First Trust
Monday Morning OUTLOOK
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Dow 15,500

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Last year, the day before the presidential election we wrote that it "may be the most important one for economic policy in our generation, but we also "expect stocks to go up over the next year regardless of who wins." Stocks were cheap then and are still cheap today. We remain bullish on equities.

In the first nine days after the election, we looked wrong: stocks lost 5.3%. Nonetheless, the Dow has rallied back and now stands 3.1% above its election-day level.

After bumping over the fiscal curb, some investors are now scared of the threat of another debt downgrade and turmoil surrounding the debt limit as well as ongoing financial issues in Europe. As everyone knows, the pouting pundits of pessimism always find something to worry about. So, if these weren't the issues, we're sure something else would take their place.

It's not that these issues aren't serious. They are. What we are saying is that the stock market remains significantly undervalued. As the future keeps turning into a present that is less dour than anticipated, equities keep going up.

The price-to-earnings ratio on the S&P 500 is now 15.8 (based on "as reported" earnings, which includes write-downs and so are lower than operating earnings). Reversing this ratio – so earnings are on top and prices on bottom – generates an "earnings yield" of 6.3%. For comparison, the earnings yield has averaged 4.6% in the past 20 years, but right about 6.8% for the past 40 years. In other words, using this model and looking at longer time horizons suggests there is nothing particularly generous about today's earnings yield, or therefore stocks.

But the analysis should not stop there. The average earnings yield of 4.6 in the past 20 years closely mirrors both the average 10-year Treasury yield over that time period (4.8%) as well as the growth rate of nominal GDP (4.6%) – real GDP growth plus inflation. The average earnings yield of 6.8% for the past 40 years closely mirrors an average 10-year Treasury of 7% and nominal GDP growth of 6.6%.

In other words, these three variables tend to move together. For today's earnings yield of 6.3% to get to today's Treasury yield of 1.9%, stocks prices would have to more than triple! Weird things happen when bond yields are artificially low.

But even if we use a more reasonable 10-year yield of 4.5% which is close to what the Federal Reserve says is its long-term target for nominal GDP growth, stocks would have to go up 40% to get to fair value. This is similar to what we get when we use a capitalized-profits model (for a recent discussion of the model, please see the MMO from November 5, 2012).

As a result, we remain bullish on equities, and expect further increases for the stock market in 2013. We're not looking for a 40% rally, but we are looking for about an additional 15% by year end, with the Dow Jones Industrials average hitting 15,500 and the S&P hitting 1700.

None of this means the ride won't be bumpy. But trying to time the market is likely to generate many more losers than winners compared to a strategy that buys and holds steadily throughout. We continue to believe the upside potential for stocks is much greater than the downside.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-15 / 7:30 pm	PPI – Dec	-0.1%	**+0.0%**		-0.8%
7:30 am	"Core" PPI – Dec	+0.2%	**+0.2%**		+0.1%
7:30 am	Retail Sales – Dec	+0.2%	**+0.5%**		+0.3%
7:30 am	Retail Sales Ex-Auto – Dec	+0.2%	**+0.5%**		+0.0%
7:30 am	Empire State Mfg Survey - Jan	0.0	**-2.5**		-8.1
9:00 am	Business Inventories – Nov	+0.3%	**+0.3%**		+0.4%
1-16 / 7:30 pm	CPI – Dec	+0.0%	**+0.0%**		-0.3%
7:30 pm	"Core" CPI – Dec	+0.2%	**+0.1%**		+0.1%
7:30 pm	Industrial Production – Dec	+0.3%	**+0.2%**		+1.1%
7:30 pm	Capacity Utilization – Dec	78.5%	**78.5%**		78.4%
1-17 / 7:30 pm	Housing Starts – Dec	0.890 Mil	**0.875 Mil**		0.861 Mil
7:30 pm	Initial Claims – Jan 12	365K	**365K**		371K
9:00 pm	Philly Fed Survey – Jan	6.0	**4.5**		4.6
1-18 / 8:55 pm	U. Mich Consumer Sentiment- Jan	75.0	**73.0**		72.9