First Trust
Monday Morning OUTLOOK
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# Can a "Perma-Bull" Turn Bearish?

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During the past five years, stock market forecasts have fallen into three different camps.

- It's a Dead Cat Bounce, Sugar High, Artificial, QE-Induced Bubble Stock Market. It will crash any day.
- It's a Real Bounce, from Artificial Undervalued Lows, With Technology and Productivity Driving Real Profits. The market is still cheap and will go higher.
- It was too low in 2009, but, as it moved higher, it became fairly, or over-valued. The risks of the world have risen and a correction or sideways market is due.

We are firmly in the second camp. Fox Business host, Dagen McDowell, with the Dow trading at 11,189 back on August 24, 2011 (link here) accused us of believing in "Unicorns and Rainbows" because we said the US stock market was 40% undervalued.

Today, we still think the broad US equity market is about 20% undervalued. Some have called us "perma-bulls." Others have questioned, fairly we might add, whether we were bullish for selfish reasons. They wonder if being bullish benefits First Trust.

So, this brings up a logical set of questions. What if we did become bearish? Would we actually tell people? Would we actually go public?

For the record, our firm manages many different asset classes in many different countries. If for some reason we thought US stocks were risky, we could always recommend products that would provide diversification in other asset classes.

But, let's put that aside. Lately, we have become very concerned the Federal Reserve has painted itself in a corner. The Fed has created $2.6 trillion in excess reserves that are like gasoline sitting next to a water heater. Instead of moving the gasoline out of the house completely by shrinking its balance sheet, it has decided to transfer the gas to different containers.

The Fed will try to pay banks not to lend. It proposes to make this work through a system of reverse repurchase agreements (known as, repos). Basically the Fed is attempting to trade bonds to banks, money market funds, and Government Sponsored Enterprise, for reserves. In this way it temporarily sops up the excess reserves without actually shrinking its balance sheet.

We believe this is dangerous for the economy. So far, there has been no sugar high because banks did not lend their excess reserves. That is beginning to change. In the past three months, commercial and industrial loans, M2 and M1, are up at a 16%, 7.7% and 15.8% annualized rates of growth, respectively.

Banks will help finance some of the massive expansion in Merger and Acquisition activity now taking place. Banks can earn more in this financing activity than current earnings on reserves (0.25%) or on reverse repos (0.08%).

The Fed will be forced to raise interest rates on its repos if it wants to compete and we see an "arms race" coming, where the Fed tries to outbid borrowers for excess reserves. This will eventually force rates up faster and further than most now believe possible.

What this does to our forecast is that we now see a money-induced spurt in growth that could end badly. We don't see that "bad ending" happening for quite some time. At least 12 months, probably more like 24 months, possibly 36+ months.

In the meantime, as money growth accelerates, the economy, stocks and inflation will accelerate, too. So, what is a good thing for the market over the next year or two will result in below-normal market returns after the surge is done.

Much will depend on how the Fed plays this out. It's still possible the Fed will find a way to unwind its balance sheet before a bubble in stocks occurs, the yield curve inverts, or there is some kind of major financial problem. As a result, an accurate timeline can't be developed just yet.

But, we promise that as these events unfold in the years ahead, we will not be shy about sharing them. We already are. There is no reason for a forecaster who values his or her reputation to spin an analysis in a way that makes no sense. The Fed is playing with fire and we wish it would stop.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 5-22 / 7:30 am | Initial Claims May 17 | 312K | **310K** | | 297K |
| 9:00 am | Existing Home Sales – Apr | 4.690 Mil | **4.680 Mil** | | 4.590 Mil |
| 9:00 am | Leading Indicators – Apr | +0.4% | **+0.3%** | | +0.8% |
| 5-23 / 9:00 am | New Home Sales – Apr | 0.425 Mil | **0.435 Mil** | | 0.384 Mil |