

# Weekly Economic Commentary



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## Communication Breakdown?

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#### Highlights

- A busy week of economic data and events this week as the Federal Reserve discusses its communication policies.
- A closer look at the housing market reveals another difficult year ahead for housing.

#### Economic Calendar

<b>Monday, December 12</b> Treasury Statement <i>Nov</i>	<b>Thursday, December 15</b> PPI <i>Nov</i>
<b>Tuesday, December 13</b> Retail Sales <i>Nov</i>	NY Fed Empire State Mfg <i>Dec</i>
Business Inventories <i>Oct</i>	Initial Claims <i>wk 12/10</i>
JOLTS Data <i>Oct</i>	Current Account Balance <i>Q3</i>
Small Business Optimism Index <i>Nov</i>	Capacity Utilization <i>Nov</i>
FOMC Decision	Industrial Production <i>Nov</i>
<b>Wednesday, December 14</b> MBA Mortgage Applications <i>wk 12/09</i>	Philadelphia Fed Index <i>Dec</i>
Import Price Index <i>Nov</i>	<b>Friday, December 16</b> CPI <i>Nov</i>

Financial markets will absorb nearly a month's worth of data and events in the next two weeks ahead of the year-end holiday season that typically slows financial market activity (and the government's economic data mills) to a crawl. This week (December 12–16), events in the United States will retake center stage after Europe dominated last week. In the United States this week, there is a full slate of economic data, ongoing debate over payroll tax cuts and extension of unemployment benefits, as well as the Federal Reserve's (Fed) eighth and final Federal Open Market Committee (FOMC) meeting of 2011. Overseas, the Chinese economic data for November will dominate early in the week. Later in the week, Europe is likely to garner most of the market's attention as a meeting of central bankers in Rome and a speech by German Chancellor Merkel on the outcome of last week's (December 4–9) European summit to the German parliament take center stage.

As previously discussed in the *2012 Outlook*, we note that the ongoing stagnation in the housing market has played a key role in driving consumer sentiment to 30-year lows, but also that the Fed's actions to stimulate the overall economy and the housing market in particular may help to further stabilize the sector. We will take a more in-depth look at housing this week.

### The Fed is in the Process of Questioning its Communication Policies, But We Do Not Expect An Answer Until Late January

The Fed's last policy meeting of the year is likely to garner most of the market's attention this week, even as investors digest a full serving of economic data for November and December and use those reports to firm up their growth estimates for the fourth quarter of 2011 and beyond.

With the Fed's policy rate (the federal funds rate: a measure of what banks charge each other to borrow and lend overnight) pinned near zero, the Fed promised in August 2011 to keep rates low until at least the middle of 2013. In September 2011, the Fed embarked on "Operation Twist", aimed at keeping longer-term Treasury yields low in order to encourage more borrowing by households, homebuyers, and businesses. Operation Twist is set to end in mid-2012. Between now and then, Fed policymakers must grapple with the European financial crisis and its impact on the global and U.S. economies. As the Fed continues to monitor its view of the economy—which is more optimistic than our view, the consensus view,



the market's view and the financial media's view—one of the tools it can employ is its communications policy.

The Fed communicates to the public and financial markets in many ways, including numerous public appearances by Federal Reserve officials, a monetary report to Congress twice a year, and, more recently, a press conference by the Fed Chairman four times a year. Perhaps the most visible way the Fed communicates is the statement that accompanies the FOMC meeting. The statement released after this week's meeting is likely to acknowledge that while the economy and labor market have improved since the last FOMC meeting (November 1–2), the economy remains vulnerable to downside risks, including ongoing strains in the global financial markets (i.e., Europe). This week's FOMC statement may also push out the "extended period", by extending the promise to keep rates at "exceptionally low levels" from mid-2013 to the end of 2013, as the economy has failed to live up to the Fed's forecast since it first made this promise in August 2011. The Fed is also likely to reiterate its promise to "continue to assess the economic outlook in light of incoming information and is prepared to employ its tools to promote a stronger economic recovery in a context of price stability."

While the economic hurdle of implementing QE3 may be low, the political hurdles both within and outside the Fed remain high, which leaves only the Fed's communication policies as a viable alternative in the near term.

Given that this week's FOMC meeting is just a one-day meeting—four of the Fed's eight meetings a year are two-day affairs at which policymakers craft a new economic forecast—the Fed is unlikely to employ any of its new "tools" at this week's meeting. In our view, those tools would include enhancing the way the Fed communicates with the public, and, if warranted, yet another round of fixed income security purchases in the open market, also known as quantitative easing, round three (QE3). While the economic hurdle of implementing QE3 may be low, the political hurdles both within and outside the Fed remain high, which leaves only the Fed's communication policies as a viable alternative in the near term.

However, we do expect the communications issue to be a key topic of discussion—the minutes of this week's FOMC meeting will be released in early January 2012—and we expect some action to be taken on the communications front at the two-day FOMC meeting in late January 2012.

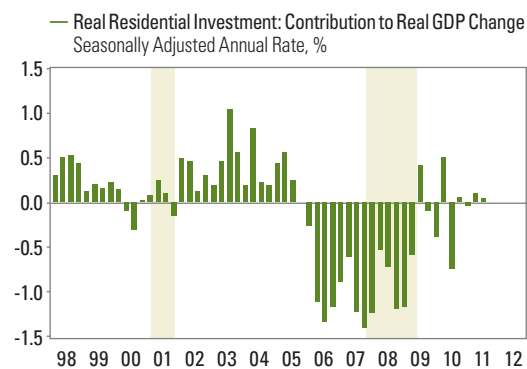
While more timely communication from the Fed is one possibility, the minutes of recent FOMC meetings suggest that Fed policymakers are leaning toward providing more clarity on their views of inflation, economic growth, its balance sheet (Operation Twist, QE3, etc.) and even interest rates. Some members of the FOMC have even hinted that having the Fed target a level of gross domestic product (GDP) or inflation may be appropriate ways to communicate with the public and financial markets (and its bosses in Congress, too!). Because this week's meeting is just a one-day meeting, we do not expect any answers from the Fed. However, we do expect the communications issue to be a key topic of discussion—the minutes of this week's FOMC meeting will be released in early January 2012—and we expect some action to be taken on the communications front at the two-day FOMC meeting in late January 2012.

### **Housing Likely to Heal Further in 2012, But Still a Long Way to Go**

Paradoxically, the most important point to make when discussing the national housing market is that, by nature, the housing market is local. Supply and demand for new and existing homes, the local rental markets,



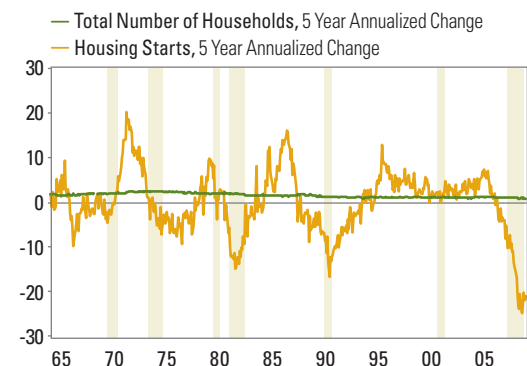
## 1 Housing Has Made Only A Modest Contribution to GDP Over the Past Three Years



Source: Bureau of Economic Analysis, Haver Analytics 12/12/11

(Shaded areas indicate recession)

## 2 The Gap Between Household Formation and New Housing Construction Has Never Been Wider



Source: Census Bureau, Haver Analytics 12/12/11

(Shaded areas indicate recession)

local lending practices, local building codes, employment conditions and even weather or other exogenous factors all have a huge influence on the housing market in a given city or town. And even within a particular locality, real estate conditions can and do vary widely among single family and multifamily, rural, suburban or in-town, new and existing, etc.

However, when we discuss housing, we need to take much the same approach as the Fed and other national policymakers do, and discuss the housing market on a national basis. Generally speaking, the major national indicators of the housing market (new and existing home sales and prices, housing construction, housing starts and permits) all bottomed out in early 2009 and have been on a very modest upward track in the three years since. Looking ahead to 2012, we expect to see a continuation of the modest upward trend in housing activity that has been in place since early 2009, albeit with some bumps along the way.

From a GDP perspective, housing was a drag on overall GDP growth for 14 quarters between the first quarter of 2006 and the second quarter of 2009. In the nine quarters since then, housing has added to GDP growth more times (five quarters) than it has detracted from growth (four quarters). Since early 2009, the housing market has been buffeted by oversupply in the existing home market, rising foreclosures and defaults, a weak labor market and still difficult lending environment on the one hand, while supported by all-time high housing affordability, near record low mortgage rates, very little new supply and the lowest inventory of unsold new homes on record on the other hand.

In the three years since early 2009, several of the factors that had weighed on the sector (tight lending standards, weak labor markets) in the early part of the period (2009 through mid-2010) have improved somewhat, as the labor market found a tenuous footing in mid-2010, and banks' lending standards for residential real estate eased a bit. The biggest factors continuing to constrain housing as we enter 2012 are the huge supply of unsold existing homes, and tougher lending requirements. The supply of unsold existing homes-and the potential for more given the still high level of homes in the foreclosure pipeline-remains the biggest impediment to a rapid improvement in the housing market. At the end of October 2011 (the latest data available) there were still nearly three million existing homes for sale. Although there is not one official estimate of the number of existing homes in the so called "shadow inventory" (bank owned, in default, in the process of default, etc.) the most credible estimates center around two and a half to three million homes. This overhang of inventory (which has been moving in the right direction, i.e. lower, for several years) remains the key to housing's full recovery, including a sustained upturn in housing prices nationwide.

While the bad news is still likely to outweigh the good for the housing market in 2012- leading to at best stable home prices and modest growth in housing construction and sales- there is still some good news. Both the Fed (Operation Twist) and the federal government continue to work to stimulate the housing market. In addition, should the Fed decide to embark on another round of quantitative easing in 2012, it is likely to target the mortgage backed securities (MBS) market, which in turn, would further



lower mortgage rates for qualified buyers. Finally, as noted above, supply of unsold new homes is at an all-time low, as in recent years, there has been little economic incentive for homebuilders to build any new homes given the glut of existing homes on the market.

But, while household formation has increased at around one percent per year since the peak of the housing bubble in 2005, the construction of new housing has contracted at an astonishing rate. The gap between the growth of household formation and new construction has never been wider. As the supply of existing homes is taken up—some of the supply is likely to be scrapped or is in areas that are not as economically desirable as they once were—builders could begin to build new homes again where it makes economic sense. Indeed, housing starts have moved up from a record low of 478,000 units in early 2009 to nearly 650,000 in late 2011. While we are unlikely to see the peak (nearly 2.4 million homes were started in at the peak in early 2006), housing activity is likely to make a modest contribution to growth in 2012.

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#### IMPORTANT DISCLOSURES

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Quantitative Easing 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.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

Stock investing involves risk including loss of principal.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

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

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

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