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First Trust

Aug 11, 2008

Monday Morning Outlook

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What Hath The Fed Wrought?

We want to add our congratulations to the US Olympic Men's, 4x100 Freestyle Relay Team. A new world-record, and an amazing anchor leg comeback over the favored French team, was simply amazing. How 'bout them apples?

The technology behind the new Speedo swimsuit worn by most swimming medalists in Beijing is a reminder of the fact that the globe is still in the midst of a technological boom. But, unlike the 1990s, this productivity growth is not holding back inflation. Neither is weak economic growth – experienced in the US since last fall when the subprime crisis first unfolded.

In fact, the value of the gold in a gold medal is up 115% since 2004, while silver prices are up 130%. Much of this increase in commodity prices has occurred in the past year, pushing the 12-month changes in consumer prices to 5% and producer prices up to 9.2%.

We believe this is due to a massive shift in Federal Reserve policy toward loose money. Between September 2007 and April 2008, the Fed added enough dollar liquidity to drive the federal funds rate down from 5.25% to 2.0%.

While it is true that these lower rates helped some adjustable-rate mortgage holders avoid re-sets to higher rates, while other borrowers experienced a reduction in borrowing costs, these benefits came with a huge cost.

Last August 16th, the day before the Fed cut the discount rate by 50 basis points at an emergency meeting, oil traded at $68.54/bbl. By July 2008, oil prices had increased to $146.13/bbl., up 113% in less than a year. As oil prices soared, airlines bled cash and car sales plummeted. Moreover, inflation has eroded consumer confidence about the economy, the future and elected politicians.

The Fed's excess money creation also caused the dollar to fall sharply in value on foreign exchange markets, which has reduced living standards for every American.

In addition, there are always two sides to every economic coin. Any benefits from lower interest rates have been offset by significant costs to lenders. Bank loans tied to the prime rate were reduced. Good for the borrower, but bad for the bank. Lenders were forced to take lower payments, while both economic risk and inflation were rising. No wonder bank stocks (even with no subprime exposure) have been hurt so badly.

In addition, Auction Rate Securities, which are often indexed to Libor, saw their yields fall as the Fed cut rates. It's not a coincidence that auctions failed when buyers balked at the lower yields. Lower interest rates also hurt retirees dependent on fixed incomes, while they undermined the fixed income marketplace, enlarging losses on fixed income portfolios that were marked to market.

All of this is to suggest that the costs of the Fed's sharp interest rates cuts have been large. In fact, they may have contributed more to current economic problems than the subprime crisis itself.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-12 / 7:30 am	Int'l Trade Balance – Jun	-$62.0 Bil	**-$60.0 Bil**		-$59.8 Bil
1:00 pm	Treasury Budget – Jul	-$90.0 Bil	**-$102.0 Bil**		$50.7 Bil
8-13 / 7:30 am	Retail Sales – Jul	-0.1%	**-0.3%**		+0.1%
7:30 am	"Core" Retail Sales – Jul	+0.5%	**+0.2%**		+0.8%
7:30 am	Import Prices – Jul	+1.0%	**+0.9%**		+2.6%
7:30 am	Export Prices – Jul	+0.6%	**+0.8%**		+1.0%
7:30 am	Business Inventories - Jun	+0.5%	**+0.7%**		+0.4%
8-14 / 7:30 am	CPI – Jul	+0.4%	**+0.6%**		+1.1%
7:30 am	"Core" CPI – Jul	+0.2%	**+0.2%**		+0.3%
7:30 am	Initial Claims - Aug 9	438K	**432K**		455K
8-15 / 7:30 am	Empire State Mfg Index - Aug	-4.0	**-2.0**		-4.9
8:15 am	Industrial Production - Jul	+0.0%	**-0.1%**		+0.5%
8:15 am	Capacity Utilization - Jul	79.8%	**79.7%**		79.9%
8:45 am	U. Mich. Consumer Sentiment	62.0	**62.0**		61.2