LPL RESEARCH

WEEKLY MARKET COMMENTARY

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ANOTHER TOUGH WEEK

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KEY TAKEAWAYS

The S&P 500 fell about 4% last week amid a myriad of concerns, among them possible peak earnings and a potentially overly aggressive Federal Reserve.

Historical market patterns suggest solid prospects for a late-year rally remain in place.

We see several positives that may help stocks make another run higher, including moving past the upcoming midterm elections, the solid U.S. economic backdrop, and a still-strong earnings outlook.

It was another tough week for stocks. The S&P 500 Index was down just shy of 4% last week, briefly dipping intraday into correction territory (more than 10% off the all-time high) and putting October on track to be the weakest month for stocks since the financial crisis. Concern about an earnings slowdown and a potentially overly aggressive Federal Reserve (Fed) seemed to be the primary drivers, but market participants saw little, if anything, encouraging out of the other "bricks" in the stock market's wall of worry. These include the U.S.-China trade dispute, Italy's deficit spending, Brexit uncertainty, Saudi tensions, and policy uncertainty ahead of midterm elections. An exhaustive list for sure, though based on closing prices the S&P 500 has managed to avoid a 10% decline from the record high on September 20.

So where do we go from here?

REASSURANCE

As we discussed here two weeks ago, this type of volatility is not unusual. The S&P 500 has endured three pullbacks of 5–10% this year, right in line with the long-term average. The two corrections this year are more than is typical, but not unusual—the S&P 500 has endured two or more corrections in a year nine times in the past 50 years. In the years since 1950 that the S&P 500 was positive, stocks averaged an 11% maximum peak-to-trough decline, which is what the S&P 500 experienced in January–February of this year. October has also historically been the most volatile month, based on the number of 1% or larger daily moves.

Putting this volatility into perspective can be reassuring, while several positive fundamental and technical underpinnings for stocks are also comforting. Some possible catalysts for stocks to rebound include:

Elections are coming. Regardless of what stocks do over the next week, the midterm elections are now just six days away. That clarity, regardless of outcome, has historically been a positive catalyst for stocks (recall the nine-day losing streak for the S&P 500 ahead of the 2016 presidential election). Since 1946, the S&P 500 has never been down over the 12 months following midterm elections (18 for 18).

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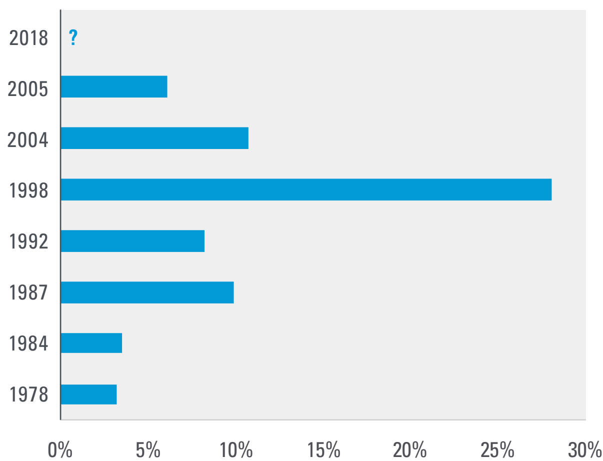
Elections aside, we have entered a favorable seasonal period. November and December have historically been two of the best months for stocks. In fact, when a year-to-date gain at the end of September becomes a year-to-date loss in October, as was the case this year, the S&P 500 has historically rallied strongly off the October lows [Figure 1]. In general, fourth quarters are the best quarter of the year for stocks, and November through April (which starts this Thursday) has historically been the best six-month period.

The U.S. economy is in excellent shape. Gross domestic product (GDP) grew at a 3.5% annualized pace in the third quarter, better than consensus (3.3%), after the 4.2% pace in the second quarter. The two-quarter average is the strongest since 2014, despite some drag from exports due to the ongoing trade dispute with China, and fiscal stimulus remains supportive (more on Friday's GDP report in today's *Weekly Economic Commentary*). Looking forward, our favorite leading indicators point to the potential for continued economic growth.

Corporate profits remain quite strong. Despite all the anxiety around corporate profits, consensus now expects a 25.2% increase in S&P 500 earnings per share in the third quarter, above the 24.9% pace in the second quarter (Thomson Reuters data). Estimates for the next four quarters have also been quite resilient, falling only 0.2% since earnings season began, despite many companies citing tariff costs. Estimates for 2019 have actually inched higher during October, which is surprising given the market reaction to some of the earnings shortfalls over the past two weeks [Figure 2].

1 YTD STOCK MARKET DECLINE COULD REVERSE

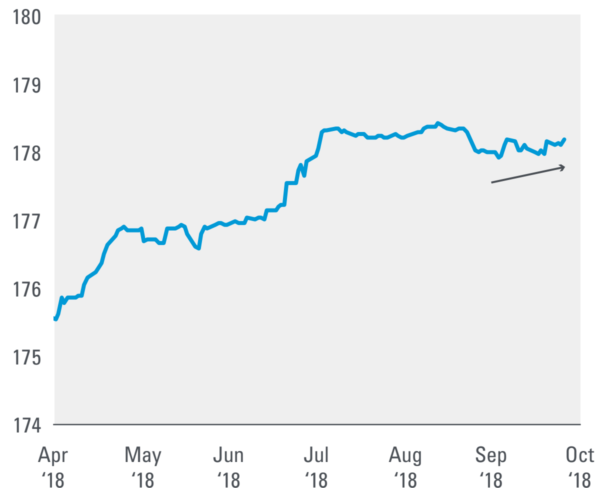


Source: LPL Research, FactSet 10/26/18

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

2 EARNINGS ESTIMATES HAVE INCREASED DURING EARNINGS SEASON



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Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

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Stocks just got—dare we say—cheap? Many have expressed concerns about stock market valuations this year, nine-plus years into a strong bull market. But the latest pullback in the S&P 500, which has been accompanied by rising earnings, leaves the S&P 500 at just over 15 times the next 12 months earnings estimates [Figure 3]. That level is slightly below the long-term average of 15.7 (since 1950), but quite a bit below the post-1980 average of nearly 17 (FactSet data). With interest rates still quite reasonable, if not historically low (about 3.1% on the 10-year Treasury), and inflation well contained, we would argue valuations are attractive even if earnings over the next year fall a bit short of estimates.

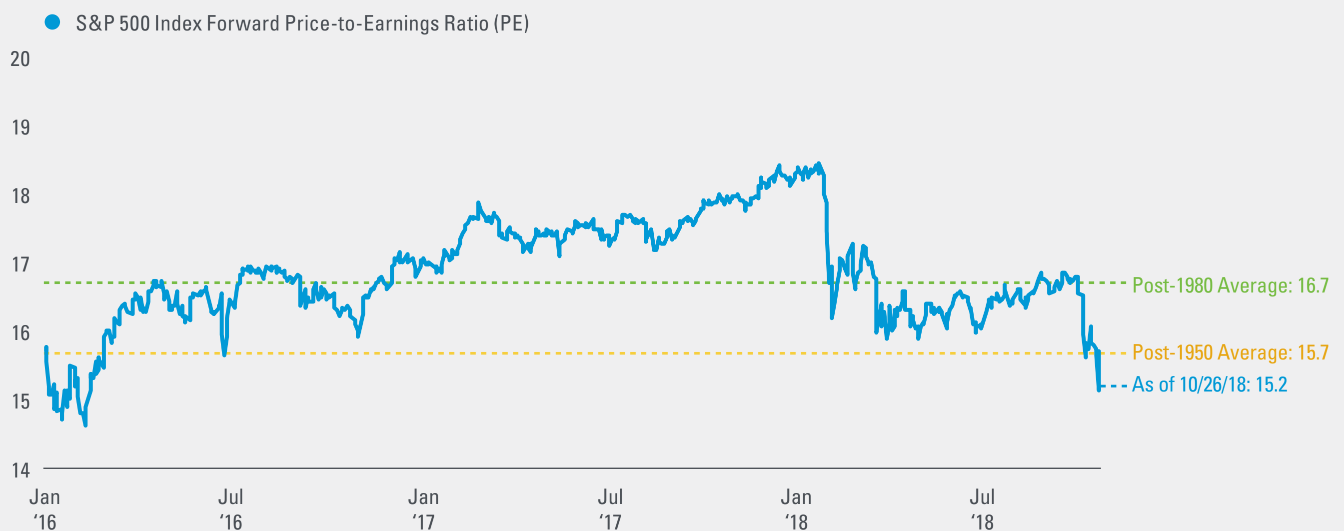
We have a market savvy Fed Chair. Widely considered the most market savvy leader of the Fed since Paul Volcker, Jay Powell's experience in the private sector is reassuring. Also reassuring is that the inflation-adjusted federal funds rate (referred to as the real fed funds rate) has historically been much higher ahead of previous recessions. Over the past eight economic cycles covering 60 years, the lowest real fed funds rate that preceded a recession was 1.9%. With the real fed funds rate currently around zero (2% inflation and a 2–2.25% fed funds rate), by any reasonable forecast, this indicator is still possibly six or seven hikes away.

CONCERNS

With Halloween this week, it makes a lot of sense to look at some things that scare us. While for us, reasons to be hopeful outweigh the worrisome factors, there are several key risks worth calling out:

Recent U.S.-China trade headlines are worrisome. We continue to expect a trade agreement of some sort by early 2019, given how

3 LATEST STOCK MARKET DECLINE LEAVES VALUATIONS ATTRACTIVE



Source: LPL Research, FactSet 10/26/18

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

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much both sides have to lose. But markets face headline risk between now and then, and there is always a chance the relationship deteriorates to such an extent that more tariffs are put in place and become permanent, and supply chain disruptions put further pressure on company profitability.

The Fed could make a mistake. The Fed seems fully committed to further rate hikes. Should long-term interest rates fall due to growth concerns while rate hikes continue, the central bank could potentially invert the yield curve, which is historically a reliable recession signal. With wage pressures building, an uptick in inflation that spooks the Fed in 2019 is possible.

Stocks have lost technical momentum. The S&P 500 broke below its 200-day moving average on October 11 and that measure is now starting to slope downward, evidence of deteriorating technical momentum. In addition, we have not seen the type of panic selling that has marked recent major lows, such as in August 2015, February 2016, and February 2018, based on the percentages of stocks that are oversold and put-call ratios, which are a measure of bearish sentiment.

CONCLUSION

While the level of volatility experienced in October is not out of the ordinary, which is reassuring by itself, an objective assessment of the economic and corporate profit backdrop also gives us the confidence to stay with stocks here. The calendar, including upcoming elections, may also bring good news based on historical seasonal patterns. Since WWII, the S&P 500 has never been down in the 12 months after midterm elections and the calendar is turning to the best seasonal period of the year for stocks. While this pullback may get a little worse before it gets better, particularly when considering resolution of the trade dispute with China is likely a few months away, we do not expect this selloff to develop into a bear market. We maintain our S&P 500 year-end fair value target of 2900–3000, a gain of about 9% from Friday's closing price (2658).

We encourage long-term investors to embrace this volatility, not fear it, especially against a backdrop of solid fundamentals. We think this latest bout of volatility provides an opportunity to reassess portfolios and look for spots to either deploy cash or rebalance to longer-term allocation targets. Recoveries from steep selloffs tend to take more time than the pullbacks themselves. Remember that bottoming is a process. ■

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Please see the *Midyear Outlook 2018: The Plot Thickens* publication for additional descriptions and disclosures.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

All investing involves risk including loss of principal.

DEFINITIONS

The 200-day moving average (MA) is a popular technical indicator which investors use to analyze price trends. It is the security or index's average closing price over the last 200 days.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

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INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. When sentiment reaches one extreme or the other, the market typically reverses course. While this is not necessarily predictive, it does measure the current degree of fear present in the stock market.

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