

GDP, U.S. PERSONAL INCOME, and INDIANA NON-FARM
PERSONAL INCOME PROJECTIONS

3rd Quarter 2007 through 2nd Quarter 2009

Prepared by
ECONOMIC FORECAST COMMITTEE

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PREVIOUS FORECAST EVALUATION

In our April forecast we predicted that U.S. economic growth would moderate during 2007 from the rate seen in 2006. In fact, output growth was quite strong the past two quarters after a weak first quarter. Inflation has been buffeted by the fluctuations in energy prices, but has decreased slightly. The net result for the past three quarters (through the third quarter) is output growth 0.8 percent above our expectation and inflation 0.2 percent above our forecast. This yields Nominal GDP growth that was over one percent higher than our forecast.

This too pessimistic forecast carried over to national income growth and even more so for income at the state level. Growth in U.S. Personal Income came in at 6.5 percent for the past three quarters, 1.4% better than our estimate. Indiana Non-Farm Personal Income increased at an impressive 7.2 percent annual rate in the first two quarters of this year, a full three percent above our forecast. Most of the discrepancy is due to extremely strong growth in the first quarter.

In terms of the *level* of Indiana non-farm income, we underestimated growth in the first half of this year by slightly under \$3 billion. However, there have also been data revisions that lowered estimates of income. These have amounted to over \$2.3 billion, implying that our estimated level of second quarter income was below the actual level by \$0.6 billion.

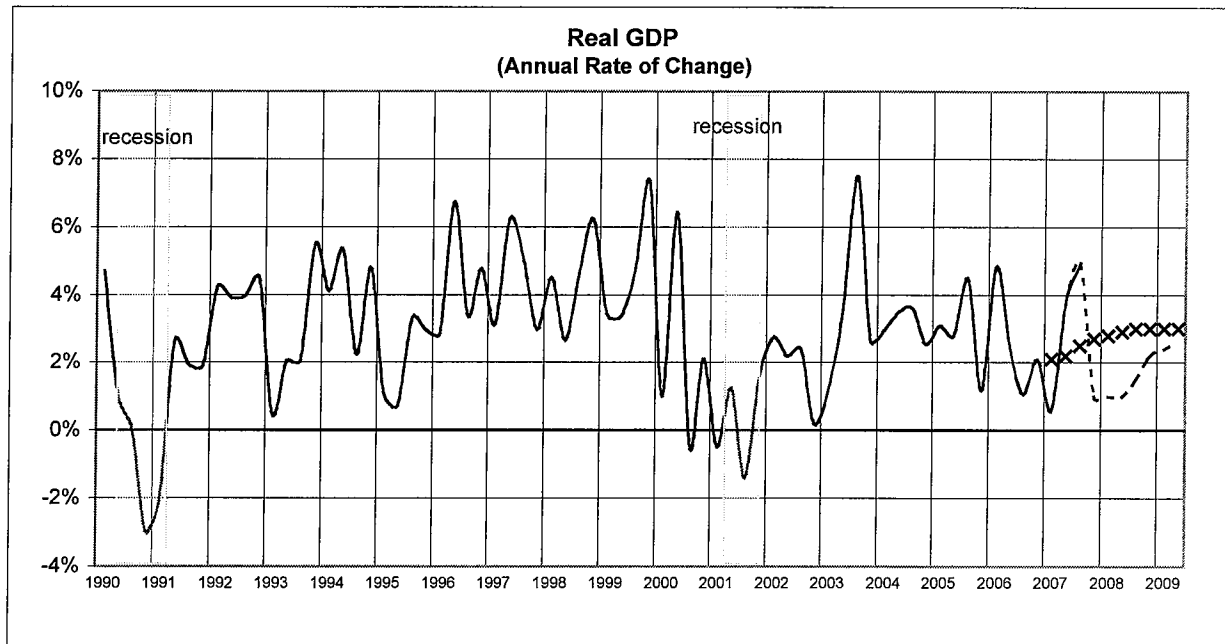
PREVIOUS FORECAST ERRORS (at annual rates)

Three quarters ending 3rd Quarter 2007

	<u>Forecast</u>	<u>Actual</u>	<u>Error</u>
Real Gross Domestic Product	2.3%	3.1%	-0.8%
GDP Deflator	2.4%	2.6%	-0.2%
Nominal Gross Domestic Product	4.7%	5.8%	-1.1%
U.S. Total Personal Income	5.1%	6.5%	-1.4%
IN Non-Farm Personal Income (2 quarters)	4.2%	7.2%	-3.0%

REAL GROSS DOMESTIC PRODUCT

As shown in the chart below we are quite pessimistic concerning output growth over the next year and a half, and especially through the first half of next year. Our forecast (shown by the dashed line) is a far weaker outlook than in our April forecast [x's are previous forecast]. The primary reason for the difference is the behavior and prospects for the housing sector. A year ago, we anticipated that growth in housing would *stall*. Instead, growth has turned decidedly *negative*. In the third quarter the decrease in residential investment lowered the overall output growth rate by more than a full percent.



Our new forecast is of an economy that is battling severe problems. In our view, these problems have worsened significantly during the past few months even while overall economic growth has been strong. The underlying cause of the difficulties facing the economy is the relentless collapse of the housing industry, which has spawned severe distress in the financial sector. Together these stresses are pressuring both investment and consumption spending by households and investment spending by business. The main positive element is the trade sector, which we think will provide enough support over the next year for the economy to avoid recession, but not by much.

In April we thought the downturn in housing would last through most of this year, with some recovery by early 2008. We now think that the decline will continue for most of next year, and that the sector will be a significant drag on the overall economy through at least mid-2008. Through the third quarter, housing starts have fallen by 38 percent from their peak in the third quarter of 2005 (eight quarters ago). By contrast, during the severe recession in 1980/81, starts fell by 59 percent over a period of 14 quarters, while in the 1990 recession the decline was 45 percent also over 14 quarters. We are clearly in a housing decline of recession proportions.

The financial side of the housing debacle also looks much worse now than in April. Then difficulties in the subprime area were just beginning to appear, but the magnitude of the problem was not at all apparent. The full magnitude of the damage is still not clear, but it is certainly going to be large. To date banks and other financial sector firms have booked about \$75 billion in losses on securities related to subprime loans. A recent Wall Street Journal analysis estimates total realized losses by business at between \$150 billion and \$400 billion. As a percent of GDP, losses will likely exceed any previous financial collapse since the end of WWII except the savings and loan crisis. Losses would have to reach the \$400 billion figure to match the severity of the S&L debacle.

The riskiest sub-prime mortgages were originated in 2005 and 2006 at low introductory rates. Most of these are variable rate mortgages with their first resets in 2008 and 2009. More than \$500 billion of these loans will reset in 2008 and about the same amount in 2009. With 16% of sub-prime loans already delinquent, home prices falling, and stricter loan standards; foreclosure and losses over the next couple of years will be huge even with a recently announced program to postpone for five years the first rate reset on some of these mortgages. This reset extension could apply to as much as \$150 billion of mortgages.

A major uncertainty for the next year is how much negative impact the subprime mess will have on both the broader financial system and on real economic activity. In both regards some significant spillover is already appearing. In the financial markets there has been a flight to quality since the summer that has driven down the yields on Treasury securities in dramatic fashion. Last week, for example, the yield on the 3-month T-bill, which is usually near the federal funds rate, was 1.5 percentage points below it. At the same time, rates on commercial paper and in inter-bank markets have been driven to significant premia as even banks are more cautious about lending to other banks. The spread on prime jumbo mortgages vs. smaller

mortgages has almost tripled compared to a year ago. Finally, Florida's state managed money market fund for local governments disclosed losses on subprime securities which resulted in a "run" on the fund and now severe restrictions on withdrawals.

Banks are responding to their losses by tightening their lending standards particularly for mortgage loans, but for other kinds of credit as well. Tighter mortgage standards reduce any hope for a quick turn-around in the sector. They limit the pool of potential buyers, and by making refinancing of high rate loans more difficult they can increase the probability of foreclosures, which dumps more homes onto the market. Already, foreclosure rates and homes available for sale are at historic highs. Credit restraints beyond housing could become a serious impediment to continued growth in both consumption and investment spending.

A third very troubling aspect of the housing downturn is that it is affecting home values broadly across the nation. According to the Office of Federal Housing Enterprise Oversight (OFHEO) the national average price of houses financed by Fannie Mae and Freddie Mac declined in the 3rd quarter, the first such decline in 13 years. The Case-Shiller Index, which includes higher priced houses, was down 4.5 % over the last year. According to the Federal Reserve's Flow of Funds, homeowners' equity declined \$129 billion in the 3rd quarter, the largest absolute decline on record and in percentage terms the largest decline since 1974. Falling housing prices can have a potent effect on household spending and psychology, an effect now being seen in measures of consumer confidence.

Another pressure on household budgets, and also the economy more generally, has been energy prices. In April our expectation was that crude oil prices would average around \$65 per barrel over the next two years. Instead, they have moved much higher – recently almost to \$100 per barrel and currently just under \$90. We now expect that oil will average near the current \$90 per barrel. At these levels, energy costs will definitely have a negative impact on household purchases of other goods and services, and will also adversely affect business profits, which could limit investment spending.

A final troubling element in the household budget situation is the low level of household saving. The personal saving rate, as measured in the National Income and Product Accounts, is only barely in positive territory. To some extent this has been explicable first due to the boom in housing values (now clearly ended) and more recently due to the rising stock market (perhaps

also ended). But from a long-term perspective, it cannot continue indefinitely, especially with the baby boom generation beginning to reach retirement age.

Until recently, an offset to these downward pressures on household spending has been the situation in the labor market. But here too the outlook has become darker. In the six months through November payroll employment gains averaged 94 thousand per month, with five months below 100 thousand. For the previous six months the average gain was 161 thousand, with only one month below 100 thousand. The recent rate of job creation is insufficient to keep pace with new entrants into the labor market, and as a result the unemployment rate has been moving higher (From 4.4% in March to 4.7% in November).

Each of these items is reason for concern about the ability of household spending (which represents two-thirds of total spending) to continue to be even a neutral factor in the economic outlook.

Business spending on new plant and equipment has been quite strong the past two quarters. Given upward pressure on costs, we feel that business will need to invest in order to improve productivity. There are areas of weakness, however. One of these is spending on heavy-duty trucks, which has been quite low. At the beginning of 2007 a new set of environmental regulations for heavy truck engines took effect. There was considerable purchasing in anticipation of these new rules. In addition, partly due to the housing recession, freight traffic has been weak. We expect some growth in overall investment spending, but well short of boom levels.

Looking beyond consumption and investment, we expect that the international sector will be a positive factor. For one thing, economies of nearly all of our trading partners are expanding. The very rapid growth in China and India is ongoing. In both Japan and continental Europe, however, there are signs that growth is slowing. A further concern is that much of the growth abroad is being driven by the export sector. A weaker U.S. outlook could cause problems. Another important factor in the trade picture is the value of the dollar, which has been falling for the past two years, thus increasing the competitiveness of U.S. goods and services on the international market. Overall, we expect that trade will be the main bright spot in the economic picture.

Beyond the trade sector, an additional source of support for the economy is the move of the Federal Reserve toward ease in monetary policy. Since September the Fed has reduced its

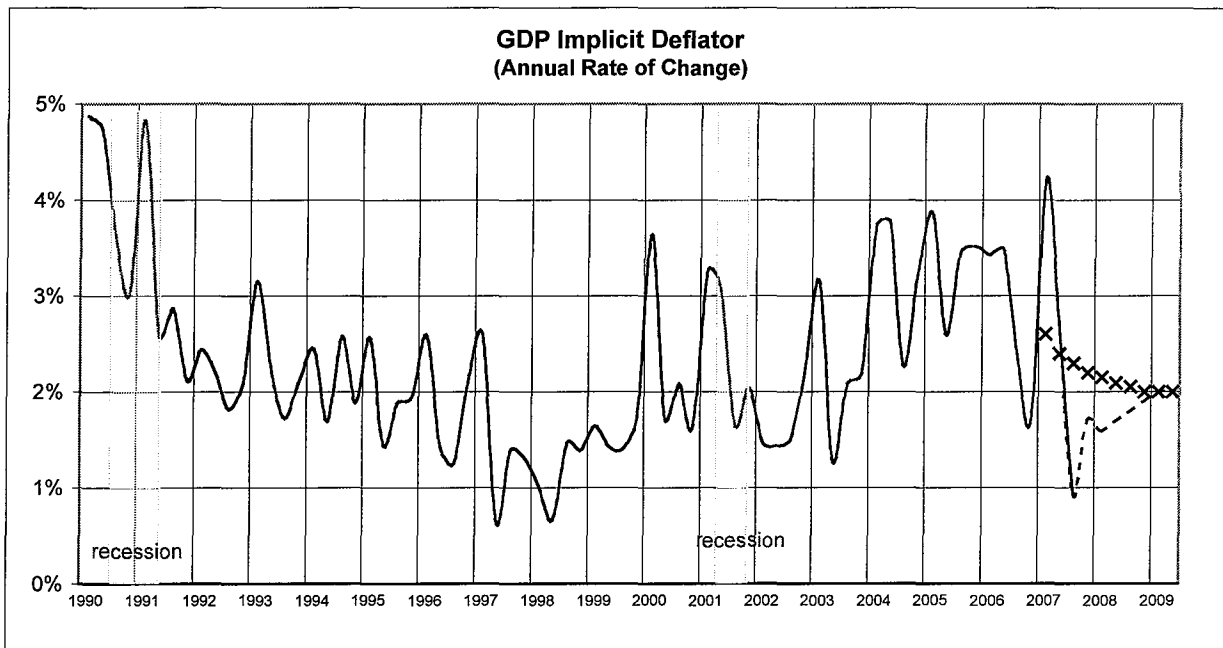
target for the federal funds rate from 5.25% to 4.25%. We believe that if the economy is as weak as we expect the Fed will ease further during 2008.

Overall, we expect that national economic growth will come perilously close to negative territory during the next couple of quarters. Our forecast of one percent growth this quarter and in the first half of next year leaves little room for negative shocks if recession is to be avoided. A more positive scenario could materialize if export growth remains really strong, and if there is a relatively rapid work out of the financial sector problems outlined above. The table below shows the forecast for the next two fiscal years. For both years our current forecast is 0.8% percentage point below our previous forecast.

Real GDP Current and Previous Forecast (2 nd Quarter to 2 nd Quarter)			
	<u>Current</u> <u>12/13/07</u>	<u>Previous</u> <u>4/18/07</u>	<u>% Point</u> <u>Difference</u>
FY 2007-08	2.0%	2.7%	-0.8%
FY 2008-09	2.2%	3.0%	-0.8%

GDP IMPLICIT DEFLATOR

As can be seen in the chart below, after an extended period in which inflation averaged at or below 2%, the overall inflation rate has moved up close to 3% during the past three years. There is, however, considerable quarter-to-quarter volatility due in large part to fluctuations in energy prices. While this volatility in energy prices is likely to continue, we expect the broad trend over the next year and a half will be toward a lower average rate. In the immediate future, we think that the inflation rate will move up from the very low third quarter rate, but will remain below 2% over the next year.



As with output, there are a number of crosscurrents in the inflation outlook. Energy prices are obviously one, and we foresee some improvement there compared with the past year. Another positive factor is the slowdown in economic growth we see for the next year (every cloud has a silver lining), which will alleviate pressure on industrial capacity and in the labor market. On the other side of the ledger, depreciation of the dollar (which we expect to continue) will put upward pressure on import prices. Rising import prices could enhance the ability of domestic firms to pass on increases in their costs, but the weak economy is likely to counter this

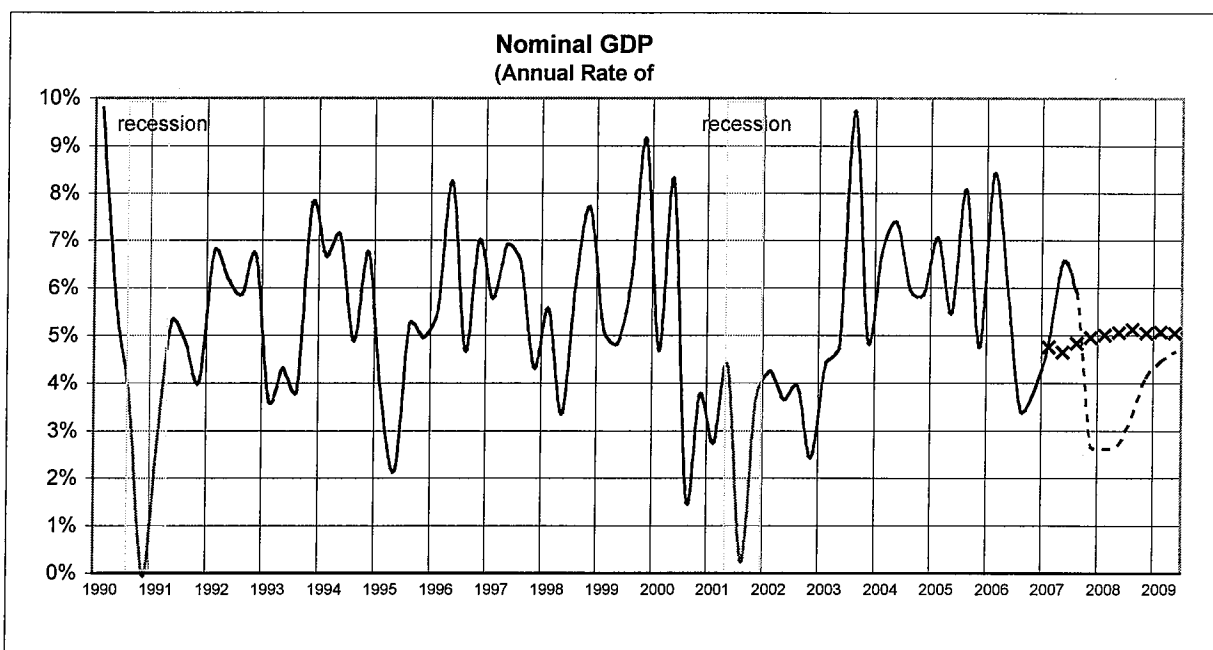
possibility. In addition, the strength we see in the world economy will continue to put upward pressure on commodity prices.

The table below shows our forecast for the GDP deflator for the next two fiscal years. While the revised forecast is 0.7% point lower this year, it is about unchanged next fiscal year.

GDP Implicit Price Deflator Current and Previous Forecast (2 nd Quarter to 2 nd Quarter)			
	<u>Current</u> 12/13/07	<u>Previous</u> 4/18/07	<u>% Point</u> <u>Difference</u>
FY 2007-08	1.5%	2.2%	-0.7%
FY 2008-09	1.9%	2.0%	-0.1%

NOMINAL GROSS DOMESTIC PRODUCT

Combining our sluggish forecast for the real economy with our moderating path for inflation, results in a weak picture for nominal GDP during the next year, with somewhat higher numbers after mid-2008. Our current forecast is substantially lower than we projected in April, especially through the first three quarters of 2008. This can be seen on a fiscal year basis in the table below.



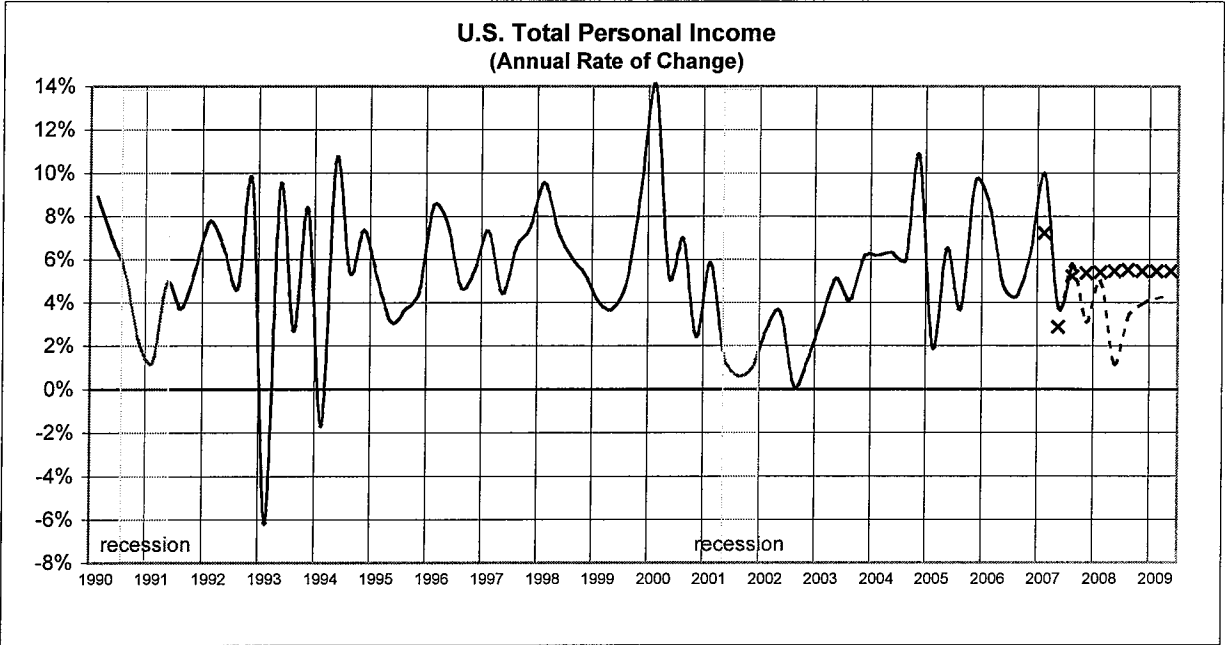
Nominal GDP Current and Previous Forecast (2 nd Quarter to 2 nd Quarter)			
	<u>Current</u> 12/13/07	<u>Previous</u> 4/18/07	<u>% Point</u> <u>Difference</u>
FY 2007-08	3.5%	5.0%	-1.5%
FY 2008-09	4.1%	5.1%	-0.9%

U.S. TOTAL PERSONAL INCOME

Beginning during the recession of 2001 and continuing until 2005 U.S. personal income grew more slowly than nominal GDP by an average of 1.0 percent per year. Since the third quarter of 2005, however, personal income has grown at a 6.6 percent annual rate, which is 1.1 percent point above the growth in nominal GDP. We expect this pattern will continue into 2008, but then to revert to growth that falls short of GDP.

The relatively slow income growth through 2005 was associated with a dramatic shift in the shares of total national income of capital and labor, with the latter falling and the share of profits rising to levels not seen since the 1960s. During the past two years a tighter labor market and rising costs for energy and other materials have reversed this trend. Rising real wages increase labor income and also put pressure on business profits. This recent experience is similar to the historical pattern during the later stages of an economic expansion. Historically, the shift toward labor income versus profits has also characterized periods of economic slowdown. Also, in a major slowdown there is an increase in transfer payments to individuals with a reversal as economic activity accelerates.

Our forecast for the first quarter of 2008 includes a little above trend growth in income to account for the bonuses that we expect will be forthcoming in the financial sector. But for the next three quarters as a whole (through the second quarter of 2008) income growth is at an unimpressive annual rate of only 3.0 percent. This is, however, above nominal GDP growth of 2.7 percent. In the following year, the economy regains a little momentum and nominal GDP grows by 4.1 percent. We think this will allow businesses to widen their profit margins somewhat causing the profit share to rise slightly and limiting personal income growth to 4.0 percent. This resulting income growth can be seen in the chart and table below.



U.S. Total Personal Income Current and Previous Forecast (2nd Quarter to 2nd Quarter)

	<u>Current</u> 12/13/07	<u>Previous</u> 4/18/07	<u>% Point</u> <u>Difference</u>
FY 2007-08	3.8%	5.4%	-1.6%
FY 2008-09	4.0%	5.5%	-1.5%

INDIANA NON-FARM PERSONAL INCOME

For over half a century Indiana personal income has lost ground relative to the nation, a trend that continues in recent data. On average, since a brief surge early in the current expansion, Indiana non-farm personal income followed a growth pattern similar to U.S. personal income, but with a growth rate about one percent lower. We expect this trend to continue over the forecast period.

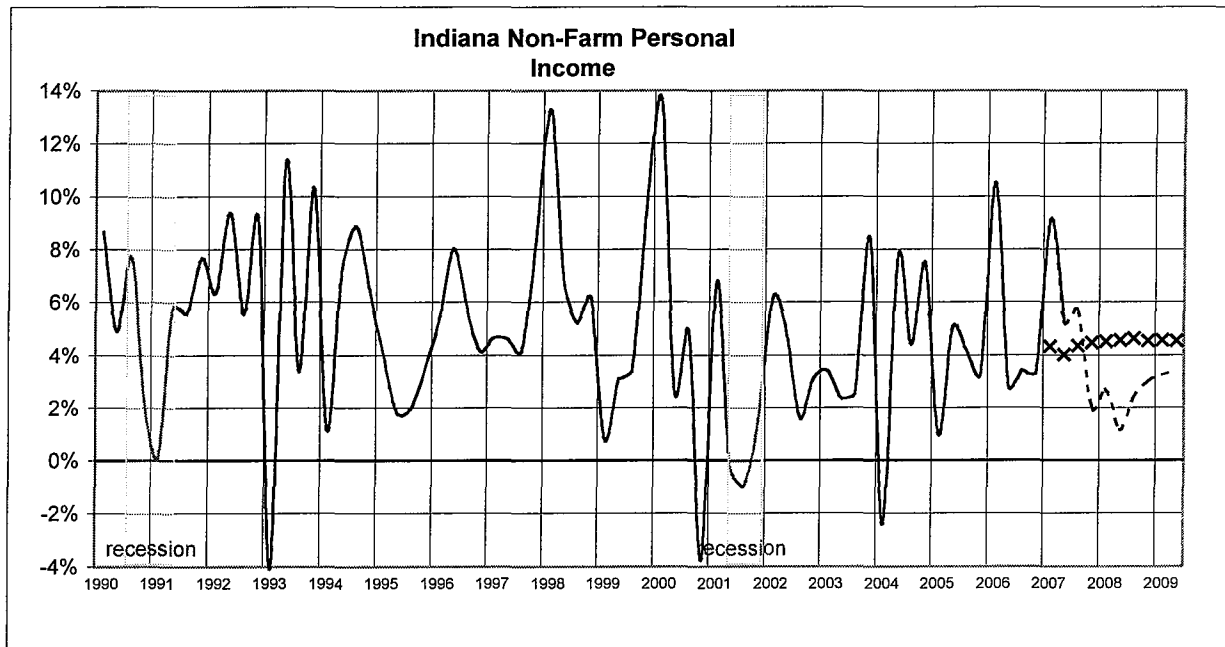
There are a number of underlying causes. To begin with, population growth in Indiana is below that for the U.S. as a whole, and to some extent this carries over to employment. But even more important, the sectors of the Indiana economy with the highest average incomes (in particular, manufacturing) are those in which employment growth is lowest, while areas in which employment in the state is rising are predominantly sectors with below average income levels. Since its low point in early 2002, for example, Indiana nonfarm employment has grown by 103 thousand. This represents growth of only 0.6 percent per year, well short of the national growth rate of 1.0 percent. Over the same period, the state's manufacturing sector has lost over 29 thousand jobs. In relative terms this is better than manufacturing at the national level, but it still implies downward pressure on the growth of state income. On the other hand, high-income sectors that are a source of significant income growth at the national level are areas where there is less employment growth in Indiana. Examples would include finance and business and professional services.

Looking to the future, we expect to see growth in Indiana income that continues below that for the nation. As can be seen in the chart below, this situation results in income growth over the period ahead that is below that of the past several years. In addition to the generally weak economic environment we are forecasting, we think that the current difficulty in the domestic auto sector, and recent slowing in the manufacturing sector more generally will adversely affect Indiana income growth in the period immediately ahead. Offsetting some of the manufacturing weakness will be continued strength for exports.

Unfortunately Indiana, and most of the surrounding states, will continue to suffer serious housing losses even though we didn't have a speculative housing bubble like areas such as California and Florida. Indiana's subprime delinquencies (21% >60 days) are as high as in those two states; the % of defaulted subprime loans with losses (84%) is third in the nation and is

close to Michigan's high of 86%; and the severity of the losses (69%) is second only to Michigan's 71%.

From the beginning of 2002 through the second quarter of this year Indiana non-farm personal income growth averaged 4.4 percent. For the two years beginning with this year's third quarter our forecast is for average income growth of only 3.0 percent. Quarterly growth starts below this average due to a sluggish economy, and then rises somewhat after mid-2008.



Indiana Non-Farm Personal Income
 Current and Previous Forecast
 (Quarterly Data Annualized)
 Fiscal Years are 2nd Quarter to 2nd Quarter)

	<u>Current</u> <u>12/13/07</u>	<u>Previous</u> <u>4/18/07</u>	<u>% Point</u> <u>Difference</u>
2007:3	5.7%	4.4%	1.4%
2007:4	2.0%	4.5%	-2.5%
2008:1	2.7%	4.5%	-1.8%
2008:2	1.2%	4.6%	-3.4%
2008:3	2.4%	4.6%	-2.2%
2008:4	3.0%	4.5%	-1.5%
2009:1	3.3%	4.6%	-1.3%
2009:2	3.4%	4.6%	-1.1%
FY 2007-08	2.9%	4.5%	-1.6%
FY 2008-09	3.0%	4.6%	-1.5%

GROSS DOMESTIC PRODUCT PROJECTIONS

December 13, 2007

		Gross Domestic Product Billions of \$		GDP Implicit Price Deflator	Quarterly Percent Change At Annual Rate		
		<u>Real</u>	<u>Nominal</u>	<u>2000 = 100</u>	<u>Real</u>	<u>Deflator</u>	<u>Nominal</u>
Actual							
2003	Q1	10126.0	10,705.6	105.724	1.2	3.2	4.4
	Q2	10212.7	10,831.8	106.062	3.5	1.3	4.8
	Q3	10398.7	11,086.1	106.610	7.5	2.1	9.7
	Q4	10467.0	11,219.5	107.189	2.7	2.2	4.9
2004	Q1	10543.6	11,405.5	108.175	3.0	3.7	6.8
	Q2	10634.2	11,610.3	109.179	3.5	3.8	7.4
	Q3	10728.7	11,779.4	109.793	3.6	2.3	6.0
	Q4	10796.4	11,948.5	110.671	2.5	3.2	5.9
2005	Q1	10878.4	12,154.0	111.726	3.1	3.9	7.1
	Q2	10954.1	12,317.4	112.446	2.8	2.6	5.5
	Q3	11074.3	12,558.8	113.405	4.5	3.5	8.1
	Q4	11107.2	12,705.5	114.390	1.2	3.5	4.8
2006	Q1	11238.7	12,964.6	115.357	4.8	3.4	8.4
	Q2	11306.7	13,155.0	116.347	2.4	3.5	6.0
	Q3	11336.7	13,266.9	117.026	1.1	2.4	3.4
	Q4	11395.5	13,392.3	117.523	2.1	1.7	3.8
2007	Q1	11412.6	13,551.9	118.745	0.6	4.2	4.9
	Q2	11520.1	13,768.8	119.520	3.8	2.6	6.6
	Q3	11659.3	13,967.3	119.795	4.9	0.9	5.9
Projections							
	<i>Q4</i>	<i>11688.3</i>	<i>14061.0</i>	<i>120.300</i>	<i>1.0</i>	<i>1.7</i>	<i>2.7</i>
2008	<i>Q1</i>	<i>11717.4</i>	<i>14152.3</i>	<i>120.780</i>	<i>1.0</i>	<i>1.6</i>	<i>2.6</i>
	<i>Q2</i>	<i>11746.6</i>	<i>14247.5</i>	<i>121.290</i>	<i>1.0</i>	<i>1.7</i>	<i>2.7</i>
	<i>Q3</i>	<i>11790.4</i>	<i>14364.2</i>	<i>121.830</i>	<i>1.5</i>	<i>1.8</i>	<i>3.3</i>
	<i>Q4</i>	<i>11854.7</i>	<i>14510.2</i>	<i>122.400</i>	<i>2.2</i>	<i>1.9</i>	<i>4.1</i>
2009	<i>Q1</i>	<i>11925.2</i>	<i>14669.2</i>	<i>123.010</i>	<i>2.4</i>	<i>2.0</i>	<i>4.5</i>
	<i>Q2</i>	<i>12002.0</i>	<i>14836.9</i>	<i>123.620</i>	<i>2.6</i>	<i>2.0</i>	<i>4.7</i>

Indiana Fiscal Years (Ending June 30th)

Percent Change (Q2 - Q2)

2002-03	1.8	2.0	3.9
2003-04	4.1	2.9	7.2
2004-05	3.0	3.0	6.1
2005-06	3.2	3.5	6.8
2006-07	1.9	2.7	4.7
2007-08	2.0	1.5	3.5
2008-09	2.2	1.9	4.1

PERSONAL INCOME PROJECTIONS

December 13, 2007

		<u>U.S. Total</u> <u>Billions of \$</u>	<u>Indiana Nonfarm</u> <u>Millions of \$</u>	<u>Quarterly Percent Change</u> <u>At Annual Rate</u>	
				<u>U.S.</u>	<u>Indiana</u>
Actual					
2003	Q1	8,998.2	175,696	3.3	3.4
	Q2	9,111.3	176,728	5.1	2.4
	Q3	9,203.6	177,867	4.1	2.6
	Q4	9,341.3	181,500	6.1	8.4
2004	Q1	9,482.8	180,399	6.2	-2.4
	Q2	9,629.6	183,786	6.3	7.7
	Q3	9,770.9	185,781	6.0	4.4
	Q4	10,025.5	189,151	10.8	7.5
2005	Q1	10,074.1	189,617	2.0	1.0
	Q2	10,234.1	191,950	6.5	5.0
	Q3	10,328.6	193,923	3.7	4.2
	Q4	10,567.4	195,497	9.6	3.3
2006	Q1	10,787.1	200,446	8.6	10.5
	Q2	10,915.5	201,844	4.8	2.8
	Q3	11,030.9	203,548	4.3	3.4
	Q4	11,200.2	205,238	6.3	3.4
2007	Q1	11,469.2	209,770	10.0	9.1
	Q2	11,577.3	212,483	3.8	5.3
	Q3	11,741.8	215,462	5.8	5.7
Projections					
	Q4	11,832.3	216,531	3.1	2.0
2008	Q1	11,977.1	217,983	5.0	2.7
	Q2	12,012.1	218,620	1.2	1.2
	Q3	12,110.5	219,927	3.3	2.4
	Q4	12,227.7	221,566	3.9	3.0
2009	Q1	12,354.4	223,368	4.2	3.3
	Q2	12,486.7	225,260	4.4	3.4

<u>Indiana Fiscal Years</u> <u>(Ending June 30th)</u>	<u>Percent Change</u> <u>(Q2 - Q2)</u>	
2002-03	2.5	2.6
2003-04	5.7	4.0
2004-05	6.3	4.4
2005-06	6.7	5.2
2006-07	6.1	5.3
2007-08	3.8	2.9
2008-09	4.0	3.0