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FIRST Trust ADVISORS L.P.

Mar. 19 2007

Monday Morning Outlook

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-20 / 7:30 am	Housing Starts - Feb	1.450 Mil	**1.381 Mil**		1.408 Mil
3-22 / 9:00 am	Leading Indicators - Feb	-0.3%	**-0.2%**		+0.1%
3-22 / 7:30 am	Initial Claims - Mar 17	320K	**323K**		318K
3-23 / 9:00 am	Existing Home Sales - Feb	6.300 Mil	**6.432 Mil**		6.457 Mil

The Lion that Squeaked

The way the story is being told, the US economy is about to get eaten alive because some unscrupulous lenders goaded some unwary homebuyers into taking out loans they couldn't afford. The fear is that "subprime" loan default rates will soar, further weakening the housing market and making it more difficult for financially healthy borrowers to get loans. And as the housing market goes, so goes the US economy.

We disagree. While poorly structured loans will result in many foreclosures and bankruptcy for some lenders, the impact on the overall US economy should be negligible.

First, US GDP growth rates are not directly reduced by a shift from homeownership to renting. Renting or owning are both counted as consumption of housing services. Foreclosures do not cause homes to disappear, nor do they remove the spending power earned by workers. The asset price of homes may change but the real value of housing services rendered by the housing stock (rentals and owner-occupied homes combined) will barely budge, if at all. And while construction or mortgage-related job losses may rise, the adjustment will take place over time, limiting the damage.

Second, the days of limited financial choice are long gone. Years ago, when local banks found themselves holding bad loans (often based on local economic conditions), they had to limit all lending, including to creditworthy borrowers – and those worthy borrowers had nowhere else to turn. Now, interstate competition and even international competition have made it almost irrelevant if a particular lender goes belly-up. There are always other healthy financial firms ready to seize market share from troubled ones, or buy assets at fire sale prices. Moreover, the world is awash in liquidity, interest rates are low, and the Fed is still accommodative – not tight like it was in 1999-2000 prior to the stock market crash.

Third, the increase in mortgage payments associated with non-fixed-rate mortgages is relatively small. Total US residential mortgage debt is about $10 trillion – with about $7 trillion fixed and $3 trillion in adjustable-rate products and other exotics, such as interest-only and negative amortization loans. About $600 billion of these non-fixed-rate loans will have major re-sets in 2007, going from the teaser rate to the full rate or going from interest-only or "negative am" periods to full amortization. These major re-sets should boost annual payments by about $15 billion – slightly more than 0.1% of GDP – a relatively small amount that is not enough to draw blood, much less mortally wound, the US economy.

Another fear is that real estate price declines might impinge on consumer net worth. To assess these risks we use a model of residential real-estate prices based on rents, after-tax incomes, interest rates, and the stock market. The model suggests that on a nationwide basis, owner-occupied homes were probably about 5% overvalued at the end of 2006, versus 10% overvalued at the end of 2005. This likely means that some markets are significantly overvalued, but most are at or near fair value. In other words, this is not the dot.com bust all over again. Falling to fair value overnight could require a loss of $1 trillion in household net worth (5 percent of total owner-occupied housing assets of $21 trillion). But even this loss is small when compared to the $3.8 trillion increase in the net worth of US citizens in 2006. The most likely outcome is for rents and incomes to gradually grow to justify the current average level of home prices. This lion won't roar.

Week of March 26, 2007

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-26 / 9:00 am	New Home Sales - Feb	1.000 Mil	**1.016 Mil**		0.937 Mil
3-28 / 7:30 am	Durable Goods - Feb	+3.0%	**+3.5%**		-8.7%
3-29 / 7:30 am	Q4 GDP Final	2.2%	**2.2%**		2.2%
7:30 am	Q4 GDP Chain Price Index	1.7%	**1.6%**		1.7%
3-30 / 7:30 am	Personal Income - Feb	+0.3%	**+0.2%**		+1.0%
7:30 am	Personal Spending - Feb	+0.4%	**+0.3%**		+0.5%
8:45 am	Chicago PMI – Mar	48.5	**49.6**		47.9
9:00 am	Construction Spending - Feb	-0.5%	**-1.3%**		-0.8%

Brian S. Wesbury; Chief Economist **Robert Stein, Senior Economist**