

PA HealthCare Credit Union

2012 Economic and Financial Forecast

The PA HealthCare Credit Union is making
your financial health better.

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Welcome & Introduction

- The PA HealthCare Credit Union is proud to sponsor this event to better educate members and non-members on the 2012 economic and financial environment which impact these indicators.
- Paul Fero is the CEO of the PA HealthCare Credit Union and is also part of the Adjunct Faculty of Robert Morris University, LaRoche College and the University of Phoenix teaching in areas of Economics and Finance.

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What we said was going to happen...

- “The sovereign debt issues of a number of European countries... will continue to add pressure to the Euro zone countries. New pressures will mount likely in Belgium, France and Italy will add to the uneasiness to the area. The resulting austerity measures approved by the governments of these and other European countries will continue to be drag on the(se) economies..(and)...will put stress on the...stronger countries within the Euro zone (as they) are forced to come to the aid of weaker countries yet again.”

Spot on forecast and will continue and worsen into 2012.

- “Look for 2011 (U.S.) fiscal deficit to exceed \$1 trillion, yet again...there is zero political will to make a meaningful and significant difference. Once again, partisan maneuvering to obscure prudent public policy. Going through the motions without outcomes, doesn't count.”

Washington at it's best...and we have only ourselves to blame by electing partisan public officials...Oh, it will get worse before it gets better.

What we said was going to happen...

- “...numerous states and therefore municipalities already struggling with deficits will continue and the meager recovery isn’t strong enough to offset federal aid. We’ll see some municipalities end up in bankruptcy but it won’t be an avalanche some predict it will be.”

This was easy and it will continue but will be contained to the worst of the worst

- “Social unrest marked by demonstrators (primarily in European countries) will continue and austerity measures are felt by disenfranchised groups, i.e.. pensioners, government workers, students and the like.”

Another fairly easy expectation and it carried across the pond to the U.S. as “Occupy <this and that>” sprouted to major cities. Funny how most of 99% all want to be in the 1%...that’s why we play the lottery.

What we said was going to happen...

- The overall economy will continue to “muddle” through throughout 2011 and will seem to appear to be on the mend.
- This will take years to repair and we’ve just completed the first quarter of recovery.

Yep...here we are with another year of the same and it will continue for many more years to come. (See long term forecast at the end.)

Recap of 2011 Forecast

- Interest Rate Forecast – Winning....
 1. “Short term interest rates, as controlled by the Fed, will continue to stay at the designated 0% to 0.25%. The Fed won’t raise rates until after the Presidential election in 2012.”

The Fed announced it won’t raise rates until 2013. Swung for the fence and got it all. Now that was a good call.

2. “Mid-term and long term yields will move plus or minus 50 to 100 basis points (from 3.5%) throughout the year as talk of possible Fed exits from Quantitative Easing as well as Sovereign disruptions will temporary swing yields around current levels.”

Pretty close except for Operation Twist pushed mid and long term yields down to record lows beginning in the Summer. (More on that later.)

Recap of 2011 Forecast

- Stock Market Forecast – Winning...
 1. “Looking for another nearly 10% correction to the S&P by Spring. Any reasonably negative external influence, whether domestic or international will bring about a swift decline and perhaps a buying opportunity.”

Ok, so it started later in the 2nd quarter and ended in the 3rd quarter. Timing was just a shade off, but still on the money.

2. “Overall, year will end relatively flat from the start with dramatic swings both ways throughout the year.”

Winner, winner, chicken dinner.

- Overall Forecast – Year in and year out, one of the most accurate forecasts on the planet. (Simple observation only...anyone want to keep track..feel free.)

Welcome to the Great Recession – Repeated last 2 years and counting

- Given this has been the worst economy since the Great Depression, the term Great Recession has been used by some and myself back in May 2009.
- Not only is this the worst economy but this will be so much longer than the other recessions we have had. How so? Because this isn't the same as the other recessions.
- Recessions that include a credit crisis or credit related component of the recession last much longer in duration. Japan in the 1990's had both and their version lasted nearly ten years and is commonly referred to as the "Lost Decade". Not quite as simple an apples to apples comparison but many of the commonalities are similar.
- While most recessions end with consumer spending as the component to pull us through. Given the debt laden consumer cutting back and unwillingness of banks to lend, this won't be happening anytime soon.

Welcome to the ongoing Great Recession (repeated again)

- Academically speaking, a recession ends when it hits the trough or bottom and the subsequent phase is the expansion. Additionally, the economy is said to be expanding when total GDP exceeds the previous level....the parts we are in right now. So even though it's been an expansion is over two years and the economy has been is just now expanding it still feels like a recession as the lingering effects of high employment and anemic growth. It only seems marginally better and therefore based on perspective from where it was.
- For unemployment to decline by 1%, GDP needs to be about 5% on an annual basis. Also, with GDP at about 2.5% the unemployment rate stays relatively flat, as that is the growth rate needed to absorb the normal labor market with new entrants etc.
- Historically, GDP in the U.S. since the Depression has risen only 2.5% annually on average. Given the size of the current economy, any meaningful sustained growth amount above the 2.5% would be unrealistic. Therefore, expect growth to fall along the normalized growth rate and unemployment to stay significantly elevated.

Federal Reserve's Operation Twist

- The Federal Reserve's Operation Twist could also be referred to as Operation Twisted. The idea behind the latest Fed move is the ongoing assumption that if you make loan rates low enough that would yield economic growth through savings on loan products. Additionally, this pushes savings rates to next to nothing forcing those to move into riskier assets, i.e. stocks. In a "normal" recession, yes that is a reasonable assumption. However, since this is far from a normal recession the outcomes are going to be very different.
- As often described, doing the same thing over and over again and expecting a different result, is often used to define crazy. The crazy part won't be felt for years to come. That is when interest rates do normalize and they will at some point (more on that later) the risks to holding long term loans or investments tied these low yields will have hugely negative consequences.

Federal Reserve's Operation Twist – Con't

- With that said, the idea is to transfer private “bad” loans, that is those “toxic assets” whether securitized or not out of the private sector and buried in new loans provided by the public sector, that is via Fannie Mae or Freddie Mac. Once again, the taxpayer is left holding the future losses.
- The ability for the Federal Reserve to create it's own demand for Treasuries and thereby lowering yields to record low levels worked. It worked so well in achieving the drop in yields to such an extent, my fear is they found a new policy to keep in their toolbox. This way, they can manipulate the yield curve even more and will continue to do so for years to come.
- During the absolute peak of the credit crisis, when the world was in fact days away from financial Armageddon, when the whole world flocked to the safety of United State's Treasuries, the 10 year U.S. Treasury yield dropped to the 2.40% area. By the end of this past summer, the same Treasury yield dropped to 1.70% and has spent many weeks well below 2%. All the while the U.S. equities remained relatively tamed in decline.

Federal Reserve's Operation Twist – Con't

- Here is where the Fed found it's new policy tool....and a precarious and perhaps dangerous one that will likely be used over and over again in the years to come that will artificially suppress yields to artificially low levels.
- As Fall approaches, the Fed will continue with it's supportive language for maintain Fed Funds at practically zero. Discussion will ensue about whether to extend the 2013 to a later year. With the upcoming Presidential election, a "formal" announcement would be unrealistic as seen as partisan in some way. Beginning of 2013, look for news extending it to 2015.
- In the end, this is the new paradigm that will keep rates low for years to come. Look for long term yields to stay "artificially" low till at least 2015.

Ongoing Crisis – Sovereign Debt

- The sovereign debt issues of a number of European countries, namely Portugal, Ireland, Italy, Greece and Spain (PIIGS) will continue and will continue to add pressure to the Euro zone countries and is expanding to periphery countries and looks to sweep up Belgium as well.
- The European Community Bank (ECB), the central bank for the Euro zone countries is providing 1% loans to banks to buy up European Sovereign debt. Not a bad idea, as banks will profit from the spread from borrowing cheap and earning higher yields from the government debt. The creates demand for the debt thereby reducing the yield and cost to that particular country. This will be beneficial to the countries only in the short term. Ideally, it's only band-aid effort until reforms can take hold. The problem is the reforms will take years to yield benefits meanwhile the countries economies will stay stagnate for years with little to no growth in not shrinking growth.
- The European banks still need additional capital reserves and the Sovereign debt at the very least will have a portion subject to write-down which will create additional strains for the banking. This may lead the countries to come to aid the banks and provide assistance, thereby creating a revolving door approach.

Ongoing Crisis – Sovereign Debt (con't)

- Look for a new European Community Treaty needed to help back stop a number of the issues, primarily country debt targets and failure implications, however it will fail to pass as Britain doesn't want to be dragged down in a sinking ship.
- This will result in a significantly negative market event by March 2012.
- Greece's effective bailout has yet to come to pass and will put even greater pressure for Greece to officially "default". Which has it's own host of issues, primarily those holding CDS (Credit Default Swaps).
- Additionally, Italy and Spain will continue to struggle and will look for a "managed" bailout of some sort.
- In the end, look for additional cuts to debt ratings across the board with France being downgraded as well and Germany teetering with the a downgrade which will be the issue of European assistance to weaker countries front and center in the debate.

Expanding Crisis – U.S. state & municipal governments

- Adding to the pressure is the continuing shortfall of revenue through taxes i.e. income and property taxes. The weak economy reduces taxable income and the continued decline (or lack of growth) of home values reduces property taxes.
- Additionally, local and statewide pension obligations will continue to add to the stress to state and municipal governments, especially those that have continually deferred payments.
- We'll see some municipalities again end up in bankruptcy but it still won't be an avalanche some predict it will be.

Problems will continue for years

- Housing Market
 - The housing market will continue to stagnate for years to come as housing values will bounce around the bottoms.
 - Foreclosures will continue as individuals will not be able to refinance do home values dropping significantly below outstanding balances
 - 1 out 4 home owners continue to be “under water” as remaining outstanding balances below market values.
 - Refinancing become difficult as market values depressed due to low volumes making comparables difficult.
 - Individuals can’t relocate for jobs due to the above.
 - “Shadow” inventory of homes is huge, that is those that would like to sell but can’t due to weak housing market.

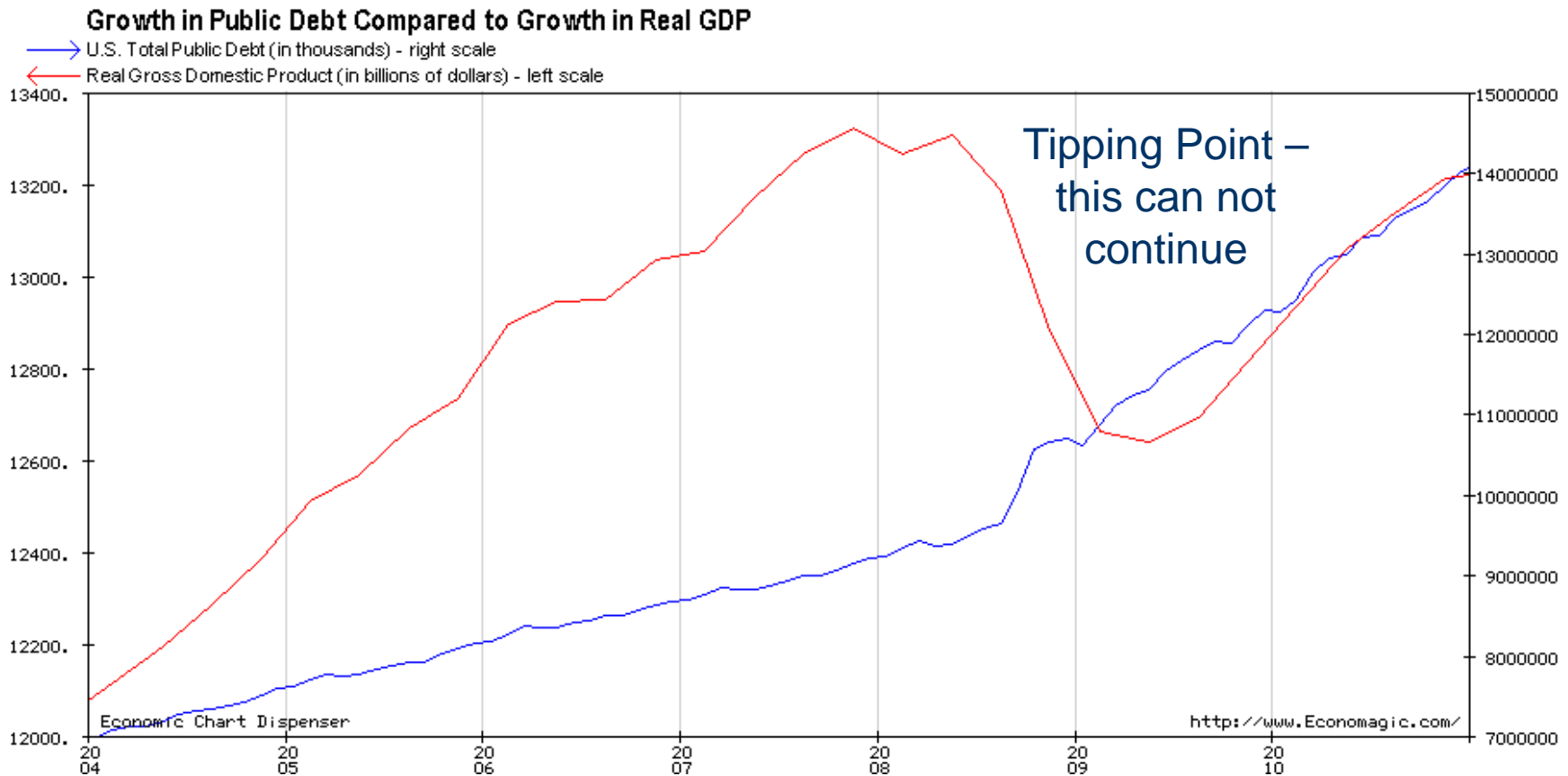
Problems will continue for years (con't)

- Housing Market (continued)
 - Vicious cycle won't be solved until existing, foreclosed and shadow inventories cleared.
 - Housing market increases marginal at best for 10 years.
 - Those that do secure low financing rates won't likely move as comparable rates won't be available
 - Real estate finance has changed for decades. The assumption of average life of first mortgages being 7 to 9 years will become 15 to 20.

Problems will continue for years (con't)

- Labor Market
 - Unemployment rate will stay elevated for years to come.
 - Labor market mobility severely impacted due to ongoing housing market difficulties.
 - With weak labor market many have and will continue to “leave” the labor market entirely.
 - Weekly unemployment claims will “appear” to illustrate stronger market but it is merely just a mirage of a remaining stagnant labor force.
 - Labor market will continue to bifurcate, that is separating between “skilled” and non-skilled with semi-skilled labor areas deteriorating.
 - Non-skilled or lesser skilled workforce will continue to be competitive as those that have been unemployed for extended periods are picking up those jobs making those jobs harder to come by for traditionally entry level workforce participants.

U.S. Government Debt Problem



U.S. Government Debt Problem

- Discretionary spending in FY 2011 was \$1.42 trillion, or 43% of total spending. More than half (\$760.8 billion) was National Defense related. Non-security spending was \$654.7 billion. The largest areas were: Education, Training and Employment related (\$129 billion), Income Security including housing assistance (\$74.1 Billion), Health (\$65.6 billion), International Affairs (\$57.7 Billion), Veterans Benefits (\$56.8 Billion), Administration of Justice (\$53.1 Billion). (Source: OMB, The Budget for Fiscal Year 2012, Table 8.7)
- Look for more confrontations from Congress about deficits with zero headway. Going through the motions of trying to save a trillion dollars over 10 years when it doesn't start till the last five years is pretty silly. Who would believe that any discipline would have that ever occur.

U.S. Government Debt Problem (con't)

- Saving a trillion dollars over 10 years only averages \$100 billion a year, when the deficits are \$1 trillion a year, that's what I would call progress.
- Using “war savings” and try to pass that off as credible means of cutting the deficit is joke.
- And the sad part....Congress can't even agree to minimal cuts.
- Look for 2012 fiscal deficit to exceed \$1 trillion, yet again.
- Look for total debt to finally exceed annual GDP and continue to climb.
- As a result, Moody's will downgrade U.S. debt rating and Fitch looks ready to do the same by year end.
- Spending cuts alone will not solve the problem...

U.S. Government Debt Problem (con't)

- Spending cuts alone will not solve the problem...what about raising revenue?
- And enough about the tax cuts for millionaires creates jobs baloney. What creates jobs is demand for products and services. How do you think those millionaires got their money in the first place. If no one bought their stuff they would have made their money.
- But I when I do win the hundred million dollar lottery...I don't want to pay high taxes on the winnings and earnings after that. Just saying....

Presidential Forecast

(Note: nothing below should be construed as an approval or endorsement of any kind to any candidate whatsoever.)

Republican Nominee will be Mitt Romney.

During the late Summer and Fall the Republic party offered up their Anti-Romney candidates almost on a monthly basis only see them falter and circle back for another. Outside of some the “gaffes” along the way, each of the Anti-Romney candidates lacks money, organization, “viable alternative to beat Obama” and/or a combination for a sustained primary campaign. That leaves Romney as the “last one standing”. Look for a less an enthusiastic National Republican Convention.

Democratic Nominee is obviously President Barack Obama.

Presidential Forecast (con't)

President Barack Obama:

With a continued weak economy, high unemployment and the President's consistent consensus building efforts for seemingly every issue, with the exception of the huge healthcare overall legislation (commonly referred to as Obamacare) leaves a fair amount of dissatisfaction. However, while some items were beyond his control it will still impact his re-election efforts.

Mitt Romney:

Some of a contender's benefits result from not just being a different candidate so he doesn't get the blame for a weak economy for example. However, being a moderate candidate, being Governor while implementing his own version of healthcare reform that has a few similar items to Obama's reform issues does not aid his cause. Additionally, some will also take issue with his beliefs.

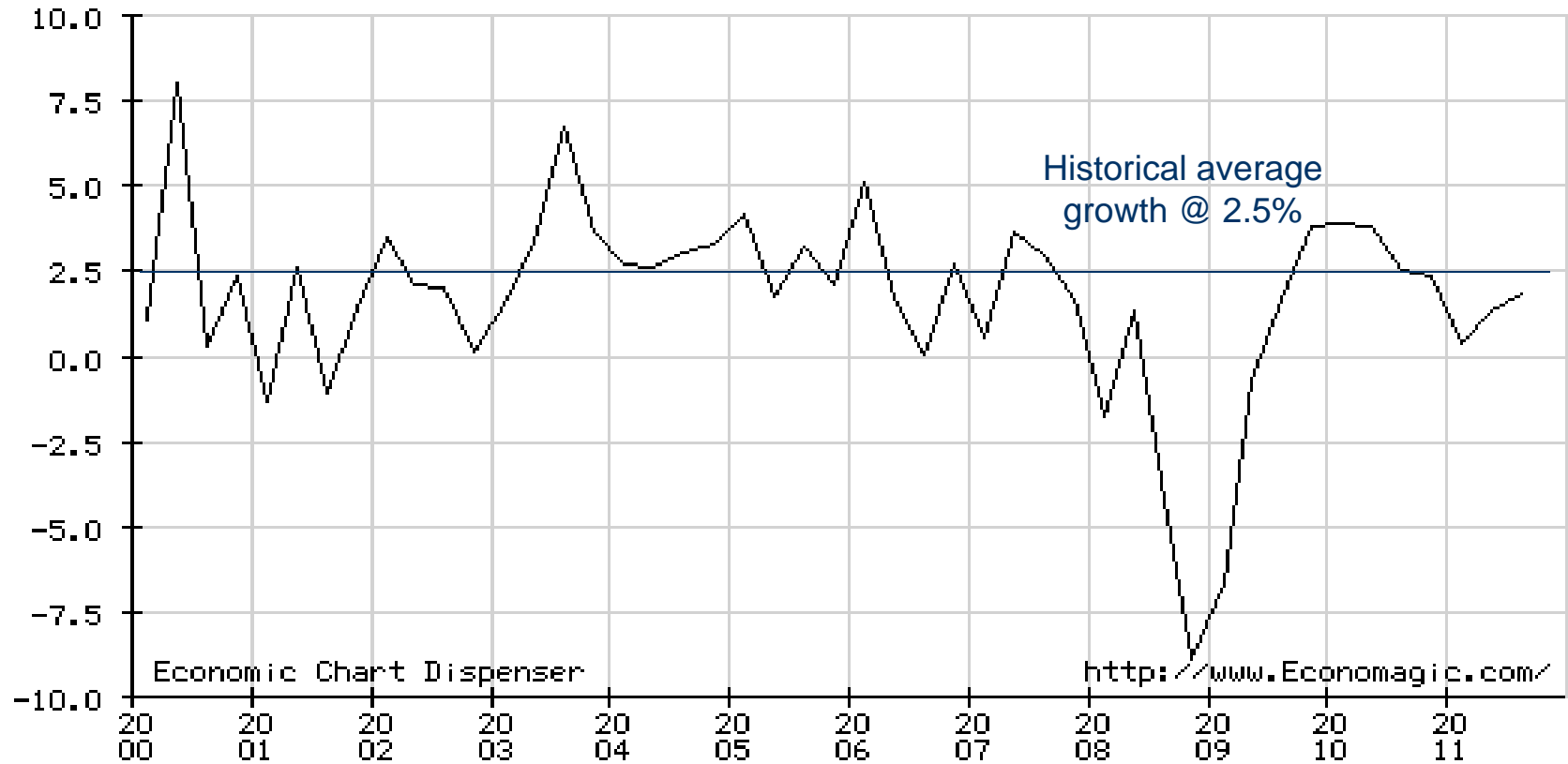
In the end, the President wins a fairly close race, as Romney can't muster enough supporters to overcome the President.

Economic Forecast - Overview

	2012				Average or Annualized
	Q1	Q2	Q3	Q4	
	<u>Forecast</u>	<u>Forecast</u>	<u>Forecast</u>	<u>Forecast</u>	<u>Annualized</u>
Oil per barrel *	\$ 100.00	\$ 110.00	\$ 120.00	\$ 100.00	\$ 110.00
CPI - Urban - Annual	2.0%	2.5%	2.5%	2.0%	2.25%
Unemployment Rate (U-3)	8.6%	8.8%	8.6%	8.6%	8.6%
Unemployment Rate (U-6)	15.3%	15.2%	15.1%	15.0%	15.1%
GDP (annualized rate)	1.5%	1.5%	2.0%	2.0%	1.75%
Fed Funds Rate	0%-0.25%	0%-0.25%	0%-0.25%	0%-0.25%	0%-0.25%
10 Year US Treasury Yield	1.75%	2.00%	2.25%	2.25%	2.00%
S&P 500 Index	1,050	1,125	1,250	1,250	1,200
* West Texas Intermediate / Light Sweet Crude					

Gross Domestic Product - GDP

Quarterly Growth in real GDP at annual rates, Percent

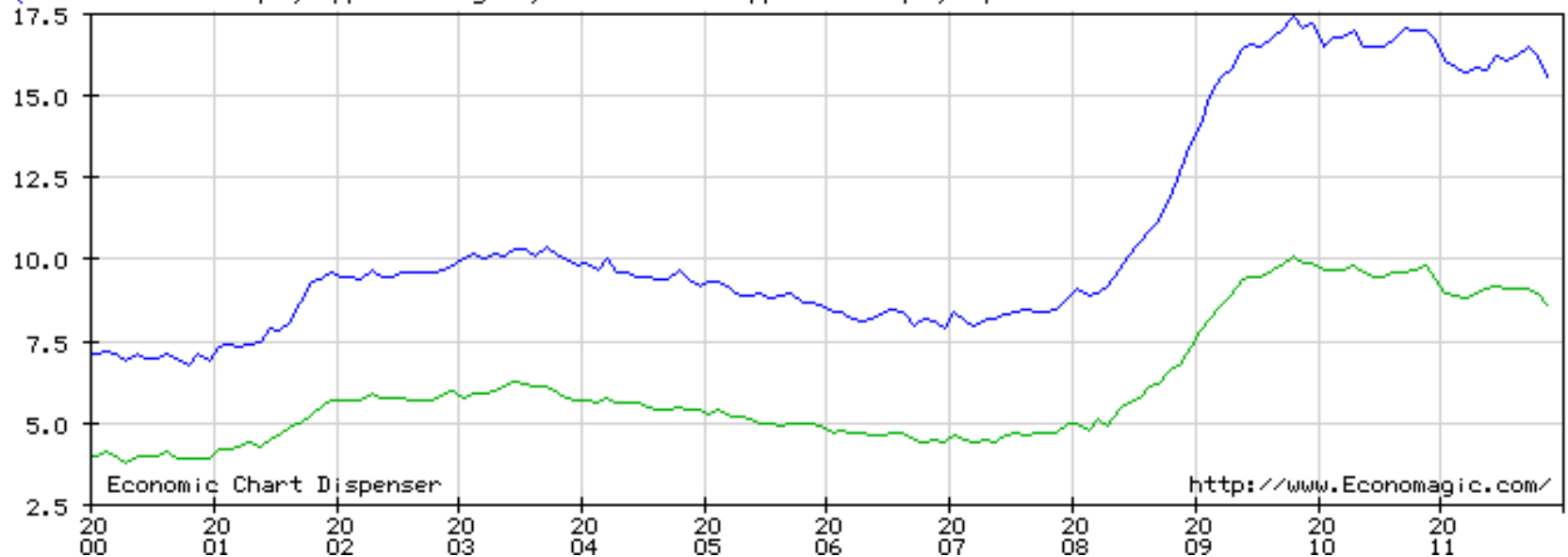


Unemployment Rate

US Unemployment Rates with Labor Underutilization

← U-3 Total unemployed

← U-6 Total unemployed, plus all marginally attached workers, plus total employed part-time for economic reasons

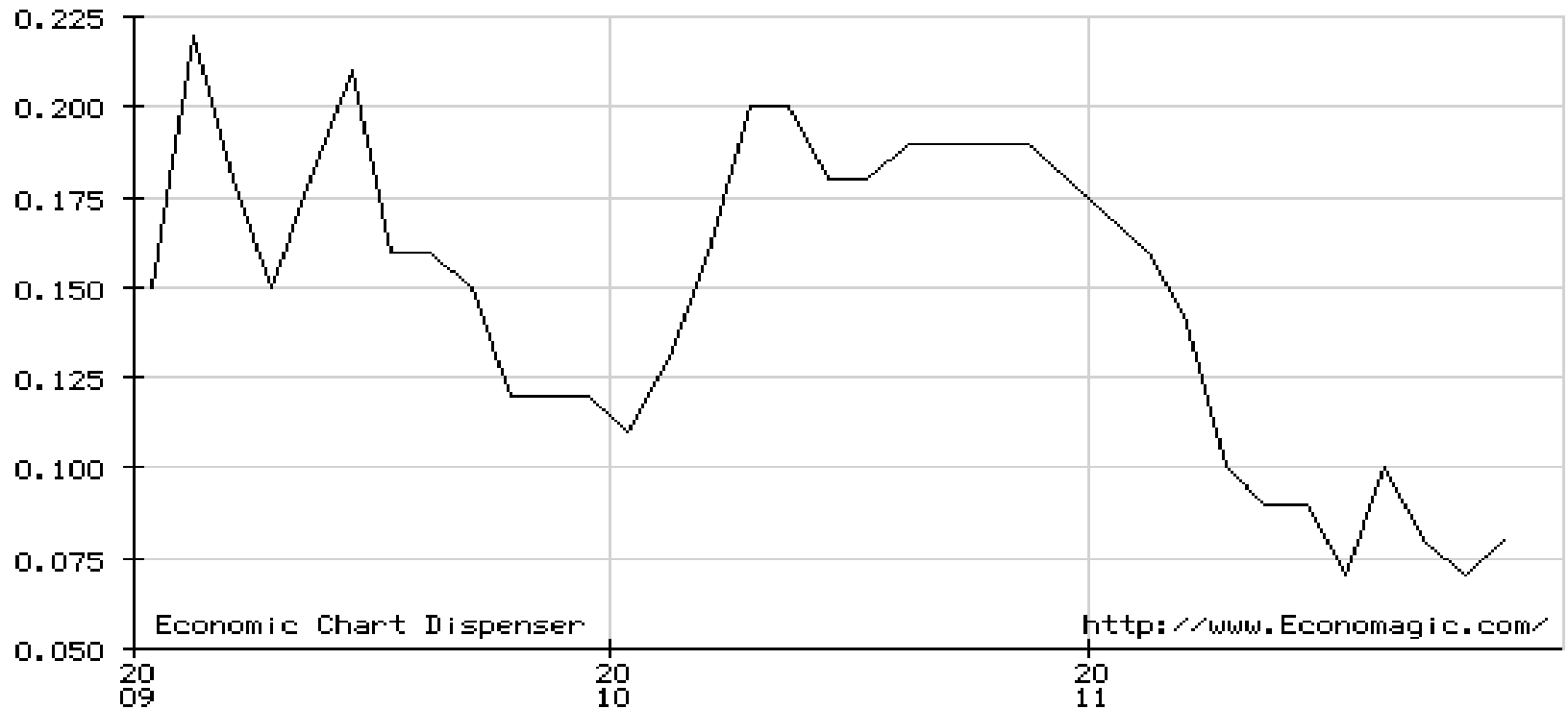


Interest Rate Forecast

- Short term interest rates, as controlled by the Fed, will continue to stay at the designated 0% to 0.25%. The Fed won't raise rates until 2015.
- Mid-term and long term yields will move plus or minus 50 basis points throughout the year as Sovereign disruptions will temporary swing yields around current levels.
- Additionally, GDP from 1.5% to 2% throughout the year and moderately acceptable inflation between 2% to 2.5% will keep the Fed in a accommodative level throughout 2012 and beyond.

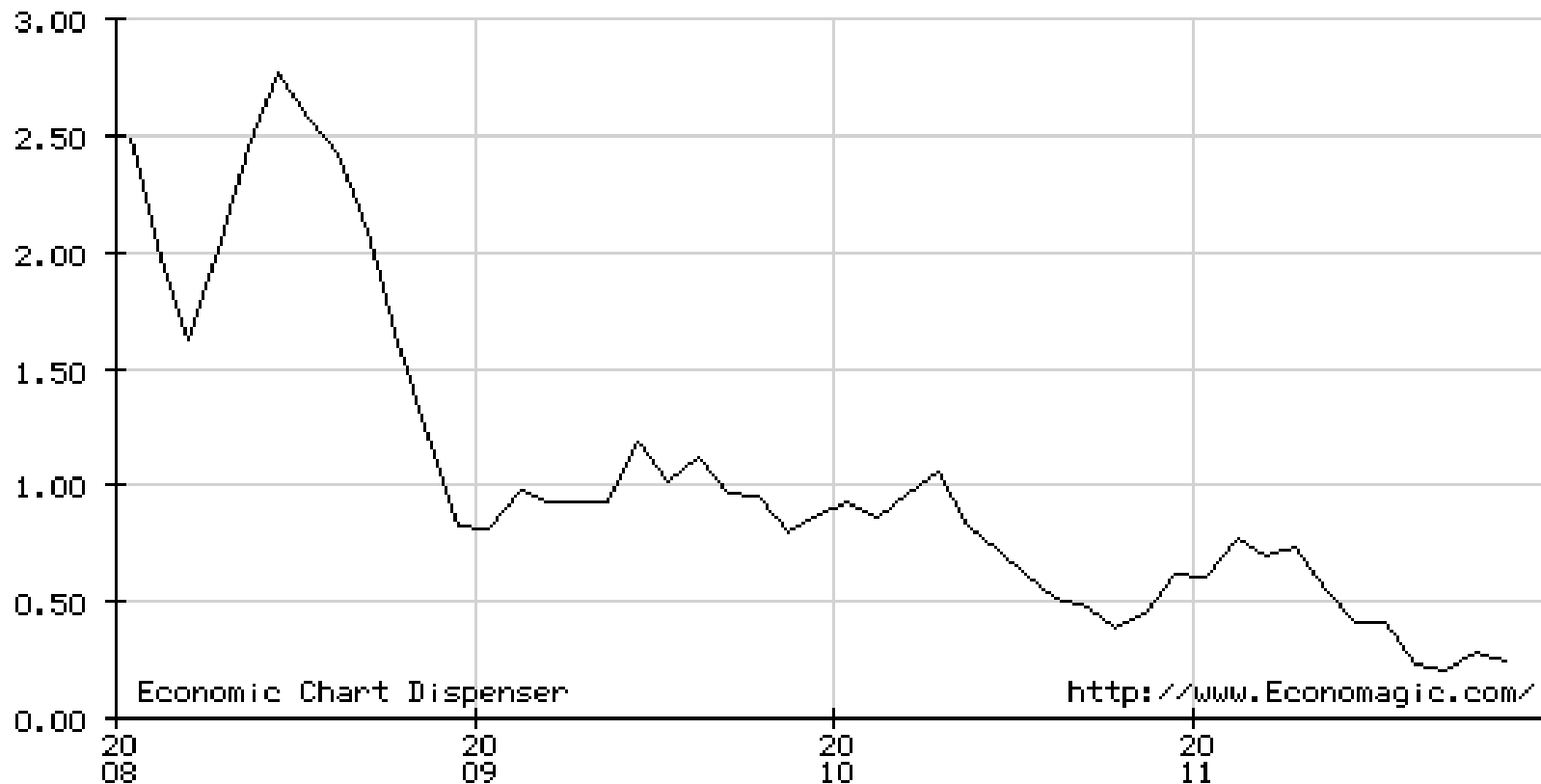
Interest Rate Forecast – Short Term Rates

Federal Funds Rate (effective)



Interest Rate Forecast – Medium Term Rates

2 Year US Treasury Constant Maturity

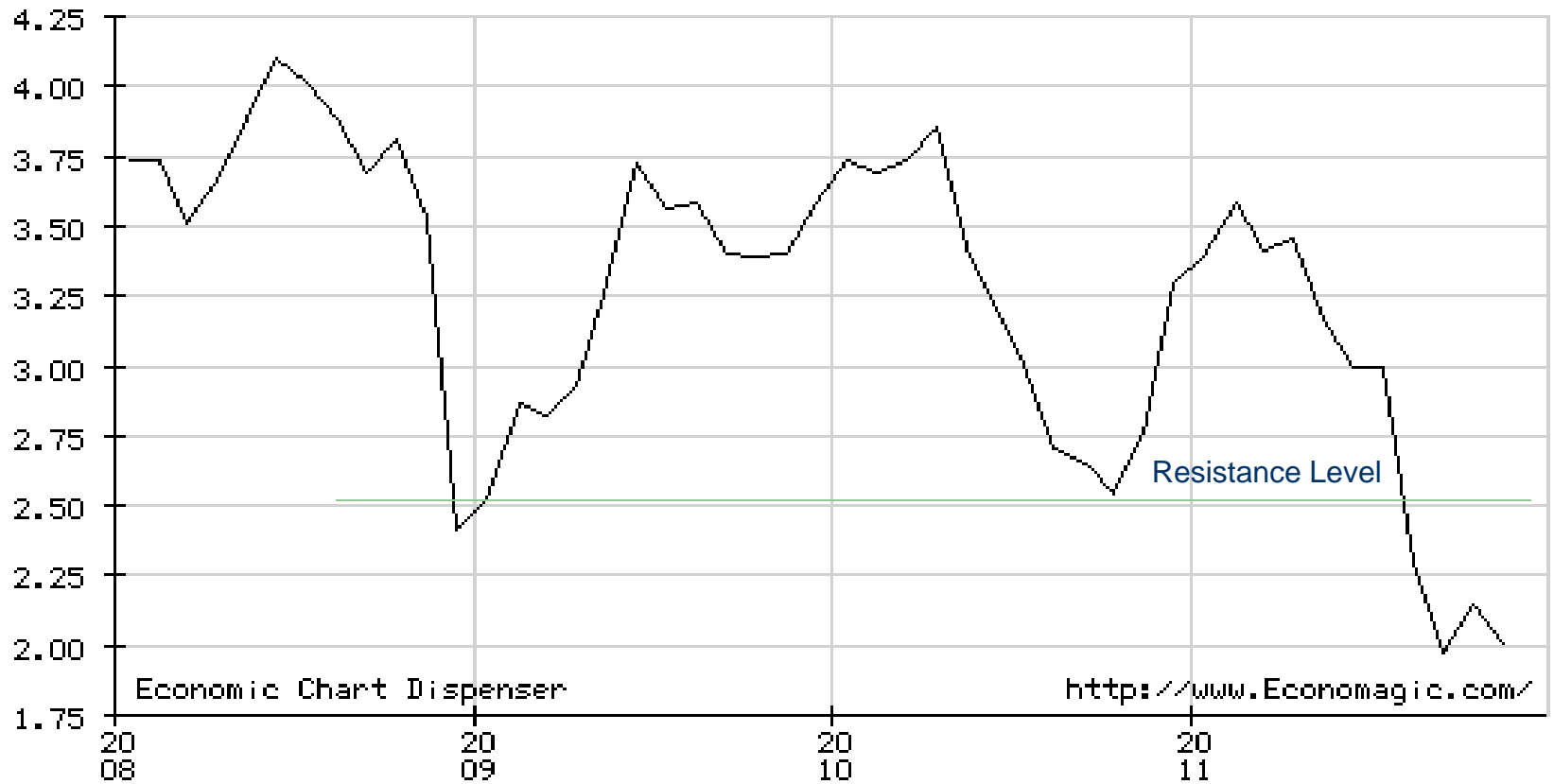


Economic Chart Dispenser

<http://www.Economagic.com/>

Interest Rate Forecast – Long Term Rates

10 Year US Treasury Constant Maturity



Stock Market Forecast

- The stock market will continue with volatile swings as market news from Europe and here as contributing factors.
- Current uptrend wedge expected to be broken based European news beginning of the year.
- Looking for a large correction easily in the 10% to 20% range within the first quarter as negative news from Europe regarding treaty changes to resolve Sovereign debt crisis come to a head by March.
- Rest of the year is spent between recovery from initial sell-off and corporate earnings reports both positive and negative.
- Corporate Earnings from European subsidiaries can be hammered by weak demand and weak economies, some in recession.
- Market easily re-tests S&P 1125. A move below will retest 1050 support which will hold.
- Overall, year will end relatively flat from the start with dramatic swings both ways throughout the year.

Stock Market Forecast



Long Term Forecast

- The overall economy will continue to “muddle” throughout 2012 and rest of the decade and will seem to appear to be on the mend.
- Global Sovereign debt issues will be ongoing problems throughout the decade.
- Look for more of the same through out the remainder of the decade.