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WHAT MIGHT SCARE MARKETS

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KEY TAKEAWAYS

We continue our Halloween tradition and feature five risks that have the potential to scare markets.

These risks do not change our expectation that stocks may add to this bull market's gains in the coming year, albeit likely with more volatility.

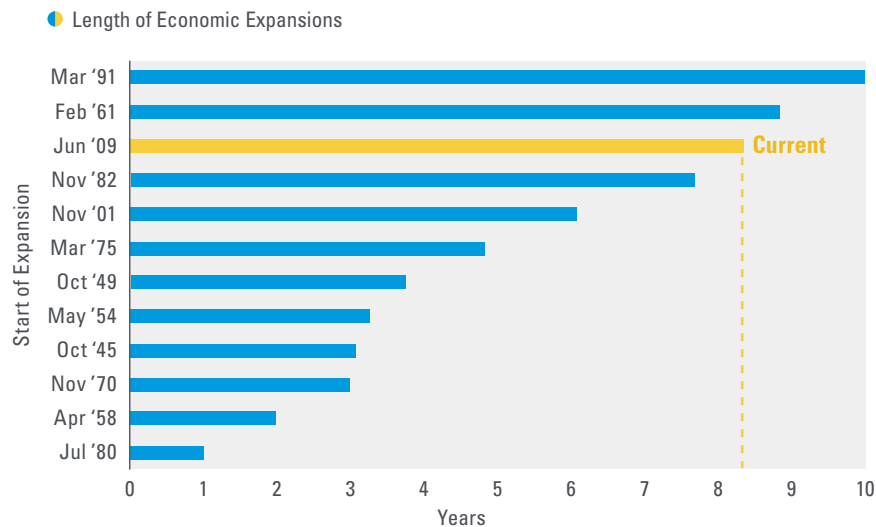
Economic momentum has picked up, the job market remains healthy, and earnings growth is solid with potential upside from a tax cut.

With Halloween upon us, we continue our tradition of writing about what might scare markets. While too much fear during stressful times for markets can lead to poor investment decisions, some skepticism in strong markets can be healthy. With that in mind, here are five risks that have the potential to scare markets. We also want to point out, however, that these worries do not change our generally positive outlook. We continue to expect further stock gains for this bull market in the coming year, although potentially with an increase in market volatility.

AGING EXPANSION AND BULL MARKET

The economic expansion officially hit 100 months old this month and is now the third longest since WWII [Figure 1]. Meanwhile, the bull market is the second longest at 8.5 years old. Some believe this alone means that the U.S. economy may soon slide into a recession and end this powerful bull market. But bull markets don't die of old age, they die of economic excesses, and we aren't seeing the types of excesses observed at previous economic peaks.

1 CLOSING IN ON SECOND LONGEST ECONOMIC EXPANSION SINCE WWII



Source: LPL Research, National Bureau of Economic Research 10/30/17

We follow a variety of leading economic indicators to help identify possible signs of overheating. The types of excesses that have ended prior economic expansions and bull markets (overspending, overborrowing, overconfidence) remain well contained at this time. Bottom line: We see a low probability of a recession in the next 12 to 18 months, although there is always the chance of an unexpected exogenous geopolitical shock or policy mistake.

OVERLY OPTIMISTIC SENTIMENT

Billionaire investor Warren Buffett famously told investors to “be fearful when others are greedy.” Remember, sentiment is a powerful tool at the extremes. When everyone is bullish there is likely no one left to buy, and vice versa when everyone is bearish.

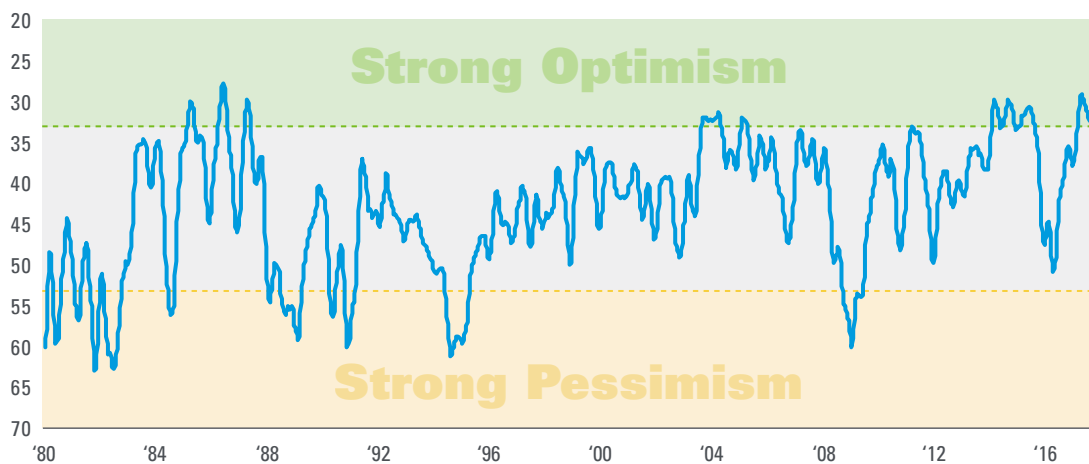
We would classify sentiment as a near-term concern, as there are some signs of greed in the market currently:

- In a recent University of Michigan consumer sentiment survey, nearly 65% of those polled expected the stock market to be higher a year from now, which is the most in the survey’s 15-year history.
- The Investors Intelligence U.S. Advisors’ Sentiment Report—a widely used contrarian indicator—showed a spread of 47% between bulls and bears, the widest spread since 1987 [Figure 2].
- A recent fund manager survey from Bank of America found that expectations for “Goldilocks” (above-trend growth, below-trend inflation) were at a record high.

Although these data points suggest overly positive sentiment, it is important to note that we aren’t

2 INVESTOR ADVISORY SERVICES ARE ABOUT AS BULLISH AS THEY GET

● Advisory Service Sentiment (13-Week Average, Lower Readings Reflect Optimism, Inverted)



Source: LPL Research, Ned Davis Research, Investors Intelligence 10/30/17

seeing huge flows into equities that might suggest a major peak. According to the Investment Company Institute, in 2017 there have been more than \$43 billion in outflows from domestic equity strategies, versus over \$330 billion into bond products. In other words, investors might be saying one thing and doing another with their money.

EXTENDED PERIOD OF LOW VOLATILITY

We have written a lot about how the stock market has been so calm this year. Last week marked the 242nd consecutive trading day without a 3% correction for the S&P 500 Index, topping the record of 241 days set in 1995. The index hasn't experienced a 5% correction since the Brexit vote (June 27, 2016). Now at 338 trading days, this marks the fourth longest streak since 1958, and could become the longest during the last 60 years if it lasts until February 2018. Looking at volatility another way, 1964 was the last time we last saw smaller average daily changes in the S&P 500 than the 0.3% we have observed so far in 2017.

The extremely low volatility is a bit concerning. Although the absence of a pullback does not predict that one will come soon, we do believe that one may be due. Pullbacks are a normal part of markets; historically, on average, a few occur each year. Although we can't necessarily forecast when the next one might come, or the precise cause, the odds do favor a dip in the near future.

CENTRAL BANK POLICY MISTAKE

History tells us that the Federal Reserve (Fed) tightening cycles can accelerate the ends of business cycles and bull markets. Several factors increase the risk associated with the current cycle:

- The Fed is undertaking an unprecedented shrinking of its massive \$4.5 trillion balance sheet.
- [We will likely have a new Fed chair in February 2018](#) (to be announced later this week), and that new chair could potentially be more hawkish than Chair Yellen. Past leadership transitions at the Fed have been accompanied by increases in market volatility.

3 LONGEST STREAKS WITHOUT A 5% S&P 500 CORRECTION

Start Date	End Date	S&P 500 at Beginning	S&P 500 at End	S&P 500 Gain	Number of Trading Days
08/19/58	09/08/59	47.30	57.70	22.0%	266
01/04/61	01/09/62	58.36	69.15	18.5%	255
11/26/63	06/08/65	72.38	85.93	18.7%	386
10/12/92	03/28/94	407.44	460.00	12.9%	370
12/21/94	07/12/96	459.61	646.19	40.6%	394
06/28/16	10/27/17	2036.09	2581.06	29.0%	338

Source: LPL Research, FactSet 10/30/17

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. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

- Europe and Japan have similarly sized balance sheets as the Fed. While Europe has only just begun to taper and Japan is probably not close to starting, these policy divergences could cause volatility in equity and currency markets.

While these transitions for central banks present risk to markets, we believe that the Fed's transparency increases the likelihood that markets are able to digest tighter monetary policies relatively smoothly. We also expect the Fed to continue to move gradually, regardless of who is running it, reducing the likelihood that the central bank spooks markets as it did in 2013, the origin of the term "taper tantrum." Look out for more from us on central banks in LPL Research's *Outlook 2018* next month.

NO TAX REFORM

The stock market appears to be pricing in a reasonable chance that the Republicans may achieve at least a corporate tax cut. Whether they get full reform or just a tax cut is hard to say, though the delineation here is gray. Although the House passed a 2018 budget resolution last week, which moves the process along, there is a real risk that Congress may be unable to pass a tax bill.

There is a reason why comprehensive tax reform hasn't happened since 1986—it's hard to do. George W. Bush passed tax cuts in 2001 and 2003—those are easier and more common—but today's political environment appears tougher to navigate. Seeing the House's comprehensive proposal later this week may help the handicappers.

It is difficult to know just how much of this year's strong stock market gains are due to potential tax deal optimism; therefore, it's equally difficult to pinpoint how negative the market's reaction will be if a deal isn't reached. Regardless, failure to reach any kind of a deal would likely cause stocks to pull back.

We believe that the odds of a tax cut (or reform) are over 50%. The Republican Party is largely unified on the issue, there are many different levers that can be pulled to secure needed votes, and dynamic scoring is likely to be used to limit the deficit impact. Dynamic scoring allows higher economic growth forecasts from lower tax rates to be used to calculate the budget impact of a tax bill.

CONCLUSION

Seeing a list of these factors that may scare markets could make some of you nervous, but the fundamentals still look quite good to us. Economic momentum has picked up, the job market remains healthy and is essentially at full employment, and earnings growth is solid with potential upside from a tax cut. Bottom line: We maintain our expectation for further gains for stocks in the coming year, despite these potential risks.*

We hope everyone has a fun and safe Halloween. And remember, a little fear is healthy for protection, but too much fear can distract us from our long-term goals. ■

Thank you to Ryan Detrick for his contributions to this report.

*As noted in our *Midyear Outlook 2017: A Shift In Market Control*, we expect the S&P 500 Index total return to be 6 – 9%, driven by 1) a pickup in U.S. economic growth; 2) mid- to high-single-digit earnings gains; 3) a stable price-to-earnings ratio (PE) of 19 – 20; and 4) prospects for a fiscal policy boost to earnings in 2018.

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.

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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.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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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