630-322-7756
www.ftportfolios.com

FIRST Trust ADVISORS L.P.

Aug 7, 2006

Monday Morning Outlook

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-8 / 9:00 am	Q2 Productivity: Preliminary	+1.0%	+1.2%		+3.7%
	Q2 Unit Labor Cots: Preliminary	+3.6%	+3.8%		+1.6%
1:15 pm	FOMC Meeting	5.25%	5.25%		5.25%
8-10 / 7:30 am	Jun Trade Balance	-$64.4B	-$64.0B		-$63.8B
	Initial Unemployment Claims	315K	305K		315K
8-11 / 7:30 am	Jul Import Prices	+0.8%	+0.6%		+0.1%
	Jul Export Prices	+0.5%	+0.4%		+0.8%
	Jul Retail Sales	+0.8%	+1.0%		-0.1%
	Jul Retail Sales Ex Autos	+0.5%	+0.6%		+0.3%

Monday Morning Fed Watching

Reading the tea leaves is not all that hard. The Fed said it thought the economy was slowing down, key GDP and employment data complied and futures markets have priced in a pause. As this happened, the Fed remained silent and allowed perceptions of a pause to build. Chairman Bernanke's public credibility is not at risk. Conventional wisdom wants a pause, and while we continue to forecast a robust economy in the year ahead, there is enough weaker-than-expected data to allow those who think the economy is slowing to claim victory. We estimate that ***the probability of a pause at tomorrow's FOMC meeting is roughly 95%.***

The bond market likes the idea of a pause. The 10-year Treasury yield has fallen to 4.88%, which is 37-basis-points below the federal funds rate – the deepest inversion of the yield curve since the first quarter of 2001. The stock market is not so sure. The Dow Jones Industrial Average jumped over 90 points on Friday on the heels of the July employment data but faded as the day progressed and ended slightly in the red. It is down again today. Gold and other commodity prices are up, while the dollar has weakened significantly.

There are four categories of opinion about a pause. First, it's too late; the Fed has already gone too far and will need to cut rates next year, if not sooner. Second, it's the right thing; Chairman Bernanke may actually achieve the elusive and perfect soft-landing. Third, it doesn't really matter; the Fed will be need to tighten again anyway and a pause now won't cause that much more inflation. Fourth, it's a big mistake; the Fed is kneeling at the feet of the Phillips Curve, ignoring gold and the dollar, and is falling so far behind the curve that it will have to overshoot next year to contain inflation. To this final group, tomorrow is "judgment day."

We find ourselves somewhere between the third and fourth explanations. If the Fed does pause it will be doing so based on a Phillips Curve approach to monetary policy. The Phillips Curve says that the higher the unemployment rate, the lower the rate of inflation. As a result, because the Fed thinks the economy is slowing, it also believes that inflation will fall.

This isn't your father's "Monday-morning quarterbacking," – when fans second-guess after the game is over. Monday-morning Fed watchers complain before the Fed actually does anything, sometimes during the game, but rarely do they think about the past. That's unfortunate. If they did, they would realize that the Phillips Curve always gets it wrong. In the late 1990s, the unemployment rate fell to 30-year lows, yet inflation remained subdued. In the late 1970s, unemployment rose sharply and inflation climbed higher anyway. A retrospective look at these time periods makes it clear that signals coming from commodity prices and the dollar are much better indicators of inflation than the unemployment rate or GDP growth.

Gold, oil and industrial commodity prices remain elevated despite perceptions of a slowing US economy. In addition, the dollar has fallen more than 10% against the Euro since mid-November 2005. This market action signals that monetary policy is still accommodative. Our models suggest that a "neutral" federal funds rate is 6% in 2006. If the Fed pauses too long, the neutral rate will rise even more. We estimate that in 2007 the neutral rate will rise by 25 basis points each quarter that the Fed remains accommodative – to 7% by the end of next year. As a result, while tomorrow is not "judgment day" in our minds, the Fed is closer to making a serious inflationary mistake than most investors understand.

Week of August 14, 2006

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-15 / 7:30 am	Jul PPI	+0.3%	+0.4%		+0.5%
	Jul "Core" PPI	+0.2%	+0.3%		+0.2%
8-16 / 7:30 am	Jul CPI	+0.3%	+0.3%		+0.2%
	Jul "Core" CPI	+0.2%	+0.3%		+0.3%
	Jul Housing Starts	1.85M	1.85M		1.85M
8:15 am	Jul Industrial Production	+0.4%	+0.6%		+0.8%
	Jul Capacity Utilization	82.6%	82.7%		82.4%

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