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First Trust

Aug 31, 2009

Monday Morning Outlook

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Fed Must Act Soon

Now that Federal Reserve Chairman Ben Bernanke has been re-nominated by President Obama, and is highly likely to be confirmed for another four-year term this fall, we keep thinking about the old advice to "be careful of what you wish for…because you may just get it." Bernanke has his work cut out for him over the next few years.

At present, consumer prices are down 1.9% in the past twelve months, the most since 1949; meanwhile, producer prices are down 6.8%, the most since World War II. However, this decline in overall inflation indices has been driven by a massive drop in energy prices that occurred late last year. As a result, the year-over-year inflation data is misleading. In the first seven months of this year, consumer prices are up at a 2.4% annual rate, while producer prices are up at a 2.0% rate. And these moderate rates of inflation are just the tip of the iceberg. Looming under the surface is a bulge of monetary accommodation and a bounce-back in monetary velocity, which could double the rate of inflation over the next 18 months.

Whether inflation moves higher after that is an open question. And the answer depends on how quickly the Fed unwinds its unprecedented liquidity injections.

Some of this exit strategy is relatively simple – with the Fed letting its exotic lending facilities wind down. But sooner or later, the Fed will need to use traditional tools – withdrawing money from the system (or slowing its growth sharply), and allowing interest rates to rise.

Right now, despite much stronger economic data, the Fed is intent on keeping rates where they are for an "extended period." The Fed has no desire to raise rates this year as it fights what it believes could be Great Depression II. We think this is a mistake. The economy is bouncing back rapidly in a V-shaped pattern. And the sooner the Fed lifts rates, the less inflation (and more economic stability) the US will have down the road.

We project that in the second half of this year, nominal GDP will grow at about a 6% annual rate, with four points from real GDP growth and two from inflation. (The GDP deflator should grow more slowly than CPI inflation as import prices increase faster than export prices.) In 2010, because of past monetary ease, nominal GDP will be growing even faster. In this environment, the federal funds rate should be significantly higher than it is today – a 5% rate would not be too tight.

While this probably took the breath away from some readers, it is important to remember that higher rates do not, by themselves, have to mean a quick end to the economic recovery. The federal funds rate was 8.5% in late 1982 as the US started emerging from the brutal recession of 1981-82. Eighteen months later the federal funds rate was 11.5% and yet the economic recovery powered on even as many banks and S&L's failed due to the bursting of the 1970s inflation bubble.

Granted, the Reagan tax cuts and de-regulation helped the economy grow without artificial monetary stimulus in the 1980s. And it is also true that fiscal policies these days are not designed to boost growth. But loose money is never a good long-term stimulant. In fact, the longer it takes the Fed to move toward the exits, the more damage will be done and the harder it will become to exit at all.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-31 / 9:00 am	Chicago PMI - Aug	48.0	**49.0**	50.0	43.4
9-1 / 9:00 am	ISM Index - Aug	50.5	**53.5**		48.9
9:00 am	Construction Spending - Jul	0.0%	**0.0%**		+0.3%
sometime	Domestic Auto Sales - Aug	4.7 Mil	**5.7 Mil**		4.2 Mil
during the day	Domestic Truck Sales - Aug	4.6 Mil	**4.8 Mil**		4.2 Mil
9-2 / 7:30 am	Q2 Non-Farm Productivity	+6.4%	**+6.5%**		+6.4%
7:30 am	Q2 Unit Labor Costs	-5.8%	**-5.6%**		-5.8%
9:00 am	Factory Orders - Jul	+2.2%	**+2.2%**		+0.4%
9-3 / 7:30 am	Initial Claims - Aug 29	561K	**562K**		570K
9:00 am	ISM Non-Man. - Aug	48.0	**49.0**		46.4
9-4 / 7:30 am	Non-Farm Payrolls - Aug	-230K	**-225K**		-225K
7:30 am	Unemployment Rate - Aug	9.5%	**9.4%**		9.4%
7:30 am	Average Hourly Earnings - Aug	+0.1%	**+0.2%**		+0.2%
7:30 am	Average Weekly Hours - Aug	33.1	**33.1**		33.1
7:30 am	Manufacturing Payrolls - Aug	-60K	**-50K**		-52K

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.