630-517-7756
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First Trust

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Monday Morning Outlook

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

Bank Lending Will Lag the Recovery, Not Lead

The signs of a V-Shaped economic recovery are all around, for anyone willing to see. New claims for unemployment insurance have been trending down, despite unprecedented layoffs in the auto sector. Home sales have started to climb from the lows set earlier this year. Consumer confidence has jumped faster than any time in the past 30 years.

Despite this, many observers still forecast a drawn out recession. They say that the US is not in recovery yet, nor is it on the verge of recovery. "Exhibit A" of the pessimists is often that bank lending remains weak. In fact, after peaking at $1.6 trillion in October, commercial and industrial loans (C&I loans) have declined in each of the past six months, for a total drop of 5%.

While we understand the focus on lending given the financial crisis, this argument has several weaknesses.

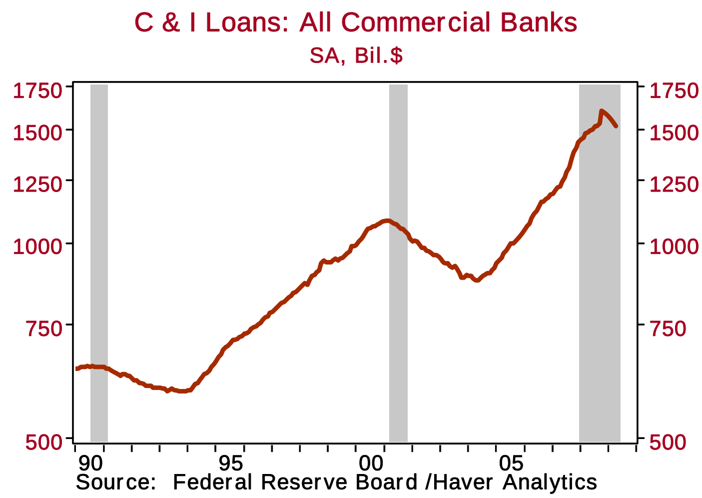
Looking at only the last six months is a bit misleading as C&I loans spiked up in October 2008, with many firms drawing on their lines of credit worried they might be taken away in the future. As a result, the level of loans in October is an artificially high base for making comparisons. And some firms may be repaying those loans now, thereby reducing loans outstanding.

Moreover, borrowing from a commercial bank is not the only way for companies to obtain funds. They could generate funds organically by increasing profits. This happened in the first quarter when US corporate profits increased at a 14.2% annual rate, the first gain in almost two years.

Yet another way for companies to obtain funds is to issue their own bonds. This method has been increasingly successful lately and is likely to get even more so. Corporate bond issuance is up almost 50% versus last year and is up almost 250% from the low set around the collapse of Lehman Brothers in September.

At the same time, credit spreads – the extra yield companies have to offer versus Treasury debt to attract investors – have narrowed substantially in recent months. Normally, the yield spread between Baa corporate bonds and 10-year Treasury notes is about 200 basis points (bps). Late last year this spread peaked at 620 bps, the most since the early stages of the Great Depression. As recently as a month ago the spread was 520 bps. Now the spread is down to 420 bps; still relatively high, but headed in the right direction.

Most importantly, bank lending is a lagging indicator, not a leading one. After the 1990-91 recession, C&I loans did not hit bottom until late 1993, almost three years after the recovery had started. After the 2001 recession, C&I loans did not hit bottom until mid-2004, well after the recovery had started.



Finally, this recovery is going to be led by consumer spending, not business investment. This is because the recession we just experienced was not caused by tight monetary policy but instead a dramatic slowdown in the velocity of money, the speed with which money circulates in the economy.

A revival in monetary velocity is likely to affect consumers before companies. In the first quarter, consumer spending was up, while production fell. The net was that real GDP fell at a 5.7% annual rate, because business investment collapsed.

But the return of consumer spending means that business will need to play catch-up in the near future. The jump in the ISM new orders index to above 50 in May could be the first sign of this. Inventories have corrected sharply, so a rebound in production should not be far behind.

Even if bank lending lags, as it has in the previous two recessions, the economy is set for a V-shaped recovery.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-1 / 7:30 am	Personal Income - Apr	-0.2%	**-0.2%**	+0.5%	-0.3%
7:30 am	Personal Spending - Apr	-0.2%	**0.0%**	-0.1%	-0.2%
9:00 am	ISM Index - May	42.0	**44.5**	42.8	40.1
9:00 am	Construction Spending - Apr	-1.8%	**-2.1%**	+0.8%	+0.3%
6-2 / *sometime*	Domestic Auto Sales - May	3.3 Mil	**3.3 Mil**		3.3 Mil
during the day	Domestic Truck Sales - May	3.8 Mil	**3.9 Mil**		3.8 Mil
6-3 / 9:00 am	Factory Orders - Apr	+0.9%	**+1.2%**		-0.9%
9:00 am	ISM Non-Man. - May	45.0	**46.5**		43.7
6-4 / 7:30 am	Q1 Non-Farm Productivity	+1.2%	**+1.5%**		+0.8%
7:30 am	Q1 Unit Labor Costs	+2.9%	**+2.4%**		+3.3%
7:30 am	Initial Claims - May 30	620K	**620K**		623K
6-5 / 7:30 am	Non-Farm Payrolls - May	-520K	**-495K**		-539K
7:30 am	Unemployment Rate - May	9.2%	**9.2%**		8.9%
7:30 am	Average Hourly Earnings	+0.1%	**+0.2%**		+0.1%
7:30 am	Average Weekly Hours - May	33.2	**33.2**		33.2
7:30 am	Manufacturing Payrolls - May	-150K	**-145K**		-149K
2:00 pm	Consumer Credit - Apr	-$6.0 Bil	**-$4.7 Bil**		-$11.1 Bil