First Trust

Quarterly Market Overview

Issue 33, April 2008

Robert F. Carey, CFA
Chief Investment Officer

Mr. Carey has 21 years of experience as an Equity and Fixed-Income Analyst and is a recipient of the Chartered Financial Analyst (CFA) designation. He is a graduate of the University of Illinois at Champaign-Urbana with a B.S. in Physics. He is also a member of the CFA Society of Chicago and the CFA Institute.

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*.

Time for U.S. investors to bring some of their dollars back home

Investors have had a big appetite for foreign stocks...

Since mid-2003, investors have poured a net $700 billion into global/international equity funds, according to Strategic Insight. The combination of a weaker dollar and a compelling global growth story, driven largely by emerging market countries, was a no-brainer in hindsight. While we would agree the outlook for emerging markets is more than optimistic over the next couple of decades, we wonder if investors are prepared for the types of shocks these markets can deliver in the near-term. The bursting of tech bubble in 2000 certainly didn't sit well. As gloomy as the mood has been in the U.S. stock market since its peak last October, the S&P 500 is actually down less than most major world markets in 2008. In addition to mounting inflationary concerns in high-growth economies, such as China and India, many countries have also been dinged by the subprime mortgage meltdown. Writedowns abroad could end up being as much or more as the $285 billion estimated for U.S. financial firms by Standard & Poor's.

The global trek for risk may be on its last leg...

Why might this be so? Well, let's begin with the latest speculative play: frontier markets. These are found in places like the Persian Gulf, Middle East and Africa. In other words, they are beyond emerging markets with respect to risk. They are more vulnerable to geopolitical events, corruption and liquidity constraints. There are already a dozen funds (open-end & ETFs) that investors can tap to gain exposure, according to SmartMoney.com. We are not opposed to such funds, but we do see them as a critical sign of just how far out on the risk spectrum investors will go in an attempt to capture outsized gains. A recent eight-year study of investment risk in 50 nations (70 bits of data per country) by Joel Kurtzman and Glenn Yago found that a strong correlation exists between low transparency and decreased performance, according to *Worth*. The study is called *Global Edge: Using the Opacity Index to Manage the Risks of Cross-Border Business*. The best countries were Great Britain, Finland, Hong Kong (not China) and the U.S.

The more things change the more they stay the same...

It has been said that the U.S. financial system is operating in unchartered waters due to the subprime-induced credit crunch. We do not subscribe to this premise and cite the early 1990s as a recent example. Not only was the climate similar when you factor in the S&L crisis and the first Gulf War, but the early 1990s was potentially more threatening and larger in scope (S&Ls, junk bonds, commercial paper, insurance companies, real estate, and European currencies trading outside their permitted band set by the Maastricht Treaty to help forge the European Union), than what we have faced this go around. Here are some similarities and differences to lend some perspective:

Notable Failures: While we just witnessed a bailout of Bear Stearns (the 5th largest investment bank in the U.S.), we also witnessed the demise of Drexel Burnham Lambert (the 5th largest investment bank at its peak) in 1990. Though some insurance companies, such as AIG, have sustained multi-billion writedowns due to the subprime meltdown yet remain well-capitalized, Executive Life Insurance Co. (once the largest in California) was declared insolvent in 1991 and seized by the California Department of Insurance. It held a multi-billion portfolio of junk bonds during the recession of '90-'91.

Central Banks: With the U.S. economy headed for recession in the second half of 1990 the Fed cut rates substantially over a two-year period. It left the federal funds target rate at 3.00% for roughly 17 months in an effort to jumpstart the economy. Meanwhile, due to the one-for-one currency swap between East and West Germany during their unification (inflationary since East Germany's currency was worth far less), the Bundesbank in Germany kept rates high in an effort to fight inflation. Fast-forward to today and it sounds the same – Fed has cut rates 300 basis points since last September, while the European Central Bank has left rates high in an effort to fight inflation.

S&L Bailout: Approx. **$500 billion** (General Accounting Office)
Subprime Meltdown (U.S.-only)**: $285 billion estimate** (S&P)

We've been down this road before!

Continued

Earnings growth stayed strong for many U.S. companies post bear market yet returns and P-Es regressed

No love for these A-listers...

Company	Subsector	Earnings Growth ('07 vs.'02)	Gross Return (12/02-12/07)	P-E ('02 vs.'07)	Index Return (12/02-12/07)	
Amgen	Biotech	+189.5%	-3.9%	33.6 vs. 11.1	AMEX Biotech	+132.5%
Ely Lilly	Pharma	+38.8%	-4.1%	24.9 vs. 15.1	S&P Pharma	+18.0%
Wal-Mart	Retail-Discount	+100.0%	+0.1%	41.4 vs. 16.4	S&P Cons. Staples	+63.8%
AIG	Insurance	+65.0%	+4.7%	26.7 vs.16.3	S&P Insurance	+53.9%
Harley-Davidson	Discretionary	+96.8%	+7.1%	24.3 vs. 12.5	S&P Cons. Disc.	+50.0%
Mattel	Toys	+30.3%	+14.3%	17.4 vs. 13.3	S&P Cons. Disc.	+50.0%
Sysco	Food	+58.4%	+14.4%	27.0 vs. 20.6	S&P Food Products	+61.4%

Source: Bloomberg

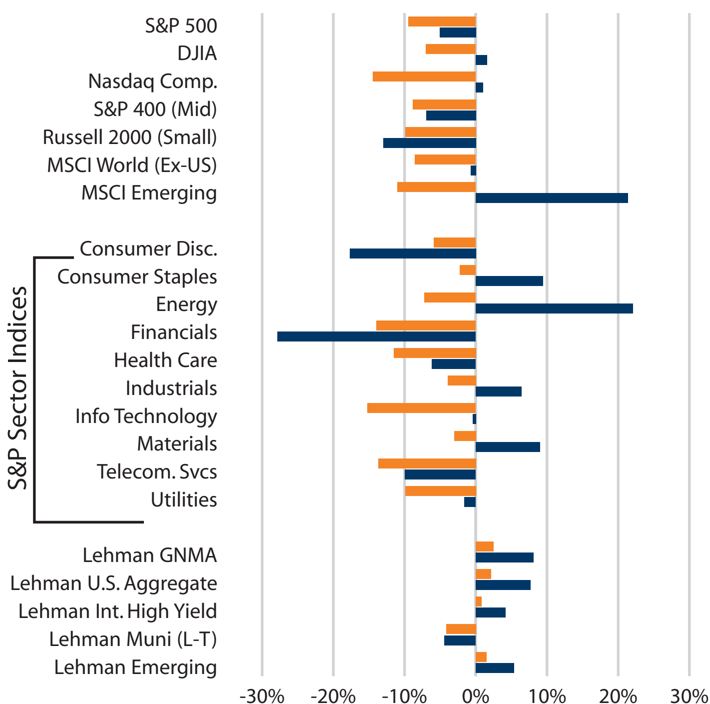
Looking for a 2nd half rebound in U.S. stocks...

We believe that investors should take another look at U.S. stocks. The one-two punch combination of fiscal and monetary stimulus has been successful in igniting economic growth in the past and we see no reason why it should not work in the current climate. On top of what is coming, there was $3.5 trillion in retail money market funds at the close of March, $1 trillion more than a year ago, according to data from the ICI. The forward-looking price-to-earnings ratio on the S&P 500 was 14.3 as of mid-April, according to Thomson Baseline. So large-caps are not expensive, in our opinion. Brian Wesbury, chief economist for First Trust Advisors, stated recently he sees the Dow ascending to 15,000, or around a 22% gain from its close in March.

U.S. equities offer upside potential with less risk...

Interest in foreign equities has been so strong for so long that the bull market in U.S. stocks since October 9, 2002, has been one of the most anemic on record. This despite a record 18 consecutive quarters of double-digit earnings growth for the S&P 500. This despite the hundreds of billions of dollars spent on stock buybacks by the companies in the index. It even looked as though we were actually on the cusp of a new global paradigm heading into '08 where foreign stock markets would completely decouple from U.S. stocks. In other words, corrections in U.S. stocks would no longer drag down the performance of those foreign markets enjoying strong economic prosperity. As is the case with most new paradigms, this one turned out to be wrong.

Total returns for *Q1* and past *12 months* (3/31/08)



A Look Ahead:

The outlook for earnings (year-over-year)...

	Q2'08E	Q3'08E	2008E
Financials	-30.0%	10.0%	11.8%
Technology	**16.6%**	**9.60%**	**8.7%**
Health Care	10.1%	7.6%	7.4%
Consumer Staples	**10.8%**	**12.1%**	**8.8%**
Consumer Discretionary	-1.5%	41.9%	9.9%
Industrials	**10.0%**	**12.2%**	**11.1%**
Telecommunications Services	0.4%	0.3%	2.1%
Energy	**11.0%**	**25.8%**	**14.5%**
Utilities	2.7%	7.5%	6.1%
Materials	**11.0%**	**12.7%**	**12.7%**
S&P 500 Index	**-0.9%**	**10.5%**	**9.0%**
S&P 400 Index (Mid-Cap)	**6.6%**	**13.9%**	**11.6%**
S&P 600 Index (Small-Cap)	**1.2%**	**12.9%**	**8.1%**

Source: Thomson First Call/Baseline (3/31/08)