

Economic Update



Written by
Jane Caron, CFA
Chief Economic Strategist

Forecasting the U.S. economy used to be a fairly straightforward exercise. The economic indicators warned us in October 2007 that we would enter a recession in December, and they accurately foretold us in early 2009 that we would exit the recession in June. They even tipped us off that the markets would put in a bottom during the first quarter of 2009.

So what are they telling us now?

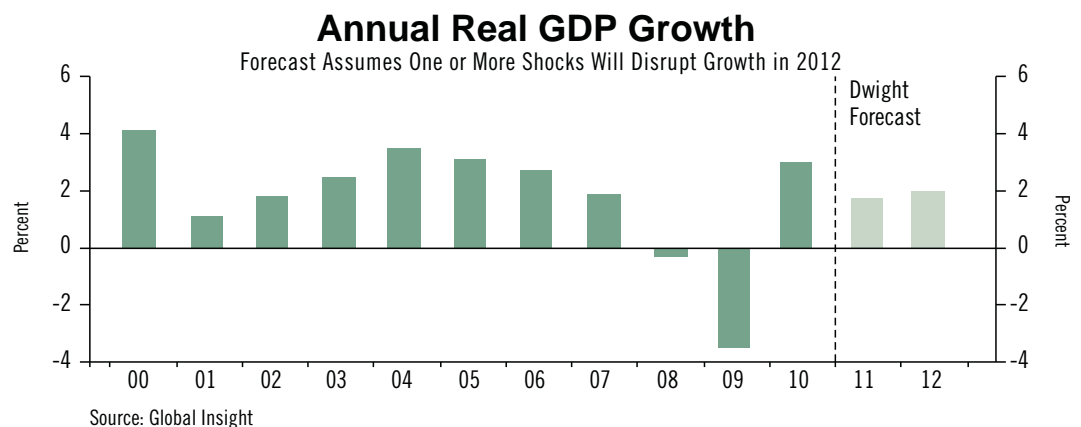
They are telling us that the U.S. economy has gathered strength and real GDP could increase by more than 3% in 2012, and nominal GDP could exceed 5%. Our official real GDP forecast, however, is a consensus-like 2%. We are handicapping our forecast because we believe one or more exogenous shocks will disrupt growth this year.

The list of potential shocks is long: polarized politics in the United States and the danger of fiscal tightening; potential knock-on effects from Europe's recession/crisis; the possibility of a

not-so-soft landing in China and other emerging markets; the risk of another surge in food and energy prices; and the risk of a geopolitical crisis in places like North Korea, Pakistan and Iran. Depressingly, these are the potential shocks that we know about. It is the unanticipated shocks that tend to do the most harm.

Forecasting the U.S. economy in 2012 is anything but a straightforward exercise. It requires the ability to successfully predict the behavior of politicians, monetary authorities, and fiscal authorities; and to have a good read on popular opinion and investor psychology. We need to be forecasting GDP growth in ranges rather than with decimal points.

The range we have in mind for 2012 extends from -1.5% to 3.5%, but a range this large is of no use to investors. A more practical range of 1.5% to 2.5% is likely to be realized, but keep in mind the curve of potential outcomes is not normal—it has



very fat tails. We worry most about downside risk because the expansion is still fragile. And, thanks to decades of fiscal folly and loose monetary policy, both monetary and fiscal policy is of limited use. Thus, a downside surprise could be quite nasty.

Europe is suffering from a similar problem. Public authorities are now correcting for years of fiscal largess without the support of monetary policy. Pundits repeatedly call on the European Central Bank to cushion sovereign fiscal tightening, but the ECB more narrowly defines its role relative to the Federal Reserve and the Bank of England. It will backstop banks, but it will not bail out fiscal authorities. It will keep the wheels greased, but it will not become the wheel itself.

The ECB is keeping pressure on fiscal authorities to solve their fiscal problems, and that is good. Albeit painfully slow, authorities are making headway. We think the European Union will eventually emerge a much stronger entity.

The near-term problem for Europe is growth. Europe is facing a debt trap whereby interest rates could remain persistently higher than nominal GDP growth, and this may require the ECB to become the ultimate lender of last resort. The IMF will surely have to step up as well, and bilateral support is also probably needed. A fiscal union is not out of the question. Nor is a breakup of the Eurozone.

Events in Europe could cost the U.S. economy as little as 0.5 percentage points of GDP growth or

more than 2.5 points if a full-blown banking crisis erupts and catches the United States in its vortex. More likely, events in Europe will cost the United States about one percentage point of GDP as the recession there impacts our trade accounts and financial conditions.

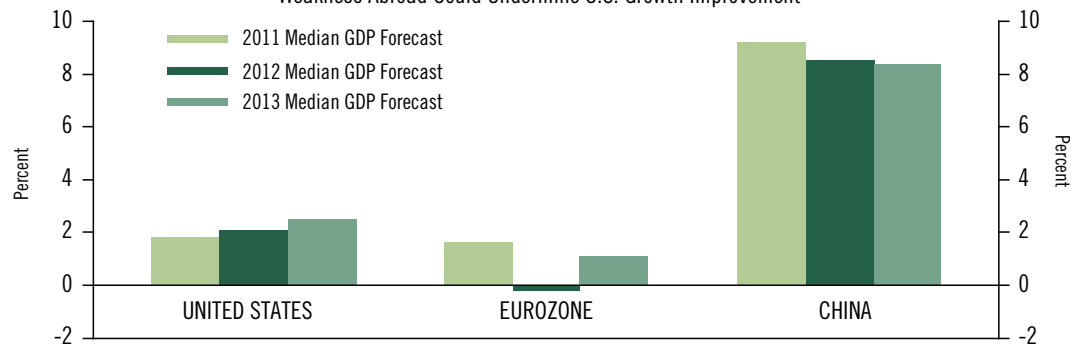
Unlike European politicians (who have felt the markets' fury), U.S. politicians are refusing to work together to form sensible policies that will overhaul our tax code, control expenditure growth, and invest in our future. Sadly, nothing productive is likely to happen in Washington until after the presidential election and only then if there is a clear mandate from voters. Voters, meanwhile, do not seem quite as troubled by our fiscal problems and may be vulnerable to popular rhetoric. We worry about this rhetoric and the damage that could result from one of the potentially ugliest presidential campaigns in modern history.

We embedded one percentage point of fiscal drag in our 2% GDP forecast, but the actual impact could be larger or smaller depending, in part, on what Washington decides to do in the first quarter with the payroll tax cut, special unemployment benefits, and other expiring stimulus. Also, if Washington's antics lead to another rout in the financial markets, this too could weigh on GDP growth.

Things will not calm down after the presidential election because, during the lame duck session, Congress will have to decide what to do about the expiring Bush tax cuts, \$1.2 trillion in automatic

Consensus Annual GDP Forecasts

Weakness Abroad Could Undermine U.S. Growth Improvement



Source: Bloomberg December 2011 Survey

sequesters, and the 3.8% Medicare tax on net investment income. Doing nothing could cost the economy more than 2.5% of GDP in 2013 and raise recession fears.

While Europe and Washington are the two loudest gorillas in the room, the tiger in the corner is China. Growth there is slowing because of weak export growth and the bursting of the property bubble. We look for GDP in year-over-year terms to average a bit more than 7.5% during the first half of 2012 compared to near 9% during the second half of 2011. While that growth rate seems robust compared to other key emerging markets, it is slow for China and could cause business managers and households to retrench. This is particularly important because China has been the key driver of global GDP growth in recent years. Our current U.S. growth forecast assumes China is able to restore 8 to 9% GDP growth by the second half of 2012.

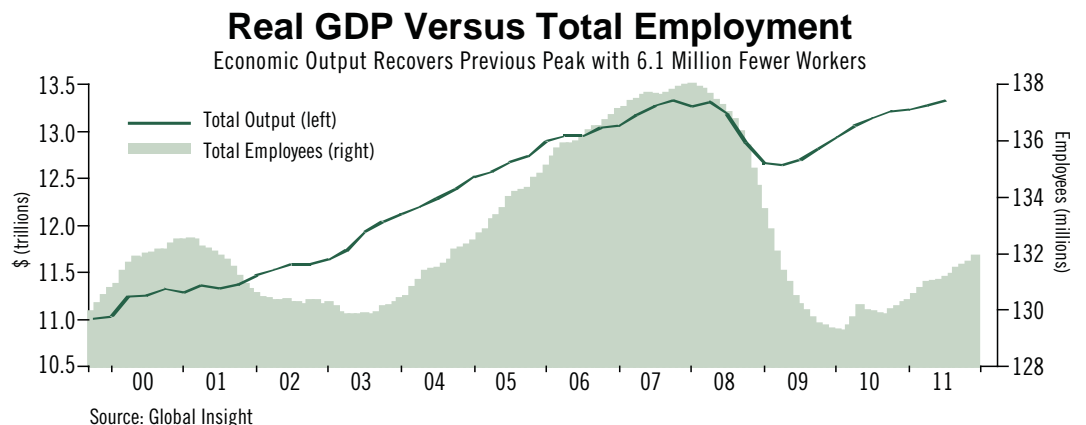
Fiscal and monetary authorities in China have the scope to ease policy and reinvigorate growth. The People’s Bank of China has already reduced the required reserve ratio by 50 basis points and will probably cut it by another 200 basis points during the first half of the year. Fiscal stimulus is also likely to be used to support business and household spending, and we expect public housing, agriculture and railway spending to be a focus. The key question is how quickly the economy responds to stimulus. A slow response

will likely put additional downward pressure on global commodities prices and GDP growth.

If China is the tiger in the room, the Middle East is the snake. It seems coiled and ready to strike, but it might or might not. Energy prices are already fairly high in response to limited spare capacity and geopolitical risk, but prices would move higher if there are actual supply disruptions. Energy demand, on the other hand, is likely to be relatively subdued in 2012 given our outlook for roughly 3% real global GDP. High oil prices have been a boon for the U.S. oil and gas industry and that should continue. Our druthers, however, are for steady-to-lower oil prices in order to free businesses and households from the energy tax.

The U.S. economy, meanwhile, has enjoyed a pickup in momentum, and that will provide a thicker cushion for absorbing negative shocks in 2012. This momentum increase has been driven, in part, by a reduction in headwinds that held the economy back earlier in the year, but we are heartened by signs that positive feedback loops are once again reinforcing the expansion. Most important, the labor market is improving in response to stronger demand. Our forecast assumes that employment growth expands by 2.0% in 2012 following 1.25% growth in 2011.

We have said many times that labor market strength is the elixir that will cure all economic ills. It will lead to increased job certainty and stronger nominal income growth, which will lead



to increased consumption, investment, savings and tax revenues. The labor market recovery to date has been very weak despite the recovery in GDP. We are now generating more economic output than we did prior to the recession but with 6.1 million fewer jobs. This has resulted in a tremendous surge in profit growth, but labor income growth has suffered mightily.

Household consumption, meanwhile, has been surprisingly robust in the face of weak income growth, and this cannot continue indefinitely. The saving rate which was 5.2% in January 2011 is now just 3.5%, and it really needs to be higher. We attribute consumption strength to a combination of pent-up demand and significant relief from slower inflation during the final quarter of the year.

Looking ahead, real labor income should improve, but we suspect households will choose to rebuild their savings during the first quarter at the expense of consumption. We also expect to see some rotation from consumer durable goods to nondurable goods and services. For the most part, we expect real labor income to drive consumption in 2012 as credit and savings are used sparingly. We anticipate real consumption growth of near 2.5% this year, a moderate outcome for a sector that comprises 71% of GDP.

One of the biggest risks for consumption growth in 2012 is the potential for higher energy

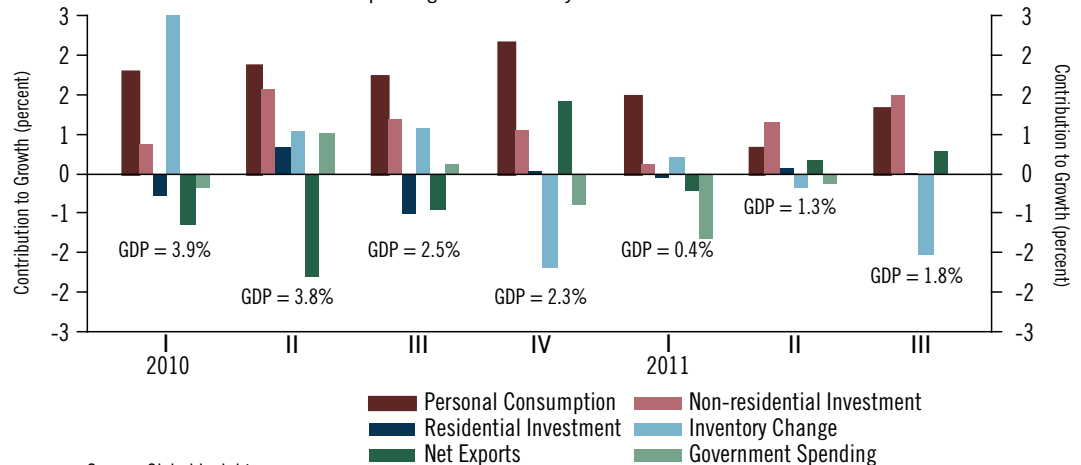
prices. More than one-third of the increase in the CPI during 2011 was due to higher energy costs. This crippled consumption growth in the second quarter of 2011. Alternatively, if energy prices find and hold lower levels in 2012, then consumption growth could exceed our forecast.

Business investment spending, on the other hand, should continue to post high, single-digit growth rates. This sector comprises 10% of GDP and has been an important contributor to GDP growth for the last two years. Initially, growth came from investment in new software as the recovery began to unfold, but managers began to purchase new equipment in 2010, and we are now finally witnessing the building of new structures. There is plenty of scope for more gains with nonfinancial profit margins at their highest levels since the 1960s and capital goods spending levels still low for most sectors. Financing costs are also very low.

Residential investment could grow in the high single-digits in 2012, but this sector is now less than 2.5% of GDP, so it will have only a small impact on overall GDP growth. Still, every little bit helps. While lawmakers are bandying about government programs to restore growth in this sector, we are focused on the labor market. Stronger labor market growth would boost household formation rates and lift demand for rentals and purchases, and, by extension lift construction. Right now,

Sources of GDP Growth

Investment Spending Has Been a Key Contributor to GDP Growth



Source: Global Insight

housing starts are running about half the pace needed to meet normal demographic demand. There is plenty of scope for improvement.

We think the housing market story could be one of the more positive stories in 2012. Housing starts have already bottomed with multi-family housing starts up sharply and single-family starts trending sideways. Bloated supply is keeping single-family construction subdued, but increased rental demand and lower vacancy rates have resulted in a surge in multi-family construction. We are also seeing a pickup in remodeling activity. National home prices are still drifting lower and will probably decline another 3–5% before bottoming in early 2013. They could bottom in 2012, particularly if the labor market strengthens by more than we expect or a new fiscal program is (intelligently) developed to turn shadow inventory into privately owned rental units.

National home prices are no longer out of line with fundamentals in our view, and there are some regions that are downright cheap. Households still fear taking on a large liability in a weak labor market, and tight mortgage credit is a headwind, but these issues are slowly being worked out.

One of the more negative stories in the last couple of years has been the public sector. Massive spending cuts here have led to large-scale layoffs and severe curtailment in activity. Public sector spending reductions will probably cost the economy a few tenths of a percentage point in 2012, a bit less than last year. International trade could also cost the economy a few tenths of a point because of a firm dollar and weak international demand. Higher inventory accumulation should partly offset the negative contributions from the international and public sectors, though.

All in all, we think the U.S. economy is getting into better shape, and it will be in fine shape in 2012

as long as exogenous shocks do not set it back too severely...a big “if” unfortunately. Key members of the Federal Open Market Committee, however, do not share our view. They are worried that the economy will stumble without additional support and appear poised to ease policy further. We think there is a fair chance that QE3 will be deployed this year if the unemployment rate remains above 8%—a likely event because a stronger labor market should beget increased labor force participation.

The Fed will have to explain to the public, however, how it can justify loosening policy when inflation is near its target rate. We expect the Fed will seek to do this as part of their new communication strategy. The Fed is currently working on a new mission statement to describe its longer-run goals and policy strategy. We think one aim of the statement will be to keep inflation expectations anchored in an environment of unusually loose monetary policy.

Our inflation forecast is for 2.2% average CPI growth and 1.8% average core CPI growth. A renewed surge in food and energy prices could scuttle our headline inflation forecast, but we feel confident that core consumer prices will remain subdued in 2012. Rising shelter costs, roughly 40% of the CPI, were the main source of upward pressure on the core CPI in 2011, and shelter costs will continue to put upward pressure on the CPI in 2012. Non-shelter components of the CPI, however, will likely remain subdued in an environment of high unemployment and relatively weak GDP growth.

In conclusion, we are feeling relatively optimistic about the economy’s prospects, but we are extremely cautious about the global environment. To succeed in life, one has to have as much luck as skill. We will hope for good luck for the economy in 2012.

This information reflects the viewpoint of Dwight Asset Management Company LLC as of December 31, 2011 and is subject to change. This article was prepared for general informational purposes only, without respect to the investment objectives, financial profile, or risk tolerance of any specific person or entity who may receive it. Investors should seek financial advice regarding the appropriateness of investing in any investment strategy or security discussed or recommended in this article and should understand that statements regarding future performance may not be realized. Investors should note that income, if any, from any investment strategy or security may fluctuate and that underlying principal values may rise or fall. Past performance is not necessarily a guide to future performance.