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FIRST Trust ADVISORS L.P.

May 15, 2006

Monday Morning Outlook

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-15 / 7:30 am	May NY Fed Mfg Survey	16.8	17.0	**12.4**	15.8
5-16 / 7:30 am	Apr Housing Starts	1.95M	2.00M		1.96M
	Apr PPI	+0.8%	+1.0%		+0.5%
	Apr "Core" PPI	+0.2%	+0.3%		+0.1%
8:15 am	Apr Industrial Production	+0.5%	+0.5%		+0.6%
	Apr Capacity Utilization	81.5%	81.6%		81.3%
5-17 / 7:30 am	Apr CPI	+0.3%	+0.5%		+0.4%
	Apr "Core" CPI	+0.2%	+0.3%		+0.3%
5-18 / 7:30 am	Initial Unemployment Claims	315K	300K		324K
9:00 am	Apr Leading Indicators	+0.1%	+0.2%		-0.1%
11:00 am	May Philadelphia Fed Survey	13.5	15		13.2

Pausing Now Would Be a Mistake

Before the Federal Open Market Committee (FOMC) meeting last Wednesday the conventional wisdom held that the market was looking for signs of a pause in Fed rate hikes. Any whisper to that effect was supposed to be good for equities.

Well the market got more than a whisper, it got a scream. By adding the word "yet" to the phrase "further policy tightening may *yet* be needed," the Fed was signaling that, at least for the immediate future, it had pushed the pause button. Fed models predict an economic slowdown this year. If correct, any further tightening is not needed.

But, instead of cheering, the equity market let out a long and loud "boo." Since the FOMC statement was released, the S&P 500 is down 2.3% and the S&P 600 small-cap index is down 5.0%. It seems clear that the conventional wisdom about the markets desire for rate hikes to end was wrong.

There is an old saying that "as long as the Fed is worried about inflation, the market does not have to be, but when the Fed is not worried about inflation, the market should be." Since the Fed began hinting of a pause, gold hit a 25-year high, the 10-year Treasury bond rose to a 4-year high, and the dollar fell to a 12-month low. Moreover, the spread between 2-year and 10-year Treasury bond yields widened to 20 basis points, a 6-month high.

Each of these market-based indicators signals inflationary pressures. The fact that they made these dramatic moves after the Fed signaled a pause suggests a widespread concern that the Fed is behind the curve. Our models concur, and estimate that the "neutral" federal funds rate is between 5.5% and 6.0%.

The problem is that if the Fed pauses now, it will stop too soon and fall further behind the curve. The longer the Fed takes to reach neutral, the higher it will eventually have to hike rates and the greater the probability that it will have to overshoot neutral in order to get inflation under control. This would negate any chance for a "soft landing" and increase the odds of a sharp slowdown in growth. This would not be good for equity markets and is likely the reason behind the recent sell-off.

The good news is that the market has overreacted and we remain relatively sanguine about Fed policy. The benefits of the 2003 tax cut (which pending the President's signature, will be extended through 2010 this week) will keep economic activity strong. In addition, because Fed policy works with a long lag, statistical measures of inflation will remain elevated for at least the next 12 months.

Fed models, because they are based on demand-side theory, are usually wrong. There will be no slowdown this year and a data dependent Fed will be forced to keep hiking. We expect the Fed to lift the fed funds rate to 5.75% by year even though there are many FOMC members who disagree. The data will lead the way.

If the Fed can get rates to neutral in 2006, commodity prices will top out and the dollar will find some footing. These signals are necessary before a pause. As this occurs, the markets will know that the Fed is serious about preventing inflation and will avoid the normal mistake of overshooting. In other words, not pausing, and continuing to move toward neutral, would actually be a positive for the US equity markets.

Week of May 22, 2006

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-24 / 7:30 am	Apr Durable Goods	-0.3%	+1.5%		+4.8%
9:00 am	Apr New Home Sales	1.16M	1.20M		1.21M
5-25 / 7:30 am	Q1 Real GDP: Preliminary	+5.9%	+5.5%		+4.8%
	Q1 GDP Price Index: Preliminary	+3.3%	+3.3%		+3.3%
9:00 am	Apr Existing Home Sales	6.75M	6.90M		6.92M
5-26 / 7:30 am	Apr Personal Income	+0.7%	+0.8%		+0.5%
	Apr Personal Consumption	+0.7%	+0.4%		+0.6%

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