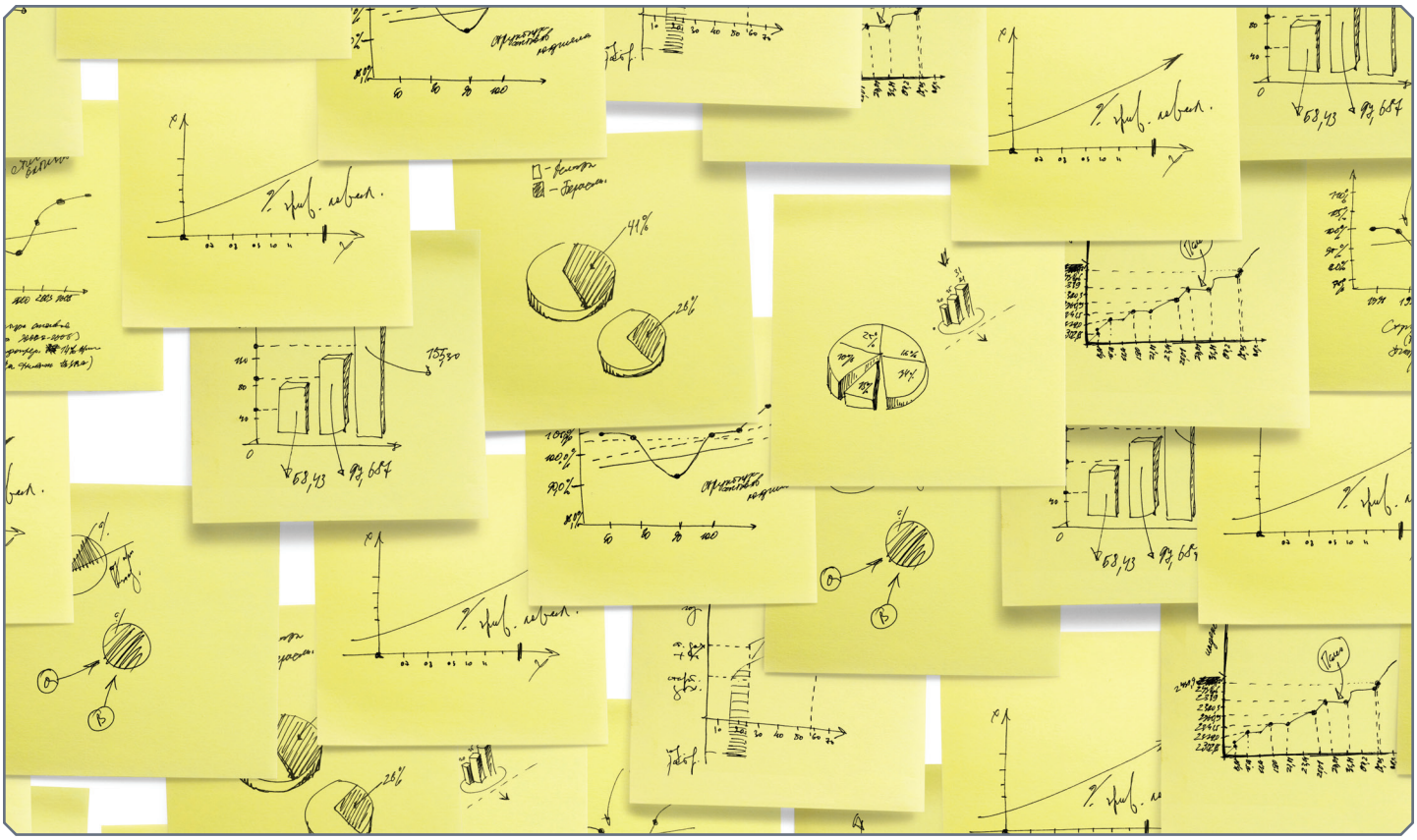

2012 Economic Forecast

In the following six articles, experts in the field of economics, energy, healthcare, real estate, banking, the stock market and small business make their predictions on what the new year will bring businesses operating in the Garden State.

The Economy

By James W. Hughes and Joseph J. Seneca,
Edward J. Bloustein School of Planning and Public Policy, Rutgers University

James W. Hughes

Joseph J. Seneca

December 2011 marks the fourth anniversary (48 months) of the start of America's Great 2007-2009 Recession, the longest and deepest economic downturn since the Great Depression.[1] While many New Jerseyans may find this difficult to believe, December 2011 also marks the 30th month of economic expansion. And, since the average post-World War II expansion lasted 59 months, the United States is now actually moving into the mature phase of an average business cycle. When 2012 comes to a close, the expansion will be fully 42 months old, and perhaps heading into the

home stretch of the cycle if it follows historical averages.

Full recovery of the nation's Gross Domestic Product (GDP) – the total output of the U.S. economy – was achieved in the third quarter of 2011, i.e., GDP finally surpassed its pre-recession peak (reached in the 4th quarter of 2007). So, the good news is that all of the economic output lost during the Great Recession was fully recovered by September 2011. Again, many New Jerseyans may find this difficult to believe. The less-than-good news is that it took a record period of time to accomplish this – fully 45 months since the start of the recession. To put this in perspective, the previous worst downturn since the Great Depression was the 1981-1982 recession. It only took 21 months from its start to fully recover all of its lost economic output. So the current recovery from a deep trough has been painfully slow.

The probable disbelief that full recovery has been achieved is the result of a badly lagging labor market. As of September 2011, private-sector employment was still approximately 6 percent lower than it was when the recession began. Thus, the nation was producing the same level of output with 6 percent, or 6.2 million fewer workers. This is a key part of America's current job problem. As of September 2011, the nation recovered 2.6 million of the 8.8 million jobs lost during the downturn. Thus, significant progress has been made, but the nation is still in a deep employment hole.

So, too, is the case in New Jersey. The job trajectory has been positive, but there is still a huge amount of ground to be made up. In 2009, the state was hemorrhaging employment – with the private-sector down 117,700 jobs. But stabilization and slow growth was achieved in 2010, when New Jersey added 5,200 private-sector jobs. Then, in the first nine months of 2011, the state gained 22,700 jobs, more than four times the amount achieved in the full 12 months of 2010. So while the growth totals may be modest in historical terms, they are moving in the right direction. And we expect this to continue in 2011.

Nonetheless, despite this positive movement, the state remains in a deep employment trough. New Jersey still needs to add about 200,000 private-sector jobs to get back to pre-recession employment levels. This will take a considerable amount of time. During 2011, we expect significant employment gains in the state, building upon the momentum of the past two years. But, full employment recovery is years away. There is just no way to sugar-coat this reality. However, the size of the employment gap reinforces the need for continued attention to be given to improving the state's business climate so that New Jersey can successfully compete to retain and attract new investment and jobs.

[1] *According to the Business Cycle Dating Committee of the National Bureau of Economic Research, the recession started in December 2007 and ended in June 2009, 18 months later.*

Energy

By Karen Alexander, President and CEO, New Jersey Utilities Association

To look ahead, it is sometimes best to take a quick look at where we have been. Since 2006, annual electricity price changes have tracked closely to annual natural gas prices in our region. That makes sense, since power generation from natural gas sets the price for electricity more than 50 percent of the time.

During 2011, the price correlation continued and is expected to follow the same track in 2012. Supply and demand will continue to be the major drivers of these highly price-volatile commodities.

A prime mover of natural gas prices has been the introduction of shale gas into the U.S. supply mix. The potential reserves appear promising, and are becoming a long-term driver of lower natural gas prices. The question that needs to be answered is: Will environmental concerns over hydraulic fracturing, the process used to extract the gas from shale, restrict access to this supply? This debate will likely continue in 2012. Governor Christie recently conditionally vetoed legislation that would have permanently banned fracking in New Jersey, limiting the moratorium to one year to allow time for studies now underway to inform the ultimate policy.

Economic uncertainties have clearly created turmoil in energy commodity markets. Over time, weather has had the most impact and it will continue to impact supply as well as consumer demand for electricity and natural gas well into the future.

Another uncertainty that could affect prices is the debate under way in the state about how to secure new sources of electricity. The New Jersey Board of Public Utilities, through ongoing hearings, has raised concerns as to the performance of the current power markets for ratepayers. The state recently passed a law to incent new in-state power plants by offering guaranteed subsidies to be paid by ratepayers. While state regulators believe this will result in lower prices, others believe these incentives will raise consumer prices in the long run and stifle the

competitive marketplace. They also point out that New Jersey cannot operate as an island given that it is part of the PJM Interconnection, which has successfully ensured electric reliability for a 13-state region from New Jersey to Chicago for decades.

The impacts of this law will not be felt immediately, but the discussion about how best to obtain the power New Jersey customers will need in 2012 and beyond will continue. It is reasonable to expect that weather and the economy will continue to be the biggest influences on energy prices, with electricity and gas commodity prices remaining relatively low, absent a major event that disrupts supply.

Healthcare

By Sarah McLallen, Vice President, New Jersey Association of Health Plans

Given the unsettling economic environment over the past three years, there is little doubt that employers fear the upward direction of health benefit costs now more than ever. Understanding that concern, I'd like to give you a preview into healthcare costs for 2012, and some of the high-cost areas to watch.

Aon Hewitt, New Jersey's actuarial firm for the State Health Benefits Plan and School Employee's Health Benefits Plan, just came out with its recommended premium levels for 2012, in which it recommends an overall premium increase of 7.1 percent. (Broken down, it's a 9.0 percent increase for Active Employees, a 3.0 percent increase for Early Retirees, and 0.0 percent for Medicare Retirees, thus reaching the average 7.1 percent.) Aon also predicted the general claims trend (the percentage for which medical costs/charges will increase) for 2012 is in the 9 percent to 10 percent range.

Figures for the state and school employee plans don't always trend identically to the private employer and individual markets, but with their numbers out, I thought I'd start there. That being said, one sure consistency for the state as a payor and for private employers as payors is that the unit cost of medical services will continue to outpace general inflation by a large margin.

A few leading factors where we see costs growing are in innovation and specialty drugs, emergency department utilization, and out-of-network provider business models.

Innovation & Specialty Drugs

Science, technology, medicine and patient expectations have all evolved: Today we have titanium hip-replacements that will long outlive us, complex heartburn and antacid relief medications that free us to eat our favorite foods, and oral chemotherapy agents that don't require visits to the doctor's office and may even cause less side effects for the patient. These developments in medicine are wonderful for a patient's comfort and convenience, and can often be life-saving. But with these innovations in medicine comes a price tag, and it's often very high: a total hip-replacement, about $22,000; a year's supply of GERD medication, about $2,800; and one round of oral chemotherapy for prostate cancer, $93,000. Now multiply this over seven million insured New Jersey residents and their healthcare needs, and we can clearly see how these innovations contribute to the upward cost trend.

Emergency Department Utilization

Emergency departments (ED) provide a critical service to persons in need of immediate, often life-saving treatment, and they are a critical component of the healthcare system. In fact, according to the most recent data from the National Center for Health Statistics (2007), 20 percent, or one in every five people visit an ED at least once in a year. However, inappropriate ED use continues to be a costly problem, particularly when hospital emergency rooms market themselves as a primary care option, advertise their wait times to attract patients for convenience, and encourage low acuity, non-emergent visits in the ED. Primary care in an emergency setting is a poorer quality, more expensive substitute for a medical home and a relationship with a primary care provider, and it drives up premium costs year after year.

Out-of-Network Provider Business Models

Many employers choose to purchase health benefit plans that offer out-of-network benefits to help insulate their employees from high cost-sharing if they choose to use a physician or facility that is not in their health plan's network. Most physicians and facilities charge reasonable out-of-network rates. However, over the last two years we've seen a growing problem in New Jersey with abuses of the out-of-network model. A certain subset of ambulatory surgical centers, hospitals and physician types (such as anesthesiologists) have made a business decision to refuse to be in-network with most or all health insurance plans, thus charging enormous sums for the same services they previously provided at a fair rate.

I would end by mentioning that for all the questions

employers and individuals have about the Patient Protection and Affordable Care Act (the federal healthcare reform law), and how it may impact costs positively or negatively, 2012 is probably not the year you will see its impact. The start-up costs of the immediate insurance reforms – such as dependent coverage to age 26 – were seen in 2011, and the next phases of insurance market reforms will become effective in years 2013 and 2014.

Banking

By John E. McWeeney, Jr., President & CEO, New Jersey Bankers Association

New Jersey's banks head into 2012 with strong capital and high deposit balances and are well-positioned to help lead an economic recovery. Remarkably, since the financial crisis began in the fourth quarter of 2008, New Jersey headquartered banks have increased their capital by $1.7 billion, or 11.1 percent to $16.6 billion. During the same time period, total deposits have also increased by $16.2 billion, or 17.1 percent to $110.5 billion as a flight to the safety of an FDIC insured institution drew funds from alternative investments. Bolstered by higher capital levels and increased liquidity, New Jersey's banks have been doing their part to spur economic development as evidenced by a $5.7 billion, or 5.9 percent increase in loans and leases since December 2008. Total loans and leases at New Jersey headquartered institutions now exceed $101 billion.

While these results are positive and reflect the strength of New Jersey's banks, the industry is poised to do so much more were it not for sluggish economic growth and weak loan demand driven by a lack of confidence on the part of both consumers and businesses. Uncertainty about federal government tax and healthcare policy along with the high unemployment rate and modest economic growth have caused both consumers and businesses to hold back on any investment spending. It's estimated that there are trillions of dollars in capital that are sitting on the sidelines until more certainty returns to government policy and the overall economy.

In the short-term, these government policy and economic headwinds will slow the banking industry's growth and profitability. Until meaningful loan demand returns, New Jersey's banks have limited options to invest their capital. The other major headwind that banks are facing is the increasing regulatory burden created by the Dodd-Frank Financial Reform Act. Promoted as legislation that was going to end "too big to fail" and prevent another financial crisis, Dodd-Frank and its over 3,900 pages of proposed rules has proven to be nothing more than a major compliance burden on our nation's banks, particularly community banks that are vital to the economic livelihood of America's small towns and neighborhoods. At a time when everyone's focus should be on creating jobs, Dodd-Frank has forced banks to concentrate valuable resources on complying with myriad rules and regulations instead of economic development.

So what's the impact of slow economic growth and a growing regulatory burden going to be on New Jersey's banks? Most likely the greatest impact will be the continued consolidation of the industry. Since the end of 2008, the number of New Jersey headquartered institutions has declined from 126 to 116. If you go back to 1992 there were 211 New Jersey headquartered institutions. Much of this consolidation has been driven by natural market conditions and has generally resulted in stronger, more efficient institutions with increased services for their customers. That said, it's just plain wrong for smaller banks to be forced to consider selling or merging their institutions because of over-regulation by the federal government. Our legislative and regulatory leaders in Washington need to peel back all the red tape and let our economy breathe, much like Governor Christie and the legislature has begun to do in Trenton.

Real Estate

By Michael G. McGuinness, Chief Executive Officer, NAIOP New Jersey

The outlook for commercial real estate markets in 2012 is a mixed bag. Economists tell us we will not return to pre-recession employment levels for many years and slow job growth continues to block a true market upswing.

In the office sector, availability rates remain high with landlords offering large concession packages to make deals. While average asking rents have increased slightly, net effective rents have actually decreased after adjusting for concessions and higher operating expenses. In addition, tenants are using their space much more efficiently, re-

newing up to 30 percent less space with the same number of employees. This excess, known as shadow space, has huge implications for market recovery.

The Northern New Jersey office market has remained flat throughout 2011. Cushman & Wakefield reports 19 million square feet of office space remains available, translating to an overall vacancy rate of 17.8 percent at the end of September. This represents a 0.5 percentage point increase from mid-year. Central New Jersey office leasing has outperformed 2010 by more than 7 percent, with vacancies down 1.2 percent from last year to 21.8 percent. Also positive is the third-quarter improvement in office market absorption from pharmaceutical and life science companies. Looking toward 2012, Wall Street's plans for smaller bonuses again and the shedding of 10,000 jobs by year-end, does not bode well for New Jersey's office market. Nevertheless, Hudson County's Gold Coast, mixed-use development, multi-family rentals and central business districts remain the sweet spots.

The industrial picture is much brighter, as New Jersey continues to be the data center location of choice and recently took the top spot from California as the hottest and largest commercial solar market. Spurred by healthy leasing activity in the first half of 2011, during which the market saw over 12 million square feet of newly leased space, this year is likely to exceed 2009 and 2010. Strong leasing activity at Exit 8A helped boost Central New Jersey's absorption to 2.66 million square feet, surpassing Northern New Jersey's 815,524 square feet. This healthy leasing and positive absorption through the first three quarters of the year have brought renewed confidence to the industrial market, and 2012 may very well see an increase in asking rates for industrial space in some markets.

Central to the industrial market is the logistics industry – the movement of goods between point of origin and point of use. According to an October 2011 report, the Port of NY and NJ generates $11.6 billion in personal income and almost $37.1 billion in business income annually. Despite the recession, jobs directly associated with port activity increased by nearly 3.5 percent from 2008 to 2010. Planned investments in New Jersey's port region are expected to generate nearly 7,000 jobs annually through 2017. The importance of the port region to New Jersey's economy is enormous and continued investment in this area is critical.

Recognizing this opportunity, the Christie Administration announced a newly revised "State Strategic Plan", which sets statewide planning goals to position New Jersey for sustained job growth, competitiveness and prosperity. One of the six priority industry clusters is Transportation, Logistics and Distribution Centers that will be entitled to special treatment and advantages.

Thanks to the many positive achievements of our policy makers in Trenton, New Jersey is markedly improving its business climate image. At NAIOP NJ's Mid-Year Economic Roundup in June, brokers reported that clients now recognize that New Jersey is finally serious about business. However, we need to be relentless in demonstrating a commitment to economic development at the local, state and regional levels. Attracting new private-sector jobs and improving our business climate is all about cutting costs and providing certainty to existing and prospective businesses.

Small Business

By Alfred J. Titone, NJ District Director, U.S. Small Business Administration

Over the last three years, New Jersey small business owners have struggled to make ends meet. Just as they were beginning to see signs of an economic turnaround, they are faced with the aftermath of Hurricane Irene, weak consumer spending, a glut of housing, high unemployment and issues with access to capital. If that wasn't enough, economists are now predicting that the Gross Domestic Product (GDP) will hover around 2 percent, just as it did in 2011. Despite all this, I am still optimistic for 2012.

Reason for Optimism

According to a recent study conducted by Pepperdine University, 41 percent of small businesses plan on expanding their workforce over the next six months. In a separate survey conducted by Citibank, 49 percent of businesses surveyed said they were holding their own, but were poised to grow when the climate is right, while 28 percent said their companies were already growing. However, while small business owners remain upbeat about their prospects for 2012 despite the unknown, 90 percent of the small business owners surveyed expressed their concern about the economy.

Year in Review

Aided by the Small Business Jobs Act and a return to pre-recession lending levels, over 61,000 small businesses nationwide had access to capital. During fiscal year 2011,

the U.S. Small Business Administration's (SBA) New Jersey district office approved 1,290 loans for $678 million. This marked an 8 percent increase in the number of loan approvals and a 49 percent increase in the dollars available to New Jersey small business owners. Of the $678 million approved, $258 million went to 439 minority-owned small businesses, a 78 percent increase in dollars over last year and an 18 percent increase in the number of loans to minorities. These are great numbers for New Jersey, and based on our conversations with our lending partners and microlenders, there is every reason to believe that we will continue to see modest growth in 2012.

Final Thoughts

Even in the toughest of economic times, there is opportunity for entrepreneurs to gain some traction. Most economists say that we will be in a holding pattern for 2012, and won't see significant economic growth until 2013. However, small businesses continue to be the backbone of our economy. Through their ingenuity and innovation, it would not surprise me to see them spark another economic rebound, where we see significant growth and job creation in 2012.

Stock Market

By Bradley H. Bofford, Managing Partner, Financial Principles, LLC

The economic recovery thus far has been shrouded in uncertainty and marked by volatility in the stock markets. Although growth has been slower than expected, it has been positive and is expected to remain so even after all the setbacks experienced this year thus far. Commodity prices, such as gas, surged in the beginning of the year. The tragic earthquake and tsunami in Japan followed soon after in March. More extreme weather events continued across the world. Despite these discouraging events that further shook consumer sentiment and investor confidence, the S&P 500 operating earnings came in at an all-time record high in the second quarter of the year.

The third quarter brought continued concerns, this time mostly over debt. Since the U.S. debt limit ceiling was raised in August and debt was downgraded, the spotlight continues to focus on the ability of policymakers in Europe to act decisively on their own sovereign debt crisis. The S&P closed down -13.9 percent for the third quarter – the worse since fourth quarter of 2008. Moving to cash can seem tempting and safe during times like these, but it may result in having to take on even more risk to make up for market rebounds that were missed out on. Even for clients looking for income, it may make sense to look beyond the traditional CDs and money markets. Interest rates remain at historic lows and aren't expected to change anytime soon, yet the dividend yield of the S&P 500 is higher than 10-year treasuries and the same yields on non-U.S. equities are even higher than the S&P. Thus, it may make sense to include dividend-paying stocks in a diversified portfolio with the goal of generating income.

Looking forward, both the U.S. and global economies are still growing. Growth is undeniably slow, but there are little signs that any of the concerns at hand will lead to huge plunges in profits or deflations. The Fed is selling $400 billion worth of short-term debt and buying longer-term Treasury notes and bonds in an attempt to keep borrowing costs down and stimulate the economy. Furthermore, stock valuations, particularly large-cap growth, remain attractive relative to high-quality bonds with high-yield bonds remaining more attractive than Treasuries. Opportunities in the markets exist and we continue to urge clients to remain invested for the long-term and well diversified since there are still risks, concerns, and further market volatility expected in the short-term.

One of the biggest events of 2012 will surely be the upcoming Presidential election. For decades, conclusions have been drawn on market performance correlated to everything from the moon cycle to these elections. This article is not meant to persuade investors on their political beliefs; however, when Republicans control Congress and the President is a Democrat the market return for that time period has been 15.3 percent. Flip it around and when Democrats control Congress and the President is Republican the return has been 6.6 percent. For election years in general, there have only been two of the last 20 election years where the S&P 500 index had a negative return. Unfortunately, as it's been said over and over, "past results cannot guarantee future performance" and unfortunately we have witnessed yet again that no president can single-handedly control the economy. Furthermore, the two of the last 20 election years when the S&P 500 index had the negative return were in 2000 and 2008 (as we all know all too well). The global economy is more connected than ever, market volatility has been at all time highs and now, more than ever, investors must adhere to the rules of asset allocation, diversification, rebalancing and risk applicable to time horizon. These remain the fundamental roots of successful financial principles. NJB

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