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First Trust

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Monday Morning Outlook

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

Mark-to-Market Reform; More Important Than Stimulus

A massive federal government stimulus bill, pushed hard by President Obama as a way to avoid “a catastrophe,” is working through the Senate. It is expected to pass and move to Conference (to reconcile the different House and Senate versions) and could be on the President’s desk for his signature later this week.

In the meantime, the major announcement from Treasury Secretary Timothy Geithner about the newest bank bailout plan (that hopefully includes some relief from mark-to-market accounting) has been postponed until Tuesday.

The explanation for the delay is that the Treasury Department needs to focus all its attention on getting the stimulus bill passed. But, it could be that the bailout package is not really ready to go – it has changed so many times in the past few days that nothing seems settled.

Unfortunately, it is the bailout package that is the most important. The financial system remains mired in uncertainty. Just the whiff of changes in mark-to-market accounting (rumored mid-day last Thursday) pushed the S&P 500 up more than 5% through Friday, while S&P 500 banking stocks moved up 20%.

The stimulus package is just not that important compared to the plans for the financial sector. In the aggregate, government spending does not create jobs. It never has. Total federal government spending increased significantly from 1950 through the early 1980s. But unemployment did not go down, it went up.

While some argue, correctly, that correlation is not causation, the fact that the unemployment rate was significantly higher at the end of the 1950-1980 period suggests government spending does not create jobs.

This was not just the vagaries of the business cycle at work. The government’s estimate of the NAIRU (the Non-Accelerating Inflation Rate of Unemployment) rose from 5.3% in 1950 to 6.2% in 1982, while government spending increased from roughly 17% to over 22% of GDP. This suggests the increase in government spending actually led to a weakening in the underlying ability of the economy to create jobs. This makes sense because a larger government sector “crowds out” the more efficient private sector. With the Obama Stimulus plan likely to push government spending to 24% of GDP, the economy could face a long-term period of stagnation.

This is part of what has held stocks down in recent months – the fear that government will continue to grow rapidly in the years ahead. But this is not the only mistake government has, or will, make. Mark-to-market accounting, for anyone with the eyes to see, has created a disaster in America’s financial system.

History also has something to say here. According to Milton Friedman, mark-to-market accounting in the Great Depression caused the failure of many banks. Little known by economic historians is that in 1938 President Roosevelt’s administration finally realized the mistake and suspended mark-to-market accounting.

Then, from 1939 to 2007, the US had a relatively subdued business cycle and experienced no panics or depressions, even in the 1980s and 1990s when more than 3000 banks and S&Ls failed. In 2002 with Sarbanes-Oxley and in 2007 with FASB 157, mark-to-market accounting made its comeback. Since then, the economy has had serious troubles. Once again, correlation is not causation, but it sure is an awful coincidence.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-11 / 7:30 am	Int’l Trade Balance - Dec	-$36.0	**-$39.6 Bil**		-$40.4 Bil
1:00 pm	Treasury Budget - Jan	-$78.0	**-$78.0 Bil**		-$83.6 Bil
2-12 / 7:30 am	Retail Sales - Jan	-0.8%	**-0.5%**		-2.7%
7:30 am	"Core" Retail Sales - Jan	-0.4%	**-0.2%**		-3.1%
7:30 am	Initial Claims - Feb 7	610K	**610K**		626K
7:30 am	Business Inventories - Dec	-0.9%	**-0.9%**		-0.7%
2-13 / 8:45 am	U. Mich. Consumer Sentiment	60.9	**60.0**		61.2

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.