

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-9 / 7:30 am	Initial Unemployment Claims	285K	275K		273K
2-10 / 7:30 am	Dec Trade Balance	-\$65.0B	-\$63.5B		-\$64.2B

A Long Way From the Edge

Last Tuesday, Alan Greenspan chaired his final meeting of the Federal Open Market Committee and presided over its 14th consecutive rate hike since June 2003. That same day, Ben Bernanke was confirmed as the new Chairman.

Clues about what policies he, and other Fed members might follow in the months ahead are few and far between. The January FOMC statement did little to change that. While the Fed dropped the word “measured,” it said, “...some further policy firming may be needed.” The market priced in one more Fed rate hike and signaled that this would be the end.

But, after the January employment report on Friday, the market changed its mind. Overall jobs increased by a less-than-expected 193,000, but revisions added 80,000 in November and December, and the unemployment rate fell to 4.7%. Average hourly earnings increased by 0.4% in January and initial unemployment claims have declined sharply in recent weeks. The data suggest a very tight labor market.

Consumer confidence surged in January, based largely on the fact that jobs were easier to find. Retail sales and durable goods orders finished 2005 on a strong note, and a solid majority of corporate earnings reports surprised to the upside.

The market quickly understood that this news meant the Fed would likely push rates to 5.0%, and not stop at 4.75%.

Despite all the rhetoric about risk management, discretionary policy, price rules, and a new Fed Chairman, the US central bank has institutionalized a simple Phillips Curve framework to manage monetary policy.

Back in the 1970s, A.W. Phillips postulated that low unemployment was associated with rising inflation, and high unemployment allowed for low inflation. This model, no matter how inconsistent it is with actual data, suggests that strong growth and rising wages cause inflation. This is why “good news” for the economy, is often taken as “bad news” for the equity markets. The stronger the economy, the more the Fed will lean into the wind. And the more the Fed leans into the wind, the more the market thinks they will lean too far.

We disagree with the view that growth causes inflation (just look at the 1970s or 1990s). Strong growth and low unemployment do not cause inflation, too much money does. And despite hiking rates 14 times, the federal funds rate is still not back to “neutral,” which means the Fed is adding excessive amounts of liquidity to the economy. Commodity prices have risen sharply and “core” inflation rates are slowly rising. This has pushed our estimate of a “neutral” federal funds rate to between 5 ½ and 6%.

While the equity market has remained fearful of further Fed rate hikes, we do not believe that the Fed will actually lift rates far enough to cause a recession in 2006 or 2007. Between 1995 and 1999, the federal funds rate averaged 5.4% and yet the economy grew at a 4% rate and the US experienced one of the greatest bull markets ever.

Today, the federal funds rate is 4.5%. Inflation is also higher than it was in the late 1990s. As a result, real interest rates are still well below those of the boom years. Even four more rate hikes should not push the economy over the edge.

Week of February 13, 2006

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous	
2-14 / 7:30 am	Dec Business Inventories	+0.3%	+0.6%		+0.5%	
	Jan Retail Sales	+0.9%	+1.0%		+0.7%	
	Jan Retail Sales Ex Autos	+0.6%	+0.8%		+0.2%	
2-15 / 7:30 am	Feb NY Fed Survey	21.0	21.0		20.1	
	8:15 am	Jan Industrial Production	+0.2%	+0.4%		+0.6%
		Jan Capacity Utilization	80.7%	80.9%		80.7%
2-16 / 7:30 am	Jan Import Prices	+0.5%	+1.0%		-0.2%	
	Jan Export Prices	+0.1%	+0.3%		+0.1%	
	Jan Housing Starts	2.00M	2.00M		1.93M	
11:00 am	Feb Philly Fed Survey	5.0	9.0		3.3	
2-17 / 7:30 am	Jan PPI	+0.1%	+0.9%		+0.9%	
	Jan “Core” PPI	+0.4%	+0.3%		+0.1%	

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Consensus forecasts come from Insight Economics, LLC

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.