



Weekly Economic Commentary



May 18, 2009

Consumer Spending a Mirage?

What's the impact of the Auto Sector Shutdowns on the Economy?

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ECONOMIC CALENDAR

Monday, May 18

NAHB Housing Survey
May

Tuesday, May 19

Housing Starts
April

Wednesday, May 20

FOMC Minutes

Thursday, May 21

Initial Claims
wk 05/16

Leading Indicators
April

Philly Fed Index
May

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The title of our most recent Weekly Economic Commentary was “What’s Next”? In the commentary, we posed some rhetorical questions about the economy and markets that market participants may be asking themselves over the next few weeks and months. We didn’t necessarily have answers for the questions we posed, but asked them to help frame our analysis of the economy, policy, and financial markets over the near term.

The questions we asked last week remain valid (and many remain unanswered!!), and not surprisingly last week’s flow of information on the markets, economy, and policy has prompted even more questions:

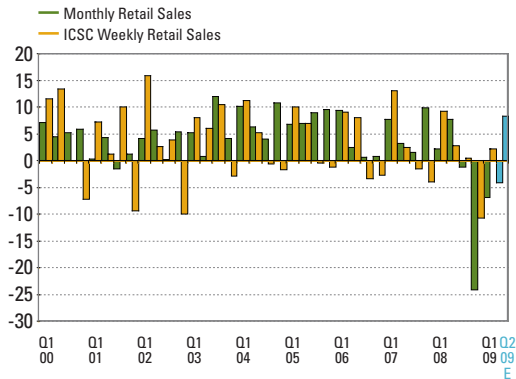
- Was the 2.2% increase in consumer spending in the first quarter of 2009 (versus Q4 2008) a mirage?
- What impact will the auto plant shutdown and auto dealer closings have on the economy over the remainder of 2009?
- Will “overreaching” government policy by both Congress and the Obama Administration help or hinder any economic recovery this year?
- What is the next “macro” catalyst for the economy and markets?

Several of these additional questions were prompted by the economic data released this past week, most notably, the surprisingly weak April retail sales data and the big jump in jobless claims. One of the questions we posed last week was “When will inflation turn up?”, and the data released last week on the Consumer Price Index (CPI) and Producer Price Index (PPI) for April provided us with some soothing guideposts on inflation. News on policy last week was a bit more disconcerting, and the news on the Auto sector was downright scary. We’ll address the impact of the Auto sector on the economy at the end of this week’s report.

In short, nothing we saw last week in the economic data or on the policy front changed our view on the U.S. economy. On balance, our base case for the U.S. economy as outlined in the 2009 Outlook remains in tact. In Q2 2009, we expect real gross domestic product (GDP) growth to be less negative than in Q1—when GDP fell at a 6.1% annualized pace versus Q4 2008. We expect real GDP growth to be roughly flat in the third quarter of 2009 and that the economy will begin to emerge from the recession in Q4 2009. Over the past six weeks or so, the incoming data suggests that the odds that our “bear case” for the U.S. economy as outlined in our 2009 Outlook have diminished considerably, while the odds of our “bull case” unfolding have increased a bit, setting aside the news on the automakers. For now, we are sticking with our base case, but we will continue to monitor the incoming data and policy actions closely.



1 Weekly Retail Sales Suggest Strong Start to Q2 2009 Spending



Source: International Council of Shopping Centers, U.S. Department of Census 05/18/09

The April retail sales report released on Wednesday, May 13, was certainly a disappointment for markets.

Our view is that we think the market (and some economists) may have overreacted to the April retail sales report.

This week is a quiet one on the data front ahead of the Memorial Day weekend. The data due out this week is generally housing themed—with the May NAHB survey and April housing starts data on tap. In addition, markets will digest the usual lineup of weekly economic data (most of which are in our Current Conditions Index (CCI) including weekly retail sales, mortgage applications, and weekly jobless claims. Also due out this week is the Philly Fed Index for May, which will provide an early look into the health of the Manufacturing sector in the Mid-Atlantic States in May.

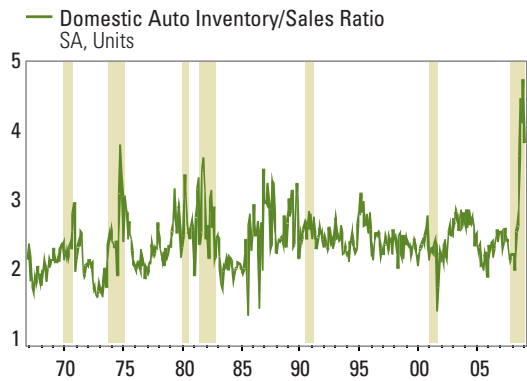
The April retail sales report released on Wednesday, May 13, was certainly a disappointment for markets. Retail sales fell 0.4% between March and April, well below the consensus expectation of a flat month-over-month reading. Excluding sales at auto dealers, retail sales fell 0.5% in April versus March. Most categories in the report were weak, and the report was even more disturbing because Easter fell in April this year, while it was in March in 2008. The best that one can say about the April retail sales report is that, in general, retail sales in April were “less bad” than sales in Q4 2008 and Q1 2009. Nevertheless, the 0.4% drop in retail sales in April left nominal retail sales running 4.4% below their Q1 2009 average, and retail sales excluding autos in April 4.0% below their Q1 2009 average (see chart). This is disturbing, because consumer spending accounts for two-thirds of GDP. The report raised concerns among market participants that the 2.2% increase in real consumer spending in Q1 2009 versus Q4 2008 was a mirage, and that consumer spending would slump over the remainder of the year. Our view is that we think the market (and some economists) may have overreacted to the April retail sales report. Why?

- First, the retail sales data released last week were for April, and we already have two weeks of retail sales data in the books for May, courtesy of the International Council of Shopping Centers (ICSC) weekly retail sales report. That data, which is part of our Current Conditions Index (CCI), posted a 0.7% weekly gain in the first week of May and rose another 0.3% in the week ending May 9. By this measure, retail sales in the first six weeks of Q2 (i.e. April and early May) are running 8.5% ahead of their first quarter average. (See chart)
- Second, there were some anomalies in the April report, from the 1.0% month-over-month drop in food sales to the 2.3% drop in gasoline service station sales—despite the gain in gasoline prices between March and April.
- Third, the big shift in the date of Easter—earliest Easter since 1913 in 2008 to a more “normal” date for Easter this year, probably had an impact on both the March and April retail sales data.
- Fourth, S&P 500 companies with April 2009 quarter-ends are just now beginning to report their results, and for the most part are saying that sales in April were at or above plan and better than March.

On balance, we aren’t too concerned about the April retail sales report, but if the weekly sales data released over the remainder of May (and the May retail sales data itself, which is due out in mid June) disappoints, we may have to revisit our thesis that the economy is “less bad” in Q2 than it was in Q1.



2 Bloated Auto (and Light Truck) Inventories Necessitate Longer than Usual Auto Assembly Plant Shutdowns this Summer



Source: Bureau of Economic Analysis, Haver Analytics 05/18/09

Auto Sector

The other key story last week is one that is likely to dominate the economic landscape over the remainder of the year (and most likely well beyond): The ongoing restructuring in the Auto sector. In early May, Chrysler, the smallest of the Big Three automakers filed for bankruptcy, shutting all of its assembly and parts plants and nearly 27,000 production workers for two months. In late April, GM—the largest U.S. automaker—announced that it would temporarily shut most of its production plants between mid-May (i.e. now) and the end of the summer, to realign bloated inventories with sales (see chart). The GM shutdowns will impact more than 24,000 production workers at 14 of GM's 18 U.S. assembly plants. GM faces a bankruptcy deadline of June 1. In recent days, both troubled automakers have also announced plans to sharply reduce the number of its dealerships around the country. GM, which has over 6,000 dealerships, has already notified over 1,000 dealers that they are being impacted, with another 1,600 to follow. Meanwhile, Chrysler plans to reduce its dealer network from just over 3200 to around 2400.

Typically, all of the nation's auto plants shut down for two weeks in the summer to retool for the new model year. This year, some plants will be shut for up to nine weeks. The longer than usual assembly shutdowns will have a knock on effect, forcing parts supplies to shut plants for longer than usual as well.

On the dealer side, some of the dealerships being forced to close will realign with other brands, some will work out deals with General Motors and Chrysler to stay in business, while some dealers will go under and still others would have gone out of business anyway. All of this disruption will then have a ripple effect on the businesses that serve those dealerships, and on the overall economy itself. The National Association of Auto Dealers, the trade group for the auto dealers, estimates that as many as 187,000 jobs at dealerships alone could disappear as a result of the closures.

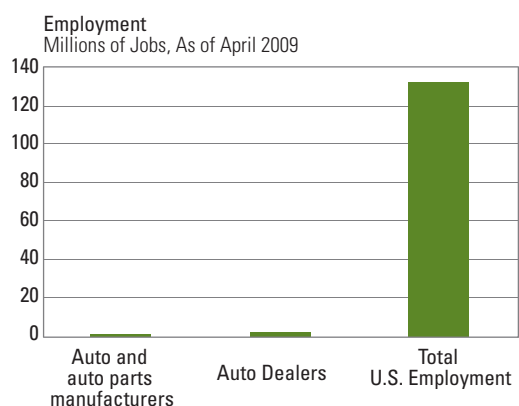
Both the plant shutdowns and the dealership closures are poised to have an impact on the economy in the coming weeks and months. Some of the impact could include:

- A rise in jobless claims—perhaps to a new peak over 700,000
- A drop in industrial production
- A drop in the monthly readings on the Institute of Supply Management's (ISM) survey of manufacturing
- More severe decreases in the number of jobs in the monthly nonfarm payroll job count
- A more rapid increase in the unemployment rate

However, some of the auto assembly jobs will return and some portion of the lost production will be made up later in the year. The key for markets is to look beyond the auto related data, and focus on the underlying health of the economy.

In terms of number, the U.S. Bureau of Labor Statistics reports that as of April 2009, just under 700,000 people work at auto and auto part assembly plants, while 1.7 million people work for auto and auto parts dealers. That's 2.4 million jobs out of a total of roughly 133 million in the whole economy, or a little

3 Auto and Auto Related Jobs Account for About 2% of All U.S. Jobs



Source: Bureau of Labor Statistics 05/18/09



under 2% of all employment (See chart 3). It's by no means a trivial number, but it's probably not large enough by itself to derail the overall economy. We will continue to monitor the situation closely.

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Weekly Market Commentary



May 18, 2009

Too Great Expectations

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LPL Financial

Highlights

As last week's performance attests, market participants' greater expectations now leave room for disappointment and the return of volatility.

Around the turning points during recessions the healing is typically uneven—some parts of the economy begin to show signs of improvement while others are still worsening. The rally often ends when investors get impatient waiting for improvement to show up in all areas.

The S&P 500 may be on the cusp of a retest to the mid-to-low 800s and be range-bound (830 to 930) for a few months.

To move higher the S&P 500 is likely to require greater expectations for earnings over the coming four quarters. While the profit contraction may be near an end for most businesses, the timing and extent of a profit recovery could take months to become evident keeping stocks range bound.

Last week's 5% loss for the S&P 500 almost fully reversed the gain of the prior week. Over the preceding nine weeks stocks rose steadily as economic data proved stronger than expected. As last week's performance attests, market participants' greater expectations now leave room for disappointment and the return of volatility.

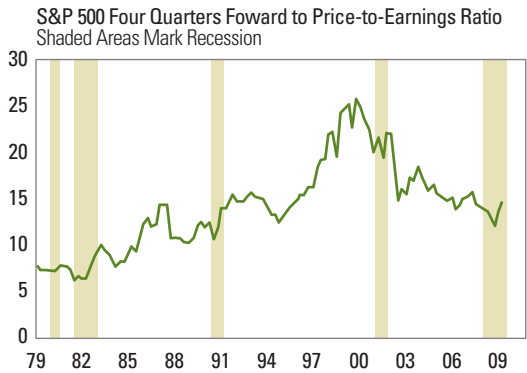
Around the turning points during recessions the healing is typically uneven—some parts of the economy begin to show signs of improvement while others are still worsening. The early signs of improvement signaling the bottom is near are usually welcomed with a rally in stocks and corporate bonds despite the mixed economic data. The rally often ends when investors get impatient waiting for improvement to show up in all areas. As expectations get too great some of the data is bound to disappoint.

This is what happened last week. After the data in March and April was consistently better than expected, last week's weaker than expected Advance Retail Sales report for April disappointed investors that began to expect more consistent signs of healing (this data is not all that bad since the first two weeks of May shows a snap back from late April weakness in retail sales). In February and March economists were expecting job losses to total in the mid-600,000s. In April, they expected a loss of only 600,000 (actual losses were 539,000). Similarly, in February and March, Economists expected the widely-followed ISM survey of manufacturers to improve to 33.8 and 36.0—in April they expected 38.4 (the actual reported index level was 40.1). While conditions may continue to improve, not all data points are likely to beat greater expectations and expectations for May could be too high.

The stock market may be on the cusp of a retest. In recent months, we highlighted that bear markets of this magnitude nearly always pull back after a relief rally triggered by policy actions. The retest is typically two to four months from the prior low. We refer to this as a retest of the low and a normal and healthy part of the bottoming process. In fact, 10 of the 11 bear markets since WWII resulted in a retest before sustainably moving higher. However, we don't think the S&P 500 will revisit the March low of 676 given the improvement in the investment environment reflected in the Current Conditions Index, the economic stimulus still in the pipeline, and the change in perspective as the efforts to restore solvency to the financial system continue to gain traction (for example, the TED spread, an important gauge of stress in the banking system has fallen to levels not seen since before the crisis began over a year-and-a-half ago). Instead, we believe a retest to the mid-to-low 800s—where there are key technical support levels—is possible.



1 P/E has Rebounded to Long-Term Average



Source: Factset Research Systems, Thomson Financial, LPL Financial

However, it is unlikely that the retest unfolds in a straight line—the dips are likely to be bought by bargain hunters. The return of volatility—in contrast to the steadily upward sloping market of the past two months—means that this retest may turn out to be a consolidation of the recent gains over a period of months rather than a sharp pullback and result in a volatile, but range-bound market between the key technical support and resistance levels of 830-930 for a few months; (830 on the downside, 930 on the upside.)

The driver of the roughly 40% market advance from the lows was the rise in the price-to-earnings ratio which rose from an intra-quarter low during early March of around 10 to near 15 as of early May. Investors became more confident that the economic freefall had halted and were more willing to buy and lift stock prices. But now the S&P 500 price-to earnings ratio is at about 15—in line with the long-term average. To move higher the S&P 500 is likely to require greater expectations for earnings over the coming four quarters. While the profit contraction may be near an end for most businesses, the timing and extent of a profit recovery could take months to become evident keeping stocks range bound.

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