First Trust
Monday Morning OUTLOOK
May 6th, 2013
630-517-7756 • www.ftportfolios.com

The QE-xcuse

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

The higher the stock market goes, the more the bears argue that it's all about easy money from the Federal Reserve. The "QE-xcuse" – says Wall Street is flying high on a wave of new money from Quantitative Easing.

But, this explanation is getting long in the tooth. The S&P 500 and the Dow Jones Industrial Average both reached all-time record highs last Friday, up 161% and 156%, respectively, from their lows of four years ago.

The last time stocks had such sharp and sustained gains near these levels was in the late 1990s when optimism was rampant. Then, the psychology was the opposite. Stocks were over-valued, but talking heads were unwilling to say anything even remotely negative.

When equity indices were hitting records in 1999, after-tax economy-wide corporate profits were just $600 billion. Last year, in 2012, they were $1.5 trillion. Nonetheless, the Pouting Pundits of Pessimism are pounding the podium and spewing pessimistic pabulum on a daily basis. Every tick higher in stocks seems to create even more anger, cynicism and disbelief.

All the talking heads have to do is say "QE" and it seems every viewer/reader has been trained to understand that, "the stock market is going up because the Fed is buying bonds." They say the market is riding a "sugar high" of new money.

But, it doesn't stop there. It gets curious-er and curious-er the deeper we dig into the mindset of these bears. The very same people who argue the rise in stocks is phony-baloney-money-printing are also saying that the economy is about to tank and fall into a double dip recession. And, some are now talking about the rising spectacle of deflation.

This defies logic. How can money boost stocks, but not the economy or inflation? This is a mistake in monetary logic. If money were so easy then the economy, inflation and stocks would be lifted together.

But, the pouting pundits never let logic get in the way of a really scary story. For them, nothing can be good. And if it is good, it's either phony or a lie. For example, if the unemployment rate comes down, or if jobs are created, they start arguing that the Labor Force Participation Rate is falling or the "real" unemployment rate is really much higher. When the data doesn't cooperate they accuse the government of being wrong or lying.

We don't claim to have a lock on the truth. As forecasters we know that we will be wrong on occasion and we don't expect everything to go our way.

What we attempt to do is provide an explanation that is based on fact and not emotion. We want our forecast based on a consistent model, not piecemeal beliefs based in political ideology.

So, let's build a story that holds together.

1) The Fed is easy, but not as easy as many think. The monetary base has grown roughly 25% annualized since QE started, but M2 money supply is up just 6% annualized during that same period. The difference is sitting idly on bank balance sheets as excess reserves.
2) Government spending and regulation have increased sharply since 2000, but spending has been reduced from 25% of GDP to 22% in the past three years.
3) The stock market – based on a capitalized profits model – is undervalued by at least 25%.
4) New technology – the cloud, smartphone, tablet, fracking, 3-D printing, etc. – is boosting productivity, efficiency and profits.
5) The collapse of 2008/09 was a case of government failure, not market failure. Mark-to-market accounting and TARP were huge mistakes.

We believe new technology is so powerful that it has been able to create new wealth and growth despite the increased size and scope of government. In other words, the Plow Horse recovery is not a case of a "new normal" – where the economy grows slowly after a financial crisis. Instead, new technology is offsetting the cost of government, and the net effect is 2% to 3% real GDP growth.

We also believe the Fed is easy, but not as easy as conventional wisdom believes. This explains two things – why inflation hasn't surged and also why a recession is not likely. A relatively easy Fed and new technology will continue to boost growth and inflation in the quarters ahead.

Finally, stocks are cheap. They are rising because that's what cheap things do. We don't need a QE-xcuse to explain the markets or the economy. Be wary of those who do.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-7 / 2:00 pm	Consumer Credit – Mar	$15.0 Bil	**$18.2 Bil**		$18.1 Bil
5-9 / 7:30 am	Initial Claims – May 4	335K	**337K**		324K