

# Weekly Economic Commentary



March 14, 2011

## Focus on Japan and the Fed

### John Canally, CFA

Economist  
LPL Financial

#### Highlights

- We examine Japan's economy and the earthquake impact on Japan's growth prospects.
- A look at the key issues at this week's Federal Open Market Committee meeting.
- United States economy still chugging along despite higher energy prices.

#### Economic Calendar

<b>Tuesday, March 15</b>	<b>Thursday, March 17</b>
NY Fed Empire State Mfg <i>March</i>	CPI <i>February</i>
Import Price Index <i>February</i>	Initial Claims <i>wk 03/12</i>
NAHB Housing Survey <i>March</i>	Capacity Utilization <i>February</i>
FOMC Decision	Industrial Production <i>February</i>
<b>Wednesday, March 16</b>	Philly Fed Index <i>March</i>
Current Account Balance <i>Q4</i>	Leading Indicators <i>February</i>
Building Permits <i>February</i>	
Housing Starts <i>February</i>	
PPI <i>February</i>	

The devastating earthquake in Japan and its short- and long-term impact on the world's third biggest economy, the Federal Reserve's policy meeting, and a scattering of economic data for February and March in the United States will be top of mind this week for investors. The Chinese economic data is quiet this week, while central banks in Norway, Hong Kong, Switzerland, Chile, Japan, Colombia and Iceland meet to set policy. Of these, only resource-rich Chile is expected to raise rates, and Japan's central bank has already injected a record \$183 billion into the Japanese economy in response to the earthquake. Last week's economic data and events in the United States revealed that rising gasoline prices were having a negative impact on consumer sentiment and near-term inflation expectations, but economic growth in the United States looks solid as the first quarter of 2011 draws to a close.

## A Quick Look at Japan, the World's Third Largest Economy

The earthquake, tsunami and still-unfolding nuclear crisis in Japan is likely to be a source of concern for market participants in the coming weeks. As we digest this catastrophic event (and its immeasurable human toll), we thought it would be appropriate to provide a quick overview of Japan's economy. Japan, with a population of over 127 million people, is the world's third largest economy, about one-third the size of the U.S. economy and just about the same size as China's economy. Of course, China and Japan's economies have moved in opposite directions in recent years with Japan's economy growing at under 1% per year over the past 10 years, while China's economy has increased by an average of over 10% per year over the past 10 years. Looking ahead, the market expects real gross domestic product (GDP) growth in Japan of just 1.5% in 2011 and only about 2.0% in 2012. Thus, the market did not expect much from Japan prior to the quake, and is likely to expect even less in its aftermath.

The area in northeastern Japan most directly impacted by the earthquake and resulting tsunami accounts for between 5% and 10% of Japan's economic activity, and is focused mainly on agriculture, pulp and paper manufacturing, and petroleum refining. By comparison, the 1995 earthquake in Kobe, Japan hit what was then the largest and busiest port in Japan. Kobe is also Japan's sixth largest city and a key industrial manufacturing center. In another comparison, closer to home, the region most impacted by



2005's Hurricane Katrina (Louisiana, Alabama and Mississippi) accounts for just over 3% of GDP in the United States.

Japan has a trade surplus (it exports more goods than it imports) and its major exports to the world are vehicles, electronics, industrial equipment and computers. Japan's biggest export customers are China, the United States, the European Union, South Korea and Taiwan. Japan's largest exports to the United States include:

- Cars and trucks
- Car and truck parts
- Industrial machinery
- Electronics

Japan biggest imports are:

- Raw materials (oil, food, lumber)
- Machinery
- Textiles

China accounts for 20% of Japan's imports, about 12% come from the United States, and around 10% of Japan's imports come from the Gulf oil states. Japan's major imports from the United States are civilian aircrafts and parts, industrial machinery, agriculture and medical equipment.

As previously noted, the Bank of Japan has already injected a massive amount of liquidity into the Japanese economy in the wake of the disaster, and the Japanese government has pledged another \$2.4 billion to hasten relief efforts, but more is likely. In short, markets did not expect much in the way of growth in the world's third largest economy prior to the catastrophe (and have not for many years) and now, in the short term, growth prospects have been diminished further. Over the medium term, as the affected infrastructure (roads, ports, electrical grid, railways, homes and buildings) are rebuilt, the economy is likely to get a lift, but the longer-term prospects in Japan remain muted. The financial costs of rebuilding are only likely to further negatively impact growth and financial flexibility in the years to come.

### Consumer Spending and Prices

	Weight	YOY%
Housing	41.5%	0.4%
Food/Beverages	14.8%	1.8%
Apparel	3.6%	0.0%
Transportation	17.3%	5.4%
Medical Care	6.6%	2.9%
Recreation	6.3%	-0.6
Education/Comm	6.4%	1.2%
Other	3.5%	1.9%
<b>Total</b>	<b>100%</b>	<b>1.6%</b>

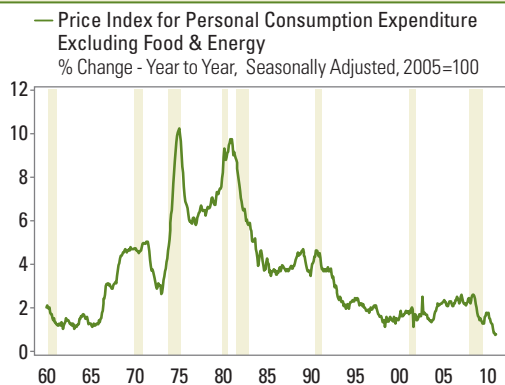
Source: U.S. Department of Labor 03/14/11

### What to watch For at This Week's FOMC Meeting

The Fed's policymaking arm, the Federal Open Market Committee (FOMC), meets this week to discuss policy. While no one expects the FOMC to raise rates at this meeting, the FOMC could acknowledge the recent gains in the labor market and economy, and further elevate the discussion over rising raw material prices and wages setting a hawkish tone. However, the FOMC is also likely to acknowledge that while economic growth has improved, the labor market is growing again and that core inflation is rising, growth is not yet strong enough to push the unemployment rate significantly lower or core inflation significantly higher to convince the FOMC that tighter monetary policy is needed. In short, while the statement from the March 15 FOMC meeting is not likely to signal an outright shift in Fed policy (which would have major implications for bond, stock and commodities markets)



## 1 Core Inflation Remains Low, but May Have Bottomed Out in Late 2010



Source: Bureau of Economic Analysis/Haver Analytics 03/14/11  
(Shaded areas indicate recession)

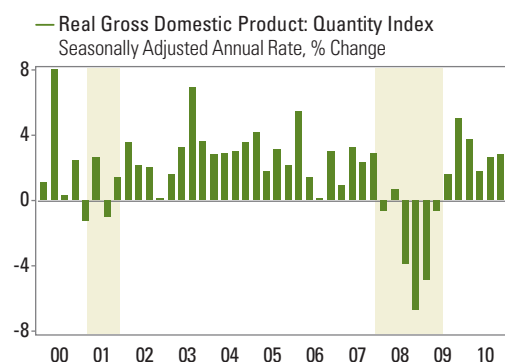
the statement is likely to be another incremental step toward an eventual FOMC interest rate hike.

The FOMC is also likely to maintain its Large Scale Asset Purchase Program (LSAP), which is commonly known as the second round of quantitative easing (or QE2 for short), and view an early end to QE2 as unlikely. We also expect the FOMC statement to reduce the odds of implementing QE3 when QE2 expires in June. We have long held the view that the hurdle was high for ending QE2, but even higher to commence QE3.

Finally, there is also likely to continue to be “dissent” within the FOMC itself, but we point out that there were no votes against maintaining current FOMC policy (federal funds rate near zero, QE2, expanding balance sheet) at the last FOMC meeting in January. Since then, however, several likely FOMC dissenters (Philadelphia Fed President Charles Plosser and Dallas Fed President Richard Fisher) have hinted that while they are not happy with QE2, they are not willing to vote against it. They have said, however, that they would not take the same view toward yet another round of quantitative easing (i.e. QE3) when QE2 expires in June. This sets up a likely battle on the FOMC over the next several months, a battle likely to be decided by the path and pace of economic growth and the ability of businesses to pass on higher input costs to end consumers.

## Last Week’s Economic Data Revealed That U.S. Economic Growth Remained Solid in the Face of Higher Energy Prices

## 2 Q4 2010 Likely to be Revised Up and Q1 2011 Growth on Track to Be Close to 3.5%, the Best Back-To-Back Quarters of Growth (Unaided By Government Stimulus) Since the Mid-2000s



Source: Bureau of Economic Analysis/Haver Analytics 03/14/11  
(Shaded areas indicate recession)

Last week’s economic data, highlighted by a 1.0% surge in retail sales in February and an energy induced dip in consumer confidence, suggested that economic activity in the United States was quite strong in the first quarter even as energy prices rose, impacting consumer sentiment and inflation expectations. Reports on consumer credit for January, small business optimism for February, business inventories for January, and retail sales for February suggested that the U.S. economy probably grew faster than previously expected in the fourth quarter (closer to 3.5% than the originally reported 2.8% growth) and that economic growth in the first quarter of 2011 (which ends on March 31) is likely to be close to 3.5% [Chart 2].

However, the larger-than-expected trade deficit in January (led by a surge in oil imports), an unexpected rise in initial claims for unemployment insurance in mid-March, and a drop in consumer sentiment fueled by rising gasoline prices tempered markets’ enthusiasm for the U.S. economy. In addition, the release of the February budget data for the U.S. government served to remind markets that the United States is well on its way to another record budget deficit in fiscal year 2011, which ends at the end of September.



---

**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.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

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.

Personal Consumption Expenditures is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, non-durables and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.

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