630-517-7756
www.ftportfolios.com

First Trust

Jul 6, 2010

Monday Morning Outlook

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

Get Real – This is Not 1932

Want to be invited to "A" list parties? Want people to think you are smart? Then, don't smile and don't say anything positive – especially about the economy. Pessimism has become so pervasive that people will believe just about anything, as long as it is negative.

Over the July 4th weekend, after a jobs report that showed 83,000 new private sector jobs were created in June, the Drudge Report had not one but two headlines that compared the US economy of 2010 to that of 1932. In other words, the US is back in Depression. This is a complete over-reaction and is indicative of the severe case of economic hypochondria that seems to have gripped the nation and the world.

One symptom of this disease is that common sense is suspended. The simple explanation is tossed aside and data releases are dredged and sifted to find the most dire possible explanation for any economic information.

For example, every ten years the United States Government conducts a census, and every ten years the government hires hundreds of thousands of very temporary workers to help in the effort. Sometime between April and June total employment goes up and down by an amount that often swamps the underlying trends of employment.

In May, total payrolls increased 433,000, but then fell by 125,000 in June. So rather than explain this to people, the Pouting Pundits of Pessimism said things like "all the jobs in May were government jobs." And then last Friday, after the June jobs report, they said "jobs fell for first time in seven months." Both of these reactions were misleading.

They could have said "once we adjust for the census, private sector payrolls increased by 33,000 in May, and then accelerated in June to 83,000." While both months were disappointing when compared to previous recoveries, the data shows six consecutive months of private sector job creation.

Another interpretation that defies common sense involves labor force data. When 805,000 more people said they were looking for a job in April, the pessimists said, "see how many people had been discouraged…the unemployment rate will never fall as they start looking again." And in June, when the labor force fell by 652,000, they said, "this is the only reason that the unemployment rate fell."

This is crazy. It defies common sense. Economic data is volatile, so quarterly data might be better. And in the second quarter the US added 357,000 private sector jobs – more than 50% greater than the 236,000 added during the first quarter.

New orders for durable goods, a leading indicator, are up 10% at an annual rate in the past three months. Excluding transportation, they are up 25%. If we look at just machinery orders, they are up 63% in the past three months and 23% in the past twelve months. This is not a depression.

Yes, housing has fallen. But what should we expect after a huge government program to support housing activity ends? Remember "cash for clunkers?" Activity was artificially boosted by the program, then it fell, then it recovered as the normal forces of economic activity kicked in again. The same thing will happen with housing in the months ahead.

So, could we be repeating 1932? We suppose anything is possible, but these fears are based on a faulty comparison with history. In 1932, the M2 measure of the money supply fell by 16.5% - the third out of four consecutive yearly declines between 1929 and 1933. Meanwhile, Herbert Hoover pushed through the largest tax hike in American history. The lowest tax rate rose from 1.5% to 4% (at $1 dollar of taxable income), the 6% rate (which kicked in at $10,000) rose to 10%, and the top rate more than doubled from 25% to 63%.

Today, the M2 measure of money is growing and tax rates, while scheduled to go higher in 2011, are nowhere near the levels of the 1930s. And there is no Smoot-Hawley Tariff Act.

None of this is to say that the government is not making it more difficult for business. Clearly, the uncertainty of new laws, spending, taxes and regulations is throwing a wet blanket over the entrepreneurial side of the American economy.

But two things are true. First, productivity is so strong that the economy is growing despite massive increases in the size of government. The US is creating jobs, even if the rate of growth is less than previous recoveries. Profits are still rising. In fact, analysts are still raising earnings estimates.

Second, the market has so much negativity priced in, that it is cheap on just about any basis. Based on forward earnings, the PE ratio for the S&P 500 is under 12. And our capitalized profits model shows that stocks are severely undervalued. Based on very conservative inputs, we continue to believe the fair value for the Dow Jones Industrial Average is 14,500. Pessimism creates value. Optimism has traditionally been rewarded. We remain optimistic.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-6 / 9:00 am	ISM Non-Man. - June	55.0	**54.0**	53.8	55.4
7-8 / 7:30 am	Initial Claims - Jul 3	465K	**464K**		472K
2:00 pm	Consumer Credit – May	-$2.0 Bil	**-$3.5 Bil**		$1.0 Bil