LPL RESEARCH

WEEKLY MARKET COMMENTARY

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DEAL OR NO DEAL

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KEY TAKEAWAYS

Escalating U.S.-China trade tensions caused stocks to sell off more than 2% last week.

Globally exposed sectors paced last week's declines, namely materials, industrials, and technology.

The maximum peak-to-trough decline of less than 3% so far this year (as of May 10) is small by historical comparison.

U.S.-China trade tensions escalated last week. President Trump increased tariffs on $200 billion of Chinese imports to the United States from 10% to 25% and has threatened to put 25% tariffs on an additional $325 billion of Chinese goods—a process that could begin this week, though it would take a couple of months to implement.

Stocks reacted as you would expect, falling 2.1% over the five trading sessions. It could've been worse, but the S&P 500 Index gained 0.4% on Friday after Treasury Secretary Steven Mnuchin reported that talks on Thursday and Friday were constructive. Though this slide could certainly go further (and is, as of the morning of May 13), it has been quite modest to this point. In fact, as of its close May 10, the S&P 500 had not experienced more than a 3% pullback yet this year. Even with Monday morning's losses, the index sits only about 4% from its record closing high of 2945.83 on April 30, 2019. Here, we put this pullback in perspective and discuss prospects for a trade deal in light of the events of the past week.

PULLBACK IN CONTEXT

Last week's selloff was not very big, but it felt worse because of how quickly it happened (and at the intra-day lows, stocks were down more than 3%).

Some context here is helpful. Stocks have come pretty far pretty fast. Erasing corrections near or more than 20% in four months is very rare (the fourth quarter 2018 correction was within an eyelash of the 20% mark). In fact, 1998 was the last time this occurred, and before that, you have to go back to 1982.

Swift rallies like this have also tended to lead to drawdowns as stocks typically have lost steam midyear (as discussed in our recent "Sell in May" commentary). When the S&P 500 has been up over 14% year to date through April, as it was this year, the average peak-to-trough decline over the next six months has been 14%.

U.S. stocks were due some volatility. On average, the S&P 500 has pulled back 5% or more three to four times each year, and we are still working on our first one for 2019.

Since 1970, the S&P 500 has made it through the first five months of the year without at least a 3% pullback only twice—in the historically calm years of 1995 and 2017 [Figure 1]. On average the peak-to-trough pullback has been 8.5% during the first five months of the year.

Bottom line, this pullback has been modest, and a bit more volatility in the near term would be normal, even though we believe fundamentals remain solid.

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SECTOR DYNAMICS

Last week's sector performance clearly reflected the concern about trade, with the global industrials, materials, and technology sectors pacing the weekly decline in the S&P 500 [Figure 2]. These sectors have among the highest percentages of international revenues, particularly China.

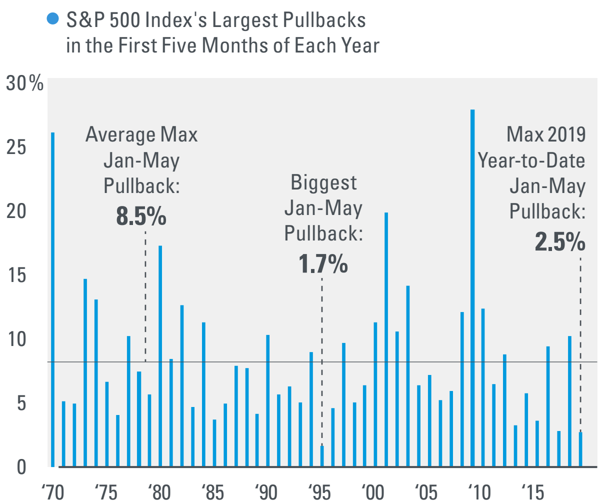
Materials have a lot at stake given that China has reportedly offered significant agriculture purchases as part of a potential agreement. Copper prices fell 1.5% last week, reflecting fears of weaker Chinese demand if tariffs remain in place.

Specific industry groups within industrials and technology have high exposure to China, such as aerospace and defense, machinery, and electrical equipment within the industrials sector. Strategas Research Partners highlighted Boeing (BA), Cummins (CMI), Emerson (EMR), and Ingersoll-Rand (IR) as industrial companies with above-average China exposure and active China lobbying efforts.

Within technology, semiconductors are heavily exposed to China, including Intel (INTC), Qualcomm (QCOM), Texas Instruments (TXN), and Applied Materials (AMAT) per Strategas. Software and services companies with high China exposure include Microsoft (MSFT), MasterCard (MA), and Visa (V).

We continue to favor financials, industrials, and technology. Industrials and technology are well positioned to benefit from a trade deal. Any potential pickup in economic growth resulting from a trade deal should help financials through more lending, higher asset prices, and a potentially steeper yield curve (a wider spread between short-term and long-term interest rates).

1 ONE OF THE CALMEST STARTS TO A YEAR IN DECADES

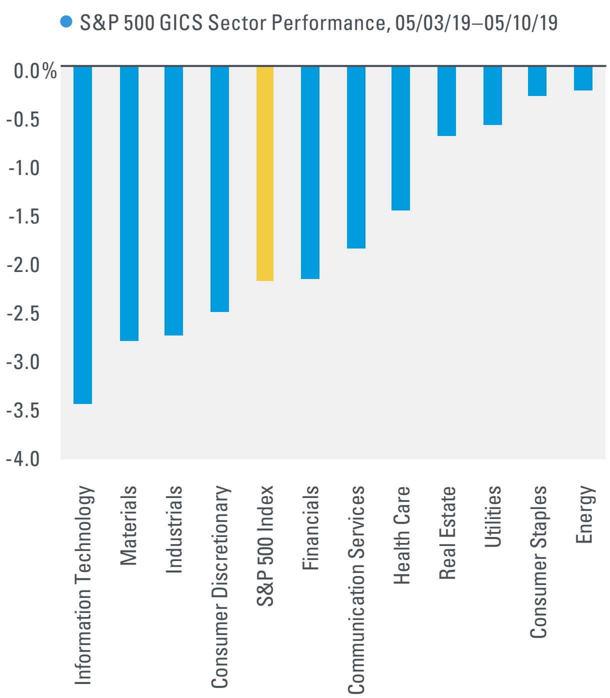


Source: LPL Research, Bloomberg 05/10/19

Our definition of pullback is based on distance from year-to-date highs on a closing basis.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

2 MOST GLOBAL SECTORS PACED LAST WEEK'S STOCK MARKET DECLINE



Source: LPL Research, FactSet 05/10/19

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WHY WE REMAIN OPTIMISTIC

Last week's headlines were unsettling, and clearly increased the odds of a prolonged trade war with China. While President Trump's latest moves caught us—and clearly markets—off guard, these developments have not changed our expectation that a deal is forthcoming. It may take a few more months, and market volatility may become the norm. It's impossible to know how far both sides are willing to go to get a better deal.

We remain optimistic for the following reasons:

- President Trump cares about the stock market. He considers it his report card.
- President Trump wants to be re-elected. A strong economy and healthy stock market are key components of his path to re-election.
- Both the United States and China have a lot to lose in a prolonged trade war. The relationship is symbiotic.
- The United States and China almost reached a deal earlier this month. We do not dismiss the risk of a longer stalemate, but reports that indicated a deal was very close tell us it is reasonable to think the remaining sticking points can be worked out.

CONCLUSION

We're not totally dismissing the possibility of a prolonged trade war, but we think cooler heads will eventually prevail. We may have to tolerate more volatility in the near term while President Trump and Chinese President Xi pursue a new path to compromise, and tariffs may remain in place for a while so President Trump can show he's playing hardball, while China can show it is willing to walk away.

We maintain our year-end S&P 500 fair value target of 3,000, about 4.0% from May 10's close. That target is based on a price-to-earnings ratio of 17.5 and our 2019 S&P 500 earnings forecast of $172.50. We continue to position portfolios with a market weight equities allocation with stocks near our target even after last week's decline and with the possibility of a pickup in volatility. We would be buyers on any material weakness assuming fundamentals remain consistent with what we see today. ■

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.

The economic forecasts set forth in this material may not develop as predicted.

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.

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.

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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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 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.

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