

Weekly Economic Commentary

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Highlights

- Market participants will be firming up their third quarter GDP estimates this week.
- Bank lending to business has probably stopped falling.

Economic Calendar

Monday, September 13 Treasury Statement <i>August</i>	Thursday, September 16 Current Account Balance <i>Q2</i>
Tuesday, September 14 Retail Sales <i>August</i>	Initial Claims <i>wk 09/11</i>
Business Inventories <i>July</i>	Producer Price Index <i>August</i>
Wednesday, September 15 NY Fed Empire State Mfg <i>September</i>	Philly Fed Index <i>September</i>
Import Price Index <i>August</i>	Friday, September 17 Consumer Price Index <i>August</i>
Industrial Production <i>August</i>	U of Mich Consumer Sentiment
Capacity Utilization <i>August</i>	

Firming Up

Markets will likely spend the week firming up their forecasts for real gross domestic product (GDP) growth in the United States in the third quarter, as participants digest key data on retail sales, consumer and producer prices for August and business inventories for July. The week's data also includes an early look at manufacturing in September, and a snapshot of consumer sentiment in the first half of the month. On the fiscal policy front, this week marks the return of the 111th Congress to Washington, which is likely to usher in plenty of noisy debate about the expiring Bush tax cuts. With the Federal Reserve's (Fed) next monetary policy meeting around the corner, this week marks the traditional "quiet period" before the meeting.

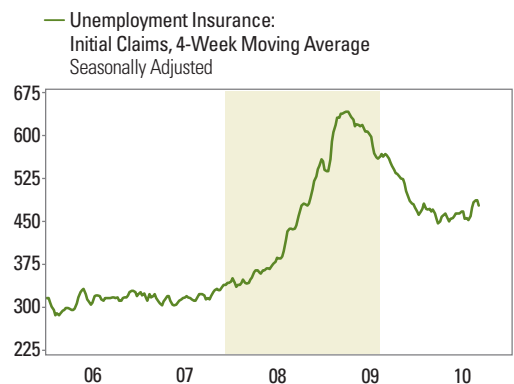
Overseas, central banks in Egypt, New Zealand, Chile, Switzerland, and Hong Kong will meet to set policy. On the economic front overseas, markets digested the August economic reports in China over the weekend of September 10-12, and are currently mulling over whether or not the data warrants a policy response from Chinese monetary authorities. The European data calendar is full this week, with key reports on retail sales, employment, manufacturing, and inflation in the United Kingdom, as well as the key ZEW survey of institutional investors and analysts in Germany.

With the data in hand thus far for July, August, and early September, real GDP growth in the third quarter of 2010 looks to be in the 2.0% to 2.5% range, well below the 50-year average of 3.0%, but not a double-dip, or decline in GDP either. Real GDP growth was a tepid 1.6% in the second quarter of 2010, and the consensus is looking for 1.9% growth in real GDP in the third quarter of 2010. While it is still early—the market has only digested a few reports for September, and the third quarter GDP data will not be released until late October—we already have a sense of the relative strength of the economy in the third quarter.

Based on retail sales data for July and vehicle sales data for July and August, the 70% of the U.S. economy tied to consumer spending is on track to post another solid, but not spectacular, gain in the third quarter. Based on the July merchandise trade report, the export sector, which was a big drag on growth during the second quarter as imports surged and exports moderated, is on track to add to overall GDP growth in the third quarter. Inventory restocking, which has been a key source of the rebound in the manufacturing sector over the past 12-15 months, looks to have continued in the third quarter, as the July data on manufacturers and wholesalers inventories suggest a sizeable build in inventories in the third quarter. Ongoing inventory building, and low inventory-to-sale ratios, suggests that businesses remain confident in the sustainability of the recovery.



1 Initial Filings for Unemployment Insurance Have Begun To Move Lower Again



Source: Department of Labor/Haver Analytics 9/13/10
Shaded areas indicate recessions.

The data released last week continued to put the burden of proof on market participants who are calling for a double-dip recession in the United States.

Based on the July construction data, the housing starts data for July and August, and the employment and hours worked data in the construction industry for July and August, neither housing construction nor business investment in structures (office parks, shopping mall, and industrial buildings) is likely to be a big contributor to GDP growth in the third quarter. Indeed, residential construction activity is likely to be a drag on growth, while business construction will be at best a small plus.

While it is still early, the best estimate is that third quarter GDP growth is likely to come in between 2.0% and 2.5%. This is slightly stronger growth than the consensus of economists is currently forecasting.

Firming Up Lending: Why Credit Extension to Businesses Has Been Tepid

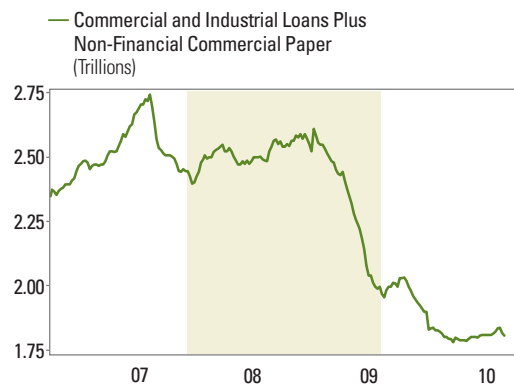
On balance, what little economic data there was last week (September 6-10) came in better than expected, and represented an improvement over the prior period, continuing a trend that began in mid-August. Recall that the vast majority of the economic data in the United States for most of the spring and summer fell short of expectations and deteriorated versus the prior period. Despite the better-than-expected news last week, the data probably does not represent a renewed upturn in the pace of economic growth, or the end to the often-discussed soft spot in the economy. The data released last week continued to put the burden of proof on market participants who are calling for a double-dip recession in the United States.

Still, the news last week that initial filings for unemployment benefits have now declined in each of the last three weeks suggests that distortions related to laying off Census workers and Congressional action over the summer to cut off (and then reauthorize) emergency and extended unemployment benefits for some workers were probably the main reason for the disconcerting rise in initial filings between mid-July (427,000) and mid-August (504,000). The 27,000 drop in claims in the latest week leaves the four-week average at 477,750. Claims probably need to move into the 400,000 to 425,000 range before the market is convinced that private sector job creation is in place.

The other major piece of good news on the economy last week was that the nation's trade deficit narrowed by more than expected between June and July. As we note earlier in this report, the better-than-expected July trade data suggests that the export sector will be, at worst, a small plus for real GDP growth in the third quarter of 2010, after subtracting more than three percentage points from growth in the second quarter of 2010. Exports rose 1.8% between June and July, while imports fell 2.1%. Exports are up 18% from a year ago reflecting the return of global trade, while imports are up 21%, reflecting inventory restocking and increased consumer spending in the United States. Our trade gap with China widened to \$145 billion in the first seven months of 2010, up from \$123 billion during the same period in 2009. This widening gap with China could prompt Congress to introduce protectionist legislation. Although such legislation would be unlikely to pass, it would be a big negative for market sentiment. We view any move toward protectionism as raising the odds of a double-dip recession, which we currently peg at around 20-30%.



2 Credit Extension to Businesses Has Stopped Falling, but Isn't Going up Either



Source: Haver Analytics 9/13/10
Shaded areas indicate recessions.

As market participants continue to firm up their third quarter GDP estimates based on the incoming economic data, businesses continue to firm up their balance sheet and banks continue to firm up their lending practices. The bottom line here is that overall credit extension to businesses has definitely stopped falling, but it is not moving higher either, and we still have a long way to get back to the pre-credit crunch peak in lending. This suggests that businesses' ability to create jobs and invest in new plant and equipment is likely to be more muted than it has been in prior recoveries.

There are several ways to measure whether or not businesses are getting the capital they need. The timeliest data is the weekly data on bank lending and issuance of commercial paper - short-term debt issued by corporations to fund their day-to-day operations. Businesses also get funding via the corporate debt market, and although the market can monitor issuance of corporate debt on a daily basis, it is not aggregated up into useful form. The most comprehensive view of how businesses fund themselves (via bank loans, commercial paper, and the corporate debt market) can be found in the Fed's flow of funds data, which, unfortunately, is released only quarterly, and even more unfortunately, with a long lag. The flow of funds data for the second quarter (which ended on June 30, 2010) is due on this Friday, September 17.

Looking at just bank lending to businesses, commercial and industrial (C&I) loans held steady in the latest week and have not changed much (a few billion in either direction) since mid-May. Adding in commercial paper issuance, the story is similar. Although we hit an air pocket in the latest week (probably due to the Labor Day holiday curtailing issuance of commercial paper), credit extension to businesses via C&I loans and commercial paper is unchanged since mid June. Why?

Given the record amount of cash on corporate balance sheets, companies may be funding day-to-day operations with cash on hand and may not need to borrow. In addition, while the terms of credit have improved (and banks lending standards have eased in recent quarters) many companies may fear taking on additional debt given the relatively uncertain legislative and political environment. Finally, booming corporate profits have left many corporations with plenty of cash flow, making it unnecessary to borrow in the credit market or from banks.



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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.

ZEW Survey is a main indicator of investors' confidence. It is calculated on basis of 350 analysts' and institutional investors' polling. The indicator reflects the difference between analysts who are optimistic about forthcoming economic development of Germany within six months and those who are pessimistic. The Survey is used for German economic prospects estimation. ZEW Survey growth causes the euro growth.

Consumer Price Inflation is the retail price increase as measured by a consumer price index (CPI).

Producer Price Index (PPI) tracks inflation by measuring price changes.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Floating rate bank loans are loans issued by below investment grade companies for short term funding purposes with higher yield than short-term debt and involve risk.

Non-financial commercial paper is short-term debt (maturities less than 270 days) issued by nonfinancial corporations.

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