

Weekly Economic Commentary



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A Busy Start to 2011

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Highlights

- Amid a flurry of key reports on the economy, the December ISM and the December jobs report are likely to stand out.
- The debate over the Federal Reserve's (Fed) role in the recovery could reignite this week.
- Although mixed, the economic data released over the final two weeks of 2010 suggest that the U.S. economy was accelerating as 2010 ended.

Economic Calendar

Monday, January 3 ISM Manufacturing <i>December</i>	ISM NMI <i>December</i>
Construction Spending <i>November</i>	Thursday, January 6 Initial Claims <i>wk 01/01</i>
Tuesday, January 4 Factory Orders <i>November</i>	Chain Store Sales <i>December</i>
Domestic Light Vehicle Sales <i>December</i>	Friday, January 7 Unemployment Rate <i>December</i>
FOMC Minutes	Nonfarm Payrolls <i>December</i>
Wednesday, January 5 ADP Employment <i>December</i>	Consumer Credit <i>November</i>
Challenger Layoff Announcements <i>December</i>	

Financial market participants return to their desks this week reflecting on a mixed end, data-wise, to 2010 and are bracing for a full slate of key U.S. economic reports. The Federal Reserve (Fed) will also be in the headlines this week, as will China's battle against inflation.

The economic reports likely to command most of the attention this week are The Institute of Supply Management's (ISM) report on manufacturing for December (released on Monday, January 3) and the U.S. Department of Labor's employment report for December, due out on Friday, January 7. Markets will also be mulling over the 2010 holiday shopping season this week (chain store sales are due out Thursday, January 6), after initial reports suggest that the 2010 holiday shopping season was the best in many years.

December ISM, Jobs Report Bookend the Week

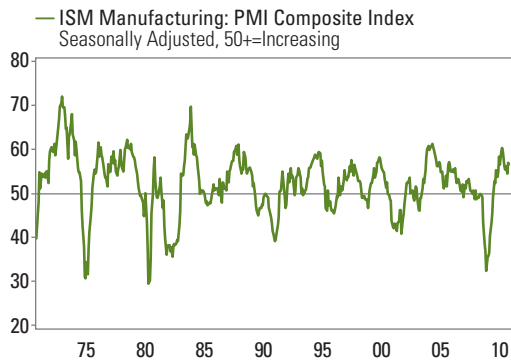
The various regional surveys of manufacturing activity in December (released over the last two weeks of 2010) hinted at the strong reading on the December ISM report. Indeed, the ISM rose to 57.0 in December 2010, a slight acceleration from the 56.6 reading in November 2010. The December ISM reading matched consensus expectations. The ISM averaged 57.3 in 2010, consistent with real gross domestic product (GDP) growth of 5.1%. However, we should point out that the ISM has only been above 57.0 in 49 of the 492 months since 1970 (i.e. 10% of the time), and rarely stays close to the 60.0 level for too long. Thus, a dip back toward 50 in the coming months would not be unusual and would not necessarily signal a double-dip recession. As highlighted in our *2011 Outlook*, our view for economic growth in 2011 is that real GDP growth will be near the long-term average at 2.5–3%.

In the *Weekly Economic Commentary* dated December 6, 2010, we noted that "the November jobs report, released on Friday morning, December 3, 2010 was both weak and disappointing, but the market did not necessarily believe the report." We also noted that "the weak November jobs report puts even more weight on the December jobs report to shine. That report is due out on Friday, January 7."

Well, the day of reckoning is nearly here, and expectations for the December 2010 jobs report are relatively lofty, with the consensus looking for a 155,000 gain in nonfarm payroll jobs following the disappointing 39,000 gain in November. If the consensus is correct, the economy will have created 1.3 million private sector jobs in 2010, just over 110,000 per month. As noted



1 The ISM Averaged 57.3 in 2010, Consistent With Real GDP Growth of 5.1%



Source: Institute for Supply Management/Haver Analytics 01/03/11

in our *2011 Outlook*, our view is that the job market will stage a comeback with nearly twice the pace of job creation experienced in 2010. What would that pace of job growth mean for the unemployment rate?

On average over the last 40 years, roughly 150,000 people enter the labor force each month, so in order for the unemployment rate (which is calculated by dividing the number of unemployed by the labor force) to fall, employment has to increase by at least 150,000 per month. In the short run, however, the business cycle can have a big impact on how many people join (or leave) the labor force. Generally, in good times, more people come into the labor force, attracted by better job prospects. Thus in the long, robust economic recovery in the 1990s, an average of 160,000 people per month entered the labor force. Even in the shorter and less powerful economic expansion in the mid-2000s, an average of 145,000 people entered the labor force each month.

However, during and just after recessions, labor force growth typically slows to a crawl. For example, during the “jobless recoveries” in 2002 and 2003, just 55,000 people per month entered the labor force. Similarly, during the Great Recession and its immediate aftermath, an average of 33,000 people per month dropped out of the labor force, discouraged by poor prospects for finding work. As the economy improved over the course of 2010, an average of 86,000 people per month joined the labor force, as the unemployment rate rose slightly from 9.7% in January 2010 to 9.8% in November. The consensus is looking for a 9.7% unemployment rate in December 2010. Over the course of 2010, we expect the unemployment rate to fall gradually to around 8.5 to 9.0%, as the pace of hiring modestly outstrips a close to typical gain in the labor force.

The Fed Returns to the Hot Seat This Week, While China’s Attempts to Cool Its Economy Met With a Collective Yawn

The release of the minutes of the December 14 Federal Open Market Committee (FOMC) on Tuesday, January 4 and testimony from Fed Chairman Ben Bernanke before the Senate Budget Committee on Friday, January 7 are likely to reignite the debate over the Fed’s role in the economic recovery. It is probably too early for the Fed (or markets) to assess the effectiveness of quantitative easing (QE2). By the end of the first quarter of 2011, both the Fed and the markets should have a better read on whether QE2 was successful and if another round of quantitative easing will commence in June 2011, when QE2 ends. The Fed’s Beige Book (a qualitative assessment of economic conditions in each of the 12 regional Federal Reserve districts) is due out on January 12 and the next FOMC meeting is January 26. We reiterate our assessment that the while the hurdle for ending QE2 remains high, the hurdle for the Fed to begin QE3 in June 2011 is even higher. The market is not expecting the Fed to raise rates until early 2012.

Overseas this week, market participants continue to fret over China’s interest rate policy, in the wake of the 25 basis point rate hike by Chinese monetary authorities on Christmas Day and the lower-than-expected

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reading on the Chinese ISM for December, which was reported on December 31, 2010. The rate hike was the second in ten weeks, and has been accompanied by no fewer than six increases in reserve ratio requirements for Chinese banks over the past 12 months. Thus far, market reaction to the latest round of interest rate hikes in China has been muted, especially relative to early 2010, when China's early attempts at tightening policy were met with a severe downdraft in both global commodity and equity prices. The economic data in China has been slowing (albeit from a very rapid pace of growth) since early- to mid-2010, and more deceleration is likely into 2011. We continue to expect more tightening of policy in China in the coming weeks and months as policymakers attempt to cool inflation. The next round of economic reports (for December) in China are due out the week of January 10–14.

Economic Data Mixed Over Final Two Weeks of 2010, but Holiday Shopping Looks Strong

The economic reports released over the final two weeks of 2010 included:

- New, existing and pending home sales for November
- New orders for, and new shipments of, business capital equipment
- Regional reports on manufacturing activity in Chicago, Dallas, Richmond and Milwaukee
- Personal income, personal spending and the Fed's preferred measure of inflation—the personal consumption deflator excluding food and energy
- Consumer confidence and consumer sentiment for December
- Weekly reports on retail sales, mortgage applications and initial claims for unemployment insurance

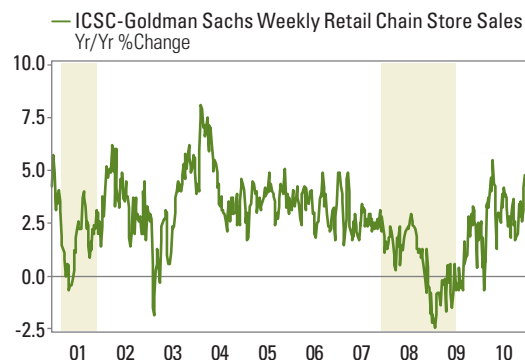
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Taken together, the data released over the final two weeks of 2010 were mixed, at best, a sharp contrast to the strong run of data released in the first half of December. The data on home sales and home prices was mixed, with sales increasing between October and November, but by less than expected. Pending home sales—a good leading indicator of future existing home sales—bucked the trend in housing, beating expectations and accelerating between October and November. Unsupported by government programs, the housing market is still bouncing along the bottom, above the lows hit in early 2009, but still barely able to stand on its own. The good news here is that the labor market is improving, housing affordability—the ability of the household with a median income to afford the payments on the median-priced house—is at an all-time high, and housing construction itself only accounts for around 2% of GDP. The bad news on housing is that loans are still difficult to get, foreclosures remain high, inventories of unsold existing homes are elevated, and prices are still falling in many parts of the country.

Most of the manufacturing data released over the final two weeks of 2010 came in above expectations and accelerated between November and December, raising expectations for the December ISM report. The weaker US dollar, strong corporate balance sheets, and a robust export market are still supporting business capital spending and exports. Sure, Europe (1.4% GDP expected in 2011) and the United Kingdom (1.9%) are beset with



2 The 4.8% Year-Over-Year Gain in Retail Sales During Christmas Week Was the Strongest Christmas Week Sales Gain Since 2003



Source: ICSC-Goldman Sachs/ Haver Analytics 01/03/11

(Shaded areas in chart indicate recessions)

fiscal issues, but 50% of U.S. exports head to emerging market economies, where real GDP growth in 2011 is expected to be well north of six percent.

Although the final tally is not in yet, most of the data in hand suggests that the 2010 holiday shopping season was the best since at least 2006. On December 28, the International Council of Shopping Centers (ICSC) raised its forecast for holiday spending for the second time in less than a month, noting that retail sales in the Christmas week rose 4.8% from the same week in 2009, the strongest Christmas week gain in sales since the 5.5% year-over-year gain in 2003. The solid performance of the U.S. equity market (more than 20.0% as measured by the S&P 500) from early September through mid-December was a good indicator of how sales were likely to track. Historically, equity market performance between September and December is one of the most accurate predictors of holiday shopping.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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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