

# Weekly Economic Commentary



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## Costs and Benefits

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#### Highlights

- Policy at home and abroad, both fiscal and monetary, is likely to dominate this week.
- The Federal Reserve (Fed) debates the costs and benefits of more monetary policy action at this week's FOMC meeting.

#### Economic Calendar

<b>Monday, September 19</b> NAHB Housing Survey <i>Sep</i>	Existing Home Sales <i>Aug</i> FOMC Decision
<b>Tuesday, September 20</b> Building Permits <i>Aug</i> Housing Starts <i>Aug</i>	<b>Thursday, September 22</b> Initial Claims <i>wk 09/16</i> Leading Indicators <i>Aug</i>
<b>Wednesday, September 21</b> MBA Mortgage Applications Index <i>wk 09/16</i>	

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Last week (September 12–16) was chock full of U.S. economic data for August and September which, on balance, painted a picture of an economy that was stagnant, but not rapidly deteriorating to the downside as it did in 2008. Still, the U.S. economy remains fragile and vulnerable to an exogenous shock (i.e. an oil price spike, a massive natural disaster, 2008–style credit crunch, etc.) and to policy mistakes, both at home and abroad. Our forecast remains that the economy will continue to sputter along, with growth in the third quarter better than the second quarter, due to a rebound in auto production and auto sales.

There is a scattering of economic data for August due this week, including:

- The National Association of Homebuilders sentiment index for September.
- Leading indicators, housing starts, and existing home sales for August.
- The mid-September weekly readings on chain store sales, mortgage applications and initial claims for unemployment insurance.

However, the key for markets will be policy, both fiscal and monetary, at home and abroad.

## Policy Prescriptions

In the United States, as this publication was being prepared, President Obama released his plan to help pay for the \$500 billion jobs and infrastructure package he proposed in early September. The plan adds to the mix of fiscal policy prescriptions being debated in Washington at the moment. In the near term, Congress has to settle on a way to fund the operation of the federal government beyond September 30, which marks the end of fiscal year 2011. Failure to do so would likely lead to a government shutdown, but not have any meaningful market implications, as the Treasury's borrowing authority (which was at risk during the debt ceiling debate in July and early August 2011) is not at stake here.

Neither market participants nor the public is prepared for another round of partisan wrangling over the budget, and most market participants expect that the end of fiscal year 2011 will not be a repeat of the confidence destroying rancor over the debt ceiling debate in July and early August 2011, from which consumer and investor confidence has not recovered.

The President's proposal is really aimed at the congressional "super-committee" charged with finding \$1.5 trillion of savings over the next



10 years as part of the debt ceiling deal that was hammered out in early August. The super-committee can take the President's plan under advisement, come up with its own plan to save \$1.5 trillion over the next 10 years, or do nothing. If it does nothing (which is increasingly likely), the \$1.5 trillion in savings would come via sequestration, meaning across the board cuts to federal spending. Tax rates would not change as a result of sequestration. The deadline for the super-committee to report back to Congress with legislation to enact the \$1.5 trillion in savings is mid-November, and if the legislation is not signed by late December, the aforementioned sequestration would kick in. However, October 14 is the date by which the various congressional committees (Agriculture, Ways and Means, Defense, etc.) must submit recommendations to the super-committee. Time is running out.

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Of course, monetary and fiscal policy in Europe continues to drive the headlines (and the financial markets) as the U.S. fiscal situation simmers in the background. A much anticipated meeting of euro-zone finance ministers in Poland over the weekend of September 16–18 failed to produce the bold and decisive actions the financial markets demand. In our view, ongoing policy and economic uncertainty in Europe remains the biggest threat to both financial markets and the fragile U.S. economy.

Monetary policy will vie for, and no doubt get, a ton of attention from financial market participants this week. Most of the action on this front is in the United States, although central banks in Hong Kong, Norway, Turkey, Iceland and South Africa all meet to set policy this week. For the most part, central banks that had been tightening policy over the past two years or so have either stopped raising rates, or begun to cut rates. Examples include the central banks in Brazil, Russia and Australia, as well as the European Central Bank (ECB). Most notably, China's central bank has hinted that it is close to the end of its rate hike regime. Meanwhile, central banks that have been cutting rates are looking to do more. Examples here include the Bank of England and the Bank of Japan. One of the central banks looking to do more, of course, is the United States' central bank, the Federal Reserve (Fed).

Financial market participants continue to demand bold policy actions from both fiscal and monetary policymakers across the globe.

At its Federal Open Market Committee (FOMC) meeting this week, the Fed is widely expected to embark on "Operation Twist" in an attempt to keep longer-dated Treasury yields lower for longer, as financial market participants continue to demand bold policy actions from both fiscal and monetary policymakers across the globe. Although it remains in the Fed's toolbox, another round of outright Treasury purchases (QE3) by the Fed—which would be viewed as a bold policy action by market participants—is not likely to be announced this week. However, we do not expect the Fed to rule out the future use of more Treasury purchases either. In addition, the Fed has also publicly stated that it is considering lowering the rate it pays on banks that hold excess reserves at the Fed. We view this option as the least likely to be implemented at this week's meeting.

The Fed may also be weighing some type of involvement in the mortgage market, as Fed Chairman Bernanke has discussed the housing market at length in several of his recent public appearances. Although this option has



not been previously mentioned by the Fed as a policy path, a move into the housing market by the Fed would also be considered a “bold” move by market participants. However, such a move is fraught with the same type of political opposition (both inside and outside the Fed) as another round of asset purchases (QE3) would be.

The economic and market impact of the Fed’s expected “Operation Twist” will be vigorously debated at this week’s FOMC meeting, which was extended from a one-day to a two-day meeting so that Fed policymakers could discuss the costs and benefits of further action on monetary policy by the Fed. Market participants have been debating the outcome of this week’s FOMC meeting for weeks now, although most now think the Fed will implement “Operation Twist.”

The keys for the market will be how the Fed approaches this operation, the size of the operation, and the timing. In addition, the market will want to know what, if any, metrics are tied to measuring the success of the operation. Key for the Fed, and its bosses in Congress, is that “Operation Twist” does not require the Fed to purchase any additional Treasury securities in the open market. We have maintained for many months that the hurdle for the Fed to buy more Treasuries was high, and while the economic and market hurdles have been lowered, the political hurdles have probably moved even higher.

What the Fed is likely to do is to use the proceeds of maturing issues, which would be a passive way to implement the operation, to fund the purchase of longer-dated Treasuries in the open market. A more active approach would see the Fed selling some of its shorter-term Treasury securities to fund the purchase of the longer-dated Treasuries. The market would also welcome increased transparency on the timing:

- When will it begin?
- How often will the purchases/sales be made?
- When will it end?

And the goals:

- Lower the 10-year rate by a certain amount
- Lower the unemployment rate by a certain amount
- Increase GDP by a certain amount

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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 Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

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