

Weekly Economic Commentary

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Highlights

Our exports to our two closest neighbors, Canada and Mexico (27%), are larger than our exports to the Eurozone, Japan, and China combined (25%).

Perhaps market participants (ourselves included) should pay more attention to the economic prospects for Canada and Mexico and a bit less time on China, the Eurozone, and Japan.

All else being equal, an unexpected and permanent shift higher in economic growth for trading partners like China, the Eurozone, and Japan, should, over time, boost U.S. exports to those nations, and, in turn, boost U.S. GDP.

Please see the LPL Financial Research Weekly Calendar on page 3

Can trade make a significant positive contribution to GDP growth in the quarters ahead, given the outlook for growth in Europe, China, Japan, and emerging markets?

Trading Partners

The upward revision to second quarter gross domestic product (GDP) garnered a great deal of market attention last week (August 26–30, 2013). The report, released on Thursday, August 29, revealed that second quarter GDP—initially reported in late July 2013 as a 1.7% gain—was revised higher to a 2.5% gain. All of the upward revision to second quarter GDP can be explained by a narrower trade deficit. Initially, the trade deficit in the second quarter was reported as \$451 billion, a 0.8% drag on overall GDP growth. Now, the revised data show that the trade gap stood at “only” \$422 billion in the second quarter—the same as in the first quarter of 2013—and as a result, the economic drag from trade for the quarter was eliminated. Looking ahead to the third quarter of 2013 and beyond, market participants and policymakers are asking: Can trade make a significant positive contribution to GDP growth in the quarters ahead, given the outlook for growth in Europe, China, Japan, and emerging markets?

Tracking the Pace of U.S. GDP Growth

While second quarter GDP was revised higher, the first quarter was not subject to revision and remained at 1.1%, leaving GDP growth in the first half of 2013 at a tepid 1.8%. The Federal Reserve (Fed) is still forecasting a 2.45% gain in GDP this year. With 1.8% growth in real GDP in the first half of the year, real GDP would have to grow by more than 3.0% in the third and fourth quarters of 2013 to match the Fed’s consensus forecast for the year. The Fed will release a revised forecast for the economy, labor markets, and inflation for 2013, 2014, and 2015 on September 18, 2013 at the conclusion of the next Federal Open Market Committee (FOMC) meeting. The FOMC is likely to revise downward its 2013 GDP growth forecast. The new forecast, along with the release of the FOMC’s initial public forecast for the economy, inflation, and the labor market in 2016 (also due on September 18), may help to soothe market fears about the pace of tapering and tightening.

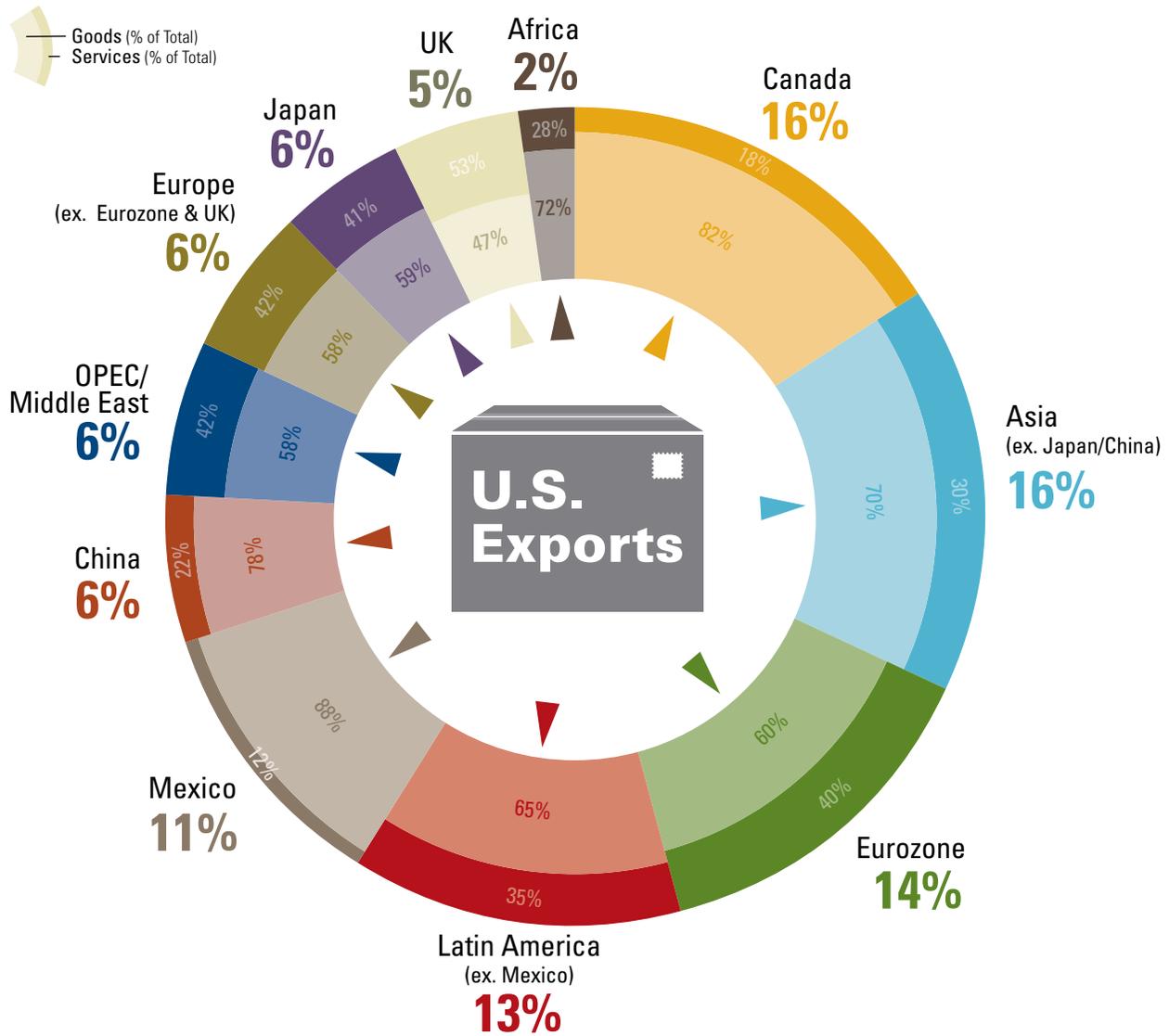
All references to GDP indicate real GDP.



Profile of U.S. Exports

While we spend a great deal of time discussing the health of the economy in China, the Eurozone, Japan, and emerging markets, the economic prospects of our nearest neighbors (Canada and Mexico) have a bigger influence on our overall exports. Below, we breakdown what we are exporting and where these goods and services go.

Destination and Composition of U.S. Exports- % of U.S. exports that go to trading partners

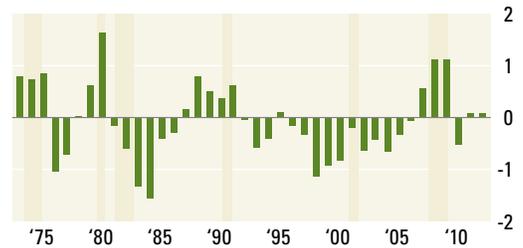


Top U.S. Good/Service Export to Each Major Trading Partner



Source: Bureau of Economic Analysis, Haver Analytics, LPL Financial 09/02/13

Recessions Aside, Net Exports Rarely Make a Large Contribution to GDP Growth % Change



Shaded areas indicate recession



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The data in hand for the first two months of the third quarter of 2013 suggest that third quarter GDP is tracking to well under 2%, and may be closer to 1%. The data released thus far for the third quarter of 2013 include:

- Personal consumption expenditures for July;
- Industrial production for July;
- Retail sales for July and August;
- Durable goods shipments and orders for July;
- Vehicle sales for July;
- Weekly initial claims for unemployment insurance through the week ending August 24;
- ISM and regional Federal Reserve Manufacturing Indexes for July and August; and
- New and existing home sales for July.

Data due out this week (September 2–6, 2013) on vehicle sales, the Institute for Supply Management (ISM) Purchasing Managers' Index (PMI), merchandise trade, construction spending, factory shipments and inventories for July and August 2013, and, of course, the August employment report (due out on Friday, September 6) will help to further clarify the pace of GDP growth in the current quarter, the rest of 2013, and into 2014.

GDP Overseas

Data released over the past several months suggest that the economies in Europe and China have stabilized. Meanwhile, market participants have increased their GDP growth forecasts for Japan over the past nine months, as Japanese policymakers have ramped up monetary and fiscal policy and embarked on a series of structural reforms aimed at jarring Japan's economy out of a multi-decade slumber. Our view remains that while the economies in China and Europe have stopped getting worse, it may take several more quarters before they can meaningfully re-accelerate. While growth has picked up in Japan—second quarter GDP growth in Japan was 2.6%—it remains disappointing relative to elevated expectations. In addition, many emerging market nations (about 50% of U.S. exports head to emerging markets), including India, Brazil, and Indonesia are now experiencing growth and inflation scares, and some (Brazil and Indonesia) are raising interest rates to head off inflation. Many of the market participants and Fed policymakers who expect U.S. GDP to accelerate in the second half of 2013 and in 2014 are likely counting on accelerating growth in Europe, China, Japan, and emerging markets to drive U.S. exports higher. But is that enough to boost U.S. GDP growth?

As noted in our *Weekly Economic Commentary: Exporting Good Old American Know-How*, from August 19, 2013, the United States has run a trade deficit (importing more goods and services from other countries than it exports) since the mid-1970s, and our large deficit on the goods side (around \$759 billion in 2012) more than offsets the trade surplus we have on

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LPL Financial Research Weekly Calendar

	U.S. Data 	Fed 	Global Notables 
2013			
2 Sep			<ul style="list-style-type: none"> ▪ Eurozone: PMI – Manufacturing (Aug) ▪ Reserve Bank of Australia (No Change Expected) ▪ China: PMI – Non Manufacturing (Aug)
3 Sep	<ul style="list-style-type: none"> ▪ Markit PMI (Aug) ▪ ISM Manufacturing (Aug) ▪ Construction Spending (Jul) 		
4 Sep	<ul style="list-style-type: none"> ▪ Challenger Layoff Announcements (Aug) ▪ Trade Balance (Jul) ▪ Vehicle Sales (Aug) 	Beige Book ↓ Williams ↓ Kocherlakota	<ul style="list-style-type: none"> ▪ Eurozone: Non-Manufacturing PMI (Aug) ▪ Eurozone: Retail Sales (Jul) ▪ Bank of Canada (No Change Expected)
5 Sep	<ul style="list-style-type: none"> ▪ ADP Employment Report (Aug) ▪ ISM- Non Manufacturing (Aug) ▪ Initial Claims (8/31) ▪ Factory Orders (Jul) 	↓ Kocherlakota	<ul style="list-style-type: none"> ▪ Germany: Factory Orders (Jul) ▪ G-20 Leaders Summit ▪ Bank of England (No Change Expected) ▪ European Central Bank (No Change Expected) ▪ Bank of Japan (No Change Expected)
6 Sep	<ul style="list-style-type: none"> ▪ Employment Report (Aug) 	↓ Evans* ↓ George*	<ul style="list-style-type: none"> ▪ Banco De Mexico (No Change Expected)

↓ 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)

the service side of the ledger (around \$213 billion in 2012). Combined, our goods and services trade deficit was \$547 billion in 2012, slightly smaller than the \$569 billion deficit in 2011. As a result of the slight narrowing of the deficit between 2011 and 2012, net exports contributed 0.1% to the 2.8% gain in GDP in 2012.

Net Exports Typically Do Not Boost U.S. GDP Growth

The infographic on page 2, "Profile of U.S. Exports" (Profile) reveals that over the past 40 years—aside from recessions (when imports fall faster than exports, narrowing the trade deficit)—net exports have never added more than 1.0% to overall GDP growth. Thus, even if the economies of Europe, China, Japan, and emerging markets accelerate sharply in the next few quarters, it is unlikely that net exports will provide a large boost to GDP growth this year.

In theory, an unexpected uptick in economic activity among our largest export destinations should be a plus for our exports to that region, but in practice, the impact to our trade balance and economy may not immediately reflect the better growth prospects overseas. In addition, exchange rate movements also can influence cross-border trade, but movements often work with a long lag. Since many of our exports do not compete on price, the value of the dollar is not always the best way to gauge the relative



strength of our exports to many markets. Generally speaking, U.S. exports compete globally on quality, rather than price.

Export Destinations: Economic Prospects in Canada and Mexico

The Profile details the destinations (trading partners) and mix (goods versus services) of our exports. Fourteen percent of our exports (both goods and services) are bound for the Eurozone, while just 6% head to China. Remarkably, only 5% of our exports go to Japan. Combined, our exports to the Eurozone, Japan, and China account for 25% of our total exports. Closer to home, 16% of our exports head north of the border to Canada, and another 11% head south of the border to Mexico. Thus, our exports to our two closest neighbors (27% of all exports) are larger than our exports to the Eurozone, Japan, and China combined (25%). Accordingly, market participants should probably pay more attention to the economic prospects of Canada and Mexico and a bit less to the prospects of China, the Eurozone, and Japan.

Mix of Goods/Services: Goods Are 70% of All Exports

The Profile also details the goods/services mix of our exports. Currently, goods account for around 70% of all exports, but that varies widely by trading partner. The export mix to Canada and Mexico is skewed toward goods rather than services, which is partially explained by auto production, since auto parts factories and final assembly plants account for such a large portion of trade. Our export mix to the Eurozone, China, and Japan is...well... more mixed. Services, at around 40%, account for more of our trade to the Eurozone and Japan than in our overall trade mix. In China, however, an above-average 78% of our exports are goods.

All else being equal, an unexpected and permanent shift higher in economic growth for trading partners like China, the Eurozone, and Japan should boost our exports to those nations over time and, in turn, our GDP. But it is important to note that outside of recessions, net exports rarely add more than 0.5% to GDP growth. So while we spend a great deal of time discussing the health of the economy in China, the Eurozone, Japan, and emerging markets, the economic prospects of our nearest neighbors (Canada and Mexico) have a bigger influence on our overall exports. ■

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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.

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 economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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

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.

Markit is a leading, global financial information services company that provides independent data, valuations and trade processing across all asset classes in order to enhance transparency, reduce risk and improve operational efficiency. The Markit Purchasing Managers' Index (PMIT) is a composite index based on five of the individual indexes with the following weights: New Orders - 0.3, Output - 0.25, Employment - 0.2, Suppliers' Delivery Times - 0.15, Stocks of Items Purchased - 0.1, with the Delivery Times Index inverted so that it moves in a comparable direction.

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Challenger, Gray & Christmas is the oldest executive outplacement firm in the United States. The firm conducts regular surveys and issues reports on the state of the economy, employment, job-seeking, layoffs, and executive compensation.

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