

Weekly Economic Commentary



November 1, 2010

At Last

John Canally, CFA

Economist
LPL Financial

Highlights

- Economics, policy, and politics will fight for room in the headlines this week, as the long awaited First Week in November finally unfolds.
- Some observers think QE2 will allow inflation expectations to become unhinged. In our view, the risk of deflation outweighs the risk of inflation by a wide margin.
- The third quarter GDP data argued against the so-called “double-dip” recession camp, as the modest gain in real GDP marked the fifth consecutive quarterly gain in GDP since the end of Q2 2009.

Economic Calendar

Monday, November 1	Domestic Light
Personal Spending	Vehicle Sales
<i>September</i>	<i>October</i>
Personal Income	FOMC Decision
<i>September</i>	Thursday, November 4
ISM Manufacturing	Productivity
<i>October</i>	<i>Q3</i>
Construction Spending	Initial Claims
<i>September</i>	<i>wk 10/30</i>
Tuesday, November 2	Chain Store Sales
Election Day	<i>October</i>
Wednesday, November 3	Friday, November 5
Factory Orders	Unemployment Rate
<i>September</i>	<i>October</i>
Challenger Layoff	Private Sector Payrolls
Announcements	<i>October</i>
<i>October</i>	Nonfarm Payrolls
ADP Employment	<i>October</i>
<i>October</i>	Consumer Credit
ISM—Service Sector	<i>September</i>
<i>October</i>	

For months now, we and most other market observers have been pointing to this week (November 1–November 5), aka the “First Week in November” as a watershed week for markets and the economy, and for good reason. Economics, policy, and politics will fight for room in the headlines this week, as the long awaited First Week in November finally unfolds. The economic data due out this week includes key reports on manufacturing, employment, retail sales, vehicle sales, and consumer spending, as the third quarter ended and the fourth quarter began.

Outside the world of economics, both policy and politics will compete for attention this week. We will revisit the policy angle, in this case, monetary policy, as we reiterate our view on what the Federal Reserve (Fed) is likely to announce at the end of the Fed’s Federal Open Market Committee (FOMC) meeting on Wednesday. We will also discuss some of the common arguments being made against doing more quantitative easing (QE).

Of course, Tuesday is Election Day, as voters decide control of both houses of Congress, 37 governorships and multitudes of state and local races. In our view, the post election “tone” in Washington could have a large bearing on the economy, and financial markets in late 2010 and early 2011.

The Arguments Against More Quantitative Easing

As we discussed in last week’s (October 25, 2010) Weekly Economic Commentary, the Fed is likely to announce on Wednesday that they are embarking on another round of QE with purchases of large quantities of Treasury and agency and/or Mortgage-Backed Securities (MBS) in the open market in an attempt to reinvigorate economic growth. As in the first round of QE when the Fed began purchasing MBS in November of 2008 and announced a larger purchase of MBS and Treasuries in March 2009, this second round is likely to push more dollars into the global financial system, lower interest rates, and lower the value of the dollar. However, in contrast to the first round of QE, QE2 should result in higher inflation and inflation expectations, more lending by banks and more borrowing (at lower rates) by both businesses and consumers, and eventually more hiring and expansion by businesses and more spending by consumers.

However, not all market observers agree that the Fed should embark on QE2. Some think that it simply will not work, so why bother doing it. Others note that the economy does not need more help and that the Fed should wait longer before it decides whether to do more. Some point to banks’ inability or unwillingness to lend as the main reason why QE will not work. The so called “transmission mechanism” of monetary policy—“transition



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mechanism” is just a fancy name for the banking system—has been called into question by the aftermath of the subprime mortgage crisis, and more recently the “transmission mechanism” argument has gained some steam. In recent weeks, it has come to light that some of the nation’s bigger banks have apparently struggled with foreclosure documentation and the threat of put backs—mortgage investors threatening to force the banks to buy back the mortgages they sold during the mid 2000s. The bottom line is, with banks focused on the bad loans they have made in the past, they are less likely to be laser focused on all the new lending they need to do to reinvigorate the economy in the weeks and months ahead.

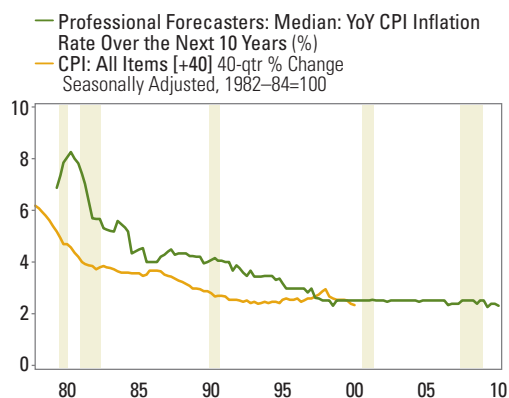
We acknowledge that one of the biggest risks of doing more QE is that it will not work, or will not work as effectively as the Fed would like. However, the Fed’s view (which we share) is that it cannot stand by and do nothing as the economy flounders. We believe that the economy needs more help, and in our view, the Fed has made the case quite well, citing an unacceptably high unemployment rate, rapidly decelerating inflation, and lack of support from fiscal policy at either the federal or state and local levels.

Because of the goal of QE is to spark inflation and inflation expectations, some observers think QE2 will allow these inflation expectations (and inflation itself) to become unhinged, leading to a late 1970s/early 1980s-like bout of inflation. In our view, the risk of deflation (falling prices) outweighs the risk of inflation by a wide margin at this point in the business cycle, and by pumping more dollars into the system, the Fed is simply “filling in” a deflationary hole, rather than stoking an already inflationary economy. The Fed shares this concern (i.e., unhinged inflation expectations) but Fed officials are confident that they can remove QE before it pushes inflation and inflation expectations too high. Indeed, the Fed has been outlining its so-called “exit strategy” from QE almost from the moment it began using QE in early 2009. While we understand the market’s fears here, we do not share the concern that another round of QE will unleash a late 1970s/early 1980s-style inflation environment.

Some market observers believe that the Fed will be wasting taxpayers’ money buying up more government debt, especially if it will not be successful in boosting the economy. Often this argument is lumped in with the other arguments that the government is too involved in the economy and financial markets. In this case, it is important to note that the Fed is not taking the money for QE2 from the Treasury. In fact, the Fed is simply making an accounting entry on its own balance sheet, and is effectively conjuring up the money out of nowhere to facilitate the next round of QE. The risk here is that the market (especially foreign market participants) believes that the Fed is “monetizing” the debt of the U.S. Treasury. This is not the Fed’s intention, and policymakers will keep a close eye on these types of claims as the process progresses.

An argument by some participants in the market for U.S. Treasury notes and bonds is that the Fed’s likely purchase of large quantities of Treasuries in the open market will limit the effectiveness and openness of the Treasury market itself. This argument is somewhat related to the previous argument, as it stems from the idea that the government/Fed is too involved in markets. We point out that if the Fed does indeed purchase as much as \$1

1 Inflation and Inflation Expectations Have Been Coming Down for Almost 30 Years



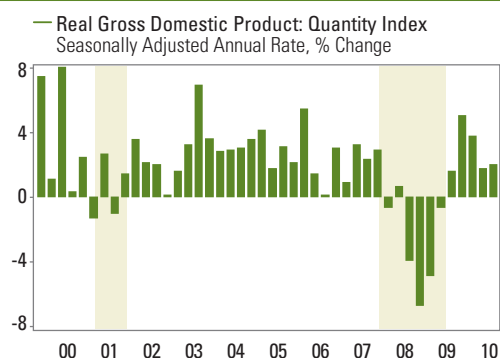
Source: Federal Reserve Bank, Bureau of Labor Statistics 11/01/10
Shaded areas indicate recessions.



trillion in Treasuries over the next 12 months, it will essentially buy up all the new Treasuries expected (by most experts) to be issued over that time. This will certainly raise the ire of some, and indeed, of some in Congress whose purview it is to oversee the Fed.

This leads us to yet another concern about QE2 in the marketplace, and that is the loss of independence by the Fed because of a potential QE2 failure. On the one hand, QE2 could fail to boost lending, borrowing and inflation, which may lead some in Congress to review the Fed's dual mandate of price stability and full employment. On the other hand, if QE2 does indeed generate high inflation and rising inflation expectations, Fed policies might also prompt more scrutiny of the Fed by Congress. Either outcome would likely lead to less independence for the Fed, which would push monetary policy closer to the hands of politicians, which, in our view, would be the worst outcome for QE2.

2 The Economy Remains Close to Stall Speed



Source: Bureau of Economic Analysis/Haver 11/01/10
Shaded areas indicate recessions.

Tepid Q3 2010 GDP Argues for More Action from the Fed

Real gross domestic product (GDP) growth in the third quarter of 2010 painted a picture of an economy near “stall speed”, where growth is strong enough to stay out of negative territory, but not strong enough to push the unemployment rate down or the core inflation rate up. Real GDP growth in the third quarter of 2010 came in right at expectations, rising 2.0% from Q2 2010. This rate of growth represents a distinct slowdown from the first half of 2010, when real GDP growth averaged 2.7%, and argues for more help (in the form of more quantitative easing) from the Fed. The components of the report were also as expected, with business capital spending, consumer spending, inventory build and government spending adding to growth. On the downside, net exports (imports grew faster than exports), housing construction, and state and local government spending were drags on GDP.

The third quarter GDP data argued against the so-called “double dip” recession camp (which was quite popular over the summer months), as the modest gain in real GDP in the third quarter marked the fifth consecutive quarterly gain in GDP since the end of the Great Recession in the second quarter of 2009. However, the underlying components of the report do not point to an immediate reacceleration in growth either. Looking ahead, we expect a similar mix of GDP growth (tepid but positive consumer spending, decelerating, but positive business capital spending, and modest inventory growth) to offset weak residential construction, slowing federal spending (as the \$787 billion stimulus package winds down) and more weakness in state and local government spending.



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Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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