

Weekly Economic Commentary



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Gauging The Fed

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Highlights

- Financial markets' attention will be split between overseas events and domestic data and policy this week.
- A closer look at Fed Policy in 2011 and 2012.
- Last week's data continues to suggest solid economic growth in the United States for the first quarter of 2011.

Economic Calendar

Monday, March 21

Existing Home Sales
February

Tuesday, March 22

Richmond Fed Index
March

Wednesday, March 23

New Home Sales
February

Thursday, March 24

Durable Goods Orders
and Shipments
February

Initial Claims
wk 03/19

Friday, March 25

GDP Price Index
Q4

Real GDP
Q4

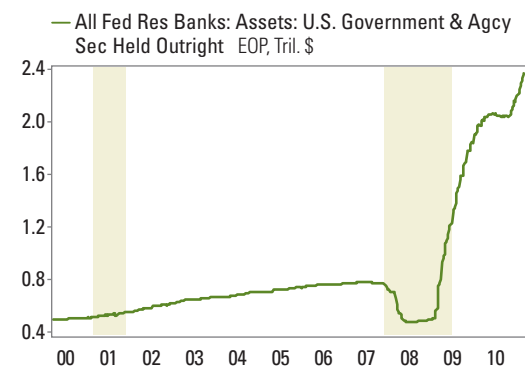
U of Mich
Consumer Sentiment
March

The attention of financial market participants will be split between the relatively light economic calendar in the United States and continuing to assess the implications of the earthquake in Japan and its aftermath along with the escalation of the conflict in Libya. In addition, U.S. monetary policy could move to the forefront this week, as Federal Reserve Board (Fed) Chairman Bernanke and two noted inflation "hawks" on the Federal Open Market Committee (FOMC), Charles Plosser from Philadelphia and Richard Fisher from Dallas, are scheduled to make public appearances. Although Congress is out of session this week, the release of the United Kingdom's budget at midweek may refocus attention on the U.S. budget situation. Elsewhere overseas, it is a quiet week for Chinese economic data, as market participants continue to gauge how much longer China's central bank will be moving interest rates higher to slow growth and rein in domestic inflation. Several overseas central banks are set to meet this week, including the Philippines, South Africa, and the Czech Republic. Of that group, only the Philippines is likely to raise rates.

This week's data in the United States includes new and existing home sales and durable goods orders for February, as well as the weekly data on initial claims, retail sales and mortgage applications for mid March. All of the data will be scoured by markets looking for impact from the earthquake in Japan and rising consumer energy prices. There have already been several company specific announcements (mainly in the automotive and technology sectors) related to supply-chain disruptions caused by the earthquake, tsunami and nuclear crisis in Japan. With the corporate earnings reporting season for the first quarter of 2011 right around the corner, we would not be surprised to see an increasing number of firms announce some type of disruption to their operations due to the situation in Japan. The economic data in the United States (and elsewhere) could also potentially be impacted by these temporary supply chain disruptions as well. As we wrote last week, markets did not expect much in the way of growth in the world's third largest economy prior to the catastrophe (and have not for many years) and now, in the short term, growth prospects in Japan have been diminished further. Over the medium term, however, as the affected infrastructure (roads, ports, electrical grid, railways, homes and buildings) are rebuilt, the economy in Japan (and globally) is likely to get a lift, but the longer-term prospects in Japan remain muted. The financial costs of rebuilding are only likely to further negatively impact growth and financial flexibility in the years to come.



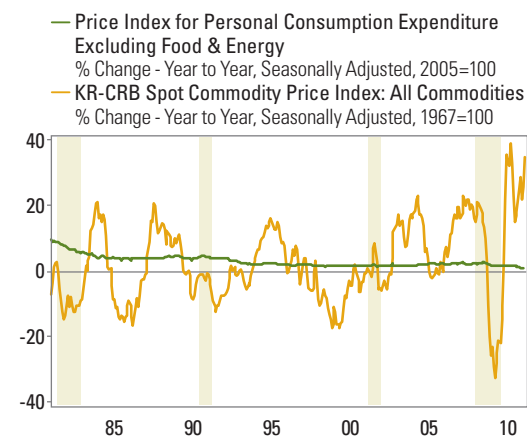
1 A Decrease in the Size of the Fed's Balance Sheet Would Send a Signal of Tighter Monetary Policy



Source: Federal Reserve Board/Haver Analytics 03/21/11

(Shaded areas indicate recession)

2 Historically, There Has Been Very Little Pass through of Higher Commodity Prices into Core Consumer Prices



Source: Bureau of Economic Analysis/CRB 03/21/11

(Shaded areas indicate recession)

The CRB Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

A Closer Look at Fed Policy in 2011 and 2012

Turning to the Fed, the noticeable improvement in the economic data so far this year, along with a measurable uptick in readings on core inflation (inflation excluding food and energy), already has some market participants debating the timing of the Fed's first policy tightening. Unlike in past Fed tightening episodes, where the Fed only had one policy lever at its disposal (typically the fed funds rate or earlier, the discount rate) this time around the Fed has several levers to tighten policy, including the size of its balance sheet and the Fed funds rate. The market puts the Fed's first rate hike in March 2012, we think it could come closer to the middle of 2012. We expect the Fed to maintain the size of its balance sheet over the second half of 2011, but the Fed is likely to begin to shrink its balance sheet in late 2011 or early 2012, by not reinvesting coupons of the Treasuries and mortgage-backed securities it owns or the proceeds of maturing holdings back into the marketplace. The signal of a shift toward allowing its balance sheet to shrink could come as soon as the June FOMC meeting. Any such move will be data dependant, and also dependant on the progression of the FOMC's economic forecasts.

Supporters of action by the Fed to tighten policy sooner rather than later are likely to be emboldened this week when Charles Plosser and Richard Fisher (policymakers more concerned about rising inflation than they are about rising unemployment and slower growth) take the stage this week. Both men are voting members on the FOMC, and both have been critics of QE2. However, at the two FOMC meetings held so far this year, neither Plosser nor Fisher has voted against continuing QE2. Both, however, have made it clear that they would very likely vote against starting another round of QE in June, when QE2 expires. As we have been saying for many months now, the hurdle to end QE2 is high but the hurdle to begin QE3 in June 2011 is even higher, although the odds have moved up slightly with the quake in Japan and higher oil prices acting to crimp growth.

Fed Chairman Bernanke is also on the docket this week, and may provide insight into how the earthquake (and its aftermath) in Japan is likely to impact the global economy, and in particular the United States economy in the coming weeks and months. Bernanke is also likely to continue to make the case that the recent rise in energy and commodity prices is transitory and that the pass through into higher core inflation is unlikely. In the past there has been little pass through of rising commodity prices into overall CPI inflation and even less pass through into the Fed's preferred measure of inflation, the personal consumption expenditure deflator excluding food and energy [Chart 2].

Looking ahead, the market will digest the minutes of the March 15 FOMC meeting on April 5. Those minutes are also likely to contain a discussion of the FOMC's initial assessment of the Japanese earthquake and aftermath on the global economy. The next Beige Book is due out on April 13, and the next FOMC meeting is set for April 27. The FOMC will produce another quarterly forecasts of the economy, inflation and the unemployment rate at the April 27 FOMC meeting. That forecast (which may set the stage for the first steps toward policy tightening) will be released in mid May 2011.



Economic Growth in the First Quarter of 2011 Still Looks Solid

U.S. economic data and policy events took a back seat to global events (Japan quake and aftermath, escalation of the conflict in Libya, and ongoing turmoil in the Middle East) last week (March 14–18). The data on manufacturing released in the United States last week (Empire State Manufacturing and Philly Fed Manufacturing Indices for March and industrial production for February) suggested that the manufacturing sector remains strong and prospects for more robust growth in the coming quarters are solid as well. The price data for February (PPI and CPI) showed that rising raw materials' prices continue to push input costs higher, but that there has been little pass-through to the end consumer, especially on core inflation. The index of leading indicators for February also suggested more solid economic growth over the next nine to twelve months, and the weekly readings on unemployment insurance, mortgage applications and retail sales continued to show little impact from rising energy prices on the job market or consumer spending. The economy is on track to post a 3.0 to 3.5% gain in Q1 2011.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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.

Empire State Manufacturing Survey is a monthly survey of manufacturers in New York State conducted by the Federal Reserve Bank of New York.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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 Commodity Research Bureau (CRB) Index is an index that measures the overall direction of commodity sectors. The CRB was designed to isolate and reveal the directional movement of prices in overall commodity trades.

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