First Trust
Monday Morning OUTLOOK
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No Recession, No Panic

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Online markets (at Intrade) put the odds of a recession in the next year at 40%. The consensus of economists (in a Wall Street Journal poll) has the odds of recession at one in three. These elevated fears are hitting consumer confidence, creating political pressures and causing volatility in financial markets.

We think the actual odds of a recession are much lower than the consensus thinks. We place them at 20%, barely above the 15% that history tells us exists in any year.

Yes, real GDP growth slowed to less than 1% in the first half of 2011, versus a 2.4% average growth rate in the past two years. But, recent data on consumption and production (as Japan recovered) suggests US growth reaccelerated to the 2.5% - 3.0% range in the third quarter.

Real consumer spending – goods and services combined – looks like it's climbing at a 1.5% to 2% annual rate in Q3. Business investment – both equipment & software and commercial construction – is up in recent months. Home building appears flat and government could be a slight drag on growth, but any weakness here should be more than offset by net exports and inventories. In other words, despite fears, there is no evidence that GDP is turning in a negative direction.

This is not a surprise. The US economy does not double-dip or slip into recession when monetary policy is loose. Our nominal GDP rule for the Fed suggests a neutral federal funds rate should be 3.0%. With the Fed now holding rates at zero, it is running an accommodative policy. With the yield curve sloping upward, it seems clear that liquidity is not a problem for the economy.

Meanwhile, income tax rates remain relatively low and are not going to rise until 2013 at the very earliest. We believe the newest proposal from the White House to raise tax rates is dead on arrival.

So, what is causing the elevated odds of recession? It appears that many worry about another Lehman-style panic. They fret that we can scare ourselves into a recession. They fear that the US will see a sudden plunge in the velocity of money, possible deflation, and frozen financial markets.

The catalyst for all this is supposedly Greece and its very real potential of default on its government debt. But as we pointed out two months ago, the five largest US banks have only $54 billion in exposure to the debts of Greece, Portugal, Italy, Ireland, and Spain, combined, versus more than $700 billion in bank capital. In the early 1980s, when Latin and South American countries were defaulting, the eight largest US banks had exposure to those countries equal to 263% of capital.

In other words, direct exposure is not a problem. So investors and some economists are worried about "counterparty risk," with our banks coming under pressure if foreign banks with greater direct exposure become undercapitalized.

But here again, we think the fears are overblown. Does anyone seriously think Germany, France and the rest of the leading countries in Europe would not recapitalize their banks if they were on the brink of failure? Moreover, changes to mark-to-market accounting mean that illiquid markets can no longer spread mayhem like an out of control wildfire. We aren't saying that losses won't happen, but we don't see how this spreads like Lehman. And in the meantime, our banks can borrow from the Federal Reserve's discount window at nearly 0%.

We are watching high frequency data – weekly data – on railcar loadings, steel production, hotel occupancy, retail sales, box office receipts, and initial unemployment claims. Through the second week of September there is no evidence that a panic is underway. In fact, the economy continues to grow.

As a result, we do not agree with the elevated odds of a recession that so many seem to believe. We think there is opportunity in financial markets. Equity values and commodity prices (excluding precious metals) have been knocked down, while Treasury bond prices have been bid up. These market moves will reverse when the data show that recession fears have been unwarranted.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-20 / 7:30 am	Housing Starts - Aug	0.590 Mil	**0.580 Mil**		0.604 Mil
9-21 / 9:00 am	Existing Home Sales - Aug	4.75 Mil	**4.79 Mil**		4.67 Mil
9-22 / 7:30 am	Initial Claims - Sep 17	420K	**420K**		428K
9:00 am	Leading Indicators - Aug	0.1%	**+0.2%**		+0.5%