



Weekly Economic Commentary



March 16, 2009

Economy Still Tracking to Base Case; Still Awaiting Policy Traction

John Canally, CFA

Economist
LPL Financial

ECONOMIC CALENDAR

Monday, Mar 16

NY Fed Empire State Mfg
March

Capacity Utilization
February

Industrial Production
February

NAHB Housing Survey
March

Tuesday, Mar 17

Building Permits
February

Housing Starts
February

PPI
February

Wednesday, Mar 18

Current Account
q4

CPI
February

FOMC Decision

Thursday, Mar 19

Initial Claims
wk 03/14

Leading Indicators
February

Philly Fed Index
March

In last week's Weekly Economic Commentary, we wrote that while the "front end" of the U.S. economy—consumer spending—which accounts for two-thirds of real gross domestic product (GDP), had stabilized thus far in the first quarter of 2009 relative to Q4; while the "back end" of the U.S. economy—business spending on plant, equipment and inventories—was still decelerating to the downside. We also noted that because the "back end" of the economy was still in free fall, the risk was rising that a massive inventory drawdown in Q1 could make the decline in Q1 real GDP worse than the 6.2% drop in real GDP recorded in Q4.

Based on last week's economic data, we are sticking with our base case for the economy for Q1 and for all of 2009, and are now less concerned about Q1 2009 being a blowout negative quarter.

Last week's data included:

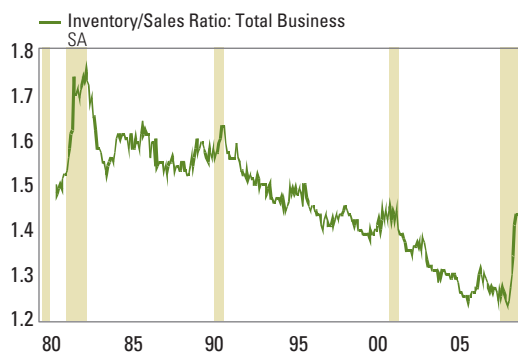
- Retail sales for February,
- Weekly retail sales for the first week in March
- Inventory data for wholesale and retail trade for January
- International trade data for January

We do continue to be concerned that policy voids remain to be filled, and the Obama Administration's response to the crisis remains scattershot, at best. We remain hopeful that all of the policies' details will be released soon and that the programs in the Administration's Financial Stability Plan begin working to restore confidence in the financial system and the economy. Until then, we think the economy and markets will suffer, and remain volatile.

Three aspects of last week's economic data provided the markets comfort that Q1 2009 real GDP would not be a double digit decline, as some forecasters feared. Why?

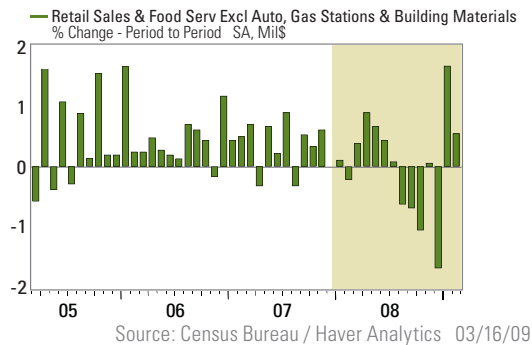
First, the inventory data embedded in last week's data were not weak enough to suggest that the inventory drawdown in Q1 will be much larger than the inventory destocking we saw in Q4 2009. This is both good and bad news. The good news is that inventories are not likely to push the decline in Q1 2009 GDP into double digits as some forecasters had feared, although it may be a bit premature to make that call as we only have one month (January) of inventory data in hand. The bad news is that the inventory-to-sales ratio has surged in recent months [chart 1], and suggests that more inventory destocking (read production and job cuts) may yet be necessary to bring production more into line with demand.

1 Inventory to Sales Ratio is Still Rising, Suggesting a Need for Inventories to Correct



Source: Census Bureau / Haver Analytics 03/16/09

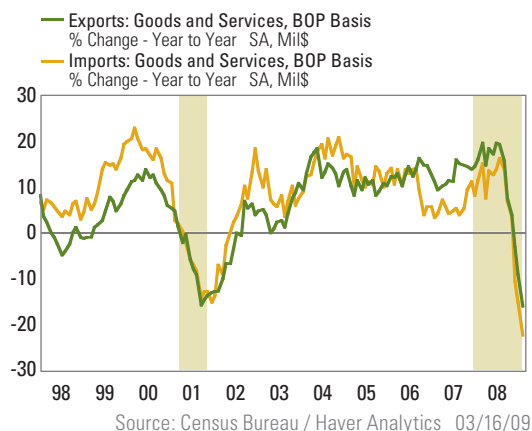
2 Core Retail Sales Have Stabilized in the First Two Months of 2009 after Plunging in Q4



The better than expected February retail sales report contained a large upward revision to the January retail sales data.

The January merchandise trade report came in better than expected, revealing that imports were still falling faster than exports

3 Trade Not Likely to Be a Big Drag on Q1 GDP as Imports Falling Faster Than Exports



Second, the better than expected February retail sales report contained a large upward revision to the January retail sales data, which, taken together, suggests that real personal consumption expenditures in Q1 are likely to be only about 1% below their Q4 average [chart 2]. As a reminder, real personal spending fell at a 4.3% annualized pace in Q4 2008 versus Q3 2008. Thus, our thesis that the front end of the economy stopped getting worse in the early part of Q1 remains in tact.

For those looking for dark clouds in this silver lining, we note that pent up demand after a horrible holiday season, the 5.8% increase in cost of living adjustments in several key government programs—most notably Social Security—, tax refunds running 18% ahead of the year ago period, and the sizable drop in gasoline prices over the past six months, all may have contributed to the better than expected performance of consumer spending thus far in 2009. So, while we are pleased that consumer spending has surprised to the upside thus far in Q1 2009 we would like to see the stabilization in the consumer persist into Q2 2009 and beyond. Only then we will be willing to sound the all clear on the consumer, as the consumer still faces stiff headwinds from a sagging labor market and massive hits to consumer net worth.

Third, the January merchandise trade report came in better than expected, revealing that imports were still falling faster than exports, as is typically the case during a recession. One of our concerns was that the global nature of this slowdown—relative to the U.S. only recessions of 1990-91 and 2001, would hit U.S. exports harder than imports, thus worsening the trade deficit. That was not the case in January as imports (-6.7%) fell faster than exports (-5.7%). [chart 3] Imports were down 23% in January 2009 versus January 2008, while exports were down “only” 16% on the same basis. On balance, the January trade balance data suggests that while the net export sector will be a small drag on real GDP in Q1, it won’t have a major impact on GDP. Until the collapse of Lehman Brothers in mid-September 2008, the trade sector had been a beacon of light for the otherwise struggling U.S. economy, with net exports more than offsetting weakness in the residential construction sector. However, the collapse in the global economy, along with the unexpected strength of the U.S. dollar in the past six months is | acting to restrain U.S. exports, putting further downward pressure on the U.S. economy.

On the policy front last week, markets did get some more clarity on the Fed’s Term Asset Backed Securities Loan Facility (TALF), the joint Fed-Treasury program designed to reignite the securitization market. The program is garnering some interest in both the private equity/hedge fund community and the major commercial banks. However, late last week, the Fed delayed the first round of TALF funding by two days (to March 19) to allow more time for participants to “complete documentation” associated with the program. Market expectations for this program, at least initially, are quite low. The details of the first offering of the TALF will be made public in late March, and by all indications, many market participants are sitting out the first round to see how well (or badly) the first round goes. Thus, we will wait until the second TALF offering in April before we provide our initial thoughts on the effectiveness of this program in restarting the critical securitization market, which has all but dried up in the past 18 months.



Treasury Secretary Tim Geithner, speaking at the G20 Finance Ministers meeting in London said that new information about the PPIF will be made available “in the next week”.

Fed Chairman Ben Bernanke became the first sitting Fed Chairman to give a press interview in at least 20 years when he appeared on CBS’s 60 Minutes; he said that he thinks the recession would end later this year and begin to recovery in 2010.

The market is still awaiting details on the final part of the Obama Administration’s four part Financial Stability Plan, the public private investment fund (PPIF), which is aimed at lifting the bad assets off of the balance sheets of the U.S. financial system. Over the weekend of March 14th and 15th, Treasury Secretary Tim Geithner, speaking at the G20 Finance Ministers meeting in London said that new information about the PPIF will be made available “in the next week.” The Treasury plans to roll out enough information on the plan for potential investors to be able to “gauge interest” in the plan. In addition, Treasury hopes to roll out an “operational timeline” on the programs.

Finally, on the policy front, Fed Chairman Ben Bernanke became the first sitting Fed Chairman to give a press interview in at least 20 years when he appeared on CBS’s 60 Minutes on Sunday night. Bernanke repeated his assertion that stabilization in the financial sector is crucial to any recovery in the U.S. economy this year. Bernanke said he thinks the recession would end later this year and begin to recovery in 2010. He hinted that the Obama Administration may need to go back to Congress to request more funds to aid the banking sector, and said that the government’s bank rescue plan is “going to take some patience. It’s going to take some support.” Bernanke’s comments came ahead of the Fed’s Federal Open Market Committee (FOMC) meeting later this week. With the Fed’s hands tied on traditional monetary policy—the Fed funds rate—the outcome of the FOMC meeting is not in doubt. What the market is looking for is any signs that the Fed will slow down (hopefully not) or speed up (hopefully) its quantitative easing efforts and whether or not the decision has been made by the FOMC to directly purchase U.S. Treasuries (or other financial assets). We do not expect the Fed to announce that it is purchasing Treasuries at this FOMC meeting.

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.

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.

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

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial, UVEST Financial Services Group, Inc., Mutual Service Corporation, Waterstone Financial Group, Inc., and Associated Securities Corp., each of which is a member of FINRA/SIPC.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit