LPL RESEARCH

WEEKLY MARKET COMMENTARY

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MODEST PULLBACK OR SOMETHING BIGGER?

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KEY TAKEAWAYS

Following such a strong rally since the December 24 lows, a pullback is reasonable to expect.

We expect additional stock market weakness beyond last week's more than 2% decline to be modest.

Fundamentals remain sound, valuations are reasonable, and most technical indicators we follow point to further potential gains ahead.

Following the strong 2019 rally, we ask if stocks are overdue for a pullback. The S&P 500 Index rallied 9.4% in 2019 and 17% since the December 24, 2018, low. The strength of the rally has been a surprise to many given widespread concerns about slower global growth, trade uncertainty, and the age of the bull market—which turned 10 last weekend, as we discussed here last week. Following that strong rally, a pullback is to be expected; but we don't think it will get much worse than last week's 2.1% drop, for reasons discussed below.

FUNDAMENTALS REMAIN SOUND

Although stocks may need a pause to digest recent gains, we continue to believe fundamentals support further gains for stocks this year. The economy is growing steadily and, despite Friday's soft and likely weather-distorted payrolls report, is creating jobs at a solid pace for this point in the cycle. We don't think it's widely understood that fiscal stimulus (tax cuts and government spending) will add more to gross domestic product (GDP) in 2019 on a percentage basis than it did in 2018.

Though earnings growth is slowing, economic growth supported by fiscal stimulus, expansionary manufacturing surveys, and solid labor markets point to another year of record profits in 2019. Historically, corporate revenue is correlated with GDP plus inflation (or nominal GDP), which could approach 5% this year, if our forecasts are accurate. History also reveals that peaks in earnings growth—as we experienced in the third quarter of 2018—have tended to be followed by several years of economic growth and stock market appreciation, which should be reassuring to those who think a now 10-year-old bull market is getting fatigued.

Though nothing has been signed, a trade deal with China over the next month or two appears likely. Key players in the negotiations have expressed increasing optimism, and it's clear President Trump wants a deal. Any agreement is probably good news for stocks at this point, but a potential rollback of tariffs put in place last year presents a possible upside surprise.

Finally, keep in mind that the post-midterm election period has historically produced strong gains—Since WWII, the S&P 500 has never been down over the 12-month period following midterm elections (18 for 18), having produced an average 14.5% gain during those periods. President Trump sees a strong stock market as part of his path to reelection, suggesting this historical pattern may hold.

MIXED TECHNICAL PICTURE

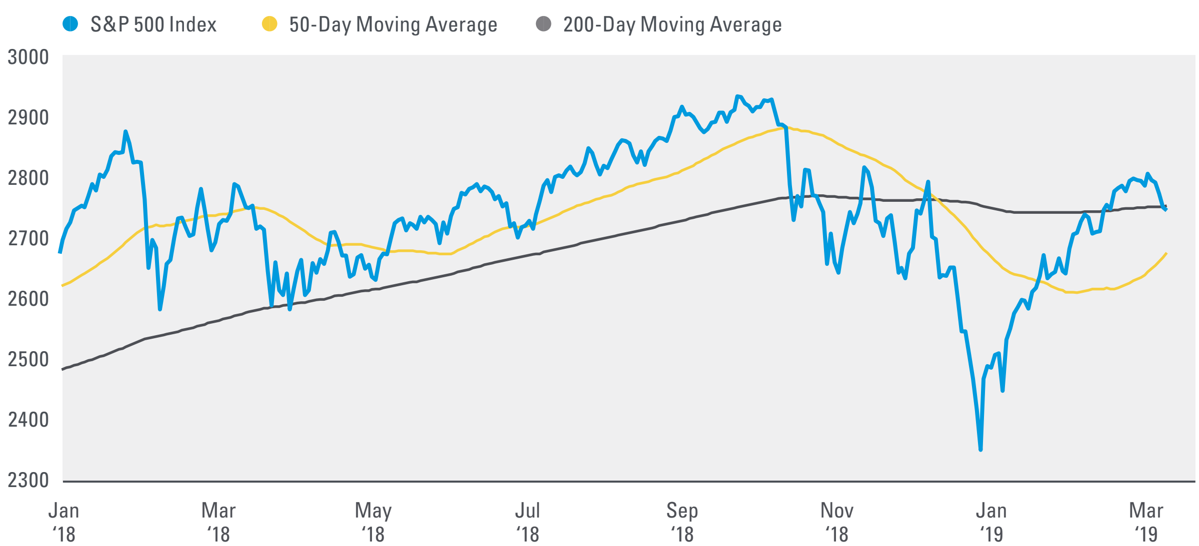
Most of our favorite technical indicators, such as market breadth, are flashing positive signals and there are a number of historical analogues pointing to more gains ahead:

- The S&P 500 is above its upward sloping 50-day moving average (MA), suggesting an improving trend, and at support in the form of its 200-day moving average.
- March has been the second strongest month for the stock market over the past 20 years.
- Stocks tend to go up in the final 10 months of a year (25 out of the last 27 years) after experiencing gains during January and February.
- Market breadth is favorable, with a high proportion of stocks participating in this year's advance.
- Investor flows have been negative in 2019—evidence of caution, not euphoria.
- Investor sentiment surveys suggest bulls are not in overabundance.

At the same time, however, some indicators suggest the S&P 500 may be due for a pullback.

- The percentage of stocks above their 50-day moving averages is still high at 84%, though down from the recent peak of 92%.
- Put/call ratios suggest investors are complacent; more nervousness is typical ahead of rallies.
- The S&P 500 has failed to sustain levels above the 2,800 level four times since mid-October, making a breakout more difficult.
- Support for the S&P 500 below the 50-day moving average is at 2,650, 3.4% below Friday's closing level.
- The average peak-to-trough pullback after a positive January and February is 9%.

1 THE S&P HAS REBOUNDED STRONGLY FROM DECEMBER LOWS



Source: LPL Research, Bloomberg 03/08/19
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

RISKS

While we do think the macro environment sets up well for stocks, we are mindful of several risks. Earnings growth has slowed quite a bit and could slow further. A potential first quarter earnings decline may fuel investor concerns about another earnings recession (not our expectation) and weigh on investor sentiment.

Though unlikely, a disorderly Brexit that creates instability in Europe is possible. The European Central Bank reminded us last week how much European economies have slowed; risk of spillover into the U.S. remains.

The latest trade headlines have been positive, but President Trump could still walk away. Even if a deal is reached, it may already be priced in and markets may sell the news.

Finally, although the Fed is on hold now, the central bank may feel the need to respond with tighter policies should economic growth improve later this year.

CONCLUSION

Putting all of that together, a 5% or so pullback may be in order. With fundamentals still sound, valuations quite reasonable (discussed here two weeks ago), and the potential catalyst of a U.S.-China trade deal, we would expect additional stock market declines beyond last week's 2% dip to be fairly modest. Keep in mind that pullbacks of this magnitude are typical—we tend to see three or four of them each year. Weakness may provide opportunities for suitable investors to add equities based on what we see as a generally favorable macroeconomic environment.

The possibility of a pullback does not scare us off of our 2019 year-end forecast for further stock gains from here. Although it's reasonable to expect a pickup in volatility following the strong bounce off December lows, we maintain our 2019 year-end S&P 500 target of 3,000, or 9% above Friday's closing level. ■

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.

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