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FIRST Trust ADVISORS L.P.

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Economic Commentary

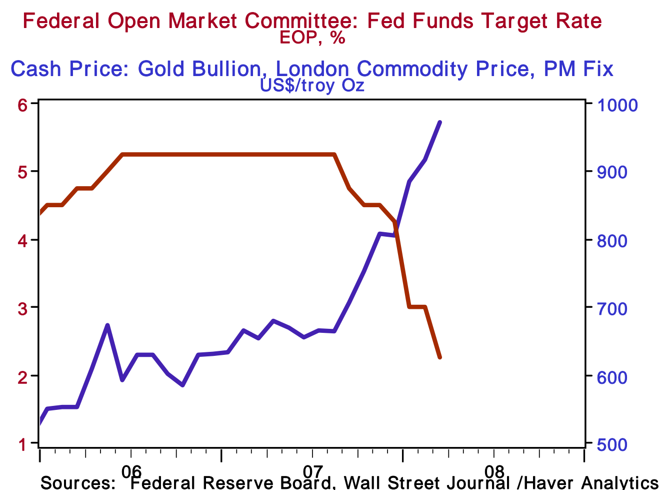
Fed Turning the Corner

When credit market turmoil first struck in 2007, a few influential economists argued in favor of Federal Reserve interest rate cuts, saying rate cuts would strengthen the dollar and reduce gold prices.

This argument built on theory proposed and advanced by the late Jude Wanniski. In late 2007, it was argued by these Wanniski-ites that high interest rates were inhibiting economic activity and that rate cuts would increase activity and demand for the dollar. As demand increased for the dollar, inflation would recede, long-term interest rates would fall and the dollar would rise.

We commented at the time that this argument was 100% backward. Interest rates were not too high, they were too low. We based this on our nominal GDP versus federal funds rate model.

We argued that lower rates would boost inflationary pressures and weaken the dollar versus other currencies. Reducing the Fed's target rate would require the Fed to add even more liquidity to the US banking system. As a result, the supply of dollars would rise. Meanwhile, higher inflation expectations would erode the demand for the dollar.



The past several months have put these two theories to the test. And the results are now in.

The Fed started cutting rates on September 18, 2007, when the dollar was valued at $1.39/Euro. At the beginning of this week, the dollar fell to $1.60/€, a 13% drop in the value of the dollar. And that calculation probably "lowballs" the effect of the rate cuts because the dollar started declining before September 18, in anticipation that the Fed would act.

During that same period, the price of gold climbed from $718 per ounce to $916 last Tuesday. Oil prices rose from $72 a barrel in August 2007 to $118. In other words the dollar lost 22% of its value versus gold and 39% of its value versus oil. This part of the test did not go according to the Wanniski-ites' plan.

But when the Fed's favorite *Wall Street Journal* reporter, Greg Ip, wrote on Thursday, that the Fed would likely end its rate cuts after one more, the markets turned around sharply. The market had been expecting more than one additional rate cut, and the leak, we believe, came directly from Chairman Bernanke. In other words, the markets had to take it seriously.

As this news made its way through the financial markets, bond yields rose, gold fell $20 an ounce, oil fell by $3 a barrel and the dollar strengthened against the Euro by 2% - a huge rally.

These market movements are very clear. The problems facing the US economy in mid-2007, and still to this day, were not caused by tight money. In fact, the low interest rate policy of 2002-2005 was the real culprit. Interest rates (relative to nominal GDP) are still the best indicator of monetary policy.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Senior Economist*

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