First Trust

Quarterly Market Overview

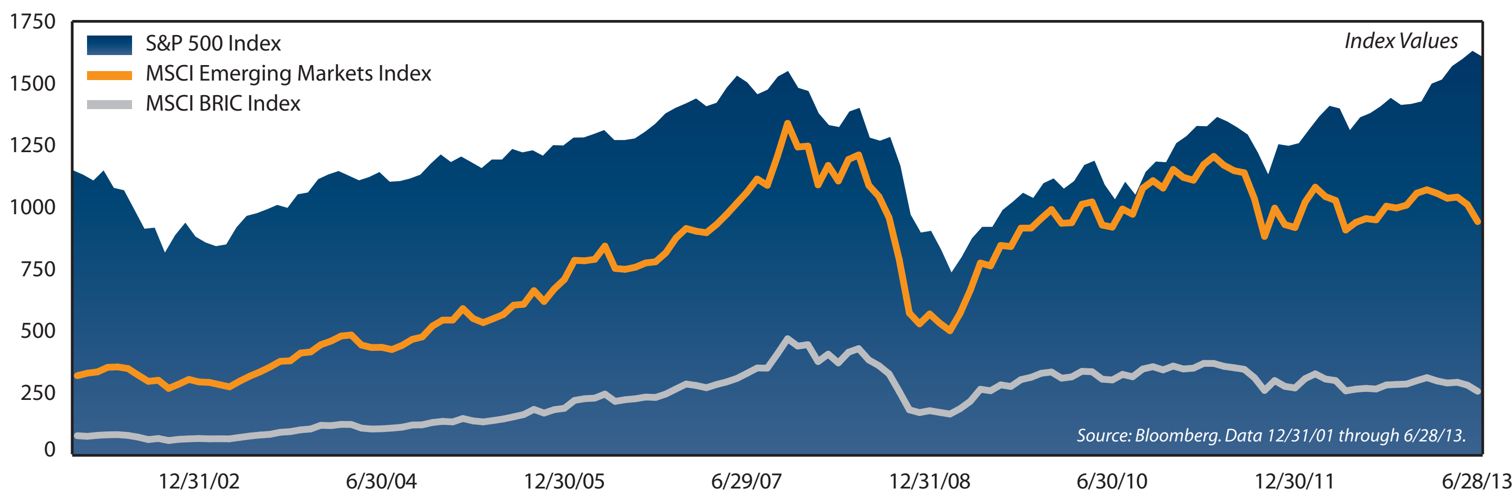
Issue 54, July 2013

Robert F. Carey, CFA
Chief Market Strategist

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 Chief Market Strategist, Bob and his staff supervise approximately $70 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.*

We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

Emerging Markets Equities Hit A BRIC Wall



How did everything so good get so bad?

Emerging markets equities enjoyed a phenomenal performance run from the start of 2002 through 2010, and this period included the 2008 global financial crisis. The MSCI BRIC Index posted a cumulative total return of 376.57% (USD), compared to a gain of 360.76% (USD) for the MSCI Emerging Markets Index. The S&P 500 was up only 31.38% over that span. Foreign stock returns for U.S. investors were aided notably by the 32.6% decline in the value of the U.S. dollar relative to a basket of major currencies, as measured by the U.S. Dollar Index (DXY). The BRIC countries (Brazil, Russia, India and China) have had, and continue to wield, a major influence on the MSCI Emerging Markets Index. Even as recent as June 2013, two of the biggest weightings in the MSCI Emerging Markets Index were China (18.2%) and Brazil (11.3%). Those two also carried the biggest weightings in the MSCI BRIC Index as of 6/13: China at 43.27% and Brazil at 26.88%. Here were the cumulative total returns for the four members of the MSCI BRIC Index from 2002-2010 (USD): Brazil/Bovespa Index (+611.09%); Russia/RTS$ Index (+740.30%); India/BSE 500 Index (+754.17%); and China/Shanghai Composite Index (+145.73%).

So what ended the emerging markets/BRIC bull run? In our opinion, it was a combination of the outsized returns already registered (think potential for profit taking), fallout from the 2008 financial crisis (investors hoped emerging markets would decouple from U.S. but it didn't happen) and the inflationary pressures stemming from the surge in commodity prices, including gold, in 2008 (investors were nervous about the U.S. dollar and many other fiat currencies). If you recall, investors around the globe were spooked by the Federal Reserve's easing of U.S. monetary policy. The Fed slashed the federal funds target rate from 5.25% to 0.25% from 9/07-12/08. A rise in inflation in the faster growing emerging nations forced central bankers in India, Brazil and China, in particular, to raise their benchmark lending rates in 2010 and 2011.

So how bad is it?

The tempering of economic activity (via tighter monetary policy) in the three most influential BRIC countries, particularly China, dampened enthusiasm for emerging markets equities after 2010. China's economy is perhaps the most important of the four BRICs because it has evolved into a vital consumption engine, similar to the U.S., especially with respect to commodities. Copper demand, which has become somewhat of an economic proxy on China, as well as the global growth story, is down and so is its price. China also happens to be Brazil's #1 trading partner.

From 2011 through June 2013, the MSCI BRIC Index posted a cumulative total return of -22.15% (USD), compared to a decline of 12.14% (USD) for the MSCI Emerging Markets Index. The S&P 500 was up 34.92% over that span. The four members of the MSCI BRIC Index performed as follows (USD): Brazil/Bovespa Index (-31.52%); Russia/RTS$ Index (-20.67%); India/BSE 500 Index (-29.88%); and China/Shanghai Composite Index (-24.83%). Over this time period, the U.S. dollar reversed course and rose 5.2%, as measured by the U.S. Dollar Index. Overall, we believe that, while painful for those investors who bought in after 2010, the sell-off in emerging markets equities/BRICs appears to be a normal correction following a prolonged rally. But as we have shown, these equity markets are capable of producing outsized returns due to their high economic growth rates. And the long-term growth prospects are still intact, in our opinion. Even today, many emerging nation's economies are growing anywhere from two to four times faster than the U.S. economy.

One distinction we would like to offer is that it appears that institutional investors have been the biggest sellers of emerging markets equities. An article published by Pensions & Investments in June featured remarks from several institutions regarding emerging markets. Neptune noted it reduced its exposure to emerging markets equities from 50% three years ago to 15%.

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This Is One Balancing Act Investors Can Manage

Dalbar releases a report every year that provides an update on the average return garnered by investors in U.S. stock mutual funds relative to the S&P 500 over a 20-year period. What this year's release showed was that the average investor earned an annualized return of 4.25% for the 20-year period ended 2012, compared to 8.21% for the S&P 500. The general takeaway from these annual findings is that too many U.S. stock fund investors feel compelled to chase returns, and do so at their own peril. While some chase what is hot, others may seek value or look to strategically position capital to either potentially exploit a theme, such as the Internet Revolution, or run from one, as in the case of the subprime mortgage meltdown, which helped trigger the global financial crisis in 2008. The table below features three specific time periods beginning with one that coincided with the Internet Revolution, which exploded onto the scene towards the latter half of the 1990s. The data highlights the amount of capital that flowed into equity and bond mutual funds on a net basis over two seven-year periods, with a five-year run tucked in the middle. From 1994 through 2000, equity mutual funds reported over $1 trillion of net inflows, while bond mutual funds experienced net outflows. From 2006 through 2012, it was bond mutual funds that reported over $1 trillion of net inflows, while equity mutual funds endured significant outflows. The five year span in the middle (2001-2005) produced a 61/39 split between the two asset classes. A 60/40 split between stocks and bonds has historically been the definition of a "Balanced Fund" in the industry. One of the goals of utilizing a balanced approach is to try and mitigate volatility (smooth out the bumps). We calculated some performance figures for the three time blocks using a 50/50 split to be truly balanced. For stocks, we used the S&P 500, while for the bond exposure we equally weighted the following three taxable BofA Merrill Lynch Indices: U.S. Treasury, U.S. Corporate and U.S. High Yield. Over the 19 years measured (1994-2012), the S&P 500 posted an average annual total return of 8.14%, vs. 6.83% for the bond allocation and 7.49% for the 50/50 split. The bond allocation did help smooth out the wide swings (**18.23%** for '94-'00 vs. **0.61%** for '01-'05 vs. **4.16%** for '06-'12) in the average returns for the S&P 500.

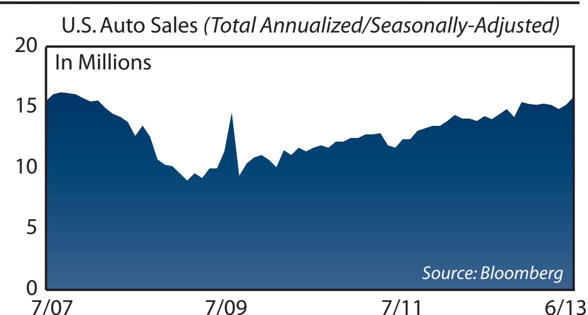
1994-2000 (7 years): **100% Equities**		2001-2005 (5 years): **61% Equities/39% Bonds Split**		2006-2012 (7 years): **100% Bonds**	
Equity Mutual Funds:	**$1.34 Trillion of Net Inflows**	Equity Mutual Funds:	**$443.53 Billion of Net Inflows**	Equity Mutual Funds:	$313.03 Billion of Net Outflows
Bond Mutual Funds:	$16.8 Billion of Net Outflows	Bond Mutual Funds:	**$283.30 Billion of Net Inflows**	Bond Mutual Funds:	**$1.24 Trillion of Net Inflows**

Source: Investment Company Institute

The Pent-Up Demand For Autos Has Been Unleashed...And We Believe Auto Stocks Are Still Relatively Inexpensive

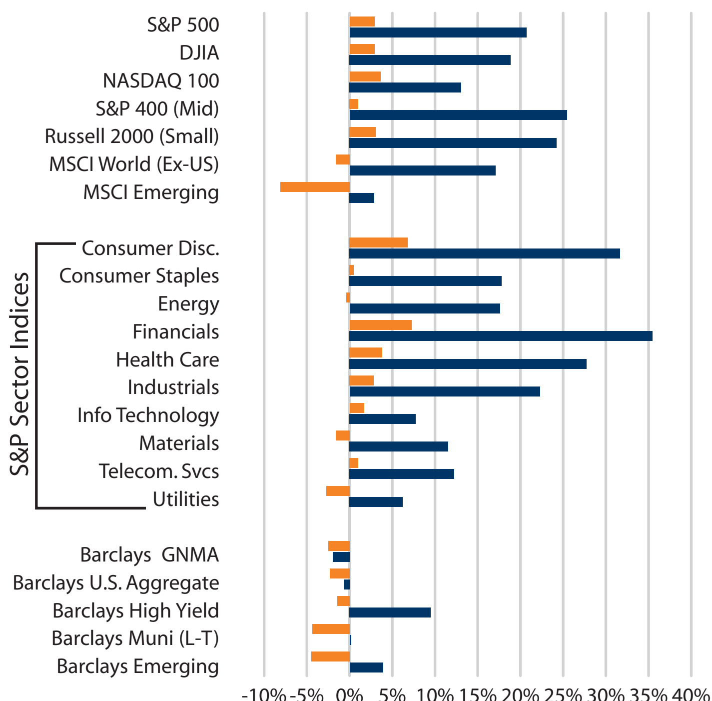
The materialistic component of the American Dream has primarily been anchored by three achievements: securing a decent job with a decent wage, owning an automobile and purchasing a house. All three of these naturally became harder to attain for many people following the 2008 financial crisis and the recession that accompanied it. The silver lining is that all three are in recovery mode. Obviously, it would be difficult to participate in the American Dream without #1 on the list: a job. While U.S. nonfarm payrolls have expanded by an average of just 99,000 per month since the end of the last recession (6/09-6/13), job creation has actually been accelerating the past 18 months (191,000 per month average). Housing prices in the U.S. fell approximately 35% from peak to trough (6/06-3/12), according to the S&P/Case-Shiller U.S. National Price Index. Home prices, however, rose by 10% for the 12-month period ended 3/13, the latest quarterly data point offered by the index. The average age of cars/light trucks in the U.S. reached a record 10.8 years in 2011, according to Polk Automotive Research. Auto sales fell from an annualized rate of 16.26 million in 9/07 to a low of 9.00 million in 2/09, and then worked their way back up to 15.89 million in 6/13. Despite the recovery in auto sales, auto stocks are relatively cheap. The estimated forward-looking P/E on the S&P 500 Automobiles Index is around 12.2, compared to 15.2 and 17.2 for the S&P 500 and S&P 500 Homebuilding indices, respectively.

U.S. Auto Sales *(Total Annualized/Seasonally-Adjusted)*



Cumulative Total Returns (6/11-6/13)	
S&P 500 Homebuilding	110.62%
S&P 500	27.26%
S&P 500 Automobiles	18.23%

Total returns for Q2 and past 12 months (6/28/13)



A Look Ahead:

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

	Q3'13E	Q3'12A	**Q4'13E**	Q4'12A	**2013E**	2012A
Financials	**4.82**	4.27	**5.11**	3.86	**20.02**	16.44
Information Technology	**8.75**	6.90	**11.10**	9.38	**36.32**	32.69
Health Care	**9.04**	7.93	**9.01**	7.23	**34.98**	31.53
Consumer Staples	**6.23**	5.73	**6.58**	6.33	**24.01**	22.59
Consumer Discretionary	**6.41**	5.73	**7.00**	6.33	**25.03**	22.27
Industrials	**6.32**	5.75	**6.63**	4.87	**24.52**	22.28
Telecom. Services	**2.59**	2.09	**2.06**	-2.90	**8.90**	3.38
Energy	**11.99**	10.13	**12.20**	10.45	**46.73**	44.30
Utilities	**4.11**	3.66	**2.52**	2.65	**11.87**	11.97
Materials	**3.57**	3.19	**3.78**	2.79	**16.02**	14.67
S&P 500 Index	**27.73**	24.00	**29.45**	23.15	**109.34**	96.82
S&P 400 Index (Mid-Cap)	**16.78**	14.13	**17.84**	13.82	**63.30**	54.54
S&P 600 Index (Small-Cap)	**7.65**	5.58	**8.05**	5.25	**28.03**	21.62

Source: Standard & Poor's (7/9/13)