

Weekly Economic Commentary

May 9, 2011



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Highlights

- April Inflation Reports highlight a busy week for data.
- Despite a solid April job report, the road to a full labor market recovery is a long one.

Economic Calendar

Tuesday, May 10

Import Price Index
April

Wholesale Inventories
March

National Federation
of Independent
Business Sentiment
April

Wednesday, May 11

Trade Balance
March

Treasury Statement
April

Thursday, May 12

Retail Sales
April

Initial Claims
wk 05/07

PPI
April

Business Inventories
March

Friday, May 13

CPI
April

U of Mich
Consumer Sentiment
May

Inflation Is Key This Week

Reports on April inflation dominate this week's economic calendar, but China's economic calendar and a possible rate hike in China are also on the market's radar. The April jobs report was solid (not spectacular), but it is still a long climb back for the labor market.

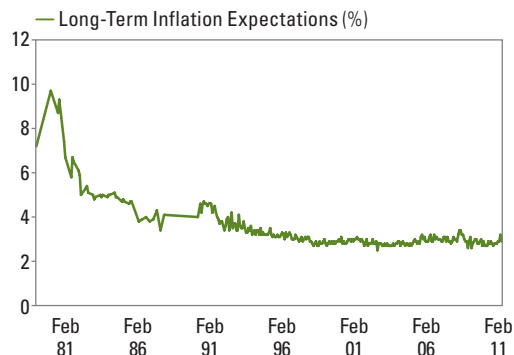
As we noted in last week's *Weekly Economic Commentary*, the first week of every month is chock full of timely economic data. The busy first week of the month usually gives way to a quiet "week after," but that is not the case this week (May 9–13, 2011). Market participants have plenty of data to digest as they mull over last week's data, which included the April jobs report, and market action, headlined by the plunge in commodity prices.

The key reports this week in the U.S. are on inflation and inflation expectations, but data on the March trade balance and April retail sales will garner plenty of attention as well. In addition, this week is when Chinese authorities release most of their economic data for April. The full slate of economic data in China coincides with the 2011 United States-China Strategic and Economic Dialogue in Washington, D.C. China's currency and interest rate policies as well as the U.S. fiscal policy are likely to be among the key topics of conversation at the summit. Markets are still anticipating another few interest rate hikes from the Chinese central bank, the Peoples Bank of China (PBOC), and the next move could come at any time. Accelerating inflation in China (5.2% year-over-year CPI inflation expected in China in April) is pushing the PBOC to act and inflation data for April due out in the U.S. this week could put similar pressure on the Federal Reserve (Fed).

April readings on the Consumer Price Index (CPI) and producer price index (PPI) are due out this week in the U.S., along with the early May reading on consumers' inflation expectations from the University of Michigan's Survey of Consumers. The year-over-year readings on the PPI and CPI are going to grab plenty of attention, with the PPI likely to post a 6.5% year-over-year gain and the CPI a 3.1% year-over-year increase. Both indices are being driven higher by surging energy and commodity prices, although the gap between the PPI (6.5% year-over-year) and CPI (+3.1% year-over-year) underscores the "firewall" between higher commodity costs and the consumer. We'll discuss this firewall effect later in this report.

Beyond what are likely to be startlingly large increases in the headline PPI and CPI, the core (excluding food and energy) readings on both are expected to be muted, which should give the Fed comfort. Still, in our view, Fed policymakers face a communications (and potentially a credibility)

1 Long-Term Inflation Expectations Have Been Stable for 10 Years at Around 2.9%



Source: Bloomberg, University of Michigan 05/09/11

In addition, the report serves as a reminder that while unemployment claims—which have moved higher in recent weeks raising concerns about a “double dip” recession—are a great, timely indicator of the health of the labor market, they say more about the unemployment rate than they do about the pace of hiring.

problem as headline inflation surges but core inflation—which is what the Fed focuses on when making monetary policy decisions—remains tame. Although our view is that Fed Chairman Bernanke did a solid job in his first-ever post Federal Open Market Committee (FOMC) press conference on April 27, his response to the questions around headline versus core inflation was not convincing. Bernanke has another chance to answer these types of questions following the June 22 FOMC meeting.

At the aforementioned April 27 press conference, Bernanke did mention that Fed policymakers were closely monitoring inflation expectations. One very timely measure of inflation expectations can be found in the University of Michigan’s Survey of Consumer Sentiment. That survey asks consumers what their expectations are for inflation over the next year and five years. The Fed typically focuses on the five-year number. Consumer’s five year ahead inflation expectations have been stable for the past ten to 15 years, after falling sharply between the late 70s and early 80s through the late 90s. The latest reading, at 2.9%, is right at the average reading over the last ten years or so. The Fed has made it clear that any upward move in inflation expectations would be met with tighter monetary policy, which makes this data point from the University of Michigan one of the most important indicators for market participants to monitor as the Fed prepares to remove the monetary stimulus from the system.

Solid April Jobs Report, but it is Still a Long Climb Back for the Labor Market

The private sector economy created 268,000 jobs in April, the 14th consecutive monthly gain. The result was better-than-expected and represented acceleration in job creation versus the prior month. A portion of the gain in jobs in April may have been related to the late Easter (April 24) in 2011 versus 2010 (April 4), which pushed some retail and lodging and leisure hiring into April this year, but the impact of the Japanese earthquake on the global supply chain may have held down hours worked and some hiring in the United States. State and local government hiring remains the weak spot in the employment market, as another 22,000 were lost here, bringing the total number of jobs shed in the state and local government sector since the end of the recession to nearly 430,000.

While not a booming report on the health of the labor market, the April jobs report (released Friday, May 6) suggests that the United States labor market weathered higher oil prices and the supply chain disruptions in Japan quite well thus far. In addition, the report serves as a reminder that while unemployment claims—which have moved higher in recent weeks raising concerns about a “double dip” recession—are a great, timely indicator of the health of the labor market, they say more about the unemployment rate than they do about the pace of hiring. Adding to the positive backdrop for the global economy was the April labor market report for Canada, which was also released on Friday, May 6. The Canadian economy added 58,000 jobs in April, which given the size of the respective economies, is the equivalent of 450,000 new jobs in the United States. The result far



exceeded expectations and serves as further confirmation of continued growth in the global economy in the months and quarters ahead.

The monthly jobs report from the United States Department of Labor is actually two reports in one, which is why the unemployment rate can rise even as the number of jobs increases. The unemployment rate (the number of unemployed persons divided by number of persons in the labor force) is calculated using the "household survey," which tallies responses from 60,000 households each month (a huge number for a nationwide sample, where political polls typically survey around 1,000 people to garner data for national political races) asking them about their employment status. This month, the number of unemployed persons increased by 205,000 while the labor force increased by 15,000, leading to the higher unemployment rate. At 9.0%, the unemployment rate is below its recent peak of 10.1% (hit in the fall of 2009), but remains above the Fed's 8.5% target for the unemployment rate for the fourth quarter of 2011.

The job count data (discussed below) is collected via the "establishment survey," which surveys 140,000 businesses and asks them about the composition of their payrolls. Over time, these two surveys ("household" and "establishment") tend to converge and tell the same story about the labor market, but over shorter periods (a month or a quarter) they can send conflicting signals.

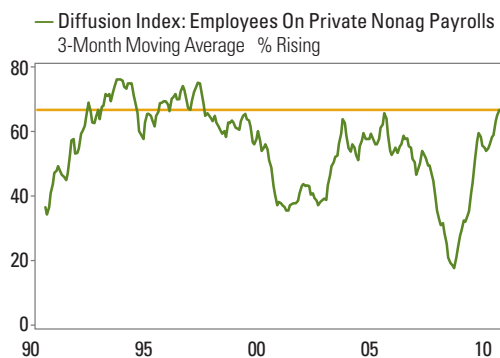
The April gain in private sector jobs was the most in any single month since February 2006. Over the past three months, the private sector economy has added an average of 253,000 jobs per month, also the best reading since early 2006. Encouragingly, the diffusion index (the number of industries adding workers less the number of industries shedding workers) ticked up to 64.6 in April from 64.4 in March. Over the past three months, the diffusion index indeed has averaged 66.6, the highest reading since 1998, when the United States economy was booming. This solid reading is further confirmation that the United States labor market recovery is well underway and firmly entrenched even in the face of rising input costs and the global supply chain disruptions as a result of the earthquake and tsunami in Japan. However, the labor market still has a long way to go.

The private sector has added 2.1 million jobs in last 14 months (March 2010 through April 2011) after the private sector economy lost 8.8 million between December 2007 and February 2010. This is the best 14-month run for job creation since September 2005 through October 2006, but there is still a long, long way to go (6.7 million) to get back all the 8.8 million private sector jobs lost.

At current pace (253,000 per month over last 3 months) it will take another two years and two months to get those 6.7 million jobs back. That's June 2013, or five and a half years after the peak in employment in December 2007.

By comparison, it took the economy four and a half years to get back to peak employment after the mild 2001 recession, and around three years after the mild 1990–91 recession, and less than three years to recover all the jobs lost in the severe 1981–82 recession.

2 The Number of Industries Hiring Workers Minus the Number of Industries Shedding Workers Hit a 13-Year High



Source: Bureau of Labor Statistics/Haver Analytics 05/09/11



The sluggish pace of job creation (relative to prior recoveries) is one of the reasons why this does not feel like a recovery yet to many people. This same phenomenon is also helping to keep wages muted, which acts as a firewall against soaring input prices being passed along to the end consumer. Finally, the tepid pace of job growth (and the still historically high percentage of people who have been out of work for more than six months) will resonate with the policymakers at the Fed, who are likely to be cautious about removing the stimulus too soon.

IMPORTANT DISCLOSURES

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Stock investing involves risk including loss of principal.

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.

Producer Price Index (PPI) is an inflationary indicator published by the U.S. Bureau of Labor Statistics to evaluate wholesale price levels in the economy.

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