Election Games, Struggling Business Cycle, Fiscal Folly & Fed Stimulus

The U.S. Economy & Policy

(September 2012)

Navigating The Business Cycle In A Political Mine Field

Where we are in the cycle...

Where we are going ...

Imbalances & risks...

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Outlook Summary

The US economy is in the thirteenth consecutive quarter of growth.

The primary risk to the economy is the inability of the political leadership of the federal government to address US fiscal policy and the looming "Fiscal Cliff." The risk of a recession resides in Washington.

The economy has lost momentum primarily because the dysfunctional fiscal policy has created an uncertain and inhospitable environment for consumers and businesses. It is weighing on spending, investment and hiring decisions.

European distress and the slowing of Asian economies are also providing a drag on the margin. The drought will cause the agricultural sector to be a temporary drag on GDP in Q3 & Q4 of 2012.

Due to the inept handling of US fiscal policy and the increased threat posed by the infamous Fiscal Cliff, Jefferies has cut second half growth projections in half. While our base case is that the tax cuts are extended and growth migrates back toward trend in 2013, Jefferies projects that the economy will contract 1% in 2013 if the political class fails to extend the expiring tax cuts before the end of 2012.

Regarding upside risks, the bright spot in the economy since Q1 has been a gradual improvement in the housing sector. Home prices appear to have bottomed and an incipient housing recovery is underway.   Developments in the energy sector also provide upside organic risks to growth, but the potential has been limited by current policies at the federal government level.

Disinflation pressures are easing at the headline level due to the recovery of commodity prices since late June. The drought has caused a surge in prices food prices. Energy prices have also firmed. Core inflation measures are increasing due to rising rents and the OER, but remain tame.

Monetary policy will remain very accommodative and is again in a creative mode. The Fed will extend the calendar reference for the rate guidance and continue the Maturity Extension Program (Twist). Policymakers are also considering asset purchases that target MBS and possibly an open-ended QE. The FOMC is also exploring "new tools to provide more accommodative financial conditions" that would provide a catalyst to bank lending and a cut in the IOER.

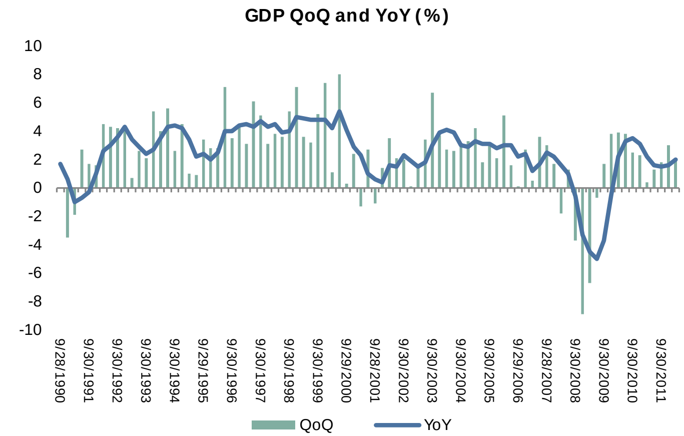
The US economy is currently in the 13th consecutive quarter of growth.

The economy has been chipping away at the massive output gap generated by the prior recession, but the expansion has lost momentum.

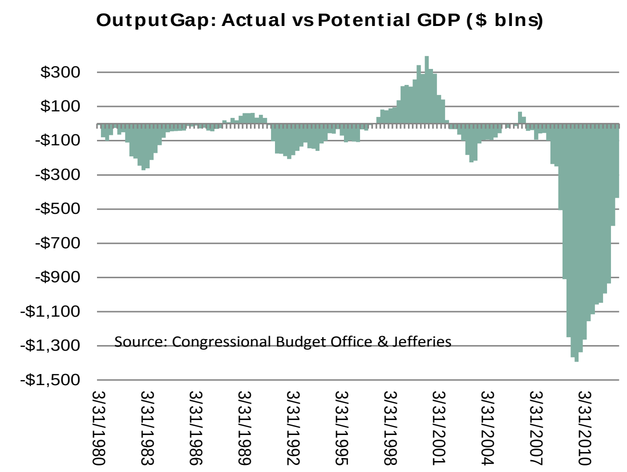
Due to the inept handling of US fiscal policy and the increased threat posed by the infamous Fiscal Cliff, Jefferies has downgraded expectations for growth in the second half of 2012 and cut growth projections to an average of 1.25% per quarter.

The labor market has generated 4.3 mln private sector jobs since early 2010 after losing 8.8 mln jobs during the recession and first two quarters of the recovery.

At the current trend growth rate, it will take another two to three years for the economy to approach potential and the labor market to approach normal.



Source: Commerce Department



The consumer sector has contributed an average of 1.5 percentage points per quarter to growth since the end of the recession in mid-2009.

Investment spending has contributed an average of 0.6 percentage points to growth.

Inventories and net exports will continue to be swing factors that that cause temporary diversions from trend growth. The drought will cause the agricultural sector to be a temporary drag on GDP in Q3 & Q4 of 2012.

The economy has lost momentum because the dysfunctional fiscal policy has created an uncertain and inhospitable environment for consumers and businesses. It is weighing on spending, investment and hiring decisions.

European distress and the slowing of Asian economies are also providing a drag on the margin.

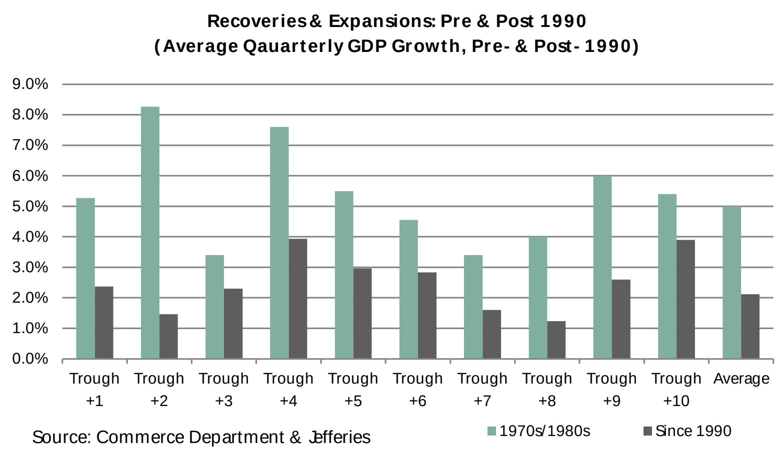
If the political class fails to extend the expiring tax cuts before the end of the year, Jefferies projects that the economy will contract 1% in 2013.

The moderate pace of the growth in the current cycle is typical of growth over the past twenty years. Growth in this recovery and the prior two cycles has been substandard and has not measured up to prior cycles.

Anatomy of the Recovery & Expansion
GDP Growth by Sector

	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012	1st Est Q2 2012	2nd Est Q2 2012	Average
Real GDP	2.6%	2.4%	0.1%	2.5%	1.3%	4.1%	2.0%	1.5%	1.7%	2.2%
PCE	2.5%	4.1%	3.1%	1.0%	1.7%	2.0%	2.4%	1.5%	1.7%	2.1%
Durable goods	7.2%	15.2%	7.3%	-2.3%	5.4%	13.9%	11.5%	-1.0%	0.0%	7.4%
Nondurable goods	2.2%	4.5%	4.6%	-0.3%	-0.4%	1.8%	1.6%	1.5%	0.5%	2.0%
Services	1.9%	2.3%	2.0%	1.9%	1.8%	0.3%	1.3%	1.9%	2.4%	1.4%
Fixed Investment	-1.0%	7.6%	-1.3%	12.4%	15.5%	10.0%	9.8%	6.1%	5.1%	5.2%
Nonresidential	7.7%	9.2%	-1.3%	14.5%	19.0%	9.5%	7.5%	5.3%	4.2%	5.9%
Structures	-2.2%	9.3%	-28.2%	35.2%	20.7%	11.5%	12.9%	1.9%	2.8%	-0.3%
Equip & Soft	11.9%	9.2%	11.1%	7.8%	18.3%	8.8%	5.4%	7.2%	4.7%	9.5%
Residential	-28.6%	1.4%	-1.4%	4.1%	1.4%	12.1%	20.5%	9.7%	8.9%	3.5%
Chg Inventories	$94.9	$45.0	$30.3	$27.5	-$4.3	$70.5	$56.9	$66.3	$49.9	$17.8
Net Exports	-4.2%	10.0%	1.4%	4.0%	1.4%	-3.5%	1.3%	-0.7%	3.1%	0.0%
+Exports	9.7%	10.0%	5.7%	4.1%	6.1%	1.4%	4.4%	5.3%	6.0%	8.4%
-Imports	13.9%	0.0%	4.3%	0.1%	4.7%	4.9%	3.1%	6.0%	2.9%	8.4%
Government	-0.3%	-4.4%	-7.0%	-0.8%	-2.9%	-2.2%	-3.0%	-1.4%	-0.9%	-1.4%
Federal	3.6%	-4.1%	-10.3%	2.8%	-4.3%	-4.4%	-4.2%	-0.4%	-0.1%	0.0%
State and local	-2.9%	-4.6%	-4.7%	-3.2%	-2.0%	-0.7%	-2.2%	-2.1%	-1.4%	-2.3%

Source: Commerce Dept



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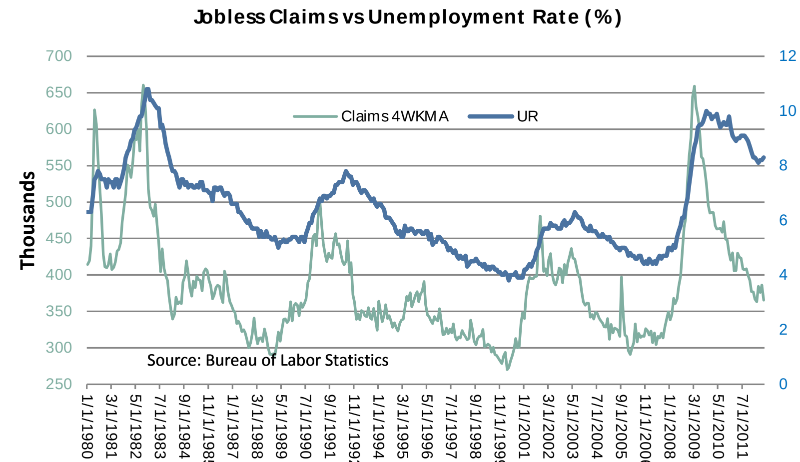
The decline in the unemployment rate has stalled, and unemployment remains high by historical standards. FOMC policy statements characterize the unemployment rate as remaining "elevated."

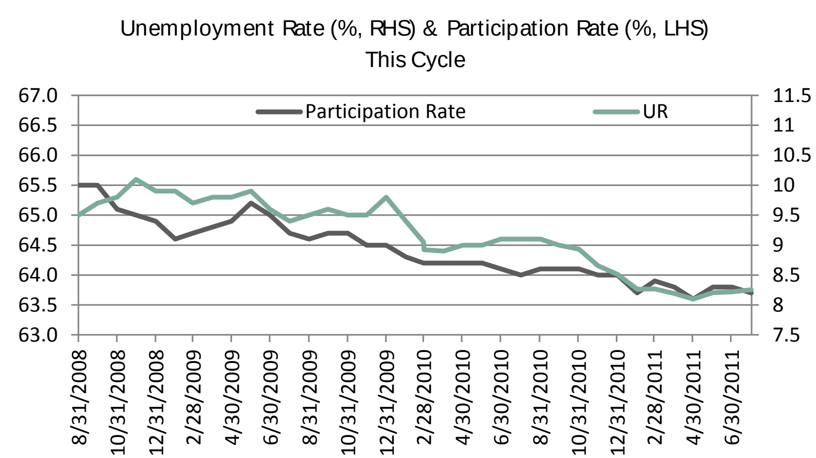
The labor force participation rate has also been declining and this takes some of the bloom off of the prior decline in the unemployment rate.

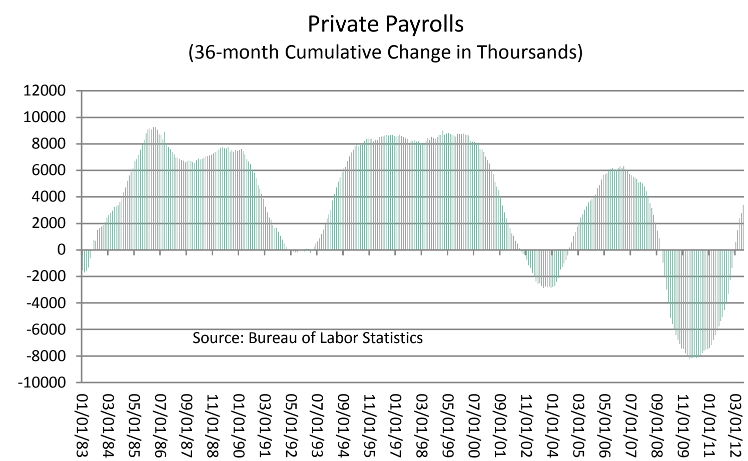
A combination of demographics and extended jobless benefits may help to explain the unusual behavior of the participation rate and the unemployment rate this cycle.

Private nonfarm payrolls have risen every month since March 2010 with average increases of 165k per month. The labor market has generated roughly 4.3 mln private sector jobs since early 2010 after losing 8.8 mln during the recession and beginning of the recovery.

There is a long way to go before the labor market will bear a semblance to being normal.





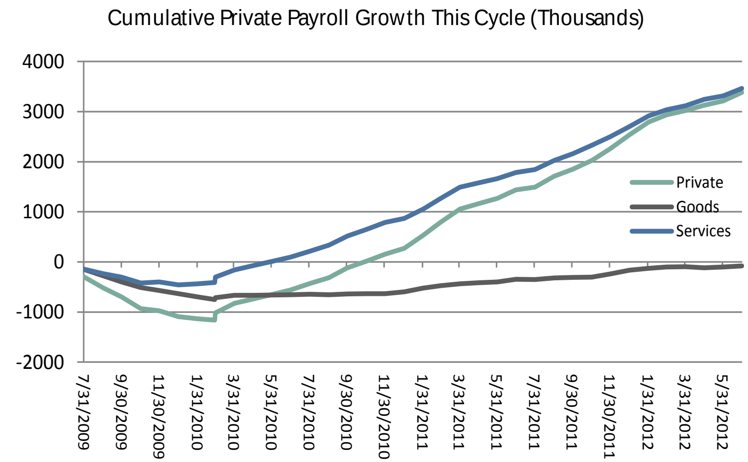


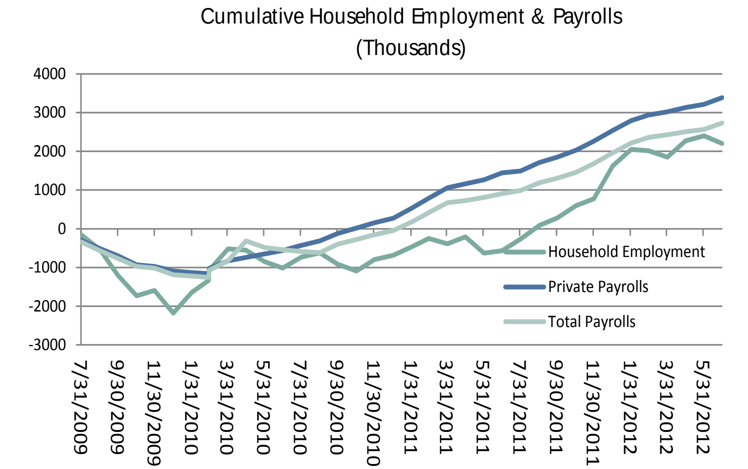
Since the US is a service-dominated economy, private nonfarm payrolls continue to be dominated by the service sector of the economy

Increases in household employment lagged nonfarm payroll gains, but have closed the gap.

Private sector payrolls rose by almost 2 mln over the past year, while household employment has risen by almost 2.5 mln.

Over the past three years, the labor market has generated a net 2.4 mln jobs, which is a reflection of the slow rate of recovery of the labor market.





Job growth in each of the most recent recoveries has been slow by prior standards. This is not the first “jobless recovery” as the following table demonstrates.

The Labor Market In Recovery
1990- 2011
----------Quarterly Change in Private Sector Nonfarm Payrolls---------

	Peak-to-Trough Decline in Payrolls	Trough +1	Trough +2	Trough +3	Trough +4	Trough +5	Trough +6	Trough +7	Trough +8	Trough +9	Trough +10	Average
1990/1991	-1,280,000	-324,000	19,000	-121,000	-38,000	296,000	179,000	480,000	472,000	685,000	622,000	227,000
2001	-1,630,000	-375,000	-164,000	-163,000	-76,000	-299,000	-54,000	191,000	288,000	501,000	627,000	47,600
2007/2009	-7,311,060	-699,000	-394,000	74,000	369,000	335,000	470,000	637,000	474,000	443,000	551,000	226,000
Average	-3,407,020	-466,000	-179,667	-70,000	85,000	110,667	198,333	436,000	411,333	543,000	600,000	166,867

Source: Jefferies & Bureau of Labor Statistics

Cautious Consumer Sets Moderate Pace

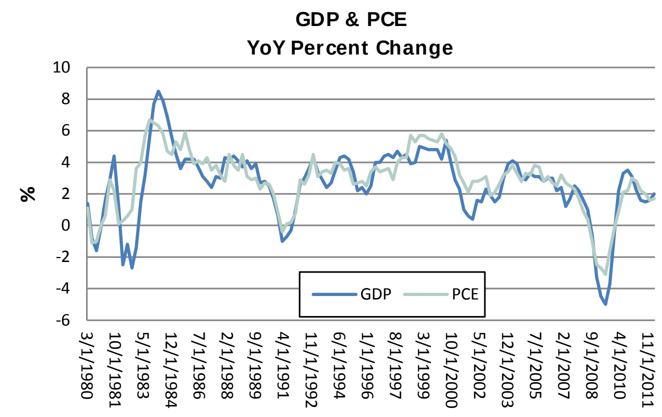
The consumer sector continues to be a primary driving force behind GDP growth this cycle.

The subdued nature of consumer spending is one of the primary reasons that GDP growth remains moderate.

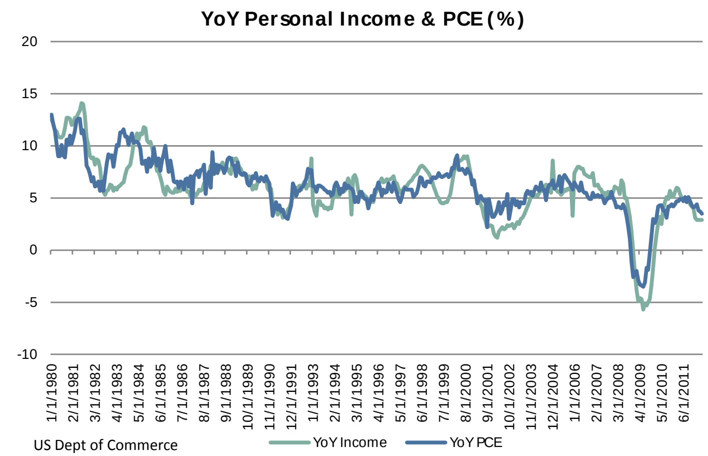
Income growth remains constrained by a combination of subdued earnings growth and cumulative employment growth that has only partially offset previous job losses.

Moderate income growth, ongoing balance sheet adjustments and the loss of home equity have limited consumer spending potential during this cycle.

Consumer spending has also lost momentum since Q1 due to the slower payroll growth and uncertainty about fiscal policy and the elections.



Source: US Dept of Commerce



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Misery Index & Political Discontent Contribute to Cautious Consumer Sentiment,

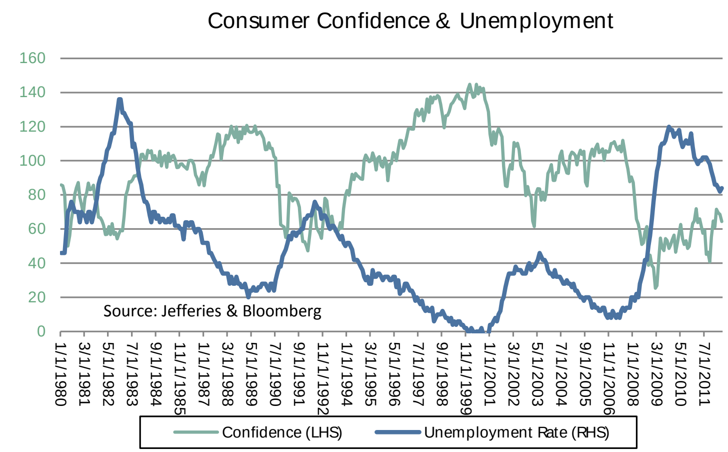
Consumers continue to restructure balance sheets and deleverage.

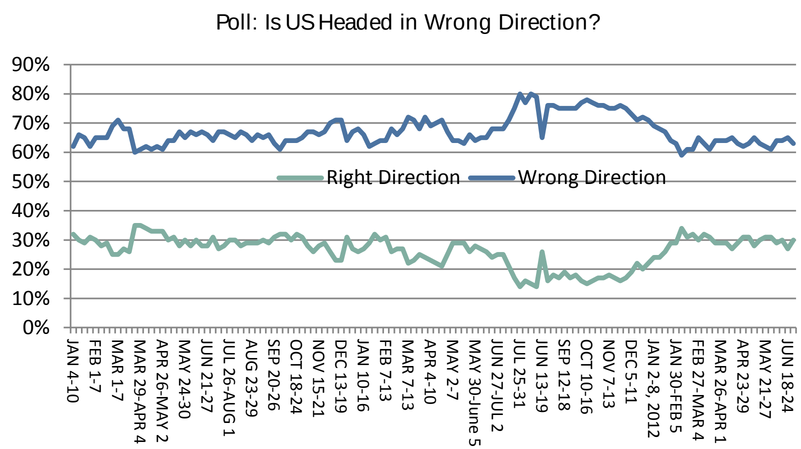
Consumers have also periodically dipped back into savings and increased borrowing to support spending due to slow income growth.

Confidence is fleeting and cautious, and has been less responsive to the decline in the unemployment rate than has been the case in prior cycles.

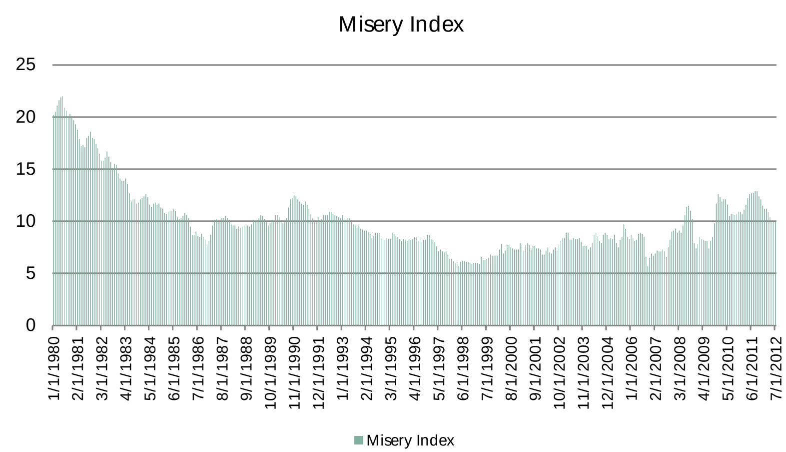
The relatively lofty misery index may help to explain the cautious consumer temperament. (The misery index is the sum of the inflation rate and the unemployment rate.)

There is also discomfort with the political situation, as more than 60% of the country thinks the US is headed in the wrong direction.





Source: Rasmussen Reports



Source: Jefferies

Although there has been improvement in delinquencies, many consumers continue to struggle to meet, or are failing to meet mortgage obligations.

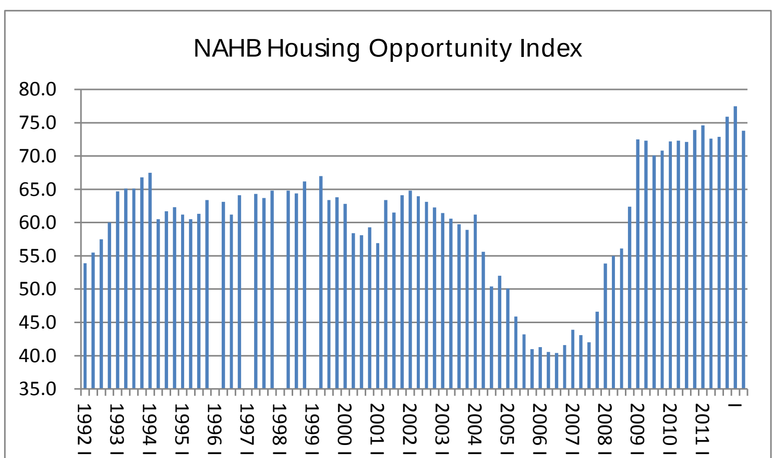
Delinquency rates have eased, but also remain high by historical standards. Foreclosures have remained stubbornly high.

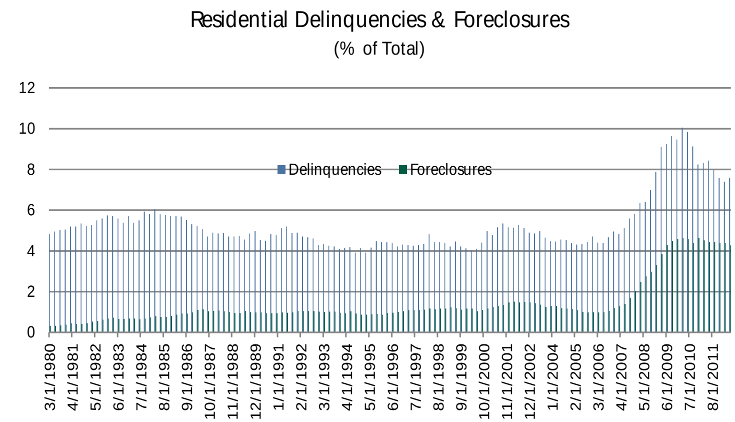
The mortgage imbalances and consequential emergence of a distressed property market created a bifurcated housing market.

Prices of distressed properties were under more pressure than non-distressed properties, and have recovered more slowly.

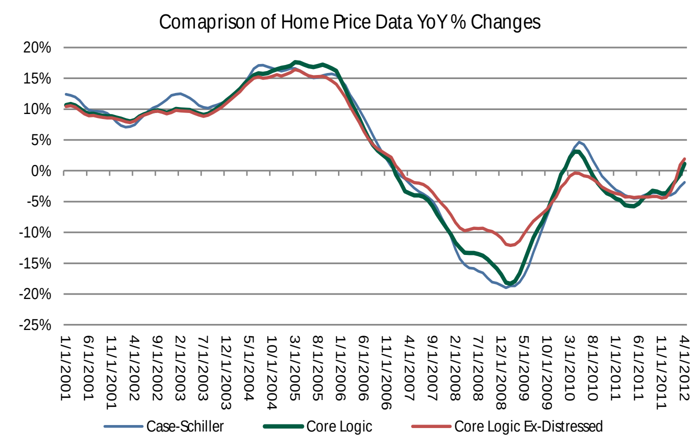
Because housing affordability has become so attractive, the market has been absorbing the flow of distressed properties associated with foreclosures, with less downward pressure on property prices.

Non-distressed property prices have stabilized and firmed in some regions. Prices may also be stabilizing in the distressed market in some regions.





Source: Mortgage Bankers Association



Source: Bloomberg & CoreLogic

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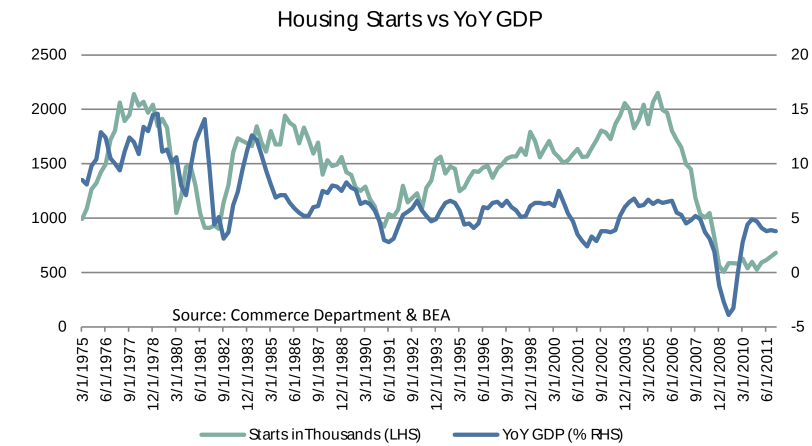
One unique feature of this business cycle has been the role of housing. The current cycle is the first recovery and expansion since WWII that has not been led by some type of housing boom.

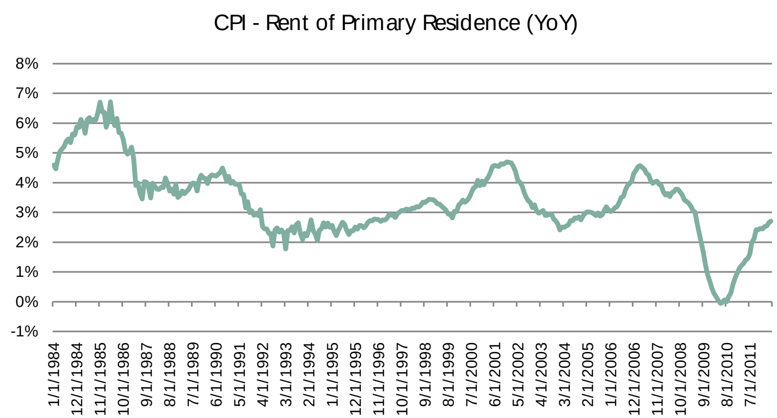
Signs of life are creeping back into home sales and home construction.

Multi-family starts have been creeping higher for the past year due to rising rents that make multifamily construction economically feasible.

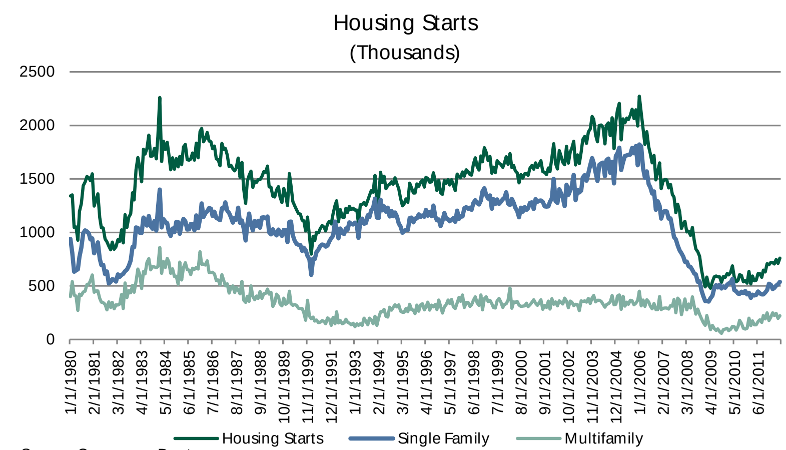
Single family starts are beginning to catch up.

A modest recovery in housing construction is having a positive effect on growth, but a broad-based recovery in housing is just in the early stages of a long-term recovery.





Source: Bureau of Labor Statistics

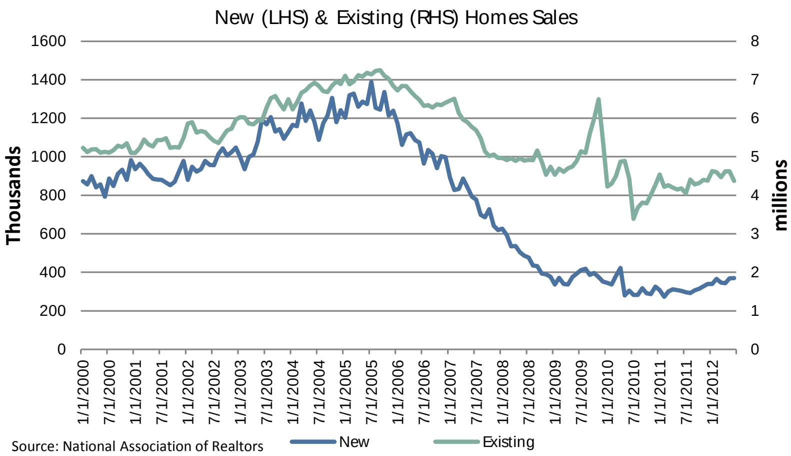


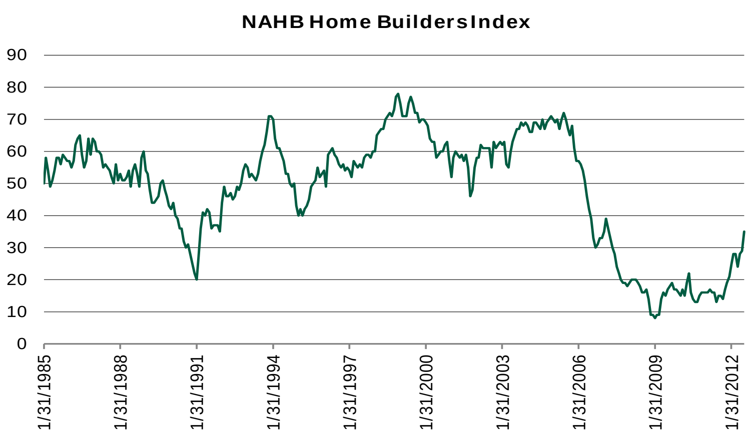
Source: Commerce Dept

Like single family housing starts, new single family home sales flat-lined until recently, but have been creeping erratically higher. New homes sales remain low by historical standards but are at the early stages of gradual long-term recovery.

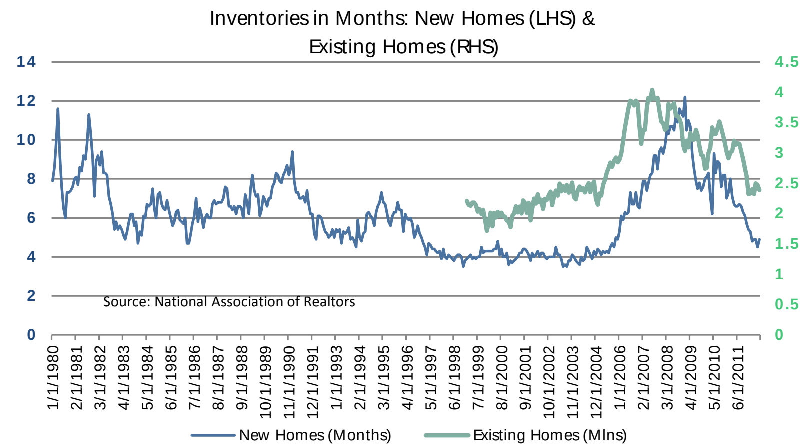
New home inventories have been edging lower, and are approaching levels that may trigger a significant rise in single family housing starts if the upward trend in sales continues.

Existing home sales have been edging higher, and inventories have been edging lower. However, there is still a large supply of distressed properties coming onto the market. Distressed property sales account for 30% or more of existing home sales on a monthly basis.





Source: NAHB/Wells Fargo



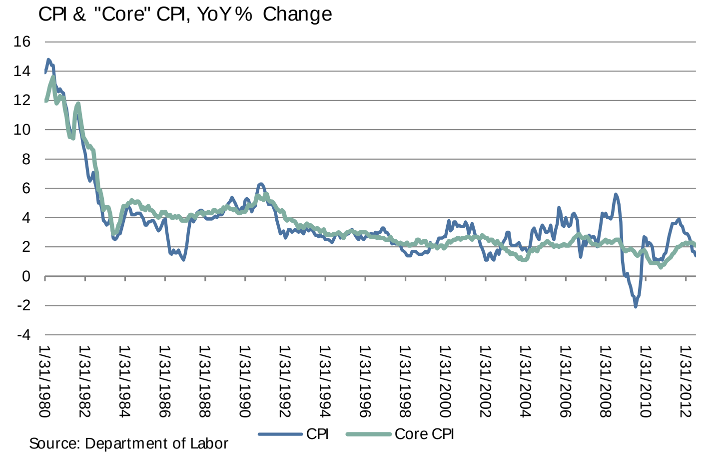
Headline & Core Inflation Converge…Commodities & Housing Are Driving Forces

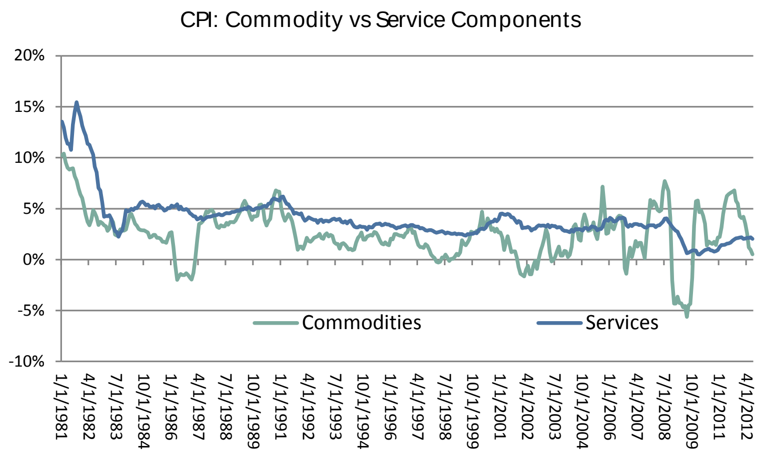
Headline and core inflation have been converging, with headline CPI decelerating and core CPI rising.

Headline inflation has been driven by commodity components of the CPI. The headline CPI decelerated between September 2011 and July 2012 because of soft commodity prices. Commodity components account for 40% of the CPI.

The recovery in commodity prices since late June will curtail the disinflation trend at least temporarily. Food and energy prices are the most significant commodities in the CPI, accounting for more than 20% of the overall CPI, and more than half of commodity components.

Core inflation has been driven by rising service components of the CPI, and drifting higher. The most important components are the housing components of the CPI, especially rents and the OER.





Source: BLS

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Weak Housing Market Boosts Rent & OER…Inflation or a Tax?

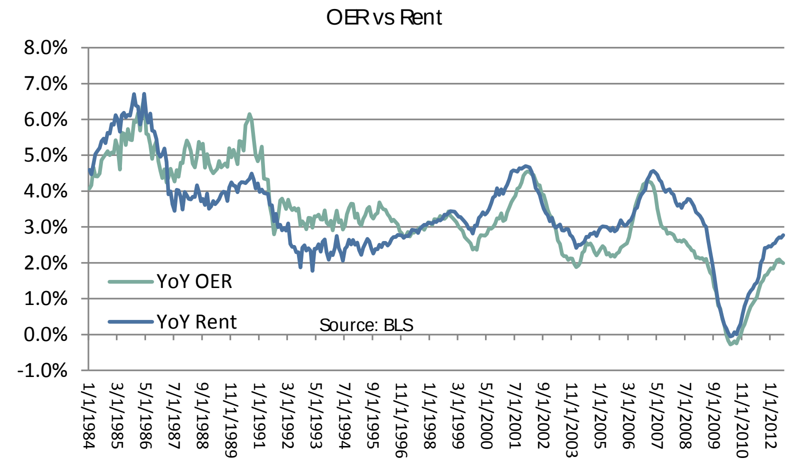
With a weak housing market, high delinquency and foreclosure rates, sluggish labor market and tight consumer credit conditions, many households turned back to the rental market for their primary residence in recent years.

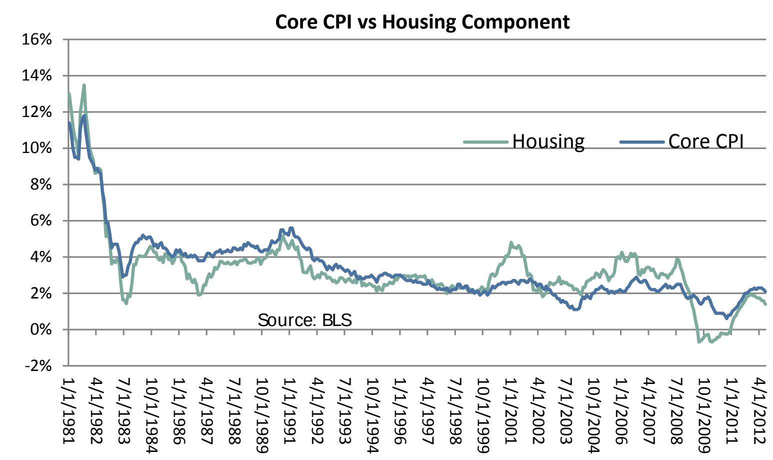
As a consequence, rents have been rising, causing the rent and the OER components in the CPI to increase as well.

Rent and the OER account for more than 30% of the CPI, and have been the primary contributor to the increase in the core CPI.

By definition, this is “inflation” but we do not embrace rising core inflation that is due to a weak housing sector as being symptomatic of building inflation pressures.

Under current circumstances, we view rising rents as more of a tax on consumers that are already cash-strapped. It will also help to support the incipient housing recovery by making home ownership more attractive on a comparative basis.





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Disinflation Pressures Easing, at Least Temporarily

The CPI has decelerated from 3.9% to 1.4% since September of 2011.

The disinflation trend was driven by the three biggest contributors; food, housing and transportation.

Food (14.3% of the CPI) price inflation has decelerated from 4.5% to 2.3%, but will accelerate in the months ahead.

Even with the rise in rents and the OER, housing (41 percent of the CPI) inflation has decelerated from 1.9% to 1.4%.

Transportation (16.9 percent of the CPI) inflation has decelerated from 11.9% to -0.9%, but will stabilize and rise now that energy prices have begun to rise again.

Food and energy prices have been firming in recent months, and this will be reflected on the headline inflation indices in the months immediately ahead.

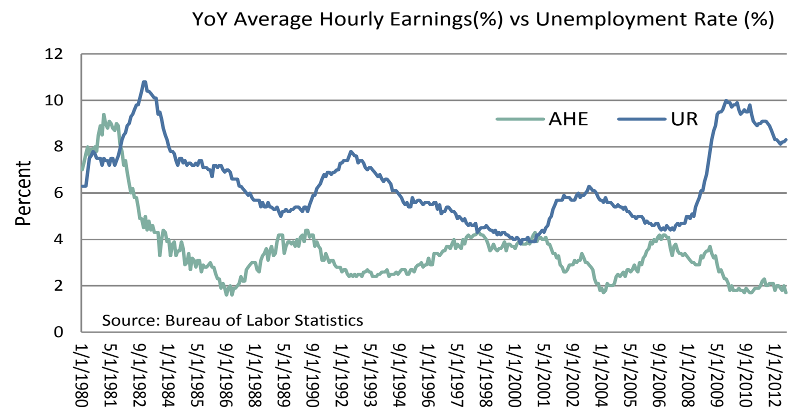
July 2012		NSA	NSA	NSA	SA	SA	SA
Major Categories	**Weighting**	**% Chng**	**Contribution**	**YoY**	**% Chng**	**Contribution**	**YoY**
Total CPI	**100.00**	**-0.2%**	**-0.2%**	**1.4%**	**0.0%**	**0.05%**	**1.4%**
Food & Beverages	15.256	0.0%	0.0%	2.3%	0.1%	0.01%	2.3%
Housing	41.020	0.1%	0.0%	1.4%	0.0%	0.01%	1.4%
Apparel	3.562	-2.3%	-0.1%	3.0%	0.2%	0.01%	3.0%
Transportation	16.875	-1.0%	-0.2%	-0.9%	-0.1%	-0.01%	-0.9%
Medical care	7.061	0.3%	0.0%	4.1%	0.4%	0.03%	4.1%
Recreation	6.044	-0.1%	0.0%	1.3%	-0.1%	-0.01%	1.3%
Education & communication	6.797	0.1%	0.0%	2.1%	0.0%	0.00%	2.0%
Other goods & services	3.385	0.4%	0.0%	2.3%	0.4%	0.01%	2.3%
Food & Beverages	**15.26**	**0.0%**	**0.0%**	**2.3%**	**0.1%**	**0.01%**	**2.3%**
Food	14.308	0.0%	0.0%	2.3%	0.1%	0.01%	3.5%
Food at home	8.638	-0.1%	0.0%	1.9%	-0.1%	-0.01%	1.9%
Food away from home	5.669	0.2%	0.0%	2.9%	0.2%	0.01%	2.9%
Alcoholic beverages	0.948	-0.1%	0.0%	1.9%	-0.1%	0.00%	1.9%
Housing	**41.02**	**0.1%**	**0.0%**	**1.4%**	**0.0%**	**0.01%**	**1.4%**
Shelter	31.539	0.2%	0.1%	2.1%	0.1%	0.02%	0.9%
OER (primary)	23.957	0.2%	0.0%	2.0%	0.2%	0.04%	2.0%
Rent (primary)	6.485	0.0%	0.0%	0.0%	0.3%	0.02%	2.8%
Fuels & utilities	5.372	-0.2%	0.0%	-2.3%	-0.8%	-0.04%	-2.3%
Furnishings & operations	4.109	0.0%	0.0%	0.9%	0.2%	0.01%	0.9%
Transportation	**16.88**	**-1.0%**	**-0.2%**	**-0.9%**	**-0.1%**	**-0.01%**	**-0.9%**
Private	15.694	0.0%	0.0%	0.0%	0.0%	0.00%	0.0%
New cars & trucks	3.195	0.0%	0.0%	0.0%	0.0%	0.00%	0.0%
Used cars & trucks	1.913	0.0%	0.0%	0.0%	0.0%	0.00%	0.0%
Motor fuel	5.463	0.0%	0.0%	0.0%	0.3%	0.01%	-5.5%
-Gasoline	5.273	-2.7%	-0.1%	-5.5%	0.3%	0.01%	-5.5%
Vehicle parts/maintenance	1.593	0.3%	0.0%	2.8%	0.3%	0.01%	2.8%
Public	1.181	-1.4%	0.0%	0.1%	-1.5%	-0.02%	0.1%
Medical Care	**7.06**	**0.3%**	**0.0%**	**4.1%**	**0.4%**	**0.03%**	**4.1%**
Commodities	1.716	0.5%	0.0%	3.4%	0.5%	0.01%	3.4%
Professional Services	3.005	0.2%	0.0%	2.0%	0.2%	0.01%	2.0%
Hospital Services	1.510	0.3%	0.0%	5.3%	0.4%	0.01%	5.3%
Recreation	**6.04**	**-0.1%**	**0.0%**	**1.3%**	**-0.1%**	**-0.01%**	**1.3%**
Video & audio	1.924	-0.1%	0.0%	1.0%	0.0%	0.00%	1.0%
Education & communication	**6.80**	**0.1%**	**0.0%**	**2.1%**	**0.0%**	**0.00%**	**2.0%**
Education	3.216	0.7%	0.0%	4.4%	0.5%	0.02%	4.4%
Communication	3.581	-0.5%	0.0%	-0.1%	-0.5%	-0.02%	-0.1%
Other	**3.39**	**0.4%**	**0.0%**	**2.3%**	**0.4%**	**0.01%**	**2.3%**
Tobacco	0.804	1.1%	0.0%	3.1%	0.4%	0.00%	2.3%
Personal care	2.581	0.1%	0.0%	2.0%	0.2%	0.00%	2.0%

Source: BLS & Jefferies

Soft Labor Market, Weak Earnings Growth to Keep Inflation Subdued

Soft labor market conditions and the sticky unemployment rate are causing wage and earnings growth to be very subdued.

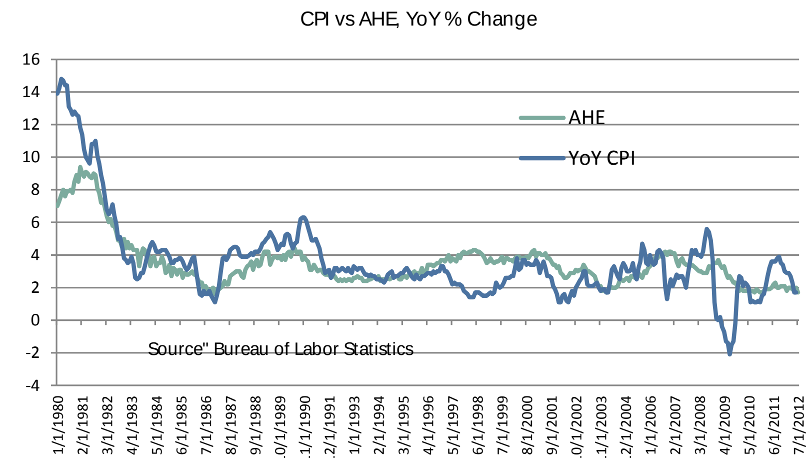
Based on historical relationships, the unemployment rate will need to decline to as low as 6% before AHE will increase toward the middle of the long-term range of roughly 2% to 4%.



Historically, inflation has tended to be constrained by AHE.

Inflation has not been able to take root in the economy when earnings growth has remained at the low end of the 30-year range of roughly 2% to 4%.

Tame earnings are a restraint on inflation taking root in this environment.



The FOMC has adopted a long term target of 2% for the PCE deflator.

The yoy rise in the deflator has decelerated from 2.7% to 1.4% since September of 2011 and will probably continue to be below target in the months ahead.

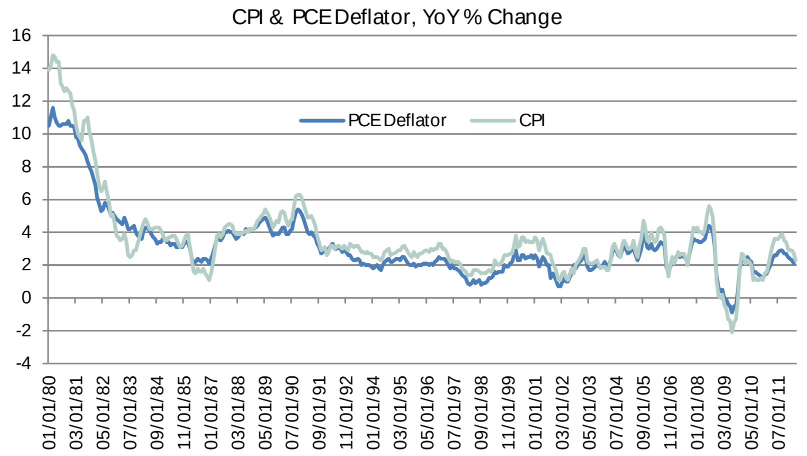
The PCE deflator is less volatile than the CPI and tends to run at a lower rate over time, which gives the Fed more policy flexibility in providing stimulus.

Since 1991, the peak inflation rate for the deflator has been 90 bps below the CPI peak, while the PCE deflator trough has been 120 bps higher than the CPI trough.

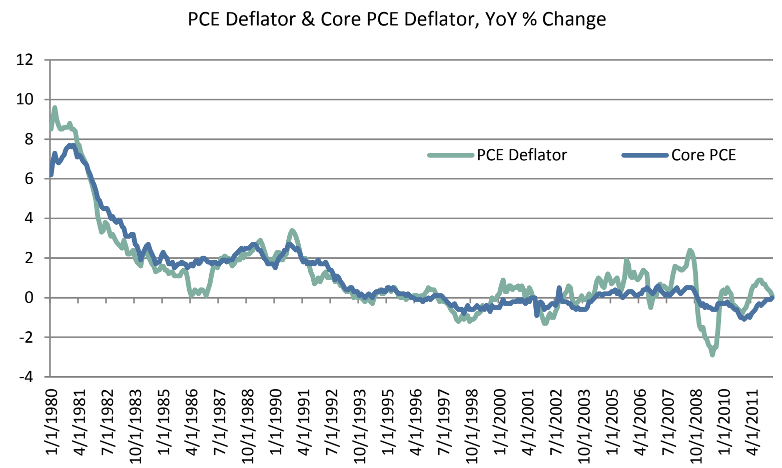
Since 1991, the CPI has risen at an average rate of 2.6%, while the PCE deflator has risen at an average rate of 2.2%, very close to the long term target.

The PCE deflator and core PCE deflator tend to move together, but also have diverged during periods of extreme movement in energy and/or food prices. The core tends to be less volatile than the headline PCE deflator.

Since 1990 the PCE deflator has risen at an average rate of 2.2%, near the long term target, while the core PCE deflator has risen at an average of 2.1%.



Source: BLS



Source: BLS

Diminishing Returns From Current Balance Sheet Tools…Time for Open-Ended QE, MBS Twist, Targeted Lending?

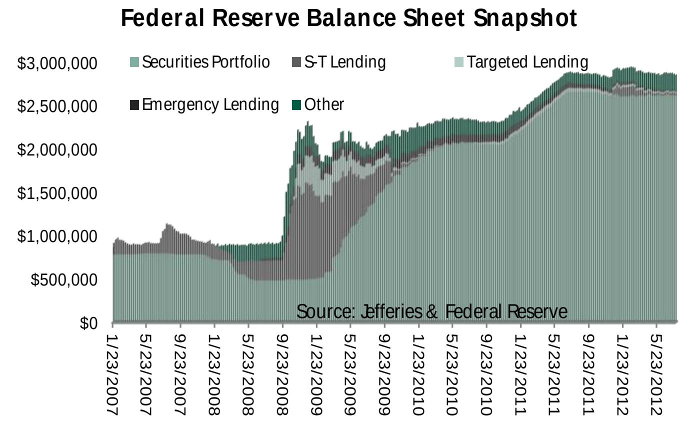
The size of the Fed's balance sheet asset holdings is a multiple of the pre-crisis size due primarily to securities purchases in QE1 & QE2.

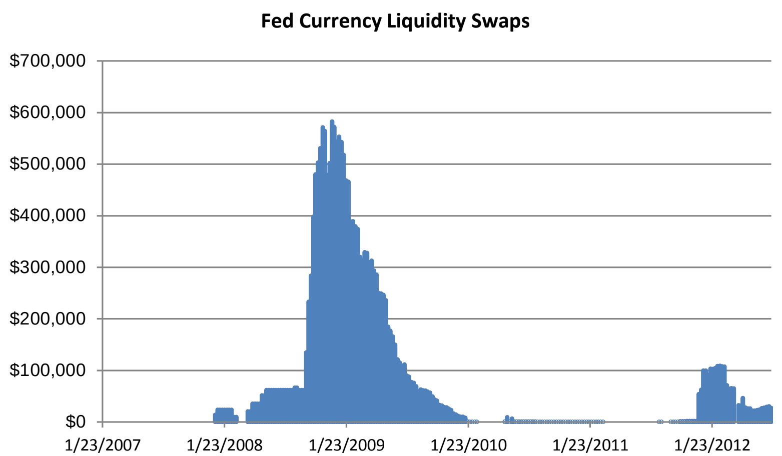
We think it is probable that the FOMC implements more accommodation after the Twist has been completed. FOMC will consider an open-ended QE and an MBS Twist. The Fed could also use of the discount window and balance sheet to stimulate bank lending.

The Twist operations largely absorb the Treasury issuance of longer-term debt and has also increased the average maturity of the Fed securities holdings to more than 110 months.

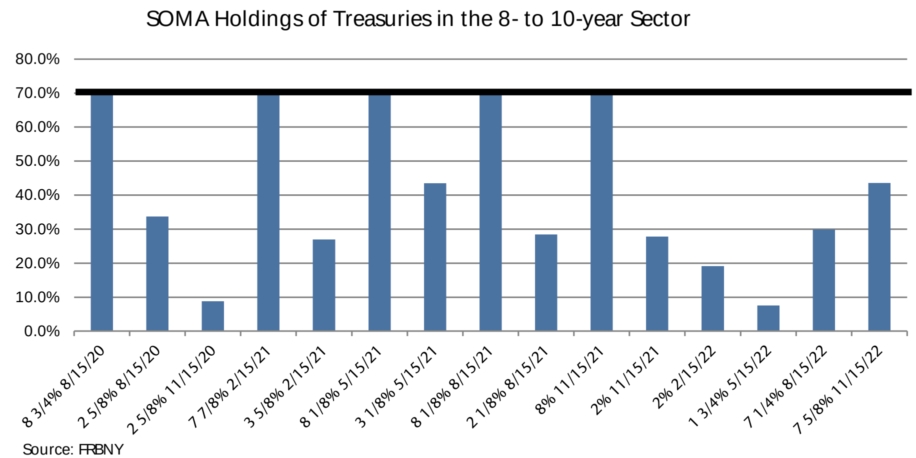
The Fed holds a large share of Treasury intermediates which may limit the Fed's ability to continue purchases in this sector.

The Fed will provide whatever is needed in currency liquidity swaps to ease dollar funding strains overseas, but those strains have eased.





Source: Federal Reserve



Jefferies

Inefficient Monetary Policy Transmission Mechanism…Discount Window Catalyst?

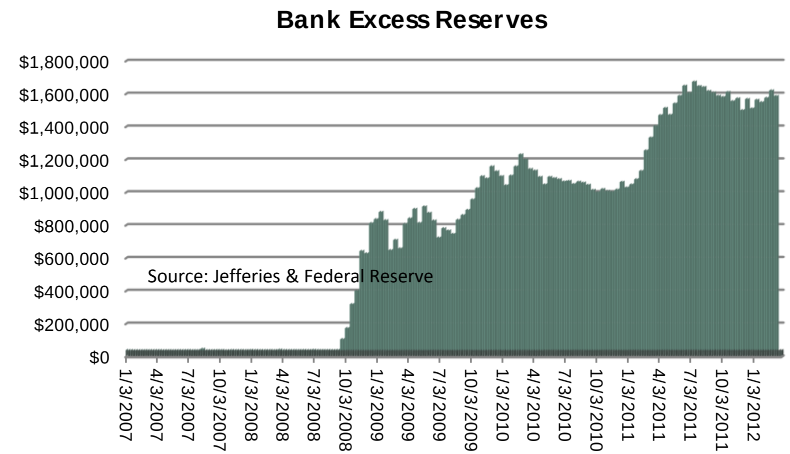
Excess reserves in the banking system increased by roughly the size of the Fed's balance sheet. As a consequence, the Fed's balance sheet expansion has had limited impact on the real sector of the economy.

Until recently, securities holdings were the only asset class on commercial bank balance sheets on the rise.

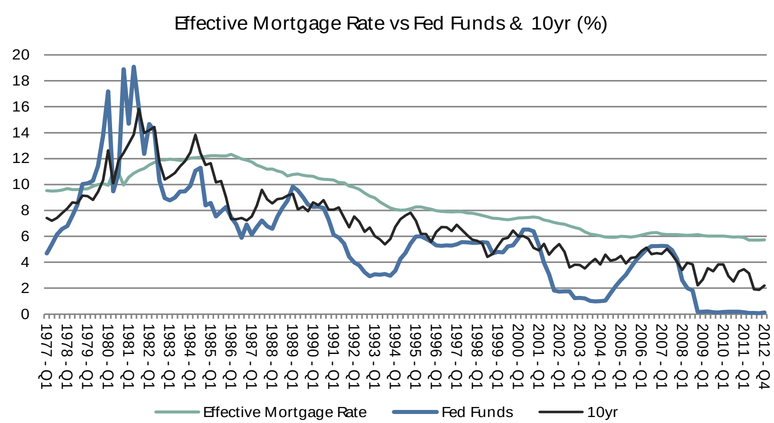
C&I loans have risen by $230 bln since the outset of 2011. This is an indication that the commercial sector is finally beginning to receiving some benefit from the Fed stimulus.

Consumer lending continues to stagnate in part because the TARP did not remove "Troubled Assets" from the banking system, leaving banks with a large quantity of poor performing consumer loans on the books.

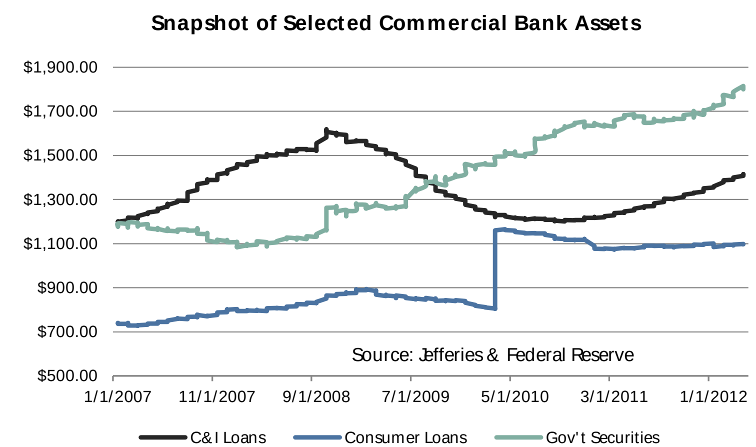
Because of a bank reluctance to refinance, many homeowners have not benefited from the sharp decline in market rates.



The FOMC may decide to spur consumer and small business lending with creative use of the discount window and balance sheet.



Source: Federal Reserve



Jefferies

FOMC Projects Tepid Growth, High Unemployment & Tame Inflation

FOMC central tendency forecasts have the unemployment rate as high as 8.2% at the end of 2012, and as high as 7.7% at the end of 2014.

The FOMC is not projecting "sustained improvement in the labor market" which Chairman Bernanke identified as the key factor behind any decision to provide more monetary stimulus. This suggests that the FOMC expects to provide more stimulus later in 2012

FOMC Economic Projections as of June 2012								
	Central Tendency Forecast				Range of Forecasts			
Variable	2012	2013	2014	Longer Run	2012	2013	2014	Longer Run
Change in real GDP	**1.9 to 2.4**	**2.2 to 2.8**	**3.0 to 3.5**	**2.3 to 2.5**	**1.6 to 2.5**	**2.2 to 3.5**	**2.8 to 4.0**	**2.2 to 3.0**
April	2.4 to 2.9	2.7 to 3.1	3.1 to 3.6	2.3 to 2.6	2.1 to 3.0	2.4 to 3.8	2.9 to 4.3	2.2 to 3.0
January 2012	2.2 to 2.7	2.8 to 3.2	3.3 to 4.0	2.3 to 2.6	2.1 to 3.0	2.4 to 3.8	2.8 to 4.3	2.2 to 3.0
November	2.5 to 2.9	3.0 to 3.5	3.0 to 3.9	2.4 to 2.7	2.3 to 3.5	2.7 to 4.0	2.7 to 4.5	2.2 to 3.0
June	3.3 to 3.7	3.5 to 4.2		2.5 to 2.8	2.2 to 4.0	3.0 to 4.5		2.4 to 3.1
Unemployment rate	**8.0 to 8.2**	**7.5 to 8.0**	**7.0 to 7.7**	**5.2 to 6.0**	**7.8 to 8.4**	**7.0 to 8.1**	**6.3 to 7.7**	**4.9 to 6.3**
April	7.8 to 8.0	7.3 to 7.7	6.7 to 7.4	5.2 to 6.0	7.8 to 8.2	7.0 to 8.1	6.3 to 7.7	4.9 to 6.0
January 2012	8.2 to 8.5	7.4 to 8.1	6.7 to 7.6	5.2 to 6.0	7.8 to 8.6	7.0 to 8.2	6.3 to 7.7	5.0 to 6.0
November	8.5 to 8.7	7.8 to 8.2	6.8 to 7.7	5.2 to 6.0	8.1 to 8.9	7.5 to 8.4	6.5 to 8.0	5.0 to 6.0
June	7.8 to 8.2	7.0 to 7.5		5.2 to 5.6	7.5 to 8.7	6.5 to 8.3		5.0 to 6.1
PCE inflation	**1.2 to 1.7**	**1.5 to 2.0**	**1.5 to 2.0**	**2.0**	**1.2 to 2.0**	**1.5 to 2.1**	**1.5 to 2.2**	**2.0**
April	1.9 to 2.0	1.6 to 2.0	1.7 to 2.0	2.0	1.8 to 2.3	1.5 to 2.1	1.5 to 2.2	2.0
January 2012	1.4 to 1.8	1.4 to 2.0	1.6 to 2.0	2.0	1.3 to 2.5	1.4 to 2.3	1.5 to 2.1	2.0
November	1.4 to 2.0	1.5 to 2.0	1.5 to 2.0	1.7 to 2.0	1.4 to 2.8	1.4 to 2.5	1.5 to 2.4	1.5 to 2.0
June	1.5 to 2.0	1.5 to 2.0		1.7 to 2.0	1.2 to 2.8	1.3 to 2.5		1.5 to 2.1
Core PCE inflation	**1.7 to 2.0**	**1.6 to 2.0**	**1.6 to 2.0**		**1.7 to 2.0**	**1.4 to 2.1**	**1.5 to 2.2**	
April	1.8 to 2.0	1.7 to 2.0	1.8 to 2.0		1.7 to 2.0	1.6 to 2.1	1.7 to 2.2	
January 2012	1.5 to 1.8	1.5 to 2.0	1.6 to 2.0		1.3 to 2.0	1.4 to 2.0	1.4 to 2.0	
November	1.5 to 2.0	1.4 to 1.9	1.5 to 2.0		1.3 to 2.1	1.4 to 2.1	1.4 to 2.2	
June	1.4 to 2.0	1.4 to 2.0			1.2 to 2.5	1.3 to 2.5		

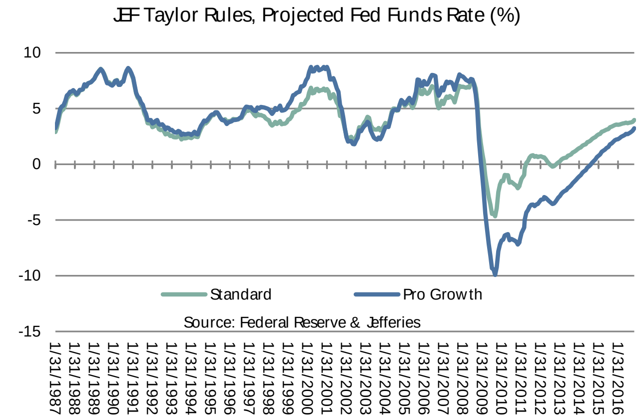
Source: Fed Board of Governors

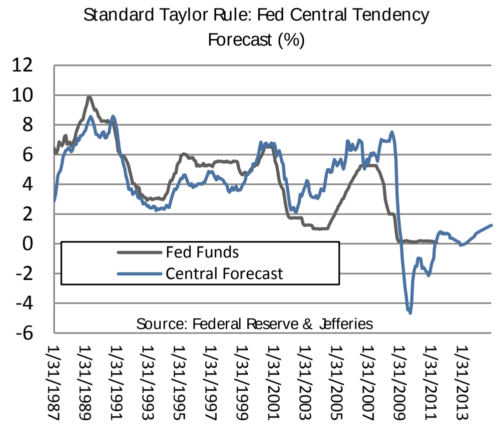
Taylor Rules Point To Extended Accommodation & More Stimulus

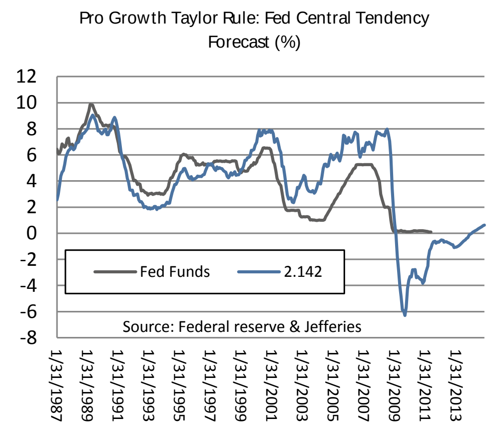
Jefferies expectations for the likely trajectory of monetary policy are based on a pro-growth Taylor Rule model which does not project a tighter monetary policy until late 2014.

A more standard Taylor Rule approach projects a rising fed funds rate in Q1 2013, but we think this is highly unlikely in the current economic environment.

Based on the central tendency FOMC forecasts and the pro-growth Taylor Rule formulation, the FOMC would not begin to raise the fed funds rate until 2015.







There Is No Fiscal Policy! Budget On Unsustainable Path, Fiscal Cliff?

The US budget deficit is on an unsustainable trajectory with or without the sequester imposed after the failure of the so-called Super Committee.

The US funds roughly 60% of expenditures with tax revenues, leaving the other 40% to be financed with debt issuance.

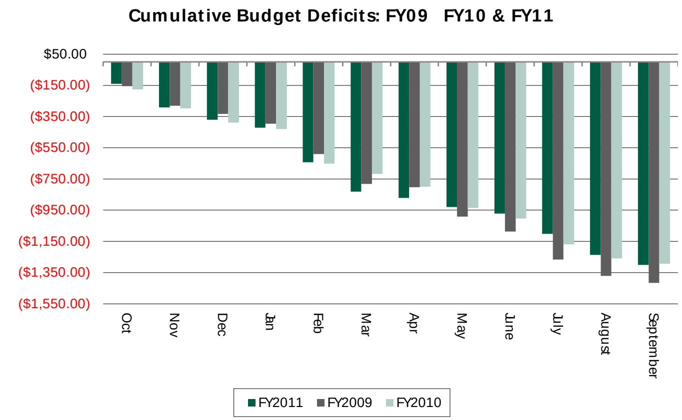
Mandatory spending --mostly social “entitlements”---comprises more than 60% of federal outlays.

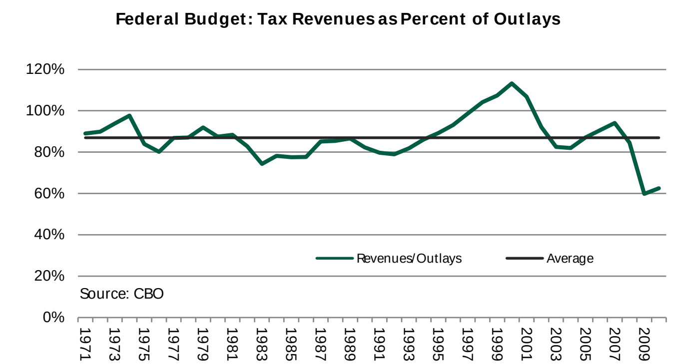
So, it could be said that tax revenues fund entitlements, the US borrows to finance all other government functions.

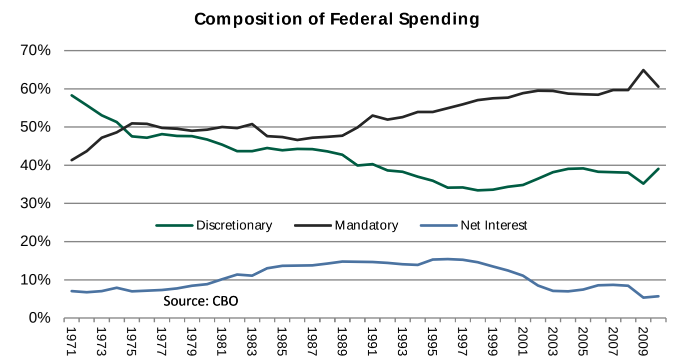
The sequester barely scratches the surface on entitlements, but cuts deeply into projected defense, security and discretionary spending. These cuts will go into effect at the beginning of 2013.

The inability of the US government to conduct an intelligible fiscal policy could result in a **“fiscal cliff”**, with taxes rising as much as 18% and federal spending being effectively flat according to CBO projections.

The Supreme Court ruling on health care complicates the budget dynamics and will make it more difficult to agree on extensions of the expiring tax cuts and long-term solutions to the structural budget imbalances.







Jefferies

Fiscal Cliff Looming Larger on Radar Screen

Under current law, revenues are projected to surge by more than $1.1 trln over the course of FY12, FY13 and FY14.

Specifically, CBO projects that revenues will increase $220 bln in FY12, $465 bln in FY13, and an additional $325 bln in FY14.

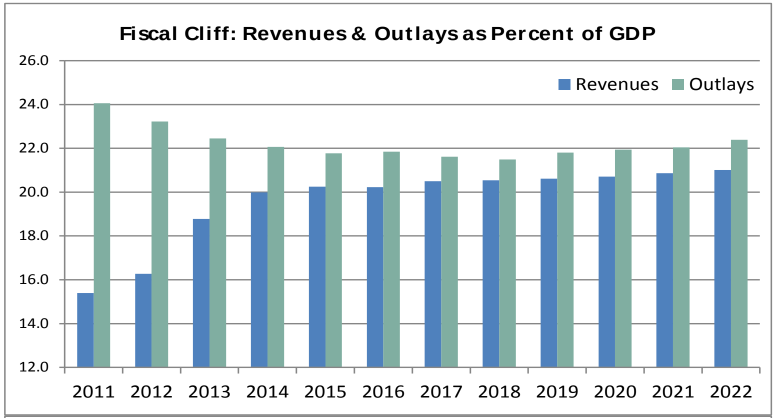
Tax receipts would rise from 15.4% of GDP in FY11 to 20% of GDP in FY14.

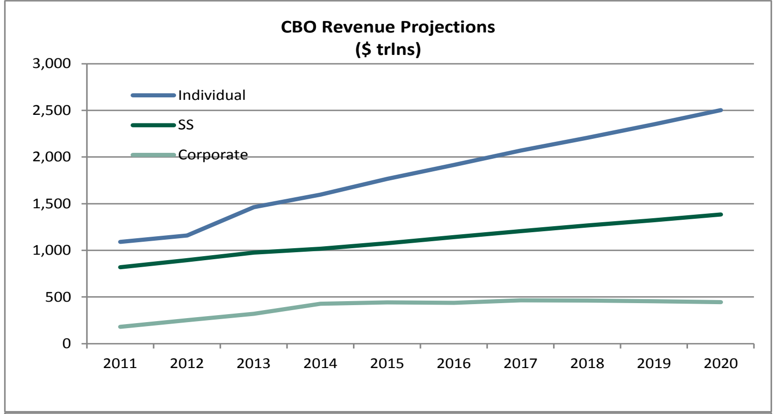
On the outlay side of the equation, CBO projects total federal outlays will increase by $3 bln in FY12, decline $28 bln in FY13 and rise $85 bln in FY14.

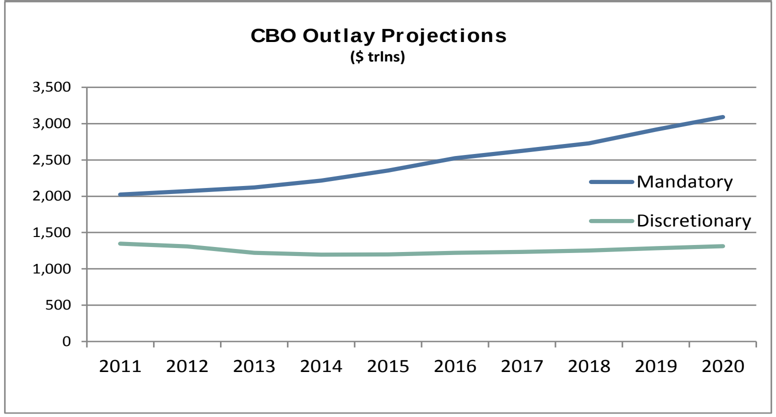
Mandatory spending would increase $45 bln in FY12, and $53 bln in FY13 and $93 bln in FY14.

Due to the sequester, discretionary spending would decline $39 bln in FY12, $88 bln in FY13 and $24 bln in FY14.

Expiring fiscal cliff tax cuts were not extended this summer and will take a bite out of Q3 & Q4 growth.







Jefferies

Europe Crisis Poses Limited Economic, More Significant Financial Risks…Asia Slowing

Exports have contributed an average of 1% since the end of the recession in mid-2009.

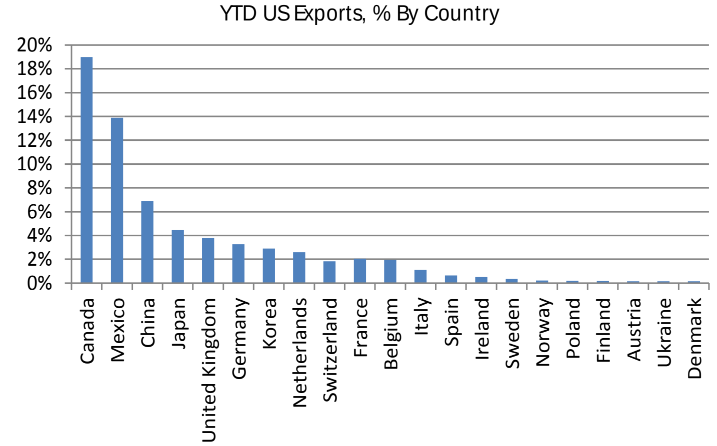
In 2011, US exports to Europe accounted for 16.5% of total US exports.

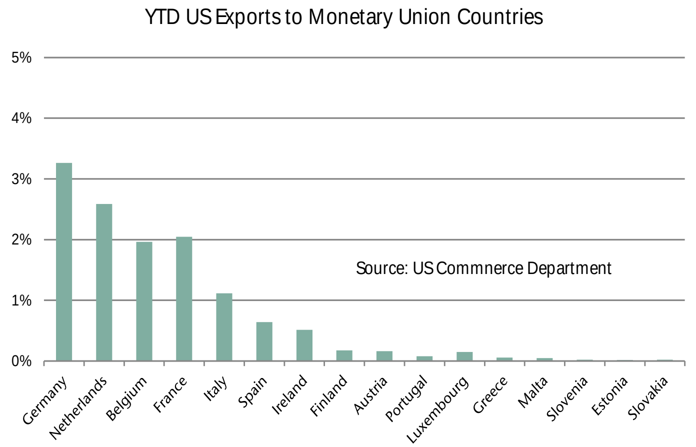
US exports to EMU accounted for 13% of total US exports.

So the direct effect of a recession in Europe on the US economy through exports is fairly limited.

The US is more vulnerable to links through the financial markets, the possibility of contagion through the banking system and a severe contraction in the European economy that has widespread global consequences.

The slowdown in the Asian economies could prove to be more problematic.





Services-Dominated Economy & Trade Deficits, Time To Rebuild Industrial Base

One of the most significant underlying imbalances in the US economy is reflected in an over-reliance on the service sector of the economy.

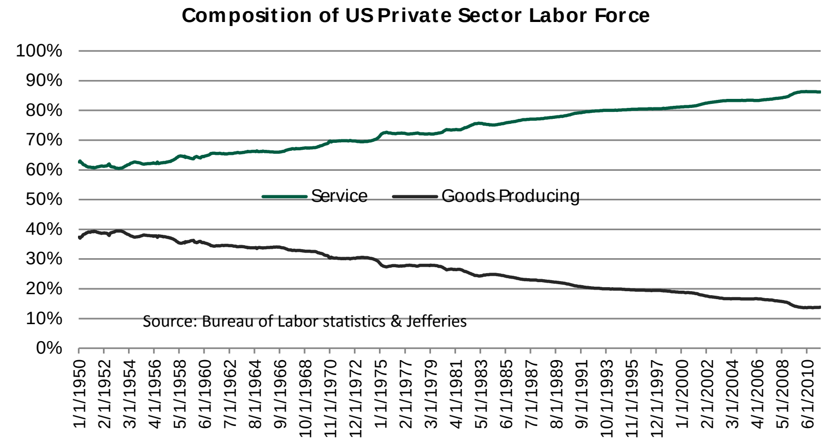
Over the past fifty years, the share of the US labor force employed in the service sector of the economy has increased as the industrial base has gradually eroded.

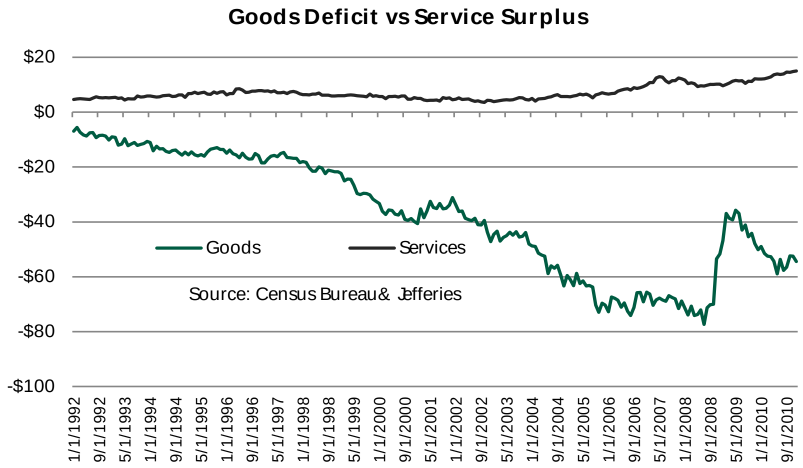
Currently, roughly 85% of the US labor force is employed in service providing activities, with only 15% employed in goods producing activity such as manufacturing, mining and construction.

It takes 85% of the US labor force to generate a monthly service sector trade surplus of less than $20 bln.

Because of the decline in good producing activities, the US runs sizeable monthly trade deficits in goods. The chronic trade deficits are a drag on the economy and help to explain why the US growth has been slower over the past 20 years.

Fortunately, manufacturing in the southern states has been on the rise due to the combination of a weak dollar and cheaper labor costs.



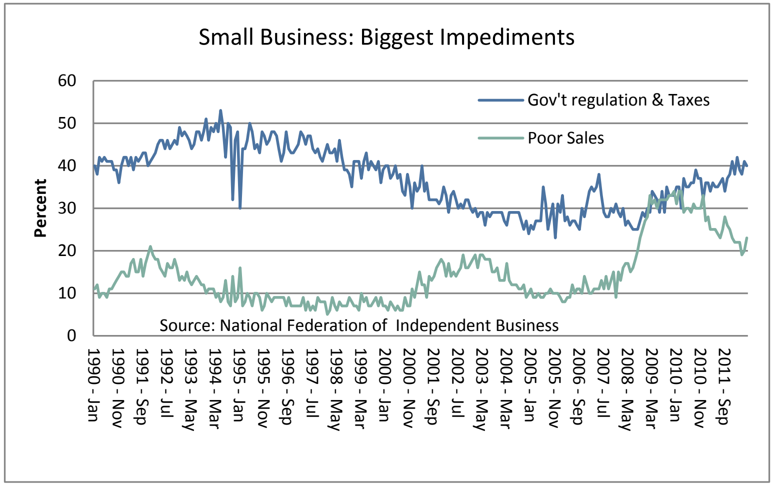


Jefferies

Based on ADP data, small and medium sized business are the primary sources of job creation in the US labor market, with start-ups playing a key role.

Small business accounted for 49% of new jobs in 2011 and also to-date in 2012.

Based on survey data, the combination of government regulation and taxes is the biggest impediment to small business.



Composition of ADP National Employment

	--- Level ---			--- Changes---				
Industry/ Size	June	July	August	June	July	August	2011	2012 YTD
Total private nonfarm	110,890	111,063	111,264	173	173	201	1,877	1,404
Small (1 - 49)	49,815	49,892	49,991	90	77	99	911	694
Medium (50-499)	43,061	43,134	43,220	71	73	86	853	598
Large (>499)	18,014	18,037	18,053	12	23	16	113	112
					0	0		
Goods-producing	18,199	18,216	18,232	17	17	16	224	152
					0	0		
Small (1 - 49)	6,698	6,702	6,709	8	4	7	82	60
Medium (50-499)	7,981	7,986	7,998	7	5	12	162	86
Large (>499)	3,520	3,528	3,525	2	8	(3)	(20)	6
Service-providing	92,691	92,847	93,032	156	156	185	1,653	1,252
Small (1 - 49)	43,117	43,190	43,282	82	73	92	829	634
Medium (50-499)	35,080	35,148	35,222	64	68	74	691	512
Large (>499)	14,494	14,509	14,528	10	15	19	133	106
Source: ADP								
Addendum:								
Manufacturing	11,777	11,785	11,786	7	8	1	120	67

Source: ADP

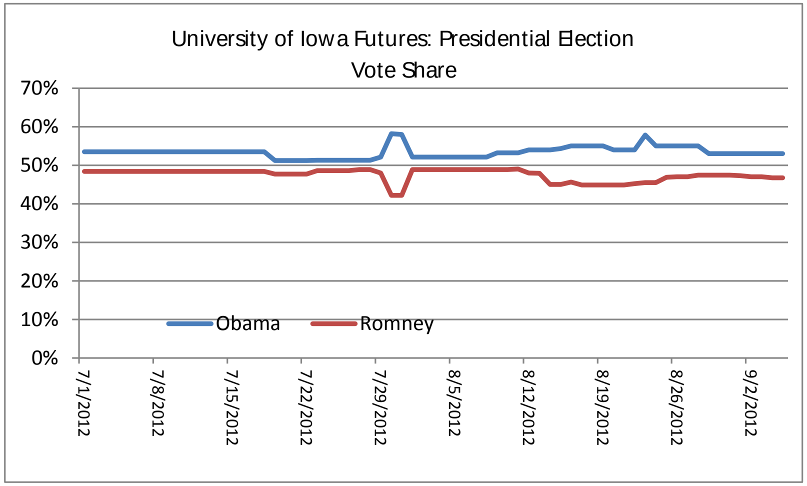
	March	April	May	June	July	August	2011	2012 YTD
Total private nonfarm	204	112	131	173	173	201	1,877	1,404
Goods-producing	44	(9)	(3)	17	17	16	224	152
Service-providing	160	121	134	156	156	185	1,653	1,252
Manufacturing	23	(9)	(5)	7	8	1	120	67
Construction & Mining	21	0	2	10	9	15	104	85

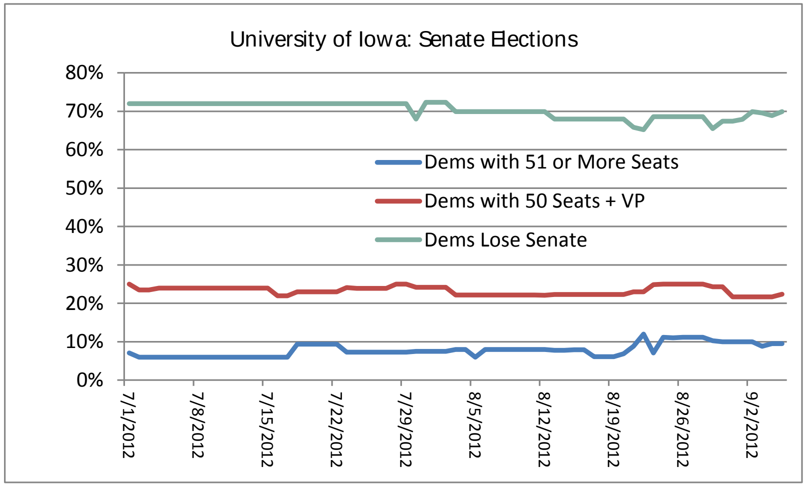
Source: ADP

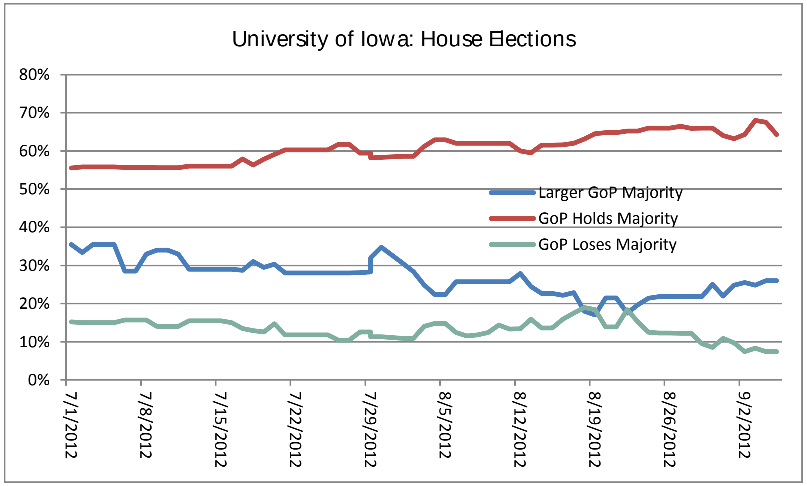
President Obama is unpopular and vulnerable but electable due to voter caution with Mitt Romney.

To date, voters appear to prefer the devil they know (Obama) to Romney. For this reason, we think that the election outcomes will be determined by the debates.

Voters also appear to be inclined to keep the GoP majority in the House, as well as reducing or eliminating Democratic control in the Senate







Key States in Presidential Election

After garnering 365 of 538 electoral votes in 2008, President Obama has a clear edge over GoP Candidate Romney. Romney needs to generate 79 electoral votes of the 92 possible electoral votes from Florida (27), Ohio (18), Indiana (11) Virginia (13),North Carolina (15) and Iowa (7) back into the Red State fold. 270 Electoral votes are needed to win.

Presidential Election Voting History

		2008	2004	2000	1996	1992	1988	1984	1980	1976	1972
Florida	29	Democrat	Republican	Republican	Democrat	Republican	Republican	Republican	Republican	Democrat	Republican
Ohio	18	Democrat	Republican	Republican	Democrat	Democrat	Republican	Republican	Republican	Democrat	Republican
Indiana	11	Democrat	Republican	Republican	Republican	Republican	Republican	Republican	Republican	Republican	Republican
Virginia	13	Democrat	Republican	Republican	Republican	Republican	Republican	Republican	Republican	Republican	Republican
North Carolina	15	Democrat	Republican	Republican	Republican	Republican	Republican	Republican	Republican	Democrat	Republican
Iowa	6	Democrat	Republican	Democrat	Democrat	Democrat	Democrat	Republican	Republican	Republican	Republican
Total	92										

Senate Election Outlook

	Democrats	Republicans	Comment
Current Seats	51	47	"Democratic Socialist" Sanders & Independent Lieberman caucus with Democrats. Maine's Angus King?
At risk/Open	16	5	With 16 contested seats, Democrats are at greater risk.
Probable win	10	2	12 out of total 21 elections appear to be done deals.
Tight Win	4	5	All of these elections could go either way. Please see below.
Tight Loss	5	4	All of these elections could go either way. Please see below.
Projected Seats	49	49	Final results may be close enough that VP could play important role in Senate votes.

Tight Senate Elections

Incumbent Party	State	Democrat	Republican	Outcome	Comment
Democrats	Wisconsin	Baldwin	Thomson	Thomson	Contentious GoP primary gives Baldwin boost, but Thompson has pulled ahead.
Democrats	Virgina	Kaine	Allen	Toss Up	Dead heat in polls, Allen has edge if he keeps hi foot out of his mouth.
Democrats	Florida	Nelson	Mack	Mack	Nelson has lead but is not popular, and Mack has been gaining.
Democrats	Missouri	McCaskill	Akin	Akin	Akin blew a healthy lead with offensive gaffe, but McCaskill's unpopularity kept him in the game.
Republicans	Massachusetts	Warren	Brown	Brown	Incumbent Brown hurt by lack of Romney support, but Warren is a weak candidate.
Republicans	Montana	Tester	Rehberg	Rehberg	Incumbent Tester has uphill battle in traditionally Red State.
Republicans	Nevada	Berkley	Heller	Heller	One Blue Senator seems to be enough for Nevada, Heller running ahead.
Republicans	North Dakota	Heitkamp	Berg	Heitkamp	North Dakota is a Red State, but tends to split its ticket. Heitkamp running ahead.
Republicans	Indiana	Donnelly	Mourdouk	Toss Up	Dead heat. Strong Donnelly election history vs strong Romney lead in Indiana. Pick it.

Source: Real Clear Politics & Jefferies

JEF Forecast Table

JEF Economic Projections															
	Actual								Projected						
			2011				2012				2013				2014
	2009	2010	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Real GDP (% saar)	-0.5%	3.1%	0.4%	1.3%	2.2%	3.0%	1.9%	1.5%	1.5%	1.0%	2.3%	2.0%	2.2%	2.5%	2.5%
Average															
Unemployment Rate	9.3%	9.6%	8.9%	9.1%	9.1%	8.7%	8.3%	8.2%	8.2%	8.1%	7.9%	7.8%	7.7%	7.5%	7.2%
CPI (yoy %)	2.7%	1.50%	2.1%	3.4%	3.8%	3.4%	2.9%	1.7%	1.5%	1.8%	2.0%	2.1%	2.3%	2.5%	2.4%
PCE Deflator (yoy %)	2.3%	1.4%	1.8%	2.5%	2.9%	2.6%	2.3%	1.6%	1.5%	1.6%	1.8%	1.9%	2.0%	2.1%	2.2%
Federal Reserve															
IOER (Average)	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%
Fed Funds (Average)	0.16%	0.18%	0.16%	0.09%	0.10%	0.10%	0.10%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%

Source: Jefferies

NB! The forecast table assumes that the federal government extends all of the tax cuts into mid-2013 during the lame duck Congressional Session following the elections. If the tax cuts are not extended, Jefferies projects that US GDP will decline 1% in 2013.

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