

Weekly Economic Commentary



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Has the Consensus Caught Up?

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ECONOMIC CALENDAR

Monday, Apr 19
Leading Indicators
Mar

Thursday, Apr 22
Initial Claims
wk 04/17

PPI
Mar

Existing Home Sales
Mar

Friday, Apr 23
Durable Goods
Mar

New Home Sales
Mar

Highlights

Financial markets showed little reaction to what was a spectacular week for economic data. This suggests that the consensus has caught up to economic reality.

The Federal Reserve (Fed) and Chinese authorities weighed in on monetary policy last week and drew conflicting opinions.

This week is a quiet, but important, week for economic data as housing and leading indicators take center stage. This week is considered the “quiet period” before the Federal Open Market Committee (FOMC) meeting, as central banks in Canada, Hong Kong, Sweden, and the Philippines make rate decisions.

Last week was a busy week for economic data and events. On balance, the mix of monetary policy messages and economic data releases left us with the same opinion of the Fed outlook, the outlook for Chinese policy, and the outlook for the United States economy that we had at the beginning of the week.

Our view remains that the U.S. economy is on track to transition from recovery to sustainable growth, the Fed may very well modify (but not remove) the “extended period” language in their policy statement at the next (April 28) Federal Open Market Committee (FOMC) meeting, and Chinese authorities are likely to continue to rein in booming growth with a combination of monetary, lending, and currency policy in the coming weeks.

Heading into 2010, our view on the outlook for the economy was decidedly above consensus, and we maintained that the incoming data would support our above consensus view on the U.S. economy and our overweight to U.S. equities. Since the beginning of 2010, as the economic data continued to beat expectations, the consensus view on the U.S. economy moved higher (closer to our view).

The market’s blasé reaction to yet another strong week of U.S. economic data last week is further evidence that perhaps most of the good news on the economy has now largely been priced into the market. This “catching up” by the consensus was one of the factors in LPL Financial Research’s recent tactical decision to reduce exposure to U.S. equities in favor of fixed income.

The above-consensus data released last week included reports on:

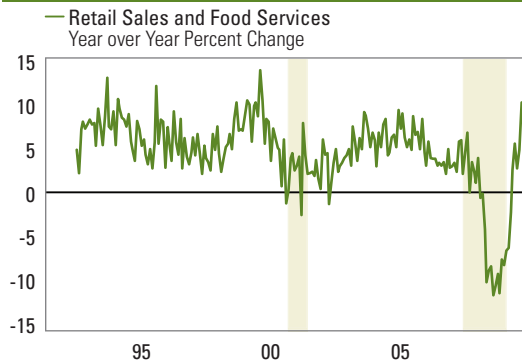
- **Manufacturing**—Philadelphia Fed and Empire State for April, and industrial production for March.
- **Housing**—National Association of Home Builders sentiment index for April and housing starts for March.
- **The consumer**—chain store sales for early April and overall retail sales for March.
- **Exports**—merchandise trade data for February, and
- **Inflation**—the Consumer Price Index for March.

Each of these reports was better than expected, and suggested, on balance, that the economy was growing smartly and that inflation was well contained, as we moved from the first quarter of 2010 into the second quarter.

Retail sales in March rose a better-than-expected 1.6% versus February, and are up 10.1% from March 2009. March marked the seventh time in the



1 Retail Sales in March 2010 Were 10% above their March 2009 Level, and have Beaten Expectations in Seven of the Past Eight Months.



last eight months that retail sales beat economists' expectations. Heading into 2010, we were more upbeat on the consumer than the consensus, although in recent months, the consensus view on the consumer has moved closer to our view. The gains in consumer spending in March were widespread, as spending increased on both non-discretionary items (things you need) and discretionary items (things you want). In addition to the better-than-expected reading in March, the retail sales data in February were revised higher. On balance, consumer spending in the first quarter of 2010 is likely to be an even bigger contributor to Gross Domestic Product (GDP) growth than it was in the fourth quarter of 2009. [Chart 1]

Accompanying the better-than-expected reading on March retail sales, last week was another benign reading on consumer price inflation (CPI). The CPI rose just 0.1% month-over-month in March versus February, and was up 2.3% from a year ago. We expect headline inflation to continue to accelerate through mid-year (to around 3.0 to 3.5% year-over-year), reflecting higher consumer energy prices in early 2010 versus early 2009.

While overall inflation is likely to accelerate over the next few months, we expect core inflation (inflation excluding food and energy) to continue to decelerate. Core CPI was unchanged between February and March and is up just 1.1% from a year ago. Core inflation was running in the 1.5 to 2.0% YOY range in most of 2009. Core inflation is the Fed's preferred measure of inflation and the benign readings on inflation should allow the Fed to keep rates low for a longer time.

The two reports that bucked the trend last week were the reports on first time filings for unemployment insurance (jobless claims) for mid April and consumer sentiment for early April. The blip up in jobless claims can be explained away by those pesky "administrative" issues—this time it was the timing of the Easter holiday in 2010 relative to 2009—that have haunted the claims data since late December, while the dip in consumer sentiment in the first half of April (versus March) is at odds with the weekly spending data that suggests consumer spending remained solid in early April.

Overheating Chinese Economy May Prompt Policy Cool Down Soon; Fed Still on Hold

2 The Chinese Economy Grew at Nearly 12% in Q1 2010



Data on new loan growth, money supply growth, property prices and China's trade balance revealed that while China's economy slowed (amid mandated policy tightening in China that began in January), it probably did not slow enough to prevent Chinese authorities from tightening policy again soon. Indeed a report later in the week last week revealed that China's economy expanded at a hotter-than-expected 11.9% from a year earlier in the first quarter. [Chart 2]

Property prices in China grew at the fastest pace in about five years in March, up 11.7% year-over-year. To cope with the threat of inflation and speculation in the property market, China's government has in recent months been moving to dial back the amount of new lending the banking system delivers to the economy. Inflation has accelerated close to China's 3% target, so additional measures are likely needed to keep price rises in an acceptable range. Banks started to shrink their new lending after the



government set a smaller target for new loans this year. Lending fell 43% in the first quarter from a year ago. The potential for the world's third largest economy and a major engine of global growth to slow significantly in the coming quarters poses a threat to global economic and profit growth.

Last week China took further steps to curb lending with the imposition of higher down payments on mortgages along with a higher interest rate for second homes. We expect more tightening of policy to come. Despite 11.9% GDP growth in the first quarter, Chinese stocks were down on this news and are down year-to-date as finance ministers seek to slow economic growth.

Neither the latest Beige Book—a qualitative assessment of economic activity in each of the 12 regional Federal Reserve districts—nor testimony from Federal Reserve Chairman Ben Bernanke changed our view that the Fed is likely hold until at least late fall 2010. The market concurs with our view.

While the Beige Book did offer a slightly more upbeat assessment of the economy and several key sectors, it noted that wage and price pressures were virtually non-existent, and that the labor market remained weak.

Fed Chairman Bernanke omitted the use of “extended period” from two speeches last week and has not used the phrase in his last four public appearances. Our view is that the Fed’s policymaking arm, the FOMC may be moving away from a time-based (i.e. rates low for an extended period) promise to a more data-dependent (i.e. is inflation or economic growth or inflation expectations tracking to the Fed's forecast) promise on rates. In short, while the FOMC may leave “extended period” in the next FOMC statement, it may modify the phrase, making low rates for an extended period dependent on continued low inflation readings, low and stable inflation expectations, and slack resource utilization.

Our View on the Key Reports and Events of the Coming Week:

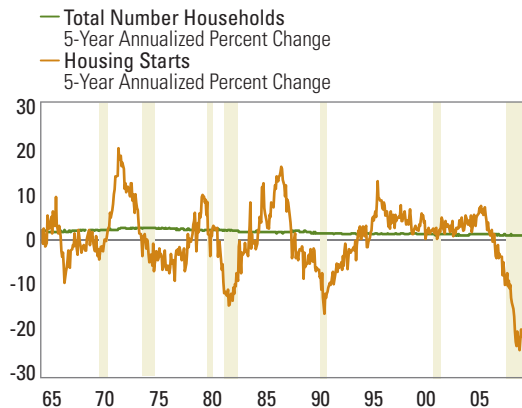
This week is a quiet, but important one, for economic data, with key reports on housing and leading indicators. There is no Chinese economic data due this week, although we would not rule out another round of policy tightening this week. Global central bank meetings to discuss policy this week include the Bank of Canada, the Swedish Riksbank, as well as the central banks of Hong Kong, the Philippines, and Thailand.

Housing remains one of the Achilles heels of the recovery. As such, data this week on both new and existing home sales for March will be closely watched, as the end of the government’s first time homebuyers tax credit looms (April 30).

While the unexpectedly large increase reported last week in housing starts in March versus February (along with a substantial upward revision to the February data) keeps the housing sector on track to make a third consecutive quarterly positive contribution to real GDP growth in the first quarter of 2010, there were a few caveats. Some of the gain in housing activity in March versus February was weather-driven (February was an unusually cold and snowy month), and all of the gain in starts came in



3 Big Under-Build in Housing Will Eventually Have to Reverse



Source: Census Bureau, Haver 04/16/10
Shaded areas represent recessions.

multifamily starts, which are quite volatile month to month, and are not as economically sensitive as single family starts. Still building permits—which are not impacted by weather—surged in March versus February, and are up nearly 60% from their low in early 2009.

Risks remain for housing however, as the second incarnation of the first-time homebuyers tax credit expires on April 30. In addition, the end of the Federal Reserve's Mortgage-Backed Securities purchase program has put some modest upward pressure on mortgage rates, while the still weak labor market, tighter credit standards, overhang of unsold existing homes, and heavy foreclosures are all still pressuring housing. Still, housing affordability remains at or near all-time highs, and while it will not ease this year, the gap between household formation (up 1% per year over the past five years) and housing starts (-25% per year over the past five years) has never been wider. We believe this imbalance will have to correct at some point (similar to the correction seen in the late '80s and the subsequent bounceback in the early '90s). [Chart 3]

Much will be made in the financial press this week about the likely peak in the year-over-year-growth rate of the index of leading indicators. Comprised of ten components, the index of leading economic indicators is designed to predict economic growth several months in advance. Many of the ten components bottomed out in March 2009, making it quite likely that the largest year over year gain in this cycle will be in March 2010.

So what happens to the economy when the year-over-year change in the index of leading economic indicators peaks?

On average, an economic recovery that is already underway when leading indicators peak lasts for another six years. At minimum, recoveries last another four years after leading indicators peak. However, coming out of the severe recession of 1981–82, the expansion continued for another seven years after the year-over-year growth rate of leading indicators peaked in early 1983. The economic expansion continued for another eight years after the year-over-year growth rate of leading economic indicators peaked in late 1992.

What about GDP growth after leading indicators peak? On average, GDP growth is slower after the index of leading indicators peaks, than it is before it peaks in the early part of a recovery. In three of the past four recoveries since 1975, real GDP growth slowed after leading indicators peaked, but during the long, technology-fueled economic expansion of the 1990s, real GDP growth was actually stronger after leading indicators peaked, than it was before.

This time around, we do expect GDP growth to slow-but not stop or turn negative-after leading indicators peak. We view this as a normal part of the economy's transition from recovery to sustainable growth.



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