THE U.S. ECONOMIC OUTLOOK:

A grudging recovery, constrained by an over-extended household sector.

NATIONAL ASSOCIATION OF STATE TREASURERS

Annual Conference, Dana Point, CA, September 1, 2009

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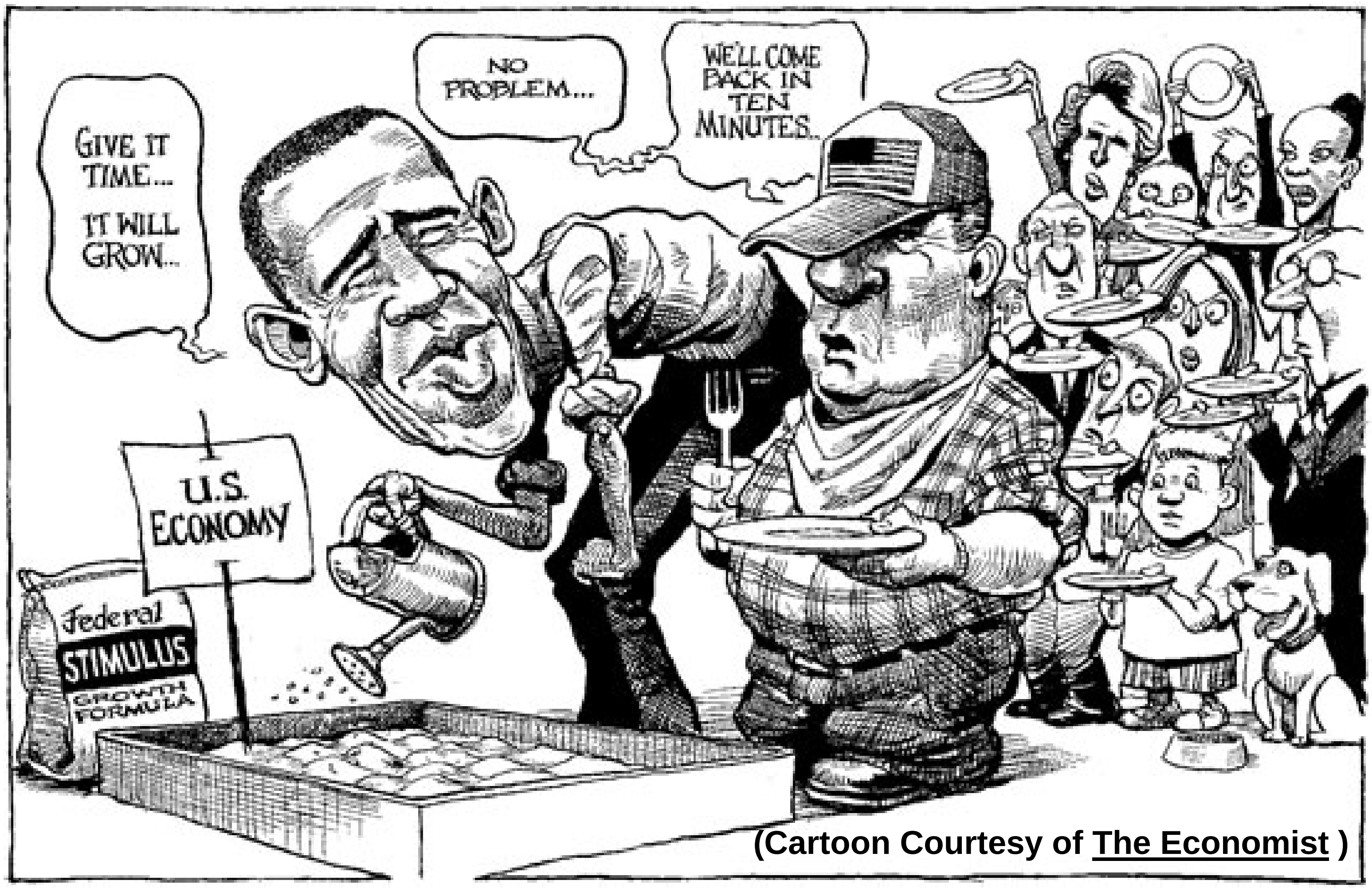
Brief Political Cycle Creates Imperative to Short-Circuit Necessary Corrections, Thus Imperiling Longer-Term Growth



(Cartoon Courtesy of The Economist)

Forecast Summary

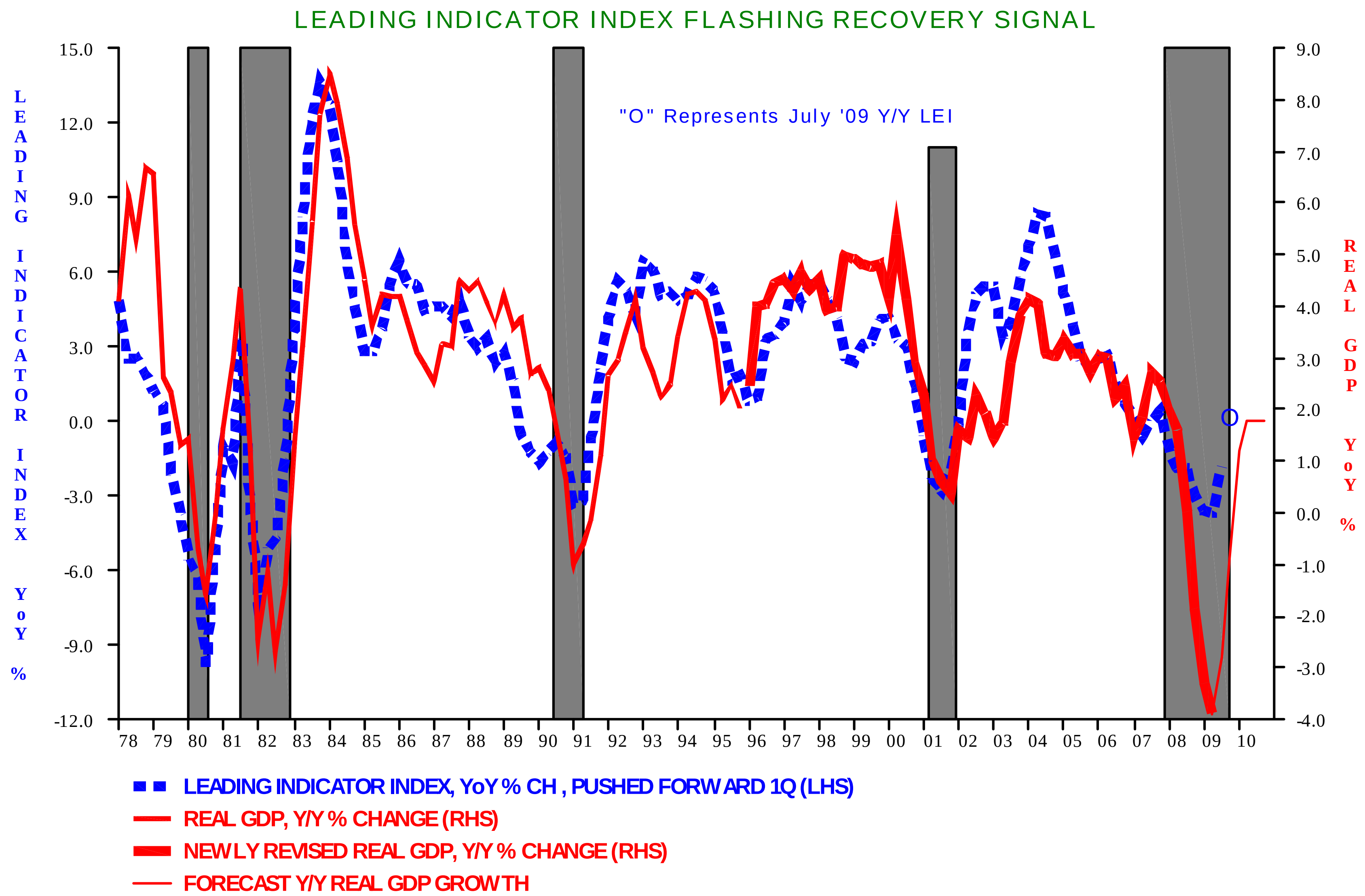
- **Inventories are now reported to have plunged by an inflation-adjusted $255B (annual rate) in the first half of the year. With final demand stabilizing, it now appears that orders and output will need to firm up in order to slow the decline in inventories.**
- **Improved automotive output, at least in the near term, will contribute to these trends, as the "cash for clunkers" program has left inventories of many models too low in the wake of extended factory shutdowns over the summer. The near-term profile of consumer spending will also benefit from the program, although there will be offsets (most notable being less spending on other items and the "payback effect").**
- **Although the outlook for 2010 does not appear to be as weak as we had been forecasting, growth shy of 2% in the first year of an economic recovery would be nothing to write home about. Our upgraded forecast for 2010 is the product of modest upward revisions to most elements of final demand (final sales forecast at a q4/q4 +1.2% versus a previous +0.3%) along with a bit more of a positive contribution from inventory change.**
- **The most important factor limiting growth will be households continuing to struggle with ravaged balance sheets and lingering labor market weakness. Moreover, negatives related to sour commercial real estate loans, consumer lending, commercial & industrial loans, non-subprime mortgage lending, etc. are all mostly yet to be felt as far as banks and other creditors are concerned, while copious spare capacity will weigh on any recovery in capital spending and will also keep disinflationary trends alive.**

Forecast Summary

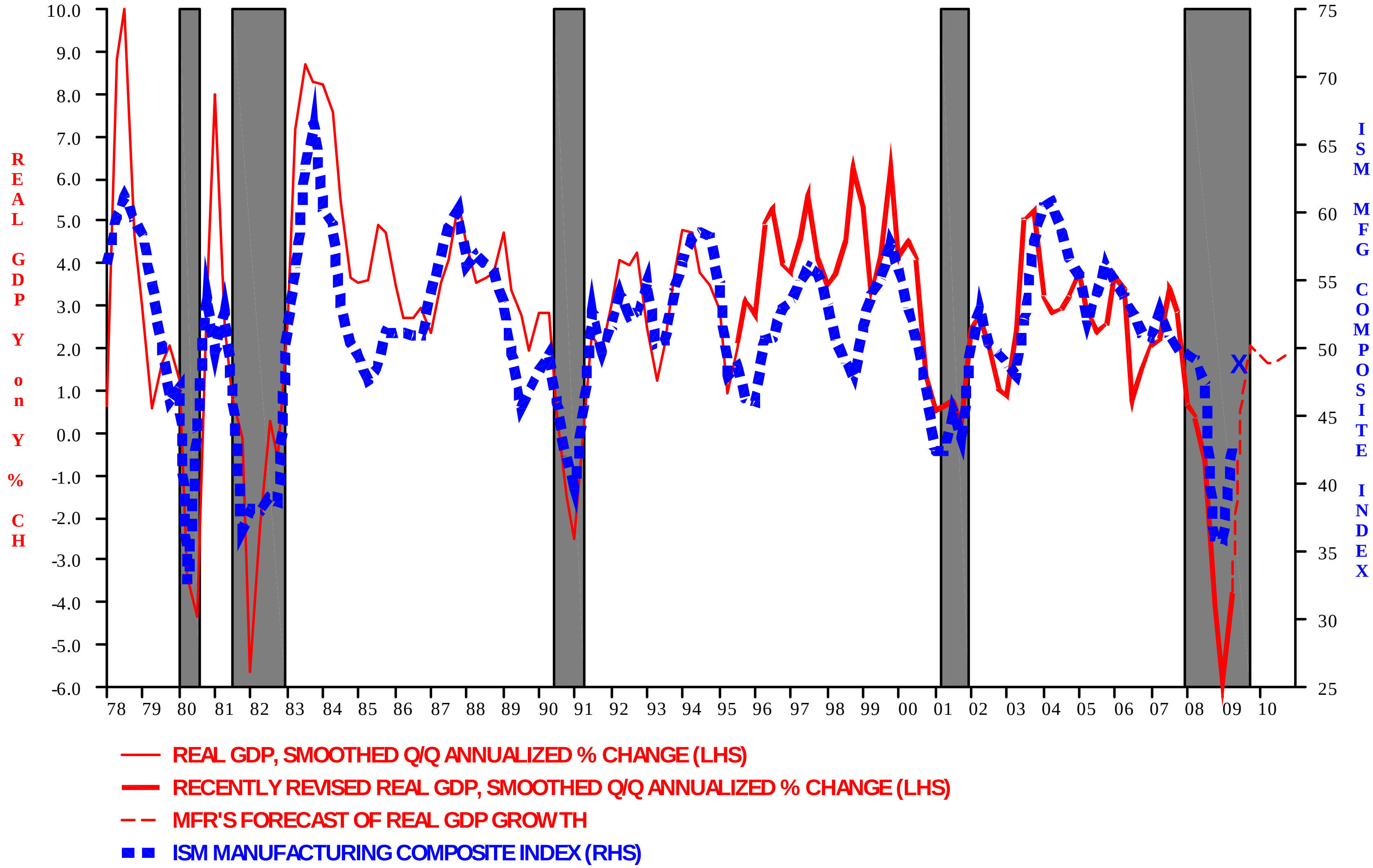
	2009:Q3	*2009:Q4*	*2010:Q1*	*2010:Q2*	*2009 q4/q4*	*2010 q4/q4*
Real GDP q/q annualized	+2.0%	+2.1%	+1.6%	+1.7%	**-0.9%**	**+1.8%**
Final Demand q/q annualized	-0.1%	1.0%	+0.9%	+1.4%	**-0.9%**	**+1.2%**
Consumer Sp. q/q annualized	+0.9%	+0.4%	-0.2%	+0.2%	**+0.2%**	**+0.1%**
Capital Spending q/q annualized	-6.6%	-5.6%	-3.8%	0.0%	**-16.4%**	**-0.2%**
CPI q/q annualized	+3.2%	+0.9%	+0.9%	+0.4%	**+0.7%**	**+0.7%**
Core CPI q/q annualized	+1.4%	+1.1%	+0.9%	+0.4%	**+1.6%**	**+0.5%**
Housing Starts (000's, saar)	560	580	600	600	**550**	**630**
Light Vehicle Sales (mlns, saar)	11.0	10.0	9.9	9.9	**10.0**	**10.0**

A Better Tone to Near-Term Growth, But Limited Follow-Through Owing to Persistent Structural Problems

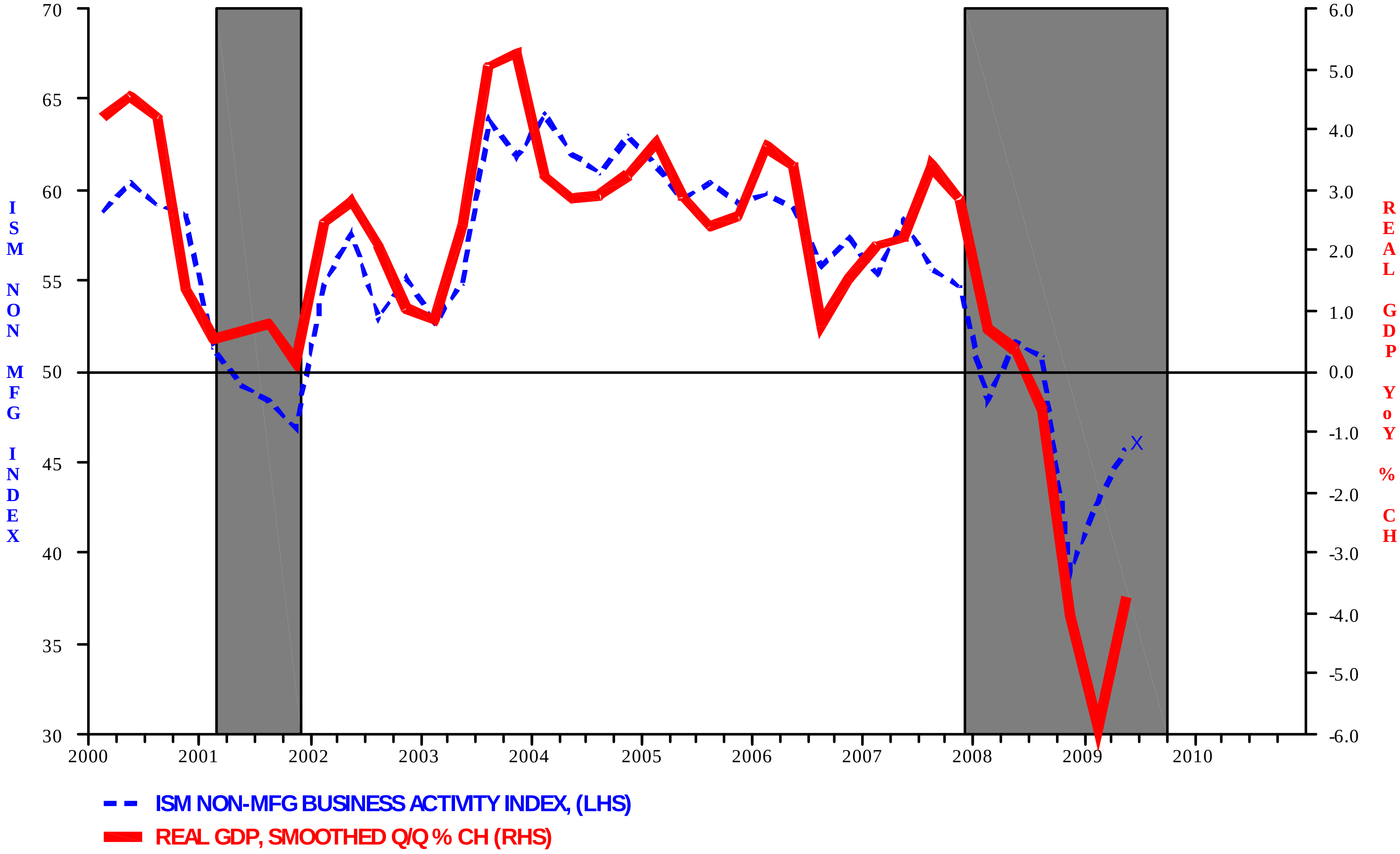
- **Inventories were liquidated at a massive $255B annualized pace in the first half of the year. However, now that final demand is no longer plunging, inventory liquidation can likewise moderate.**
- **Success of the "cash for clunkers" program adds to this dynamic, as automotive output will add significantly to growth in coming months as vehicle inventories are replenished. However, it is important to understand that higher imports will provide a partial offset to the positive impetus from inventories as far as GDP growth is concerned (good news for our trading partners, though).**
- **Moreover, housing has ended its free-fall. While pricing will remain weak, particularly in the middle to upper end of the market, home sales and housing starts appear to have bottomed. This will remove a large negative from the GDP calculation.**
- **But, with structural problems persisting, we do not believe that an end to declining real GDP is destined to transition into anything resembling a normally robust economic recovery.**
- **In particular, household balance sheets remain a wreck, and consumer spending is unlikely to grow in a significant, sustained fashion for quite some time.**


LEADING INDICATOR INDEX FLASHING RECOVERY SIGNAL
L E A D I N G I N D I C A T O R I N D E X Y o Y %
R E A L G D P Y o Y %
15.0
12.0
9.0
6.0
3.0
0.0
-3.0
-6.0
-9.0
-12.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
"O" Represents July '09 Y/Y LEI
O
LEADING INDICATOR INDEX, YoY % CH , PUSHED FORWARD 1Q (LHS)
REAL GDP, Y/Y % CHANGE (RHS)
NEWLY REVISED REAL GDP, Y/Y % CHANGE (RHS)
FORECAST Y/Y REAL GDP GROWTH

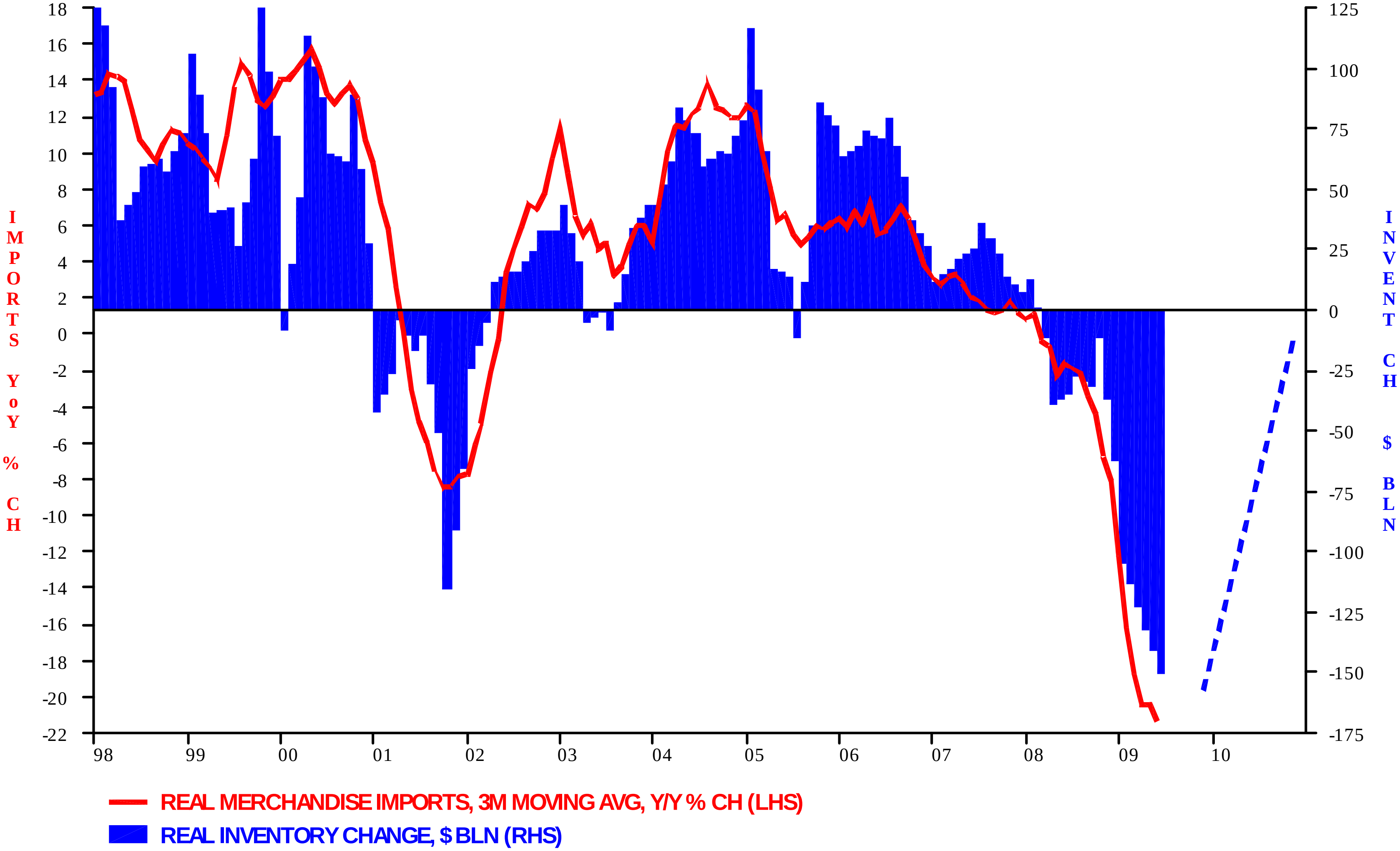
INVENTORY CYCLE BOOSTING MANUFACTURING ACTIVITY, PRESAGING POSITIVE GDP



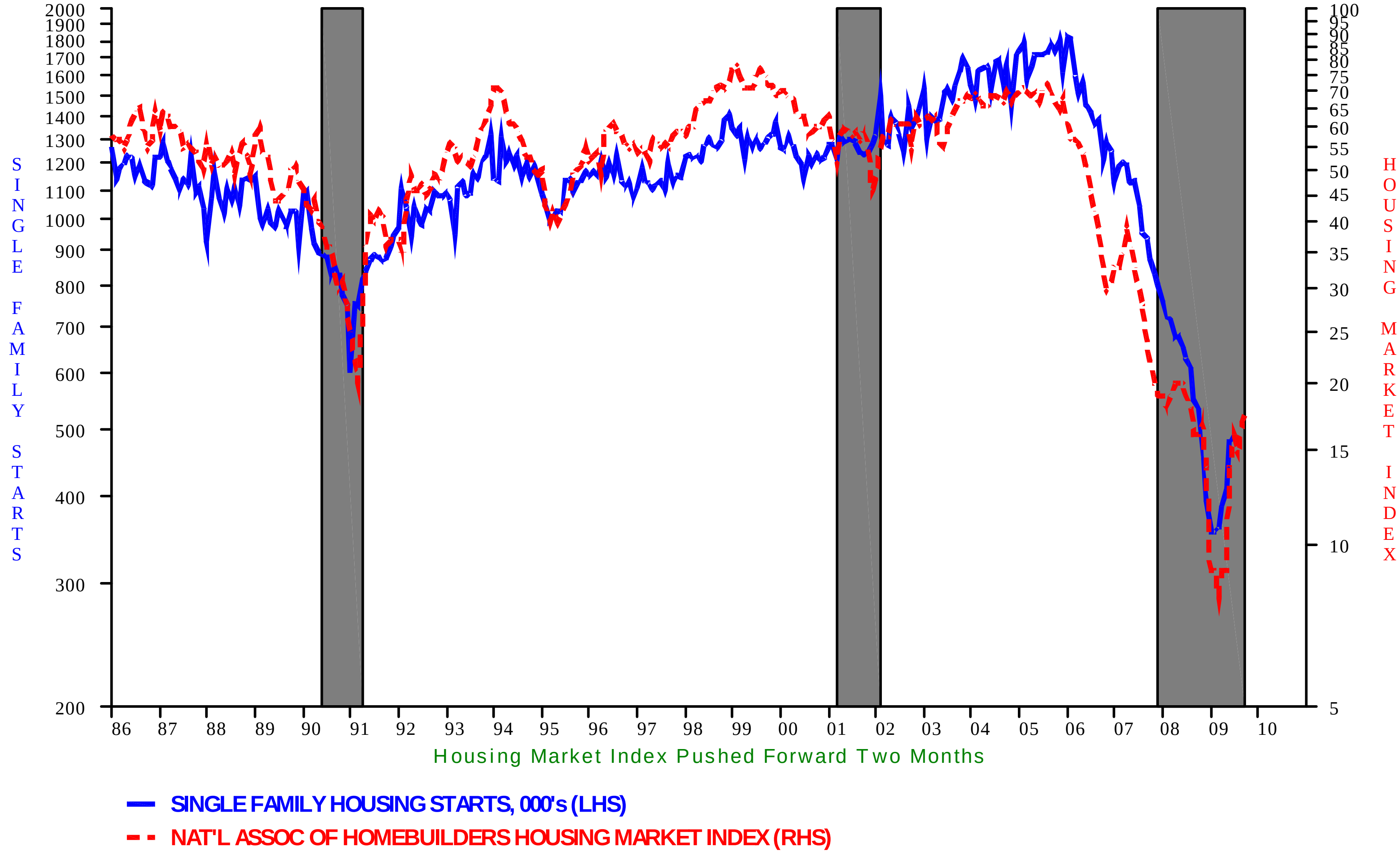
BUT, THE MUCH LARGER NON-MANUFACTURING SEGMENT OF THE ECONOMY IS NOT BENEFITING TO THE SAME EXTENT AS MANUFACTURING



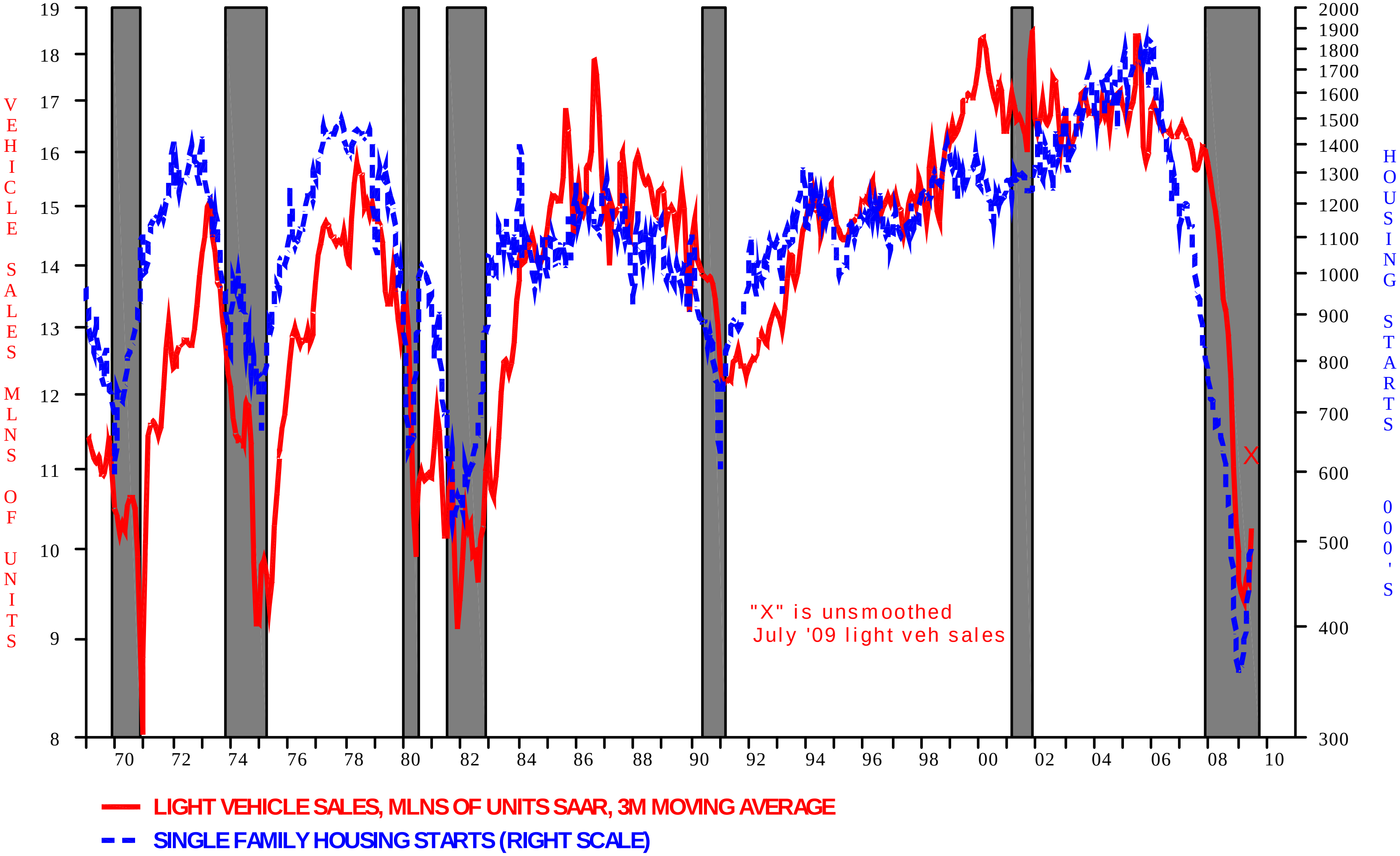
AND, AS INVENTORIES MOVE BACK TOWARD STABILITY,
A GOOD CHUNK OF THE BENEFIT WILL FLOW ABROAD AS IMPORTS PICK UP



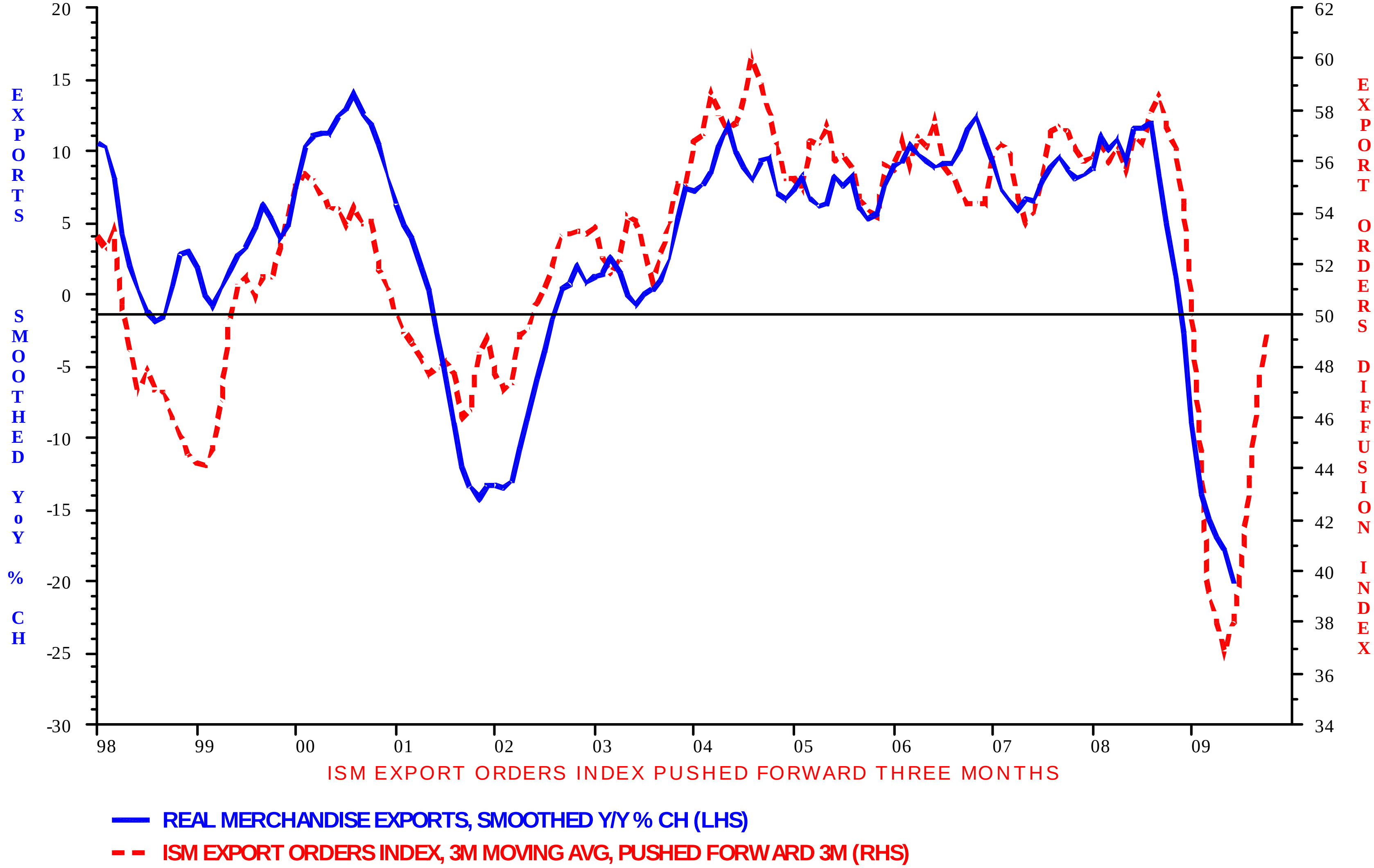
LATE 2008/EARLY 2009 PLUNGE IN HOUSING ACTIVITY HAS BEEN REVERSED, BUT SIGNIFICANTLY EXTENDING THESE GAINS WILL BE MORE DIFFICULT TO ACHIEVE



CASH-FOR-CLUNKERS EXAGGERATED THE MOVE, BUT AUTOMOTIVE SALES HAD PROBABLY ALREADY HIT BOTTOM



ISM EXPORT ORDERS INDEX POINTS TO EXPORT RECOVERY IN COMING MONTHS




UNEMPLOYMENT
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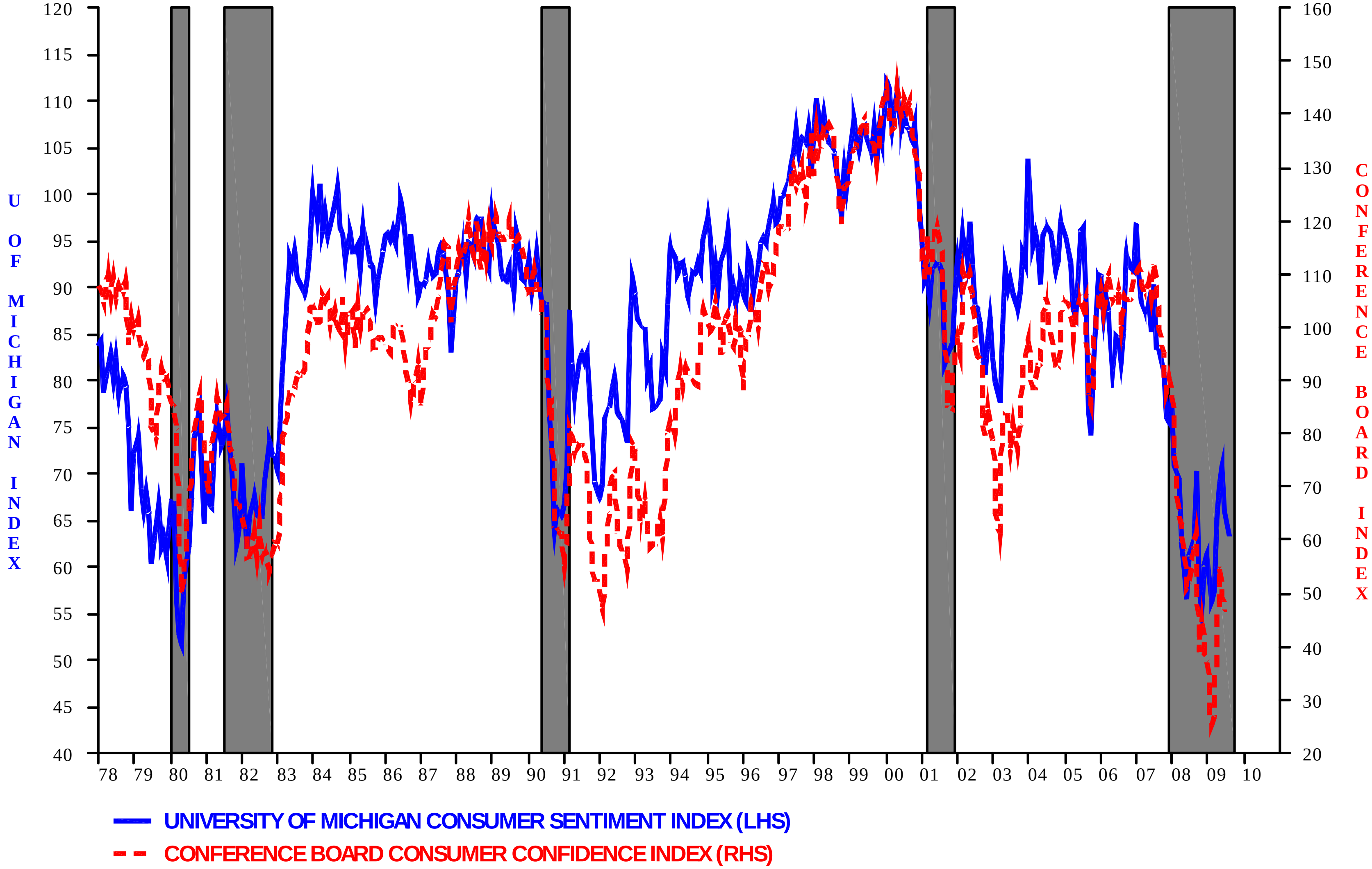
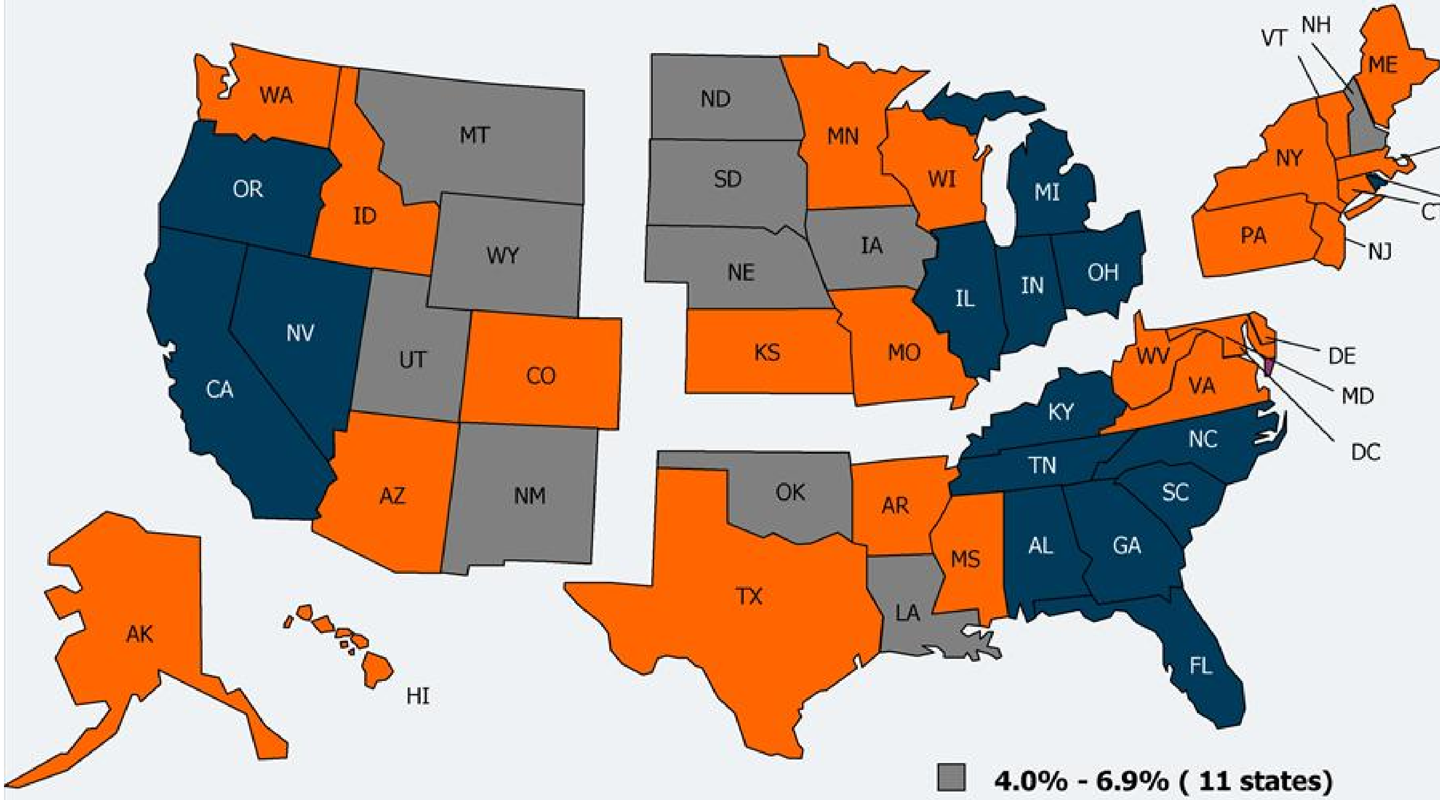
4.13.09

CONSUMER CONFIDENCE & SENTIMENT WELL OFF THEIR LOWS, BUT REMAIN DEPRESSED



States with Unemployment Rates at Various Levels, June 2009

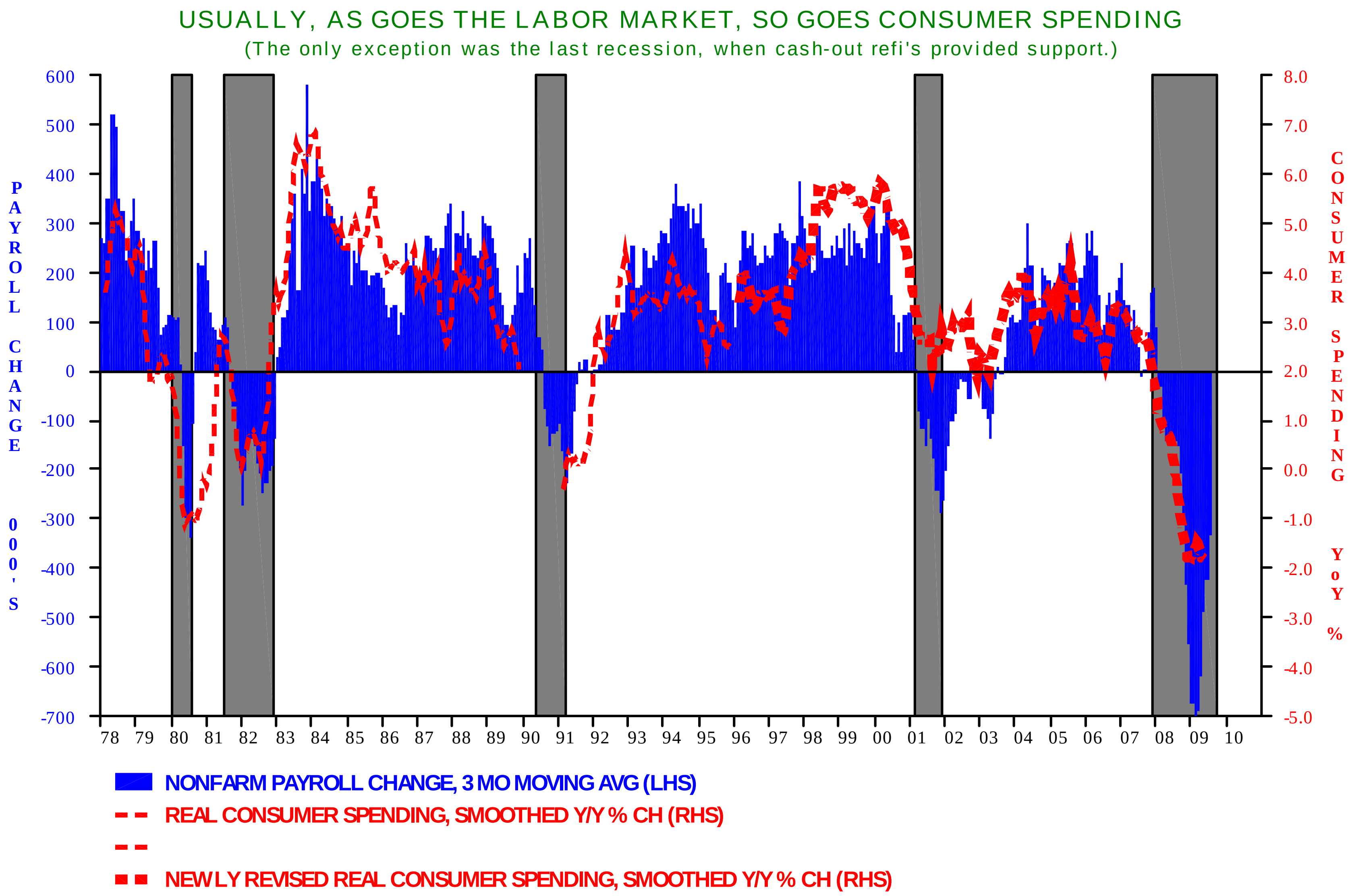


US Average: 9.5%

- **4.0% - 6.9% (11 states)**
- **7.0% - 9.9% (24 states)**
- **10.0% - 15.2% (16 states including DC)**

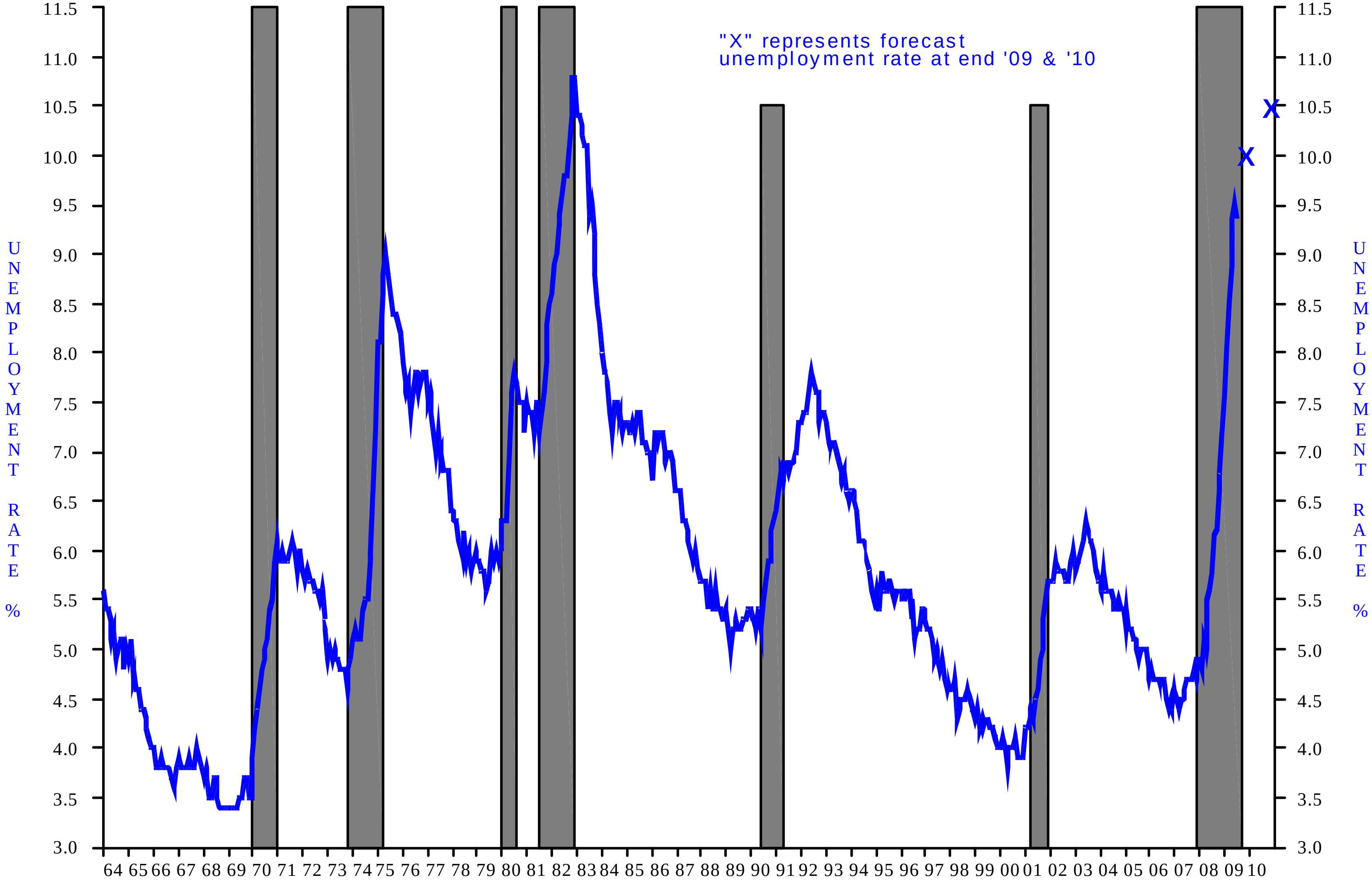
SOURCE: State and territory figures from Table 3, Regional and State Employment and Unemployment: December 2007 and June 2009, Bureau of Labor Statistics.

THE HENRY J. KAISER FAMILY FOUNDATION



USUALLY, AS GOES THE LABOR MARKET, SO GOES CONSUMER SPENDING
(The only exception was the last recession, when cash-out refi's provided support.)
PAYROLL CHANGE 000'S
CONSUMER SPENDING YoY %
600
500
400
300
200
100
0
-100
-200
-300
-400
-500
-600
-700
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
NONFARM PAYROLL CHANGE, 3 MO MOVING AVG (LHS)
REAL CONSUMER SPENDING, SMOOTHED Y/Y % CH (RHS)
NEWLY REVISED REAL CONSUMER SPENDING, SMOOTHED Y/Y % CH (RHS)

WE EXPECT UNEMPLOYMENT RATE TO CONTINUE TO EDGE HIGHER IN COMING QUARTERS



Pace of Recovery to be Significantly Constrained by Correction of Debt-Driven Asset Bubble

- **There is far too much debt relative to the size of the economy. Simply put, there is not sufficient income growth to support this debt. Therefore, substantial deleveraging must occur in order to put the debt/GDP relationship on a more sustainable footing.**

- **Starting in the early 1980's, the U.S. saving rate began to plunge and, as a mirror image, consumer spending began to soar as a share of GDP. These trends occurred because of plentiful credit, massive global liquidity that kept U.S. interest rates abnormally low, and asset price inflation (financial and real estate).**

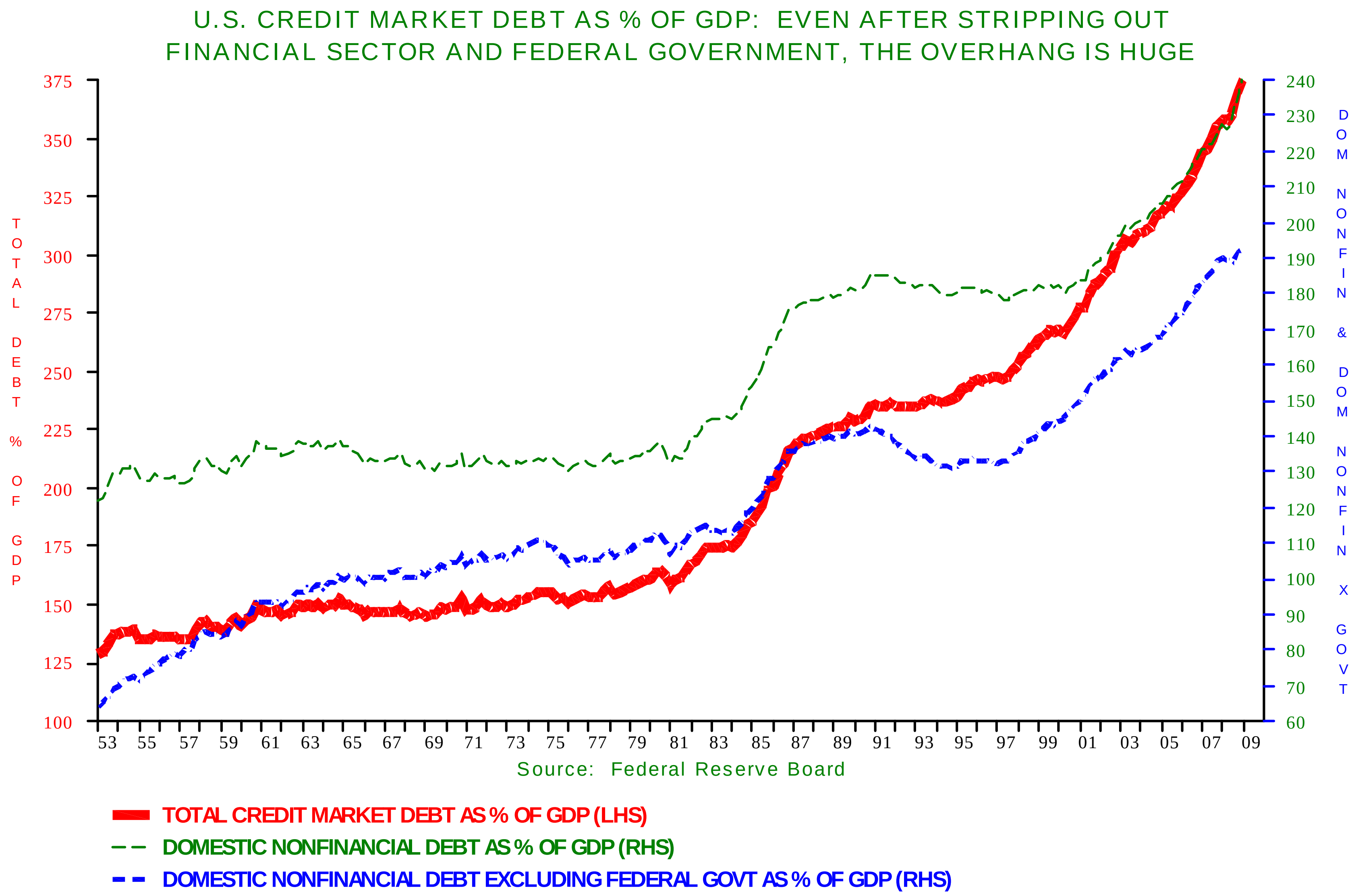
- **Now, though, the factors that drove the decline in the saving rate and rise in consumption as a share of GDP have reversed decisively:**

  --Asset prices have plunged; retirement saving has been decimated, the idea of using the home as an ATM, which was a driving economic force early this decade, is unthinkable.

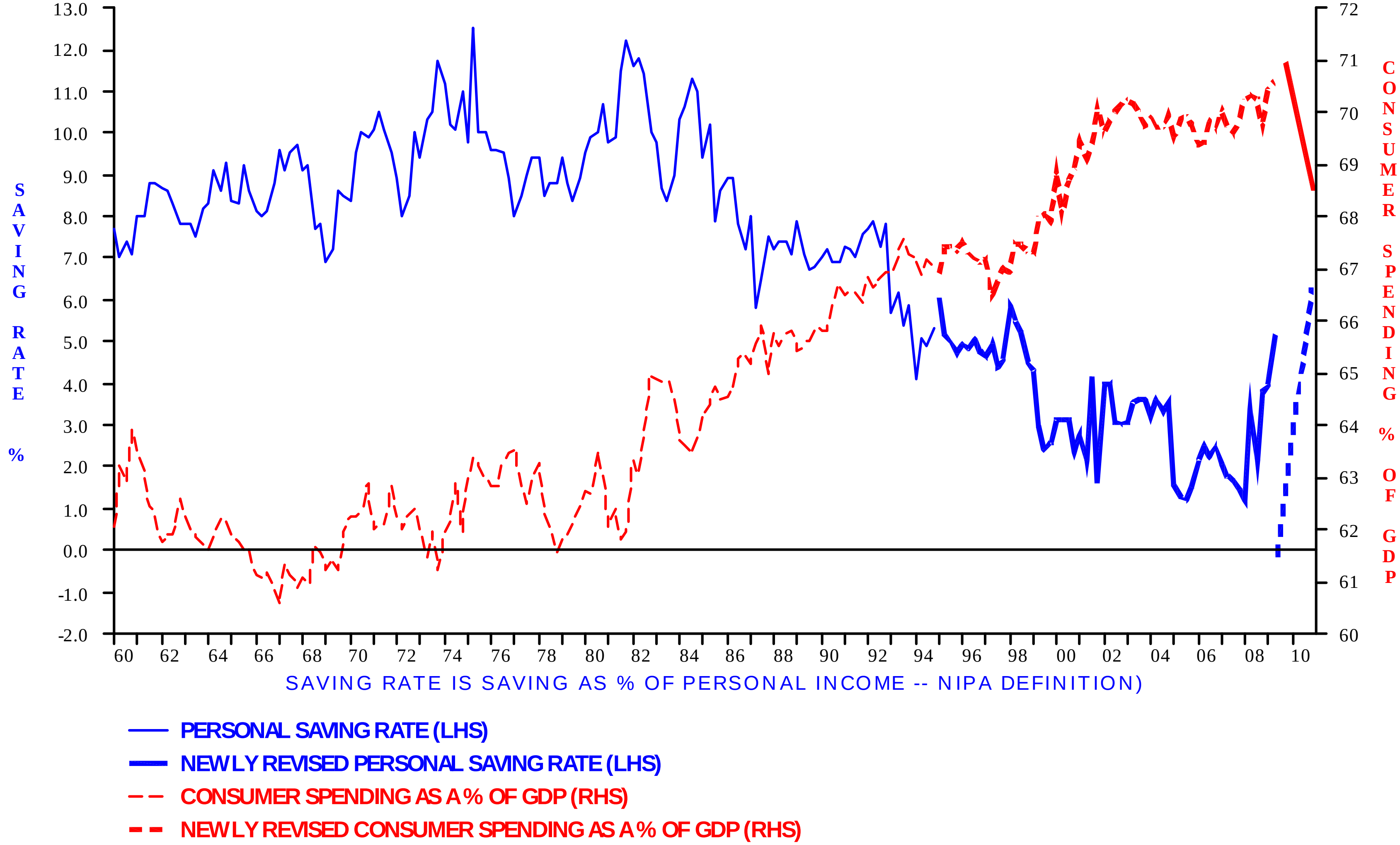
  --Credit is tight; running an ever-expanding credit card balance to finance a profligate lifestyle is no longer an option for most families.

  --Household balance sheets, which became overextended during the credit boom, now need to be cleaned up.

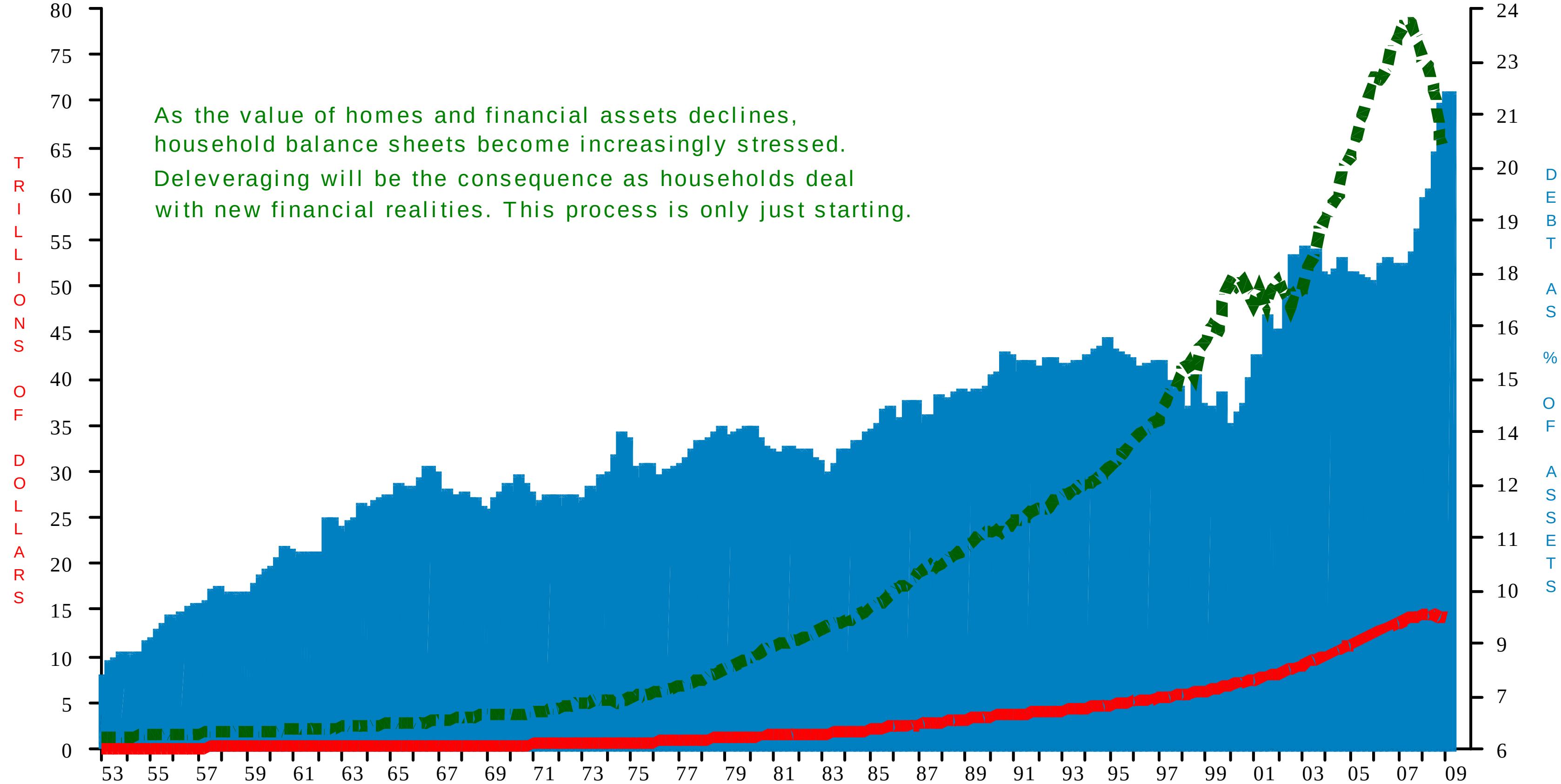
- **The inescapable fact is that consumers now face a need to devote some of their current income to saving – in other words the saving rate must rise and consumption as a share of GDP must fall. This process will weigh on growth over the medium to longer term.**


U.S. CREDIT MARKET DEBT AS % OF GDP: EVEN AFTER STRIPPING OUT
FINANCIAL SECTOR AND FEDERAL GOVERNMENT, THE OVERHANG IS HUGE
TOTAL DEBT % OF GDP
DOM NONFIN & DOM NONFIN X GOVT
375
350
325
300
275
250
225
200
175
150
125
100
240
230
220
210
200
190
180
170
160
150
140
130
120
110
100
90
80
70
60
53 55 57 59 61 63 65 67 69 71 73 75 77 79 81 83 85 87 89 91 93 95 97 99 01 03 05 07 09
Source: Federal Reserve Board
TOTAL CREDIT MARKET DEBT AS % OF GDP (LHS)
DOMESTIC NONFINANCIAL DEBT AS % OF GDP (RHS)
DOMESTIC NONFINANCIAL DEBT EXCLUDING FEDERAL GOVT AS % OF GDP (RHS)

SURGE IN CONSUMER SHARE OF GDP FINANCED BY DROP IN THE SAVING RATE WHICH WAS SPURRED BY EASY CREDIT AND ASSET PRICE INFLATION; ALL THIS IS REVERSING NOW.



HOUSEHOLD DEBT RELATIVE TO ASSETS SOARING AS ASSET VALUES DECLINE; DELEVERAGING WILL PICK UP STEAM



Source: Federal Reserve Board, Data Through Q1 2009

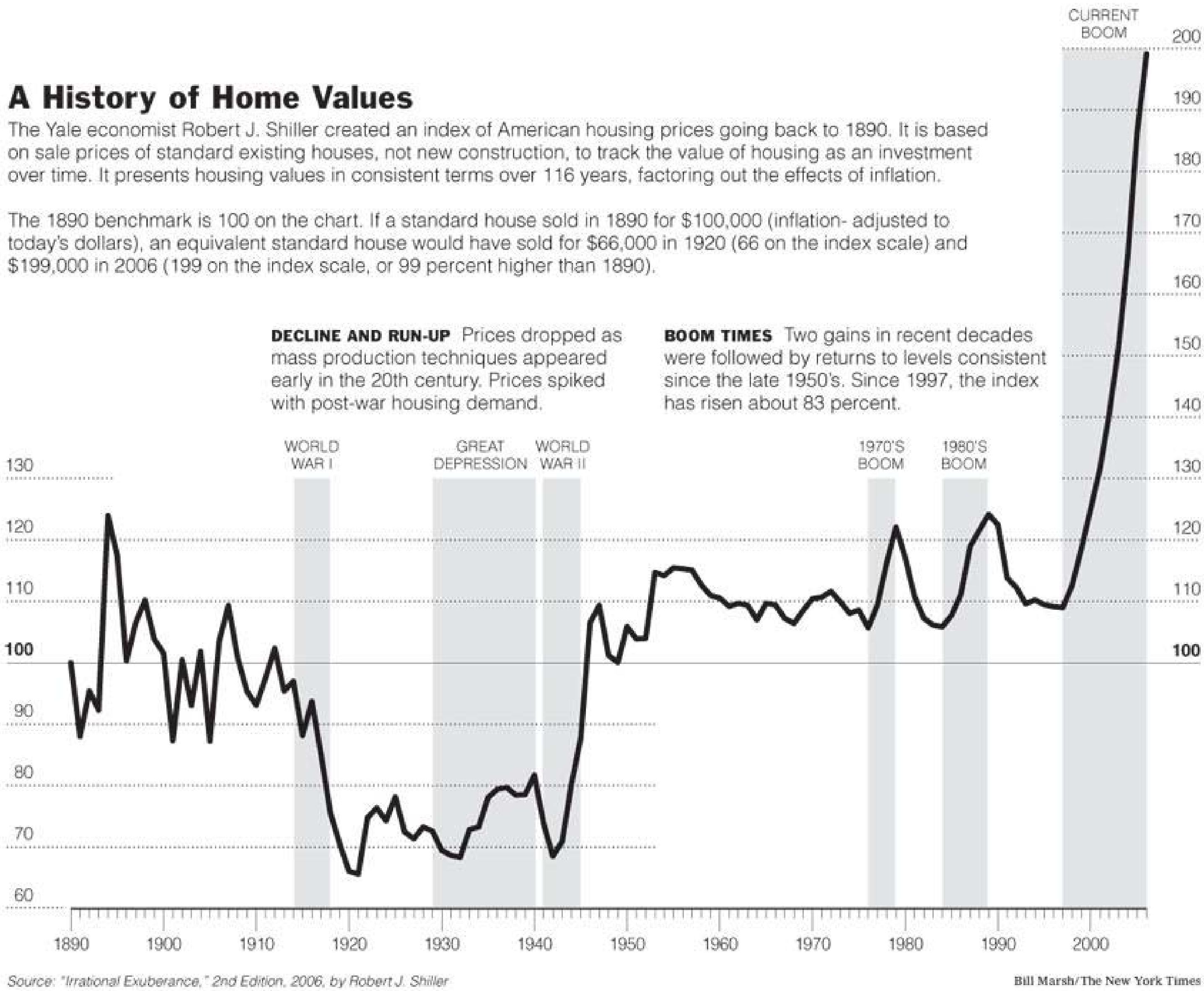
HOUSEHOLD SECTOR ASSETS (LHS)

HOUSEHOLD SECTOR DEBT (LHS)

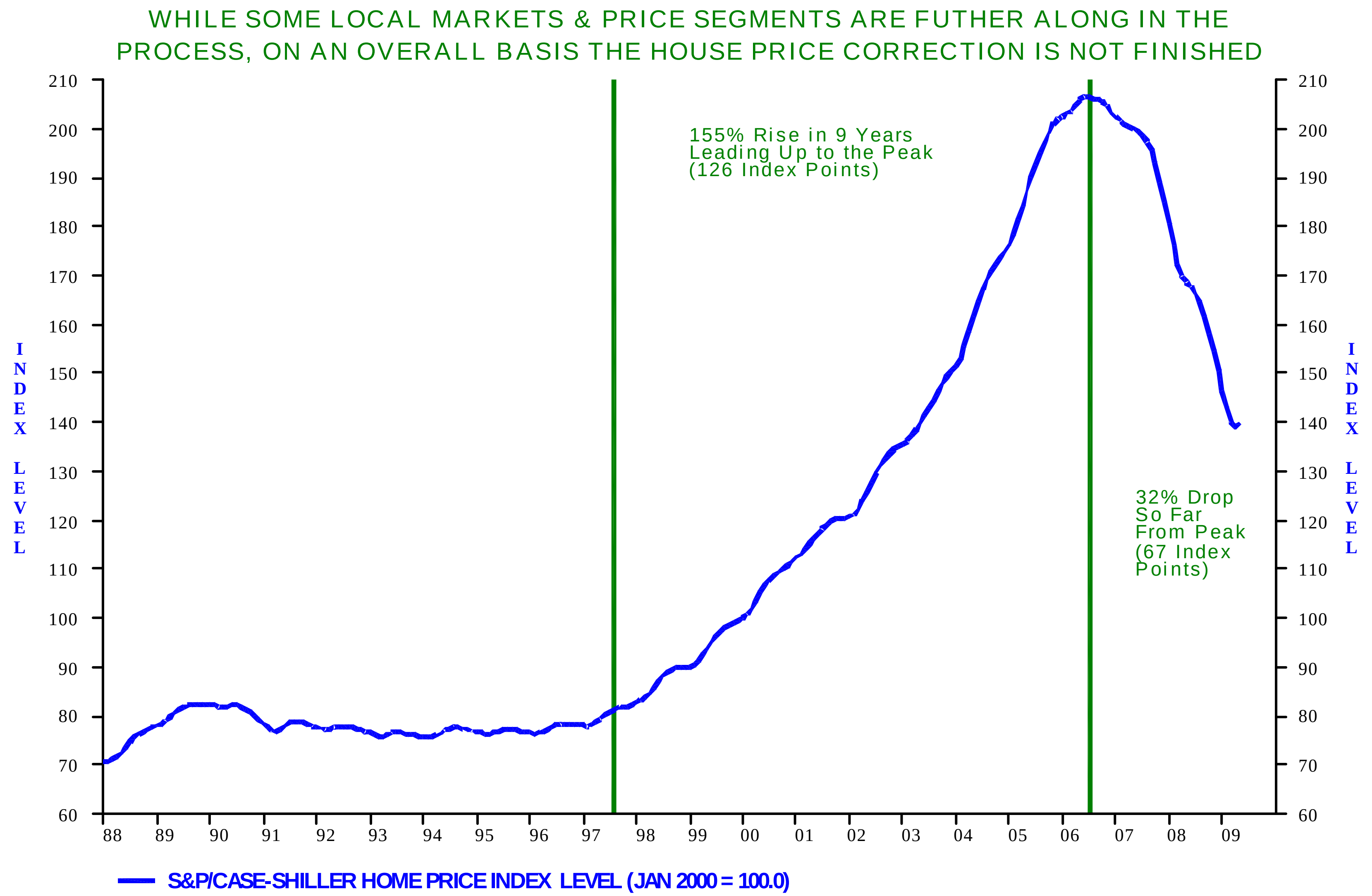
HOUSEHOLD DEBT AS % OF ASSETS (RHS)

Foreclosures at record level in July, resets & recasts of option ARM mortgages and Alt-A mortgages set to pick up sharply in coming months. The pain is far from over in the housing market, particularly in the middle and upper price segments.

The Housing Bubble Was Unprecedented

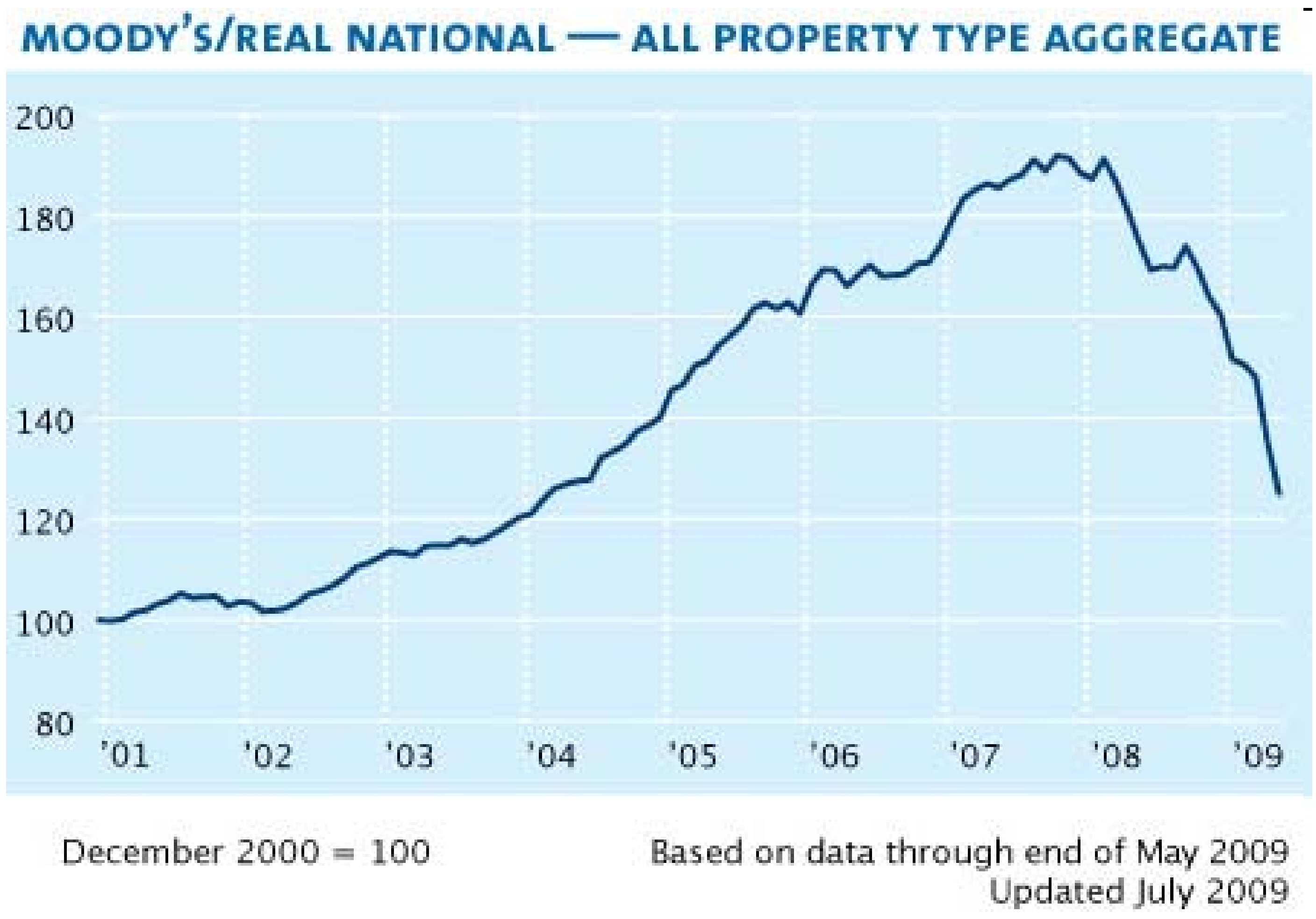


*May '09 est.



Downward pressure on home prices is increasingly coming from the upper end of the market. High unemployment, mortgage re-sets, and lower values are all taking a toll.

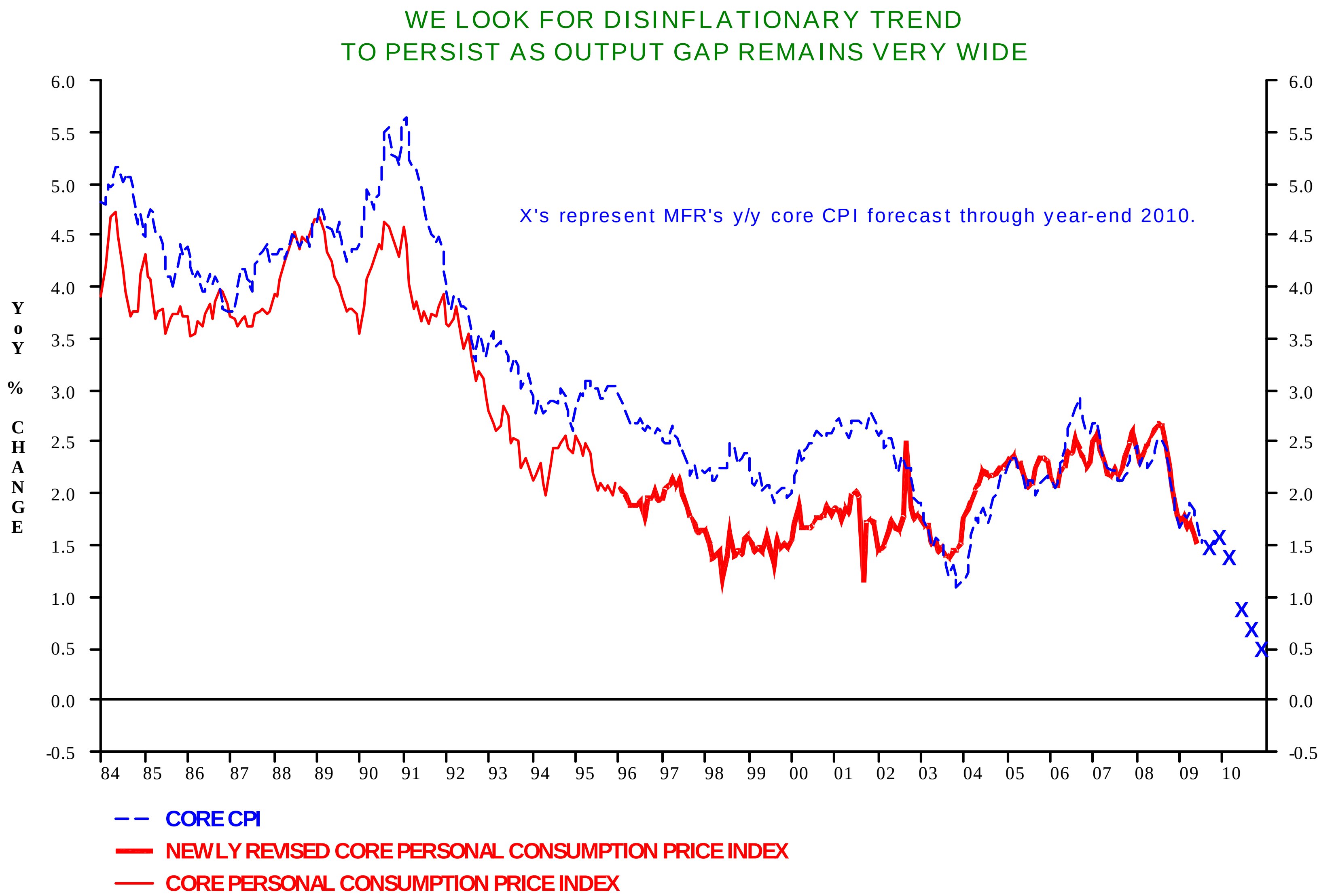
Commercial Real Estate Values Are Plunging



Copious Spare Capacity Indicates Continued Disinflation Over Near to Medium-Term

- **An already wide output gap plus below-trend growth is a recipe for continued disinflation.**
- **While our inflation forecast is not as low as it was previously, it nonetheless remains one of the lowest.**

	2009:Q3	*2009:Q4*	*2010:Q1*	*2010:Q2*	*2009 q4/q4*	*2010 q4/q4*
CPI q/q annualized	+3.2%	+0.9%	+0.9%	+0.4%	**+0.7%**	**+0.7%**
Core CPI q/q annualized	+1.4%	+1.1%	+0.9%	+0.4%	**+1.6%**	**+0.5%**


WE LOOK FOR DISINFLATIONARY TREND
TO PERSIST AS OUTPUT GAP REMAINS VERY WIDE
X's represent MFR's y/y core CPI forecast through year-end 2010.
YoY % CHANGE
6.0
5.5
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10
CORE CPI
NEWLY REVISED CORE PERSONAL CONSUMPTION PRICE INDEX
CORE PERSONAL CONSUMPTION PRICE INDEX

Supply of Treasuries Will Continue To Be Enormous

•Federal government bailouts, market support actions, etc., along with the regular operating deficit, will create a huge need for Treasury financing in coming quarters.

•This money essentially represents the government's efforts to prevent massive deleveraging, write-downs, and failures from cumulating into a deflationary spiral.

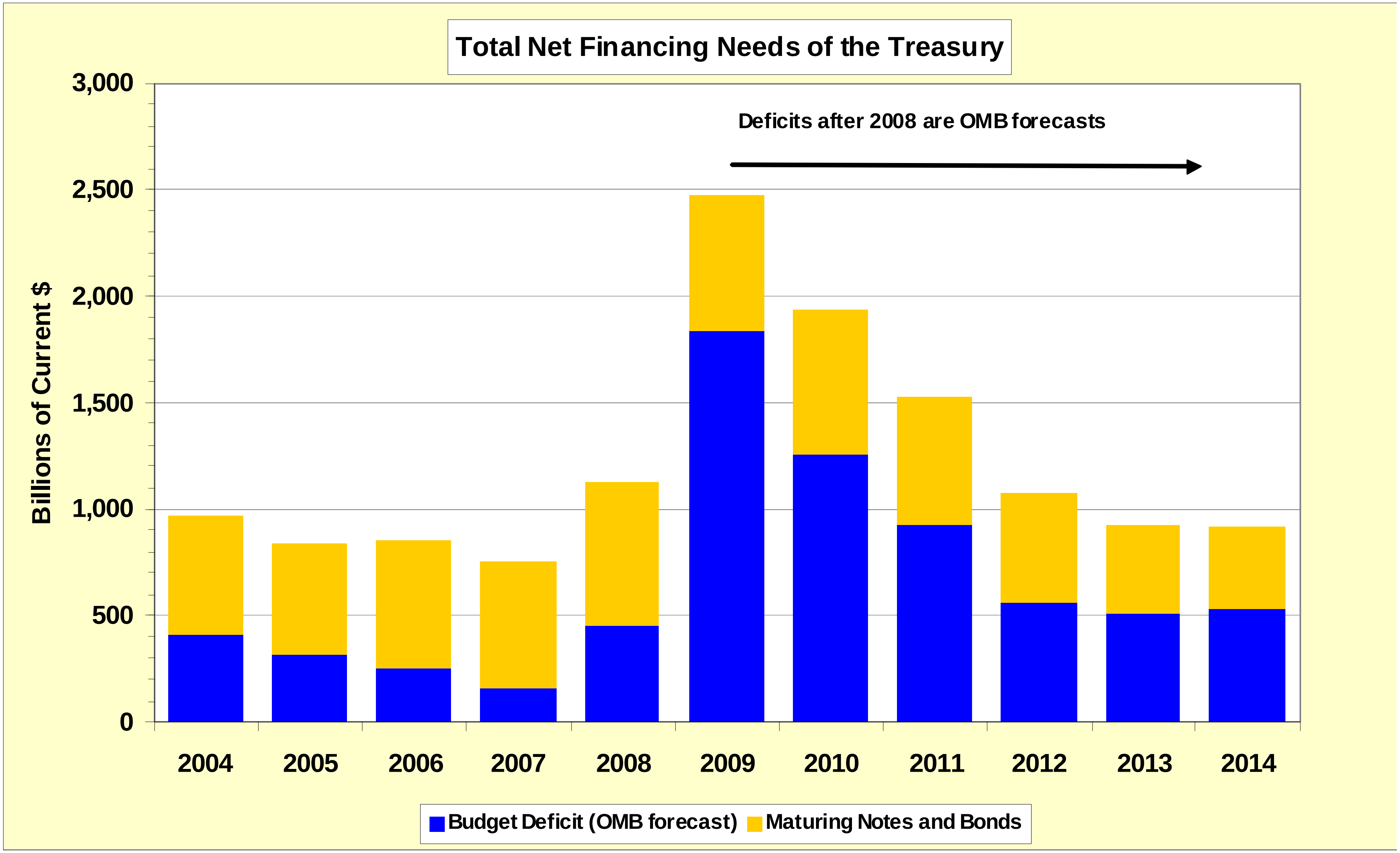
•We estimate that Treasury financing needs (maturing debt plus new deficits) will total about $2.4 trillion in fiscal year 2009 (which ends on September 30).

•In fiscal 2010, financing needs will total about $2 trillion.

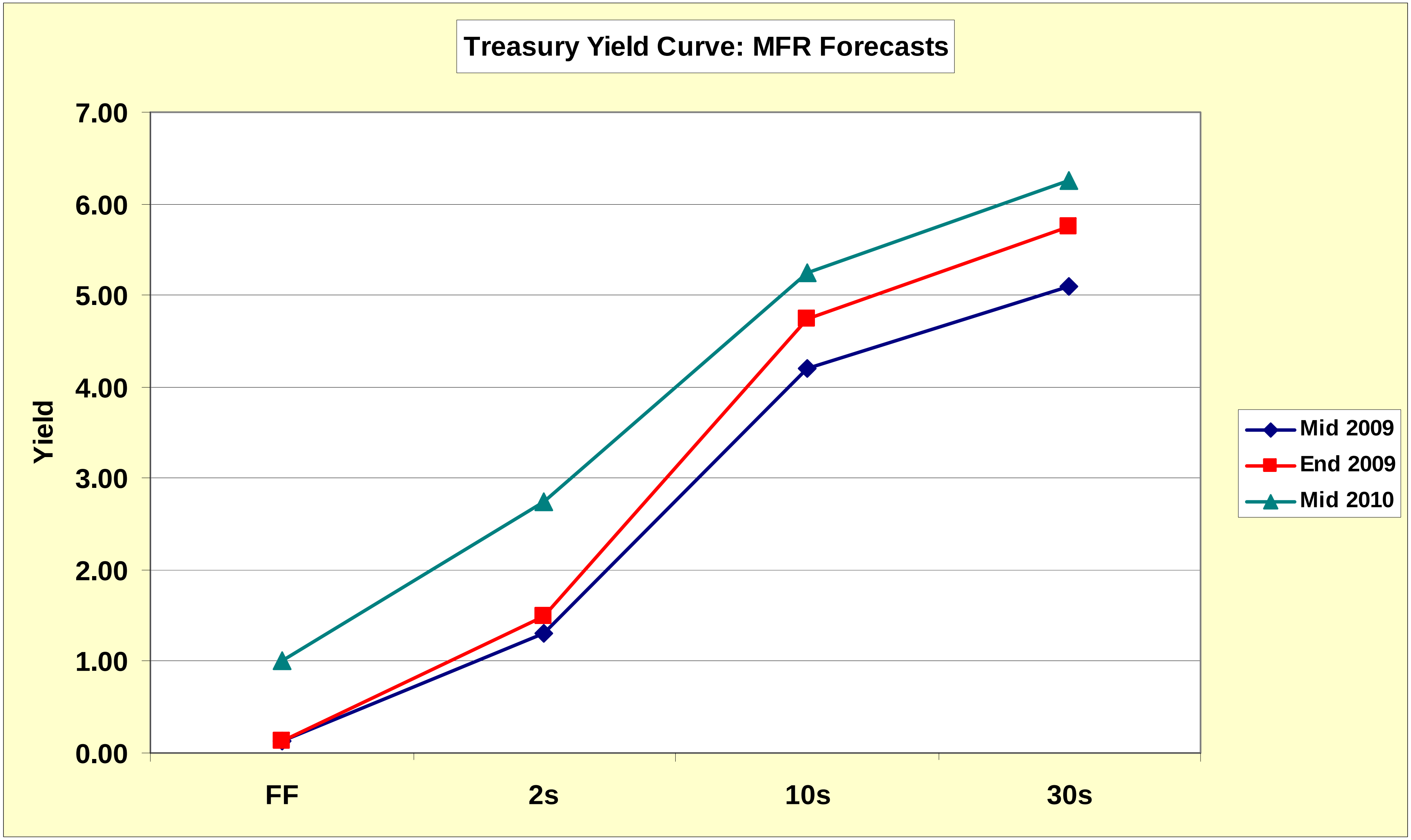
•By way of comparison, the Treasury's financing needs in fiscal 2008 were $975 billion, up from $750 billion in fiscal 2007.

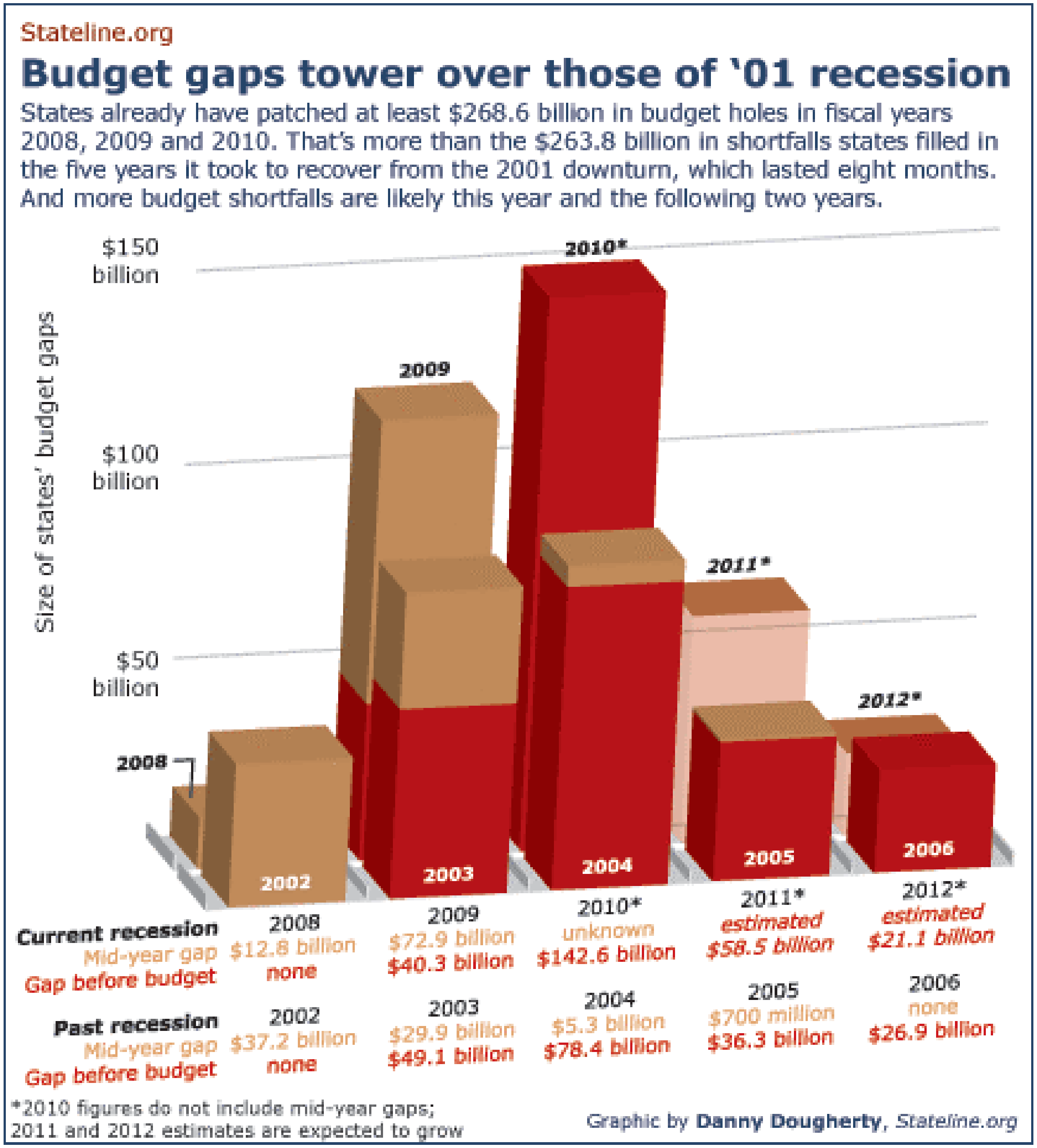
•We believe that the sheer enormity of Treasury supply will push market interest rates higher even as the economic recovery moves ahead at a plodding pace and core disinflation continues. This will be exacerbated by erosion of "flight to safety" demand for Treasuries.

The Treasury's Financing Needs Are Huge



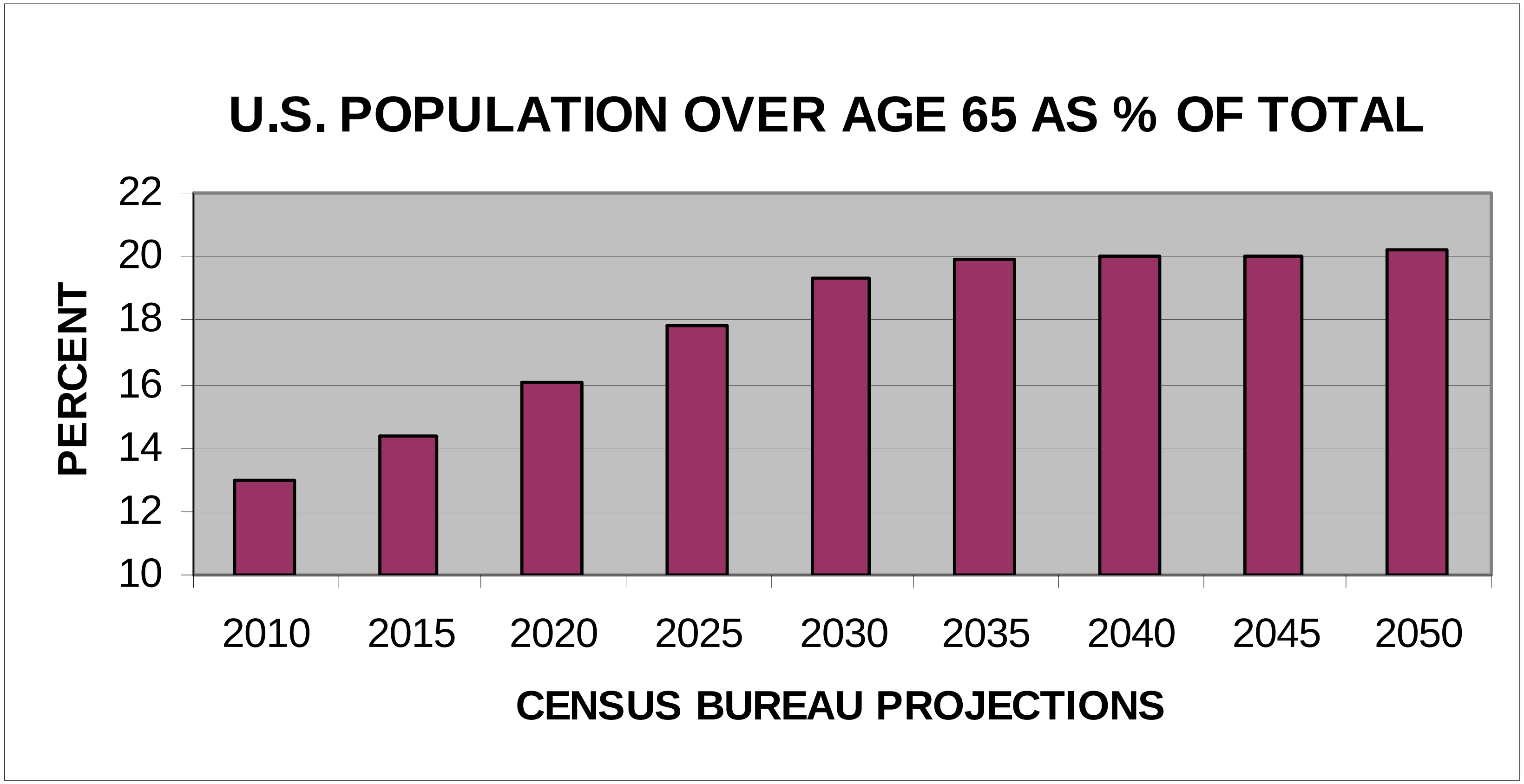
Higher Rates Expected As Supply Weighs Heavily





Source: The National Conference of State Legislatures' "State Budget Update: July 2009"

Aging Population Will Weigh on Tax Revenues & Increase the Burden on Government – A Bad Combination



WRAP-UP

- Inventories were liquidated at a massive $255B annualized pace in the first half of the year. However, now that final demand is no longer plunging, inventory liquidation can likewise moderate.
- Success of the “cash for clunkers” program adds to this dynamic, as automotive output will add significantly to growth in coming months as vehicle inventories are replenished. However, it is important to understand that higher imports will provide a partial offset to the positive impetus from inventories as far as GDP growth is concerned (good news for our trading partners, though).
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- But, with structural problems persisting, we do not believe that an end to declining real GDP is destined to transition into anything resembling a normally robust economic recovery.
- In particular, household balance sheets remain a wreck, and consumer spending is unlikely to grow in a significant, sustained fashion for quite some time.
- With spare capacity copious, we believe that core inflation measures will continue to decelerate in coming quarters.

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WSJ - Most accurate inflation forecast from 2001 to 2004

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