Weekly Economic Commentary

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Trade Offs

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Highlights

The mild recession in Europe that we expect (and is unfolding) may not have as big an impact on the U.S. economy or U.S. corporations' sales and profits as is widely feared.

Trade flows are sizable between Europe and emerging markets, but they are relatively small between Europe and the U.S.

Economic Calendar

Tuesday, February 14
Import Price Index
Jan

NFIB Small Business Optimism Index
Jan

Retail Sales
Jan

Business Inventories
Dec

Wednesday, February 15
NY Fed Empire State Mfg
Feb

Capacity Utilization
Jan

Industrial Production
Jan

NAHB Housing Survey
Feb

FOMC Minutes

Thursday, February 16
Initial Claims
wk 2/11

Core PPI
Jan

PPI
Jan

Building Permits
Jan

Housing Starts
Jan

Philadelphia Fed Index
Feb

Friday, February 17
CPI
Jan

Leading Indicators
Jan

With the fourth quarter earnings reporting season wrapping up for corporate America, financial market participants will likely be focused on this week's full docket of United States economic data and the latest flare-up in the European debt debacle in Greece. European debt markets outside of Greece will likely be in focus this week, as Italy, the Netherlands, France and Spain are slated to hold debt auctions. Central banks in Japan, Chile, and Sweden meet to set rates this week, with Sweden's Riksbank expected to cut rates for a second time in two months after tightening monetary policy in 2010 and 2011. While the Federal Reserve's next policy meeting isn't until mid-March, several Fed officials are scheduled to make public appearances this week, including Fed Chairman Ben Bernanke.

All Eyes on Greece and Full Slate of U.S. Economic Data in the Week Ahead

Greece dominated the headlines last week in the vacuum created by a lack of United States economic data releases and only a scattering of corporate earnings reports for the fourth quarter of 2011. As we prepared this report for publication, the latest flare-up in the European fiscal mess that has dominated the headlines for nearly two years appears to have subsided (for now) after the Greek parliament agreed to another round of severe budget cuts in exchange for another round of loans from the international community led by the International Monetary Fund (IMF), the European Union and the European Central Bank. We continue to expect a mild recession in Europe in 2012 amid ongoing fiscal flare-ups similar to the one witnessed in Greece over the past week or so. This week's debt auctions in several key European nations will be another test for markets wary of (and perhaps weary of) another debt-related market disruption in Europe.

Looking ahead, Bernanke will deliver his semiannual monetary policy report to Congress on February 29, the same day the Fed will release its Beige Book, a qualitative assessment of economic and banking conditions in each of the 12 Federal Reserve districts (Boston, Kansas City, Philadelphia, etc.) The next FOMC meeting is on March 13. Markets this week will try to reconcile the recent set of stronger than expected economic reports (especially the very robust January employment report) in the United States with the Fed's aggressively loose monetary policy stance.

On Tap This Week

The full slate of economic data this week in the United States includes reports on the consumer (retail sales for January), manufacturing (Empire State and Philly Fed manufacturing indices for February, industrial production and capacity utilization for January), housing (homebuilder sentiment for February as well as housing starts and building permits for January) and inflation (January readings on both consumer prices and producer prices). The Fed will be back on the market's radar this week as well, with the release of January 24–25 Federal Open Market Committee (FOMC) meeting minutes due out, along with speeches from Fed Chairman Bernanke, and several regional Federal Reserve bank presidents from both the dovish (favoring the full employment side of the Fed's dual mandate) and hawkish (favoring the low and stable inflation side of the Fed's dual mandate) wing of the FOMC.

Trade Offs and Trade Flows

At his latest press conference (January 25, 2012) Fed Chairman Bernanke answered a question about whether or not the Fed had doubts about the recent run of stronger than expected economic reports in the United States by noting: "...we continue to see headwinds emanating from Europe, coming from the slowing global economy and some other factors as well. So, you know, we are obviously hoping that the strength we saw in the fourth quarter and in recent data will continue into 2012, but we're going to continue to monitor that situation. I don't think we're ready to declare that we've entered a new, stronger phase at this point; we'll continue to look at the data."

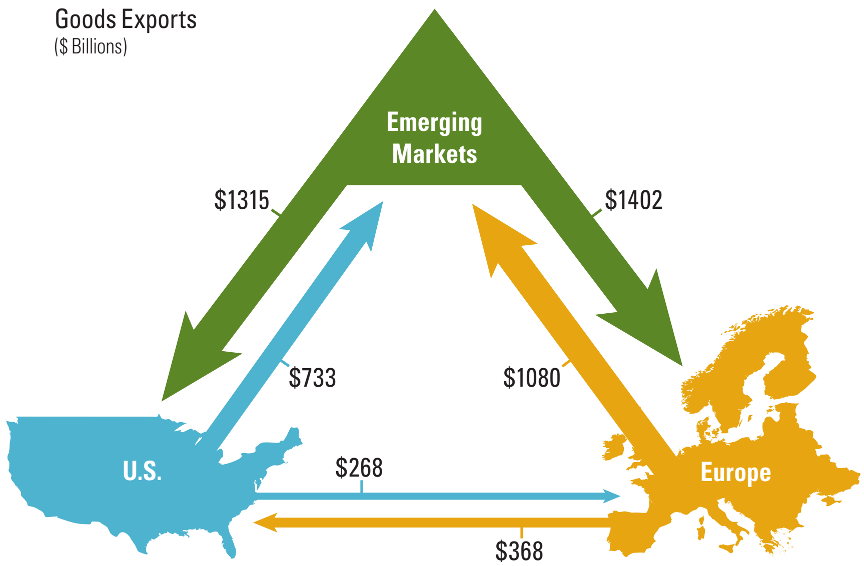
We concur with Fed Chairman Bernanke that Europe remains a risk to the outlook for economic growth in the United States. However, in our view, the risk to the United States economy from Europe is concentrated on the financial side—a collapse of a European financial institution similar to the collapse of Lehman in the fall of 2008, which would likely trigger a freeze of global credit and another sharp contraction in the global economy—rather than on the strictly "economic" side of the ledger via fewer U.S. exports to Europe. The risks of such a collapse have diminished, thanks to bold policy actions by policymakers in late 2011, which included:

- A commitment to closer fiscal and monetary integration within Europe (The "Grand Plan") hammered out in October 2011;
- The introduction of coordinated swap lines by global central banks in late November 2011; and
- The European Central Bank's (ECB) offering of an unlimited amount of cash (Long Term Refinancing Operation or LTRO) to financial institutions for three years in late December 2011.

But risks of this sort remain, as markets were reminded last week by the latest drama in Greece. There is still more work to do, as European nations face many monetary, fiscal and political hurdles in 2012. The ECB's next LTRO is on February 29, and Italy, Spain, France, and the Netherlands issue debt this week. But, should a systemically important European financial institution trigger a global credit crunch, a recession in the United States is quite likely.

However, the mild recession that we expect (and is currently unfolding) in Europe in 2012 may not have as big an impact on the United States economy or on the sales and profits of U.S. corporations as is widely feared. As noted in Chart 1, United States' trade with Europe is relatively small. In 2011, we shipped just $268 billion worth of goods to Europe, equal to about 2% of the United States' gross domestic product (GDP). In that same period, the United States shipped more than $700 billion in goods to fast-growing emerging markets, a figure equal to nearly 6% of U.S. GDP. In 2011, 50% of our exports headed to fast-growing emerging markets, while just 15–20% of our goods exports head to Europe.

1 The Temple of Trade Flows Shows Emerging Markets' Peak Position



Source: US Department of Census and Eurostat 02/13/2012

Europe = All 27 Countries in the EU 27: Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany (originally West Germany), Great Britain, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden.

Emerging Markets: All non-developed economies outside of the United States and the EU 27.

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The trade flows between Europe and the emerging markets are also of interest, as market participants weigh the possibility of a "hard landing" in China. What stands out to us is just how enormous the trade of goods is between Europe and emerging markets. The size of these flows may cut both ways however, as investors asses the risks of a slowdown in Europe on the global economy. In 2010 (the latest full year of data available) the emerging market economies shipped $1.4 trillion worth of goods to Europe, an amount that dwarfs the size of the trade flows between the United States and Europe. At the same time, Europe sent $1.1 trillion in goods to fast-growing emerging markets, a figure that represents 60% of Europe's overall exports. Europe's ability to send 60% of its exports to fast-growing emerging markets will help to offset some of the weakness in consumer, business and government spending within Europe in 2012.

Of course the slowdown in Europe will crimp demand for emerging market economies' goods, which will, at the margin, slow growth in that region. But, on balance strong domestic demand for consumer goods, housing and investment, robust government spending in many emerging market economies, decent growth in emerging markets' "other" major export destination (the United States) and central banks cutting rates should allow emerging markets to easily weather the mild recession in Europe. As in the United States, however, a collapse of a European financial institution and a freeze up of global credit and trade would likely also send many emerging markets on a course towards a "hard landing." ■

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.

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