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# MYTH BUSTING

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## KEY TAKEAWAYS

The underlying fundamentals and technicals suggest this bull market is alive and well.

There are many market myths circulating that may be distracting investors from focusing on the positive fundamentals.

The yield curve, peak in manufacturing, rising interest rates, and earnings slowdown are all myths we will bust.

There are several market myths related to certain market indicators which have the tendency to distract investors from what really matters in assessing market opportunities. We believe the overall fundamental backdrop is currently quite positive thanks to solid economic growth and strong corporate earnings trends, while market sentiment and technicals continue to suggest future equity strength. This week we will bust some common market myths.

## MYTH 1: THE YIELD CURVE

The yield curve has flattened throughout 2018, causing some to fear that a recession may be right around the corner. This makes sense, as the past nine recessions all saw a yield curve inversion right ahead of the economic contraction. The difference between 2- and 10-year Treasury yields broke below 0.50% recently, reaching 0.41% just last week—the flattest it has been since September 2007.

Though significant, it is important to note that when looking back at the previous five recessions, once the yield curve hit 0.50%, it took a median of nearly a year before the curve inverted [Figure 1]. Once it inverted, it took about 20 months until

### 1 A FLATTER YIELD CURVE DOESN'T NECESSARILY MEAN A RECESSION IS AROUND THE CORNER

Recession Start Date	Months from 0.5% Yield Curve Steepness to Inversion	Months From Inversion to Recession	Total Months from 0.5% Yield Curve Steepness to Recession	S&P 500 Price Return From 0.5% to Recession
February 1980	11.9	17.8	29.6	19.8%
August 1981	0.8	10.9	11.7	5.8%
August 1990	53.9	19.8	73.7	137.0%
April 2001	42.4	34.7	77.1	155.3%
January 2008	7.4	24.5	31.9	21.5%
Median	11.9	19.8	31.9	21.5%
Average	23.3	21.5	44.8	67.9%

Source: LPL Research, FactSet 04/23/18

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt.

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

a recession started. All along the way, the S&P 500 Index posted a median return of 21.5% over those 32 months. In other words, there could be years left to this expansion before the yield curve truly becomes a worry. For more of our thoughts on why we believe the yield curve isn't yet a major concern, be sure to read our latest *Bond Market Perspectives*, due out tomorrow.

## MYTH 2: A MANUFACTURING PEAK

The Institute for Supply Management's (ISM) Manufacturing Index hit a cycle high back in September 2017, but then made yet another new cycle high in February 2018. Many have posited that a peak in manufacturing suggests an impending recession, but the data does not back this up.

Over the past five economic cycles, it has taken the United States 45 months on average to enter a recession following a peak in the ISM. Meanwhile, the average cumulative S&P 500 price return during those periods (using end of month returns) was 56.7% [Figure 2]. Note that this average includes periods of very strong returns in the mid- to late-1980s and 1990s, and one period of negative returns in the early 1980s, which is an indication that not every cycle is equal. With ISM manufacturing making a new high so recently, we think this means there is still plenty of time left in this economic cycle.

## MYTH 3: RISING INTEREST RATES

With yields surging around the globe, breaking out to multi-year highs in several cases, many think that higher rates are a bad thing. The data suggest quite the opposite.

We have found that stocks and bond yields historically have been positively correlated until the 10-year yield gets up around 5%, at which point

## THE YIELD CURVE

The yield curve is a graphical representation of bond yields of similar credit quality across a range of maturities. A flattening curve, when shorter-term rates rise more quickly than longer-term rates (or fall more slowly), is often perceived as an indication that slower economic growth lies ahead. An inverted yield curve, where short-term rates are higher than long-term rates, has historically been a precursor to a recession.

### 2 A PEAK IN ISM DOES NOT MEAN STOCK MARKET GAINS ARE OVER

ISM Peak Date	Beginning of Recession	Months from ISM Peak to Beginning of Recession	Cumulative S&P 500 Performance from ISM Peak to Beginning of Recession
Jul 1978	Feb 1980	18	12.9%
Nov 1980	Aug 1981	9	-12.6%
Dec 1983	Aug 1990	80	95.6%
Oct 1994	Apr 2001	77	164.5%
May 2004	Jan 2008	44	23.0%
	Average	45.6	56.7%
	Median	44	23.0%
	Max	80	164.5%
	Min	9	-12.6%

Source: LPL Research, Bloomberg 04/23/18

ISM – Institute for Supply Management Manufacturing Index

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

the correlations break down. In other words, it is perfectly normal for yields to rise along with stocks. Taking this a step further, [Figure 3](#) shows that out of the most recent 23 periods of higher rates (based on the 10-year Treasury yield), stocks have gained ground 19 of those times. Recent periods have produced even better performance, as stocks have risen during each of the last 11 periods of rising rates (since 1996).

Stocks have done well since interest rates began to move higher in September 2017. History suggests that higher rates may actually be a good thing, and

should the 10-year Treasury yield break above the psychologically important 3% level, the equity bull market may garner further support.

## MYTH 4: EARNINGS SLOWDOWN

LPL Research is looking for S&P 500 earnings growth to approach the mid-teens in 2018, with many expecting even stronger growth. What we find interesting about this is even though corporate profits are expanding and making new highs, some are predicting trouble again for stocks as earnings

### 3 STOCKS HAVE HISTORICALLY DONE WELL DURING PERIODS OF RISING RATES

Rising Rates Start Date	Rising Rates End Date	Duration (Months)	Change in 10-Year Treasury Yield	S&P 500 Gain/Loss
01/19/96	07/08/96	6	1.5%	6.7%
10/05/98	01/21/00	16	2.6%	45.8%
11/07/01	04/01/02	5	1.2%	2.8%
06/13/03	09/03/03	3	1.5%	3.8%
03/16/04	06/14/04	3	1.2%	1.3%
06/01/05	06/28/06	13	1.3%	3.6%
03/17/08	06/16/08	3	0.9%	6.5%
12/30/08	06/10/09	5	1.8%	5.4%
10/08/10	02/08/11	4	1.3%	13.7%
05/02/13	09/05/13	4	1.3%	3.6%
07/08/17	04/19/18	8	1.2%	11.4%
All Periods Since 1962: 23 Instances (Not all Shown)	Average	13	2.3%	5.9%
	Median	8	1.5%	3.8%
	Percent Positive			82.6%
Post 1996: 11 Instances	Average	6	1.5%	9.5%
	Median	5	1.3%	5.4%
	Percent Positive			100.0%

Source: LPL Research, FactSet 04/20/18

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growth potentially slows later this year or in 2019, (a topic we discussed in our [earnings preview commentary on April 9](#)).

Once more, looking purely at the data shows that double-digit earnings growth is a major positive for equity returns. As [Figure 4](#) reveals, going back to 1991 there have been 12 calendar years that sported at least double-digit earnings growth and all 12 years the S&P 500 produced positive total returns, with an average return of 16.7%. Should earnings come in comfortably above double-digits as we expect, this is yet another reason to expect the bull market to continue in 2018.

## CONCLUSION

It is important for investors to not get distracted by these or other market myths. Remember that the overall global economy continues to expand, fiscal policy remains a major tailwind to growth for the U.S. economy and corporate profits, and we are not seeing any of the same excesses seen at previous market peaks that led to recessions. We continue to anticipate double-digit stock market gains this year, with leadership from the value style, small caps, cyclical sectors, and emerging markets.\* ■

#### 4 WHEN EARNINGS ARE UP >10%, THE S&P 500 IS HIGHER 12 OF 12 TIMES

Year	S&P 500 Earnings	S&P 500 Earnings Growth	S&P 500 Total Return
1993	26.9	15.8%	10.0%
1994	31.3	16.3%	1.3%
1995	38.6	23.1%	37.2%
1997	46.1	10.7%	33.1%
1999	55.8	20.9%	20.9%
2003	58.5	11.5%	28.4%
2004	67.4	15.2%	10.7%
2005	76.3	13.2%	4.8%
2006	87.0	14.1%	15.6%
2010	85.3	37.8%	14.8%
2011	98.9	15.9%	2.1%
2017	134.0	13.1%	21.6%
2018	\$152.5*	13.8%	?
S&P 500 Avg Return If EPS >10%			16.7%
% Higher			100% (12 of 12)

Source: LPL Research, Bloomberg 04/14/18

EPS – Earnings Per Share

\*LPL Research's 2018 S&P 500 EPS forecast is \$152.50. Earnings gains are supported by LPL Research's expectations of better economic growth, with potential added benefit from lower corporate tax rates.

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Earning forecast may not develop as predicted.

\*As noted in [Outlook 2018: Return of the Business Cycle](#), LPL Research's S&P 500 Index total return forecast of 8–10% (including dividends), is supported by a largely stable price-to-earnings ratio (PE) of 19 and LPL Research's earnings growth forecast of 8–10%.

## 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 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.

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.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond and bond mutual fund values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

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 fund shares is not guaranteed and will fluctuate.

## DEFINITIONS

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

## INDEX DESCRIPTIONS

The S&P 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 Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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