First Trust
Monday Morning OUTLOOK
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New Highs, Still a Buy

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The Dow Jones Industrials Average and S&P 500 are breathing down the neck of record highs set last Fall. Some take that as a sign to sell, time to shift out of equities and realize gains. We think that would be a mistake.

At the end of last year, we forecast the Dow would finish this year at 28,750 while the S&P 500 hit 3,100. At the time, those goals seemed outlandishly optimistic to many investors. We wrote that "[W]e do best by our readers when we tell them exactly what we think is going to happen, without altering our projections so we can run with the safety of the herd. Grit your teeth if you have to; those who stay invested in the year ahead should earn substantial rewards."

Now we think we were too pessimistic.

Through Friday's close, the Dow is up 13.2% year-to-date, while the S&P 500 is up 16.0%. To reach our year-end targets, the Dow would have to gain another 8.9% while the S&P 500 would have to rise 6.6%.

We think investors should be undeterred by new record highs. To assess market valuations, we use a capitalized profits model, which takes the government's measure of profits from the GDP reports and divides by interest rates. Think of it this way: if profits are higher, stocks should be higher, too; if interest rates are higher, stocks should be lower, as they compete against an alternative with a higher rate of return.

Our traditional measure - using a current 10-year Treasury yield of about 2.57% - suggests the S&P 500 is still massively undervalued. At the end of last year we used 3.40% for the 10-year yield, and generated a fair value on the S&P 500 of 3,100. Now that looks like an aggressive call for long-term yields. Using, say, 3.00% for the 10-year puts fair value at 3,500. The model needs a 10-year yield of nearly 3.6% to conclude the S&P 500 is already at fair value, with recent profits.

What would obviously throw the cap profits model for a loop would be a recession, but we don't see one on the horizon. As we wrote last week, the US economy is on very solid ground, with Q1 real GDP estimates up from near-zero to now over 2%. In addition, we lack the imbalances we often see before recessions. Household debts are near a multi-decade low relative to assets, and household debt service is very low relative to after-tax income. Banks, meanwhile, have ample capital, and are no longer tied to the overly strict mark-to-market accounting rules that exacerbated the financial crisis.

In addition, the economy is still adapting to lower tax rates, particularly on corporate profits. We expect a continued shift of corporate operations toward the US.

Another angle to consider is that recessions often follow drops in home building, but the US is still building fewer homes than we'd expect given population growth and the scrappage of homes (knockdowns, fires, floods, hurricanes, tornadoes,…etc.). In other words, we think the number of housing starts, which have grown every calendar year since bottoming in 2009, will rise again in 2019.

Notice, however, what we're not worried about: quantitative tightening, which is one of President Trump's favorite recent targets. We still don't think quantitative easing helped equities, because the extra reserves in the banking system sat on balance sheets earning near-zero returns. Withdrawing those previously inert reserves won't hurt markets either.

To be sure, we are not saying stocks will go up today or this week, or even this quarter. Corrections happen. But, given the level of corporate profits and our outlook for economic growth, it looks more likely than not that equities will move substantially higher in the year ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-15 / 7:30 am	Empire State Mfg Survey - Apr	8.0	**11.5**	10.1	3.7
4-16 / 8:15 am	Industrial Production – Mar	+0.2%	**+0.1%**		0.0%
8:15 am	Capacity Utilization – Mar	79.2%	**79.1%**		79.1%
4-17 / 7:30 am	Int'l Trade Balance – Feb	-$53.5 Bil	**-$53.4 Bil**		-$51.1 Bil
4-18 / 7:30 am	Initial Claims Apr 13	205K	**204K**		196K
7:30 am	Retail Sales – Mar	+1.0%	**+1.1%**		-0.2%
7:30 am	Retail Sales Ex-Auto – Mar	+0.7%	**+1.0%**		-0.4%
7:30 am	Philly Fed Survey – Apr	11.0	**10.2**		13.7
9:00 am	Business Inventories – Feb	+0.3%	**+0.5%**		+0.8%
4-19 / 7:30 am	Housing Starts – Mar	1.230 Mil	**1.232 Mil**		1.162 Mil