ECONOMIC & FINANCIAL CONSULTING, INC.

ECONOMIC UPDATE AND FORECAST SUMMARY

(*Prepared under contract for Prudential Capital Group)*

JANUARY 2013

QUICK LOOKS:

- Economy enters 2013 in relatively good shape with employment growing steadily
- Tax increases and probable spending cuts resulting from fiscal cliff fix will negatively affect growth but not so much as to prevent gradual decline in unemployment
- Fed's easy money policies will continue through 2013 and into 2014
- Yield curve will likely steepen; long-term rates may increase as a result of expectations of somewhat higher inflation

Despite the uncertainty of the presidential election, the devastation of Superstorm Sandy and the later- than- last minute resolution to the fiscal cliff, the U.S economy still managed to add 500,000 jobs during the last three months of 2012. The resiliency of the labor market in the face of these problems is in our view a key positive for the economy. In addition, housing remains on the upswing and real consumer spending is growing at a bit more than 2.0 percent annually. Business investment spending and exports both slowed in the second half of 2012, but they too are growing at paces consistent with a moderately stronger recovery heading into 2013.

There are however two important negatives hitting the economy this year, both a result of the fiscal cliff agreement. The first negative is tax increases, in particular the elimination of the two percent reduction in the payroll tax that was enacted in 2010. We estimate that will reduce household take-home pay by an average of $1,000 in 2013, or $120 billion in the aggregate. That will surely impact consumer spending. The second negative is the still to be determined government spending cuts. Though the details are sketchy, it seems likely that these spending cuts will also reduce economic growth at least in the short-run. Putting it together – improving economic fundamentals and negative fiscal policy impacts -- and we are right back to square one, with the economy likely to grow at around 2.0 percent in 2013, just as it has since the recovery began three years ago. We expect the unemployment rate to decline slowly throughout the year, falling from 7.8 percent to 7.2 percent by the end of the year.

With fiscal policy being restrictive, we expect the Federal Reserve to continue its accommodating monetary policy throughout the year. That means no increase in the fed funds rate and no end to the Fed's latest round of bond buying. We take the Fed at its word when it says it is planning to continue its current policy approach until the unemployment rate falls near 6.5 percent, a process that is likely to take another two years.

One important announcement made by the Fed is the change in the inflation target to 2.5 percent from their longstanding target of 1.5 to 2.0 percent. We do not think inflation will reach 2.5 percent in 2013 but the Fed's apparent willingness to tolerate higher inflation is one of the

reasons why long-term rates have already risen 50 points from their mid-year lows. Government bonds will continue to get support during times of particular uncertainty – say for example when the debt ceiling limit is again debated. Nonetheless, we think the upward trend in long-term yields will continue in 2013 and expect the 10-year Treasury rate to hit 2.35 percent by year-end.

2013 therefore looks like another year of relatively slow growth and only a gradual reduction in unemployment. A key difference is that in the past we were getting two percent growth supported by fiscal policy whereas in 2013 we expect two percent growth in the face of restrictive fiscal policy. How well the economy actually does this year will no doubt be a key factor determining when the Fed makes a change in its policy aid to the economy.

Economic Forecasts: RCF and Consensus
Actual Economic Data as of January 4, 2013

		What We Said	What We Saw	What We See	
		2012 2nd Half	2012 2nd Half	2013 1st Half	2013 2nd Half
Real GDP	**RCF**	**1.7%**	+3.1%	**+1.9%**	**+2.1%**
	Consensus	*1.9%*	(2012Q3)	*+1.9%*	*+2.7%*
Inflation	**RCF**	**1.7%**	1.8%	**1.9%**	**2.2%**
	Consensus	*1.9%*		*2.0%*	*2.0%*
Core Inflation#	**RCF**	**2.0%**	1.9%	**2.0%**	**2.3%**
	Consensus	*2.0%*		*2.0%*	*2.0%*
Unemployment	**RCF**	**7.7%**	7.8%	**7.5%**	**7.2%**
	Consensus	*8.1%*		*7.6%*	*7.4%*
Fed Funds Rate	**RCF**	**0.125%**	0.125%	**0.125%**	**0.125%**
	Consensus	*0.125%*		*0.125%*	*0.125%*
2-year Treasury Rate	**RCF**	**0.35%**	0.25%	**0.30%**	**0.45%**
	Consensus	*n.a.*		*n.a.*	*n.a.*
10-year Treasury Rate	**RCF**	**1.95%**	1.78%	**1.95%**	**2.35%**
	Consensus	*1.83%*		*2.03%*	*2.34%*

RCF: RCF Economic & Financial Consulting, Inc. Consensus (except for core inflation): Wall Street Journal January Survey of Economists. # Core Inflation (excludes food and energy prices); consensus forecast is from the Philadelphia Federal Reserve's Survey of Professional Forecasters

ECONOMIC & FINANCIAL CONSULTING, INC.

2012 Forecast Review

As this is our first issue of 2013, it is worthwhile to look back at our 2012 forecasts that were published in January of 2012. Bottom line: GDP growth was less than we expected and as a result, inflation and interest rates were also lower than projected. Our forecasts of the unemployment rate, core inflation rate, and the fed funds rate were all very close to their actual values.

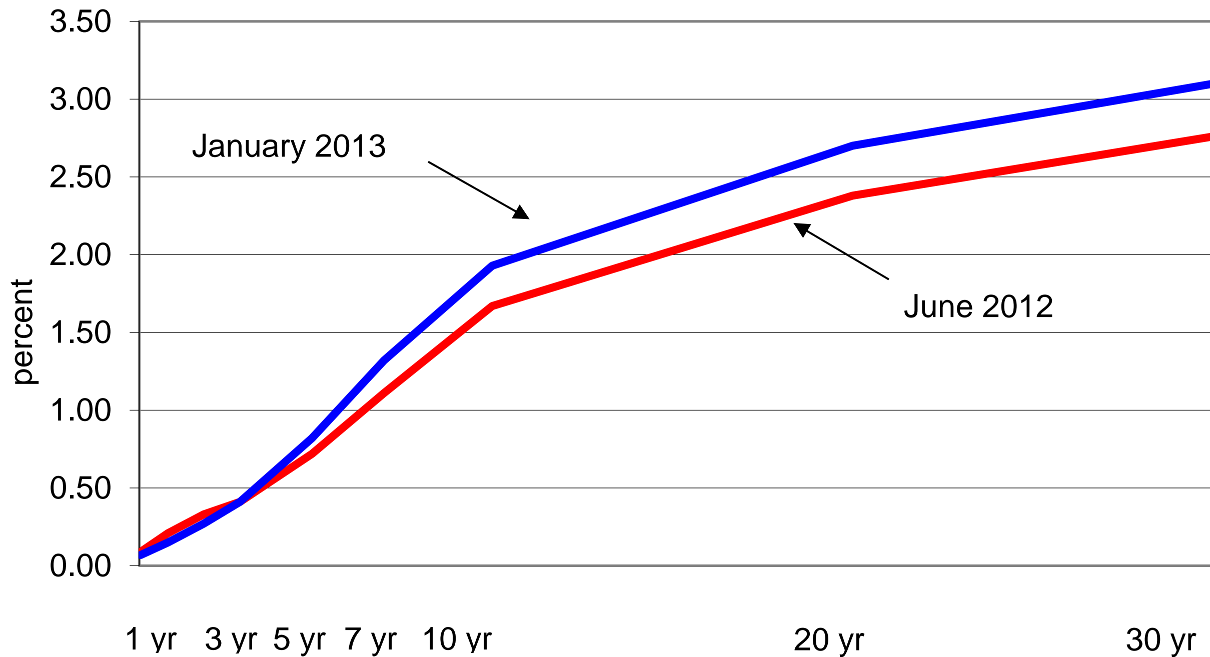
RCF Forecasts for 2012 made in January 2012

	What We Said	What We Saw
	2012 Year End	2012 Year End
Real GDP	+2.7%	+2.2%
Unemployment Rate	7.7%	7.8%
Inflation	2.4%	1.8%
Core Inflation	2.0%	1.9%
Fed Funds Rate	0.125%	0.125%
2-Year Treasury Rate	0.35%	0.25%
10-Year Treasury Rate	2.75%	1.78%

I. INTEREST RATE OVERVIEW

The yield curve steepened during the second half of 2012. 10-year yields climbed from below 1.50 percent in July to over 1.90 percent in early January, with about half the increase coming after the resolution to the fiscal cliff. 30-year yields rose above 3.00 percent in early January, hitting their highest level since the spring of 2012.

Chart 1: Treasury Yield Curve January 2013 vs. June 2012



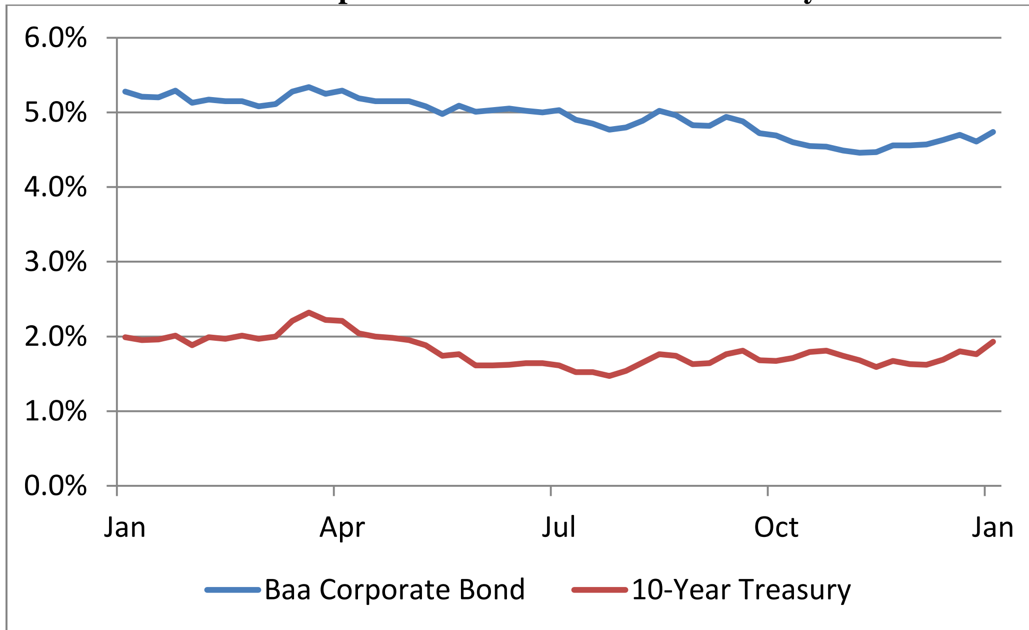
Source: Federal Reserve

It would be easy to chalk up the increase in long-term rates to the elimination of the fiscal cliff uncertainty, and indeed that was one factor in their rise. But we feel there are other reasons why long-term rates have risen. First, the Federal Reserve's decision to change its inflation target from 1.5 – 2.0 percent to 2.5 percent indicates that the inflation risk associated with holding long-term debt has grown. Second, nominal GDP rose at nearly a 6.0 percent rate in the third quarter of 2012 and while we do not expect this to continue, there does appear to be more underlying strength to the economy now than there was at mid-year. A third possible factor is a shift of investment from bonds to stocks driven by a solid year for equities in 2012 and the frustration that bondholders may feel from earning low yields on fixed income assets.

Nonetheless, U.S. government debt will remain the safe haven in times of turmoil. Thus, while we see a moderate upward trend in long-term rates for the rest of 2013, there will be times when the safety of Treasuries becomes attractive again, resulting in what we think will be temporary dips in long-term yields.

On the corporate side, rates declined during the time when long-term Treasury yields rose, resulting in a notable drop in the spread between the two. In July, when 10-year Treasury rates were below 1.50 percent, Baa-rated corporate debt was yielding 4.80 percent, a spread of 330 basis points. By early January 2013, corporate rates were down to 4.60 percent and their spread vs. the 10-year Treasury had fallen to 285 basis points. The declining spread is further evidence that the economy is on firmer footing now than it was in 2012.

Chart 2: Baa-Rated Corporate Bond and 10-Year Treasury Yields



Source: Moody's

II. INSIDE GDP

The economy grew at 3.1 percent annual rate in the third quarter of 2012 (the last quarter of data available as of this writing). However, two factors contributed heavily to that growth rate, neither of which was likely to have occurred in the fourth quarter of 2012. First, business inventories ballooned in Q3, which counts as Q3 GDP but means that businesses will probably cut back production in the fourth quarter. Second, government defense purchases increased substantially. Defense spending would have been significantly reduced if the country had gone over the fiscal cliff so the Q3 spending increase (which comes at the end of the government's fiscal year) might have been an attempt to take advantage of appropriations that might not be there in 2013.

Together, these two factors explained almost half of the 3.1 percent growth rate in 2012Q3. Put differently, aside from these factors, the Q3 GDP numbers were fairly weak. Consumer spending increased at a modest 1.6 percent rate, fixed business investment (excluding inventories) was flat, and export growth was considerably weaker than what we saw in 2010 and 2011. However, preliminary data for the fourth quarter of 2012 are somewhat encouraging. Real consumer spending – 70 percent of the economy – grew at about a 3.0 percent rate in November compared with three months ago.

We are fairly optimistic about 2013 for several reasons. First, we think much of the underlying weakness last year was due to the uncertainties about the 2012 election outcome. Second, consumer spending should continue to strengthen, aside from the impact of tax increases which we will discuss shortly. Average weekly earnings grew a bit faster than inflation in 2012 whereas they lagged inflation in 2011. Moreover, continued growth in employment should push up real household incomes by two percent in 2013. Finally, consumer credit is growing again, which along with improvements in net worth from rising stock and home prices will support consumer spending throughout the year.

The big offset is the impact of the tax increases resulting from the fiscal cliff resolution. We believe the elimination of the payroll tax cut will have a meaningful impact on consumer spending, more so than the increase in taxes on high income households, which will largely affect their savings and investments. Nonetheless, the payroll tax hike alone could reduce household incomes by $120 billion compared to the case in which the tax break was continued. Households have shown a willingness to reduce savings to offset declines in income but we believe that the tax increase will have a meaningful negative impact on the economy in 2013.

Of course, the tax increases in the fiscal cliff agreement are nowhere near as large as what would have happened had the economy gone over the cliff. Similarly, while we think there will be government spending cuts, they too will be nowhere near as large as the automatic cuts that would have taken place without an agreement. As a consequence, instead of reducing GDP by as much as 4 percent in 2013 (which is our estimate of the impact of "going over the cliff") we think that the tax increases and expected future spending cuts will reduce GDP by about 1 percent.

To illustrate the possible impacts, Chart 3 presents our forecasts of changes in real GDP and its components both without and with the effect of the fiscal cliff resolution. For comparison purposes, we also show percent changes in these variables in 2012Q3 vs. a year earlier.

Chart 3: Fixing the Cliff --- How it Will Affect Real GDP in 2013

	2012Q3 vs. 2011Q3 (actual)	2013 (no tax or spending changes)	2013 (with cliff fix)
Consumer Spending	1.9%	2.3%	1.5%
Business Investment	11.1%	7.0%	7.0%
Exports	3.2%	4.5%	4.5%
Imports	2.5%	2.5%	1.9%
Government Purchases	-0.5%	0.0%	-2.0%
GDP	2.6%	2.8%	2.0%

Source: U.S. Department of Commerce and RCF Projections

If the current tax and spending policies were allowed to continue into 2013, we think real consumer spending would have grown 2.3 percent. Higher taxes included in the cliff fix agreement will reduce growth in consumer spending to 1.5 percent. We do not change our forecast of business investment spending which we see growing 7.0 percent next year. That is slower growth than in 2012 but as we mentioned, much of that was due to a one-time build up in business inventories. While it is true that slower consumer spending could cause businesses to cut back to an even greater degree, we feel any negative will be offset by the reduction in uncertainty facing businesses now that they know more about what is in store for them in the coming year. Similarly, exports are not likely to be affected much by the fix. We believe export growth will improve over 2012 as the situation in Europe seems to be stabilizing and most of the rest of the world is showing stronger economic growth. Imports will slow (due to the slowing of consumer spending). Finally, we believe government spending cuts will eventually be enacted, causing a real decline in government purchases.

Bottom line, we project the economy will grow 2.0 percent in 2013, with the fiscal cliff fix knocking 0.8 percent off of what GDP would have been if current tax and spending were continued. That is a somewhat smaller impact than we have seen estimated elsewhere, mainly because we believe that consumers will react to the drop in after-tax income by reducing savings more than they will reduce spending.

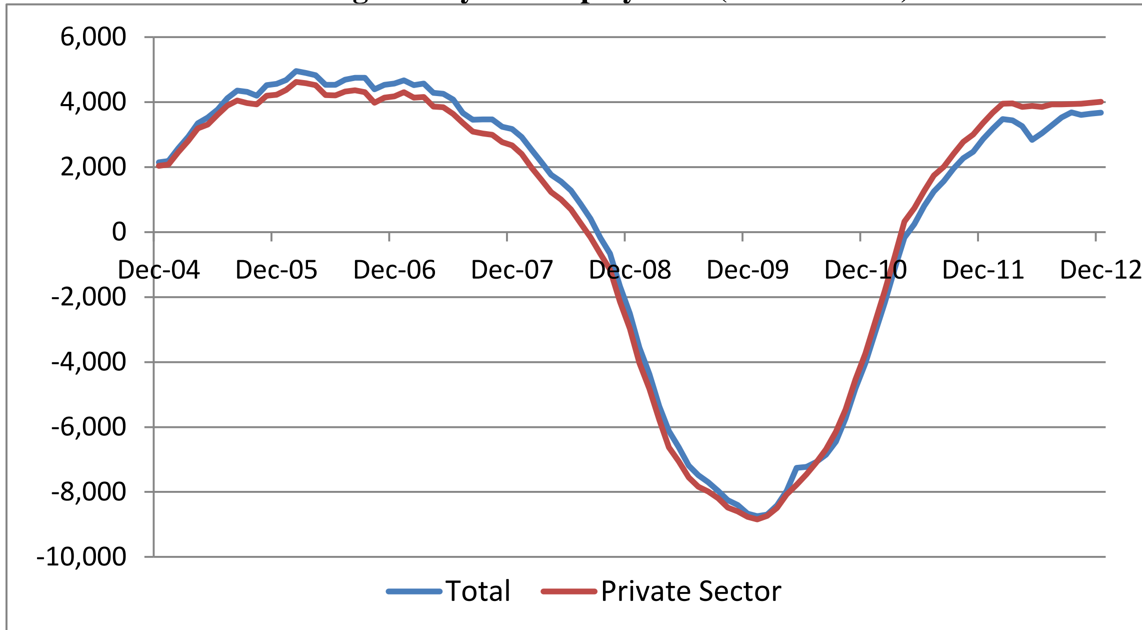
As we noted, the reduction in GDP that we expect from the fiscal cliff fix is far less than what would have occurred had we gone over the cliff. But that last point deserves more discussion. The fiscal cliff was not some wild plan designed to destroy the economy. Instead, it was a fairly aggressive proposal to bring government revenues in line with government spending. We believe this is a process better done slowly than quickly, but it is a process that will be a dominant theme of fiscal policy for years to come. As a result, we expect economic growth over the next few years to be below its historical average of 3.0 percent per year.

III. THE JOBS PICTURE

The private sector added 540,000 jobs during the last three months of 2012, with total employment growing somewhat less due to cuts in government workers. With all the negatives facing business owners – election uncertainty, Superstorm Sandy, the fiscal cliff – the fact that employment continued at a steady pace is a very encouraging sign.

For the year, the economy added about 1.9 million jobs, the same as in 2011. The private sector did a bit better, adding a total of 4 million jobs over the last two years. As Chart 4 shows, that is the strongest two-year employment increase for the private sector since before the recession. However, the downside of Chart 4 is that employment growth seems to have plateaued at its current pace.

Chart 4: Two-Year Change in Payroll Employment (in thousands)



Source: Bureau of Labor Statistics

There were a few other positives from the labor market in 2012. The average work week has been recovering, reaching 33.8 hours at the end of the year compared to a recession low of 33.0 hours. Average weekly earnings outpaced inflation in 2012, a turnaround from 2011 when earnings lagged price increases. The unemployment rate continued its slow decline, ending the year at 7.8 percent compared to 8.5 percent at the end of 2011. The closely watched "underemployment" rate, which also includes discouraged workers and involuntary part-time employment, also fell during the year. 2012 was not a great year for the labor market but it was a "good enough" year for the most part.

Probably the most significant labor development during the year was not the steady increase in employment but the increase in the labor force which rose by 1.5 million. That was equal to its long-term historical average growth of about 1 percent per year and marked a sharp contrast

from the previous four years in which the labor force was flat or declining. Growth in the labor force matters for several reasons. First, it means people are feeling their job prospects are bright enough that it is worth seeking employment. Second, it shows the labor market is returning to more normal conditions. And third, it is a key driver of long-term economic growth because the greater is the supply of labor the greater is the economy's potential output. One final positive from a growing labor force is that the decline in the unemployment rate reflects real improvement as opposed to statistical improvement that occurs when people stop looking for work and are no longer counted as unemployed.

The unemployment rate will take on even greater importance now that the Federal Reserve has said that it will continue its accommodative policies until unemployment drops to 6.5 percent. An exercise worth doing is to see how long that will take, assuming recent trends continue. In 2012, employment as measured by the Labor Department's survey of households grew by 2.4 million while the labor force increased by 1.5 million. [The household survey often shows greater employment growth than the payroll survey data shown in Chart 4 because the former includes the self-employed.] If both these numbers continue to grow at these rates, it will take until early 2015 for the unemployment rate to fall to 6.5 percent. For 2013 at least, we think the current trends will continue which would bring down the unemployment rate to 7.2 percent by the end of this year.

In short, job growth will be strong enough to keep the economy growing and the unemployment rate declining but not so strong as to cause an increase in inflation or cause the Fed to raise interest rates.

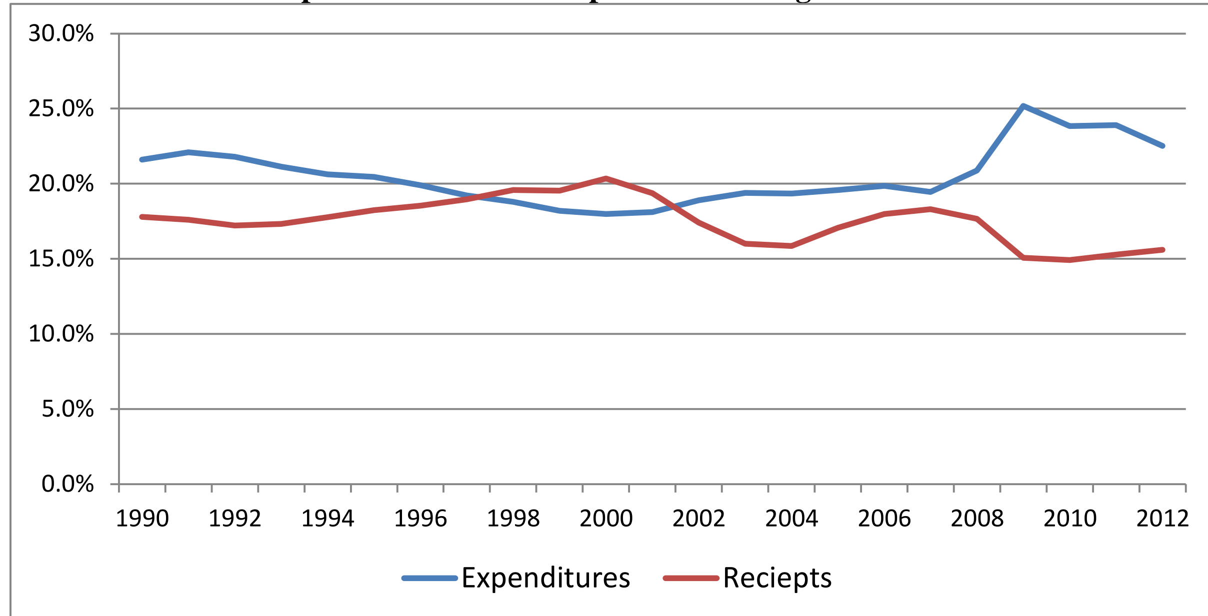
IV. FISCAL AND MONETARY POLICY

The fiscal cliff ended with a half-resolution – an agreement on taxes but no agreement on spending. As we discussed in our section on GDP, the tax increases will slow the economy some in 2013. The planned spending cuts included in the fiscal cliff were delayed until March 1. By that time, we expect the President and Congress to agree on some smaller measure of spending cuts when the two sides once again take up the issue of raising the nation's debt ceiling. The battle on spending is likely to be fought on two fronts. The first is the breakdown of defense vs. non-defense cuts. Here the issue is likely to be how much a reduction in defense spending Republicans will accept and how successful they will be in leveraging those reductions into reductions in non-defense spending. Bear in mind that the original fiscal cliff had defense accounting for half the total spending adjustment.

The second front will be on entitlements – predominantly social security, Medicare, and Medicaid. Both sides face a problem on entitlement reform as these programs are immensely popular but, in the case of Medicare and Medicaid, growing at rates far greater than the growth in the tax revenues used to support them. A likely compromise will involve changes to the methodology used to calculate cost of living increases for these programs. This is the kind of technical adjustment favored by Jack Lew, Obama's prospective new Treasury secretary which would have little immediate impact but greater effect in the long-run.

Buried beneath all the discussion of the fiscal cliff and government's debt ceiling has been a gradual, but meaningful decline in the government's budget deficit. Most of this has been the result of improvements in the economy which have increased tax revenues and reduced some spending on income-support. In addition, the stimulus spending from 2009 and 2010 is finished while defense spending has also declined since the end of major U.S. operations in Iraq. The deficit for fiscal 2012 was about 7 percent of GDP, down from a peak of 10 percent of GDP in 2009. Believe it or not, there does appear to be some light at the end of the fiscal tunnel.

Chart 5: Federal Expenditures and Receipts as Percentages of GDP



Source: U.S. Department of the Treasury

With fiscal policy turning more restrictive, we see no reason for the Federal Reserve to curtail its efforts to stimulate the U.S. economy, despite rumors from both inside and outside of the Fed that an "exit strategy" is on the horizon. Instead, we take the Fed at its word when it says that the current policy approach will continue until there is an appreciable decline in the unemployment rate. As we discussed in the prior section, it will likely not be until 2015 before unemployment falls to 6.5 percent, the level taken as being the cut-off point for the Fed's current monetary strategy. Whether the Fed will wait that long remains to be seen but at least for the rest of this year we expect no change in the fed funds rate and no end of the Fed's bond and mortgage security purchases.

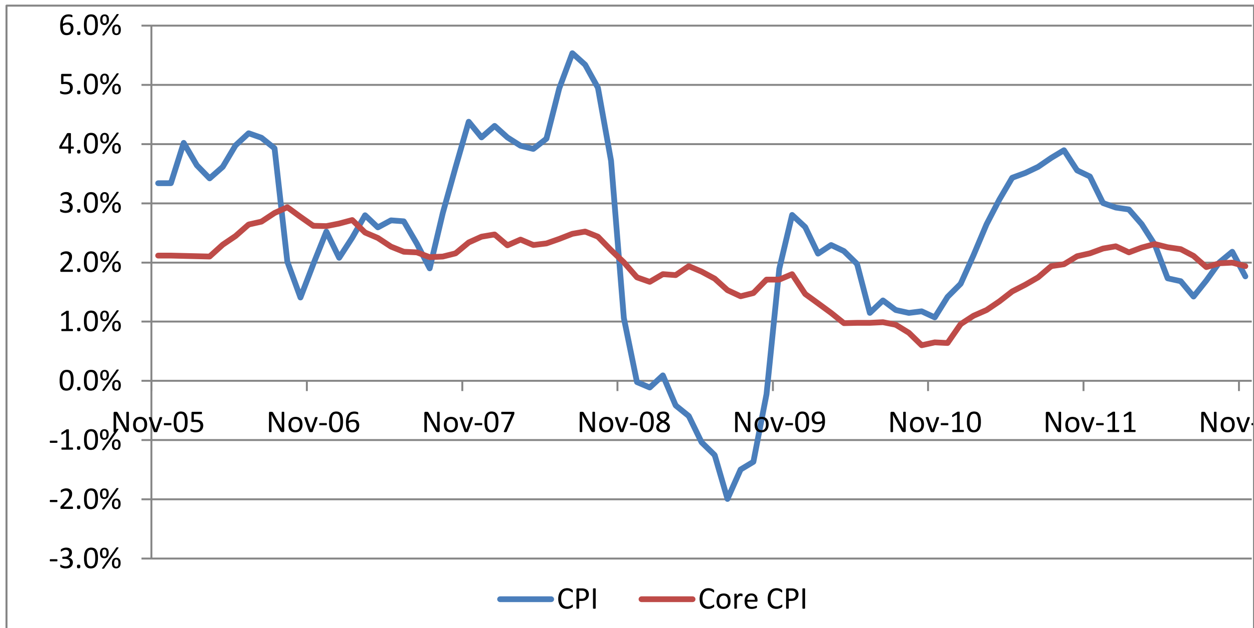
The more significant event to come out of the Fed lately is the change in their inflation target from 1.5 – 2.0 percent to a new target of 2.5 percent. It was even reported that the Fed was considering raising the target to as high as 3.0 percent. As we have said on many occasions before, inflation is well down on the list of Fed concerns and this new policy only reinforces this point. In fact, we believe the majority of the Board of Governors of the Federal Reserve, including Chairman Bernanke, are not only willing to *tolerate* higher inflation but are actively seeking to *generate* more inflation.

The main reason why the Fed wants higher inflation is that it would be evidence that monetary policy is actually starting to raise the level of consumer spending in the economy. Inflation is for the most part a by-product of higher demand creating a situation in which businesses cannot increase production enough to match that demand. The excess demand results in higher prices. For the Fed, the absence of inflation is evidence of continued weakness in consumer spending. Put differently, an increase in inflation would mean that demand is rising which would

presumably be a catalyst to increases in production and employment. In short, that has been the unspoken goal of the Federal Reserve since the recession began.

However, as Chart 6 shows, despite all their efforts, the Fed has been unable to generate higher inflation, especially if one looks at changes in the core-CPI which strip away the volatility of food and energy prices. Core inflation has for the most part been below 2 percent (and at times below 1 percent) for the last several years. The irony here is that low inflation is usually seen as evidence that the Federal Reserve policy is working. In this case, however, it is evidence that it is not.

Chart 6: Measures of Inflation



Source: U.S. Bureau of Labor Statistics

It was always known that someday the federal government would have to stop pumping a trillion dollars a year of borrowed money into the economy and that someday the Federal Reserve would have to end its zero federal funds rate policy. The first of those "somedays" appears to be upon us, with taxes being raised and government spending being curtailed. How the economy reacts to what is really no more than moderate fiscal tightening will provide a lot of information on when the Fed will begin the far more significant process of monetary tightening. Someday, but not any day in 2013.