Weekly Economic Commentary

January 7, 2013

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Highlights

The current economic recovery is running at about two-thirds the speed of recent recoveries, and half the speed of a "normal" recovery.

Failure to address the debt ceiling may lead to a recession in early 2013, though this is not our Base Path in our *Outlook 2013* publication.

The current quarter may receive a boost from Superstorm Sandy, but the payroll tax increase may put a dent into consumers' disposable income.

This year might look like last, when balancing the positives such as the housing recovery with the negatives such as tepid consumer spending.

Please see the LPL Financial Research Weekly Calendar on page 3

Full Speed Recovery?

After a quick start to 2013 for economic data and events last week (December 31–January 4), the week ahead is a relatively quiet one in the United States. The key domestic economic report due out this week is likely to be the latest weekly reading on initial claims, as markets focus on the unofficial start of the fourth quarter earnings reporting season. Five Federal Open Market Committee (FOMC) members are scheduled to speak this week, and almost all of them have spoken out against quantitative easing. Overseas, a full slate of Chinese economic data for December 2012 are due out, as well as key central bank meetings in the Eurozone, the United Kingdom, and South Korea. In addition, both Spain and Italy will auction debt.

On balance, last week's U.S. economic data on manufacturing, employment, vehicle sales, consumer sentiment, and the service sector for December 2012 exceeded expectations, and kept real gross domestic product (GDP) on track to post a gain of between 1.5% and 2.0% for the fourth quarter of 2012. Any increase in GDP in the fourth quarter of 2012 would mark the fourteenth consecutive quarter of economic growth since the end of the Great Recession in the second quarter of 2009. (See the box on page 2 for a look at how this recovery is stacking up to prior post-World War II recoveries.)

Growth Might Rebound in First Quarter 2013

Looking ahead into the current quarter (first quarter of 2013), growth may get a boost from a rebound from Superstorm Sandy, but the payroll tax increase that occurred as a result of the fiscal cliff deal signed into law by President Obama last week will put a dent into consumers' disposable income in the quarter, and leave real GDP growth around 2.0%. As noted in our *Outlook 2013*, failure to address the debt ceiling (and lingering sequestration issue) may lead to a recession in early 2013, while a quick resolution to the looming debt ceiling debate along with a "Grand Bargain" to address the nation's longer term fiscal issues could lift real GDP growth into the 3.0% range for the year. Please see our *Outlook 2013* for more details.

Disposable income is one of the best predictors of consumer spending, which in turn, accounts for around two-thirds of GDP. Disposable income is income derived from the following, less taxes paid:

- Wages and salary income;
- Rental income;

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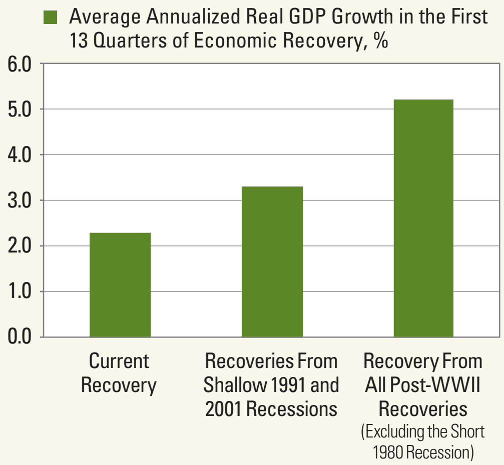
1 The Current Recovery Is Running at About Two-Thirds the Speed of Recent Recoveries, and the Speed of a "Normal" Recovery



Source: Bureau of Economic Analysis, LPL Financial 01/04/13

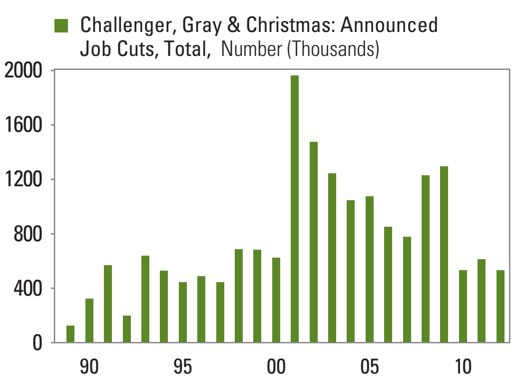
Benchmarking the Recovery

The recovery is running two-thirds the speed of the prior two (1991 & 2001) recoveries and half the speed of all recoveries since WWII.

- Real GDP has expanded by a cumulative 7.5% since the end of the recession in Q2 2009 (13 quarters: Q2 2009 through Q3 2012), for an average growth rate of 2.3% over the first 13 quarters.
- Following the last two recoveries (from the shallow 1991 and 2011 recessions), the economy expanded by 10.7% in the first 13 quarters, for an average growth rate of 3.3% over the first 13 quarters.
- Looking at all recoveries since WWII (excluding the recovery from the 1980 recession), the economy has typically expanded by 20% from the trough 13 quarters into a recovery, for an average growth rate of 5.2% per quarter.

The nature of the Great Recession (financial and housing-related versus a "typical recession" caused by rate hikes from the Federal Reserve or minor imbalances in the economy), along with the breakdown of the financial transmission mechanism (banks unwilling or unable to lend to businesses and consumers) since the collapse of Lehman Brothers in late 2008 have all contributed to the tepid recovery. Another key factor in the subpar recovery is on the fiscal side, particularly at the state and local government level. Typically, state and local spending (and hiring) is a modest source of strength and an offset to weaker parts of the economy during the recession and a boost in a recovery. This time around, state and local governments have come under severe pressure, detracting from growth both during the recession and since the end of the recession. Finally, the global nature of the Great Recession (and its aftermath) has prevented a sustainable surge in export growth from boosting economic growth in this recovery.

2 Announced Job Cuts Hit a 15-Year Low in 2012



Source: Challenger, Gray & Christmas, Haver Analytics 01/06/13

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.

- Dividend and interest income; and
- Transfer payments (payments by governments at all levels to individuals) like Social Security, Veterans Benefits, or unemployment insurance.

The sizable drop in disposable income (around 4.0% annualized between the fourth quarter of 2012 and the first quarter of 2013) may be partially offset by the recent gains in consumer net worth, which is up $6 trillion over the four quarters ending in the third quarter of 2012. Driving that gain is the improvement in housing prices, the nearly 20% gain in the U.S. equity market over the past year (early January 2012 through early January 2013), and a solid 4% gain in the bond market, as measured by the Barclays Aggregate Bond Index. In addition, the labor market has stabilized, with layoff announcements at a 15-year low in 2012, and consumer sentiment recently hit a five-year high.

2013 Is Shaping Up a Lot Like 2012

On balance, the first quarter, and indeed 2013 in general, is shaping up as follows: On the positive side:

- Rebuilding of infrastructure and housing stock damaged by Sandy;
- A continuation of recovery in the housing market;

LPL Financial Research Weekly Calendar

2013	U.S. Data	Fed	Global Notables
7 Jan			
8 Jan	■ Small Business Sentiment Index (Dec) ■ Consumer Credit (Nov)	Lacker (Hawk)	■ Eurozone: Consumer Confidence (Dec) ■ **Germany: Exports and Imports (Nov)** ■ Eurozone: Retail Sales (Nov)
9 Jan			■ Thailand: Central Bank Meeting ■ **Germany: Industrial Production (Nov)** ■ **China: Exports and Imports (Dec)** ■ China: Money Supply (Dec) ■ China: New Loan Growth (Dec)
10 Jan	■ **Initial Claims (1/5)** ■ JOLTS (Nov)	**George *** Bullard * (Hawk) **Kocherlakota (Dove)**	■ **European Central Bank Meeting** ■ **China: CPI (Dec)** ■ China: PPI (Dec) ■ **Spain: Bond Auction** ■ UK: Central Bank Meeting ■ Indonesia: Central Bank Meeting
11 Jan	■ **Trade Balance (Nov)** ■ Monthly Treasury Statement (Dec)	Plosser (Hawk)	■ **Italy: Bond Auction** ■ South Korea: 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)

- A reacceleration in growth in China and emerging markets, which will help boost exports; and
- A rebound in business spending after fiscal cliff and election-related uncertainty hurt business capital spending in the fourth quarter of 2012;

should help offset the following negatives:

- Tepid consumer spending;
- Weak federal and state and local government spending; and
- Muted contribution from net exports with Europe still in recession.

Overall, from an economic standpoint, 2013 may look and feel a lot like 2012. ■

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.

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 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.

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.

China PPI - The change in the price of goods purchased and sold by producers.

Barclays Aggregate Bond Index: is comprised of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

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.

National Federation of Independent Business (NFIB) surveys their members for the Small Business Optimism Index every month. Each member is sent a questionnaire and one reminder. While there is no standard definition of a "small business," the typical NFIB member employs 10 people and reports gross sales of about $500,000 a year.

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LPL FINANCIAL RESEARCH

Weekly Market Commentary

January 7, 2013

Checking for Collateral Damage

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Highlights

This week, we will begin to see if any collateral damage from the fiscal cliff battle was done to corporate profits in the fourth quarter as companies begin to release their fourth quarter earnings reports.

When the earnings season winds down in February 2013, the fiscal cliff battle part II may emerge as we approach the limit on U.S. borrowing authority, the end of the delay to the spending sequester, and funding of the U.S. government.

After a bounce on the relief from the fiscal cliff deal that took place on New Year's Day, the stock market has been in a sideways holding pattern. Investors are waiting to see if there was some collateral damage from the battle over the fiscal cliff. This week, we will begin to see if any damage was done to corporate profits in the fourth quarter of 2012.

Macroeconomic factors have been the key driver of the market lately, but microeconomics will begin to garner investors' attention in the coming weeks as companies begin to release their fourth quarter earnings reports. Four times a year, investors focus on the most fundamental driver of investment performance: earnings. While only a handful of S&P 500 companies report fourth quarter 2012 results this week, earnings reports will be issued from big U.S. companies including Alcoa, Constellation Brands, Monsanto, and Wells Fargo, among others as the fourth quarter earnings season kicks off.

While the fiscal cliff battle ultimately ended in a modest deal to avert some of the worst consequences to the economy, the related caution, contingency planning, special dividend distributions, and other distractions may have restrained business results. There is some reason to believe the fiscal cliff issues may have had some impact. While Friday's (January 4, 2013) employment report for December 2012 reflected another month of modest job growth and broad economic indicators show little measurable effect of the concern over the fiscal cliff, we saw weak business investment act as a drag on growth in the third quarter of 2012. This generally extended into the fourth quarter as corporate leaders were more likely to sit on cash, or return it to shareholders in the form of dividends and share buybacks, rather than make longer term commitments by increasing capital expenditures or ramping up hiring. For example, new orders for business investment were only up 0.5% year-over-year in November 2012, according to the latest U.S. Commerce Department data. Excluding transportation equipment, orders for business spending were flat.

Expectations for profit growth among S&P 500 companies in the fourth quarter of 2012 are down to about 3% year-over-year, sharply lower than the 10% growth expected at the start of the quarter. While the estimates are now in line with our long-held outlook*, two sectors are expected to provide double-digit gains and may still present some risk of disappointment [Figure 1].

* Please see our *2012 Outlook* and *2012 Mid-Year Outlook* publications for further information.

- The strong gains in the consumer discretionary sector—largely driven by strong demand for autos and housing—may be at risk due to disappointing retail sales reported during the holiday shopping season as consumers fretted over tax increases.
- The strong performance by financial stocks backed by similarly strong earnings growth—driven by mortgage lending, securities gains, and cost cutting at the big diversified financial services companies—may be at risk with relatively weak demand for credit, low interest rates along a flat yield curve, and large insurance losses.

1 Flat Earnings Growth Expected Overall

Wall Street Analysts' S&P 500 Sector Earnings Per Share Expectations for Q4 2012

	Year-Over-Year Growth Rate	
Sector	Current Expectations	Expectations at Start of 4th Quarter
Financials	14.5%	28.9%
Consumer Discretionary	11.1%	16.8%
Telecommunications Services	5.1%	4.1%
Consumer Staples	5.0%	7.4%
Materials	0.7%	21.9%
Utilities	0.7%	-4.4%
Information Technology	-1.0%	9.4%
Energy	-1.8%	-1.3%
Industrials	-5.6%	3.4%
S&P 500	**2.8%**	**9.9%**

Source: ThomsonONE 01/07/13

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

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

On the other hand, the industrials sector—expected to post the biggest year-over-year earnings decline (-5.6%) among S&P 500 sectors, may offer the potential for an upside surprise. Industrial production has been solid and exceeded economists' estimates in the latest data reported for November 2012. Also, in the jobs report for December 2012 released on Friday, January 4, 2013, manufacturing job growth turned much more positive after weak numbers in the prior four months. Renewed hiring among industrial companies may be a sign of confidence by management in the recently improving trend.

Wall Street analysts' consensus forecast of S&P 500 earnings per share for the fourth quarter of 2012 is $25.56. If accurate, this will be the lowest quarterly total for earnings per share in 2012. This is unusual; fourth quarter profits during a year of growth are typically the highest of the year. While this week—the week that Alcoa reports its earnings—is most often referred to as the start of the reporting season, some companies have already provided their fourth quarter numbers and confirmed a soft environment for profits. For example, FedEx Corporation reported in mid-December 2012 and missed expectations, posting a 12% decline from a year ago, reflecting a weak global economic backdrop and the impact of Superstorm Sandy.

While the results reported for the fourth quarter are important in measuring the impact of the fiscal cliff battle, so will the profit guidance for the coming quarters provided by corporate leaders.

While the results reported for the fourth quarter are important in measuring the impact of the fiscal cliff battle, so will the profit guidance for the coming quarters provided by corporate leaders. Earnings per share for 2012 are expected to end up 3.7% above the total for 2011. We expect another year of lackluster profit growth again in 2013. However, the consensus of Wall Street analysts' expectations is for 10% growth. The coming weeks may provide insight on the trajectory of profits in 2013.

The focus on microeconomic data in the coming weeks leads us to expect a relatively range-bound market in the near term. However, when the earnings season winds down in February 2013, the fiscal cliff battle part II may emerge as we approach the limit on U.S. borrowing authority, known as the debt ceiling, along with the end of the delay to the spending sequester on February 28 and funding of the U.S. government on March 27. These factors may weigh on the confidence of business leaders to employ capital in the first quarter and extend the sluggish profit environment. ■

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Stock investing involves risk, including the risk of loss.

Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Consumer Staples Sector: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

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.

Telecommunications Services Sector: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

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INDEX DEFINITIONS:

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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