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DE Business Cycle Indicators

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Global Indicators: Pages 3-4

- GDP focus shifts to 2013. More of the same for the U.S. and Canada, better in the EU. Global PMI data generally on the upswing but still below 50.
- Periphery spreads in the Eurozone have narrowed on optimism of the new backstop program, the OMT.

U.S. Consumer: Pages 5-6

- Confidence measures rising on more optimistic economic outlook, as higher gas prices keep coincident indices down.
- Retail sales show a weaker consumer, while auto sales remain a bright spot.

Housing Market: Pages 7-9

- The Case-Shiller index has turned positive, and the months supply of homes on the market is approaching pre-crisis levels.
- The housing market appears to be recovering, supporting the DE bullish view on the housing sector over the next 18 months.
- Shadow inventory a concern going forward.

Labor Market: Pages 10-11

- Non-farm payrolls were better in Q3 with a 145K average after a Q2 which averaged a measly +67K. But the pace of hiring has slowed over the quarter as the economy approaches the Election and Fiscal Cliff.
- The unemployment rate is finally below 8%, at 7.8% in October. However, that result is partly attributable to low labor force participation. How much of low LFP is structural versus cyclical?
- Hours and wage growth more supportive of a robust consumer in September.

Business Conditions: Page 12

- Both ISM surveys looked stronger in September.
- Small business sentiment and hiring lag as those firms cut costs in current uncertain environment.

Inflation Measures: Page 13

- Inflation running behind 2% target, Fed behind on both sides of the dual mandate.
- Year-ahead expectations are elevated on higher gas prices. But industrial indicators suggest well-anchored inflation.

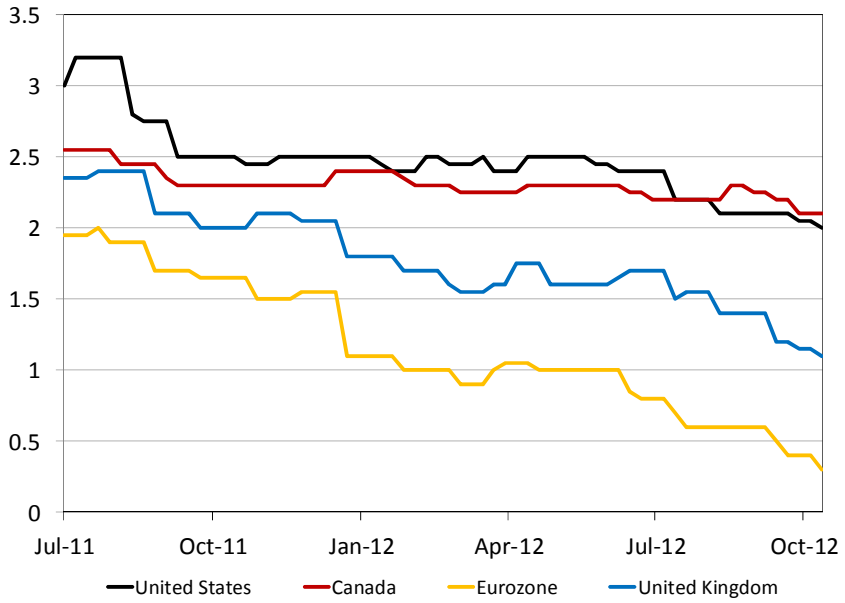
Financial Markets: Pages 14-16

- Earnings forecasts for 2012 tack lower on softer growth forecasts both here and abroad, better projections for 2013 and 2014.
- Treasuries remain supported by Fed "low for long" pledge while corporate spreads uptick on risk-off attitude.
- Gold surges as "store-of-value" commodity, while the recent drought pushed up agricultural commodities.

DE Forecast

- **GDP:** Less than 2% 2012, down from 2.5%. Fiscal consolidation a drag in 2013—growth close to 2% again.
- **Unemployment:** Despite stronger September reading of 7.8%, still close to 8% at the end of the year. 7.1% by end of 2013 as Fiscal Cliff mostly avoided and QE3 takes hold.
- **Interest rates:** Fed lower and longer than ever with QE Unlimited and forward guidance extending into 2015. Global tilt towards easing.
- **Equities:** Strategically bullish with DE's fair market value estimate for the S&P 500 at 1500 or a bit above. EPS revised lower to $110 in 2013 from $113 on weaker revenues, particularly in Europe.

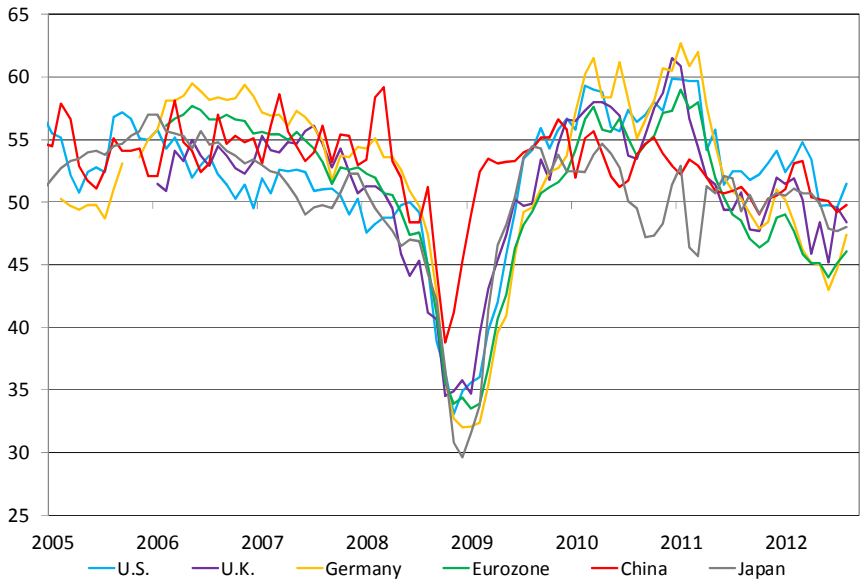
Chart 1: 2013 GDP Forecast, Percent Y/Y



As GDP forecasts for 2012 steady out with the U.S. and Canada close to 2% and the UK and Eurozone around -0.5%, we shift our attention to 2013.

Canada expectations have remained relatively steady while U.S. and EU forecasts have deteriorated. The Eurozone recession may be sharper or more persistent than expected—although forecasts call for mild growth next year—and it is dragging the UK with it. Fiscal restraint a factor for the U.S., as well as continued spillover effects from Europe.

Chart 2: Global Manufacturing PMIs

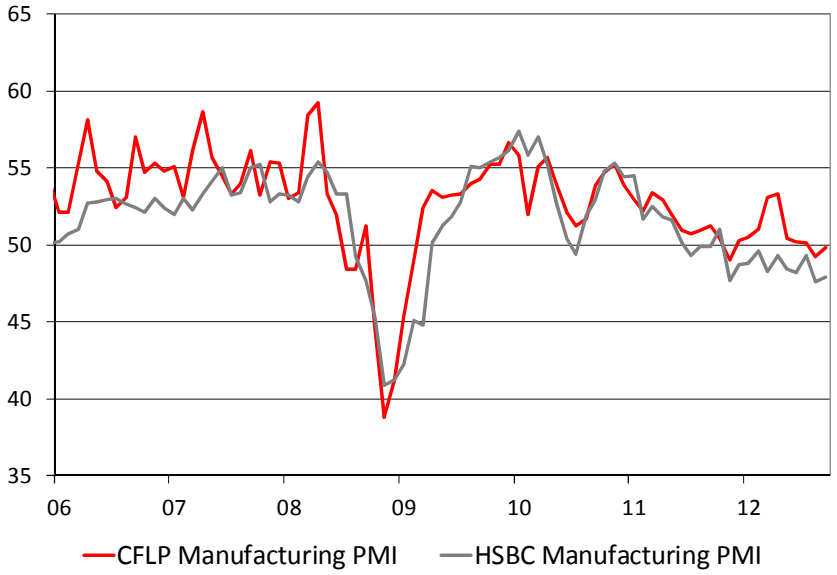


PMI readings largely rebounded in September—particularly in the U.S.. However, most major countries are still below 50. On the bright side, activity in Europe is stronger than the PMI readings would suggest as industrial production numbers have been largely upbeat.

While the Presidential Election and potential Fiscal Cliff impact the U.S., China is facing a once-per-decade leadership change in November. Meanwhile, 85% of Europe is contracting and Spain has so far resisted the ECB bailout. Uncertainty is still the name of the game.

Sources: Bloomberg and Decision Economics, Inc.

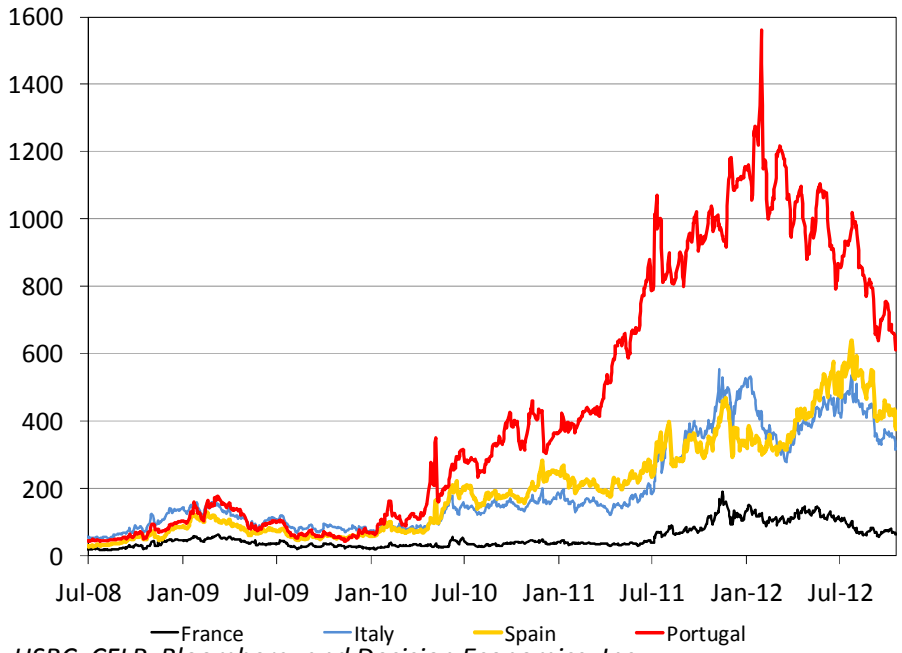
Chart 3: China Manufacturing PMI



The Chinese government releases its official Manufacturing PMI, while HSBC has a similar independent indicator. The official PMI tends to be optimistic and has hovered near 50. The HSBC indicator suggests contracting manufacturing activity, as it has over the past eleven months.

The DE forecast for a soft landing scenario in China and other emerging markets is still the most likely outcome. However, with GDP growth forecasts trimmed from 8.8% to 7.7% for 2012 over the past year, the soft landing will likely be firmer than initially anticipated.

Chart 4: 10yr Spread to German Bund, Weekly (bps)



Sovereign spreads have eased somewhat on recent OMT optimism. However, lower spreads make it less likely for countries to seek bailout funds as debt service costs fall—particularly as any additional austerity requirements imposed by the ECB may be construed as an attack on sovereignty.

Going forward, will Spain refuse the bailout, postpone reforms, and prolong the uncertainty—further irritating the already unyielding Bundesbank? Or will Rajoy go forward with austerity measures, likely exacerbating the Spanish recession and then have to face the wrath of voters?

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

Chart 5: Consumer Sentiment Indices, Levels

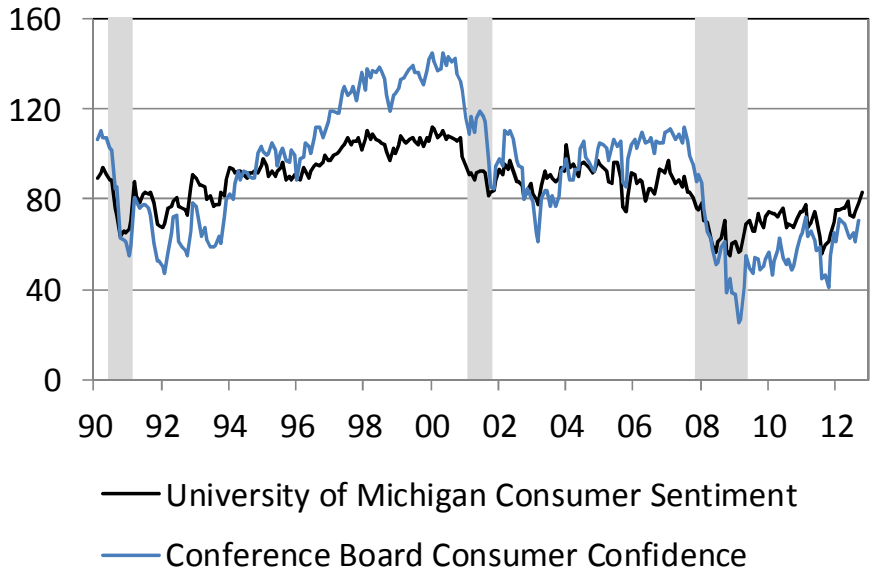
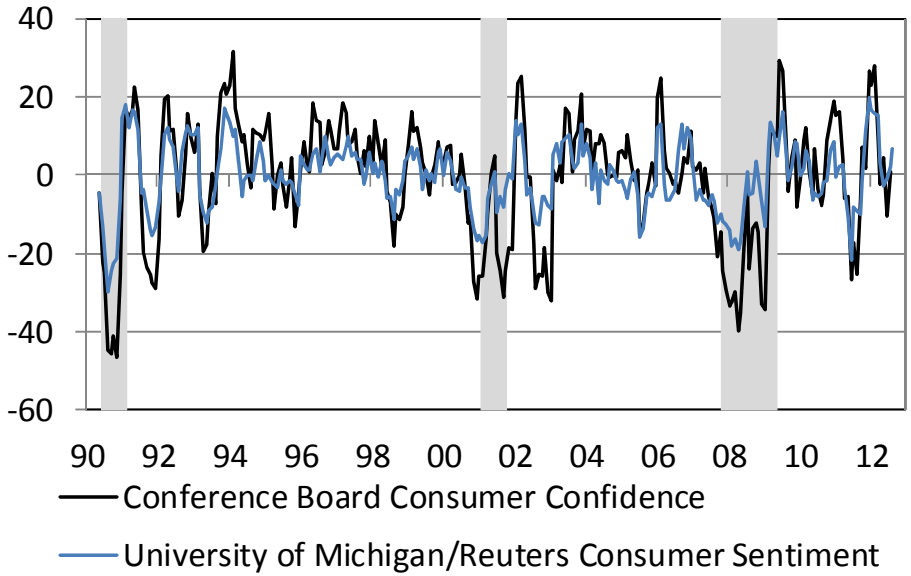


Chart 6: Consumer Sentiment Indices, 6 month Change



Consumer sentiment indices have taken a more positive tone recently, with the Conference Board and University of Michigan indices posting nine and four point respective gains in September. The preliminary October results for University of Michigan showed a 4.8 point rise.

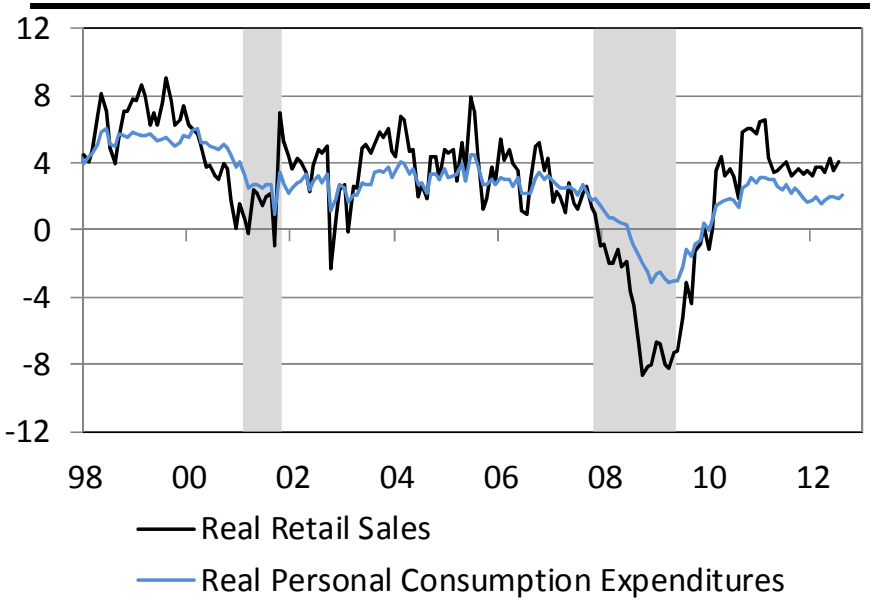
While rising gas prices are keeping a lid on the coincident indices, consumers feel much more optimistic about the future. The forward-looking components of the two confidence measures each posted strong increases last month.

With the Presidential Election less than three weeks away, consumer sentiment readings are especially interesting. No presidential incumbent has ever won re-election when the University of Michigan index is below 75—currently, it sits at 83.1.

Changes in sentiment, rather than levels, are the better recession indicator. Each of the indices is currently barely hovering in positive territory, reflecting the general atmosphere of uncertainty that consumers have faced in the past six months.

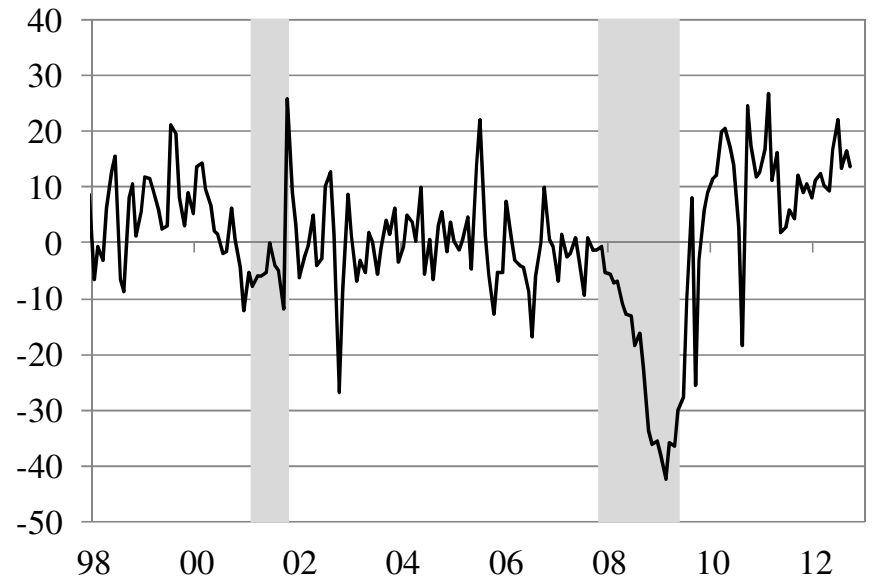
Sources: The Conference Board, University of Michigan/Reuters and Decision Economics, Inc.

Chart 7: Real Retail Sales and PCE, Percent Y/Y



So goes the consumer goes the U.S. economy…in which case, steady but unexceptional. Retail sales are more volatile than consumption expenditures which tend to track rather closely to GDP. Retail spending has looked stronger in recent months; however, in year-on-year terms spending is just barely on par with pre-recession averages.

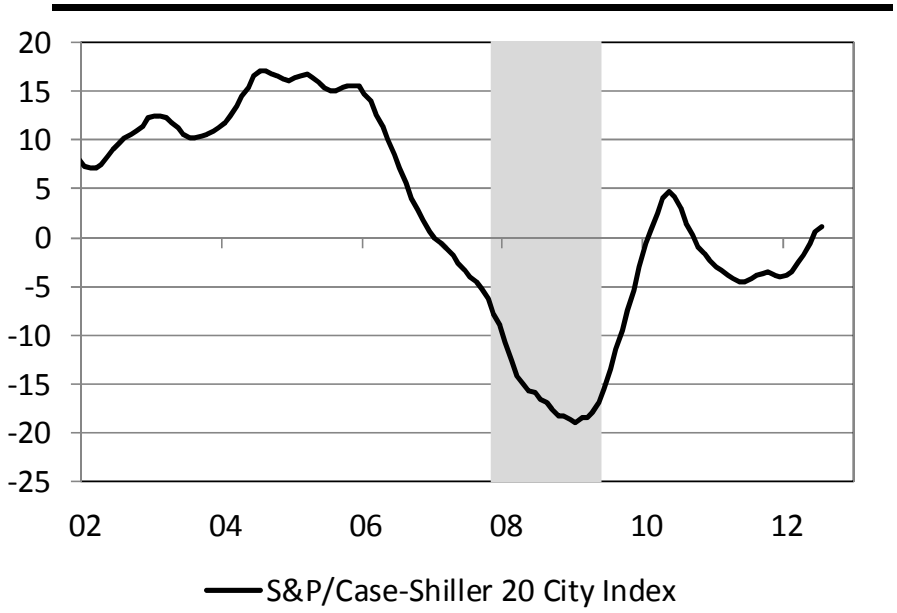
Chart 8: Auto Sales, Units, Percent Y/Y



On a more upbeat note, auto sales have recovered nicely as pent up demand is being released. The Big 3 are reporting strong sales to date in 2012.

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

Chart 9: S&P/Case-Shiller, Percent Y/Y



In year-over-year terms, the Case-Shiller 20 City composite has finally crept into positive territory. This supports the DE bullish viewpoint on housing over the next eighteen months.

Chart 10: Case-Shiller, Percent Y/Y, and Existing Inventories

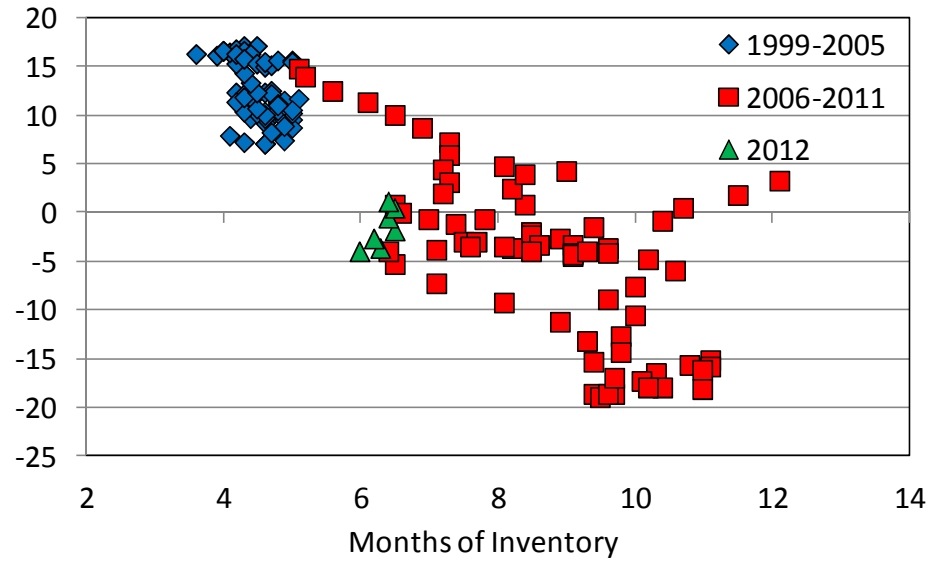


Chart 10 shows how closely inventories and prices move together. The housing market is making progress, albeit quite gradually, towards the pre-bubble equilibrium represented by the blue diamonds.

The issue going forward is the magnitude of shadow inventory remaining—bank balance sheets put the figure at $40 billion. As prices increase, banks with real estate holdings and overstretched homeowners have greater incentive to sell. Any sudden influx of inventory would definitely have a negative price effect.

Sources: Case-Shiller, the Census Bureau, and Decision Economics, Inc.

Chart 11: Single and Multi Family Starts

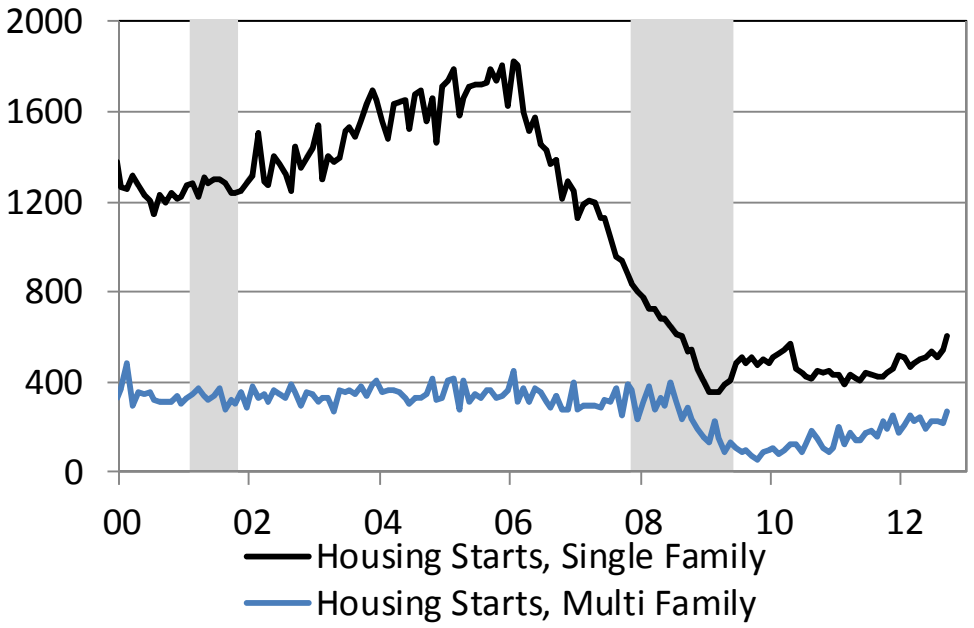
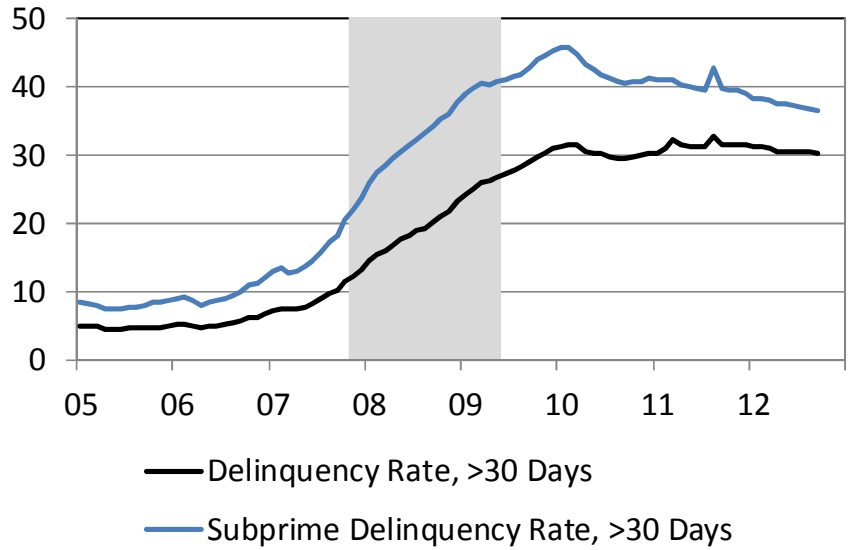


Chart 12: Delinquency Rates



Builders have sharply curtailed activity over the past three years as foreclosed properties saturated the market, creating a shadow inventory which helped to depress prices. With prices rebounding, will activity pick up?

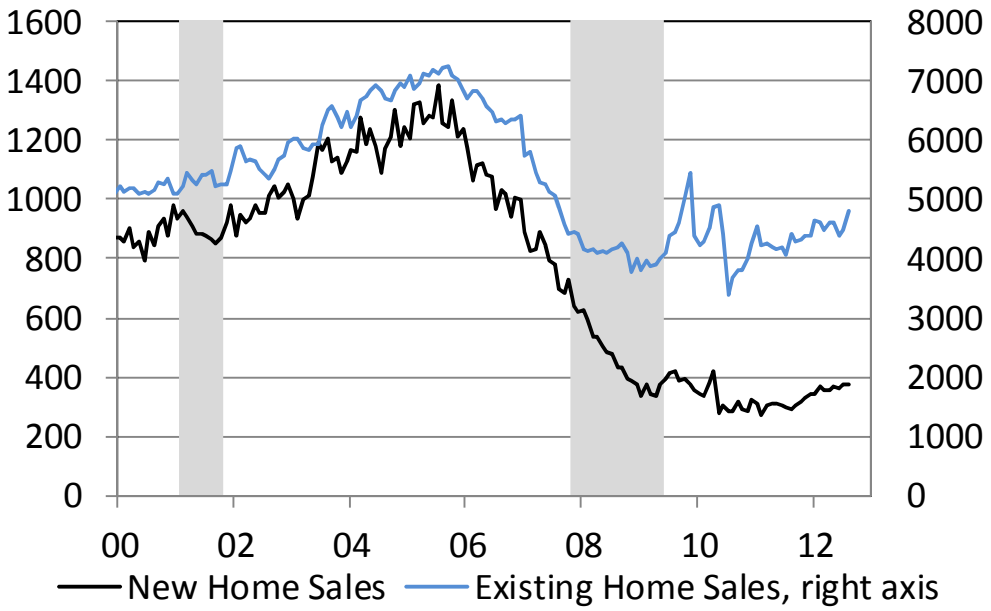
September data showed a large increase in the pace of starts, with single and multi-family units rising a respective 10% m/m and 25% m/m to levels not seen since July 2008.

Again, the issue going forward concerns shadow inventory. Will it weigh on activity? Or are these distressed properties largely undesirable to potential homebuyers either in terms of location or quality? If so, starts may rebound quite strongly?

On the other hand, mortgage delinquencies still remain worryingly high, having barely edged downward since the height of the crisis.

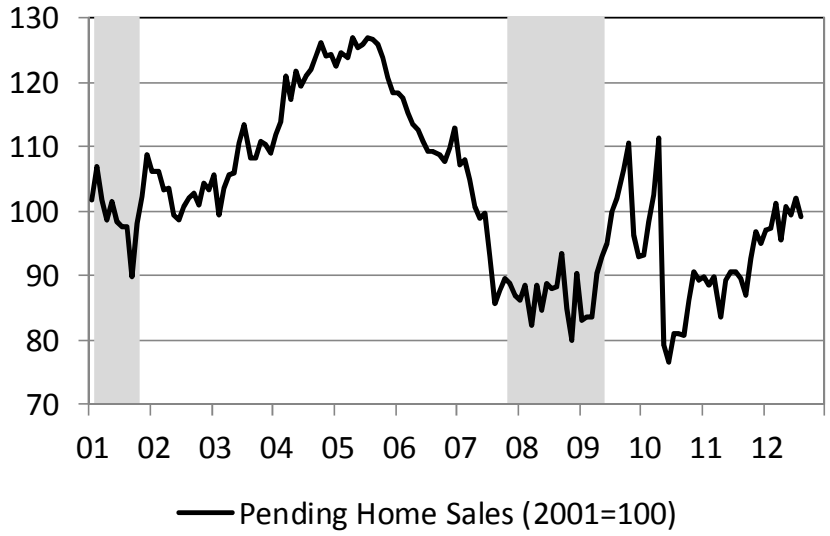
Sources: U.S. Census Bureau and American Bankers Association

Chart 13: New and Existing Home Sales, Thousands



New single family homes enjoyed a 20% market share relative to existing homes pre-crisis, but only have a 8% share currently. Both new and existing homes sales are experiencing a gentle recovery; however, new home sales will be slower than their pre-crisis pace for many years.

Chart 14: Pending Home Sales



Pending home sales, a leading indicator for existing home sales, are also on the upswing.

Sources: U.S. Census Bureau. National Association of Realtors, and Decision Economics, Inc.

Chart 15: Nonfarm Payrolls and GDP

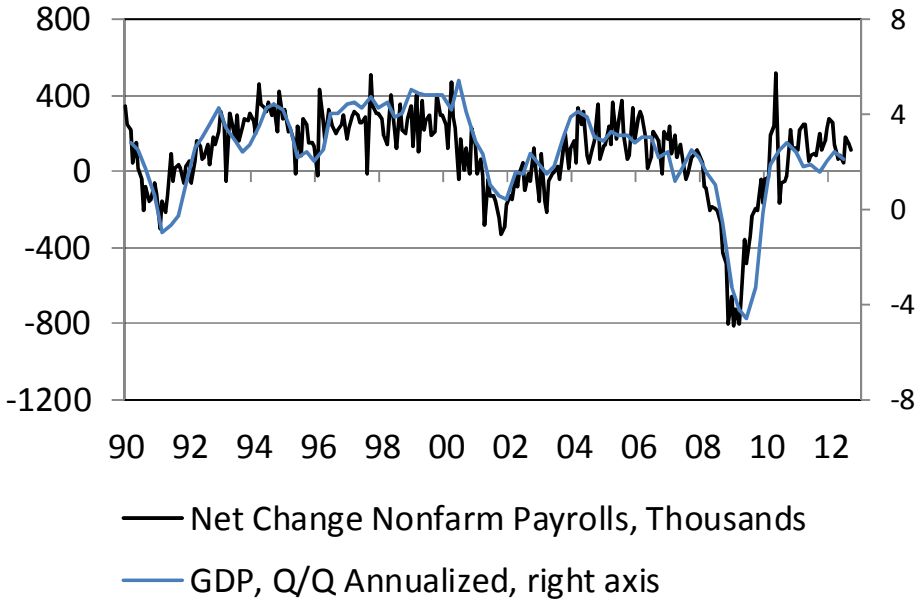
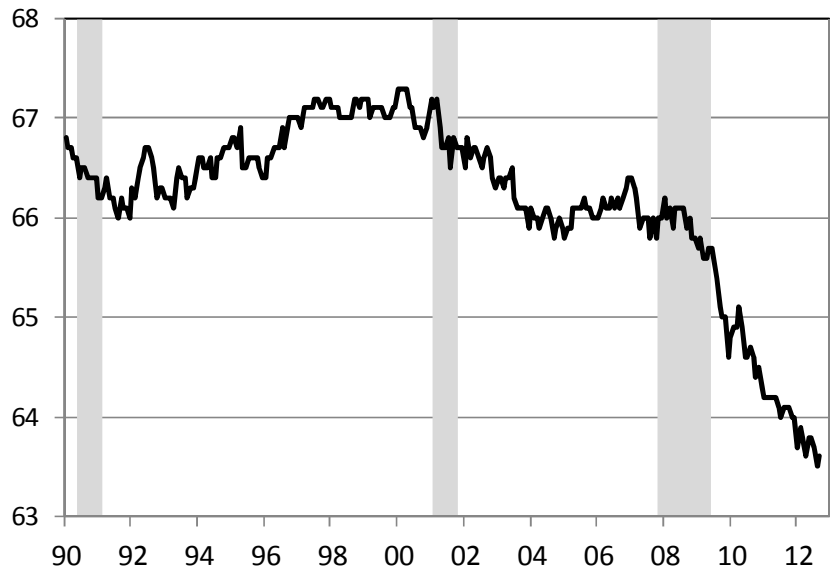


Chart 16: Labor Force Participation Rate



Sources: BLS, Department of Labor, and Decision Economics, Inc.

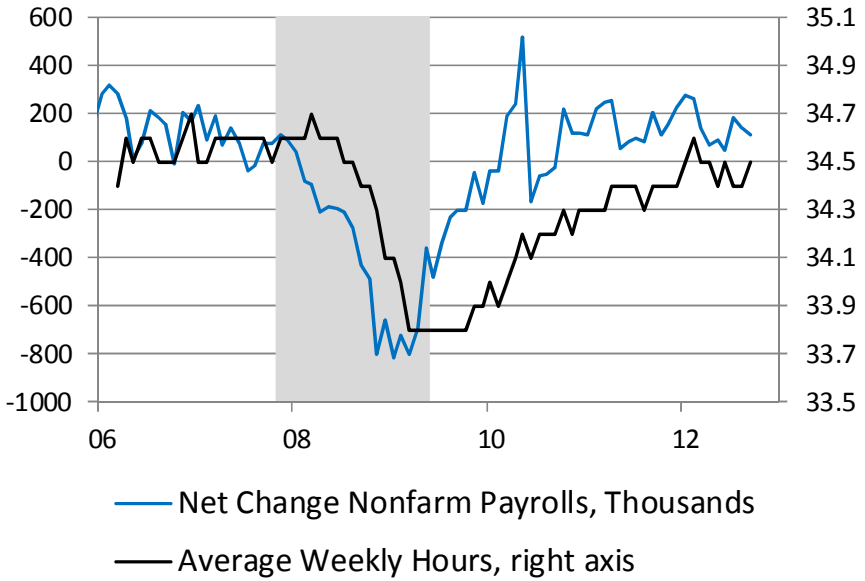
The unemployment rate is at 7.8% after exceeding 8% for forty-four consecutive months. The labor market has been making slow and choppy progress from the 10% rate seen in 2009.

Nonfarm payrolls has a strong relationship with GDP, and unlike weekly hours (See Chart 17) is a coincident indicator. The Fed wants to see a string of strong employment numbers (that is, over 150,000) before ending QE3 purchases as progress towards full employment is key to growth. Ignoring the labor force participation rate, about 125,000 jobs need to be added each month just to maintain the current unemployment rate.

One reason why the unemployment rate is deceptively low at 7.8%? Labor force participation (LFP) is at a historic low. If potential workers stop searching for jobs—or have not searched over the past four weeks—then they are not counted in the unemployment rate. The result is that the headline number looks markedly healthier than the labor market actually is.

While the aging U.S. population will have a lower LFP rate as Baby Boomers enter retirement, there is a clear cyclical component in recent data as workers have become discouraged. This cyclical unemployment will become structural if the labor market does not heal.

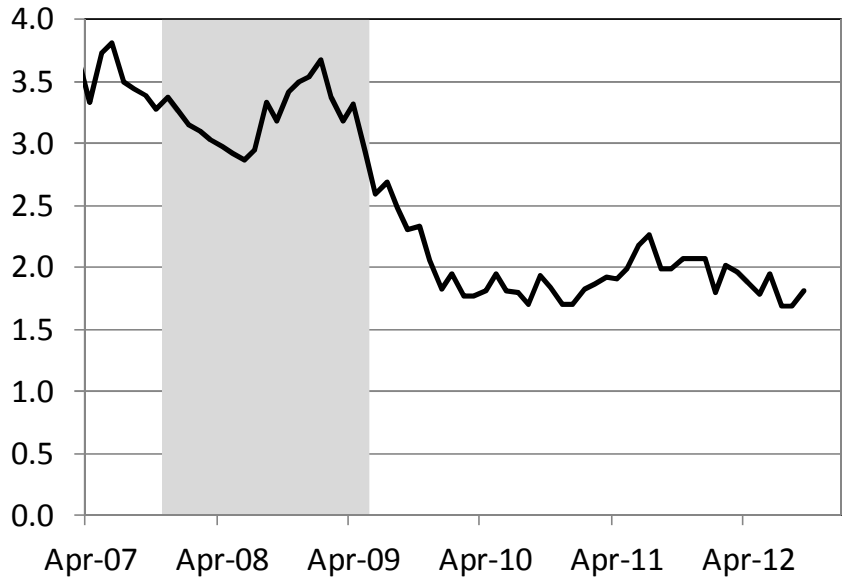
Chart 17: Nonfarm Payrolls and Average Hours



Non-farm payrolls were better in Q3, averaging 145.7K, after a Q2 which averaged a measly +67. However, revisions have pointed to a slowing in hiring as the November election and Fiscal Cliff approach.

Payrolls have been a leading indicator for hours in this most recent downturn and recovery. However, recent gains in employment are below that of early 2012, while hours upticked last month. Is this strength in hours only temporary?

Chart 18: Average Hourly Earnings, Percent Y/Y

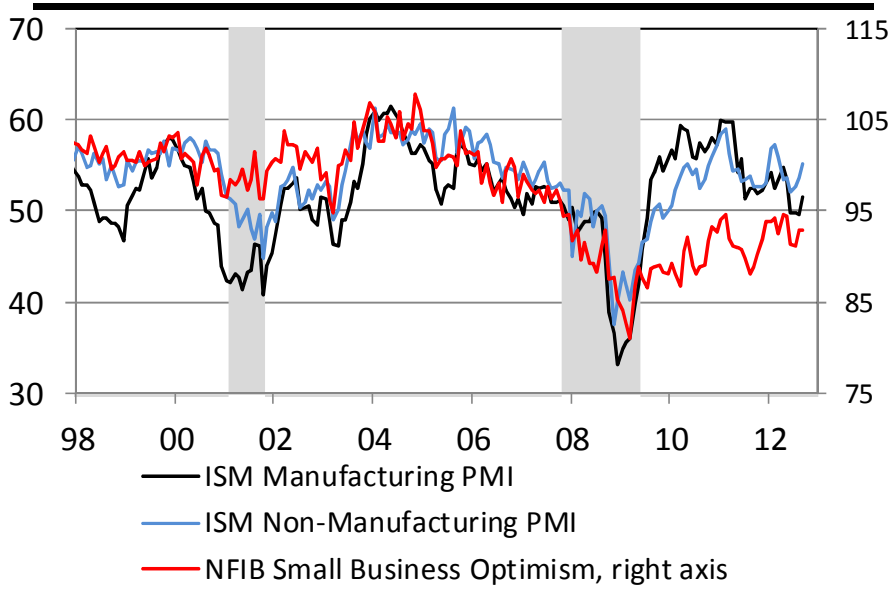


Average hourly earnings have also stagnated, as wage growth barely keeps pace with inflation. Even with a strong September report, the entrenched trend still looks stable-to-lower.

With flat real incomes and the Bush payroll tax cuts set to expire at the end of the year as the Budget Control Act takes effect, it is unsurprising that the consumer is looking softer. The Bush payroll tax cuts are the aspect of the Fiscal Cliff that will be the most visible to households.

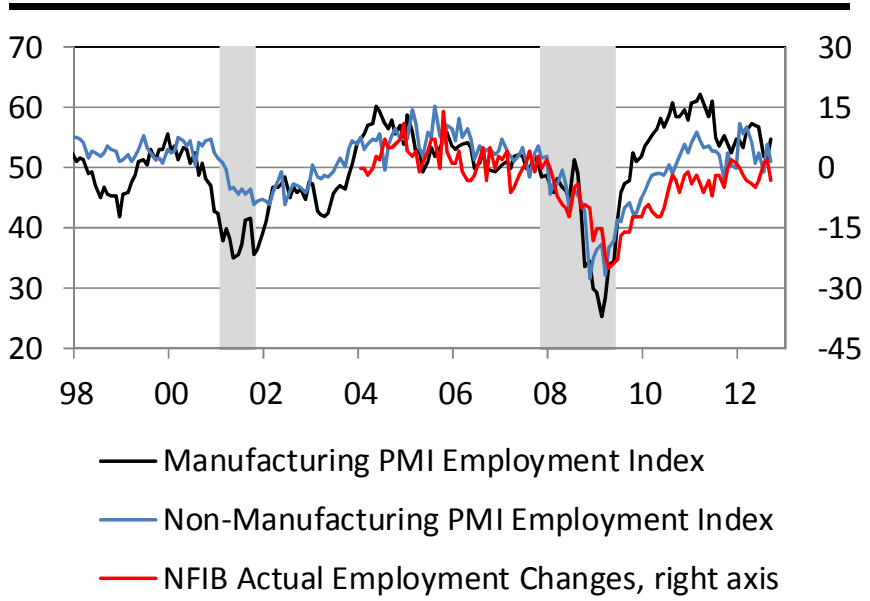
Sources: BLS and Decision Economics, Inc.

Chart 19: Small Businesses Lagging in Sentiment…



While the PMIs have ended their Q2 skid and both ISM surveys are now back above 50, small business optimism continues to lag.

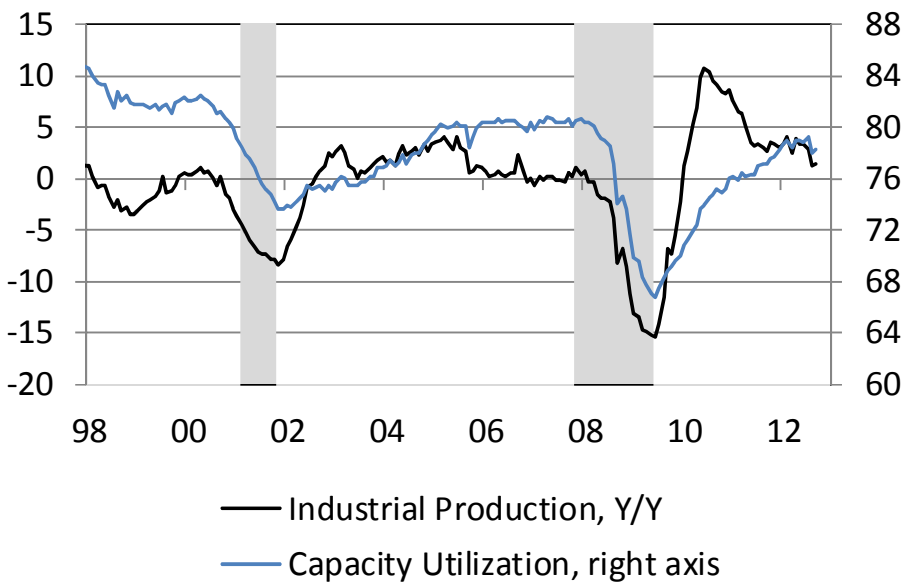
Chart 20: …and Hiring



Future corporate tax rates and health care requirements hinge on the election outcome. Therefore, it is not surprising that firms are cutting costs and hesitating to increase workforces. This trend is exacerbated in small firms.

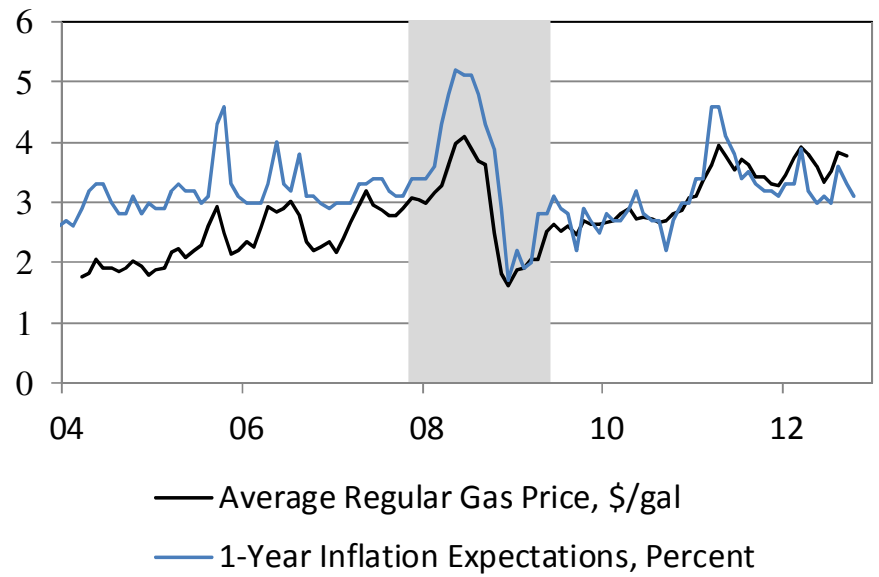
Sources: Institute for Supply Management and NFIB

Chart 21:Capacity Utilization and Industrial Production, Pct. Y/Y



Capacity utilization measures the amount of slack in the manufacturing, mining, electric and gas industries. It tends to be a solid leading indicator for inflation as it shows conditions in the industrial sector. A reading around 82 or above would set off hawkish alarms, but the pressures remain contained for now.

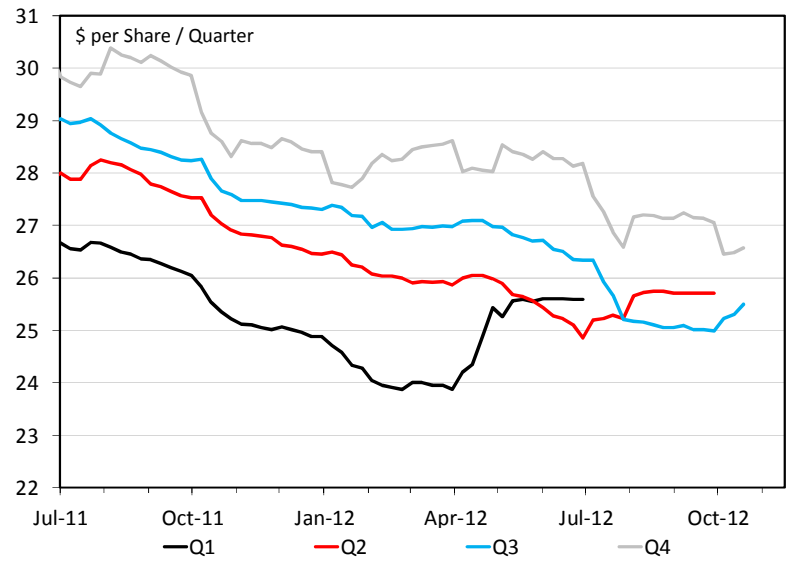
Chart 22: Gas Prices and Inflation Expectations



A reason to be distrustful of consumer survey data? Inflation expectations seem to mirror current gas prices—likely because gas is one of the main consumer goods with visible, volatile prices.

Sources: BLS, University of Michigan/Reuters, AAA, and the Federal Reserve

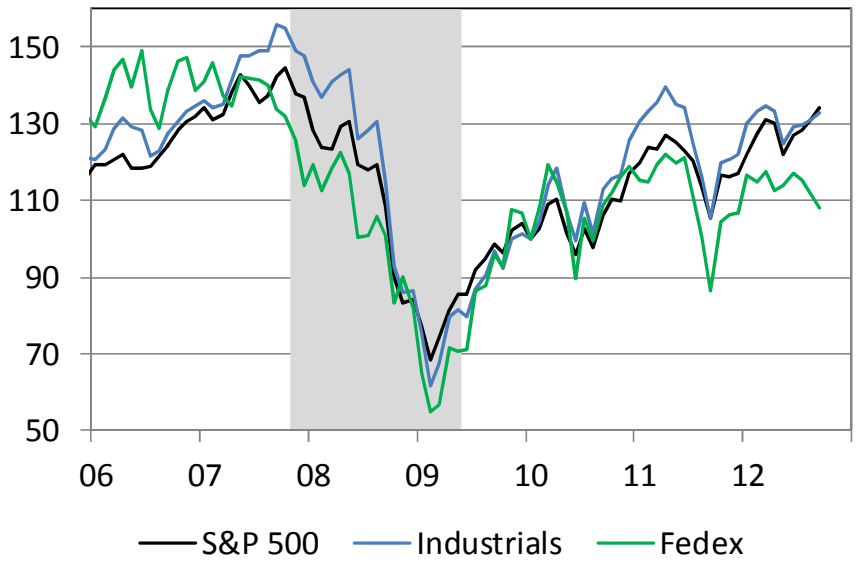
Chart 23: Estimated 2012 Earnings Per Share by Quarter, S&P 500



Where to from here for company earnings? Analysts have pulled 2012 EPS estimates way down over the past year as global growth softened. Q3 results are coming in stronger than expected, more in line with DE expectations.

Markets are betting that earnings projections have bottomed in advance of policy stimulus, and under the assumption European growth is not falling off a cliff. DE still expects 7-8% EPS growth in 2013 and 2014 – well in excess of nominal GDP growth as companies maintain profitability in spite of numerous risks and slow growth.

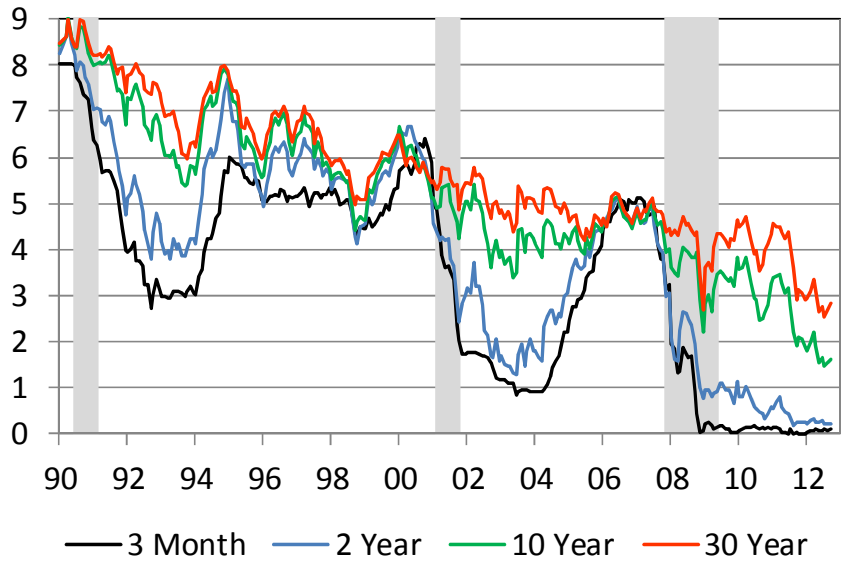
Chart 24: S&P 500 and Logistics Stocks, 1/1/2010=100



While equities have rallied throughout the year, FedEx has lagged behind. Logistics firms are struggling as global demand conditions remain lukewarm.

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

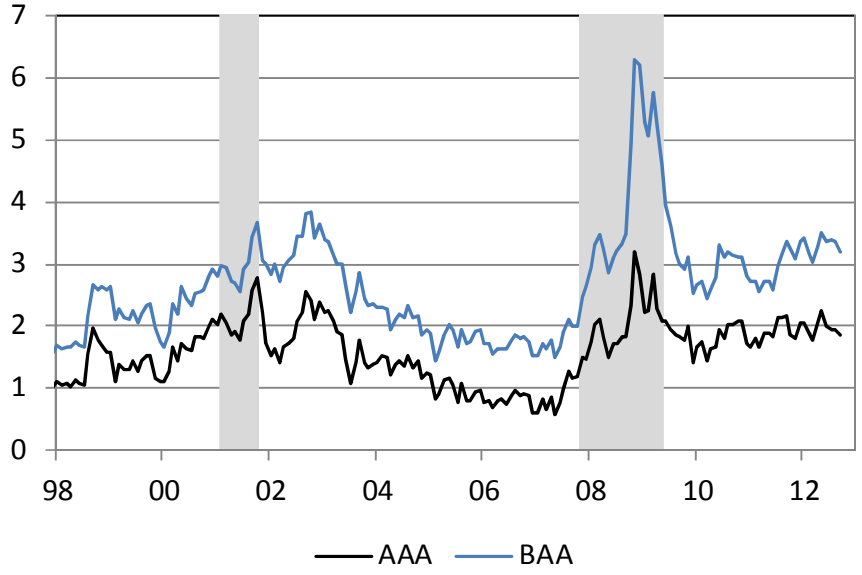
Chart 25: Treasuries



Treasuries plumb historic lows as investors look for a safe haven. Spreads narrow as markets hunker down to ride out the potential Perfect Storm of the emerging market slowdown, Eurozone (economic, fiscal, financial, housing, etc.) crises, the upcoming Presidential election and the potential Fiscal Cliff.

With the Fed extending the "low for long" pledge through the middle of 2015 at the September meeting, don't expect a rebound any time soon.

Chart 26: Corporate Bond Spreads over 10-Year Treasury

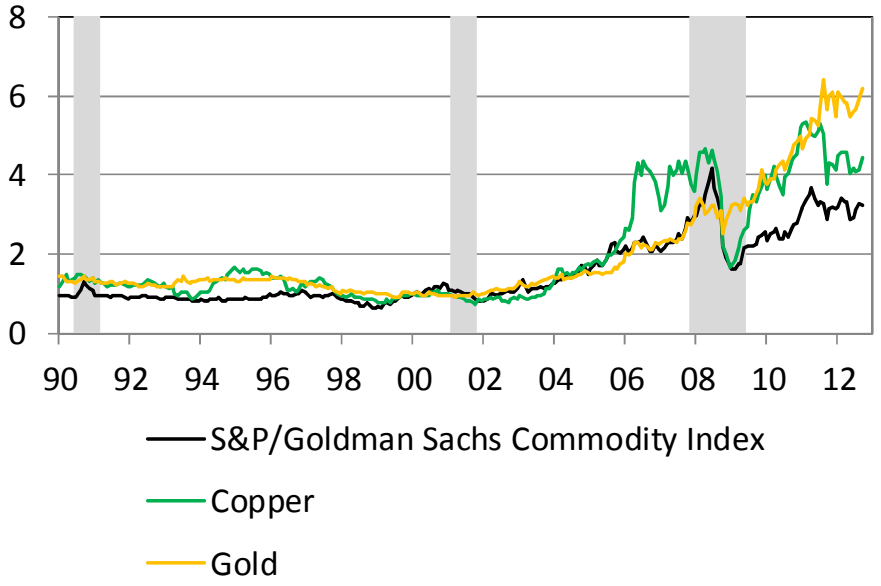


Although well below the recession highs, spreads are elevated as investor attitude is rather risk-off.

While QE3 likely eased investor fears somewhat, it also will keep 10-Year Treasuries low—so it is not surprising that spreads only edged downward mildly.

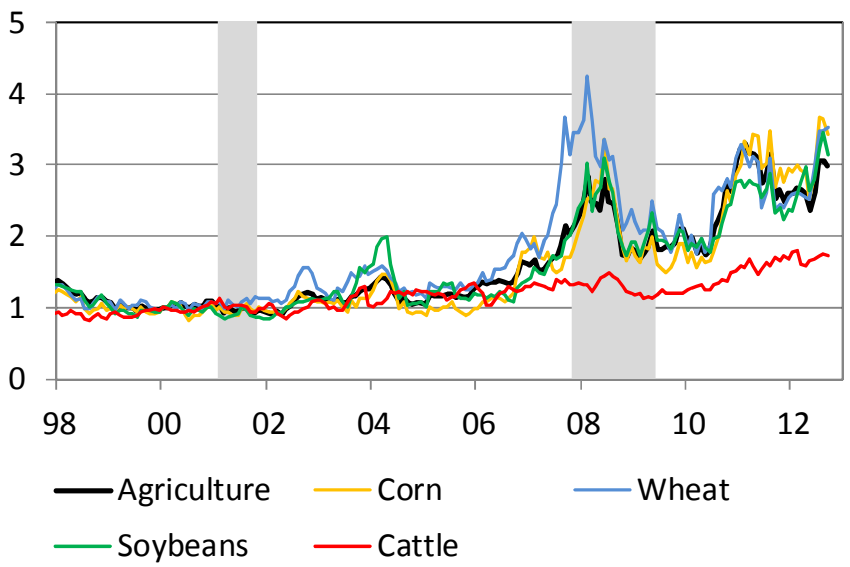
Sources: Moody's, Bloomberg, and Decision Economics, Inc.

Chart 27: Metals Commodity Indices (1/1/2000=1)



Broad commodity indices recover but have outperformed by both defensive and cyclical metals since the end of the recession. Gold is again on the upswing as an Open Ended QE3 has some investors searching for an inflation hedge. Meanwhile, copper remains muted as growth in China still appears to be slowing.

Chart 28: Agriculture Commodity Indices (1/1/2000=1)



The drought affecting the Great Plains has elevated most agriculture commodities. Expect the effects to ripple through food prices, as over 70% of grain in the U.S. is fed to farm animals.

Sources: Standard and Poors, Bloomberg, and Decision Economics, Inc.