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Economic Update

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The global growth recession continues but we believe that the global economic slowdown probably reached its weakest point in the third quarter of 2012. We continue to expect global economic growth to be about 3% on the IMF definition in 2012, followed by a modest acceleration in 2013. While the global economy is currently weak and fiscal policy has been consolidating in some key countries, global monetary policy remains quite stimulative and financial conditions are easy in many parts of the world. These easy financial conditions should result, with a lag, in less economic weakness over the coming quarters. We assume that there will not be a major disruption of the flow of oil out of the Middle East. If there were a limited disruption, there should be some ability to shift to alternative sources of energy, given substantial strategic oil reserves and ample supplies of coal worldwide and natural gas in the U.S.

We believe that part of the current slowdown reflects a global inventory correction. It has been difficult for companies to reduce inventories quickly in the seasonally slow July/August period, but it should prove more achievable this fall. In the real world, prior to seasonal adjustment by the statisticians, the pace of sales tends to be weaker in the summer than in the fall, especially in North America and Europe. This seasonally slower pace of actual sales tends to make it more challenging to reduce excess inventories in the summer than in the fall. Now that the slow summer months have passed, we expect the global inventory correction to run its course over the next several months.

In Asia, economic indicators have been weak in the last several months. In Japan, the benefits of the recovery from the earthquake and tsunami appear to have largely run their course. Japan tends to have weak domestic demand and the Japanese economy is relatively sluggish. The Chinese economic indicators have been weak, especially in the goods producing sector. That reflects a combination of an intended cooling in the housing market and the effect of the European recession. We expect a gradual shift to more stimulative policies in China over the next three to six months, but hardly anything as large as what was done in 2008. The result should be somewhat less weakness in China over the coming quarters. In Latin America, there are favorable prospects for several large countries. Mexico is benefiting from the expansion of the U.S. economy. The Brazilian central bank has cut interest rates by a total of 500 basis points and the government has adopted several stimulative policies. We believe that the Brazilian economy has bottomed and should have faster growth over the next 12 to 28 months.

Many emerging market countries have several key advantages relative to developed economies. Most have avoided the debt-boom/debt-bust pattern in recent years, having painful memories of such a pattern in prior decades. In addition, their interest rates are not close to zero, so it is easier for them to implement stimulative monetary policy the old fashioned way--by cutting interest rates. Despite higher food and energy prices, a weak global economy is limiting the magnitude of upward pressures on emerging market inflation.

What about Europe? Europe is in a full-scale recession. We think that the deepest and fastest decline is probably occurring now. Declining economic activity should continue through year-end, but at a decelerated pace. The overall European economy should be roughly flat in 2013, with economic activity rising slightly in core Europe, while peripheral Europe continues to decline. The British economy has been quite weak in the last several quarters. The decline appears to have run its course but it should be followed by only a moderate rebound in economic activity, rather than by a strong recovery.

While financial conditions have been stimulative in most countries, peripheral Europe has been an outlier. Much of peripheral Europe has been in a severe credit crunch. Peripheral yields on sovereign and corporate credits have been high as investors have demanded compensation for the "redenomination risk" or "convertibility risk" of a potential exit from the euro.

We believe that the ECB's new plan has lowered the tail risk of a full-scale European financial meltdown by creating a plausible but painful path to financial support for vulnerable peripheral countries. This plan can contribute to an easing of liquidity stresses in peripheral countries but does not solve underlying problems of competitiveness, structural balance of trade deficits, excessive legacy debt burdens and forced fiscal consolidation during a recessionary period. Nonetheless, this coherent, executable plan is a major achievement for Europe. We expect the intensity of European economic weakness to ease by early 2013.

The Outright Monetary Transactions (OMT) program of the European Central Bank (ECB) did solve four key problems. First, only a support program potentially unlimited in size could be credible. By mobilizing the ECB balance sheet in a potentially unlimited way, the plan reduced concerns that the size of the EFSF and ESM support funds would prove too small to absorb sufficient credit risk to stabilize the European financial system. Second, the German government had to be willing to sign off on the mechanism by which it absorbed credit risk from the periphery, directly and indirectly. The conditionality mechanism gave an effective veto to Germany over the terms of the support programs and thus garnered the support of the German government despite the objections of the Bundesbank. Third, by targeting bond purchases in the one to three year maturity range, the ECB was able to make the argument that it was operating within its monetary policy mandate to improve the monetary transmission of central bank policy rather than violating the European Treaty by financing budget deficits. Fourth, ECB holdings of peripheral debt under the OMT will be "pari-passu" (given equal treatment) rather than treated as senior to private bondholders. We believe that the ECB insistence on seniority in the Greek case badly damaged private sector confidence in peripheral debt. The new "pari-passu" approach should lower fears that a "subordination engine" would lower the value of private sector holdings of the debt of peripheral sovereigns. In addition, a key uncertainty about the OMT program was removed by the decision of the German Constitutional Court to permit German participation in the ESM, albeit with conditions.

The OMT plan appears well-designed technically but may require skillful negotiations among the European leaders to be effectively implemented, due to a combination of "austerity fatigue" among voters in the peripheral countries and "support fatigue" among voters in the stronger countries. The German government is likely to drive a hard bargain in the coming negotiations, since it is the country bringing financial strength to the negotiations. While this plan has lowered the tail risk of a financial meltdown in Europe, Europe remains in both a financial crisis and a recession. Our most likely case is that the European recession of 2012 should be followed by roughly flat overall economic activity in 2013, with recession continuing in peripheral countries but ending in core countries.

We believe that the U.S. economy is in a sustainable economic expansion, although the pace of recovery from the Great Recession is only about one half of the average rate of growth in prior Postwar recoveries. Our view is that the U.S. economy is in a recuperative mode in the aftermath of a credit boom and bust. Residential construction is in a basic uptrend from a very depressed level. The homebuilders' sentiment index ranged between 13 and 17 from the summer of 2010 to the fall of 2011, but has just risen to 40, a six-year high. House prices appear to have bottomed and begun an uptrend. Auto sales have trended higher due to an aged auto fleet and the ample availability of auto financing.

Fears that a large rebound in the U.S. savings rate would weaken consumer demand have not proved correct. It has been sluggish income growth more than a higher savings rate which has restrained the growth rate of consumer spending in the U.S. One reason that the savings rate has remained low is that Federal Reserve policy has held down interest rates, especially on low risk investment vehicles. The Federal Reserve prefers, at least for now, that Americans spend a large portion of their income on goods and services or on the purchase of riskier assets rather than increasing their savings in low risk assets.

The most recent program of quantitative easing announced by the Fed (QE3), had several aspects which indicated a more aggressive easing posture. First, the program is open-ended and is not limited in either total size or time. Second, the Federal Reserve has explicitly indicated that it intends a highly accommodative stance of monetary policy "for a considerable time after the economic recovery strengthens." The central tendency of the forecast for four quarter real GDP growth of the Federal

Reserve Board Members and Reserve Bank Presidents is 1.7% to 2.0% for 2012, 2.5% to 3.0% for 2013, 3.0% to 3.8% for 2014 and 3.0% to 3.8% for 2015. While the Fed is forecasting above-trend growth for both 2014 and 2015, due in part to the stimulus from its own easy monetary policy, it "anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015."

We regard the Fed's stance as tilted toward the maximum employment aspect of its dual mandate and away from the price stability aspect of its dual mandate. The basic logic of the central bank's actions was laid out in Chairman Bernanke's Jackson Hole speech: "Unless the economy begins to grow more quickly than it has recently, the unemployment rate is likely to remain far above levels consistent with maximum employment for some time." Chairman Bernanke indicated that he saw "little evidence of substantial structural change" in the labor market which would render "the current levels of unemployment impervious to additional monetary accommodation." In other words, his view is that additional monetary ease is needed and will work--at least to some degree.

The recent announcements by the Federal Reserve raise several key questions. Is the Fed's diagnosis correct? Will its monetary medicine work? How severe will the side effects be, both short term and long term? We agree that weak labor market demand is primarily due to the relatively slow pace of the U.S. economic recovery. However, some of the causes of slow U.S. economic growth cannot easily be offset by monetary ease. Credit is available but there are major uncertainties about the fiscal cliff, future tax policy, regulation and European financial stresses.

We believe that monetary ease tends to strengthen energy prices, which should tend to mitigate some of the benefits of that monetary ease. Energy prices have a relatively large impact on the global economy. When real interest rates (interest rates minus inflation) are negative and there are fears of dollar weakness, oil may take on some aspects of a superior store of value money, more volatile than Treasury securities but expected to have a positive real return over time.

Oil exporting countries with national oil companies may conclude that a slow pace in the development of oil reserves may make sense if the expected rate of return on the reserve currency is unattractive due to negative real interest rates and potential weakness in the currency. We believe QE3 will provide some net support to the U.S. economy, but the overall impact is likely to be reduced by the tendency of aggressive monetary ease to support energy prices. Stimulative monetary policy should tend to make energy prices higher than they would otherwise be, but that does not necessarily imply that they will rise above current levels.

Concerns about the consequences of very stimulative monetary policy are discussed in an article published by the Federal Reserve Bank of Dallas entitled "Ultra Easy Monetary Policy and the Law of Unintended Consequences" by William R. White, an economist currently at the OECD and previously at the Bank for International Settlements. As he states, "…ultra easy monetary policies have a wide variety of undesirable medium term effects –

the unintended consequences. They create malinvestments in the real economy, threaten the health of financial institutions and the functioning of financial markets, constrain the "independent" pursuit of price stability by central banks, encourage governments to refrain from confronting sovereign debt problems in a timely way, and redistribute income and wealth in a highly regressive fashion. While each medium term effect on its own might be questioned, considered all together they support strongly the proposition that aggressive monetary easing in economic downturns is not "a free lunch."

Other observers express concern that ultra easy monetary policy can be a breeding ground for "endless bubbles" or an eventual inflation acceleration in future years. We have no doubt that the Federal Reserve has the technical tools to prevent a sustained upward shift in inflation. But now that it is helping the U.S. Treasury finance persistent budget deficits and taking responsibility for mortgage interest rates, it is open to question whether the Federal Reserve will have enough political independence to utilize these tools in a timely way in future years.

The U.S. labor market has been weak over the last six months due to weak hiring rather than to increased layoffs. The job layoff rate in the recent Job Openings and Labor Turnover Survey was quite low and weekly unemployment claims have also remained low. While actual hiring has been weak so far, surveys of hiring intentions have improved. In the latest survey of the National Federation of Independent Business, planned hiring within the next three months reached the highest level since February 2008. The second-quarter 2012 Manpower survey of U.S. hiring intentions reached the highest level since the third quarter of 2008. The recent University of Michigan consumer survey recorded perceptions of more favorable prospects for employment. Nonetheless, actual employment statistics have been quite weak in recent months. While hiring intentions have improved, actual hiring has been weak. We suspect that tax and fiscal cliff uncertainties may have led to postponement of actual hiring despite a rise in tentative plans to hire.

Reported real GDP growth rates in the U.S. should be shifted down in 2012 and up in 2013 by the effect of the drought on farm income this year, probably followed by a more normal pattern of weather and farm income next year. Reported real GDP growth should be in the 1.7% to 2.0% range for 2012 and in the 2.5% to 3.0% range for 2013, including the drought effect. Excluding the effect of the recent drought, which we regard as likely to be a one-time special factor, we expect real GDP growth for the rest of the U.S. economy of about 2% in 2012 and 2.5% in 2013.

The rough size of the fiscal cliff of tax increases and spending cuts scheduled to begin January 1, 2013 is about 4% of GDP for the Federal fiscal year ending September 30, 2013 and about 5% of GDP for calendar year 2013. Fears of the fiscal cliff appear to be having the most negative impact on orders for postponable capital goods, including large trucks and various equipment categories. We assume that, in the end, fiscal tightening in 2013 will be only about 1% to 1.5% of GDP, much less severe than the fiscal policy embedded in current law. However, the political path to avoiding the fiscal cliff is unclear. It is uncertain whether the fix for the fiscal cliff will become law before or after the scheduled tax hikes and spending sequesters go into effect. We believe that uncertainty about the fiscal cliff is already acting as somewhat of a drag on current economic activity.

Three key fiscal issues are distinct: (1) the potential cyclical shock of abrupt fiscal tightening in early 2013, due to the fiscal cliff of tax hikes and cuts in Federal spending, (2) the details of the new tax rules for 2013 and beyond, and (3) the persistent uptrend in Federal debt as high budget deficits are forecast to persist for many years. We expect eventual legislative action to mitigate the potential short-term cyclical shock of the fiscal cliff. However, we are more skeptical that a major "grand bargain" can be achieved after the election to deal with both the long-term debt problem and the future tax regime. A less impressive "small bargain" may prove more likely. The political pressures to make major compromises on long-term budget priorities are limited since current budget deficits are easy to finance, given weak private sector credit demand and exceptionally easy monetary policy from the Federal Reserve. Easy monetary policy and low interest rates are enabling the two political parties in Washington to postpone making key fiscal decisions. However, we doubt that fiscal policies will be dysfunctional enough to generate a recession. We expect several more years of a recuperative economic expansion.

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