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First Trust Advisors L.P.

Jan. 15 2007

Monday Morning Outlook

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-16 / 7:30 am	Empire State Mfg. Index	20.0	**25.0**		23.1
1-17 / 7:30 am	PPI - Dec	+0.5%	**+0.6%**		+2.0%
7:30 am	"Core" PPI - Dec	+0.1%	**+0.2%**		+1.3%
8:15 am	Industrial Production - Dec	+0.1%	**+0.1%**		+0.2%
8:15 am	Capacity Utilization - Dec	+81.7%	**+81.7%**		+81.8%
1-18 / 7:30 am	CPI - Dec	+0.5%	**+0.4%**		+0.0%
7:30 am	"Core" CPI - Dec	+0.2%	**+0.3%**		+0.0%
7:30 am	Housing Starts - Dec	1.563 Mil	**1.569 Mil**		1.588 Mil
9:00 am	Leading Indicators - Dec	+0.1%	**+0.2%**		+0.1%
11:00 am	Philadelphia Fed Survey	2.5	**2.0**		-4.3

Don't Worry About the Inverted Yield Curve

For almost four years, a pessimistic pall has generated forecasts and press reports suggesting that the economy is due for a substantial slowdown, perhaps even a recession. Some of these forecasts finger the "housing bubble," oil prices, or debt loads as the catalyst. But, lately, the number one crutch of the pessimists is an "inverted yield curve" – the fact that short-term interest rates are higher than long-term rates.

On one point, the pessimists are right: the yield curve has inverted before every recession in the past 40 years. But a closer look at past episodes of inversion and recession suggests that today's economy is different. Our models indicate very low odds of a recession and continue to point to strong economic activity throughout 2007.

The current inversion is different because it has occurred with low short-term interest rates. Our measuring stick is nominal GDP growth (real GDP growth plus inflation). Whether short-term interest rates are above long-term interest rates is not as important as whether short-term rates are above the trend growth rate of nominal GDP. Think of nominal GDP growth as the ability of the economy to repay its loans. If interest rates are lower than the growth of the ability to repay, that's okay; if interest rates are higher, that constrains future living standards.

Simply comparing short-term rates and long-term rates does not answer the question of whether short-term rates are high or long-term rates are low. And that question has to be answered because the economic effects of high short rates and low long rates are not the same. High short-term rates represent tight money, which leads to slower economic growth. Low long-term rates do not harm the economy. If the yield curve is inverted because long-term rates are low, then that's just another way for consumers and businesses to borrow without hurting their future standard of living.

Past inversions of the yield curve occurred when monetary policy was very tight and short-term rates were high. There have been six recessions since 1961, and prior to each of them the yield curve inverted when the federal funds rate rose at least one full percentage point above nominal GDP growth, and 4.5 percentage points above the inflation rate.

Today, the federal funds rate is well below these trigger points. Nominal GDP growth has been 6.26% in the past two years, a full percentage point *above* the current 5.25% federal funds rate. Meanwhile, the federal funds rate is just 3 percentage points above "core" inflation. By either measure – nominal GDP growth or inflation – short-term interest rates are not too high. The driving force behind the inverted yield curve is low long-term rates, which are not something to worry about.

This helps explain why the economy remains strong. ShopperTrak RCT – a Chicago-based company that monitors foot-traffic and sales at retail outlets across the country – calculates that Christmas-season sales were up 5.1% versus 2005. This healthy gain is not statistically different from last year's 5.4% increase when the yield curve was normally sloped. It's hard to find any signs that the economy is anywhere near crumbling under the weight of excessively high interest rates.

Week of January 22, 2007

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-25 / 9:00 am	Existing Home Sales - Dec	6.245 Mil	**6.280 Mil**		6.277 Mil
1-26 / 7:30 am	Durable Goods - Dec	+1.2%	**+4.5%**		+1.6%
9:00 am	New Home Sales - Dec	1.050 Mil	**1.050 Mil**		1.047 Mil

Brian S. Wesbury; Chief Economist