Weekly Market Commentary

January 21, 2014

The Meryl Streep of the Stock Market

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

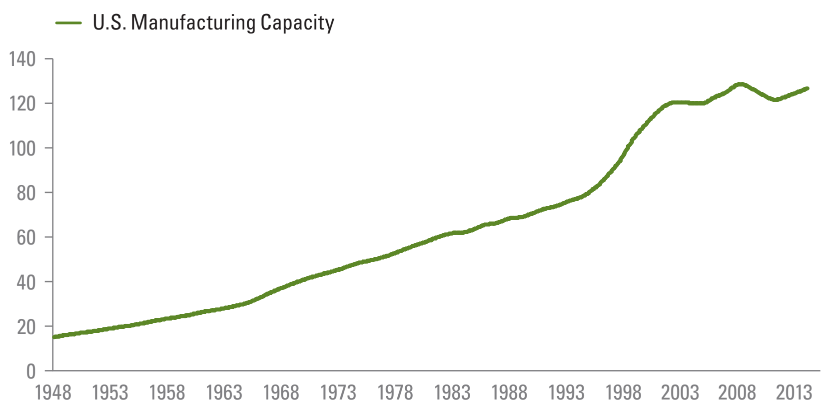
Highlights

Business spending may be the best actor supporting the stock market with the industrials sector taking a leading role and delivering a performance worthy of an award.

Some things just go together — like the Oscars and Meryl Streep. The actress received her 18th Academy Award nomination last week. It is not all that surprising since half of the annual Academy Awards over the past 36 years have featured Meryl Streep as a nominee. While not as well known, business spending and stock market gains go together at least as well — especially when it comes to renewed spending by manufacturers and the stocks in the industrials sector.

Last week's monthly report of U.S. factory capacity utilization, which measures the percentage of maximum potential output currently in use, reached the highest level since mid-2008. The drawdown in spare capacity highlights how long it has been since capacity has been expanded for America's manufacturers. After a binge of investment in the late 1990s, almost no growth has occurred in manufacturing capacity in a decade [Figure 1].

1 U.S. Manufacturing Capacity Has Flatlined



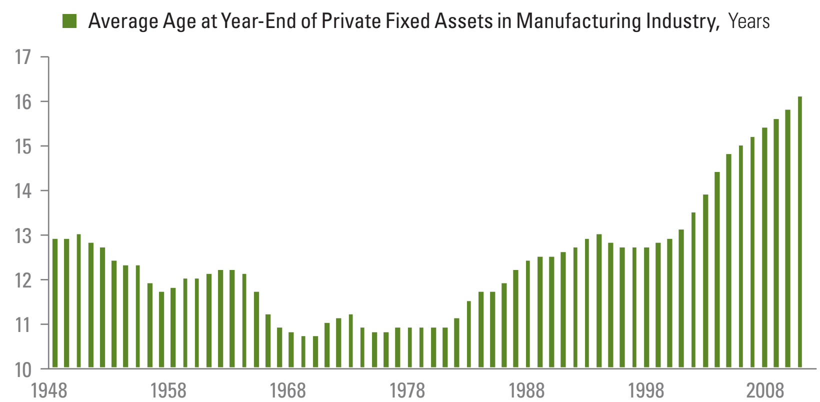
Source: LPL Financial Research, Federal Reserve 01/21/14

Past performance is no guarantee of future results.

If sales accelerate on better domestic and global economic growth in 2014, manufacturers will likely look to upgrade capacity in order to maintain profit margins on increased output.

No new investment in capacity in 10 years means that equipment and plants have aged and are now old by any historical comparison [Figure 2]. A consequence of aging equipment is that productivity decreases as older machines tend to break down more often and require more maintenance, leading to more costly operation. At capacity utilization of 79.2%, manufacturers still have more than 20% of full capacity to spare and seemingly have no need to expand. However, this is misleading since the remaining spare capacity is old and no longer efficient to operate. If sales accelerate on better domestic and global economic growth in 2014, manufacturers will likely look to upgrade capacity in order to maintain profit margins on increased output.

2 Average Age of Manufacturing Plant and Equipment



Source: LPL Financial Research, Bureau of Economic Analysis 01/21/14

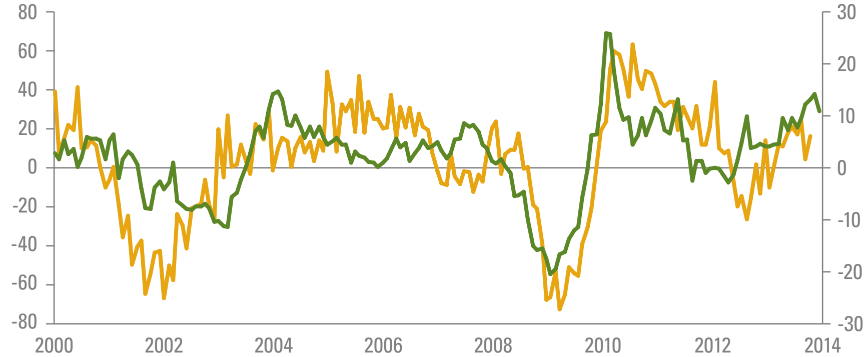
Past performance is no guarantee of future results.

New investment is likely as sales growth rises in 2014 and in some areas is already taking place. Recent reports, including those from last week such as Federal Reserve's (Fed) Beige Book (see this week's *Weekly Economic Commentary* for details), business and manufacturing surveys from New York and Philadelphia Fed districts, and corporate earnings reports highlighted an improved outlook for expenditures by manufacturers on plant and equipment.

The industrials sector is a key beneficiary of growth in spending on equipment by manufacturers [Figure 3]. An example of an industry within the industrial sector that benefitted from added spending on plant capacity in 2013, and is positioned to do so again in 2014, is the engineering and construction industry [Figure 4]. Finally, the U.S. energy renaissance, which is helping to power the renewed uptrend in spending by manufacturers, has been helping to power railroad stocks with a rapidly increasing demand for petroleum railcar shipments [Figure 5].

3 Business Spending on Equipment Should Benefit Industrials Sector

— S&P 500 Industrials Index, Year-Over-Year, % *(Left Scale)*
— New Orders for Non-Defense Capital Goods Excluding Aircraft and Parts Year-Over-Year, % *(Right Scale)*



Source: LPL Financial Research, Bloomberg data 01/21/14

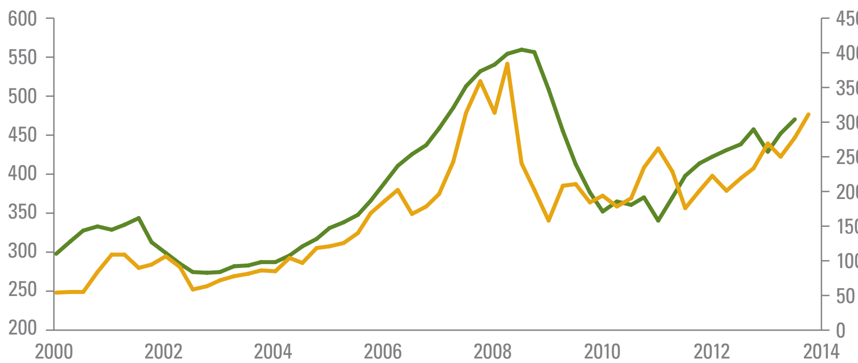
Past performance is no guarantee of future results.

The industrials sector is a key beneficiary of growth in spending on equipment by manufacturers.

The S&P Industrials Index is comprised of companies whose businesses: Manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

4 Engineering and Construction Stocks May Benefit From More Spending on Structures

— U.S. Nominal Business Spending on Structures *(Left Scale)*
— S&P 500 Engineering & Construction Index *(Right Scale)*



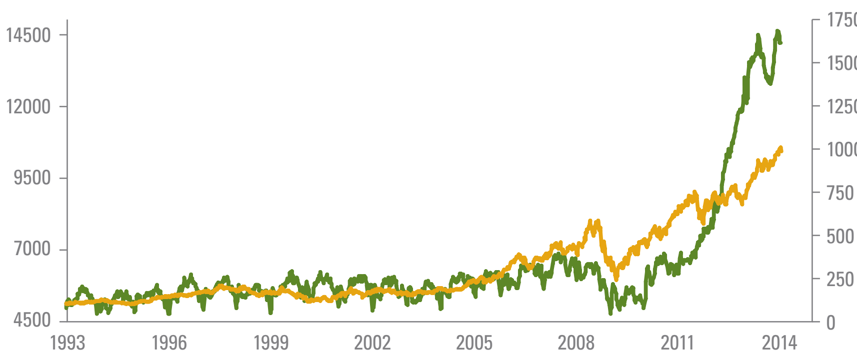
Source: LPL Financial Research, Bloomberg data 01/21/14

Past performance is no guarantee of future results.

The S&P Engineering and Construction Index consists of the 10 largest stocks from engineering and construction sector in the United States. The S&P Railroad Index consists of the 4 largest stocks from Railroad sector in the United States.

5 U.S. Energy Renaissance Positive for Railroads

— U.S. Railroad Freight Petroleum Carloads Four-Week Moving Average *(Left Scale)*
— S&P 500 Railroads Index *(Right Scale)*



Source: LPL Financial Research, Association of American Railroads, Bloomberg data 01/21/14

Past performance is no guarantee of future results.

Investing in specialty market and sectors carry additional risks such as economic, political or regulatory developments that may affect many or all issuers in that sector.

If sales growth does improve in 2014, as gross domestic product (GDP) growth accelerates, business spending may be the best actor supporting the stock market with the industrials sector taking a leading role and delivering a performance worthy of an award. ■

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.

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.

RES 4473 0114
Tracking #1-238654 (Exp. 01/15)