

# Weekly Economic Commentary

August 30, 2010



## John Canally, CFA

Economist  
LPL Financial

### Highlights

- A busy week for data capped off by the August employment report.
- While temperatures have been well above normal this summer, the economic data has been downright chilly, raising the odds of more policy action from the Federal Reserve later this year.

### Economic Calendar

<b>Monday, August 30</b> Personal Spending <i>July</i>	ADP Private Sector Employment <i>August</i>
Personal Income <i>July</i>	<b>Thursday, September 2</b> Initial Claims <i>wk 08/28</i>
<b>Tuesday, August 31</b> Chicago Purchasing Managers Index <i>August</i>	Productivity <i>Q2</i>
Consumer Confidence <i>August</i>	Factory Orders <i>July</i>
<b>Wednesday, September 1</b> ISM Manufacturing <i>August</i>	Chain Store Sales <i>August</i>
Construction Spending <i>July</i>	<b>Friday, September 3</b> Private Sector Payrolls <i>August</i>
Domestic Light Vehicle Sales <i>July</i>	Unemployment Rate <i>August</i>
Challenger Layoff Data <i>August</i>	Nonfarm Payrolls <i>August</i>
	ISM – Service Sector <i>August</i>

## It Has Been a Long, Cold Summer

The week before the Labor Day holiday is traditionally a slow week for financial markets, which is not likely to be the case this week, as there are plenty of key reports on the economy for July and August to keep market participants' minds off their vacations. Markets are still buzzing about what Fed Chairman Ben Bernanke did or did not say at a speech in Wyoming on Friday, August 27, and while Bernanke is in vacation mode this week, several of his colleagues on the Federal Open Market Committee (FOMC), the Fed's monetary policymaking arm, are on the docket. Data on both the manufacturing and service sectors in August are due out in China, as policymakers in Beijing debate whether the Chinese economy needs another dose of stimulus. In Europe this week, the economic data calendar remains busy, as market participants try to gauge whether or not the recent series of better-than-expected economic data was a head fake prior to the onset of the fiscal tightening that is just now taking place. [Chart 1]

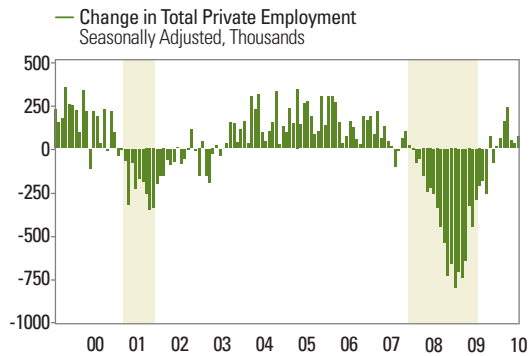
In the United States, the week kicks off with data on spending and incomes in July, and by mid-week, the market will be focusing on the Institute of Supply Management's (ISM) manufacturing index for August. The economic reports over the final two days of the week are dominated by the labor market, with the August employment report due out on Friday, September 3. Because temporary workers hired to conduct the 2010 Census are still being laid off as the Census-taking process winds down, the market will again be focused on employment in the private sector, where more than 600,000 jobs have been created since the start of the year. The economist consensus expectation is that the private sector added about 50,000 jobs in August, a slightly slower pace of job growth than the 71,000 jobs added in July. As of Monday, August 30, the highest economist estimate for job creation in August is 120,000. The lowest estimate is -17,000. A change in private sector payrolls in August within that range is not likely to move markets. The unemployment rate is expected to tick up to 9.6% in August from 9.5% in July.

## Is Another Round of Quantitative Easing in the Cards?

The economic data released last week was once again on the wrong side of consensus, and continued to show that the recovery in the U.S. economy that began in mid-2009 had slowed noticeably by mid-2010. For most of the late spring and summer of 2010, a significant portion of the U.S. economic data released last week (August 23-27) fell short of expectations, and represented a downshift in activity from the prior month. As we detailed in the Weekly Economic Commentary of August 16, our view remains that economic growth in the second half of 2010 will be slower than growth in the first half.

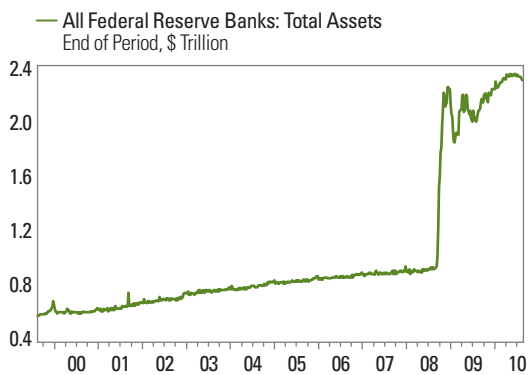


## 1 The Private Sector Employment Figure in the August Employment Report Will be the Market's Focus



Source: Bureau of Labor Statistics/Haver Analytics 08/30/10  
(Shaded areas in chart indicate recessions)

## 2 The Fed's Balance Sheet Would Resume its Expansion if the Fed Embarks on Another Round of Quantitative Easing



Source: Bureau of Labor Statistics/Haver Analytics 08/30/10

While the odds of a double-dip recession have risen (to around 20% in our view), the main preconditions for a double dip are not in place now.

In a much-anticipated speech last week at the Fed's annual summer symposium in Jackson Hole, Wyoming, Fed Chairman Bernanke agreed with our assessment of the economic outlook: no double dip. However, the Fed remains far more optimistic about the economy in 2011 than most private forecasters, ourselves included. The Fed's forecast of 3.5% to 4.2% for Gross Domestic Product (GDP) in 2011 is well above the 2.8% consensus of private sector economic forecasters. In his Jackson Hole speech, Bernanke stated that the preconditions for a pickup in growth in 2011 "appear to be in place", citing a variety of factors that we note often in this and other publications, including:

- Monetary policy remains very accommodative.
- Financial conditions have become more supportive of growth.
- Banks are improving their balance sheets and appear more willing to lend.
- Consumers are reducing their debt and building savings, returning household wealth-to-income ratios near to longer-term historical norms.
- Stronger household finances, rising incomes, and some easing of credit conditions will provide the basis for more-rapid growth in household spending next year.
- Business investing in equipment and software should continue to grow at a healthy pace in the coming year, driven by rising demand for products and services, the continuing need to replace or update existing equipment, strong corporate balance sheets, and the low cost of financing, at least for those firms with access to public capital markets.
- On the fiscal front, state and local governments continue to be under pressure; but with tax receipts showing signs of recovery, their spending should decline less rapidly than it has in the past few years.
- Federal fiscal stimulus seems set to continue to fade but likely not so quickly as to derail growth in coming quarters.

However, Bernanke also hinted that if the economic outlook were to "deteriorate further" (i.e. the daily, weekly, and monthly drumbeat of economic data continues to come in on the weak side of expectations), the Fed stands ready to embark on another round of stimulus, which could include:

- Additional Quantitative Easing (QE): large scale purchases by the Fed of agency debt, agency Mortgage-Backed Securities (MBS), and longer-term Treasury securities
- Modifying communication to suggest "extended period" means the Fed is on hold for an even longer period of time than currently believed
- Reducing the interest rate paid on excess reserves held by banks at the Federal Reserve.

Of the three, Bernanke's speech suggested that the Fed would prefer to use QE to stimulate the economy. The Fed's first foray into quantitative easing began in March 2009, and saw the Fed purchase \$1.25 trillion of MBS, \$175 billion of agency debt and \$300 billion in Treasuries by the end of March



2010. The result was lower borrowing costs for businesses, and importantly, homeowners and households looking to repair their balance sheets.

Market participants are likely to have several questions about the next round of QE, including:

- When will it occur?
- How much additional agency, MBS, and Treasury debt will the Fed buy?
- Will it be effective in keeping the economy out of a double-dip recession?

As to when QE might commence, the next FOMC meeting is September 21, and the market will focus on that date in the near term. In our view, there is probably not enough data on the economy due out between now and then to force the Fed's hand. November 3, the day after the 2010-midterm elections, is the next FOMC meeting, and by then the Fed will have digested two more jobs reports, two more months of retail sales and inflation data, and perhaps another Senior Loan Officers survey.

As to the size of the action, the market seems to be focused on the \$1 trillion mark, smaller than the first round of QE, but enough to be felt in the targeted markets and in the economy.

The real debate among market participants will be around the effectiveness of any additional QE. Some will argue that the Fed is merely "pushing on a string", by pushing rates on mortgages and bank loans even lower, because the issue is not the cost of the financing for businesses and households, it is the availability of financing. Our view is that credit is becoming more readily available in the system, and that lower rates will help eligible businesses to continue to lower their borrowing costs, and that lower consumer financing rates will further hasten the repair of consumer balance sheets, which has progressed nicely over the past 18 months, but may have another 12 to 18 months to go.



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# Weekly Market Commentary



August 30, 2010

## Catalysts on the Horizon

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#### Highlights

We continue to believe a late-year rally for stocks will fulfill our long held outlook for modest single-digit gains on the year for the S&P 500.

Unfortunately, all of the potential catalysts are a month or more away while the economic data continues to disappoint.

In the meantime, we continue to find yield-producing investments attractive, including High-Yield Bonds, which offer investors a return while waiting out the volatility in the stock market.

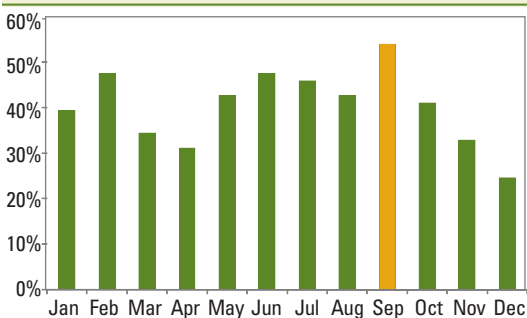
The stock market posted solid gains on Friday August 27, but still closed lower for the third week in a row. Economic data was generally disappointing, especially housing. This week brings the most important data of the month, including the Institute for Supply Management (ISM) gauge of conditions in the manufacturing sector and the employment report. Outside of consumer spending, the majority of these indicators are likely to show sequential declines.

We continue to believe a late-year rally for stocks will fulfill our long-held outlook for modest single-digit gains on the year for the S&P 500. However, over the next month or two, the risk that the soft spot lingers and pulls the market back to the lows of the year is significant. Seasonal factors also favor caution given the historically weak performance in September and October. Since 1950, the month of September has more often led to a decline than a gain in the S&P 500 index. However, November and December have provided some of the best returns of the year, on average. [Charts 1 and 2]

There are a number of potential catalysts for a fourth quarter rally:

- **At the Federal Reserve (Fed) Meeting on September 21, the Fed may announce additional stimulus measures to stimulate growth.** On Friday of last week, in his speech from the Fed's Jackson Hole symposium, Fed chairman Ben Bernanke seemed to pave the way for another round of monetary stimulus. Although he noted that the Fed needs to see more evidence of a slowing economy or further disinflation to act. Friday's profit warning from a large Technology company is potentially significant in tilting the Fed towards easing should it be followed by a number of other companies in the coming weeks. The unemployment rate ticking up in the August employment report due to be released this Friday would move the Fed in the direction of more stimulus, as well. It may be unlikely the Fed will move as soon as a few weeks from now, there will be plenty of data released before the September 21 FOMC meeting that could show further softening of the economy, raising investor expectations for Fed action.
- **Positive pre-election policy discussions in Washington as incumbents seek to alter the tide of the popular vote — often termed an "October surprise".** In the weeks ahead of the November 2 mid-term elections, incumbents in Washington may take positive stances on issues that are market friendly. Incumbents are in trouble according to state and regional polling data. In seeking to turn the tide of voter

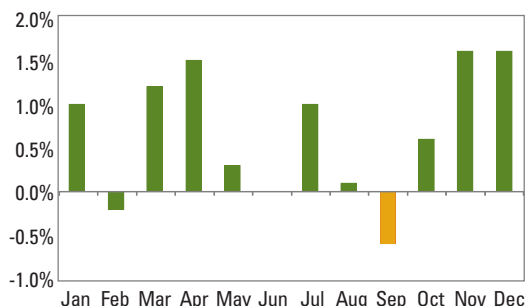
1 Percentage of Months with Price Declines in the S&P 500 Index Since 1950



Source: LPL Financial, Bloomberg 8/27/10

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

**2 Average Price Change for the S&P 500 Index by Month Since 1950**



Source: LPL Financial, Bloomberg 8/27/10

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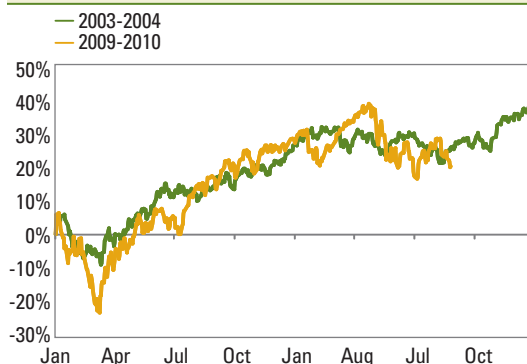
**Mid-Term Election Stock Performance S&P 500**

Mid-Term Election Year	Fourth Quarter Price Performance
2006	6.2%
2002	7.9%
1998	20.9%
1994	-0.7%
1990	7.9%
1986	4.7%
1982	16.8%
1978	-6.3%
1974	7.9%
1970	9.4%
1966	4.9%
1962	12.1%
1958	10.3%
1954	11.4%
1950	5.0%
<b>Average</b>	<b>7.9%</b>

Source: LPL Financial, Bloomberg

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**3 S&P 500 Index Performance the 2003–04 and 2009–10 Recoveries**



Source: LPL Financial, Bloomberg 08/27/10

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sentiment they may talk about tax cuts or other issues favorable to stock market investors.

- **Post-election clarity in Washington may begin to emerge.** The balance of power is likely to shift between political parties following the elections. This may lead to more of a political balance in Washington and slow the pace of legislative change resulting in the “gridlock” the market has historically favored.
- **Following the election, the potential for tax cut extensions may become more visible.** Based on comments in recent weeks, the party consensus among congressional Democrats on taxes seems to be eroding with some members increasingly in favor of extending the Bush tax cuts. After the election, it is possible PAYGO rules that require budget offsets to any tax cuts are waived allowing the extension of many, if not all, of the Bush tax cuts into 2011.
- **The fourth quarter of mid-term election years is almost always favorable for stocks.** The market’s reaction to mid-term elections, as uncertainty fades, has almost always been positive, with fourth quarter gains averaging 8% in mid-term election years. So far, the stock market performance in 2010 has tracked the typical pattern for U.S. stocks in mid-term election years, albeit with a bit more than the usual volatility.
- **If history is any guide, the disappointingly soft economic data over the past few months may soon begin to firm.** Looking back over the past 60 years, about one year after the start of every recovery a soft spot emerges. Some closely watched indicators of growth are likely to be near the bottom of their typical soft spot-driven decline and poised for a rebound. As the data begins to firm later this year, the typical pattern of recovery may continue to unfold as it did in the post-recession recovery years of 2003 and 2004 when a late year rally in 2004 resulted in gains for the year. [Chart 3]

Unfortunately, all of these potential catalysts are a month or more away while the economic data continues to disappoint.

The volatility that has defined this year is likely to continue with ongoing losses to be recouped by a late-year rally. In the meantime, we continue to find yield-producing investments attractive, including High-Yield Bonds, which offer investors a return while waiting out the volatility in the stock market.



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