Weekly Economic Commentary

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Beige Book Window on Main Street

Economy Still Growing, but Uncertainty Returns

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Highlights

Beige Book heralds the return of uncertainty.

Federal Reserve (Fed) Chairman Ben Bernake still open to more quantitative easing despite recent press reports.

Households still digging out of net worth destruction brought on by housing bust and financial crisis.

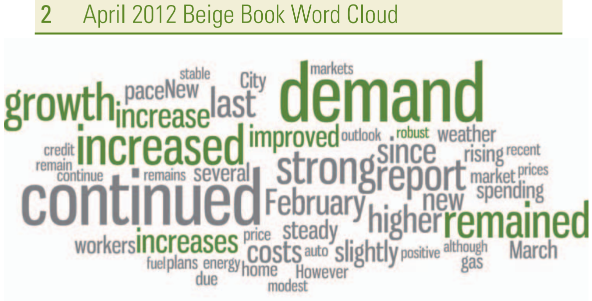
Please see the LPL Financial Research Weekly Calendar on page 3

The Federal Reserve (Fed) released its Beige Book—one of our favorite economic reports—last Wednesday, June 6, 2012. Along with testimony by Fed Chairman Ben Bernanke on Thursday, June 7, the report provided market participants with valuable insights into the economy and the future of the Fed's monetary policy actions. A separate report prepared by the Fed and released last week, the Flow of Funds report for the first quarter of 2012, provided a detailed, although not particularly timely window into the health of consumer balance sheets in early 2012.

1 June 2012 Beige Book Word Cloud

Source: The Federal Reserve Beige Book, LPL Financial 06/11/12

2 April 2012 Beige Book Word Cloud



Source: The Federal Reserve Beige Book, LPL Financial 04/16/12

The nearby word clouds are dominated by words describing the tone of the economy at the time the Beige Books were published. Below are some observations on the current Beige Book (released on June 6, 2012) and the Beige Book released in early April 2012.

- The economy is still expanding at a modest pace.
- Themes that dominated the Beige Books last summer and fall—weak confidence, European concerns, and high uncertainty—which had nearly disappeared from the Beige Books released in early 2012, are starting to reappear amidst the renewed turmoil in Europe. Importantly, while the word "uncertain" appeared 15 times in the June 2012 Beige Book (up from 10 mentions in April and just nine in February 2012), the word "uncertain" appeared in the Beige Book 26 times as recently

as the October 2011 Beige Book, after peaking at 38 mentions in the September 2011 Beige Book.

- Warm weather almost certainly made an impact on economic activity in the late winter of 2011 and early spring of 2012, and the economy is now experiencing "payback" as weather patterns return to normal.
- Rising fuel prices, which had been a major concern in the economy and in the Beige Book early this year, as they were in the spring and summer of 2011, are now much less of a concern. In most cases, the mentions of "gasoline" or "fuel" in the most recent Beige Book were to note that prices had declined recently and were below year-ago levels.
- Supply chain disruptions from the Japanese earthquake and tsunami and flooding in Thailand, which were frequently mentioned in the Beige Books from mid-2011 through early 2012, have now largely dissipated.

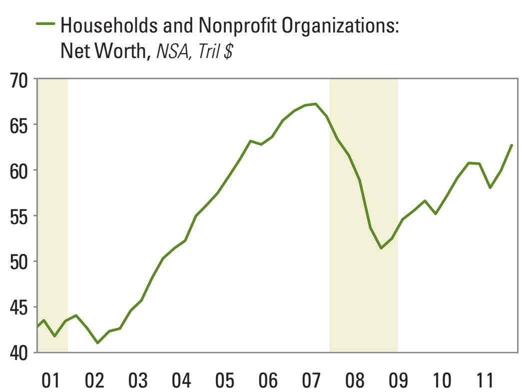
On balance, the latest Beige Book depicts an economy that has not changed much since the last Beige Book, with words like "growth," "continued," "strong," "demand," and "increase" dominating both clouds. In short, the details of the June 2012 Beige Book do support the idea that some of the recent strength in the economic data may have been weather-related, which suggests that we could continue to see "payback" in the form of softer data over the remainder of the spring as the weather normalizes. The pace of economic growth, job growth, wage inflation, and overall prices hinted at in the Beige Book also support further policy action from the Federal Reserve as soon as the June 19–20 FOMC meeting.

In our view, Bernanke did little to dissuade the market from thinking the Fed would act on June 20, and comments from the parade of Fed officials during the week of June 4–8.

Fed to Replace "Operation Twist" or Fed to Twist Again

Reports in the financial media on Thursday, June 7 attributed that day's big reversal (from solid gains in the morning to declines by the end of the session) in equities to the lack of commitment from Fed Chairman Ben Bernanke (in testimony before the Joint Economic Committee [JEC] of Congress) to another round of quantitative easing. In our view, Bernanke did little to dissuade the market from thinking the Fed would act on June 20, and comments from the parade of Fed officials during the week of June 4–8 also support our view that the Fed will act to replace "Operation Twist" (which ends on June 30, 2012) with some type of monetary stimulus at the conclusion of the June 19–20 FOMC meeting.

3 Household Net Worth Has Increased in Nine of the Past 12 Quarters, but Is Still Below the All-Time High Hit Five Years Ago



Source: Federal Reserve Board, Haver Analytics 06/11/12

Net Worth Flowing Back to Households

The Fed's Flow of Funds data revealed that household net worth (household assets—including real estate, cars, cash, appliances, mutual funds, pension funds, Treasury notes, other financial assets, etc.—less household liabilities—consumer installment debt, mortgages, student loans, etc.) rose to $62.9 trillion by the end of the first quarter of 2012, up more than $3 trillion from a year earlier, but still about $4 trillion below the all-time peak hit in mid-2007, before the real estate collapse and the onset of the Great Recession. A rising stock market, stability in home prices, and debt pay down (both voluntary and involuntary) have helped to push household net worth higher in recent quarters. Household net worth has now increased in nine of the 12 quarters since the stock market bottomed in the first quarter of 2009.

Although equity markets have declined so far in the second quarter, bond markets have moved higher, consumers have continued to pay down debt, and home prices have moved higher nationwide. This suggests that household net worth will increase again in the second quarter, but will still remain short of the all-time peak set in mid-2007. Household net worth is one of the best predictors of current and future consumer spending which, in turn, accounts for two-thirds of Gross Domestic Product (GDP). ■

Some Color on the Beige Book

As we noted in the June 4, 2012 *Weekly Economic Commentary*, the Beige Book compiles qualitative observations made by community bankers and business owners about economic (labor market, prices, wages, housing, nonresidential construction, tourism, manufacturing) and banking (loan demand, loan quality, lending conditions) conditions in each of the 12 Fed districts (Boston, New York, Philadelphia, Kansas City, etc.). This local color that makes up each Beige Book is compiled by one of the 12 regional Federal Reserve districts on a rotating basis—the report is much more "Main Street" than "Wall Street" focused. It provides an excellent window into economic activity around the nation using plain, everyday language. The report is prepared eight times a year ahead of each of the eight Federal Open Market Committee (FOMC) meetings. The next FOMC meeting is June 19–20, 2012.

The previous "word clouds" or "text clouds," which are a visual format useful for quickly perceiving the most important words in a speech, text, report, or other transcript, are culled from the Fed's Beige Books published last week and in early April 2012. In general, the more often a word appears in a speech, text, report or other transcript, the larger that word appears in the word cloud. The word clouds show the top 50 words for each of the two Beige Books mentioned above. Similar words are grouped together and common words like "the," "and," "a," and "is" are excluded, as are words that appear frequently in all Beige Books (Federal, district, loan, level, activity, sales, conditions, firms, etc.).

LPL Financial Research Weekly Calendar

2012	U.S. Data	Fed	Global Notables
11 June		Lockhart* Williams * Pianalto* Evans	**China: CPI (May)** China: PPI (May) China: Retail Sales (May) China: Exports (May) China: New Loan Growth (May) **China: Money Supply (May)**
12 June	Small Business Optimism (May) Treasury Statement (May)		Indonesia: Central Bank Meeting **Germany: Merkel speech on debt crisis** World Bank releases semiannual economic forecast
13 June	PPI (May) Retail Sales (May)		Thailand: Central Bank Meeting Iceland: Central Bank Meeting New Zealand: Central Bank Meeting
14 June	**CPI (May)** **Initial Claims (6/9)**		**Eurozone: CPI (May)** Germany: Bond Auction **Italy: Bond Auction** Switzerland: Central Bank Meeting Philippines: Central Bank Meeting Chile: Central Bank Meeting **Japan: Central Bank Meeting** **OPEC Meeting**
15 Jun	**Empire State Mfg. Index (Jun)** Industrial Production (May) Consumer Sentiment (1H Jun) Deadline for California Budget to be Passed		**Greece: Elections (6/17)** **French Provincial Elections (6/17)** Russia: Central Bank Meeting

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

* Voting members of the Federal Open Market Committee (FOMC)

China CPI: In total there are about 600 "national items" used for calculating the all-China CPI. The list of items is revised annually for representativeness based on purchases reported in the household surveys. The number of items can change from year to year, but rarely by more than 10 in any given year.

Chinese Purchasing Managers Index: The PMI includes a package of indices to measure manufacturing sector performance. A reading above 50 percent indicates economic expansion, while that below 50 percent indicates contraction.

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

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.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasure securities).

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.