

2nd Quarter 2012 Economic Updates

Prepared for: A Colorado Bank Board of Directors

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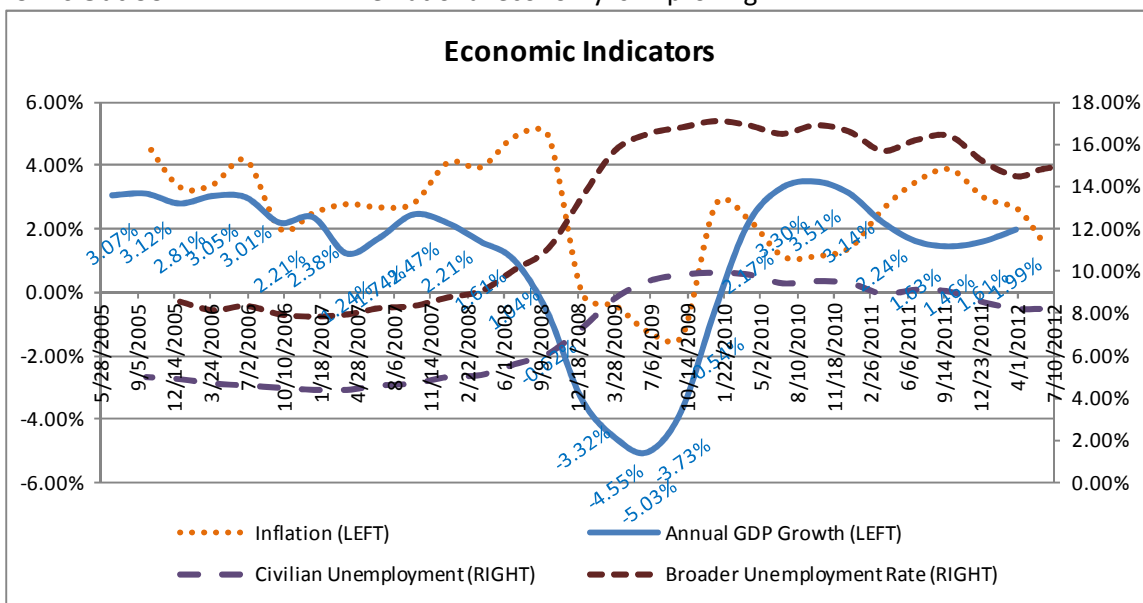
Date: July, 18, 2012

Executive Summary:

- **GDP Growth Holding For Now:** As of 1Q12, Annual GDP growth at 1.99%, improved for 9 quarters straight. That is, even though this is not exactly strong it suggests that positive GDP growth is holding. However, the US Leading Index is at 1.05 as of Apr '12 and is below the long term average of 1.17, weakening the case for positive Annual GDP growth holding.
- **Consumer Sentiments Continue to Decline:** Consumer Sentiments at 73.2 as of Jun '12 continues long term decline from 111.30 in Feb '00. This trend is unlikely to turn around until Disposal Income growth (0.53% as of Apr '12) increases at a faster rate than Personal Consumption growth (1.80% as of 1Q12), and will continue to erode the (70%) consumer side of the economy.
- **Unemployment Recovery Continues:** Unemployment (UNRATE) is still high at 8.2%, and recovery has slowed slightly, pushing out a 6% unemployment rate (1Q12 Board Economic Report) from Feb '15 to Jul '15. High unemployment will continue to put downward pressure on Disposal Income growth. On the positive side the Broader Unemployment (U6RATE) rate has fallen 2.3% from its Oct '09 high of 17.2% to 14.9% in Jun '12. This is a slight uptick from 14.5% (Mar '12 & Apr '12). Suggesting that the slowing of the unemployment (UNRATE) recovery is due to this recovery of the Broader Unemployment Rate (U6RATE) as part-time employment converts to full-time employment and not due to structural factors.
- **Slowing Sectors Visible:** Major sectors are slowing, with manufacturing contracting at -10.93% (Jun '12), Construction Spending slowing from a high of 10.00% (Feb '12) to 6.98% (May '12) and Retail & Food growth slowing from a high of 6.38% (Feb '11) to 3.50% (May '12). The trends suggest that a recession (if at all) is not likely until 1Q13, and there may still be enough time for policy to combat this undesirable outcome.
- **Inflation Abated:** Inflation has abated to 1.73% and the inflation trend has reversed in the last 12 months. It is now decreasing at the rate of -0.16% per month, and may pose deflationary risk, by 4Q12 or 1Q13.
- **Banking Sector is Improving:** The Velocity of Money M2 is 1.58 (Mar '12), and its contraction has slowed from an average -11.04% in 2011 to -5.55% in 1Q12. The trend suggests that the growth in the Velocity of Money M2 should turn positive in Jul '14. Commercial & Industrial loan growth continues to 12.92% (May '12), and both Real Estate & Consumer loan growth turned positive 0.47% in Apr '12, and 0.93% in Jan '12, respectively.
- **Property Sector Recovery:** The worst is behind us with delinquencies peaking in 2Q 2010. Commercial & residential loan delinquencies are 5.7x & 5.9x greater than 2006 rates of 1.1% & 1.7%, respectively. This is indicative of a recovery in 2014 & 2026, respectively. Home price decline slowed to -1.86% p.a. as of Apr '12.
- **Colorado State Improving with Possible Soft Patch:** The Colorado GDP grew 4.43% (4Q11), much better than the national economy. However, the CO Leading Index contracted by -29.03% from a year ago, suggesting the possibility of a slowing state economy, later this year.

Economic Outlook:

The national economy is improving



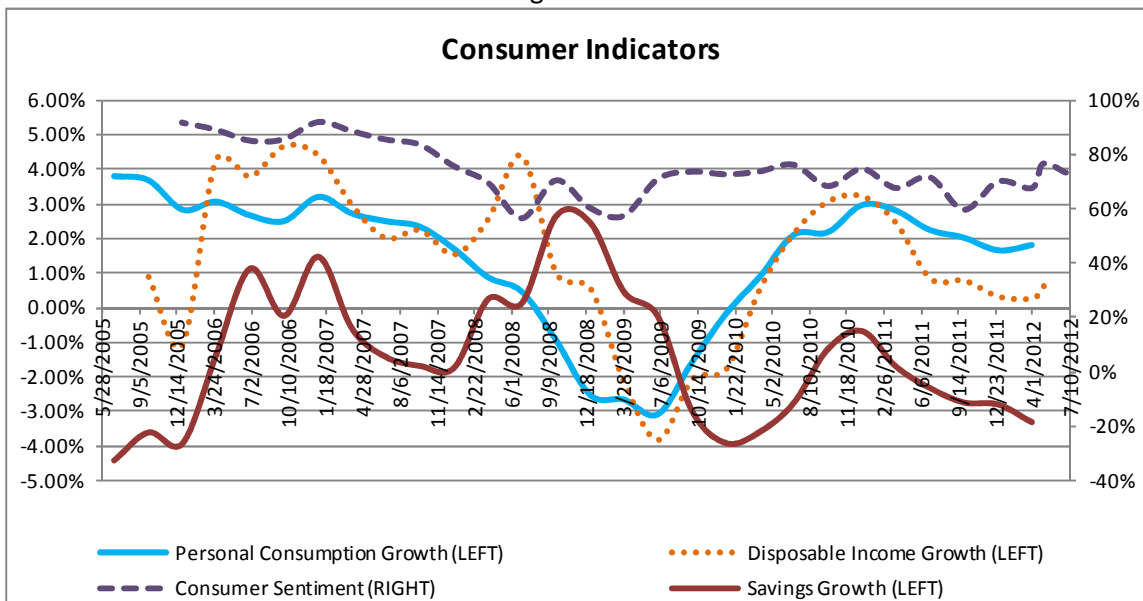
Data Source: Federal Reserve Bank of St. Louis's GDP growth (GDPC1), inflation (CPIAUCSL), civilian unemployment (UNRATE) & the broader unemployment rate (UGRATE).

| Date | Annual GDP Growth (LEFT) | Civilian Unemployment (RIGHT) | Broader Unemployment Rate (RIGHT) | Inflation (LEFT) |
|--------|--------------------------|-------------------------------|-----------------------------------|------------------|
| May-12 | | 8.20% | 14.80% | 1.73% |
| Mar-12 | 1.99% | 8.20% | 14.50% | 2.65% |
| Mar-11 | 2.24% | 8.90% | 15.70% | 2.65% |

- Improving GDP growth.** The Annual¹ GDP growth hovered between 1.46%² and 1.61% in 3Q11 and 4Q11, respectively. At 1Q12 the Annual GDP growth was 1.99%³. This is still less than the post recession 3Q10 peak of 3.51%⁴. That is, barring unforeseen Black Swans to the economy, GDP growth is improving, albeit slowly.
- Declining unemployment.** Unemployment peaked at 10.0% in Oct '09. Though decreasing, it remains high at 8.2% as of May '12. The rate of decline over a 28 month period has slowed from Jan '12⁵ - 0.73% to May '12 -0.69%, pushing out the 6% and 4% unemployment recovery dates by five months to Jul '15 and Jun '17, respectively. However, the Broader Unemployment Rate (UGRATE) has come down from its Oct '09 high of 17.2% to 14.9% in Jun '12. This is a slight uptick from 14.5% in Mar '12 & Apr '12.
- Inflation is decreasing.** Inflation has increased steadily from its low of -1.99% (Jul '09) to 3.90% (Sep '11) and has come down some to 1.73% in May '12. The inflation trend has reversed in the last 12 months. It is now decreasing at the rate of -0.16% per month, and may pose deflationary risk, by 4Q12 or 1Q13.

¹ The Annual GDP growth metric (GDP growth measured over 4 Quarters) is less volatile (i.e. less noisy) than the Quarter-to-Quarter metric that is reported in the news, and is a better indicator of trends than the Quarter-to-Quarter metric.
² This is equivalent to the Annualized Quarter-to-Quarter GDP growth of 3Q11's 1.81% and 4Q11's 2.95%.
³ Is equivalent to 1.86% Quarter-to-Quarter growth.
⁴ Is equivalent to 2.51% Quarter-to-Quarter growth.
⁵ Per 1Q12 Board Economic Report

Consumer Outlook: Consumer strength continues to wane



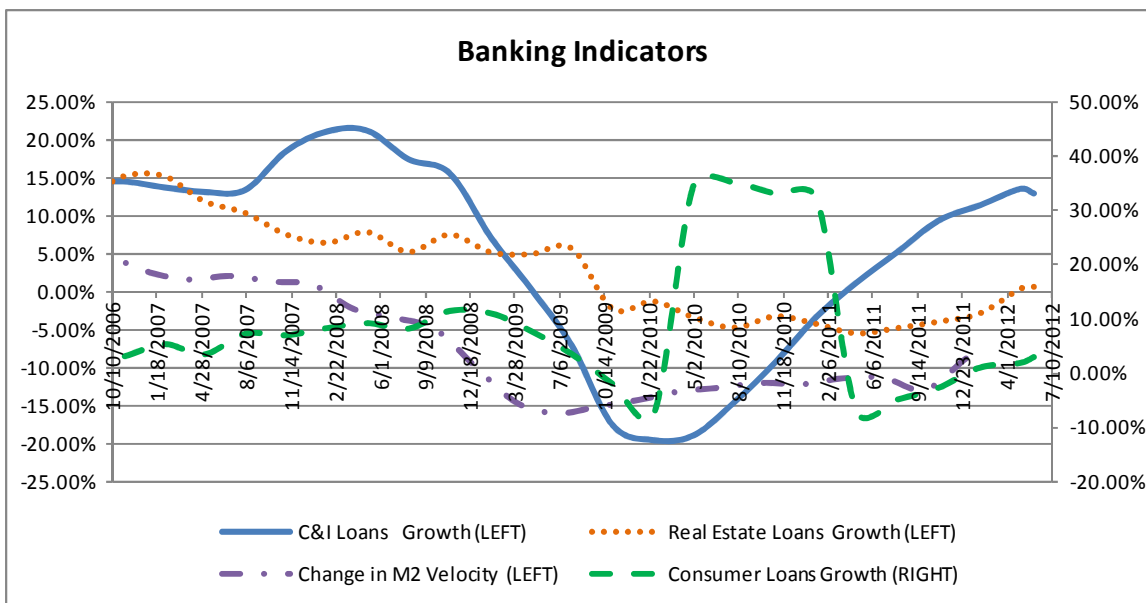
Data Source: Federal Reserve Bank of St. Louis's Consumption (PCECC96), Disposable Inc. (DSPIC96), U of MI Consumer Sentiment (UMCSENT) & Healthcare Coverage Rate (USHICCOVPCT). Note: UMCSENT is divided by 100 to fit on the graph.

| Date | Consumer Sentiment (RIGHT) | Personal Consumption Growth (LEFT) | Disposable Income Growth (LEFT) | Savings Growth (LEFT) | Date | Healthcare Insurance Coverage Rate (LEFT) |
|--------|----------------------------|------------------------------------|---------------------------------|-----------------------|--------|---|
| Jun-12 | 73.2 | | | | Dec-11 | |
| Apr-12 | 76.4 | | 0.62% | | Dec-10 | 83.70% |
| Mar-12 | 67.5 | 1.80% | 0.27% | -18.32% | Dec-09 | 83.90% |
| Mar-11 | 67.5 | 2.80% | 2.43% | 2.24% | Dec-08 | 85.10% |

- *Consumer Sentiments in the dumps.* University of Michigan Consumer Sentiments shows steady long term decline from 111.30 in Feb '00, to 55.8 in Aug '11, with some pick up to 79.30 in May '12 and a drop to 73.2 in Jun '12. Since Mar '10, the Consumer Sentiments has hovered around 70.97 ±6.74 with no significant trends, and this is a statistically significant reduction from the Feb '00.
- *Personal Consumption slows.* The Personal Consumption growth turned positive in 1Q10 and has remained in positive territory since, with a 1.80% growth as of 1Q12. However, this positive trend has been declining since 1Q11, and mirrors Disposal Income growth. There is a long term slowing in Consumption growth, from an average of 2.85% in 2006 to 0.93% in the 4-quarters to 1Q12. Within this context the 2009-2010 Personal Consumption growth spurt appears to be a correction for the 2008-2009 contraction.
- *Disposal Income slows.* Disposal income growth has slowed from an average 4.05% in 2006 to 0.53% for the 12-months up to Apr '12. This is much less than Consumption growth of 1.93% at 1Q12.
- *Savings in negative territory.* From 2006 to mid 2009 Disposable Income grew at a faster rate than Personal Consumption, ensuring growth in Savings. This has reversed from late 2009 to 2012 except for a very short period in mid 2010. As of 1Q12 Savings growth is a negative -18.32%.

Banking Outlook:

Overall bank lending has turned around



Data Source: Federal Reserve Bank of St. Louis's C&I (BUSLOANS), Consumer (CONSUMER), Real Estate (REALLN) loans & Velocity of M2 (M2V).

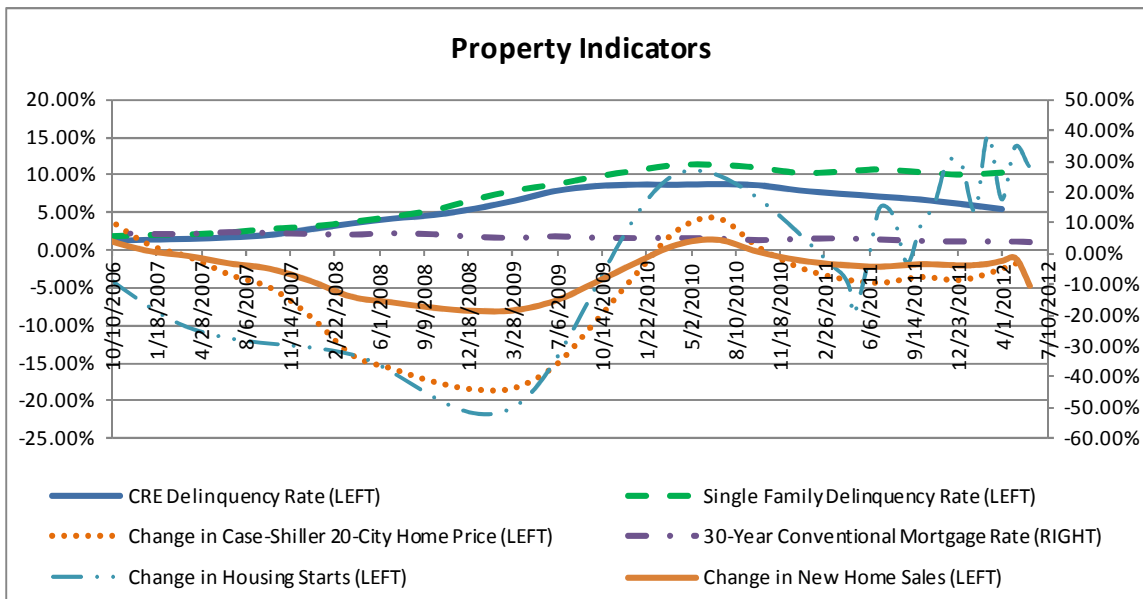
| Date | C&I Loans Growth (LEFT) | Consumer Loans Growth (RIGHT) | Real Estate Loans Growth (LEFT) | Date | Change in M2 Velocity (LEFT) |
|--------|-------------------------|-------------------------------|---------------------------------|--------|------------------------------|
| May-12 | 12.92% | 2.87% | 0.74% | Mar-12 | -5.55% |
| Apr-12 | 13.51% | 1.79% | 0.47% | Dec-11 | -8.72% |
| Apr-11 | 1.19% | -7.14% | -5.34% | Dec-10 | -12.11% |

| (\$Billions) | C&I Loans (LEFT) | Consumer Loans (LEFT) | Real Estate Loans (RIGHT) | Date | Velocity of M2 Money Stock (RIGHT) |
|--------------|------------------|-----------------------|---------------------------|--------|------------------------------------|
| May-12 | 1,413 | 1,111 | 3,530 | Mar-12 | 1.58 |
| Apr-12 | 1,404 | 1,099 | 3,533 | Dec-11 | 1.60 |
| Apr-11 | 1,237 | 1,080 | 3,517 | Dec-10 | 1.69 |

- *Improving velocity.* The contraction in the Velocity of Money M2 averaged -5.08% (2008), -14.92% (2009), -12.41% (2010) and -11.04% (2011). At this rate the growth in the Velocity of Money M2, should turn positive in Jul '14.
- *C&I bright spot.* The revised numbers show that Commercial & Industrial Loan growth is the bright spot in the bank-lending, having bottomed in Oct '10 at \$1,199 Billion, growth turned positive in Mar '11 and is now at 12.92% as of May '12.
- *Positive consumer loan growth.* Consumer (Individual) loan growth experienced an unusual spike in 2010, dipped into negative territory, turned around in Jan '12 and is now at 2.87% (May '12). This 4-month positive growth is hopeful, even though it is below the pre-recession long term 2000-2007 average growth of 5.46%.
- *Anemic real estate loan growth.* Real Estate loan growth turned a positive 0.47% in Apr '12. As of May '12 it is at 0.74%. This 2-month positive growth is anemic but hopeful; and below the pre-recession long term 2000-2007 average growth of 12.38%.

Property Outlook:

Residential mortgage/housing market recovery is sluggish



Data Source: Federal Reserve Bank of St. Louis's Case-Schiller (SPCS20RSA), CRE Delinquency (DRCRELEXFACBS), Single-Family Delinquency (DRSFRMACBS), Housing Starts (HOUST), New 1-Family Homes for Sale (HNFSEPUSSA), Average Sale Price (ASPNHSUS) & 30-Yr Mortgage Rates (MORTG).

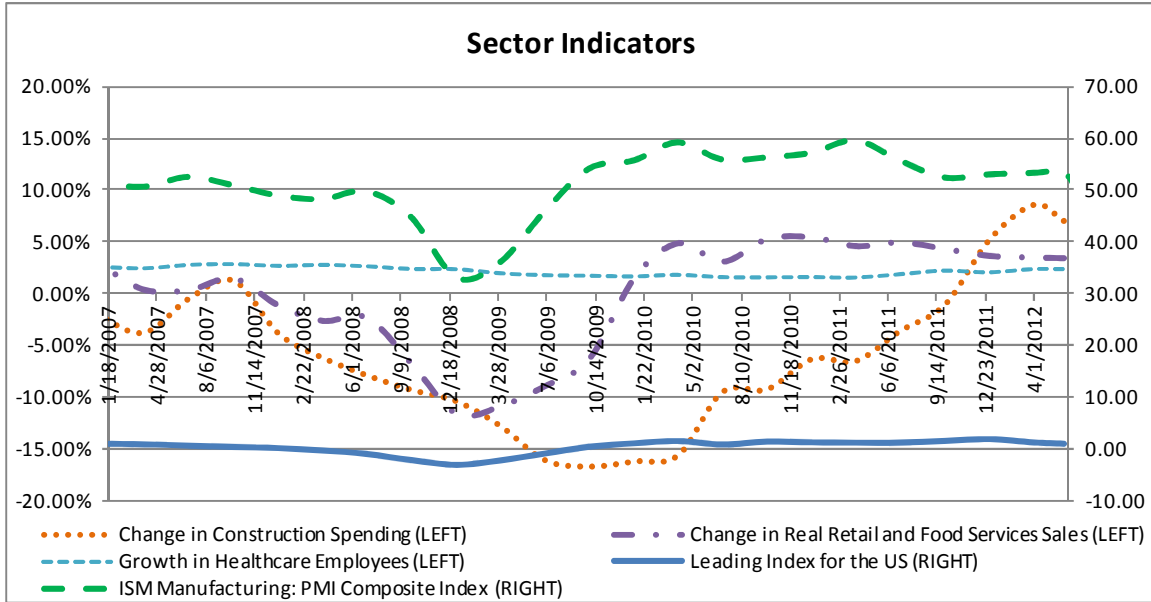
| Date | CRE Delinquency Rate (LEFT) | Single Family Delinquency Rate (LEFT) | Change in Case-Shiller 20-City Home Price (LEFT) | Change in Housing Starts (LEFT) | Change in New Home Sales (LEFT) | 30-Year Conventional Mortgage Rate (RIGHT) |
|--------|-----------------------------|---------------------------------------|--|---------------------------------|---------------------------------|--|
| May-12 | | | | 28.49% | -10.54% | 3.80% |
| Apr-12 | | | -1.86% | 34.78% | -1.86% | 3.91% |
| Mar-12 | 5.42% | 10.18% | -2.54% | 17.67% | -2.54% | 3.95% |
| Mar-11 | 7.51% | 10.30% | -3.84% | -5.66% | -3.84% | 4.84% |

- *Home price decline slowed.* The Case-Shiller 20-City Home Price Index continues to decline, though this decline has slowed to -2.01% per annum from -4.39% annual rate between 147.65 (May '10) to 136.49 (Feb '12). That is home prices have fallen by -32.95% and will continue to fall by another 1.86% or -34.82% before turning around in Apr '13.
- *Commercial mortgage recovery by 4Q14.* The worst of commercial mortgage delinquencies (8.79%, 2Q'10) are behind us, now (1Q12) at 5.42%. This is still very high at 5.7x 2006 delinquency rate of 1.12%. At the current rate of decline, delinquencies will return to 2006 levels by 4Q14. This is the same forecast as per 1Q12 Board Economic Report, implying that the rate of decline in delinquencies is stable.
- *Residential mortgage recovery has slowed.* The worst of residential mortgage delinquencies (11.20%, 2Q '10) are behind us, now (1Q12) at 10.18%. This is still very high at 5.9x 2006 delinquency rate of 1.73%. At the current rate of decline, delinquencies will return to 2006 levels by 4Q26. That is the residential mortgage recovery has slowed and moved out by 2-years.
- *Housing starts jump.* New housing starts increased significantly 28.5% (May '12), and have increased every month since Aug '11.
- *New home sales declined.* One-family new homes sold (derived from HNFSEPUSSA*ASPNHSUS), but excluding unsold for sale, continue to decline (-10.54%⁶ in May '12) every month since Nov '07.
- *Mortgage rate lower.* The 30-Year Conventional Mortgage Rate is at a 41 year low at 3.80%.

⁶ Note, all growth rates in this report are based on either rolling 4-quarters or rolling 12-months as they are less sensitive to seasonality and short term spikes in the data, and may appear to be different from that published in the media.

Sectors Outlook:

Many Sectors are Slowing

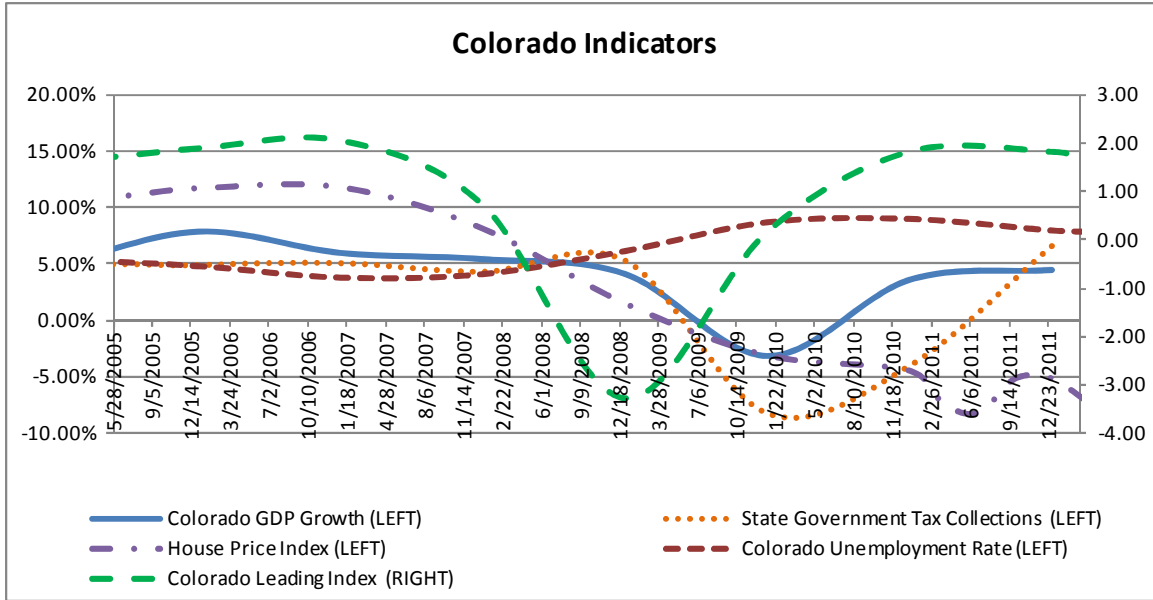


Data Source: Federal Reserve Bank of St. Louis's Leading Index (USSLIND), ISM Composite Index (NAPM), Construction Spending (TTLCONS) Retail and Food Sales (RRSFS), & Healthcare Employees (CES6562000101).

| Date | Leading Index for the US (RIGHT) | ISM Manufacturing: PMI Composite Index (RIGHT) | Change in Construction Spending (LEFT) | Change in Real Retail and Food Services Sales (LEFT) | Growth in Healthcare Employees (LEFT) |
|--------|----------------------------------|--|--|--|---------------------------------------|
| Jun-12 | | 49.70 | | | |
| May-12 | 1.05 | 53.50 | 6.98% | 3.50% | 2.43% |
| Jun-11 | 1.27 | 55.80 | -3.62% | 5.02% | 1.95% |

- *Leading Index declines.* The US Leading Index increased significantly since the recession from -2.86 in Jan '09 to a high of 1.94 in Nov '11 and then declined to the current 1.05 as of Apr '12. It is significantly below its historical high of 3.53 in Aug '83, and below the long term average of 1.17.
- *Manufacturing continues to contract.* ISM Manufacturing PMI Composite Index declined from a recent high of 59.9 in Jan '11 to 49.7 as of Jun '12. The long term average for this index is 52.8 with a historic high of 77.5 (Jul '50). This index has been contracting every month since May '11.
- *Construction growth is slowing.* Total Construction Spending has turned around from a low of \$795 billion in Feb '10 to \$830 billion as of May '12. The contraction in the industry was at its worst in Nov '09 at -17.34% with positive growth in the last 7 months up to May '12 at 6.98%. However, this positive growth seems to be slowing since Feb '12 when growth peaked at 10.00%.
- *Retail growth is slowing.* Retail and Food Services Sales is the bright spot, its growth is a positive 3.50% as of May '12 but has been slowing from 6.38% in Feb '11.

Colorado State Outlook: Looking Better with Risks



Data Source: Federal Reserve Bank of St. Louis's CO GDP Growth (CONGSP), CO Leading Index (COSLIND), Sales Tax (COSALESTAX), House Price Index (COSTHPI) & CO Unemployment (COUR)

| Date | State | | | | |
|--------|----------------------------|--------------------------------|-----------------------------------|--------------------------|-----------------------------------|
| | Colorado GDP Growth (LEFT) | Colorado Leading Index (RIGHT) | Government Tax Collections (LEFT) | House Price Index (LEFT) | Colorado Unemployment Rate (LEFT) |
| Apr-12 | | 1.32 | | | 7.90% |
| Mar-12 | | 1.68 | | -7.09% | 7.80% |
| Dec-11 | 4.43% | 1.82 | 6.59% | -5.10% | 7.90% |
| Dec-10 | 3.55% | 1.82 | -3.97% | -4.42% | 8.90% |
| Dec-09 | -3.19% | 0.16 | -8.17% | -3.07% | 8.60% |

- **Better CO GDP Growth.** Colorado GDP growth is positive at 4.43% as of 4Q11. This is much better than the national economy's Annual GDP growth of 1.61% for the same period of 1Q11-4Q11.
- **Possible future soft patch.** The Colorado Leading Index is 1.27 at Apr '12 but this is a contraction of -29.03% from a year ago, and also a contraction with respect to the previous two months of 1.68 (Mar '12) and 1.76 (Feb '12).
- **State revenues improving.** Collection of Sales Tax has increased by 6.59% in 2011 compared to contractions of -3.97% in 2010 and -8.17% in 2009. Therefore, CO's GDP growth is converting into increased tax revenues.
- **Home prices fall.** The Colorado House Price Index shows a price decrease of -7.09% (1Q12) which is greater than the Case-Shiller 20-City Home Price Index rate of decline of -2.54% (Mar '12).
- **Lags in Unemployment.** The Colorado unemployment is at 8.10% (May '12) which is the same as the national average of 8.2% (May '12). In the 1Q Board Economic Report the respective numbers were 7.9% and 8.3% (Dec '11), suggesting that Colorado's unemployment lags the national economy by several months if not a year.
- **Denver Real Estate Summary by CBRE:**

| CBRE Local Reports | Total Vacancy | | Direct Vacancy | | Lease Rates | | Net Absorption | | Under Construction | |
|--------------------|---------------|--------|----------------|--------|-------------|----------|----------------|-------|--------------------|---------|
| | 2Q12 | 1Q12 | 2Q12 | 1Q12 | 2Q12 | 1Q12 | 2Q12 | 1Q12 | 2Q12 | 1Q12 |
| Industrial | 6.30% | 7.30% | 5.70% | 6.30% | \$ 6.21 | \$ 6.00 | 1.4M | 800k | 841k | 252k |
| Office | 14.70% | 15.30% | 14.20% | 14.70% | \$ 20.00 | \$ 19.79 | 606k | 566k | 911k | 452k |
| Retail | 8.20% | 8.30% | 7.90% | 8.00% | \$ 16.57 | \$ 16.47 | 114k | -125k | 418k sf | 295k sf |

On The Horizon: Hope, Clouds or Black Swans?

- **Supreme Court Healthcare Ruling Impact:** “In 2014 the initial levy will be just \$95. By 2016, it is scheduled to increase to \$695 or 2.5 percent of taxable income—up to a maximum of \$2,085 (indexed for inflation in subsequent years). It will increase, that is, if Congress does not slow the phase-in.” *Obamacare: Tax Or Penalty? Call It What You Want, But IRS Won't Be Able To Collect It*⁷, Howard Gleckman, Forbes, 7/3/2012.
- **More Clouds for Banking Regulation:** If history is any guide to the future, expect more regulation over the next 7 years. After the crash of 1929, the US legislature introduced several regulations; Securities Act of 1933, Securities Exchange Act of 1934, Trust Indenture Act of 1939, Investment Company Act of 1940, Investment Advisers Act of 1940.
- **Europe, Potential Black Swans:** “The International Monetary Fund⁸ forecasts the euro-area economy will contract 0.3 percent this year, compared with projected expansions of 2.1 percent in the U.S. and 8.2 percent in China.” *German Exports Increased More Than Forecast in May: Economy*, Jeff Black, Bloomberg, 7/9/2012.

Europe is just starting to get its act together. The euro crisis shows that the euro zone monetary union is in need of joint banking supervisor and a euro zone permanent bailout fund, just for starters⁹. This is not likely to happen anytime soon. Therefore, euro crisis exposes other world economies to potential shocks of a disorderly bailout of the weaker European economies.

This is uncharted territory, and it is anyone's guess whether a disorderly correction in the euro monetary union would domino into a US recession.

An important lesson for the US which was critical to US recovery was that an independent FDIC could take unpopular action that politicians were not willing to take on themselves. One can observe in Europe, the opposite. The lack of a common banking supervisor and the unwillingness of politicians to take unpopular actions to correct the crisis in Europe, has prolonged the duration of this euro crisis.

⁷ <http://www.forbes.com/sites/beltway/2012/07/03/some-tax-few-will-face-obamacare-uninsured-penalty-and-irs-hamstrung-to-collect/>

⁸ <http://www.bloomberg.com/news/2012-07-09/german-exports-increase-more-than-forecast-to-boost-economy-1-.html>

⁹ Euro banking union won't come fast, Hugo Dixon, Bloomberg, 6/18/2012, <http://blogs.reuters.com/hugo-dixon/2012/06/18/hugo-dixon-euro-banking-union-wont-come-fast/>