the Whitepaper

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Highlights

- Lately the market has been nervous about the consequences of its own brakes and anchors. The primary brake worrying the markets is when the Fed will decide to unwind its easy monetary policies and lower interest rates in an effort to side-step accelerating economic growth and the fear of inflation. The primary anchors have been the slumping housing market as well as the massive job losses that accelerated as the economy severely contracted.
- As the economy has improved, both anchors—the slumping housing market and unemployment drag—have all but been "cut loose."
- The market, despite the news that its two biggest anchors have essentially been "cut loose", has stalled over the last couple of months. The reason is that the market has shifted concern from the anchors holding it back to the fear that the driver of this economic recovery (the Fed) may put on the brakes too soon.
- The outlook? The Fed will remain firmly on the gas pedal for the remainder of 2009 and into early 2010, which combined with the anchors that this market has "cut loose", points to an attractive environment that favors rising stock prices, higher commodity values and continued economic growth.

The Brake and the Anchor

Have you ever started your car, began to drive, and noticed that it feels a bit sluggish? So sluggish that in order to accelerate, you have to push the pedal to the floor just to move forward. Sure, your first thought is: why didn't I turn this scrapheap of metal in for something spanking new during the summer's Cash for Clunkers program? Then you realize you left the parking brake on; whereupon you release it and move forward as expected.

Interestingly enough, that is exactly the scenario that the market is experiencing right now. The driver in this case is the Federal Reserve (the Fed) that has the "pedal to the metal" with low interest rates and easy monetary policy in an attempt to accelerate the market, our version of the car, from contraction to growth. Slowing the car down is the market's version of a parking brake, which economically has been the slumping housing market and the significant unemployment across America.

But driving this economic car from recession to recovery is a tricky endeavor that has the market on edge and somewhat explains the markets stall in gains over the last couple of months. While we need enough stimulus and accommodating monetary policies in order to drive fast enough to accelerate the economy into steady growth, we can not risk driving too fast, which would cause an even more devalued dollar, bulging deficits, and soaring inflation expectations.

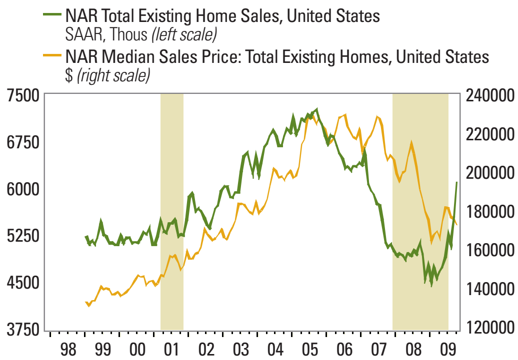
So how does our driver know how fast to drive and more importantly when to transition from pressure on the gas pedal to tapping the brakes? The answer begins with an examination of what factors are present that can stop our economic growth car. Simplistically there are two ways to stop this economy: apply the brakes to slow growth or drop an anchor to prevent growth.

Is it a Brake or an Anchor?

Let's face it, the way that one chooses to slow down or even stop matters. After all, going from 60 miles per hour to a dead stop using brakes is certainly different than, say, crashing into a brick wall. The end result may be the same (one stops), but the effects are quite a bit different.

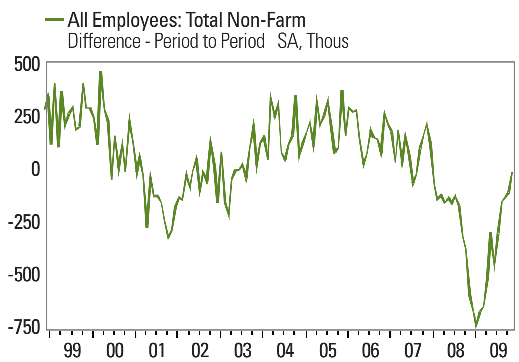
Regardless of whether your mode of transportation is a car, boat, train or something else, other than running out of gas, there are two primary methods of slowing down to a stop. These can be loosely characterized

1 One Anchor Cut Loose: House Sales Bottomed in Mid-2009 and have Slowly Risen



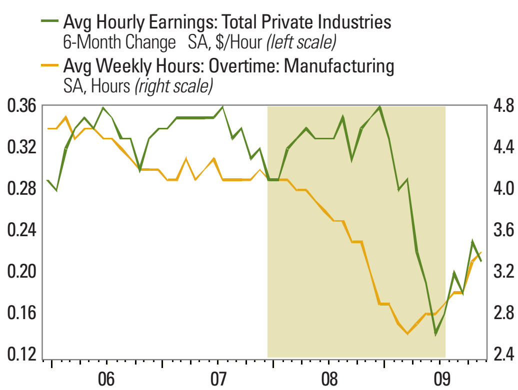
Source: National Association of Realtors, Haver 12/09/09

2 Another Anchor Almost Cut Loose: Job Losses Have Slowed Significantly



Source: Bureau of Labor Statistics, Haver 12/09/09

3 Another Anchor Almost Cut Loose: Hourly Earnings are on the Rise — Slightly



Source: Bureau of Labor Statistics, Haver 12/09/09

as the brake and the anchor. Under the brake scenario, a moving object knowingly slows itself, like the way a car, train or a person running slows down to stop. The anchor, on the other hand, is where the moving object is slowed by a separate force, like a boat dragging an anchor, a bug being stopped by a windshield, a car with a parking brake on or a person crashing into a wall. While both the brake and the anchor can be effective methods to slow momentum, each offer varying degrees of benefits and consequences.

Lately the market has been nervous about the consequences of its own brakes and anchors. Specifically, the market has been worried about the prospects of anything that can slow down the economic recovery that has helped to reignite growth following the worst recession since the 1930s.

For the market, the primary anchors have been the slumping housing market as well as the massive job losses that accelerated as the economy severely contracted. The primary brake worrying the markets is when the Fed will decide to unwind its easy monetary policies and low interest rates in an effort to side-step accelerating economic growth and the fear of inflation.

We Have Cut Loose the Anchors

While the economy is far from operating at normal levels, the two primary hindrances (or anchors) to growth have been the slumping housing market and rising unemployment. However, as the economy has improved, both of these anchors have all but been "cut loose". From a housing perspective, existing home sales bottomed in mid-2009 and have since been on the rise, thanks in part to the New Home Buyer Tax Credit [Chart 1]. Home prices have also begun to stabilize. As a result, the housing anchor that was a drag on economic growth has diminished and is now virtually "cut loose" from slowing down this economic recovery.

The other anchor has been a more significant issue. Soaring unemployment caused by companies "right-sizing" to diminished customer demand led to significant lay-offs, reduced work hours, and led to an unemployment rate that has topped 10% for the first time since 1982. However, recent data suggests that the labor market is improving and may no longer be an anchor holding back economic growth. In the November '09 employment report issued by the Department of Labor, nonfarm payrolls declined by only 11,000 jobs for the month, the lowest amount since late 2007 [Chart 2]. More importantly, the result indicates that the economy is very close to making net jobs and has recovered nicely from the worst levels of this recession when losing 500,000 to 725,000 jobs per month was a regular occurrence.

Validating the fact that the employment situation is improving, average hourly earnings rose almost $0.10 per hour, which is very significant when pooled across millions of employees working many hours per week [Chart 3]. Additionally, overtime hours in the manufacturing segment of the economy have been on the rise, as increased orders and customer demand has resulted in more hours worked.

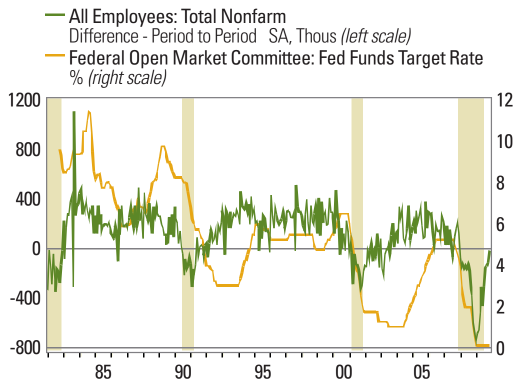
The end result is that less people are losing jobs, more hours are being worked, and the average hourly earnings have increased a bit. This bodes very well for the employment situation in the U.S. As such, it appears that both housing and unemployment are no longer significant anchors constraining the growth of this economy. So, why hasn't the market been more excited?

The Fear Shifts from the Anchors to the Brakes

The market, despite the news that its two biggest anchors have been all but "cut loose", has stalled over the last couple of months. The reason is that the market has shifted its concern from the anchors holding it back to the fear that the driver of this economic recovery may too soon or too rapidly put on the brakes. Remember that either anchors or brakes can slow down this economy. The fear is that given the improving economic backdrop, especially on the housing and employment fronts, the Fed will come to the conclusion that the economy does not need its easy monetary policy and low interest rates to maintain growth and it will begin to retract its stimulus or put the brakes on.

While this is indeed a fear, we believe the Fed realizes that despite improvements, the economy remains fragile and continues to need accommodative monetary policies to fuel and sustain growth. Therefore, it's more likely this approach will be implemented nearer to mid- to late-2010.

4 The Fed Raises Rates Coming out of Recessions Only Well-After Steady Job Growth is Seen



Source: Bureau of Labor Statistics, Haver 12/09/09

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In addition, the Fed has usually shown signs that it favors growth over inflation, which is best shown by plotting nonfarm payroll growth against the Fed funds rate [Chart 4]. Notice that following recessions (the grayed areas) the Fed did not increase the Fed funds rate well until jobs were growing sustainably in the 100,000-300,000 per month levels. In fact, after the last three recessions, the Fed did not start to raise rates until the market was averaging job growth over the previous 6 and 12 months by 246,000 and 211,000 jobs, respectively. Put another way, after the last three recessions, the Fed waited until an average 2.5 million new jobs were created until they began to raise interest rates to slow down the economy. That is a long way from where we are now. Remember that despite the dramatic improvement in the labor landscape, this economy still lost 11,000 jobs last month and is a long way from growing by 100,000 or more jobs per month in a sustainable fashion.

THE FED HOLDS RATE HIKES FOR DEFINITIVE PROOF OF JOB GROWTH

Date When the Fed Started Raising Rates	Jobs Added Per Month		Cumulative Jobs Added	
	6 Months Prior	12 Months Prior	6 Months Prior	12 Months Prior
Feb 84	372	306	2232	3672
Jan 94	242	224	1454	2688
Jun 04	124	102	744	1224
Average	**246**	**211**	**1477**	**2528**

Source: Haver, LPL Financial
Please Note: All numbers are in thousands

Given the market's skittishness over the Fed's potential policy actions, it is natural for market participants to be concerned prior to the Federal Reserve's FOMC meetings and then feel relief following the meetings. This manifested itself in 2004, where in the three FOMC meetings before the Fed raised rates, the market sold off an average of 1.2% in the two weeks heading into the meetings and then rallied 1.3% in the month following the meetings. We have seen the same action over the last two FOMC meetings in September and November of 2009, where the market dropped an average of 1.0% in the two weeks before the meetings and rallied a strong 3.7% on average in the month following.

Therefore, heading into the Federal Open Market Committee (FOMC) meeting on December 16, 2009, it was understandable that the market sold off a couple of percentage points and was nervous which pedal the Fed will continue to press: the brake or the gas. But with the Fed once again declaring its foot on the gas, markets have rallied ("Santa Claus Rally?") to close in on 2009 stock market highs.

In my opinion, the Fed will remain firmly on the gas pedal for the remainder of 2009 and into early 2010, which combined with the anchors that this market has essentially "cut loose", points to an attractive environment that favors rising stock prices, higher commodity values, and continued economic growth.