



Weekly Economic Commentary

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ECONOMIC CALENDAR

Tuesday, Oct 7

Consumer Credit
August

Thursday, Oct 9

Initial Claims
wk 10/04

Chain Store Sales
September

Wholesale Inventories
August

Friday, Oct 10

Trade Balance
August

Import Price Index
September

Treasury Statement
September

Executive Summary:

Crisis Spreads from Wall Street to Main Street

After teetering on the edge of recession since the middle of the year, the U.S. economy has now slipped into recession, pushed over the brink by the severe credit crunch that has gripped the entire economy since the beginning of September. The credit crunch—which first manifested itself in late 2007—has now spread from Wall Street to Main Street, as first banks, and more recently, businesses of all kinds, continue to hoard cash, fearing yet another bank collapse or bank run. It was this jump from the financial centers to the rest of the economy over the past three weeks that likely pushed the economic slowdown into a recession.

Through the first few waves of the credit crunch—summer/fall 2007, yearend 2007, mid-March 2008, and mid-July 2008, the broad U.S. economy, aka Main Street, was largely unaffected by the temporarily disruptions in the overnight lending markets between banks. The economy grew, albeit modestly, in the first half of the year, and job losses were minimal, despite record high oil and gasoline prices, and food price inflation such as has not been seen in 20 years. Bank lending was growing, especially at smaller and mid-sized banks not impacted by the subprime mess, and while there were stresses on the economy, our view was that the broad based and well diversified U.S. economy could avert a recession, aided by strong exports, solid but not spectacular consumer spending, and a steady increase in business capital spending.

However, since the bankruptcy of Lehman Brothers over the weekend of September 13-14, the credit market crisis, which had previously manifested itself as sporadic seize-ups in lending between large global banks, began to directly impact Main Street. The list of impacts is long, but here are a few examples:

- Small businesses looking to borrow to make payrolls or add to inventory or buy new machinery were unable to borrow, or were forced to pay sharply higher interest rates.
- Municipalities of all sizes, looking to refinance debt to pay their employees, or to get funding to pave roads or build new schools and roads, were unable to borrow or forced to pay higher rates.
- Average consumers looking to buy a car, or refinance a personal or home loan were unable to do so, or were forced to pay sharply higher rates.



- College students, looking to borrow from government run entities to pay their fall 2008 tuition bills, saw funding cut off completely.

In short, the credit crunch began to impact business and consumer behavior. The initial failure of the U.S. House of Representatives to pass the Troubled Asset Relief Program (TARP) bill on Monday, September 29, only intensified the crisis, and although both the House and Senate have now passed the TARP, and President Bush has signed the bill into law, the short-term damage to the economy is real and palpable, and will take time to heal. The TARP will help—absent the TARP, the U.S. economy might have faced a deep and prolonged recession—but it will take months, not weeks, until the credit markets return to normal. Even if the TARP is successful in lifting the “toxic assets” off of banks’ balance sheets—which in turn, should allow the resumption of a more normal flow of credit between banks and between the financial sector and Main Street—the U.S. and global banking system is likely to remain under stress.

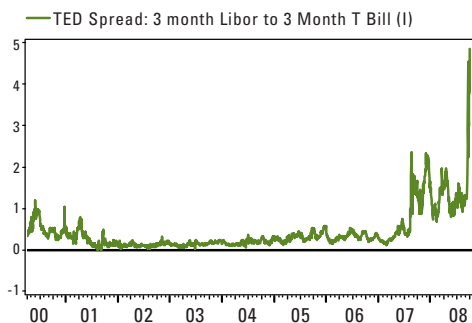
Until credit begins flowing freely from the banking sector to Main Street, economic activity is likely to be sluggish, with near zero growth in Q3 2008 and negative GDP growth in the current quarter (Q4 2008), and with sluggish growth extending into 2009. At this point, we certainly don’t foresee a deep and prolonged recession like we saw in 1973–75 and again in 1980–82, largely because the imbalances and high inflation that preceded those prior periods are not in place today. Still, we expect the unemployment rate to rise from current levels (the unemployment rate stood at 6.1% in September 2008), and we are likely to see further erosion in consumer spending and business capital spending over the remainder of 2008 and into the first half of 2009. Housing will remain stagnant as well, pending the success of the TARP in unclogging banks’ balance sheets. The net export sector—which has almost singlehandedly kept the U.S. economy out of recession over the past year or so—will continue to be a plus for real GDP growth, but slowing economic growth overseas will dampen our export performance.

As a result of the recession, inflation is likely to slow, with headline inflation slowing dramatically as oil prices continue to fall. This deceleration in inflation should provide the Fed cover for the Federal Reserve’s Open Market Committee (FOMC) to cut rates if conditions warrant. The Fed has already embarked on a “stealth ease,” holding the Federal Funds Rate below its target of 2.0% by injecting massive amounts of short term liquidity into the system. The Fed could choose to make the rate cut official by lowering its Fed Funds target to 1.50% or even lower, if the TARP isn’t effective.

Week in Review:

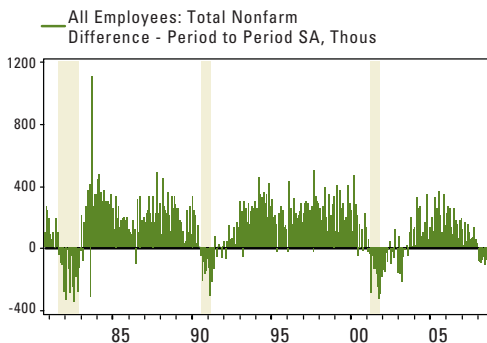
In last week’s Weekly Economic Commentary, we observed that the incoming economic data was dreadful, at best, while the fate of the TARP was looming over the market. Last week’s batch of data, although no better, was not so uniformly weak. With the TARP now passed into law, financial markets are now likely to turn their attention to the weekly flow of economic data, which has been largely ignored over the first nine months of 2008.

1 Credit Crunch Intensified Dramatically Over the Past Three Weeks and has Spread from Wall Street to Main Street



Source: Haver Analytics 10/03/08

2 Job Losses are Likely to Intensify Over the Next Several Months



Source: Bureau of Labor Statistics / Haver Analytics 10/03/08



Here's a quick summary of last week's economic data:

- Personal spending—two thirds of GDP—was unchanged between July and August, and adjusted for inflation, real spending in the first two months of Q3 2008 was running 2.3% below its Q2 2008 level. Thus, even before the September data point comes in, it's clear that consumer spending is likely to be a big drag on GDP in Q3.
- Total light vehicle sales fell to a 12.5 million annualized pace in September, the slowest sales pace in more than sixteen years. Unless credit markets unfreeze in a hurry, the sales pace in October is likely to be even worse.
- The economy shed 159,000 jobs in September, worse than the consensus expectation of a 105,000 drop, but far better than the "whisper number" that pegged the job loss at over 200,000. Despite a strike at a major aircraft manufacturer and the impact of Hurricane Ike on the Gulf Coast of the U.S., the September job report was a "clean number." The job losses over the next few months are likely to intensify, and the unemployment rate, now at 6.1%, is likely to continue to move up.

As we pointed out last week, almost all of this bad news on the economy preceded the credit market turbulence of the past two to three weeks, **which suggests to us that the rest of the economic data for September and October will almost certainly look worse than the data we have seen to date.**

The Week Ahead:

As is typically the case the week after the release of the monthly payroll employment report, there is not a lot of economic data on the docket this week. We will get the weekly report on jobless claims, which provides a "real time" look into the health (or lack thereof) of the labor market, as well as the merchandise trade balance for August, which should confirm that the nation's export sector remained a source of strength in an otherwise stagnant economy. The market will also digest the chain store same store sales data for September, which will provide further insight into the health of the consumer as the credit crunch moved from Wall Street to Main Street in September.

Now that the TARP has been signed into law, the question of its effectiveness in relieving the credit crunch will move into the foreground. If the Treasury is successful in breaking the credit logjam—we think they will be—and can free up the frozen credit markets, the real economy should begin feeling the effects almost immediately via:

- Lower interest rates
- Tightening credit spreads
- More lending by banks and financial institutions
- Increased consumer and business confidence



If we do not see that the TARP is achieving these goals, we will become even more concerned about the health of the economy, and will have to ratchet down our forecast of economic growth over the second half of 2008 and into early 2009.

As always, we will continue to monitor the “real time” data points, weekly retail sales, weekly jobless claims, credit spreads, mortgage rates, mortgage applications, gasoline prices and company specific news, and use all of that information to guide us until more long-term summary data is available.

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