First Trust

Quarterly Market Overview

Issue 45, April 2011

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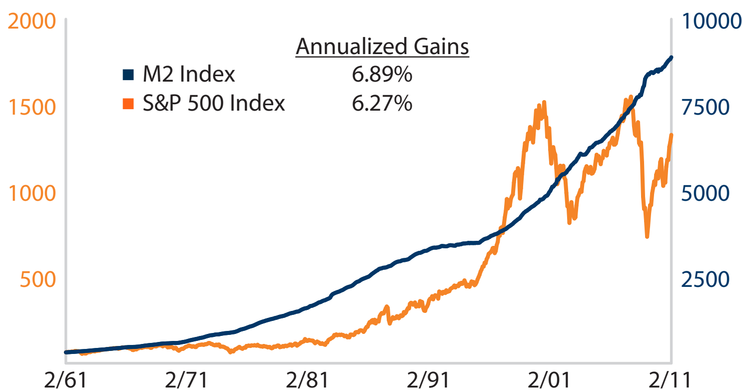
Mr. Carey has nearly a quarter century of experience as an Equity and Fixed-Income Analyst and is a recipient of the Chartered Financial Analyst (CFA) designation. He is a graduate of the University of Illinois at Champaign-Urbana with a B.S. in Physics. He is also a member of the CFA Society of Chicago and the CFA Institute. As CIO, Bob and his staff supervise over $48 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.*

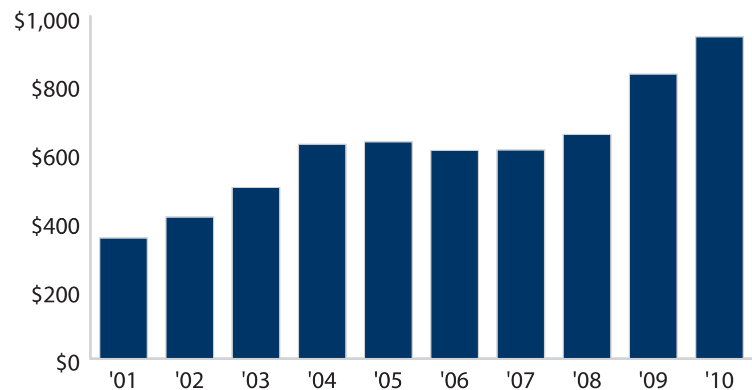
"Show Me the Money!"
From the movie Jerry Maguire (1996)

M2 Index vs. S&P 500 Index Price-Only Returns



Source: Bloomberg

S&P 500 (Industrial Old) Cash Holdings ($ Billions)



Source: Standard & Poor's

We chose the header above because it captures the essence of our theme today and it is timely with respect to the current NFL lockout. The NFL owners would like to cut a better revenue sharing agreement with the players. The NFL Players Association has requested, as it has in the past, to see the owner's books to determine if they really are operating at as much of an economic disadvantage as they claim to be. The owners have yet to acquiesce to their request. Unless the legal system steps in and changes things, it will be business as usual. The players will have to navigate the negotiation process without being able to assess the big picture. They won't know the true state of the game; they'll work off perceptions instead. Working from perceptions can be costly. We've dedicated nearly every issue of this newsletter over the past two-plus years to providing investors with strong arguments and evidence for embracing risk in the markets. While we knew many were disheartened, we were confident we had our story straight.

One of the misperceptions, in our opinion, about the economic crisis that materialized in 2008 was the root cause of it. We all know the lion's share of the fallout stemmed from the popping of the bubble in residential real estate, but there was more at play. This was not your standard case of an economy running out of gas heading for recession. This was a systemic meltdown. This was man-made trouble. If you rewind the clock back to June 2007, just prior to the start of the subprime meltdown, you would find that the Federal Reserve was poised to raise the federal funds target rate – not cut it. Brian Wesbury, Chief Economist at First Trust Advisors, called it what it will likely be remembered as: a panic!

The S&P 500 posted a cumulative total return of 104.5% from 3/9/09 (end of bear market) through 3/31/11, compared to a 5.3% cumulative total return for the Barclays Capital U.S. Treasury: Intermediate Index. We were huge proponents of owning stocks, and we noted on more than one occasion that the only thing worse than riding out a bear market is not hanging around for the rebound. A tip of the hat to those who did.

In our never-ending quest to disclose good and timely information pertaining to the securities markets, we offer the two charts above. It's our way of *showing you the money*. The first chart compares the annual growth in M2 to the return on the S&P 500 (not including dividends) over the past 50 years. Economists use M2 when looking to quantify the amount of money in circulation, and some find it to be a useful indicator when forecasting inflation. The chart reflects the easy monetary policy of the Fed over the past three years. The topic of inflation is creeping more and more into the conversation these days thanks to the spike in oil and gasoline prices.

Why should investors still feel optimistic about making money in the market? The S&P 500 closed out the first quarter 15.3% below its all-time high of 1565.15 on 10/9/07. The S&P 500 has never failed to recover from a bear market. The index posted a record-high free cash flow value of $495 billion in 2010, up from $302 billion in 2009, according to Standard & Poor's. The estimated earnings growth rate for the index in 2011 is 15.4%, according to S&P. Its foward-looking price-to-earnings ratio is only 13.7. Not bad!

The second chart above not only reveals a huge increase in the amount of cash holdings sitting on the books of those companies S&P calls "Industrial Old, " which essentially are the non-financials, but also a surprising surge since 2007. Remember, we've been told by the Obama Adminstration that this economic period ('08-'10) was probably the worst since The Great Depression. So let's recap. With the help of aggressive easing by the Fed (M2), not only did the S&P 500 more than double since 3/9/09, its non-financial constituents boosted their cash stash from $646.6 billion (2008) to $940.1 billion (2010). As the saying goes, we live in strange times.

Investors funneled a net $35 billion into U.S. stock funds in Q1'11, according to Strategic Insight. That is the best start to a calendar year since 2007. Investors, while probably still somewhat risk averse, appear to be warming to it. We suspect they will warm to it even faster if inflation rears its head.

Continued

Buy today and tuck away

Here are 3 investment themes we believe investors can own for the next decade...

Biotechnology

Forget Obama Care (regardless of whether it is deemed Constitutional or not); we believe the future of health care lies in biotechnology. Biotech companies have the deepest pipelines targeting the most lethal diseases. It took this industry three decades to finally turn an aggregate profit (2008). So in a sense, the biotech industry has just reached the starting line. Approximately 52 cents out of every health care dollar goes to surgical procedures and follow-up care, compared to around 11 cents for prescription drugs. If new medicines help keep people from having expensive surgeries, we all win.

Dividend-Paying Stocks

The dividend-paying stocks in the S&P 500 (equal weight) outperformed the non-payers in 9 out of the last 11 calendar years, according to data from S&P. The only two years they failed to do so were 2003 and 2009 – both of which were the first year following the end of a bear market. The empirical evidence shows the value of compounded stock dividends. Stock dividends have accounted for approximately 44% of the 9.87% average annual total return on the S&P 500 Index since 1926, according to Ibbotson Associates. But the real argument for owning them moving forward is demographics. The first baby boomers have entered their retirement years and this enormous wave (78 million strong) has only just begun. The combination of longer life spans and the potential for being on the hook for a higher percentage of their health care tab should drive boomers towards securities that offer growth and income.

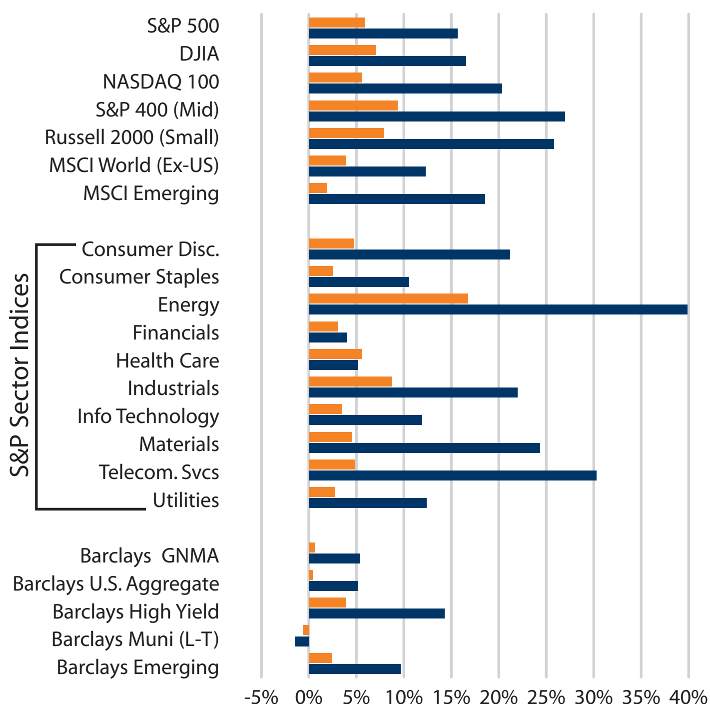
Mid-Caps

The S&P 400 has outperformed both the S&P 500 and Russell 2000 indices over the past 1-, 3-, 5- and 10-year periods through Q1'11. While some might make the case that dominance like that is reason enough to shy away from mid-caps, we left out an important fact – mid-caps also outperformed both large- and small-caps for the past 15 and 20 years. A clean sweep! It appears that investors have made this cap space the sweet spot of the market. We think mid-caps are a good niche for M&A activity and, with corporate cash holdings at record levels, there is no reason for us to think this will change in the near future.

A brief commentary on "Following the Leader"

There is an important distinction to be made between chasing the hottest stocks or groups of stocks in the market at a given time and following the asset classes that are leading the market over a given time. At first glance, it might appear to be nothing more than acknowledging the difference in mentality between those who trade securities and those who buy and hold them. It isn't that simple. Even buy and hold investors chase returns. The annual Dalbar study that tracks fund investor habits documents it. In the 2009 edition, the latest available, it found that for the 20-year period ended 12/09, equity fund investors averaged 3.17%, compared to 8.20% for the S&P 500. Why the disparity? Human emotion. Investors are moved by world events and headlines. But most of all, investors chase returns out of the fear of missing out. The allure of making a fast buck is all too real. So is living for today. That perspective is front and center when it comes to retirement investing. A recent survey by Wells Fargo & Co. found that the average American has saved less than 7% of their retirement goal. Middle class Americans think they will need $300,000 to fund their retirement, but have saved only $20,000, on average, to date. Those who fail to plan, plan to fail! But for people who enjoy getting free tips, we have one for you. The leadership role in the markets is in the process of shifting from bonds to stocks in our opinion. And once the leadership baton is passed, it is often years before it gets handed back. While the signal may be as subtle as two ships passing in the night, the numbers say it is so. The S&P 500 returned 15.7% for the 12-month period ended March 2011, compared to the 14.3% return for the Barclays Capital U.S. Corporate High Yield, which outperformed all other major debt groups, both domestic and abroad. High yield corporate bonds topped the performance of the S&P 500 by a very small margin in 2010. You can see it in mutual fund flows in Q1'11. A net $35 billion flowed into U.S. equity funds, compared to $40 billion into taxable bond funds, according to Strategic Insight. In 2010, U.S. equity funds had *outflows* totaling $12.9 billion, vs. *inflows* totaling $241 billion for taxable bond funds.

Total returns for Q1 and past 12 months (3/31/11)



A Look Ahead:

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

	Q2'11E	Q2'10A	**Q3'11E**	Q3'10A	**2011E**	2010A
Financials	**4.48**	3.81	**4.61**	3.92	**18.25**	14.82
Information Technology	**7.23**	6.11	**7.53**	6.70	**30.46**	26.25
Health Care	**8.13**	7.23	**8.27**	7.44	**32.54**	28.89
Consumer Staples	**5.25**	4.81	**5.54**	5.01	**21.27**	19.46
Consumer Discretionary	**5.15**	4.63	**5.05**	4.43	**20.03**	18.20
Industrials	**5.16**	4.61	**5.28**	4.85	**20.57**	18.41
Telecom. Services	**1.92**	1.98	**1.98**	1.84	**7.83**	7.36
Energy	**10.64**	9.29	**10.78**	8.39	**42.46**	35.21
Utilities	**2.81**	2.66	**4.26**	4.11	**12.90**	12.34
Materials	**4.75**	3.47	**4.00**	3.25	**16.78**	13.33
S&P 500 Index	**23.90**	20.90	**24.68**	21.56	**96.66**	83.77
S&P 400 Index (Mid-Cap)	**12.95**	10.93	**14.16**	11.82	**53.42**	43.91
S&P 600 Index (Small-Cap)	**5.62**	4.28	**6.12**	4.86	**22.81**	17.00

Source: Standard & Poor's (3/31/11)