

THE ECONOMY

as of November 3, 2011

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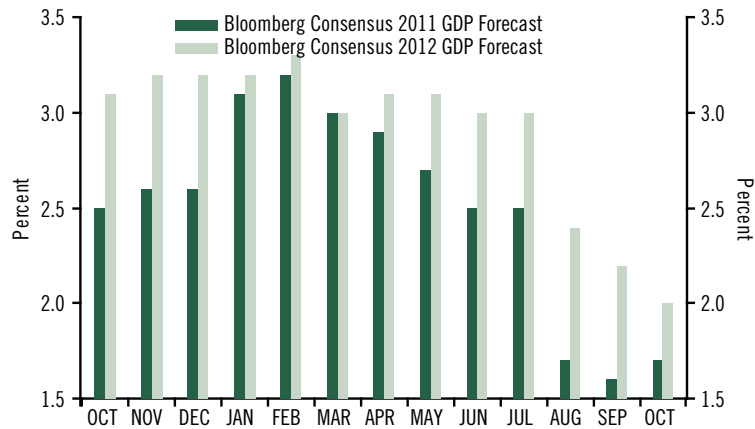
This information reflects the viewpoint of Dwight Asset Management Company LLC as of November 3, 2011, and is subject to change. This report is provided for informational purposes only.

- ◆ Our consensus-like 2011 GDP forecast for 1.8% growth has changed little since July, but we raised our 2012 forecast from 0.7% to 1.5% in October because the economy has exhibited more resiliency to adverse economic shocks than we anticipated. Our still below-consensus call reflects our relatively pessimistic view on fiscal policy and the European crisis.
- ◆ The economy is flying at a fairly low altitude, and this presents a number of problems. First, the economy is quite vulnerable to exogenous shocks. Second, there will be little improvement in the unemployment rate. And third, our fiscal deficits and debt ratios will remain high. Monetary and fiscal stimulus is limited, but policymakers could still boost the economy by providing more clarity about regulatory and taxation policies and easing stress in the housing market.
- ◆ The Federal Reserve is expected to keep overnight rates unchanged through mid-2013 and possibly longer if inflation remains benign and the unemployment remains high as suggested by the FOMC's latest forecasts through 2014. Our near-term outlook for inflation is similarly benign, but the jury is still out regarding medium-term inflation.
- ◆ The Fed's Duration Extension Program has guided long-term interest rates lower, but overall financial conditions are no better today than they were prior to the launch of this program. The European debt crisis coupled with concerns about Washington's ability to manage our debt load has weighed on stock market and other risky asset prices.
- ◆ In November, Washington legislators will likely have to agree to another continuing resolution to keep the government funded past November 18. The Joint Select Committee on Deficit Reduction (super committee) will also have to issue their recommendations by November 23 ahead of a full Congress vote by December 23.
- ◆ We expect the super committee to fall short of the \$1.2 trillion long-term deficit reduction goal. If they make it, we suspect it will be because of accounting maneuvers that do not result in real savings. We are particularly concerned that Washington will not live up to the spirit of the Budget Control Act. This could send a negative signal to the markets and credit rating agencies. Fitch or Moody's could cut their AAA sovereign debt rating for the U.S. as soon as this quarter.
- ◆ Our relatively cautious stance on 2012 GDP growth is based on concerns that the stalemate in Washington will continue, and Congress will not materially reduce scheduled fiscal tightening. We are also concerned about the anticipated recession in Europe, and the fact that real disposable income growth is currently insufficient to support even moderate GDP growth.
- ◆ The economic outlook is highly uncertain. Business and household confidence has been depressed by Washington politics, a weak labor market, financial market volatility and the ongoing debt crisis in Europe. Animal spirits are dim because it is nearly impossible to accurately gauge future income.

ECONOMIC GROWTH

Bloomberg Consensus Growth Forecast

Slow GDP Growth Leaves Economy Vulnerable to Shocks



Source: Bloomberg

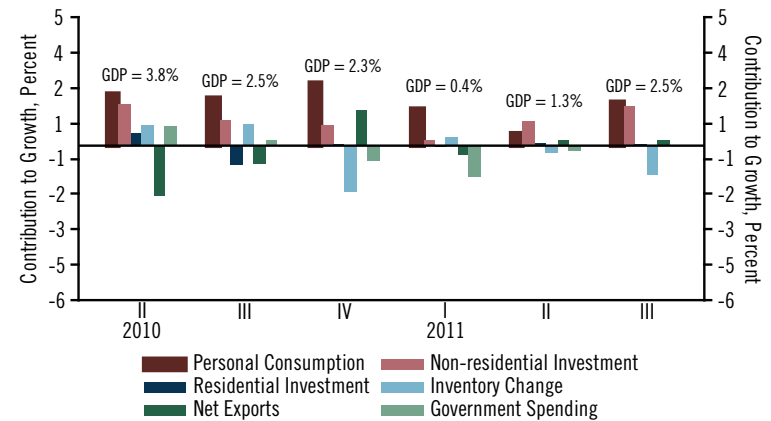
- ◆ The consensus slashed its 2011 forecast in August in reaction to an unusually large and negative GDP benchmark revision that accompanied a weaker-than-expected second-quarter GDP report. Better-than-expected growth in the third quarter led to an upward revision in October.
- ◆ Economists reduced their 2012 GDP growth estimates for a third consecutive month in October. Weak employment growth, low confidence levels, volatile financial markets, impending fiscal tightening and slower growth abroad are all factors behind this.

Dwight View:

- ◆ Our consensus-like 2011 GDP forecast for 1.8% growth has changed little since July, but we raised our 2012 forecast from 0.7% to 1.5% in October because the economy has exhibited more resiliency to adverse shocks than we anticipated. Our still below-consensus call reflects our relatively pessimistic view on fiscal policy and the European crisis.

Sources of GDP Growth

Q3 Inventory Drag Should Be Reversed in Q4



Source: Global Insight

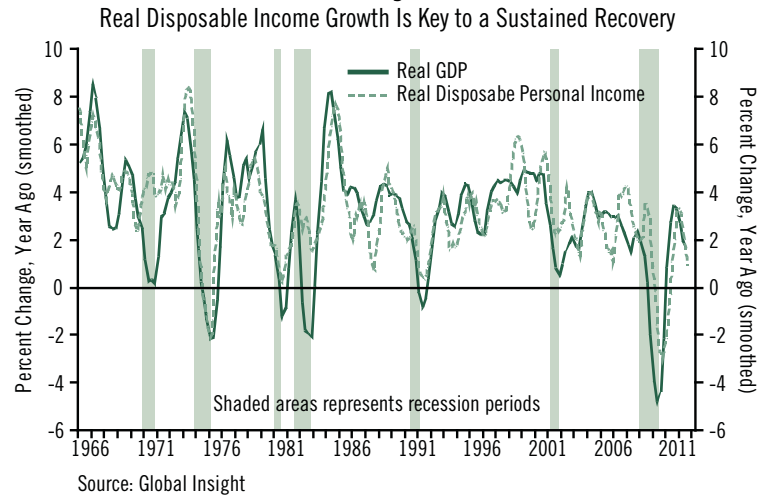
- ◆ Headwinds that held back activity in the first half of the year have now dissipated or become tailwinds, giving the economy a lift in the second half. A key question is: how long will this last?
- ◆ Households and businesses are releasing some pent-up demand, but households have run down their saving rate in the process. Barring a strong pickup in real disposable income growth, consumption will likely be constrained going forward. Businesses, however, continue to invest in productivity-enhancing equipment and software, and they are even starting to build more structures. Strong profit growth should continue to support investment.

Dwight View:

- ◆ We raised our fourth-quarter 2011 GDP forecast from 1.5% to 2.5% because of stronger consumption and investment patterns and the view that inventory accumulation should rise. We continue to worry that the economy is highly vulnerable to shocks, and we still think the economy is on a recessionary track. Good policymaking and/or a rebound in personal income could throw the switch, though.

ECONOMIC GROWTH

After-Tax, Inflation-Adjusted Income & GDP

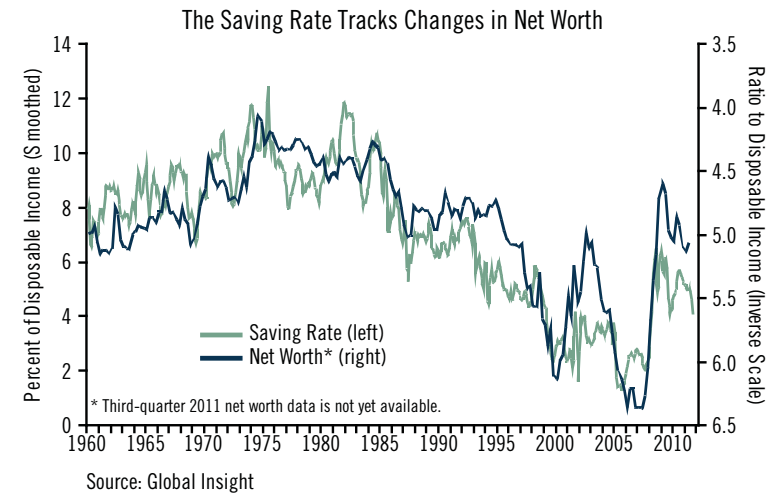


- ◆ One of our main economic concerns is the major bite that inflation has taken out of disposable income. Real disposable personal income has fallen for three consecutive months and was unchanged in the six months prior to that.
- ◆ Nominal disposable income growth has been OK, but rising inflation has weighed heavily on the inflation-adjusted figure. Consumer inflation appears to be close to a peak, and this will help relieve pressure, but payroll taxes are currently slated to increase in 2012, and that drag could offset the boost from lower inflation.

Dwight View:

- ◆ During the third quarter, the national saving rate fell from 5.3% to 3.6% as households chose to increase spending at the expense of saving. This is remarkable because household financial wealth declined in the third quarter, and this usually signals an increase in the saving rate.

Personal Saving Rate & Household Net Worth



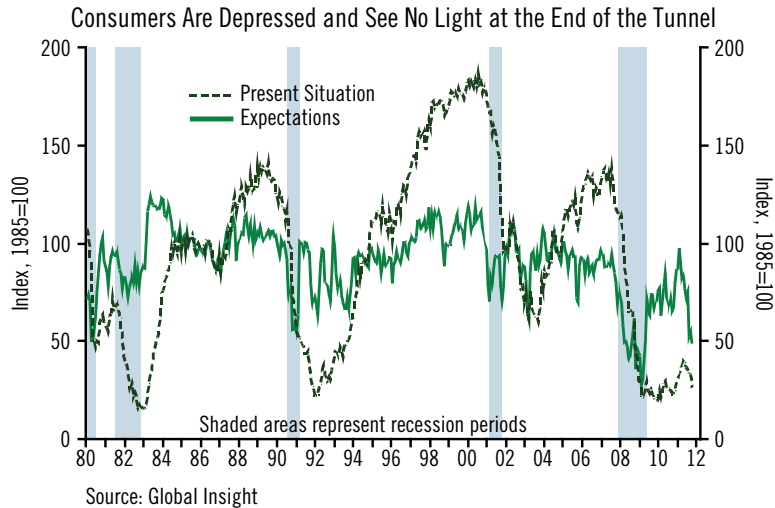
- ◆ The saving rate tends to track changes in net worth, and we believe that the saving rate will begin to trend higher again. We are surprised that households were willing to reduce savings as much as they did in the third quarter, and we question the validity of the data.
- ◆ The saving rate series is often revised and sometimes substantially so. It would not surprise us to learn that income growth and the saving rate have been stronger than reported, but that still will leave us pondering why consumer confidence is so depressed.

Dwight View:

- ◆ If income growth and the saving rate are not revised substantially higher, and real disposable income growth continues to be dangerously weak, then we will look for consumption growth to weaken substantially this quarter or next.

CONSUMER CONFIDENCE

Consumer Confidence: Two Measures

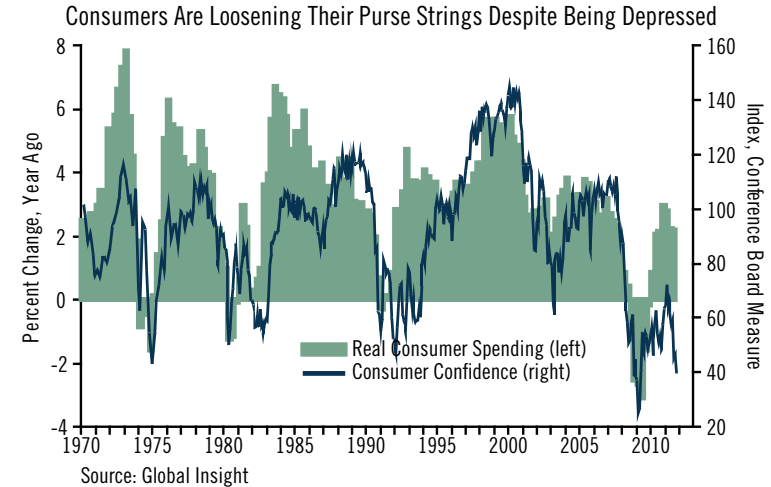


- ◆ Consumers' opinions about their present situation have not improved materially since the end of the recession in June 2009. At times, consumers have had a better outlook, but optimism about the future was squashed in August by the debt-ceiling debacle, the European crisis and financial market volatility.
- ◆ The aptly named "Misery Index," which combines headline inflation and the unemployment rate is probably the best explanation of why households are depressed about the present situation. During September, this index reached 13%, the highest level since 1983 when it was 13.5%.

Dwight View:

- ◆ We believe consumers are depressed about the future because there are few signs that their situation will change materially anytime soon. Our reliance on public policymakers to reboot the economy whenever it freezes has made us dependent on fiscal and monetary policy. There is currently only limited scope for policy easing.

Consumer Spending vs. Confidence



- ◆ Surprisingly, depressed consumers have not cut back their spending to a significant degree. The outlook for fourth-quarter auto sales and the holiday shopping season suggests real consumption should be up about 2% from a year ago this quarter. If so, the large disparity between consumer spending and sentiment will likely remain in place.
- ◆ The University of Michigan confidence survey and the Bloomberg US Weekly Consumer Comfort Index are also exhibiting recession-like readings.

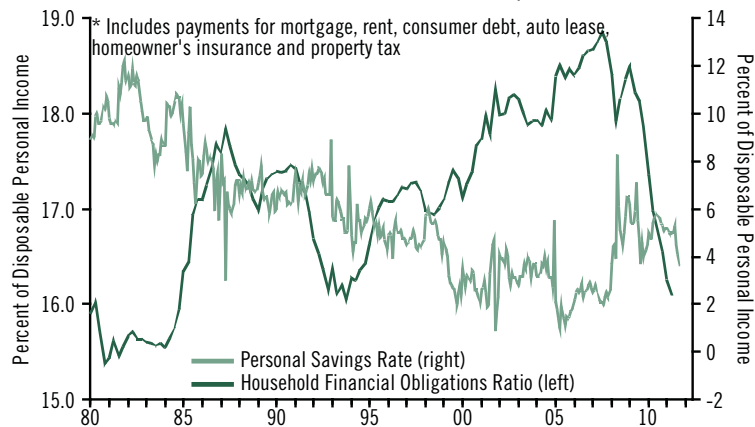
Dwight View:

- ◆ The link between confidence and real activity tends to strengthen when there is a very sharp decline in confidence as seen in August and October. We will be watching the weekly Bloomberg consumer comfort index for clues about November. With the focus back on Washington again, it could be a rocky ride.

DELEVERAGING TRENDS

Financial Obligations Ratio* & Savings Rate

Household Balance Sheets Have Improved



Source: Global Insight

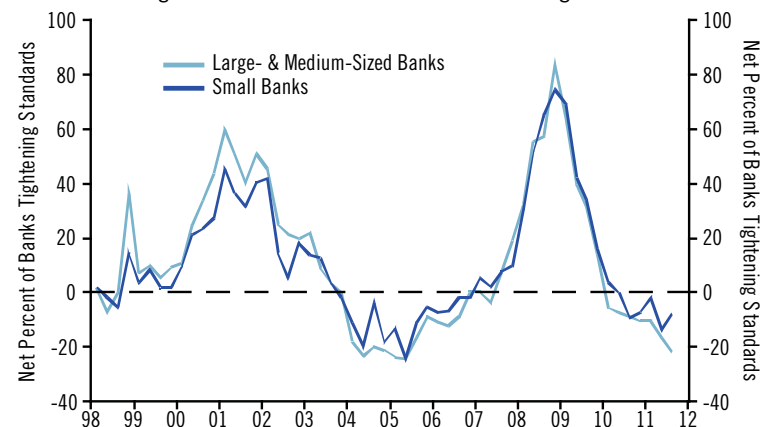
- ◆ The foul mood of households could also be a product of the rapid pace of deleveraging, but the good news is that households are in much better shape today, largely thanks to lower interest rates. The financial obligations ratio has fallen from a peak of nearly 19% of disposable income to a more manageable 16%, a level last seen in 1993.
- ◆ Moreover, household debt as a percent of GDP peaked at 99.4% in 2009, and in dollar terms, it peaked in 2008 at \$13.9 trillion. Since then, it has declined about 4.5% to its lowest share of GDP since 2005 at 88.5%. The saving rate has also risen from unreasonably low levels, and estimated credit card debt per U.S. household is now about \$6,400 rather than \$8,000.

Dwight View:

- ◆ The household deleveraging process has further to run, but the urgency to pay down debt has lessened. The household debt overhang will remain a constraining factor on GDP growth, but less of one. Indeed, consumer credit has expanded in ten of the last eleven months.

Fed Sr. Loan Officer Survey: C&I Loans

22% of Large- and Medium-Sized Banks Eased Lending Standards in Q3



Source: Global Insight

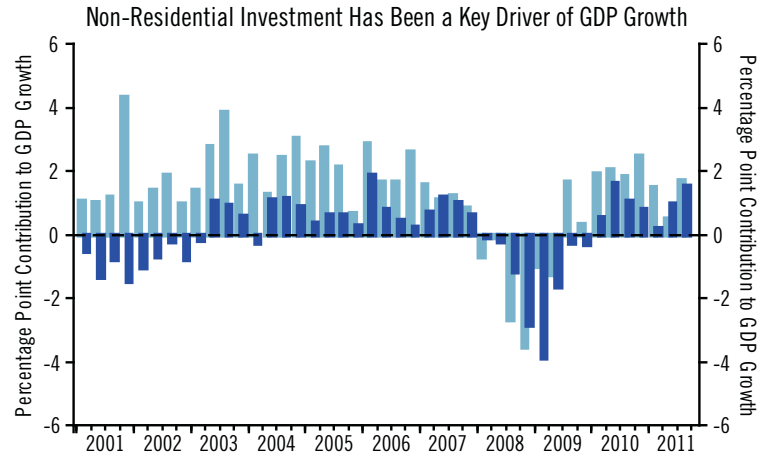
- ◆ The use and availability of bank debt within the business sector is improving at a relatively quick pace. The Senior Loan Officer Survey tells us that increased competition for commercial and industrial loans has led domestic banks to ease standards, on net, since early 2010.
- ◆ Demand for C&I loans has also improved with a modest net fraction of domestic banks reporting increased demand. An increase in non-residential fixed investment spending is probably driving this demand. Overall demand remains lackluster, however, but this is partly because many corporations are in a position to self-fund or borrow in the public markets.

Dwight View:

- ◆ Bank lending standards are still relatively tight compared to pre-crisis trends, but we are pleased to see C&I loans on the rise. We consider this a green shoot.

BUSINESS INVESTMENT

Consumption & Non-Residential Investment



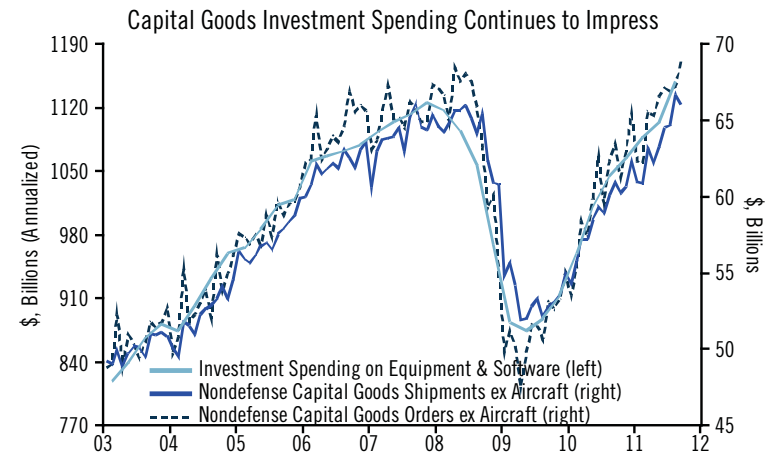
Source: Global Insight

- ◆ Consumption comprises 71% of GDP, while non-residential fixed investment comprises just 12%. Still, the contribution to GDP growth from this much smaller sector has been nearly as large as the consumer sector. We expect this dynamic to continue in 2012.
- ◆ Within the non-residential investment sector, spending on equipment and software, about 7% of GDP, has been a key driver of growth. Indeed, since the recovery began in the middle of 2009, equipment and software spending has accounted for one-third of GDP growth and over half of the growth in final sales.

Dwight View:

- ◆ Normally, capital spending and hiring are highly synchronized, but the current cycle seems to be out of alignment. We look for continued, albeit slower, growth in capital goods spending and an eventual pickup in employment growth.

Business Spending on Capital Equipment



Source: Global Insight

- ◆ The most important source data for estimating equipment and software spending is the series on shipments of capital equipment in the monthly durable goods report. This report can be volatile on a monthly basis and suffers from some seasonal quirks, but the trend is quite telling.
- ◆ Investment spending was slashed dramatically during the recession, and we are only now reaching pre-recession levels. During the third quarter, capital goods orders continued to advance, and this bodes well for fourth-quarter capital goods shipments.

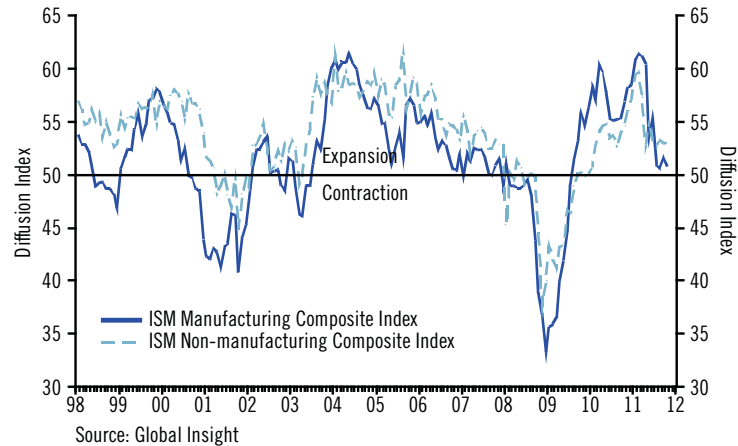
Dwight View:

- ◆ We look for another double-digit gain in real capital goods spending on equipment and software in the fourth quarter. During 2012, we expect equipment and software spending to moderate to a more normal 5% pace.

FAVORITE INDICATORS

ISM Purchasing Manager Indices

The Suddenness of the Correction Is Worrying



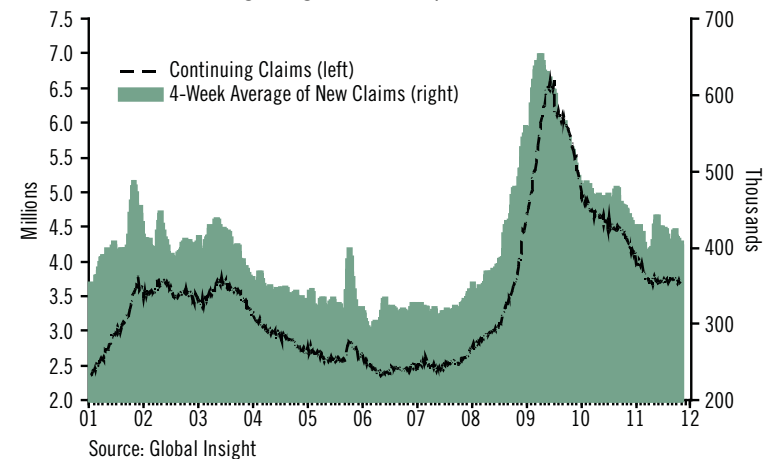
- ◆ The ISM indices are usually good tell-tales for broader economic activity, but they have been sending incorrect signals this year. During the first-half of the year, ISM readings were strong but economic growth was soft. The ISM readings fell sharply in the third quarter, but the economy picked up.
- ◆ The suddenness of the recent decline in the ISMs is worrying, but these data may have been skewed by global supply chain swings this year. Still, as a measure of breadth, there is no denying the fact that these indices are telling us that fewer businesses are reporting growth.

Dwight View:

- ◆ A dip below 50 would not necessarily signal a renewed recession, but it would indicate a more narrowly based expansion, and that is risky. Business confidence has been damaged by uncertainty about regulation, taxation and economic growth, and clarity here is unlikely in the near term. A corporate tax cut would certainly lift corporate spirits.

Jobless Claims

Claims Data Are Signaling Moderate Improvement in the Labor Market



- ◆ Jobless data have also been very good leading indicators of economic growth in the past. Indeed, claims have long been one of our favorite indicators. Right now, claims data are signaling a sustained expansion, but only moderate—read, not enough—improvement in employment growth.
- ◆ The level of claims consistent with a recession has changed over time, but claims always rise ahead of a recession. Currently, the four-week average for new claims is 397,000, down from an April high of 497,000, so no recession signal here.

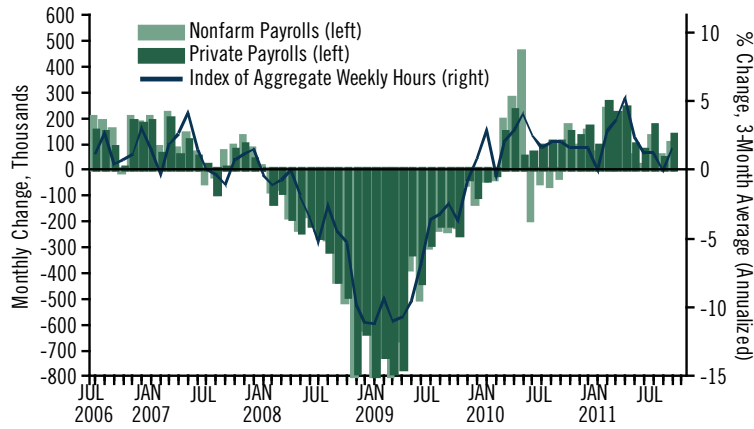
Dwight View:

- ◆ Claims would have to rise to the 450,000–475,000 area and hold that level for a month or so to signal a recession. Let's hope that does not happen.

LABOR MARKET

Nonfarm Payrolls

We Need More Oomph



Source: Global Insight

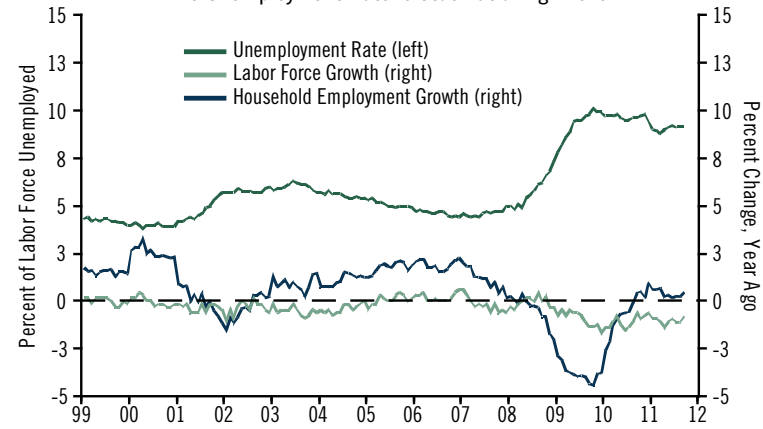
- ◆ The September employment report was notably improved relative to earlier reports, with an above-consensus gain in non-farm payroll growth of 103,000 and upward revisions totaling 99,000 to earlier data.
- ◆ Also important was an uptick in the average workweek to 34.3 from 34.2, and a 0.2% increase in average hourly earnings. This combination helped support 0.3% wage and salary income growth in September, but inflation offset two-thirds of this increase. The key to a sustained recovery lies with the labor market. We need more oomph.

Dwight View:

- ◆ Average payroll growth has been trending near 100,000 per month, and no significant improvement is expected in the near term. At best, this pace is consistent with about 2% GDP growth, and it is too slow to meaningfully reduce the unemployment rate.

Unemployment Rate

The Unemployment Rate Is Stuck at a High Level



Source: Global Insight

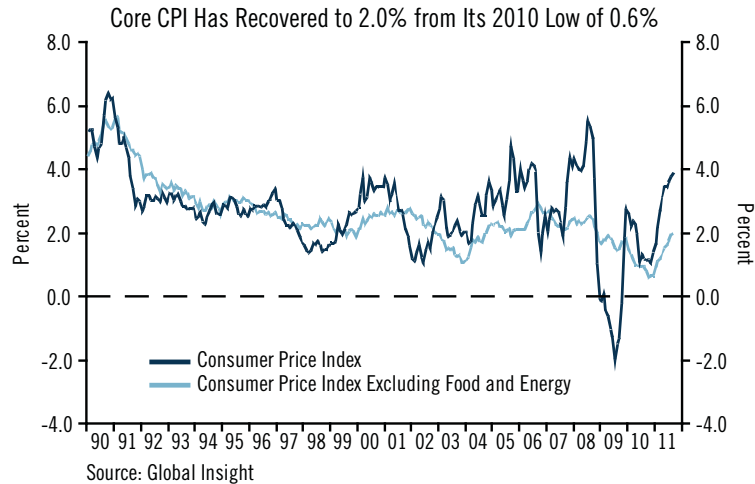
- ◆ The unemployment rate has inched back up to 9.1% after hitting a low of 8.8% in March. Despite having entered the third year of recovery, the unemployment rate is still only a point below the cycle high of 10.1% reached in 2009.
- ◆ The tough labor market has discouraged participation, particularly for those under the age of 24, who appear to be losing out to candidates with more job experience. Meanwhile, older adults (55+) have shown more inclination to participate. These trends are likely to continue until there is a meaningful recovery in new hiring.

Dwight View:

- ◆ We continue to look for the unemployment rate to end the year at 9.2%, and we anticipate it will still be near 9.5% at the end of 2012 barring a successful jobs stimulus program—unlikely. Very high unemployment is putting pressure on the Fed to ease policy further, but there is little the Fed can do to address the economy's problems, which are not monetary in nature.

INFLATION

Consumer Price Indices: Total & Core

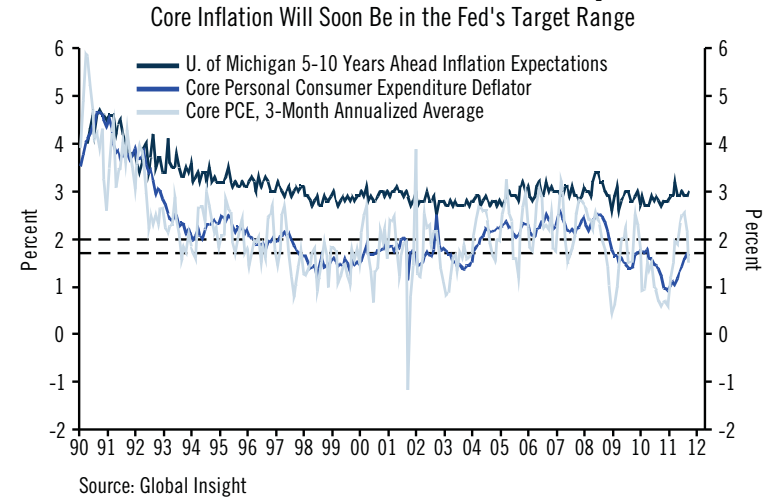


- ◆ While the weaker economy is preventing a meaningful decline in the unemployment rate, it is also likely to prevent a meaningful rise in core consumer inflation. This combination should allow the Federal Reserve to keep monetary policy extraordinarily accommodative for a long time.
- ◆ The rising trend in the inflation rate will likely give way to slower inflation in 2012, but not before year-over-year inflation for the headline and core CPI reach post-recession highs.

Dwight View:

- ◆ We expect headline CPI inflation to rise by an average of 3.2% in 2011, while the core CPI should rise by an average of 1.7%. On a year-over-year basis, we expect the headline CPI to peak at 3.9% and the core CPI to peak near 2.2%. In 2012, we expect inflation to ease to average growth rates near 2%.

Core PCE Inflation & Inflation Expectations



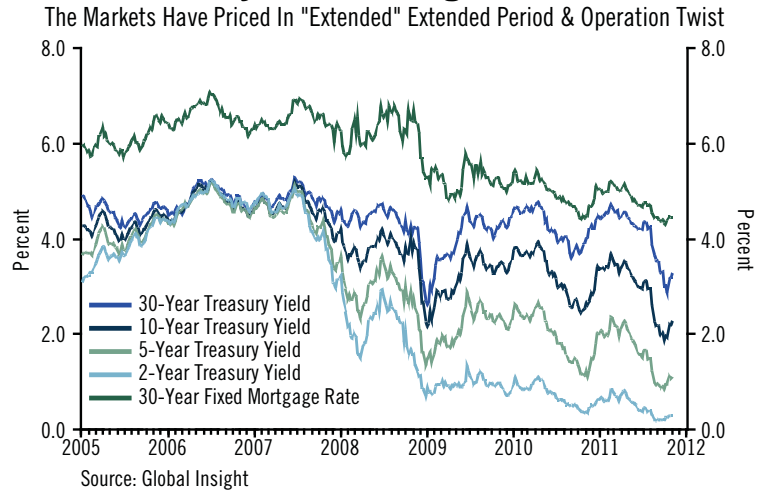
- ◆ The Federal Reserve prefers the PCE deflator as its main measure of inflation. The inflation indices have not risen as quickly as the CPI, but the core measure has reached the low end of the Fed's target zone of 1.7% to 2.0%. By the end of this year, we expect the core PCE deflator to be 2% or higher, but we think it will settle to just below 2% next year, in line with the Fed's forecast.
- ◆ Normally, one would expect the Fed to have a less accommodative policy in place when inflation is in the target zone, but the Fed is focused on reducing the unemployment rate, and it is not concerned about the risk of inflation briefly overshooting its unofficial target range.

Dwight View:

- ◆ We are not overly concerned about inflation either. Weak economic growth is likely to put a cap on inflation in the near term and inflation expectations remain stable. Still, one should not lose sight of the fact that there is a lot of tinder piled up that could ignite in dryer weather. The Fed must maintain an exit strategy.

MONETARY POLICY

Key Borrowing Rates

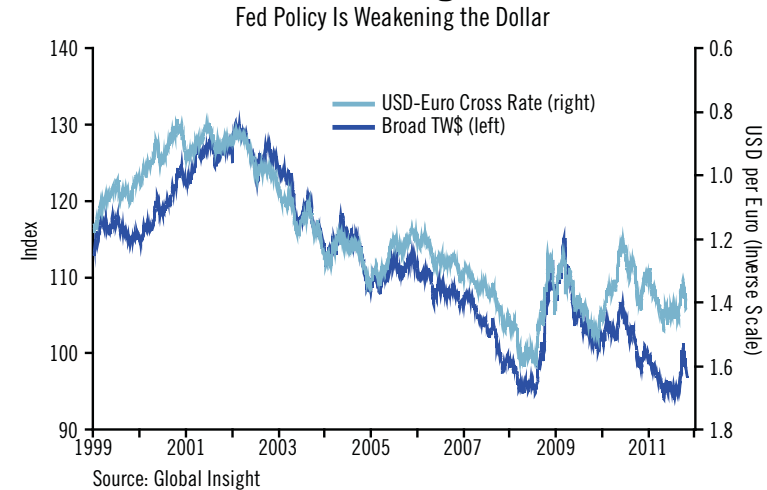


- ◆ The Fed has succeeded in driving down interest rates by stating that overnight rates are likely to remain extraordinarily low through mid-2013, and by announcing a \$400 billion program to lengthen the duration of the Treasuries held in the SOMA account.
- ◆ The Duration Extension Program, dubbed Operation Twist by market participants, will target 29% of the purchase activity in the 20- to 30-year part of the Treasury curve. This, along with Fed plans to roll over its mortgage-related bond holdings into new MBS, has encouraged 30-year fixed mortgage rates to hold near record lows.

Dwight View:

- ◆ Sadly, we think the Fed is shooting BBs at a gorilla. Lower interest rates are unlikely to get us out of our rut. We really need sound fiscal policies that provide effective short-term stimulus, and long-term policies that focus on assuring a sustainable fiscal debt trajectory.

Broad Trade-Weighted Dollar



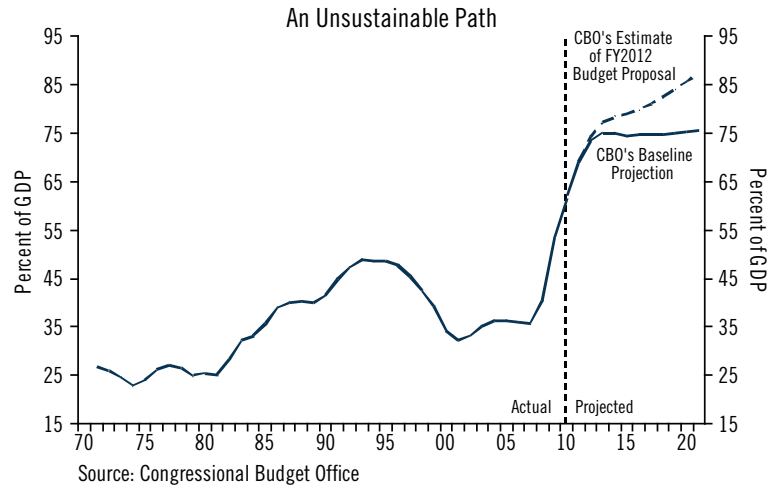
- ◆ The recent weakening of the trade-weighted exchange rate has been supporting exports and dampening imports, and we look for changes in the trade balance to provide a notable lift to second-half GDP growth.
- ◆ Central banks around the world are conducting monetary policy with an eye on the exchange rate impact. Some major central banks have reversed earlier tightening, but there is scope for more easing if global inflation slows as expected and growth continues to weaken.

Dwight View:

- ◆ Our economic forecast assumes that the trade-weighted dollar will be little changed in 2012. The actual path of the dollar will greatly depend on domestic and foreign policies in 2012, which are simply not predictable right now.

PUBLIC DEBT

Federal Debt Held by the Public



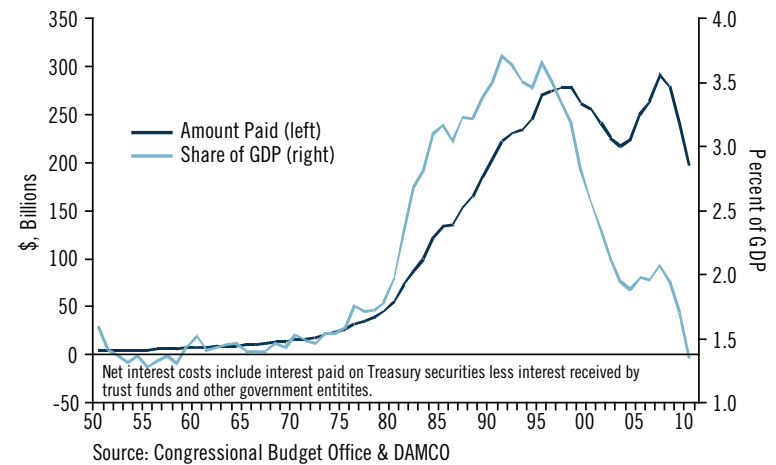
- ◆ The country's long-term fiscal imbalances are a result of an aging population and rapidly rising healthcare costs. Unfortunately, the fiscal crisis and recession added to the problem by raising the starting level. We can no longer ignore this pending disaster. A credible, practical and enforceable plan must be developed now.
- ◆ The budget deficit should narrow once the economy improves, but unless Congress and the President engage in strenuous fiscal house cleaning our debt ratio is unlikely to stabilize. At this time, we are far away from a successful bipartisan solution, and the public is generally ignorant about the extent of necessary austerity.

Dwight View:

- ◆ This backdrop is not supportive of a AAA-sovereign credit rating, and more rating agencies could strip it away if material progress is not made. S&P has already cut this rating to AA+, while Moody's and Fitch have warned of the risks as well.

Federal Government Net Interest Outlays

Falling Rates Have Lowered Overall Interest Expense Despite Debt Surge



- ◆ Although the federal government has increased its net borrowing substantially, net interest costs have dropped from \$253 billion in 2008 to \$197 billion in 2010 because of remarkably low interest rates.
- ◆ The CBO, which assumes current laws are unchanged when making projections, anticipates the cumulative deficit from 2012 through 2021 will exceed \$6.7 trillion. Borrowing to finance that deficit—in combination with an expected rise in interest rates—would lead to a fourfold increase in net interest payments over the next ten years. The CBO forecast shows a \$792 billion (3.3% of GDP) net interest expense in 2021.

Dwight View:

- ◆ If interest costs rise to 3.5% of GDP, then Washington will need to run a primary surplus of 3.5% of GDP in order to balance the budget. That will be a nearly impossible task to accomplish without dramatically cutting the defense, entitlement and discretionary budgets. Tax increases, even big ones, cannot do the job alone.