First Trust
Monday Morning OUTLOOK
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Valuation, Not Election

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Senior Economist*
Strider Elass – *Economic Analyst*

Tomorrow's election may be the most important one for economic policy of our generation. Years from now, we may look back at the choice Americans make as an inflection point leading toward either more economic freedom or less, with major effects on long-term economic growth and living standards.

Despite this, the first thing on everyone's mind this week – the election, obviously – should be the last one on the mind of equity investors. This is not because the election doesn't matter, but because stocks are still very cheap. As a result, we expect stocks to go up over the next year regardless of who wins.

Financial markets still seem to be pricing in all sorts of disaster scenarios, including deeper turmoil in Europe, falling off the "fiscal cliff," and a major and persistent drop in earnings. Instead, at current prices, we think equities are still cheap despite 25% odds of a recession.

Chances are the European situation gets resolved with a combination of more aid from Germany, more defaults by peripheral governments, and a substantial depreciation of the Euro. We're not advocating any of these policies, but they will generate the cash flow governments are looking for to recapitalize insolvent banks.

On the fiscal cliff, we still expect an extension of most, if not all, of the 2001/03 tax cuts, while cuts to military spending get postponed. And, if anything, cutting non-defense spending would spur growth.

We are more sympathetic with fears about prolonged slow economic growth and the burden of big government. If they remain an issue, the market would be correct to expect less in the way of future after-tax profits. Slower economic growth would boost deficits, while unchecked government spending would increase the odds of higher future taxes.

But the stock market is significantly undervalued already. If the future turns out to be less dour, investors should look out above.

We use a capitalized-profits model to find the fair-value of equities. We divide corporate profits by the current 10-year Treasury yield (1.7%), and then compare the current level of this index to each quarter for the past 60 years. This method estimates a fair-value for the Dow at an absurdly high 51,500, about four times the current level.

Obviously, this is crazy. It's a result of using artificially low long-term interest rates. So, we adjust the model and assume the appropriate 10-year Treasury yield is 4.5%, the same as the Federal Reserve's estimate of long-term growth in nominal GDP (real GDP growth plus inflation). Using a 4.5% discount rate gives us a much more reasonable fair value of 19,750 on the Dow and 2,150 for the S&P 500.

But what if record high corporate profits – about 12% of GDP – revert to their historical norm of about 9.5%, at the same time the *10-year Treasury yield moves to 4.5%?* If that happened, the fair value of the Dow would be 15,500 and for the S&P 500 it would be 1675. In other words, *if* profits fall roughly 25% *and* interest rates almost triple from current levels, broad stock market indices are still undervalued.

None of this means the stock market is going to rally today, or this week, or even over the next year. What it means is that the upside risks for stocks are much greater than the downside risks. The capitalized profits model clearly says that the stock market is currently discounting a very bleak future.

If, like us, you believe there are dangers in the years ahead, but that US growth will push profits higher over time and that the odds of a positive turn in fiscal policy are real, then equities are really cheap.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-5 / 9:00 am	ISM Non-Man – Oct	54.5	**54.9**	54.2	55.1
11-7 / 2:00 pm	Consumer Credit– Sep	$10.3 Bil	**$12.0 Bil**		$18.1 Bil
11-8 / 7:30 am	Initial Claims – Nov 3	370K	**410K**		363K
7:30 am	Int'l Trade Balance – Sep	-$45.0 Bil	**-$45.7 Bil**		-$44.2 Bil
11-9 / 7:30 am	Import Prices – Jul	+0.0%	**-0.9%**		+1.1%
7:30 am	Export Prices – Jul	+0.1%	**+0.0%**		+0.8%
8:55 am	U. Mich Consumer Sentiment	82.9	**83.0**		82.6

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.