Outlook and First Quarter 2011 Review

In the first quarter of 2011 the U.S. economy suffered through unusually bad weather, unrest in the Middle East, disruptions due to the earthquake and nuclear disasters in Japan, and spikes in oil prices. Real GDP growth for the quarter was a disappointing 1.75%, according to the advance estimate from the Bureau of Economic Analysis. GDP growth on a year-over-year basis was 2.3%. The housing and labor markets have yet to provide consistent support for economic expansion. There is no clear bottom to housing prices and downward pressure on prices from foreclosures and short sales continues. Job growth in the first quarter created some optimism for an improved labor market, but the unemployment rate moved back to 9% as workers re-entered the labor force faster than new jobs were created.

Inflation measures offer mixed signals. Core inflation measures for the CPI and PCE remain low but the top of the line measures show creeping inflation beyond the Fed target of 2.5%. Even without the classic definition of high inflation (rise in the overall index), consumers are forced to make hard choices to substitute higher portions of their budgets to energy and food while paring down spending on other goods.

Over the past three years monetary and fiscal policies created large government stimulus spending, rapid growth in bank liquidity, and historic low interest rates. Nevertheless, the economy's response to these massive moves has been disappointing. Low interest rates have not prevented declining housing asset prices nor have they stimulated consistent investment by the private sector. Companies have maintained profits by cutting costs, especially labor costs. They have good cash positions and have exhausted labor productivity gains, suggesting that hiring will improve. Business and consumer confidence is improving, but it is fragile. Uncertainty over the future of taxes, costs of benefits, and unknown details about regulatory initiatives encourage firms to delay long run commitments. Fiscal policy is likely to be neutral, if not contractionary, as deficit reduction takes center stage. Monetary policy will end its second round of expansion by mid-summer and will likely be neutral until early 2012 when higher interest rate policies may be necessary to prevent inflation beyond the 2.5% target. The question is whether or not a self sustaining recovery can emerge without expansionary policy tailwinds.

Prospects for economic growth in the remainder of 2011 now look dimmer than they did at the start of the year. Growth for 2011 is likely to be in the 2.5% to 3% range with very modest improvement in the unemployment rate to 8.8%. Interest rates are most likely to move up slightly as modest inflation pressures, improved private sector demand for credit, and neutral monetary policy phases in. Price pressures currently developing in the wholesale and producer levels of the economy should filter through to higher overall inflation in the 2.75 to 3% range. Relief in energy prices will be modest at best and households will be forced to either cutback on other forms of consumption or reduce the 5% savings rate that has been achieved.

The Reality of Federal Debt and Debt Reduction

Traditional Debt Burden Analysis

Federal debt reduction is the focal point for both the political debate that will dominate 2011 and 2012 and the future of financial markets. The great recession from December 2007 to June of 2009 is over but the recovery has been slow. Fiscal stimulus from budget deficits on top of growing entitlement expenditures helped propel federal debt levels to post-World War II highs. Table 1 shows annual real GDP and the corresponding ratio of Federal Debt to GDP.

Table 1. Annual Change in U.S. Real GDP and the Ratio of Federal Debt to GDP

Year	GDP in Billions of $s	Federal Debt as % of GDP
1990	5800.5	55.28
1991	5992.1	60.05
1992	6342.3	63.10
1993	6667.4	65.26
1994	7085.2	65.54
1995	7414.7	66.36
1996	7838.5	66.10
1997	8332.4	64.44
1998	8793.5	62.30
1999	9353.5	59.93
2000	9951.5	56.56
2001	10286.2	56.09
2002	10642.3	58.24
2003	11142.1	60.67
2004	11867.8	61.97
2005	12638.4	62.55
2006	13398.9	63.07
2007	14077.6	63.58
2008	14441.4	69.15
2009	14119.0	84.11
2010	14508.2	93.25

Gross domestic product (GDP) is a measure of the dollar amount of total output for the economy in a given year. The most common measure of the debt burden for a country is the ratio of debt to GDP, which is a type of coverage ratio. A low debt-to-GDP ratio suggests solvency and sovereign debt capacity in case increased deficit spending should be needed in the future. A critical first step in analyzing the debt-to-GDP ratio is to fully understand what is included and excluded from the definition of debt. The definition of government debt used in the popular press often confuses federal debt with public debt. Federal (Gross) debt includes federal government debt held by the public, federal government debt monetized and held by the Federal

Reserve due to open market security purchases, and intra-government debt (such as Social Security IOUs). The total Federal Debt as of February 2011 was $14.2 trillion. This is the number used to calculate the 2010 Debt to GDP ratio of 93.25% in the table above. Many sources only use the public debt component of the total debt when they calculate the debt to GDP ratio. The problem with this approach is that the Federal government borrows from trust funds like the Social Security Trust Fund and the Civil Servant Retirement Fund and is obligated to pay back by either raising taxes or suspending contracted payments, much like any other form of debt. In a similar manner, debt held by the Federal Reserve is a contractual obligation of the government and is an earning asset supporting the Fed's liabilities.

Table 2 shows a comparison of debt to GDP ratios for selected countries in 2010 using the two popular measures of federal government debt (Public and Federal). Countries like the U.S. with large amounts of monetary easing and borrowing from entitlement funds will have much higher federal debt to GDP ratios than public debt to GDP ratios. The U.S. ranks 36 in the OECD countries with respect to debt to GDP coverage, which is better than many countries facing a fiscal crisis but much worse than a number of key creditors and trade partners. The Office of Management and Budget forecasts that gross federal debt will total $16.3 trillion by the end of fiscal year 2012. Thus, the projected federal debt will equal 101% of projected gross domestic product, which represents a milestone in the U.S. economy. Public debt alone, which excludes amounts that the government owes its citizens via various trust funds, will be 67% of GDP by the end of fiscal 2012.

Table 2. Rankings and Ratios of Government Debt to Real GDP for Selected Countries

Rank	Country	Public Debt as a % of Real GDP[1]	Federal Debt as a % of Real GDP[2]
1	Japan	225.80	225.8.
6	Iceland	124.8	115.6
8	Italy	119.0	118.4
11	Ireland	96.2	93.6
14	Portugal	93.0	83.1
16	France	81.7	84.2
23	United Kingdom	76.5	76.7
32	Spain	60.1	64.5
36	**United States**	**58.9**	**92.7**
85	Canada	34.0	81.7
111	China	17.5	19.1
121	Russia	9.5	11.1

Sources:

1. The World Factbook, United States, Central Intelligence Agency and Eurostat
2. Public Debt, IMF

The growing debt to GDP ratio for the U.S. is actually worse than it appears. Much like an unfunded pension obligation of a firm, the U.S. has a large unfunded obligation to entitlement programs that are growing rapidly. For example, the present value estimate of unfunded entitlement obligations going into 20010 was $45.8 trillion. This amount represents what would have to set aside going into 2010 such that the principal and interest would pay for the unfunded commitments through 2084. Approximately $7.7 trillion relates to Social Security, while $38.2 trillion relates to Medicare and Medicaid. If we also add the 14 trillion plus national debt and other federal commitments, the total obligations in a present value context would be nearly $62 trillion. This total amounts is not considered in the popular press but is clearly relevant to issues of the U.S. federal government's debt burden.

Why is the Heavy Debt Burden Such an Immediate Problem?

Any approach that hopes to reduce the debt to GDP ratio must achieve some combination of reduced government spending, higher government tax revenues, slower growth in entitlement benefits, and/or more rapid growth in GDP. Rapid GDP growth would be an attractive alternative to lower the ratio, but this is not under government control. Contractionary fiscal policies offer the only viable approach to lowering the deficit and debt growth. These policies must either be put in place today or the magnitude of future contractionary policies must increase. Such policies are very unpopular today during a period of very slow growth in the early stages of an economic recovery and could cause a recovery to stall, or worse yet may tip the economy into another downturn.

There is little disagreement on the point of whether or not debt reduction is needed once the debt to GDP ratio is unsustainable. In the short run, deficit spending and debt accumulation boosts the economy, consistent with the Keynesian theories for managing economic disequilibria that drive most public policy decisions today. But, chronic deficits are not due to temporary disequilibria in the economy. At some point, debt must be repaid, or at least creditors must believe that it can be repaid. If not, confidence in the country's currency and debt erodes and a currency crisis can occur. Even if this crisis doesn't materialize there will at least be a higher expected return from holding government debt due to risk and due to the imbalance of demand for credit relative to the supply of credit (foreign credit in the case of the U.S.). Domestic growth is affected by higher real interest rates that crowd out private spending and investing. GDP growth is slowed, making the ability to cover debt worse. Future generations will either pay higher taxes or suffer from large cuts in government expenditures in order to keep the debt to GDP ratios reasonable.

The concern over the rising debt to GDP ratio is not just a theoretical argument. Reinhart and Rogoff ("Growth in a Time of Debt," *NBER Working Paper* no. l 15639, January 2010) conducted a study of 44 countries over a two hundred year period and found that there is a threshold effect for the public debt to GDP ratio. Once this ratio hits 90%, the median growth rates falls by 1% with more dramatic declines for many countries. Another potential economic problem that can take place with growing debt burdens is a resort to high rates of inflation to reduce the debt burden by paying fixed cost obligations with depreciated currencies. Slower future growth and/or high rates of inflation are not attractive alternative for failing to address deficit spending today.

Behind the Numbers - How Much Progress Can we Expect on Debt Reduction?

A simple math problem illustrates the quandary of trying to achieve debt reduction rather than just deficit reduction. The following relationships determine the public debt to GDP ratio for the next period given the current level of public debt (8.4 trillion), the current level of GDP (1.4 trillion), a current public debt/GDP ratio of .6, a 3% GDP growth rate (optimistic), a 3% average rate of interest paid on public debt, and a whopping 10% reduction in the federal deficit.

[Old Debt + Deficit + New Interest owed on Debt] / (Old GDP + Growth in GDP) = Debt/GDP

[8.4 trillion + (.9)(1.4 trillion) + .03(8.4 trillion)] / (14 trillion)(1.03) = .683

A healthy 10% reduction in the deficit led to a public debt to GDP ratio of .683 from a ratio of .6. The point of this example is that deficit reduction is not sufficient to halt the growth of the debt to GDP ratios. There must be debt reduction (surpluses) or unreasonably high growth in GDP relative to the interest paid on the debt to bring the debt burden down. At best, the rate of growth of the debt/GDP ratios will be slowed, but it is not likely that it will be reduced.

It may not be realistic to expect serious deficit reduction, let alone debt reduction, when the composition of government spending is considered. Here are a few important points that will make any deficit reduction plan controversial and of limited scope.

- **Mandatory Spending Is the Largest Portion of the Budget -** Over half of the budget is Mandatory Spending required by legislation. Examples include the following
  - Social Security and Medicare.
  - Income support programs such as Medicaid, Food Stamps, Unemployment Compensation, Child Nutrition, Child Tax Credits, Supplemental Security for the blind and disabled, and Student Loans.
  - Retirement and Disability programs for Civil Servants, the Coast Guard and the Military.
  - In FY 2011 and FY 2012, it also included the TARP program, job creation initiatives, and a credit from health care reform.

- **Discretionary Spending Is Negotiated by Congress and the President---**Nearly 40% of the budget is technically discretionary. Discretionary spending is governed by the appropriations that are passed each year, but even here cuts are difficult. Key examples include the following:
  - Military, which is nearly half of the discretionary budget.

- International, which is about 5%, and includes the diplomatic offices and foreign aid.
- Other Discretionary, which includes all other domestic programs.

- **Interest Payments on the National Debt-** Just under 5% of the budget, $240 billion, was for interest payments for the national debt. However, by 2021, interest payments on the debt are projected to increase to $928 billion, or 15% of spending. It will be the fourth largest budget item, after Social Security ($1.3 trillion), security spending ($1.03 trillion) and Medicare ($792 billion).

- **The Percent Allocated to Social Security is Increasing -**The amount for Mandatory programs is increasing thanks to the huge number of Baby Boomers who will be reaching retirement age. The two major senior programs, Social Security and Medicare, went from 28% of the budget in fiscal year 1988 to 34% of the budget in fiscal year 2008. By fiscal year 2021, the OMB projects that these two programs will rise to 35% of total spending. Other Mandatory programs, such as Medicaid, Food Stamps and Unemployment Compensation, will increase from 20% of the budget in fiscal year 2008 to 23% of the budget in FY 2021.

While households and businesses have achieved substantial delevering over the past three years, the likelihood of the Federal government achieving significant deficit reduction, let alone debt reduction or debt to GDP reduction, is small. The magnitude of the deficit and the rigidity of spending options represent difficult obstacles to spending cuts. At some point, there will likely be a push for increased revenues once the spending reduction obstacles have been addressed. The economy is not likely to be strong enough to prevent these moves from being painful.

Summary of Recent Economic Data

GDP - *the first quarter is slow and prompts downward revisions of 2011 growth*

- The advanced estimate of Real GDP growth by the Bureau of Economic Analysis for the first quarter of 2011 was 1.75%. The revised growth rate for the fourth quarter of 2010 was 3.1%. GDP growth on a year over year basis was 2.3%. Real GDP has been positive for seven consecutive quarters but has been below long term targets

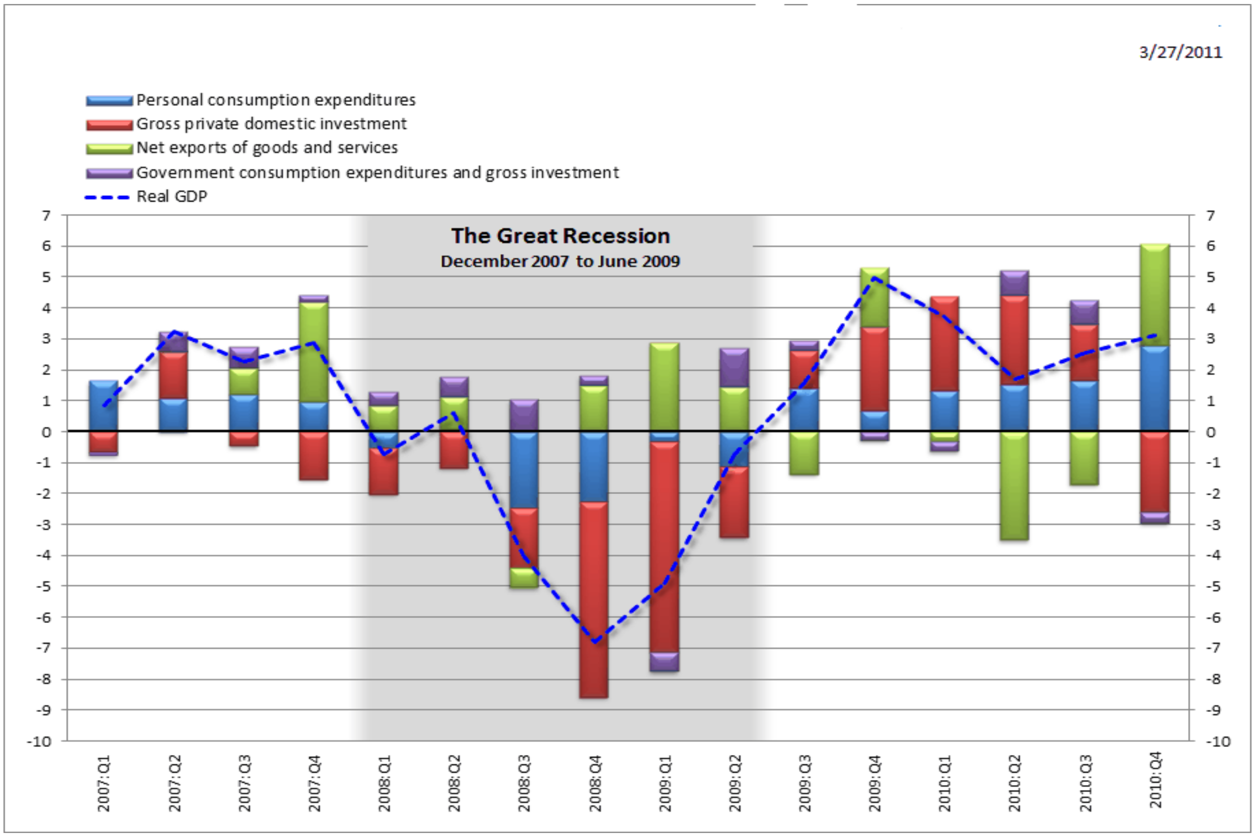
- The increase in real GDP in the first quarter primarily reflected positive contributions from personal consumption expenditures, private inventory investment, and nonresidential fixed investment that were partly offset by negative contributions from federal government spending and net exports.

- GDP minus the change in inventories was only .8% in the first quarter.

- The economy has not been able to establish a consistent driver for the expansion. Consumer spending has been a positive contributor, but has not been strong enough to drive a typical recovery. Fixed investment, especially fixed residential investment, has often been a drag on growth rather than a contributor to growth.

- In most recoveries, a combination of growth in consumer spending from pent up demand and growth in net private domestic investment provide consistent contributions to GDP growth. Figure A below illustrates the changing contributions to growth of each of the GDP components from 2007 through the fourth quarter of 2010. The collapse of the housing market and drag on the economy created by negative fixed residential investment clearly played a key role in the downturn.

Figure A. GDP and GDP Components from 2007 through 2010



- In most recoveries we see consistent contributions from consumer spending (blue bar in Figure A) and gross private domestic investment (red bar). There was an encouraging pattern of positive contributions (although weak) from these two sectors in this recovery until the fourth quarter of 2010 when gross private domestic investment took a nose dive. The consumer continues to provide positive but weak contributions. Net exports (green bar) have helped at times and hurt at times. Government spending (purple bar) has had limited direct impact and will likely be a drag in the future as government spending slows.

Industrial Production – *production pauses and slack remains high*

- Industrial production was flat in April and capacity utilization remained low. Overall demand was weak.

- Durable goods orders picked up in the first quarter following dismal fourth quarter performance.

- The ISM manufacturing index and regional Fed surveys suggest growing strength in production and durable good orders, which apparently began to surface in the first quarter.

- Table 3 below summarizes the monthly increase in new durable goods orders.

Table 3. Durable Goods Orders

	Mar '11	Feb '11	Jan '11	Dec '10	Nov '10	Oct '10
Monthly % change in Durable Goods Orders	2.5	0.7	3.7	-0.6	-0.1	-3.1

- Inventory investment made positive contributions to GDP growth in the first quarter. However, the inventory to sales ratio remains stable at 1.23. The inventory to sales ratio was 1.25 one year ago.

Employment and labor Market Conditions – *job creation improves and labor costs remain low but unemployment doesn't budge*

- Unemployment increased to 9.0% in April from an 8.8% rate in March. Non-farm payrolls posted a healthy increase of 241,000 jobs in April, but the labor participation rate (denominator of the unemployment rate) ticked up enough to increase the unemployment rate.

- First quarter job growth was 500,000, the best since 2006.

- The low labor force participation rate in the economy (only 64.2 % of potential workforce) reflects a large pool of potential workers who no longer are searching for jobs. As the job market improves these potential workers join the official workforce making it difficult to lower the unemployment rate. It is unlikely that a 5.5% "full employment rate" can be reached in the next five years without sustained supernormal GDP growth.

- The ratio of unemployed workers to the total population was 58.4% in April. The April ratio is only .2% above the cyclical low.

- Pressures on labor costs remain low. Average hourly earnings increased only .1% in April following increases of .2% and .1% in the prior two months.

- There has been little change in the average workweek over the past six months. For April, the average was 34.3 hours per week. Use of overtime seems to have hit a plateau.

- A summary of labor market conditions appears in Table 4 below.

Table 4. Monthly Labor Market Data

	Apr '11	Mar '11	Feb '11	Jan '11	Dec '11	Nov '11	Oct '11
Change in Non-farm Payroll (thousands)	244	221	235	68	152	93	171
Average Workweek (hours)	34.3	34.3	34.3	34.2	34.2	34.2	34.3
Average Hourly Earnings (Monthly % change)	.1	.2	.1	.4	0	0	.3
Labor Force participation Rate	64.2	61.2	64.2	64.2	64.3	64.5	64.5
Unemployment Rate	9.0	8.8	8.9	9.0	9.4	9.8	9.7

Source: Bureau of Labor Statistics

- High labor productivity coming out of the downturn has been a key reason for low inflationary pressures and low labor costs, especially in manufacturing. Firms reduced the labor force over the past three years but achieved more output per worker. When it is no longer possible to achieve cost reductions from greater labor productivity, firms will need to hire again to meet increased consumer demand when it develops.

- Table 5 below illustrates the quarterly movement in output per hour and unit labor costs in Non-farm payrolls in general and in the manufacturing sector in particular.

Table 5. Quarterly Percentage Change in Productivity and Unit Labor Costs

	I Q '11	IV Q '10	III Q '10	II Q '10	I Q '10	IV Q '09
Non-farm Business Output per Hour	1.6	2.9	2.3	-1.7	4.6	6.7
Non-farm Business Unit Labor Costs	1	-1	.1	4.9	-4.6	-4.1
Manufacturing Output per Hour	6.3	5.1	2.1	5.2	4.7	6.9
Unit Labor Costs	-3.5	-2.3	.3	-.2	-8.6	-2.5

Source: Bureau of Labor Statistics

- The employment cost index increased only .6% in the first quarter, largely due to the 1.1% increase in benefits. Wages have been growing at a low rate of 2% for the past year, well below the corresponding increase in labor productivity. Table 6 below summarizes the quarterly and annual change in total compensation and the wage and benefits components.

Table 6. Compensation, Wages, and Benefits

	I Q '11	IV Q '10	III Q '10	II Q '10	I Q '10
Total Compensation (Quarterly % change)	.6	.4	.4	.4	.6
Wages (Quarterly % change)	.4	.4	.3	.4	.4
Benefits (Quarterly % change)	1.1	.5	.7	.6	1.0
Total Compensation (% change 1 year ago)	2.0	2.0	2.0	1.8	1.7
Wages (% change 1 year ago)	1.5	1.6	1.5	1.6	1.6
Benefits (% change 1 year ago)	3.0	2.9	2.8	2.5	2.2

Personal Income & Saving – *personal income slows but a 5.5% saving rate is maintained*

- Personal income grew only .1% in January following increases of .4% in February and 5% in March.

- Personal consumption expenditure increased 2.7% in the first quarter following a 4% increase in the fourth quarter of 2010.

- The savings rate remained steady at 5.5% in the first quarter.

- Households continue to payoff credit even while credit conditions are beginning to ease. Table 7 below shows the monthly pattern for household credit and delinquency rates.

Table 7. Household Credit and Delinquency Rate my Month

	Apr '11	Mar '11	Feb '11	Jan '11	Dec '10	Nov '10	Oct '10
% Change in Credit from one year ago	-3.7	-3.5	-3.5	-3.8	-3.8	-3.9	-4.2
Delinquency Rate	6.2	6.52	6.83	6.94	6.88	6.98	7.14

Retail Sales – *stable sales create a base for expansion*

- Retail sales had a stable monthly increase over the past two quarters. Table 8 below shows both the monthly percentage increase and the percentage change form one year ago.

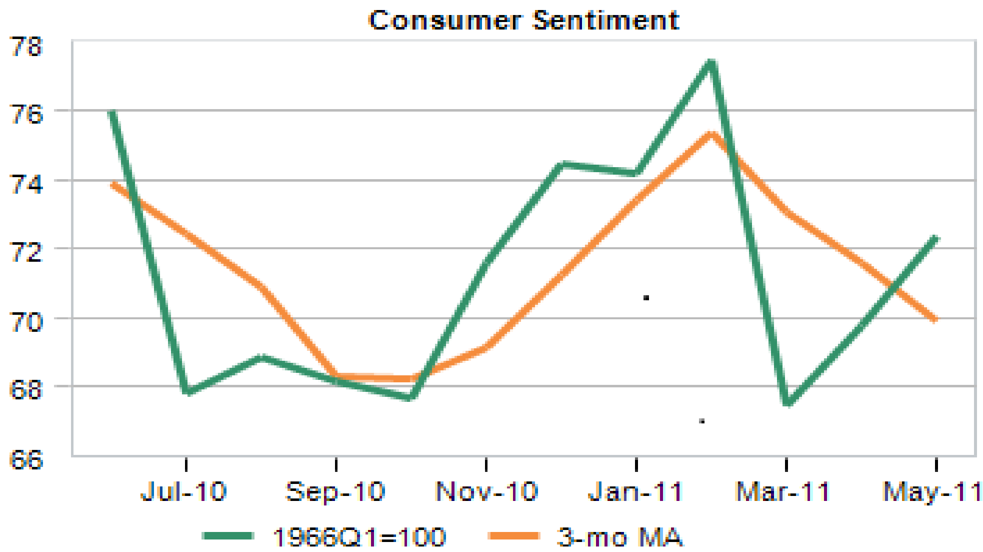
Table 8. Percentage Change in Retail Sales

	Apr '11	Mar '11	Feb '11	Jan '11	Dec '10	Nov '10	Oct '10
Monthly % Change in Retail Sales	.5	.9	1.3	.8	.6	.7	1.3
% Change from One Year Ago in Retail Sales	7.6	7.6	9.1	8.0	7.6	7.5	8.0

Sentiment and Confidence – *confidence is improving but remains fragile*

- The University of Michigan Consumer Sentiment index increased 2.6 points in May. The index reached a quarterly high in February (77) and a low of 66.5 in March. Figure C illustrates the movement of the index over the last year.

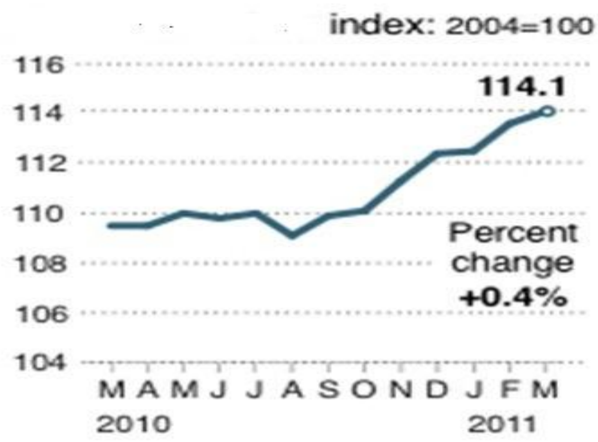
Figure C. University of Michigan Consumer Sentiment Index (1966 = 100)



- The Conference Board Index of Leading Economic Indicators, which measures future economic activity, rose 0.4 percent in March. The index has increased for nine straight months.

- The leading indicators began moving sharply higher last fall, coinciding with a decline in the unemployment rate and a stock market rally. Figure B below illustrates movement in the index over time.

Figure B. Index of Leading Indicators from March 2010 to March 2011



- The ISM Manufacturing Index has remained above 60 for four straight months. The historic average of the index is only 52.7. The index has been on the rise since August 2010. Overall, the ISM index supports an optimistic view for a stronger expansion in the last half of 2011.

- Table 9 below shows the monthly values of the ISM index.

Table 9. Monthly ISM Index

	Apr '11	Mar '11	Feb '11	Jan '11	Dec '10	Nov '10	Oct '10
Monthly ISM index (above 50 suggests expansion	60.4	61.2	61.4	60.8	58.5	58.2	56.9

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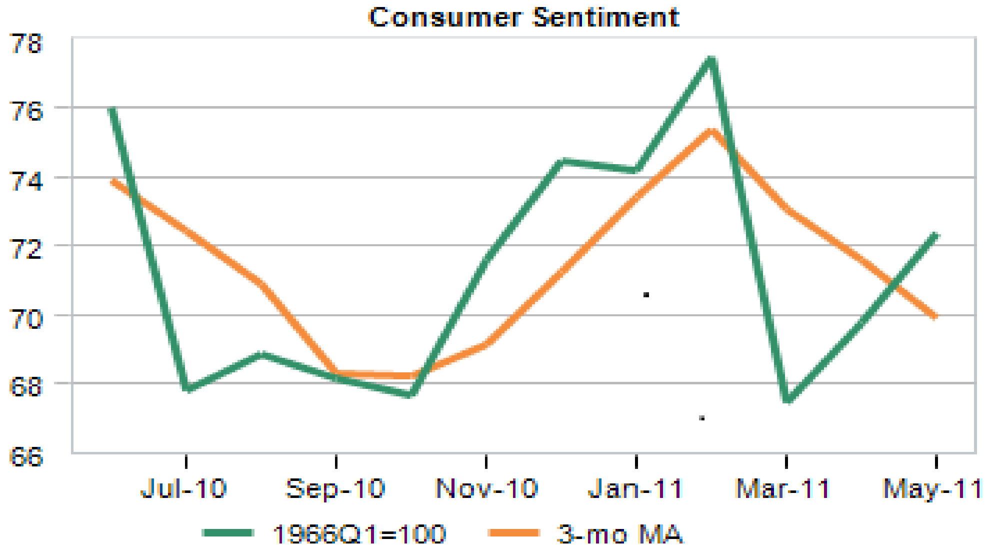


- The Conference Board index of consumer confidence increased in April, partially offsetting the decline in March. Improvements in the labor market were not enough to make up for concerns over higher energy prices. Confidence rose to 65.4 from 63.8 (revised from 63.4) but was still below February's 72. The present situation component led the gain, rising to 39.6 from 37.5 (previously 36.9).

Inflation – *core inflation remains tame but pressures are building at the producer and wholesale level – relative price changes cause tough choices*

- The Personal consumption expenditure index (PCE) increased at a 3.8% rate in the first quarter of 2011 following a 1.7% increase in the fourth quarter. The core PCE (excluding energy and food) increased 1.5% in the first quarter and .4% in the fourth quarter.

- The PCE measure of inflation, the Fed's preferred index, has ticked up. The monthly increase in the PCE is shown in Table 10. While the core PCE, excluding energy and food, has remained flat. This suggests that pressures from energy and food product price increases have not yet leaked into the prices of other goods. Even without overall inflation, consumers are making difficult choices as relative prices change, taking more of their disposable income for energy and food. Eventually, if the cost pressures from higher energy and food prices are not eased, higher overall inflation will occur.

Table 10. Monthly Percentage Change in the Personal Consumption Expenditure Index

	Mar '11	Feb '11	Jan '11	Dec '10	Nov '10	Oct '10
Monthly % Change in PCE index	.4	.4	.3	.3	.1	.2
Monthly % Change in Core PCE Index	.1	.2	.2	0	.1	0

Note: A .4% monthly rate would be $(1.004)^{12} - 1$ annual rate of 4.91% inflation.

- The GDP price index increased at a 1.9% annual rate in the first quarter of 2011 following a .4% annual rate of increase in the fourth quarter.

- While the CPI inflation index remains relatively tame, the year over year rate of producer / wholesale inflation is currently 6.5%. Not all of this price pressure will be passed on to the consumer, but at some point businesses will either pass on price increases to the consumer or will have to absorb them in lower margins leading to lower profitability.

- Table 11 below summarizes a wide range of inflation measures to include consumer and producer price indexes.

Table 11. Monthly CPI and PPI Measures of % Change on a Year-ago Basis

	Apr '11	Mar '11	Feb '11	Jan '11	Dec '10	Nov '10	Oct '10
CPI Index - % Change 1 Year Ago	3.1	2.7	2.2	1.7	1.4	1.1	1.2
Core CPI Index - % Change 1 Year Ago	1.3	1.2	1.1	.9	.6	.7	.6
PPI Finished Goods - % Change 1 Year Ago	6.5	5.7	5.8	3.7	3.8	3.3	4.2
Core PPI Finished Goods - % Change 1 Year Ago	2.1	2	1.9	1.6	1.4	1.2	1.6

International – *global inflation and sovereign risk are important themes and the trade deficit becomes a drag on U.S. GDP*

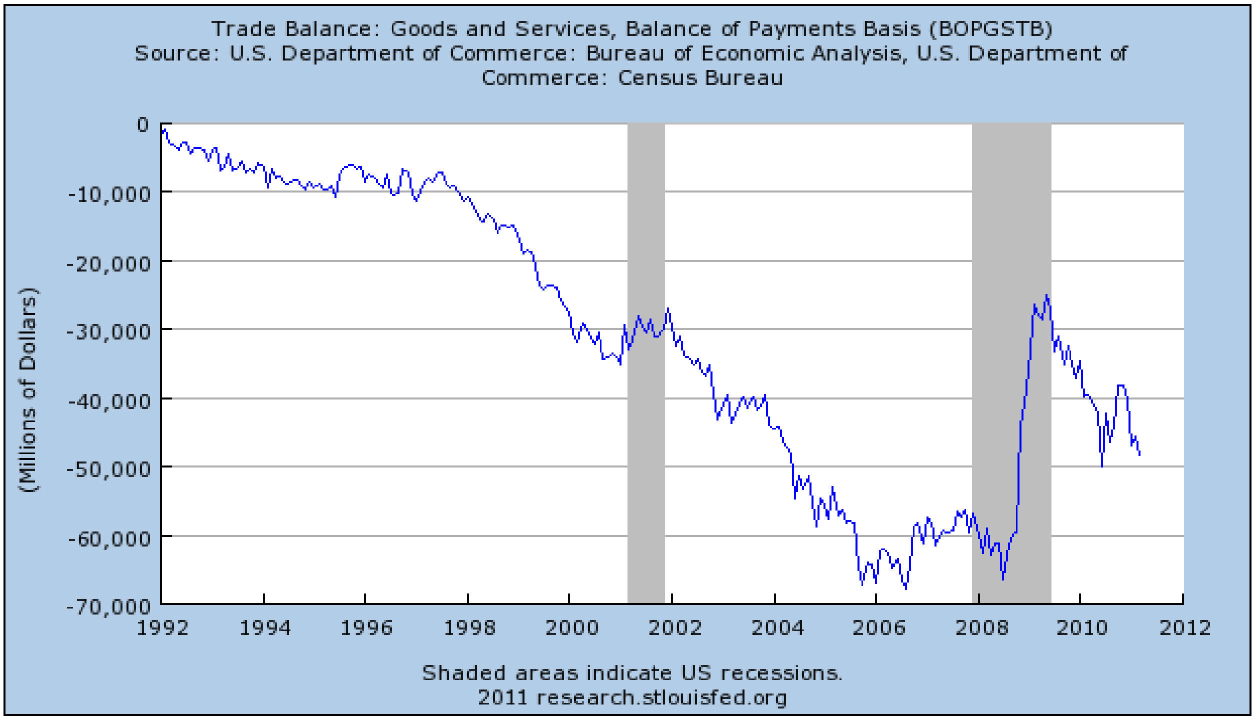
- Rising prices for energy and commodities have had greater influence on overall inflation abroad than in the U.S. Greater uncertainty is reflected in both price and volatility levels. The Nikkei Index fell 6.2% for the quarter and the CBOE Volatility Index (VIX) hit an intra-day high above 31 from the normal 15-16 level for the first two months of the year.

- The Australian banking industry was shaken when Moody's Investors Service downgraded the debt ratings of the country's four largest banks, pushing both the Australian dollar and bank stocks lower. The downgrade to Aa2 is increases the banks' costs just as concern grows over the potential for rising interest rates to hurt profitability.

- Standard & Poor's cut Greece's long-term credit rating to B from double-B-minus. Sovereign debt remains a key source of potential global financial risk.

- The U.S. Balance of Trade deficit improves during recessions as U.S. imports fall faster than exports. Now that the economy is in an early expansion phase, the trade deficit is returning to its long run pattern. While there was a blip of improvement in the last half of 2010, it appears as if international trade will continue to be a drag on the economy. Figure D below shows the trade deficit pattern from 1992 to the present.

Figure D. U.S. Trade Deficit in Millions of Dollars from 1992 to the First Quarter 2011



- The dollar declined in the first quarter of 2011 relative to the Euro (Figure E), remained flat with the Yen (Figure F), and fell relative to the Chinese Yuan (Figure G). A falling dollar should help improve the trade deficit, everything else equal. But the benefits of a declining dollar can easily be offset by relatively lower real interest rates, relatively higher expected inflation, or relatively stronger GDP growth in the U.S.

Figure E. Euros per Dollar Over the Past Six Months – Trending Down

Figure F. Yen per Dollar Over the Past Six Months –Flat and Volatile

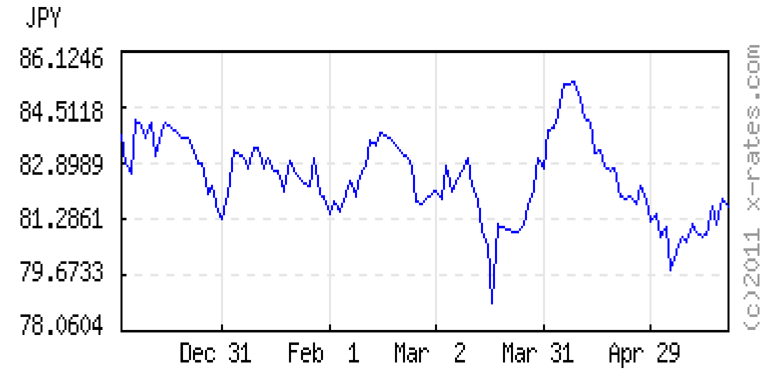
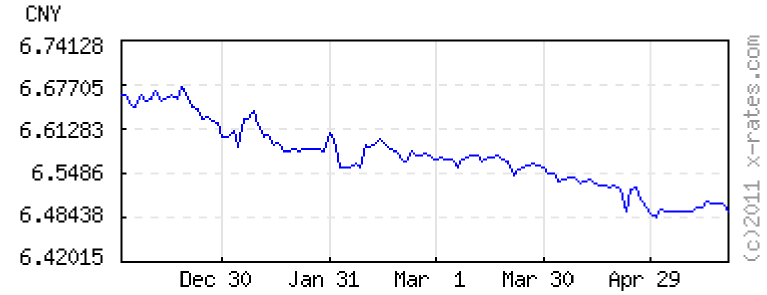


Figure G. Chinese Yuan per Dollar Over the Past Six Months – Trend Down



Housing – *we may not have hit bottom yet*

- Investment in residential structures fell .1% in the first quarter of 2011. Total investment in residential structures is 59% below its peak in 2005.

- According to the National Association of Realtors, pending home sales fell 11.4% in March from one year ago.

- New Home sales fell in January and February but recovered somewhat in March as the Table below illustrates.

Table 12. New Home Sales

	Mar '11	Feb '11	Jan '11	Dec '10	Nov '10	Oct '10
New Home Sales – Millions of $s*	.3	.27	.31	.33	.29	.28
New Home Sales – Monthly % Change	11.1	-13.5	-6.6	16.8	2.1	-11.7
Months of Supply on the Market	7.3	8.2	7.2	6.8	8.2	8.6

Source: Census Bureau

** Seasonally adjusted*

- The National Association of Home Builders index of confidence is currently at its lowest level since the end of 2008.

- The S&P/Case-Shiller Home Price Index through February 2011 shows prices for the 10- and 20-city composites are lower than a year ago but still slightly above their April 2009 bottom.