630-322-7756
www.ftportfolios.com

FIRST Trust ADVISORS L.P.

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Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein - Senior Economist

Inflation is Much Worse Than Fed Tightening

The first questions investors ask us, after hearing our forecast that the Fed will hike interest rates again later this year, is: "How can you be bullish on the stock market; won't another rate hike take stocks down?"

The answer to these questions is: We are bullish about stocks because our capitalized profits model tells us that the stock market is 25-30% undervalued, and while a rate hike could cause the market some indigestion, it will shake this off quickly. Any sell-off in stocks, due to another Fed rate hike, would create a nice buying opportunity.

Between June 2004 and June 2006, as the Fed lifted the federal funds rate seventeen times (from 1% to 5.25%), the S&P 500 provided a total return of roughly 16%. In other words, despite a widespread belief that rate hikes would hurt the stock market, it didn't happen.

The reason these rate hikes did not hurt the market is that the Fed was not becoming restrictive. It was lifting rates from an excessively accommodative level, to a less accommodative level. After the rate hikes, the Fed was less loose, but not tight. In fact, at 5.25%, we still believe that the federal funds rate is below neutral by about 75 basis points.

This is why inflation is still on the rise. Gold prices are back above $690/oz., the dollar has fallen back near its all-time low versus the *euro*. Oil prices are elevated again, and the CRB spot commodity price index (which does not include oil) is at an all-time high.

While some viewed last week's release of an unchanged reading for the March "core" producer price index (PPI) as a sign of benign price pressures, this is a mistaken view. Within the PPI, consumer goods prices (excluding energy) increased by 7.8% at an annual rate in the first quarter, the largest quarterly gain in over 18 years. Capital goods prices (in the PPI) are up 2.0% in the past twelve months, a significant increase from the 0.1% average annual increase in capital goods prices between 1996 and 2002 – when the Fed was tight and the dollar strong.

The market is still fearful that the Fed will make the same mistake it made in 1999 and 2000, when it tightened excessively, causing deflation, recession and a market crash. But, in 2000, the real federal funds rate climbed to 4.0% - a very tight policy. Today, the real federal funds rate is just 2.5%, and with inflation on the rise, the Fed must lift rates just to tread water. Not lifting rates, when inflation is on the rise, causes real rates to fall – a *de facto* easing of monetary policy.

In the end, history is clear. Inflation is the real threat to equity markets. Inflation creates uncertainty, raises effective tax rates and boosts the cost of capital. In the 1970s, inflation undermined the US economy and equity markets, while disinflation boosted economic growth and equity values in the past 25 years.

Accommodative Fed policy, which would cause more inflation, should be what the markets fear most.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-16 / 7:30 am	Empire State Mfg Index - April	7.6	**15.0**	***3.8***	1.9
7:30 am	Retail Sales - Mar	+0.2%	**+0.4%**	***+0.7%***	+0.5%
7:30 am	"Core" Retail Sales - Mar	+0.8%	**+1.0%**	***+0.8%***	+0.4%
9:00 am	Business Inventories - Feb	+0.3%	**+0.3%**	***+0.3%***	+0.2%
4-17 / 7:30 am	Housing Starts - Mar	1.493 Mil	**1.470 Mil**		1.525 Mil
7:30 am	CPI - Mar	+0.6%	**+0.6%**		+0.4%
7:30 am	"Core" CPI - Mar	+0.2%	**+0.3%**		+0.2%
8:15 am	Industrial Production - Mar	+0.1%	**+0.3%**		+1.0%
8:15 am	Capacity Utilization - Mar	81.9%	**82.1%**		82.0%
4-19 / 7:30 am	Initial Claims - April 14	320K	**323K**		342K
11:00 am	Philly Fed Survey - Mar	2.0	**-0.5**		0.2