

Weekly Economic Commentary



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The Lowdown on the Shutdown: The Impact on the Economy and Federal Reserve

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Highlights

We continue to expect around 2.0% growth in real GDP in 2013, despite the drag from government spending.

Continued delays in economic data could indicate early 2014 Fed tapering.

The latest edition of the Fed's Beige Book again described the economy as increasing at a modest-to-moderate pace, with little wage or inflation pressures.

The shutdown and debt ceiling debate were apparent in the latest Beige Book and likely acted as a drag on growth.

With the shutdown and debt ceiling debate now in the rear view mirror, the market's attention—and possibly the Federal Reserve's (Fed) as well—will likely shift to the performance of the private sector economy here in the fourth quarter of 2013 and in the first quarter of 2014. We continue to expect around 2.0% growth in real Gross Domestic Product (GDP) in 2013, despite the drag from government spending.

Some of the indirect impact of the shutdown—for example, the business lost by a privately owned campground near a national park like the Grand Canyon, or by a restaurant near a defense contractor's offices in suburban Washington—cannot be recovered later in the quarter and is likely gone forever. However, because Congress agreed during the shutdown to provide back pay to furloughed federal workers, the overall impact of the shutdown should be less severe than if the workers were not provided back pay. A loss of confidence and increase in uncertainty surrounding the shutdown and debt ceiling debate among consumers and businesses was quite apparent in the latest Beige Book, and also likely acted as a drag on growth late in the third quarter and early in the fourth (see section below for details on the Beige Book).

The Shutdown, the Data, and the Fed

Some economic data sourced from the private sector (ADP employment, vehicle sales, Challenger layoff announcements), the state governments

1 The Lowdown on the Shutdown

Federal Government Shutdowns



Federal Government Spending



Source: LPL Financial Research 10/21/13

*Federal government spending has been a drag on GDP growth in nine of the past 11 quarters dating back to the fourth quarter of 2010, as the impact of the \$787 billion fiscal stimulus package passed in 2009 faded and as the impact of the sequester took hold in early 2013.



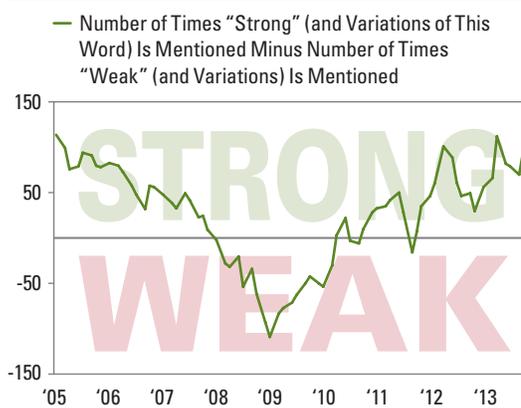
Because the shutdown occurred early in the quarter, there is still plenty of time left in the quarter for the spending to occur.

(weekly jobless claims), and the Fed (consumer credit, regional manufacturing surveys, etc.) were released during the 16-day shutdown. This provided the public, market participants, and Fed policymakers with a partial view of the health of the economy as the third quarter ended and the fourth quarter began. The lack of clarity on the health of the economy will likely prevent the Fed from tapering its bond purchases, known as quantitative easing (QE), at the upcoming Federal Open Market Committee (FOMC) meeting on October 30, 2013.

A few of the many government-sponsored economic reports postponed during the shutdown are due out this week—including the postponed September 2013 employment report, originally scheduled for release on October 4, 2013 and now due out on Tuesday, October 22, 2013. However, many key reports have not yet been rescheduled. Indeed, it may be mid-to-late November 2013 before the government's data collection and reporting agencies can begin to release economic data on time, providing another dose of uncertainty to market participants and policymakers. In short, the longer it is before the economic data calendar is back to normal, the more likely it is that Fed policymakers will consider postponing the start of tapering until early 2014, rather than starting to taper at the December 2013 FOMC meeting.

An additional hurdle to tapering is the timing of the next government shutdown and debt ceiling debate. (See this week's *Weekly Market Commentary* for details.) Under the terms of the bill passed by Congress last week to end the shutdown and lift the debt ceiling, the government could shut down again in mid-January 2014, and the Treasury could hit its borrowing limit by early February 2014. As has been the case in the past few years, these deadlines create uncertainty for the public, market participants, and policymakers, and could weigh on economic activity. In addition, a special bipartisan House-Senate conference committee charged with breaking the impasse on the budget must issue a report on December 13, 2013, just days before the December 17–18, 2013 FOMC meeting. While a "grand bargain" on the budget might pave the way for the Fed to taper in December 2013, the more likely outcome is that the rancor surrounding this report will only add to the fiscal uncertainty, which argues for a Fed taper in early 2014 and not at the December 17–18, 2013 meeting. Of course, if Congress can agree in the next few weeks (for example, by Thanksgiving) on a deal that would eliminate the possibility of another shutdown and bruising debate about the debt ceiling in early 2014, a December taper becomes more likely.

2 Beige Book Barometer Rebounds in October, Despite Uncertainty Around the Government Shutdown



Source: Federal Reserve, LPL Financial Research 10/17/13

Latest Beige Book Shows Continued Modest Growth

The latest edition of the Fed's Beige Book, released on October 16, 2013, once again described the economy as increasing at a modest-to-moderate pace, with little wage or inflation pressures. To provide one snapshot of the entire Beige Book collage of data, we created our proprietary Beige Book Barometer (BBB) [Figure 2]. The barometer ticked up to +97 in October 2013, from +70 in September 2013. The barometer was +79 in July 2013



How the Barometer Works

The Beige Book Barometer is a diffusion index that measures the number of times the word “strong” or its variations appear in the Beige Book less the number of times the word “weak” or its variations appear. When the Beige Book Barometer is declining, it suggests that the economy is deteriorating. When the Beige Book Barometer is rising, it suggests that the economy is improving.

See page 4 for “Beige Book: How It Works.”

and +82 in June 2013. It’s worth noting that the October 2013 reading was the highest since April 2013’s 112 reading, and one of the highest readings in the past eight and a half years despite the uncertainty around the fiscal issues in Washington that dominated the headlines during the collection period (mid-to-late September 2013 through October 7, 2013) for the October 2013 Beige Book.

The move up to +97 from +70 between the September and October 2013 editions of the Beige Books came as the number of positive words increased to near a nine-year high and the number of negative words hit a fresh seven-and-a-half year low. The drop in the number of negative words in the Beige Book came despite the uptick in the concern over fiscal policy (33 mentions of the shutdown, fiscal policy, and the sequester in October 2013 versus just four mentions in September) and 19 uses of the word uncertainty in the October 2013 Beige Book, more than double the nine mentions in September. Another policy-related headwind in recent Beige Books has been the Affordable Care Act (ACA). The ACA and health care received 33 mentions in the October 2013 Beige Book, up from 26 in September’s edition. A year ago, in the October 2012 Beige Book, there were no mentions of the ACA or health care.

4 Beige Book Word Clouds



Source: The Federal Reserve Beige Book, LPL Financial 10/17/13



Source: The Federal Reserve Beige Book, LPL Financial 09/06/13

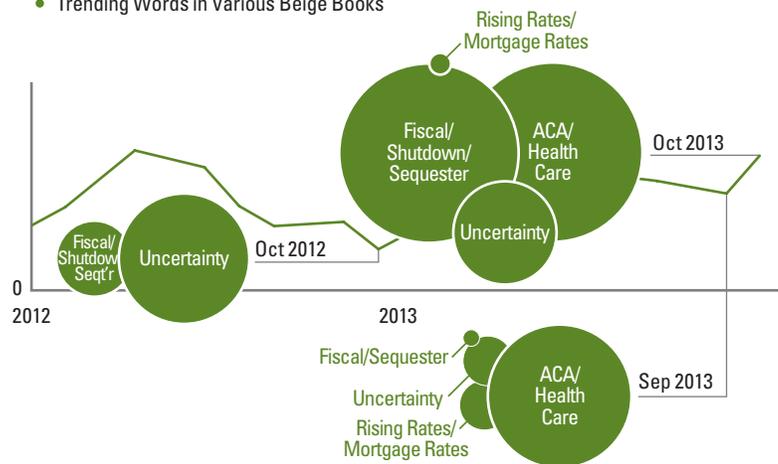


Source: The Federal Reserve Beige Book, LPL Financial 10/10/12

3 Positive Words in the Beige Book Up to a Nine-Year High

— Number of Times “Strong” (and Variations of This Word) Is Mentioned Minus Number of Times “Weak” (and Variations) Is Mentioned

• Trending Words in Various Beige Books



Source: Federal Reserve Board, LPL Financial 10/17/13

In short, the Beige Book describes an economy that is still growing slowly, but is poised to accelerate once the uncertainty surrounding the fiscal issues lifts. Unfortunately, unless Congress can act quickly, we may be headed into another period (late 2013 to early 2014) where the deliberations around the nation’s long-term fiscal health overwhelm and hamper economic activity in the short term. ■



Beige Book: How It Works

The Beige Book compiles qualitative observations made by community bankers and business owners about economic (labor market, prices, wages, housing, nonresidential construction, tourism, manufacturing) and banking (loan demand, loan quality, lending conditions) conditions in each of the 12 Fed districts (Boston, New York, Philadelphia, Kansas City, etc.). This local color that makes up each Beige Book is compiled by one of the 12 regional Federal Reserve districts on a rotating basis—the report is much more “Main Street” than “Wall Street” focused. It provides an excellent window into economic activity around the nation using plain, everyday language. The report is prepared eight times a year ahead of each of the eight Federal Open Market Committee (FOMC) meetings. The next FOMC meeting is October 29–30, 2013.

The previous word clouds or text clouds, which are a visual format useful for quickly perceiving the most important words in a speech, text, report, or other transcript, are culled from the Fed’s Beige Books published last week (October 16, 2013), the prior report (September 4, 2013) and in October 2012. In general, the more often a word appears in a speech, text, report or other transcript, the larger that word appears in the word cloud. The word clouds show the top 50 words for each of the two Beige Books mentioned above. Similar words are grouped together and common words like “the,” “and,” “a,” and “is” are excluded, as are words that appear frequently in all Beige Books (federal, district, loan, level, activity, sales, conditions, firms, etc.).

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 investing involves risk including loss of principal.

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.

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 (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 U.S. Treasury securities).

This research material has been prepared by LPL Financial.

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