First Trust
Monday Morning OUTLOOK
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Rally Not Built on Complacency

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There are three types of people involved in the prognostication business these days. The "end of the world" types, the "it's a slower, post-apocalypse world" types, and the "everything is going to be OK" types.

For a long time now, we have been saying that the "end of the world" types are over-doing it. This is actually a dangerous stance for us to take because the "end of the world" types can be very nasty to people who disagree with them. The "it's a slower world" types are more cerebral and less nasty, but equally adamant. We, obviously, fall in the third camp.

No matter how we make our argument, and no matter how consistently the economy grows, the doubt and fear and disbelief just won't go away. We noticed this recently, when conventional wisdom started to say that investors were being "complacent" these days.

In other words, when the equity markets go down, investors are "living in reality" and "accepting" that the economy and financial markets just aren't in great shape. But when the equity markets go up, they are being schizophrenic, overly optimistic, and now some are saying "complacent."

We couldn't disagree more. Private sector payrolls have grown 160,000 per month in the past year. The unemployment rate is down almost a full percentage point from a year ago, while the size of the labor force is up (just like it was up in 2010, too). Over the past four weeks, unemployment claims have averaged 10% lower than the same period a year ago.

Retail sales are up 6.5% from a year ago; orders for long-lasting durable goods are up 12.1%, and auto sales are up 8.4%.

Perhaps most importantly, the long-awaited recovery in the housing sector has finally started. Housing starts in the fourth quarter hit the highest level since late 2008 and were up at a 32% annual rate compared to Q2. This was not all apartment buildings; single-family housing was up at a 13% annual rate in the second half of 2011.

Meanwhile, even after a recent rally, US equities remain incredibly cheap. Based on trailing after-tax earnings, the price-to-earnings ratio on stocks in the S&P 500 is roughly 13.5. On future earnings it's even cheaper.

Flipping this over, so earnings are on top and price is on bottom, the "earnings yield" on stocks is 7.4%, compared to a 10-year Treasury yield of only 2%. This suggests that stocks are cheap relative to bonds.

In other words, rather than being the result of complacency, craziness or stupidity, the recent rally has a much more straightforward explanation. The economy is growing, it's very likely to continue to grow, and if that is the case then stocks are grossly undervalued relative to bonds.

And the good news continues. With about 15% of the S&P 500 companies having reported earnings for the fourth quarter of 2011, 60+% have beaten street estimates.

Notice how none of this has anything to do with a third round of quantitative easing by the Federal Reserve. The last round of quantitative easing was essentially useless, with banks boosting their excess reserves from $1 trillion to $1.6 trillion.

Nonetheless, bank lending is picking up and accelerated after QE2 ended. This has helped boost the M2 measure of money (Milton Friedman's favorite gauge), which has also been growing faster since the end of QE2 than during it.

So far in 2012, the S&P 500 has had eleven up days versus only two down days. That ratio probably won't continue for the full year, but the idea that it is unwarranted, crazy or complacent is a point of view that is supported by a decidedly bearish set of assumptions.

Rather, it appears that the stock market is finally (or once again) beginning to realize that the world is not ending and that the recovery is not so fragile that it cannot last. We remain optimistic. We continue to believe that things are getting better and we don't feel complacent at all.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-26 / 7:30 am	Durable Goods - Dec	+2.2%	**+0.4%**		+3.7%
7:30 am	Durable Goods (Ex-Trans) - Dec	+0.9%	**+1.0%**		+0.3%
7:30 am	Initial Claims – Jan 21	370K	**369K**		352K
9:00 am	New Home Sales - Dec	0.320 Mil	**0.318 Mil**		0.315 Mil
9:00 am	Leading Indicators - Dec	+0.7%	**+0.8%**		+0.5%
1-27 / 7:30 am	Q4 GDP First Report	+3.0%	**+3.5%**		+1.8%
7:30 am	Q4 GDP Chain Price Index	+1.9%	**+1.8%**		+2.6%
8:55 am	U. Mich. Consumer Sentiment	74.0	**74.5**		74.0

Consensus forecasts come from Bloomberg. 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.