

Weekly Economic Commentary



September 6, 2011

Policy Matters

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Highlights

- A quiet week ahead for economic data in the United States, as policy retakes center stage.
- August employment report disappoints, even relative to low expectations.

Economic Calendar

Tuesday, September 6 ISM Nonmanufacturing <i>Aug</i>	Thursday, September 8 Initial Claims <i>wk 09/03</i>
Wednesday, September 7 MBA Mortgage Applications Index <i>wk 09/02</i>	Trade Balance <i>Jul</i>
Fed's Beige Book	Consumer Credit <i>Jul</i>
	Friday, September 9 Wholesale Inventories <i>Jul</i>

It is worth noting, however, that this data is likely to be heavily influenced by the disruptions to economic activity along the east coast caused by Hurricane Irene. In addition, the usual difficulties in seasonally adjusting weekly economic data in the weeks around a holiday with a moveable date, in this case Labor Day, will only add to the economic volatility.

The week of August 29–September 2 ended on a sour note amid a flurry of bad news on the economic and public policy fronts, although most equity markets finished a volatile week little changed despite all the economic volatility that dominated the week. This week (September 5–9) is a quiet one for economic data, but given the uncertain backdrop, the reports that are due out are likely to receive extra attention from market participants. The light week for economic data and events opens the door for policy to take center stage, at home and abroad. The major reason for the dour end to last week was a disappointing employment report. We examine the few plusses and many minuses of the report.

Policy Takes Center Stage This Week

Last week was one of the busiest weeks for economic data releases of the year in the United States, with August reports on employment, manufacturing, retail sales, vehicle sales, and consumer confidence all providing plenty of fodder for market participants during the pre-Labor Day week that is traditionally one of the quietest trading weeks of the year. This week, there is very little economic data on the calendar, but given financial market participants' uneasiness surrounding the economic outlook, the scattering of reports that are due out will likely garner intense scrutiny.

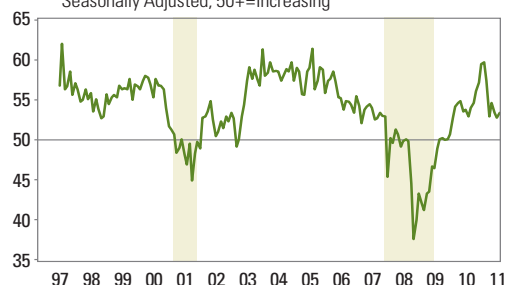
Of the few economic reports due out in the United States this week, the weekly data on retail sales, mortgage applications and initial claims for unemployment insurance could draw the market's attention. It is worth noting, however, that this data is likely to be heavily influenced by the disruptions to economic activity along the east coast caused by Hurricane Irene. In addition, the usual difficulties in seasonally adjusting weekly economic data in the weeks around a holiday with a moveable date, in this case Labor Day, will only add to the economic volatility. On balance, the September economic data is going to be key, as markets have already written off August as a lost month for the economy, due to the confidence jarring debate over the debt ceiling in early August, the downgrade of the U.S. credit rating in the first week of the month, and the ongoing turmoil in Europe.

The other notable economic report due out this week is the August reading on the service sector from the Institute of Supply Management (ISM). The report was released as this report was being prepared for publication on September 6, 2011. The August nonmanufacturing ISM report exceeded expectations, helping to ease, for now, the market's fears of recession. The



1 The Bounce Higher in Non-Manufacturing ISM in August Should Help to Ease Recession Fears, For Now

— ISM Nonmanufacturing: NMI Composite Index
Seasonally Adjusted, 50+=Increasing



Source: Institute for Supply Management/Haver Analytics 09/06/11

(Shaded areas indicate recession)

With the 53.3 reading in August 2011, the non-manufacturing ISM Index has now been above 50 in all but one of the 24 months since September 2009, and points to slow growth, rather than recession.

August reading on the nonmanufacturing ISM rose to 53.3 from 52.7 in July. Expectations were for a decline to 51.0 in August, and the “whisper number” (the unofficial consensus among traders) was looking for a reading well below 50.

Although the ISM’s report on manufacturing (the August reading on this report was released last week) is a more reliable indicator of the economy and has a much longer track record (the ISM report on manufacturing was first published in 1948) than its survey of the service sector (which dates back only 1997), the service sector does account for nearly 80% of economic activity in the United States. In hindsight, the sharp drop in the service sector ISM between December 2007 (52.9) and January 2008 (45.3) was a good indication that the U.S. economy had dipped into recession. On this index, a reading above 50 indicates that the service sector is expanding, while a reading below 50 indicates that the service sector is contracting. With the 53.3 reading in August 2011, the non-manufacturing ISM Index has now been above 50 in all but one of the 24 months since September 2009, and points to slow growth, rather than recession.

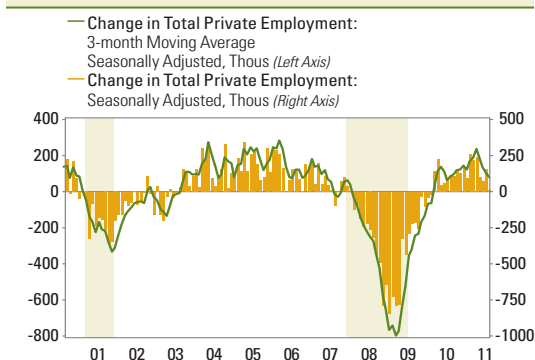
In our view, the recent turmoil in financial markets has been a result of both lackluster economic data and a lack of clarity and sense of purpose on the policy front. This week, Fed Chairman Bernanke will deliver a speech on monetary policy on Thursday, September 8. That speech will be preceded by the release of the Fed’s Beige Book, a qualitative assessment of economic activity in each of the 12 regional Federal Reserve districts (Boston, New York, Philadelphia, Richmond, Dallas, etc.) as reported by bankers and business owners in each of the districts, on September 7. The tone of the Beige Book, along with tone of Bernanke’s speech, may provide the market some further insight into the outcome of the September 20–21 Federal Open Market Committee (FOMC) meeting. The FOMC is the Fed’s policymaking arm and meets eight times a year to discuss monetary policy.

Fed Chairman Bernanke’s speech in Jackson Hole, WY at the end of August, along with the weak tone to the August jobs report, and the lack of any forward progress on the fiscal policy front at home or abroad, makes it quite likely, in our view, that Bernanke and the Fed will take some kind of action on September 21. The most likely course of action is for the Fed to lengthen the maturity of their current holdings of Treasuries by selling short-dated Treasury securities and buying long-dated ones, as discussed in the minutes of the August 9 meeting, which were released last week. While this would not increase the size of the Fed’s balance sheet (there are many inside and outside the Fed who are opposed to this), the effects on the economy should be similar—i.e. lower costs of borrowing by businesses and consumers and pushing yield-oriented investors to seek risk outside of the Treasury market, which may, in turn, lead to more purchases of riskier assets like corporate and high-yield debt.

President Obama is also set to deliver a major speech on the economy and job creation this week to a joint session of Congress. Markets would also be comforted by additional, visible progress toward the creation of a Eurobond, as discussed in last week’s *Weekly Market Commentary*. Inaction on the



2 The Deteriorating Trend in Private Sector Job Creation Is a Concern

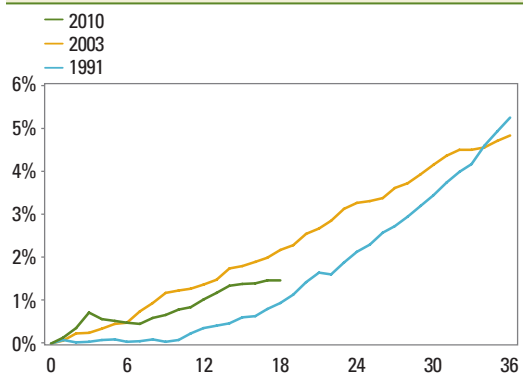


Source: Bureau of Labor Statistics/Haver Analytics 09/06/11

(Shaded areas indicate recession)

The bottom line is that the labor market is stalled out, a hostage to a great deal of economic and policy uncertainty both in the United States and overseas.

3 Job Creation in This Recovery is Running at the Average of the Past Two Recoveries



Source: LPL Financial Research/Bloomberg data 09/02/11

policy front in Europe and the lingering uncertainty surrounding European sovereign debt and its impact on European banks' balance sheets has been a key driver of both economic and financial market volatility in recent weeks.

Disappointing August Jobs Report Adds to Recession Fears

As noted in this week's *Weekly Market Commentary*, financial markets have already priced in a recession. The questions now are: Can the economy prove the markets wrong, and continue to post sluggish growth over the final months of 2011? And, if we are in a recession, will it be a mild recession (similar to 1990–91 and 2001) or a severe recession (1973–75, 1981–82 and 2007–2009)?

We continue to place the odds of a recession at around one-in-three, up from a few weeks ago, but well below the odds financial markets seem to be placing on a recession. The disappointing August employment report (released on Friday, September 2) increased the odds of recession slightly. The August jobs report fell short of lowered expectations, raising the odds that the Fed will act at the next FOMC meeting (September 20–21). As noted in the section above, the most likely outcome at that meeting, in our view, is that the FOMC decides to implement "Operation Twist", where it would buy longer-dated Treasuries using the proceeds of selling shorter-dated Treasuries it owns.

After surprising financial market participants with a better-than-expected July employment report (released in early August), the August jobs report disappointed investors with the private sector creating just 17,000 jobs in August, below the consensus estimate of a 95,000 gain. However, the result was within the range of economists' estimates of a gain between 5,000 and 155,000 jobs in August. In addition, a strike at Verizon (which has since settled) subtracted 46,000 jobs in August, meaning the August result was more like a gain of 63,000 jobs (rather than the reported 17,000 gain), but still a deceleration from the 156,000 gain jobs in July. The composition of the report was not all that encouraging either. The prior month's job count was revised down, hours worked fell in August, and the mix of industry employment was weak. The weekly readings on the number of individuals filing first-time claims for unemployment benefits in recent weeks suggest that companies are not laying off workers, but the August employment report suggests that businesses are not hiring very many workers either. The bottom line is that the labor market is stalled out, a hostage to a great deal of economic and policy uncertainty both in the United States and overseas.

The meager 17,000 gain in private sector jobs in August likely overstates the weakness in the labor market, due in part, to the impact of the Verizon strike noted above. Taking a three-month average to smooth out the month-to-month volatility, the labor market has still decelerated noticeably since the spring of 2011. In the three months ending in April 2011, the economy created an average of 240,000 private sector jobs per month. In the three months ending in August, the economy created an average of only 83,000 jobs per month, leaving the labor market vulnerable to further shocks.



The high unemployment rate intensifies the spotlight on the Fed, Congress and the Obama administration to enact policy and/or remove regulatory constraints to help foster a better backdrop for job creation.

The news is not all bad on the labor front, however. After shedding more than 8.8 million private sector jobs in the 2007–2009 “Great Recession” and its aftermath, the economy has added back 2.4 million jobs over the past 18 months, or an average of around 133,000 jobs per month. In fact, as noted in [Chart 3](#), the jobs gains during this recovery are running at about the average pace of post-recession job creation following the 1990-91 and 2001 recessions. While the recent stall is a concern, the job market remains on a path of recovery.

The nation's unemployment rate remained at 9.1% in August. The unemployment rate data is culled from a survey of households, while the monthly job count is calculated from a survey of businesses. The unemployment rate is calculated by dividing the number of people who are unemployed (roughly 13 million) by the number of persons in the labor force (153 million). The high unemployment rate intensifies the spotlight on the Fed, Congress and the Obama administration to enact policy and/or remove regulatory constraints to help foster a better backdrop for job creation.

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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 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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