

Weekly Economic Commentary

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Highlights

- What the Fed says or does not say in its FOMC statement this week is key.
- The labor market remains tepid, but points to slow growth, not a double-dip recession.

Economic Calendar

Tuesday, August 10	Thursday, August 12
Productivity <i>Q2</i>	Import Price Index <i>July</i>
Wholesale Inventories <i>June</i>	Initial Claims <i>wk 08/07</i>
Small Business Optimism <i>July</i>	Friday, August 13
FOMC Decision	Retail Sales <i>July</i>
Wednesday, August 11	CPI <i>July</i>
Trade Balance <i>June</i>	U of Mich Consumer Sentiment <i>August</i>
Treasury Statement <i>July</i>	Business Inventories <i>June</i>

Will They, or Won't They?

The Federal Reserve's (Fed) policy making arm, the Federal Open Market Committee (FOMC), meets this week amid increased market chatter about deflation (or falling prices) and calls for more monetary policy stimulus. The U.S. economic data calendar gets off to a slow start this week, but by the end of the week, the market will know more about the inflation/deflation debate, merchandise trade, retail sales, and small business sentiment as the second quarter ended and the third quarter began.

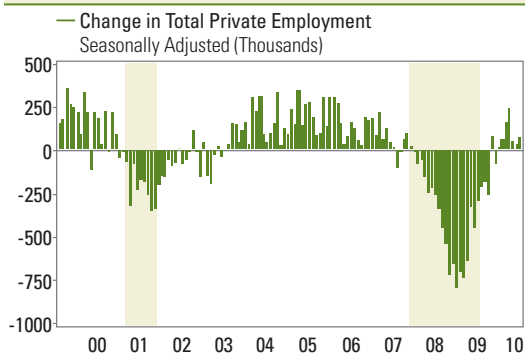
Overseas, where the economic data in Europe in recent weeks has been measurably better than the economic data released in the United States, the focus will be on the Chinese economic data for July. Virtually every piece of key Chinese economic data for July is due out this week, as the Chinese authorities try to cool their economy without causing a recession. Thus far, China is having success in its quest to slow the Chinese economy down from an unsustainable 12% growth rate in Gross Domestic Product (GDP) to a more sustainable pace. Market participants often call this engineering a "soft landing". As a result, markets have become much more comfortable with a slowing Chinese economy as a more acceptable outcome than an overheating Chinese economy cooled down by a massive dose of policy tightening. Although most of Europe is on vacation this month, the economic data mills will remain fully operational, as this week brings another slew of key reports on the economies in the United Kingdom and Europe. While the economic reports in the United Kingdom and Europe have looked better in recent weeks, Europe has yet to feel the pinch of the tax increases and spending cuts that were made in late spring and early summer. The full force of those tax increases and spending cuts is yet to come.

Aside from the FOMC meeting, global central banks will be busy this week with rate setting policy meetings slated for Japan, India, Norway, Chile, and South Korea. While the Fed and the Bank of Japan will be mulling over ways to stimulate the economy, the central banks in Chile, South Korea, and possibly Norway will raise rates (or strongly considering such a move). Chile, South Korea, and Norway have already raised rates in this cycle.

As previously mentioned, the focus for markets this week is on the Fed, and whether or not they will announce another round of policy stimulus (dubbed QE II- quantitative easing, part two by some clever talking heads). The market action late last week and early this week seems to suggest that market participants will be disappointed if the Fed does not announce some type of additional quantitative easing at this week's FOMC meeting. Our view is that, given the current political environment, the likelihood of any additional fiscal stimulus is low, which leaves monetary policy as the only



1 The Private Sector Has Added Jobs in Eight of the Past Nine Months



Source: Bureau of Labor Statistics/Haver Analytics 08/09/10
(Shaded areas in chart indicate recessions)

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other option. In recent FOMC statements, the door was left open for more easing by stating, “The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability.”

However, whether or not the Fed actually does more is dependent on how the economy and inflation is tracking to the FOMC’s forecast. At the August 10 FOMC meeting, the Fed is likely to downgrade its assessment of the economy, labor market and housing market in the statement that accompanies the end of the meeting. The key to the statement, and to prospects for any further meaningful quantitative easing by the Fed, may be in the FOMC’s assessment of the inflation/deflation debate.

In the early 2000s, when current Fed Chairman Ben Bernanke was a Fed Governor under then Fed Chairman Alan Greenspan, the FOMC used code words to talk about deflation. It used the phrase “an unwelcome substantial fall in inflation” as a proxy for deflation. Any use of similar language this time around would portend more aggressive quantitative easing by the Fed in the coming weeks and months.

What We Make of the Key Reports and Events of Last Week

Last week’s economic data reports in the United States brought more of the same. Some better-than-expected news (July vehicle sales, service sector economy in July, mortgage applications in early August, and July job cut announcements) and some reports that missed expectations (the July jobs report, weekly filings for unemployment insurance, and pending home sales for June). Eight central banks met last week, but only two (Serbia and Peru) raised rates. It was a quiet week for Chinese economic data last week but, remarkably, the incoming data in most of Europe and the United Kingdom was better than expected, and points to an acceleration in growth in the third quarter of 2010 versus the second quarter.

The key report in the United States last week was of course the employment report for July. The Federal government continued to lay off temporary Census workers, while state and local governments, struggling to balance budgets, and continued to lay off teachers and other education workers. In the private sector, firms have stopped laying off workers, but have not really stepped up their hiring either. Thus, while the private sector economy has added jobs in eight of the last nine months, totaling 622,000, that doesn't begin to put a dent in the 8.4 million jobs lost in the Great Recession of 2007-2009. While job creation in this recovery has thus far easily surpassed job creation at similar points in the recoveries in the early 1990s and early 2000s, we continue to lag job creation seen in the recoveries from the severe recessions of the mid 70s and early 80s. The employment data continues to suggest that the economy is headed for slow growth rather than a double-dip recession.

The unemployment rate remained steady at 9.5% in July, as both the number of unemployed and the number of people in the labor force fell between June and July. On an industry basis, we saw encouraging gains in retail (+7k) and manufacturing (+36k), but also observed disturbing job



losses in construction (-11k) and temporary help services (-6k). Overtime hours worked held steady, while hours worked surged 0.3% in July versus June, and there were still more industries adding jobs than losing jobs in July. The bottom line is that the labor market is essentially idling in neutral—no firing, but no hiring either.

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