LPL RESEARCH

WEEKLY MARKET COMMENTARY

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BEST QUARTER FOR STOCKS SINCE Q4 2013

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KEY TAKEAWAYS

We've just wrapped up the best quarter for the S&P 500 Index since the fourth quarter of 2013, despite a variety of challenges.

Continued strength in the U.S. economy and impressive growth in corporate America were key drivers of stock market performance last quarter.

The third quarter was a challenging one for the bond market, with the Bloomberg Barclays Aggregate Bond Index flat over the three months.

Investors endured a flurry of trade headlines and emerging market turmoil in the third quarter, but that didn't slow down U.S. stocks. The S&P 500 Index rose 7.2% during what has historically been the most volatile quarter of the year (7.7% including dividends), its biggest quarterly gain since the fourth quarter of 2013, its best performance in a third quarter since 2010, and the 11th gain in the past 12 quarters. It is also notable that the S&P 500 did not close up or down 1% on any day during the quarter, only the second time in history that feat has been accomplished during the usually volatile third quarter (1963 was the other time). Here we recap the third quarter and highlight some key factors for markets in the fourth quarter.

STOCK MARKET RECAP

The stock market's third quarter performance was impressive given the tariffs and trade tensions, but those weren't the only challenges. Fiscal stresses in Turkey sparked fears of contagion in emerging markets (EM), which entered a bear market in August. The Federal Reserve (Fed) raised interest rates for the eighth time this cycle last week and is on track to hike again in December. Long-term interest rates rose during the quarter, but the yield curve stayed flat in what some believe may be a sign of near-term economic weakness. The upcoming midterm elections introduce policy risk. Add to all that the fact that the third quarter has historically been the worst quarter for the stock market. Stocks sailed right through all of these headwinds, extending the longest bull market ever.

The strong performance of the U.S. economy was clearly a primary driver of the market's strength:

- Gross domestic product (GDP) grew at a very strong—though likely not sustainable—4.2% annualized pace in the second quarter (reported in late July). With continued support from fiscal stimulus, expectations are for solid 3% growth in the current (third) quarter, based on Bloomberg consensus forecasts.
- Manufacturing activity remains robust, with the Institute for Supply Management's Purchasing Manager's Index reaching a 14-year high in August.
- Business confidence is strong. Small business confidence in August reached its highest level since 1973, according to the National Federation of Independent Business. The Business Roundtable and *Chief Executive* magazine surveys of U.S. CEO confidence are both elevated.

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- Consumers remain upbeat, with the Conference Board's consumer confidence measure at an 18-year high.
- Job growth remains steady and income growth is accelerating, though not by enough to spook the Fed.

In addition to the solid performance of the U.S. economy, corporate America delivered one of its strongest quarters of earnings growth in decades, supported by tax reform. More stellar earnings growth—likely over 20% based on Thomson Reuters' consensus estimates—is expected in the third quarter. This would be the third consecutive quarter of earnings growth over 20%.

The overwhelming majority of recent data reflect a solid backdrop, but it's not all good news. The housing and auto markets cooled; tariffs have started to curb some capital investment; and growth in Europe is slowing.

MARKET LEADERSHIP

In terms of market cap, the globally focused large caps led during the quarter, which is encouraging given ongoing trade disputes with our largest trading partners. The U.S. dollar's advance paused, which helped U.S. multinationals relative to smaller more U.S.-focused companies. Large cap stocks in the healthcare, industrials, and technology sectors performed particularly well.

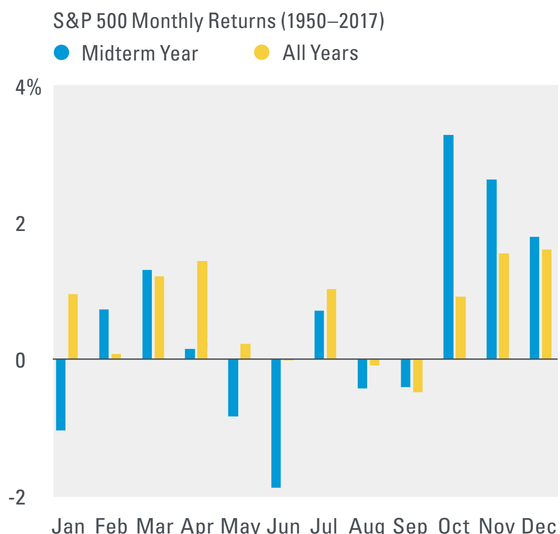
Growth stocks maintained leadership over their value counterparts, driven by solid gains for the growth-heavy technology sector. Meanwhile, weakness in the energy and utilities sectors weighed on value. Accelerating economic growth has historically boosted value, but the style has been held back by underperformance in the traditional value sectors.

By region, the U.S. was the place to be, as the S&P 500 strongly outpaced the MSCI EAFE and MSCI Emerging Markets indexes during the quarter. Flare-ups in EM led to some rotation from EM to the U.S., while the U.S. continued to lead major developed nations in economic and earnings growth. Strong gains in domestic consumer discretionary, healthcare, and technology stocks drove most of the performance gap between the U.S. and developed international markets.

SEASONAL TAILWIND?

Historically, the third quarter has seen the worst average performance for the S&P 500 among the four quarters. Stocks far exceeded their historical seasonal pattern last quarter and are up about 10% year to date based on the total return for the S&P 500 Index, which begs the question: Were gains from the seasonally strong fourth quarter potentially pulled forward? As shown in Figure 1, the last three months of the year have historically been the strongest, particularly during midterm election years (based on data back to 1950).

1 OCTOBER TENDS TO BE A STRONG MONTH FOR STOCKS DURING MIDTERM YEARS



Source: LPL Research, FactSet 09/28/18

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.

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.

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It is certainty possible that the historical fourth quarter tailwind could be muted somewhat given the strong gains this year. Political uncertainty may weigh on investor sentiment as the midterms approach. A strong performance from the Democrats may lead to some rollback of the Republican tax cuts next year. However, a late-year trade agreement with China, which is still our base case, could enable this strong seasonal pattern to hold. (The trade agreement between the U.S. and Canada reached over the weekend is a positive development on the trade front and has the fourth quarter off to a great start.) Investors may also like the political clarity that an election result would bring, regardless of the results.

QUICK THOUGHTS ON THE BOND MARKET

The third quarter was a challenging one for the bond market, with the Bloomberg Barclays Aggregate Bond Index flat over the three months. Year to date, the index is down 1.6%, setting up potentially one of the weakest years ever (the bond market benchmark has only had three down years since 1978). During the quarter, the yield on the 10-year Treasury rose from 2.85% to 3.06%, pushed higher by solidifying Fed rate hike expectations and a modest pickup in inflation.

We still suggest that suitable investors hold bonds in portfolios that may provide some cushion in the event of market declines. Higher rates offered by the short and intermediate parts of the yield curve have provided investors potential opportunities to generate a reasonable amount of income with relatively limited interest rate sensitivity. We continue to recommend mortgage-backed securities and investment-grade corporate bonds among high-quality fixed income options. For appropriate investors seeking more potential income, we suggest modest allocations to bank loans or high-yield bonds, which carry relatively less interest rate sensitivity than core, high-quality fixed income options but also tend to be more volatile due to credit risk. ■

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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.

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 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.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield. High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

Mortgage backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

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 Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

The Morgan Stanley Capital International Europe, Australia, Far East (MSCI EAFE) Index is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australia, and the Far East.

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.

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