Weekly Economic Commentary

February 22, 2010

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ECONOMIC CALENDAR

Tuesday, Feb 23
Consumer Confidence
Feb

Wednesday, Feb 24
New Home Sales
Jan

Bernanke Testimony

Thursday, Feb 25
Initial Claims
wk 02/20

Durable Goods
Jan

Friday, Feb 26
Core PCE Deflator
Q4

GDP Price Index
Q4

Real GDP
Q4

Chicago PMA
Feb

U of Mich
Consumer Sentiment
Feb

Existing Home Sales
Jan

Highlights

Monetary policy took center stage last week, as the Federal Reserve (Fed) took another step toward normalizing monetary policy by raising the discount rate.

Aside from another disappointing reading on jobless claims, the week's economic data on the housing and manufacturing sectors came in better than expected. In addition, the market digested Fed deliberations on the economy, inflation, and monetary policy "exit" strategies.

This week's U.S. economic data focuses on the manufacturing sector, housing, and the consumer. Both fiscal and monetary policy will be on the front burner this week, with key testimonies from both Federal Reserve Chairman Ben Bernanke and U.S. Treasury Secretary Tim Geithner.

Watch Your Step

The Federal Reserve moved another step in the process of "normalizing" monetary policy last week, announcing a 25 basis point increase to the discount rate—the rate the Fed charges banks who borrow money from the Fed—after the market closed on Thursday. The move was well telegraphed, as Fed Chairman Ben Bernanke mentioned such a move in a speech in early February, and the minutes of the January 26-27 Federal Open Market Committee (FOMC) meeting (released on Wednesday, February 17) showed that the FOMC discussed raising the discount rate as part of the process.

As part of the ongoing steps towards the "normalization process", the Fed has already:

- Slowed the purchases of Mortgage-Backed Securities (October 2009),
- Tested the mechanism to drain its balance sheet of assets and sop up the excess cash in the commercial banking sector (December 2009 and January 2010), and
- Ended most of the emergency liquidity programs it put into place during the height of the credit crisis (February 1).

It's important to note that the discount rate has not been a "policy signal" for the Fed for many years, and neither consumers nor businesses will see higher loan rates as a result of the discount rate increase, which should mean little or no impact on the "real economy" in the near term. In fact, the move was more technical in nature, made to encourage banks to borrow from the private market, rather than from the Fed for overnight funds.

While the discount rate increase was the most visible step thus far in the Fed's tightening process, our view is that the process still has a long way to go. Next up:

- Fed Chairman Bernanke's semi-annual testimony on monetary policy before Congress on February 24,
- The release of the Fed's Beige Book (a qualitative assessment of the economy from the Fed's network of business contacts) on March 2, and
- The next FOMC meeting on March 15-16.

As we have noted in prior publications, the Fed now has many ways to withdraw its support for the economy, while it really only had one (raising the Fed funds rate) in prior recoveries. The multitude of ways the Fed can tighten monetary policy this time (versus prior periods) only adds to the uncertainty in Washington. Already facing legislative (health care reform, financial services reform, and climate reform) and fiscal uncertainties (soaring budget federal budget deficits, rising state, and local fiscal woes), markets are now bracing for monetary policy uncertainty.

Of course, investors and business leaders find comfort in certainty and clarity. The lack of certainty and clarity emanating from Washington is most likely contributing to the lack of hiring by small businesses—who account for nearly 60% of all hiring—and will continue to lead to more volatility in the financial markets over the course of 2010. (Please see this week's Weekly Market Commentary for more details)

Key Reports Last Week

Monetary policy took center stage last week, as the Federal Reserve raised the discount rate. However, the market also digested Fed deliberations on the economy, inflation and monetary policy "exit strategies" in the minutes of the January 26-27 FOMC meeting. In addition, the week's economic data came in better than expected, with stronger than expected reports on housing and manufacturing along with a benign report on consumer inflation that may have saved the day. The unexpected rise in weekly initial claims for unemployment benefits was the most disappointing report of the week.

The Federal Reserve released the minutes of its January 26-27 FOMC meeting last week. The FOMC is the Fed's policy setting arm. The minutes revealed that the FOMC raised its forecast for the economy in recent months, but also raised its forecast for inflation and the unemployment rate for 2010.

More importantly, the minutes underscored the internal debate at the Fed about how they should proceed with the next steps in the process of tightening monetary policy.

One faction at the Fed wants to raise interest rates first, while another faction wants to drain the Fed's balance sheet first, in an effort to sop up all the excess cash in the banking system that has the potential to trigger higher inflation down the road.

Subdued readings on both the overall Consumer Price Index (CPI) and the CPI excluding food and energy (core CPI) were just what the doctor ordered last week in the wake of the Fed's discount rate hike. The overall CPI rose just 0.2% month-over-month in January and was up 2.6% from January 2009. Meanwhile, core CPI fell 0.1% between December 2009 and January 2010, the first such decline since 1982. Over the past year, the core CPI is up just 1.6%, well within the Fed's comfort zone of 1.0 to 2.0%. The January CPI data suggests that inflation remains in check, giving the Fed ample time to remove the extraordinary monetary stimulus that has been in place for well over a year now. [Chart 1]

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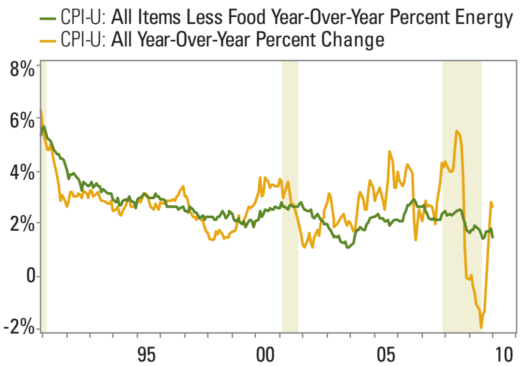
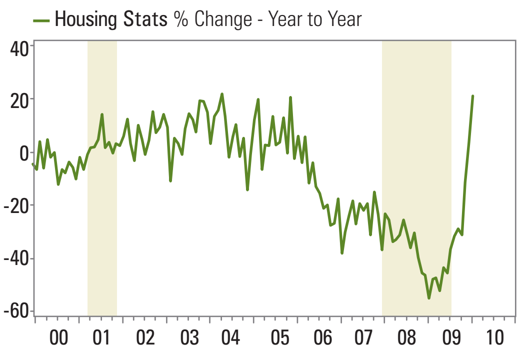


Source: Department of Labor, Haver 02/22/10

January housing starts rebounded nicely, after an upwardly revised December reading. Housing starts were up 21% in January 2010 versus January 2009, and housing will be a plus for Q1 2010 Gross Domestic Product (GDP), as it was in Q3 and Q4 2009. The return to normal winter weather and the resumption of the first time homebuyers' tax credit boosted housing starts in January. [Chart 2]

2 Housing starts were up 21% in January 2010 versus January 2009, and housing will be a plus for Q1 2010 GDP.



Source: Census Bureau, Haver Analytics 02/22/10

Industrial production posted a better than expected gain in January, after bad weather depressed December's reading. Industrial production continues to benefit from the return of global trade, inventory restocking, and the rebound in business capital spending. Business capital spending will also add significantly to GDP growth in Q1 2010.

Last week's most disappointing economic report was the weekly jobless claims report. First time claims for jobless benefits moved back up in the latest week, but were probably again distorted by bad weather. Several states admitted to only "estimating" their claims data for the week, calling into question the veracity of the data. The recent jobless claims data is both good and bad news. The good news is that at 467,000, claims are 200,000 below their peak hit in March 2009. The bad news is that the four-week average on claims has been stalled at around 467,000 since mid December 2009, and the weather and "administrative" distortions in the data are making it difficult to get a clear understanding of the underlying health of the labor market.

Key Reports This Week

This week's U.S. economic data focuses on the manufacturing sector (January durable goods orders and the February reading on the Chicago area purchasing managers index), housing, (new and existing home sales for January), and the consumer (consumer confidence and consumer sentiment for February). The market will also be keenly interested in Federal Reserve Chairman Bernanke's Monetary Policy testimony to Congress. In addition to Bernanke, several other Fed officials, as well as Treasury Secretary Tim Geithner have public appearances scheduled. Thus, the Fed's exit strategy, along with all matters fiscal (debt ceiling, budget deficits, the TARP, etc) are likely to be in the news.

January Durable Goods Orders (Thursday, February 25)

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- Business capital spending was a big plus for real GDP growth in Q4 2009, and we expect business spending to be additive to GDP again in Q1 2010, as companies continue to replenish severely depleted inventories, aided by low financing rates.
- Although we have already digested qualitative reports on business spending, orders, and inventories in January from companies reporting Q4 2009 results, and from the various regional and national Institute of Supply Management (ISM) reports, and regional Federal Reserve surveys for January, the release of the January 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 the first month of Q1 2010.
- Business capital spending, along with housing, has led the economy out of recession in each of the 10 recoveries since WWII.
- The market will want to focus on shipments and orders for capital goods, excluding aircraft. These "core" shipments and new orders are key contributors to the business-spending portion of GDP.
- The inventory portion of this report will be closely watched by market participants looking to gauge the ongoing process of inventory restocking as Q1 2010 began. A slower pace of inventory destocking added more than three full percentage points to real GDP growth in Q4 2009, and the market is counting on a further slowdown in inventory destocking—and maybe even some inventory rebuilding— in early 2010.

January Housing Starts (Wednesday, February 17)

- In recent months, uncertainty surrounding the U.S. government's first time homebuyer tax credit program has played havoc with the new and existing home sales data.
- Based on the 1% month-over-month gain in pending home sales in January, the market is looking for small month-over-month gains in both new and existing home sales in January.
- The housing market (housing starts, housing construction, new and existing home sales, and home prices) stabilized over the course of 2009, after a precipitous drop between 2006 and 2009. However, the rebound in housing activity in this cycle has lagged compared to other economic recoveries.

RES 2057 0210
Tracking #616140 (Exp. 02/11)

LPL FINANCIAL RESEARCH

Weekly Market Commentary

February 22, 2010

Investing for Volatility

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Highlights

- The volatility and classic 5-10% pullback we have seen so far this year is perfectly normal and very likely to be a recurring pattern throughout 2010 as the economy transitions from recovery to sustainable growth.
- A key contributor to the volatility that accompanied the transition to sustainable growth in 1994 and 2004 was the signaling of rate hikes by the Fed. After hiking the discount rate last week, the market is likely to remain focused on the Fed this week as Federal Reserve Chairman Ben Bernanke will deliver his semi-annual report on the economy and interest rates to House and Senate panels on February 24–25.
- There are several ways to potentially enhance returns during market volatility including: More frequent tactical adjustments to portfolios, focusing on the yield, using active management rather than passive indexing strategies, increase diversification by adding low correlation investments and incorporating non-traditional strategies that help in an environment of increased volatility.

On Friday, the S&P 500 was up 5% from its low for the year on February 8. From January 19 to February 8, the index fell about 8%. Since then, it has recovered more than half of the losses and is now essentially unchanged for the year. The volatility and classic 5-10% pullback we have seen this year is perfectly normal and very likely to be a recurring pattern in 2010.

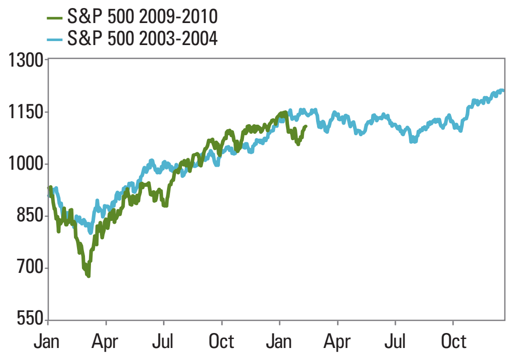
We have often commented that stock market pullbacks of 5-10% are very common and have accompanied every recovery. In fact, this is the third 5-10% pullback during the stock market rally that began in March 2009. During the four and a half year bull market from March 11, 2003 to October 9, 2007, the S&P 500 experienced a 5-10% pullback eight times. However, the volatility in 2010 is likely to be accompanied by a lower return environment than what we experienced in 2009. The environment may be more like that of 1994 and 2004, the last two times the economy transitioned from recovery to sustainable growth.

Both 1994 and 2004 had multiple 5-10% pullbacks in the S&P 500 as the recovery matured, stimulus faded, and the Federal Reserve (Fed) hiked interest rates marking a return to normal conditions. Both years also provided only single-digit buy and hold returns. Just as in 2009, the S&P 500 followed the path of 2003, the stock market in 2010 is tracking the volatile pattern of 2004. [Chart 1]

A key contributor to the volatility that accompanied the transition to sustainable growth in 1994 and 2004 was the normalization of monetary policy—or, in other words, hikes to the Federal Funds rate by the Fed. The volatility began early in those years as the Fed signaled the coming of the rate hikes that took place later in the year. In a surprise move last week, the Fed raised the discount rate (the rate at which the Fed makes direct loans to banks) by 0.25 to 0.75 percent. The Fed stated that the discount rate increase would encourage banks to borrow in private markets rather than from the Fed. In addition, U.S. central bankers closed four emergency lending facilities this month and are preparing to reverse the more than $1 trillion in excess bank reserves they have pumped into the banking system. The Fed noted that these actions represented a "normalization" of lending after providing emergency liquidity since late 2008 rather than a change in monetary policy signaled by a hike in the Federal Funds rate. The message from the Fed repeated that economic conditions warrant low levels in the federal funds rate "for an extended period." Regardless of the Fed's description, these steps toward a return to a more normal lending environment are likely to lead to higher interest rates and tighter credit for banks even without the hikes to the Federal Funds rates, which we do not

1 Volatility Ahead

S&P 500 Index in 2003 – 2004 and 2009 – 2010



Source: LPL Financial, Bloomberg 2/22/2010

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

expect until the second half of the year. For more insight on the Fed's action see this week's Weekly Economic Commentary entitled *Watch Your Step*.

The market is likely to remain focused on the Fed this week, as Federal Reserve Chairman Ben Bernanke will deliver his semi-annual report on the economy and interest rates to House and Senate panels on February 24 – 25. He will probably assure Congress that the central bank is mindful of the lack of job growth in the U.S. and an increase in the Federal Funds rate is not likely to come soon. In fact, last week New York Fed President William Dudley indicated that policy makers need to focus now on maintaining growth rather than fighting inflation, citing a smaller-than-forecast increase in the consumer price index (CPI) for January and the monthly change in the core CPI, which excludes the volatile energy and food components, turned negative for the first time since 1982.

It is relatively easy to figure out how to invest when you believe the market is likely to go up or go down, but how do you invest when it is likely to go both up AND down? There are several ways to potentially benefit from market volatility, including:

- More frequent rebalancing and tactical adjustments to portfolios are recommended to help take advantage of the opportunities created by the pullbacks and rallies. Seeking undervalued opportunities and taking profits are key elements of a successful volatility strategy.
- Focusing on the yield of an investment rather than solely on price appreciation may enhance total returns. High-yield bonds and even stocks such as Real Estate Investment Trusts (REITs) offer a yield advantage over investments that are solely price-driven during periods of high volatility.
- Using active management rather than passive indexing strategies to enhance returns. Opportunistic-style investments provide a wide range of opportunities for managers to exploit during volatile markets.
- Increase diversification by adding low correlation investments and incorporating non-traditional strategies that provide some downside protection, risk management, and help in an environment of increased volatility. These would include investment vehicles exposed to Covered Calls, Managed Futures, Global Macro, Long/Short, Market Neutral, and Absolute Return strategies.

In last week's Weekly Market Commentary, we cited the tailwinds and headwinds for the markets contributing to higher volatility. Some investors are wary of this volatility and view it as a sign of a fragile market. We see volatility as a normal part of the healing process of recovery and a transition to sustainable growth.

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.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability.

Stock investing involves risk including loss of principal.

Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise, are subject to availability, and change in price.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Investing in real estate/REITS involves special risks such as potentially illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

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.

Correlation is a statistical measure of how two securities move in relation to each other.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing entire amount paid for the options.