Profitis Capital Services LLC

A REVIEW OF THE MONETARY LANDSCAPE

MARCH 17, 2011

Executive Summary

The financial crisis that arose in the Autumn of 2008 prompted the Federal Reserve to provide an extraordinary amount of liquidity to the capital markets. Two quantitative easing programs were subsequently launched in an effort to provide support for asset markets.

Either the U.S. economy has embarked on a significantly different path or none of these Fed actions have worked. Money supply growth is tepid at best and money multipliers are sitting at multi-decade lows. Financial institutions are holding an unprecedented amount of excess reserves, undermining the Fed's expansion of the monetary base.

Employment gains are weak relative to past economic recoveries and the specter of margin compression is confronting corporate America. Can financial markets continue to thrive in the absence of the "Federal Reserve's Put"?

Where Are We Now?

- Measures of Money Supply
  - M3
  - M2
  - Reserves
  - Multiplier

- Measures of Price Levels
  - CPI
  - PPI
  - GDP Deflator

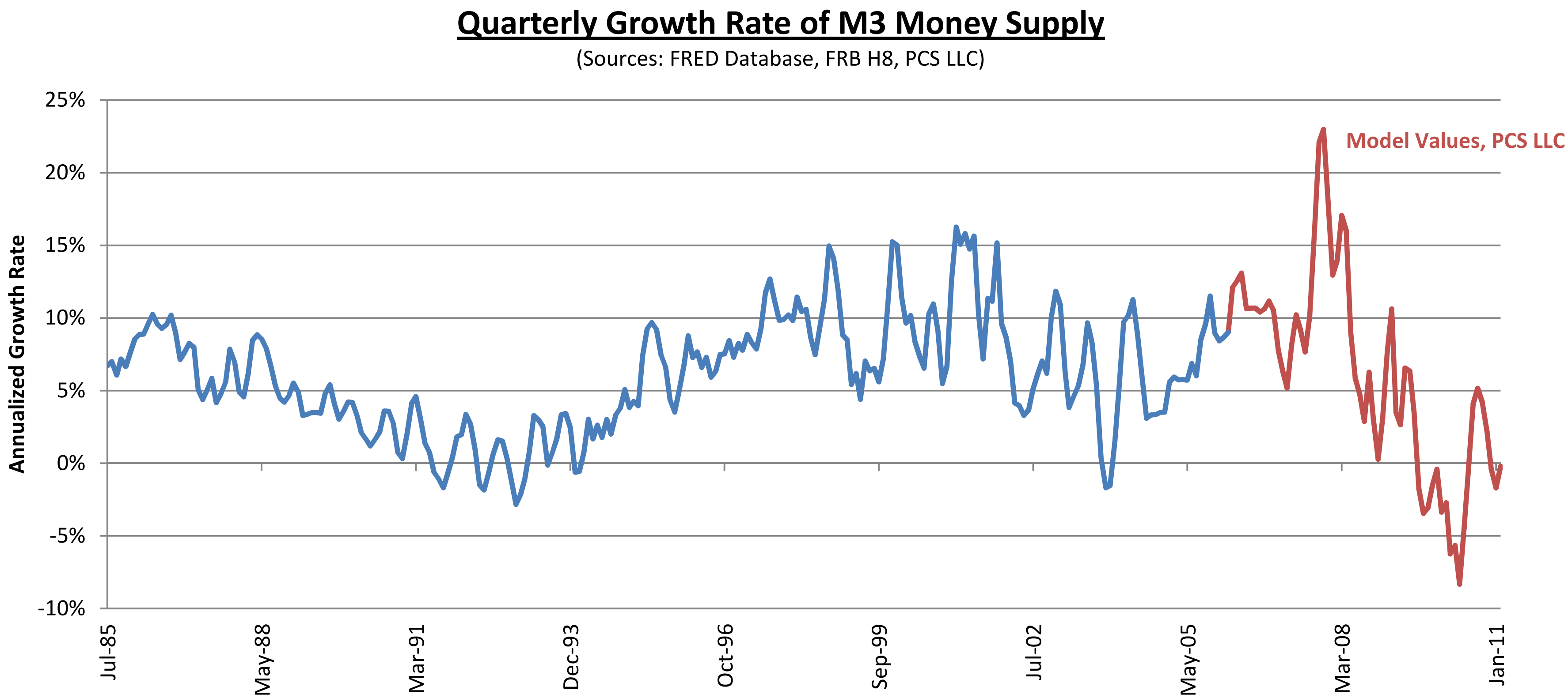
- Measures of Debt Levels
  - Federal
  - Corporate
  - Consumer
  - Capital Markets Activity / Securitization

Where Are We Now? (continued)

- Measures of Economic Activity
  - GDP
  - Employment

- Measures of Corporate Strength
  - Corporate Profits
  - Loan Charge-Offs

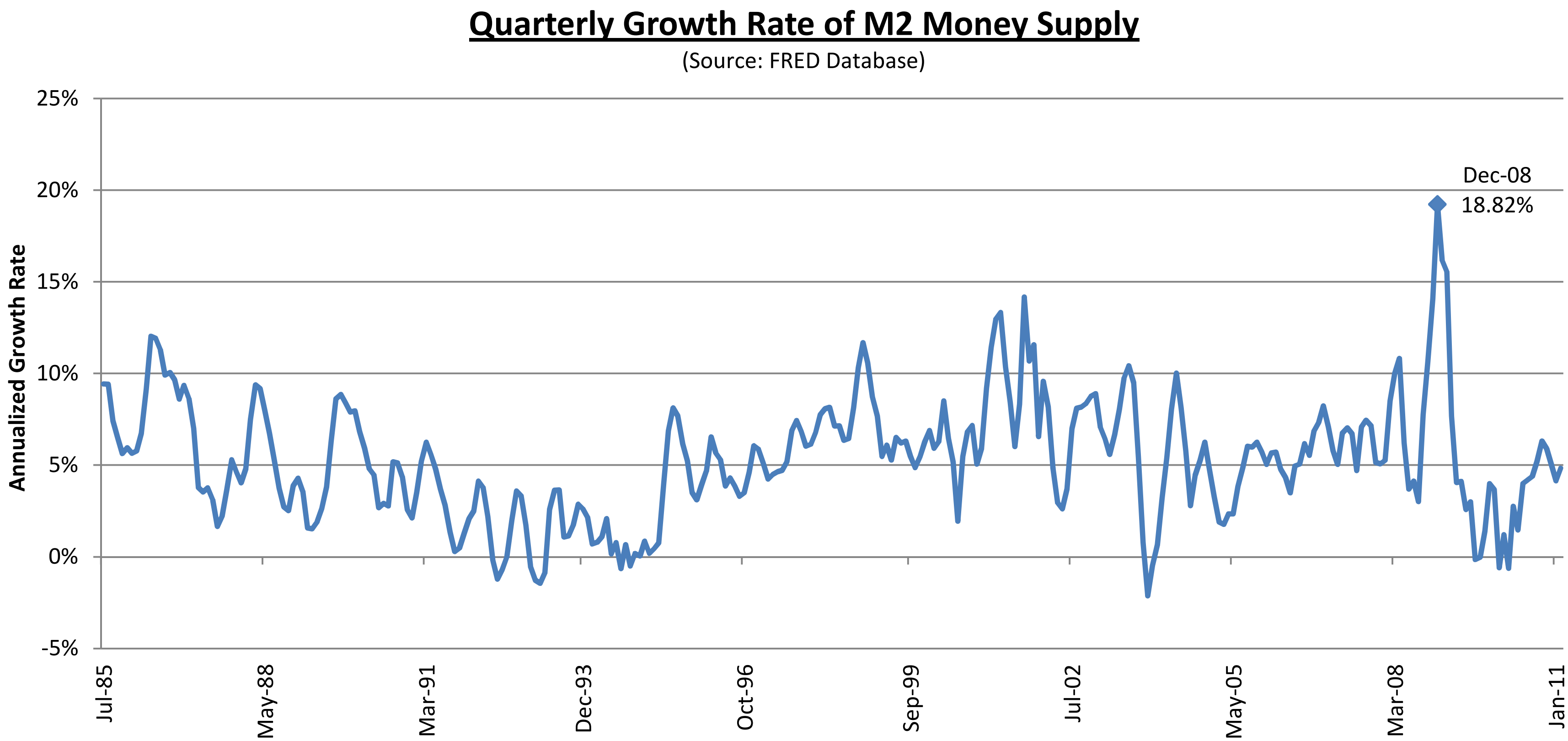
Money Supply[1]



Growth in M3 spooled up dramatically after the Fed's initial actions during the fall of 2007. Between that time and the summer of 2010, growth in M3 was best described as first disinflationary and then deflationary.

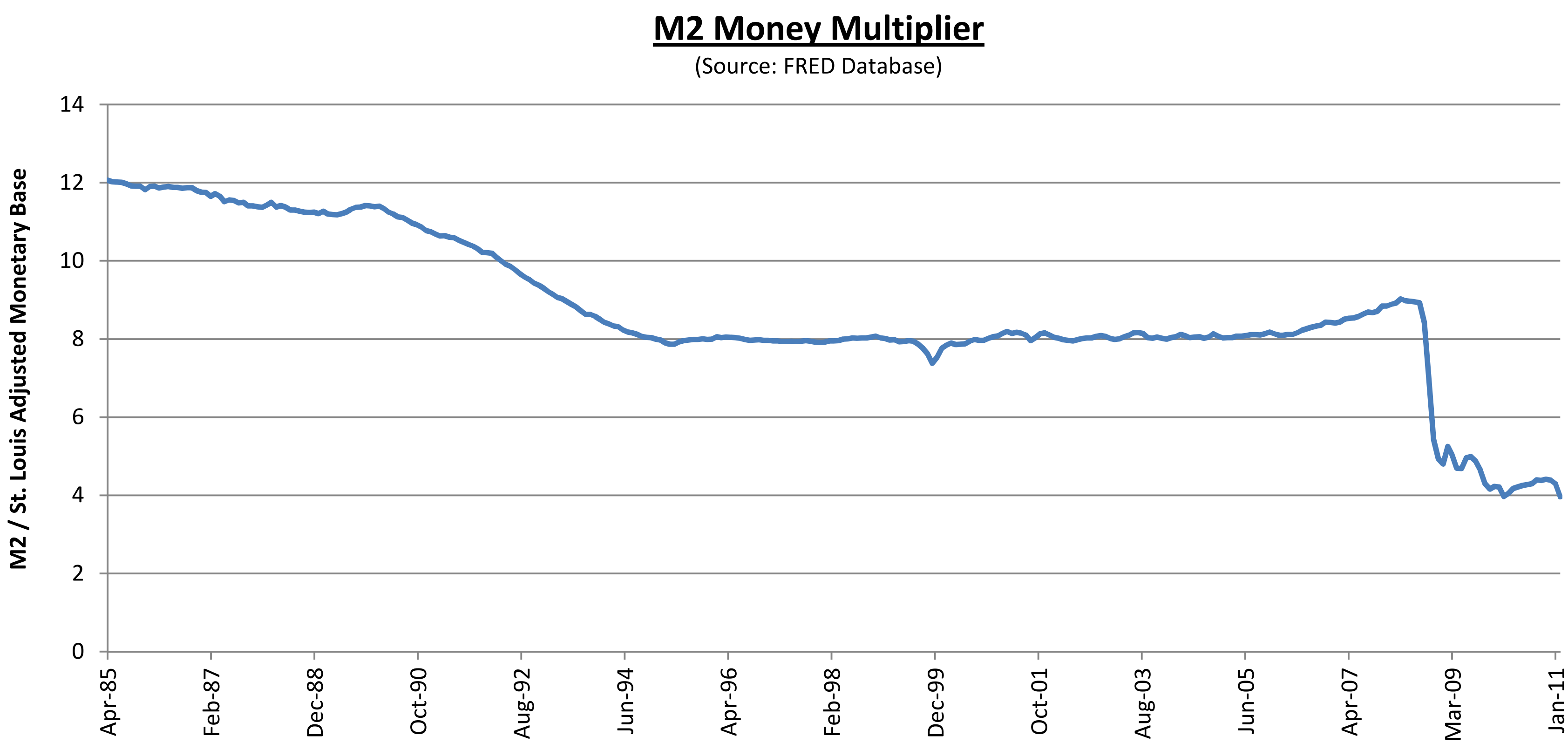
[1] The Fed ceased reporting M3 in March of 2006. PCS LLC's model incorporates available Fed data to reasonably recreate the measure.

Money Supply



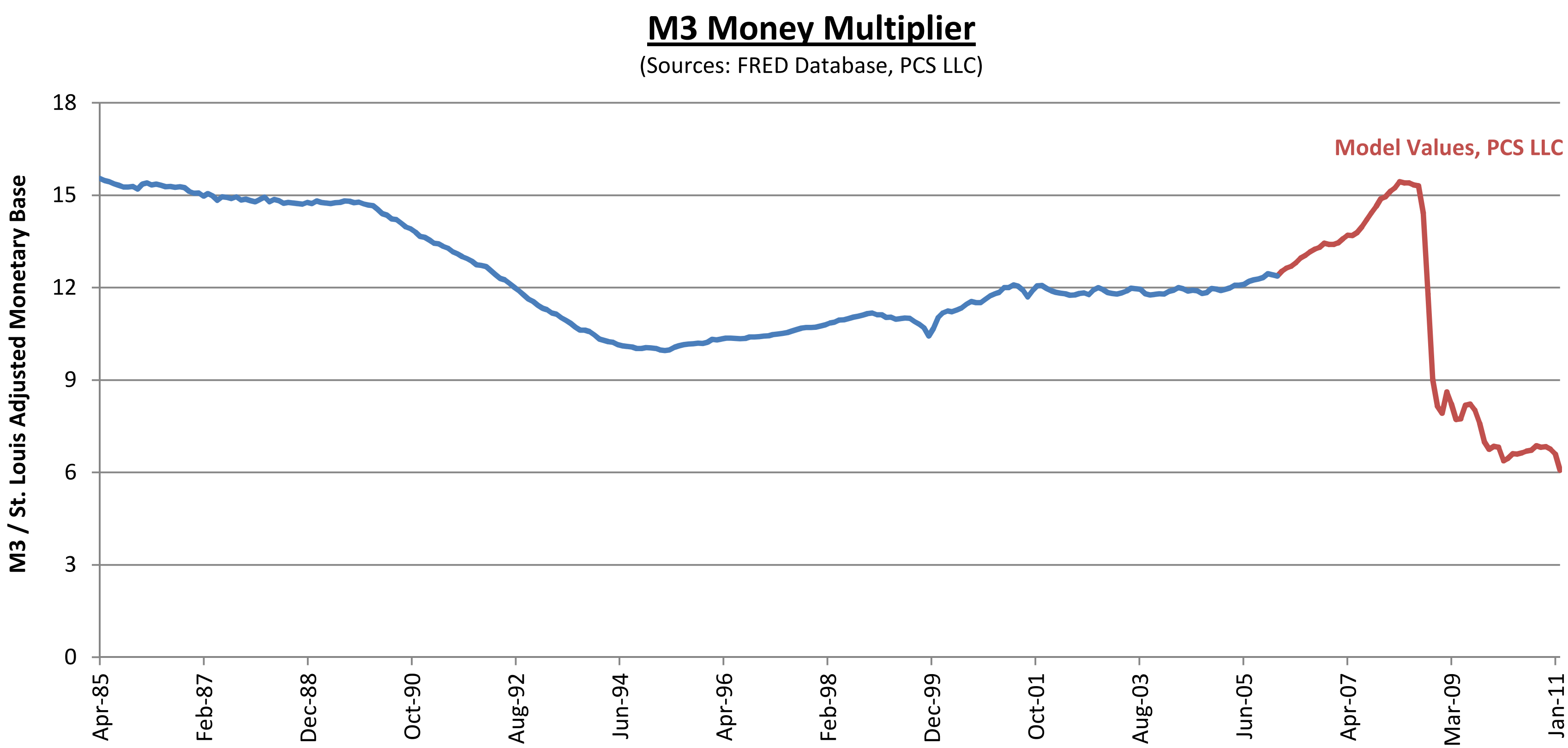
Growth in M2 also dipped into negative territory at points during the last 14 months. The most recent tallies are well within the range of historic observations.

Money Supply



The money multiplier is a ratio of broad money supply to high powered money. This figure illustrates the inability of the Fed to significantly increase money supply, despite materially increasing the monetary base.

Money Supply



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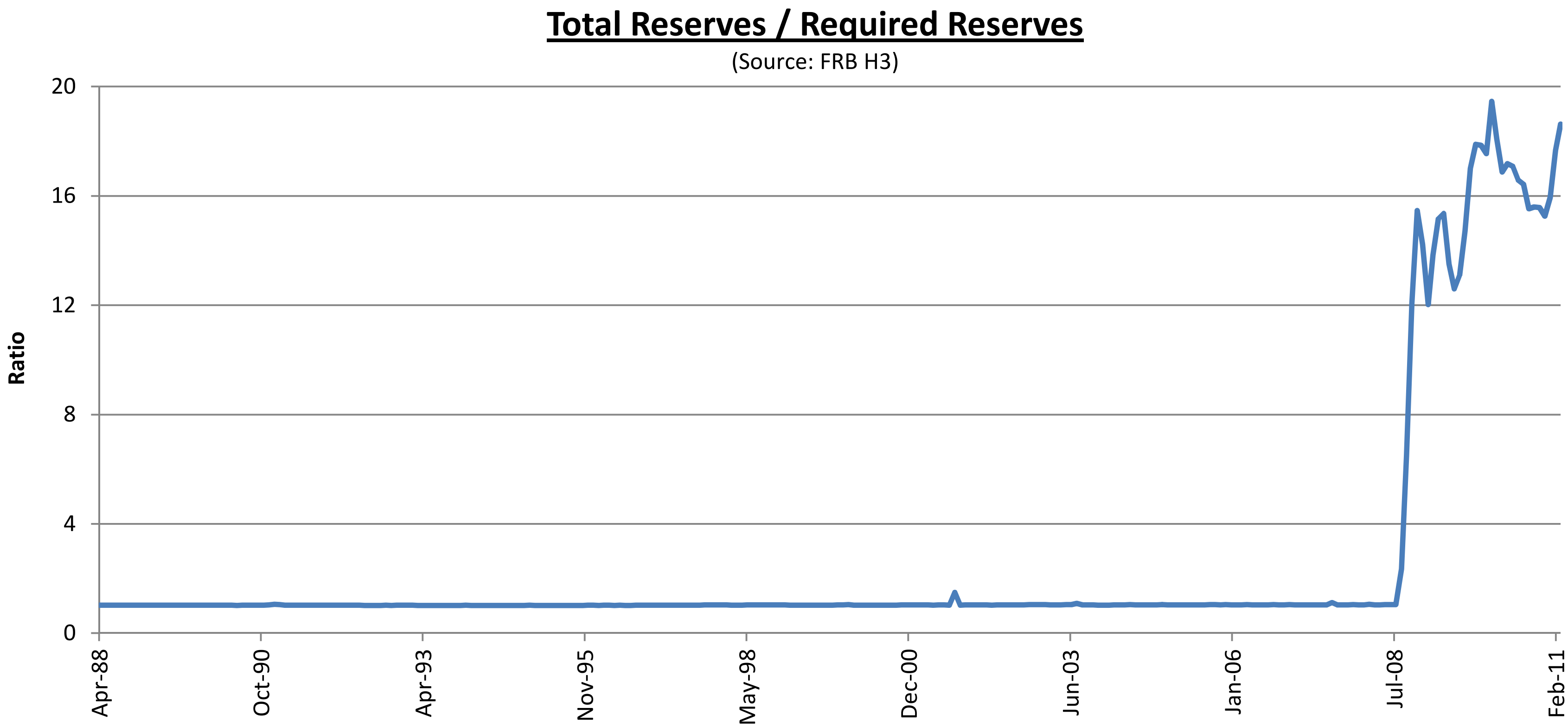
Reserves of Fed Member Banks



Historically, reserves were held near the required minimum to maximize high margin activity (thereby expanding money supply). In October, 2008, the Fed announced the payment of interest on reserves.

Modern Money Mechanics

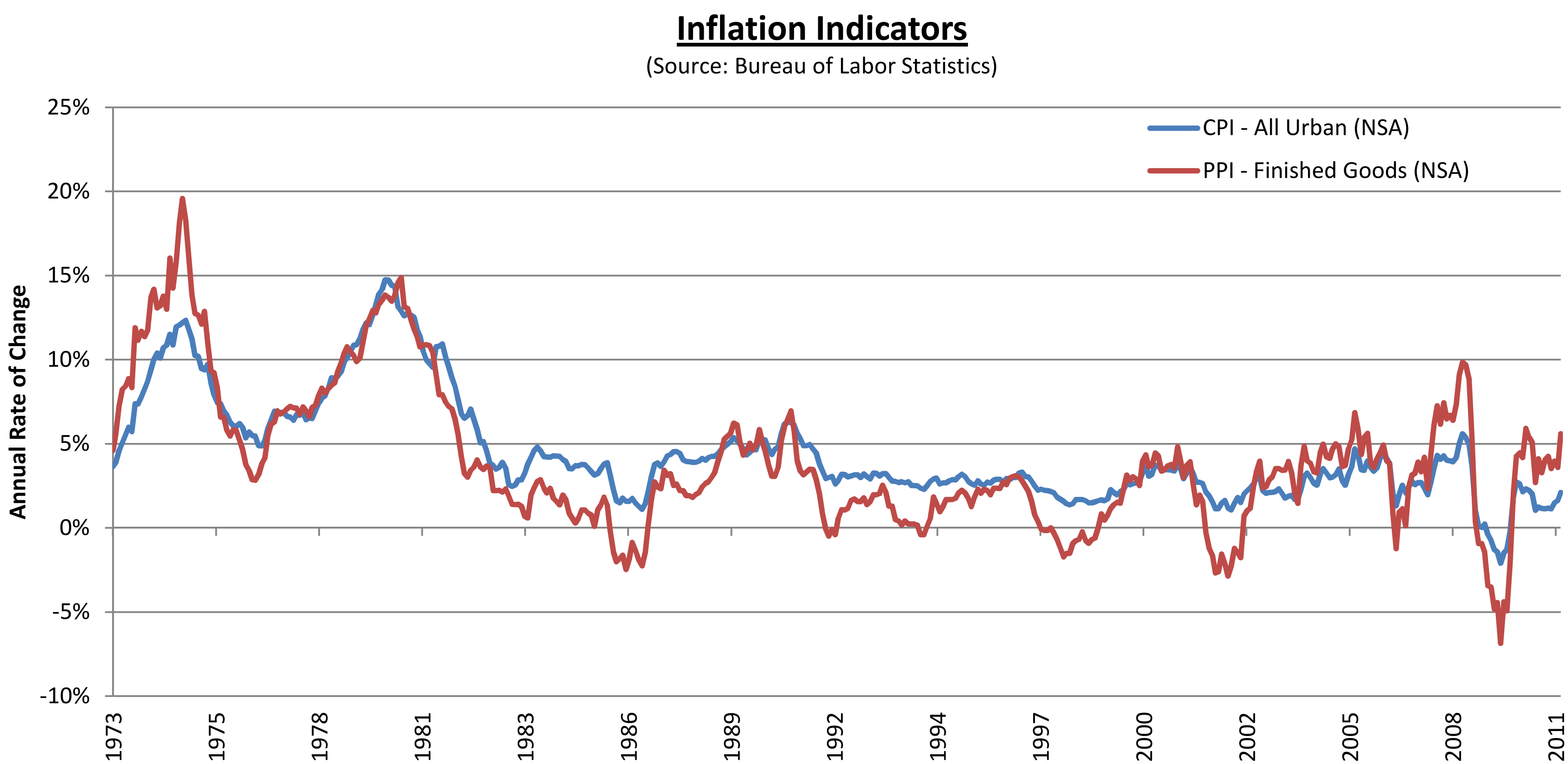
"There is one important difference between the expansion and contraction processes. When the Federal Reserve System adds to bank reserves, expansion of credit and deposits ***may*** take place up to the limits permitted by the minimum reserve ratio that banks are required to maintain. But when the System acts to reduce the amount of bank reserves, contraction of credit and deposits ***must*** take place (except to the extent that existing excess reserve balances and/or surplus vault cash are utilized) to the point where the required ratio of reserves to deposits is restored. But the significance of this difference should not be overemphasized. Because excess reserve balances do not earn interest, there is a strong incentive to convert them into earning assets (loans and investments)."

(emphasis in original)

Modern Money Mechanics
Federal Reserve Bank of Chicago

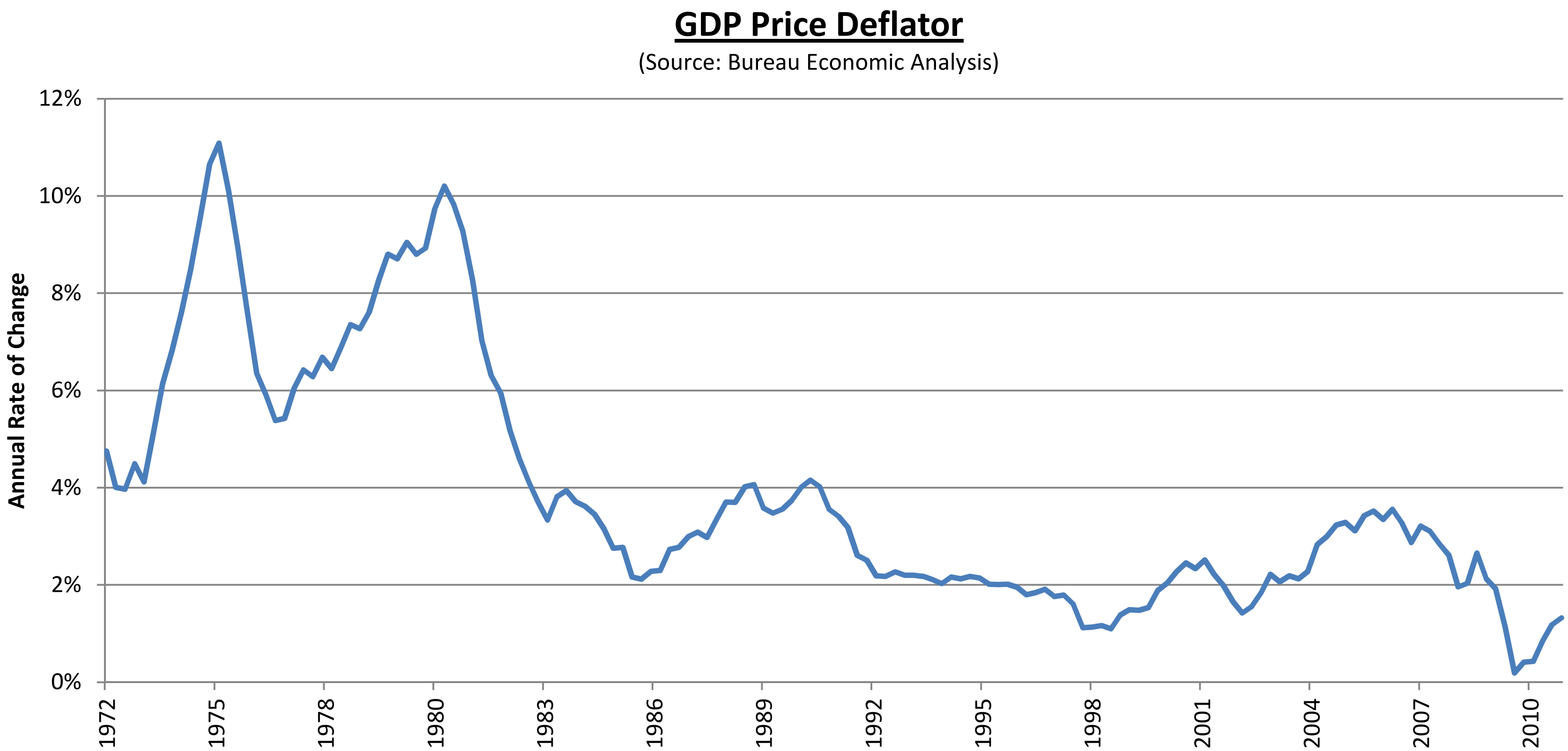
Please Note: publication was written before reserves earned interest.

U.S. Inflation



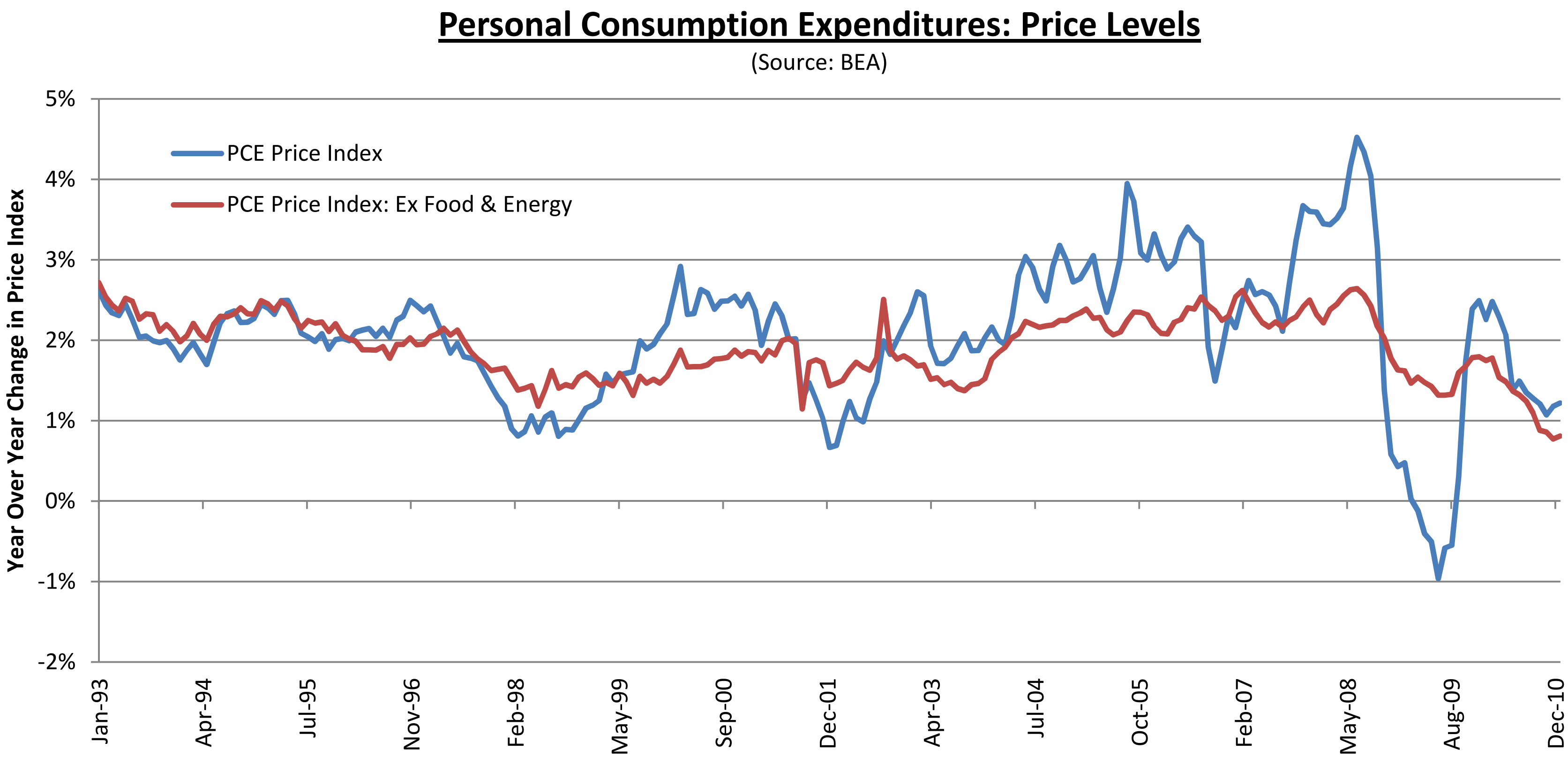
- Recent observations are within historical norms
- Producer prices outstripping consumer prices: lack of pricing power

U.S. Inflation



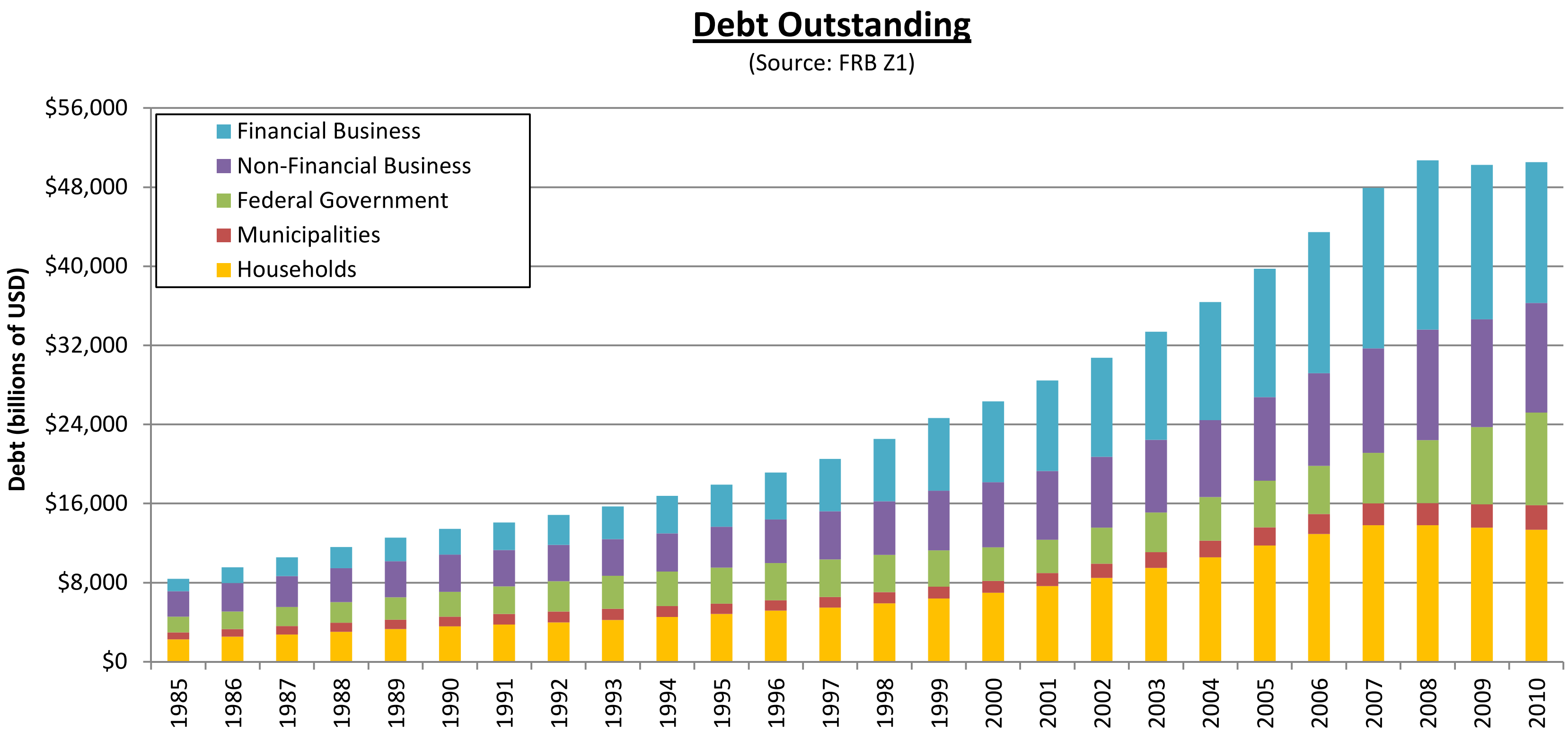
- Recent observations are well below historical norms
- Not based on a fixed basket of goods, unlike CPI

U.S. Inflation



- Recent observations are within historical norms
- Routinely referred to in the press as the Fed's preferred inflation gauge

D-E-B-T in the U.S.A.

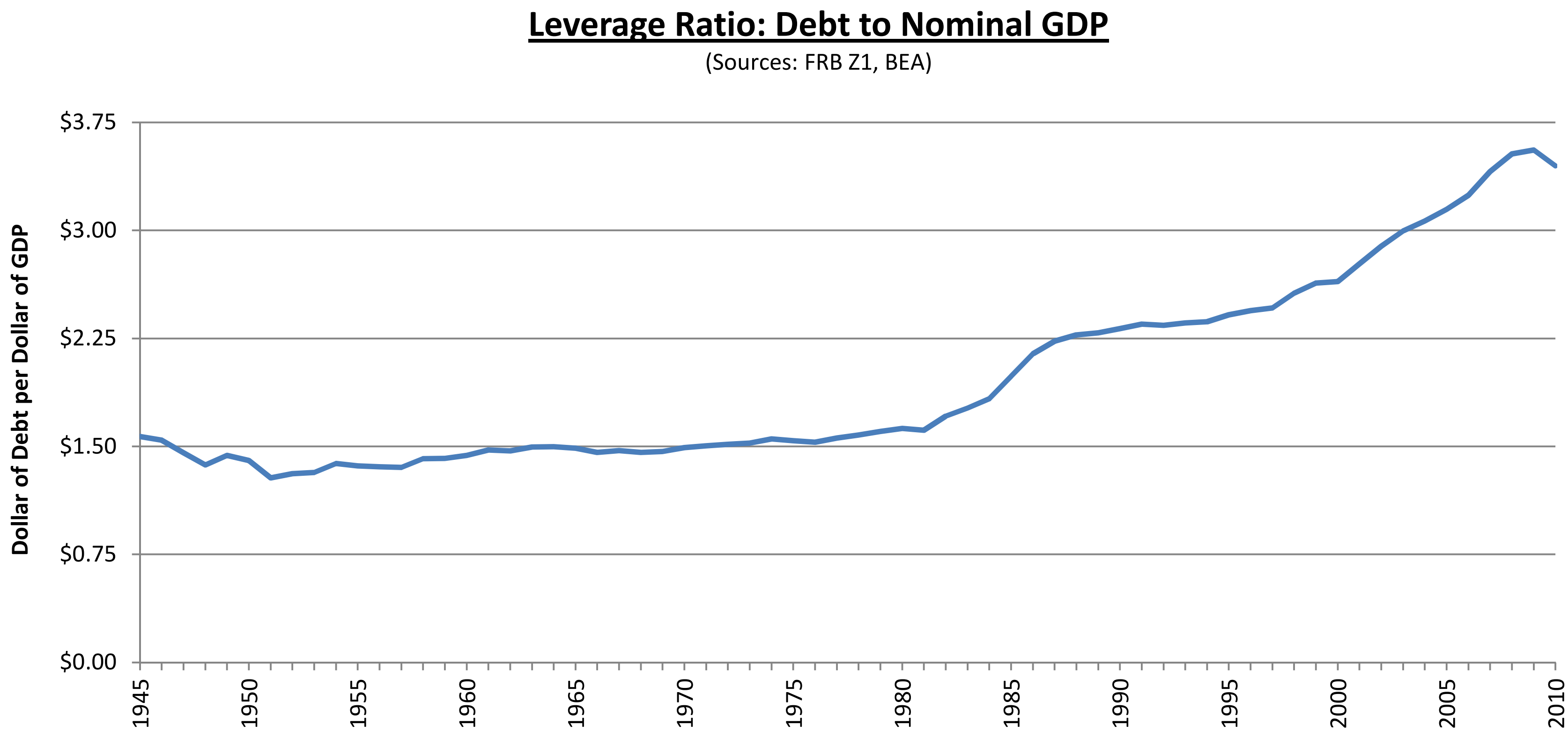


- Compounded annual growth rate since 1985: 7.45%
- This Fed data release only includes debt held by the public
- Deleveraging has only just begun

D-E-B-T in the U.S.A.

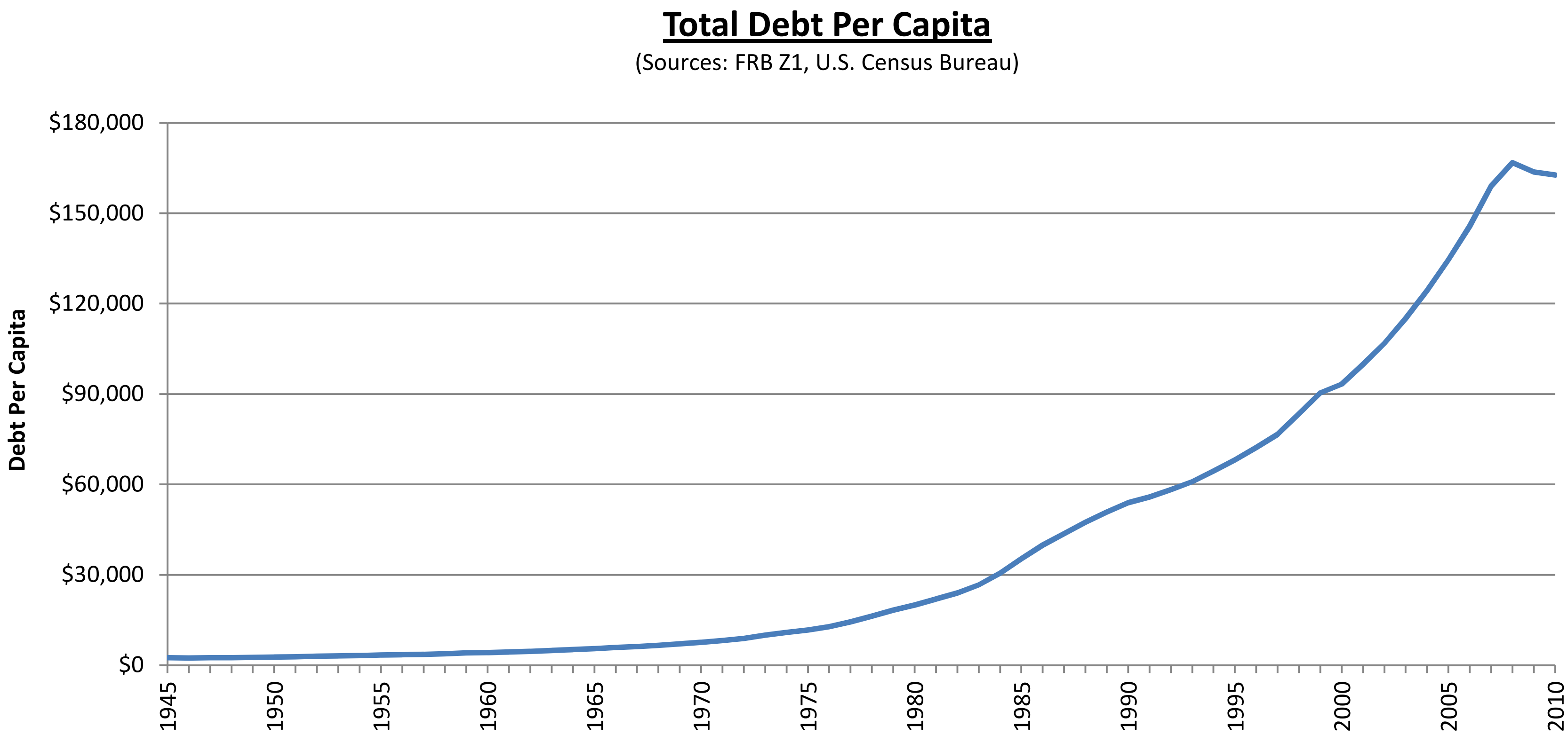
	Compounded Annual Growth Rates		
	20 Years	10 Years	5 Years
Total	6.84%	6.74%	4.91%
Households	6.80%	6.69%	2.61%
Municipalities	4.68%	7.48%	5.85%
Federal Government	6.84%	10.74%	14.83%
Non-Financial Business	5.54%	5.33%	5.54%
Financial Business	8.84%	5.73%	1.84%

Debt: Relative Basis



- Ability of debtors to service liabilities depends on income generation
- Has the intertemporal relationship between debt and future production been breached?

Debt: Relative Basis



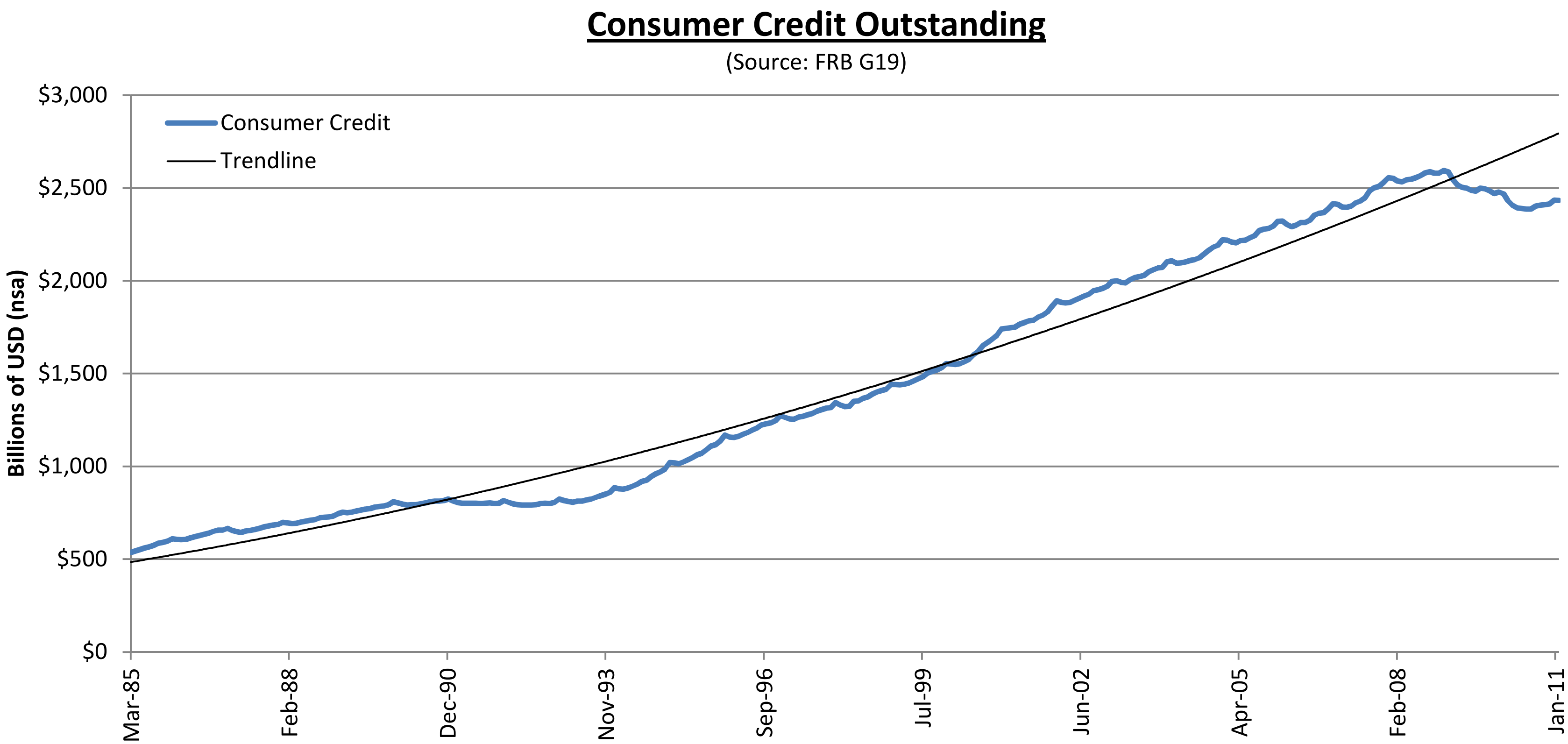
Most importantly, debt outstanding has increased on a relative scale. Whether through consumption, taxation or income growth, can households generate sufficient activity for the service of debt?

Mortgage Debt

Year End	Home Value (Billions of USD)	Mortgage Debt (Billions of USD)	Owner's Equity
1990	$6,800.9	$2,488.8	63.41%
1991	$6,973.3	$2,667.0	61.75%
1992	$7,259.0	$2,840.0	60.88%
1993	$7,501.3	$2,998.7	60.02%
1994	$7,773.2	$3,165.3	59.28%
1995	$8,054.8	$3,318.9	58.80%
1996	$8,431.1	$3,523.8	58.20%
1997	$8,864.8	$3,739.3	57.82%
1998	$9,694.0	$4,040.6	58.32%
1999	$10,644.0	$4,416.3	58.51%
2000	$12,183.0	$4,798.4	60.61%
2001	$13,552.8	$5,305.4	60.85%
2002	$14,816.3	$6,009.9	59.44%
2003	$16,413.5	$6,894.4	58.00%
2004	$18,912.1	$7,835.3	58.57%
2005	$22,005.2	$8,874.3	59.67%
2006	$22,687.7	$9,865.0	56.52%
2007	$20,879.4	$10,539.9	49.52%
2008	$17,470.3	$10,495.5	39.92%
2009	$17,081.0	$10,339.8	39.47%
2010	$16,370.4	$10,069.6	38.49%

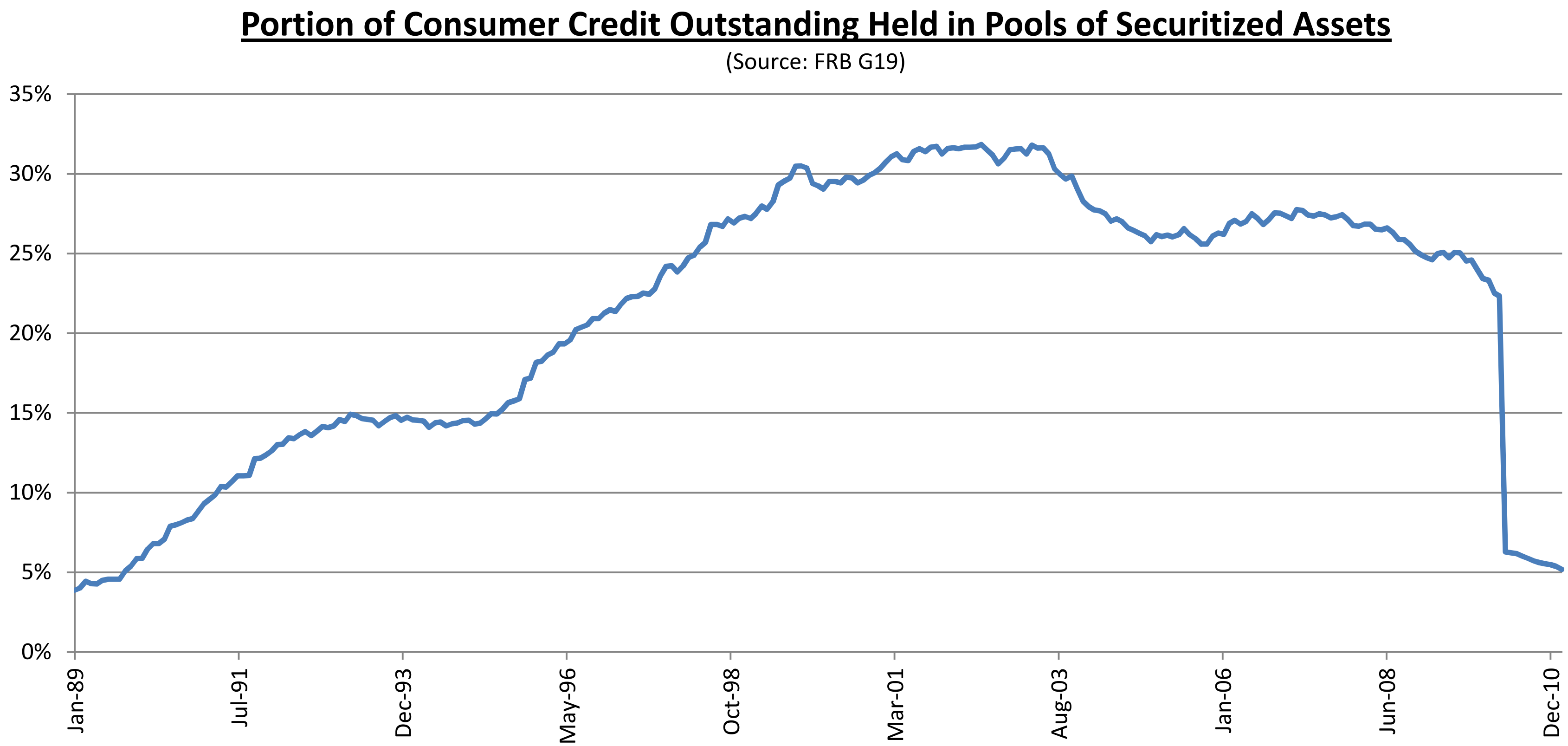
- Compounded annual growth rate of home value: 4.49%
- Compounded annual growth rate of mortgage debt: 7.24%

Consumer Borrowing



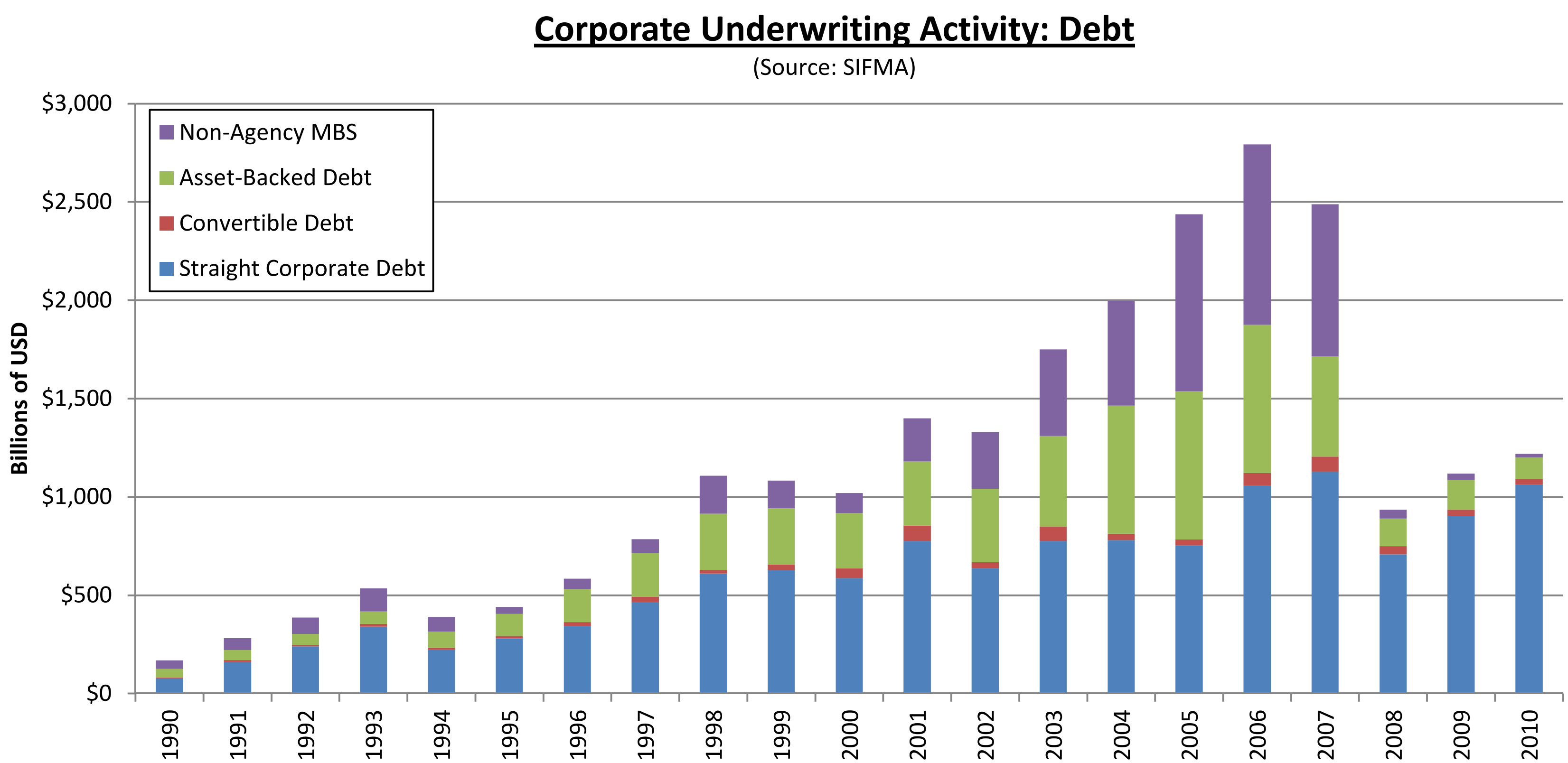
- Consumer Credit = Non-revolving debt + Revolving debt
- Consumer Credit outstanding peaked in December, 2008
- Since that time, revolving debt has decreased at an annualized rate of 9.35%

Consumer Borrowing



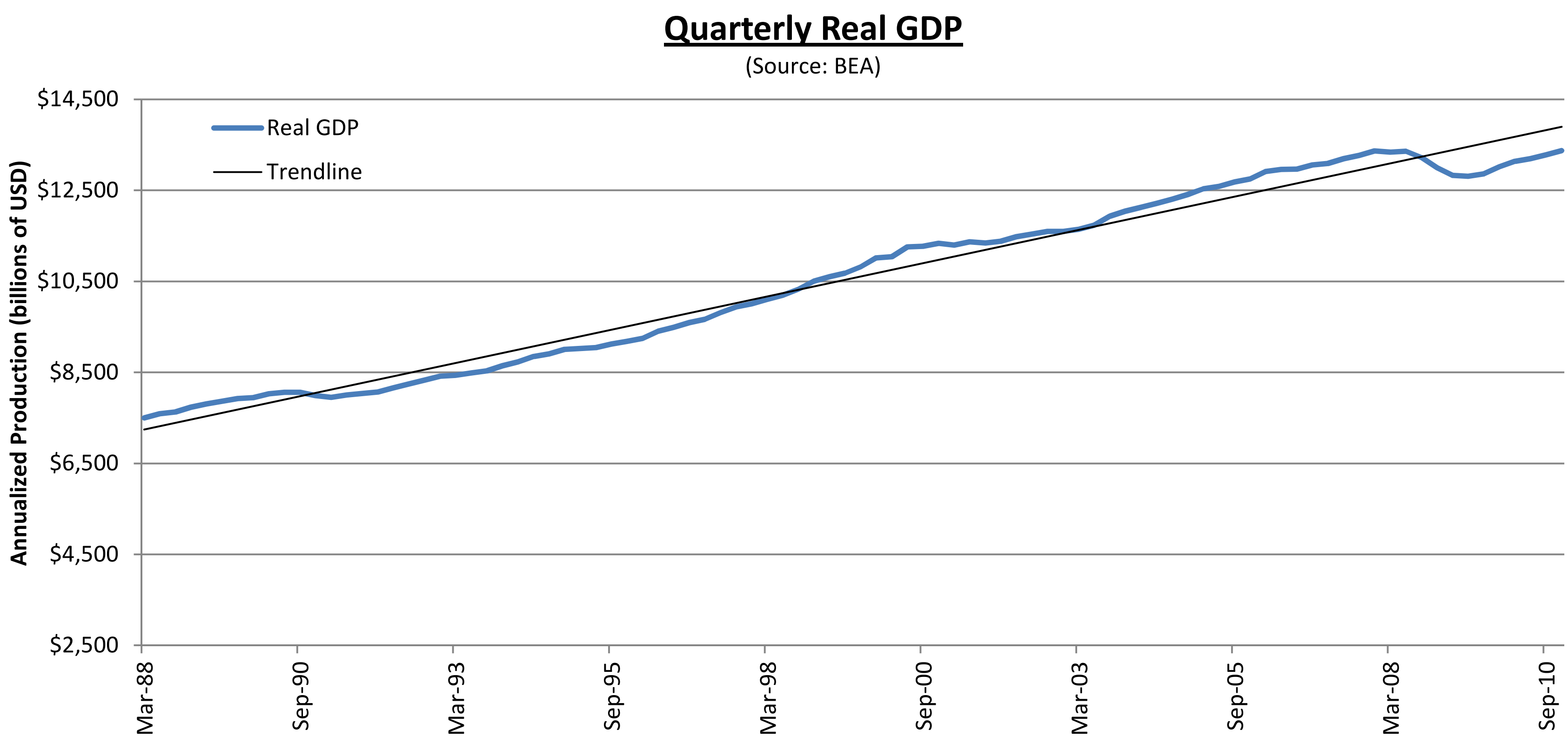
- Regulations (FAS 166 & 167) changed the accounting for certain loans
- How will this impact the growth of consumer credit?

Corporate Funding



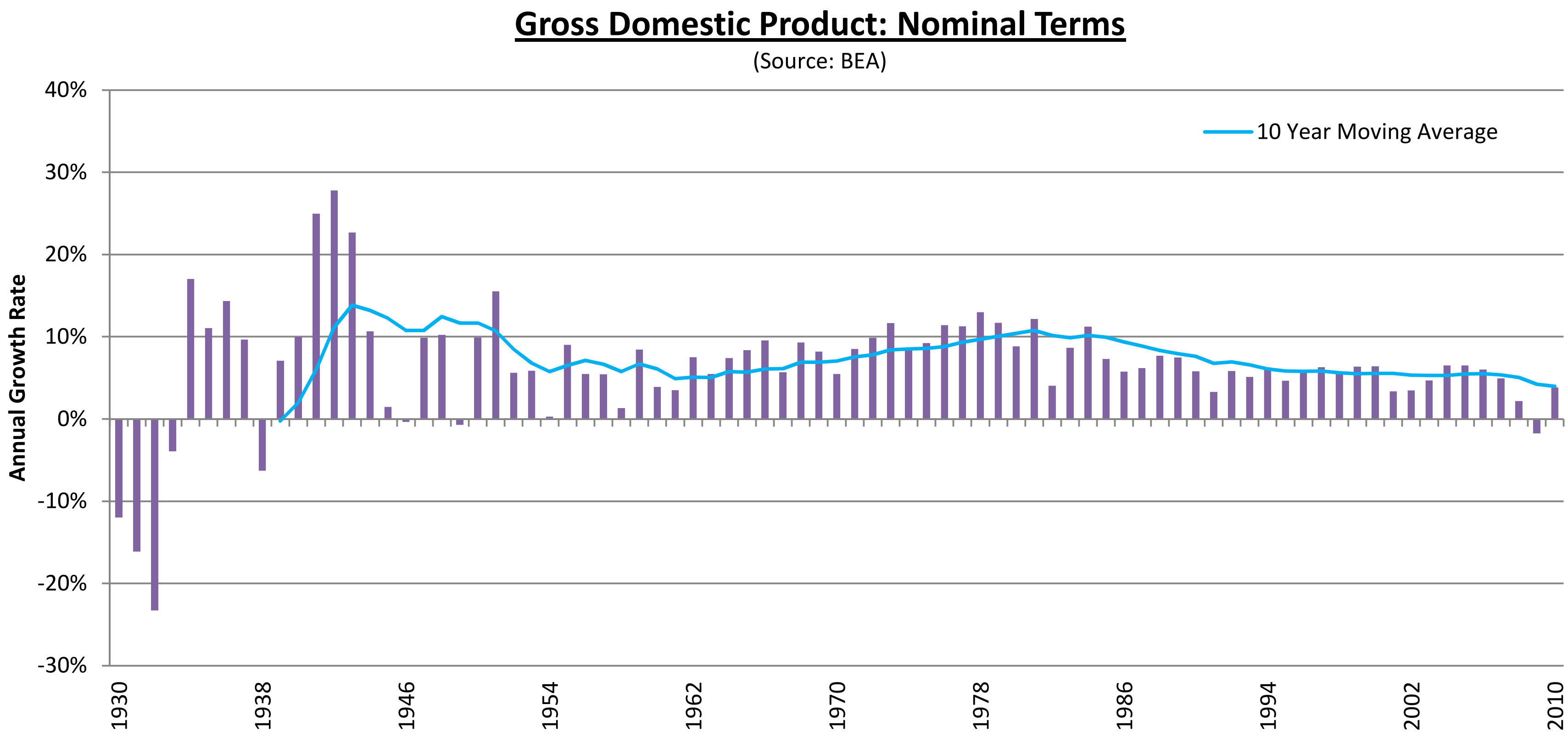
- Demand for securitized debt has fallen dramatically
- Falling dominos: reduced profitability of investment banks

U.S. Gross Domestic Product



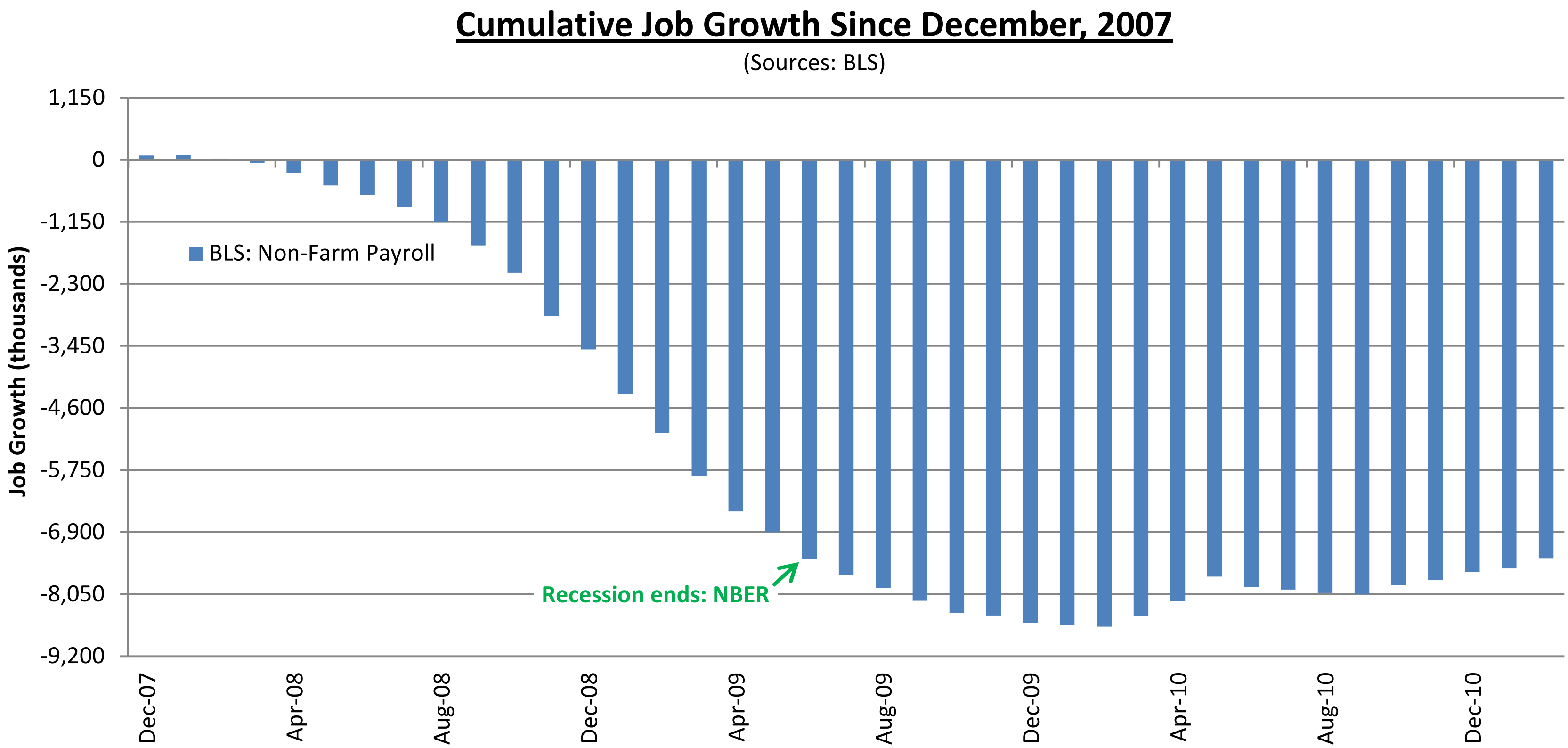
- Q4 2000 to Q4 2010: 1.67% compounded annual growth rate
- Q1 2008 to Q2 2009: negative growth in 5 out of 6 quarters

U.S. Gross Domestic Product



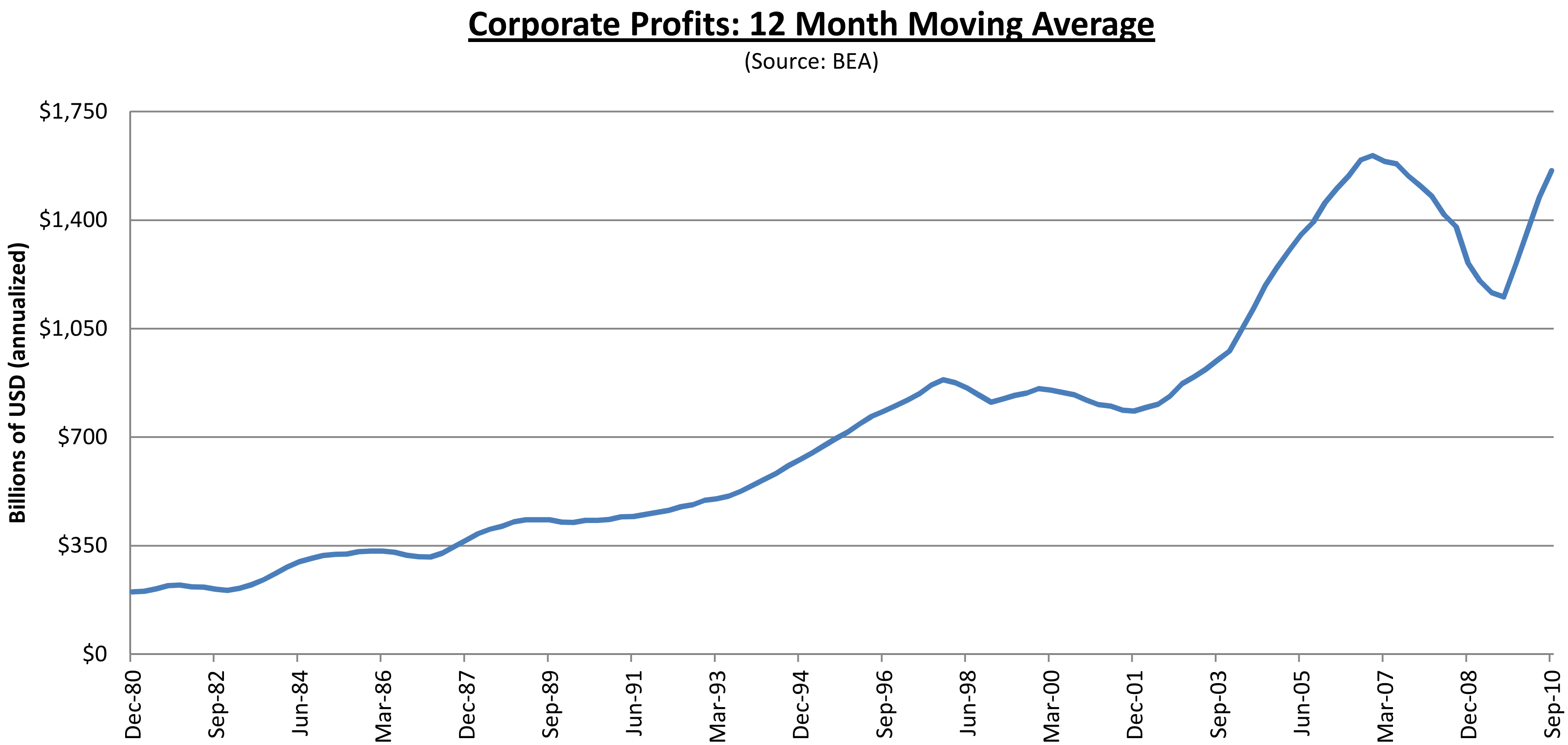
- 2009 Nominal GDP negative for the first time in 60 years
- Combined impact of slowing economy & falling prices

Employment Situation



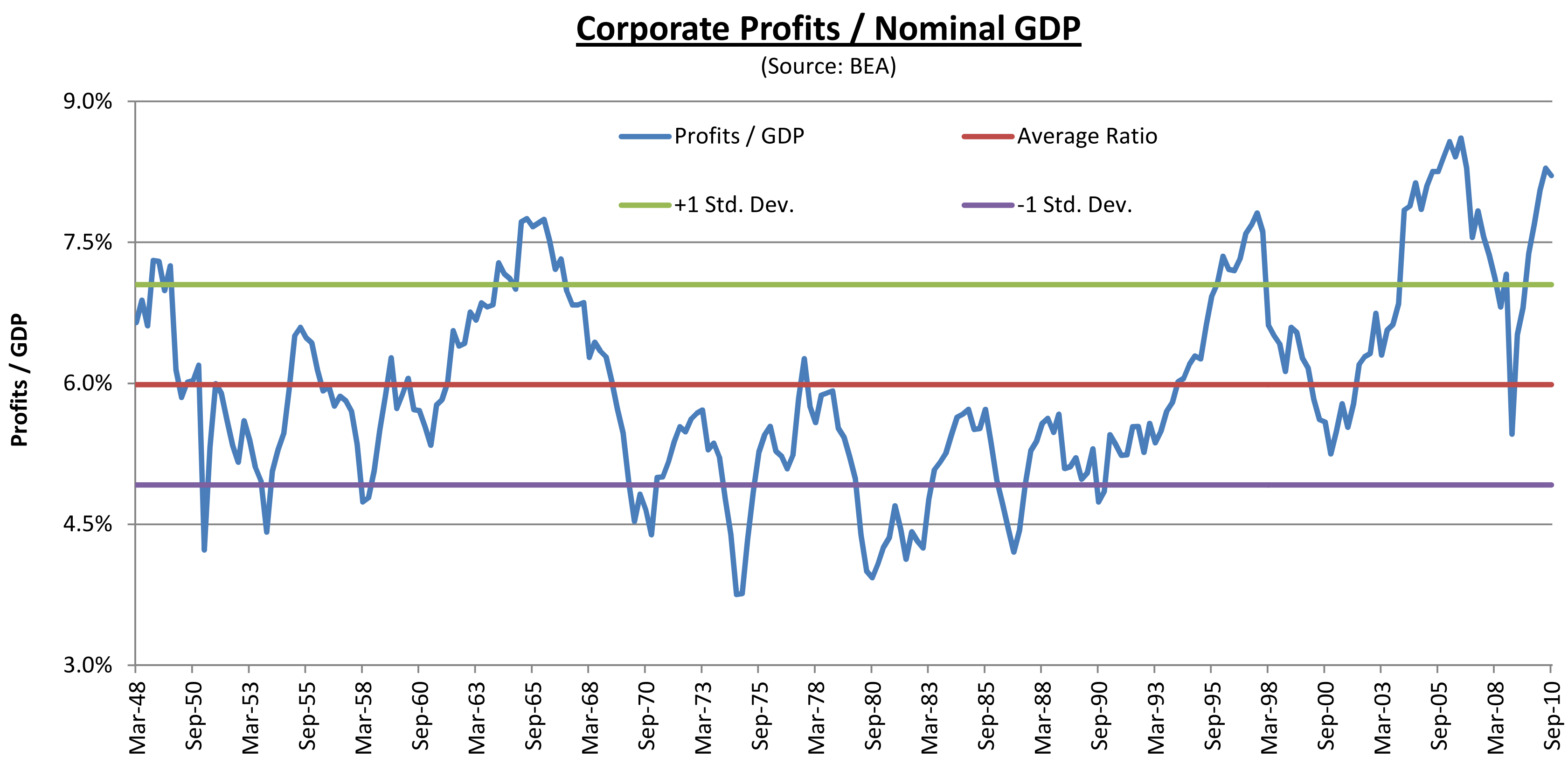
- Dramatic job loss begs the question: Will these jobs come back?
- Most severe & persistent jobs bear market since the Great Depression

Corporate Profits



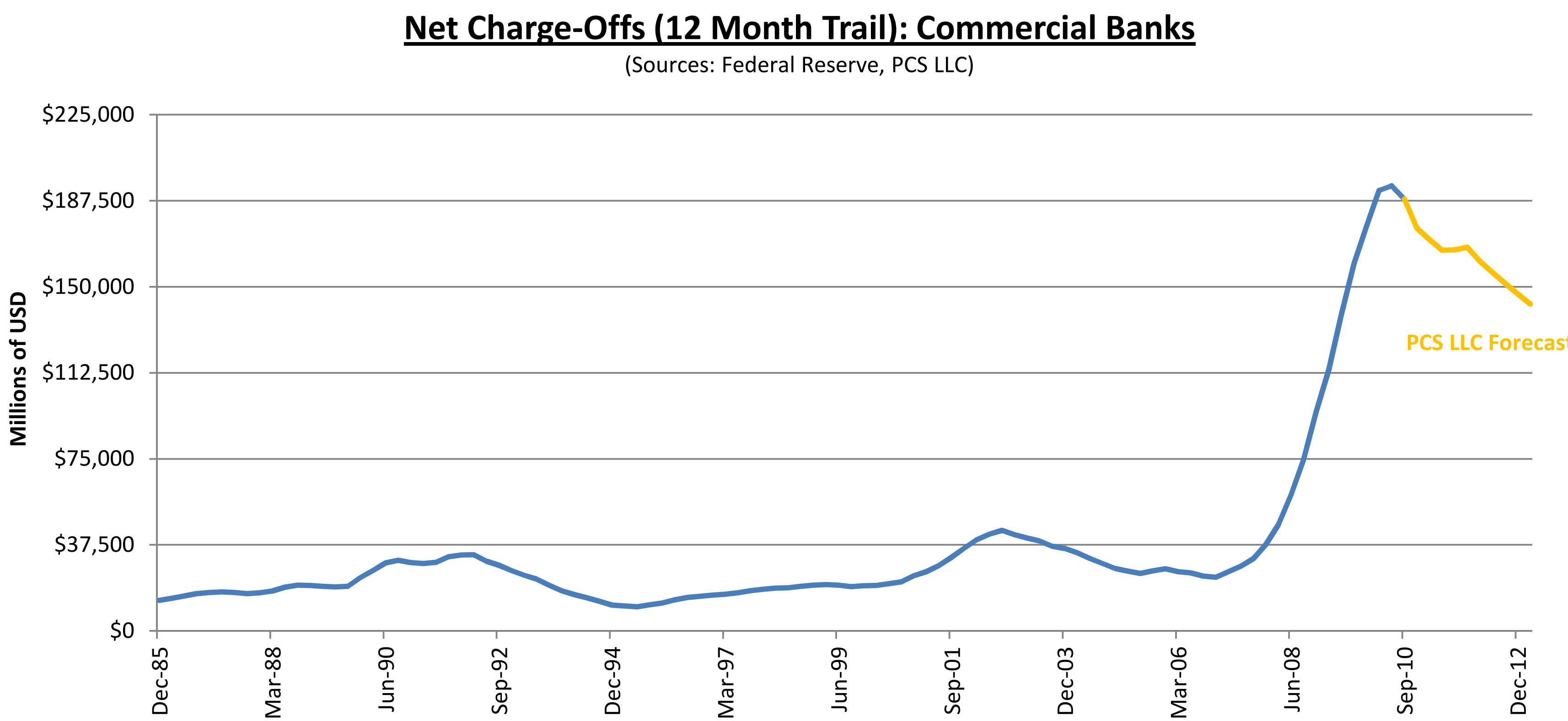
- Corporate profit growth has resumed
- Absent job cuts, can Corporate America generate profit growth from an expanding top line?

Corporate Profits



- Have corporate earnings reached an inflection point?

Bank Charge-Offs



- Although charge-offs may have peaked, financial institutions are reluctant to expand lending activity

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