

An Immaculate Recovery, This is Not

Early in 2009 we forecast that real GDP would grow at about a 4% rate from the middle of this year through the end of next year. At the time, this prediction was well outside the boundaries of the conventional wisdom, which saw the economy treading water – with a growth rate of about 2%. Now, with optimism rising and consensus estimates moving closer to our view, it's time to straighten out a misconception.

We are not forecasting the “immaculate recovery.” We do not expect a long expansion (of eight or ten years) like the US experienced in the 1980s or 1990s. Chances are, it won't even last as long as the expansion of the 2000s, which endured for six years. Government policy is just not pointed in the right direction to give us a long recovery.

Slow down...hold your horses...we are not lurching from a “V-shaped” recovery to a “W-shaped” double-dip. To us, a “W-shaped” cycle means the US would experience a very short (12 month) recovery, like between July 1980 and July 1981, and then fall back into recession again. We are very confident this will not happen.

What concerns us is a combination of higher taxes and tighter money that should start to have an impact on the economy in 2011 and may eventually push us into recession out in 2013 – after 3 ½ years or so of growth.

Everyone already knows that tax rates are scheduled to go back up on January 1, 2011, with the top rates moving to 39.6% on income and 20% on dividends and capital gains. Alone, these tax hikes are smaller than the rate hikes enacted in 1993 and are probably not enough to tilt us into recession.

But given all the spending of the last several years plus President Obama's goal of socializing the health care system, more tax hikes are likely on the way. And with each passing

month, the president looks less and less likely to support measures like those taken in the 1990s to offset higher taxes, such as welfare reform and freer trade. In fact, the move to put a tariff on Chinese tires threatens a skirmish on the trade front in the months ahead.

Meanwhile, the Fed has engaged a very loose monetary policy. This will not go on forever. Sooner than the consensus now believes, the Federal Reserve will have to tighten monetary policy to combat rising inflationary pressures.

Higher taxes and tighter money will be the headwinds that the US economy must face in the years ahead, just beyond the robust early stages of the current expansion. Without any shift in the direction of the political policy winds, the US will find itself back in a 1970s-style roller-coaster economy in the decade ahead. This means unemployment will not see a 5% handle again for many years and potential GDP growth will slowly erode.

The only way the US could experience an “immaculate recovery” is if the policy winds change. These miracles have happened before. After the mid-term elections in 1994, President Clinton moved sharply to the right. And with welfare reform, capital gains tax cuts and a firm stance against protectionism he created the environment necessary for a very long and robust recovery. President Obama has the ability to follow this path as well.

Will he or won't he? That's the \$2 trillion question. The good news is that for at least the next 18-24 months, the recovery will continue. What happens after that, whether a miracle turns the direction of policy dramatically or not, is the key to economic growth and market performance in the decade ahead.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|-----------------|------------------------------|-----------|------------------|--------|-----------|
| 9-15 / 7:30 am | Retail Sales - Aug | +1.9% | +2.9% | | -0.1% |
| 7:30 am | "Core" Retail Sales - Aug | +0.3% | +0.4% | | -0.6% |
| 7:30 am | PPI - Aug | +0.8% | +0.9% | | -0.9% |
| 7:30 am | "Core" PPI - Aug | +0.1% | +0.1% | | -0.1% |
| 7:30 am | Empire State Mfg Index - Sep | 15.0 | 18.0 | | 12.1 |
| 7:30 am | Business Inventories - Jul | -0.9% | -0.8% | | -1.1% |
| 9-16 / 7:30 am | CPI - Aug | +0.3% | +0.3% | | 0.0% |
| 7:30 am | "Core" CPI - Aug | +0.1% | +0.1% | | +0.1% |
| 8:15 am | Industrial Production - Aug | +0.6% | +0.7% | | +0.5% |
| 8:15 am | Capacity Utilization - Aug | 69.0% | 68.9% | | 68.5% |
| 9-17 / 7:30 am | Housing Starts - Aug | 0.600 Mil | 0.625 Mil | | 0.581 Mil |
| 7:30 am | Initial Claims - Sep 12 | 555K | 555K | | 550K |
| 9:00 am | Philly Fed Survey - Sep | 8.3 | 10.4 | | 4.2 |