Weekly Market Commentary

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Another Great Year Ahead for Stocks

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Highlights

Stocks have posted the most consistent gains when GDP has been around 3%, our forecast for 2014.

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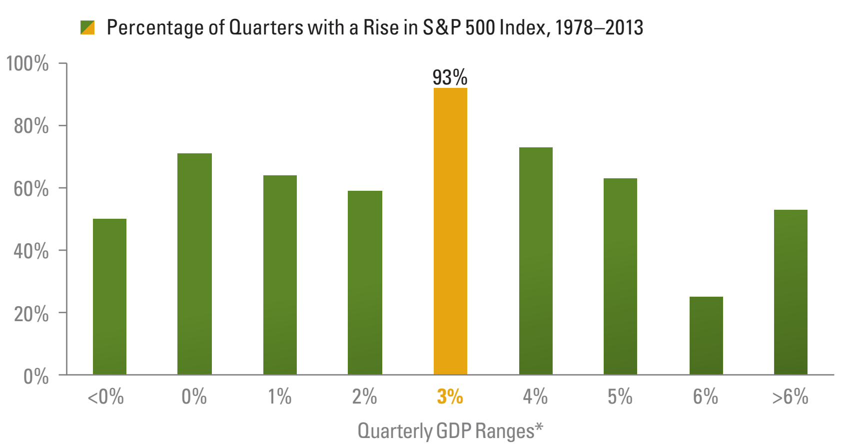
Stock market investors should be rooting for low single-digit economic growth next year—and the reason why has nothing to do with the Federal Reserve (Fed).

We forecast a low double-digit gain of 10–15% for U.S. stocks in 2014, as measured by the S&P 500 Index. This forecast for a slightly above-average annual return is rooted in our expectations for high single-digit earnings growth and a modest rise in the price-to-earnings (PE) ratio. An improvement in economic growth to an average 3% pace in 2014 should drive solid profit gains and boost confidence in the durability of growth.

Contrary to conventional wisdom, and what may be a surprise to those who see low single-digit rates of gross domestic product (GDP) growth as incompatible with solid double-digit stock market gains, GDP does not have to be booming to produce solid gains in the stock market—as 2013 can attest. In fact, there is little relationship between the magnitude of GDP growth and stock market performance.

There are perfectly logical explanations for this counter-intuitive fact. Strong GDP can be a sign of an overheating economy that may be due for

1 Stronger Is Not Always Better: Stocks Have Posted Gains Most Consistently When GDP Has Been Around 3%



Source: LPL Financial Research, Bloomberg data 12/02/13

*+/-0.5% around GDP (example: 3% includes those quarters with GDP above 2.5% and below 3.5%)

The S&P 500 is an unmanaged index which 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.

Past performance is no guarantee of future results.

a recession, and weak GDP may be discounted by the stock market ahead of an actual turnaround. As evidence, over the past 35 years, the S&P 500 posted gains in half of the 16 quarters that GDP was negative. Also, over the same time period, the S&P 500 posted gains in only about half of the quarters when annualized GDP was stronger than 6% and booming.

Historically, stocks have posted the most consistent gains when GDP has been around 3%.

Historically, stocks have posted the most consistent gains when GDP has been around 3%. When GDP for a quarter was within plus or minus a half of a percentage point of 3%, the S&P 500 posted an average gain of 6.5% during that quarter—the highest of any 1% range in quarterly GDP and nearly triple the 2.4% gain when GDP was more than twice as strong. Even more impressively, when GDP was around 3%, the S&P 500 posted a gain in 22 of the 24 quarters [Figure 1]. That 93% batting average stands well above other GDP 1% ranges, even those with stronger growth, and is much higher than the 66% average for the whole 35 year period.

Looking back further to a full calendar year of GDP growth, rather than the usual annualized quarterly pace of GDP growth, we can see that 3% remains the sweet spot for economic growth as it pertains to the stock market. Since WWII, U.S. GDP of plus or minus 1% around the long-term average of 3% has produced an average gain of 16% in the S&P 500 and produced a positive return 83% of the time.

This is not just true of the United States; around the world GDP and stock market performance have not been closely related. For example, in 2013, the relatively sluggish pace of economic performance in the United States and Europe was not an impediment to much stronger stock market performance than in emerging markets that boast much faster economic growth rates. An example can be seen with Brazil and Spain. Brazilian GDP is expected to be 2.5% in 2013, while the stock market has declined 24.6%, measured by the Ibovespa Index in dollar terms year to date through last Friday. In Spain, GDP is expected to be negative while the stock market in Spain is up 24.3% this year, measured by the IBEX 35 Index also in dollar terms year to date through last Friday.

The risk to our forecast is from growth disappointing our expectations, not from policymakers derailing the recovery. Volatility in the months ahead is more likely to come from "growth scares," when economic data may temporarily disappoint expectations on a path to better growth in 2014, rather than from the antics in Washington. A key lesson from 2013 is that the stock market and economy can overcome many challenges by policymakers, including the fiscal cliff tax increases, the sequester spending cuts, the Fed tapering concerns, and the shutdown and debt ceiling brinkmanship. But a better pace of growth must materialize to find the growth sweet spot for clients; just more bond buying by the Fed is not enough to lift valuations from current levels to propel further gains. ■

Our stock market forecast is derived from earnings per share (EPS) for S&P 500 companies growing 5 - 10% and a rise in the price-to-earnings ratio (PE) of about half a point from just under 16 to 16.5, leaving more room to grow. The PE gain is due to increased confidence in improved growth allowing the ratio to slowly move toward the higher levels that marked the end of every bull market since World War II (WWII).

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 reference is historical and is no guarantee of future results. All indices 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. Past performance 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.

Stock and mutual fund investing involves risk including loss of principal.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The P/E 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 P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

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 Ibovespa Index is a gross total return index weighted by traded volume and is comprised of the most liquid stocks traded on the Sao Paulo Stock Exchange.

The IBEX 35 is the primary stock index for securities traded on the Madrid Stock Exchange. It tracks large-cap stocks and is weighted for market capitalization. It was established in 1992.

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