First Trust
ECONOMIC RESEARCH REPORT

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Dow Down 500, But Fundamentals Still Strong

Major stock market indices are down 4-5% today as investors move into panic mode. There is no single piece of news driving the sell-off; rather the market seems to be gathering downward momentum on its own. Selling is creating more selling.

Like 1987, the sell-off does not appear to be driven by fundamental factors. In fact, the fundamentals suggest the market is undervalued and getting more so as it drops. Many investors assume (or wonder) if the sell-off is indicating deep economic problems. However, there is no evidence that this is true.

The Federal Reserve is still running a very accommodative monetary policy. Money supply data shows no contraction – M1 is up 13.8% and M2 is up 8.3% at an annual rate over the past thirteen weeks. The Fed is holding the funds rate near zero, while nominal GDP is rising near a 4% annual rate recently and "core" inflation is at 3%. In other words, interest rates are very low in comparison.

If you are worried about a cut in government spending – don't be. Federal spending in 2011 is still rising and according to the OMB and CBO it will rise each and every year over the next 10 years. If you are worried about the size of government and think the budget deal was terrible – you shouldn't. Supertanker America is turning and government spending as a share of GDP is scheduled to fall by about 2% of GDP over the next 10 years.

Corporate earnings are rising rapidly. According to Bob Carey, First Trust's Chief Investment Officer, with about 80 companies left to report, S&P 500 earnings are up 20% over last year and the S&P 500 P-E ratio (on forward earnings) is roughly 12. The market is cheap.

Economic data are not tanking. Initial claims are at 400,000 (down from 478,000 at the end of April). Car and truck sales were up 6.9% in July (over June) and chain-store retail sales were up 4.6% in July (from last year) versus 2.8% year-over-year growth in July 2010. Taken together, retail sales appear to have increased by about 0.7% in July even though gasoline prices fell.

Yes, the ISM manufacturing index was just 50.9 in July, but that is the 24th consecutive month above 50 and is consistent with 2% or more real GDP growth. Finally, the ADP employment report showed 114,000 new private sector jobs in July, which was the 18th consecutive monthly gain. In other words, there is absolutely no evidence of a recession at this point.

This leaves us at perhaps the best explanation for the decline: European debt problems, specifically Italy. It is clear that hot money is moving as investors worry about money market funds and bank solvency. The euro is falling, European bond yields are rising, US Treasury yields are plummeting and gold is up. Italy says that it does not face imminent default, but the market acts as if it may.

European countries have spent themselves into a corner, but correcting this mistake will be good for long-term growth, not bad. While some financial institutions may take losses, government debt itself is water under the bridge. It's a sunk cost. As a result, it has little effect on the economy unless losses create financial contagion. With mark-to-market accounting now fixed to allow cash flow to be used to value assets, the odds of contagion are minimized and the cost of immunizing America from contagion would be small when compared to 2008.

In the end, the sell-off looks as if it is more of a technical correction in the market, not a fundamental change in direction. This does not mean that it will end soon. Corrections run their course and then end. We wish we could trade each and every move in the market, but we can't and we don't know anyone who can. We are investors, and the market is more undervalued right now than it was when it opened for trading this morning.

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