

Weekly Economic Commentary



August 8, 2011

Double Dip?

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Highlights

- Policy will likely be back on the front burner this week.
- What policy actions might the Fed employ to boost the economy?
- What indicators are we watching to monitor the risk of a double-dip recession?

Economic Calendar

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| Monday, August 8 Small Business Optimism <i>Jul</i> | Thursday, August 11 Initial Claims <i>wk 08/06</i> |
| Tuesday, August 9 Productivity <i>Q2</i> | Trade Balance <i>Jun</i> |
| FOMC Meeting | Friday, August 12 Retail Sales <i>Jul</i> |
| Wednesday, August 10 MBA Mortgage Application Index <i>wk 08/05</i> | U of Mich Consumer Sentiment <i>Aug</i> |
| Wholesale Inventories <i>Jun</i> | Business Inventories <i>Jun</i> |
| Budget Deficit <i>Jul</i> | |

After last week's dramatic market plunge and the downgrade of United States debt to AA+ from AAA by Standard and Poor's, policymakers at home and abroad will be on the spot this week, as the economic data fades in importance, at least in the United States. The data that is due out in the United States this week—weekly readings on initial claims for unemployment insurance, consumer confidence, weekly retail sales for early August, retail sales and small business optimism for July, and merchandise trade and business inventories for June—will be pored over by market participants looking for signs of a double-dip recession.

Overseas, there is a ton of data due out in Japan this week, which will help markets assess whether or not the pace of recovery from the earthquake accelerated in June and July, and there is a full slate of July economic data due out in China this week. Fears that the Chinese economy is, at the same time, generating too much inflation and slowing down too much has raised concerns about a "hard landing" in China. Our view is that China will be able to achieve a soft landing and that the People's Bank of China (PBOC) is much closer to the end of its tightening process, aimed at keeping domestic inflation in check, than it is to the beginning.

European policymakers have some work to do in order to help calm markets, and reassure investors that so-called "core" Europe (Germany, France and Italy) is insulated from the fiscal and banking woes of peripheral Europe (Greece, Portugal, Ireland, etc.). This problem was many years in the making, and as of this writing, there does not appear to be a silver bullet to solve all of Europe's problems at once. Still, markets would welcome a stepped up pace of policy actions in Europe in the coming weeks, which are typically very quiet summer weeks, with most of core Europe out on holiday. Indeed, over the weekend of August 6–7, the European Central bank announced plans to purchase the sovereign debt of Spain and Italy to try to prevent the spread of the fiscal woes of peripheral Europe into "core" Europe.

The Course for Fed Policy

Of course, the real action this week will be at the Federal Reserve (Fed), which holds its Federal Open Market Committee (FOMC) meeting on August 9. Our view on the Fed is that while the hurdle for the Fed to stimulate the economy by buying more Treasury securities in the open market (A.K.A. QE3) remains quite high, the odds of QE3 have increased in the past few weeks.



At the moment, in our view, Fed policymakers probably do not have enough evidence that the economy warrants another dose of quantitative easing, although they are probably in a position to provide “liquidity” to the financial markets should interbank lending freeze up like it did throughout 2007 and 2008.

The Fed makes decisions on monetary policy against the backdrop of its dual mandate granted to the Fed by Congress in 1977: low and stable inflation and full employment. In his now-famous August 2010 speech in Jackson Hole, WY, Fed Chairman Ben Bernanke cited both a weak economy and the threat of deflation as reasons why the Fed may purchase more Treasury securities in the open market (it began those purchases in November 2010). At the time of the Jackson Hole speech, the private sector economy had only been creating jobs for six months—at an average of around 100,000 per month—after shedding nearly 9 million jobs between 2007 and early 2009. Today, the private sector economy has added jobs in 17 consecutive months, and over the past six months, the economy has created an average of nearly 200,000 jobs per month.

On the inflation front, in August 2010, the Fed’s preferred measure of inflation, the core personal consumption deflator, was running at just 1.0% year-over-year, well below the Fed’s comfort zone of 1.5 to 2.5%. In addition, the Fed saw further downside risk to inflation, and indeed, by October 2010, core inflation had dipped to just 0.8% year-over-year, perilously close to deflation. Deflation is defined as falling wages and prices.

Today, thanks in part to the cumulative effects of QE1 and QE2 (which ended in June 2011), core inflation is running at 1.3% year-over-year, and accelerating. Thus, on both measures (the economy and core inflation) the conditions are not as dire as they were in the summer of 2010 when the Fed embarked on QE2.

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With so much internal (voting members of the FOMC who have publicly stated that they would not support more quantitative easing) and external (the Fed’s bosses in Congress are in no mood to do anymore stimulus of any kind) pressure lining up against another round of Treasury purchases by the Fed, policymakers appear to be boxed in.

However, the Fed can still impact the economy and markets in several ways, even without purchasing additional Treasury securities. In recent weeks, Fed officials, including Fed Chairman Ben Bernanke, have detailed other ways the Fed could act. These potential actions include, but are not limited to:

- Announcing (perhaps in the statement following this week’s FOMC meeting) how long it intends to keep rates low and when it would begin reducing the size of its balance sheet. This would help to create more certainty in the economy and the markets about financing rates. Other countries, most notably Canada, have used this approach in the past.
- Changing the mix of the Treasury securities it already holds. For example, the Fed could sell some of its shorter maturity Treasury holdings and buy longer maturity Treasuries in the open market. This would push interest rates down on loans used by consumers and businesses looking to borrow and spend, thus boosting growth prospects. The Fed and Treasury did this in the early 1950s.



- The Fed could also lower the rate it pays financial institutions on excess reserves (over and above what they are required to hold against their loan portfolios) held at the Fed. This would probably not have much of an impact, especially since the rate the Fed pays on these reserves is just 0.25%.
- Finally, the Fed could of course buy more Treasuries in the open market, but do so against the wishes of both its bosses in Congress and several of the voting members of the FOMC. We view this outcome as unlikely, although odds are rising.

How Likely is a “Double Dip”?

There has been increased talk recently about the possibility of a “double-dip” recession occurring in the United States. Our view is that while the odds of a double-dip recession have increased in recent weeks, mainly as a result of the big drop in equity prices, very sluggish consumer and investor confidence and slight deterioration of financial market conditions, a return to modest, trend-like economic growth over the second half of 2011 and into 2012 is more likely.

A “double-dip” recession would mean that the U.S. economy, which has been in a recovery since the summer of 2009, would slide back into another recession at some point in the near future. In our view, while the odds of a double dip have increased in the past few months, we do not think a “double dip” is likely to occur given the current economic and policy backdrop. However, a sudden surge in consumer energy prices, a collapse of a major European bank and a resulting freeze up of global credit markets, a sharp increase in global central bank policy rates, a collapse in overseas economic growth, a rapid reduction in the budget deficit for this year or next year in the United States and/or a dramatic flattening of the yield curve would cause us to change our view.

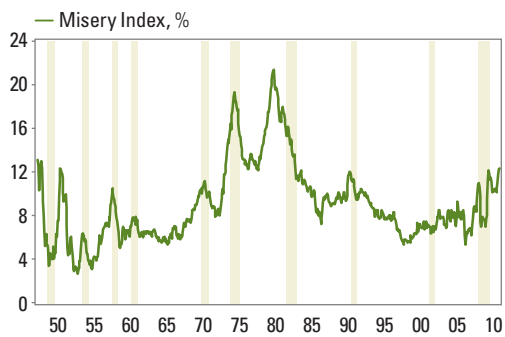
For background, over the past 80 years, the economy has endured two “double-dip” recessions, in 1937–38 and again in 1981–82. In this section, we will look at each of the prior “double dips”, and then compare those periods with the current period. The 1937–38 recession was quite severe, and is often lumped in with the “Great Depression” of the 1930s. The National Bureau of Economic Research (NBER), the apolitical, nonpartisan, academic think tank that assigns dates to recessions and expansions, tells us that the Great Depression ended in early 1933 and a recovery that lasted four years, until mid-1937, ensued. At that point, the Federal Reserve began to tighten policy, the U.S. government raised taxes and cut government spending in order to balance the budget, and the economy hit a wall, plunging into a severe downturn that lasted for 15 months.

Jumping ahead 40 years, there was a sharp, Federal Reserve induced recession in the first half of 1980. The causes of the first leg of the early 1980s double-dip recession are fairly clear:

- The Fed raised rates sharply in late 1979/early 1980 to combat 13% inflation.

In our view, while the odds of a double dip have increased in the past few months, we do not think a “double dip” is likely to occur given the current economic and policy backdrop.

1 While Elevated Relative to Recent History, the “Misery Index” Now Stands at About Half of its Early 1981 Level



Source: Bureau of Labor Statistics /Haver Analytics 08/05/11

(Shaded areas indicate recession)



- President Jimmy Carter went on television in early 1980 and urged people to not use their credit cards.
- Oil prices were surging, in part due to the Iranian hostage crisis, which began in November 1979.

As a result, consumer spending, business investment and housing activity collapsed. The Fed lowered interest rates in early 1980 to end the recession, but inflation, even inflation excluding food and energy, was still high and market interest rates started going up again. In addition, the wage price spiral was still intact, oil and other commodity prices continued to move higher, and the economic recovery in late 1980/early 1981 was shaky at best. The U.S. economy entered another severe recession in July 1981 which lasted until November 1982.

We recently completed an analysis that looked at the behavior of dozens of economic indicators today and in late 1980 and early 1981. Unfortunately, there is not enough readily available data for the 1936–37 period to make a similar comparison. Of the dozens of metrics we looked at (comparing late 1980/early 1981 to today) we found that only a handful are “worse today” (i.e. pointing to “double dip”) than they were in mid-1981, when the second leg of the double dip began.

Those indicators that are worse today than in mid-1981 include:

- Credit spreads today are wider than they were in mid-1981, just prior to the onset of the second half of the double-dip
- Private sector employment gains since end of prior recession
- Consumer sentiment and consumer expectations (although the evidence is mixed here)
- Real Money Supply Growth (evidence is mixed here as well)

Looking at the data, it is clear the 1980–81 period should have been called one big recession. The already fragile economy coming out of the sharp 1980 recession just buckled under the weight of high inflation, a tightening Fed, the lagged effect of soaring oil prices and very weak trading partners, a soaring dollar, and extremely high nominal interest rates that dissuaded investment.

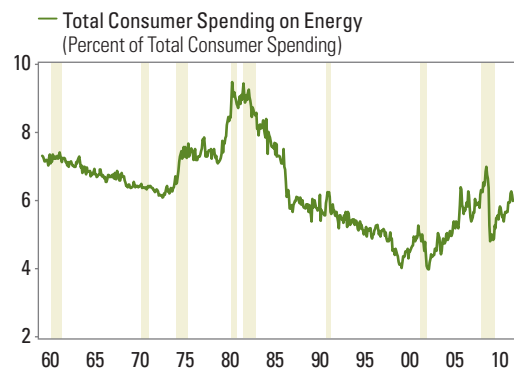
We have none of these things now; In fact, the recovery since June 2009 has been much more robust than the recovery in late 1980 through early 1981:

- Oil prices had risen by 40% and 30% over the prior three and four years in mid-1981.
- Both headline and core (excluding food and energy) inflation was over 10%, prompting the Fed to raise rates.
- Business capital spending was tepid, at best, in late 1980 and early 1981, weighed down by exorbitant financing costs.
- The US dollar surged (crimping exports) while our major foreign trading partners saw modest economic growth at best.

In fact, the recovery since June 2009 has been much more robust than the recovery in late 1980 through early 1981.



2 Consumer Spending on Energy Goods and Services is Below 2008 Peak, and Nearly One-Third Lower Than the Double-Dip Inducing Levels in 1980-81



Source: Haver Analytics 08/05/11

(Shaded areas indicate recession)

- Equity prices, as measured by the S&P 500, were only up modestly in mid-1981 versus the end of the recession in 1980.
- The absolute level of the 10-year Treasury note, mortgage rates, and the 3-month T-bill were absurdly high in 1981, crushing investment and consumption.
- The so-called “Misery Index” (the inflation rate plus the unemployment rate) was in the 20s. It is closer to 10 today. [Chart 1]
- In addition, the ISM (and its key leading components) in the 1980-81 period barely got over 50, let alone to well above 60 as they have been now.
- The slope of the yield curve, the difference between the 10-year Treasury note and the fed funds rate, was negative, often a harbinger of recession.

Looking at the data today, it is hard to make a case for double-dip, but the data does point to a modest pace of growth in the second half of 2011, although growth should be stronger in the third quarter than in the fourth quarter:

- Today, the ISM and its key components have been above 50—indicating an expanding manufacturing sector—for 24 consecutive months most or all of the past 12 months, and many have spent significant time above 60.
- The Fed today is at worst, on hold, (not raising rates as they were in late 1980 and early 1981) and even today we are still feeling the effects of the Fed’s quantitative easing program and prior rate cuts. More “growth-friendly” steps toward easing are likely from the Fed in the weeks and months ahead.
- Over the past three and four years, the price of oil and gasoline are little changed (up about 7 to 10%), while in late 1980 and early 1981 they were soaring, crimping the consumer.
- Today the 10-year/fed funds rate yield curve is hugely positive; in 1980–81 it was negative and inverted most of the time, signaling a recession.
- Our exports are booming today, and although our trading partners are slowing, economic growth in our trading partners today (even post-Europe debt crisis) is more than triple the level in 1981. 50% of our exports head to emerging markets where growth estimates are being revised up and economies are expected to grow more than three times faster than the U.S. economy.
- The dollar is down five to ten percent versus a year ago, while in mid-1981, the dollar was up 15% year-over-year versus mid-1980, hurting exports. A weaker dollar helps to boost our exports.
- Today, business capital spending (led by low absolute interest rates, and low corporate financing costs, plenty of cash on corporate balance sheets, soaring profits and cash flows and a 20% year-over-year gain in equity prices) is a much more robust backdrop for corporate spending than was the case in late 1980/early 1981. The recent sell off in the equity market is a new threat here.
- On housing, the inventory of unsold homes is much lower today than it was in 1980–81, housing affordability is triple what it was in 1981,



and mortgage rates are at all-time lows now. In late 1980/early 1981, mortgage rates were at all-time highs.

- As noted above, one of the few metrics that is “worse” now than in late 1980/early 1981 is private sector job creation. But when you adjust for outsourcing (there is a ton of outsourcing now and there was none in 1981) and productivity (negative to +1.0% in 1980–81), soaring today, job growth is currently on a par with that in early 1981.

In addition, fiscal policy in the United States, while tightening a bit relative to where it was in 2009, is still very loose by historical standards, and a balanced budget is years away, if not decades away. Still, this past weekend’s downgrade of U.S. debt to AA+ from AAA raises the odds that fiscal policy at the federal level will become even more restrictive in the coming years, which, in turn, lowers the potential growth profile for the U.S. economy even further.

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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.

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Weekly Market Commentary



August 8, 2011

The Downgrade: What You Need To Know

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Highlights

We view the U.S. rating downgrade from AAA to AA+ as a disappointing, but lagging indicator of the pressures already reflected in the markets. We find plenty of historical evidence that markets have priced in the events that led to the downgrade much earlier than when the downgrades took place.

While there are some negative consequences, there are not triggers stemming from the downgrade that would spark a chain of events leading to a financial crisis.

Could this mark a "Sputnik moment" for policy makers tasked with finding the additional savings stipulated in the debt ceiling legislation?

The initial beneficiaries of the downgrade include precious metals and Treasuries given the hit to investor sentiment and the desire to seek safety and liquidity. Stocks, led by Financials, may initially suffer. However, low valuations and efforts to address the debt problems in Europe combined with improving economic data may put a halt to the stock market's decline.

Despite passing the debt ceiling and spending cut deal anticipated by the markets, last week's data and events pulled bond yields lower and left the S&P 500 now down about 10% from this year's high. This slide may seem all too familiar. Market participants are worried about a repeat of the 2008 financial crisis. While the message from the markets is important, in last summer's soft spot the 10-year Treasury note yield fell below 2.4% and the stock market fell 15%, but no recession took place. Instead, as the market became too pessimistic on the prospects for growth in the second half of the year, stock returns and bond yields moved to new post-crisis highs. The summer of 2010 is the more relevant comparison to the current market slide than the summer of 2008, in our opinion.

Friday's news that one of the three U.S. rating agencies was downgrading the U.S. credit rating from AAA to AA+ hit the markets and sapped the gains fueled by the report of better-than-expected job growth in the month of July (and positive revisions to prior months). As the rumors of a downgrade hit, stocks slumped. Is this a killing blow for a market and economy already suffering from a series of disappointments or a disappointing but lagging indicator of the pressures already reflected in the market's path and level of recent years? We favor the latter assessment.

Here we will present our views on the downgrade from; why it happened and what it means for investors and policymakers, and what is next for the markets. For more insight, please see the *Bond Market Perspectives* publications from July 19 and August 2 where we discussed the details surrounding the pending downgrade.

Why did it happen?

While the imbalance in the U.S. long-term fiscal situation is no mystery, the reasoning for the downgrade at this time is best left in the words of Standard and Poor's. The first news of a near-term potential downgrade came on April 14 of this year. Standard and Poor's rating agency stated, *"We believe there is a material risk that U.S. policymakers may not reach an agreement on how to address medium- and long-term budgetary challenges by 2013; if an agreement is not reached and meaningful implementation is not begun by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer 'AAA' sovereigns."*

On July 14, the outlook for a downgrade became even clearer as Standard and Poor's clarified their position with the statement: *"The CreditWatch*



placement of the U.S. sovereign ratings signals our view that, owing to the dynamics of the political debate on the debt ceiling, there is at least a one-in-two likelihood that we may lower the long-term rating on the U.S. within the next 90 days.” Standard and Poor’s cited \$4 trillion in savings as part of the debt ceiling bill as the number that would be a trigger to avoid a downgrade. As it became apparent that a “grand bargain” of around \$4 trillion was off the table, a downgrade by Standard and Poor’s became likely.

On Friday, August 5, the rumor of a downgrade announcement negatively impacted the markets. The announcement of the downgrade was delayed by the Treasury pointing out an error to Standard and Poor’s in their calculations of \$2 trillion as it related to the size of the total debt-to-GDP ratio which was a prominent component of their economic justification for the downgrade. S&P acknowledged the error and removed that component and focused on the political environment for the justification for their downgrade and announced it on Friday evening, after the markets had closed.

What does it mean for government bonds?

Historically, downgrade announcements do not mean much to the markets. They have priced in the events that led to the downgrade much earlier. We can find plenty of evidence of this in the downgrades from AAA of large countries and companies over the past 20 or so years.

Bond prices did not plunge as yields were flat to down when countries lost their AAA ratings in the past. There are a number of smaller countries that lost their AAA ratings, but they are not really comparable to the United States. The big three of Canada, Japan, and Australia are far more important comparisons. In both Australia and Canada, yields fell when the downgrade from AAA came after having run up in the months before. Both of these countries eventually regained AAA status. Yields also declined following Japan’s downgrade from AAA.

In the early 1980s, 60 companies in the S&P 500 were rated AAA, today there are only four: Microsoft, Exxon Mobil, Johnson & Johnson, and Automatic Data Processing. In general, the downgrade from AAA came after the market had already reacted to the drivers that made the rating downgrade an obvious next step. Companies like Berkshire Hathaway, General Electric, and Pfizer all lost their AAA status during the recent financial crisis. But the markets had already priced in the prospects for these companies well before they were downgraded leaving no reaction to the news when it finally came.

We see the prospects for Treasuries more influenced by the outlook for economic growth than by this downgrade. We do not expect sharply rising yields in response to the downgrade, but instead a steady move higher over the remainder of the year as economic growth proves to be better than is currently being priced in the market.



Are there triggers that would cause a financial crisis?

There are not triggers stemming from the downgrade that would cause forced selling of Treasuries or a chain of events leading to a financial crisis. In fact, Treasury yields may decline as investors seek safety and liquidity.

Nearly half of U.S. government bonds are held by foreigners. The biggest holder of U.S. government debt, China, holds U.S. debt as part of their currency management and trade policy and growth strategy rather than as a traditional investment. They are not constrained by ratings as a condition of their holding. In fact, China's rating agency, Dagong, downgraded the U.S. last year. Importantly, with no other high-quality, liquid bonds of sufficient size to absorb the demand and with other AAA-rated countries on review for downgrade these investors have nowhere else to go.

The next largest holder is the U.S. Federal Reserve who is unlikely to sell the Treasury bonds acquired under the quantitative easing programs until it believes the economy is strong enough to absorb the potentially higher interest rates that would result from the sales.

Insurance companies are required by law to hold a large portion of their portfolios in very safe and very liquid securities. However, they are generally allowed to hold U.S. government bonds no matter what they are rated. For example, the New York life insurance law stipulates obligations issued by "the United States of America or any agency or instrumentality thereof."

Money market funds will not have to sell. The U.S. short-term debt rating has not been changed. Regardless, money market mutual funds must hold "top-tier" securities with no stipulation for rating.

Banks do not need to raise capital, as they were forced to do after the failure of Lehman Brothers triggered losses that forced additional selling. This was made clear by the Federal Reserve, FDIC, and other bank regulators on Friday, *"For risk based capital purposes, the risk weights for Treasury securities and other securities issued or guaranteed by the U.S. government, government agencies, and government-sponsored entities will not change."*

Even those entities that are required to hold AAA-rated debt can still hold Treasuries since two of the three U.S. rating agencies still rate the United States as AAA. Unless S&P cuts the credit rating further or Moody's and/or Fitch also cut the U.S.'s long-term rating (both have reaffirmed the U.S. AAA rating) the debt is still considered AAA.

What are the consequences?

The lagging nature of downgrades, coming after the drivers have already been discounted by investors and reflected in the economy, do not usually carry much in the way of major negative consequences. However, there are some negative consequences that while not dire do pose some challenges and should not be completely overlooked.

First, a lower rating may mean that interest rates will be higher over the longer term as investors demand more yield for taking on the perceived greater risk of Treasuries. However, this is not a near-term threat to economic growth or the markets.



It is possible that the municipal bond market may be impacted. The 15 AAA-rated states could be subject to a modest downgrade given some funding sources that are dependent upon the Federal government. It is hard to see what the market impact of this rating change may be; however, it is unlikely to be sizable.

A higher cost for collateral in repo, derivative, and swap transactions may result from the downgrade. These agreements are typically collateralized by Treasuries. As a result of the downgrade, counterparties would likely have to post slightly more of these securities as collateral slightly increasing costs.

The United Kingdom and France are likely the next countries to see downgrades from AAA. However, markets have discounted this outcome. French credit default swaps, essentially an insurance policy against the risk of default, are over three times that of the United States.

Finally, the United States is still on negative outlook despite having been downgraded to AA+. Without additional actions to put the United States on a path to fiscal sustainability the United States will likely be downgraded further. This could have ramifications for those entities required to hold AAA-rated bonds even if the other two rating agencies do not change their ratings.

What does it mean for policymakers?

The downgrade adds another point to fuel the increasing divisiveness between the political parties. In addition, Timothy Geithner, who was already considering leaving his post as Treasury Secretary (as is common after more than two years), may have to stay on so as to not appear as the scapegoat for the downgrade.

Washington has repeatedly shown the ability to miss opportunities to address the long-term U.S. fiscal imbalance. However, perhaps the moment has arrived. Could the downgrade of the U.S. credit rating be a Sputnik moment for policymakers? Probably not. But Washington has the ability to address this in the November 23 and December 23 deadlines for agreement on finding the \$1.5 trillion in additional savings stipulated in the debt ceiling legislation and for Congress to pass them. They are tasked with finding a minimum of \$1.5 trillion, but there is no limit on them finding more than \$1.5 trillion in savings. Two weeks ago a bipartisan proposal delivered by the Republican Speaker of the House, John Boehner, and the Democrat Majority Leader in the Senate, Harry Reid, to save nearly \$4 trillion over the next 10 years was rejected by the President. Could that plan get dusted off and find new support in light of the downgrade? The markets would welcome a larger bipartisan plan.

What is next for the markets?

The announcement of a downgrade of the U.S. credit rating from AAA to AA+ added to the list of disappointments investors have suffered in recent months, including: softer economic growth (although data has been more mixed than consistently weak as it was last week), European debt problems spreading, and Washington's debt ceiling demagoguery.



The initial beneficiaries include precious metals and Treasuries given the hit to investor sentiment and the desire to seek safety and liquidity. AAA-rated German bunds may also be winners as investors seek quality while the debt of France and the United Kingdom may suffer as investors' price in the likelihood that they are next in line for a downgrade.

Stocks may suffer from investors seeking a safe haven. Stocks may go down due to some selling as investors who own Treasuries to diversify riskier positions in their portfolios may want to sell some stocks to recognize that their Treasury holdings are riskier. Among stocks, the banks may suffer the worst—not that they would have to raise capital—but since not only is the “Washington put”, or the willingness of policymakers to intervene with a bailout to avert a crisis, already called into question but now its ability to back stop a failure is also questioned.

However, stock prices reflect a wall of worry. Stocks are inexpensive on both a trailing and forward basis compared to history. The S&P 500 trailing price-to-earnings ratio (measuring earnings over the past four quarters) is 13, the lowest since 1990. The S&P 500 forward price-to-earnings ratio (using earnings forecast over the next four quarters) is 11, the same as it was at the bottom of the financial crisis in March of 2009. While valuations could compress further, the spring is already tightly coiled. The solid second quarter earnings season suggests the market is too bearish with the price it is putting on earnings. Notably, S&P indicated it is not planning on downgrading companies' AAA ratings despite the agency's policy not to have a company's rating be higher than its home country's sovereign rating.

Finally, while much of the world has been focused on the downgrade of the United States by Standard and Poor's, the more important credit situation for the world economy is in Europe right now. Both Italy and Spain have been under intense pressure recently after the debt crisis for the peripheral nations of Greece, Ireland, and Portugal was addressed with a second rescue package for Greece. This past weekend the European Central Bank (ECB) announced plans to buy Italian and Spanish debt in the markets, pending fiscal reform commitments. Rather than tap the European Financial Stability Facility (EFSF), which has a flexible mandate but limited funding, the ECB has stepped in. Unlike the EFSF, the ECB has the scale to address bond markets of countries the size of Spain and Italy.

The stock market is likely close to making the low point of the year as events in Europe stabilize and earnings and economic growth prove better than the now overly gloomy expectations priced in for the third quarter.



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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

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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.

Stock investing may involve risk including loss of principal.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

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.

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

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 P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

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.

The securities mentioned herein are not a recommendation to buy or sell. All decisions should be based on your risk tolerance, time horizon and overall goals.

A Credit Default Swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

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