

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2009 through the Fourth Quarter of 2013

It appears that after about a year and a half on the ropes, the national economy is on the rebound. The most convincing argument for the start of the recovery came in the form of the 2.8% annual growth in GDP during last year's third quarter, which ended a four-quarter slide in output. (From the recession's start in 2008 to the second quarter of 2009, real output has declined 3.7%.) Even better news is it is estimated real GDP grew 2.7% in last year's fourth quarter, which suggests the recovery has legs. However, it must be noted that some of the strength in last year's second half was the result of special factors that will not be available in the future. Real GDP benefited from the federal government's Car Allowance Rebate System. More commonly known as "cash for clunkers," this program issued nearly 680,000 vouchers worth about \$3 billion. They helped new motor vehicle sales jump at a 112% annual pace in last year's third quarter. In addition, sales of both new and existing homes jumped in the third quarter thanks in part to the federal first-time homeowner's tax credit. The real test for the economy should come this year when it is expected to stand on its own two feet. Three areas bear watching to see whether it will pass muster.

The economy cannot sustain growth without consumers. Consumer spending traditionally accounts for about two-thirds of GDP and has been a weak link. Retrenching consumers have curtailed spending over the last few quarters, creating a huge drag on the economy. The "cash for clunkers" program showed Americans can be induced with the right incentives to spend. However, absent these incentives, last summer's spending jump will not be repeated. Instead, it should expand gradually. This outlook is shaped by high consumer debt burdens, depleted wealth, tight credit, and incomes being squeezed by a weak job market. Given these conditions, spending is more likely to grow in line with income than it has in the recent past. Specifically, real consumer spending expands 1.8% in 2010, 2.4% in 2011, 2.7% in 2012, and 2.2% in 2013.

The anticipated gradual improvement in the job market should help consumers beginning this year. A tough question is how far companies can push existing workers before they must hire additional ones. A couple of items suggest they may be near that point. One is the much better-than-expected November employment report that showed nonfarm employment fell by just 11,000 jobs. The second factor is the soaring output per worker. Productivity cannot continue to grow by 8% as it did late last year. With productivity soaring, firms will likely hire workers sooner than they did after the last recession. The nation's job engine is expected to restart this spring. As a result, after peaking at 10.4% in 2010's first quarter, the unemployment rate falls gradually to 7.5% by the end of 2013.

The nation's housing sector has been a severe drag on the economy since 2006, and the economy cannot prosper until this burden is lifted. After peaking at over 2 million starts in 2005, housing starts dropped below 600,000 units last year. Since 2005, the sales of existing homes has fallen nearly 27%. New home sales dropped almost 70%. The median price for existing homes retreated 21% and new home prices dropped 9%. Ironically, these falling prices are one of the cornerstones of the recovery. They improve the affordability of homes, which in turn stimulates sales that help work off the huge inventory overhang. Once the demand and supply of homes is in better balance, companies (and construction workers) will resume building. After last year's trough, housing starts climb to about 1.7 million units in 2013.

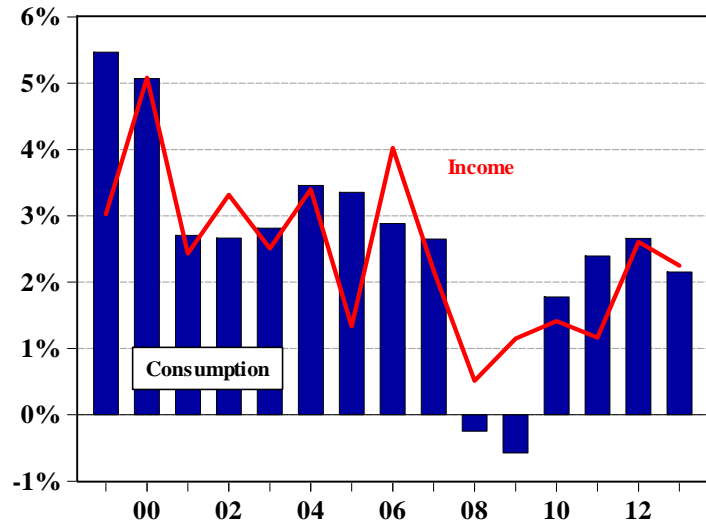
The improvements to these factors helps paint a picture of cautious optimism. The economy is expected to advance gradually over the next few years. Admittedly, risks to the economy exist, but it appears the worst is behind us.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: After declining for two consecutive years, real consumer spending is expected to begin expanding in 2010. This reversal is significant because consumer spending accounts for about two-thirds of the economy, so it would be impossible to sustain a recovery without it. This point is further illustrated by looking at its recent contributions to real GDP growth. After the 2000 recession, consumer spending was virtually the only source of economic growth. The U.S. economy started its current recession at the beginning of 2008. Not coincidentally, real spending shrank 0.2% that year. It is forecast to decline another 0.6% in 2009 and real GDP is expected to retreat 2.5%. To break it down further, real spending stripped 0.2% from GDP growth in 2008 and by an estimated 0.4% in 2009. Obviously, real GDP cannot advance while spending retreats.

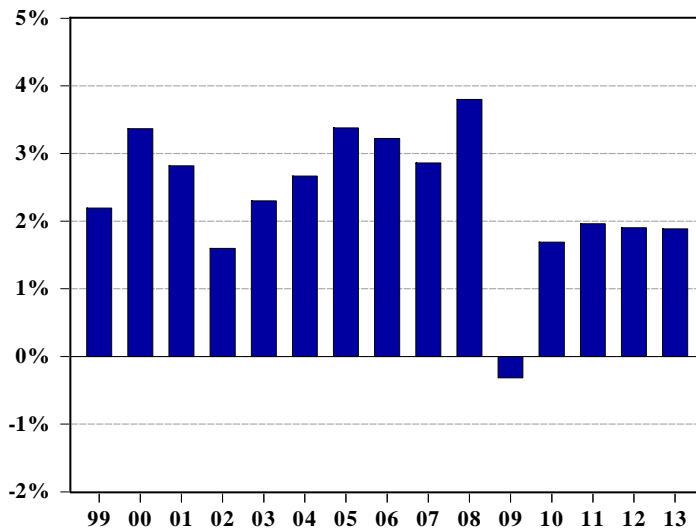
The good news is spending is forecast to resume growing this year. However, it is not expected to return to the heady pace experienced earlier this decade when spending growth often eclipsed income growth. This spending spree was made possible by easily available credit and strong net household wealth gains. From 2000 to its peak in 2007, monthly financial obligations as a percent of disposable personal income increased from 17.4% to 18.7%. Interestingly, over this period there were already signs of household financial stress. For example, the percent of credit card accounts that were at least 30 days delinquent increased from 3.2% in 2000 to a peak of 4.8% in 2005 before settling at 4.3% in 2008. Another source of funds was homes. The housing boom caused prices to increase about 7% annually from 2000 to 2007, which was better than the stock market whose wild swings netted investors a 0.5% average gain over this same period. As a result of the strong housing prices, U.S. household net worth climbed from 5.7 times disposable income in 2000 to 6.4 times disposable income in 2006. With their household portfolios doing so well, consumers felt less compelled to put aside money for the future. As a result, the personal savings rate was halved from 2.9% in 2000 to 1.4% in 2006. Eventually, however, these sources that augmented income began to dry up. Most notably, the housing bust sent prices south. They dropped 5.8% in 2008 and an estimated 4.5% in 2009. The 2008 housing price drop and nearly 35% decline in equities caused household net worth to fall 17.2% in 2008. It is estimated to have expanded almost 6% in 2009 thanks to a 30.6% recovery in equities. However, net worth in 2009 was 5.1 times disposable personal income, which is significantly below its 2006 peak. One result of the falling net worth is that consumers are saving more. The personal savings rate had already climbed to 2.6% in 2008 and is estimated to rise further to 4.5% in 2009. The current forecast assumes this newfound thriftiness will continue through the forecast period. Some of it is voluntary and some of it is not. For example, credit has become tighter. In addition, the lingering weak housing market should make consumers more cautious about spending. As a result, they are more likely to spend within their means. This translates into real consumer spending growth mirroring real disposable income growth in the future. Real disposable income is expected to rise 1.4% this year, 1.2% next year, 2.6% in 2012, and 2.2% in 2013. Real spending is forecast to advance 1.8% in 2010, 2.4% in 2011, 2.7% in 2012, and 2.2% in 2013.

U.S. Real Consumption and Disposable Income Growth



Source: IHS Global Insight

Consumer Price Inflation



Source: IHS Global Insight

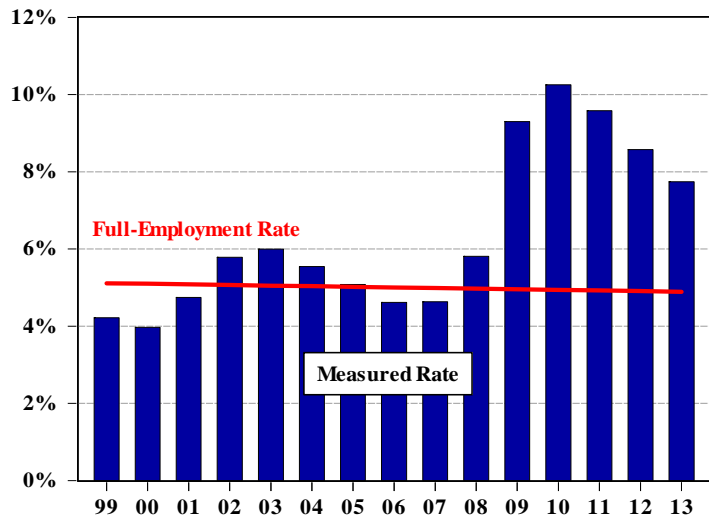
Inflation: During the next few years, one item low on the list of economic concerns will be inflation. Inflation did spike at 3.8% in 2008, but this was largely due to the huge run up in energy prices that is not expected to recur during the forecast period. Given its role in shaping overall inflation, a review of energy prices is in order. According to the Energy Information Agency, world crude oil prices, which had been hovering between about \$20 and \$40 per barrel, began to take off in the middle of the decade. In early 2004 it topped \$30 per barrel and a year later it was over \$40 per barrel. But these gains would pale against what would follow. Fueled by strong demand, the price of oil soared over the next few years, causing the weekly price to climb above \$100 per barrel in March 2008. It

would peak at almost \$150 per barrel that July. This increase pushed the energy commodity component of the consumer price index to climb at a whopping 37.3% pace in the third quarter of that year. The overall consumer price index advanced at a 6.2% annual pace that same quarter, its biggest jump since the last quarter of 1990. Consumers were reminded of these increases every time they fueled their cars. The price of gasoline rose from under \$2.00 per gallon at the start of 2005 to over \$4 per gallon in the summer of 2008. However, energy prices have retreated significantly since then and are not expected to return to the heights of the summer of 2008. By the end of 2008, oil was down to \$36 per barrel. At the time of this writing, the world price of crude oil was just below \$80 per barrel and the domestic price for gasoline was about \$2.70 per gallon. Given the demand for petroleum is expected to grow slowly over the forecast period, energy prices should advance gradually. The per barrel price of West Texas Intermediate crude oil is projected to average \$61.98 in 2009, \$68.25 in 2010, \$77.17 in 2011, \$83.16 in 2012, and \$87.02 in 2013. As a result, the energy commodity component of the consumer price index is forecast to drop 27.4% in 2009, then it rises 10.2% in 2010, 8.1% in 2011, 5.4% in 2012, and 3.1% in 2013. But even with these increases, the overall consumer price index does grow faster than 2.0% over the forecast period. Removing the volatile food and energy components from the consumer price index results in a core inflation rate that is expected to average 1.7% over the forecast period. This measure is being held in check by anticipated slow employment cost gains resulting from the lackluster labor market. Specifically, the employment cost index increases 1.5% in 2009, 1.8% in 2010, 1.6% in 2011, 1.8% in 2012, and 2.5% in 2013.

Employment: The Obama Administration received an early Christmas gift this year in the form of one of the most favorable national employment reports (i.e., least negative) in the last two years. The day after the President convened his jobs summit, the U.S. Department of Labor released its November *Employment Situation* report which showed the employment situation was healthier than most economy watchers had expected. On December 4, 2009, the Labor Department reported the U.S. unemployment rate actually fell to 10% in November from the previous month's 10.2%, which marks just the fourth time it has declined since the recession started. The job's number was better than expected in November. The consensus was the number of nonfarm jobs would decline by 150,000 in that month. Instead, 11,000 jobs were lost. This drop was the smallest of the recession. (The largest drop of over 740,000 jobs

occurred at the beginning of 2009.) Other good news came in the form of revisions which showed the number of job losses in recent months were lower than had been previously reported. September's decline was reduced by 80,000 and October's drop shrank by 59,000. In addition to the brighter job picture, the average workweek increased 0.2 hours in November. While this news may raise hopes for an earlier start for the jobs recovery, it may be premature to declare the bottom of the jobs cycle. In fact, other data from the U.S. Department of Labor show the level of stress is still high in the job market. The Job Opening and Labor Turnover Survey and the recent monthly jobs reports can be combined to put the job market into perspective. These data show there were 15.7 million persons seeking work and 4.38 million job openings. As a result, there were 6.3 seekers per job opening, compared to 1.7 seekers per job opening when the economy last peaked in December 2007. The large number of seekers relative to jobs helps make the case that the job recovery will be gradual. In fact, nonfarm employment is not expected to attain its previous peak until the last quarter of 2012. The civilian unemployment rate is expected to rise again and peak at 10.4% early this year. It is expected to recede to 7.7% in 2013, which is still well above the full employment threshold.

U.S. Civilian Unemployment Rate

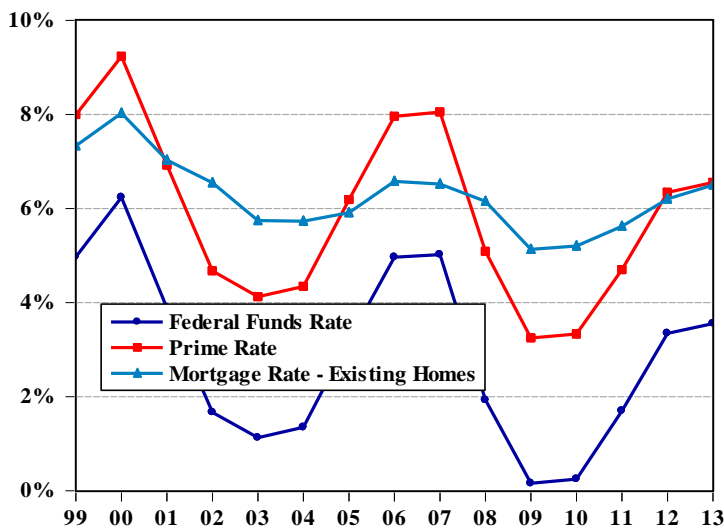


Source: IHS Global Insight

Financial Markets: Perhaps the biggest challenge Chairman Bernanke currently faces may not be the economy but, instead, Congress. On December 3, 2009 the Chairman testified before the Senate Banking Committee in his re-nomination hearing. Despite a grilling by the committee members, it is

likely he will be re-nominated. While the chairman's job seems safe, the Federal Reserve faces major threats from proposed legislation that would have a major impact on its mandate and scope. There is a proposed bill in the House that subjects the Federal Reserve's monetary policy decisions to some kind of audit review. Another proposal in the Senate removes banking and financial regulation and supervision from the central bank's mandate. Bernanke has defended the Federal Reserve's current role in an article in the *Washington Post*, but it remains to be seen whether it sways the thinking of other policy makers. Bernanke remains committed to price stability and that the Federal Reserve will not monetize the federal debt. (Monetizing the debt occurs when the

Selected U.S. Interest Rates

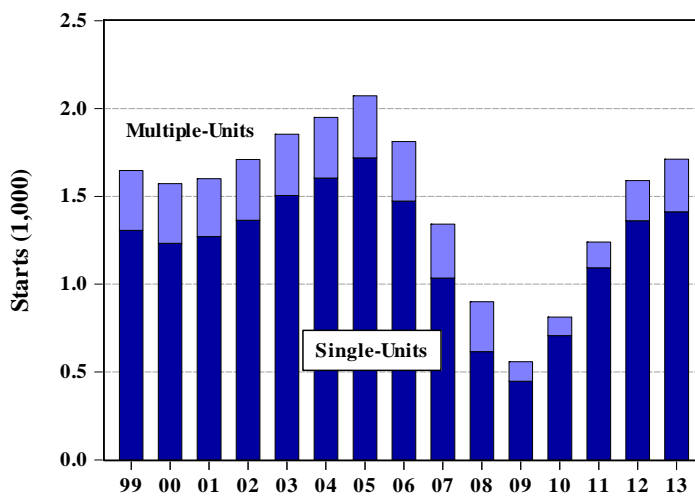


Source: IHS Global Insight

central bank purchases debt instruments of the federal government. In essence, the Federal Reserve creates money to finance the national debt.) Bernanke pointed out the rapid rise of entitlement spending as a risk to the fiscal outlook, and that healthcare reform must include a major focus on controlling costs. These are longer term policy issues. In the short-run, the central bank is expected to keep its bellwether federal funds rate near 0% through the first half of this year, then begin to increase it gradually as the economy improves. It can afford to keep interest rates low because inflation is not a threat. Specifically, the inflation measure preferred by the Federal Reserve, the core personal consumption deflator, is expected to remain well below the two-percent ceiling favored by the central bank. The federal funds rate is projected to average 0.24% this year, 1.7% next year, 3.3% in 2012, and 3.6% in 2013.

Housing: The housing sector continues to improve, which bodes well for the overall economy because a strong housing sector is an essential cog in the recovery. Since 2006, housing has been a drag on the overall economy, and the economy simply cannot soar until the burden of a weak housing sector is removed. The key to the housing recovery is to work off inventories of unsold houses to bring demand and supply more in line, so that new residential investment can take place. Several years of robust growth left the housing sector with too many homes when demand collapsed. Housing starts were near 2 million units from 2003 through 2006. By 2009, starts fell to under 600,000 units. But housing starts were not the only indicator to sink. The average price of existing single-family houses tumbled from \$270,000 in 2006 to an estimated \$217,000 in 2009, as prices bore the brunt of the supply/demand imbalance. These were the only three years on records (that go back to 1968) that housing prices have declined. By last year, the housing sector was near bottom and ripe for recovery. Ironically, tumbling prices were an essential ingredient. Lower housing prices made housing more affordable, which stimulated demand. Demand also was pushed by the federal first-time homeowner’s tax credit that expired in November 2009. After falling to a low of 4.9 million units in the second quarter of 2008, sales of existing homes gradually expanded. They took a noticeable jump in the third quarter of 2009 coincident with the termination of the original federal credit. This helped to push the number of unsold new homes to 239,000 units—the 30th straight monthly decline and the lowest level since 1971. This first-time homebuyer tax credit has been extended to include sales with a binding contract occurring between January 1, 2010 and April 30, 2010. A tax credit of up to \$6,500 is available to non-first time buyers meeting certain requirements. These credits should temporarily boost sales in the first part of this year, but the annual sales should be the same as in 2009. Single-family housing starts and new home sales gradually improve despite the expiration of these two credits. They are propelled by the need to replenish inventory, a gradual pick up in household formation, and job growth. Household formation is an interesting factor. U.S. Census Bureau data show household formations has slowed recently due to lower immigration and the weak economy, which has forced some Americans to move back in with family. The latter is likely to reverse once job growth takes off. The forecast calls for housing starts to grow to 812,000 starts this year, 1.2 million starts next year, 1.6 million starts in 2012, and 1.7 million units in 2013. Over this same period, sales of existing homes climb from 5.2 million units to 6.4 million

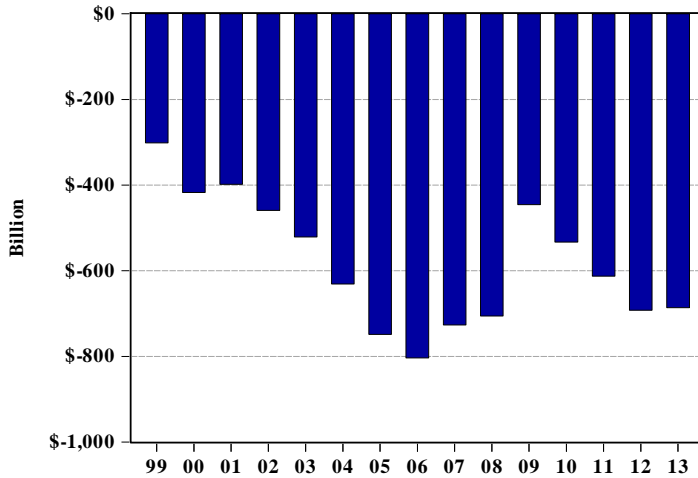
U.S. Housing Starts



Source: IHS Global Insight

units. The average sales price for an existing home goes from \$216,000 to \$238,000. After being a drag on real GDP growth for four consecutive years, real residential fixed investment becomes a contributor to growth beginning in 2010.

U.S. Current Trade Deficit



Source: IHS Global Insight

International: After bottoming out in the second quarter of last year, the trade deficit is expected to climb steadily through 2011. In fact, by late 2011, the real trade gap will be as large as it was when the recession began in early 2008. The real trade deficit is anticipated to stabilize in early 2012 as import growth slows down. A major factor shaping the trade situation is inventories. Net exports (exports less imports) and inventory changes have been almost mirror images of each other over the last few years, and they should remain so for the next few years. For example, when businesses cut inventories imports plunge, and this causes net exports to rise. Conversely, imports rise with growing inventories, so net

exports fall. After about a year of sideways movement, the rebound of foreign demand for U.S. products will begin to whittle down the real trade deficit with help from both a weak dollar and restrained domestic demand. After enjoying a slight recovery last year, the greenback is expected to slide gradually through 2013. Strong exports also reflect the stronger demand from recovering foreign economies. After a dismal 2009, most major economies are anticipated to pick up steam in 2010. And most of them are expected to grow even faster after this year. The major exception is China. It grew 8.5% in 2009. It is projected to advance nearly 10% this year, but average 8.6% growth from 2011 to 2014. The nominal net exports deficit improved drastically in 2009, dropping by over \$300 billion from the previous year. This decline was due in large part to the reduced bill for petroleum imports. It is estimated this component of imports dropped from \$453 billion in 2008 to \$264 billion in 2009. It also benefited by the drop in non-automotive capital goods. After 2009, the nominal net exports deficit is forecast to rise again, but not approach its 2008 deficit. Because recent nominal deficits were heavily influenced by volatile prices, it is useful to look at the inflation-adjusted net exports deficit. As expected, it shows a smaller swing from 2008 to 2009—\$494 billion to \$365 billion. After 2009, it expands to a peak of \$461 billion in 2012, but drops to \$410 billion in 2013, making it a drag on real GDP growth during most of the forecast period.

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. It is assumed in this forecast that the government will not allow emergency unemployment benefits to expire at the end of 2009. It also includes the impacts of the expanded homeowners’ tax credit that was passed in November 2009 as part of the “Worker, Homeownership, and Business Assistance Act of 2009.” Another part of that bill that has been incorporated in the forecast is the corporate tax provisions that temporarily increase the carry-back period for net operating losses, but postpone a planned corporate tax break. The corporate tax measures raise about \$10 billion over the 2010-19 period, but they initially reduce revenues by \$33 billion in fiscal year 2010. Another important assumption is the top marginal tax rates of income tax, including the top marginal rate on capital gains and dividends, increase in 2011. The

rest of the Bush tax cuts are left in place. Beyond 2011, it is assumed a further increase in the income tax burden that is not confined to the top brackets. 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 repayments of \$95 billion 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. One of the most publicized programs was the Car Allowance Rebate System (CARS) that was more commonly known as the “cash for clunkers” program. According to the federal government, as of the beginning

of November 2009, 678,024 CARS vouchers (with a price tag of \$2.9 billion) were either paid or approved for payment. This program contributed to the estimated 112% annualized increase in real spending on new motor vehicles during last year’s third quarter. The stimulus package, financial bailout costs, and recession will lift the federal budget deficit to \$1.4 trillion in both 2009 and 2010. (It was less than one-half trillion dollars in 2008.) The deficit is not expected to drop below one trillion dollars until after 2012. However, the lasting effects of these deficits 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%. It was 44% of GDP in 2008, but it is expected to climb to 70% by 2013.

U.S. Federal Government Surplus Unified Basis

