

E Themes on the Economy®

Seeking Calmer Waters and Dodging Icebergs Special Annual Outlook Edition

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Politics and the Outlook

*Come senators, congressmen
Please heed the call
Don't stand in the doorway
Don't block up the hall
For he that gets hurt
Will be he who has stalled
There's a battle outside
And it is ragin'
It'll soon shake your windows
And rattle your walls
For the times they are a-changin'.*

Bob Dylan first sang those words from his song “The Times They Are A-Changin’” at Carnegie Hall in New York on October 26, 1963. The song quickly became an anthem for the change that defined the 1960s – the civil rights movement, the war on poverty and social change – and seem to carry as much weight today as they did then, particularly when it comes to the role that our political leaders are playing in determining the outcome of those changes:

- If Congress can't find some common ground on deficit reduction, and decide what they will or will not do for the economy today, then we could stumble again in 2012.
- If Europe can't execute on its plans to unify quickly enough, then the debt crisis could worsen and the euro could implode.
- If emerging markets (most notably China) can't make the structural changes necessary to boost domestic demand and wean themselves off exports, then they could endure a massive slowdown.

“It would help if our political leaders, both at home and abroad, had better navigational skills than the captain of the Titanic.”

The question is whether we will learn from our collective fiscal missteps, or splinter and compound the problems that got us in this position in the first place. The coordinated moves by central banks to shore up liquidity in the cash-strapped euro area on November 30 represent what we have learned: our problems are more surmountable if we are united, rather than divided, in our resolve to fix them. The failure of the Super Committee to agree upon \$1.2 trillion in deficit reduction over the next decade (which is only a small fraction of the \$5 trillion now needed) illustrates how far we have to go on our learning curve.

The remainder of this report takes a closer look at the outlook for 2012. Economic fundamentals are clearly improving, with labor markets stabilizing and the private sector picking up where the public sector has failed us. The question is whether those gains will be enough to offset the ongoing headwinds from political uncertainty both at home and abroad. The situation in Europe remains particularly precarious, despite some real efforts by the European Union to more proactively deal with its debt problems.

The 2012 Outlook

A Moderate Reacceleration

Chart 1 shows the forecast for real GDP growth in 2012. The recovery is expected to

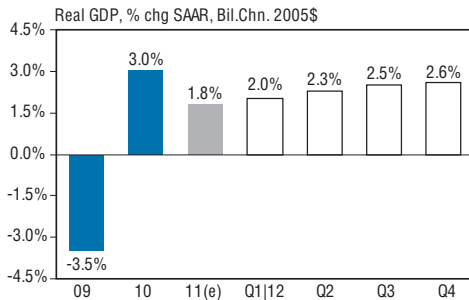
reaccelerate after nearly stalling in 2011. Gains, however, will remain extremely uneven:

- Consumer spending should continue to recover, but more slowly than the overall economy. Employment is expected to pick up and the payroll tax cut is expected to be extended, which should keep income growth in the black. However, a further increase in health care costs, stagnant wages and an end to extensions for unemployment insurance will dampen those gains. A low savings rate, persistently volatile financial market conditions and the ongoing de-leveraging of consumer balance sheets are also expected to remain problems. The only bright spot on the credit front is the auto sector, which received a waiver on new consumer protection laws and can offer more aggressive subprime financing than other sectors. If you can't qualify for a mortgage, you might still be able to buy a new vehicle to live in.
- Residential investment is expected to accelerate and grow faster than the overall economy. The threshold for new housing construction, however, is extremely low; we are currently trending at depression-era levels after adjusting for population growth. The overwhelming bulk of the gains that we see next year will be

For all charts/graphs: ■ = Actual ■ = Estimate (e) □ = Forecast

CHART 1 ZOOM ■ ■

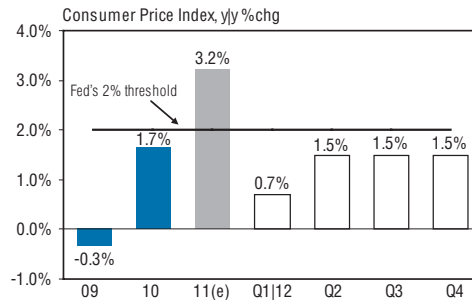
Economy Reaccelerates



Source:Haver Analytics/Mesirow Financial

CHART 2 ZOOM ■ ■

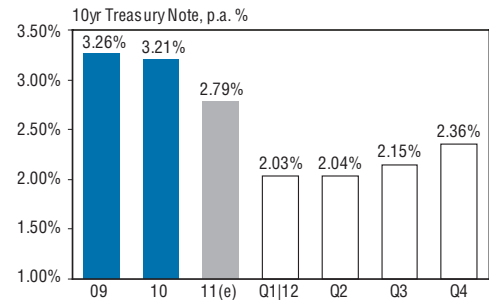
Inflation Falls Below Fed's Threshold



Source:Haver Analytics/Mesirow Financial

CHART 3 ZOOM ■ ■

Treasury Bonds Remain a Safe Haven



Source:Haver Analytics/Mesirow Financial

concentrated in apartment construction, as developers try to cash in on rising rents and the increased demand for rental properties. Renovations are also expected to accelerate, as those unable to move do more with what they have, and investors continue to snap up distressed properties to flip and rent. The demand for single-family rentals, in particular, has soared, because those who lost a home to foreclosure would still rather live in a free-standing home than in an apartment. The same is true of first-time home buyers, who are finding it more difficult to qualify for a mortgage.

- Business investment is expected to remain strong and continue to grow faster than the overall economy. Cash on corporate balance sheets now exceeds \$2 trillion, while borrowing costs remain extremely cheap. Manufacturers, in particular, are pushing to upgrade and continue to substitute capital for labor as a hedge against another downturn. This isn't great for employment, but could keep equipment investment afloat. Tax credits, which are slated to expire at the end of 2011, will likely borrow some investment from early 2012. Investment in structures also appears to have bottomed out and is beginning to pick up but (once again) from extremely low levels.
- Inventories are expected to continue to be rebuilt in 2012.
- Government spending is the biggest negative in the outlook, with federal spending now contracting faster than spending at the state and local levels. Much of the earlier stimulus has played out; the war in Iraq is winding down; and, the U.S. Postal Service has finally realized that it's hemorrhaging money.

- Exports are expected to outpace imports so the trade deficit is expected to continue to narrow. The pace of export growth, however, is expected to slow fairly dramatically between 2011 and 2012 in response to slower growth abroad. To some extent, it already has. This will temper manufacturers' decisions to expand capacity via idled plants.

Risks. The risks remain heavily weighted toward Europe and the spillover effects that any missteps there could have on global growth and financial market stability. The euro area has made some more meaningful plans to unify and stave off a full-blown debt crisis in recent weeks. An expansion of funding for the International Monetary Fund (IMF), and more credible austerity plans for members of the European Union, should open the door to additional funding from the emerging market. Both South Korea and China appear to be easing their stance on providing funding for the IMF, especially now that their own economies are slowing in response to the loss of demand from Europe.

That said, the crisis in Europe is still expected to get worse before it gets better, especially in the banking sector. This will eventually force the European Central Bank to engage in less traditional monetary policies, including an expansion of its balance sheet.

Inflation Abates

Chart 2 shows the forecast for overall and core inflation in 2012. Price increases are expected to slow considerably and slip back below the Fed's comfort zone in the year ahead:

- Most commodity prices have either hit a plateau or come off highs hit earlier in the year.

- Vehicles prices are falling, now that inventories are being rebuilt.
- Airfares are plummeting as yet another major airline struggles with bankruptcy.
- Housing prices continue to depreciate.
- Consumers continue to expect discounts to motivate them to buy, even at luxury retailers.
- The only fly in the ointment is residential rents, which are rising as household formation is outpacing our ability to place people in homes instead of in rental properties.

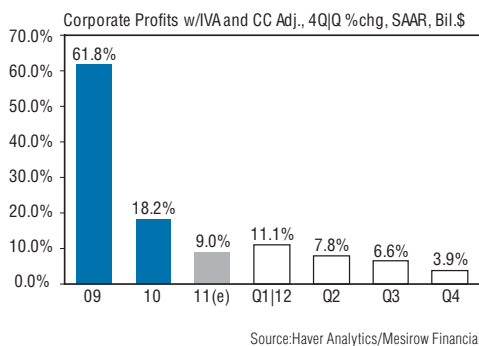
Risks. The greatest risk to the outlook for inflation is the "Arab Spring," or "Arab Winter," as some are now calling it. Moves to oust dictators have disrupted oil supplies and upped the subsidies that monarchies in the region are now paying to quell unrest in their own backyards. The result is a higher floor for oil prices coming from the Middle East. Most estimate that Saudi Arabia must now clear more than \$80 per barrel to meet subsidy costs, while many smaller countries in the region must now exceed more than \$100 per barrel to clear the costs subsidies are imposing on their budgets.

The Fed Mulls Further Accommodation

The Fed is expected to remain extremely accommodative in 2012 and will not hesitate to use more unconventional policies to both boost growth and stabilize financial markets if necessary:

- Inflation is forecast to decelerate, which would allow the Federal Reserve to focus more on reinflating the economy and lowering the unemployment rate.
- The composition of members voting on monetary policy will be less hostile toward additional stimulus in January, when

CHART 4 ZOOM ■ ■ Profit Growth Slows



many of the Fed's most vocal dissenters rotate off voting duty.

- Political uncertainty both at home and abroad still has the potential to disrupt financial markets.

What could the Fed do next? The lowest-hanging fruit is probably a reduction in the discount rate, which is the rate that the Fed charges banks to use the Fed as a lender of last resort. A return of auctions to protect the anonymity of banks using the discount window could help to mitigate spillover effects from Europe's bank funding problems. It would also make it easier for European banks with subsidiaries operating in the U.S. to gain access to cheaper funding. Six of the top ten banks using the discount window in 2008 to meet urgent funding needs were foreign banks with subsidiaries in the U.S. – five of them European.

Another tool in the Fed's arsenal is a change in how the Fed communicates its policies. The Fed is close to making its guidance on rate decisions more transparent to the public and to financial markets by tying them more closely to its forecasts for inflation and unemployment.

The lessons of the Great Depression and Japan suggest that the central bank must convince the public and financial markets that it is committed to re-inflating the economy when inflation is too low and unemployment too high. This, coupled with the Fed's move to lengthen the duration of its balance sheet, is designed to move investors out of cash or the perceived safety of the U.S. Treasury market into riskier, more productive and financially rewarding investments in our future.

Separately, the Fed still has some of the tools that it used to stabilize financial markets in

late 2008 and early 2009, such as acting as lender of last resort to primary dealers, something it hadn't done since the 1930s. It also still has an ability to intervene in the commercial paper market, with approval from the Treasury, should money market funds come under duress.

Risks. The Fed may not be able to stem the panic accompanying a financial crisis in 2012 as well as it did in 2008-09. Its own balance sheet is already large and additions via purchases of mortgage-backed securities are likely to be more incremental than they were in 2009, while the tools associated with fiscal policy have been taken off the table entirely.

There is also the risk that today's actions by the Fed will undermine its ability to curtail future inflation problems. Most members of the Federal Open Market Committee (FOMC), however, would prefer to battle inflation. As former Fed Chairman Paul Volcker demonstrated, even the most insidious inflation can be curtailed with rising rates.

Yields Remain Low

Chart 3 shows the forecast for the 10-year Treasury bond yield. The yields on long-term Treasury bonds are expected to remain exceedingly low for much of the year:

- Inflation is expected to abate, which will alleviate the upward pressure on bond yields associated with firming U.S. growth.
- The Fed is expected to continue shifting its portfolio of maturing, short-term Treasury bonds into long-term Treasury bonds (at least through the middle of 2012), in this way, limiting any upward movement in rates.
- The ongoing credit crisis in Europe, and questions about whether the single European currency will survive, should enhance the Treasury market's status as a safe haven, at least in the near term.

Risks. Inaction by Congress in dealing with our own deficit could prompt another downgrade in the U.S. credit rating, which would eventually raise the risk premium that we must pay on our debt. This is in addition to the increased competition that we are likely to see in international debt markets, as Japan is forced to find more foreign buyers and China's appetite for U.S. Treasuries wanes.

We could also see some upward pressure on our bond yields if markets become truly convinced that Europe has its sovereign debt problems under control. All of these look more like two-to-three year risks, however, than near-term concerns.

Financial Markets Remain Volatile

Chart 4 shows the forecast for after-tax profit growth in 2012. After-tax, corporate profits are expected to rise almost 4% from a year ago, slower than in 2011, but still a good year.

Revenues are expected to pick up slightly with stronger demand, but profit margins are expected to be squeezed a bit. Rising health care costs and a slowdown in productivity growth are the primary reasons. We are also seeing the need for persistent discounting in the retail sector, despite more aggressive management of inventories.

In general, the news on profits, along with some overshooting on the downside in late 2011, suggests that the Dow Jones Industrial Average could easily cross 13,500 before the end of 2012. The path from here to there, however, will remain extremely bumpy, so buckle your seat belts.

The Dollar Appreciates

The dollar remains the uncontested reserve currency of the world; ongoing fiscal uncertainties in Japan and Europe suggest that the dollar should continue to appreciate modestly over the next year. The only thing holding it back appears to be Germany, which is much stronger and recession-resistant than the rest of the region. Indeed, the yield on German government securities dipped into negative territory in recent weeks, as investors fled default risks in Europe's peripheral countries for the perceived safety of German government debt.

The Bottom Line

The economy is recouping lost ground and appears to be regaining some momentum, particularly in the private sector. The last few years have taught us, however, that the U.S. is not an unsinkable vessel and can quickly lose steam. This is to say nothing of the obstacles that we still must overcome to get us out of such treacherous waters. It would help if our political leaders, both at home and abroad, had better navigational skills than the captain of the Titanic. I can hope, but I am wearing a life vest just in case.

Mesirow Financial Economic Forecast (Numbers as of December 9, 2011)

	2011(E)	2012	2013	2011:3(A)	2011:4	2012:1	2012:2	2012:3	2012:4	2013:1
National Outlook										
Chain-Weighted GDP*	1.8	2.3	2.6	2.0	3.3	2.0	2.3	2.5	2.6	2.0
Personal Consumption	2.3	2.1	2.1	2.3	2.6	2.0	2.0	2.3	2.5	1.3
Business Fixed Investment	8.8	7.6	5.3	14.8	7.0	7.7	4.3	6.0	6.0	4.7
Residential Investment	-1.7	6.7	18.2	1.6	5.6	6.5	7.5	10.7	12.5	18.3
Inventory Investment (bil.)	19.2	16.5	38.3	-8.5	-2.8	0.3	10.5	21.1	34.2	42.7
Net Exports (bil.)	-407.5	-388.0	-361.5	-400.7	-388.4	-393.4	-383.1	-383.3	-392.2	-388.8
Exports	6.8	5.0	7.9	4.3	5.1	3.6	5.9	6.3	7.5	8.5
Imports	4.7	3.2	5.4	0.5	1.8	3.9	2.9	5.2	7.9	6.4
Government Expenditures	-1.9	-1.1	-1.1	-0.1	0.1	-1.4	-2.0	-1.7	-1.3	-1.2
Federal	-1.5	-2.0	-3.4	1.9	0.0	-2.5	-4.7	-4.3	-4.0	-3.6
State and Local	-2.1	-0.5	0.5	-1.4	0.1	-0.6	-0.2	0.0	0.5	0.5
Final Sales	2.1	2.4	2.4	3.6	3.1	1.9	1.9	2.1	2.1	1.7
Inflation										
GDP Deflator	2.1	1.3	1.2	2.5	1.2	0.8	1.4	1.0	0.9	1.3
CPI	3.2	1.6	1.9	3.1	1.2	0.7	1.5	1.5	1.5	1.9
Core CPI	1.7	1.6	2.0	2.7	1.6	1.0	1.4	1.3	1.3	2.1
Special Indicators										
Corporate Profits**	8.6	7.3	0.3	7.9	9.0	11.1	7.8	6.6	3.9	-0.9
Disposable Personal Income	1.1	1.2	1.3	-2.1	3.3	0.1	2.4	1.5	3.3	-2.0
Housing Starts (mil.)	0.60	0.71	0.96	0.61	0.63	0.65	0.68	0.73	0.78	0.85
Civilian Unemployment Rate	8.9	8.5	8.3	9.1	8.7	8.5	8.5	8.5	8.4	8.4
Total Nonfarm Payrolls (thous.)***	1,625	1,169	1,594	280	456	404	287	274	205	281
Vehicle Sales										
Automobile Sales (mil.)	6.2	6.4	6.7	5.8	6.6	6.5	6.3	6.4	6.5	6.5
Domestic	4.3	4.3	4.4	4.1	4.3	4.3	4.2	4.2	4.3	4.3
Imports	1.9	2.2	2.3	1.7	2.3	2.2	2.1	2.2	2.2	2.2
Lt. Trucks (mil.)	6.5	7.2	7.4	6.7	7.0	7.0	7.1	7.2	7.4	7.2
Domestic	5.6	6.1	6.2	5.7	6.0	5.9	6.0	6.1	6.2	6.1
Imports	1.0	1.1	1.2	1.0	1.0	1.1	1.1	1.1	1.2	1.1
Combined Auto/Lt. Truck	12.8	13.6	14.1	12.4	13.5	13.5	13.4	13.6	13.9	13.7
Heavy Truck Sales	0.3	0.4	0.5	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil.)	13.1	14.0	14.6	12.8	13.8	13.9	13.8	14.0	14.3	14.1
Interest Rates/Yields										
Federal Funds	0.10	0.12	0.17	0.08	0.08	0.08	0.11	0.13	0.15	0.16
10-Year Treasury Note	2.79	2.15	2.90	2.43	2.05	2.03	2.04	2.15	2.36	2.68
Corporate Bond AAA	4.63	4.12	4.64	4.46	3.90	4.12	4.08	4.06	4.24	4.51
Exchange Rates										
Euro/Dollar	1.39	1.33	1.37	1.41	1.35	1.32	1.30	1.33	1.35	1.35
Dollar/Yen	79.4	76.5	77.8	76.8	77.0	76.2	76.2	76.6	76.9	77.0

A=Actual E=Estimate

*In 2010, GDP was \$13,088 billion in chain-weighted 2005 dollars.

**Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

***Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation. Totals may not add up due to rounding.

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