**Productivity, Profits Strong, Stocks Making New Highs**

The S&P 500 hit a five and one-half year high last week. The NASDAQ is less than 4% from 5-year highs and the Dow Jones Industrial Average is within one good day of a new all-time high.

This was not supposed to happen. Many investors and analysts had become convinced that the US economy was built on sand – given one good storm it would crumble into a pile of rubble that would finally expose its obvious weaknesses.

But the economy is not cooperating with this pessimistic view. After many great calamities the economy is still standing. The reason for this is simple – productivity is booming.

In the past five years, non-financial corporate productivity has climbed at a 4% annualized rate, and is up 4.8% in the past year. Robust productivity growth is a strong foundation that holds up the economy despite strong storms.

It is one of the key reasons corporate profits have been so strong. After-tax corporate profits, as measured by the Bureau of Economic Analysis, have doubled since the market peak in 2000.

But stock prices have clearly not kept pace. Our capitalized profits models continue to signal that the broad US equity market remains 30% undervalued. As a result, recent strength in stock prices is not all that surprising.

Neither is better-than-expected economic news. Housing market data suggested that the sector may be finding a bottom after declining sharply in recent months. Consumer confidence, initial claims, and the Chicago Purchasing Managers’ Survey all signaled that the economy retains its forward momentum, and our models put third quarter real GDP growth at 3% or slightly above.

This week's data should continue this trend. The National ISM manufacturing and non-manufacturing indices likely signaled continued growth in September, while job growth was relatively strong and wage growth continued to accelerate.

Evidence that the economy is not slowing down significantly could be a problem for stocks. Perversely, a weaker economy has helped the stock market in recent months – the belief that the Fed will cut interest rates has been part of the reason that equities markets have improved.

As a result, our forecast that the Fed is not yet done hiking interest rates suggests that there will be some indigestion when this realization finally dawns on the market as a whole. But this should not be a long-term problem.

The real long-term problem is inflation. By not pushing rates to neutral (which we still estimate at 6%), price pressures could become even a bigger negative. It’s not Goldilocks yet, but the US economy has more good things going for it than bad.

**Week of October 9, 2006**

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