LPL RESEARCH
WEEKLY MARKET COMMENTARY

June 19 2017

MIDYEAR OUTLOOK 2017

BUSINESS FUNDAMENTALS BACK AT THE CONTROLS

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KEY TAKEAWAYS

We forecast 6–9% returns for the S&P 500 in 2017, commensurate with expected earnings gains.

As investors increasingly trust that the economy can stand on its own without the need of monetary policy support, business fundamentals should take over as the primary market engine.

The economic expansion is poised to continue, and powered by business fundamentals, this eight-year-old bull market will probably continue as well.

We think stocks are in a good position to stand on their own as monetary policy support is removed and deliver modest additional gains in the second half of 2017.

We forecast 6–9% returns for the S&P 500 Index in 2017. As investors increasingly trust that the economy can stand on its own without the need of monetary policy support, business fundamentals should take over as the primary market engine and corporate profits will take on increasing importance. We have slightly raised our 2017 S&P 500 Index total return forecast to 6–9%, commensurate with expected earnings gains.

BUSINESS FUNDAMENTALS TAKING OVER

As investors increasingly trust that the economy can stand on its own without the need of monetary policy support, business fundamentals should take over as the primary market driver. As a result, corporate profits will be increasingly important for stocks over the balance of 2017 and into 2018. Our confidence that earnings growth will come through over the balance of the year has led us to slightly raise our 2017 S&P 500 Index total return forecast to 6–9%, up from mid-single-digits previously, driven by: 1) a pickup in U.S. economic growth; 2) mid- to high-single-digit earnings gains; 3) a stable price-to-earnings ratio (PE) of 19–20; and 4) prospects for a fiscal policy boost to earnings in 2018.

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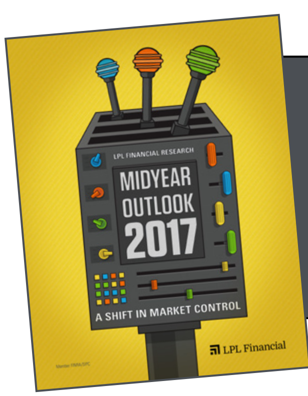


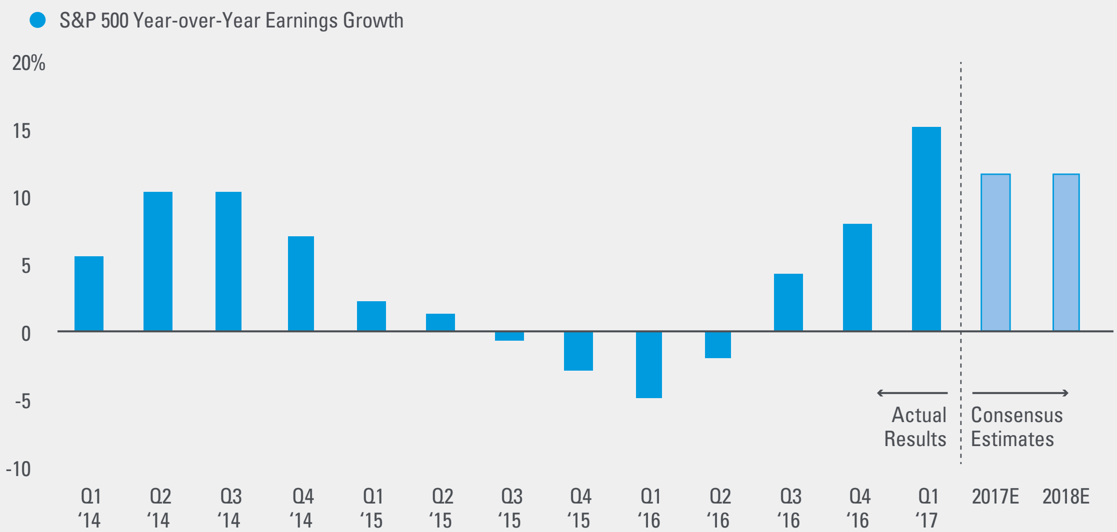
Please see our *Midyear Outlook 2017: A Shift In Market Control* publication for insights on the economy, stock and bond markets, and investments for the year ahead. This week's commentary features content from that publication.

EXPECT SOLID GAINS IN CORPORATE PROFITS

Over the past three years, operating earnings for the S&P 500 have been basically flat, at around $118 per share. Consequently, market returns over this period have been largely due to the combination of PE ratio expansion and dividends. This dynamic has already begun to change. In 2017, we expect solid gains in corporate profits, driven by potential improvement in economic growth, resilient profit margins, a stable U.S. dollar, and rebounding energy profits. We believe S&P 500 earnings growth near 10% is attainable, putting earnings for the index in the range of $130 per share, even without any material impact from fiscal policy changes this year.

Corporate America is off to a good start toward hitting our earnings target. First quarter earnings season was a very good one, with S&P 500 profits rising by a much better than expected 15% year over year (Thomson data) [Figure 1], while company guidance for the remainder of the year was also positive. The bar for growth was fairly low, as the comparison was relatively easy considering the struggles of early 2016, particularly in the energy sector. But even excluding the strong contribution from rebounding energy sector profits, S&P 500 earnings were still up over 10% year over year in the first quarter. Even if the earnings trajectory slows some over the course of the year as comparisons with 2016 get tougher, business fundamentals may still point toward further growth in output and profits.

1 EARNINGS SHIFTING TO HIGHER GEAR



Source: LPL Financial, Thomson Reuters 05/19/17

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. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

We look for stocks to see gains commensurate with profit growth, consistent with historical mid-to-late economic cycle performance. At 19–20 times trailing S&P 500 earnings, stocks are expensive relative to their long-term history. However, when viewed against interest rates and inflation still near historic lows [Figure 2], valuations look fair to us. Moreover, the potential policy upside to earnings in 2018 on top of an already upward trajectory for corporate profits could provide further support for equities. Remember, history is littered with examples showing that valuations have been poor predictors of one-year stock market performance.

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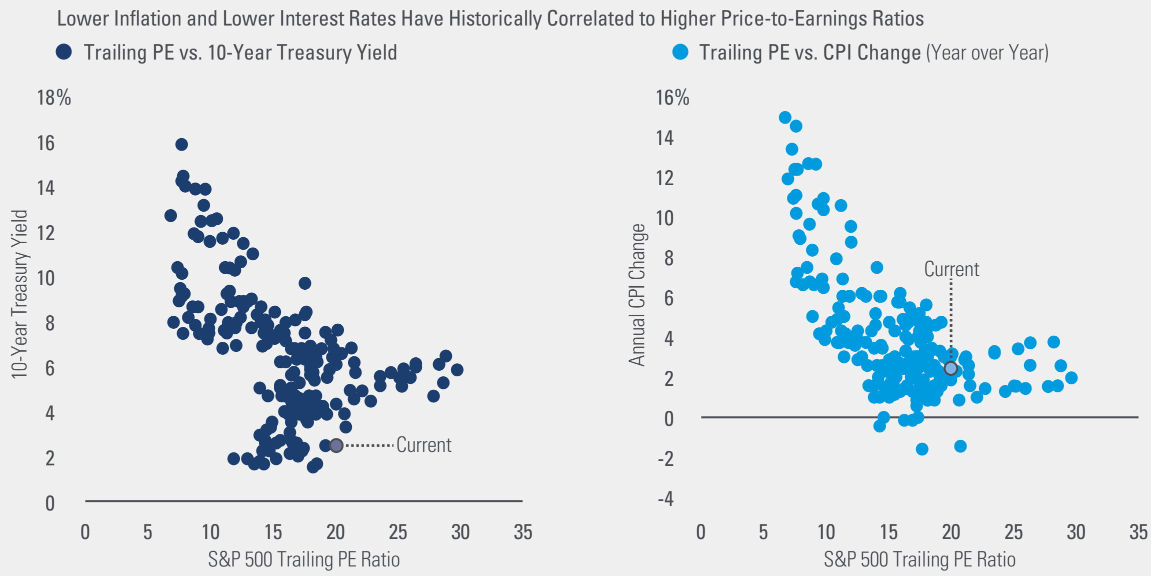
POTENTIAL POLICY UPSIDE TO 2018 EARNINGS

Additional clarity on corporate tax reform in the coming months will provide further insight into 2018 profit growth and potentially justify elevated

2 HIGHER VALUATIONS HAVE A FAIR AMOUNT OF SUPPORT



Source: LPL Research, FactSet, Thomson Reuters, Haver Analytics 05/19/17

Data are monthly going back to 1962.

The PE 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 PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Consumer price inflation is the retail price increase as measured by a Consumer Price Index (CPI).

stock market valuations. In fact, although we have little more than a high-level framework to go on as June begins, the potential exists for corporate tax reform to boost S&P 500 earnings by 5% or more in 2018, with the obvious condition that the Trump administration and Congress can come together on a package that can get enough votes to pass the House and Senate. Far from a slam dunk but still, we believe, more likely than not.

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RISKS

While accelerating earnings growth may provide further support for stocks, challenges implementing President Trump's agenda and additional Fed rate hikes could lead to periodic bouts of stock market volatility and may prevent stocks from adding meaningfully to year-to-date gains. Fiscal policy is therefore a wildcard, but meaningful progress toward implementation of corporate tax reform could provide upside for corporate profits in 2018, adding potential fundamental justification for forward PE ratios.

CONCLUSION

Investors should feel good about where the stock market is as the halfway point of 2017 approaches. The economic expansion is poised to continue, and powered by business fundamentals, this eight-year-old bull market will probably continue as well. Fiscal policy may not help much this year, and there may be bouts of volatility as monetary conditions tighten further, but we think stocks are in a good position to stand on their own and potentially deliver modest additional gains in the second half of 2017. ■

Given the environment we expect over the second half of 2017, our preferred investments include:

U.S. Small Cap Stocks	U.S. small caps have benefited from accommodative monetary policy and may benefit from fiscal policy changes, though valuations are stretched.
Emerging Markets	Near-term catalysts (global growth, monetary policy) and longer-term trends (six billion consumers) offer opportunities.
Cyclical Sectors	**Technology** is positioned to benefit from continued solid earnings growth as business investment potentially picks up and drives higher productivity. **Industrials** may benefit from potential spending on defense and infrastructure projects and stronger global demand. **Financials** should benefit from deregulation that may free up capital for lending and dividends, while tighter monetary policy may help profitability.
Master Limited Partnerships	The Trump administration's stance on energy deregulation is supportive; yields remain very attractive but introduce interest rate risk.

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

Investing in MLPs involves additional risks as compared with the risks of investing in common stock, including risks related to cash flow, dilution, and voting rights. MLPs may trade less frequently than larger companies due to their smaller capitalizations, which may result in erratic price movement or difficulty in buying or selling. MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment, including the risk that an MLP could lose its tax status as a partnership. Additional management fees and other expenses are associated with investing in MLP funds.

IMPORTANT DISCLOSURES

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets, as well as weather, geopolitical events, and regulatory developments.

Currency risk arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Because of its narrow focus, investing in a single sector, such as energy or manufacturing, will be subject to greater volatility than investing more broadly across many sectors and companies.

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.

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.

RES 5953 0617 | Tracking #1-618572 (Exp. 06/18)