First Trust

# Quarterly Market Overview

Issue 42, July 2010

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Mr. Carey has appeared throughout the United States and Canada as a guest on television and radio programs. These programs include: Bloomberg TV, CNBC and Canada's Business News Network and on Chicago's WBBM Newsradio 780's Noon Business Hour. He has been quoted by several publications, including *The Wall Street Journal, The Wall Street Reporter, Bloomberg News Service, and Registered Rep.*

## That deaf, dumb and blind kid...Sure plays a mean pinball! (Pinball Wizard by The Who)

The S&P 500 at one point in late April had rallied 84% from its 3/9/09 bear market low. While we concede a run like that is too far, too fast, we do not believe that it was necessarily too good to be true. After all, it was our own Brian Wesbury, Chief Economist at First Trust Advisors, who very early on publicly labeled the subprime/asset-backed meltdown that ignited the bear market a "panic" and called for the easing of mark-to-market accounting rules to end the run of capital destruction at our largest banking and Wall Street institutions. That is eventually what transpired and it triggered the bottom on 3/9.

The 15.6% correction in the S&P 500 we experienced from 4/23-7/2 is not only justifiable, but healthy. It has been well documented that this bull market has largely been driven by institutional dollars and the smart money was balking at pushing valuations any higher without the help of the retail investor. Mutual fund flows clearly show that the retail investor has opted for bonds over stocks over the past 18 months. A correction like this one gives anyone who has missed out on the move in stocks another chance to commit some capital.

Why is now an entry point worth considering? It can be summed up in one word: earnings. Earnings estimates have been trending higher. Standard & Poor's, for example, has been ratcheting up its estimates for the companies in the S&P 500 throughout the first half of 2010. As of June 30, it puts 2010 earnings at $81.82 and 2011 earnings at $95.03. That is a far cry from the $49.51 earned in 2008, when we were in the midst of the bear market. Some industry pundits argue that earnings growth moving forward can't be this optimistic and cite the macroeconomic outlook is less rosy than once thought due to the austerity measures being implemented in Greece, and potentially other EU countries, as well the tempering of growth in China. And therein lies the rub for the retail investor: Who to believe?

When in doubt put your faith in history repeating itself. History shows that the S&P 500 has never failed to recover from a bear market. Since 1946, it has experienced 12 of them, according to S&P. It takes 39 months, on average, for investors to recoup losses from a bear market, according to InvesTech. We were 16 months into the current bull on July 9. As of 7/15, the S&P 500 would have to rally another 42.7% to reach its previous all-time high of 1565.15 on 10/9/07. The S&P 500 has returned 9.81%, on average, from 1926-2009, according to Ibbotson Associates. That means that investors have the potential to capture a 42.7% gain in the stock market over the next 23 months – if this proves to be an average recovery – versus the 18.8% norm. Of course, past performance is no guarantee of future results.

Putting one's faith in the notion of history repeating itself is going to require some restraint. In other words, one needs to act a bit deaf, dumb and blind (hence The Who reference). Stop listening to those who claim that buy and hold is dead. Pretend you never knew that Wall Street broke down. And ignore the day-to-day swings in the market. If you pick this course of action then trust it. While we believe the market can navigate the prevailing headwinds over the next couple of years, but to be fair we would like to identify the many speed bumps stocks are facing.

Keep in mind that a picture like the one forthcoming, albeit likely to encompass different indicators, could probably be painted in any given year. Also, keep in mind that the smartest folks in the room will gladly explain to you why this time around is different and that stocks won't prevail. *Here is a laundry list of reasons provided by the financial media and pundits as to why investors should shy away from stocks right now:*

**Deflation:** The lack of any serious inflation to date in the U.S. proves the economic recovery is weak, likely fueled only by government stimulus, and will soon stall or form a double-dip.

**Legislation:** Health Care Reform, Credit Card Reform, FinReg, and the potential for Energy Reform will hurt bank lending and lead to higher taxes – a further drag on the economy.

**Bush Tax Cuts:** Taxes are already heading higher. As it stands, the Bush tax cuts are due to expire at the end of 2010. Even if the Obama Administration tinkers with the capital gains and stock dividend rates the marginal rates are going up.

**Jobless Recovery:** The unemployment rate was 9.5% in June. The U.S. economy has been growing for the past nine months and only 600,000 jobs have been created. Over 8 million jobs were eliminated in the recession.

**Consumer Confidence:** It is retrenching. The Thomson Reuters/University of Michigan's Surveys of Consumers recorded a reading of 66.5 in July, the lowest since the 65.7 registered in August 2009. It was just at 76.0 in June. Could be tied to lack of serious job growth.

**Residential Real Estate:** Still soft. Close to 528,000 homes were seized by lenders in the first six months of 2010 (1 million-plus pace), according to RealtyTrac. More than 900,000 were repossessed in 2009. A typical year would involve around 100,000 foreclosures.

**Commercial Real Estate:** The Green Street Advisors' Commercial Property Price Index (GSAS CPPI) indicates that property values have risen approximately 20% since May 2009, yet remain close to 25% below the 2007 market peak, according to REIT.com. Close to $500 billion in loans will come due by the end of 2012 and another $900 billion by 2014, according to *Kiplinger* and *Real Estate Investors Daily*. Will the capital be there to roll them?

**$70-plus Oil:** The global recovery is well underway and yet a spike in the demand for oil has not materialized. But the price remains above $70. What will energy reform, if passed, do to energy prices?

**The Lost Decade**: The fact that the S&P 500 posted a cumulative total return of -9.10% in the 2000s has some pundits convinced that this go around really is different. What most fail to point out is that the S&P 500 posted a cumulative total return of 432.0% in the 1990s. That equated to an average annual return of 18.2%, which was around 800 basis more per year over a 10- year span than the index had generated since 1926. The 2000s were a give back.

While we may not know what tomorrow will bring, **we do know as of today that the S&P 500 has never failed to recover from a bear market.**



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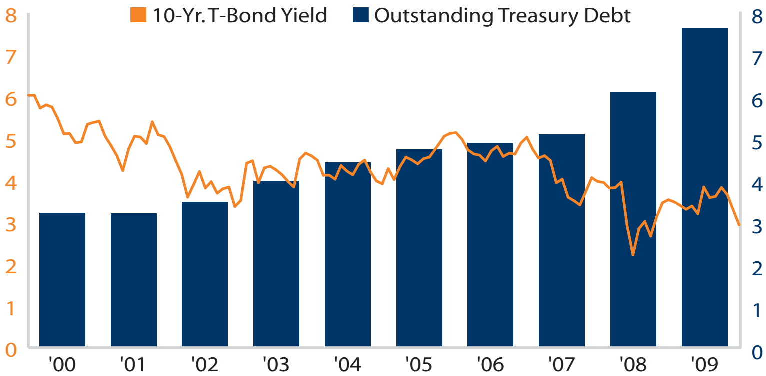
## Corporate America looks lean and mean while the federal government looks tired and bloated

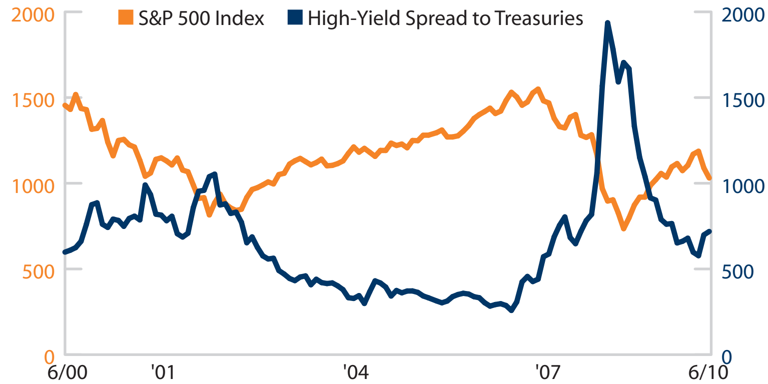
***Something is wrong with this picture...***




Sources: Bloomberg & U.S. Department of Treasury

The amount of outstanding Treasury debt rose 115% in the 2000s. The part of the picture above that doesn't make sense is the yield on the 10-year T-Bond fell by about 50%. Normally, when supply surges yields trend higher. Investors tend to demand more income when volume surges to compensate for greater perceived market risk. The relatively low inflationary climate due to two recessions and two deep bear markets helped keep rates down. But how much longer can this last? The only thing saving the U.S. at this point is its AAA rating. But both Moody's and Standard & Poor's commented in Q1'10 that its AAA status is not guaranteed. If inflation ever rears its ugly head again we could see a mass exodus from overpriced Treasuries accompanied by some serious wealth destruction. Too many investors are hiding out in government bonds.

***This picture looks right...***



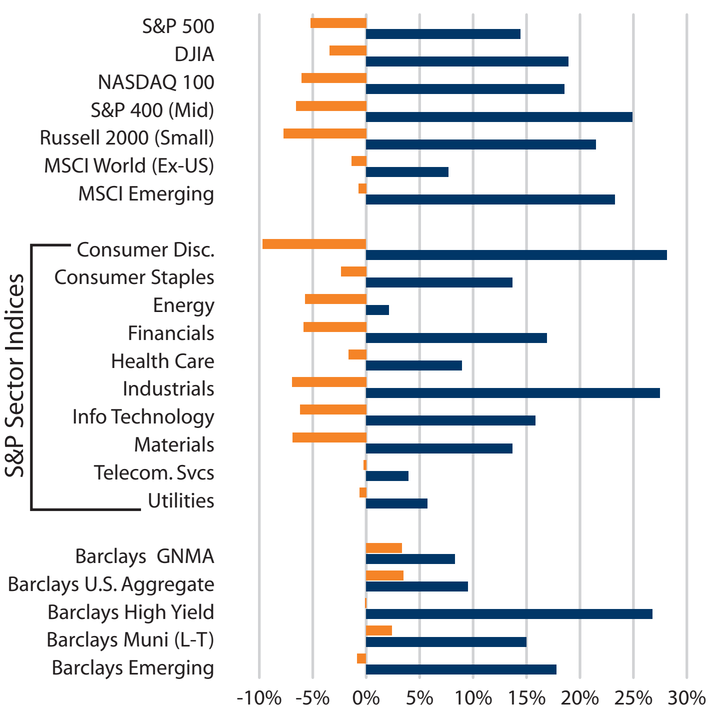

Sources: Bloomberg & Merrill Lynch High Yield Master II Index

The chart above illustrates one example of the relationship between the cost of capital to companies and its impact on stock prices. As the cost of financing falls stock valuations tend to rise and vice versa. Spreads have declined dramatically since 2008 and potentially could fall further. Corporate America has been boosting cash levels and curbing debt. In the past two years alone, total cash and short-term investments have risen 42.6%, 35.9%, and 30.8%, respectively, for the nonfinancial companies in the S&P 500, S&P 400, and S&P 600 indices, according to Standard & Poor's. The cash holdings at these 1,500 companies (excluding financials) total well over $1 trillion. Over the same span, total debt increased by only 5.6% and 3.4%, respectively, for the nonfinancial companies in the S&P 500 and S&P 400, and declined by 8.5% for the nonfinancials in the S&P 600.

### A brief commentary on risk

Nobody can blame a retail investor for being apprehensive about owning stocks. It is rare enough to experience two severe bear markets in the same decade let alone have them both be scandal-ridden. But the bottom line about risk is it is everywhere. As we noted above, you can run smack dab into it even in the U.S. Treasury market if you're not paying attention. The truth of the matter is that investors never really turned their back to risk in the tech crash of 2000-2002, they simply packed it up and went elsewhere. The first stop was real estate, because land is a tangible asset that holds its value well. Eventually it too became a bubble and we now know how bubbles end. Then investors sent their capital overseas to exploit the weakness in the dollar and tap into the surging growth in the emerging markets. Only that fizzled in 2008 thanks to the global credit crunch. And guess which stock markets have performed the best so far in 2010? Believe it or not it is those countries called frontier markets. They haven't even reached emerging status yet. If you want to make money you are going to have to take risks. With a forward-looking P/E of around 13 on the S&P 500, we believe the risk/return dynamic favors owning stocks.

## Total returns for Q2 and past 12 months (6/30/10)




## A Look Ahead:

### The outlook for earnings (year-over-year comparison in $)...

| | Q3'10E | Q3'09A | Q4'10E | Q4'09A | 2010E | 2009A |
|---|---|---|---|---|---|---|
| Financials | **3.71** | 1.35 | **4.09** | 1.54 | **15.00** | 4.39 |
| Information Technology | **6.21** | 4.52 | **7.49** | 6.44 | **25.15** | 17.48 |
| Health Care | **7.51** | 6.92 | **7.69** | 6.27 | **29.68** | 26.41 |
| Consumer Staples | **5.04** | 4.88 | **5.12** | 4.96 | **19.22** | 18.36 |
| Consumer Discretionary | **3.99** | 3.49 | **4.45** | 4.32 | **16.58** | 10.96 |
| Industrials | **4.29** | 3.24 | **4.58** | 4.15 | **16.63** | 14.22 |
| Telecom. Services | **1.98** | 1.77 | **2.09** | 1.62 | **7.94** | 7.23 |
| Energy | **8.68** | 5.93 | **9.05** | 6.32 | **34.44** | 17.26 |
| Utilities | **4.11** | 3.81 | **2.56** | 2.28 | **12.77** | 11.50 |
| Materials | **2.85** | 2.27 | **3.10** | 2.11 | **12.34** | 7.09 |
| S&P 500 Index | **20.72** | 15.78 | **22.03** | 17.16 | **81.82** | 56.87 |
| S&P 400 Index (Mid-Cap) | **11.54** | 8.50 | **12.39** | 9.12 | **43.60** | 27.59 |
| S&P 600 Index (Small-Cap) | **4.78** | 2.26 | **5.20** | 2.85 | **17.49** | 7.62 |

Source: Standard & Poor's (6/30/10)