

Weekly Economic Commentary



August 29, 2011

Good Night, Irene

John Canally, CFA

Economist
LPL Financial

Highlights

- Hurricane Irene caused less damage than feared, but disrupted economic activity.
- Expectations are low for the important August ISM and August employment readings.
- Fed Chairman Bernanke's August 26 speech in Jackson Hole, WY struck the right tone for markets.

Economic Calendar

Monday, August 29 Personal Spending <i>Jul</i>	Thursday, September 1 Chain Store Sales <i>Aug</i>
Personal Income <i>Jul</i>	Initial Claims <i>wk 08/27</i>
Tuesday, August 30 Consumer Confidence <i>Aug</i>	<i>Productivity</i> <i>Q2</i>
Wednesday, August 31 MBA Mortgage Applications Index <i>wk 08/26</i>	ISM Manufacturing <i>Aug</i>
ADP Employment Change <i>Aug</i>	Construction Spending <i>Jul</i>
<i>Chicago PMI</i> <i>Aug</i>	Domestic Light Vehicle Sales <i>Aug</i>
<i>Factory Orders</i> <i>Jul</i>	Friday, September 2 Private Sector Payrolls <i>Aug</i>
<i>Challenger Layoff</i> <i>Announcements</i> <i>Aug</i>	Unemployment Rate <i>Aug</i>
	Nonfarm Payrolls <i>Aug</i>

Federal Reserve (Fed) Chairman Ben Bernanke's widely anticipated speech in Jackson Hole, WY last Friday (August 26) apparently struck just the right tone for markets. The speech allowed market participants to look ahead to several key economic and policy events this week, including the impact of Hurricane Irene in the economy and markets, the August reports on ISM manufacturing, chain store sales, vehicle sales and most importantly, employment, as well as key data on China (August ISM) and Japan (July industrial production, retail sales, and vehicle production).

On the policy front this week, the Fed will release the minutes of the August 9 FOMC meeting, and perhaps more importantly, German Chancellor Angela Merkel holds a key policy conference with her own caucus as the market continues to wait for a policy response from Europe. Japan's ruling party will choose a new Prime Minister from its own ranks, after the current Prime Minister resigned on Friday, August 26. As with elsewhere around the globe, the path of future fiscal and monetary policy in Japan is crucial to the outlook for the global economy.

Further out on the horizon for markets on the policy front is the now two-day long September Federal Open Market Committee (FOMC) meeting on September 20 and 21, some type of policy actions in Europe (see this week's Weekly Market Commentary), a jobs proposal from President Obama, and ongoing work by the so-called congressional "super committee" tasked with finding at least \$1.5 trillion in budget savings by the end of this year.

Potential Economic Impact from Hurricane Irene

Another, shorter term concern for markets is Hurricane Irene, which made its way up the East Coast over the weekend of August 27–28. As of Monday morning, August 29, damage estimates were in the \$5 to \$10 billion range. [Table 1](#) shows the costliest hurricanes in United States history in terms of economic damage. Although the damage from Irene was less than feared, it caused major disruptions in a very heavily populated area of the country, keeping businesses closed and consumers at home for several days in the key back-to-school shopping season. The high frequency economic data (i.e. initial claims, shipping and rail traffic, weekly retail sales, consumer confidence, auto production, etc.) we, other market participants, and policymakers track may be difficult to interpret for a few weeks due to the impact of the storm. This potential lack of clarity on the underlying



health of the economy arrives at a particularly inopportune time, as markets and policymakers try to gauge the true underlying strength of the economy and the risk of recession.

Although several major public transportation systems from the Metro in D.C., to the MBTA in Boston were closed for all or part of the weekend of August 27–28 (and some remain partially closed as of Monday morning, August 29), it appears that most of the other major economic infrastructure (ports, roads, airports, railways, refineries, utilities, etc.) related assets in the path of the storm were largely spared. Flooding remains the largest concern in the aftermath of the storm, especially in New Jersey, New York, and Vermont. If authorities take longer than now expected to repair the infrastructure, the hurricane may have a longer lasting impact on the economy in the region, and would push the United States economy closer to recession. Prior to the storm, we place the odds of recession at around one-in-three, up from a few weeks ago, but well below the odds financial markets seem to be placing on a recession.

Irene may end up in the lower end of that \$10 to \$20 billion category in terms of economic cost, although the true cost of the storm may not be known for weeks.

As previously noted, very preliminary estimates put the economic cost of Irene at between \$5 and \$10 billion. In terms of economic damage (adjusted for inflation), at \$108 billion, Katrina (2005) was the costliest hurricane ever to hit the United States. Andrew (1992) at \$45 billion was next costliest, followed by Ike (2008), Wilma (2005), Ivan (2004), Charley (2004), Hugo (1989), Rita (2004) and Agnes (1972). These storms (again in 2010 dollars) caused between \$10 and \$20 billion in damage. Irene may end up in the lower end of that \$10 to \$20 billion category in terms of economic cost, although the true cost of the storm may not be known for weeks. Three storms that took the same track as Irene—up the East Coast—and were roughly the same magnitude as Irene: Floyd (1999), Bob (1991) and Gloria (1985) were the 14th, 30th, and 30+ most costly storms in history. For perspective, the size of the United States economy is around \$15 trillion dollars.

Costliest Hurricanes to Hit the United States (In 2010 dollars)

Rank	Name	Year	Cost (Billions)	Area Impacted
1	Katrina	2005	\$105	Gulf Coast
2	Andrew	1992	\$45	Florida/Louisiana
3	Ike	2008	\$28	Texas/Louisiana
4	Wilma	2005	\$20	Florida
5	Ivan	2004	\$20	Florida/Alabama
14	Floyd	1999	\$9	Mid Atlantic/Northeastern US
30	Bob	1991	\$3	North Carolina/Northeastern US
30+	Gloria	1985	~\$1	Northeastern US

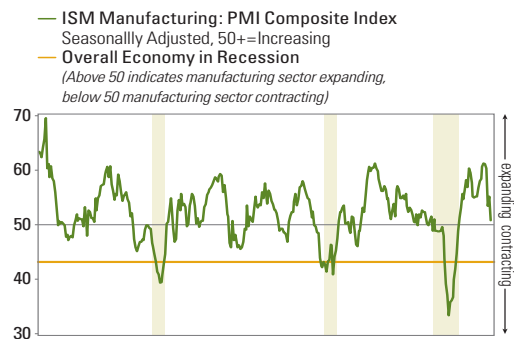
Source: National Hurricane Center

A Key Week for Economic Data

Although the week is chock full of economic data in the United States and abroad, the key reports are likely to be the ISM report on manufacturing for August (Thursday, September 1) and the August employment report (Friday, September 2).



1 The ISM Often Dips Below 50 in the Middle of Expansions; A Reading Below 42 Signals a Recession



Source: Institute for Supply Management/Haver Analytics 08/29/11

Shaded Areas Indicate Recession

2 New Export Orders Rarely Dip Below 50



Source: Institute for Supply Management/Haver Analytics 08/29/11

Shaded Areas Indicate Recession

Based on weakness in various regional ISM and Federal Reserve manufacturing sentiment surveys already released for August (Philly Fed, Empire State manufacturing, Richmond Fed, Dallas Fed), the consensus expects the August reading on the ISM to dip below 50 (to 48.5), from the 50.9 reading in July. The so-called “whisper number” among traders (who often informally have their own forecasts for key economic data and events that differs from the consensus estimate culled from economists) is probably closer to 44.0 or 45.0. Thus, expectations for ISM are quite low. A reading below 50 on the ISM has historically corresponded with contraction in the manufacturing sector, while a reading about 50 suggests an expanding manufacturing sector. The last time the ISM was below 50 was in July 2009, the first month of the current economic recovery.

As noted in [Chart 1](#), it is not unusual to see the ISM to approach, and dip below, 50 in the midst of an economic expansion. The index dipped below 50 in the middle of the long 1982–1990 expansion and did several round trips above and below 50 in the 1991–2001 recovery, notably in 1995 and again in 1998. In the 2001–2007 expansion, the ISM dipped back toward the 50 level in 2004, before reaccelerating in 2005. More recently, we point out that manufacturing activity/output—vehicle production, industrial production, durable goods shipments and orders, manufacturing employment etc., have held up much better than measures of manufacturing sentiment like the ISM and the regional Federal Reserve manufacturing indices.

As sustained reading of 42 or below indicates recession, and the ISM did get to that level in both the 1991 and 2001 recessions. It got as low as 33.3 at the worst of the 2007–2009 Great Recession.

Some of the components of ISM bear close scrutiny, given the composition of the economic recovery this far. The new orders index—which dipped below 50 in July for the first time since June 2009—is a decent leading indicator of future readings on the overall ISM. Some stabilization in the orders component near 50 would be welcome, although a sustained dipped below 50 does not necessarily indicate recession.

Exports helped to lead the economy out of recession in 2009 and 2010, as signaled by the surge in the new export orders index to above 60 in 2009 and 2010, and the sustained stay above 55. The reading was 54.0 in August 2011, and although no formal consensus estimate is available for this component, the best bet is that the market is looking for this index to stay around 50 in August. As noted in the nearby chart, the new export orders series does dip below 50 in recessions, but rarely gets below 50 during an expansion. The index did temporarily dip below 50 in 1998 due to the Asian financial crisis, One could argue that the turmoil in Europe might also push the export index lower as well.

Inventory restocking by businesses (and especially manufacturers) also played a big role in the economic recovery in 2009 and 2010. As noted in the nearby chart, the inventory component of ISM spends most of its time below 50, and dips well below 40 during recessions. It got as low as 31.3 in June 2009, the final month of the 2007–2009 Great Recession. The inventory component of ISM has spent much of the past two years above 50 as businesses have



3 The ISM Inventory Index is Rarely Above 50



Source: Institute for Supply Management/Haver Analytics 08/29/11

Shaded Areas Indicate Recession

restocked inventories to meet increased final demand. It dipped to 49.3 in August 2011 however. A reading above 43 on this component of ISM suggests that the economy is still expanding.

The other key report due this week is of course the August employment report. The employment report is actually two reports in one. One part of the report surveys 60,000 households on their employment status, generating the widely cited unemployment rate figure, calculated as the number of people unemployed and looking for work as a percentage of all the people in the labor force. The other side of the report surveys 140,000 businesses, and generates the number of workers on payrolls, their wage rates, hours worked etc. Both surveys have huge nationwide sample sizes—far greater than the survey sizes (typically 1000 people) used in polling for national political races—and have been conducted for more than half a century. Although jobs are a lagging indicator of the economy (and the economy itself lags financial markets), the monthly jobs report is perceived by markets and the media as the most important economic report of the month.

The market is looking for the economy to create 103,000 private sector jobs in August, a deceleration from the 154,000 jobs created in July. As is the case with the “whisper number” for the August ISM report, at between zero and 25,000 jobs, the whisper number for the private sector job count is probably a lot lower than the published consensus. So, as is the case with the August ISM report, expectations are quite low for the employment report. State and local governments, which have shed nearly 600,000 jobs over the past three years, are expected to shed another 25,000 in August, so the overall economy (private sector and government) is expected to have added only 75,000 jobs in August. The whisper number here is well below zero, again suggesting that even an outright decline in overall jobs between July and August is somewhat priced in.

Weather, strikes, and other “one time” events often impact the monthly jobs report, and the August report is no exception. A strike at Verizon that impacted 45,000 workers will negatively impact the August job count, although the market should take this into account. The supply chain disruptions caused by the Japanese earthquake and the early (June instead of July) shutdown of auto plants for summer vacations may also wreak havoc with the August job count. Most importantly however, the dour mood that descended on the country in late July and early August as the debt ceiling debate raged, followed by a further dip in consumer, business and market confidence after S&P downgraded the U.S. debt rating on August 5 almost certainly curtailed hiring in the month. In addition, tightening financial market conditions (and very elevated readings on market volatility) also likely weighed on businesses decisions to hire in August.

Our Take on Fed Chairman Bernanke’s Jackson Hole Speech

Fed Chairman Bernanke’s speech in Jackson Hole on Friday, August 26 struck just the right tone for investors. As we expected, Fed Chairman Ben Bernanke did not hint at any new, immediate actions by the FOMC in the speech. Instead, Bernanke sounded relatively optimistic about the economy,



especially in the long-term. In the short-term, Bernanke did note that the upcoming FOMC meeting (mid-September) has been changed to a two day meeting from a one day meeting. In our view, the extra day would provide the FOMC the additional time to:

- A. Further refine the policies it has been discussing: extending the maturity of its Treasury holdings, lowering the rate it pays on excess reserves, or buying more Treasuries (QE3).
- B. Come up with a completely different policy approach to address slow growth in the U.S. economy.

Bernanke also noted that the sovereign debt issues in Europe, as well as the fiscal situation in the United States were at the top of the list of FOMC concerns. Bernanke was unusually blunt in his criticism of Congress (his bosses) and its ability to make prudent fiscal decisions. Bernanke also reiterated his view that Congress should take into account the “fragility” of the economy when considering additional spending cuts as part of the debate to further address the long term budget issues faced by the United States.

Bernanke, a Republican first appointed by President George W. Bush, noted, “Fortunately, the two goals of achieving fiscal sustainability—which is the result of responsible policies set in place for the longer term—and avoiding the creation of fiscal headwinds for the current recovery are not incompatible. Acting now to put in place a credible plan for reducing future deficits over the longer term, while being attentive to the implications of fiscal choices for the recovery in the near term, can help serve both objectives.”



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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.

The Philadelphia Fed Survey is a business outlook survey used to construct an index that tracks manufacturing conditions in the Philadelphia Federal Reserve district. The Philadelphia Fed survey is an indicator of trends in the manufacturing sector, and is correlated with the Institute for Supply Management (ISM) manufacturing index, as well as the industrial production index.

Empire State Manufacturing Survey is a monthly survey of manufacturers in New York State conducted by the Federal Reserve Bank of New York.

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Weekly Market Commentary

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Eurobonds: A Potential Positive Not Lost in Translation

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

While market participants have been demanding a response by policy makers, they are looking for that response in Europe more than in the United States.

Creating a Eurobond market may provide global investors with a highly liquid, well-rated alternative to U.S. Treasuries. The liquidity boost provided by an alternative to U.S. Treasuries may lower collective yields for the Eurozone members, even for Germany.

Eurobond draft legislation, which may be unveiled soon, may be helpful in providing market participants with a confidence-boosting glimpse of a long-term solution to Europe's debt problems that they have been demanding even if the implementation is not imminent.

Last week, Federal Reserve chairman, Ben Bernanke delivered his speech from the Fed's Jackson Hole conference, the event that helped to turn around last summer's fear of recession. While people along the eastern seaboard lined up at stores on Friday, August 26, to buy batteries and bottled water in anticipation of the unknown ravages of hurricane Irene, gentle Ben provided no surprises to disturb the markets. Instead he provided a review of the Fed's economic outlook and policy options already well known to market participants. The attention on the Fed was misplaced. While market participants have been demanding a response by policy makers, they are looking for that response in Europe more than in the United States.

Last week's gain was the first in five weeks for the U.S. and European stock markets. Indications that the European Central Bank (ECB) was leaning towards reversing rate hikes they implemented earlier this year and signs that a proposal for so-called Eurobonds was gaining acceptance as a longer-term solution to Europe's debt problems boosted investor confidence. In recent months, the U.S. S&P 500 stock market has been driven in no small part by the unfolding events in Europe. European economies, policy makers, debt markets, and the banks that hold the troubled debt have been acting and reacting to the worsening sovereign debt problem, and rising likelihood of a sovereign default. Markets are demanding a policy response that goes beyond bailouts and they may soon get it.

Translating and interpreting some of the European events and parties involved into terms more common to U.S. investors may be helpful to explain why investors are catching on to the idea that so-called Eurobonds are the most likely long-term solution to Europe's debt problems.

The European Commission, unlike the often temporary and powerless commissions of the U.S. Congress (where the answer to every thorny political issue is to avoid the tough questions by putting together yet another commission—remember how the president backed away from his own bi-partisan deficit commission when they finally reported their results), is actually the ruling body of the European Union. It is the executive branch, so think "White House" when we refer to the European Commission.

European Commission regulators are pushing for Eurobonds. The European Parliament (think "Congress") needs to see a proposal for Eurobonds and vote to pass rules allowing them. Most of the European Parliament appears to now be on board with Eurobonds as an end game (even France). The European Commission is writing up the Eurobond proposal now and, as it

European Debt Problem: Europe to United States Translator

European Entity	U.S. Equivalent
European Commission	White House
European Parliament	Congress
Germany	Tea Party
EFSF	TARP
ECB	Fed
Eurobond	Treasuries



prepares to present it to Parliament, is seeking to get Germany (think “Tea Party”) on board.

In September, the European Parliament will ratify the flexible mandate of the European Financial Stability Facility (EFSF) (think “TARP”). The EFSF will be able to buy the debt of any country or business or inject capital into any bank in Europe and make it a collective obligation of the Eurozone. The European Central Bank (think “Fed”) is acting in this capacity now, but is limited by what it can buy. The EFSF is a step towards a common European obligation, but is limited by its size. Accompanying the EFSF ratification is the enactment of laws to strengthen Europe’s deficit-limits to keep budget imbalances among Eurozone members from developing in the first place.

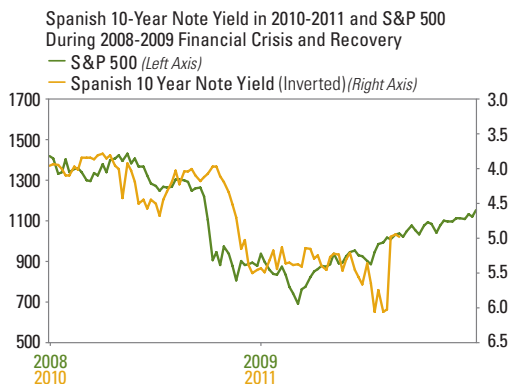
The Eurobond (think “Treasuries”) proposal due out before the end of the year may be released just after the EFSF is ratified by the end of September. The European Commission President indicated that draft legislation for Eurobonds will be presented in the near future, but is unlikely to unveil it until after the EFSF vote. The proposal, which is already well developed, is likely to be a plan where 60% of a country’s GDP would be financed by Eurobonds (or special sovereign bonds guaranteed by the Eurozone) at a common low interest rate and be backed by the credit of the entire Eurozone and the remainder of the country’s debt would be supported by their own issuance backed by their own sovereign credit. For example, Greece has about 150% debt to GDP so 60% would be financed by low rate Eurobonds, while the remainder would be financed at higher rates unique to Greece providing an incentive to keep debt ratios low. This would be a huge benefit to countries such as Greece now facing unaffordable high interest rates on all of their debt coming due.

Why would Germany go along with the introduction of Eurobonds when it would clearly mean a higher interest rate for Germans to help guarantee nearly about \$7 trillion in collective European debt? Because creating a European government bond market of about \$7 trillion would result in the world’s second largest after U.S. Treasuries (\$10 trillion). It would provide markets with a highly liquid, well-rated alternative to U.S. Treasuries, just as the United States has seen its credit rating downgraded by Standard and Poor’s. Six of the members of the Eurozone are AAA-rated (Austria, Finland, France, Germany, Luxembourg, Netherlands). Also, the deficit-to-GDP for the Eurozone is a much better 6% (according to Eurostat) compared to 9% for the United States (according to The Congressional Budget Office). The liquidity boost provided by an alternative to U.S. Treasuries may lower collective yields for the Eurozone members, even for Germany.

If enacted, Eurobonds may likely be a big plus for European stocks and bonds. It would likely be a negative for Treasuries and the dollar given the creation of a competing market for the world’s liquid capital. The potential rise in interest rates in the U.S. could put further pressure on economic growth and housing—perhaps this is part of the reason Bernanke pledged to keep rates low at least through the middle of 2013 and may use maturing short-term debt holdings to buy long-term bonds to try to keep rates down. A weaker dollar does have a silver lining in that it is good for U.S. exports and good for commodity prices.



1 Policy Response Key to Turning Confidence Around?



Source: LPL Financial, Bloomberg data 08/26/11

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Eurobonds are likely to be the ultimate direction in which European policymakers will go, or will be forced to go, but it may be a while before they get there. In the meantime, even Eurobond draft legislation, which may be unveiled soon, may be helpful in providing market participants with a glimpse of a long-term solution they have been demanding even if the implementation is not imminent. Merely hinting at Eurobonds as a potential solution can create a powerful turnaround in sentiment as a shift begins from a monetary union that markets view as no stronger than its weakest link to a massive economic zone that is stronger than the sum of its parts. This could spark the return of investor confidence and begin to lower yields. Confidence is most important right now, as it was back in 2009 for the stock market. Perhaps not surprisingly, the yields on some of the troubled debt of European nations appear to be tracking the pattern of the S&P 500 during the 2008–2009 financial crisis and recovery [Chart 1]. As I stated last week: the stock market climbs a wall of worry not when risks go away, but when the confidence that they will be overcome returns.

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An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

Debt-to-GDP is a measure of a country's federal debt in relation to its gross domestic product (GDP). By comparing what a country owes and what it produces, the debt-to-GDP ratio indicates the country's ability to pay back its debt. The ratio is a coverage ratio on a national level.

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.

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