



Weekly Market Commentary

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A Recession of Confidence

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

Rather than an economic recession, we seem to be experiencing a confidence recession.

In contrast to the pronounced lack of any recession readings in the U.S. economic data last week, the readings on sentiment were uniformly weak as they priced in a recession.

There are several events here and abroad in the next week or two that may provide the stimulus needed to turn around this confidence recession.

In contrast to last week's market performance, the U.S. economic data released was generally solid. Shipping traffic, business lending, mortgage applications, industrial production, retail sales, initial jobless claims, corporate earnings reports, and the consumer price index all came in with solid growth readings. Notably, even the Index of Leading Economic Indicators (LEI) posted a solid and better-than-expected 0.5 gain and marking the third straight month of re-acceleration in the year-over-year growth of the LEI.

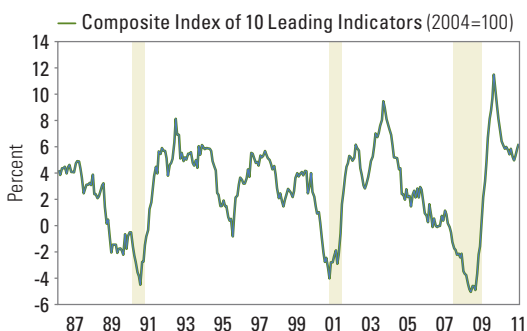
In contrast to this pronounced lack of any recession readings in the U.S. economic data, the readings on sentiment were uniformly weak as they priced in a recession. The stock and commodities markets fell, as did bond yields, and credit spreads widened. Consumer confidence readings slid to recession-like levels.

The biggest disappointment last week came on Thursday, the day the stock market fell over 4%, when the Philadelphia Fed manufacturing survey was released. While treated like economic data, this is actually a sentiment index based on a survey of manufacturers in the Philadelphia region. The plunge in the Philly Fed survey further heightened fears of a recession and contributed to the sharp decline in stocks last week. However, we believe this is a case of weaker sentiment and not weaker manufacturing. Importantly, the economic data that actually measures the output of the manufacturing sector is the Industrial Production report which posted a strong and better-than-expected gain last week. The increase was led by a rebound in vehicle production which appears to have increased further in August.

Rather than an economic recession, we seem to be experiencing a confidence recession. The market clearly believes that the return of business and consumer confidence to historical lows will inevitably lead to an economic recession—no matter what the data says. Market participants are placing a high probability that businesses will not merely slow their rate of hiring and investment, but actually make cuts despite rising profits and strong sales. They also expect that consumers are in the process of shutting down their spending despite the fact that the past five weeks have seen the strongest year-over-year retail sales increase in a year and the credit card delinquency rate decline further in July to near a record low.

We disagree. Though risk of a recession has risen, we place the odds substantially lower than what the markets are placing on such an event which seems to be well over 50% given stock market valuations and bond yields at recession levels.

1 Index of Leading Economic Indicators Year-Over-Year Change

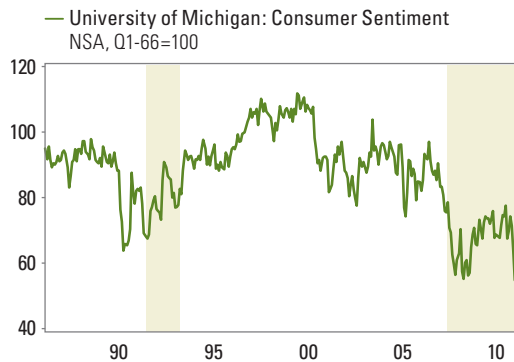


Source: LPL Financial, Factset Research Systems 08/22/11

(Shaded areas indicate recession)



2 University of Michigan Consumer Sentiment Index



Source: University of Michigan, Haver Analytics 08/22/11

(Shaded areas indicate recession)

Might this place too much emphasis on the prospects for the United States? Concerns about recession have also been driven by events in Europe as second quarter economic growth was weak and fear of default moved on from Europe's periphery to its core nations, with fear rising that Italy might default. However, Italian bond yields and credit default swap spreads (a measure of the value of an insurance policy against default) declined last week suggesting the already limited risk of default eased further.

What is the confidence stimulus that could turn around this confidence recession? There are several events here and abroad in the next week or two that may affect investor sentiment.

- The Federal Reserve's Jackson Hole conference, the event that helped to turn around last summer's fear of recession, may lead to bullish comments by chairman Bernanke.
- The August employment report is due out September 2. Job growth could again exceed expectations. The consensus of economists expects the U.S. economy created 130,000 private jobs in August.
- The White House is expected to deliver an economic plan which could exceed very low expectations.
- The European Central Bank (ECB) could make a surprise rate cut. After hiking rates in April and July, the ECB may reverse those hikes, rather than hike again in October, as growth is coming in weaker than expected and inflation pressures are easing.
- European policy makers may do more quantitative easing (QE) with the newly flexible mandate of the European Financial Stability Facility (the European version of the TARP).
- A possible end to the conflict in Libya as rebel forces lay siege to Tripoli and loyalist forces abandon their positions.
- Consistently positive economic readings highlighted by strong back-to-school sales.

The market is often said to climb a wall of worry. It does this when confidence is high and that impedes growth, both real and imagined. However, the markets always overcome no matter how bad they may seem at the time. History shows that it does not take much for the market to turn from agonizing over a wall of worry to climbing it. Importantly, the risks do not need to be resolved; merely confidence returns that the risks will be overcome.



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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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.

The index of leading economic indicators (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

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