LPL FINANCIAL RESEARCH

Weekly Market Commentary

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Searching for Inspiration

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Highlights

The U.S. stock market's stalling momentum and increasing volatility, combined with other signs evident in the market's recent behavior, suggest investors may be looking for new inspiration.

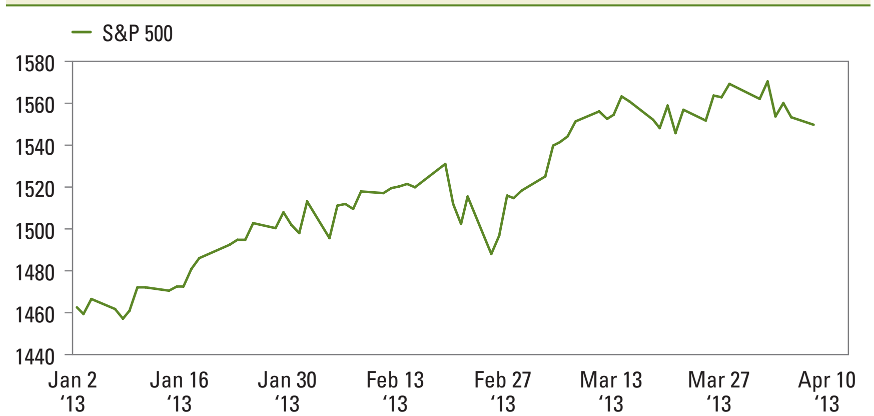
A flu pandemic or an act of war by North Korea could be a shock that results in a setback to the economy and stock market, while the aggressive stimulus in Japan could be a boost that finally gets stocks to break out of their month-long range.

The S&P 500 Index closed at 1553 on Friday, April 5, the level the current rally first reached a month ago. The stock market's stalling momentum and increasing volatility, combined with other signs evident in the market's recent behavior, suggest investors might be looking for new inspiration.

- **Daily push-and-pull action:** The S&P 500 has now reversed direction on a daily basis 12 times in a row—that has never happened before in the 85-year history of the S&P 500 Index. It may be noteworthy that the only time the index had reversed direction daily for 11 days in a row was July 26, 1981, ahead of a 15% loss, and the last time it reversed direction 10 days in a row was April 17, 2002, ahead of a 30% stock market decline.
- **Stronger selling conviction:** Over the past month, trading volume for the S&P 500 stocks has been 20% higher on down days than on up days.
- **Risk vs. safety battle:** Last week, traditional opposites—the S&P 500 Index and gold prices—both traded at the same level (1554). Gold rebounded later in the week while stocks slumped. The last time their paths crossed was May 2010, just before the stock market reversed its trend and began a pullback.
- **Defensive leadership:** Stocks have recently been led higher by defensive, rather than economically-sensitive, stocks.

These signs suggest that an event in the coming weeks could tip the market trend into a modest pullback or refresh it for another run.

1 Up-and-Down Days, and Stalling Stock Market Momentum



Source: S&P 500 Index 04/08/13

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

While much of the attention in recent months has been directed toward Europe as a source of potential crisis or breakthrough, global attention has now turned to Asia. The weak U.S. economy and extended stock market run-up may be vulnerable to a shock or due for a recharge. A flu pandemic or an act of war by North Korea could be a shock that results in a setback to the economy and stock market, while the aggressive stimulus in Japan could be a boost that finally gets stocks to break out of their month-long range.

Spreading Bird Flu

An influenza pandemic has the potential to exact a great human and financial toll. The Chinese stock market suffered last week, despite better economic data, from the spreading outbreak of the bird flu, referred to as the H7N9 virus. None of the 21 confirmed cases in China have yet confirmed that the virus has spread from human to human. In the past, it was at that point that it began to impact the markets.

- The sudden spread of human-to-human transmission of Severe Acute Respiratory Syndrome (SARS) briefly added to the pressures on global stock markets in March 2003.
- In May 2006, the strain of avian flu referred to as H5N1, was spread directly between members of an Indonesian family. This first case of human-to-human transmission of the lethal virus garnered much attention and pressured the markets.
- Adding to the stresses of the financial crisis in early 2009 was the fast-spreading swine flu as the World Health Organization (WHO) confirmed human-to-human transmission.

While in each of these cases the U.S. stock market experienced at least a 5–10% decline around the time of initial human-to-human transmission, other contributing factors helped to result in a weak environment for stocks.

The market may react negatively to headlines about infections spreading and the potential for limited human-to-human transmission. We will continue to watch these developments closely.

North Korean Aggression

Action could occur ahead of the anniversary of North Korea's founding President Kim Il-Sung's birthday on April 15.

South Korea's stock market was down each day last week as geopolitical risk escalated. North Korea, angered over recent U.N. sanctions prompted by the North Korean nuclear test in February and routine U.S.-South Korean naval exercises, has threatened to launch a nuclear strike against U.S. territories and a missile strike on South Korea.

While likely inflated, such rhetoric has been followed by action in the recent past with attacks that included the sinking of ships and short-lived artillery barrages. The sinking of the South Korean naval vessel Cheonan, and the resulting deaths of 46 crewmen, took place on March 26, 2010. An investigation concluded a month and a half later that the source of the attack was a North Korean submarine and contributed to global stock market weakness. On November 23, 2010, North Korea launched artillery shells and rockets at South Korean military and civilian targets on Yeonpyeong Island—contributing to a pause in the rally among global stock markets.

Last week, stocks fell on Wednesday, April 3, when the news broke that the Pentagon will deploy a missile defense system to Guam in the coming weeks in response to North Korea's threat. This may mark a break from much of the past 20 years, when threats and aggressive actions by North Korea typically resulted in high-level meetings, a short-lived agreement, and economic aid. Stocks may react negatively to any escalation. Action could occur ahead of the anniversary of North Korea's founding President Kim Il-Sung's birthday on April 15.

Japan's Shock-and-Awe QE

In contrast to the weakness seen in other major world stock markets, Japan's Nikkei Index was up 3.5% last week, adding to a year-to-date rally of over 20% on an aggressive policy move to revive growth by the Japanese central bank.

The Bank of Japan (BoJ) announced it will buy 7.5 trillion yen ($76 billion) of bonds a month. Japan was the first nation to use the now common bond purchases known as quantitative easing (QE) 12 years ago and has had little success to show in combating deflation and a stagnant economy. The new, bolder approach is intended to achieve a two-year inflation target of 2%, a level achieved only briefly over the past 20 years (in 1997 and 2008 as oil prices rose sharply). The BOJ shifted its focus to expanding the amount of cash in circulation and on deposit at the BOJ, intending to grow it in excess of the pace of economic output. The surprisingly bold move weakened the yen, which has fallen over 20% in the past six months.

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A weaker currency may help promote exports and raise domestic inflation, while higher inflation expectations may encourage consumers to spend now rather than wait. Pushing down bond yields may also encourage banks to stop holding so many government bonds and instead be more eager to make loans. Of course, the ability to pull forward spending among aging consumers and the willingness by businesses to borrow is not assured. Also, there is a risk posed by the longer-term consequences of driving up inflation, resulting in a serious increase in interest costs for a country already using 25% of its budget to service debt. In fact, the interest rate on Japan's 10-year government bonds is now less than 0.5%—the lowest in the world, despite a very high level of government debt and annual budget deficits. Japan's debt is roughly 230% of gross domestic product (GDP) and rising, higher than that of Greece (175% of GDP) and nearly twice that of Italy (125%). Japan believes the only way to turn this trend around is to drive GDP higher and is pulling out all the stops.

Perhaps this bold move may inspire investors to believe more stimulus may be forthcoming from the European Central Bank or the U.S. Federal

Reserve, given the weak manufacturing and jobs reports last week, capable of renewing the stock market's rally.

Given the market's recent behavior, we expect a modest pullback is most likely.

Plenty of events—including those listed here—may serve as inspiration for investors to sell and take profits or put more money to work in the coming weeks. Given the market's recent behavior, we expect a modest pullback is most likely. ■

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 reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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.

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.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

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.

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 Nikkei Index is short for Japan's Nikkei 225 Stock Average, the leading and most-respected index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S. In fact, it was called the Nikkei Dow Jones Stock Average from 1975 to 1985.

The Chinese stock market is represented by the Hang Seng Index, which is a freefloat-adjusted market capitalization-weighted stock market index in Hong Kong. It is used to record and monitor daily changes of the largest companies of the Hong Kong stock market and is the main indicator of the overall market performance in Hong Kong.

The South Korean stock market is represented by the Korea Composite Stock Price Index or KOSPI is the index of all common stocks traded on the Stock Market Division of the Korea Exchange. It's the representative stock market index of South Korea, like the Dow Jones Industrial Average or S&P 500 in the U.S.

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