Weekly Economic Commentary

September 24, 2012

The Inflation Situation

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Highlights

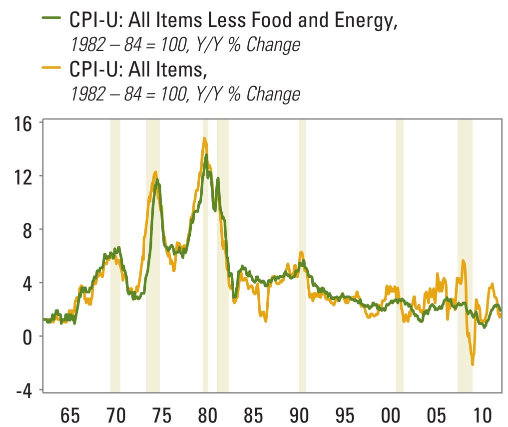
We believe the U.S. economic backdrop does not support a sustained uptick in inflation anytime soon.

However, food and energy prices may begin to push overall inflation readings modestly higher over the next few months.

Our review of the Federal Reserve's (Fed) Beige Book suggests that the typical preconditions for inflation do not appear to be currently in place.

Please see the LPL Financial Research Weekly Calendar on page 3

1 Inflation Has Been Low and Stable for Past 30 Years After 15-Year Surge From Mid-60s through Early 80s



Source: Bureau of Labor Statistics, Haver Analytics 09/24/12

Shaded areas indicate recession.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

While inflation and inflation expectations in the United States remain in check, the Federal Reserve's (Fed) decision to pursue another round of bond purchases in the open market (quantitative easing) has generated some discussion of inflation among financial market participants and the media. Our view remains that the economic backdrop does not support a sustained uptick in inflation anytime soon, although higher food and energy prices—as a result of the drought and recent geopolitical unrest—may push overall inflation readings modestly higher over the next several months. Finally, we examine some snippets from the Fed's Beige Book—a qualitative assessment of economic, business, and banking conditions in each of the 12 Fed districts—relating to the inflation situation and compare them to similar comments from the Beige Books in the 1970s, when the pace of inflation surged, seemingly out of nowhere [please see page 5].

Inflation is a sustained, broad-based increase in the general level of prices. As noted in Figure 1, inflation, the rate of change in the general level of prices as measured by the consumer price index (CPI), has been trending lower for more than 30 years. Inflation excluding food and energy (core inflation) has followed a similar path. Forecasts for inflation from the Fed, the consensus of economists and market participants, and the Congressional Budget Office all suggest ongoing tame inflation over the next several years and over the long term [Figure 2]. Some of the factors responsible for this well-established trend are:

- **Low and stable inflation.** Simply put, low and stable inflation fosters low and stable inflation. At around 1.0% in the mid-1960s, inflation surged over the following 15–20 years, peaking at nearly 15% in 1980. Since then, inflation has moved sharply lower, and stayed there, with only a few blips higher over the past three decades.
- **Low and stable inflation expectations.** The public's views (the general public and professional forecasters) on inflation are often cited by Fed Chairman Ben Bernanke and other Fed officials as one of the key weapons against inflation. Both measures have been low and stable for the past 13 years, and have been moving lower for 30 years [Figure 3].
- **Fed's inflation-fighting credibility.** In the early 1970s, the Fed had no experience with or credibility from the public in keeping inflation low and stable. Indeed, the Fed generally kept rates lower than they should have been as the economy grew above its long-term potential in the mid-to-late 1960s and early 1970s. By the end of the decade, the public had lost

2 Tame Inflation Expected Over the Next Few Years and the Long Term, Percent

	2012	2013	2014	Long Term*
Federal Reserve	1.7	1.8	1.8	2.0
Market Consensus	2.0	2.0	2.3	2.4
CBO	2.1	1.6	2.1	2.2

Source: Federal Reserve, Bloomberg, Congressional Budget Office, Comsumer Price Index (CPI) forcasts 09/24/12

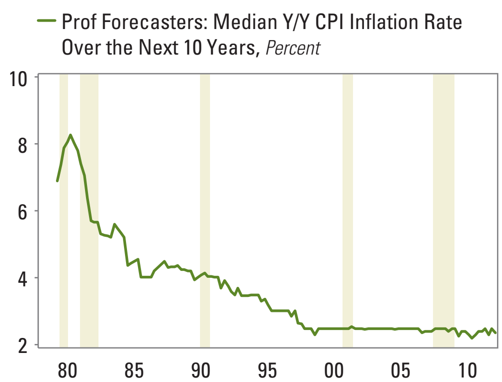
*Long Term:

For the Fed forecasts, long-term projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy.

For the Market Consensus forecasts, long-term forecasts are from the Philadelphia Fed's Survey of Professional Forecasters forecast for inflation over the next 10 years.

For the CBO, long-term forecasts are the CPI inflation forecast over the years 2012 – 2022.

3 Low and Stable Inflation Expectations Are a Key Factor in Keeping Inflation Rates Low and Stable



Source: Federal Reserve Bank of Philadelphia, Haver Analytics 09/24/12

Shaded areas indicate recession.

faith in the Fed, but the last 30 years has seen the Fed regain the public's trust, often by "taking away the punchbowl" (i.e., raising rates) before the party got out of hand and inflation became evident.

- **Globalization.** When inflation was surging in the mid-1960s through the early 1980s, the U.S. economy was relatively insular. Prices (and in some cases, wages) were made and set within our borders, and trade accounted for only a small portion of our gross domestic product (GDP). Today, the United States has a much more open economy, and there is now plenty of overseas competition in both wages and prices. In general, the push toward globalization has put downward pressure on prices.
- **Spare capacity in product and labor markets.** Related to the bullet above, slack in product and labor markets is one of the key drivers of low inflation today, despite the successive rounds of quantitative easing from the Fed and other central banks around the world. High unemployment rates here in the United States and in Europe, along with very high levels of unused factory and office space around the globe, make it very difficult to pass along higher input prices to end users. In contrast, as inflation surged higher in the 1960s and 1970s, there was very little, if any, spare capacity, and the unemployment rate was abnormally low.
- **Mobile workforce.** In the United States, wages and salaries account for about two-thirds of business costs. In the 1960s and 70s, low unemployment, the "closed" U.S. economy, and a less mobile workforce pushed wages sharply higher. Wages remain the most important factor in business costs and in determining the overall pace of inflation. Today, wage inflation is muted, as 30 years of globalization have led to wages being partially set overseas, where overall employment, not the pay scale, is often more important.
- **Declining union membership.** At the start of the decade-and a-half surge in inflation in the mid-1960s, nearly 25% of the nation's workforce was unionized. This led to a high portion of the overall wage structure in the United States being tied to cost of living adjustments (COLAs). COLAs tied wage increases to increases in the overall price level of goods and services in the economy. Thus, when inflation accelerated in the 1960s and 1970s, that acceleration was automatically factored back into wages, and the wage price spiral was on. Today, less than 10% of the workforce is unionized, and COLAs are few and far between. In short, the link between rising inflation that caused a lot of inflationary damage in the 1970s is broken.
- **Economy growing below long-term potential.** For the past five years, the U.S. economy has been growing more slowly than the long-term potential growth rate of the economy, pushing the "output gap" wider [Figure 4]. The more negative the output gap, the less upward pressure on capacity constraints in the economy and, in turn, the less upward pressure on wages and prices. In sharp contrast, note that in the 11-year span between 1963 and 1974, the output gap was positive in all but a handful of quarters, meaning that the economy was growing above its long-term potential for more than a decade. During this time, the Fed

LPL Financial Research Weekly Calendar

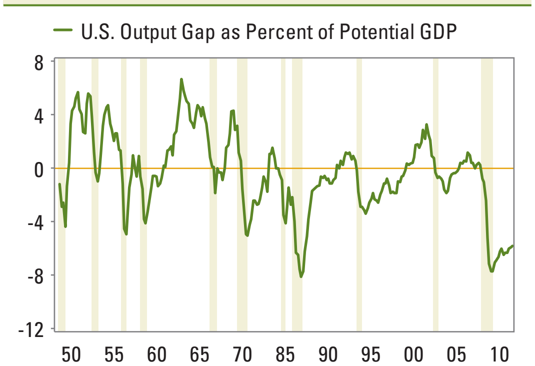
2012	U.S. Data	Fed	Global Notables
24 Sep	Dallas Fed Mfg. Index (Sep) Chicago Fed National Activity Index (Aug)	Williams * Plosser	**Germany: IFO Index (Sep)**
25 Sep	**Case-Shiller Home Price Index (Jul)** Consumer Confidence (Sep) Richmond Fed Index (Sep)	Plosser	
26 Sep	**New Home Sales (Aug)**	Evans	Germany: Bond Auction
27 Sep	Durable Goods Orders and Shipments (Aug) **Initial Claims (9/15)** GDP (Q2) **Pending Home Sales (Aug)** Kansas City Fed Mfg. Index (Sep)		Spain: Cabinet votes on 2013 budget **Italy: Bond Auction**
28 Sep	Personal Income and Spending (Aug) Chicago Area Purchasing Managers Index (Sep) Consumer Sentiment (Sep)		**Spain: Bank stress test results released** **China: PMI (Sep)**

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)

4 The Seeds for the High and Rising Inflation in the 1960s Were Sown in the Mid-1960s as the Fed Kept Policy Accommodative Against a Backdrop of a Surging Economy



Source: Congressional Budget Office, Haver Analytics 09/24/12

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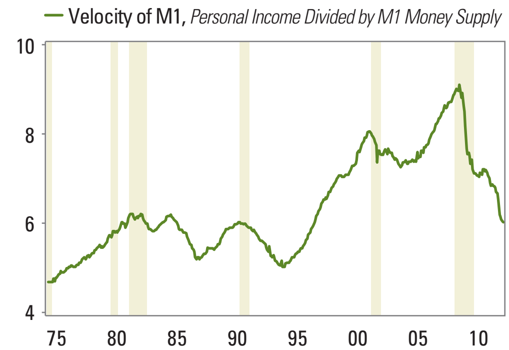
made things worse by keeping monetary policy relatively loose, adding fuel to the already inflationary environment.

Many factors have the potential to push inflation higher. Those include, but are not limited to:

- **Cash on banks' balance sheets.** As a result of successive rounds of QE from the Fed over the past four years, more than $1.6 trillion is sitting on banks' balance sheets waiting to be lent out to consumers and businesses. This is an enormous amount of money, and if the transmission mechanism between the Fed's monetary policy and the overall economy was functioning properly, this would be a huge concern. However, the transmission mechanism is not functioning properly and the velocity of money, or how quickly the cash on banks' balance sheets moves through the economy, has dropped dramatically over the past four years [Figure 5]. If velocity does reaccelerate, inflation could move from banks' balance sheets to the real economy as well. We continue to monitor this closely.
- **Recent run-up in food and energy prices.** The U.S. drought and the rise in geopolitical tensions have pushed up wholesale prices of food and energy products. Those price increases should begin to show up in headline consumer inflation in the coming months, pushing the CPI higher. However, economy-wide, commodity prices account for only

5 Financial Crisis in 2007–2009 Damaged Monetary Policy Transmission Mechanism, and Velocity of Money Has Plummeted



Source: Haver Analytics 09/24/12

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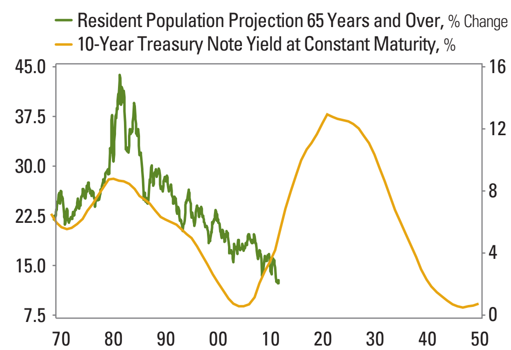
6 Demographics May Play a Part in Pushing Inflation—and Interest Rates—Higher in the Coming Decades



Source: Haver Analytics, Federal Reserve 04/16/12

10% of business' input costs, and with near-record high profit margins, firms have the ability to absorb some of these higher input costs. The key, however, is that the COLA/wage price spiral paradigm that ruled in the 1960s and 1970s is basically nonexistent in today's economy, suggesting that higher input costs are unlikely to be passed through to higher inflation in any significant way. In addition, a rise in the prices of some goods and services tends to lead to less demand and a shift to less expensive substitutes. This effect, along with sluggish income growth may further mute any pass-through of higher food and energy prices to other parts of the economy.

- **Demographics.** As the population ages, the mix of goods and services purchased by the overall economy shifts as well. In general, prices for goods consumed by younger population cohorts are stable or falling. Of course, tuition for college is rising rapidly, but prices for big screen televisions, computers, hand-held mobile devices, software, etc. are not surging, and in some cases are falling when adjusted for quality. On the other hand, the cost of health care, a major component of older consumers' budgets is rising rapidly, and those price increases are pressuring insurance rates at the individual level, and putting tremendous strain on the Federal budget outlook as well [Figure 6].

On balance, while several factors are poised to push inflation higher, far more factors are working today to push inflation lower. In addition, virtually none of the main causes of the inflationary 1970s—an economy running above its long-term potential growth rate, rising inflation expectations, high union membership and COLA-induced wage price spiral, and/or a "closed" U.S. economy—are in place today, making the inflation situation today far different than at the start of the last inflation surge in the early 1970s. ■

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.

Beige Book: Today Vs. 40 Years Ago

The excerpts below are from the most recent Beige Book, and from several Beige Books 40 years ago, in the fall of 1972. Today, the inflation rate is under 2.0% as the economy continues to recover slowly from the financial crisis and Great Recession of 2007–2009. In 1972, the inflation rate had decelerated to under 3.0%, after running as high as 6% in the late 1960s, as the economy continued to struggle with "spare capacity" and labor shortages.

THEN

September 13, 1972: "Reports from some Banks indicated that **concern** over **inflation remains strong.** A number of New York's directors cited the inflationary implications of the large and widening Federal budget and of the heavy calendar of wage negotiations in 1973."

September 13, 1972: "A survey by Minneapolis found a significant increase in local firms reporting **plant capacity** as "less than needed"."

October 11, 1972: "Labor market conditions generally continue to show improvement and some Districts are experiencing **labor shortages**. Businessmen and economists expressed concern over the possibility of renewed inflationary pressures in 1973, and over what public policy measures might be taken to counteract those pressures."

NOW

August 29, 2012: "Most Districts reported that the **selling prices** of manufacturing and retail products were **largely stable**. By exception, several Districts noted concerns about rising agricultural commodity prices, and Richmond mentioned a small uptick in retail prices. Hiring was said to be modest across the Districts, and **wage pressures** were characterized as **contained**."

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

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).

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

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Tracking #1-103084 (Exp. 09/13)

Weekly Market Commentary

September 24, 2012

Global Profit Recession

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Highlights

This quarter is shaping up to be the worst quarter for corporate profits in three years when the recovery was just getting underway, as the United States joins Europe and China in experiencing falling profits.

The currently sluggish U.S. economy, European recession, and slowing Chinese economic growth—not to mention the threat of the fiscal cliff—all suggest that this is probably not the last quarter of disappointing earnings growth.

This quarter we will be watching three factors to help us gauge the extent of the earnings slowdown: the stall in manufacturing, the peaking of profit margins, and the impact of share buybacks.

In the absence of further policy action in Washington or Europe following recent major events, attention this week turns from macroeconomic events to microeconomic as the earnings pre-announcement season heats up. As the third quarter of 2012 draws to a close, companies provide guidance as to how their earnings are shaping up for the quarter. Not only will companies provide guidance this week about how they fared during the quarter, but also, 11 S&P 500 companies will actually report their earnings for the third quarter.

While policy events such as moves by the Federal Reserve (Fed) or leaders in Europe garner the attention of traders and move the markets from week to week, it is actually the long-term growth of earnings that drive the stock market over longer periods of time that matters most to investors. Illustrating the importance of earnings growth even during the policy-dominated—some might even say distorted—markets of the past few years, is the fact that earnings growth and stock market performance has been the same since the recovery began. The trailing-four-quarter total earnings per share for S&P 500 companies has risen 82% since the first quarter of 2009, as economic momentum began to improve. During the same time period since the end of the first quarter of 2009, the S&P 500 index has gained 83%. Earnings drive stocks, but the momentum is now stalling.

This quarter is shaping up to be the worst quarter for corporate profits in three years when the recovery was just getting underway. In the third quarter of 2012, earnings are expected to have fallen -2% from a year ago and from the prior quarter. The United States is joining profit declines expected around the world, including Europe (-22%) and China (-1%). So far, 112 S&P 500 companies have issued guidance for the third quarter with a ratio of negative-to-positive guidance of 4.3 to 1. This 4.3 ratio is the weakest showing in over a decade and well above the average of 2.3. As an example, last week FedEx, a global economic barometer, lowered its earnings guidance and warned about “the slowdown in the global economy and global trade.”

The economic backdrop to the quarter’s revenues and profits has been soft as the recent retail sales and industrial production data for August 2012 attest. The rise in total spending outpacing income growth suggests an unsustainable pace of spending confirmed by August retail sales advancing just 0.1%, when excluding auto and gasoline sales. In fact, sales in clothing, general merchandise, and electronics stores posted outright declines.

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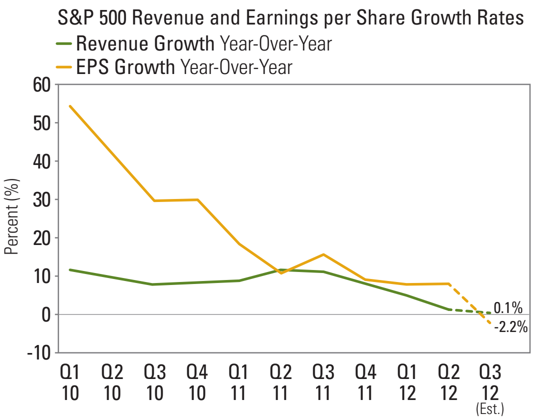
1 Both Revenue and Earnings Slump



Source: LPL Financial, FactSet 09/24/12

The S&P 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Businesses are also having it tough. Industrial production fell 1.2% month-over-month in August, the biggest monthly drop since March 2009.

While the first drop in profits in three years is worrisome by itself, it is not just this quarter that is of concern to investors, it is the outlook for earnings in future quarters, as well.

Despite the poor showing likely in the third quarter, our long-held outlook for 7%* earnings growth in 2012 appears to be on track relative to the year-ago consensus estimate by Wall Street analysts of 15%. The Wall Street analyst consensus for the profit growth of S&P 500 companies in 2013 is 12%. The currently sluggish and slowing U.S. economy, the ongoing European recession, and slowing Chinese economic growth all weighing on revenue growth combined with the diminishing impact of expanding profit margins to lift earnings beyond revenue growth [Figure 1]—not to mention the threat of the fiscal cliff—all suggest that this estimate is again likely too high. Low-to-mid single-digit earnings growth is probably the best we can hope for in 2013, while outright declines are not out of the question.

The three factors we will be watching most closely among the earnings news this quarter are:

- **Stalling manufacturing** – We will be watching to see the impact on profits the global stall in manufacturing activity has on the economically sensitive Materials and Energy sectors.
- **Peaking profit margins** – Examining how broadly and in which sectors profits can exceed the pace of revenue growth can tell us how much further profit margins may have to expand and help drive earnings per share.
- **Shrinking share count** – To what extent and in what sectors share buybacks allow for positive earnings per share growth despite shrinking net income.

These factors will help us gauge the extent of the earnings slowdown and its trajectory for coming quarters, crucial for stock market investors.

* LPL Financial Research provided this range based on our earnings per share growth for 2012, and a modest expansion in the price-to-earnings ratio.

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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.

The company names mentioned herein are for information and illustrative purposes only. This isn't an endorsement of their products or services no an offer to buy or sell such products. Every investor has different goals and objectives, which should be discussed with their financial advisor.

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