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FLAT START DOES NOT MEAN FLAT FINISH

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KEY TAKEAWAYS

The S&P 500 dipped into negative territory for the year last week intraday on a price basis.

A flat year into August should not be interpreted as a sign that stocks are in store for a weak year.

A look back at history reveals that high-single-digit returns may be in the offing, and we see several potential catalysts for a late-year rally.

This year has brought a whole lotta flat. The S&P 500 dipped into negative territory for the year last week (on August 12) and is only up about 1% year to date. The bond market has been flat—the Barclays Aggregate Bond Index has returned just 0.51% so far in 2015. Even the U.S. economy was relatively flat during the first half of 2015, with just 1.5% growth in gross domestic product (GDP) on an annualized basis, well below potential. Flat, flat, and more flat.

With the S&P 500 still fairly close to flat on the year (+1.6% on a price basis as of August 14), we look at how likely stocks are to produce a solid year of gains. A look back at history over recent decades is encouraging.

WHAT BEING FLAT IN AUGUST MEANS

The S&P 500 is about 1% higher than where it started the year, but it crossed under the flat line briefly last week (August 12) and into negative territory intraday on a

1 A FLAT YEAR INTO AUGUST HAS PRECEDED MORE POSITIVE YEARS THAN NEGATIVE YEARS

Year	YTD S&P 500 Change as of July 31	Full-Year S&P 500 Change
1968	1.3%	7.7%
1990	0.8%	-6.6%
1992	1.7%	4.5%
1994	-1.8%	-1.5%
2004	-0.9%	9.0%
2005	1.8%	3.0%
2010	-1.2%	12.8%
2015	2.2%*	
Average:		4.1%
Average of Positive Years:		7.4%

Source: LPL Research, FactSet 08/14/15

*As of August 14, year to date change was 1.6%.

Data series back to 1950.

Flat defined as up or down less than 2%.

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. Past performance is no guarantee of future results.

price basis. The first question we tackle is how likely the S&P 500 is to produce a positive year when it moves less than 2% as of the start of August. We looked at data back to 1950 and found that if the S&P 500 is within 2% of where it started the year as of August 1, it is more than 70% likely that the index ends the year higher [Figure 1], similar to the odds in any year. And in those years when it does end higher, the average gain is a solid 7.4% (excluding dividends). A fairly encouraging picture.

A different way of looking at the data reveals an even more encouraging picture. There have been 30 years since 1950 in which the S&P 500 was flat or down as of August 1. In 14 of those 30 years the S&P 500 ended the year higher. An impressive feat, considering some of those years saw significant annual declines when August began. But the same analysis during a more recent period—going back to 1980, which some refer to as the modern stock market era—reveals an even more compelling story. During those 17 years in which the S&P 500 was flat or down as of August 1, in only 6 of them did the S&P 500 end lower (8 were higher and 3 were flat). The average gain during those up years was 9.6%.

It is also interesting to look at how late in the year the S&P 500 showed a year-to-date loss before producing these solid gains [Figure 2]. The figure shows years when the S&P 500 was flat or down at the start of August and ended the year higher. Many of these solid years (1971, 1982, 1998, and 2004) were in the red for the year as late as October or even November and still produced solid high-single-digit or even double-digit gains. This is the classic fourth quarter rally that we may see again this year.

Some observations after reviewing this data:

- **1998: Quite a year for the stock market.** The S&P 500 was down on the year as of October 8, 1998, and rallied to end the year up 27%. Granted, it was near the peak of the internet bubble and the Federal Reserve was cutting interest rates, but still quite a comeback.

2 MANY GOOD YEARS FOR STOCKS SAW LOSSES VERY LATE IN THE YEAR

Year	Last Date of Year S&P 500 in Negative Territory	Full-Year S&P 500 Change
1959	September 22	8.5%
1971	November 26	10.8%
1982	October 5	14.8%
1987	December 11	2.0%
1992	October 23	4.5%
1998	October 8	26.7%
2004	October 26	9.0%
2005	November 1	3.0%
2007	November 26	3.5%
2010	September 10	12.8%
Average:		9.6%

Source: LPL Research, FactSet 08/14/15

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- **2007: Stocks rallied from being down in early November to end the year 4% higher.** Although that scenario could potentially occur this year (hopefully we are doing better than breakeven in early November), we believe that is where the similarities between 2007 and 2015 end.
- **1986: This year is not included in the list of flat or down years as of August 1.** The S&P 500 was up 12% that year as of August 1 and never looked back, producing a 15% gain that year. We highlight this year because of the U.S. energy boom and subsequent collapse in oil prices seen then and now.
- **Though not listed here, the years when stocks are down in August, and stay down, have clear catalysts:** energy crisis (1973 and 1977), high inflation (1981), and bubbles bursting or recessions (1990, 2000–2002, 2008). The U.S. stock market is clearly facing some challenges today, but the current environment looks very different from these years.

Bottom line, history suggests stocks are capable of posting total returns this year in the range that we forecast in our *Midyear Outlook 2015* (5–9% including dividends*), despite touching negative territory on the year in August.

POTENTIAL CATALYSTS

So what might fuel another late year rally?

We continue to expect earnings to be a catalyst to push stocks higher over the balance of the year. Although on the surface the 1–2% year-over-year earnings growth figure for the S&P 500 in the second quarter is hardly impressive, earnings growth excluding the energy sector is very impressive (estimated at 9%). Also consider that figure includes several percentage points of drag from the strong U.S. dollar, which reduces overseas profits generated by U.S. multinationals. Better economic growth in the U.S., less drag from the energy sector and a strong dollar, and effective cost controls could potentially all contribute to improving earnings growth in the second half, while moving further beyond the one-year anniversary of the start of oil's decline (June 20, 2014) should help contribute to a more positive earnings trajectory as 2016 begins.

The possibility that the Federal Reserve (Fed) surprises the market somehow is a risk, but as we discussed at length in our *Midyear Outlook 2015* publication, the stock market has a history of effectively negotiating the start of Fed rate hike cycles. Slowing growth and the currency devaluation in China do not change our expectation that the Fed will hike rates before the end of 2015.

> History suggests stocks are capable of posting total returns this year in the 5 – 9% range that we forecast, despite touching negative territory on the year in August.

*Historically since WWII, the average annual gain on stocks has been 7–9%. Thus, our forecast is in-line with average stock market growth. We forecast a 5–9% gain, including dividends, for U.S. stocks in 2015 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5–10%. Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2015.

A more pronounced slowdown in China, however, is a risk (though not our base case). We expect slower growth in China to be offset by potentially stronger growth from other overseas economies, including most of Europe and Japan, and to lead to slightly stronger global growth in 2015 than 2014 (see our *Weekly Economic Commentaries*, "Global GDP Tracker: Summer 2015 Edition" and "China Currency Conundrum"). Meanwhile, previously enacted stimulus measures from the Chinese government are still working their way through the system and more actions are likely on the way.

CONCLUSION

This year has brought a whole lot of flat. But the S&P 500's dip into negative territory last week should not be interpreted as a sign that a weak year for stocks is a guarantee. A look back at history reveals that stocks are more likely to end this year higher than lower, and that high-single-digit returns may be in the offing even if the S&P 500 is flat or down slightly well into the fall. We see several potential catalysts for a late-year rally—most notably earnings—and continue to expect stocks may deliver high-single-digit returns in 2015. ■

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 Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

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