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The National Economic Review

SECOND QUARTER 2012

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The discussion and analysis of the national economy for the second quarter of 2012 is based upon a review of current economic statistics, articles in the financial press, reviews found in current business periodicals, and information posted on numerous Internet sites. The purpose of this publication is to provide a representative "consensus" review of the national economy and its general outlook at the end of the second quarter of 2012. Mercer Capital is not responsible for any specific application of the data or discussion contained in the review, and subscribers affirmatively assume responsibility for any material prepared using this information. This publication is intended for the direct use of its subscribers and is prohibited from resale.

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The National Economic Review
Second Quarter 2012

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APPLICATION	FILENAME	NOTES
Word 2010	NER-2012-02.docx	Full Report
Word 2010	NER-2012-02_Text-Only.docx	Main Text Only (no charts)
Plain Text	NER-2012-02_Plain-Text.txt	ASCII

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Excel 2010	NER-2012-02_ Data.xlsx	Main Data
Excel 2010	NER-2012-02_Charts-Data.xlsx	Charts & Data Only
Comma Delimited (CSV)	NER-2012-02_Plain-Data.csv	Main Data

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THE NATIONAL ECONOMIC REVIEW
Second Quarter 2012

GENERAL ECONOMIC OVERVIEW

According to advance estimates released by the Department of Commerce's Bureau of Economic Analysis, Real Gross Domestic Product ("GDP"), the output of goods and services produced by labor and property located in the United States, increased at an annualized rate of 1.5% during the second quarter of 2012. This represents the twelfth increase in annualized quarterly GDP beginning with the third quarter of 2009, and follows a growth rate of 2.0% during the first quarter of 2012. GDP grew 1.8% for all of 2011, versus growth of 2.4% in 2010 and a 3.1% contraction in 2009. The increase in real GDP during the second quarter is attributed to personal consumption expenditures, exports, nonresidential fixed investment, private inventory investment, and residential fixed investment. These factors were partially offset by negative contributions from federal, state, and local government spending. Imports, a subtraction in the calculation of GDP, increased.

The 1.5% growth rate in the second quarter of 2012 was modestly lower than economists' expectations in the weeks prior to the release, and materially lower than expectations at the end of the first quarter of 2012. The 1.5% growth rate during the second quarter of 2012 compares to 4.1% in the fourth quarter of 2011 and 2.0% in the first quarter of 2012. These measures were considerably better than the negative annualized growth rates in the third and fourth quarters of 2008 and the first two quarters of 2009, which marked the first time since 1975 that the U.S. economy contracted for more than two consecutive quarters. The first quarter 2008 decline in real GDP marked the first negative GDP rate since the 2001 recession.

The economy deteriorated considerably during the fourth quarter of 2008 and continued to display declining performance during the first half of 2009 as crisis engulfed the financial sector causing significant damage to financial institutions on a global scale. As a result of the crisis, lending activities and market liquidity became constrained, intensifying a downward spiral in the broader economy as businesses struggled to obtain the capital necessary for operations and investment while consumers controlled spending in response to high unemployment and unfavorable conditions in the housing market.

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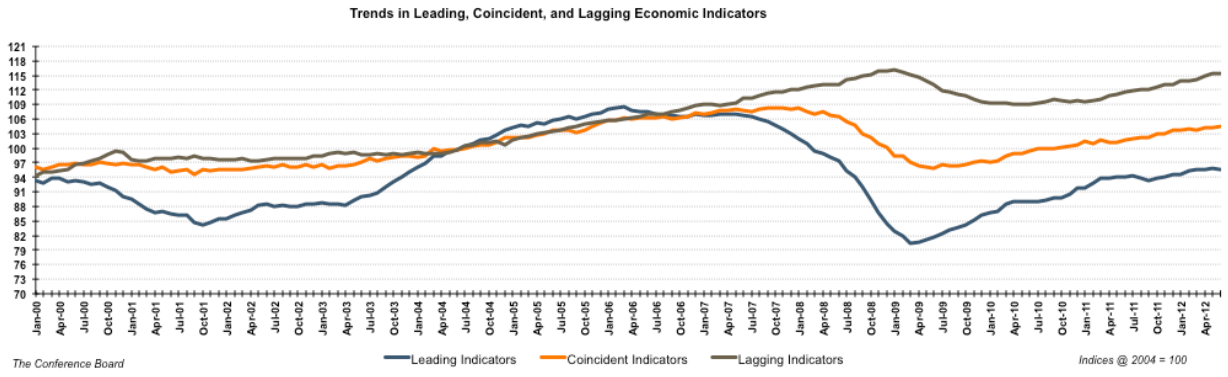
In late November 2008, the Business Cycle Dating Committee of the National Bureau of Economic Research ("NBER") determined that economic activity in the U.S. had peaked in December of 2007 and that the economy had then entered a state of contraction. In September 2010, the NBER determined that the contraction that began in December 2007 had ended in June 2009. The following table provides perspective concerning NBER business cycles from the Great Depression to the present. The most recent contraction represented the longest of 13 contractions subsequent to the Great Depression.

NBER Business Cycle Reference Dates (1929 - Present)

Month & Year of Economic		Duration in Months of	
Peak	Trough	Contraction	Prior Expansion
August 1929	March 1933	43	21
May 1937	June 1938	13	50
February 1945	October 1945	8	80
November 1948	October 1949	11	37
July 1953	May 1954	10	45
August 1957	April 1958	8	39
April 1960	February 1961	10	24
December 1969	November 1970	11	106
November 1973	March 1975	16	36
January 1980	July 1980	6	58
July 1981	November 1982	16	12
July 1990	March 1991	8	92
March 2001	November 2001	8	120
December 2007	June 2009	18	73

The Conference Board ("TCB") reported that the Composite Index of Leading Economic Indicators ("LEI"), the government's primary forecasting gauge, declined 0.3% in June 2012 to 95.6 after a 0.1% decline in April and a 0.4% increase in May. The components and calculation of the LEI were significantly revised in December 2011. Traditionally, the index is thought to gauge economic activity six to nine months in advance. Multiple consecutive moves in the same direction are said to be indicative of the general direction of the economy. According to Ken Goldstein, an economist at The Conference Board, "The LEI is pointing to no strengthening over the next few months, as the economy continues to sail through strong headwinds domestically and internationally."



Four of the LEI's ten leading economic indicators rose during June. The positive contributors to the LEI (largest to smallest) included interest rate spread, average weekly manufacturing hours, the *Leading Credit Index*™ (inverted), and manufacturers' new orders for consumer goods and materials. The ISM new orders index, consumer expectations, building permits, weekly initial unemployment insurance claims (inverted), stock prices, and manufacturers' new orders for nondefense capital goods declined during June. During the six-month span through June 2012, the LEI increased by 1.0%. In June, the Coincident Index and Lagging Index both increased by 0.2%.

On August 2, 2011, (the same day the U.S. Treasury Department expected the U.S. to reach its congressionally mandated debt ceiling) President Obama signed the Budget Control Act of 2011, ending the debt crisis, at least in the near-term. The Act immediately increased the debt ceiling by $400 billion, with additional increases contingent upon congressional disapproval (i.e., Congress must vote to deny the ceiling increase requests) and future spending cuts.

Despite this action, on August 5, 2011, Standard & Poor's lowered the U.S. long-term credit rating from AAA to AA+, citing that the "fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics." Congressional discord during the debt ceiling crisis also had an effect, as Standard & Poor's stated that "the effectiveness, stability, and predictability of American policymaking and political institutions have weakened" due to "difficulties in bridging the gulf between the political parties over fiscal policy, which makes us pessimistic about the capacity of Congress and the Administration to be able to leverage their agreement this week into a broader fiscal consolidation plan that stabilizes the government's debt dynamics any time soon." Additionally, Standard & Poor's credit outlook for the U.S. is negative. The other major credit rating agencies, Moody's and Fitch, maintained U.S. long-term credit ratings of Aaa and AAA, respectively (both the highest possible credit ratings).

After a successful restructuring of Greek sovereign debt in the first quarter of 2012 eased worries over the European sovereign debt crisis, adverse developments during the second quarter intensified concerns. The political party Coalition of the Radical Left (commonly referred to as "Syriza") garnered the second largest number of votes in Greece's May 6th legislative election. Syriza's platform included scaling back austerity measures required under the terms of Greece's bailout package and potentially ceasing the country's debt service payments, increasing fears of a Greek exit from the eurozone. On the same day, Socialist Party candidate François Hollande was elected President of France on a platform that growth is the answer to the region's economic problems, not additional austerity measures. Talks to form a Greek coalition government failed, so a subsequent election was held on June 17th. "Pro-bailout" political parties earned enough votes to successfully form a new coalition government, allaying immediate fears of a Greek departure from the eurozone.

In early June 2012, Spanish Economy Minister Luis de Guindos announced that Spain would request a €100 billion bailout to help recapitalize the nation's banks. Yields on Spanish sovereign debt later rose to the highest levels ever recorded since Spain adopted the euro, as investors worried about the rising indebtedness of the nation and the health of its banks. Higher yields may limit Spain's ability to access the debt capital markets for funding, increasing the likelihood that a bailout will be required for the entire nation, rather than just the banking sector. However, the quarter ended on a positive note. A summit of European leaders held at the end of June resulted in three key agreements related to bank bailout funds, a single eurozone banking supervisory body, and measures designed to promote growth. Leaders agreed to allow for the direct infusion of funds into struggling banks, rather than adding to the sovereign debt of countries, helping lower sovereign borrowing costs. To help ensure more consistent regulation, the European Central Bank will establish a bank supervisory body to oversee all eurozone banks. Authorities hope this will also help decouple banks from their home governments. Finally, leaders agreed to a €120 billion package designed to stimulate growth, including funds for the European Investment Bank to invest in business projects.

CONSUMER SPENDING AND INFLATION

According to the Bureau of Labor Statistics, the Consumer Price Index ("CPI") was unchanged in June, on a seasonally adjusted basis. The unadjusted CPI stood at 229.5 (CPI-U all urban consumers, 1982-1984 = 100). Declining energy costs were offset by increases in most other categories, including food. The core rate of inflation, which excludes food and energy, increased by 0.2% in June, with notable increases including apparel prices (up 0.5%) and medical care services (up 0.7%). The seasonally adjusted annual rate ("SAAR") of inflation for the second quarter of 2012 declined 0.8%, compared to increases of 0.3% and 3.7% in the fourth quarter of 2011 and first quarter of 2012, respectively. The core rate of inflation increased at a 2.6% (SAAR) rate during the second quarter of 2012, following increases of 2.0% in the fourth quarter of 2011 and 2.2%, in the first quarter of 2012.

The Producer Price Index ("PPI"), which is generally recognized as predictive of near-term consumer inflation, increased by 0.1% in June (PPI for finished goods, seasonally adjusted), after decreases of 0.2% and 1.0% in April and May, respectively. The seasonally adjusted decline in energy goods (down 0.9% in June) was offset by increases in other items. On an unadjusted basis, the twelve month change in PPI was 0.7%, compared to a 4.7% increase in 2011. After adjustment for seasonal considerations, the core PPI for finished goods (excluding food and energy) rose 0.2% in June, following increases of 0.2% in both April and May. The increase in core PPI was driven predominately by light motor truck prices (up 1.4%), with higher prices for major household appliances and pet food also factors.

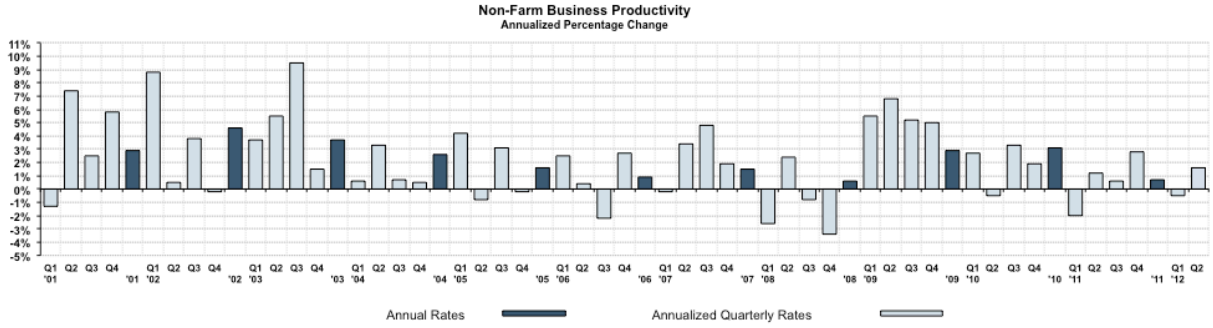
According to the Census Bureau of the U.S. Department of Commerce, the advance estimates of U.S. retail and food service sales (adjusted for seasonal, holiday, and trading-day differences) for June 2012 were down 0.5% from the previous month, but 3.8% above June 2011 levels. Most store types reported a seasonally adjusted monthly decline in retail sales, with only food & beverage stores, clothing & clothing accessories stores, miscellaneous store retailers, and nonstore retailers posting increases. However, on a year over year basis, all stores except electronics & appliance stores and general merchandise stores reported retail sales increases.

Personal consumption spending represents approximately two-thirds of total economic activity and is a primary component of overall economic growth. Real personal consumption spending increased 1.5% in the second quarter of 2012, compared to increases of 2.0% in the fourth quarter of 2011 and 2.4% in the first quarter of 2012. Personal consumption spending decreased 1.9% in 2009, but was up 1.8% in 2010 and 2.5% in 2011. According to the Bureau of Economic Analysis, durable goods purchases declined 1.0% in the second quarter of 2012, well below the 13.9% and 11.5% increases observed in the fourth quarter of 2011 and first quarter of 2012, respectively.

BUSINESS AND MANUFACTURING PRODUCTIVITY

According to the Bureau of Labor Statistics, the seasonally adjusted annual rate of nonfarm business productivity, as measured by the hourly output of all persons, increased 1.6% in the second quarter of 2012. The increase in productivity surpassed economists' expectations (an increase of 1.3%), and follows a revised 0.5% decline during the first quarter. Real hourly compensation increased 3.3% during the second quarter. The increase in productivity reflected the net effect of a 2.0% increase in output and a 0.4% increase in hours worked. Annual average productivity increased 1.1% from second quarter 2011 to second quarter 2012 and increased 0.7% for all of 2011. The second quarter productivity figures imply slowing growth, as output increased 2.0%, compared to a 2.7% increase during the first quarter.

Productivity increased 1.9% for the business sector in the second quarter of 2012. This was the result of a 2.3% increase in output coupled with a 0.4% increase in hours worked. Manufacturing productivity, generally more volatile in its quarterly measures, increased 0.2% during the quarter as output increased 1.7% and hours increased by 1.4%.



INDUSTRIAL PRODUCTION AND CAPACITY UTILIZATION

According to the Federal Reserve, industrial production increased 0.4% in June 2012, after an increase of 0.8% in April and a 0.2% decline in May (all figures recently revised). Second quarter 2012 production increased at an annual rate of 2.2%. Manufacturing output increased 0.7% in June, following a 0.7% increase in April and a 0.7% decline in May. For the second quarter, manufacturing output increased 1.4%, a significant decrease from the 5.6% and 9.8% increases observed in the fourth quarter of 2011 and first quarter of 2012, respectively. The second quarter increase in manufacturing output was driven primarily by motor vehicles and parts, which increased 18.2% in the quarter. Excluding motor vehicles and parts, manufacturing output increased by only 0.1% for the quarter.

Capacity utilization was 78.9% in June 2012, rising from 78.7% in May. Additionally, June's capacity utilization was significantly higher than June 2011's level of 76.3%. Capacity utilization for the second quarter of 2012 measured 78.8%. During the fourth quarter of 2011 and first quarter of 2012 capacity utilization measured 77.9% and 78.7%, respectively. Capacity utilization remains below the historical average of approximately 80% dating back to the early 1970s, but above levels seen at the height of the financial crisis. High rates of capacity utilization (generally above 80%) can be a predictor of higher inflation as incremental output becomes more difficult to achieve without higher wages and capital investment. The current measure of capacity utilization suggests that business investment for infrastructure will not likely be a significant component of economic improvement in the near-term.

THE FINANCIAL MARKETS

Broad market equity indices declined in the second quarter of 2012, as did yields on intermediate and long-term Treasury securities. A worsening situation in Europe, along with disappointing domestic economic data, shook investor confidence during the second quarter. Although some investors believed this would lead to additional stimulus from the Federal Reserve, the only monetary policy action taken during the quarter was the extension of Operation Twist (discussed in a subsequent section) through the end of 2012.

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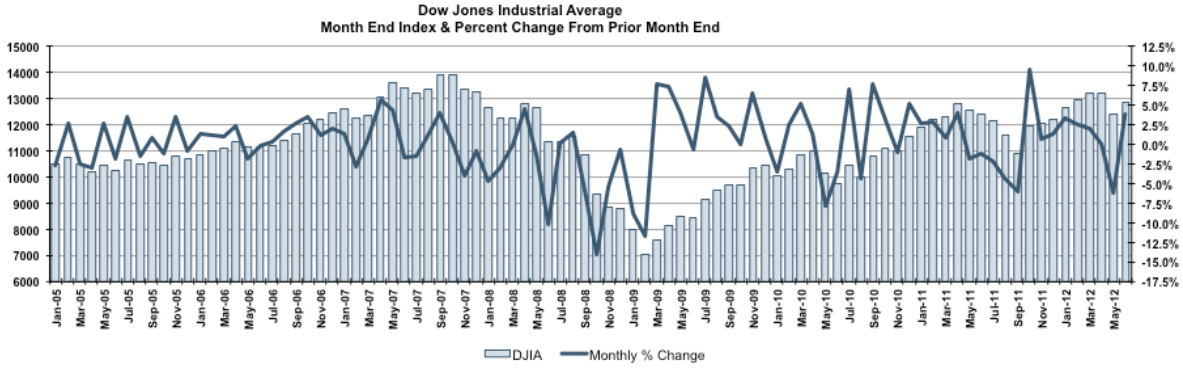
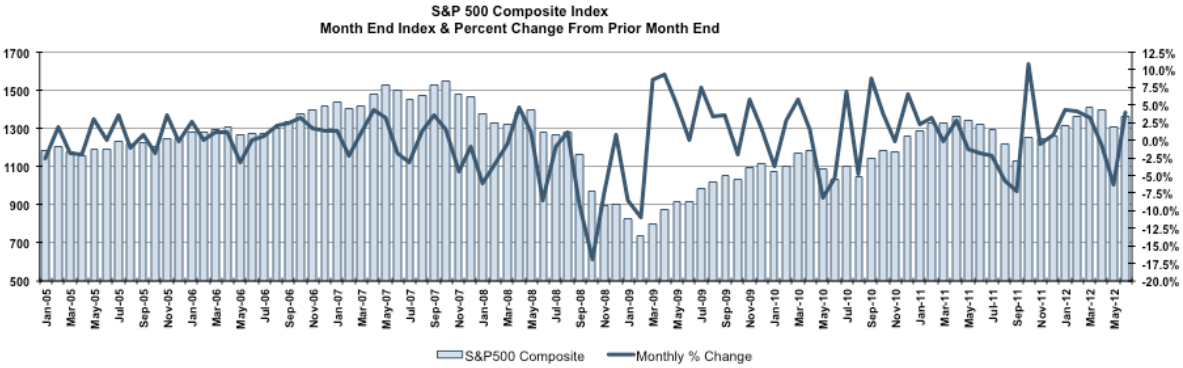
» The Dow Jones Industrial Average closed the second quarter of 2012 at 12880.09, down 2.5% for the quarter, following gains of 12.0% in the fourth quarter of 2011 and 8.1% in the first quarter of 2012. The Dow was up 5.5% for all of 2011.

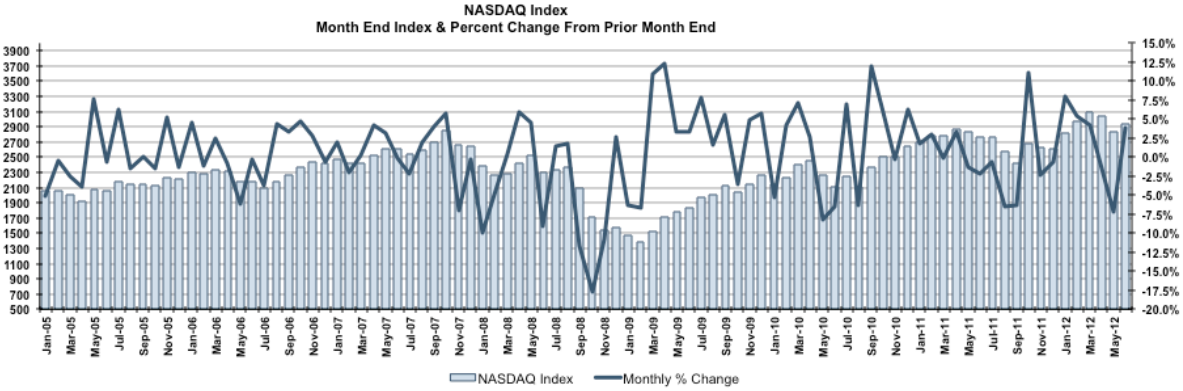
» The S&P 500 Index declined 3.3% during the second quarter to close at 1362.16, following gains of 11.2% and 12.0% in the fourth quarter of 2011 and first quarter of 2012, respectively. The S&P 500 remained essentially unchanged for 2011.

» The NASDAQ Composite Index declined 5.1% during the second quarter to close at 2935.05, following increases of 7.9% in the fourth quarter of 2011 and 18.7% in the first quarter of 2012. For all of 2011 the NASDAQ was down 1.8%.

» The broad market Dow Jones U.S. Total Stock Market Index (full cap) closed at 14208.64, down 3.7% for the quarter. It was down 1.4% for all of 2011.







The stock market decline of 2008 was the worst since the Great Depression, while the 2009 market increase represented the most favorable year since 2003. Going forward, continued weakness in labor and housing markets, coupled with continued uncertainty in Europe and slowing economic growth in China, are expected to weigh on investor sentiment despite signs of continued economic growth. Given the run-up in equity indices during the first quarter and modest pullback in the second, the outlook for the remainder of 2012 is somewhat subdued.

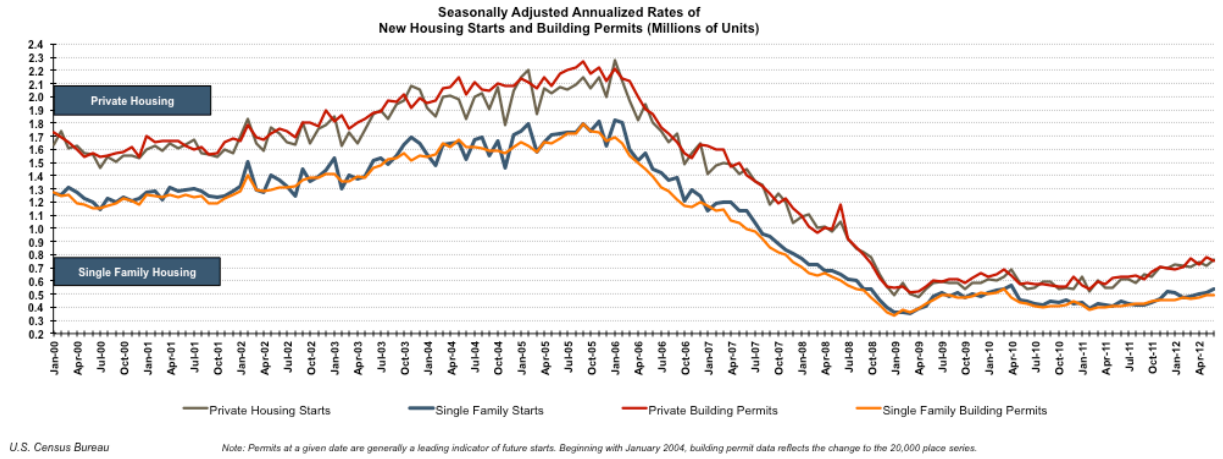
Standard & Poor's downgrade of U.S. debt had the somewhat ironic effect of causing a rally in Treasuries as investors fled to quality, pushing down yields. The yield on ten-year Treasury securities set a historical low in 2011, before falling even further during the second quarter of 2012.

The monthly average yields-to-maturity on the 20-year Treasury bond during the second quarter of 2012 were 2.82%, 2.53%, and 2.31%, respectively, for April, May, and June. After decreasing during 2008, long-term rates generally rose during 2009 before falling again in 2010. Yields continued to fall during 2011. Yields rose in the first quarter of 2012 after Greece's successful restructuring of its sovereign debt eased investor concerns and increased appetite for risk. However, adverse developments during the second quarter led to a flight to safety, driving yields lower. Bond prices are negatively correlated with their respective yields, which can shift abruptly due to investor reactions to major variances in reported economic data versus market expectations (i.e., expected inflation, growth, monetary policy and other Fed action, etc.). Economists surveyed by *The Wall Street Journal* anticipate yields to rise over the next several years.

HOUSING STARTS AND BUILDING PERMITS

Home building activity has traditionally been a primary driver of overall economic activity because new home construction stimulates a broad range of industrial, commercial, and consumer spending and investment. According to the U.S. Commerce Department's Bureau of the Census, new privately owned housing starts were at a seasonally adjusted annualized rate of 760,000 units in June, 6.9% above the revised May estimate and 23.6% above the June 2011 level. Single-family housing starts were 539,000 in June, 4.7% above the revised May estimate. An estimated 608,800 privately owned housing units were started in 2011, 3.7% above the 2010 figure of 586,900.

The seasonally adjusted annual rate of private housing units authorized by building permits (considered the best indicator of future housing starts) was 755,000 units in June, 3.7% below the revised May rate of 784,000 units, but 19.3% higher than the June 2011 level.

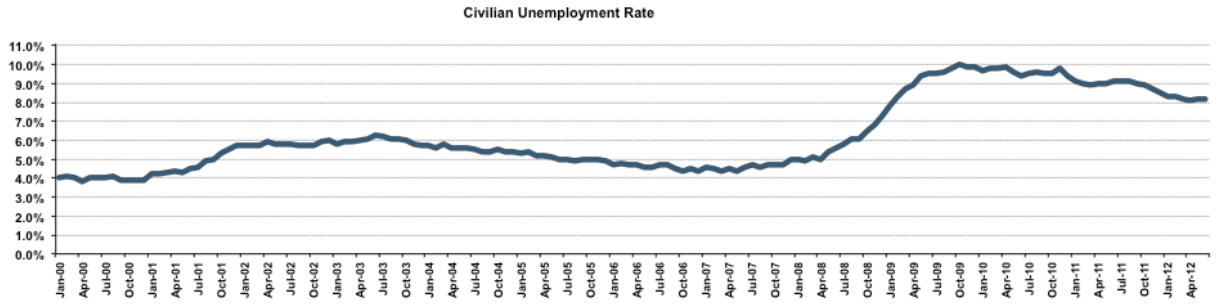


The housing market has fallen sharply from its highs in 2005 and 2006. As mortgage rates rose, underlying demand and speculative investment fell and home sales declined. Housing activity began declining in early 2006, and during 2007 the situation worsened as a crisis in the sub-prime mortgage industry spread to the overall mortgage industry.

Overall, the June 2012 data point to a stronger housing market, with housing starts, houses under construction, and housing completions all showing increases for the month. However, building permits declined. Housing starts reached their highest reported level since October 2008, though remain significantly lower than levels observed prior to that. While the data seem to indicate a recovery in the housing market is taking hold, improvement is expected to be constrained in the near term given high levels of inventories and elevated unemployment. A continued recovery of the residential construction industry will require improvement in both employment and income measures and will take time as current inventories must decline before demand inspires a significant level of new housing starts.

UNEMPLOYMENT AND PAYROLL JOBS

According to the Labor Department's Bureau of Labor Statistics ("BLS"), the unemployment rate was 8.2% in June 2012, unchanged from May and up slightly from April's level of 8.1%. Unemployment rates increased steadily throughout 2008 and into 2009, peaking at a level of 10.0% in October 2009. The October 2009 unemployment rate represented the highest level since 1983. While the unemployment rate has decreased by almost a percentage point over the past year, the labor force participation rate has also decreased as individuals stopped seeking employment. As job availability increases, the labor force will likely increase due to individuals re-entering the workforce. The increase in the labor force numbers could lead to an increase in the unemployment rate in the short-term. This was evident in April and May of 2012, as the labor force participation rate increased from 63.6% to 63.8%, and the unemployment rate increased from 8.1% to 8.2%. The labor force participation rate for June was unchanged at 63.8%. Economists surveyed by *The Wall Street Journal* anticipate an unemployment rate of 8.0% at year-end.



The number of nonfarm payroll jobs increased by 80,000 in June 2012. This followed increases of 68,000 and 77,000 jobs in April and May, respectively. In 2008 a total of 3.6 million nonfarm payroll jobs were lost, with an additional 5.1 million nonfarm payroll jobs lost during 2009. In 2010 and 2011 nonfarm payrolls increased by 1.0 million and 1.8 million, respectively. Economists surveyed by *The Wall Street Journal* anticipate payroll gains of approximately 140,000 a month over the next year. Population growth currently adds approximately 100,000 individuals to the workforce per month.

INTEREST RATES

The Federal Reserve's Open Market Committee ("FOMC") lowered its target for the federal funds rate to a range of 0% to 0.25% during the fourth quarter of 2008, representing a total rate cut of 175 to 200 basis points during the quarter. Target rates were held steady during 2009 and have remained unchanged through the second quarter of 2012. In January 2012 the FOMC announced that rates would likely stay low until late 2014 (an increase from previously stated mid-2013). Information received by the FOMC indicated that the economic recovery is continuing. Business fixed investment, consumer spending, and the housing market continue to improve, though at a very modest pace. Unemployment remains elevated, and strains in global financial markets continue to be a concern. The FOMC expects the economic recovery to continue, although growth is expected to be moderate through 2014. Inflation has been subdued in recent quarters and long-term inflation expectations have remained stable.

In an effort to spur investment and aid the housing market by lowering benchmark interest rates, without increasing the size of the Fed's balance sheet, the FOMC decided to increase the average maturity of the Fed's securities by selling short term maturities and using the proceeds to purchase longer dated securities (this action is widely referred to as "Operation Twist," named after a similar FOMC operation conducted in the early 1960s). The effort was initially announced in September 2011. Originally slated to end on June 30, 2012, the FOMC extended the program through the end of 2012.

The following was excerpted from the Fed's June 20th press release:

> *Information received since the Federal Open Market Committee met in April suggests that the economy has been expanding moderately this year. However, growth in employment has slowed in recent months, and the unemployment rate remains elevated. Business fixed investment has continued to advance. Household spending appears to be rising at a somewhat slower pace than earlier in the year. Despite some signs of improvement, the housing sector remains depressed. Inflation has declined, mainly reflecting lower prices of crude oil and gasoline, and longer-term inflation expectations have remained stable.*

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects economic growth to remain moderate over coming quarters and then to pick up very gradually. Consequently, the Committee anticipates that the unemployment rate will decline only slowly toward levels that it judges to be consistent with its dual mandate. Furthermore, strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee anticipates that inflation over the medium term will run at or below the rate that it judges most consistent with its dual mandate.

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee expects to maintain a highly accommodative stance for monetary policy. In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.

The Committee also decided to continue through the end of the year its program to extend the average maturity of its holdings of securities. Specifically, the Committee intends to purchase Treasury securities with remaining maturities of 6 years to 30 years at the current pace and to sell or redeem an equal amount of Treasury securities with remaining maturities of approximately 3 years or less. This continuation of the maturity extension program should put downward pressure on longer-term interest rates and help to make broader financial conditions more accommodative. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. The Committee is prepared to take further action as appropriate to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.

SUMMARY AND OUTLOOK

While the aptly named Great Recession reached its official end in mid-2009, economic growth remains subdued and the recovery is viewed as fragile. The pace of recovery is likely to remain moderate but positive, though strains in global financial markets could be disruptive. The sovereign debt crisis in Europe continues to weigh on investor sentiment despite a successful restructuring of Greek sovereign debt. Hiring is taking place, though not at rates high enough to significantly change the unemployment rate given population growth and workers re-entering the workforce. Activity in the housing market, while strengthening, remains well below pre-recession levels. The outlook is not expected to significantly improve until inventories of unsold new homes decline and the backlog of bank-owned and foreclosed properties clears the market. GDP growth expectations from private economists surveyed by *The Wall Street Journal* are on the order of 2.1% for the third quarter of 2012 and 2.0% for all of 2012. This compares to GDP growth of 1.8% in 2011 and 2.4% in 2010, and GDP contractions of 3.1% and 0.3% in 2009 and 2008, respectively.

The Federal Reserve's outlook concurs with that of many private economists by suggesting that GDP growth is expected to continue but will likely remain constrained in the near-term due to slowing growth of foreign economies, decreased government spending, weak labor and housing markets, continued consumer deleveraging, and high levels of uncertainty among households and businesses. On average, economists surveyed by *The Wall Street Journal* expect unemployment to decline slightly to 8.0% by year-end 2012, and continue downward to 7.6% by year-end 2013. Given the FOMC's statements, it is unlikely there will be any tightening of monetary policy until late 2014 at the earliest. Governmental response to the financial and economic crisis has been significant. However, the existence and magnitude of future stimulus is uncertain given the end of the Fed's most recent round of quantitative easing (referred to as "QE2") and the somewhat minimal scope of Operation Twist. Further improvements in the labor and housing markets will be necessary to support sustained growth going forward.

Special Notes:

The following page can be combined with the General Economic Overview section beginning on page 1 of **The NER** to develop a condensed version for use in shorter and/or more limited engagements.

Financial data presented in the quarterly and annual spreadsheets can be omitted or used selectively when using the abbreviated format, as most vital statistics are referenced in the text.

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CONSUMER SPENDING AND INFLATION

The Consumer Price Index ("CPI") was unchanged in June, on a seasonally adjusted basis. The unadjusted CPI stood at 229.5. Declining energy costs were offset by increases in most other categories, including food. The seasonally adjusted annual rate ("SAAR") of inflation for the second quarter of 2012 declined 0.8%, while the core rate of inflation increased at a 2.6% (SAAR) rate over the same period. The Producer Price Index ("PPI") increased by 0.1% in June. The seasonally adjusted decline in energy goods (down 0.9% in June) was offset by increases in other items. On an unadjusted basis, the twelve month change in PPI was 0.7%, compared to a 4.7% increase in 2011.

The advance estimates of U.S retail and food service sales for June 2012 were down 0.5% from the previous month, but 3.8% above June 2011 levels. Real personal consumption spending increased 1.5% in the second quarter of 2012, compared to increases of 2.0% in the fourth quarter of 2011 and 2.4% in the first quarter of 2012. Personal consumption spending decreased 1.9% in 2009, but was up 1.8% in 2010 and 2.5% in 2011. Durable goods purchases declined 1.0% in the second quarter of 2012, well below the 13.9% and 11.5% increases observed in the fourth quarter of 2011 and first quarter of 2012, respectively.

BUSINESS AND MANUFACTURING PRODUCTIVITY

The seasonally adjusted annual rate of nonfarm business productivity increased 1.6% in the second quarter of 2012, surpassing economists' expectations of a 1.3% increase. The increase in productivity reflected the net effect of a 2.0% increase in output and a 0.4% increase in hours worked. Annual average productivity increased 1.1% from second quarter 2011 to second quarter 2012 and increased 0.7% for all of 2011. Productivity increased 1.9% for the business sector in the second quarter of 2012. This was the result of a 2.3% increase in output coupled with a 0.4% increase in hours worked. Manufacturing productivity, generally more volatile in its quarterly measures, increased 0.2% during the quarter as output increased 1.7% and hours increased by 1.4%.

INDUSTRIAL PRODUCTION AND CAPACITY UTILIZATION

Industrial production increased 0.4% in June 2012, after an increase of 0.8% in April and a 0.2% decline in May (all figures recently revised). Second quarter 2012 production increased at an annual rate of 2.2%. Manufacturing output increased 0.7% in June, following a 0.7% increase in April and a 0.7% decline in May.

Capacity utilization was 78.9% in June 2012, rising from 78.7% in May and significantly higher than June 2011's level of 76.3%. Capacity utilization for the second quarter of 2012 measured 78.8%. The current low measure of capacity utilization suggests that business investment for infrastructure will not likely be a significant component of economic improvement in the near-term.

THE FINANCIAL MARKETS

Broad market equity indices declined in the second quarter of 2012, as did yields on intermediate and long-term Treasury securities. A worsening situation in Europe, along with disappointing domestic economic data, shook investor confidence during the second quarter. Although some investors believed this would lead to additional stimulus from the Federal Reserve, the only monetary policy action taken during the quarter was the extension of Operation Twist through the end of 2012.

- The Dow Jones Industrial Average closed the second quarter of 2012 at 12880.09, down 2.5% for the quarter. The Dow was up 5.5% for all of 2011.
- The S&P 500 Index declined 3.3% during the second quarter to close at 1362.16. The S&P 500 remained essentially unchanged for 2011.
- The NASDAQ Composite Index declined 5.1% during the second quarter to close at 2935.05. For all of 2011 the NASDAQ was down 1.8%.
- The broad market Dow Jones U.S. Total Stock Market Index (full cap) closed at 14208.64, down 3.7% for the quarter. It was down 1.4% for all of 2011.

The monthly average yields-to-maturity on the 20-year Treasury bond during the second quarter of 2012 were 2.82%, 2.53%, and 2.31%, respectively, for April, May, and June. Economists surveyed by *The Wall Street Journal* anticipate yields to rise over the next several years.

HOUSING STARTS AND BUILDING PERMITS

New privately owned housing starts were at a seasonally adjusted annualized rate of 760,000 units in June, 6.9% above the revised May estimate and 23.6% above the June 2011 level. Single-family housing starts were 539,000 in June, 4.7% above the revised May estimate. An estimated 608,800 privately owned housing units were started in 2011, 3.7% above the 2010 figure of 586,900. The seasonally adjusted annual rate of private housing units authorized by building permits was 755,000 units in June, 3.7% below the revised May rate of 784,000 units, but 19.3% higher than the June 2011 level.

UNEMPLOYMENT AND PAYROLL JOBS

The unemployment rate was 8.2% in June 2012, unchanged from May and up slightly from April's level of 8.1%. While the unemployment rate has decreased by almost a percentage point over the past year, the labor force participation rate has also decreased as individuals stopped seeking employment. As job availability increases, the labor force will likely increase due to individuals re-entering the workforce. The increase in the labor force numbers could lead to an increase in the unemployment rate in the short-term. This was evident in April and May of 2012, as the labor force participation rate increased from 63.6% to 63.8%, and the unemployment rate increased from 8.1% to 8.2%. The labor force participation rate for June was unchanged at 63.8%. Unemployment is expected to decline to 8.0% by the end of 2012.

The number of nonfarm payroll jobs increased by 80,000 in June 2012. This followed increases of 68,000 and 77,000 jobs in April and May, respectively. Economists surveyed by *The Wall Street Journal* anticipate payroll gains of approximately 140,000 a month over the next year. Population growth currently adds approximately 100,000 individuals to the workforce per month.

INTEREST RATES

In January 2012 the FOMC announced that rates would likely stay low until late 2014 (an increase from previously stated mid-2013). In an effort to spur investment and aid the housing market by lowering benchmark interest rates, the FOMC decided to increase the average maturity of the Fed's securities by selling short term maturities and using the proceeds to purchase longer dated securities (this action is widely referred to as "Operation Twist," named after a similar FOMC operation conducted in the early 1960s). The effort was initially announced in September 2011. Originally slated to end on June 30, 2012, the FOMC extended the program through the end of 2012. The following was excerpted from the Fed's June 20th press release:

> *In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.*

SUMMARY AND OUTLOOK

While the aptly named Great Recession reached its official end in mid-2009, economic growth remains subdued and the recovery is viewed as fragile. The pace of recovery is likely to remain moderate but positive, though strains in global financial markets could be disruptive. The sovereign debt crisis in Europe continues to weigh on investor sentiment despite a successful restructuring of Greek sovereign debt. Hiring is taking place, though not at rates high enough to significantly change the unemployment rate given population growth and workers re-entering the workforce. Activity in the housing market, while strengthening, remains well below pre-recession levels. The outlook is not expected to significantly improve until inventories of unsold new homes decline and the backlog of bank-owned and foreclosed properties clears the market. GDP growth expectations from private economists surveyed by *The Wall Street Journal* are on the order of 2.1% for the third quarter of 2012 and 2.0% for all of 2012. This compares to GDP growth of 1.8% in 2011 and 2.4% in 2010, and GDP contractions of 3.1% and 0.3% in 2009 and 2008, respectively.

The Federal Reserve's outlook concurs with that of many private economists by suggesting that GDP growth is expected to continue but will likely remain constrained in the near-term due to slowing growth of foreign economies, decreased government spending, weak labor and housing markets, continued consumer deleveraging, and high levels of uncertainty among households and businesses. On average, economists surveyed by *The Wall Street Journal* expect unemployment to decline slightly to 8.0% by year-end 2012, and continue downward to 7.6% by year-end 2013. Given the FOMC's statements, it is unlikely there will be any tightening of monetary policy until late 2014 at the earliest. Governmental response to the financial and economic crisis has been significant. However, the existence and magnitude of future stimulus is uncertain given the end of the Fed's most recent round of quantitative easing (referred to as "QE2") and the somewhat minimal scope of Operation Twist. Further improvements in the labor and housing markets will be necessary to support sustained growth going forward.