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FIRST Trust ADVISORS L.P.

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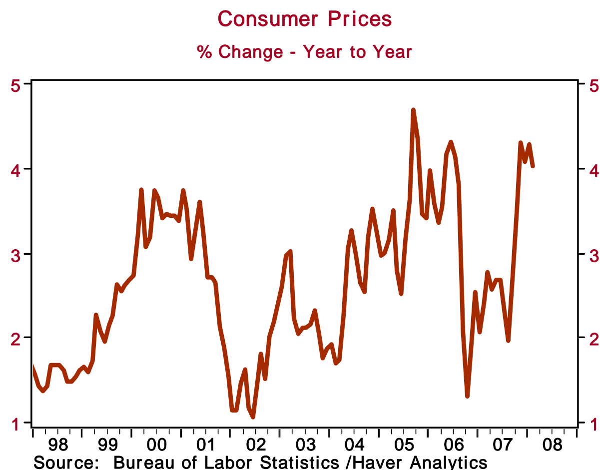
Economic Commentary

Inflation Still A Long-Term Problem

Summary: Despite widespread fears of a prolonged economic slowdown and Friday's benign report on the February CPI, we think inflation remains the leading macroeconomic threat to the US economy. Some broad measures of inflation are significantly above the yield on 10-year Treasury Notes and monetary policy is still loose, meaning inflation will continue along an upward trend for at least the next two years. As a result, investors in regular Treasury securities are likely to earn low to negative after-tax real returns in the year ahead.

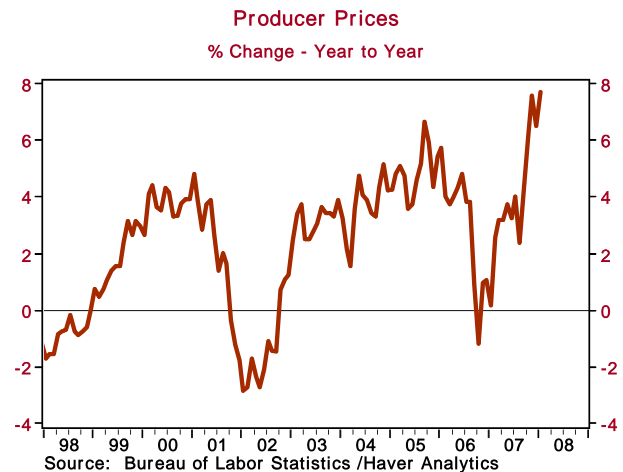
Inflation is Already a Problem

During the past twelve months, the Consumer Price Index (CPI) is up 4.0%, the Producer Price Index (PPI) is up 7.7%, and import prices are up 13.6%. These inflation rates signal an overly loose monetary policy and are not consistent with the policy goal of long-term price stability.



Although many analysts focus on "core" measures of inflation we believe this view is obsolete. When food and energy prices are volatile both up and down, removing them can help reveal the underlying inflation trend. However, in the past six years almost all of the volatility in food and energy prices has been on the upside. In this environment, focusing on core inflation tends to *hide* the underlying inflation trend, not reveal it.

A better measure of the "underlying trend" in the CPI is the "trimmed-mean" CPI, which is calculated by the Federal Reserve Bank of Cleveland. As opposed to the core CPI, which always excludes food and energy, trimmed-mean CPI excludes the 8% of items that are going up the fastest *and* the 8% that are going down the fastest (or going up the slowest). This measure is up 2.8% in the past year while the core CPI is up just 2.3%.



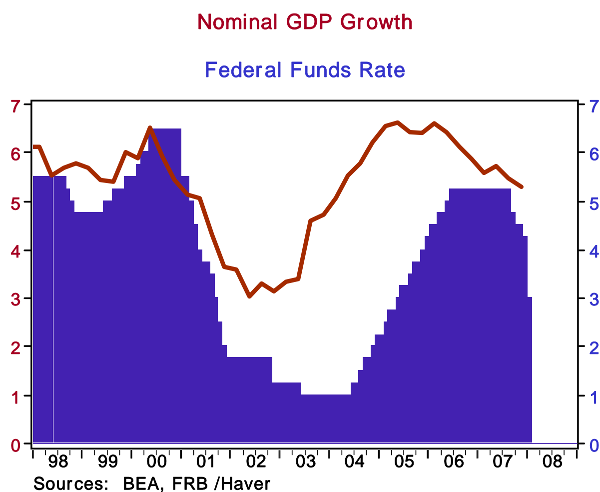
Negative Treasury Returns

Despite higher inflation, Treasury yields remain extremely low. As a result the yields on all but the very longest maturity Treasury securities are lower than recent increases in consumer prices, threatening to leave investors in regular Treasury debt with negative real returns even before taxes on interest are factored in.

The current relationship between Treasury yields and inflation is not sustainable. Over time, Treasury investors will not willingly lose money. The key issue is whether inflation will fall, so that today's Treasury investors can earn a positive real return, or whether yields will rise, providing extra compensation for inflation-related risks.

Higher Inflation in the Pipeline

We do not expect a decline in the inflation trend because monetary policy is already loose and likely to get looser in the weeks ahead. Our primary gauge of the stance of monetary policy is the gap between the trend in nominal GDP growth (real GDP growth plus inflation) and the federal funds rate. For monetary policy to start exerting downward pressure on the inflation trend, the federal funds rate should be close to or above the trend in nominal GDP growth, as it was in the late 1990s through 2001. As the chart below shows, the Federal Reserve started cutting rates in late 2007 before it ever got tight enough to bring down the inflation trend.

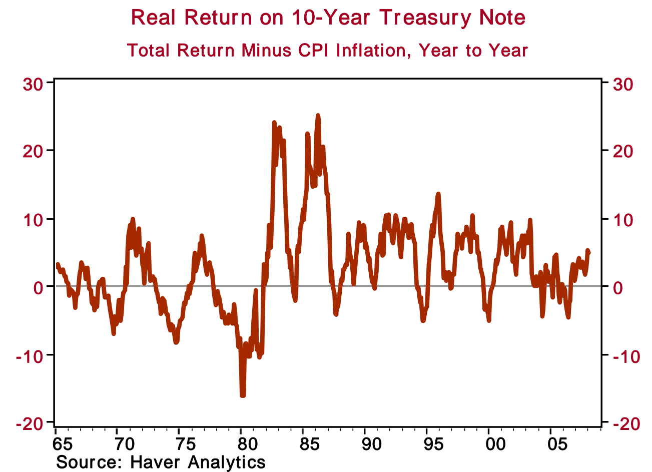


Historically, it takes about two years for monetary policy to achieve its maximum impact on inflation. This suggests that unless the Federal Reserve quickly reverses course and starts raising rates, which we do not expect until late 2008, the inflation trend will continue to rise for at least the next two years.

Real 10-Year Treasury Returns Will Go Negative

Despite the inflation of the past year, real returns on Treasury Notes and Bonds have been positive and surprisingly healthy. The reason is that Treasury yields have fallen, generating capital gains for owners of these securities, providing an extra return over and above interest earnings.

But the 10-year Treasury yield is now at about 3.5% and inflation has been coming in consistently higher than expected over the past few years. As a result, we believe Treasury investors will eventually demand much greater interest compensation for inflation risk over the next two years, leading to much higher yields across the maturity spectrum, meaning current holders of long-term Treasury securities will suffer capital losses that subtract from interest earnings.



Higher Yields Ahead

The current fixed income environment has a precedent and it is not a good one. During the 1950s and early 1960s the US experienced persistent low inflation. The bond market became so confident the Federal Reserve would maintain low inflation that even as the 1960s progressed and inflation started creeping upward, bond yields stayed low, as investors assumed inflation would return to previous levels.

Eventually, inflation soared in the 1970s and so did Treasury yields. Treasury investors, having been so badly burned, then got "smart" demanding a huge inflation premium. This pushed yields much higher, generating outsized fixed income returns in the 1980s through the early 2000s.

History Repeats Itself

The bottom line is that the bond market is neither inherently "smart" nor inherently "dumb." It displays varying degrees of sensitivity to inflation depending on how seriously it has been burned in the past. At present, the bond market is still savoring the low inflation of the 1990s and early part of the current decade. Don't expect that to last.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Senior Economist*

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.