Update on the Global Market Outlook

THE PARTHENON GROUP
Boston • London • Mumbai • San Francisco

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Parthenon's Forecast Is Still Focused on Likely Outcomes, Not Drama

NOVEMBER 2011 — **MARCH 2012** — **JUNE 2012** — **FORECAST 2012–2013**

Concern	Outcome	Recent News
• Congressional and Super Committee failures would lead to immediate US debt and fiscal crisis	• Congress extends payroll tax cut and unemployment benefit stimulus • Public complacency replaces anger and panic	• CBO publishes notice of $600B "fiscal cliff" of restraint January 1, 2013 with no new legislation
• Greece, Italy, Spain, and Portugal would default, causing the euro to collapse	• Germany "caves in," recognizing its self-interest in euro • EU attempts a common fiscal union with more paper targets	• Greeks vote to stay in euro • German finance minister speaks of adjustments

- Consistently, we see political brinkmanship dissipate before calamity arrives
- In the US, we anticipate substantial, but not dramatic, fiscal restraint after the election
- In Europe, we see recession flowing from fiscal and monetary policy mistakes

Developments Since March

Pessimism is gaining the upper hand over optimism

- **The European financial crisis has become more worrisome**
  - The vicious cycle of abrupt fiscal austerity seeking immediate budget balance and falling government revenues then creating more budget angst is playing out in the predictable, renewed European recession
  - Voters in Greece and France reacted to austerity by rejecting incumbents and partially repudiating fiscal balance commitments
  - Spanish banks' huge capital shortfalls hit the headlines
  - German policymakers continue to insist on extreme and immediate austerity for their suffering partners
  - In response to the new European recession, Asian exports are faltering, creating broad global deceleration
- **US economic data confirms tepid growth, as Parthenon warned**
  - The earlier-reported and surprisingly good employment gains for winter were revised substantially lower, and spring growth is trivial
  - Home sales improving but auto sales dropped; early consumer spending strength appears to have been helped by warm winter with some relapse now
  - The Democrat/Republican extreme partisan gridlock continues to preclude even the passage of a current year federal budget, much less a blueprint for long-term budget balance
- **Financial markets are reacting predictably to higher risk and slower growth**
  - Strong US and German bonds; stronger $US
  - Equity markets retreat
  - Oil and commodity prices weaken (priced in $US)

New Evidence Since March
Key Indicators of Assumptions and Outcomes

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Key Indicators	March Forecasts		Small Forth-coming Updates*	New Data or Evidence Since March
	2012	2013		
Change in Fiscal Stimulus	-$95B	-$200B		**No action in DC, but publicity increasing of "fiscal cliff": tax increases and spending cuts equal to $600B or 4% of GDP effective January 1, 2013**
Productivity Growth (GDP per Employee)	1.7%	1.7%		**Real GDP growth and job growth both revised down for 2012 Q1 to produce -0.3% productivity decline; Q2 data points to 1-1.5% productivity growth**
European ("Big 4") Real GDP Growth	-0.2%	1.2%		**Decline for Q4 confirmed; no growth found in Q1; decline likely in Q2**
Federal Funds Rate	0.1%	0.3%		**Fed affirms low rates and talks of further bond market activity**
Oil Prices ($ 2011)	$110/bbl	$94/bbl		**Oil collapses to $84 on strong dollar, major global recession fears**
Consumer Sentiment	74	75		**Michigan Index relapses to 74.1 in June, lowest level of 2012**
Housing Start	0.80M	0.94M		**At .73m rate, April and May total housings starts were 32% above year ago, and we were forecasting a 31% gain for the year**
US Real GDP	2.1%	1.7%		**Q1 revised down to 1.9% annualized rate, about the same as 2.0% 4-qtr. average, matching our outlook for sustained but tepid growth at 2%**
US Unemployment Rate	8.5%	8.6%		**US rate hit bottom at 8.1% in April, rose to 8.2% in May, matching our expectation of upward drift; year-end may be 8.5%+ but 2012 avg. <8.5%**
Consumer Spending (Real)	1.9%	2.1%		**Q1 revised down to 1.8% versus year ago; Q2 looks weaker, but weather effects have been significant**

The preliminary Q2 US and Global Real GDP data will be available soon, leading to a comprehensive Parthenon forecast update in mid-July; only minor changes to our March outlook appear necessary as of now.

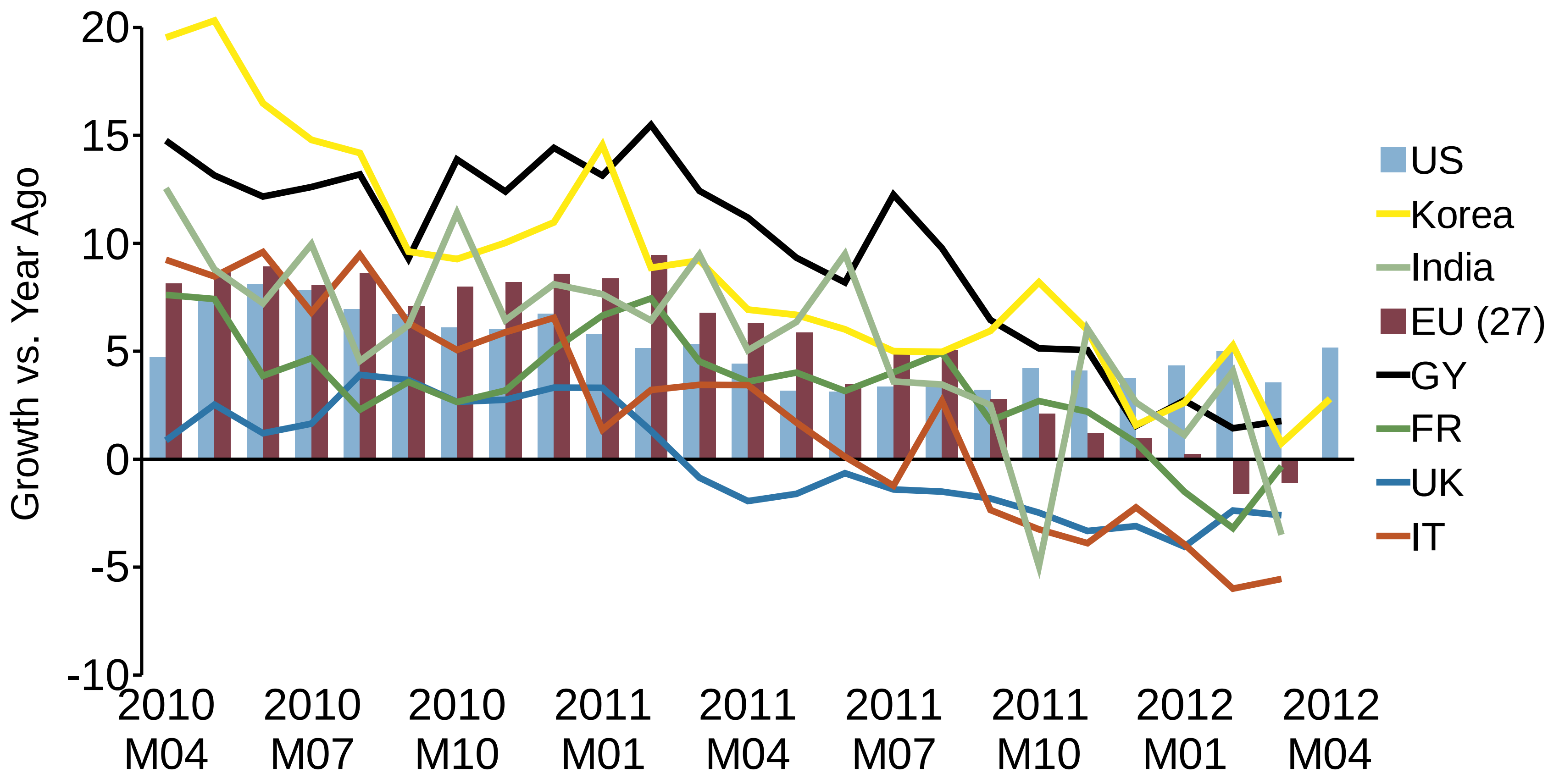
Expanded Commentary and Exhibits

- European Crisis and Recession
- US Tepid GDP Growth but Housing Recovery
- Global and US Equity Market Reactions to Risk and Weak Growth
- Reference Material: The March Framework and Forecasts

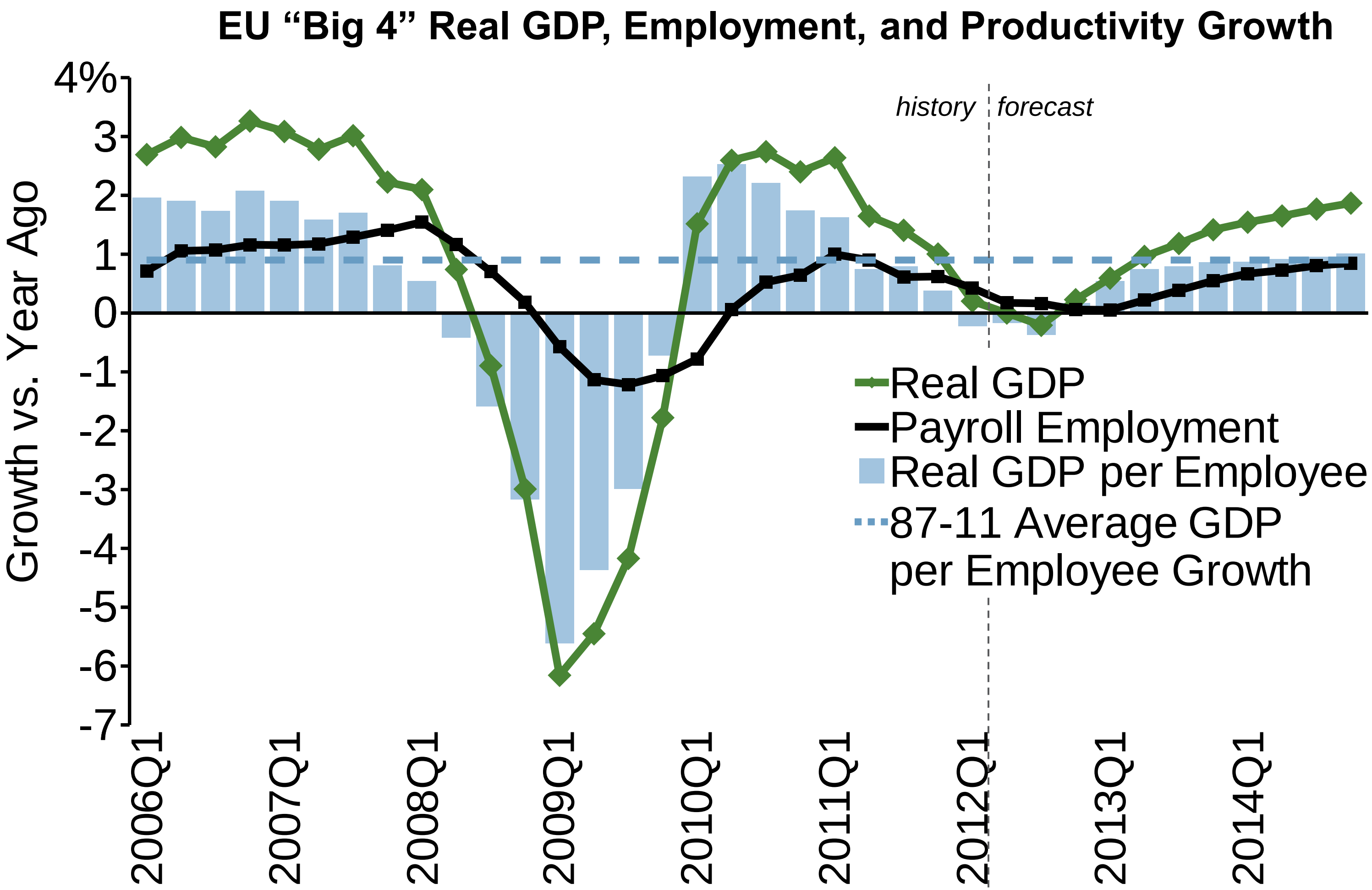
Very Serious Pessimism for Europe

- **Jobs have been protected through job sharing, not good demand growth**
- **Well-paced and structured deficit reduction is needed but policy makers are dysfunctional and pan-European governance is not organized**
- **Germany is playing a grossly misguided "game of brinksmanship"**
  - Germany is behaving as a free-rider, achieving growth based on exports to Asia and the US, where stimulus has been strong, but refusing to give the prompt, massive fiscal and financial support needed for European stabilization and growth
  - As the ECB President Mario Draghi states, they "underestimate the problem, then come out with a second, or third, or fourth assessment. That's the worst possible way of doing things. Everybody ends up doing the right thing but at a high cost"
  - Now their own economy will suffer: banks in trouble, exports failing, and a potential calamitous failure of the euro
- **The European Financial Crisis has intensified over the past few months**
  - One aspect of this escalation is political uncertainty, as polls in Greece showed rising popularity for the once-marginal Syriza party and its anti-austerity platform, culminating in a close second place showing during May and June elections
  - Separately, Spain followed in the footsteps of Greece, Ireland and Portugal by accepting a $125B banking system bailout, that thus far, has done little to settle nerves. Sovereign bond spreads have risen relative to safe haven, German bunds and the euro declined ~8%
  - The rational answer for the Greeks and Germans is for the eurozone to remain intact, but the crisis is coming close to a point of no recovery. Will Germany "see the light" in time? This seems increasingly less likely but still possible

Industrial Production Is Falling Throughout Europe, Except in Germany (Where a Stall Appears Imminent)



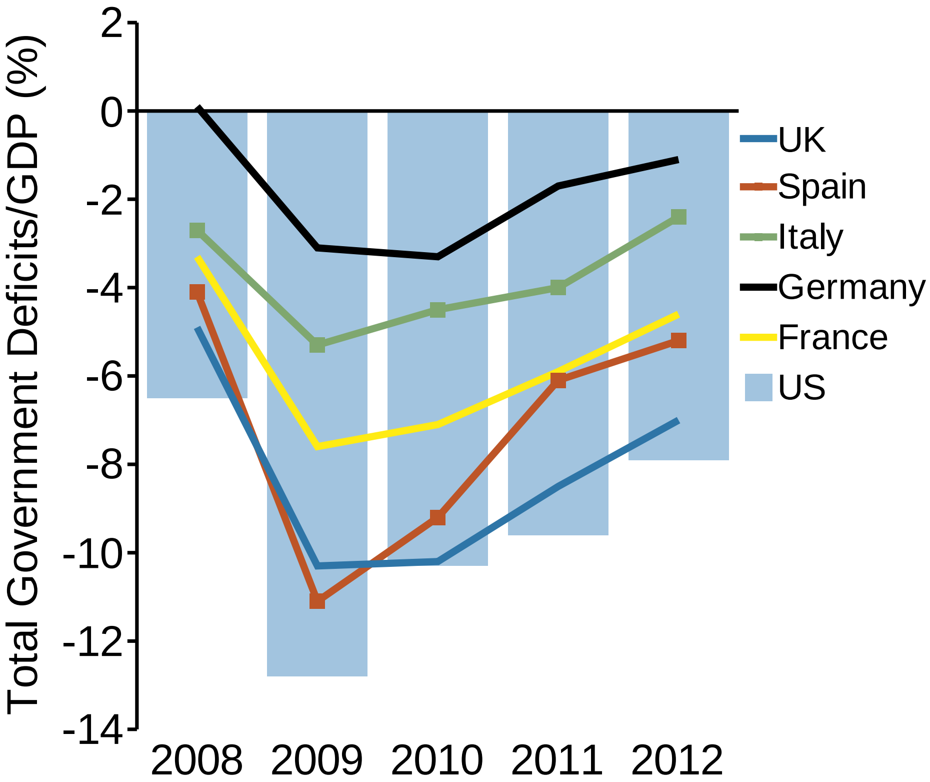
Europe Has Moved Back into Recession



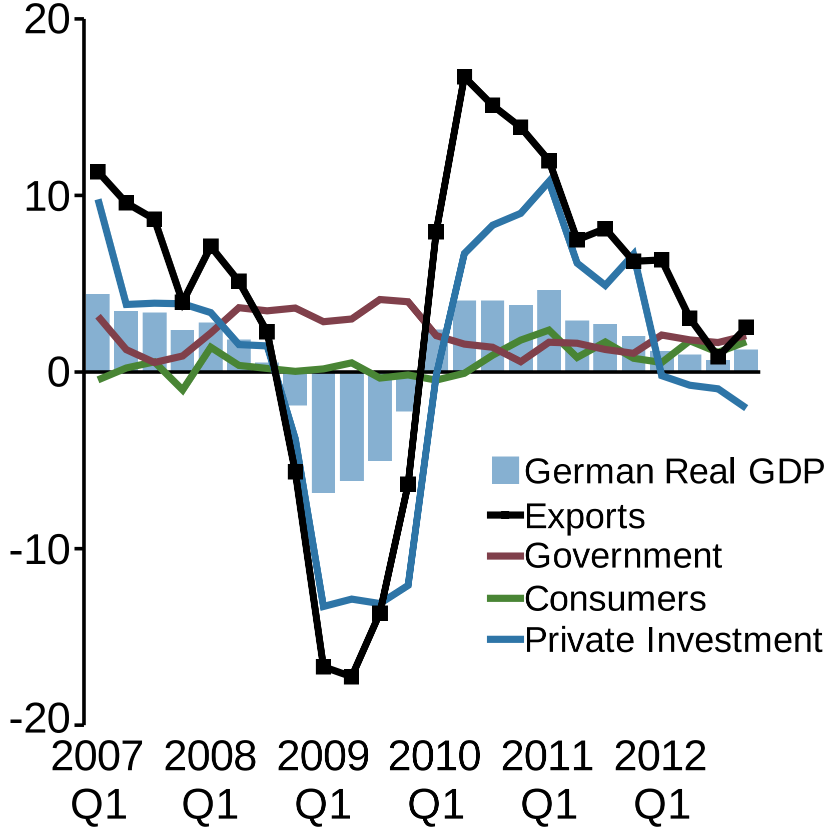
Europe will, at best, shift to stagnant employment

Source: Parthenon analysis; HIS Global Insight European Forecasts

Germany Is Not Doing Enough to Help, While Prospering on Exports to Responsible Countries Pursuing Stimulus in Asia and the US

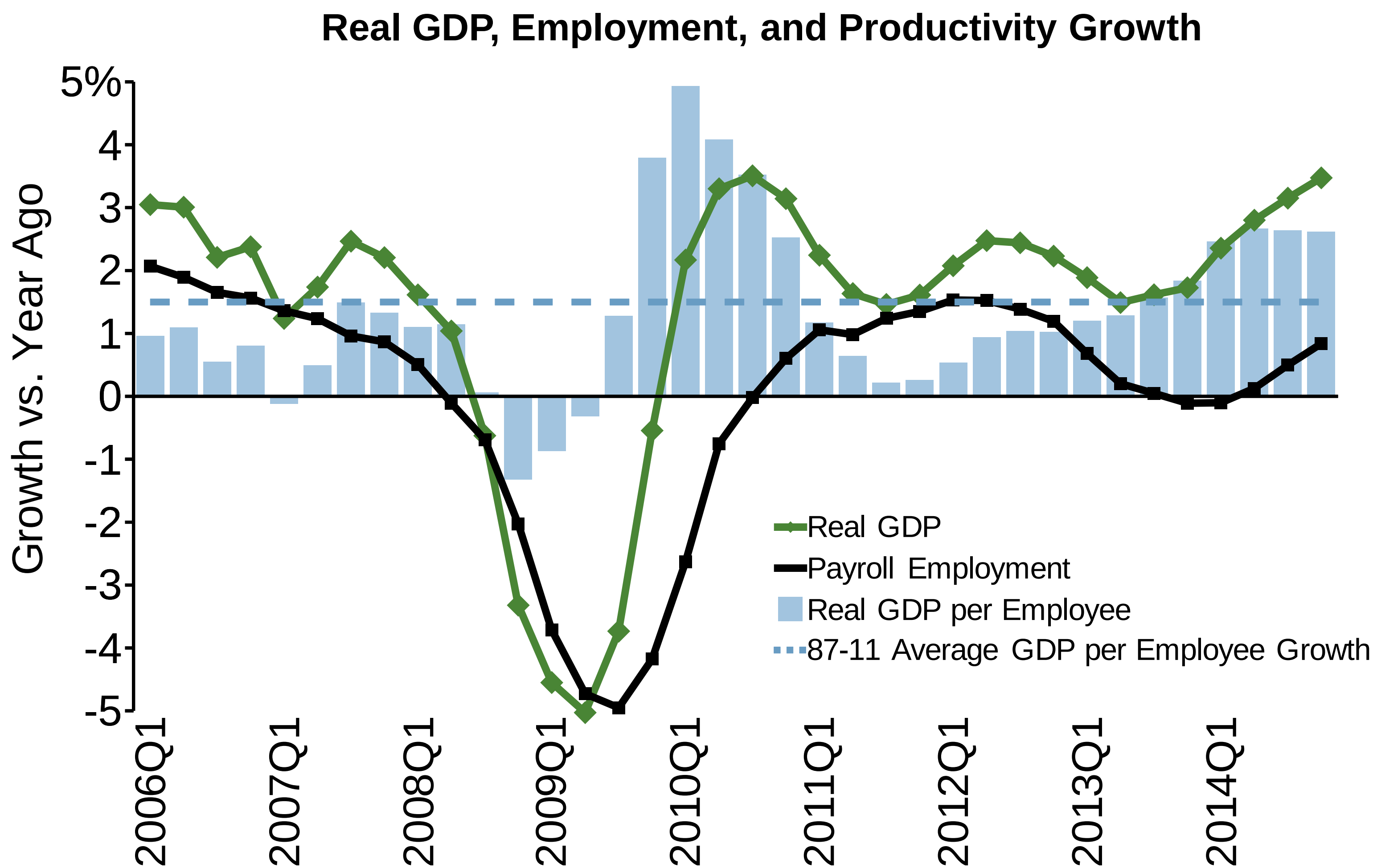


German Growth Is Built Entirely on Exports (and the Cap Ex Exports Drive): Government and Consumer Spending Growth Rates Are Well Below GDP



Source: IMF

Our March Framework Remains Intact
US Job Growth May Be Meager Until 2014, if Productivity Expands Normally

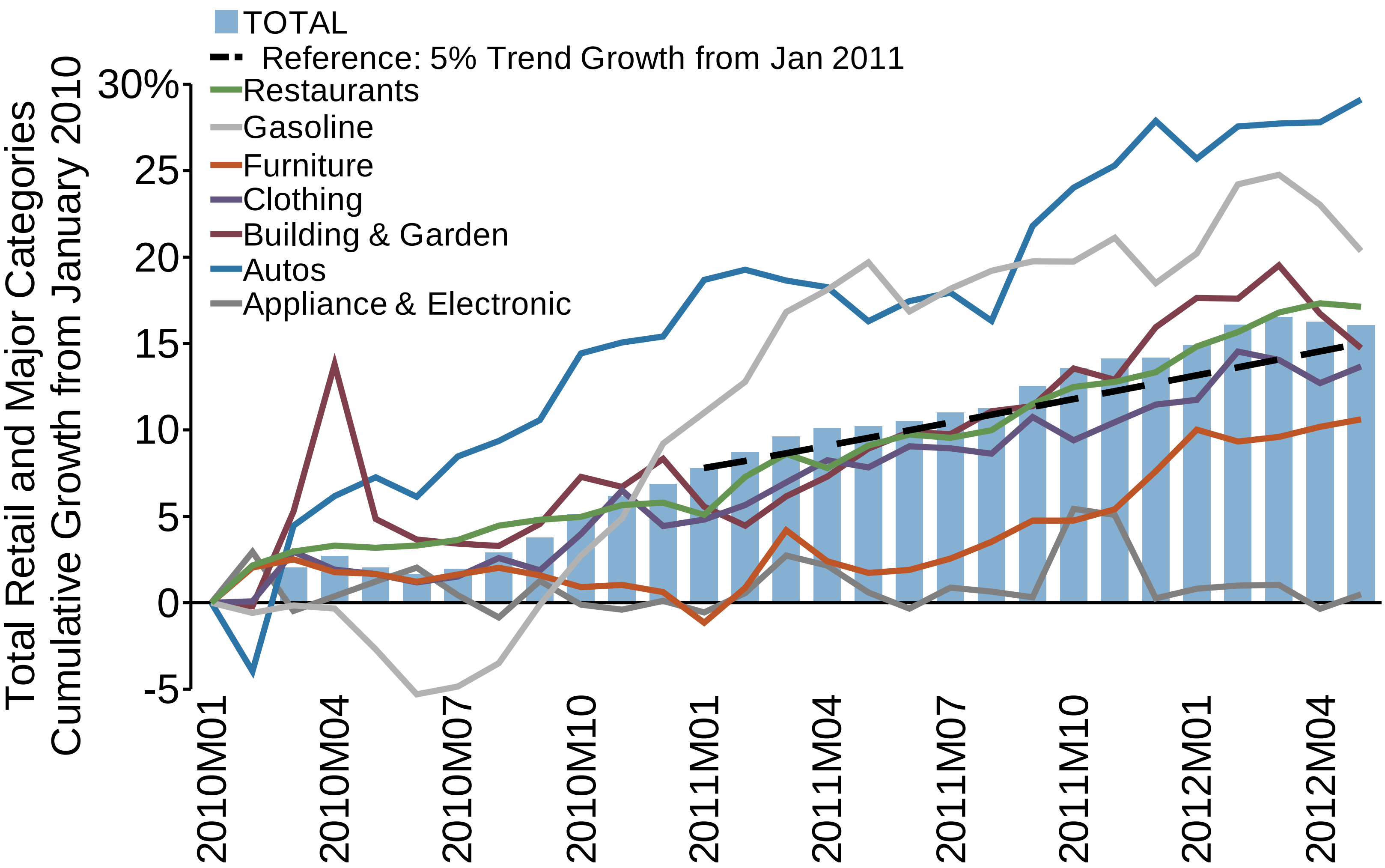


- As in the last major business cycle, productivity first surged above trend and then fell back, creating a job growth surge in 2011 even with decelerating GDP growth
- Employment gains in 2012 will be meager as firms adjust to high risk and low growth

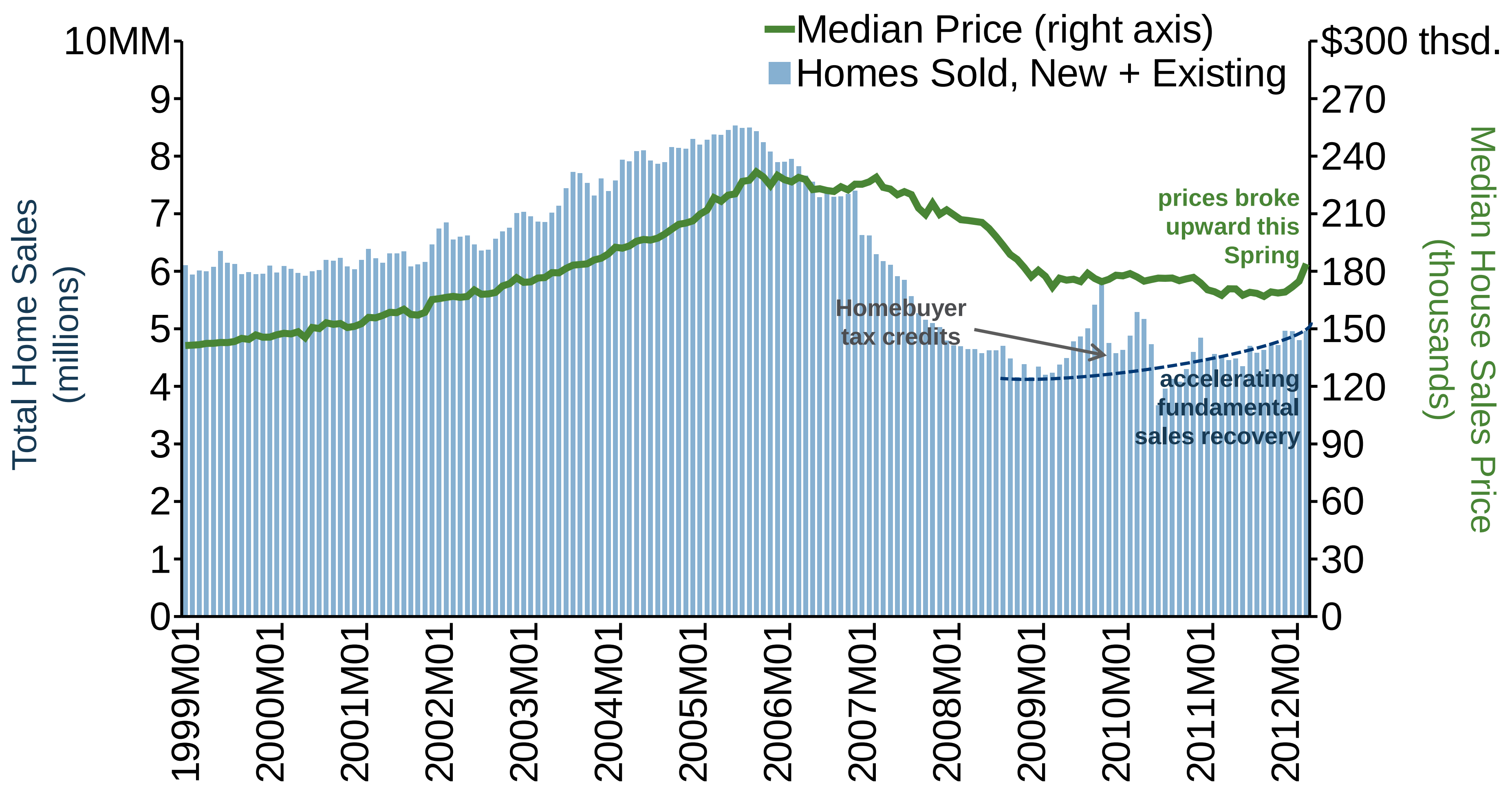
Source: Parthenon analysis; Bureau of Economic Analysis; Bureau of Labor Statistics

US Consumer Spending Growth Has Slowed Down

Retail Sales Growth Rates Benefitted from Higher Job Growth and a Warm Winter but Have Since Relapsed



However, Home Sales Are Accelerating and Home Prices Have Improved Greatly This Spring



Source: National Association of Realtors, Commerce Dept. Sales are the sum of new and existing properties, including condos and coops. Prices are a weighted average of median sales prices for new and existing properties. All data is through April, 2012.

Very High Risk Premia Have Crushed Global Stock Prices in the Public Markets

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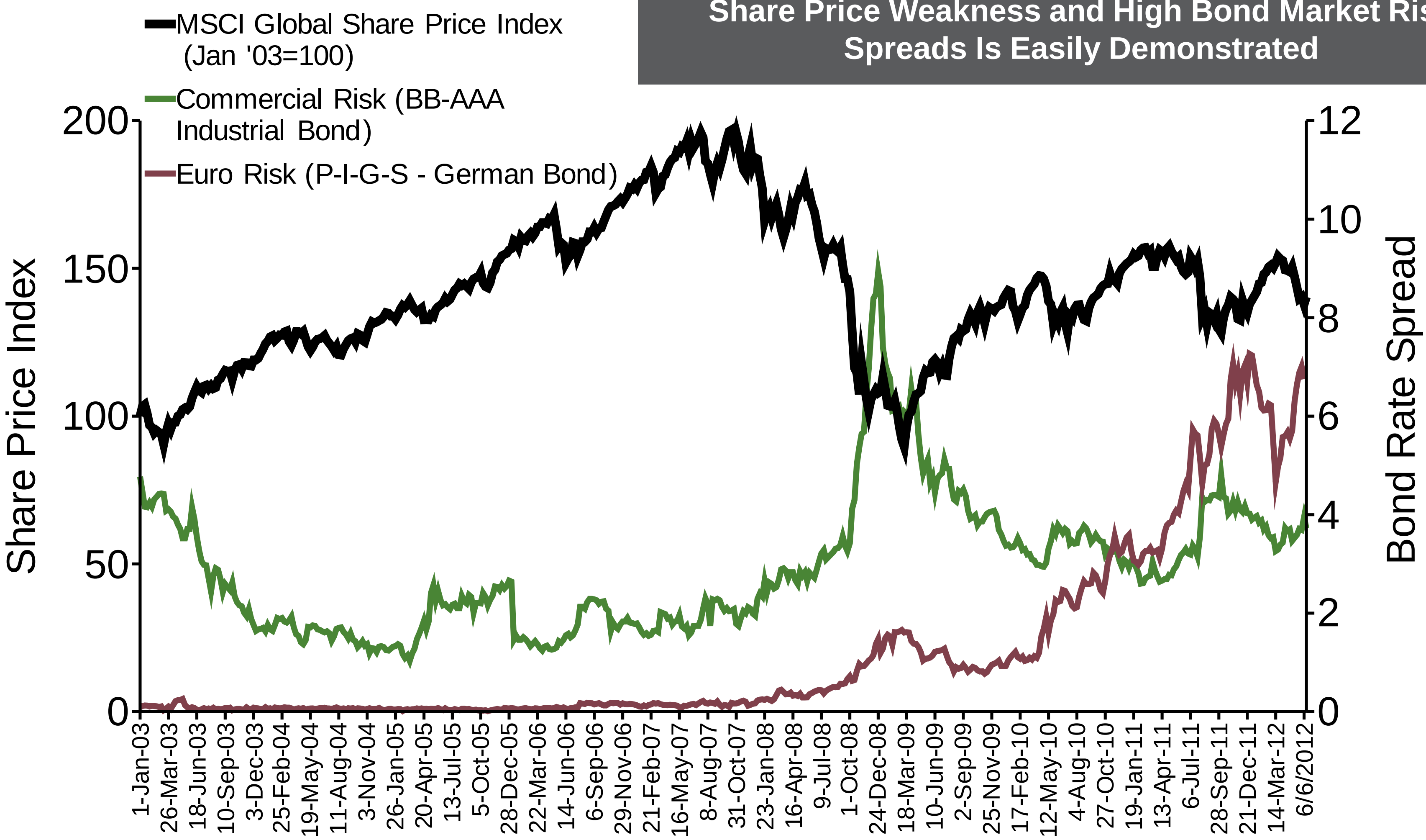
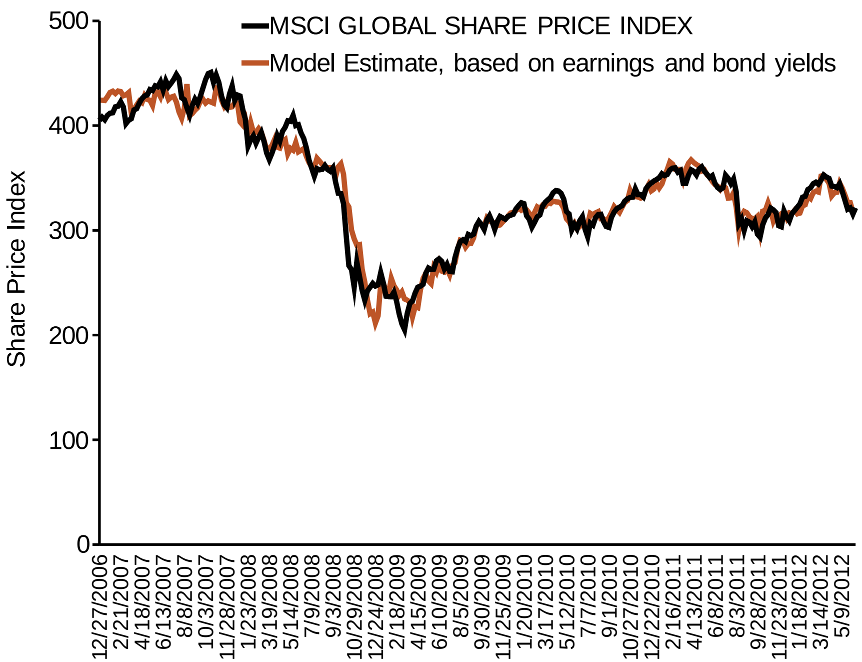
The Exceptionally High Negative Correlation Between Share Price Weakness and High Bond Market Risk Spreads Is Easily Demonstrated



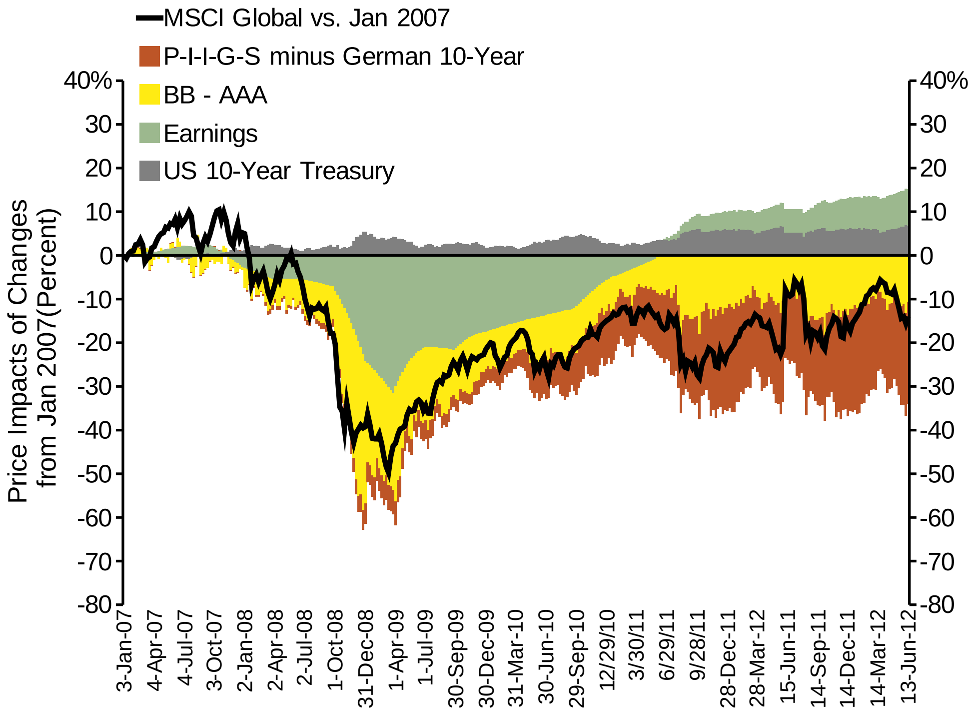
Risk Premia Cut Global Equity Markets by 35%

A Statistical Model of Global Share Prices Fully Explains the Weak and Cyclic Behavior of Equity Prices:

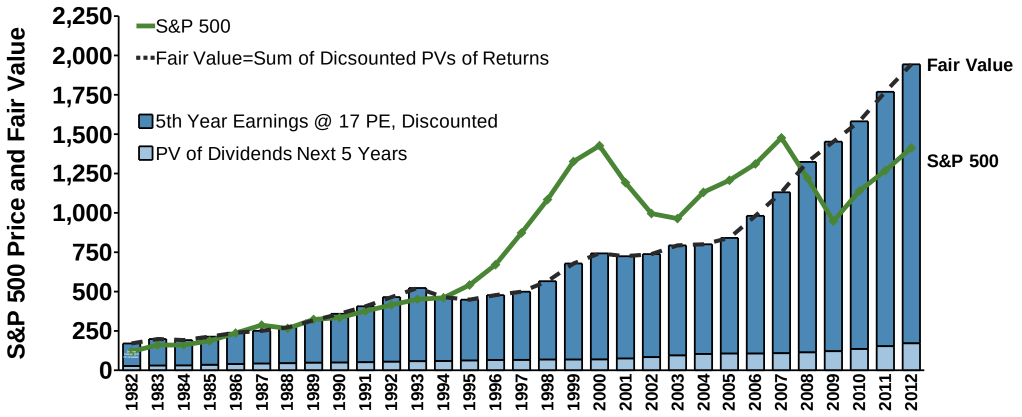
- Earnings have just recovered to 10% above mid-decade levels
- Low US treasury bond yields (the safe haven alternative to corporate investments) add ~5% to equity prices today
- But large risk spreads reflect investor fears, cutting ~35% from prices
  - The euro crisis, reflected in the P-I-I-G-S spread vs. German bond yields, cuts prices ~25% today
  - The adverse impact of us-centric corporate risk, the BB vs. AAA spread, has diminished but still costs ~10%

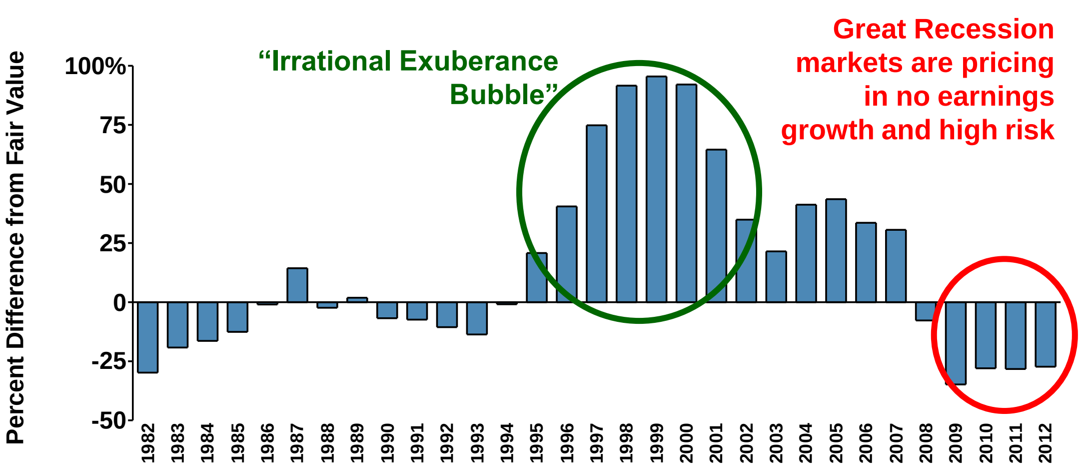


Measured Contributions to Global Share Prices (Percentage Impacts versus January 2007)



US Share Prices Are Far Below the Fair Value Measured as the Discounted Present Value of Likely Future Dividends and Earnings





	Fair Value Today		Apparent Market Valuation: Zero Growth and Huge Risk	
	EPS and Dividends (S&P 500)	Discounted Present Value @5.2%*	EPS and Dividends (S&P 500)	Discounted Present Value @10.2%**
2011 EPS, Dividend	87, 26		87, 26	
2012 EPS, Dividend	91, 32		91, 32	
Sum 2012–2016 Dividends	191	171	160	140
2017 EPS	130		91	
2017 EPS x 17 PE Multiple	2218	1722	1547	1201
Sum		1893		1341
S&P 500 on 6/21		1326		1326
Implied discount versus fair value		30%		0%

*5.2%= 5 year Treasury rate + 4.25% equity risk premium
**10.2%=5 year Treasury rate + 9.25% equity risk premium

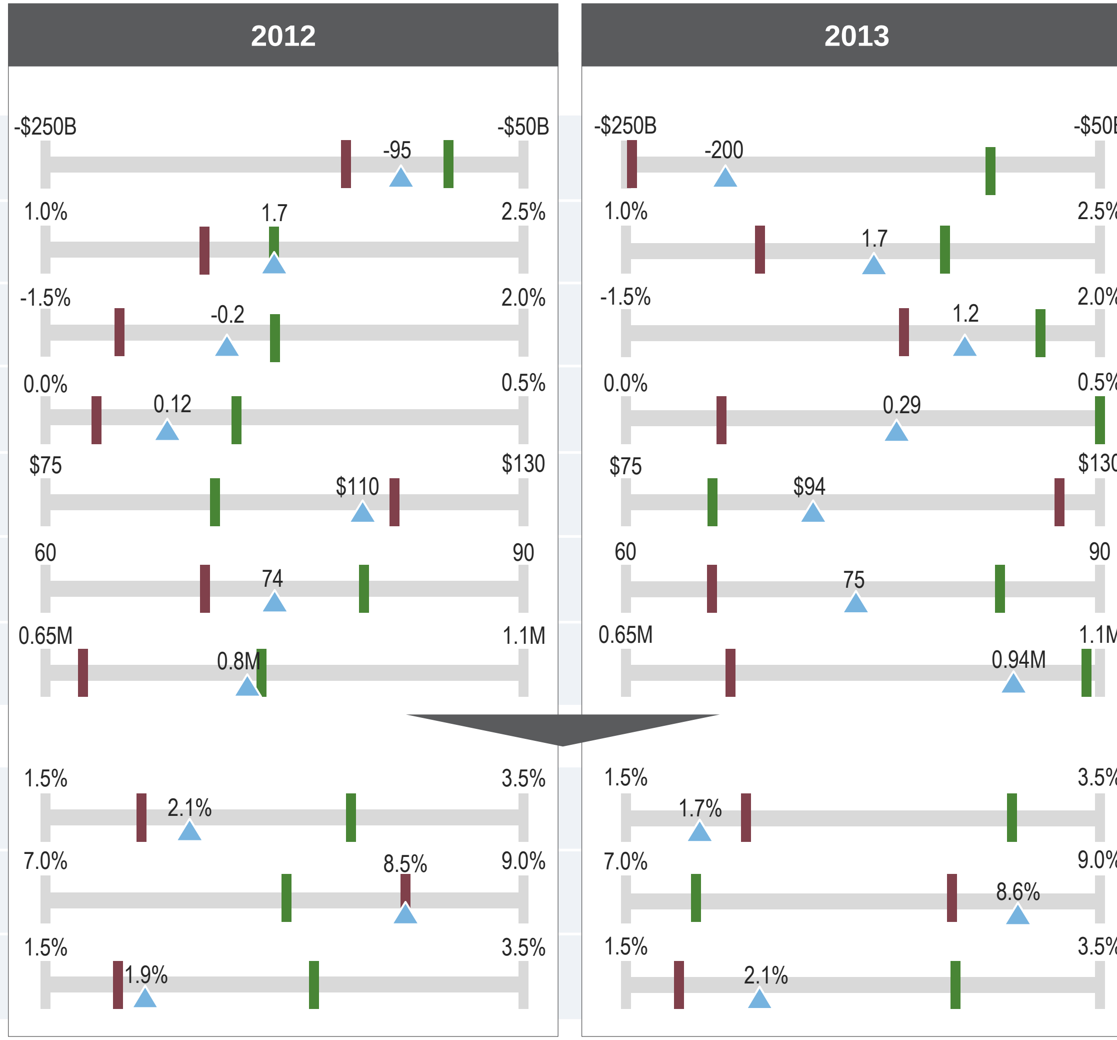
The Economic Challenge: Coping with Global Deficit Reduction

- For over a year, the right attitude has been that **neither extreme optimism nor pessimism is appropriate**. The same is true now, with the risk today that people have become overly optimistic, which is the reverse of last fall
- **Growth decelerated as we expected in 2011, as fiscal stimulus was reduced** worldwide **and the eurozone crisis created fear and high risk premiums** in equity markets
- **Residential construction markets are poised for a tripling** in coming years, but this segment of the economy is small relative to the shrinking government
- The **most surprising economic development has been the substantial decline in the US unemployment rate**
  - First, **labor force growth has been exceptionally anemic**; discouraged workers are not looking for jobs, hence they are not counted as unemployed
  - Second, employers have hired at such a rapid pace that **there has been almost no productivity growth**. Both go beyond historic norms
  - To the extent something similar has happened **in the past, a reversal has always occurred** to restore labor force and productivity growth, hence stabilizing the unemployment rate near 8.5% with roughly 2% real GDP growth, 1.7% productivity (GDP per employee), and 0.5% employment and labor force growth

Our March Framework
Key Indicators of Assumptions and Outcomes

March Parthenon Forecast
March “Consensus” Range

Key Indicators	*Historic Avg. ‘85–‘05*	*2011 Results*
Change in Fiscal Stimulus	0	-$94B
Productivity Growth (GDP per Employee)	1.5%	0.6%
European (“Big 4”) Real GDP Growth	1.8%	1.5%
Federal Funds Rate	5.0%	0.1%
Oil Prices ($ 2011)	$30/bbl	$103/bbl
Consumer Sentiment	92	67
Housing Starts	1.54M	0.61M
US Real GDP	3.1%	1.7%
US Unemployment Rate	5.6%	9.0%
Consumer Spending (Real)	3.4%	2.2%



Parthenon forecasts substantially greater fiscal restraint in 2013 and 2014, a key element in our less-optimistic-than-consensus forecast for real US growth in 2013

Parthenon Background and Contact Information

About The Parthenon Group

The Parthenon Group is a leading advisory firm focused on strategy consulting with offices in Boston, London, Mumbai, and San Francisco. Since its inception in 1991, the firm has embraced a unique approach to strategic advisory services built on long-term client relationships, a willingness to share risk, an entrepreneurial spirit, and customized insights. This unique approach has established the firm as the strategic advisor of choice for CEOs and business leaders of Global 1000 corporations, high-potential growth companies, private equity firms, educational institutions, and healthcare organizations.

Learn more about us at **www.parthenon.com**

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