First Trust
Monday Morning OUTLOOK
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October 1, 2018

# No Looming Recession

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As far as Harvard economist Martin Feldstein is concerned, we're all doomed.

Feldstein says that the low interest rates of the last several years have created a stock market bubble rivaling the housing bubble that precipitated the last crisis. As interest rates keep rising, he says, the stock market bubble will eventually burst, sending the economy into another "long and deep downturn." But, unlike in the prior recession, with interest rates still relatively low, the Federal Reserve will have less room to respond to a weaker economy.

We have to admit to feeling a little awkward disagreeing so strongly with Feldstein. He's been a long-time advocate of lower tax rates and less government spending, policy positions near and dear to our hearts.

But, when it comes to forecasting what the economy will do in the next few years, we think he's laid an egg.

Why? Let's start by looking back. We like to assess fair value in residential housing by comparing the asset value of owner-occupied homes to the annualized rent these homes could earn. Using historical averages, our calculations suggest home prices were about 40% above fair value at the end of 2005. With US homes valued at about $21 trillion, that meant an overvaluation of about $6 trillion. (Note: When an asset is priced 40% too high, it takes a loss of 28.6% from the *overvalued* level to bring the price down to fair value.) For perspective, GDP was $13 trillion that year.

By contrast, the stock market is not even close to that kind of overvaluation. At present, the price-to earnings ratio on the S&P 500 is 22.3. The average in the past 40 years is 20.2. So even if you accept the P-E ratio as the gospel (and we don't), equities only appear about 10% over-valued.

Except the current P-E ratio only reflects two quarters of the tax cut so far. The forward P-E ratio is 16.9, which leaves room for a 20% rally in equities just to get back to the 40-year average of 20.2 (assuming earnings estimates are accurate.) Moreover, the average P-E ratio of 20.2 over the past 40 years was established when the yield on the 10-year Treasury Note was averaging 6.26%, not the 3.06% it's at today. In other words, bonds were a much more attractive alternative to equities in the past than they are today.

The basic problem with all this is that if you want to sound smart – and if you want media attention - it's better to be a pessimist. Warn people about impending doom and they hang on every word. And let's be honest, telling people the bull market has room to roam is not the best way to get published.

We're sure the economy will eventually face another recession. It may even be a deep one, although our best bet is that the next recession will be mild compared to the last. When it happens, the pessimists will tell you how they got it right all along. But getting it right, briefly, at least a few years from now is not worth losing out on the gains to be made in the meantime. Those who stay long equities will be rewarded.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 10-1 / 9:00 am | ISM Index – Sep | 60.0 | **60.4** | 59.8 | 61.3 |
| 9:00 am | Construction Spending – Aug | +0.4% | **0.0%** | +0.1% | +0.2% |
| *afternoon* | Total Car/Truck Sales – Sep | 16.8 Mil | **17.1 Mil** | | 16.6 Mil |
| *afternoon* | Domestic Car/Truck Sales – Sep | 13.1 Mil | **13.1 Mil** | | 12.9 Mil |
| 10-3 / 9:00 am | ISM Non Mfg Index – Sep | 58.0 | **58.1** | | 58.5 |
| 10-4 / 7:30 am | Initial Claims – Sep 29 | 215K | **210K** | | 214K |
| 9:00 am | Factory Orders – Sep | +2.1% | **+1.9%** | | -0.8% |
| 10-5 / 7:30 am | Non-Farm Payrolls – Sep | 181K | **150K** | | 201K |
| 7:30 am | Private Payrolls – Sep | 180K | **145K** | | 204K |
| 7:30 am | Manufacturing Payrolls – Sep | 15K | **15K** | | -3K |
| 7:30 am | Unemployment Rate – Sep | 3.8% | **3.8%** | | 3.9% |
| 7:30 am | Average Hourly Earnings – Sep | +0.3% | **+0.3%** | | +0.4% |
| 7:30 am | Average Weekly Hours – Sep | 34.5 | **34.5** | | 34.5 |
| 7:30 am | Int'l Trade Balance – Aug | -$53.5 Bil | **-$53.7 Bil** | | -$50.1 Bil |
| 2:00 pm | Consumer Credit– Aug | $15.0 Bil | **$13.4 Bil** | | $16.6 Bil |