630-517-7756
www.ftportfolios.com

First Trust

Mar 28, 2011

Monday Morning Outlook

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

The Shorts Get Whipsawed by the VIX

The VIX – a (tradable) measure of equity price volatility – tends to spike when the US equity market falls. As a result, short-sellers (who see Black Swans everywhere) like it. It has also become a popular tool for equity investors who want buy some insurance on their long positions.

In early March, Japan's triple whammy of earthquake, tsunami, and nuclear troubles, along with ongoing political uprisings across North Africa and the Middle East caused the VIX to spike. Short-sellers were in heaven. They anticipated a significant correction, or maybe even the next leg down in what they still think is a secular bear market.

According to the Wall Street Journal (here), the VIX peaked at 31.28 on March 16 – well below the Mt. Everest-like highs of about 80 that we saw during the Panic of 2008 – but still the highest since mid-2010. Then it collapsed, falling 45% in seven trading days – its fastest seven-day swoon on record. It now stands near 18.

The shorts have been shellacked like this many times in the past two years. The reasons are simple to understand. The world is not about to come to an end. It is true that some parts of the economy, especially housing and employment, are lagging, but the rest of it is doing just fine, thank you.

And Friday's numbers on corporate profits support the optimistic outlook. Overall profits hit a record high at the end of 2010, tracing out a perfect V-shaped recovery from the Panic of 2008 (see chart here). Profits were up at a 10% annualized rate in Q4 and up 18% from a year before.

We use a capitalized profits model to value stocks. We start by taking overall corporate profits and dividing them by the 10-year Treasury yield. Then we compare the result to the actual market in each quarter for the past 60 years and use it to find an average fair value for stocks today.

If we assume profits increase another 2% in Q1 and use a 10-year Treasury yield of 3.5%, the model gives us a fair value estimate for the Dow of 22,800. We think this is too high because we believe the Fed is holding interest rates artificially low. So, in our official model we use a 10-year T-note yield of 5%. This generates a "fair value" estimate of 16,000 on the Dow and 1715 for the S&P 500.

In other words, getting to fair value would require the US equity markets to rise 31% from Friday's close. And that assumes no further gain in profits after Q1. We think these results are pretty robust. If we stress test for rising rates, the 10-year Treasury yield would need to rise to 6.5%, with no intervening increase in profits for the model to show equities are at fair value already.

We stand by the forecast we made at the start of the year that the Dow should hit 14,500 by year-end 2011, while the S&P 500 strikes 1575. In other words, short the shorts – equities are still cheap. And watch out for the VIX, too.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-28 / 7:30 am	Personal Income - Feb	+0.4%	**+0.4%**	+0.3%	+0.1%
7:30 am	Personal Spending - Feb	+0.5%	**+0.8%**	+0.7%	+0.2%
3-29 / 9:00 am	Consumer Confidence - Mar	65.4	**59.8**		70.4
3-31 / 7:30 am	Initial Claims - Mar 26	380K	**379K**		382K
8:45 am	Chicago PMI - Mar	70.0	**72.7**		71.2
9:00 am	Factory Orders - Feb	+0.5%	**-0.4%**		+3.1%
4-1 / 7:30 am	Non-Farm Payrolls - Mar	195K	**180K**		192K
7:30 am	Manufacturing Payrolls - Mar	33K	**40K**		33K
7:30 am	Private Payrolls - Mar	222K	**200K**		222K
7:30 am	Unemployment Rate - Mar	8.9%	**8.8%**		8.9%
7:30 am	Average Hourly Earnings - Mar	+0.2%	**+0.2%**		+0.0%
7:30 am	Average Weekly Hours - Mar	34.3	**34.3**		34.2
9:00 am	ISM Index - Mar	61.0	**61.2**		61.4
9:00 am	Construction Spending - Feb	0.0%	**-0.3%**		-0.7%
sometime	Domestic Auto Sales - Mar	4.6 Mil	**4.6 Mil**		4.7 Mil
during the day	Domestic Truck Sales - Mar	5.5 Mil	**5.3 Mil**		5.5 Mil