

Weekly Economic Commentary



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Bucking the Trend

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Highlights

- Housing, manufacturing and the consumer dominate this week's economic data in the United States as the economy accelerates into year-end.
- The struggling state and local government sector is likely to struggle in 2012.

Economic Calendar

Monday, December 19	Real GDP
NAHB Housing Survey	Q3
Dec	
Tuesday, December 20	U of M Consumer
Building Permits	Sentiment
Nov	Dec
Housing Starts	Leading Indicators
Nov	Nov
Wednesday, December 21	Friday, December 23
MBA Mortgage	Durable Goods
Applications	Shipments and Orders
wk 12/16	Nov
Existing Home Sales	Personal Spending
Nov	Nov
Thursday, December 22	Personal Income
Initial Claims	Nov
wk 12/17	New Home Sales
GDP Price Index	Nov
Q3	

Housing, the consumer, and the manufacturing sectors will likely dominate the economic landscape this week in the United States, as the U.S. government's economic data mills make one final push ahead of the traditional lull in the economic calendar the week between Christmas and New Year's Day. Of course, the U.S. economic data has taken a back seat to other events in recent weeks, and this week is not likely to be an exception. The debt dilemma in Europe, the final wrangling in Congress over the extension of the payroll tax cut and unemployment benefits, along with the fallout from the death of North Korean leader Kim Jong Il might once again force financial market participants' focus elsewhere.

The state and local government sector is likely to continue exerting downward pressure on U.S. economic growth in 2012, even after restraining growth in gross domestic product (GDP) in all but three of the 15 quarters since the beginning of 2008.

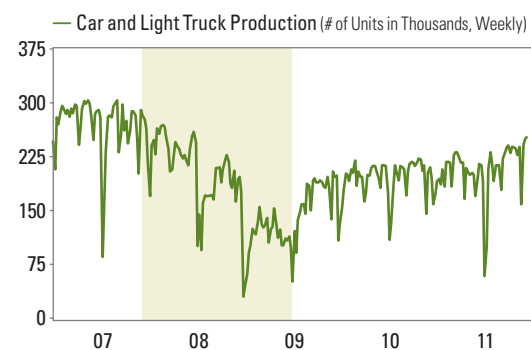
The Week's Economic Reports Likely to Take a Back Seat to Washington, Europe and Korea

Even as consumers rush to make their final purchases of the 2011 holiday shopping season—Hanukkah begins on December 20 and ends on December 28, and of course Christmas is December 25—the government's data mills are making one last push to get all of the economic data out the door. This week's dataset in the United States is dominated by housing, manufacturing and the consumer. The housing data due this week includes a mix of reports on sales, prices, starts, permits and sentiment for both November and December 2011. In general, the housing reports due this week are likely to show that the modest recovery in the housing market that began nationally in early 2009 continued through the end of 2011. As noted in last week's *Weekly Economic Commentary*, "Communications Breakdown?" we expect housing to continue to heal further in 2012, but that the sector still has a long way to go before it can become a reliable contributor to overall economic growth again.

Manufacturing is another focus of this week's data in the United States. In recent months, domestic manufacturing activity has bucked the global trend of deceleration, and has reaccelerated a bit. Part of the reacceleration has come as the global supply chain returned to normal after the Japanese earthquake and tsunami. For example, auto and light truck production in the United States in the latest week (ending December 16) was the strongest since early 2008.



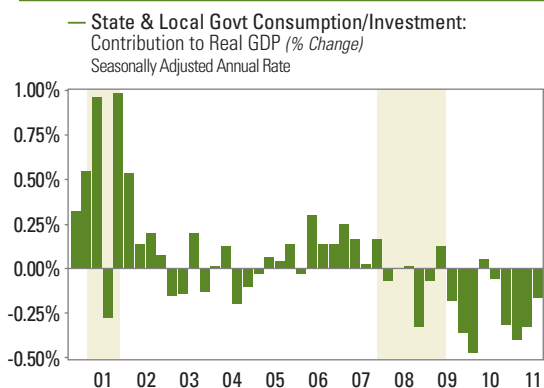
1 Auto and Light Truck Production Was Hit Another Three and a Half Year High in the Latest Week



Source: Haver Analytics 12/19/11

(Shaded Areas Indicate Recession)

2 State and Local Government Spending Has Been A Drag on GDP Growth in 12 of the Past 15 Quarters



Source: Bureau of Economic Analysis, Haver Analytics 12/19/11

(Shaded Areas Indicate Recession)

Auto and light truck production has not been sustained at these levels since late 2007, prior to the onset of the Great Recession.

This week, data on durable goods orders and shipments in November are likely to provide further evidence that the U.S. manufacturing sector continues to move in the right direction as 2011 draws to a close. Will the likely recession in Europe along with slower growth in China and other emerging markets impact manufacturing in the United States in 2012? It almost certainly will, but it probably already has had an impact. But, despite the slowing, the underlying strength in the manufacturing sector has been stronger than the consensus thought just a few months ago.

Finally, the consumer will be in the spotlight this week as well with the regular weekly reading on retail sales due out on Tuesday, December 20, the University of Michigan's consumer sentiment index for December on Thursday, December 22, and the November personal income and spending data on Friday, December 23. Consumer spending, which accounts for two-thirds of the overall economy, has been buoyed in recent weeks by a sharp drop in gasoline and other consumer energy prices, better news on the labor market and more stability in the housing market. Last week (December 12–16), the National Retail Federation (NRF)—a trade group of the nation's retailers—raised its 2011 holiday sales forecast by a full percentage point. The group, which forecast a modest 2.8% year-over-year gain in holiday shopping in 2011 back in early October 2011, now says holiday shopping is likely to rise by 3.8%—above the long-term average gain in holiday sales of 2.6%, but below the robust 5.2% sales gain seen during the 2010 holiday shopping season.

In the past, the National Retail Federation has been very conservative in its holiday sales forecasts. Thus, the guidance provided by the NRF last week, along with the return of cold weather to much of the nation in mid-December, and the solid gain in the equity market since September, all suggest that sales are likely to come in at around 4 to 5% when all the receipts are counted. Retailers will report their December sales on Thursday, January 5.

State and Local Governments Likely to Continue to Be a Drag on Economic Growth in 2012

Since the onset of the Great Recession in the first quarter of 2008, the state and local government sector—traditionally a reliable, though modest source of strength for the U.S. economy over the past 30 years—has exerted downward pressure on economic growth amid a major disconnect between revenues and spending. Over that time (15 quarters), the state and local government sector has been a drag on overall GDP in 12 quarters, or 80% of the time. Between the end of World War II and the end of 2007, the state and local government sector made a positive contribution to growth 85% of the time.

As the Great Recession took hold, state and local governments struggled to match declining revenues—as property taxes, corporate taxes, sales taxes, income taxes and fees all were negatively impacted by the downturn—with rising costs. The most visible realignment of costs to lower revenues came in state and local government employment. Since peaking in August 2008, state



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and local governments have shed nearly 4% of their workers, or more than 610,000 jobs. If anything, that figure probably understates the impact to the overall economy, because it does not take into account that many older state and local government employees are retiring early, and being replaced by lower paid workers, who often are not receiving the same level of benefits.

Looking ahead, the decline in state and local government workers is likely to persist into 2012, though likely at a more modest pace than over the past three and a half years. As the economy has stabilized in 2010 and 2011, so too have state and local government revenues. However, the Great Recession did little to relieve state and local governments of their obligations to meet mounting post-retirement benefits like healthcare and pension costs for current and former employees. When continued pressure on federal aid to state and local governments is factored in it leaves state and local governments with very little wiggle room to hire any additional workers or make any major commitments to spend on social programs, education or infrastructure projects. Thus, one of the few avenues left for state and local governments to continue to align short and long term costs with revenues is to continue to pare workers and cut back on expansion of existing programs. The net result is likely to be another year in which the state and local government sector provides little support for the overall economy.

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