First Trust
Monday Morning OUTLOOK
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It's Not That Bad Out There

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Certain things, like the sun rising, or the tides shifting, can be counted on. It's also true that when government shrinks as a share of GDP, things start to pick up.

For the past three years, gridlock in Washington has held total spending by the federal government basically flat. This means federal spending has fallen from more than 25% of GDP to 22%, creating more room for the private sector.

Contrary to popular Keynesian thinking, this means entrepreneurship will have a more pronounced, and positive, economic impact on the economy. In other words, the "end of the world" trade, which hasn't really worked in the past four years is becoming more dangerous. We expect gold to fall, while bond yields, the dollar, and stock prices rise.

We don't disagree with the angst of many over deficits and debt, but things are rapidly getting better. Tax revenues are up sharply and we are forecasting a budget deficit of about $725 billion, or 4.5% of GDP, this year. In 2014 and 2015, we expect deficits of near 3% and below 2%, respectively. This is not magic. It's what happens when spending is contained.

It's not that deficits matter all that much; but it's a sign of how wrong the pessimists can be. And the same thing is happening in markets. The "smart guys" at hedge funds have been short the dollar and stocks, while long gold and bonds. But, in the past year, this trade has not worked.

And the fundamentals suggest this trade will continue to be a loser. We think stocks and growth are still underappreciated.

Gold is well above fair value. Comparing its value to oil, corn, copper, M2, nominal economic growth or even the monetary base suggests that it is worth somewhere between $800 and $1,100 an ounce today. We're forecasting further declines in gold over the next 12 months. It probably won't be a bloodbath, but it's not the asset to be long.

The same goes for bonds. At the start of the year, we were forecasting a 10-year Treasury yield of 2.85% at year end. Historically, this would have been an outsized jump in yields, especially if the Fed does not move to tighten. A more sanguine forecast of 2.4% still means capital losses.

Even if you think the Fed won't raise rates until 2015, yields are too low. If the Fed held short-term rates near zero for two years and then hiked them to 4% over the next two years and held them there, the average funds rate for the next decade would be 2.8%. Slap a premium of 0.5% on this for the 10-year Treasury and a yield of 3.3% is the result.

Meanwhile, despite a sharp increase in equity prices recently, the S&P 500 still has a generous earnings yield of 6%. Stocks are still cheap and we expect further increases. In other words, not letting the conventional wisdom get you down has been, and will continue to be, the profitable trade.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-13 / 7:30 am	Retail Sales – Apr	-0.3%	**-0.1%**	+0.1%	-0.4%
7:30 am	Retail Sales Ex-Auto – Apr	-0.2%	**+0.3%**	-0.1%	-0.4%
9:00 am	Business Inventories – Mar	+0.3%	**+0.3%**	+0.0%	+0.1%
5-14 / 7:30 am	Import Prices – Apr	-0.5%	**-0.5%**		-0.5%
7:30 am	Export Prices – Apr	-0.2%	**-0.2%**		-0.4%
5-15 / 7:30 am	PPI – Apr	-0.6%	**-0.5%**		-0.6%
7:30 am	"Core" PPI – Apr	+0.1%	**+0.1%**		+0.2%
7:30 am	Empire State Mfg Survey – May	4.0	**3.1**		3.1
8:15 am	Industrial Production – Apr	-0.1%	**-0.3%**		+0.4%
8:15 am	Capacity Utilization – Apr	78.3%	**78.2%**		78.5%
5-16 / 7:30 am	CPI – Apr	-0.3%	**-0.3%**		-0.2%
7:30 am	"Core" CPI – Apr	+0.2%	**+0.2%**		+0.1%
7:30 am	Initial Claims – May 11	330K	**333K**		323K
7:30 am	Housing Starts – Apr	0.973 Mil	**0.973 Mil**		1.036 Mil
9:00 am	Philly Fed Survey – May	2.1	**2.3**		1.3
5-17 / 8:55 am	U. Mich Consumer Sentiment- May	77.9	**77.0**		76.4
9:00 am	Leading Indicators – Apr	+0.2%	**+0.2%**		-0.1%