Weekly Economic Commentary

March 15, 2010

Dour U.S. Consumer Keeps on Spending

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ECONOMIC CALENDAR

Monday, Mar 15
NY Fed Empire State Mfg
Mar

Capacity Utilization
Feb

Industrial Production
Feb

NAHB Housing Survey
Mar

Tuesday, Mar 16
Import Price Index
Feb

FOMC Decision
Feb

Housing Starts
Feb

Wednesday, Mar 17
PPI
Feb

Thursday, Mar 18
Current Account
Q4

CPI
Feb

Initial Claims
wk 03/13

Philly Fed Index
Mar

Leading Indicators
Feb

Highlights

The vast majority of last week's U.S. economic reports support our view that the U.S. economy remains on track for a sustainable recovery in 2010.

The latest batch of Chinese economic data is likely to prompt more policy tightening in China in the coming weeks.

The week ahead is likely to be dominated by the outcome of, and discussion about, the Federal Reserve's Federal Open Market Committee (FOMC) meeting.

What We Make of the Key Reports Last Week:

The vast majority of last week's U.S. economic reports support our view that the U.S economy remains on track for a sustainable recovery in 2010. The key report of the week was the better-than-expected February retail sales data, but data on jobless claims, merchandise trade, mortgage applications, consumers' balance sheets, and business inventories also helped to make the case that the U.S. economy is continuing along the path toward a sustainable recovery.

It was not all good news last week, however, as the vulnerability of the economy was evident in several reports, including:

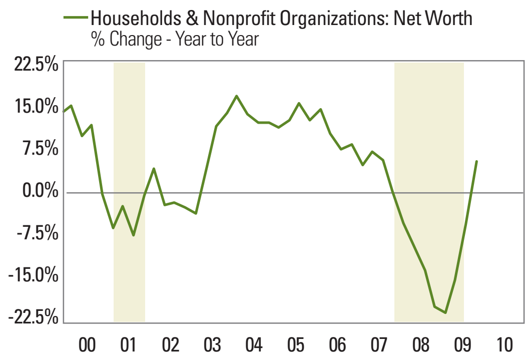
- Another weak reading on small business sentiment in February,
- A dip in consumer sentiment in early March, and
- The whopping $221 billion budget deficit racked up by the federal government in February.

In addition to the economic news last week, the market was bracing for this week's FOMC meeting. News reports suggest that President Obama will select Janet Yellen to replace Don Kohn as Vice Chairman of the Federal Reserve Board of Governors. Yellen, who is currently the President of the San Francisco Fed, is not a voting member of the FOMC, but would be a permanent voting member as Vice Chair of the Board. This is crucial, because Yellen is a well-known monetary policy "dove", who would lean to the "full employment" side of the Fed's dual mandate of full employment and low and stable prices.

Yellen was President Clinton's top economist (as Chairwoman of the Council of Economic Advisors) and was a Fed Governor in the mid-1990s. Traditionally, the Vice Chair of the Federal Reserve Board serves as the Administration's voice on the FOMC and, in this instance, being a "dove" Yellen would likely support the idea that rates should remain low for an extended period to help bolster the labor market and the overall economy.

Consumer spending continued to confound the experts in February, as retail sales posted a surprising gain versus expectations of a small month-over-month drop in sales. The gain in retail sales in February—despite the severe winter storms that hit the northeast corridor of the U.S. during the month—suggests that real consumer spending will again be a plus for overall GDP growth in Q1 2010. Early in the economic recovery, spending was mainly confined to items that consumers needed to buy. In February, and over the past two or three months, however, spending has broadened out to include discretionary items like electronics, sporting goods, and furniture.

1 Rebound in Household Net Worth Helps to Explain Resilient Consumer Spending



Source: Federal Reserve Board, Haver 03/15/10
Shaded areas represent recessions.

One of the key drivers of the better-than-expected consumer spending data has been the recovery in consumer net worth over the past year. Consumer net worth—defined as household assets (cars, houses, financial assets including stocks) less household liabilities (mortgage debt, credit card debt, consumer loan debt)—posted another quarter-over-quarter gain in Q4 2009, and has now posted three consecutive quarterly gains. The increase in consumer net worth is a result of higher asset prices (equity prices up more than 70% from their lows and home prices up 5–7%), combined with a drop in liabilities. While some of the drop in liabilities is certainly involuntary (consumers walking away from mortgages, consumer loans, and credit card debt), some of the big drop ($1.5 trillion) in household liabilities since early 2008 reflects a healthy, voluntary paring down of debt by consumers.

Among the bad news, last week was the February 2010 federal budget deficit. The $221 billion deficit recorded in February 2010 suggests that the budget is still feeling the effects of the recession. In fact, the $221 billion budget deficit in February 2010 was larger than any annual budget deficit recorded in the United States in any year up until 1991!

Fiscal year to date (October 2009 through February 2010), the budget deficit is running at $651.6 billion compared with the $589.8 billion deficit in the first five months of fiscal 2009. Thus, remarkably, the deficit has deteriorated by $61.8 billion from last year's record deficit.

The good news is that federal government receipts posted a 23% gain in February 2010 versus February 2009, marking the first time since April 2009 that has occurred. The bad news is that in the first five months of the fiscal year, federal government receipts are still down 7% versus the comparable period a year ago.

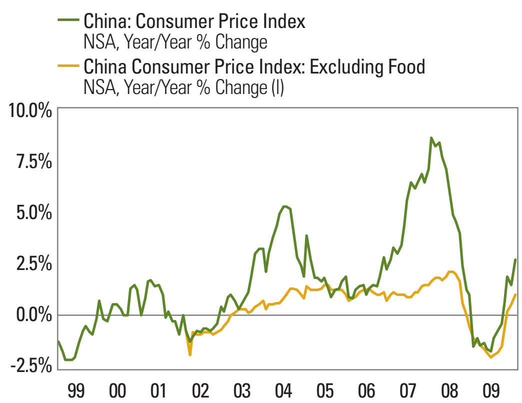
Worse still, is the fact that the spending on "three headed monster" (Social Security, Medicare and Medicaid) rose 8% in the first five months of fiscal year 2010 versus the same period in fiscal year 2009. Nominal Gross Domestic Product (GDP) has risen by less than 1% over the past year, which means that spending on the "three headed monster" continues to outstrip economic growth, which is unsustainable, even in the short run.

Some very difficult decisions need to be made in the next several years regarding these programs (such as possibly raising taxes, cutting benefits, or some combination of the two), but the risk is that Congress will wait until there is a crisis to address the issue.

China's Economic Data for February Points to More Policy Tightening Ahead

The latest batch of Chinese economic data for February is likely to prompt more policy tightening in China in the coming weeks, as the Chinese authorities try to head off a surge in unwanted inflation. The February trade data showed that Chinese exports surged a stunning 46% year-over-year in February 2010, while imports posted an equally stunning 45% year-over-year gain. While the timing of the Chinese Lunar New Year in 2009 versus 2010 may have impacted the year-over-year figures, the surge in Chinese exports shows just how bad global trade got in early 2009 and how far it has come since.

2 Accelerating Inflation in China Likely to Prompt More Tightening From Chinese Authorities



Source: China National Bureau of Statistics, Haver 03/15/10

China also reported the closely watched loan growth numbers for February last week. Bank lending grew by just 700 billion Yuan in February, well below the 1.39 trillion in January and, most importantly, 35% below the 1.07 trillion in new loans created during the loan binge in February 2009. At the same time, M2 money supply growth slowed in February, to 25.5% year-over-year from 26% in January, which indicates stabilization.

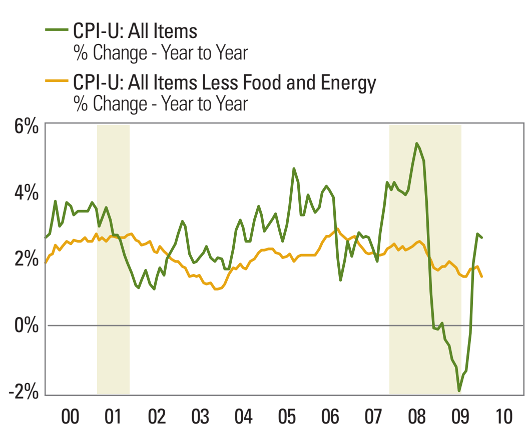
The key economic report released in China last week was probably the Consumer Price Index report. The report for February showed that inflation in China accelerated to 2.7% year-over-year growth in February versus expectations of a 2.5% year-over-year gain. China's CPI rose by 1.5% year-over-year in January 2010. Although the February data may have been distorted by the timing of the Chinese Lunar New Year in 2010 versus 2009, Chinese authorities will not be able to ignore accelerating inflation, stronger-than-expected loan growth, retail sales, and money supply growth for much longer. Having already embarked on a regime of monetary policy tightening in late 2009, more tightening is likely in China sooner rather than later to clamp down on the unwanted rise in inflation.

Markets remain hopeful that Chinese authorities can bring the huge Chinese economy in for a "soft landing" (a mild deceleration in economic growth to a more sustainable pace) in 2010, but will be quick to punish any investments related to China if the soft landing is too "hard", or too "soft". Please keep in mind that this is a key crosswind, or risk to our economic outlook, that we detailed in our *2010 Market Outlook: From Tailwinds to Headwinds*.

Our View on the Key Reports and Events of the Coming Week:

The week ahead is likely to be dominated by the outcome of, and discussion about, the Federal Reserve's Federal Open Market Committee (FOMC) meeting. However, key reports on inflation, housing, and the manufacturing sector will also fight for the market's attention.

3 Overall Inflation Likely to Accelerate Over the Next Few Months, But Core Inflation Likely to Decelerate



Source: Bureau of Labor Statistics, Haver 03/15/10
Shaded areas represent recessions.

FOMC:

- The market expects that the FOMC will retain the key "extended period" language in the FOMC statement, but leave interest rates unchanged.
- The FOMC is likely to comment on the end of its quantitative easing (purchases of Mortgage-Backed Securities) program in the statement—the program ends on March 31, 2010—and will likely acknowledge that the economy has improved since the last FOMC meeting in January, but not by enough to warrant immediate policy tightening.
- In addition, the FOMC is likely to continue to make a distinction between ending its various emergency liquidity programs, draining its balance sheet, and raising its policy rate—either the Fed Funds rate or the interest rate on excess reserves.

Inflation:

- The market has been sensitive in recent weeks about signs of inflation emerging the United States.
- The February Consumer Price (CPI) and Producer Price (PPI) indices are likely to continue to show accelerating overall (headline) inflation, but decelerating core (excluding food and energy) inflation in February.
- The divergence in headline and core inflation is the result of the big swings in energy prices since mid-2008. Energy prices plunged between mid-2008 and the first few months of 2009, as the global economy slowed sharply. This led to headline deflation (falling prices) for both CPI and PPI.
- As 2009 unfolded, the economy recovered, driving energy prices higher, although nowhere near as high as the mid-2008 peak.
- For the next few months (through late spring and early summer), headline inflation will likely continue to accelerate, as oil prices (close to 80 dollars), are still well ahead of oil prices in the first several months of 2009. Oil prices averaged around $50 dollars per barrel in the first five months of 2009.
- Long-term Inflation expectations remain low, and well contained, and have not moved at all since the Fed began its quantitative easing program in March 2009.

Weekly Market Commentary

March 15, 2010

Made in America

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Highlights

- Last week provided evidence that export growth may be becoming a focus of investors.
- The United States is the world's largest manufacturer and ranks among the top three nations in terms of exports.
- Exports matter to investors because S&P 500 companies derive about 40% of their revenue from foreign sources and global markets.

Last Thursday, the U.S. trade data was reported for the month of January reflecting a brief pause in an improving trend of export growth. On the same day, the stock market, measured by the S&P 500, moved up to a new 17-month high. The market reaction was fitting since export growth is a key driver of the economy and profits for S&P 500 companies. In fact, exports accounted for 2.3 percentage points of the 5.9 percent fourth quarter Gross Domestic Product (GDP) growth rate, this marked the biggest contribution to U.S. GDP in 13 years. Exports of American-made goods now matter more than ever to investors.

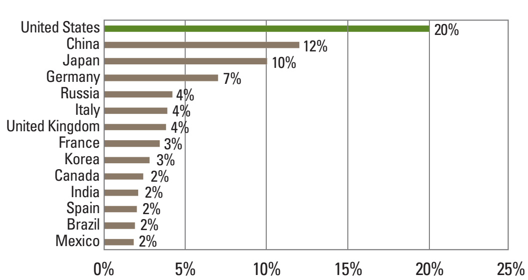
Also, last week, President Obama took action to support his goal of doubling U.S. exports within five years by signing an executive order to ''marshal the full resources of the United States government behind American businesses that sell their goods and services abroad" under his National Export Initiative. The export strategy will strive to improve access to financing for domestic exporters and help them promote their products overseas particularly in rapidly growing emerging nations such as China, Brazil, and India.

Some pessimists argue that America can't be a leading exporter since we don't make anything here anymore. However, they are wrong on both counts. It may come as a surprise to some, but the United States is the world's biggest manufacturer. In fact, the United States is the largest manufacturer by a long shot, making up 20% of the world's total manufacturing output. The United States manufactures almost twice as much as China, double what Japan makes, and almost three times what is produced in Germany. [Chart1]

It may come as a surprise to some, but the United States is the world's biggest manufacturer, making up 20% of the world's total manufacturing output.

If that seems a little hard to believe then think of it this way: exports are measured based on the total value of what is produced, not merely the quantity. High-value items made in the United States and exported to customers in other countries include machine tools, medical equipment, computer software, pharmaceuticals, commercial airplanes, defense products, and satellites among many other products. It is the value of these exports that matters more than the quantity. After all, one U.S. built airliner is worth a lot of Chinese made toys. The United States is a leader, ranking among the top three nations in terms of exports, alongside China and Germany. [Chart 2]

1 United States is Top Manufacturer
Percent of Global Manufacturing Output in 2009



Source: United Nations, LPL Financial as of 03/12/10

American-made goods have become more attractive for overseas buyers following a decline in the dollar last year. It has fallen about 11% against the currencies of the biggest U.S. trading partners from a five-year high reached on March 9, 2009. The dollar decline gives U.S. companies a competitive advantage in global markets.

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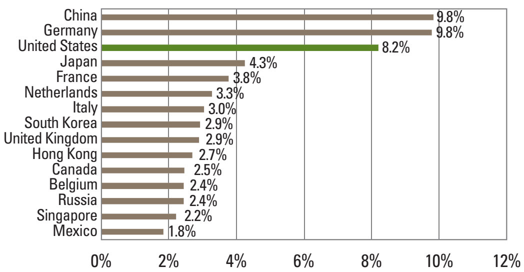
2 United States is Among Top Exporters
Percent of 2009 Global Exports by Country



Source: Central Intelligence Agency, LPL Financial as of 03/12/10

Even better, the United States sells more to emerging than developed countries. According to the Department of Commerce, Emerging Markets now make up a little over 50% of U.S. gross exports. These end markets are growing much more rapidly than domestic or foreign developed markets. Developed markets like the Eurozone and Japan are struggling with stalled recoveries, as fourth quarter annualized Gross Domestic Product (GDP) in the Eurozone was a mere 0.1% and in Japan was only 0.9%. Much stronger rates of economic growth can be found among emerging market nations such as China, Brazil, and India.

Exports matter to investors because S&P 500 companies derive about 40% of their revenue from foreign sources and global markets. Sectors with a high proportion of export-driven sales include Information Technology, Industrials, Energy, and Materials. We continue to favor these sectors of the stock market.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific aThe 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.

Stock investing involves risk including loss of principal.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Industrials Sector: Companies whose businesses: Manufacture and distribute capital goods, including aerospace and defense, construction, engineering, and building products, electrical equipment, and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Telecommunications Services: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Materials Sector: Companies that engage in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Information Technology: Companies that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services. Technology hardware & equipment include manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Health Care: Companies in two main industry groups: Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oilrigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Consumer Staples: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages, and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.