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Sept 24, 2007

Monday Morning Outlook

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TIPS: A "Vanity Mirror" for the Fed?

Many economists think inflation is not a problem because Treasury yields are low and the spread between inflation-indexed Treasury securities (known at TIPS) and regular Treasury securities is also low. The Fed likes to watch the "implied 5-year *forward* inflation rate," which uses 10-year and 5-year TIPS yields, compared to 10-year and 5-year nominal Treasury yields, to estimate what the market thinks the 5-year inflation rate will be starting five years from now.

Right now the implied 5-year forward inflation rate is about 2.6% (estimating inflation between 2012 and 2017). While still low, this is the highest in more than a year. The implied forward inflation rate has widened about 20 basis points since the Fed cut rates last Tuesday, coinciding with a sharp rise in gold prices and a drop in the dollar. Despite all of this, and even though a long-term inflation forecast of 2.6% is nothing to be comfortable about, many economists still argue that inflation remains anchored.

But this is a stretch. The TIPS market has a very limited track record. Although TIPS were introduced in the late 1990s they were thinly traded until about five years ago. This means that we have no way of knowing whether these 5-year forward inflation forecasts are any good. There is just no actual data available to test.

A more straight-forward test of the TIPS market, using the simple 5-year implied inflation forecast, shows TIPS spreads have underestimated inflation. Using the spread between TIPS yields and nominal Treasury yields in January 2003 shows that the market was forecasting average annual inflation of 1.4% between January 2003 and January 2008. So far, with less than six months until the full results are in, inflation has averaged 2.9%.

This was not a one-year fluke. In January 2004 the Treasury market was forecasting average annual inflation of 2% through January 2009. More than 70% of the way through that 5-year period, inflation has averaged 3.1%. In January 2005 the Treasury market forecast an inflation rate of 2.6% for the next five years. Half way through this five-year period, inflation has averaged 3.2%.

While many forecasters have decided the bond market is smart, this is not at all clear. Bond yields were slow to react in the late 1960s and 1970s. Bond investors got killed by 15 years of unexpectedly high inflation. And in the 1980s, bond yields remained stubbornly high even though inflation fell sharply in the early 1980s after Paul Volcker's tightening and then stayed low for decades.

Finally, a decade-old analysis by economists Christina and David Romer found that the actions of the private sector show that it believes the Fed is the best forecaster of inflation. So if the Fed looks to the Treasury market as a window to assess investors' inflation expectations, it is really not looking at a window at all. Instead, because investors' decisions reflect confidence in the central bank, the Fed ends up looking in a mirror, in this case a vanity mirror, which offers no firm guide for monetary policy.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-25 / 9:00 am	Existing Home Sales - Aug	5.490 Mil	**5.540 Mil**		5.750 Mil
9-26 / 7:30 am	Durable Goods - Aug	-3.0%	**-6.7%**		+5.9%
7:30 am	Durable Goods (Ex-Trans) - Aug	-0.7%	**-0.7%**		+3.7%
9-27 / 7:30 am	Q2 GDP Final	3.9%	**3.9%**		4.0%
7:30 am	Q2 GDP Chain Price Index	2.7%	**2.7%**		2.7%
7:30 am	Initial Claims - Sep 22	320K	**317K**		311K
9:00 am	New Home Sales - Aug	0.830 Mil	**0.847 Mil**		0.870 Mil
9-28 / 7:30 am	Personal Income - Aug	+0.4%	**+0.3%**		+0.5%
7:30 am	Personal Spending - Aug	+0.4%	**+0.5%**		+0.4%
8:45 am	Chicago PMI - Sep	53.1	**52.9**		53.8
9:00 am	Construction Spending - Aug	-0.2%	**-0.5%**		-0.4%
9:00 am	U. of Michigan Confidence - Sep	84.0	**84.0**		83.8

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.