LPL RESEARCH

WEEKLY MARKET COMMENTARY

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THAT WAS THE EASY PART

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KEY TAKEAWAYS

Stocks posted their best January in more than 30 years after a historically bad December.

Stocks' bounce was the easy part; the next 10% will likely be much harder.

There are technical signs that suggest December marked a major low and potentially higher prices are ahead.

2019 is off to a roaring start, as the S&P 500 Index gained 7.9% for its best January since 1987. Stocks' strong January comes on the heels of the worst December in 87 years. What happens now? This week we will discuss why we see signs that point to higher prices, why the easy gains have likely already occurred, and what several key hurdles lie ahead.

IMPRESSIVE RALLY OFF THE LOWS

Since its low on December 24, 2018, the S&P 500 is up 15% (through 02/01/19) after investors bargain shopped. With the focus now shifting to trade, corporate profits, and clarity on Federal Reserve (Fed) policy, this was the easy part of the bounce; the next 10% will likely be harder.

After the worst fourth quarter since the Great Depression, which included a nearly 20% drop leading to December 24 and a 9% drop in December alone, equities were extremely oversold, so a healthy bounce wasn't a big surprise. Importantly, we've recently learned that much of the selling during the second half of December was hedge fund driven. Once the S&P 500 broke the triple bottom support near 2,600–2,625, we saw massive indiscriminate selling, which is often tied to hedge funds. In fact, hedge fund liquidations in December were the largest in any month this cycle, so much of the selling took place during a perfect storm of worry and computer-driven trading.

Can stocks gain another 10% this year and make new highs along the way? We think it's possible, but it won't be easy. Trade tensions continue to linger, although we do see the potential for some type of resolution between the United States and China over the coming months. Fourth-quarter corporate profits are once again very solid, albeit at a slower rate of growth than in the third quarter. The Fed announced last week that it would pause interest rate hikes and was open to slowing its balance sheet runoff. (The Fed has been slowly reducing the amount of Treasuries and mortgage-backed securities on its balance sheet following purchases made during the 2007–2009 financial crisis to stabilize the economy.) As we noted last here last week, stocks have tended to hold up well during Fed pauses.

We do think enough of these uncertainties will eventually resolve in a way that markets can discount and lead to higher prices.

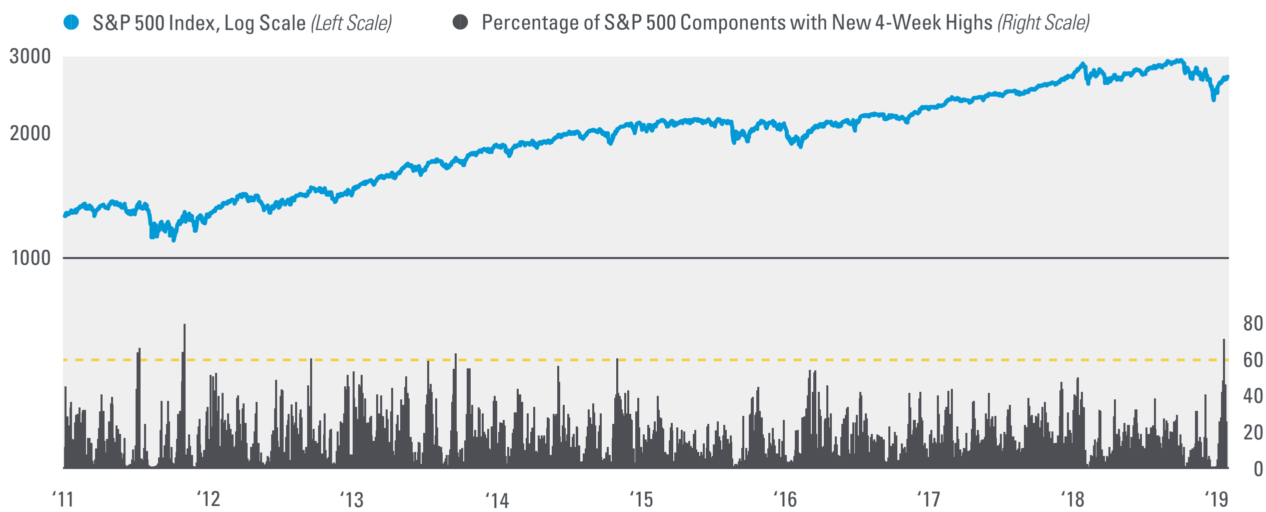
W OR V BOTTOM?

The big question is: Will the S&P 500 retest the December 24 lows? History is littered with retests of previous lows, which is affectionately called a "W bottom," as the shape of the price pattern resembles a W shape. Just look at the last few major corrections: There was a double bottom in August and October 2011, a double bottom in August and September 2015, a double bottom in January and February 2016, and a double bottom in February and April 2018. Recent history would say the December lows will likely be retested sometime soon.

The other type of bottom is a "V bottom," which doesn't include a retest and is shaped like the letter V. Here's the catch: We do see growing evidence that we could be looking at a V type of bottom this time around. As Figure 1 shows, 71% of the components in the S&P 500 recently reached new 4-week highs. This type of extreme strength is very rare and is usually a sign the lows have been made and higher prices are yet to come. In fact, the last time we saw this many of the S&P 500 components make a new 20-day high was in October 2011, showing just how rare this is.

Since 1990, stocks have booked strong 3-, 6-, and 12-month returns after at least 60% of S&P 500 components made a new 4-week high, thus increasing the odds of a V bottom this time around, as shown in Figure 2. In fact, stocks have been higher a year later every single time.

1 BIG SURGE IN 4 WEEK HIGHS



Source: LPL Research, Bloomberg 01/31/19

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. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

Some other important considerations:

- Stocks have risen during the third year (pre-election year) of every four-year presidential cycle since 1939.
- The S&P 500 historically has gained an average of 32% in the 12 months following the midterm-year lows and has been higher every single time since World War II.
- Stocks gained last Wednesday after the Fed meeting. This was the first time this has happened under Fed Chair Jerome Powell. Is this yet another clue the markets and the Fed are seeing more eye to eye?
- You can have a bear market without a recession, and historically these bottom near a 20% correction—exactly where the recent correction ended.

CONCLUSION

The easy gains are likely over, but we still think the S&P 500 can make its way to new highs before year-end. History shows we typically see a W and not a V bottom, but given that the selling in December was likely hedge fund liquidations, coupled with 71% of stocks in the S&P 500 recently hitting 20-day highs (learn more in our *Market Signals Podcast*), the chances it is a V bottom have significantly increased in our view.

As we discussed in our *Outlook 2019*, focusing on improving fundamentals will be important throughout the year. We are encouraged by the improving technical backdrop along with steady U.S. economic growth, the ongoing effects of fiscal stimulus, mid-to-high-single digit earnings gains, and a potential (we think likely) U.S.-China trade agreement—all of which should support solid gains ahead in 2019. ■

2 LARGE THRUSTS OF S&P 500 INDEX COMPONENT 4-WEEK HIGHS HAVE LED TO STRONG FUTURE RETURNS

Date	S&P 500	60% or More at a 4-Week High	3-Month Return	6-Month Return	12-Month Return
02/07/91	356.52	62.9%	7.5%	9.2%	16.1%
12/30/91	415.14	66.3%	-2.9%	-1.5%	5.8%
05/05/97	830.24	69.9%	14.5%	10.2%	34.4%
03/21/03	895.79	65.6%	11.2%	15.7%	22.3%
06/02/03	967	61.0%	4.2%	9.4%	15.9%
07/23/09	976.29	64.0%	10.8%	11.8%	12.9%
07/01/11	1339.67	63.6%	-15.5%	-6.1%	1.9%
10/24/11	1254.19	64.0%	5.7%	10.9%	12.7%
09/14/12	1465.77	60.4%	-2.4%	6.3%	17.7%
09/18/13	1725.52	63.4%	3.2%	8.5%	16.6%
10/31/14	2018.05	60.4%	1.6%	3.5%	4.3%
01/18/19	2670.71	71.5%	?	?	?
		Average	3.4%	7.1%	14.6%
		Median	4.2%	9.2%	15.9%
		Percent Higher	73%	82%	100%

			S&P 500 Returns Since 1990		
			3-Month Return	6-Month Return	12-Month Return
		Average	2.1%	4.3%	9.0%
		Median	2.8%	5.2%	10.9%
		Percent Higher	68.7%	74.6%	79.4%

Source: LPL Research, Bloomberg 01/31/19

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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.