FIRST Trust ADVISORS L.P.

Quarterly Market Overview

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Mr. Carey has appeared as a guest on such programs as Bloomberg TV and CNBC and has been quoted by several publications, including *The Wall Street Journal, The Wall Street Reporter, Bloomberg News Service, and Registered Rep*.

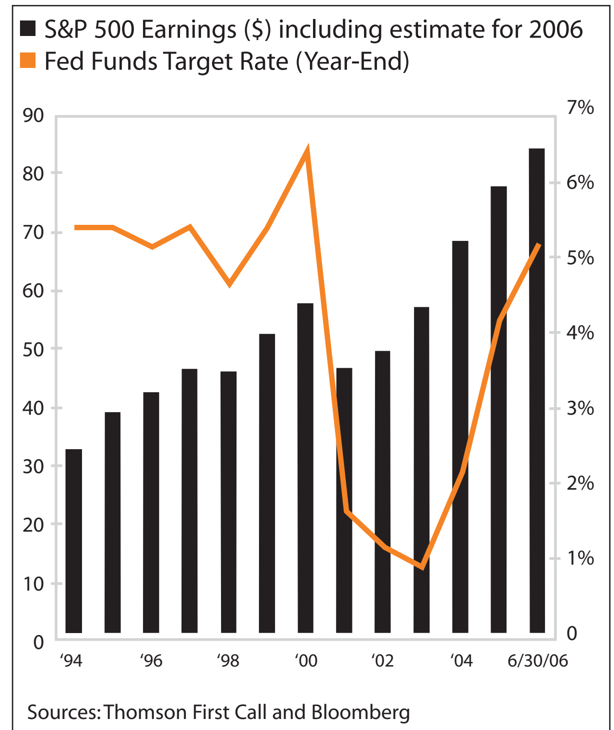
The S&P 500 continues to sputter...and there is some method behind this madness

In our Q1'06 newsletter, we discussed the terrific returns that had been posted by emerging markets equities in recent years, particularly in the popular BRICs countries (Brazil, Russia, India & China). We cited one organization's forecast estimating that an additional $345.2 billion would flow into emerging markets equities in 2006. We summed up our take on this phenomenon with the following observation: "In light of the generous returns posted in recent years, we believe it is time for investors to respect the risks associated with these securities." We are certainly not suggesting that investors shy away from investing in emerging markets, especially if they have a long time horizon, but we do encourage them to maintain realistic expectations with respect to returns. As we learned with the Nasdaq bubble back in 2000, the concept of valuation does play an integral role in the stock market.The MSCI Emerging Markets Index slid 4.35% (USD) in Q2'06, vs. a 1.44% decline for the S&P 500. India, arguably the most popular emerging market over the past year, saw its Sensex 30 Index fall 8.22%. The index also suffered a one-day correction of 6.8% in May.

We would like to expound a bit on the relevance of the valuation process, while also turning our attention back to the U.S. Aside from such external influences as war or an uncharacteristically lengthy period of speculation, as was the case with the Internet revolution and Y2K in the latter part of the 1990s, there are some proven methods that are useful in attempting to discern the "fair value" of a stock or market. Perhaps the most common method is to discount the future earnings of a company or index by an expected return rate. Since the future isn't certain, the more accurate one is with predicting the direction of interest rates and their impact on future earnings, for example, the better chance they have of assessing fair value. Low interest rate levels can lower a company's cost of capital, which can help boost earnings. The chart we provided to the right reflects the change in both the fed funds target rate and the actual earnings for the S&P 500 since 1994. As you can see, earnings have risen despite the fed funds rate hikes that began in June 2004, *but with inflation on the rise investors are acting as though earnings have already retrenched.* Despite 16-consecutive quarters of double-digit earnings growth for the companies in the S&P 500 Index, the index is noticeably undervalued based on 2006 estimated earnings. The Fed Model backs this claim as well.

Historically, equity returns have tended to mirror earnings growth over the long haul. For example, S&P 500 earnings grew 300% from 1992 through 2005, according to data from Thomson First Call. The S&P 500 posted a total return of 293.2% over that same period. However, if consensus earnings estimates for 2006 prove correct (estimates call for a gain of 8.47% – reflecting a deceleration in earnings growth), from 2003 (S&P 500 bottomed 10/02) through June 2006, S&P 500 earnings will have grown by 71.9%, yet the S&P is up just 53.7% with six months to go in 2006. That means the index is potentially 25% undervalued as of June 30, 2006.

The Fed Model compares the earnings yield of the S&P 500 to the yield on the 10-yr. T-Note to determine if stocks are fairly valued. As of June 30, the yield on the 10-yr. t-Note was 5.13%, and the S&P 500 closed at an index reading of 1270. Using $82.75 for the 2006 estimated earnings for the S&P 500 and dividing it by the 5.13% T-Note yield, the S&P 500 fair value index reading should be 1613, or 27% higher than on June 30.



Sources: Thomson First Call and Bloomberg

Continued

Investor sentiment can turn on a dime...what's hot today could cool tomorrow and vice versa

REITs

Equity REITs have been red hot ever since the bubble burst in the Nasdaq. Prior to that event, not so hot. That event inspired many investors to shift from a growth-oriented strategy to one that targeted income. At the end of 1999, equity REITs yielded just under 9% as a group. Today, closer to 4.25%. REIT returns have been bolstered by institutional buying and mergers over the past two years. REITs are no longer a bargain, in our estimation.

Utilities

Utility stocks turned hot in 2000 as some of the more aggressive companies began to expand into areas such as broadband (cable). Utilities turned cool in 2001 once the bubble in the Nasdaq burst and investors learned that a high percentage of cable across the U.S. was dark. With stock prices washed out and companies focused on core businesses (cutting debt), utilities got hot again. Utilities were a logical growth and income opportunity in 2003.

Large-Cap Growth

Large-Cap Growth stocks lost their leadership role in the market in Q2'99. Multiples had expanded too far. Small- and mid-cap stocks dominated after the recession ended in Q3'01. From 9/02 (S&P 500 hit bottom on 10/9/02) through 6/06, the S&P Citigroup Growth Index gained 18.7%, vs. 86.9% for the S&P 400 Index and 90.3% for the Russell 2000. A recent survey by Russell found that **69%** of money managers are bullish on large-cap growth stocks, vs. 27% for small-caps.

Pharmaceuticals

If you were to look at a chart of FDA drug approvals dating back to 1993, you would see a strong correlation between the years in which drug approvals rose significantly and the best performing years for drug stocks. Drug approvals were higher than average from 1994-1998, as well as in 2000 and 2003. The pipeline is the key. There are currently 2,300 experimental drugs in clinical testing, up 31% from three years ago, according to IMS Health.

NAREIT Equity REIT Index

06'06	12.9%
2005	12.2%
2004	31.6%
2003	37.1%
2002	3.8%
2001	13.9%
2000	26.4%
1999	-4.8%
1998	-17.5%

Source: National Association of Real Estate Investment Trusts

S&P Utility Index

06'06	0.4%
2005	16.8%
2004	24.2%
2003	26.2%
2002	-29.9%
2001	-30.4%
2000	57.2%
1999	-9.2%

Source: Bloomberg

S&P Citigroup Growth Index

06'06	-0.9%
2005	4.0%
2004	6.1%
2003	25.7%
2002	-23.6%
2001	-12.7%
2000	-22.1%
1999	28.2%
1998	42.1%
1997	36.5%
1996	23.8%

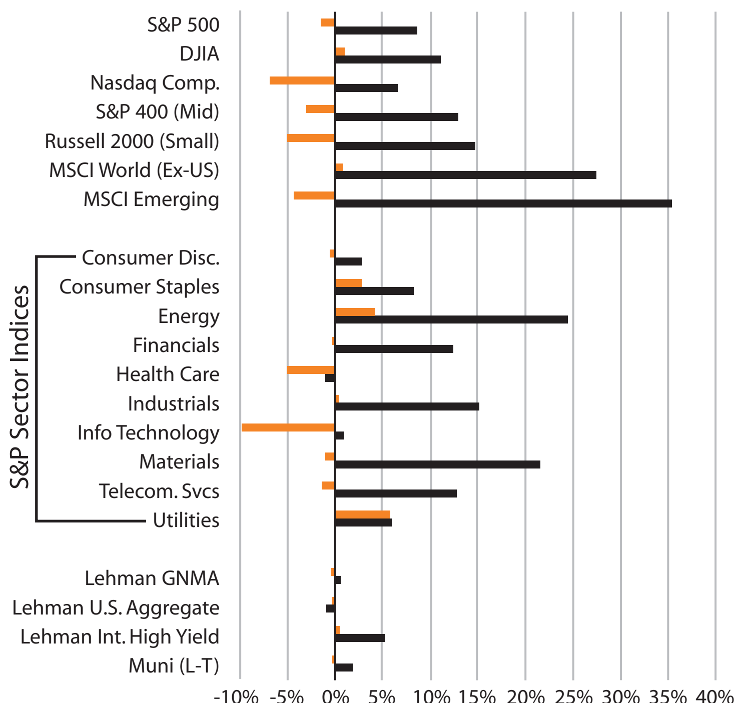
Source: Bloomberg

S&P Pharmaceutical Index

06'06	3.3%
2005	-3.4%
2004	-7.4%
2003	8.8%
2002	-20.0%
2001	-14.5%
2000	36.3%
1999	-12.0%
1998	49.0%
1997	53.6%
1996	25.5%
1995	60.1%
1994	16.7%
1993	-6.7%
1992	-17.2%

Source: Bloomberg

Total returns for *Q2* and past *12 months* (6/30/06)



A Look Ahead:
The outlook for earnings (year-over-year)...

	Q3'06E	Q4'06E	2006E
Financials	26.7%	22.5%	16.2%
Technology	**1.5%**	**5.5%**	**1.3%**
Health Care	2.8%	5.2%	4.8%
Consumer Staples	**4.7%**	**9.2%**	**3.9%**
Consumer Discretionary	27.2%	22.9%	21.6%
Industrials	**16.3%**	**15.9%**	**14.9%**
Telecommunications Services	13.2%	10.7%	13.7%
Energy	**13.3%**	**2.1%**	**18.0%**
Utilities	8.8%	11.4%	13.0%
Materials	**46.9%**	**40.5%**	**26.5%**
S&P 500 Index	**11.9%**	**6.8%**	**8.5%**
S&P 400 Index (Mid-Cap)	**25.4%**	**19.7%**	**18.1%**
S&P 600 Index (Small-Cap)	**19.2%**	**19.2%**	**15.1%**

Source: Thomson First Call/Baseline (7/3/06)