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FIRST Trust ADVISORS L.P.

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Monday Morning Outlook

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Unnecessary Rate Cut…On Its Way?

Our view is that any Fed rate cut would be a mistake. Nonetheless, a weaker-than-expected August jobs report, pressure from politicians, panicky comments from former Fed officials, and howls of protest from Wall Street, have pushed the Fed into a corner. As a result, the probability of a rate cut, at or before the next FOMC meeting on 9/18, is above 50%. And we believe that if the Fed does cut rates it will do so by a total of 50 basis points before the end of 2007.

In such a short column we cannot deal with every argument being made for a rate cut, so we will deal with just three.

1) – *Some say the Fed is just too tight, while others have gone as far as comparing today to the late 1920s – when the Fed ignored signs of deflation and tightened monetary policy anyway, causing the Great Depression.*

These concerns are over-the-top hyperbole. Between 1926 and 1929, the Consumer Price Index was declining by an average of 1.1% per year. Gold prices were fixed, but silver prices plummeted. In other words, there were clear signs of deflation in the late 1920s, but the Fed lifted the federal funds rate to 6% anyway, making its biggest mistake ever.

Today is different. Gold and silver prices have surged in the past six years and are pressing higher, consumer prices are climbing in the 2% to 3% range, and the dollar is weak.

The real (or inflation-adjusted) federal funds rate is low relative to any historical pre-recession period regardless of what inflation rate one uses to calculate the real funds rate – the CPI, the "core" CPI, the PCE deflator, or the "core" PCE deflator. Any similarity between today and the Depression are figments of an overactive imagination.

2) – *Some argue that during the past 50 years, every time the US housing market has contracted like it has in the past year it translated into an economy-wide recession.*

This idea that housing slumps trigger recessions is a confusion between cause and correlation. Every recession since 1913 (the year the Fed was created) has been accompanied by tight money. And because housing is a big-ticket, interest-rate-sensitive, industry, it has almost always reacted early to tight money. It falls first, before the economy as a whole. But this does not mean housing caused the recession. Tight money did.

Both short-term and long-term interest rates, even rates on jumbo mortgage loans (yes, they are still available), are lower today than they were in the late 1990s – when things were so good many called it a bubble (a false boom).

Today's problems were created because interest rates were artificially low between 2001 and 2004, not because rates are currently too high. The Fed is not tight, its just less loose.

3) – *Finally, the credit market is seizing up, and the Fed must cut rates to make it work again.*

But loans are available to credit worthy borrowers, corporate profits are still sky-high and the world is awash in liquidity. Risk spreads have widened but remain well within historical ranges. Credit problems are only visible in the highly-leveraged, asset-backed marketplace – a market that was not pricing risk correctly and got itself into trouble because it expected interest rates to stay at absurdly low levels forever.

The bottom-line is that if the Fed eases, it will do so when it is not tight. It will reverse course at the lowest real federal funds rate for any reversal since the mid-1970s. This is dangerous because it will "lock-in" the inflationary pressures it already created. That is what $700 gold, $76 oil and a $1.38/euro exchange rate are saying. An aggressive Fed easing will push commodity prices even higher and the dollar lower.

Most fearful is that leading voices in the political and financial world are so willing to think that Fed policy can save the world. The probability of tax hikes, massive government involvement in the healthcare system and rising regulation against "global warming" are real threats to prosperity. No matter how much money the Fed prints, it can't offset damage from too much government interference. It's not a repeat of the Depression we should fear; it's a repeat of the 1970s.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-11 / 7:30 am	Int'l Trade Balance - Jul	-$59.0 Bil	**-$57.7 Bil**		-$58.1 Bil
9-13 / 7:30 am	Initial Claims - Sep 8	325K	**320K**		318K
9-14 / 7:30 am	Import Prices – Aug	+0.2%	**-0.2%**		+1.5%
7:30 am	Export Prices - Aug	+0.1%	**+0.1%**		+0.2%
7:30 am	Retail Sales - Aug	+0.5%	**+0.9%**		+0.3%
7:30 am	Retail Sales Ex-Autos- Aug	+0.2%	**+0.1%**		+0.4%
8:15 am	Industrial Production - Aug	+0.3%	**+0.1%**		+0.3%
8:15 am	Capacity Utilization - Aug	82.0%	**81.8%**		81.9%
9:00 am	Business Inventories - Jul	+0.3%	**+0.4%**		+0.4%