

Weekly Economic Commentary



April 25, 2011

Focus on the Fed

John Canally, CFA

Economist
LPL Financial

Highlights

- The first-ever post-FOMC press conference highlights this week's economic calendar.
- The economy probably decelerated in the first quarter, but the expansion is far from over.

Economic Calendar

Monday, April 25 New Home Sales <i>March</i>	Thursday, April 28 Real GDP <i>Q1</i>
Dallas Fed Mfg Index <i>April</i>	Initial Claims <i>wk 04/23</i>
Tuesday, April 26 Consumer Confidence <i>April</i>	Friday, April 29 Employment Cost Index <i>Q1</i>
Richmond Fed Mfg Index <i>April</i>	Personal Spending <i>March</i>
Wednesday, April 27 Durable Goods <i>March</i>	Personal Income <i>March</i>
FOMC Decision	Chicago PMA <i>April</i>
Bernanke Press Conference	U of Mich Consumer Sentiment <i>April</i>

The main event this week for financial markets is likely to be the Federal Reserve's (The Fed) Federal Open Market Committee (FOMC) meeting and the first-ever post-FOMC press conference by Fed Chairman Ben Bernanke. The U.S. economy receives its first quarter report card this week, and the results are likely to look worse on the surface than they actually are in substance.

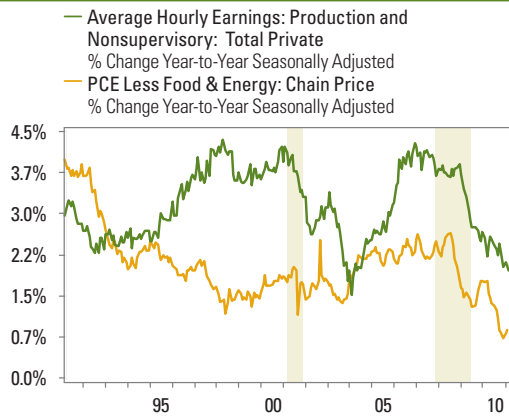
Earlier this year, the Fed announced that Chairman Bernanke will hold a press conference after four of the eight meetings of the Fed's policymaking arm, the FOMC. The press conferences will coincide with the release of the FOMC's quarterly economic forecasts, which are made at the FOMC meetings held in January, April/May, June, and October/November each year. Thus, on April 27, June 22 and November 2, 2011, the FOMC statement will be released at 12:30 PM ET, 1 hour and 45 minutes earlier than usual. Although the two-day FOMC meeting, the release of a new economic forecast, and the first ever post-FOMC meeting press conference by a Fed Chairman presents a seemingly perfect opportunity for the FOMC to signal a shift in policy, our view is that the conditions are not right yet for the FOMC to signal the change this week.

If the consensus is correct, the outcome of this week's two-day FOMC meeting is not in doubt. All 80 of the economists and strategists surveyed by Bloomberg news expect the FOMC to keep rates steady at the conclusion of the meeting, and we concur with that view. Market participants do not expect the FOMC to raise rates until the first quarter of 2012, and we concur with that view as well. We also share the consensus that the FOMC will continue to endorse its Treasury purchase program (Quantitative Easing or QE2) at this week's meeting, and that the hurdle for the FOMC to launch a new round of purchases (QE3) when QE2 ends on June 30 remains high. [\[Chart 1\]](#)

While the outcome of the meeting is not in doubt, the "internals" of the meeting (the FOMC's latest economic forecast, the wording of the FOMC statement, and most importantly, the tone and content of Bernanke's press conference) are all likely to move the FOMC one step closer to removing the unprecedented monetary policy stimulus now in the system. As noted in the most recent Beige Book (a qualitative assessment of economic and business conditions in each of the Fed's 12 regional districts), while the overall economy and labor market have improved this year, they have not improved enough yet to warrant a tightening of policy.



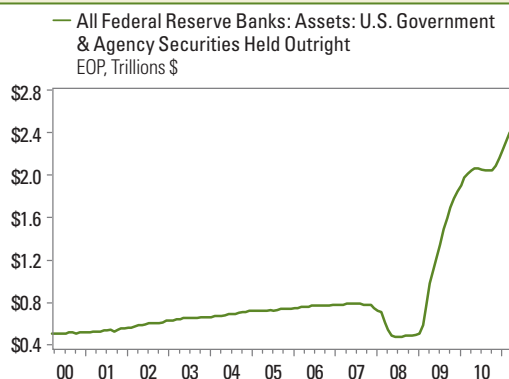
1 With Wages Still Subdued, Inflation is Likely to Remain in Check and The Fed is Likely to Remain on Hold



Source: BLS, BEA, Haver 04/25/11

(Shaded areas indicate recession)

2 A Decrease in the Size of the Fed's Balance Sheet Would Send a Signal of Tighter Monetary Policy



Source: Federal Reserve Board/Haver Analytics 04/25/11

While it is not unusual for the economy's growth rate to slow for a quarter in the midst of an economic recovery—our view remains that the economy is in the early stages of recovery—the deceleration in growth between the fourth quarter of 2010 and the first quarter of 2011 will draw a great deal of attention from the media.

Inflation, inflation expectations, and the recent surge in commodity prices will likely dominate the FOMC's internal discussion this week, and are likely to be the topic of many of the questions posed to Bernanke at the post-meeting press conference. While the most recent Beige Book notes that some manufacturers are having success in passing on higher input costs to their end users, rising input costs are not being passed through in the rest of the economy. Preventing these higher input prices from being passed through is, in large part, due to slack in the labor market. The weak, though improving, labor market is keeping wage inflation to a minimum. Thus, until the FOMC sees more sustained evidence of stronger labor markets leading to higher wage inflation, they are unlikely to signal any change in policy.

As we have written in prior *Weekly Economic Commentaries*, the noticeable improvement in the economic data so far this year, along with a measurable uptick in readings on core inflation (inflation excluding food and energy), already has some market participants debating the timing of the Fed's first policy tightening. We say "policy tightening" because unlike past episodes, where the Fed only had one policy lever at its disposal (typically the Fed funds rate), this time around the Fed has several levers to tighten policy, including reducing the size of its balance sheet and/or increasing the target Fed funds rate. While a lot can change between now and 2012, the market now expects the Fed's first rate hike in March or April of 2012, and we also expect a hike in 2012, but perhaps not until the middle of the year. We expect the Fed to maintain the size of its balance sheet [Chart 2] over the second half of 2011, but the Fed is likely to begin to shrink its balance sheet in 2012, by not reinvesting interest payments from Treasury and mortgage-backed securities holdings or proceeds of maturing bond holdings. The signal of a shift toward allowing its balance sheet to shrink could come as soon as the June 2011 FOMC meeting. Any such signal would be data dependent, and also dependent on the progression of the FOMC's economic forecasts.

Economic Growth in the First Quarter Stronger than it Appears

Six weeks ago, we wrote in a *Weekly Economic Commentary* that economic growth in the United States in the first quarter "looked solid" and that the economy was on track to post a 3.0 to 3.5% gain in the first quarter of 2011. Since then, the economic data that feeds into gross domestic product (GDP) has faltered, and consensus estimates for GDP growth in the first quarter have moved down sharply, from 3.3% at the beginning of the year to 1.9% now. The economy grew at a 3.1% annualized rate in the fourth quarter of 2010 relative to the third quarter of 2010, so the 1.9% growth rate projected for the first quarter (relative to the fourth quarter of 2010) represents a marked deceleration in growth. While it is not unusual for the economy's growth rate to slow for a quarter in the midst of an economic recovery—our view remains that the economy is in the early stages of recovery—the deceleration in growth between the fourth quarter of 2010 and the first quarter of 2011 will draw a great deal of attention from the media.



The likely deceleration in growth between the fourth quarter of 2010 and the first quarter of 2011 is largely the result of an expected slowdown in consumer spending (which accounts for two-thirds of GDP) from the torrid 4.0% annualized pace in the fourth quarter of 2010. While the press is likely to cite rising energy prices as the main reason for the slowdown in consumer spending between the fourth quarter and the first quarter, our work suggests that rising consumer energy prices usually have the biggest impact on spending six to nine months after the price increase occurs. The culprit for the deceleration in spending in the first quarter may simply be the surge in vehicle sales in the fourth quarter of 2010.

Another area of weakness in the first quarter is likely to be net exports. In the GDP accounts, exports add to GDP while imports subtract from GDP. During the first quarter, imports surged (in part due to rising commodity prices) but mostly due to stronger consumer and business demand in the United States for consumer and industrial goods. Export growth remained solid in the first quarter, but the pace of growth slowed. Taken together, the surge in imports and the slowdown in the pace of exports could shave as much as two percentage points off of first quarter GDP. Net exports added more than three percentage points to growth in the fourth quarter as imports dipped and exports surged.

On the bright side, inventory accumulation is likely to be a plus for GDP growth in the first quarter, and business capital spending could be a plus as well. Beyond that, housing construction, business investment in new office parks, malls and factories, and especially state and local government spending are likely to be drags on growth in the first quarter.

Looking ahead, we continue to maintain our below-consensus estimate for GDP growth for 2011. However, despite the ongoing supply chain disruptions in the automotive and technology sectors as a result of the earthquake and tsunami in Japan, we expect growth will reaccelerate in the second quarter and over the course of 2011. Additionally, the leading indicators of economic growth continue to point to expansion in the economy over the next nine months.

Although rising consumer prices, uncertainty over both fiscal and monetary policy, the aforementioned earthquake-related supply disruptions, and a still sluggish housing sector are likely to weigh on growth, an improving labor market, booming emerging market economies, a thriving manufacturing sector, low business and consumer financing costs, and falling consumer debt burdens suggest the continuation of a modest economic recovery in 2011.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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.

Stock investing involves risk including loss of principal.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured No Bank or Credit Union Guarantee May Lose Value Not Guaranteed by any Government Agency Not a Bank/Credit Union Deposit
--