FIRST Trust ADVISORS L.P.

Monday Morning Outlook

March 6, 2006 • 630.322.7756 • http://www.ftportfolios.com

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-6 / 9:00 am	Jan Factory Orders	-6.0%	-5.0%	**-4.5%**	+1.6% - r
3-7 / 7:30 am	Q4 Productivity: Revised	-0.3%	-0.1%		-0.6%
	Q4 Unit Labor Costs	+3.1%	+3.0%		+3.5%
3-9 / 7:30 am	Jan International Trade	-$67.0B	-$66.4B		-$65.7B
	Initial Unemployment Claims	290K	285K		285K
3-10 / 7:30 am	Feb Non-Farm Payrolls	+185K	+250K		+193K
	Feb Manufacturing Payrolls	+7K	+15K		+7K
	Feb Unemployment Rate	4.7%	4.7%		4.7%
	Feb Average Hourly Earnings	+0.5%	+0.4%		+0.4%
	Feb Weekly Hours	33.8	33.8		33.8

Are Bonds Finally Recognizing Reality?

Treasury bonds are having a rough go of it, with yields rising across the curve. Last week, the 10-Treasury bond yield jumped to 4.68% (this morning 4.71%), its highest level since June 2004 when the Fed first hiked interest rates. The 2-year yield increased to 4.75% (4.76% this morning).

Just a little over a week ago, the Treasury yield curve was inverted by 15 basis points from the 2-year to the 10-year. This morning, this inversion had narrowed to just 5 basis points.

This was not supposed to happen. Conventional wisdom believed that a flat or inverted yield curve signaled a slower economy, falling inflation and an end to Fed rate hikes.

Starting with the very first Fed rate hike in 2004, the markets have consistently underestimated the true extent of Fed tightening. It's as if the markets forgot that the federal funds rate was only pushed to 1% in order to fight deflation. And with every rate hike, expectations of a slower economy have built.

But, nominal GDP growth has accelerated consistently in the past three years, the unemployment rate has fallen to 4.7% and real GDP growth should be north of 5% in the first quarter. Commodity prices (including gold) are up sharply, and inflation has climbed as well. Given historical norms, the federal funds rate is still below our estimate of neutral – somewhere between 5.5% and 6.0%.

The bond markets have never believed this, and have always felt that the Fed would stop tightening somewhere south of 5%. Markets have also believed that the European and Japanese Central Banks would keep rates low. When the "carry trade" (borrowing short and buying long) stopped working in the US as the yield curve flattened, hedge funds started borrowing at lower rates overseas to buy long-term US bonds. With the ECB raising rates and Japanese inflation on the rise, this trade is becoming more uncertain and is being unwound.

Accommodative central banks and the "carry trade" have caused very low real US long-term rates. The real 10-year Treasury yield (calculated using the overall CPI) has fallen consistently since the late 1990s. Between 1990 and 1999, the average real 10-year Treasury yield was 3.66%. In the past three years the average real yield has fallen to 1.39%, and over the past 12 months it has averaged just 84 basis points.

Real yields this low mean one of three things – the market expects inflation to fall, it expects real growth and productivity to slow sharply, or yields have been pulled lower by accommodative Fed policy. We believe in the third reason. As this error becomes more visible, and the Fed continues to tighten, long-term rates should move higher. We expect the 10-year Treasury yield to reach 6% by year-end 2006.

Week of March 13, 2006

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-14 / 7:30 am	Jan Business Inventories	+0.4%	+0.3%		+0.7%
	Feb Retail Sales	-0.8%	-1.0%		+2.3%
	Feb Retail Sales Ex Autos	-0.6%	-0.4%		+2.2%
3-15 / 7:30 am	Mar Empire State Mfg Survey	19.0	19.0		20.3
	Feb Import Prices	-0.4%	-1.0%		+1.3%
	Feb Export Prices	+0.1%	+0.4%		+0.7%
3-16 / 7:30 am	Feb CPI	+0.2%	+0.1%		+0.7%
	Feb "Core" CPI	+0.2%	+0.3%		+0.2%
	Feb Housing Starts	2.00M	2.10M		2.28M
11:00 am	Mar Philly Fed Survey	13.0	16.0		16.0
3-17 / 8:15 am	Feb Industrial Production	+0.8%	+0.7%		-0.2%
	Feb Capacity Utilization	81.5%	81.4%		80.9%

Brian S. Wesbury: Chief Economist **Bill Mulvihill: Senior Economist**

Consensus forecasts come from Insight Economics, LLC