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First Trust

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Monday Morning Outlook

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The Bouncing Balls of History

From March 9th to April 9th, the Dow Jones Industrial Average gained 23% while the S&P 500 and the Nasdaq Composite were up 26% and 30%, respectively. Small-cap stocks significantly outpaced large-caps, with the Russell 2000 Index up 36% in the same period. According to S&P's Howard Silverblatt, this has been the steepest 23-day advance since 1933.

Such rapid price appreciation in US equities led one investment officer to say the rally is "too explosive to be sustainable." According to Birinyi Associates, when small-cap stocks outperform large-cap stocks to this degree after bear markets, rallies fizzle. Others point to relatively high price-to-earnings (P/E) ratios as evidence stocks are still overvalued.

These pessimistic viewpoints seem to rest on one major assumption – that history is a good guide for the future. But we believe that history is a very poor guide for investors to follow these days. In fact, it has probably been a century since the economy has experienced a sharp decline in the velocity of money like it did last year. Not since 1907 has the US economy experienced a true panic like it did in late 2008.

To paraphrase Larry Summers, President Obama's Chief Economic Advisor, the economy behaved like a ball falling off the edge of a table in late 2008. Almost every major piece of economic data resembles the front half of a "V," which started around September. Vehicle sales fell to a level well below the scrappage rate, while housing starts fell to just 1/3 of the volume necessary to keep up with fundamentals, like population growth.

The combination of a rapid decline in economic activity, rising foreclosures and mortgage defaults as well as mark-to-market accounting led to large losses at banks and panic selling of stocks. For those who believed the next Great Depression was upon us, this was not a surprise.

But for those of us who believe the drop in velocity was a once in a century event, a near permanent Armageddon was unlikely. With the Fed (which wasn't around in 1907) flooding the system with liquidity and panic subsiding, a sharp upturn in the economy was to be expected. Such low levels of economic activity were truly unsustainable. To put this in Mr. Summers' words, once the ball hits the floor it will bounce.

But reality bites. Calendar year 2008 reported earnings for the S&P 500 were $14.97, while operating earnings equaled $49.49. These data give the S&P 500 a trailing P/E-ratio of 53.3x reported earnings and 16x operating earnings. No wonder some investors come to the conclusion that the market cannot continue to rally.

But University of Pennsylvania economist Jeremy Siegel suggests these data overstate the P/E-ratios because S&P aggregates earnings rather than weighting them by market value. Calculating earnings by market cap (the same way that the S&P 500 Index is calculated), Professor Siegel estimates that the trailing P/E-ratios are 11x for reported earnings (versus S&P's 53.3) and 10x for operating earnings (versus 16). In other words, huge losses at very low market value financial institutions (such as AIG) cause earnings to be understated for the index overall.

To put all of this in context, the economy hit rock bottom after falling off the table last fall. But the drop in economic activity was unsustainable and the drop in equity prices was overdone. Mark-to-market accounting changes and massive Fed liquidity have turned the tide. The economy and the market are just rebounding from the historically rare events of last year. It may seem logical to look at history, create some rules from past averages, and then doubt that this good news can last. But this would be a mistake. History is not always a good guide to the future.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-14 / 7:30 am	Retail Sales - Mar	+0.3%	**+0.3%**		-0.1%
7:30 am	"Core" Retail Sales - Mar	+0.0%	**+0.1%**		+0.7%
7:30 am	PPI - Mar	+0.0%	**-0.2%**		+0.1%
7:30 am	"Core" PPI - Mar	+0.1%	**+0.2%**		+0.2%
9:00 am	Business Inventories - Feb	-1.2%	**-1.2%**		-1.1%
4-15 / 7:30 am	CPI - Mar	+0.1%	**+0.2%**		+0.4%
7:30 am	"Core" CPI - Mar	+0.1%	**+0.2%**		+0.2%
7:30 am	Empire State Mfg Index - Apr	-35.0	**-30.0**		-38.2
8:15 am	Industrial Production - Mar	-0.9%	**-0.9%**		-1.5%
8:15 am	Capacity Utilization - Mar	69.6%	**69.4%**		70.2%
4-16 / 7:30 am	Housing Starts - Mar	0.540 Mil	**0.530 Mil**		0.583 Mil
7:30 am	Initial Claims - Apr 11	658K	**645K**		654K
9:00 am	Philly Fed Survey - Apr	-32.0	**-30.2**		-35.0
4-17 / 8:45 am	U. Mich. Consumer Sentiment	58.5	**58.5**		57.3