First Trust

Quarterly Market Overview

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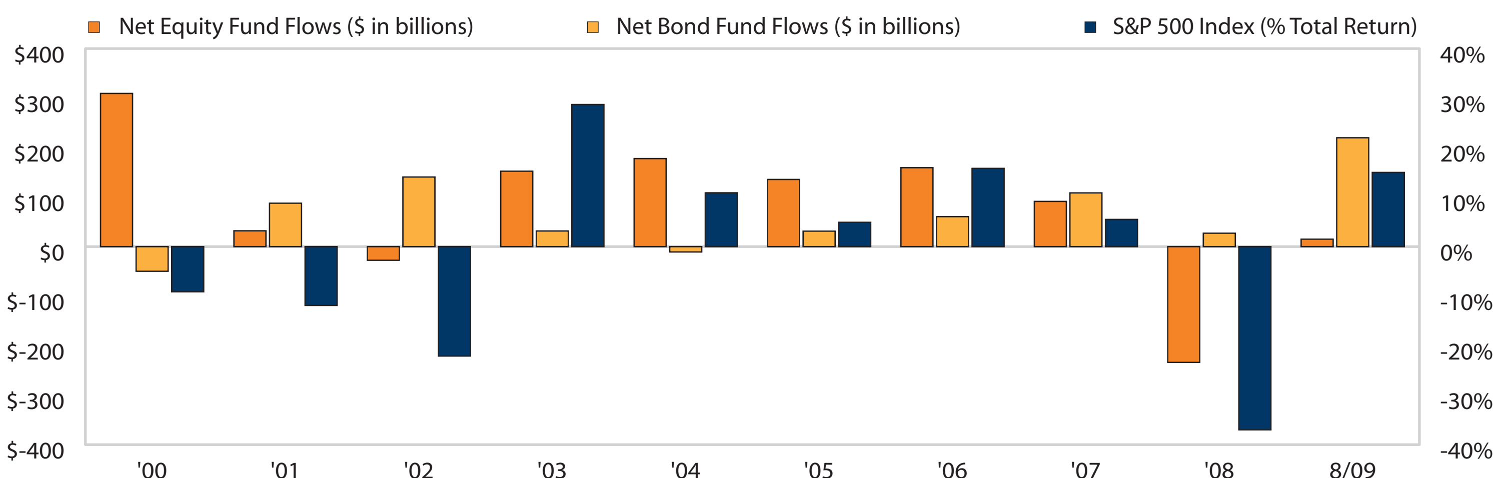
Mr. Carey has appeared throughout the United States and Canada as a guest on television and radio programs. These programs include: Bloomberg TV, CNBC and Canada's Business News Network and on Chicago's WBBM Newsradio 780's Noon Business Hour. He has been quoted by several publications, including *The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

Once bitten, twice shy



Source: Investment Company Institute and Bloomberg

Debt carries an inherent obligation

One of the biggest complaints about the U.S. is our burgeoning debt levels. The bigger the burden grows the greater the strain on the value of the dollar. Since so many of our trading partners are dependent on exports to grow their economies, a weak dollar is about as welcome as a case of the H1N1 virus.

Investors have poured billions of dollars into bond funds this year. Year-to-date through August, net inflows into bond funds totaled $219.9 billion, versus just $15.0 billion for equity funds, according to the Investment Company Institute. That is better than a 14-to-1 ratio. In Q1'09, net inflows to bond funds totaled $54.6 billion, while equity funds posted net *outflows* totaling $43.5 billion. From the end of March through August, however, the ratio narrowed to 3-to-1 in favor of bonds. Why? The S&P 500 posted a total return of 52.55% from its March 9th low through August. That is bound to attract attention.

Perhaps there is a logical explanation for the disparity in fund flows. The credit crunch fallout from the subprime mortgage meltdown triggered a massive sell-off in debt securities not backed by the full-faith-and-credit of the U.S. government. With the economy still in recession through Q2'09, it could be that investors realized they could lock in double-digit yields (from high yield corporate bonds) plus the potential for substantial price appreciation. In other words, use bonds as a surrogate for stocks. At least for now.

Trust in the stock market is harder to come by

One method of tracking the evolution of this bull market is by monitoring the following three stages: bottoming of the bear market (3/9/09); end of recession/cost-cutting measures (consensus says Q2'09); and companies growing top-line earnings (?). In our opinion, if companies can grow their businesses over the next few quarters more capital should flow from safe havens into stocks.

It makes sense that investors are cautious on stocks. They have endured two scandal-ridden bear markets this decade. In both instances, the value of S&P 500 was slashed by more than 45%. They see the government extending support to Wall Street firms, but not to them. It can't help but shake one's confidence. But at its core, Wall Street and the equities markets are designed to function as a wealth-building system. So if the bailouts manage to stabilize the system, as appears to be the case, then in an indirect way the government is extending something to investors – the chance to fight another day. With real estate still destabilized and spreads on bonds approaching their historical ranges, stocks may once again be the top wealth building option. Like it or not.

From 1926 through 2008, the S&P 500 generated an average annual total return of 9.62%, compared to 5.69% for Long-Term Treasuries, according to Ibbotson Associates. At the close of September, the 30-yr. T-Bond yielded 4.05%, 1.64 percentage points below average.

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"They can pass all the laws they want. All they can do is change the rules. They can never stop the game."
From the movie Other People's Money (1991)

We mentioned earlier that stocks may once again be the top wealth building option for investors, whether they like it or not. Even Federal Reserve Chairman Ben Bernanke commented last July that he had to "hold my nose" during the taxpayer-financed bailouts. We are likely to see a litany of new laws passed designed to clamp down on fraud in the banking system and on Wall Street. We have already seen major brokerage firms converted into commercial banks. That transformation, however, did not stop Goldman Sachs from posting its highest quarterly profit in its 140-year history – over $3.0 billion – in Q2'09. Its stock price jumped 25.3% in Q2, vs. a gain of 15.6% for the broader S&P 500. As the quote above says, the game goes on. About the only thing worse than experiencing a bear market is not taking a stake in the next bull. Remember, the S&P 500 doubled in value in the five years following the end of the dot-com bomb (10/9/02-10/9/07). While there is still much work to be done repairing the damage from the subprime meltdown, an argument can be made that the worst is behind us. After all, the S&P 500 has already recovered over 40% of its losses from the last bear (1565.15 on 10/9/07 to 676.53 on 3/9/09 to 1057.08 on 9/30/09).

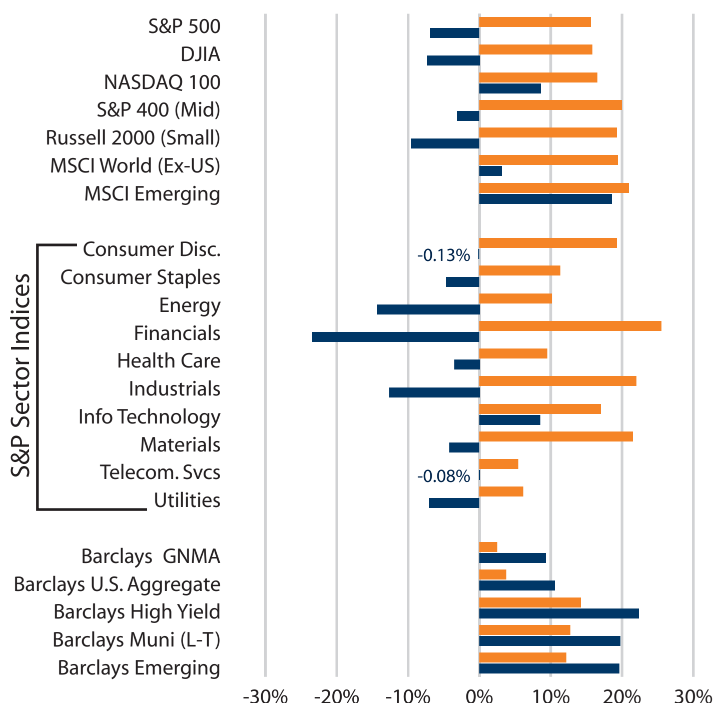
Three critical steps that helped bring an end to the crisis

Step 1: Stabilizing the banking system. The Bush Administration began the process and the Obama Administration expanded it. The one player involved throughout was Treasury Secretary Timothy Geithner, formerly president of the Federal Reserve Bank of New York. While a chunk of the $700 billion appropriated for the Troubled Asset Relief Program (TARP) was to remove some of the toxic debt from the balance sheets of troubled banks in order to free up lending, it was later ditched in favor of infusing the capital directly via preferred shares. The plan got off to a slow start, but it seems to have worked. Some of the TARP recipients have already paid back the money. As of early September, banks and insurers had sustained $1.62 trillion in credit losses since the crisis began in July 2007, according to Bloomberg. Chris Flanagan, Head of ABS Research at J.P. Morgan, believes we are already nearly three-quarters of the way through the writedowns. He projects total losses will peak at $2.25 trillion with remaining losses spread over the next five years. If so, such writedowns should not pose a major problem for banks, according to Flanagan.

Step 2: Thawing of the credit markets. In addition to the Federal Reserve's easing of monetary policy (lowered federal funds rate from 5.25% to 0.25%) the Fed increased the size of its balance sheet from $800 billion in Q4'08 to about $2.2 trillion today, primarily by purchasing Treasuries, mortgages/agencies and commercial loans. The Fed has added much needed liquidity and has helped keep mortgage rates down. Thanks to the Fed's participation, corporations have been able to tap the capital markets quite easily in 2009.

Step 3: Relaxing mark-to-market accounting (FASB 157). The pricing of toxic assets (mortgage-related securities) via mark-to-market in such an illiquid climate was accelerating the depletion of capital at many financial institutions. Brian Wesbury, Chief Economist at First Trust Advisors, was among the first to call for its suspension. The Financial Accounting Standards Board (FASB) voted on April 2, 2009, to modify the rules to allow companies additional flexibility to use their judgement in determining the "fair value" of their assets. The stock market had already responded favorably to the announcement that the House Financial Services Committee was holding a hearing on mark-to-market accounting on the 12th of March . As we now know, the market bottomed on March 9. From March 9 through April 2, the day FASB voted to soften the mark-to-market rules, the S&P Banks Index posted a total return of 47.5%, vs. a gain of 23.5% for the broader S&P 500 Index. The S&P Banks Index was up 137.3% from its bottom through September 30.

Total returns for Q3 and past 12 months (9/30/09)



A Look Ahead:

The outlook for earnings (year-over-year comparison in $)...

	Q4'09E	Q4'08A	**Q1'10E**	Q1'09A	**2010E**	2009E
Financials	**2.07**	-13.93	**2.32**	0.50	**11.91**	5.20
Information Technology	**4.98**	2.73	**4.45**	2.90	**20.62**	15.55
Health Care	**6.56**	5.66	**7.05**	6.61	**28.95**	26.38
Consumer Staples	**4.60**	4.20	**4.33**	3.90	**19.38**	17.69
Consumer Discretionary	**2.86**	-0.37	**2.80**	0.38	**13.60**	8.63
Industrials	**3.77**	4.63	**3.30**	3.08	**15.12**	14.08
Telecom. Services	**2.15**	1.87	**2.01**	1.95	**8.13**	8.01
Energy	**6.15**	4.44	**7.50**	0.44	**32.05**	16.85
Utilities	**2.55**	2.37	**3.05**	2.89	**12.86**	11.66
Materials	**1.35**	-4.56	**2.42**	1.04	**10.48**	5.16
S&P 500 Index	**15.94**	-0.09	**16.37**	10.11	**73.47**	54.77
S&P 400 Index (Mid-Cap)	**9.16**	-0.79	**8.85**	2.45	**41.07**	27.42
S&P 600 Index (Small-Cap)	**3.70**	-1.27	**3.84**	0.68	**17.82**	9.36

Source: Standard & Poor's (10/6/09)