

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the First Quarter of 2009 through the Fourth Quarter of 2012

The U.S. recession celebrated its first birthday this winter, fanning concerns it is entering its “terrible twos.” Indeed, its second year is off to a bad start. The U.S. Department of Commerce estimates real GDP shrank an annualized 6.3% in the last quarter of 2008 followed by a 6.1% drop in this year’s first quarter. The economy continues to shed jobs, with 663,000 jobs lost in March alone. And housing prices continue to fall. But this bad news must be weighed against other factors. For example, recent data for retail sales, consumer spending, housing starts and permits (especially the latter), home sales, financial risk spreads, and commodity prices suggest the economy is thawing. The mere fact that not all the data look like they are falling off a cliff is a good sign. Second, even for the data that are still falling, the rate of descent for many has diminished. This too can be a leading indicator of a turning point.

Nonetheless, a closer look at the data of the past few weeks suggests that while some parts of the economy may be approaching bottom, others are a long way off. For example, after registering positive growth in the first quarter, consumer spending will probably falter in the second quarter, before beginning a sustained recovery in the third. Similarly, housing starts will probably bottom out in the current quarter and begin to increase sometime over the summer. At the same time, while some financial spreads are at levels last seen before the September collapse of Lehman Brothers (the TED spread and commercial paper spreads), other indicators of financial distress have not eased much, especially corporate bond spreads for companies with less than stellar credit ratings. Similarly, while prices of some commodities such as energy and nonferrous metals have clearly bottomed out, others such as steel have more downside risks.

Other data provide stronger evidence that the economy has not yet hit bottom. While the 663,000 drop in March payrolls was huge, ironically it was not as bad as many had expected. Nevertheless, employment always lags the recovery. So, even though economic growth will turn positive by the fourth quarter of this year, employment growth is not expected to rebound until the second quarter of 2010. Exports are also likely to lag the recovery because the upturns in Europe and Japan are expected to begin a quarter or two later than in the United States. Finally, business spending on structures will continue to contract at double-digit rates through the second quarter of 2010, because of excess capacity, the credit crunch and (in the case of drilling) low energy prices.

There is a tendency in the depths of a recession to fall into the trap of fearing that the bad times will last for a long time. But it will pass. Typically, the longer the downturn, the more the pent-up demand. This pent-up demand is eventually released when households sense that the worst news on the economy, house prices, and the stock market is over. A similar pattern is also evident among businesses. During the current business cycle, there are at least three triggers that will be the catalysts for the release of pent-up demand: lower commodity prices, lower interest rates, and fiscal stimulus.

The current year is one of transition. The U.S. economy is expected to take its first steps toward recovery later this year, but will not grow near its potential until the second quarter of next year. Real consumption is projected to fall in the second quarter of 2009, then pick up its pace. Nonfarm employment is anticipated to continue declining through the first quarter of 2010 and grow slowly thereafter. However, the pace of nonfarm employment growth will not be strong enough to help return the country to full employment during the forecast period. Housing starts will fall to about one-half million units this year then gradually advance to one and one-half million units by 2012.

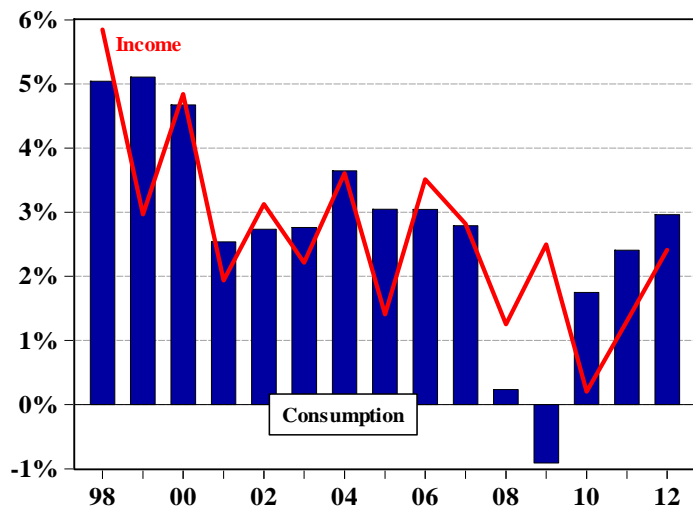
SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: Consumer spending will continue to be a drag on the economy through the first half of this year. After a long streak of positive growth, real consumer spending began a slump in 2007 that culminated with large declines in the second half of 2008. Individually, the drops of 3.8% in the third quarter and 4.3% in the fourth quarter were disappointing, reducing real GDP growth by three percentage points in last year's third quarter and in the fourth quarter. Together, they delivered a disappointing one-two combination to an already weakened economy. Unfortunately, real consumer spending is expected to continue shrinking in the first half of 2009, but not as steeply as it did in 2008. It is forecast to grow slowly over the rest of the year despite decent real disposable income growth. This year's consumption outlook is still likely to be shaped by factors that

contributed to its poor showing in 2008. It will take awhile for consumers to shake off the impacts of job losses, declining asset values, and tight credit. A closer look at some of these factors shows why consumers are not in a spending mood. From December 2007 to February 2009, the U.S. economy shed about 4.4 million jobs. Another three million jobs are expected to be lost by the start of next year, pushing the unemployment rate above 10% for the first time since the end of 1982. In addition to their job worries, consumers have watched their household net worth fall, as the stock market dropped and home prices receded. From spring 2007 to the end of 2008, household net worth fell by \$12.9 trillion, which was more than the \$12.1 trillion in personal income earned last year. These factors have been particularly hard on durable goods because they mainly consist of big-ticket items that are financed. Automobiles are an excellent example. Real spending on new automobiles dropped at over a 50% annualized pace in both the third and fourth quarters of 2008. Nondurable goods spending also retreated, but not nearly as steeply. Spending on services was the least impacted, it suffered a 0.1% decline in the third quarter of last year and has gradually expanded since then. After declining in the first half of this year, total real consumer spending will also slowly improve. However, the strength in the second half of 2009 is not expected to offset the weakness of the first half of that year. As a result, real spending on goods and services is forecast to drop 1.2% this year—its first annual decline since 1980 and its biggest drop since 1942. Real spending growth should accelerate after this year as household net worth first stabilizes then grows and payrolls begin expanding. In addition, household income will benefit from the combination of tax cuts, refundable credits, and income support payments that are part of the fiscal-stimulus plan. One consequence of the spending recovery is the falling personal savings rate. Spendthrift consumers drove the personal savings rate negative in 2005. As the economy cooled, consumers hunkered down and, as a result, the rate is expected to top 7% this year. The rate is expected to fall again as consumers loosen their collective purse strings, but the savings rate is not expected to slip below zero percent anytime in the near future.

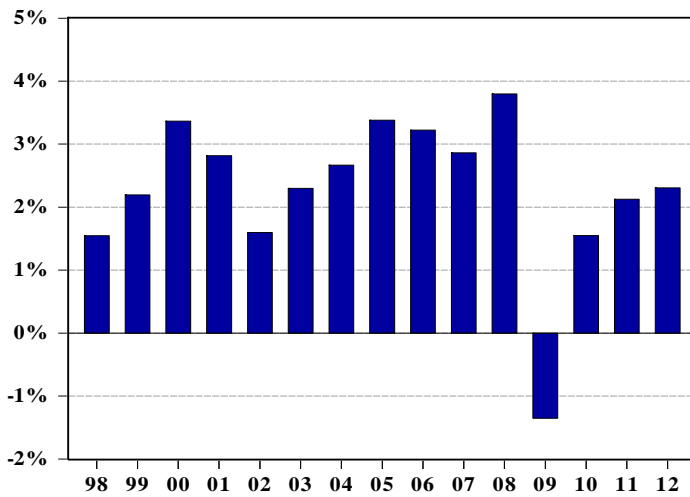
Inflation: Inflation is not expected to be a threat during the forecast period. Instead, deflation is more likely to be a problem in the short term. The risk of falling prices is symptomatic of the weak economy. Some of these are the results of ongoing softness. Housing prices are expected to continue declining for another year. Employment costs should remain soft until labor markets firm up. But the biggest change

U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

Consumer Price Inflation



Source: Global Insight

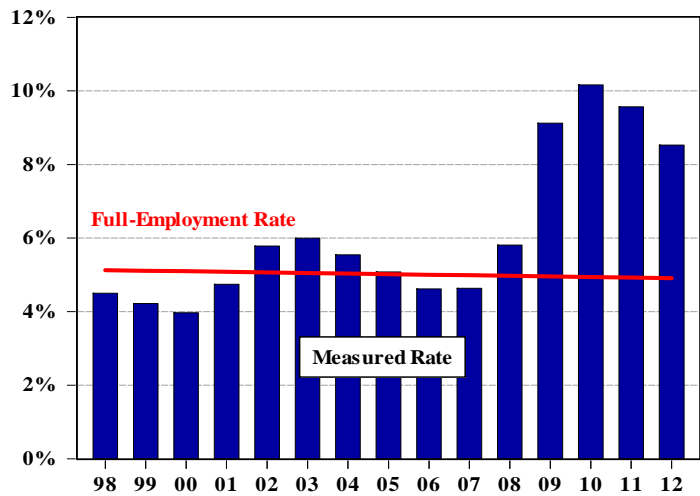
since last year is energy prices. No one enjoys being reminded that oil prices spiked near \$150 per barrel and gasoline topped \$4 per gallon last summer thanks to strong demand. Since last year the global economy has weakened significantly, which is expected to cause energy demand to decline this year. In the U.S. alone, the demand for all fuels is projected to go from 2008's 98.3 quadrillion Btu to 97.1 quadrillion Btu. The biggest decline will come from imported fuels, which drops from 33.0 quadrillion Btu to 31.1 quadrillion Btu. The lower expected imported fuel volumes and lower prices should slash the nation's imported fuel bill by more than half, which will help the country's trade

deficit. Unfortunately, energy prices will not stay low. For example, West Texas Intermediate Crude is projected to go from an average of \$45 per barrel this year to \$74 per barrel in 2012 and the average retail price of gasoline (including taxes) should rise gradually from \$2.05 per gallon to \$2.74 per gallon over the same period. Labor markets are expected to improve slowly, and so are employment costs. The Employment Cost Index is forecast to rise by no more than 2% during most of the forecast period. The lower inflation outlook provides the Federal Reserve some welcome wiggle room. In 2008, the core personal consumption deflator rose 2.2%, which was at the high end of the central bank's comfort range. The classic response to heating inflation is for the Federal Reserve to tighten. However, this option had to be weighed carefully, as the economy was already showing signs of cooling. The combination of heating prices and the cooling economy raised the specter of a return to 1980s-type stagflation. Fortunately, the economy has dodged this bullet. It is forecast that the personal consumption deflator will grow by well less than 2% annually over the forecast period, which is now near the bottom end of the Federal Reserve's comfort range. The energy price collapse causes the consumer price index, the most well known inflation indicator, to retreat 1.4% in 2009, its first drop since 1955. After this year inflation will pick up speed, but still remain tame by historical standards.

Employment: As expected, the employment situation so far this year has been disappointing. The U.S. Department of Labor reported that the U.S. unemployment rate rose to its highest level since late 1983 in March 2009. At 8.5%, it is nearly a percentage point higher than it was at the beginning of this year and about three and one-half percentage points higher than its year-ago level. The deterioration of the job market is also evident in the nonfarm data. America has been losing jobs faster than it has been creating them since the beginning of last year. Recently the flow of job losses has increased. The average monthly loss in 2008 was about 250,000 jobs. In comparison, losses have averaged 685,000 jobs per month so far this year. The worst month was January 2009 when the economy shed 741,000 jobs. Every major employment category, except for education and health care, has suffered losses. Hardest hit in March 2009 were the construction and manufacturing sectors that continued their long employment declines. The nation's construction payroll shrank by just over 125,000 jobs and manufacturing lost just over 160,000 jobs. March 2009 marks the 21st consecutive month construction employment has fallen, while manufacturing employment has dropped in 32 of the last 33 months. Over these respective periods, construction employment has shrunk by almost 1.25 million jobs and manufacturing has dropped by over 1.9 million jobs. Thankfully, the period of large monthly job losses

should be over by this year's first half, but it must be stressed that the job recovery is expected to move at a very slow pace. Initially, monthly job losses will continue but grow smaller. For example, during the first half of this year the projected average monthly decrease is 574,000 jobs. Over the following six months it is expected to fall by 243,000 jobs per month. The next year starts with a further, small (0.4% annualized) loss before the economy begins adding jobs. However, at the projected pace, nonfarm employment does not recover the jobs lost since the recession's start. The weak job outlook suggests the unemployment rate has not yet peaked. It is forecast to rise to 10% later this year and stubbornly remain near that level through next year and the first half of 2011.

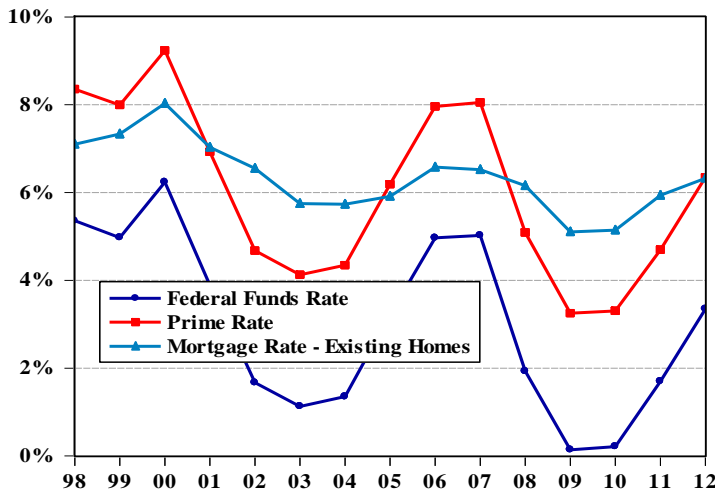
U.S. Civilian Unemployment Rate



Source: Global Insight

Financial Markets: During its March 17-18 meeting, the Federal Open Market Committee (FOMC) voted unanimously for a massive expansion of both the volume and scope of its long-term asset purchases. The total volume of the program was nearly tripled from \$600 billion to \$1.75 trillion. Planned purchases of mortgage-backed securities will be expanded from \$500 billion to \$1.25 trillion, purchases of government sponsored enterprise (GSE) debt will be doubled from \$100 billion to \$200 billion, and the Federal Reserve launched a brand new program to purchase \$300 billion of long-term securities. The Federal Reserve's programs to relieve pressure on mortgage interest rates and long-term

Selected U.S. Interest Rates



Source: Global Insight

Treasury yields have had some success. The initial stage of Term Asset-Backed Securities Lending Facility (TALF) program has been below expectations. It appears to be burdened by concerns about compliance requirements for the program and potential future changes in government policies that could affect TALF borrowers. However, it is expected that the Federal Reserve and Congress will successfully iron out some of the wrinkles in the TALF program. The current federal funds rate target range is 0% to 0.25%, and it is expected to remain there through October of 2010. Eventually, the FOMC will have to pull the punch bowl from the party, but for now it is enticing the guests to have a drink.

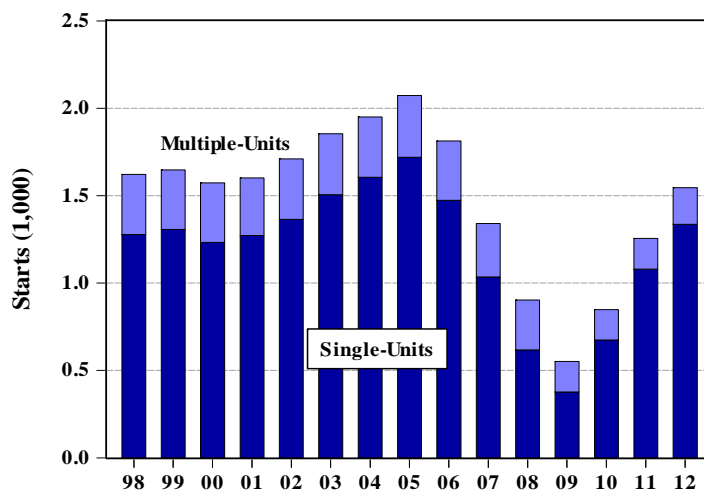
Housing: Recent housing industry data should be viewed with the warning that one month does not signify a turning point. Housing starts, housing permits, existing home sales, and new home sales all

rebounded smartly in February. More positive news came in the form of all-time low 30-year mortgage interest rates that helped make housing the most affordable it has been since at least 1971. First-time homeowners are also being enticed by a tax credit worth up to \$8,000. At first blush, the coincidence of these positive factors may suggest the housing sector turned a corner recently. However, it is still too early to make this call. A couple of factors suggest why this would be premature. First, it is likely the February housing numbers were inflated by favorable weather conditions. Second, while many of that month's estimates were positive, they were not statistically significant. In addition, not all of the recent news has been positive. The Case-Shiller

home price readings for January were worse in every detail than for December. The indexes continue to show year-on-year declines across 20 cities, with each reporting five months of consecutive price declines. According to the Mortgage Bankers Association, weekly applications to purchase homes continued to decline. Finally, Fannie Mae's serious delinquency rate for conventional single-family homes rose to 2.77% in January from 1.06% in January 2008. While the mixed signals so far this year suggest the bottom has not yet been reached, it is often a sign that the bottom may be near. In the current forecast, the housing starts are expected to hit bottom in the second quarter of this year and slowly start climbing as renewed economic growth and lean inventories of new homes induce builders to start more houses. In the near term, housing starts are forecast to drop to 551,000 units this year and then bounce back to 848,000 units next year. After that year, U.S. housing starts are predicted to climb above one million units in both 2011 and 2012. Home sales are expected to also bottom out during the first half of this year. Housing prices will take longer to improve. Housing prices are near their equilibrium level, but they will continue to drop because current inventory levels remain near record highs and foreclosure rates are still rising. As a result, the housing price decline should continue through this year before hitting its low point early next year.

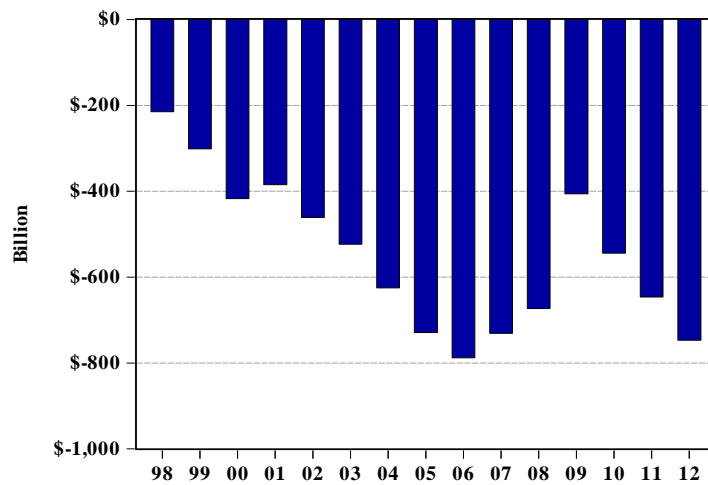
International: The world is experiencing the worst economic downturn in the postwar era. It is anticipated this recession will cause global economic output to shrink 2.6% this year—its first decline since the end of World War II. Not only is the downturn deep, it is also widespread, with most major economies expected to shrink this year. At an expected 3.5% decline, U.S. real GDP does not experience the worst decline. That honor goes to Japan, whose output is forecast to retreat nearly 7% in 2009. Europe's real GDP is projected to decrease by 4%. Mexican output is also expected to drop by about this percent. North of the U.S., Canada's economy should shrink by 2.9%. South America's economy should drop 1%. China and the rest of Asia (except Japan) are expected to see their economies grow. However, while positive, these expected rates are slow enough to be considered recessionary. Earlier this year the leaders of the Group of 20 (G-20) nations met in London. Leaders left the summit in London broadly satisfied with the outcome—which included a capital boost for the International Monetary Fund (IMF), fresh momentum on financial regulation, and a crackdown on tax havens. Unsurprisingly, on some of the grander ambitions, they came up short. But despite a fair degree of posturing ahead of the summit, leaders managed to avoid any major breakdowns. Despite the apparently stark differences in bargaining

U.S. Housing Starts



Source: Global Insight

U.S. Current Trade Deficit



Source: Global Insight

positions leading up to the G-20 summit, there is something for everyone in the final communiqué. The challenge will be holding governments to their promises, and ensuring they enact pro-growth measures and avoid protectionism. The economic backdrop remains negative and for most, the situation continues to deteriorate. One area that leaders still need to address urgently is how to cleanse the banks of bad assets that continue to clog the financial system and credit flows. Without fixing the banks, a sustainable economic recovery is not really possible. These matters, while recognized, have been left for individual countries to manage. The U.S. 2009 trade picture will be one of two halves.

In the first half of this year, inventory reductions cut imports and hurts foreign sources. As a result, trade will be a positive contributor to GDP, in as much as the inflation-adjusted trade balance should improve, but only because the U.S. economy is making less, consumers are buying less, businesses are investing less, and the economy is absorbing inventories. Trade is expected to become a drag on output later this year as the economy improves. This transition occurs because imports are expected to revive as consumers begin spending and industries require more raw materials. This will push the trade balance deeper into the red from mid-2009 onward. Specifically, the nominal current trade balance nearly doubles from \$406 billion in this year to \$747 billion by the end of 2012.

Business Investment: Nonresidential investment is forecast to be the biggest drag on economic growth this year, subtracting just over 2 percentage points. This outlook should not come as a surprise, as several factors point toward weakness. The economy is in recession, job losses are mounting, developers over-expanded during the good years when credit was cheap and readily available, the securitization market for commercial real estate loans is totally frozen, and commercial real estate prices are dropping. In addition, investment in oil and natural gas well drilling has fallen because of lower energy prices. As a result, real investment on nonresidential structures is expected to drop 22.5% in 2009 and 12.8% in 2010. Hardest hit is mining and petroleum spending, which, after growing 17.1% last year, is expected to drop 43.2% this year and grow just 4.3% in 2010. Investment in other types of structures will take even longer to recover. Investment in buildings is forecast to fall 15.4% in 2009 and another 16.6% in 2010. Spending on power and communications buildings is projected to shrink 17.2% this year and 15.2% next year. This year will also not be a good one for spending on equipment and software. It is forecast to drop nearly 17%, as investment in computers declines 22.4%. Spending on software should drop 7.6%. The softness in real equipment and software spending is expected to spill over into next year, with investment growing just 6.3%. It does shift into higher gear after 2010, however. On an aggregate basis, real gross private nonresidential investment is anticipated to retreat 18.8% in 2009 and by 0.1% in 2010 then advance 13.2% in 2011 and 13% in 2012.

Government: The federal government's \$787-billion stimulus package has been incorporated into this forecast. It is assumed that \$561 billion will be spent in the first two years. This amount breaks down into \$143 billion in personal tax cuts, \$97 billion in targeted transfer payments (e.g., food stamps and extended unemployment insurance), \$88 billion in corporate tax cuts, \$149 billion in aid to the states,

and \$82 billion for infrastructure and other spending. The Treasury has \$700 billion in budget authority under the Troubled Asset Relief Program. Of the first half, it is assumed that about \$270 billion is allocated for capital infusions to banks; \$40 billion is allocated to AIG; \$20 billion to the Term Asset-Backed Securities Lending Facility (TALF); and \$20 billion goes to the auto companies. The second \$350 billion will be divided \$20 billion for further auto loans and \$75 billion for the new housing plan. The remaining \$255 billion will be allocated as follows: TALF II, \$80 billion; AIG II, \$56 billion; and other capital injections, \$119 billion. In addition, it is assumed another \$550 billion in funding. All of these financial programs push up the unified budget deficit substantially, and then reduce it in later years as acquired assets are sold off. Specifically, the federal deficit was \$160 billion in 2007. It is expected to grow to \$1.9 trillion in 2009 and still be nearly \$1.7 trillion in 2010. In fact, it does not drop below the trillion-dollar mark until 2011, and even then it is still about \$800 billion higher than in 2007. The stimulus package is estimated to add about 0.8 percentage points to 2009 GDP growth and 1.3 percentage points in 2010. It is also expected to create or save just under 2.5 million jobs by the end of 2010.