

Weekly Economic Commentary



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Hitting the Ground Running

John Canally, CFA

Economist
LPL Financial

Highlights

- Financial markets have a full plate of economic and policy events to digest as they return from the year-end holidays.
- The FOMC minutes may provide some hints as to the Fed's communications strategy.

Economic Calendar

Tuesday, January 3	Challenger Layoffs <i>Dec</i>
Construction Spending <i>Nov</i>	ISM Service Sector <i>Dec</i>
ISM Manufacturing <i>Dec</i>	Chain Store Sales <i>Dec</i>
FOMC Minutes	
Wednesday, January 4	Friday, January 6
Factory Orders <i>Nov</i>	Unemployment Rate <i>Dec</i>
Domestic Light Vehicle Sales <i>Dec</i>	Nonfarm Payrolls <i>Dec</i>
Thursday, January 5	
ADP Employment Change <i>Dec</i>	

Financial markets absorbed a lot of bad news in 2011, but will have to set those memories aside quickly here in the New Year, and be ready to focus on another key round of economic data and policy events. Key reports on the state of the manufacturing sector, consumer spending and the labor market as 2011 ended will compete for attention with the minutes of the December 13 Federal Open Market Committee (FOMC) meeting.

As noted in our final *Weekly Economic Commentary* of 2011, "Bucking the Trend" (December 19, 2011), 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 December was the strongest since early 2008, and orders for durable goods surged by 3.8% month-over-month in November, indicating that the manufacturing sector had enough momentum to carry it into early 2012.

As this report was being prepared for publication, the Institute of Supply Management (ISM) released its report on manufacturing for December. The market is looking for another modest acceleration in manufacturing activity in December. The ISM (a reading above 50 on this index means that the manufacturing sector is expanding while a reading below 50 indicates that the manufacturing sector is contracting; a reading at or below 42 indicates a recession) decelerated sharply from readings over 60 in early 2011 to just 50.6 in August, as the domestic manufacturing sector experienced the full brunt of the global supply chain disruptions. Since then, the ISM has moved steadily higher as the global supply chain recovered [Chart 1].

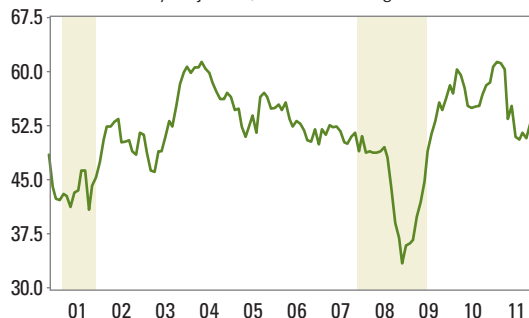
However, the likely recession in Europe along with slower growth in China and other emerging markets may halt the improvement in the manufacturing sector in early 2012. Our view is that the turmoil in Europe and the slowdown in China have probably already had an impact on manufacturing in the United States, though manufacturing has been stronger than the consensus forecast just a few months ago.

The consumer will also be in the spotlight this week, as retailers report their December sales and automakers report their tally of December auto and light truck sales. In recent weeks, consumer sentiment has recovered nearly all the ground lost during, and just after, the wrenching debate in Washington over the debt ceiling in July and August 2011. Lower gasoline and grocery prices as well as some better news on housing helped to lift sentiment, but sentiment



1 The Slowdown in China and the Recession In Europe May Slow Manufacturing in Early 2012

— ISM Manufacturing: PMI Composite Index
Seasonally Adjusted, 50+=Increasing



Source: Institute for Supply Management, Haver Analytics 12/23/11

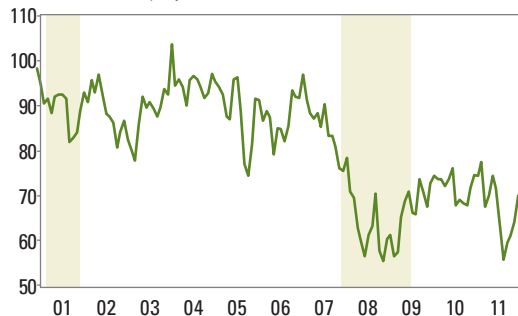
(Shaded Areas Indicate Recession)

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

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.

2 Thanks in Part to An Improving Labor Market, Consumer Sentiment Has Recouped Nearly All of the Ground it Lost During the Summer Debt Ceiling Debate

— University of Michigan: Consumer Sentiment
Not Seasonally Adjusted, Q1-66=100



Source: University of Michigan, Haver Analytics 12/23/11

(Shaded Areas Indicate Recession)

continued to be weighed down by horrible news in Europe, the late December 2011 wrangling in Washington over the extension of the payroll tax cuts, and extreme volatility in the financial markets.

In mid-December, the National Retail Federation (NRF)—a trade group of the nations 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.

As noted in our *Weekly Economic Commentary* from December 19, in the past, the National Retail Federation has been very conservative in its holiday sales forecasts. Thus, the positive guidance provided by the NRF 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.

The key report of the week is likely to be the December employment report, due out on Friday, January 6. Underlying improvement in the labor market in recent months has helped to drive the number of Americans filing initial claims for unemployment insurance to three-and-a-half-year lows and has also probably helped to boost consumer sentiment as well [Chart 2]. The December employment report will provide a comprehensive look at the labor market in the month.

Our view is that the labor market is stuck in neutral, but recent data suggests it may be moving into gear, as some of the economic, policy and regulatory uncertainty that restrained hiring in the middle part of 2011 is beginning to lift. This is by no means an “all clear” on the labor market, as the private sector economy shed more than 8.8 million jobs between the end of 2007 and early 2010, and has added just under 3 million back since then. A steadier pace of economic growth coupled with ongoing reduction in the economic, policy and regulatory uncertainty that weighed on hiring will lead to an improved labor market in the months and quarters ahead.

The unemployment rate, which is derived from a survey of 60,000 households, is expected to tick up to 8.7% in December after falling a stunning 0.4% between October and November to 8.6%. The dip in the rate, which was widely questioned at the time, now seems more reasonable given the data we now have on initial claims, consumer sentiment and consumer spending for November and December. The unemployment rate is calculated by dividing the number of unemployed persons seeking work (about 14 million) by the number of people in the labor force (about 154 million). The unemployment rate peaked at 10.1% in October 2009, but was as low as 4.4% as recently as early 2007.

The monthly job count is derived from a survey of businesses (140,000 businesses representing more than 400,000 worksites) and has been conducted each month for more than 60 years. The market is expecting an



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increase of 160,000 private sector jobs in December, a slight acceleration from the 140,000 private sector jobs created in November. From January through November 2011, the economy created an average of 156,000 private sector jobs per month, which is about the same pace at which the labor force increases each month, which helps to explain why the unemployment rate has remained around 9.0% in 2011. While the private sector is expected to have added about 160,000 jobs in December, the public sector (federal, state, and local governments) is expected to see another drop in jobs. In particular, the state and local government sector shed jobs in ten of the first eleven months of 2011 and in 32 of the past 40 months. In all, state and local governments have shed 610,000 jobs since mid-2008, an average of about 15,000 per month. We expect this pace of downsizing in the state and local government sector to persist for the foreseeable future as state and local governments struggle to realign costs with revenues. We expect that 2012 will be another year in which the state and local government sector provides little support for the overall economy.

Communication Clarification from the Fed?

As this report was being prepared for publication, the Federal Reserve (Fed) will release the minutes of its December 13 FOMC meeting. The December 13 FOMC meeting itself was a non-event, as the Fed made very few changes to the statement it released after the meeting, reiterated its promise to keep rates at extraordinarily low levels until at least mid-2013, and maintained its program of extending the maturity of its Treasury holdings to keep yields low in order to encourage more borrowing by households, homebuyers, and businesses (dubbed “Operation Twist”, set to end in mid-2012).

Between now and then, Fed policymakers must grapple with the European financial crisis and its impact on the global and U.S. economies. As the Fed continues to monitor its view of the economy—which is more optimistic than our view, the consensus view, the market’s view and the financial media’s view—one of the tools it can employ is its communications policy. Market participants are hoping to learn more about how the Fed intends to alter the way it communicates with the public, the markets and its bosses in Congress from the minutes of the December 13 meeting.

While the economic hurdle of implementing QE3 may be low, the political hurdles both within and outside the Fed remain high, which leaves only the Fed’s communication policies as a viable alternative in the near term.

However, given that the December 13 meeting was just a one-day meeting—four of the Fed’s eight meetings a year are two-day affairs at which policymakers craft a new economic forecast—the Fed was unlikely to have agreed to employ any of its new “tools” at that meeting, but it more than likely discussed the options on the table ahead of the two-day FOMC meeting at the end of this month. In our view, those tools would include enhancing the way the Fed communicates with the public, and, if warranted, yet another round of fixed income security purchases in the open market, also known as quantitative easing, round three (QE3). While the economic hurdle of implementing QE3 may be low, the political hurdles both within and outside the Fed remain high, which leaves only the Fed’s communication policies as a viable alternative in the near term.



We expect the communications issue was a key topic of discussion at the December 13 FOMC meeting, and the minutes of that meeting will likely pave the way for some action to be taken on the communications front at the two-day FOMC meeting in late January 2012.

As we noted in a recent *Weekly Economic Commentary*, "Communication Breakdown" (December 12, 2011), while more timely communication from the Fed is one possibility, the minutes of recent FOMC meetings (prior to the December 13 meeting) suggest that Fed policymakers are leaning toward providing more clarity on their views of inflation, economic growth, their balance sheet (Operation Twist, QE3, etc.) and even interest rates. Some members of the FOMC have even hinted that having the Fed target a level of gross domestic product (GDP) or inflation may be appropriate ways to communicate with the public and financial markets (and its bosses in Congress, too!). Thus, we expect the communications issue was a key topic of discussion at the December 13 FOMC meeting, and the minutes of that meeting will likely pave the way for some action to be taken on the communications front at the two-day FOMC meeting in late January 2012.

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Stock investing involves risk including loss of principal.

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.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

The University of Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

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