Expect a “V” Shaped Recovery

The US economy has weakened substantially in the past several weeks and the National Bureau of Economic Research will eventually get around to declaring an official recession. Conventional wisdom believes that the current recession will be longer and deeper than any recession the US has experienced since the early 1980s, continuing through 2009 and perhaps into 2010.

When the NBER picks the start date of this recession, we suspect that they will reach back to the fourth quarter of 2007, when real GDP fell by a slight -0.2%. We do not agree that the US was in recession then, or for that matter, up through August 2008. Despite a horrible housing market, real GDP expanded at a 2.8% annual rate in Q2, while real GDP was basically flat in the third quarter.

Nonetheless, when the government releases its advance estimate of Q3 real GDP growth on October 30th, the report will probably show a slightly negative number, something in the -0.1% to -0.5% range. This will be based on some more pessimistic than necessary estimates of data that is not yet available. When the final data comes in and GDP is revised, we expect that negative figure to move into slightly positive territory.

But in September, the economy fell off a cliff, with real GDP likely contracting at a 3% annual rate in the fourth quarter, making it the worst quarter since 1982.

Rather than being the first of several negative quarters of economic growth, we expect this will be a temporary capitulation to the credit crunch, with almost all of the economic losses postponing economic activity into what will turn out to be a healthy period of growth in the second half of 2009. To be precise, we expect real GDP to be flat in Q1-2009, but then grow at an average annual rate of 3.0% in the final three quarters of next year.

The reason: This sharp drop in growth is due to a temporary drop in velocity due to a true credit crunch with some panic thrown in for good measure. It is not a typical recession caused by fundamental, economy-changing events such as higher tax rates, tighter money, protectionism, or other public policies that stifle innovation or entrepreneurship.

The failure of Lehman Brothers, money market fund losses, widening credit spreads, and a sudden tightening in bank credit – even an unwillingness of banks to lend to each other – hit hard in September. As a result, the velocity of money – the speed with which money moves through the economy – fell rapidly. The monetary equation $MV = PQ$ helps explain what is happening. Normally, monetary velocity ($V$) is stable, so once money ($M$) is known, we can forecast nominal GDP ($PQ$ or real growth plus inflation).

If there is a slowdown in the turnover of money – say a 5% decline – the impact on nominal GDP growth is no different than if the money supply itself shrinks by 5%.

But there is good news. After ham-handing the rescue operation for months, the cavalry has finally arrived. The Fed has injected massive amounts of liquidity, driving the federal funds rate to roughly 1% - where it traded last week.

Moreover, the Treasury Department has drawn a line in the sand. It has decided that no more banks will fail due to a lack of liquidity. We still wish the SEC would have suspended mark-to-market accounting, but instead the Treasury injected capital (by buying preferred shares) in order to stabilize the system and bring back investor confidence. This will work, but it is clearly a sub-optimal policy, involving the federal government more deeply in the private sector than is comfortable for a democracy.

Despite the downside for free markets, these actions by the Fed and Treasury will help unlock the credit markets and turn velocity upward. With velocity and the money supply both heading up; a “V” shaped recovery is likely.

While the conventional wisdom is betting on an “L” shaped economy, and the equity market is pricing in the risk of a prolonged slump in earnings, we think the odds favor a much quicker recovery. The economy has succumbed to a panicky, credit crisis, not a typical policy-induced recession. As a result, the downturn is unlikely to last long.

<table>
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<tr>
<th>Date/Time (CST)</th>
<th>U.S. Economic Data</th>
<th>Consensus</th>
<th>First Trust</th>
<th>Actual</th>
<th>Previous</th>
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<tbody>
<tr>
<td>10-20 / 9:00 am</td>
<td>Leading Indicators - Sep</td>
<td>-0.1%</td>
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<td>4.950 Mil</td>
<td>4.790 Mil</td>
<td>4.910 Mil</td>
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Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.