

Economic Review and Outlook

**FinPro, Inc.**

January 2010



## **Primary Economic Indicators**

1. Employment and personal income
2. Real estate values and affordability
3. Credit availability and demand
4. Government borrowing and spending

# Bloomberg

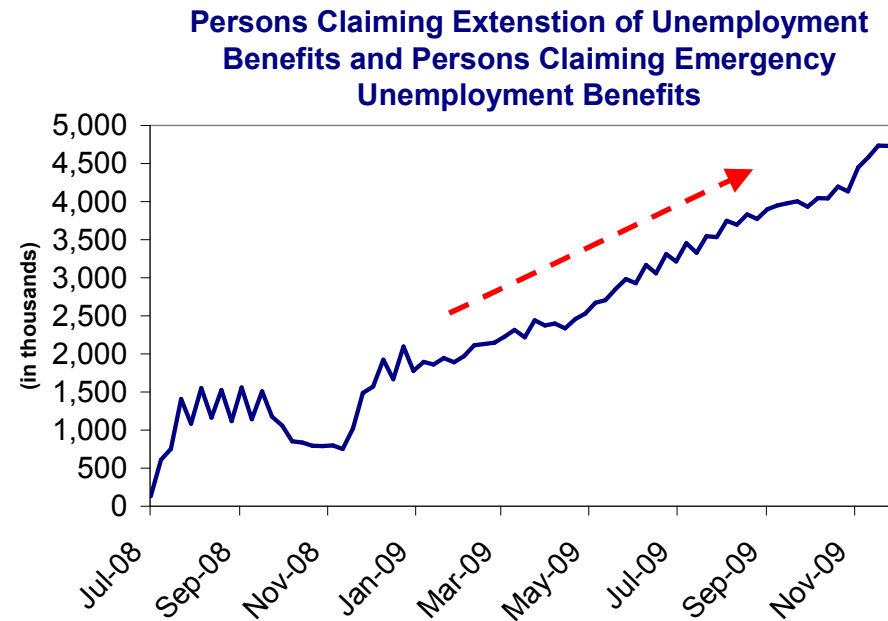
December 24, 2009

**Headline:** “U.S. Jobless Claims Unexpectedly Fall to One-Year Low”

“The number of Americans filing first- time claims for unemployment benefits unexpectedly fell last week to the lowest level in more than a year.”

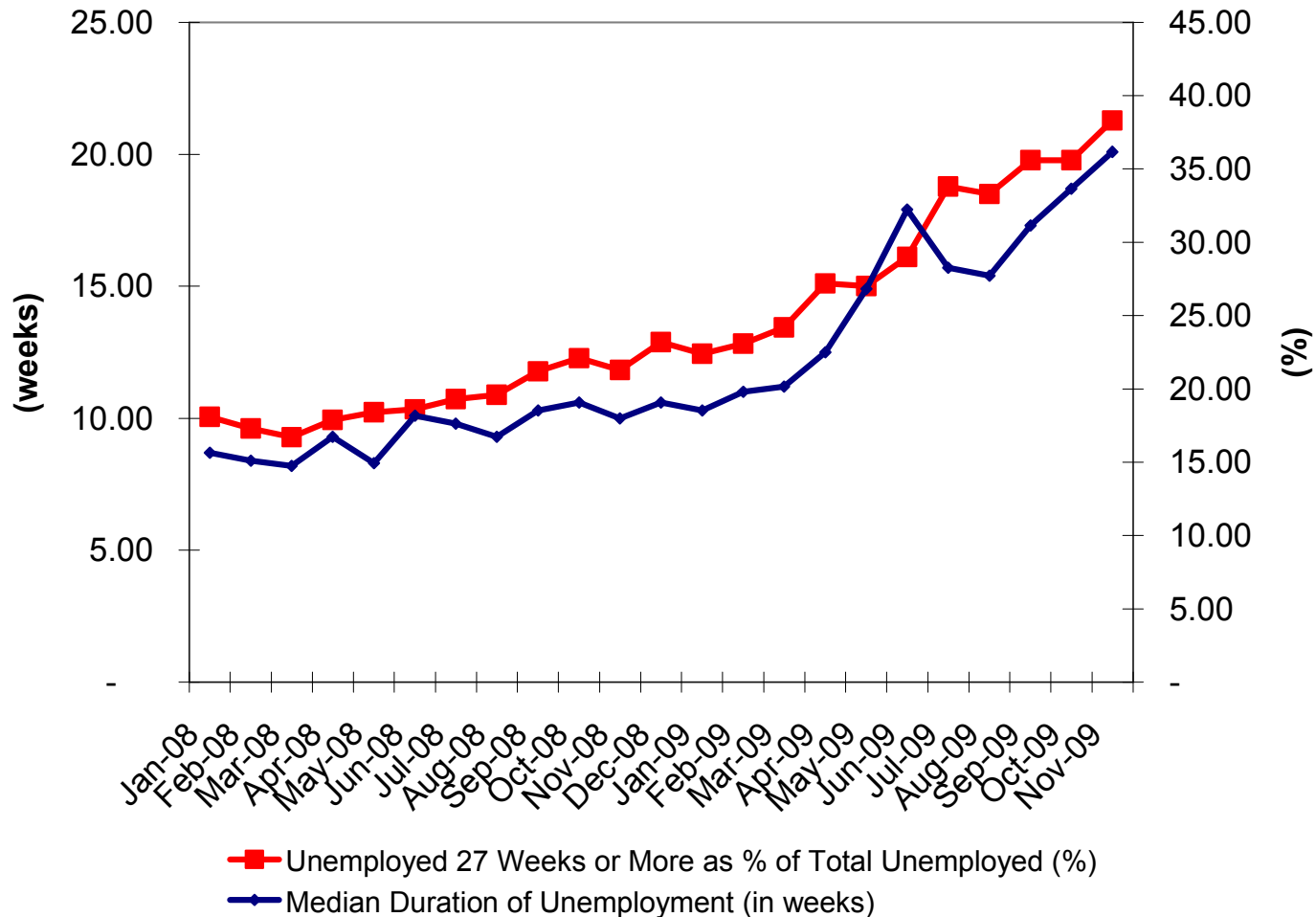


**Real Story:** Jobless claims do not take into account the increase in the number of people demanding continuous unemployment benefits. The total number of people claiming benefits actually increased.

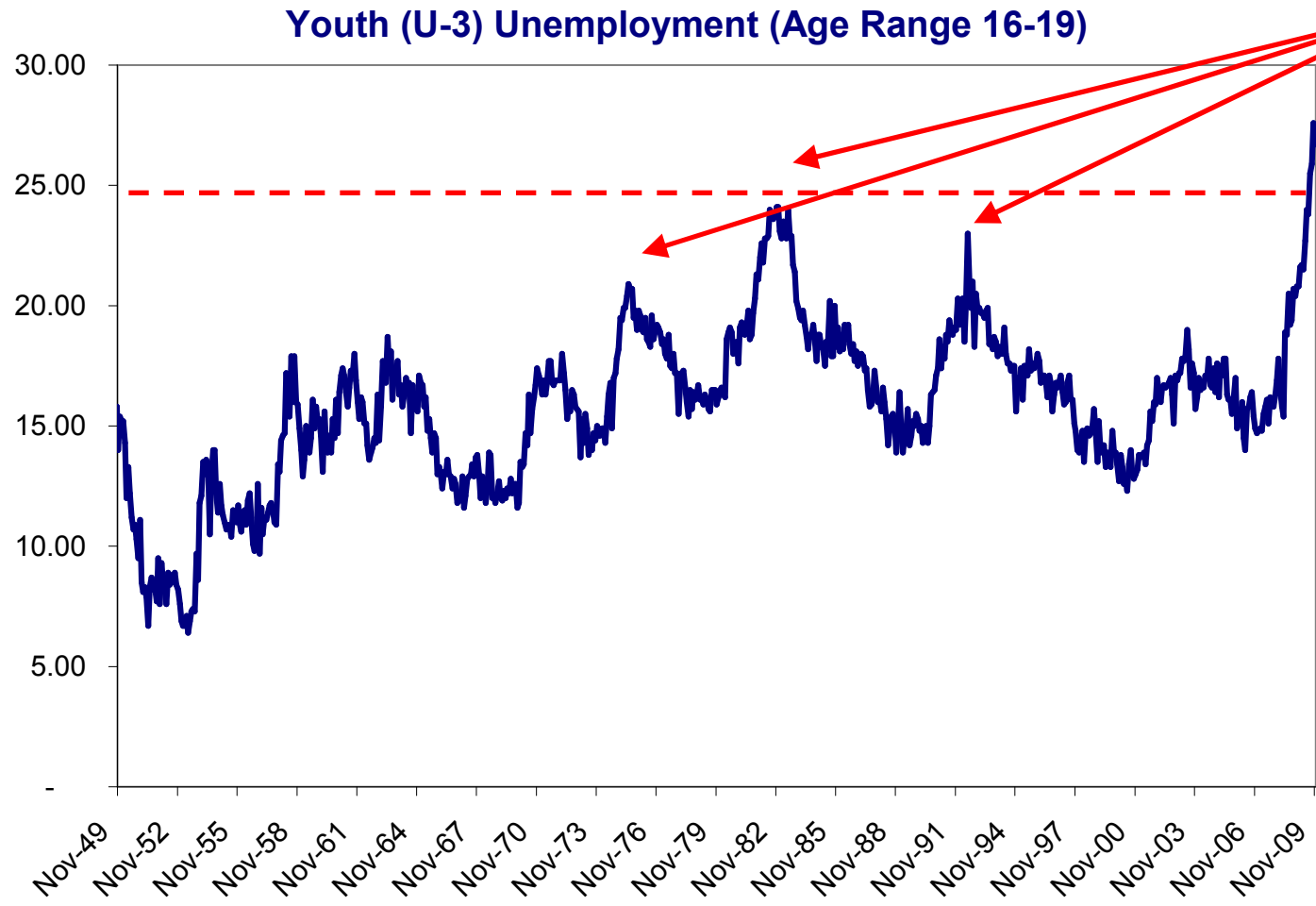


1. Employment and personal income

While it may be true that organizations are slowing their pace of firings, there is no indication that organizations have begun hiring again . . .



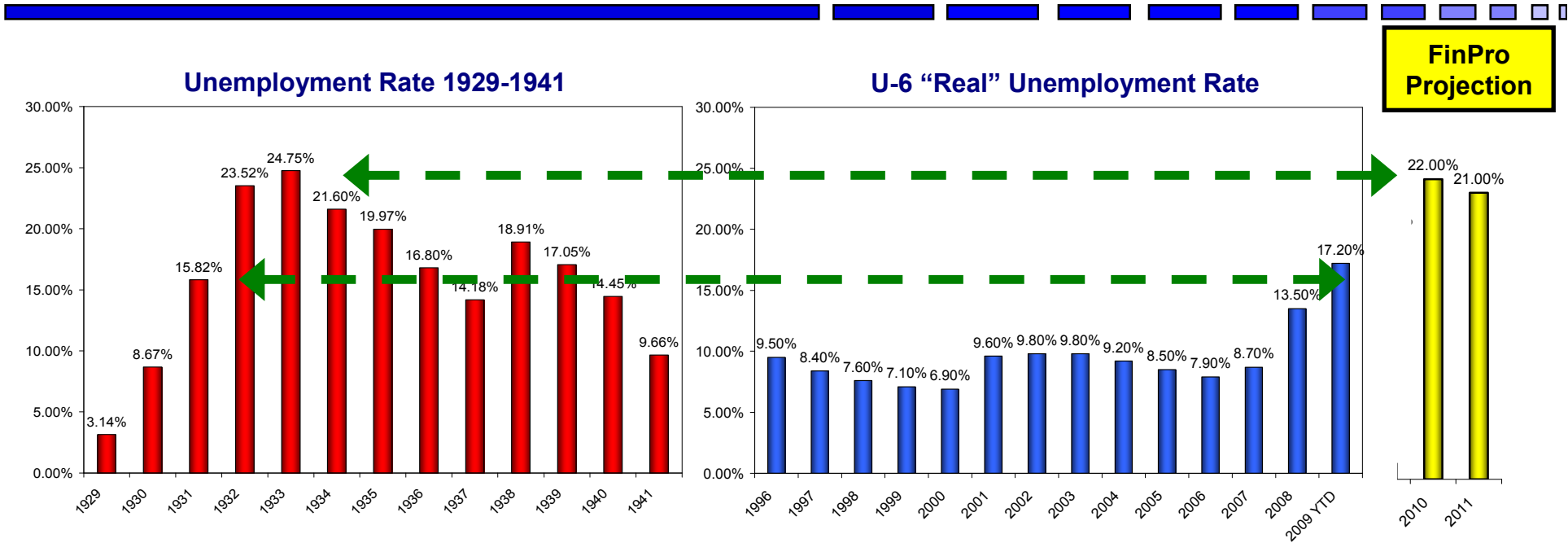
Youth unemployment has hit crisis levels, which again, indicates companies are not hiring new workers . . .



Youth unemployment has traditionally been high during previous downturns . . .

. . . It has risen above the historical threshold in the current downturn.

Taking into account all of these factors, it is no surprise that the all-inclusive U-6 unemployment rate has increased to a level over 17% . . .



FinPro  
Projection

We believe U-6 will continue to increase in 2010, but will peak near the end of 2010 at 22%. Although we predict U-6 will stop increasing in late 2010, we do not see where **sustained job creation** will come from. As such, unemployment will remain high and be a drag on the economy for years to come.

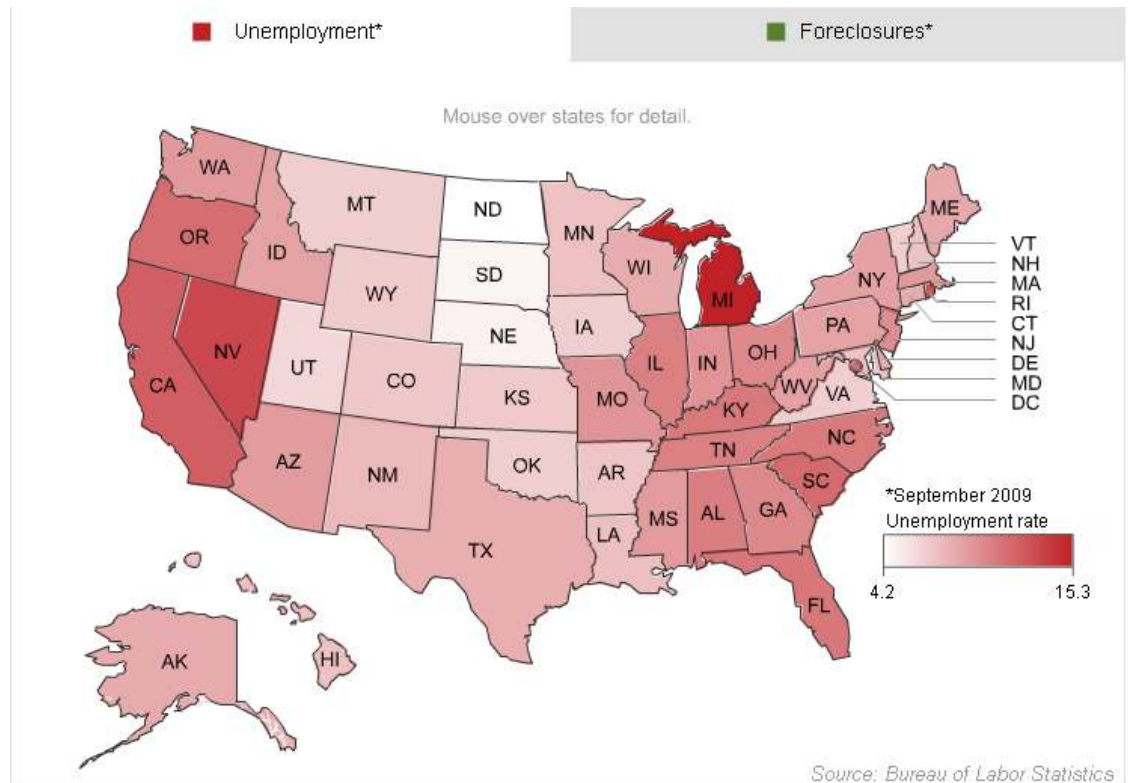
## Primary Economic Indicators

### 1. Employment and personal income

When analyzing unemployment by states, several of the highest (U-3) unemployment levels are found in political “blue states” and those with large populations . . .

States With The Highest Unemployment	
State	Rate
Michigan	15.3%
Nevada	13.3%
Rhode Island	13.0%
California	12.2%
South Carolina	11.6%
Oregon	11.5%
District of Columbia	11.4%
Florida	11.0%
Kentucky	10.9%
North Carolina	10.8%

States With the Lowest Unemployment	
State	Rate
North Dakota	4.2%
South Dakota	4.8%
Nebraska	4.9%
Utah	6.2%
Iowa	6.7%
Montana	6.7%
Oklahoma	6.7%
Vermont	6.7%
Virginia	6.7%
Wyoming	6.8%



## Primary Economic Indicators

### 1. Employment and personal income

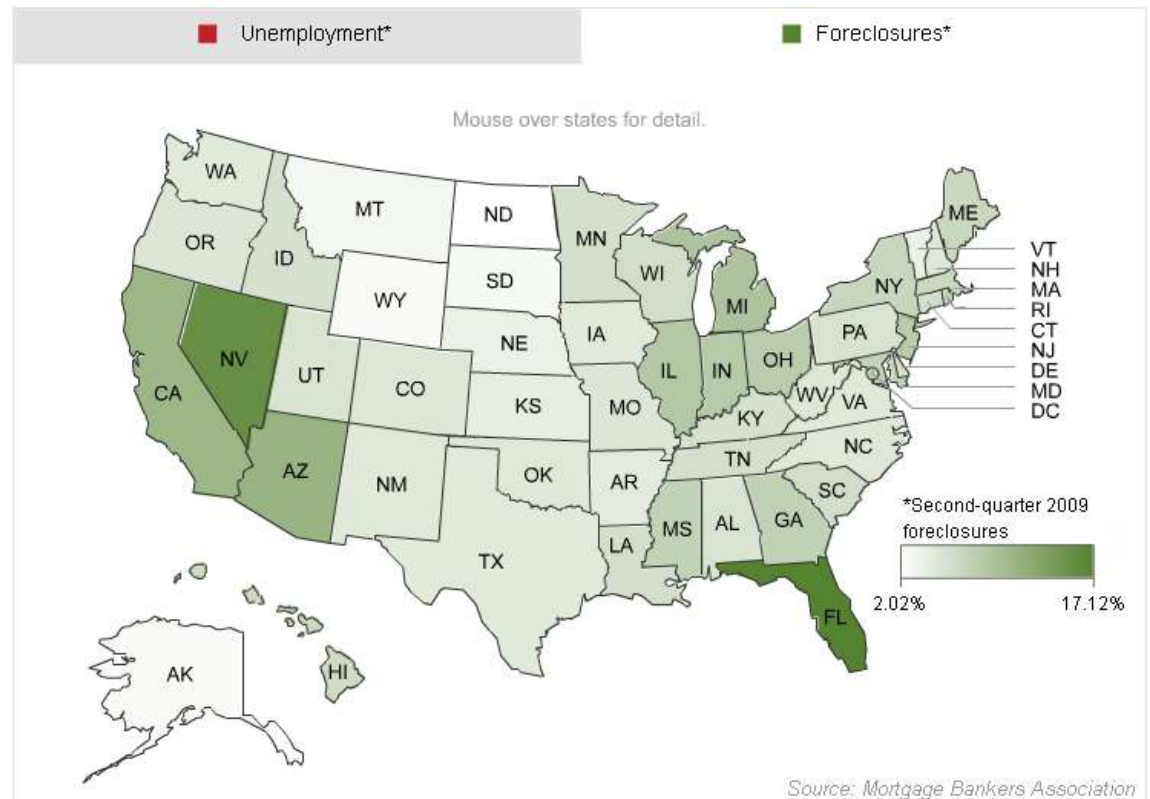
And foreclosure levels follow a similar pattern. Four of the states with the highest unemployment also have foreclosure rates in the top ten . . .

#### States With The Highest Foreclosures

State	Rate
Florida	17.12%
Nevada	15.62%
Arizona	11.07%
California	10.81%
Michigan	9.16%
Illinois	8.62%
Indiana	8.37%
Ohio	8.26%
New Jersey	8.25%
Rhode Island	7.57%

#### States With The Lowest Foreclosures

State	Rate
Iowa	4.65%
Arkansas	4.50%
Kansas	4.32%
Vermont	3.76%
Nebraska	3.75%
Montana	3.07%
South Dakota	2.86%
Alaska	2.56%
Wyoming	2.56%
North Dakota	2.02%



Budget gaps appear to be correlated with high unemployment and foreclosure rates . . .



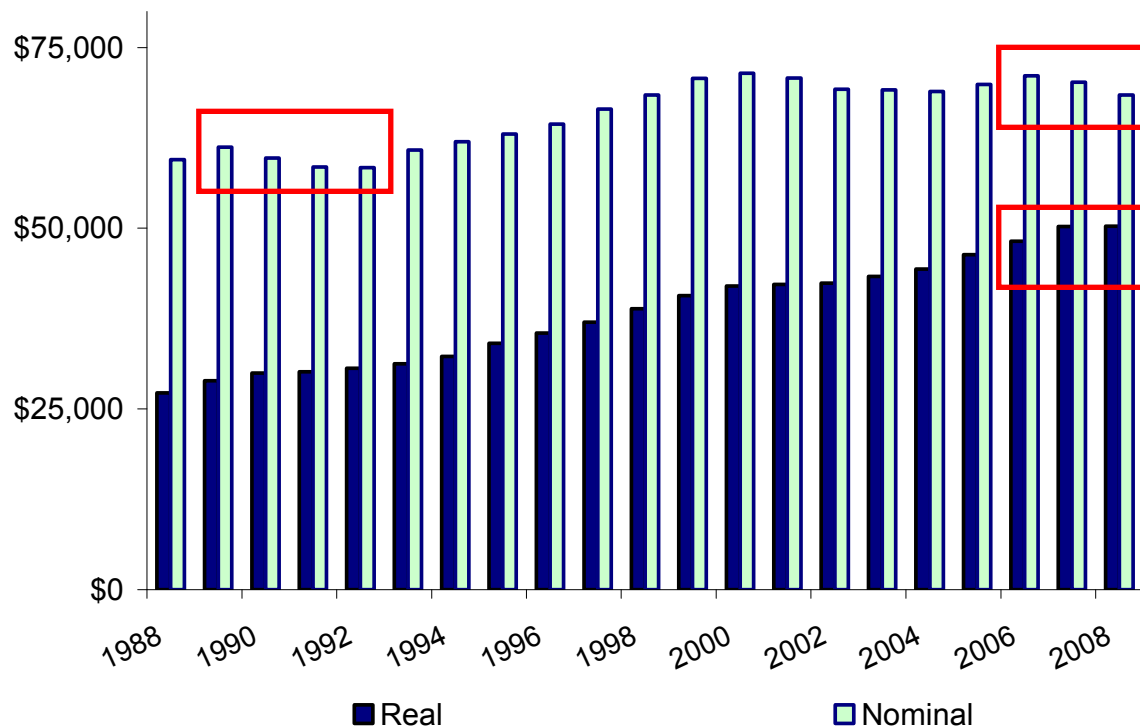
- Of the states with the top ten largest budget gaps, six are states with the highest unemployment and/or foreclosure rates . . .

Largest FY 2010 Budget Gaps By State (in millions)					Total % of General Fund Budget
State (\$ millions)	Before Budget		Total Gap		
	Adoption	Mid Year Gap			
California	\$ (45,500)	\$ (1,100)	\$ (46,600)		50.50%
New York	\$ (17,900)	\$ (3,000)	\$ (20,900)		37.70%
Illinois	\$ (13,200)	\$ -	\$ (13,200)		37.70%
New Jersey	\$ (8,800)	\$ -	\$ (8,800)		29.90%
Florida	\$ (5,900)	\$ (147)	\$ (6,047)		23.30%
Massachusetts	\$ (5,000)	\$ (600)	\$ (5,600)		20.00%
Pennsylvania	\$ (4,800)	\$ -	\$ (4,800)		18.00%
Connecticut	\$ (4,200)	\$ (500)	\$ (4,700)		26.70%
Arizona	\$ (3,200)	\$ (1,500)	\$ (4,700)		47.80%
North Carolina	\$ (4,600)	\$ -	\$ (4,600)		21.90%

On top of higher overall unemployment and the longer duration of unemployment, wages in the U.S. have declined since the start of the crisis in 2007 . . .



Real and Nominal U.S. Median Income



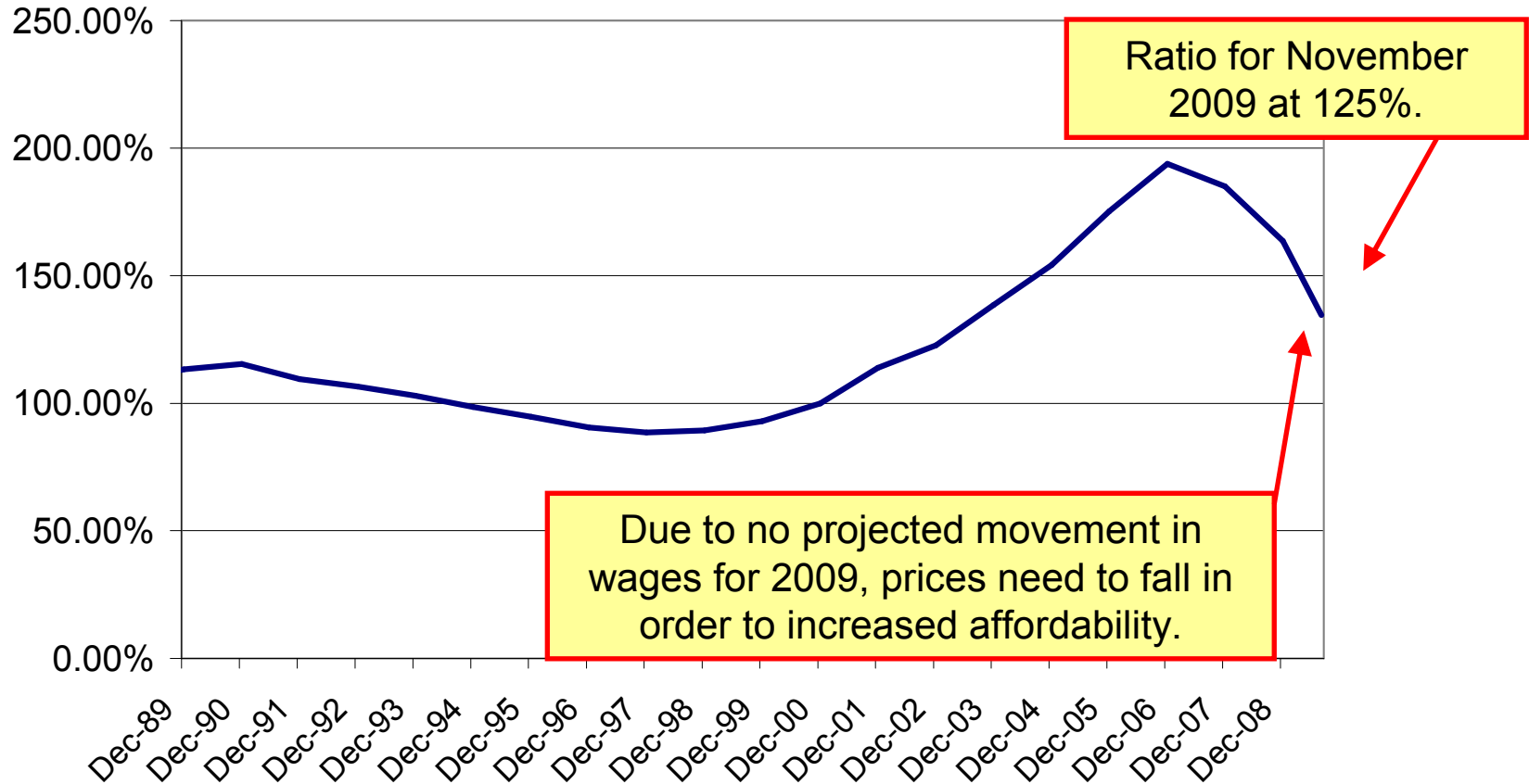
Nominal income fell from 2006 to 2008 by 3.7%. A two year decline of that magnitude has not been seen since the 1989 to 1991 decline of 4.5%.

Real wages showed no increase from 2007 to 2008 and are projected to show no increase from 2008 to 2009.

Which leads FinPro to believe home prices still have room to fall in order for the home price to income ratio to decline to a level inline with the historical trend . . .



Case Shiller 10 City Home Price Index to Real Median U.S. Household Income



December 22, 2009

# Bloomberg

**Headline:** “Home Sales Exceed Forecasts as Buyers Seek Credit”

**Real Story:** “Sales of existing U.S. homes in November rose to the highest level in almost three years as first-time buyers rushed to take advantage of a government tax credit and lower prices.”

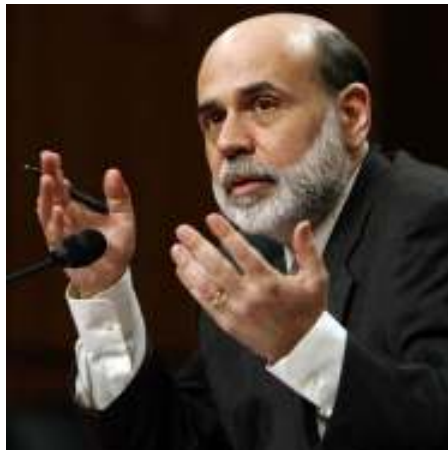
“Fed debt purchases are helping keep mortgage rates close to record lows, while Barack Obama’s Nov. 7 extension and expansion of the tax credit through April may provide short-term impetus to sales and construction.”

**Conclusion:** The housing market has been dependent upon government intervention and stimulus. Removal of the government stimulus will threaten price stability.

**Threat #1:** The Federal Reserve and the U.S. Treasury have indicated they will **end agency MBS purchases** by March 31, 2010 and December 31, 2009, respectively . . .

“In order to promote a smooth transition in markets, the Committee is gradually slowing the pace of these purchases, and it anticipates that these transactions will be executed by the **end of the first quarter of 2010.**”

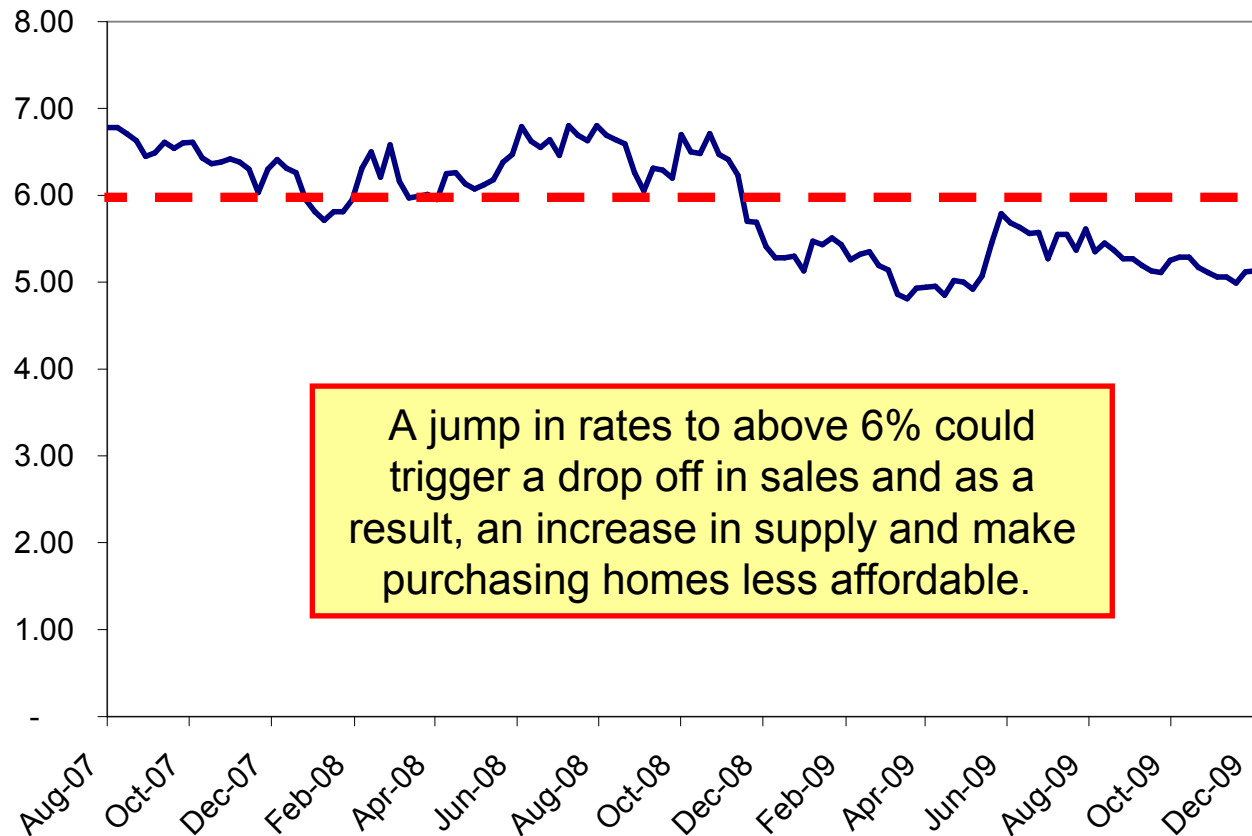
“The program that Treasury established under HERA to support the mortgage market by purchasing Government-Sponsored Enterprise (GSE) - guaranteed mortgage-backed securities (MBS) will end on **December 31, 2009.**”



**Threat #2:** Mortgage rates need to remain at low levels, and even decline further, to keep housing affordable . . .



Mortgage Bankers Association  
Average 30-year Fixed Rate Mortgage



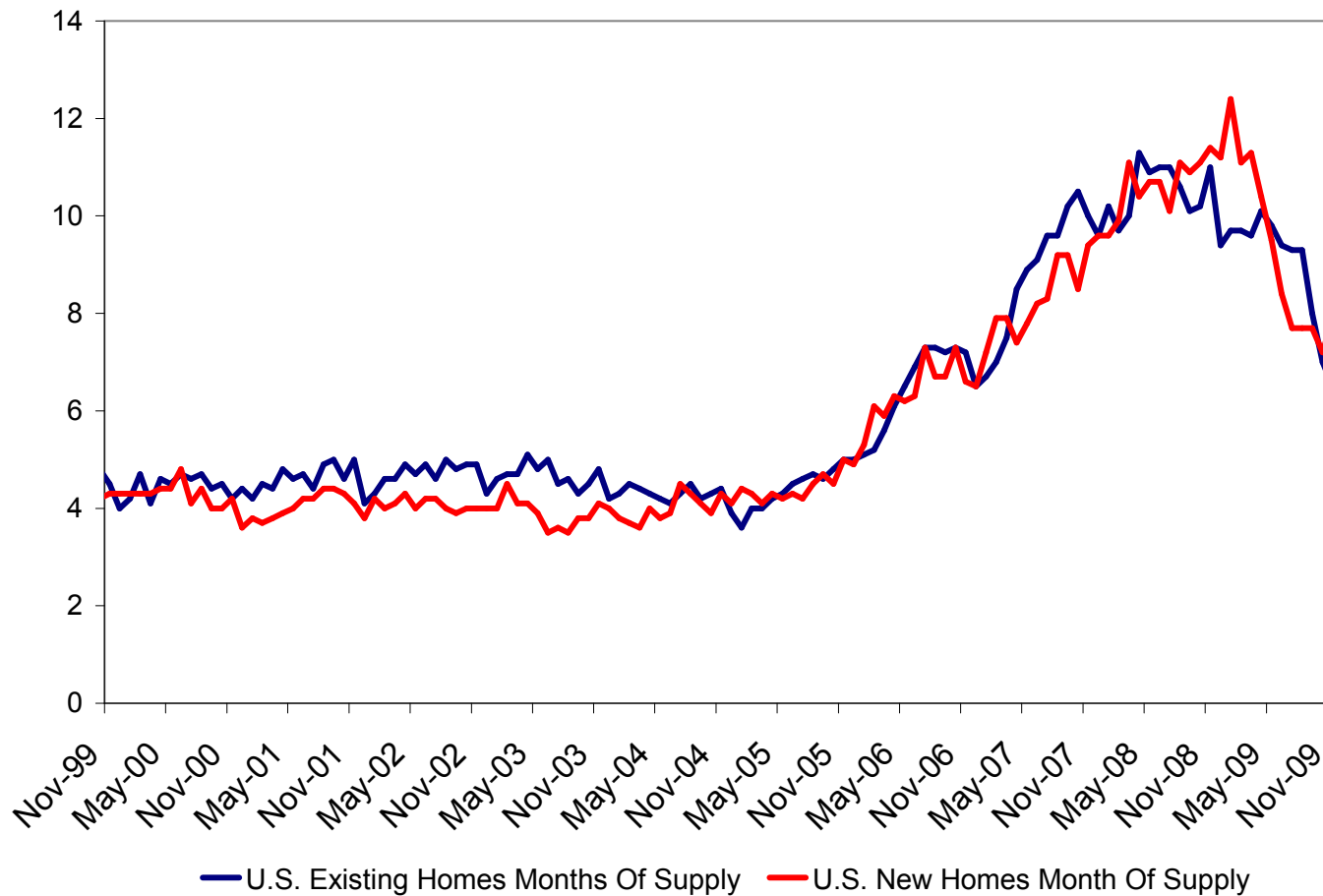
A jump in rates to above 6% could trigger a drop off in sales and as a result, an increase in supply and make purchasing homes less affordable.

Amy Crews Cutts, deputy chief economist at Freddie Mac, told the newspaper that interest rates were bound to rise to **6 percent** by the end of 2010.

**Threat #3:** The supply of homes in the U.S. has been declining due to increased sales, but still remains above the historical trend of 4 months of supply . . .



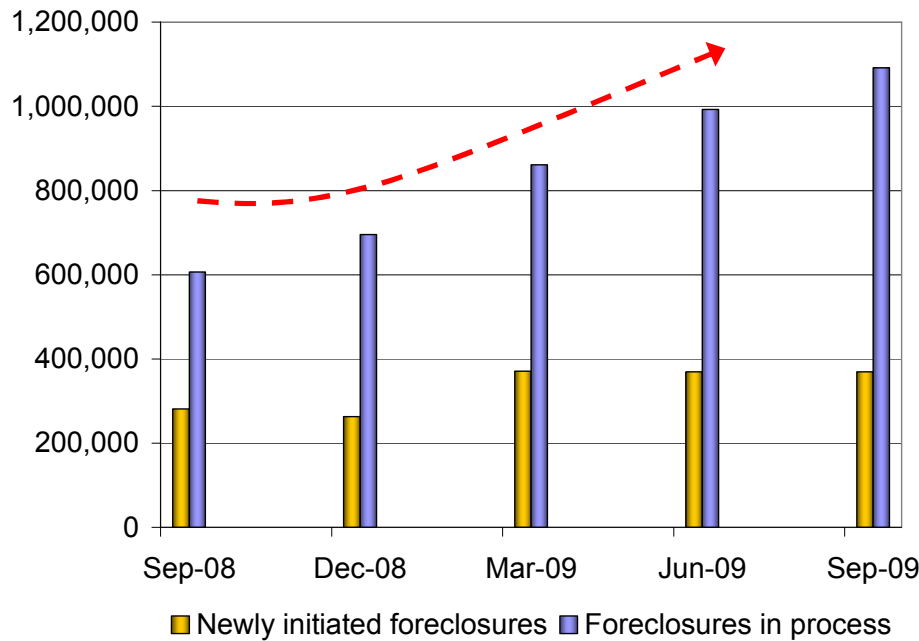
Months of Supply for New and Existing Homes in the U.S.



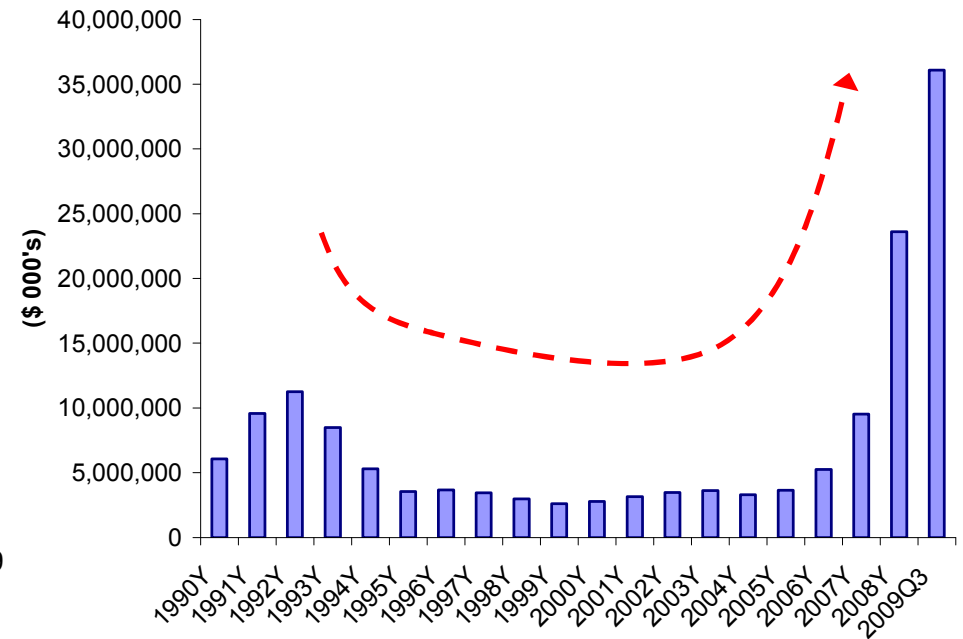
**Threat #4:** The supply of homes in the U.S. will be negatively impacted by increasing foreclosures and real estate owned by banks . . .



New and In Process Foreclosures



Other Real Estate Owned (OREO) at U.S. Banks and Thrifts



In mid-December, one of the most watched headlines was the increase in Household Net Worth . . .

December 11, 2009

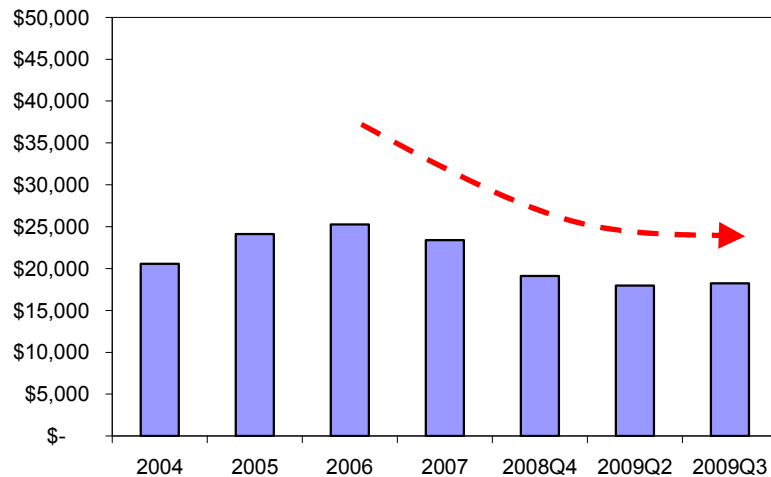
# Bloomberg

**Headline:** “Household Net Worth in U.S. Increases by \$2.67 Trillion”

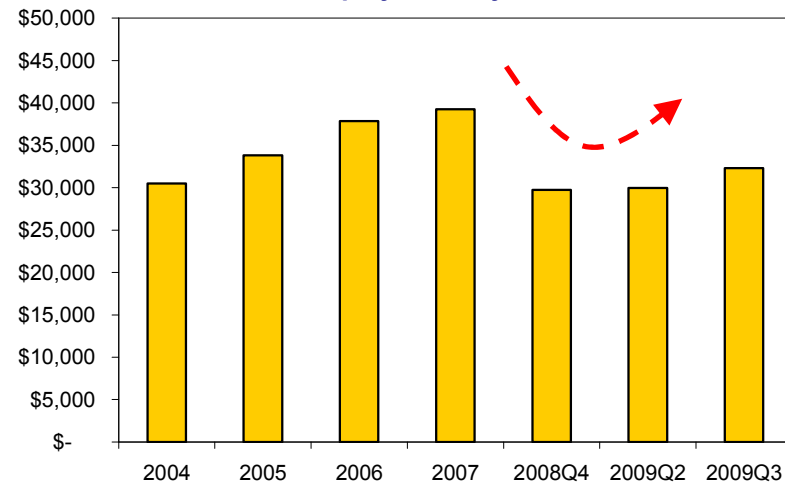
“Household wealth in the U.S. increased by \$2.67 trillion in the third quarter as [stock prices](#) and [home values](#) climbed, putting consumers farther along the path of recovery from the biggest destruction of assets on record.”

**Real Story:** Be careful what you read, the value of real estate assets has not increased significantly quarter-to-quarter, but the value of equity securities did increase and was responsible for all the gains in household net worth . . .

Value Of Real Estate Assets



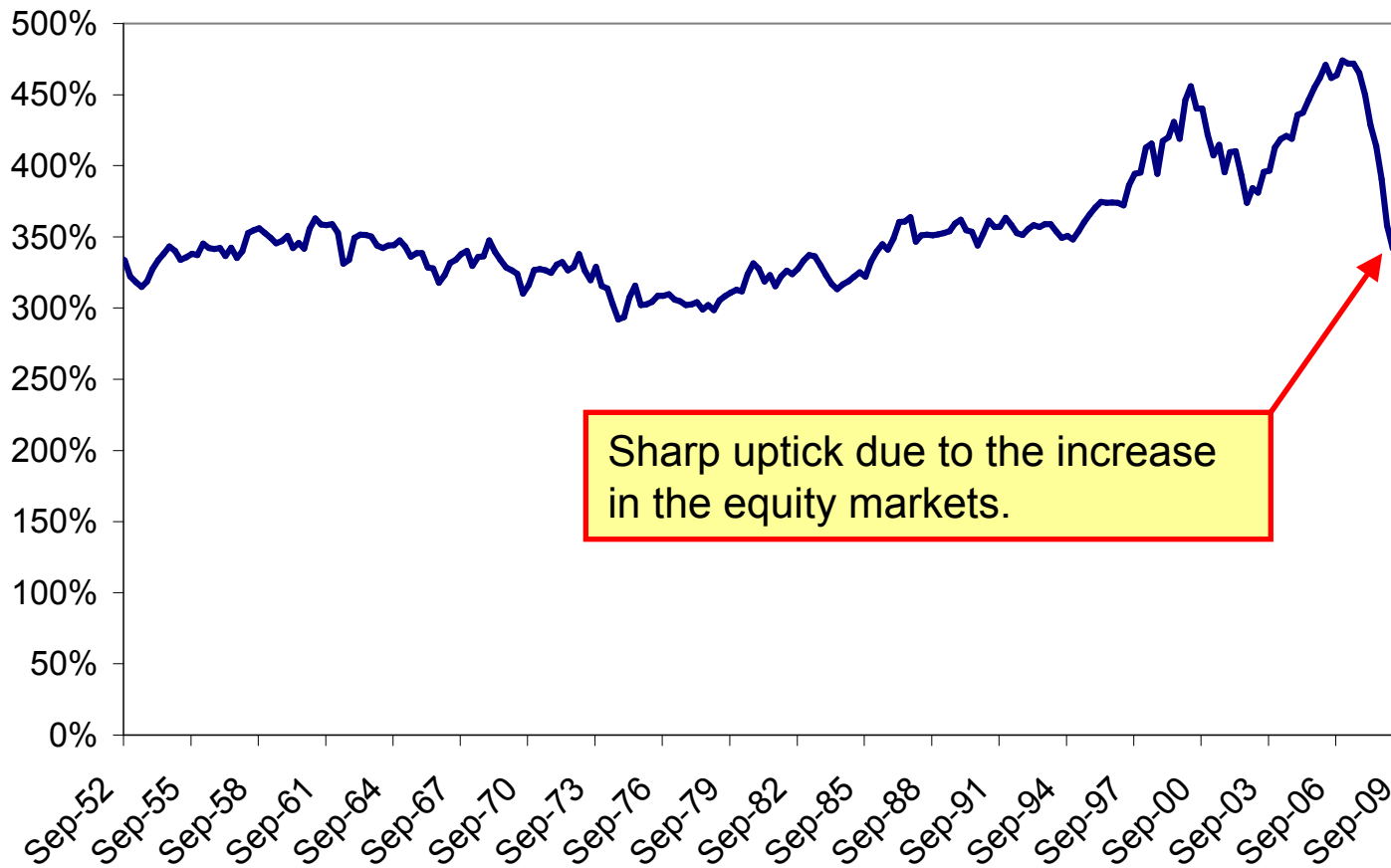
Value Of Equity Security Assets



The sharp uptick in the Household Net Worth to GDP ratio was driven by the increase in the equity markets during the latter half of 2009. With a possible pullback in the equity markets, household net worth still has potential to decline further in the near-term . . .



Household Net Worth As a % of GDP

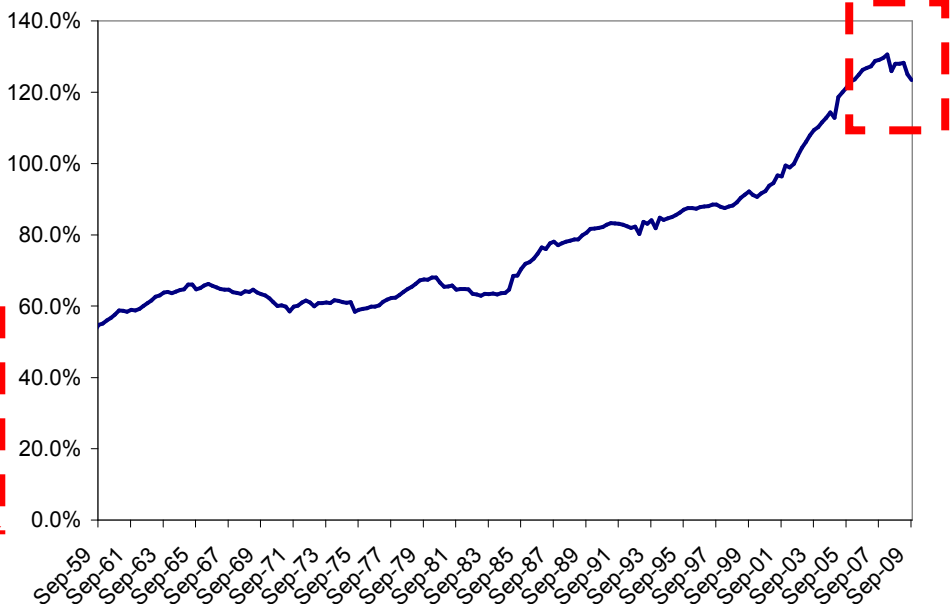
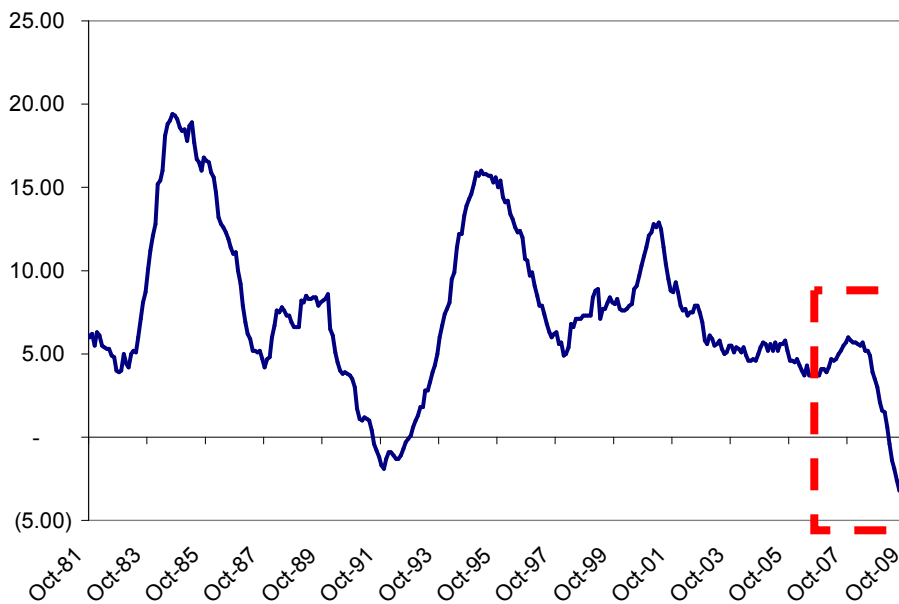


Even though household asset values look to be near a “floor”, the de-leveraging trend continues unabated and will continue in the coming years until the household debt to income ratio reverts back to the historical norm of 70-90% . . .



Annual Change In Consumer Credit Outstanding

Household Debt as a % of Disposable Income



Consumers are not taking out new loans . . .

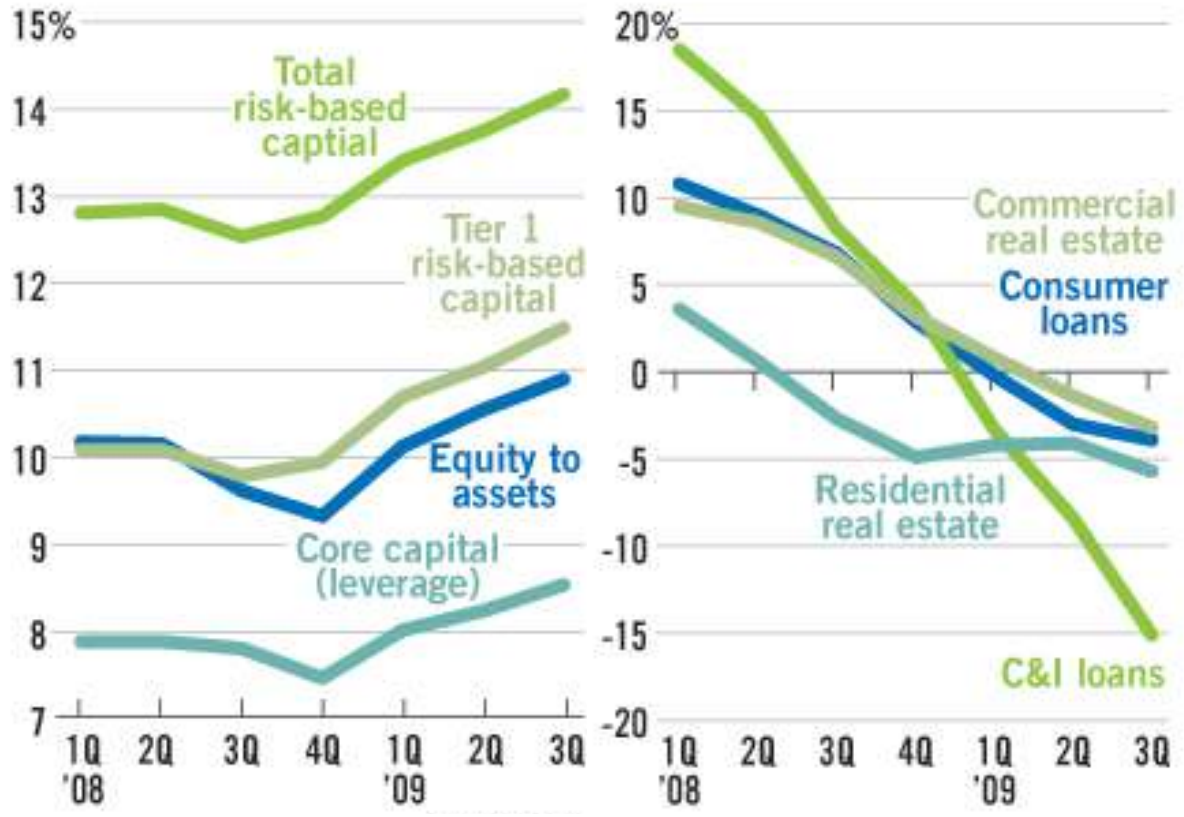
. . . And are decreasing their overall debt ratio by shedding debt and saving more.

The de-leveraging process has just begun. This is a slow and drawn out process, which will weigh on retail spending in the coming years.

The decline in credit is also seen in bank lending statistics . . .



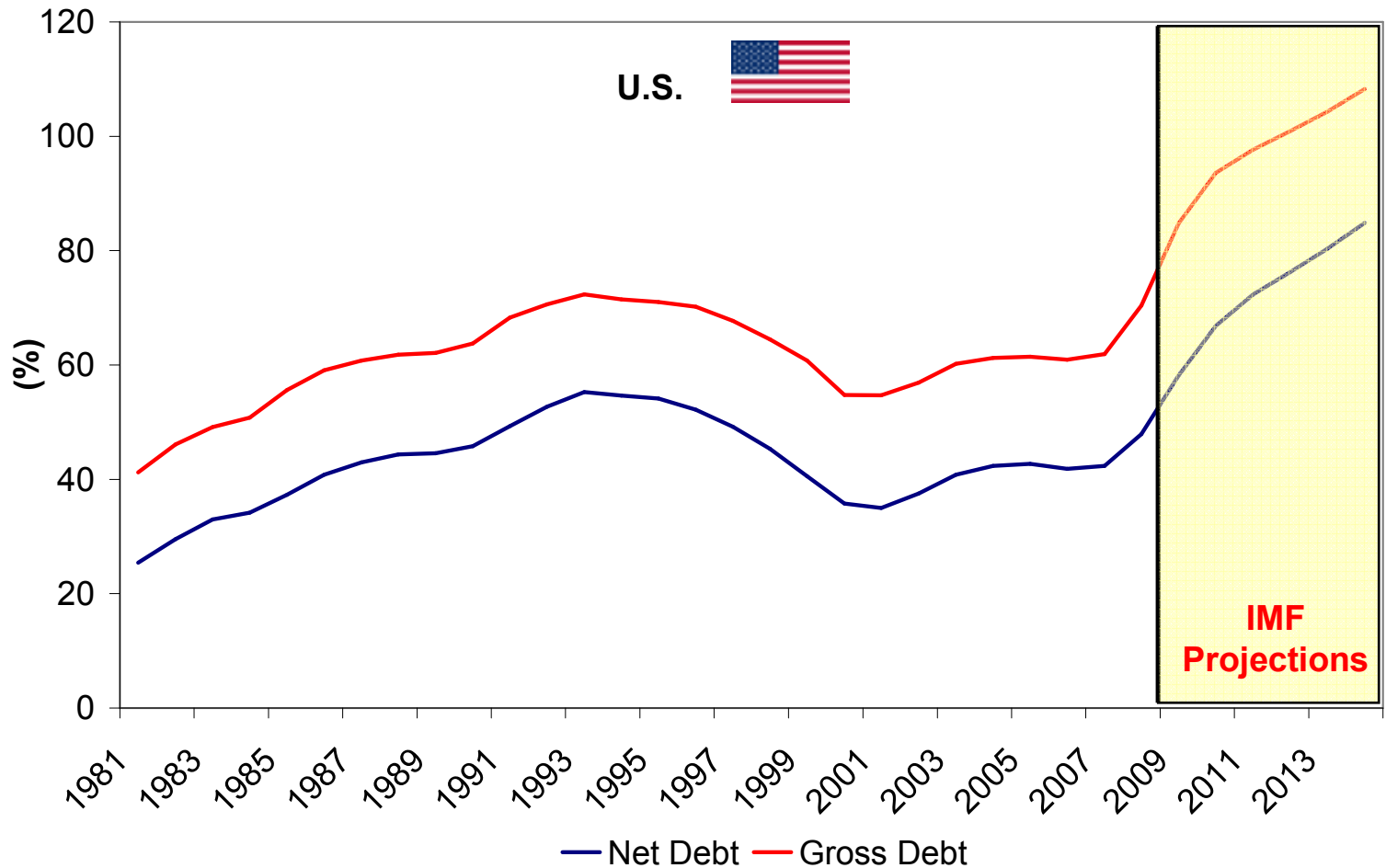
Although banks are increasing capital, they continue to de-lever by decreasing outstanding loans . . .



As we have reported in past reports, as a result of the excessive stimulus, the U.S. government's debt to GDP levels have continued to increase since the start of the crisis and show no sign of stopping . . .

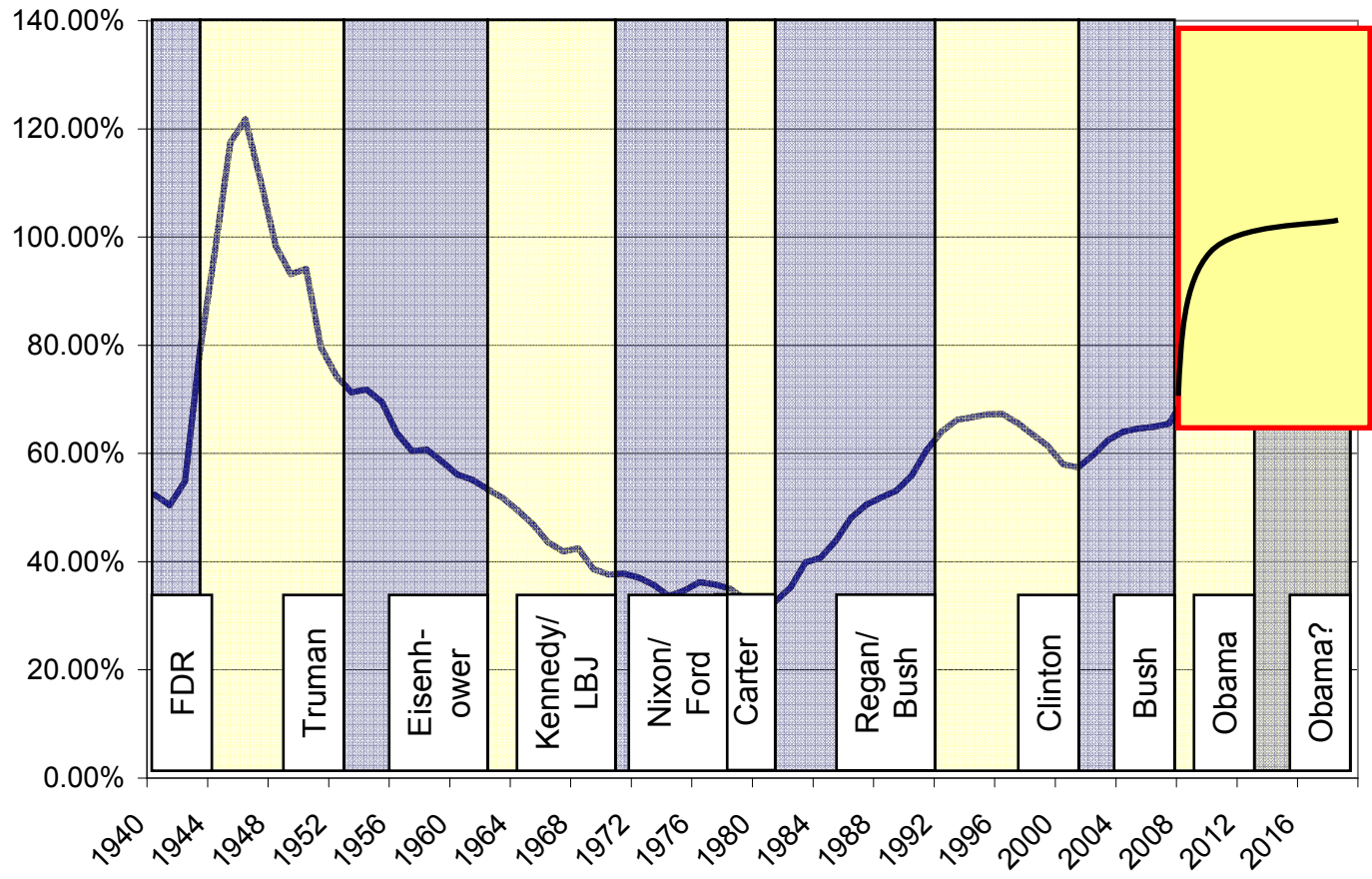


U.S. Net and Gross Debt to GDP Ratio

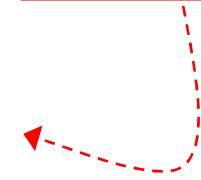


The projected Gross Debt to GDP ratio could be back at levels not seen since World War II . . .

U.S. 

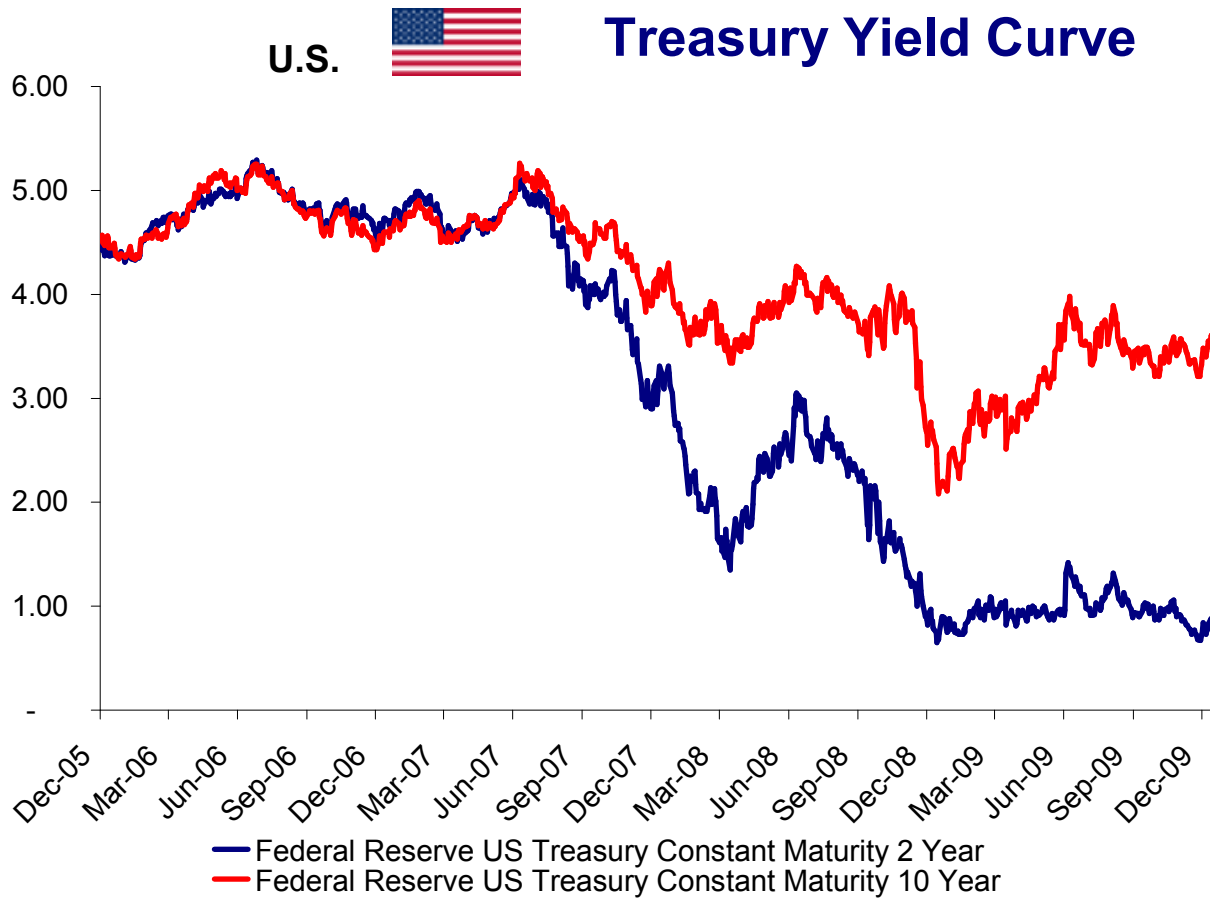


Congress Budget Office projections



Is this flattening out in 2012 even realistic? Probably not . . .

Treasury yields have been under pressure in December as supply has exceeded demand, and thus the price of the bonds has decreased (and yields have increased) . . .



# Bloomberg

“U.S. 2-Year Yields Highest in 2 Months Before \$44 Billion Sale.”



“Treasury prices stayed lower on Monday, pushing yields on 10-year notes to a four-month high, after the government's first of three auctions this week was met with lackluster demand.”

Even with the assumption of a static 2009 government budget, the effects of a cost-of-funds increase on the deficit are significant . . .



**Effects of Inflationary Rate Shocks On Government Debt**

	Oct-09	+10 bps	+ 200 bps	Rates Double
Total US Debt Outstanding	12,867.50	12,867.50	12,867.50	12,867.50
At a Blended Rate of	3.36%	3.46%	5.36%	6.72%
Interest Cost	432.61	445.47	689.96	865.21
Total US Government Budget (2009)	3,100.00	3,100.00	3,100.00	3,100.00
Interest (% of Total Budget)	13.96%	14.37%	22.26%	27.91%
Increase in Deficit From Today	0.00	12.87	257.35	432.61

*\*figures in billions\**

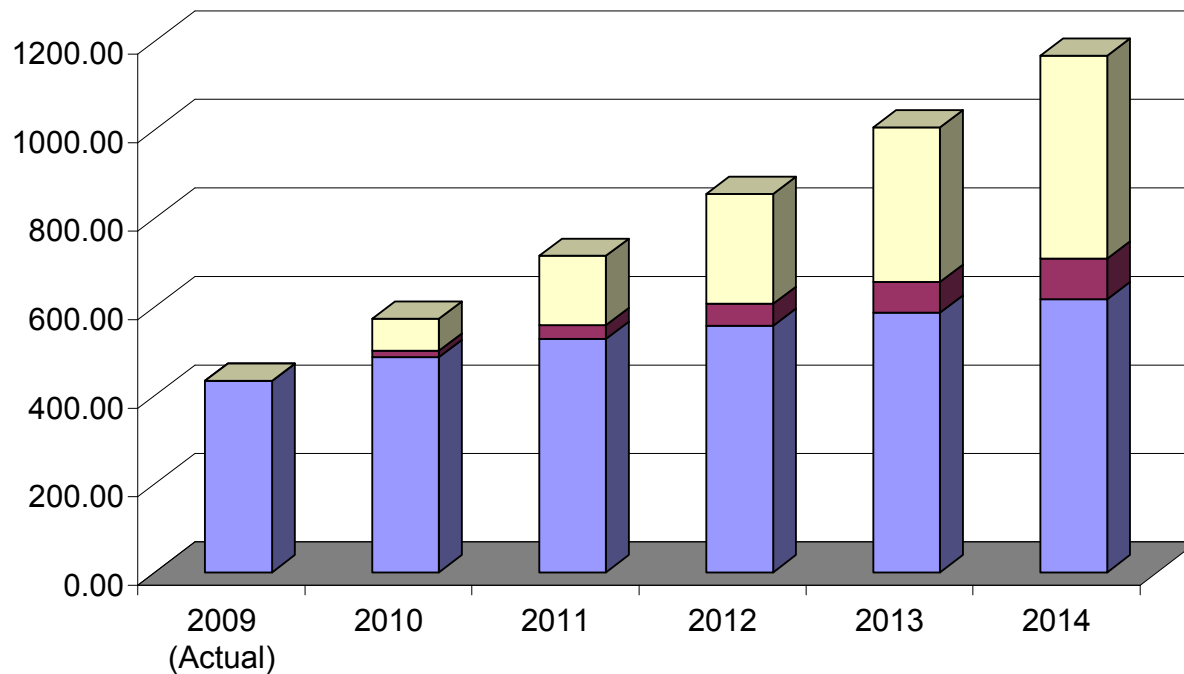
*\*assumes static 2009 government budget\**

For every 10 basis point increase in interest cost, the US deficit will rise \$12.86 billion. The U.S. government will be under immense pressure if funding costs rise.

OMB (Office of Management and Budget) projections for the national debt provide a clearer picture of what rate increases could do. For a +50 bps / year increase, interest on the national debt reaches over \$1.0 trillion by 2014 . . .



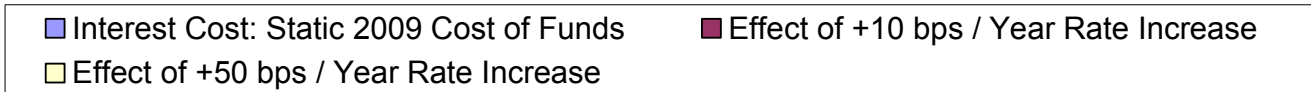
Interest On the National Debt (in Billions)



**Projected US Debt**

Year	US Debt
2009 (Actual)	12867.50
2010	14456.30
2011	15673.90
2012	16565.70
2013	17440.20
2014	18350.00

\*figures in billions\*



Where do we go from here . . .

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***Primary Economic Indicators***

1. Employment and personal income
2. Real estate values and affordability
3. Credit availability and demand
4. Government borrowing and spending

***Where do we go from here?***

1. The unemployment rate continues to increase, albeit at a slower pace than in previous months. The troubling fact is that the duration of unemployment has not declined, and we believe it will not decline for quite some time.

***Key indicator:***

U-6 Unemployment; Median Duration of Unemployment

Where do we go from here . . .

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***Primary Economic Indicators***

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***Where do we go from here?***

2. The threats to price stabilization continue to be seen: the potential for higher mortgage rates, the unaffordability of homes compared to median U.S. income, and continued foreclosures that add to an already higher than historical supply level.

***Key indicators:***

Months of Housing Supply; Home Price to Median Income Ratio

Where do we go from here . . .

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***Primary Economic Indicators***

1. Employment and personal income
2. Real estate values and affordability
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***Where do we go from here?***

3. The consumer and corporate de-leveraging process has just begun and will likely be long and drawn out. Household net worth increased, but the majority of the gain was due to increases in the equity markets.

***Key indicator:***

Outstanding loans as U.S. banks;  
consumer debt to income ratio

Where do we go from here . . .

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**Primary Economic Indicators**

1. Employment and personal income
2. Real estate values and affordability
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**Where do we go from here?**

4. The U.S. debt to GDP ratio is projected to reach WWII levels of over 100%. With government healthcare almost a done deal and “cap and trade” possibly next, the government shows no sign of fiscal conservatism.

**Key indicators:**

U.S. debt to GDP ratio; 10 year U.S. Treasury bond yield

## *Why are yields rising?*

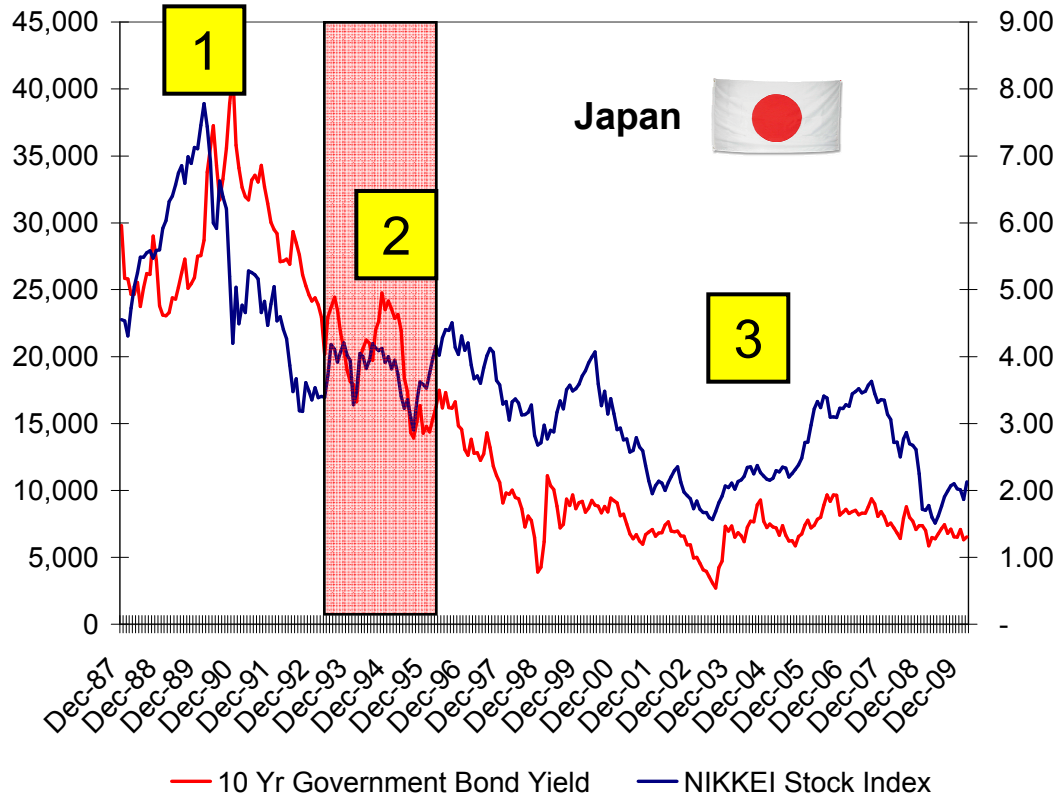
If economic recovery is not the reason for rising yields, the prospect of a supply/demand mismatch must be analyzed . . .

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- Foreign investors (who purchased 47% of the issued Treasuries in 2009) may purchase a smaller percentage of Treasuries in future auctions.
  - The 3 largest purchasers of Treasury bonds have domestic issues of their own:
    - China’s economy may or may not be overheated. There is the possibility of the Chinese currency appreciating against the dollar, which could hurt overall Treasury purchases.
    - Japan continues to be stuck in a deflationary cycle. Less government revenue from exports may lead to less Treasury purchases.
    - The United Kingdom (U.K.), like the U.S., has structural, credit and spending issues which will probably lead to lower tax revenue and lower government funds available to invest in Treasuries.
- Domestic investors allocate funds out of Treasuries in favor of potentially higher yielding instruments.
- Investors may demand higher yields due to increased focus on sovereign credit risk.

## Did this happen in Japan?

Japan, much like the U.S., cut short-term rates and embarked on repeated massive stimulus packages. The result was 19 years (and counting) of volatility. Although there were short-term increases in government yields, the overall trend was down . . .



1  
The beginning of the downturn in Japan. Bond yield decline drastically.

2  
Bond yields on the stock market index value mirror each other. Yields range from 5% to 3% over a 3 year span.

3  
Bond yields decline below 2% and remain below 2% for the remainder of the time horizon.

**Conclusion:** Although a long period of low interest rates happened, there are some important differences between 1990's Japan and the U.S., most importantly the savings culture of the Japanese and the strong demand for Japanese debt among the citizens of Japan. It is important to note though, a prolonged period of low yields could occur, even in the face of massive government stimulus.

## Conclusions . . .

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- The FinPro Economic Indicators point to **continued economic turmoil** in 2010.
- The projected U.S. government spending points to **an increase in Treasury bond supply** in 2010 and beyond.
- The U.S. equity markets continue to increase, keeping funds out of the fixed income markets.
- **Conundrum:** Rising Treasury issuance, continued economic hardship and a supply/demand mismatch for Treasury bonds.