



Weekly Economic Commentary

December 15, 2008



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ECONOMIC CALENDAR

Monday, Dec 15

NY Fed Empire State Mfg
December

Capacity Utilization
November

Industrial Production
November

NAHB Housing Survey
December

Tuesday, Dec 16

Housing Starts
November

Core CPI
November

CPI
November

FOMC Decision

Wednesday, Dec 17

Current Account
Q3

Thursday, Dec 18

Initial Claims
wk 12/13

Philly Fed Index
December

Leading Indicators
November

Executive Summary:

Economy Continues to the Downside in Q4, Any Glimmers of Hope?

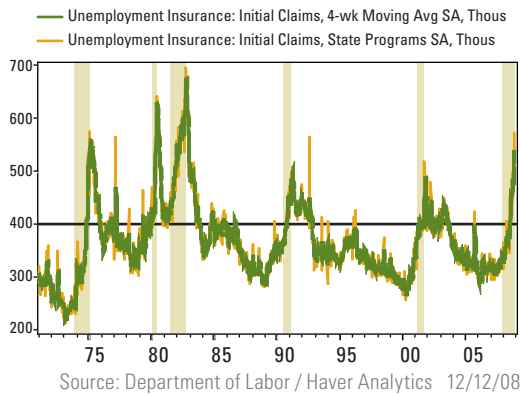
With a sizeable portion of the November economic data now in hand, we can say with confidence that the economy didn't stop getting worse in November, and in fact, last week's data continued to suggest that economic conditions in the U.S. (and globally) deteriorated sharply between October and November. Looking ahead to the December data on the U.S. economy (largely due out over the month of January), the anecdotal evidence, as well as the early December readings on weekly jobless claims, suggests that the economy continued to decelerate to the downside in December. The big jolts this past week came with the release of the October trade data, which implied that the massive slowdown in global economic growth stopped U.S. exports in their tracks in October, and the weekly jobless claims data for the week ending December 6, which revealed a dramatic deterioration in the labor market in early December, even after the economy experienced the worst monthly job loss since 1974 in November. This week, markets are bracing for key policy announcements from the Federal Reserve and the Organization of Petroleum Exporting Countries (OPEC), as well as data on housing, consumer inflation, manufacturing, and jobless claims.

On balance, last week's economic data, and in particular the October trade data and the weekly jobless claims data, suggest that we are still being a bit too optimistic about real GDP in the current (fourth quarter) of 2008. Previously, we had expected real GDP to contract at an annualized pace of at least 4.0% in Q4 2008, but after seeing last week's data, we now expect GDP to contract by at least 5.0%—and possibly more—in Q4. If realized, a drop in real GDP of 5.0% or more would be the weakest reading on GDP since the 1981–82 recession. The Q4 GDP data are due out in late January. The current consensus forecast for real GDP in Q4 is for a 4.3% decline.

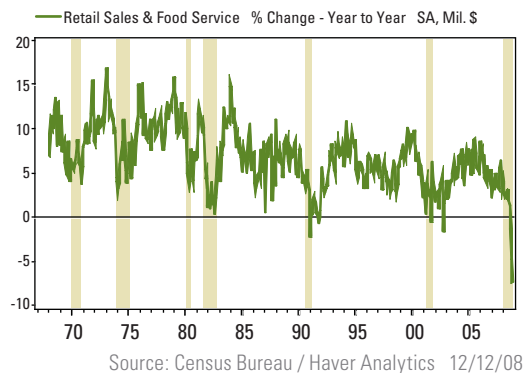
The steady drumbeat of dire economic data, along with the unfolding drama over the fate of the U.S. automakers, continues to foster more volatility in financial markets as we head into the New Year. We expect both the bad news on the economy and the concomitant volatility in the financial markets to persist into 2009. However, as we noted last week, the good news is that most market participants seem to be warming up to the view—which we espouse—that the U.S. economy is not headed for a 1930s-style Great Depression. The S&P 500 last week rose 0.4%—the second gain in the past three weeks—all but shrugging off the horrible news on the economy, and the lack of a bailout deal for the automakers.



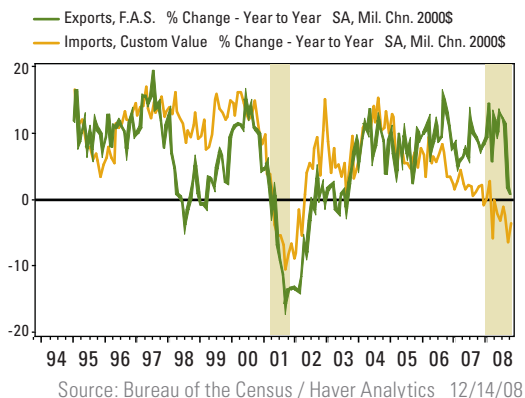
1 Record Jobless Claims Spike Week Ending December 6, Suggests Labor Market Deteriorated in Early December



2 Consumer Spending has Collapsed in the Face of the Credit Crunch and Unsteady Labor Market



3 U.S. Export Growth has Decelerated Sharply Since Global Financial Crisis Began in Earnest in Mid September



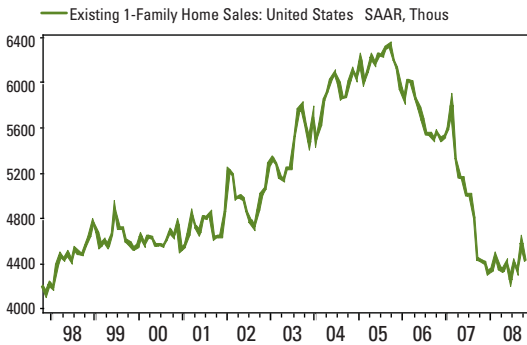
While we don't know for sure, and may never know, our sense is that financial markets may be beginning the process of looking past the horrible fourth quarter data, and focusing on what may lie ahead for the economy beyond the fourth quarter of 2008 and early 2009. Indeed, although it was buried deep beneath the horrible headlines, there were some faint glimmers of hope in the economic data released last week (details follow). That glimmer, along with the huge drop in consumer energy prices since the summer (roughly the equivalent of a \$250 billion tax cut) and the impact of the unprecedented amount of fiscal and monetary policy stimulus already in place (and in the pipeline) suggests to us that the U.S. economy can begin to regain its footing by the middle of 2009.

Looking quickly at last week's economic data, the following reports, on the labor market, retail sales, and exports, fit solidly into the "continuing to decelerate to the downside" category:

- Initial claims for unemployment insurance**, which rose by a record 58,000 in the week ending December 6 to a 26-year high of 573,000, suggest that the U.S. labor market deteriorated sharply in the first week of December. At 573,000, claims are at their highest level since the tail end of the severe 1981–82 recession, and are very likely to move higher (and significantly so) if the economy doesn't stabilize soon. The one mitigating factor in this data for the week ending December 6 is that the reading was artificially elevated by efforts to seasonally adjust the data due to the Thanksgiving holiday, which fell "late" (November 27) in the month this year versus an "early" Thanksgiving (November 24) in 2007. Nonetheless, the four-week average on claims, which smoothes out the volatile week-to-week changes, stands at 540,500 jobless claims, up 14,250 from the prior week, and at its highest reading since December 1982, just after the end of the severe 1981-82 recession.
- Retail sales** in November plunged 1.8%, and while slightly better than the expected -2.0% reading, the report nevertheless painted a grim picture of consumer spending for the fourth quarter of 2008. As noted in the chart, retail sales in November 2008 were down a whopping 7.4% versus November 2007, which represents the steepest decline on record (dating back to the late 1960s). A 28.8% plunge in auto sales from a year ago, as well as a 22% drop in gasoline sales versus a year ago are largely to blame for the big year-over-year drop in November. The glimmer of hope in this report is that excluding gasoline and service stations, retail sales actually rose 0.3% in November versus October. However, sales on that basis are still down 2.2% from a year ago, suggesting that real consumer spending (two-thirds of GDP) is likely to contract by roughly 5.0% in Q4. If realized, that 5.0% decline would be the worst since the 8.6% drop in consumer spending in Q2 1980. The freeze-up in credit markets, a rapid deterioration in the labor market, and ongoing deleveraging in the consumer sector all help to explain the collapse in consumer spending in the quarter. The consumer must at least stabilize before the overall economy can start to recover.
- The October merchandise trade report** revealed a sharp drop in U.S. exports in October, as the heretofore buoyant U.S. export sector hit a brick wall in the wake of the global economic slowdown that began in



4 Relative Stability in Pending Home Sales Since March Consistent with Stability in Existing Home Sales over Past Year



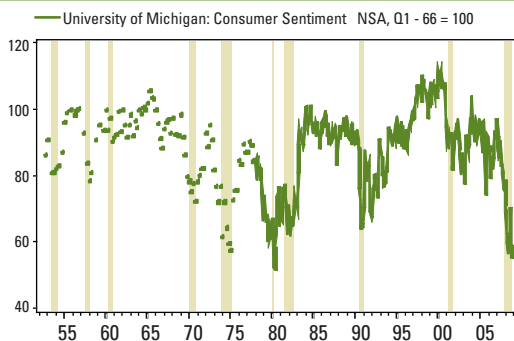
Source: National Association of Realtors / Haver Analytics 12/14/08

earnest in mid September. The U.S. trade sector has been a big plus for U.S. economic growth over the last two years, more than offsetting the weakness in housing. Now, with global economies reeling, U.S. export growth stopped on a dime in September and October, kicking the last remaining pillar of strength out from under the U.S. economy. While it is hard to find any glimmer of hope in the October trade data, one could point to another large drop (\$610 million) in civilian aircraft exports in October—following the \$3.33 billion drop in September. The outsized declines were likely artifacts of the strike at Boeing, and are likely to be reversed in coming months.

Reports last week on pending home sales in October and consumer sentiment in early December provided the **most upbeat news of the week on the economy**. Pending home sales in October fell just 0.7% (versus expectations of a 3.0% decline), after a 4.3% decline in September. A home sale is considered “pending” when a sales contract has been signed but the transaction hasn’t closed. Thus, pending home sales often lead new and existing home sales by a month or two. Pending home sales bottomed out in March 2008 and have been trending modestly upward since then. The stability of pending home sales over the last six months is consistent with the stability seen in the existing home sales market over the past year.

Consumer sentiment—as measured by the University of Michigan’s survey of consumer sentiment—rose 3.8 points in early December to 59.1, from 55.3 in November. The reading came in above expectations of a drop to a 54.8 reading. Sentiment rose due to another steep drop in gasoline prices and some stability in stock prices. Despite the gain in early December, consumer sentiment remains pinned near all time lows (51.7 in May 1980) and needs to recover in order for the economy to recover.

5 Despite an Unexpected Uptick in Early December, Consumer Sentiment Remains Pinned Near All Time Lows

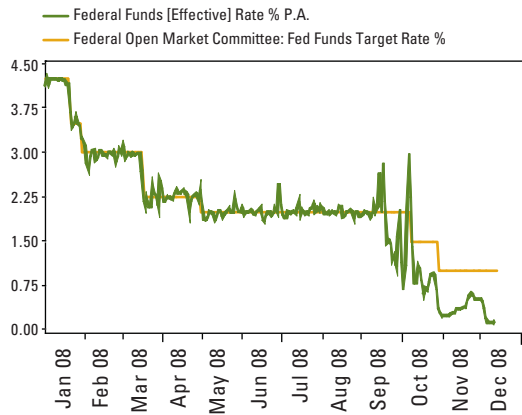


Source: University of Michigan / Haver Analytics 12/14/08

Looking over this week, the market has a lot to digest on both the policy and economic fronts. The Fed’s rate setting arm, the Federal Open Market Committee (FOMC) is meeting, with a decision on rate cuts due on Tuesday, December 16. The market has priced in at least a 25 basis point cut to the target Fed funds rate, which would lower the rate to 0.75 basis points, but some market participants are looking for a 50 basis point cut to 0.50. As noted in the nearby chart, **whether the FOMC decides to cut by 25 or 50 basis points is almost irrelevant at this point, as the effective rate on fed funds—what banks are actually charged for overnight lending—has been close to zero for more than a month now**. In addition, the market is bracing for some type of formal announcement from the FOMC about how it is likely to proceed should it decide to formally move down the path of quantitative easing—growing the money supply in the face of a zero or near-zero Fed funds rate target—in 2009 and beyond. Also likely to garner market attention this week is the Organization of Petroleum Exporting Countries (OPEC) meeting this Wednesday, December 17. OPEC has been threatening to cut oil production dramatically in response to the 70% drop in oil prices since the summer. In our view, OPEC had virtually no success in raising production to combat rising oil prices over the past five years as oil rose from under \$30 to \$150 a barrel, and they are likely to have a similar limited impact as prices fall.



6 Effective Fed Funds Rate Close to Zero and Well Below Target Rate Since Early November



Source: Federal Reserve Board / Haver Analytics 12/15/08

There is a full slate of economic data due out this week, with housing, consumer prices and industrial production data for November and December leading the way. The market will also digest the latest reading (December 13) on weekly jobless claims, as participants continue to look for signs that the economy has stabilized in December after an absolutely horrid performance in September, October, and November.

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