

# Weekly Economic Commentary



January 31, 2011

## Snowed Under

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#### Highlights

- A busy week for economic data and policy in the United States and abroad.
- Will the rise in energy prices short circuit the recovery?
- January jobs report likely to be impacted by weather, revisions.

#### Economic Calendar

<b>Monday, January 31</b> Personal Spending <i>December</i>	<b>Thursday, February 3</b> Unit Labor Costs <i>Q4</i>
Personal Income <i>December</i>	Productivity <i>Q4</i>
Chicago Purchasing Managers Index <i>January</i>	Initial Claims <i>wk 01/29</i>
<b>Tuesday, February 1</b> ISM Manufacturing <i>January</i>	Chain Store Sales <i>January</i>
Construction Spending <i>December</i>	Non-Manufacturing ISM Report on Business <i>January</i>
Domestic Light Vehicle Sales <i>January</i>	Factory Orders <i>December</i>
<b>Wednesday, February 2</b> Challenger Layoff Announcements <i>January</i>	Bernanke Press Conference
ADP Employment <i>January</i>	<b>Friday, February 4</b> Unemployment Rate <i>January</i>
	Nonfarm Payrolls <i>January</i>

Financial market participants will be pulled in several directions this week as January turns into February. Political developments in North Africa and the Middle East are likely to be top of mind this week and serve as a reminder that geopolitics are never too far removed from the headlines. (Please see this week's *Weekly Market Commentary*, "Geopolitical Risks Return," for more details). Policy—a key theme in markets last week (January 24–28)—lingers as a potential market-mover this week, as does Federal Reserve Chairman Ben Bernanke who will hold a press conference, a very unusual event for a Chairman of the Federal Reserve. Additionally, central banks in Australia, Iceland, India, the Czech Republic, Indonesia, as well as the European Central Bank (ECB) meet to set policy this week. Other than India, none of these central banks are expected to raise rates, although rising inflation in much of the developing world has put renewed focus on the actions of emerging market central banks in response to higher food and fuel prices.

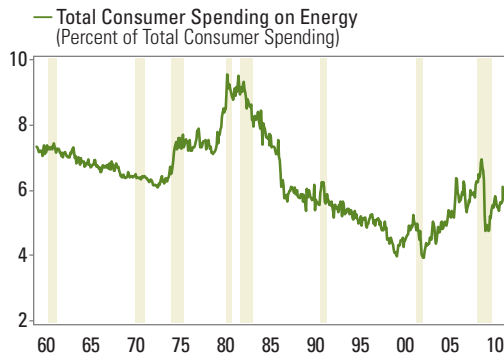
Back home in the United States, fiscal policy will continue to be at or near the top of the headlines, as the battle over the debt limit ceiling looms. In addition to the geopolitics and policy, a full slate of crucial economic data for December and January in the United States is due out this week. Data on consumer spending, inflation, manufacturing, construction and the labor market are all due out this week. The key report of the week is the employment report for January, on Friday, February 4. In China, a key report on manufacturing activity in January is set to be released late Monday night. Markets remained concerned about the pace of economic growth and, more importantly, inflation in China, and we continue to expect more policy tightening in China in the coming weeks and months.

### Will The Rise in Energy Prices Short Circuit the Recovery?

As this publication was being prepared, December data on consumer spending, personal income, and the Fed's preferred measure of inflation, the personal consumption expenditure (PCE) deflator, excluding food and energy, along with reports on manufacturing activity in Chicago, Milwaukee and Dallas in January were being released. Later in the week, the employment picture in early 2011 will come into focus, as first the Challenger layoff data for January, then the ADP employment report and finally the nonfarm payroll jobs report for January will be released. Unusually severe winter weather across large swaths of the United States in much of



### 1 Energy Spending As A Percent of Total Spending Is Rising, But Remains Well Below Early 80s and Mid-2008 Peaks



Source: Haver Analytics 01/31/11

(Shaded areas in chart indicate recessions)

January is likely to have an impact on the employment data and indeed all the economic data for January.

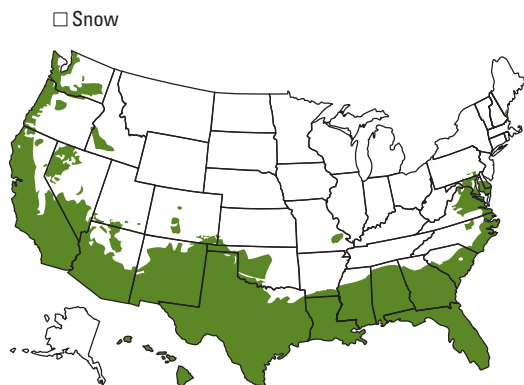
The income, spending and price data for December largely reinforced the Fed's case for continuing its program of quantitative easing. Income growth (at just 3.8% year-over-year) suggests that employment is growing too slowly, while the 0.7% year-over-year gain in the core PCE deflator in December remains well below the low end of the Fed's unofficial comfort zone for this metric, +1.5 to 2.0%. The Fed's decision to embark on a second round of quantitative easing was based on the idea that the Fed was not fulfilling either part of its dual mandate of low and stable inflation and full employment. The latest data on spending and inflation continues to show that while the economy is growing, and a recovery is underway, it remains tenuous. Our view remains that despite political pressure, the Fed will continue to pursue quantitative easing until it is slated to end in June 2011, but that the hurdle is high for the Fed to initiate yet another round of quantitative easing later this year.

One concern many market participants (and consumers) have had in recent weeks and months as oil and gasoline prices have moved higher is what impact these rising energy prices will have on the economy as a whole, and on consumer spending in particular. The data embedded in the monthly personal income and spending report released as this report was being prepared will likely shed some light on this. In December 2010, consumers spent \$646 billion (on an annualized basis) on gasoline, electricity, home heating oil, natural gas, etc. That figure represented just over 6.0% of total consumer spending. Since hitting a low of 4.8% of spending in late 2008/early 2009, energy spending by consumers as a percent of total spending has moved steadily higher, although it remains well below the peak hit in mid-2008 of 7.0%. [Chart 1] In dollar terms, U.S. consumers were spending \$710 billion (annualized) in mid-2008 (versus the aforementioned \$646 billion today) as oil prices hovered near \$150 per barrel, gasoline prices were above \$4 per gallon and natural gas was close to \$14 per BTU.

Today, oil prices are just below \$90 per barrel, gasoline prices are about \$3 per gallon and natural gas is running between \$4 and \$5 per BTU. A "shock" in the form of a cut in oil production and resulting sharp rise in consumer energy prices was one of the preconditions for the double-dip recession in 1980–82, and played a big part in the economic slowdown in late 2007 and early 2008 ahead of the worst of the financial crisis in late 2008/early 2009 that was precipitated by the collapse of Lehman Brothers in September 2008. On balance, while we are watching the rise of consumer energy prices closely, our view is they have not risen far enough or fast enough to suggest that the economy is headed for a double dip. In 2008 (and 1981, when the second leg of the double-dip recession ensued), the labor market was deteriorating, real incomes were stagnating, inflation, interest rates and, most importantly, consumer debt levels were high and rising. Today, the labor market is improving, real incomes are accelerating, and inflation, consumer interest rates and, most importantly, consumer debt levels, are falling.



## 2 In Mid January 2010, 70% of the United States Was Snow Covered



Source: National Oceanic and Atmospheric Administration 01/11/11

## January Jobs Report Likely To Be Impacted By Weather, Revisions

In the second half of the week, markets' attention will turn to the labor market. Reports on layoffs (as measured by the outplacement firm Challenger, Gray and Christmas) and private sector employment (as measured by ADP, the nation's largest payroll processing firm) for January will set the stage for the monthly employment report from the U.S. Department of Labor on Friday, February 4.

Unfortunately, the most closely watched data is likely to be beset with distortions this time around, making it even more difficult to interpret. The weather is the key wildcard for the report and could have a significant impact on the headline job count. Much colder and wetter wintery weather in most of the country in January [Chart 2] will most likely hold down the job count in weather-sensitive industries like retail, construction and leisure.

In the month of January, the weekly data on initial filings for unemployment insurance was heavily influenced by the weather. The employment indices in the various regional manufacturing indices during January (Chicago, Philadelphia, Empire State, Dallas, Richmond, etc.) were mixed at best, and many of these surveys cited poor weather as an influence on economic activity in the month. Markets will try to look past the weather impact and hope that February brings more "normal" winter weather, which would allow markets to simply average January and February's employment readings to get a better gauge of the underlying health of the labor market.

The January jobs report will also incorporate some methodological changes to the report, as well as the annual benchmark revision to the jobs data done each year to synch up tax records and payroll counts over the past several years. Both the establishment survey (which tallies the number of employees at businesses) and the household survey (which queries some 300,000 households about the employment status of the members of the household) are subject to revision. The revisions to the payroll survey are likely to show that 366,000 fewer jobs were created between March 2010 and December 2010 than was previously thought. Revisions and methodological changes may also impact the household survey, which is used to derive the nation's unemployment rate.



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