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## ECONOMIC UPDATE

December 2011

By Andrew Kohl

### Commentary

December has continued the disappointing trend seen over the last several months. Risky assets rally leading up to a summit meeting by Eurozone leaders, only to sell-off once the results of the meeting are revealed. The market is demanding much more than the Euro leaders (mainly Germany) are willing to give. Germany continues to worry about the moral hazard risk of a full-blown bailout of its less fiscally disciplined neighbors. Therefore, its focus has been on demanding further austerity measures to try to ensure that a bailout never occurs again, rather than containing the turmoil in the financial markets. Going into 2012, the biggest risk to U.S. growth is that the Euro zone cannot find an effective solution to its sovereign debt problems and the euro falls apart. While we assign a relatively low probability to that event occurring, the outcome could easily trigger a financial crisis similar to the Lehman failure in 2008.

Fortunately, the U.S. seems to be on relatively strong footing heading into the New Year. The fourth quarter is shaping up to be the best quarter in well over a year as many economists are expecting 3%+ growth. The economy is benefitting from a reduction of many of the headwinds that constrained growth earlier in the year. Mainly, gasoline prices have fallen sharply (-17%) from their highs and the supply disruptions from Japan are now behind us. The big question is whether the fourth quarter pace of growth can continue into 2012. Sadly, we think the answer is “no.”

We believe that the structural realignment of several areas of the economy are not complete and will continue to weigh on the market. Realignment needs to continue in the following areas:

1. **Housing** – The large supply overhang of distressed properties still exists and will continue to weigh on housing prices. In addition, a psychological shift in the benefits of home ownership will cause demand to remain restrained. It will still take a few years before the housing market works through its excesses.
2. **Local Government Budgets** – Local governments will need to continue to cut costs in order to pay for previously promised pension benefits and to close current budget gaps. This means more employee layoffs and property tax increases (which could further harm house prices).
3. **Personal Savings Rate** – The personal savings rate typically increases in times of uncertainty; instead, it has been falling. Given the potential for tax hikes and the amount of wealth destruction over the past several years, the savings rate should be much higher.
4. **Government Debt** – Eventually, the exploding U.S. debt will need to be contained. That means reduced government spending and/or higher taxes (likely both). The only question is when these austerity measures will kick in.

Despite these headwinds, we still believe that the economy will grow in the 1-2% range in 2012 (absent a Euro-area meltdown). Growth will be closer to the bottom of this range if a payroll tax cut extension



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cannot be hashed out before the end of the year. At the time of this writing, the outlook for an extension looks bleak. Even though there seems to be bipartisan support to extend the cuts, Democrats and Republicans cannot agree on how to pay for them. Even an effort to extend the cuts for two months while they negotiate on the payment terms is failing, as of this writing. The Senate has passed a bill to extend the cuts for two months, but the House has rejected it and has demanded a one-year extension. It looks like Congress is shooting for lowering its approval ratings even further.

Going into the latter half of 2012, the focus will clearly turn towards the presidential election and the impending expiration of the Bush tax cuts. The best case would be for some bargain to be reached whereby the tax code is simplified and tax hikes are delayed until the economy is on firmer footing. Absent a compromise by both political sides, the expiration of the Bush tax cuts along with scheduled spending cuts will create a tough growth scenario for 2013.

### **Alloya's Outlook**

We continue to expect the fourth quarter to be strong. Recent data related to the housing and labor markets have been better than expectations and it looks like fourth quarter growth is tracking around 3-3.5%. We expect growth to drop off into the New Year as structural forces take hold. Growth should track around 2%, but the downside risks to the economy are much higher than the potential upside.

As for the Fed, we think they are ready to act in a very quick manner if the economy shows any signs of stalling. Chairman Bernanke has gained a resurgence in popularity in economic/political circles as his handling of the economic crisis compares very favorably to the European Central Bank's. The euro crisis has made it clear that austerity measures, combined with a weak economy and little to no monetary stimulus, is a recipe for disaster. Austerity pushes a weak economy further into recession, which increases debt further and lowers GDP. We hope that the U.S. has learned this lesson.

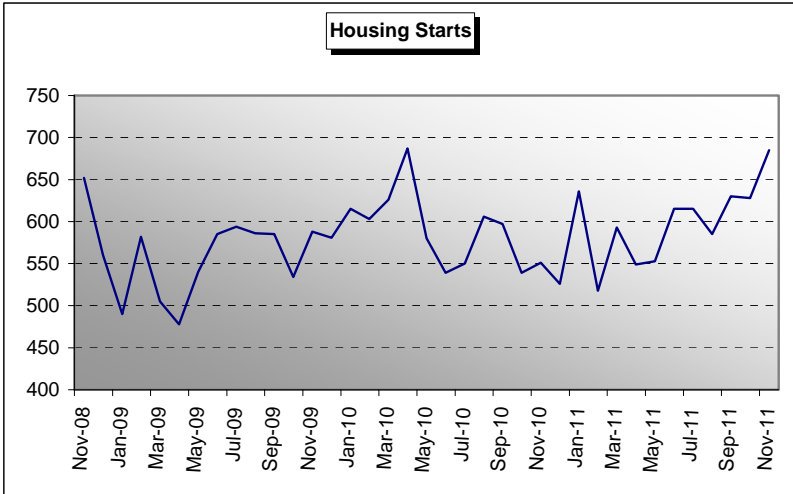


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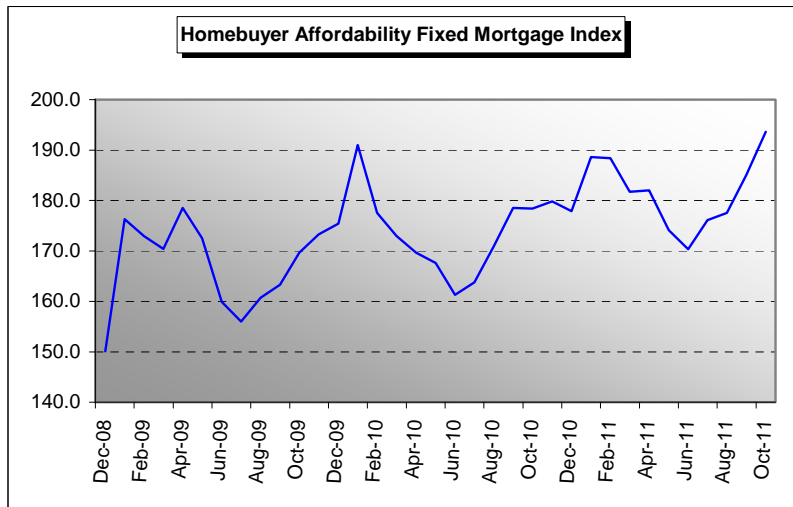
### Housing

(Data source: Bloomberg)



#### Housing Starts Hit a 19-Month High

Housing starts for November came in much higher than estimates and now stand at a 19-month high. The improving trend over the past several months has been driven by the strength in multi-family construction as foreclosures have turned former homeowners into renters. This month also showed a gain in single family construction. Despite the gains, single family construction is headed for its worst year in more than five decades. We expect that single family construction will remain subdued in 2012 as the glut of foreclosed properties remains. Multi-family construction should continue to gain, but the net impact of housing construction on the economy will remain well below what is seen in a typical recovery.



#### Housing Affordability Continues to Climb

Affordability measures continue to improve with the impact of falling home prices and declining mortgage rates. In the 1990s and 2000s the index averaged close to 130. While this measure points to potential improvement in the housing market, it ignores the tight credit conditions and likely change in psychology concerning home ownership. There is no doubt that houses are cheaper. but if demand is waning and those with demand cannot access the credit needed, housing will remain weak.

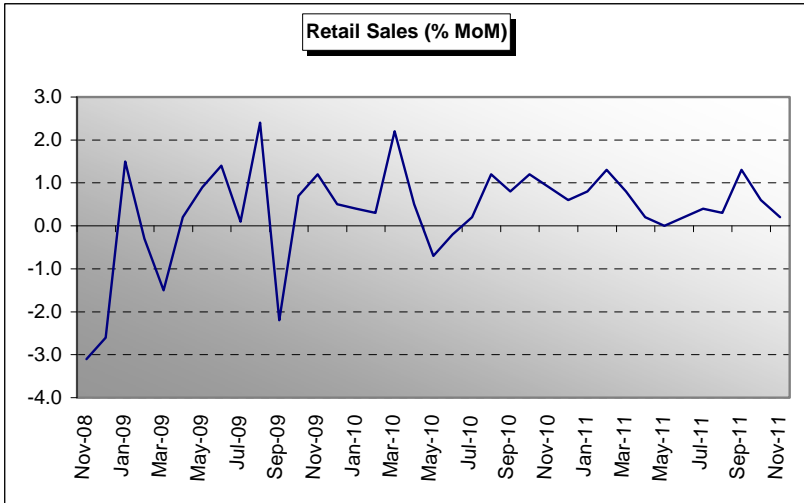


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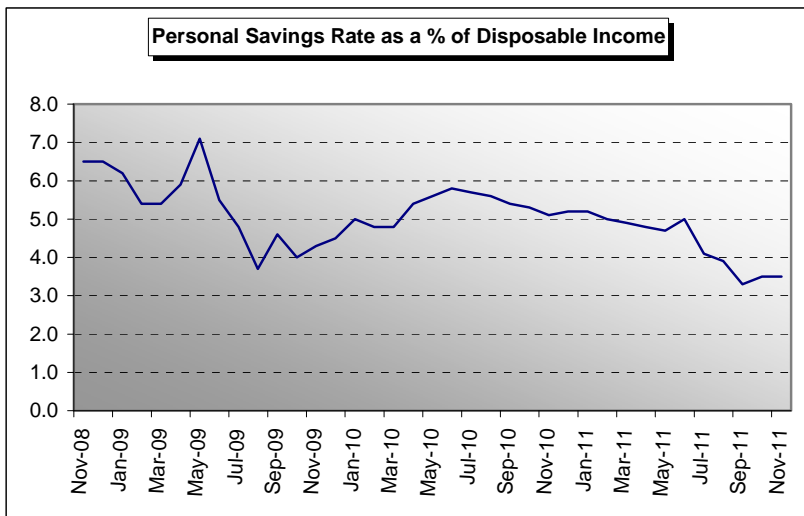
### Consumer Readings

(Data source: Bloomberg)



#### Retail Sales Lower than Expectations

Retail sales in November posted a 0.2% monthly gain versus an expectation of a 0.6% increase. Partially offsetting the downside miss in November's sales were upward revisions to the prior two month's sales. Despite the revisions, November sales were especially disappointing given the recent news that Thanksgiving holiday sales were very strong. It seems that consumers held off on making purchases during the month until retailers offered large discounts during the holiday period. We believe that consumer spending will remain subdued until the employment picture improves.



#### Personal Savings Rate Continues to Fall

Over the past year, the personal savings rate has continued to fall to pre-recession levels. This means that consumers have less cushion against potential income shocks. The fall is surprising given the uncertainty over taxes and the continued weak labor market. We believe that the savings rate will begin to trend back up in 2012. If so, this means that consumer spending will be lower than many economists' expectations.

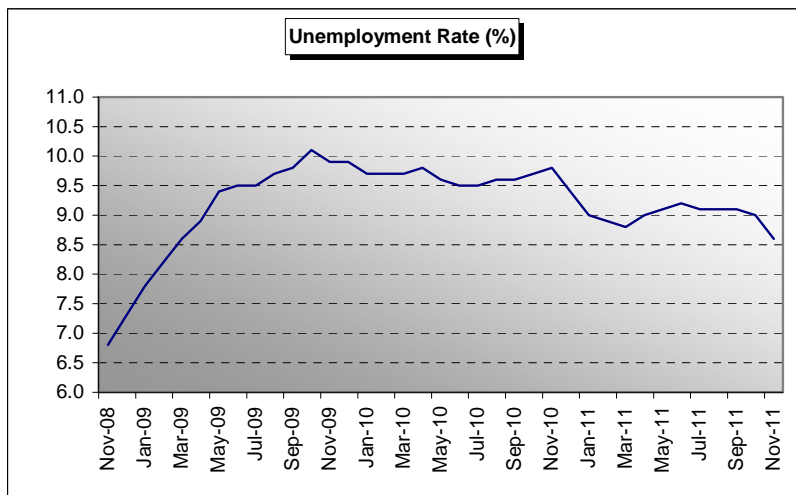


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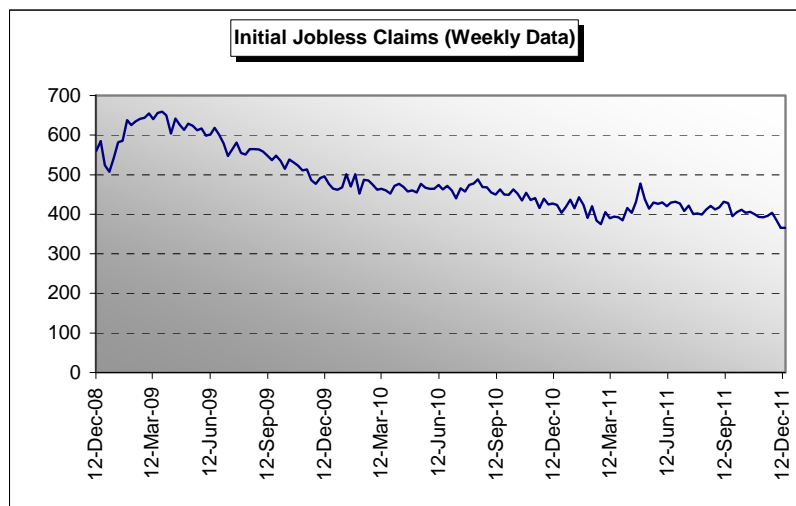
### Labor

(Data source: Bloomberg)



#### Unemployment Rate Falls to 8.6%

The unemployment rate unexpectedly fell to 8.6% in November from 9.0% the prior month. This is the lowest level of unemployment in more than 2 1/2 years. The rate fell due to a mix of job gains along with a large number of people leaving the workforce. We expect the unemployment rate to tick back up in coming months as people re-enter the labor force. The current pace of payroll gains is about what is needed to keep the unemployment rate steady, but not enough to offset an increase in labor force participation.



#### Jobless Claims Hit New Cycle Low

Jobless claims were much lower than expected and hit their lowest level in more than 3 1/2 years. This marks two weeks of significant declines and the four-week rolling average stands at multi-year lows. The trend clearly shows that firings have ebbed. The question remains as to whether hiring will pick up. We still think hiring will be subdued given the economic uncertainty related to the European debt crisis, taxes, the presidential election, etc.