First Trust
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THE ECONOMIC ANTIDOTE
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This is a Correction, Not a Recession

With the S&P 500 down 10.5% through February 11th, questions about the health of the economy seem to intensify daily. The concerns typically go something like this: If the financial markets are a predictor of where the economy is headed, has the plow horse finally lost traction? Is a recession looming?

Let's put this to the test.

An old joke says the stock market has predicted 19 of the last five recessions. Stocks don't always lead the economy, and earnings clearly don't show that things are awful. With 375 S&P 500 companies having reported Q4 earnings as of February 11th, 70.7% have beat estimates, although earnings are down 5% from a year ago it's all due to just one sector, energy. Of the 375 companies that have reported, only 23 of them have been energy. Excluding those 23 energy companies, earnings for the other 352 companies are up 1.0% from a year ago. So, for those claiming the market drop is due to declining earnings, it seems more like an energy story than an economic one. It's plow horse earnings growth outside of energy, but it's earnings growth.

Corrections are designed to scare the snot out of people. This is one of those corrections, and if you read my email inbox or watch, read, or listen to the financial press, it's working.

But this is an emotional correction, not a fundamental one. The US is not entering a recession. Let's look at a few more facts:

Retail sales rose 0.2% in January, beating consensus expectations and were up 0.4% including revisions to prior months. This is the third consecutive month of gains, which is particularly impressive considering gas station sales plummeted 3.1% in January, due to lower prices at the pump. Again more of an energy story than an economic one. Excluding gas stations, retail sales have risen seven months in a row and are up 4.5% from a year ago.

In 2015, hourly earnings rose 2.7%, acceleration from the sub-2.0% trend seen over the previous two years. At the same time, initial claims have been below 300,000 for 49 consecutive weeks. Private payrolls grew at a 216,000 monthly rate in 2015, and the unemployment rate is down to 4.9%. And no, this is not a "part-time" recovery. In the past twelve months, full-time employment has grown by 2.5 million jobs while part-time employment is **down** 120 thousand! With 5.6 million unfilled jobs (the second highest on record), and quit rates at the highest levels of the recovery, there should be little question why the Fed started to hike rates in December.

What about inflation? Oil has plummeted and we must be near deflation if we aren't there already, Right?!? But, "core" inflation, which excludes the volatile food and energy components was up 2.1% year-to-year in December, very close to the Fed's 2% inflation target. Even with the huge drop in oil, the overall index is still up 0.7% in the past twelve months. And the consumer price index is about to drop off the huge declines from early last year when oil plummeted. If the consensus is right and a 0.1% drop occurred in December, year-to-year CPI will rise to 1.3% in January, from just 0.7% in December.

In other words we don't have deflation in the US.

You can tell there is massively negative emotion in the market because everything is bad. Low oil prices are bad. Strong car sales are bad - by the way, autos sold at a record pace in 2015 and continued to rise in January. When the Fed dot plot forecast four rate hikes in 2016, that was "bad." And now it's "bad" that the Fed may hold off on another rate hike for a while.

Whether the Fed continues to raise rates or folds to market concerns and holds off, the Fed won't be tight any time soon. Commercial and industrial loans grew 13.6% at an annual rate in past 13 weeks, that doesn't sound like evidence of tight monetary policy to us.

What we focus on are the Four Pillars of Prosperity: Monetary Policy, Tax Policy, Trade Policy, and Spending & Regulation. So let's see where those stand:

1. Monetary Policy – As we mentioned above, the Fed is still easy and will be for the foreseeable future
2. Tax Policy – If anything, tax policy is likely to get better before it gets worse, but don't expect much until after the elections
3. Trade Policy - The US is not going to become protectionist
4. Spending & Regulation – This is the only real area of concern. Spending and regulation are too high, but spending is still a smaller share of GDP than it was five years ago and the Supreme Court just blocked harmful EPA regulations.

To say it succinctly, the fundamentals of the economy show no evidence of recession. And, out of the four potential threats, only one is moderately negative.

This is a correction, not a turning point for the stock market. Our models, with stocks driven by interest rates and corporate profits, not sentiment, suggest the market is still significantly undervalued.

It's not often you get recession level prices when there is no recession.

Put money to work, don't run away.

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