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FIRST Trust ADVISORS L.P.

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Economic Commentary

The Energizer Bunny Economy

Conventional wisdom believes turmoil in the credit markets will engulf the economy and cause a slowdown or possibly a recession. In turn, these economic problems are expected to force the Federal Reserve to cut interest rates in response.

What is forgotten is that the US economy is very strong right now. Moreover, it has survived, and even thrived, during multiple periods of turmoil in the past 20 years.

Second quarter real GDP will be revised next week to show about a 4% annualized growth rate – this is a sharp acceleration from the 0.6% first quarter growth rate and a noticeable upward revision from the government's original estimate of 3.4%.

And despite the turmoil, the data already released for the third quarter suggest growth in the 3% range. We also expect growth of 3.3% in the fourth quarter, and an average growth rate of 3.5% in 2008. These forecasts assume no Fed rate cuts.

How can we be so optimistic? How can the economy grow so fast when the financial markets have absorbed so much recent pain?

The key is that nothing fundamental has changed. Tax rates remain relatively low, monetary policy is not tight, technology continues to increase efficiency, and profit growth remains high – increasing incentives for hiring and investing. Consumer net worth is up substantially in the last four years, and consumer cash flow is growing at a healthy pace even after factoring out inflation, taxes, and financial obligations such as mortgages, rents, car payments, and all other debt service.

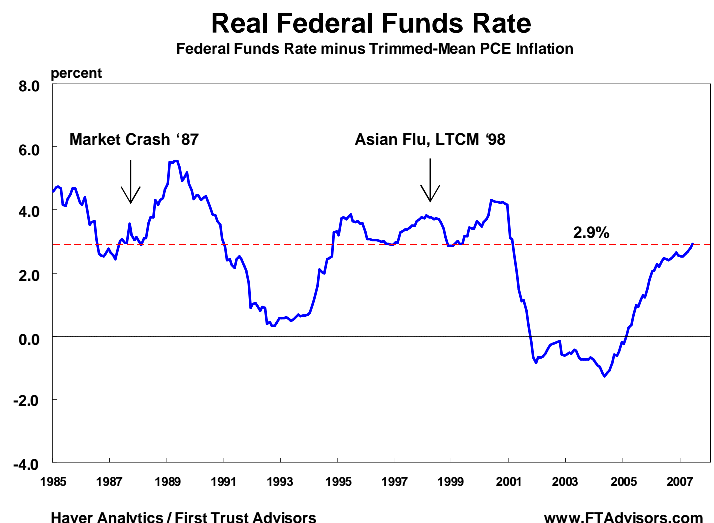
In addition, the resilient economy has proven time and again during recent years that it can take a blow, and like the Energizer Bunny, keep on going.

Take October, 1987, when the stock market fell 22.6% in one day. At today's levels, that's like the Dow dropping 3000 points. And yet in the year after this huge drop in the market, the economy grew 4.1% versus growth of 3.2% in the year leading up to the crash.

The same thing happened after the 1998 financial crisis. The U.S. economy grew 4.4% in the year after credit markets seized up, compared to 3.7% in the previous four quarters.

True, the Fed cut rates on both occasions. But on both occasions, real (inflation-adjusted) interest rates started out at higher levels than we see today. In addition, even after the Fed rate cuts in 1987 and 1998, the real federal funds rate was still at 2.9%, the exact same level we already have today. In fact, during the entire boom of the late 1990s, the real federal funds rate never went below 2.9%.

Moreover, it's very hard to believe that 75 basis points of rate cuts (which is what the Fed did on both occasions) could work so quickly and so forcefully that real GDP growth not only failed to slow down but actually accelerated in the year after each crisis.



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An economic model published several years ago by the Fed says a rate cut of 75 basis points should increase growth by about 0.5 percentage points in the first year after the rate cuts. This suggests that even if the Fed had not cut rates in 1987 or 1998, real GDP growth would have continued along at the pre-crises growth rates, perhaps even faster.

Some may argue that rate cuts related to financial crisis are more effective. So let's triple the assumed effect of the 1987 and 1998 rate cuts and imagine they boosted real GDP growth by 1.5 percentage points in the year after each of these two crises. Without them, real GDP growth would have been 2.6% in the year after the 1987 crash and 2.9% after the 1998 market freeze, hardly recessionary numbers.

Take a third example. In August 2005, Hurricane Katrina devastated large sections of Louisiana and Mississippi and completely shut down the city of New Orleans. Hundreds of thousands of workers were dislocated, energy prices soared, and more than $100 billion in structures and equipment were lost. Fears of a major economic slowdown – even a recession – were widespread.

But in the four quarters after Katrina, real GDP growth, excluding housing, increased 3%, exactly the same as in the previous four quarters. In fact, the job market did not miss a beat. The most recent data show that payrolls grew by a solid 105,000 in September 2005, the month most affected by the hurricane.

We are not arguing that the Federal Reserve should never respond to financial crises with rate cuts. If trades are having trouble clearing (think September 11, 2001), or if an overly tight monetary policy itself is the cause of financial problems (think 1929), cutting rates can be the right policy.

But neither of these conditions applies today. We continue to expect the Federal Reserve to hold the line against rate cuts and think the economy will once again show surprising resilience. Just like the Energizer Bunny, it will keep on going…and going…and going.

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