

# Weekly Economic Commentary



June 13, 2011

## Lowered Expectations

### John Canally, CFA

Economist  
LPL Financial

#### Highlights

- Over the past four weeks, only 25% of economic reports in the United States beat expectations.
- This week, Fed Chairman Bernanke is likely to continue to prod Congress to put the United States on a sounder fiscal footing.
- One of the underappreciated stories in the economy over the past several years has been the recovery in consumer net worth.

#### Economic Calendar

<b>Tuesday, June 14</b>	NAHB Housing Survey <i>Jun</i>
NFIB Small Business Optimism <i>May</i>	<b>Thursday, June 16</b>
Retail Sales <i>May</i>	Initial Claims <i>wk 06/11</i>
PPI <i>May</i>	Current Account Balance <i>Q1</i>
Business Inventories <i>Apr</i>	Housing Starts <i>May</i>
<b>Wednesday, June 15</b>	Philadelphia Fed Index <i>Jun</i>
NY Fed Empire State Mfg <i>Jun</i>	<b>Friday, June 17</b>
CPI <i>May</i>	U of Mich Consumer Sentiment <i>Jun</i>
Capacity Utilization <i>May</i>	Leading Indicators <i>May</i>
Industrial Production <i>May</i>	

Fresh data on manufacturing and housing for June highlight this week's busy economic data calendar in the United States as markets try to assess the duration and severity of the economic soft spot. Fiscal and monetary policy intersect this week as Federal Reserve (Fed) Chairman Bernanke delivers a speech on fiscal sustainability, as both chambers of Congress return to work on the debt ceiling issue. We examine households' balance sheets two years into the equity market rebound.

In a speech to bankers last week in Atlanta, Fed Chairman Bernanke said he viewed the recent weakness in the economy as temporary. Bernanke described the economic recovery as uneven and frustrating, but disappointed those market participants looking for the Fed to embark on another round of quantitative easing to jolt the recovery to life. Bernanke's speech also suggests, however, that the Fed is in no mood to tighten policy either. The Fed's Beige Book, a qualitative assessment of economic conditions in each of the 12 Federal Reserve districts, released last week, confirmed that view. This week's full docket of economic data reports for May and June will test that view.

This week is a very busy week for economic data in the United States, as market participants try to assess the duration and severity of the current soft spot in the economic recovery, which turns two years old this month. While last week's quiet economic calendar saw about half of the reports beat expectations, over the past four weeks, only 25% of economic reports in the United States beat expectations. About the same percentage of reports released over the past four weeks saw an improvement versus the prior period (i.e. the May report represented an improvement from the April reading), and only 40% of the reports saw upward revisions to the prior period's data. Taken together, the economic data over the past four weeks has been the weakest in two years. As we head into this week, expectations are low. But are they low enough?

June data on manufacturing conditions in New York and Philadelphia highlight this week's economic data calendar, which also includes reports on May inflation (producer price index and consumer price index), retail sales, housing starts, leading indicators and industrial production. On balance, the data are likely to show that growth continued to decelerate in May versus April as a result of the earthquake in Japan, the late Easter and unusually severe weather. The consensus forecasts for the June data all suggest that the market is expecting a reacceleration in activity in June. We



would agree, but that reacceleration may not become evident in the data until July.

### Bernanke Joins the Budget Battle

This week, the Fed is in its unofficial “quiet period” ahead of next week’s (June 22) Federal Open Market Committee (FOMC) meeting. The FOMC, the Fed’s policymaking arm, will release a new economic forecast next week, and Fed Chairman Bernanke will hold another press conference at the conclusion of the June 22 meeting. In our view, the Fed will not materially change its stance on monetary policy at the June 22 FOMC meeting, and that the latest round of quantitative easing (QE2) will end on time at the end of June. The Fed is likely to leave the stimulus provided by QE2 in place until at least autumn of 2011, if not longer, to allow the economy to regain some of the steam it has lost over the past few months.

Bernanke is slated to speak this week on fiscal policy, a topic he addressed in-depth on June 7, and has addressed nearly every time he appears before Congress. Bernanke this week is likely to continue to prod Congress to put the United States on sounder fiscal footing. In his June 7 address, Bernanke cautioned that “a sharp fiscal consolidation focused on the very near term could be self-defeating if it were to undercut the still-fragile recovery.” Bernanke seems to be suggesting to Congress to enact a long-term deficit reduction plan without cutting spending (or raising taxes) too much in the next few years.

Both houses of Congress are in session this week, and legislative time is running low as we approach the August 2 deadline on the debt ceiling. The good news is that the conversation in Washington has moved from whether or not to cut the deficit to how much to cut, but the bad news is that the two sides (the White House/Senate Democrats and House Republicans) remain far apart on the “hows”: How much to cut - the latest word is that a plan to cut the deficit by \$2 trillion dollars over the next 10 years is in the works - and how to cut (spending cuts, tax increases, or both) remain up in the air. President Obama’s much publicized golf outing with House Speaker John Boehner this weekend (June 18–19) may provide the impetus for the next round of the negotiations. Our view is that Congress will act to raise the debt ceiling, but that the path toward that outcome may be a rocky one for financial markets.

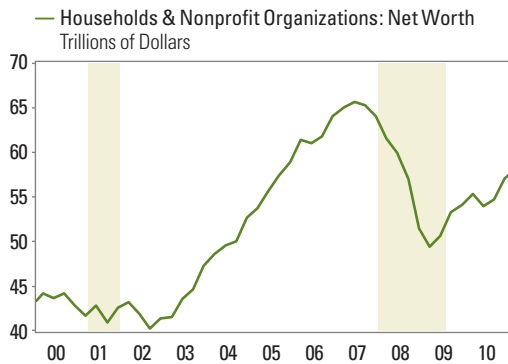
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### Household Net Worth Up, As Rising Bond and Stock Markets Offset Housing

One of the underappreciated stories in the economy over the past several years has been the recovery in consumer net worth since the depths of the Great Recession in late 2008 and early 2009. Consumer net worth—defined as household assets (cars, houses, financial assets including stocks, bonds, mutual funds, pension assets, money market accounts, etc.) less household liabilities (mortgage debt, credit card debt, consumer loan debt)—posted another quarter-over-quarter gain in the first



## 1 Household Net Worth Has Risen In Seven of the Past Eight Quarters, But Remains Below Its Pre-Recession Peak



Source: Federal Reserve Board/Haver Analytics 06/13/11

(Shaded areas indicate recession)

quarter of 2011 — the latest data available — and has now posted quarterly gains in seven of the past eight quarters dating back to early 2009.

Since hitting a five-year low at just over \$49 trillion in Q1 2009, consumer net worth has increased by \$9 trillion, and stands at just over \$58 trillion. Despite the gain in recent years, household net worth remains nearly \$8 trillion below its all-time peak, set in early 2007 before the onset of the Great Recession and the accompanying collapse in housing prices. The slow recovery in household net worth helps to explain the below-average consumer spending during the first two years of the economic recovery, a period that typically sees robust consumer spending growth.

The \$9 trillion increase in consumer net worth over the past two years is a result of a 13% gain in asset prices, and a 2% drop in liabilities of households.

The gain in asset prices was driven by:

- Equity prices, as measured by the Russell 3000 Index, rising 100%+ from their early 2009 lows.
- Bond prices, as measured by the Barclays Capital Aggregate Bond Index, increasing 18% from their early 2009 lows.

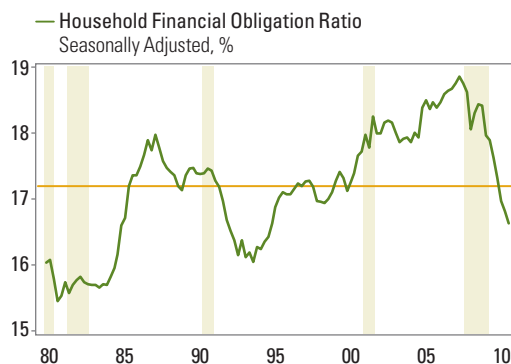
The large gain in equity and bond prices more than offset the 2% drop in real-estate values since early 2009.

While some of the 2% drop in liabilities over the past two years was certainly involuntary (consumers walking away from mortgages, consumer loans and credit card debt), part of the big drop in household liabilities since mid-2008 (\$688 billion) reflects a healthy, voluntary paring down of debt by consumers.

While the consumer net worth data is somewhat stale — the latest data available is for the first quarter of 2011 — the monthly report on consumer credit outstanding (released on June 3) can provide a fresher look at the state of consumer finances. Although consumer credit outstanding has increased in each of the past seven months (through April 2011), the ratio of consumer credit outstanding to disposable income fell again and at 20.7% in April 2011 is 60 basis points (bps) below year-ago levels (21.3%) and 370 bps below the peak of 24.4% hit in 2005.

As we note regularly in the *Weekly Economic Commentary*, consumer spending accounts for more than 70% of U.S. gross domestic product (GDP). Consumer finances have been vigorously debated by market participants since the onset of the financial crisis and the Great Recession. Starting in the early 1990s, consumers had been on a spending spree — accelerating spending, reducing savings, and piling up debt. However, there has been a noticeable reversal of that trend the last few years as strapped consumers have been forced to address soaring debts by reducing discretionary spending. This is best illustrated by the Financial Obligations Ratio (FOR), which the Fed uses to track how much of a household's disposable income goes toward paying debt, including mortgage (or rent), credit card, lease, homeowners' insurance, and property tax payments.

## 2 Consumers Debt Burdens Are Improving



Source: Federal Reserve Board/Haver Analytics 06/13/11

(Shaded areas indicate recession)



As of the fourth quarter of 2010 (the latest data available), the FOR was the lowest in 15 years and is below the long-term average of 17.2%. Based on the big drop in the monthly debt-to-income ratio in early 2011, the FOR likely improved further in the first quarter of 2011. Some of the reduced debt burden is the result of consumer defaults, but the drop in the FOR in recent quarters suggests that the combination of low interest rates, attractively refinanced mortgages, rising incomes (personal income in April 2011 was up 4.4% from a year ago and is at an all-time high), and less debt to service is hastening the improvement in consumers' ability to spend. Consumers have been paying down debt, increasing their spending (at a modest rate for this point in a recovery), and saving more since late 2008.

We would expect this pattern to continue over the remainder of 2011, and into 2012, which means slower-than-normal consumer spending dampening economic growth, but not causing outright declines that would portend a double-dip recession.

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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 Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

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# Weekly Market Commentary



June 13, 2011

## America's Latest Pastime

### Jeffrey Kleintop, CFA

Chief Market Strategist  
LPL Financial

#### Highlights

The attraction of a summer day at the ballpark endures, but it is no longer the most common topic of conversation during these early days of summer. The boys of summer are taking a backseat to the Dogs of the Dow.

After six weeks of market declines, totaling almost 7%, as measured by both the Dow and the S&P 500, we believe we are the middle innings of this pullback with a few left to go.

The good news is that we do not expect this pullback to extend into extra innings and, despite the tough season, stocks are likely to have a winning year.

Before television, the internet, football, cars and movie stars, Americans were obsessed with baseball. Baseball was the one thing that everyone could talk about with family, neighbors, and co-workers. It became America's favorite summer pastime one hundred and fifty years ago.

The attraction of a summer day at the ballpark endures, but it is no longer the most common topic of conversation during these early days of summer. Instead, the six-week decline in the U.S. stock market seems to be the topic on everyone's lips. The boys of summer are taking a backseat to the Dogs of the Dow. The big question about the stock market pullback is: what inning are we in?

After six weeks of declines, totaling almost 7% in both the Dow and S&P 500, we believe we are in the middle innings with a few weeks and percentage points left to go. The pressure on stocks may continue for a few more innings due to the following:

- **Soft economic data** – Economic data remaining soft in the next few weeks as the data continues to be negatively impacted by the lagged effect of high oil prices, the Japanese earthquake and tsunami, and severe weather and natural disasters in the United States.
- **Pre-announcement season** – The so-called earnings “pre-announcement season” is coming up in the next few weeks when corporate leaders often pre-announce any bad news ahead of their second quarter earnings reports that begin in mid-July. For the past couple of years, the pre-announcement season has been relatively quiet and not acted as a negative for stocks. However, due to the slowdown during the second quarter and supply chain problems extending from the disaster in Japan, the next few weeks may feature more bad news than in recent quarters as companies lower their earnings outlook.
- **End of QE2** – With the Federal Reserve due to cease being the biggest buyer of debt issued by the Treasury to fund the government on June 30, 2011, low rates are dependent upon foreigners stepping back in to buy the increasing quantities of Treasuries. The end of QE2 (Quantitative Easing) may heighten concerns about the US dollar, interest rates, and debt levels adding to the environment of uncertainty.
- **Debt ceiling debate** – The battle is likely to heat up in the coming weeks in Washington over raising the debt ceiling and making budget cuts with the threat of a potential U.S. default looming if an agreement is not forthcoming and implemented by August 2.



While these negatives are not new, they may continue to pressure stocks until they begin to recede by mid-July. At that point, we expect that:

- The debt ceiling debate should be nearing an end,
- Earnings reports will get underway for what was likely to have been another solid quarter for profits, and
- Economic data is likely to rebound from the negative effects of the earthquake and tsunami in Japan and the unusual weather patterns.

The lifting of these negatives may coincide with an end to the pullback and the start of a rebound.

While we do not expect this pullback to extend into extra innings, there are alternative outcomes that we are on the lookout for that could lengthen and deepen the decline. These outcomes include the following:

- Earnings reports accompanied by significant downward guidance on earnings for the second half of the year.
- The economic data continuing to soften and come in weaker-than-expected throughout July and August.
- A banking crisis emerges from the European debt problems.
- More bad weather, natural disasters, or other unforeseen negative events posing additional shocks to the economy as the transition away from the support of fiscal and monetary stimulus takes place.

The season is far from over and there will be wins to balance out the losses as a volatile, but range-bound, summer ensues. Despite the tough season, stocks are likely to have a winning year. We continue to expect the stock market to post a high single-digit rate of return this year, accompanied by high volatility.

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