Weekly Market Commentary

March 18, 2013

The Market's March Madness

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Highlights

It has been a sweet sixteen weeks for the S&P 500. The broad stock market index has had only three down weeks out of the past sixteen, tying a record unbroken for over 20 years.

As the NCAA basketball tournament gets down to its own sweet sixteen late this week, 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.

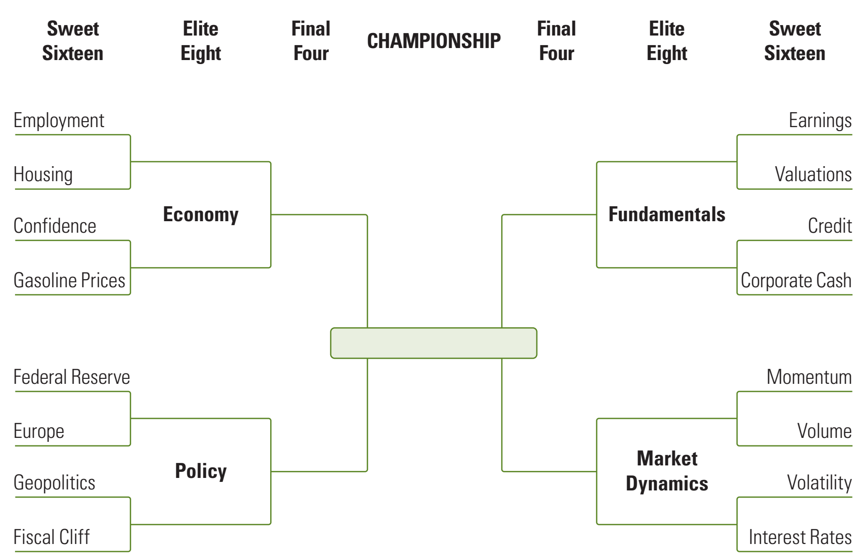
There will likely be some upsets that result in volatility as these factors face off against each other.

It has been a sweet sixteen weeks for the S&P 500. The broad stock market index has had only three down weeks out of the past sixteen. While this stretch is tied by the same period a year ago, it is important to note that there has not been a sixteen-week period with fewer weeks of losses in over 20 years—since the period ending September 1, 1989.

March has been maddening for investors in the past few years (2010–2012) as 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 at the end of this week, 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 03/18/13

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

Economy

- **Employment –** Job growth has been picking up with more than 200,000 jobs created in three of the past four months and first-time filings for unemployment benefits have started to fall after stabilizing around 350,000 for over a year.
- **Housing –** The powerfully rebounding housing market, as seen in data such as housing starts and building permits, is a positive for growth.
- **Confidence –** Last week's University of Michigan data showed that consumer confidence fell sharply in the preliminary reading for March to the lowest level in over a year.
- **Gasoline Prices –** Retail gasoline prices are back up near the "danger zone" that coincided with stock market pullbacks in each of the past few years.

Policy

- **Federal Reserve –** "Don't Fight the Fed" rally is intact, but as the Federal Reserve publicly contemplates ending the latest stimulus program, the stock market may suffer the same sell-off that surrounded the ending of prior quantitative easing programs, so-called QE1 and QE2.
- **Europe –** With the Eurozone back in recession, an inconclusive election leaving no government in Italy, a political scandal hampering the ability to implement needed reforms in Spain, Greece unlikely to meet the terms of its own bailout, and Germany pushing hard terms on any aid ahead of its fall elections, the events in Cyprus could provide the catalyst for another Europe-driven spring slide in the world's stock markets.
- **Geopolitics –** The hot spots are heating up again given the power grab following the death of Chavez in Venezuela, the coming elections in Iran, different factions vying for power in war-torn Syria, and North Korea annulling its cease fire agreement.
- **Fiscal Cliff –** A fiscal drag on gross domestic product (GDP) of about 2%, and showdowns over the continuing resolution funding the government and the debt ceiling still to come, may weigh on investor sentiment as the recently implemented sequester threatens to halt labor market improvement with an estimated cost of 750,000 jobs, according to the Congressional Budget Office.

Fundamentals

- **Earnings –** Earnings are the most fundamental of all drivers of stocks. Earnings growth has been the most consistent factor driving the markets in recent years, but growth has now slowed to the low-single digits for S&P 500 companies.
- **Valuations –** The price-to-earnings ratio of the S&P 500, at around 15 on the past four quarters' earnings, is well below the 17–18 seen at the end of all prior bull markets since WWII.

- **Credit** – Demand for credit has improved and credit spreads have narrowed; both trends are key supports to growth.
- **Corporate Cash** – Strong cash balances provide a cheap source of capital to invest and incentive to buy back shares to boost earnings per share growth.

Market Dynamics

- **Momentum** – Stocks have been on a strong winning streak that could continue.
- **Volume** – Trading volume in the markets has been light this year, 10–15% below last year, traditionally seen as a sign that a trend has become vulnerable.
- **Volatility** – Investors have once again become net sellers of U.S. stock mutual funds in the past two weeks, according to data from the Investment Company Institute (ICI), despite strong and steady gains. A return to more volatile markets may further undermine individual investor support.
- **Interest Rates** – Interest rates are on the rise, potentially acting as a drag on everything from housing to the U.S. budget, but from very low levels.

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: don't be too confident in any particular outcome. Respect the complexity of the situation. This is a time for caution and taking some profits, not for indiscriminate selling. It is a time to nibble at opportunities as they emerge; it is not a time to jump in with both feet.

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. Two years ago, the Japanese earthquake had a big impact on markets and natural disasters—despite tremendous advances in technology—are very hard to predict with any degree of accuracy. Geopolitical outcomes can also be hard to foresee as we look to the stresses in the Middle East. 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.

These factors will play out in the markets over the course of the year, not just in the coming weeks. This means 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 a positive year with many opportunities 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.

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 the risk of loss.

The Standard & Poor's 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

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.

The Congressional Budget Office is a non-partisan arm of Congress, established in 1974, to provide Congress with non-partisan scoring of budget proposals.

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.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

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.

The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market Bass-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

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

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 4109 0313
Tracking #1-151229 (Exp. 03/14)