Weekly Market Commentary

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Soft Spot Arrives on Schedule

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Highlights

In recent years, the spring slide in the stock market was driven by the arrival of a spring soft spot in the economy.

This soft spot has emerged again — for the fourth year in a row.

The bond and commodity markets have already responded negatively. Will the stock market also react as it has in the past?

There are certain things we have gotten used to counting on each spring: the season changes and the weather warms, baseball games bring fans to the stadiums, the economy weakens, and investors "sell in May and go away."

The old Wall Street adage "sell in May and go away" refers to the seasonal tendency of stocks' performance to weaken in the spring until the fall. In recent years, this spring slide in the stock market was driven by the arrival of a spring soft spot in the economy. This soft spot has emerged again — for the fourth year in a row. Will the stock market react as it has in the past? We think so.

The selling effect actually began in April of each of the past three years rather than waiting until May. In early 2010, 2011, and 2012, run-ups in the stock market, similar to this year, pushed stocks up about 10% for the year as April began. Specifically, on April 23, 2010, April 29, 2011, and April 2, 2012, the S&P 500 made peaks that were followed by 10–19% losses that were not recouped for more than five months.

In the United States, the first quarter of this year presented a modest bounce back from the fourth quarter's flat economic performance. However, the emerging trend in economic data both here and abroad suggests that the economy may once again be entering a soft spot as it did in the spring of each of the last three years:

- **Employment** – Job growth in March was very disappointing. This week's April employment report may show that even for those with jobs, hours worked are shrinking in response to the sequester.
- **Manufacturing** – Durable goods orders were weaker than expected in March 2013. The Institute for Supply Management (ISM) Manufacturing Index for March 2013 dropped to its lowest level since December 2012, and the flash report for April 2013 came in below expectations.
- **Retail sales** – Retail sales fell in March 2013 and continue to decelerate on a year-over-year basis.
- **Foreign demand** – The Eurozone recession is now well over a year old and is deepening and infecting the core northern countries like Germany and France. China's recent gross domestic product (GDP) for the first quarter of 2013 came in below expectations, as the pace of growth slowed from the fourth quarter of 2012, despite concerns of an overheated property market.
- **Corporate earnings** – The earnings reporting season for the first quarter of 2013 has revealed that S&P 500 companies are mildly exceeding low estimates of 1–2% earnings per share growth through austerity (cost

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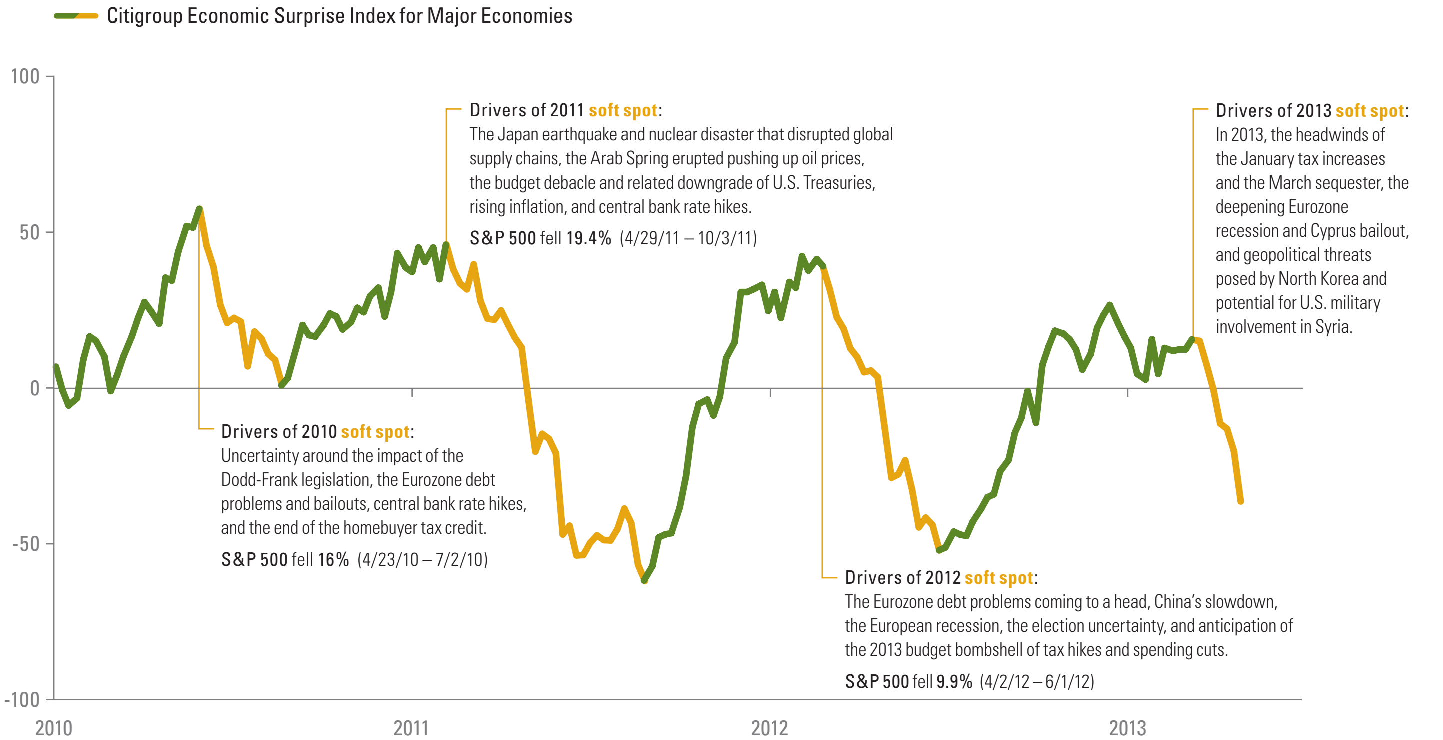
1 Another Soft Spot Emerging



Source: LPL Financial. Bloomberg data 04/29/13

The Citigroup Economic Surprise Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

10 Indicators

A month ago, we provided our list of the 10 indicators that seemed to precede the 10–19% stock market declines in 2010, 2011, and 2012. An update of these indicators reveal mixed signs of a potential spring slide in the stock market this year, suggesting the potential for a decline that may not be as severe as the 10–19% experienced in each of the past three years.

Fed stimulus
Energy prices
Initial jobless claims
Inflation expectations

Yield curve
LPL Financial Current Conditions Index

Economic surprises
Consumer confidence
Earnings revisions
The VIX

cutting), not with growth. Most companies are missing revenue growth expectations of just 1% year over year.

A good way to see this spring spot soft is by taking a look at the Citigroup Economic Surprise Index [Figure 1], which measures how economic data fares compared with economists' expectations and has marked the spring peaks in both economic and market momentum in recent years. The developing soft spot again suggests expectations may have become too high. The big swings in this index typically have either led or coincided with major moves in the stock market.

While there are many similarities to the past few years' soft spots, as you can see in Figure 1, a difference that we noted in our spring slide indicators we published a month ago in the *Weekly Market Commentary: 10 Indicators to Watch for a Spring Slide in the Stock Market*, is that in 2010, 2011, and 2012, the soft spot materialized near the end of the Federal Reserve's (Fed) bond-buying programs: QE1, QE2, and Operation Twist. These Fed programs were later brought back or extended and the economy began to improve. This year, however, the current quantitative easing (QE) program is not expected to taper off until late this year at the earliest. While we note with a green flag that this is a positive for the economy and markets compared with prior years, a caveat is that the economy is slowing down even while QE continues unabated. If the market is looking for a boost to the pace of bond purchases, it may be disappointed. While not impossible, it would be very difficult for the Fed to expand QE beyond the current pace.

The bond market has reflected the soft spot with a decline in yields that began in mid-March 2013, with the yield on the 10-year Treasury having fallen from 2.06% to 1.66%. The commodities market, as measured by the Chicago Board Options Exchange (CBOE) as of 4/29/13, has also reacted to the slower growth trajectory with a sharp decline in prices, with copper down 8% and oil down 9% since March 27, 2013. Next, we will be watching closely if stocks join the other market and succumb to the soft spot as they have in the past. ■

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.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Operation Twist is the name given to a Federal Reserve monetary policy operation that involves the purchase and sale of bonds. "Operation Twist" describes a monetary process where the Fed buys and sells short-term and long-term bonds depending on their objective.

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.

INDEX DESCRIPTIONS

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

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

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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.

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