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FIRST Trust ADVISORS L.P.

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Monday Morning Outlook

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The Fed is Wrong, Not Incompetent

Since August, when turmoil in credit markets began, we have argued against Fed rate cuts. So far, the data seems to support our view. Inflation is rising and growth is strong.

In November, producer prices increased 3.2%, and are up 7.7% versus last year. Consumer prices increased 0.8%, and are up 4.3% in 12 months.

Meanwhile, retail sales are up 9.4% at an annual rate in the past three months, with "core" sales up at a 7.1% annual rate (excluding autos, building materials, and gas). There is no evidence yet that credit problems are affecting the consumer in any significant way.

True, headline chain-store sales figures have not been as strong, with sales in November up only 3.5% versus last year. But those are "*same store*" sales. "*Total*" sales by these stores are up 10.7% versus last year, apparently the result of a major expansion in the number of retail outlets. This competitive expansion may dampen the bottom-line for some retailers but it does not depress economic growth.

We remain convinced that current credit market problems are the result of lax lending standards and excessively easy monetary policy between late-2001 and early-2005. Our models show that the Fed was never tight in this business cycle. What the US is experiencing is a credit-market correction, not a cyclical downturn caused by tight money. As a result, it is highly unlikely that these problems will spread beyond those institutions that took excessive risk.

That said, we have some sympathy for the Fed. In the back of every central banker's mind is the specter of the Great Depression and the Fed is under enormous pressure from Wall Street to "do something." So while we disagree with the Fed's rate cuts, we can understand their desire to take out some "insurance," in the form of easier money.

What we do not understand and cannot sympathize with is the vitriol now being hurled at the Fed from Wall Street – the very group the Fed's actions were designed to appease. It's almost as if these pundits think that Wall Street should feel no pain after making billions of dollars of bad loans. So, when the stock market fell after the Fed gave the market a smaller than hoped-for 25 bps. rate cut, they screamed bloody murder.

And then, on the next day, when the Fed unveiled a new method of directly attacking financial difficulties in the banking system without expanding its balance sheet, the pundits went berserk again because the Fed had delayed the announcement. But, the Fed had no choice.

Highly-placed sources tell us that the new targeted approach – a coordinated auction of emergency funds by the top central banks around the world – was ready to be rolled out even before the Fed's meeting on Tuesday. However, the European Central Bank, which has not cut rates at all, refused to be involved unless the plan was made public at least a day *after* the Fed's meeting.

The ECB believed that if the Fed released the new approach and *then* cut rates the ECB would have been pressured to cut rates too, and the Fed would have been signaling the new approach was not strong enough. We think the ECB was right.

More importantly, we see the new approach as one worthy of expansion if banks require additional assistance. This surgical attack is better than cutting interest rates and risking even higher inflation. What we fear most is that the Fed has lost its inflation-fighting credibility. The only way to win that back is to reverse these recent rate cuts. We expect that to happen in 2008.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-17 / 7:30 am	Empire State Mfg Index - Dec	20.0	**19.0**	***10.3***	27.4
12-18 / 7:30 am	Housing Starts - Nov	1.180 Mil	**1.188 Mil**		1.229 Mil
12-20 / 7:30 am	Initial Claims - Dec 15	335K	**335K**		333K
7:30 am	Q3 GDP Final	4.9%	**5.1%**		4.9%
7:30 am	Q3 GDP Final Chain Price Index	0.9%	**0.9%**		0.9%
9:00 am	Leading Indicators - Nov	-0.3%	**-0.3%**		-0.5%
11:00 am	Philly Fed Survey - Dec	6.8	**7.4**		8.2
12-21 / 7:30 am	Personal Income - Nov	+0.5%	**+0.5%**		+0.2%
7:30 am	Personal Spending - Nov	+0.6%	**+0.7%**		+0.2%
9:00 am	U. Michigan Confidence - Dec	75.0	**75.0**		74.5