Weekly Economic Commentary

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Unintended Consequences of Low Rates

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Highlights

Lower rates have hurt consumer incomes and consumer spending

However, companies' increased dividend payments to consumers have provided a slight offset

Lower consumer energy prices have put more spending power in consumer wallets

Economic Calendar

Monday, January 30
Personal Consumption Expenditures
Dec

Personal Income
Dec

Tuesday, January 31
Employment Cost Index
Q4

Chicago PMA
Jan

Consumer Confidence
Jan

Wednesday, February 1
ADP Employment Change
Jan

Challenger Layoff Announcements
Jan

ISM Manufacturing
Jan

Construction Spending
Dec

Domestic Light Vehicle Sales
Jan

Thursday, February 2
Initial Claims
wk 1/28

Productivity
Q4

Chain Store Sales
Jan

Friday, February 3
Private Sector Payrolls
Jan

Unemployment Rate
Jan

Nonfarm Payrolls
Jan

ISM – Nonmanufacturing Sector
Jan

As is typical in the first week of a new month, this week (January 30–February 3) is packed with key economic releases in the United States. Employment, manufacturing, consumer spending and consumer confidence will compete with another flare-up of the European fiscal woes and key manufacturing data in China. In addition, a number of Federal Reserve (Fed) officials are scheduled to make public appearances this week, including Fed Chairman Ben Bernanke, who will deliver testimony to the House Budget Committee on Thursday, February 2.

Impact of Energy Prices, Interest Rates and Dividends on Personal Income and Spending

Last week (January 23–27) the news that real gross domestic product (GDP) grew at just 2.8% in the fourth quarter of 2011 was a disappointment relative to expectations of a 3.0% gain. Consumer spending, which accounts for more than two-thirds of GDP, was a major contributor to that disappointing result, rising at just 2.0% between the third and fourth quarters of 2011. Market participants were looking for a slightly more robust gain of 2.4%.

The causes of tepid consumer spending in the economic recovery that began in mid-2009 are well documented and include (but are not limited to):

- Sluggish labor market, underemployment and very modest income growth
- Large overhang of consumer mortgage and consumer installment debt
- Increased economic uncertainty leading to increased savings
- Weak housing market
- Tighter lending standards for consumer installment and mortgage debt

Consumer Income Growth Improving Modestly, but Employment Picture Needs to Change

Over time, consumer income growth is the best determinate of consumer spending growth. In 2011, personal incomes (which include income from wages and salaries, government transfer payments, rental income and income of small business owners) rose 4.7%, a stronger pace of growth than seen in 2010 (+3.7%), and a complete turnaround from 2009, when personal income fell 4.3%. However, over the past 50 years, personal income growth has averaged 7% per year. During the middle of the last economic recovery (2001–2007), personal income growth averaged close to

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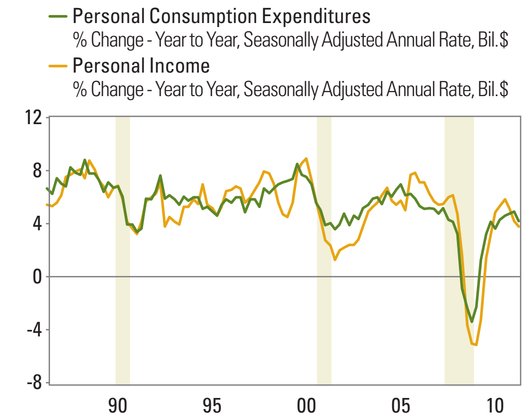
1 Over Time, Spending By Consumers Tracks Consumers' Incomes



Source: Bureau of Economic Analysis, Haver Analytics 01/30/12

(Shaded areas indicate recession)

6%. The subpar growth in personal income in the current recovery relative to history and to prior recoveries is a direct result of the high unemployment rate (8.5% in December 2011) and the high underemployment rate (workers who are working part time, discouraged workers, etc.). Both the unemployment rate and the underemployment rate need to decline further in order to see a higher pace of income (and spending) growth in 2012 and beyond.

Some of the factors weighing on spending have improved in recent quarters, and some of the factors that have restrained incomes have eased as well. Consumers have spent the past three years spending a little, saving a little and paying down debt, reducing the record high debt-to-income levels seen at the worst of the financial crisis. However, debt burdens (as measured by total debt to income) remain high by historical standards. The housing market likely bottomed out nationally in early 2009, and has been recovering (albeit very slowly) since then. This has helped some consumers feel "wealthier," but in general, the tepid housing market remains a key impediment to consumer spending. Banks' lending standards for businesses and consumers seeking loans have loosened over the past several years, but it remains difficult for many consumers to borrow at low rates to finance a home or some other type of consumer good.

Lower Energy Prices Putting Dollars in Consumer Wallets

On the spending side, although the rise in consumer energy prices crimped economic growth in the first half of 2011, lower consumer energy prices since their peak in mid-2008 have helped to put more spending power in consumer wallets. In mid-2008, consumers were spending $713 billion per year on consumer energy products. In December 2011, the spend rate was just $621 billion. That is nearly $100 billion in additional spending power for consumers relative to the peak in energy prices in mid-2008. Warmer weather in much of the nation in December 2011 helped to hold down energy costs, and that warm weather extended into January 2012, which should leave some additional dollars in consumers' pockets in early 2012.

Consumers Are Experiencing Lower Interest Payments and Less Interest Income

However, the big drop in interest rates (engineered by the Fed at the short end of the yield curve and the result of flight to safety, a lack of inflation and sluggish growth at the long end of the curve) cuts both ways. In general, consumers are net recipients of interest income (from savings accounts, certificates of deposit, Treasury notes and bills, etc.). As 2011 ended, consumers were receiving $975 billion in interest income and paying about $685 billion in interest to their creditors (credit cards, banks, mortgages, etc.). Both figures have dropped dramatically since the peak in 2008, when consumers were on the receiving end of over $1.4 trillion in interest income while paying out around $950 billion in interest. Thus, as 2011 ended, consumers were net recipients of around $300 billion in interest payments, down from close to $500 billion in mid-2008.

At his press conference after last week's Federal Open Market Committee (FOMC) meeting, Fed Chairman Ben Bernanke acknowledged that low

Lower Rates Have Led To Lower Consumer Interest Payments, But Also To Less Interest Income

	Q4 2012	2008/2009
Interest Paid by Consumers	$684 Billion	$950 Billion
Interest Received by Consumers	$976 Billion	$1.4 Trillion
Dividends Received by Consumers	$813 Billion	$562 Billion
Total Net Interest Plus Dividends	$1.1 Trillion	$1.3 Trillion
Consumer Spending on Energy Goods	$621 Billion	$713 Billion

Source: Bureau of Economic Analysis 01/30/12 interest rates were impacting savers, but pointed out that "savers in our economy are dependent on a healthy economy in order to get adequate returns. In particular, people own stocks and corporate bonds and other securities as well as say, Treasury securities. And if our economy is in really bad shape, then they are not going to get good returns on those investments."

Comeback of Dividend Payments by Corporations Provides Modest Offset

To Chairman Bernanke's point, a modest offset to this hit to income for consumers is the comeback of divided payments by corporations since mid-2008. Dividends paid by corporations to individuals are now almost back to their all-time peak set in early 2008, and have increased by more than $225 billion since their low in mid-2009. Adding dividends to the net interest received, we find that consumers' net interest income plus dividends at the end of 2012 was $1.1 trillion, about $200 billion lower than at the peak in late 2008.

On balance then, lower rates have hurt consumer incomes and consumer spending, but Fed policies that help to stimulate growth helped companies to achieve and sustain profitability and increase their dividend payments to consumers, providing a slight offset. Lower consumer energy prices have also helped to boost consumers' disposable incomes slightly, leaving more jobs and more incomes as the key driver of consumer spending in the period ahead. ■

LPL Financial Research 2012 Forecasts

- GDP 2%*
- Federal Funds Rate 0%^
- Private Payrolls +200K/mo.†

Please see our *2012 Outlook* for more details on LPL Financial Research forecasts.

IMPORTANT DISCLOSURES

The 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.

* Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

^ Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

† Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn't include:

- general government employees
- private household employees
- employees of nonprofit organizations that provide assistance to individuals
- farm employees

The unemployment rate is the percentage of the total labor force that is unemployed but actively seeking employment and willing to work.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Consumer Price Inflations is the retail price increase as measured by a consumer price index (CPI).

Stock investing involves risk including loss of principal.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

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Yield Curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.