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First Trust

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Monday Morning Outlook

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Darkest Before the Dawn

Last week's economic data shows that "risk aversion hysteria" has had a major impact on economic activity in the United States.

The total number of people receiving unemployment benefits (a.k.a. continuing claims) increased to almost 3.9 million in late October. As a share of the workforce, continuing claims are now back to the peak hit in the aftermath of the 2001 recession. Meanwhile, retail sales plummeted in October and are down 4.1% versus a year ago, the worst one-year comparison on record.

September's international trade data showed a smaller trade deficit, but the underlying figures reported record declines for both imports and exports.

All of these figures are consistent with our view that the US has been experiencing a once-in-a-multiple-generation negative shock to monetary velocity, the speed with which money moves its way through the economy, as both business and consumers pull back from economic activity.

As a result, we are forecasting that real GDP shrinks at a 4% annual rate in the current quarter, the largest decline since 1982. However, we believe the economy will stabilize in the first quarter of 2009, grow at a 2% annual rate in Q2 and then expand at a 3% rate in the second half of next year.

An economic recovery does not require monetary velocity to reaccelerate. As long as velocity simply stops falling, a recovery can take hold.

Loan data for October suggest this may already be starting to happen. In October alone, banks increased commercial and industrial lending by 4.2%, real estate loans by 3.4%, and consumer loans by 2%. While securitized non-bank lending remains locked-up, other lending continues.

In addition, the Federal Reserve has rapidly expanded its balance sheet to offset the drop in velocity. Inventory ratios remain very low. In other words, this is not the kind of environment that creates an endless downward spiral.

Mark-to-Market Mayhem, Continued

Fannie Mae and Freddie Mac recently released third quarter financial statements and reported shareholder equity on a GAAP and mark-to-market basis.

Fannie Mae reported that its shareholder equity on a fair value basis (using market prices, even if the market is illiquid) fell to -$46.4 billion, but was +$9.3 billion on a GAAP basis. Freddie Mac data showed -$13.8 billion on a GAAP basis, but -$42.4 on a mark-to-market basis.

In the early 1980s, a vast majority of money center banks in the US would have been declared insolvent if they had been forced to write down Latin American debt to market prices of roughly 10 cents on the dollar. The rules in force back then allowed these banks to avoid marking these loans to market and the system did not collapse.

Today, the accounting rules force institutions to use market prices. With 75% of sub-prime loans still paying on time, and many markets still highly illiquid, forcing institutions to write assets down to so-called "fair value" is creating more pain than is justified. While Secretary Paulson says that the financial system is "stabilized," the impact of mark-to-market accounting remains a huge impediment to recovery.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-17 / 7:30 am	Empire State Mfg Index - Nov	-26.0	**-25.0**		-24.6
8:15 am	Industrial Production - Oct	+0.2%	**+1.7%**		-2.8%
8:15 am	Capacity Utilization - Oct	76.5%	**77.5%**		76.4%
11-18 / 7:30 am	PPI - Oct	-1.8%	**-2.7%**		-0.4%
7:30 am	"Core" PPI - Oct	+0.1%	**+0.1%**		+0.4%
11-19 / 7:30 am	CPI - Oct	-0.8%	**-0.9%**		+0.0%
7:30 am	"Core" CPI - Oct	+0.1%	**+0.2%**		+0.1%
7:30 am	Housing Starts - Oct	0.780 Mil	**0.762 Mil**		0.817 Mil
11-20 / 7:30 am	Initial Claims - Nov 15	501K	**506K**		516K
9:00 am	Philly Fed Survey - Nov	-35.0	**-35.6**		37.5
9:00 am	Leading Indicators - Oct	-0.6%	**-0.8%**		+0.3%