



Weekly Economic Commentary

October 20, 2008



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ECONOMIC CALENDAR

Monday, Oct 20

Leading Indicators
September

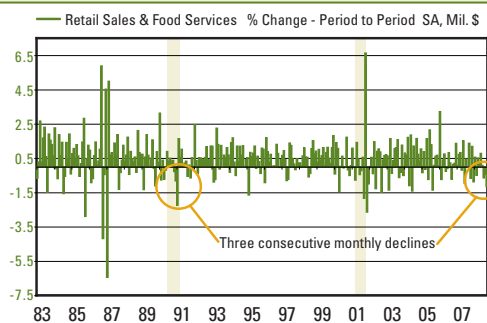
Thursday, Oct 23

Initial Claims
wk 10/18

Friday, Oct 24

Existing Home Sales
September

1 Retail Sales Have Now Posted Month over Month Declines for Three Consecutive Months—the Longest Stretch since the 1990–91 Recession



Executive Summary:

The Great Debate—Mild Recession, Deep Recession... Or Depression

Volatility remained in vogue last week as equity markets endured one of the most down-and-up weeks on record. With the acute phase of the financial crisis/credit crunch now largely in the rear view mirror, financial markets last week abruptly refocused on the ramifications of the crisis on corporate earnings and the economy.

Investors generally didn't like what they saw in last week's batch of economic data, as they tried to discern the breadth and depth of the recession. The big shocker (for financial market participants, at least) came with the release of the September retail sales data, which showed a sharp 1.2% decline in spending between August and September. This data marked the third consecutive monthly decline in retail sales, the first time since the 1990–91 recession that retail sales have declined in three consecutive months.

The market interpreted this single data point as a sign that:

- The U.S. economy was indeed in a recession.
- The recession would be a long and deep one, similar to those experienced in 1973-75 and again in 1981-82.

In some ways, it appeared to us as if financial market participants hadn't acknowledged that the U.S. economy was in a recession, or that the financial crisis had even impacted the real economy at all, **until** they saw the September retail sales report. It's an oddly late realization, because many economists have been saying that the U.S. economy has been in a recession since the end of last year.

As we have been writing for several weeks now, while there have been disruptions on Wall Street and within the financial system for well over a year, it was not until the collapse of Lehman Brothers on September 13-14 that those disruptions spread from Wall Street to Main Street, and banks virtually stopped lending to regular Americans and to each other. The dislocations seen over the past six weeks have almost certainly damaged the U.S. economy. The longer the credit markets remain frozen, the more damage will be done to Main Street consumers and businesses, deepening and lengthening the recession. While credit markets did begin to thaw a bit this week, the pace of the thaw thus far has been, glacial at best, which has led to disappointment in financial markets, and yes, more volatility.



To reiterate, as a result of the spread of the financial crisis from Wall Street to Main Street over the past six weeks, we and other market observers have been revisiting our forecasts for economic activity in the current (fourth) quarter of 2008 and beyond. LPL Financial expects near zero to slightly below zero growth in real GDP in Q3 2008, a sharp contraction in real GDP in the current quarter (Q4 2008), and further sluggish growth extending into 2009. At this point, we certainly don't anticipate a deep and prolonged recession such as we saw in 1973–75 and again in 1980–82, largely because the imbalances and high inflation that preceded those prior periods are not in place today. But, each week that passes with still-frozen credit markets pushes the economy further into the red, and closer to that kind of deep recession.

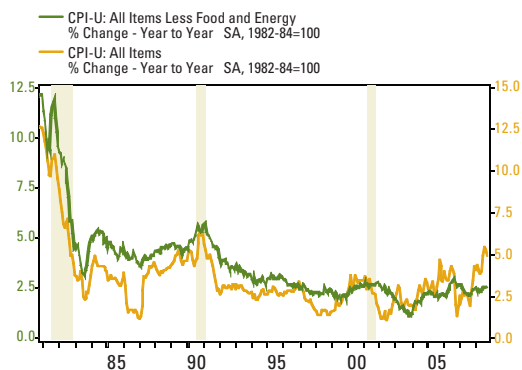
Week in Review:

Aside from the aforementioned September retail sales data, there was a deluge of economic data releases, as the market continued to debate the length and severity of the recession. For the most part, the data were universally weak, and probably pushed down consensus estimates for real GDP in Q3 2008, which now stands at 0.0%, down from 0.5% to 1.0% just a few weeks ago.

The weaker than expected data included:

- The Philly Fed and Empire State manufacturing indices for October, which revealed that the manufacturing sector basically fell off the table in October, largely as a result of the credit crunch.
- The September industrial production (IP) data, which showed a 2.8% monthly decline, the largest since 1974, when the economy was mired in a deep recession. While there's no doubt that industrial activity was weak and at recessionary levels in September, the weakness was probably overstated due to the impact of Hurricane Ike on the energy sector and the Boeing strike on the aircraft manufacturing sector. Excluding these items, industrial activity declined by a much more modest 0.1% in September, the second consecutive monthly drop in IP, and the sixth in the past eight months.
- The housing starts data for September, which revealed that housing activity plunged to its lowest pace since 1991—and is now even lower than it was in the deep recessions of 1973-75 and 1981-82.

2 Headline Inflation Peaked in July 2008 and Is Likely to Decelerate Further in the Coming Months

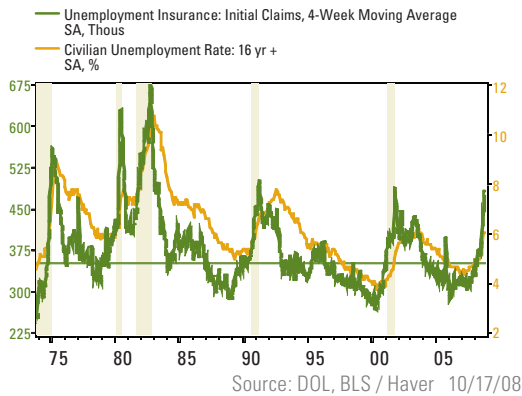


The good news last week came on the inflation front, where rapidly declining energy prices contributed to an unchanged reading on the consumer price index (CPI) in September after a 0.1% drop in August. The overall CPI was up 4.9% in September 2008 versus September 2007, down from the recent peak of 5.6% in July 2008, which is when oil prices peaked at \$147 a barrel. The core CPI (excluding food and energy) rose just 0.1% in September and was up just 2.5% year over year, right the middle of the 2.0 to 3.0% range it has been in for the past 15 years. (See nearby chart.)

There is a chance that the \$700 billion bank rescue plan passed by Congress in early October and the unprecedented expansion of the balance sheet of the Federal Reserve in the past six weeks could lead to higher inflation down the road if not offset or clawed back at some point. In the near term



3 Jobless Claims Are Now Clearly in Recession Territory, But Well Below Levels Seen in 1973-75 and 1981-82



however, inflation is likely to continue to decelerate—led by falling energy and commodity prices—giving the Federal Reserve plenty of room to cut rates further as needed to further stimulate economic growth.

The Week Ahead:

There is virtually no economic data due out next week, as the market continues to debate the length and severity of the recession in the United States. The data released thus far for September and October have been abysmal, and we expect that trend to continue for the foreseeable future—and most certainly through year end 2008.

This week, the only scheduled readings for the markets to digest are the weekly reading on jobless claims (for the week ending October 18) and the September reading on existing home sales.

The recent readings on jobless claims continue to indicate that we are currently in a recession most similar to the 1990-91 recession, rather than the recessions of 1973-75 and 1901-82, when claims climbed to well over 500,000 and the unemployment rate moved as high as 10.8%. (See nearby chart.)

Based on the pending home sales data for August, existing home sales data in September are likely to show an increase versus August, which in normal times would most likely elicit a cheer from financial markets looking for the long awaited bottom in the housing market. However, we point out that the existing home sales data for September are the result of sales made in July or August, **prior to the turmoil in financial markets in September**. Thus, existing home sales are likely to turn lower over the remainder of the year, or as long as the credit crunch continues to impact the mortgage market.

As always, we will continue to monitor the “real time” data points: weekly retail sales, weekly jobless claims, credit spreads, mortgage rates, mortgage applications, gasoline prices and company specific news, and use all of that information to guide us until more long-term summary data is available.

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