First Trust
Monday Morning OUTLOOK
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The Bull Market Still Lives

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Stock market corrections (usually defined as 10% pullbacks) are hard to understand. Often they happen in the midst of long-term bull markets. But why? Is it like getting the flu? Is it just emotion? Or, are corrections a necessary cleansing out of excess optimism? Our answer: we don't really know.

One thing we do know is that almost every time they happen, pessimists come out of the woodwork saying that a Bear Market has begun. In the past seven years, this has happened a number of times, but each time, the market has bounced back to new highs. Think about 2011, when the S&P 500 fell by 19.4% from April 29th to October 3rd. Even with the recent decline, the market is up 77.5% since then. We think the 2015 correction is no different and expect stocks to move to new highs.

There's no real definition of a bear market, or a bull market, for that matter. Most pundits use the rule-of-thumb that a bear market is a 20% drop from a prior peak. However, in 1962 this happened in the midst of a long running rise in stock prices that went on until 1966. So, we don't really know what to call that!

That still leaves several other 20% market declines in 1957, 1970, 1973-74, 1980, 1981-82, 1990, 2000-02, and 2007-09. But each of these was correlated with recession and a recession anytime soon is extremely unlikely.

Monetary policy is loose and will remain that way even when the Federal Reserve starts raising interest rates (still later this year, in our view). We wish marginal tax rates were lower, but they're not high by historical standards. Trade policy continues to move, at least gradually, in a direction of lower barriers to international trade. The federal government could certainly find ways to spend less and reform entitlements, but government is not growing as quickly as it did in the prior decade.

Moreover, financial firms are better capitalized than they've been for years, corporate balance sheets are loaded with cash, and households' financial obligations are hovering near the smallest share of after-tax income since the early 1980s. Meanwhile, as much as home building has revived the past few years, it still has further to go. This is just not a recipe for recession.

There were two other "bear" markets that didn't accompany a recession. One was in 1966, during the long economic expansion of the 1960s. The other was in 1987, with the famous and short-lived Crash in October that year.

But the 1966 decline in stocks followed the "Great Society" legislation, and inflation was ramping up. And 1987 was a fluke. In addition, our capitalized profits models – what we use to estimate fair value for equities – would have said both times that equities were overvalued before those bear markets started. By contrast, the same model is now saying equities are still undervalued.

The model uses after-tax corporate profits discounted by the 10-year Treasury yield. Partly because profits have risen so much but mostly because the 10-year Treasury yield is artificially low, this model still suggests that the S&P 500 is massively undervalued. Using a 10-year Treasury yield of 2%, the model says the "fair value" of the S&P 500 is 4,850.

But this number is artificially high because the discount rate is being held down by the Fed. Using a 4% 10-year discount rate gives us a "fair value" 2,425, leaving plenty of room for equities to rebound from the recent correction and move much higher. Assuming zero growth in profits, the 10-year yield would have to rise to about 5% to signal that equities are fairly priced right now.

None of this means equities have to hit new highs this week, or even this month. It does suggest that fears about a bear market are way overblown. We see no reason for a recession on the horizon, and equities still look cheap.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-5 / 9:00 am	ISM Non Mfg Index – Sep	57.5	**57.8**	56.9	59.0
10-6 / 7:30 am	Int'l Trade Balance – Aug	-$48.0 Bil	**-$48.6 Bil**		-$41.9 Bil
10-7 / 2:00 pm	Consumer Credit– Aug	$19.5 Bil	**$23.0 Bil**		$19.1 Bil
10-8 / 7:30 am	Initial Claims – Oct 3	275K	**272K**		277K
10-9 / 7:30 am	Import Prices – Sep	-0.5%	**+0.4%**		-1.8%
7:30 am	Export Prices – Sep	-0.6%	**0.0%**		-1.4%