# Weekly Economic Commentary

November 12, 2012

## Return of Recession Obsession

John Canally, CFA

Economist
LPL Financial

### Highlights

We believe lawmakers will move swiftly to avoid the looming fiscal cliff, and act as soon as possible to put the United States on a path to longer term fiscal stability.

We do not expect a recession in the United States.

Please see the LPL Financial Research Weekly Calendar on page 3

We last wrote about the global economic outlook for 2013 in the October 22, 2012 edition of the *Weekly Economic Commentary: Gauging Global Growth,* and we last wrote about the prospects for a recession in the United States in the July 30, 2012 edition of the *Weekly Economic Commentary: Resisting Recession.*

The results of last week's presidential and congressional elections in the United States—and the looming fiscal cliff—provide us with another opportunity to revisit the odds of a recession in the United States in the coming quarters. We will provide a full update on our economic forecast for 2013 in our *2013 Outlook* publication, due later this month.

### Media Mentions

At 2.0%, the economy is growing below the pace seen over the past 40 years, about 3.0%—and below the 2.6% pace of the past 20 years. The economic recovery that began in June 2009 will turn three-and-a-half in December 2012. At this point in a typical recovery, market participants debate whether or not growth is too fast and when the Federal Reserve (Fed) will likely raise rates to head off a bout of inflation. Instead, in recent weeks, a bout of economic uncertainty surrounding the fiscal cliff, the impact of Superstorm Sandy, the ongoing recession in Europe, and the slowdown in economic growth in China have all contributed to an increase in recession talk.

Figure 1 shows the number of times the word "recession" appeared in news stories from major news outlets, such as Bloomberg News, Dow Jones News (including *The Wall Street Journal*), the Associated Press (AP), and *The Washington Post.* In the latest week, the word recession was mentioned in more than 2,000 stories, the most mentions since the early part of May 2012, matching the number of stories with the word recession seen during the worst of the European financial crisis in late 2011.

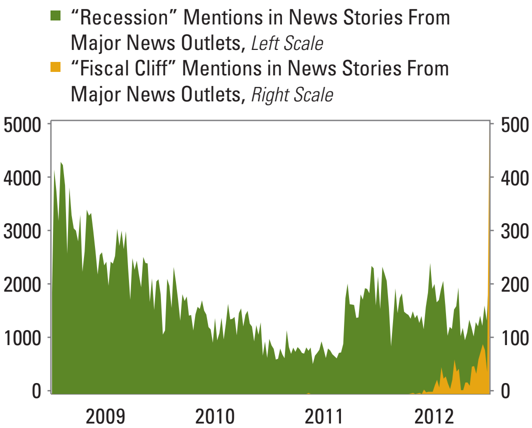
There is no doubt that many of these news stories mentioned the word recession when discussing the fiscal cliff, which we have written about several times in the past month or so. In the latest week alone (November 4–10, 2012), 490 news stories mentioned the fiscal cliff.

### CBO Discussions

Earlier this year, the nonpartisan Congressional Budget Office (CBO) noted that should the full impact of the fiscal cliff occur—a 3.5% hit to Gross Domestic Product (GDP) in the first quarter of 2013—the United States would enter a mild recession, with real GDP contracting by 0.5% and the unemployment rate moving up to 9.1% from 8.0% today. Our view is that lawmakers will come to

LPL Financial

1 Looming Fiscal Cliff Has Led to a Spike Higher in News Stories Containing the Word Recession



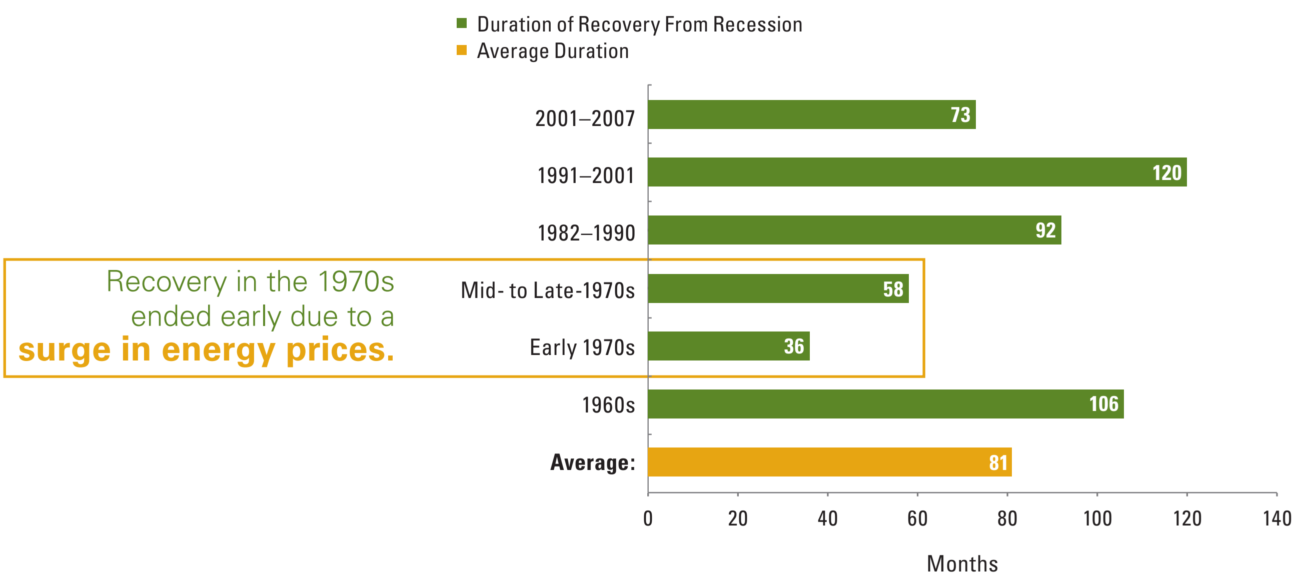

Source: Bloomberg News 11/09/12

an agreement that will avoid most, but not all of the impact of the fiscal cliff, and that the economy will avoid recession. In a recent report, the CBO outlined various scenarios regarding the fiscal cliff as follows:

> "Output would be greater and unemployment lower in the next few years if some or all of the fiscal tightening scheduled under current law—sometimes called the fiscal cliff—was removed. However, CBO expects that even if all of the fiscal tightening was eliminated, the economy would remain below its potential and the unemployment rate would remain higher than usual for some time. Moreover, if the fiscal tightening was removed and the policies that are currently in effect were kept in place indefinitely, a continued surge in federal debt during the rest of this decade and beyond would raise the risk of a fiscal crisis (in which the government would lose the ability to borrow money at affordable interest rates) and would eventually reduce the nation's output and income below what would occur if the fiscal tightening was allowed to take place as currently set by law."

If the fiscal cliff was not an issue, the outlook for the U.S. economy would likely be for more of the same—GDP growth below its long-term average growth rate and only modest gains in the labor market. The reliable leading indicators of recession, most notably the Conference Board's Index of Leading Economic Indicators, the Institute for Supply Management's Report on Manufacturing, and the forward-looking components of the labor market, all suggest only a modest chance (10–20%) of recession over the next 12–18 months. For example, in September 2012, the Index of Leading Economic Indicators was 2.9% higher than in September 2011. Over the past 52 years, the LEI was up between 2.5% and 5.0% in 133

2 Average Economic Recovery in the Past 50 Years Has Lasted 81 Months




Source: National Bureau of Economic Research 11/09/12

LPL Financial Research Weekly Calendar

| 2012 | U.S. Data | Fed | Global Notables |
|---|---|---|---|
| 12 Nov | | | ■ EU Finance Ministers Meeting |
| 13 Nov | ■ **Congress in session**<br>■ Small Business Sentiment Index (Oct)<br>■ Treasury Statement (Oct) | Yellen* | ■ **EU Finance Ministers Meeting**<br>■ **Germany: ZEW Index (Nov)** |
| 14 Nov | ■ PPI (Oct)<br>■ Retail Sales (Oct)<br>■ Business Inventories (Sep) | ■ **FOMC Minutes**<br>Williams* | ■ Italy: Bond Auction<br>■ **Labor strikes likely in Spain, Portugal, and Italy** |
| 15 Nov | ■ CPI (Oct)<br>■ **Empire State Manufacturing Index (Nov)**<br>■ **Initial Claims (11/10)**<br>■ **Philly Fed (Nov)** | **Bernanke***<br>Lacker*<br>Fisher<br>Plosser<br>Dudley* | ■ France: Bond Auction<br>■ **China: Leadership transition continues**<br>■ **Eurozone: GDP (Q3)** |
| 16 Nov | ■ Industrial Production (Oct)<br>■ Capacity Utilization (Oct) | Lockhart* | |

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)

months. The economy has been in recession 12 months later only 14 times, or 11% of the 133 months. The 2.9% year-over-year gain in the LEI yields similar recession odds looking 18 and 24 months out. In addition, due in part to the sluggish pace of the recovery to date, there are few imbalances (overbuilding, overspending, or overinvestment in one or more sectors of the economy) that have triggered prior recessions.

Although economic recoveries (or recessions for that matter) are not driven by the calendar, we note that the last three economic recoveries (2001–2007, 1991–2001, and 1982–1990 lasted 73, 120, and 92 months, respectively. Excluding the short recovery in 1981, the prior three economic recoveries in the mid-to-late-1970s, early 1970s, and mid-to-late-1970s lasted 58, 36, and 106 months, with the last two ending early due to a surge in energy prices. On average these six recoveries lasted 81 months, and at just three-and-a-half years old (42 months) the economy today is only about halfway to that 81-month mark.

However, even if the U.S. economy does not feel the full impact of the fiscal cliff, many factors could cause a recession, including:

- A surge in consumer energy prices;
- A major fiscal or monetary policy mistake at home or overseas, such as a breakup of the Eurozone, immediate removal of stimulus from the Fed, a hard landing in China;

- A major terrorist attack that disrupts economic activity across a wide area for an extended period; and/or
- A major natural disaster that disrupts economic activity across a wide area for an extended period.

On balance, lawmakers should move swiftly to a avoid the looming fiscal cliff, and act as soon as possible to put the United States on a path to longer term fiscal stability. In the meantime, the impact of Superstorm Sandy, the ongoing recession in Europe, and the slowdown in China are all likely to have a major impact on the health of the U.S. economy in the coming quarters. ■

| 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 Congressional Budget Office is a non-partisan arm of Congress, established in 1974, to provide Congress with non-partisan scoring of budget proposals.

## 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 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.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.





RES 3966 1112
Tracking #1-117455 (Exp. 11/13)

# Weekly Market Commentary

November 12, 2012

## Global Gridlock

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

### Highlights

With the power transitions taking place last week, it has become apparent that gridlock is now a global phenomenon taking root in the United States, Europe, and China.

Fortunately for them, the Chinese possess an advantage that other countries do not: economic growth seems to be improving.

Investments that benefit from China's growth may do well, namely commodities such as precious metals and oil, along with stock market sectors that benefit from solid export demand from China, like information technology.

Last week's post-election press conferences from the President, Senate Majority Leader Reid, and House Speaker Boehner offered some hope of a bipartisan deal to mitigate the budget bombshell of tax increases and spending cuts known as the fiscal cliff, due to hit on January 1, 2013. The status quo election outcome is likely to result in a deal in the lame duck session, but this is not assured given the gridlocked Congress. Last year's August breakdown between these same parties over an increase to the debt ceiling is not encouraging. The battle is likely to result in a compromise that averts the worst-case outcome, but the negotiations themselves, coming on the heels of hard-fought election battles, may drive market swings in the days and weeks ahead.

While there were no televised attack ads or public debates, the second-largest economy in the world after the United States is also experiencing a political transition and faces some tough challenges ahead. The Chinese Communist Party's 18th Congress, a week-long transition of power that started last Thursday and is set to end this Wednesday, is the most important political meeting in China in at least a decade. A new generation of leaders, headed by Xi Jinping, is replacing the current top bureaucrats and their chief Hu Jintao.

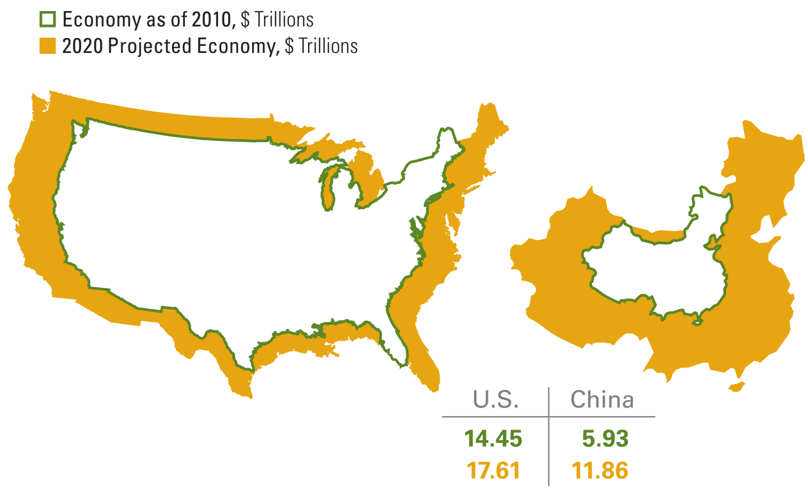
In his departing speech last week, President Hu Jintao cited many of the challenges China faces: a wide gap between the rich and the poor, imbalanced development between the wealthy cities of the east, and the struggling farms of the western countryside. Rather than redistribution, the departing head of the Communist party's remedy was faster growth. He announced a commitment by the government to a doubling of China's Gross Domestic Product (GDP) this decade, a goal that would bring China to two-thirds the size of the U.S. economy, a tall order given recent slowing trends.

### China's "Fiscal Cliff"

Much like in the United States, China's political transition is taking place amid a looming crisis. China is experiencing its own version of a "fiscal cliff." China's growth rate has declined dramatically from double-digit rates to an official, and "politically-adjusted," 7.4% — although externally verifiable measures of economic activity in the third quarter appeared to slow even more sharply. Inflation has weakened China's competitive position in many product categories with other emerging market Asian nations. And China continues to sacrifice domestic consumption for the benefit of export

LPL Financial

1 China's Growth Plan Takes China From 40% to 67% of the Size of the U.S. Economy




Source: LPL Financial, World Bank 11/12/12

Note: Assumes continued 2% GDP growth rate for United States and stated 2020 target for China.

In his departing speech, President Hu Jintao announced a commitment by the government to a **doubling of China's GDP** this decade, a goal that would bring China to **two-thirds** the size of the U.S. economy.

growth, which is very weak, given soft demand from key customers due to the European recession and below-average U.S. growth.

As in the United States, factions within China have competing visions for how to combat these challenges. One party does not mean one vision. China's new leadership must address the country's economic problems, but there is no agreement on the path to take. Some constituencies want to reverse some of the decentralization that they argue has contributed to wasteful spending and re-establish central control over the economy. Others want to further westernize China's version of communism, but that would lead to some still antithetical outcomes, like bankruptcies and unemployment, and risking social order that Chinese hold above all else.

With the power transitions taking place last week, it has become apparent that gridlock is now a global phenomenon:

- In the United States, the two parties with two different visions on how to mitigate the fiscal cliff control different sides of Capitol Hill.
- There is a lack of a consensus on action in Europe, with Northern Europe struggling with Southern Europe on how to best manage budgets and emerge from recession as the downturn deepens. Even Germany is increasingly feeling the downward pull on growth.
- The Chinese Communist Party seeks to always create a consensus, but different constituencies that control different parts of the economy have conflicting visions on how to reverse the country's slowing economic momentum, which risks paralysis.

The political systems of all three of the world's major governments are finding it difficult to make decisions vital to economic growth.

## China's Advantage

Fortunately for them, the Chinese possess an advantage the other countries do not: growth seems to be improving. The re-acceleration of growth can paper over a lot of structural problems and alleviate the near-term need for tough decisions. Starting over a year ago, Chinese policymakers began a series of stimulative policy initiatives that have accumulated and had time to work. They appear to finally be making a difference in growth; China posted the second month in a row of improving economic data late last week.

China has appeared to stop its economy from slowing further.

- China's Index of Leading Economic Indicators (LEI) rose again. Key measures such as rail traffic, bank loans, and money supply growth continued to show healthy signs.
- Manufacturing and non-manufacturing Purchasing Managers' Indexes (PMIs) improved, industrial production rose by 9.6% from a year ago, and fixed asset investment rose by 22.2%.
- Retail sales rose by a better-than-expected 14.5% year-over-year in October 2012 — very impressive and pointing to strong underlying spending trends given the low rate of inflation compared with a year ago.
- China's pace of inflation, measured by the Consumer Price Index (CPI), over the past year has slowed from a peak of +6.5% that threatened any ability to provide economic stimulus to just +1.7%. In October, the monthly CPI reading was a drop of -0.1%. Importantly, food prices have stalled over the past 15 months from growing at a 14% year-over-year pace to just 1.8%.

China has appeared to stop its economy from slowing further.

The improving trend in inflation gives China the flexibility to provide more stimulus without risking social unrest. The ability to cut interest rates and implement new spending programs or tax cuts to drive an acceleration in growth and ensure the recent stabilization is sustained is a luxury not enjoyed by policymakers in the United States or Europe.

While a moderately defensive stance may be desirable for some investors, investments that benefit from China's growth may do well, namely commodities such as precious metals and oil, along with stock market sectors that benefit from solid export demand from China, like information technology. ■

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.

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.

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.

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 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.

Information Technology: Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

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.





RES 3965 1112

Tracking #1-117442 (Exp. 11/13)