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## **ECONOMIC UPDATE**

December 2011

By Andrew Kohl

### **Commentary**

Having been down for much of November due to lingering European debt concerns, the S&P rallied back sharply after returning from the Thanksgiving holiday weekend. News that consumers went on a buying spree over the long weekend (retail sales were up 16% over last year's Thanksgiving holiday) caused the S&P to rally by 3%. The gains were extended later in the week as six central banks (including the Fed) announced a coordinated effort to lower the cost for banks to borrow in dollars. This was mainly done to address the liquidity crunch that European banks were experiencing. Those banks have been unable to raise dollar funding from their normal course of business of issuing commercial paper to U.S. money market funds. The coordinated effort led many market participants to assume that a solution to the European sovereign debt crisis is not far behind. All told, the S&P rallied by 7.5% over the last three trading days in November and ended the month relatively flat.

We are skeptical that either of these two positive forces will continue into 2012. First of all, it is hard to envision that consumer spending will continue its strong trend. There are several forces working against spending going forward:

1. Consumer confidence continues to be at recessionary levels – While confidence and spending is not 100% correlated, confidence at current levels normally points to much lower spending. We think that it is more likely that spending declines than confidence increases substantially, given the backdrop of high unemployment and weak housing prices.
2. The personal savings rate has declined again – The latest data shows that the personal savings rate hit its lowest level in almost four years. The normal response to economic uncertainty is an increase in savings. We believe that the savings rate will begin to climb again in 2012 as the uncertainty continues.
3. Income growth will likely be muted – With a 9% unemployment rate, the bargaining power for workers demanding pay raises is still weak.
4. Fiscal stimulus is set to expire – The payroll tax cut and expanded unemployment benefits are set to expire at the end of the year. While there is a chance that one or both of these measures will be extended, it will require compromise across political party lines. Democrats are currently seeking to pay for the payroll tax cut with a 3.25% surcharge on millionaires. Republicans are seeking to pay for the cut by freezing the pay of federal workers for another three years. After the failure of the Super Committee to reach any compromises on debt reduction, it is hard to be optimistic about a resolution being achieved.

As for the European debt crisis, added liquidity certainly helps and may buy some time, but it does not solve the main issue. There are solvency issues at European banks and countries that need to be addressed. The only solution will require stronger fiscal integration between the Eurozone countries.



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Germany remains the key. Its politicians and citizens remain concerned about the moral hazard created by helping to bail out their less frugal neighbors. While moral hazard is a concern, when weighed against the potential costs of the dissolution of the Euro, the issue is relatively small. For the heavily indebted countries, it will be a difficult sell to their citizens to give up their fiscal independence and be forced to take additional austerity measures. We still think a solution is well off into the future.

We would be remiss not to talk a little bit more about the Super Committee's failure to achieve its goal of \$1.2 trillion in "savings" over the next 10 years. To be clear, the "savings" is not referring to actually running budget surpluses versus deficits each year. In fact, annual deficits are still expected to occur. The "savings" is versus the projected path (as determined by the Congressional Budget Office) for spending. To put things into perspective, the \$1.2 trillion represents only 3% of total spending expected over the next 10 years. It is also only about 25% of the amount needed to balance the books over the 10-year period. Even more troubling about a failure to reach a compromise is that many politicians are actively discussing ways to avoid the automatic spending cuts that are set to occur in 2013 due to the failure to reach an agreement. We still believe that the best solution provides near-term stimulus with austerity measures in later years. Given that 2012 is an election year, do not expect any compromise on the debt situation, and we see a further downgrade of U.S. debt by one or more rating agencies in 2012 as highly probable.

### **Alloya's Outlook**

It looks like the fourth quarter of 2011 will be the strongest quarter of the year. We look for 2.5%-3.0% growth due mainly to strong consumer spending. Unfortunately, we do not think that the growth rate is sustainable into 2012. As mentioned earlier, we do not think that consumer spending will remain at the current elevated levels. In addition, European debt concerns will continue to linger and a Eurozone recession seems all but assured for 2012. We look for slow growth in the 1.0% to 2.0% range for 2012 in the U.S. We are even more concerned about 2013, when the Bush tax cuts are set to expire and the automatic spending cuts kick in. The combination of those two events is worth about 2.4% of GDP. With the economy on such a low-growth trajectory, that could easily tip us back into a mild recession.

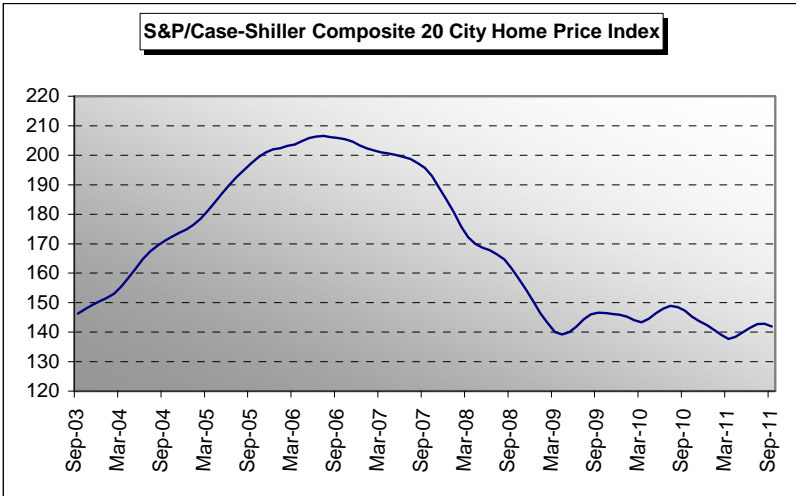
As for the Fed, we are growing more confident that there will be a QE3 program in 2012. Several FOMC members have been talking about providing more stimuli. We believe that this is an effort to prep the market for the next round of quantitative easing. This will likely entail another round of purchasing mortgage securities. If first quarter growth comes in below expectations, we expect the Fed to act.



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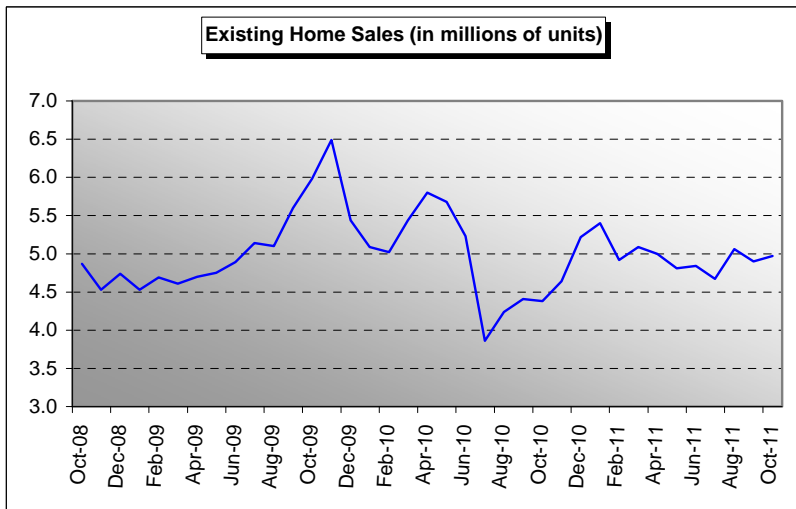
**Housing**

(Data source: Bloomberg)



**Home Prices Continue to Disappoint**

Home prices for September dropped 3.6% on a year-over-year basis versus an expectation of a 3.0% drop. Eighteen of the 20 cities showed a year-over-year decline, led by a 9.8% drop in Atlanta. Many economists see housing prices dropping further during 2012 as a temporary halt on foreclosures stemming from faulty seizures largely comes to an end. In the third quarter, foreclosures increased for the first time in a year. High unemployment and tight credit conditions are more than offsetting the Fed's efforts to keep mortgage rates low to spur housing prices.



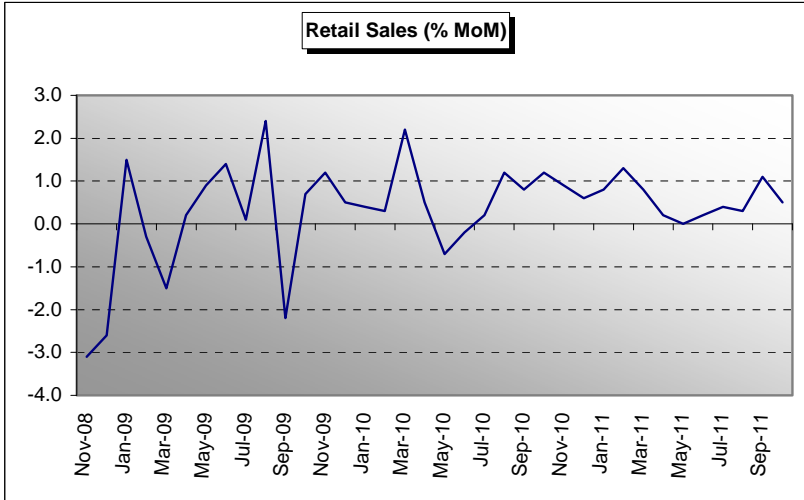
**Existing Home Sales Stronger than Expected**

Existing home sales were stronger than expected for October. Sales gained by 1.4% on a month-over-month basis versus an expectation of a drop of 3.0%. The median price of a previously owned home decreased to \$162,500. This is off the July 2006 record high of \$230,300. Cash transactions continue to play a large role in purchases, with almost 30% of the transactions in cash. Distressed sales made up 28% of overall sales for the month.



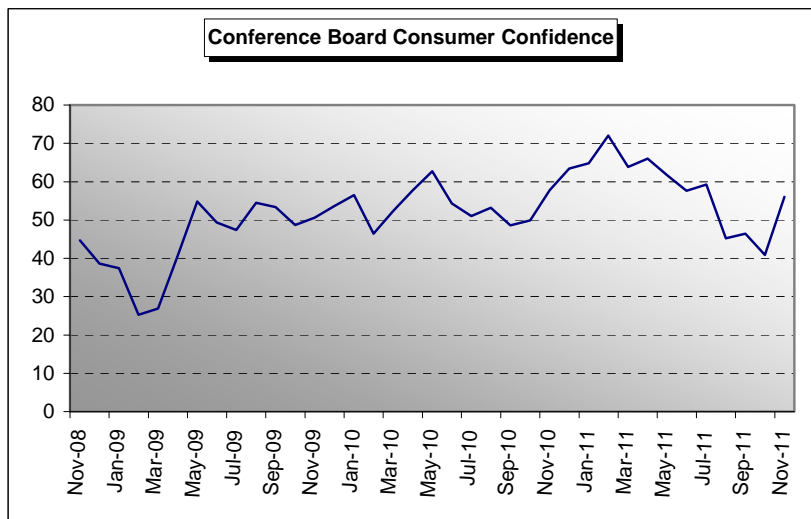
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**Consumer Readings**  
(Data source: Bloomberg)



**Retail Sales Higher than Forecast**

Retail sales in October posted a 0.5% monthly gain versus an expectation of a 0.3% increase. The gains were broad-based with 9 of the 13 major categories showing increases over the previous month. Electronic sales led the surge, posting the highest increase in almost two years. Initial sales figures for the Thanksgiving holiday period also point to strong November sales. Retail sales climbed 16% over last year's Thanksgiving weekend. While strong retail sales are encouraging, the strength came at the expense of savings. In September, Americans saved just 3.6% of their disposable income. This was the lowest level in nearly four years. That could point to weaker sales in the future.



**Consumer Confidence Rises Sharply**

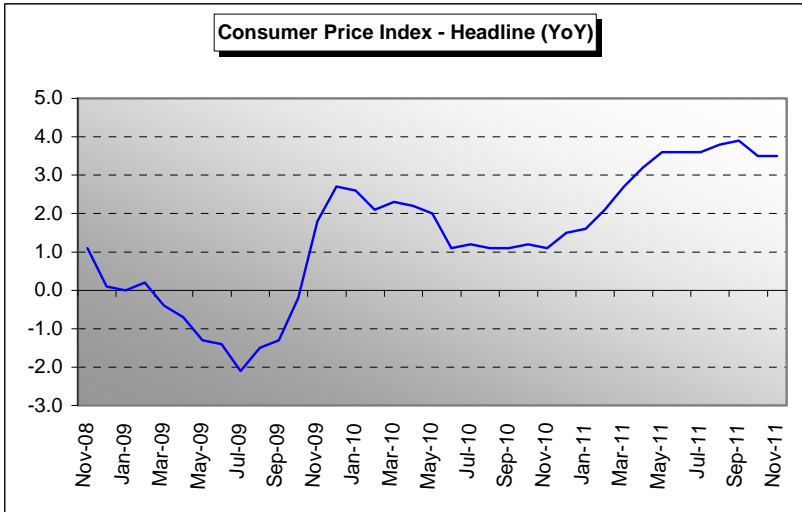
Consumer confidence in November climbed by the largest monthly amount in more than eight years. The confidence index increased to 56 from 40.9 in October. It was also well above the November estimate of 44. Measures for the present and expectations for the future both improved. This may help to explain the strong holiday sales seen over the Thanksgiving weekend.



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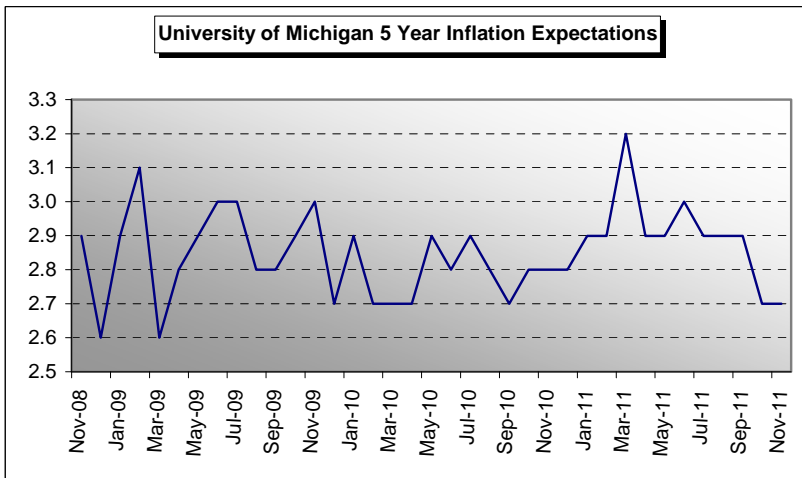
**Inflation**

(Data source: Bloomberg)



**Consumer Prices Fall**

Consumer prices fell in October for the first time in four months. Energy costs decreased 2% from a month earlier, driven by a 3.1% drop in gasoline prices. The cost of food rose by the smallest amount this year. Receding raw material costs may make it easier for retailers to hold prices constant or offer discounts during the upcoming holiday shopping season.



**Inflation Expectations Remain Tame**

Inflation expectations remain at 2 1/2 year lows. Despite aggressive Fed easing over the past several years, expectations for future inflation have remained well contained. This should provide comfort to Fed officials as they contemplate another potential round of quantitative easing.