First Trust

Quarterly Market Overview

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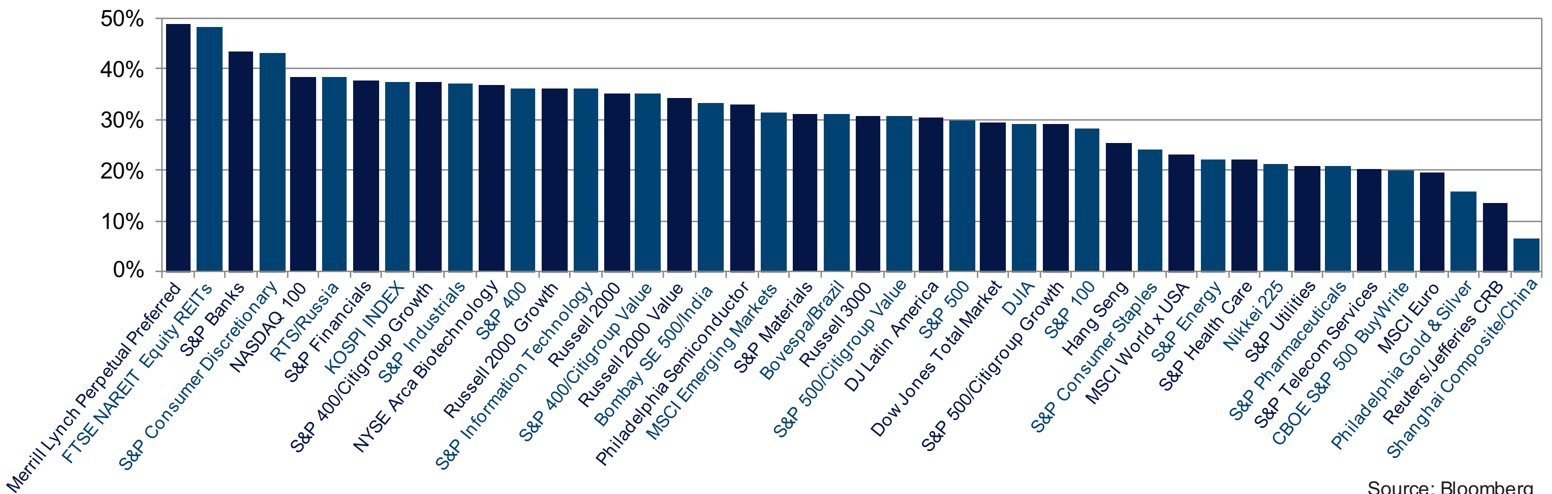
Mr. Carey has over a quarter century of experience as an Equity and Fixed-Income Analyst and is a recipient of the Chartered Financial Analyst (CFA) designation. He is a graduate of the University of Illinois at Champaign-Urbana with a B.S. in Physics. He is also a member of the CFA Society of Chicago and the CFA Institute. As CIO, Bob and his staff supervise approximately $55 billion in assets.

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 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.*

Piecing together the "Big Picture"

Annualized returns (USD) for major equity indices from 3/9/09-3/30/12



Source: Bloomberg

We chose the following header for the front page of our quarterly newsletter in March 2008: *Time for U.S. investors to bring some of their dollars back home*. This edition was written about a half-year before Lehman Brothers filed for bankruptcy, and nearly a full year before the bear market in stocks ended on 3/9/09 (see chart for bull market update). We managed to launch this call just before heading into the teeth of the global credit crisis. At that time, the lion's share of investment capital had been flowing into foreign stocks and bonds. Investors had funneled a net $700 billion into global/international equity funds from mid-2003 to Q1'08, according to Strategic Insight. Investors wanted little to do with U.S. equities as the S&P 500 was in the latter stages of the so-called "lost decade" for stocks. Anyone who heeded our call to commit capital to U.S. large-cap stocks and held those positions likely fared pretty well, on a relative basis. From 3/31/08-3/30/12, the cumulative total return on the S&P 500 was 16.39%, compared to a gain of 4.04% (USD) for the MSCI Emerging Markets Index and a loss of 12.77% (USD) for the MSCI World (ex U.S.) Index. The 16.39% cumulative gain in the S&P 500 translated into an annualized gain of 3.87%, which topped the 3.69% annualized return posted by the Barclays Capital U.S. Treasury: Intermediate Index. Treasuries, if you recall, were one of the most popular asset classes for investors during, and after, the financial crisis of 2008. We liked the underpinnings of the U.S. stock market in 2008 and we like them even more today. Equities, in our opinion, remain the optimal asset class for building wealth over the long term.

In our January 2010 newsletter, we noted that it takes 39 months, on average, for investors to recoup the losses sustained in a bear market, according to InvesTech. Well, as of 3/30/12, the rally in the S&P 500 was just nine days shy of completing its 37th month. The S&P 500 stood at 1408.47 on 3/30, just 10% below its all-time high of 1565.15 on 10/9/07. We view history repeating itself, or in this case close enough considering all of the volatile political climates around the globe, as one more reason to feel constructive about U.S. equities. Two of the most common indicators for assessing the equities markets over time are corporate earnings and valuation (price-to-earnings ratio). S&P 500 earnings grew by 14.9% in 2009, 47.3% in 2010, and 15.1% in 2011, according to Standard & Poor's. The 2012 and 2013 estimated earnings growth rates for the index are currently 8.8% and 13.3%, respectively, according to S&P. The companies in the S&P 500 have not only delivered substantial earnings growth so far in this recovery, but have shown they are capable of sustaining nearly double-digit growth. The P/E ratio for the S&P 500 is 13.34 based on the estimated earnings growth rate for 2012 and 11.77 based on 2013's earnings growth estimate. The average P/E for the index has been about 16.5 over the past 50 years, according to data from Bloomberg.

One sad drawback to this bull market, in our opinion, is that it has largely been fueled by institutional buying. The retail investor has not participated en mass. The retail investor primarily opted for fixed-income securities. Data from the Investment Company Institute (ICI) shows that open-end equity funds reported net cash outflows totaling $410 billion from 2008-2011, compared to $770 billion of net cash inflows to bond funds. While we have to acknowledge that a high percentage of fixed-income investors enjoyed terrific returns in most debt categories after the credit markets thawed in Q1'09 (see chart on page 2), the likelihood of replicating such generous returns moving forward is close to nil with interest rates already at such low levels.

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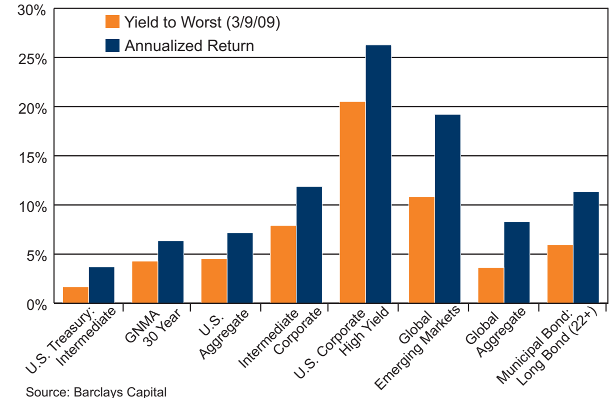
Debt is a big part of the "Big Picture"

It only makes sense that debt plays such a pivotal role in the financial markets. The total worldwide debt market is valued at approximately $80 trillion, roughly double the size of the worldwide equity market, according to Barry Randall at MarketWatch.com. What doesn't make sense is why so many investors flock to fixed-income securities when you consider that the number one complaint throughout the globe is that the U.S., Europe and Japan have entirely too much debt. Why complain if you gobble the bonds up as fast the issuers can pump them out? The fear is that such heavy debt loads will inevitably force interest rates higher, which, in turn, will push bond prices lower. With respect to the U.S. debt market, particularly Treasury securities, this day of reckoning has been pushed out due to the quantitative easing initiatives by the Federal Reserve (buying close to $2 trillion worth of T-Notes, T-Bonds and Mortgages), as well as the ongoing struggles in the housing market and modest job creation, which are helping to keep inflation in check.

As far as the Fed is concerned, inflation in the U.S. is subdued so long as the Core CPI, which does not include the more volatile food and energy categories, remains near its target rate of 2.0% or less. It seems steadfast in its desire to lower the unemployment rate. Federal Reserve Vice Chairman Janet Yellen said in a recent speech that she is not concerned that additional asset purchases will render the Fed unable to control inflation when necessary. Federal Reserve Chairman Ben Bernanke believes the 8.2% unemployment rate posted in March is too high. Bernanke recently stated that consumption levels remain too low. He has not completely abandoned the idea of a third round of quantitative easing. Looking ahead, at best, the majority of fixed-income investors may need to settle for clipping coupons.

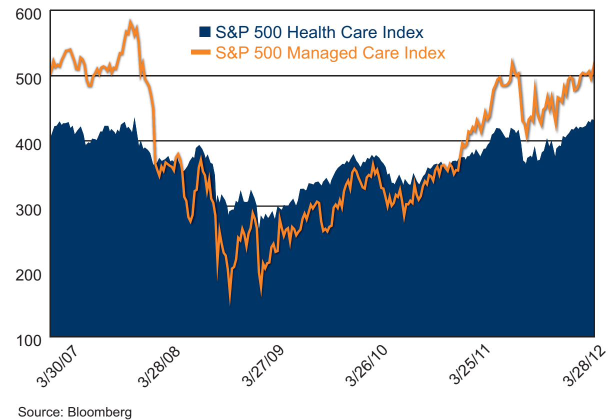
What makes the chart below so attractive is that each of the annualized returns on the bond indices from Barclays Capital exceeded the yield the index offered as of the 3/9/09 start date. All of the debt groups captured some price appreciation.

Annualized returns (USD) for major bond indices
3/9/09-3/30/12

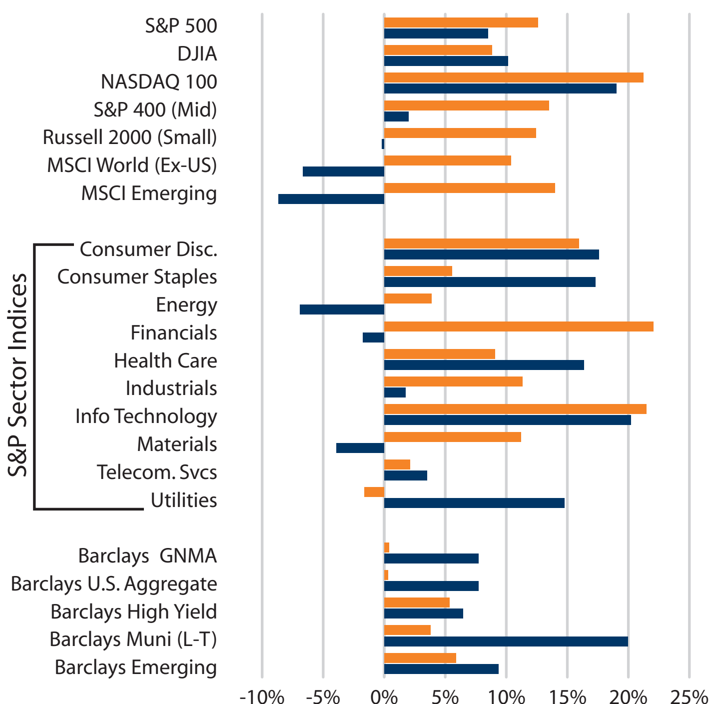


The best defense is a good offense!

Morningstar data shows that nearly $17 billion flowed into equity-income funds in 2011, while close to $80 billion flowed out of all U.S. stock funds. The best performing sector in the S&P 500 in 2011 was Utilities, up 20%. With the yield on the 10-Year T-Note trading below 2.50% for much of the second half of the year, many investors sought higher income streams from stock dividends. With all of the uncertainty surrounding the European debt crisis, as well as the sovereign debt downgrade in the U.S. in August, utility stocks not only offered double the yield of intermediate Treasuries, but a defensive posture as well. With the S&P 500 off to such a positive start in 2012, utility stocks, which have an estimated earnings growth rate of -0.9% for 2012 (S&P 500 Utilities Index), significantly lagged the other major sectors in Q1'12. Utilities do not offer any growth prospects for 2012. What other defensive sector does offer growth? Health Care, in our opinion. The S&P 500 Health Care Index has the third highest sector earnings growth estimate for 2012 at 11.9%, and it has a 2012 P/E multiple of 12.49 – below the S&P 500's 13.34 based on an earnings growth rate estimate of 8.8%.



Total returns for *Q1* and past 12 months (3/30/12)



A Look Ahead:

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

	Q2'12E	Q2'11A	**Q3'12E**	Q3'11A	**2012E**	2011A
Financials	**4.26**	3.95	**4.31**	4.48	**17.26**	16.23
Information Technology	**8.59**	7.69	**9.19**	7.32	**36.78**	31.44
Health Care	**8.74**	8.27	**8.79**	7.70	**34.77**	31.08
Consumer Staples	**5.68**	5.39	**5.89**	5.51	**22.49**	21.38
Consumer Discretionary	**5.46**	5.38	**5.68**	5.18	**22.08**	20.81
Industrials	**6.01**	5.54	**6.18**	5.44	**23.73**	20.96
Telecom. Services	**1.83**	1.78	**1.82**	1.95	**6.90**	6.85
Energy	**12.29**	12.98	**12.55**	14.11	**49.26**	47.94
Utilities	**2.68**	2.87	**4.09**	4.13	**12.36**	12.47
Materials	**4.82**	5.44	**4.23**	3.92	**17.21**	16.20
S&P 500 Index	**25.89**	24.86	**26.89**	25.29	**104.89**	96.44
S&P 400 Index (Mid-Cap)	**14.95**	13.07	**16.34**	13.23	**61.04**	50.31
S&P 600 Index (Small-Cap)	**6.44**	5.36	**7.03**	5.26	**26.49**	20.59

Source: Standard & Poor's (4/4/12)