

Weekly Economic Commentary



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High Hopes

John Canally, CFA

Economist
LPL Financial

Highlights

- Expectations for this week's United States economic data are high.
- The U.S. trade gap with China remains a political issue.
- Consumer balance sheet repair continues, as net worth continues to improve.

Economic Calendar

Monday, December 13	Industrial Production <i>November</i>
Fed Discount Rate Meeting	
Tuesday, December 14	NAHB Housing Survey <i>December</i>
Retail Sales <i>November</i>	
	Thursday, December 16
PPI <i>November</i>	Current Account Balance <i>Q3</i>
Business Inventories <i>October</i>	Building Permits <i>November</i>
FOMC Decision	Housing Starts <i>November</i>
Wednesday, December 15	Initial Claims <i>wk 12/11</i>
NY Fed Empire State Mfg <i>December</i>	Philly Fed Index <i>December</i>
Consumer Price Index <i>November</i>	Friday, December 17
Capacity Utilization <i>November</i>	Leading Indicators <i>November</i>

Each December, the U.S. government's "data mills"—the agencies like the Bureau of Labor Statistics, the Bureau of Economic Analysis, the Bureau of the Census and the Federal Reserve Board (Fed) that crank out report after report on the United States economy each month—cram a month's worth of data into just two weeks to accommodate the yearend holiday season. This year is no different. After a "week off", the government data mills will make a final push this week, as no fewer than 11 major reports on the economy are due out.

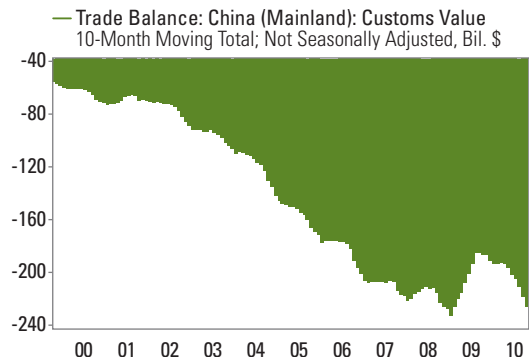
Despite several recent high profile reports on the economy in November (Employment and ISM) that disappointed markets, expectations for this week's economic reports are quite high. About 85% of this week's economic data in the United States, which includes data on manufacturing, housing, retail sales, leading indicators and inflation, is expected to accelerate versus the prior month, setting the bar fairly high for market expectations. Although most of the talk of a double-dip recession in the United States—widespread over the summer months—has faded in recent weeks, this week's combination of elevated expectations and a full slate of data may provide the "double dippers" with some more talking points. In our view, we would view any weakness in the economic data to be transient and any renewed talk of a "double dip" recession as misplaced.

In addition to the crowded economic calendar in the United States, eight global central banks—including the Federal Reserve—will meet this week to set policy for the final time in 2010. Only two of the eight, Chile and Sweden, are expected to raise rates. Chinese monetary authorities raised the reserve ratio requirement for its banks by 50 bps late last week, ahead of a run of stronger than expected November economic data in China.

The increase in reserve requirements, or the amount banks must hold in reserve when making new loans, in China last week was the sixth increase this year, and the third in the past four weeks, as China tries to cool its economy, especially the property lending market. The increase in the reserve requirement is less significant than the rate hike that most market participants have been expecting for several weeks now. Last week's action on the reserve requirement does not preclude a rate hike in China in the coming weeks, and a rate hike in early 2011 is still in the cards. China engineered its first rate hike of this cycle in October of 2010.



1 The United States' Ever-Widening Trade Gap With China Is A Potential Threat to Global Growth



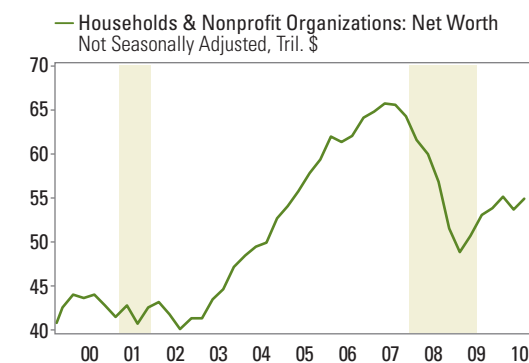
Source: Census Bureau/Haver Analytics 12/13/10

United States Trade Deficit Unexpectedly Narrowed in October, But Our Large Trade Imbalance With China Remains a Potential Flashpoint

China's booming economy figured into at least one of the few economic data reports released last week in the United States, the October trade balance data. The U.S. trade deficit unexpectedly narrowed between September and October (as exports surged and imports cooled), which sent forecasters scrambling to raise their forecasts for fourth quarter gross domestic product (GDP) growth. A narrower trade deficit adds to GDP growth, while a wider deficit subtracts from growth. Heading into the quarter, most forecasters expected no help from the net export sector in the fourth quarter of 2010. The improvement in the October trade report—if sustained over the remainder of the quarter—suggests that the net export sector will add between 0.5 and 1.0 percentage points to GDP growth.

Contributing to the unexpected narrowing of the trade deficit between October and November was the narrowing of our trade deficit with China. The United States' trade deficit with China narrowed to \$36 billion in October from \$28 billion in September, but in the first 10 months of 2010, our trade gap with China stands at a whopping \$227 billion, nearly \$40 billion wider than in the similar period in 2009. This yawning trade gap, and China's lack of flexibility on its exchange rate, is likely to continue to draw the ire of Congress. A rise in protectionism would present a major threat to the global economic recovery.

2 The \$6 Trillion Rebound in Household Net Worth Since Early 2009 Helps to Explain Resilient Consumer Spending



Source: Federal Reserve Board/Haver Analytics 12/13/10
(Shaded areas in chart indicate recessions)

Consumers Continue To Make Good Progress in Working Down Their Debt Burden

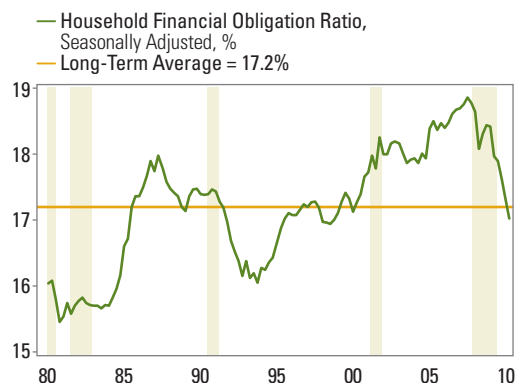
One of the key drivers of the better-than-expected consumer spending data in 2010 has been the recovery in consumer net worth since the depths of the Great Recession in late 2008 and early 2009. Consumer net worth, defined as household assets (cars, houses, financial assets including stocks) less household liabilities (mortgage debt, credit card debt, consumer loan debt), posted another quarter-over-quarter gain in the second quarter of 2010 and has now posted quarterly gains in five of the past six quarters dating back to early 2009. Since hitting a five-year-low at just under \$49 trillion in Q1 2009, consumer net worth has increased by \$6 trillion, and stands at just under \$55 trillion.

The increase in consumer net worth is a result of higher asset prices (equity prices up 90%+ from their lows and home prices up 4-5%), combined with a drop in liabilities. While some of the drop in liabilities is certainly involuntary (consumers walking away from mortgages, consumer loans and credit card debt), some of the big drop (\$623 billion) in household liabilities since mid 2008 reflects a healthy, voluntary paring down of debt by consumers.

While the consumer net worth data is somewhat stale—the latest data available is for the second quarter of 2010—the monthly report on consumer credit outstanding (which was released last week) can provide a fresher look at the state of consumer finances. Although consumer credit outstanding rose in October (by \$3.4 billion), the ratio of consumer credit



3 Consumers Debt Burdens Are Improving



Source: Federal Reserve Board/Haver Analytics 12/13/10
(Shaded areas in chart indicate recessions)

to disposable income fell again and at 20.8% in October is 150 basis points (bps) below year-ago levels (22.3%) and 360 bps below the peak of 24.4% hit in 2005. The back-to-back gains in consumer credit outstanding in September and October, albeit small, were the first back-to-back gains in this series since the fall of 2008.

As we noted in our recently published *Outlook 2011*, consumer spending accounts for more than 70% of U.S. GDP. Consumer finances have been vigorously debated by market participants since the onset of the financial crisis and the Great Recession. Starting in the early 1990s, consumers had been on a spending spree—accelerating spending, reducing savings, and piling up debt. However, there has been a noticeable reversal of that trend the last few years as strapped consumers have been forced to address soaring debts by reducing discretionary spending. This is best illustrated by the Financial Obligations Ratio (FOR), which the Fed uses to track how much of a household's disposable income goes toward paying debt, including mortgage (or rent), credit card, lease, homeowners' insurance, and property tax payments.

As of the second quarter of 2010 (the latest data available) the FOR was the lowest in 12 years and is below the long-term average of 17.2%. Based on the big drop in the monthly debt to income ratio (noted above) in July, August, September, and October, the FOR likely improved further in the second half of 2010. Some of the reduced debt burden is the result of defaults, but the drop in the FOR in recent quarters suggests that the combination of low interest rates, attractively refinanced mortgages, rising incomes (personal income is up 4.1% from a year ago and is at an all time high), and less debt to service is hastening the improvement in consumers' ability to spend. Consumers have been paying down debt, increasing their spending (at a modest rate for this point in a recovery), and saving more since late 2008.

We would expect this pattern to continue well into 2011, and perhaps into 2012, which means slower-than-normal consumer spending dampening economic growth, but not causing outright declines that would portend a

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Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

The ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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