

Weekly Economic Commentary

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If Europe Sneezes, Does the United States Catch a Cold?

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ECONOMIC CALENDAR

Monday, May 24	GDP Price Index <i>Q1:2</i>
Existing Home Sales <i>Apr</i>	Real GDP <i>Q1:2</i>
Tuesday, May 25	Friday, May 28
Consumer Confidence <i>May</i>	Personal Spending <i>Apr</i>
Home Prices <i>Mar</i>	Personal Income <i>Apr</i>
Wednesday, May 26	Chicago PMI <i>May</i>
Durable Goods <i>Apr</i>	U of Mich Consumer Sentiment <i>May</i>
New Home Sales <i>Apr</i>	
Thursday, May 27	
Initial Claims <i>wk 05/22</i>	
Core PCE Deflator <i>Q1:2</i>	

Highlights

- United States economic data still pointing to solid economic growth in the second quarter, but the global headwinds are intensifying.
- Will the slowdown in the Eurozone cripple the global economy?
- Data on manufacturing, housing, and consumer spending is likely to be pushed to the background by the European debt problem.

The good news on the U.S. economy last week included the benign readings on both producer and consumer prices in April, solid news on manufacturing in April, and decent housing data for April and May. However, all of that good news was largely ignored amid the unfolding debt crisis in Europe. The bad news last week included an unexpected drop in the index of leading economic indicators, another disappointing reading on initial filings for unemployment insurance, and another big drop in weekly mortgage applications. Taken together, these reports raised concern among market participants that economic growth in the United States was poised to slow in the coming months.

For now, our view remains that economic growth (as measured by real gross domestic product, GDP) is likely to grow at a faster pace in the second quarter of 2010 than it did in the first quarter. However, we continue to expect that real GDP growth in the United States will decelerate in the second half of 2010, as global economic and policy tailwinds of 2009 give way to the intensifying global headwinds of 2010. A significant worsening of the Eurozone debt problem, accompanied by a freeze up of global trade (similar to the one seen in the wake of the collapse of Lehman Brothers in the fall of 2008), would make us alter that view from slower growth to contraction.

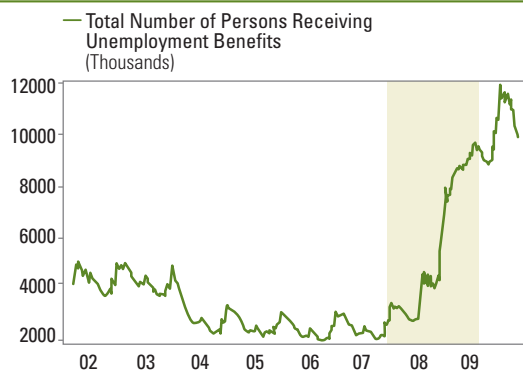
On the monetary policy front last week, the minutes of the April 28 Federal Open Market Committee (FOMC)—the Federal Reserve's (Fed) policy-making arm—showed a relatively upbeat assessment of the U.S. economy, but growing concern among policymakers surrounding the impact of the Eurozone debt problem on the U.S. economy.

Since the European debt crisis moved to the front pages, financial markets have largely ignored the incoming U.S. economic data - good or bad. That was not the case last week, as the bounce higher in first-time filings for unemployment benefits along with the first month-over-month drop in the index of leading economic indicators (LEI) since early 2009 worried market participants. The "growth is slowing" story was also bolstered by the deceleration in the year-over-year gain (versus the year-over-year gain in March) in the LEI.

After falling by more than 200,000 between their peak in April 2009 and December 2009, first-time filings for unemployment benefits have stalled out near the 450,000 per week level over the past five months, raising concerns that the improvement in the labor market may be waning. While we would certainly like to see initial jobless claims resume their downward trend, the number of people receiving some type of unemployment insurance has dropped by more than 2 million since the beginning of the year, which suggests that the unemployment rate has likely peaked for this cycle.



1 The Number of Persons Receiving Unemployment Benefits, While Still Uncomfortably High, has Dropped by 2 Million since the Beginning of 2010



Source: Haver Analytics 5/24/10
Shaded areas represent recessions.

The good news is that although Europe is, along with the United States, the biggest economy in the world, it has not been an engine of growth in recent years, nor was it expected to add much to global GDP growth in 2010 or 2011.

Slowdown in Europe

Financial markets here in the United States and around the globe often discount bad (or good) news well before it happens. When pricing in bad news, markets oftentimes price in the worst-case scenario. Is the European debt problem one of those times? Maybe, but as the market struggles to price in all the news, participants appear to be concerned with two related outcomes of the European debt problem that are similar, but not identical.

The first path is the possibility of one or more of the troubled European nations default on their debt leaving European banks and investors in European banks on the hook for the bad debt, which would, in turn, dry up liquidity globally and send the global economy plunging into another severe recession and a financial crisis.

The other related outcome the market is trying to discount is related to all of the fiscal measures taken by European governments. The concern here is that the steps being taken by governments across Europe to rein in runaway spending will slow growth in Europe, which in turn, would send the global economy into recession as exports dry up.

The risk of the first path (i.e. a default of one of the heavily indebted European nations) has dropped substantially in our view since the \$1 trillion Eurozone loan package was enacted and funded in early May. The much higher risk is the second outcome, where less government spending in Europe spills over into the rest of the world, sending the global economy back into recession.

Europe's economy is the same size as the United States' economy. About 15% of U.S. exports go to Europe, while 20% of Chinese exports go to Europe. The good news is that although Europe is, along with the United States, the biggest economy in the world, it has not been an engine of growth in recent years, nor was it expected to add much to global GDP growth in 2010 or 2011.

Markets were not counting on Europe for too much growth in 2010 and 2011. The consensus estimate of growth in Europe for 2010 was low heading into 2010 (1.4%) and is even lower today, at just 1.2%. At the same time, growth estimates for Europe for 2010 have been marked down, prospects for global economic growth has moved higher, led by upward revisions to growth in places like Brazil, China, Canada, the United States, and even Japan.

On the other hand, global growth prospects for 2011—which may be what the market is worried about now that we are halfway through 2010—have stalled in recent months, but at 3.8%, are still right at where they were at the beginning of 2010 (3.8%), and still above where they were last fall (3.6%) and last summer (3.6%).

Our View on the Key Reports and Events of the Coming Week:

The economic data calendar in the United States this week is chock full of what otherwise would be interesting data for April and May on manufacturing, housing and personal income, and spending. However, financial markets are unlikely to pay much attention on what happened in April and May in the United States, preferring instead to focus on what might happen in the Eurozone and in the global economy in the coming weeks and months.



The manufacturing data includes the report on April durable goods orders and shipments, the first look at business capital spending in the second quarter, along with data for May on the Chicago Area Purchasing Managers Index of manufacturing.

Data on both new and existing home sales for April are due out this week, and both are likely to be strong reports, reflecting a surge in sales as the government first time homebuyer tax credit expired on April 30, 2010. The limited data points the market has seen on housing in May (weekly mortgage applications) suggests that while low rates have triggered another heavy round of refinancing, home purchases have slowed.

On the policy front this week, while there are a number of Federal Reserve officials slated to make speeches, Fed chairman Ben Bernanke is not. However, both Bernanke and Treasury Secretary Tim Geithner are in China this week, as the United States and China begin their Strategic and Economic dialogue. There are several global central bank meetings this week, and the expectation now is that any central bank that had been in the early stages of tightening policy (Israel, India, China) may now pause to see what, if any impact, the Eurozone debt crisis has on global growth. In effect, central banks around the globe may let the European debt crisis do the “dirty work” of slowing growth.

IMPORTANT DISCLOSURES

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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.

Consumer Price index (CPI) is a measure estimating the average price of consumer goods and services purchased by households.

Producer Price index (PPI) tracks inflation by measuring price changes.

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