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FIRST Trust ADVISORS L.P.

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Economic Commentary

Indigestion

After hitting an all-time high of 13,676 on Monday June 4, 2007, the Dow Jones Industrial average fell 1.5% through Wednesday, and is down again today, along with other broad market indices.

In terms of reaction, analysts and pundits can be divided into three groups. The "Bears" argue the market was overvalued, is still overvalued, and that the US economy is in trouble unless the Fed cuts rates. In other words this is just the beginning of the bad times.

The "Goldilocks" crowd argues that the market probably needed a consolidation and that rising interest rates are a negative for stocks. But they don't fret too much because the economy is in good shape and inflation will remain low. The only thing they worry about is that the Fed might lift rates again, and that may turn some of them into "Bears."

The third camp is where we reside. For lack of a better term, let's call ourselves "The Bulls." For the past year we have argued that the economy would prove resilient and that the stock market was substantially undervalued. We have also forecast rising inflation, higher interest rates and more Fed tightening.

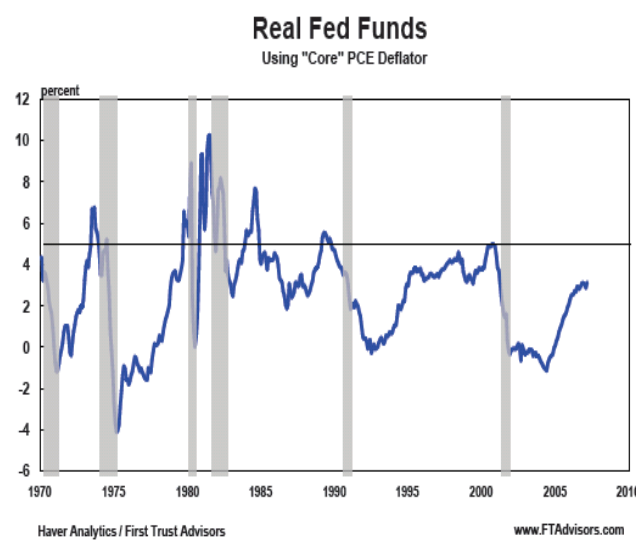
When asked what another Fed rate hike and rising long-term interest rates might do to the market, we have always answered that it would cause some indigestion, but that any short-term uncertainty would be more than offset by long-term gain.

The playing field is somewhat confusing. The Bears and a great many pundits continue to believe that private equity buyouts and M&A activity are behind the 13.5% run-up in the Dow since early March. They ignore rapidly rising corporate profits as a catalyst because they await imminent economic problems.

But the economy is not cooperating. Not only has the manufacturing sector shown renewed signs of growth, the non-manufacturing sector appears to be on a tear. The recent stock market drop coincided with a surge in the ISM Non-manufacturing Index to 59.7 in May, its strongest reading in a year, and a sign that our 3.5% real GDP forecast for Q2 is on track. This took rate cuts off the table.

The Goldilocks crowd received their blow at the same time. The 10-year Treasury bond yield has climbed by more than 50 basis points – from 4.5% to over 5.0% - since early March. More importantly, Fed Chairman Ben Bernanke has stuck to his guns and remains focused on inflation.

With the economy bouncing back and overall inflation data remaining stubbornly high, the probability of a rate cut has vanished. Options and futures markets show that when the DJIA bottomed in early March, the consensus expected 50 basis points in rate *cuts* by year end. As of yesterday, the consensus forecast was that the Fed would not change rates in 2007. We believe this trend will continue and that by year-end the Fed will actually lift rates.



The reason for this is simple. The Fed held interest rates too low for too long and now inflation has been too high for too long. While many think the Fed has over-tightened, the chart above shows that the "real" or "inflation-adjusted" funds rate is still well below the 5% level that pushed the economy into every recession since 1970. Given current inflation rates, we believe the Fed would need to push the funds rate to 7% or higher to be as tight as it was prior to past recessions. This is highly unlikely.

Rather, our models suggest that a 6% federal funds rate would be perfect for the current economic situation – not too hot and not too cold. It would be high enough to bring down inflation, but not so high as to cause a recession. Unfortunately, a return to tightening by the Fed would help prolong the markets indigestion because many misunderstand the long-term benefit from higher interest rates.

Inflation is the single most dangerous development for US and global equities markets at the current time. Allowing inflation to get a foothold would force the Fed to overreact and tighten too far, hurting the economy and corporate profits. Pushing rates to neutral quickly is the best course of action.

The good news is that economic fundamentals are all still very positive. Technology is still boosting productivity and will do so for a long time. This will result in much higher corporate profit growth than conventional wisdom expects.

Moreover, our equity market valuation model remains very bullish. We use a modified capitalized profits model, similar to the one proposed by Arthur Laffer. It is a simple fundamental model that capitalizes corporate profits with the 10-year Treasury bond yield.

It is true that as interest rates rise, this model will reflect a reduced value for equities. However, we have adjusted for this. Because we have consistently believed that US interest rates were being artificially held down, we have used a 6%, 10-year Treasury yield as the discount rate for the past year.

Given strong corporate profits growth, the model (with a 6% discount rate) still shows that the broad US equity market remains 15-20% undervalued. It is this undervalued stock market, and the artificially low interest rates that are attracting private equity and increased stock buybacks.

In the end, the fundamentals for the US economy remain robust, the Fed appears to be headed in the right direction and any indigestion should be viewed as a buying opportunity.

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