

Weekly Economic Commentary

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Highlights

- The week ahead includes data on manufacturing and housing.
- A look at the state of the housing market two years into the economic recovery.

Economic Calendar

Monday, May 16 NY Fed Empire State Mfg <i>May</i>	Wednesday, May 18 Minutes of the April 27 FOMC Meeting
NAHB Housing Survey <i>May</i>	Thursday, May 19 Initial Claims <i>wk 05/14</i>
Tuesday, May 17 Building Permits <i>April</i>	Existing Home Sales <i>April</i>
Housing Starts <i>April</i>	Philly Fed Index <i>May</i>
Capacity Utilization <i>April</i>	Leading Indicators <i>April</i>
Industrial Production <i>April</i>	

Housing Woes Continue

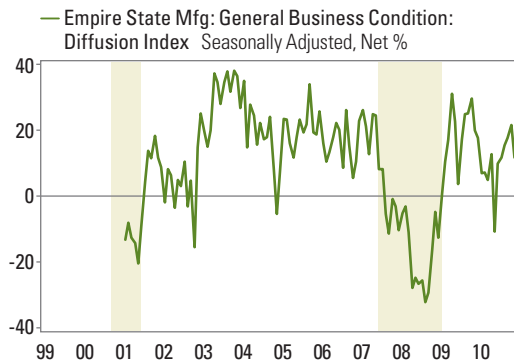
Housing and manufacturing data for April and May will provide the economic data backdrop in the United States this week, as investors react to the latest fiscal flare-up in peripheral Europe. Nearly two years into the economic recovery, the housing market remains in turmoil. We examine the positive and negative aspects of the housing market, and its impact on the health of the recovery.

Housing and Manufacturing Dominate the Week Ahead

As the market debates commodity prices and the fate of Greek debt, investors will absorb data for April and May on housing, manufacturing, and leading indicators this week. As always, markets will also digest the weekly readings on chain store sales, mortgage applications and initial filings for unemployment insurance. The Federal Reserve (Fed) will release the minutes of the April 26–27 Federal Open Market Committee (FOMC) meeting and several voting members of the FOMC are scheduled to make public comments this week. Overseas, it looks like a quiet week for central bank activity, as the only notable central bank meeting to set policy this week is the Bank of Japan, although another rate hike from the Peoples Bank of China (PBOC), which does not have a set schedule for its meetings, could come at any time.

The manufacturing sector will be represented this week by the Empire State Manufacturing Index for May (the first look at manufacturing in May), the Philadelphia Fed Manufacturing Index for May, along with the industrial production and capacity utilization data for April. The Empire State data was released as this report was being prepared and revealed that manufacturing activity continued to expand in New York State in May, but at a slower pace than in April. The 11.88 reading in May (a reading above zero in this Index indicates an expanding manufacturing sector in the New York region while a reading below zero indicates contraction in the sector) was the sixth consecutive reading above zero, and the twenty-second reading above zero in the past 23 months dating back to the beginning of the economic recovery in June 2009. We expect the rest of the month's manufacturing data, including the Institute for Supply Management's (ISM) report on Manufacturing, to show a similar pattern—continued growth in the manufacturing sector in May, but at a slower rate than in April. This pattern is consistent with the behavior of the manufacturing sector at a similar point (i.e., two years in) in virtually every other economic recovery since World War II.

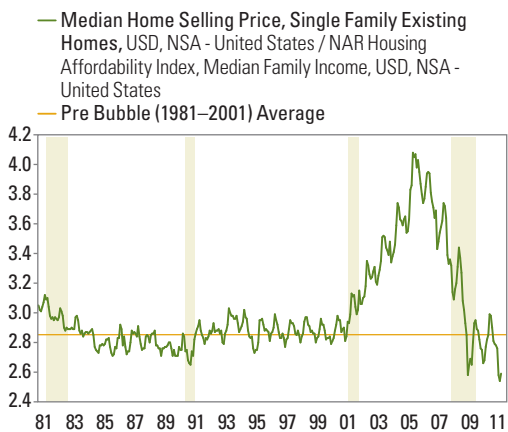
1 Empire State Manufacturing Data for May Shows Continued Expansion in the Manufacturing Sector, but at a Slower Pace than April



Source: Federal Reserve Bank of New York, Haver Analytics 05/16/11

(Shaded areas indicate recession)

2 Housing PE Shows that the Housing Bubble has Deflated... and then Some



Source: National Association of Realtors 03/31/11

(Shaded areas indicate recession)

Housing Market Still Struggling Two Years Into the Economic Recovery

Housing data for April and May will dominate this week, as we reach the peak weeks of the important spring selling season in the housing market. At the beginning of the week, the National Association of Homebuilders (NAHB) survey for May will provide a crucial update on the health of the new home market. At the end of the week, the existing home sales data for April will provide some color in the market that is still suffering the after-effects of the bursting of the mortgage debt bubble. In between, data on housing starts and building permits for April will be released.

There are many positives for the housing market including:

- Homebuyer affordability (the ability of a household with the median income to afford the payments on a median priced home) is at an all-time high
- The ratio of home prices to median income is at an all-time low (indicating that the housing bubble that peaked in 2005 has now fully deflated, and then some) [Chart 2]
- Banks' lending standards for making home loans have been loosening since mid-2008
- The financial obligations ratio (the ratio of financial obligations—including automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance and property tax payments—to disposable personal income) for renters is at a 16-year low
- The inventory of unsold new homes is at an all-time low. As noted below however, it's the inventory of unsold existing homes that is the concern
- A rapidly improving foreclosure pipeline (mortgage delinquencies, defaults, bank-owned houses)

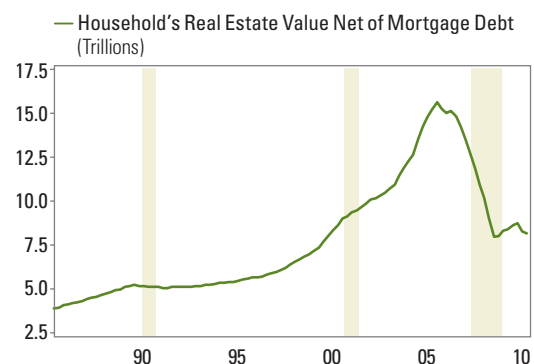
Nationwide, the housing market (sales, prices, construction) has been stagnant, at best, since bottoming out in early 2009, with the recent slide in home prices nationwide receiving most of the financial media's attention. But the housing market is "local" and while the national stats on housing have stabilized, pockets of severe weakness remain in places like California, Nevada, Florida, Michigan and Arizona.

The main issue remains the huge inventory of unsold existing homes (3.5 million as of March 2011) plus the so called "shadow inventory" of bank-owned and foreclosed homes (roughly 3 to 4 million) that will enter the market. In addition, the slowdown in the later stages of the aforementioned foreclosure pipeline may largely be the result of the delays in processing documents rather than a fundamental improvement in the housing market. In addition, "distressed" sales continue to account for a large portion (one-quarter to one-third) of all existing home sales, putting further downward pressure on prices.

The housing market impacts the overall economy via several avenues. The most direct impact is on home construction. In 2010, construction of new homes accounted for around 2% of gross domestic product (GDP), down



3 The Drop in Real Estate Values Over the Past Five Years and Tepid Recovery Is Having A Chilling Effect on the Consumer



Source: Haver Analytics 05/16/11

(Shaded areas indicate recession)

The economic recovery has occurred without the help of housing, and can continue without the help of housing, but the recovery is not likely to feel like a real recovery—nor achieve a more robust pace of growth—for most American's until housing can regain some of its former glory.

from 6% at the peak of the housing boom in 2005-2006. Not much was expected out of housing in 2011, and thus far, the sector is meeting those lowered expectations. Housing also impacts GDP indirectly via construction employment, commissions of real estate and mortgage brokers, and most importantly, via the wealth effect.

In April 2011, 564,000 people were employed in building houses and condos, representing less than one half of one percent of total private sector employment. At the peak of the housing bubble in 2005-2006, 1.1 million people were employed in the construction of new houses and condos, representing close to 1% of private sector employment. It is quite unlikely that the nearly 500,000 construction jobs lost over the past five years are coming back anytime soon. At the peak, nearly 2.2 million people were employed in the real estate industry as brokers and lenders. Today, that figure is closer to 1.9 million workers, and the 200,000 or so jobs lost here are unlikely to come back soon either.

The wealth effect associated with housing probably has the largest indirect impact on the economy. At the peak in 2005–2006, the value of residential real-estate (less the debt associated with residential real estate) stood at nearly \$16 trillion. At the worst of the housing bust in early 2009, the value of real estate net of home mortgages was under \$8 trillion. Today, more than two years later, the value of residential real estate (less real estate debt) remains close to \$8 trillion. The good news is that despite the lackluster performance of real estate, overall household net worth (household assets less household liabilities) has increased by nearly \$8 trillion since the early 2009 low, thanks to the surge in the stock market—and despite the flat performance of residential real estate. Still, in order for the consumer to fully recover the spending power it had prior to the real estate downturn, the housing market has to start to perform better. The economic recovery has occurred without the help of housing, and can continue without the help of housing, but the recovery is not likely to feel like a real recovery—nor achieve a more robust pace of growth—for most American's until housing can regain some of its former glory.



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Stock investing involves risk including loss of principal.

The NY Empire State Index is a regional economic indicator published by the Federal Reserve Bank of New York and released around the middle of the month. It's considered to be an indicator of economic conditions in one of the most populated states in the U.S.

Philadelphia Federal Index is a regional federal-reserve-bank index measuring changes in business growth. The index is constructed from a survey of participants who voluntarily answer questions regarding the direction of change in their overall business activities. The survey is a measure of regional manufacturing growth. When the index is above 0 it indicates factory-sector growth, and when below 0 indicates contraction.

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.

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