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First Trust

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Monday Morning Outlook

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Stocks: The Only Game in Town?

The Dow Jones Industrials Average is down roughly 20% from its peak in 2007 and fears of recession (or worse) are rampant. Bearish sentiment on equities is elevated and as is typical in fear-filled environments, opportunity exists.

Not only are fears of recession overblown, but earnings continue to surprise analysts to the upside. The bottom-line is that the US equity market is at least 35% undervalued. And when we survey the entire investment landscape it is clear the equity market is the only broad market category where significant future gains can be reasonably expected. Equities are the most undervalued asset class.

Consider the alternatives – real estate, commodities, and bonds. Although there are regional pockets of resilience, on a national average, residential real estate is still in the process of adjusting to a Fed-induced "bubble." We still do not see home prices hitting bottom until mid-2009.

While commercial real estate is faring much better than residential, and REIT prices are down significantly from their peaks, if bond yields rise as we suspect, the returns in this asset class will face strong headwinds.

In the past few years commodity markets have provided all the excitement and entertainment one could ever ask for. And in the process have provided significant profits for investors. This success has attracted even more money to the sector, but in the process has driven prices well above fundamental value. And despite recent sharp declines, commodities are still priced as if the Fed is not ever going to try and reign inflation back in again. We highly doubt this will be the case. Fed Chairman Bernanke is a keen student of monetary history and does not want to become the Arthur Burns of his generation – a highly respected academic economist whose policies in the 1970s gave the US our worst persistent bout of peacetime inflation ever.

Interestingly, while commodities are overestimating inflation, the bond market is underestimating inflation. Consumer prices are up 5% in the past year, but the 10-year Treasury yield is roughly 4.1%. What is important to realize is that it takes 18-24 months for changes in monetary policy to affect inflation. Eighteen to twenty-four months ago the federal funds rate was 5.25%; now it's 2%. So the Fed is *looser* today than it was when its policy was generating the high headline inflation we see today. The underlying inflation trend will be up in the next two years, not down.

Some Treasury investors have already experienced negative real returns, and – with inflation at elevated levels – this should spread throughout the maturity spectrum in the year ahead, as interest rates rise across the yield curve.

Meanwhile, US stocks appear substantially undervalued. Even if we discount earnings with a 6% rate (which is well above market rates) and use earnings depressed by "paper" losses at financial firms due to "mark-to-market" accounting requirements, historical relationships between stocks, profits, and interest rates suggest a fair value of at least 15000 on the Dow by the end of 2008. As a result, stocks are not the contrarian investment, but the only one where there is a true chance of outsized gains in the years ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-31 / 7:30 am	Q2 GDP Advance	2.3%	**3.0%**		1.0%
7:30 am	Q2 GDP Chain Price Index	2.3%	**3.0%**		2.7%
7:30 am	Initial Claims - Jul 26	395K	**395K**		406K
9:00 am	Chicago PMI - Jul	49.0	**49.6**		49.6
8-1 / 7:30 am	Non-Farm Payrolls - Jul	-75K	**-10K**		-62K
7:30 am	Unemployment Rate - Jul	5.6%	**5.6%**		5.5%
7:30 am	Average Hourly Earnings - Jul	+0.3%	**+0.3%**		+0.3%
7:30 am	Average Weekly Hours - Jul	33.7	**33.7**		33.7
7:30 am	Manufacturing Payrolls - Jul	-40K	**-45K**		-33K
9:00 am	ISM Index - Jul	49.2	**49.1**		50.2
9:00 am	Construction Spending - Jun	-0.3%	**-1.0%**		-0.4%
sometime	Domestic Auto Sales - Jul	5.0Mil	**5.1 Mil**		4.9 Mil
during the day	Domestic Truck Sales - Jul	4.9 Mil	**4.9 Mil**		5.0 Mil