LPL FINANCIAL RESEARCH

the Whitepaper

October 2009 | Vol. 7

Burt White
Chief Investment Officer
LPL Financial

Highlights

Market Relay Race Runners

- **Lead off: Government stimulus** - The catalyst to start the move of the market from recession to recovery.
- **Second: China** - Tremendous growth has made China a strong early runner.
- **Third: Corporations** - Increased spending, expanded worker compensation, and creation of jobs position corporations as an important leg of the race.
- **Anchor: Consumers** - The race can't be won until the consumers join the final sprint to the finish line.

Passing the Baton in the Market's Road to Recovery

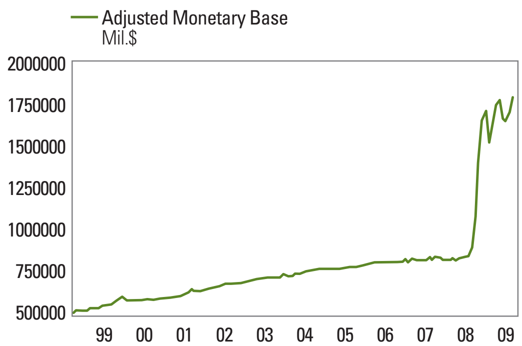
In 1996, I was fortunate enough to attend the Summer Olympic Games when they visited Atlanta, Georgia. Of all of the events that I attended, the evening of track and field was the most memorable. Throughout the stadium, track and field icons were setting and breaking world records. That evening Carl Lewis won his fourth gold medal in the long jump. Dan O'Brien held off the field in a hotly contested decathlon. And the golden shoe-clad Michael Johnson set a new world record winning the 200 meters.

But perhaps the most memorable was the men's 4x400m relay race. The drama in the standing-room only stadium was thick that evening given the results from the night before when the heavily favored American team lost in the 4x100m relay to the Canadian team, anchored by the "world's fastest man": Donovan Bailey. The upset by the Canadian squad was shocking given that the U.S. team had never finished without a gold medal in the 4x100m relay event in any Olympic Games that the U.S. had ever participated in—to have lost on home soil took the air right out of the crowd. The next night, the American team fielded a dominant line-up of elite runners to try to redeem itself in the 4x400m. What made the task even more daunting was that the team tried to do it without the services of the golden shoes of world-record holder Michael Johnson, who sat out the race due to his lack of practice working with the team in baton handoffs.

For the casual viewer of relay races, it is hard to understand why the Americans would not want to have the fastest 400m runner in the world participate. While running is usually viewed as an individual sport, in a relay race, teamwork is the real key to winning or losing. Although much of the time is spent with a single runner carrying the baton over his leg of the track, it is the pass-off of the batons that usually determines the outcome. A lot can go wrong in a relay. The baton can be dropped. If you pass the baton too late (outside of the handoff zone), the team is disqualified. But if you pass the baton too early, the team loses the momentum of the current runner.

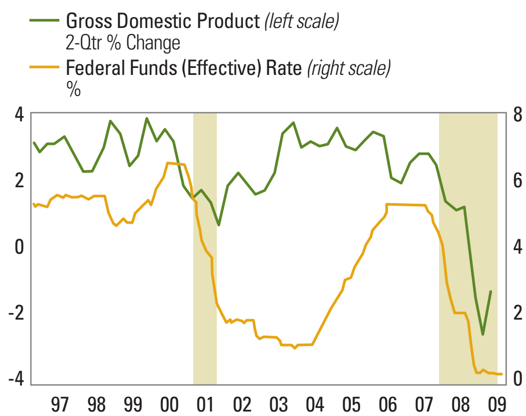
Thus, it is often not the strength of the individual runners that decides the outcome of a relay race, rather the execution of the handoffs. The U.S. team went on to win the 4x400m relay that night. But that race forever memorialized the concept that the execution of a team is more important than the speed or strength of individuals.

1 Fed Makes More Reserves Available for Banks



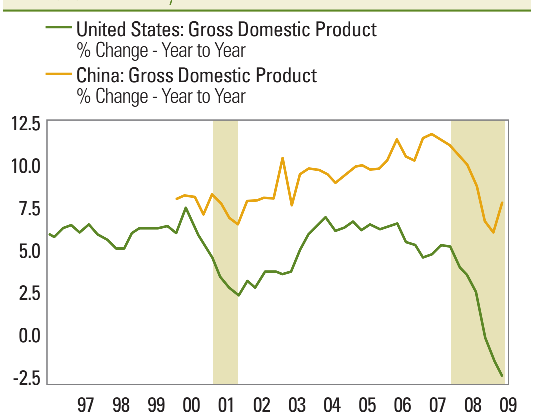
Source: Federal Reserve Board, Haver

2 How Interest Rates Help Boost Economic Growth



Source: Bureau of Economic Analysis, Federal Reserve Board, Haver

3 The Chinese Economy Did Not Contract Like the U.S. Economy



Source: Bureau of Economic Analysis, CNBS, Haver

The Initial Runners in the Road to Recovery Relay

Currently, the market's Road to Recovery is in its own relay race. In any economic recovery, there is a required "teamwork" of factors that contribute to the healing and ultimately the return to growth. No element of the economy—whether it is the consumer, business, or government—can move an economy from recession to recovery alone. It requires a coordinated effort by market forces to "take turns" providing recovery leadership. The first runners in the market's Road to Recovery have been the strength of **government stimulus** and the powerful demand of **China**. These two "runners" have been the catalyst to start the move of the market from recession to recovery.

With both consumer and business spending at multi-year lows, global central banks provided quick stimulus to ailing economies in late 2008 and throughout 2009. Government stimulus serves as the jolt that jump starts an economy in contraction to one that has the backdrop to expand. The first part of the government action was through monetary policy as central banks swiftly moved to lower interest rates and flooded the economy with easy access to capital. Within the U.S., the monetary base exploded as the Federal Reserve (the Fed) made more reserves for banks readily available [Chart 1]. In addition, interest rates were slashed to record low levels, in an attempt to spur a stabilization of the housing market and coerce demand for business and consumer loans. The effects of easing monetary policy is dramatic, as lower rates often serve as the most effective catalyst to reverse the recession's economic contraction [Chart 2].

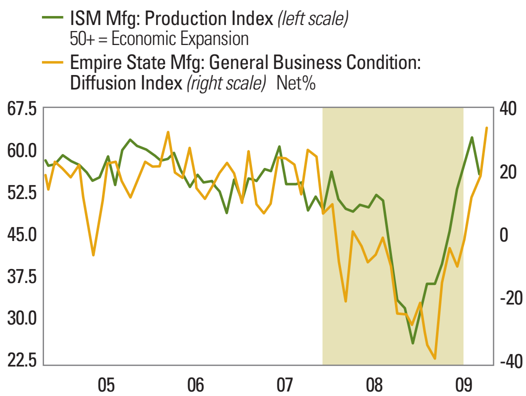
China's tremendous growth also served as an early runner in the market's Road to Recovery relay race. China has adopted capitalism over the last few decades and has seen its place among the world's spending and manufacturing ranks rise. In fact, the tremendous growth and favorable demographics has China on pace to pass the U.S. as the world's largest economy in the next 10 years. It has been this growth in China that has taken some of the sting off of the recent recession as Chinese consumption has remained strong [Chart 3].

The Next Runner in the Relay

While government stimulus and robust consumption by China has served as the catalyst for growth, neither is strong enough to move the global economy from contraction to expansion alone. China's demand, while impressive, cannot pull the sluggish economies of the rest of the world for long and government stimulus is limited, especially for debt-ridden countries like the U.S. and U.K.

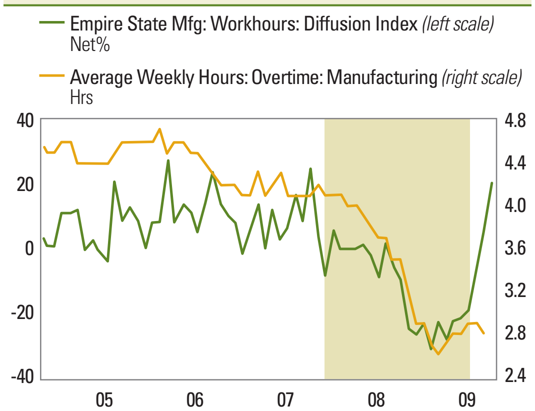
So, the baton needs to be passed off soon to the next runner in the market's relay race. The next runner appears to be **corporations** through increased business spending, creation of jobs (or at least mitigate job losses), and expanded worker compensation. In the end, there is no runner that has a bigger multiplier effect than business spending—as it benefits the economy in two ways. First, it generates demand for new goods and services through increased consumption (technology spending, materials, etc.) and a shift from

4 Production is Picking Up



Source: ISM, FRBNY, Haver

5 Hours Worked and Overtime Worked by Current Employees is Increasing



Source: Bureau of Labor Statistics, FRBNY, Haver

6 Unemployment Has Not Yet Peaked, But Will Soon

Source: Bureau of Labor Statistics, Haver

decreasing to re-stocking inventories. Secondly, as business spending picks up, workers feel more secure, the average work week and overtime hours expand, temporary workers are engaged and ultimately jobs are created.

So, what is the evidence that businesses are ready to grab the "baton" and start running? In two well-respected business surveys, conducted by the Federal Reserve Bank of New York and the Institute of Supply Management (ISM), respectively, data shows that production and general business conditions have improved dramatically over the last few months. The ISM Production Index is above the 50 level for the first time in almost two years, reflecting expansion in factory and manufacturer production driven by increased orders. In the Fed's Empire State survey, companies indicated that general conditions have rebounded to the highest levels in more than five years [Chart 4].

In addition, data has begun to show that factories and manufacturers are beginning to expand their payrolls in order to meet increased production demands. While job growth continues to be muted, businesses are increasing hours worked by employees and offering more overtime opportunities [Chart 5]. In general, businesses are slow to add to their permanent labor forces following a recession and favor more hours for current employees and the use of temporary workers until conditions are stable enough to warrant bringing in full-time staff. This is the beginning phase of healing in the labor market and it is driven by the emerging growth of business spending.

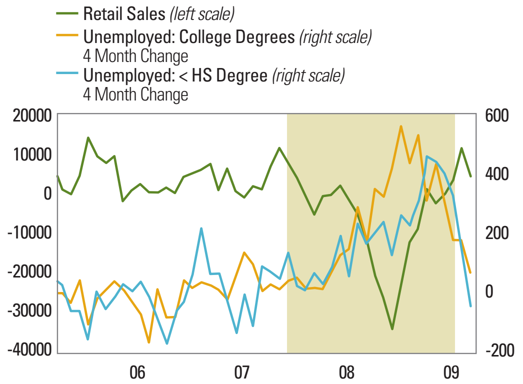
Our Final and Star Runner: The Consumer

The final runner in a relay is called the anchor, which is usually the fastest and most important of the runners. The key is to get the baton in the hands of the anchor runner as quickly as possible and then watch the gold-medal sprint to the finish line. In the market's Road to Recovery relay, the anchor is the **consumer**. Representing almost 70% of the GDP of the U.S. economy, no recovery can take hold until the consumer joins the race.

Perhaps the biggest headwind facing the consumer is the dire, but rapidly improving, employment situation. With the unemployment rate hovering just below 10% [Chart 6], which is the highest level over the last 60 years outside of the 1981-82 recession's 10.4% peak, the concern holding back the pocketbooks of consumers is: just how high will unemployment go? In the last two mild recessions (1991 and 2001-2002), the unemployment rate continued to rise an average of 0.9% higher during the 15 to 18 months after the recession ended. However, we feel that the unemployment rate in this latest recession will follow the path of the more severe 1973-75 and 1981-82 contractions. In both cases, the unemployment rate topped out within six months of the end of the recession. As such, we look for the employment rate to begin to moderate around year-end 2009.

That said, we believe that the unemployment rate and even the number of unemployed is the wrong way to look at the healing of the labor market and the subsequent potential re-engagement of the consumer back to spending. While the *number of job losses* is an issue, it is *which jobs are being lost*

7 Retail Sales Improve When Higher Earners Unemployment Rate Ebbs



Source: CEN/H, Bureau of Labor Statistics, Haver

that has the greatest impact on consumer spending. Make no doubt about it, losing any jobs is a bad result and is a social issue that needs to be resolved. However, economically, not all job losses have the same impact on consumer spending and thus GDP growth.

In fact, more than 60% of consumer spending is conducted by the 20% highest earners. While any job losses are an important social issue, from an economic perspective, having healing at the top end of the labor market delivers the biggest consumer spending "bang for the buck". As shown nearby [Chart 7], the number of unemployed with a college degree (proxy for the highest earners) peaked early in this recession and well before the job losses among less than high school degree recipients (proxy for lower earners). This was due to the extraordinary elimination of top paying jobs within auto manufacturing, corporate middle management, and financial services at the outset of this current crisis. However, what is important to note is how retail sales began to improve as soon as the unemployment for higher earners began to moderate even though lower wage earners continued to see the rate of job losses rise. In the end, for robust consumer spending to return, we have to get the entire labor market healed. However, as long as the upper end of the labor market continues to improve, retail sales and overall consumer spending are likely to continue to surpass expectations and allow for the consumer to run through the "finish line" with surprising strength.

How to Invest in the Next Two Runners

The question remains: what is the best way to benefit from the sprinting of the final two runners? Classic early cycle opportunities continue to be the most attractive investments. Asset classes that are most tied to the initial stages of economic growth should provide the greatest leadership, including Commodities, Small and Mid Cap Stocks, and Emerging Markets—debt and equity.

As business spending returns, perhaps the biggest beneficiary will be the Information Technology sector, as corporate America upgrades software, hardware, and devices to gain productivity. On the consumer side, Consumer Discretionary names, such as Retailers, appear to benefit most from rebounding consumer spending. In addition, as business and consumer spending takes hold, increasing demand for products will lend a tailwind to the Materials and Energy sectors.

The Finish Line

When it comes to relays, it is not only the strength and speed of the individual runners, but also the execution of the baton handoffs that ultimately determine the winner. The market's Road to Recovery relay is also at an important transition as it looks to handoff the baton from the government stimulus and Chinese demand driven growth to our next runners, which require organic expansion in productivity and spending increases from both corporations and consumers. While the race is far from over, this recovery is well ahead of schedule. And, who would have thought at the beginning of the year, that words like "recovery", "growth", and even

"Dow 10,000" would be the market headlines? This just proves that a strong start out of the gates, smooth sprints around the corners, and well executed handoffs can turn a race lost into a gold medal performance at the finish line.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Stock investing involves risk including loss of principal.