Weekly Economic Commentary

November 26, 2012

Budget Defense

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Highlights

This week's commentary continues our series on the long-term U.S. budget problems and possible solutions.

The defense budget is a sizable portion of the U.S. budget and likely to be part of any long-term fix.

As in other large areas of the U.S. budget, there are no easy fixes, and hard choices will have to be made.

Please see the LPL Financial Research Weekly Calendar on page 3

As Congress and the President work together to avoid the looming fiscal cliff during the lame duck session of Congress, a more intransient problem remains in the background: the United States' structural budget deficit. In our *Weekly Economic Commentaries* of October 29, 2012 (*Budget Debate*) and November 19, 2012 (*Budget Myths*), we wrote about how often the budget was mentioned during the campaign season and how the nation's long-term budget problem cannot be solved by eliminating waste, fraud, and abuse, domestic discretionary programs, and foreign aid alone. In our view—a view shared by most non-partisan budget experts—all aspects of the budget must be on the table during the fiscal cliff deliberations, and again in 2013 as lawmakers hammer out a longer term fix to our budget mess.

Setting the Stage

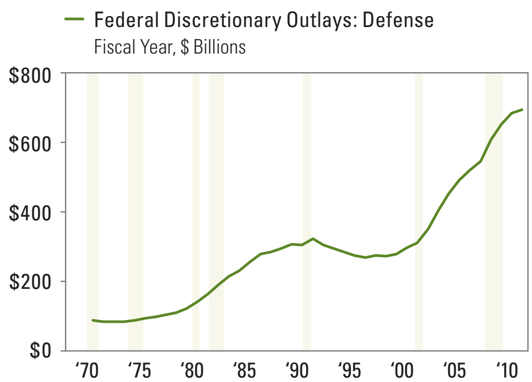
In late 2010, three different non-partisan organizations released plans that would put the U.S. on a path toward a balanced budget, using a combination of revenue/tax increases and spending cuts to achieve that goal. These organizations are:

- The President's National Commission on Fiscal Responsibility and Reform (commonly known as Bowles-Simpson);
- Bipartisan Policy Center (commonly known as Rivlin-Domenici); and
- Pew-Peterson Commission on Budget Reform.

While each plan differed on certain aspects of the longer term fix for our budget woes, they all generally agreed that there are no easy answers and no quick fixes. Both Democrats and Republicans populated the three commissions. Some hold (or once held) elected office, while others served in the federal government or were on the boards of the many think tanks in and around Washington. All were focused on finding bipartisan solutions to the problem.

In early November 2012, the non-partisan Congressional Budget Office (CBO) released a report called "Choice for Deficit Reduction," which "reviews the magnitude and causes of the federal government's budgetary imbalance, various options for bringing spending and taxes into closer alignment, and criteria that lawmakers and the public might use to evaluate different approaches to deficit reduction."

1 Defense Spending Has Accelerated Since the 9/11 Terror Attacks



Source: Congressional Budget Office, Haver Analytics 11/26/12

Shaded areas indicate recession.

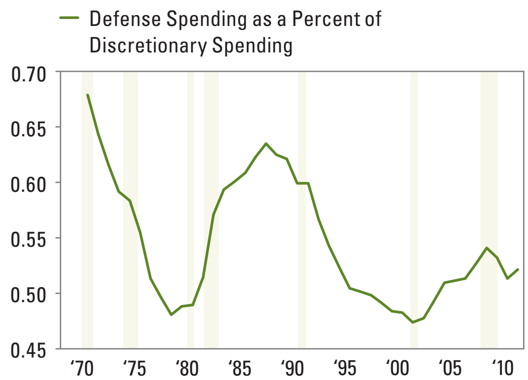
We urge you to go to the websites of the non-partisan organizations referenced on page 1, as well as to the CBO site, and review their budget plans. While the policy prescriptions in any of these plans are unlikely to be adopted "as is" and passed into law, the budget concepts discussed in these reports are likely to form the basis of any long-term fix to our budget problems.

In general, the three commissions (and the CBO) concluded that in order to successfully tackle the longer term deficit problem, formerly politically untouchable areas must be on the table in any serious negotiation. These areas include:

- Social Security;
- Defense spending;
- Farm subsidies;
- Medicare;
- Medicaid;
- Personal and corporate tax rates; and
- So-called tax expenditures, more commonly known as personal and corporate tax deductions (e.g., home mortgage interest, state and local real estate tax, or charitable contributions).

The plans put forth by the three deficit commissions did vary on the amount of revenue increases (via some combination of higher tax rates, fewer deductions, and more income subject to taxation) relative to spending cuts (across all categories of federal spending) needed to achieve a long-term path toward fiscal stability. The outcome of the November 6, 2012 election suggests that the ultimate mix of revenue increases and spending decreases that will set the country on that path is likely to be more reliant on revenue increases than spending cuts than if Governor Romney won and/or the Republicans took control of the Senate.

2 Defense Spending Accounts for About Half of Discretionary Spending, Well Below the Mid-80s, Cold War Peak of 65%



Source: Haver Analytics 11/26/12

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Slicing and Dicing

As we noted in last week's commentary, the federal budget can be sliced and diced several ways. One way to look at the budget is by function or cabinet post, such as the Department of Labor, Department of the Interior, Department of Defense, etc. Another way is to group the spending categories together by legislative mandate—mandatory spending and non-mandatory spending (also known as discretionary spending). Mandatory spending is all spending that is not controlled through Congress' annual appropriation process. For the most part, mandatory spending is based on eligibility criteria and benefit of payment rules set into law. Examples include Social Security, Medicare, Medicaid, the Affordable Care Act (aka "Obamacare"), and interest on the public debt. In recent fiscal years, mandatory spending has accounted for nearly two-thirds of all federal spending, and this slice of the pie is set to rise dramatically in the coming decade. Therefore, curbing mandatory spending, or changing the way mandatory spending is funded, holds the key to addressing our long-term budget issues. Discretionary spending is what Congress agrees to spend each year on things like national defense, education, Veterans Affairs, the national park system, etc. We will leave the discussion of mandatory spending for another time, and focus this week on defense spending.

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LPL Financial Research Weekly Calendar

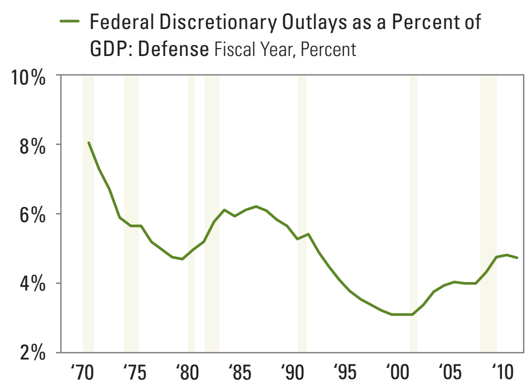
2012	U.S. Data	Fed	Global Notables
26 Nov	▪ Dallas Fed Mfg. Index (Nov)		▪ Belgium: Bond Auction
27 Nov	▪ **Durable Goods Orders and Shipments (Oct)** ▪ Case-Shiller Home Price Index (Sep) ▪ Richmond Fed Mfg. Index (Nov) ▪ Consumer Confidence (Nov)	Fisher Lockhart* Evans **Bernanke** *	▪ UK: GDP (Q3)
28 Nov	▪ **New Home Sales (Oct)**	▪ **Beige Book**	▪ Germany: Bond Auction ▪ **Brazil: Central Bank Meeting** ▪ Thailand: Central Bank Meeting
29 Nov	▪ **Initial Claims (11/24)** ▪ **Pending Home Sales (Oct)** ▪ Kansas City Fed Index (Nov) ▪ GDP (Third Quarter)	Fisher	▪ China: MNI Business Sentiment Indicator ▪ **Italy: Bond Auction** ▪ **Germany: Unemployment (Nov)** ▪ **Eurozone: Consumer Confidence (Nov)**
30 Nov	▪ Personal Income (Oct) ▪ Personal Spending (Oct) ▪ **Chicago Area Purchasing Managers Index (Nov)**	**Kocherlakota**	▪ **China: PMI (Nov)** ▪ Eurozone: CPI (Nov) ▪ Mexico: 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)

3 Defense Spending Is Running at About 4% of Overall GDP



Source: Congressional Budget Office, Haver Analytics 11/26/12

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Defense Spending: A Sizable Portion of the U.S. Budget

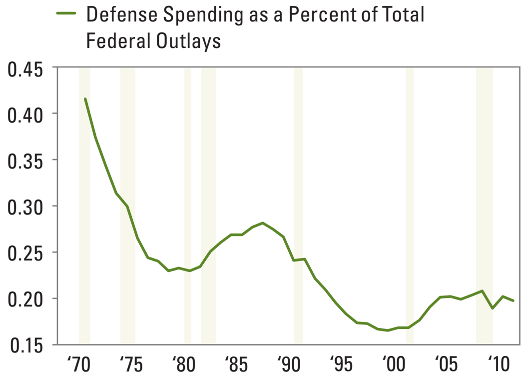
In fiscal year 2012, defense spending was close to $640 billion and is one of the largest categories of discretionary spending. In recent years, defense spending has accounted for between 50% and 55% of discretionary spending, 4.5% of gross domestic product (GDP), and about 20% of overall federal government outlays. During the Reagan administration at the end of the Cold War, defense spending accounted for 65% of total discretionary spending, 6% of GDP, and nearly 30% of all federal government outlays. After the fall of the Berlin Wall in 1989, defense spending as a percent of discretionary spending fell swiftly—bottoming out in 2001 at under 48%, 3% of GDP, and 15% of total federal outlays—just as the "war on terror" and the wars in Afghanistan and Iraq began.

Because defense spending is such a large part of federal outlays, it is often discussed as an area to cut in order to reduce the long-term deficit. Although there is likely some kernel of truth in oft-cited media reports of $600 hammers and $300 toilet seats being purchased by the Pentagon, eliminating all waste, fraud, and abuse from the defense budget, while a worthwhile endeavor, would only make a small dent in overall spending.

Some of the proposals put forth by the deficit commissions and the CBO regarding defense spending include:

- Freezing defense spending at current levels of GDP;
- Cutting the rate of increase in defense spending; and
- Finding savings within the Department of Defense's procurement system.

4 Defense Spending Accounts for Roughly 20% of Total Federal Outlays



Source: Haver Analytics 11/26/12

Shaded areas indicate recession.

We continue to share the view of the three fiscal commissions that in order to successfully tackle the longer term deficit problem, formerly politically untouchable areas—including defense spending—must be on the table in any serious negotiation.

The three plans (and the CBO) are clear, however, that simply reducing troop deployment as the wars in Iraq and Afghanistan continue to wind down would not likely be enough to substantially reduce defense spending in the coming years. Thus, in the coming months and years, policymakers face difficult choices about where and how much to cut defense spending. In the report previously cited, the non-partisan CBO summed up the policymakers' dilemma surround the defense budget:

"Cuts in defense spending could be targeted toward personnel levels, pay rates, and benefits; training and supplies; day-to-day operating and administrative costs; procurement, operation, and maintenance of existing weapon systems; or research and development aimed at producing more advanced weapon systems. However, large and sustained reductions in funding in those areas could have substantial effects on military capabilities and thus could require changes in broad strategic objectives, with significant implications for national security."

We continue to share the view of the three fiscal commissions that in order to successfully tackle the longer term deficit problem, formerly politically untouchable areas—including defense spending—must be on the table in any serious negotiation. ■

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.

The index of leading economic indicators (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

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.

INDEX DESCRIPTIONS

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.

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.

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LPL FINANCIAL RESEARCH

Weekly Market Commentary

November 26, 2012

Does Black Friday Mean Green for Investors?

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Highlights

A Black Friday for retailers does not necessarily mean a green holiday season for investors.

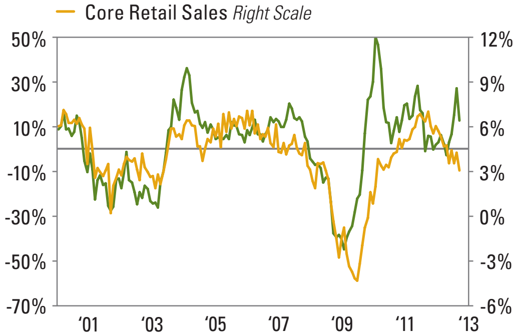
However, stocks, particularly those of the retailers, have reflected the improving consumer incomes and balance sheets, and now sales may begin to reflect the release of pent-up demand.

This may create a positive feedback loop, supporting job and economic growth in 2013.

1 Solid Consumer Demand Typically Comes Along With Solid Investor Demand

Year-Over-Year Change in S&P 500 and Core Retail Sales
(Excluding Autos, Gasoline, and Building Supplies)

— S&P 500 *Left Scale*
— Core Retail Sales *Right Scale*



Source: U.S. Census Bureau, LPL Financial 11/26/12

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

Retail sales during Thanksgiving weekend — the traditional start of the holiday shopping season — climbed 13% as more shoppers hit the stores and spent more money, according to the National Retail Federation, wildly exceeding consensus estimates. The news helped to lift stocks on Friday, making for the strongest week for stocks since early June 2012.

Retail sales matter to the stock market mainly because they reflect the health and sentiment of the consumer and investor [Figure 1], but also because they contribute to the growth of the economy and corporate profits.

Does a Black Friday for retailers assure a green holiday season for investors? Not necessarily; there have been years where positive fourth quarter retail sales did not bring positive results for the stock market. In fact, there is not even much of a relationship between how well holiday sales results fare against forecasts and stock market performance. To illustrate this point, over the past 20 years, the performance of the S&P 500 during the period from Thanksgiving through year-end was about the same (2.7% vs. 2.5%) when retailers exceeded the widely followed forecast from the National Retail Federation compared to when they were in line, on average [Figure 2].

The question of what Black Friday means for investors actually has the relationship backwards; it is instead the gain in the stock market that is the predictor for retail sales during the holiday season. This makes sense since the stock market is one of the best barometers of consumer confidence and, if it is rising, it stands to reason that consumers are feeling a bit more confident and willing to spend.

With the S&P 500 Index having gained 12% this year, it should be no surprise that early reports of sales this holiday season have been solid:

- The National Retail Federation reported Thanksgiving weekend sales up 12.8% over last year. Shoppers spent $59 billion over the weekend, with the average shopper spending $423.
- Online sales trends have been very strong, with sales estimated up 26% from last year on Black Friday. Tight inventories may have forced many to go online in search of favored styles and colors. Strong online sales have prompted shipping companies to issue solid outlooks, with UPS predicting a 6.2% increase over last year and boosting seasonal hiring by 10%. Federal Express is forecasting a gain of 12% between Thanksgiving and Christmas.

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2 Little Relationship Between Holiday Sales Versus Expectations and Stock Market Performance

Holiday Season	Holiday Sales Forecast[1]	Holiday Sales Gain[2]	S&P 500 Price Change[3]
1992	+4.0 to +5.0%	4.9%	3.1%
1993	+4.0 to +6.0%	4.4%	0.7%
1994	+6.0%	3.4%	1.5%
1995	+4.0% to +5.0%	2.5%	2.7%
1996	+6.0%	3.2%	1.1%
1997	+3.8%	3.4%	-2.8%
1998	+5.0% to +6.0%	4.5%	5.4%
1999	+6.0% to +6.5%	6.3%	2.6%
2000	+5.5% to +6.5%	3.4%	-1.6%
2001	+2.5% to +3.0%	2.7%	0.9%
2002	+2.6%	3.0%	-5.9%
2003	+5.7%	5.3%	5.9%
2004	+4.5%	3.6%	2.5%
2005	+5.0%	3.5%	-1.6%
2006	+5.0%	2.6%	1.2%
2007	+4.0%	2.5%	2.6%
2008	+2.2%	-0.2%	9.1%
2009	-3.2%	2.2%	3.2%
2010	+2.3%	3.6%	4.8%
2011	+2.8%	4.2%	8.5%
2012	+4.1%		
		Better Than Forecast	2.7%
		In Line With Forecast	2.5%
		Worse Than Forecast	1.9%

Source: International Council of Shopping Centers, National Retail Federation, Bloomberg Data, LPL Financial 11/26/12

[1] Holiday season overall sales forecast from the National Retail Federation

[2] Thanksgiving through year-end five-week average of year-over-year sales growth from International Council of Shopping Centers

[3] S&P 500 Index Price change over period of holiday sales

What Is Driving All This Demand From Consumers?

The question of what Black Friday means for investors actually has the relationship backwards; it is instead the gain in the stock market that is the predictor for retail sales during the holiday season.

- A rising stock and housing market has helped consumers feel wealthier, plus the modest increase in jobs and paychecks may have given consumers the confidence to boost purchases during the holiday season.
- Consumers' balance sheets look a lot better. The percentage of income consumed by financial obligations, such as a mortgage, rent, auto, and student loans has fallen to a level not seen since well before the financial crisis and is below the long-term, 30-year average.

A more confident consumer leads to more confidence in corporate America, which may lead to brighter prospects for job and economic growth in 2013.

- Consumers are starting to borrow again. U.S. consumer debt has fallen by about $1.3 trillion since the pre-recession peak, according to the Federal Reserve, with credit card debt being one of the most sharply contracting categories. But in four of the last six quarters, American households' credit card borrowing has increased after having fallen for 11 consecutive quarters.

Stocks, particularly those of the retailers, have reflected the improving consumer incomes and balance sheets, and now sales may begin to reflect the release of pent-up demand. While stocks are already signaling gains in sales this holiday shopping season, the performance of retailer stocks has been pointing to solid gains with the S&P 500 Retail industry group of stocks posting a gain of 2.4% relative to the decline of -1.8% in the S&P 500 so far during the fourth quarter.

However, one weekend does not make a season. Stocks have slumped so far in the fourth quarter, and retail sales have yet to break out of their slump. The widely watched weekly measure of retail sales from the International Council of Shopping Centers has averaged a relatively consistent year-over-year gain of 2–3.5% during the second half of 2012. If sales do begin to accelerate, it may be good news for the economy. A more confident consumer leads to more confidence in corporate America, which may lead to brighter prospects for job and economic growth in 2013. ■

INDEX DESCRIPTIONS

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.

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