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FIRST Trust ADVISORS L.P.

Dec. 18 2006

Monday Morning Outlook

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-19 / 7:30 am	Nov PPI	+0.4%	**+0.3%**		-1.6%
7:30 am	Nov "core" PPI	+0.2%	**+0.3%**		-0.9%
7:30 am	Nov Housing Starts	+1.54M	**+1.58M**		+1.486M
12-21 / 7:30 am	Final Q3 GDP	+2.2%	**+2.2%**		+2.2%
7:30 am	Final Q3 Chain Price Index	+1.8%	**+1.8%**		+1.8%
7:30 am	Initial Claims - Dec 22	+315K	**+306K**		+304K
9:00 am	Nov Leading Indicators	+0.0%	**+0.0%**		+0.2%
11:00 am	Philadelphia Fed Index	+4.0	**+9.3**		+5.1
12-22 / 7:30 am	Nov Durable Goods Orders	+1.3%	**+3.2%**		-8.2%
7:30 am	Nov Personal Income	+0.4%	**+0.6%**		+0.4%
7:30 am	Nov Personal Consumption	+0.5%	**+0.7%**		+0.2%

Is it Goldilocks, or Not?

Despite a strong stock market, the current US economic recovery still faces the same skepticism it experienced from its very first day. The pessimists remain convinced that the economy is in trouble. They view the trade deficit, budget deficit, housing bubble, low savings rate, weak incomes, rising interest rates and a huge increase in energy prices as poisonous.

Some of this pessimism has taken the shape of very depressing long-term forecasts, such as Bill Gross's *Dow 5000* prediction back in September 2002. But most of the dour forecasts have settled on some sort of ongoing economic problems caused by an over-indebted consumer, a loss of US competitiveness or a weak dollar.

Average real GDP growth of just 2.4% in Q2 and Q3 encouraged the pessimists to become even more so, while an inversion in the yield curve has convinced many that the Fed has gone too far and a serious slowdown in growth (or possibly a recession) is virtually guaranteed. These forecasters think the stock market is wrong and the bond market is right.

Others have looked at recent data and decided that Goldilocks has arrived – that both the stock market and bond market are correctly seeing the future. In this scenario, even though the Fed has gone too far, a few rate cuts next year and all will be well. In other words, the Fed has engineered a perfect soft landing that brought inflation under control without throwing the economy into recession.

There is a third view, which is held by a clear minority of forecasters. In this view, the recent weakness in economic data is not a function of tight money, and the inverted yield curve does not indicate that the Fed has gone too far.

In fact, the economic slowdown over the spring and summer reflects blowback from excessively loose monetary policy following 9/11. By driving interest rates to 1%, the Fed encouraged a housing market boom, while 0% financing from auto companies stole sales from the future. With interest rates now back to more normal levels, these sectors are reverting to trend. Unlike previous cycles, the current contraction in housing and autos is not due to tight money, nor is it a harbinger of overall economic weakness.

In fact, after a few months of sub-par growth, the economy appears to have rebounded sharply in November, with retail sales, employment and most purchasing managers' surveys all reflecting stronger growth ahead. The Dow is nearing 12,500 for the first time, and the S&P 500 is up 16.6% since mid-June, finishing last week at 1427 – a new six-year high.

This still leaves the conundrum of the bond market. The 10-year Treasury bond yield is near 4.6%. At a tax rate of 35%, the after-tax yield is roughly 3.0%, and after subtracting the past year's "core" CPI (which is 2.6%), the real-after-tax yield is 0.4%. This is a very low take-home yield and suggests that the bond market expects slow growth, falling inflation, Fed rate cuts, or some combination of these developments.

This is not our view. Our models view Fed policy as still accommodative, and forecast economic growth and "core" inflation both near 3.5% next year. As a result, we continue to see the stock market as undervalued and the bond market as overvalued. Call it Goldilocks with some rising inflation.

Week of December 25, 2006

12-27 / 9:00 am	Nov New Home Sales	+1.02M	**+1.00M**		+1.004M
12-28 / 9:00 am	Nov Existing Home Sales	+6.18M	**+6.20M**		+6.241M
9:00 am	Dec Chicago PMI	+51.3	**+52.4**		+49.9

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