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May 22, 2006

## Monday Morning Outlook

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Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-24 / 7:30 am	Apr Durable Goods	-0.5%	+1.0%		+6.5%
9:00 am	Apr New Home Sales	1.15M	1.15M		1.21M
5-25 / 7:30 am	Q1 Real GDP: Preliminary	+5.8%	+6.0%		+4.8%
	Q1 GDP Price Index: Preliminary	+3.3%	+3.3%		+3.3%
	Initial Unemployment Claims	315K	310K		367K
9:00 am	Apr Existing Home Sales	6.79M	6.90M		6.92N
5-26 / 7:30 am	Apr Personal Income	+0.7%	+0.8%		+0.5%
	Apr Personal Consumption	+0.6%	+0.6%		+0.6%

## **Stagflation Fears Create Buying Opportunity**

The conventional wisdom (CW) is almost always wrong every once in awhile it gets lucky. Take the economy, for example. For the past three years, the CW has forecast its demise; that rising oil prices, rate hikes, a housing bubble, the trade deficit, consumer debt, hurricanes, the budget deficit or bird flu would undermine growth.

At the same time, the CW was sanguine about inflation. It has been widely predicted that booming productivity and globalization could hold back inflation forever. Rising commodity prices were also not taken seriously because "commodities make up such a small part of total spending and the US is becoming a service economy."

Growth, of course, has defied the CW. Real GDP has expanded at a 3.8% average annual rate for the past three years, the unemployment rate has fallen to 4.7%, and federal tax revenues are growing at strong double digit rates.

It has been a long slow process, but inflation has now risen to levels that hardly anyone can ignore. In April, the "core" consumer price index jumped by a larger-than-expected 0.3% for the second month in a row. The 3-month annualized change has climbed to 3.2%, its fastest growth in 10 years, while the 6-month annualized change is 2.8%. "Core" inflation is rising faster today than it was in 1999 and 2000 when the Fed was worried about inflation and lifted the federal funds rate to 6.5%.

The CW about inflation and growth has been wrong. But, with so much pessimism in the air, the major business press has Week of May 29, 2006

quickly shifted to accepting the rise in inflation, while remaining pessimistic about growth. The CW is fretting about stagflation and thinks Chairman Bernanke faces a serious dilemma – hike rates and risk a recession or don't hike rates and risk inflation.

This, however, is a false choice. The economy is doing well for reasons having nothing to do with the Fed. Technological advances and lower tax rates have combined to boost investment and productivity. Non-financial sector corporate productivity is advancing at a record-setting pace, profits are booming, employment growth is strong, and wages are growing faster than inflation. The US economy is in the midst of a robust, and sustainable, recovery.

We continue to believe that a neutral federal funds rate is between 5.5% and 6.0%. Lifting rates into this zone would cause inflation to moderate without harming the economy. Not hiking at this juncture would be the biggest mistake and could create the stagflation that the CW fears. High inflation undermines growth and increases the probability of Fed mistakes.

We are not at this point yet. Clearly, the Fed is closer to the end of tightening than to the beginning. That means uncertainty has increased. But the extent of the pessimism is not warranted. We view the recent sell-off in equities due to fears of Fed mistakes (and the widening scandal of back-dating options) as a buying opportunity for equity investors.

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-31 / 9:00 am	May Chicago PMI	57.0	57.0		57.2
6-1 / 7:30 am	Q1 Productivity: Revised	+4.2%	+4.2%		+3.2%
	Q1 Unit Labor Costs	+1.5%	+1.8%		+2.5%
9:00 am	Apr Construction Spending	+0.2%	+0.4%		+0.9%
	May ISM Index	56.0	56.5		57.3
Sometime During	May Domestic Auto Sales	5.5M	5.6M		5.6M
the Day	May Domestic Light Truck Sales	7.1M	7.1M		7.2M
6-2 / 7:30 am	May Non-Farm Payrolls	+175K	+215K		+138K
	May Unemployment Rate	4.7%	4.7%		4.7%
	May Average Hourly Earnings	+0.3%	+0.3%		+0.5%
9:00 am	Apr Factory Orders	+0.6%	+0.5%		+4.2%
Brian S. Wesbury; Chief Economist				Bill Mulvihill; Senior Economist	

## Brian S. Wesbury; Chief Economist

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.