

Weekly Economic Commentary

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Highlights

- Economic data and earnings may take a back seat to policy concerns this week.
- Real gross domestic product is poised to move past the pre-recession peak in the fourth quarter of 2010.
- The President's State of the Union speech may reignite the budget debate.
- The Federal Reserve meeting this week could reveal more dissent on policy.

Economic Calendar

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| Tuesday, January 25 | Initial Claims <i>wk 01/22</i> |
| Consumer Confidence <i>Jan</i> | Pending Home Sales <i>Dec</i> |
| Richmond Fed Index <i>Jan</i> | Friday, January 28 |
| State of the Union Address | ECI <i>Q4</i> |
| Wednesday, January 26 | Core PCE Deflator <i>Q4</i> |
| New Home Sales <i>Dec</i> | Real GDP <i>Q4</i> |
| FOMC Decision | Thursday, January 27 |
| Durable Goods Orders <i>Dec</i> | U of Mich Consumer Sentiment <i>Jan</i> |

Policy Week

Monetary and fiscal policy may dominate headlines this week, even as market participants absorb more than 128 fourth quarter earnings reports from S&P 500 companies and a busy slate of economic data. In addition, several major central banks meet to set policy including the Bank of Japan, the Reserve Bank of New Zealand and Norway's central bank, Norges Bank. Both Norway and New Zealand have already raised rates in this cycle, and no rate increases are expected this week. There is no economic data due in China this week, as the country approaches its Lunar New Year holidays, which begins on February 2. The next key economic release in China is the Chinese Purchasing Managers Index for January 2011, due out on Monday, January 31.

This week's economic data in the United States is an eclectic mix of reports on housing, consumer confidence, labor costs, and manufacturing activity as 2010 ended and 2011 began. Although "old news" at this point, the financial media is likely to focus on Friday's release of gross domestic product (GDP) data for the fourth quarter of 2010. The consensus is looking for a 3.5% quarter-over-quarter gain in real GDP in the fourth quarter of 2010 relative to the third quarter, a marked acceleration from the 2.6% rate of growth in the third quarter. Estimates range from a low of 2.9% growth to a high of 5.9% growth in the fourth quarter. [Chart 1]

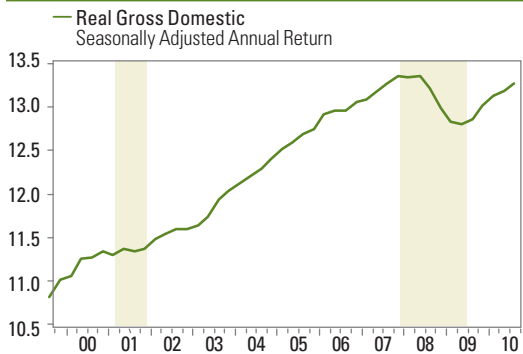
We estimate GDP growth accelerated to 4.0% in the fourth quarter, after averaging about 2.5% over the first three quarters of 2010. One highlight of the GDP report is likely to be that consumer spending in the fourth quarter of 2010 is on track to outpace business spending for the first time since early 2009. In addition, a growth rate of real GDP faster than 2.6% in the fourth quarter will push the level of real GDP back above its pre-recession peak, hit in late 2007, after adjusting for inflation. The level of nominal (i.e., non-inflation adjusted) GDP moved past its prior peak in mid-2010. As highlighted in our 2011 Outlook, our view for economic growth in 2011 is that real GDP growth will be near the long-term average at 2.5–3%.

State of the Union Address May Reignite the Budget Battle

President Obama's State of the Union address on Tuesday, January 25 will help to usher in the budget season in Washington and could reignite talk of a battle of the debt ceiling and a potential government shutdown sometime in late winter or early spring 2011. While the State of the Union speech is the unofficial start of the budget season and the timeline for the budget process over the next several months is set, the only deadline investors



1 Real GDP Poised To Move Higher Than Pre-Recession Peak



Source: Bureau of Economic Analysis/Haver 01/24/11
(Shaded areas in chart indicate recessions)

are going to worry about is the debt ceiling limit deadline, which may occur anytime between mid March and mid May 2011.

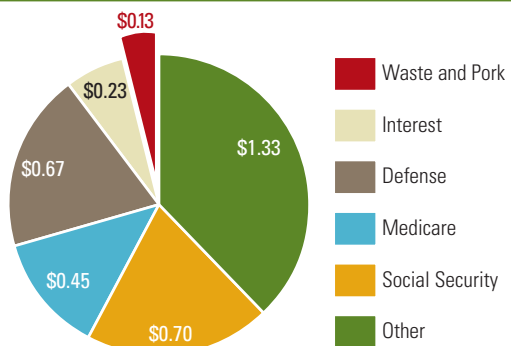
President Obama will release his proposed budget for fiscal year (FY) 2012 in mid-February and shortly thereafter, the house Republicans will release their own vision for the nation's finances for fiscal year 2012, which begins on October 1, 2011. This week, just after the President's State of the Union address, the non-partisan Congressional Budget Office (CBO) will release its 2011 budget and economic outlook on Wednesday, January 26, and in March 2011, the CBO will release its analysis of the President's budget.

One thing is for sure, neither the President's budget nor the House Republicans' version will be passed into law anytime soon. While there was a flurry of healthy conversations in Washington in late 2010 as several bi-partisan commissions released deficit reduction plans, talk of balanced budgets faded soon thereafter, as the President and House Republicans agreed to a deal that:

- Extended the Bush tax cuts for two years
- Extended unemployment insurance benefits for a year
- Cut payroll taxes by 2 percentage points
- Provided tax incentives for businesses to make purchases of capital equipment in 2011

2 Eliminating Waste, Fraud, Abuse, and Pork from Budget a Good Start, But Not Enough to Meaningfully Reduce the Deficit

\$ Trillions



Source: Congressional Budget Office, LPL Financial Research 01/24/10

According to the non-partisan CBO, that deal also raised deficit estimates for FY 2011 (which ends on September 30, 2011) by close to \$400 billion and did little or nothing to address the nation's long-term deficit problem, which is too much spending on mandatory programs like Social Security, Medicaid and especially Medicare, and not enough revenue. And while we applaud recent efforts by some members of Congress to focus attention on "waste, fraud and abuse" and political "pork" in the Federal budget, the fact is that "waste, fraud and abuse" along with pork barrel projects (earmarks) together account for only a small portion of the \$3.5 trillion budget. Recent non-partisan studies pegged waste, fraud and abuse in the Federal budget at anywhere between \$75 billion and \$100 billion per year. Earmarks are close to \$20 billion per year. [Chart 2]

While waste, fraud, and abuse, along with earmarks total an enormous sum (\$100 to \$125 billion) on an absolute basis, relative to the total federal outlays of close to \$3.5 trillion dollars, they are literally just a rounding error. Again, we applaud the effort to root out waste from the Federal budget process, but in order to make any real progress on bringing the budget back into balance, many difficult choices lie ahead.

We expect the debt-ceiling limit to be an almost daily topic of conversation in the markets and in the financial media between now and the spring of 2011. Normally, the raising of the limit on the debt ceiling is a non-event for markets, but because deficits are in the news (here and abroad) and because the newly elected House GOP ran on deficit reduction, there is a risk that the debt ceiling debate could lead to a government shutdown. On the positive side, a government shutdown could pave the way for a more substantive discussion of the debt and deficit, and prompt some significant action. On the downside, the debate may unnerve some foreign investors, who hold half of our federal debt.



However, we do not expect the debate on the raising of the debt limit to lead to actions that significantly reduce entitlement spending and the deficit anytime soon, although the odds are not zero. The best guess is that the 2012 election cycle will provide the platform for a more substantive discussion of entitlement reform and what its consequences for taxes and spending, so that some progress can begin to be made in 2013.

Dissent Drives the Debate

Our view remains that the hurdle for the Fed to end QE2 early is high, and the hurdle to start QE3 in June 2011 is even higher.

While the outcome of the Federal Open Market Committee (FOMC) meeting is not in doubt—the FOMC will leave interest rates unchanged and continue its program of quantitative easing—the details of the meeting could attract attention. Even though Fed Chairman Ben Bernanke has more than enough votes on the 12-member FOMC to continue QE2, there is likely to be discussion that is more heated and dissent at this FOMC meeting. Despite the increased rhetoric around in the Fed, our view remains that the hurdle for the Fed to end QE2 early is high, and the hurdle to start QE3 in June 2011 is even higher.

During his one-year tenure as a voting member on the FOMC in 2010, Thomas Hoenig, the president of the Kansas City Fed, voted against the second round of quantitative easing, QE2, and keeping rates near zero at each of the eight FOMC meetings. While Hoenig will rotate off of the FOMC as a voting member this week, two new members of the FOMC, Philadelphia Fed president Charles Plosser and Dallas Fed President Richard Fisher—who are noted inflation hawks and critics of QE2—are potential “dissenters” that will move on to the committee as voting members. Thus, we would not be surprised to see at least one, and possibly two dissents in the statement accompanying the FOMC decision on Wednesday, January 26.

The FOMC also prepares economic forecasts four times a year, and will be preparing a forecast at this week’s meeting. The FOMC is likely to upgrade its view of the economy and express some optimism about employment, but continue to note that while raw materials costs have risen, businesses have in large part been unable to pass these increases on to consumers. The bottom line is that the FOMC is likely to note that while the economy has improved since the last FOMC meeting in December, it is not growing quickly enough to push the unemployment rate down meaningfully or the core inflation rate up meaningfully. The forecast made at this week’s FOMC meeting will be released along with the minutes of that meeting on February 16. The release of the minutes of this week’s FOMC meeting will precede Fed Chairman Bernanke’s high-profile monetary policy testimony to Congress in mid to late February. Bernanke is likely to face withering questioning from House members on both sides of the aisle who oppose QE2 and Fed intervention in the economy.



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