630-517-7756
www.ftportfolios.com

First Trust

Dec 28, 2009

Monday Morning Outlook

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

Stocks Are Still Cheap

What a difference a year makes. At this time last year, when many thought the whole economic and financial world was falling apart, we forecast that the Dow Jones Industrial Average would rally and recover to 11,000 by the end of 2009. As it stands now, it looks like the market is going to fall a bit short of our expectations, but not by much.

Today, our model for valuing the broad US equity market signals that "fair value" for the Dow is around 19,000. This does not mean the Dow will hit that level anytime soon. To get fair value for the stock market we take the level of corporate profits that the government reports (based on filings with the Internal Revenue Service) and then discount these profits by the prevailing 10-year US Treasury interest rate. This simple "capitalized profits" model suggests the broad equity market in the US is still extremely cheap.

Of course, our capitalized profits model is vulnerable to overestimating fair value during periods of abnormally low Treasury interest rates, like the one we are in right now. If interest rates are low, the model discounts profits less than usual, meaning profits appear more valuable than they actually are.

But even with a 10-year Treasury yield of 5% (compared to the current 3.8%), fair value on the Dow is still a very appealing 14,500. And that assumes higher interest rates would not be accompanied by any further increase in profitability – an unlikely outcome given the V-shaped economic recovery and recent surge in corporate profits. In other words, those who can stay bullish in 2010 are likely to be well rewarded.

We realize that some investors fear a large upward move in interest rates in the year ahead, largely due to rising inflation. These fears are not completely unsound. We ourselves believe inflation will rise above consensus expected levels next year and that interest rates will also move higher.

But the 10-year Treasury yield would have to be almost 7%, and without any additional profits, for the stock market to be fairly valued at current levels. And even then, the model would simply signal that investors should anticipate future returns consistent with historical averages, not a bear market.

Nonetheless, some investors are still skittish about stocks in 2010 because they expect the Federal Reserve will finally pull the trigger and start raising short-term rates. In the past these moves have caused some "indigestion" for the stock market. But any indigestion is likely to be temporary. After an initial stumble in 2004, right after the Fed started lifting interest rates, the Dow rallied strongly late in the year even though the Fed raised rates at every meeting for the next two years.

Stocks also rallied in 1999 after the Fed started raising rates, until investors finally realized monetary policy was too tight. This time around, with interest rates at essentially zero, it will take a great deal of time for monetary policy to actually get tight.

Moreover, everyone already knows that the Fed's next move is up. So why should a move that everyone already anticipates hurt stock market values in any significant way?

In sum, we expect stocks to rally to 13,000 by the end of 2010, with further gains ahead for 2011. If there is one "wild card" we fear that could upset this forecast it's the health care bill now wending its way through Congress toward President Obama's desk. We think the Senate bill is already priced into the market. But a final law along the lines of what House Speaker Pelosi wants – which we think is unlikely – could cap the Dow at 12,000 and slow its growth in the future. Much like the 1970s, government policy would be detrimental to long-term stock market valuation.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-29 / 9:00 am	Consumer Confidence - Dec	53.0	**53.3**		49.5
12-30 / 9:00 am	Chicago PMI - Dec	55.1	**54.5**		56.1
12-31 / 7:30 am	Initial Claims - Dec 26	460K	**448K**		452K