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First Trust Advisors L.P.

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# Monday Morning Outlook

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## Keeping Our Fingers Crossed For a Hard Money Fed

Tuesday's meeting at the Federal Reserve is the most important in at least several years, but not because of the reason most people think. The markets and most pundits are asking whether the Fed will give a 25 or 50 basis point rate cut. But, we still hold out hope the Fed will do the right thing, which is not cut rates at all. Cutting rates, when they are already too low, will "lock in" inflation, force more rate hikes later, and puts the Fed's credibility as an inflation fighter at risk.

After all, the economy looks good. Using the latest data on sales, inventories, trade, and production our "add-em-up" forecast of real GDP growth remains at 3% for Q3. High frequency data, like initial claims for unemployment insurance are also painting a robust and resilient picture.

San Francisco Fed President Janet Yellen said last week that the U.S. economy has proven before that it can rebound quickly from financial turbulence and that "the effects of these disruptions can turn out to be surprisingly small."

In addition, conditions in the commercial paper market are improving rapidly, a good piece of news because so many analysts focused on problems in this market as a reason for the Fed to cut rates. Never mind that there is no historical link between commercial paper and future economic growth, and that problems were mostly isolated in the asset-backed marketplace.

It is true that overly-aggressive mortgage borrowers, lenders, and investors have issues that will take a long time to be fully worked out. But there are few signs that these troubles are dragging down the rest of the economy.

Some try to make it seem that the entire economy is at risk of drowning if the Fed, like an alert lifeguard, doesn't throw out a life ring (rate cut) to the credit markets. But, cutting the federal funds rate would be more like turning an entire cruise ship around, risking everyone on board, just to save one person.

We understand this desire, but it's an emotional decision not a rational one. This is a job for the Coast Guard, or in monetary policy language – the Discount Window. The Window is a specific tool designed to help particular financial institutions that are really having trouble. It does not cause general inflationary pressures, and it does not lead to a further misallocation of resources.

Measures of "core" inflation have fallen of late, but these measures are not useful when food and energy prices have been volatile in only one direction – up. Gold prices are over $700/oz. and the dollar is at a 15-year low. In addition, China's consumer prices are up 6.5% versus a year ago, a 10-year high. This is important because China pegs its currency to the dollar, which means its inflation rates are largely determined by the Fed. The evidence seems very clear. Inflation is visible in many markets. Nonetheless, because the conventional wisdom *assumes* a slowdown ahead, it ignores this inflation and recent strong economic growth. This seems like risky behavior to us.

During the past few days the stars seem to be aligning to strengthen Chairman Bernanke's resolve *if* he decides to resist rate cuts. Former Chairman Alan Greenspan opined that the winding down of globalization will put upward pressure on inflation in the years ahead. Meanwhile, the heads of the European Central Bank and Bank of England have both refrained from cutting rates and have publicly defended their positions, noting that staying the course now will diminish the threat and severity of future crises.

Now the ball's in Bernanke's court: will he go with the consensus if others at the Fed want to cut or will he stand his ground and do the right thing?

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 9-17 / 7:30 am | Empire State Mfg Index - Sep | 18.0 | **15.0** | ***14.7*** | 25.1 |
| 9-18 / 7:30 am | PPI – Aug | -0.3% | **-0.3%** | | +0.6% |
| 7:30 am | "Core" PPI – Aug | +0.1% | **+0.1%** | | +0.1% |
| 9-19 / 7:30 am | CPI – Aug | +0.0% | **0.0%** | | +0.1% |
| 7:30 am | "Core" CPI – Aug | +0.2% | **+0.2%** | | +0.2% |
| 7:30 am | Housing Starts – Aug | 1.350 | **1.373 Mil** | | 1.381 Mil |
| 9-20 / 7:30 am | Initial Claims - Sep 15 | 320K | **321K** | | 319K |
| 9:00 am | Leading Indicators – Aug | -0.4% | **-0.3%** | | +0.4% |
| 11:00 am | Philly Fed Survey – Sep | 2.7 | **2.8** | | 0.0 |