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RIDING THE WAVE...FOR NOW

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KEY TAKEAWAYS

We are maintaining our year-end fair value S&P 500 target of 3,000 even though the index is very close to that level.

The Fed tailwind is at the market's back, making further stock market gains a realistic possibility.

We expect the ride to second-half gains may be a bit bumpy, creating opportunities to potentially buy dips.

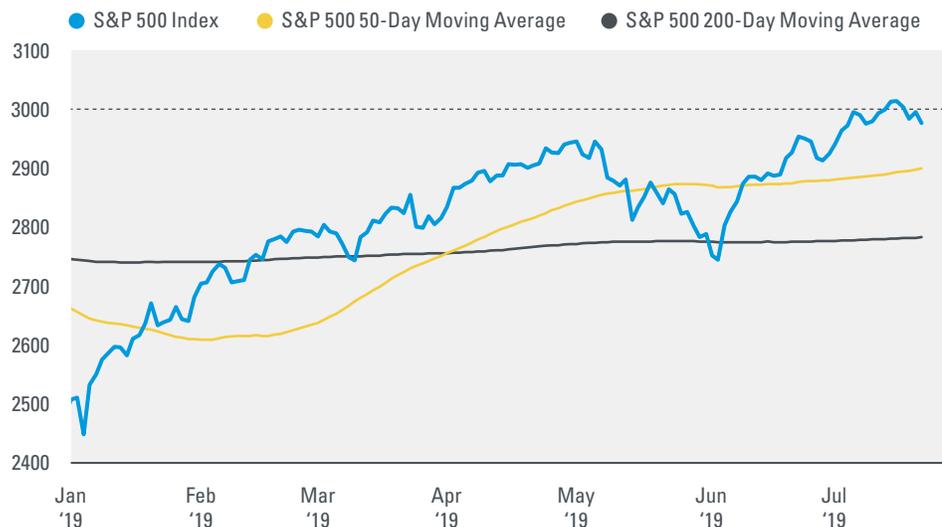
The S&P 500 Index is very close to our year-end target of 3,000. The S&P 500 is up nearly 20% year to date and, after first closing above our year-end fair value target range July 12, it now stands less than 1% from our target [Figure 1]. Now that we've reached our target, is it time to sell? Here we provide some context for our stock market forecast to help explain why we haven't raised our fair value target or recommended investors reduce their equities allocations.

TIME TO SELL?

In late March of this year, we lowered our equities recommendation to [market weight](#). This change was an acknowledgement that stocks had made a strong run and the risk-reward trade-off between stocks and bonds had become more balanced. We cited slower economic growth in the United States and internationally, trade tensions, stalled capital investment, and a weakening corporate profit outlook. Interest rates were higher than they are now, so bonds were slightly more attractive.

When we made that decision, the S&P 500 was around 2,800, about 6% below July 19's close. Recently, the S&P 500 closed above 3,000, and at 2,977 as of

1 S&P 500 INDEX HIT 3,000—NOW WHAT?



Source: LPL Research, FactSet 07/19/19

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

Friday's close, it's just fractionally short of our year-end fair value target.

We don't think it's time to sell, though, primarily because this market is giddy about rate cuts. The adage "Don't fight the Fed" applies here. The last five times the Federal Reserve (Fed) began cutting rates outside of recessions (1984, 1987, 1989, 1995, and 1998), the S&P 500 rose an average of 11.1% over the subsequent six months. Over the next 12 months, the S&P 500 gained an average of 15.8% [Figure 2]. The Fed hasn't cut rates yet, but it appears almost certain to do so at its meeting the last week of July. So for now, even though fundamentals may not justify the market going much above current levels, we'll ride the wave.

We also recognize stock market forecasting is an art, not a science. We use all available information and try to get close, but we acknowledge that making stock market predictions is not a high-precision exercise. That's why we talk about forecasts in terms of fair value and ranges. Stocks trade above and below fair value all the time and can remain over- or undervalued for extended periods

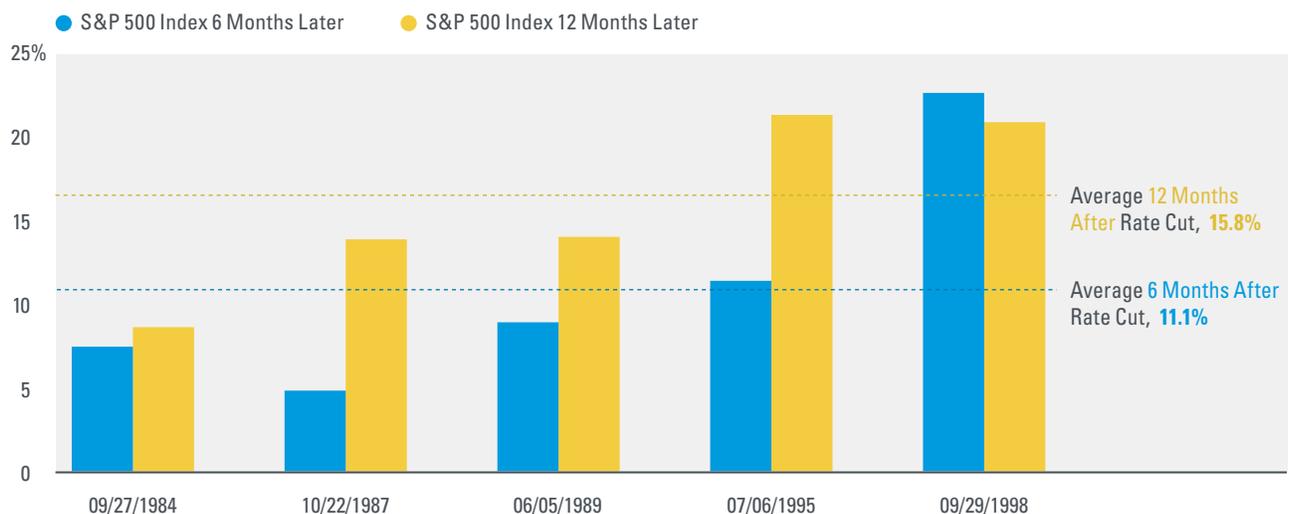
of time. Accordingly, we don't want to force a recommendation change too quickly.

WHERE ELSE DO YOU GO?

If not U.S. equities, then what? This conundrum has its own acronym: T-I-N-A, which stands for "there is no alternative." If you think U.S. stocks are too expensive, you could look internationally, but the economic and political environment in Europe is challenging; Japan may be on the cusp of recession and has a tax hike on the books for this fall. Although we like emerging market (EM) equities, we would suggest modest allocations due to the risk associated with investing in those markets. Correlations with U.S. equities are high, so even though the EM benchmark outperformed the S&P 500 during the fourth quarter of 2018, EM is unlikely to offer much protection against a U.S. stock market decline.

How about bonds? The latest dovish U-turn by the Fed and stubbornly low inflation have inflated Treasury prices, leaving the 10-year Treasury yielding about 2%—a high price to pay for safety.

2 OUTSIDE OF RECESSIONS, STOCKS TEND TO DO WELL AFTER INITIAL FED RATE CUTS



Source: LPL Research, FactSet 07/19/19

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At this stage of the economic expansion, we want high-quality bond allocations to help act as shock absorbers when stock market volatility comes, but bond valuations make stock valuations look cheap.

We believe stocks are still quite reasonably valued despite the S&P 500 having reached record highs. The S&P 500's forward 12-month price-to-earnings ratio (P/E) at 17 is at the same level as it was three years ago and is within historical norms. P/E ratios relative to interest rates and inflation are both well below long-term averages.

TECHNICALS AND SENTIMENT

Technical analysis gives us another reason not to recommend reducing equities at this time. Even though the S&P 500 is up nearly 20% this year, the index is less than 4% above where it was in January 2018. You could characterize the past 18 months as the stock market simply digesting the large gains from the previous two years.

Sentiment is also unusually subdued despite the S&P 500, Dow Jones Industrial Average, and Nasdaq Composite all hitting record highs last week. The percent of individual investors that feel bullish about the next six months is actually below historical averages, according to the most recent American Association of Individual Investors (AAII) Investor Sentiment Survey. More flows went into bond exchange-traded funds (ETF) than equity ETFs during the first six months of this year, even after the best start to a year for the S&P 500 in more than 20 years. This lack of euphoria, coupled with

the long consolidation in equities, indicates to us that the bull market may have more room to run.

We would, however, like to see more entrenched cyclical leadership to gain more confidence in the next possible leg of this rally. Cyclical sectors have performed well over the past month but have been inconsistent this year. Energy, financials, industrials, and materials have been unable to sustain the type of momentum that we would like to see as a sign of market health.

CONCLUSION

We're maintaining our year-end fair value target range of 3,000 for the S&P 500. We would consider raising our forecast if clarity on trade and monetary policy support result in an improved earnings outlook. At the same time, we would consider recommending reducing equity allocations if the market's giddiness about Fed rate cuts goes too far or fundamentals deteriorate. With the Fed at our backs, we'll ride the wave for now.

We think the chances are good that stocks will end the year above current levels. But the second half of the year could be a bit bumpy given risks around trade, geopolitics, and central bank policy. The average maximum peak-to-trough correction in the second half of a year since 1950 has been 10%. When the S&P 500 was up 15% or more in the first half of a year, as it was this year, the average second half correction has been 12%. We suggest suitable investors who may be under-invested consider using any volatility that comes along to their advantage to rebalance portfolios. ■

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DEFINITIONS

Price to Forward Earnings is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation.

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 1950 incorporates the performance of predecessor index, the S&P 90.

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