Weekly Market Commentary

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Is Investor Complacency Finally Ending?

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

Last week, U.S. stocks suffered their worst drop in over nine months as a terrorist attack and poor economic and earnings data shook investor confidence.

Breaking down last week's market drivers may reveal insights about the likely future direction of the stock market.

Last week, U.S. stocks suffered their worst drop since June 1, 2012, measured by a 2.1% loss—totaling 318 points—in the Dow Jones Industrial Average. The week began with a terrorist attack that disrupted the Boston Marathon and a report that China's economic growth unexpectedly slowed in the first quarter of 2013. Throughout the week, first quarter 2013 earnings results, including widely watched companies such as Bank of America and IBM, missed analysts' expectations.

The U.S. stock market has risen for much of this year, despite the United States' fiscal failings, another European bailout, geopolitical threats, high energy prices, and weak global economic and earnings growth. So last week's notable drop may mark a departure. Breaking down last week's market drivers may reveal insights about the likely future direction of the stock market.

Terrorist Attacks

A major terrorist attack that disrupts economic activity and raises security fears is always a risk for the capital markets—especially considering that terrorist attacks of all types around the world now total over 4,000 per year, according to data compiled by the Institute for Economics and Peace.

The human toll is immeasurable. The impact of the terrorist attacks will stay in the hearts and minds of Americans long after any economic cost is recouped. With many thousands of terrorist attacks worldwide over the past 25 years, we have a lot of history to examine when looking at the economic or market impact of an attack.

Historically, major acts of terrorism have not had lasting long-term negative effects on financial markets.

Historically, major acts of terrorism have not had lasting long-term negative effects on financial markets. In the countries where these attacks have occurred, the stock market has fully recovered in one week, on average (excluding the 1990 London Stock Exchange bombing, when an unrelated recession emerged around the same time).

With the exception of the 9/11 attacks on the United States, there has never been a terrorist attack that has materially and negatively affected economic activity. The 9/11 attacks depressed economic activity for a very short period; however, the fourth quarter of 2001 marked the end of the recession, when economic activity re-accelerated from the third-quarter loss of 1.1% in real gross domestic product (GDP) with a fourth-quarter gain of 1.4%, followed by a 3.5% gain in the first quarter of 2002. The stock market responded similarly; within a week of reopening after the 9/11 attacks,

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1 Major Terrorist Attacks Have Had No Lasting Impact on Stocks

Weeks to Return to Pre-Attack Level for Stock Market Index in Country in Which Attack Occurred

Terrorist Attack	Date	Weeks to Return to Pre-Attack Level
Munich Olympics	9/5/72	0
Muslim Terrorists Seize D.C. City Hall	3/9/77	1
Harrod's Bombing in London	12/1/83	0
Pan Am Bombing (Lockerbie, Scotland)	12/21/88	0
London Stock Exchange Bombing	7/20/90	31*
World Trade Center Bombing	2/26/93	0
Tokyo Subway Sarin Gas Attack	3/20/95	1
Oklahoma City Bombing	4/19/95	0
9/11 Attacks	9/11/01	4
HSBC & British Consulate Bombing, Turkey	11/20/03	1
Madrid Train Bombing	3/11/04	3
London Public Transit Bombing	7/7/05	0
Average		**4**
Average excluding 1990		**1**

Source: LPL Financial Services, Bloomberg data 04/22/13

*The London Stock Exchange Bombing was followed two weeks later by Iraq's invasion of Kuwait and July marked the start of a recession in the United States.

Stock Market Indices by Country: Germany - DAX; United States - S&P 500; United Kingdom - FTSE 100; Japan - Nikkei 225; Turkey - Borsa Istanbul Stock Exchange (BIST) National 100; Spain - IBEX 35.

For illustrative purposes only. Not an all-inclusive list of events during this time period.

the stock market was rallying—in the following nine weeks, the S&P 500 posted a gain of 20%.

Nevertheless, there is still the risk that, for the first time in history, a terrorist attack would result in a serious disruption of economic activity and cause substantial declines in the markets. If the attack remains a tragic—but isolated—event, it is unlikely to alter the market's direction. However, a series of follow-on attacks—the letters laced with the poisonous toxin ricin sent to the President and a U.S. Senator last week, for example—may erode confidence and negatively impact consumer spending, business investment, and investors' willingness to buy stocks, sending the market lower.

Data Sensitivity

In the past, stocks have had more significant reactions to changing economic fundamentals and geopolitical events rather than terror attacks. An example can be seen in the lengthy stock market decline that followed, but was unrelated to, the London Stock Exchange Bombing in 1990. The London Stock Exchange Bombing was followed two weeks later (August 2, 1990) by Iraq's invasion of Kuwait, and July 1990 marked the start of a recession in the United States.

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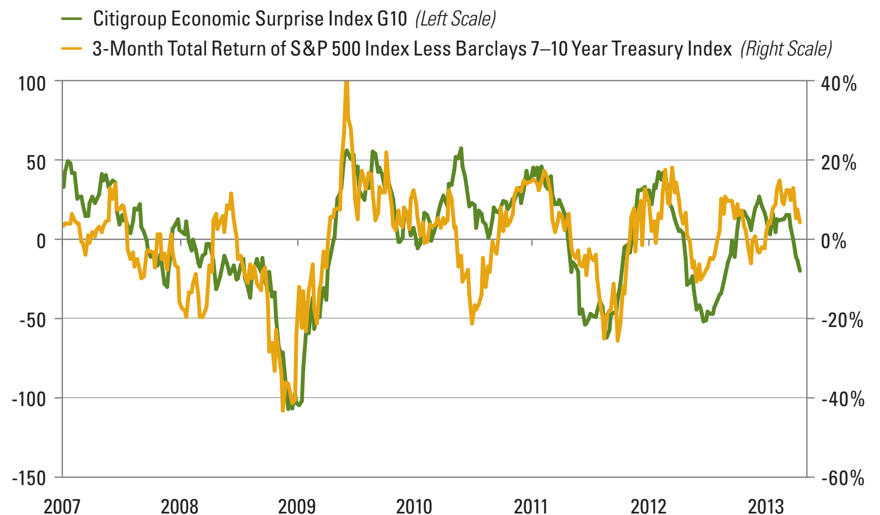
2 Global Economic Data Increasingly Falling Short of Expectations



Source: LPL Financial. Bloomberg data 04/22/13

Note: A declining line means the economic data are weaker than expected. A rising line indicates data are stronger than expected.

evidenced by the reaction on Monday, April 15, 2013 to China's GDP report. This resulted in a 1.8% stock market decline, which was driven primarily by disappointment in the report on first quarter economic growth in China that was released before the market opened and led to a decline that unfolded steadily throughout the day. Most of the decline had taken place by the time of the Boston Marathon terror attack at 2:50pm ET.

Investors are likely becoming increasingly wary of news or events that could prompt another decline.

Economic data are increasingly falling short of expectations. The Citigroup Economic Surprise Index measures how economic data for the world's major economies fares compared with economists' expectations. In recent years, a slide in this index has corresponded to a slide in the performance of stocks relative to bonds. The index has peaked and made a steady decline in recent weeks, but only now may the stock market be beginning to react.

Disappointments came from companies, as well. While many companies are able to meet or beat the very low earnings growth expectations of about 1–2% for the first quarter of 2013 from a year ago, revenues have been weak. Of the 91 S&P 500 companies that reported revenues, more than half (56%) missed expectations, according to data tracked by Thomson Reuters.

Market participants may be getting increasingly sensitive to disappointing news after being complacent for some time. The VIX, the market's so-called "fear" gauge, jumped up and averaged 16 during the past week, after averaging a complacent 13.6 this year. While 16 is a far cry from the levels north of 25 seen during last spring's 10% stock market slide or even the 22 reached during November 2012's 7% pullback in the S&P 500, it is a sign investors are becoming increasingly wary of news or events that could prompt another decline. ■

IMPORTANT DISCLOSURES

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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.

International and emerging markets investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

INDEX DESCRIPTIONS

All indices are unmanaged, and cannot be invested into directly. Past performance is no guarantee of future results.

The Barclays Capital 7-10 Year U.S. Treasury Index includes all publicly issued, U.S. Treasury securities that have a remaining maturity from 7 up to (but not including) 10 years, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and non convertible

Citigroup Economic Surprise Index (CESI) measures the variation in the gap between the expectations and the real economic data.

Dow Jones Industrial Average (DJIA): The Dow Jones Industrial Average Index is comprised of U.S.-listed stocks of companies that produce other (non-transportation and non-utility) goods and services. The Dow Jones Industrial Averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore their component weightings are affected only by changes in the stocks' prices.

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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