



# Weekly Market Commentary

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## Uncertain Fed Means Certain Outcome

### Jeffrey Kleintop, CFA

Chief Market Strategist  
LPL Financial

#### Highlights

In his recent testimony to Congress, Federal Reserve Chairman Ben Bernanke used the phrase “unusually uncertain” to describe the U.S. economic outlook. However, based on the Fed’s own words, this current level of uncertainty is actually common at this stage of the economic cycle.

The response by the Fed to uncertainty over the economic environment has been anything but uncertain. They always provide the economy with one last booster shot of stimulus.

We believe the Fed will remain on hold this week, but could undertake additional stimulus if the uncertainty lingers later this year.

In his recent testimony to Congress, Federal Reserve Chairman Ben Bernanke used the phrase “unusually uncertain” to describe the U.S. economic outlook. The word uncertain was used five times in the statement released at the conclusion of the June 23 meeting, and was used 16 times in the minutes released on July 28. We may see more of the word “uncertain” this week, as the Fed releases the statement from its August 10 meeting at 2:15pm that day.

The economy again began to grow last summer, putting the current bout of early cycle uncertainty at about four quarters since the end of the recession. In contrast to Chairman Bernanke’s remark, the current uncertainty is not all that unusual at this early stage of an economic cycle. In fact, based on the Fed’s own words, the current level of uncertainty is actually common at this stage of the economic cycle.

- In March 2003, about five quarters after the 2001 recession had ended, the Fed’s Beige Book used the word “uncertain” 30 times to describe the economic environment, almost twice as often as the July 2010 Beige Book. Also, the minutes of the March 2003 Fed meeting used the word “uncertain” 16 times, three times as often as the five times it was used in the June 2010 meeting minutes.
- In October 1992, about six quarters after the end of the 1991 recession, the word “uncertain” appeared 23 times in the transcript of the October 1992 Fed meeting.

The response by the Fed to uncertainty over the economic environment has been anything but uncertain. They have always provided the economy with one last booster shot of stimulus. During the past four decades, the Fed has cut rates one last time well after the recession had ended when a soft spot emerged. For example, related to the above examples of Fed uncertainty, the Fed cut the Federal Funds target rate in June 2003 and in September 1992.

With the Federal Funds target rate effectively at zero the typical rate cut is not an option this time, so what will the Fed’s uncertainty lead it to do?

- First, the Fed will likely signal its sensitivity to heightened risk by updating the message from the June meeting that it “will employ its policy tools as necessary” to reflect the latest language from the recent semiannual testimony that it “is prepared to take further actions as needed.” This will send the signal that the Fed has a greater bias toward easing monetary policy. This signal alone may have some of the effects desired by the Fed on the markets.



Uncertainty is to be expected given the challenges facing an economy in the early stages of growth following an unprecedented upheaval.

- Second, in lieu of the Fed cutting rates, they may reinvest interest and principal payments on the Fed's holdings of Mortgage-Backed Securities back into the market with the intention of adding money to the system and keeping rates low. However, we believe the Fed is not likely to take this step without a downgrade to its recently stated growth outlook for above-average Gross Domestic Product (GDP) growth in 2011 and a 1% decline in the unemployment rate over the next year. The Fed has the ability to wait on any additional stimulus given the improvement in market conditions, from the stock market to the TED spread, since the last Fed meeting in June. If the uncertainty lingers, and the Fed further downgrades their outlook, the Fed could pursue the path of further easing consistent with prior early cycle periods of uncertainty.

Uncertainty is to be expected given the challenges facing an economy in the early stages of growth following an unprecedented upheaval. The sentiment of unusual uncertainty is expressed in this excerpt from the pages of TIME magazine:

*"If America's economic landscape seems suddenly alien and hostile to many citizens, there is good reason: they have never seen anything like it. Nothing in memory has prepared consumers for such turbulent, epochal change, the sort of upheaval that happens once in 50 years. "*

*"The outward sign of the change is an economy that stubbornly refuses to recover. In a normal rebound, Americans would be witnessing a flurry of hiring, new investment and lending, and buoyant growth. But the U.S. economy remains almost comatose a full year and a half after the recession officially ended. Unemployment is still high; real wages are declining."*

*"The current slump already ranks as the longest period of sustained weakness since the Great Depression. That was the last time the economy staggered under as many "structural" burdens, as opposed to the familiar "cyclical" problems that create temporary recessions once or twice a decade. The structural faults represent once-in-a-lifetime dislocations that will take years to work out. Among them: the job drought, the debt hangover, the defense-industry contraction, the savings and loan collapse, the real estate depression, the health-care cost explosion and the runaway federal deficit."*

The same article quoted an economist as saying, "this is a sick economy that won't respond to traditional remedies. There's going to be a lot of trauma before it's over." But it was over. This excerpt is from September 28, 1992.

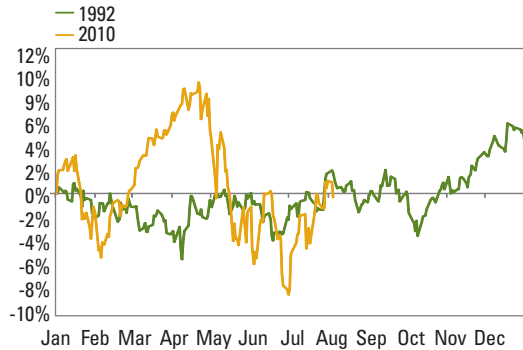
The recession ended in 1991 and real GDP was an above average +3.4% in 1992 (about the same pace of growth the economy has averaged this year). Yet, in September 1992, TIME described the economy as "comatose". When the article was published, the economy had already been growing for six quarters. Hiring had weakened to averaging only +77,000 jobs per month in the four months leading up to this article, but in the following four months it averaged +210,000. In addition, while the structural problems apparent then seemed unsolvable for years to come, real GDP was +2.9% the following year.

It is not easy to assess the health of the economy as we are living through it. The amount of current press coverage devoted to fretting over a double-dip recession will be expanded by last Friday's lackluster private payroll growth



## 1 Years of Uncertainty

S&P 500 Performance in 1992 and 2010



Source: LPL Financial, Bloomberg 8/6/10

The S&P 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results

report of +71,000 for last month. We continue to believe the data supports a typical economic soft spot (much like the one in 1992) that always comes about one year after a recovery begins and not the double-dip that has been largely priced into the stock market.

In 1992, the uncertainty expressed in the sentiment from the Fed and in the media at the end of the third quarter set the stock market up for a solid fourth quarter rally after a relatively flat year for stocks in the first three quarters. The stock market in 1992 ended with a modest single-digit total return (including dividends) of 7.6%, very similar to our outlook for a modest single-digit gain this year.

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The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability.

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

The TED Spread measures the difference between 3-month LIBOR rate and the yield on 3-month Treasury bills. This is an effective measure of the liquidity available to banks. With bank capital adequacy near the center of the current crisis this is an important gauge of the stress in the banking system. A rise in the TED Spread acts as a negative on the CCI.

Mortgage Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

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