

# the Whitepaper

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## Highlights

### Good News Lurking Below the Surface

- The recent GDP report was not a good one, on the surface.
- However, while the headline results were negative, two “big fish” lurking below could end up being the good news that propels the economy from recession to recovery.
- There are growing indications of underlying strength in corporate earnings and an understated wealth effect for U.S. consumers.

### Corporate Earnings Looking Up

- The depletion of inventories rising at an alarming rate is leading corporations to spend to ensure shoppers are not greeted by empty shelves.
- Also helping is a steep reduction in input costs (commodities and raw materials) used in manufacturing of finished products.

### The Wealth Effect is Growing

- Consumers are starting to feel the benefits of an improving stock market, stabilizing housing market, and their individual debt reduction.

## Sometimes a Bad Cast Can Bait the Biggest Fish

Ask any avid recreational fisherman; making that perfect cast into the ideal spot with just the right lure on a cloudless day is what makes this outdoor pastime such a rewarding way to spend a few weekend hours. Last weekend, on a morning when the sunrise rivaled any sunset you have ever seen and the water of my local lake was as smooth as glass, I motored the 45-minute ride past many promising fishing spots to my favorite fishing hole—a secret spot that requires my personal “treasure map” to find. It is an x-marks-the-spot location where, at least in my own mind, the fish and I have an understanding that they wait for just me to deliver that heart-thumping excitement that all fisherman seek. I dropped anchor, rigged my rod with the perfect lure, and got ready to cast into the fishing hole I have been thinking about for the last month.

But being a bit rusty (I blame the wind when I tell this story to my buddies), my “perfect” cast overshot the hole and ended up wrapped around a tree limb overhanging the side of the lake. Suddenly the perfect build-up that I have been visualizing for weeks became the reality that my fishing day might end up worse than I had imagined. But hope was restored when I tugged on the line; the lure freed itself from the branch and fell perfectly into the prime fishing spot. Feeling lucky again, I began the retrieve until I realized nature had played a cruel joke on me. While the lure was in the right spot, the fall from the tree resulted in the hooks being wrapped around the line. As a result, the lure didn’t move like that perfect replica of a small bait fish that would entice a bigger fish to bite. Instead, it meandered in a twisted, unnatural path. As my heart once again faced the reality that my visions of a perfect day of fishing would be dashed, the water exploded and I ended up catching one of the biggest fish of my life. The cast appeared unpromising. But what I failed to acknowledge was that you cannot just look at the cast on the surface; you need to think about what fish might be lurking below and what the lure from your bad cast really looks like to them.

After getting the big fish (a seven pound largemouth bass) into the boat, I said to myself that was the “best worst cast” I have ever made, and just like that, a new fishing story was added to my collection of true yet exaggerated fish tales.

Corporate earnings potential and U.S. consumers' understated wealth effect are two "big fish" lurking below the surface.

As employment improves, consumers find jobs, feel more comfortable to spend, and begin to benefit from a return of "frozen" corporate benefits, such as 401k matching.

**1** Business inventories continue to decline at a rapid rate



Source: Bureau of Economic Analysis, Haver

## Big Fish Lurking Below the Recession's Surface

Also last week, the Department of Commerce's Bureau of Economic Analysis released its second quarter GDP (Gross Domestic Product) report, which is the most telling report card on the health of the U.S. economy. GDP measures the market value of all final goods and services produced in the United States for the latest quarter. On the surface, the report was not a good one. The U.S. economy contracted for the fourth consecutive quarter, the longest streak since 1953. In addition, the declines were led by the usually resilient U.S. consumers, who represent 70% of GDP, and reversed what was a positive result in the first quarter to a weak result in the second quarter. From a fisherman's perspective, this GDP report was one really bad cast.

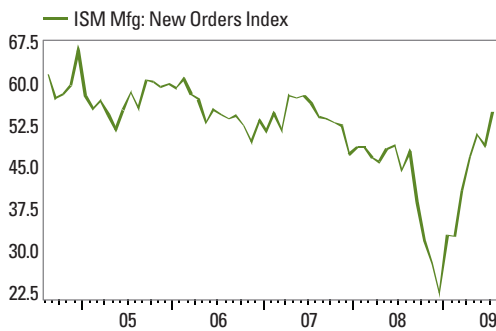
But there are big fish lurking below the surface. Sometimes poor results on the surface can hide the actuality that good things are hidden just below. Make no doubt about it: that GDP report was not glowing. But, it could be the "best worst" numbers this economy could ever hope for. In the case of this GDP report, while the headline results were negative, two "big fish" lurking below could end up being the good news that propels this economy from recession to recovery. Despite the numbers pointing to a continuation of a "recession-esque" economy in the second quarter, there are growing indications of underlying strength in corporate earnings potential as well as an understated wealth effect for U.S. consumers. These two "big fish" lurk beneath the surface of this recession and could be the catalysts that propel this economy from contraction to expansion.

## Corporate Earnings May be in Store for Greater Than Expected Growth

While consumer spending makes up 70% of GDP, perhaps the most significant element that can swing this economy to positive growth is the return of business spending and an increase in corporate profits. The reason is that in addition to the direct contribution that a return of strength to corporate business will have on the economy and GDP, its greater benefit may be in the indirect multiplier effect that companies can have on the overall economy. As corporate profitability returns, so does business spending, which includes employment adds. As employment improves, consumers find jobs, feel more comfortable to spend, and begin to benefit from a return of "frozen" corporate benefits, such as 401k matching. Thus, the return of corporate strength has a direct and indirect multiplier effect that has the potential to be the catalyst for economic growth.

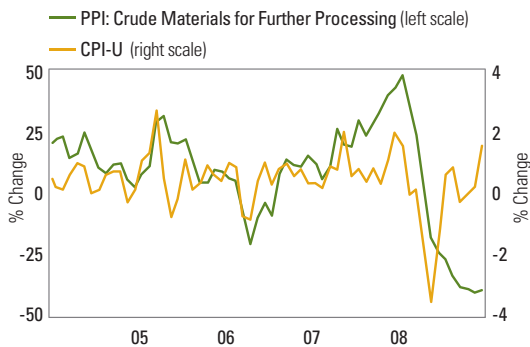
So, what evidence is there that business spending will return soon, and that it will result in a surge to corporate earnings? First of all, there is the depletion of inventories at an alarming rate. Inventories are the items that stock the shelves for consumers and businesses to purchase. As the latest recession began to set in and consumer spending dried up, businesses reduced their spending and thus their inventories. But now inventories are at levels that are unsustainably low. The drawdown in inventories means that corporations will have to start to spend, as businesses do not want to deter

**2 New orders surge**  
*Manufacturing increases to meet demand*



Source: Institute for Supply Management, Haver

**3 Producer costs have decreased significantly while consumer costs have risen slightly**



Source: Bureau of Labor Statistics, Haver

Americans are starting to feel the benefits of the improving stock market, a stabilizing housing market, and debt reduction.

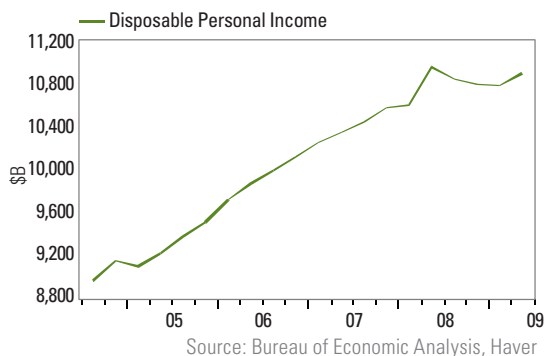
a return of consumer shoppers by greeting them with bare shelves. To meet the demand, factory production of goods will have to ramp up and some workers will have to be rehired to spearhead the increase in production. This inventory restocking is starting to show signs of developing, as the ISM (Institute of Supply Management) survey for July saw the new orders index surge to 55.3, a big rebound since its December 2008 lows, and an indication that new orders in manufacturing are expanding for the first time since July 2007.

Another factor that bodes well for corporate earnings is the steep reduction in input costs, which are the commodities and raw materials used in the manufacturing of finished products sold to consumers. Notice in the nearby chart that PPI (Producer Price Index) for crude materials, which measures the level of input costs for manufacturers, increased dramatically relative to the CPI (Consumer Price Index), the cost level of goods and services for consumers, in the 2002-2007 period. This increase was driven by the surge in commodity prices following the 2000-2001 recession, highlighted by oil's record climb to \$147 per barrel. These higher input costs for making goods cramped business profits as they were unable to pass on those price increases fully to the consumer (evidenced by how the PPI advanced higher but CPI stayed flat). However, the current recession has certainly resulted in a deflationary bias to producer costs (PPI), which had the largest year-over-year decrease in the history of the index, tracked since 1947. The positive news is that as input costs decline, so does the cost of making new products. But, consumer costs have not dropped as much as producer costs (CPI has fallen less than PPI), which means that companies will be able to make products at lower costs and sell them at better mark-ups. This lower drop in consumer costs relative to producer costs results in better corporate profits.

Last, corporate earnings could be poised to also move higher, given that businesses are currently at the most lean and focused they have been in many years. In addition to the reduced input costs mentioned above, cost-cutting initiatives and reductions in staff have left corporate America with bare-bones expense levels. As economic growth begins to improve, any small incremental growth of revenues will flow directly to the bottom-line of companies and result in direct increases in earnings—more significant revenue growth would result in powerful surges in earnings. This earnings growth will be the fuel that justifies higher stock market levels and will serve as the first of our “big fish” lurking just below the surface.

### The Wealth Effect is Growing

It is hard to fathom talking about a wealth effect given the economic conditions facing this market. However, evidence is pointing to the fact that Americans are starting to feel the benefits of the improving stock market, a stabilizing housing market, and the deleveraging efforts they have undertaken over the last year. With the expenses of Americans lessened through frugal spending and debt reduction, the average household is seeing some improvement. In fact, in the most recent GDP report, disposable personal income, the amount of money consumers have to spend after

**4 Disposable personal income begins to rise**

paying income taxes, rose for the first time in a year. While consumers are unlikely to start spending at pre-crisis levels, previously cut-back spending on necessary goods and low cost discretionary purchases (like going to the movies or buying a new pair of shoes) will likely take a larger share of the average consumer's wallet. While this seems like "small potatoes" on a historical basis, remember that with inventories so low and businesses so streamlined, any uptick in consumer spending will slow directly to corporate earnings and move GDP towards positive growth.

**These are the "Best Worst" Numbers this Economy Has Ever Seen**

In the second quarter of 2009, the U.S. economy continued to shrink as consumers and businesses alike found "fishing" to be quite tough. But it is below the surface that the good news is lurking. Accelerating new orders, unsustainably low inventories, and streamlined companies bode well for a potential surge in corporate earnings growth. The consumer is also showing signs that the worst may be over, as a stabilizing housing market, declining layoffs, and a sizeable stock market rally have left disposable incomes for households at the highest levels they have been in more than a year. As far as I am concerned, these are the "best worst" results this economy could ask for. Get the net ready, as I feel a bite coming soon.

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