Outlook and Market Review – Third Quarter 2012

Third quarter 2012 real GDP growth was revised upward by the Bureau of Economic Analysis to 2.7% from the preliminary announcement of 2%. Second quarter GDP growth was 1.3% after revision. Few segments of the economy performed well in the third quarter and much of the 2.7% gain was due to unexpected increases in government spending and unexpected increases in businesses inventory investment. Real final sales of domestic product, GDP less change in private inventories, increased only 1.9%. Consumer spending contributed to growth in the third quarter but was not supported by a commensurate increase in disposable income, resulting in a drop of the savings rate. The housing market improved with housing prices rising 1.3% on a year over year basis for the 10-city index and 2% for the 20-city index. Housing starts and sales were both up and builder optimism improved. International trade and business investment continue to a drag on the economy.

Job growth improvement in the third quarter was offset by an increase in the labor force participation rate and population growth, moving the unemployment rate from 7.8% to 7.9%. Long-term unemployed, non-voluntary part time workers, and marginally attached workers remain at historic levels. Even with an improvement in the overall economy, it will be difficult to address what has now become structural unemployment where worker skills no longer match labor market needs. Average hourly compensation over the past year has barely kept up with inflation, offering further evidence of the weakness in the labor market. Employment costs increased only 1.1% over the past year due to the combination of higher labor productivity and modest compensation increases. Even so, businesses are reluctant to add new workers due to rising benefit costs, uncertainty over taxes and regulation, difficulty of forecasting future sales, and a generally hostile environment for business.

Inflation remains at or below the Fed's target of 2%, allowing the Fed to stay the course on its mortgage buy-back program. As long as inflation remains below target, Fed policy will be fully dedicated to the goal of stimulating employment and economic growth. Real interest rates have been negative for most of the last year creating an environment where investment should pick up if prospects for a more certain long run future can be developed.

The fourth quarter of 2012 and all of 2013 will see sluggish performance at best. If automatic tax increases and budget cuts occur on January 1 the economy will likely have two quarters of negative growth. Fourth quarter growth is likely to be close to 2% and growth in 2013 is not likely to exceed 2% until late in the year. GDP growth for 2013 should be between 2% and 2.25%. Interest rates are expected to remain low and just above the inflation rate at the 10-year Treasury bond maturity. Inflation should continue to be below the Fed's target of 2% but volatility of energy costs may introduce hardships for households.

Fiscal Cliff or an Abyss?

A short term compromise will probably be achieved to moderate the automatic budget cuts and tax increases that are in store for the economy on January 1. The larger issue is whether the compromise is just another "kick the can down the road" or a long term plan to restore stability and fiscal restraint in taxes, stimulate private domestic investment, improve global competitiveness, and restructure entitlement spending.

With no change the economy, will likely hit a negative GDP growth in the first and second quarters of 2013. With either a short term patch or a long term plan, the economy will still underperform in 2013 with GDP growth between 2% and 2.25%. Consumers are doing their part by spending even though disposable income is not growing very fast. Government has likely spent whatever discretionary room there can be with annual budgets that are already over a trillion dollars in the red while approaching seventeen trillion in debt. Exports are limited by slow economic growth in Europe and most of the rest of the world.

The longer term prospects for the economy hinge on whether or not long term capital investment can be spurred. Corporations have ample cash and interest rates are low but prospects for future cash flows from capital investment must be improved. The double taxation of corporate earnings is a major drag on investment and job creation. The combination of the corporate tax rate plus taxes on the distribution of earnings through dividends or capital gains makes the U.S. unattractive for investment.

Kicking the Can with Piecemeal Revisions to the Tax Code and Entitlements

It is likely that the compromise will give each side of the debate minor victories but will push off major changes into the future. Unfortunately, this outcome is not good news for the economy. To put the economy on a path for a real recovery there must be a long run plan to reduce the deficit in a consistent and orderly fashion to slow the growth of debt and actually lower the amount of debt in the long term. It is very difficult to see how this can be done without a major overhaul of the tax code to eliminate all deductions and lower rates in line with government spending limits to about 20% of GDP. Medicare costs must be reduced with a combination of plans to offer lower-cost services by increasing the supply of services along with curbs on excessive demand. The current configuration of Obamacare does not deliver on either of these points.

Changes in Social Security promises must be phased in slowly over time with a long term plan to move away from the "pay as you go" structure. These outcomes may not be achievable in a political process and suggestions along these lines in the Simpson-Bowles report from an independent blue ribbon committee have been openly criticized by Senate leadership. Both sides must end up with something that promises to lower the deficit over time to slow the growth of debt. In the debt ceiling fight last August we learned that there are two immovable agendas. One side wants spending reductions with an overhaul of the tax code and revision of entitlement promises without raising existing tax rates. The other side wants to raise more revenue with higher tax rates targeted at higher income households. Middle ground that will put the economy on a higher growth path may not exist.

Key Areas for Limited Tax Reform

Likely targets for tax reform without a large scale revision of the tax code would include the following tax benefits that are currently in place. Special interest groups will likely prevent serious attention to many of these targets, but this list represents the areas where the largest potential gain in tax revenue could occur. If none of these areas are changed, there will not be enough tax revenue gained to offer significant reduction in the budget deficit. It is important to remember that debt reduction will not occur until we first balance the annual government deficit, which is running over one trillion each year. None of the tax reforms below will come close to matching that amount of extra tax revenue needed to balance the budget, making it clear that significant cuts in government spending must be made. The largest components of government spending by far are the entitlement programs of Medicare and Social Security. Without serious revisions in these programs, the issue of reducing the national debt in the long term is a pipedream.

- Employer-paid health-care benefits are the single biggest tax break in the U.S. Deductions for medical expenses and Medicare payments would also fit into this category. Something is likely to be changed here since the magnitude of potential revenue is so large. A compromise will likely be an end to tax exemptions on employer paid health care benefits. These benefits will be taxed like ordinary income.

- Retirement-savings plans allow households to defer taxes on investments dedicated to retirement. The annual tax loss to the government is large but it is likely that these tax benefits will be extended and may actually be increased. This move to encourage households to plan for retirement in their earning years is necessary if Social Security revisions are going to be on the table.

- Interest deduction on mortgages represents a large tax break that has many special interest groups to defend it. It is not likely that the timing is right for this revision since housing is just now recovering, but it should be in a long run mix of reform. Artificial incentives here lead to over-investing in housing and treatment of housing as an investment rather than part of the consumption equation. The benefit also tends to fall largely on upper middle and higher income households.

- Taxes on long term capital gains and dividends are set lower than ordinary income as an incentive to invest in capital formation. This tax break has a long history as a tool to stimulate the economy, but it clearly benefits high income households more than low income households. Top–bracket taxpayers currently pay 15% on dividend and capital gains income while the tax rate on ordinary income is 35%. There will be a fight here because there are two strong sides. It is not a good time to lower incentives for business investment but the general perception is that these are only tax breaks for the wealthy. There will likely be a compromise but rates will go up.

- Charitable donations are tax deductions up to a limit but these deductions are not subject to the alternative minimum tax rules, making it more favorable for high income households. Good arguments can be made on both sides of this point but philanthropy would be affected in a major way. Ending this deduction is a difficult political position to take, making this deduction less likely to be revised.

Economic Forecast from the Conference Board

The Conference Board recently posted an abbreviated economic forecast for the U.S. Economy that reinforces much of this outlook. Quarterly forecasts through 2013 appear in Table 1. It is clear that the forecasters do not see the fiscal cliff catastrophe taking hold in the first part of 2013, but very slow growth is expected. Even as far out as 2014, the forecasters do not predict economic growth approaching the long term average of 3.2%. These growth rates are not strong enough to make significant improvement in the unemployment rate. It is interesting to note that growth in consumer spending remains at or below the GDP growth rate, implying that the consumer is not leading growth. Consumers are likely to remain hamstrung by low income growth and fading benefits from refinancing at low interest rates.

The Conference Board forecasters see steady improvement in housing but not a dramatic rebound. An odd aspect of the forecast is the strong growth in real capital spending. Such growth hinges on a dramatic improvement in certainty with respect to taxes, regulation, and foreign economies. Most analysts would have a more optimistic view on GDP growth with these expectations for real capital spending.

Table 1. Quarterly Forecasts of GDP, Consumer Spending, Housing Starts, and Capital Spending

	IV Q 2012	I Q 2013	II Q 2013	III Q 2013	IV Q 2013
Real GDP Growth^	1.7	1.4	1.6	2.4	2.7
Real Consumer Spending^	2.6	0.8	1.0	2.4	2.4
Housing Starts*	0.87	0.95	1.02	1.09	1.12
Real Capital Spending^	-1.6	2.4	4.1	5.7	8.2

^ *Seasonally adjusted annual percentage change*
** Millions of units*
Source: The Conference Board

Annual forecasts by the Conference Board for 2012 (based on three quarters of actuals and a forecast), 2013 and 2014 appear in Table 2. The economy is expected to be weaker in 2013 than it was in 2012 with only marginal improvement in 2014. It is interesting to note that measures of consumer confidence have been on the upswing while forecaster views are not so optimistic. As in the quarterly forecasts, real capital spending appears to be very healthy compared to the more dismal views of overall growth. The forecasters must be expecting businesses to unleash built up cash for investment, but it is difficult to see this forthcoming without stronger employment and consumer spending.

Table 2. Annual Forecasts of GDP, Consumer Spending, Housing Starts, and Capital Spending

	Annual 2012	Annual 2013	Annual 2014
Real GDP Growth^	2.1	1.8	2.4
Real Consumer Spending^	2.0	1.7	2.3
Housing Starts*	0.78	1.04	1.25
Real Capital Spending^	7.1	2.3	6.6

^ *Seasonally adjusted annual percentage change*
* *Millions of units*
Source: The Conference Board

Key Global Economies

Europe remains weak with a recent downgrade of French debt and threats for downgrades of other euro countries that are bearing the burden of bailing out Greece. Alignment of fiscal policies is a necessary but difficult step toward stability. Analysts gained more optimism for a solution to the debt crisis in Europe in the third quarter as the commitment to do “whatever it takes” appeared to be in place. More recently, Euro-zone finance ministers failed to agree with the International Monetary Fund on conditions for giving Greece its next installment in bailout money. Talks are resuming but confidence in bailout plans has been eroded.

The Asian economies are showing signs of improvement with an increased flow of funds into Asian equity markets. China is expected to have a 7.5% growth rate in 2012. More important, China’s moves to control inflation appear to have been successful without a hard landing. Australia is an exception to Asian recovery as economic conditions there are deteriorating.

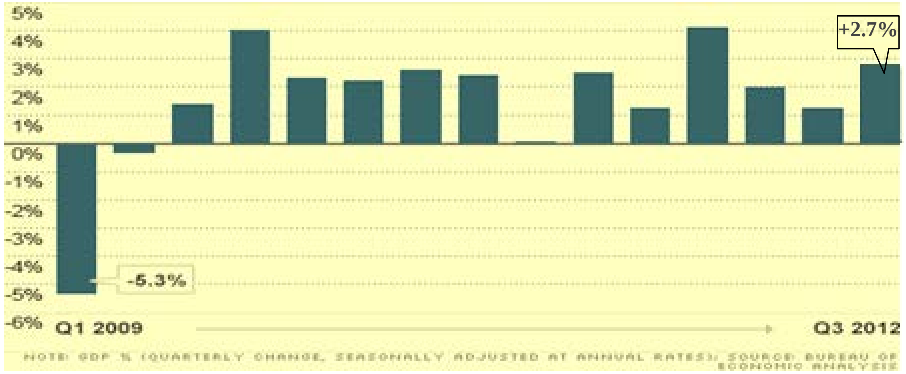
Overall, the U.S. trade deficit continues to be a drag on GDP growth. A weaker dollar offers a tailwind for U. S. exports but economies of export target countries must improve if international trade is going to make a positive contribution to growth.

Summary of Recent Economic Data

GDP Growth ***– sluggish economic growth remains below the long run 3.2% average. The 2.7% GDP growth rate in the third quarter was ahead of the forecast by the Survey of Professional Forecasters, but increased government spending and inventory growth were largely responsible for the surprise.***

- U.S. economic growth increased 2.7% in the third quarter of 2012 from a dismal revised rate of 1.3% in the second quarter. The revised estimate of 2.7% for the third quarter benefitted from higher than expected inventory accumulation, which may bleed some growth away from the fourth quarter. GDP growth from 2009 through the third quarter of 2012 is illustrated in Figure 1.

Figure 1. GDP Growth from 2009 through 2012



Source: Bureau of Economic Analysis

- Third quarter growth was boosted by stronger consumer spending, higher inventory investment, increased government spending on defense, and an improving housing sector.

- The change in real private inventories added 0.77 percentage point to the third-quarter change in real GDP, after subtracting 0.46 percentage point from the second-quarter change.

- Residential construction spending grew at a 14% pace in the third quarter as housing continues to improve. But, housing had a minor impact on GDP because housing construction expenditure makes up less than 3% of total spending in the U.S. economy.

- Real personal consumption expenditures increased 1.4 percent in the third quarter, compared with an increase of 1.5 percent in the second. Durable goods increased 8.7 percent, in contrast to a decrease of 0.2 percent. Nondurable goods increased 1.1 percent, compared with an increase of 0.6 percent. Services increased 0.3 percent, compared with an increase of 2.1 percent.

- Oddly, higher federal defense spending also boosted the economy significantly, growing at a 13% annual rate after shrinking in the three prior quarters. Some economists have suggested that this will be revised downward in the next revision.

- State and local governments contracted for the 12th consecutive quarter. Meanwhile, businesses cut back on their spending and are not expected to offer a significant boost to the economy until the tax and regulatory environment becomes clearer.

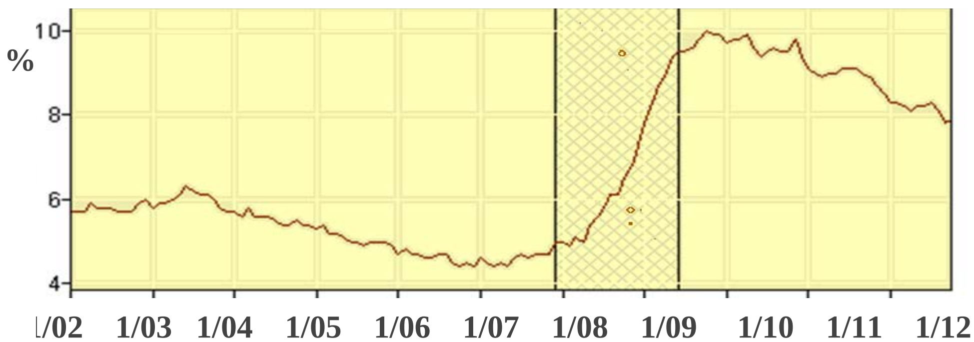
- Global weakness hurt manufacturers in the third quarter as Europe continued to be in recession and China's growth slowed.

- GDP growth is not strong enough to make a lasting improvement in the labor market. Growth continues to lag well behind the average 3.2% growth rate of the economy over the last several decades. Growth greater than 3% a year is needed to get the unemployment rate down by as much as 1%.

Employment – *The unemployment rate remains at 7.9%. Higher levels of employment and job creation were offset by an increase in the labor participation rate as new workers entered the labor force. As the labor market improves the unemployment rate is not going to improve dramatically due to a corresponding increase in workers seeking jobs. Long term unemployed and involuntary part-time workers continue to be at historic highs.*

- The unemployment rate in October was 7.9% even though total nonfarm payroll employment increased by a higher than expected 171,000 jobs.   (See Figure 2 below)

Figure 2.   Seasonally Adjusted Unemployment Rate



(Month/Year)
Shaded area represents the recession

- The labor force participation edged up slightly in October to 63.8%, which is about equal to the 12-month average. The civilian labor force increased by 578,000 to 155.6 million in October while total employment rose by 410,000 over the same month.

- The employment-population ratio was essentially unchanged at 58.8 percent in October, following an increase of 0.4 percentage point in September.

- The number of long-term unemployed, defined as persons who are jobless for 27 weeks or more, was little changed at 5.0 million in October. The long term unemployed make up 40.6 percent of the unemployed.

- People employed part time for economic reasons (sometimes referred to as involuntary part-time workers) fell by 269,000 to 8.3 million in October to partly offset an increase of 582,000 in September. People in this category were working part time because their hours had been cut back or because they were unable to find a full-time job.

- Workers who were marginally attached to the labor force remained steady at 2.4 million. Marginally attached workers are defined as people not in the labor force but who are available for work and have looked for a job within the prior 12 months. These workers are not counted as unemployed because they had not searched for work in the 4 weeks preceding the jobs survey.

- Among the marginally attached workers, there were 813,000 discouraged workers in October, a decline of 154,000 from a year earlier. Discouraged workers are persons not currently looking for work because they believe no jobs are available for them.

- The average workweek for all employees on private nonfarm payrolls was 34.4 hours for the fourth consecutive month in October. The manufacturing workweek edged down by 0.1 hour to 40.5 hours, and factory overtime was unchanged at 3.2 hours. The average workweek for production and nonsupervisory employees on private nonfarm payrolls edged down by 0.1 hour to 33.6 hours.

- Average hourly earnings for all employees on private nonfarm payrolls edged down by 1 cent to $23.58 in October. Average hourly earnings over the past 12 months grew by only 1.6 percent, barely matching inflation. In October, average hourly earnings of private-sector production and nonsupervisory employees fell by 1 cent to $19.79.

- Wages and salaries grew 0.3 percent and benefits rose by 0.8 percent for civilian workers from June to September 2012. Over the year, compensation grew 2 percent with benefits rising 2.6%.

- The Bureau of Labor Statistics reports that wages and salaries averaged $20.27 per hour, representing 70.4% of total employee costs. The remaining 29.6% represented benefits.

Productivity – *Over the last four quarters unit labor costs rose only 1.1 percent. Productivity and labor costs provided a mixed picture in the third quarter of 2012. Productivity in the nonfarm business sector increased 1.9 percent while unit labor costs fell 0.1 percent on a seasonally adjusted annual rate. Nevertheless, in manufacturing, productivity fell 0.4 percent and unit labor costs increased 1.5 percent. The U.S. Bureau of Labor statistics reported that nonfarm business sector labor productivity increased at a 1.9 percent annual rate during the third quarter of 2012. The productivity gain reflects an increase of 3.2 percent in output and 1.3 percent in hours worked.*

- From the third quarter of 2011 to the third quarter of 2012, productivity increased 1.5 percent as output and hours worked rose 3.3 percent and 1.8 percent, respectively.

- Unit labor costs in nonfarm businesses decreased 0.1 percent in the third quarter of 2012, while hourly compensation increased 1.8 percent. Unit labor costs rose 1.1 percent over the last four quarters. BLS defines unit labor costs as the ratio of hourly compensation to labor productivity.

- Manufacturing sector productivity declined 0.4 percent in the third quarter of 2012, as output and hours worked decreased 0.6 percent and 0.2 percent, respectively. Productivity fell 0.7 percent in the durable goods sector and 0.1 percent in the nondurable goods sector. Over the last four quarters, manufacturing productivity increased 1.5 percent, as output increased 4.1 percent and hours worked rose 2.6 percent. Unit labor costs in manufacturing rose 1.5 percent in the third quarter of 2012 and decreased 0.8 percent from the same quarter a year ago.

Inflation – *Inflation based on the CPI is 2% over the past year ending in September for both the all items and core components. Inflation based on the PCE index was only 1.62% for the last year. The PCE, the Fed's preferred inflation measure, is generally lower and less volatile that the CPI. Inflation is matching labor cost increases, resulting in no real gains in labor costs or labor compensation. Energy prices continue to be the main driver of inflation.*

- The seasonally adjusted Consumer Price Index for All Urban Consumers in September matched the increase of 0.6 percent in August. The core rate, excluding food and energy, rose 0.1 percent in September, also matching the August increase.

- For the second month in a row, the increase in the all items index was mostly the result of an increase in the gasoline index, which rose 7.0 percent in September after increasing 9.0 percent in August. The other major energy indexes increased in September as well.

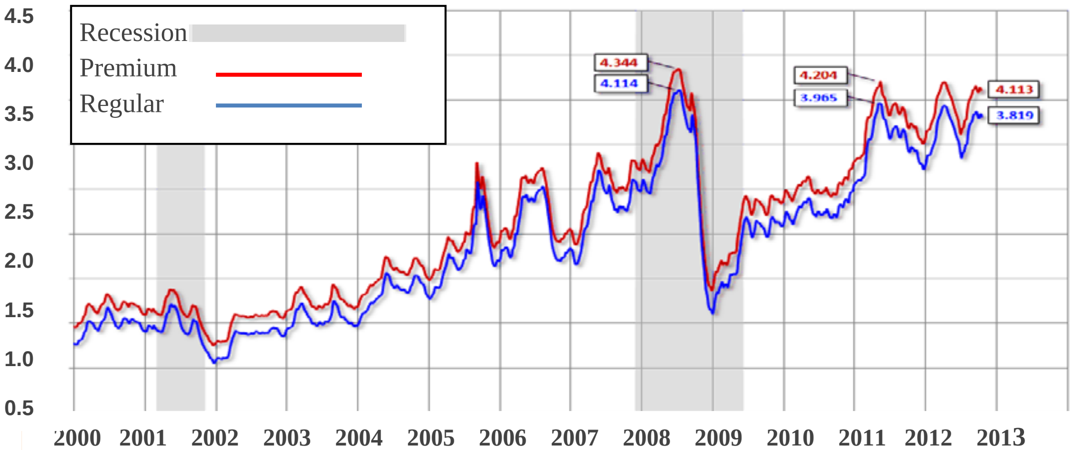
- The 12-month change in the index for all items was 2.0 percent in September. The index for all items less food and energy also rose 2.0 percent for the 12 months ending in September. The food index has increased 1.6 percent and the energy index has risen 2.3 percent over that same one year span.

- The annualized rate of increase in the personal consumption expenditure (PCE) index was only 1.3% in the third quarter following 1.7% in the second quarter, both well below the Fed's announced target of 2%. The annualized core PCE inflation rate (excluding food and energy) was 1.58% in October compared to 1.64% in September and 1.62% last year. The long run average of the PCE is 3.50%.

- Policy makers like to focus on the core inflation index, which excludes energy and food prices. In the real world we cannot exclude energy and food from our monthly budgets. Figure 3. below illustrates trends in gasoline prices since 2000. The recession in 2008-

2009 clearly broke the upward trend in gasoline prices, but the post-recession growth rate appears to be back on track even though the overall economy is not. Energy prices are likely to grow faster than other prices and will continue to take a larger chunk of household income.

Figure 3. Retail Gasoline Prices and Trend Growth since 2000



Source: *Department of Energy, Energy Information Association*

<u>Personal Income and Consumer Credit</u> – *In real terms, personal income fell over the last two months. The growth in consumer spending has not been supported by growing disposable income. Without higher growth in income the consumer is not likely to sustain the spending rates of the last few quarters.*

- In September, personal income increased $48.1 billion, or 0.4 percent, while disposable personal income (DPI) increased $43.0 billion, or 0.4 percent, according to the Bureau of Economic Analysis.

- Real disposable income decreased less than 0.1 percent in September, compared with a decrease of 0.3 percent in August. Real PCE increased 0.4 percent in September compared with an increase of 0.1 percent in August.

- Personal consumption expenditures (PCE) increased $87.9 billion, or 0.8 percent in September. For August, revised estimates of PCE increased $59.9 billion, or 0.5 percent in August, based on revised estimates. The data in Table 3. show that consumers have a lower saving rate matched with lower growth in disposable income. Higher consumer spending since mid-2011 has largely been the result of lower costs of revolving credit and refinancing.

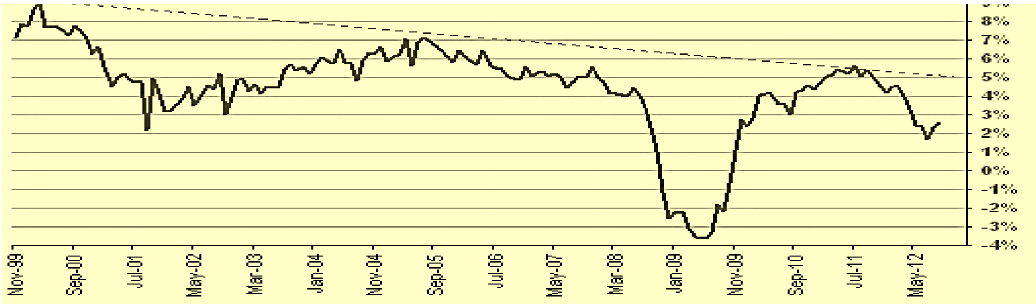
Table 3. Personal Savings and Disposable Income - Quarterly Percent Change

	2010 IQ	2010 IIQ	2010 IIIQ	2010 IVQ	2011 IQ	2011 IIQ	2011 IIIQ	2011 IVQ	2012 IQ	2012 IIQ	2012 IIIQ
Personal Savings as % of Personal Disposable Income	4.6	5.6	5.4	4.8	5.1	4.6	3.9	3.4	3.6	4.0	3.7
Personal Disposable Income % Change from Prior Quarter*	7.6	6.9	2.5	3.1	7.7	2.0	1.1	0.9	6.3	3.8	2.6

**The current-dollar measure is deflated by the implicit price deflator for personal consumption expenditures.*

- Figure 4. below shows the long run year over year percentage change in PCE since November of 1999. The consumer clearly backed off from spending in the middle of 2011 and has not yet fully returned.

Figure 4. Year over Year Percentage Change in Personal Consumption Expenditures



Sentiment and Consumer Confidence – *Surveys indicate that consumer sentiment has improved while business sentiment remains unchanged in the face of the looming year-end deadline for automatic tax increases and government spending cuts. Consumers have increased confidence about their near-term prospects and personal finances, but they continue to have a high level of uncertainty about the longer term health of the economy.*

- The Thomson Reuters/University of Michigan final index of consumer sentiment was little changed at 82.7 in November, a five-year high, from the prior month's 82.6. The November index was disappointing based on the 84.9 median forecast by 65 economists surveyed by Bloomberg.

- Bloomberg's gauge of consumer expectations which rose to 4 in November from minus 7 a month earlier. The monthly reading showed 37 percent of households projected the economy will get better, the highest share since March 2002.

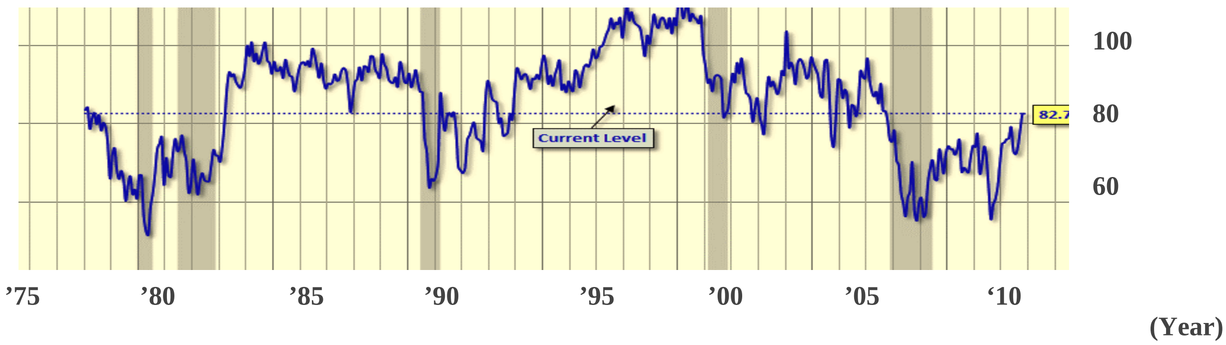
- The Michigan survey's index of current conditions, which reflects Americans' perceptions of their financial situation and whether it is a good time to buy big-ticket items like cars, climbed to 90.7 from 88.1 the prior month. The preliminary reading was 91.3 for November.

- The index of consumer expectations for six months from now, which more closely projects the direction of consumer spending, dropped to 77.6 from 79 in October. The preliminary November reading was 80.8.

- Consumer optimism is linked to rising home values as record-low mortgage rates drive a recovery in housing. Sales of previously owned homes unexpectedly climbed in October, and the median price rose 11.1 percent from a year earlier, the National Association of Realtors reported this week.

- The Michigan average since its inception is 85.3. During non-recessionary years the average is 87.8. The average during the five recessions is 69.3. So the latest sentiment number of 82.7 moves us closer to the non-recession sentiment averages. It's important to understand that this indicator can be somewhat volatile. Figure 5 below shows the three-month moving average of the confidence index since 1977 and illustrates the volatility of the series.

Figure 5. University of Michigan Consumer Sentiment Index

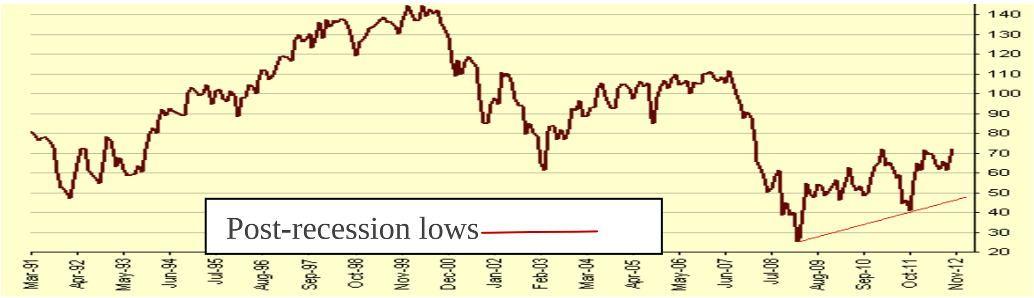


Shaded areas are Recessions

- To put the University of Michigan Sentiment report into the larger historical context since its beginning in 1978, consumer sentiment is 3% below the average reading (arithmetic mean) and 2% below the geometric mean. The current index level is at the 39th percentile of the 419 monthly data points in this series.

- The Conference Board *Consumer Confidence Index*®, increased to 72.2 in October from 68.4 in September. The Present Situation Index increased to 56.2 from 48.7. The Expectations Index rose to 82.9 from 81.5 last month. Figure 6. shows the movement in the index from 1991 to the present.

Figure 6. U. S. Conference Board Consumer Confidence Index 1991 to 2012



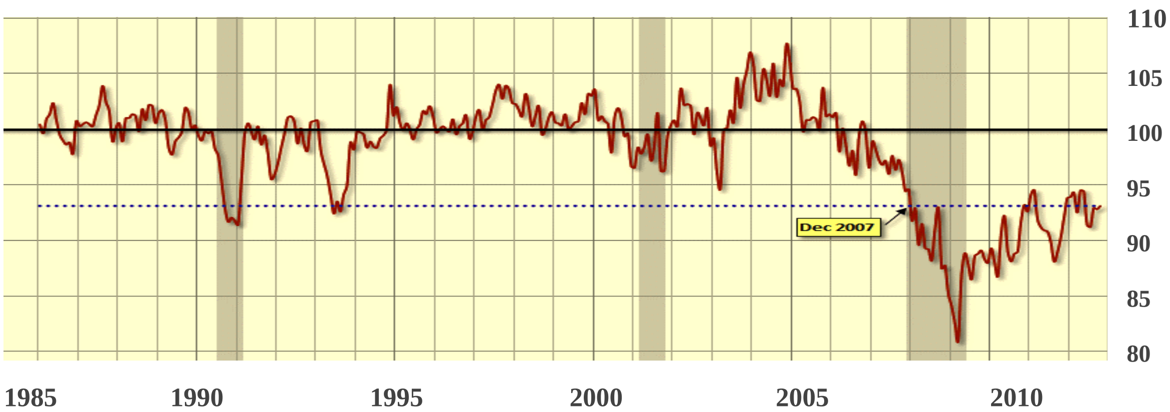
- Consumers' assessment of current conditions improved in October. Those claiming that business conditions are "good" rose to 16.5 % from 15.3%, while those saying business conditions are "bad" edged down to 33.1% from 33.8%. Consumers' views of the labor market were more positive. Those stating jobs are "plentiful" increased to 10.3 percent from 8.1 percent, while those claiming jobs are "hard to get" declined to 39.4%t from 40.7%.

- Consumers were more optimistic about the short-term. Those anticipating an improvement in business conditions over the next six months rose to 21.4% from 17.9%. Those expecting business conditions to worsen rose to 15.1% from 14.5%.

- Consumers' outlook for the labor market was also mixed. Those anticipating more jobs in the months ahead increased to 19.2 percent from 18.1 percent, while those expecting fewer jobs increased to 20.3 percent from 18.7 percent. The proportion of consumers expecting an increase in income edged up to 16.7 % from 15.9 %.

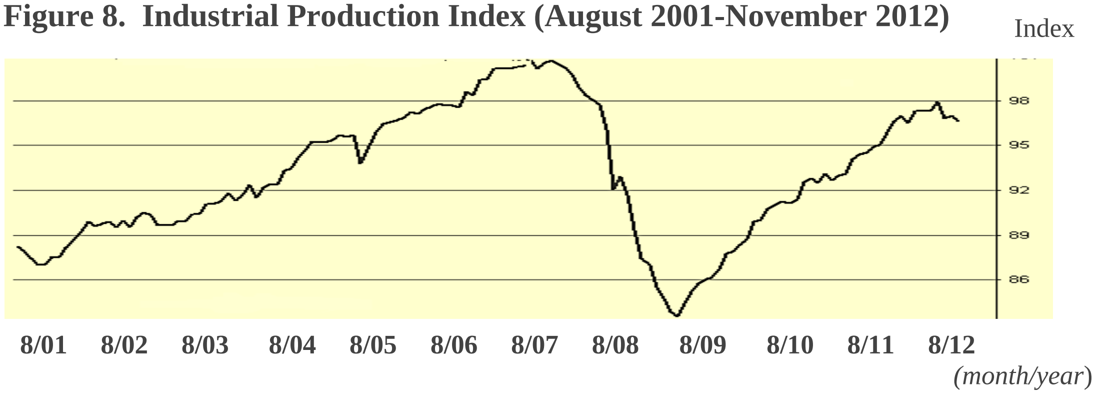
- The NFIB Small Business Optimism Index, plotted in Figure 7, reached 93.1 in October. The index remains well below the long run average of 100.

Figure 7. NFIB Small Business Optimism Index 1985 - Present



- Industrial production declined 0.4 percent in October after rising 0.2 percent in September. Figure 8 shows the movement of the index since August of 2001.

Figure 8. Industrial Production Index (August 2001-November 2012)



- In October, the index for manufacturing decreased 0.9 percent; excluding storm-related effects, factory output was roughly unchanged from September. The output of utilities edged down 0.1 percent in October, and production at mines advanced 1.5 percent. At 96.6 percent of its 2007 average, total industrial production in October was 1.7 percent above its year-earlier level.

- The production of consumer goods declined 0.9 percent in October. The output of durable goods advanced 0.2 percent, but the output of nondurables fell 1.2 percent.

- Total industry Capacity utilization for total industry decreased 0.4 percentage point to 77.8 percent, a rate 2.5 percentage points below its long-run (1972--2011) average.

- Manufacturing output declined 0.9 percent in October. Excluding the estimated effects of Hurricane Sandy, manufacturing output was little changed from its September level. Declines were widespread across both durable and nondurable goods industries. The factory operating rate slipped to 75.9 percent in October, a rate 2.9 percentage points below its long-run average.

Housing- *The housing market is improving at a solid pace and appears to be building momentum. Housing starts, sales, and prices have all turned up. The housing recovery has benefitted from historically low interest rates and pent up demand. But, low growth in consumer income and wealth does not yet warrant a strong boost to GDP from housing.*

- The National Association of Home Builders' sentiment index rose to 46 in October, the highest since May 2006. The index was 41 one month ago. While the improvement is well underway, there is still a long way to go. A reading below 50 means more builders view market conditions as poor than favorable. The index has not been above 50 since April 2006.

- Construction of single-family homes, which made up two-thirds of housing starts last month, dropped 0.2% in October to a rate of 594,000 units. Single-family construction was up 35.3% from a year earlier.

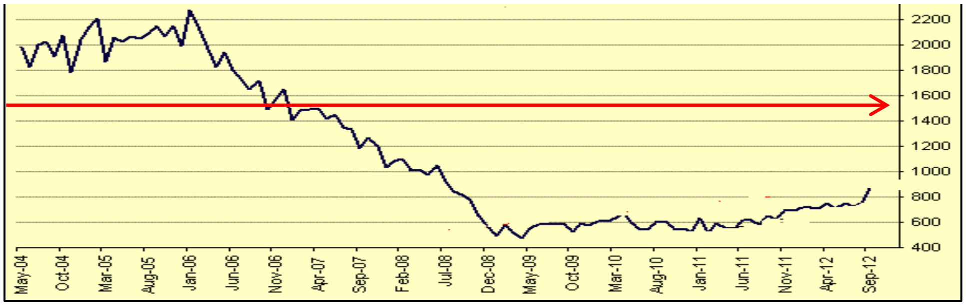
- Sales of previously owned homes grew 2.1% in October, marking the 16th consecutive month of year-over-year increases, according to the National Association of Realtors said Monday.

- The nation's inventory of existing homes for sale fell 1.4 percent during October to 2.14 million, the lowest level since December 2002.

- Housing starts increased 3.6% from September to November for a seasonally adjusted annual rate of 894,000, the Commerce Department said Tuesday. Compared with a year earlier, new home construction was up 41.9%. It is at its highest rate since July 2008, before the depths of the financial crisis. Figure 9. illustrates the time series of housing starts since May of 2004. The data are showing an upward trend, but on average, builders have constructed 1.5 million new homes per year since 1959 (red line).

Figure 9. Housing Starts (May 2004 – September 2012)

(Thousands of units)



The long run average housing starts per year is represented by the red line

- The National Association of Realtors reported that existing home sales climbed 2.1 percent in October to a seasonally adjusted annual rate of 4.79 million units, beating forecasts.

- Total existing-home sales rose 2.1 percent to a seasonally adjusted annual rate of 4.79 million in October from a downwardly revised 4.69 million in September. Existing home sales are 10.9 percent above the 4.32 million-unit level in October 2011.

- Foreclosures and short sales accounted for 24 percent of sales in both September and October (12 percent were foreclosures and 12 percent were short sales). For a comparison, foreclosures and short sales were 28 percent in October 2011. Foreclosures sold for an average discount of 20 percent below market value in October, while short sales were discounted 14 percent.

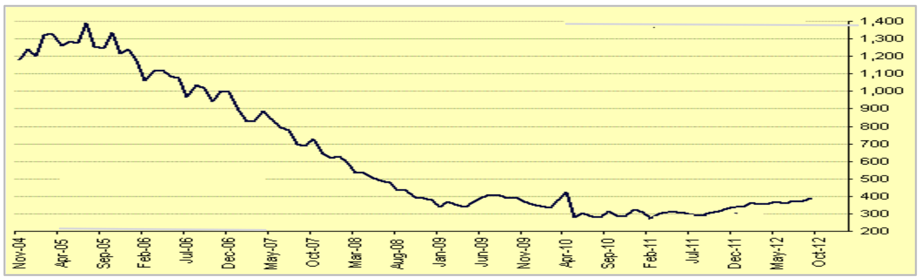
- Total housing inventory at the end of October fell 1.4 percent to 2.14 million existing homes available for sale, which represents a 5.4-month supply at the current sales pace, down from 5.6 months in September, and is the lowest housing supply since February of 2006 when it was 5.2 months. Listed inventory is 21.9 percent below a year ago when there was a 7.6-month supply.

- Single-family home sales rose 1.9 percent to a seasonally adjusted annual rate of 4.22 million in October from 4.14 million in September, and are 9.6 percent above the 3.85 million-unit pace in October 2011.

- New home sales were 389,000 units in September following 368,000 in August of 2012. The month over month change in home sales was 5.7% while the change on a year over year basis was 27.1%. Figure 10. below shows the month to month movement of new home sales since November of 2004.

Figure 10. New Home Sales since November 2004

(Thousands of units)

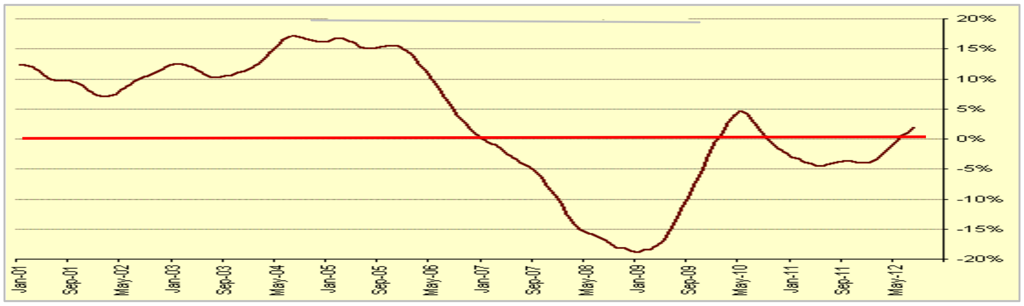


- The national median existing-home price for all housing types was $178,600 in October, which is 11.1 percent above a year ago. This marks eight consecutive monthly year-over-year increases, which last occurred from October 2005 to May 2006.

- The S&P/Case-Shiller housing price index indicated that average home prices increased 0.9% in August and July for both the 10-city and 20-city indexes.

- Based on the Case-Shiller index, the year over year increase in housing prices was 1.3% for the 10-city index and 2.0% for the 20-city index. Figure 11 below shows the year over year percentage change in the Case-Shiller index since January of 2001.

Figure 11. U.S. Case- Schiller Housing Price Index Year over Year Percent Change



Global Economies – *The Euro economies continue to struggle. The recent downgrade of France's debt may spread to other member countries, but euro interest rates have not taken a large hit yet. Most economists expect a very weak 1% growth for 2013 for the region, but a continued recession is not ruled out. The Asian economies have regained some momentum and are likely to rebound in 2013. The U.S. current account continues to be negative with an average monthly deficit of $44 billion since the recession.*

- Eurozone gross domestic product shrank by 0.2% in the second quarter, and 0.1% in the third, leaving the 17-nation currency area stuck in recession.

- The European Commission forecasts growth of 0.1% for the Eurozone in 2013, but with more spending cuts and tax hikes to come in countries such as France, Italy and Spain. The margin for error in the forecast does not rule out a continued recession.

- The overall German PMI reading stood at 47.9, up from 47.7 in October. But the German services sector saw its fastest contraction since June 2009.

- The Purchase Manager's Index for France in November was 44.6, up from 43.5 in October. The level of the index continues to reflect a decline for Europe's second biggest economy. The PMI for France has declined for nine consecutive months.

- On Nov. 19, Moody's Investors Service downgraded France's AAA bond rating. The move, though widely anticipated, raises the likelihood that other core European economies could be hit with downgrades. The Moody's downgrade followed a similar action by Standard & Poor's last January.

- Even with the downgrade, yields on French debt remain relatively low for now. The yields on French 10-year debt widened to 2.134 percent, which was the biggest increase in a month but still close to a record low 2.002 percent reached on Aug. 3.

- The euro fell in early trading against other currencies after the announcement of the downgrade of France's debt.

- Moody's maintained a "negative outlook" on the ratings of Germany, Netherlands, and Austria. In general, Moody's is taking a more pessimistic view for countries that are bearing the brunt of the mechanisms put in place to aid the region's weaker economies. Bond rating agencies are also concerned that the European Financial Stability Facility (ESFS), which raises money to fund the bailouts of euro-area countries, could also be at risk of a downgrade.

- France is struggling with rising unemployment and weak growth. French industrial orders declined in most sectors during September, and manufacturing output was down 2.5 percent year-on-year.

- A preliminary Chinese manufacturing index released Nov. 22 indicated output may have expanded for the first time in 13 months, while data on Nov. 20 showed Taiwanese export orders climbed more than estimated in October. Malaysia reported Nov. 16 that gross domestic product rose 5.2 percent in the third quarter, compared with the 4.8 percent increase forecast in a Bloomberg survey.

- The Bloomberg-JPMorgan Asia Dollar Index rose 0.2 percent in the past five days after declining for the previous three weeks. The peso strengthened 0.7 percent this week to 41.052 per dollar, South Korea's won appreciated 0.6 percent to 1,086.11 and Malaysia's ringgit climbed 0.5 percent to 3.0590. China's Yuan gained 0.11 percent to 6.2285.

- The U.S. Census Bureau and the U.S. Bureau of Economic Analysis, through the Department of Commerce, announced that total September exports of $187.0 billion and imports of $228.5 billion resulted in a goods and services deficit of $41.5 billion, down from $43.8 billion (revised) in August. September exports were $5.6 billion more than August exports of $181.4 billion. September imports were $3.4 billion more than August imports of $225.2 billion.

- The goods and services deficit decreased $2.9 billion from September 2011 to September 2012. Exports were up $6.4 billion, or 3.5 percent, and imports were up $3.4 billion, or 1.5 percent.

- For the three months ending in September, exports of goods and services averaged $183.9 billion, while imports of goods and services averaged $226.5 billion, resulting in an average trade deficit of $42.6 billion. For the three months ending in August, the average trade deficit was $42.7 billion, reflecting average exports of $183.2 billion and average imports of $226.0 billion. Figure 12 illustrates the movement of the U.S. trade balance since April of 1999.

Figure 12. U. S. Monthly Balance of Trade since April 1999.

Billions of Dollars