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Monday Morning Outlook

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Markets Bend, Economy Stays Strong

As the days of 2007 wind to a close, and year-end pressures come to a head, financial institutions that let lending standards deteriorate excessively are writing down losses, raising capital and cleaning up the mess. The housing industry is also recovering from its hangover. Home prices are down and sales have contracted, but home building has fallen so much that the inventory of unsold homes has peaked. In other words, while the pain is both real and costly, free markets are healing themselves.

In the meantime, those who have no faith in the economy continue to predict a recession is either already upon us or is clearly on its way.

To understand them, one must understand a very basic underpinning of Keynesian economic theory. We are not referring to IS-LM models, liquidity traps, or government spending multipliers. We are referring to the cornerstone of Keynesian economic theory – that a free market economy is inherently unstable. Keynesians believe that if left on its own, the economy will ultimately come unglued. The government's job is to make sure this does not happen.

This is the theoretical underpinning behind recent Federal Reserve rate cuts, term auction facilities, the Super-SIV (which lost all support last week), government renegotiated mortgages, and a direct bailout of mortgage holders (advocated by Alan Greenspan).

There are two problems with all of this. First, this Keynesian idea is wrong. Government failure is much more prevalent than market failure. In fact, it seems clear that easy Fed policy and extremely low interest rates were a key cause of housing market problems in the first place. Second, despite all the pain caused by lax lending standards and loose money, the economy is not close to recession.

Fourth quarter real GDP growth will not be released until late January, but available data puts our "add-m-up" Q4 real GDP forecast at 2.5%. In addition, we think the economy will grow in the 3 - 3.5% range in 2008. Although 2.5% in Q4 is below trend, it is an understandable offset to the fast growth of Q2/Q3.

Combined, the growth rate in the last three quarters of 2007 will be 3.7%. For all of 2007, the economy will expand at nearly a 3% rate. Excluding housing, the economy will grow at about a 3.5% rate in Q4 and about a 4% rate for all of 2007. Below is our "add-m-up" Q4 real GDP forecast:

Personal Consumption: The monthly pattern of consumption through November suggests real consumption will grow at about a 3.3% rate in Q3. With consumption accounting for 70% of GDP, real PCE growth in Q3 will contribute about 2.3 percentage points to real GDP growth (2.3 equals 70% of 3.3).

Housing: Our statistical model suggests home building fell at a 20% annual rate in Q4. Given that the sector makes up 4.5% of GDP, this translates into a drag of 0.9 percentage points on real GDP growth (0.9 equals 4.5% of 20).

Business Investment: So far we only have hard data on business spending through October. If we assume the moderate trends of the past year extend through December, business investment will grow at about a 5% annual rate in Q4, down from about 10% in Q2/Q3. Business investment being 10% of GDP means this adds 0.5 points to the real GDP growth rate (0.5 equals 10% of 5).

Inventories: Inventories added almost a full percentage point to real GDP growth in Q3. We expect a slowdown in inventory accumulation in Q4, subtracting 0.2 points from real GDP growth.

Trade: The inflation-adjusted trade deficit has been declining for the past year. We expect this trend to continue as trade flows keep on responding to weakness in the dollar. However, to be cautious, we assume trade adds only 0.5 points to growth in Q4 versus an average of 0.9 points in the past year.

Government: In the past five years, on average, government spending has accounted for 0.3 points of GDP growth. Given moderate figures on public-sector construction in Q4, we assume this trend continues.

Fourth Quarter Real GDP Total: = 2.5%

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-27 / 7:30 am	Durable Goods - Nov	+2.0%	**+4.4%**		-0.2%
7:30 am	Durable Goods (Ex-Trans) - Nov	+0.3%	**-0.5%**		-0.4%
7:30 am	Initial Claims - Dec 22	340K	**343K**		346K
12-28 / 8:45 am	Chicago PMI - Dec	52.0	**51.4**		52.9
9:00 am	New Home Sales - Nov	0.715 Mil	**0.730 Mil**		0.728 Mil