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Economic Update

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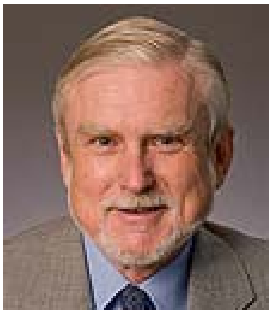

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In 2012, we continue to expect worldwide economic growth of about 3%, somewhat slower than the IMF's April 2012 forecast of 3.5%. We expect a global growth recession, with an economic decline in Southern Europe, slight declines or slight growth for several quarters in the U.K. and much of Northern Europe, near-trend growth in the U.S. and sustained but slower growth in China and other emerging market countries. On the assumption that a full-scale financial meltdown in Europe will be avoided, we do not expect a global recession, despite the ongoing European recession and financial crisis.

Two main causes of the slow global growth in 2012 are (1) the lagged impact of last year's monetary tightening in the Eurozone and in many emerging countries and (2) the direct and indirect effects of the continuing financial crisis within the Eurozone. However, global monetary policy has become more stimulative in 2012. Countries that avoided monetary tightening in 2011 (including the U.S., U.K. and Japan) have retained their easy monetary policies, while nearly all countries that tightened in 2011 have reversed policy and have now adopted an easy monetary policy, which is helping to generate easy financial conditions in most countries. The notable exception is Southern Europe, which suffers from forced fiscal tightening and tight financial conditions due to the continuing European financial crisis. We believe current ECB policy is restrictive relative to economic conditions and financial stresses in the peripheral countries. Expected inflation in the next year or two differs among countries of the Eurozone, so the expected real policy rate (the policy interest rate minus expected inflation) also differs. The same ECB policy rate can be somewhat inflationary for Germany and somewhat deflationary for peripheral countries. The two rounds of liquidity supply from the ECB's LTROs have only partially mitigated the growth-hostile financial and fiscal conditions in Southern Europe. While Greek debt is now primarily owed to public entities rather than to the private sector, there are substantial concerns that events in Greece could motivate deposit outflows in other peripheral countries unless European policymakers become more proactive in managing fundamental stresses within the Eurozone. Aside from Southern Europe, the broad global pattern is of easy monetary policy and easy financial conditions worldwide. The growth-stimulative impact of this easy monetary policy is being partially offset by (1) a pro-cyclical tightening of regulatory policy in the financial sector, (2) a "deleveraging drag" and (3) an "uncertainty drag." However, the net effect is still growth-supportive. Global economic expansion may also be supported by the recent calming of fears of a major oil price spike. Fears that military action in the Middle East might generate a major blockage in the Strait of Hormuz and a major oil price spike have faded somewhat.

How should the fact that commodity prices have dropped sharply in recent weeks be interpreted? We offer several perspectives. First, spot commodity prices are a traditional short-term leading indicator of economic activity. The reason for this is that they are sensitive indicators of shifts in global supply and demand and are available with no reporting lag, unlike many government statistics. We believe that the recent sharp drop in commodity prices is a valid signal of economic slowdown in many European countries as well as in many emerging countries, such as China, Brazil and India. However, these are short-term signals and can prove volatile.

Second, commodities were a focus of financial speculation on the theme of a commodity super cycle due to increased demand from an emerging market boom, a thesis which is now being questioned during the global growth recession. The growth of commodity supply has been rapid in response to the combination of the past rise in commodity prices and profits and the availability of cheap financing.

Third, prices which are very sensitive to expectational influences, including commodity prices, are priced not just on the most likely case, but rather on the full probability distribution of multiple scenarios, including unlikely but plausible "tail risks." While we expect that a full financial meltdown is likely to be avoided in Europe due to reactive and proactive responses from European policymakers, it is not possible at this time to entirely rule out such a negative tail risk scenario. In this context, volatility in prices can occur due to changing estimates of tail risks, even when there is little or no change in the consensus about the most likely case.

Fourth, while the value of most commodities represent a miniscule share of global economic activity, energy commodities are a large and influential portion of global economic activity. We regard energy commodity prices as both an effect of the current global economic growth rate and a cause of acceleration or deceleration in the global economy. Major rises in energy prices are a drag on real income growth, while major declines in energy prices aid real income growth. From that perspective, the recent fall in the price of many energy commodities is likely to help support global economic activity later this year, except in the energy-exporting countries.

Inflation has been decelerating in many emerging market countries due to a combination of past interest rate increases, past currency strength, lower current commodity prices and the current phase of slow economic growth. One result of this inflation slowdown is that many policymakers in emerging countries have been willing to ease monetary policy and tolerate a drop in their exchange rate (as long as it is not too rapid). We expect that in many non-energy emerging countries, which are currently expanding at a slow pace, the combination of lower interest rates, lower currency levels and lower energy prices in 2012 should contribute to a moderate economic reacceleration later this year. We expect that China, where economic statistics have been quite weak over the last several months, will be among the countries experiencing a moderate reacceleration later this year. While the residential property sector in China should remain depressed, the broader economy should benefit later this year from the persistence of lower inflation and a succession of selective policies to stimulate the Chinese economy.

Among the fundamental underlying causes of recent economic and financial problems in Europe are the strains on sovereign debt sustainability from a combination of adverse demographics and the overhang of private and public sector debt. The demographic challenges are clear in many countries, notably in Europe, where both the overall population and the working-age population are likely to be declining over the coming decades. The good news for individuals is that people are living longer. However, that is bad financial news for many governments, given their pension and health care commitments. The average number of years in retirement has been trending higher in most industrial countries in recent decades due to (1) earlier retirement and (2) greater longevity. The ratio of workers to non-workers was already drifting downward even before the Great Recession and the European financial crisis. The financial challenges created by increased longevity are reviewed in "The Financial Impact of Longevity Risk," an article in the April 2012 Global Financial Stability Report of the International Monetary Fund. We believe that the German insistence on a "debt brake," embodied in a "fiscal compact," which would limit the increases in sovereign debt for both itself and other European countries, reflects an attempt to anticipate and mitigate the future financial impact of these adverse demographic trends.

Fiscal consolidation makes sense for many countries from a long-term point of view. However, it is cyclically painful during a European recession, weakening both economic activity and political support for continued fiscal consolidation. Fiscal austerity at a time of economic weakness is proving both politically unpopular and economically painful in Europe. This is especially true since the ECB has been more reluctant to adopt an aggressively easy monetary policy than have the central banks of other industrial countries. We expect that Europe is likely to eventually agree to slow the pace of fiscal austerity, while further easing actions from the ECB are likely.

We believe that the Eurozone is trapped into a situation where, from an economic perspective, "one currency fits none" and "one policy rate fits none." We expect that the euro will survive in some form and that a full-scale European financial meltdown will be avoided, but we are pessimistic about economic activity in the peripheral and soft core countries of Europe over the next several years. The cumulative erosion of competitiveness in many Eurozone countries relative to Germany over the last decade has created major problems. There has also been a large rise in debt-to-GDP ratios, especially in the peripheral countries. Within the Eurozone, this large increase in sovereign debt has been denominated in euros rather than in domestic currencies. The U.S., U.K., Japan and many other countries borrow in their own currencies, for which they control the supply. However, each country in the Eurozone has been borrowing in a foreign currency that it cannot create, the euro. One set of countries has promised to pay in a currency they can print. This is a relatively credible nominal promise, even if the true internal value and external value of such debt obligations can be eroded by inflation or currency depreciation. Another set of countries has promised to pay in a currency they can't print, which is a credible nominal promise in the long run only if (1) their economic fundamentals are favorable, (2) their debt is on a sustainable path and (3) they have an ability to pay in that foreign currency which is matched by a political willingness to pay. If they can get another country or group of countries to support their payments, that is less likely to prove credible in the long run than in the short run, since the political support for subsidies is likely to fade in the contributing countries.

To rebalance competitiveness within the Eurozone, there may need to be a persistent differential of higher inflation in Germany than in the more vulnerable countries in Europe. The combination of forced fiscal tightening and financial stresses should begin to generate deflationary pressures in vulnerable countries. The pressures for rising inflation in Germany may increase. Already, the Bundesbank has begun to concede that, with the ECB's inflation target specified for the overall Eurozone and not just for Germany, inflation in Germany may need to run somewhat above the Eurozone average. In formal terms, the ECB targets Eurozone inflation, not German inflation. It is an open question how much of an acceleration of German inflation would prove politically acceptable in Germany. However, the pressure for a higher inflation rate in Germany than in the periphery does reflect the inherent logic of the Eurozone under current cyclical conditions.

We expect U.S. economic growth at about 2.5% in 2012. Among the industrial economies, the U.S. has favorable long-term growth prospects. The U.S. has better demographics, a strong corporate sector and the strong likelihood that rapidly expanding energy production can provide a U.S. production cost advantage, slowing the long-term decline in manufacturing employment. The long-term budget challenge of the U.S. is basically grounded on a ratio of health care expenditures to GDP which is higher than in many other industrial countries. The U.S. faces a problem in its health care costs that is somewhat less severe in many other countries. However, the U.S. has so far chosen not to make the political compromises necessary to substantially mitigate high and growing health care costs. This is a problem which could potentially be mitigated at some point in the future, but it will probably take a crisis in some future year to motivate a solution.

A notable feature of the U.S. economy this year has been the persistent expansion of bank credit and consumer credit. The stress tests for U.S. banks were both early and effective, which has created the preconditions for sustainable credit creation in the U.S. The financial sector is functioning much more effectively to support economic growth in the U.S. than in much of Europe.

We believe that the cyclical sectors of the U.S. economy remain in favorable trends. New cars offer improved gas mileage, the average age of the auto fleet is old and auto credit is widely available. Automobiles have proved to be good collateral for loans in recent years. The feared upsurge in the savings rate has not occurred and debt-service ratios have dropped sharply from burdensome levels. We believe the cyclical expansion in the U.S. auto sector is sustainable.

Residential construction has also moved into a sustainable expansion, in our opinion. Employment is expanding, new household formation has increased and home building companies have seen a substantial rise in orders for new homes after a severe contraction. While house prices nationwide appear to be stalled at the bottom of an L-shaped pattern, the volume of residential construction has improved substantially. Despite strong gross exports, net exports may prove a slight drag on the U.S. economy. The starting level of U.S. exports is substantially lower than U.S. imports. Both exports and imports are rising, but imports are rising more than exports since the economy in the U.S. is stronger than in many of its trading partners.

With residential construction moving into a sustainable expansion, U.S. real GDP could potentially grow at a 3% to 4% pace in 2013 in the event of supportive economic policy. However, we believe that there are several drags on the U.S. economy: (1) the European financial crisis and recession, (2) the uncertainty about future tax and spending policy, and (3) the prospect of a disruptive political struggle in the lame-duck session of Congress after the election. On balance, we expect real GDP growth of about 2.5% in 2013, after taking into account both an "uncertainty drag" and a likely fiscal drag in 2013 of 1% to 1.5% of GDP after budget legislation is finally passed, following an intense political battle.

Our best guess is that the lagged impact of past policy stimulus and a trend of improvement in key cyclical sectors will keep the U.S. on its current growth path for the balance of this year. However, our confidence in this outlook is limited by the difficulty in gauging the impact of both the European financial crisis and of the "uncertainty drag" in the U.S. The uncertainty about 2013 is even greater as the U.S. policy mix will depend both on the outcome of the election and the policy results of the political battles afterwards. Our most likely case is a turbulent battle over taxation, spending and the debt ceiling in a post-election lame-duck session of Congress, eventually resolved by a fiscal tightening of 1% to 1.5% of GDP for 2013 in the U.S., much smaller in size than the "fiscal cliff" of about 4% of GDP embodied in current law and widely feared.

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