US Economic Outlook

Stronger economy meets fiscal drag

NOMURA

- US Economics

- Ellen Zentner; Executive Director
- Senior US Economist
- ellen.zentner@nomura.com
- (212) 667-9668

- April 2013

NOMURA

2013 Outlook in a nutshell

Strengthening of fundamentals meets fiscal headwinds

- Weak wage and salary growth continues, driven by high unemployment and low-quality job creation.
- Borrowing is unlikely to drive the economy forward. We expect personal consumption to broadly track growth in personal income.
- We expect the FOMC to continue its long-term asset purchases through Q1 2014.
- A strengthening of the housing market should support investment, job creation, and aggregate demand.
- Wealth effect and housing market are two very important drivers of a stronger recovery in 2013 and beyond.
- Fiscal tightening equal to 1.5% of GDP in 2013 will hold back growth.

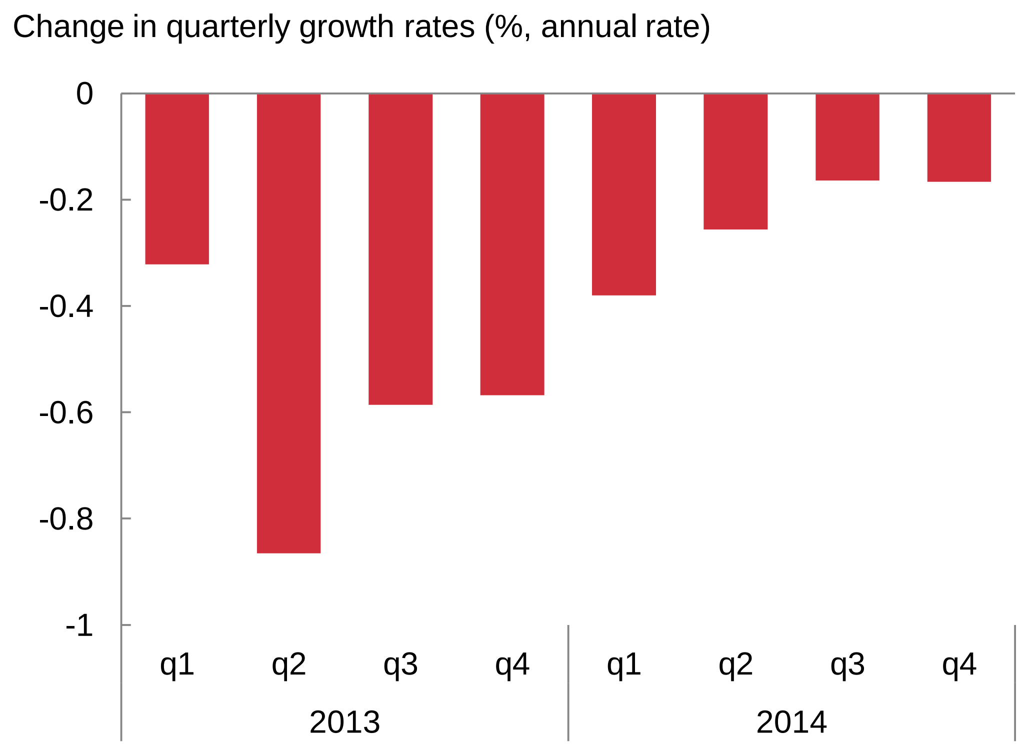
See "US forecast update", *Special Report*, 14 March 2013

"Blessed are the young for they shall inherit the national debt" – Herbert Hoover, Thirty-First President, 1929-1933

- The US federal budget deficit has topped $1 trillion for four straight fiscal years.
- Total public debt outstanding is now more than $16.7 trillion (103% of GDP).
- The US pays a low interest on outstanding debt, about 2.6% (and declining).
- Still, the gov't paid more than $359 billion in interest in FY2012.
- We won't always enjoy these ultra low interest rates.
- We have breached the level of "debt intolerance".

Impact of Spending cuts which began on 1 March

Estimated impact on US GDP growth of cuts in Federal spending that took effect on 1 March (percent, deviation from baseline)



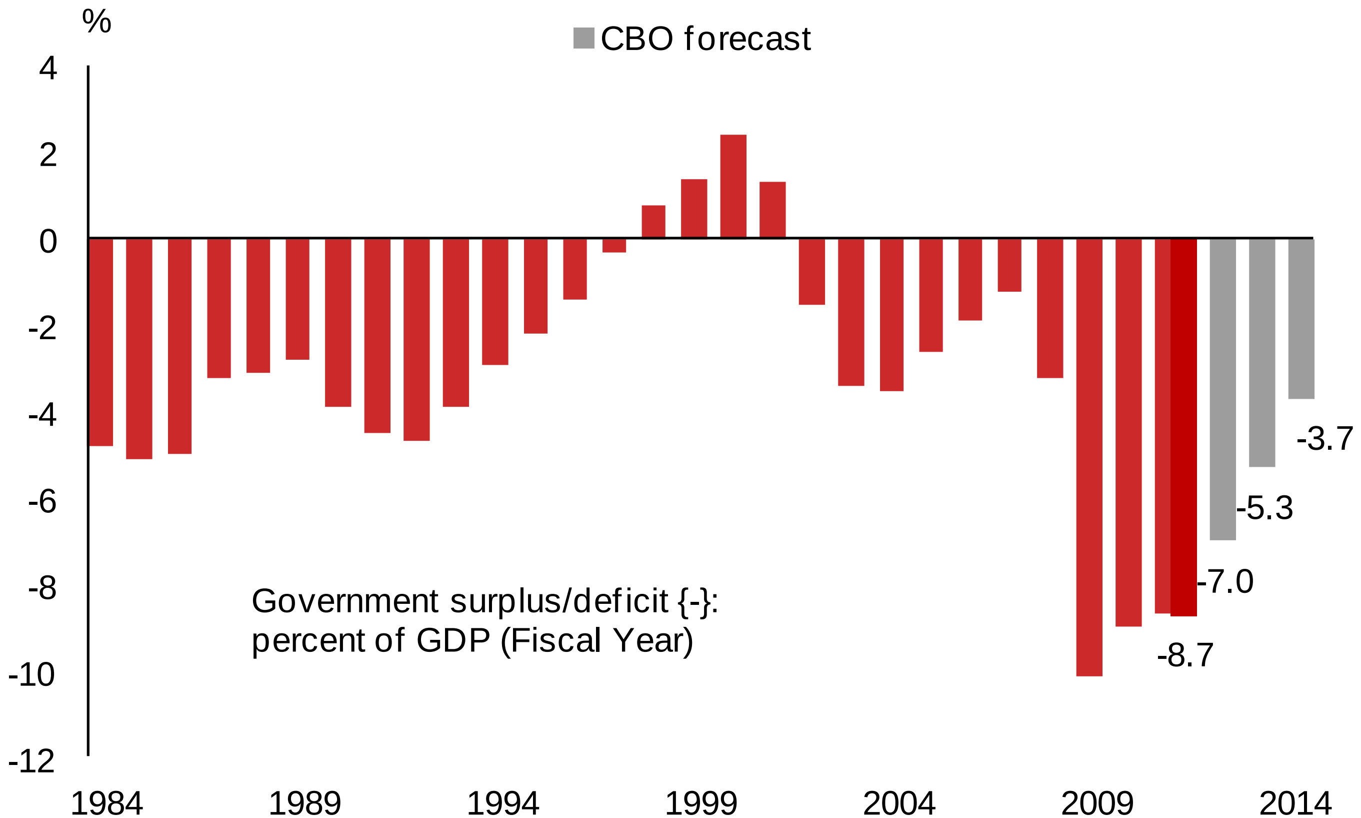
- Permanent implementation of the scheduled spending cuts will reduce GDP growth (Q4/Q4) by:
  - 0.6 percent in 2013
  - 0.25 percent in 2014
- Our forecast assumes these cuts will be implemented permanently.

Note: based on simulations of the Fair Model. Source: CBO, Nomura

NOMURA

The deficit/GDP ratio is improving

But becomes a problem again by 2020 on rising health care expenditures



Source: CBO, Nomura

The fiscal debate ahead

- The debt limit looms large again.
  - We have already breached the debt limit, but it has been suspended through mid-May.
  - The debt limit will most likely become binding by early August.
- Budget negotiations will remain contentious.
  - Little progress has been made in bridging a large ideological gap between the two sides.
- We expect long-term issues to be dealt with, to the extent possible, in a version of the "normal" budget process for FY2014.
- Ratings agencies have the US debt rating on "negative watch" with a further downgrade penciled in if no credible long-term debt reduction plan is reached.

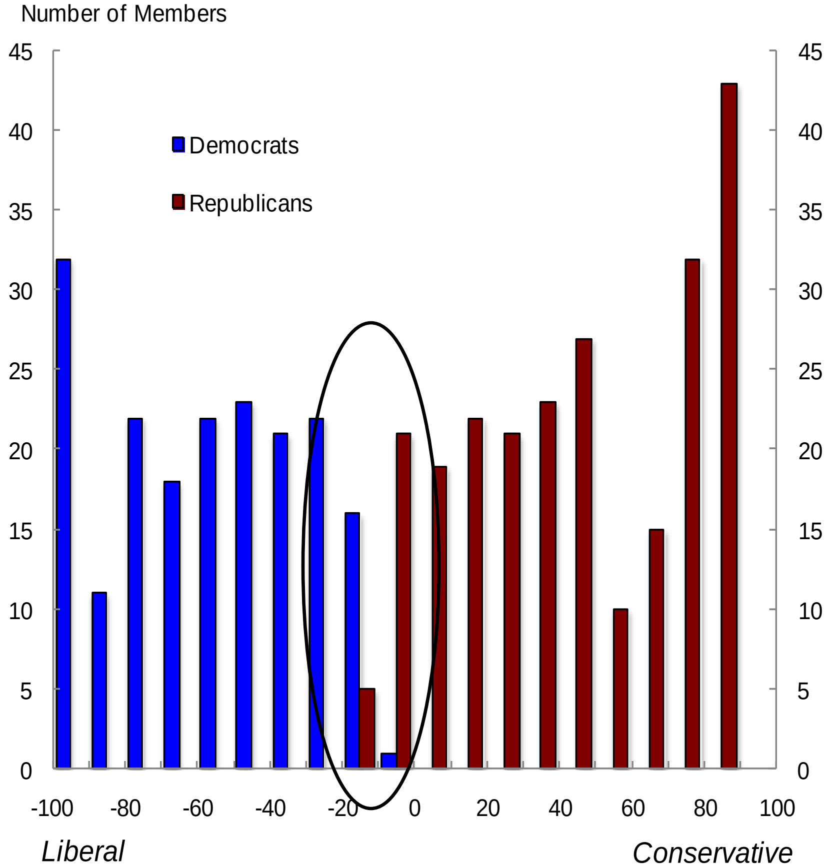
Source: Nomura

NOMURA

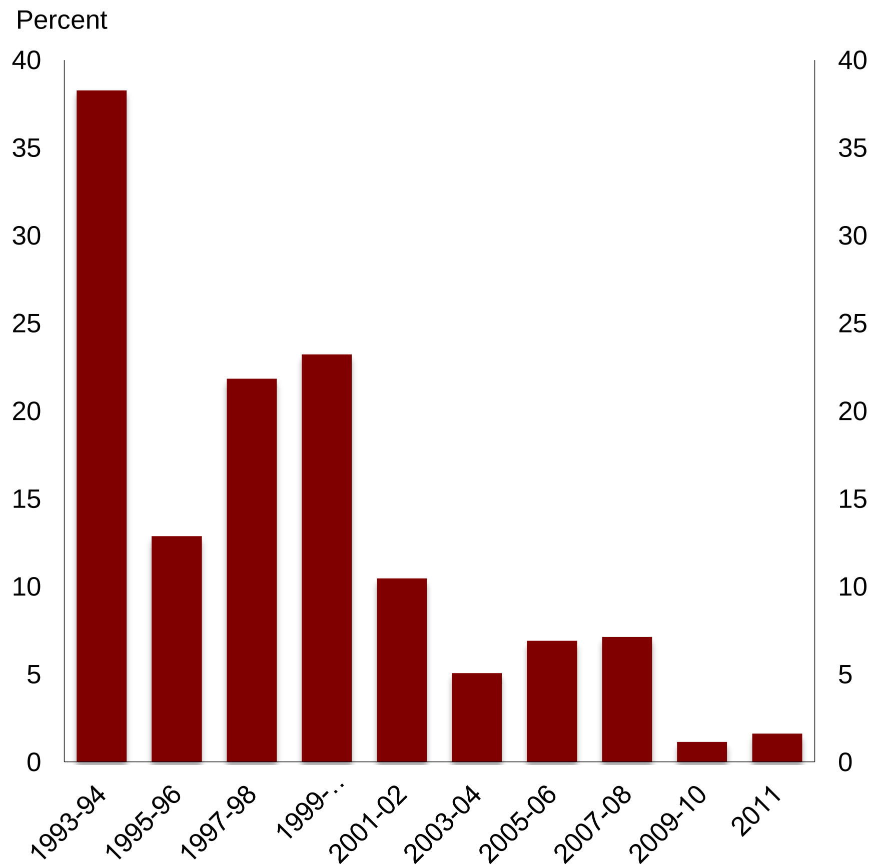
The Partisan Divide in Congress

The house has become more partisan on economics, and that trend should continue

Distribution of House Members by their Liberal/Conservative Voting Record on Economic Issues in 2011 by Party



Overlap of Liberal Republicans and Conservative Democrats in the House Based on Economic Votes (percent of all members)



Source: National Journal, Nomura

The long-term fiscal challenge

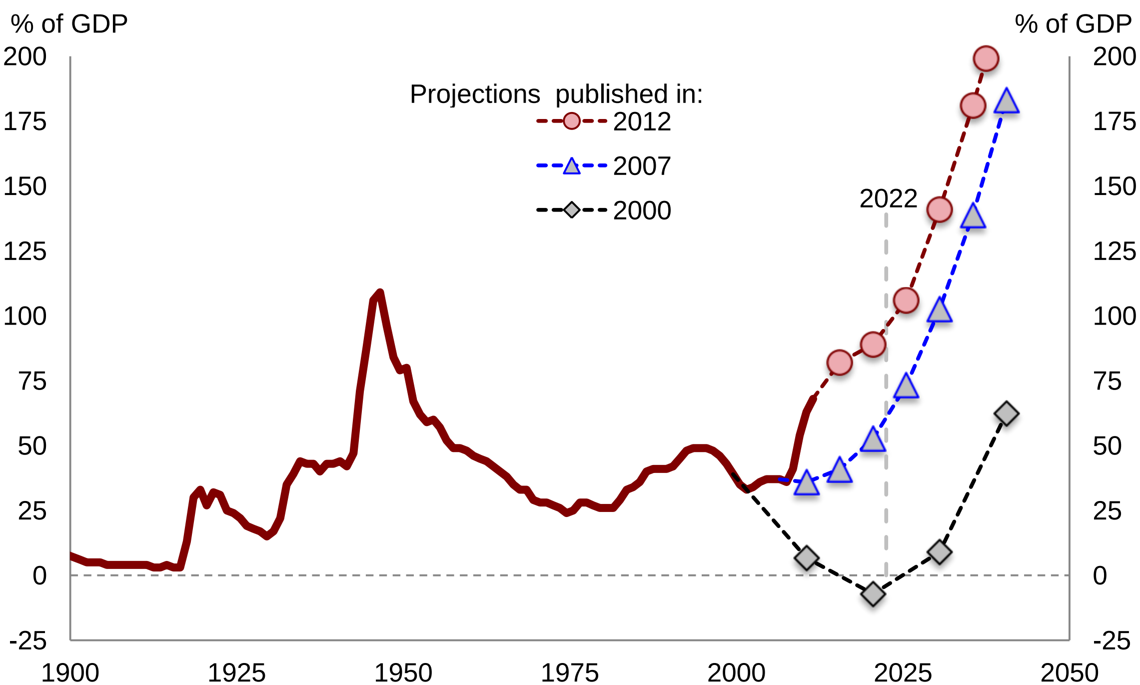
- The debate over fiscal policy should be shaped by the nature of the long-term fiscal problem.
- The cyclical improvement in the US fiscal accounts as the economy continues to recover is likely to be significantly offset by two other factors.
  - An eventual normalization of interest rates which would increase interest costs.
  - The combined effects of the aging of the population and rapidly increasing healthcare costs on entitlement spending (the biggest factor driving the long-term problem).
- Stabilizing the US fiscal outlook over the long-term requires some combination of:
  - A reduction in healthcare cost growth
  - Reductions in benefits
  - Higher taxes
- This is challenging as:
  - There is no silver bullet for containing the cost of healthcare
  - Entitlements are among the most popular government programs

NOMURA

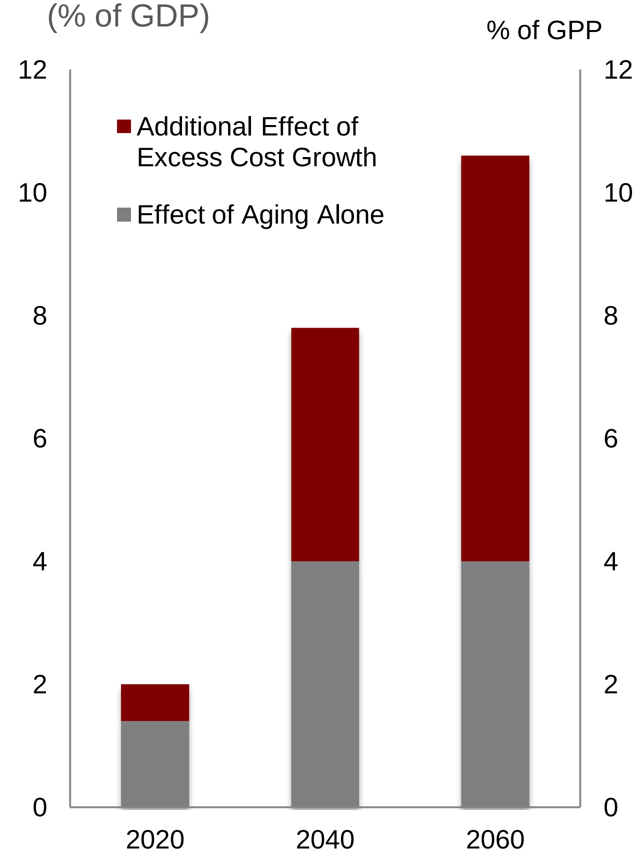
Healthcare

Containing healthcare costs is the single most important long-term challenge

Federal debt held by the public, 1900-2011, and as projected in CBO's long-term analysis of current policies published in 2000, 2007, and 2012 (percent of GDP)



Impact of aging and health care cost growth on CBO's projections of annual Federal spending under current policies (% of GDP)



Source: Congressional Budget Office, Nomura

Legacy of financial crises

- The credit-to-GDP ratio balloons in the 10 years leading up to financial crises
- Retrenchment lasts as long as the credit surge
- In the 10 years following the crisis:
  - Deleveraging of private debt damps credit and employment growth (and lasts for about 7 years)
  - Housing prices remain significantly lower (by 15-20%)
  - Unemployment remains significantly higher (in 2/3 of the observations never returning to pre-crisis level)
  - Inflation remains lower
  - GDP growth is about 1% lower in the decade post-crisis (we have averaged 2.1% growth in the current recovery)
- It has taken governments 23 years on average to return debt-to-GDP ratios to sustainable levels.

Source: Carmen and Vincent Reinhart, "After the Fall", FRBKC Jackson Hole Symposium, 2010; Reinhart, Reinhart, and Rogoff, "Public Debt Overhangs"; Nomura

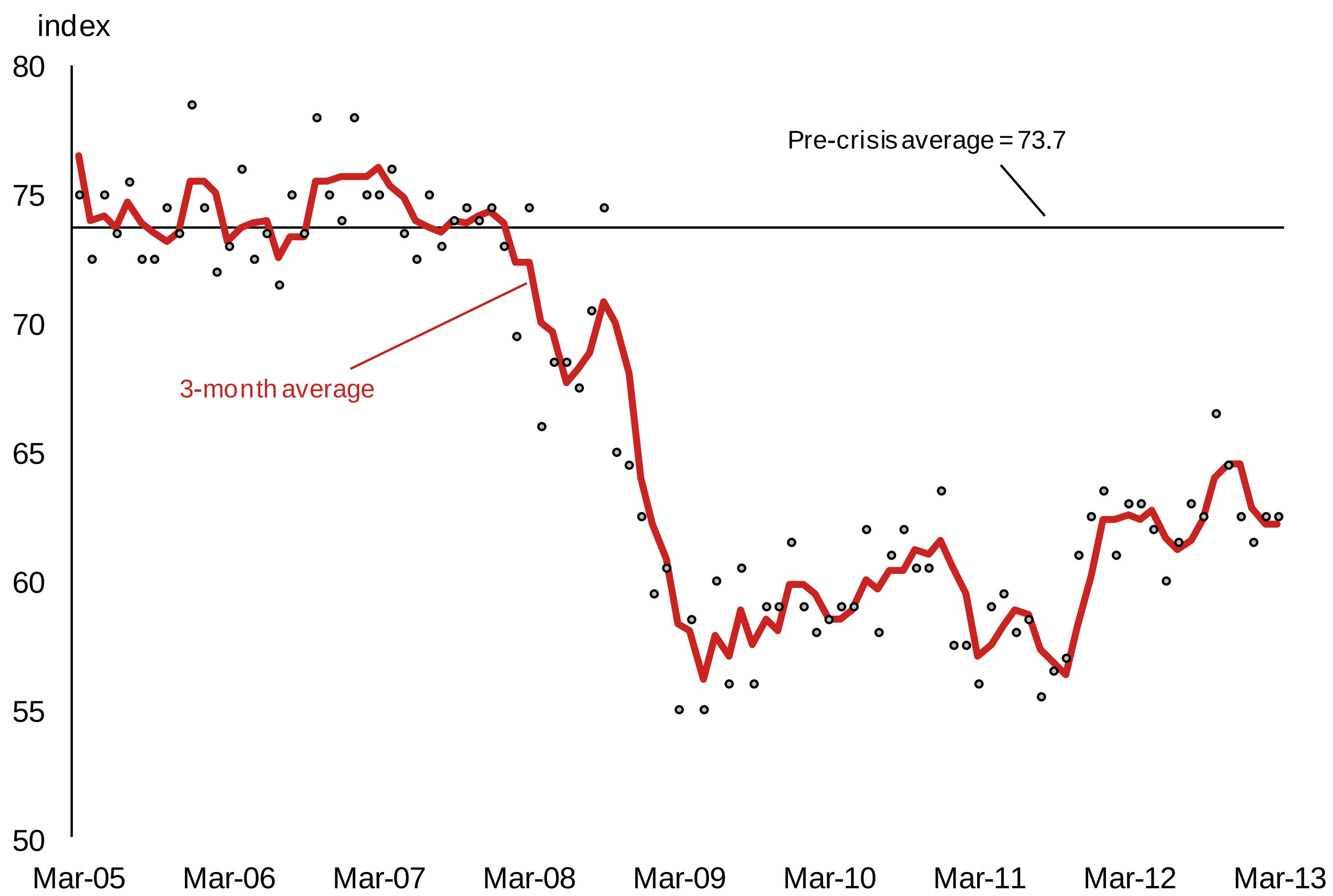
The US consumer in 2013

- By the end of 2012, US households nearly fully recovered the $16 trillion lost in wealth since the housing meltdown and financial crisis.
- Households have also been reducing debt levels for four years.
- Household balance sheet adjustment is largely complete.
- Trends in consumer spending have diverged greatly across income groups.
- Weak wage and salary growth, elevated energy prices, and disproportionate tax burden is holding back spending among lower-income households.
- Rising prices for real estate and financial assets have emboldened upper-income households.

See "Spendthrift households to the rescue", *Special Report*, 13 March 2013

Expected income has not recovered…

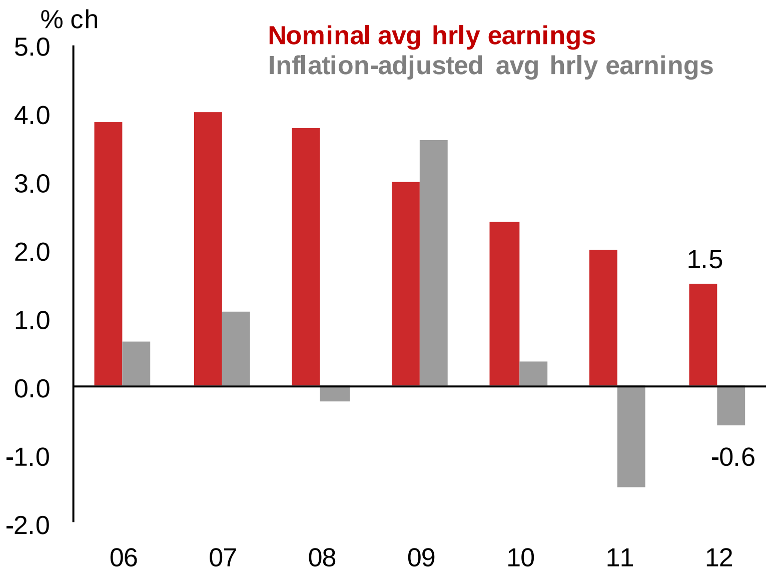
expected family income over the next 12 months



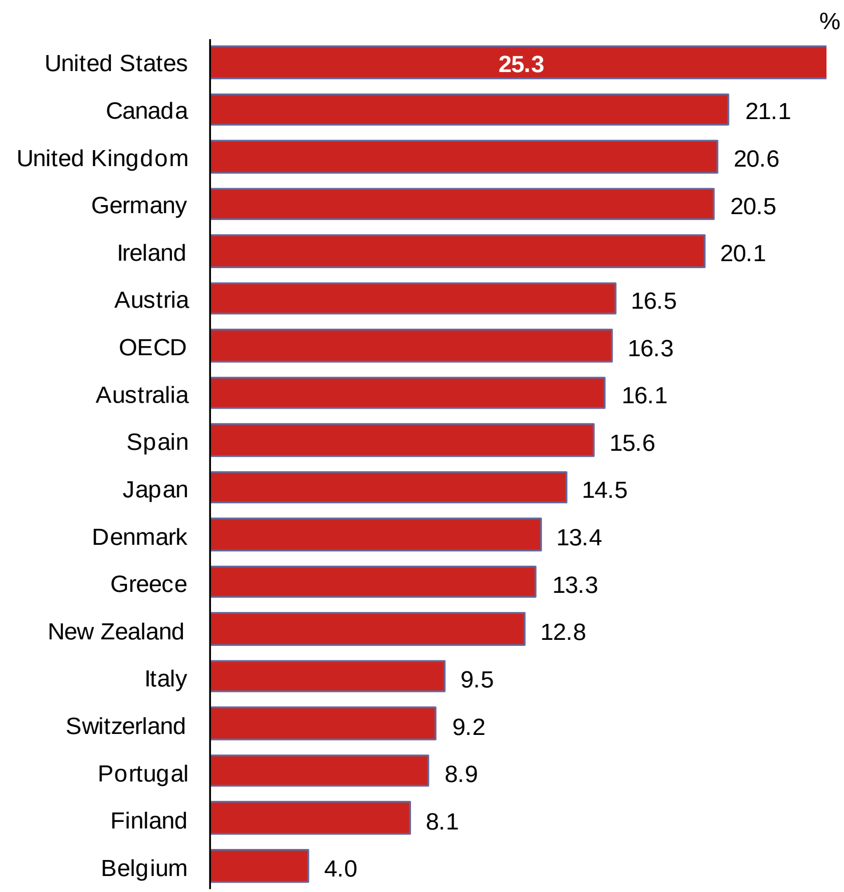
Source: University of Michigan, Nomura

…and is tied to a weak labor market

Earnings have suffered from high unemployment and lower-quality job creation



Share of low paying jobs by country, 2010

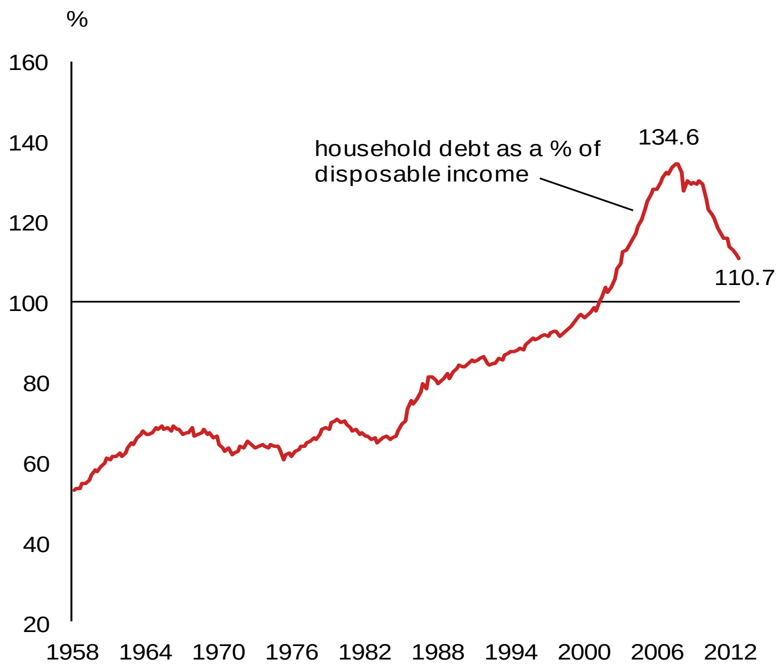


Source: BLS, OECD, Nomura. Note: Low-paying jobs defined as earning less than two-thirds of the national median hourly wage.

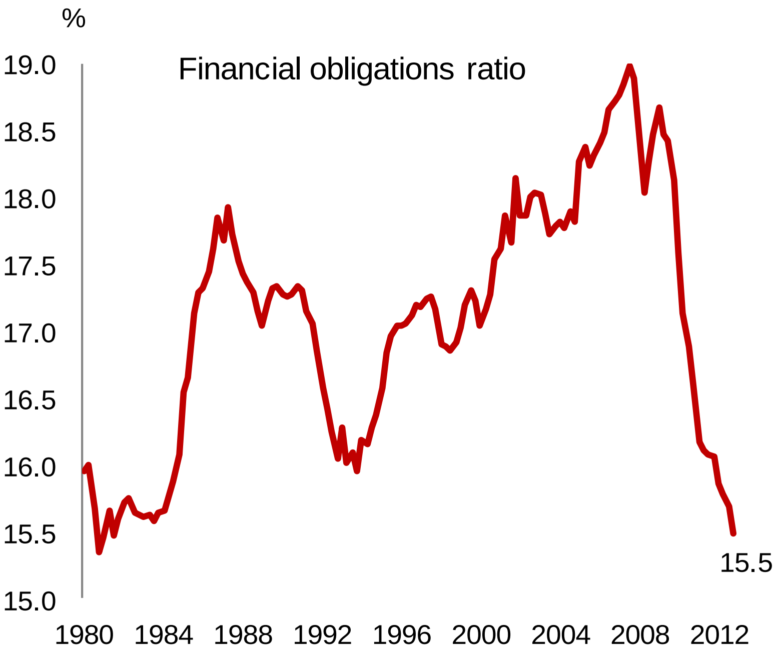
Households are still debt constrained

…but balance sheet adjustment is largely complete and low interest rates help

Ratio: Household debt to after-tax income



FOR: Payments to after-tax income

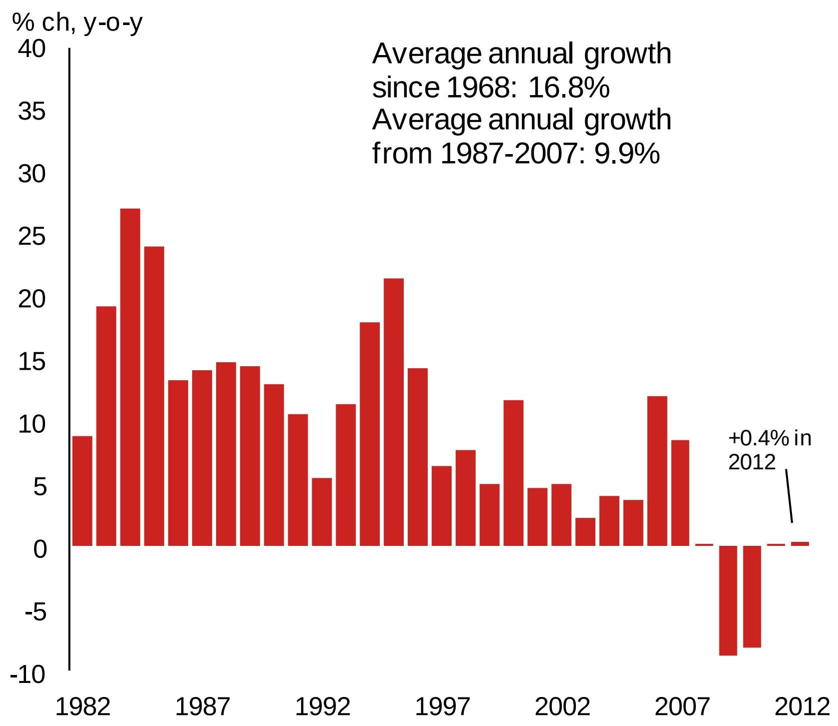


Notes: The financial obligations ratio (FOR) is a broader measure than the debt service ratio (DSR). It includes automobile lease payments, consumer debt payments, rental payments on tenant-occupied property, payments on mortgage debt, homeowners' insurance and property tax payments. The DSR only includes payments on outstanding mortgage and consumer debt.
Source: Bureau of Economic Analysis, Federal Reserve, Haver Analytics, Nomura

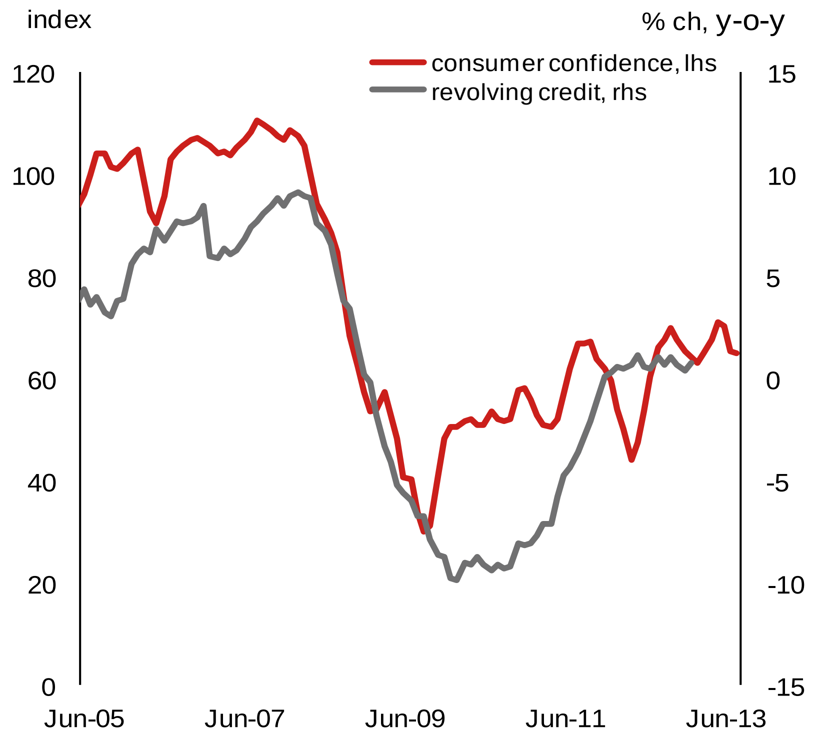
NOMURA

… and are reluctant to add debt

Unprecedented shift in the use of credit cards



Revolving credit vs consumer confidence

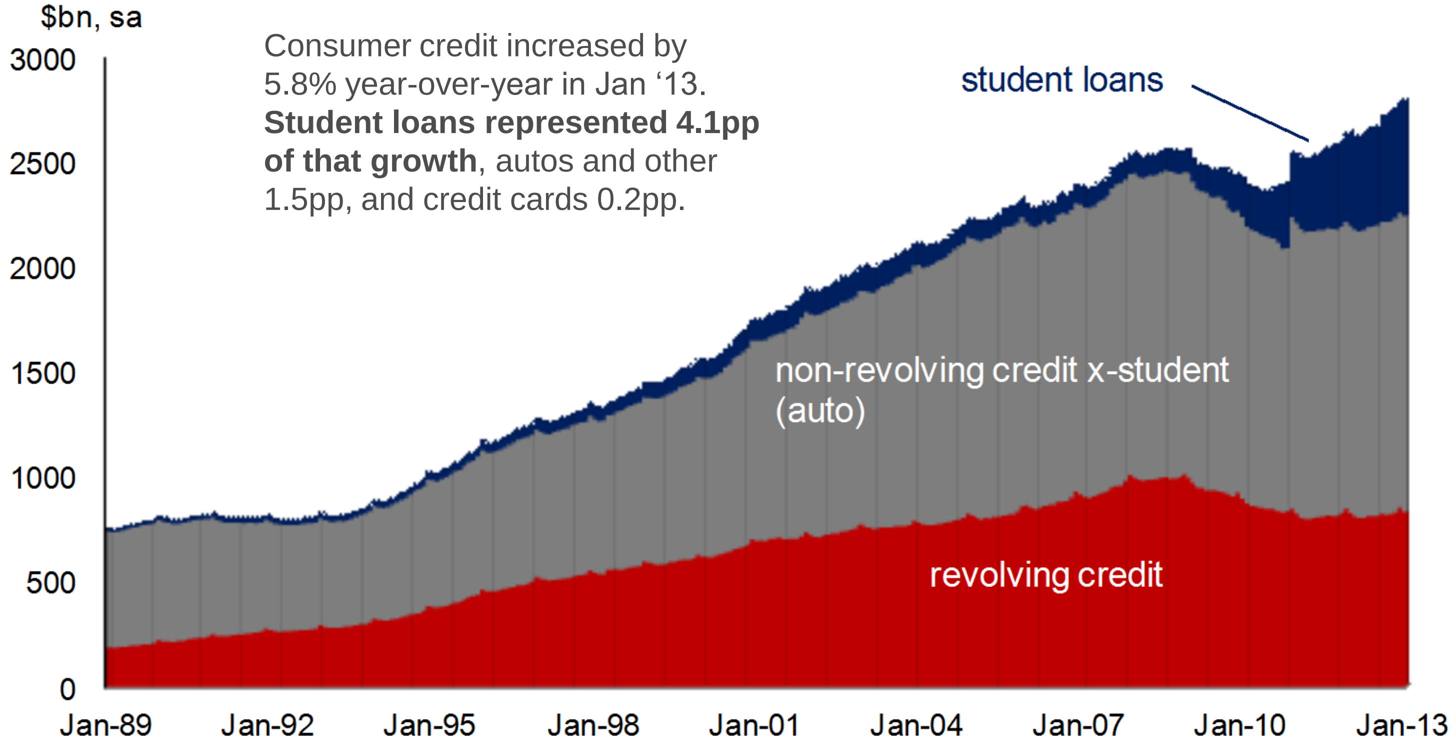


Source: Federal Reserve, Nomura

NOMURA

… outside of student and auto loans

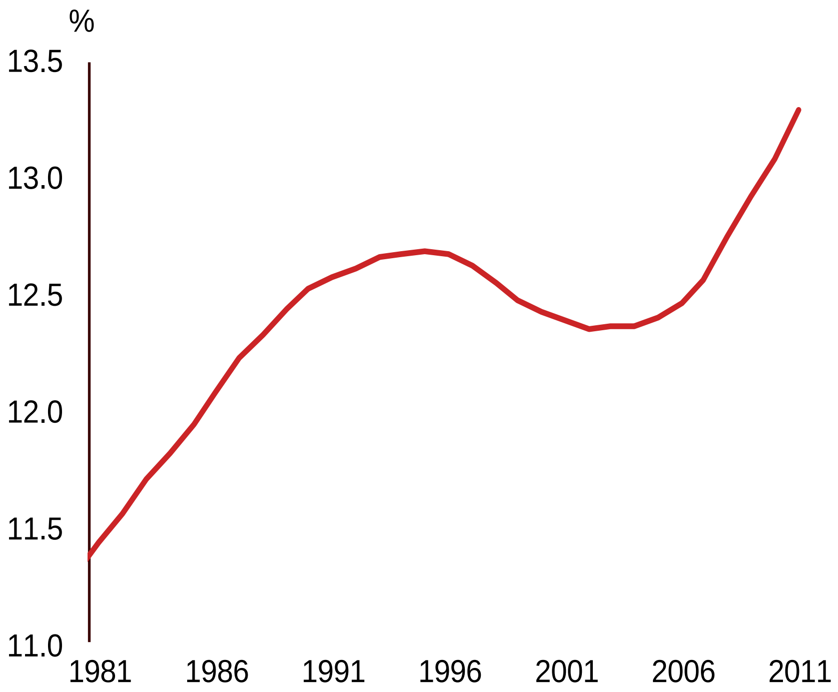
Consumer credit increased by 5.8% year-over-year in Jan ‘13. **Student loans represented 4.1pp of that growth**, autos and other 1.5pp, and credit cards 0.2pp.



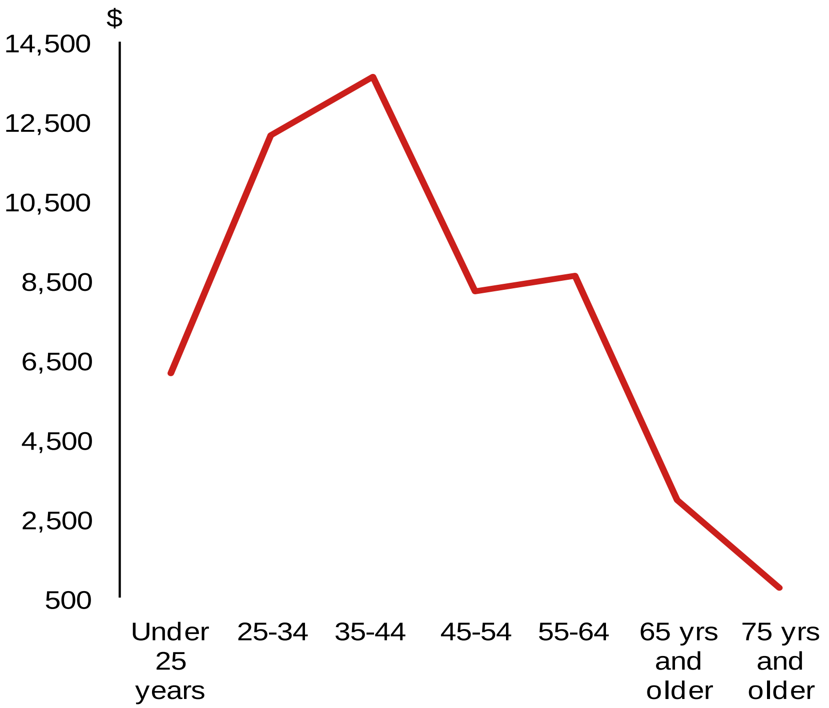
Source: Federal Reserve, Nomura

Demographic shifts are a big drag

Share of the population over 65



Net change in total liabilities by age (2011)

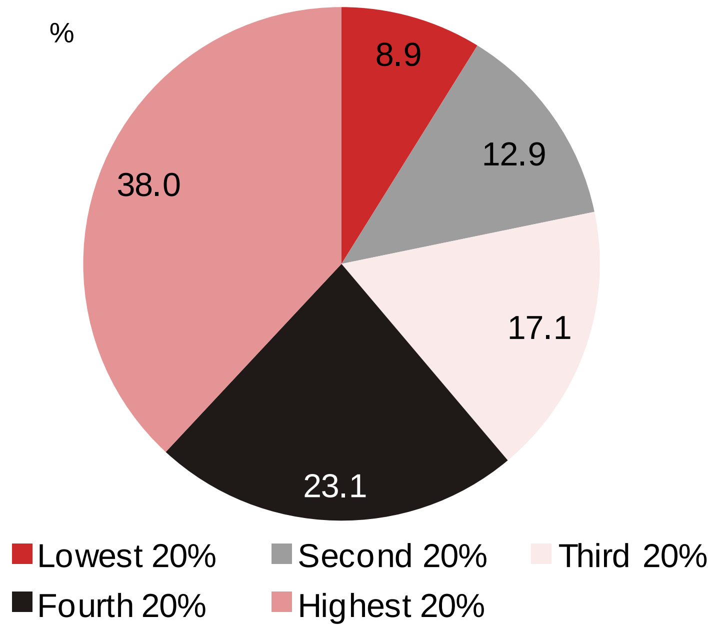


Source: BLS consumer expenditure survey data, Nomura

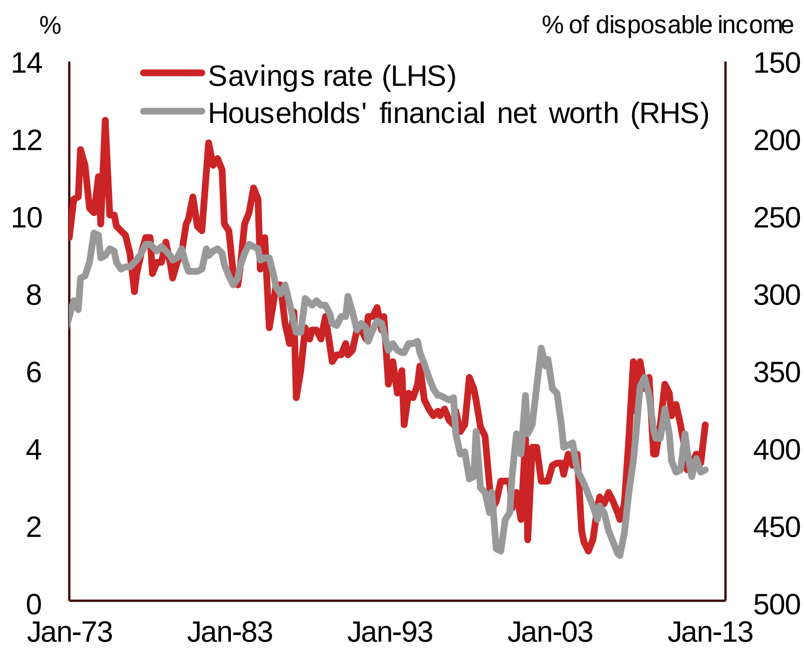
NOMURA

Spending behavior of upper income households matters a great deal

Share of annual expenditures by income group, 2011



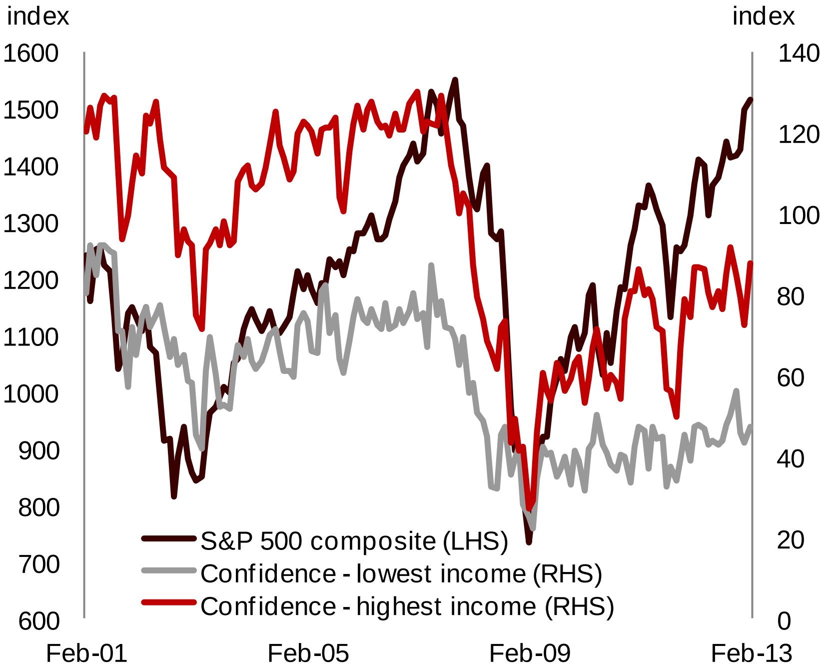
Household savings rate vs households' financial net worth (quarterly average)



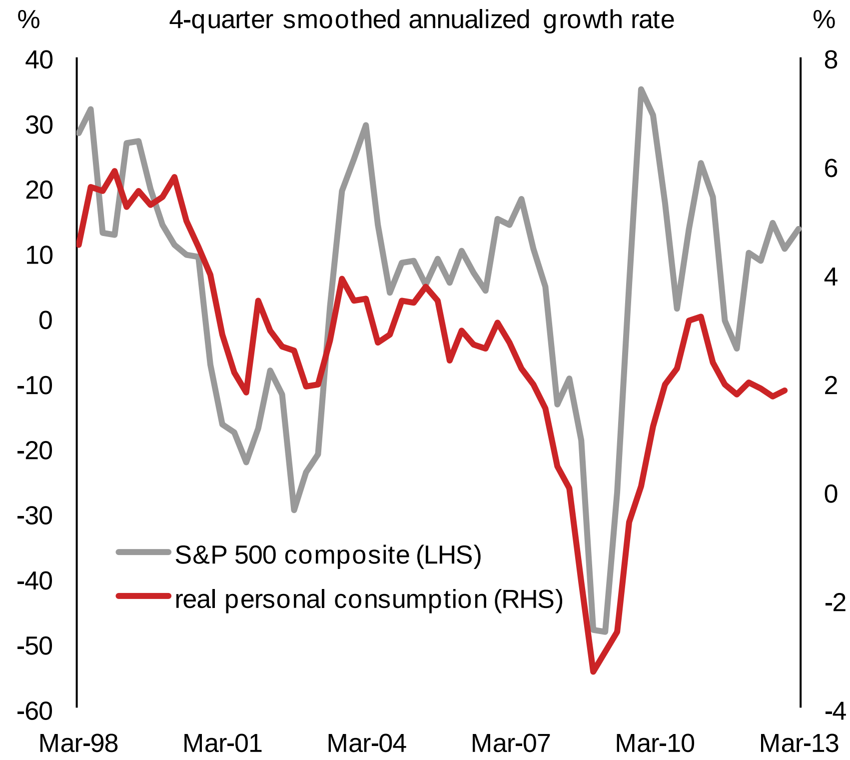
Source: BLS, University of Michigan, Nomura

Spending and confidence tracks equities

Confidence rises and falls with the stock market



Rise in equities explains stronger-than-expected spending in Q1 2013



Source: Conference Board, BEA, Haver Analytics, Nomura

Disclosure Appendix A-1

ANALYST CERTIFICATIONS

I, Ellen Zentner, hereby certify (1) that the views expressed in this report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

Important Disclosures

Online availability of research and additional conflict-of-interest disclosures

Nomura research is available on www.nomuranow.com/research, Bloomberg, Capital IQ, Factset, MarkitHub, Reuters and ThomsonOne.

Important disclosures may be accessed through the left hand side of the Nomura Disclosure web page http://go.nomuranow.com/research/globalresearchportal or requested from Nomura Securities International, Inc., on 1-877-865-5752. If you have any difficulties with the website, please email grpsupport-eu@nomura.com for technical assistance.

The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by Investment Banking activities.

Unless otherwise noted, the non-US analysts listed at the front of this report are not registered/qualified as research analysts under FINRA/NYSE rules, may not be associated persons of NSI, and may not be subject to FINRA Rule 2711 and NYSE Rule 472 restrictions on communications with covered companies, public appearances, and trading securities held by a research analyst account.

Nomura Global Financial Products Inc. (“NGFP”) Nomura Derivative Products Inc. (“NDPI”) and Nomura International plc. (“NIplc”) are registered with the Commodities Futures Trading Commission and the National Futures Association (NFA) as swap dealers. NGFP, NDPI, and NIplc are generally engaged in the trading of swaps and other derivative products, any of which may be the subject of this report.

ADDITIONAL DISCLOSURES REQUIRED IN THE U.S.

Principal Trading: Nomura Securities International, Inc. and its affiliates will usually trade as principal in the fixed income securities (or in related derivatives) that are the subject of this research report. Analyst Interactions with other Nomura Securities International, Inc. Personnel: The fixed income research analysts of Nomura Securities International, Inc. and its affiliates regularly interact with sales and trading desk personnel in connection with obtaining liquidity and pricing information for their respective coverage universe.

Valuation methodology – Fixed Income

Nomura’s Fixed Income Strategists express views on the price of securities and financial markets by providing trade recommendations. These can be relative value recommendations, directional trade recommendations, asset allocation recommendations, or a mixture of all three.

The analysis which is embedded in a trade recommendation would include, but not be limited to:

•Fundamental analysis regarding whether a security’s price deviates from its underlying macro- or micro-economic fundamentals.

•Quantitative analysis of price variations.

•Technical factors such as regulatory changes, changes to risk appetite in the market, unexpected rating actions, primary market activity and supply/ demand considerations.

The timeframe for a trade recommendation is variable. Tactical ideas have a short timeframe, typically less than three months. Strategic trade ideas have a longer timeframe of typically more than three months.

Disclaimers

This document contains material that has been prepared by the Nomura entity identified at the top or bottom of page 1 herein, if any, and/or, with the sole or joint contributions of one or more Nomura entities whose employees and their respective affiliations are specified on page 1 herein or identified elsewhere in the document. The term "Nomura Group" used herein refers to Nomura Holdings, Inc. or any of its affiliates or subsidiaries and may refer to one or more Nomura Group companies including: Nomura Securities Co., Ltd. ('NSC') Tokyo, Japan; Nomura International plc ('NIplc'), UK; Nomura Securities International, Inc. ('NSI'), New York, US; Nomura International (Hong Kong) Ltd. ('NIHK'), Hong Kong; Nomura Financial Investment (Korea) Co., Ltd. ('NFIK'), Korea (Information on Nomura analysts registered with the Korea Financial Investment Association ('KOFIA') can be found on the KOFIA Intranet at http://dis.kofia.or.kr); Nomura Singapore Ltd. ('NSL'), Singapore (Registration number 197201440E, regulated by the Monetary Authority of Singapore); Nomura Australia Ltd. ('NAL'), Australia (ABN 48 003 032 513), regulated by the Australian Securities and Investment Commission ('ASIC') and holder of an Australian financial services licence number 246412; P.T. Nomura Indonesia ('PTNI'), Indonesia; Nomura Securities Malaysia Sdn. Bhd. ('NSM'), Malaysia; NIHK, Taipei Branch ('NITB'), Taiwan; Nomura Financial Advisory and Securities (India) Private Limited ('NFASL'), Mumbai, India (Registered Address: Ceejay House, Level 11, Plot F, Shivsagar Estate, Dr. Annie Besant Road, Worli, Mumbai- 400 018, India; Tel: +91 22 4037 4037, Fax: +91 22 4037 4111; SEBI Registration No: BSE INB011299030, NSE INB231299034, INF231299034, INE 231299034, MCX: INE261299034); and NIplc, Madrid Branch ('NIplc, Madrid') . 'CNS Thailand' next to an analyst's name on the front page of a research report indicates that the analyst is employed by Capital Nomura Securities Public Company Limited ('CNS') to provide research assistance services to NSL under a Research Assistance Agreement. CNS is not a Nomura entity.

THIS MATERIAL IS: (I) FOR YOUR PRIVATE INFORMATION, AND WE ARE NOT SOLICITING ANY ACTION BASED UPON IT; (II) NOT TO BE CONSTRUED AS AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY ANY SECURITY IN ANY JURISDICTION WHERE SUCH OFFER OR SOLICITATION WOULD BE ILLEGAL; AND (III) BASED UPON INFORMATION FROM SOURCES THAT WE CONSIDER RELIABLE, BUT HAS NOT BEEN INDEPENDENTLY VERIFIED BY NOMURA GROUP.

Nomura Group does not warrant or represent that the document is accurate, complete, reliable, fit for any particular purpose or merchantable and does not accept liability for any act (or decision not to act) resulting from use of this document and related data. To the maximum extent permissible all warranties and other assurances by Nomura group are hereby excluded and Nomura Group shall have no liability for the use, misuse, or distribution of this information.

Opinions or estimates expressed are current opinions as of the original publication date appearing on this material and the information, including the opinions and estimates contained herein, are subject to change without notice. Nomura Group is under no duty to update this document. Any comments or statements made herein are those of the author(s) and may differ from views held by other parties within Nomura Group. Clients should consider whether any advice or recommendation in this report is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. Nomura Group does not provide tax advice.

Nomura Group, and/or its officers, directors and employees, may, to the extent permitted by applicable law and/or regulation, deal as principal, agent, or otherwise, or have long or short positions in, or buy or sell, the securities, commodities or instruments, or options or other derivative instruments based thereon, of issuers or securities mentioned herein. Nomura Group companies may also act as market maker or liquidity provider (within the meaning of applicable regulations in the UK) in the financial instruments of the issuer. Where the activity of market maker is carried out in accordance with the definition given to it by specific laws and regulations of the US or other jurisdictions, this will be separately disclosed within the specific issuer disclosures.

This document may contain information obtained from third parties, including ratings from credit ratings agencies such as Standard & Poor's. Reproduction and distribution of third party content in any form is prohibited except with the prior written permission of the related third party. Third party content providers do not guarantee the accuracy, completeness, timeliness or availability of any information, including ratings, and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such content. Third party content providers give no express or implied warranties, including, but not limited to, any warranties of merchantability or fitness for a particular purpose or use. Third party content providers shall not be liable for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including lost income or profits and opportunity costs) in connection with any use of their content, including ratings. Credit ratings are statements of opinions and are not statements of fact or recommendations to purchase hold or sell securities. They do not address the suitability of securities or the suitability of securities for investment purposes, and should not be relied on as investment advice.