First Trust
Monday Morning OUTLOOK
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Still Bullish

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Like Rip Van Winkle, imagine you went to sleep on October 9, 2007 and didn't wake up until yesterday. On 10/9/2007, equities were at record highs: 14,165 for the Dow Jones Industrial Average and 1,565 for the S&P 500.

You slept right through a housing bust, a financial panic, the deepest recession since the Great Depression, the passing (and upholding) of Obamacare, multiple bouts of debt-limit brinksmanship, two fiscal cliffs, the European financial "crisis," a tsunami in Japan, the BP oil fiasco, and a long list of other media-obsessions over the past 67½ months.

You woke up, and the Dow and S&P 500 were up 8.4% and 6.5%, respectively, from when you fell asleep, with both at new record highs. Including dividends, the S&P 500 has returned 3.3% per year since you went to sleep, while consumer prices rose 2% per year and short-term rates averaged 0.5%.

Now…imagine that no one would tell you what happened in the past six years. All you could do was compare current market data to what it was when you fell asleep. Would you buy equities, or sell them?

Corporate profits rose 34% during the deep sleep, so Price-to-Earnings (P-E) ratios are lower. Short-term interest rates were 4%, now they are near zero; yields on long-term Treasury notes were 4.5% back then, and now below 2%. Gold has jumped from $740 per ounce to $1,350; oil from $73 per barrel to $96.

In a nutshell, relative to fixed income and commodity markets, equities look significantly cheaper today than they did in 2007. There is even more reason to buy.

The unemployment rate was only 4.7% when you fell asleep: now it's 7.5%. Believe it or not, that is good news. Historically, high unemployment means things are going to get better, while periods of low unemployment suggest things are about to get worse. We get the flu when we feel good; we get over it when we feel bad.

It was this focus on fundamentals that motivated our forecast that equity values would rise this year. At the beginning of 2013, we forecast the Dow at 15,500 and S&P 1700 by year-end. We felt that this higher-than-consensus forecast was realistic and, yet, conservative. We've been proven right. Equities have gone up even faster than we thought and we see no reason the bull market won't continue.

As a result, we are raising our forecast. We now expect a year-end Dow of 16,250, with the S&P 500 at 1,765, a respectable gain of 5.8% from Friday's close. That's an annualized gain of almost 10% for the rest of the year, with dividends boosting the total return to 12% annualized.

This would boost the 2013 return for the Dow to 24%, the most for any year since 2003. So even though bearish forecasters are saying the 2013 increase in equity prices is "insane," it is actually well within historical norms.

We use a capitalized-profits model to find fair-value for equities. We divide corporate profits by the current 10-year Treasury yield (1.95%), and then compare the current level of this index to each quarter for the past 60 years. This method gives us a fair-value for the Dow of 48,000 – three times the current level. Obviously, this is crazy.

But it's what happens when the Fed holds interest rates at artificially low levels. So, we adjust by using a 10-year Treasury yield of 4.5% - the same as the Federal Reserve's estimate of long-term growth in nominal GDP (real GDP growth plus inflation). Using 4.5% as our discount rate suggests a much more reasonable fair value of 21,000 on the Dow and 2,250 for the S&P 500.

But what if record high corporate profits –12.7% of GDP – revert to their historical norm of about 9.5%, *at the same time* the 10-year Treasury yield moves to 4.5%? If that happened, the fair value of the Dow would be 15,650, and the S&P 500 would be 1700. In other words, ***if*** profits fall 25% ***and*** interest rates more than double, broad stock market indices are still slightly undervalued. That said, this scenario is highly unlikely. If rates are rising, it will most likely be because the economy is doing well, which means corporate profits will not collapse.

This does not mean markets will rise in a straight line. Volatility is part of life. But, if you can find a way to sleep through the next few years, and be long equities at the same time, you should wake up wealthier. Stay bullish.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-22 / 9:00 am	Existing Home Sales – Apr	4.990 Mil	**4.970 Mil**		4.920 Mil
5-23 / 7:30 am	Initial Claims May 18	346K	**346K**		360K
9:00 am	New Home Sales – Apr	0.425 Mil	**0.423 Mil**		0.417 Mil
5-24 / 7:30 am	Durable Goods – Apr	+1.5%	**+1.1%**		-5.8%
7:30 am	Durable Goods (Ex-Trans) – Apr	+0.5%	**-0.2%**		-1.5%