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FIRST Trust ADVISORS L.P.

April 9, 2007

Monday Morning Outlook

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Pushing Back Our Rate Hike

The Fed is between a rock and hard place. On the one hand, the slump in housing has pulled overall real GDP growth down to a 2.3% annualized growth rate in the past three quarters. On the other hand, the non-housing economy grew 3.5% over the same period of time, the unemployment rate has fallen to 4.4%, the dollar remains weak, and inflation is on the rise.

We still expect the next move by the Fed to be a rate hike, but we have pushed our forecast back by six months. Rather than a 5.5% federal funds rate by mid-year, we now expect the first rate hike to occur in the fourth quarter, followed by two more rate hikes and a peak 6.0% federal funds rate in the first half of 2008.

The Fed does not want to lift rates, but as the economy re-accelerates later this year, and inflation refuses to decelerate, it will have no choice.

While many believe that weakness in housing signals an excessively tight Fed policy, which will lead to imminent, and possibly severe, economic weakness, it's most likely different this time. Housing is not weak because interest rates are too high; housing is weak because the sector is no longer being artificially boosted by excessively low interest rates.

In fact, by virtually every measure we can think of, monetary policy appears accommodative. Gold prices are up 18% in the past year and 51% in the past two years, the dollar has lost 10% of it's value relative to the euro in the past twelve months, and real interest rates remain at very modest levels.

And while the current yield curve is flat to inverted, we do not believe this is a signal of tight monetary policy. Rather, long-term interest rates remain low because of international capital flows and a continued (and we believe mistaken) belief by investors (especially hedge funds) that the Fed will cut rates.

The recent slowdown in economic activity, while related to housing, appears to be similar to the so-called "growth recession" of 1995. Then, after rapid Fed rate hikes in 1994, real GDP growth slowed from 4%, to 2.5% in 1995, only to re-accelerate to 4.0% in 1996.

Today, after 17 rate hikes between mid-2004 and mid-2006, a slowdown in economic activity should not be a huge surprise. The good news, however, is that the rate hikes were not deadly to the economy. Rapid non-housing GDP growth rates have pulled unemployment down in many industries to levels that force wages up.

Real average hourly earnings are up 1.8% in the past year, which is faster growth than in the boom years between 1995 and 1999, when average real hourly earnings grew an average of just 1.2% annually. In other words, while fears of weaker growth will keep the Fed on hold for longer than we thought a few weeks ago, the economy is in better shape than most think, inflation is on the rise, and the Fed is not yet done tightening.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-12 / 7:30 am	Import Prices - Mar	+1.0%	**+1.0%**		+0.2%
7:30 am	Export Prices - Mar	+0.2%	**+0.3%**		+0.7%
7:30 am	Initial Claims - April 7	316K	**316K**		321K
4-13 / 7:30 am	Int'l Trade Balance - Feb	-$60.0 Bil	**-$60.3 Bil**		-$59.1 Bil
7:30 am	PPI - Mar	+0.8%	**+0.7%**		+1.3%
7:30 am	"Core" PPI - Mar	+0.2%	**+0.1%**		+0.4%
4-16 / 7:30 am	Business Inventories - Feb	+0.3%	**+0.3%**		+0.2%
7:30 am	Empire State Mfg Index - April	15.0	**15.0**		1.9
7:30 am	Retail Sales - Mar	+0.2%	**+0.4%**		+0.1%
7:30 am	"Core" Retail Sales - Mar	+0.6%	**+0.8%**		-0.1%
4-17 / 7:30 am	Housing Starts - Mar	1.483 Mil	**1.470 Mil**		1.525 Mil

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.