LPL RESEARCH

WEEKLY MARKET COMMENTARY

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BREAKOUT

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KEY TAKEAWAYS

This week we look at some interesting, under-the-radar breakouts in the economy and markets.

The breakout in economic surprises is a positive sign for the stock market and cyclical sectors.

The breakout in valuations suggests only potential moderate gains for stocks in the near term.

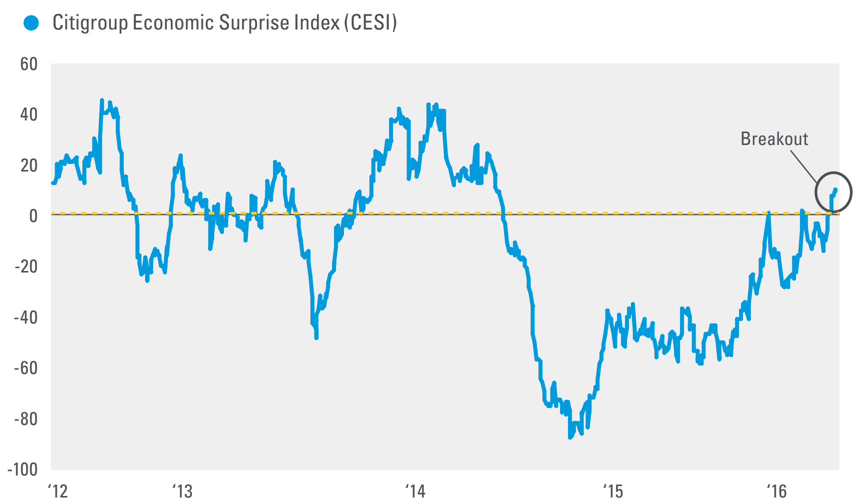
The breakout in emerging markets suggests strong recent performance for that group may continue.

The S&P 500, Dow Jones Industrials, and other major indexes have recently broken out to new highs. But this commentary is not about the breakouts in those indexes (check out lplresearch.com for more on those). Nor is this commentary about the classic video game called Breakout that debuted in the mid-1970s, which some of us more seasoned investment professionals recall. And it's definitely not about the 2008 Miley Cyrus album by that name (even though the authors of this report have six daughters between the two of them). In this week's commentary, we look at some interesting, under-the-radar breakouts in the economy and markets.

BREAKOUT #1: ECONOMIC SURPRISES

Many wonder how the stock market can do so well when S&P 500 earnings have not produced any gains since the second quarter of 2015, and even then earnings grew by a meager 1.3%. Valuations have risen, which has been helpful (more on that below). Central banks have also helped, which could explain why

1 ECONOMIC SURPRISES HAVE BROKEN OUT ABOVE ZERO FOR THE FIRST TIME IN 18 MONTHS



Source: LPL Research, Bloomberg 07/22/16

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

The Citigroup Economic Surprise Index is an objective and quantitative measure of economic news. It is defined as weighted historical standard deviations of data surprises. A positive reading of the Economic Surprise Index suggests that economic releases have on balance beaten consensus. The index is calculated daily in a rolling three-month window.

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the VIX measure of stock market volatility is sitting near post-financial crisis lows and about 7 points (or 35%) below its 25-year average. But another reason that few would cite is that economic data have been increasingly beating expectations—our first featured breakout.

The Citigroup Economic Surprise Index, or CESI, tracks how economic data are faring relative to expectations. The index rises when economic data exceed economists' consensus estimates and falls when data come in below estimates. After an 18-month stay in negative territory, the July 8, 2016 reading put the index above zero [Figure 1].

Economic growth has not picked up during this time period but the data have been better than expected, supporting stocks during their recent ascent—including the month since the Brexit vote in the U.K.—highlighted by the June Institute for Supply Management (ISM) Purchasing Managers' Index (53.2 versus 51.4 expected) and the June Employment Situation report (287,000 net new jobs versus 175,000 expected).

More data beats than misses is an encouraging sign for stocks. Over the past 10 years, when the CESI breaks above zero (14 instances), the S&P 500 was higher over the subsequent 6 months 79% of the time with a median gain of 5.2% (the average is lower, dragged down by a 35% drop in 2008). Excluding the Great Recession, stocks rose in 11 of 12 instances with a median gain of 6.3% (and an average of 6.9%) over the subsequent 6 months. We have also observed better performance from the more economically sensitive sectors in these scenarios. Both good signs.

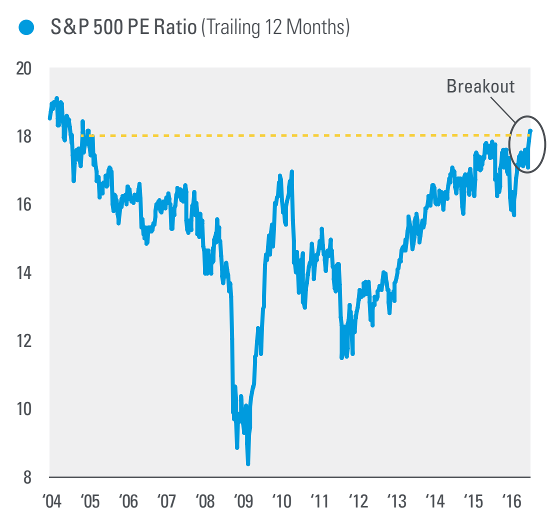
The second quarter 2016 gross domestic product (GDP) report will be released this Friday, July 29, which may deliver another surprise. GDP is expected to pick up strongly from the tepid 1.1% annualized growth rate posted in the first quarter of 2016. The Bloomberg consensus forecast for the second quarter is 2.6%.

Something else that is poised for a breakout after an extended stay below zero is earnings growth. After what will likely make four consecutive quarters of earnings declines in the second quarter of 2016, consensus estimates are calling for a modest low-single-digit gain in the third quarter. More on earnings in the coming weeks.

BREAKOUT #2: VALUATIONS

Our next breakout is not as upbeat, and that is valuations. Based on the trailing 12 months price-to-earnings ratio (PE), one of our preferred valuation measures, stock valuations have broken out to a new post-financial crisis high. In fact, you have to go back more than 11 years—to November 2004—to find a higher PE than the current 18.3 [Figure 2].

2 VALUATIONS ARE AT POST-FINANCIAL CRISIS HIGHS



Source: LPL Research, FactSet 7/22/16

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Trailing price-to-earnings ratio (PE) is the sum of a company's price-to-earnings, calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months. This measure differs from forward PE, which uses earnings estimates for the next four quarters.

These lofty valuations are understandably concerning to many. Most bull markets since WWII have ended at similar PEs to where we are today (the 1990s bull market ended at a much higher valuation of near a 30 PE). These multiples are now above long-term averages. Stock market corrections tend to be more painful when they come at higher valuations.

Even more worrisome, some other valuation measures look even more stretched than this one. Professor Robert Shiller's Cyclically Adjusted PE ratio (or CAPE), which uses 10-year average S&P 500 earnings, is over 26, versus a long-term average at 17. The median PE for stocks in the S&P 500 is 23, compared with an average of 17. And the S&P 500 PE based on GAAP, or as reported accounting earnings, is 21, above its average at 18. These are all valid concerns and certainly play into our cautious second half outlook for stocks.

Two things keep us from getting overly worried about this breakout. One, valuations have not historically been good market timing tools (Shiller publicly admits this about his own valuation metric). From year to year, it is random whether higher or lower valuations will lead to better returns. And second, inflation and interest rates are low. Lower interest rates and less inflation make future earnings more valuable and make bonds a less attractive opportunity than stocks. We continue to watch for downside catalysts that may suggest valuations will become problematic.

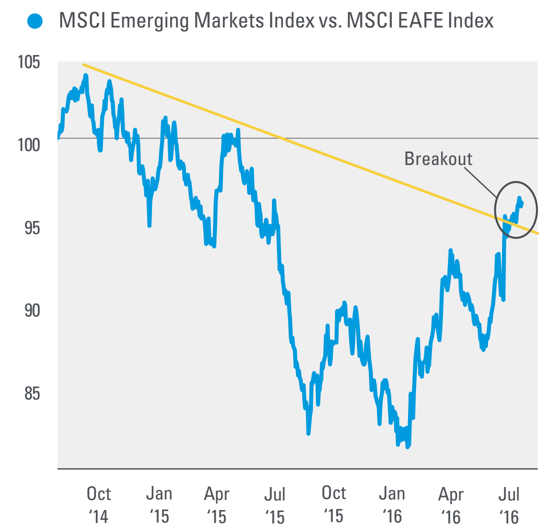
The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

BREAKOUT #3: EMERGING MARKETS

Emerging markets (EM) is another group that is on the verge of a potential breakout. EM has been a major underperformer relative to U.S. equities over the past five years, mainly due to a combination of earnings weakness, commodity declines, political strife, and U.S. dollar strength. With commodities performing well so far this year and earnings and currency stabilizing, EM has finally begun to reverse the tide.

EM is not near a breakout on an absolute basis like the S&P 500—the MSCI Emerging Markets Index is still more than 30% below its all-time high set back in October 2007. But on a relative basis versus developed foreign markets, EM has broken above a two-year downtrend line [Figure 3].

3 EMERGING MARKETS IN PROCESS OF BREAKING TWO-YEAR DOWNTREND



Source: LPL Research, FactSet 7/22/16

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The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is a free float-adjusted, market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.

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After numerous head fakes in recent years, it may be a good time to accumulate this beaten down group from a technical perspective.

In next week's *Weekly Market Commentary*, we will continue the breakout theme and discuss some sentiment indicators that could be considered breakout candidates and potential contrarian bearish indicators.

CONCLUSION

The breakouts for the S&P 500 and the Dow Jones Industrials are getting the most attention, but they are not the only ones. The breakout in economic surprises is a positive sign for the stock market and cyclical sectors, though the breakout in valuations suggests only potential moderate gains for stocks in the near term. Finally, the breakout in emerging markets, coupled with improving fundamentals and attractive valuations, suggests strong recent performance for that group may continue. ■

Thanks to Ryan Detrick for his contributions to this commentary.

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 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, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

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.

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 Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries and widely held by individuals and institutional investors.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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