First Trust
Monday Morning OUTLOOK
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Let's Stress Test Governments

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Several years ago, Treasury Secretary John Snow was testifying to Congress about the federal budget. He worked for President Bush and, after a long career of opposing deficits, was trying to justify a deficit of about 3% of GDP.

Representative Barney Frank was incredulous. He asked Snow how he could now justify deficits. Frank then came up with a theory: He said Snow was opposed to deficits when the president was a Democrat, but didn't care about them when the president was a Republican.

Frank was being sarcastic, but he had a good point. Nonetheless, his theory is also true when the roles are reversed.

It now seems that deficits don't matter all over again. Paul Krugman, a leading apostle of fiscal liberalism, consistently denounced President Bush for deficits. Now he is aggressively arguing against austerity around the world and asking for a substantial boost in federal spending despite the largest peacetime deficits in US history. He doesn't just say "deficits don't matter," he suggests that "deficits are necessary."

If you can't see the political nature of all this, you are not looking. Barney Frank was certainly right – it depends on which side is in power.

No matter who is in office, our view has been consistent. Deficits themselves don't matter. Ultimately, what matters is how much of the nation's resources are being spent by the government. Spending is the key…it is what crowds out the private sector.

The deficit itself is huge, but interest rates are very low today, emerging market countries have a huge appetite for US debt to back their own expanding currencies, the US has a massive asset base ($150 trillion in the private sector alone), and a budget which freezes spending could eradicate the deficit in five or six years.

In other words, right now the deficit itself is not the problem. It is, however, indicative of the problem – that leaders (of both political parties) cannot control their spending habits. This is not about the economy. If spending created wealth, Greece, Italy, Spain, or even California, would be booming. But they aren't. They are falling apart.

California recently announced it's looking at a $16 billion deficit, not the $9 billion it forecasted in January. The new projected deficit is about 18% of revenues. California already has some of the highest tax rates in the country. It's not taxes or the deficit that matters, it's the spending.

And the problems go deeper than just money. Big government tends to erode the character traits – motivation, thrift, self-reliance – that make progress and economic growth possible. The bottom line is that the last thing the economy needs now is more government spending.

In light of these budget issues, it's interesting that a recent series of bad trades at JP Morgan generated a current loss of $2 billion for a company that earned about $5 billion last quarter. The stress tests forced on big banks suggested that losses like this could be absorbed and they were right.

But the federal government is running a deficit of more than $3 billion per day, European countries are going bankrupt and California is falling apart financially.

Instead of arguing about deficits, why don't we stress test governments? And then get spending down to fix the problem.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-15 / 7:30 am	CPI – Apr	+0.0%	**+0.1%**		+0.3%
7:30 am	"Core" CPI - Apr	+0.2%	**+0.2%**		+0.2%
7:30 am	Retail Sales – Apr	+0.1%	**+0.2%**		+0.8%
7:30 am	Retail Sales Ex-Auto - Apr	+0.2%	**+0.5%**		+0.8%
7:30 am	Empire State Mfg Index – May	9.3	**10.5**		6.6
7:30 am	Business Inventories - Mar	+0.4%	**+0.4%**		+0.6%
5-16 / 7:30 am	Housing Starts – Apr	0.685 Mil	**0.670 Mil**		0.654 Mil
8:15 am	Industrial Production - Apr	+0.5%	**+0.5%**		0.0%
8:15 am	Capacity Utilization - Apr	78.9%	**78.9%**		78.6%
5-17 / 7:30 am	Initial Claims - May 12	365K	**373K**		367K
9:00 am	Philly Fed Survey – May	10.0	**13.0**		8.5
9:00 am	Leading Indicators - Apr	+0.1%	**+0.2%**		+0.3%

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.