



Weekly Economic Commentary



September 14, 2009

Cash for Clunkers a Dominant Theme in This Week's Economic Data Reports

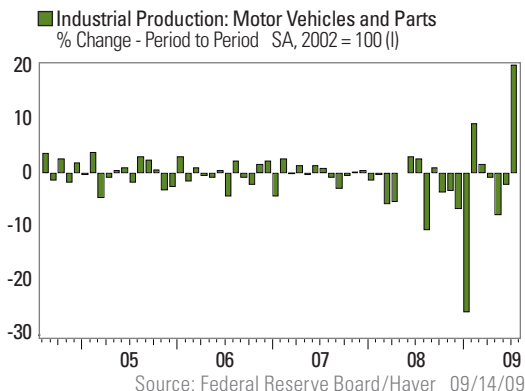
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ECONOMIC CALENDAR

Tuesday, Sept 15	Industrial Production
Retail Sales	Aug
Aug	NAHB Housing Survey
NY Fed Empire State Mfg	Sept
Sept	Thursday, Sept 17
PPI	Building Permits
Aug	Aug
Business Inventories	Housing Starts
July	Aug
Wednesday, Sept 16	Initial Claims
Current Account	wk 09/12
Q2	Philly Fed
CPI	Sept
Aug	
Capacity Utilization	
Aug	

1 Cash for Clunkers Likely to Impact Many of the Economic Reports This Week, Including the August Industrial Production Report



As the first full week of September begins, market participants are likely to continue to dismiss economic data showing that economic growth (as measured by real gross domestic product) returned in Q3 2009, as worries about the health of the economy in Q4 2009 and beyond persist. Due in part to the impact of the “cash for clunkers” program, the deluge of economic data due out this week for August and September is not likely to provide the market a clearer picture of the economy in Q4 and beyond. As such, we expect the economic data to largely be ignored by market participants, who will likely be more focused on the beginning of Q3 earnings preannouncement season, a potential trade war with China, the ongoing policy wrangling in Washington, and the one year anniversary of the collapse of Lehman Brothers.

As we wrote last week, based on the data in hand for Q3 2009, the economy is on track to post a GDP growth rate that is likely to be above the upper end of our previously stated range for the second half of 2009, 2.0 to 3.0%. We continue to point out that the “consensus” is still looking for 2.0% real GDP growth in both Q3 and Q4 2009, although that number has been creeping higher (to closer to 2.5 or 3.0%) for Q3 in recent weeks.

We expect the data due out this week to bring the market closer to our view on GDP growth in Q3 2009, as we expect reports on housing, manufacturing and retail sales to reveal above consensus expectations readings for August and September. The main theme of the week's economic reports is likely to be the positive impact of the “cash for clunkers” program on the August data. The flip side of that, is that the market and the financial media are likely to spend a great deal of time this week ignoring too good data for August, and focusing on the negative implications of the end of the “cash for clunkers” program on the September data.

The price data due out this week (August PPI and CPI) will again tell the story of headline deflation but core inflation. As we head into late 2009 and early 2010, headline deflation will give way to headline inflation, due to the impact of the surge (and subsequent decline) in oil prices over the last half of 2008. However, core inflation (running at about 1.5% year-over-year now) is likely to decelerate as we head into 2010, which will give the Fed plenty of leeway to keep rates lower longer than the market now anticipates. Currently, the market is pricing in the first Fed rate hike of the cycle in March 2010. Our view is that the Fed could be on hold until the summer of 2010.



The Week Ahead

The section below provides some observations on this week's key economic releases. Alongside the preview are questions that markets, the media and, yes, economists are likely to be asking as the data is released.

Our best guess is that the minute the August retail sales are released they will be dismissed by the media and market participants, and focus will shift to September sales, which will be weighed down by a big drop in auto sales as "cash for clunkers" ends.

Given the New York region's relatively low exposure to the auto sector, the report will provide market participants some insight into how the manufacturing sector outside of the auto sector is faring three months into the "Great Vehicle Production Binge of 2009"

August Retail Sales (Tuesday, September 15)

- Cash for clunkers gave vehicle sales a big boost in August.
- Gasoline prices, mortgage rates, the equity markets and consumer confidence can provide good guideposts for consumer spending.
- Gasoline prices ticked up a bit (by about 3%) between July and August, while mortgage rates dipped a few basis points. Equity prices rose more than 3%, and consumer confidence improved between July and August.
- The market will be looking for signs of improvement in discretionary spending (non staples retailers, food away from home, furniture, etc) and should focus on retail sales excluding auto dealers and gasoline service stations for a good gauge of the underlying pace of consumer spending in August.
- Our best guess is that the minute the August retail sales are released they will be dismissed by the media and market participants, and focus will shift to September sales, which will be weighed down by a big drop in auto sales as "cash for clunkers" ends.

September Empire Manufacturing (Tuesday, September 15)

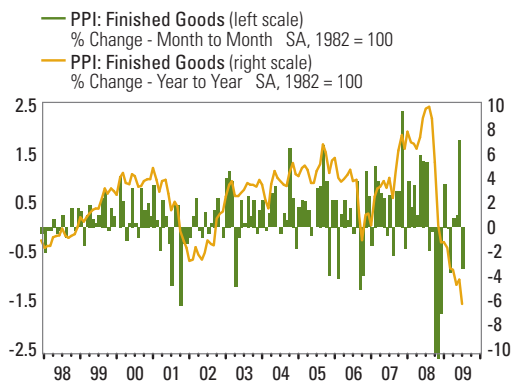
- This report provides the markets with the first look at the health of the manufacturing sector in September.
- Given the New York region's relatively low exposure to the auto sector, the report will provide market participants some insight into how the manufacturing sector outside of the auto sector is faring three months into the "Great Vehicle Production Binge of 2009"
- What impact is the weaker dollar having on manufacturing, which is heavily dependant on exports?
- Can the index remain above zero for the third consecutive month, which would signal that the expansion in the manufacturing sector in the New York region that began in July was taking a firmer hold.

August Producer Price Index (Tuesday, September 15)

- Consensus forecast is for more headline deflation on producer prices for finished goods in July, but mild inflation on "core" PPI.
- We are likely to see inflation first at the producer level, (especially at the intermediate and crude levels) before we see it at the consumer level; we are already seeing commodity price inflation return.
- Crude oil prices were little changed between July and August, while natural gas prices fell another 7%. However, gasoline prices ticked up a

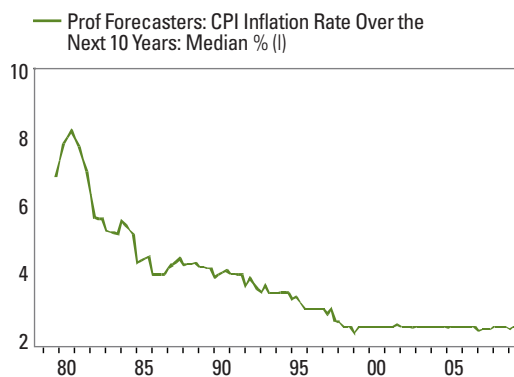


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Source: Bureau of Labor Statistics, Haver Analytics 09/02/09

3 Overall, long term inflation expectations remained well anchored—even in the face of the Fed's massive quantitative easing program—, which will allow the Fed to keep rates lower for longer



Source: Bureau of Labor Statistics, Haver Analytics 09/02/09

bit. On balance, energy prices are likely to be a drag on the PPI in August versus July.

- Tobacco and new and used vehicle prices are always wildcards for the PPI. It's anyone's guess how the "cash for clunkers" program that kicked into high gear in late July will impact new vehicle prices in the PPI in August.
- CPI and PPI tend to move together over long periods, but month to month, they are not highly correlated.

July Business Inventories (Tuesday, September 15)

- The monthly report on business inventories is most often greeted with a big yawn from financial markets, but the data are important around turning points in the economy.
- The U.S. economy saw a big inventory drawdown in Q1 and Q2 '09 as companies cut production (and jobs) to counter falling demand in the wake of the collapse of Lehman Brothers and the seizing up of financial markets in Q4 2008. Inventory destocking was a huge drag on GDP in the first half of 2009.
- Now, underlying demand has picked back up, and production has to catch up. That means inventories have to be restocked, or destocked at a slower pace, in the second half of 2009. The pace of that restocking will be a big determinate of GDP growth in 2H 2009.

August CPI (Wednesday, September 16)

- On a year-over-year basis, the market expects headline deflation, but inflation on core CPI in August.
- Both headline and core CPI inflation are likely to continue to fall well after the end of the recession, which likely ended in late Q2 2009.
- The August CPI data is likely to be impacted by a modest increase in gasoline prices, and a drop in food prices. Gasoline prices rose 3.4% in August versus July, after a similar drop between June and July.
- One wildcard in August will be the impact of the "cash for clunkers" program on new vehicle pricing.
- Overall, long term inflation expectations remained well anchored—even in the face of the Fed's massive quantitative easing program—, which will allow the Fed to keep rates lower for longer.
- In its most recent statement, the Federal Open Market Committee (FOMC) downplayed the risk of deflation in 2009, but we still think deflation, not inflation is a bigger risk in the second half 2009 and early 2010.
- In the last few months, financial markets have shifted from worries about the Great Depression and then recession, to concerns about recovery and inflation. Therefore, a "bad" CPI report could move the markets, especially the Treasury market. Equity markets continue to worry about a "W" shaped recovery that would be precipitated by a surge in inflation



and draconian round of policy tightening by the Fed in response to the inflation.

Auto production is expected to surge again in August as a result of the "cash for clunkers" program, so the real question is, what does production look like outside of the auto sector?

August Industrial Production/Capacity Utilization (Wednesday, September 16)

- Through June 2009, industrial production had posted month over month declines in 17 of the 18 months since the recession began in December of 2007.
- Most market participants are dismissing the 0.5% month-over-month gain in industrial production in July as an artifact of the ramp up in auto production after the auto bankruptcies of the Spring.
- Auto production is expected to surge again in August as a result of the "cash for clunkers" program, so the real question is, what does production look like outside of the auto sector?
- In general, the end of inventory destocking (see business inventories) suggests that industrial production will begin to pick up in the second half of 2009.
- If the consensus is correct, the 13.5% year-over-year drop in IP in June will mark the low point of industrial production for the cycle. The year-over-year decline in June was the biggest in more than 60 years, since July 1946's -16% decline.
- More seasonably warm weather in many parts of the country in August is likely to boost utility production. Mining output is likely to be weak again given the depressed state of natural gas prices.
- Capacity utilization is expected to tick up for the second consecutive month after hitting an all time low of 68.1% in June. Slack capacity will help to keep a lid on any uptick in inflation late this year and into 2010, and allow the Fed to remain on hold well into 2010.

September Housing Market Index (Wednesday, September 16)

- The market is looking for another small improvement to 19 in September vs. 18 August.
- A reading below 50 suggests that homebuilders think conditions are poor/above 50 conditions are good. The index has not been above 50 since April 2006.
- At 18 in August, the NAHB index is up from a low of 8/9 in late 2008/early 2009, but still well below peak of 72 hit in 2005.
- Mortgage rates moved down about 0.25% to around 5.00% between early August and early September.
- Has the good news on the economy, the equity markets, the labor market and home prices begun to push potential buyers off the sidelines and into model homes?
- Lowball appraisals have become an issue in the housing market lately, with lenders requiring bigger down payments from buyers or price cuts

In addition, the expiration of the \$8,000 first time homebuyer tax credit at the end of November is looming, and could impact the housing market as that date approaches.



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August Housing Starts (Thursday, September 17)

- Looking for more signs that the housing market has stabilized, albeit at a very low level.
- Housing has been a drag on GDP growth for 14 consecutive quarters through Q2 2009 but it looks like it's on track to be a plus for GDP growth in Q3 2009, a quarter earlier than we had previously thought.
- Housing and business capital spending have helped to lead the way in most of the post WWII recoveries.
- Single-family starts are more economically sensitive and they have now posted six consecutive non-negative month-over-month readings since February, the longest streak since mid 2005!
- Multi-family starts are very credit market sensitive, and it's still tough sledding right now for builders and developers who are dependant on financing. In addition, multi family housing starts are notoriously volatile from month to month.
- Weather is sometimes a factor for housing starts, but usually not in the summer months. Permits are not weather sensitive and are a good leading indicator of future housing activity.
- As is the case with the NAHB index, the end of the \$8,000 tax credit for first time homebuyers may begin to impact the single family housing starts data in the coming months.

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September Philadelphia Fed (Thursday, September 17)

- Along with the Empire State Manufacturing Index, one of the first readings on the manufacturing economy in September.
- Through July 2009, the index had been below zero, indicating that manufacturing activity in the Philadelphia area is contracting, in every month but one since the recession began in 2007. The index moved above zero in August.
- Aside from the overall index, and whether or not it can remain above zero, the prices paid, employment, inventories and new orders subcomponents of the report will be of interest to the market, as it continues to gauge the pace, composition and sustainability of the recovery.

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Weekly Market Commentary



September 14, 2009

One Year Ago and What it Means Now

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Highlights

One year ago, the event that precipitated the peak of the financial crisis took place—Lehman Brothers filed for bankruptcy.

One of the consequences of the financial crisis is that virtually every company in every country around the world is now synchronized in one global business cycle. A unified global business cycle may intensify the cyclical nature of demand and price swings for raw materials, credit, and labor.

Another outcome of the crisis is the changing landscape of financial market regulation.

On September 15, 2008, Lehman Brothers filed for bankruptcy. That was the event that precipitated the peak of the financial crisis. Let's not just look back at what that event meant for the markets, but also forward to what it means today and what the consequences of the financial crisis may be for the markets in the years to come.

While GDP growth was below average in the first half of 2008, it was positive and credit markets were functioning. The TED spread began 2008 at about 1% then doubled around the time Bear Stearns was bailed out when JP Morgan absorbed it with the Federal Reserve guaranteeing a lot of the toxic assets. The potential crisis appeared to be averted and the TED Spread narrowed to 1% again. During the summer the rate rose again this time as Fannie and Freddie—the two entities that make possible about half of the home loans in America—were bailed out and effectively nationalized. Again, the rate came back down in August. It was widely assumed in the markets that Lehman was next on the list to get bailed out. The general expectation was that Barclays would absorb Lehman Brothers with the Fed guaranteeing them against some of the losses—essentially the same deal that the Fed provided to Bear Stearns. In fact, this was so much a foregone conclusion that the stock market was up in the several days that lead up to the weekend the deal was to take place.

The TED Spread measures the difference between 3 month LIBOR rate and the yield on 3 month Treasury bills. This is an effective measure of the liquidity available to banks. With bank capital adequacy near the center of the current crisis this is an important gauge of the stress in the banking system. A rise in the TED Spread is a sign of rising stress.

However, it was not to be. The backlash against bailouts and a desire to contain the toxic debt rather than spread it to more solvent institutions was too great and over the weekend of September 13-14 Barclays' was denied the support it wanted and approvals it needed resulting in the bankruptcy of Lehman on Monday, September 15. The shock of a major player in the credit markets that was leveraged more than 30-to-1 resulted in a spike in the TED spread. Banks would not lend to each other for fear that their counterparty may go bankrupt. Without deposits, investment banks were dependent upon borrowing from commercial banks to support their investing. As investment banks became unable to raise funds from other banks they were forced to sell their investments in housing-related securities. There were few buyers to absorb the supply. This accelerated the decline in the value in the securities and the prices entered freefall adding further pressure to the highly leveraged financial system.

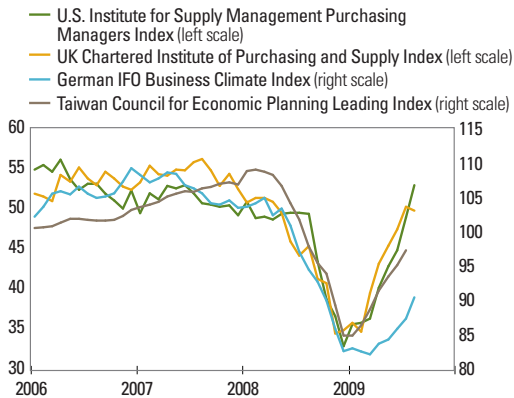
1 Key Financial Risk Gauge Clearly Shows the Impact of Lehman Brothers Bankruptcy
TED Spread: 3 month U.S. LIBOR Less 3 Month Treasury Bill Yield



Source: LPL Financial, Bloomberg



2 Measures of Economic Activity Have Reaccelerated in Most Countries



Source: LPL Financial, Bloomberg

Tight credit spreads prompted the investment banks to use high amounts of leverage in order to increase the profit on investments. To illustrate the problem, consider that a homeowner would be leveraged 5-to-1 with a purchase of a home with 20% down payment and an 80% mortgage. With a 5-to-1 ratio, when the price of the home declines 10%, the value of the homeowners' equity would be cut by 50%. Some investment banks, like Lehman Brothers were leveraged more than 30-to-1 on their housing-related investments.

In the aftermath, the whole financial system seized up. This tipped the sluggish economy into recession and the markets into a tailspin. Within a few days of Lehman's bankruptcy, a money market fund broke the buck and money markets stopped buying the commercial paper of financial institutions. General Electric, one of the few companies in the U.S. that had the highest possible credit rating, tried to borrow some money on a short-term basis. Despite very low short-term interest rates, on October 2, GE had to pay 10% plus equity to Warren Buffett's Berkshire Hathaway to get the \$3 billion it needed. If credit was unavailable to a company like GE it was certainly inaccessible to smaller businesses and consumers and the economy seized up. Short-term credit is not the engine of the U.S. economy, it is the oil in that engine - we even refer to it as liquidity. Once the oil is gone, the engine seizes up.

The Federal Reserve and Treasury responded to the credit crisis with enormous and unprecedented policy actions to liquefy the seized up financial markets and restore funding to financial institutions. These included the TARP which directly injected capital into embattled institutions, the credit facilities available to banks and other financial institutions, the commercial paper program to lend directly to businesses, over a trillion in direct purchases of mortgage-backed securities, and providing explicit guarantees of the liabilities of a few financial institutions including AIG and Citigroup. Eventually, the credit markets began to heal. With the oil restored to the economic engine it restarted as we entered the second half of 2009. This is true outside the U.S., as well. In the past few months, virtually every country has seen a turnaround in key measures of growth, including: manufacturing output, exports, housing activity, business confidence, and the stock market.

One of the outcomes of the crisis that may have far reaching consequences is that virtually every company in every country around the world is now in one global business cycle. The effects of the Lehman Brothers bankruptcy plunged nearly every economy in the world into recession and now we are witnessing an unprecedented synchronized global upturn. A unified global business cycle may intensify the cyclical nature of demand for raw materials, credit, and labor. In the past, the world's economies were often at different stages of the business cycle and this helped to smooth the rise and fall of demand for raw materials, credit, and labor. But now, with virtually every company in every country in sync the volatility has been intensified. After companies cut production and costs leading to an unprecedented plunge in commodity prices and much larger drop in employment and wages than during the average recession, the return of confidence by business leaders and renewed focus on growth may boost commodity prices, interest rates, and wages more than many expect based on past



experience. The investment implications of this outcome are reflected in our recommendations for exposure to the commodity markets and the Consumer Discretionary sector of the stock market.

Another outcome of the crisis is the changing landscape of financial market regulation. The mandate for action in Washington was clear in the aftermath of the Lehman Brothers bankruptcy. The November elections that took place near the peak of the crisis reflected a decisive vote for change with much of that sentiment directed to Wall Street institutions and their regulators. Over the next six months, Congress will likely enact major changes in regulation of the financial markets, derivatives and credit default swaps, hedge funds, the mortgage markets, and establish a council of regulators to oversee systemic risk. In addition, a new Consumer Financial Protection Agency is in the works.

The most unique of these new rules is how to address the issue of “Too Big Too Fail.” Systematically important financial institutions would have to be designated. This may imply a competitive advantage because they would have what amounts to an implied government guarantee. But also could be a negative depending upon the special regulation and costs that may accompany the designation. This may result in major changes in the business mix and scale of the financial conglomerates. Crafting new rules and a framework to oversee them is a major challenge. The oversight of the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac failed despite the implied government guarantee.

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