



Weekly Economic Commentary



October 19, 2009

How, Why and When?

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ECONOMIC CALENDAR

Monday, Oct 19

NAHB Housing Survey
Oct

Tuesday, Oct 20

Housing Starts
Sept

PPI

Sept

Wednesday, Oct 21

Beige Book

Thursday, Oct 22

Initial Claims
wk 10/17

Leading Indicators

Sept

Friday, Oct 23

Existing Home Sales

Sept

After a month-long respite in September, the economic data is once again beating expectations in October, returning to the pattern seen in June, July and August, when nearly 70% of economic reports beat expectations. This past week, only the early October University of Michigan consumer sentiment report failed to match what are now raised expectations for the economy.

This week, the economic data calendar is dominated by housing, with reports on homebuilder sentiment for October, housing starts, building permits, existing home sales for September, and housing prices for August. The Federal Reserve (The Fed) also releases its “Beige Book”—a qualitative assessment of the economy in the 12 Federal Reserve districts—ahead of the November 4 Federal Open Market Committee (FOMC) meeting. The FOMC is the policymaking arm of the Fed.

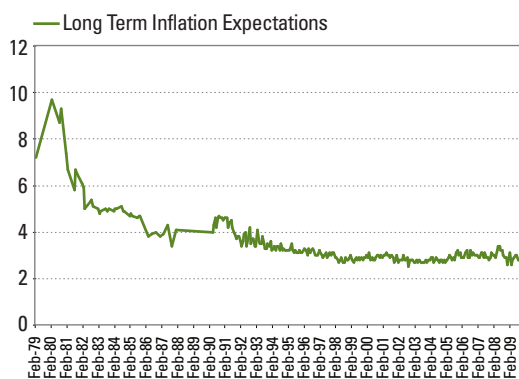
Although the housing data is likely to draw some attention from the market this week, the deluge (137 to be exact) of Q3 earnings reports and guidance from S&P 500 companies is more likely to move the financial markets. While squarely focused on Q3 results (for both corporate America and the U.S. economy) right now, very soon (perhaps at the end of this busy week for earnings) financial market participants will begin to take a closer look at Q4 2009 and 2010.

Along with the daily drumbeat of data on employment, new orders, yield spreads and price earnings ratios, one of the metrics we will be tracking very closely in the coming months is inflation expectations. Why? The Fed, and in particular, when and by how much the Fed raises rates in 2010 will be one of the big market movers as 2010 unfolds. The Fed has been telling the market “**how**” it will raise rates since early 2009. Last week, the Fed began to talk publicly about “**why**” it might raise rates. They have not, and probably will not tell the market “**when**” it will tighten policy. But we view inflation expectations as a key to when (and by how much) the Fed raises rates.

The most recent mention of “**why**” the Fed might raise rates came in the minutes of the September 23 FOMC meeting which were released last week. In the minutes, FOMC members noted that “In any case, all participants recognized that inflation expectations are a key determinant of inflation, and that various measures of inflation expectations, although imperfect, needed to be carefully monitored in the current environment.”

Each month, the University of Michigan surveys at least 500 households in the U.S. via telephone and asks them about their views on, among other things, the economy, the labor market, their finances, and inflation. The survey began in the mid 1960s.

1 Inflation Expectations Remain Well Contained



Source: Bloomberg; LPL Financial Research



In early October consumers' inflation expectations for inflation over the next five to 10 years as measured by the University of Michigan's survey were 2.9%, little changed from the 2.8% in September. As can be seen in Chart 1, consumers' long term inflation expectations have been in a very tight range around 3.0% for the past 10 years, and on a sharp downward trend over the past 30 years. Although some have concerns that the Fed's "quantitative easing (QE)" program—the Fed is adding money to the banking system and economy by purchasing Treasury notes, Agency (Freddie Mac and Fannie Mae) mortgages, and Agency debt obligations from commercial banks—would erode and unhinge inflation expectations, the data won't bear that out. At 2.9% in October, consumers' inflation expectations for the next five to 10 years are virtually unchanged from the 2.8% in April, the month after the Fed began its QE program. We, the market and the Fed, will be watching inflation expectations closely in the coming months.

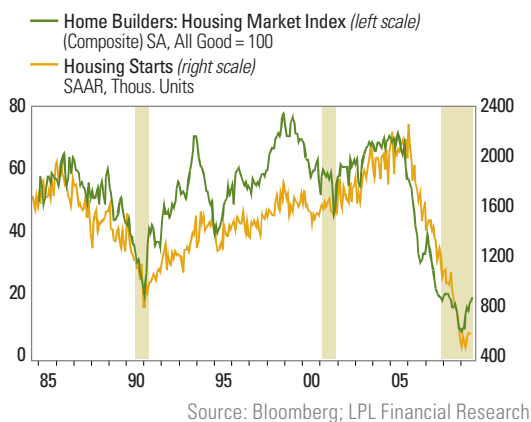
The Week Ahead

The section below provides some observations on this week's key economic releases. Alongside the preview are questions that markets, the media and, yes, economists are likely to be asking as the data is released.

October Housing Market Index (Monday, October 19)

- The market is looking for another small improvement to 20 in October vs. 19 in September.
- A reading below 50 suggests that homebuilders think conditions are poor/above 50 conditions are good. The index has not been above 50 since April 2006.
- At 19 in September, the NAHB index was up from a low of eight or nine in late 2008/early 2009, but still well below the peak of 72 hit in 2005.
- Mortgage rates moved down about 0.25% to around 5.00% between early September and early October.
- In our view, the good news on the economy, the equity markets, the labor market and home prices has begun to push potential buyers off the sidelines.
- Lowball appraisals have become an issue in the housing market lately, with lenders requiring bigger down payments from buyers or price cuts from sellers to make deals happen.
- In addition, the expiration of the \$8,000 first time homebuyer tax credit at the end of November is looming, and could impact the housing market as that date approaches. We now expect the first time homebuyer tax credit to be extended into 2010, as 2010 is a mid term election year for Congress, and voting against such a measure would not be politically expedient in many parts of the country.

2 At 19 in September, the NAHB Index was up from a Low of Eight or Nine in Late 2008/early 2009, but Still Well below the Peak of 72 Hit in 2005





We are likely to see inflation first at the producer level, (especially at the intermediate and crude levels) before we see it at the consumer level; we are already seeing commodity price inflation return.

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September Producer Price Index (Tuesday, October 20)

- Consensus forecast is for more headline deflation on producer prices for finished goods in September, but mild inflation on “core” PPI.
- We are likely to see inflation first at the producer level, (especially at the intermediate and crude levels) before we see it at the consumer level; we are already seeing commodity price inflation return.
- Crude oil prices fell modestly between August and September, while natural gas prices rose a bit. However, gasoline prices fell sharply (about 12%) between August and September. On balance, energy prices are likely to be a drag on the PPI in September versus August.
- Tobacco and new and used vehicle prices are always wildcards for the PPI. It’s anyone’s guess how the “cash for clunkers” program that kicked into high gear in late July and ended in August will impact new vehicle prices in the PPI in September.
- CPI and PPI tend to move together over long periods, but month to month, they are not highly correlated.

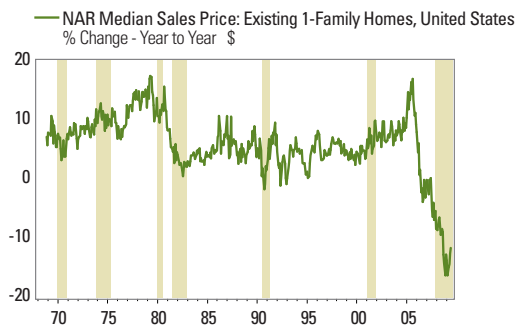
September Housing Starts (Tuesday, October 20)

- Looking for more signs that the housing market has stabilized, albeit at a very low level.
- Housing has been a drag on GDP growth for 14 consecutive quarters through Q2 2009 but it looks like it’s on track to be a plus for GDP growth in Q3 2009, a quarter earlier than we had previously thought.
- Housing and business capital spending have helped to lead the way in most of the post WWII recoveries.
- Single-family starts are more economically sensitive than multifamily starts. Before dipping by 3% between July and August, starts had posted six consecutive non-negative month-over-month readings since February, the longest streak since mid 2005!
- Multi-family starts are very credit market sensitive, and it’s still tough sledding right now for builders and developers who are dependent on financing. In addition, multi family housing starts are notoriously volatile from month to month. Multi-family starts surged 25% between July and August, so a similar drop in September wouldn’t be unusual.
- Weather is sometimes a factor for housing starts, but usually not in the summer months. Permits are not weather sensitive and are a good leading indicator of future housing activity.
- As is the case with the NAHB index, the end of the \$8,000 tax credit for first time homebuyers may begin to impact the single family housing starts data in the coming months, although as we note above, we expect the first time homebuyer tax credit to be extended into 2010.



Over time, the LEI is a good predictor of S&P 500 earnings growth, nominal GDP growth and the ISM Index Of Manufacturing.

3 On a year-over-year Basis through August, Existing Single-Family Home Prices are Down 12%, an Improvement from the -16.7% year-over-year Drop Recorded in January 2009



Source: Bloomberg; LPL Financial Research

September Leading Economic Indicators (Thursday, October 22)

- Nine of ten components are known prior to the release of the report, so this report shouldn't move markets, but it often does, and gets undue attention in the financial media.
- The LEI has now posted five consecutive month-over-month gains, the longest winning streak for the index since 2004.
- If the consensus is correct, LEI will rise again (by 0.8%) in September, led by the yield curve, consumer expectations and jobless claims.
- Over time, the LEI is a good predictor of S&P 500 earnings growth, nominal GDP growth and the ISM Index Of Manufacturing.

September Existing Home Sales (Friday, October 23)

- The housing market was at the forefront of the economic and financial meltdown we saw in late 2008 and early 2009. We think housing (sales of new and existing homes, housing prices and housing starts) has now finally entered a bottoming process. We also believe that housing is likely to make a positive contribution to GDP growth by Q3 2009, a quarter earlier than we thought earlier this year.
- Existing home sales fell 38% from late 2005 through January 2009, bounced around near the bottom in early 2009, but have moved up by 15% since then.
- Pending home sales, which tend to lead existing home sales by one or two months, rose for the seventh consecutive month in August, suggesting an ongoing rebound in existing home sales well into Q4 2009 and early 2010.
- Supply of existing homes for sales is down from its peak in early 2008, but remains elevated relative to its history. The market will want to see further improvement in this metric before it is convinced that the housing recovery is for real, especially given concerns over the "shadow" inventory in the market—homes that were being held off the market until conditions improved.
- This report also has data on existing home prices, and existing home prices have now posted month-over-month gains in four of the past seven months through August, and are up 8.0% from the January 2009 low. However, the data are not adjusted for seasonality, and since the majority of home sales (about 60%) occur in the spring and summer, home prices also tend to rise in the spring and summer months.
- On a year-over-year basis through August, existing single-family home prices are down 12%, an improvement from the -16.7% year over year drop recorded in January 2009.
- Because existing home sales are counted when a sale is "closed," and not when the contract is signed, and there is typically a lag of a month or so between a signed contract and closing. This data is not likely to have been impacted by the small drop in mortgage rates between August and September.



- Looking ahead, mortgage rates fell further—in some cases to under 5.0% for a 30 year fixed rate mortgage—but the rising trend of “low ball” appraisals, along with the looming end to the \$8000 tax credit for first time homebuyers are threats to the sustainability of the now eight month old housing recovery.

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