First Trust

Quarterly Market Overview

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Robert F. Carey, CFA
Chief Market Strategist

Mr. Carey has 30 years 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. Bob is the Chief Market Strategist at First Trust Advisors L.P., and has appeared throughout the United States and Canada as a guest on television and radio programs. These programs include: Bloomberg TV, CNBC 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.*

We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

Once a bubble pops...the X Factor in the recovery is time

If a person wanted to have a scar removed from their body, a dermatologist might perform the procedure using a laser. It is just one small example of how technological innovation can improve quality of life. It's a shame, however, that there isn't a laser that can repair emotional scaring, like the kind investors feel after they endure a severe bear market in stocks (price decline of 20% or more), which has happened twice to the S&P 500 Index since 2000. At the epicenter of those two bear markets were bubbles in the technology and financial sectors. Both popped. A third bubble, in our opinion, popped in June 2014 in the energy sector. While it may not have led to a bear market to date, it did contribute to a correction (price decline of 10% but <20%) in the S&P 500 Index in August 2015. As indicated in the brief descriptions below, recoveries following bubble situations share some common characteristics, such as euphoria and new regulations.

Technology Bubble (S&P 500 Info. Technology TR Index)	
Peak to Trough	3/27/00-10/9/02
Index Return	-82.43%
% Relative to Peak (3/31/16)	-13.99%
Recovery thru 3/31/16	4,923 Days

Financial/Mortgage Bubble (S&P 500 Financials TR Index)	
Peak to Trough	6/1/07-3/6/09
Index Return	-82.92%
% Relative to Peak (3/31/16)	-28.20%
Recovery thru 3/31/16	2,583 Days

Energy Bubble (S&P 500 Energy TR Index)	
Peak to Trough	6/23/14-1/20/16
Index Return	-44.91%
% Relative to Peak (3/31/16)	-33.89%
Recovery thru 3/31/16	72 Days

Source: Bloomberg. All three indices are Total Return (TR) indices.

Investment Theme: **Internet Revolution**

From 3/95 through 3/00 (peak), a five-year span that captured a good portion of the buildout of the Internet's backbone/infrastructure, the S&P 500 Information Technology Index sported an average price-to-earnings (P/E) ratio of 34.52, according to Bloomberg. For comparative purposes, the average P/E on the S&P 500 Index for the 50-year period ended 3/16 was 16.55. Just three days prior to the peak (3/27/00), the P/E on the S&P 500 Information Technology Index stood at 79.58, according to Bloomberg.

The euphoria surrounding the technology sector was driven in part by a surge in tech-related initial public offerings (IPOs). Due to the fact that the average investor did not have access to IPO shares, they were forced to purchase stock once it began trading publicly, and that often proved to be an expensive buy. Many investors chased returns in tech stocks out of a fear of missing out, in our opinion. A research report from Tim Loughran at the University of Notre Dame and Jay R. Ritter at the University of Florida, dated 3/18/02, revealed that the average first-day return on technology and internet-related IPOs from 1999-2000 was an eye-popping 81.1%, compared to 23.9% for non-technology IPOs.

When the fallout from a bubble popping is as painful as this one, some new safeguards are likely to follow. The Sarbanes-Oxley Act of 2002 was signed into law on 7/30/02. This act mandated reforms in accounting, financial disclosures and corporate responsibility, according to the SEC.

Investment Theme: **Real Estate Is Solid**

The bubble that formed in the financial sector from around mid-2000 through mid-2007 was to some degree a by-product of the technology bubble, in our opinion. Many investors had such a bad experience with technology stocks, or stocks in general, that some turned to real estate as an investment alternative. The perception of real estate was that it had a fairly good track record of either holding its value or appreciating over time, as well as having income-generating capabilities, such as real estate investment trusts. Because so many upstart technology companies failed when the bubble burst, some investors liked that real estate represented a tangible asset.

The epicenter of this bubble situation was the banking industry, in our opinion. Banks generated fees from writing mortgage loans on residential real estate (housing), and then many of the largest banks generated profits by packaging said loans to sell to investors seeking income, a process known as securitization. At a basic level, the combination of the origination of too many adjustable-rate and subprime mortgages, too many house flippers, mark-to-market accounting and the Federal Reserve's act of hiking the federal funds target rate from 1.00% to 5.25% from 6/04-6/06 helped pop this bubble.

To try to curb risk-taking in the banking industry (think "Too Big to Fail"), the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on 7/21/10, according to the SEC.

Investment Theme: **Weak $/Unstable Middle East**

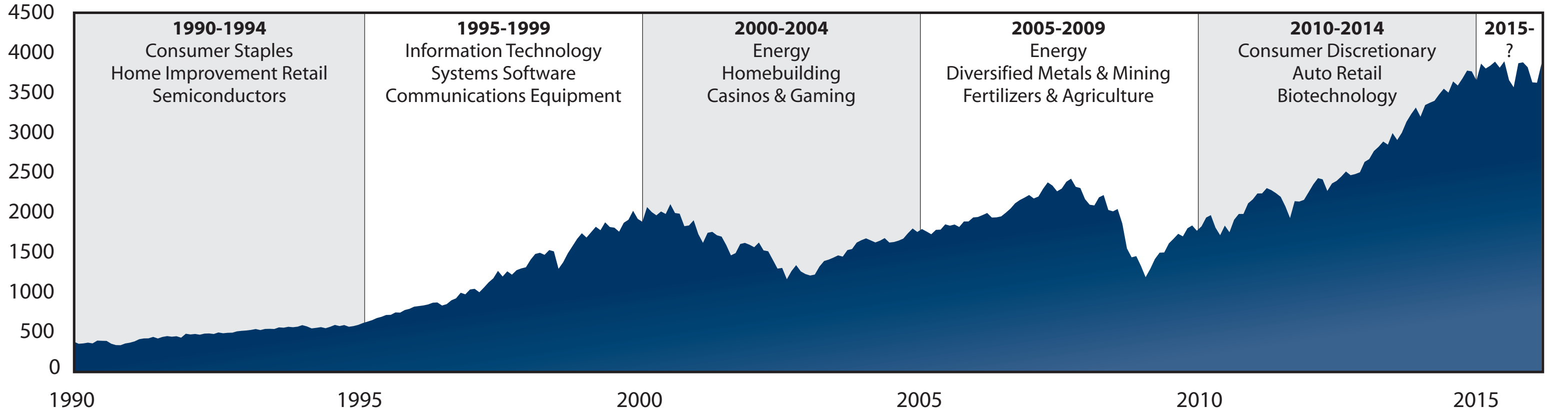
Prior to 5/04, one would need to go back to 10/90 (1st Gulf War) to see the price of a barrel of crude oil above the $40 level, according to data from Bloomberg. The price of crude oil never even reached $40 per barrel in the days and weeks following the terrorist attacks on 9/11/01. The price of crude oil started to trend above $40 in earnest in the second half of 2004. Unlike the first Gulf War, the U.S. did not return home after its quick military victory over Iraq in 2003. One of the ongoing concerns about all of the conflicts in the Middle East is the potential for supply disruption, but such an event has yet to come to fruition.

With respect to most commodities, the relative value of the U.S. dollar tends to move inversely with their underlying prices over time. From 5/11/04 (oil at $40.06) through 6/23/14 (peak of S&P 500 Energy TR Index), the U.S. Dollar Index (DXY) declined by 12.71%, while the price of crude oil surged 165.03%, according to Bloomberg. From 6/23/14 through 3/31/16, the U.S. Dollar Index (DXY) rose by 17.84%, while the price of crude oil plunged 63.89%.

On December 18, 2015, President Barack Obama signed a spending bill into law that included the repeal of a 40-year old ban on U.S. oil producers exporting their oil. This is an interesting development moving forward because one of the things that fueled the euphoria about investing in the energy sector was the discovery of substantial oil reserves in the shale regions of the U.S.

What's an investor to do without a hot theme to chase? Diversify.

S&P 500 TR Index (Top Sectors/Subsectors)

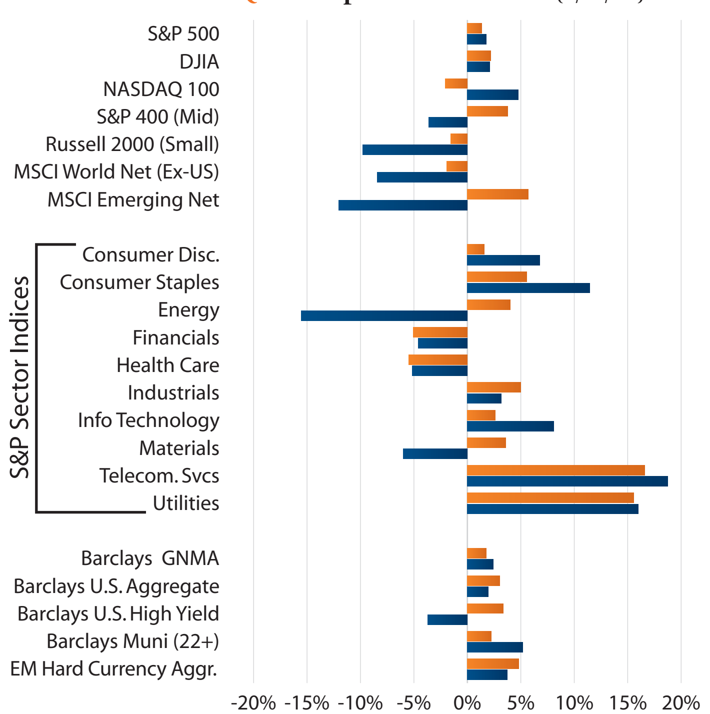


Source: Bloomberg.

Looking at the top performing S&P 500 Index sectors and subsectors referenced in the chart above, our main takeaway is that it reflects diversity. Aside from Energy, there were no repeat winners, which lends some support to the merits of diversification. While having the opportunity to invest in a dominant theme may sound enticing, as we just noted, the experience can end badly for those that don't know when to sell. Generally speaking, knowing when to sell out of a security is probably tougher than recognizing a buying opportunity, in our opinion. It takes discipline. One of the lessons learned from the popping of the technology bubble in 2000 was that sometimes the hype gets ahead of the story. While some investors were chasing returns moving between communications-equipment stocks, semiconductor stocks, software stocks, and Internet-related stocks, the end game largely went unnoticed. What was the end game? It was the eventual marriage between high-speed digital broadband and content. Here is an example. Perhaps the best television show throughout most of the 1990s was NBC's *Seinfeld*. Its theme was that it was a show about nothing. Today, Jerry Seinfeld has a popular web series on the Internet called *Comedians In Cars Getting Coffee,* where he interviews famous people for around 15 to 20 minutes, not far off the 22 minutes or so his broadcast network show lasted when you factor in commercials. By the way, his webcast is also sponsored. The convergence of broadband and content extends way beyond entertainment. It's now called the "Internet of Everything."

Among the multitude of feedback we receive from investors, one of the things that has come up lately is the difficulty in identifying a catalyst/theme that could drive the stock market higher. The S&P 500 Index closed on 3/31/16 at 2,059.74, just 3.34% below its all-time high of 2130.82, set on 5/21/15. Since the answer isn't apparent in the current climate, our standard response to the question of what will drive stock prices higher is higher corporate earnings. Earnings appear to have retrenched a bit in the past couple of quarters, as measured by the S&P 500 Index (see below). We believe that slower global growth and the relative strength of the U.S. dollar, which has negatively impacted U.S. industrial companies, in particular, in recent months, are two reasons for the dip in earnings, in our opinion. We would also acknowledge that the Federal Reserve's decision to slow the pace of interest rate hikes in 2016, from three or four to two or three, could be a contributing factor. By tempering its forecast for future rate hikes, the Fed is signaling that economic activity may not be strong enough to support the hikes, which could influence the spending decisions of consumers and business owners. Having said that, the outlook for earnings is actually optimistic after Q1'16. Here are the S&P 500 Index's quarterly dollar earnings amounts and consensus estimate projections from Bloomberg for Q3'15-Q3'16 (as of 4/18/16): $28.11 (Q3'15); $26.94 (Q4'15); $27.13 Est. (Q1'16); $29.01 Est. (Q2'16); and $31.17 Est. (Q3'16). We should note that there can be no assurance that any of these projections cited will occur.

Total returns for *Q1* and past 12 months (3/31/16)



Past performance is no guarantee of future results.

A Look Ahead:

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

	Q2'16E	Q2'15A	**Q3'16E**	Q3'15A	**2016E**	2015E
Consumer Discretionary	**8.44**	7.61	**8.96**	8.08	**33.68**	30.44
Consumer Staples	**6.23**	6.38	**6.69**	6.23	**25.16**	24.32
Energy	**1.08**	-0.51	**2.04**	-4.52	**4.80**	-13.71
Financials	**5.58**	5.82	**5.67**	5.97	**22.06**	23.01
Health Care	**12.83**	9.68	**13.23**	9.59	**51.25**	38.72
Industrials	**7.46**	6.96	**8.44**	7.73	**29.48**	28.00
Information Technology	**9.98**	8.86	**10.70**	8.98	**43.56**	37.97
Materials	**4.56**	3.79	**3.82**	1.25	**15.84**	8.49
Telecom. Services	**3.13**	2.94	**3.16**	2.86	**12.29**	12.15
Utilities	**3.06**	2.97	**4.44**	4.28	**13.99**	11.25
S&P 500 Index	**29.00**	26.14	**31.01**	25.44	**117.78**	100.45
S&P 400 Index (Mid-Cap)	**19.23**	14.83	**20.39**	15.81	**76.68**	55.49
S&P 600 Index (Small-Cap)	**9.05**	5.45	**9.82**	4.59	**36.38**	19.66

Source: Standard & Poor's (4/7/16)