Weekly Economic Commentary

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Highlights

In our view, Yellen remains the leading candidate to replace Bernanke as Fed Chairman.

History suggests that in the second half of a U.S. economic expansion, economic growth decelerates and inflation picks up relative to the first half.

If this recovery is more like the lengthy recovery in the mid-90s, the U.S. economy may accelerate and inflation could decelerate over the second half of this recovery.

Business capital spending is always the best-performing economic sector in the second half of an economic cycle.

Real Consumption, Real Housing, and Capital Spending: Don't miss our half-page graphic on page 4.

Dawning of a New Era?

Fedlines

As this publication was being prepared on Monday, September 16, 2013, equity markets around the globe were rallying and bond yields were dropping on the news over the weekend of September 14–15, 2013 that Larry Summers—who market participants had pegged as the front-runner to replace Ben Bernanke as Federal Reserve (Fed) Chairman—withdrew his name from consideration. Our long-held view was that current Fed Vice Chair Janet Yellen would be the next Fed Chairman, and the market has now pegged her as the new front-runner. Still, former Fed Vice Chair Don Kohn, former Treasury Secretary Tim Geithner, and former Fed Governor Roger Ferguson, among others, are also likely under consideration for the job. President Obama is likely to nominate a candidate to replace Bernanke in the next several weeks. Bernanke's term as Chairman ends on January 31, 2014.

Financial markets have reacted favorably to the news that Summers is no longer a candidate for several reasons: Most importantly, Yellen is more likely to continue the same policy path as Bernanke, and markets are embracing that certainty, even as the uncertainty around the Fed's quantitative easing (QE) program ramps up. In addition, Yellen is viewed by the markets as slightly more "dovish" than Summers on monetary policy, but our view has been that any of the candidates nominated by President Obama (a Democrat) and subject to confirmation by the Senate (which is controlled by Democrats) are likely to fall on the dovish side of the Fed policy spectrum. Perhaps just as importantly, however, is that Yellen's confirmation by the Senate is likely to be a lot less contentious than the process would have been with Summers as the nominee.

"A Message to You" From the Economic Cycle

For a full discussion about our views on the FOMC meeting, please see *Weekly Economic Commentary: Trust* from September 9, 2013 and *Bond Market Perspectives: Reaching Barriers* from September 10, 2013.

The outcome of this week's Federal Open Market Committee (FOMC) meeting, which includes the FOMC's latest economic forecasts and Bernanke's post-meeting press conference is likely to dominate the headlines this week and perhaps for weeks and months to come. The Fed meeting could herald a new era for both Fed policy and the economy. In addition, the nonpartisan Congressional Budget Office will release its latest outlook for the federal budget over the next several decades, which will also likely foster debate about longer-term economic and legislative policies.

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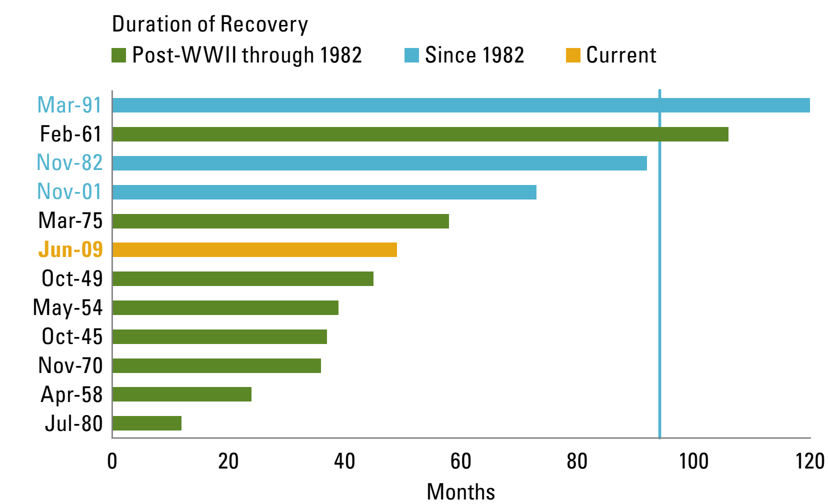
What segments of the economy tend to shine in the second half of a recovery, and which ones tend to struggle? The answers may surprise you.

As we discussed in our recent *Weekly Economic Commentaries: Revisiting the Recovery* (August 5, 2013) and *Measuring Economic Expansion* (August 12, 2013), the U.S. economy is now in the fifth year of the 12th economic recovery (or expansion) since the end of World War II. It is already the sixth-longest expansion and would have to last another year to become the fifth longest. Our view remains that we are roughly at the halfway point of the current recovery [Figure 1], and that the odds of a recession in the next two years are low, but that the odds of recession move higher as each year passes. As we move into the latter half of the expansion, investors may be asking: What does the second half of an economic expansion usually look like? What segments of the economy tend to shine in the second half of a recovery, and which ones tend to struggle? The answers may surprise you.

1 The Current Economic Expansion Is the Sixth Longest Post-WWII Recovery



Source: National Bureau of Economic Research 08/05/13

Since the start of the current expansion in mid-2009, annualized real economic growth as measured by inflation-adjusted (real) gross domestic product (GDP) has averaged 2.2%. If the economic expansion is indeed at its midpoint, real GDP growth in the first half of the recovery is the slowest of any in the past 50 years. We've discussed the reasons for the sluggish pace of the recovery in prior editions of the *Weekly Economic Commentary*. In addition, in six of the seven expansions since 1960, economic growth has actually slowed in the second half of the expansion relative to the first [Figure 2].

The exception was in the long 1991–2001 recovery following the 1990–1991 recession, which was caused by the savings and loan crisis of the late 1980s and early 1990s and the spike in energy prices in mid-1990 when Iraq invaded Kuwait. During the first half of the 1991–2001 expansion, real GDP growth was 3.1%, but, aided by a boom in technology spending, it accelerated to a 4.1% annualized pace in the second half. Will the second half of this recovery follow the historical pattern and decelerate, or will it mirror the second half of the 1990s expansion, and pick up momentum?

2 Comparing the First Half and Second Half of an Economic Expansion

Recovery	U.S. Real GDP		U.S. Core PCE Deflator		U.S. Nominal GDP	
	1st Half of Expansion	2nd Half of Expansion	1st Half of Expansion	2nd Half of Expansion	1st Half of Expansion	2nd Half of Expansion
'61–'69	5.9%	4.2%	1.4%	3.7%	7.3%	8.1%
'70–'73	5.7%	4.4%	3.8%	4.2%	10.6%	10.7%
'75–'80	5.3%	3.4%	6.3%	7.3%	11.3%	11.7%
'81–'90	5.4%	3.5%	4.0%	3.9%	8.5%	7.1%
'91–'01	3.1%	4.1%	2.5%	1.6%	5.4%	5.9%
'01–'07	3.1%	2.5%	1.7%	2.2%	5.5%	5.4%
'09–??	2.2%	?	1.5%	?	3.8%	?

Source: LPL Financial 09/16/13

Nominal GDP is a measure of gross domestic product in a given year that has not been adjusted for differences in prices (such as inflation) between that year and a base year.

The Core PCE Price Index is a summary measure of the prices of all goods and services that make up personal consumption expenditures. The Federal Reserve uses measures based on the PCE price index as its primary measures of inflation in conducting monetary policy, because those measures are more representative of current consumer spending patterns than is the consumer price index. The PCE price index is also referred to as the chained price index for personal consumption expenditures.

Real GDP is adjusted to remove the effects of inflation. Real output represents the quantity, rather than the dollar value, of goods and services produced. Real aggregates, such as real gross domestic product, are constructed by a procedure that allows the real growth of the aggregate to reflect the real growth of its components, appropriately weighted by the importance of the components.

Is a 2-Tone Recovery in Place?

A solid argument can be made that the causes of the 2007–2009 Great Recession (financial crisis and a spike in global energy prices) were similar to the conditions that led to the recession in the early 1990s, and that the revival of the domestic energy sector today mirrors the tech boom of the late 1990s. If so, this might set the stage for acceleration in real economic growth in the second half of this expansion. Other determinates of growth, including demographics, labor force growth, and globalization, will also have a big impact on U.S. economic growth in the years to come. While we do expect a mild reacceleration of real GDP growth in the next few years as the drag from fiscal policy fades, economic growth outside the U.S. accelerates, and the housing market continues to recover, it may be difficult for the U.S. economy to accelerate over the entire second half of the expansion relative to the first half.

Will Inflation Be "Too Hot"?

Turning to inflation (based on the Fed's preferred measure, the personal consumption deflator excluding food and energy, also known as the core PCE deflator), we note that inflation almost always picks up over the second half of an expansion. During the expansions in the 60s, early 70s, and late 70s, the acceleration in inflation was dramatic. Over the last 25+ years, inflation's performance over the second half of a cycle has been mixed, remaining constant throughout the 80s expansion, decelerating

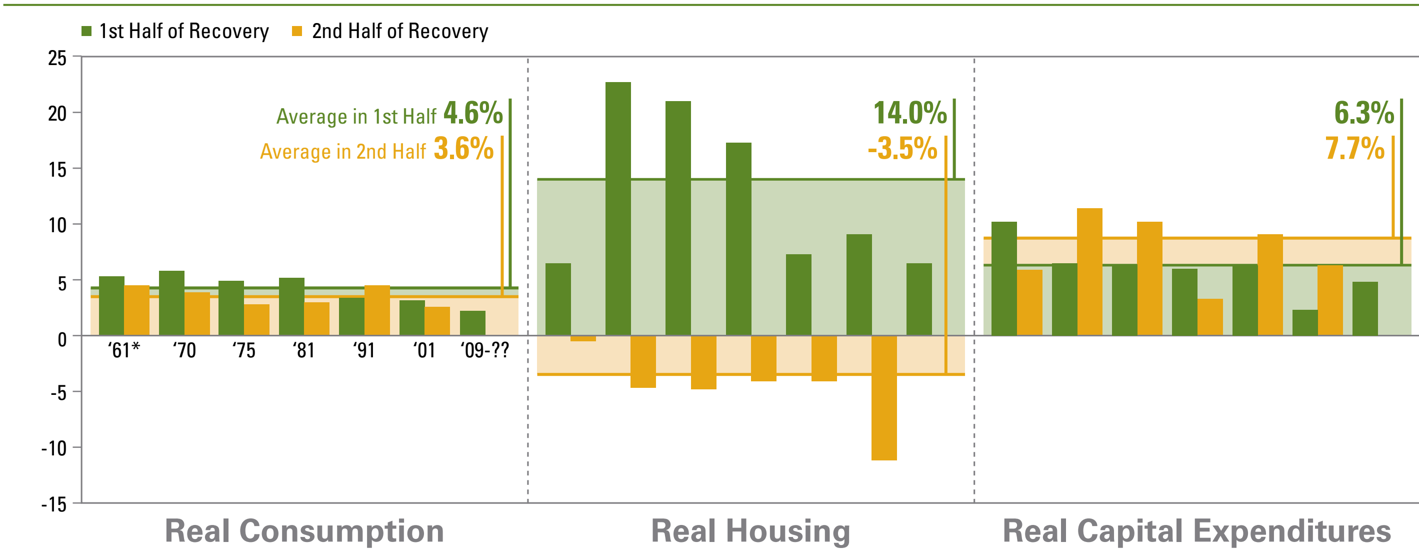
For more details about inflation, see the *Weekly Economic Commentary: The Inflation Situation Revisited* from March 13, 2013.

in the second half of the 90s (thanks to plunging oil prices and the boost to productivity from the aforementioned tech boom), but accelerating modestly in the 2000s expansion, as oil prices surged.

Given the extremely low rate of inflation in the first half of the current cycle (1.5%, the lowest rate of inflation in the first half of any expansion since the early 1960s), it seems unlikely that inflation will match the second half of the 1990s expansion and decelerate. However, because there are still many more factors pushing down on inflation than pushing inflation higher, we do not foresee a rapid acceleration in inflation in the years ahead either. Instead, inflation readings are likely to accelerate gradually to a more "normal" pace in the second half of the expansion.

Given that sales and profits of U.S. businesses have become more dependent on overseas economies in the past 20 years, nominal GDP may not be as important as it once was as a gauge for corporate revenue growth. Nevertheless, a good proxy for corporate revenues is the growth of nominal GDP, or GDP not adjusted for inflation. In two of the past three expansions (the 1980s and 2000s), nominal GDP has decelerated in the second half of the expansion relative to the first half. The 1990s expansion is an outlier here as well (an outlier for the performance of both real GDP growth and inflation), as the expansion in the 1990s saw nominal GDP growth accelerate in the second half of the expansion. Nominal GDP growth accelerated in the second half of the recoveries in the 60s, early 70s, and late 70s. This time around, we would argue that the pace of nominal GDP is likely to accelerate in the next few years as the economy continues to shake off the effects of the Great Recession, but it is not likely to accelerate very much, which may act as an important constraint on corporate revenues in the coming years.

3 Housing Always Leads Growth in First Half of an Expansion, but Gives Way to Capital Spending in the Second Half



Source: Bureau of Economic Analysis, LPL Financial Research 09/16/13

*Dates indicate beginning of economic expansion. Refer to Figure 2 for full range.

"Ghost Town" for Housing?

Business capital spending has been the best-performing sector of the economy in the second half of expansions in every one of the six expansions since 1960.

The performance of three major components of GDP (consumption expenditures, housing, and business capital spending) in the first and second halves of expansions (and relative to each other) is also worth investigating. Aside from the expansion in the 1960s, housing has outperformed consumer spending and business capital spending in the first half of every economic expansion in the past 50 years, including the current expansion. On the other hand, business capital spending has been the best-performing sector of the economy in the second half of expansions in every one of the six expansions since 1960.

Consumption, which accounts for two-thirds of GDP, has decelerated in the second half (relative to its first half performance) in all but one of the recoveries, the long expansion in the 1990s, since 1960. Housing, on the other hand, has not only seen slower growth in the second half of expansions relative to the first half, but has experienced outright declines in the second half of all but one of the six expansions in the past 50 years. And although business capital spending is the best performer (relative to consumer spending and housing) in the second half of expansions, it has slowed relative to its first half performance in two expansions (the 1960s and 1980s), while accelerating in the second half in the other four expansions.

"You're Wondering Now What to Do"

Looking ahead, a case can be made that housing still has a long way to go to get "back to normal," and that this sector, not capital spending, will be the best performer over the second half of the expansion. History suggests, however, that housing will not only decelerate, but post outright declines over the next several years. Given how far we have to go to get back to normal on housing, outright declines in housing in the second half of the expansion seem unlikely. So, for now, we'll go with the historical trends here and suggest that business capital spending will likely be the best-performing economic sector over the second half of the expansion, while housing will buck the historical trend and post modest gains. ■

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.

Quantitative easing (QE) 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 United States Treasure securities).

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.

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