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First Trust

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Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

It's A Good Deal

As the Senate votes to pass the tax cut deal announced by President Obama last Monday night, political debate rages on. What's left of the Left in Congress hates the deal. It's the second drubbing in a row (November 2nd, being the first). The deal says "lower tax rates are better than higher tax rates."

After years of complaining about the Bush tax cuts on the wealthy, two Democratic Presidents (Clinton and Obama) have now come out in support of them. President Obama's chief political advisor, David Axelrod, called that part of the deal "odious" on the Sunday talk shows.

Some Republicans don't like the deal because it includes, by *their* count, more than $300 billion in "spending" that they feel they were elected to stop. This includes the one-year reduction in the payroll tax rate, extending the program of 99 weeks of unemployment benefits, plus other tax credits.

There is still a small chance that Congress will add so many goodies as the bill is written (like continued credits for ethanol), that the deal becomes unsupportable. But, the odds of any crack-up on the way to passage remain very low. We expect it to pass within the next week or two with very minor additions.

The benefits of the deal outweigh its costs by a significant margin. The consensus seems to expect about a 1% kick to real GDP growth from a deal, but that is in comparison to "no deal." We have been more bullish than the consensus and have expected the extension of Bush era tax rates. As a result, we have raised our forecast a small amount – from 3.7% real GDP growth in 2011 to 4%.

Many have argued that the "cost" of the deal is $900 billion, but this is Washington speak and has little to do with reality. After bottoming at an annual run rate of $2.0 trillion (roughly 14.5% of GDP) in 2009, total tax revenues to the federal government have climbed to about $2.2 trillion (15% of GDP) in the past year. This has happened without higher tax rates. And as long as the economy continues to recover, revenues will continue to climb, eventually rising back to 19% of GDP, where they were before the Panic of 2008. After that, "bracket creep" generated by economic growth will push revenue even higher relative to GDP.

In other words, the US does not need higher tax rates in order to gather more revenue and balance the budget. If government spending were frozen at current levels, the budget would be balanced at the end of 2014. If government spending were cut back to 2008 levels, a balanced budget could be achieved sooner than that. In other words, this deal does not spin the budget out of control. On the contrary, it focuses all the energy of those who want to balance the budget on the spending side of the ledger rather than the tax side. This is great news.

Some analysts are trying to tie rising Treasury bond yields to fears about a bigger deficit and the "cost" of the deal. This is a misreading of the markets. Treasury bond yields are rising because a tax hike has been avoided and economic growth is likely to be robust. The bottom line is that stocks remain cheap, while bonds are certainly not.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-14 / 7:30 am	Retail Sales - Nov	+0.6%	**+0.6%**		+1.2%
7:30 am	Retail Sales Ex-Autos - Nov	+0.6%	**+1.1%**		+0.4%
7:30 am	PPI - Nov	+0.6%	**+0.8%**		+0.4%
7:30 am	"Core" PPI - Nov	+0.2%	**+0.5%**		-0.6%
7:30 am	Business Inventories - Oct	+1.0%	**+1.1%**		+0.9%
12-15 / 7:30 am	CPI - Nov	+0.2%	**+0.2%**		+0.2%
7:30 am	"Core" CPI - Nov	+0.1%	**+0.1%**		+0.0%
7:30 am	Empire State Mfg Index - Dec	5.0	**5.0**		-11.1
8:15 am	Industrial Production - Nov	+0.3%	**+0.3%**		+0.0%
8:15 am	Capacity Utilization - Nov	75.0%	**75.1%**		74.8%
12-16 / 7:30 am	Housing Starts - Nov	0.550 Mil	**0.553 Mil**		0.519 Mil
7:30 am	Initial Claims - Dec 11	425K	**414K**		421K
9:00 am	Philly Fed Survey - Dec	14.8	**+12.3**		+22.5
12-17 / 9:00 am	Leading Indicators - Nov	+1.1%	**+1.2%**		+0.5%