

# Weekly Economic Commentary

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### Highlights

- The economic data for April and May continues to be impacted by poor weather and the Japanese earthquake. Is the weak economic data a signal or just noise?
- The end of QE2 and its impact on the economy.

### Economic Calendar

<b>Tuesday, May 31</b>	Factory Orders
Chicago PMI	<i>April</i>
<i>May</i>	<b>Friday, June 3</b>
Consumer Confidence	Private Workweek
<i>May</i>	<i>May</i>
<b>Wednesday, June 1</b>	Average Hourly Earnings
ISM Manufacturing	<i>May</i>
<i>May</i>	Manufacturing Payrolls
Construction Spending	<i>May</i>
<i>April</i>	Private Sector Payrolls
Domestic Light	<i>May</i>
Vehicle Sales	Unemployment Rate
<i>May</i>	<i>May</i>
<b>Thursday, June 2</b>	Nonfarm Payrolls
Initial Claims	<i>May</i>
<i>wk 05/28</i>	ISM NMI
Unit Labor Costs	<i>May</i>
<i>Q1</i>	
Productivity	
<i>Q1</i>	

## Will the End of QE2 Derail the Economy?

The week ahead features an avalanche of economic data for April and May, including the key Institute for Supply Management's (ISM) report on manufacturing for May and the May employment report from the U.S. Bureau of Labor Statistics. June arrives this week, but as the month ends, the Federal Reserve's Quantitative Easing 2 (QE2) will also likely end. This week we explore what impact QE2 had on the economy, what is likely to happen in the economy after QE2 ends, and what may cause the Fed to extend QE2 or embark on yet another round of quantitative easing (QE3?).

## Severe Weather, Japan and Late Easter Still a Factor in United States Economic Reports for April and May

In our view, part of the weakness (relative to expectations) in the U.S. economic data over the past month or so has been more noise than a signal. The economy has been impacted by the aftermath of the earthquake in Japan, severe winter and spring weather, and the late Easter. This week, we and other market participants will be carefully reviewing the data for signs that the temporary factors noted above waned as April turned to May. The caveat here is that while there is some evidence that the cleanup in Japan is ending and the rebuilding is underway—industrial production in Japan rose 1.0% in April versus March, after plunging 15% between March and April—the weather did not improve much in May.

Flooding and the worst outbreak of tornadoes in more than 70 years ravaged the Midwestern and Southern United States, caused widespread damage and disrupted economic activity throughout the month of May. May was also an abnormally rainy and cool month in much of nation, and that combination is likely to further dampen economic activity. Thus, assuming the weather in June is relatively normal, it may not be until the June economic data is reported in July that markets can get a clean reading on the underlying health of the economy. Until then, the signal versus noise debate will likely continue.

Although the reports on the health of the manufacturing sector and labor market in May are likely to garner most of the market's attention this week, there are a number of other key reports due out this week. A quick preview of those reports, along with the ISM and employment reports are below:

**Vehicle Sales for May:** Market participants will ask how much impact did parts shortages, lack of key vehicles in auto dealer showrooms and the big



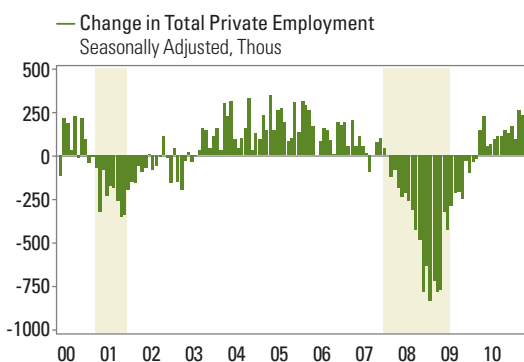
drop in gasoline prices have on consumer spending in the month of May. On the positive side, banks and auto financing firms are making it easier to finance a new car, and interest rates are low.

**Non-manufacturing ISM for May:** The big plunge in ISM's reading on sentiment in the non-manufacturing sector (roughly 80% of the economy) in April triggered a sharp drop in financial markets in early May. Was the plunge related to supply disruptions due to the Japanese earthquake, the late Easter and historically bad weather, or was it the start of a new trend? The consensus expects that the non-manufacturing ISM will bounce back in May, but remain below its early 2011 highs, which were the highest readings in the series since 2005.

**Consumer confidence for May:** Consumer spending accounts for two-thirds of the U.S. economy, and consumer confidence is a decent (although not a perfect) gauge of the mood of consumer. Falling gasoline prices and a strengthening labor market should help confidence in May, while the stagnant housing market continues to keep consumers on the defensive. The data available thus far on consumer confidence in May (daily reports on consumer sentiment from the Rasmussen polling firm, weekly reports from Bloomberg, and the University of Michigan's reading on consumer sentiment) all suggest that consumer confidence bounced higher in May.

**ISM for May:** The market is expecting a 57.6 reading on ISM in May, below the 60.4 reading in April. The ISM reached 61.4 in February, the high for the cycle. At this point in the business cycle (the economic recovery will turn two years on in June 2011), the ISM for manufacturing typically peaks at around 60, and begins to roll back to 50. A reading on the ISM above 50 indicates an expanding *manufacturing sector*. A reading above 42 indicates an expanding *economy*. In the last economic cycle (2001–2007), the ISM got as high as 61.4 in mid-2004 (about two and a half years in to the expansion) before moving back to near 50 in late 2005. The ISM remained above 50 until early 2008, and remained above 42 until late 2008. The same pattern occurred in the 1991-2001 expansion and virtually all the other expansions that preceded it.

## 1 The Private Sector Economy has Added 2.1 Million Jobs in the Past 14 Months

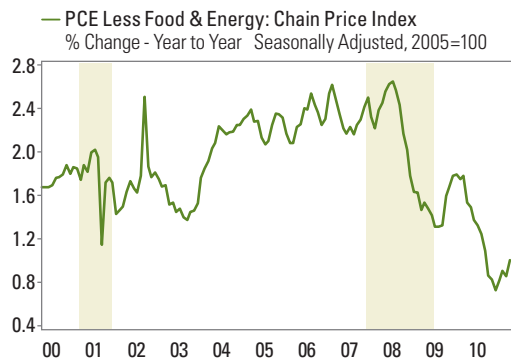


Source: Bureau of Labor Statistics/Haver Analytics 05/31/11

(Shaded areas indicate recession)

**Employment report for May:** The private sector economy shed 8.8 million jobs during and just after the Great Recession that ended in June 2009. However, the private sector has added jobs in each of the past 14 months, totaling 2.1 million, the best performance by the labor market since 2006 and early 2007. The market expects that total to be extended to 15 months and 2.3 million jobs, looking for a 200,000 gain in payrolls in May 2011, after the 268,000 increase in private sector jobs in April. The payroll count is conducted using a survey of businesses across the country. The unemployment rate, which is calculated using a survey of households, is expected to tick down to 8.9% in May from 9.0% in April. The unemployment rate peaked at 10.1% in October 2009, and has moved down slowly over the past 20 months. The late Easter in April, poor weather, the auto plant shutdowns (as a result of parts shortages related to the Japanese earthquake) are all likely to negatively impact the May jobs report.

## 2 Deflation was a Real Threat in the Fall of 2010, Prompting Action from the Fed



Source: Bureau of Economic Analysis/Haver Analytics 05/31/11

(Shaded areas indicate recession)

QE2 appears to have reversed the course of core inflation over the past six to nine months. In our view, this has been the most successful element of QE2.

## The End of QE2

Fed Chairman Bernanke first hinted at QE2 in August 2010, implemented in November 2010, and slated to end on June 30, 2011. Our long-held view remains that the hurdle for the Fed to begin QE3 when QE2 ends remains even higher. In this section, we detail the direct and indirect impact QE2 had on the economy, and what the end of QE2 might mean for economic activity. In addition, we examine what might cause the Fed to embark on another round of large scale asset purchases.

From an economic perspective, QE2 had the biggest impact on inflation, the dollar and asset prices (commodity and equity prices). The threat of deflation (falling wages and prices) prompted the Fed to act in the fall of 2010, and in fighting deflation, QE2 was a success. Deflation—which gripped the U.S. economy in the early 1930s and the Japanese economy off and on for the last 20 years—causes declines in both prices and wages, lowers living standards, and is generally difficult to escape once its firmly entrenched in an economy. In August 2010, the Fed’s preferred measure of inflation, the personal consumption deflator excluding food and energy (core PCE deflator), was 1.2% above its August 2009 level, and decelerating. By December 2010, the year-over-year gain in the core PCE deflator decelerated to 0.7%, an all-time low reading. Since then, the core PCE deflator has turned higher, and in April 2011 (the latest data available) stood at 1.1%. Thus, QE2 appears to have reversed the course of core inflation over the past six to nine months. In our view, this has been the most successful element of QE2. Looking ahead, core inflation is likely to continue to push higher, although the pace of inflation will continue to be constrained by slack in the labor markets (8.9% unemployment rate) and overall economy (actual GDP exceeds potential GDP by 5%, and the difference is being taken up very slowly).

Since Fed Chairman Bernanke’s speech in Jackson Hole, Wyoming in late August 2010, outlining the need for QE2, the US dollar has declined in value by more than 12% relative to the currencies of our major trading partners. The weaker dollar has made our exports more attractive, and pushed up the costs of goods we import, and most importantly, pushed the prices of globally traded commodities higher. The dollar has been declining since leaving the gold standard in the early 1970s. The onset of QE2 probably exacerbated the drop in the dollar, and the end of QE2 may slow the decline from its recent pace. Still, our view is that the dollar will continue to decline at a modest pace after QE2 ends, providing a boost to our exports, and modestly higher domestic inflation via higher input and commodity costs.

As noted in this week’s *Weekly Market Commentary*, equity prices and commodity prices were a big beneficiary of QE2, as the S&P 500 rose nearly 27% from the end of August 2010 through the end of May 2011. A rising stock market added to household net worth, helping to offset the drag on housing prices over the past nine months. According to the Case-Shiller Home Price Index, housing prices in 20 major U.S. cities dropped by 6% between August 2010 and March 2011 (the latest date available). Although mortgage rates have risen (to 4.70% from 4.50% in August 2010) since



QE2 was first announced, banks have eased lending standards for real estate, and applications for a mortgage to purchase a home have increased by 13%. Looking ahead, the end of QE2 will (along with other factors) slow the pace of gains of equities, but with the liquidity created by QE2 still in the system for a while longer, the improved tone of bank lending to consumers should continue.

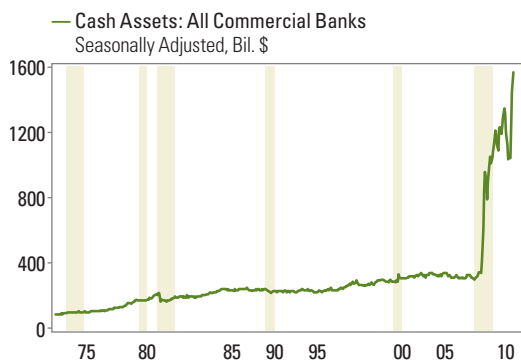
The major secondary effects of QE2 should continue even after QE2 ends.

- A weaker dollar was a major consequence of QE2. A weak dollar helped to create more export business for U.S. companies, which in turn created more manufacturing jobs. As noted, the dollar is likely to remain under pressure (low short-term interest rates, slow economic growth, huge budget deficit) in the months ahead beyond the end of QE2, which will continue to support U.S. exports and export-related job creation.
- QE2 provided a backdrop for more favorable financial conditions. This environment fostered more bank lending, which in turn led to more expansion and hiring by businesses, but is hard to measure directly. The best way to show the more favorable financial conditions is via bank lending. Commercial and industrial loans by banks to businesses have increased by 4% since August 2010, the best showing for bank lending since prior to the credit crunch in 2007. After QE2 ends, the banks' balance sheet will remain flush with excess cash for many months to come. With the recovery now more firmly entrenched than it was when QE1 ended in March 2010, businesses are more willing to borrow. The combination of banks more willing (and able) to lend and businesses more confident to borrow should allow businesses to continue to expand and hire after QE2 ends.
- Rising equity (and commodity) prices were a major benefactor from QE2. The gain in equity prices, among other things, made households feel wealthier, offsetting the stagnant home prices, allowing consumer spending to move higher despite tepid job growth. The gain in equity prices also likely made business more confident in the recovery, fostering more investment and jobs, as well as merger and acquisition activity. We expect all of these activities to continue after the end of QE2, albeit at a somewhat more subdued pace than over the past nine months.

On balance, after QE2 ends, the banking system will still be flush with cash, and the economic impact may be hard to discern. Although we think the odds of the Fed embarking on yet another round of quantitative easing (QE3) are low, they are not zero. What may cause the Fed to embark on another round of quantitative easing?

- A drastically tighter fiscal stance from Congress. In a recent press conference, Fed Chairman Bernanke hinted that a multi-year deal to cut multiple trillions of dollars in spending from federal spending would likely be met with more easing by the Fed.
- A sharp leg down in the economic data indicating that another recession was approaching and or price data that indicated that deflation was once again a real threat to the U.S. economy.

### 3 QE2 has Left the Banking System Flush with Cash. This Cash will Remain for Many Months After QE2 Ends



Source: Federal Reserve Board/Haver Analytics 05/31/11

(Shaded areas indicate recession)



- Renewed and more severe disruptions in global financial markets as a result of the fiscal situation in peripheral Europe. The fiscal situation in peripheral Europe has been unfolding for over a year now, and to date, the economic repercussions have been mainly felt in Europe. Should the situation worsen and spread to the rest of Europe and beyond, the Fed may have to step in to ease lending conditions.
- The earthquake in Japan in mid-March dealt a severe blow to the world's third largest economy. A similar (or larger) event in the United States (or in another major global economy), might prompt the Fed to provide more monetary stimulus. In addition to natural disasters (earthquakes, floods, tsunamis, etc.) a major terrorist attack large enough to impact global trade may also be enough for the Fed to act.

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#### 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.

Stock investing involves risk including loss of principal.

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.

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.

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.

Personal Consumption Expenditures (PCE) 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.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

S&P/Case-Shiller Home Price Indexes- A group of indexes that tracks changes in home prices throughout the United States. The indexes are based on a constant level of data on properties that have undergone at least two arm's length transactions. Case-Shiller produces indexes representing certain metropolitan statistical areas (MSA) as well as a national index.

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