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RETEST

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KEY TAKEAWAYS

Last week's losses were driven primarily by increased recession fears related to U.S.-China trade tensions, a possible Fed policy mistake, and sharply lower oil prices.

Recent volatility may have provided one of the most important ingredients of a stock market bottom: fear.

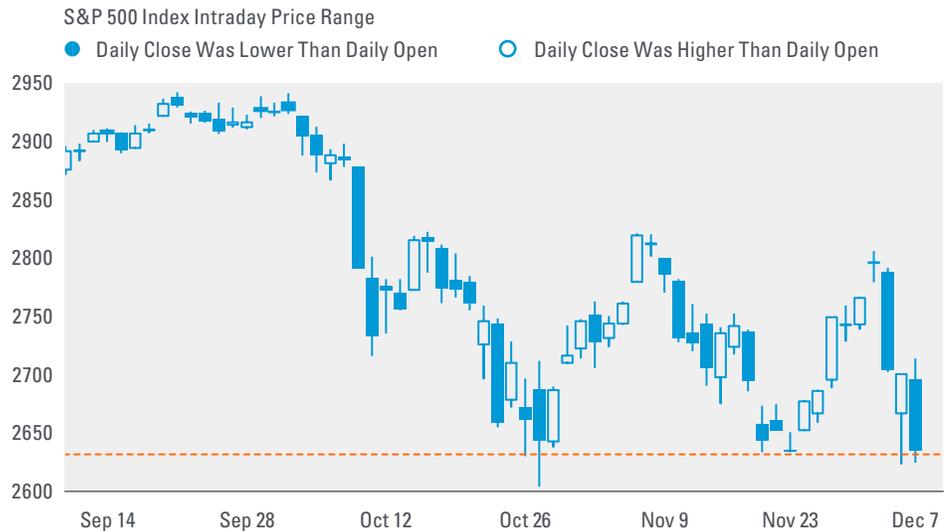
We see elevated put/call ratios, increased trading volume, and extremely negative breadth as signs of fear, a potentially bullish development with the S&P 500 at/above recent lows.

We view last week's market decline as a retest of the October–November lows. The S&P 500 Index fell 4.6% last week, leaving the index in line with the low of the autumn correction and 10% off the September highs [Figure 1]. Losses were driven primarily by three issues: the risk that U.S.-China trade talks fall apart, concerns about a Federal Reserve (Fed) policy mistake, and sharply lower oil prices, all of which contributed to increasing concerns about slowing global growth or potential recession. This week, we summarize our views on these issues and discuss prospects for a potential stock market rebound based on technical analysis.

TRADE PROGRESS HAS BEEN MADE

We continue to see the U.S.-China trade dispute as the biggest headwind for stocks. Against that backdrop, it's understandable that stocks threw a tantrum after U.S. trade officials walked back part of the apparently overly optimistic initial recount of

1 POSSIBLE TRIPLE BOTTOM FORMING ON S&P 500 INDEX?



Source: LPL Research, Bloomberg 12/10/18

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.

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

the Trump-Xi meeting at the G20 summit that has given rise to the admittedly already overused “he said, Xi said” phrase on Wall Street (Xi is pronounced “she”).

The initial reaction to the Trump-Xi dinner at the summit was positive, with the United States suspending plans to raise tariffs to 25% on January 1 while the two countries intensify talks to work toward a resolution over a 90-day period (a so-called “trade truce”), ending March 1. After the G20, we emphasized that, while not a resolution, a path toward progress on trade should be viewed favorably. Unfortunately, mixed messages have come from both sides in recent days. For more on trade, see today’s [Weekly Economic Commentary](#).

We do not expect the arrest of an executive from Chinese telecom equipment provider Huawei to derail a possible trade deal. Importantly, credible Chinese officials expressed optimism for an eventual agreement after that news came out.

WORRISOME SIGNALS?

Risk of a full-blown trade war with China and some potentially concerning market signals have increased fears of recession. One such signal is the inversion of the short end of the yield curve, including the spread between 2- and 5-year Treasuries.

But the yield curves that have historically been more predictive of future recessions (2-year and 10-year, and 3-month and 10-year Treasuries) have not inverted. And even if they do, history shows stocks can continue to go higher for a year or two. We believe the bond market is sending a slower growth signal, and is not signaling a recession in 2019. Low interest rates overseas continue to put downward pressure on long-term rates in the U.S.

Sharply lower oil prices are also being cited by some as a sign of an impending recession. But oil’s weakness has been driven mostly by supply issues, including Iran sanctions, record levels of

U.S. production, and elevated domestic inventories. We think OPEC’s decision to cut 1.2 million barrels of production at its December 6–7 meeting is a positive step toward resolving oil’s supply problem and can help stabilize prices.

Bottom line: When we look at these and our other favorite leading indicators, we believe the odds of recession in the U.S. in the coming year are low.

RISK OF A FED POLICY MISTAKE HAS EASED

Fears of a policy mistake by the Fed have also caused recent market weakness. The Fed has been a cause of past recessions and could be again. But we believe Fed Chair Jay Powell’s speech on November 28 provided evidence of more flexibility from the Fed, thereby limiting the chances of over-tightening. Powell essentially told the markets the central bank would not be as aggressive in 2019 as many feared.

Also consider last week’s *Wall Street Journal* report that Fed officials were actively considering signaling a wait-and-see mentality after their likely interest rate hike in December (odds of a December hike being priced in by the bond market have fallen by 12 percentage points to 69% since Powell’s speech).

We think falling asset prices, slower economic growth overseas, tariffs, housing market softness, falling oil prices, and lower inflation expectations all add to the Fed’s “cover” to ease up on rate hikes, which could be a positive stock market catalyst in the coming weeks.

BOTTOMING PROCESS PROGRESS

From a technical analysis perspective, the S&P 500 continues to be range-bound between 2630 on the low end and overhead resistance at 2817. However, recent volatility within this range may have provided one of the most important ingredients of a stock market bottom: fear.

As the S&P 500 Index tumbled more than 6% in just two days last week, we saw elevated put/call ratios, increased volume, and extremely negative breadth, all of which gave a “sell what you can” feel to the market. We see these signs of fear—as the S&P 500 remained above recent lows—as bullish. Perhaps more important than the sentiment indicators, though, was the reversal off of support Thursday, which means we may be forming a triple bottom around the 2640 level of the benchmark index, as shown in [Figure 1](#). This retest of prior lows is an important part of the bottoming process.

Looking forward, we would like to see strong demand for stocks following the extreme risk-off mentality. This could potentially be in the form of strong breadth (significantly more advancers versus decliners), small-cap leadership, or a reversal of recent leadership from defensive sectors such as utilities and into more economically sensitive sectors such as financials and industrials. Above the 2817 level on the S&P 500, stocks may encounter resistance near 2870, while on the downside, below Friday’s closing low (2633), we would look to the intraday lows from February, near 2530, as the next level of support.

CONCLUSION

These issues need to be monitored, but they do not change our opinion that U.S. stock market fundamentals remain generally favorable. Moreover, we think stock prices are reflecting much of the risks discussed above, and the latest move lower represents a retest of recent lows, not the start of a bear market. At the same time, we are mindful of the impact that lower asset prices and the slowdowns in business investment and home prices can have on consumer sentiment and corporate confidence.

We recognize that market volatility can weigh on investor confidence and encourage investors to focus on the many fundamentals supporting growth in the economy and corporate profits. We reiterate our fair value range of 2900–3000 for the S&P 500 at year end. Although stocks may run out of time to get there in 2018, with only 15 trading days remaining, we believe the S&P 500 is trading below fair value and see potential for solid gains for stocks in the year ahead. ■

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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 1928 incorporates the performance of predecessor index, the S&P 90.

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