First Trust
Monday Morning OUTLOOK
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Optimism Is Winning

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Ever wonder what the dog would do if it "caught the car"? Well, that's what happened when real GDP contracted at a 0.1% annual rate in Q4. The pessimists finally had a mouthful of taillight. It was the first negative reading for GDP since 2009. The doom and gloom crowd finally had hard data showing a double dip.

Meanwhile, early data on January and late data on November and December, showed the opposite – manufacturing, home prices, construction, auto sales, and the labor market all improved.

New orders for durable goods surged 4.6% overall in December and 1.3% excluding the volatile transportation sector. Construction increased 0.9% in December with home building up 24% from a year ago while commercial construction rose a solid 8%.

In addition, the ISM Manufacturing index rebounded sharply to 53.1, the Case-Shiller home price index is up 5.5% from a year ago, auto sales are up 9% from a year ago, and payrolls expanded by 157,000 in January, just under the average of the past twelve months. In other words, no signs of the broader negativity we would expect if the US was really in recession.

To the chagrin of the pessimists, the stock market listened to the bullish case and the dog got carried along by the car. Broad stock indices hit the highest levels since late 2007; very near all-time highs. Bond yields, although still very low by historical standards, rose as well, with yields on the 10-year Treasury finally breaking above 2%.

Expect higher stock prices and higher bond yields to be recurring themes in 2013. Despite the rally in stocks, after-tax earnings in the past twelve months show the earnings yield on the S&P 500 remains above 6.5%. This is quite generous in a world of low interest rates and nominal GDP growth – real GDP growth plus inflation – of 3.6% per year in the past two years.

In other words, being optimistic about stocks does not require an investor to think the economy is going to get better faster than the consensus view. Stocks are underpriced today even if the consensus forecast of 2% real growth turns out to be prescient and profits stagnate; even if interest rates continue to rise. On the other hand if our plow horse starts to trot a little faster and our forecast of 2.75% real GDP growth is correct, things will be better.

The same thing goes for bond yields. To some extent, 10-year rates reflect the consensus investor view about the path for short-term interest rates over the next 10 years. If so, and even if the Federal Reserve does not start raising rates 'til mid-2015, they should eventually head up to a fundamental level of about 4%+.

With each passing month, a new 10-year Treasury reflects a timeframe that contains one *less* month with short-term rates near zero and one *more* month with short rates at about 4%. As a result, bond yields should rise in 2013. And if, like us, you think the jobless rate will come down faster than the Fed predicts, short-term rates could easily start rising in 2014, pushing long-term rates up a little faster as well.

In many respects, last week may turn out to be a microcosm for 2013. Most of the economic data will show improvement, but enough traces of weakness will remain to prevent any sort of "irrational exuberance" from developing. This will not be 1995-96. But stocks will trend higher and bond yields will as well.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-4 / 9:00 pm	Factory Orders – Dec	+2.3%	**+2.2%**	+1.8%	-0.3%
2-5 / 9:00 am	ISM Non Mfg Index - Jan	55.0	**56.0**		55.7
2-7 / 7:30 am	Initial Claims - Feb 2	360K	**361K**		368K
7:30 am	Q4 Non-Farm Productivity	-1.4%	**-2.0%**		+2.9%
7:30 am	Q4 Unit Labor Costs	+2.9%	**+3.3%**		-1.9%
2:00 pm	Consumer Credit– Dec	$14.0 Bil	**$16.0 Bil**		$16.0 Bil
2-8 / 7:30 am	Int'l Trade Balance – Dec	-$45.8 Bil	**-$47.0 Bil**		-$48.7 Bil

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.