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FIRST Trust ADVISORS L.P.

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Monday Morning Outlook

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The Consumer Will Not Fade

A central tenet beneath the widespread forecast of a slowing economy is that consumer spending will slow. According to those who hold this view, a combination of falling home prices, re-sets on exotic mortgage products, and tougher credit standards will undermine consumption.

We think these fears are overdone. Incomes are growing rapidly, unemployment is low and consumer net worth is at a record high.

While many argue that job growth is sluggish, it is important to remember that with the unemployment rate at 4.7%, the labor market is tight, making it more difficult to find workers. One sign of a tight labor market is that average hourly earnings are up 8.4% versus September 2005, the fastest pace of wage gains for any two-year period since 1990. We expect more of the same in the months and quarters ahead.

Continued wage gains will bolster our measure of consumer "free cash flow." To calculate consumer free cash-flow we take after-tax personal income adjusted for inflation, and subtract property taxes, mortgage payments, homeowners insurance, rent, car lease payments, and debt service payments, including auto loans and credit cards.

Through the second quarter, this measure of real free cash-flow was up 3.4% versus last year, or $230 billion. This increase more than offsets energy price increases and allows consumers to absorb higher interest rates.

Our analysis suggests mortgage re-sets will add about $15-20 billion per year for the next few years to the payments homeowners must make to lenders. Although this seems large at first glance, it will absorb only 0.25% of consumer free cash-flow. Even more importantly, any increased payments on mortgages or energy must be paid to someone else, who in turn will spend or save it.

Despite rising incomes, many still fear a decline in home prices. But even a nationwide decline of 10% in home prices will be small relative to overall wealth. Household net worth is up more than $20 trillion in the past five years, and it takes years for consumers to fully react to changes in wealth. A 10% decline in home prices would chop only $2 trillion off that number. And, if our expectation of rising stock prices comes true, the loss of wealth in housing will be offset by rising wealth due to equity investments.

It's odd that so many would be so concerned about consumption when we have a recent example of a huge loss in wealth not causing a major consumer downturn. From late 1994 through early 2000, consumer net worth increased $18.2 trillion. In the next 2.5 years, it dropped $5.4 trillion. And yet consumption grew at a 2.7% annual rate over this period. The recession of 2001 occurred on the business side; it was not a consumer-led slowdown.

This shows the futility of looking at the economy through the eyes of the consumer. Recessions are caused by tight Fed policy, tax hikes, or protectionism, not a "tapped out" consumer. Right now, despite rising threats from government, all systems are still a go for rapid economic growth in the quarters ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-11 / 7:30 am	Import Price Index - Sep	+0.9%	**+0.5%**		-0.3%
7:30 am	Export Price Index - Sep	+0.3%	**+0.1%**		+0.2%
7:30 am	Initial Claims - Oct 6	315K	**315K**		317K
7:30 am	Int'l Trade Balance - Aug	-$59.3 Bil	**-$58.5 Bil**		-$59.2 Bil
1:00 pm	Treasury Budget Statement - Sep	$99.5 Bil	**$113.0 Bil**		-$117.0 Bil
10-12 / 7:30 am	PPI - Sep	+0.5%	**+0.5%**		-1.4%
7:30 am	"Core" PPI - Sep	+0.2%	**+0.2%**		+0.2%
7:30 am	Retail Sales - Sep	+0.3%	**+0.3%**		+0.3%
7:30 am	"Core" Retail Sales - Sep	+0.4%	**+0.3%**		-0.4%
9:00 am	U. of Michigan Confidence - Oct	84.0	**83.5**		83.4