

4Q 2011 Economic Review

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US Economy Slowly Improving ---

Recent news has been rather favorable. Employment has taken a sudden jump, after making only incremental and tiny progress in employment statistics throughout most of the year. Much of the current pick-up may merely reflect temporary hiring for the holiday season, however, and we should be cautious in reading too much into one employment report.

Still, many other data tracts are perking up. Leading indicators were up 0.9% in October. Manufacturing has increased, and inventory demand and new orders are also both up. Small business lending may be finally increasing, with recent loan volumes up 20% or more. Loan delinquencies are also decreasing. Total commercial and industrial loans, for all business activities, are up \$100 Billion in the last 12 months.

Consumption may even be turning positive, with Christmas retail sales so far running 15% ahead of last year, and consumer confidence shooting up dramatically in the latest numbers. Consumer confidence is very important to the US economy, as consumption is responsible for almost two-thirds of domestic output.

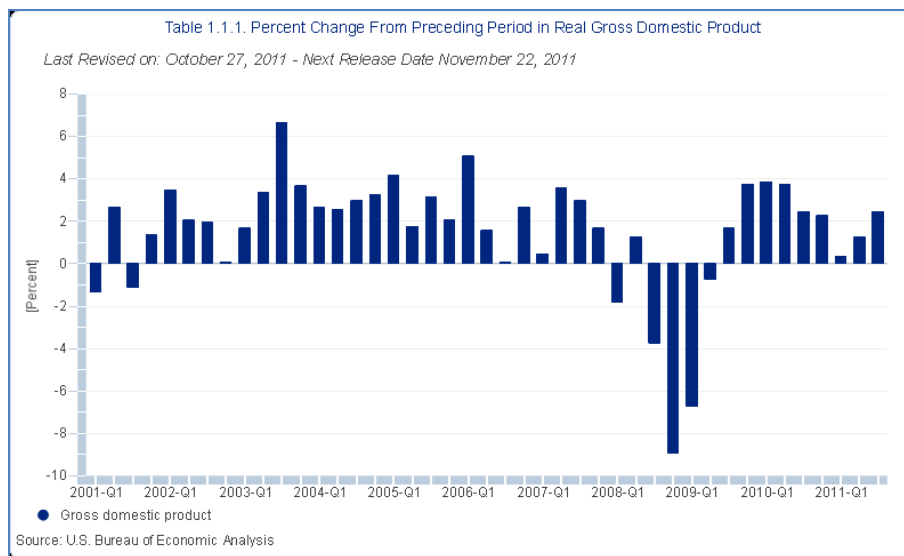


In spite of the good news, real estate and construction sectors are still bumping along the bottom of a terrible decline in activity. With a huge inventory of distressed commercial and residential holdings, residential pricing is expected to continue declining well into 2012 and possibly beyond, while many commercial projects continue to be at a stand-still. The depressed levels in real estate over the last four years may have accounted for 40% of all jobs lost in the recession.

Sources: *St. Louis Fed paper; St. Louis PD, 11-27-11.* With this realization, it becomes difficult to believe that the economy will lift into a clear expansion until the disasters in real estate are worked out.

The Federal Reserve's latest take on the economy is that the US has grown moderately in recent weeks, but hiring and housing continue to be weak. Inflation from earlier in the year has subsided, with cost pressures easing. Manufacturing expanded throughout the nation. Economic activity increased at a slow to moderate pace in all districts except locally in the St. Louis district.

Overall, US GDP grew at 2% in the third quarter. Businesses sold inventories to meet stronger than expected consumer demand. Excluding inventories, the economy grew at 3.6%, an amazing figure compared to the tepid conditions during the summer. With inventories likely being restocked in the current quarter as well as other data being positive, growth may lean towards 2.5% or higher at the end of 2012. All this assumes, however, that Europe does not implode.

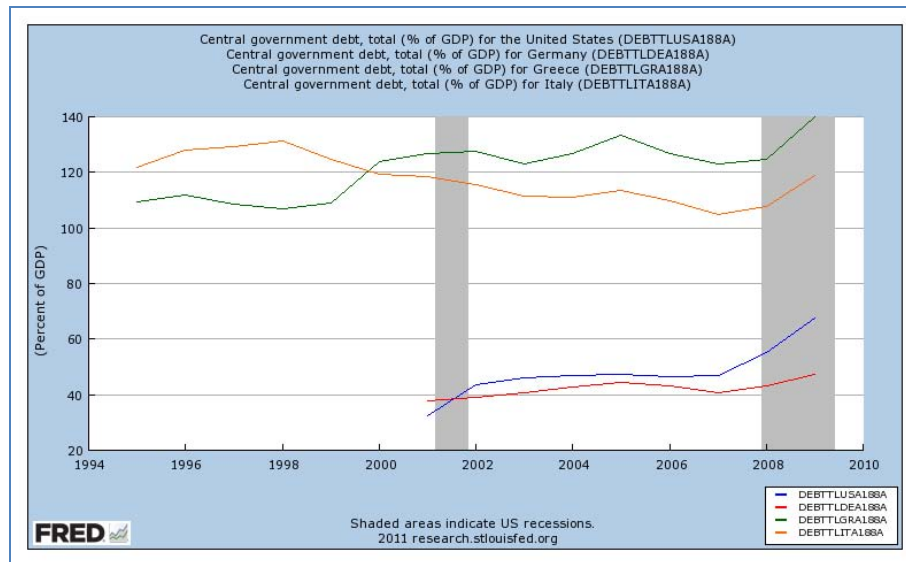


International Arena is Troubling ---

The largest risks currently facing workers, businesses, and investors, may not be from the domestic economy, but from conditions abroad. With national economies more closely linked in today's global markets, no economic review is complete without consideration being given to international economic activities.

Much of the world is now slumping. Brazil is starting fiscal stimulus, in an abrupt turnaround from recent central policies aimed at tightening. International production indexes have turned decidedly negative. With 50.0 being no growth in production, Brazil is at 48.7; Japan 49.1; UK at a dismal 43.8; and Germany at 47.9. The US is actually looking good in comparison, with a production index of 52.7, indicating some manufacturing growth. Canada is also growing nicely, with its general economy at a 3.5% increase in the most recent period.

The greatest concern is Europe, and more specifically, the sovereign debt of several European nations. Greece and Italy has debt at well over 100% of GDP. Several other nations also have exorbitant debt loads. As the graph shows below, the central debt (as a percentage of GDP) of both the US and Germany is much smaller in comparison. Not surprisingly, there has been continued demand for US bonds even with the downgrade by S&P of US ratings.



Investors have been fleeing most euro-zone bonds lately. If the trend continues, some or all EU-based nations may be locked out of the public bond markets, unable to continue capitalizing their debt. All the pandemonium is causing ripples far and wide. Many banks on the continent have been losing deposits from both corporations and general investors. Several US financial institutions are reviewing their bond indentures for contingencies, while currency traders are dusting off old trading systems to develop quotes on older currencies. Many ratings agencies have warned that if Europe worsens, some US banks and businesses may be impacted in another round of credit tightening, this time originating from abroad.

While recent news has focused on Europe, the pacific region is also of concern. Japanese exports fell by 3.7% compared to a year ago. This is mostly due to lowered European demand. The IMF has now warned Japan that its debt is also too high, at almost 200% of GDP, which is actually worse than Greece or Italy.

China's GDP is quickly falling, as weaker demand from Europe and lower real estate activities inside China may be impacting matters there. The big concern is whether China can coast to a more sustainable economic growth from its current export-dominated economy. Since the capital markets are less developed in China and the centralized planning there is rather behind the western economies, the real concern is that of a "hard landing" in an economic melt-down.

Investment News —

The following topics are meant only as very short news items of relevance to investors. Please consult investment advisors for more complete investment and portfolio considerations.

Bond Ratings. Many institutional investors have grown frustrated with overly rosy bond ratings which were then reduced to junk status during the recession. More alternatives may now be developing on bond ratings. Morningstar has recently started ratings on bonds backed by home mortgages, and is already rating commercial mortgage bonds. The firm plans to compete directly against S&P, Moody's, and Fitch. Several other companies are also in the early stages of ratings.

Asset Allocations. Traditionally, allocations have relied upon the assumption of a "normal" probability distribution in optimizing risk and return through means variance (MVO) techniques. With so many severe plunges regularly occurring in today's economic climate, some theoreticians feel that severe stress events may be far more probable than what is currently modeled. In response to this concern, several commercial products are becoming available. Morningstar has now developed model asset allocations which take into account extreme events through a "fat tails" type of mathematical distribution. Ibbotson & Associates is also active in developing value at risk considerations that account for the probability of asset losses.

US for the Long Run. From a generational perspective, domestic prospects may be in decent shape. The US remains the leader in many technological innovations. Most importantly, the workforce is expected to grow by 37% in 2050, while EU work population will shrink up to 21% in the same time period (from lower birth rates and anti-immigration policies). Even China may experience a decreasing work force, down some 10%. Many fiscal policy experts believe over the long-term, economic growth will align with population and work force growth. *Source: WSJ, 11-12-11.*