LPL FINANCIAL RESEARCH

Weekly Economic Commentary

February 1, 2010

The Good, The Bad, The Ugly… And the FOMC, Too

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ECONOMIC CALENDAR

Monday, Feb 1
- Personal Spending *Dec*
- Personal Income *Dec*
- Construction Spending *Dec*
- ISM Manufacturing *Jan*
- Senior Loan Officer Survey

Tuesday, Feb 2
- Light Vehicle Sales *Jan*
- Pending Home Sales *Dec*

Wednesday, Feb 3
- ISM — Service Sector *Jan*
- Challenger Layoff Announcements *Jan*
- ADP Employment *Jan*

Thursday, Feb 4
- Initial Claims *wk 01/30*
- Productivity *Q4*
- Factory Orders *Dec*
- Chain Store Sales *Jan*

Friday, Feb 5
- Unemployment Rate *Jan*
- Nonfarm Payrolls *Jan*
- Consumer Credit *Dec*

It was the second consecutive positive quarter for real GDP growth, which should help to reinforce the idea that the recession ended in mid 2009 and that a solid recovery is underway.

The data released last week (and early on Monday, February 1) can be grouped into The Good, The Bad, and the Ugly. The "Good" news dominated the "Bad" and "Ugly", suggesting that the economic data was not a root cause of last week's sell off in the financial markets.

Although "Good" data dominated last week, we are sticking with our 3–5% forecast for real Gross Domestic Product (GDP) growth in the first half of 2010, and our 3–4% forecast for all of 2010. We will continue to monitor the incoming data and adjust our forecast as warranted.

The "Good" reports released last week (and early this week) included:

- The Q4 2009 report on real GDP, the broadest measure of economic activity, which revealed that the economy grew by 5.7% in Q4 2009, the fastest pace of growth in six years.
- The January reading on the Institute of Supply Management's (ISM) report on manufacturing. The index also climbed to a six year high, and suggested that real GDP growth in Q1 2010 got off to a strong start.

The "Bad" data last week included another uncomfortable gain in weekly jobless claims and another step toward tightening from the Fed, while the "Ugly" data last week was the horrible new and existing home sales reports for December, along with the Congressional Budget Office's Budget Outlook for 2010–2020.

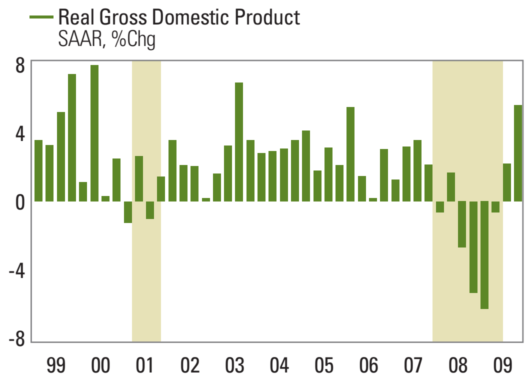
Key Reports Last Week:

The Good

The broadest measure of economic activity, GDP, expanded at a much faster than expected 5.7% annualized rate in Q4 2009 versus Q3 2009. It was the second consecutive positive quarter for real GDP growth, which should help to reinforce the idea that the recession ended in mid 2009 and that a solid recovery is underway. The report should also help to put to rest some of the lingering "double dip" recession talk still circulating in the news media and among some market participants. The consensus was looking for a 4.7% gain in real GDP in Q4 and a few credible economists were looking for GDP growth as high as 5.7%, so the number wasn't a complete shocker.

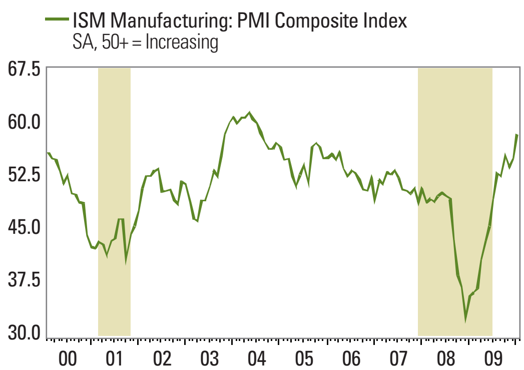
The bulk of the strength in the Q4 GDP report came from less inventory destocking, which added 3.3 percentage points to GDP growth. **Market participants looking to put a negative spin on this report will likely point to the major contribution from inventories to Q4 GDP, but we think that misses the point that there was substantial underlying**

1 Recovery from Severe 2007 – 2009 "Great Recession" Is Well Underway



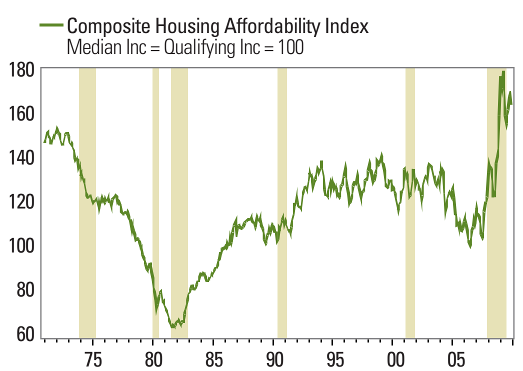
Source: Bureau of Economic Analysis/Haver 02/01/10

2 Strong January ISM Report Suggests another Strong GDP Report in Q1 2010



Source: Institute for Supply Management/Haver 02/01/10

3 Housing Affordability Remains near An All Time High



Source: National Association of Realtors/Haver 02/01/10

strength in the economy in Q4. Sizeable contributions to Q4 GDP were made by business capital spending (+13.3% quarter-over-quarter), personal consumption (+2.0% quarter-over-quarter (Q/Q)), housing (+5.7%Q/Q), and exports. Commercial real estate and government spending were drags on GDP growth in Q4. The composition of the GDP in Q4 supports our view that business spending, exports, and to a lesser extent, housing will help to lead the economy out of recession, while the consumer just "hangs in there."

The January 2010 reading on The Institute for Supply Management (ISM) Index of manufacturing, which is one of the first reports on the state of the economy in early 2010, was a very strong report, and gets Q1 2010 off to a healthy start. At 58.4, the reading in January was way above consensus (55.5) and the strongest reading on ISM in six years. (A reading above 50 suggests that the manufacturing sector is expanding). According to the ISM "The past relationship between the PMI and the overall economy indicates that the PMI for January (58.4 percent) corresponds to a 5.5 percent increase in real gross domestic product (GDP) on an annual basis."

The details of the ISM report were as strong as the headline. Every key category rose between December and January (new orders, employment, production, new export orders, and supplier deliveries. The composition of the report strongly suggests that the manufacturing recovery will persist well into 2010.

The Bad

One of the "bad" reports released last week was initial filing for jobless claims. Jobless claims in the week ending January 23 remained elevated relative to their late 2009 levels, but there are still indications that the "administrative" issues (filings made in the last few weeks of 2009 not being processed until mid January 2010) that dampened claims in the final weeks of 2009 (and pushed them higher in mid January 2010) may still be present in the system. On balance, the downward trend in claims that have been in place for the past nine months remain in place, but the pace of the downward trend has stalled. It remains to be seen whether the stall out is the beginning of a new trend, or just noise. The claims data still suggests a more robust recovery in the labor market than in the prior two recoveries.

The Ugly

Along with the nation's fiscal outlook (as provided by the Congressional Budget Office last week), the two most disturbing reports of the week were the new and existing home sales reports for December. Our view is that the weakness in new and existing home sales data for December is primarily the result of uncertainty surrounding the fate of the first time homebuyer tax credit. The underlying fundamentals of housing (affordability, home prices, and houses for sale) have not changed, and have largely improved over the past few months.

As noted in Chart 3, housing affordability remains close to an all time high, and home prices have moved steadily higher since bottoming out in early 2009. However, if we do not see a stabilization in pending home sales in December (reported early this week) and a pickup in new and existing home sales in January (reported in late February), it would be a concern.

And The FOMC, Too

At the margin, last week's FOMC statement pushed the Fed closer to signaling that they will tighten.

As expected, at its meeting last week, the Federal Reserve's policymaking arm, the Federal Open Market Committee (FOMC) left rates unchanged at near zero and retained the "extended period" phrase in its statement on monetary policy, which suggests that the Fed will be on hold for the near future. The market is currently pricing in the first Fed rate hike in September/October, and we would concur with that assessment. At the margin, last week's FOMC statement pushed the Fed closer to signaling that they will tighten. That signal could come as soon as the next FOMC meeting (March 15-16, 2010) or possibly the April 27-28 meeting. Compared to the previous FOMC statement in December 2009, the FOMC did upgrade its assessment of current economic conditions (most notably business spending), and the economic outlook, and noted that it will end its purchase of agency mortgage-backed securities as expected on March 31, 2010. The FOMC sounded a little cautious on the inflation outlook as well. There was one dissenting vote, Kansas City Fed president Thomas Hoeing, who voted against keeping rates unchanged.

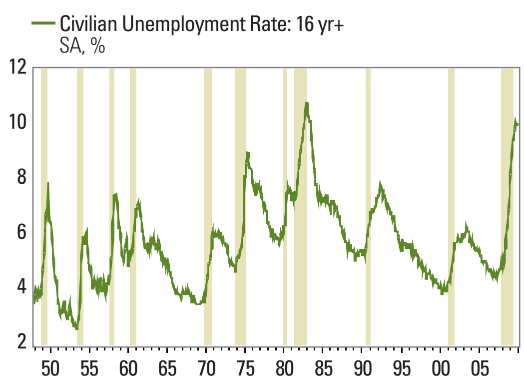
Key Reports This Week:

Fiscal matters will dominate the economic news in the early part of this week, as the Obama Administration will release its proposed budget for Fiscal Year 2011, and the House will debate raising the nation's debt limit to $14.3 trillion. Later in the week, the market will focus on the nation's employment situation, with the release of the January jobs report on Friday. Key data on chain store sales for January (Thursday, February 4) and vehicle sales (Tuesday, February 2) are also on deck this week.

December Pending Home Sales (Tuesday, February 2)

- Usually a sideshow, the pending home sales report for December will be closely watched given the weakness in home sales in December reported last week.
- Pending home sales tend to lead new and existing home sales by a few months. The market is looking for some stabilization in pending home sales in December, which would suggest that new and existing home sales stabilized in January.
- The January home sales data is due out in late February.

4 The Unemployment Rate Remains Uncomfortably High at 10.0%



Source: National Association of Realtors/Haver 02/01/10

January Employment Data (released throughout the week)

- The above 50 reading (53.3) on the employment component of the national ISM report for January provided an early window into Friday's nonfarm payroll report, and raises the odds of a gain in nonfarm payrolls in January 2010.
- Through the worst of the recession in late 2008 and early 2009, the Automatic Data Processing (ADP) employment report (Wednesday, February 3), provided a fairly reliable "early read" on the overall national employment report, as it accurately predicted the direction and magnitude of job losses. In recent months, however, the ADP report has

had a spotty track record, overestimating the number of jobs lost relative to the national report in each of the past eight months.

- The Challenger job cut (Wednesday, February 3) data has been a good leading indicator of the labor market in 2009, peaking in January of 2009, roughly two to three months before jobless claims peaked in late March 2009. Layoff announcements fell between November and December 2009, and in ten of the past eleven months. In December 2009, layoff announcements were down sharply (73%) from a year ago (December 2008). Another drop in layoff announcements in Januaryr would comfort the market. The period in the immediate aftermath of the collapse of Lehman Brothers in September 2008 saw a sharp ramp up in job layoff announcements.
- The four week average on initial filings for jobless benefits (Thursday, February 4) has now declined by more than 200,000 from its peak in April 2009. Jobless claims are no longer tracking toward the jobless recoveries of 1991 and 2001, but, instead, are now tracking to the pattern seen in the robust job recoveries from the severe recession in the mid 1970s and early 1980s. We do not think the market has recognized this yet.
- The market expects the January jobs report (Friday, February 8) to show a small gain in jobs (+8,000) after a disappointing (85,000) drop in December and a small gain (4,000) in November
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