

INVESTMENT UPDATE

For this month's Investment Update, we're going to keep it rather brief and give you a quick update on the "big picture," with special emphasis on employment and housing.

We're currently getting a sense of *deja vu*, as there have been some positive developments, both here and abroad, on the economic front, a very similar pattern to what we saw at the beginning of 2011. Unfortunately, last year the good economic news came to a crashing halt, as the European fiscal crisis took a dramatic turn for the worse, energy markets were rocked by mass uprisings in the Middle East, and the Japanese tsunami severely disrupted the industrial base and supply chain of one of our major trading partners. The result, which played out during the middle of 2011, was a drop in investor and consumer confidence, a jump in retail prices and the general shedding of riskier assets. These factors, combined with the Fed's "QE 2.5" program (which shifted the Fed's portfolio holdings into longer maturities), caused Treasury bonds to become the best performing asset of the year, favored by risk-averse investors the whole world 'round.

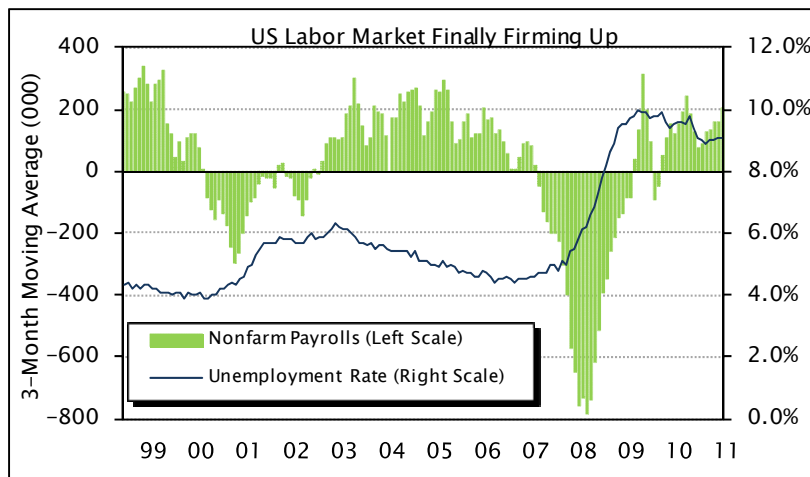
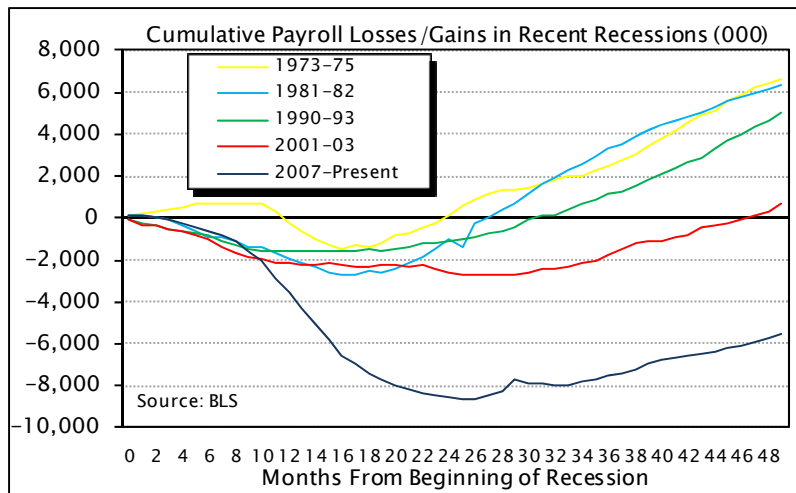
So far in 2012, we've already seen a surprisingly strong "print" on the US labor front, with the December unemployment rate dropping to 8.3%, its lowest level in 34 months, combined with an increase in private non-farm payrolls of 203,000, the biggest gain since, you guessed it, last Spring. As always, the employment numbers get a lot of attention, and for good reason; having a job not only puts money in people's pockets, boosting spending on consumer goods, but also gives a lift to our confidence in the future. It could be argued that this psychological lift has an even greater impact on longer-term economic growth than the immediate impact of a paycheck.

A closer look at the numbers shows that even with the recent improvement, this economy has been devastating to the working population of our country. At its worst (late 2008 to early 2009), the US economy was shedding more than 700,000 jobs per month. By early 2010, after more than two years of recession, the US had lost approximately 8.6 million jobs. As the top chart shows, that absolutely blows away comparisons to any recent recessions, where job losses were far less severe (even if we adjust for the larger population of today's economy). Furthermore, the recovery of jobs was far more rapid in every one of the previous four recessions; at this point into the cycle (more than four years since late

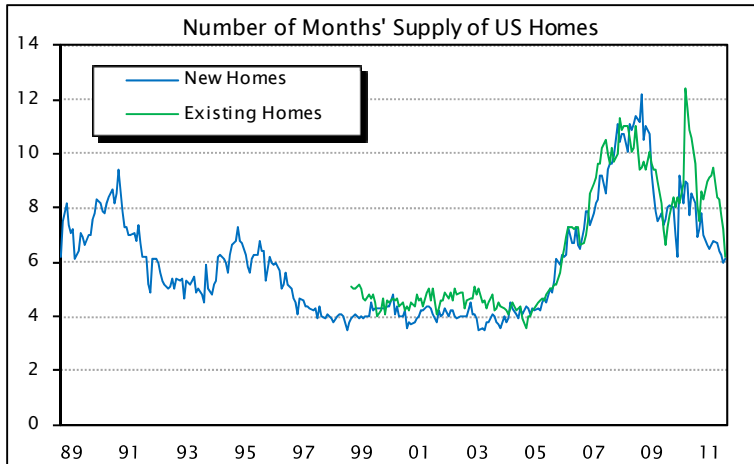
2007, the official beginning of the recession) we had fully recovered all the lost jobs in each of the previous four recessions. As of today, while we've added three million jobs since the trough, we're still down approximately 5.5 million jobs since the recession began.

The second chart details just how severe those job losses were, by month. It also shows the effect on the US unemployment rate, which more than doubled, from 4.5% to 10%, between 2007 and

2009. Since then, payroll growth has averaged well below what policymakers had hoped for. With new workers entering the labor markets every day, economists estimate that the US needs to add approximately 140,000 jobs per month just to keep the unemployment rate from rising. A clarification: Keep in mind that throughout this analysis we are talking about the aggregate "net" jobs gained and lost, as over the course of a month there are many millions of jobs created and destroyed. That 140,000 figure is a net number, which includes terminations, retirements, new hires and quits.



Many of these lost jobs were the result of the bursting of the US housing bubble. When home prices collapsed, it set off a chain reaction that created a gigantic glut of unsold new and previously owned homes. The home construction industry—including building products, appliances, plumbing supplies, and so on—as well as the mortgage and real estate brokerage and appraisal business, all took huge hits, and millions of US workers lost their jobs. As the top chart on this page shows, the excess supply of new and used homes has been worked off to a much more manageable level.



In a growing society, purchases of durable goods, transportation and housing can be put off for only so long. Cars wear out, factories need modernization, and young people eventually

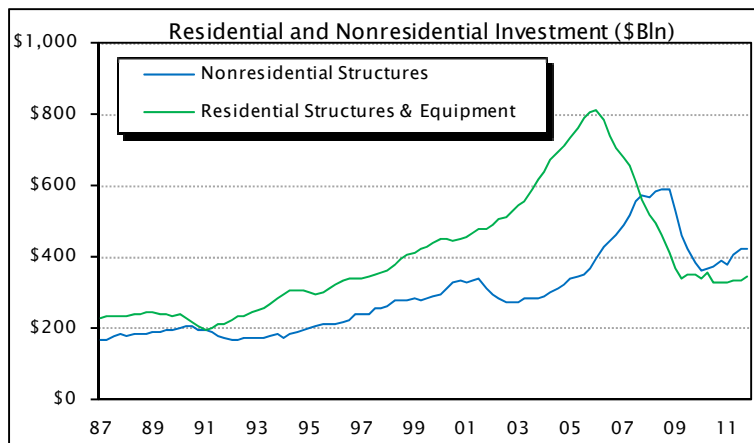
move out of their parents' basements and find their own dwellings. We're currently witnessing a significant uptick in auto sales; even GM is once again making healthy profits. Likewise, there is a positive upward trend in industrial investment. Perhaps most encouraging is the recent turnaround in household formations, as shown in the bottom chart. After all, it doesn't matter if home affordability is at a multi-

This is a significant development for the US economy, as reducing this housing inventory is the first step in the recovery of the housing market—and someday, the addition of millions of "lost" jobs. To be sure, we are still many, many months away from being able to declare that the housing market is recovering, but it's clear that the process is well-advanced.

decade high if there are no new buyers entering the market. We wrote a few months back about the troubling stagnation (and

for a short time, the outright decline) in new household formations, after growing by an average of 1.2 million per year for 25 years. This critical measure is back on the rise, which is unambiguously positive for the real estate market, and should help further stabilize home prices by spurring demand, even if it's only investors looking for properties for potential new renters.

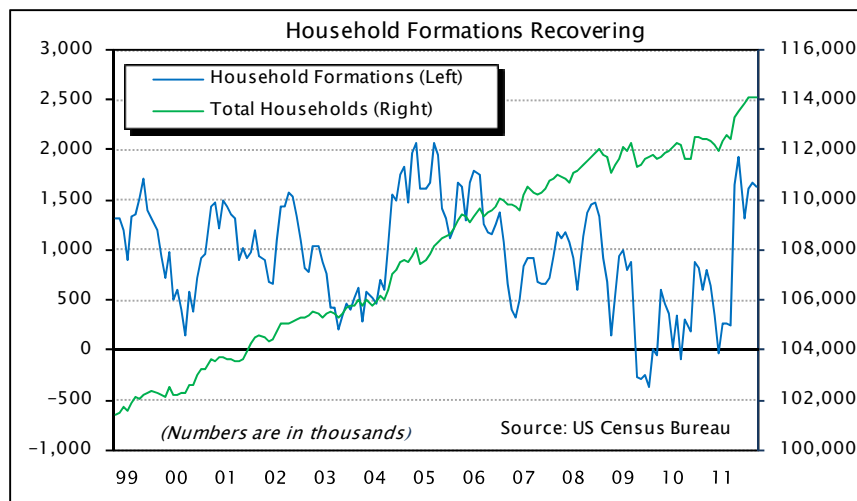
The middle chart indicates just how much capital investment in the residential real estate market has fallen; it now stands at less than half of what it was at the top of the market, while new home sales have fallen to their lowest levels since the series began to be tracked in the late 1950's.



This chart also shows that the investment in commercial (i.e., "nonresidential") real estate also hit rock bottom, but is now showing a slight upward trend. Previously, these two components had been the primary drivers (along with information processing and non-residential industrial and transportation spending) of US capital investment, the very backbone of the US economy. It is no exaggeration to say that there can be no real recovery in our economy without significant growth in residential and nonresidential investment.

Bottom line? The labor markets are "joined at the hip" with

residential (and non-residential) investment. The decline in the housing market has had a deep and protracted impact on US employment, well beyond just construction jobs. We will not have vibrant job growth and economic growth until the housing glut is worked off, and new buyers are a big part of that process.



begun, but we are still in the early stages. Stay tuned.