Thoughts on the Market Sell-Off

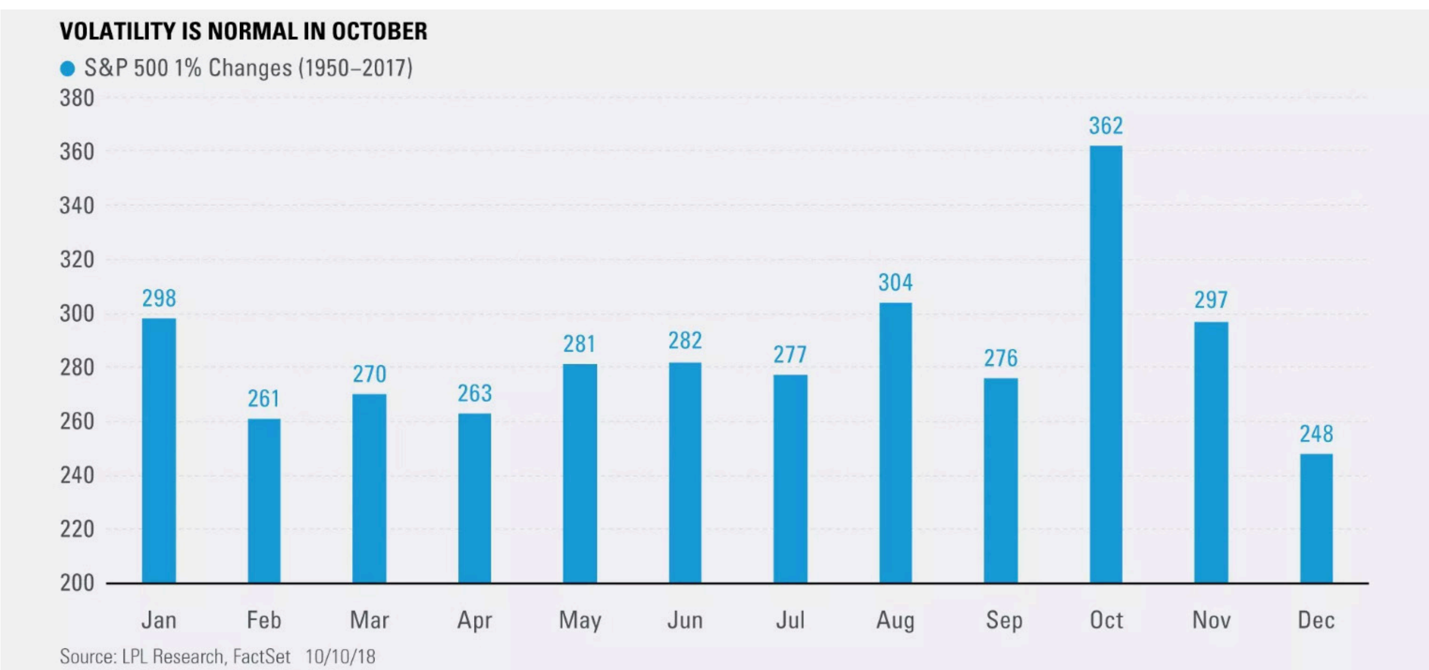
Stocks just had their worst one-day drop since February, as a combination of higher bond yields, U.S./China tensions, nervousness over the upcoming midterm elections, six straight months of gains, and worries about peak margins this earnings season all added up to a big sell-off.

“Volatility is back and it may require more active strategies on the part of investors to pursue their long-term goals. Volatility is also not to be feared, but embraced, as varying data points will cause bouts of market anxiety. But remember that fundamentals are still strong,” explained LPL’s Chief Investment Strategist John Lynch.

We know big drops can cause uneasiness and concern, so we wanted to share our perspective on the recent weakness and put the sell-off into context.

- **The S&P 500 Index had one of its least volatile third quarters in history.** In fact, it was the first year since 1963 that the index’s usually volatile third quarter didn’t have a single 1% change (up or down). The S&P 500 had gone 74 consecutive days without a 1% move—the 10th longest streak in history. The bottom line is: Equity markets were wound tight and some type of volatility was likely.

- **October has historically had above-average volatility and average returns.** October is known for spectacular crashes (1929, 1987, and 2008), but in reality it’s about average in terms of returns. What it really should be known for is volatility. Incredibly, no month has seen more 1% changes (up or down) than the month of October for the S&P 500 going back to 1950.



- **The economy is in excellent shape.** Consumer spending is growing solidly, consumer and business confidence is high, the job market is quite strong, manufacturing surveys are near record levels, and by historical standards, interest rates are still fairly low.

- **Stocks tend to do very well after midterm elections.** The average 12-month gain off midterm election year lows is over 30%, and since 1946 the S&P 500 has never been down 12 months following midterm elections. That means we may have just entered the best nine-month period for stocks in the entire four-year presidential cycle.

- **Pullbacks are normal.** Even though stocks tend to average a 7–8% gain each year, they also tend to have three to four pullbacks each year (5–10% drops) and at least one 10–20% correction.* We got both earlier this year but history tells us we may get more. Still, we see the potential for a year-end rally.

- **Corporate profits remain quite strong.** Consensus expects a 21% increase in S&P 500 earnings per share in Q3,** supported by strong U.S. economic growth and tax cuts. Over the past month, forward earnings estimates for the S&P 500 have risen by about 1%. The tariff impact has been minimal to date and repatriation has given companies a huge cash hoard that they may invest in growth or return to shareholders.

- **Weakness ahead of elections had been quite normal recently.** In fact, ahead of the November 2016 presidential election the S&P 500 fell nine consecutive days—one of the longest losing streaks ever. With the highly anticipated midterm elections coming up in November, some form of jitters isn't surprising.

- **Over time, stocks tend to do well as interest rates rise, as long as rates are rising because of better economic growth.** We believe that is the case now. When rates spike, as they have done in recent days, and as they did during the "taper tantrum" in 2013, volatility usually spikes as well. However, we think much of the increase in interest rates is now behind us, which should enable stocks to settle down in fairly short order. (See the recent Weekly Market Commentary, "The Dow Joins the Party" for more on stock performance during rising rate periods.)

- **All of our favorite leading indicators point to continued economic growth,** including the Leading Economic Index. As our Recession Watch Dashboard indicates, we see only early signs of excesses that have ended past economic cycles, such as excess leverage, over-spending, or extreme overconfidence. Even the yield curve has steepened some in recent weeks, a positive signal. We have a market-savvy Federal Reserve Chair who won't take a yield curve inversion lightly.

- **Despite tough rhetoric from both sides, we see a U.S./China trade deal as very likely.** Though a deal may not happen until after the midterms, the two parties have too much to lose economically and, especially in the case of the U.S., politically. Regardless, the amount of fiscal stimulus put into place in the U.S. this year is 3–4 times the dollar amount of the tariffs that have been implemented or threatened.

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*Data going back to 1950.

**Consensus estimates are according to FactSet.

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The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1928 incorporates the performance of predecessor index, the S&P 90.

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