# Weekly Market Commentary

February 24, 2014

## The Real Reason for the Rebound

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

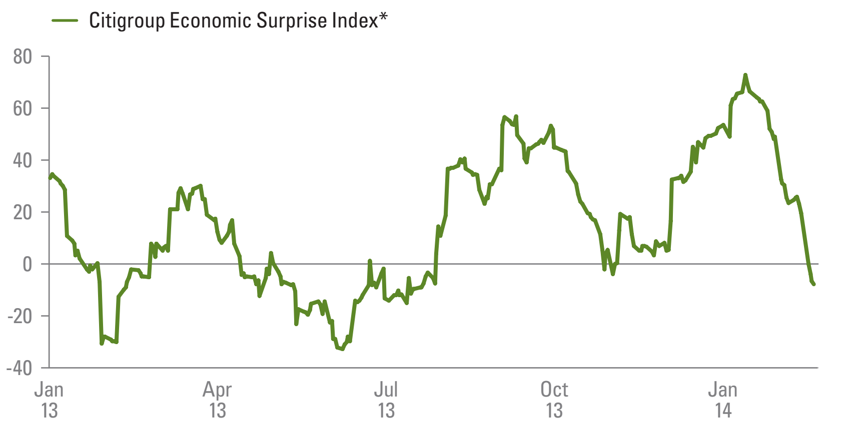
### Highlights

The idea of a change in Congress to a more business-friendly environment may be a welcome thought for many market participants and a behind-the-scenes reason for the rebound.

The first market storm of 2014 (that we had named Angel) is over with the S&P 500 and broader Russell 3000 stock market indexes rebounding to all-time highs after reversing a 6% decline.

The decline was sparked by turmoil in emerging markets (EM) and weak economic data here in the United States in what amounted to a "growth scare." Stocks have rebounded even though conditions in EM, measured by bond yields and credit default swaps, have not improved much, and the U.S. economic data continue to disappoint economists' expectations [Figure 1]. Also, the Federal Reserve has communicated no change in path or message as a result of these developments. So what turned stocks around from their intraday low point on February 5? It was most likely fading concerns over weaker growth and deteriorating conditions for EM.

1 U.S. Economic Data Continue to Disappoint Economists' Expectations




Source: LPL Financial Research, Bloomberg data 02/24/14

*Line rises when data exceed economist consensus expectations and falls when data are worse than expected.

Citigroup Economic Surprise Index (CESI) measures the variation in the gap between the expectations and the real economic data.

Past performance is no guarantee of future results.

But another potential driver of the turnaround is the prospect for a change to a more business-friendly political environment. On February 6, just one day ahead of the debt ceiling deadline—and the need for the Treasury to shift to extraordinary measures to continue to meet the United States' obligations—a leak emerged that House Republicans were dropping their demands over lifting the debt ceiling. They had been considering linking an increase to the debt ceiling to the Affordable Care Act (ACA) or the Keystone XL pipeline, among other ideas. On the news, stocks posted a 1.3% gain. Another 1% gain came on Tuesday, February 11, as the House Republicans' shift to a "clean" debt ceiling bill was publically announced.

To be clear, this was not much of a surprise. The markets expected the debt ceiling to be lifted. The Treasury bill market was showing no signs of stress that a deal to lift the debt ceiling would ultimately fail. We foresaw an eventual clean lift in the debt ceiling in early 2014 back in November of last year, and discussed it in our *Outlook 2014: The Investor's Almanac*, published at that time. Few expected the debt ceiling to act as a negative for the stock market.

Rather than relief over the likelihood of a deal, the positive surprise in the market may have instead been the result of the Republican tactic of seeking to pass a "clean" bill without first attempting a poll-hurting run at attaching controversial provisions to the increase tied to the ACA, XL Keystone pipeline, or other concessions. The fact that they did not again risk being blamed for triggering a potential crisis may raise the odds that the Republicans retain their majority in the House and make gains in the Senate in the November 2014 mid-term elections. The stock market may have rallied on the perception that a more business-friendly legislative environment may result.

## The Numbers

There are 21 Democratic seats and 15 Republican seats up for re-election in the Senate this year. With the current 55–45 split, to take effective control of the Senate, Republicans would need to pick up six seats and appeared likely to pick up three to four before the debt ceiling deal, based on state polling and analysis from non-partisan experts like Charlie Cook. Although the odds remain a bit less than 50%, a lot can happen between now and November. It would not take that much to tilt the election to the Republicans, giving them control of Congress and making President Obama's last two years in office even more of a lame duck.

Historically, when Republicans control both the House and Senate, the stock market produces above-average gains. However, it is not a robust data set—there have only been two periods when the Republicans held both houses since 1950. Both were generally favorable periods for the stock market: from the election on 11/8/94 when the Republicans won control of both houses to the election on 11/7/00 when they lost it, the S&P 500 Index rose 23% on an annualized basis, and during the period from 11/5/02 to 11/7/06 stocks went up at a 13% annualized pace. This is interesting, but not really convincing as the driving factor of performance, given all the other events that occurred during those two periods.

2 Single Most Important Small Business Problem in January 2014

| January 2014 National Federation of Independent Business Survey: Single Most Important Problem | | | | |
|---|---|---|---|---|
| Problem | Current | One Year Ago | Survey High | Survey Low |
| Taxes | 24 | 21 | 32 | 8 |
| Govt. Reqs. & Red Tape | 22 | 21 | 27 | 4 |
| Poor Sales | 14 | 19 | 33 | 2 |
| Comp. From Large Bus. | 8 | 6 | 14 | 4 |
| Quality of Labor | 8 | 5 | 23 | 3 |
| Cost/Avail. of Insurance | 8 | 8 | 29 | 4 |
| Other | 7 | 9 | 31 | 2 |
| Cost of Labor | 4 | 3 | 9 | 2 |
| Inflation | 3 | 5 | 41 | 0 |
| Fin. & Interest Rates | 2 | 3 | 37 | 2 |

Source: LPL Financial Research, National Federation of Independent Business data 02/11/14

Past performance is no guarantee of future results.

**Taxes** and **regulation** have eclipsed sales growth, which had been cited as the number one problem in recent years.

## The Real Reason?

The historical outperformance under Republican control is unlikely to be the real reason for the market's recent turn. The real motivation may be seen in the January 2014 report from the National Federation of Independent Business, the leading small business association in the United States. The report shows that taxes and government regulation are most cited as the two biggest problems facing U.S. businesses [Figure 2]. In fact, taxes and regulation have eclipsed sales growth, which had been cited as the number one problem in recent years. Regulation has been the only category of problems that has been rising for the past five years and stands closest of all problems to its 40-year high. Whether this business menace is real or just perceived, it may be sapping confidence of business leaders and investors, and the idea of change in Congress to a more business-friendly environment may be a welcome thought for many market participants and a behind-the-scenes reason for the rebound. ■

## 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. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance 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.

Stock and mutual fund 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 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. As of the latest reconstitution, the average market capitalization was approximately $4 billion; the median market capitalization was approximately $700 million.





RES 4507 0214
Tracking #1-248881 (Exp. 02/15)