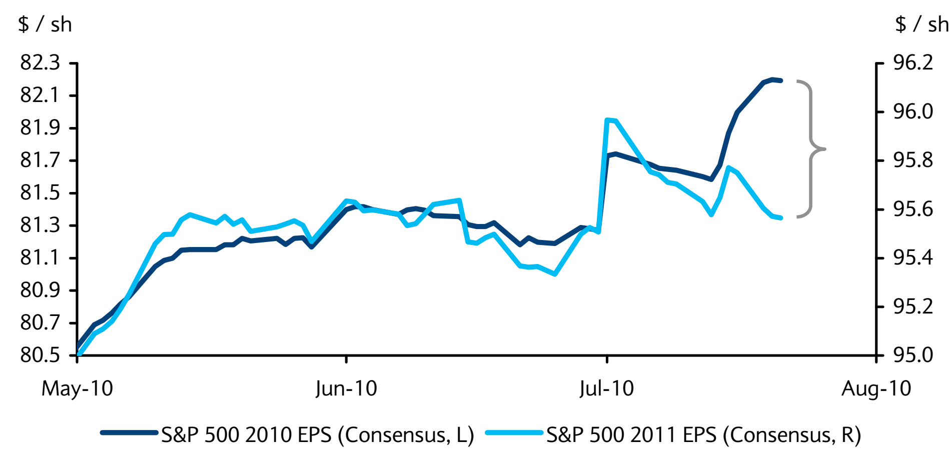
- **Robust earnings, strong European data and tentative signs of a pause in Chinese monetary policy tightening have improved the near-term outlook for capital markets.**
- **The fiscal policy debate is picking up momentum in the U.S. and policy makers' current approach may prove less effective against the powerful force of consumer deleveraging.**
- **If the White House allows the tax cuts for top earners to expire, multiples could compress by at least another point (12x currently). The difference between 11x and 12x consensus earnings of roughly $96 for 2011 is 100 index points.**

Our read of earnings season thus far supports our view that the equity and Treasury markets have extrapolated an outcome from the recent downtrend in macroeconomic data that is very unlikely in 2H10 (a substantial growth slowdown or even a double dip). Still, while 2Q10 earnings results are moving 2010 earnings estimates higher, there has been a small cut to 2011 estimates since July 1, perhaps reflecting policy headwinds from regulatory tightening (Dodd-Frank, Basel III, Affordable Care (Obama Care)) and fiscal tightening and the expiration of the Bush tax cuts (the subject of this week's Focus section). In other words, the bulk of the 'unusual uncertainty' relates to the 2011 outlook; we think that 2H10 is in better shape than the Treasury or equity markets would lead you to believe.

Figure 1: There has been a small cut to 2011 estimates since July 1, perhaps reflecting policy headwinds



Note: Consensus represents analyst bottom up estimates. Source: Bloomberg

The equity market fixated on Fed Chairman Bernanke's remarks in the opening leg of Wednesday's Humphrey Hawkins testimony where he described the economic environment as 'unusually uncertain' leading to a sharp move lower in equities. We weren't surprised by his comments (which made the equity market reaction surprising) having read the minutes of the last FOMC meeting and formed the view that any talk of contingency planning (additional easing steps) is theoretical unless the growth forecast dropped below potential growth (2 ¾%). A chart within the minutes showed the range of projections and the central tendency forecast that made it pretty clear the 'unusual uncertainty' pertained to

2011 forecasts not 2010. Some of the increased dispersion is the nature of forecasting; however, with the economy at an important inflection point (the massive inventory replenishment cycle is largely complete, fiscal policy is likely to turn restrictive and monetary policy, though clearly in accommodative territory, is no longer driving an improvement in credit creation), the 2011 outlook is murky, in our view. Additionally, we are reluctant to view one of the major sources of that uncertainty, fiscal policy, as subject to a normal distribution. In other words, when politics impact economics and markets, the range of outcomes expands; the tails get fatter and the probability of adding constraints that move the center of the distribution away from the efficient frontier increases. So, while we don't disagree with the Fed's 2010 forecast, we do find its 2011 forecast for growth to *accelerate* 'unusually uncertain' given the historical pattern that the strongest growth is in the first year of a recovery and the outlook for fiscal tightening. We can only surmise that the Fed expects all of the deleveraging and policy related headwinds to dissipate; we are far less confident that policy makers will create conducive conditions for growth acceleration.

In the short run, the shorts are all dead

In our view, three factors drove the equity market correction from late April through early July; one was endogenous (weak U.S. macro data) and two were exogenous (Asian monetary policy tightening and European fiscal policy tightening). In our view, the most important of these variables was and continues to be the U.S. growth outlook. Additionally, there has been some degree of reduced uncertainty with respect to the two exogenous factors. While the improved outlook is likely to have a limited duration, we do believe there is additional upside, though probably not back to the late April highs.

Chinese equities have been weak most of the year, however, they have recovered recently led by real estate stocks amid talk of easing real estate lending and development restrictions. Commodities and commodity currencies have rebounded sharply as well due to market expectations of slower monetary policy tightening in China, strong data from Germany and the UK and an improvement in the U.S. growth outlook owing in part to strong corporate earnings. China is operating at full capacity, inflation pressures are building and will be evident over time; however, for now we seem to have reached a pause in the tightening process.

In Europe, a set of strong economic reports from Germany and the UK offset what seems to be a disappointing stress test process. Despite what appeared to be a reasonable set of economic conditions, the amount of the capital shortfall was a small fraction of street estimates. It looks to us that the capital test utilized total tier 1 capital rather than core tier 1 capital or the tangible equity capital ratio. European banks have taken loan book write-offs of less than half the percentage amount in the U.S. and tangible equity capital levels are significantly lower. The stress tests in the U.S. created conditions supportive of raising private capital and the Fed's securities purchases helped accommodate bank balance sheet deleveraging. Conversely, the European stress tests will facilitate very little capital raising, the ECB has virtually halted its securities purchases and European bank balance sheets are three times as large as in the U.S. suggesting a lengthy deleveraging process and implying the stress tests are unlikely to represent an inflection point with Basel III looming quite large. We would avoid the European bank stocks.

So, while Chinese and emerging market monetary policy tightening, European fiscal policy tightening and bank deleveraging are not complete, in the short term none of these factors seem likely to be acute enough to negatively impact U.S. capital markets unless the endogenous variable, U.S. growth, deteriorates.

Figure 2: Earnings season is progressing as we expected; revenue growth is above the 10% y/y analyst consensus forecast and earnings are exceeding expectations by 4.6%

	S&P 500 Revenues				S&P 500 Earnings			
Sector	Q1 2010A	y/y % chg	Q2 2010E	y/y % chg	Q1 2010A	y/y % chg	Q2 2010E	y/y % chg
Discretionary	271	2.5	274	9.0	16.9	1,043.2	16.6	51.2
Staples	293	5.0	305	4.7	18.0	14.1	19.5	4.6
Energy	281	35.6	323	38.5	22.5	1,807.8	23.5	92.6
Financials	318	5.4	307	(0.6)	29.7	844.4	31.4	358.2
Health Care	267	6.5	270	6.1	24.4	(1.5)	25.8	6.6
Industrials	225	(1.8)	241	3.5	15.1	17.8	18.3	17.5
Technology	201	17.9	210	22.0	29.3	95.5	33.3	78.8
Materials	78	21.8	85	31.1	5.7	217.9	6.4	127.0
Telecom	73	1.1	73	0.1	5.2	(0.3)	5.3	2.5
Utilities	93	5.7	79	11.2	8.2	24.1	6.2	6.6
S&P 500	2,098	9.0	2,168	11.0	175.0	99.3	186.3	54.1

Note: S&P 500 Revenues and Earnings are based on float weighted shares. Source: Standard & Poor's, Compustat, Reuters, FactSet, Barclays Capital

Our read of the most recent U.S. micro and high frequency macro data is encouraging as it reduces the risk that the recovery will prove unsustainable and growth will soften significantly in 2H10. To begin with, earnings season is progressing as we expected; revenue growth is above the 10% y/y analyst consensus forecast and earnings are exceeding expectations by 4.6% which is moving the 2010 estimate higher. We expected top-line growth would be the primary driver for not only the stock market but also for capital markets broadly, given what a strong result would say for macroeconomic momentum. While results are only marginally exceeding forecasted revenue growth, the strength is robust across sectors with technology and industrials performing best relative to expectations. The only sector with negative y/y revenue growth (financials) is marginally exceeding estimates, and the sector expected to provide the greatest upside to corporate revenues, energy, has only had 8% of its market capitalization report thus far, implying that the aggregate revenue growth could go higher than the 11% y/y run rate. Despite IBM's poor top line result, the investment recovery looks very much intact to us as technology revenues are showing the best positive surprise and are tracking +22% y/y while earnings are up +79% y/y. Industrial results have also been impressive; on Thursday, a number of the key components of the S&P 500 Industrials Index (MMM, CAT, UNP, and UPS) all posted strong results and saw sharp share price increases. Industrial revenues have turned positive (+3.5% y/y) and earnings are +17% y/y. Additionally, while we believe this is the wrong stage of the cycle to be long the consumer discretionary sector, revenue growth of 9.0% y/y (in line with forecasts), operating earnings growth of 51% y/y (+0.8% above forecasts) underscores that despite the recent apparent stalling of the labor market recovery, the uptrend in labor income or wealth effects continue to support positive consumption patterns.

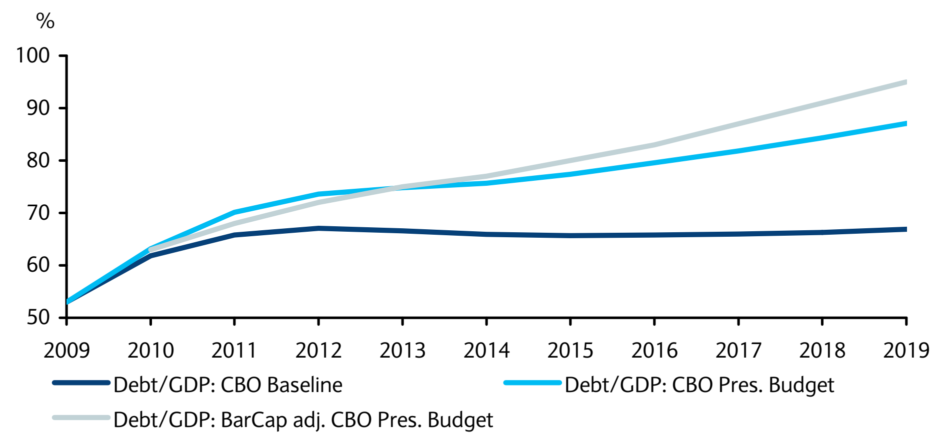
Also supportive of an improved tone in consumer spending in early 3Q10 was the JD Power forecast for a sharp rebound in July sales (which would break a three month downtrend in non-fleet sales), the ICSC Chain Store Sales report (running +5.6% y/y in July) and the ICSC forecast for a 3-4% monthly increase (after a 3% increase in June and 2.6% increase in May). We checked in with our transportation analyst Gary Chase and if you have considered either deflation or a sharp growth slowdown as plausible outcomes for 2H10 (or if you are a Dow Theorist) we suggest you do the same. For airlines, rails, and packaging delivery, revenues are exceeding expectations and guidance is rising due to pricing and/or volumes. This bodes well for consumer and business spending in 3Q10, in our view.

As we anticipated, this week's housing reports were positively skewed relative to reduced expectations. While the NAHB Homebuilder Survey and Housing Starts missed forecasts, single family starts, permits, existing home sales and the FHFA House Price Index all exceeded expectations. In addition, the Moody's Real CPPI Commercial Real Estate Price Index rose sharply and is now up 8.6% from the September 2009 low. Taken in conjunction with the various residential real estate price measures, it appears to us that real estate has found a market clearing price. It will take an extended period to clear the excess inventory in residential real estate and office space, implying prices are not about to start rising; however, given the banking system's exposure to these assets, price stability suggests that the improvement evident in this quarter's bank credit metrics looks sustainable.

Keynesian pushing on a string: Next year, the longs might be dead

The common theme from both legs of Chairman Bernanke's semi-annual Congressional testimony was questions on the budget deficit. The Chairman suggested that reducing the deficit to the level of interest payments by 2013 or 2015 at the latest would stabilize the debt to GDP ratio. It seems pretty clear that under any of the current proposals, the President's budget, CBO projections and our rates strategy team's adjusted CBO projections, debt/GDP levels are headed higher.

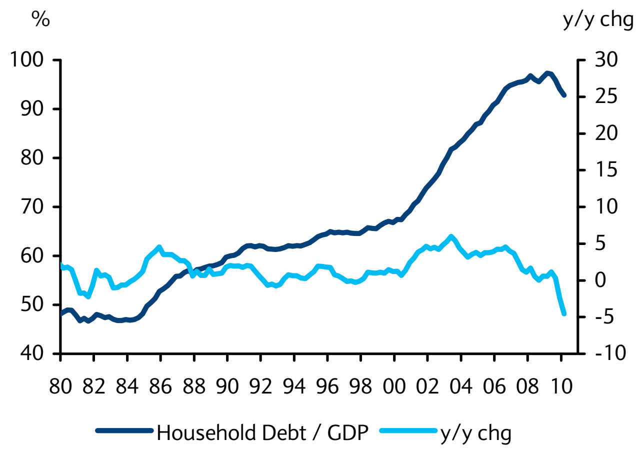
Figure 3: It seems pretty clear that debt/GDP levels are headed higher



Source: CBO, Barclays Capital Fixed Income Strategy

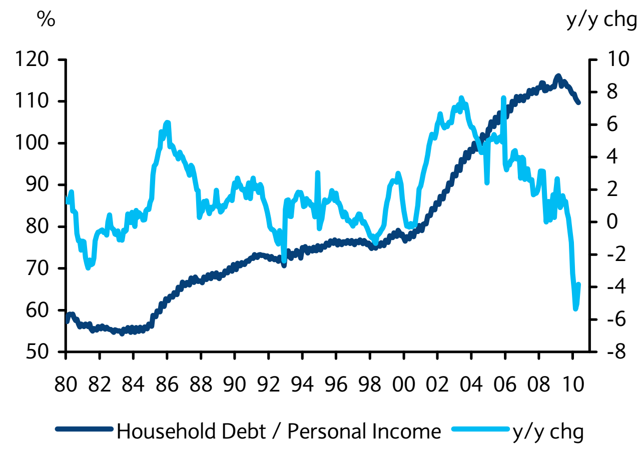
The Chairman was also asked about approaches to cutting the deficit and while he was reluctant to get embroiled in the spending cuts or tax hike debate we are not. The mix and nature of the approach has important implications for the cost of capital and equity valuations. In our view, consumer deleveraging will have a significant impact on the effectiveness of the various approaches. The most daunting way of estimating the magnitude and duration of the trend towards consumer deleveraging is to look at total consumer debt to GDP at 93% (down from a peak in March 2009 of 97%) or debt to personal income of 110% (also down from a peak in March of 2009 of 116%). Both of these levels have more than doubled since the 1980's.

Figure 4: Both total consumer debt to GDP at 93% and …



Source: FRB, Bloomberg, Barclays Capital

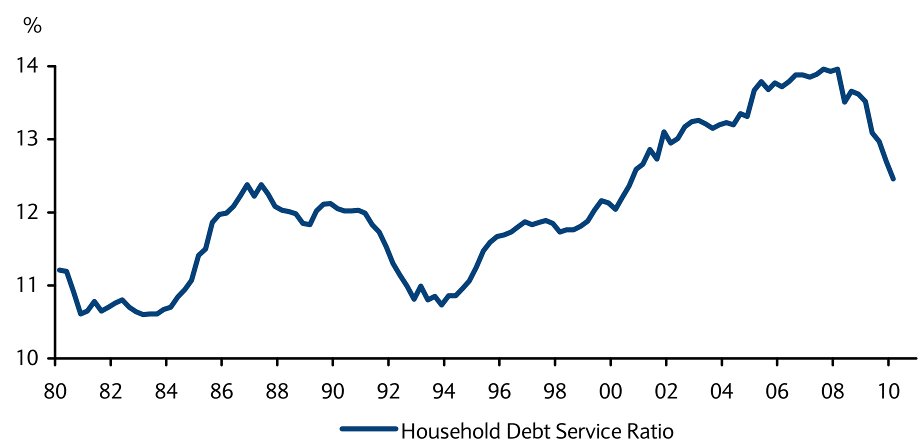
Figure 5: … debt to personal income of 110% have more than doubled since the 1980's



Source: FRB, Bloomberg, Barclays Capital

Measures of debt service are a bit more encouraging; total household debt service, which rose from its early 1990's trough level of 10 ¾% to 14% in September 2007 has retraced nearly half the increase and is only 35bp above the mean since 1980 (the beginning of the series) and has fallen as much and for the same length of time (three years) as it did in the aftermath of the early 1990's recession.

Figure 6: Consumer debt service is easing, but still trending lower



Source: FRB, Haver

Still, we don't believe the drop is complete; the early 90's deleveraging retraced virtually the entire increase during the prior expansion and this chart is showing no signs of stabilization. The rates of change may slow, but the absolute levels imply the trend is not complete. The consumption pattern during the recovery has confounded economists. A surge in government transfer payments in the spring of 2009 failed to produce the spending multiplier the Administration's economics team was counting on, while the 2009 stock market recovery led to a faster than expected recovery in spending (wealth effect). In other words, the primary driver of the U.S. economy, the consumer, is attempting to rebalance towards investment away from consumption. Despite the strong evidence suggesting this trend is likely to continue (perhaps to attempt to ease the period of adjustment and avoid

Keynes' 'paradox of thrift'), policy makers continue to insist on attempting to stimulate consumption via wealth transfer payments rather than creating investment incentives. Extending unemployment benefits without offsetting spending cuts, repealing the tax cuts for only the highest income brackets, and the Affordable Care legislation are all examples of attempting to stimulate consumption at the expense of investment. These policies may prove to be the fiscal equivalent of 'pushing on a string' given the apparent increase in the consumer's marginal propensity to save rather than consume. There is little doubt that tax hikes will play a role in the coming fiscal adjustment; the type of hikes will impact the cost of capital and their relative effectiveness is not likely to cooperate with those simplifying assumptions economists are so fond of, due in large part to the trend that seems likely to continue through the cycle: Consumer deleveraging.

FOCUS

Tax policy & P/E multiples – on a collision course?

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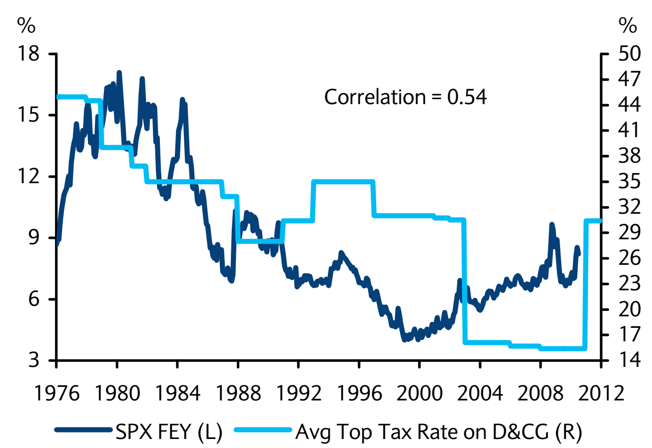
As the debate about the Bush-era tax cuts intensifies, one thing seems certain: The Obama administration will allow tax cuts for the wealthiest Americans to expire after 2010 (*White House to Allow Tax Cuts for Wealthy to Expire*; the Wall Street Journal; 07/22/10). Many economists have argued that the recovery is too fragile to raise taxes so soon, and we agree it would add to the headwinds facing the economy. As strategists, however, we thought we'd try to help investors by contributing our thoughts on the stock market impact of tax increases for top earners.

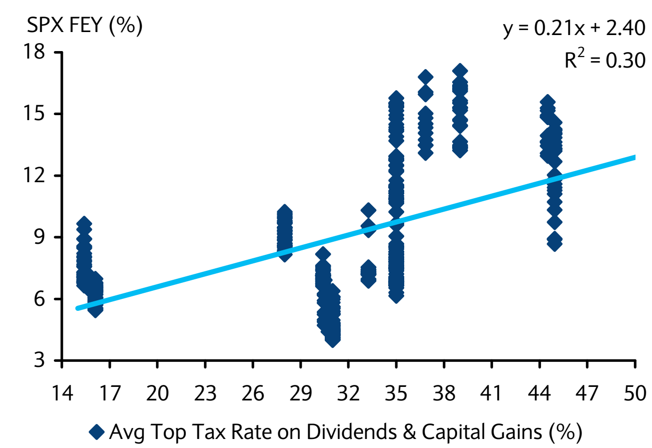
The charts below show the average top federal tax rate on dividends (currently 15%) and capital gains (currently 15%), both of which have an intuitive link to the equity market, alongside the S&P 500 forward earnings yield since 1976. While a correlation coefficient of 0.54 is decent, admittedly, it's far from perfect. As such, we think it's reasonable to make the general observation that tax increases have gone hand-in-hand with a downward re-rating of equity valuations (read: higher earnings yields); however, we doubt one could easily conclude the end of the world is nigh, at least based on this single variable. The bottom line is there's enough of a relationship here to flesh out some thoughts about the impact of taxes (higher) on P/E multiples (lower) over the next couple of years.

Figure 1: There's enough of a relationship here to flesh out some thoughts about the impact of taxes on P/E multiples



Source: Barclays Capital. Note: FEY = forward earnings yield; D&CG = dividends & capital gains.

Figure 2: Generally, tax increases have gone hand-in-hand with a downward re-rating of equity valuations



Source: Barclays Capital. Note: FEY = forward earnings yield.

How many multiple points could we lose if the White House allows the tax cuts for top earners to expire? If we assume that the top tax rate on dividends reverts back to pre Bush-era tax cut levels of 39.6% (taxed as ordinary income), and the top tax rate on capital gains does the same to 20%, the average of the two doubles from 15% to 30%. Plugging this x-value into the simple albeit less-than-perfect regression equation from Figure 2, we get a y-value of 11x. In other words, multiples could compress by at least another point (12x currently); this doesn't sound like much, but one multiple point can make a big difference when estimating the level of the S&P 500 one year from now. For example, the difference between 11x and 12x consensus earnings of roughly $96 for 2011 is 100 index points.

Figure 3: Multiples could compress by at least another point, from 12x to 11x; the difference between 11x and 12x consensus earnings of $96 for 2011 is 100 index points

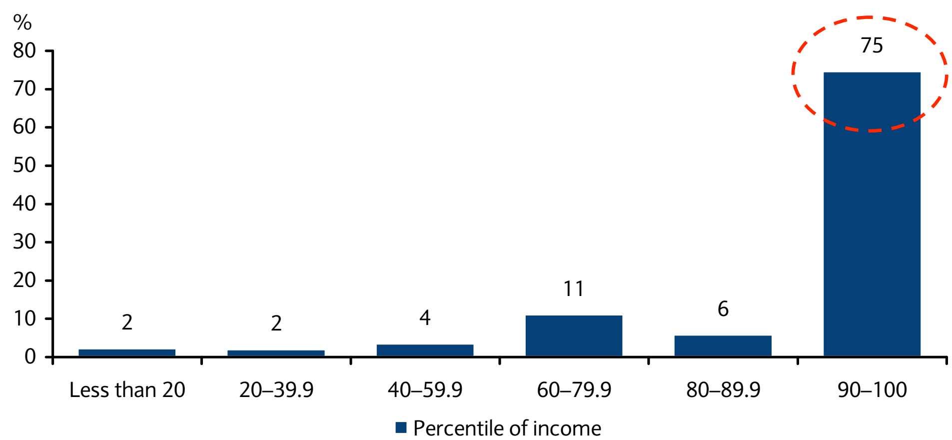
Y	=	M	*	X	+	B
9% (11x)	=	0.20992	*	30%	+	2.39903

Source: Barclays Capital.

What about the other income strata? True, the Obama administration plans to extend tax cuts for middle- and lower-income earners. However, we'd like to point out that according to the Fed's 2007 Survey of Consumer Finances, 75% of stock market wealth is held by families in the top percentile of income (Figure 4). From a behavioral standpoint, if the government follows through on its plan to raise dividend and capital gains taxes for the highest income earners, it could influence the asset allocation decisions of an important investor class and potentially bring about a shift away from equities, with negative knock-on effects for the economy.

If the government follows through on its plan to raise dividend and capital gains taxes for the highest income earners, it could influence the asset allocation decisions of an important investor class and potentially bring about a shift away from equities, with negative knock-on effects for the economy.

Figure 4: According to the Fed's 2007 Survey of Consumer Finances, 75% of stock market wealth is held by families in the top percentile of income



Source: The Federal Reserve Board, Barclays Capital.

How much stock market wealth is taxable? While that's a difficult question to answer, using data through 1Q10 from the Fed's Flow of Funds Accounts (L.213 and B.100e), we estimate that 60% of the equity market value held by households and nonprofit organizations is taxable which equates to 50% of the overall market value of corporate equities (Figure 5). Granted, these are high estimates because "Households and Nonprofit Organizations" is a residual account that includes farm households and domestic hedge funds, "Corporate Equities" includes holdings of U.S. issues by foreign residents, and "Directly held" includes a portion of non-taxable equities in IRAs. Nonetheless, the point we're trying to make is that a big chunk of market cap is vulnerable to tax policy changes. Food for thought in the current political landscape.

Figure 5: We estimate that 60% of the equity market value held by households & nonprofit organizations is taxable which equates to 50% of the market value of corporate equities

Taxable Equity MV Held by Households & Nonprofit Organizations (Bil of $)	1Q10
Corporate Equities	**21,242.1**
Households & Nonprofit Organizations	**16,878.1**
Directly held	*7,793.3*
Indirectly held	9,084.8
Life insurance companies	1,340.2
Private pension funds	3,232.8
Defined benefit plans	999.1
Defined contribution plans	2,233.7
State & local government retirement funds	1,806.5
Federal government retirement funds	127.8
Mutual funds	*2,577.4*
Taxable Equity MV = Directly held + Mutual funds	**10,370.7**
As a % of Households & Nonprofit Organizations	**61%**
As a % of Corporate Equities	**49%**

Source: The Federal Reserve Board, Barclays Capital. Note: MV = market value.

A summary of the President's proposed tax policy changes

The 2001 (EGTRRA) and 2003 (JGTRRA) tax cuts are set to expire in 2011. Broadly speaking, President Obama proposes to extend tax cuts for those making less than $200,000 (single) and $250,000 (married). Relative to 2010, 2011 taxes would be higher for high-income earners and about the same for lower-income earners.

Individual

Income Tax Rates: Reinstate 39.6% (from 35%) and 36% (from 33%) tax brackets. 39.6% would apply to >$375,000 and 36% would apply to $200,000 (single) and $250,000 (married).

Tax Increase (Treasury estimate): $13 bn (2011) and $29 bn (2013).

Limit Exemptions and Itemized Deductions: Limit tax rates on deductions to 28% for 36% and 39.6% tax brackets. Reinstate limits on deductions and reinstate personal exemptions (allow EGTRRA to expire).

Tax Increase (Treasury estimate): $15 bn (2011) and $42 bn (2013).

Dividends & Capital Gains: Increase to 20% from 15% for incomes higher than $200,000 (single) and $250,000 (married).

Tax Increase (Treasury estimate): $12 bn (2011) and $3 bn (2013).

Corporate

Corporate Tax Rates: Changes are largely unclear (reform the U.S. international tax system, impose a financial crisis responsibility fee, bank tax dropped for now, some extension of bonus depreciation, eliminations of fossil fuel exemptions like biofuel).

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