

Weekly Economic Commentary



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Policy Parade

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Highlights

- March retail sales: A battleground for improving job market and rising energy prices.
- Plenty to cheer about in the March jobs report.
- Fiscal and monetary policy debates to dominate this week.

As is often the case during the week following the release of the monthly employment report, this week's economic calendar is relatively sparse. The few reports that are due out are not likely to be market-moving. Instead, market participants are likely to continue to mull over the March employment report (released Friday, April 1) and shift their focus to policy issues (both fiscal and monetary) at home and overseas. In addition, market participants will continue to monitor the price of oil, which ended last week close to \$108 per barrel.

Rising Food and Energy Prices Battle with Improving Labor Market for Consumer's Attention

If recent history is any guide, this week's sparse slate of economic data in the United States is not likely to be market-moving. While the weekly reports (for late March) on retail sales and initial claims for unemployment insurance may draw some market attention, the only other data that has the potential to move markets are the reports by the nation's retailers of their March "same store sales" on Thursday, April 7. The caveat here is that the late Easter this year (April 24) is likely to pull sales from March into April, while the relatively early Easter in 2010 (April 4) pulled sales in March at the expense of April.

Thus, retailers this year face tough comparisons in March 2011 relative to March 2010, although gasoline prices near \$3.75 per gallon and sagging consumer confidence will also likely be blamed for poor sales in March. Although the financial media is likely to be quick to pounce on any weakness in spending in March and blame it on rising oil prices, due to the Easter shift, most market participants will average retail sales in March and April to get a better sense of the underlying health of the economy.

In our view, an improving labor market, rising personal incomes, and a doubling in the equity markets over the past two years have thus far trumped rising food and energy prices, and sagging home prices, and allowed consumer spending to make a modest contribution to overall economic growth in 2011. However, further gains in oil (and gasoline) prices would cause us to revisit this view.

The Labor Market Gains Momentum

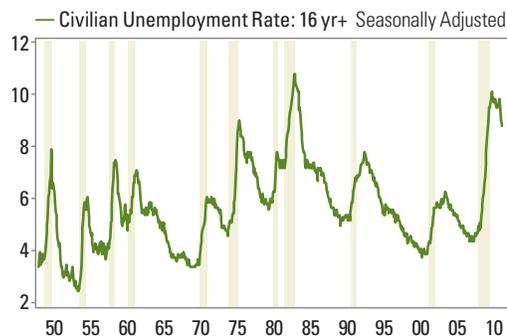
The private sector economy added 230,000 jobs in March 2011, exceeding economists' expectation of a 206,000 gain. The unemployment rate fell

Economic Calendar

Tuesday, April 5	Consumer Credit
ISM Non Manufacturing	<i>February</i>
<i>March</i>	Chain Store Sales
FOMC Minutes	<i>March</i>
Thursday, April 7	Friday, April 8
Initial Claims	Wholesale Inventories
<i>wk 04/02</i>	<i>February</i>



1 At 8.8%, the Unemployment Rate is Now Below the Federal Reserve's Forecast for 2011



Source: Bureau of Labor Statistics/Haver Analytics 04/04/11

(Shaded areas indicate recession)

Since August 2008, state and local government employment has declined in 26 of 31 months, the weakest period for state and local government employment on record (data extends back to 1940).

another 0.1% to 8.8% in March and the components of the March jobs report were all solid, suggesting similar sized job gains in the months ahead.

The monthly jobs report is chock full of information, and we could fill several pages with all the details of the report. The items below caught our attention:

- **Looking Ahead:** The composition of the March jobs report suggests more solid jobs gains are ahead in the coming months, as the number of jobs at temporary help supply firms increased markedly in March. This job category is one of the best leading indicators of future job gains. In addition, hours worked rose, and overtime hours held steady in March. Both metrics suggest that companies have pushed their current production capacity to the limit, and probably need to hire more staff to meaningfully increase production.
- **Japan:** There was not much discernable impact on the March jobs data from the Japanese earthquake and its aftermath. Timing played a big role here, as the earthquake hit just after most of data for the March jobs report was collected. The slight dip in hours worked in manufacturing between February and March may have been the result of Japan-related parts shortages at several auto plants in the United States. Our best guess is that the April jobs data will see a larger impact from the quake and its aftermath.
- **Weather:** Weather often plays a role in the monthly jobs report, and the harsh winter weather at the end of 2010 and in early 2011 was not especially data-friendly. The weather was more “normal” in March, and that may have boosted payrolls modestly in March relative to February. However, in construction, an area that is especially weather-sensitive (i.e. warmer and drier weather means more jobs), the number of jobs fell by 1,000 in March after a 37,000 gain in February. Overall, the impact of weather on the monthly jobs report should fade as the calendar turns to springtime.
- **State and Local government:** State and local governments shed another 15,000 jobs in March 2011 and nearly 300,000 state and local jobs have been lost in the last 12 months. Since the end of the recession in June 2009, nearly 500,000 state and local government employees have lost their jobs. We continue to expect that state and local government employment will be a drag on the overall labor market for the foreseeable future, as states, counties, cities, and towns struggle with too many expenses and not enough tax revenue.

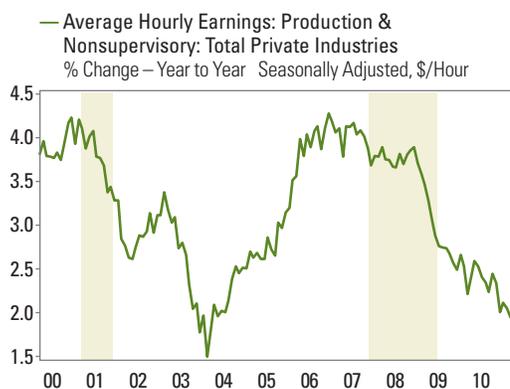
Typically, state and local government employment is a reliable source of strength for the economy and labor market. But in this cycle, state and local governments, under severe pressure from lawmakers and the public, are shedding jobs instead of adding them. In the early part of the Great Recession, state and local governments actually added jobs, but since August 2008, state and local government employment has declined in 26 of 31 months, the weakest period for state and local government employment on record (data extends back to 1940).

Late Easter: As noted above in our discussion of retail sales in March, Easter in 2011 is “late” this year. Based on the “late” Easter (and because



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2 Very Low Wage Inflation Makes it Difficult to Pass on Higher Commodity Prices to the Consumer



Source: Bureau of Labor Statistics/Haver Analytics 04/04/11

(Shaded areas indicate recession)

Easter-related school holidays are later this year than last), we expected to see a drop in retail and in leisure/hospitality employment in March, and then a big snapback in April. Instead, both the retail sector and the leisure/hospitality sector saw sizeable employment gains in March, suggesting that there more gains to come in these sectors in months ahead.

Fed: At 8.8% in March, the unemployment rate is already below the Fed's forecast: Fed policymakers expected the unemployment rate to average 8.9% in the fourth quarter of 2011. This, by itself, does not mean that the Fed is behind the curve and has to tighten policy immediately however. Indeed, the Fed will release a new forecast at the end of April, and wage growth, which is key to the transmission of higher commodity prices into overall consumer prices, remains subdued. Average hourly earnings fell to \$19.20 per hour in March from \$19.30 in February, and are running just 2.0% ahead of year-ago levels. With wages accounting for 70% of business costs (commodity prices account for between 5 and 10% of costs economy wide) it will be difficult for businesses to pass on higher commodity costs to the end user. We will continue to monitor this and other measures of wages in order to gauge when the Fed is likely to begin removing stimulus in the system.

Revisions to Prior Months: Keeping with the recent pattern (and consistent with a growing economy), net revisions to prior months private job counts were higher again. In a sea-change in sentiment from last summer, many market participants are beginning to worry that the government's monthly tally of employment is systematically underreporting the strength in the labor market.

Policy Parade This Week

There are plenty of fiscal and monetary policy (at home and abroad) events this week to fill the void left by the absence of key economic reports this week.

On the fiscal policy side, Congress is facing a very short-term (April 8), an intermediate-term (sometime in the next two months) and longer-term (two to three years) set of fiscal issues, all of which will be debated—although not necessarily resolved—this week.

In the short term, Congress has to agree this week on how much spending to cut this fiscal year (which is already six months old), as a government shutdown looms this Friday, April 8. Negotiations have been ongoing behind the scenes for weeks, but as this commentary was being prepared for publication (April 4, 2011) no deal had been reached to fund the government for the next six months.

In the intermediate term, Congress must raise the debt ceiling (basically, the limit on the U.S. government's credit card) before the Treasury runs out of the ability to borrow. (Please see the March 15 edition of the weekly *Bond Market Perspective* for more details on the debt ceiling issue.) The latest estimate is that the Treasury will hit that limit between now and mid-May, although they could use accounting gimmicks and other one-time items to extend that to the end of June. Over the longer term, it is possible that Congress could use the short- and intermediate-term deadlines to work out



a solution to the nation's longer-term budget problem—too much spending and not enough revenue, but odds are low that this can be achieved this year.

House Republicans will grab headlines this week as they release their budget proposal for fiscal year 2012, which begins on October 1, 2011. Early copies of the budget circulated over the weekend of April 2–3, and the budget is likely to call for \$4 trillion in cuts (mainly in healthcare) over the next 10 years. This is only the start of the fight for the future of the budget.

Not to be outdone by fiscal policy, there is plenty for markets to digest on the monetary policy side this week. There are eleven appearances by various Fed officials this week, including one by Fed Chairman Ben Bernanke. In addition, the Fed will release the minutes of the March 15 Federal Open Market Committee (FOMC) meeting. Participants will be scouring public comments (and the minutes) for signs that the Fed is planning to remove some of the monetary stimulus now in the system. The Fed's Beige Book is due out on April 5, and the next FOMC meeting is April 27. On that day, Fed Chairman Bernanke will release the FOMC's latest economic forecast and hold his first post—FOMC meeting press conference. We do not expect a signal of a change in policy from the Fed at the April meeting, but a signal at the June meeting is increasingly likely given the improving job market and rising inflation expectations

Overseas, central banks in Australia, Japan, England, Poland, Peru and Europe will meet this week to discuss monetary policy. The Bank of Japan remains in easing mode, and has done even more easing of policy since the earthquake, and it is no surprise that that Peru's central bank will hike interest rates as it combats high commodity prices and a booming local economy bolstered by those same soaring commodity prices.

Remarkably, however, the European Central Bank (ECB) is poised to raise rates at its meeting this week, despite the ongoing fiscal and banking woes in Europe. Unlike the Fed, which has a mandate from Congress to promote full employment and low and stable inflation, the ECB's only mandate is to keep inflation low and stable. This fact will not be lost on opponents of the Fed in Congress and elsewhere this week. Our long held view remains that while the hurdle for the Fed to end its latest round of quantitative easing (QE2) early is high, the hurdle for starting QE3 in June when QE2 ends is even higher.

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