Currently, the domestic and global economic situation is the most disrupted it’s been since at least 1990. In fact, it closely resembles the S&L crisis of the late ‘80s and early ‘90s. Back then, the big problems were caused by junk bonds.

Today, the big problems are caused by the notorious portfolios of mortgages known as Collateralized Debt Obligations (CDO)s. But, as much trouble as these securities and the housing crash they fueled may be causing, there are two big under-appreciated economic trends emerging that point the way forward:
The first is the bold stance taken by the Federal Reserve to contain the credit crisis.

The second is the stabilization that is beginning to take hold in the U.S. housing market.

As we’ll explain, these two trends will have dramatic implications for the stock and bond markets and the broader economy. But before we explore these in detail, let’s take a look at the economic fundamentals that best describe the present situation.

Let’s start with the job market. U.S. payrolls dropped by 80,000 jobs in March, after falling an adjusted total of 147,000 in January and February. However, economists Brian Wesbury and Robert Stein remind us that there are at least five reasons to doubt that these numbers signal a recession:

- First, the number of hours that Americans worked actually increased in March. The average workweek went up from 33.7 hours to 33.8 hours. This extra time per week, spread across the workforce, is the equivalent of increasing U.S. payrolls by 120,000 jobs. If the economy was really in a recession, the average workweek would be going down, not up.

- Second, the Bureau of Labor Statistics cites the weather, which was unusually bad even for March, for skewing the statistics by 55,000 jobs.

- Third, it’s not that unusual for employment figures to go up and down due to normal fluctuation. This has happened many times over the years. The first half of 2003 is typical: On average, payrolls dipped by 57,000 each month, while real GDP climbed at a 2.3 percent annualized rate.

- Fourth, even though the four-week moving average for jobless claims stood at 378,000 in the middle of April, it did not reach the 400,000 mark, which is the figure that we’d be likely to see in a recession.

- Fifth, even if the total number of jobs falls, the economy will continue to expand because of increases in productivity. Quite simply, companies are learning how to do more with fewer people. At an annualized productivity growth of 3 percent, the real GDP growth rate should be right around 2 percent.

Furthermore, as pointed out recently by economist Donald Luskin, writing on SmartMoney.com, “When we’re three months into a recession [as some analysts believe], we’d expect to see a loss of 250,000 jobs every month.” We’re nowhere near that.

In fact, the March unemployment rate was only 5.1 percent, which is low compared to the rate we’d expect to see in a recession. Even the increase of 0.7 percent in the unemployment rate compared to last year hasn’t been as abrupt as the sudden loss of jobs that typically occurs in a recession.

More significantly, according to the latest survey of 14,000 employers by Manpower Inc., 26 percent of companies expect to increase the size of their workforce between April and June. Sixty percent predict no change. These numbers are slightly — but not drastically — worse than those for the same quarter in 2007.

Industrial production is probably the most unfavorable indicator of recent economic trends. But Brian Wesbury points out that falling industrial production does not equal a recession. Since November 2001, the six-month annualized change in industrial production has fallen into negative territory in 2003, 2005, early 2007, and now. None of the previous periods signaled the end of the expansion. We conclude that this is true today as well.
Confirming this, manufacturing output increased 0.1 percent in March, despite a 5.5 percent decline in the output of motor vehicles and parts. The production of high-tech equipment grew 2.6 percent in March, and is up 26.5 percent versus last year. Overall capacity utilization increased to 80.5 percent in March, while manufacturing capacity utilization ticked down to 78.5 percent.

Instead of scaling back, as we'd expect in a recession, manufacturers are producing and selling more goods than in the previous month — and demand is so strong that they're charging higher prices, as reflected in the "prices paid" part of the index, which achieved a two-year high of 57.3.

What's more important is that previous production downturns that led to recessions were made in the face of an inventory overstock that crushed the economy. Today, inventories remain razor-thin, even while consumer spending continues to expand, interest rates are extremely low, exports are booming, and productivity continues to grow strongly.

That brings us back to the most important factor for the long-term health of the economy: productivity. Non-farm productivity increased at a 1.9 percent annual rate in the fourth quarter of 2007 and was up 2.9 percent for the entire year. As highlighted earlier, productivity growth makes the economy grow even when payrolls are shrinking.

As with industrial production and jobs, consumer spending in the first quarter of 2008 is consistent with sluggish growth, but it's not what you'd expect to see in a recession. For example, the International Council of Shopping Centers announced that chain store revenues erased a 0.5 percent year-over-year decline in March and jumped 4.1 percent in the first two weeks of April.

Admittedly, capital goods orders were off 1.7 percent in February and that can be attributed to an unusually sharp drop in orders for machinery. We suspect that simply reflects the fact that companies were waiting for clarification on the government's so-called "fiscal stimulus" program. Now that investment incentives have been approved, we expect this number to rebound. Nevertheless, despite such month-to-month volatility, an overall upward trend in both orders and shipments has been evident in recent months.

On the downside, nearly 90 percent of chief financial officers of global public companies don't see an economic recovery coming until 2009, according to a new survey by Duke University and CFO Magazine. Similarly, The Expectations Index within the Conference Board's broader Consumer Confidence Index reached a 35-year low in March. The last time it was lower was in December 1973 during the first Oil Embargo and the Watergate crisis. However, as we'll explain, this cloud of gloom has begun to lift and this will become dramatically clear in the coming quarters.

As we forecasted, the service sector rebounded in February. The ISM non-manufacturing Composite Index rebounded to 49.3 in February from 44.6 in January. As the Consumer Confidence data shows, there is still plenty of negative sentiment. However, Wesbury argues that this mood will dissipate in the months ahead, meaning more increases in the services index.

Finally, inflation is up, so consumers are paying more money for goods and services; but the good news is that incomes are going up even faster, so they have more money to spend. Obviously, the prices of food and oil are the biggest problems. As we've explained in previous issues, these price escalations have been driven largely by poor energy policies and the natural lags associated with increasing
supply in the energy and agricultural sectors. These imbalances will be corrected over the next few years and prices will return to their long-term trend line.

Looking at the whole picture, we see that the biggest problems are essentially confined to the housing and financial services industries. And, due to some shrewd maneuvering by the Fed and other regulatory bodies, they are likely to remain so. That brings us back to our two main stories, the credit crisis and the housing crisis.

§ § §

Let’s look first at housing. Existing home sales increased 2.9 percent in February to an annual rate of 5.03 million, well above the consensus expected level of 4.85 million. The median price of an existing home fell to $195,900 in February and is down 8.2 percent compared with a year earlier. More importantly, the supply of existing homes at the current sales rate declined to 9.6 months in February, down from 10.2 months in January.

The Standard & Poor’s/Case-Shiller 20-city composite home price index fell 10.7 percent in January from a year earlier. In short, owners of existing homes are cutting prices which, together with lower mortgage rates, are starting to have an impact on the market to make home ownership attractive again. By June, it’s likely that the existing home market will be heading back toward normal territory.

The news for new homes inventories was equally upbeat. A normal inventory figure for completed new homes should be around 87,000. At the end of 2007, that number had ballooned to 197,000. But, it has fallen steadily in January and February to 188,000. The drop in February was the steepest in 35 years. This is the first sign that the market has begun to stabilize. It may take until late 2009 to get down to normal inventory levels, but the trend is in the right direction.

Since the improvement in the housing market owes a lot to interest rate cuts and their impact on adjustable rate mortgages, it’s time to turn our attention to the credit crisis. Right now, the median home price is at its 2004 level, just under $200,000. Note that this is still 60 percent higher than a decade earlier. As Larry Kudlow observes, since the Fed started slashing its target rate last summer, the owner of this median-price home is now saving about $3,600 a year in mortgage interest, a much bigger stimulus than the checks being mailed by the IRS this month.

This Fed strategy seems to be paying off already. On the housing-credit front, University of Michigan economist Mark Perry, using data from the Mortgage Bankers Association, points out that of the 46 million mortgages outstanding, only 2 percent were in the foreclosure process in the fourth quarter of 2007. And most of those were confined to Nevada, Florida, Michigan, and Indiana. Meanwhile, commercial mortgage delinquencies ended 2007 at near-record lows.

To understand how this housing problem developed, why it could potentially sink the global economy, and why we’re optimistic that it will be resolved with relatively little damage to the broader economic system, we need to understand its historical precedents. To do so, let’s take a quick look back to the Savings & Loan Crisis of the late 1980s. That crisis had its roots in junk bonds issued to finance leveraged-buyout activity.

When Michael Milken and his peers started the junk bond business, those bonds looked like a great deal. By selling a diversified portfolio of bonds to investors (mostly S&Ls and annuity companies), they were supposed to be providing a high-yield investment vehicle.

Theoretically, these bonds were
safe because, even though the chance of one creditor defaulting was relatively high, the chances of enough creditors defaulting to destroy the return from the total portfolio was believed to be small.

However, as the investment looked better and better, there was a demand for even more of these bonds. In order to produce a greater volume of those bonds, Milken and others funded ever more risky deals.

The whole house of cards came crumbling down when the business cycle put pressure on the cash flows of the businesses acquired with the bonds. Often these deals involved real estate speculation, particularly in the South and West. A wave of issuers defaulted, leaving the S&Ls with inadequate assets. Since the deposits the S&Ls used to purchase the bonds were Federally insured, the government had to step in to clean up the mess.

Fast-forward to the current decade. When Merrill Lynch, UBS, Bear Stearns, and others started the CDO business, those securities also looked like a great deal. By placing a wide range of home mortgages in each CDO and selling a diversified portfolio to investors — mostly institutions and governments — they were supposed to be providing a high-yield investment vehicle that was safe. Even though the chances were high that any one homeowner would default, a mass default was considered very unlikely. As with the junk bonds, the deal worked so well that there was an enormous demand for CDOs.

To fill the demand, mortgage lenders like Countrywide and Ditech began to fund ever more risky mortgages. Implicitly, lenders and those who bought the CDOs assumed that home prices would continue to rise forever.

But, as we've explained before, the long-term price of a home is tied to the cost of renting an equivalent home. The extraordinary price appreciation from 2002 to 2006, driven by out-of-control lending, resulted in an unsustainable deviation from that historical relationship. As prices rose, the median home became unaffordable to the median consumer, and demand disappeared. The inventory built up, and prices collapsed, just as the Trends editors forecast as far back as 2003.

As waves of homeowners defaulted, bond insurers and investment banking firms were left with inadequate assets. And, just as the S&L crisis boiled over into the broader economy, consumers are now worried about their net worth evaporating as equity vanishes.

Fortunately, just as in the S&L crisis, the Federal Reserve, Treasury Department, and Congress are working with the private sector to ensure that this does not result in an economic doomsday scenario.

Unfortunately, as Brian Wesbury and Robert Stein pointed out in a recent Monday Morning Outlook, the business punditry has mindlessly compared this to examples of economic meltdowns that had a totally different set of causes from today's economic woes.¹⁵

For example, the Great Depression was caused when misguided governmental policy led to a tight money supply in the 1920s. The resulting deflation pushed the dollar up, and that suggested that protectionism was the way to go. After a bout of protectionism and misguided government intervention, the economy was finally saved by the capital investment boom needed to win World War II.

Today's crisis has little, if anything, in common with the Great Depression or the stagflation of the ‘70s. On the other hand, it has much in common with the S&L crisis, and policymakers are
handling that type of situation quite effectively.

That’s why, even with all the mistakes that were made in this decade and the economic downturn we’re seeing, the most recent quarterly Anderson Forecast from the University of California at Los Angeles says we’re most likely not headed for a recession.\(^\text{16}\)

One of the main reasons — and one of the key differences between today and previous slow-downs — is that the Federal Reserve has implemented sensible, well-considered policies at each stage of the crisis. For instance, the Fed announced in March that it would be lending up to $200 billion in cash to the financial institutions that were in crisis due to the subprime mortgages and the housing slump. And, it was giving them 28 days to hold the money, as compared with the traditional overnight rate.

This is already having a positive effect on liquidity. And according to the National Association of Realtors, home sales are now on the increase. In part, that simply reflects a working marketplace. Existing home prices are down 14 percent from two years ago, when they peaked. People with the means are snapping up bargains.

This quick action by the Fed has helped change the mood on Wall Street from doom and gloom to the beginnings of optimism, which goes a long way toward putting the financial crisis behind us. You don’t have to be an expert to see that the stock market has started to rise once again, along with the dollar, while the price of gold has begun to drop.

In light of this trend, the Trends editors offer the following seven forecasts for your consideration:

**First, expect to see a wave of consolidation in the financial services industry.** The recent Bear Sterns deal was just the beginning. The banking industry is run on trust, and regulators around the world aren’t going to allow a wave of bank failures to undermine that trust. As necessary, they will take over unmarketable assets and facilitate mergers that weed out the weak players. As a result, confidence will be restored and people will recognize that their money is safe.

**Second, in an election year, the government will make every effort to devise a quick fix to the foreclosure threat.** The trick will be to avoid solutions that appeal to voters, but do more harm than good.

Some plans are better than others. Part of the trouble with financial institutions fixing the housing problem is that with CDOs no one institution owns a single given mortgage. That makes it much more difficult for a homeowner to go to his friendly bank manager and negotiate some plan to prevent a foreclosure.

One plan highlighted by The Wall Street Journal\(^\text{17}\) was formulated by Martin Feldstein, a Harvard professor and chairman of the Council of Economic Advisors under President Reagan. He suggested a government program of lending homeowners 20 percent of the value of their mortgage at an attractively low rate to reduce the potential of foreclosures. This type of plan, known as a “loan substitution program,” could have the triple benefits of:

1. Stopping the fall in housing prices
2. Reviving the credit market
3. Giving consumers the confidence to begin spending again

Third, the U.S., China, Japan, Saudi Arabia, and others will launch a quiet campaign to strengthen the dollar. The weak dollar has helped our balance of trade in goods and boosted the profits of American multinationals...
that have major earning components overseas. However, it has contributed to consumer unease, particularly as the price of oil has soared. For China, Japan, and OPEC, it has cut the value of their dollar reserves and weakened American demand for their products. In fact, the slow-growth “euro zone” is one of the few economies still benefiting from a weak dollar and still more worried about inflation than recession. Such an intervention will be most apparent in importing commodities such as oil. All other things being equal, bringing the dollar back to its 2006 relationship to the euro would drop the price of oil from around $105 per barrel to about $85.

Fed rate cuts undermined the dollar, but now that inflation has risen by 1.4 percent to reach 4.3 recently, a strong signal is being sent to the Fed that the dollar needs attention to make it more attractive overseas, as well as to improve retail sales at home and keep the stock market rally going.

The weak dollar has caused import prices to rise 13.7 percent. But the turnaround is already in the wind. The time is ripe for the Treasury to buy dollars and send a clear signal abroad, as commodity prices are now dropping.

According to a recent article in The Economist, currency buybacks can work. We won’t get everything in the economy resolved this year, but the housing and credit markets will stabilize and head for normalcy owing to aggressive policy intervention. Because a strong dollar is in the long-term interest of OPEC, Japan, and China, coordinated international efforts will restore the strength of the dollar.

Fourth, expect a strong stock market resurgence with the Dow exceeding 20,000 by the end of 2010 or early 2011. As the Trends editors highlighted in the April 2008 issue, investor confidence seemed to bottom out during the last week of March, after falling steadily since early February 2007. This is consistent with the so-called Armstrong Confidence Model, which runs on an 8.6-year cycle of peaks and declines. Going back through time, as well as forward from its formulation in the early ‘90s, the cycle provides an uncannily accurate description of investor confidence. Notable peaks occurred in 1998, before the Asian debt crisis, and again in 2000, just before the NASDAQ crash that year (and into the next). It hit bottom in October of 2002. And the most recent cycle peaked in February 2007, with a decline beginning in March 2007. The downward trend continued into this year. But, as predicted, it appears to have hit bottom in late March. Consistent with this model, the Trends editors expect to see a new all-time high before the end of this year. In fact, Brian Wesbury predicted that the DJIA would reach 15,000 by the end of 2008, an increase of 25 percent over the 12,000 it was scoring earlier this year. With all the background noise of panicky news reports concerning an “economy in free-fall,” it’s easy to forget that profits are at near-record highs. Using a conservatively high interest rate benchmark of 6 percent for the 10-year Treasury, Wesbury calculated a fair value for the Dow that lies somewhere above 15,000.
Fifth, banks will keep lending to qualified borrowers, averting a broad credit crisis. Next to the risk of foreclosures undermining consumer confidence, the biggest short-term risk is a lack of working capital lending for businesses. Fortunately, lenders are still writing loans for businesses despite the turmoil. In fact, credit is fairly easy in the areas of medical equipment and supplies, biotech, energy, agriculture, and companies that thrive on exports. According to The Kiplinger Letter, there is plenty of cash available, and smaller banks are seeing a golden opportunity to grow as larger rivals pull back. Borrowers will undergo more scrutiny, but that is as it should be. Within a two-year window, we should be back to the standard banking practices that were in effect before the subprime frenzy took hold, and ordinary, well-qualified people who wish to buy a home will do so without any undue anxiety.

Sixth, as firms realize that interest rates have bottomed, businesses and consumers who have put off investment decisions will rush to buy before rates climb. The level of economic uncertainty and the extended nature of the Fed's rate cuts have encouraged many people to stay on the sidelines. But soon they will realize that the window of opportunity is closing. With that situation now upon us, we expect the economy to deliver a surprise on the upside in the months ahead. Coupled with stabilizing home prices, lower debt service costs, and economic stimulus checks that start arriving in May, this one-time investment surge will help improve confidence at the lower end of the economy. At the same time, a rising stock market will improve confidence at the upper end. All this adds up to a positive picture for the months ahead.

Seventh, the dramatic power of globalization will deliver a major boost to this recovery. Analysts who look to historical precedents often overlook the fact that this is the first U.S. economic crisis since the rise of globalization. We’ve already seen extensive investment by foreign funds used to rescue failing financial firms. And since much of the CDO debt is held off-shore, the pain is also spread around the world. Today, the United States is just one of the players in the global economy. A financial crisis in the U.S. can be offset by gains in emerging economies, and the result will be a renewed virtuous cycle of growth.

May 2008 Trend #1
Resource List:

1. To access Brian Wesbury's and Robert Stein’s commentary on March 2008 payrolls, visit the First Trust Advisors website at: http://www.ftportfolios.com/Commentary/EconomicResearch/2008/4/4/Non-farm_payrolls_declined_80,000_in_March_

2. Ibid.

3. To access Donald Luskin’s commentary on whether or not we are in a recession, visit the SmartMoney website at: http://www.smartmoney.com/aheadofthecurve/index.cfm?story=20080404-we-are-not-in-a-recession

4. For information about the employment outlook in the 2nd quarter of 2008, visit the Manpower Inc. website at: http://www.manpower.com/investors/releasedetail.cfm?ReleaseID=298482

5. To access Brian Wesbury's and Robert Stein’s commentary on industrial production as it applies to recession, visit the First Trust Advisors website at: http://www.ftportfolios.com/Commentary/EconomicResearch/2008/3/17/February_Industrial_Production_and_Capacity_Utilization_Report
May 2008 Trend #1 (cont.)

Resource List:

6. To access Brian Wesbury’s and Robert Stein’s commentary on March industrial production, visit the First Trust Advisors website at: http://www.ftportfolios.com/Commentary/EconomicResearch/2008/4/16/Industrial_production_increased_0.3_Percent_in_March

7. To access Brian Wesbury’s and Robert Stein’s commentary on non-farm production during 2007, visit the First Trust Advisors website at: http://www.ftportfolios.com/Commentary/EconomicResearch/2008/3/5/Non-farm_productivity_increased_at_a_1.9Percent_annual_rate_in_Q4

8. To access Brian Wesbury’s and Robert Stein’s commentary on the Producer Price Index for March 2008, visit the First Trust Advisors website at: http://ftportfolios.com/Commentary/EconomicResearch/2008/4/15/The_Producer_Price_Index_PPI_increased_1.1Percent_in_March


10. To access Brian Wesbury’s and Robert Stein’s commentary on the February ISM non-manufacturing composite index, visit the First Trust Advisors website at: http://www.ftportfolios.com/Commentary/EconomicResearch/2008/3/5/ISM_Non-Manufacturing_Index_rebounded_to_49.3_in_February

11. To access Brian Wesbury’s and Robert Stein’s commentary on February existing home sales, visit the First Trust Advisors website at: http://www.ftportfolios.com/Commentary/EconomicResearch/2008/3/24/Existing_Home_Sales_increased_2.9_Percent_in_February

12. To access the Standard & Poor’s/CASE-Shiller® Home Price Indices, visit the Standard & Poor’s website at: http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,1,0,0,0,0,0,0.html

13. To access Larry Kudlow’s observations on interest rate cuts, visit the Real Clear Politics website at: http://www.realclearpolitics.com/articles/2008/03/ben_bernanke_is_my_kind_of_guy.html

14. To access the Mortgage Bankers Association report on delinquency rates for mortgage loans, visit their website at: www.mortgagebankers.org/NewsandMedia/PressCenter/60619.htm

15. To access Brian Wesbury’s and Robert Stein’s commentary on how the government is working to stabilize the economy, visit the First Trust Advisors website at: http://www.ftportfolios.com/Commentary/EconomicResearch/2008/3/24/Government_Failure,_Or_Market_Failure?

16. To access the UCLA Anderson Forecast, visit their website at: http://uclaforecast.com/contents/archive/media_3_08_1.asp


18. The Economist, March 27, 2008, “Divine Intervention.” © Copyright 2008 by The Economist Newspaper and The Economist Group. All rights reserved.

19. To find out why Brian Wesbury and Robert Stein feel the Dow will reach 15,000, visit the First Trust Advisors website at: http://ftportfolios.com/Commentary/EconomicResearch/2008/4/7/Still_at_Dow_15000

20. The Kiplinger Letter, April 2, 2008, “Credit Crunch? Not for Most Firms,” by Jerome Iadaszak. © Copyright 2008 by The Kiplinger Washington Editors, Inc. All rights reserved.