First Trust
Monday Morning OUTLOOK
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The Recovery Is Not A Sugar High

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What happened to stocks in January and early February is nothing new. It's happened quite a few times in the past four years and eleven months. Ever since mark-to-market accounting was fixed in March/April 2009, these corrections have been short-lived and relatively mild. And once they were over the market went higher. It's been a very strong bull market.

Nonetheless, few investors truly understand why things turned around so abruptly in 2009 and every time the stock market declines there is a mad rush to believe this time the sky really is falling.

A key reason for this belief is that conventional wisdom has coalesced around a relatively simple-minded narrative that goes like this – "the economy died in 2008 and Quantitative Easing (QE) is the life support system…it's a false recovery, a sugar high…without QE, the markets would not be up."

We think this narrative has it wrong… it's mistaken.

First of all, the entire subprime crisis was only about $400 or $500 billion dollars of bad loans. Yes, those are large numbers, but in an economy that was producing $15 trillion of GDP each year, it's just not enough to cause a cataclysm.

Rather, it was an accounting rule – mark-to-market accounting – that created losses for financial institutions well in excess of the true problems in the housing market. This rule forced financial firms to sell mortgage-related assets into a fire sale, markets became illiquid, and prices fell to levels well below fundamental value. Without mark-to-market accounting the crisis would have remained contained.

We're not saying firms should *never* mark assets to market. The rule makes sense when firms are *always* ready to sell an asset. But the rule makes no sense at all when markets seize up and no sane owner would sell an asset (that is still performing) for a price massively below its true value; unless an accounting rule forced it. If in the absence of the rule, asset owners could or would just wait out the storm then the only justification for marking an asset down in value is if it is truly credit impaired.

But instead of fixing the overly rigid accounting rule, the US government invented policies – TARP and QE were the big ones – to fill the hole in bank capital caused by mark-to-market losses. Both TARP and QE started in October 2008 and the stock market promptly plummeted – falling an additional 40%, with financial stocks down significantly more than the market as a whole.

Only after Barney Frank and the House Banking Committee leaned on the Financial Accounting Standards Board to fix mark-to-market did things turn around. A hearing was announced on March 9, 2009, the exact day the market hit bottom. The rule wasn't officially changed until early April 2009, but by then markets had already anticipated the change. It was the change in this rule that stopped the crisis, not TARP and QE.

Our main point is that the crisis was never actually as bad as many thought. The bubble wasn't as big as many Austrian economists think. Once the accounting rule was changed, the recovery was virtually guaranteed. TARP and QE didn't "save" the economy and "tapering" is not dangerous. The odds of a return of the crisis are virtually nil.

The economy, profits and stock prices are rising because of "real" economic developments – fracking, new computer software, and communication technologies are raising energy production and productivity, which, in turn, are driving growth. Yes, the economy could be doing even better, but we shouldn't ignore real improvements either.

The bottom line is that while so many people view the recovery as fragile and fake, they are missing the important narrative outlined above. The economy and markets are so much more robust than the conventional wisdom believes. So, when markets fall and fear overwhelms so many because they believe the wrong narrative, opportunity abounds for the bulls.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-13 / 7:30 am	Initial Claims – Feb 8	330K	**331K**		331K
7:30 am	Retail Sales – Jan	+0.1%	**0.0%**		+0.2%
7:30 am	Retail Sales Ex-Auto – Jan	+0.2%	**+0.4%**		+0.7%
9:00 am	Business Inventories – Dec	+0.4%	**+0.4%**		+0.4%
2-14 / 7:30 am	Import Prices – Jan	-0.1%	**+0.1%**		0.0%
7:30 am	Export Prices – Jan	0.0%	**+0.1%**		+0.4%
8:15 am	Industrial Production – Jan	+0.3%	**0.0%**		+0.3%
8:15 am	Capacity Utilization – Jan	79.3%	**79.2%**		79.2%
8:55 am	U. Mich Consumer Sentiment- Feb	80.7	**81.5**		81.2