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Monday Morning Outlook

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Discipline and Fundamentals Beat Uncertainty

The biggest problem with basing investment decisions on economic forecasts is uncertainty. Not just ambiguity about how any particular economic outcome will actually move markets, but murkiness about the forecast itself. Even when it seems that a forecast is correct, there are questions about the accuracy of the available data that allow doubt to creep in at any point.

For example, in the past 12 months, there was inversion in a significant portion of the Treasury yield curve, while futures markets priced in Fed rate cuts. This kind of market activity, according to the economic handbook, should precede an economic slowdown.

And that's exactly what happened. The economy slowed sharply with just 0.7% annualized real GDP growth in Q1 2007, led by a weak housing market. The economic pessimists and the bond bulls felt vindicated. They started to call rising stock prices a bubble.

But the 10-year Treasury bond yield is up slightly from a year ago, the futures market no longer expects rate cuts, the stock market remains strong, and forecasts for the economy have been ratcheted upward. This would seem to support the economic optimists and the bond bears.

But, very few forecasters have changed their underlying assumptions, which turbo-charges uncertainty. Now, the employment data are in question. Some ask, "How can the unemployment rate stay at 4.5%, and construction jobs remain robust in the midst of a housing slowdown?" Some even point to the fact that a smaller share of the overall population is working or looking for a job than in the late 1990s – to them, a clear sign of trouble.

The point is that even when economic data and markets seem to be speaking clearly, there is still a great deal of doubt, ambiguity and uncertainty in any economic outlook.

This is why we fall back on fundamentals. As long as tax rates remain at levels which encourage risk taking, as long as government interference is not overwhelming, and as long as the Fed is not leaning too far one way or another, the economy will be fine.

It is true that the labor force stands at 66.1% of the population, well below its peak of 67.3% back in 2000. It is also true that if the labor force as a share of the population was still at that 2000 peak, the unemployment rate would be 6.2%. But this is not a worrisome development.

With the US population aging, teenage participation rates falling, women fully incorporated into the workforce, and immigrants reluctant to pop-up on the radar screen, a leveling off in the labor force should be expected.

Also, as we explained in our Monday Morning Outlook on 6/4/2007 "*The Construction Job Mystery*," there are a multitude of reasons why the slowdown in housing has not had a major impact on the jobs market.

In the end, in the midst of a dynamic and fluid world order, there will always be uncertainty – about everything. With this in mind, the best advice we can give to those who incorporate economic forecasts into investment decisions is to stay disciplined about watching the true underlying causes of economic change. Employment-population ratios, construction jobs, sub-prime loans, gas prices, the trade deficit, or whatever, are just sideshows.

Policy is what matters. With tax rates low, the real federal funds rate nowhere near levels which preceded prior recessions, a great deal of noise but no action on trade protectionism, and gridlock in Congress on new spending, the fundamentals look good. As a result, we remain convinced that the US and most of the globe will continue to grow nicely in the years ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-10 / 9:00 am	Wholesale Trade - May	+0.5%	**+1.1%**		+0.3%
7-12 / 7:30 am	Initial Claims - Jul 7	319K	**320K**		318K
7:30 am	Int'l Trade Balance - May	-$60.0 Bil	**-$58.3 Bil**		-$58.5 Bil
1:00 pm	Treasury Budget Statement - Jun	$29.5 Bil	**$25.0 Bil**		$20.5 Bil
7-13 / 7:30 am	Import Prices - Jun	+0.6%	**+0.6%**		+0.9%
7:30 am	Export Prices - Jun	+0.3%	**+0.2%**		+0.1%
7:30 am	Retail Sales - Jun	+0.1%	**+0.1%**		+1.4%
7:30 am	"Core" Retail Sales - Jun	+0.3%	**+0.2%**		+1.3%
9:00 am	Business Inventories - May	+0.3%	**+0.4%**		+0.4%
9:00 am	U. Mich. Consumer Confidence	85.5	**85.5**		85.3