YOUR FINANCIAL FUTURE

Your Guide to Life Planning

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Weekly Economic Commentary | Week of January 17, 2011

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Weekly Market Commentary | Week of January 17, 2011

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Weekly Economic Commentary | Week of January 17, 2011

Highlights

•Data on housing, manufacturing and more data from China will compete for attention with a flood of corporate earnings reports this week.

•Inflation has prompted higher rates from many foreign central banks.

•Last week's data suggests that the United States economy accelerated in the fourth quarter, carrying momentum into 2011.

Economic Calendar

Monday, January 17
Holiday- No Data

Tuesday, January 18
NY Fed Empire State Mfg
Jan

NAHB Housing Survey
Jan

Wednesday, January 19
Housing Starts
Dec

Thursday, January 20
Initial Claims
wk 01/15

Existing Home Sales
Dec

Philly Fed Index
Jan

Leading Indicators
Dec

Competing For Attention

Housing, the Federal Reserve's (Fed) monetary policy, and the manufacturing sector in early 2011 are likely to compete for market participants' attention this week. This data comes amid a flurry of corporate earnings reports for the fourth quarter of 2010 and guidance for 2011. Overseas this week, another round of Chinese economic data for December, more hand wringing about the European fiscal situation, and interest rate decisions from no fewer than seven central banks are on tap. In addition, markets will continue to digest and debate last week's full slate of economic data in the United States, which helped to boost expectations for real gross domestic product (GDP) growth in the recently completed fourth quarter of 2010. GDP growth is likely to accelerate to 4.0% in the fourth quarter, after averaging about 2.5% over the first three quarters of 2010. As highlighted in our *2011 Outlook*, our view for economic growth in 2011 is that real GDP growth will be near the long-term average at 2.5-3%.

Manufacturing, Housing and the Fed On the Docket This Week in the United States

The Empire State (released as this report was being prepared) and Philly Fed (Thursday, January 20) manufacturing surveys for January offer the first look at the manufacturing sector in 2011. As market participants digest these reports, the key question will be: Can the manufacturing sector continue to accelerate into 2011, or are we due for a deceleration soon? Business capital spending, and exports (both driven in large part by manufacturing) have grown faster than consumer spending in every quarter since the second quarter of 2010. That string may have been broken in the fourth quarter of 2010, although we continue to expect manufacturing, along with business spending and exports, to continue to add to GDP in 2011.

Housing, which has added to real GDP growth in just one quarter (the third quarter of 2010) in the past four years, is big news this week. Reports on homebuilder sentiment in January (released as this report was being prepared), housing starts (Wednesday, January 19) and existing home sales (Thursday, January 20) for December are due out. As noted above, housing construction-although a small part of GDP- has been a drag on GDP growth in 16 of the past 17 quarters. The good news is that unassisted by any government programs, the housing market seems to have found a floor. But the question is: Can the housing market reaccelerate on its own, and can it do so with only modest job and income growth and still stringent bank lending standards? Our best guess is that housing will continue to muddle along, not significantly adding to (or subtracting from) GDP growth in 2011.

In the last public appearance by a Fed official ahead of next week's Federal Open Market Committee (FOMC) meeting, the president of the Philadelphia Fed, Charles Plosser, is scheduled to deliver a speech this week in Chile. While Fed officials do not often break any new ground when speaking overseas (let alone a first time voter on the FOMC speaking the week before the FOMC meeting), Plosser's speech will be closely monitored. Plosser is a well-known inflation "hawk", and will likely cast a vote against continuing the Fed's program of

quantitative easing. There will likely be other dissenters at the January 26 FOMC meeting as well, but our view is that despite the political pressures, the hurdle for the Fed to end QE2 early is high, and the hurdle to start QE3 in June 2011 is even higher.

Elsewhere, bad weather will dominate the weekly data on claims and retail sales this week. With more wintry weather along the East Coast this week, market participants are beginning to ask: How long will it be before we can get a clean reading on the economy in early 2011? The Martin Luther King holiday, along with persistently harsh winter weather-that continued into mid January-are likely to disrupt the economic data for the next several weeks, especially the weekly readings on retail sales and initial filings for unemployment insurance. As a result, market participants may have to wait until early February to get a better gauge on the underlying health of the economy in early 2011.

Several Surprise Rate Increases Last Week as Emerging Markets Combat Domestic Inflation Worries

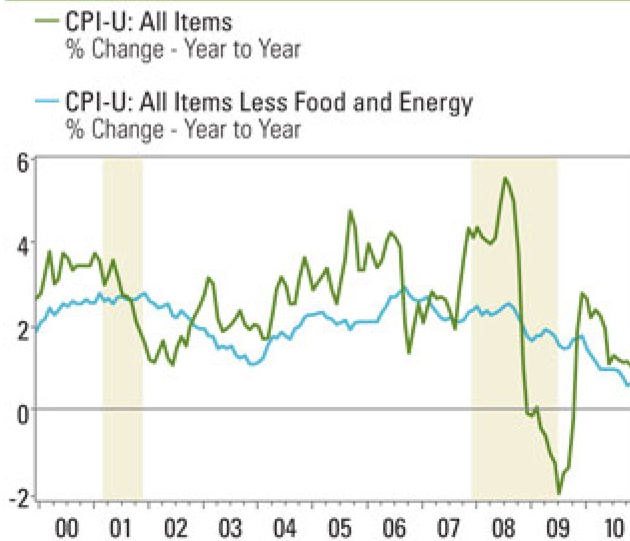
There were many signs in last week's batch of economic data for late 2010 and early 2011, that the United States economy gathered steam as 2010 ended and 2011 began, although more wintry than usual winter weather made some of the data even more difficult to interpret than usual. Last week's economic data in China for December continues to point to more policy tightening in China in the coming weeks and months. Several central banks around the globe did actually raise rates last week, including South Korea, Chile, Serbia and Thailand. All four have been raising rates for some time now to combat domestic inflation, although the rate hikes in Chile and South Korea were unexpected. The data released in the United States last week included reports on retail sales, inflation, jobless claims and the Beige Book. In addition, the data released in China last week continues to argue for more tightening there.

A Strong Finish to 2010, and a Solid Start to 2011

A quick recap of last week's key data in the United States and China is below:

The United States government's tally of December retail sales suggested that overall December retail sales were soft, but that holiday and overall consumer spending in the fourth quarter of 2010 were quite strong. As noted above, consumer spending in the fourth quarter of 2010 is on track to outpace business spending for the first time since early 2009.

Perhaps impacted by bad weather right before and right after Christmas, retail sales in December fell short of expectations. However, the strength in sales in November indicates that holiday shopping may have started earlier this year than last. Over the final two months of the year "holiday" sales posted a 7% gain over the final two months of 2009, the best performance since 1999. Overall, retail sales have now climbed all the way back to their pre-recession, mid-2007 peak. In addition, the growth rate of all major categories of retail sales accelerated between Q3 2010 and Q4 2010, suggesting much stronger consumer spending in the fourth quarter of 2010 than the third quarter growth rate of 3.2%. Finally, the level of core retail sales in December 2010 was higher than the fourth quarter 2010 average, imparting some upward momentum to spending as 2011 begins.



Source: Bureau of Labor Statistics/Haver 01/18/11
(Shaded areas in chart indicate recessions)

December consumer and producer prices were driven higher by energy and tobacco prices, but core inflation remains subdued. Both producer price and consumer price indices for December were pushed higher by surging gasoline prices, but behind the headlines on higher raw materials, energy, and grocery prices, inflation remains tame.

The overall consumer price index (CPI) rose 0.5% between November and December, pushed higher by gasoline (+8.5%) and tobacco (+0.8%) prices. The 0.5% month-over-month increase in the overall CPI was the strongest since June 2009, and may raise concerns about a spike higher in inflation. However, a quick look behind the headlines suggests a much more benign price environment, as consumer prices excluding food and energy (core CPI) rose just 0.1% month-over-month in December and were up just 0.8% from December 2009. At 0.8% year-over-year, core inflation remains well below the lower end of the Fed's unofficial comfort zone for core inflation of 1.5% to 2.0%. The benign December core CPI data provides the Fed with more support to continue QE2.

How can prices at the grocery store be rising so quickly (prices for meats, poultry, fish and eggs in December 2010 were 6% higher than December 2009, while prices for milk and dairy products were 4% higher) and overall inflation be so tame? Core inflation accounts for 78% of overall CPI, and includes, among other items, measures of housing prices and rents (42% of CPI), computers, cell phones, apparel and household furnishings including televisions, appliances and furniture.

Taken together computers, cell phones, apparel and household furnishings account for nearly 15% of the CPI, while items like groceries (8% of the CPI) and gasoline (4% of CPI) account for an ever-smaller (around 12%) portion of our spending. In general, prices of computers, cell phones, apparel, appliances, and furniture are falling, and that decline in prices helps to offset the big increases in food and gasoline prices over the past year. But since our purchase of groceries and our trips to the gas station to "fill 'er up" are more frequent than our trips to the appliance store or the furniture store or the clothing store, it sure does seem like inflation is rising faster than it actually is.

Initial claims for unemployment insurance spiked higher last week, but weather and holidays are the likely culprit, not a deteriorating labor market. More people filed for unemployment insurance in the week ending January 8, 2011 (445,000), an increase of 35,000 from the prior week. The consensus called for just 410,000 individuals to file. As we have noted in recent weeks, the weekly jobless claims data between mid-December and mid-January are always difficult to interpret. Severe winter weather makes the data even more suspect. While we cannot dismiss the latest reading entirely (there is a chance that the labor market deteriorated in late December and early January), we would like to see a few "clean" readings on claims before reaching that conclusion. Unfortunately, the latest round of foul weather in some parts of the country along with the Dr. Martin Luther King Jr. Day federal holiday will continue to distort the data in the coming weeks. As noted in our *2011 Outlook*, our view is that the job market will stage a comeback with nearly twice the pace of job creation experienced in 2010. Over the course of 2011, we expect the unemployment rate to fall gradually to around 8.5 to 9.0%, as the pace of hiring modestly outstrips the gain in the labor force.

The Fed's Beige Book, a qualitative assessment of economic activity in each of the 12 regional Federal Reserve districts (Boston, New York, Philadelphia, Atlanta, Dallas, etc.), found that the economy continued to expand between the December 14 FOMC meeting and early January 2011. Business and banking contacts reported better hiring, very good holiday sales, and some improvement in commercial real estate. Bank loan demand and lending activity was mixed, while residential real estate remained weak. On the price front, while there was more evidence of higher input prices impacting some businesses, there was little evidence that these were

being passed on to the end user. Wages, which account for 70% of business costs, continue to be quite subdued, suggesting that widespread consumer inflation is unlikely any time soon. The Beige Book was prepared ahead of the next FOMC meeting, which is set for January 26.

Chinese authorities released money supply and bank loan data for December last week. December money supply growth (one of the most reliable and least politically influenced economic data points in China) unexpectedly accelerated in December and while new loan growth decelerated between November and December, loans exceeded expectations. The economic data in China has been slowing (albeit from a very rapid pace of growth) since early- to mid-2010, and more deceleration is likely into 2011. Real GDP growth in China is expected to be near 9.5% year-over-year in the fourth quarter of 2010, and is expected to grow at that pace in 2011 as well. Real GDP growth began the year at 12.0%. We continue to expect more tightening of policy in China in the coming weeks and months as policymakers attempt to cool inflation.

IMPORTANT DISCLOSURES

This research material has been prepared by LPL Financial.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

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

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Philadelphia Fed Survey is a business outlook survey used to construct an index that tracks manufacturing conditions in the Philadelphia Federal Reserve district. The Philadelphia Fed survey is an indicator of trends in the manufacturing sector, and is correlated with the Institute for Supply Management (ISM) manufacturing index, as well as the industrial production index.

Empire State Manufacturing Survey is a monthly survey of manufacturers in New York State conducted by the Federal Reserve Bank of New York.

Quantitative Easing (QE) 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.

Tracking #698397

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•The microeconomics depicted in earnings reports this week are improving as companies report higher profits and stronger balance sheets. However, the durability of the gain in the market is dependent, in part, on how the macroeconomic risks are developing.

•The top five risks investors are focused on for 2011 are: European debt problems, municipal budget woes, inflation concerns, weak bank lending, and Federal Reserve rate hikes.

•Overall, the key risks of 2011 have been receding lately, helping to boost the markets. However, the evolution of these risks is unlikely to be in a straight line. We will continue to monitor these risk measures closely in 2011 for the opportunities they may provide to profit or help protect portfolios.

Measuring the Risks

While the stocks of the large companies tracked by the major U.S. stock market indexes have extended their gains to make new two-year highs, mid- and small-cap stocks have fared even better. In fact, mid-cap stocks, measured by the S&P 400 Mid-Cap index, hit a new all-time high on Friday, January 14, 2010.

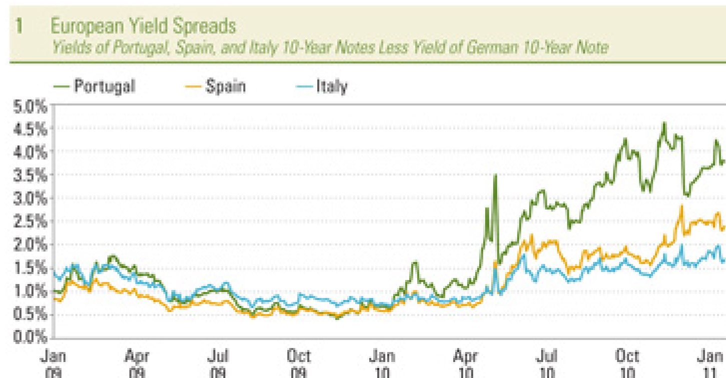
The S&P 500 has been less worried about risks over the past several months as the economy rebounded in the fourth quarter of 2010 from weakness over the summer months. In addition, the microeconomics depicted in earnings reports this week are improving as companies report higher profits and stronger balance sheets. However, the durability of the gain in the market is dependent, in part, on how the macroeconomic risks are developing. We believe the top five risks investors are focused on for 2011 are:

- European Debt Problems
- Municipal Budget Woes
- Inflation Concerns
- Weak Bank Lending
- Federal Reserve (Fed) Rate Hikes

We will take a look at key measures of each of these risks to the markets and an update on their developing status.

European Debt Problems

While business conditions have been improving for Europe's largest economy, Germany, the peripheral economies have been showing financial strains. Measuring the yields of the debt of troubled European countries relative to those of Germany provides a gauge of whether the debt problems for those countries are improving or worsening.



Source: LPL Financial, Bloomberg data 01/14/11

The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market Bass-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

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The stabilization in European credit spreads in recent months has helped lift stocks, commodities, and other markets. However, these spreads remain high and bear watching closely.

Municipal Budget Woes

The states' budget woes have raised concerns in the municipal bond market, but have broader impacts to other markets as well. The cutbacks and/or tax hikes also affect state economies and growth to a degree that can be felt nationally. To some degree, cuts in spending and tax hikes at the state level are neutralizing Federal stimulus and tax cuts. Watching the growth of state tax receipts provided by the U.S. Census Bureau is important to measuring the pace of improvement or deterioration in state finances and whether additional spending cuts or tax hikes will be necessary.

Fortunately, the economic rebound has led to a rise in tax receipts over the past year, narrowing the gap with spending.

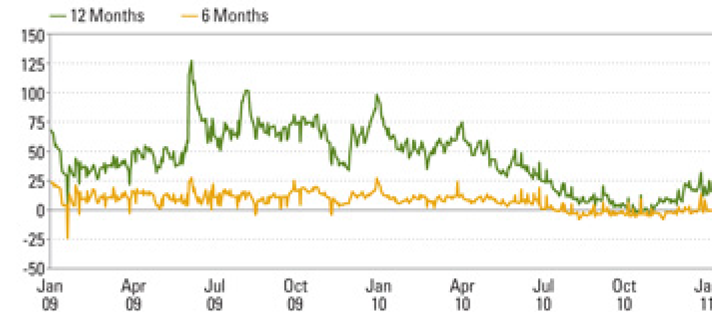
Inflation Concerns

Investors and central bankers alike worry about too little and too much inflation. Too little inflation, called deflation, can be bad for markets since falling prices and wages can cause consumers to defer purchases resulting in a weaker economy. A lot of inflation is bad for the markets as it erodes purchasing power and raises borrowing costs. A little inflation is the most favorable for the markets. While inflation is very low now, markets react to the evolving outlook for inflation.

Current inflation expectations have returned to be in line with pre-crisis history and suggest deflation concerns have lifted for the markets. While inflation expectations have recently stabilized at about 2.7%, a further rise could ignite concern. Inflation expectations rose to 3.5% in 2004 prompting the Fed to start to hike rates in the summer of that year to cool the economy and avoid the negative consequences of much higher inflation.

Fed Rate Hikes

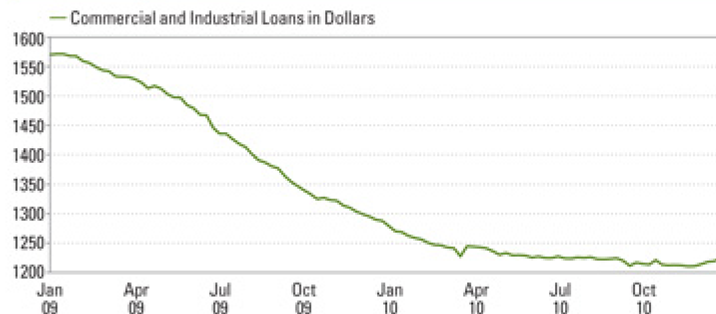
The Fed has been very aggressive in fighting economic weakness by cutting the federal funds rate effectively to zero and by providing additional stimulus through trillions of dollars in bond purchases. Looking at the forward federal funds rate tells us when market participants believe the Fed may begin to rein in stimulus. Stocks typically perform poorly around the first in a series of rate hikes, so it is worth monitoring when a Fed rate hike is expected to take place. A component of the LPL Financial Current Conditions Index (CCI) is the difference between the implied yield of the six-month forward federal funds contract and where the federal funds rate stands today. This measures the changes in the federal funds rate priced in over the next six months - a time frame likely to affect the markets. Monitoring the outlook over the next 12 months can provide insight as to what is on the horizon that may soon affect the markets.



Over the next six months there is little expected Fed tightening. However, the outlook for a rate hike in the next 12 months has picked up slightly in recent weeks.

Weak Bank Lending

Bank loans are often used to finance inventory or buy new equipment. Business loan growth tells us whether the economic stimulus is beginning to take root as businesses demand more funding for growth and banks are more willing to make loans, or not. We consider them so timely and important these C&I (Commercial and Industrial) loans are a component of the CCI.



Business loans have shown some acceleration beginning in December. Whether that was merely holiday sales driven inventory stocking or a longer-term commitment to growth remains to be seen.

Overall, the key risks of 2011 have been receding lately helping to boost the markets. However, the evolution of these risks is unlikely to be in a straight line. We will continue to monitor these risk measures closely in 2011 for the opportunities they may provide to profit or help protect portfolios.

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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. It is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index - while providing a real rate of return guaranteed by the U.S. Government.

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

The S&P Midcap 400 Index serves as a barometer for the U.S. mid-cap equities sector and is the most widely followed mid-cap index in existence. To be included in the index, a stock must have a total market capitalization that ranges from roughly $750 million to $3 billion dollars. Stocks in this index represent household names from all major industries including energy, technology, healthcare, financial and manufacturing.

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