

Weekly Economic Commentary



February 07, 2011

Fighting the FED

Facing a limited domestic economic calendar this week, market participants in the United States are likely to focus on the still unfolding political crisis in Egypt, another round of corporate earnings reports in the United States, several key overseas central bank meetings, Chinese economic data for January, and a full slate of public appearances from Federal Reserve (Fed) officials. Amid an upside breakout in yields on U.S. Treasury notes, this week's \$72 billion Treasury auction of 3-, 10- and 30-year notes will draw close attention. (Please see this week's *Weekly Market Commentary* for insights on the recent rise in interest rates and the impact of rising rates on the equity market). In the absence of fresh data on the U.S. economy, markets will pay even closer attention to the weekly economic data on retail sales, mortgage applications and jobless claims, and continue to reflect on last week's heavy slate of data which included the monthly jobs report for January.

A Survey of Small Businesses Highlights a Quiet Economic Calendar

The week after the release of the monthly employment report is usually a quiet one for economic data in the United States, and this week is no exception. Although the market will digest reports on consumer credit outstanding, wholesale inventories, and imports and exports for December, none of the reports is likely to be market-moving, as the fourth quarter of 2010 is now a distant memory. Instead, markets may place more focus on the regular slate of weekly data on retail sales, mortgage applications and initial claims for unemployment insurance. Although this data is likely to again be impacted by severe winter weather, it will shed some light on how the economy was performing as January turned to February.

The National Federation of Small Business (NFIB) report on small business optimism for February is due this week, providing a more timely, though limited, view on small business in the middle of the first quarter of 2011. Heavily dominated by construction firms (roughly 20% of the respondents are construction-oriented while only 5% of the overall economy is construction-related), this index has moved steadily higher from its mid-2009 lows. The index is expected to tick up again in February but, on balance, small business optimism remains well below levels seen in the mid-2000s. Poor sales, difficulty obtaining credit, too much government regulation and taxes continue to weigh on small business optimism. Small businesses accounted for nearly two-thirds of all hiring over the past 20

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Highlights

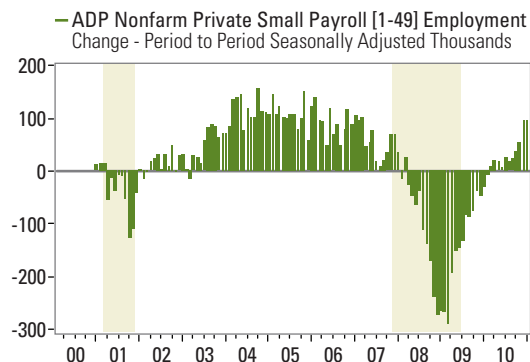
- A typically quiet post-employment report week for United States economic data lies ahead.
- Federal Reserve Chairman Ben Bernanke is in the hot seat this week in Congress.
- The January employment report was stronger than the headline indicated amid weather distortions.

Economic Calendar

Monday, February 7 Consumer Credit <i>December</i>	Friday, February 11 Trade Balance <i>December</i>
Thursday, February 10 Initial Claims <i>wk 02/05</i>	U of Mich Consumer Sentiment <i>February</i>
Wholesale Inventories <i>December</i>	
Treasury Statement <i>January</i>	



1 Hiring At Small Businesses Has Been Muted



Source: ADP/Macroeconomic Advisers/Haver 02/07/11

(Shaded areas indicate recession)

While overall GDP growth in the emerging markets is expected to be in the 6.0% to 7.0% range in 2011, despite a modest deceleration in growth in China from close to 10.0% in 2010 to 9.5% in 2011.

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years, and have only recently (and tentatively) begun adding to payrolls, according to the ADP survey of small business hiring. [Chart 1]

Overseas, the end of the Lunar New Year celebration in China brings economic reports on Chinese imports and exports for January, and opens the door for more interest rate increases and other policy actions designed to slow inflation in China. Elsewhere, central banks in the United Kingdom, The Philippines, and South Korea meet this week to decide policy. The Bank of England (BOE) is in easing mode, but the consensus is looking for higher rates out of the BOE by year-end. The South Korean central bank has been raising rates since mid-2010 and surprised markets with a rate hike in mid-January. Another rate hike is expected this week. No rate hike is expected in the Philippines. Despite 7.0% GDP growth, the inflation rate remains in check at around 3.0%. GDP growth in the Philippines, an emerging market nation, is expected to decelerate to around 5.0% in 2011, while overall GDP growth in the emerging markets is expected to be in the 6.0% to 7.0% range in 2011, despite a modest deceleration in growth in China from close to 10.0% in 2010 to 9.5% in 2011.

Ben Bernanke in the Hot Seat This Week

The Fed will remain in the headlines this week, as several key Fed officials are slated to make public appearances. Markets will likely focus on a speech by Dallas Fed President Richard Fisher on Tuesday, February 8, and Fed Chairman Ben Bernanke's testimony before noted Fed critic Congressman Ron Paul's House Budget Committee on Wednesday, February 9. Last week, Fisher, a well-known inflation "hawk" (a policy maker more likely to be worried about too much inflation than not enough growth), stated that he would not support another round of quantitative easing when the current round of quantitative easing ends in June.

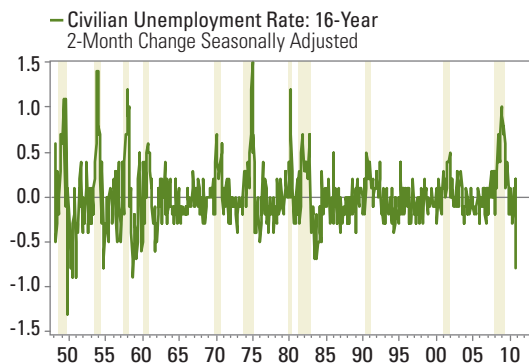
Quantitative easing is also likely to be a key topic of discussion when Fed Chairman Bernanke is questioned by Congressman Paul. Paul is a well-known Fed critic, is not in favor of QE2, and is author of a book called "End the Fed." Paul will likely push Bernanke on the Fed's transparency and also call for a full audit of the Fed, which Bernanke has strongly opposed in the past. It should make for an interesting Wednesday morning in Washington.

The January Employment Report Was Stronger Than the Headline Suggested

The January employments report (released on Friday, February 4) was beset with the same weather-related problems that impacted most of the other data we have in hand for January 2011. Our basic view on the labor market—the economy is growing quickly enough to generate some job growth, but not quickly enough to generate enough job growth to satisfy the Fed—was unchanged by the report. Much of the weakness in the January employment report, including the meager 36,000 gain in employment between December and January, can be explained away by foul weather. Expectations were for the economy to create more than 140,000 jobs in the month. It marked the eighth consecutive January in which the job count fell short of expectations.



2 The 0.8 Percentage Point Drop in the Unemployment Rate in December and January Was the Largest Two-Month Drop in More Than 50 Years



Source: Bureau of Labor Statistics/Haver 02/07/11

A quick refresher to remind readers that the monthly jobs report is actually derived from two surveys, each of which surveys an unusually large number of businesses and households relative to other nationwide polling done, for example, in Presidential elections. The monthly job count is derived from a monthly survey of approximately 140,000 businesses and government agencies representing approximately 440,000 worksites throughout the United States. This is referred to as the “establishment survey.” The household survey, which provides us with the unemployment rate, uses a sample of 60,000 households. The data are collected by personal and telephone interviews. By comparison, national polling on presidential races poll only around 1,000 or so individuals.

There were signs behind the headlines of the report that the underlying health of the labor market continued to improve. Bucking a strong three-decade trend, the December job count was revised higher. In 23 of the last 31 years (dating back to 1980), the December jobs count was revised down along with the release of the January data. In addition, three “weather-sensitive” areas of employment (construction, transportation and leisure) saw a combined 75,000 drop in employment in January relative to December. Over much of 2010, these three sectors combined added around 25,000 jobs per month. The 100,000 swing between the “normal” gain of 25,000 per month for most of 2010 and the 75,000 drop in January (largely due to weather) accounted for all of the disappointment (relative to expectations) in January.

Digging a little deeper, there was also some good news about the underlying health of the labor market in the “household survey.” The household survey revealed that the unemployment rate dropped by 0.4 percentage points in January 2011 to 9.0%. The 0.8 percentage point drop in the unemployment rate over the past two months (December 2010 and January 2011) was the steepest two-month drop in the unemployment rate since 1958. The only other time in the last 50+ years that came close to matching the 0.8% drop over a two-month period was in mid-1983, as the unemployment rate dropped 0.7 percentage points in what turned out to be the start of a very robust recovery in the labor market.

There are certainly reasons to cast some suspicion on the big drop in the unemployment rate since nearly one million people were unable to work in January due to bad weather, according to the household survey, nearly five times the normal amount in a typical January. The Fed and the markets will be watching to see if the unemployment rate continues to drift lower from here in the next several months amid more “normal” weather. If so, the view held by us, the Fed and, to some extent, the consensus of a tepid labor market may be challenged and suggest the labor market is improving more rapidly than is now thought.

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