First Trust
Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*
Bryce Gill – *Economist*

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Closer to a Turning Point

In spite of weakness in some economic data, problems in the banking sector, and much higher interest rates, real GDP in the first quarter will almost certainly show moderate growth. Meanwhile, the S&P 500 is 15% higher than its low point in October 2022. And, now, many are starting to believe that a recession isn't going to happen.

But we still think a recession is coming. Ultimately, recessions are about mistakes. In particular, there's too much investment broadly throughout the economy or in some important segment of the economy, like technology back in 2001 or housing several years later. Once businesses realize they made a mistake – that the return on their investment will be too low – they ratchet back economic activity to bring the capital stock back into line with economic fundamentals.

Almost always, it is government policy mistakes that cause this over-investment (or "malinvestment"). Then, when imbalances become too great, and policymakers change course after realizing their prior mistakes, the economy contracts and a recession becomes nearly inevitable.

Sound familiar? We think so. The Fed opened the monetary spigot in 2020-21 while Congress and two different presidents passed out enormous checks to try to smooth over the damage done to the economy by COVID Lockdowns. Inflation has been the result. Now both fiscal and monetary policy have turned tighter. The unprecedented nature of policies during the COVID Era makes the timing of a contraction in activity difficult to predict, but, in our opinion, this contraction is almost certain.

If anything, the notion among some businesses and investors that recession risk is declining may, by itself, contribute to *greater* risk, as it's also consistent with less of a pullback in investment. It means businesses are not as widely coming to terms with past mistakes, which, in turn, means more problems ahead.

This is why we think no one should get excited about a positive first quarter GDP report. As always, it tells us where the economy has been recently, not where it is going. The economy grew 2.9% in 2000; we had a recession in 2001. And, real GDP grew 2.4% in the year ending in mid-1990, right before a recession.

Most importantly, recent data show some early signs of weakness. Jobless claims have risen. Manufacturing production in March was lower than a year ago. Real (inflation-adjusted) retail sales are down from a year ago.

In addition, keep in mind that the Fed used policy measures (like insuring more deposits) in the wake of the banking problems in March in order to prevent any widespread crisis in the financial system. In turn, that makes the likely path for short-term interest rates, for at least the next several months, higher than most investors anticipate.

We think the futures market is correct in anticipating another 25 basis point hike in May, just like we had in February and March. But the markets are not as prepared for another rate hike in June, which we think is more likely than not. Inflation remains a problem and the April inflation print, arriving May 10, should confirm that problem. The federal funds futures market expects the Fed to end the year with short-term rates lower than they are today; we think they end up higher than today at year-end, instead.

Where does that leave equity investors? We understand the desire for optimism, but our model still says equities are overvalued. There will come a time to get bullish, but that'll be after the recession starts, not before.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-25 / 9:00 am	New Home Sales – Mar	0.633 Mil	**0.642 Mil**		0.640 Mil
4-26 / 7:30 am	Durable Goods – Mar	+0.8%	**+1.7%**		-1.0%
7:30 am	Durable Goods (Ex-Trans) – Mar	-0.2%	**-0.1%**		-0.1%
4-27 / 7:30 am	Initial Claims – April 22	250K	**243K**		245K
7:30 am	Q1 GDP Advance Report	2.0%	**2.2%**		2.6%
7:30 am	Q1 GDP Chain Price Index	3.7%	**3.6%**		3.9%
4-28 / 7:30 am	Personal Income – Mar	+0.2%	**+0.3%**		+0.3%
7:30 am	Personal Spending – Mar	-0.1%	**0.0%**		+0.2%
8:45 am	Chicago PMI – Apr	43.5	**43.6**		43.8
9:00 am	U. Mich Consumer Sentiment- Apr	63.5	**63.0**		63.5