630-322-7756
www.ftportfolios.com

FIRST Trust ADVISORS L.P.

Sep 11, 2006

Monday Morning Outlook

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-14 / 7:30 am	Aug Import Prices	-0.2%	-1.0%		+0.9%
	Aug Export Prices	+0.3%	+0.2%		+0.4%
	Aug Retail Sales	-0.2%	-0.3%		+1.4%
	Aug Retail Sales Ex Autos	+0.3%	+0.4%		1.0%
	Initial Unemployment Claims	315K	305K		310K
9-15 / 7:30 am	Aug CPI	+0.2%	+0.1%		+0.4%
	Aug "Core" CPI	+0.2%	+0.3%		+0.2%
	Sep NY Fed Survey	13.5	12.3		10.3
8:15 am	Aug Industrial Production	+0.3%	+0.2%		+0.4%
	Aug Capacity Utilization	82.5%	82.5%		82.4%

Commodities Drop, But Inflation Still Here

Because lags between changes in Fed policy and overall inflation can take up to two years, understanding today requires us to step back in time. The story begins in 1999, when the Fed feared that high stock prices and an overheating economy were inflationary.

This view was mistaken for two reasons. First, growth does not cause inflation. With commodity prices low, and falling, in the late 1990s the Fed should not have fretted that policy was too easy.

Secondly, Y2K caused the Fed and markets some confusion. Massive demand for high-tech equipment and software boosted spending above trend. Investors priced into many high-tech stocks ongoing growth rates in sales of 50% or 60%, while the Fed made the assumption that this growth, and some pricing pressures that it created, were permanent.

Between June 1999 and June 2000, the Fed hiked the federal funds rate from 4.75% to 6.5%. The real federal funds rate peaked at 4.0% - a very tight policy. This mistake caused deflation, recession and a collapse in the stock market.

The Fed reacted to this by cutting interest rates 11 times in 2001 (three of these cuts were in between meetings). In 2002, then Fed Governor, Ben Bernanke gave his famous speech about fighting deflation by dropping money out of helicopters. The Fed eventually cut the federal funds rate to 1%, and real rates fell to lows not seen since the 1970s – the Fed had gone too far in the other direction.

Commodity prices immediately started to rise, and for many years the increases remained on a steady upward trend. For example, silver traded near $4/oz. at the end of 2001 and $7/oz. in mid-2005. Gold rose from $255/oz. top $430/oz during this same time period. Easy money was causing a depreciation of the dollar relative to commodities. Oil prices moved up steadily as well.

Then, in mid-2005, as Alan Greenspan became more of a lame duck, the commodity markets got red hot. Even though the Fed was still hiking rates, gold shot above $700/oz., silver surged to more than $14/oz., and oil pushed over $75/bbl. Many analysts blamed these surges on Chinese demand, but almost every market had record speculative activity. Despite our belief that inflation was on the rise, these price increases appeared out of line with reality. Commodity markets were overvalued.

Lately, this mini-bubble in commodity prices has started to collapse. Oil futures prices have plummeted from $77/bbl. to $65/bbl. in just over a month. Gasoline prices have fallen as well. In the past three days, silver prices have collapsed by 15%, while gold is down by $50/oz.

Does this mean inflation is dead? No. These movements in commodity prices are more speculative than real. While commodity markets are fabulous indicators of excess liquidity, the day-to-day or month-to-month movements can be misleading. When we stand back, and look at these markets over a five-year period, the inflationary signal they are sending is very clear.

Broader measures of inflation have corroborated these signals. The CPI and "core" CPI, the PCE deflator and the Cleveland Fed's median CPI (a measure designed to reduce the impact of one or two rapidly appreciating prices – like oil) are all showing rising inflationary pressures. This median CPI tells us that inflation is more broadly based than just energy or housing.

The real federal funds rate remains low relative to inflation and nominal GDP, and by these traditional measures it appears that the Fed has not yet reached neutral. As a result, our models continue to forecast rising inflationary pressures. Moreover, the recent drop in commodity prices is not a signal of Fed tightness, but instead a sign of panicked speculators. While the Fed is not as easy as it once was, it is still not tight. Inflationary pressures are still alive and well.

Week of September 18, 2006

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-19 / 7:30 am	Aug PPI	+0.3%	0.0%		+0.1%
	Aug "Core" PPI	0.2%	+0.3%		-0.3%
	Aug Housing Starts	1.77M	1.78M		1.80M
9-20 / 1:15pm	FOMC Meeting	5.25%	5.25%		5.25%
9-21 / 11:00 am	Sep Philly Fed Survey	14.9	16.0		18.5

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