First Trust
Monday Morning OUTLOOK
October 1st, 2012
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Recession Risk Rising

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Economic forecasting was relatively easy from the end of World War II until the middle of the prior decade. Most of the time, you could just focus on monetary policy.

When the federal funds rate was much lower than the growth of nominal GDP – real GDP growth plus inflation – then the Federal Reserve was too loose and nominal GDP growth would go up. When the Fed kept the funds rate above nominal GDP growth, it was tight and nominal GDP growth would slow, raising recession risk and reducing inflation.

But then came the last recession, which had nothing to do with the Fed being too tight. Instead, falling home prices and mark-to-market rules rendered some major banks under-capitalized. A pure financial panic ensued, the likes of which we had not seen for 100 years. Consumers and businesses clung to as much cash as possible. As a result, the velocity of money – the speed with which money circulates through the economy – plunged.

But what if this was not a one-time event? What if we are now in a new era where shifts in the velocity of money often dominate the economic effects of changes in the money supply?

We are not saying this is definitely the case, but it now appears more plausible. And, if so, forecasting the economy just got a great deal tougher. Not just for the next few years, but, perhaps, for a generation. In this environment, we have to pay attention to data like we've seen in the past few weeks, including a 1.2% drop in industrial production (IP) and a 13.2% plunge in new orders for durable goods.

Both reports are likely the result of extenuating circumstances. For IP, output at mines, utilities, and automakers – all of which are very volatile – fell sharply. And, although manufacturing ex-autos declined 0.4%, it could have been due to hurricane Isaac or just statistical noise. With durable goods, almost all the drop was in the volatile transportation sector. But machinery, which is usually more stable, is down 10% from a year ago, something that almost never happens except when the economy is in a recession or on the verge of one.

Right now, we are forecasting 1.5% real GDP growth for Q3. But, given the drought, a much lower number – *even below zero* – cannot be casually dismissed. And if that happens, we have to recognize the chance of another plunge in monetary velocity, particularly given financial fears about Europe.

As a result, we are raising our odds of recession to 25%, the highest since mid-2009. Our base case is still modest growth, but the odds of a downturn are no longer very slim, like we said they were (correctly) during the soft patches of 2010 and 2011.

If a recession happens, it will not be the result of the typical causes: tight money, tax hikes, or protectionism. Instead, it would be our new nemesis, "uncertainty," leading to a decline in velocity.

In our view, at the heart of the recent uncertainty is a massive growth in government spending and debt, and the fear of large future tax hikes if we stay on this path. Potential tax hikes are changing the risk-reward calculation of every business in America. In a few months, we should know how much of this potential will become reality.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-1 / 9:00 am	Construction Spending - Aug	+0.5%	**+0.4%**		-0.9%
9:00 am	ISM Index – Sep	49.8	**49.7**		49.6
10-2 / *Afternoon*	Domestic Car/Truck Sales – Sep	11.5 Mil	**11.4 Mil**		11.6 Mil
10-3 / 9:00 am	ISM Non-Man – Sep	53.0	**54.1**		53.7
10-4 / 7:30 am	Initial Claims – Sep 29	370K	**370K**		359K
9:00 am	Factory Orders – Aug	-5.9%	**-5.9%**		+2.8%
10-5 / 7:30 am	Non-Farm Payrolls – Sep	120K	**115K**		96K
7:30 am	Private Payrolls – Sep	134K	**150K**		103K
7:30 am	Manufacturing Payrolls – Sep	5K	**5K**		-15K
7:30 am	Unemployment Rate – Sep	8.2%	**8.1%**		8.1%
7:30 am	Average Weekly Earnings – Sep	+0.1%	**+0.2%**		+0.0%
7:30 am	Average Weekly Hours – Sep	34.4	**34.5**		34.4
2:00 pm	Consumer Credit– Aug	$6.3 Bil	**$11.0 Bil**		-$3.3 Bil

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.