Weekly Economic Commentary

November 16, 2009

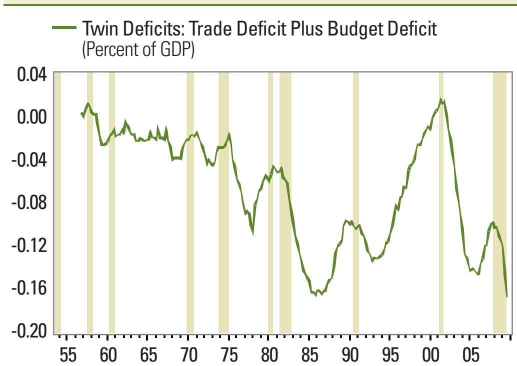
Data Deluge on the Way This Week

John Canally, CFA
Economist
LPL Financial

ECONOMIC CALENDAR

Monday, Nov 16	Wednesday, Nov 18
Retail Sales *Oct*	CPI *Oct*
NY Fed Empire State Mfg *Nov*	Building Permits *Oct*
Business Inventories *Sept*	Housing Starts *Oct*
Tuesday, Nov 17	**Thursday, Nov 19**
PPI *Oct*	Initial Claims *wk 11/14*
Capacity Utilization *Oct*	Philly Fed Index *Nov*
Industrial Production *Oct*	Leading Indicators *Oct*
NAHB Housing Survey *Nov*	

1 Surging Twin Deficits Helping To Drive Dollar Lower



Source: Haver

Last week's rather sparse U.S. economic data calendar highlighted two fundamental factors that are driving the U.S. dollar lower: the twin trade and budget deficits. While a weak report on consumer sentiment in early November was worrisome, data on jobless claims, banks' willingness to lend, another set of robust economic data from China, and the weaker dollar were enough to keep the eight month, 65% rally in the U.S. equity markets on track.

In sharp contrast to last week's data calendar, this week's is chock full of data. Among the reports due out are:

- The first look at manufacturing in November, with the release of the November readings on the Empire State and Philadelphia Fed manufacturing indices.
- Both Consumer and Producer Price Indices for October, which are expected to continue to show headline deflation (falling prices) and mild core inflation on a year-over-year basis.
- Data on the housing market, including homebuilder sentiment, housing starts, and building permit data from October. The numbers are likely to show that the housing market remains in recovery mode, aided by the extension and expansion of the first-time homebuyers tax credit.

As this report was being published, the October retail sales data was released. The retail sales data reveales that core consumer spending—retail sales excluding autos, building materials, and gasoline services stations—got off to a solid start in Q4 2009. Still, discretionary spending on furniture and electronics remains muted heading into the crucial holiday selling season. The sharp downward revision to the September sales data suggests the gain in Q3 real GDP will be revised to around 2.7%, down from the originally reported 3.5% gain.

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.

October Retail Sales (Monday, November 16)

- Overall, retail sales in October is likely to be strong, due to auto sales, which surprised to the upside in October. Consensus calls for a 0.9% gain in retail sales in October.

LPL Financial

- Although the gain in auto sales between September and October was "clean" (i.e. no impact from cash for clunkers", the market will still want to see strength outside of autos (and gasoline), and the consensus there is +0.3% after the +0.4% gain in September.
- Retail sales excluding autos surprised to the upside in both August (better than expected back to school) and September (carryover from better than expected back to school and end of cash for clunkers), which helped to push up non-auto related sales.

The temperature was favorable for shopping in October. It was the third coolest October on record (dating back to 1895).

- Chain store sales posted week-over-week gains in each of the five weeks of October, though the back half of the month was weaker than the front half.
- Consumer sentiment slipped between September and October, while gasoline prices were unchanged.
- The temperature was favorable for shopping in October. It was the third coolest October on record (dating back to 1895).
- However, October 2009 was the rainiest October on record, again, dating back to 1895, but maybe that is good news, as people had to go indoors to the malls to escape the rain!

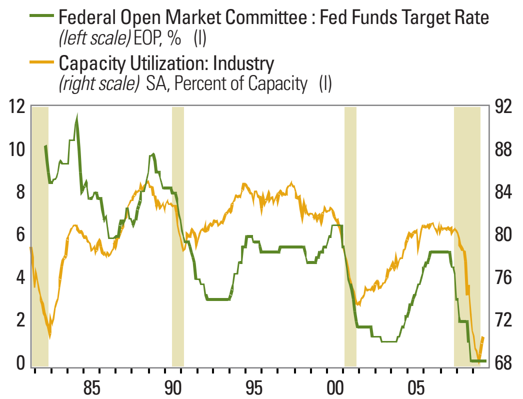
November Empire Manufacturing (Monday, November 16)

- The November Empire State Manufacturing report was released as the Weekly Economic Commentary was being published.
- This report provides the markets with the first look at the health of the manufacturing sector in November.
- The report will help the market gauge what, if any, impacts the weaker dollar (down 15% since mid March 2009) will have on manufacturing, which is heavily dependent on exports.
- The Empire State Manufacturing index pushed above zero in August, indicating that the region's manufacturing output was expanding for the first time since late 2007.
- At 34.5% in October, the Empire State Manufacturing index was at its highest level since 2004.
- The new orders portion of the index has been above zero since July, and the Employment index joined the New Orders index in October. Another above-zero reading for the employment portion of the Empire State Manufacturing index would be welcome news to market participants who remain concerned about the sustainability of the economic recovery.

October Industrial Production/Capacity Utilization (Tuesday, November 17)

- Industrial production is a coincident indicator of the economy.
- 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.

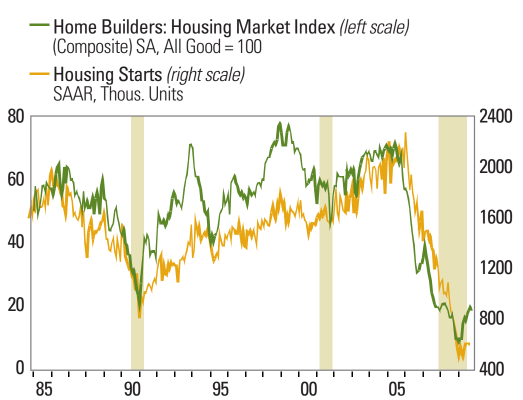
2 The FOMC cited capacity utilization as one of the factors it is watching closely as it decides when and by how much to tighten monetary policy



Source: Haver, Federal Reserve Board

At 18 in October, the NAHB index was up from a low of eight or nine in late 2008/early 2009, but still well below its peak of 72, which was hit in 2005.

3 The market is looking for more signs that the housing market has stabilized in Q4 2009, albeit at a very low level



Source: NAHB, CENSUS, Haver

- Industrial production has posted month-over-month gains in each of the last three months (July, August, and September) and the consensus is looking for another month-over-month gain in October.
- Most market participants dismissed the back-to-back month-over-month gains in industrial production in July and August as an artifact of the ramp up in auto production after the auto bankruptcies of the spring. Nevertheless, the solid gain in industrial production in September, along with the composition of the underlying data IP data, shows that the production gains have spreads beyond autos.
- Auto production, which posted huge month-over-month gains in July, August, and September, is expected to post another gain in October, but the market is likely to be more interested in industrial production outside of the auto sector in September.
- If the consensus is correct, the 13.5% year-over-year drop in IP in June 2009 will mark the low point of industrial production for the cycle. The year-over-year decline in June was the largest in more than 60 years, since July 1946's -16% decline.
- Capacity utilization is expected to tick up for the fourth consecutive month in October after hitting an all time low of 68.3% 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.
- In its most recent statement, the Fed's Federal Open Market Committee (FOMC) cited capacity utilization as one of the factors it is watching closely as it decides when, and by how much, to tighten monetary policy.

November Housing Market Index (Tuesday, November 17)

- The market is looking for a small improvement to 19 in November versus 18 in October.
- 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 October, the NAHB index was up from a low of eight or nine in late 2008/early 2009, but still well below its peak of 72, which was hit in 2005.**
- Mortgage rates were little changed—at just under 5.0%—between early October and early November.
- As we expected, the first time homebuyer tax credit was extended (to mid 2010) and expanded earlier this month.

October Producer Price Index (Tuesday, November 17)

- On a year-over-year basis, the consensus forecast is for more headline deflation on producer prices for finished goods in October, 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.

- 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 rose modestly between September and October, while natural gas prices rose sharply. Wholesale gasoline prices rose sharply (close to 10.0%) between September and October. On balance, energy prices are likely to impart upward pressure on the PPI in October versus September.
- Food prices are also likely to put upward pressure on wholesales prices between September and October.
- CPI and PPI tend to move together over long periods, but month to month, they are not highly correlated.

October Housing Starts (Wednesday, November 18)

The market is looking for more signs that the housing market has stabilized in Q4 2009, albeit at a very low level.

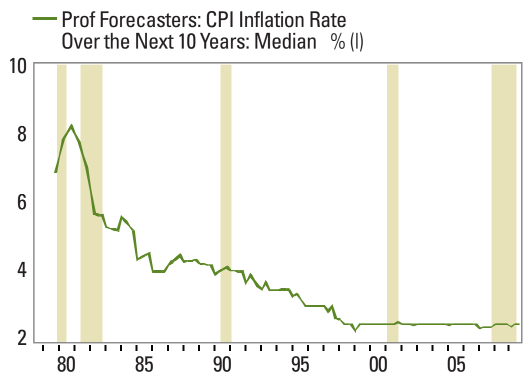
- The market is looking for more signs that the housing market has stabilized in Q4 2009, albeit at a very low level.
- Housing was a drag on GDP growth for 14 consecutive quarters from early 2006 through Q2 2009 but added to GDP growth in Q3 2009, a quarter earlier than we had previously thought.
- 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 than multifamily starts. Aside from a 5% dip between July and August, single-family starts have posted seven non-negative month-over-month readings since February 2009.
- Multi-family starts are very credit market sensitive, and it is 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. Multi family starts surged 21% between July and August, and fell 15% between September and October. A month-over-month rebound in October is likely.
- Weather is sometimes a factor for housing starts. October 2009 was the wettest October on record, and soggy ground can sometimes delay housing start activity. Permits are not weather sensitive and are a good leading indicator of future housing activity.
- The first time homebuyer tax credit has been extended into 2010 and expanded, and should continue to provide support for housing activity over the next six to nine months.

October Leading Economic Indicators (Thursday, November 19)

- Nine of ten components are known prior to the release of the report, so this report should not move markets, but it often does, and gets undue attention in the financial media.
- The LEI has now posted six consecutive month-over-month gains, the longest winning streak for the index since early 2004.

Over time, the LEI is a good predictor of S&P 500 earnings growth, nominal GDP growth and the ISM Index Of Manufacturing.

4 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: Federal Reserve Bank of Philadelphia, Haver

- If the consensus is correct, LEI will rise again (by 0.4%) in October, led by the yield curve, consumer expectations and stock prices.
- Over time, the LEI is a good predictor of S&P 500 earnings growth, nominal GDP growth and the ISM Index Of Manufacturing.

November Philadelphia Fed (Thursday, November 19)

- **Along with the Empire State Manufacturing Index, it is one of the first readings on the manufacturing economy in November.**
- From the onset of the recession in December 2007 through July 2009, the Philadelphia Fed index had been below zero, indicating that manufacturing activity in the Philadelphia area was contracting. The index moved above zero in August, and pushed higher into positive territory in September and October posting the strongest readings since mid 2007.
- Aside from the overall index, and whether or not it can remain above zero for the fourth consecutive month, the 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.

October CPI (Wednesday, November 18)

- On a year-over-year basis, the market expects headline deflation, but inflation on core CPI in October. This pattern has been in place since the beginning of 2009, but will fade in the next few months due mainly to rising energy costs.
- 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 October CPI data is likely to be impacted by modest gains in gasoline prices and natural gas prices. Food prices likely rose between September and October.
- One wildcard in October will be the impact of the end of the "cash for clunkers" program on new vehicle pricing. The end of the cash for clunkers program boosted retail prices for autos and light trucks in September, and another boost is likely in October.

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.

- 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.
- We still think deflation, not inflation is a bigger risk over the remainder of 2009 and in 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.

- The recent drop in the dollar (16% since its recent peak in March 2009) has raised some concerns among market participants and Fed officials alike, that the falling dollar could trigger an uptick in inflation. Over the long term, there is virtually no relationship between movements in the dollar and the CPI inflation rate.

Weekly Market Commentary

November 16, 2009

Third Quarter Earnings Review

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

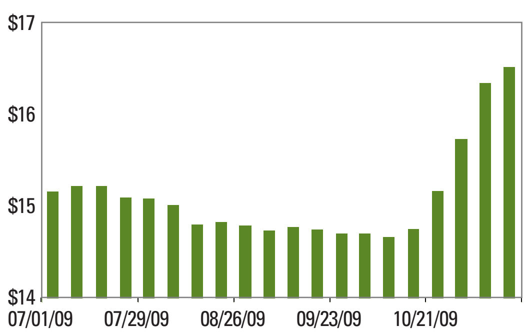
- The third quarter earnings season delivered revenue growth, a record-breaking percentage of companies beating estimates, a rise in the outlook for fourth quarter earnings, and a narrowing in the range of 2010 estimates.
- The aggressive cost cutting in corporate America has led to a profit-driven economic recovery. As earnings rebound, businesses are looking to reinvest in growth. We expect that this renewed pace of business spending will lead to job growth by early next year, helping to sustain the recovery.

At around 1100, the S&P 500 index is in line with its high of the year. Signs that the recovery in the economy and earnings are sustainable are encouraging investors to drive stocks higher. The key sign of sustainability is job growth, and the key to job growth is profit growth.

In our Third Quarter Earnings Preview published on October 5, we stated that we were looking for four trends during the upcoming earnings-reporting season: revenue growth, a record-breaking percentage of companies beating estimates, a rise in the outlook for fourth quarter earnings, and a narrowing in the range of 2010 estimates. With nearly all of the results in for the third quarter, we are pleased to see the season delivered on all four trends.

1. We expected to see better top-line growth in the third quarter compared to the second quarter. While down about 10% from a year ago, revenues did rise sequentially from the second quarter. 58% of companies reported sales above analyst expectations.
2. We believed analysts' estimates for the quarter were too low given the improvement in our Current Conditions Index relative to the falling estimates for earnings during the quarter. Therefore, we hoped to see most companies exceed expectations in the third quarter by another record-breaking margin similar to the second quarter when over 72% of companies exceeded the average consensus estimate. As it turns out, an astounding 80% of companies exceeded estimates in the third quarter—a record that may stand for a long time. The consensus S&P 500 earnings per share expectation for the third quarter went from \$14.65 at the start of the reporting season, to \$16.51 after most companies had reported. The strongest results relative to expectations were in the Information Technology, Consumer Discretionary, and Materials sectors. In aggregate, S&P 500 companies posted about a 25% annualized increase in earnings from the second to the third quarter.
3. We hoped to see the analyst expectation rise for the fourth quarter. The consensus estimate for fourth quarter earnings was \$16.27 before the reporting season got underway—it is now \$16.96.
4. We were less concerned about estimates for 2010 moving up; we instead hoped to see increased confidence in the 25% consensus gain. We measure this by a narrowing of the range between the analysts' high and low estimates for 2010. While still wide by historical standards, the range did narrow by about \$2 per share as the low-end moved up by \$2.50, and the high-end rose by \$0.50. The consensus earnings per

1 Q3 Earnings Ended Up Much Better Than Analysts Expected
Analyst Consensus for Third Quarter S&P 500 Earnings per Share



Source: LPL Financial, Factset Research Systems share estimate for 2010 is about $76–$77. Earnings are expected to be strongest in the first half of 2010, an easy comparisons to early 2009, with the first quarter expected to post a growth rate of 38%.

The rebound in corporate earnings is very important to the economic recovery. Conditions for consumers are poor as evidenced by surveys, job losses, and weak income growth. However, corporate profits have accelerated at a record-breaking pace since the fourth quarter of 2008. While consumers face a heavy debt burden, businesses generally have good balance sheets with low debt and high cash balances. Profits have been boosted by cost cutting on everything including employment, advertising, capital spending, travel, and inventories. The aggressive cost cutting in corporate America has led to a profit-driven economic recovery. As earnings rebound, businesses are looking to reinvest in growth. We expect this renewed pace of business spending to lead to job growth by early next year, helping to sustain the recovery in the economy and markets into early 2010.