LPL RESEARCH
WEEKLY MARKET COMMENTARY

July 8 2019

TAKING STOCK AT THE HALFWAY MARK

John Lynch *Chief Investment Strategist, LPL Financial*
Jeffrey Buchbinder, CFA *Equity Strategist, LPL Financial*

KEY TAKEAWAYS

The S&P 500 delivered its best first-half performance since 1997, raising questions about what that strong start may mean for the second half.

Stocks' track record after the strongest first-half rallies is mixed but points to modest gains ahead.

We would consider this bull market to have a stronger foundation if it had more sustained leadership from cyclical sectors and relied less on central bank policy.

Even after such a strong first half of this year, we think stocks may have more left in the tank. The S&P 500 Index gained 17.4% during the first half of 2019—an excellent performance—even though a decent chunk of those gains reversed the 2018 fourth quarter losses. Putting that six-month performance into perspective, it was the best start to a year for the stock market since 1997, and its tenth-best start since 1950. This week we recap the first half and analyze prior strong starts to see what we might expect in the second half of 2019.

FIRST-HALF RECAP

The main drivers of the strong first half were the Federal Reserve's (Fed) U-turn on monetary policy and progress on trade. The Fed's reversal helped not only the market's expectations for the U.S. economy but also supported stock valuations by pushing interest rates lower.

Even with the S&P 500 at record highs and a less rosy corporate profit growth outlook due to tariffs and trade uncertainty, the forward price-to-earnings ratio (P/E) for the index is still only 17, as of July 3, 2019. At that valuation, with such low interest rates, stocks look more enticing relative to bonds. The latest move in the 10-year Treasury yield below 2%—its lowest level since November 2016—was driven by President Trump's recent nominees to the Federal Reserve Board, who are expected to favor lower rates, and expectations that Christine Lagarde, current head of the International Monetary Fund (IMF), will carry on Mario Draghi's preference for lower rates as the new head of the European Central Bank.

Although progress on trade has been uneven, the United States and China came close to an agreement in April before talks derailed, fueling optimism that a more comprehensive deal to reduce or eliminate tariffs may be coming this fall. President Trump and China's President Xi have since resumed negotiations after the Trump administration removed the latest tariff threat, adding to the optimism. Removing the tariff threats from Mexico and Europe (mainly on autos) was also well received by markets.

Looking ahead, the Democrats may delay ratifying NAFTA 2.0 (the United States-Mexico-Canada Agreement, or USMCA) until after the 2020 election, and the Trump administration could slap tariffs on European autos this fall. These concerns didn't stop stocks from hitting more new highs last week but remain on our radar.

The strong first half was particularly impressive given slower economic and profit growth. Although first quarter gross domestic product (GDP) growth in the United States was solid at 3.1% annualized, the details suggest slower growth in coming quarters.

And even though first quarter earnings results were better than feared, the earnings increase from S&P 500 companies was marginal, and the next two quarters may bring more of the same. In addition, growth internationally has been challenging, particularly in Europe and Japan, while geopolitical risk remains heightened (Iran).

MARKET LEADERSHIP

We don't particularly like the stock market's reliance on monetary policy support from the Fed, but that's the market environment we are in right now. Beyond that, sector leadership has been somewhat disconcerting. We would consider this bull market's foundation to be stronger if it were being driven by more convincing leadership from the cyclical sectors. While cyclical sectors mostly outpaced defensives in the first half, it wasn't convincing. And the defensive sectors (consumer staples, healthcare, real estate, and utilities) have each outperformed the S&P 500 over the past year [Figure 1] even as the broad stock market benchmark gained 9% during that same period (through July 2, 2019).

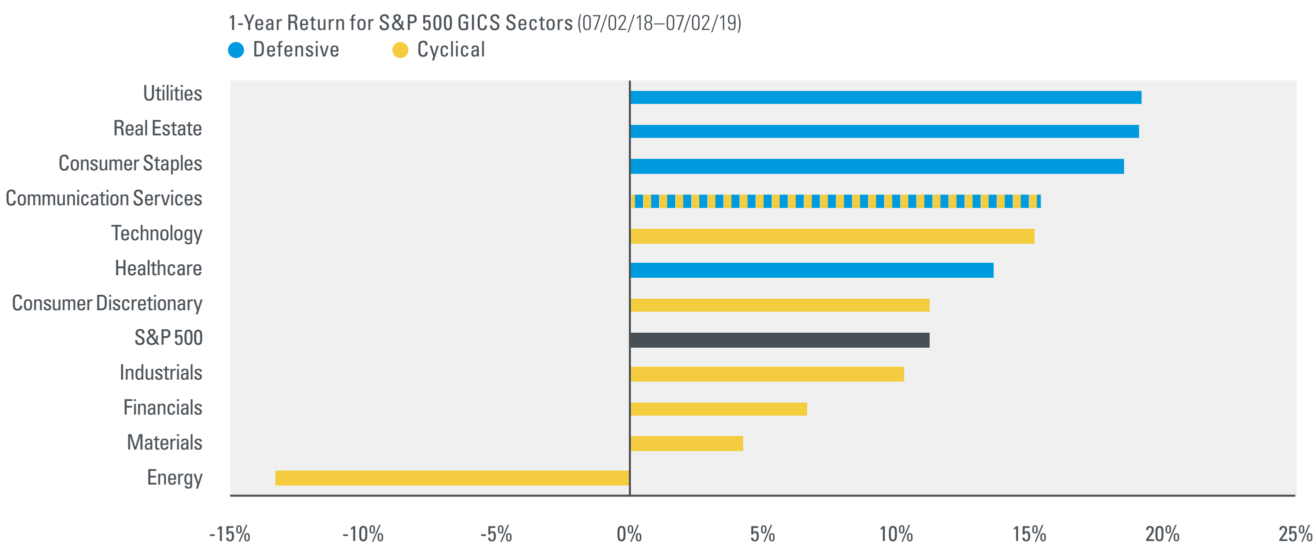
Gold, which has benefited from the Fed's U-turn and also exhibits defensive characteristics, has also outperformed the S&P 500 during this time, based on the Bloomberg Gold Subindex. At the same time, the more defensive large caps have beaten small caps, based on the Russell indexes; and transports, often viewed as a barometer of economic activity, underperformed, based on the S&P 500 Transports Index.

We continue to favor cyclical sectors and expect performance to improve in the second half. Technology has been a bright spot all year, and financials led during the second quarter. However, we would like to see more consistent leadership from these groups as a sign of this bull market's health.

HISTORICAL PERSPECTIVE

After such an impressive start and now that it's four months past the bull market's tenth birthday, how much is left in the tank? In the 1990s, strong starts

1 DEFENSIVE SECTORS HAVE LED OVER THE PAST YEAR



Source: LPL Research, FactSet 07/02/19

The characterization of the communication services sector as both cyclical and defensive reflects the change in the sector's composition during the time period represented.

All indexes are unmanaged and cannot be invested into directly.

to the year (15% or larger gains) in 1995, 1997, and 1998 were followed by additional strength as one of the strongest bull markets in history lasted 10 years.

However, when we look back further in time to 1983, 1986, and the infamous 1987, we see that strong starts were followed by weakness [Figure 2]. The sample size is small, but an average or median second-half gain of roughly 3% in these nine cases wasn't too bad, and stocks rose more than they fell.

The average pullbacks were larger in these instances, with the 1987 Black Monday crash providing a dramatic example. In a typical year, the maximum S&P 500 pullback during the second half has been about 10%. In the nine strong starts listed in the chart, the average pullback was 21% (again, skewed by 1987). Taking out 1987, the median calculation results in an average annual pullback of 9%, similar to the average across all years. This analysis suggests that this second half may not be too different from most years.

Also consider that if we lower the threshold for a strong first half to 10% or greater gains, then the average second-half advance is actually over 7%, and stocks have added to first-half gains in the second half 80% of the time.

CONCLUSION

We maintained our year-end fair value estimate on the S&P 500 of 3,000 in our *Midyear Outlook 2019* publication. After getting within a whisker of that target on July 3, we acknowledge that this forecast could be interpreted as negative and a reason to sell stocks. While we constantly review our market forecasts and might raise this one at some point, we would emphasize that stocks, or even bonds for that matter, frequently trade above what we would deem as a fair value range for an extended period of time. We are sticking with our market weight equities recommendation and continue to look for opportunities to add on weakness rather than selling into strength. At the same time, should stocks move significantly above our fair value estimate, we may reconsider.

The second half of the year could be a bit bumpy given risks around trade, geopolitics, and reliance on central bank policies. History tells us pullbacks of 5–10% are quite common, while corrections of 10% or more are not rare by any means. We encourage suitable investors who may be under-invested to use volatility to their advantage to rebalance portfolios. ■

2 WHAT DO STOCKS DO AFTER A BIG START TO A YEAR?

S&P 500 Index Returns After >15% Year-to-Date Returns as of the End of June

Year	Yearly Return as of the End of June	Return for the Final 6 Months	Pullback for the Final 6 Months
1954	17.7%	23.2%	-4.4%
1975	38.8%	-5.3%	-14.1%
1976	15.6%	3.0%	-8.4%
1983	19.5%	-1.9%	-6.6%
1986	18.7%	-3.5%	-9.4%
1987	25.5%	-18.7%	-33.5%
1995	18.6%	13.1%	-2.5%
1997	19.5%	9.6%	-10.8%
1998	16.8%	8.4%	-19.3%
2019	17.4%	?	?
	Average	3.1%	-12.1%
	Median	3.0%	-9.4%
Average Year (1950–Current)			
	Average	4.4%	-10.3%
	Median	4.9%	-7.7%

Source: LPL Research, FactSet 06/30/19

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

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.

Economic forecasts set forth may not develop as predicted, and there can be no guarantee that strategies promoted will be successful.

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

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.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Rebalancing a portfolio may cause investors to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

All information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

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.

RES-41912-0719 | For Public Use | Tracking #1-870200