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Monday Morning Outlook

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Despite Fear: Economy Still Strong

With all the turmoil and volatility in financial markets, we understand investor unease. However, because the Fed is not tight (and never was), tax rates remain low (and are protected by the threat of veto), trade protectionism is more bark than bite, technology continues to proliferate, and productivity remains robust, we do not foresee any serious economic slowdown.

Yes, the housing market is down sharply, and yes credit markets are in turmoil, but these problems are localized. Exports are booming, real GDP grew 3.9% in the third quarter, and the labor market remains stout.

Moreover, since the GDP report was released last Wednesday, new data on construction, shipments of capital goods and inventories point to an upward revision to *above* 4%. Meanwhile, October ISM reports show continued expansion in both manufacturing and non-manufacturing sectors of the economy.

Unfortunately, investors have become so pessimistic, strong economic data is virtually ignored. For them, the goal-posts have been moved. Many suggest that since the credit crunch did not start until August the strong third quarter growth rate was a mirage. Just wait until data for the fourth quarter starts to roll in and clear signs of a slowdown become obvious, they say.

But there is a problem with this line of thought. All of this was well known months ago and most forecasters still underestimated the strength of the economy. The same is true for third quarter earnings of S&P 500 companies, with upside surprises still running at the same 65-70% level they have had for many years now.

What appears to be happening is that just like recent periods of economic stress, the fundamentals of this huge economy remain intact. And as long as they do, the US economy will remain resilient. Some early data already suggest that this is the case.

The most important piece of data so far for the fourth quarter arrived on Friday and it was excellent news. Payrolls expanded by 166,000 in October and the number of hours worked in the private sector hit a new record high. Meanwhile, although October vehicle sales were down from September, they were still above expectations.

True, housing will remain a drag on real economic growth. But home building's share of GDP has already shrunk roughly 30%, meaning that sector's weakness has less of an impact on the overall economy. Moreover, the trade deficit is shrinking rapidly as exports boom. Exports are taking up the slack of a housing slump.

The disparity between the conventional wisdom and actual economic performance continues to resemble what happened after both the 1987 stock market crash and the 1998 credit market freeze. On both occasions, pessimism about the economy was palpable. Yet, real GDP actually accelerated. It grew 3.2% in the year before the 1987 crash and 4.1% in the year after. For the so-called "seizing-up" of financial markets in 1998, the economy grew 3.7% in the year before, and 4.4% in the year after.

On both occasions, faster than expected economic growth forced the Federal Reserve to retract its emergency interest rate cuts and eventually move rates higher than when the financial market turmoil began. We expect this time to be no different. With strong economic growth through at least 2008 will come higher interest rates. It's only a matter of time.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-5 / 9:00 am	ISM Non-Man. – Oct	54.0	**56.1**	***55.8***	54.8
11-7 / 7:30 am	Q3 Non-Farm Productivity	+3.0%	**+3.4%**		+2.6%
7:30 am	Q3 Unit Labor Costs	+1.2%	**+0.7%**		+1.4%
9:00 am	Wholesale Trade - Sep	+0.2%	**+0.3%**		+0.4%
11-8 / 7:30 am	Initial Claims - Nov 3	325K	**327K**		327K
11-9 / 7:30 am	Import Price Index - Oct	+1.1%	**+1.2%**		+1.0%
7:30 am	Export Price Index - Oct	+0.4%	**+0.4%**		+0.3%
7:30 am	Int'l Trade Balance - Sep	-$58.5 Bil	**-$58.0 Bil**		-$57.6 Bil