Weekly Market Commentary

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The Five Long Years

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Highlights

This week will mark five long years since the S&P 500 reached its all-time peak on October 9, 2007.

As the S&P 500 nears the previous highs for the third time in 15 years, is the market poised to repeat the pattern and soon embark on a third long and deep multi-year slide?

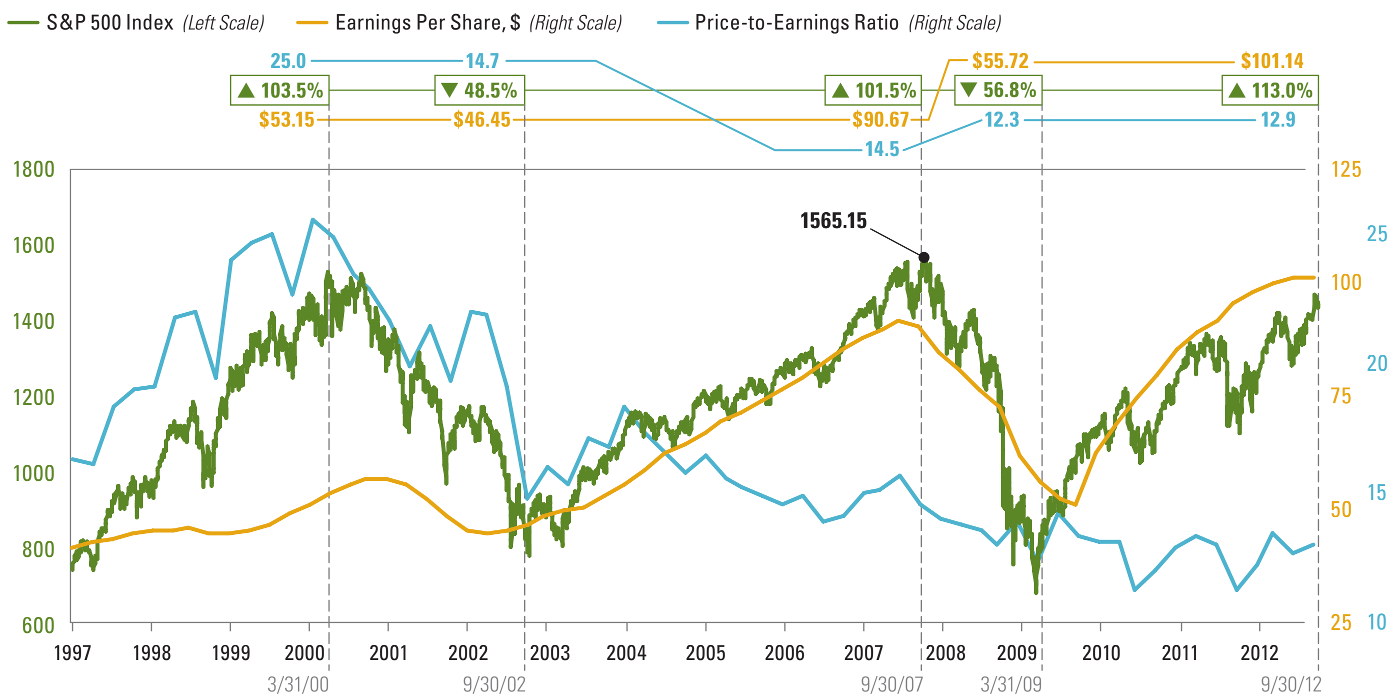
We see four key supports that make it unlikely that stocks will follow the pattern of another multi-year trip back to the bottom of the 15-year range: earnings, dividends, valuations, and the economy.

This week will mark five long years since the S&P 500 reached its all-time peak on October 9, 2007. As you can see in Figure 1, the stock market has been oscillating in a wide range for 15 years. Doubling and then falling by half over and over again. The latest is the fifth leg in the pattern of ups and downs. As the S&P 500 nears the 1565 all-time high, now just 7% away, is the market poised to repeat the pattern and soon embark on another long and deep multi-year slide? We believe that while it is possible, it is unlikely.

There are four key supports that make it unlikely that stocks will follow the pattern and soon embark on another multi-year trip back to the bottom of the 15-year range: earnings, dividends, valuations, and the economy.

- **Earnings –** Most importantly, while stocks have been range bound, earnings have not. At just over $100, earnings per share for S&P 500 companies are now double what they were at the peak of the market in

1 Back at the Top of the S&P 500 15-Year Range



Source: LPL Financial, Thomson Financial, Standard & Poors, Bloomberg 10/08/12

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

2000. It is interesting to note that at the bottom of the market decline in early 2009 earnings per share were still greater than they were at the peak of the market in 2000. While earnings could experience a drop if the U.S. were to return to recession, the current level of earnings may not decline anywhere near as much as they did in the past downturn. A 20% decline in earnings, often accompanying recessions, would result in earnings in the range of $80 and supportive of a market bottom at higher levels on the S&P 500 index than the lows of the past 15 years.

- Dividends – Supported by higher earnings, dividends per share for S&P 500 companies are much higher than at prior peaks in the index. For example, the annualized dividends per share for the S&P 500 currently total $31.09, more than 10% higher than at the last peak that occurred near the end of the third quarter of 2007, and nearly double the $16.32 of the first quarter of 2000.
- Valuations – The most commonly accepted measure of the value of stocks, the price-to-earnings ratio (the current price of the index divided by the earnings per share expected to be generated over the next year), are half of the lofty levels when the S&P 500 index first neared 1500 in the year 2000. When stocks most recently reached the low of the range in the first quarter of 2009 the price-to-earnings ratio was 12.3. Since then it has not risen much and currently stands at 12.9, below the two prior bottoms. For the S&P 500 to drop all the way back to the prior lows in price, the valuation would need to decline to the single digits — levels not seen since the much worse economic backdrop of double-digit inflation and unemployment in the early 1980s.
- Economy – U.S. economic output, measured by Gross Domestic Product (GDP), has also grown dramatically. At $15.6 trillion, U.S. GDP is over 50% larger than in the first quarter of 2000 when it stood at $9.7 trillion.

Individual investors are cautious as stocks approach top end of 15-year range. Even though the stock market has rallied, stock market exchange volume declined 4% in the past week, has fallen 30% from a year ago, and plunged by 44% from two years ago. At the same time, net outflows from U.S. stock mutual funds have accelerated in the past two weeks to -$10 billion from -$93 billion so far this year, according to data from the Investment Company Institute.

Individual investors may be too cautious. We believe that stocks may produce below average returns in the years ahead and in the near-term face daunting challenges in the coming months, including: a sluggish global economy, European financial stress, U.S. budget battles, and the looming fiscal cliff. However, with support from better fundamental drivers of value than at similar points in the past 15 years, stocks are likely to weather nearly any outcome of the near-term challenges better than they have in the past, making a return trip to the lows of the 15-year range unlikely. ■

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 reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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.

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.

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 P/E ratio (price-to-earnings 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.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

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