

NATIONAL FORECAST DESCRIPTION

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

The national economy reached an important milestone this summer when real GDP grew for the first time in a year. In late October, the U.S. Department of Commerce released its advance estimate for the third quarter of 2009 that showed real output rose at a 3.5% annual rate. After a string of declines, the news of this increase was greeted with great excitement and publicity. Some commentators even went as far as to declare the recession was over. However, this was not their call to make. The official ending (and starting) dates of recessions are determined by a panel of experts with the National Bureau of Economic Research. These economists base their decisions not just on real GDP, but on a plethora of economic data. One of these factors is the labor market, and a look at recent conditions suggests it may be a bit premature to chisel the ending date on this recession's tombstone.

Indeed, a review of conditions shows things are getting worse instead of better. According to the U.S. Department of Labor the national unemployment rate continued to rise to 9.8% in September 2009—its highest level since June 1983. But this measure only captures persons currently looking for employment. It does not include discouraged workers that have quit looking for work or part-time workers that would prefer full-time employment if it were available. Including these persons into the labor force causes the unemployment rate to jump to 17.0%. Put another way, almost one out of five workers is either unemployed or underemployed. Another area of concern is the number of jobs. The same publication that reported the unemployment rate had climbed also showed nonfarm payroll employment fell by 263,000 jobs. This decline was disappointing because it was an increase from the previous month, and up until September the monthly losses had been declining all summer.

Looking ahead, the current forecast shows that the third quarter real GDP gain was the first in an anticipated growth streak that should run the length of the forecast period. However, it is expected to take a while to pick up speed. After this summer's 3.5% jump, quarterly gains will slip below this level through the beginning of 2011. The first half of 2010 should be especially challenging, as growth drops below 2%. It picks up in the second half of that year, but does not grow at its potential until the second quarter of 2011. On an annual basis, real GDP is forecast to drop 2.5% in 2009, but then it expands 2.1% in 2010, 2.9% in 2011, and 3.7% in 2012.

The labor market recovery is expected to lag the real GDP recovery. First of all, it has not yet hit its bottom. That is expected to take place in the beginning of next year when the national unemployment rate hits 10.1%. This peak is the result of continued job losses through the first quarter of 2010. After that quarter, the economy is expected to add jobs, but gradually. The subdued job growth has two consequences worth noting. First, it is expected to take almost three years to recover all the jobs lost during the recession. Second, the unemployment rate will probably remain stubbornly high. For example, at the end of next year it is 9.8%—the same as it was in September 2009. A year later, at the end of 2011, the unemployment rate is 9.1%. A year after that, it is 8.2%. Despite this improvement, at the end of the forecast period, the unemployment rate is still three percentage points above the 5% consistent with full employment.

The current recession is similar to all preceding slowdowns in that it too will end. Where it differs is in what form the recovery will take. Unlike more traditional recessions where employees were hired soon after output increased, it appears this recovery will look more like the jobless recoveries from the last two recessions.

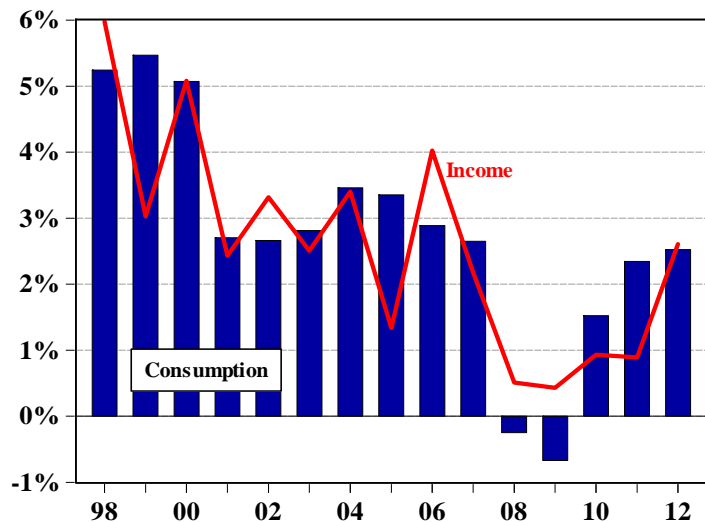
SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: After several years of free spending, American consumers appear ready to begin living within their means. However, this frugal turn will be a double-edge sword for the nation's economy. It is admirable that consumers are getting their financial houses in order by spending less and saving more, but the lower spending will reduce consumer's contribution to output growth. This is a significant change from the recent past when consumers fueled the economic expansion. For example, real consumer spending propped up the national economy by growing faster than real GDP from 2000 to 2003. This strong spending helped make the 2001 recession one of the mildest on record. Real consumer spending grew slightly faster than real disposable income during 2001, but income grew faster than spending in the next year. However, beginning in 2003 spending once again

outpaced income. The best example of this occurred in 2005 when real consumption rose 3.4% but real disposable income increased just 1.3%. This spending spree was partially bankrolled with inexpensive and easily available credit, lower savings, and home equity financing. From 2000 to 2007, the percentage of disposable personal income to monthly financial obligations increased from 17.4% to 18.7% in 2007. Over this same period the personal savings rate dropped from 2.9% to 1.7%. And from 2003 to 2006 real household net worth climbed strongly, thanks in part to rising home values. Unfortunately, the housing collapse has contributed to the steep decline in household net worth since 2005. As a result, consumers will not be able to use their homes to secure loans. In addition, consumer credit is much harder to obtain than it was earlier this decade. With external financing sources drying up, consumer spending is expected to shrink in 2009. This drop will reduce real GDP growth by about one-half percentage point in 2009. After that year, consumer spending is once again expected to be a net contributor to GDP. Interestingly, spending is expected to grow slightly faster than income again beginning in 2010. Specifically, real spending is forecast to grow 1.5% in 2010, 2.3% in 2011, and 2.5% in 2012. Real disposable personal income is projected to increase 0.9% in both 2010 and 2011 and 2.6% in 2012. As a consequence, the personal savings rate is expected to be cut in half from about 4% in 2009 to 2.1% in 2012. A positive result is spending contributes to overall economic growth in every year from 2010 to 2012.

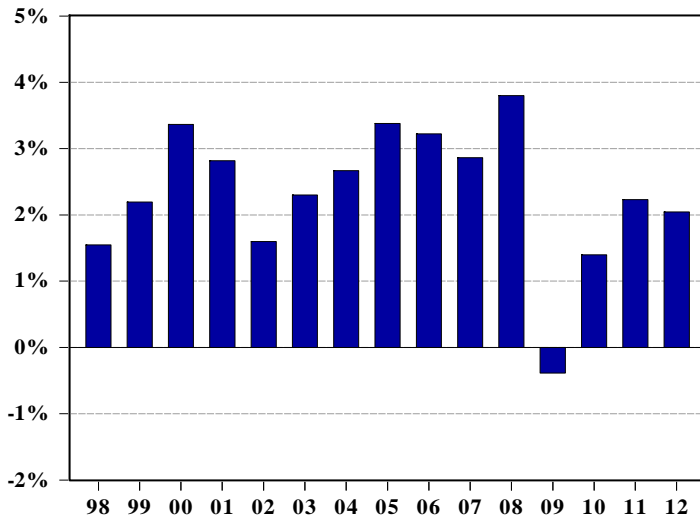
Inflation: Inflation may not be dead, but it should be tame over the next few years. Two factors play a large part in its domestication. The consumer price index (CPI) is expected to actually decline this year for the first time in 54 years, as a result of plunging energy prices and low employment costs escalation. After rising 13.5% in 2008, the energy component of the CPI is forecast to plunge 19% this year. This drop reflects price drops from the downturn in energy demand resulting from the global recession. Oil traded around \$70 per barrel this summer compared to a high of nearly \$150 per barrel in 2008. The price of gasoline remained well below \$3 per gallon this summer versus over \$4 per gallon last year. Households paid just under \$15 per thousand cubic feet of natural gas this July compared to just over \$20 last summer. This wild swing in energy prices is not expected to be repeated over the forecast period. The energy component of the CPI should rise by 1% in 2010, then it advances 8.3% in 2011 and

U.S. Real Consumption and Disposable Income Growth



Source: IHS Global Insight

Consumer Price Inflation



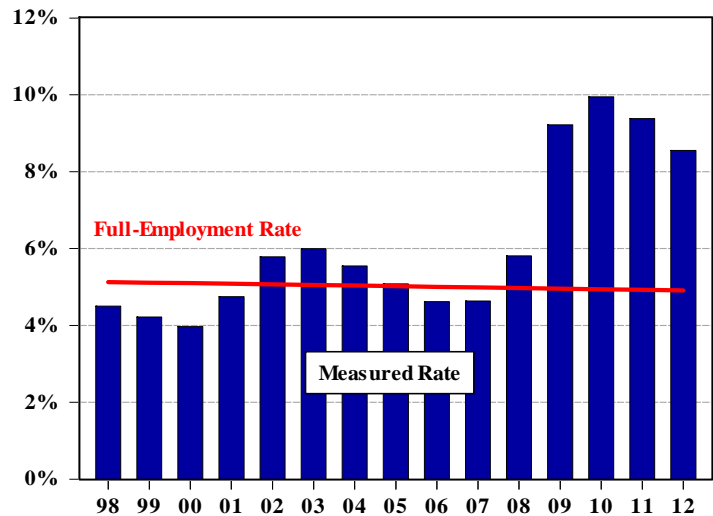
Source: IHS Global Insight

5.1% in 2012, as energy demand picks up thanks to the recovering global economy. Another factor tempering inflation is low employment cost escalation. These costs will be held in check by the anticipated slow recovery of the labor markets. Specifically, these costs are forecast to increase 1.3% this year, 1.6% next year, 1.6% in 2011, and 1.9% in 2012. The slowest growing component of these costs is wages and salaries, which is expected to expand less than 2% annually. Not surprisingly, the fastest growing component is benefits, reflecting upward pressure from health insurance. Inflation, as measured by the CPI, is forecast to be -0.4% in 2009, 1.4% in 2010, 2.2% in 2011, and 2.0% in 2012.

Stripping out the influences of the food and energy components leaves a core CPI that increases 1.7% in 2009, 1.4% in 2010, and 1.7% in both 2011 and 2012.

Employment: This September's employment numbers serve as reminders of the tenuousness of the nation's job market. Economists were predicting there would be about a 175,000-job loss in that month. This expected drop would be smaller than August's drop and be the first time in over a year the monthly job decline would slip below the 200,000 threshold. The U.S. Department of Labor reported nonfarm employment shrank by 263,000 jobs in September, or nearly 100,000 more jobs than had been expected. Not only was the magnitude of the loss significant, but so was its direction. Ever since peaking at over 680,000 jobs in December 2008, economists have noted that while monthly job declines continued, they were generally growing smaller over time. September's performance raises questions whether this trend will continue. But this was not the only disappointing employment news. The nation's unemployment rose to a 23-year high of 9.8%. Since the recession's start, the number of unemployed has doubled from 7.6 million to 15.1 million. In addition, not only are fewer Americans working, some of those that are still working are working fewer hours. The U.S. Department of Labor reported that in September the average workweek for production and nonsupervisory workers on private nonfarm payrolls edged down by 0.1 hour to 33 hours. Ironically, short workweeks and rising output will fuel productivity that is forecast to soar at a 6.3% pace in this year's third quarter, which follows a 6.6% spurt in the second quarter. This increase is common at the

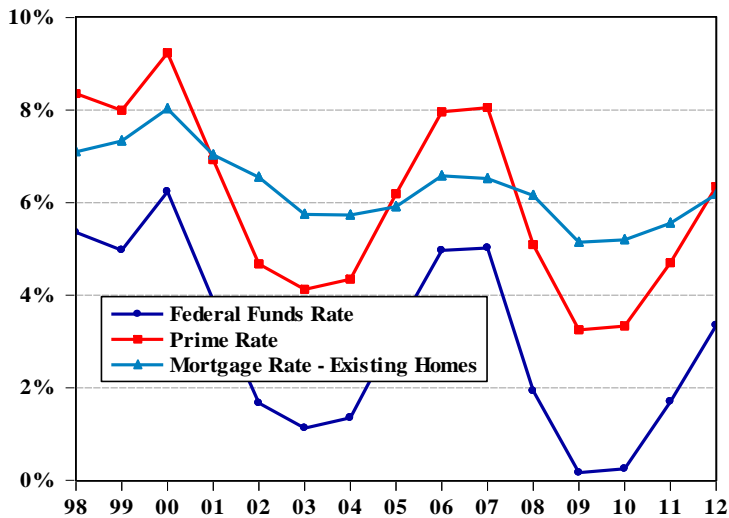
U.S. Civilian Unemployment Rate



Source: IHS Global Insight

beginning of an economic recovery. While the economy may have started recovering, the employment situation has not yet hit its trough. Nonfarm employment is forecast to continue falling through the start of next year, before posting its first gain in over two years in the second quarter of 2010. Coming out of the deepest recession since the Great Depression, businesses are expected to cautiously expand their payrolls. As a result, nonfarm employment is forecast to expand by less than 2% until 2011. One result of the predicted tepid job growth pace is the nation's unemployment rate is expected to climb to just over 10%, six months after the recovery's start. And its descent from this peak should be gradual, declining about one percentage point per year, so that by the last quarter of 2012 it is about 8%, which is well above the 5% unemployment consistent with full employment.

Selected U.S. Interest Rates



Source: IHS Global Insight

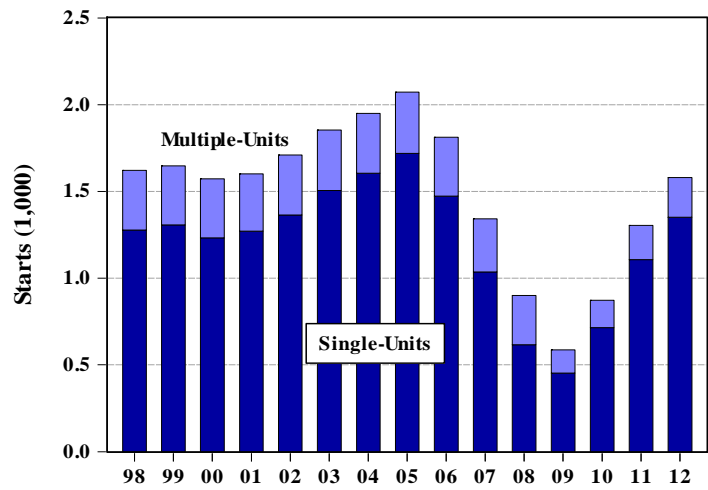
Financial Markets: The amount of nonmortgage computer credit declined by a relatively steep \$12 billion in August. Revolving credit dropped sharply, by \$9.9 billion, despite a solid pickup in non-auto retail spending. It suggests consumers must be using cash more frequently for purchases as opposed to credit cards—this may be connected with the recent tightening of credit-card borrowing conditions. The real shocker was a \$2.1 billion-decline in installment credit. This drop occurred despite the surge in auto sales caused by the “cash-for-clunkers” program in August. One explanation is that many of the “clunker” transactions may well have been leases, which show up as business credit rather than consumer credit. Of particular concern is consumer credit has

been declining at an accelerated rate since the last quarter of 2008, with no end in sight. These conditions spell increased risk for the incipient recovery. The Federal Open Market Committee (FOMC) voted unanimously during its September meeting to maintain the target range of the federal funds rate of 0% to 0.25%. The FOMC noted economic activity had picked up since its previous meeting and that the recovery was underway. However, it also reiterated that weak economic conditions will warrant exceptionally low federal funds rates over an extended period. The FOMC is assumed to hold its federal funds rate near 0% through mid-September 2010. Thereafter, it raises it very gradually. The outlooks for the federal funds rate and other key interest rates are charted in the accompanying graph.

Housing: It appears the nation's housing sector is taking its first shaky steps toward recovery. According to recent estimates, housing starts bottomed out at about one-half million units in the first quarter of this year. By year's end, annualized housing starts are expected to approach 700,000 units. Most of this improvement is due to single-unit starts that should climb from 358,000 units to 543,000 units from the beginning to ending quarters of this year. On an annual basis, single-family starts are projected to jump nearly 60% in 2010 to 714,000 units. The key reason for the expected increase is that at current production levels, the backlog of unsold homes is being worked off quickly. Production will need to increase to prevent inventories from falling too low. The resurgent demand for housing is being fueled by increased affordability and the federal first-time homebuyer tax credit. Affordability is being aided by house prices that are expected to continue dropping through 2010. The up-to \$8,000 federal

homebuyer credit has provided a temporary boost; it expires at the end of November. It is expected that once it expires, home sales, housing starts, and housing prices will take a hit. But this hit will not be strong enough to hobble the recovery. Single unit starts are forecast to climb in every year after 2009 and reach nearly 1.4 million units in 2012. The outlook is weaker for multiple-family housing. Renters are taking advantage of falling house prices and the federal tax credit by moving out of apartments into homes. As a result, the rental vacancy rate, which is already at an all-time high, will rise to nearly 11% by the end of this year and drop slowly over the next few years. National multi-family housing starts are forecast to hit a trough of 133,000 units this year and gradually climb to 229,000 units by 2012. Total housing starts are expected to be about 590,000 units in 2009, 870,000 units in 2010, 1.3 million units in 2011, and 1.6 million units in 2012. The housing sector's improvement can also be measured by real spending on residential construction. After falling by 21% in 2009, this measure is forecast to increase 9.7% next year, 25.2% in 2011, and 17.7% in 2012. As a result, after being a drag on the economy for four consecutive years, housing will be a contributor to growth beginning in 2010.

U.S. Housing Starts

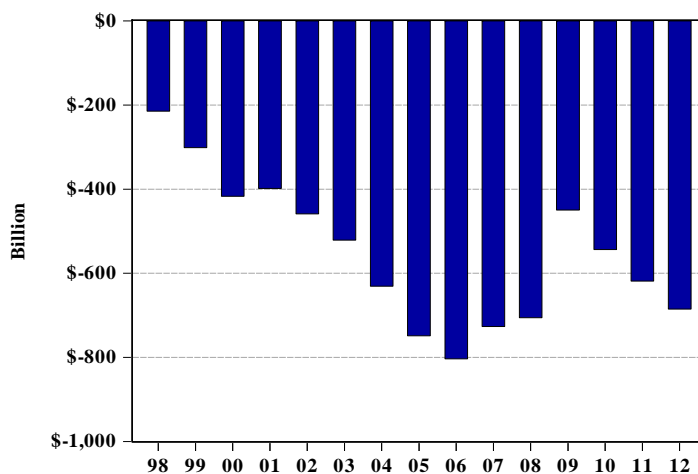


Source: IHS Global Insight

International: The global economy is expected to rebound next year after shrinking 2.1% in 2009. This year's slowdown reflects the synchronous downturns for most countries this year. Mexico's economy declines the most this year, dropping 7.5% from 2008. Japan suffers another decline this year, following 2008's drop of 0.7% by a decline of nearly 6% in 2009. Europe's output is expected to drop 4% this year. Canada's economy is expected to drop by 2.6%, which is about the same as the anticipated drop of 2.5% in the United States. South America is forecast to drop just 0.4%—the smallest of all the declines.

China and the other Asian countries are both expected to rise in 2009. However, these expected increases are low for these fast-growing areas, so they also are considered to be in recessions. By next year, all of the world's economies should be expanding. Not surprisingly, China is expected to remain the world's fastest growing economy by posting over 10% growth that year. China's recovery is being fueled by its internal policy stimulus and the end of massive liquidations that will require its manufacturers to increase their output. Monetary and fiscal stimuli are sparking growth. However, tight credit, housing corrections, a strong euro, and rigid labor markets will impede its recovery. A slow but consistent recovery

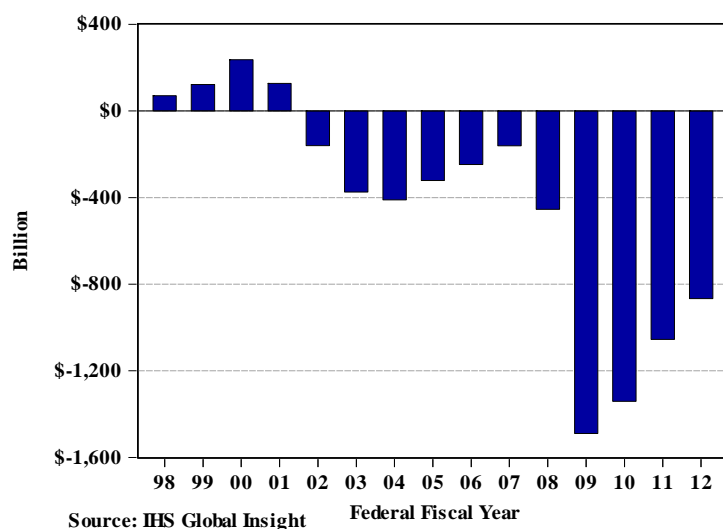
U.S. Current Trade Deficit



Source: IHS Global Insight

is now underway in Japan, but it will be tempered by cautious consumer spending caused by rising unemployment. The U.S. trade balance is expected to improve drastically this year thanks to a favorable inventory cycle. Deteriorating sales forced the manufacturing and distribution system to shed inventories. This situation reduced the demand for goods and services, which tilted the trade balance toward exports. For example, real imports of goods and services fell at a 14.7% pace in this year's second quarter, compared to a 4.1% reduction in real exports. As a result, the real net exports deficit shrank to its lowest level (\$339.1 billion) since the last quarter of 1999. On an annual basis, the real net exports deficit is expected to average \$368.9 billion—its lowest level since 2002. It also marks the low of the forecast period. After this year, the real net exports deficit is projected to climb to \$430.4 billion next year, \$446.7 billion in 2011, and \$447.8 billion in 2012. The U.S. current account deficit displays a similar pattern over the forecast period. It, too, shrinks in 2009 then grows in each year of the forecast.

U.S. Federal Government Surplus Unified Basis



Government: The full fiscal stimulus package is valued at around \$787 billion over ten years. It is assumed that \$561 billion of the total will be injected during the first two calendar years. The \$561 billion breaks down into \$143 billion in personal tax cuts, \$97 billion in personal transfer payments (e.g., food stamps, extended unemployment insurance), \$88 billion in corporate tax cuts, \$149 billion in transfers to states, and \$82 billion for infrastructure and other spending. The stimulus is projected to increase 2009 GDP growth by 0.8 percentage point and next year's growth by 1.3 percentage points. It is also expected to create or save just under 2.5 million jobs by the end of next year, which is slightly lower than the three

million jobs estimated by the Obama administration. Despite the boost to jobs, the predicted peak-to-trough decline in nonfarm employment is nearly eight million jobs and the nation's unemployment rate will rise above 10%. The U.S. Treasury has \$700 billion in budget authority under the Troubled Asset Relief Program. This forecast assumes the Treasury spends only \$615 billion, or a net of \$520 billion after recent repayments by some banks. This amount is assumed to be distributed as follows: \$73 billion to the auto sector, \$467 billion to the financial sector, and \$75 billion for the housing plan. The federal government's "cash for clunkers" program is estimated to have helped finance around 690,000 new vehicle sales in July and August. The stimulus package, financial bailout costs, and recession will take the federal budget deficit to \$1.5 trillion in 2009 and \$1.3 trillion in 2010. (It was less than one-half trillion dollars in 2008.) Keep in mind that these figures do not include the costs of other proposed programs, such as universal health care, or another round of stimulus spending. The deficit is expected to drop below one trillion dollars after 2011. However, the lasting effects of the recession can be seen in the national debt. For the first half of this decade the amount of publicly held debt as a percentage of GDP hovered near 35%. In 2009, it is expected to jump to 57% of GDP and rise to 69% by 2012. The need to service this debt will put upward pressure on interest rates.