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First Trust

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Monday Morning Outlook

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Public Policy Looking Better

We think there are five (5) reasons to be bullish about the US economy. First, monetary policy is loose and likely to remain so. Second, the financial panic is over, thanks to the end of overly-strict mark-to-market accounting rules. Third, technological advances continue to boost productivity growth. Fourth, our free market economy is incredibly resilient, much more so than the pessimists believe. And fifth, the policy environment is improving.

Despite what Ben Bernanke might say (that quantitative easing lifted stock prices), we think the 15% total return in the S&P 500 since late last year has more to do with a positive shift in government policy. Not only were the lower Bush-era tax rates extended for two years, but lawmakers are becoming even more serious about cutting spending.

The debate over the 2011 budget, which resulted in some very slight reductions in spending, is over. But now a more serious fight about the "debt ceiling" is taking shape. We don't want to get too far ahead of ourselves; after all we are dealing with politicians here. But, it appears that we can expect some modest, but noticeable, reductions in the size of government in the years ahead.

Our "most likely" outcome (about 50%) from this political wrangling expects the path of discretionary spending to be lowered and that entitlements would be tinkered with. We would be moving in the right direction, but the Congress would "kick the can" of major entitlement reform down the road for another time. This would be good for markets, but it would not be a watershed moment.

The next most likely outcome (about 30%) would be "market neutral." In this scenario, Congress caves on the debt ceiling and we see little more than token measures to improve the long-term fiscal outlook. In this scenario, the stock market treads water.

There is obviously a small chance (make it 5%) that the Congress goes back on a spending binge and doesn't cut spending at all. It seems impossible, but it is Congress.

The final option, and the one that intrigues us most, is the still small, but growing, possibility of a major breakthrough – a watershed moment – on the US's long-term entitlement problems. To be careful, we would put relatively low odds (say 15%) on this scenario. But if it does happen the positive effect on the stock market could be huge, rivaling the impact on the markets of the change in policy direction that resulted from the 1994 election.

One reason we are intrigued by this option is how fast the political landscape has changed. On April 21, 2011, when Brian Wesbury wrote this very short piece for National Review Online (link here), he was among a small minority who thought using the "debt ceiling" as a political tool to force spending cuts was a wise, or even doable, thing. Even last Monday morning, when Brian participated in this press conference (see C-Span coverage here), the conventional wisdom, even among those who advocate for smaller government, was that the debt limit would have to be raised regardless of whether significant policy improvements could be achieved.

Congressional leaders were scared about using the debt ceiling as a political tool and many of them were angry with members of the Tea Party and other members of Congress who stood firm. But in just a few short days, many of these same congressional leaders are saying they won't support lifting the debt limit unless trillions are cut from the budget. In other words, the odds of some very significant cuts in government spending are growing.

The political battles of the next decade are going to be fierce. And the outcomes of those battles will have major implications for the long-term growth path of the economy and financial markets. The sooner and more favorably those battles get resolved the longer and stronger the current bull market will be.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-16 / 7:30 am	Empire State Mfg Index - May	19.6	**15.0**	11.9	21.7
5-17 / 7:30 am	Housing Starts - Apr	0.568 Mil	**0.560 Mil**		0.549 Mil
8:15 am	Industrial Production - Apr	+0.4%	**+0.3%**		+0.8%
8:15 am	Capacity Utilization - Apr	77.6%	**77.6%**		77.4%
5-19 / 7:30 am	Initial Claims - May 14	420K	**430K**		434K
9:00 am	Philly Fed Survey - May	20.0	**24.6**		18.5
9:00 am	Leading Indicators - Apr	+0.1%	**0.0%**		+0.4%
9:00 am	Existing Home Sales - Apr	5.200 Mil	**5.170 Mil**		5.100 Mil