Outlook and Market Review – Third Quarter 2011

In the first revision of third quarter GDP, the Bureau of Economic Analysis announced that the U.S. economy grew at only 2% in the third quarter. For the year, the real GDP growth was 1.5%, which is well below normal growth in the third year of an expansion. Consumers led the way in the third quarter but spending was not supported by increased disposable income, resulting in a declining saving rate. While delevering has created room for consumers to spend, the rate of spending relative to income in the third quarter is not sustainable. Unemployment remains at 9% but labor markets are positioned to improve as we move into 2012. First claims for unemployment in recent weeks dropped below the 400,000 benchmark that is often used to measure the health of labor market. Job creation is slow for now but unit labor costs have continued to decline to set the stage for more hiring. Inflation eased in the third quarter after picking up earlier in the year. The personal consumption expenditure index has moved back in the range of acceptable inflation. Nevertheless, the misery index, calculated as the sum of the unemployment rate and the inflation rate, is higher than it was during the financial crisis and 2008-2009 recession. The misery index is at its highest point since the early 1980s.

Financial markets continue to be very volatile as both internal and external threats to the U.S. economy build. Europe is facing a recession with a mounting crisis over the ability and willingness to maintain the Euro through bailouts of Eurozone countries. Greece, Italy, Spain, Belgium, and Portugal all appear to need help at this point. A tipping point is approaching where any solution will require more aggressive demands for fiscal policy integration in addition to existing monetary policy integration. This will be contentious and difficult to achieve in the short run. Overall, the European economies are weakening, reflected by recent declines in the Purchase Managers Index (PMI). Yields are rising and talk of a potential downgrade of France's bond rating is picking up. Europe is not the only global problem area for the U.S. The PMI of China is weakening as the government is trying to achieve a soft landing from an over-heated economy. U.S. exports will take a substantial hit if both Europe and China have much lower growth. The Middle East will continue to be a concern with unknown shifts in the balance of power for countries where leadership was toppled. Worse yet, the Iranian nuclear program backed by China and the Soviet Union creates the possibility of pre-emptive strikes by Israel and major disruption of oil supplies.

Internal threats to the U.S. economy are also serious. Fiscal policy will become a drag on the economy as automatic spending cuts kick in due to the failure of the "Super Committee" to structure a long run plan for deficit reduction. While the debate over higher taxes relative to spending cuts continues, no progress has been *made on fundamental problems in entitlement programs and tax reform. The total national debt now exceeds 15 trillion with annual deficits that are approximately 10% of GDP. These underlying conditions and ineffectiveness of the 2009 one trillion dollar stimulus package make it unlikely that a "jobs bill" with a temporary stimulus of approximately 400 billion will have a serious chance of passing.*

Fourth quarter GDP will get a boost from inventory investment and consumers are likely to carry forward strong spending in the third quarter into the fourth quarter. Government will be a drag on GDP but business spending should pick up to take advantage of tax laws ending in 2011. Net exports are not likely to help GDP as much as in the third quarter. Without major unexpected shocks, GDP growth is likely to be in the range of 2% to 2.5%. Inflation has moderated and will remain in the 2.5% range unless there are key shocks to energy prices. The Fed will help keep interest rates down with a flatter yield curve. The Fed is likely to step up purchases of Mortgage Backed Securities in 2012 to lower the spread between Mortgage rates and Treasury rates. The inability of fiscal policy to provide stimulus to the economy will make it likely that the Fed uses monetary expansion in 2012.

European Debt Crisis Contagion

The evolution of the European debt problems started with an implosion of Greece's debt nearly two years ago. Rather than immediate debt restructuring and requirements for banks to raise more capital, the problem was allowed to fester. In addition, short selling was banned leaving only outright sales of bonds to avoid sovereign risk. These conditions exacerbate the move in rates and bond prices when countries are in trouble servicing debt.

What started out as a debt crisis in Greece is now threatening the core of the Eurozone. Agreements to bail out Greece earlier in the year have been contentious with the Greek population, but the scale of the problem was within the resource capacity of member countries. Political support for the bailout conditions firmed in Greece with a new government. But, with lightning speed the attention on the debt crisis moved from Greece to Italy making the magnitude of the problem much more serious. Italy is the eighth largest economy in the world, making the combined debt of Greece and Italy a daunting bailout amount. The problems run deeper. Mounting trouble is occurring in Spain where a lack of confidence in banks is creating disintermediation with a rapid pace of bank deposits flowing out of the banking system and a corresponding increase in yields. Belgium debt is also now very unattractive with the spread between Belgium and German debt reaching 350 basis points.

The debt problems in Greece, Italy, Spain, Portugal, and Belgium may have reached a tipping point where the core countries of Germany and France are now approaching a crisis. Fitch recently announced that the debt rating of France may be downgraded in the near future. Germany had a dismal bund auction recently where only half of the offering received bids. Higher yields will be needed to attract investors in reaction to the perception of higher risks even for the core countries of Europe. The disastrous bund offering in Germany on the 23rd of November of this year is most likely related to pessimism of European bailout plans rather than a direct reflection of German economic conditions. The magnitude of the sovereign debt crisis is enormous. For example, the U.S. crisis was tipped by about three trillion dollars of bad debt linked to loans. In Europe, the sovereign debt holdings are approximately 30 trillion dollars. Banks holding these securities may be looking at massive haircuts even if defaults are avoided.

The Eurozone was created to achieve the desirable conditions of free trade and a stable or fixed exchange rate for member countries. These conditions can only be met if both monetary and fiscal policies of all countries are in line with each other. Now the core economies of Europe are faced with plans to backstop overspending members of the Eurozone for what is now an unknown amount that is growing. At a minimum, austerity programs must be put in place to bring fiscal policies of all members back in line to prevent further problems. A common central bank is in place but the current crisis illustrates the necessity of a common integrated fiscal policy across Europe. Only a severe crisis is likely to move member countries to this position. We may be on the threshold of this crisis.

The European debt crisis is raising the odds of a U.S. recession according to research from the San Francisco Federal Reserve Bank by Travis Berge, Early Elias and Oscar Jorda (*San Francisco Fed Economic Letter*). It will be very difficult for the Europeans to get ahead of the problems in the short run without massive money printing on the part of the European Central Bank. Such an expansion of the euro would effectively lower the cost/value of existing euro debt and help stimulate euro exports while lowering imports. But such a move runs counter to Germany's preference for stable prices. Nevertheless, the expansion of money by the ECB becomes more likely if the European economies are in recession.

A growing view is that integration of fiscal policies is unlikely. As a result, we are rapidly approaching the time when either the ECB prints money rapidly or the euro disappears and Eurozone countries get their currencies back, and *then* they print like mad.

Fiscal Drag and Center Stage for the Fed

The Federal Open Market Committee kept monetary policy unchanged in its last meeting. The FOMC notes show that the Fed remains concerned about weak growth and the high unemployment rate and expects inflation to slow. The statement noted that risks are to the downside. The central bank will continue "operation twist" by selling short-term securities over the next year and purchase long-term securities in an effort to keep long-term interest rates low and support growth. Operation twist will flatten the yield curve but not lead to a net expansion of the money supply. The Federal Reserve will also roll over maturing Treasuries and mortgage-backed securities to keep its balance sheet stable. The fed funds target rate will remain in the 0% to 0.25% range.

Fiscal policy will be a drag on the economy as automatic spending cuts occur and taxes effectively go up. The unemployment rate is unacceptably high, and the Obama administration's $400 billion jobs bill was dead on arrival. Under current law, federal fiscal policy will shave 1.7 percentage points from real GDP growth next year. The Fed may need to attempt to offset some of the fiscal drag. With this backdrop the Fed is likely to step up stimulus plans in 2012. The Fed may need to attempt to offset some of the fiscal drag. Unfortunately, a long held view in economics is that monetary policy attempts to influence GDP are short term and not very effective. The Fed is more effective in reigning in the economy than in stimulating it.

In an effort to directly affect mortgage rates, Fed Governor Daniel Tarullo is openly suggesting that the Fed resume large-scale asset purchases with a focus on mortgage and agency-backed securities to bring down mortgage rates. The goal is to narrow the spread between mortgage rates and the 10—year Treasury yield, which has more than doubled since August. While the lower mortgage rates will help the floundering housing market, it is clear that interest rates alone are not the key driver of decisions to buy homes. In order to really have an impact on housing, the Fed would have to announce something significant to get people to buy a home. Even though rates are at historically low levels and homes are at relatively low prices, home sales are sluggish due to structural economic problems that the Fed can't fix.

Summary of Recent Economic Data

- **GDP and Growth** - ***The Bureau of Economic Analysis announced in its first revision that real GDP grew at a 2.0% annualized rate in the third quarter of 2011, down from the preliminary announcement of 2.5%. Over the past year, the economy expanded just 1.5%, well below the pace needed for a strong recovery. Overall, the recovery remains weak and vulnerable to a variety of different external shocks.***

- Real GDP is now above its prerecession peak in the fourth quarter of 2007 and has expanded for nine straight quarters. GDP growth and components of growth are summarized in Table 1 for the last nine quarters.

- Consumer and business demand was surprisingly strong in the third quarter.

- Consumer spending added 1.63% to growth in the third quarter. Personal consumption expenditures rose 2.3% at an annualized rate following a 0.7% gain in the second quarter.

- Fixed nonresidential investment strengthened in the third quarter and added 1.41 percentage points to growth.

- Investment in residential structures rose, but added less than a 0.1 percentage point to growth. While small, this was the second straight increase.

- Inventories subtracted 1.55 percentage points from growth as firms reduced stocks in response to weak demand in the first half of the year.

- The trade deficit shrank in the third quarter. Overall, net exports added 0.2 percentage point to top-line GDP growth.

- Government purchases were flat in the third quarter, with no contribution to growth. An increase on the federal side offset the drag from state and local governments.

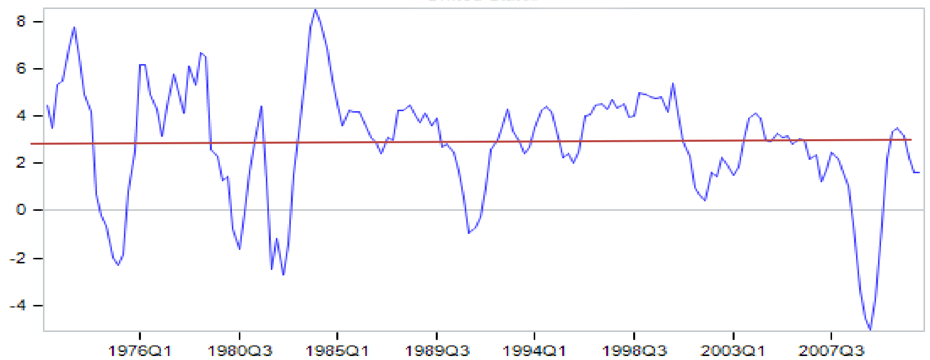
Table 1. Annualized Percentage Change in GDP and GDP Components

	2011 Q3	2011 Q2	2011 Q1	2010 Q4	2010 Q3	2010 Q2	2010 Q1	2009 Q4	2009 Q3
Real GDP	2.00	1.33	0.36	2.35	2.51	3.79	3.93	3.80	1.69
Consumption	1.63	0.07	1.47	2.48	1.85	2.05	1.92	0.33	1.66
Fixed investment	1.45	0.69	0.15	0.88	0.28	2.12	0.15	- 0.42	0.13
Fixed residential	.04	0.08	- 0.06	0.06	- 0.76	0.50	- 0.41	- 0.10	0.42
Fixed nonresidential	1.41	0.61	0.20	0.82	1.04	1.62	0.56	- 0.33	- 0.29
Inventories	-1.55	0.18	0.32	- 1.79	0.86	0.79	3.10	3.93	0.21
Net exports	.49	0.58	- 0.34	1.37	- 0.68	- 1.94	- 0.97	0.15	- 0.59
Government	-.02	- 0.23	- 1.23	- 0.58	0.20	0.77	- 0.26	- 0.18	0.28

Source: Bureau of Economic Analysis

- Figure 1 shows the long run year-over-year percentage change in GDP. Normally, a recovery is more rapid than what we have seen recently. Sustained growth above 2.5% (red line) will be needed to feel comfortable that a significant recovery is underway.

Figure 1. Year over Year % Change in GDP over the Past 25 Years



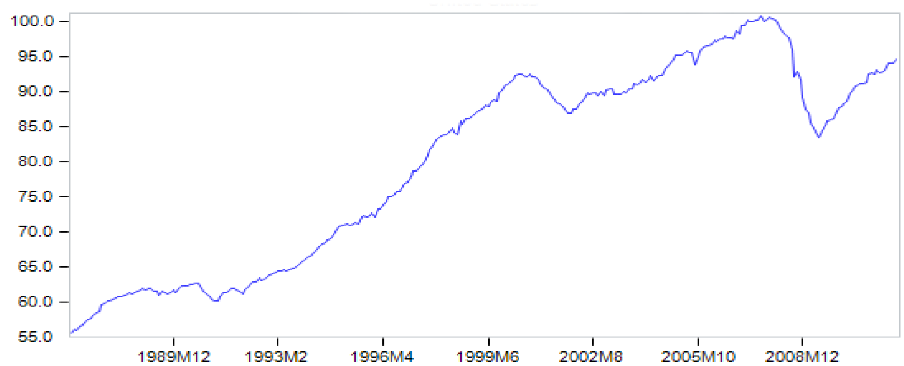
Production – ***Production is slowly approaching the pre-recession levels. Inventories were depleted in the third quarter leaving room for fourth quarter growth.***

- Industrial production increased 0.7% in October following a modest downward revision to prior months. Auto production led an increase in manufacturing of 0.5%, the most since July. Healthy final sales numbers and lower inventory accumulation in the third quarter suggests continued growth in manufacturing in the fourth quarter.

- Weak inventory data for the third quarter were increases the chances of greater inventory investment in the fourth quarter. Real inventories were up only $5.4 billion in the third quarter, the smallest gain in almost two years.

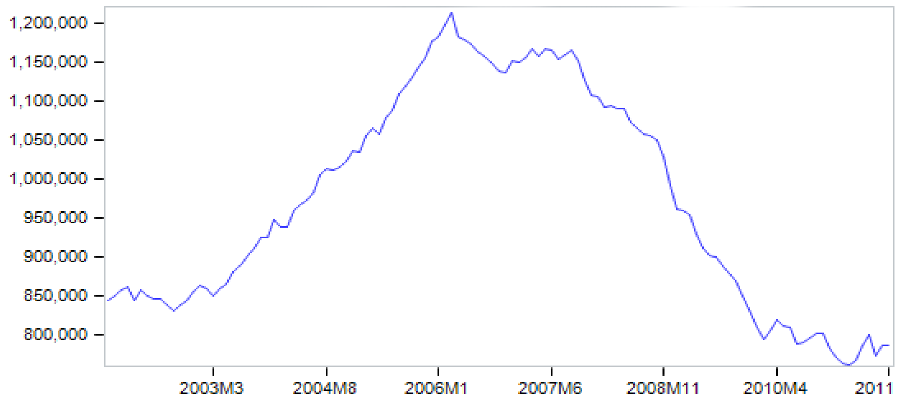
- Production has not yet returned to pre-recession levels. Figure 2 below shows a long run perspective on U.S. production based on a production index of 100 in 2007.

Figure 2. U.S. Industrial Production Index since 1985 (Index = 100 in 2007)



- Construction spending for September increased 0.2% above its revised August level, though it is still 1.3% below its September 2010 level. The increase in total spending was led by increases in private residential and nonresidential spending, though public construction spending is still falling. The revised August and September data confirm that total construction spending is on an upward trend, though still being pulled down by public spending cuts. Figure 3 shows the time series for dollar construction.

Figure 3. Construction Put in Place in Millions of Dollars (Seasonally Adjusted)

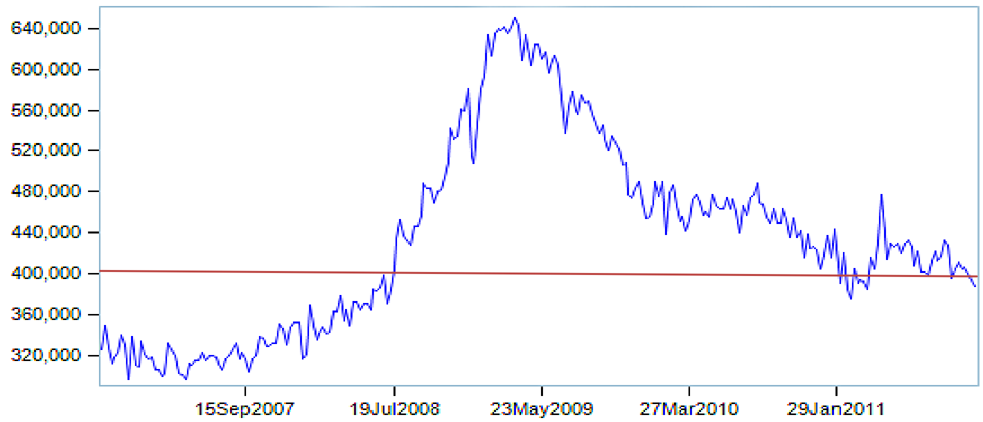


Source: Bureau of the Census

<u>Unemployment</u> – ***Conditions are improving but there is a long way to go. Low unit costs of labor will help stimulate hiring when sentiment and forecasts of the future improve.***

- Figure 4 illustrates changes in initial unemployment claims over the past five years. Claims fell to 388,000 for the week ending November 12 following 393,000 claims in the prior week. The four-week moving average fell to 396,750,000 from 400,750, marking the first time it has been below the 400,000 threshold (red line) since April.

Figure 4. Initial Unemployment Claims over the Last Five Years



- The unemployment rate fell from 9.1% to 9% in October. Private nonfarm employment increased by 104,000 in October. Total employment rose by 80,000 following gains of 158,000 in September and 104,000in August. Near-term reductions in the unemployment rate may be limited as an improved labor market draws more people into the labor force. Labor force growth has been minimal for several years despite population growth.

- Average hourly earnings for private workers increased by 0.2% in October while the average workweek was unchanged between September and October.

- Continuing claims for the week ending November 5 fell to 3.608 million from 3.665 million. Declining jobless claims brings the four-week moving average to 3.67 million from 3.703 million.

- In September the number of job openings increased to 3.4 million from 3.1 million in August. Both hires and separations increased with hiring of 4.2 million workers while 4.1 million left their jobs. The net gain was small as a result.

- Payroll employment rose by only 80,000 jobs in October but employment gains were revised upward by 102,000 for the prior two months.

- Nonfarm business productivity rose 3.1% in the third quarter, as output increased more than hours. Unit labor costs fell 2.4%. Low unit labor costs should encourage firms to hire as demand increases.

Table 2. Productivity and Unit Labor Costs (Seasonally adjusted)

	2011 Q3	2011 Q2	2011 Q1	2010 Q4	2010 Q3	2010 Q2	2010 Q1	2009 Q4
Non-farm Business								
Output per hour	3.1	**-0.1**	**-0.6**	2.2	2.1	1.2	4.6	5.5
Compensation per hour	0.6	2.7	5.6	0.6	1.9	2.6	1.4	1.2
Unit labor costs	**-2.4**	2.8	6.2	**-1.6**	**-0.2**	1.4	**-3.1**	**-4.1**
Manufacturing								
Output per hour	5.4	**-2.3**	4.2	4.9	2.1	5.2	4.7	7.3
Compensation per hour	0.6	3.0	4.1	2.3	1.7	3.8	**-2.7**	3.1
Unit labor costs	**-4.6**	5.5	**-0.2**	**-2.5**	**-0.5**	**-1.3**	**-7.1**	**-3.9**

Source: Bureau of Labor Statistics

Consumer Spending, Income, and Debt - *Savings fell in the third quarter as the rate of consumption exceeded growth in personal disposable income. Revolving credit (credit card) balances declined but consumers increased the use of non-revolving credit.*

- Consumers spending made a strong contribution to aggregate demand in the third quarter, even with relatively weak income growth. Nominal consumer spending rose 0.6% and real spending rose 0.5%.

- Personal income increased only 0.1% while real disposable income fell 0.1%, its third consecutive decline. The result was a plunge in savings from 4.1% to 3.6%. As recently as June the saving rate was 5.3%. Overall prices rose 0.2% while core prices were unchanged. Monthly data on personal income, consumption, inflation, and the saving rate appear in Table 3.

Table 3. Personal Income and Saving (Percentage Change from 1 year Ago)

	Sep 2011	Aug 2011	Jul 2011	Jun 2011	May 2011	Apr 2011	Mar 2011	Feb 2011
Personal income	4.4	4.3	5.0	5.3	5.3	5.6	5.9	6.0
Consumption	5.3	4.9	5.2	4.7	4.9	4.9	4.7	4.7
PCE deflator	2.9	2.9	2.8	2.6	2.6	2.4	2.0	1.8
Savings rate, %	**3.6**	**4.1**	**4.5**	5.3	5.0	5.0	4.9	5.0

Source: Bureau of Economic Analysis

- The Personal Consumption index, the Fed's preferred measure of inflation, has remained at a 2.9% annual rate in September. The inflation rate has ticked up on a rather consistent basis since the start of 2011.

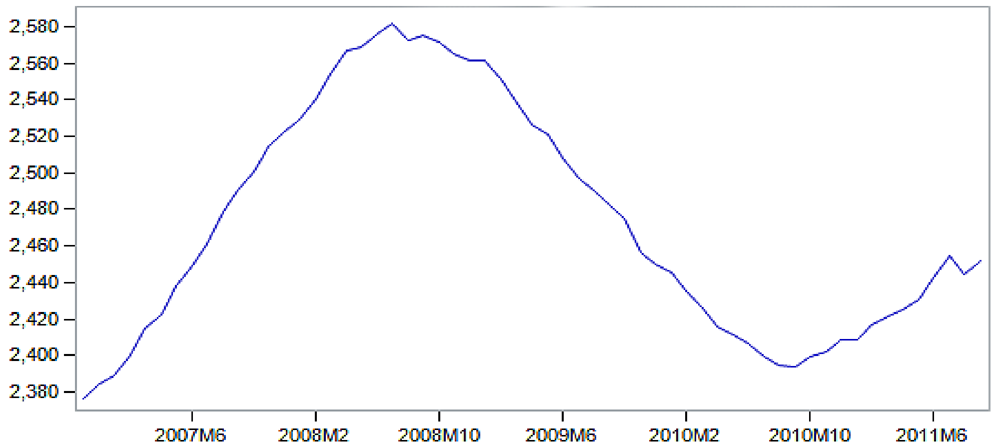
- Consumer credit conditions are improving but at an uneven pace. The rate of delinquency and debt balances both declined in October while default rates (including bankruptcies) held steady. On a year-ago basis, consumer credit balances were 2.6% lower in October. Lending standards appear to be easing slowly and the demand for credit is picking up.

- Consumer credit increased by $7.4 billion in September, which is the 11th increase in 12 months. The September rise was due entirely to an $8 billion rise in non-revolving credit. Growth in non-revolving credit slowed to an annualized pace of 3.9% over the three months through September

- In percentage terms, consumer credit rose 0.3% in September. The time series of consumer credit appears in Figure 4. Consumers have clearly delevered since 2008, but there is a trend of increasing use of debt in 2011.
- The September rise was due entirely to an $8 billion increase in non-revolving credit. Growth in non-revolving credit slowed to an annualized pace of 3.9% over the three months through September.

- The rise in non-revolving credit was partially offset by a decline in revolving balances. Revolving credit, which consists of credit card usage, is declining largely due to persistent troubles in the labor market weighing on consumer confidence. High unemployment and economic uncertainties have prompted households to keep debt in check rather than spend on non-necessities.

Figure 5. Total Consumer Installment Credit (Billions of $s, Seasonally Adjusted)



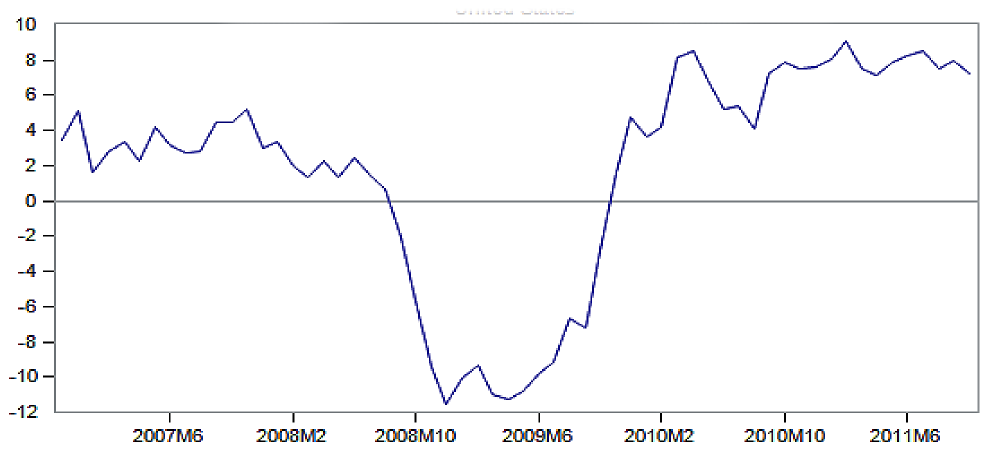
- Consumers are improving their balance sheets, but spending grew 7% in September as the savings rate fell. As consumers spend faster than their incomes, demand for credit will likely grow faster.

- Despite improvement in the trajectory of the labor market, weak job growth and high unemployment are making it difficult for consumers to pay their bills. Disposable income is even weaker than wage income as transfer income has about stopped growing and tax payments are rising.

- Strict lending standards helped the deleveraging of households. The quality of new loans is good leading to lower defaults and bankruptcies. The overall quality of loans in lender portfolios is improving as bad loans originated before the recession are eliminated through either the default process or amortization.

- Figure 6 illustrates the year-over-year percentage change in retail sales. Retail sales rose 0.5% in October. While sales were down by 1.1% for September, it was the second strongest growth since March. Year-over-year growth slowed to 7.2% in total. Consumer spending started the fourth quarter on a brighter note than anticipated.

Figure 6. Retail Sales Year-over-Year % Change



- Wage income is growing slowly. In September, wage income was only 3.7% above its year-ago level in September. Disposable income growth is even slower, despite temporarily reduced payroll tax withholdings, because tax payments have risen rapidly and transfer income is falling. Fortunately, debt payments are down and the pace of deleveraging is gradually slowing, increasing available cash.

- Personal bankruptcy filings fell in the third quarter. The year-over-year decline accelerated further to 15.4% as the result of the improving economy and tight lending standards.

Inflation – ***Inflation picked up in the first part of 2011 but now shows signs of easing. Third quarter inflation was at the threshold of the Fed' s target but weaker producer prices suggest slower inflation going forward.***

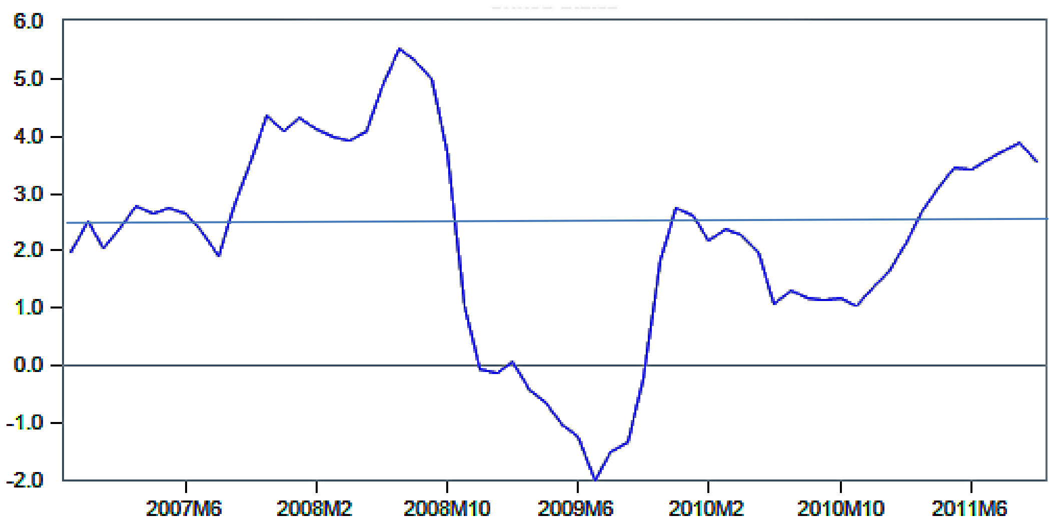
- The overall GDP price index increased at an annualized 2.5% rate in the third quarter, matching the rate for the second quarter. The Personal Consumption Expenditure price index rose 2.9% annualized in the third quarter.

- The Federal Reserve's preferred inflation measure, the core PCE deflator, which excludes food and energy prices, increased at an annualized 2.4% rate in the third quarter. The PCE deflator grew at a 3.3% rate in the previous quarter.

- After several months of relatively high headline inflation, the consumer price index fell 0.1% in October. The decline was largely due to lower energy prices. Excluding food and energy, the CPI rose 0.1% for the second consecutive month. October's gain leaves the core CPI up 2% on a year-ago basis. If core inflation remains low relative to the Fed target of 2.5%, the Fed is likely to continue monetary stimulus.

- The year-over-year growth in the Consumer Price Index over time appears in Figure 7. October's decline in the CPI lowered year-over-year growth from 3.9% to 3.6%. This was the first decline in year-over-year growth since June and the largest since June 2010.

Figure 7. Consumer Price Index Year-over-Year % Change (Seasonally Adjusted)



- Producer Prices fell 0.3% in October following September's 0.8% increase. Excluding food and energy, producer prices were unchanged in October, a deceleration from September's 0.2%.

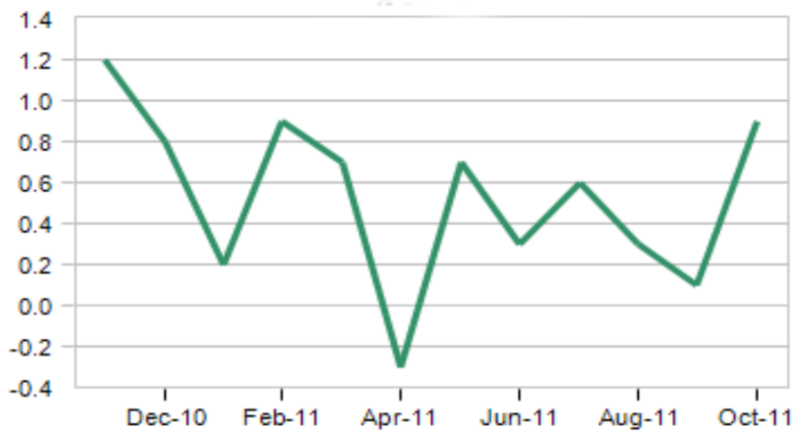
Sentiment - ***Consumer spending was stronger than expected in the third quarter even as sentiment about the economy remained pessimistic. Confidence alone does not drive long run spending, but there was little improvement in other important measures affecting spending. Jobless claims, financial market performance, and housing prices did not improve enough to explain the spending boost to the economy in the third quarter. Consumers are becoming more sanguine about the outlook for inflation and more convinced low interest rates will persist. With corporations still flush with cash and substantial pent-up demand, the economy continues to grow, but at a very low rate. Both internal and external threats to the economy are substantial.***

- The Conference Board index of leading indicators increased by 0.9% in October after rising 0.1% in September. Instead, the declining spread between long and short term interest rates (reflecting lower expected inflation) pulled the index into positive territory.

- As Figure 8 below illustrates, the index of leading indicators has been "choppy" without a clear trend. However, consecutive increases in September and October may foreshadow economic improvement in 2012 if the pattern continues throughout the rest of

2011. Normally, a pattern of at least five consecutive months of improvement is required for a signal of economic improvement.

Figure 8. Conference Board Index of Leading Economic Indicators (Monthly % Change)



- Table 3 offers more detail on monthly movements of the Index of Leading Indicators. The six-month annualized rate of increase in the index fell to 3.7% from 4.8%.

Table 3. Conference Board Leading Indicators (2004 = 100)

Leading Indicators	**Oct 2011**	**Sep 2011**	**Aug 2011**	**Jul 2011**	**Jun 2011**	**May 2011**	**Apr 2011**	**Mar 2011**
% Change (Monthly)	0.9	0.1	0.3	0.6	0.3	0.7	-0.3	0.7
% Change (3 Mo. Moving Average)	0.4	0.3	0.4	0.6	0.3	0.4	0.4	0.6

Source: The Conference Board

- Table 4 provides data on monthly movements in the University of Michigan consumer sentiment index. The index rose by 3.3 points in November following an improvement of 1.5% in October. Nevertheless, confidence is low and has fallen about 13 points from the start of the year. A lack of confidence in the economy continues to be a drag on spending and growth. Long run expectations for inflation in the Michigan survey continue to decline slowly. The one-year expectation for inflation fell to 3.2% in November from 4.6% in March. The five-year expectation declined to 2.6% from 3.2% in March.

- The University of Michigan confidence index is particularly sensitive to household wealth and finances. Finances are improving gradually with lower debt levels and a slow improvement in access to credit. Wealth improved over the last two years but has fallen since spring. Housing remains a significant drag on confidence and it doesn't appear as if housing prices have hit a bottom yet.

Table 4. University of Michigan Consumer Confidence Index (1966 QI = 100)

	Nov 2011	Oct 2011	Sep 2011	Aug 2011	Jul 2011	Jun 2011	May 2011	Apr 2011	Mar 2011
Overall Index	64.2	60.9	59.4	55.7	63.7	71.5	74.3	69.8	67.5
% Change in Index	3.3	1.5	3.7	-8.0	-7.8	-2.8	4.5	2.3	-10.0
1 yr. Inflation Expectations	3.2	3.2	3.3	3.5	3.4	3.8	4.1	4.6	4.6
5 Yr. Inflation Expectations	2.6	2.7	2.9	2.9	2.9	3.0	2.9	2.9	3.2

Source: University of Michigan

- Data for the monthly change in the Conference Board index of consumer confidence appears in Table 5. The index declined in October, falling below 40 for the first time since March 2009, in the midst of the recession. The index has dropped nearly 20 points in the last three months and 32 points from its peak in February. The fall in assessment of present conditions was the sixth straight decline.

- Consumers have a lot to be concerned about. Job growth is slow, wages are lagging, stock prices are volatile and fragile, house prices are falling modestly; credit remains tight, and future economic policies with respect to taxes and spending are up in the air. Gasoline prices have stabilized, but at a level more than 60 cents per gallon above last year's levels.

- While inflation expectations were unchanged from September, more consumers expect lower interest rates and stock prices over the next year. In fact, over half now expect the stock market to be lower in a year than it is today. The pessimism in the stock market is the highest since October 2008.

Table 5. Conference Board Consumer Confidence Index (1985=100)

	Oct 2011	Sep 2011	Aug 2011	Jul 2011	Jun 2011	May 2011	Apr 2011	Mar 2011
Overall	39.8	46.4	45.2	59.2	57.6	61.7	66.0	63.8
Present conditions	26.3	33.3	34.3	35.7	36.6	39.3	40.2	37.5
Expectations	48.7	55.1	52.4	74.9	71.6	76.7	83.2	81.3

Source: Conference Board

- According to the Bloomberg consumer comfort index data shown in Table 6., sentiment improved in the most recent week. The index rose to -50 from -51.6 for the week ending November 13. The slight uptick in confidence was supported by gains in all three segments of the index. Although it moved away from its lowest reading of the year, the index remains at a very depressed level. Consumer assessments of the state of the economy (-88.9) fell the most.

Table 6. Bloomberg Consumer Comfort Index

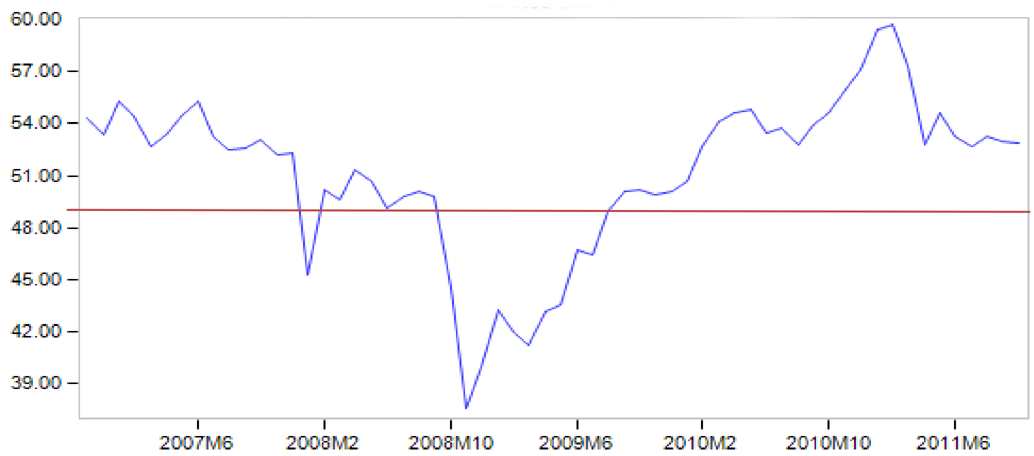
	13 Nov 2011	6 Nov 2011	30 Oct 2011	23 Oct 2011	16 Oct 2011	09 Oct 2011	02 Oct 2011	25 Sep 2011
Overall index	-50	-51.6	-53.2	-51.1	-48.4	-50.8	-50.2	-53.0
State of economy	-88	-88.9	-90.2	-90.0	-85.8	-87.1	-84.3	-86.4
Personal finances	-14.6	-17.4	-16.2	-11.6	-7.7	-11.5	-9.1	-11.6
Buying climate	-47.4	-48.6	-53.3	-51.8	-51.5	-53.7	-57.3	-61.0

Source: Bloomberg News

- Moody's survey metric for the probability that the U.S. economy will be in recession within the next six months fell from 45% to 40% for October. This marks the first decline in the Moody's measure since April but the probability of recession remains elevated near its third quarter average of 39%. Despite October's decline, the probability of recession has risen 10 percentage points over the past year.

- Figure 9 shows the time series of the ISM nonmanufacturing index. The index barely moved in October, coming in at 52.9, compared with September's 53. Inventories fell below their neutral threshold of 50, a positive for future growth. After disappointing in September, the employment index rebounded, rising from 48.7 to 53.3. All told, the ISM index is consistent with an economy operating below its potential but with no sign of recession in the October survey.

Figure 9. ISM Non-manufacturing Index (An Index Above 50 Suggests an Expansion)



Housing – ***Home sales continue to decline and residential construction is flat. On the other hand, a decline in foreclosures and a rise in non-distressed sales prices suggest that the housing market will improve in 2012.***

- Housing is showing signs of life. Permits jumped 11% in October, the fourth gain in the past six months and the largest since December 2010. Multifamily permits rose 24% while single-family permits rose 5% in October

- The CoreLogic home price index fell 1.1% from August to September, and is down by 4.1% from September 2010. However, the home price index excluding distress sales increased 0.3% in September and is down by 1.1% compared with September 2010.

- Home sales slowed substantially in September. Total sales came in at 108,400, a decrease of 27.1% from August and also down by 10% from September 2010.

- Home sales excluding distress sales also fell. Non-distress sales came in at 63,100 in September, down by 35.1% from August and also down by 18.1% from September 2010.

- Residential construction was about flat in October, with housing starts falling 0.3% from September. Single-family starts increased 3.9% on a month over month basis. Completions fell 5.7% in October compared with September and 2.8% compared with October 2010. Permit issuance is more positive, increasing nearly 11% month over month and 18% year over year.

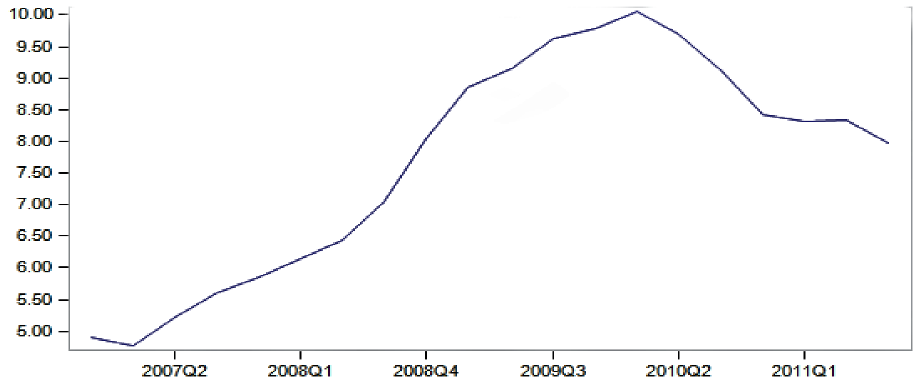
- The NAHB housing market index came in at 20 for November, up 3 points from its revised October level. The index increased by 4 points from its level in November 2010. Builder sentiment appears to be improving as the aggregate index is now at a level not seen since early 2008.

- The NAHB index is still far below 50, which means that most builders still view conditions as poor. Tight lending standards and weak consumer sentiment continue to hurt housing demand, even though mortgage rates are low and homes appear undervalued relative to long-term income and population trends. According to the Mortgage Bankers Association, only about one-fourth of all mortgage applications are for purchases with refinancing making up the bulk of all applications.

- The aggregate mortgage delinquency rate declined from 8.44% to 7.99% in the third quarter, according to the Mortgage Bankers Association. This is the first quarterly decline in the mortgage delinquency rate in 2011.

- Figure 10 shows the time series of mortgage delinquency rates. The aggregate mortgage delinquency rate is down 2.07 percent from the peak, but much higher than the prerecession lows. The recent report suggests that there is room for improvement.

Figure 10. Percentage of Mortgage Loans Past Due



International - ***The trade balance improves but further gains will be difficult as world economies slow and as U.S. imports increase with expected inventory building.***

- The U.S. trade deficit in September was smaller than expected. Net exports appear to have contributed around three-quarters of a percentage point to real GDP growth. The trade deficit over time is plotted in Figure 11.

- While the narrower trade deficit is a positive for third quarter growth, the important message for near-term performance is the improvement in export growth. With the September gain, merchandise export volumes are up 24% at an annual rate over the last three months. The last time growth was very early in the recovery, when export volumes were still about 15% below their prior peak. Exports now stand just over 2% above their prerecession peak.

- Trade flows typically respond to final demand with a lag of about a quarter, so it is likely that there is damage from the recent slowing in global growth that has yet to show up in the trade data. Moreover, with Europe representing around 15% of U.S. exports, the weakening taking place in that region will undoubtedly depress exports in the months ahead. Still, the data do raise the hope that growth in the rest of the world will help keep a floor under export growth. An inventory correction in Asia appears to be winding down, suggesting exports to the region may pick up toward the end of the year.

- The strength of domestic demand in the third quarter led to a dramatic slowing in inventory investment. An expected return to somewhat more normal inventory levels this quarter will cause import growth to accelerate as businesses stock their shelves with goods from overseas. The result is likely to be a further narrowing in the growth rates of imports and exports and a smaller positive boost from foreign trade this quarter and early in 2012.

Figure 11. U.S. Trade Balance (Millions of $s, Seasonally Adjusted)