First Trust
Monday Morning OUTLOOK
May 31, 2011
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The "Unreal" Debate About Reality

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Not since the early 1980s has such widespread pessimism about the US economy been so prevalent. This pessimism – fueled by political demagoguery and an overbuilt short-selling industry – denies and ridicules any upward move in growth or stock prices. Basically, if something moves up (if it's positive), then the pessimists argue that it cannot possibly be "real."

Even smart analysts, like Robert Arnott, have fallen into the trap of looking at the world in a negative way. In this piece, Mr. Arnott argues that much of our recent GDP growth is "unreal," because it has been driven by government debt. He calculates "private sector GDP" by subtracting the increase in public debt from published overall GDP, to come up with "real" growth numbers. Not surprisingly, his calculations show a sharp decline in economic output since 2007. This fits with the pessimistic view of the world and seems like it makes sense.

But it doesn't. Don't get us wrong, like Arnott we are worried by government growth and rising debt. Nonetheless, we think he is mistaken about its implications for GDP.

Arnott argues that the government can generate economic growth "at will" by borrowing money and spending. To paraphrase, he says; *Borrow 5% of GDP, spend it, and get 5% GDP growth (20% annualized on a quarterly basis).*

The problem is that economies just don't work the way Arnott claims. If the government borrows 5% of GDP and spends it, GDP will rise by less than 5%. Government spending is less efficient than private sector spending.

If the government had not borrowed the 5% to begin with, the private sector would have spent it and gotten more out of it. The same goes for taxes. If the government takes 5% of GDP in taxes, it is taking money that would have been spent anyway. It's not the deficit that matters, it's the government spending – financed by deficits or taxes.

This is why, despite so-called stimulus, this recovery is not nearly as strong as the one in the early 1980s when the size and scope of government was being reduced. A recent paper found that the debt-financed stimulus bill enacted in early 2009 created 450,000 government jobs but destroyed one million private-sector jobs.

In other words, the reason people feel so bad (the reason unemployment remains high) is that government is so big. Government spending is a drag, not an artificial boost. But government spending is *still* spending. If government delivers the mail or makes cars or mortgages, it may be less efficient than the private sector, and it may distort the capitalist system, but it still adds to real GDP. Our GDP statistics still measure increases in income and output. They are "real," not "unreal."

The bottom line is that the unbelievably resilient US economy continues to grow and generate higher profits, despite the growth in government. Investors who recognize this – who realize that the Pouting Pundits of Pessimism are overdoing it – will be rewarded for staying focused on what is positive. In the end, it's the pessimism that seems so unreal.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-31 / 8:45 am	Chicago PMI - May	62.0	**67.0**	***56.6***	67.6
6-1 / 9:00 am	ISM Index - May	57.5	**58.3**		60.4
9:00 am	Construction Spending - Apr	+0.3%	**+0.6%**		+1.4%
afternoon	Domestic Vehicle Sales - May	9.8 Mil	**9.5 Mil**		10.2 Mil
6-2 / 7:30 am	Q1 Non-Farm Productivity	+1.7%	**+1.6%**		+1.6%
7:30 am	Q1 Unit Labor Costs	+0.8%	**+0.6%**		+1.0%
7:30 am	Initial Claims - May 28	417K	**427K**		424K
9:00 am	Factory Orders - Apr	-1.0%	**-1.6%**		+3.5%
6-3 / 7:30 am	Non-Farm Payrolls - May	180K	**135K**		244K
7:30 am	Private Payrolls - May	210K	**155K**		268K
7:30 am	Manufacturing Payrolls - May	11K	**25K**		29K
7:30 am	Unemployment Rate - May	8.9%	**8.9%**		9.0%
7:30 am	Average Hourly Earnings - May	+0.2%	**+0.2%**		+0.1%
9:00 am	ISM Non-Man. - May	54.0	**54.8**		52.8