First Trust
Monday Morning OUTLOOK
630-517-7756
June 22nd, 2015

Stocks Are Still Cheap

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

You know those TV shows – the ones about ice trucking, fishing in Alaska, or digging for gold. They're made to bring out these interesting jobs, but also the danger. They leave you hanging, and break for commercial, just when the truck starts to slide on a bridge, or just when a huge wave is approaching.

If you watch long enough, you realize that, yes, these are tough jobs, but major accidents are few and far between because "these guys and gals are good" – they know what they are doing. Things become routine and viewership falls off after season two and they're taken off the air.

Not so with financial markets. Every day, at least for the past six years or so, investors get to see a new episode. And every day there's another potential danger. It's mesmerizing, the danger never stops and apparently nothing becomes routine.

Resetting ARMs were taken off the air. Cyprus, the dollar's reserve currency status, and the hidden inventory of unsold homes, too. Greece hangs around because we can get pictures of protests and riots. But, the latest episode, the one that says earnings are slowing just when interest rates are going up, well, maybe, just maybe, this is the one that needs to be taken seriously. After all, earnings and interest rates are key components of stock market values. In fact, they are the key components of our capitalized profits market model.

So when some analysts, who we respect, highlight the recent weakness in overall corporate earnings growth, our ears finally perk up. Is this true? Is this something to worry about, or is it still just noise?

We believe it is much ado about nothing. In June of 2014, energy stocks made up 10.9% of S&P 500 market cap and we all know what happened to energy prices - oil prices and natural gas prices are both down roughly 40% from a year ago. That has dragged down overall S&P 500 earnings.

But, when we look at equity values, we use government estimates of total corporate profits, and for the economy as a whole, the energy sector generates only about 3% of total corporate profits. So the weakness in energy earnings is not as important for the whole economy as it is for energy stocks or indices that have a heavy energy weighting. Moreover, even within the S&P 500, with all Q1 results in, *non-energy earnings* were up 11.7% from a year-ago.

Of course, if you pick and choose which sectors to exclude, you can always find a silver lining. But consumers and businesses are only starting to shift resources away from the energy sector to other purchases and investment, it hasn't happened overnight. As a result, weak earnings in the energy sector will, over time, generate higher earnings elsewhere.

This is why we use a Capitalized Profits Model to assess stock market value. Our model uses *after-tax* corporate profits discounted by the 10-year Treasury. And in spite of soft total profits in Q1, including the energy sector as well as weather-related issues, the model says the S&P 500 is still undervalued. Using the current 10-year Treasury yield (2.35%), our models say the "fair value" of the S&P 500 is 4,335.

This number is artificially high because the discount rate is being held down by the Federal Reserve keeping short-term rates artificially low. Using a 4% 10-year discount rate gives us a "fair value" calculation of 2,550 and it would take a 10-year yield north of 4.8% and no growth in corporate profits in Q2 for the model to suggest equities are fully valued.

None of this means equities are as attractive today as they were back in March 2009. Nor does it mean we won't have a "correction" in equities at some point. What it does mean is that after considering their risk profile, age, and financial goals investors should be more tilted toward equities than they would normally be and we believe those that are should continue to enjoy attractive returns over at least the next couple of years. This bull has further to run.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-22 / 9:00 am	Existing Home Sales – May	5.260 Mil	**5.280 Mil**	5.350 Mil	5.040 Mil
6-23 / 7:30 am	Durable Goods – May	-0.9%	**-2.2%**		-1.0%
7:30 am	Durable Goods (Ex-Trans) – May	+0.5%	**+0.5%**		-0.2%
9:00 am	New Home Sales – May	0.523 Mil	**0.505 Mil**		0.517 Mil
6-24 / 7:30 am	Q1 GDP Final Report	-0.2%	**-0.3%**		-0.7%
7:30 am	Q1 GDP Chain Price Index	-0.1%	**-0.1%**		-0.1%
6-25 / 7:30 am	Initial Claims - Jun 20	273K	**273K**		267K
7:30 am	Personal Income – May	+0.5%	**+0.4%**		+0.4%
7:30 am	Personal Spending – May	+0.7%	**+0.7%**		0.0%
6-26 / 9:00 am	U. Mich Consumer Sentiment- Jun	94.6	**94.6**		94.6