Weekly Economic Commentary

July 29, 2013

Midsummer Madness

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Highlights

We continue to expect the Fed to begin to slow its bond-buying program (QE) in the fall of 2013.

We believe the U.S. economy will continue to grow at about 2% in 2013, supported by housing as well as consumer and business spending, offsetting the government spending drag.

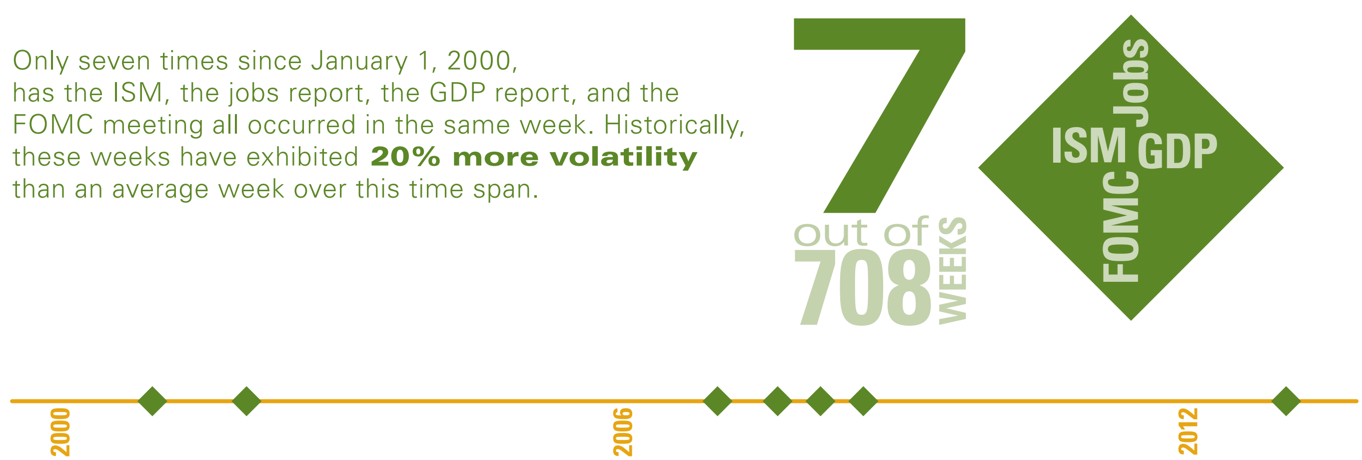
The health of the labor market as measured by the monthly job count (around 200,000 jobs per month) has met the Fed's "real and sustainable" improvement expectations, but other job market measures tell a different story.

Please see the LPL Financial Research Weekly Calendar on page 3

Eight times a year, the outcome of the Federal Reserve's (Fed's) Federal Open Market Committee (FOMC) meeting becomes the focal point for market participants. Four times each year, the first look at the health of the economy in the prior quarter (via the Bureau of Economic Analysis's (BEA) report on gross domestic product [GDP]), dominates the headlines. Similarly, at the start of each month, the Report on Business from the Institute for Supply Management (ISM) and the monthly labor market report from the U.S. Department of Labor are the centerpieces of any trading week. This week (July 29–August 2, 2013), all four of these key events are on the docket. How rare is this? In the 708 weeks between January 1, 2000 and today (13 years and seven months), all four of these often market-moving events have all occurred in the same week just seven times, most recently in the last week of January of this year. Historically, these weeks have exhibited 20% more volatility than an average week over this time span.* Add in the 135 S&P 500 companies expected to report their earnings results for the second quarter of 2013 this week, and this week is unlikely to be just another boring mid-summer week for financial market participants.

In addition to those four key events, markets will digest vehicle sales for July, pending home sales for June, home prices for May, as well as key data

1 Four Focal Points in the Same Week a Rarity



Source: Bloomberg, LPL Financial 07/29/13 in China (Purchasing Managers' Index [PMI] for July) and Japan (industrial production and vehicle sales for June 2013) along with the Bank of England (BOE) and the European Central Bank's (ECB) monthly policy meetings.

FOMC in Focus: Tuesday, July 30 & Wednesday July 31, 2013

- This is the fifth of eight FOMC meetings this year.
- This meeting will not include a press conference from Fed Chairman Ben Bernanke, and the FOMC will not be releasing a new economic forecast at the conclusion of this meeting. In recent years, markets have been conditioned not to expect many changes to Fed policy at FOMC meetings that do not include press conferences and new forecasts from the FOMC.
- The GDP report for the second quarter of 2013 will be released at the start of the second day of the two-day meeting, and the report will likely show that the economy barely expanded in the quarter. The FOMC will likely acknowledge this in the statement.

We expect that the Fed will maintain the fed funds rate near zero the rest of this year and all of next year.

- A lack of communication between the Fed and the markets—especially the bond market—in May and June 2013 led to an uptick in market volatility. The FOMC will likely want to use the statement that follows this week's meeting to further clarify its position on tapering quantitative easing (QE), but at the same time strengthen its commitment to keep the fed funds rate near zero, even as it is winding down its QE program.
- As noted in our *Mid-Year Outlook 2013*, we expect that the Fed will begin to slow its QE program this fall, dependent on the economy meeting the Fed's above-consensus forecasts. We expect that the Fed will maintain the fed funds rate near zero the rest of this year and all of next year.

Q2 GDP in Focus: Wednesday, July 31

- The consensus of economists (as measured by Bloomberg News) is looking for a very modest 1.0% annualized increase in real GDP for the second quarter of 2013. Estimates have moved sharply lower over the past four weeks, as several of the high-profile reports on the economy for May and June that feed into GDP (inventories, exports and imports, retail sales, durable goods shipments) fell short of expectations.
- The impact of higher taxes, the sequester, cooler-than-usual weather in most of the nation for most of the spring, as well as weak economies in Europe and China all acted as impediments to growth in the second quarter.
- The second quarter GDP report may be more difficult than usual for markets to interpret. Every July, the government agency (BEA) that compiles the GDP data releases revised data on GDP and its components going back three years. The revised data are based on new

LPL Financial Research Weekly Calendar

2013	U.S. Data	Fed	Global Notables
29 Jul	▪ Pending Home Sales (Jun)		▪ **Japan: Industrial Production (Jun)** ▪ Japan: Retail Sales (Jun)
30 Jul	▪ Consumer Confidence (Jul) ▪ Case-Shiller Home Price Index (May)		▪ Japan: PMI (Jul) ▪ Spain: GDP (Q2) ▪ Germany: CPI (Jul) ▪ Germany: Retail Sales (Jun) ▪ India: Central Bank Meeting ▪ Italy: Bond Auction
31 Jul	▪ **GDP (Q2)** ▪ ADP Employment (Jul) ▪ Employment Cost Index (Q2) ▪ Chicago Purchasing Managers Index (Jul)	▪ **FOMC Meeting**	▪ **China: Markit PMI (Jul)** ▪ **China: PMI (Jul)** ▪ Eurozone: CPI (Jul)
1 Aug	▪ Challenger Job Cut Announcements (Jul) ▪ Initial Claims (7/27) ▪ **ISM (Jul)** ▪ Vehicle Sales (Jul)		▪ UK: Central Bank Meeting ▪ **Eurozone: Central Bank Meeting** ▪ Euzozone: PMI (Jul) ▪ Spain: Bond Auction ▪ Japan: Vehicle Sales (Jun)
2 Aug	▪ **Employment Report (Jul)** ▪ Factory Orders (Jun) ▪ Personal Income and Spending (Jun)	Bullard*	▪ **China: Non-Manufacturing PMI (Jul)**

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

* Voting members of the Federal Open Market Committee (FOMC)

information from individuals, corporations, and businesses across the economy that was not available to the BEA initially.

- This year, the GDP accounts are undergoing what the BEA calls a "comprehensive revision." Every five years or so, the BEA incorporates both new data and new methodology into its revisions of GDP. Overall GDP and its components are subject to revision all the way back to 1929!
- This year, the most significant changes to the way the BEA calculates GDP come from the treatment of intellectual property (IP). Currently, items like corporate spending on research and development (R&D) or television and film rights are not counted as final GDP. The comprehensive revision will count IP as final GDP, and that will provide a one-time boost to the level of GDP. The market—and the Fed—are well aware of these changes, and although the financial media will likely make a big deal of these changes, the market is not likely to react much.
- Overall, while the quarter-to-quarter wiggles of GDP growth may change—and perhaps show a deeper Great Recession and a slightly stronger recovery—the pattern of GDP is likely to stay the same.
- As noted, in our *Mid-Year Outlook 2013*, we expect that the U.S. economy will continue to grow at about 2% in 2013, supported by housing, as well as consumer and business spending, offsetting the drag from government spending.

July ISM in Focus: Thursday, August 1, 2013

- The consensus of economists (as measured by Bloomberg News) is looking for a 52.0 reading on the ISM for July, after the 50.9 reading in June.
- A reading above 50 on the ISM indicates that the manufacturing sector is expanding.
- A reading below 50 on the ISM indicates that the manufacturing sector is contracting, and an ISM reading at 42 indicates that the overall economy is in recession.
- The ISM has been in a narrow range between 49 and 54 for the past 12 months.
- The Markit PMI — released several weeks ahead of the ISM report — has been gaining acceptance among market participants as a good proxy for the ISM report, and may, over time, diminish the importance to the markets of the ISM report. The Markit PMI reading for July 2013 was strong. At 53.2, it was above consensus expectations of 52.6 and also above the June 2013 reading of 51.9.
- Over the second half of 2013, we continue to expect the manufacturing sector is likely to be boosted by "onshoring" of jobs, relatively cheap and plentiful supplies of energy, and decent pace of capital spending. Weakness in Europe and China and a stronger dollar continue to be drags on the manufacturing sector.

July Employment Report in Focus: Friday, August 2

Generally speaking, the economy needs to create around 150,000 jobs per month to keep the unemployment rate steady.

- The consensus of economists (as measured by Bloomberg News) is that that the economy created a net new 185,000 jobs in July 2013. The economy has created around 200,000 jobs per month over the past three, six, and 12 months. This figure is derived from a survey of business establishments.
- The consensus is looking for the unemployment rate (measured from a survey of households) to tick down to 7.5% in July from 7.6% in June. Generally speaking, the economy needs to create around 150,000 jobs per month to keep the unemployment rate steady.
- The shift in weather from a cool, damp June to a more normal July should lead to a rebound in weather-sensitive areas of employment like leisure and hospitality, food services and recreation.
- Teachers and other education workers employed by state and local governments are always a wild card this time of year, as most local governments end their fiscal years on June 30. State and local governments have shed teaching jobs in each of the past three months (April, May, and June), and a bounce back could occur in July.

Other measures of the health of the labor market—hiring rates, the quit rate, and the unemployment rate—still show that the labor market is not yet back to normal.

- Our view is that the health of the labor market as measured by the monthly job count (around 200,000 per month) has met the Fed's expectations of a "real and sustainable" improvement in the labor market. But other measures of the health of the labor market—hiring rates, the quit rate, and the unemployment rate—still show that the labor market is not yet back to normal See the *Weekly Economic Commentary: Real and Sustainable: Revisited* from July 8, 2013 for more details. ■

*Between January 2000 and December 2012, the median percent difference between the high price and low price of the week for the S&P 500 was 2.9%. In the weeks where there were all four of these events in the same week, the median percentage difference between the high price and low price of the week for the S&P 500 was 3.5%.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasure securities).

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.

Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The S&P/Case-Shiller U.S. National Home Price Index measures the change in value of the U.S. residential housing market. The S&P/Chase-Shiller U.S. National Home Price Index tracks the growth in value of real estate by following the purchase price and resale value of homes that have undergone a minimum of two arm's-length transactions. The index is named for its creators, Karl Chase and Robert Shiller.

The Institute for Supply Management (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.

Markit is a leading, global financial information services company that provides independent data, valuations and trade processing across all asset classes in order to enhance transparency, reduce risk and improve operational efficiency. The Markit Purchasing Managers' IndexT (PMIT) is a composite index based on five of the individual indexes with the following weights: New Orders - 0.3, Output - 0.25, Employment - 0.2, Suppliers' Delivery Times - 0.15, Stocks of Items Purchased - 0.1, with the Delivery Times Index inverted so that it moves in a comparable direction.

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