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First Trust

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Monday Morning Outlook

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Stocks Are Dirt Cheap

One year ago, we thought the Dow Jones Industrial Average would finish 2008 at 15,000. Needless to say, the Dow is nowhere near this level and would need an unprecedented miracle to get there in the next few days.

Nonetheless, our model for valuing the broad US equity market continues to signal that "fair value" for the Dow is at or above 15,000.

Don't take this as another forecast – given economic issues, the Dow is not likely to get to 15,000 anytime soon. What this model is saying is that *if* the Dow were trading at 15,000 today, expectations of future returns would settle at an historical average rate of return.

So, with the Dow roughly 44% below our estimate of fair value (needing to rise about 75% to get to 15,000), investors can reasonably expect a rate of return that is well above historical averages in coming years.

To get fair value for the stock market we take the level of corporate profits that the government generates (based on reports to the Internal Revenue Service) and then discount these profits by the prevailing 10-year US Treasury interest rate. This simple "capitalized profits" model suggests that broad US equity market in the US is at is cheapest level since at least 1953.

In other words, the market is cheaper than it was in 1974, 1982, and 1994 – all of which had huge bull markets ahead of them. True, interest rates are currently at historically low levels and this can skew our fair value measure higher. (If interest rates are low, the model discounts profits less than usual, meaning profits appear more valuable.)

To address this potential problem, we use a 5% 10-year Treasury yield, instead of the current bubbly yield of 2.15%. The 5% yield reflects the average since the mid-1990s. In addition, we assume corporate profits fell at an annual rate of 10% in the current quarter (2008-4Q), which is slightly faster than the 9.2% decline experienced over the past year. Even using these conservative estimates the market is cheap.

Another reason to be bullish on stocks is that although awful data reports are ahead – for example, we expect real GDP to contract at an annual rate of roughly 6% in Q4, the worst in more than 25 years – the most intense parts of the economic contraction are already behind us.

History shows that the stock market tends to bottom before recessions end. The stock market bottomed in August 1982, and was up 26% before the recovery began in November 1982. And in 1974, the stock market bottomed in December, and was up more that 24% by the time that nasty recession ended in March 1975. We believe the current recession will end sometime early in 2009, which suggests that US stocks have probably already bottomed.

Attentive readers will note that the stock market did not start rising until well after the 2001 recession had ended. However, our models show that the stock market was wildly overvalued prior to the 2001 recession, and remained overvalued until mid-2002.

Knowing when the recession may end is a key to this relationship (and forecast). On this front there seems to be some good news. While weak housing data from November reflects credit market problems and panic that spread after the failure of Lehman Brothers, recent market action suggests that this is ending.

Not only have mortgage rates plummeted (pushing mortgage lenders to hire back laid-off workers), but risk spreads are coming down sharply. Scott Grannis, author of a must-read blog – *Calafia Beach Pundit* – points out that two-year swap spreads have narrowed significantly. This is a sign that risk aversion hysteria is on the wane.

While many are suggesting that "this time it is different," and certainly this past year has witnessed unprecedented events, the market is dirt cheap. And even though our mothers told us that we wouldn't touch a hot stove twice, we will brave another stock market forecast for 2009. We expect a 30% increase in the Dow during 2009, taking it back to 11,000 by year-end, and then another 25% gain in 2010. Most amazing of all is that the market will still be undervalued, even if these large gains in the next two years occur, suggesting that above average returns will be the norm for the next few years.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-30 / 9:00 am	Chicago PMI - Dec	33.0	**29.8**		33.8
9:00 am	Consumer Confidence - Dec	45.5	**45.8**		44.9
12-31 / 7:30 am	Initial Claims - Dec 27	575K	**579K**		586K
1-02 / 9:00 am	ISM Index - Dec	35.4	**35.1**		35.5