First Trust
Monday Morning OUTLOOK
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Economy Improving, Stocks Cheap

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Senior Economist*
Strider Elass – *Economic Analyst*
Andrew Hull – *Economic Analyst*

Remember the big fat "zero" jobs reports back in August? The Pouting Pundits of Pessimism reported it as the end of the world. The US was supposedly teetering on the brink of another recession, or maybe depression. Democrats wanted more government spending "stimulus." Republicans said President Obama was the equivalent of a "zero." With all this negative sentiment, the Dow fell 250 points that day.

But something happened on the way to the bank. One month later, that big fat zero was revised up to a +57,000, the next month it was revised up again to +104,000. All that recession talk in early September was highly misleading.

Private payrolls are up 157,000 per month in the past year and that's happening even though the "labor-intensive" construction industry is still in the doldrums.

Unemployment is now 8.6%, way down from 9.8% last November. Many are saying that the lower unemployment rate was caused by a 315,000 drop in the labor force (people looking for work). These pessimists say, "everyone is discouraged, so falling unemployment rates are actually a bad thing." But this is a Chicken Little view of the world.

In the past four months, civilian employment (calculated by canvassing households), has jumped by 1.28 million – an average of 321,000 new jobs each month. During the same four months, the labor force has expanded by an average of 164,000 new entrants per month. In other words, the labor market is getting better, on all fronts, not worse. We may see unemployment tick up next month, but this would be a correction for an exaggerated one month drop.

Meanwhile, reports on consumer spending and manufacturing production keep signaling growth. Auto sales – big-ticket items people shy away from when they anticipate recession – hit 13.6 million in November, the best pace since early 2008 (except for "cash for clunkers," when the government was cutting checks of $4,000 each to buy a vehicle). Industrial production is up 4.5% from a year ago.

Even the housing market is starting the long path back to normalcy. So far this year, multi-family builders have started 45% more homes than they did in the same time frame in 2010. And permits to build single-family homes are up 5% from a year ago.

And yet the stock market is more undervalued today than it was at the very bottom of the panic in March 2009.

We use a capitalized profits model to value stocks, dividing corporate profits by the 10-year Treasury yield. We compare the current level of this index to that from each quarter for the past 60 years to estimate an average fair-value. Not only are 10-year yields low (2.1%), but corporate profits are at a record high. As a result, the model says fair value for the Dow is currently 45,000.

But this result is largely due to artificially low interest rates. If we use a more realistic discount rate of 5% for the Treasury, we get a fair value of 19,500 on the Dow and 1,980 for the S&P 500.

As we've said before, there are many moving parts to this model. Interest rates could go higher than 5%, profits could fall or both could happen. Profits, for example, are now 13% of GDP, the highest in measured history (back to 1947) except for one quarter in 1950.

So what does our model say if profits revert to the historical mean of about 9.5% of GDP? Even in that scenario, *and assuming a 5% yield on the 10-year Treasury*, fair value is 14,200 for the Dow and 1450 for the S&P 500.

Back at the peak of the stock market in 2000, an ounce of gold could get an investor fewer than 4 shares of Intel (INTC). Today it is trading for about 70 shares. Meanwhile, Intel yields around 3.4% and gold yields zilch. Stocks are dirt cheap, relative to bonds and relative to gold.

Of course, it would be great to know the exact moment that all the bad news from Europe finally at long last blows over. But no one knows. Investors have a simple choice. Do they want to own stocks when they are dirt cheap, or will they wait and pay more when the fear disappears?

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-5 / 9:00 am	Factory Orders - Oct	-0.3%	**-0.2%**	-0.4%	-0.1%
9:00 am	ISM Non-Man. - Nov	53.9	**53.8**	52.0	52.9
12-7 / 2:00 pm	Consumer Credit - Oct	+$7.0 Bil	**+$7.5 Bil**		+$7.4 Bil
12-8 / 7:30 am	Initial Claims - Dec 3	395K	**399K**		402K
12-9 / 7:30 am	Int'l Trade Balance - Oct	-$43.9 Bil	**-$42.2 Bil**		-$43.1 Bil
8:55 am	U. Mich. Consumer Sentiment	65.8	**65.0**		64.1