Weekly Market Commentary

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Markets Entering Area 51

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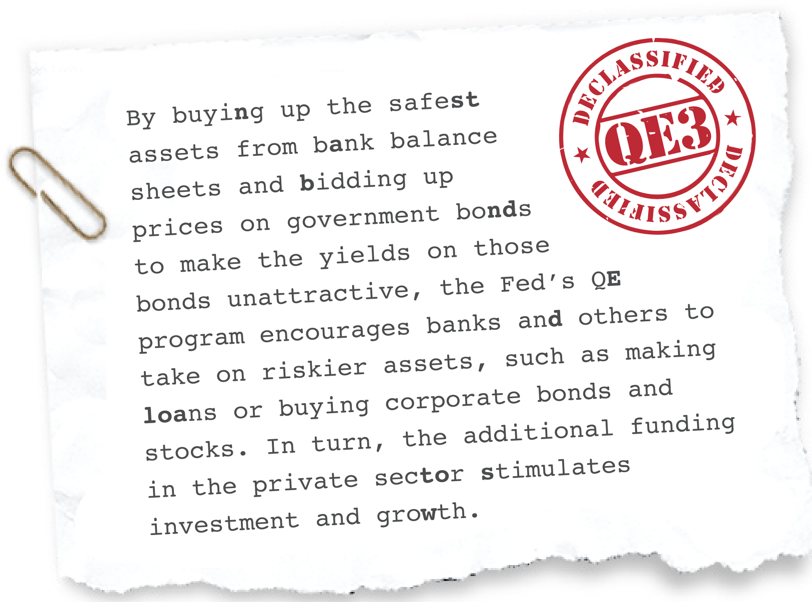
Highlights

CIA documents released late last week officially acknowledge the existence of Area 51 and suggest that its actual function was far less extraordinary or essential than believed by some. It is time to declassify QE3 and reveal the same thing.

Area 51 has been steeped in mystery and a favorite subject of conspiracy theorists for decades. But CIA documents released late last week officially acknowledge its existence and suggest that its actual function was far less extraordinary or essential than believed by some. The declassified documents include a map of Area 51's location in southern Nevada, but more importantly that it was merely a testing site for U-2 surveillance aircraft as part of the Cold War spy programs.

Like Area 51, QE3 — the latest round of quantitative easing, as the Federal Reserve's (Fed) bond-buying program is known — has been surrounded by mystery (What is it actually doing? Is it working? When will it end?). Also like Area 51, the truth of how QE3 operates is less exciting than many believe.



This truth often gets lost in the conspiracy theories about a U.S. government entity buying U.S. government debt, banks pumped up with taxpayer money, or how the Fed "manipulates" the markets.

With the next Fed meeting now less than a month away on September 17 – 18 and about a 50% likelihood that they announce a tapering, or reduction, in the amount of the monthly bond-buying program at that meeting, the economic data take on a lot of importance for market participants. For example, last week was the survey week for the employment report for August that will be released on September 6, putting greater-than-normal attention on this Thursday's (August 22) initial jobless claims report that provides a glimpse into the health of the labor market last week. That means the markets may get spooked by mixed data points and volatility may remain high over the coming weeks.

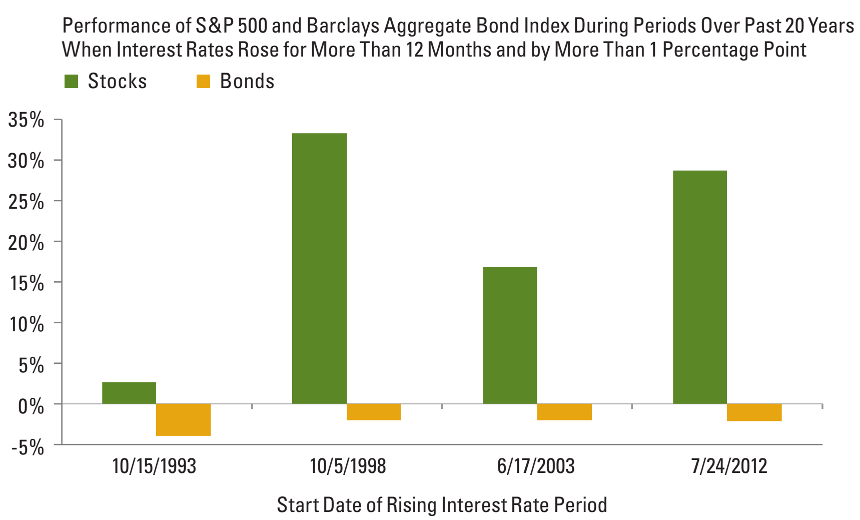
As we enter the unknown territory, or "Area 51" of tapering in the coming months, the reaction of the stock market should not be very mysterious: stronger economic data are good news for the stock market.

The pending tapering has created concerns among market participants that fear the mysterious power of the Fed has been the only thing holding the stock market up. As we enter the unknown territory, or "Area 51" of tapering in the coming months, the reaction of the stock market should not be very mysterious: stronger economic data are good news for the stock market—maybe not every day, but on balance over weeks and months—no matter if that means QE3 is ending and interest rates may head higher.

The last time 10-year Treasury yields were this high (above 2.8%) was right around the end of QE2, over two years ago. When both QE1 and QE2 ended, the 10-year Treasury yield fell by 1.5 percentage points (and stocks fell more than 10%) because the economy was not ready to come off of Fed support. In contrast, the fact that yields are rising as QE3 is coming to an end suggests that market participants now see economic growth as self-sustaining, and the potential for a more favorable environment for the stock market.

Rising bond yields accompanying economic growth have been good for the stock market in the past. There have been four periods over the past 20 years when interest rates rose for more than 12 months and by more than 1 percentage point. The S&P 500 Index rose in all of those 12-month periods, including over the past year, while the bond market fell [Figure 1]. This was not setting up for an eventual fall—stocks rose in the following 12 months, as well.

1 Rising Interest Rates Have Been Good for Stocks



Source: LPL Financial, Bloomberg data as of 08/17/13

The S&P 500 and the Barclays Aggregate Bond Index are unmanaged indexes, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. Index performance is not indicative of any particular investment. Past performance is no guarantee of future results.

While in general, rising rates have been favorable for stocks, that has not been true for all sectors. The most interest rate sensitive sectors of the stock market, utilities and telecom, have suffered when rates rose in the past — including during the dip we have seen so far in August with these being the worst-performing sectors of the S&P 500. However, it is worth keeping in mind that they only make up about 6% of the S&P 500 Index.

It is the swift, sharp moves higher in yields that have caused some short-term jitters for stocks this year, but not panic. We have only seen one 5% or more pullback this year and that ended with a total decline of 5.8% (which took place as the 10-year Treasury yield rose above 2% and quickly shot up to 2.6% in about a month), and the current pullback from the S&P 500's all-time high two weeks ago on August 2 has been 3.2%. This is well below the typical amount of volatility in a given year. There have been three 5% or more pullbacks in every year, on average, since WWII. And the typical peak-to-trough drop each year is about 15%. We expect some volatility, but not a major downturn for stocks.

For true believers, faith in the existence of UFOs and a government cover up of extraordinary and essential activities at Area 51 is unshakable. Next week's release of the minutes of the Fed's July 31 meeting may help to reveal some of the behind-the-scenes deliberations and cast some light on when the Fed may begin to taper. The release may also help to shake the perception that the Fed's QE3 program is something far more extraordinary than it really is. ■

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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.

Stock investing involves risk including loss of principal.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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 Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

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