LPL RESEARCH
WEEKLY MARKET COMMENTARY

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FOCUS FAQs

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KEY TAKEAWAYS

Last week we had the pleasure of joining about 4,000 LPL advisors at our Focus 2018 national conference in Boston.

We share the most frequently asked questions from Focus 2018, on topics such as trade tensions, emerging markets, growth versus value, and the yield curve.

Last week we had the pleasure of joining about 4,000 LPL advisors at our Focus 2018 national conference in Boston. Many of you reading this were likely among them. The conference is an excellent opportunity for us in the LPL Research department to interact directly with our clients, and to learn about what they like and don't like so we can better tailor our publications and investment options to them. Focus also gives our advisors a chance to ask us questions about the markets. In this week's commentary, we share the most frequently asked questions from Focus 2018.

1. **Will we have a full-blown trade war?**

   It's no surprise this one made the list. We may get further escalation of trade tensions, and some of the possible retaliatory actions from China, such as boycotts of U.S. products sold in China or disruptive regulatory hurdles that make it difficult for U.S. companies to operate, are no doubt concerning. Supply chains could be significantly disrupted, driving up costs and causing production delays for manufacturers.

   That said, the U.S. and China have a lot to lose (including U.S. midterm elections) in escalating the dispute into a full-blown trade war. We are comforted by the fact that the dollar amount of proposed tariffs—including China's retaliation—is still far less than the amount of fiscal stimulus being pumped into the U.S. economy this year, providing some cushion should tensions escalate.

   The reaction of the U.S. stock market to more tough words this week (from both sides) and higher tariffs is also reassuring: The S&P 500 Index stands just 1.1% from its all-time closing high on January 26, 2018, after last week's 0.8% gain, the fifth straight weekly advance. Trade is the number one risk to markets in 2018 and something we will continue to watch very closely.

2. **How can you still like emerging market (EM) equities with all the trade risk going on?**

   Emerging markets, particularly China, are clearly very exposed to trade risk. However, we see several reasons to like EM. First, the MSCI EM Index is trading at a bigger-than-average 30%-plus discount to the S&P 500 on a forward (next 12 months) price-to-earnings ratio basis. Second, economic growth in the emerging world remains strong—at about 5% based on gross domestic product—despite U.S. dollar strength. We see EM as being on a more sustainable trajectory than

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foreign developed economies. Third, EM earnings growth is rebounding nicely and expected to grow faster than in international developed markets in 2018 (17% versus 9%). Finally, demographics are generally favorable.

The trade risk is real, however, as is the potential for further U.S. dollar appreciation, which could weigh on EM. Because of that, in tactical portfolios, we suggest keeping EM equity exposure modest for suitable investors (and we believe active implementation over passive makes a lot of sense in the asset class). Nevertheless, solid economic growth, cheap valuations, and the likelihood of a compromise between the U.S. and China leave us comfortable with our cautiously optimistic EM equity view.

3. Growth has done so well. Why do you still like value?

Growth has had a great run. In fact, the run of growth style outperformance relative to value is the longest ever, according to data from Ned Davis Research. Over just the past five years, the Russell 1000 Growth Index has returned 108%, compared with the Value Index's 59% return. That growth rally has left the Russell 1000 Growth Index at about a 50% premium to the 1000 Value Index on a forward price-to-earnings ratio basis, the highest since the aftermath of the dot-com crash in the early 2000s. These factors suggest to us that there may be a little too much optimism reflected in growth stocks currently.

Going forward, we see several potential catalysts for value, including better economic growth in the U.S., which tends to help value more than growth, and the easing of capital requirements for banks by the Federal Reserve. Financials are by far the biggest component of the Russell Value Indexes (a potentially steeper yield curve may also help).

We were encouraged by the strong July for value stocks. During the month, the Russell 1000 Value Index outpaced its Growth counterpart by more than 1%. During the last week of July, value stocks staged one of their biggest five-day rallies relative to growth in several years. More of our thoughts on a possible value reversal here.

4. Are you worried about the flat yield curve, which has historically been a reliable recession signal?

This one went to our fixed income analysts more than the equity folks, but it is a relevant question for stocks as well. An inverted yield curve—that is, short-term interest rates higher than long-term interest rates—has historically been a reliable indicator of economic recessions. However, as we noted in the *Midyear Outlook 2018*, a flattening yield curve when interest rates are rising, rather than falling, has been an indicator for future economic growth. Also keep in mind that over the last five economic cycles, it has taken an average of about four years between a flat curve (0.5% spread or less between short- and long-term rates) and recession. During that period, stocks have produced solid gains, especially over the past three economic expansions, those ending in 1990, 2001, and 2008. For more on the implications of a flat yield curve, please refer to our *Midyear Outlook 2018*.

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5. Do you have any more of those cool T-shirts from Burt White's main stage presentation?

Unfortunately, we underestimated the popularity of the LPL Focus experience concert T-shirts. We are looking into making more for LPL advisors, so please check back with us.

There you have it. Our top questions from Focus 2018. Now start getting your questions ready for Focus 2019 in San Diego. See you there! ■

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 the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks. Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

All 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.

The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

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.

The MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of the Americas, Europe, the Middle East, Africa and Asia.

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