Weekly Economic Commentary

October 1, 2012

Are You Better Off?

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Highlights

It is not just current income, but also accumulated wealth in assets that determine whether someone is better off.

Savers are still struggling to gain traction.

Household wealth has surged lately with homes and equities rebounding.

Please see the LPL Financial Research Weekly Calendar on page 3

It was one of the most famous moments in the history of presidential debates. About a week before the 1980 election, Ronald Reagan asked the nation, *"…are you better off than you were four years ago?"* With the first presidential debate between President Barack Obama and Mitt Romney scheduled for this Wednesday, October 3, 2012, the theme of "are you better off" is beginning to re-emerge in the media and the marketplace.

Candidate Reagan specifically cited the unemployment rate and inflation in the question he posed. Incomes, benefits, and pay increases are important to feeling better off and have been lackluster. However, there are other ways to measure "better off" than inflation and jobs. This week, we focus on the balance sheet for U.S. households—a snapshot of a household's assets (e.g., real estate, vehicle, computers, appliances, cash, investments in equities, real estate, fixed income instruments) and their liabilities (e.g., mortgages, credit cards, personal loans). The nearby figures detail the composition of household balance sheets, and what percentage of households hold each asset.

1 The Great Recession—and Its Aftermath—Has Put a Dent in Consumers' Balance Sheets

	Q4 2007	Q2 2012	% of Households That Own the Asset (as of Q2 2012)
Interest-Bearing Assets & Cash	$7.5	$8.7	92.5
Real Estate	$20.8	$16.9	67.3
Durable Goods	$4.5	$4.8	86.7
Equities	$20.9	$19.1	49.9
Fixed Income	$5.0	$4.8	1.6
Ownership Interest in Private Business	$9.3	$7.7	13.3
Total Household Assets	$80.3	$76.1	N/A

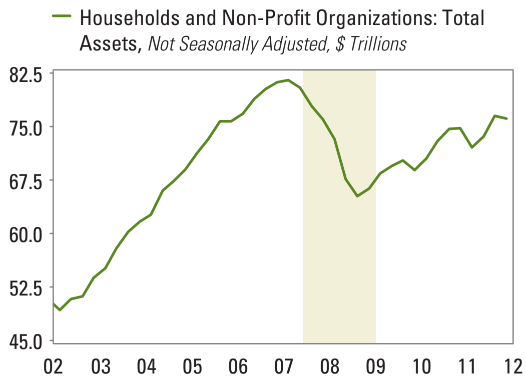
Source: Federal Reserve, Survey of Consumer Finances Reports 10/01/12

Household Balance Sheet

Savers Under Stress

For example, savers are clearly not better off than they were in 2008. About 10–15% of household assets are held in interest-bearing accounts. Overall, households had $8.7 trillion in interest-bearing assets at the end of the second quarter of 2012, up more than $1 trillion from pre-crisis levels (late 2007). The increase in savings reflects the fear and uncertainty among households, as they continue to struggle to recover from the Great Recession. Yields on money market funds were close to 4.0% in late 2007, but moved to under 2.5% by the end of 2008, as the Federal Reserve (Fed) cut rates in response the emerging financial crisis. Yields are now around 0.50%. Similarly, the yields on a five-year certificate of deposit were close to 4.0% in late 2007, moved down to 3.0% by late 2008, and are now sitting at about 1.50%. In 2008, households received $1.4 trillion in interest payments. Over the past 12 months, households in aggregate earned just under $1 trillion in interest payments. Clearly, savers are not better off than they were four years ago.

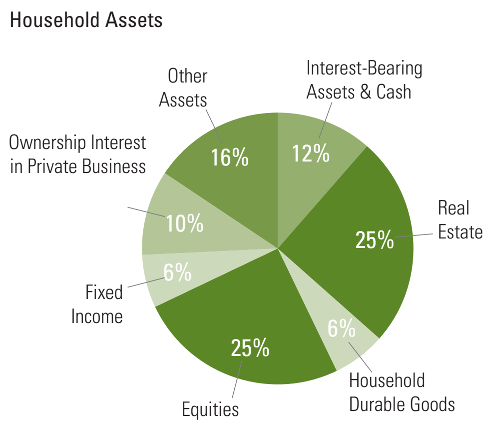
2 Led by the Equity Market and Recent Stability in Home Prices, the Asset Side of Households' Balance Sheets Have Recovered Nearly All the Ground Lost During the Great Recession



Source: Federal Reserve, Haver Analytics 10/01/12

Shaded areas indicate recession.

3 Composition of Household Assets: Q2 2012



Source: Federal Reserve 10/01/12

Real Estate Making Modest Gains

According to the Fed's Flow of Funds report, household real estate holdings totaled $17 trillion at the end of the second quarter of 2012, and represented 25% of assets. Real estate, along with holdings of equities, is the largest single asset owned by households across the country. The average household's heavy exposure to real estate made the severe 2007–2009 Great Recession, which was largely the result of the collapse in the real estate market, even worse. The slow recovery in housing values has made the subsequent modest economic recovery seem even less inspiring.

At $17 trillion, the value of all the housing stock in the nation is still down nearly $6 trillion, or 25%, from the housing peak in 2006. Most of that 25% drop in home values took place in 2007 through the early part of 2009, and since then values have been running sideways, at best. However, as the elections approach, home values have increased in each of the past two quarters (the first and second quarters of 2012). The home price data available thus far for the third quarter suggest that another increase is likely. Despite the modest gains this year, home values are the same today as they were in late 2004, so the housing bust and modest recovery has left homeowners worse off than they were. The good news is that prices now finally seem to be moving in the right direction for households' largest single asset.

Stocks Surging After Steep Drop

Households own stocks in several forms: directly in brokerage accounts, 401k plans, and other retirement accounts, and indirectly in mutual funds, exchanged-traded funds (ETFs), closed-end funds, and in public and private pension funds. At the peak of the stock market in 2007, the total value of households' stock holdings was nearly $23 trillion. By early 2009, the financial crisis and Great Recession reduced the market value of stocks held by households to just $11 trillion—a devastating 52% drop. That crushing blow to equity holdings wiped out six years' worth of gains for household stock values, dropping them back to levels last seen in early 2003. This drop was only partially offset by gains in the value of household bond holdings, which moved from just under $4.9 trillion in 2007 to $5.3 trillion in early 2009.

Since then, stock values have surged, and by the second quarter of 2012 (the latest data available in the Flow of Funds accounts) households' stock holdings were worth $19 trillion. In the recently completed third quarter of 2012, the broad stock market, as measured by the Russell 3000 Index, rose another 6%, pushing the value of household's equity holdings to over $20 trillion. At $20 trillion, stock market values are still 10% below their 2007 peak, but up more than 80% from the early 2009 lows.

Other Assets Mixed

At nearly $8 trillion at the end of the second quarter of 2012, ownership interests in private businesses account for another 10% of household assets. Asset values in this area of consumers' balance sheets also peaked in mid-2007, and fell sharply in 2008 and early 2009, but not quite as sharply as publicly traded stocks. From mid-2007 through mid-2009, the value of

LPL Financial Research Weekly Calendar

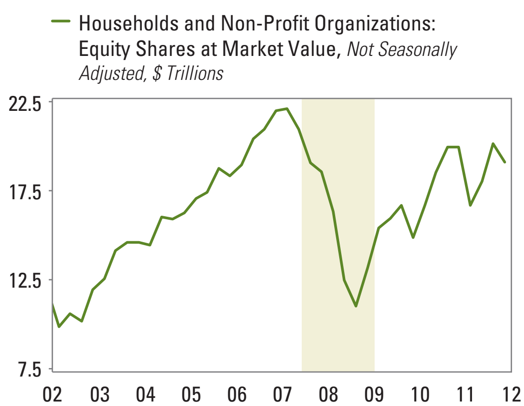
2012	U.S. Data	Fed	Global Notables
1 Oct	**ISM (Sep)** Construction Spending (Aug) Fiscal Year 2013 Begins	Williams* **Bernanke***	**China: PMI (Sep)** **Japan: Tankan (Q3)** **Eurozone: PMI (Sep)**
2 Oct	Vehicle Sales (Sep)		China: PMI- Service Sector (Sep) Australia: Central Bank Meeting
3 Oct	**ADP Employment (Sep)** Service Sector ISM (Sep)	**FOMC Minutes**	**Eurozone: Retail Sales (Aug)**
4 Oct	**Challenger Layoff Announcements (Sep)** Initial Claims (9/29) Chain Store Sales (Sep)	Bullard	UK: Bank of England Meeting **Europe: European Central Bank Meeting** **Spain: Bond Auction** France: Bond Auction
5 Oct	**Employment Report (Sep)** Consumer Credit (Aug)		Japan: Bank of Japan 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)

4 After Plunging 52% Between Late 2007 and Early 2009, the Value of Households' Equity Holdings Has Recovered Most of the Drop



Source: Federal Reserve, Haver Analytics 10/01/12

Shaded areas indicate recession.

households' ownership in private businesses fell 32% to $6.5 trillion. Values in this asset have risen off the lows as well, but remain 20% below their peak.

The final large piece of household assets is called consumer durables: vehicles, furniture, appliances, etc. This category of assets accounts for just under 6% of household assets. Asset values here are now back at all-time highs, after running sideways just prior to and during the Great Recession.

It Depends

Household assets at the end of the second quarter stand at $76 trillion dollars, $11 trillion higher than in the first quarter of 2009—the worst point of the stock market and Great Recession—but still $5 trillion (or 7%) below their pre-Great Recession peak, although the gains in house prices and the equity markets in the third quarter of 2012 closed that gap even further. Household liabilities (debt taken out to finance the purchases of the assets) stand at $13 trillion, down $1 trillion from the peak in 2008. Overall consumer net worth (assets minus liabilities) was nearly $63 trillion at the end of the second quarter, nearly $12 trillion higher than at the start of 2009, but also still $5 trillion below the 2008 peak. Thus, the three-and-a-half-year rally in stock prices and the more recent run-up in home values have helped consumers feel wealthier than at any time in the tepid recovery from the Great Recession. However, there is still some work to do for consumers to feel better off than they were at the peak of the housing and equity markets in 2006 and 2007, respectively. ■

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 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.

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Challenger, Gray & Christmas is the oldest executive outplacement firm in the United States. The firm conducts regular surveys and issues reports on the state of the economy, employment, job-seeking, layoffs, and executive compensation.

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.

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. As of the latest reconstitution, the average market capitalization was approximately $4 billion; the median market capitalization was approximately $700 million.

Weekly Market Commentary

October 1, 2012

A Fiscal New Year's Resolution

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Highlights

The new fiscal year likely brings another trillion in U.S. federal debt to add to the mounting total.

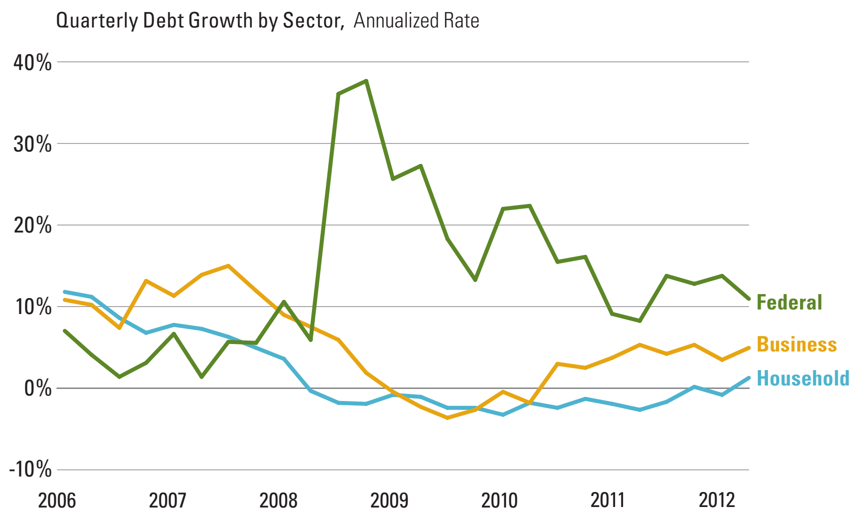
Federal debt held by the public has doubled from five years ago, before the financial crisis and Great Recession.

The big buyers of federal debt have been foreigners; further dependence on foreign demand may continue to weaken the dollar and benefit precious metals.

This week marks Golden Week, a national holiday in China. However, the United States has its own holiday to observe. Today begins a new fiscal year for the U.S. government. Unfortunately, a new year likely brings another trillion in federal debt to add to the mounting total. The proportion of U.S. federal government debt held by the public reached 70% of the U.S. economy in fiscal year 2012, while total federal debt crossed 100%. Federal debt held by the public has doubled to $11 trillion today from roughly $5 trillion five years ago, before the financial crisis and Great Recession. The turning of the calendar to a new fiscal year presents little to celebrate.

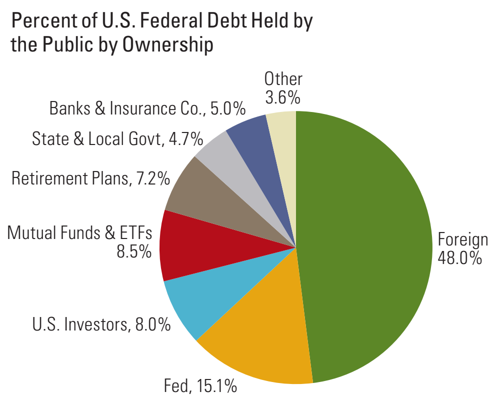
Rather than dwell on how we got here, what is most important for investors is whether demand will remain sufficient to absorb the rising supply and what the market effects may be of continued borrowing. The trillion-dollar pace of growth in federal debt requires strong and growing demand. As you can see in Figure 1, the annualized pace of growth each quarter since the financial crisis began has been very rapid. While at the same time, the growth of household and corporate debt has been modest or negative. The lack of strong demand for borrowing from the private sector has helped to support demand for the soaring supply of government debt.

1 U.S. Debt Growth Fueled by Federal Government



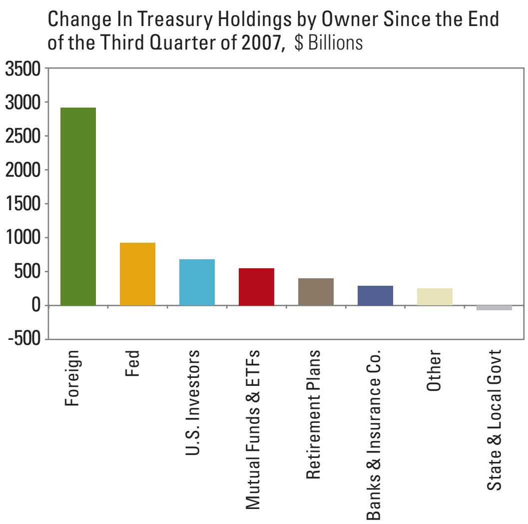
Source: LPL Financial, Federal Reserve Flow of Funds 10/01/12

2 Who Owns Our Federal Debt?



Source: LPL Financial, Federal Reserve's Flow of Funds 10/01/12

3 Who Bought All Those U.S. Treasuries Over the Past Five Years?



Source: LPL Financial, Federal Reserve's Flow of Funds 10/01/12

The pie chart in Figure 2 shows who currently owns the $11 trillion in Treasuries, and it is clear to see that foreigners hold nearly half of the outstanding Treasuries. Perhaps more interestingly, the column chart in Figure 3 shows who purchased the incremental $6 trillion in government debt that has been issued during the past five years. The big buyers have been foreigners, led by China, as well as the Federal Reserve (Fed) through its bond buying programs. Together, they have purchased about two-thirds of the Treasuries issued during the past five years. U.S.-based investors, retirement plans, banks, and mutual funds have also been big net buyers of Treasuries and account for almost all the rest, while state and local governments have been sellers.

Over the past five years, the demand for safety by investors and lack of new debt supply from households and businesses helped interest rates move down, despite the tremendous pace of borrowing by the federal government. However, as of mid-2012, household borrowing began to grow again along with business borrowing for the first time since the financial crisis. Looking forward, if the economic recovery is sustained in 2013, demand for borrowing from all sectors — household, business, and government — may result in even more dependence on foreigners to finance the United States' growing debt.

If that is the case, the dollar may continue the slide recently renewed by the actions of the Fed. A falling dollar and rising debt supply, combined with very low Treasury yields, may increasingly push investors seeking safety to Treasury alternatives such as precious metals. As China observes Golden Week, U.S. investors may take a golden opportunity to make a fiscal new year's resolution to seek precious metals as a hedge against a further rapid rise in debt in fiscal 2013. ■

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