



Weekly Market Commentary

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The Butterfly Effect

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Highlights

Some northern states are seeing the first monarch butterfly of the season as they complete their summer migration.

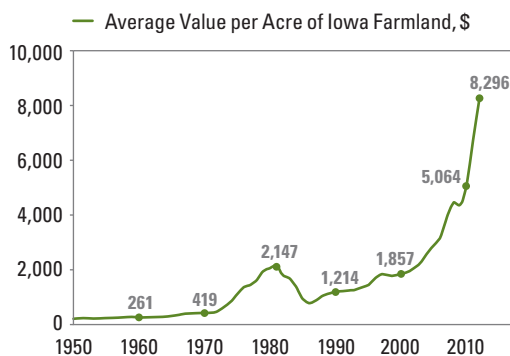
It is possible the market will see a butterfly effect from small changes in farmland, state budgets, manufacturing, and weather.

Summer gets underway with a lot of beating wings as millions of butterflies travel home. This week, many northern states are seeing their first Monarch butterfly of the season. Monarchs migrate from their winter home in Mexico to summer homes across the United States.

The “butterfly effect” is a term from a pioneer of chaos theory, Edward Lorenz; his 1972 presentation *Predictability: Does the Flap of a Butterfly's Wings in Brazil Set Off a Tornado in Texas?* describes the idea that a tiny event can start a chain reaction and have large and wide-reaching effects. It is why those seven-day forecasts for the weather are only right a small percentage of the time, and why it can be so challenging to predict markets with millions of seemingly random and tiny events each triggering a ripple effect that could cause a major impact half a world away.

We know the big changes and events the markets face in the second half of 2013: the potential end of the Federal Reserve's (Fed) bond-buying program, the need for Congress to craft a deal to avert the debt ceiling, the German elections and path of growth in Europe are a few examples. These 2,000 pound butterflies will be closely watched. But what are the less watched, smaller changes and events taking shape that, through a rippling chain of events, may have just as great an effect on the world's markets?

1 U.S. Farmland Prices Have Soared Recently



Source: LPL Financial, Iowa State University Extension and Outreach Land Value Survey 06/10/13

Farmland – Over the past several years, U.S. farmland prices have soared as grain prices rose and the Fed drove interest rates to historic lows [Figure 1]. What happens now is that grain prices are falling as global output surges, yet U.S. farmers are suffering from a swing from a drought last year to too much rain this year, limiting their production as they lose global market share to foreign competition. Furthermore, the Fed is contemplating ending its bond-buying program later this year, which is already pushing up borrowing rates. These trends could lead to a reversal in land prices that could in turn be felt well beyond the farm. The U.S. Farm Credit System is a government-sponsored enterprise that provides federal guarantees for bad loans—much like Fannie Mae and Freddie Mac helped to fuel the U.S. housing boom. While a much smaller potential financial fiasco than the housing bust, financial companies with exposure may suffer. Also, investors around the world have poured billions into farmland as a “real asset” in recent years and may see losses.

State Budgets – An unexpected state budget surplus in California and other states is turning the fiscal policy debate around. Policymakers are



now focusing on what to spend on rather than cut. While long-term budget challenges remain unaddressed, the current year surplus is estimated to be over \$1 billion by the California Office of the Governor and the Legislative Analyst's Office and comes just after the state was facing a deficit of nearly \$60 billion. In states recently reporting budget surpluses, including Texas, Iowa, Indiana, Tennessee, South Dakota, Utah, Hawaii, Florida, and Wisconsin, legislative battles have turned to tax cuts, rehiring workers, and spending on bridges and roads. If the small series of improvements in state budgets continues, the fiscal drag that for years has been felt at the state and local level on hiring and spending may turn to a fiscal boost, with all potentially positive ramifications—U.S. growth, employment, and profit—for the stock market. While a stronger credit profile may be a plus for municipal bonds, rising rates may result from better economic growth prospects and pressure municipal bond prices.

With wages rising in China and the boom in U.S. energy production, there are some small changes taking place that if part of a larger series of ripple effects could herald a renaissance for U.S. manufacturing.

Manufacturing – This week's data reveal a tough climate for manufacturing. On Monday, June 3, the widely-watched Institute for Supply Management (ISM) Manufacturing Index dropped below 50, indicating output is no longer expanding. And on Friday, June 7, the employment report revealed that the U.S. economy lost manufacturing jobs for a fourth straight month and that manufacturing jobs have been stalled for about a year. However, with wages rising in China and the boom in U.S. energy production, there are some small changes taking place that if part of a larger series of ripple effects could herald a renaissance for U.S. manufacturing. U.S. oil production has reversed its three-decade decline. The International Energy Agency forecasts that the United States could become the world's largest oil producer by 2020 and may be energy self-sufficient by 2035. In the 1940s and 50s when the United States was the world's largest producer of oil, U.S. manufacturing also led the world. Companies are taking notice. With U.S. manufacturing plants running above full capacity, Ford recently announced plans to increase North American manufacturing capacity by 200,000 vehicles in 2013, adding jobs and expanding production lines. In late May, Apple revealed that Texas will be the site of a new \$100 million plant that will make Apple products in the United States for the first time since the 1990s. Could the recent spate of weak readings on the state of U.S. manufacturing merely be the calm before the storm?

Weather – In 2013, the United States experienced the coldest spring in 16 years, measured in heating degree day deviations from normal. This followed 2012's warmest spring in over 25 years. This has likely acted as a drag on economic activity. A cool wet spring can have many small effects on behavior. It depresses sales of warm weather clothing, people avoid shopping for cars and mountain bikes, fewer head out to restaurants or the mall, and it hits hard on businesses that depend on outdoor activity such as beach hotels or concessions. This cloud over the spring economic data may lift and may lead to a pickup in economic activity as pent-up demand is released. In turn, this could lead to stronger-than-expected economic reports in the coming months that could prompt optimism about the state of the economy and prompt the Fed to feel the pace of growth warrants a slowdown in the pace of its bond-buying program.

Wherever they are, anywhere in the world, small events can interact with others to start the winds of change to blow and shape the investing environment.



Monarch butterflies are one of the few insects that can cross the Atlantic; if the winds are right they can make it from North America to the United Kingdom. Wherever they are, anywhere in the world, small events can interact with others to start the winds of change to blow and shape the investing environment. ■

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