

Weekly Economic Commentary

September 26, 2011



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Highlights

- Policy is likely to outduel both corporate and economic data for the market's attention this week.
- The sentiment says "recession" while the data says "slow growth." Which is correct?

Economic Calendar

Monday, September 26 New Home Sales <i>Aug</i>	Thursday, September 29 Core PCE Deflator <i>Q2</i>
Dallas Fed Survey <i>Sep</i>	GDP Price Index <i>Q2</i>
Tuesday, September 27 Consumer Confidence <i>Sep</i>	Real GDP <i>Q2</i>
Richmond Fed Index	Initial Claims <i>wk 09/23</i>
Wednesday, September 28 MBA Mortgage Applications Index <i>wk 09/23</i>	Pending Home Sales <i>Aug</i>
Durable Goods Orders and Shipments <i>Aug</i>	Friday, September 30 Personal Spending <i>Aug</i>
Bernanke Speech in Cleveland, OH	Personal Income <i>Aug</i>
	Chicago Purchasing Managers Index <i>Sep</i>
	U of Mich Consumer Sentiment <i>Sep</i>

Hard Data Versus Soft Sentiment

Markets across the globe are still calling out for bold, coordinated policy actions here and abroad as participants await earnings results and guidance from Corporate America and another set of economic data for August and September in the United States. On the plus side, policymakers in Europe seem to be getting the market's message, and there were signs over the weekend of September 23–25 that some type of bold response from Europe was in the works. In addition, the European Central Bank (ECB) hinted last week that it may cut rates at its next meeting in early October. Also, euro-zone officials are talking openly about recapitalizing European banks most exposed to the debt of Greece and other troubled peripheral European nations, similar to the United States' Troubled Asset Relief Program (TARP). On the downside, Congress continues to bicker over funding the government for fiscal year 2012 (which begins on Saturday, October 1), the incoming economic data remains tepid, and despite the talk of coordinated policy action on Europe, none has been taken.

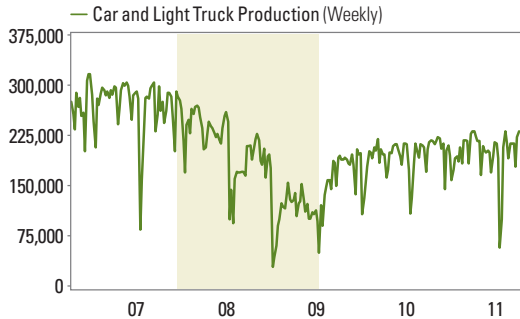
Policy Likely To Trump Corporate and Economic Data Again This Week

While there are a number of key economic reports due out in the United States and overseas this week, policy (or lack thereof) is likely to continue to dominate the headlines and drive financial markets. Although no key developed or emerging market central banks are scheduled to meet this week to discuss policy, there are a number of central bankers on the docket this week, including Federal Reserve (Fed) Chairman Ben Bernanke. Bernanke is slated to deliver a speech in Cleveland, OH, and there ten other speeches by Fed officials this week. Central officials from the ECB, Bank of England (BOE) and Bank of Canada are all slated to make speeches this week as well.

As we have been noting for several weeks in the *Weekly Economic Commentary*, central banks that had been tightening policy over the past two years or so have either stopped raising rates, or begun to cut rates, as inflation risks fade amid a sharp slowdown in economic activity and prospects for future growth wane. Examples in this group include the central banks in Brazil, Russia, New Zealand, and Australia, as well as the ECB. Israel, which has been raising rates since mid-2009, unexpectedly cut its overnight lending rate on Monday, September 26. Most notably, China's central bank has hinted in recent weeks that it is close to the end of its rate



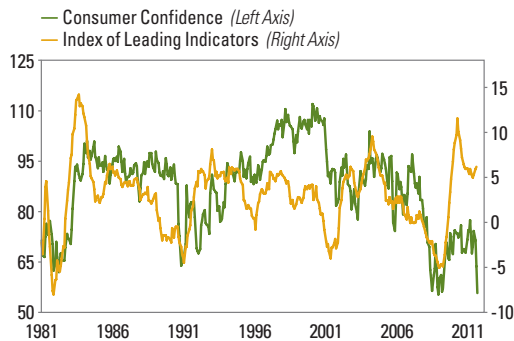
1 Auto and Light Truck Production At Highest Levels in Three Years



Source: Haver Analytics 09/26/11

(Shaded areas indicate recession)

2 Sentiment Flashing Recession, Hard Data Is Not



Source: LPL Financial, Bloomberg data 09/14/11

3 Steel Production at a Three-Year High



Source: American Iron and Steel Institute/Haver Analytics 09/26/11

(Shaded areas indicate recession)

hike regime. Meanwhile, central banks that have been cutting rates are looking to do more. Examples here include the Fed, the BOE and the Bank of Japan.

Both corporate and economic data will compete with policy for the market's attention this week. The corporate earnings preannouncement season remains in full swing as company managements continue to quantify the impact of the ongoing uncertainty in the global economy on corporate sales and earnings. Thus far, corporate managements have not guided Wall Street analysts' expectations down much despite the sizeable drop in stock prices. That may change in the coming weeks and months, as companies report their earnings for the third quarter of 2011, and provide outlooks for the fourth quarter of 2011 and beyond. These preannouncements are likely to garner less attention than the ongoing policy wrangling, but are likely to move markets more than this week's batch of economic data.

Given the recent financial market and policy turmoil at home and across the globe, we continue to prefer using actual data (the number of vehicles produced, the tons of steel manufactured, the number of homes sold, the amount of new orders for capital goods, how many dollars consumers spent, what actions central banks are taking, etc.) rather than sentiment data (that measures how consumers or business owners feel about the current situation or the prospects for future activity). The September 6, 2011 edition of the *Weekly Market Commentary* explores this difference in depth.

This week's economic reports are roughly split between sentiment indicators (September reports on consumer sentiment and several regional Federal Reserve manufacturing reports for September) and "hard data" indicators (initial claims, weekly retail sales, durable goods orders and shipments, new home sales and personal income and spending).

Despite the nation's dour mood and unprecedented turmoil and volatility in financial markets, the sentiment data released thus far in September including the:

- Philadelphia Fed Manufacturing Index,
- Dallas Fed Manufacturing Index,
- Empire State Manufacturing Index,
- University of Michigan' Consumer sentiment,
- National Federation of Independent Business' Small Business Optimism Index
- National Association of Homebuilders Sentiment Index

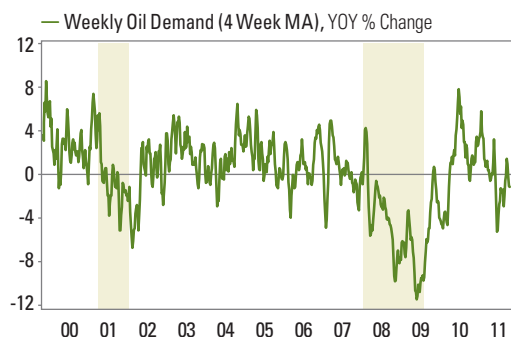
have painted a picture of an economy that is weakening, but not dramatically so. Nearly all of the indicators in the list above remain solidly above their 2007–2009 Great Recession lows, although several are flashing recessionary signals.

On the other hand, much of the hard data we have seen for August and September continues to suggest that the economy can avoid a recession, but that slow growth is the most likely outcome.

- Initial claims for unemployment insurance remain near 400,000 per week, a level that historically has suggested slow, but positive job growth.



4 Oil Demand Suggests Slow Growth, Not Recession



Source: Energy Information Administration/Haver Analytics 09/26/11

(Shaded areas indicate recession)

- Industrial production in the United States increased by 0.2% month-over-month in August and was running 3.4% ahead of year-ago readings. Although industrial production remains below its pre-recession peaks, it was at a three-year high in August.
- At 231,557 units, auto and light truck production in the latest week (September 19–23) was the highest for any week since mid-2008, before the onset of the worst of the Great Recession in the fall of 2008 following the collapse of Lehman Brothers.
- Weekly retail sales, a component of the LPL Financial Research Current Conditions Index, was running 3.4% ahead of a year-ago in the week ending September 17, a level consistent with the pace of economic growth and consumer spending seen during the 2002-2007 economic recovery in the United States.
- At 1.9 million tons, steel production in the latest week was nearly 10% above year-ago levels. While still below the two million tons per week average seen in the 2002–2007 economic recovery, steel production is at its highest level since mid-2008.
- Production of lumber (479,000 board feet) was running 34% above year-ago levels last week and, while not yet back to pre-recession levels, is at its highest level since mid-2008.
- Total demand for petroleum products (gasoline for auto and truck use, diesel fuel for heavy truck and railroad use, and jet fuel for passenger and cargo jet traffic use), as measured in the U.S. Energy Department's Weekly Petroleum Status Report, was running at more than 19 million barrels per day. That reading is little changed from the demand seen a year ago, and more than two million barrels per day more than in late 2008/early 2009, the worst of the 2007–2009 Great Recession.

The sentiment and data continue to tell two different stories about the economy. The sentiment is flashing “recession” and worse, while the data continues to tell a story of a struggling economy, but one that is growing slowly, not collapsing.

As we have noted in our recent commentaries, the U.S. economy remains fragile and vulnerable to an exogenous shock (i.e. an oil price spike, a massive natural disaster, large-scale terror attack, 2008-style credit crunch, etc.) and to policy mistakes, both at home and abroad. However, 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.



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.

Philadelphia Federal Index is a regional federal-reserve-bank index measuring changes in business growth. The index is constructed from a survey of participants who voluntarily answer questions regarding the direction of change in their overall business activities. The survey is a measure of regional manufacturing growth. When the index is above 0 it indicates factory-sector growth, and when below 0 indicates contraction.

The NY Empire State Index is a seasonally-adjusted index that tracks the results of the Empire State Manufacturing Survey. The survey is distributed to roughly 175 manufacturing executives and asks questions intended to gauge both the current sentiment of the executives and their six-month outlook on the sector.

The University of Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

The Texas Leading Index is a single summary statistic that sheds light on the future of the state's economy. It is designed to signal the likelihood of the Texas economy's transition from expansion to recession or vice versa. The index is a composite of eight leading indicators—those that tend to change direction before the overall economy does. These indicators include: Texas Value of the Dollar, U.S. Leading Index, Real oil prices, Well permits, Initial claims for unemployment insurance, Texas Stock Index, Help-wanted advertising, Average weekly hours worked in manufacturing.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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

The small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of ten seasonally adjusted components based on questions on the following: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job opening, expected credit conditions, now a good time to expand, and earnings trend.

National Association of Homebuilders Sentiment Index is an index of more than 300 home building companies measuring demand for the construction of new homes. The housing market index goes from 0 to 100, with a measure over 50 meaning that demand for new homes is rising.

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Weekly Market Commentary



September 26, 2011

Europe's Problems Are Manageable, but They Need to Be Managed

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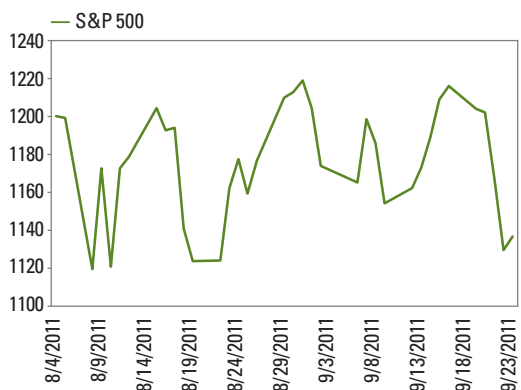
Highlights

Stock markets around the world lost over \$3 trillion last week and entered a bear market as fear of default among some troubled European nations increased once again.

The S&P 500 Index has remained range bound for the past seven weeks. This is most likely due to the fact that a sharp downturn in earnings is already priced in combined with the prospect for earnings growth if a crisis is averted.

Europe's problems are manageable, but they require management. The market moves seen last week push policymakers closer to the tough decisions needed to regain the confidence of investors.

1 S&P 500 Moves from Top to Bottom of Range in Latest Week



Source: LPL Financial, Bloomberg data 09/25/11

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

Last week, the S&P 500 Index dropped 6.5% to 1,136. The Index gave back the 5.4% gain achieved in the prior week, the third-biggest weekly gain since 2009, which had lifted the Index to the top end of the range at 1216. The volatility continues within the range of about 1120 to 1220 on the S&P 500, a range that has prevailed since early August as you can see in [Chart 1](#).

The declines were not restricted to the U.S. markets as the concerns remain focused on the European debt problems. Based on the MSCI All-Country World Index, stock markets around the world lost over \$3 trillion last week (by comparison, all of Greece's government debt totals about \$200 billion) and entered a bear market as fear of default among some troubled European nations increased once again. This was the third largest weekly decline since the global recovery began in March 2009.

It is no surprise that the market appears to be demanding a policy response to the debt problems in Europe. All of the major European stock markets are in a bear market, having declined by about 30% from the peak in early May. However, many of the world's largest markets have avoided a 20% or more decline defined as a bear market, such as those of the United States, United Kingdom, Canada, Singapore and New Zealand. The losses in Europe have been, in general, twice as large as those in non-European nations. They are more severe than even the 21% decline from the peak in Japan which suffered a devastating earthquake and tsunami earlier this year.

While stock values have been affected by the negative sentiment, analyst earnings estimates, in contrast, have remained resilient. In fact, there is not a single nation among the largest 24 whose companies are expected by analysts to produce a loss in aggregate during the coming fiscal year. For example, in the United States, the estimated earnings growth rates for the S&P 500 for the coming four quarters are in the double-digits: 14%, 15%, 11% and 15%. Even in Europe any losses are expected to be temporary and give way to double-digit earnings growth in the coming fiscal year, as you can see in [Chart 2](#).

While U.S. stocks have fallen 15%, analysts' earnings estimates have only been trimmed by about 2%. While we continue to believe, as we have all year, that earnings estimates are a bit too high, we do not believe the major decline priced in by the market is likely. The earnings outlook remains supported by company guidance and world industrial output that remains close to all-time highs. In Europe, earnings growth also remains positive. Market participants have priced in an expectation that earnings will suffer



2 Analysts' Expected Earnings Growth Rates By Country

Companies by Country	Current Fiscal Year	Next Fiscal Year
United States	22.4	16.4
Canada	38.8	18.8
France	7.7	9.8
Germany	2.5	13.1
Italy	20.8	18.6
Japan	19.6	21.6
United Kingdom	16.0	13.1
Austria	11.5	15.8
Belgium	-29.5	76.9
Denmark	15.1	23.2
Finland	-8.6	20.0
Netherlands	19.3	7.6
Spain	-3.9	11.6
Sweden	0.5	12.5
Switzerland	-3.0	14.6
Australia	15.2	15.1
Hong Kong	16.5	4.1
China	23.8	21.3
India	13.3	18.5
Singapore	10.3	3.1
Taiwan	-4.0	20.2
Argentina	16.6	25.0
Brazil	3.8	11.8
Mexico	28.5	16.6

Source: LPL Financial, Thomson Financial data 09/23/11

double-digit declines as a recession and financial crisis erupts, rather than double-digit gains in the coming year as a crisis is averted.

Despite all the negative news, the S&P 500 Index has remained range bound for the past seven weeks. This is most likely due to the fact that a sharp downturn in earnings is already priced in combined with the prospect for earnings growth if a crisis is averted.

There are several ways a crisis may be averted. While euro-zone members have yet to ratify the changes proposed to the European Financial Stability Facility (EFSF) this summer, we believe they will do so with votes scheduled in the coming weeks. Once ratified, a concern market participants have with the EFSF is its limited size of about 440 billion euros. A plan championed by U.S. Treasury Secretary Geithner to address the size of the facility that is winning some support in Europe is to allow the EFSF to borrow from the European Central Bank (ECB), multiplying the funds at its disposal and the impact it can have. The leveraged EFSF funds could be used to buy substantial amounts of troubled European nation debt, making the debt a collective obligation of the euro zone and essentially providing a bridge to eurobond issuance down the road. This form of rescue plan also has the added benefit of acting as stimulus in the form of quantitative easing for the euro zone. These assets can also be used to recapitalize banks that may suffer losses from a partial default by Greece. This is just one of several plans being discussed in Europe to avert a crisis.

Europe's problems are manageable, but they need to be managed. The market moves seen last week push policymakers closer to the tough decisions needed to take decisive action and regain the confidence of investors.



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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.

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.

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.

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

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 MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of June 2007 the MSCI World Index consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

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