

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2011 through the Fourth Quarter of 2015

The evidence from the U.S. economy continues to point to positive, albeit slow growth. Third quarter 2011 showed a modest acceleration in growth as business and consumer spending defied the shock waves from the domestic debt-ceiling crisis and the Eurozone sovereign debt crisis. The outlook remains for modest growth, but risks remain to the downside without a convincing resolution of the Eurozone crisis.

Third-quarter GDP growth at 2.5% showed a clear improvement over the second quarter, with business fixed investment rising at a strong 16.3% annualized pace. Despite miserable sentiment readings, consumer spending growth accelerated to 2.4%, from just 0.7% in the second quarter. And economy-wide spending growth outpaced production, so that inventories deducted 1.1 percentage points from GDP growth. The bad news in the third-quarter data was that real personal disposable income fell 1.7%, its biggest drop in two years. Consumer spending only accelerated because the savings rate dropped by a full percentage point. That is not a solid foundation for growth. Real GDP should advance 2.0% in the fourth quarter of 2011.

However, once inventories are replenished, real GDP growth will slip below 2.0% at the start of 2012 and remain there through most of the year. On an annual basis, it should expand 1.6%, which is slightly lower than 2011's 1.8% pace. Almost all sectors will contribute to 2012's 1.6% increase. Consumption, the largest part of the U.S. economy, will also account for the largest piece of its growth—1.5% of the expected 1.6%. Boosted by its equipment and software category, business investment should add another 0.7% to total growth. Net exports contribution to real output growth is expected to be negligible. Not all sectors will contribute to growth. The government sector, which is weighed down by expected cuts at both the federal and state and local levels, is anticipated to shave 0.5% from 2012 real GDP growth.

National economic growth is projected to accelerate after this year, but the expansion will remain muted. For example, real GDP growth jumps from 1.6% in 2012 to 2.5% in 2013. It speeds up to 3.5% in 2014 and nearly maintains that pace in 2015. At these rates, the economy makes up some of the ground lost during the Great Recession, but not all of it. It is estimated that if the economy had been expanding at its potential rate, real GDP would have been \$15.0 trillion in 2012. It is expected to be just \$13.5 trillion, or \$1.5 trillion below its potential. Real GDP is predicted to climb to \$14.8 trillion in 2015, which is still \$1.2 trillion under its potential.

Employment will also recover slowly. Nonfarm employment posted its first gain in four years in 2011. It is expected to add jobs gradually through 2013 then grow by about 2.0% in both 2014 and 2015. At this pace, nonfarm employment is not expected to summit its 2007 peak until 2015. In addition, the unemployment rate will take even longer to recover. It is forecast to decline from 9.2% this year to 9.0% next year, drop to 8.2% in 2014, and decline to 7.4% in 2015. Despite these declines, the unemployment rate remains well above the level consistent with full employment (around 4.8%) over the forecast period.

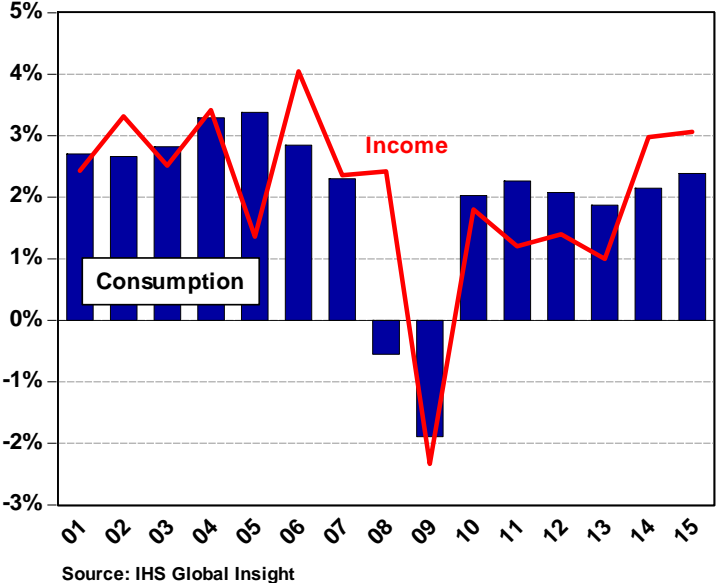
It should be noted that while the forecast calls for modest growth, the risk of a downturn is high. IHS Global Insight estimates the probability of the economy slipping into a recession over the forecast period at 40%. In the *Pessimistic Scenario*, real GDP declines 0.5% in 2012, rises just 1.0% in 2013, expands 3.1% in 2014, and increases 2.7% in 2015. The details of this scenario can be found in the Alternative Scenario section of this forecast.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: Consumer spending has been doing better than consumers’ moods would suggest. The recent economic news has been mixed. The University of Michigan’s index of consumer sentiment for mid-November increased 3.3 points to reach 64.2. However, consumer confidence as measured by both the Conference Board and Reuters/University of Michigan is still at recessionary levels. Despite these low confidence levels, retail sales have chugged along, although people are saving less and spending on necessities, and not desires. Pent-up demand is helping spending, but consumers face too many negatives to allow a robust spending recovery. The list of factors is familiar: a weak labor market, high debt burdens, still-falling house prices, price

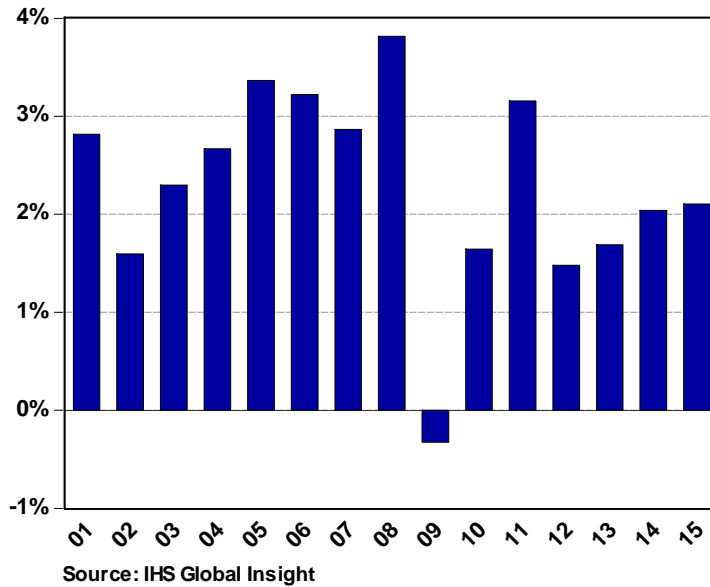
increases that have outpaced wage growth, and a lack of confidence in the government’s ability to make things better. The May–October payroll figures were weak, and the unemployment rate stood at 9.0% in October. Personal income increased 0.1% in September, after falling 0.1% in August. Wage and salary disbursements increased 0.3%, but interest income and government social benefits (mostly Medicaid) have taken major hits in recent months. Real disposable income fell three months in a row, and the savings rate retreated from 4.1% in August to 3.6% in September—the savings rate currently stands at the lowest rate since December 2007. Given the list of negative factors, consumers are expected to spend more within their means over the forecast period. Real consumer spending growth is forecast to hover near 2.0% through 2014, and then nudge up to 2.4% in 2015. Real disposable income is forecast to rise 1.4% this year, 1.0% next year, and about 3.0% in both 2014 and 2015.

U.S. Real Consumption and Disposable Income Growth



Inflation: Consumer inflation should be lower over the forecast period than it was in 2011. Bolstered by high energy and food prices, consumer prices grew by over 4.0% in the first half of last year. Energy prices surged at nearly a 40% annual pace in the first quarter and climbed nearly 15.0% in the following quarter. Contributing to this increase was soaring gasoline prices that were 20% higher at the beginning of 2011 than they were at the start of 2010. This price jump reflected rising oil prices. The West Texas Intermediate Spot Price (WTI) rose from \$78.62 per barrel in the first quarter of 2010

Consumer Price Inflation

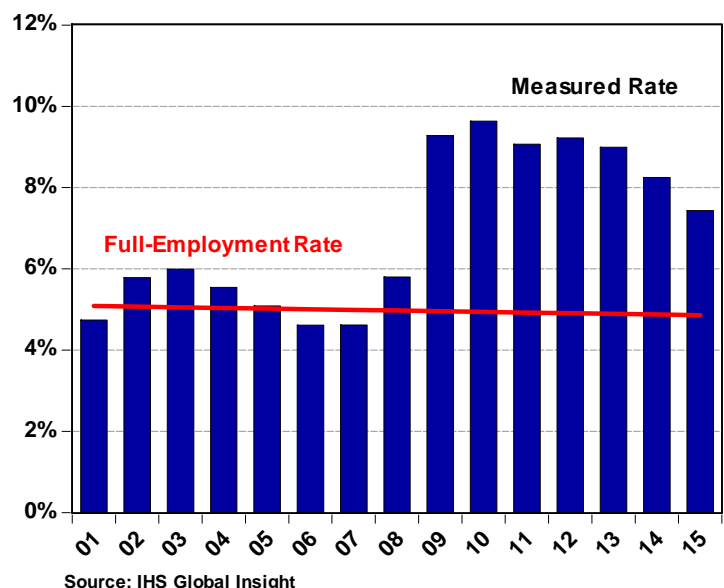


to \$93.52 per barrel in the first quarter of 2011. It topped \$100 per barrel in the second quarter of 2011 for the first time since the summer of 2008. Fears of a return to a summer of high prices were allayed as oil prices began easing in the second half of the year. Gasoline prices also began easing this summer, but were still higher than they were in 2010. Energy prices are estimated to have grown 15.2% in 2011. Food prices rose more gradually than energy prices last year. Instead of experiencing an early runup and gradual easing like energy prices, food prices grew at about a 5.0% clip during most of the year. Both food and energy prices are expected to be better behaved over the next few years. Removing the energy

and food components from the inflation basket of goods and services result in the less volatile core inflation rate. It is primarily driven by labor costs. Given the nation's employment market will tighten gradually over the forecast period, labor costs are anticipated to slowly accelerate from 2.1% this year to 2.8% in 2015. These increases are largely fueled by benefit costs, which are boosted by health insurance gains. Overall, consumer inflation, which topped 3.0% in 2011, should remain near 2.0% over the next few years.

Employment: The most recent employment statistics have been the most positive in months. However, a closer look reveals the situation is not as rosy as it may have seemed during the first glance. The U.S. Department of Labor estimated the nation's unemployment rate fell from 9.0% in October 2011 to 8.6% in November 2011. Not only was this month's 0.4-percentage point drop the largest in nearly a year, the unemployment rate is the lowest it has been since March 2009. However, half of the decline in the unemployment rate is due to the reduction in the labor force. The rate is 8.8% when it is adjusted for the shrinking labor force, which is about where it was in March 2011. And the fact that the labor force is shrinking does not bode well for the economy because it suggests more workers are becoming discouraged and dropping out of the labor force. The economy did take a step in the right direction when it added

U.S. Civilian Unemployment Rate

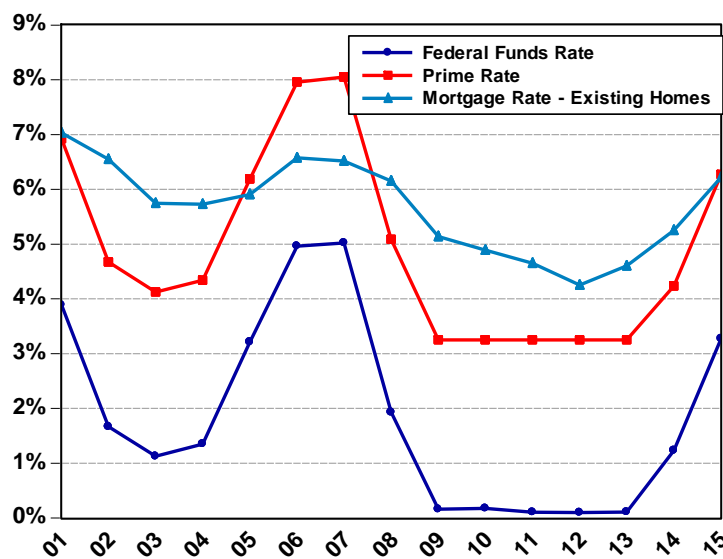


120,000 jobs, but the steps need to be larger to lower the unemployment rate significantly. For example, the unemployment rate would not change significantly over the next twelve months even if the economy generated an additional 120,000 jobs per month. It would need to add twice as many jobs per month to drop the unemployment rate by one percentage point by November 2012. Nonfarm employment is forecast to grow 0.9% in 2012, 1.4% in 2013, and about 2.0% in both 2014 and 2015. At this pace, the unemployment rate slowly falls to 7.4% in 2015, which, as the chart shows, is still well above the rate consistent with full employment.

Monetary Policy: There was little excitement in the Federal Open Market Committee’s November 2 statement, with no new policy announcements or hints at future policy announcements. The key points made by the Federal Reserve: (1) It noted that growth had strengthened somewhat in the third quarter, partly as temporary factors reversed, and expected a “moderate pace” of growth ahead. (2) It noted that inflation appears to have moderated as energy and other commodity prices have eased, and emphasized that longer-term inflation expectations have remained stable. (3) It repeated that there are “significant downside risks” to the outlook, including from global financial market strains. (4) It reiterated that it will continue its “twist” operation extending the average maturity of its security holdings. (5) It reiterated that the federal funds rate is likely to remain “exceptionally low” until at least mid-2013. Chairman Bernanke indicated that quantitative easing via

purchases of mortgage-backed securities, to try to lower mortgage rates, was a viable option. The Federal Reserve has embarked upon a \$400-billion “twist” operation aiming to drive down long-term bond yields, and we assume that it will introduce a QE III program in 2012 of similar size to QE II (\$600 billion), targeted at least partly towards mortgage-backed securities. However, neither operation is expected to give much support to growth. The central bank has given as firm a commitment as possible to keep the federal funds rate near zero through at least mid-2013. This forecast assumes it keeps the current federal funds target rate (0.00%-0.25%) until at least 2014

Selected U.S. Interest Rates



Source: IHS Global Insight

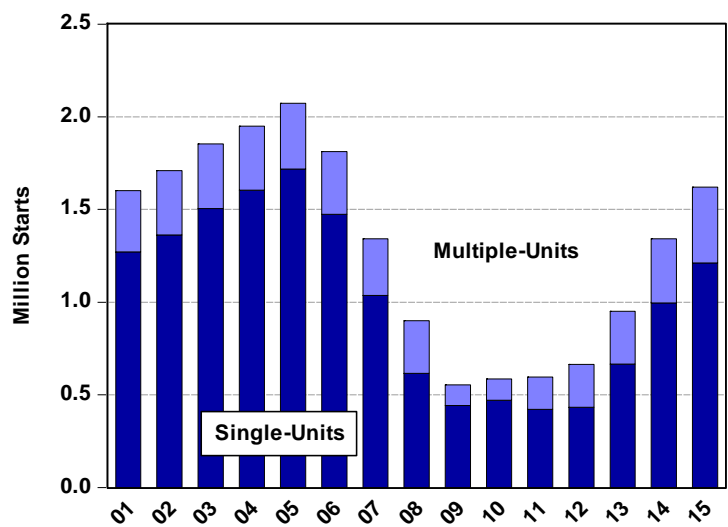
Business Investment: The 2010 Tax Relief Act allows businesses to fully expense qualified assets purchased and put into use by the end of 2011, and to apply a 50% bonus depreciation on qualified assets bought in 2012 (software can be expensed through 2012). The savings from buying equipment this year are considerable, particularly for assets with long lives. It appears businesses are responding to this incentive. Assets with long lives posted almost across-the-board strong gains. Real business fixed investment increased at a 16.3% annual rate in 2011’s third quarter, contributing 1.6 percentage points to real GDP growth. Real spending on equipment and software grew 17.4% (annual rate), with transportation (up 38.1%), and industrial equipment (up 33.1%) all having an impressive third quarter. Still, in order to be effective, the outlook for businesses must be a favorable

one. Unfortunately, it is not the case today. Businesses remain flush with cash and will want to address replacement needs neglected during the recession. But slow growth in end markets means that accelerated depreciation will have a limited impact on equipment spending going forward. Real spending on equipment and software should grow at a respectable, but far-from-impressive, 7.7% in the fourth quarter and at a respectable 6.7% in 2012. Spending slows in early 2013 after the program expires, but then quickly picks up because of an improving economy. Specifically, real investment on equipment and software is projected to increase 6.8% in 2013, 7.7% in 2014, and 6.0% in 2015.

Government: The congressional committee tasked with cutting \$1.2 trillion off the budget deficit over the next ten years has failed. This is not surprising given the substantial gap between Republican and Democratic proposals in the weeks leading up to November 23. This leaves both automatic spending cuts and the expiry of the Bush tax cuts looming in January 2013. It is assumed that the new Congress and president will produce a package of spending cuts and tax increases that mostly spares discretionary spending. There will be a combination of cuts in Medicare, Medicaid, and Social Security, and increases in income tax. The measures mostly begin in January 2014 (i.e., we assume that the Bush tax cuts are extended in 2013). In combination, these actions are sufficient to stabilize the federal debt-to-GDP ratio. Congress will need to decide on the fate of the payroll tax cut and extended emergency unemployment benefits (both expiring at the end of 2011), the Medicare payments to doctors scheduled to be cut on January 1, 2012, and the Alternative Minimum Tax “fix” that also expires on January 1, 2012. The current forecast assumes the 2% payroll tax cut and emergency unemployment insurance benefits are extended for 2012 and then phased out over several years, rather than disappearing overnight.

Housing: The housing sector is forecast to expand gradually over the next few years. Although not all the data are in, 2011 looks to have been the worst year on record for the single-family housing market. New home sales (data start in 1963), single-family housing starts (data start in 1959), and single-family permits (data start in 1960) will all set record lows in 2011 nationally and within all four regions of the country. Existing home sales (data start in 1999) may also drop into the cellar nationally. These rankings do not adjust for population growth. If they did, conditions would look even worse. Policies at different levels have tried to jump-start housing, but all of them have fallen short in getting the market moving, and prospects for other policies appear similarly anemic. The better news is in the multifamily market, which makes up about one-third of the housing stock and continues to improve. September multifamily starts were up 51% nationally, propelled forward by a 141% surge in the South and a 52% jump in the West. For the third quarter, multifamily starts rose to a 190,000 annualized rate, their highest level in 11 quarters. Indeed, the stars are starting to align for this segment. Rents

U.S. Housing Starts



Source: IHS Global Insight

are rising (as are the prices of rental properties), rental vacancy rates are falling, the economy continues to create enough jobs to sustain a moderate recovery, and homeownership rates are falling. The housing market should improve slowly going forward, with single-family and multifamily housing starts, new home sales, and existing home sales all higher in 2012 than in 2011 (but not by much), housing prices finding a bottom in 2012, and the multifamily and rental markets faring better than the single-family market. Still, the overall housing market is not expected to shift into high gear until at least 2013. Eventually, sales and starts can return to demographically driven norms, but malaise trumps demographics in the short term. There are expected to be 665,000 housing starts this year, 951,000 starts next year, 1.34 million starts in 2014, and 1.62 million starts in 2015.

International: The U.S. trade deficit narrowed by \$1.8 billion in September, to \$43.1 billion, as exports posted stronger gains than imports. Total exports rose 1.4%, as goods exports jumped 2.1% in value and 1.4% in volume. Most major subcategories posted strong gains. Industrial supplies (up 1.9%) and consumer goods (up 5.2%) led the export charge, while capital goods (up 0.7%) and automotive goods (up 1.5%) followed close behind. But the boost from September exports to current production levels is not as strong as it would seem on the surface. A closer look at industrial supplies show that nonmonetary gold (not part of current production and therefore not included in the GDP calculations) was the single-largest contributor to the jump there. Excluding this category, industrial supplies exports fell 0.5%, and the total export gain would have been halved. The early part of 2012 should see imports dominating exports so that the trade deficit widens. As worries about global growth dissipate in the second half of 2012, exports should return to a more robust growth rate. For next year, IHS Global Insight expects export volumes to increase 3.4% while import volumes rise 2.5%. On net, foreign trade should represent a small drag to real GDP growth in the first half of 2012, but provide a minor boost to growth in the second half of the year. The dollar is expected to strengthen against the euro in the immediate future on continuing fears over Eurozone sovereign debt. However, the greenback's medium-term trend against major currencies is less clear. The dollar should continue declining against emerging-market currencies, though. The goods and services trade deficit should have widened in 2011, but the overall current-account deficit should shrink to 3.0% of GDP (from 3.2% in 2010), because strong profits from overseas operations have boosted the surplus on the income account. However, weaker growth overseas and a stronger dollar are likely to reduce the income surplus in 2012.