630-322-7756
www.ftportfolios.com

Jan 22, 2008

Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

Dow 15,000

The Dow Jones Industrial Average fell 500 points last week and looked like it might fall another 500 again today before the Federal Reserve stepped in and cut short-term interest rates by 75 basis points, the largest single rate cut since the Fed started targeting interest rates in the mid-1980s. Fear is spreading like wildfire, undercutting equity prices around the world.

Investors are fleeing risk. The 10-year Treasury yield is down to 3.48%, while the yield on the 2-year Treasury is 2.06%. The last time these yields got so low was in 2002-03, when the federal funds rate was already down to 1.75% (and headed lower). At that time, many economists argued that the Federal Reserve did not have the ability to prevent a debilitating cycle of self-reinforcing deflation.

Today, many fear that the Fed can do nothing to stop the financial markets from melting down. But this underestimates once again the power of the Fed. The rate cuts of the early 2000s worked to end deflation and the recent large rate cuts will cause a surge in economic activity later in 2008.

There is little to no sign of the kinds of economic imbalances that preceded past recessions. Inventory-to-sales ratios are razor thin. And during the past four years, businesses have invested a smaller share of their profits than during any four-year period since the 1960s. As a result, there is no massive overhang of plant and equipment investment like there was after the Y2K-related surge in 2000. Corporate profit margins remain high and labor compensation remains relatively low, meaning firms are still in a position to hire and bid up wages.

Meanwhile, the policy levers that have generated recessions in the past – tax hikes and tight money – have yet to be pulled. Marginal tax rates remain relatively low and monetary policy has generated increasing inflationary pressures.

Yes, the home building industry is a man-made disaster area, with the level of housing starts down more than 55% from the peak two years ago. But home building has been declining for so long that it now comprises too small a share of the economy to, by itself, push the economy into recession.

The only plausible scenario for recession is a major pullback by consumers. Here, the pessimistic worldview gets downright circular, claiming consumers will slow their spending because they will lose jobs due to consumers having slowed their spending. But incomes grew more than 3% above inflation last year, even after taking out income taxes as well as monthly obligations such as mortgages, rent, car loans/leases, property taxes, and debt service on credit cards.

The next couple of months will be crucial in determining whether all the extreme apprehension exhibited in markets is warranted. In our view, when the economy is still standing as the winter snow starts to melt, investor sentiment will turn on a dime and the stock market will head up sharply by year-end.

To determine fair value for stocks we use a capitalized profits approach, taking government figures on profits based on corporate tax filings and then discounting those profits with a 6% 10-year Treasury yield. We use a 6% 10-year yield because we believe bond yields are being held artificially low today by the Fed. By using a higher bond yield than necessary as a discount rate, we are taking a conservative stance.

This model suggests that the market is undervalued by 25% today. With the economy picking up steam in 2008, our forecast is that the Dow moves up as well and our year-end 2008 forecast is 15,000, with the S&P 500 at 1625.

Once recession fears prove unfounded, US equities will soar. Those who maintain their appetite for risk will be richly rewarded sooner than they think.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-24 / 7:30 am	Initial Claims - Jan 19	320K	**328K**		301K
9:00 am	Existing Home Sales - Dec	4.95 Mil	**4.91 Mil**		5.00 Mil