First Trust

Quarterly Market Overview

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Mr. Carey has nearly a quarter century of experience as an Equity and Fixed-Income Analyst and is a recipient of the Chartered Financial Analyst (CFA) designation. He is a graduate of the University of Illinois at Champaign-Urbana with a B.S. in Physics. He is also a member of the CFA Society of Chicago and the CFA Institute. As CIO, Bob and his staff supervise over $30 billion in assets.

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.*

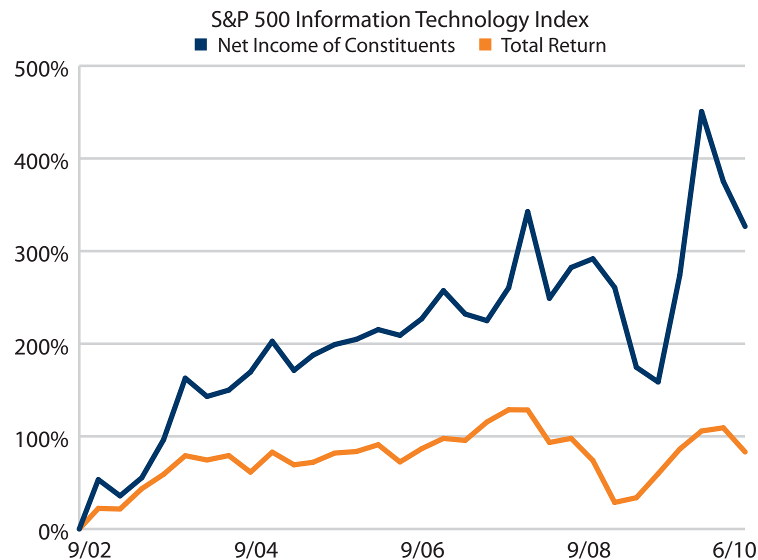
Stocks own the 4th Quarter

Some football players raise four fingers to the sky at the end of the 3rd quarter to signify that their team owns the 4th quarter. Seeing that we are in the thick of the 2010 football season, we thought it might be interesting to take a look at how stocks and bonds have performed in the 4th quarter over the past 15 years. The 4th quarter is a bit unique because it has a seasonal influence. The Christmas shopping season alone can make or break a consumer company's year. It has also traditionally been a critical launch period for new technology products.

Speaking of technology, aside from being the second best performing major sector in Q4 since 1995 (see bottom right), the stock prices of tech companies have lagged their profits dramatically since the end of the bear market in 2002 (see top right). Profits were up 326.7% in the period depicted, while the S&P Information Technology Index posted a gain of only 93.4%. S&P 500 profits rose just 42.8% over that span, but the index posted a gain of 47.4% – essentially mirroring profit gains.

Is it possible that the lack of love for tech stocks is a function of the ill will derived from the bursting of the dot-com bubble? After all, tech stocks declined about 83% from peak-to-trough in the bear market from 3/24/00-10/9/02. That plunge begot us new securities regulations (Sarbanes-Oxley). If so, what does such a lesson portend for the Financial sector? Financials declined about 84% from peak-to-trough in the subprime mortgage-driven bear market from 10/9/07-3/9/09. That plunge also begot us new securities regulations (Dodd-Frank Wall Street Reform and Consumer Protection Act). The price-to-earnings ratio of the S&P Information Technology Index averaged around 30 from 1995-2009, according to Bloomberg. Today, its P/E is closer to 14 based on earnings projections looking out 12 months. The S&P Information Technology Index closed September 48.4% below its 10-year high on 10/2/00.

While we at First Trust appreciate the buy-and-hold investor as much as any asset manager, we can also reach out to those investors with shorter-term goals. ETFdb.com reported at the end of April 2010 that the average holding period in the SPDR S&P 500 ETF was 3.3 days. It was 2.7 days in the SPDR S&P Metals and Mining ETF. So this Q4'10 theme can work for the trader as well as the buy-and-hold investor. How can the investor with a longer horizon use this information? Remember, as of 9/30, the S&P 500 would still have to rally 37% just to climb back to its all-time high of 1565.15 on 10/9/07. Net *inflows* to bond funds in the first eight months of 2010 totaled $216.1 billion, compared to net *outflows* totaling $18.2 billion for equity funds, according to the Investment Company Institute. This suggests there are a lot of retail investors that are likely underexposed to equities. Considering that November and December are the two best performing months for stocks (since 1950), October is as timely an entry point as any.



Source: Bloomberg

Q4 Total Return Performance (1995-2009)

Index	Average	Best	Worst
S&P 500 Telecommunication Services	7.96%	37.69% '02	-19.12% '00
S&P 500 Information Technology	7.34%	36.46% '98	-33.39% '00
S&P 500 Consumer Staples	6.33%	22.25% '98	-12.83% '08
S&P 500 Consumer Discretionary	5.97%	29.39% '98	-22.85% '08
S&P 500 Materials	5.78%	23.14% '03	-30.78% '08
S&P 500 Industrials	5.15%	18.18% '98	-23.92% '08
S&P 500	5.04%	21.30% '98	-21.94% '08
S&P 500 Health Care	5.02%	14.69% '98	-12.10% '08
S&P 500 Utilities	4.16%	16.76% '97	-10.92% '08
S&P 500 Financials	3.61%	22.23% '98	-36.92% '08
S&P 500 Energy	3.02%	15.30% '03	-20.61% '08
U.S. Aggregate Bond	1.81%	4.58% '08	-0.12% '99
Municipal Bond (22+)	1.24%	4.37% '00	-0.96% '09

Source: Bloomberg & Barclays Capital

Continued

How about we pick up where we left off...

Oh, where were we before we were so rudely interrupted? That's right, it was **half time 2007**. Things were going fairly well until the subprime mortgage market started to implode. Perhaps a quick recap is in order. It seems that too much cheap money was floating around in the early 2000s and it set the stage for a run on real estate in the U.S. Real estate became the asset of choice because we had just witnessed the bursting of the dot-com bubble (Q2'00) and investors were no longer enamored with owning stock in companies with no earnings and poorly structured business plans. Real estate, on the other hand, was a tangible asset that "never seemed to go down in value." So investors began piling into REITs (Q2'00) and people began purchasing homes with little or no money down in some cases. Mortgage lenders provided prospective buyers with exotic loans that not only aided them in securing homes, but fostered a climate that would allow interested parties to buy and quickly flip properties at a profit. As it turned out, the Achilles heel of too many of these exotic loans was that they were structured as adjustable-rate mortgages. The resets wouldn't be a problem so long as rates stayed low and property values remained high. Many of these loans, unfortunately, found their way into the hands of subprime borrowers. Financial firms purchased a lot of these mortgages from lenders in order to package them into relatively high-yielding investment products (process known as securitization) that carried investment-grade ratings. These products were attractive, especially to institutional investors both here and abroad, compared to the yields being offered on prime mortgages and Treasuries. The securitization of these loans continued to provide subprime lenders with a steady stream of capital to fund more loans. Well, long story short, the bubble in the real estate market burst after the Federal Reserve hiked the federal funds rate from 1.0% to 5.25% (6/04-6/06) to combat inflationary pressures. Tens of thousands of homeowners could no longer make their house payments once their mortgage rates reset higher. The thrust of the cleanup from the subprime meltdown has been underway since the government bailouts commenced in Q4'08. The healing process, while not pretty to watch and painful for many, is well underway. Despite the fact that unemployment remains high and foreclosures a problem, people need to hear that progress is being made. In fact, there is evidence that some critical components of the economy have already recovered. Here are three snapshots that show how some key indicators are already back to pre-subprime meltdown levels:

High Yield Corporate Bond Market – The current yield on the Merrill Lynch High Yield Master II Index was **8.18%** on 6/30/07. The credit crisis stemming from the subprime meltdown and recession pushed the yield to a high of **20.73%** on 3/9/09. As of 9/30/10, the yield was back down to **8.12%**.

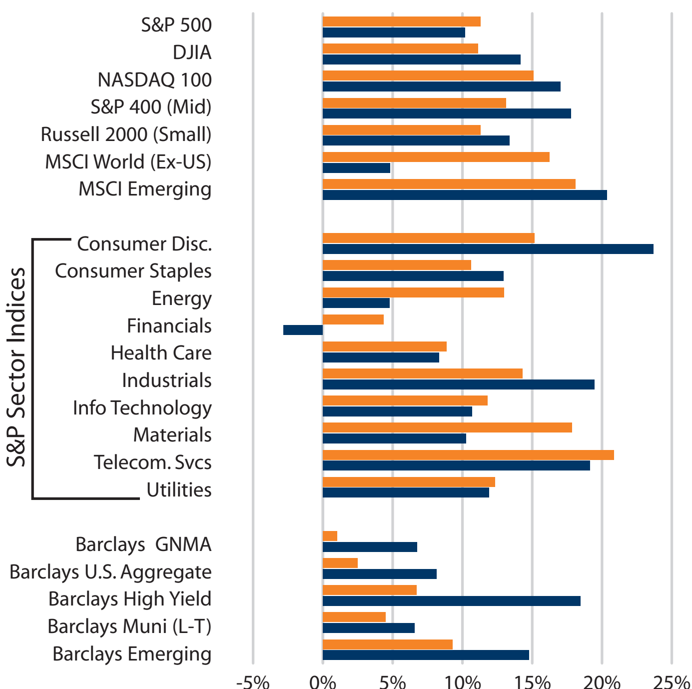
VIX – This index reflects a market estimate of future volatility (S&P 500). The lower the reading the better. The VIX registered a reading of **16.23** on 6/29/07. The turmoil in the debt markets plus extremely high levels of uncertainty about financial firms on Wall Street pushed the index to an all-time high of **80.86** on 11/20/08. It stood at **15.73** on 4/20/10. Over the past decade (2000-2009), the index averaged **21.92**. On 9/24/10, the VIX stood at **21.71**.

ISM Manufacturing Index – A reading above 50 indicates that manufacturing activity is expanding. The index stood at **53.2** in 6/07. Obviously, manufacturing slumped during the recession (12/07-6/09). It posted a recent low of **32.5** in 12/08. It has since rebounded and stood at **54.4** in 9/10.

A brief commentary on Mid-Cap stocks

One of the popular tag lines you hear with respect to the stock market is "The Lost Decade." The problem with it is that it is incomplete. It should read "The lost decade in large-cap stocks." From 9/30/00-9/30/10, the S&P 500 posted a cumulative total return of -4.22%, compared to 69.05% for the S&P 400 (Mid-Caps) and 48.53% for the Russell 2000 (Small-Caps). In fact, mid-cap stocks have outperformed their large- and small-cap counterparts over the past 1-, 3-, 5- and 10-year periods through 9/30/10, and by big margins, as measured by the three aforementioned indices. Yet they get little fanfare. One of the theories offered to explain their success is that investors lost interest in large-caps after their run in the 1990s ended and dropped down a class to mid-caps in search of value. Another theory is that M&A activity shifted aggressively to the mid-cap space as the market values of large-cap corporations surged thereby enabling them to acquire larger targets. Private equity firms raised so much capital they became big players as well. Maybe both theories are true. Regardless of how it came to be, it might behoove investors to double-check their equity allocations to see if they are underweight mid-caps.

Total returns for *Q3* and past **12 months** (9/30/10)



A Look Ahead:

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

	Q4'10E	Q4'09A	**Q1'11E**	Q1'10A	**2010E**	2011E
Financials	**4.05**	1.54	**4.42**	3.66	**15.22**	18.06
Information Technology	**7.32**	6.44	**6.29**	5.54	**25.11**	28.34
Health Care	**7.32**	6.27	**7.89**	7.08	**28.90**	32.66
Consumer Staples	**5.15**	4.96	**4.76**	4.37	**19.28**	21.30
Consumer Discretionary	**4.50**	4.32	**4.15**	4.09	**17.30**	19.33
Industrials	**4.67**	4.15	**4.34**	3.71	**17.48**	19.61
Telecom. Services	**2.12**	1.62	**2.00**	1.91	**8.08**	8.32
Energy	**9.05**	6.32	**9.64**	8.42	**35.41**	40.97
Utilities	**2.53**	2.28	**3.35**	3.41	**12.61**	13.10
Materials	**2.77**	2.11	**3.90**	3.20	**12.12**	15.27
S&P 500 Index	**21.78**	17.16	**21.83**	19.38	**82.69**	93.93
S&P 400 Index (Mid-Cap)	**11.98**	9.12	**11.87**	9.22	**43.47**	53.16
S&P 600 Index (Small-Cap)	**5.13**	2.85	**5.19**	3.45	**17.48**	23.15

Source: Standard & Poor's (10/5/10)