Outlook and Market Review – Second Quarter 2012

Real GDP growth for the second quarter of 2012 was revised upward to 1.7% from 1.5% in the preliminary announcement by the Bureau of Economic Analysis. The revised GDP growth rate in the first quarter was 2%. Overall, the economy is performing well below the long run average of 3.3% GDP growth and even further below what would be expected in a recovery period. While there is some momentum for the economy going into the third quarter, growth for the remainder of the year is not likely to exceed a 2.5% annual rate. Inflation remains consistent with the 2% target of the Fed due to weak aggregate demand. There is little chance of demand pull inflation, but cost push inflation may occur as the extremely hot and dry weather causes food prices to spike. The Fed is committed to a low interest rate environment as long as inflation remains moderate.

The labor market is improving but payroll expansion will be offset by an uptick in the labor force participation rate. The unemployment rate of 8.3% is not likely to move more than a small fraction of a percent in any direction for the remainder of the year. Conditions for an improvement in hiring are in place with low costs of employment if the business environment for hiring and expansion improves. Consumer and investor sentiment remain low and are more consistent with a downturn than an expansion. But, equity values have climbed and the housing market is improving, offering some hope for a rebound in confidence. Major drags on the economy continue to be uncertainty over taxes and fiscal restraint, concern for the growth of the national debt and the lack of a consensus for a long term plan to address debt reduction, worry over unsustainable entitlement programs, and regulatory constraints on energy and business expansion.

The fall elections will play an important role in shaping expectations and directions for the future. On one hand, the current administration's policies for traditional short run stimulus with higher taxes on both investment returns and high income households will be pitted against a longer run vision of investment incentives, major tax reform, major entitlement reform, and a long run plan to limit and reverse the national debt. A key issue is that long run plans to improve the economy tend to offer more favorable tax treatment for higher income households. Short run plans emphasize higher tax breaks to lower income households but offer little or no incentive for long term growth and expansion.

A compromise on the key elements of the "fiscal cliff" is likely, easing the planned budget cuts and automatic tax rate increases. However, there will be a battle over debt limits and types of budget cuts and/or tax changes that will retard real progress on needed fiscal changes. Without an extension of current tax rates and a delay of budget cuts the economy will likely go into a recession in 2013.

Projections from the Survey of Professional Forecasters (SPF) - *Forecasts from the Survey of Professional Forecasters (SPF), a group of 48 forecasters surveyed by the Federal Reserve Bank of Philadelphia, were revised downward significantly on August 10, 2012. The second half of 2012 will be very sluggish with GDP growth just under 2%, based on the consensus forecast. Past forecasts from the SPF have been on the optimistic side, likely due to expectations of a stronger recovery given the massive monetary and fiscal stimulus. Now, forecasters are likely to be more realistic. Forecasters expect inflation to be consistent with the Fed's 2% goal. Analysts' projections call for lower additions to payrolls than in prior forecasts but expectations for a very gradual reduction in the unemployment rate remain in place.*

GDP, Unemployment, and Payroll Growth Forecasts by the SPF

An outline of the forecasts for GDP growth, unemployment rate, and monthly payroll growth is provided in Panel A of Table 1 below. The consensus forecast for real GDP growth in the third quarter of 2012 was recently revised downward to only 1.6% with a fourth quarter GDP growth rate forecast of 2.2%. On an annual-average over annual-average basis (Table 1 Panel B), the forecasters see real GDP growth for 2012 and 2013, at 2.2 % and 2.1 %, respectively. These estimates reflect more pessimistic views on the economy by the forecasters. The forecasters predict real GDP will grow of 2.7% in 2014 and 3.1 % in 2015

To add some perspective on expected GDP growth rates, the long run average real GDP growth rate for the U.S. economy is 3.3%. There is no precedent for being this far along in the timeline of a recovery with growth rates below the long run average. Forecasters expect GDP growth to remain below the long run average as far out as 2015.

Table 1. GDP, Unemployment Rate, and Payroll Growth Forecasts from the SPF

Panel A: Quarterly Data

	Real GDP (%)		**Unemployment Rate (%)**		**Payrolls (000s/month)**	
	Prior	Recent	Prior	Recent	Prior	Recent
2012:Q3	2.5	1.6	8.0	8.2	170.0	125.0
2012:Q4	2.6	2.2	7.9	8.1	172.6	135.3
2013:Q1	2.6	1.8	7.9	8.0	170.3	151.7
2013:Q2	2.7.	2.3	7.7.	7.9	185.8	139.7
2013:Q3	N.A.	2.5	N.A.	7.8	N.A.	149.0

Panel B. Annual Data (Average Annual Estimates)

	Real GDP (%)		Unemployment Rate (%)		Payrolls (000s/month)	
	Prior	Recent	Prior	Recent	Prior	Recent
2012	2.3	2.2	8.1	8.2	171.9	154.6
2013	2.7	2.1	7.7	7.9	175.7	143.2
2014	3.1	2.7	7.2	7.3	N.A.	N.A.
2015	3.4	3.1	6.6	7.0	N.A.	N.A.

The Survey of Professional Forecasters (SPF) also shows a more pessimistic view of the labor market in recent forecasts. Forecasters revised the unemployment rate down to 8.2% for the third quarter and 8.1% in the fourth quarter. Forecasters expect for unemployment to wind down to 7% in 2015, which would still be about 2% to 1.5% above what the Fed believes to be a full employment target. However, it is difficult to put much faith in projections beyond 2013 given the uncertainty of new policy initiatives that may follow the 2012 presidential and congressional elections.

On the employment front, forecasters revised downward their estimates of the growth in jobs for the next four quarters. The forecasters see nonfarm payroll employment growing at a rate of 125,000 jobs per month this quarter and 135,300 jobs per month next quarter. The forecasters' projections for the annual-average level of nonfarm payroll employment suggest job gains at a monthly rate of 154,600 in 2012 and 143,200 in 2013. (These annual-average estimates are computed as the year-to-year change in the annual-average level of nonfarm payroll employment, converted to a monthly rate.).

The SPF job growth forecasts appear high when compared to the modest GDP growth rate forecasts. While the labor market is improving, we have yet to see a strong foundation for hiring. There may be continued or even higher drags on hiring due to higher taxes linked to Obamacare, potentially higher taxes on business owners and corporate profits, continued outsourcing to lower tax countries, and evolving red tape linked to environmental issues. Clarity on these issues will not be forthcoming until much later this year when the elections are over.

Inflation Projections by the SPF

In January of 2012 the Federal Open Market Committee announced that a 2% inflation rate, measured by the annual change in the personal consumption expenditure index (PCE), is consistent with the long run Federal Reserve statutory mandate. A commitment to continue a low interest rates environment for the next several years was also announced. The Fed does not see a contradiction with these policies, suggesting that a weak economy is likely through 2014. If the inflation rate were to pick up, the Fed would be obligated to contract liquidity (the money supply) and increase interest rates in the short run. The view that low inflation and low interest rates can coexist through 2014 is viable only if aggregate demand remains low and cost-push inflation elements do not get worse.

Forecasters in the SPF believe that the Fed's 2% inflation target will be achieved. Forecasters expect current-quarter headline CPI inflation to average 1.5%, down by about 80 basis points from prior estimates. They predict current-quarter headline PCE inflation of 1.5 %, 40 basis points lower than their previous estimate. Measured on a fourth-quarter over fourth-quarter basis, headline CPI inflation is expected to average 1.8% in 2012, down from 2.3% in the last survey; 2.2 % in 2013, up from 2.1 %; and 2.3% in 2014, down from 2.5 %. Forecasters expect fourth-quarter over fourth-quarter headline PCE inflation to average 1.7% in 2012, down from 2.1% in the last survey; 2.0 % in 2013, unchanged from the previous estimate; and 2.2% in 2014, unchanged from prior estimates. The SPF forecasts for quarterly and annual inflation rates appear in Panels A and B of Tables 2 below.

Table 2. Survey of Professional Forecasters Inflation Estimates

Panel A. Quarterly Inflation Data

	Headline CPI		**Core CPI**		**Headline PCE**		**Core PCE**	
	Prior	**Recent**	**Prior**	**Recent**	**Prior**	**Recent**	**Prior**	**Recent**
2012:Q3	2.3	1.5	2.0	2.2	1.9	1.5	1.7	1.9
2012:Q4	2.1	2.0	2.0	2.0	2.0	2.0	1.7	1.8
2013:Q1	2.2	2.1	2.0	2.0	2.2	2.0	1.9	1.9
2013:Q2	2.2	2.1	2.1	2.0	2.0	2.0	1.9	2.0
2013:Q3	N.A.	2.2	N.A.	2.1	N.A.	2.1	N.A.	2.0

Panel B. Annual Inflation Data (Average Annual Estimates)

	Headline CPI		**Core CPI**		**Headline PCE**		**Core PCE**	
	Prior	**Recent**	**Prior**	**Recent**	**Prior**	**Recent**	**Prior**	**recent**
2012	2.3	1.8	2.0	2.2	2.1	1.7	1.8	1.9
2013	2.1	2.2	2.0	2.0	2.0	2.0	1.9	2.0
2014	2.5	2.3	2.2	2.2	2.2	2.2	2.0	2.0

Over the next 10 years, 2012 to 2021, the forecasters expect headline CPI inflation to average a 2.35 annual rate, lower than the estimate of 2.48% from the survey of three months ago. The 10-year annual-average headline PCE inflation estimate was unchanged at 2.20 %. Such forecasts do not support a view that the economy will generate GDP growth in excess of 2.5% to 3% over the next decade. It is important to note that lower than average long term GDP growth is built into the consensus forecasts.

Obstacles to Fixing the Economy with Traditional Tools – *Keynesian theories that are currently guiding policymakers were not designed for an economy that already has huge deficits and accumulated national debt going into a downturn. Keynesian policies aver very short run options that should offset temporary deficits with surpluses over time and should not lead to chronic debt buildup. In the current economic environment Keynesian policies only offer short run relief if the long term consequences are not factored into expectations. An alternative is to focus on fundamental problems that must eventually be addressed to launch long term growth. A brief list of such structural changes include: revision of U.S. entitlement programs to sustainable levels, dramatic streamlining of the inefficient and complicated tax structure, changes to make business taxes internationally competitive, restructuring primary and secondary education standards and delivery systems to be more competitive in a global economy, initiatives to make college education more affordable, and revisions of policies with moral hazards that discourage work or job creation.*

There are well known critical economic issues that must be addressed to put the economy on a higher growth plane, but a lack of consensus across political parties makes the future uncertain. Traditional policies of deficit spending coupled with monetary expansion to boost the economy in the short run have not been very effective for good reason. Current economic conditions are not conducive to the use of traditional policies to fix the economy.

Traditional Approach to a Slumping Economy: Deficit Spending and Monetary Easing

A few points from economic history shed some light on the policy controversy and actions that will shape short run and long run growth. "Keynesian" economics was designed at the start of the Great Depression when the federal government was very small relative to the private sector and central banking was primarily designed to regulate and monitor bank solvency. The theory of expansionary fiscal and monetary policy was designed to offer government intervention options for short run downturns in the private sector. If the private sector slumps the government sector can boost the economy by increasing spending while cutting taxes to offset the loss of private spending and investing. The central bank can expand the money supply by buying government debt issued to finance the deficit, which would add liquidity and lower interest rates. Added liquidity and lower interest rates should promote spending and investing. In theory, these temporary moves stimulate the economy for a recovery and are to be reversed as the economy improves. The national debt (an accumulated total of past deficits) would be small at any point in time if downturns are infrequent and policymakers reverse expansionary policies with a surplus when the economy recovers. The conditions for which Keynesian policies were designed have not been in place for over a decade. Deficits were not restricted to periods of economic downturns and the national debt has mushroomed. Interest rates were kept low long before the downturn in 2008-2009 leaving little room for additional interest rate declines to make a difference.

Keynes, Krugman, and Current Macroeconomic Policies

Economist Paul Krugman is a key proponent of the view that additional stimulus spending is needed without regard for the size of the national debt or record of recent large deficits. Krugman's argument is that the U.S. is too big to fail and represents too much of the global economy to be compared to typical countries in a debt crisis, like Greece. Added deficit spending and growing national debt is justified, since Krugman believes the U.S. can use the central bank to continue buying massive amounts of government debt without repercussions. He argues that the dollar will remain the most attractive global currency to hold with few alternatives, especially with the euro in such trouble. Foreign investors will continue to hold U.S. debt since it is safer than other sovereign debt. The growth in the money supply doesn't pose an inflation problem as long as the economy remains weak. Krugman's underlying assumption is that both fiscal and monetary policies will be reversed in a timely manner when the economy improves to avoid inflation in the longer run. This last critical assumption is open to question, since there is little empirical evidence to support the view that appropriate timing of fiscal and monetary policies occurs.

The Counter to Krugman – Friedman, Fisher and Minsky

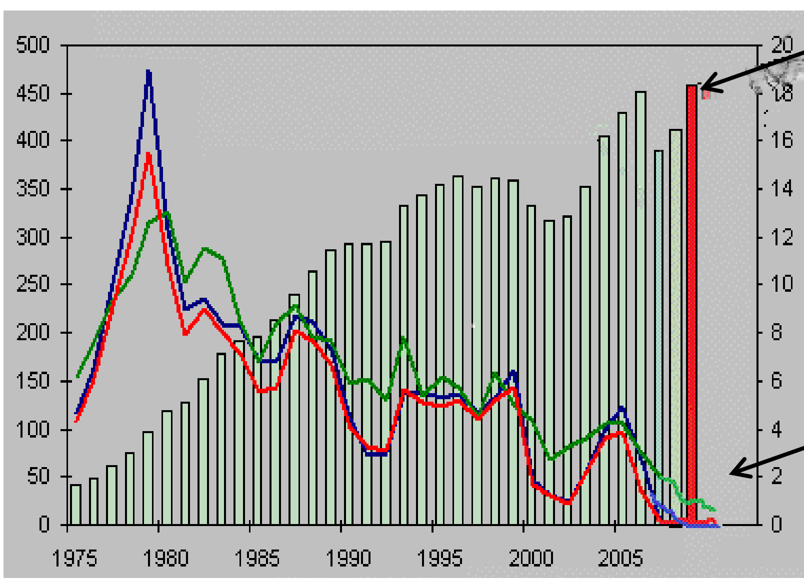
Economists following the tradition of Milton Friedman strongly refute the ability of policy makers to time policy decisions correctly, suggesting that government intervention generally makes things worse more often than making things better. Friedman coined the phrase, "there is nothing so permanent as a temporary government program". Other economists, such as Irving Fisher and Hyman Minsky, predicted a debt crisis scenario where government and private debt climb to such high levels that a de-levering process eventually leads to prolonged deflation and long run declines in GDP growth. Traditional Keynesian policies contribute to this crisis and are not capable of solving it. The current U. S. situation, as well as the situation for most of the world, tends to support the view that temporary fiscal policies to stimulate the economy are not reversed over time, eventually resulting in a crushing level of national debt. For the U.S. the national debt is over $16 trillion and growing at over $1 trillion per year. Traditional Keynesian policies in this environment have been offset by a variety of factors to include:

- private sector de-levering,
- recognition that transfer payments will not support long term investing and purchasing,
- growing uncertainty about taxes to finance the deficit,
- uncertainty about Obamacare taxes and employer-provided benefit plans,

- realization of the unsustainability of entitlement programs that drive government spending,
- and pessimism for the future due to projected costs of servicing the national debt.

The figure below illustrates the building debt crisis that comes simply by servicing outstanding national debt. Even with historic lows in interest rates, the interest expense on the national debt each year has been growing rapidly. In 2011, for example, the interest expense alone was $454 billion dollars. In the first seven months of 2012 the interest expense is already $241billion dollars. The size of the national debt grows until a balanced budget is achieved, which is clearly a very long term proposition at this point. The interest expense grows as the national debt grows and as interest rates go up. The debt crisis scenario takes hold when the level of the national debt is so high that the interest expense alone is making a balanced budget impossible without very drastic austerity policies leading to deflation and dismal short run GDP growth rates. This reality underscores the Fed's priority of keeping interest rates low. If rates tick up the national debt problem becomes significantly worse. These relationships help demonstrate why economists like Fisher and Minsky cautioned against allowing national debt to rise to unsustainable levels. Once accumulation of debt occurs, short run Keynesian options make conditions worse in the longer run.

Figure 1. Bar Chart of Dollar Interest Expense on National Debt Relative to Interest Rates



Total Interest Paid on National Debt hit 454 billion dollars in 2011 and is already 241 billion in the first 7 months of 2012

Interest rates paid on the National Debt have been very low ….what happens if rates go up without debt reduction?

Fed Funds Rate % is the Blue line
Five Year Note Rate % is the Green line
Treasury Bill Yield % is the Red line
Bar Chart = Interest expense on National Debt in billions of dollars

Policies Focused on the Long Run

The alternative "non-Keynesian" view on fixing the economy is less focused on the short run and more attuned to setting the stage for a return to a longer run growth path. Policy initiatives are aimed at reducing and re-contracting unsustainable entitlement programs, completely overhauling the tax code to eliminate perverse incentive structures, providing a simpler and more efficient tax system, putting in motion fiscal reductions in government spending that pave the way for long term reductions in national debt, lowering tax rates overall to stimulate spending and investing, eliminating red tape obstacles to new businesses and job creation, identifying unnecessary environmental protection obstacles to growth, creating more incentives and opportunities for work rather than transfer payments from the government, revamping the primary and secondary education systems in the U.S. to stem the tide of outsourcing, revising the tort system to reduce unnecessary costs of litigation, increasing competition in the insurance industry across state lines, and promoting more domestic energy development.

Any long run forecast of the economy must first weigh which of the competing philosophies is most likely to be implemented <u>and</u> how effective the chosen policies will be in stimulating growth. Traditional Keynesian/Krugman policies have not been very effective so far and are not likely to be effective in the short run with the current environment. Long run growth prospects will be lower if deficit spending is not controlled. The non-Keynesian approach is likely to promote long run growth but will not offer immediate stimulation for the short run. It will take time to grow the tax base to allow lower overall tax rates to generate enough revenue to balance the budget, especially if spending is not reduced. Fundamental improvements in the efficiency and certainty of tax and entitlement laws are controversial and will take time to show results once implemented, especially if grandfather clauses are in place. Since it appears the <u>short run outcome will not be good with either policy direction</u>, <u>risk controls must be a priority for the short run</u>.

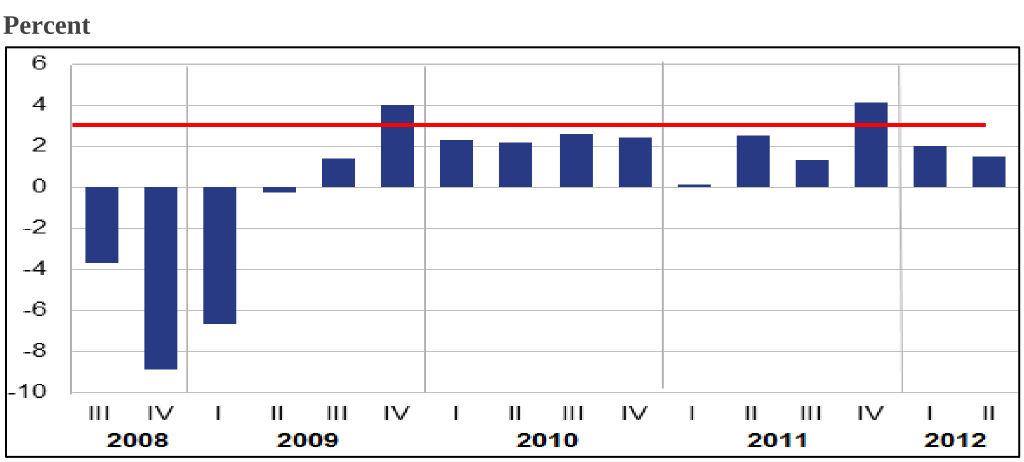
Summary of Recent Economic Data

Gross Domestic Product *From 1947 to 2012, the United States GDP Growth Rate averaged 3.3%, reaching a high of 17.2 % in March of 1950 and a record low of -10.4 % in March of 1958. For the period of "expansion" from the second quarter of 2009 to the first quarter of 2012, real GDP increased at an average annual rate of only 2.3 %.*

- U.S. real gross domestic product increased at an annual rate of 1.5% from the first quarter to the second quarter, according to the "advance" estimate released by the Bureau of Economic Analysis. The "second" estimate for the second quarter, based on more complete data, will be released on August 29, 2012.

- In the first quarter, the revised real GDP increased to 2.0 %. The quarterly GDP growth rates since the third quarter of 2008 appear in Figure 2 below. The red line represents the average GDP growth rate over the 1947 to 2012 period.

Figure 2. Quarter to Quarter Real GDP Growth



Source: U.S. Bureau of Economic Analysis
GDP Measured as a Seasonally Adjusted Annual Rate
Long Run Average GDP Growth Rate of 3.3%

- Real final sales of domestic product -- GDP less change in private inventories -- increased 1.2 % in the second quarter, compared with an increase of 2.4 % in the first.

- Positive contributions to GDP in the second quarter came from personal consumption expenditures (PCE), exports, nonresidential fixed investment, private inventory investment, and residential fixed investment. State and local government spending and imports made negative contributions to GDP.

- Real personal consumption expenditures increased 1.5 % in the second quarter, compared with an increase of 2.4 % in the first quarter.

- Real nonresidential fixed investment increased 5.3 % in the second quarter, compared with an increase of 7.5 % in the first quarter.

- Real exports of goods and services increased 5.3% in the second quarter, compared with an increase of 4.4 % in the first. Real imports of goods and services increased 6.0%, compared with an increase of 3.1% in the prior quarter.

- Real federal government consumption expenditures and gross investment decreased 0.4 % in the second quarter, compared with a decrease of 4.2 % in the first. National defense decreased 0.4 %, compared with a decrease of 7.1 % in the first quarter.

- The change in real private inventories added 0.32 % to the second-quarter change in real GDP after subtracting 0.39 % from the first-quarter change.

***Labor Market and Employment** – Hiring is picking up while layoffs and filings for employment insurance are moderating. The unemployment rate remains high and will edge up if the labor force participation rate picks up later in the year as expected. Employment costs remain low with little pressure for higher wages.*

- The unemployment rate is 8.3% and both the labor force participation rate and civilian employment/population ratio are low by long run historic standards. Table 3 below summarizes recent employment data.

Table 3. Unemployment and Labor Participation

	Prior 12 Months*	**Quarterly Rate#**				**Latest Monthly Rate**			
Employment Situation	**Ave.**	**Q3-'11**	**Q4-'11**	**Q1-'12**	**Q2-'12**	**Apr' 12**	**May '12**	**Jun' 12**	**Jul-'12**
Civilian Unemployment Rate	8.5	9.1	8.7	8.3	8.2	8.1	8.2	8.2	8.3
Labor Force Participation Rate	63.9	64.1	64.0	63.8	63.7	63.6	63.8	63.8	63.7
Civ. Employment/Population Ratio	58.5	58.3	58.5	58.5	58.5	58.4	58.6	58.6	58.4

Notes *Source: Bureau of Labor Statistics*
** Data are prior 12-month average.*
 # Quarterly figures are monthly averages

- Unemployment insurance claims are moderating somewhat. Table 4 summarizes recent data.

Table 4. Unemployment Insurance

	Prior 12-Month Weekly Ave	Average Weekly Claims for the Quarter				Latest Week Data			
Measure	**Ave.**	**Q3 '11**	**Q4 '11**	**Q1 '12**	**Q2 '12**	**May '12**	**Jun '12**	**Jul '12**	**Aug '12**
Initial Claims per Week	384	409	389	369	382	377	386	366	361

Source: Bureau of Labor Statistics

- The Bureau of Labor Statistics reported that seasonally adjusted compensation costs for civilian workers increased 0.5 % for the 3-month period ending June 2012. Wages and salaries (which make up about 70 % of compensation costs) increased 0.4 %, and benefits (which make up the remaining 30 % of compensation) increased 0.6 %.

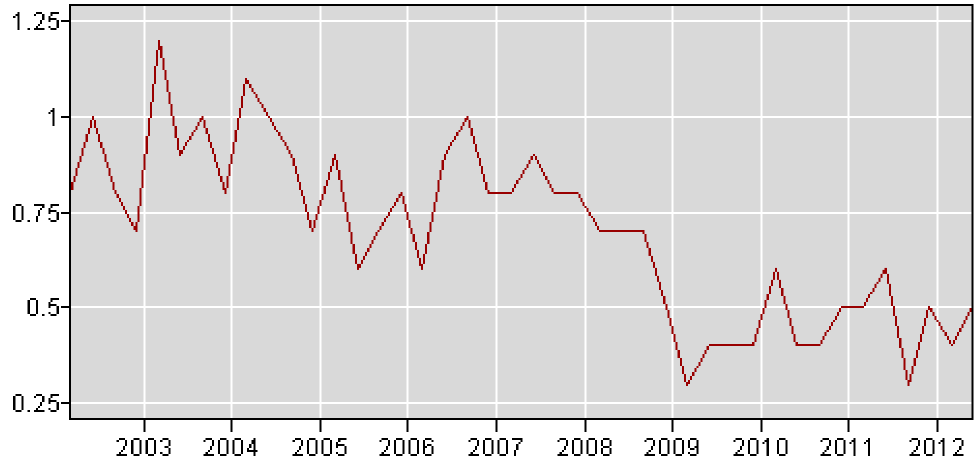
- The Conference Board Employment Trend Index (ETI) improved slightly in July after declining in June. The ETI is now at 108.11 from June's 107.68 figure. On a year-ago basis, the index is 5.9% higher. The index in July is below the level set in May, consistent with a slow employment growth scenario for the next quarter.

- For the 12-month period ending June 2012 compensation costs for civilian workers increased 1.7 % following an increase of 2.2% in June 2011. Wages and salaries increased 1.7 % for the current 12-month period, essentially unchanged from a year ago when wages and salaries increased 1.6 %. Benefit costs increased 2.1 % for the 12-month period ending June 2012 down from the June 2011 increase, which was 3.6 %.

- The Employment Cost Index (ECI) measures the change in the cost of labor, free from the influence of employment shifts among occupations and industries. The Figure below illustrates the relatively low increase in employment costs in the post 2008-2009 period compared to earlier years.

Figure 3. Employment Cost Index (ECI) – Quarterly % Change

Quarterly % Change



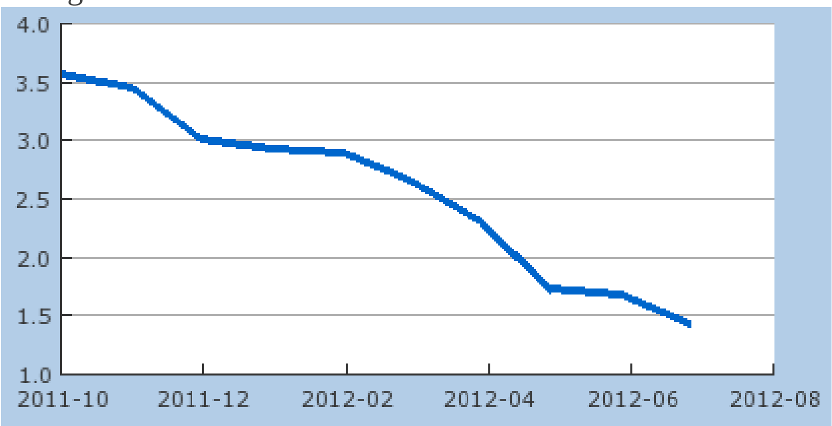
Source: Bureau of Labor Statistics

Inflation *The U.S. consumer-price index was unchanged in July. The cost of living climbed 1.4 % over the past 12 months, the smallest year-to-year increase since November 2010. The weak economy makes it difficult to push prices through to consumers, especially with the trend of discount shopping.*

- The U.S. consumer-price index was unchanged in July. Figure 4 below illustrates the declining rate of inflation, as measured by the CPI.

Figure 4. Consumer Price Index – All Urban Consumers (October 2011-July 2012)

% Change from
One Year Ago



- The cost of living climbed 1.4% over the past 12 months, the smallest year-to-year increase since November 2010, the Labor Department reported.

- The core index, which excludes volatile food and fuel costs, rose 0.1 % last month following an increase of 0.2% in June. Declining prices for a broad-range of goods and services, including hotel rates, airline fares and new and used cars helped offset rising costs for medical care and rents, the report showed.

- The Producer Price Index for finished goods rose 0.3 % in July. This advance followed a 0.1% increase in June and a 1.0% decline in May. Prices for finished goods less foods and energy moved up 0.4% in July.

Personal Income and Consume Credit *-- Growth in personal income continues to outpace GDP growth. Retail sales recovered in July from a poor second quarter, offering some momentum for the third quarter. Consumer credit is fully in an expansion phase as the willingness to lend has eased over the past several months.*

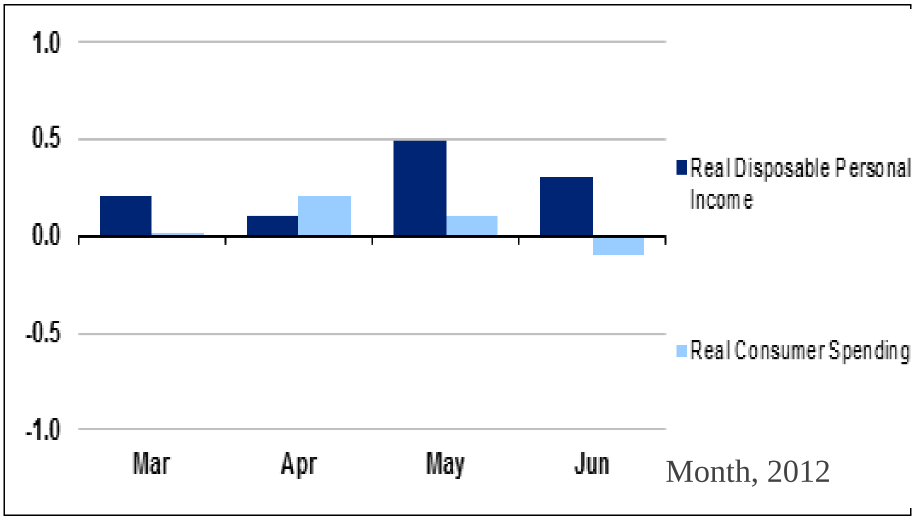
- Current-dollar personal income increased $140.5 billion (4.3 %) in the second quarter, compared with an increase of $199.9 billion (6.3 %) in the first quarter. Personal current taxes increased $24.9 billion in the second quarter, compared with an increase of $30.0 billion in the first.

- Disposable personal income increased $115.6 billion (4.0 %) in the second quarter, compared with an increase of $169.9 billion (6.0 %) in the first. Real disposable personal income increased 3.2 %, compared with an increase of 3.4 %.

- Personal saving -- disposable personal income less personal outlays -- was $475.3 billion in the second quarter, compared with $419.5 billion in the first. The personal saving rate (saving as a % of disposable personal income) was 4.0 % in the second quarter, compared with 3.6 % in the first quarter. Figure 5 illustrates the relationship between disposable income and spending from March to June 2012.

Figure 5. Real Disposable Income and Real Disposable Spending

%



Source: U.S. Bureau of Economic Analysis

- Consumer credit increased by $6.5 bln in June after rising by a downwardly revised $16.7 bln in May (from $17.1 bln). Figure 6 below illustrates the percent change in consumer credit since 1997.

Figure 6. Consumer Credit Year over Year % Change

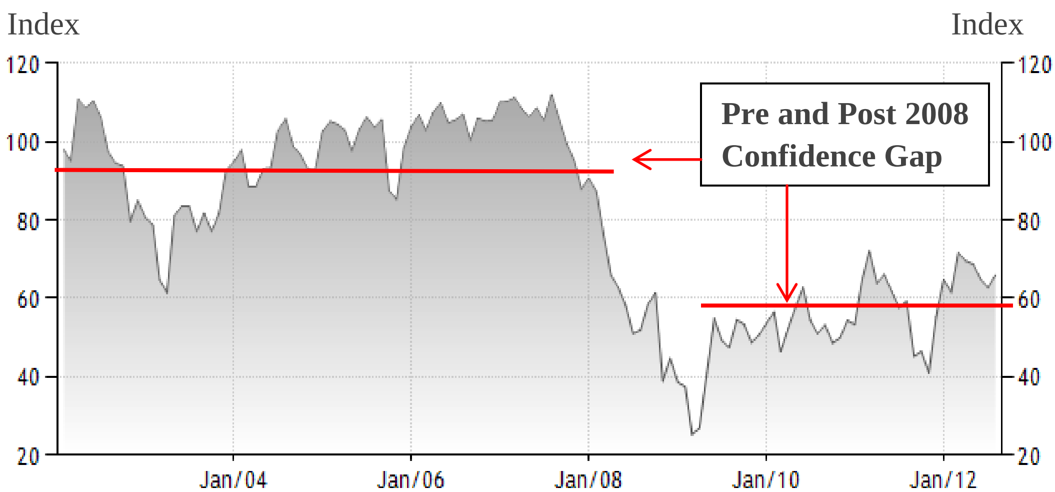
% Change

- Revolving credit fell by $3.7 bln in June after rising by $7.5 bln in May.
- Nonrevolving credit increased by $10.2 bln in June after rising by $9.2 bln in May and has increased for 24 of the last 25 months.
- Retail sales rose for the first time in four months in July. The Commerce Department announced that sales at retailers climbed 0.8%, exceeding analysts' expectations and bouncing back from a 0.7% drop in June.

<u>Sentiment and Confidence Index</u> *– Index measures of sentiment and confidence remain at or near historic lows. The gap in confidence before and after 2008 is large and persistent. Confidence is not yet where it should be for a typical recovery.*

- Consumer confidence, measured by the Conference Board's Consumer Confidence Index (CCI), improved to 65.9 in July of 2012 from 62.7 in June of 2012. From 1967 until 2012, the United States Consumer Confidence averaged 93.3 with a high of 144.7 in January of 2000 and a low of 25.3 in February of 2009. The Figure below illustrates the gap in consumer confidence between pre-and post-2008 periods.

Figure 7. Conference Board's Consumer Confidence Index

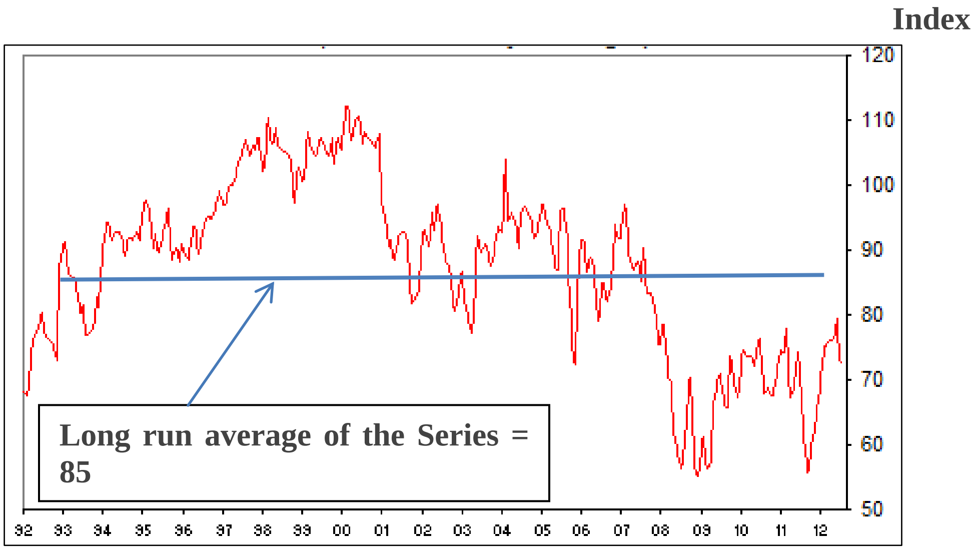


- The CCI is a barometer of the health of the U.S. economy from the perspective of the consumer. Economists view the index as a leading indicator for the U.S. economy.

- The Conference Board Leading Economic Index (LEI) fell 0.3 % in June to 95.6 (2004 = 100), following a 0.4 % increase in May, and a 0.1 % decline in April. The index declined in two of the last six months and the six month moving average has declined. The movement of the LEI is consistent with a slow but steady improvement in economic activity.

- The revised University of Michigan Consumer Sentiment Index (UMCSI) for July was 72.3, down from the 73.2 level in June. Figure 8 below offers a longer term perspective on the index. Confidence should have a mean reverting tendency over time (long term mean is 85). The blue line represents about where the mean of the series would be relative to the observed index values. The series appears to revert toward the mean very slowly, meaning that confidence can be below normal for a sustained period.

Figure 8. University of Michigan Consumer Sentiment Index



Source: University of Michigan Consumer Sentiment Survey, July 2012

- Since the beginning of the UMCSI in 1978, consumer sentiment is about 15% below the average reading (arithmetic mean). The current index level is at the 20.2 percentile of the 415 monthly data points in this series.

- The average of the UMCSI since its inception is 85.0. During non-recessionary years the average is 87.9 and during the five recessions the average is 69.3 (just 3 points below the current index reading). The latest sentiment number of 72.3 is well below the midpoint (78.6) between recessionary and non-recessionary sentiment averages

- The National Association of Home Builders/Wells Fargo confidence index rose to 37, higher than projected and the best showing since February 2007. Readings below 50 mean more respondents said conditions were poor.

Production *– Production is improving in most areas of the economy, helping to stem mass layoffs and creating an environment for new hiring.*

- Manufacturing, which makes up about 75 % of total output, rose 0.5 % in July for a second month.

- The Fed's production report showed motor vehicle output increased 3.3 % in July after a 1.9 % increase the month before.

- Production at factories, mines and utilities increased 0.6 % in July following a 0.1 % gain the prior month.

- Industrial production increased 0.6 % in July after having risen 0.1 % in both May and June. Revisions to the rates of change for recent months left the level of the index in June little changed from its previous estimate.

- Total industrial production in July was 4.4 % above its year-earlier level.

- Capacity utilization for total industry moved up 0.4 % to 79.3 %, a rate 1.0 % point below its long-run (1972--2011) average.

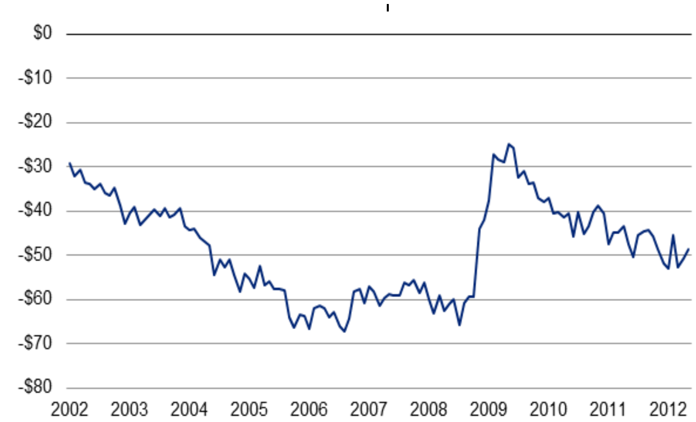
U.S. Trade and Selected International Data – *The U.S. economy continues to perform better than most of its trading partners. Recessionary problems continue in Europe.*

- U.S. June exports of $185.0 billion and imports of $227.9 billion resulted in a goods and services deficit of $42.9 billion, down from $48.0 billion in May. June exports were $1.7 billion more than May exports of $183.3 billion. June imports were $3.5 billion less than May imports of $231.4 billion. Lower deficits provide a boost to GDP.

- Historically, from 1992 until 2012, the United States Balance of Trade deficit averaged $31.62 billion with the lowest deficit of $0.83 billion in February of 1992 and a record high of $67.35 billion in August of 2006. The Figure below illustrates the balance of trade time series.

Figure 9 . U.S. Balance of Trade (Monthly Seasonally Adjusted)

$s in Billions



Source: U. S. Census Bureau

- United States main exports are: machinery and equipment, industrial supplies, non-auto consumer goods, motor vehicles and parts, aircraft and parts, food, feed and beverages.

- U.S. imports non-auto consumer goods, fuels, production machinery and equipment, non-fuel industrial supplies, motor vehicles and parts, food, feed and beverages.

- Main trading partners are: Canada, European Union, Mexico, China and Japan.

Euro Zone Economies…A long way to go.

- The euro zone's economy shrank in the second quarter following a flat first quarter. The 17-nation currency bloc contracted by 0.2 % in the second quarter. Germany had growth of 0.3 % but its forward-looking ZEW sentiment index slid for a fourth straight month.

- For most of Europe we see a debt cycle crisis characterized by budget cuts, high interest rates in the periphery countries, and rising sovereign debt.

- France has had three consecutive quarters of zero growth and its central bank has already forecast a mild contraction in the third quarter. Technically, France is not in recession but it is clearly weakened.

- Austria and the Netherlands were close to Germany's performance in the second quarter with each posting growth of 0.2 %. Finland continues to be a German ally on the austerity policy front even though it has suffered a 0.7 % year-on-year fall in GDP.

- Spanish and Italian bond yields have steadied since ECB President Mario Draghi promised to do whatever it takes to save the euro zone although a government would first have to ask for help.

- Greece, the weakest member of the euro zone, continues to contract rapidly. It appears as if Greece will be chasing a moving target in trying to meet its bailout obligations as economic conditions get worse. G.D.P. fell more than 6 % in back-to-back quarters, but tourism is proving a bright spot. GDP fell 6.2 % in the second quarter from a year earlier following a 6.5 % year-over-year contraction in the first quarter. The unemployment rate in May reaching a record 23.1 %, up from 22.6 % in April. The jobless rate among youth has reached almost 55%. A shrinking economy creates pressure for further budget cuts, since the deficit and debt grow as a percentage of the overall economy.

- Portugal's recession deepened with GDP diving by 1.2 % on the quarter and Cyprus contracted by 0.8 %.

- Italy's second quarter data showed the economy contracted 0.7 % quarter-on-quarter, compounding the difficulties for Mario Monti's technocrat government as it tries to avoid a bailout. Spain's economy shrank 0.4 % over the same period, pushing it deeper into recession.