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First Trust

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Monday Morning Outlook

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No Soft Patch, No Excuse for QEII

Imagine that Congress passed a $50 per hour minimum wage. Ridiculous, we know, but the end result would be a sharp rise in the unemployment rate and real damage to many businesses. And while everyone would know that this increase in the unemployment rate had nothing to do with monetary policy, the Federal Reserve, under Chairman Bernanke, would apparently try to fix it by pumping money into the system to bring unemployment down again.

How do we know? Because last week the Fed justified another round of quantitative easing by arguing that the economy was growing more slowly than it should. But it is fiscal policy (not monetary policy) that has acted like a ball and chain – holding back the economy and keeping unemployment high.

Of course, not all of today's unemployment problem is due to a policy shock like our example of a higher minimum wage. But with zero percent interest rates and excess reserves in the banking system already at $1 trillion, the Fed just needs to give its policies time to work, not pile on more. The Fed has already expanded its balance sheet dramatically with little impact on lending, a large negative impact on the dollar, and soaring gold and other commodity prices.

Moreover, the "soft patch," which so many people feared would turn into a 1937-style double-dip, was probably a figment of the statistical imagination. Before QEII, private sector jobs were already accelerating. Private payrolls grew 79,000 per month in Q1-2010, 118,000/month in Q2, 122,000/month in Q3, and then accelerated again to +159,000 in October. No soft patch there.

In addition, we believe seasonal adjustments for oil prices have played havoc with quarterly GDP data. The reported data show that after growing at a rapid 5% annual rate in late 2009 and at a 3.7% rate in early 2010 a "soft patch" of just 1.9% real growth developed in Q2 and Q3. This slowdown in growth created major concern.

But what if the "soft patch" wasn't a soft patch at all? What if the earlier growth was exaggerated and the later growth artificially subdued?

Oil prices spiked above $140/bbl in mid-2008 and then fell to less than $50/bbl during the Panic. Now, because seasonal adjustments are updated with about a one year lag, the government's models include what happened in 2008. As a result, the GDP models now expect a big jump in prices during the summer and a large drop in the fall.

So, when oil prices did not collapse late in 2009, as they did in 2008, seasonal adjustments artificially boosted the price used in the models. In turn, this meant that "real" (inflation-adjusted) oil imports fell substantially. And because imports are a negative for GDP, lower oil imports meant higher real GDP.

The same process worked in reverse in Q2/Q3. The government expected a sharp increase in oil prices, which meant it downwardly adjusted prices and upwardly adjusted "real" imports. This created what appeared to be a bigger trade deficit and therefore weaker real GDP growth.

What this means is that real GDP was artificially inflated in late 2009 and artificially depressed last summer. It also means that real GDP in Q4 should surprise to the upside. Right now, we expect a 5% real GDP growth rate in Q4 – partly due to these seasonal issues and partly due to underlying strength in the economy.

The bottom-line here is that QEII – which we believe is ineffective anyway – was unnecessary, especially when the ball and chain of fiscal policy is under attack. Not only will current tax rates likely be extended for two (possibly three) years, but the White House has made it clear it is willing to eliminate the 1099-reporting requirement for purchases over $600. This was a part of Obamacare and other parts of that law may also face the knife as well.

What this means is that the Fed is trying to hammer the accelerator at the same time the ball and chain of fiscal policy is lightened. With the economy already accelerating, the soft patch a figment, the new Congress heading to the Capitol, and the Fed putting both feet on the accelerator, the economy and equity markets have only one way to go – and that's up.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-10 / 7:30 am	Int'l Trade Balance – Sep	-$45.0 Bil	**-$45.3 Bil**		-$46.3 Bil
7:30 am	Export Prices – Oct	+0.2%	**+0.6%**		+0.6%
7:30 am	Import Prices - Oct	+1.2%	**+1.7%**		-0.3%
7:30 am	Initial Claims - Nov 6	450K	**452K**		457K
11-12 / 8:55 am	U. Mich. Consumer Sentiment	69.0	**69.0**		67.7

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.