

Weekly Economic Commentary



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Beige Book and Budget Battle Take Center Stage

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Highlights

- Beige Book and March CPI highlight a busy economic calendar.
- One budget battle ends and another begins.

Economic Calendar

Tuesday, April 12 Import Price Index <i>March</i>	Thursday, April 14 Initial Claims <i>wk 04/09</i>
Trade Balance <i>February</i>	PPI <i>March</i>
Treasury Statement <i>March</i>	Friday, April 15 NY Fed Empire State Mfg <i>March</i>
Small Business Optimism Index <i>March</i>	CPI <i>March</i>
Wednesday, April 13 Retail Sales <i>March</i>	Capacity Utilization <i>March</i>
Beige Book	Industrial Production <i>March</i>
Business Inventories <i>February</i>	U of Mich Consumer Sentiment <i>April</i>

The outlook for Federal Reserve (Fed) policy provides the backdrop for this week's batch of economic data and events in the United States. In addition, while the first skirmish in the great Budget Battle over 2011 is over, an even bigger battle lies ahead: the debt ceiling.

Beige Book and CPI Highlight a Busy Economic Calendar

The key economic release in the United States this week could be the Fed's Beige Book—a qualitative assessment of business conditions in each of the 12 Federal Reserve districts around the nation. Also in the spotlight this week will be the March CPI data and the March retail sales report. Released eight times a year, the release of the Beige Book precedes the meeting of the Fed's policymaking arm, the Federal Open Market Committee (FOMC), by two weeks. Often, what businesses (small business owners, bankers, retailers, real estate agents, manufacturers, etc.) tell their contacts at each of the 12 regional Federal Reserve branches (San Francisco, Dallas, Atlanta, Richmond, Kansas City etc.) end up as a big part of the discussion at the FOMC meeting.

In recent Beige Books, some businesses have sounded the alarm over rising commodity and raw materials prices, and their inability to pass these increases on to the end user. Economy-wide, raw materials costs account for around 5 to 10% of business' input costs. In addition, recent Beige Books have noted some upward pressure on wages (which account for 70% of business costs and therefore have a much bigger impact on inflation).

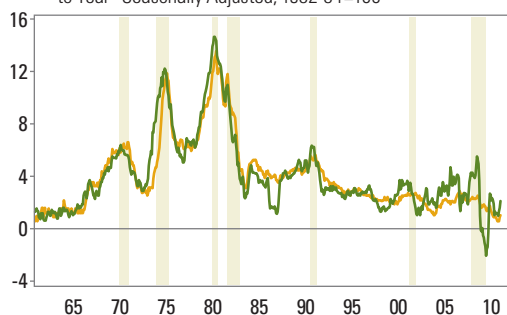
Broadly speaking, recent Beige Books (which also comment on the overall economy, the labor market, housing, retail sales, nonresidential building—office parks, malls, factories, etc.—bank lending and financial conditions) have been consistent with moderate growth in the economy, very modest increases in overall inflation, and most importantly, with still accommodative monetary policy. We will be closely monitoring the Beige Book for any mention of the Japanese earthquake, fiscal conditions at the state and federal level, and how weather conditions may be having an impact on the economy.

On balance, we expect this week's Beige Book to continue to show that businesses are still coping with rising commodity prices, that the labor market is improving, and that the overall economy continues to heal. Financial markets (especially the fixed income markets) are likely to be very sensitive to any ratcheting up of concern over inflation in the Beige Book.



1 Despite the Recent Run-up in Food and Energy Prices, Both Overall Inflation and Core Inflation Remain Low by Historical Standards

— CPI-U: All Items, % Change - Year to Year Seasonally Adjusted, 1982-84=100
 — CPI-U: All Items Less Food and Energy, % Change - Year to Year Seasonally Adjusted, 1982-84=100

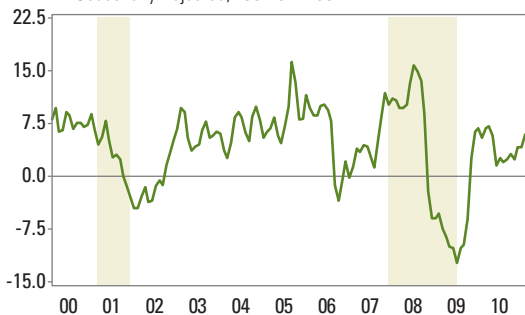


Source: Bureau of Labor Statistics/Haver Analytics 04/11/11

(Shaded areas indicate recession)

2 Sharply Higher Food and Energy Prices Threaten the Fed's Focus on Low Core Inflation Readings

— CPI-U: Food and Energy, % Change - Year to Year Seasonally Adjusted, 1982-84=100



Source: Bureau of Labor Statistics/Haver Analytics 04/11/11

(Shaded areas indicate recession)

The real battle on the budget is likely to come in the debate over the debt ceiling.

Our view remains that the hurdle for the Fed to end its current course of quantitative easing (QE2) remains high, but that the hurdle remains even higher for the Fed to start another round of quantitative easing when QE2 ends on June 30, 2011.

The Fed's Communication Problem on Inflation

While markets will be interested in all of the data due out this week (including the April data on manufacturing activity in the New York region and the weekly readings on retail sales, mortgage applications and initial filings for unemployment insurance in early April), the key report of the week is likely to be the March report on the consumer price index (CPI).

Rising food and energy prices have dominated the inflation debate for months now, and there are likely to be sizeable month-over-month gains in both food and energy prices in March. However, excluding food and energy (core CPI), the consumer price index is expected to be tame in March, rising just 0.2% month-over-month. The 0.2% month-over-month gain translates into a 1.2% increase year-over-year, a very tame reading by historical standards [Chart 1].

In formulating monetary policy, the Fed monitors core inflation, and while policymakers are sure to be pleased that core inflation remains quite low by historical standards, some have expressed concern that core inflation appears to have bottomed out in late 2010 at 0.6% year-over-year (October 2010), and has moved steadily higher since then. Markets have taken notice as well and, in general, consumers remain more concerned with rising food and energy prices, leaving the Fed with a communication problem. Hopefully, in his first ever post-FOMC meeting press conference on April 27, Fed Chairman Bernanke will address and assuage those fears. Until then, markets will focus on the accelerating core CPI and consumers will focus on the higher prices they pay each week at the gas pump and grocery store [Chart 2].

More Budget Battles Loom in the Months Ahead

Late last week, Congress and the White House agreed on a budget for the rest of fiscal year 2011, which ends on September 30, averting a government shutdown at the eleventh hour. However, more intense budget battles lie ahead—the 2012 budget and the Treasury's borrowing authority (debt ceiling)—and markets are likely to be less sanguine about the upcoming budget battles than they were about the potential of a government shutdown. While the 2012 budget is a factor, in most years, including this one, budgets to fund the government are not finalized until well after the start of the fiscal year. Thus, the real battle on the budget is likely to come in the debate over the debt ceiling.

In exchange for raising the debt ceiling, Congressional Republicans are most likely going to want deep cuts in spending for both fiscal year 2012 and beyond. The Senate Democrats and the White House want smaller cuts, and for spending cuts to be accompanied by tax increases.



All three of these areas, along with some tax increases, are likely to be part of any bipartisan effort to tackle the deficit in 2012 and beyond.

The game of “political chicken” over the debt ceiling limit in the next few months has the potential to move markets, especially the debt markets. A series of short term increases in the debt ceiling is possible over the next few months, which would lead to a number of “drop dead” dates on the budget that may impact financial markets. And while some observers may think that an agreement on the debt ceiling and more spending cuts is more likely in the wake of the agreement reached last week on the 2011 budget, we disagree. Our view is that despite the agreement on the 2011 budget late last week, the risks of the battle leading to a default by the U.S. Treasury (while still extremely low-lawmakers would almost certainly act to prevent such an outcome), they have risen in recent weeks, as the political rhetoric at the extremes of both sides of the aisle ramps up.

At the same time, while the odds are long that a deal can be worked out soon between House Republicans, Senate Democrats, and President Obama to pass a package that would begin to meaningfully address the nation’s long-term budget deficit problem (too much spending, not enough revenue, too much debt), the chances have gone up in recent weeks as well.

Although the details of the budget deal agreed to last week are unclear, it does appear as if there was an agreement to cut some discretionary spending, defense spending, as well as some entitlement spending. All three of these areas, along with some tax increases, are likely to be part of any bipartisan effort to tackle the deficit in 2012 and beyond.

We expect debate about the debt ceiling limit (and to a lesser extent the budget for fiscal year 2012, which begins on October 1, 2011) to be front and center for the next two months. Last week, Treasury Secretary Tim Geithner told Congress that the nation’s \$14.29 trillion debt limit would be reached on May 16, 2011, although he noted that actions could be taken to extend that date into early July if necessary (please see the *Bond Market Perspectives* from March 15, 2011 for more detail on the debt ceiling and its impact on the fixed income markets).

Last week, the Chairman of the House Budget Committee, Paul Ryan of Wisconsin, released a plan to cut trillions off of the deficit over the next 10 years, mainly by addressing Medicare, an entitlement program that helps to provide healthcare to senior citizens. Later this week, President Obama is expected to release his response to the Ryan plan, and that response is likely to include both spending cuts and tax increases to help restore fiscal sanity in Washington.

So although the first round of the budget battle is over, the next phase of the fight has just begun, and is likely to persist as part of the debate over the health of the economy and the financial markets for the next several months.



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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 Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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