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First Trust

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Monday Morning Outlook

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Commodity Peak, Dollar Bottom

One of our recurring themes is that US monetary policy has been too loose for at least the last five years and that the rapid "emergency" interest rate cuts from September 2007 through April 2008 – implemented to address credit market turmoil – were a mistake.

Gold prices hovered around $665/ounce in the six months through late August 2007. By mid-March, gold had risen roughly 50% to above $1000/oz. and still stands at about $900/oz. today. In addition, oil, which had been at about $75/barrel last August, rose 85% to a peak of $139/bbl. earlier this month and is now at about $135/bbl.

The purchasing power of the US dollar had dropped not only against commodities but versus other major currencies that have not adopted as inflationary a monetary policy as the Federal Reserve. For example, while it took $1.36 to buy a Euro last August, it took $1.60 in late April and still takes $1.56 today.

However, in our view, we have likely seen the peak in gold prices, are near the peak for oil – if it has not peaked already – and are unlikely to see further major dollar depreciation against other major currencies.

The reason we are taking this view – despite our opinion that US monetary policy is still way too loose – is that we now believe the Federal Reserve is nearing an aggressive move upward in short term interest rates, one that will "shock and awe" those who believe the Fed will eventually embark on only modest increases in the federal funds rate, if it does so at all. We now anticipate that the Fed will lift the funds rate from 2% to 3% by the end of 2008 and then 5.0% by the end of 2009, with more rate hikes to follow in early 2010.

The Fed meets this week to mull over the stance of monetary policy and, although hope springs eternal, we highly doubt it will be bold enough to kick off its series of rate hikes at this juncture. High level Fed officials often use key publications such as the Wall Street Journal to signal its intentions and recent stories indicate that although a rate hike will be discussed at the meeting it is unlikely to command a consensus.

The likely result of the meeting, which ends on Wednesday, is no change in either the target federal funds rate or the discount rate but a subtle change in wording that shifts the Fed away from a neutral "balance of risks" to one that just narrowly tilts in favor of fighting inflation.

But regardless of the outcome of this particular meeting, events in the next few months are likely to force the Fed's hand, making it more aggressive about raising rates than its leadership now thinks it has to be. In the last 12 months, consumer prices are up 4.1% and producer prices are up 7.2%. Both of these year-to-year comparisons are likely to get worse during the next few months, not better.

Moreover, we believe the Fed will see increasing signs that inflation expectations, which have already leapt upward in consumer surveys, are filtering into investors' decisions.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-25 / 7:30 am	Durable Goods - May	+0.0%	**-2.2%**		-0.6%
7:30 am	Durable Goods (Ex-Tran) - May	-0.9%	**-3.0%**		+2.4%
9:00 am	New Home Sales - May	0.512 Mil	**0.514 Mil**		0.526 Mil
6-26 / 7:30 am	Q1 GDP Final	1.0%	**0.9%**		0.9%
7:30 am	Q1 GDP Chain Price Index	2.6%	**2.6%**		2.6%
7:30 am	Initial Claims - Jun 21	375K	**376K**		381K
9:00 am	Existing Home Sales - May	4.950 Mil	**4.960 Mil**		4.890 Mil
6-27 / 7:30 am	Personal Income - May	+0.4%	**+0.4%**		+0.2%
7:30 am	Personal Spending - May	+0.6%	**+0.8%**		+0.2%
8:45 am	U. Mich. Consumer Sentiment	56.7	**57.0**		56.7