



Economic Update: Central Banks Search for Solutions

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U.S. Summary

- **Three years of expansion, but viewed as a disappointment**
- **The employment situation remains troubling**
- **Consumer balance sheet repair and the restructuring of housing finance will take time**
- **Fiscal policy remains at an impasse, risking a “cliff” event**
- **The Federal Reserve is providing more support**

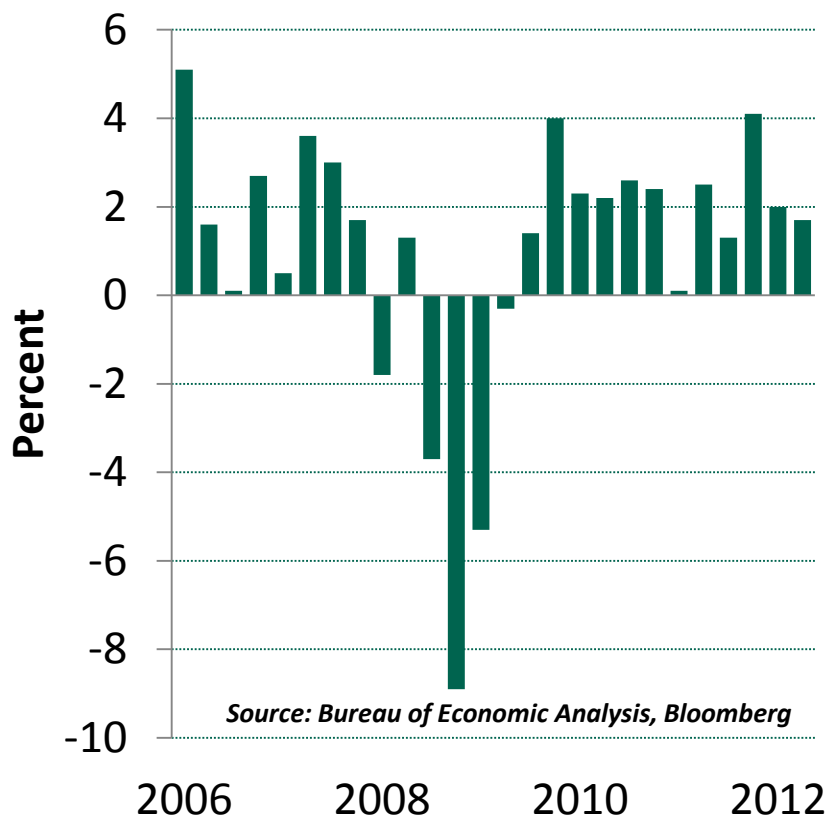




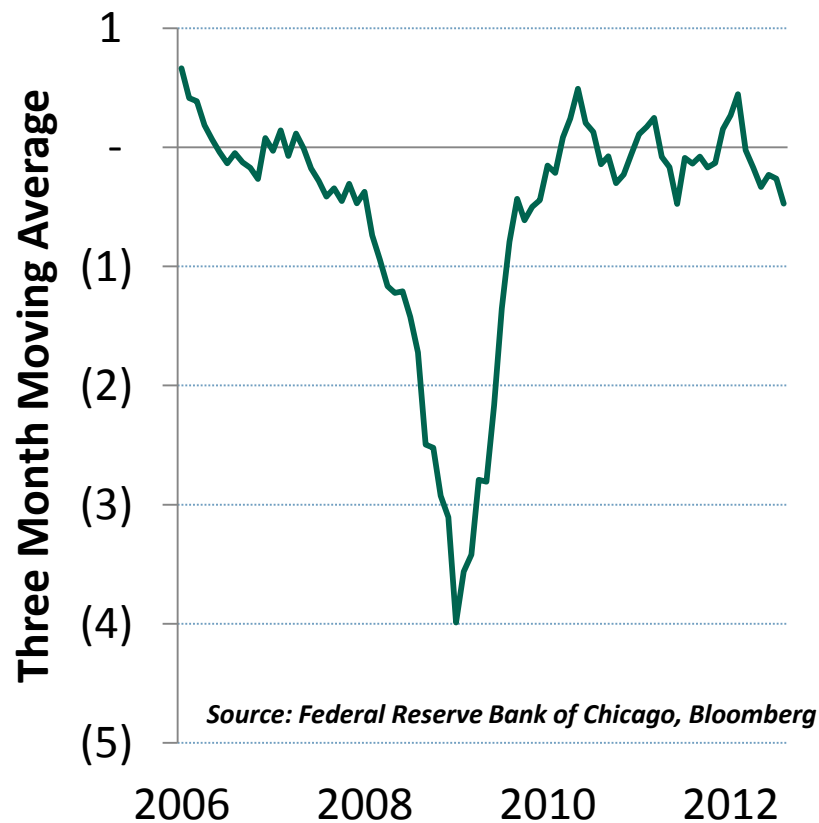
Our Modest Expansion

- Steady, but unspectacular growth
- Forward-looking indicators retreat

U.S. GDP Growth



Chicago Fed National Activity Index



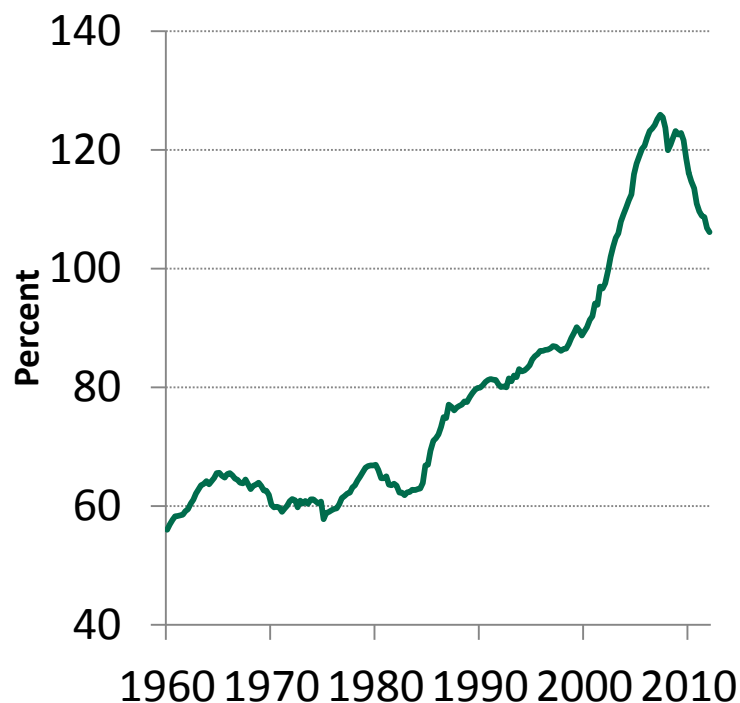
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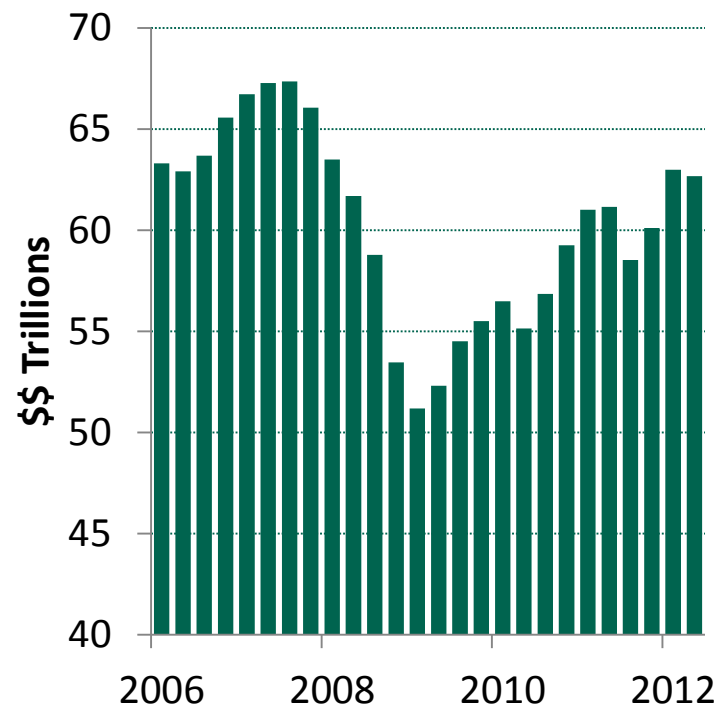
Consumer Balance Sheet Repair

- Debt levels have been declining, but may have further to go
- Stock values have recovered, home equity has not

Debt to Disposable Income



Household Net Worth



Source: Federal Reserve, Bloomberg



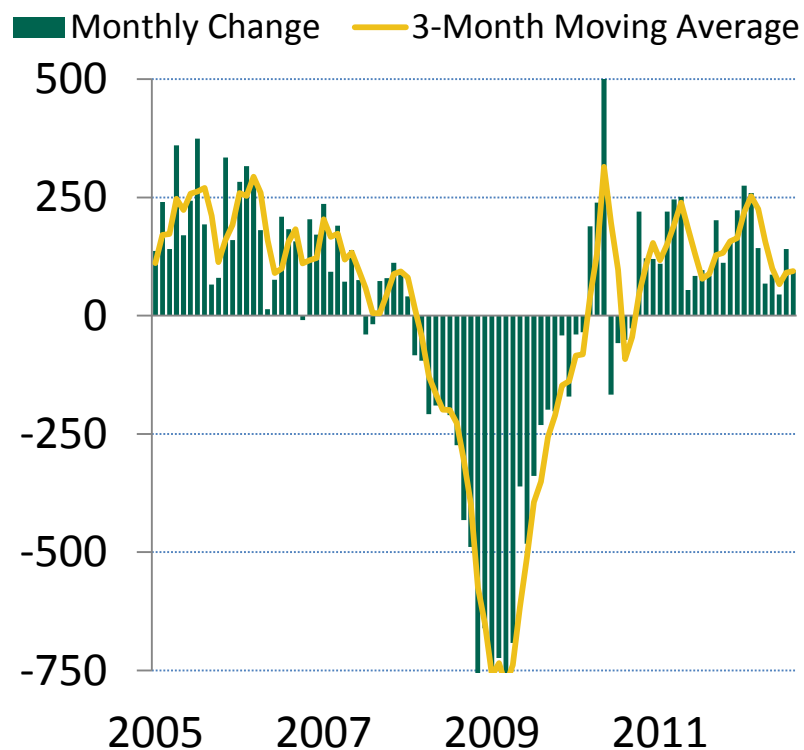
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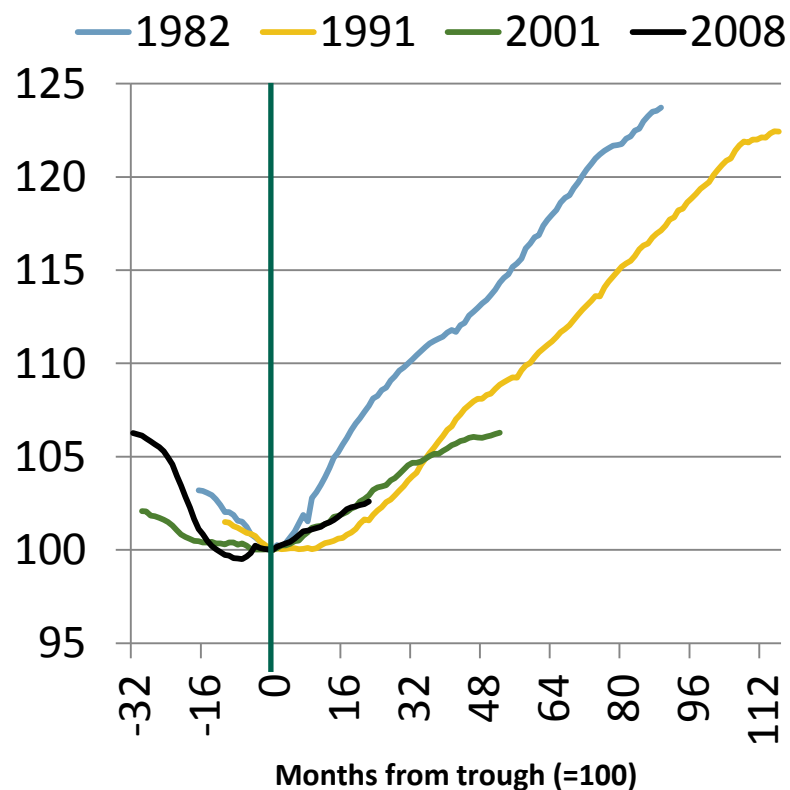
Disappointing Job News

- New hiring lags well behind past precedents
- Little noticeable momentum

Nonfarm Payrolls



Payroll Trends in Past Cycles



Source: Bureau of Labor Statistics, Bloomberg



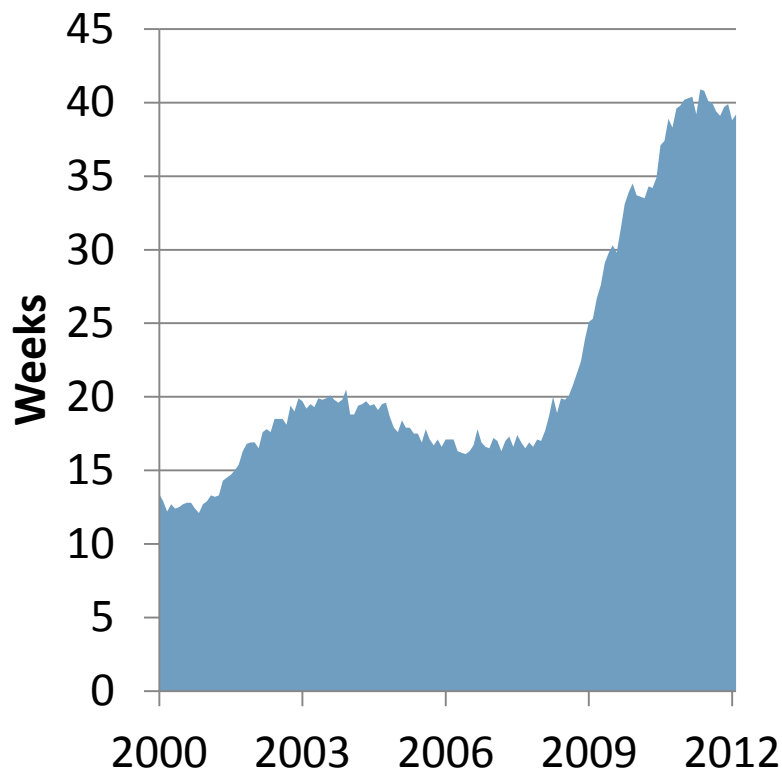
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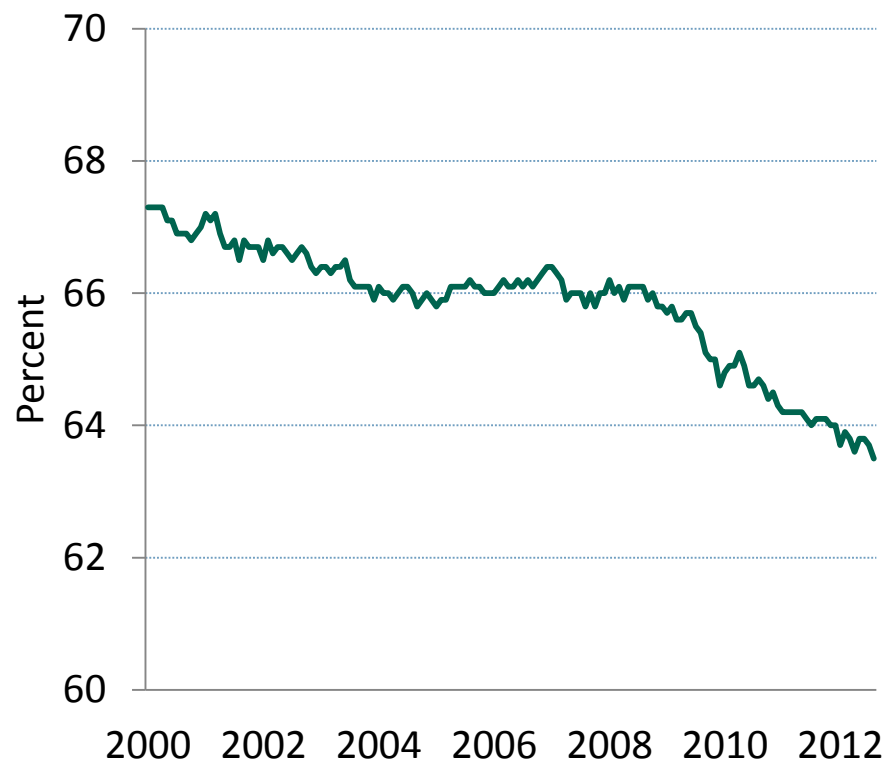
Labor Readings: Beneath the Surface

- Search times are very long
- How many workers are discouraged?

Mean Duration of Unemployment



Labor Force Participation Rate



Source: Bureau of Labor Statistics, Bloomberg



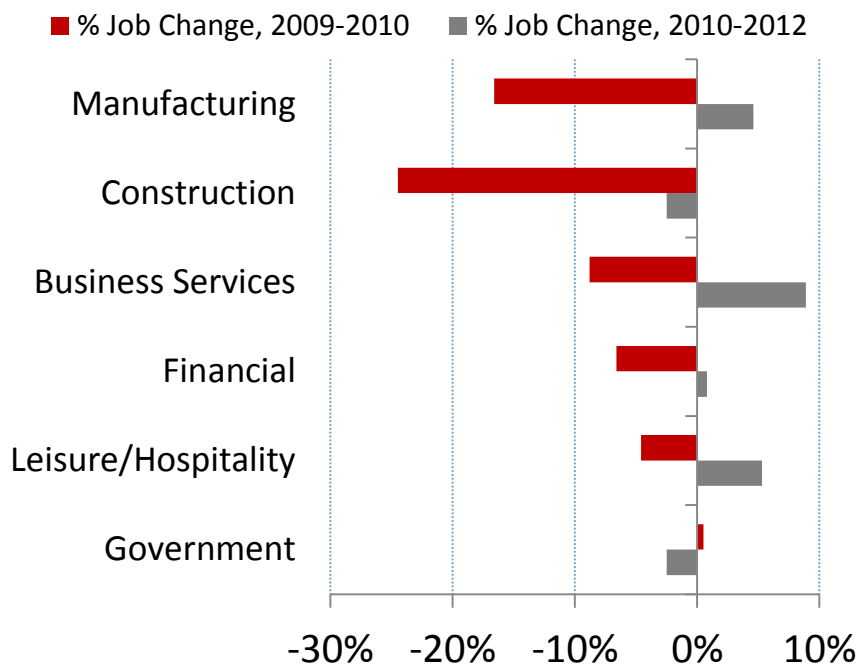
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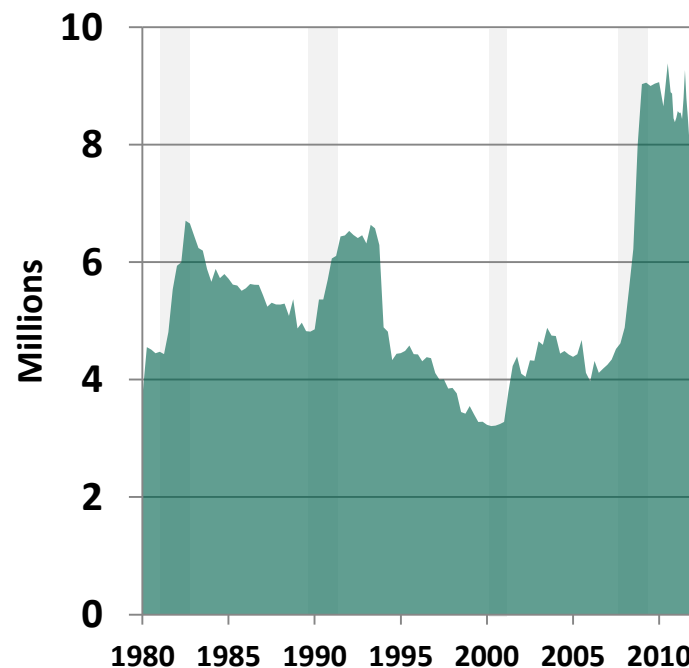
The Composition of New Hiring

- New positions carry lower wages than the ones lost
- Part-time employment seems more like an end state than a transitional state

**Trends in Payroll Employment
For Selected Industries**



**Working Part-Time for Economic
Reasons**



Source: Bureau of Labor Statistics, Bloomberg



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Our Views on the Labor Market

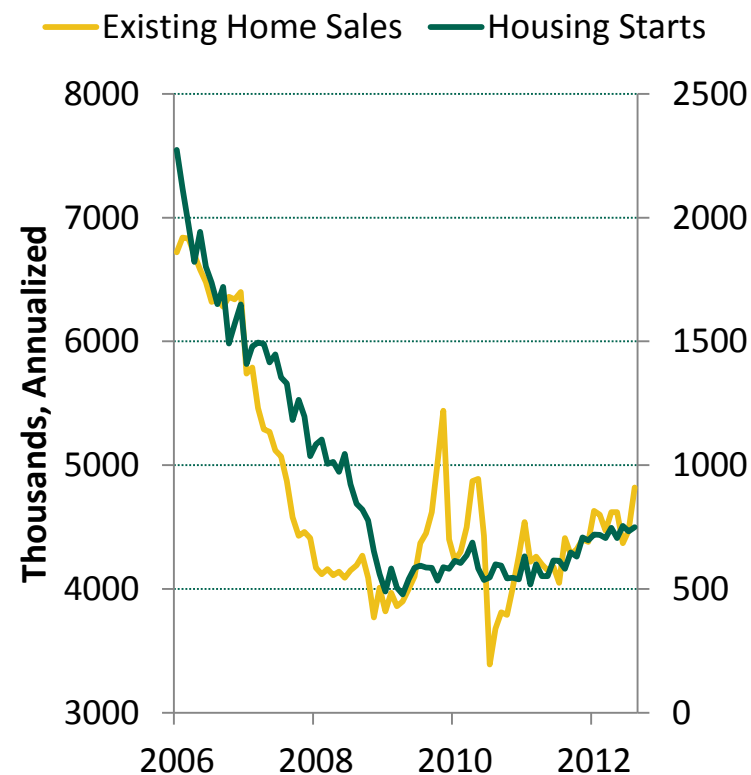
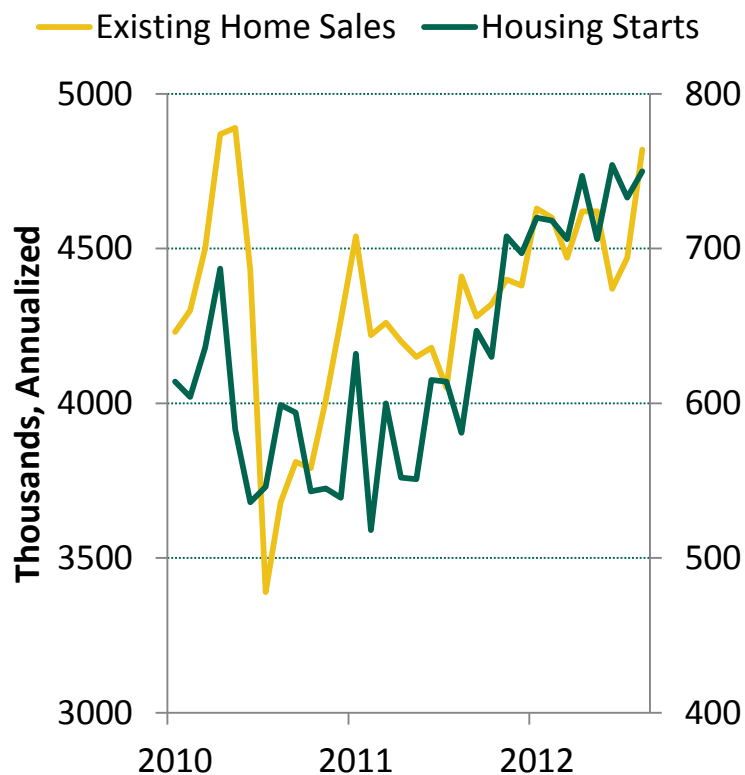
- **Lingering unemployment is primarily the product of modest growth, and not skill mismatches**
 - Supported by specific studies of openings
 - Past industrial shifts have not prevented unemployment from returning to pre-recession levels
- **Hiring demand may be constrained by an uncertain outlook and a desire to preserve profitability**





Is Housing Turning?

- The degree of improvement is a matter of perspective



Source: National Association of Realtors, US Census Bureau, Bloomberg



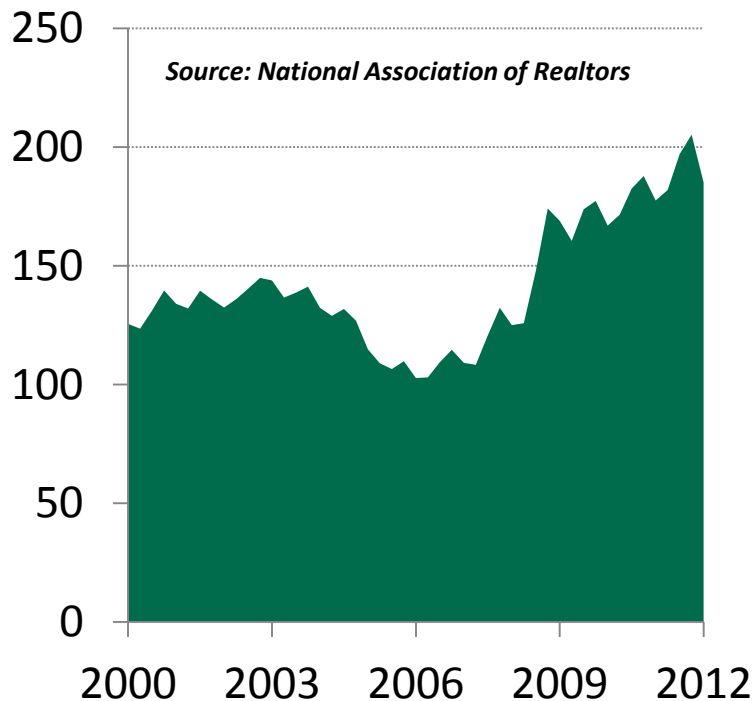
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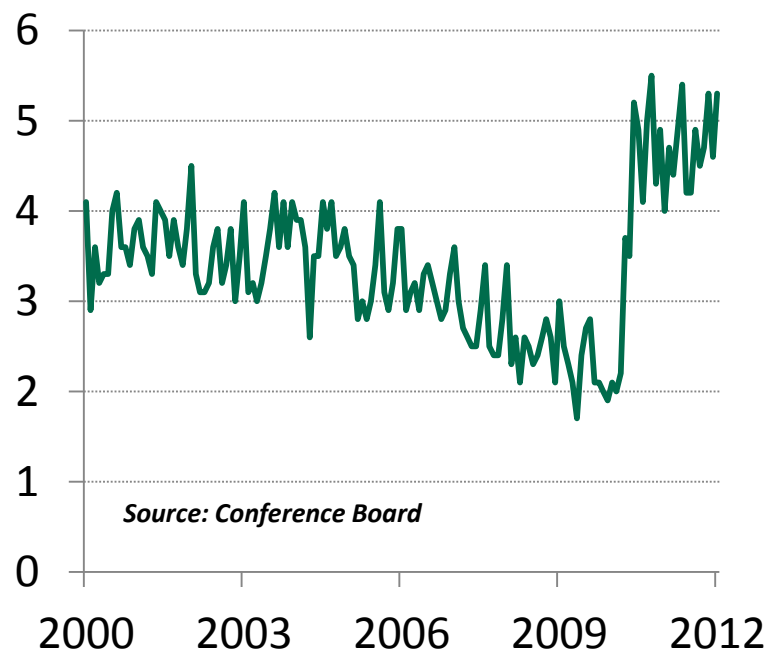
Good Conditions for Home Purchasers

- Price correction hurts owners, helps buyers

Housing Affordability Index



% of Consumers Planning to Buy A Home in the Next 6 Months



Source: National Association of Realtors, US Census Bureau, Bloomberg

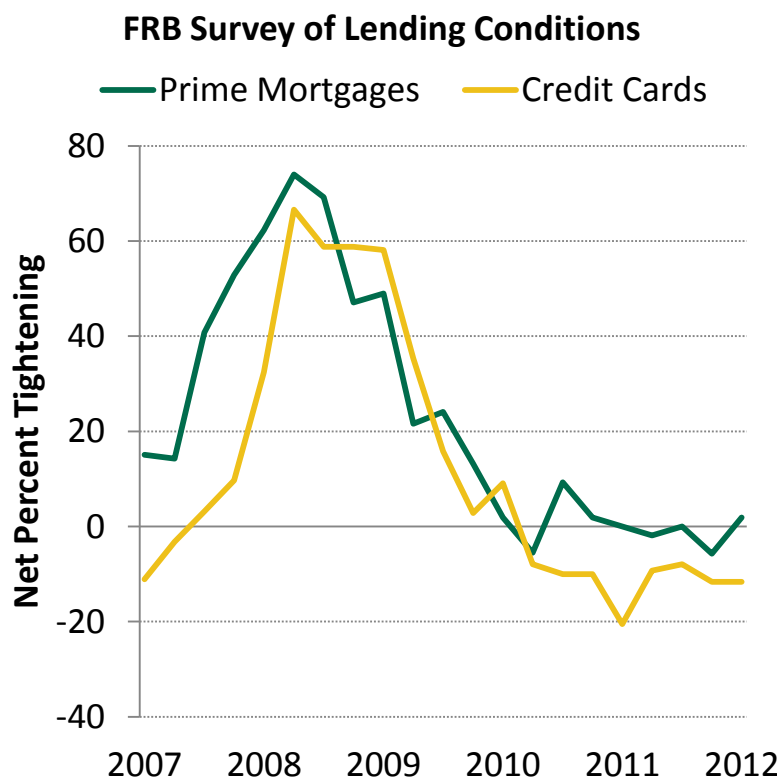


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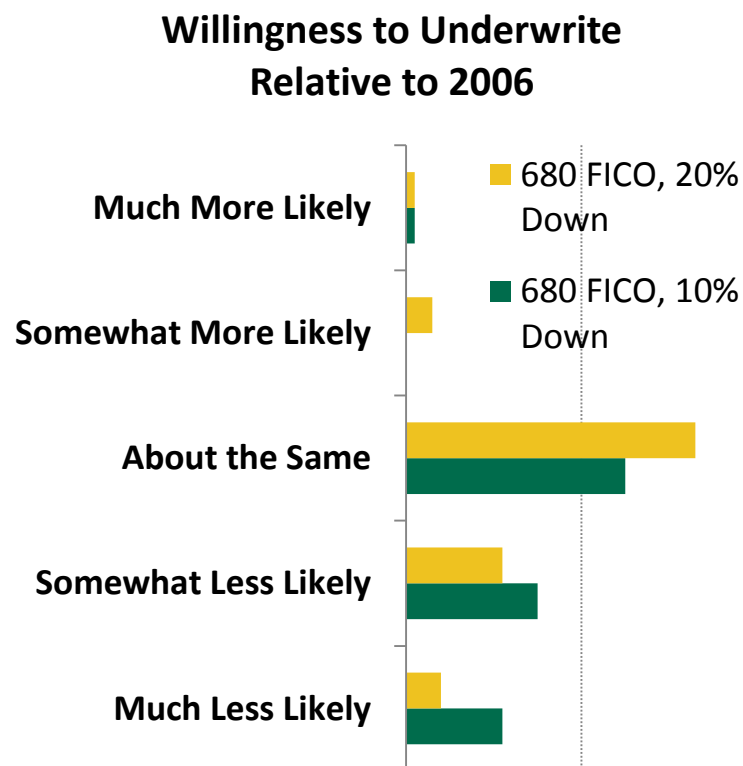


Mortgage Lending Standards

- Mortgage standards have yet to ease
- Higher FICO scores and down payments required



Source: Federal Reserve, Bloomberg



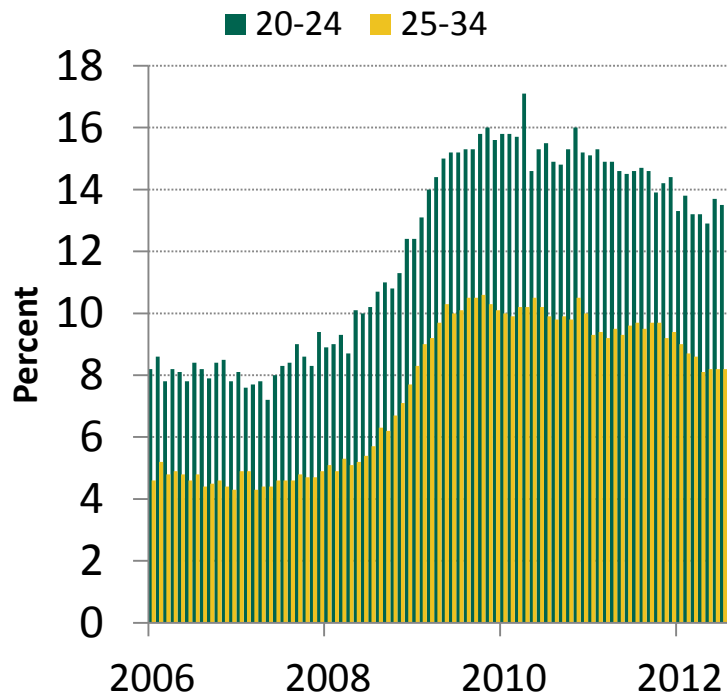
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Household Formation

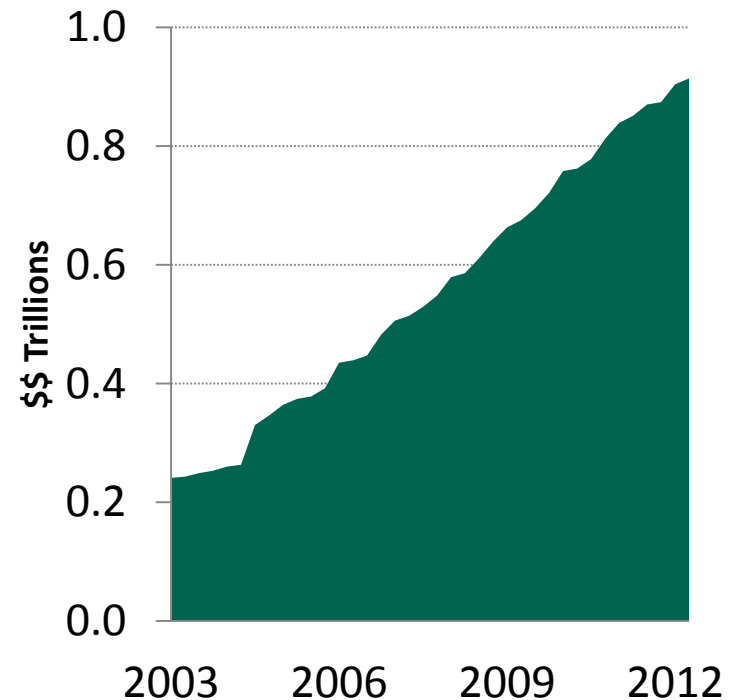
- Major impediments to housing purchases among young people
- Many parents are not in a position to assist

Unemployment Rates by Age



Source: Bureau of Labor Statistics, Bloomberg

Total Student Loans Outstanding



Source: Federal Reserve Bank of New York, Bloomberg

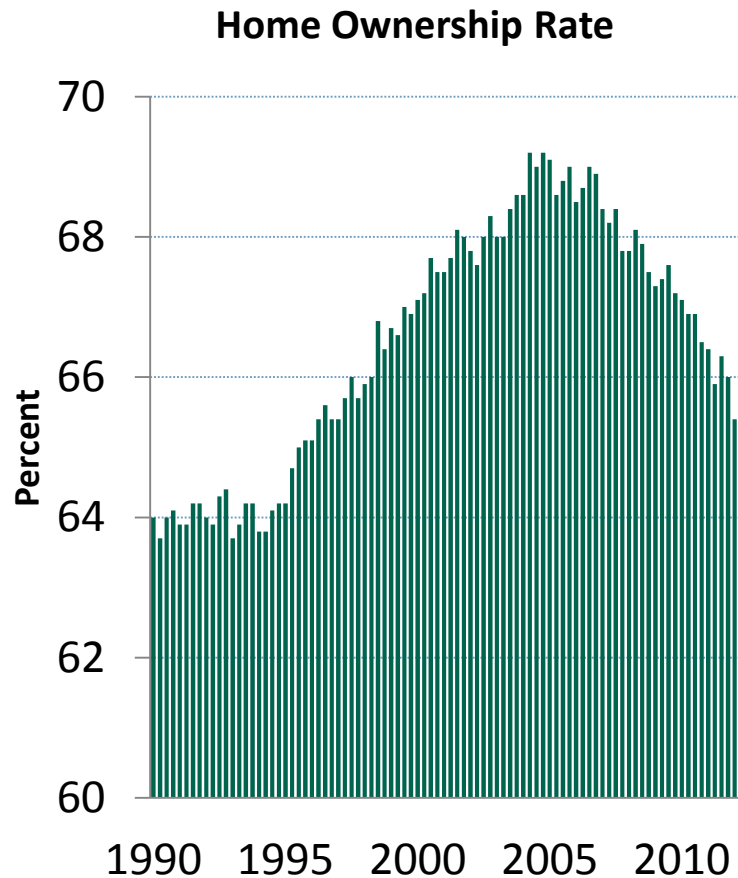


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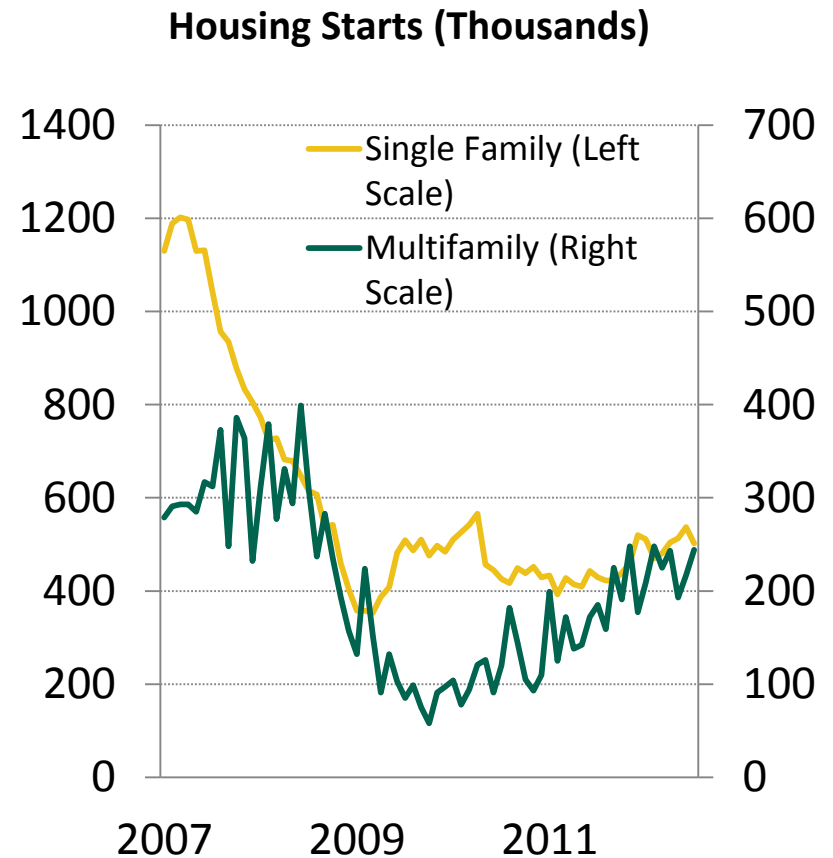


Return to Rental

- Absent policy intervention, nature will take its course



Source: US Census Bureau, Bloomberg

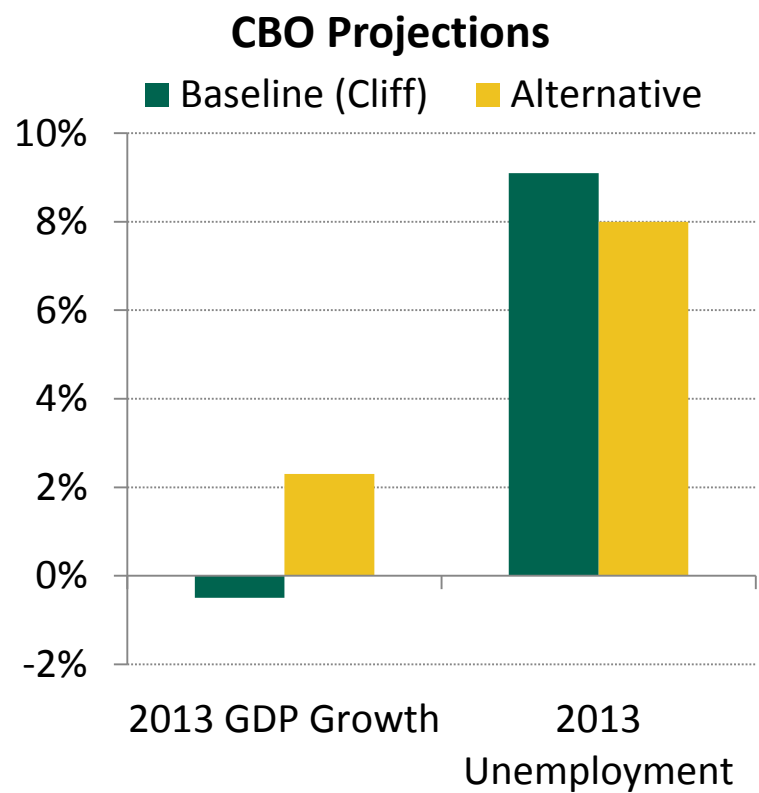


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The Fiscal “Cliff”

- Approaches early next year; resolution awaits election results
- Ratings agencies watching intently



Item	Impact (\$\$bn)
Expiration of income tax cuts, AMT growth	221
Expiration of payroll tax relief	95
Other expiring tax provisions	65
Spending cuts	65
Expiring unemployment benefits	26
Other (including projected impact of lower growth)	134

Source: Congressional Budget Office



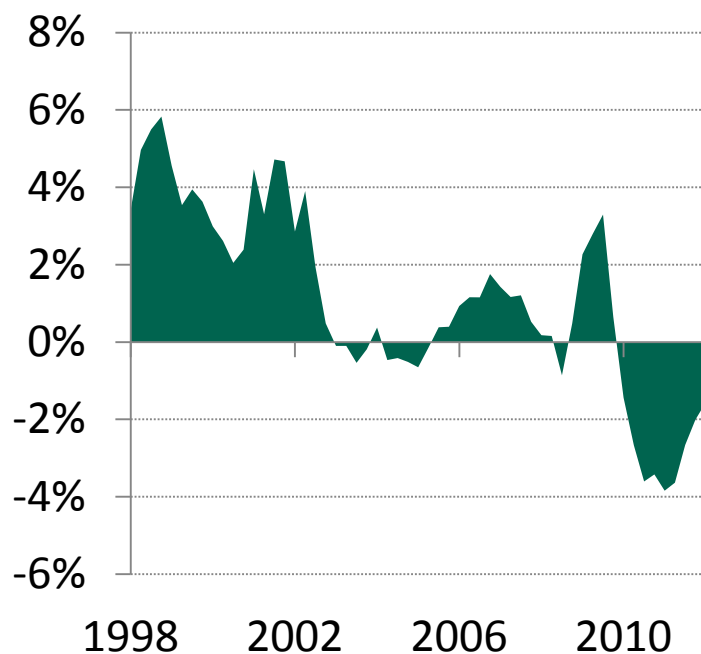
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The “Cliff” Closer to Home

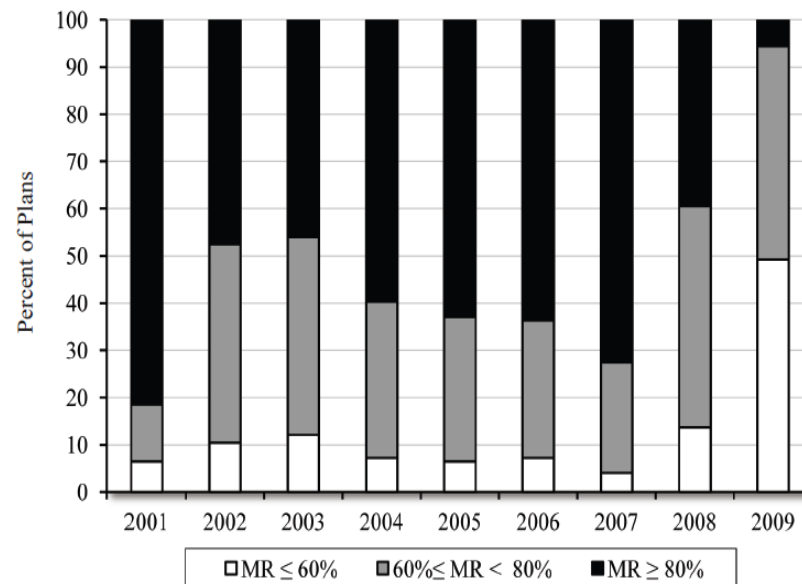
- Immense pressure on local government budgets
- Tension between taxpayers and civil servants

YOY Change in Real State/Local Government Spending



Source: Bureau of Economic Analysis, Bloomberg

State and Local Government Pension Plans by Funding Ratios Based on Market Value of Assets (MR)



Source: CATO Institute



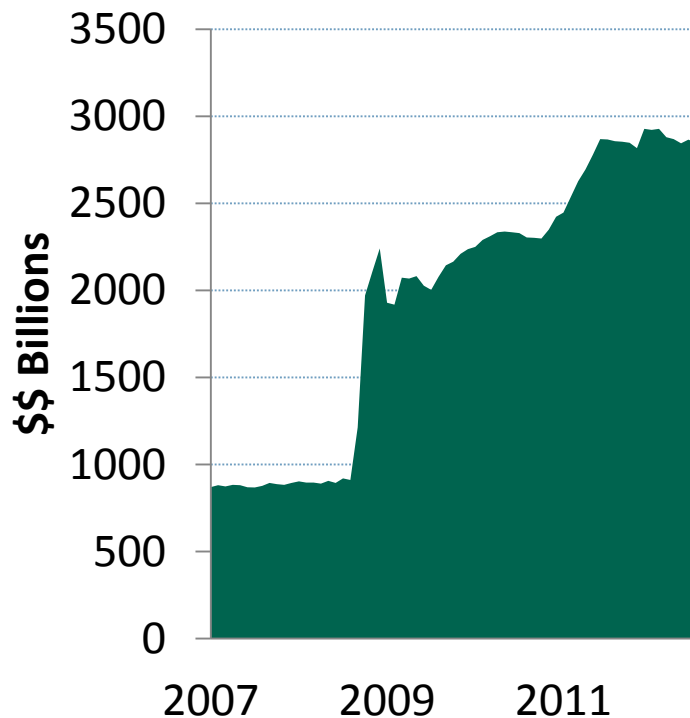
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Monetary Policy: Taking the Next Step

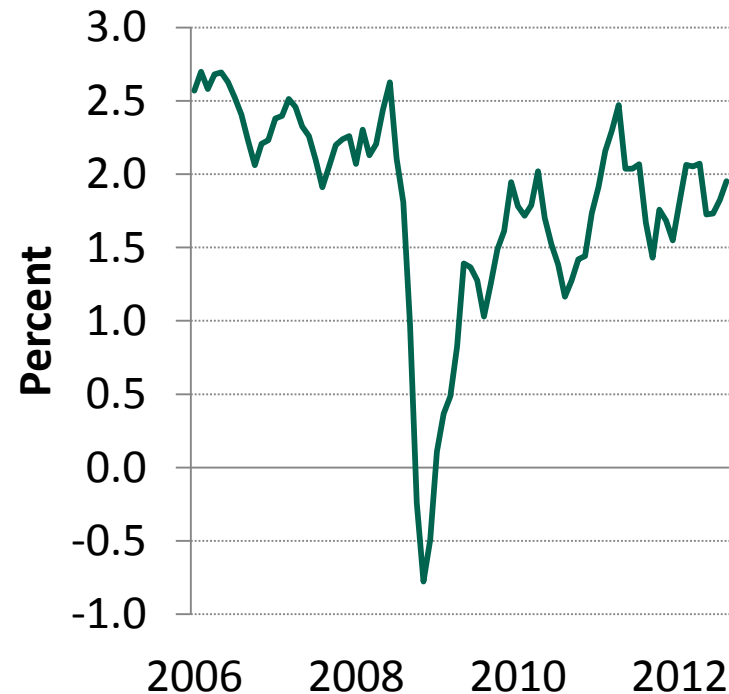
- Risks of QE have been well-managed
- QE III initiated in September

Federal Reserve Total Assets



Source: Federal Reserve, Bloomberg

Inflation Expectations, TIPS Market



Source: Bloomberg



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Europe: Things to Worry About

- **Many of the same challenges as the U.S.**
 - Property bubble
 - Undercapitalized banks
 - Deciding between austerity and stimulus
- **Some important distinctions**
 - No central regulator
 - Central bank powers more limited
 - Differences in economic culture
- **Considerable linkages between sovereigns and banks**
 - Potential for systemic contagion to U.S. institutions and funds

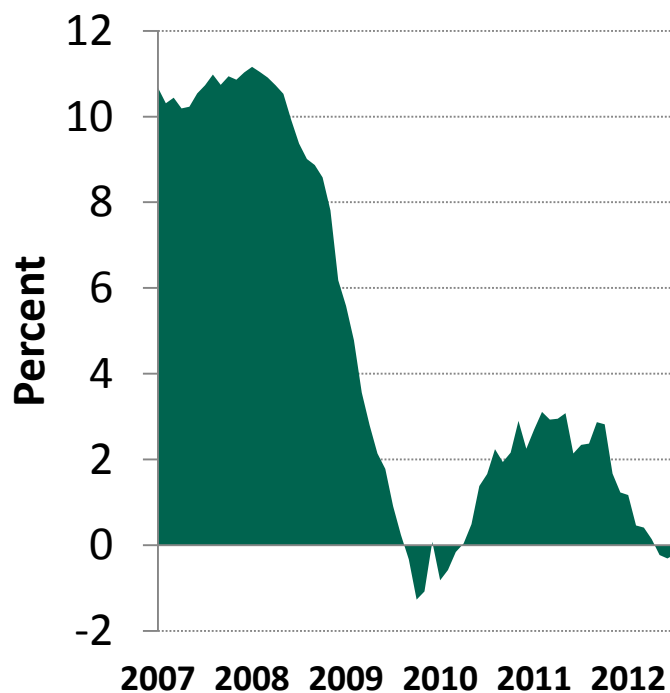




Europe: Troubling Credit Conditions

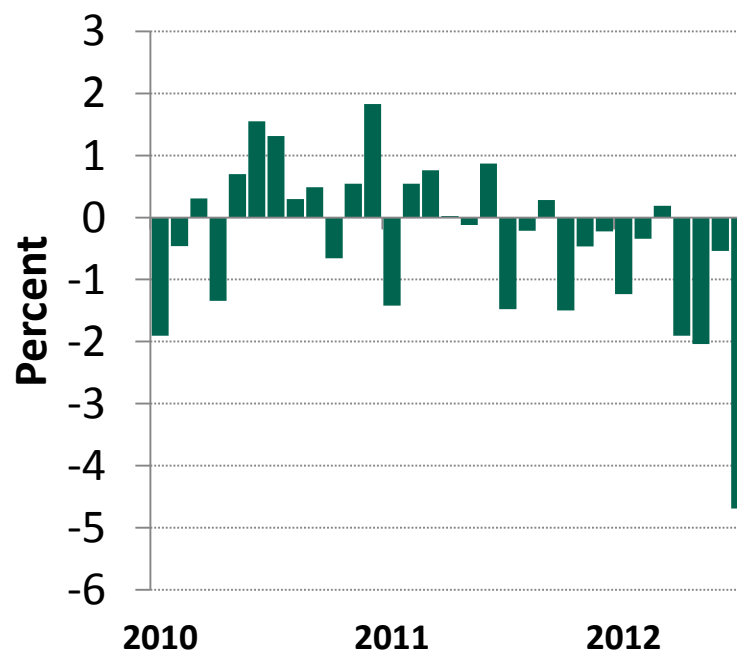
- Significant impairment of liquidity and capital
- Credit constriction accentuates economic duress

Year over Year Change in EU Lending



Source: European Central Bank, Bloomberg

Month over Month Change in Spanish Deposits



Source: Haver Analytics



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Some Thoughts on Europe

- **Best to apply therapy first, then deal with the root causes of the patient's problems**
- **Institutional reforms needed**
 - ECB as lead regulator
 - Broad deposit insurance
 - Review of the single mandate?
- **Allowing Greece to withdraw from the euro would set a dangerous precedent**
 - Expectations may turn to other countries
 - Hard to know how far the dominos might fall

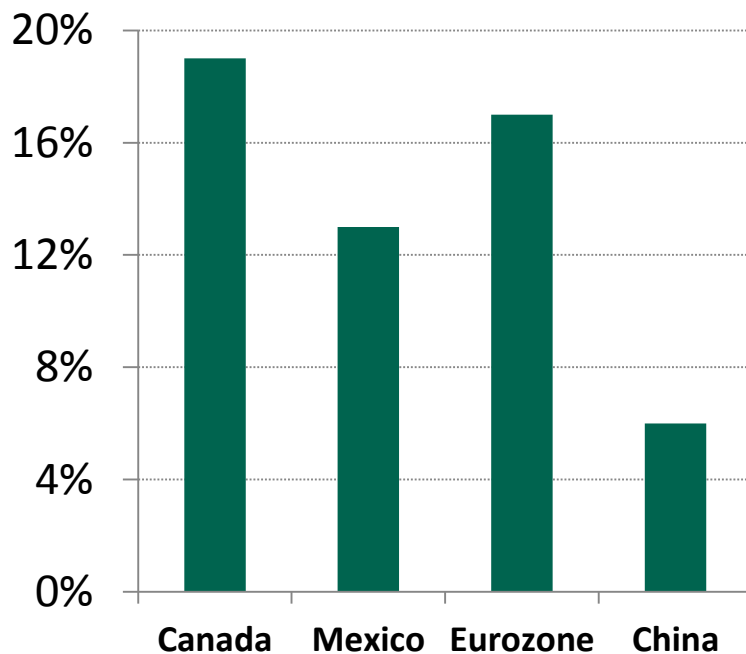




Potential Contagion

- Fundamental and financial linkages
- Negative psychology

Share of U.S. Exports to Selected Markets



Source: US Census Bureau, Bloomberg

- U.S. money funds have lightened European exposure, but it only takes one fund failure to cast doubt on the whole sector
- Interbank linkages would transmit difficulty from European banks to others around the world



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■ Our outlook calls for slow, but steady progress

- Gradual drop in unemployment
- An orderly resolution of fiscal issues
- An orderly resolution of European issues
- No change in Fed policy for a long time

■ Risks seem aligned on the downside

- Dissolution of current euro compact
- Brinksmanship over the U.S. budget
- Arab spring turns into Arab fall





U.S. Forecast Summary

	2012	2013
Real GDP Growth	2.2%	2.2%
Real Consumption Growth	1.9%	2.0%
CPI Increase	1.8%	1.5%
Unemployment Rate (EOP)	8.1%	7.5%
3-Month Treasury Yield (EOP)	0.1%	0.1%
10-Year Treasury Yield (EOP)	1.8%	2.1%



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