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FIRST Trust
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Aug 20, 2007

Monday Morning Outlook

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Bernanke Resists "Hair of the Dog"

We have written repeatedly that the recent turbulence in financial markets is part of the legacy of an overly loose monetary policy, a mistake that led to over-leverage in general with particular excesses in both residential real estate and the price of financial instruments based on housing-related cash flows.

Now that the hangover from monetary excess has settled in, cries for one last drink can be heard up and down Wall Street: one last drink of the same loose policies that started the trouble to begin with. Not too much or for too long, they say; only enough to let them sober up gradually. That the extra tab for additional monetary looseness has to be paid by everyone else in our economy, through higher inflation risk, gives them little concern.

But instead of giving in by cutting the target federal funds rate (now 5.25%), Federal Chairman Ben Bernanke has been orchestrating a protracted intervention, buying time while firms sober up enough to realize that the Fed is not coming to their rescue and that the real economy is doing fine.

Despite all the stories about dysfunctional credit markets, last week the amount of commercial paper outstanding issued by domestic non-financial companies was 38% higher than the same time last year. Meanwhile, the Baa bond spread over 10-year Treasury Note yields was 2.1 percentage points versus a ten-year average of 2.3.

In our view, Bernanke's performance last week is in the same league as former Fed Chairman Alan Greenspan's bold policy gestures to loosen policy in 1987, 1998, and the week after September 11, 2001. Wall Street just isn't sober enough yet to know it.

Just what did the Fed do last week? Exactly what it should have done: almost nothing, except for a shrewd token gesture.

On Friday the Fed issued two statements. The first announced that the Fed was cutting the discount rate from 6.25% to 5.75% and extending discount window loans to as long as 30 days. The discount rate is the interest rate the Fed charges banks that borrow directly from it. Meanwhile, the target federal funds rate, the rate banks charge each other for overnight loans, remains at 5.25% and the effective funds rate has traded even lower in recent days.

With the funds rate target still at 5.25%, it is hard to see any major bank on solid footing going to the Fed instead of another bank. This despite the Fed convening a conference call last week to tell major firms that there should be no embarrassment in accessing credit directly from the discount window. In this way, the Fed re-asserted its role as the lender of last resort, without having to take any major action.

The second statement the Fed issued on Friday said "tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward." The statement also said "the downside risks to growth have increased appreciably."

We draw three conclusions from this latter statement. First, notice the word "potential" regarding the restraint on economic growth. In other words, the Fed has yet to see any actual evidence that growth has slowed.

Second, the Fed will not act due to financial market pain by itself; it's focused on whether financial market pain has a significant negative impact on real economic growth.

And third, the Fed is ready to shift to a neutral bias at the September 18 meeting, if a month from now the markets are still being tossed around.

By that time, we think the markets will have safely entered rehab, thankful the Fed never gave it that one last drink.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-20 / 9:00 am	Leading Indicators - Jul	+0.4%	**+0.4%**		-0.3%
8-23 / 7:30 am	Initial Claims - Aug 18	317K	**320K**		322K
8-24 / 7:30 am	Durable Goods Orders - Jul	+1.0%	**+5.0%**		+1.3%
7:30 am	Durable Goods (Ex-Trans) - Jul	+0.6%	**+1.5%**		-1.0%
9:00 am	New Home Sales - Jul	0.820 Mil	**0.834 Mil**		0.834 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.