LPL RESEARCH WEEKLY MARKET COMMENTARY

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TWEAKING OUR FORECASTS

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We are tweaking our 2019 forecasts to reflect increased risk to economic growth and corporate profits from the ongoing trade conflict between the United States and China. We are maintaining our year-end fair value target on the S&P 500 of 3,000 as lower interest rates and inflation support higher valuations.

Recession fears from the yield curve inversion offset the boost from the tariff delay. Trade fears swung around stocks last week before some tariffs were delayed August 13 to avoid impacting the holiday shopping season. On August 14, the first inversion of the 2-year/10-year Treasury yield curve since 2007 sparked recession fears, which caused stocks to erase the prior day's gains. For the week, a variety of factors weighed on sentiment, including trade, slowing global growth, and plunging sovereign bond yields.

While the tariff delay is an encouraging step, and we expect the United States and China to keep talking (talks are scheduled for September), our timetable for a potential agreement has been pushed out. Odds that the dispute drags into 2020 have increased, introducing more risk to economic growth and corporate profits. As a result, we are tweaking our forecasts for gross domestic product (GDP), the 10-year Treasury yield, and S&P 500 Index earnings as follows:

- U.S. GDP growth: 2%, down from 2.25–2.5%
- 10-year Treasury yield: 1.75–2%, down from 2.50–2.75%
- S&P 500 earnings per share (EPS): $165, down from $170

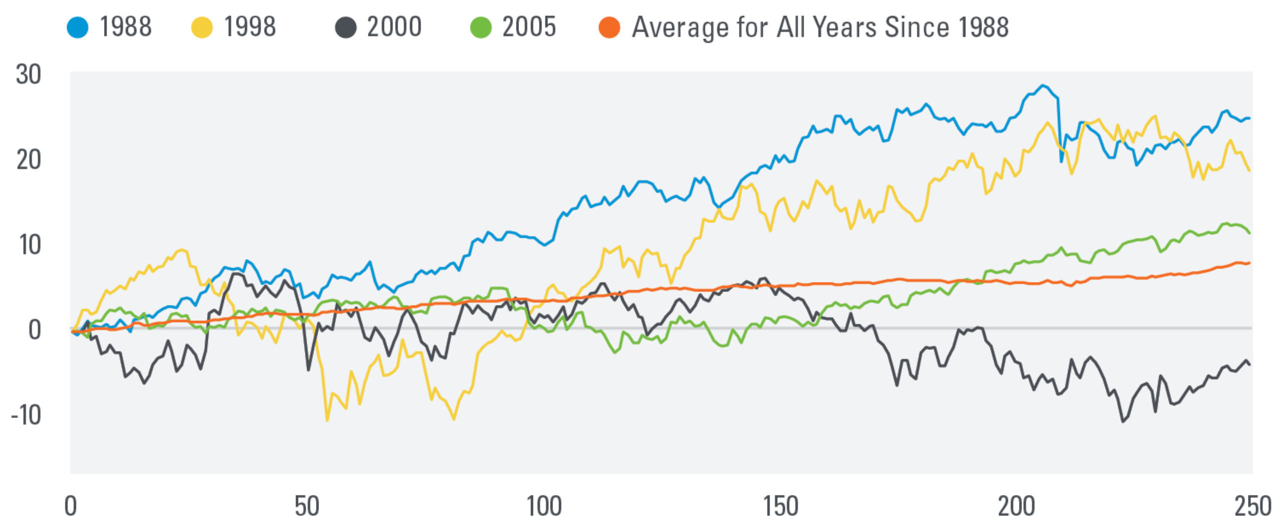
Importantly, we are maintaining our year-end fair value target on the S&P 500 of 3,000 as lower interest rates and inflation support higher valuations.

LOWERING GDP FORECAST TO 2%

We are reducing our 2019 U.S. GDP growth forecast to 2%, down from our prior forecast of 2.25–2.5%. Even after last week's tariff reprieve on roughly $270 billion in Chinese goods, 25% tariffs remain in place on around $200 billion of Chinese goods, and 10% tariffs on an additional $100 billion or so in goods are scheduled for September 1. Businesses are absorbing some of these costs while facing uncertainty about future trade actions, which may continue to weigh on capital investment decisions. Slower international growth adds to near-term pressure on U.S. growth, which could offset the impacts of fiscal stimulus and accommodative monetary policy.

Although the yield curve has sparked recession fears (discussed in our Takeaways on the Yield Curve Inversion blog), we do not interpret this latest inversion of the 2-year/10-year Treasury yield spread as a sign of imminent recession. We believe the yield curve's shape has been driven more by technical factors and relative valuations than domestic economic weakness, as Treasury yields have been weighed down by intense global demand amid negative sovereign debt yields internationally. The U.S. economy remains in good shape with full employment and rising wages fueling strong consumer activity. We take comfort in the fact that stocks historically have done well after 2-year/10-year inversions, with an average one-year gain of 14% for the S&P 500 following inversions **[Figure 1]**.

1 S&P 500 INDEX PERFORMANCE FOLLOWING YIELD CURVE INVERSIONS



Source: LPL Research, Strategas Research Partners 08/14/19

Trading days shown on the horizontal axis. This chart shows S&P 500 performance in the 12 months following the inversion of the 2-year/10-year Treasury yield curve. All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

LOWERING 10-YEAR TREASURY YIELD FORECAST

We are lowering our year-end forecast for the 10-year Treasury yield to 1.75–2%, down from 2.50–2.75%. We expect a softer economic growth outlook with mild inflationary pressures in the United States and record-low yields internationally to translate into lower domestic yields.

CORPORATE PROFITS

We are lowering our 2019 S&P 500 EPS forecast for 2019 from $170 to $165 due to the impact of tariffs, lower business investment, and trade uncertainty. Slower growth hampers revenue, while tariffs, supply chain disruptions, and business uncertainty introduce near-term risk to profits. Upside from a surprise trade agreement appears to becoming increasingly unlikely. Note that our revised forecast matches consensus for this year (Source: FactSet).

MAINTAINING S&P 500 FAIR VALUE TARGET

After exceeding our fair value target of 3,000 a few weeks ago, stocks have struggled with concerns about trade's impact on the global economy. Although we have lowered our earnings forecasts, we believe potential Federal Reserve rate cuts, mild inflation, and lower market interest rates support higher price-to-earnings ratios (P/E) for stocks. We look for a P/E of slightly over 18 on $165 in S&P EPS to get us back to the 3,000 range by year-end.

INTRODUCING PRELIMINARY 2020 FORECASTS

We are also introducing preliminary forecasts for 2020. At this point, we expect 1.75% GDP growth, 2–2.25% on the 10-year Treasury yield, $175 in S&P 500 EPS, and a range of 3,150–3,200 for S&P 500 fair value at year-end 2020. Our forecasts for GDP and the 10-year yield are near consensus while our EPS projection is currently $8 below the consensus ($183) estimate. These forecasts reflect increasing odds of a prolonged trade conflict and increased odds of recession in the latter half of 2020.

CONCLUSION

We are tweaking our 2019 forecasts to reflect increased risk to economic growth and corporate profits from the ongoing trade conflict between the United States and China. Although we continue to expect resolution later this year or in early 2020, the odds of a more prolonged dispute have risen. As a result, we think it is prudent to slightly reduce our forecasts for economic growth, interest rates, and corporate profits. Look for more on our revised forecasts in upcoming weekly publications and blogs.

NEW WEEKLY MARKET PERFORMANCE REPORT

We are pleased to share our new Weekly Market Performance report with insights on major asset classes.

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 referenced is historical and is no guarantee of future results.

The economic forecasts set forth in this material may not develop as predicted and are subject to change at any time based on market and other conditions. .

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

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 information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

DEFINITIONS

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

The price-to-earnings ratio (P/E 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.

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.

Treasuries are a marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments (Yield) semi-annually.

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.

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