First Trust

Quarterly Market Overview

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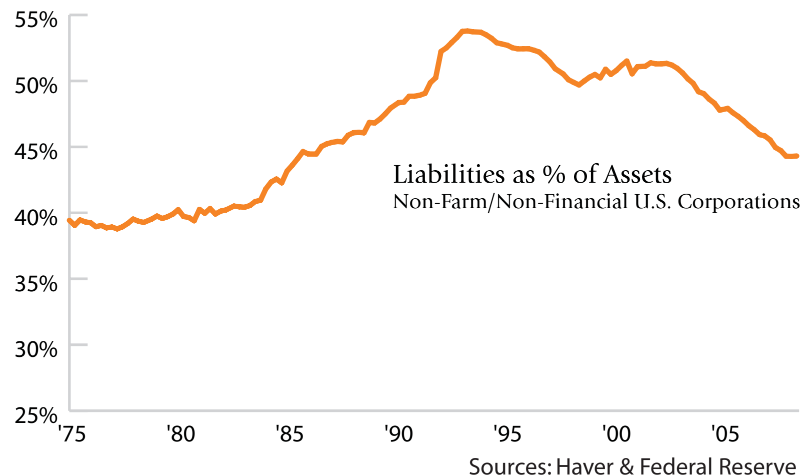
Mr. Carey has appeared throughout the United States and Canada as a guest on television and radio programs. These programs include: Bloomberg TV, CNBC and Canada's Business News Network and on Chicago's WBBM Newsradio 780's Noon Business Hour. He has been quoted by several publications, including *The Wall Street Journal, The Wall Street Reporter, Bloomberg News Service, and Registered Rep.*

The clock ran out on the speculators

In our July 2008 edition we noted that over the long haul corporate earnings drive stock prices. In the short run, other influences can play a critical role. For example, the 5-year bull market (10/9/02-10/9/07) produced a cumulative return of 87% (excluding dividends), as measured by the S&P 500. Over that span, the index's earnings increased 79%, according to Thomson First Call. Since last October, however, the U.S. and foreign stock markets wilted under the weight of a global credit crunch. We have maintained since day one that the cause of the credit crunch was excessive leverage – not a lack of liquidity. One of the primary drags on equities in recent months has been the unwinding (selling) of said leverage.

One of the definitions of **leverage** offered by Merriam-Webster is the following: **The use of credit to enhance one's speculative capacity**. Institutions that utilized leverage in an aggressive manner to purchase high-yielding CDOs anchored by subprime mortgage pools and those that sought hefty premiums in return for backstopping billions of dollars of credit default swaps were speculating that short-term rates would remain low and residential housing prices would hold their ground. Neither of which, in hindsight, came to fruition. Because these institutions committed hundreds of billions of dollars to illiquid securities, the fallout has nearly paralyzed the global debt markets. Hence, the need for a rescue plan.

The Emergency Economic Stabilization Act of 2008 (EESA) was passed into law on October 3, 2008. The plan authorizes the Treasury to tap $700 billion to buy distressed assets/debt from financial firms in an effort to jumpstart lending. It raises FDIC (Federal Deposit Insurance Corp.) insurance caps on bank deposits from $100,000 to $250,000 for individuals, which could help prevent further runs on banks. The EESA also addresses accounting standards, the restructuring of some existing mortgages and executive pay, among other matters. Since its passage, the Treasury Department has said it may buy stakes in a wide range of banks in an effort to achieve stability.



Sources: Haver & Federal Reserve

The chart above was selected to let investors know that not all institutions got drunk on debt over the past six years. In fact, some companies were being called out a couple of years ago for not exploiting the low interest rate climate enough. Many companies were using their own equity rather than debt to finance operations even though equity carried a higher cost of capital than debt.

Two areas of the credit market (both speculative in nature) that still pose a potential drag on the economy are credit-cards and high yield corporate bonds. Why credit-cards? Because 30% of outstanding credit-card debt is owed by the riskiest borrowers (subprime status), compared to just 11% of mortgage debt, according to *BusinessWeek*. Plus, the sheer volume of debt has grown by over 75% since 1999, according to Innovest Strategic Value Advisors. Credit-card companies have been scaling back credit limits fearing that consumers will not be able to repay bigger balances in the current climate.

High Yield debt could be vulnerable if the credit crunch doesn't ease soon. The yield spread between the Merrill Lynch U.S. High Yield Master II Index and the 10-yr. T-Note was 10.83 percentage points as of 10/2/08, up from 4.16 percentage points a year ago, according to Bloomberg. That large of a spread would normally be associated with a default rate approaching 10%, not the current 3.4%, according to Moody's. In June, 33% of high yield's were on review for downgrade, according to S&P.

Continued

Investing is a little like dribbling a basketball...you'll be better at it if you keep your head up

Black & Blue All Over

A lot of investors both here and abroad are hanging their heads right now in response to the dismal returns posted by the global equities markets since the U.S. market peaked on 10/9/07. Who can blame them? The chart below indicates that there was nowhere to hide. The silver lining in this sad episode is the extraordinary level of risk-taking on Wall Street is likely behind us. Investment banks are now commercial banks. The use of leverage moving forward is destined to pale in comparison to the days of 40-to-1 (debt-to-equity). The global rescue effort of our financial institutions comes with strings attached. One of those strings will surely be greater oversight.

Collateral Damage

The global credit crunch has likely pushed the U.S. and some foreign countries into recession. Time will tell how severe of a downturn we are in for. The last couple of recessions in the U.S. have been quite shallow. The Treasury Department has yet to put to work the $700 billion earmarked for the acquisition of bad debt from the books of struggling financial institutions. This is a critical step in unfreezing the credit markets. We have also just entered into earnings season for Q3 so be prepared for more volatility, both up and down. There is a silver lining here as well. The price of a barrel of oil is down nearly 50% from its $145.29 peak. That is essentially a tax cut for the consumer.

Buy & Hold Revisited

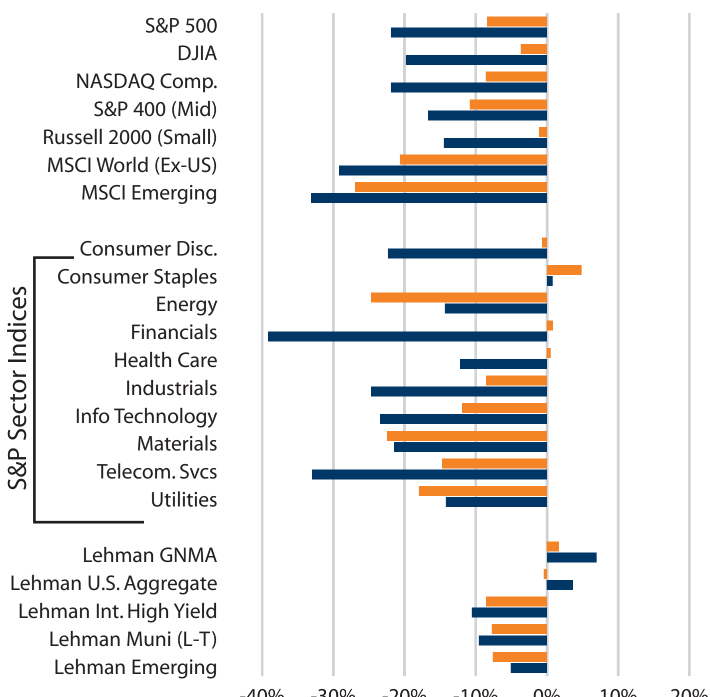
Now that we are in the midst of another bear market, and with Wall Street less inclined to push the envelope to generate outsized returns, investors may want to consider investing in ideas that make sense on paper but need some time to develop. In other words, old school buy and hold investing. Two ideas that come to mind are infrastructure and biotechnology. The latter is grounded in the fact that roughly 52% of health care costs stem from surgery, hospital stays and rehab, according to The National Coalition on Health Care. The pipeline for biotech medicines has been building for a decade. The answer to reining in costs is to keep folks out of the hospital.

Total Return Performance from 10/9/07-10/13/08

Russia (RTS) -62.83% (USD)	China (Shanghai) -59.58% (USD)	S&P Financials -53.25%	India (Bombay) -50.70% (USD)	MSCI Emerging -48.39% (USD)	Brazil (Bovespa) -46.78% (USD)
Latin America (DJ) -45.81% (USD)	MSCI World (xUS) -42.32% (USD)	MSCI Euro -41.53% (USD)	Hang Seng -40.42% (USD)	Philly Gold & Silver -39.15%	S&P Telecom Svcs -39.03%
S&P 500 Value -37.71%	S&P Consumer Disc -37.46%	S&P Industrials -37.07%	DJ Wilshire 5000 -35.71%	Russell 3000 -34.66%	S&P 500 -34.49%
Russell 2000 Growth -34.12%	S&P Materials -33.88%	NASDAQ 100 -33.82%	S&P Info Tech -33.66%	S&P 400 Growth -32.98%	S&P 400 Value -32.83%
DJIA -31.95%	S&P REIT -31.95%	Russell 2000 -31.56%	S&P 500 Growth -31.27%	DJ Dividend Select -30.99%	S&P Energy -30.27%
Russell 2000 Value -29.24%	S&P Utilities -27.42%	S&P Health Care -23.01%	CBOE Buywrite -20.36%	Amex Biotech -19.00%	S&P Consumer Staples -8.90%

Source: Bloomberg

Total returns for *Q3* and *past 12 months* (9/30/08)



A Look Ahead:

The outlook for earnings (year-over-year)...

	Q4'08E	Q1'09E	2009E
Financials	421.6%	300.7%	130.6%
Technology	**3.6%**	**9.6%**	**14.5%**
Health Care	7.3%	5.6%	10.3%
Consumer Staples	**16.0%**	**8.4%**	**11.6%**
Consumer Discretionary	-5.5%	20.0%	45.1%
Industrials	**2.6%**	**6.4%**	**8.9%**
Telecommunications Services	-4.3%	4.1%	8.7%
Energy	**17.0%**	**21.5%**	**6.7%**
Utilities	5.1%	5.9%	9.2%
Materials	**26.5%**	**17.6%**	**14.1%**
S&P 500 Index	**31.9%**	**19.7%**	**7.8%**
S&P 400 Index (Mid-Cap)	12.3%	17.4%	19.4%
S&P 600 Index (Small-Cap)	**11.1%**	**24.1%**	**21.8%**

Source: Thomson First Call/Baseline (10/7/08)