Weekly Economic Commentary

June 3, 2013

Real and Sustainable

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Highlights

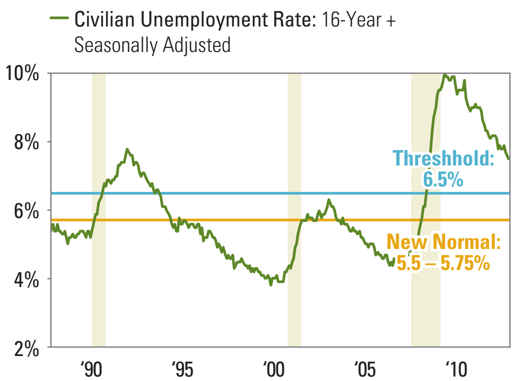
The May 2013 employment report is expected to show solid labor market improvement, with 165,000 new jobs created in May and unemployment holding steady at 7.5%, in line with the April 2013 report.

The May 2013 employment report could challenge the Fed's view that there has not yet been "real and sustainable" improvement in the labor market or the economy.

However, based on our review of recent Fed commentary, we believe the "center of gravity" at the Fed is not yet ready to scale back QE.

Please see the LPL Financial Research Weekly Calendar on page 3

1 The Unemployment Rate Remains Well Above the Fed's "Threshold" of 6.5%, but Is Only One of Many Labor Market Indicators the Fed Is Watching



Source: Bureau of Labor Statistics, Haver Analytics 06/03/13

Shaded areas indicate recession.

The U.S. Department of Labor's monthly employment report always generates plenty of attention from the media, Main Street, and the markets—and this week will be no exception. The May 2013 report scheduled for release on Friday, June 7, is expected to show that the economy added a net new 165,000 jobs in May 2013, (the same number of net new jobs created in April 2013) and that the nation's unemployment rate held steady at 7.5% in May 2013. (See "Closer Look: Labor Market Surveys" on page 5). This week's report is of particular interest, given the rumblings from the Federal Reserve (Fed) on potentially scaling back, or tapering its quantitative easing (QE)—purchases of mortgage-backed securities (MBS) and Treasury securities—program. (See the *Bond Market Perspectives* from May 21 and May 28, 2013 for the impact of Fed tapering fears on the bond market).

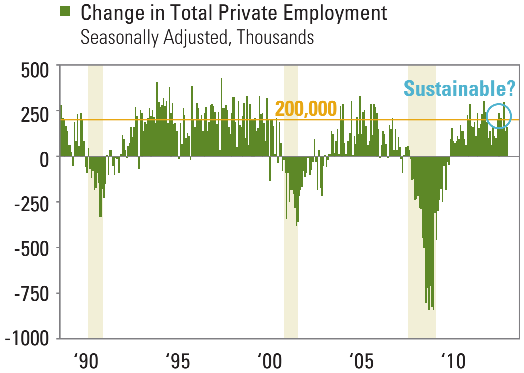
Fed policymakers must decide if the recent pace of job creation—on average, the economy has added 175,000 per month over the past year—and/or the drop in the unemployment rate (from 10.0% at the peak in 2010 and from 8.2% in May 2012) is enough to warrant a tapering of QE. As yet, the Fed has not provided the public with specific guidance regarding the pace of economic growth, or job creation, or the rate of inflation around when (and by how much) they would taper or scale up QE. The aforementioned market "rumblings" began on May 22, 2013, as Fed Chairman Bernanke testified before the Joint Economic Committee (JEC) of Congress.

While Bernanke's prepared remarks suggested that the Fed was in no hurry to begin tapering QE, the market's reaction since the start of the Q&A with the members of the committee suggested otherwise. Between 10:15 AM on May 22, 2013—as Bernanke answered the first question from members of the JEC—and Friday, May 31, the S&P 500 fell 3.3%, and the yield of the 10-year Treasury note moved 32 basis points higher, from 1.88% to 2.20%. Interestingly, Fed Chairman Bernanke did not use the word "taper" in either his prepared testimony or in the question and answers with JEC members.

What the Fed Is Still Watching

Bernanke did however note that, "As the economic outlook and particularly the outlook for the labor market improves in a real and sustainable way, the committee will gradually reduce the flow of purchases." These comments echoed what Bernanke said in his press conference after the March 21 Federal Open Market Committee (FOMC) meeting, which, in turn, were

2 On Average, the Private Sector Economy Has Created Between 175,000 and 200,000 Jobs per Month Over the Past Year



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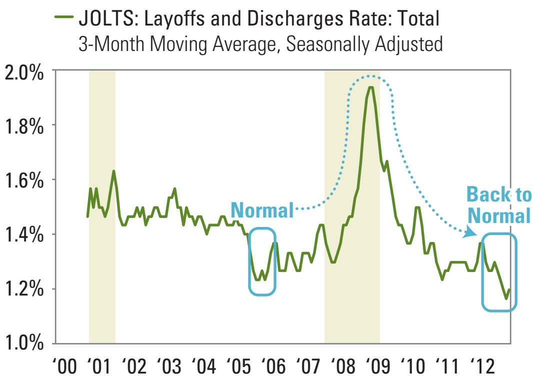
The "center of gravity" at the Fed are all saying the same thing.

3 Companies Are Reluctant to Lay Off Staff…



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Job Openings and Labor Turnover Survey (JOLTS) is a survey done by the United States Bureau of Labor Statistics to help measure job vacancies. It collects data from employers including retailers, manufacturers and different offices each month. Respondents to the survey answer quantitative and qualitative questions about their businesses' employment, job openings, recruitment, hires and separations. The JOLTS data is published monthly and by region and industry.

similar to comments made by FOMC Vice Chair Janet Yellen—who is a leading candidate to replace Bernanke as Fed Chairman in 2014—in early March 2013. (Please see our *Weekly Economic Commentary: Watch What the Fed Watches* from March 25, 2013 for more details).

The list of indicators Yellen mentioned included:

- The unemployment rate;
- Payroll employment;
- The hiring rate;
- Layoffs/discharges as a share of total job separations;
- The "quit" rate as a share of total job separations; and
- Spending and growth in the economy.

Yellen noted specifically that:

"I also intend to consider my forecast of the overall pace of spending and growth in the economy. A decline in unemployment, when it is not accompanied by sufficiently strong growth, may not indicate a substantial improvement in the labor market outlook. Similarly, a convincing pickup in growth that is expected to be sustained could prompt a determination that the outlook for the labor market had substantially improved even absent any substantial decline at that point in the unemployment rate."

"Center of Gravity" Insights

Essentially, Yellen (who along with being one of the leading candidates to replace Bernanke as Fed chairman, is also at the Fed's "center of gravity," with Bernanke and New York Fed President Bill Dudley) is saying that the FOMC will need to see strong performance of the labor market AND solid gross domestic product (GDP) growth before it begins to scale back or eliminate QE.

The third member of the center of gravity at the Fed, Bill Dudley, the President of the Federal Reserve Bank of New York, has also weighed in recently on QE. On May 21, 2013, the day before the Bernanke testimony before Congress, in a speech to the Japan Society in New York and in an interview with Bloomberg News, Dudley hinted at his reluctance to remove the stimulus too soon, saying:

> *"I don't really understand really well how the tug-of-war between the fiscal drag and the improving economy are going to sort of work their way out over the next couple months..."*

> *"Three or four months from now I think you're going to have a much better sense of is the economy healthy enough to overcome the fiscal drag or not."*

Dudley went on to say,

> *"If we continue to do purchases, we're adding stimulus…."*

> *"People act like if we dial the rate of purchases down, somehow we're tightening monetary policy. What we're actually doing is adding less stimulus."*

LPL Financial Research Weekly Calendar

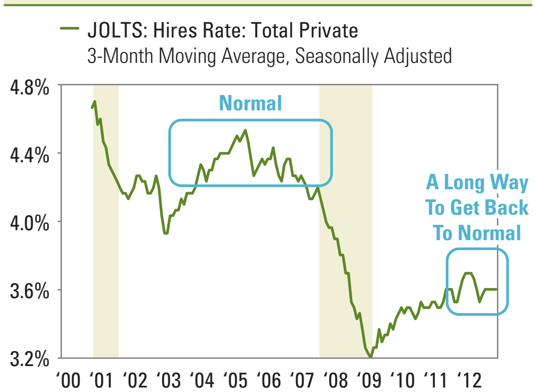
2013	U.S. Data	Fed	Global Notables
3 Jun	▪ **ISM—Manufacturing (May)** ▪ Construction Spending (Apr) ▪ **Vehicle Sales (May)**	Williams	▪ **Eurozone: PMI (May)**
4 Jun	▪ Trade Balance (Apr)	George* Fisher	▪ Australia: Central Bank Meeting
5 Jun	▪ ADP Employment (May) ▪ ISM—Service Sector (May) ▪ Factory Orders (Apr)	**Beige Book**	▪ Germany: Bond Auction
6 Jun	▪ **Challenger Job Cut Announcements (May)** ▪ **Initial Claims (6/1)** ▪ Flow of Funds (Q1) ▪ Chain Store Sales (May)	Plosser	▪ UK: Central Bank Meeting ▪ **Eurozone: European Central Bank Meeting** ▪ Spain: Bond Auction
7 Jun	▪ **Employment Report (May)** ▪ Consumer Credit (Apr)		▪ China: CPI (May)—Data due Saturday, June 8 ▪ China: PPI (May)—data due Saturday, June 8 ▪ **China: Imports and Exports (May)—data due Saturday, June 8** ▪ **China: Industrial Production (May)—data due Sunday, June 9** ▪ **China: Retail Sales (May)—data due Sunday, June 9**

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)

4 …But Also Remain Somewhat Reluctant to Hire More Staff, Either



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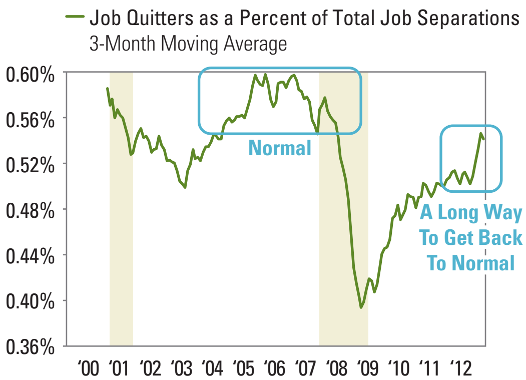
Dudley noted on May 21, 2013 that the goal of Fed policy is "really about achieving escape velocity. When are we going to have an economy where everything is sort of self-reinforcing, and when the jobs generate income, the income generates demand, demand generates more employment?"

"I don't think we're quite there yet," he added.

On balance, Dudley's comments, along with Bernanke's May 22 appearance, echoed comments made in early March 2013 by Fed Vice Chair Yellen, and suggest that the "center of gravity" at the Fed is not yet convinced that there has been "real and sustainable" improvement in the labor market or the economy. This week's employment report for May 2013 could challenge that view, and validate the market's recent "taper" induced fears. On the other hand, a soft May employment report would likely give market participants comfort that the Fed is not likely to begin removing QE anytime soon, but also raise the risk that the Fed may wait too long to remove the stimulus, which could lead to higher inflation and higher interest rates in the future.

Yellen and Bernanke—two of the three FOMC members of the "center of gravity" at the Fed—are probably not yet ready to begin scaling back QE.

5 Workers Are Feeling More Confident About Their Own Prospects, and About the Labor Market in General



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At 3.6% in March 2013, the latest data available, the hiring rate remains depressed, and well below the 4.5–5.0% hire rate seen prior to the onset of the Great Recession in 2007.

Tracking the Labor Market: An Update

Figures 1–5 show the labor market indicators mentioned by Bernanke on May 22, 2013 and Yellen in early March 2013. A quick review of the figures suggests that Yellen and Bernanke—two of the three FOMC members of the "center of gravity" at the Fed—are probably not yet ready to begin scaling back QE.

- While down from the peaks seen during the Great Recession of 2008–2009, the unemployment rate, at 7.5% in April 2013, remains well above the 6.5% threshold for raising rates, and also well above the 5.5–5.75% rate the FOMC forecasts as the new "normal" unemployment rate.
- It is well documented that the private sector economy has created more than 200,000 jobs in three of the past six months. However, the labor market turned in a similar performance in late 2011 and early 2012, only to see a marked slowdown in job creation over the spring and summer of 2012. Bernanke mentioned this during the Q&A with reporters following the March 20, 2013 FOMC meeting, noting, "So I think an important criterion would be not just the improvement (in the labor market) that we've seen, but is it going to be sustained for a number of months."
- At 3.6% in March 2013, the latest data available, the hiring rate—the level of new hiring as a percent of total employment measured from the JOLTS data—remains depressed, and well below the 4.5–5.0% hire rate seen prior to the onset of the Great Recession in 2007. In her March 4, 2013 speech, Yellen noted, "the hiring rate remains depressed. Therefore, going forward, I would look for an increase in the rate of hiring."
- In that same speech, Yellen noted "layoffs and discharges as a share of total employment have already returned to their pre-recession level." Indeed, Figure 3 shows that the discharge rate, at 1.2% in March 2013, is very close to an all-time low. A good proxy for this metric is the weekly readings on initial claims for unemployment insurance and the monthly Challenger layoff data, both of which continue to show that companies are reluctant to shed more workers at this point in the business cycle.
- The quit rate measures the percentage of people who leave their jobs voluntarily, presumably because they are confident enough in their own skills—or in the health of the economy—to find another job. In the three months ending in March 2013 (the latest data available), 54% of the people who were separated from their jobs (laid off, fired, retired, or left voluntarily) were job quitters. This was the highest reading on this metric since mid-2008, but remains well below its pre-Great Recession normal of 56–60%. Commenting on this metric in her March 4, 2013 speech, Yellen noted "a pickup in the quit rate, which also remains at a low level, would signal that workers perceive that their chances to be rehired are good—in other words, that labor demand has strengthened." The final metrics mentioned by Yellen—consumer spending and overall economic growth—both remain well below average, and indeed still point to an economy that is running at around two-thirds speed. ■

Closer Look: Labor Market Surveys

- A survey of 60,000 households nationwide — an incredibly large sample size for a national survey — generates the data set used to calculate the unemployment rate, the size of the labor force, part-time and full-time employment, the reasons for and duration of unemployment, employment status by age, educational attainment, and race. The "household survey" has been conducted essentially same way since 1940, and although it has been "modified" over the years, the basic framework of the data set has stayed the same. The last major modification to the data set (and to how the data is collected) came in 1994. To put a sample size of 60,000 households into perspective, nationwide polling firms typically poll around 1,000 people for their opinion on presidential races.
- The headline unemployment rate (7.5% in April 2013) is calculated by dividing the number of unemployed (11.7 million in April 2013) by the number of people in the labor force (155 million). The civilian population over the age of 16 stood at 245.2 million in April 2013. A person is identified as being part of the labor force if they are over 16, have a job (employed), or do not have a job (unemployed) but are actively looking for work. A person is not in the labor force if they are neither employed nor unemployed. This category includes retired persons, students, those taking care of children or other family members, and others who are neither working nor seeking work.
- In April 2013, the labor force was 155 million, which consists of 143.6 million employed people and 11.7 million unemployed people. Another 89.9 million people over the age of 16 were classified as not in the labor force. The 155 million people in the labor force plus the 89.9 million people not in the labor force is equal to the civilian population over 16, 245.2 million.
- The payroll job count data is culled from a survey of 440,000 business establishments across the country. The sample includes about 141,000 businesses and government agencies, which cover approximately 486,000 individual worksites drawn from a sampling frame of Unemployment Insurance (UI) tax accounts covering roughly 9 million establishments. The sample includes approximately one-third of all nonfarm payroll employees. From these data, a large number of employment, hours, and earnings series in considerable industry and geographic detail are prepared and published each month.

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.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

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

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

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.

Stock investing involves risk including loss of principal.

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).

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.

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.

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.