

Weekly Economic Commentary



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Fed in Focus

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Highlights

- The Fed's policymaking arm, the Federal Open Market Committee (FOMC), meets to set policy this week.
- We examine what might cause the FOMC to embark on another round of quantitative easing.

Economic Calendar

Tuesday, June 21

Existing Home Sales
May

Wednesday, June 22

FOMC Decision

Bernanke Press
Conference

Thursday, June 23

Initial Claims
wk 06/18

New Home Sales
May

Friday, June 24

Core PCE Deflator
Q1

Durable Goods Orders
and Shipments
May

GDP Price Index
Q1

Real GDP
Q1

This week's relatively quiet economic calendar in the United States (new and existing home sales along with durable goods orders and shipments for May) will allow markets to focus on the Federal Reserve (Fed), Greece, and the fiscal debate in the United States. In many ways, what the Fed does after the second round of quantitative easing, known as QE2, ends next week will depend on the outcome of the situation in Greece (and elsewhere in peripheral Europe) and on the outcome of the fiscal debate in the United States.

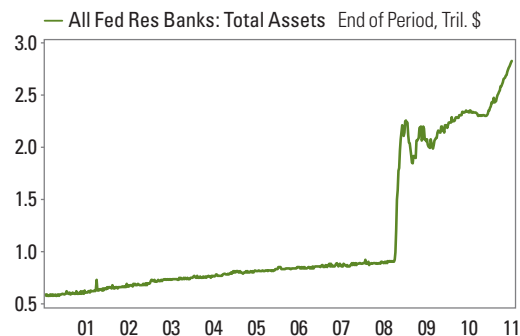
The Fed's policymaking arm, the Federal Open Market Committee (FOMC), meets to set policy this week amid a soft spot in the global economy, the end of QE2, concern over the ability of Greece to meet its upcoming debt obligations and the debate over U.S. fiscal policy. How these events unfold over the coming weeks and months may help to guide Fed policy, but unfortunately for the Fed and market participants, none of these issues are likely to be resolved anytime soon.

The Fed is expected to leave its policy rate at near zero percent, and signal that it will maintain the current size of its balance sheet for the foreseeable future, but that it will not make any new purchases of Treasury securities that could be called QE3. Fed policymakers are likely to acknowledge the recent "soft spot" in the economy, but view it as transitory in nature. While the Fed will be pleased with the recent drop in consumer energy prices (since the FOMC last met on April 27, retail gasoline prices have moved from well over \$4.00 per gallon to under \$3.75 per gallon as crude oil prices dropped from \$113 per barrel to near \$91 per barrel), the increase in bank lending to businesses, and the stability in inflation expectations. We continue to expect the Fed to take a wait-and-see attitude on monetary policy, given the weak run of economic data over the past few months. Our view this year has been that the hurdle for the Fed to end QE2 early was high, but that the hurdle for the Fed to begin another round of quantitative easing (QE3) was even higher.

At his press conference on April 27, when asked about the possibility of QE3, Bernanke said that the risks (i.e. higher inflation and unhinged inflation expectations) of doing another round of quantitative easing were not worth the rewards (a lower unemployment rate and a better labor market). In addition, several voting and non-voting members of the FOMC have publicly stated that they would not support another round of quantitative easing. Meanwhile, many members of Congress have been openly hostile to the

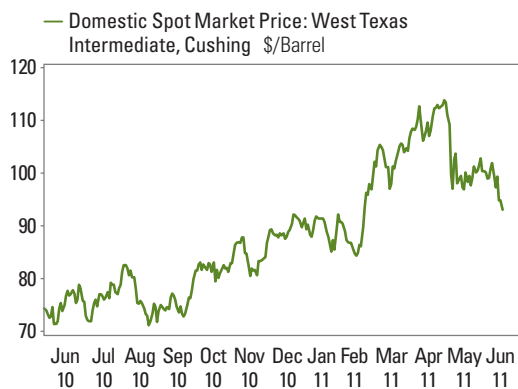


1 We Expect the Fed to Maintain the Size of its Balance Sheet for the Foreseeable Future



Source: Federal Reserve Board/Haver Analytics 06/20/11

2 Oil Prices Have Dropped by 20% Since the April 27 FOMC Meeting



Source: Wall Street Journal/Haver Analytics 06/20/11

Our view here is that the hurdle for the Fed to act based on a deal to cut the deficit over the long term is quite high.

idea of more stimulus from the Fed, and since Congress is ultimately the Fed's "boss", the Fed has to take that into consideration as it formulates monetary policy.

Still, several events that may trigger the Fed to consider QE3 are on the front burner as the Fed meets this week.

- Should the soft spot in the economy spiral into something more severe or long lasting (which is not our, nor the Fed's forecast), the Fed might consider another dose of monetary policy (in the form of more purchases of Treasuries), but the threat of a double-dip and deflation, a period of falling wages and prices, would have to be substantial. The FOMC will release its latest economic forecast this week, and while we expect the Fed to lower its growth outlook for 2011 and raise its unemployment rate forecast, we do not expect a significant enough shift to warrant action from the Fed.
- A worsening and widening of the European fiscal crisis that leads to widespread defaults by nations in Europe that could be accompanied by a freeze-up of global credit markets would likely lead the Fed to consider another round of monetary stimulus. We expect Fed Chairman Bernanke to field a number of questions on the situation in Europe and its potential impact on the U.S. economy at this week's press conference.
- A sharp contraction in fiscal policy (beyond what is already expected as state and local governments shed workers and as 2009's \$787 billion fiscal stimulus package fades further) over the near term, might prompt the Fed to do another round of quantitative easing, or at least stay on hold for longer. At his press conference following the April 27, 2011 FOMC meeting, Fed Chairman Bernanke noted that if any changes to fiscal policy are focused entirely on the short-run, and then these changes might have some negative consequences for growth. In that case, he noted, the Fed would take those into account appropriately. Our view here is that the hurdle for the Fed to act based on a deal to cut the deficit over the long term is quite high.

In addition to the potential catalysts for QE3 listed above, there are a number of other events—for example a series of severe natural disasters in the United States or a terrorist attack that does widespread damages to the nation's economic infrastructure—which may cause the Fed to consider adding more monetary policy stimulus to the economy. Our view remains that, while we expect monetary policy to remain on hold for the foreseeable future, the hurdle for the Fed to begin QE3 remains high.



IMPORTANT DISCLOSURES

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The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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.

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.

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