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First Trust

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Monday Morning Outlook

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2011: Dow 14,500, S&P 1575, 10-Year 4%

Seven weeks ago our Monday Morning Outlook was titled "Stocks Are Cheap, Bonds Are Not." We said, "the bull market is still young….and bond yields are headed higher." Since then, the S&P 500 is up 6% and investors in the 10-year Treasury note have lost more than 4%.

Our models tell us to expect more of the same in 2011. We use a capitalized profits model to value stocks. We divide corporate profits by the 10-year Treasury yield, compare the result to each quarter for the past 60 years and use it to find an average fair value for stocks.

If we use the 2010 year-end 10-year Treasury yield of 3.3%, this model gives us a fair value estimate for the Dow of 23,500. But we believe the Treasury bond market, which is being artificially manipulated by the Federal Reserve, is in a bubble. To adjust for this, we use a more conservative estimate for the 10-year T-note yield of 5% in our equity model. This provides a "fair value" estimate of 15,500 on the Dow and 1675 for the S&P 500.

Getting to fair value would require the US equity markets to rise roughly 34% in 2011 – the largest one-year gain since 1975. Back in 1975, monetary policy was extremely loose. In other words, with the Fed following a highly accommodative monetary policy right now, this kind of outsized gain in one year is entirely plausible.

But there are some stumbling blocks to such a big gain. The market still faces headwinds, such as financial difficulties in Europe and also in US municipalities. Moreover, the markets rarely close large gaps to fair value in one year. If often takes multiple years.

Offsetting these headwinds are some tailwinds. Fiscal policy should move in a better direction faster than is currently priced into the market. President Obama wants to be re-elected to make sure his health program is fully implemented. That will require moving in a free-market direction on practically all other (non-health care) economic issues. For example, don't be surprised if the president proposes significant changes to Social Security early this year, to make the program more solvent over the long run.

The net of these headwinds and tailwinds suggests that markets will have a good year in 2011, but not close the gap to fair value in just 12 months. We think gains of roughly 25%, to 14,500 on the Dow and 1575 on the S&P 500 at the end of 2011 is a very doable forecast.

Meanwhile, our model of nominal GDP suggests continued upward pressure on Treasury yields. In fact, we estimate the fair value yield for the 10-year Treasury at 5%. However, with the Fed holding short-term rates at essentially zero, we doubt the 10-year Treasury yield will be sustained above 4%. We know of no time since the Fed was created in 1913 when the 10-year Treasury yield has been more than 400 basis points above the funds rate, even in the inflationary 1970s. That anchor will not hold the 10-year yield down forever, but we think it lasts through the end of 2011. Our call: a 10-year yield of 4% by year-end 2011.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-3 / 9:00 am	ISM Index - Dec	57.0	**57.8**	57.0	56.6
9:00 am	Construction Spending - Nov	+0.2%	**+0.5%**	+0.4%	+0.7%
1-4 / 9:00 am	Factory Orders - Nov	-0.2%	**-0.5%**		-0.7%
sometime	Domestic Auto Sales - Dec	3.9 Mil	**3.9 Mil**		3.8 Mil
during the day	Domestic Truck Sales - Dec	5.3 Mil	**5.3 Mil**		5.3 Mil
1-5 / 9:00 am	ISM Non-Man. - Dec	55.8	**55.9**		55.0
1-6 / 7:30 am	Initial Claims - Jan 1	405K	**391K**		388K
1-7 / 7:30 am	Non-Farm Payrolls - Dec	+140K	**+120K**		+39K
7:30 am	Private Payrolls - Dec	+153K	**+140K**		+50K
7:30 am	Manufacturing Payrolls - Dec	0	**+5K**		-13K
7:30 am	Unemployment Rate - Dec	9.7%	**9.7%**		9.8%
7:30 am	Average Hourly Earnings - Dec	+0.2%	**+0.2%**		0.0%
7:30 am	Average Weekly Hours - Dec	34.3	**34.3**		34.3
2:00 pm	Consumer Credit – Nov	+$0.5 Bil	**-$1.8 Bil**		+$3.4 Bil