



Weekly Market Commentary



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Investors Await Clarity as They Doubt the Sincerity of the Popularity of Austerity

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

Like a slogan that has a nice rhyme and broad appeal, Washington has suddenly embraced the mantra of fiscal austerity. But the markets are not buying it.

We believe the market's passive response to the austerity in Washington is largely because they doubt Washington's sincerity, there are other drivers at work in the markets, and there are both winners and losers from the proposed reforms.

This passive response by investors may turn more active as the debt ceiling deadline looms and greater clarity emerges around the sincerity of Washington's efforts at austerity.

Like a slogan that has a nice rhyme and broad appeal, Washington has suddenly embraced the mantra of fiscal austerity. But the markets are not buying it.

Last week, following the deal on spending cuts that allowed the passage of the 2011 fiscal year budget, President Obama entered the deficit reduction debate with a plan of his own. His outline calls for \$4 trillion in deficit reduction over 12 years, while the House Republican plan calls for \$6 trillion in deficit reduction over 10 years. In addition, the President's deficit commission, which called for \$4 trillion in deficit reduction over 10 years, is being written into a bill by senators to be introduced to Congress. The sudden swing in Washington towards embracing austerity by both parties—even if more in word than deed—is striking.

The emphasis on the federal deficit and spending in Washington is now finally matching the concern evident in the consistently high ranking of this issue by Americans in nationwide polls (second only to job creation). Given this fact, it begs the question: Why are markets not reacting as dramatically as the headlines suggest?

The markets have given the deliberations in Washington a big yawn. The S&P 500 has been fairly range-bound, up or down less than 1% so far during the month of April. The bond market has been relatively quiet, as well. In fact, last week's auctions of three-month Treasury bills that mature after July 8—the date that the Treasury would potentially run out of money and be forced into default if the debt ceiling is not raised—was a non-event and passed with flying colors.

We believe the market's passive response to the austerity in Washington is largely because they doubt Washington's sincerity, there are other drivers at work in the markets, and there are likely both winners and losers from the proposed reforms.

Bond Market and the Dollar

The flat bond market performance this month suggests bond market participants believe that a deal on the debt ceiling gets done with little risk of default. We agree the risk of default is low, but it is not miniscule. We suspect Treasuries may begin to become more volatile as the deadlines approach. The Treasury has stated that the debt limit will be reached around



May 16, but they can likely push out a default until July 8. The fireworks lighting up Washington around the fourth of July as a contentious deal on the debt ceiling gets pushed to the last minute could disturb the bond market and push interest rates up. But in the meantime, the bond market is not worried.

On the other hand, bond market participants clearly believe the deal will not be anything close to what has been proposed so far. The dramatic cuts to spending and federal debt, if implemented, would be positive for Treasuries and the dollar. However, the broad plans laid out by both parties are just a starting point for negotiations and are likely to be significantly watered down before passing the Senate. This perspective that investors have adopted has helped to keep yields from rallying back to the lows of the year and also helped to keep the dollar weak.

In addition, a final comprehensive budget deal could take a long time. It would not be surprising to see the debt limit follow the pattern of the 2011 budget battle with several small increases in the debt ceiling every few weeks or months in exchange for modest spending cuts to be repeated until a more comprehensive bill can be agreed upon.

Finally, both of the clear winners of any actual austerity, the dollar and Treasuries, also have issues to contend with. These include the pending end of the Federal Reserve's Quantitative Easing Treasury debt purchase program and the rising pace of inflation.

Stock Market

Austerity in Washington, leading to a fiscally sustainable path for the United States, would be a clear positive for U.S. stocks. However, countering the positive of an improved domestic fiscal position is the impact on businesses of the spending cuts. Those sectors and industries most affected by cuts are likely to be Health Care, Defense, Machinery, Information Technology, and REITs.

- Any true attempt at deficit reduction must address Health Care costs. The biggest and most rapidly growing portion of the budget must be tamed. A lower pace of spending may curb revenue growth for the companies in this sector. President Obama reiterated support for an Independent Payment Advisory Board which would impact pricing for drug and device makers.
- Defense spending also makes up a large portion of the budget and would likely see spending cuts as part of any major plan to reduce the deficit.
- Machinery, an industry that may lose infrastructure due to less funding for U.S. transportation and other infrastructure projects, may still do well with rebuilding and emerging market growth remaining positive.
- Companies in the Information Technology sector and some REITs may suffer from weaker demand if federal and defense employment declines as part of an austerity plan.

Like bonds and the dollar, stocks also have other drivers at work limiting the potential benefit from clarity around the fiscal outlook. Stock market participants still have to contend with slowing earnings growth, European



debt problems, and the elevated geopolitical conflict in North Africa and the Middle East.

The passive response by investors may turn more active as the debt ceiling deadline looms and greater clarity emerges around the sincerity of Washington's efforts at austerity.

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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.

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Health Care Sector: Companies are in two main industry groups—Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Technology Software & Services Sector: Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

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