630-322-7756
www.ftportfolios.com

First Trust

Sep 29, 2008

Monday Morning Outlook

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

## Psychology and the Economy

Since the subprime crisis first became evident, we have steadfastly believed the US would avoid a recession. And, at least so far, it has. But with today's vote, two things have happened. First, Congress finally said enough already with the knee-jerk responses to the crisis by Treasury. Second, any immediate relief (if there was really any coming) to credit problems and confidence has been put off. However, these issues will be short-lived; once the nation is able to focus on the long-term again, all will be well.

Up to this point, economic weakness has been isolated in the housing market or financials exposed to it, and in sectors affected by energy (airlines and autos). The weaknesses in these areas have not dragged down overall GDP. Real GDP grew at a 2.8% annual rate in the second quarter and is up 2.1% in the past year. Excluding home construction, real GDP has grown 3.1%.

Our argument has been that the economy does not experience recessions when productivity is strong, the Fed is easy, and tax rates are relatively low. These things are true today and this has kept the economy from falling into recession.

However, panic is spreading. Forget job security…normally positive and optimistic people are now worried that they will lose their money. President Bush said that if the Treasury Plan was not passed very bad things could happen. He said, "banks could fail, including some in your community," further stock market declines could "reduce the value of your retirement account," "the value of your home could plummet," and "millions of Americans could lose their jobs."

From a President, these kinds of statements are unprecedented. In fact, the only parallels we can think of were 1977 and 1979 national TV addresses by Jimmy Carter, talking about energy and a crisis in confidence. Like then, much of our current economic crisis has been caused by government failure, even though conventional wisdom is blaming market failure.

The isolated storms in housing, finance and energy, are now being exaggerated by excessive government intervention (on a knee-jerk basis), mark-to-market accounting and panicky words from political leaders. As a result, consumers are pulling back, credit is being squeezed even to solid, well-run businesses and the economy is being threatened by this spreading panic.

If the economy fell into recession because of this it would be an unprecedented event. Consumer psychology has never caused a recession…never! In fact, there are only three times in history that psychology has impacted the economy in any significant way.

First, at the beginning of the Korean War people worried that goods would be rationed (like WWII), so they spent like crazy. The same was true for the introduction of muscle cars in the mid-1960s, which led to an almost crazy spending spree on autos. And, finally, in 1999 when everyone bought a new computer because they were fearful of Y2K. Each of these spending sprees was followed by an offsetting slowdown in the quarters that followed.

Never in history has a drop in consumer confidence caused a recession. But that does not mean there won't be a first time. It could happen in the next few months and we would expect to see some very negative data on economic activity. But this would be followed by an offsetting increase in activity following the psychological slowdown.

Productivity is still booming, and so are exports, the Fed is exceedingly accommodative and tax rates have not been hiked. Moreover, oil prices are below $100 per barrel. Finally, all it would take to fix financial market problems today is a temporary suspension of mark-to-market accounting for a targeted set of illiquid assets.

In other words, any economic problems that the US faces in the next few months or quarters is temporary. Financial markets have priced in Armageddon, and as a result still present one of the greatest buying opportunities of our lifetimes.

*See page 2 for the weekly economic table*

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 9-29 / 7:30 am | Personal Income – Aug | +0.2% | **+0.4%** | +0.5% | -0.7% |
| 7:30 am | Personal Spending – Aug | +0.2% | **+0.3%** | 0.0% | +0.2% |
| 9-30 / 9:00 am | Chicago PMI – Sep | 53.0 | **54.8** | | 57.9 |
| 10-1 / 9:00 am | ISM Index – Sep | 49.5 | **48.7** | | 49.9 |
| 9:00 am | Construction Spending – Aug | -0.5% | **-0.1%** | | -0.6% |
| *sometime* | Domestic Auto Sales – Sep | 4.6 Mil | **4.7 Mil** | | 4.5 Mil |
| *during the day* | Domestic Truck Sales – Sep | 5.6 Mil | **5.5 Mil** | | 5.9 Mil |
| 10-2 / 7:30 am | Initial Claims - Sep 27 | 475 K | **479K** | | 493K |
| 9:00 am | Factory Orders – Aug | -2.9% | **-3.1%** | | +1.3% |
| 10-3 / 7:30 am | Non-Farm Payrolls – Sep | -105K | **-90K** | | -84K |
| 7:30 am | Unemployment Rate – Sep | 6.1% | **6.0%** | | 6.1% |
| 7:30 am | Average Hourly Earnings - Sep | +0.3% | **+0.3%** | | +0.4% |
| 7:30 am | Average Weekly Hours – Sep | 33.7 | **33.7** | | 33.7 |
| 7:30 am | Manufacturing Payrolls – Sep | -50K | **-45K** | | -61K |
| 9:00 am | ISM Non-Man. – Sep | 50.0 | **49.7** | | 50.6 |