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FIRST Trust ADVISORS L.P.

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Monday Morning Outlook

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After the Pause, A Refreshing Rebound

Between June 2004 and June 2006, the Federal Reserve lifted the federal funds rate seventeen times from 1% to 5.25%. Even though we believe the Fed stopped short, leaving rates too low to bring inflation back down, these seventeen rate hikes have still had an economic impact.

The most visible effects have been in the housing sector. Real residential investment fell 16.7% during the four quarters ending in March 2007, pulling overall real GDP growth down to 2.1%. But this slowdown in housing is just a payback for years of above trend growth driven by an excessively accommodative Fed policy.

Absurdly low interest rates in 2002, 2003 and 2004 pushed housing activity well above where fundamentals suggested. With interest rates now closer to normal, many decisions based on a belief that interest rates would remain absurdly low no longer make sense. The housing crunch is not a result of excessively high interest rates today. Instead, it is a correction from rates that were too low in the past.

This fact does not remove the pain of the housing slump, but it does explain why it will not spread. Non-housing real GDP growth is still humming along, expanding 3.1% during the past year. This growth rate outside of housing equals the average of the past 30 years.

Despite this, many analysts have become convinced that housing weakness is spreading (or will soon spread) to the rest of the economy.

The employment report on Friday, which reported just 88,000 new jobs in April (with rare downward revisions to the previous two months) was taken by many as a signal of spreading weakness. But that is not the way we see it.

Employment is a lagging indicator that tends to reflect past real GDP growth. Some slowing in early 2007, after a ratcheting down of the growth rate in 2006, should not be a surprise. Leading or coincident indicators on the other hand have now begun to turn up. Initial unemployment claims remain extremely low, the ISM manufacturing index rebounded strongly in April to 54.7 from 50.9 in March, and the ISM non-manufacturing index jumped to 56.0 from 52.4.

These data suggest an accelerating economy despite continued woes in housing. As long as the Fed is accommodative there will be plenty of liquidity. Resources once devoted to housing will be shifted into other sectors of the economy. The transition of resources takes a few quarters. It does not happen immediately. After the shock of rate hikes works its way through the system, the ample liquidity of an easy monetary policy will re-assert itself.

In 1995, real GDP growth slowed to 2.5% after a series of sharp Fed rate hikes, but real growth returned to 4% in 1996.

With technological change still rapid, tax rates low, and the Fed still holding rates below neutral, a rebound in the economy is not only likely, but already underway. With the US stock market still undervalued, more gains are ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-08 / 9:00 am	Wholesale Trade - Mar	+0.6%	**+0.8%**		+1.2%
5-10 / 7:30 am	Import Prices - Apr	+0.9%	**+1.2%**		+1.7%
7:30 am	Export Prices - Apr	+0.4%	**+0.3%**		+0.7%
7:30 am	Initial Claims - May 5	315 K	**317 K**		305 K
7:30 am	Int’l Trade Balance - Mar	-$60.0 Bil	**-$60.5 Bil**		-$58.4 Bil
1:00 pm	Treasury Budget - Apr	+$140.0 Bil	**$176.0 Bil**		-$96.3 Bil
5-11 / 7:30 am	Business Inventories - Mar	+0.3%	**+0.4%**		+0.3%
7:30 am	PPI - Apr	+1.0%	**+0.7%**		+1.0%
7:30 am	"Core" PPI - Apr	+0.2%	**+0.2%**		+0.0%
7:30 am	Retail Sales - Apr	+0.4%	**+0.1%**		+0.7%
7:30 am	"Core" Retail Sales - Apr	+0.4%	**-0.1%**		+0.8%