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June 2012 Economic Commentary and Capital Market Update

Overview: Concerns ratcheted up this month about the global economy. Fears that Greece will soon leave the euro zone rose as the country's unstable politics undermined its economic reform process. Spanish banks also face a shrinking deposit base and ratings downgrades. The euro remains under pressure, and markets drove up government borrowing costs in Spain, Italy and Portugal. Though less publicized, worries over the Chinese economy have also emerged, as electricity use and real estate data point to a slowing growth.

The U.S. is facing another warm-weather slump. "Deja vu" all over again? In 2010, the summer slowdown came partly from less inventory building. In 2011, supply disruptions after the Japan earthquake and tsunami disaster plus the Arab Spring-related spike in gasoline prices impacted growth. The culprits for 2012 are the protracted euro-zone debt crisis, a stock-market swoon and the anemic job growth. Uncertainty about Washington policy may also be restraining optimism, especially when it comes to the labor markets.

One silver lining in the gloomier market sentiment is that the price of oil has pulled back recently, which at the very least diminishes one of the key risks to the outlook we've have forecasted recently. We expect crude oil price to fall further, giving consumers much needed relief as we head into the summer driving season.

While global economic and financial strains are troublesome, it would take a very large foreign shock to push the U.S. economy off its growth trajectory. While the housing market still faces challenges, the sector is entering the early stages of recovery and should prove to once again to be a homegrown source of growth in the coming years. Furthermore, manufacturing output rebounded in May despite slower growth in Europe and China; the domestic auto sector remains alive and well. As U.S. business investment picks up later this year, capital equipment manufacturers should experience another homespun boost.

GDP: The revised estimate of first quarter 2012 real GDP was lowered to 1.9% (annualized) from an initial estimate last month of 2.2% (see Chart 1 below). We expected a downward revision due to the sharp contraction in government spending. The private output part of the equation grew by a more satisfying 2.7%.

Consumer spending grew by the strongest pace since 2010. We expect to see a deceleration in spending activity in 2Q. While growth should be supported by falling gasoline prices, it will be negatively affected by a declining stock market and falling confidence – effects from the uncertainty created by the re-emerging European debt crisis.

The decline in government spending in Q1 is also a reminder of the impact of austerity in the U.S. Political uncertainty will continue to weigh on the U.S. growth outlook over the next year. A steep fiscal cliff still hangs over us in 2013, but so too does another potentially contentious debate over the U.S. debt

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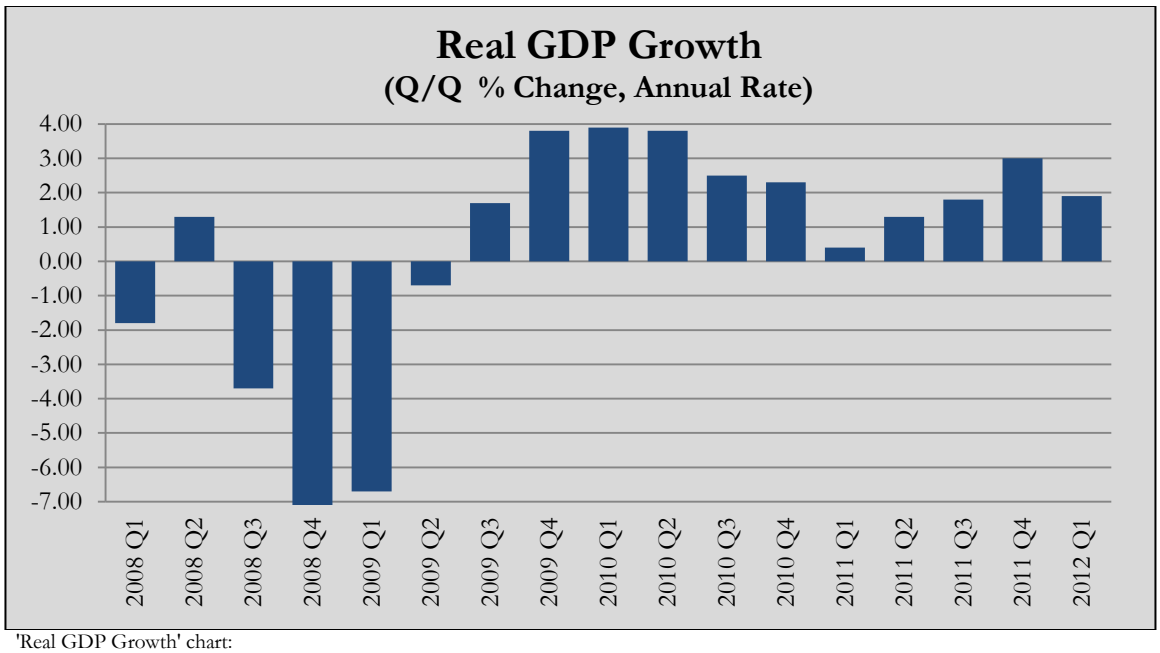
ceiling before the end of this year. Both of these very public issues will likely feed into elevated market volatility.



'Real GDP Growth' chart:
Bureau of Economic Analysis
http://www.bea.gov/national/xls/gdpchg.xls

Labor: The U.S. economy created a scant 69,000 jobs in May. Made worse, revisions cleaved off 49,000 jobs from the prior two months. Private sector jobs were up 82,000 with job gains concentrated in education, health, trade and transportation. Jobs gains in other sectors were unremarkable, with the construction sector losing 28,000 jobs in the month. The unemployment rate edged up to 8.2%in May from 8.1%.

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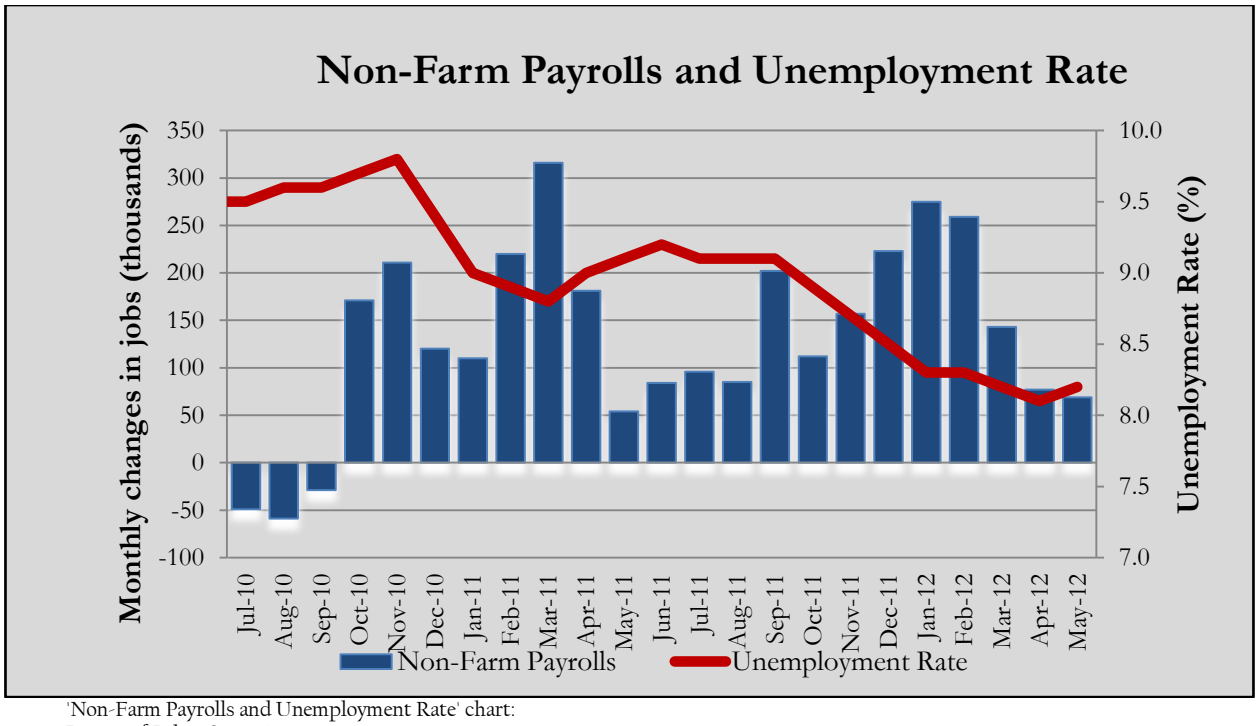

'Non-Farm Payrolls and Unemployment Rate' chart:
Bureau of Labor Statistics
http://www.bls.gov/cps/

We now have three recent disappointing monthly payrolls reports under our belts, and first quarter GDP growth was less than expected. Pessimists will focus on the loss of momentum in hiring, but we see the glass as half-full with current levels consistent with sub-par growth. Given economic growth of 1.9% in the first quarter, the +250,000 jobs created in January and February was probably an anomaly.

Long-term unemployment and a declining participation rate are of concern, as evident in the continued high level of the median duration of unemployment and the lowest participation rate since 1981. While the extension of unemployment benefits has some influence on unemployment duration, the larger and structural issue is that many workers do not have the skills required by employers in the location where employers are seeking jobs, causing long spells of unemployment or a withdrawal from the labor force. The lack of household mobility caused by the housing crisis exacerbates the problem.

In an economic recovery that lacks a strong foundation, ripples of uncertainty can make a big splash on business and consumer confidence. Already, there have been a couple of disconcerting trends trickling into the labor market outlook. Aside from the deterioration in consumer confidence in May, jobless claims are edging up. Neither one is of significant enough magnitude to suggest the bottom will fall out from employment. However, together they support the notion that we could see persistence in soft job gains as uncertainty builds abroad and on the home.

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Consumer Confidence: Consumer confidence fell 3.8 points in May to 64.9, marking the third consecutive monthly drop and largest monthly decline in seven months. The overall index has averaged about 59 over the past 12 months. That pace, however, includes last summer's plunge that followed the debt ceiling debacle and downgrade of the U.S. sovereign debt rating. Aside from that summer slide, overall consumer confidence appears hovering somewhere around 65 and 70. Confidence is the key to sustainably higher capital market prices.

Retail Sales: U.S. retail sales grew 0.1% in April following a downwardly revised 0.7% increase in March. Following a solid performance in the first quarter, April's retail sales report was disappointing and sets up a soft consumer spending trend for the second quarter. That being said, we still expect overall Q2 consumer spending to register a respectable performance as service spending accelerates and falling gas prices boost real spending power.

Manufacturing: The ISM Manufacturing Index declined to 53.5 in May from 54.8 in April. The details inside the report were mixed. May's ISM reading was not all that bad, but it does add to the list of recent downside economic surprises, including the recent dismal jobs report and yesterday's downward revision to Q1 GDP.

U.S. producers are unlikely to experience much export strength in the near term. There is no end in sight for Europe's economic and financial challenges, and a soft PMI reading from China has raised concerns that the world's second largest economy is headed for a larger than expected slowdown. This means U.S. manufacturers will remain reliant on a domestic economy that appears to be losing steam.

Despite this, we believe that manufacturing will remain a steady and stable source of growth moving forward: auto production continues at a healthy pace, businesses will eventually need to increase capital goods spending and the housing market is still on a path towards recovery.

Housing: Existing home sales rose 3.4%in April to 4.62 million units (annualized). The median sales price for all homes are up 10%from year ago levels. We will need a few more months of data to know whether April's price increase was an anomaly or truly the start of a new upward trend.

Rising prices will build housing related equity wealth, important for homeowners currently underwater. The downside is that rising prices may discourage more first-time homebuyers from entering the market. However, we believe that any price increases will be moderate, and that they will ultimately support a stronger housing market recovery, not detract from it. Good news in housing should translate in increased consumer confidence. Confidence will be needed to sustain higher equity prices.

Housing starts rose to 717,000 units in April and are up 30 percent from their levels a year ago. The rise in total starts was led by multi-family starts, and single-family starts were also up. While we do not expect a major resurgence in housing construction over the next several months, this support level is likely to form

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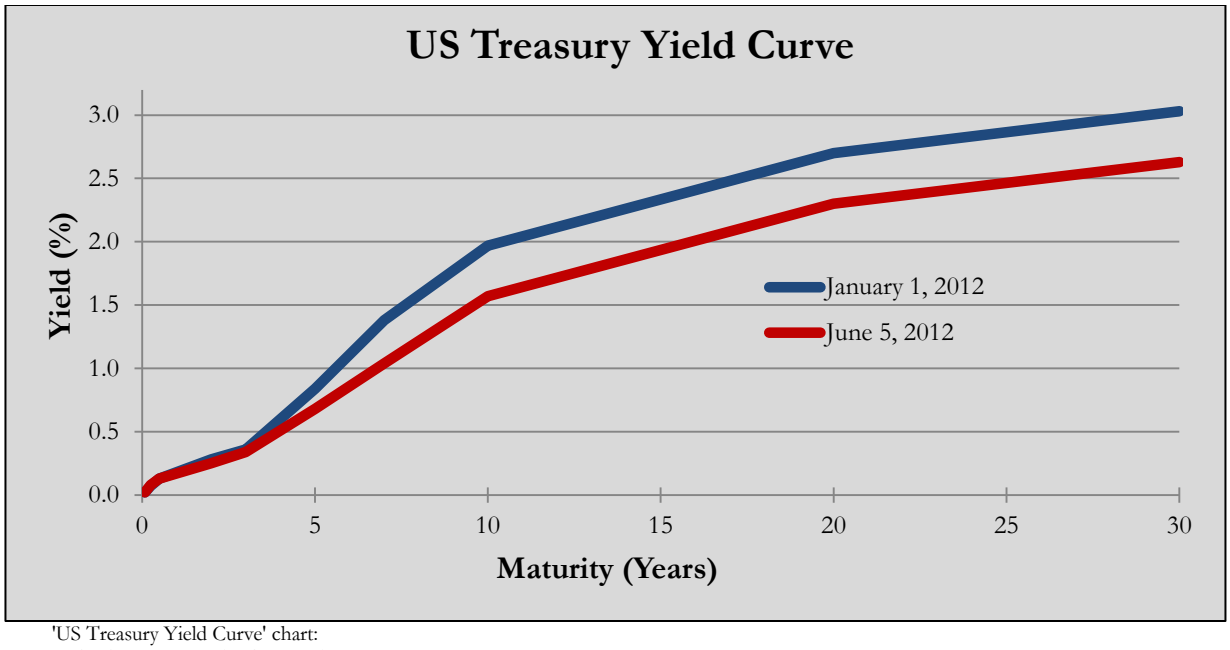
the new floor for housing construction. With the gain in April, residential investment – which added 0.5%to growth in the first quarter – appears set to contribute positively again in the second quarter.

We cannot lose sight that the foreclosure overhang is still very much a factor for the housing market outlook. Until the 2 million mortgages in foreclosure and nearly as many in serious delinquency are drawn down to more normal levels, home prices and new housing construction will remain under pressure.

Inflation: The headline consumer price index (CPI) remained unchanged in April. Core CPI rose 0.2%. On an annualized basis, headline CPI rose to 2.3% in April, down from 2.7% in March. The deceleration was due to a 1.7 % month-over-month decline in energy-related prices. Excluding food and energy, core inflation also rose to an annualized 2.3%, unchanged from March. Inflation readings are not far above the Fed's long-run target of 2.0%.

Federal Reserve: For the Fed, the resilient but subdued nature of the U.S. economy has left the possibility of additional monetary stimulus open, but the threshold for action is high. A continued escalation of Europe's financial crisis to the point of threatening the U.S. financial system presents one scenario in which the Fed would likely act. Indeed, if Europe continues to deteriorate, there is a good chance central banks will undertake another round of coordinated action to shore up confidence.



'US Treasury Yield Curve' chart:
Federal Reserve Bank of St. Louis
https://research.stlouisfed.org/useraccount/datalists

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The odds that domestic economic conditions will prompt additional monetary stimulus are smaller – but not improbable. If the recent downward trend in inflation expectations continues, more Fed members will start calling for stimulus to preempt its disinflationary effects. But with ten-year interest rates near 1.5%, the value and effectiveness of additional stimulus is questionable. The case for additional stimulus must also address recent inflation trends. Core price growth is now trending near the Fed's 2% target. While board members believe inflation will start to trend lower, a gradual improvement in credit markets and uncertainty about the true level of economic slack present upside risks to the inflation outlook.

The Fed will remain vigilant on inflation, but we don't expect price pressures to force a premature interest rate hike this year. *With so much slack in the labor market and sluggish income growth, it's hard to see where the domestic risks of higher inflation will come from.*

Euro zone: More than two years have passed since Greece precipitated the Euro crisis, and still the crisis builds in threat and intensity. At the core of the continued crisis is a current and capital account imbalance within the euro area, the resolution of which is drawn-out by the need for internal exchange rate adjustment through wage austerity and price deflation.

For years, Europe's periphery countries have not generated enough income from their exports and foreign investments to cover the cost of their imports and debt service. That was fine so long as creditors with surpluses, like Germany, were willing to finance them. But when the crisis struck and the periphery's creditworthiness was called into question, foreign financing dried up.

Fortunately, Europe's deficit countries have managed to avert economic disaster by securing official financing The European Central Bank (ECB) through its liquidity programs, allowing banks in crisis-stricken states to borrow from the ECB by posting their own sovereign's debt as collateral. Some of these borrowed funds make their way back to Germany, for example, as payments for goods and services. This has resulted in growing claims by German banks (specifically the Bundesbank) on the euro system, matched by growing periphery bank liabilities to the euro system.

Technical details aside this amounts to de facto German lending to periphery countries via the ECB. So while Germany has refused to embrace Eurobonds as a potential solution to the crisis, it is still providing core financial support to the euro zone. Should the ECB end its support, the currency union could not survive. The cost of a breakup would be enormous, not least of all for Germany, whose claims against the euro system are unlikely to be repaid.

What then is the path forward? To end the crisis, European policymakers must come up with a credible plan to finance the deficits of the periphery in the short term while ending them in the long term. That necessarily entails some form of fiscal federalism, whereby member states assume joint liability for each others' debts. Unfortunately, Germany wants to see results before it will commit, while deficit countries need that commitment to get results.

In the event that Greece chooses to exit the euro zone, there is likely to be a savage deleveraging, and extreme pressure on liquidity. Unlike 2008, central banks are already engaged in crisis management, so

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liquidity is plentiful. But, the potential re-introduction of national European central banks with their own currencies will make crisis management and cross border liquidity provision all the more difficult to manage. This still constitutes the tail risk, but as it is now driven by an austerity-fatigued electorate rather than policymakers, it is the tail risk that continues to wag the market.

Outlook: The lesson of the last several weeks is that the global economy is a long way from clear blue skies. Europe is nowhere near resolving a crisis that can only end in a more perfect union or a divorce. *As long as the possibility of a breakup of the world's second biggest monetary block hangs over global markets, continue to expect large swings in sentiment.* Similarly, in the United States, buffeted by global shocks, the long hard process of deleveraging continues.

Despite a number of downside risks, however, the U.S. economic recovery has broadened considerably over the last few months. First, bank lending has risen steadily in the last year. Although mortgage lending is still quite anemic, business bank loans and consumer credit have persistently increased in recent months. Second, unlike any other in the post-war era, the contemporary recovery has thus far proceeded without the housing industry. Housing, however, finally seems to be joining the recovery. An array of data in recent months suggests activity in this industry is more pronounced than at any time since the recovery began.

Third, despite May's disappointing job report, through the first five months of this year, monthly household job gains and the U.S. labor force have averaged 300,000 and 224,000 respectively—both representing one of the strongest five-month gains of the recovery. Unemployment claims have declined 15% in the last year falling below 400,000 for the first time in the recovery and currently hover about 370,000. Supporting this move is a 1.2% decline in the unemployment rate since the end of 2010—its largest and most sustained decline of the recovery.

Fourth, perhaps because both the job and housing markets are showing more signs of life, most consumer confidence measures have recently established new recovery highs. Improved reports on home prices, a lower unemployment rate, a higher stock market, lower pump prices and record-low mortgage rates are beginning to revive consumer spirits. Fifth, stronger job gains and improved confidence have boosted the pace of consumer spending. For the last two quarters, real personal consumption has grown at a 2.4% annualized pace and in the last eight months real retail sales have risen at almost a 6% annualized pace. Even big ticket spending has improved as evidenced by rising numbers of home buyers and by a recovery-high almost 15 million annual rate of U.S. auto sales.

Lastly, improved balance sheet strength highlights the more sustained nature of the economy today. Delinquencies, defaults, and foreclosures are all off substantially compared to levels during the first couple years of this recovery. The U.S. household savings rate has hovered near a 10-year high since the recovery began, total household net worth is now only about 15 percent below all-time highs even though home prices have yet to begin a recovery. A much lowered debt burden argues favorably for future growth.

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