Weekly Economic Commentary

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Highlights

- This week is dominated by Fed speakers and data on the third quarter of 2010.
- We highlight what we will be watching in the coming weeks and months to measure effectiveness of quantitative easing.

Economic Calendar

Monday, October 25
Existing Home Sales
September

Tuesday, October 26
Consumer Confidence
October

Wednesday, October 27
Durable Goods Order
September

New Home Sales
September

Thursday, October 28
Initial Claims
wk 10/23

Friday, October 29
Employment Cost Index
Q3

Real GDP
Q3

Chicago PMA
October

U of Mich Consumer Sentiment
October

What to Look For After Quantitative Easing Begins

Federal Reserve officials are likely to dominate the economic backdrop this week, as no fewer than eight Fed officials are scheduled to speak, including Fed Chairman Ben Bernanke. Markets are still trying to gauge what form the next round of quantitative easing (QE) by the Fed will take, and are hoping the conga line of Fed speakers this week will shed some more light on this issue. In addition, markets will digest news on new and existing home sales as well as durable goods orders for September, along with October readings on consumer confidence and sentiment. The week will conclude with the release of the gross domestic product (GDP) report for the third quarter of 2010. The market is looking for a 2.0% annualized gain in GDP in the third quarter versus the second quarter, but as we wrote in last week's Weekly Economic Commentary, the Fed is more concerned with growth in the third quarter of 2011 than it is with growth in the already completed third quarter of 2010.

What We Will Be Watching After QE2 Begins

Next week, November 1-5, is likely to be a watershed week for financial markets, as the much talked about mid-term Congressional elections are finally decided, the October jobs report is released, and the Fed likely to announce another round of QE. As we have written in previous Weekly Economic Commentaries, QE is intended to prompt interest rates to fall, businesses to borrow, hire and expand, and motivate consumers to refinance debt and continue to repair their balance sheets.

Since it takes a while (sometimes up to a year or so) for monetary policy to work its way through the system, any policy enacted by the Fed in the remainder of 2010 would only provide a small boost to growth in the fourth quarter. Although the market has already seen some benefits of QE (lower Treasury and mortgage rates), the real test will come in the weeks, months and quarters after the next round of QE is announced and put into place.

Initially, the market is likely to focus on interest rates (Treasury yields, mortgage rates, refinance rates, car loan rates, credit card rates, etc.) to measure whether QE is creating conditions for growth, and participants are likely to measure the change in rates from the end of August 2010, which is when Fed Chairman Bernanke began hinting that the Fed was considering another round of QE. The value of the US dollar (which has already weakened since late August) is another key metric by which the market can monitor QE.

Next, markets will want to see that lower rates have spurred demand for loans from individuals and businesses, and that the banking system is able to provide the loans. The Federal Reserve publishes weekly data on loan

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balances of all types (business loans, real estate loans, personal loans, etc.) at commercial banks, which is a great "real-time" way to gauge the intersection of loan availability and loan demand. In addition, weekly data on mortgage applications will provide additional insight into the health of the housing market, a key concern for the Fed.

The Fed's FOMC statement, Beige Book (a qualitative assessment of conditions in each of the 12 Federal Reserve districts), and FOMC minutes will provide more detail around bank lending and borrowing by businesses and consumers, while the Fed's quarterly "Senior Loan Officers Survey", provides plenty of detail about loan availability and loan terms by banks and loan demand from consumers and businesses across the full spectrum of loan types. Finally, company earnings reports and earnings preannouncements can provide some detail on loan demand and loan availability.

Assuming the monetary policy transmission mechanism—the path the Fed's monetary policy takes through the system as it impacts the overall economy—is not compromised by the resurgent foreclosure and/or "loan put back" issue that has been in the headlines recently, the markets will want to see that lower rates, more dollars, a cheaper dollar, and increased bank lending has indeed prompted a reacceleration in economic activity.

The LPL Financial Current Conditions Index (CCI) provides a weekly look into the health of the economy, tracking shipping rates, initial filings for unemployment insurance, commodity prices, retail sales as well as six other key weekly readings on the health of the economy. In addition, daily readings on consumer confidence (from the Rasmussen polling organization), weekly readings on consumer sentiment from ABC/Washington Post, and semi-monthly readings on consumer confidence from the University of Michigan and the Conference Board will be closely watched for signs of improving consumer sentiment. Timely measures of business confidence (the National Federation of Independent Business surveys its membership monthly) will also be an important gauge of the impact QE has on business sentiment, as business, and in particular, small business are a vital link in the transmission mechanism.

Finally, the market will want to see the impact of all the lending, borrowing, and increased confidence begin to show up in the monthly and quarterly economic reports we regularly discuss in the Weekly Economic Commentary. More borrowing by businesses should lead to more production by businesses, which in turn should lead to more hiring. The monthly reports on retail sales, industrial production, businesses' new orders, shipments and inventories, as well as the monthly employment report will be key to tracking the impact of QE.

More dollars in the system means a cheaper dollar on world currency markets, and that means a better export environment for U.S. exporters. The monthly merchandise trade report (which details imports and exports of both goods and services along with the export component of the monthly ISM reports on manufacturing and services) will be closely watched, as always.

Also, the monthly data on inflation (producer prices, consumer prices) as well as housing prices and import prices (a weaker dollar means higher prices for goods we import from overseas for domestic consumption), In embarking on another round of QE, the Fed wants to generate inflation (rising prices) and avoid deflation (falling prices).

should begin to reflect the impact of QE by the first part of 2011. The flood of dollars in the system, along with lower borrowing costs for consumers and businesses, should lead to more demand for goods and services, and higher prices for these items. In embarking on another round of QE, the Fed wants to generate inflation (rising prices) and avoid deflation (falling prices).

Monetary policy works with a lag, even if the Fed follows through with dramatic and bold policy involving the purchase of large quantities of fixed income securities in the open market intended to flood the system with cash. Thus, while we have already seen, in some cases, lower market interest rates and a cheaper dollar, it may be weeks before QE begins to fully affect the high profile, monthly and quarterly reports on the economy like employment, inflation, and GDP. Our view is that we should begin seeing the impact of QE in this data in early 2011.

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