Weekly Economic Commentary

October 26, 2009

Q3 Report Card Due This Week

John Canally, CFA
Economist
LPL Financial

ECONOMIC CALENDAR

Tuesday, Oct 27
Consumer Confidence
Oct

Wednesday, Oct 28
Durable Goods
Sept

New Home Sales
Sept

Thursday, Oct 29
GDP
Q3

GDP Price Index
Q3

Initial Claims
wk 10/24

Friday, Oct 30
Employment Cost Index
Q3

Personal Spending
Sept

Personal Income
Sept

Chicago PMA
Oct

U of Mich Consumer Sentiment
Oct

Not surprisingly, in a week dominated by the first full week of the Q3 earnings reporting season, the economic data took a back seat to all the headlines on earnings. On balance, the week's economic data was mixed, with a few reports beating expectations, a few in line, and a few disappointments. Importantly, none of the data changed our view that the U.S. economy will experience 2.0 to 3.0% GDP growth in the second half of 2009, and that the consensus forecast for 2010, at 2.4%, is still too low.

This week, there are even more Q3 earnings reports (150+) than last week (137), but the market seems almost immune to all the good news there. Thus, we expect there to be more focus on the week's full slate of economic data which include reports on:

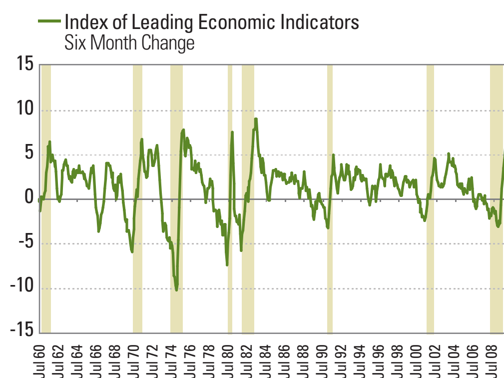
- Real Gross Domestic Product (GDP) for Q3 2009
- Manufacturing activity in Dallas, Chicago ,Milwaukee and Richmond in October
- New home sales and durable goods orders in September

The key report of the week (in terms of media attention) will be the preliminary Q3 GDP report. While the report will help to confirm to the public at large that the recession has ended, the market will probably be more focused on the reports for October, which provide insight into the economy in Q4. Thus, we will be closely watching the various manufacturing reports for October (and in particular the new orders and employment components of those reports), along with the weekly reports on retail sales and jobless claims, that are part of our Current Conditions Index.

Our suspicion is that even after Wall Street (and Main Street) digests the Q3 GDP report, and sees that the economy actually grew for the first time in 15 months, doubts will remain about the pace and sustainability of composition of the recovery.

In our view, the (global) recovery is on solid footing, and the U.S. economic expansion that began in the summer will continue. One way to illustrate that point is to look at the Conference Board's Index of Leading Economic Indicators (LEI). [Chart 1] Over the past six months, the LEI has risen by 5.7%, the fastest six month rise in the index since 1983, when the economy was in the midst of the robust recovery from the severe 1981-82 recession. While not a perfect indicator, the LEI does suggest that the economic recovery that began this past summer will be more robust than the last two recoveries (from the mild 1990-91 and 2001 recessions). It won't feel that way to many Americans, however, until the unemployment rate peaks and job growth returns in early 2010.

1 Over the past six months, the LEI has risen by 5.7%, the fastest six month rise in the index since 1983



Source: Bloomberg; LPL Financial Research

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.

September New Home Sales (Wednesday, October 28)

New home prices were down 12% in August 2009 versus August 2008. The market would view any signs that new home prices have bottomed as yet another sign that the overall housing market was in the bottoming process.

- The housing market was at the forefront of the economic and financial meltdown we saw in late 2008 and early 2009.
- We think housing (sales of new and existing homes, housing prices and housing starts) have now finally entered a bottoming process.
- Due, in large part, to the 80% drop in housing starts over the past three years, the inventory of unsold new homes is close to its long term average.
- As is the case with existing home sales, a potential threat to the underlying improvement in the market we have seen since early 2009 is the looming expiration of the $8,000 first time homebuyer tax credit in November.
- In recent weeks, the odds of the credit being extended well into 2010 (and even expanded to all homebuyers) has increased, due mainly to political considerations surrounding the 2010 Congressional mid-term elections.
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September Durable Goods Orders (Wednesday, October 28)

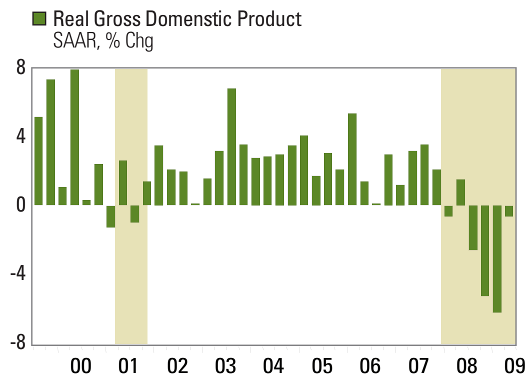
The market will want to focus on shipments and orders for capital goods, excluding aircraft. These "core" shipments and orders are highly correlated to the business spending portion of GDP

- Although we have already digested qualitative reports on business spending in September from companies with September quarter-ends reporting Q3 results and from the various regional and national ISM reports for September, the release of the September durable goods orders report represents the first "hard" data on business capital spending (durable goods shipments), future capital spending (durable goods orders) and business inventories in September.
- Two key themes for the September report are likely to be the big drop in aircraft orders in the month, offset by the big increase in auto related orders as a result of the cash for clunkers program.
- We expect that business capital spending grew in Q3 2009 versus Q2 2009, the first quarter-over-quarter gain since the recession began in Q4 2007. The expected gain in business capital spending comes as companies replenish severely depleted inventories.
- Business capital spending, along with housing, has led the economy out of recession in each of the 10 recoveries since WWII.
- The market will want to focus on shipments and orders for capital

goods, excluding aircraft. These "core" shipments and orders are highly correlated to the business spending portion of GDP.

- One concern in recent weeks has been the still elevated pace of inventory destocking among U.S. companies. Inventories are still likely to be a drag on Q3 GDP growth, but less so than in prior quarters. Still, the market will want to get a sense of where the inventory process was as Q3 2009 ended.

2 If the consensus is correct, the quarterly gain in real GDP will be the first gain in GDP since the second quarter of 2008



Source: Bureau of Economic Analysis, Haver

Q3 Real GDP (Thursday, October 29)

- The consensus of economists is for a 3.2% annualized gain in real GDP between Q2 2009 and Q3 2009 after the 0.7% drop between Q1 2009 and Q2 2009.
- If the consensus is correct, the quarterly gain in real GDP will be the first gain in GDP since the second quarter of 2008. This may help to reinforce the idea among investors, the financial media and the public at large that the recession has in fact ended.
- From the market's perspective, the Q3 GDP data is already "old news" at this point. The market is already looking ahead to Q4 GDP and to 2010, and more importantly, to the pace, and sustainability of the recovery.
- If the Q3 GDP data disappoints, inventories are likely to be the culprit. As mentioned in our preview of the September durable goods report, inventory destocking has not slowed as much as the market expected in Q3. Thus, there is a risk that inventories will again negatively impact GDP growth in Q3. If this is the case, we would view that as a positive sign, setting the stage for more robust growth in Q4 2009 and into 2010.

October Chicago Purchasing Managers Index (Friday, October 30)

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- The market will be looking for signs in this report that business capital spending is poised to help lead the economy out of recession.
- The new orders component, a good predictor of future manufacturing activity in the region, pushed above 50 in August, to 52.5, indicating that manufacturers' orders were expanding for the first time since September 2008. However, the new orders index dipped below 50 in September to 46.3, worrying market participants who are overly concerned about a "double dip" in the economy.
- The export, employment and inventory/supplier delivery components of the report will be closely watched for indications of the strength of the manufacturing economy early in Q4 2009.

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Weekly Market Commentary

October 26, 2009

Back to the Future: Will 2010 Look Like 2004?

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

- While some forecasters are reaching back to the 1930s to find comparisons to the environment the markets are likely to encounter in 2010, we find a more recent comparison to be compelling.
- 2010 is likely to be similar to 2004 in a number of areas, including: earnings growth for S&P 500 companies, the actions by the Federal Reserve, the outcome of the congressional elections, and the performance of the stock and bond markets.

While some forecasters are reaching back to the 1930s to find comparisons to the environment the markets are likely to encounter in 2010, we find a more recent comparison to be compelling. We believe that 2004 could be a useful guide to what may happen in 2010.

The idea that 2010 could be similar to 2004 in many ways may not be as far fetched as it may seem. After all, 2009 looked a lot like 2003. Consider that in both 2003 and 2009:

- The S&P 500 index started the year at about the 900 level and closed in on 1100 as the year wore on.
- The stock market made its low in March in the aftermath of a recession brought on by a bursting bubble in the financial markets.
- Key economic barometers like the Institute for Supply Managements Purchasing Mangers Index (ISM) rose above 50 in the second half of the year signaling the return of expansion in the manufacturing sector.
- The dollar fell and commodity prices rose.

Heck, not only did the charts look similar, the years even sounded the same: the best selling album in 2009 is actually a compilation from 2003, Michael Jackson's Number Ones.

Just as 2009 echoed 2003, 2010 is likely to be similar to 2004 in a number of areas, including: earnings growth for S&P 500 companies, the actions by the Federal Reserve, the outcome of the congressional elections, and the performance of the stock and bond markets.

In 2004, earnings growth for S&P 500 companies rebounded 25%. That is the same gain forecast by the analyst consensus for 2010. This is similar to a typical post-recession profit rebound for S&P 500 companies despite the far deeper than normal trough in profits during the recession. By year-end 2010 the forecast rebound would take S&P 500 earnings only back to about $76 where they were in 2005, which is about 20% below the trailing four quarter earnings peak that took place back in mid-2007. We believe this is reasonable given the mix of drivers in 2010 including very wide profit margins driven by aggressive cost cutting.

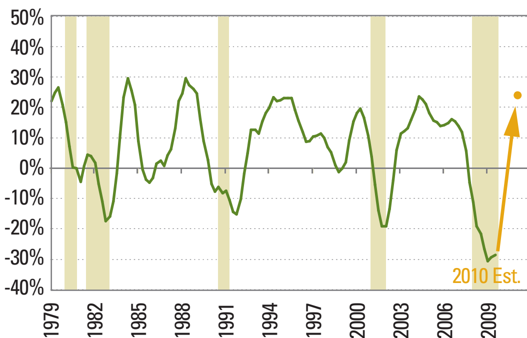
The Federal Reserve began to hike interest rates in mid-2004 as it began to take back the stimulus provided in the aftermath of the bursting of the Tech stock bubble when it cut rates by 550 basis points. Similarly, we expect the Fed will to begin to hike rates in mid-2010 as it begins the process of taking back the stimulus it provided in the aftermath of the housing bubble,

1 Stocks Followed a Similar Path in 2003 and 2009
S&P 500 Index in 2003 and 2009

Source: Bloomberg, LPL Financial

The S&P 500 is an unmanaged index which can not be invested into directly. Past performance is no guarantee of future results.

2 2010 Earnings Rebound Echoes 2004
S&P 500 Operating Earnings Year-Over-Year Change in Four Quarter Sum



Source: Bloomberg, LPL Financial

when it cut rates by 525 basis points. Also, we expect the Fed to abandon use of the phrase "extended period" in their statements as it relates to how long the Fed intends to keep rates low in the early part of 2010, just as they abandoned a similar phrase "considerable period" in early 2004, signaling the rate hikes to come.

In 2004, the Republicans picked up seats in both the House and Senate. Based on polling, Republicans appear likely to pick up at least 15 seats in the House of Representatives and their gains could go as high as 40 seats. In the Senate, given the seats up for election in 2010, a gain of 3-4 seats appears likely. This would eliminate the likelihood of filibuster-proof margins for the Democrats in the Senate and reduce the uncertainty associated with the potential for sweeping changes to legislation.

The bond market, measured by the Barclays Aggregate Bond index, posted a gain of 4%--similar to our outlook for weak returns in the bond market in 2010. The S&P 500 was up 9% in 2004 and ended the year around 1200, similar to our outlook for a mid-to-high single-digit gain. However, there are differences in the pattern of performance in 2004 and what we expect for 2010. The first half of 2004 was weak for stocks and bonds; all the gains were achieved in the second half. That is the opposite of what we expect in 2010 when the impact of Fed rate hikes in the second half of the year may reverse some of the gains achieved by the markets early in 2010.

In a number of ways, 2004 provides similarities to what we expect for 2010. However, every year brings its own unique set of risks and opportunities. We look forward to publishing our comprehensive Outlook for 2010 in about six weeks.

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