RCF
ECONOMIC & FINANCIAL CONSULTING, INC.

ECONOMIC UPDATE AND FORECAST SUMMARY

(*Prepared under contract for Prudential Capital Group)*

APRIL 2012

QUICK LOOKS:

- Little has changed from our January report, with the economy growing modestly
- Despite lower than expected growth in March payrolls, the labor market is still on track to add 2.5 million jobs in 2012
- Inflation should remain moderate as energy prices level off, but real wages are unlikely to grow much
- We expect consumer spending to pick up -- labor market improvements and pent-up demand will cause households to open their wallets more this year than last

Although the March employment numbers came in below expectations, the economy still managed to add over 600,000 new jobs in the first quarter of 2012. There has also been solid growth in industrial production, a significant rebound in auto sales, and modest but consistent increases in consumer spending, business investment, and exports. Consequently, we expect the economy to grow at a 2.7 percent rate this year. While that increase is hardly a boom, remember that at this time last year some analysts were saying a 2012 recession was all but guaranteed.

At the same time, it seems unlikely that the economy will grow fast enough to substantially reduce the unemployment rate this year. In fact, improved labor market conditions have brought some discouraged workers back into the labor force. While that is a good thing, it means that the unemployment rate will not decline as rapidly this year as it did in 2011. We expect the rate to fall to 7.7 percent by year-end, the same as we projected in our January report.

There are several hindrances to growth. Beyond the obvious drawbacks of a stagnant housing market and higher gasoline prices, it is beginning to look like the economy's long-run potential output has slowed from the historical average of about 3.0 percent per year. Some of this is due to demographics – the aging and eventual retiring of the baby boomers. Another factor is the plight of the long-term unemployed, who continue to represent more than 40 percent of all workers without jobs. Thus, there is a Catch-22 facing the economy. Long-term unemployment will not decline until the economy experiences stronger growth, but how can the economy grow rapidly if a significant portion of the work force appears to be cut off from the recovery in the labor market?

Interest rates rose during the first three months of 2012 but fell again in early April. However, we believe that rates are gradually headed higher as fears of a recession in 2012 have faded. Importantly, the spread between Baa-rated corporate debt and 10-year Treasuries has narrowed recently, an indication that the corporate default risk has declined. The rise in stock prices over the past six months has boosted household net wealth, which should help support consumer spending even as wage growth lags behind inflation.

We expect no major changes in Federal Reserve policy in 2012. Fed Chairman Ben Bernanke has indicated that the economy is not likely to need another round of quantitative easing. At the same time, the Fed has given no reason to believe they will be raising rates this year. As such, we expect the yield curve to steepen as longer-term rates gradually increase and short-term rates remain close to zero percent. We share the belief of many, including Bill Gross of PIMCO that the 30-year period of declining long-term interest rates has come to an end. Borrowers who lock in now will likely be glad they took advantage of an opportunity that we do not expect to last for much longer.

You will note that our forecasts are mostly unchanged from the projections we made in January. Compared to the consensus, we expect stronger first-half growth owing to early signs of a modest pick-up in consumer spending. Our forecast of core inflation is above the Fed's supposed comfort zone (1.5 – 2.0 percent) but we expect overall inflation to decline somewhat during the year as energy prices level off following a sharp rise over the past few months.

Economic Forecasts: RCF and Consensus
Actual Economic Data as of April 6, 2012

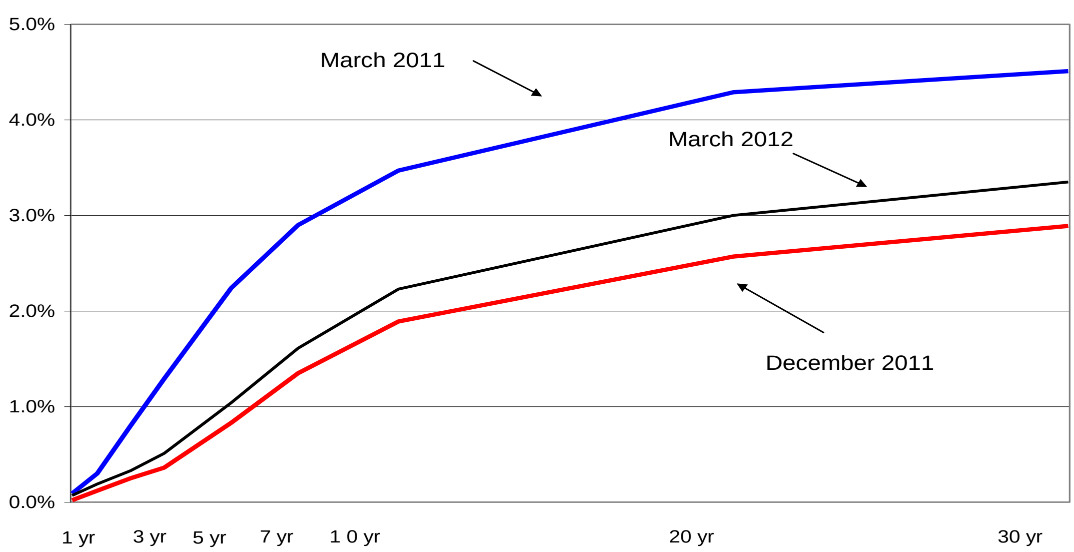
		What We Said	**What We Saw**	**What We See**	
		2012 1st Half	2012 Q1	2012 1st Half	2012 2^{nd} Half
Real GDP	**RCF** *Consensus*	**2.7%** *2.5%*	3.0% (2011Q4)	**2.7%** *2.3%*	**2.7%** *2.6%*
Inflation	**RCF** *Consensus*	**2.2%** *2.3%*	2.7%	**2.2%** *2.4%*	**2.6%** *2.4%*
Core Inflation#	**RCF** *Consensus*	**2.2%** *1.7%*	2.3%	**2.2%** *1.8%*	**2.3%** *1.8%*
Unemployment	**RCF** *Consensus*	**8.1%** *8.7%*	8.2%	**8.1%** *8.2%*	**7.7%** *7.9%*
Fed Funds Rate	**RCF** *Consensus*	**0.125%** *0.125%*	0.125%	**0.125%** *0.125%*	**0.125%** *0.125%*
2-year Treasury Rate	**RCF** *Consensus*	**0.30%** *n.a.*	0.33%	**0.35%** *n.a.*	**0.45%** *n.a.*
10-year Treasury Rate	**RCF** *Consensus*	**2.25%** *2.38%*	2.23%	**2.25%** *2.28%*	**2.65%** *2.55%*

RCF: RCF Economic & Financial Consulting, Inc.
Consensus (except for core inflation): *Wall Street Journal* April Survey of Economists
Core Inflation (excludes food and energy prices); consensus forecast is from the *National Association of Business Economists (NABE)*

I. Interest Rate Overview

In the first three months of the year, 10-year Treasury rates increased about 25 basis points while 30-year yields have risen about 40 points. As Chart 1 shows, rates are still well below the level of a year ago. Yields fell in early April in response to a weaker than expected March jobs report, with 10-year Treasuries dropping briefly below 2.0 percent. However, we believe rates are gradually headed in the direction of their March 2011 levels. Recall that at that time the economy seemed to be on relatively solid footing, before the Japanese earthquake, economic slowdown, and uncertainty surrounding the U.S. debt ceiling negotiations led to a flight to safety and a decline in Treasury yields. While there will no doubt be ups and downs going forward, we forecast 10-year yields to reach 2.25 percent by mid-year and 2.65 percent by the end of 2012. On the other hand, we expect short-term rates to stay near their current levels as a result of the continuation of the near-zero federal funds rate.

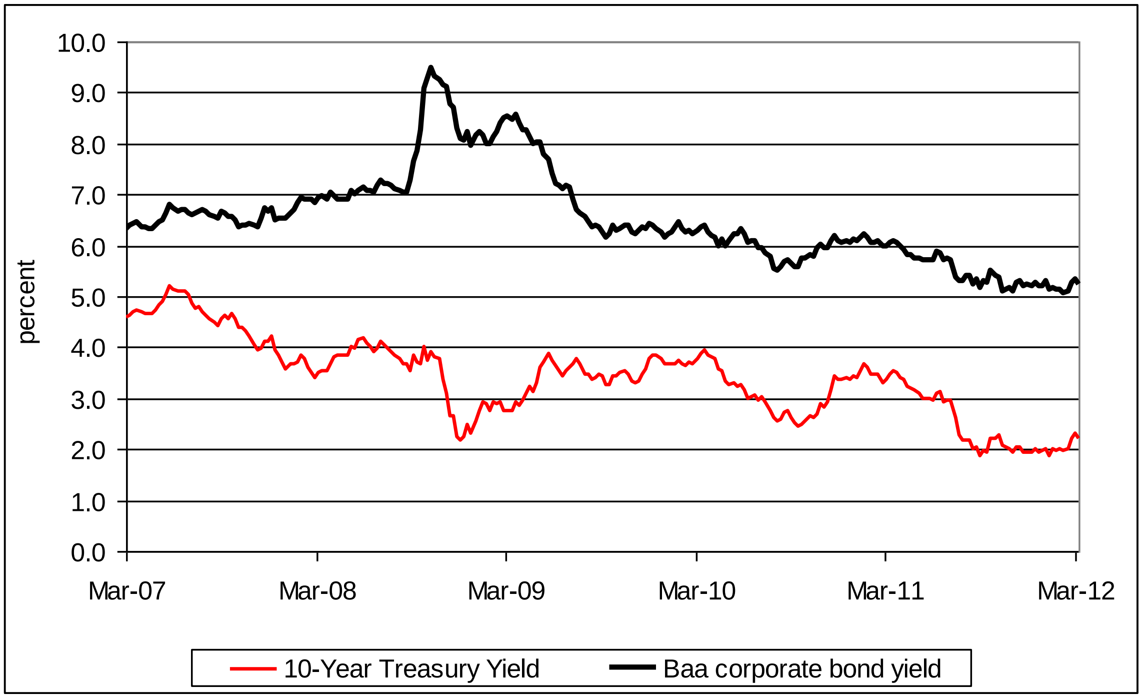
Chart 1: Treasury Yield Curve March 2012 vs. Earlier Periods



Source: Federal Reserve

Over the course of 2012, we expect the all-in coupon for corporate bonds to rise, though not by as much as the 10-year yield, as the default premium on corporate debt gradually declines. Already, the spread between Baa-rated corporate debt yields and 10-year Treasury yields has narrowed, leaving the corporate rate no higher than it was at the start of the year. Companies are taking advantage of the current rate environment, with the volume of corporate bond issuances in the first quarter of this year hitting an all-time high.

Chart 2: 10-Year U.S. Treasury and Baa Corporate Bond Yields



Source: Federal Reserve and Moody's

One unknown is the effect that the end of the Federal Reserve's "Operation Twist" will have on long-term Treasury yields. Under "Twist" the Fed was using the proceeds from maturing short-term securities to buy long-term securities, in an effort to reduce long-term rates. Currently about 60 percent of all long-term U.S. government debt is purchased by the Fed, and most of those purchases will come to an end when "Twist" ends in June. Some analysts believe the rate effect will be minor as other investors enter the market to take over the Fed's purchases. At some price, non-Fed buyers of long-term debt will be found. The question is how much lower bond prices will have to fall (and how much higher bond yields will have to rise) to bring enough buyers to take the Fed's place. We suspect the increase in rates may be higher than the consensus view.

Though we expect interest rates to rise this year, we do not believe that the higher rates will do much to slow the economy in 2012 as rates will remain well below historical averages. One recent development unlikely to change is that every time the U.S. or global economy is hit with bad news, U.S. Treasury yields decline. With Spain replacing Greece as Europe's next trouble spot, expect to see plenty of days in which investors jump to the safety of U.S. government debt. That said, as long as the chance of an American recession remains low – as we think it does – interest rates will trend toward their levels of one year ago.

II. Inside GDP

Final GDP numbers for 2011Q4 show that the economy grew only 1.6 percent compared to 2010Q4. Since the recession officially ended in June 2009, the economy has grown by an average of just 2.4 percent per year, confounding hopes that the deepest recession in over 70 years would be followed by a strong recovery. The "half-full" interpretation of this situation is that the economy is growing and recession fears have justifiably faded. We expect the economy to grow at a 2.7 percent rate in 2012 driven by further strengthening of consumer spending. It is not that consumers are particularly flush with cash, but rather that an improved job market and several years of pent-up demand is causing households to ramp up their purchases.

Chart 3: 2011Q4 Growth in Real GDP and its Components

	2011Q4 vs. 2010Q4	2011Q4 vs. 2011Q3 (annualized)
GDP	**+1.6%**	**+3.0%**
Consumer Spending	+1.6%	+2.1%
Business Investment	+8.1%	+22.1%
ex inventories	+7.3%	+6.3%
Exports	+4.7%	+2.7%
Imports	+3.6%	+3.7%
Government Purchases	-2.8%	-4.1%
GDP (ex Government)	**+2.7%**	**+4.7%**

Source: U.S. Department of Commerce

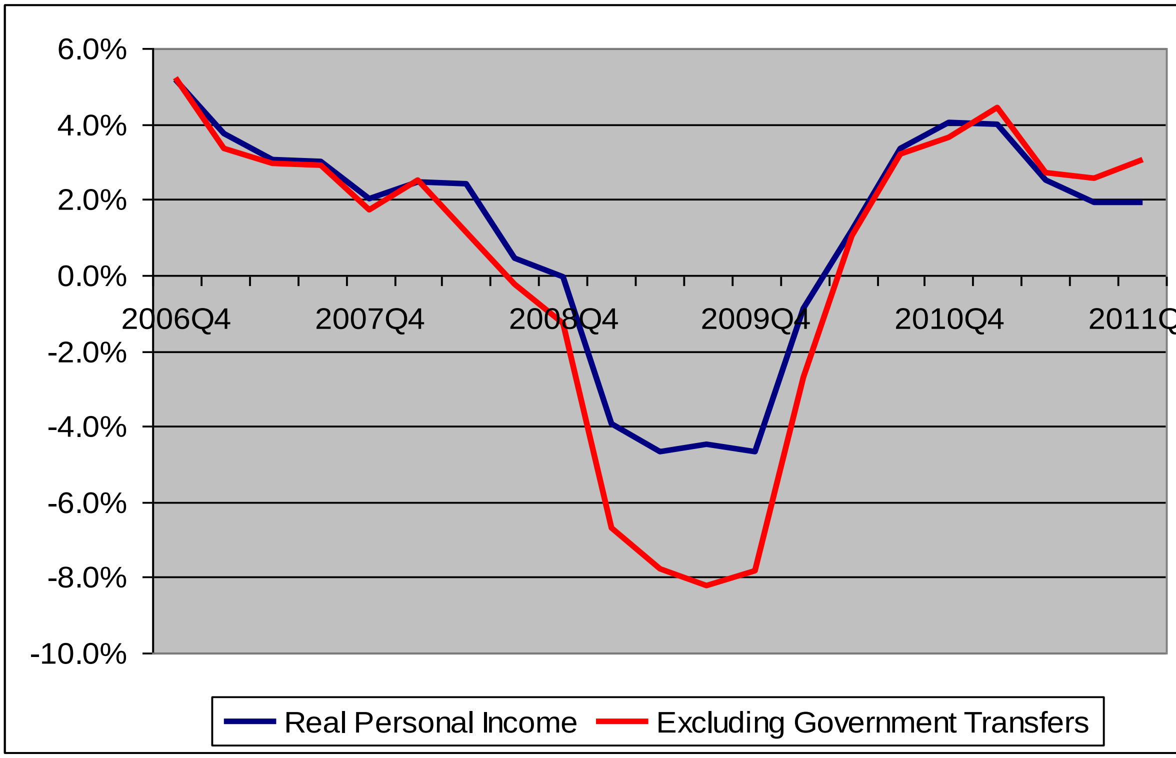
Looking back at 2011, two things caught our eye. The first is that the economy ended the year on a high note, growing faster in the fourth quarter than it did for the full year. The key was the modest year-end pick-up in consumer spending, which still accounts for 70 percent of GDP.

The second issue is that the decline in government purchases has been acting as a drag on GDP. State and local governments have been cutting back for some time now. In addition, national defense expenditures fell as a result of the end of operations in Iraq. If one excludes the impact of these declines, then the "private sector" GDP numbers look notably better – 2.7 percent growth vs. a year ago and a solid 4.7 percent annualized gain vs. 2011Q3.

More evidence that the economy is weaning itself from government stimulus is found by comparing two measures of real personal income. The first, commonly reported, measure includes government transfer payments to individuals. These payments include Social Security and Medicare but also recession-driven programs such as unemployment benefits and food stamps. The second measure of real personal income excludes all these transfer payments, providing a better look at what is happening outside of the impact of government.

As Chart 4 shows, the increase in government transfer payments during the recession helped cushion the large drop in personal income. Recently, however, as unemployment has declined, personal income excluding government transfers has grown more than the measure which includes the impact of these benefits.

Chart 4: Real Personal Income with and without Government Transfer Payments (percent change vs. one year earlier)



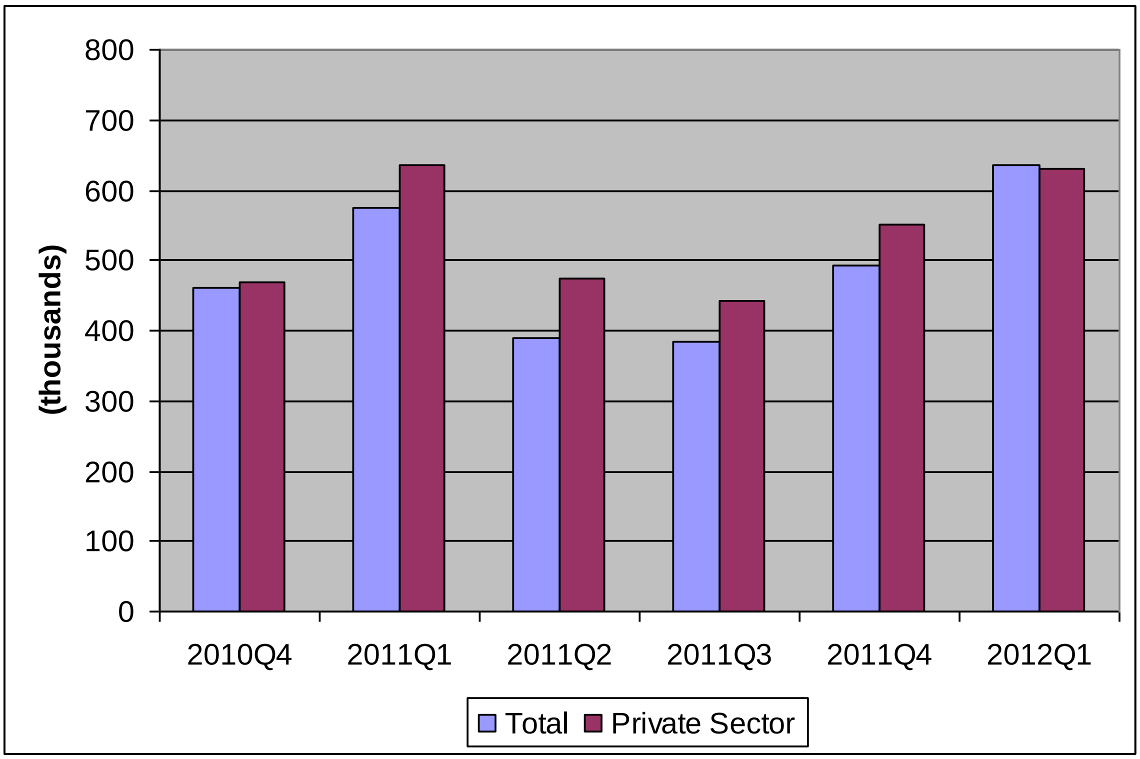
Source: U.S. Department of Commerce and RCF Calculations

The key point illustrated in Charts 3 and 4 is that the growth we are seeing, though modest, appears to be sustainable, even as government fiscal support continues to fade away in 2012. There is of course considerable government monetary support coming via the Federal Reserve, an issue we will look at in the final section of this report.

III. The Jobs Picture

The U.S. economy added more than 600,000 jobs in the first quarter of 2012. Although job gains slowed in March from the pace of the first two months, we believe that the quarterly growth pace is sustainable and is in line with our earlier projection of 2.5 million additional jobs for all of 2012. Importantly, new claims for weekly unemployment insurance benefits have continued to trend downward, reinforcing our belief in solid, if not spectacular improvement in the labor market. Another positive has been the drop in part-time work in favor of full-time work, evidence that employers are more confident in the economy.

Chart 5: Quarterly Gain in Total and Private Sector Employment



Source: Bureau of Labor Statistics

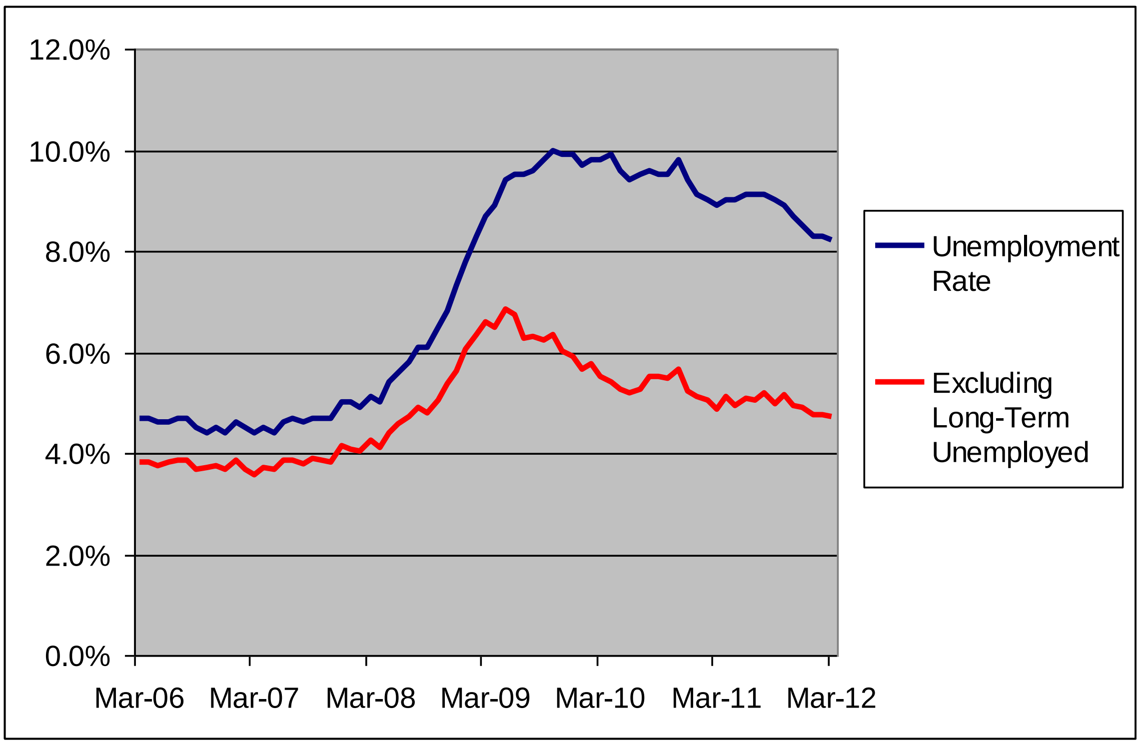
Nevertheless, it is hard not to compare the first quarter of 2012 with the first quarter of 2011, when similar job growth gave way to a slowdown. However, the reduction in payroll gains last spring and summer were attributable to the negative impacts of the Japanese earthquake and, later, the uncertainty surrounding the U.S. debt ceiling negotiations. Overall, our take on Chart 5 is that private sector job growth has been steady, with quarterly gains ranging from about 450,000 to about 630,000 over the last year and a half. We expect employment gains to be near the top end of this range through the rest of 2012.

The Labor Department's separate survey of households showed the unemployment rate falling to 8.2 percent in March, compared with 8.9 percent in March 2011 and 9.8 percent in March of 2010. Some of the decline in March unemployment was due to a decline in the labor force.

However, a broader measure of unemployment which includes these discouraged workers showed a similar drop, falling to 8.7 percent in March 2012 compared to 9.4 percent a year earlier. Over the past 12 months, we find that the labor force has increased by about one million while the number of unemployed has also fallen by about one million, reflecting a gain of about two million jobs over the past 12 months.

Yet, we hold little hope for a substantial decline in unemployment in 2012 and maintain our earlier projection of 7.7 percent unemployment by year end. The problem continues to be the plight of the long-term (greater than six months) unemployed, who represent more than 40 percent of all unemployment. Amazingly, if the long-term unemployed are excluded from the calculation of the unemployment rate, it would not be much higher than it was before the recession.

Chart 6: Unemployment Rate with and without Long-Term Unemployed



Source: Bureau of Labor Statistics and RCF Calculations

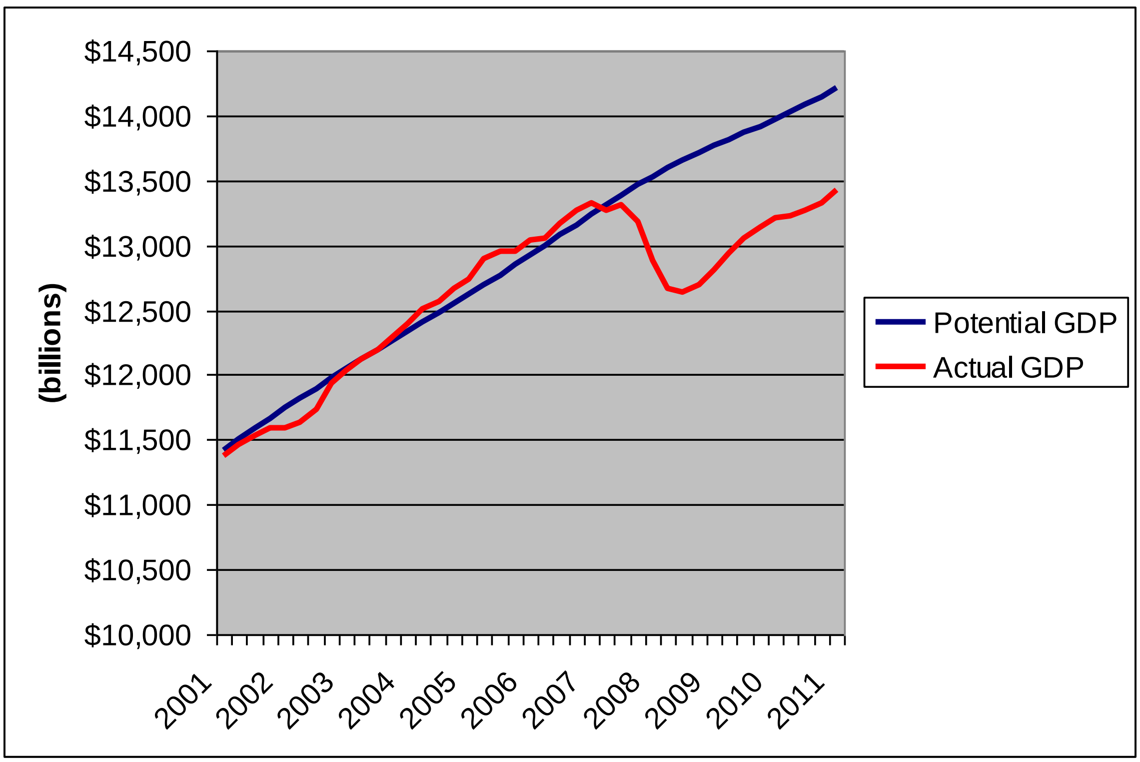
There are currently more than five million long-term unemployed, compared to just one million before the recession. Re-employing people who have been out of work for more than six months – and in many cases more than a year – is more difficult than finding jobs for the recently laid off. Consequently, the economy may remain in a slow growth mode for several more years.

IV. Monetary and Fiscal Policy

In the minutes from its March meeting, the Federal Reserve struck a moderately optimistic tone stating that "on balance, U.S. financial conditions became somewhat more supportive of growth." Unless the economy weakens substantially, the Fed probably will not provide any additional easing once "Operation Twist" – designed to lower long-term interest rates – comes to its planned end in June. At the same time, the Fed continues to project that the fed funds rate will remain "exceptionally low" at least into 2014.

One area where there was debate among Fed members was the extent to which the economy is suffering from cyclical weakness (which can be alleviated with easy monetary policy) and structural weakness (which might require remedies beyond the Fed's control). This difference can be summarized by looking at Chart 7 which shows actual GDP and the Fed's estimate of potential GDP.

Chart 7: Potential and Actual Real GDP



Source: Federal Reserve and the U.S. Department of Commerce

As presented, actual GDP is well below the Fed's estimate of the economy's potential. If the Fed is correct, then adding monetary fuel to the economy is unlikely to boost inflation. Any increase in spending would likely result in an increase in output as businesses hire unemployed workers and the economy moves toward its potential output. On the other hand, if the recent drop in GDP reflects a structural decline and potential GDP is lower than the Fed's estimate, then there is less upside growth for the economy. For example, if the housing market has moved to a consistently lower level of activity, then monetary stimulus will not produce the kind of increases in construction, home sales, and home prices that we have seen in past recoveries. Similarly, long-term joblessness might be more persistent than it has been in the past, leaving the country with a higher "natural" level of unemployment. In these scenarios, additional spending might result in a smaller increase in output and a larger increase in the price level.

For now, Fed policy is not doing much to drive up output or prices. Eventually, however, we believe that the aggregate impact of the Fed's expansionary monetary policies over the past 3-1/2 years will turn into stronger spending. Whenever that happens, the breakdown of the increased spending into higher output versus higher prices will determine how soon and how rapidly the Fed will start raising interest rates. In short, while Ben Bernanke claims that the near-zero rate policy will remain in effect for as long as the next 24 months, he certainly has the power to change his mind if conditions warrant.

Of all the uncertainties on the horizon, fiscal policy probably poses the greatest near-term risk to the economy. With an election in November, it is even less likely than usual that the two parties will be able to agree on any substantive fiscal issues. In the absence of any action, the fiscal changes negotiated as part of last year's debt ceiling bill will automatically take effect in 2013. These changes include fairly substantial cuts in spending and tax increases. These actions could take as much as 3.5 percent off of GDP next year and drag the economy toward recession.

Presumably, the scheduled spending cuts and tax increases will not happen and the fiscal "can" will be kicked down the road again. In our view, that is just as well – sometimes doing nothing is the best thing for the economy. But the uncertainty over what, if any, changes will be made and when, if ever, they will take effect could sap consumer and business confidence. The best bet is probably to chalk it up to election-year positioning and assume that, in the end, not much will change.

"Not much will change" sums up our view of the economy as well. The U.S. appears to have settled into a period of modest growth, gradually declining unemployment, relatively low inflation, historically low, but likely rising long-term interest rates, and for the time being, easy monetary policy with little change in the government deficit.