

**APRIL
2012**

Economic Review - Continued - March 31, 2012

* **The Direction of Interest Rates**

Central banks remain committed to ultra-low interest rates, both at the short and long ends of the yield curve. While the recent uptick in economic activity might suggest a possible lull in future stimulus, the odds seem to support more stimulus rather than less. The Federal Reserve has articulated a plan to keep interest rates unchanged from the current zero to 0.25% target range through 2014. In turn, the short end of the yield curve should remain extremely low for at least another year to come, if not longer. Moving farther out the yield curve, 10-year bond yields (now in the 2% range) should also remain quite low. Central bankers appear committed to suppressing longer-term interest rates, and risk aversion should remain elevated given fears about Europe. Economic weakness will not encourage many to second-guess the situation, which is in line with our base case for sluggish economic growth. Yet traditional methods for valuing conventional bonds remain less effective in light of today's heavily manipulated fixed income markets. The key message in the bond market seems to be that a long period of low growth and low inflation has been priced in.

Moderate Inflation Levels

Across most of the world, inflation remains reasonably well behaved. Commodity prices are again rising, presenting an upside risk to inflation. However, consumer food prices look as though they are trending downward which may provide a partial offset. There is substantial economic slack nearly everywhere which argues that demand-side inflation should not be a problem for some time to come. Inflation has remained quite well-anchored despite enormous stimulus and strong commodity prices. We anticipate more of the same, although there is a hint of slight upward inflationary pressures as the economy recovers and central bankers prove reluctant to tighten monetary policy in light of a surprisingly more robust growth scenario. Yet, we do not see this as a near-term prospect and we expect that core inflation will continue to fluctuate at around 2.0%.

Employment

The big development over the past several months has been the surge U.S. job creation. Employment gains have materially exceeded expectations and have put the pace of improvement ahead of gains that were forecast for one year from now. Strong profitability seems to have led some business to add to their payrolls, which is reflected in declining layoffs and falling jobless claims. But not everything is back to normal. For instance, the average duration of unemployment remains extremely long, which suggests that some atrophy in job skills may be taking place. Fewer people are opportunistically hopping from their current jobs to work for another company. If economic growth reverts to a more sluggish trend as we expect, job creation may be dialed back to a range of between 100,000 to 150,000 new jobs per month, and the unemployment rate could show signs of stalling out.

* **The U.S. Housing Market**

The U.S. housing market is clearly in transition. We do share the view that the deterioration has slowed and may give way to a slight rebound. Housing affordability is now remarkably good. Ultra-low interest rates and home prices have made homes more affordable than they have been in a generation. The housing market still has three main areas in need of a resolution: first, credit conditions may tighten again as mortgage lenders grow wary as they observe elevated delinquency and foreclosure rates. Many prospective home buyers acknowledge that prices are attractive but remain reluctant to buy. Finally, there is still an excess of between 2 to 3 million homes on the market; it may take several years for this backlog to be absorbed.

Elevated Geopolitical Risks

Geopolitical risks remain elevated. This is largely a consequence of the unrest over economic stagnation and volatility. This unrest is pooling in various hot spots around the world; we have seen this at opposite ends of the political spectrum in the U.S. (Occupy Wall Street and the Tea Party), in mass protests and recriminations in Europe, and in the Arab Spring movement. Iran's increasingly icy relations with much of the world are less clearly tied to recent economic events, but nonetheless weigh on investor sentiment and oil prices.

PSDLAF NEWSLETTER

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**APRIL
2012**

Holiday Schedule

**Jan. 2, 2012
New Year
Observance**

**Jan. 16, 2012
MLK Day**

**Feb 20, 2012
President's Day**

**May 28, 2012
Memorial Day**

**Jul 4, 2012
Independence Day**

**Sep. 3, 2012
Labor Day**

**Oct. 8, 2012
Columbus Day**

**Nov. 12, 2012
Veteran's Day
Observed**

**Nov. 22, 2012
Thanksgiving Day**

**Dec. 25, 2012
Christmas Day**

**PSDLAF is rated AAA
by Standard & Poor's**



Economic Review - March 31, 2012

Executive Overview

The United States has enjoyed an impressive economic rebound since the fall of 2011. The consensus economic forecasts have begun to shift higher in response to the recent barrage of good cheer. Our own estimates are mostly unchanged relative to where we began the year. Further, our 2013 forecasts, on the whole, correspond to the view that 2013 will be reminiscent of 2012, with the expectation for the continued application of the fiscal handbrake and a lingering financial crisis-induced hangover.

Europe remains a focal point for global markets, and is one of our biggest worries. We can say with reasonable confidence that the Eurozone - representing one-fifth of the global economy - will be in recession in 2012. Fiscal austerity and structural reforms have a long way to go, and banks are in no position to lend.

While there has been an impressive rebound in some areas of the economy, the U.S. housing and job markets have yet to fall in line. Yet, they may be starting to heal. The U.S. housing market is clearly in transition, with visible signs that the rate of deterioration is stopping. A big development over the past several months has been a surge in U.S. job creation. Employment gains have materially exceeded expectations.

Prospects for Economic Growth

Our own forecasts for growth are mostly unchanged relative to our fourth quarter forecast. We remain reluctant to raise our forecasts, recognizing how fleeting swings in sentiment can be, and with an eye on the mounting threat from oil price volatility. Our forecast for growth in the U.S. remains at between 2.0% and 2.5%.

RBC has recently conducted research into what constitutes sustainable economic growth which lead us to believe growth prospects will remain muted going forward. Three main themes have surfaced:

- (1) Economic output is unlikely to fully rebound from the financial crisis, mostly due to the lingering effects of stubbornly high unemployment rates;
- (2) The depth and global breadth of the financial crisis associated with the housing crash will also mute economic growth for several years. The effects of deleveraging figure centrally in this forecast. Our current slower growth model also results from an assumption of ebbing government stimulus and heavy debt loads;
- (3) Assuming these factors fade at some point, today's prospects may never measure up to pre-2008 levels. The free-flowing access to credit and low commodity prices of the past 25 years artificially boosted growth during that period. There may also be new headwinds, featuring such trends as the retirement of baby boomers, which may also reduce annual growth by as much as one third.

Confidence Measurements

Economic data has been good on an absolute basis in recent months. The upward trend is beginning to be reflected in measurements of confidence such as consumer credit and in purchasing managers reports. Our compendium of leading indicators is now running at a slightly better than average pace. This is quite a contrast to several months ago, when data was weak and deteriorating. However, this experience is hardly uniform for all countries. Generally, U.S. data is doing somewhat better than elsewhere, and the business sector is outperforming other sectors.

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PSDMAX 30 Day Average Yield:
.0206%

PSDLAF 30 Day Average Yield:
0.0183%



**Cash
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*Increase Your Investment
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Thank you to our loyal Settlers for another successful year at the 57th Annual PASBO Conference.

We hope to see you again next year!

Save the date.... March 19, 2013 through March 22, 2013 at the David L. Lawrence Convention Center in Pittsburgh.



Safety, Liquidity, Yield