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First Trust

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Monday Morning Outlook

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Stock Rally and Economic Recovery: Not "Sugar Highs"

Just two months ago, the consensus among economists was that we would not see any significant economic growth until the end of this year and that whatever growth we did see would be tepid, at least through the end of 2010.

Now, with a plethora of economic reports showing that a recovery has probably already begun – falling unemployment claims, rising housing starts, growing exports, and today's Empire State manufacturing index – the conventional wisdom appears to have pivoted. Forecasts for second half growth have been increased. But, for the most part, this is a tempered optimism. Conventional wisdom is saying "*alright Wesbury and Stein, it looks like you were right about the V-shaped recovery, but it can't last, it will eventually look like a square-root* (√‾‾)."

One theory supporting this view is that an inventory cycle will add to growth in the near-term, but deleveraging and a weak job market will not allow this to build into a sustained recovery.

Obviously, we disagree. Easy monetary policy must show up somewhere. While we do not always know where it will show up, in the next year or two a shrinking trade deficit, a turnaround in home building, and a revival in business investment and consumption will all help economic growth continue.

A second theory suggests that any recovery in growth we are seeing right now is due to government stimulus spending. This stimulus is expected to level out and therefore will no longer boost economic activity.

But federal stimulus has little or nothing to do with the recovery. In fact, we count it as a headwind – the more government spends, the more it crowds out private investment and economic activity.

The real forces behind the recovery have been easy money, an end to the post-Lehman panic and FASB's correction of mark-to-market accounting rules.

While easy money can be thought of as a temporary positive (a sugar high), the end of panic and changes in mark-to-market accounting are more fundamental. What they do is take Armageddon off the table. As a result, the economy and the stock market can reflect the continued impact of technology and productivity. Our stock market model suggests fair value is substantially above current levels even if interest rates rise as we are forecasting over the next few years.

The way we see it, those who were pessimistic about stocks and the economy early this year are going through the classic five stages of grief. First, they *denied* a recovery was going to happen anytime soon. Then they lashed out with *anger* at those who spotted signs of the recovery. Now, they are *bargaining*, admitting the existence of the recovery that they did not see coming, but belittling it. Next, when things keep moving up, expect them to get *depressed*. We don't expect *acceptance* to fully set in until late next year.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-17 / 7:30 am	Empire State Mfg Index - Aug	3.0	**8.0**	12.1	-0.6
8-18 / 7:30 am	PPI - Jul	-0.3%	**-0.4%**		+1.8%
7:30 am	"Core" PPI - Jul	+0.1%	**0.0%**		+0.5%
7:30 am	Housing Starts - Jul	0.598 Mil	**0.630 Mil**		0.582 Mil
8-20 / 7:30 am	Initial Claims - Aug 15	550K	**559K**		558K
9:00 am	Philly Fed Survey - Aug	-2.0	**-0.5**		-7.5
9:00 am	Leading Indicators - Jul	+0.7%	**+0.7%**		+0.7%
8-21 / 9:00 am	Existing Home Sales - Jul	4.990 Mil	**4.950 Mil**		4.890 Mil

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.