Outlook and Market Review – First Quarter 2012

The U. S. economy continues to muddle along as predicted in prior Outlooks. Annualized first quarter GDP growth was 2.2% in preliminary announcements by the Bureau of Economic Analysis, following a weak 1.7% growth for all of 2011. Over the entire "recovery" period starting in the third quarter of 2009, the economy has averaged only 2.4% growth. Two bright spots in the first quarter GDP report were consumer spending, with a healthy 2.9% annualized growth rate, and a 19.1% annualized growth in the housing sector. Both of these numbers were aided by a warm winter and may have bled spending away from normal spending patterns in the spring. The boost from consumers in the first quarter is likely to be temporary. Disposable income barely grew in the first quarter, forcing workers to save less in order to support spending. After three consecutive months of relatively strong job growth through January of 2012, employers added fewer workers in March and April while a continued slide in the worker participation rate made the unemployment rate look better than it really is. Even so, the unemployment rate is 8.1% as we enter into the third year of this recovery. If the work force participation rate had remained at the March 2012 level, April's unemployment rate would have been 8.4%.

Slower growth in the first quarter reflected sharp cutbacks in government spending and weaker business investment. Nonresidential fixed investment, a measure of business spending on everything from plant and equipment to computers, fell for the first time in more than two years. Spending on equipment and software grew at its slowest pace since the recession ended. Massive monetary easing and fiscal stimulus spending in the early phases of this recovery have now run their course without a strong response from the private sector. A return to more normal government spending and efforts to reduce the deficit are now drags on growth that the private sector is struggling to overcome. Housing prices may have hit bottom in the first quarter, although a very flat bottom is more likely than a rebound. A potential QE 3 (quantitative easing three) by the Fed appeared to be off the table at the end of 2011 but the chances are improving as the economy continues to flounder in the face of less expansionary fiscal policy. In fact, the market's rather muted response to poor first quarter economic performance may be linked in part to increased expectations of monetary easing.

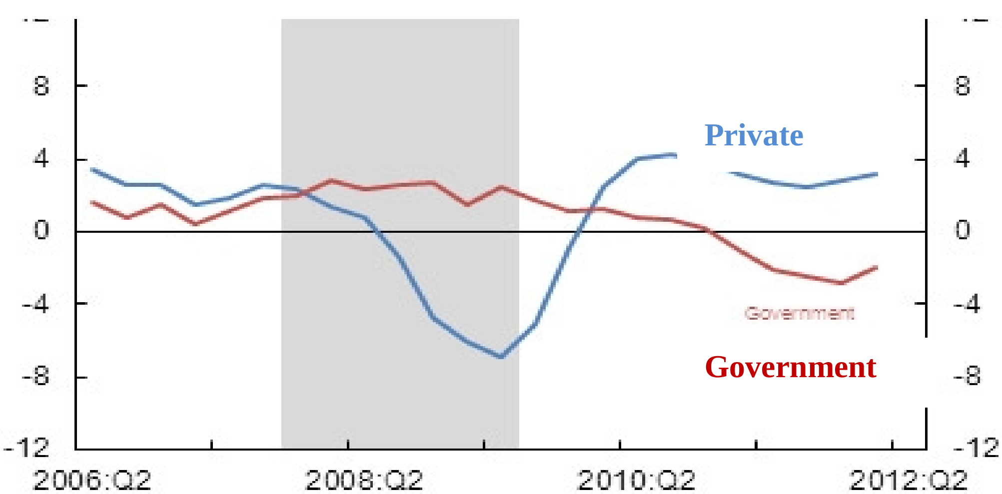
GDP growth is likely to remain in the 2% to 2.5% range for the remainder of the year. The unemployment rate should pick up as the labor force participation rate increases to a normal level. Core U. S. inflation remains modest and weakness in global economies for the remainder of the year should prevent new price pressures. The debt crisis and spreading recessions in Europe will be an added drag on the U. S. economy and equity market. Even with high and growing debt, the demand for dollar *denominated securities should remain strong given the more risky alternatives. Global demand for U. S. securities along with the Fed's announced policies and low inflation should keep interest rates low for the remainder of 2012.*

Near Term Weakness and the "Fiscal Cliff" – *Concerns are growing over a combination of events that will be a drag on the economy in early 2013. The added uncertainty surrounding taxes and government programs will hamper investment.*

Economic performance in the first quarter was especially disappointing because many economists thought the first quarter of 2012 would build on the final three months of 2011 where the economy grew at a 3% pace. At the turn of 2012 consumers showed signs of stronger spending, automakers were rebounding from a slump, and record warm weather across the country meant there would be a lot more construction and other weather-related economic activity. Instead, the first quarter demonstrated that the economy is not able to sustain a normal recovery with growth in the 4% to 8% range.

In a typical recovery from a recession, the private sector rebounds enough to allow the government sector to withdraw stimulus and still post good GDP growth. This is not the pattern of this recession, as Figure 1 illustrates. If government spending had not changed in the first quarter of 2012, GDP growth would have been 3.5%. With government debt now approaching 100% of GDP, we no longer have the luxury of expansionary fiscal policy. In fact we now will see a prolonged period where government spending must trend downward, even though it will remain at a large deficit, to slow the growth of the national debt. This is the price the economy pays for government expansion in earlier periods. The problem is that private spending growth has leveled off below 4% leaving the net growth rate in a disappointing 2% to 2.5% range. If the private sector does not reach a higher growth trend we will see the same general GDP growth results of the first quarter of 2012 for the remainder of the year.

Figure 1. Annual Percentage Change in Government and Private Spending Components (Second Quarter 2006 to Second Quarter 2012)



A comparison of economic performance to potential GDP growth is another way to see how much the economy is underperforming. The government estimates that the annual GDP based on the first quarter of 2012 would be $14.27 trillion if the economy operated at full potential. Actual annual GDP of $13.5 trillion is $768 billion short of potential, illustrating the wealth lost in what should be a robust recovery. The picture doesn't look any better for the next quarter of 2012. Government spending will continue to be a drag on the economy and consumer spending is likely to be lower and more in line with disposable income. The balance of trade is also likely to be a bigger drag on growth as the recession in Europe makes it more difficult to sell U.S. goods there and a weaker Euro stimulates more imports into the U.S. Odds are small but increasing for monetary stimulus since fiscal stimulus is out of the question, and it is clear that the private sector expansion is well below a reasonable recovery trend. Energy prices are moderating and inflation is low enough to allow room for the Fed to maneuver.

While the rest of 2012 is in line for slow growth, a cloud hangs over the outlook for 2013. At the end of 2012 there will most likely be a return to the higher Clinton tax rates while at the same time the payroll tax cut ends, extended unemployment benefits end, and the government continues to reduce military spending just to slow (not end) growth of the national debt. This "fiscal cliff" makes government an even bigger drag on the economy in 2013 and increases uncertainty. In a recent press conference, Fed Chairman Ben Bernanke said the fiscal cliff poses "significant risk to the recovery."

On one hand, slow growth and prolonged unemployment represent a price the economy may have to pay to slow down growth of the national debt. On the other hand, the U.S. may not have the political will to address long term debt reduction, restructure entitlement promises, fully revise the tax code, and avoid new programs that lead to more government transfer payments. This is similar to the political dynamic that is in play in Europe. The option of outgrowing a large debt burden, like the experience after World War II, is not in the cards this time. Conditions are very different from the post WWII period where there was a large pent up demand, technological applications of war time research to peace time abounded, household formation and housing demand boomed, population growth picked up, and rapid investment in infrastructure (real assets) occurred.

Europe in Recession – *Europe offers a real time example of the policy dilemmas posed by overextending debt in one period and coping with the results in a later period. Europe is on the horns of a dilemma with no good solution. Austerity measures designed to help reshape sovereign debt gluttony of the past are also creating a drag on current economic activity. As more European countries enter a new recession, the resolve to deal with the debt crisis is tested and a return to dependence on government spending gains populist support.*

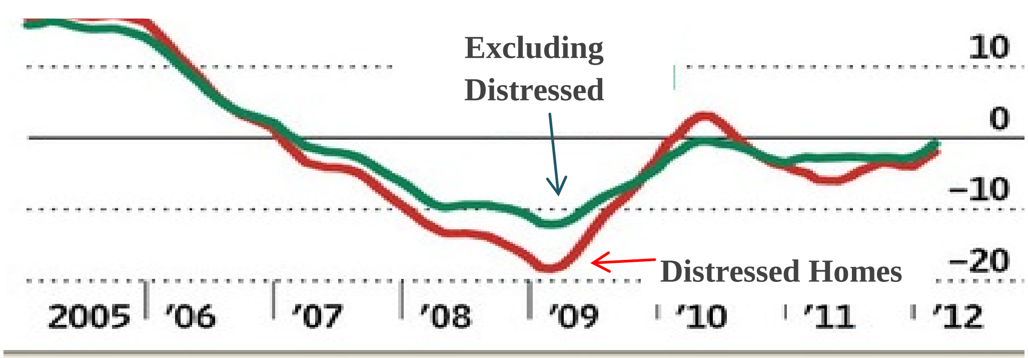
The U.S. equity markets had strong starts in 2010 and 2011 before sovereign debt problems in Europe and a weak economy prompted stimulation from the Fed. This scenario is likely to develop again in 2012. Spain joined seven other euro-zone nations in recession during the first quarter of 2012. Standard & Poor's recently lowered Spain's sovereign debt rating by two notches to double B plus. The banking sector suffered a widespread credit downgrade, putting further pressure on the financial markets. Spain's gross domestic product contracted 0.3% in the first quarter from the fourth quarter following a fourth-quarter contraction of the same magnitude. This is the second contraction in Spain since 2009. Spain joins Greece, Ireland, Italy, the Netherlands, Portugal and Slovenia as ECU countries in recession. Outside the ECU bloc, the U.K., Denmark and the Czech Republic are also in recession.

The worsening economic picture in Europe is causing a swing in support to short run socialist policies that threaten existing agreements required to solve the long term sovereign debt crisis. A growing number of politicians, such as François Hollande in France and Italian Prime Minister Mario Monti, are already calling for a shift in policies toward growth and away from austerity. The extent to which the commitment to deal with the debt crisis will be eroded by policies to improve short run economic conditions is not clear. Nevertheless, the markets have already reacted to the prospects of Greece "renegotiating" their debt agreement. Germany is the key player in the region and currently favors only monetary easing without expanding deficits. Yet, Germany is the only country in the EMU that has the size and capacity to really help the region in the short run by boosting demand. Stimulus in other countries will aggravate the already serious debt condition and may have little long term benefit, especially if spending is geared toward transfer payments and entitlements rather than investment in real assets.

Housing – *How much bounce will there be when it hits bottom?*

The housing market may have hit the long awaited bottom after six years of decline and the question now is whether or not there will be a bounce. Hitting the bottom does not mean that a significant recovery is on the way. New home sales growth in the first quarter of 2012 hit double digits compared to one year ago, but home construction collapsed to such a low level in the past four years that even healthy growth rates going forward must be judged by the fact that the starting base is so low. Relative to the low point of existing home sales after the expiration of the home-buyer tax cuts in mid-2010, first quarter sales represent a 32% gain. Housing prices have not shown the same trend of improvement to this point. Figure 2 below illustrates annual percentage change in the home price index since 2005. When prices of distressed homes are excluded, a prolonged bottom appears to be improving, but the pace will be very slow.

Figure 2. Year-over-year Percentage Change in the Home Price Index



* *Seasonally adjusted annual rate* *Source: National Association of Realtors*

When foreclosures are eliminated, home prices are still falling but without the downward trend. Foreclosures and distressed sales will be a key obstacle to a recovery and may lead to a prolonged flat bottom for the market. At the end of March about 450,000 properties were owned by banks with another two million loans in some stage of foreclosure. The “shadow inventory” of distressed homes will not go away any time soon and lending standards remain tight. The supply of homes for sale nevertheless is falling and interest rates remain at record lows. Investors also continue to convert houses to rentals units at a hefty rate.

Housing is not likely to give the economy the lift it needs for a stronger recovery, but a prolonged recovery will eventually work down the housing inventory to a point where housing prices will bounce back. This bounce is likely to be slow and shallow.

Equity Market Performance – *Not much room to run?*

One of the most important props for the stock market has been record strength in corporate earnings. In general, first quarter earnings looked good. Of the 300 companies in the S&P index that reported, 70% beat analysts' estimates. Profit margins held up but the pace of earnings growth is slowing. S&P 500 earnings are on track to grow only 7.6% from the year-ago-quarter compared to a growth rate of 18.2% at this time last year.

The Operation Twist program of last year shifted the balance of the Fed’s almost $3 trillion portfolio toward long term securities, pushing long term rates lower. This program helped fuel the recent upswing in stock prices. The S&P price to earnings ratio went from 12.5 in September of 2011 to 14.1 at the end of the first quarter. The Fed’s Operation Twist program is scheduled to end in June of 2012. Normally, equity markets flatten out when the Fed ends a stimulus program. The relatively poor showing of the economy in the first quarter opens the door to discussion of added monetary stimulus. While there has been no indication that the Fed is ready for another stimulus package, the combined impact of renewed Euro problems and government spending reductions may force the Fed to consider monetary easing. Pressure for such a move may increase since this is an election year and there will be some fallout from Europe’s struggling economies.

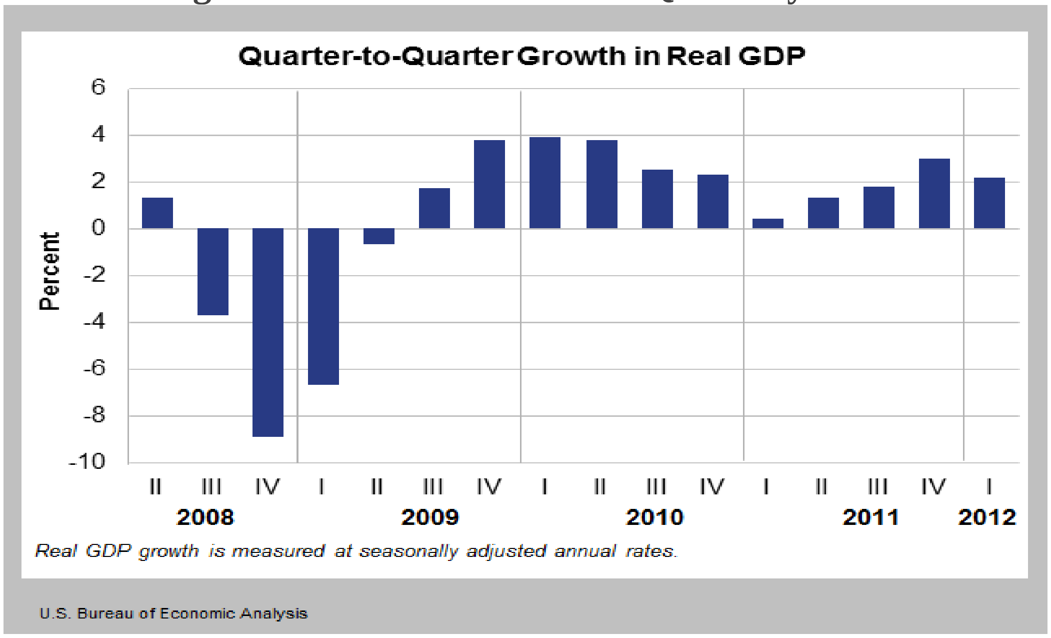
Summary of Recent Economic Data

GDP – *Slow growth is likely to continue with only modest labor market improvements.*

- GDP grew at a 2.2% annual rate in the first quarter, based on preliminary announcements. Fourth quarter 2011 GDP growth was 3% in the final revision. These growth rates are too low to generate the job creation required to significantly lower the unemployment rate.

- Even though the "official recovery" began in the third quarter of 2009, GDP growth has only averaged 2.4% since then. We are not seeing a typical strong trend in post-recession growth rates, as Figure 2 below illustrates.

Figure 2. Post-Recession GDP Quarterly Growth

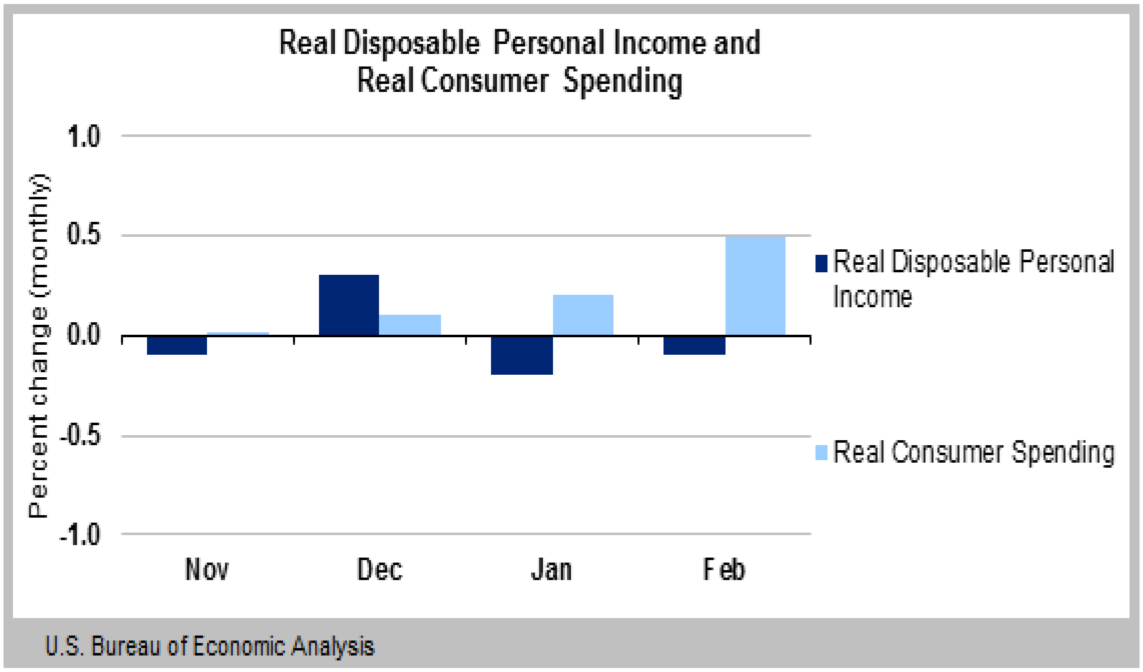


- The biggest drag on the economy in the first quarter came from government spending cuts. Federal government spending declined 5.6%, driven primarily by defense cuts, in the wake of massive stimulus spending in 2009 and 2010. State and local government spending also fell 1.2%. The first quarter marked the sixth consecutive quarter that government cuts have weighed on GDP, and this trend will likely continue even with one trillion dollar plus deficits.

- Retail sales were strong in the first quarter and consumer spending increased at an annual rate of 2.9%. Spending was particularly robust on long lasting items like autos, with durable goods spending rising 15.3% in the quarter. The fluctuation in the data, however, has led many economists to believe the mild winter gave the economy only a temporary boost at the beginning of the year. For example, auto sales may have been unusually strong in January and February, simply because of warmer temperatures.

- Figure 3 below illustrates a fundamental imbalance in the growth of spending and disposable income. It is not likely that consumers can maintain this pace of spending without improvements in disposable income.

Figure 3. Unsustainable Consumer Spending



- Personal income increased $50.3 billion, or 0.4 percent, and disposable personal income (DPI) increased $42.5 billion, or 0.4 percent, in March, according to the Bureau of Economic Analysis.

- Personal consumption expenditures (PCE) increased $29.6 billion, or 0.3 percent. In February, personal income increased $39.6 billion, or 0.3 percent, DPI increased $29.4 billion, or 0.2 percent, and PCE increased $93.7 billion, or 0.9 percent, based on revised estimates.

- Real disposable income increased 0.2 percent in March, in contrast to a decrease of 0.1 percent in February. Real PCE increased 0.1 percent, compared with an increase of 0.5 percent.

- A surge in residential building, helped by unseasonably warm weather, also provided support for GDP growth in the first quarter.

Employment – *A lower unemployment rate due to a shrinking labor force participation rate is no cause for celebration. For the third year in a row a spurt of job growth early in the year fades in the spring.*

- Job growth started off robust in January, but then faltered in March. At a less-than-3% growth rate, the economy will find it difficult to absorb the 130,000 or so people who enter the workforce each month, much less the 14 million or so who are officially unemployed.

- While layoffs and job reductions are now easing, the number of new jobs added remains modest. Since the recession ended in June of 2009, the average number of jobs created each month was only 70,000. That's why the jobless rate has stayed above 8% since the first part of 2008.

- The U.S. economy has 1.6 million fewer jobs today than at the start of 2008.

- In recent weeks, jobless claims have started to edge up again toward recessionary levels, with the four-week moving average last week rising 6,000 to 389,000.

- The Bureau of Labor Statistics announced that compensation costs for civilian workers increased 0.4 percent, seasonally adjusted, for the 3-month period ending March 2012. For the 12 month period ending March 2012, compensation costs increased only 1.9 percent, which is below the rate of inflation.

- Wages and salaries (which make up about 70 percent of compensation costs) increased 0.5 percent, and benefits (which make up the remaining 30 percent of compensation) also increased 0.5 percent in the first quarter. For the 12-month period ending March 2012, wages and salaries increased 1.7 percent. Benefit costs increased 2.7 percent for the 12-month period ending March 2012.

- Productivity declined 0.5 percent in the nonfarm business sector in the first quarter of 2012. Unit labor costs rose at a 2.0 percent seasonally adjusted annual rate. In manufacturing, productivity grew 5.9 percent and unit labor costs fell at an annual rate of l4.2 percent.

- Only 115,000 jobs were added in April compared to an expected 170,000 jobs from forecasters. The unemployment rate fell to 8.1% in April from 8.2% in March, but improvement was due in large part to a shrinking workforce. Approximately 342,000 workers left the labor force in April. If the labor force participation rate of March is used, the unemployment rate in April would be 8.4%.

- The percentage of Americans 16 and over either working or looking for work is down to 63.6%, the lowest since 1981. For men, the labor force participation rate is 70%, the lowest since the statistic was first collected in 1948. The jobless rate for workers under the age of 25 is 16.4%.

- For the recession period 2007-June 2009 the economy lost 8.2 million jobs. Only 3.57 million jobs have been recovered since then.

Manufacturing – *A strong first quarter for manufacturing ended with lower expectations for growth in the second quarter.*

- Industrial production was unchanged in March for a second month but rose at an annual rate of 5.4 percent in the first quarter of 2012. Manufacturing output declined 0.2 percent in March but jumped 10.4 percent at an annual rate in the first quarter.

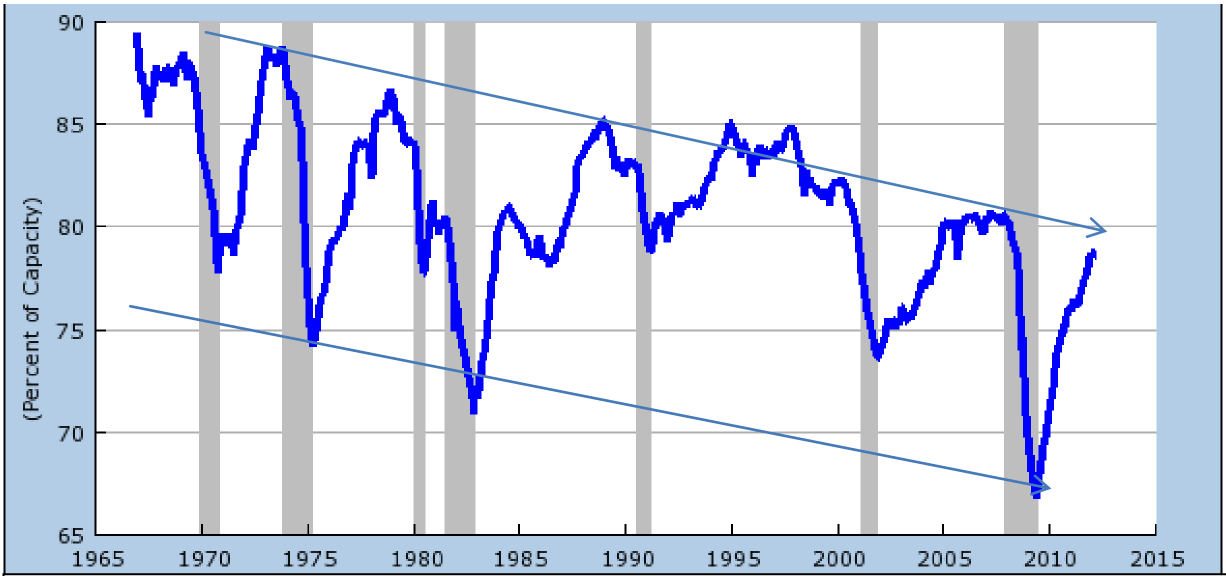
- The gain in manufacturing output in the first quarter was broadly based. Even when we exclude the strong improvement for motor vehicles and parts, manufacturing output increased at an annual rate of 8.3 percent.

- Total industrial production at the end of the third year of expansion is only 96.6 percent of its 2007 average; however, total industrial production for March was 3.8 percent above its year-earlier level.

- The production of consumer goods fell 0.2 percent in March but moved up at an annual rate of 2.4 percent in the first quarter overall. The output of durable consumer goods increased at an annual rate of 17.6 percent in the first quarter.

- The rate of capacity utilization for total industry edged down to 78.6 percent, a rate 2.1 percentage points above its level from a year earlier but 1.7 percentage points below its long-run (1972--2011) average. Capacity utilization for manufacturing in March moved down 0.2 percentage points to 77.8 percent, a rate 14.0 percentage points above its trough in June 2009 but still 1.0 percentage point below its long-run average. Figure 4 below illustrates the overall declining trend in capacity utilization going as far back as 1965.

Figure 4. Capacity Utilization –Total Industry



Note: Shaded areas represent recession periods.
Source: Federal Reserve Bank of St. Louis

<u>Interest Rates and Inflation</u> – *Inflation eased from the pace at the end of 2011. Even with spikes in energy and commodity prices, the CPI and PCE inflation indices do not raise concerns at this point. With employment low and only modest wages increases, many retailers can't charge more without risking a loss of business. A small amount of inflation is good for the economy because it encourages spending and investment sooner rather than later, before inflation erodes its value. Core inflation remains below the Fed's target of 2.5%. Interest rates have moved back down due to the combined influence of low inflation and strong demand for Treasury securities. As uncertainty abroad and at home increases, investors still prefer U. S. Treasuries as a safe haven.*

- The Consumer Price Index for All Urban Consumers (CPI-U) increased 0.3 percent in March on a seasonally adjusted basis following a .4% increase in February. Food and energy continue to be the key drivers of the inflation index. Over the last 12 months, the all items index increased 2.7 percent before seasonal adjustment. The index for all items less food and energy rose 0.2 percent in March after increasing 0.1 percent in February.

- The Fed's preferred measure of inflation, the Personal Consumption Expenditures Index (PCE) was 1.90% in March, compared to 1.93% in February and 1.10% last year. The PCE index increased 2.3% in the first quarter while the core PCE went up 1.9% on an annualized basis. The PCE is tracking well below the long run average of 3.52%.

- Average hourly wages, adjusted for inflation, fell for the third month in a row.

Table 1. Consumer Price Index and Personal Consumption Expenditure Data*

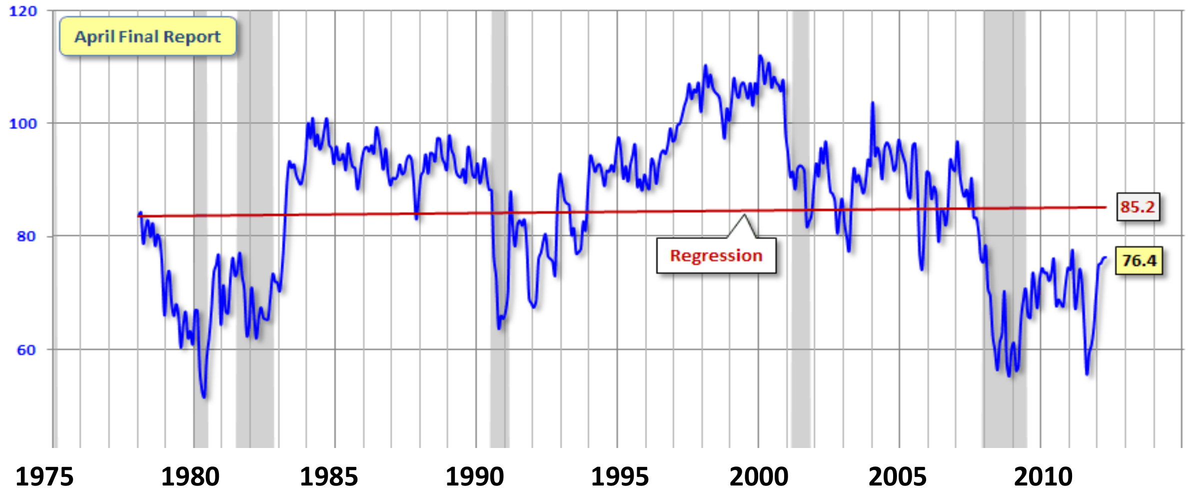
	March '12	February '12	January '12	December '11	November '11	October '11
CPI-U	2.65	2.87	2.93	2.96	3.39	3.53
PCE		2.3	2.4	2.5	2.7	2.7
Core PCE		1.9	1.9	1.9	1.8	1.6

***Seasonally adjusted annual rates**

Sentiment and Confidence

- The preliminary University of Michigan Consumer Sentiment Index for April came in at 76.4, up slightly from the 76.2 March final report. As Figure 5 below illustrates, the index has bounced around in the post-2008 period and has not established a return to trend. The shaded areas in Figure 5 represent past recession periods. Based on a long run regression of the index over time the index would be 85.2 in April if it were back to its trend. The average for the Michigan Consumer Sentiment Index since its inception is 85.5. During non-recessionary years the average is 88.1. Note that following past recessions the index rises above the long run trend line, unlike the 2008-2009 downturn. This finding suggests that recovery is much more complicated this time, consistent with Vantage's view of a debt cycle downturn rather than a typical "Keynesian inventory adjustment" cycle.

Figure 5: University of Michigan Consumer Sentiment Index (1978-2010)



Notes:

April's index is noted in yellow and the regression line forecast is in red.
Shaded area represents recessions
Regression suggests that April's Sentiment Index would be 85.2 if it followed the long run trend

- For the sake of comparison the Conference Board's Consumer Confidence Index has the same pattern illustrated as the University of Michigan Consumer Sentiment index in Figure 5 over time. The Conference Board Index is the more volatile of the two, but the broad pattern and general trends are very similar to the Michigan Index.

- The Conference Board Consumer Confidence Index, which declined slightly in March, was virtually unchanged in April. The Index now stands at 69.2 (1985=100), down slightly from 69.5 in March. The expectations index declined to 81.1 from 82.5, while the present situation index improved to 51.4 from 49.9 last month.

- The Conference Board Leading Economic Index for the U.S. increased 0.3 percent in March to 95.7 (2004 = 100), following a 0.7 percent increase in February, and a 0.2 percent increase in January. The Leading Economic Index increased for the sixth consecutive month in March, offering a more positive outlook than other sentiment measures. Nevertheless, subdued consumer expectations and weakness in manufacturing new orders persist.

Global Economies at a Glance – *Short run weaknesses cut across the global economy. OED forecasts look for improvement in 2013 but growth remains slow overall as far out as 2025.*

- Global growth projections from the Organization of Economic Development (OED) call for 3.5 percent in 2012 followed by 3.6 percent from 2013-2016. Growth is likely to slow to 2.7 percent from 2017-2025. At 3 percent, on average, global growth will still be somewhat higher than for the period 1980-1995 but between one-half and a full percentage point below the growth rate from 1995-2008.

- The OED forecast for growth in advanced economies calls for a slowdown from an already meager 1.6 percent in 2011 to 1.3 percent in 2012. For 2013-2016, the outlook suggests some recovery in advanced economies, bringing these countries back to the pre-recession growth trend of a little more than 2 percent.

- In 2012, emerging economies will slow in growth by 0.7 percentage points on average, going from 6.3 percent growth in 2011 to 5.6 percent in 2012, partly as a result of slower export growth and partly because several of them have been growing above trend. From 2017-2025 emerging and developing countries are projected to grow at 3.3 percent. Many economies will begin to show signs of maturing, at which point the rapid catch-up growth abates.

- The greatest challenge for the global economy in this slow growth environment is to raise productivity without losing job opportunities for the millions who are looking for reasonably paid jobs to support their living standards. The growth rate of per capita income globally has been around 2.5 percent since the beginning of the century but sometime between 2017 and 2025, this rate will fall below 2 percent. In contrast to the past half century, that slowdown will also be accompanied by slower growth in population.