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FIRST Trust
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Monday Morning Outlook

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U.S. Stocks Remain Undervalued

Last week was an ugly one for US equities. The Dow Jones Industrials fell 4.1%, the NASDAQ dropped 2.9%, and the S&P 500 was off 3.9%. The total market cap of US stocks fell by $553 billion. Meanwhile, the 10-year Treasury yield fell below 4.4%, and at the close on Friday, futures markets had raised the probability of a 25 bps rate cut by the Fed on 10/31 to 59% (16% for 50 bps, and just 25% odds of no cut at all).

Explanations for this include spiking oil prices, some weak economic data, negative earnings reports, and concerns about further fallout in the asset-backed marketplace. While all are worthy of attention, they are excuses for profit taking, not signs of serious trouble. Like the equity market downdrafts in February and May of this year, falling stock prices should be viewed as a buying opportunity, not a time to panic.

The price of oil (which bounced off $90/bbl last week) is up almost $20 per barrel in the past two months. With the dollar weak and Fed policy accommodative, $100 oil – which many previously thought unthinkable absent a shut-off of Middle East oil – is now a plausible scenario over the next few months.

But investors should have learned by now that there is no “magic price” for oil that causes the economy to shut down. Even with prices as high as they are, total spending on all energy by US consumers is still only 5% of income, about the same as it was in 1970 and well below its 7% peak in the early 1980s. Oil prices reflect strong demand in the US and around the world. Moreover, there is no leak in the system. Oil-producing countries must recycle their dollar earnings back into dollar-denominated investments. They have no other choice.

On the economic front, there was very little important data last week, but some of it fit preconceived notions and therefore it was viewed as more important than it really was.

The Philadelphia Fed’s index of manufacturing fell to 6.8 in October from 10.9 in September. This was an inconsequential drop, and the index, like other regional surveys still signals expansion. New claims for unemployment insurance increased to 337,000 in the week ending October 13 – 25,000 higher than expected. But one week’s worth of data for this series provides almost no information. Claims spiked above 340,000 in early April, only to fall back to the low 300,000s again. Moreover, the unemployment rate is still at 4.7%.

Housing starts plummeted in September but everyone knew residential construction had to slow further for homebuilders to start whittling down their inventories. In our view, the fact that this is happening quickly is a reason for optimism, not pessimism.

That leaves earnings and fears of a credit crunch as the culprits for the equity sell-off. True, some financial companies reported very weak earnings late last week, but to us this looks like an aggressive and responsible acceptance of losses, which leaves more room for future earnings growth. Note that the earnings yield (100 divided by the P-E ratio) on the S&P 500 was a hearty 5.6% in September, better than the yield throughout the vast majority of the 1990s. Moreover, the high earnings yield on U.S. stocks is attractive when compared to current interest rates, which are much lower than in the 1990s.

Finally, while fears of a credit crunch remain high, we find it hard to believe that there are huge surprises that “no one” knows about.

Our fundamental outlook remains unchanged: stocks are still cheap and the volatility is worth the ride.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-24 / 9:00 am	Existing Home Sales - Sep	5.280 Mil	**5.300 Mil**		5.500 Mil
10-25 / 7:30 am	Durable Goods - Sep	+1.5%	**-0.1%**		-4.9%
7:30 am	Durable Goods (Ex-Trans) - Sep	+0.7	**-0.5%**		-1.8%
7:30 am	Initial Claims - Oct 20	320K	**317K**		337K
9:00 am	New Home Sales - Sep	0.775 Mil	**0.814 Mil**		0.795 Mil
10-26 / 9:00 am	U. Mich. Consumer Sentiment	82.0	**82.5**		82.0