630-322-7756
www.ftportfolios.com

First Trust

Oct 6, 2008

Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

Cut to 1%; Now!

The Dow Jones Industrial Average was up 290 points on Friday just before the US House of Representatives finally passed, and the President signed into law, the Treasury's $700 billion bailout. But the Dow closed down 157 points anyway. It has fallen another 500 at the time of this writing, and the Dow is now down 1,300 points (or 12%) from its peak just prior to the failed Congressional vote.

Supporters of the bill, along with almost every pundit, argued the bill was absolutely necessary to stabilize the markets. But the markets are not cooperating. In fact, volatility and fear are spiking. One reason is that any Treasury purchases under the plan will not be made for at least two weeks, maybe more. Another reason is that missteps by the Federal Government have turned what was a large financial problem into a massive one.

Looking back to last year, it is clear the Fed's rapid interest rate cuts were a huge mistake. It was clear that risks to lenders were rising as the economy suffered, but because the Fed drove down short-term interest rates, lenders were forced to take less in income. This undermined lending markets. Why would a bank make a loan in a riskier environment at a lower interest rate? As a result, credit spreads widened. But, for some markets, like those for auction rate securities, the market just froze. Investors balked at buying these assets at lower rates. Worse still, the Fed's easy money caused a surge in commodity prices and a doubling in the price of oil.

Another mistake made by government was not changing mark-to-market accounting rules. This has turned a containable $300 billion subprime loan problem into a crisis that has become almost triple that size. Mark-to-market accounting has scared away investors and caused bankruptcies even for firms who are still solvent on a cash flow basis. These failures have led to more fear and some bank runs.

These mistakes were like throwing gasoline on a fire. Now, instead of realizing its mistakes, the government is intervening again with a huge $700 billion intervention in the markets. The whole purpose of this plan is to stabilize prices, which could have been, and still can be accomplished with accounting rule changes.

To top it off, the President used a nationally televised address to sell the bill. In it, he painted a dire picture of the economy, saying people's retirement savings, businesses, jobs, and homes were all at risk. This helped stir the panic.

The combination of all this has now altered the course of the economy. Less than two weeks ago, after a 2.8% growth rate in the second quarter, the data were still reflecting positive economic growth in the second half of 2008. However, in late September, a seize-up in credit markets and spreading fear over the economy has undermined both business and consumer spending. Looking at data for the second half of September has forced us to lower our forecast for fourth quarter real GDP from +3.0% to a *negative* 1.5%.

In terms of monetary theory, what we are seeing is a rapid, and historically unprecedented, drop in the velocity of money – how many times money turns over. The money equation MV=PQ, is at the root of our analysis. Money x Velocity = Prices x Quantity (nominal GDP).

Typically, the velocity of money is relatively stable. Changes in money growth cause changes in economic activity. But monetary ease, which began last September, should be lifting economic activity right now and the opposite is happening. As a result, it is now our belief that fear and panic are causing a drop in money turnover, or velocity.

There are only two ways to offset this problem – end the drop in velocity by stopping the panic, or boost money (M). Since there is no way of knowing whether velocity will pick up soon, then it is now important for the Fed to boost money growth as rapidly as possible.

In other words, the Fed must cut interest rates again. We suggest an immediate cut of 100 basis points, which would push the Federal Funds Rate back to 1%, from its current level of 2%. Cutting by 25 basis points or even 50 bps at a time would leave the market wanting more, so we suggest some shock and awe from the Fed.

After all, other short-term market rates are already down at this lower level.

The government should also immediately change mark-to-market accounting rules. This is the only way to end the uncertainty and illiquidity in the markets right now. Waiting two to four weeks for the Treasury to make any purchases with its new $700 billion fund will just keep the uncertainty levels high.

Cutting interest rates again goes completely against our arguments of the past year, but we are now facing an unprecedented drop in velocity. Unfortunately, it was the Fed's rapid rate cuts of the past year, and a refusal by officials to change mark-to-market accounting rules that have forced the US into a corner. The only way out is to cut interest rates sharply and quickly all over again.

There are two very important things to remember. First, the US equity market remains extremely undervalued. Second, any velocity driven economic slowdown will likely be very short-lived. Our forecast of the economy expects a sharp, one-quarter, slowdown in economic activity and a relatively quick recovery in 2009. As a result, the panic lows in equities have created a buying opportunity at valuations not seen since the early 1980s.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-7 / 2:00 pm	Consumer Credit - Aug	$5.5 Bil	**$4.4 Bil**		$4.6 Bil
10-9 / 7:30 am	Initial Claims - Oct 4	475K	**482K**		497K
10-10 / 7:30 am	Int'l Trade Balance - Aug	-$59.0 Bil	**-$60.9 Bil**		-$62.2 Bil
7:30 am	Import Prices - Sep	-2.8%	**-2.5%**		-1.7%
7:30 am	Export Prices - Sep	-0.4%	**-0.2%**		-3.7%
1:00 pm	Treasury Budget - Sep	+$63.5 Bil	**+$54.3 Bil**		-$111.9 Bil