

Weekly Economic Commentary



February 28, 2011

Will Rising Energy Prices Derail the Recovery?

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Highlights

- The February jobs report dominates this week's extremely busy data calendar.
- Fed Chairman Bernanke, a potential government shutdown, and several key central bank meetings are on the docket this week.
- Putting the recent rise in consumer energy prices in perspective.

Economic Calendar

Monday, February 28	ADP Employment Report <i>February</i>
Personal Spending <i>January</i>	Bernanke Testimony - House
Personal Income <i>January</i>	Beige Book
Chicago Purchasing Managers <i>February</i>	Thursday, March 3 Initial Claims <i>wk 02/26</i>
Pending Home Sales <i>January</i>	Productivity <i>Q4</i>
Dallas Fed Survey <i>February</i>	ISM-Nonmanufacturing <i>February</i>
Tuesday, March 1	Chain Store Sales <i>February</i>
ISM Manufacturing <i>February</i>	Friday, March 4 Unemployment Rate <i>February</i>
Construction Spending <i>January</i>	Nonfarm Payrolls <i>February</i>
Domestic Light Vehicle Sales <i>February</i>	Factory Orders <i>January</i>
Bernanke Testimony - Senate	
Wednesday, March 2	
Challenger Layoff Data <i>February</i>	

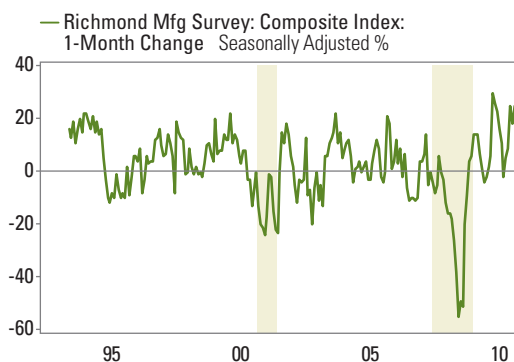
Financial market participants face a barrage of key policy events and economic data this week as they try to assess the impact of rising consumer energy prices on the global economic recovery. On the policy side, Federal Reserve (Fed) Chairman Bernanke will deliver key testimony on the economy and monetary policy, the Fed will release its Beige Book (a qualitative assessment of economic conditions in the United States), and central banks in Canada, Brazil, Australia, India, Indonesia and the European Central Bank (ECB) all meet to set policy this week. In addition, a shutdown of the U.S. government looms later in the week (March 4) as Congress scrambles to cobble together a spending bill that both parties can agree to (see this week's *Weekly Market Commentary* for more details).

On the economic front, the week is full of potentially market-moving reports. Early in the week, reports on manufacturing sentiment in the United States (Chicago Area Purchasing Managers Index), the Institute for Supply Management's (ISM) report on Business for February, along with a report on Chinese manufacturing sentiment in February will garner most of the market's attention. By midweek, the market will begin to focus on the state of the labor market in February with the release of the Challenger-tracked corporate layoff announcements and ADP employment report. The consumer is in the mix this week as well, with reports on consumer spending and personal income for January, vehicle sales for February, and chain store sales for February all due out. The week concludes with the much-anticipated February employment report, which is likely to show that the economy added over 200,000 jobs after severe weather held down employment in January.

Last week's economic data and events were dominated by the sharp rise in oil prices, which, in turn, were largely the result of further unrest in the Middle East, mainly in Libya. The drop in initial claims for unemployment insurance, the gains in consumer confidence, Richmond Fed manufacturing index and weekly retail sales (all data readings for February) were consistent with previously released data for February. This data suggests that severe weather negatively impacted economic activity in January and that more normal weather in February allowed for a sharp rebound in activity. Thus, the underlying health of the U.S. economy can best be measured by taking an average of January and February's data. Weak reports (for January) released last week included new home sales, and durable goods orders and shipments. We expect that when this data is reported for February (in late March), it too will show a rebound in activity.

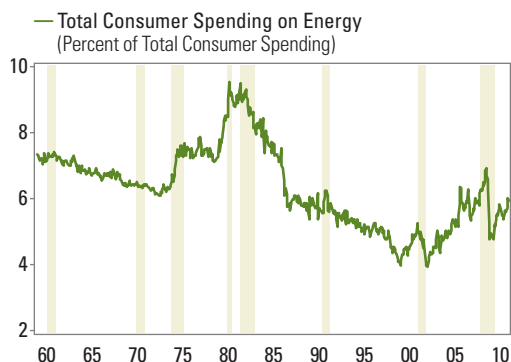


1 The Richmond Fed Index of Manufacturing Conditions Surged in February and is at One of Its Highest Readings Ever



Source: Federal Reserve Bank of Richmond /Haver Analytics 02/28/11
(Shaded areas indicate recession)

2 Energy Spending As a Percent of Total Spending Has Moved Up Over the Past Two Years, But Remains at a Low Level...For Now



Source: Haver Analytics 02/28/11
(Shaded areas indicate recession)

Will Rising Consumer Energy Prices Derail the Recovery?

We will shift our focus now to the issue of rising energy prices and its impact on the economic recovery and on the consumer in particular. As we previously noted, one of the biggest threats to the economic recovery is a big spike in energy prices that would sharply curtail consumer spending and, to a lesser extent, business spending and lead to a slowdown in the economy and a potential recession. The relentless rise in consumer energy prices in the mid-2000s (from 2003 through mid-2008) were a major factor in derailing the mid-2000s (2002-2007) economic recovery and we remain vigilant to those risks. However, although oil prices pierced the psychologically important \$100 per barrel level last week (and gasoline prices climbed closer to \$3.25 per gallon in most of the nation), we do not think the recent rise in prices is enough to derail the recovery.

Detailed data on consumer spending in January 2011 found in the monthly report on personal income and spending (which was released as the *Weekly Economic Commentary* was being prepared) help to provide a broader perspective on what consumers spend on energy related goods and services. In January 2011, consumers spent an annualized \$631 billion on energy goods and services (gasoline, home heating oil, propane, electricity, natural gas, etc.). The table below details how that \$631 billion was spent. The data on spending is adjusted for seasonality, so it takes into account the fact that people spend more on heating oil and natural gas in January than they do in June, but also accounts for the fact that consumers do more driving in June than in January. Seasonally adjusting data allows us to compare month-to-month changes in dataset and also allows us to compare spending in one month to spending in a different month on an “apples-to-apples” basis.

Detail of Consumer Energy Spending and Prices

	Spending in January 2011	% of Total in January 2011	Price Today	Price in July 2008
Gasoline	\$375.2 Billion	59%	\$3.19 /gallon	\$4.11/gallon
Electricity	\$163.2 Billion	26%	\$52/MWH	\$115/MWH
Natural Gas	\$63.1 Billion	10%	\$4.06 BCF	\$13.35 BCF
Heating Oil	\$29.7 Billion	5%	\$2.93/ gallon	\$3.90/gallon
Total	\$631.2 Billion	100%		

Source: U.S. Bureau of Economic Analysis, Bloomberg 02/28/11

Out of context, \$631 billion appears to be a great deal of money, but when compared to total personal spending (\$10.6 trillion in January 2011), personal income (\$12.9 trillion) and gross domestic product (\$14.9 trillion), consumer spending on energy and energy services is relatively small. On balance, 6% of consumer spending and around 5% of personal incomes were spent on energy and energy services in January 2011 (See table on page 3). While low, these readings have moved steadily higher over the past two years, as prices of energy climbed from their Great Recession lows. For example, at the peak of energy prices in July 2008, consumers spent \$710 billion on energy goods and services, representing 7% of total



personal spending and 5.7% of personal incomes. In the worst of the Great Recession in late 2008, spending on energy goods and services sunk to \$469 billion (4.8% of spending and 3.8% of incomes).

Higher energy costs impact businesses as well, although the data on what businesses spend on energy related goods and services is not as detailed as the consumer spending data. On balance, energy costs account for between 5 and 10% of overall business costs. By comparison, labor costs are roughly 70% of business costs. We note that the most noticeable impact on businesses from higher energy prices is on shipping and transportation costs. Businesses will try to pass these higher transport and shipping costs onto the end user (typically, the consumer), and if they are unable to pass on these costs, businesses profit margins (which are near record high) could suffer, which would slow corporate profit growth.

Since December 2008, spending on energy goods and services has moved from 4.8% of total consumer spending to 6.0% of spending, but still shy of the 7.0% of spending hit in mid-2008. Even that elevated reading was dwarfed by the near 10% of spending on energy goods and services relative to total spending seen in the late 1970s and early 1980s. Still, it is how far and how fast energy spending rises that matters most, and by those metrics the recent rise in consumer spending on energy goods and services is still muted. For example, in 1973, consumer spending on energy goods and services accounted for around 6% of total spending. After two oil embargoes (1973 and 1979), consumer energy spending accounted for nearly 10% of spending by 1980. This rising share of energy spending acted as a tax on the economy during the mid-to-late 1970s, slowing consumer spending and the overall economy, contributing to three recessions (1973-75, 1980 and 1981-82).

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Consumer Spending on Energy Goods and Services

	Early 2000s Lows	July 2008 Peak	Late 2008 Lows	January 2011
Total Consumer Spending on Energy Goods and Services	\$286 Billion	\$700 Billion	\$469 Billion	\$631 Billion
Consumer Energy Spending As a Percent of Total Spending	4.0%	7.0%	4.8%	6.0%
Consumer Energy Spending As a Percent of Income	3.2%	5.7%	3.8%	4.9%

Source: U.S. Bureau of Economic Analysis 02/28/11

In our view, the surge from around 5% in late 2006 to the aforementioned peak in mid-2008 (7%) was a key factor in causing the onset of the Great Recession in late 2007.

Energy spending as a percent of total spending troughed in the early 2000s at around 4.0%, and by mid-2008 had nearly doubled to 7%. In our view, the surge from around 5% in late 2006 to the aforementioned peak in mid-2008 (7%) was a key factor in causing the onset of the Great Recession in late 2007. In short, the move higher in energy prices and spending in the last 24 months or so has probably not been sharp enough or rapid enough to derail the recovery by itself. However, should consumer energy prices (gasoline, heating oil, electricity) move sharply higher in the coming months, and income gains reverse course and stagnate, the recovery would be in jeopardy. We will continue to monitor this important metric closely.



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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.

The Richmond Fed Index is based on one of many regional surveys that measure manufacturing activity. These surveys can be of some help in forecasting the national NAPM - particularly the Philadelphia and Chicago surveys which are more closely watched due to their timeliness and the fact that these regions represent a reasonable cross section of national manufacturing activities. This report is released after the National Association Purchasing Managers (NAPM) survey and is therefore of little value.

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