Mid-Day Economic Color

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BullTick Capital Markets

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In Today's Piece:

- **Market Comment:** The about-face in US equities this morning came on the back of House Speaker Boehner's more optimistic comments regarding a potential sooner, rather than later, resolution to the fiscal cliff. US markets and broader risk assets remain vulnerable to any news flow with regard to the fiscal cliff resolution until one actually comes to pass. In US economic data, new home sales fell 0.3% m/m to a 368,000 annual rate versus the expected +390. September's new homes number was significantly downwardly-revised to +369k from +389k. The y/y rate of growth in new home sales, however, remained in double digits at 17.2% y/y taking year-to-date to +20.3% annual expansion.

- **Brazil:** The BCB is due to release its Selic rate decision today. We expect COPOM to remain on hold at 7.25%, where it will stay through at least 2Q2012. Our call for Selic rate movement next year is for a mere 50bp in hikes to 7.75% by year-end reasons: 2013's recovery will likely be a moderate, at potential 4% after this year's paltry 1.3% - 1.5%, the government's determination to push down electricity costs in 2013, the government's explicit determination to take the Selic to a sustained record low single digits and the evident disposition of Brazilian authorities that they are ready to accept higher rates of inflation in order to keep the Selic rate down and foster domestic industrial production and broader economic growth. As indicated in our 2013 rate call, we still maintain that some hikes will become evidently necessary.

- **Venezuela:** The sudden, clandestine departure of President Chavez from Venezuela to Cuba yesterday after weeks of scare public appearances could potentially be a game-changer if it is indicative of a swift deterioration in the President's health. Note that if there is an "absolute failure" at the presidential level in the next few months, it would give the president extremely little time to attempt to enact a change to the Venezuelan Constitution. Indeed there is no formal proposal at all as yet to attempt to change the Constitution to allow the Vice President to serve out the presidential term before four years' time.

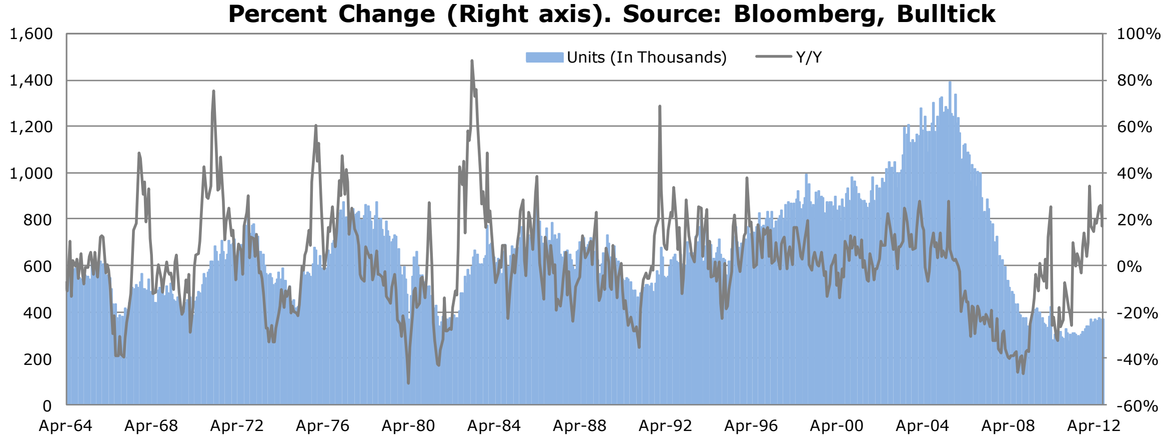
- **Argentina:** Fitch decided to downgrade Argentina's local and foreign currency rating on Tuesday afternoon, citing that a near-term international law debt default was "probable", following the adverse decisions (from the standpoint of the Republic) recently announced by the NY Court system. As we have argued in other research pieces, the decision taken by Judge Griesa to lift the *Stay* and grant 100% reparation to the plaintiff (holdouts), have placed the holders of performing debt in an impossible spot –hence the incredible collapse that performing bond prices have shown in the past couple of weeks. The rating agency also defended its decision to cut Argentina's local rating on the back of the deteriorating macroeconomic environment that the country has been seen since last year.

Market Comment

The about-face in US equities this morning came on the back of House Speaker Boehner's more optimistic comments regarding a potential sooner rather than later resolution to the fiscal cliff as US markets and broader risk assets remain vulnerable to any newsflow with regards to the fiscal cliff resolution until one actually comes to pass. At mid-day US equities moved into positive territory after reaching a 1% drop earlier in the morning consistent with the dramatic swings and elevated volatility associated with the issue. In this final quarter of the year, the VIX volatility index rose from 14.33 in early October to 19.1 the day after the presidential election back down to 15.0 in mid November to 15.6 as of today, a level still comparatively low versus the post 2008 financial crisis average of 21.

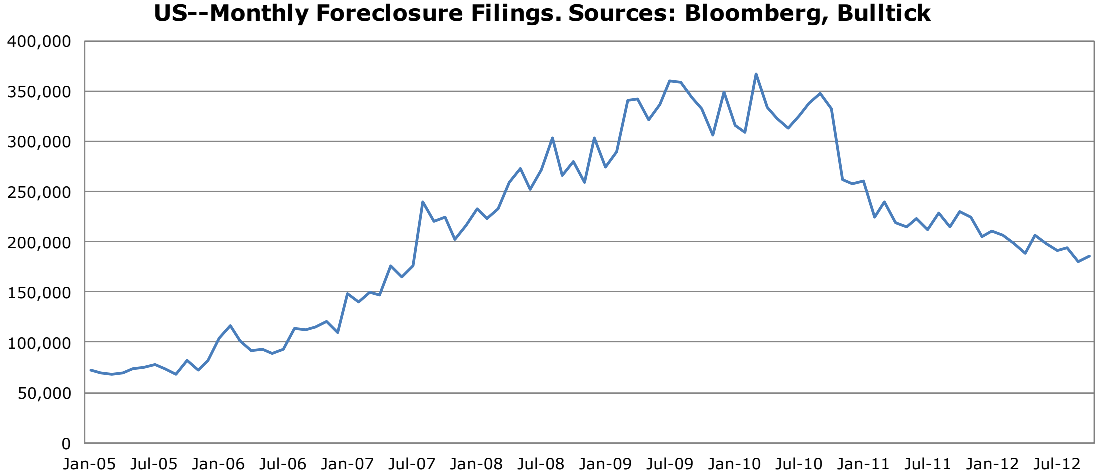
In US economic data, new home sales fell 0.3% m/m to a 368,000 annual rate versus the expected +390,000. September's new homes number was significantly downwardly-revised to +369,000 from +389,000. The y/y rate of growth in new home sales, however, remained in double digits at 17.2% y/y taking year-to-date to +20.3% annual expansion. One would need to go before 1960 to find a comparable reading on new home sales. New home sales were running at annualized rates north of 1.4 million in 2007.

US HOUSING--New Home Sales, Units, Annualized (Left axis), Annual Percent Change (Right axis). Source: Bloomberg, Bulltick



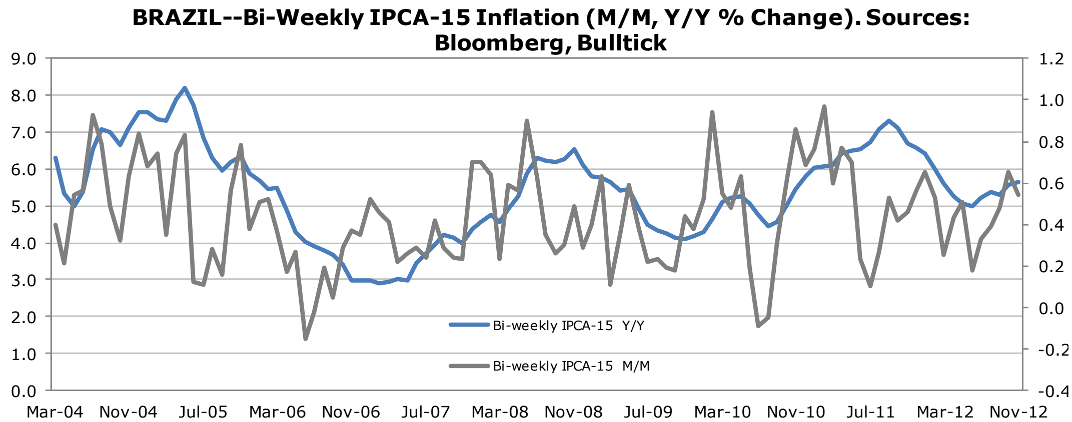
The US housing market's overall recovery trend is strong. The inventory ratio was 4.8 months in October and foreclosures -19.2% y/y (see graph below). As this process continues, combined with improvements (albeit slow) in labor market plus rising home prices (and higher confidence) and record low 30yr mortgage rates (3.35% or so), demand for NEW homes rises. Housing trends ar egood: September's absolute level of foreclosure filings, at 180,427, dropped to the lowest since July 2007's 175,458. Existing home sales average +8.2% y/y YTD, pending +12% y/y, average building permits - important leading indicator for future construction and demamd at +28.2% y/y.

US--Monthly Foreclosure Filings. Sources: Bloomberg, Bulltick



Brazil

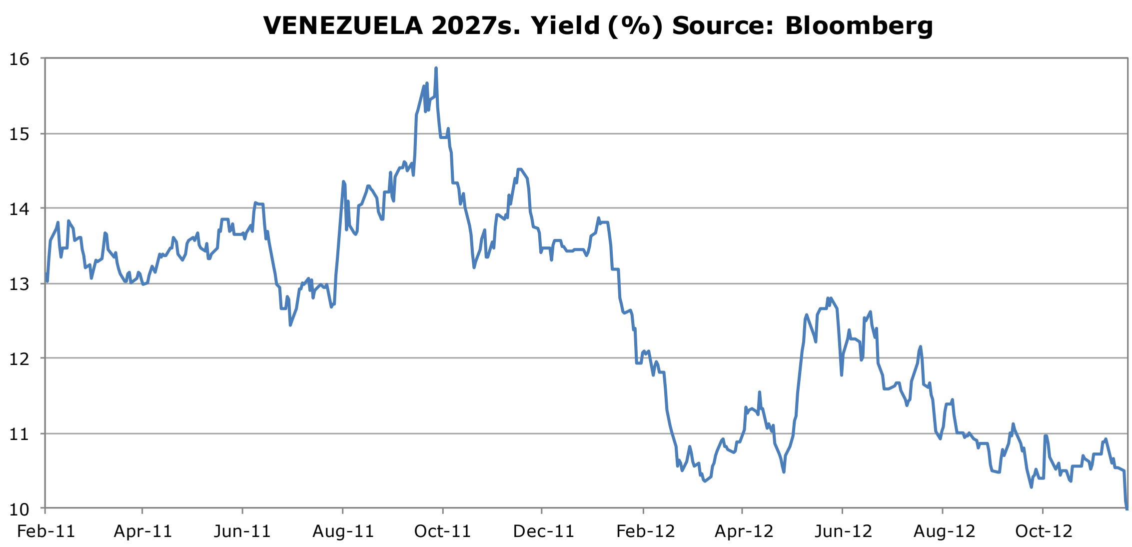
The BCB is due to release its Selic rate decision today. We expect COPOM to remain on hold at 7.25%, where it will stay through at least 2Q2012. Our call for Selic rate movement next year is for a mere 50bp in hikes to 7.75% by year-end reasons: 2013's recovery will likely be a moderate, at potential 4% after this year's paltry 1.3% - 1.5%, the government's determination to push down electricity costs in 2013, the government's explicit determination to take the Selic to a sustained record low single digits and the evident disposition of Brazilian authorities that they are ready to accept higher rates of inflation in order to keep the Selic rate down and foster domestic industrial production and broader economic growth. As indicated in our 2013 rate call, we still maintain that some hikes will become evidently necessary. However, at this point, and given the aforementioned variables, we think the risk is more tilted towards fewer than more hikes. This call is contingent upon the economic recovery we envision coming to fruition and with it exacerbated inflation expectations.



Venezuela

The sudden, clandestine departure of President Chavez from Venezuela to Cuba yesterday after weeks of scare public appearances could potentially be a game-changer if it is indicative of a swift deterioration in the President's health. Note that if there is an "absolute failure" at the presidential level in the next few months, it would give the president extremely little time to attempt to enact a change to the Venezuelan Constitution. Indeed there is no formal proposal at all as yet to attempt to change the Constitution to allow the Vice President to serve out the presidential term before four years time.

The Venezuelan constitution defines what happens in the event of 1) "absolute failure" and 2) "temporary failure" of the president. Absolute failure is what we are concerned about and under this clause, the constitutions stipulates that if the president-elect dies within the first four years of his six-year term, the vice president assumes power, in this case, Nicolas Maduro, and elections are called. If he passes in the last two years of his term, the vice president takes over as president for the rest of the term. If President Chavez passes BEFORE being sworn in (Jan 10th 2013), the National Assembly president takes over, in this case Diosdado Cabello, and elections are called.

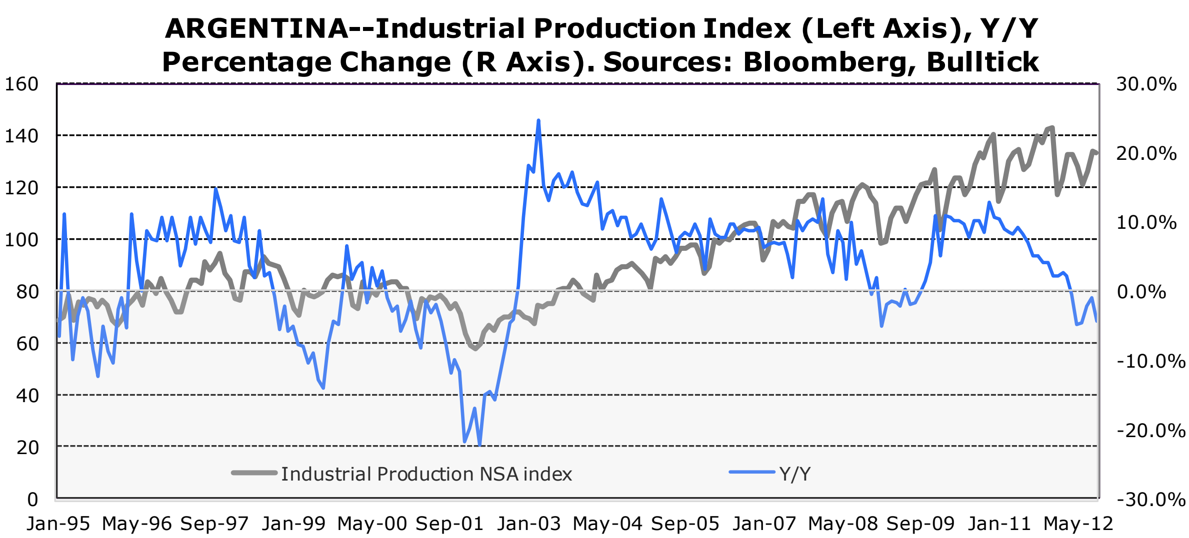


Another variable is the December 16th governor elections. A poll released November 21st by Ivad shows that Capriles is set to win in the state of Miranda against former VP Jaua. (Ivad was one of the few agencies that correctly pegged Chavez the Oct 7th winner and came very close to the actual numerical outcome). According to Ivad, Capriles is beating Jaua by 21 points 55% to 34%. This is VENZ and PDVSA bond positive news. A Capriles win would solidify him as the candidate to face off against Maduro, against whom past polls showed he would win, in the ensuing election.

IF Capriles loses in Miranda state (which he did not carry in the presidential election) it would cause a move down in bond prices as opposition would be scrambling. Admittedly Jaua is no Chavez, but this is not a comforting fact given the opposition's legitimate loss only two months ago) the opposition would be in chaos without a clear leader to represent them in the elections which would have to be held within 30 days after an "absolute failure" of the president. VENZ 27s trading at 10.13% today and Venezuelan 5-year CDS down to 731bps from 760 a week ago.

Argentina

Fitch decided to downgrade Argentina's local and foreign currency rating on Tuesday afternoon, citing that a near-term international law debt default was "probable", following the adverse decisions (from the standpoint of the Republic) recently announced by the NY Court system. As we have argued in other research pieces, the decision taken by Judge Griesa to lift the Stay and grant 100% reparation to the plaintiff (holdouts), have placed the holders of performing debt in an impossible spot –hence the incredible collapse that performing bond prices have shown in the past couple of weeks. The rating agency also defended its decision to cut Argentina's local rating on the back of the deteriorating macroeconomic environment that the country has been experiencing since last year.



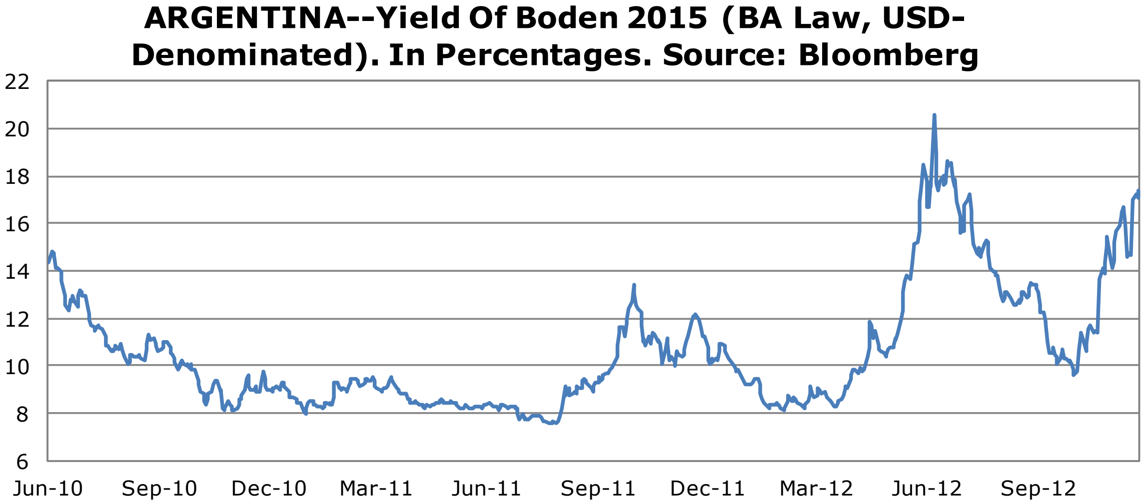
Here is the view that Fitch delivered on the credit. We decided to reproduce the whole release because the text includes very timely and market relevant information: *"Fitch Ratings has downgraded Argentina's long-term foreign currency (FC) Issuer Default Rating (IDR) to 'CC' from 'B' and the short-term IDR to 'C' from 'B'. All securities issued under international law have been downgraded to 'CC' while both FC and local currency (LC) denominated securities issued under Argentine Law have been downgraded to 'B-'. Fitch has also downgraded Argentina's LC IDR to 'B-' from 'B'; the Outlook on the LC IDR is Negative. The Country Ceiling has been downgraded to 'B-' from 'B'…….The downgrade of the long-term foreign currency IDR reflects Fitch's view that a default by Argentina is probable. The increased probability that Argentina will not service its restructured debt securities issued under New York law on a timely basis reflects US District Judge Griesa's decision on Nov. 21 to remove the stay order on the ruling that Argentina must pay US$1.33 billion to holdout investors concurrent with or prior to its payments due to holders of the 2005 and 2010 restructured debt. The stay order will be removed with effect from Dec. 15…….Argentina is due to pay approximately USD3 billion of GDP-linked warrants on Dec. 15, 2012. A missed payment on the GDP-linked warrants could trigger a cross default on all exchanged debt securities issued under international law. Subsequently, a missed coupon payment of any other external securities would also trigger a cross default on all exchanged bonds issued under international law"*

"Following the US Court of Appeals decision to uphold Judge Griesa's ruling that Argentina breached the 'Equal Treatment Provision' of the original New York-based law bonds that defaulted in 2001, the court remanded the case back to Griesa for specific clarifications on how the ratable payment formula would work and to which third parties the injunctions should apply. On Nov. 21, Judge Griesa explained that the clarifications requested of his court by the superior court 'did not affect the basic ruling that there can be no payments by Argentina to exchange bondholders without an appropriate payment to plaintiffs'…….In light of Argentina's official statements that the government will not honor the court's decision and the country's 2005 'Lock Law' which prohibits the government from re-opening the exchange or from conducting any type of settlement with holdouts without prior authorization from Congress, Judge Griesa decided that the stay should be lifted 'at the earliest possible time' so there is more assurance against a possible evasion. The Dec. 15 date 'gives some reasonable time to arrange mechanics' and allow the Appeals Court to consider the merits of the circuit court's clarifications on the two issues at stake."

"According to the ruling, the payment due to the plaintiffs should be made into an escrow account by Dec. 15 with the provision that it could be adjusted by any modifications that the Court of Appeals may impose subsequently. The Argentine government is in the process of challenging Judge Griesa's decision in the U.S. Appeals Court and has also announced its intention to take the case to the U.S. Supreme Court if needed, although it is not clear if the Supreme Court will agree to preside on the matter………….Fitch will continue to monitor how the case evolves and the Argentine government's response in the coming weeks. A missed payment on exchanged debt securities issued under NY law (including the GDP-linked warrants), which remains uncured within the stipulated 30 days grace period, would constitute a default event. In such a scenario, on expiry of the grace period Fitch would move Argentina's FC IDR to 'RD' (Restricted Default) and the bond ratings of the affected securities to 'D' (Default). On the other hand, a positive resolution, under which the Argentine authorities decided to pay the plaintiffs in line with the court ruling, and which therefore allowed the sovereign to continue servicing its NY-law external debt without interruption after the Appeals Court's final ruling, would be reflective of its willingness to pay and lead to a positive rating action on the FC IDR."

"Fitch's downgrade of Argentina's local currency IDR reflects the sustained deterioration of its credit fundamentals. The uncertainty related to the impact of the U.S. Court ruling is likely to further damage confidence and intensify political and social tensions in the country and undermine growth prospects. Argentina's economy has decelerated sharply in 2012 owing to the increased state intervention. This has been highlighted by the progressive tightening of capital controls, the nationalization of YPF and the inability of certain provinces to access USD to repay their dollar-denominated debt under local law. While the authorities have been able to stabilize international reserves by progressively tightening capital controls, this has come at the expense of increased economic distortions. The sustainability of this strategy is also vulnerable to international commodity prices, especially soy……….The concentration of power in the executive continues to undermine policy predictability and contributes to a tense and polarized political climate in Argentina. The recent massive protests indicate a general public dissatisfaction with issues ranging from high inflation, stringent FX controls, weakening infrastructure and corruption allegations. The authorities' disregard for popular protest and their rhetoric suggests that interventionist policies that lead to further concentration of power and increase economic distortions are likely to intensify. As a consequence, further deterioration in Argentina's policy framework is possible, which could adversely impact the country's medium term growth prospects………The steady attempts by Argentine authorities to 'Pesofy' the economy, the recent intervention in the insurance sector to redirect 15% of their investments to real-economy projects and the recently approved financial system reform are all indications of the trend towards further financial repression or interventionist policies."

"Sustained economic weakness that heightens fiscal pressures, which in the context of limited financing flexibility could lead to significant erosion of international reserves and greater monetization of the fiscal deficit with adverse repercussions for inflation, would increase downward pressure on the rating. A material escalation of inflation from the already high levels could undermine Argentina's fragile equilibrium as depreciation pressures would mount due to erosion of competitiveness. Alternatively, improvement in the overall policy stance that leads to sustainable growth and greater financing flexibility would stabilize the rating. Improvement in the transparency of official data and normalization of relations with creditors and multilaterals would also buttress confidence."



On the positive front, Minister of Economics Hernan Lorenzino announced from Buenos Aires that the government would be willing to think about the possibility of reopening the debt exchange to the *holdout* community once the Appeals Court had reviewed Griesa's decision. It is impossible to know how much (or if) this "conciliatory" announcement will make a difference with the decision of the judiciary. That said, the announcement does show that the government wants to reduce the level of animosity that now exists between the NY Courts and the Fernandez de Kirchner administration.

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APPENDIX A – IMPORTANT DISCLOSURES

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