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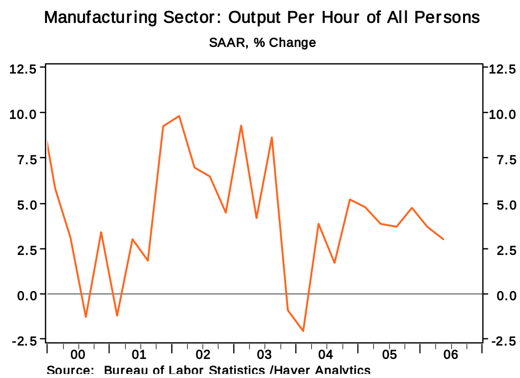
Data Watch

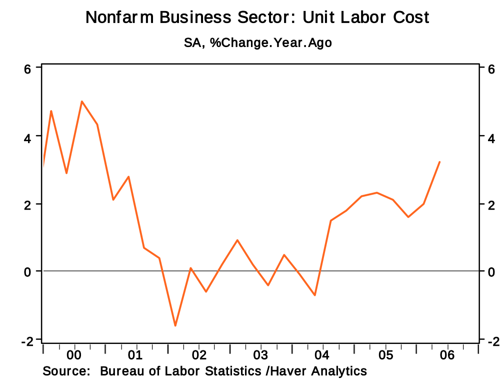
August 8, 2006 • 630.322.7756 • http://www.ftportfolios.com

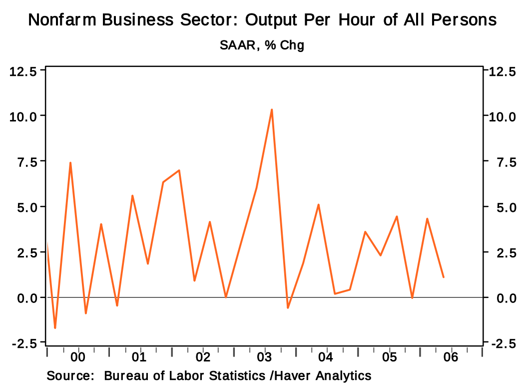
Q2 Productivity

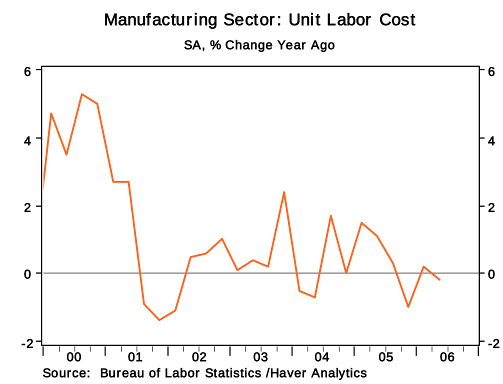
Brian S. Wesbury
Chief Economist
Bill Mulvihill
Senior Economist

- Following the pattern in GDP data, non-farm productivity slowed to a 1.1% annualized growth rate in the second quarter after a barn-burner Q1 growth rate of 4.3%. Non-farm productivity is up 2.4% in the past year.
- Manufacturing productivity continues to outpace the gains in other sectors, and grew an annualized 3.0% in Q2. Manufacturers have increased productivity by 3.8% in the past year as they adapt their business models to utilize new technology and compete in a global economy.
- As forewarned by revisions in income data, non-farm unit labor costs increased by 4.2% at an annual rate in Q206.









Implications: A slowdown in output caused non-farm productivity growth to pull back to a 1.1% annualized growth rate in Q2. While this is well below the 4.3% growth in Q1, the long term-trend remains strong. In the past five years, non-farm productivity has increased 3.1% at an annual rate, significantly higher than the 30-year average growth rate of 1.9%. The ability of US companies to produce more with less is the secret sauce that allows profits to grow despite rising energy prices, higher interest rates and more rapid growth in compensation. Nonetheless, today's data show large gains in unit labor costs, which increased an annualized 4.2% in Q2 and are up 3.2% in the past year - the fastest YOY gain since 2000. While some are suggesting that slower growth in productivity and rising unit labor costs signal stagflation, we do not believe that this is a correct assessment of the current situation. Yes, inflation is rising and this is beginning to push up wages, but the recent moderation in growth is transitory because Fed policy is not restrictive. While proliferating signs of inflation should push the Fed to tighten, a pause appears imminent because the Fed is basing its decisions on a forecast of slower growth that it believes will eventually tame inflation.

Productivity and Costs *(% Change, All Data Seasonally Adjusted)*	**Q2-06**	**Q1-06**	**Q4-05**	**Q3-05**	**YOY %** **(Q2-06/Q2-05)**	**Prior YOY %** **(Q2-05/Q204)**
Nonfarm Productivity	**1.1**	4.3	-0.1	4.4	2.4	2.2
- Output	**2.5**	6.7	1.8	4.9	3.9	4.1
- Hours	**1.4**	2.3	1.8	0.4	1.5	1.9
- Compensation	**5.4**	6.9	2.9	7.8	5.7	4.0
- Unit Labor Costs	**4.2**	2.5	3.0	3.3	3.2	1.8
Manufacturing Productivity	**3.0**	3.7	4.7	3.7	3.8	4.5
- Output	**5.4**	5.8	9.4	2.6	5.8	5.5
- Hours	**2.3**	2.0	4.6	-1.0	1.9	1.0
- Compensation	**1.7**	5.2	0.5	7.1	3.6	2.1
- Unit Labor Costs	**-1.2**	1.4	-4.0	3.2	-0.2	-2.2
Durable Goods Productivity	**3.8**	3.8	9.9	6.5	6.0	5.0
Nondurable Goods Productivity	**2.6**	3.2	-1.9	0.7	1.1	4.5

Source: US Department of Labor