First Trust Portfolios L.P.

A Quarterly Newsletter Featuring Market Analysis and Product Overviews

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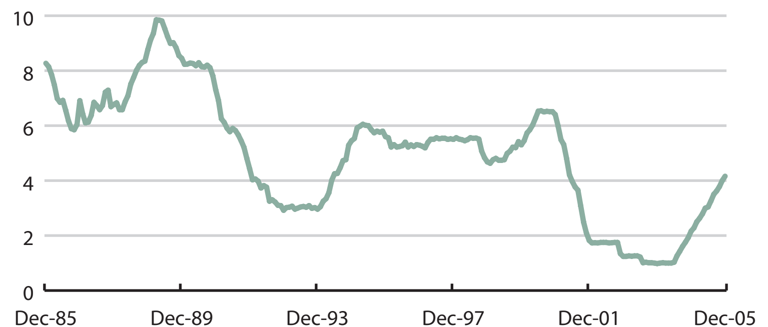
Mr. Carey has appeared as a guest on such programs as Bloomberg TV and CNBC and has been quoted by several publications, including *The Wall Street Journal, The Wall Street Reporter, Bloomberg News Service, and Registered Rep*.

Don't get caught up in the spin when sizing up the economy!



One of the biggest phenomenons in America today is "Reality TV." You don't have to watch many of these shows for very long, however, before it dawns on you that what is being portrayed isn't that realistic at all. For example, in 2001, the show **Survivor** was set in the "dangerous" Australian Outback. The basic gist of the show is for contestants to live together, perform a variety of tasks, and compete at various challenges. Each week a contestant is voted off the show until only one is left. The winner gets a prize of $1 million. *By the way, if you are looking for a bit of reality, the show's first winner is reportedly in trouble for failing to declare his $1 million prize to the IRS*. Paul Hogan, who is an Australian citizen and the actor that gained fame playing Crocodile Dundee, was asked during an unrelated interview what he thought about this reality show being staged in his native country. In paraphrasing his remarks, he essentially said that if he were in charge of the show he would have taken the contestants to a part of Australia that was truly dangerous and that one contestant would in fact disappear from the show each week – but not because he or she was voted off. Hogan's tongue-in-cheek response made it quite clear that he didn't find the show to be an accurate portrayal of life in the Outback.

We find similar fault in how our economy has been portrayed by the media in recent years. On the whole, we feel that the American people are not being given an accurate assessment of the state of the U.S. economy, particularly when it comes to the major broadcast networks, where a great many people reportedly get their news. We believe the message has been too negative for way too long. We would like to highlight a key economic indicator that the Federal Reserve uses in shaping its monetary policy – and this indicator says times are good.

If you had to select just one economic indicator to gauge the state of the economy, which one would you choose? We would suggest capacity utilization. It measures the production levels at our factories, utilities, and mines, and tends to move up and down with the various business cycles. The index is released on a monthly basis by the Federal Reserve. Economists and the Fed have traditionally found it to be an effective barometer for inflation. Historically, when the utilization rate for the nation reaches 83% or higher, inflationary pressures can rise. When the utilization rate is low, pricing pressures abate. We think it is one of the most useful snapshots an investor can use to form a near-term bias as well as monitor longer-term trends.

As the chart above and to the left illustrates, utilization rates bottomed in December 2001 at 73.9%, according to the Fed. If you recall, the U.S. experienced a recession from March 2001 through September 2001, even though we didn't experience two consecutive quarters of negative GDP growth, according to the National Bureau of Economic Research. The weakness hit the manufacturing sector the hardest. A quick check of the utilization rate each month beginning in January 2001 would have provided a clear picture of where the economy was heading by as early as April. The chart to the right depicting the Fed funds rate shows a corresponding drop in borrowing costs. In an effort to jump start the economy, the Fed began lowering the funds target rate from a high of 6.50% at the start of 2001 to a low of 1.0% in June 2003, where it remained for 12 months. Today, the utilization rate is at 80.7%, up from a low of 73.9% at the end of 2001. That move is substantial and indicates that this recovery has had strong underpinnings for some time.

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Here are a few more reasons to feel optimistic about the prospects for 2006...

Inventory-to-Sales Ratio

1.26

November 2005

The record low is 1.25, according to the Commerce Dept. The high since 1992 was 1.56. The lower the number the better. An increase in new orders in 2006 would likely boost production levels causing the utilization rate to trend higher. Prior to 2004, industrial production in manufacturing had essentially not expanded since 2000, when it was up 4.6%, according to the Federal Reserve. Production increased 4.8% in 2004 and 3.9% in 2005.

Capital Spending

+24%

Q3'05

Is the most recent change in capital spending for the companies in the S&P 500, according to Thomson Financial. That rate was closer to 11% on average the prior year. Look for spending to remain strong, according to *The Wall Street Journal*. Tobias Levkovich, an analyst at Citigroup, likes the technology sector. He expects companies to upgrade in an effort to boost productivity.

Cash Holdings

$634 Billion

Q4'05

This is the amount held in cash and equivalents by the non-financial companies in the S&P 500 Index. It was just shy of the record ($638B), according to S&P. Cash totaled just $352B at the end of 2001 – the start of the current expansion. In addition to boosting capital expenditures, firms can use their cash in a variety of ways, such as for stock repurchase plans, M&A activity and stock dividends.

Productivity

+4.7%

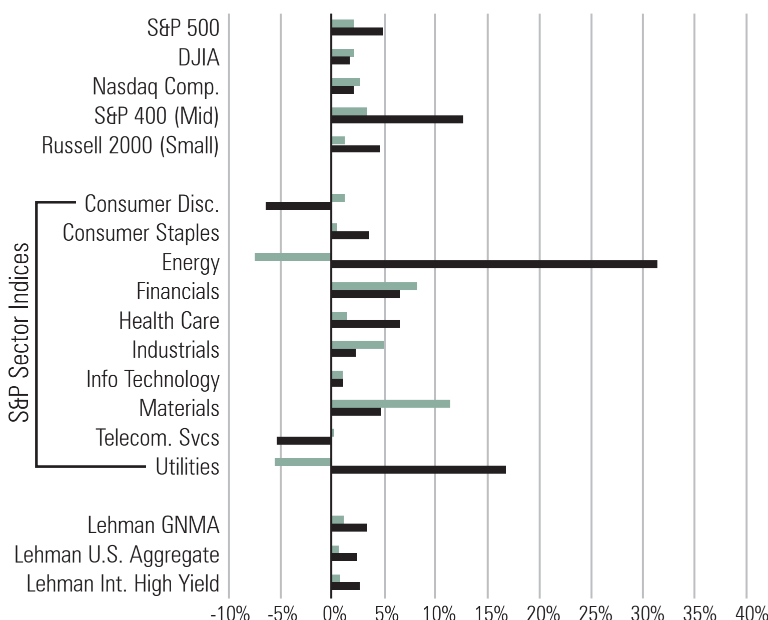
Q3'05

Strong productivity gains have helped curb inflation. Despite the sharp rise in commodity prices in 2005 the core CPI rate is still just 2.2%. Higher production costs have been offset to a large degree by productivity gains. Since the last recession ended in the fourth quarter of 2001, productivity gains have averaged 3.4% annually, far exceeding any similar period since the 1960s.

Stocks have not bounced back as well as the economy has...

Despite the fact that the companies in the S&P 500 posted double-digit earnings growth for 14 consecutive quarters through Q3'05, the index has only generated an average annual gain of 3.8% over that 42-month span, well below the average annual gain of 10.4% for large company stocks since January 1926. That return even lagged the 4.2% average annual return of the Lehman Brothers U.S. Treasury: Intermediate Index. We are looking for both CEOs and investors to get more aggressive in 2006.

Total returns for *Q4* and past *12 months* (12/30/05)



A Look Ahead:

The outlook for earnings (year-over-year)...

	Q1'06E	Q2'06E	2006E
Financials	1.0%	9.2%	14.1%
Technology	**16.1%**	**15.5%**	**14.5%**
Health Care	6.3%	6.5%	7.9%
Consumer Staples	**6.3%**	**4.7%**	**5.5%**
Consumer Discretionary	23.4%	16.1%	18.8%
Industrials	**10.6%**	**13.2%**	**13.9%**
Telecommunications Services	13.6%	6.0%	8.8%
Energy	**41.5%**	**15.7%**	**13.6%**
Utilities	8.4%	19.9%	13.9%
Materials	**0.8%**	**6.2%**	**7.7%**
S&P 500 Index	**5.8%**	**5.3%**	**7.2%**
S&P 400 Index (Mid-Cap)	**18.2%**	**13.8%**	**22.4%**
S&P 600 Index (Small-Cap)	**19.2%**	**16.0%**	**19.8%**

Source: Thomson First Call/Baseline