Weekly Economic Commentary

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Festive Fed FAQ

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Highlights

We expect the Federal Reserve (Fed) to continue Operation Twist at this week's Federal Open Market Committee (FOMC) meeting. Before ending quantitative easing (QE), the Fed has repeatedly said it is looking for "sustained and substantial" improvement in the labor market.

The Fed's communication policy is likely to be at the heart of the agenda.

Looking ahead, the rotation to new FOMC members in January 2013 is unlikely to significantly impact monetary policy in 2013.

Please see the LPL Financial Research Weekly Calendar on page 3

Why Write About the Federal Reserve (Fed) This Week When the Fiscal Cliff Is Looming?

The Fed may deliver the most important policy announcement of the week, given the ongoing behind-the-scenes fiscal policy debate in Washington. The Fed continues to play a key role in markets and the economy, and that will continue into 2013 and beyond. Although Fed Chairman Ben Bernanke has said that the Fed cannot offset the impact of the fiscal cliff, Fed policymakers are keenly aware that they remain the "only game in town" when it comes to simulative policy.

What Is the Schedule of Events for the Fed This Week?

The Fed holds its eighth and final Federal Open Market Committee (FOMC) meeting of 2012 this Tuesday and Wednesday, December 11–12. The meeting will be followed by an FOMC statement at 12:30 PM ET, the FOMC's latest economic and Fed funds projections at 2:00 PM ET, and Chairman Bernanke's final press conference of 2012 begins at 2:15 PM ET.

What Is Likely to be on the Fed's Agenda at This Meeting?

In additional to discussing the fiscal cliff and its impact on the economy now and in early 2013, topics of conversation at this week's FOMC meeting are likely to include Superstorm Sandy, the recent improvement in the labor market, the situation in Europe, and the health of emerging market economies as 2012 transitions in 2013. The future of Operation Twist and the Fed's communication policy are also likely to be on the very busy agenda.

What Will the Fed Do With Operation Twist?

FOMC members are likely to be focused on the end of Operation Twist at this week's meeting. Operation Twist, which was announced in September 2011 and extended in June 2012, saw the Fed sell its holdings of shorter dated Treasury securities and use the proceeds of these sales to purchase longer dated Treasuries. Twist is scheduled to end on December 31, 2012, and most market participants (ourselves included) take the view that the Fed will roll Operation Twist into Quantitative Easing 3 (QE3). This combination (continuing Twist's purchases of Treasuries and QE3's purchase of $40 billion of agency mortgage-backed securities [MBS] per month) will see the Fed purchases continue at about $85 billion per month.

When Will the Fed Stop Quantitative Easing?

The Fed's communication policy has come under increased scrutiny since September 2012, when the FOMC committed to purchase $40 billion in agency MBS per month until it saw "sustained and substantial" improvement in the labor market in a context of price stability. The FOMC repeated that commitment at the conclusion of its October 23–24, 2012 meeting. In addition, several Fed officials, including Chairman Bernanke, Vice Chair Janet Yellen, and Chicago Fed President Charles Evans have reiterated this promise, with Yellen, Evans, and others speaking in favor of setting specific thresholds for "sustained and substantial" improvement in the labor market "in the context of price stability." These thresholds, and how to communicate them to the public, are likely to be on the agenda at this week's meeting.

What Unemployment Rate and/or Inflation Rate Might the FOMC Use as "Thresholds?"

In a speech in mid-November 2012, Fed Vice Chair Janet Yellen, who also heads up the FOMC's communications committee, made the case for increased transparency around FOMC policy and suggested that the FOMC might "eliminate the calendar date entirely and replace it with guidance on the economic conditions that would need to prevail before liftoff of the federal funds rate might be judged appropriate."

Yellen noted that several of her FOMC colleagues—Charles Evans, president of the Chicago Fed, and Narayana Kocherlakota, president of the Minneapolis Fed—had already advocated such an approach, and even provided specifics:

> *"Charles Evans, president of the Chicago Fed, suggests that the FOMC should commit to hold the federal funds rate in its current low range at least until unemployment has declined below 7 percent, provided that inflation over the medium term remains below 3 percent. Narayana Kocherlakota, president of the Minneapolis Fed, suggests thresholds of 5.5 percent for unemployment and 2.25 percent for the medium-term inflation outlook. Under such an approach, liftoff would not be automatic once a threshold is reached; that decision would require further Committee deliberation and judgment."*

Of course, the other members of the FOMC will likely want to weigh in as well, so that is why it is a tough call as to whether or not the FOMC can collectively come up with "thresholds" as soon as this week's meeting. If they do not adopt thresholds at this meeting, they would likely wait until March 2013 before doing so, which is the next time the FOMC will release its economic projections and Fed Chairman Bernanke will hold a press conference. The next FOMC meeting (January 2013) will only produce a new policy statement from the FOMC, and is therefore less likely to produce a major shift in the FOMC's communication policy.

Although not specifically mentioned by Yellen, the FOMC has discussed (in September 2010) targeting a level of nominal gross domestic product (GDP) as one of its policy "thresholds." Chicago's Evans has also discussed this approach in public appearances as well. While this approach to "thresholds"

LPL Financial Research Weekly Calendar

2012	U.S. Data	Fed	Global Notables
10 Dec			Germany: Exports and Imports (Oct.
11 Dec	**Small Business Sentiment Index (Nov)** Merchandise Trade: (Oct) JOLTS (Oct)		Germany: ZEW Survey (Nov) **China: New Loan Growth (Nov)** **China: Money Supply (Nov)** Indonesia: Central Bank Meeting
12 Dec	Monthly Budget Statement (Nov)	**Federal Open Market Committee (FOMC) Decision** **FOMC Economic Projections** **Bernanke Press Conference**	**Eurozone Finance Ministers Meet on Banking Regulation** South Korea: Central Bank Meeting Eurozone: Industrial Production (Oct) **OPEC Meeting** Eurozone: CPI (Nov)
13 Dec	PPI (Nov) **Retail Sales (Nov)** **Initial Claims (12/1)** Business Inventories (Oct)		**European Finance Ministers Meeting** **Spain: Debt Auction** **Italy: Debt Auction**
14 Dec	**CPI (Nov)** **Markit PMI (Dec)** Industrial Production (Nov) Capacity Utilization (Nov)		Eurozone: PMI (Dec)

is a possibility, the FOMC is likely to use the employment and inflation approach first.

Based on our forecast for very modest economic growth of around 2.0% and muted inflation in the United States in 2013, we don't expect the Fed to begin seriously discussing an end to quantitative easing or exceptionally low interest rates anytime soon.

Will the Rotation to New FOMC Members in 2013 Impact Fed Policy?

It is not too soon to look ahead to the voting lineup of the FOMC starting with the January 29–30, 2013 FOMC meeting. The FOMC consists of 19 members: 12 voting members and seven nonvoting members. The 19 members are the presidents of each of the 12 regional Federal Reserve Banks (Boston, New York, Philadelphia, Richmond, etc.) and the seven members of the Board of Governors of the Fed. The seven board members include Chairman Bernanke and Vice Chair Yellen.

According the Fed's website:

> *"The (voting members of the) Federal Open Market Committee (FOMC) consists of twelve members — the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis. The rotating seats are filled from the following four groups of Banks, one Bank president from each group: Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St.*

Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco. Nonvoting Reserve Bank presidents attend the meetings of the Committee, participate in the discussions, and contribute to the Committee's assessment of the economy and policy options."

In 2013, the Boston Fed's Eric Rosengren, a policy dove, will replace Richmond's Jeffrey Lacker, a hawk (please see nearby box for description of hawks and doves). Chicago's Charles Evans replaces Cleveland's Sandra Pianalto in a dove-for-dove swap. The president of the St. Louis Fed, James Bullard, a hawk, will replace dove Dennis Lockhart (Atlanta), and Kansas City's Esther George, who has not made her views on monetary policy clear yet, will replace the dovish John Williams of the San Francisco Fed.

FOMC Hawks and Doves

- **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.

1 2013 Rotation of FOMC Members

In			Out		
Name	District	Policy Tilt	Name	District	Policy Tilt
Eric Rosengren	Boston	Dove	Jeffrey Lacker	Richmond	Hawk
Charles Evans	Chicago	Dove	Sandra Pianalto	Cleveland	Dove
James Bullard	St. Louis	Hawk	Dennis Lockhart	Atlanta	Dove
Esther George	Kansas City	?	John Williams	San Francisco	Dove

Source: Federal Reserve Board of Governors 12/10/12

While the regional bank presidents rotating onto the FOMC as voters are, in aggregate, likely to be more hawkish than the regional bank presidents leaving the committee as voters, the returning voting members of the Fed Board of Governors are likely to continue to vote with the chairman and vice chairman on monetary policy. Thus, the net addition of perhaps one additional hawk on the FOMC in 2013 is not likely to substantially alter the course of monetary policy next year. As we noted in our *Outlook 2013* publication, we expect the Fed to continue its purchase of around $85 billion in Treasuries and MBS throughout 2013. ■

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.

* 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.

Mortgage-backed securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

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.

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.

Job Openings and Labor Turnover Survey (JOLTS) is a survey done by the United States Bureau of Labor Statistics to help measure job vacancies. It collects data from employers including retailers, manufacturers and different offices each month. Respondents to the survey answer quantitative and qualitative questions about their businesses' employment, job openings, recruitment, hires and separations. The JOLTS data is published monthly and by region and industry.

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.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

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Weekly Market Commentary

December 10, 2012

Washington's Dilemma

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Highlights

The "prisoners' dilemma" is the name of an example of game theory that illustrates why two parties might not cooperate, even if it appears that it is in their best interests to do so — much like the fiscal cliff debate in Washington.

Steps could be taken to mitigate the initial tax and spending impacts of temporarily going over the fiscal cliff to minimize the economic and market damage until a deal can be finalized.

Here's to the hope that this holiday season policymakers can find common ground and work together to resolve their differences, so investors are no longer held prisoner to Washington's dilemma.

The advance in the S&P 500, boosted by the latest three weeks of consecutive gains, is at risk if negotiations over the tax increases and spending cuts, known as the fiscal cliff, make no progress in the coming weeks.

The fiscal cliff negotiations between the two parties in Washington are reminiscent of a prisoners' dilemma. The "prisoners' dilemma" is the name of an example of game theory that illustrates why two parties might not cooperate, even if it appears that it is in their best interests to do so. It was originally created in 1950. The classic example of the game goes like this:

> Two people are arrested, but the police do not have enough information to convict them. The police separate and isolate the two, and offer both the same deal: if one testifies against his partner, and the other remains silent, the first goes free and the one that remains silent gets a one-year sentence. If both remain silent, they get the best outcome: both are sentenced to only one month in jail on a minor charge. But if each rats out the other, they each receive a three-month sentence. Each prisoner must choose either to betray or remain silent; the decision of each is kept secret from his partner until the sentence is announced.

1 The Prisoners' Dilemma

	Prisoner B stays silent	Prisoner B betrays
Prisoner A stays silent	Both serve one month	A serves 12 months; B goes free
Prisoner A betrays	A goes free; B serves 12 months	Both serve 3 months

Source: Albert W. Tucker 12/10/12

In the game, not cooperating with the other party seems like the best option — if you betray them you either get off free, or if they betray you too you get sentenced to only three months. The risk of staying silent on the hope that they work with you is just too high, since you could get a year in jail if they rat you out. In the game, the two parties almost always fail to work together as they pursue their own rational self-interests, even though they both know they would be better off if they did.

This is the situation in Washington right now in the negotiations over the fiscal cliff. The Republicans and Democrats know they can craft a better deal together, but the risk of making a serious offer that includes concessions that may not be met by a similar offer by the other side is too high.

If the Republicans give in and the Democrats do not, the Republicans get nailed with a terrible deal from their perspective and are likely to face primary challenges in 2014. In fact, right after Senate Republican Saxby Chambliss indicated his support for raising tax revenue if it were done in exchange for cuts to entitlement programs, two Republican candidates made it clear they intend to run against him from the right in 2014. Of course, this risk is the same for Democrats as well.

The odds are rising that a deal does not happen in 2012, risking at least a temporary jump over the fiscal cliff. In our *Outlook 2013*, we present our base case path of the economy and markets that includes a deal getting done — either late this year or early next year. It is possible we go over the cliff, but avoid crashing on the rocks below if a deal can be made in early 2013.

Steps could be taken to mitigate the initial tax and spending impacts of temporarily going over the fiscal cliff to minimize the economic and market damage until a deal can be finalized.

- Treasury Secretary Geithner has the authority to leave the IRS income withholding tables unchanged even if tax rates go up based on a section of the tax code that says the tables "provide such amounts to be deducted and withheld, as the Secretary determines to be most appropriate." This could mitigate the impact of the rise in both payroll and income taxes. If Secretary Geithner instructs the IRS not to change the withholding tables, as 2013 begins employers would not withhold any more in taxes from employees' paychecks than they do now, despite the higher rates going into effect.
- Even though the sequestered automatic spending cuts will go into effect at the start of the year, there is no reason why the roughly 10% across-the-board cuts to discretionary spending programs for 2013 must be made evenly during the year. Federal agencies can accelerate their spending in the first part of the year with the intention of relief as a result of a breakthrough on the fiscal cliff or make up for the cuts later in the year.

However, it is unlikely these steps would be taken unless it appeared the parties were close to a deal.

The prisoners' dilemma can tell us a bit about how two isolated parties may choose not to cooperate despite it being in everyone's best interest that they do. Of course, the difference from the game is that in Washington parties are not isolated. They merely choose to be.

Here's to the hope that this holiday season policymakers can find common ground and work together to resolve their differences so investors are no longer held prisoner to Washington's dilemma. ■

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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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