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BUY THE DIP? WHAT DIP?

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KEY TAKEAWAYS

Beyond the double-digit gains and series of record highs, the absence of pullbacks is perhaps the biggest story for the S&P 500 in 2017.

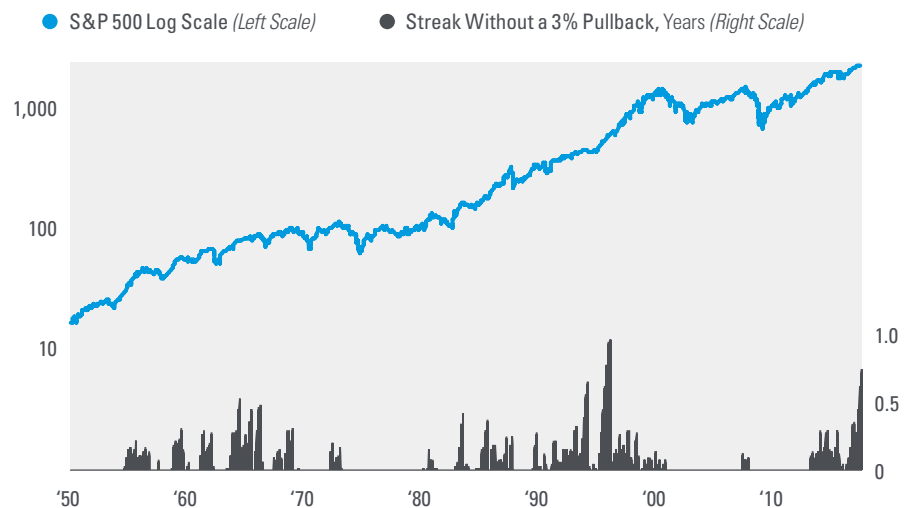
What may cause pullbacks is extremely difficult to predict, but we are mindful of the risks across central bank policy, policymaking in Washington D.C., and geopolitics.

Historical technical analysis tells us that buying the dip is often the right move in bullish trending markets.

Buy the dip? What dip? Beyond the double-digit gains in stocks this year¹ and all of the all-time highs (29 for the S&P 500 Index already this year), perhaps the biggest story for the S&P 500 in 2017 is the absence of pullbacks. Here we discuss the lack of pullbacks, what could cause the next one, and how technical analysis could help us decide whether to buy the dip.

Whether you look at the number of trading days since the S&P 500 has pulled back 5% (279 days), or just 3% (187 days), it has been an unusually calm and steady advance. The streak without a 3% pullback, pictured in [Figure 1](#), is particularly noteworthy as it has only been matched once since 1950. From January 1995 through January 1996, the S&P 500 went 241 trading days (about two weeks short of a full calendar year) without a 3% pullback. The early stages of the technology boom, Federal Reserve (Fed) rate cuts, falling market interest rates, and low (at least for that period) and stable inflation all played a role in the stock market's steady move higher during that period.

1 LATEST STRETCH WITHOUT A 3% PULLBACK IS ONE OF THE LONGEST EVER



Source: LPL Research, FactSet 08/04/17

Please note: The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

¹ As of 08/07/17, the S&P 500 index has generated a 12.1% total return year-to-date.

WHAT COULD DRIVE A PULLBACK

Pullbacks often come from unexpected events, so it is very difficult to predict what will cause them. But today we see several areas to watch that could potentially drive the next pullback:

1. **Central bank policy.** A potential policy mistake by the Fed, or other major global central bank, carries the potential to cause the next stock market pullback. The Fed is about to begin reducing its massive balance sheet, while a rate hike surprise, though unlikely, is possible should inflation pick up in the fall. The market's expectations for Fed rate hikes are low, setting up a potential negative surprise.
2. **Washington, D.C. developments.** A number of political risks could potentially drive stocks down 5% or more. If Congress cannot pass a budget resolution for 2018, tax reform is almost certainly dead. Disagreements about spending cuts could throw a wrench in the budget process. The federal debt limit will have to be raised in September and may have other provisions tacked on that could make passage more difficult. The ongoing Russia investigation accelerated last week with the convening of a grand jury, and brings at least potential distractions, if not worse.
3. **Geopolitical tensions.** Escalating global conflicts could drive stocks lower. North Korea is the latest threat while relations with China have been fraying. Tariffs on Chinese goods still carry the potential to start a trade war.

A CASE FOR BUYING THE DIP

Although it has taken longer than most expected for the much anticipated market dip to arrive, we can analyze the likelihood that buying the dip—when it eventually comes—may end up being the right move. Specifically, we can use technical analysis to identify whether the long-term trend may be bullish and then assess the odds that a stock market pullback is shallow and should be bought.

First, we define a bullish trending market as starting when the S&P 500 moves above an upwardly sloping 200-day moving average and ending when the S&P 500 moves below a negatively sloping 200-day moving average. By this definition, the S&P 500 has been operating in a bullish trend since June 2016, around the time of the last 5% pullback, which occurred right after the Brexit vote (for the record, we do not count the overnight drop in S&P futures the night of the election as a 5% pullback).

Now, let's look back at pullbacks during bullish trending markets. Since 1950, there were 21 periods when the S&P 500 was considered to be operating in a bullish trend. On average, those bullish periods have lasted 866 days, or about 28 calendar months. The average magnitude of those pullbacks is 6.8%, although during the current bull market, since March 2009, the pullbacks have been shallower, averaging just 6.1%. Over this very long time horizon stocks, on average, have pulled back 3% or more 4.3 times per year, and 5% or more 2.5 times per year.

Since 1950, the S&P 500 has pulled back 3% or more 4.3 times per year, on average, and 5% or more 2.5 times per year.

So, how do stocks perform after a 3% dip in a bullish trending market? Over 203 instances, after a 3% pullback, S&P 500 returns were higher 77% of the time over the next year, with an average gain of 9.9% [Figure 2]. This is higher than the average

2 SUBSEQUENT CHANGE IN S&P 500 FOLLOWING 3% PULLBACKS IN BULLISH TRENDING MARKET

	3 Months	6 Months	12 Months
Average S&P 500 Gain	5.2%	7.1%	9.9%
Percent Positive (%)	80%	77%	77%

Source: LPL Research, Bloomberg 08/04/17

Date Range: 1950–2017

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annual return (8.9%) and the batting average (73%) for the S&P 500 for the entire period. The figure also shows that buying dips in a bullish trending market tends to work over shorter time periods.

CONCLUSION

It has been a great year for the stock market thus far, but perhaps more impressive (or surprising) than the double-digit gains is the calm with which those gains have come. The length of time since stocks

have pulled back is historic, but we all know that this will not last forever. We will continue to watch central banks, policy developments out of Washington, D.C., and geopolitical tensions to attempt to get at least some warning of when the next pullback may arrive. And when it does arrive, buying the dip may end up being a good strategy. We remain comfortable with near-benchmark exposure to equities, consistent with your risk tolerance. ■

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All investing involves risk including loss of principal.

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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