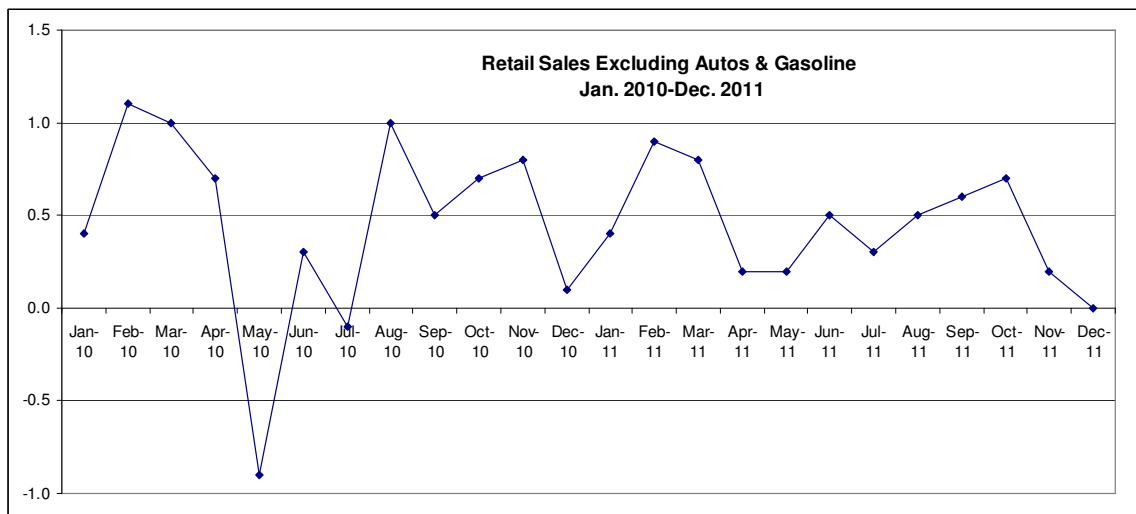




Quarterly Economic Report – 4th Quarter 2011

Pick up the pace and don't look back, something might be gaining on you.

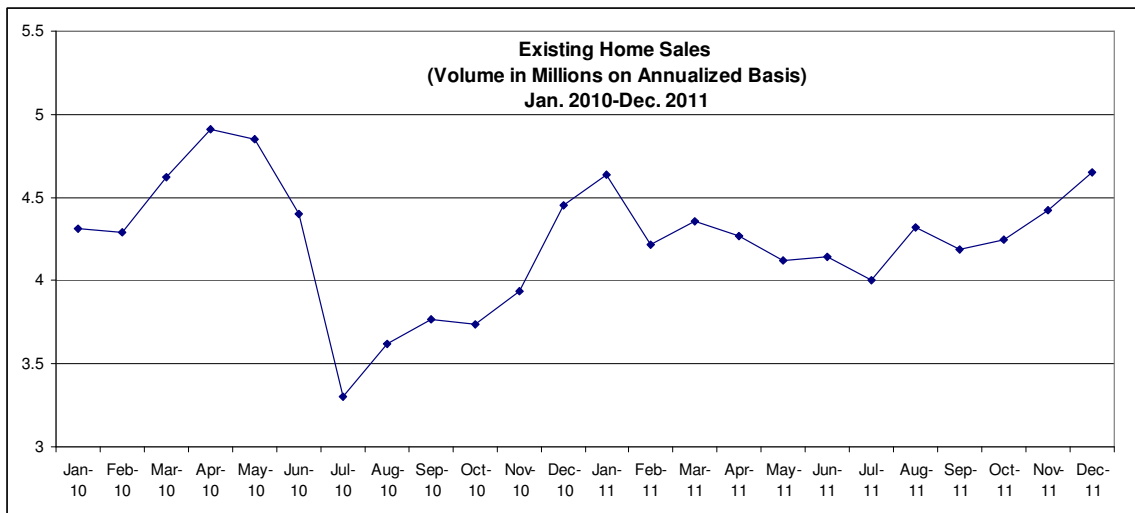
The Holiday Season for 2011 seemed to begin sometime right after The 4th of July and although all the ads describing Christmas sales, huge mark downs and then “final” sales combined to bring us a better than expected level of holiday sales, it did leave consumers exhausted. Those consumers spent more this year than in each of the previous three years and although the sales were much more focused by market sector (primarily motor vehicles and high tech smart phones and other similar gadgets), there has been some spill over into manufacturing jobs for replacing inventory and we should get some support for economic activity carrying over into next quarter.



Domestic activity in the US has reached a level plane which is “good enough” for establishing a sustainable positive level of GDP. However, there remains a long way to go to reach a level of growth that will allow some recover of jobs lost during the Great Recession of 2008-09.

Housing in America remains moribund. Values of properties in many parts of the country remain in decline and it is estimated that there are over 1 million homes that have been foreclosed upon or are in foreclosure. These properties will still need to be sold by the lenders. Financial institutions in these areas are reluctant to issue new mortgages because of the declining values or, in some cases, have been “discouraged” from doing so by bank regulators

European leaders are still having difficulty finding any solid footing. The longer the situation in countries like Greece and Italy remain uncertain, the more difficult it will be to achieve any positive outcome. Greece has repeatedly notified the ECB that they will not be able to meet the deficit reduction goals that were mandated for it and it is generally accepted that a default is speeding its way. The European Central Bank has established its own version of the US Treasury's TARP program which allows euro-banks to borrow funds for up to three years, based upon a very broad list of acceptable collateral, including much of the European sovereign debt that has raised much concern. By preemptively getting these questionable assets out of the bank's liquidity portfolios, it reduces much of the threat of a liquidity crisis if there is a sizeable default or restructure down the road.



The question about a reasonable resolution of the European crisis only adds more questions about the sustainability of growth in the US. If the austerity programs being adopted by most ECB member nations take hold, the resulting reduced governmental spending and higher taxes could contribute to a continent-wide recession. The “contagion” of a Euro-recession into other markets would be likely, especially the emerged and emergent markets like the People’s Republic of China and other Asian nations. The dominoes could continue to fall all the way around to the US and the Fed’s monetary policy stance has targeted mid-2013 as the earliest point where a shift in policy might be considered at this time.

Fed policy will have several other guideposts to watch as we move from 2011 into 2012.

The mediocre level of private job creation is a major concern. As Federal spending has been ratcheted down and State and Local governments find themselves funding more programs, while at the same time their revenues are declining, there are between 15-20,000 public sector employees losing jobs every month. Current federal budget plans also call for a sharp reduction in the number of military personnel and that group also will be looking for private sector employment.

The political jousting in Washington, that has polarized members of both parties towards their respective extremes, seems likely to not be remedied until the 2012 elections are behind us. During the quarter, when the members of Congress failed to reach an agreement on a “simple” piece of legislation to increase the US debt ceiling on a timely basis, Standard and Poor’s responded with a downgrade of the US credit rating from AAA to AA+. They acknowledged this was not a result of the US being less creditworthy, but rather that the political process in the US had reached such levels of ineptitude.

Lastly, one of the biggest pleasant surprises of 2011 was the decline in demand for energy, especially gasoline. We finished off the year with much larger than expected inventories of refined products and if the outlook for energy prices is tied to global growth, then the uncertainties of the European situation will add downward pressure on prices for most of 2012 as well. The outlier here would be a geo-political event in the Middle East that might threaten to interrupt the flow of crude from Saudi Arabia and other producers in the area. The biggest buyers of this product is Europe and China and any disruption could run the price up over \$105 and further “deflate” the economies that are already putting on the brakes.

If we learned anything from 2011, it is that our current world is tied together economically in many ways that are not always visible. We will need to watch for any fraying in the ties that are holding that bundle together here and abroad as the new year commences.