

US Financial Reality Index

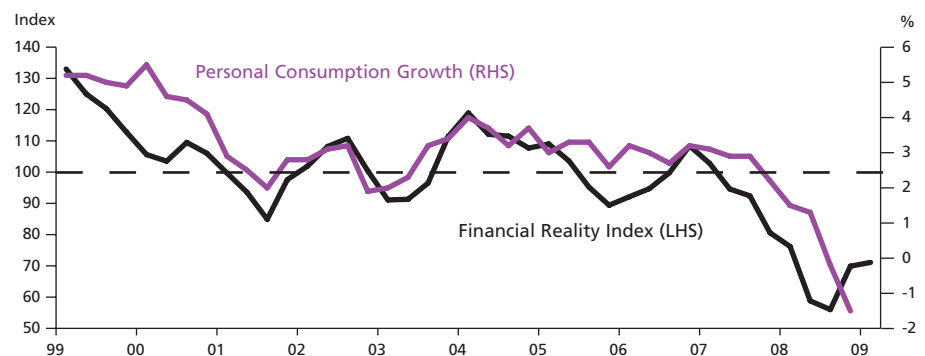
May 2009



Alliance Trust Research Centre has developed an index which measures objectively the financial conditions facing US consumers. The Financial Reality Index has been calculated over the ten year period from 1999 and the key findings are:

- The Financial Reality Index reached a high of 133.0 in Q1 1999 but had fallen to a record low of 56.0 by Q3 2008 reflecting sharply falling house and equity prices, together with rising debt levels and falling economic activity.
- The Economic Background Index fell to a record low of 12.0 in the first quarter of 2009 as economic growth continued to fall and unemployment and delinquencies continued to rise.
- The Household Budget Index increased to a record high of 147.1 in the first quarter of 2009 as lower inflation boosted real earnings and real disposable incomes. Lower interest rates also helped to lower mortgage payments.
- The Net Wealth Index fell to a record low of zero at the end of 2008. Falling house and equity prices hit household wealth hard while the debt burden remained high.
- Despite a small improvement in the financial situation facing households, the correlation between the Financial Reality Index and consumer spending growth suggests that spending will remain weak over the coming quarters.

Financial Reality Index v Household Expenditure



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Our Conclusion – Consumer Spending Expected to Remain Weak

Our Financial Reality Index was constructed as a tool to measure the financial health of consumers. It tracks a wide variety of variables, chosen to reflect important economic background factors, budgetary considerations and wealth accumulation and preservation. The index has been calculated on a quarterly basis over the ten year period since 1999. During much of that time, it has shown a close correlation with growth in

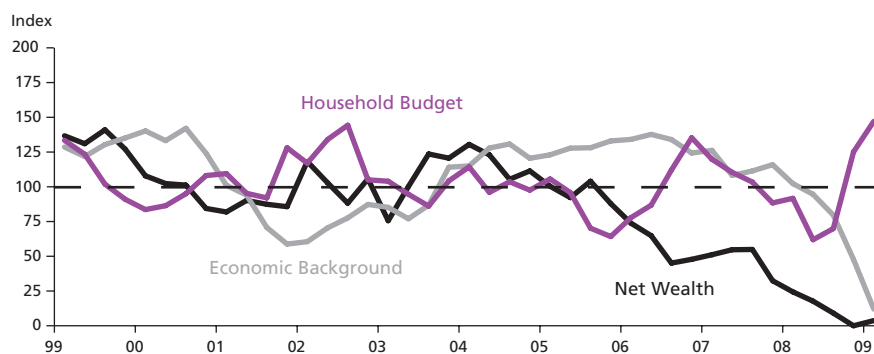
consumer spending. The Financial Reality Index has remained below the critical level of 100 since Q2 2007 and fell to a record low just over a year later. This reflected a broad based deterioration in the economic background, falling house and equity prices and elevated levels of debt. In a reaction to the worsening outlook for household finances, consumer spending dropped 1.5% in Q4 2008, the largest fall since 1951. The Financial Reality Index has since risen from its record low level but remains well below 100, signalling that consumer spending growth will remain weak.

Explaining our results

Our key findings show that:

- The Financial Reality Index peaked at a level of 133.0 in Q1 1999 reflecting a favourable economic background, a supportive labour market and relatively mild pressures on household budgets. The index was volatile during the global economic slowdown and equity bear market in the following years, falling as low as 84.9 in Q3 2001. The index subsequently recovered to a level of 118.9 by the start of 2004. During 2005, the Financial Reality Index deteriorated, due primarily to pressure on household budgets as income gains failed to keep up with rising costs. On top of that, the burden of household debt was weighing heavily on household wellbeing. The index hit a record low of 56.0 in Q3 2008 as the credit crunch, falling house and equity prices, rising delinquencies, falling economic growth and rising unemployment all impacted on the financial situation facing households.
- The Economic Background Index peaked at a level of 142.1 in Q3 2000, reflecting high levels of GDP and employment. The index then fell below the critical level of 100 in 2001 and did not rise back above this level until the final quarter of 2003. Despite lower GDP growth in 2006, the index remained in positive territory, helped by low unemployment and a low level of delinquencies. In Q2 2008 the index fell below the critical level of 100 and it has remained there ever since, falling to a record low of 12.0 in Q1 09, with all three components contributing to the deterioration.
- The Household Budget Index hit a record low of 61.9 in Q2 2008 as higher inflation eroded household purchasing power. The index then peaked at a level of 147.1 in Q1 2009. This reflected gains in real earnings and disposable income due to sharply falling inflation. On top of that, lower gasoline and basic goods prices, together with lower interest rates gave a boost to household budgets.
- The Net Wealth Index peaked in Q3 1999 at a level of 141.0 due to strong stock market performance and rising property prices. The index has remained below 100 since the end of

Financial Reality Index – 3 Components



2005 given rising levels of debt and falling house prices. The index fell to a record low of zero in Q4 2008, with all components also at zero.

Methodology

Alliance Trust Research Centre has developed an index measuring consumer financial wellbeing in the US. This follows similar research which has proved to be a good predictor of spending in the UK. The index is constructed using only measurable variables as the purpose is to reflect the 'reality' rather than the 'perception', of household finances.

Our model is constructed on the belief that the underlying strength of a consumer's financial situation is influenced by many factors. The model incorporates 11 key variables which are measured in terms of either actual levels or rates of change. In each case, the long-term average of the variable is measured and set equal to 100, which is deemed to be the mid-point of the index. Individual readings for each variable are then scaled on a range from 0-200, depending on deviation from the mean. Values below 100 reflect negative influences whilst values above 100 reflect positive influences. The Financial Reality Index is calculated as an average of all 11 components, with each variable given equal weight. This method of construction allows us to capture and quantify the influence of prevailing economic conditions, recent income, interest rate and cost developments, plus changes in households' longer-term store of net wealth.

The Financial Reality Index has a 10-year history starting in the first quarter of 1999. All of the data used in the model is official, taken from various sources. In

several cases, in-house analysis has been applied to basic data to construct the selected series.

The model has been designed to produce three important sub-indices, created by combining the 11 identified variables into distinct groups focusing on the Economic Background, Household Budget, and Net Wealth. These three indices are calculated in a similar manner to the headline Financial Reality Index, and again have a mid-point of 100, a maximum of 200 and a minimum value of zero.

Economic Background – we have used three variables to reflect background economic factors in our model i.e. current GDP growth, strength of the labour market and the incidence of delinquencies on consumer loans.

Household Budget – our index is designed to measure the prevailing financial situation facing consumers, and uses several variables to reflect regular household income and expenditure. We use real, as opposed to nominal, measures of both earnings and disposable income, and capture important out-goings such as mortgage payments, the costs of basic goods and services and spending on gasoline.

Net Wealth – we believe wealth to be an important variable in providing a longer-term perspective on the consumer's financial situation. This is measured in terms of both property and equities using asset values and rates of change. We also include consumer debt which has displayed significant growth over the last few years, making it one of the key elements in any judgement of financial wellbeing.

Sources: EcoWin, In-house Analysis