First Trust
Monday Morning OUTLOOK
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Stocks Are Really Cheap

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

America's equity markets have rallied sharply since last October, with the S&P 500 up 22%. Nonetheless, the stock market has been stuck in a range for 18 months, with the Dow Jones Industrials Average trading between 10,650 and 13,280, well below the October 2007 high of 14,165.

Financial markets have priced in all kinds of bad things – a fiscal cliff, slower earnings growth, a potential recession, and big government. Along with range-bound stocks, the 1.5% 10-year Treasury yield seems to confirm this.

But, we think these markets are overly pessimistic. We don't buy the fears about the fiscal cliff. Regardless of the outcome of the election, most likely, the 2001/03 tax cuts will end up getting extended another year or two, while military spending cuts get postponed. And, if anything, cutting non-defense spending would spur growth.

We are more sympathetic with fears about prolonged slow economic growth and the burden of big government. If they remain an issue, the market would be correct to expect less in the way of future after-tax profits. Slower economic growth would boost deficits, while unchecked government spending would increase the odds of higher future taxes.

But the stock market is significantly undervalued already. If the future turns out to be less dour, investors should look out above.

We use a capitalized-profits model to find the fair-value of equities. We divide corporate profits by the current 10-year Treasury yield (1.5%), and then compare the current level of this index to each quarter for the past 60 years. This method estimates a fair-value for the Dow at an absurdly high 63,000. Yes, you read that right, that's almost five times the current level.

Obviously, this seems crazy. We agree. It's a result of using artificially low long-term interest rates. So, we adjust the model and assume the appropriate 10-year Treasury yield would be in the 4% to 5% range. Using a more conservative discount rate of 5% gives us a fair value of 18,700 on the Dow and 1,985 for the S&P 500.

Alright, that seems more reasonable. But what if record high corporate profits – about 13% of GDP – revert to their historical norm of about 9.5%, at the same time the *10-year Treasury yield moves to 5%?* If that happened, the fair value of the Dow would be 13,900 and for the S&P 500 it would be 1475. In other words, *if* profits fall roughly 25% *and* interest rates more than triple from current levels, broad stock market indices are still undervalued.

None of this means the stock market is going to rally today, or this week, or even over the next year. What it means is that the upside risks for stocks are much greater than the downside risks. The capitalized profits model says clearly that the stock market is currently discounting a very bleak future.

If, like us, you believe there are dangers in the years ahead, but that US growth will push profits higher over time and that the odds of a positive turn in fiscal policy are real, then equities are really cheap.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-16 / 7:30 am	Empire State Mfg Index – Jul	4.0	**4.5**	7.4	2.3
7:30 am	Retail Sales- Jun	+0.2%	**+0.0%**	-0.5%	-0.2%
7:30 am	Retail Sales Ex-Auto- Jun	+0.0%	**-0.3%**	-0.4%	-0.4%
9:00 am	Business Inventories- May	+0.2%	**+0.1%**	+0.3%	+0.4%
7-17 / 7:30 am	CPI – Jun	+0.0%	**-0.1%**		-0.3%
7:30 am	"Core" CPI – Jun	+0.2%	**+0.2%**		+0.2%
8:15 am	Industrial Production- Jun	+0.3%	**+0.4%**		-0.1%
8:15 am	Capacity Utilization - Jun	79.2%	**79.2%**		79.0%
7-18 / 7:30 am	Housing Starts - Jun	0.745 Mil	**0.745 Mil**		0.708 Mil
7-19 / 7:30 am	Initial Claims – Jul 14	365K	**365K**		350K
9:00 am	Philly Fed Survey – Jul	-8.0	**-15.0**		-16.6
9:00 am	Leading Indicators – Jun	-0.1%	**+0.0%**		+0.3%
9:00 am	Existing Home Sales - Jun	4.620 Mil	**4.600 Mil**		4.550 Mil

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.