Weekly Market Commentary

March 17, 2014

March Madness in the Markets

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

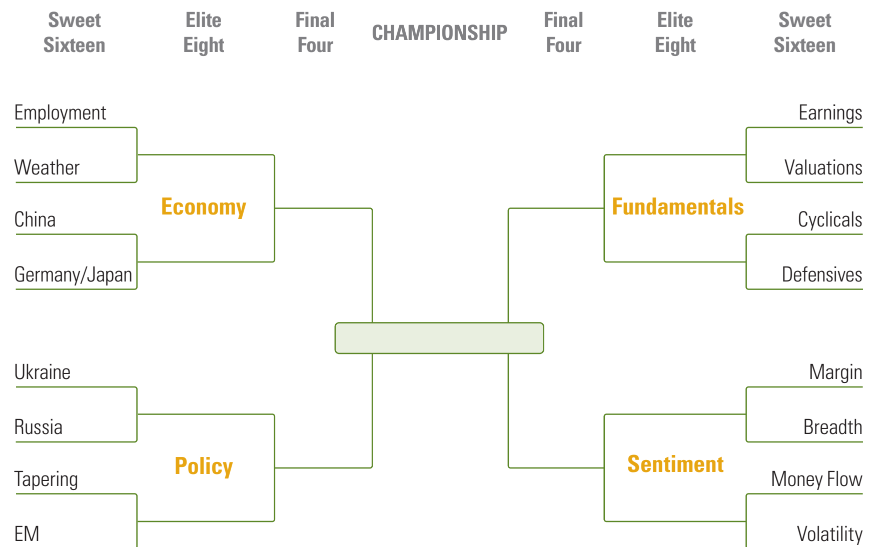
Highlights

As the NCAA basketball tournament gets down to its own sweet sixteen while the rest of March plays out, it is a good time to reflect on the sixteen competing drivers of the markets that may make for an exciting showdown in the weeks and months to come. There will likely be some upsets that result in volatility as these factors face off against each other.

With the exception of last year's steady rise, March has been maddening for investors. In three of the past four years the S&P 500 raced higher in March only to reverse all of those gains in a pullback of about 10% that began in late March or April. It later took stocks at least five months to climb back to the peaks of March.

As the NCAA tournament gets down to its own sweet sixteen while the rest of March plays out, it is a good time to reflect on the competing drivers of the markets that may make for an exciting showdown in the weeks and months to come.

1 Stocks' Sweet Sixteen



Source: LPL Financial Research 03/17/14

As we narrow down stocks' "sweet sixteen" potential drivers again this year, the four "regions" of market-moving factors vying for investor attention are: economy, policy, fundamentals, and sentiment.

Economy

- **Employment vs. Weather** – Job growth and other indicators of economic growth slowed in recent months. We will learn in the coming weeks how much of that reflected a genuine softening of economic activity versus just the impact of extreme winter weather across the United States in the form of snowfall and low temperatures.
- **China vs. Germany/Japan** – What is the trajectory of global growth? The second largest economy in the world, China, appears to be slowing. However, the third and fourth largest economies, Germany and Japan — which when combined are similar in size to China — have shown signs of accelerating growth. In the short term, Japan faces a fiscal drag due to a tax increase, but tremendous monetary stimulus should help to sustain growth over the remainder of the year.

Policy

- **Ukraine vs. Russia** – While a resolution to the Ukraine-Russia conflict may be elusive, that has also been the case in other countries in recent years and did not keep stocks from moving on once the prospects for a broader military engagement faded. U.S. stock market sell-offs due to geopolitical events have led to quick reversals in recent years as seen with Egypt and Syria. Market participants have been trained to buy quickly on signs that a crisis is likely to be averted. *What to watch:* if unrest prompts Russian action in other parts of Ukraine or armed clashes begin to break out, the risk of a broader crisis rises.
- **Tapering vs. Emerging Markets** – The soft global economy of the past five years prompted the Federal Reserve (Fed) to pump money into the global financial system, encouraging capital to flow into the emerging markets and allowing them to run unsustainable trade and budget deficits. Now, as global growth is improving, we are seeing the Fed begin to taper its bond purchases, and that change is prompting some emerging markets to have to quickly adjust by devaluing their currencies and cutting spending dramatically. These consequences of tapering have created weakness in emerging markets that has spilled over into developed economy stock markets.

Fundamentals

- **Earnings vs. Valuations** – Earnings growth for S&P 500 companies is accelerating from the sluggish, low single-digit growth seen for much of 2013. However, 2013's run up in valuations leaves the market much more dependent upon that growth. The price-to-earnings ratio of the S&P 500 on the past four quarters' earnings is now only about one point below the 17–18 seen at the end of all prior bull markets since WWII (with the one exception of March 2000 when it was much higher).
- **Cyclicals vs. Defensives** – After strong cyclical leadership last year from sectors up over 40% like consumer discretionary and industrials, defensives (such as the health care and utilities sectors) have been the strongest performers in 2014's volatile market. A return to cyclical leadership would be a sign of strength for the stock market.

The P/E 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 P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

Sentiment

- Margin vs. Breadth – Is the market showing signs of a top? Margin debt has soared to all-time highs as data from the Fed show that individuals now have the same percentage (41%) of their financial assets allocated to stocks as at the 2007 stock market peak (but well below the 53% in early 2000). However, margin debt and the S&P 500 have tended to move together, historically, as the stock market's rise to all-time highs have lifted margin balances and stock weightings. These would be more worrisome and point to a market top if, as the S&P 500 Index continued to climb indicators of the breadth of the advance in the market, or how broad the participation among all stocks is in the gains of the index, began to decline (measured by indicators like cumulative advance decline line or number of stocks hitting new 52-week highs).
- Money Flow vs. Volatility – In the last several months individual investors have joined corporations and started buying funds that invest in U.S. stocks after many years of net selling, based on data from the Investment Company Institute (ICI). While investors tend to chase returns, and the one-, three-, and five-year returns of the S&P 500 all currently reflect double-digit gains, investors could be spooked out of additional buying by rising volatility. Last year's steady gains for stocks encouraged buying, but a bumpier ride to gains in 2014 could curtail investors' recent risk appetite.

There are quite a few listed here, but these certainly are not all the factors that are influencing the markets. The key message for investors in considering these factors is: do not be too confident in any particular outcome. It is a time to nibble at opportunities as they emerge; it is not a time to jump in with both feet, or for indiscriminate selling.

Investing is not a game, but it is important also to remember that forecasting is not an exact science, and many factors can affect outcomes that are hard to predict. For example:

- Extreme Weather and Natural Disasters – The extreme winter weather in the U.S. had an impact on the economy. A few years ago the Japanese earthquake had a sizable impact and natural disasters — despite tremendous advances in technology — are very hard to predict with any degree of accuracy.
- Geopolitics – Geopolitical outcomes can also be hard to foresee as we look to Ukraine. For example, the outcome of the Arab Spring uprisings and the changes they have led to in countries including Syria and Egypt were hard to foresee.

The markets rarely offer perfect clarity on their direction because they are driven by these factors as well as many others. Even this week's NCAA March Madness can be seen as a reminder of how it can be notoriously hard to predict winners; historically, a team's ranking has meant nothing after getting down to the elite eight.

There will likely be some upsets that result in volatility and pullbacks as these factors face off against each other. In the end, we expect positive fundamentals and economic growth to win out and a potentially rewarding year for investors. ■

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. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance 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.

Stock and mutual fund investing involves risk including loss of principal.

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

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $11.18 trillion and serve nearly 90 million shareholders.

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.

This research material has been prepared by LPL Financial.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit

LPL Financial