LPL RESEARCH

WEEKLY MARKET COMMENTARY

April 2 2018

FIRST QUARTER MARKED BY RETURN OF VOLATILITY

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KEY TAKEAWAYS

The S&P 500 nine-quarter win streak has ended, with stocks down in a volatile first quarter.

Bright spots in the quarter's market performance included: growth, small caps, technology, consumer discretionary, and emerging markets.

While risks remain, market fundamentals have not deteriorated and economic growth remains on pace.

Market volatility resurfaced in the first quarter of 2018, following the stock market's calm and steady rise in 2017. This week's *Weekly Market Commentary* recaps first quarter stock market performance, discusses some of the themes that were in play, and summarizes our outlook for the rest of the year.

A LOOK BACK AT Q1

Stocks fell slightly in the first quarter, losing 0.8% on a total return basis and ending a streak of nine quarterly wins for the S&P 500 Index. The return of volatility was the big story of the quarter (besides the bull market's ninth birthday), as the index suffered its first 10% correction since January 2016. Weakness was driven by several factors that led to the return of market volatility:

- **Federal Reserve (Fed) fears.** Heightened concerns that the Fed would quicken its pace of rate hikes after a bigger than expected increase in wages was the primary catalyst that drove the stock market correction in late January through early February. In addition, markets tend to test new Fed chairs, as they did when Alan Greenspan, Ben Bernanke, and Janet Yellen began their terms. Jerome Powell's introduction was no different; in fact, Powell's welcome was one of the most unpleasant, with the S&P 500 tumbling more than 4% on his first day in the new role.

  Our view: We expect two more rate hikes in 2018, as we suspect the worst of the pricing fears will fail to materialize. We believe a move higher in the 10-year Treasury yield this year will be gradual and therefore manageable for the equity markets as inflation remains under control.

- **The short volatility unwind.** Though not the root cause of the correction, the sell-off intensified because of a complicated and crowded trade where investors essentially bet on volatility staying low. Once volatility began to increase in late January, many market participants who had aggressively expressed that view were caught on the wrong side of the trade.

  Our view: We believe the market disruptions from the unwinding of short volatility trades are largely behind us, though we continue to expect further, periodic bouts of market volatility over the course of 2018.

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- **Escalating trade tensions.** If an aggressive Fed is perhaps risk number one for this market, protectionist trade policy is probably "1A." Trade tensions escalated in March after several "tit for tat" tariffs from the United States, on an estimated $50 billion in Chinese goods, and from China, though only on about $3 billion in American goods. Though a full-blown trade war appears unlikely, uncertainty over trade measures and potential retaliatory actions may continue to weigh on investor sentiment. As discussed last week, we believe both sides have the willingness and wherewithal to negotiate.

  Our view: Bilateral negotiations with China may prevent an all-out trade war. We are encouraged by the relatively small economic impact of the announced tariffs (approximately $40 billion) relative to the amount of fiscal stimulus going into the economy this year (estimated $700–800 billion).

- **Soft first quarter economic data.** Investors have gotten used to this seasonal pattern (as discussed in this week's *Weekly Economic Commentary*), so weaker first quarter data seems to have done little to change growth or inflation expectations among market participants. The latest drop in Treasury yields may have been driven more by trade tensions than expectations that the slower pace of economic growth reflected in first quarter data would continue.

  Our view: We expect economic growth to accelerate in the second quarter, after a soft patch in the first quarter, as the impact of the new tax law kicks in and weather-related and other seasonal quirks in the data reverse.

- **Technology privacy and regulatory concerns.** Privacy-driven regulatory concerns contributed to technology sector weakness during the latter half of March, even though the sector still outperformed during the first quarter thanks to a strong January, February, and early March. Despite the strong quarter overall, technology's volatile March performance weighed on investor sentiment and, because of the sector's substantial weight, dragged down the broad indexes.

  Our view: We continue to favor the technology sector for its strong earnings growth, leverage to capital spending, and several powerful business trends, e.g., mobility, cloud computing, and artificial intelligence, as well as the sector's significant cash hoards overseas that are now being repatriated at reduced tax rates.

WHAT WORKED

Keeping those factors that contributed to the backdrop in mind, below is a quick overview of the asset classes and sectors that performed best within the equity market during the first quarter [Figure 1]:

- **Growth continued its long run.** Growth style outperformance, which has lasted the better part of 10 years, continued in the first quarter, based on the Russell style indexes. The top-performing sectors, technology and consumer discretionary, are both categorized as "growth" sectors, while value sectors including energy, financials, and utilities all lagged (though financials only marginally).

  Our view: We expect to see a reversal in this trend in 2018 and the start of value outperformance as the performance of the financials sector potentially improves.

- **Small caps slightly outpaced large and mid caps.** After lagging throughout much of 2017, the market finally began to recognize the relatively larger benefit from tax reform generally enjoyed by small cap companies. Escalating trade tensions also played a role, as smaller companies tend to be more domestically focused than their larger cap counterparts.

  Our view: We continue to recommend above-benchmark weightings in small caps, where appropriate.

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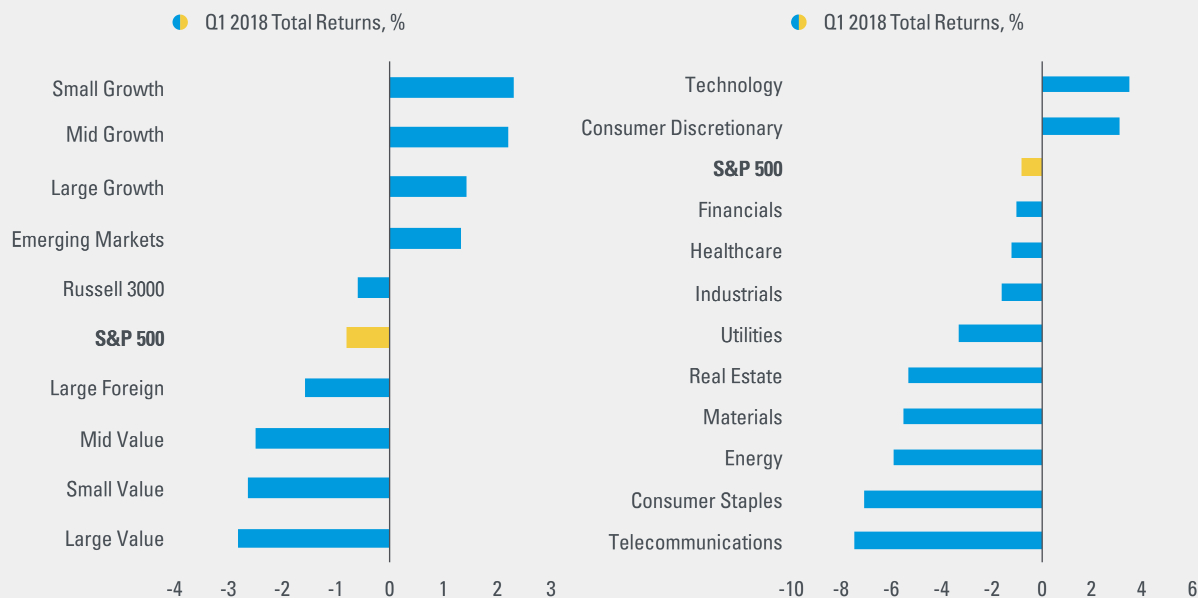
- **Emerging markets (EM) outperformed developed foreign.** EM equities benefited from strength in Brazil, Russia, and Taiwan, and a weak U.S. dollar, which enabled the asset class to generally shrug off global trade risk and outperform both the MSCI EAFE and S&P 500 indexes. Disappointing economic data weighed on European markets, particularly in Germany, while ongoing Brexit negotiations and strength in the British pound hurt the United Kingdom.

  Our view: We continue to favor EM over developed foreign equities.

CONCLUSION

After a great start to the year, the increased volatility over the past two months has been slightly unnerving for many investors. However, just because stocks were down in the quarter—and not by much—that does not mean that market fundamentals have deteriorated. While we acknowledge the risk associated with protectionist U.S. trade policy, we continue to expect accelerating economic growth this year, in large part due to the effects of the new tax law, which could give earnings a significant boost. We believe still-contained inflation and low interest rates are supportive of stock valuations at current levels. We reiterate our year-end fair value S&P 500 target of 2950–3000, representing a double-digit return for the year. We continue to recommend equity positioning that favors cyclical sectors, small caps, EM, and value over growth.* ■

1 GROWTH AND TECHNOLOGY LED MARKETS IN FIRST QUARTER 2018



Source: LPL Research, FactSet 03/29/18

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.

Because of their 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.

*LPL Research's S&P 500 Index total return forecast of 8–10% (including dividends), is supported by a largely stable price-to-earnings (PE) ratio of 19 and LPL Research's earnings growth forecast of 8–10%. Earnings gains are supported by LPL Research's expectations of better economic growth, with potential added benefit from lower corporate tax rates.

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

All investing involves risk including loss of principal.

DEFINITIONS

Small cap is a term used to classify companies with a relatively small market capitalization. The definition of small cap can vary, but it is generally a company with a market capitalization of between $300 million and $2 billion. The prices of small cap stocks are generally more volatile than large cap stocks.

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 MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East.

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization. Russell Growth style indexes measure the performance of companies with higher price-to-book ratios and higher forecasted growth values. Russell Value style indexes measure the performance of companies with lower price-to-book ratios and lower forecasted growth values.

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