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First Trust

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Monday Morning Outlook

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The Shorts Are On the Run

A few weeks ago it looked like the economy and markets were on the mend. The Dow Jones Industrial Average (DJIA) was trading near 8500 and the yield on the 10-year Treasury note was above 3.5%, both significantly higher than the lows set earlier this year.

Then came the June employment report. The consensus among economists was that payrolls declined 365,000 in June. Instead, the Labor Department said payrolls fell by an extra 102,000, or a total of 467,000.

Despite the unemployment rate coming in below expectations and the fact that revisions to previous months' data are sometimes more than 100,000 per month, many optimists lost their confidence. More importantly, short-sellers saw this as their opportunity – it was finally time to go back and re-test the lows. After all, the employment report was proof that "green shoots" were really just a few hearty weeds. In the week after the jobs data, the DJIA fell to a closing low of 8147 – 7.4% below the mid-June high – and the yield on the 10-year Treasury fell to 3.30%.

Since then, however, the short-sellers have been on the run. Almost every major piece of data since that employment report has been stronger than consensus expectations. This includes the ISM services index, jobless claims, the trade deficit, retail sales, industrial production, home building, both consumer and producer prices, and finally import and export prices. The case for a deflationary malaise was mortally wounded.

As of this morning, the DJIA was up more than 7% from its post-employment report lows (in fact, at new highs for the year), while the yield on the 10-year Treasury was at 3.68% and moving higher.

All of this should not be a surprise. Monetary policy is incredibly loose, velocity is stabilizing and panic is subsiding. In addition, our capitalized profits model shows that broad equity indices in the US are still undervalued. To be sure, all of these things were true in January and February, but the markets fell to new lows anyway.

In other words, just because the Fed is easy and the market undervalued, there are no guarantees that it will head higher. But, back in January, the market had to contend with overly strict and inappropriate mark-to-market accounting. This rule created massive uncertainty in the marketplace.

In March and early April, this insane accounting rule was finally hog-tied by FASB. Now, financial institutions can use cash flows to help price securities when the market is illiquid.

To determine fair value for the stock market we use historical norms for the relationship between stock prices, interest rates, and corporate profits. These norms suggest that with interest rates at current levels and corporate profits where they were in the first quarter of 2009, stocks today are at no more than 50% of fair value.

True, we are forecasting higher interest rates as the economy grows robustly over the next 18 months and the inflation problem returns. But even using a 10-year Treasury yield of 5.5% suggests the stock market is at no more than 75% of fair value.

Despite this, it is unlikely that stock prices will quickly move all the way back to fair value. Investors have to remain concerned about the prospects for a huge expansion of government in the form of health care spending and regulation as well as limits on carbon emissions. But with each passing week, it appears more and more likely that our new president's legislative agenda on these issues is not going to be altogether successful.

Our forecast is that the Dow will finish the year at 10,000, but with the risks for the economy and the markets tilted to the upside. This rally will not be over until some short-only hedge funds go bankrupt. As a result, a sharp upward run to new highs is likely at any time.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-20 / 9:00 am	Leading Indicators - Jun	+0.5%	**+0.9%**	+0.7%	+1.2%
7-23 / 7:30 am	Initial Claims - Jul 18	558K	**545K**		522K
9:00 am	Existing Home Sales - Jun	4.830 Mil	**4.900 Mil**		4.770 Mil
7-24 / 9:00 am	U. Mich. Consumer Sentiment	65.0	**66.0**		64.6