First Trust
Monday Morning OUTLOOK
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Stocks Rising, But Still Cheap

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

The stock market is on a roll. The S&P 500 has had the best start to any year since 1997, while the Dow Jones Industrial Average looks set to move back above 13,000 for the first time since May 2008.

Fears about some sort of Lehman-style financial panic in Europe are waning. While problems in the Middle East persist, this is nothing new. Moreover, analysts and investors are increasingly focused on reports that show improvement in the US economy. The Fed has not been able to justify QE3.

Maybe the best news is that investors are looking deeper into economic data, not just trading on headlines. Last week's retail sales and industrial production reports were both lower than the consensus expected, but each came with a convincing alibi.

In the case of retail sales, the Census Bureau estimated a drop in auto sales even though reports on sales by automakers themselves, were up strongly. The markets believed the automakers.

Industrial production came in with a big fat zero for January, but a steep drop in output at utilities and mines masked a strong 0.7% increase in manufacturing, driven largely by automakers, who, even after a recent production surge are still running well behind demand, leaving dealer inventories unusually thin.

Meanwhile, regional manufacturing surveys – the Empire State index and Philadelphia Fed index – both beat consensus expectations for February and reported better employment conditions. On cue, new claims for jobless benefits hit the lowest level since early 2008. In addition, housing starts climbed, more proof that the trend in home building is now consistently upward.

The rise in equities so far this year is not just a "sugar high." The Fed has done nothing new, while Keynesian pump-priming is on the wane. Federal spending peaked at 25.3% of GDP back in 2009. It's still way too high, but has fallen to 23.7%. Meanwhile, despite shenanigans like the temporary payroll tax cut, federal revenue has risen from 15.1% of GDP to 15.4% in the past year. Spending is down and taxes are up. From a Keynesian perspective, fiscal policy is contractionary.

Yes, the Fed is loose and is holding interest rates down artificially. But even if we assume more normal interest rates and stable profits (which implies declining margins), stocks are very cheap. Cheap enough in our view to take us to 14,500 on the Dow and 1475 on the S&P 500 by year end 2012.

Using a capitalized-profits approach, we divide corporate profits by the current 10-year Treasury yield of 2% and then compare the current level of this index from each quarter for the past 60 years. Hold on to your hats…this method estimates a fair-value for the Dow at 46,000. But, this extremely bullish result is largely due to artificially low interest rates. Current levels on inflation are above the 10-year Treasury yield and we believe that once the Fed normalizes its policy stance interest rates will climb to much higher levels.

If we use a more realistic discount rate of 5% for the 10-year Treasury, we get a fair value of 18,800 on the Dow and 1,975 for the S&P 500.

Another potential problem is that profits have been an unusually large share of GDP – currently almost 13%. If profits revert to a historical norm of about 9.5% of GDP at the same time the *10-year Treasury yield is 5%*, fair value would be 13,900 for the Dow and 1460 for the S&P 500. Just to be clear, that would be in a world where profits fall roughly 25% and interest rates more than double from their current levels. In other words, this doesn't look like a dead cat bounce to us.

Valuations are robust and with the economic recovery re-accelerating, the bull market that started in March 2009 has much further to run.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-22 / 9:00 am	Existing Home Sales - Jan	4.660 Mil	**4.700 Mil**		4.610 Mil
2-23 / 7:30 am	Initial Claims - Feb 18	355K	**356K**		348K
2-24 / 8:55 am	U. Mich. Consumer Sentiment	73.0	**73.0**		72.5
9:00 am	New Home Sales - Jan	0.315 Mil	**0.313 Mil**		0.307 Mil