ECONOMIC UPDATE AND FORECAST SUMMARY

(*Prepared under contract for Prudential Capital Group*)

JANUARY 2012

QUICK LOOKS:

- 2011 was not a great year but it sure could have been worse. The economy is gaining strength heading into 2012
- Labor markets are in best shape since before recession but wage gains still lag inflation
- Uncertainties are mostly coming from overseas – Europe recession, China slowdown, Iran and oil prices
- We expect 2.7 percent growth in 2012, declining unemployment, moderating inflation, and continued low interest rates

2011 is best described as a year in which "no news was good news." It was the things that did not happen over the past 12 months that were the most encouraging. Despite slowing, the economy did not slide back into recession. Employment growth did not stall. Inflation rose but remained moderate. Europe's monetary system did not collapse. Congress and the President did not allow the debt ceiling debate to spiral out of control. There was no wave of municipal bond defaults or further collapses in the financial or housing sectors.

That said, it was a fairly weak year for the economy. Real GDP likely expanded only 1.7 percent, slower than the modest 3.0 percent growth seen in 2010. The stock market was flat while U.S. Treasury rates fell as ongoing concerns about almost everything led investors to the safety of government debt. On the plus side, economic growth picked up as the year progressed. Private sector employment increased by 1.9 million and the unemployment rate fell to 8.5 percent in December from 9.4 percent in December 2010.

For 2012, we expect the economy to grow at a 2.7 percent rate with 2.25 million jobs added and the unemployment rate falling to 7.7 percent by year-end. The biggest drag on growth will be softness in consumer spending due to slow growth in wages combined with households' efforts to further reduce their debt burdens. Business investment will continue to outpace the overall economy as will exports, which have become a key contributor to growth in the last two years. [For more on the growing importance of exports, see our Special Focus Issue included with this report.]

Interest rates defied our expectations and fell to record lows with 10-year Treasury yields ending the year below 2.0 percent. The rate drop occurred despite the fact the inflation rose to 3.4 percent over the past 12 months, with core inflation reaching 2.2 percent.

That was above the Federal Reserve's previously-stated target rate of 1.5 percent, but it is clear that inflation is low on the list of Fed concerns. The fed funds rate stayed near zero for the entire year and will likely remain near zero for all of 2012 and possibly 2013 as well. Short-term Treasury rates will stay low but we do expect an increase in longer-term yields on both government and corporate debt. However, we expect the spread between corporate and government yields to narrow as fears of recession are finally put to rest.

Compared to the *Wall Street Journal* consensus, we are a little more optimistic on overall economic growth and considerably more optimistic when it comes to the unemployment rate. We believe the labor markets have finally turned for good.

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

		What We Said	What We Saw	What We See	
		2011 2nd Half	2011 2nd Half	2012 1st Half	2012 2nd Half
Real GDP	**RCF**	**2.0%**	1.8% (2011Q3)	**2.7%**	**2.7%**
	Consensus	*2.1%*		*2.5%*	*2.3%*
Inflation	**RCF**	**3.4%**	3.4%	**2.2%**	**2.4%**
	Consensus	*3.1%*		*2.3%*	*2.2%*
Core Inflation#	**RCF**	**2.3%**	2.2%	**2.2%**	**2.0%**
	Consensus	*2.2%*		*1.7%*	*1.7%*
Unemployment	**RCF**	**8.9%**	8.5%	**8.1%**	**7.7%**
	Consensus	*9.1%*		*8.7%*	*8.5%*
Fed Funds Rate	**RCF**	**0.125%**	0.125%	**0.125%**	**0.125%**
	Consensus	*0.125%*		*0.125%*	*0.125%*
2-year Treasury Rate	**RCF**	**0.40%**	0.25%	**0.30%**	**0.35%**
	Consensus	*n.a.*		*n.a.*	*n.a.*
10-year Treasury Rate	**RCF**	**2.25%**	1.89%	**2.25%**	**2.75%**
	Consensus	*2.15%*		*2.38%*	*2.75%*

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

2011 Forecast Review

As this is our first issue of 2012, it is worthwhile to look back at our 2011 forecasts that were published last January. Bottom line: GDP growth was less than we expected and

inflation was higher. Put another way, overall spending was in line with our expectations but more of that spending was eaten up by higher prices and less turned into real growth. The weaker economy kept interest rates below our projected levels. Ironically, the unemployment rate fell even more than we predicted, though overall job growth was in line with our earlier comments.

RCF Forecasts for 2011 made in January 2011

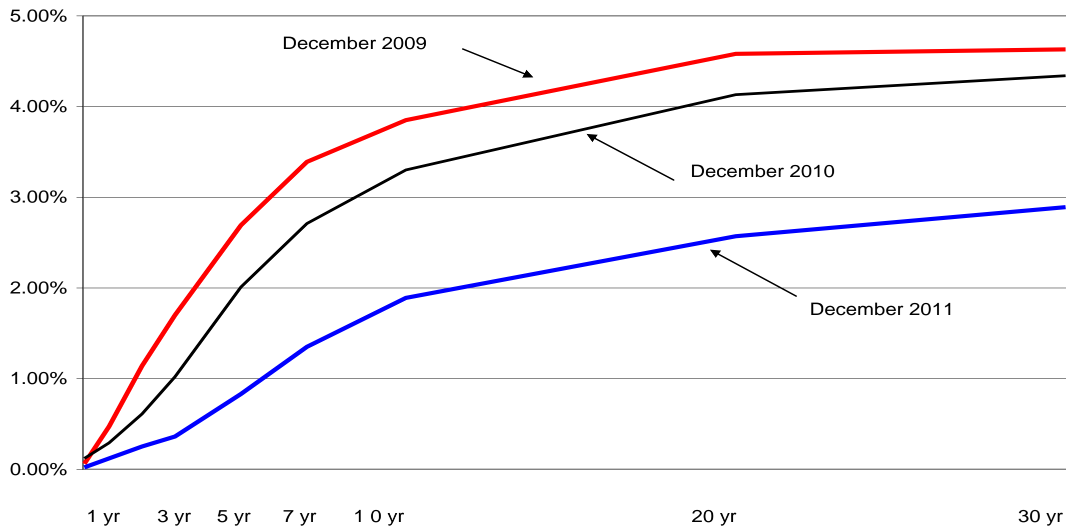
	What We Said	What We Saw
	2011 Full Year	2011 Full Year
Real GDP	+3.5%	+1.7%
Unemployment Rate*	8.9%	8.5%
Inflation	1.7%	3.4%
Core Inflation	1.2%	2.2%
Fed Funds Rate*	0.375%	0.125%
2-Year Treasury Rate*	1.00%	0.25%
10-Year Treasury Rate*	3.95%	1.89%

Forecasts provided by RCF Economic and Financial Consulting in January 2011
* end of year value

I. Interest Rate Overview

Another year meant another round of record low interest rates. Whether it was U.S. government debt, corporate debt or mortgages, rates started 2011 low and ended the year even lower. Like many economic forecasters, we keep expecting this rate trend to reverse itself but it never does. Still, rates cannot keep falling forever, can they?

Chart 1: Treasury Yield Curve
December 2011 vs. December 2010 and December 2009



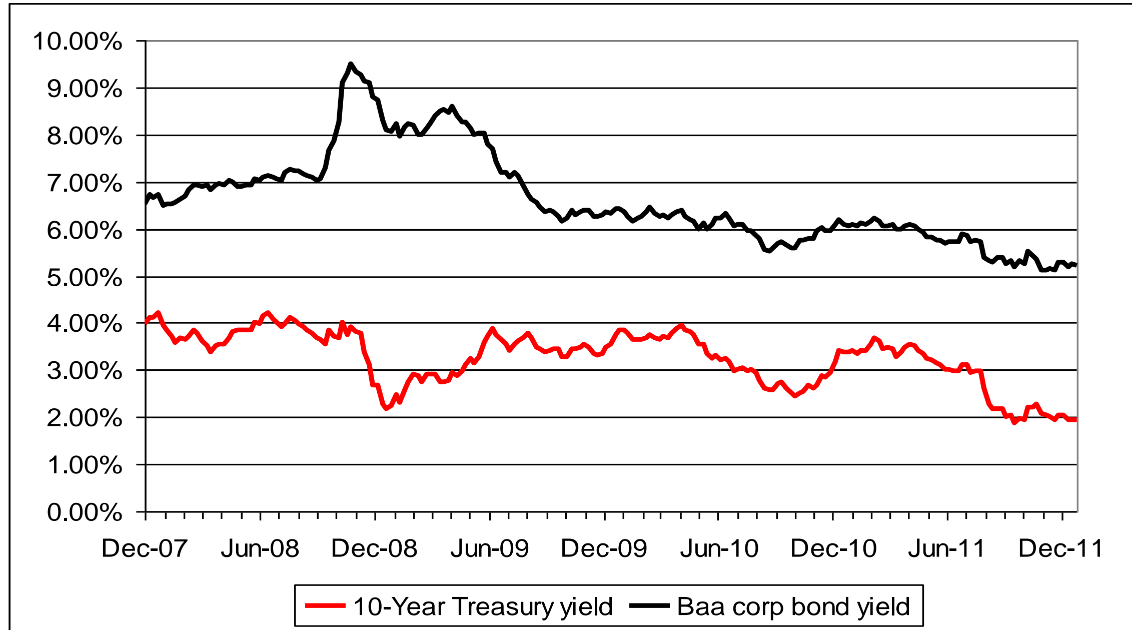
Source: Federal Reserve

Low rates on the short end of the yield curve are clearly a product of the Federal Reserve's near zero fed funds rate. Low rates on the long end, and the resulting flattening of the yield curve over the past two years, remain somewhat of a mystery to us. Certainly, economic uncertainties play a role in the demand for U.S. government debt, but it is hard to argue that things are more uncertain now than they were two years ago. We suspect investors have been chasing a trend here as falling rates have created capital gains for bond holders. Indeed, one of the best performing assets in 2011 was long-term U.S. government debt (up 30 percent), easily outperforming equities or even gold. But that is in the past and if rates do not fall further, bondholders will be left with the meager yield as their only return. Consequently, we expect investors to gradually shift from bonds to equities and as that happens longer-term rates will rise and the yield curve will steepen.

From the corporate borrowing perspective rate continue to be extremely attractive. The yield on Baa-rated corporate bonds has not fallen as much as on 10-year treasuries, causing the spread between the two to increase from a low of about 250 basis points in

early 2011 to about 325 basis points at year-end. Still, while the spread rose, the overall yield on Baa-rated corporate debt fell almost a full percentage point during the year, ending 2011 around 5.25 percent.

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



Source: Federal Reserve and Moody's

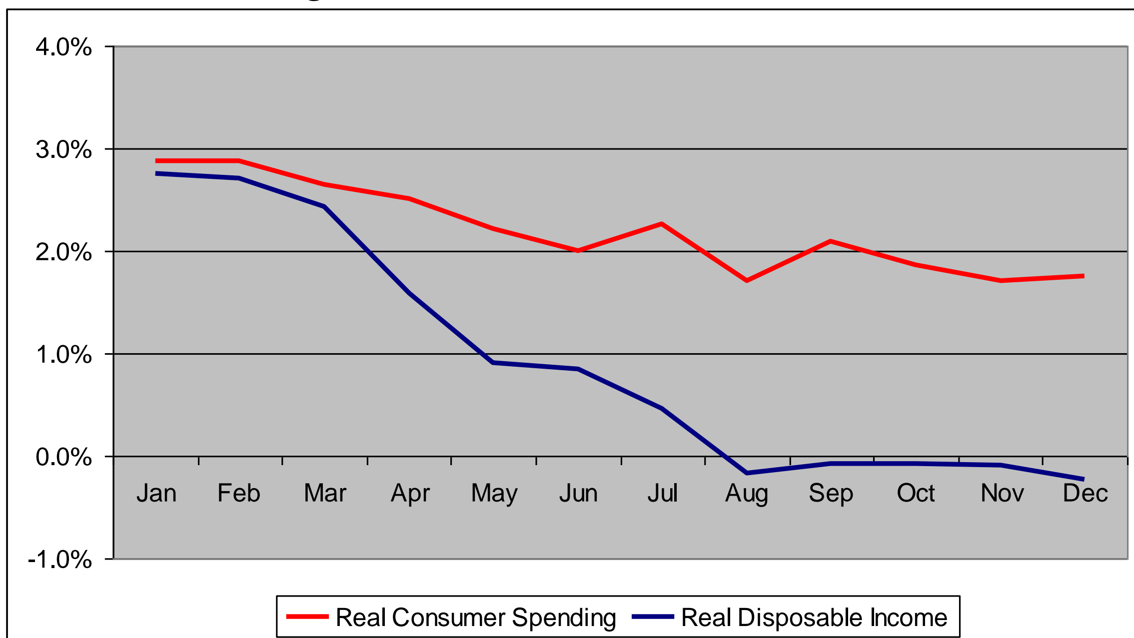
Admittedly, yields have remained lower for longer than we have expected, a situation that could create some inertia for borrowers who do not see a need to rush into locking in current rates. Still, they say never look a gift horse in the mouth, and corporate borrowing rates, which are the lowest in almost 50 years, look like a nice gift.

II. Inside GDP

Real GDP likely increased by only 1.7 percent in 2011, weaker than the 3.0 percent growth that occurred in 2010. On the plus side, the economy gained strength throughout the year. Following a first quarter growth rate of only 0.4 percent, real GDP rose 1.3 percent in Q2, 1.8 percent in Q3, and likely close to 3.0 percent in Q4. Fourth quarter growth was driven by a continued rise in exports, an increase in business investment spending as companies took advantage of expiring tax breaks, and the largest increase in real consumer spending since the final quarter of 2010.

Now here is the bad news. The growth in consumer spending was mainly a result of a decrease in household savings which dipped from 5.0 percent at mid-year to below 3.5 percent by year-end. The reduction in savings, in turn, was a direct result of weakness in consumer income. In fact, real disposable income has been flat or declining since August 2011 and trailed real consumer spending throughout all of that year.

Chart 3: Real Disposable Income and Real Consumer Spending
Percent Change in 2011 vs. same month in 2010



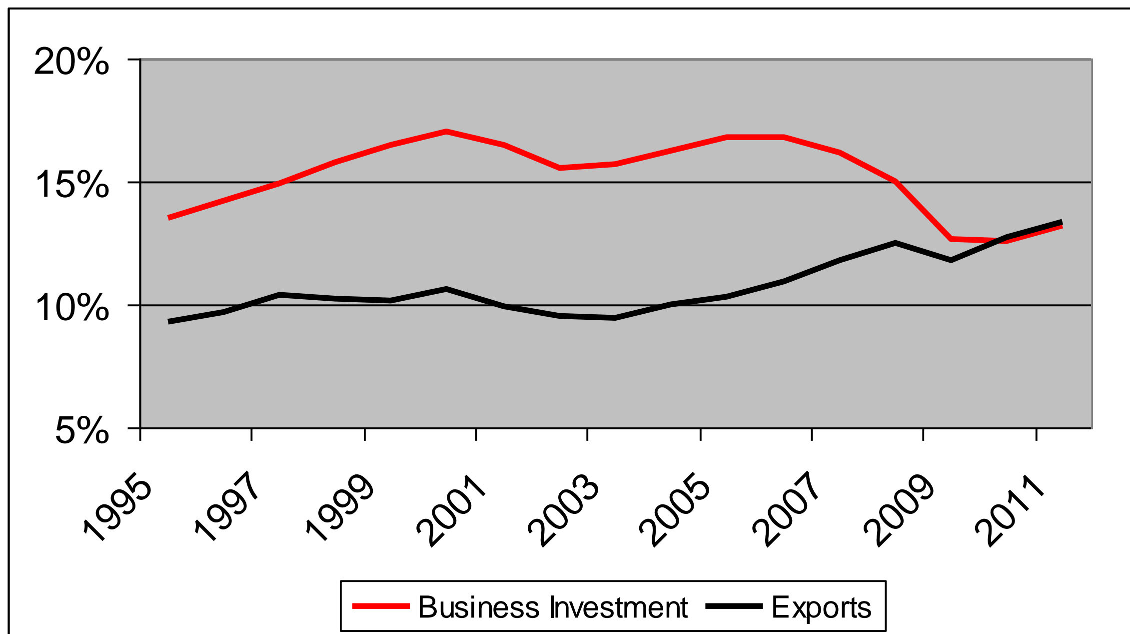
Source: U.S. Department of Commerce

Looking to 2012, we expect the economy to grow 2.7 percent. Household income growth is likely to be modest, driven mostly by increases in employment as opposed to increases in real wages. Therefore, we also expect real consumer spending to grow at between 1.5 and 2.0 percent for the year. Other sectors of the economy are expected to show more growth. We expect real business investment to grow 6.0 percent in 2012, similar to the 2011 increase. Residential investment is finally making a comeback, driven by new construction of multi-unit rental housing. Businesses have been hesitant to make capital

investments, which is understandable given the severity and length of the recent economic downturn. By historical standards, investment spending is near a record-low as a share of GDP indicating that many companies have been trying to extend the life of their existing capital stock. Eventually, upgrades will be needed and investment spending will recover.

We expect exports to have another strong year in 2012, also growing at about a 6.0 percent pace, though a meltdown in Europe would knock a point off that growth rate. One interesting development over the past few years is that exports are now a larger share of GDP than business investment spending, as U.S. companies are finally starting to take advantage of growing consumer income around the world.

Chart 4: Business Investment and Exports as a Share of GDP



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

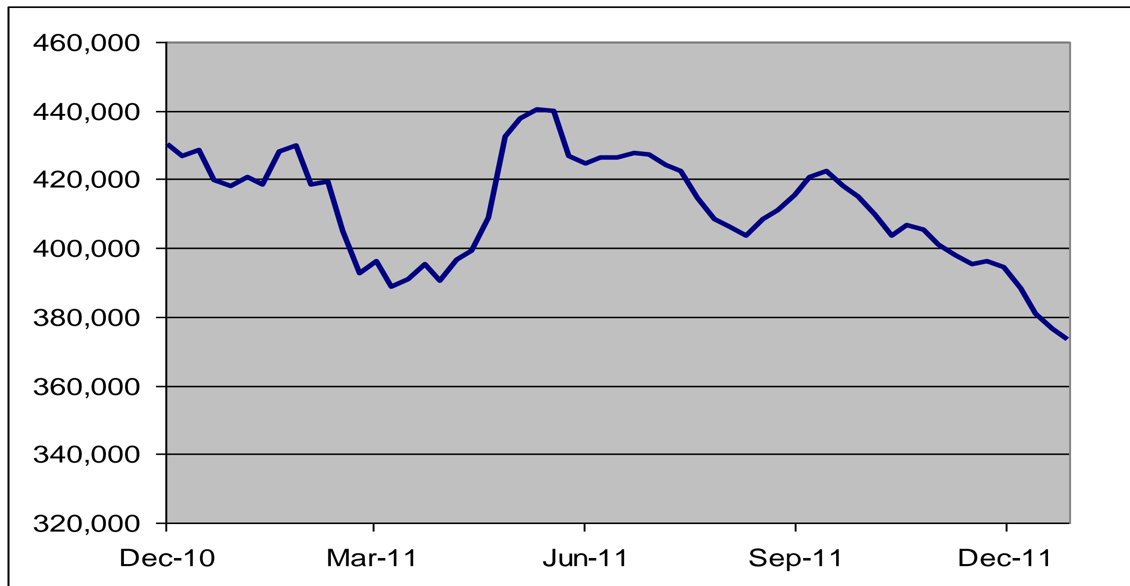
Finally, government expenditures are expected to have little impact on overall growth. Federal spending restrictions are expected to take hold in 2012. However, state government finances are improving, which will likely reduce the need for local governments to reduce their spending.

III. The Jobs Picture

The economy added 1.6 million jobs in 2011 (1.9 million in the private sector partially offset by a loss of 300,000 government jobs). The unemployment rate fell from 9.4 percent in December 2010 to 8.5 percent in December 2011. True, a good portion of that decline occurred because a number of unemployed workers stopped looking for work and were therefore no longer counted in the Labor Department's unemployment calculation.

Even so, there is no doubt that the job market has improved. Perhaps the best indication of that is the drop in claims for new unemployment benefits. After rising in the spring, claims have been in a decidedly downward trend, especially over the last three months of the year. At the end of December, claims were at their lowest level in 3-1/2 years.

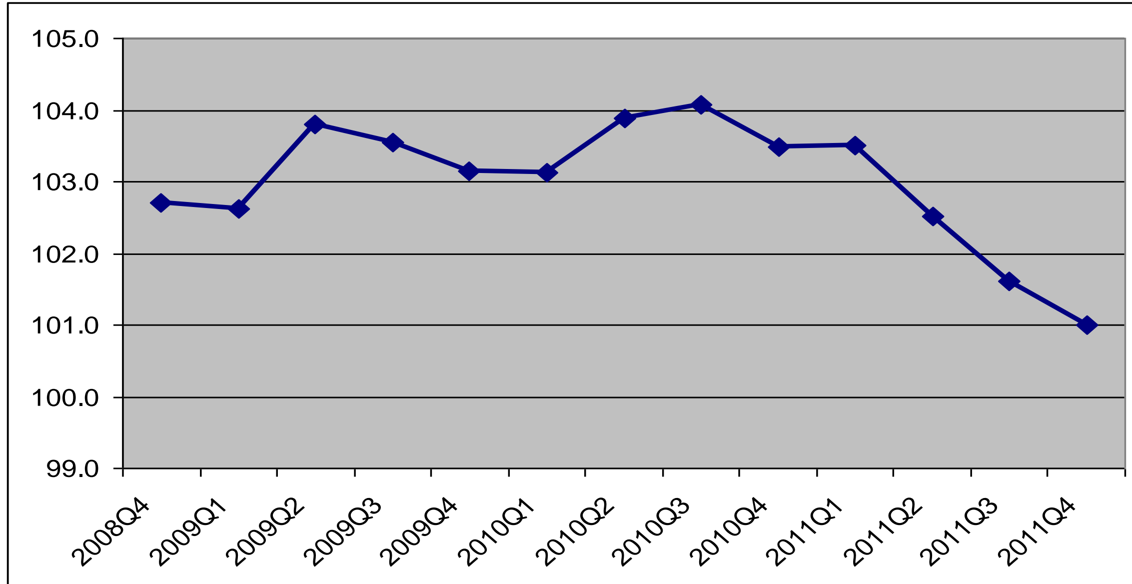
Chart 5: 4-Week Average of Initial Claims for Unemployment Insurance



Source: U.S. Department of Labor

Employment gains for 2011 were the best since 2006 and private sector job growth was the largest since 2005. A reasonable question is how the economy was able to add more jobs in 2011 than it did in 2010, despite 2011's weaker overall growth in output. One reason is that employment has always been a lagging economic statistic. Another reason for the increase in hiring is the decline in real labor costs, which we alluded to in the previous section. Since peaking in the third quarter of 2010, real labor costs have been on a decline. That is simple economics. High unemployment means that the demand for labor is less than the supply. And when labor demand is less than labor supply, price (or in this case labor costs) fall, which in turn creates an incentive for employers to hire more workers.

Chart 6: Index of Real Labor Costs (2005 = 100.0)



Source: U.S. Department of Labor

We expect this trend to continue in 2012, with employment growing but real wages flat or declining. Unemployment is still high and the recent improvements in the labor market will turn some of those discouraged workers back into active jobseekers. Thus, the supply of labor will likely grow almost as much as the demand, thereby keeping the lid on labor costs.

Most importantly, we believe that the labor market turned the corner in 2011 and the issue for 2012 will not be if conditions will improve, but how quickly things will get better. Our forecast is for the addition of 2.25 million jobs in the coming year and the unemployment rate falling to 7.7 percent by year-end. Of course, it is only after the struggles we have seen that near-eight percent unemployment would be considered a positive.

IV. Monetary and Fiscal Policy

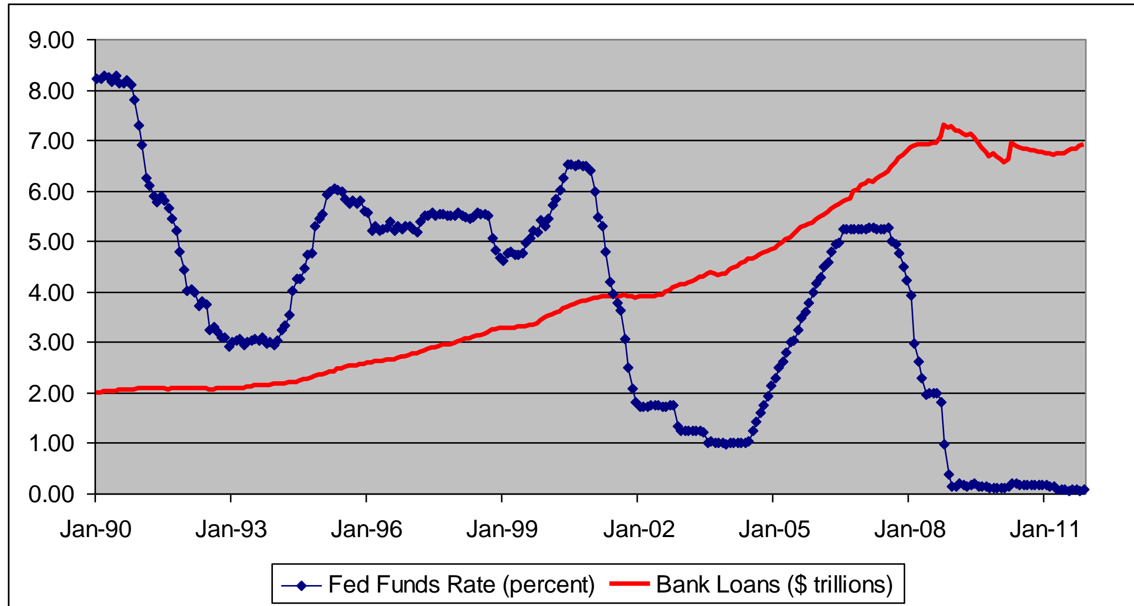
Perhaps the expectation of fiscal policy, and the whole fiscal process, should change. Instead of lamenting that the budget deal reached last August put more emphasis on short-term spending cuts than on more important long-term spending reform, perhaps we should be happy that any kind of deal at all was made to forestall default on the national debt. Instead of asking why Congress and the President would spend almost three months debating a two-month extension of the payroll tax cut, we should assume this is the merely the first-step in the process toward a year-long extension. And it probably is not worth the trouble to worry why these two most recent acts of fiscal policy run counter to one another, with the payroll tax cut adding to the very deficit that the debt ceiling legislation was supposed to reduce.

In all seriousness, the state of fiscal policy is not nearly as big a concern as it might appear. True, the budget deficit will exceed $1 trillion in 2012. But the demand for U.S. government debt seems almost insatiable, with the problems in Europe creating yet another reason to prefer Uncle Sam's IOU's to those of anybody else. There is a lot of red ink in the budget, but with government borrowing rates at or near record lows, it is virtually free red ink. There is also good news coming from state governments. The combined budget deficit of the 50 states in 2012 is projected to be half what it was in 2010 as a result of higher taxes, lower spending, and improved finances due to the gradually improving economy.

Monetary policy discussions used to center around the federal funds rate. An entire industry arose around projecting its future level. Well, it appears that the Federal Reserve is in the job-destroying business, at least when it comes to economic forecasters. The Fed has stated that it intends to keep the fed funds rate unchanged throughout 2012 and likely through 2013 as well. The Fed is also planning to start publishing its internal forecasts of interest rates. Fed funds forecasters will need to find something else to do.

While the level of the fed funds rate is no longer a variable, the impact of this near-zero rate remains uncertain. It clearly is one of the factors behind the low interest rate environment in the U.S. and, after all, that was a main purpose of the Fed's policy. But it has not been nearly as successful at the second part of this low interest rate policy – stimulating borrowing and spending. The Fed has kept the funds rate at its current level for three full years now and, yet, loans made by commercial banks were lower at the end of 2011 than they were at the end of 2008. On the plus side, low interest rates have helped drive new issuances of corporate bonds. Still, the far larger banking sector has not followed suit.

Chart 7: Fed Funds Rate (percent) and Commercial Bank Loans ($ trillions)



Source: Federal Reserve

The recent failure of the low fed funds rate to stimulate bank lending is in contrast to what happened following the 1990 and 2001 recessions. In both those cases, bank loans stalled, the Fed cut rates, and soon afterward, bank lending growth resumed. But as we have heard before: this time is different. Moreover, the problem is not entirely due to banks' unwillingness to make loans. A recent Fed survey of senior loan officers found that the willingness of banks to make consumer loans has consistently exceeded the demand for consumer loans.

It all comes back to the consumer. Monetary policy, fiscal policy, business spending, and exports – all of these things matter. But none matters as much as the health of household finances and nothing matters to that as much as the condition of the job market. Though there will be some up and downs during the year, we believe that labor situation has reached the point of a self-sustaining positive cycle. Increases in employment will lead to increases in total consumer income and total consumer spending, driving additional increases in employment. No great leaps, merely little steps in the right direction.