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FIRST Trust ADVISORS L.P.

June 5, 2006

# Monday Morning Outlook

| Date/Time (CDT) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 6-5 / 9:00 am | May ISM Non Mfg Index | 60.0 | 61.0 | | 63.0 |
| 6-8 / 7:30 am | Initial Unemployment Claims | 330K | 320K | | 336K |
| 6-9 / 7:30 am | May Import Prices | +0.6 | +0.8% | | +2.1% |
| | May Export Prices | +0.3% | +0.3% | | +0.5% |
| | Apr Trade Balance | -$65.0 | -$64.0B | | -$62.0B |

**It's Not the Eighth Inning Yet**

Since the beginning of the Fed's current rate hiking campaign there have been many in the market who have felt the next rate hike would be the end. Last June, Dallas Fed President Richard Fisher said the Fed was in the "eighth inning" of rate hikes. This statement set off a frenzy of trading because there were many who felt that the Fed had already done enough. Since then, the Fed has hiked rates eight times.

Lately, expectations of a "pause" have increased once again. Even Fed staff models are predicting a slowdown in the economy due to the lagged impact of past rate hikes. Others view the cumulative impact of 16 rate hikes and a five-fold increase in interest rates (from 1% to 5%) as damaging to the economy even if rates have not reached neutral.

Evidence of a slowdown in the economy is most obvious in the housing market. From their peaks, housing starts are down 18.4%, new home sales are down 12.4%, and pending home sales have fallen 12.8%.

While this is an important piece of evidence, housing is not the leading indicator of economic activity it once was. For example, housing remained robust throughout the 2001 recession. Part of the reason for this strength was the 1997 capital gains tax cut – which allows up to $500,000 in tax-free gains per couple every two years. The boom caused by the tax cut became frothy between 2001 and 2004 when the Fed cut rates to 50-year lows in an attempt to fight deflation, and again when the Fed lifted rates as investors accelerated activity to borrow before rates increased. We are not believers in a "housing bubble," but we do believe housing was pushed to its recent heights by extraordinary circumstances – 1% interest rates are not normal.

Now, however, rates have moved up enough to reduce demand to more normal levels. Despite the recent sharp declines, housing activity remains above levels of the dot.com era. Housing starts are still 12.3% higher than they were in 1999, existing home sales are 30.7% higher, and new home sales are 36.3% higher. Housing may slow down, but it is unlikely to collapse unless the economy falls into recession.

But, the probability of a recession is very low. Monetary policy is not tight, it is just less loose. While rising interest rates may cause a slowdown in some sectors (such as housing), which were boosted by the accommodative stance of Fed policy, they are not yet high enough to cause a recession or contain inflation.

As a result, we are skeptical that the May employment data signals a serious slowdown in the labor market or the overall economy. While non-farm payrolls increased by a less-than-expected 75,000 in May, the Household Survey (which has been a more accurate measure of labor market strength for the past three years) reported a 288,000 increase in jobs during May and is up 2.5 million in the past year. The unemployment rate is at a post-recession low of 4.6%, and while average hourly earnings increased by just 0.1% in May, they increased by 0.6% in April, and are up 4.2% at an annual rate in the past six months.

The job market is still strong and wages are rising faster than inflation. Despite the willingness of the market to believe that any apparent weakness in the data is a clear sign of an economic slowdown and justification for the Fed to stop hiking rates, our models suggest that the Fed has not yet reached neutral. Call it the seventh inning. Rates should, and most likely will, continue to rise, while the economy continues to grow strongly.

***Week of June 12, 2006***

| Date/Time (CDT) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 6-13 / 7:30 am | Apr Business Inventories | +0.5% | +0.4% | | +0.7% |
| | May PPI | +0.5% | +0.6% | | +0.9% |
| | May "Core" PPI | +0.2% | +0.3% | | +0.1% |
| | May Retail Sales | +0.1% | 0.0% | | +0.5% |
| | May Retail Sales Ex Autos | +0.5% | +0.5% | | +0.7% |
| 6-14 / 7:30 am | May CPI | +0.4% | +0.4% | | +0.6% |
| | May "Core" CPI | +0.2% | +0.3% | | +0.3% |
| 6-15 / 7:30 am | Jun NY Fed Survey | 13.5 | 13.0 | | 12.4 |
| 8:15 am | May Industrial Production | +0.2% | +0.1% | | +0.8% |
| | May Capacity Utilization | 82.0% | 82.0% | | 81.9% |

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