

# Weekly Economic Commentary

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### Highlights

- Policymakers remain on the front lines this week, as economic data takes a back seat.
- Several of the high frequency data points we watch to gauge recession risk have deteriorated in recent weeks, but the odds of a recession are still below 50% in the United States.

### Economic Calendar

<b>Tuesday, August 23</b> New Home Sales <i>Jul</i>	<b>Thursday, August 25</b> Initial Claims <i>wk 08/20</i>
<i>Richmond Fed</i> <i>Aug</i>	<b>Friday, August 26</b> U of Mich Consumer Sentiment <i>Aug</i>
<b>Wednesday, August 24</b> MBA Mortgage Applications Index <i>wk 08/19</i>	Bernanke Speech at Jackson Hole, WY
Durable Goods <i>Jul</i>	

## Recession...Or Not?

Another week, another dramatic plunge in global equity markets, as market participants continue to price in another recession. While the odds of a recession in the United States continue to rise (mainly due to a lack of confidence and decisive policy actions, the plunging stock market, and a likely recession in Europe), we continue to believe that the U.S. economy can avoid a recession. However, we continue to forecast that the growth in the United States in the remainder of 2011 and into 2012 is likely to be tepid, at best, keeping the unemployment rate elevated, and keeping the markets on constant Fed watch.

This is likely to be a big week for the Federal Reserve (Fed), as Fed Chairman Ben Bernanke delivers a speech on Friday in Jackson Hole, Wyoming, as part of the annual Kansas City Fed economic symposium. Speculation about what Bernanke will say and propose will likely be a key driver of financial markets this week. Until then, it is likely that the Fed, along with other major central banks, could be in the market with measures to address liquidity and currency concerns. It is a relatively quiet week for economic data in the United States with the key reports being the weekly readings on jobless claims and retail sales, along with the July durable goods orders and shipment reports.

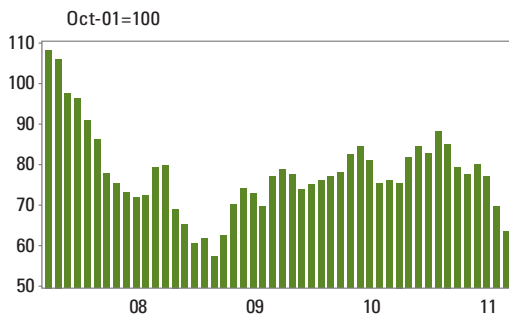
### Revisiting Our Recession Odds

As noted in this week's *Weekly Market Commentary*, the huge plunge in the Philadelphia area manufacturing index in August further fueled the recessionary fears already present in the market two weeks ago, in the August 8 edition of the *Weekly Economic Commentary*, we outlined what conditions need to be in place to trigger a recession. Over the past two weeks, a few of conditions have moved in the wrong direction, pushing the odds of a recession higher. Those conditions include:

- A 6% drop in equity prices (as measured by the Russell 3000 Index) in the United States, which wiped out over a trillion dollars worth of market capitalization. Unless it is reversed quickly, this will have a negative impact on consumer net worth, and ultimately, consumer spending. In addition, equity prices are one of the ten leading indicators in the Conference Board's index of leading economic indicators.
- Consumer confidence, as measured daily by the Rasmussen polling firm, dipped to a 30-month low (March 2009), before recovering modestly last week. Month-to-date, this measure of consumer confidence is at its lowest reading since March 2009. Consumer sentiment is more of a coincident



### 1 Rasmussen Consumer Index



Source: Rasmussen Reports, Inc. /Haver Analytics 08/22/11

### 2 Financial Conditions Have Deteriorated in Recent Weeks



Source: Federal Reserve Bank of St. Louis /Haver Analytics 08/22/11

### 3 Yield Curve Has Flattened in Recent Months, But Remains Steep By Historical Standards



Source: Haver Analytics 08/22/11

(Shaded areas indicate recession)

indicator (i.e. it moves at the same time) of the economy and equity market. But the persistent slide in consumer sentiment since early 2011 is reminiscent of (although not as steep as) the slide during 2007 through 2009.

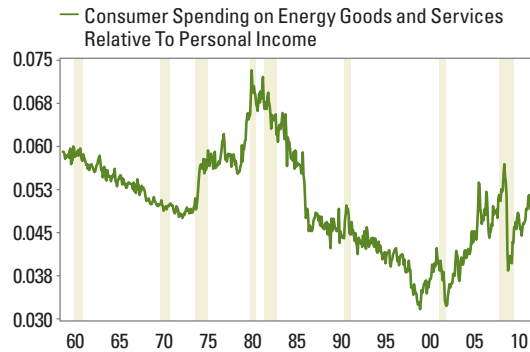
- Financial conditions (encompassing equity prices, interbank money market lending rates, credit spreads, etc.) have worsened considerably in the past two weeks. This suggests that businesses and consumers are finding it a bit more difficult to borrow to spend and invest. However, it should be noted that while financial conditions have worsened at a relatively rapid pace, they are nowhere near as bad as they were in late 2008 (after the collapse of Lehman Brothers led to a seize up of financial markets). In general, financial market conditions are about the same as they were during the worst of the spring 2010 flare-up of the European debt worries.
- The slope of the yield curve (the difference in yields between the ten-year Treasury note and the two-year Treasury note) has compressed to around 190 basis points, down from nearly 300 basis points in early 2011. The yields on both the two-year note (at 18 basis points versus 85 in early 2011) and the ten-year note (2.10% versus 3.75% in early 2011) have moved lower, but the ten-year yield has moved lower faster. One potential bright spot here is that prior to other recessions, the yield curve has often inverted, with the yield in the ten-year note falling below the yield on the two-year note. As of today, that is not the case this time around. In addition, the curve also inverts when the market begins pushing up the yield on the two-year note, as the market prices in Fed tightening. This time around of course, the Fed is on hold, and is likely to do more to stimulate the economy.

Still, there are plenty of positives for the markets and the economy, and this list is keeping us from changing our view on the economy for now. The positives include:

- A solid bounce in U.S. auto production in the third quarter after the Japanese earthquake curtailed production in the second quarter.
- The snapback in Japanese economic activity continued into July and August.
- Initial claims for unemployment insurance, which shot up quickly in 2007 and 2008 as credit markets froze up, have remained near 400,000 per week, a reading that suggests a stable labor market.
- Bank lending is robust. Bank lending to businesses and consumers has expanded noticeably since the beginning of 2011, a sign that banks are in a better position to lend and businesses and consumers in a better position to borrow now than they were in 2007 and 2008.
- Consumer energy prices remain subdued. Although they have been volatile in recent weeks and months, consumer energy prices remain relatively subdued. In June, consumers spent 4.9% of their incomes on energy and energy products (gasoline, natural gas, electricity, etc.), down from 5.2% in the spring. Consumer energy spending got as high as 5.8% in 2008, and was nearly 7.5% in the early 1980s. A supply shock here (hurricane related supply disruption or terror attack) would push consumer energy prices higher, hurting an already fragile consumer. But for now, they remain subdued.



#### 4 Consumer Energy Prices Remain Subdued Relative to Income



(Shaded areas indicate recession)

#### 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.

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.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Russell 3000 Growth Index is an unmanaged index comprised of those Russell 3000 companies with higher price-to-book ratios and lower forecasted growth values. The Russell 3000 Value Index measures the performance of those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.

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