GENERAL FUND REVENUE & ECONOMIC OUTLOOK

October 17 , 2008

Highlights

- Downward economic trends in the economy continue to effect economy-based taxes such as the sales tax and personal income withholding tax. Collections are 5% below first quarter target.
- Major disruptions in the financial markets put the economy in risk of a significant and long-term recession. Fed actions may help avoid a deep recession.
- State economic conditions deteriorate as housing, financial, and global downturns continue to worsen.
- Many of the risks surrounding the FY 2008-09 forecast have come to fruition.
- Budget pressures mount with slowdown in revenue collection.

How Do 2007-08 Revenues Look So Far?

- FRD can report that the first quarter General Fund revenue came in about $230-$235 million below a $4.6 billion target for the period.
  - In other words, collections are running 5% below expectations. The target growth rate for the first quarter was 1.8%, which is less than the total growth expected for the full fiscal year.
  - Total General Fund growth for the year is expected to be 4.4%. The forecast envisioned the economic slowdown to improve later in the fiscal year and this is reflected in the targeted growth rates.

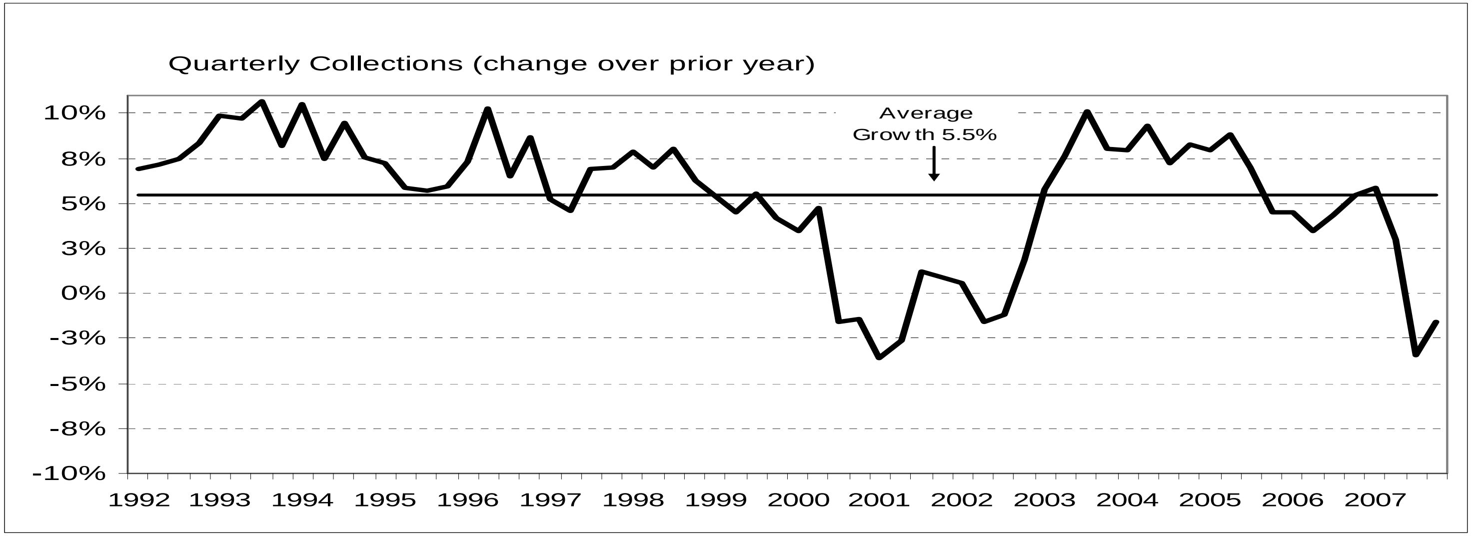
How Do 2008-09 Revenues Look So Far?

- Regarding revenues in the first quarter, keep these caveats in mind:
  - The first quarter of the fiscal year is the least important from an end-of-year indicator point of view.
  - Major receipts in these early months (sales tax and withholding tax) closely track the experience of the last few months of the prior fiscal year
  - Volatile revenue sources such as the corporate income tax and non-withholding taxes do not show up until the second half of the fiscal year.

Tracking Economy-Based Collections

It is clear from looking at economy-based taxes that the economic downturn is well underway. Sales tax growth for July-September fell 1.6% after adjusting for tax law changes, which is well below the long-term average growth of 5.5%.

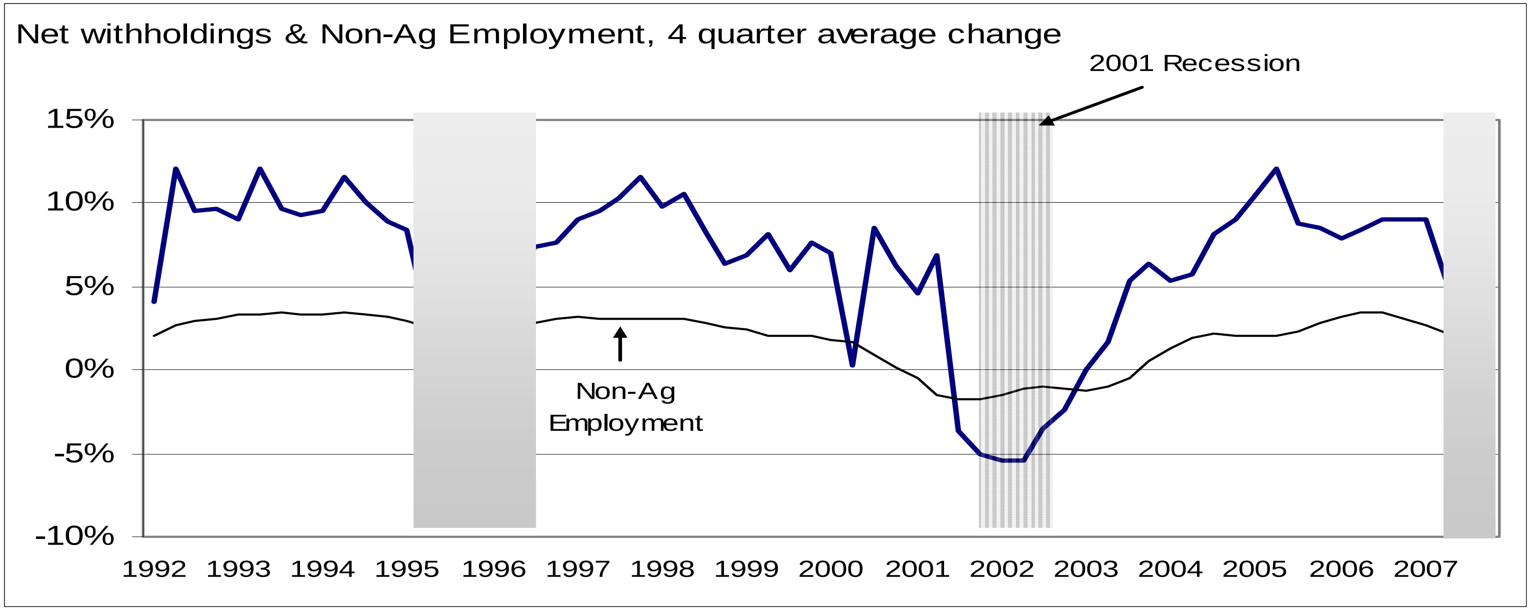
Sales & Use Tax Collections
(adjusted for tax law changes)



Tracking Economy-Based Collections (cont.)

Net withholding (withholding less refunds) continued its steady slowdown with growth of 1.5% through September. This compares to 7% for the same quarter last year, and is well below historical growth of 6.3%. This suggest withholding has been significantly impacted by the housing market recession and financial sector losses.

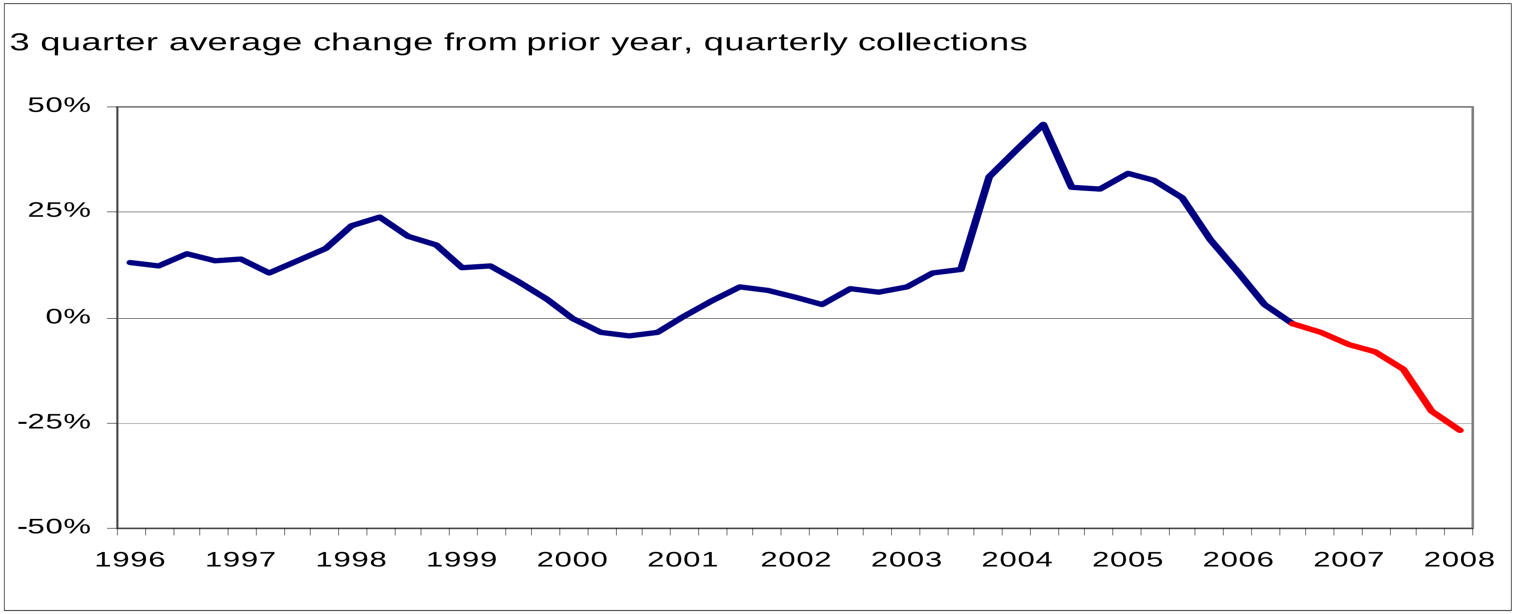
Withholding Tax Receipts



Tracking Economy-Based Collections (cont.)

While the Real Estate Conveyance tax is not part of the General Fund, it does illustrate the impact of the housing slump on these collections and in turn the potential impact on other real estate related activity such as residential construction and retail furniture sales.

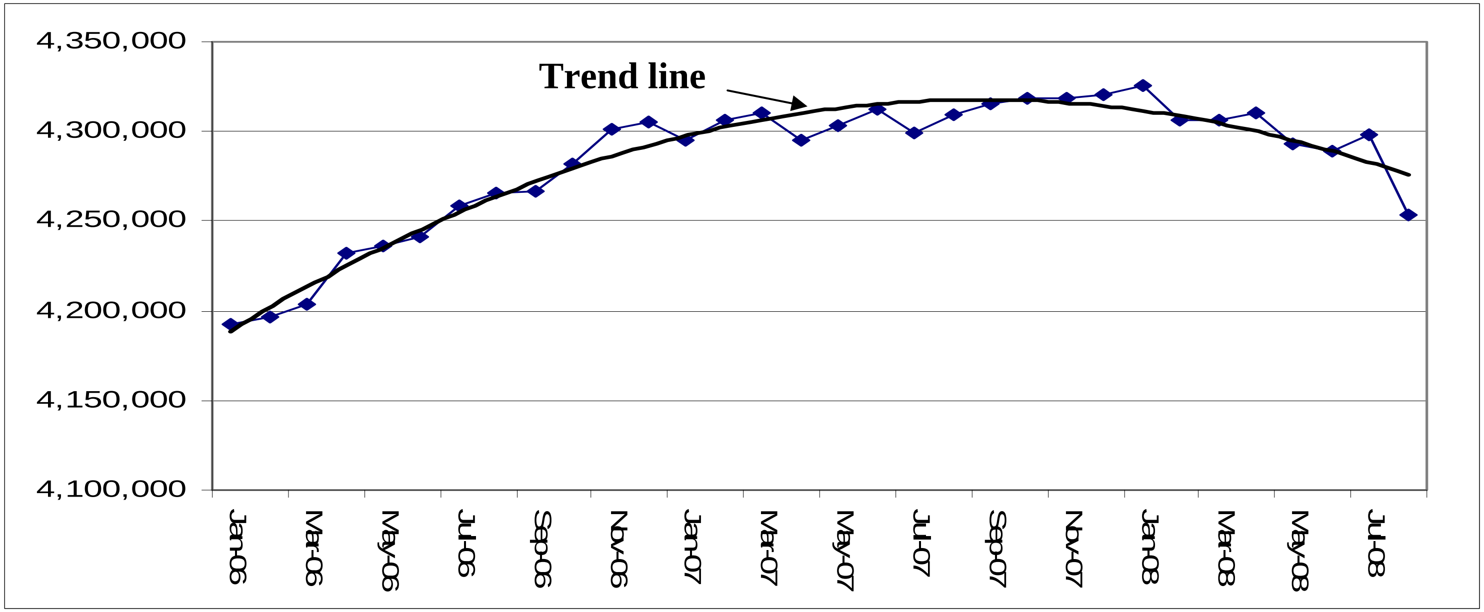
Real Estate Conveyance Collections



Tracking Economy-Based Collections (cont.)

One explanation for the decline in the economy-based taxes is the weaker employment market. Since August of last year, the state now has 55,000 fewer people employed. This downward trend in employment is expected to persist through the end of the year and well into 2009.

Non-Agricultural Employment, Seasonally Adjusted



2008-09 Forecast Assumptions and Risks

- In May, national forecasts projected the worst of the nation's economic troubles would be behind us at summer's end, with sluggish, but positive, economic growth to follow for the rest of the forecast period.
- North Carolina seemed to be affected less by the housing slump than some states (California, Arizona, Florida) and would avoid a major downturn caused by the housing recession.
- Consumer spending was expected to be impacted with adjusted sales tax growth expected to be only 3.1% compared with long term growth of 5.6%.
- Additionally, the forecast anticipated that sub-par job growth due to a soft economy would lead to lower growth of personal income tax collections.

2008-09 Forecast Assumptions and Risks

- Corporate profits were forecast to grow only 2.4%. This assumed input prices would moderate and the economy, both nationally and globally, would not slip into a recession.
- The May forecast cautioned that there were potential risks to the State's economic well-being, which included a variety of economic and non-economic events.
- Namely:
  - Significant energy and commodity price increases;
  - Continued decline in housing markets;
  - Further tightening of consumer credit;
  - Financial market disruptions;
  - A weakened economy is also susceptible to external shocks such as terrorist attacks. global conflicts, and Katrina-like natural disasters.
- ***Four out of five of these forecast risks have come to fruition over the past five months.***

National Economic Outlook

- The housing recession has caused a lot of damage to the economy as housing prices fall and consumer wealth is reduced.
  - Recent, albeit preliminary, reports suggest there may be at last a light at the end of the tunnel on housing. Nonetheless, there is still a long way to go before the housing mess is fully behind us.
- Consumers hit hard by the economic downturn
  - Falling employment
  - Lower inflation-adjusted wages
  - Loss of wealth from housing recession
  - 35-40% decline in equity markets
  - Tight credit conditions
  - High debt burden

National Economic Outlook (cont.)

- While the last six months have not been good for consumers, there are some potential improvements on the horizon.
  - Housing prices may be near the bottom and after-tax monthly mortgage payments are near historically low levels measured as a percent of after-tax income.
  - Financial market interventions by the Fed (including Fannie and Freddie) have lowered mortgage rates and further improved housing market prospects.
  - The possibility of low lending rates, lower gas prices, and lower grocery bills may lead to improved consumer confidence and provide sufficient stimulus to keep us out of a prolonged recession.

National Economic Outlook (cont.)

- The financial crisis exploded in earlier October and trillions of dollars in the global economy have been wiped out.
- Credit markets froze leaving businesses and consumers with few or no financing alternatives.
- The result is the economy already in a mild recession is at risk of a deeper, more prolonged recession than originally anticipated.
- A global economic slowdown has taken hold and export demand is no longer supporting positive real GDP growth.

National Economic Outlook (cont.)

- Stresses on the economy are starting to show with the release of each new economic indicator.
- Based on key monthly indicators the U.S. economy is in a recession, each of these key indicators peaked late last year or early this year and have since turned downward.
  - Manufacturing & Trade Sales peaked in October 2007
  - Employment peaked in December 2007
  - Personal Income peaked in October 2007
  - Industrial Production peaked in January 2008
  - Consumer Confidence Index peaked in September 2007

State's Economic Outlook

- Many of the State's industry sectors, once thought resistant to the national housing and financial market meltdown, are now showing signs of vulnerability.
- The combination of weak housing, high commodity prices (both gas and food), and tight credit have taken a toll on consumer spending. This is beginning to cause declines in the service and retail sectors.
- A stalwart growth industry, financial services, has been hit hard by the financial markets troubles. Job losses in the State are now expected in this industry over the next 4 to 6 quarters.
- The manufacturing sector continues to shed jobs (a rate of 2% to 3%), but this recession should not accelerate job losses like the last recession in 2001-2002, where manufacturing experienced quarterly declines of over 10%.

State's Economic Outlook

- Thus, overall employment growth will stall in the State with no growth envisioned for this fiscal year and less than 2% in FY 2009-10. This will translate into well below normal growth in personal income.
- Moody's economy.com forecasters envision only 2.7% growth in the State's personal income for 2009, which is far less than the 5.5% to 7.5% growth of the previous 4 years.
- The State, by comparison, is expected to fair better than the nation where national employment is projected to fall 1% in FY 2008-09 and grow less than 1% the following year.
- Likewise, personal income is anticipated to grow faster in the State than the nation as a whole.

State's Economic Outlook

- Despite all the negative conditions facing consumers in the state, the state is forecast to eke out positive growth in retail sales in the 1% to 3% range through 2009. The nation on the whole is expected to experience little or possibly negative growth during this same period.

- Finally, the State remains in a relative better position than some states, but recession-like conditions will persist through at least the first two quarters of 2009 and possibly into 2010.

Additional Thoughts on 2008-09 Outlook

- The economy has seen economic headwinds intensify.
  - Housing prices continue to fall - down 26% nationally
  - The housing recession fuels a financial market crisis
  - Consumers forced to cut back on spending
  - Global economy weakens significantly

- The Feds have undertaken several important and historical steps to reverse the financial market crisis and thaw frozen credit markets. These may prove beneficial and head-off a prolonged and difficult recession. They include:
  - Bank debt guarantees
  - Raise FDIC insurance to $250,000
  - Direct capital infusion to banks ($250 million+)
  - Coordinated rate cut of 50 basis points
  - More fiscal stimulus possible?

Additional Thoughts on 2008-09 Outlook

- The recent actions by the Feds will provide some relief, but the economy is in a recession and early prognostications suggest it will be 2010 until a full economic recovery will be underway. Therefore, fiscal difficulties around the nation and in this state are likely to grow as unemployment increases and income taxes begin to decline (sales and corporate taxes have already slowed significantly).

- A conservative budgeting/forecasting approach was adopted here in North Carolina and this will help soften the impact, but the recession's affects over the next two years could result in a difficult fiscal situation.

Budget Outlook

- Governor is managing FY 2008-09 as per G.S. 143C-6-2
  - Reducing agency allotments
  - Delaying expenditures, where appropriate
  - Carefully monitoring Medicaid and other key budget areas

Budget Outlook

- Mounting pressures for remainder of FY 2008-09:
  - Potential for significant revenue shortfall
  - State Health Plan will need additional infusion of cash ($200 - $300 million)
  - Medicaid and other income assistance programs are counter-cyclical