First Trust

Quarterly Market Overview

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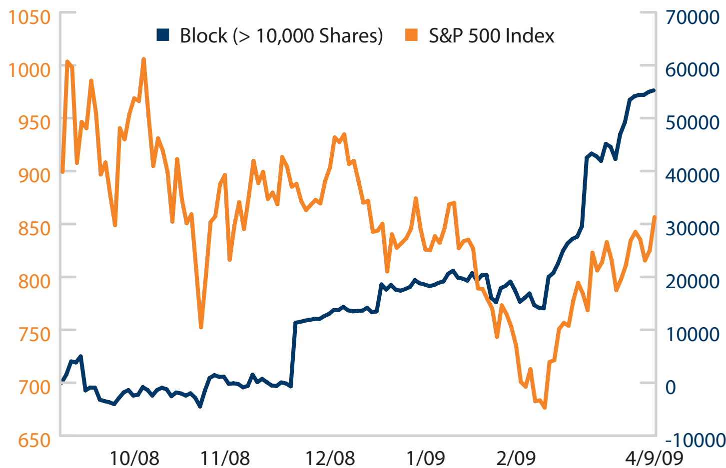
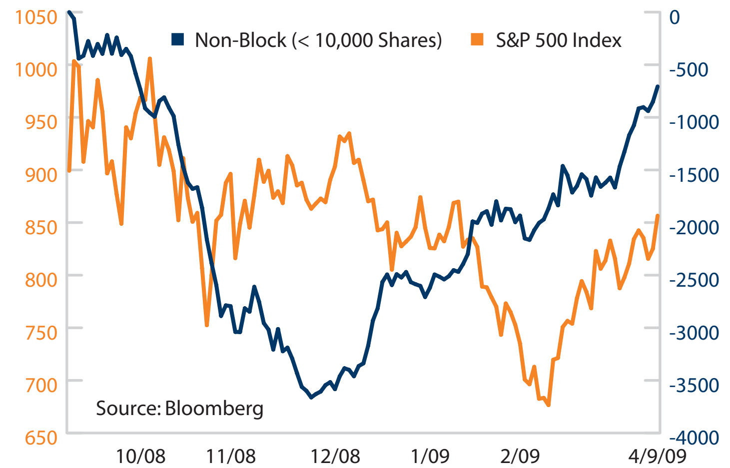
Mr. Carey has appeared throughout the United States and Canada as a guest on television and radio programs. These programs include: Bloomberg TV, CNBC and Canada's Business News Network and on Chicago's WBBM Newsradio 780's Noon Business Hour. He has been quoted by several publications, including *The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

Money is flowing back into equities

The charts below show cumulative dollar flows of money (millions) compared to the level of the S&P 500. The recent trend is up in both snapshots. The chart on the left reflects institutional trading, while the one on the right captures the retail investor's flows. On a net basis, institutional flows are up significantly, while retail flows are almost back to 10/08 levels.





Bearish sentiment peaked in early March

In our last edition (archived at ftportfolios.com) we showed the relationship between the performance of the S&P 500 relative to investor bearishness sentiment, as measured by the American Association of Individual Investors (AAII) Bearish Sentiment Index, looking back 20 years. The takeaway from the chart we referenced is that bearishness tends to spike/peak in periods of economic weakness (1990-1991, 2002-2003 & 2007- Q1'09) then gives way to multi-year gains in the S&P 500.

The level of bearishness in Q1'09 surged from 43.86 at the close of 2008 to a *record-high* 70.27 in the first week of March. A very high bearish reading is considered a sign the market is in the process of bottoming. It certainly was in this instance. The total return on the S&P 500 was -24.6% from 12/31/08-3/9/09 (the index bottomed on 3/9). From 3/9/09-4/9/09, the S&P 500 returned 26.9%. The AAII Bearish Sentiment Index stood at 44.29 as of April 9, still above its 5-year average of 36.53, according to data from Bloomberg.

In addition to money flowing into stocks, volatility is starting to stabilize. The VIX Index, which measures the volatility in the S&P 500, posted an average reading of 44.9 in Q1'09. The index's all-time high was 80.86 on November 20, 2008. Over the past 5 & 15 years the average has been approximately 19-20. As of April 9, the VIX stood at 36.53. This is one instance where down is good.

Opportunity might be knocking

- After factoring in the impressive rally in the S&P 500 since it bottomed on March 9, the index is still around 45% below its all-time high of 1565.15 on 10/9/07.
- When the S&P 500 peaked on 10/9/07 its market cap was $13.78 trillion. When the index bottomed on 3/9/09 its cap was $5.89 trillion, a loss of $7.89 trillion. Its cap stood at $7.44 trillion on 4/9.
- The S&P 500 declined for the sixth quarter in a row falling 11.0% in Q1'09. The only other time the index posted a losing streak comparable to this one was from Q4'68 through Q2'70, according to Standard & Poor's.
- Merrill Lynch's fund manager survey conducted in March found that 42% of managers believe equities are undervalued, up from 24% in February. Average fund cash balances rose from 4.9% in February to 5.2% in March. Cash balances reached 5.2% at the close of 2002.
- While many financial firms are being squeezed by the credit crunch, 168 of the 419 nonfinancial firms in the S&P 500 are sitting on at least $1 billion in cash and equivalents, according to Strategas Research Partners. Nonfinancial firms had a total of $811 billion in cash holdings as of early March, according to Goldman Sachs.

Continued

Convertibles are built for this type of climate

Those investors eyeballing the stock market but too skittish to commit might consider a portfolio of convertible securities in the current climate. Convertibles are essentially securities that may be exchanged for another asset – generally a fixed number of shares of common stock. Convertibles are usually structured as fixed-income securities, such as debentures and preferred stock. Their prices are influenced by interest rate fluctuations and the underlying value of the asset (stock) into which they can be exchanged. Convertible securities tend to be more volatile than most debt securities, but less volatile than common stocks (see chart). Like most bonds, convertibles can be called by the issuer.

Convertibles are well-suited for this type of climate because they capture a high percentage of the gains generated by stocks during bull markets, which most investors are hoping for at this juncture of the bear market, while tempering the losses that accompany bear markets. Regardless of whether the stock market is rising or falling, the convert pays the investor a fixed rate of interest or dividends. Investors who were wise enough to shift some of their money from stocks to bonds during the bear to preserve capital, and have since grown attached to the income, are prime candidates for convertibles. They can maintain a current income stream, while gaining a stake in the stock market.

The average convertible security has a credit rating of BB from Standard & Poor's, according to *Kiplinger*. That places them at the top of the speculative-grade category. Most of the focus in speculative-grade securities is on high yield corporate bonds. Due to the severe credit crunch, high yields are currently sporting much higher yields than normal (Merrill Lynch High Yield Master II Index yields around 18%). High yields, however, carry considerably more credit risk due to the fact that a high percentage of them are rated B or CCC. With respect to default rates the difference in credit ratings is huge.

Income Vehicles with Credit Risk vs. S&P 500
Annualized Returns (Bull & Bear Market)

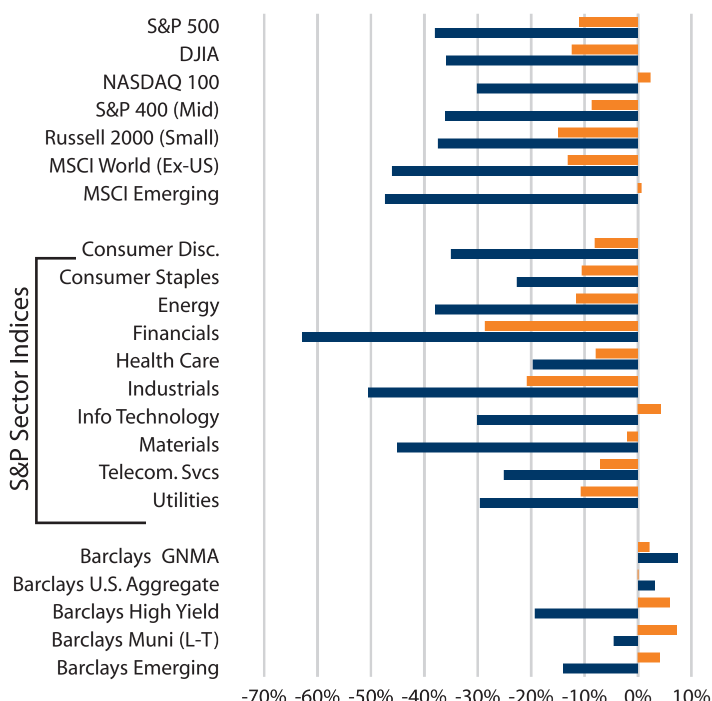
Index	10/9/02-10/9/07	10/9/07-4/9/09
Merrill Lynch Convertibles (All Qualities)	13.47%	-21.84%
Barclays U.S. Corporate High Yield	13.02%	-14.61%
Barclays Intermediate Corporate	4.93%	-1.79%
Barclays Municipal Bond: Long Bond (22+)	5.17%	-5.16%
FTSE NAREIT Equity REITs	25.42%	-43.41%
S&P 500	17.15%	-31.43%

Source: Barclays Capital & Bloomberg

In the recession of 2001, the default rate on BB-rated corporates was 1.2%, vs. 9.1% for B-rated issues and 31.3% for CCCs, according to Moody's. An investor sizing up these two opportunities should know that Moody's expects the default rate on high yield corporates to increase from 7.4% in March to peak at 13.5% in December. In our opinion, if the stock market continues to rally the edge would go to convertibles. For those investors feeling opportunistic, closed-end funds are worth a serious look.

The value-added offered by Convertible closed-end funds today is their use of leverage. These funds are able to distribute a much higher level of current income than portfolios that do not employ leverage. The spread that is being generated right now by the borrowed capital is bolstered by extremely low short-term interest rates. In the current climate, an investor can find distribution rates in excess of 13%, while rates for portfolios that do not use leverage are more likely to range from 4-8%. Since leverage increases volatility, some of the yield advantage comes from the depressed valuations posted during the bear market.

Total returns for *Q1* and 12-month (3/31/09)



A Look Ahead:
The outlook for earnings (year-over-year)...

	Q2'09E	Q3'09E	2009E
Financials	131.6%	245.8%	497.7%
Technology	**-28.7%**	**-22.6%**	**-18.6%**
Health Care	-0.7%	1.3%	0.3%
Consumer Staples	**-0.7%**	**-2.9%**	**3.3%**
Consumer Discretionary	-47.0%	13.5%	-32.7%
Industrials	**-35.7%**	**-27.8%**	**-28.6%**
Telecommunications Services	-29.1%	-18.7%	-1.0%
Energy	**-62.8%**	**-62.4%**	**-56.1%**
Utilities	-8.1%	1.6%	4.8%
Materials	**-62.6%**	**-61.3%**	**-56.8%**
S&P 500 Index	**-17.9%**	**-7.6%**	**-9.6%**
S&P 400 Index (Mid-Cap)	-29.5%	-20.1%	-19.3%
S&P 600 Index (Small-Cap)	**-31.4%**	**-11.2%**	**-16.4%**

Source: Thomson First Call/Baseline (4/7/09)