

# Weekly Economic Commentary



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## John Canally, CFA

Economist  
LPL Financial

### Highlights

- A number of key economic reports are due out over the year-end holiday period, including a key report in China.
- Reports over the next two weeks will highlight the best and worst of the economy.
- Strong consumer spending in November and early December leads to upward revision of 2010 holiday shopping forecasts.

## Rising Economic Expectations As 2010 Ends

Light trading on financial exchanges around the globe through year-end 2010 will serve as the backdrop for a number of key economic reports across the full spectrum of economic activity in the United States and abroad. Taken together, the reports will help solidify the markets' expectation for real gross domestic product (GDP) for the fourth quarter of 2010 in the United States, and set the stage for the early part of 2011.

The reports due out over the next two weeks include:

- 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.
- 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.

## Reports Over the Next Two Weeks Will Highlight the Best and Worst of the Economy

Virtually every area of the economy is represented over the next few weeks, and the reports are likely to highlight the best and worst of the economy 2010 turns into 2011.

Although housing remains the weakest part of the recovery, the housing data due out over the next two weeks is expected to show that housing improved somewhat 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 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.

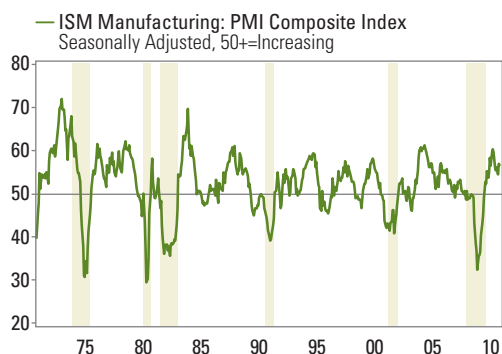
The manufacturing data due out between now and year-end is likely to be upbeat, underscoring the idea that the weaker US dollar, strong corporate balance sheets, and a robust export market are still supporting business capital spending and exports. Sure, Europe (1.4% GDP expected in 2011) and the United Kingdom (1.9%) are beset with fiscal issues, but 50% of

### Economic Calendar

<b>Wednesday, December 22</b>	Personal Spending <i>November</i>
Core PCE Deflator <i>Q3</i>	Personal Income <i>November</i>
GDP Price Index <i>Q3</i>	Initial Claims <i>wk 12/18</i>
Real GDP <i>Q3</i>	U of Mich Consumer Sentiment
Existing Home Sales <i>November</i>	<i>December</i>
<b>Thursday, December 23</b>	New Home Sales <i>November</i>
Durable Goods <i>November</i>	



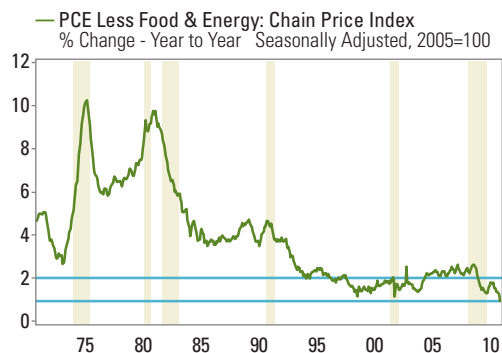
## 1 At 56.6, The ISM Suggests Strong Economic Growth As 2010 Ends and 2011 Begins



Source: Institute for Supply Management /Haver 12/20/10

(Shaded areas in chart indicate recessions)

## 2 Core Inflation Remains Below the Lower End of the Fed's Comfort Zone, Supporting the Need for More Quantitative Easing



Source: Bureau of Economic Analysis/Haver Analytics 12/20/10

(Shaded areas in chart indicate recessions)

Our view is that some of the strength early in the fourth quarter (October and November) may have been borrowed from December, but that a real GDP growth rate of between 3.0 and 3.5% is likely.

U.S. exports head to emerging market economies, where real GDP growth in 2011 is expected to be well north of 6%. Strong readings on the regional manufacturing indices (Dallas, Richmond, Milwaukee and Chicago) will raise the bar for the Institute of Supply Management's (ISM) report on national manufacturing for December, which is due out on Monday, January 3.

Reports on personal income, personal spending, and, most importantly, core inflation in November will help to frame the debate on the efficacy of the Federal Reserve's (Fed) latest foray into quantitative easing. Core inflation, as measured by the core personal consumer expenditures, the Fed's preferred measure of inflation, is expected to remain at 0.9% (year-over-year) in November, the same year-over-year reading as in October. But at 0.9% year-over-year, core inflation remains well below the lower end of the Fed's informal target for core PCE inflation of 1.5 to 2.0%.

Fed Chairman Ben Bernanke, and the Fed itself, will likely face withering criticism from Congress in the new year, as Texas Congressman Ron Paul, a vocal critic of the Fed, will head up the committee in the House of Representatives that is responsible for oversight of the Fed. In our view, it is probably too early for the Fed (or markets) to assess the effectiveness of quantitative easing (QE2). However, by the end of the first quarter of 2011, both the Fed and the markets should have a better read on if QE2 was successful and if another round of QE will commence in June 2011, when QE2 ends. 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.

European economic data released will be limited over the year-end holiday season, as will meetings of global central banks. The only major central bank meeting over the final two weeks of 2010 is the Bank of Japan. The next key event for U.S. monetary policy is the release of the December 14 Federal Open Market Committee (FOMC) meeting minutes on January 4, 2011. The next FOMC meeting is January 26.

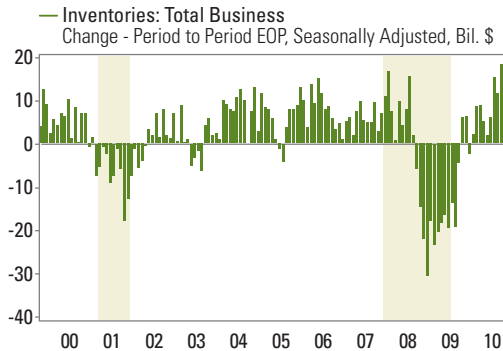
The Chinese economic calendar is also quiet over the holidays, as the next batch of economic data for December is not due out until mid-January. However, a key report on the Chinese economy, the December Purchasing Managers' Index (PMI), is set to be released on December 30, 2010, at the height of the holiday vacation season. The report may set the tone for further rate increases by Chinese monetary authorities early in 2011, and therefore will be closely watched by market participants across the globe, even if they are on vacation.

## Strong Consumer Spending in November and Early December Leads to Upward Revision of 2010 Holiday Shopping Forecasts

Against the backdrop of very high expectations, 85% of last week's batch of U.S. economic data beat expectations, 80% accelerated from the prior period, and more than 75% of the data saw upward revisions to prior period's data. In all, it was a very strong week for economic data that had forecasters talking about 4.0% growth in real GDP in the fourth quarter. Our view is that some of the strength early in the fourth quarter (October and November) may have been borrowed from December, but that a real GDP growth rate of between 3.0 and 3.5% is likely.



### 3 Businesses Adding To Inventories Are a Sign of Confidence in the Health of the Expansion



Source: Census Bureau/Haver Analytics 12/20/10

(Shaded areas in chart indicate recessions)

As noted above, the data released last week was nearly uniformly strong on both the front end (consumer spending) and back end (business spending). The monthly retail sales data for November (and the weekly data through mid-December) suggests that the 2010 holiday shopping season is on track to exceed expectations. Indeed, the three most well-known, independent organizations that track retail sales through the holidays—ShopperTrak, the International Council of Shopping Centers and the National Retail Federation—raised their 2010 holiday shopping forecasts last week. Those estimates are now roughly in-line with where we think holiday sales may end up, although the risk remains that estimates for 2010 holiday shopping are still too pessimistic given the improving labor market, pent-up demand, and the solid performance of the U.S. equity market (+20.0% as measured by the S&P 500) from early September through mid-December. Equity market performance between September and December is one of the most accurate predictors of holiday shopping.

On the back end of the economy, the December reports on the Philadelphia Fed manufacturing index and the Empire State manufacturing index (both released last week) strongly suggest that the ISM for December will accelerate from its strong 56.6 reading in November. A reading above 50 on the ISM suggests that the manufacturing sector is expanding, and at 56.6, the ISM is consistent with a GDP growth rate of close to 5.0%. In addition, businesses continue to show confidence in the sustainability of the recovery, adding to their inventories for the tenth consecutive month in October. In all, businesses have added to inventories in 12 of 13 months since October of 2009. The restocking of depleted shelves in response to better economic growth at home, and booming economic growth in the emerging markets (where 50% of U.S. exports end up), has been a big plus for manufacturing and the overall economy since the recession ended in June 2009.



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**IMPORTANT DISCLOSURES**

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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.

Philadelphia Federal Index is a regional federal-reserve-bank index measuring changes in business growth. The index is constructed from a survey of participants who voluntarily answer questions regarding the direction of change in their overall business activities. The survey is a measure of regional manufacturing growth. When the index is above 0 it indicates factory-sector growth, and when below 0 indicates contraction.

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.

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.

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