LPL FINANCIAL RESEARCH

Weekly Economic Commentary

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Is Another Round of Quantitative Easing on the Way?

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Highlights

- Although it is a relatively quiet week for economic data, each report is likely to be scoured for clues as to the Fed's next move.
- With more than 20 global central banks are tightening, when will the markets care?

Economic Calendar

Monday, September 27
Dallas Fed Survey
September

Tuesday, September 28
Consumer Confidence
September

Richmond Fed Survey
September

Thursday, September 30
Initial Claims
wk 09/25

Core PCE Deflator
Q2

Real GDP
Q2

Chicago Purchasing Managers Index
September

Friday, October 1
Personal Spending
August

Personal Income
August

U of Mich Consumer Sentiment
September

ISM Manufacturing
September

Construction Spending
August

Domestic Light Vehicle Sales
September

There is an eclectic mix of events and data due out this week in the United States, as market participants:

- Reflect on last week's Federal Open Market Committee (FOMC) statement
- Look ahead to the September jobs report, set to be released on Friday, October 8
- Continue to assess the odds of a double-dip recession

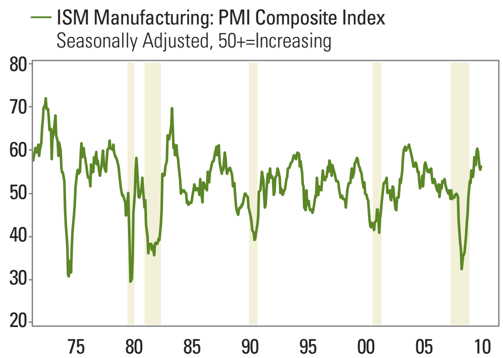
After digesting last week's generally better-than-expected economic data, and hearing from the Federal Reserve (Fed) that it is prepared to do whatever it takes to prevent deflation, the market marked down the odds of a double-dip. Looking ahead, the market will continue to view each new data point through the prism of a possible response from the Fed.

- If the economic data turns down again, it will raise the odds of a double-dip recession, and make another round of "quantitative easing" (QE)—large-scale purchases of Treasuries, Mortgage-Backed Securities, and/or agency securities by the Fed—more likely.
- If the data continues to come in as it has in recent weeks—strong enough for the economy to avoid a double-dip, but not strong enough to suggest that the economy is growing fast enough to push inflation up or the unemployment rate down—the Fed most likely will still need to do another round of QE to "re-flate" the economy, and ensure that it can grow fast enough to avoid deflation.
- If the data suggests that the economy is reaccelerating to a new, higher growth rate—roughly 3.5 to 4.5% growth in real gross domestic product—then the Fed will most likely not have to do another round of QE, as the economy under this scenario would be growing fast enough to lower the unemployment rate and push inflation higher.

Our best guess is that the economy will continue to muddle along, which will eventually prompt the Fed into doing another round of QE. The most likely start of the next round of QE would be at the November 3 FOMC meeting, although the December 14 FOMC meeting is also a possibility.

Although it is a relatively quiet week for economic data, each report is likely to be scoured for clues as to the Fed's next move. The week starts off quietly, but key data on manufacturing (September Purchasing Managers Index) and vehicle sales in September, along with consumer prices, spending and incomes for August are all due at the end of the week. In addition to the data, there are several Fed officials scheduled to make speeches this week, as the market continues to try to read the tea leaves on the Fed's next monetary policy move.

1 The ISM is Likely Still on its Way from 60 to 50



Source: Institute for Supply Management/Haver Analytics 9/27/10
Shaded areas indicate recessions.

The two key reports in the United States this week are the September ISM report and the report on personal consumption deflator excluding food and energy. Both reports are due out on Friday, October 1. Taking a closer look at the ISM report, we note that the August ISM report surprised markets when it was released on September 1, not only beating expectations, but also coming in higher than the July reading. Markets had thought that the ISM was in the midst of a slow slide from above 60 (60.4 in April 2010) to below 50, which is typically what happens to the ISM in the second year of an economic recovery. Market participants are betting that the slide resumes in September, looking for a 54.5 reading on the September ISM, down from 56.3 in August. A reading above 50 on the ISM signals that the U.S. manufacturing sector is expanding. A reading above 42 signals that the overall economy is expanding. The year-to-date reading on the ISM (January 2010 through August 2010) of 57.8 suggests that real gross domestic product (GDP) (excluding the effects of inflation) is growing at close to 5.0%.

Outside the United States, it is likely to be a relatively quiet week for monetary policy, with only a handful of central banks (Israel, Hungary, India, Poland, Romania) making policy decisions this week. Israel and India, along with more than 20 other global central banks, have already been raising rates since the worst of the global financial crisis ended in late 2009 and, thus far, markets have taken the rate increases in stride. At some point, markets will stand up and take notice of this tightening. However, with the Fed, the European Central Bank (ECB), the Bank of England (BOE), and the Bank of Japan (BOJ) all still on hold (and in most cases contemplating further monetary policy easing), markets are giving central banks in Emerging Markets and commodity-based countries in the developing world, including Canada, Australia, New Zealand and Norway, a "free pass" to rein in domestic inflation.

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The wild card remains the Peoples Bank of China (PBOC), which has been selectively tightening policy in China since late 2009, but has not "raised rates" in the traditional sense. More recently, Chinese authorities (ahead of a likely vote in the U.S. House of Representatives this week) have been allowing the Chinese currency to appreciate versus the US dollar, making Chinese exports slightly more expensive in dollar terms, thereby "tightening" policy in China. Still, the market continues to await an actual rate hike in China, which may draw attention to the economies of the other 20+ nations that are already raising rates.

Aside from the Chinese September ISM report, it is another quiet week for the Chinese data calendar, as the focus remains on the Chinese currency and the aforementioned key vote on the Chinese currency in the U.S. Congress later this week. There is a ton of data due out this week in both the Eurozone and the United Kingdom. After surprising the markets over the summer, the European economic data has begun to disappoint again, perhaps reflecting the tax increases and government spending cuts put in place in early and mid 2010 in response to the flare-up in European debt concerns. On the other hand, the data in the United Kingdom has been softening (relative to expectations and in absolute terms) since June. Tax increases and spending cuts are expected in the United Kingdom in early 2011.

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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.

Investing in alternative investment may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, potential liquidity. There is no assurance that the investment objective will be attained.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

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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