Weekly Market Commentary

December 31, 2012

Standing on the Edge

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Highlights

Confidence has gone over the cliff, but economic activity remains on solid ground—leaving investors standing on the edge.

If fears are realized, we expect economic activity to fall and a recession to take place in 2013.

The debt ceiling may be another fiscal cliff that may weigh on consumer and business confidence and increasingly affect economic activity in the first quarter of 2013.

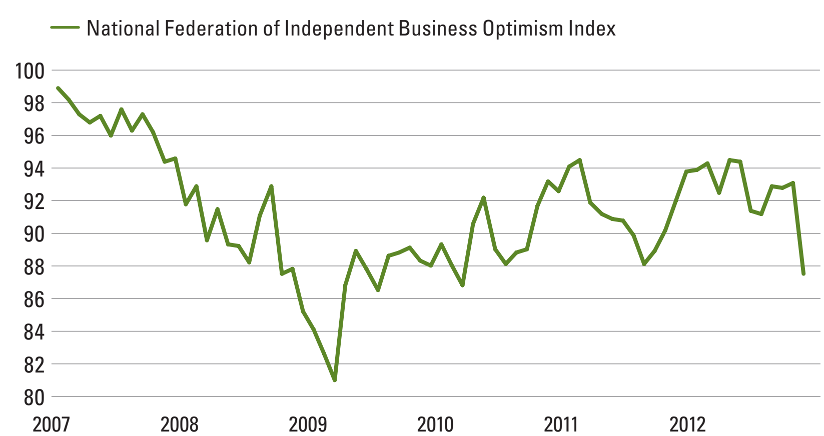
As the battle rages on in Washington over the tax increases and spending cuts, known as the fiscal cliff, their impact has already been felt in some ways and not in others. Confidence has taken a hit, while activity has not—yet.

While a deal has yet to be struck, steps could be taken to blunt 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—and so far has not communicated any changes, so that employers would not withhold any more in taxes from employees' paychecks in 2013, despite the higher rates going into effect. In addition, even though the sequestered automatic spending cuts will go into effect at the start of the year, federal agencies can accelerate their spending early in the year with the intention of relief emerging from a deal or of making up for the cuts later in the year.

While some of the direct impacts of the fiscal cliff may be mitigated or delayed, such as the above-referenced higher tax rates and spending cutbacks, some indirect impact has already been felt.

- **Consumer Confidence** – The widely followed consumer confidence indexes from the Conference Board and University of Michigan sunk to their lowest levels since stocks' 2012 low point in August. The last time

1 Business Optimism Taking a Dive



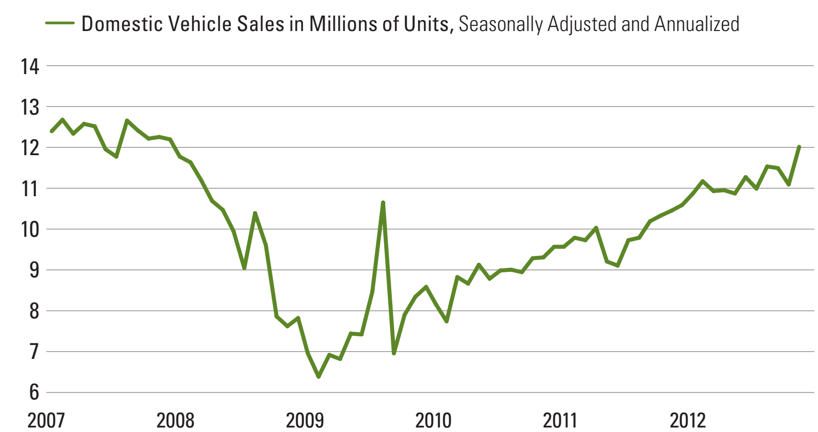
Source: Bloomberg, LPL Financial 12/31/12 confidence turned negative so quickly was in August 2011, amid the debt ceiling debacle and U.S. credit rating downgrade. However, then it dropped to the low 50s rather than just the low 70s, where it stands today. So while confidence has already been affected, there is room for significantly more downside.

- Business Confidence – Similar to consumer confidence, business confidence also took a dive as the cliff nears. The National Federation of Independent Business's Optimism Index fell sharply in November to the lowest reading in almost three years [Figure 1]. November registered the biggest drop in monthly records going back to 1986. Despite solid fourth quarter stock market performance, U.S. initial public offerings raised only about $44 billion in the fourth quarter, the lowest quarterly total during 2012—even weaker than the spring quarter when stocks were falling—as companies lacked the confidence to come to market.

On the other hand, activity in key economically sensitive areas has not seen any impact yet.

- Consumer Spending on Big Ticket Items – Despite the high likelihood of an economic recession should we go over the cliff, highly economically sensitive areas of the economy such as auto sales and home construction have showed no signs of slowing, much less declining. In fact, both are reaching levels not seen since the start of the Great Recession of 2008–09. Existing homes sold at their strongest pace in more than two years in November, and building permits reached a four-year high. Car sales hit a four-year high in November [Figure 2].

2 Auto Sales Continue to Rebound



Source: Bloomberg, LPL Financial 12/31/12

- Business Output – Manufacturing, which struggled during much of 2012, has showed signs of rebounding in recent months. Industrial production jumped by the most in two years, and orders for business equipment climbed for a second month. The regional manufacturing surveys outside of Hurricane Sandy-impacted areas rose and reflected expanding output. Indicators of service sector production also are on the rise.

Confidence has already gone over the cliff, but economic activity remains on solid ground — leaving investors standing on the edge with an unsteady stock market that has been up one week and down the next during December. If the fears are realized, we expect economic activity to fall and a recession to take place in 2013, along with a drop for the stock market.

A small deal designed to mitigate some of the consequences of the current fiscal cliff may be passed in the next few days. The negative economic impact would depend on the composition of the deal. While it could lead to a short-term bounce in sentiment, it may not last. This is because a small deal would be unlikely to address a debt ceiling agreement. The government has hit the $16.4 trillion limit, and the Treasury department will begin using extraordinary measures to finance deficits into 2013. These measures may last about two months before threatening more drastic measures, making the limit on U.S. borrowing authority another fiscal cliff — that may weigh on consumer and business confidence and increasingly affect economic activity — that needs to be dealt with in the first quarter of 2013. ■

INDEX DEFINITIONS

The National Federation of Independent Business Optimism Index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of ten seasonally adjusted components based on questions on the following: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job opening, expected credit conditions, now a good time to expand, and earnings trend.

Weekly Economic Commentary

December 31, 2012

Quick Start

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Highlights

We are still seeing a slow but sustained rebound in the U.S. economy in the year ahead.

We believe the U.S. unemployment rate is likely to decline modestly over 2013.

China's economy is poised to re-accelerate, and recent economic data support our view.

Please see the LPL Financial Research Weekly Calendar on page 3

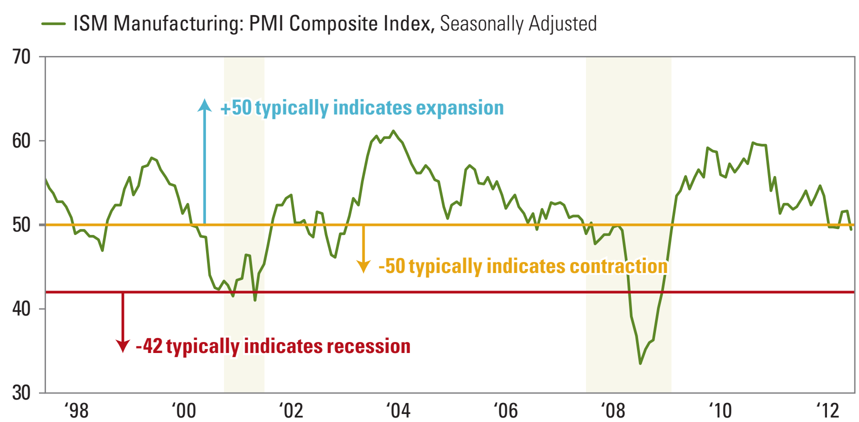
2013 will get off to a quick start, as many market participants return from the holidays to face several key economic reports at home and overseas including:

China's Purchasing Managers' Index for December was released Monday, December 21 at 8 PM ET. In our *Outlook 2012*, we said that China would avoid a hard landing, and instead achieve a soft landing, growing real gross domestic product (GDP) at around 7% or 8%. Data released over the past few months in China—along with a sustained rebound in Chinese equity markets—suggest that China has indeed avoided a hard landing, and that the world's second-largest economy may be re-accelerating as 2012 turns into 2013.

The U.S. Institute for Supply Management (ISM) Report on Manufacturing for December 2012 is due out on Wednesday, January 2, 2013. The ISM is a key gauge of the health of the manufacturing economy, and in turn the health of the firms in the S&P 500 Index, which is heavily weighted toward the business and manufacturing sectors of the U.S. economy. In recent months, the ISM has hovered near 50. A reading above 50 on the ISM indicates that the manufacturing economy is expanding, and a reading below 50 indicates a contracting manufacturing economy. A reading of around 42 or below typically indicates that the overall U.S. economy is in a recession [Figure 1]. The ISM

The ISM is a key gauge of the health of the manufacturing economy.

1 The ISM Has Been Hovering Near 50 Since the Summer, but Could Re-accelerate in 2013 as Uncertainty Fades



Source: Institute for Supply Management, Haver Analytics, LPL Financial 12/24/12

Shaded areas indicate recession.

A Look at the Weather:

Much warmer-than-usual weather in the United States artificially boosted economic activity beginning in November 2011, and warm weather extended into late winter 2012. The winter of 2012–13 has started out even warmer than the winter of 2011–12, and this could skew the economic data (like ISM, employment, vehicle sales, retail sales, housing, etc.) to the strong side again this year.

In Figure 2, note that the period from November 1 through December 20, 2012 was 1.8 degrees warmer than normal (the last 10 years). This is even warmer than the start of the winter of 2011–2012, when temperatures in the six weeks ending December 20, 2011 were 1.4 degrees above normal. Importantly, there was a big swing between a colder-than-usual start to winter in 2010–11 (1.9 degrees colder) and the warm start to winter 2011–12. While it is true that this winter is starting out to be even warmer than last winter, the swing (just 0.4 degrees) between early winter this year and last, is not even close to the 3.3 degree swing between early winter 2010–11 and winter 2011–12. Thus, the data may not be impacted as much as it was last winter.

2 Warmer-Than-Usual Weather in the Past Two Winters Has Skewed Economic Data to the Strong Side

	Deviation From Normal (10-Year Average) Temperature Nationwide (+ is warmer; – is colder)
11/1/08–12/20/08	-1.6
11/1/09–12/20/09	-0.2
11/1/10–12/20/10	-1.9
11/1/11–12/20/11	+1.4
11/1/12–12/20/12	+1.8

Source: National Oceanic and Atmospheric Administration, LPL Financial 12/21/12

is expected to remain around 50 again in December 2012, as a rebound from Superstorm Sandy and acceleration in Chinese demand in recent months is offset by the uncertainty surrounding the fiscal cliff.

U.S. light vehicle sales for December 2012 will be reported throughout the day on Thursday, January 3, 2013. In the United States, we are at a five-year high for both vehicle sales and production, but at a sales pace of around 15 million units, we are still not at the all-time high of 18 million units per year seen in the early to mid-2000s. Overseas, the picture is mixed, with vehicle sales in Europe stuck in first gear, but sales in China booming. Looking ahead, continued Chinese growth—as China moves to a more consumer-oriented domestic economy—along with a slow but sustained rebound in the U.S. economy should help to push vehicle sales higher again in 2013.

The minutes of the December 11–12, 2012 Federal Open Market Committee Meeting (FOMC) are due out on Thursday, January 3, 2013. The minutes are likely to reveal how much agreement there was among FOMC members to abandon time-based monetary policy guidance in favor of “threshold-based" guidance. The minutes will likely shed light on what other indicators, besides the unemployment rate, the inflation rate, and inflation expectations the FOMC will assess as part of its deliberations. As noted in our *Outlook 2013,* we expect the Federal Reserve (Fed) to remain accommodative well into 2015, and purchase $85 billion of Treasury and agency mortgage-backed securities (MBS) per month in 2013 as part of its recently expanded quantitative easing (QE) program.

The December 2012 **employment report** is due out on Friday, January 4, 2013. In mid-December 2012, the Fed said the “exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6.5%.” In November 2012, the unemployment rate stood at 7.8%, and it is expected to dip to 7.7% in December 2012. The latest projections of the FOMC put the unemployment rate at 6.5% sometime in 2015, while the nonpartisan Congressional Budget Office (CBO) does not see the unemployment rate reaching 6.5% until 2016. Our view is that the unemployment rate is likely to decline modestly over the course of 2013, which is consistent with employment gains in the 150,000 per month range in 2013. As detailed in our *Outlook 2013,* our Bull path for 2013 would lead to stronger economic growth (and job growth) than what the economy experienced in 2012, but this still keeps the Fed in accommodative mode for 2013 and beyond. ■

LPL Financial Research 2012 Forecasts

GDP 2%*
Federal Funds Rate 0%^
Private Payrolls +200K/mo.†

Please see our *Outlook 2012* for more details on LPL Financial Research forecasts.

LPL Financial Research Weekly Calendar

	U.S. Data	Fed	Global Notables
31 Dec '12	▪ Dallas Fed Mfg Index (Dec)		▪ **China: PMI-Manufacturing (Dec)**
1 Jan '13			
2 Jan '13	▪ Markit PMI (Dec) ▪ **ISM (Dec)** ▪ Construction Spending (Nov)		▪ China: PMI – Service Sector (Dec) ▪ **Eurozone: PMI-Manufacturing (Dec)** ▪ Germany: Bond Auction ▪ Germany: CPI (Dec)
3 Jan '13	▪ **Challenger Job Cut Announcements (Dec)** ▪ ADP Employment Report (Dec) ▪ **Initial Claims (12/29)** ▪ Vehicle Sales (Dec)	▪ **Minutes of December 11 – 12 FOMC meeting**	▪ **France: Bond Auction**
4 Jan '13	▪ **Employment Report (Dec)** ▪ Factory Orders (Nov) ▪ **ISM- Non Manufacturing (Dec)**	Plosser **Yellen*** Bullard*	▪ Eurozone: CPI (Dec) ▪ Eurozone: PMI – Services (Dec)

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)

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.

Mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by an accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

Mortgage-backed securities are subject to credit, default, prepayment, extension, market, and interest rate risk.

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.

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 U.S. Treasury securities).

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 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

China CPI: In total there are about 600 "national items" used for calculating the all-China CPI. The list of items is revised annually for representativeness based on purchases reported in the household surveys. The number of items can change from year to year, but rarely by more than 10 in any given year.

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 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.

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.

The Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The MCSI uses telephone surveys to gather information on consumer expectations regarding the overall economy.

The S&P/Case-Shiller U.S. National Home Price Index measures the change in value of the U.S. residential housing market. The S&P/Chase-Shiller U.S. National Home Price Index tracks the growth in value of real estate by following the purchase price and resale value of homes that have undergone a minimum of two arm's-length transactions. The index is named for its creators, Karl Chase and Robert Shiller.

The Empire State Manufacturing Index is a seasonally-adjusted index that tracks the results of the Empire State Manufacturing Survey. The survey is distributed to roughly 175 manufacturing executives and asks questions intended to gauge both the current sentiment of the executives and their six-month outlook on the sector.

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