Weekly Economic Commentary

February 25, 2013

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Highlights

The Humphrey-Hawkins testimony used to be a rare window of transparency for an otherwise opaque Federal Reserve (Fed), but now it is just one of the many ways the Fed is transparent.

In this week's Humphrey-Hawkins testimony, the market is looking to Federal Reserve (Fed) Chairman Ben Bernanke to apply more of a quantitative threshold on the pace of quantitative easing (QE).

We expect the Fed to maintain its accommodative policy.

Please see the LPL Financial Research Weekly Calendar on page 3

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#HumphreyHawkins

On Tuesday, February 26 and Wednesday, February 27, 2013, Federal Reserve (Fed) Chairman Ben Bernanke will deliver his semiannual monetary policy testimony before the Senate Banking Committee (Tuesday) and House Financial Services Committee (Wednesday). For market observers over a "certain age," this appearance is, and likely will always be known as the Humphrey-Hawkins testimony. This testimony, which is likely to be followed on social media sites like Twitter under the category #HumphreyHawkins, was mandated by the Full Employment and Balanced Growth Act of 1978, which helped to set into place the Fed's current dual mandate of full employment and low inflation. The sponsors of the Act were Senator Hubert H. Humphrey of Minnesota and Augustus Hawkins of California—hence the original name for semiannual testimony that usually occurs in February and again in July/August—and is accompanied by the Fed's Semiannual Monetary Report to Congress.

#Transparency

During the 80s and 90s—first under Fed Chairman Paul Volcker (1979–1987) and then Fed Chairman Alan Greenspan (1987–2006)—the Humphrey-Hawkins testimony provided a rare window of transparency into an otherwise opaque Fed. In those years, until 1994, the Fed's policymaking arm, the Federal Open Market Committee (FOMC), didn't even issue a statement at the conclusion of its policy meeting, leaving market participants, pundits, and the financial media guessing as to what action the FOMC actually took at a particular meeting. Beginning in 1994, the FOMC released a statement each time they changed policy (at the time, the FOMC was raising rates) but didn't issue a statement if no action was taken. This regime continued until 2000, when the FOMC began issuing a statement after each of the eight FOMC meetings per year.

Since then, the Fed's transparency to the markets (and to the public) has only increased. Fed Chairman Bernanke now holds a press conference four times a year, and the FOMC publishes forecasts for key policy variables like inflation, gross domestic product, and the unemployment rate. From 1993 through 2004, the minutes of each of the eight FOMC meetings used to be published a few days after the next FOMC meeting, roughly seven weeks after the meeting. Since late 2004, the minutes of each FOMC meeting are released three weeks after each meeting. In addition, the FOMC now provides a forecast for the fed funds rate (one of its key policy tools), and is currently providing very specific guidance—unemployment rates below 6.5% and inflation above 2.5%—as to when it would begin to raise rates.

Market participants will likely call for even more transparency on Bernake's views on QE.

Despite the dramatic shift toward more transparency at the Fed, many pundits, politicians, and market participants are likely to clamor for even more transparency particularly regarding Bernanke's views on the Fed's quantitative easing (QE) program. The language in the minutes of the January 29–30 FOMC meeting on Wednesday, February 20, 2013, suggested a shift within the FOMC, and noted that "many" members of the FOMC are now concerned with the potential risks and costs of further QE, and "several" FOMC members noted that the FOMC "should be prepared to vary the pace of asset purchases." On balance, the minutes suggested that if economic conditions do not deteriorate further—due to the fiscal cliff or some other event—the FOMC was prepared to at least scale back the pace of the QE3 (currently at $85 billion per month) later in the year. In this week's Humphrey-Hawkins testimony, the market is looking to Bernanke for confirmation of the tone of the minutes, and perhaps to apply more of a quantitative threshold on the pace of quantitative easing. We expect Bernanke to comment—and be questioned by Congress—on the costs and benefits of continuing to pursue QE at the current pace.

#Fiscal Policy

On the fiscal side, Bernanke will likely gently remind his bosses in Congress, and the general public, that it is Congress' job to run fiscal policy. Bernanke almost never misses a chance to chime in on fiscal policy, even though it is outside of the Fed's mandate, as outlined in the Humphrey-Hawkins Act of 1978. Still, Bernanke is likely to be pressed by Congressmen and Senators as to the likely impact of the sequestration on the overall economy, and on various sectors as well. He is also likely to be asked directly about what approach he would favor to address the nation's long-term budget problems. Although Bernanke is now starting his eighth and maybe his last year as Chairman of the Fed, he is not yet as adept as his predecessor Alan Greenspan was in dealing with Congress at these Humphrey-Hawkins testimonies. Still, Bernanke has been fairly consistent when asked by Congress (or the public) about fiscal policy. His remarks at his post-FOMC press conference on December 13, 2012 sum up his view well: "...it will be critical that fiscal policymakers come together soon to achieve longer-term fiscal sustainability without adopting policies that could derail the ongoing recovery." Bernanke has also made it clear that the Fed cannot offset the full impact of the fiscal cliff.

Bernake has consistently called for policymakers to work together on a plan for long-term fiscal sustainability.

#Tone

As market participants prepare to follow #HumpreyHawkins on social media, investors may wish to focus on the tone of Bernanke's comments and his answers to questions. A barrage of hashtags (#economy #employment #Bernanke) may accompany #HumphreyHawkins, but investors will ultimately want to glean how long Bernanke and company will maintain accommodative policy. We expect the Fed will make the point that accommodation is still very much in place. ■

LPL Financial Research Weekly Calendar

2013	U.S. Data	Fed	Global Notables
25 Feb	■ Dallas Fed Manufacturing Index (Feb)	Lockhart	■ **Italy: Bond Auction** ■ **Italy: Presidential Election Results**
26 Feb	■ Case-Shiller Home Price Index (Dec) ■ Consumer Confidence (Feb) ■ **New Home Sales (Jan)** ■ **Bernanke's Humphrey Hawkins Testimony**	Bernanke	
27 Feb	■ Durable Goods Orders and Shipments (Jan) ■ **Pending Home Sales (Jan)**	Fisher	■ **Italy: Bond Auction**
28 Feb	■ GDP (Q4-revision) ■ **Initial Claims (2/24)** ■ Chicago Area Purchasing Managers' Index (Feb)	Evans*	■ Germany: Retail Sales (Jan) ■ **Eurozone: CPI (Feb)** ■ **China: HSBC Manufacturing PMI (Feb)** ■ China: Manufacturing PMI (Feb)
1 Mar	■ Personal Income (Jan) ■ **Personal Spending (Jan)** ■ Consumer Sentiment (Feb) ■ Inflation Expectations (Feb) ■ **ISM (Feb)** ■ Vehicle Sales (Feb) ■ Construction Spending (Jan)		■ **Eurozone: PMI (Feb)** ■ China: Non-Manufacturing PMI (Feb) – Data due out on Saturday 3/2/13

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)

INDEX DESCRIPTIONS

The Chicago Purchasing Managers' Index is read on a monthly basis to gauge how manufacturing activity is performing. This index is a true snapshot of how manufacturing and corresponding businesses are performing for a given month. A reading of 50 or above is considered a positive reading. Anything below 50 is considered to indicate a decline in activity. Readings of the index have the ability to shift the day's trading session one way or another based on the results.

The Dallas Fed Manufacturing Survey is a widely followed monthly survey of state manufacturing and factory conditions.

The Eurozone Consumer Price Index (CPI) is the key monthly measure for inflation in the Eurozone.

The Eurozone Purchasing Managers' Index (PMI) measures the opinions of purchasing managers in the manufacturing and services sectors in the Eurozone.

China's monthly Manufacturing Purchasing Managers' Index (PMI) measures the opinions of purchasing managers in the manufacturing and services sectors in China.

HSBC's China Manufacturing Purchasing Managers' Index (PMI) measures monthly economic trends while attempting to remove seasonal impacts on production and demand, such as national holidays. The index includes data from purchasing executives from both state-owned and private business.

China's Non-Manufacturing Purchasing Managers' Index (PMI) measures monthly economic trends in a range of sectors, from retail trade, to environmental management, to the real estate industry.

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Weekly Market Commentary

February 25, 2013

Gasoline Prices Racing Toward Danger Zone

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Highlights

Watching the Daytona 500 from the "danger zone" can be a thrill, but gasoline's "danger zone" may be just plain scary. Gasoline prices are nearly back to the highs of the past five years that marked a "danger zone" for market participants.

In each of the past two years, rising energy prices have been one of the 10 "spring slide" indicators that helped us to predict the stock market pullbacks that took place during the second quarter of each year.

For more information on Spring Slide indicators, see *Weekly Market Commentary: 10 Indicators to Watch for Another Spring Slide,* published 03/26/12.

Do you feel like you are paying too much for gasoline? At least you did not have to fill up for the Daytona 500. The special ethanol-blended fuel that NASCAR drivers put into their tanks at the race on Sunday cost more than twice the national average for regular unleaded. And at about 18 gallons per tank, that comes to about $150 a fill up in a car that gets single-digit miles per gallon!

Even so, you are paying more. The U.S. average retail price of regular gasoline has risen to $3.75 per gallon, up 16 cents from last year at this time. The national average price has seen double-digit increases two out of the last three weeks and is up 45 cents since the beginning of the year.

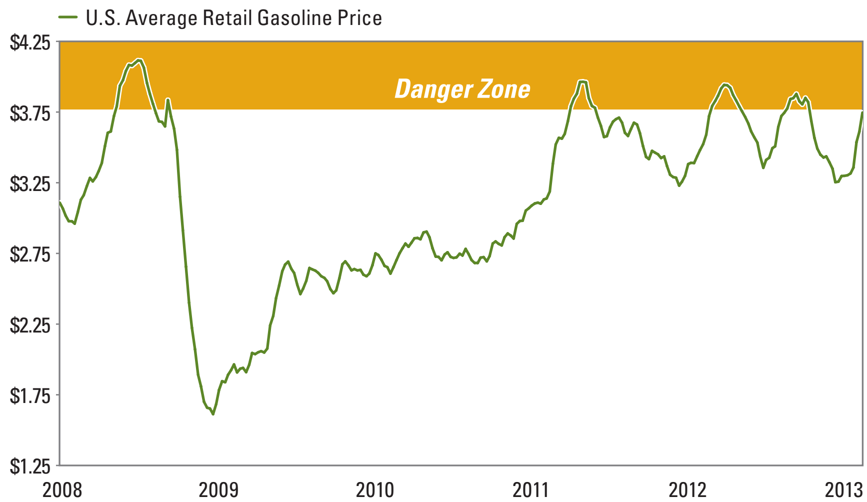
The race higher in gasoline prices is worth watching closely. In each of the past two years, we have tracked 10 "spring slide" indicators that helped us to predict the stock market pullbacks that took place during the second quarter of each year. Energy prices were one of 10 that accurately predicted a market slide each year. In each of the past two years, energy prices began to climb sharply in February, two months ahead of the peak in the stock market.

Danger Zone

Watching the Daytona 500 from the "danger zone," where cars whip by at high speeds of around 175 to 200mph—but can also burst through the walls in a crash—can be a thrill. But gasoline's "danger zone" may be just plain scary. At $3.75, retail gasoline prices are nearly back in the "danger zone" marked by the highs of around $3.85 to $4.10 per gallon seen over the past five years, as you can see in Figure 1. This range has marked a "danger zone" for market participants. When gasoline prices reached this range in the past, it preceded the stock market slides experienced in 2008, 2011, and 2012.

While high gasoline prices were certainly not the driving factor in the 2008 U.S. financial crisis-driven plunge in the stock market, the high prices did add to stress on the economy as they did again in the springs of 2011 and 2012, when concerns over a European financial crisis rattled investors. Again in the fall of 2012, high energy prices weighed on investor sentiment and helped to fuel a pullback driven by the election and fiscal cliff concerns. In short, high energy prices can make the economy and markets more vulnerable to a negative event that drives stocks lower.

1 Gasoline Prices Nearing "Danger Zone"



Source: Bloomberg 02/25/13

High energy prices can make the economy and markets more vulnerable to a negative event that drives stocks lower.

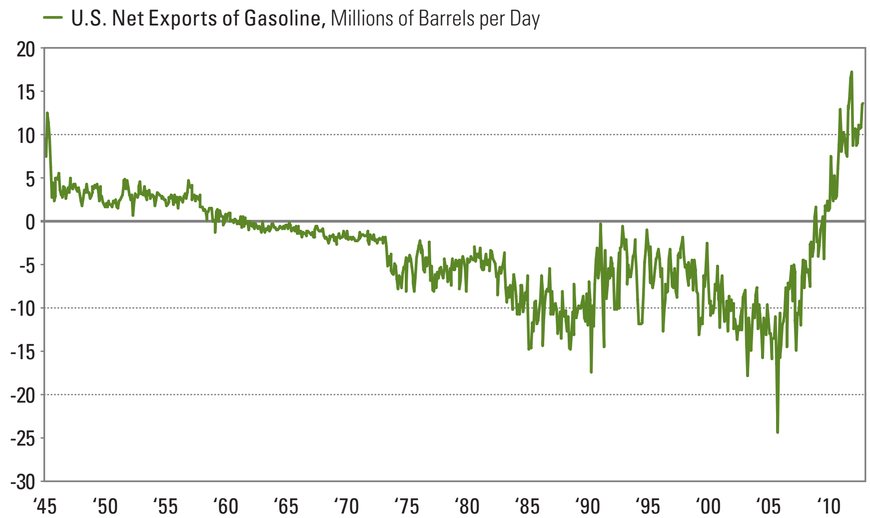
Factors Driving Gasoline Prices

Three major factors have combined to drive the surge in gasoline prices this year: oil prices, gasoline margins, and refinery outages.

- Crude oil prices are on the rise. The price of waterborne light sweet crude that drives the wholesale price of gasoline sold in most U.S. regions rose about $6 per barrel, or about 15 cents per gallon. This accounts for about one-third of the rise in gasoline. Gasoline's gains are outstripping crude oil's run up this year.
- Throughout much of November and December 2012, gasoline refining margins were very low, and in some cases negative with a barrel of gasoline worth less than a barrel of crude. As a result, retail gasoline prices were lower relative to crude oil prices. Since the beginning of 2013, gasoline prices versus crude oil have started to rebound.
- Both planned and unplanned maintenance at several refineries have supported higher refining spreads. Many refineries schedule maintenance early in the year when gasoline demand is seasonally low. A string of refinery outages resulted in substantial off-line capacity. The U.S. Energy Information Administration (EIA) estimates that inputs into U.S. refineries fell 9% from 15.9 million barrels per day in mid-December 2012 to 14.4 million for the week ending February 15, 2013.

A factor that is often misunderstood, but likely did not contribute to higher prices was the surge in exports. The United States has become a net exporter of gasoline. The turnaround in U.S. gasoline net exports is remarkable after about five decades of being a net importer, as you can see in Figure 2. But that has not come as a result of undersupplying the U.S. market.

2 U.S. Is Net Exporter of Gasoline



Source: Energy Information Agency, LPL Financial 02/25/13

The seasonal increase in demand, which typically begins in the spring, could keep upward pressure on prices.

U.S. demand for gasoline has declined, but solid global demand has allowed refineries to export gasoline produced using capacity that would otherwise have been taken offline. Over 80% of U.S. exports of total gasoline are produced and shipped from the Gulf Coast, while U.S. gasoline is generally imported along the East Coast. Given the Jones Act (which effectively limits the ability to ship oil from one U.S. port to another), infrastructure constraints, and costs of transporting gasoline around the U.S., were U.S. gasoline exports to be constrained, global gasoline supply would likely decline and U.S. gasoline consumers, especially in the Northeast, would face higher prices.

Avoiding the Danger Zone

Hopefully, gas prices can avoid the danger zone. There are indications that gasoline prices may soon ease.

- Both gasoline futures and crude oil prices declined last week.
- The EIA notes that 11 million barrels of waterborne gasoline are en route to the United States and Canada.
- U.S. refinery maintenance, which reduces capacity, typically peaks in February, and output should return to normal in the coming weeks.

However, the seasonal increase in demand, which typically begins in the spring, could keep upward pressure on prices. If prices again enter the danger zone, we will be watching this spring slide indicator along with the others closely for signs of an impending stock market slide. We will provide an update of all of our spring slide indicators in an upcoming *Weekly Market Commentary.* ■

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.

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Alternative investments may not be suitable for all investors and involve special risks such as leveraging the investment, potential adverse market forces, regulatory changes and potentially illiquidity. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

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