Weekly Market Commentary

March 18, 2013

The Market's March Madness

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Highlights

It has been a sweet sixteen weeks for the S&P 500. The broad stock market index has had only three down weeks out of the past sixteen, tying a record unbroken for over 20 years.

As the NCAA basketball tournament gets down to its own sweet sixteen late this week, it is a good time to reflect on the sixteen competing drivers of the markets that may make for an exciting showdown in the weeks and months to come.

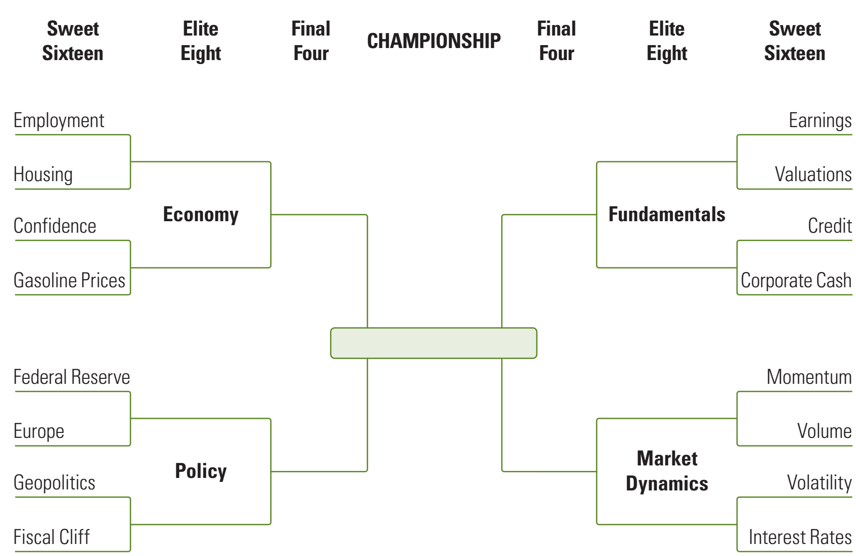
There will likely be some upsets that result in volatility as these factors face off against each other.

It has been a sweet sixteen weeks for the S&P 500. The broad stock market index has had only three down weeks out of the past sixteen. While this stretch is tied by the same period a year ago, it is important to note that there has not been a sixteen-week period with fewer weeks of losses in over 20 years—since the period ending September 1, 1989.

March has been maddening for investors in the past few years (2010–2012) as the S&P 500 raced higher in March only to reverse all of those gains in a pullback of about 10% that began in late March or April. It later took stocks at least five months to climb back to the peaks of March.

As the NCAA tournament gets down to its own sweet sixteen at the end of this week, it is a good time to reflect on the competing drivers of the markets that may make for an exciting showdown in the weeks and months to come.

1 Stocks' Sweet Sixteen



Source: LPL Financial 03/18/13

As we narrow down stocks' "sweet sixteen" potential drivers this year, the four "regions" of market-moving factors vying for investor attention are: economy, policy, fundamentals, and market dynamics.

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Economy

- **Employment –** Job growth has been picking up with more than 200,000 jobs created in three of the past four months and first-time filings for unemployment benefits have started to fall after stabilizing around 350,000 for over a year.
- **Housing –** The powerfully rebounding housing market, as seen in data such as housing starts and building permits, is a positive for growth.
- **Confidence –** Last week's University of Michigan data showed that consumer confidence fell sharply in the preliminary reading for March to the lowest level in over a year.
- **Gasoline Prices –** Retail gasoline prices are back up near the "danger zone" that coincided with stock market pullbacks in each of the past few years.

Policy

- **Federal Reserve –** "Don't Fight the Fed" rally is intact, but as the Federal Reserve publicly contemplates ending the latest stimulus program, the stock market may suffer the same sell-off that surrounded the ending of prior quantitative easing programs, so-called QE1 and QE2.
- **Europe –** With the Eurozone back in recession, an inconclusive election leaving no government in Italy, a political scandal hampering the ability to implement needed reforms in Spain, Greece unlikely to meet the terms of its own bailout, and Germany pushing hard terms on any aid ahead of its fall elections, the events in Cyprus could provide the catalyst for another Europe-driven spring slide in the world's stock markets.
- **Geopolitics –** The hot spots are heating up again given the power grab following the death of Chavez in Venezuela, the coming elections in Iran, different factions vying for power in war-torn Syria, and North Korea annulling its cease fire agreement.
- **Fiscal Cliff –** A fiscal drag on gross domestic product (GDP) of about 2%, and showdowns over the continuing resolution funding the government and the debt ceiling still to come, may weigh on investor sentiment as the recently implemented sequester threatens to halt labor market improvement with an estimated cost of 750,000 jobs, according to the Congressional Budget Office.

Fundamentals

- **Earnings –** Earnings are the most fundamental of all drivers of stocks. Earnings growth has been the most consistent factor driving the markets in recent years, but growth has now slowed to the low-single digits for S&P 500 companies.
- **Valuations –** The price-to-earnings ratio of the S&P 500, at around 15 on the past four quarters' earnings, is well below the 17–18 seen at the end of all prior bull markets since WWII.

- **Credit** – Demand for credit has improved and credit spreads have narrowed; both trends are key supports to growth.
- **Corporate Cash** – Strong cash balances provide a cheap source of capital to invest and incentive to buy back shares to boost earnings per share growth.

Market Dynamics

- **Momentum** – Stocks have been on a strong winning streak that could continue.
- **Volume** – Trading volume in the markets has been light this year, 10–15% below last year, traditionally seen as a sign that a trend has become vulnerable.
- **Volatility** – Investors have once again become net sellers of U.S. stock mutual funds in the past two weeks, according to data from the Investment Company Institute (ICI), despite strong and steady gains. A return to more volatile markets may further undermine individual investor support.
- **Interest Rates** – Interest rates are on the rise, potentially acting as a drag on everything from housing to the U.S. budget, but from very low levels.

There are quite a few listed here, but these certainly are not all the factors that are influencing the markets.

The key message for investors in considering these factors is: don't be too confident in any particular outcome. Respect the complexity of the situation. This is a time for caution and taking some profits, not for indiscriminate selling. It is a time to nibble at opportunities as they emerge; it is not a time to jump in with both feet.

Investing is not a game, but it is important also to remember that forecasting is not an exact science, and many factors can affect outcomes that are hard to predict. Two years ago, the Japanese earthquake had a big impact on markets and natural disasters—despite tremendous advances in technology—are very hard to predict with any degree of accuracy. Geopolitical outcomes can also be hard to foresee as we look to the stresses in the Middle East. For example, the outcome of the Arab Spring uprisings and the changes they have led to in countries including Syria and Egypt were hard to foresee. The markets rarely offer perfect clarity on their direction because they are driven by these factors as well as many others. Even this week's NCAA March Madness can be seen as a reminder of how it can be notoriously hard to predict winners. Historically, a team's ranking has meant nothing after getting down to the elite eight.

These factors will play out in the markets over the course of the year, not just in the coming weeks. This means there will likely be some upsets that result in volatility and pullbacks as these factors face off against each other. In the end, we expect a positive year with many opportunities for investors. ■

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 and mutual fund investing involves risk, including the risk of loss.

The Standard & Poor's 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

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.

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.

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.

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $11.18 trillion and serve nearly 90 million shareholders.

The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market Bass-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

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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LPL FINANCIAL RESEARCH

Weekly Economic Commentary

March 18, 2013

The Inflation Situation Revisited

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Highlights

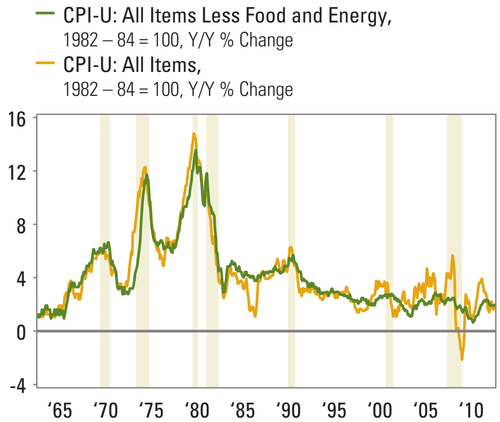
Our view remains that the economic backdrop does not support a sustained uptick in inflation anytime soon, although some factors may push readings modestly higher in the coming months.

Wages remain the most important factor in business costs and in determining the overall pace of inflation.

While there are several factors poised to push inflation higher, there are far more factors working today that are pushing inflation lower.

Please see the LPL Financial Research Weekly Calendar on page 3

1 Inflation Has Been Low and Stable for the Past 30 Years After a 15-Year Surge from the Mid-60s Through Early 80s



Source: Bureau of Labor Statistics, Haver Analytics 03/15/13

Shaded areas indicate recession.

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.

We last wrote about the inflation outlook in the September 24, 2012 edition of the *Weekly Economic Commentary: The Inflation Situation*. Since then, while inflation and inflation expectations in the United States have remained in check, the Federal Reserve (Fed) has begun another round of bond purchases, known as quantitative easing (QE). This decision—along with the recent run-up in consumer gasoline prices and recent comments from some members of the Federal Open Market Committee (FOMC) that the costs of QE may soon begin to outweigh the benefits—has generated plenty of discussion of inflation among financial market participants and the media.

Our view remains that the economic backdrop does not support a sustained uptick in inflation anytime soon, although higher food and energy prices—as a result of last summer's drought and recent geopolitical unrest—may push overall inflation readings modestly higher over the next several months. Finally, we examine some snippets from the Fed's Beige Book—a qualitative assessment of economic, business, and banking conditions in each of the 12 Fed districts—relating to the inflation situation and compare them to similar comments from the Beige Books in the 1970s, when the pace of inflation surged, seemingly out of nowhere, and also to 2004, when the FOMC began raising rates it had lowered to combat the impact of the 2001 recession.

Inflation is a sustained, broad based increase in the general level of prices. As noted in Figure 1, inflation, the rate of change in the general level of prices as measured by the consumer price index (CPI), has been trending lower for more than 30 years. Inflation excluding food and energy (core inflation) has followed a similar path. Forecasts for inflation from the Fed, the consensus of economists and market participants, and the Congressional Budget Office all suggest ongoing tame inflation over the next several years and over the long term [Figure 2]. Some of the factors responsible for this well-established trend are:

- **Low and stable inflation.** Simply put, low and stable inflation fosters future low and stable inflation. At around 1.0% in the mid-1960s, inflation surged over the following 15–20 years, peaking at nearly 15% in 1980. Since then, inflation has moved sharply lower, and stayed there, with only a few blips higher over the past three decades. ***Neither overall inflation nor core inflation has moved much since our last update on inflation in September 2012.***

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2 Tame Inflation Expected Over the Next Few Years and the Long Term

	2013 F	2014 F	Long Term* F
Federal Reserve	1.6%	1.8%	2.0%
Market Consensus	1.8%	2.2%	2.3%
CBO	1.5%	2.0%	2.2%

Source: Federal Reserve, Bloomberg, Congressional Budget Office, Consumer Price Index (CPI) forecasts 03/15/13

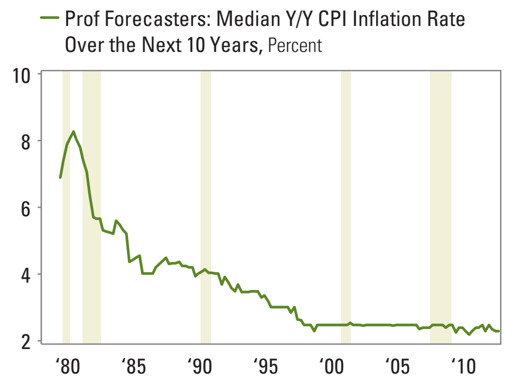
*Long Term:

For the Fed forecasts, long-term projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy.

For the Market Consensus forecasts, long-term forecasts are from the Philadelphia Fed's Survey of Professional Forecasters forecast for inflation over the next 10 years.

For the CBO, long-term forecasts are the CPI inflation forecast over the years 2012–2022.

3 Low and Stable Inflation Expectations Are a Key Factor in Keeping Inflation Rates Low and Stable



Source: Federal Reserve Bank of Philadelphia, Haver Analytics 03/15/13

Shaded areas indicate recession.

- **Low and stable inflation expectations.** The public's views (the general public and professional forecasters) on inflation are often cited by Fed Chairman Ben Bernanke and other Fed officials as one of the key weapons against inflation. Both measures have been low and stable for the past 13 years, and have been moving lower for 30 years. ***Since we last wrote about inflation in September 2012, long term inflation expectations have nudged down to 2.3% from the 2.4% reading in the third quarter of 2012 [Figure 2].***
- **Fed's inflation-fighting credibility.** In the early 1970s, the Fed had no experience or credibility with the public in keeping inflation low and stable. Indeed, the Fed generally kept rates lower than they should have been as the economy grew above its long-term potential in the mid-to-late 1960s and early 1970s [Figure 3]. By the end of the decade, the public had lost faith in the Fed, but the last 30 years has seen the Fed regain the public's trust, often by "taking away the punchbowl" (i.e., raising rates) before the party got out of hand and inflation became problematic. ***Over the past six months, the Fed has maintained its inflation fighting credibility in the marketplace, but it must be prepared to act in order to convince the market that it will treat the threat of inflation the same way it dealt with the threat of deflation.***
- **Globalization.** When inflation was surging in the mid-1960s through the early 1980s, the U.S. economy was relatively insular. Prices (and in some cases, wages) were made and set within our borders, and trade accounted for only a small portion of our gross domestic product (GDP). Today, the United States has a much more open economy, and there is now plenty of overseas competition in both wages and prices. In general, the push toward globalization has put downward pressure on prices.
- **Spare capacity in product and labor markets.** Related to the bullet above, slack in product and labor markets is one of the key drivers of low inflation today, despite the successive rounds of quantitative easing from the Fed and other central banks around the world. High unemployment rates here in the United States and in Europe, along with very high levels of unused factory and office space around the globe, make it very difficult to pass along higher input prices to end users. In contrast, as inflation surged higher in the 1960s and 1970s, there was very little, if any, spare capacity, and the unemployment rate was abnormally low. ***Since September 2012, the Chinese economy has reaccelerated, but the European economy remains mired in a deepening recession. But, according to the Federal Reserve, in the United States, capacity utilization rates have ticked up some (from 76.8 to 78.3) and the unemployment rate has dipped 0.1% to 7.7%, according to the Bureau of Labor Statistics (BLS). Neither reading is indicative of an overheating economy.***

LPL Financial Research Weekly Calendar

2013	U.S. Data	Fed	Global Notables
18 Mar	▪ **Homebuilder Sentiment (Mar)**		▪ **China: Property Prices (Feb)**
19 Mar	▪ Housing Starts (Feb)		▪ Germany: ZEW Index (Mar) ▪ **India: Central Bank Meeting**
20 Mar		▪ FOMC Meeting ▪ FOMC Forecast ▪ **Bernanke Press Conference**	▪ **China: HSBC Flash PMI (Mar)** ▪ UK: Annual Budget Address
21 Mar	▪ **Initial Claims (3/16)** ▪ Markit PMI (Mar) ▪ Philadelphia Fed Index (Mar) ▪ **Existing Home Sales (Feb)** ▪ Leading Indicators (Feb)		▪ **Eurozone: PMI (Mar)** ▪ UK: Retail Sales (Feb) ▪ **Spain: Bond Auction** ▪ France Bond Auction
22 Mar			▪ **Germany: IFO (Mar)**

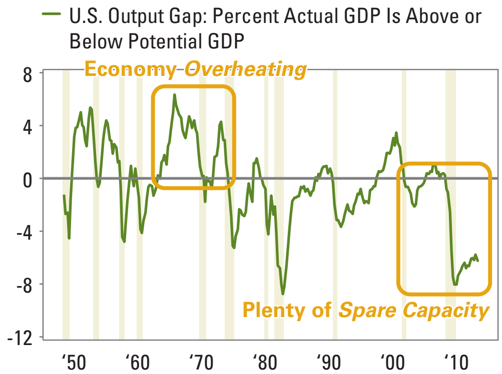
Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

* Voting members of the Federal Open Market Committee (FOMC)

- **Mobile workforce.** In the United States, wages and salaries account for about two-thirds of business costs. In the 1960s and 1970s, low unemployment, the "closed" U.S. economy, and a less mobile workforce pushed wages sharply higher. Wages remain the most important factor in business costs and in determining the overall pace of inflation. Today, wage inflation is muted, as 30 years of globalization have led to wages being partially set overseas, where overall employment, not the pay scale, is often more important. ***Since we last wrote about inflation in September 2012, wage inflation has accelerated to a still muted 2.0% year-over-year, up from the 1.4% year-over-year reading in September 2012, according to BLS.***
- **Declining union membership.** At the start of the decade-and a-half surge in inflation in the mid-1960s, nearly 25% of the nation's workforce was unionized. This led to a high portion of the overall wage structure in the United States being tied to cost of living adjustments (COLAs). COLAs tied wage increases to increases in the overall price level of goods and services in the economy. Thus, when inflation accelerated in the 1960s and 1970s, that acceleration was automatically factored back into wages, and the wage price spiral was on. Today, less than 10% of the workforce is unionized, and COLAs are few and far between. In short, the link between rising inflation that caused a lot of inflationary damage in the 1970s is broken. Today, less than 6% of private sector workers are unionized, while 36% of public sector employees are unionized, according to BLS.

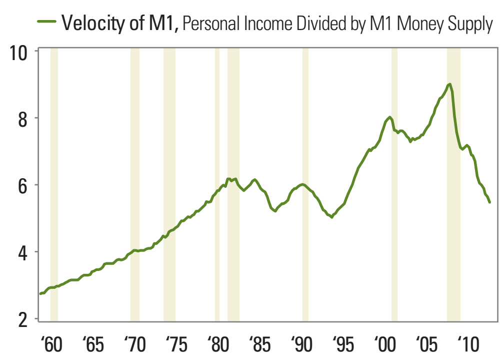
4 The Seeds for the High and Rising Inflation in the 1960s Were Sown in the Mid-1960s as the Fed Kept Policy Accommodative Against a Backdrop of a Surging Economy



Source: Congressional Budget Office, Haver Analytics 03/15/13

Shaded areas indicate recession.

5 Financial Crisis in 2007–2009 Damaged the Monetary Policy Transmission Mechanism, and the Velocity of Money Has Plummeted



Source: Haver Analytics 03/15/13

Shaded areas indicate recession.

M1 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) traveler's checks of nonbank issuers; (3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (4) other checkable deposits (OCDs), consisting of negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions. Seasonally adjusted M1 is constructed by summing currency, traveler's checks, demand deposits, and OCDs, each seasonally adjusted separately.

- **Economy growing below long-term potential.** For the past five years, the U.S. economy has been growing more slowly than the long-term potential growth rate of the economy, pushing the "output gap" wider [Figure 4]. The more negative the output gap, the less upward pressure on capacity constraints in the economy and, in turn, the less upward pressure on wages and prices. In sharp contrast, note that ***in the 11-year span between 1963 and 1974, the output gap was positive in all but a handful of quarters, meaning that the economy was growing above its long-term potential for more than a decade.*** During this time, the Fed made things worse by keeping monetary policy relatively loose, adding fuel to the already inflationary environment.

Many factors have the potential to push inflation higher. Those include, but are not limited to:

- **Cash on banks' balance sheets.** As a result of the successive rounds of QE from the Fed over the past five years, nearly $1.8 trillion is sitting on banks' balance sheets waiting to be lent out to consumers and businesses. This is an enormous amount of money, and if the transmission mechanism between the Fed's monetary policy and the overall economy was functioning properly, this would be a huge concern. However, the transmission mechanism is still not functioning properly and the velocity of money, or how quickly the cash on banks' balance sheets moves through the economy, has dropped dramatically over the past five years [Figure 5]. If velocity does reaccelerate, inflation could move from banks' balance sheets to the real economy as well. We continue to monitor this closely, but since we last wrote about inflation in September 2012, there has been no increase in the velocity of money in the economy.
- **Recent run-up in food and energy prices.** The U.S. drought in the summer of 2012 and the rise in geopolitical tensions have pushed up wholesale prices of food and energy products. Those price increases should begin to show up in headline consumer inflation in the coming months, pushing the CPI higher. However, economy-wide, commodity prices account for only 10% of business' input costs, and with near-record high profit margins, firms have the ability to absorb some of these higher input costs. The key, however, is that the COLA/wage price spiral paradigm that ruled in the 1960s and 1970s is basically nonexistent in today's economy, suggesting that higher input costs are unlikely to be passed through to higher inflation in any significant way. In addition, a rise in the prices of some goods and services tends to lead to less demand and a shift to less expensive substitutes. This effect, along with sluggish income growth, may further mute any pass through of higher food and energy prices to other parts of the economy.

- **Demographics.** As the population ages, the mix of goods and services purchased by the overall economy shifts as well. In general, prices for goods consumed by younger population cohorts are stable or falling. Of course, tuition for college is rising rapidly, but prices for big screen televisions, computers, hand-held mobile devices, software, etc. are not surging, and in some cases are falling when adjusted for quality. On the other hand, the cost of health care, a major component of older consumers' budgets is rising rapidly, and those price increases are pressuring insurance rates at the individual level, and putting tremendous strain on the Federal budget outlook as well. The pace of healthcare cost increases will continue to have a major impact on both the inflation outlook, and the outlook for the Federal budget deficit in the coming years due to the impact of the Affordable Care Act.

On balance, while there are several factors poised to push inflation higher, there are far more factors working today that are pushing inflation lower. In addition, virtually none of the main causes of the inflationary 1970s—an economy running above its long-term potential growth rate, rising inflation expectations, high union membership and COLA induced wage price spiral, and a "closed" U.S. economy—are in place today, making the inflation situation today far different than at the start of the last inflation surge in the early 1970s. ■

The Beige Book is a commonly used name for the Fed report called the Summary of Commentary on Current Economic Conditions by Federal Reserve District. It is published just before the FOMC meeting on interest rates and is used to inform the members on changes in the economy since the last meeting.

Beige Book: Today Vs. 40 Years Ago

The excerpts on the following page are from the most recent Beige Book (March 6, 2013), and from several Beige Books 40 years ago, in the fall of 1972. Today, the inflation rate is right at 2.0% as the economy continues to recover slowly from the financial crisis and Great Recession of 2007–2009. In 1972, the inflation rate had decelerated to under 3.0%, after running as high as 6% in the late 1960s, as the economy continued to struggle with limited "spare capacity" and labor shortages.

Even when compared to the mid 2000s—the last time the Fed began raising rates to keep a lid on inflation and inflation expectations—there is a noticeable difference in tone on the topic of employment, wages, and inflation in the Beige Book today. The following page also includes excerpts from the Beige Book of June 2004, the month the Fed began raising rates for the first time in five years.

Please see page 6 for Beige Book excerpts from each of these periods.

THEN

September 13, 1972: "Reports from some Banks indicated that **concern** over **inflation remains strong.** A number of New York's directors cited the inflationary implications of the large and widening Federal budget and of the heavy calendar of wage negotiations in 1973."

September 13, 1972: "A survey by Minneapolis found a significant increase in local firms reporting **plant capacity** as "less than needed"."

October 11, 1972: "Labor market conditions generally continue to show improvement and some Districts are experiencing **labor shortages.** Businessmen and economists expressed concern over the possibility of renewed inflationary pressures in 1973, and over what public policy measures might be taken to counteract those pressures."

June 16, 2004: "Employment activity continued to improve, with **hiring increasing** at a faster pace in most districts; meanwhile, wages and salaries experienced little or muted upward pressures. Many Reserve Banks reported **modest increases** in **consumer prices,** but most districts noted rising prices of inputs, especially energy-related products, building materials, and steel."

NOW

March 6, 2013: "The majority of Districts reported **modest improvements** in **labor market** conditions, although hiring plans were limited in several Districts."

March 6, 2013: "Wage pressures were mostly limited, but some contacts reported upward pressure for skilled positions in certain industries due to **worker shortages."**

March 6, 2013: **"Price pressures** remained **modest,** with the exception of increases in prices for certain raw materials and slightly higher retail prices in several Districts. Even with some input costs rising, most District contacts did not plan to increase selling prices."

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International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

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.

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 Congressional Budget Office is a non-partisan arm of Congress, established in 1974, to provide Congress with non-partisan scoring of budget proposals.

Deflation is a general decline in prices, often caused by a reduction in the supply of money or credit. Deflation can also be caused by a decrease in government, personal or investment spending.

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.

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