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TAKING A LITTLE RISK OFF THE TABLE

Burt White *Chief Investment Officer, LPL Financial*
Jeffrey Buchbinder, CFA *Market Strategist, LPL Financial*

KEY TAKEAWAYS

While we do not believe the bull market is over, we do believe investors should consider taking some equity risk off the table.

Risks have begun to stack up and the risk-reward trade-off has become a bit less favorable.

The longer-term outlook still looks good—we see no recession on the horizon and corporate America is in excellent shape.

We think it is a good time to consider taking a little risk off table. Two weeks ago we wrote about how stocks are probably due for a pullback given their steady advance and some of the risks facing markets. This past week (August 16), we slightly reduced equity exposure in some of our model portfolios. By doing so, we acknowledged that those risks had begun to stack up during a seasonally weak period and that the trade-off between upside potential and downside risk, at least in the near term, had become a bit less favorable. This week we discuss some of the details behind that tactical decision and reiterate our positive longer-term view.

Disclaimer: Today's eclipse did not play a role in the tactical asset allocation decision discussed in this report.

WHAT WE DID AND WHY

As always, investors should consider their own individual risk tolerances and portfolio positioning. Here are some of the reasons we chose to slightly scale back our equity exposure and reduce risk in certain portfolios:

- **Stocks have had a strong run.** The S&P 500 Index's 10% return year to date is ahead of our 2017 forecast (6–9%). Furthermore, despite Thursday's declines, the S&P 500 and Dow Jones Industrials Average are both about 2% from their all-time closing highs (the Nasdaq is about 3% away from its all-time high). Although we continue to believe that valuations are supported by earnings growth, low interest rates, and low inflation, it is logical to expect pullbacks to be bigger when they start at higher valuations. The price-to-earnings ratio for the S&P 500, at just over 19 times consensus forward estimates (next 12 months, Thomson Reuters data), is at its highest level since the peak of the dotcom bubble in 1999.
- **Volatility drought.** Stocks are in one of their longest streaks ever without a pullback. The last 5% pullback in the S&P 500 was in June 2016 (Brexit vote), the longest such streak since 1994–96 and the fourth longest since 1958. Perhaps more unusual is that we haven't had a 3% pullback since the November 2016 election, a streak only matched once since 1950 (again, in the mid-1990s). Since 1950, the S&P 500 over a one-year period has pulled back 3% or more an average of 4.3 times and 5% or more an average of 2.5 times, so the current environment is unusually calm. We have also seen record low levels of the Chicago Board Options Exchange Volatility Index (VIX), which measures implied

stock market volatility based on options prices. Although the VIX rose sharply late last week, at 14, it remains well below its long-term (post-1990) average of 19.

- **Weak seasonal period.** August and September are the only calendar months that have averaged losses for the S&P since 1980 [Figure 1]. Some of the biggest drawdowns in recent decades have occurred during August and September, including Iraq invading Kuwait (1990), "Asian contagion" (1997), the collapse of Long-Term Capital Management (1998), Lehman's collapse (2008), the U.S. debt downgrade (2011), and China's currency crisis (2015). Plus, the calendar is lacking any obvious, potential near-term positive catalysts. The estimated deadline to raise the debt limit is only about a month away and perhaps carries the most potential to be a positive catalyst should it be resolved; our best guess is that it will be without any major market disruption. However, raising the debt limit is not always straightforward, which we learned from the 2011 debt limit debacle that led to the U.S. credit rating downgrade by Standard & Poor's.

1 WE ARE AMID THE WORST TWO MONTHS OF THE YEAR

S&P 500 Monthly Performance from 1980–2016

Month	Average Return	% Higher*
January	0.8%	59.5%
February	0.3%	62.2%
March	1.2%	64.9%
April	1.6%	70.3%
May	1.0%	67.6%
June	0.1%	56.8%
July	0.8%	45.9%
August	-0.1%	56.8%
September	-0.7%	45.9%
October	1.3%	64.9%
November	1.6%	70.3%
December	1.5%	73.0%

Source: LPL Research, FactSet 08/21/17

* Percentage of time the S&P 500 is higher during the month referenced since 1980.

All indexes are unmanaged and cannot be invested into directly.

- **Earnings season is behind us.** Although results were good in terms of upside to forecasts, growth rates, and guidance from management teams, earnings have not been a positive catalyst for the stock market during the just completed second quarter earnings season. In fact, according to FactSet data, shares of companies that have beaten estimates this earnings season have seen an average decline of 0.3% around their reporting date, compared to the five-year average of +1.4% (performance includes two days before and two days after the reporting date). Looking ahead, earnings may not be a positive catalyst for stocks for the next two to three months.

- **Central bank transitions.** As discussed in our *Midyear Outlook 2017* publication, the stock market faces a challenging transition away from central bank support. The Federal Reserve is likely to begin shrinking its $4.5 trillion balance sheet "relatively soon," per its latest statement, while the market's expectations for rate hikes are very low, both bringing the potential for a negative surprise.

- **Geopolitical risks are high.** Geopolitical risk is always relevant even though stocks have historically been resilient to these events. There are several potential scenarios that could impact the markets in the near term, such as the threat from North Korea, difficult Brexit talks, NAFTA renegotiations, and elections in Germany. In addition, terrorism unfortunately reared its ugly ahead again last week with the tragedy in Barcelona.

- **Distractions in Washington, D.C.** Each day that policymakers are focused on issues other than tax policy, the odds of corporate tax reform decrease and the possibility of budget or debt limit stumbles increase. We still believe a tax deal in early 2018 is more likely than not, with the Republicans in need of a political win, but the odds of success have fallen.

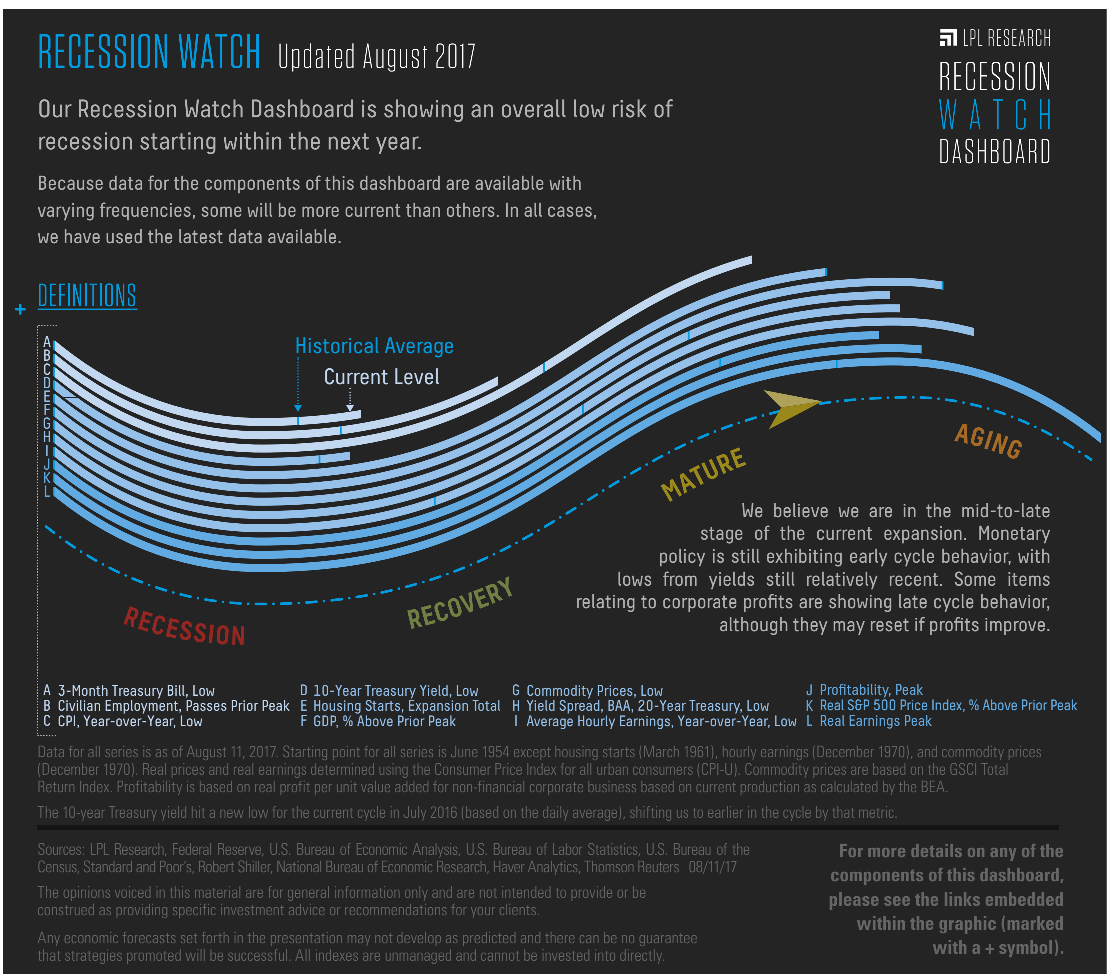
THE GOOD NEWS

While that is a long list of risks, we want to be clear that we are not sounding an alarm bell and turning bearish. Our decision to slightly reduce equity exposure was a small tactical move executed within a select group of portfolios more focused on a short- to intermediate-term time horizon (within the range of 3–12 months). We remain nearly fully invested with roughly benchmark-level risk in most of our tactical models. And we have shifted equities to cash rather than bonds so that we can be nimble and put the cash back to work when a more attractive opportunity emerges. In other words, we are still inclined to buy a dip when it comes.

> We made no changes to our strategic asset allocation recommendations.

It is also important to note that we have made no changes to our strategic asset allocation recommendations, which focus on longer, three- to five-year time horizons. Our long-term equity market view remains positive primarily because of where we think we are in the business cycle. We expect the economic expansion and bull market to continue well into 2018 and likely beyond, with leading indicators pointing to further economic growth and our Recession Watch Dashboard [Figure 2] suggesting that the economic cycle is in its mature

2 OUR RECESSION WATCH DASHBOARD SUGGESTS LOW ODDS OF RECESSION OVER NEXT YEAR



phase but not nearing its end. We see few signs of excesses (overspending, overborrowing, and overconfidence) that have historically led to the end of prior business cycles. Remember, bull markets don't die of old age, they die of excesses.

We are also encouraged by the financial health of corporate America. Even though the market's reaction to earnings was muted, companies delivered another excellent earnings season and balance sheets are in outstanding shape. A likely reduced tax rate to repatriate overseas cash in 2018 will only strengthen corporate America's financial position. Consumer spending picked up in July based on the strong retail sales report last week; and data released thus far for the third quarter suggests a potential pickup in gross domestic product growth.

CONCLUSION

The risks have begun to stack up—some seasonal, some policy related, some geopolitical, and some simply a function of the unusually quiet year we've had. But the longer-term outlook still looks good. We see no recession on the horizon, the economy is showing no signs of excesses that have historically led to the ends of business cycles, and corporate America appears to be in excellent shape. ■

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 NASDAQ-100 is composed of the 100 largest domestic and international non-financial securities listed on The Nasdaq Stock Market. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade, and biotechnology, but does not contain securities of financial companies.

Dow Jones Industrial Average is the most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. The 30 stocks are chosen by the editors of the Wall Street Journal. The Dow is computed using a price-weighted indexing system, rather than the more common market cap-weighted indexing system.

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.

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