Weekly Economic Commentary

October 26, 2009

Q3 Report Card Due This Week

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ECONOMIC CALENDAR

Tuesday, Oct 27
Consumer Confidence
Oct

Wednesday, Oct 28
Durable Goods
Sept

New Home Sales
Sept

Thursday, Oct 29
GDP
Q3

GDP Price Index
Q3

Initial Claims
wk 10/24

Friday, Oct 30
Employment Cost Index
Q3

Personal Spending
Sept

Personal Income
Sept

Chicago PMA
Oct

U of Mich Consumer Sentiment
Oct

Not surprisingly, in a week dominated by the first full week of the Q3 earnings reporting season, the economic data took a back seat to all the headlines on earnings. On balance, the week's economic data was mixed, with a few reports beating expectations, a few in line, and a few disappointments. Importantly, none of the data changed our view that the U.S. economy will experience 2.0 to 3.0% GDP growth in the second half of 2009, and that the consensus forecast for 2010, at 2.4%, is still too low.

This week, there are even more Q3 earnings reports (150+) than last week (137), but the market seems almost immune to all the good news there. Thus, we expect there to be more focus on the week's full slate of economic data which include reports on:

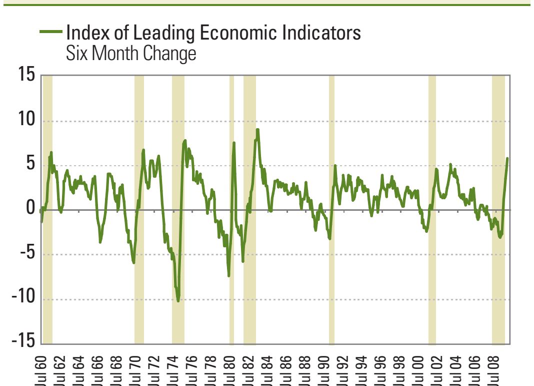
- Real Gross Domestic Product (GDP) for Q3 2009
- Manufacturing activity in Dallas, Chicago ,Milwaukee and Richmond in October
- New home sales and durable goods orders in September

The key report of the week (in terms of media attention) will be the preliminary Q3 GDP report. While the report will help to confirm to the public at large that the recession has ended, the market will probably be more focused on the reports for October, which provide insight into the economy in Q4. Thus, we will be closely watching the various manufacturing reports for October (and in particular the new orders and employment components of those reports), along with the weekly reports on retail sales and jobless claims, that are part of our Current Conditions Index.

Our suspicion is that even after Wall Street (and Main Street) digests the Q3 GDP report, and sees that the economy actually grew for the first time in 15 months, doubts will remain about the pace and sustainability of composition of the recovery.

In our view, the (global) recovery is on solid footing, and the U.S. economic expansion that began in the summer will continue. One way to illustrate that point is to look at the Conference Board's Index of Leading Economic Indicators (LEI). [Chart 1] Over the past six months, the LEI has risen by 5.7%, the fastest six month rise in the index since 1983, when the economy was in the midst of the robust recovery from the severe 1981-82 recession. While not a perfect indicator, the LEI does suggest that the economic recovery that began this past summer will be more robust than the last two recoveries (from the mild 1990-91 and 2001 recessions). It won't feel that way to many Americans, however, until the unemployment rate peaks and job growth returns in early 2010.

1 Over the past six months, the LEI has risen by 5.7%, the fastest six month rise in the index since 1983



Source: Bloomberg; LPL Financial Research

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.

September New Home Sales (Wednesday, October 28)

New home prices were down 12% in August 2009 versus August 2008. The market would view any signs that new home prices have bottomed as yet another sign that the overall housing market was in the bottoming process.

- 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) have now finally entered a bottoming process.
- Due, in large part, to the 80% drop in housing starts over the past three years, the inventory of unsold new homes is close to its long term average.
- As is the case with existing home sales, a potential threat to the underlying improvement in the market we have seen since early 2009 is the looming expiration of the $8,000 first time homebuyer tax credit in November.
- In recent weeks, the odds of the credit being extended well into 2010 (and even expanded to all homebuyers) has increased, due mainly to political considerations surrounding the 2010 Congressional mid-term elections.
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September Durable Goods Orders (Wednesday, October 28)

The market will want to focus on shipments and orders for capital goods, excluding aircraft. These "core" shipments and orders are highly correlated to the business spending portion of GDP

- Although we have already digested qualitative reports on business spending in September from companies with September quarter-ends reporting Q3 results and from the various regional and national ISM reports for September, the release of the September durable goods orders report represents the first "hard" data on business capital spending (durable goods shipments), future capital spending (durable goods orders) and business inventories in September.
- Two key themes for the September report are likely to be the big drop in aircraft orders in the month, offset by the big increase in auto related orders as a result of the cash for clunkers program.
- We expect that business capital spending grew in Q3 2009 versus Q2 2009, the first quarter-over-quarter gain since the recession began in Q4 2007. The expected gain in business capital spending comes as companies replenish severely depleted inventories.
- Business capital spending, along with housing, has led the economy out of recession in each of the 10 recoveries since WWII.
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- One concern in recent weeks has been the still elevated pace of inventory destocking among U.S. companies. Inventories are still likely to be a drag on Q3 GDP growth, but less so than in prior quarters. Still, the market will want to get a sense of where the inventory process was as Q3 2009 ended.

Q3 Real GDP (Thursday, October 29)

- The consensus of economists is for a 3.2% annualized gain in real GDP between Q2 2009 and Q3 2009 after the 0.7% drop between Q1 2009 and Q2 2009.
- If the consensus is correct, the quarterly gain in real GDP will be the first gain in GDP since the second quarter of 2008. This may help to reinforce the idea among investors, the financial media and the public at large that the recession has in fact ended.
- From the market's perspective, the Q3 GDP data is already "old news" at this point. The market is already looking ahead to Q4 GDP and to 2010, and more importantly, to the pace, and sustainability of the recovery.
- If the Q3 GDP data disappoints, inventories are likely to be the culprit. As mentioned in our preview of the September durable goods report, inventory destocking has not slowed as much as the market expected in Q3. Thus, there is a risk that inventories will again negatively impact GDP growth in Q3. If this is the case, we would view that as a positive sign, setting the stage for more robust growth in Q4 2009 and into 2010.

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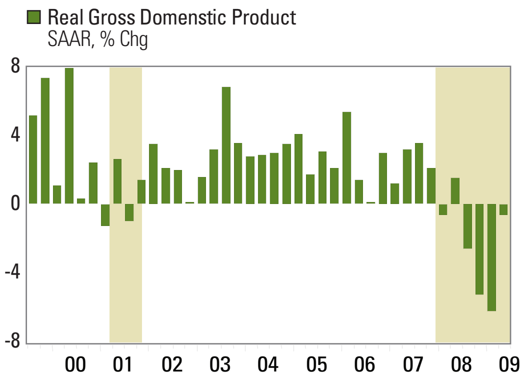

Source: Bureau of Economic Analysis, Haver

October Chicago Purchasing Managers Index (Friday, October 30)

- The market will be looking for signs in this report that business capital spending is poised to help lead the economy out of recession.
- The new orders component, a good predictor of future manufacturing activity in the region, pushed above 50 in August, to 52.5, indicating that manufacturers' orders were expanding for the first time since September 2008. However, the new orders index dipped below 50 in September to 46.3, worrying market participants who are overly concerned about a "double dip" in the economy.
- The export, employment and inventory/supplier delivery components of the report will be closely watched for indications of the strength of the manufacturing economy early in Q4 2009.

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IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

RES 1811 1009
Tracking #587495 (Exp. 10/10)