



Market Update

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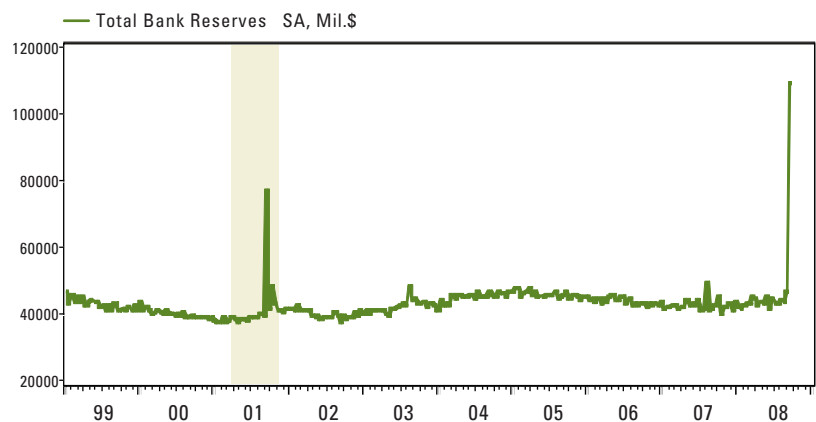
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Plan B:

If Fiscal Policy Does Not Heal Credit Markets , The Fed Will Reflate

With little fanfare, Federal Reserve Chairman Bernanke has dropped out of sight on the struggle to get legislation passed to deal with the financial crisis, which does not mean he has returned to business as usual. Instead, I believe the Federal Reserve (Fed) is moving ahead with Plan B. Plan A is to pass the Emergency Economic Stabilization Act (EESA), a fiscal policy action. And the EESA has now passed both the Senate and the House and will shortly be signed into law by the President. While I believe that the EESA will work to reduce the stress in credit markets, that is, by no means a surety. I believe that Plan B, ready in case Plan A fails, is to deal with the crisis using monetary policy.

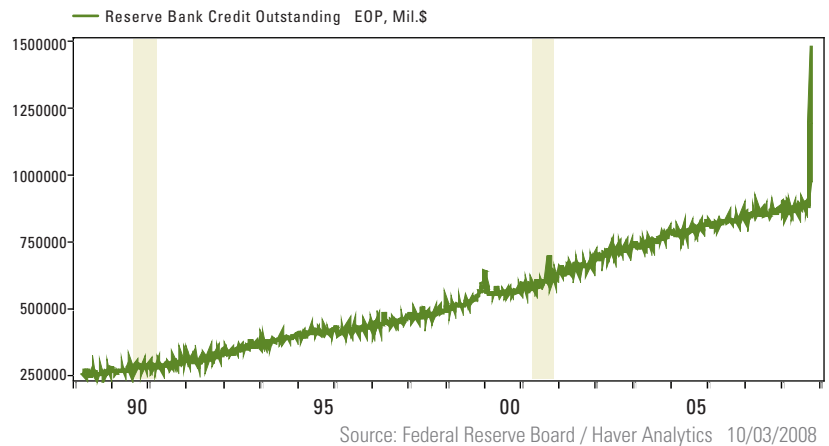
Accordingly, three weeks ago the Fed began to flood the economic system with high powered money, increasing total bank reserves by \$62.4 billion (132%) in three weeks (see chart below) and increasing the monetary base by \$67.5 billion (8%) in one week!



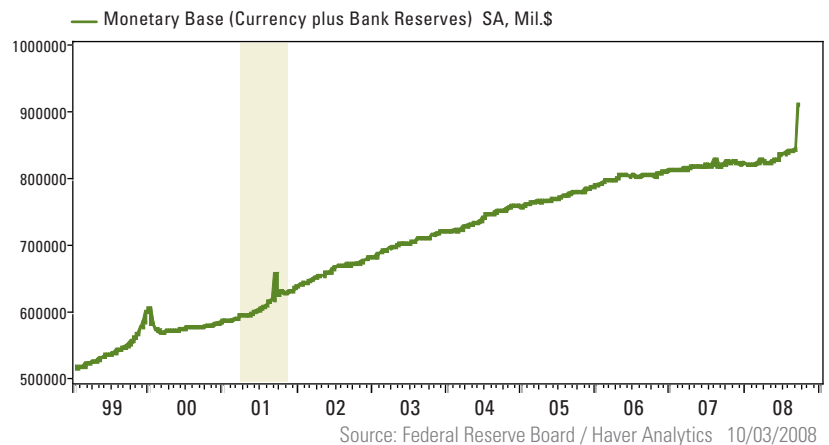
Source: Federal Reserve Board / Haver Analytics 10/03/2008



This reserve injection far exceeds that required after 9/11. Heretofore, the Fed had maintained control over its balance sheet, permitting only a slow, noninflationary expansion by selling Treasury securities off as it added low quality bank debt through the TAF, the Primary Dealer Lending Facility and other programs. Suddenly, all that has changed. The Fed has stopped selling Treasury debt, but continues to add debt through the TAF, et al. This course of action is what is causing the explosion in the Fed's balance sheet, bank reserves and high powered money. The chart below shows what is happening to the Fed's balance sheet total (called "Reserve Bank Credit"). The increase over the last two weeks is about as large as the increase over the prior 20 years!

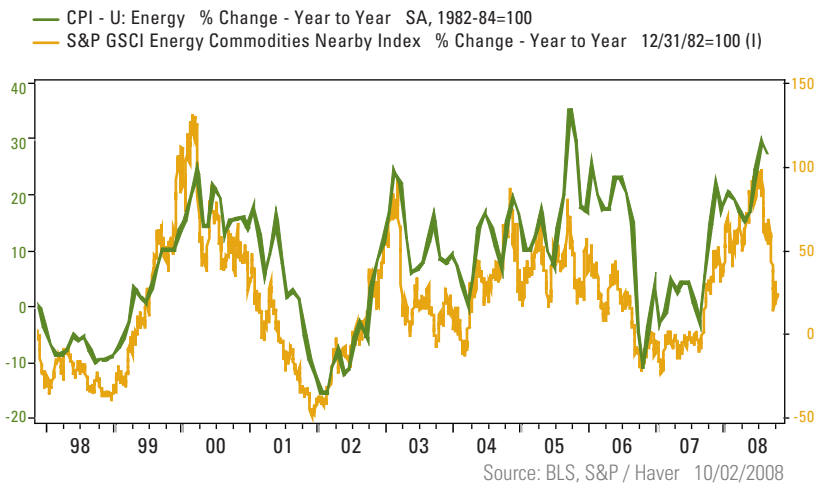
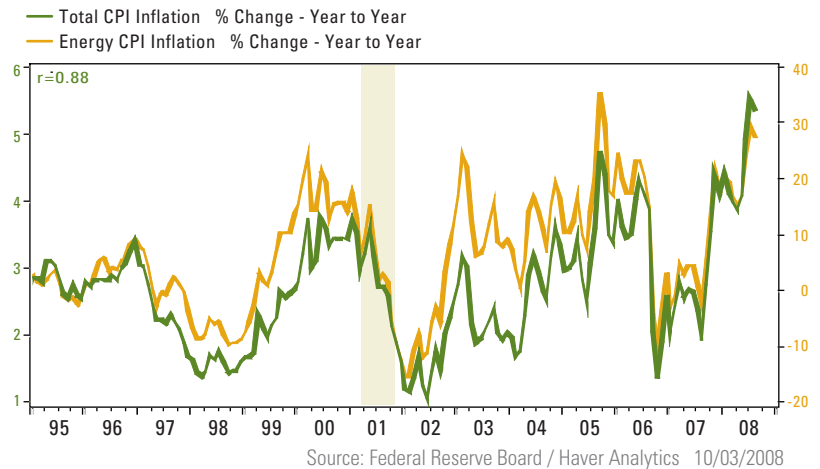


And you have not seen anything yet! On September 29, the Fed announced an enormous further expansion, increasing currency swaps with foreign central banks to \$620 billion from \$290 billion, and doubling the size of the 28- and 84-day TAF auctions to \$300 billion. And the Fed is adding two forward TAF auctions totaling \$150 billion in November to provide funding over year-end. This expansion will cause second and third round expansions of the Fed's balance sheet, bank reserves and base money the likes of which you have never seen before. The monetary base could double in the next few months, a process that usually takes about a decade.





Heretofore I have been unpersuaded by arguments that a serious surge in generalized U.S. inflation was likely due to an excessively easy monetary policy. Certainly total CPI inflation has been pushed higher by the seemingly inexorable rise in oil prices, but the core CPI inflation rate has remained low. In my view, sky-high oil prices were the result of a speculative bubble that is now correcting lower. Now, with oil prices breaking lower, I expect we will see a sharp drop in total CPI inflation as the CPI energy component falls. As shown in the chart below, about 90% of the year-to-year variation in total CPI inflation comes from swings in the energy component of the CPI.



So, given the downturn in energy prices to date, the 12-month change in the energy component of the CPI is likely to fall to zero shortly. That means the total CPI inflation rate is soon likely to fall to about 2.5%.

That said, this new Fed balance sheet expansion, if it is sustained, will lead to a significant rise in inflation a year or so from now. It is ironic that, over the last six years, those forecasting higher inflation pointed to a "sea of liquidity" in credit markets as the principal source of rising inflation. I never could see the sea. With the exception of the huge rise in retail and institutional money fund balances—which I view as investment portfolio shifts, not



inflationary money supply accelerations—all money aggregates have shown low, not high, growth rates.

I think that the very low risk aversion in the banking sector and the willingness to take on excessive credit risk with huge amount of leverage created a credit bubble in the housing market over the last six years. At the same time, this very high tolerance for risk allowed the Fed to keep short-term interest rates at their target while maintaining high powered money growth at non-inflationary rates. We had a classic credit bubble, not a money bubble.

Now we have the reverse environment. Risk aversion is very high, and the banks have tightened credit standards enormously. Many large banks are in trouble and now have extremely low tolerance for risk. That change means that the Fed now has to expand high powered money at very high rates to hold short-term interest rates to target. We have shifted from a super easy credit/tight money environment to a super tight credit/super easy money environment.

There is a chance that the Fed will reverse course and claw back the expansion in the monetary base over the next three to four months, if the Emergency Economic Stabilization Act succeeds in stabilizing credit markets and reduces the now extremely high aversion to risk to more normal levels. Or, more likely we will end up with a combination of fiscal and monetary policy actions.

Near term, I expect further oil price declines as the global economy, including the U.S., moves into recession. This very much needed fall in energy prices will pull down just about all U.S. total inflation measures sharply in short order. So, for the next six to nine months I expect falling U.S. real GDP and falling inflation. Then, a year or so from now I expect that we will begin to shift to rising real GDP and rising inflation.

Under more normal conditions, not in the midst of the financial panic we are currently enduring, the investment implications would favor bonds, excepting Treasuries, over stocks near-term and in six to nine months would begin to favor stocks over bonds on a sustained basis. However, in this panic, with the EESA now enacted and with, in my view, a very depressed general stock market valuation, I believe that the worst may be over for U.S. equity markets. But it is certainly time to keep a very close watch on fiscal policy - the EESA in operation and on monetary policy - Fed actions. This paper is the start of that close policy watch.

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