Weekly Economic Commentary

February 4, 2013

Less Defense?

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Highlights

We believe defense spending, after a rebound in the first quarter of 2013 on the heels of the big drop in the fourth quarter of 2012, is likely to be flat in 2013.

If Congress can agree to substantial cuts in defense spending as part of an overall budget deal (an unlikely scenario, in our view), defense would likely be a modest 0.1 to 0.2% drag on overall gross domestic product (GDP) growth in 2013 and beyond.

Eliminating all "waste, fraud, and abuse" from the defense budget, while a worthwhile endeavor, would only make a small dent in overall spending.

Please see the LPL Financial Research Weekly Calendar on page 2

On Sunday, February 3, 2013, the Baltimore Ravens defeated the San Francisco Forty Niners 34–31 to win Super Bowl XLVII. The talk of the game was certainly not about defense, but defense spending, and its impact on the economy, was a key topic of conversation in financial markets in the week leading up to the Super Bowl.

Economic Data Halftime Show Highlights

The financial markets in the week preceding the Super Bowl (January 28–February 1) featured four key economic events:

- The Institute for Supply Management's (ISM) Report on Business for January 2013;
- The January 2013 employment report;
- The fourth quarter 2012 gross domestic product (GDP) report; and
- The Federal Reserve's Federal Open Market (FOMC) meeting.

Any one of these events happening in one week would draw a great deal of attention from the media and financial market participants, but all of these top-ranked data points playing out in one week is rare—almost as rare as a power outage at the Super Bowl!

On balance, last week's economic reports, along with the statement accompanying the FOMC meeting, revealed an economic playbook that included economic growth fast enough to create jobs and move the widely watched ISM index, at 53.1, to a nine-month high, but not fast enough to cause the Federal Reserve (Fed) to think about ending its program of bond purchases (quantitative easing, or QE3) anytime soon.

The outlook for defense spending is a bit less certain due, in part, to yet another piece of the fiscal cliff: spending cuts known as sequestration.

Last week's economic data halftime show that drew the most attention was Thursday (January 31, 2013) morning's release of the surprising -0.1% drop in GDP between the third and fourth quarters of 2012. Economists had been expecting a number around 1%. Within that surprisingly weak report was a stunning 22% drop in defense spending, the largest quarter-over-quarter drop in defense spending since 1972, as the Vietnam War was winding down. This drop alone shaved 1.3 percentage points from GDP. Although there is no precise measurement, the effect of Superstorm Sandy likely shaved another 0.5 percentage points off of GDP. Add in the 1.3 percentage point drag from fewer inventories being built up in the fourth quarter than

LPL Financial Research Weekly Calendar

2013	U.S. Data	Fed	Global Notables
4 Feb	■ Factory Orders (Dec)	No Fed Speakers/ Scheduled News This Week	■ Australia: Central Bank Meeting ■ **Germany's Merkel Meets Spain's Rajoy**
5 Feb	■ ISM- Non Manufacturing (Jan) ■ **CBO releases its Economic and Budget Outlook**		■ Eurozone: PMI Services (Jan)
6 Feb			■ Poland: Central Bank Meeting
7 Feb	■ Productivity (Q4) ■ **Initial Claims (2/2)** ■ Consumer Credit (Dec)		■ **Eurozone: Leaders' Summit** ■ **UK: Bank of England Meeting** ■ **Eurozone: European Central Bank Meeting** ■ **Spain: Bond Auction** ■ Germany: Industrial Production (Dec) ■ France: Bond Auction ■ India: GDP (FY 2013) ■ **China: Money Supply (Jan)** ■ New Loan Growth (Jan)
8 Feb	■ Trade Balance (Dec) ■ Wholesale Trade (Dec)		■ **Eurozone: Leaders' Summit** ■ **China: Trade Balance, Imports, and Exports (Jan)** ■ **China: CPI (Jan)** ■ China: PPI (Jan) ■ Germany: Trade Balance, Imports, and Exports (Dec)

in the third, and it is likely that real GDP growth would have been closer to 3.0% than to zero.

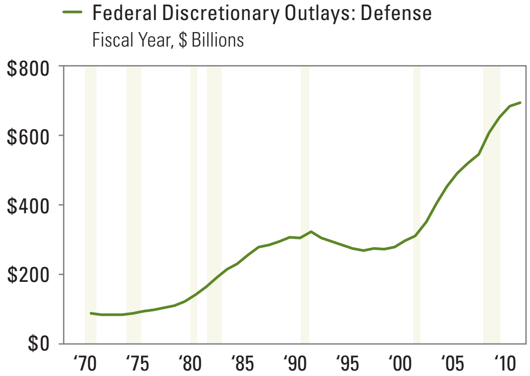
The drawdown in inventories may have been related to uncertainties among businesses ahead of the fiscal cliff and the impact of Superstorm Sandy. These are likely to be at least partially reversed in the first quarter of 2013 and add to GDP growth. However, the outlook for defense spending is a bit less certain due, in part, to yet another piece of the fiscal cliff: spending cuts known as sequestration.

Defense Spending Running at About 4–5% of GDP

At least a portion of the 22% drop in defense spending—from an annualized pace of $698.1 billion in the third quarter of 2012 to an annualized pace of $655.7 billion in the fourth quarter of 2012—was likely due to the fiscal cliff, as some defense contractors may have curtailed some non-mission critical spending ahead of the pending cuts tied to sequestration. Indeed, the research and development-related portion of defense spending fell at a whopping 58% annualized rate in the fourth quarter, while outlays for troop pay dropped by just 3.0%. Thus, the ongoing drawdown in troop levels in Iraq and Afghanistan also most likely played only a part in the big drop in defense outlays in the fourth quarter. Government spending on big ticket military items like aircraft, missiles, ships, vehicles, and electronics fell by only 2.2% between the third and fourth quarters of 2012.

The defense sector remains one of the largest single segments of the federal budget.

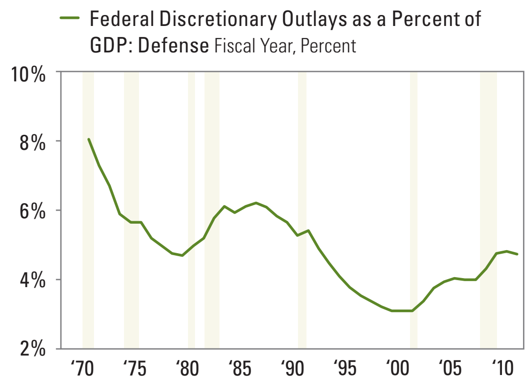
1 Defense Spending Has Accelerated Since the 9/11 Terror Attacks



Source: Congressional Budget Office, Haver Analytics 11/26/12

Shaded areas indicate recession.

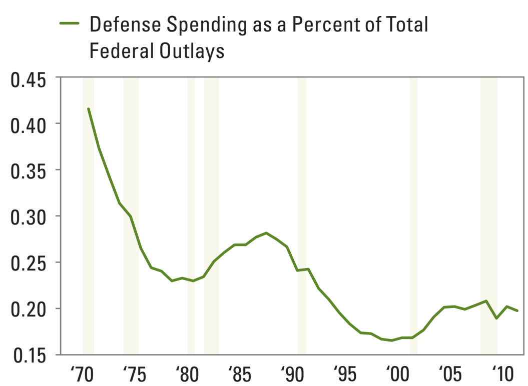
2 Defense Spending Is Running at About 4% of Overall GDP



Source: Congressional Budget Office, Haver Analytics 11/26/12

Shaded areas indicate recession.

3 Defense Spending Accounts for Roughly 20% of Total Federal Outlays



Source: Haver Analytics 11/26/12

Shaded areas indicate recession.

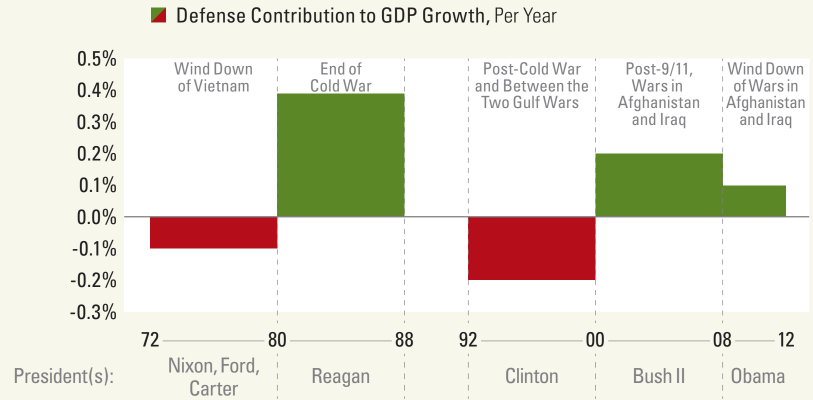
Between $25 billion and $30 billion of automatic spending cuts will hit defense spending on February 28, 2013, representing roughly a 10% cut to defense outlays, unless Congress acts to modify, suspend, or delay the cuts. Moving past the sequestration, the defense sector remains one of the largest single segments of the federal budget. In fiscal year 2012, defense spending was close to $640 billion and is one of the largest categories of discretionary spending. In recent years, defense spending has accounted for between 50% and 55% of discretionary spending, 4.5% of gross domestic product (GDP), and about 20% of overall federal government outlays. During the Reagan administration at the end of the Cold War, defense spending accounted for 65% of total discretionary spending, 6% of GDP, and nearly 30% of all federal government outlays. After the fall of the Berlin Wall in 1989, defense spending as a percent of discretionary spending fell swiftly—bottoming out in 2001 at under 48%, 3% of GDP, and 15% of total federal outlays—just as the war on terror and the wars in Afghanistan and Iraq began.

Defense spending is often discussed as an area to cut in order to reduce the long-term deficit because it is such a large part of federal outlays. While there is likely some kernel of truth in oft-cited media reports of $600 hammers and $300 toilet seats being purchased by the Pentagon, eliminating all "waste, fraud, and abuse" from the defense budget, while a worthwhile endeavor, would only make a small dent in overall spending.

Defense Spending Under Different Administrations

Since President Obama took office, defense spending has added just 0.1% to GDP per year, half of the contribution this sector made during the administration of George W. Bush, a period that included the 9/11 terror attacks, the war in Afghanistan, and the war in Iraq. During President Clinton's two terms in office, which coincided with relative calm on the geopolitical front after the end of the Cold War and the first war in Iraq, defense spending shaved around 0.2 percentage points from GDP on average each year. This was in sharp contrast to the final years of the Cold War, which saw defense spending add 0.4 percentage points to growth each year during the Reagan administration. From 1972 through 1980, under Presidents Nixon, Ford, and Carter, defense spending subtracted 0.1% from GDP growth per year, as the Vietnam War ended [Figure 4].

4 Defense Contribution to GDP Growth, 1972–2012



Source: LPL Financial 02/04/13

Potential Slowing in Pace of Defense Spending Ahead

Looking ahead from a budget perspective, perhaps the best that can be hoped for is a slowing in the pace of defense spending, not outright declines similar to those seen in the late 1970s and 1990s Some of the proposals put forth by the deficit commissions and the Congressional Budget Office (CBO) regarding defense spending include:

- Freezing defense spending at current levels of GDP;
- Cutting the rate of increase in defense spending; and
- Finding savings within the Department of Defense's procurement system.

Please see our *Weekly Economic Commentary: Budget Defense* from November 26, 2012 for more details.

From a GDP perspective, the best case for defense spending in 2013 is that it has a modest positive impact on GDP.

From a GDP perspective, the best case for defense spending in 2013 is that it has a modest positive impact on GDP. More likely, defense spending, after a rebound in the first quarter of 2013 on the heels of the big drop in the fourth quarter of 2012, is likely to be flat. The worst case — again from a GDP perspective — and least likely, would be if Congress can agree to substantial cuts to defense spending as part of an overall budget deal. In this scenario, defense would likely be a modest 0.1 to 0.2% drag on overall GDP growth in 2013 and beyond. ■

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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.

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 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).

International Monetary Fund (IMF) is an international organization created for the purpose of promoting global monetary and exchange stability, facilitating the expansion and balanced growth of international trade, and assisting in the establishment of a multilateral system of payments for current transactions.

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

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 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.

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.

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Weekly Market Commentary

February 4, 2013

Seeing Shadows

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Highlights

This Groundhog Day, when looking at the Dow, we are seeing shadows of what took place in each of the past three years as a new milestone was reached. It took the better part of a year for the market to break free of a period of ups and downs after reaching the milestone before beginning to move toward the next one.

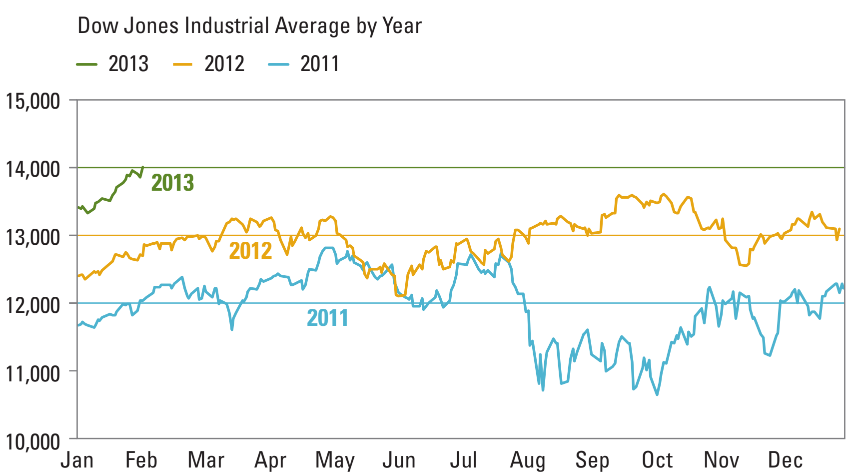
That pattern may be repeated this year; however, the bull market is not likely to be over. If so, stocks would be ending a bull market with the S&P 500 priced at the lowest multiple of earnings for a bull market peak since WWII.

As we all know, the Groundhog Day tradition holds that when a groundhog emerges from its burrow on February 2, if the groundhog sees its shadow the cold winter weather will continue for six more weeks. If not, spring will come early. This Groundhog Day, when looking at the Dow Jones Industrial Average (Dow), we are seeing shadows of what took place in each of the past three years as a new milestone was reached. As a result, the current levels on the index may linger for six or more months.

The Dow closed at 14,000 on Friday for the first time since October 2007. For each of these round numbers (11,000, 12,000, and 13,000) the Dow has crossed in the past few years, it has taken the better part of a year for the market to break free of a period of ups and downs after reaching the milestone before beginning to move toward the next one.

- 11,000 was reached in April 2010, and the Dow was not able break free above it until seven months later in November of 2010.
- 12,000 was reached in February 2011, and the Dow was not able break free above it until 10 months later in December 2011.
- 13,000 was reached in February 2012, and the Dow was not able break free above it until 10 months later in December 2012.

1 Dow Milestones and Resulting Ranges



Source: Bloomberg data, LPL Financial 02/04/13

The Dow Jones Industrial Average Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

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If this pattern of the past few years, seen in Figure 1, repeats in 2013, now that we have crossed the 14,000 milestone in early February, the Dow may remain around that level nearly all year and not break free above that level until December again this year.

Milestones

Why might the Dow soon take a break after reaching 14,000 on Friday?

- The fourth quarter 2012 earnings reporting season "sweet spot" is behind us. The first half of the earnings season, which is now behind us, has tended to lift stocks as companies tend to exceed expectations, while the second half often sees a slide with the good news already discounted.
- Inflows to U.S. stock mutual funds were positive in January 2013 for the first month in almost two years. However, inflows have been a contrarian indicator for the stock market in recent years. For example, the last time U.S. stock mutual funds recorded a month of inflows was April 2011 — just as stocks peaked for the year on April 29, 2011.
- The Italian elections this month may return attention to the lingering problems in Europe and deepening economic crisis, as measured by the Investment Company Institute (ICI). European markets led the world's stock markets to the upside late last year as a financial crisis was averted, but have recently begun to lag other markets.

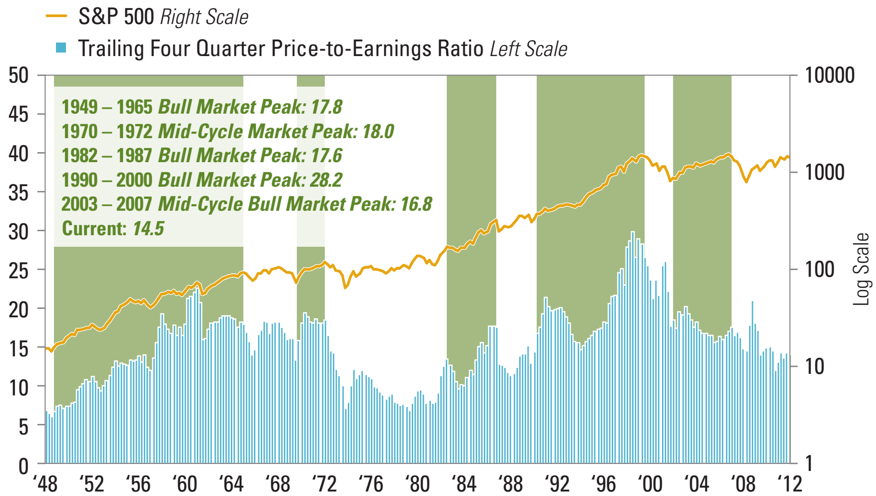
The bull market is not likely to be over; if so, stocks would be ending a bull market with the S&P 500 priced at the lowest multiple of earnings at a bull market peak since WWII.

These are fundamental reasons why a pause may be in store. But there is also a psychological reason why it tends to take some time to move beyond market milestones that are especially true this time. This milestone has extra significance, since Dow 14,000 marks a return to the stock market peak reached in October 2007, and lies just 1% below the all-time high of 14,164.53 on October 9, 2007. On that same day, the S&P 500 index — a broader measure of the stock market than the Dow — reached 1,565.15. The S&P 500 recently breached the 1500 milestone and has seen that milestone two times before, in October 2007 and March 2000; both times marked the ceiling for the stock market and the beginning of long and steep declines. As the stock market again nears the level that has defined the ceiling for the stock market during the past 13 years, market participants may show signs of caution.

The Bull Is Not Dead

The bull market is not likely to be over; if so, stocks would be ending a bull market with the S&P 500 priced at the lowest multiple of earnings at a bull market peak since WWII [Figure 2]. However, a pause with some ups and downs around the recently reached milestone may be in store. The dips may make for attractive buying opportunities for investors who have been underinvested in stocks in recent years relative to their long-term target allocation.

2 Bull Markets End at Higher Stock Market Valuations



Source: Thomson Analytics, Bloomberg data, LPL Financial 02/04/13

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

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

It may be that we repeat the pattern of the past few years and wake up each day to a stock market stuck right around 14,000 for a while before we can move beyond it.

These days, when someone refers to *Groundhog Day*, it is more likely they are referring to the classic Bill Murray movie where he is stuck in time and forced to repeat the same day over and over again—until eventually being able to move beyond it. This past weekend, "Punxsutawney Phil," the world's most well-known groundhog, saw his shadow and predicted more of the same winter weather in the weeks ahead. As Bill Murray's character, Phil, said: "This is one time where television really fails to capture the true excitement of a large squirrel predicting the weather." It may be that we repeat the pattern of the past few years and wake up each day to a stock market stuck right around 14,000 for a while before we can move beyond it.

After reaching 14,000, the stock market may be due for some modest ups and downs, but there may still be some excitement. Investors may want to get their shopping list ready to take advantage of stock market pullbacks to add their portfolios. ■

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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.

Dow Jones Industrial Average (DJIA): The Dow Jones Industrial Average Index is comprised of U.S.-listed stocks of companies that produce other (non-transportation and non-utility) goods and services. The Dow Jones Industrial Averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore their component weightings are affected only by changes in the stocks' prices.

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