

# PA HealthCare Credit Union

## 2011 Economic and Financial Forecast

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

# Agenda

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- Recap of 2010 Forecast
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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 2011 forecast of economic and financial 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.

**DISCLAIMER:** The views and comments, are solely the views of the presenter and do not necessarily reflect the views of the PA HealthCare Credit Union.

# What we said was going to happen...

- For 2010, “while it may appear on the surface that the financial and credit crisis is over, it’s far from over”. A significant majority of economic forecasts anticipated a “traditional” recovery....they were wrong, we were right. They’re finally are starting to figure out it’s not a traditional recovery. A little late.
- “The residential real estate market will continue to struggle...without the demand for homes, real estate values (and purchases) will stagnate.” That’s almost a gimme. This won’t be getting better for years to come.
- “Anticipated financial regulation will be so watered down it will be a mere nuisance.” Yep, too big to fail still around. By the way, the cure for too big to fail is to make smaller, period.

# What we said was going to happen...

- “Look for the federal budget deficit to easy exceed \$1 trillion.” – Right on the money. With a weak economy and continuing federal spending this was easy as well. As I like to say about Washington, when your only tool is a hammer, everything looks like a nail.
- “Top-line unemployment rate (U-3) isn’t expected to fall much (from 10%) in 2010...and (U-6) rate won’t fall below 15%.” Right on the money, with U-3 rate 9.6% and U-6 rate at 17%. With GDP around 2.5% the unemployment rate stays flat, except those that stop looking for a job then the rate goes down.
- “This is a tale of two economies....those that have jobs and those that don’t”. And this will continue for years to come.
- “The expanded crisis will result from the sovereign debt of a number a countries, primarily in Europe...Greece, Portugal, Spain and Italy.” We had included Iceland and Ireland already as the financial systems and guarantees' would overwhelm the countries. Right on the money and it’s not over yet.

# Recap of 2010 Forecast

- Interest Rate Forecast - Right on the money, almost
  - Short-term rates – The Federal Reserve keeps rates at 0%-0.25% all year. Right on the money. For those forecasters expecting the Fed raising rates last year, step away from the punch bowl.
  - Medium and long term rates will hover around 3.5%. Pretty close except for the QE2 pushed mid and long term rates further. (More on that later.)
- Stock Market Forecast – Right on the money...partly.
  - We forecasted the S&P 500 to correct mid-year to 1,000 and then recover some what. Missed on the continued rise as a result of QE2. (More on that later.)
- Overall Forecast – Much better than the majority of forecasts for yet another year.
  - Once again, while not perfect all the way around, the forecast was better than most others once again, so therefore better than most wins again.

# Welcome to the Great Recession – Repeated from last year and still fits

- 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

- 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.

# Quantitative Easing 2 (QE2)

- Given the Federal Reserve has lowered the fed funds rate to essentially zero, there isn't much else the Fed can do to stimulate the economy. The Fed utilized about \$1.7 trillion during the initial credit crisis, it's first round of quantitative easing. That is purchases of mortgage back securities (MBS) and other collateralized and non-collateralized debt obligation CDO's, once referred to as "toxic assets", to move from off the books of financial institutions, so the theory was they would lend that money. That's a nice theory but not really what happens in the real world.
- QE2 is set to purchase government treasuries creating the demand and therefore reduce yields and/or rates ultimately. The idea is to force rates so low that it creates huge opportunities for homeowners, businesses and anyone else looking to borrow long term for cheap rates. This part works out quite well for these folks assuming they qualify. However, the other side is the loser that when rates ultimately rise and they will, the values of these tank. In the case of mortgages, that's Fannie Mae and Freddie Mac of which 95% of all mortgages and done by these and the other government GSE's.

# Quantitative Easing 2 (QE2) – continued

- The whole idea with QE2 is that it will create savings for some so that they will ultimately spend. That's an assumption but reasonable enough.
- The other benefit is that as rates fall, that moves more money into the stock market and other financial markets and that will create a “wealth effect”. The idea being if investments go up that individuals will be feel wealthier and feel better about spending and therefore this will add to the GDP. There is some benefit to that, but at the expense of the holders of securities based on the artificially low rate securities. This also creates the precedent of support for rising asset classes (stock prices) at the expense of those that aren't participants.
- If the economy recovers slightly (and it would have anyway), the Fed take credit that QE2 worked. If the economy stays stagnate, the Fed will say it wasn't enough. This type of approach may lead to QE3 and QE4.
- This is a horrifically bad public policy that will huge negative consequences on the holders of these securities and by extension government GSE's and ultimately taxpayers. As well as sets the wrong precedents.

# 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.
- 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 economies of Europe.
- “Social unrest” as marked by demonstrators in these countries will continue and austerity measures are felt by disenfranchised groups, i.e.. pensioners, government workers, students and the like.
- Euro zone countries will put stress on the Euro relative to other currencies and stronger countries within the Euro zone are “forced” to come to the aid of weaker countries yet again.

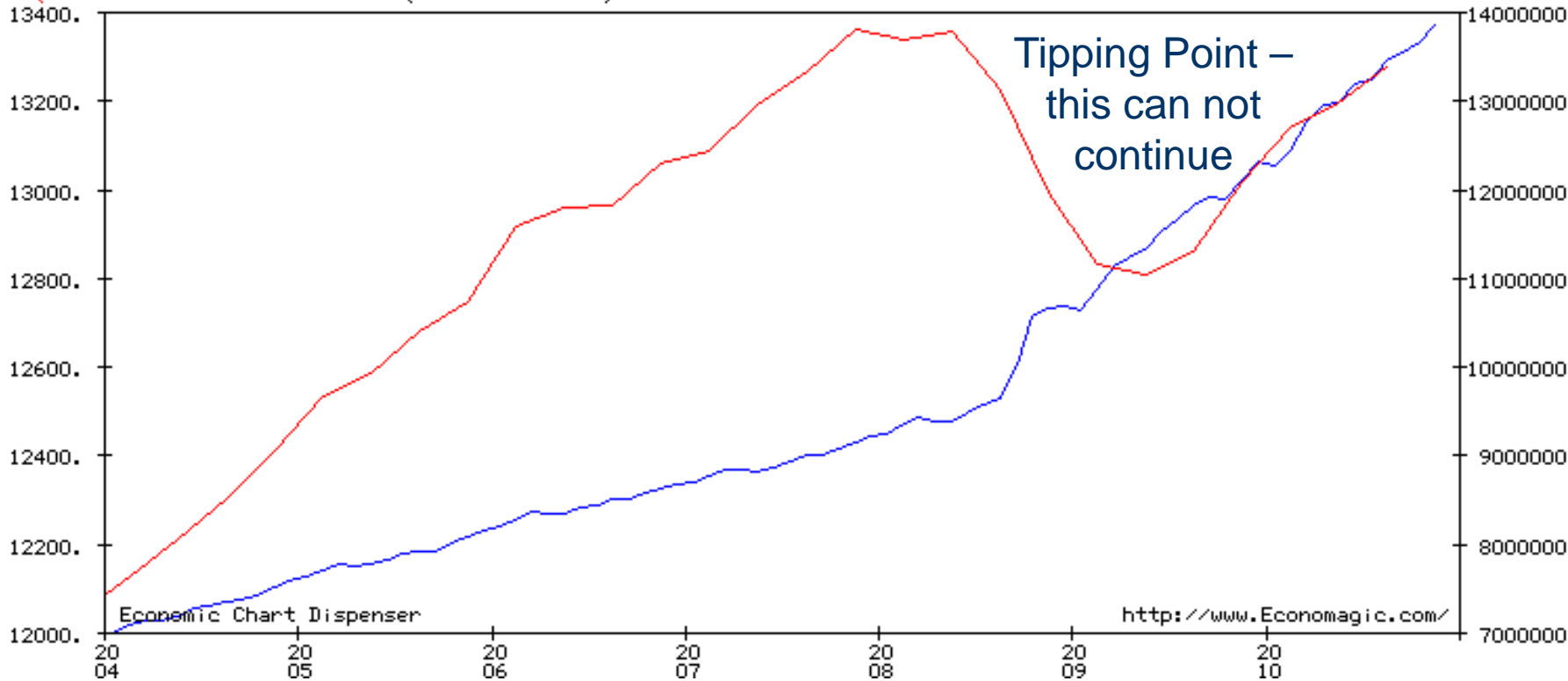
# Expanding Crisis – U.S. state & municipal governments

- With federal stimulus funds coming to end in the Spring, numerous states and therefore municipalities already struggling with deficits will continue and the meager recovery isn't strong enough to offset federal aid.
- 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 end up in bankruptcy but it won't be an avalanche some predict it will be.

# U.S. Government Debt Problem

## Growth in Public Debt Compared to Growth in Real GDP

→ U.S. Public Debt (in thousands of dollars) - right scale  
← Real Gross Domestic Product (in billions of dollars) - left scale



# U.S. Government Debt Problem

- Once again, when your only tool is a hammer everything looks like a nail.
- Discretionary spending in FY 2010 was \$1.39 trillion, or 38% of total spending. More than half (\$844 billion) was security spending, which includes the Department of Defense, overseas contingency programs and Homeland Security. Non-security spending was \$553 billion. The largest departments were: Health and Human Services (\$84 billion), Transportation (\$76 billion), Education (\$46.8 billion), Housing and Urban Development (\$43.6 billion) and Agriculture (\$25 billion). (Source: OMB, [Table S-11](#))
- So what does that leave to cut....not much.
- However, when politicians need to show how they bring back the “bacon” in grants for schools, libraries, hospitals, other miscellaneous funding, there is ZERO political will to make a meaningful and significant difference. (Going through the motions without outcomes, doesn’t count.)

# U.S. Government Debt Problem - continued

- Say what you will...cutting spending alone will NOT solve the problem unless everyone's favorite programs (i.e. Social Security and Medicare) get cut. (The assumption is that raising specific Social Security and Medicare taxes are out of the question.)
- Tax cuts work well during a recession but then they need to end to help offset the previous cuts.
- Solution...need to cut spending but also raise taxes for everyone.
- Look for 2011 fiscal deficit to exceed \$1 trillion, yet again.
- With the Republican landslide in Congress and subsequent extension of Bush tax cuts for 2 years, look for the pivotal debate for the 2012 Presidential cycle being who's going to raise your taxes. Once again, partisan maneuvering to obscure "prudent" public policy.

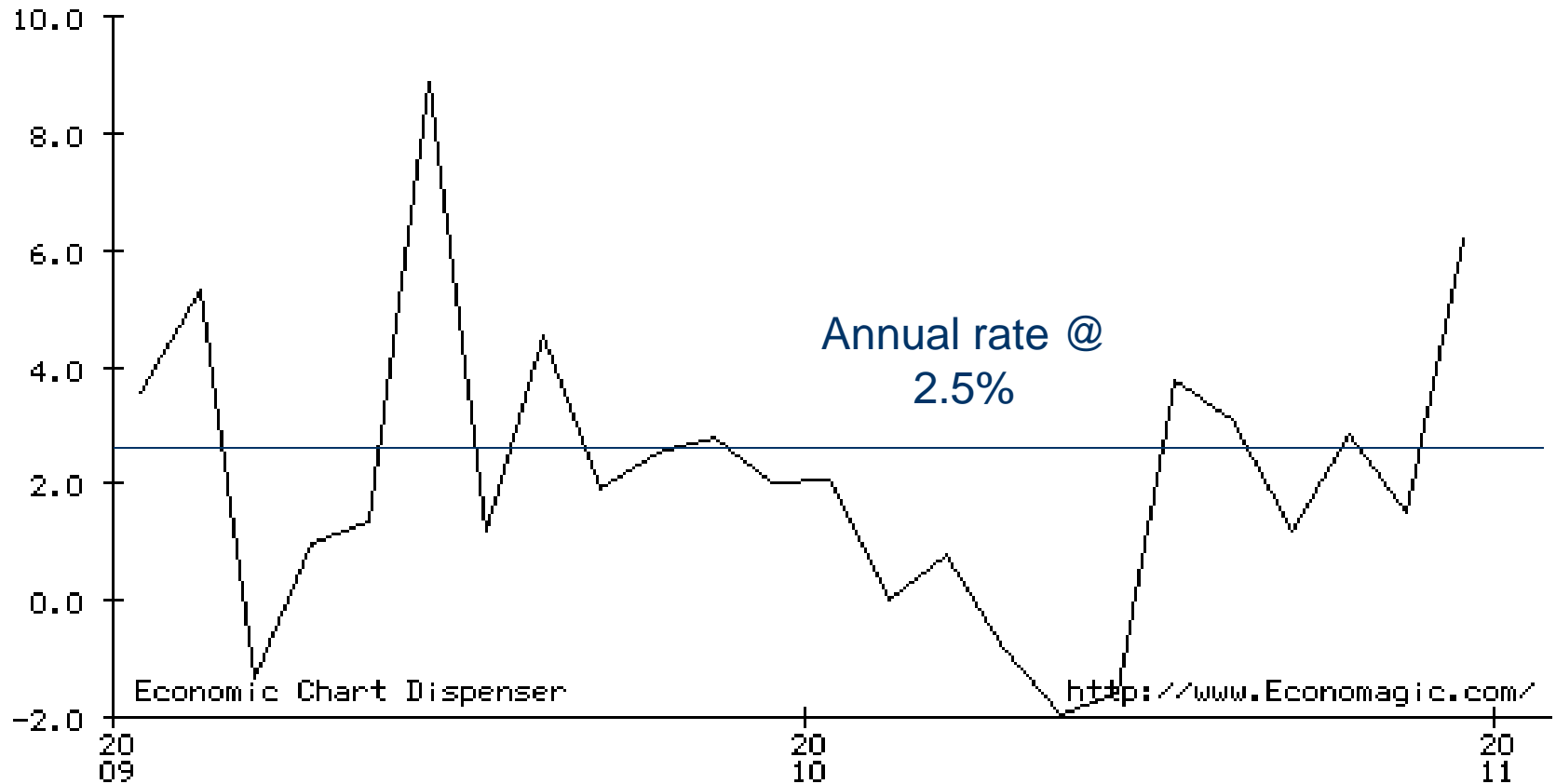
# Economic Forecast - Overview

	2011				Average or Annualized
	<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>	
Oil per barrel*	\$90	\$100	\$110	\$100	\$100
CPI - Urban - Annual	2%	2.5%	2.5%	2%	2.25%
Unemployment Rate (U-3)	9.5%	9%	9%	8.8%	9%
Unemployment Rate (U-6)	16%	15.5%	15%	14.5%	15%
GDP	3%	3%	2.7%	2.7%	2.8%
Fed Funds Rate	0%-0.25%	0%-0.25%	0%-0.25%	0%-0.25%	0%-0.25%
10 Yr U.S. Treasury Yield	3.30%	3.70%	3.50%	4.00%	3.50%
S&P 500 Index	1300	1125	1200	1250	1250

\* West Texas Intermediate / Light Sweet Crude

# Consumer Price Index - CPI

## Inflation in Consumer Prices at Annual Rates: Percent (Monthly)

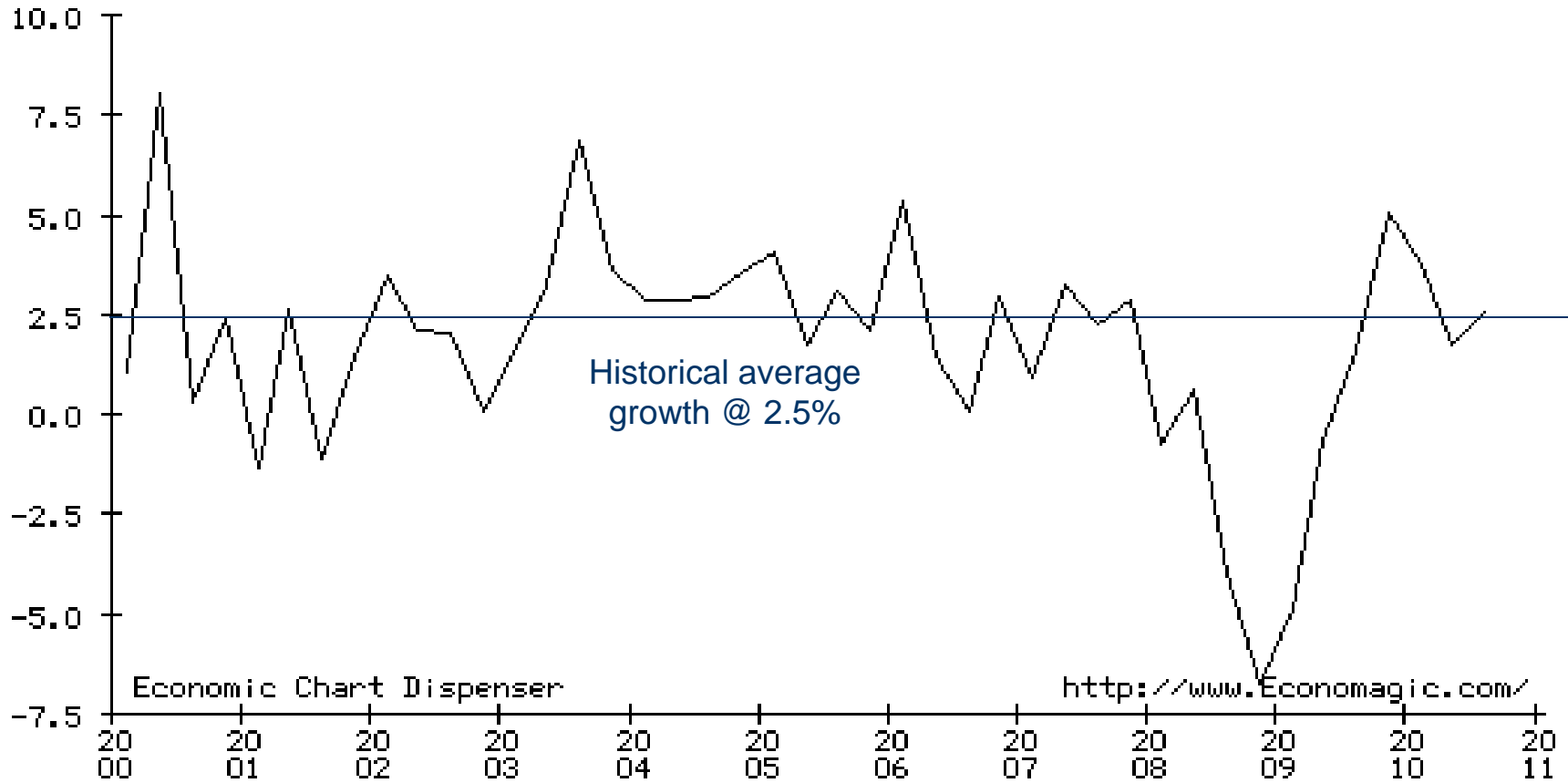


Economic Chart Dispenser

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

# Gross Domestic Product - GDP

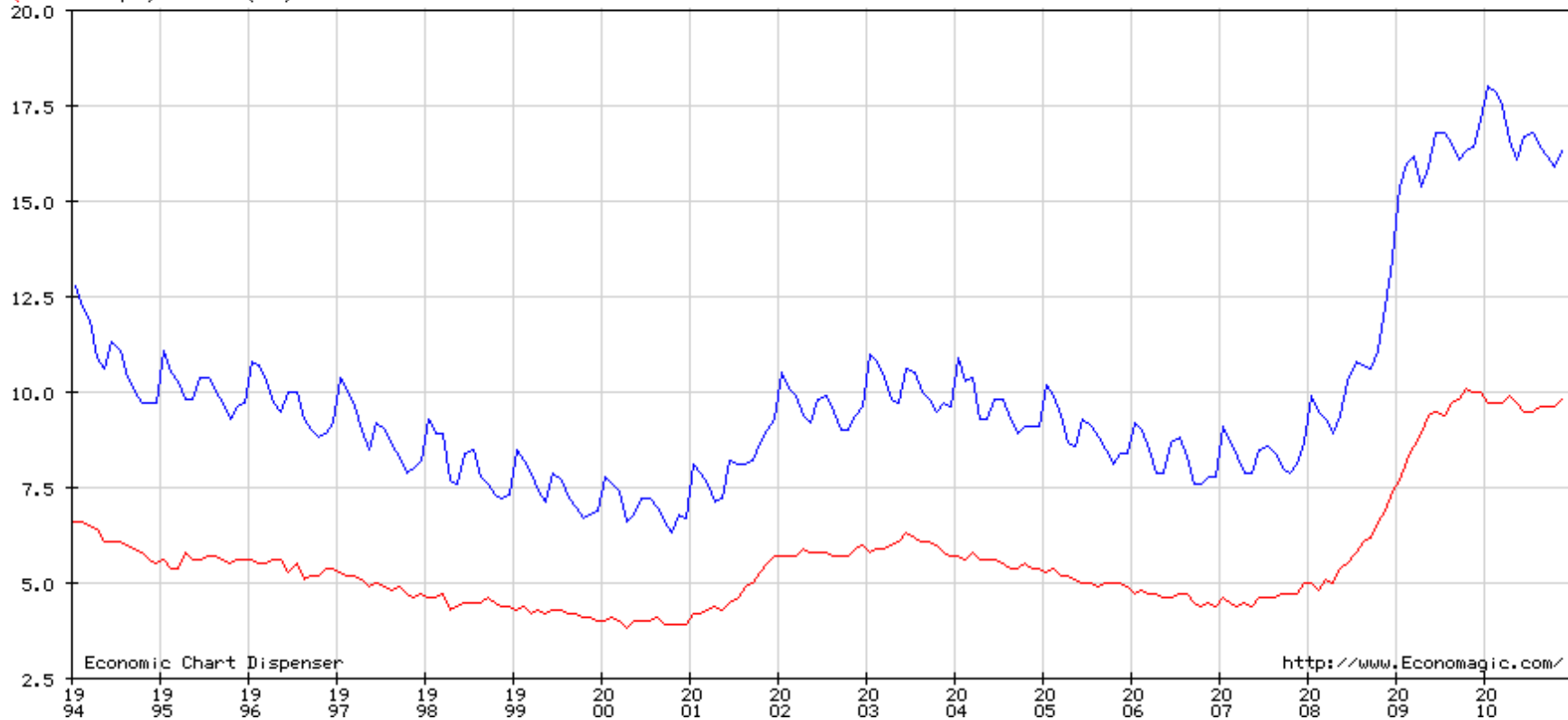
## Quarterly Growth in real GDP at annual rates, Percent



# Unemployment Rate

## Unemployment Rates

- ← Unemployment Rate (U-6)
- ← Unemployment Rate (U-3)

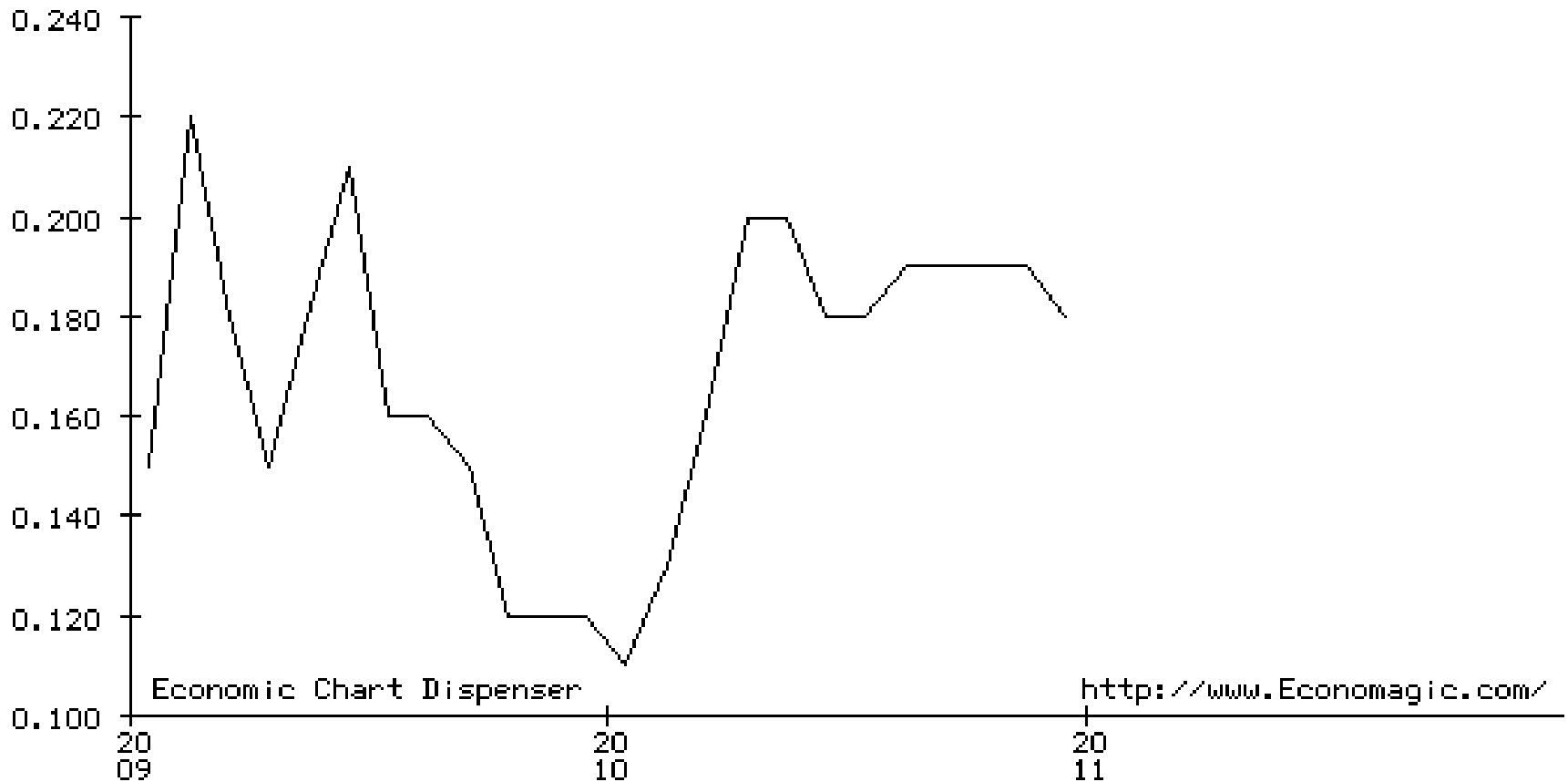


# Interest Rate Forecast

- 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 after the Presidential election in 2012.
- While the Fed is supposed to be "impartial" to the political process, it doesn't want to have the "appearance" of influence, so therefore it will do nothing until after the 2012 election. (And they'll make the case of trying to "ensure" the economy is stable....blah, blah, blah.)
- Mid-term and long term yields will move plus or minus 50 to 100 basis points throughout the year as "talk" of possible Fed exits from Quantitative Easing as well as Sovereign disruptions will temporary swing yields around current levels.
- Additionally, moderately acceptable GDP from 2.7% to 3% throughout the year and with moderately acceptable inflation between 2% to 2.5% will keep the Fed in a neutral level throughout 2011.

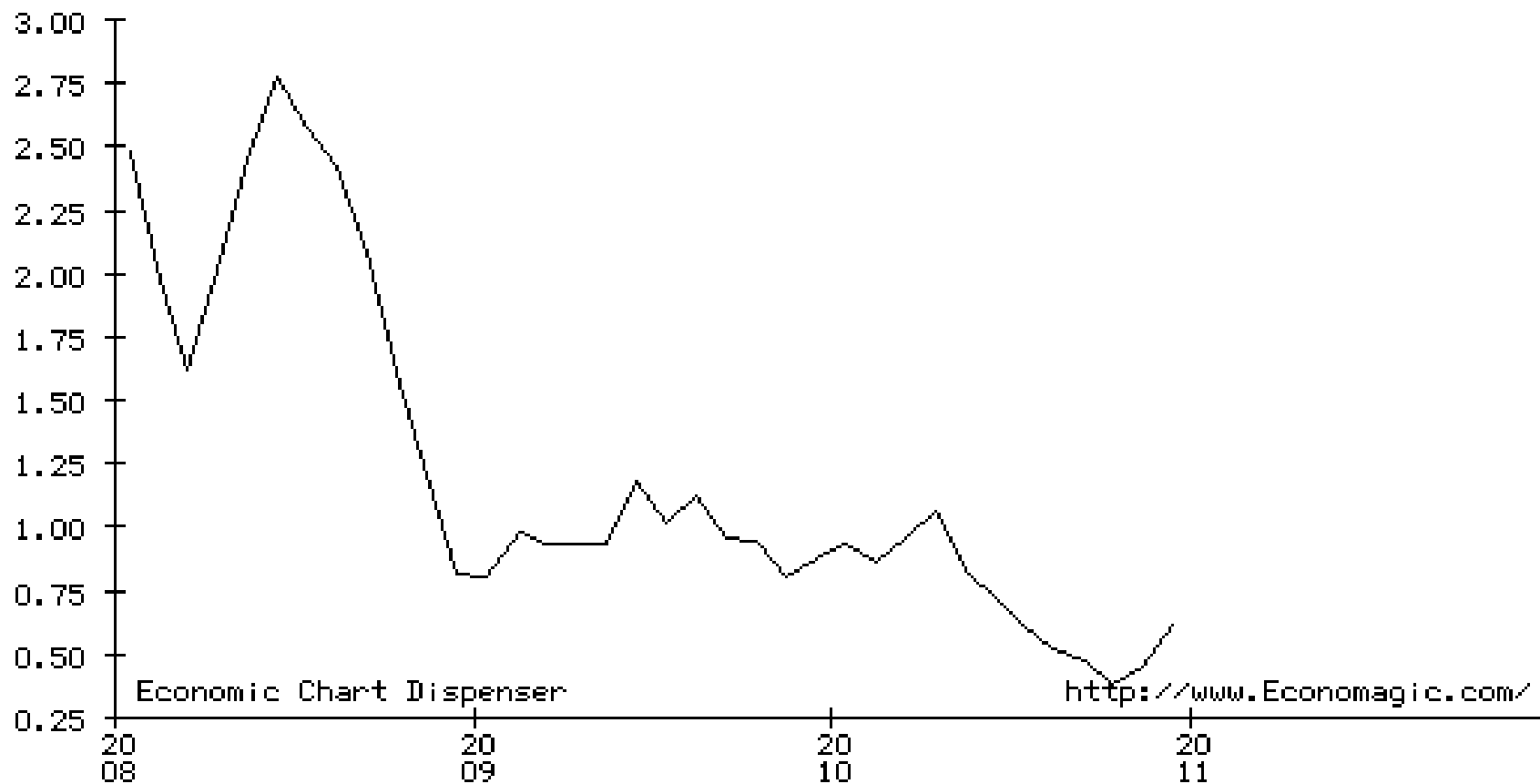
# Interest Rate Forecast – Short Term Rates

## Federal funds (effective)



# Interest Rate Forecast – Medium Term Rates

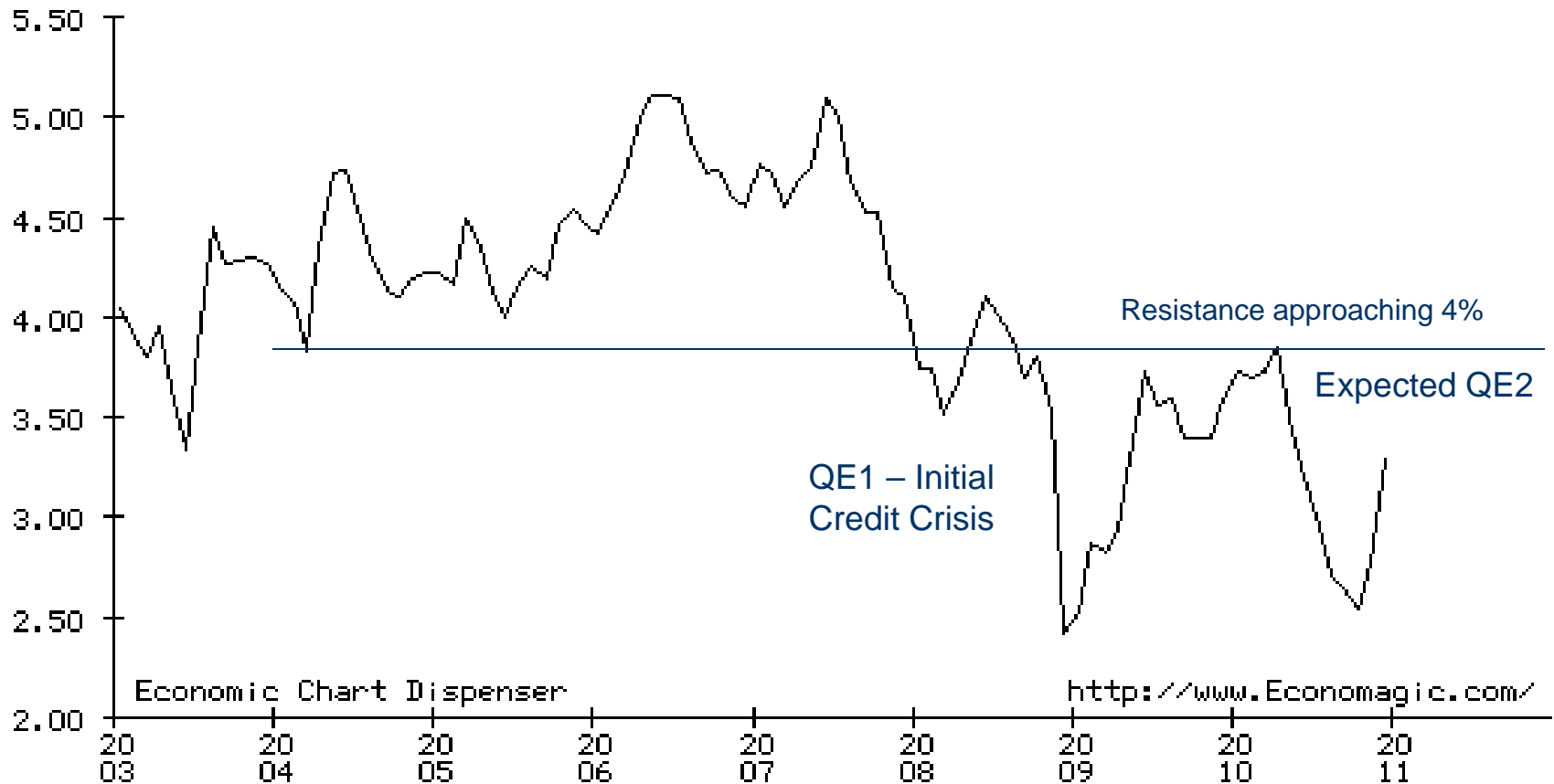
## 2-year Treasury Constant Maturity



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# Interest Rate Forecast – Long Term Rates

## 10-year Treasury



# Stock Market Forecast

- The stock market will continue to be “supportive” with strength in corporate earnings. Unfortunately...top line, revenue to begin to moderate while expense will begin to drift upwards putting some pressure on record margins. So the record earnings levels will begin to move towards normalized levels.
- With record levels of bullish sentiment, almost begs one to be a contrarian, and move away from equities. Not that equities are bad, just that the risks are increasing at a greater rate than returns. This can be seen in the VIX, CBOE Volatility Index at levels well below 20. As the saying goes, when the VIX is low it's time to go.
- 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.
- Overall, year will end relatively flat from the start with dramatic swings both ways throughout the year.

# Stock Market Forecast

## S&P 500: Close



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# Putting It All Together

- 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.