

Weekly Economic Commentary



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A Confidence Game

John Canally, CFA

Economist
LPL Financial

Highlights

- Data on inflation, the consumer and the manufacturing sector in the United States all will compete for attention this week with the start of the Q2 2011 earnings reporting season.
- Fed Chairman Bernanke will be on the hot seat in Congress this week.
- June Jobs Report Jolts Markets

Economic Calendar

Tuesday, July 12

Trade Balance
Minutes of June 22
FOMC Meeting Released
May

Wednesday, July 13

Import Price Index
Jun
Treasury Statement
Bernanke Testimony
Jun

Thursday, July 14

Initial Claims
wk 07/02
Retail Sales
Jun
PPI
Jun
Business Inventories
May

Friday, July 15

Retail Sales
Jun
PPI
June
Business Inventories
May
NY Fed Empire State Mfg
Jul
CPI
Jun
Capacity Utilization
Jun
Industrial Production
Jun
U of Mich Consumer
Sentiment
Jul

Data on inflation, the consumer, and the manufacturing sector in the United States all will compete for attention this week with the latest round of debt ceiling talks in Washington, the Chinese economic data for June, and the start of the Q2 2011 earnings reporting season for most S&P 500 companies. The Federal Reserve (Fed) will also join the mix this week, as they release the minutes of the June 21–22 Federal Open Market Committee (FOMC) meeting and Fed Chairman Ben Bernanke will deliver his semiannual Monetary Policy testimony to Congress. More concerns over the fiscal health of Europe (the latest flare-up involves Italy) will also be on the market's radar this week, as will central bank meetings in Japan, Indonesia, South Korea, Thailand and Chile. Finally, last week's disappointingly weak June jobs report is likely to reverberate through the market, as participants continue to wait for the long awaited "bounce" in economic data, after an economically difficult second quarter, impacted by weather, natural disasters at home, and, of course, the Japanese earthquake.

Bernanke on the Hot Seat in Congress This Week

In years past, a Fed chairman appearance before the House Financial Services Committee to deliver the Congressionally-mandated semiannual monetary policy testimony (formerly known as the Humphrey Hawkins testimony) would be met with a great deal of anticipation and hype from the market, and especially the financial media. This year, however, the approach of current Fed Chairman Ben Bernanke's testimony has not generated as much buzz. The reason may be that while in years past the Humphrey Hawkins testimony was one of the only opportunities anyone outside the Fed had a chance to ask the Fed Chairman a question, or to allow the Fed Chairman to elaborate on various issues. These days, the Fed is more transparent than ever. In just the past two and a half years, Bernanke has appeared on the CBS news magazine 60 Minutes twice, held several "town hall" meetings, held a limited access press conference (where questions were submitted in advance) and, more recently, has conducted two full-scale press conferences, where reporters can ask Bernanke whatever they want.

Still, in the wake of the weak June jobs report, and in the midst of the debt ceiling debate, Bernanke's comments will be closely watched by market participants. It is quite likely that Fed Chairman Bernanke will be grilled by Congress on the economy, and especially the labor market, and what, if



anything, the Fed can do to create more jobs. Bernanke's response is likely to be similar to the responses given in his recent press conferences (April 27 and June 22), in which he described the economy as frustratingly slow and uneven. In addition, members of Congress are likely to question Bernanke about the ongoing debt ceiling debate. In response, Bernanke is likely to gently remind the members of the House Financial Services committee (who are essentially his boss) that it is Congress' jobs to balance the budget, while it is the Fed's job to run monetary policy.

In recent public appearances, Bernanke has suggested that the budget negotiations focus on the long term, and that it would be very desirable to take "strong action" to lower the budget deficit over the long term. However, Bernanke has also made it clear that "it would be best not to have sudden and sharp fiscal consolidation in the very near term" as it does not do much for the long-run budget situation and is "just a negative for growth". Finally, Bernanke is likely to be asked under what conditions the Fed would consider doing more to help the economy, i.e. more quantitative easing (QE3).

When asked about the possibility of QE3 at his last press conference on June 22, Bernanke downplayed the idea, noting that the risk of deflation had waned and that economic activity had picked up since the summer of 2010 when the Fed first hinted at QE2. He did leave the door open slightly saying that the Fed would "continue to monitor" economic activity and "act as needed." Our view here remains that the hurdle for the Fed to embark on QE3 remains very high.

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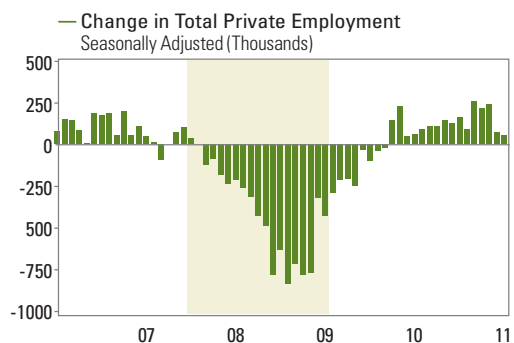
June Jobs Report Jolts Markets

The June jobs report was a major disappointment to markets, and to those market participants (including ourselves) that had been saying that the economic "soft spot" had ended and that the economy would reaccelerate back to a slightly more robust growth path in the second half of the year. Even after seeing the report, we maintain the view that the private sector economy can create between 200,000 and 250,000 jobs per month in the next few years, which would be enough to push the unemployment rate down slightly, and keep the consumer "hanging in there" as a support to modest growth in the economy. Our forecast for the United States economy and the labor market in particular, continues to be below the consensus, although the consensus has moved down considerably since the beginning of 2011.

The June nonfarm payroll jobs report (which is actually two reports in one) revealed that the private sector economy created just 57,000 jobs in June, the fewest in any month since June 2010. Making matters worse, the job count in the prior two months was revised downward by 44,000. Over the past two months (May and June 2011) the economy added an average of just 65,000 jobs per month, after adding close to 225,000 per month in the early part of 2011. The data that generates the monthly job count is based on a survey of 140,000 businesses across the United States.



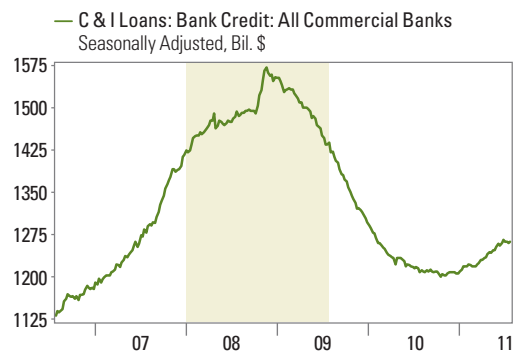
1 The Private Sector Economy has Added Jobs in Sixteen Consecutive Months, but the Pace of Gains Has Slowed in Recent Months



Source: Bureau of Labor Statistics /Haver Analytics 07/11/11

(Shaded areas indicate recession)

2 Increased Bank Lending is a Support to More Hiring



Source: Federal Reserve Board /Haver Analytics 07/11/11

(Shaded areas indicate recession)

The unemployment rate, which is calculated using data culled by surveying 60,000 households about their employment status, rose 0.1% to 9.2% in June, the highest reading since December 2010 [Chart 1]. The sample sizes of both the establishment survey (140,000 businesses) and household survey (60,000 households) are extraordinarily large sample sizes for a national survey. For perspective, national polling on presidential elections only uses around 1,000 respondents.

Other than sizeable gains in retail, transportation and leisure, and hospitality employment in June, there were few bright spots in the June employment report. State and local government payrolls fell by another 25,000 and have now dropped in ten of the last eleven months. Since August 2008, state and local government employment (which at just over 19 million, accounts for around 15% of all employment in the United States) has decreased by 577,000, as states, counties, cities and towns across the country struggle in the aftermath of the Great Recession.

Despite the disappointment in June, conditions are favorable for job creation in the months ahead, although significant obstacles to hiring remain, especially in the small business community. Banks are lending again, and terms of these loans are getting more favorable, although they are not yet back to pre-2007 levels. Business capital spending is booming, corporate profits are approaching all-time record levels, and companies have plenty of cash. Near record-low market interest rates have allowed many larger corporations to reduce costs even more by refinancing existing debt. In addition, overseas growth (50% of U.S. exports go to fast-growing emerging markets) is still running at more than three times growth in the United States, even as China continues to slow its economy. [Chart 2]

In our view, the biggest impediment to hiring may be confidence. Businesses must have confidence that the now two-year old recovery is firmly in place before committing to expanding their workforce. In addition, businesses need to be confident that our leaders in Washington and at the state and local level will tackle the debt and deficit problems, while fostering a hiring-friendly regulatory environment. On the flip side, in order to lend to businesses confidently, banks need to have certainty around their regulatory backdrop, while at the same time having confidence that the economy is strong enough to support lending.

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IMPORTANT DISCLOSURES

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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.

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