DECISION ECONOMICS, INC.

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DE Business Cycle Indicators

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Decision Economics: *Mixed Messages in Economic Data (Data through 5/7/2012)*

Global Indicators: Page 3

- GDP forecasts for 2012 have stabilized, but risks tilt to the downside on Eurozone anxieties. Global PMI data are cautiously optimistic.

U.S. Consumer: Pages 4-5

- Confidence measures resilient despite higher gas prices.
- Retail and auto sales show modest growth.

Housing Market: Pages 6-7

- Single-family starts and new homes sales remain depressed.
- Recovery continues to be uneven across geographic markets.

Labor Market: Pages 8-9

- In April, the employment report showed only marginal improvement while claims data was persistently elevated. The latest May data suggests some improvement

Business Conditions: Page 10

- ISM readings show growing activity in both manufacturing and non-manufacturing sectors.
- Small business sentiment declined sharply in March on inflation concerns.

Financial Markets: Pages 11-13

- Earnings stronger in Q1, but outlook unchanged for the year.
- Cyclical equity sectors advance. Commodities indices trip on weaker China PMI data.
- Treasuries remain supported by Fed "low for long" pledge while corporate quality spreads trend lower.

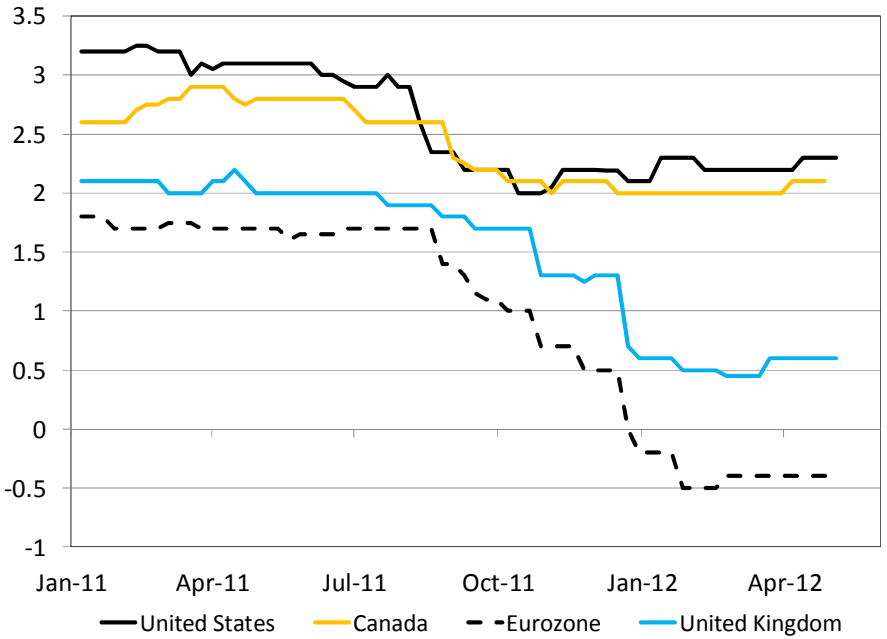
Risks to the Outlook: Page 14

- China PMI data still shows some weakness, although the soft landing scenario seems likely.
- Europe remains the primary risk to the U.S. outlook. Recent political turmoil suggests the "Merkozy" approach of strict austerity may be rejected for more growth-centric measures.

DE Forecast

- **GDP:** 2.5% to 3% for 2012.
- **Unemployment:** Labor market improvement slows; 7.7% at the end of the year.
- **Interest rates:** No change in Fed Funds rate this year. Treasury yields remain depressed on hunt for safe haven assets.
- **Equities:** Strategically bullish with end of 2012 fair market value for the S&P 500 at 1375-1450—up from 1350-1400 in previous DE forecast.

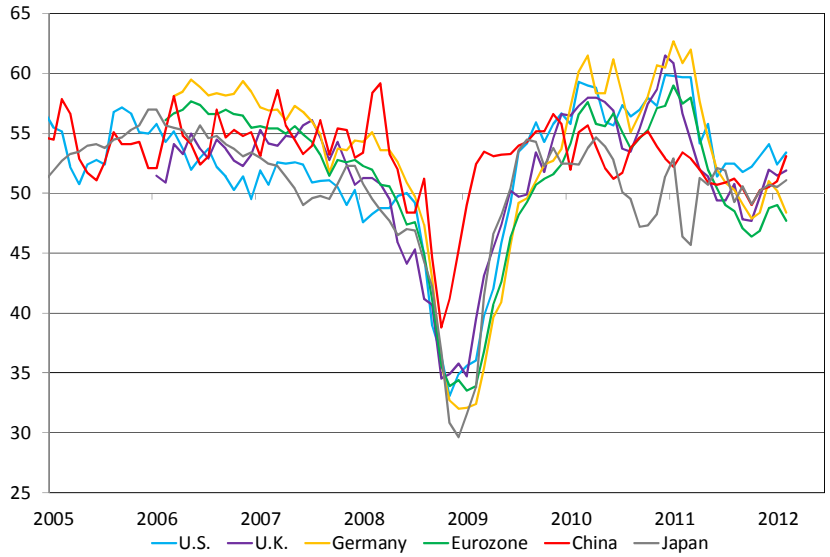
Chart 1: 2012 GDP Forecast, Percent Y/Y



GDP forecasts for 2012 have stabilized, or even improved recently. The Eurozone recession will likely end in Q3. Both the U.S. and Canada have revised growth upwards on European spillover effects which have been lower than anticipated to date.

Political tensions are running high in Europe, as the debate between austerity versus growth-centric reforms intensifies. Current risks towards global GDP remain tilted towards the downside.

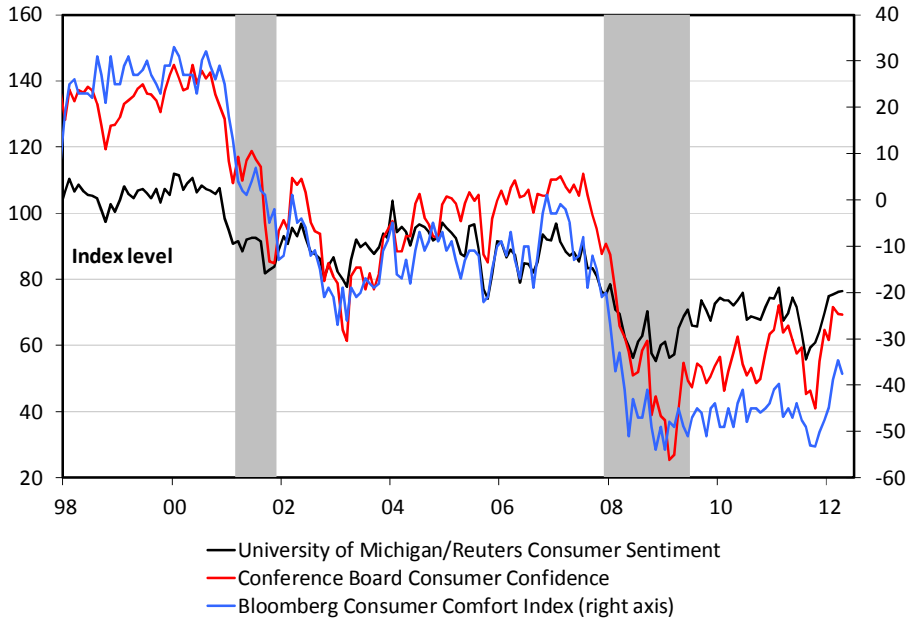
Chart 2: Global Manufacturing PMIs



While German and Eurozone PMIs have shown weakness of late, slipping into the contractionary territory of sub-50 readings, the overall mindset of global manufacturing is cautiously optimistic.

Sources: Bloomberg and Decision Economics, Inc

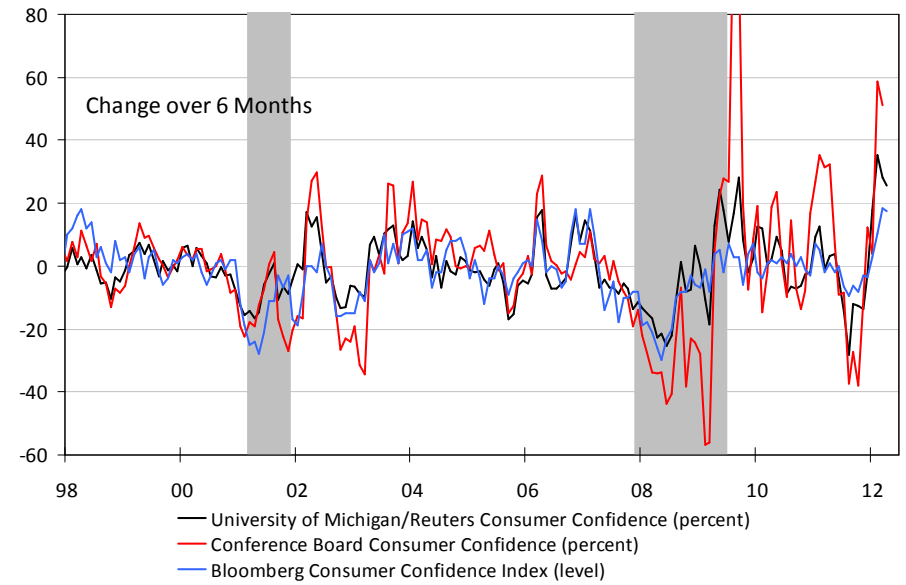
Chart 3: Consumer Sentiment Indices, Levels



Consumer sentiment indices have been more optimistic since late-2011.

However, recent downturns in consumer confidence are likely due to higher gas prices. While oil prices are already moderating off of February highs, geopolitical tension between Israel and Iran remains.

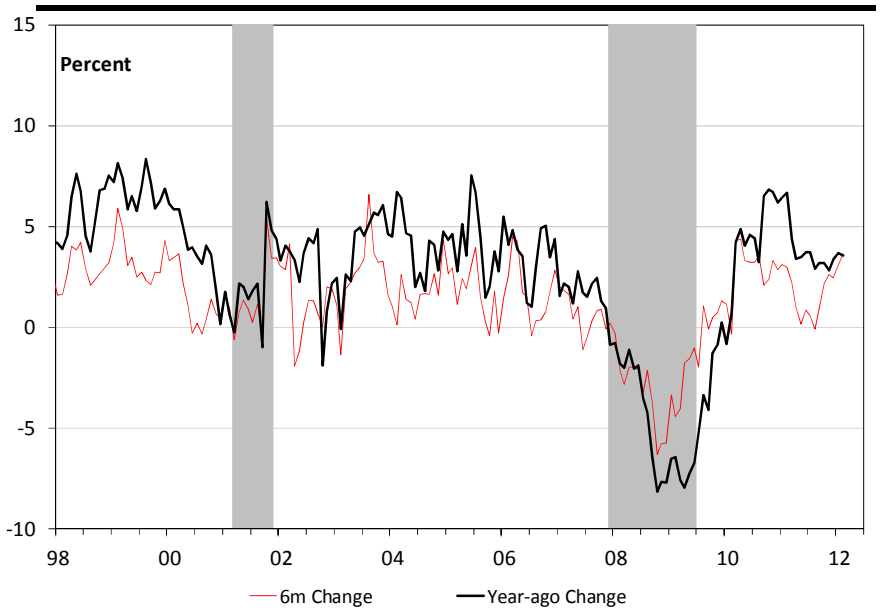
Chart 4: Consumer Sentiment Indices, Changes



Changes, rather than levels, are the better recession indicator. While higher gasoline prices exerted a drag on sentiment of late, both headline indices have still moved in a strongly positive direction in the last six months.

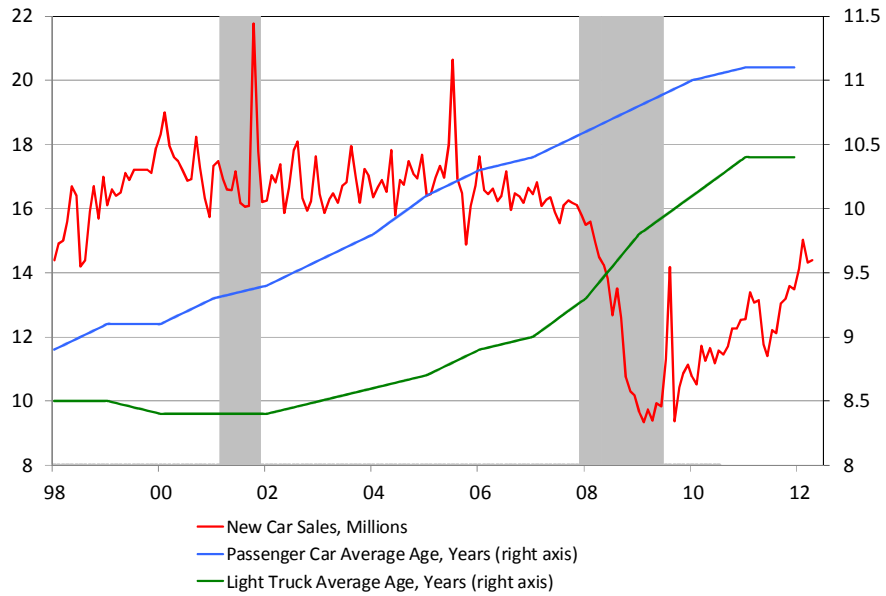
Sources: The Conference Board, University of Michigan/Reuters and Decision Economics

Chart 5: Real Retail Sales



Retail sales continue to grow at a modest rate. However, other consumption indicators show mixed results as households continue to unwind balance sheets.

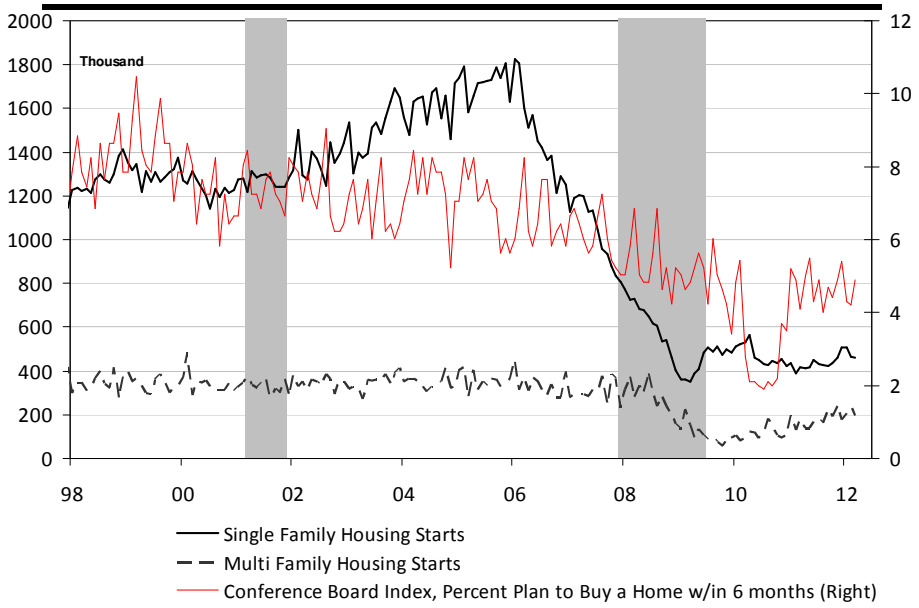
Chart 6: Auto Sales and Average Age of Cars



Auto sales are recovering towards pre-recession levels. Auto sales are a particularly good indicator of consumers' expectations about the economic outlook, as households tend to hold on major purchases during recessions. The average age of cars on the road in the U.S. reached a historic high in 2011, but it appears that this pent up demand is being released. Big 3 companies are reporting robust sales to start 2012.

Sources: BEA and Decision Economics, Inc

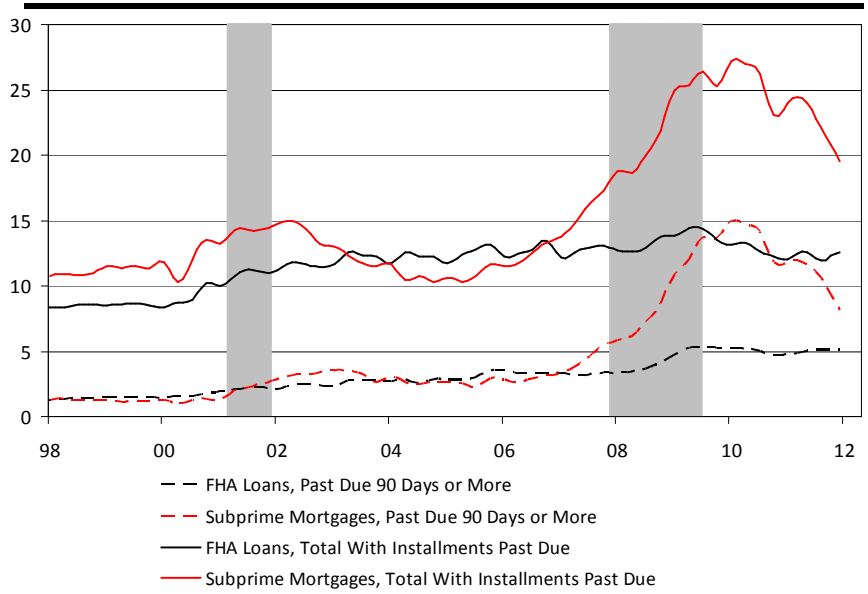
Chart 7: Housing Starts and Home Buying Plans



Single family housing starts remain particularly depressed, while multi-family starts have had a more robust recovery. Although the percent of households looking to buy has increased, the market is already flooded with the inventory from existing homes. This "shadow inventory" will likely have to diminish before single family starts recover.

Better job growth, particularly among younger cohorts, should help to build household formation and clear inventories.

Chart 8: Distressed Mortgages, Percent of Total

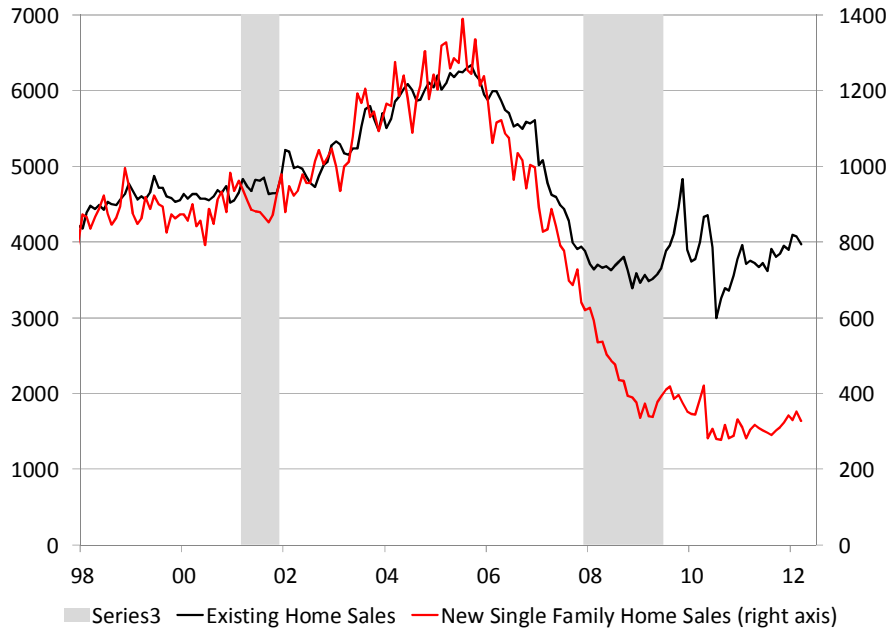


While the proportion of mortgages which are distressed has declined from 2010 highs, it remains elevated relative to pre-crisis levels. This trend is exacerbated among sub-prime mortgages.

On the whole some progress has been made in healing the market, but it still has a long way to go.

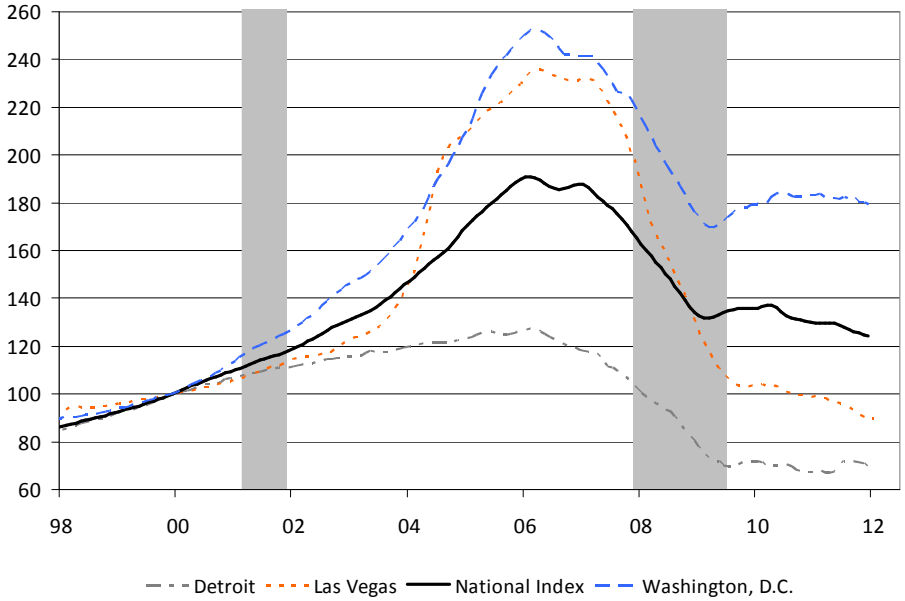
Sources: Census Bureau, National Association of Realtors, and the Mortgage Bankers Association

Chart 9: New and Existing Home Sales



New single family homes enjoyed a 20% market share relative to existing homes pre-crisis, but only have a 7% share currently. This excess inventory of existing single family homes is one of the key factors depressing home prices and housing market activity.

Chart 10: Case-Shiller Home Price Index (2000=100)



Housing markets weathered the bubble and the aftermath differently. Rust belt markets like Detroit experienced a muted bubble, while sun belt markets like Las Vegas were torpedoed by sub-prime lending. The headline index shows no real improvement from the nadir of the crisis. For this reason, some FOMC doves will continue to push for Fed purchases of MBS if additional monetary stimulus becomes necessary.

Any forthcoming housing policy measures will grapple with the issue of how to help particularly troubled markets without re-inflating others.

Sources: Bloomberg, Merrill Lynch, and Decision Economics, Inc

Chart 11: Payroll Survey and Long-Term Unemployment

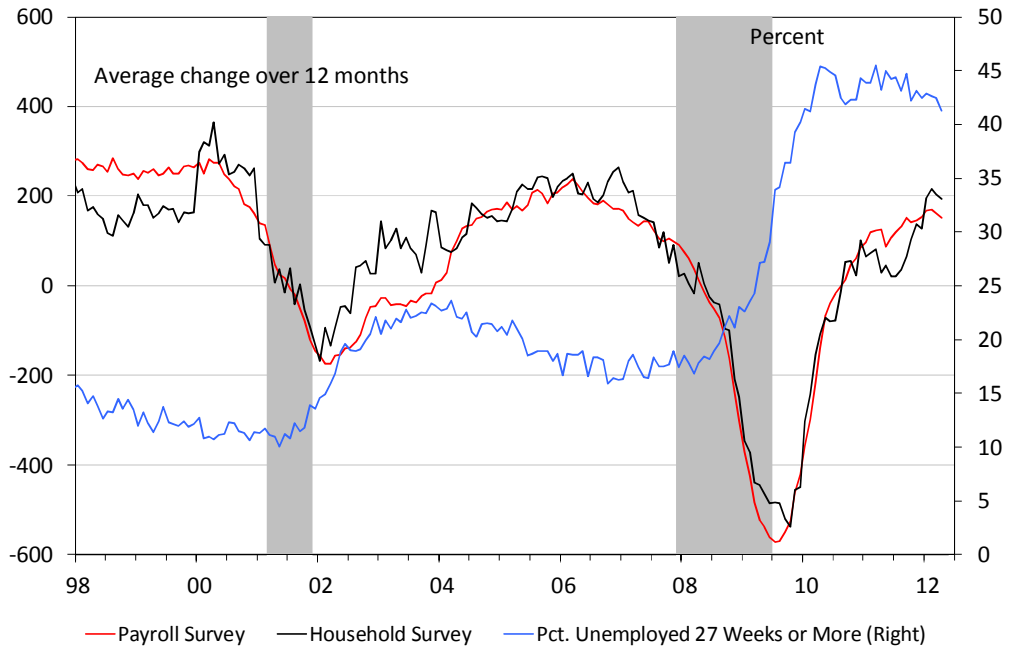
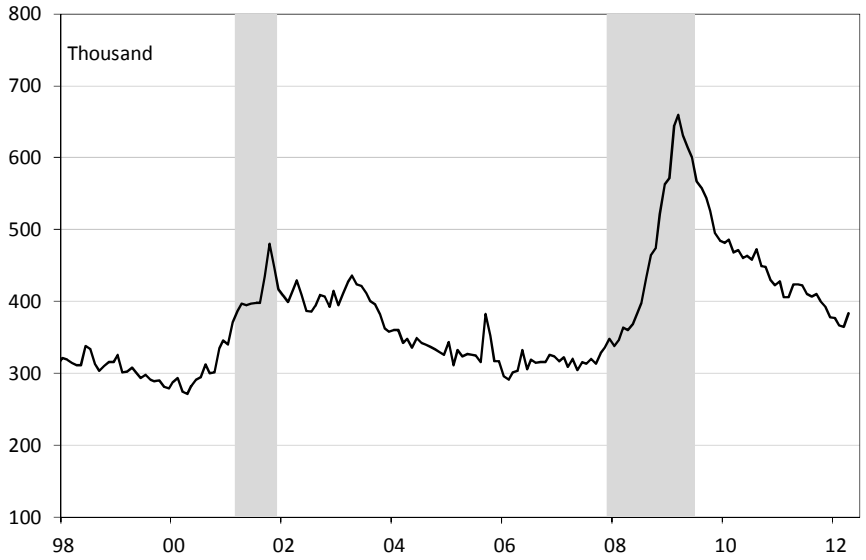


Chart 12: Initial Claims



Sources: BLS and Decision Economics, Inc.

The labor market continues to add jobs however, improvement in the BLS Payroll Survey has decelerated of late—averaging +130K in payroll employment in March and April versus +250K in the three prior months. Bernanke continues to doubt whether domestic demand has improved enough to sustain early 2012 employment data.

Long-term unemployment remains disturbingly high, and the risk is that these workers become marginally attached to the labor force or discouraged.

Initial claims continues to edge lower, in general, in 2012. Weekly data can be noisy with weather, holidays, and ends of quarters sometimes dominating the general trends.

While claims have trended towards the "normal" range seen in economic expansions, April claims data showed a stubborn upward shift to the high 380s (although the most recent claims print was an improvement at 365K). Markets will watch whether this shift is simply a temporary level shift or a more disquieting freshly increasing trend.

Chart 13: Flows Within Private Payrolls, In Thousands

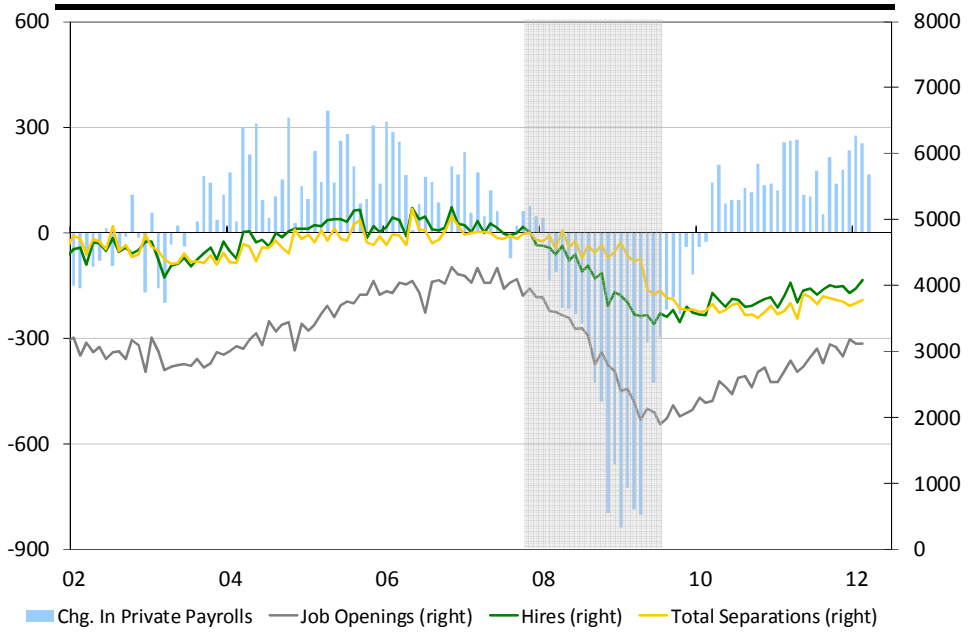
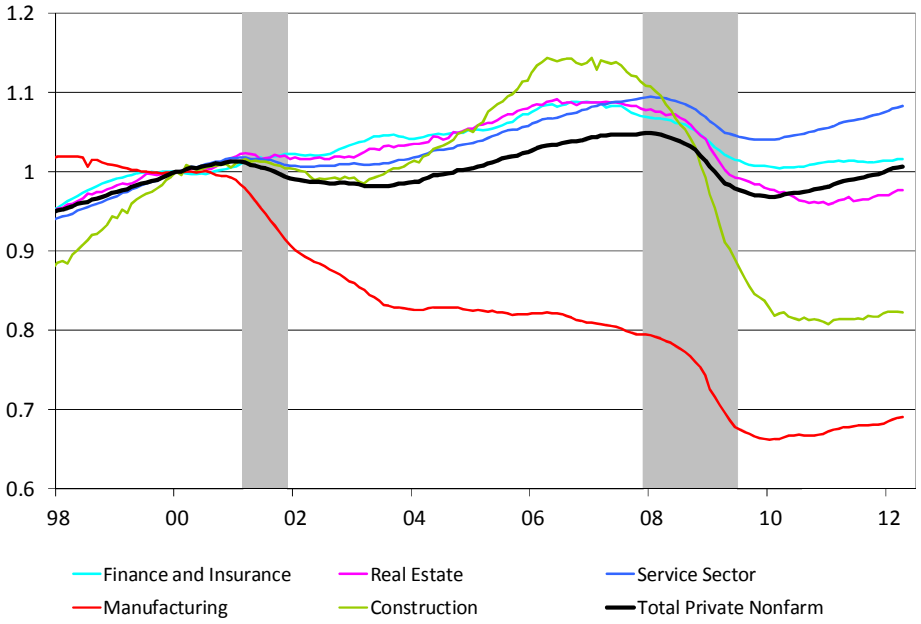


Chart 13 shows BLS data on job openings and labor turnover in the private sector (JOLTS survey), versus the change in private payrolls from the closely-watched employment report. Given levels of employment changes are occurring at lower absolute levels of flows, increased demand for workers will be magnified in month-on-month changes.

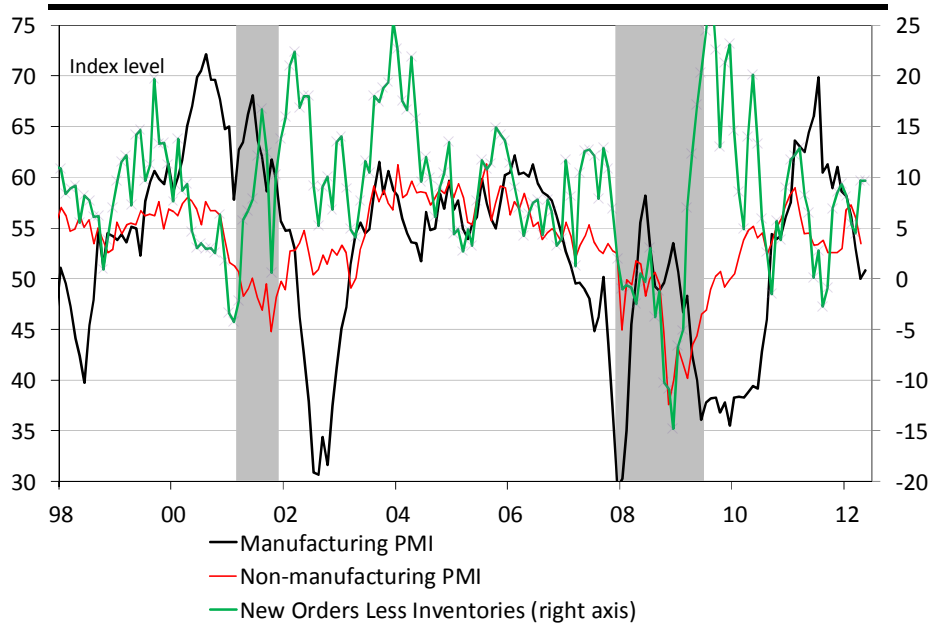
Chart 14: Number of Employees in Selected Industries (2000=1)



Employment trends point to a stronger service sector and weaker manufacturing sector since 2000. The recession only served to magnify such effects.

Sources: BLS, IHS Global Insight, and Decision Economics, Inc

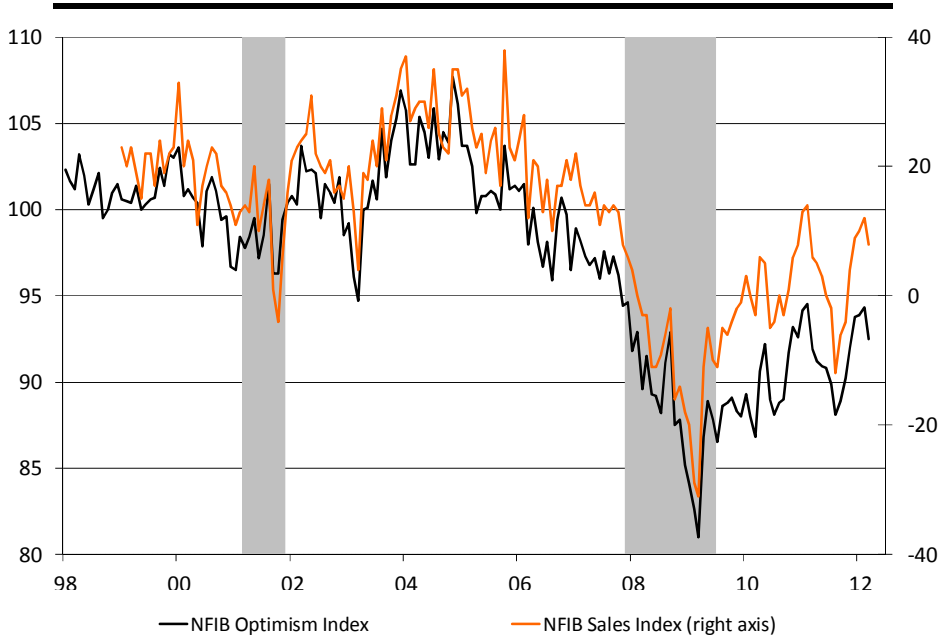
Chart 15: ISM Surveys



Both the service sector and manufacturing PMIs have continued to slide through 2012. Each of the indices remains in expansion territory, although recent activity in the manufacturing sector is significantly more fragile.

The New Orders index less the Inventories index is a leading indicator, with values over zero signaling expected expansion. This measure has been cautiously optimistic of late, as businesses may be wary of getting burned by another false start like 2011.

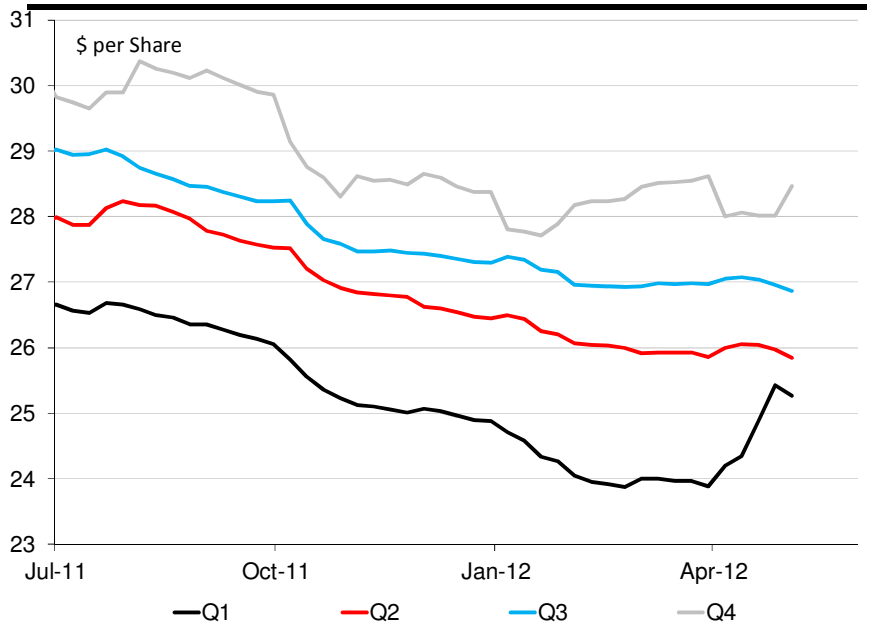
Chart 16: NFIB Small Business Survey



Small business sentiment declined in March after six months of increases. Nine of the ten components of the headline Optimism Index fell, as business owners feel uncertain on the outlook. Inflation was cited as the primary concern. Look for some snapback as oil prices ease.

Sources: Institute for Supply Management and NFIB

Chart 17: Estimated 2012 Earnings Per Share by Quarter, S&P 500



A major takeaway from the Q1 earnings season was that despite the hockey-stick surge in Q1 estimates (black line), analysts did not see enough to boost earnings projections for the rest of 2012.

Europe? Again? Despite DE's strategically bullish stance toward the equity market, we recognize near term price action may very well see markets reflecting higher odds of downside risk scenarios, given the news flow out of Europe.

Chart 18: Discretionary vs. Staples and Private Payrolls

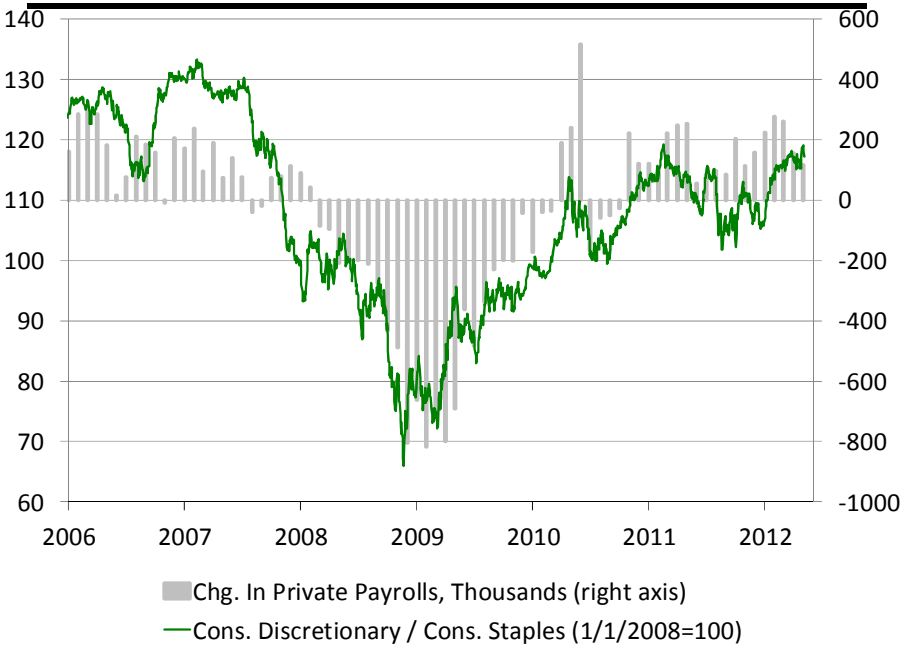
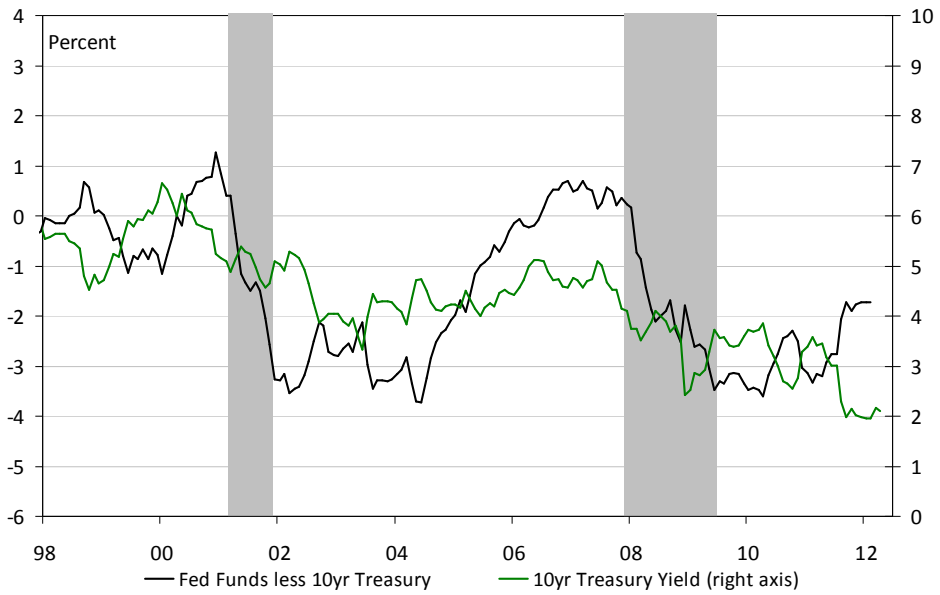


Chart 18 hints that firmer payroll growth could help consumer discretionary sector performance relative to consumer staples. Other more cyclical Sectors (FINL, INFT) have also outperformed the market in the last three months, which suggests that the U.S. economy is entrenched in the expansion phase of the business cycle.

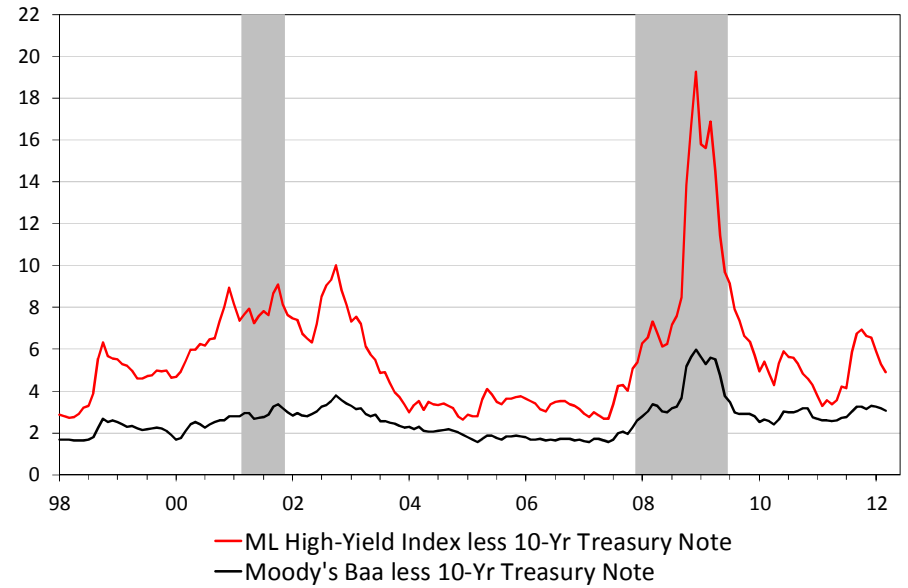
Sources: Standard and Poors, BLS, and Decision Economics, Inc

Chart 19: Treasuries Supported by "Low for Long" Pledge



Fed not taking rates higher anytime soon, keeping curve flat. "Low for long" means that rates may not increase until 2013. The current dovish composition of FOMC voters will leave quantitative easing on the table, especially as a weaker March employment report and higher initial claims in April cast doubt upon the health of the labor market. FOMC hawks, mostly relegated to the sidelines for 2012, will continue to push for withdrawal of monetary stimulus especially in the face of a firmer inflation profile.

Chart 20: Corporate Quality Spreads (Percent)

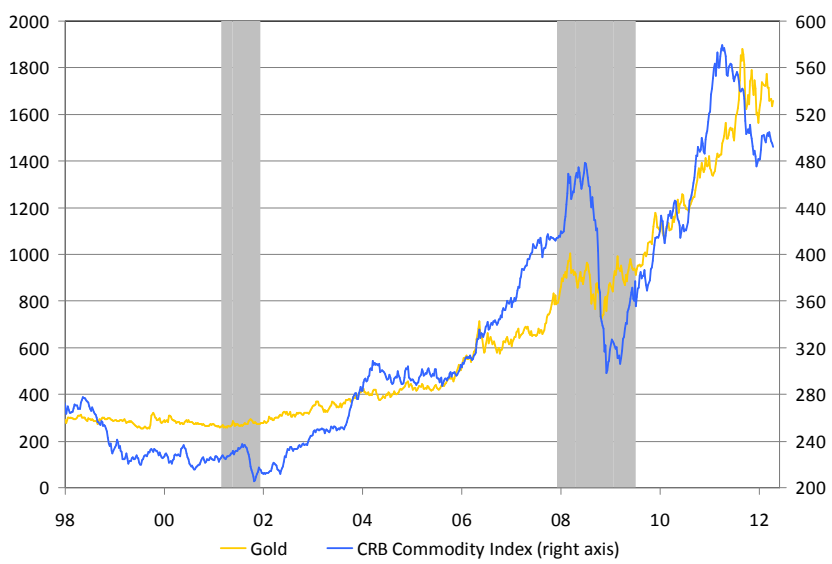


Corporate quality spreads have come down markedly from recession highs.

Mid-grade bonds are trading in the normal range in terms of premiums over Treasuries. The still-elevated premium for high yield bonds suggests lingering anxieties.

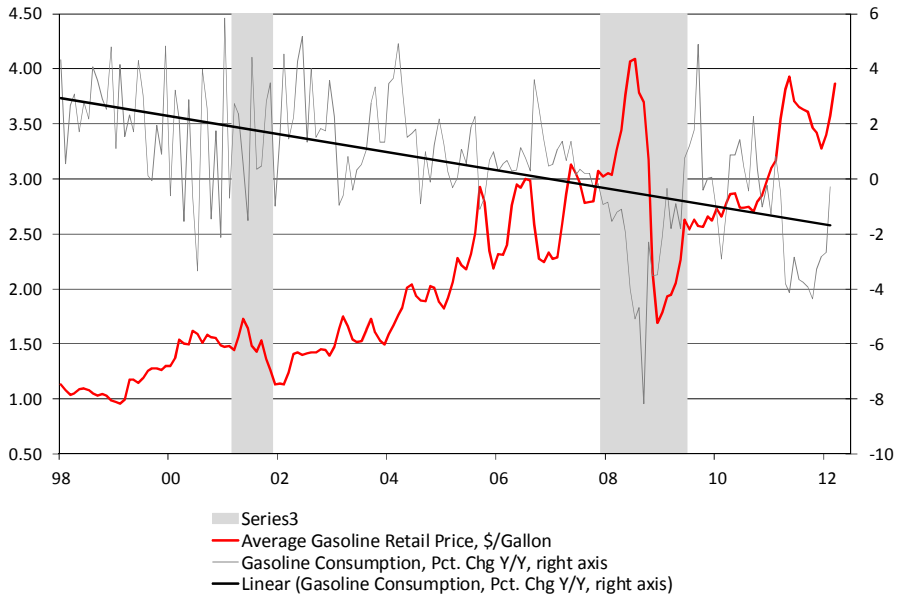
Sources: Federal Reserve, Bloomberg, and Decision Economics, Inc.

Chart 21: CRB Commodity Index, Gold Price



Broad commodity indices slip a bit on weaker PMI data and decelerating growth forecasts for China. Gold recovered on comments that the Fed is willing to allow inflation over 2% in the short term to help the labor market.

Chart 22: Average Regular Unleaded Gasoline Price ($/Gal.)



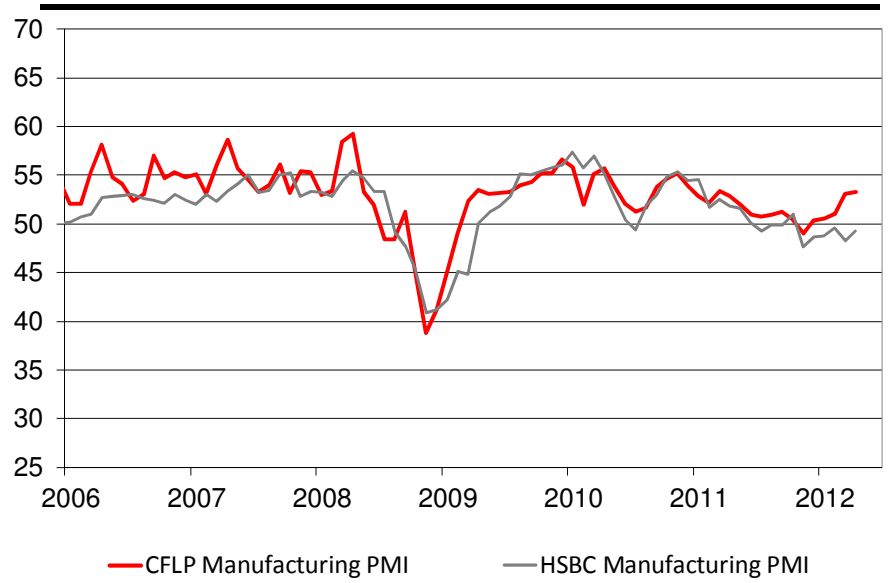
After mild weather and excess inventories had depressed prices in Q4, growing concerns over (and sanctions from) Iran pushed up gasoline prices.

Consumers have compensated for rising gas prices by reducing gas consumption, holding energy expenditures around 6% of total household expenditures. Better fuel efficiency and consumer preferences have both contributed.

Prices have eased somewhat in April, but still remain high relative to recent history.

Sources: CRB, Bloomberg, and Decision Economics, Inc.

Chart 23: China PMIs Recover

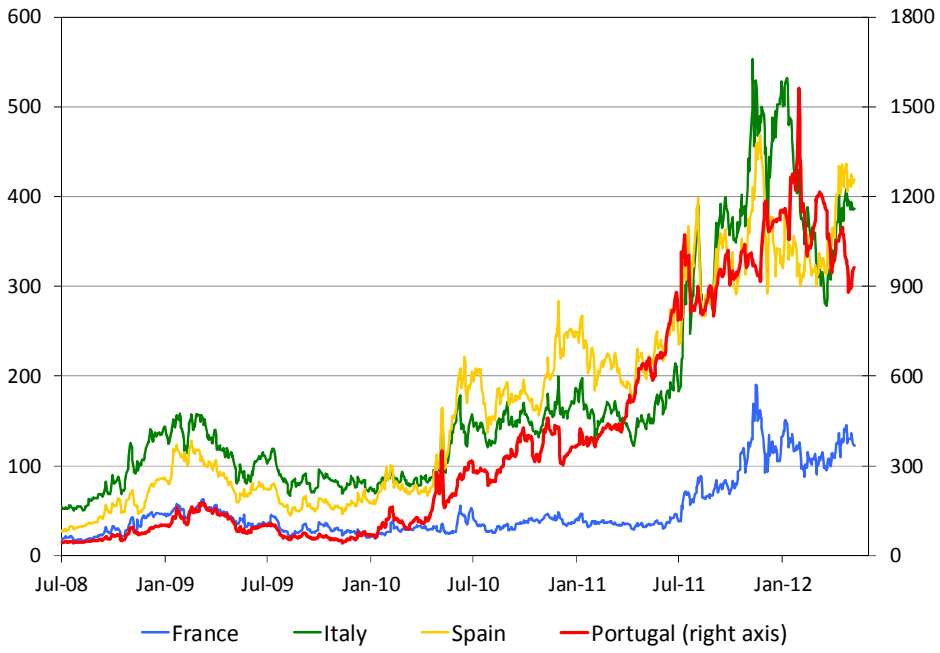


The Chinese government releases its official Manufacturing PMI, while HSBC has a similar independent indicator. The official PMI tends to be more optimistic and currently is in the expansion zone, while the HSBC indicator suggests contracting manufacturing activity.

As these indices tend to come together over time, it will be worth noting if the convergence is in the plus- or sub-50 area.

The DE forecast for a soft landing scenario in China and other emerging markets is still the most likely outcome.

Chart 24: 10yr Spread to German Bund, Weekly (bps)



Sovereign spreads have risen of late, amid political turmoil. Socialist candidate Hollande defeated Sarkozy in France, while Greek voters flocked to anti-austerity parties in the parliamentary elections.

High debt levels make debt sustainability a delicate balancing act. Spain budget deficits have led to growth-crippling austerity measures. Expect Hollande to balance Merkel and to advocate growth-centric measures rather than austerity to resolve the debt crisis.

Sources: HSBC, CFLP, Bloomberg, and Decision Economics, Inc.