630-517-7756
www.ftportfolios.com

First Trust

Jun 22, 2009

Monday Morning Outlook

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

# The Overrated Unwinding

One thing *New York Times* columnist David Brooks can do is capture a mood. Back on January 6, 2009, in "An Economy of Faith and Trust," Brooks said the "recession was caused by deep imbalances" and "mass delusions." He argued that classical economic models and efficient markets theory were flawed – that people weren't rational.

And in "The Great Unwinding" (published June 11, 2009), he perfectly describes the pessimistic zeitgeist of many analysts about the long-term prospects for the US economy. His argument is that economic growth of the past generation was built on a mountain of unsustainable debt and consumption, fueled by the collective bad decisions of America's households.

Unfortunately, while this description of the economy captures the pessimism and doubt many people have about capitalism and the future, the economic argument is flawed.

First, consumer demand and borrowing do not drive long-term trends in productive capacity. Debt does not generate economic growth. When someone borrows money to buy more than they produce, they must get the money from someone else who spends less than they earn. Debt is a claim on someone's production or assets; it does not by itself make a business or a worker more or less productive. And every dollar of debt is equaled by a dollar of savings.

Second, the numbers Brooks uses are accurate but misleading. While it is true that consumption is now measured at 71% of GDP versus 63% back in 1960, comparisons of consumption and GDP can be tricky.

For example, about half the increase in consumption's share of GDP is due to higher medical spending. But health care is counted as consumption at the time it is purchased even though it often generates benefits that (literally) last a lifetime. Amortizing health care spending would make consumption look much less frothy. The same goes for education spending.

In addition, government undercounts business R&D. And, because many small businesses make purchases at big box stores (think Staples, Office Depot, Home Depot, and Lowes), government attributes many of those purchases to consumers. As a result, government data overestimates consumption and underestimates investment.

Meanwhile, an aging population means that a growing share of consumption comes not from *carpe diem* workers but from retirees who are drawing down some of their assets. This boosts consumption relative to measured income.

Back in 1960, personal consumption, home building, and net exports combined for 69% of GDP. In 2008, these same three factors again added up to exactly 69% of GDP. Of course, the key difference is that the US had a small trade surplus in 1960 and had a large trade deficit in 2008.

But that's the source of our opportunity, not our economy's demise. Brooks makes the rhetorical jump that slower consumption growth must ipso facto mean slower economic growth. But then how do we explain Post-WWII Japan, or Germany, or China, India and Singapore, today? These are all countries where, for long periods of time, production growth substantially outpaced consumption growth. Savings rates were very high, but so was/is economic growth.

In other words, even if Brooks is right about a slow path for consumption ahead – which we doubt – output growth need not falter. Households would become a growing source of capital for US businesses and foreign investments, elevating the incomes of US savers and creating lower US trade deficits and perhaps even trade surpluses. It's not the unwinding that threatens the economy, but the government's reaction to a mistaken analysis.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 6-23 / 9:00 am | Existing Home Sales - May | 4.800 Mil | **4.850 Mil** | | 4.680 Mil |
| 6-24 / 7:30 am | Durable Goods - May | -0.6% | **-1.0%** | | +1.9% |
| 7:30 am | Durable Goods (Ex-Trans) - May | -0.5% | **-0.4%** | | +0.8% |
| 9:00 am | New Home Sales - May | 0.360 Mil | **0.362 Mil** | | 0.352 Mil |
| 6-25 / 7:30 am | Q1 GDP Final | -5.7% | **-5.7%** | | -5.7% |
| 7:30 am | Q1 GDP Chain Price Index Final | +2.8% | **+2.8%** | | +2.8% |
| 7:30 am | Initial Claims - Jun 20 | 603K | **605K** | | 608K |
| 6-26 / 7:30 am | Personal Income - May | +0.3% | **+0.2%** | | +0.5% |
| 7:30 am | Personal Spending - May | +0.3% | **+0.6%** | | -0.1% |
| 9:00 am | U. Mich. Consumer Sentiment | 69.0 | **70.0** | | 69.0 |