WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

September 2014

Making a positive impact on as many lives as I can.

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Weekly Economic Commentary | Week of September 22, 2014

Highlights

- The key now for the Fed, as it deliberates when to begin to raise rates, is to gauge how quickly the output ga is likely to close.
- The pace at which the U.S. economy takes up slack is likely to command a great deal of attention from the F and market participants in the coming months.
- We believe the first Fed rate hike is likely to occur in about a year's time, assuming the economy tracks the FOMC's forecast.

Mind the Gap

On September 17, 2014, the Federal Reserve's (Fed) policymaking arm, the Federal Open Market Committee (FOM met for the sixth time this year. On the one hand, the FOMC surprised markets by announcing "how" it would exit from quantitative easing (QE) and reduce the size of its balance sheet in the coming years. On the other hand, the FOMC calmed markets by not making any substantive changes to its forward guidance to the public and financial markets on when it would begin raising rates.

The statement released after the meeting once again said that the FOMC would keep rates low for a "considerable time" after QE ends. However, the new set of economic and rate forecasts by FOMC members indicated an earlier start to rate hikes than the forecasts made at the conclusion of the June 2014 FOMC meeting and a slightly steeper path for the fed funds rate once rate hikes commenced. Some market participants--ourselves included--thought tha perhaps the FOMC would switch to a more explicitly data-dependent approach (how quickly the economy is growin where the unemployment rate is, what the inflation rate is, etc.). The FOMC, however, decided to strike a more balanced tone, and Fed Chair Janet Yellen repeatedly stressed in her post-FOMC meeting press conference that the timing of the first Fed rate hike would be data dependent. On balance, **it appears that the financial markets h it about right, and the first Fed rate hike is likely to occur in about a year's time--assuming the economy tracks the FOMC's forecast.**

As noted above, last week the FOMC released a new set of forecasts for economic growth (as measured by inflation-adjusted [or real] gross domestic product [GDP]), the unemployment rate, and inflation. The FOMC upda its forecasts four times per year: in March, June, September, and December. Fed Chair Yellen stressed that the decision to raise rates will be based on two factors:

1. The gaps between where inflation and the unemployment rate are now (1.7% and 6.1%, respectively) and th rate associated with the Fed's dual mandate (2.0% and 5.4%)
2. How quickly those gaps change

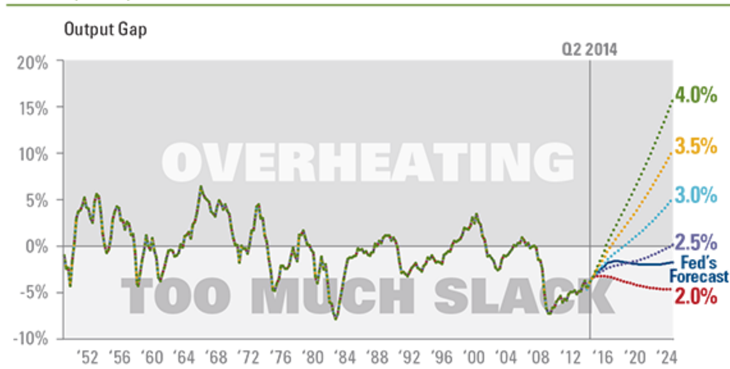
This is the data-dependence part of the Fed's message.

Output Gap

What Yellen did not specifically mention last week was the output gap--the difference between the actual output of the economy and what the economy would produce at full capacity, or what economists call the long-term potential growth rate of the economy. The nonpartisan Congressional Budget Office publishes a history of and provides projections for potential GDP. We adopt these projections for the analysis in the remainder of this commentary, bu acknowledge that projections of potential GDP contain a wide range of potential outcomes.

Since 1982, the output gap has averaged around 1.5%. As shown in Figure 1, the gap tends to narrow during econon expansions and in some periods (mid-1960s, mid-1970s, late 1970s, late 1980s, late 1990s, and briefly in the mid-2000s) the economy grows faster than its long-term potential. When this occurs, inflation is usually rising, anc in the past 30 or so years, the Fed has typically responded by raising rates to cool the economy. The Fed didn't act quickly and decisively enough to cool the economy in the mid-1960s and early 1970s, and one of the results was the runaway inflation that gripped the U.S. economy in the 1970s and early 1980s.

1 Output Gap Forecasts Under Different Growth Scenarios



Real GDP Growth Runs At:	Output Gap First Reaches '82–'14 Average (-1.5%)
4.0%	Q4 2015
3.5%	Q2 2016
3.0%	Q4 2016
2.5%	Q1 2020
Fed's Forecast	Q3 2017
2.0%	Never

Source: LPL Financial Research, Congressional Budget Office; Federal Reserve 09/19/14

On the other hand, when the economy persistently runs at a slower pace than its long-term potential--usually durin economic recessions--depression and deflation can ensue. Since 2001 (the past 13 years) the economy has consistently run below its long-term potential growth rate. **The Great Recession widened the output gap to i widest since the wrenching early 1980s recession.** Unlike the robust recovery that followed the 1981-82 recession, when the output gap narrowed within a few years of the end of the recession, the recovery since the Grea Recession, which ended in mid-2009, has been lackluster. The output gap remains the widest it has been outside of recession. The nature of the Great Recession, a recession caused and exacerbated by a financial crisis, is mostly to blame for the sluggish recovery and still wide output gap. We have devoted many pages in these *Weekly Economic Commentaries* to detailing the other reasons for the sluggish recovery.

The key now for the Fed, however, as it deliberates when to begin to raise rates, is to gauge how quickly the output g is likely to close. In the past, the Fed has not waited until the output gap has completely closed. Instead, the Fed has usually acted to hike rates around a year or so before the gap closed to around 1.5%--its 1982-2014 average. Figure 1 provides the history of the output gap along with GDP growth scenarios and how quickly the output gap would close under those scenarios.

For more information about the Fed's labor market indicators, please see the *Weekly Economic Commentary, "Reconnected?"* (August 4, 2014).

For example, under the FOMC's forecast for GDP--published last week--the output gap would reach 1.5% in the thir quarter of 2017. In that scenario, the Fed would likely have to begin raising rates sometime in early to mid-2016. If the economy maintains its current 4.0% growth rate in the coming quarters, the output gap would narrow to its 1982-2014 average by the end of 2015, suggesting the first rate hike would be likely in the next few months. Were th economy to slow to its 2011-13 average growth rate of around 2.0%, the output gap would never get close to 1.6%, a the Fed may need to do more QE. If real GDP growth in 2015 and 2016 is 3%, in line with our 2014 forecast, the output gap would reach its long-term average by Q4 2016, putting the first Fed rate hike sometime in the latter half 2015, which is just about what the market has priced in today. Although projecting the economy's growth rate relati to its long-term potential growth rate is not the only metric on the Fed's radar as it prepares to normalize rates, the pace at which the economy takes up slack is likely to command a great deal of attention in the coming months amon the members of the FOMC, investment professionals, and the public. LPL Financial Research will continue to moni the Fed as it begins its transition away from six years of monetary policy easing and toward a more normal policy.

IMPORTANT DISCLOSURES

As noted in the Outlook 2014: The Investor's Almanac, LPL Financial Research expects GDP to accelerate from th 2% pace of recent years to 3% in 2014. Since 2011, government spending subtracted about 0.5% each year from GDP growth. Government spending should be less of a drag on growth, which when combined with better global growth and business spending would result in +1% increase for 2014.

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The economic forecasts set forth in the presentation may not develop as predicted.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of US Treasury securities).

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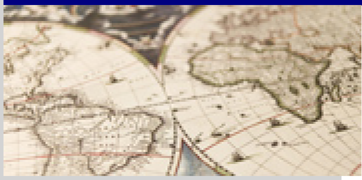


Weekly Market Commentary | Week of September 22, 2014

Highlights:

- Last week we discussed why buying European stocks now, following the recent stimulus announced by the ECB, is very different from buying U.S. stocks during periods of Fed stimulus in recent years.
- This week we take a deeper dive into the investment opportunity in Europe and evaluate fundamentals, valuations, and technicals.
- We recommend that investors "fight the ECB." We do not believe the additional stimulus is enough for us to recommend European equities over U.S. equities at this time.

Don't Fight the ~~Fed~~ ECB? (Part 2 of 2)

There have been a lot of bad movie sequels. Remember *Ghostbusters II? Grease 2? Blues Brothers 2000? In* the case of this *Weekly Market Commentary*, "Don't Fight the Fed ECB? (Part 2 of 2)," we hope you find the sequel at least as good as the original, perhaps something closer to *The Godfather: Part II* than *The Godfather: Part III*.

Last week we answered the question of whether the latest bold stimulus measures by the European Central Bank (ECB) are a buy signal for European equities. We highlighted key differences between buying Europe now and the United States several years ago during the start of the Federal Reserve's (Fed) quantitative easing (QE) programs. The different pictures for growth, valuations, and corporate profits in Europe versus the United States lead us to conclude that we should take a broader view to evaluate the investment opportunity in Europe. To that end, this week we take a deeper dive into the investment opportunity in Europe and evaluate fundamentals, valuations, and technicals--none of which we find particularly compelling at this time.

What We Would Like to See to Get More Positive on Europe

- **Higher inflation.** Inflation rising back above 1% would suggest the ECB's asset-backed securities purchase plan is helping to avert deflation.
- **Stronger loan demand.** More loan demand would be welcomed as a sign that the fractured banking system is being repaired and no longer constraining growth.
- **Lower earnings expectations.** More realistic earnings expectations that are more easily achievable may help reduce risk of market sell-offs in response to earnings failing to meet forecasts.
- **Cheaper valuations.** European stocks usually trade at a discount to U.S. stocks due to a different sector mix and slower growth, but we don't find the current discount attractive.
- **Better relative strength.** We would like to see European stocks establish relative momentum versus the United States before becoming more positive on the region.

A Broader Look at Europe

Although we view the ECB stimulus measures positively, the differences between Europe now and the United States a few years ago, and the fact that Europe's stimulus moves may not be as effective as what the United States has done, tell us not to overemphasize the ECB in making decisions on Europe. So we turn to our investment process, with its emphasis on fundamentals, valuations, and technicals, and look at some of the key factors that shape our current view of European equity markets:

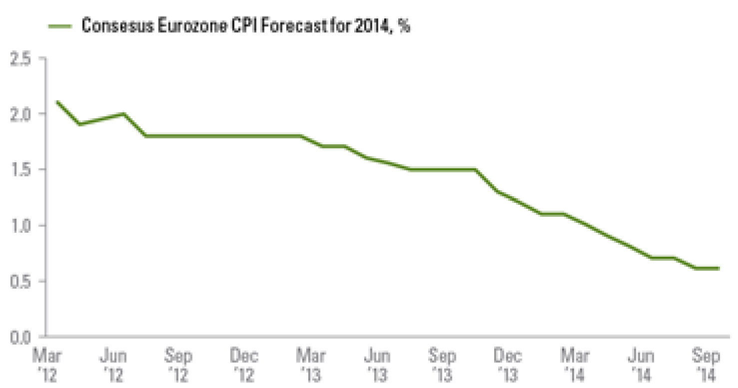
- **Economic growth is lackluster.** The latest ECB action was driven by the dismal set of Eurozone economic data for July and August 2014, which highlights the lackluster economic growth Europe is experiencing and increases the risk of a growth shortfall in the coming months. Eurozone economic confidence dipped to 100.6 in August 2014, a nine-month low. German unemployment unexpectedly rose in August, and retail sales in Italy in July were down 2.6% from a year ago. Based on the forward-looking components of the data released for July and August 2014, we do not expect near-term improvement in the sluggish 1% pace of gross domestic product (GDP) growth in the Eurozone, and the risk of recession has risen.

1 The U.S. Economy Is Growing Faster Than Europe with Better Momentum

Source: LPL Financial Research, Haver Analytics 09/12/14

- **Deflation risk is rising.** Sluggish growth has led to lower inflation and increasing fears of deflation in the Eurozone. The most recent inflation reading for August 2014 of 0.3% year over year (based on the Consumer Price Index [CPI]), well below the ECB's 2% target and the lowest level since just after the financial crisis, is cause for the ECB's and investors' concern. Low inflation expectations are also worrying. During the past year, Bloomberg-tracked economists' expectations for the Eurozone's CPI for 2014 have fallen from 1.5% to 0.6% [Figure 2]. In Spain, deflation has already taken hold, with its August 2014 CPI reading down 0.5% from the year-ago period. Italy has seen similar declines in prices. Even Germany's somewhat healthier economy saw prices rise just 0.8% from a year ago, well below the ECB's 2% target.

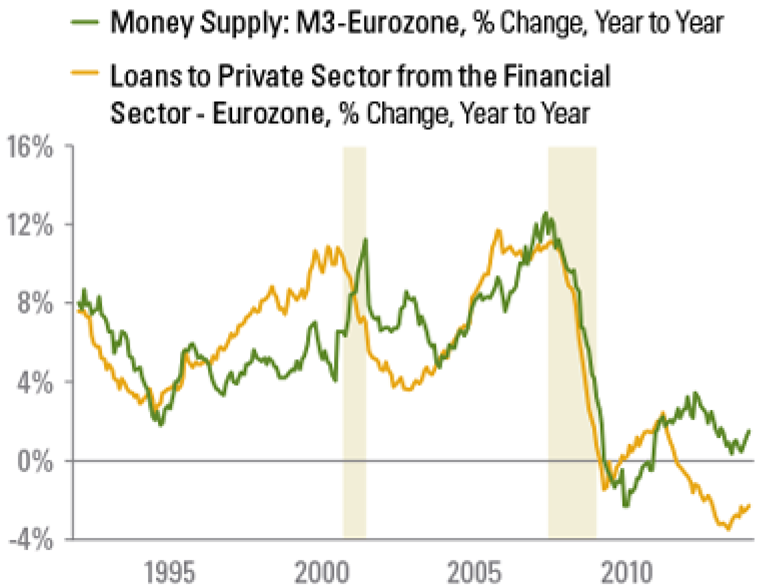
2 Falling Consumer Prices in the Eurozone Have Sparked Deflation Fears



Source: LPL Financial Research, Bloomberg 09/12/14

- **The financial transmission mechanism in Europe is still not working.** Unless the fractured banking system can be repaired, the impact of the ECB's just-announced asset-backed securities (ABS) purchase plan, or even outright QE, could be muted. The necessary credit to fuel economic growth is not getting through the banks to the businesses--particularly small businesses--and households that need it, due to the fractured European banking system (discussed in our *Weekly Economic Commentary, "Central Bankapalooza,"* on September 2, 2014). In July, according to data released on August 28, 2014, money supply growth was about 2% versus the prior year, whereas bank lending to the private sector fell by 3% [Figure 3]. The ECB's new bank lending program (referred to by the acronym TLTRO) experienced much weaker than expected demand last week, providing further evidence that the banking system in Europe is not functioning properly and growth is constrained.

3 Europe's Fractured Banking System Remains a Big Drag on Growth in the Eurozone



Source: LPL Financial Research, European Central Bank, Haver Analytics 09/02/14

Shaded areas indicate recession.

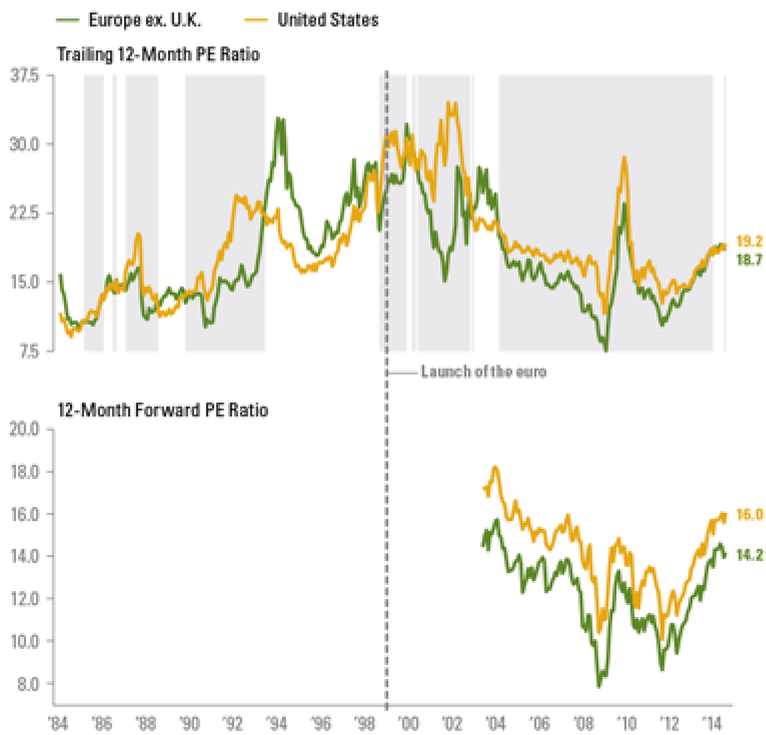
M3 is a measure of money supply (total amount of currency and other liquid assets available in an economy at a point in time) as well as large time deposits, institutional money market funds, short-term repurchase agreements, and other larger liquid assets.

- **Earnings expectations may be too high.** Based on recent weak economic data out of the Eurozone and Europe's recent track record of missing earnings estimates (Q2 2014 earnings came in 6% shy of June 30, 2014 estimates), earnings may disappoint investors. The Thomson-tracked consensus is calling for double-digit earnings growth in both the third and fourth quarter of 2014 and in the first half of 2015, despite marginal revenue growth expectations and expected GDP growth around 1% (based on the Bloomberg-tracked consensus of economists). The sluggish economic environment increases our fear that the high hurdle for earnings growth will not be met and may disappoint investors.

- **Geopolitical risks are high.** Geopolitical risks are present for all markets globally, but they are particularly acute for Europe. Because of Europe's energy dependence on Russia and Ukraine and its closer trading ties to Russia, the Russia-Ukraine conflict in particular impacts Europe more than the United States and other regions. Europe's close proximity to the Middle East also contributes to heightened geopolitical risk, given the turmoil in Iraq and Syria.

- **We believe European stocks should trade more cheaply relative to U.S. stocks.** A bigger valuation discount for Europe versus the United States is warranted given the divergence in economic growth and momentum, and greater structural constraints on Europe's growth. Figure 4 shows European stocks are trading at about a 10% discount to U.S. stocks, measured by the forward 12-month price-to-earnings ratio (PE) for the MSCI Europe Index (excluding the United Kingdom) versus the MSCI U.S. Index (similar to the S&P 500). On a trailing 12-month PE basis, the PE discount is even smaller (19.2 versus 18.7, or less than 3%), perhaps providing a stronger argument for the U.S. market being more attractively valued. On a relative basis versus the United States, Europe's PEs (trailing and forward) are 4-5% above their averages during the current bull market.

4 European Stocks Deserve a Bigger Discount to U.S. Stocks Than They Are Getting



Source: LPL Financial Research, Ned Davis Research, MSCI 09/22/14

Monthly data from 01/31/84 to 08/31/14.

Shaded areas indicate periods when Europe ex. U.K. is cheaper on a trailing PE basis.

Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.

- **European market's technicals are inferior to the United States.** From a technical perspective, European equities look less appealing to us than the United States. The two accompanying price charts [Figure 5] tell different stories from a trend perspective. The MSCI Europe Index in absolute terms (top panel) is exhibiting a bullish weekly trend, identified by the positive slope of the 40-week simple moving average (SMA) over the past two years (the orange line in the chart). From an absolute perspective, European equities continue to make higher highs and higher lows, which may make them attractive as a possible buy-and-hold type investment based on technical analysis.

  However, the bottom panel of Figure 5, which shows the MSCI Europe Index relative to the U.S. stock market (based on the S&P 500), tells a different story. It is exhibiting a bearish weekly trend, identified by the negative slope of the 40-week SMA over the past two years (orange line). A negative sloping weekly trend means that the MSCI Europe Index continues to underperform the S&P 500 Index, suggesting a more positive technical picture for U.S. equities. Although this trend may reverse, we do not believe fundamentals and valuations are supportive enough to consider a positive recommendation before we get technical confirmation of a turn in momentum.

5 Europe Is in an Uptrend but Is Losing Relative Strength to the United States

Source: LPL Financial Research, Bloomberg 09/22/14

Data range: 09/16/11 –09/19/14

Past performance is not indicative of future results.

A simple, or arithmetic, moving average that is calculated by adding the closing price of the security for a number of time periods and then dividing this total by the number of time periods. Short-term averages respond quickly to changes in the price of the underlying, while long-term averages are slow to react.

Indexes are unmanaged and cannot be invested in directly.

Conclusion

Part one of this two-part series told us to stay close to home and the sequel tells us to do the same. We continue to recommend that investors "fight the ECB." We do not believe the additional stimulus--even at its boldest--is enough for us to recommend European equities over U.S. equities. We do not find the fundamentals particularly compelling at this point, given the lackluster economic and profit growth outlook for the Eurozone and the risk of deflation. We do not believe European stock valuations are attractive relative to those in the United Sates. And the technical picture for the United States looks better to us than that of Europe.

Bottom line, we continue to favor the United States over Europe, but we will continue to watch for opportunities to go overseas later this year and in 2015. For investors looking for overseas equity market exposure, we suggest looking at the emerging markets, where we see a better combination of fundamentals, valuations, and technicals.

IMPORTANT DISCLOSURES

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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.

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. PE is a valuation ratio of a company's current share price compared to its per-share earnings.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Europe Index captures large and mid cap representation across 15 developed markets (DM) countries in Europe.

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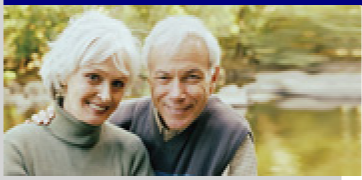

Take Steps to Keep Your Retirement Income Stream Flowing

A number of factors will influence your choice of withdrawal rates including your longevity, the potential impact of inflation on your assets, and the variability of investment returns.

After years of accumulating assets, the time will come for you to begin drawing on those assets to provide income throughout retirement. Before that day arrives, be sure to consider some steps to assist you in keeping your retirement income stream flowing.

Set a Sustainable Withdrawal Rate

As tax-advantaged retirement savings vehicles such as 401(k)s and IRAs have proliferated, so too has the trend toward self-funding of retirement. In the future, the share of personal assets required to fund retirement is sure to grow, which makes knowing how much you can withdraw from your investment accounts each year -- and still maintain a healthy cushion against uncertain market and personal circumstances -- a necessity to any retirement income plan.

A number of factors will influence your choice of withdrawal rates. These include your longevity, the potential impact of inflation on your assets, and the variability of investment returns. Therefore, when crafting a retirement asset allocation, a key question will be how much to allocate to stocks.[1] Certainly you will want to maintain enough growth potential to protect against inflation, yet you will also need to be wary of being too exposed to stock market gyrations. Generally speaking, those who have planned well and amassed enough assets to comfortably finance retirement may be in a better position to include more stocks in their portfolios than those who enter retirement with less.

Developing a Withdrawal Rate

The goal of your withdrawal plan is to crack your nest egg in such a way as to provide a reliable stream of income for as long as you live. The question is, "How much can I plan to withdraw each year without depleting my financial resources?" Academic studies suggest a yearly withdrawal rate of 3% to 4% of your portfolio's value based on an asset allocation of 60% stocks and 40% cash and fixed-income investments.[2] By staying within this withdrawal range you potentially should be able to maintain your portfolio's value in real, inflation-adjusted terms for an extended period of years, although past performance is no guarantee of future results.

Tax Rules Affecting Retirement Account Withdrawals

IRA and other retirement plan owners may be subject to a 10% income tax penalty if withdrawals begin before age 59½. Also, mandatory withdrawals, called "required minimum distributions" or "RMDs," must begin by age 70½. Failure to take full RMDs may result in a penalty tax of 50% of the required distribution amount.

Consult with your tax and/or financial advisor for additional help analyzing your specific situation. You should also revisit your personal withdrawal strategy each year, as your situation and tax laws may change.

[1] *Asset allocation does not assure a profit or protect against a loss. Investing in stocks involves risks, including loss of principal.*

[2] *This example is hypothetical and not intended as investment advice. Your results will vary.*

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Behind the Sticker Shock: The Real Cost of College

Most college students qualify to receive some form of financial aid that brings the total cost down to a more manageable bottom line.

The numbers are enough to rattle the bank accounts of even financially comfortable families. Ivy League bastion Harvard College will charge $58,607 for the 2014-2015 academic year. That figure, which is 3.9% higher than the $56,407 price tag for the previous year, includes tuition, room and board, and fees. Yale announced similar cost increases for the coming academic year -- a 4% jump to $59,800.[1]

Elite schools aside, the sticker-shock of attending college is still very real. Nationwide, the total average cost of a year at a private four-year college was $40,917 for the 2013-2014 academic year, while four-year public colleges came in at $18,391.[2]

Published Vs. Net Price

But there is more to the story than the so-called "published" costs. These eye-opening amounts are based on the full price that colleges list in their admissions documentation -- and that only the wealthiest families are asked to pay. Dig deeper into the numbers and you will find that the majority of college students pay nowhere near the published costs. Instead, most qualify to receive some form of financial aid that brings the total cost down to a more manageable bottom line. This dollar amount is referred to by The College Board and others in the field as the "net-price" tuition.

For instance, using Harvard as an example, a majority (nearly 60%) of its freshman class this fall will receive needs-based financial assistance from the institution that amounts to, on average, about $12,000 per student annually.[3] This is separate from any government aid qualifying students may receive.

Putting the net-price calculation into a broader context, after accounting for financial aid, the average student at a four-year private college paid tuition and fees of $12,460 in the 2013-2014 school year. Add to that average room and board charges of $10,830, and the estimated total net price would have been $23,290 -- a far cry from the published total price of $40,917.[4]

A similar pattern emerges when comparing the published versus net cost of attending a four-year public college. For these students, financial aid and tax offsets brought their tuition and fees down to an average net cost of $3,120 for the 2013-2014 academic year compared with the published cost of $8,893. When combined with the full charge for room and board, the total net cost for a year at a public college was $12,620 -- significantly less than the published rate of $18,391.[5]

What's Behind the Numbers Game?

Why does this two-tiered pricing scheme exist in the first place? Published, or list, prices have long been used by the U.S. government to track college-tuition inflation. Taken at face value, these prices measured the cost of college for affluent families that did not qualify for any form of financial assistance. They, in essence, paid the full list price. But that left the rest of the population -- from upper middle class and more needy families -- with a distorted sense of what a college education might cost them.

Over the past decade, the Bureau of Labor Statistics -- the government body responsible for tracking and reporting college costs -- has been gradually adapting its calculations to include the effects of financial aid and to provide a more accurate accounting to the general public.

So, while you may still lament the seemingly rapid rise in college costs -- some of which has been brought on by deep cuts to state budgets since the Great Recession -- take heart in knowing that the numbers you may be hearing don't apply to the vast majority of American families.

[1]*Harvard Magazine, "Harvard College Announces Admissions, Term Bill," March 27, 2014.*

[2]The College Board, "Average Published Undergraduate Charges by Sector, 2013-14."

[3]*The Harvard Crimson*, "Tuition Will Increase by 3.9 Percent, Largest Percentage Increase in Seven Years," March 28, 2014.

[4]The College Board, "Trends in Higher Education, Average Net Price for Full-Time Students over Time -- Private Institutions."

[5]The College Board, "Trends in Higher Education, Average Net Price for Full-Time Students over Time -- Public Institutions."

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