

Weekly Economic Commentary



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Leading The Way

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Highlights

- Europe, a full slate of economic data, the super committee's failure and the run-up to Black Friday will drive markets this week.
- The index of leading economic indicators suggests that the chance of recession in the next 12 months is low.

Economic Calendar

Monday, November 21	Durable Goods Orders and Shipments
Existing Home Sales	Oct
Tuesday, November 22	Initial Claims
Richmond Fed Index	wk 11/19
Nov	Personal Spending
FOMC Minutes	Oct
Real GDP	Personal Income
Q3	Oct
Wednesday, November 23	U of M Consumer Sentiment
MBA Mortgage Applications	Nov
wk 11/18	

Concerns over the eurozone are likely to continue to dominate the investing landscape this week, but the super committee's failure (please see this week's *Weekly Market Commentary* for details), a full slate of economic data, the minutes of the November 1–2 Federal Open Market Committee (FOMC) meeting, along with the build up to "Black Friday", the unofficial start of the holiday shopping season, will also compete for the market's attention.

The data in the United States this week include manufacturing (durable goods orders, Richmond Fed, Kansas City Fed, and Dallas Fed), existing home sales, personal income and spending, and the regular weekly readings on initial jobless claims and retail sales. The market continues to ignore the relatively solid run of economic data seen over the past several months, focusing instead on the fiscal crisis in Europe. Nevertheless, the economic data helped to drive earnings prospects in the United States, and earnings are the ultimate drivers of stock prices. The economic and corporate data may not matter today, but once it does start to matter again, some market participants may be surprised by how well the U.S. economy is performing in the fourth quarter.

Orders for core durable goods (business capital equipment expected to last more than one year, excluding defense and aircraft), are expected to post a month-over-month decline in October—as is often the case as the most orders tend to be placed at the end of the quarter, pulling forward demand from the first month of the following quarter. The expected decline in October would mark the fourteenth consecutive time that core orders posted a month-over-month decline in the first month of the quarter (i.e. January, April, July and October). The durable goods data—along with virtually all of the other data we monitor—is seasonally adjusted, and should help to smooth out these anomalies, but this one persists. We will focus on the other aspects of the report (shipments, backlog of new orders, etc.), and we and the markets will discount a mild decline in core orders in October and place more weight on the regional Fed surveys (Kansas City, Dallas and Richmond) of manufacturing for November due out this week.

The release of the minutes from the November 1–2 FOMC meeting this week is likely to reignite talk about the internal discord at the Fed, the Fed's next policy move, and the Fed's latest forecast for the economy. We will continue to watch the "center of gravity"—Chairman Bernanke, Vice-Chair Yellen and New York Fed President Dudley—for any shift in tone at the Fed, and continue to expect the Fed to pursue historically accommodative

monetary policy in the period ahead. Even if the economy tracks to the market's expectations (roughly 2.0% real gross domestic product growth in 2012 and 2.5% in 2013), the Fed is likely to ease even more in 2012 (via additional purchases of Treasury securities or mortgage-backed securities in the open market), as the Fed's forecasts for economic growth and the unemployment rate remain more optimistic than the market's.

Expectations for the holiday shopping period are low. The National Retail Federation is expecting just a 2.8% gain in holiday sales in 2011 versus 2010, while the International Council of Shopping Centers is projecting a gain in holiday sales of between 2.2% and 3.5% from a year ago. ShopperTrak, a group that tracks the number of shoppers at malls, is looking for a 3.0% year-over-year gain in holiday sales, despite a 2.2% drop in foot traffic at the malls this holiday season versus a year ago.

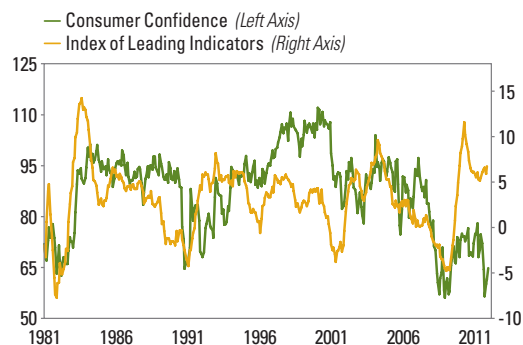
Looking at the relationship between equity market performance and holiday shopping trends over the past 20 years suggests that equity prices drive shopping, not the other way around. Despite the 6% drop in U.S. equity prices over the past week or so, the equity market's performance since mid-September suggests that holiday sales will increase by between 4.5% and 6.0% from a year ago. Thus, the market has a slightly better outlook for the holiday shopping season than the pundits do, although this does set the bar a bit higher should sales disappoint.

Index of Leading Economic Indicators Place Low Odds on Recession in the Next 12 Months

The index of leading economic indicators (LEI) rose a larger-than-expected 0.9% month-over-month in October, the largest month-over-month increase since February 2011. The October LEI was released on Friday, November 18. The 0.9% month-over-month gain was the sixth consecutive increase, and the twenty-ninth gain in the past 31 months dating back to early 2009. The consensus of economists surveyed by Bloomberg News expected just a 0.6% month-over-month increase in the LEI in October. The gain in October was broad-based as nine of the ten components of the LEI increased in the month. Only vendor deliveries—a measure of the backlog of businesses new orders—were a detractor from the index in October. Because virtually all of the ten components of the LEI are known to the market prior to the release of the report, the LEI is rarely market moving, even when it surprises like it did in October.

The LEI is designed to predict the future path of the economy, with a lead time of between 6 and 12 months. The 0.9% month-over-month increase in the LEI in October pushed the year-over-year gain in the LEI to 6.6%. Over the past 50 years (1962 to today), the year-over-year increase in the LEI has been at least 6.6% in 93 months. Not surprisingly, the U.S. economy was not in a recession in any of those 93 months. Thus, it is highly unlikely that the economy was in recession in October, despite the ongoing fiscal and political turmoil in Europe, the fiscal uncertainty here in the United States and the slowdown in economic growth in China.

1 Leading Economic Indicators Point To Decent Economic Growth, While Consumer Sentiment Points to Recession



Source: LPL Financial, Bloomberg data 09/14/11

The index of leading economic indicators (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.



Aside from that unusual episode, the current strong year-over-year reading on the LEI suggests virtually no chance of recession in the next 12 months.

But the LEI is designed to tell market participants what is likely to happen to the U.S. economy, not what has already happened. Three months after each of the 93 months that the LEI was up 6.6% or more, the economy was never in recession. The same is true six months after the LEI is up by 6.6% or more on a year-over-year basis. Looking out 12 months after the LEI is up 6.6% or more, the economy was in recession in just six of the 93 months, or 6% of the time. For the record, those six months all occurred in 1972 and 1973, when the LEI was up strongly in late 1972 and early 1973. The Arab oil embargo—and an overnight tripling of consumer energy prices—in October '73 triggered a recession. Aside from that unusual episode, the current strong year-over-year reading on the LEI suggests virtually no chance of recession in the next 12 months.

However, the LEI says the risk of recession in the next 12 month is negligible (6%), but not zero. We would agree. But, the financial markets—along with the historically low level of consumer sentiment—are telling us that the risk of recession is much higher than 6%. Our view remains that the U.S. economy is likely to grow between 2.5% and 3.0% in the fourth quarter of 2011 and post growth of around 2.0% in 2012. A dramatic deterioration of the fiscal and financial situation in Europe, a policy mistake here in the United States or abroad, or an exogenous event (terror attack, natural disaster, etc.), among other events, may cause us to change our view. Market participants continue to assess what impact a potential recession in Europe and slowdown in emerging markets will have on the U.S. economy, and when that impact is likely to be felt.

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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