Weekly Market Commentary

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What Is Priced In?

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Highlights

The stock, bond, and commodities markets appear to have priced in a return to a positive environment for investors consisting of stronger economic and job growth accompanied by a return of some mild inflation.

The S&P 500 seems to have absorbed the prospect for rate hikes by the Federal Reserve (Fed) beginning as soon as the middle of next year reasonably well. While stocks slid on Friday, March 21, early in the day they hit a new all-time intraday high a day after Fed Chair Yellen indicated a potential time frame for the Fed to begin rate hikes after ending their bond-buying program.

Since stocks seemed to have a relatively mild reaction to the Fed news last week, it begs the question: what is priced into the markets about future economic growth and inflation?

Stocks Pricing In Better Jobs Gains

The labor market is a lagging indicator of economic health. It tends to peak and trough after a turn in the broad economy. Therefore, stocks tend to react ahead of changes in the job market. In fact, stocks tend to lead future job growth by about six months, as you can see in Figure 1. The S&P 500 Index is up over 20% from a year ago. Given the historical relationship between

1 Stocks Are Pricing In Better Job Gains Ahead

Source: LPL Financial Research, Bloomberg data 03/24/14

*Given that the stock market as measured by the S&P 500 is a discounting mechanism that anticipates economic events approximately six months in advance, we have shifted forward the S&P 500 to show this implied economic relationship.

The S&P 500 is an unmanaged index which 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.

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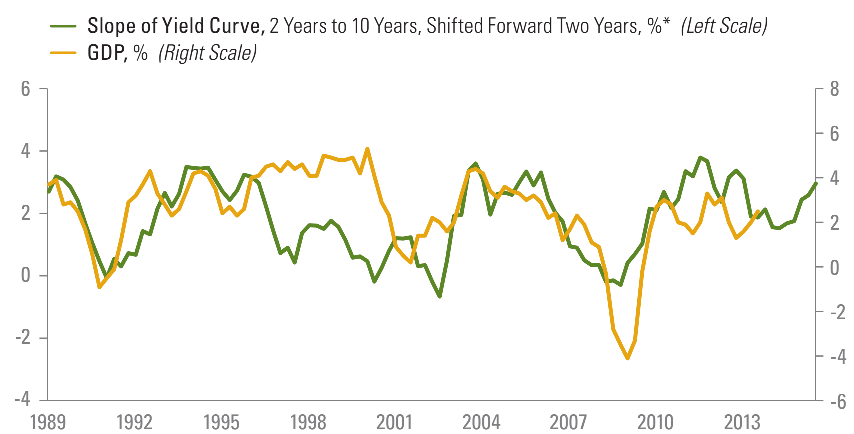
stocks and jobs, this suggests about a 2% year-over-year growth rate for net new jobs or a pace of about 230,000 per month. This would mark a pickup from the 186,000 average of the past three years and a big jump from the 129,000 three-month average.

Bonds Pricing In Economic Rebound

Historically, in the bond market a rise in long-term yields relative to short-term yields is an indication that investors are expecting stronger economic growth. The bigger the difference in these yields, in technical terms known as the slope of the yield curve, the stronger the expected pace of growth for the economy. This relationship can be seen in Figure 2, where the difference in yields led growth in the economy, as measured by gross domestic product (GDP), over the next two years (with the exception of the late 1990s).

While short-term yields have not changed much in recent years and remain pinned down by the Federal Reserve (Fed) at under 0.1%, the yield on the longer-term 10-year Treasury note rose by about one percentage point from around 1.6% in the fourth quarter of last year to 2.7%. The increase in the slope of the yield curve may suggest bonds are pricing in a better growth outlook. When viewed in the historical context seen in Figure 2, the yield curve suggests bonds are pricing in a rebound to 3–4% GDP in the years ahead, well ahead of the growth seen, on average, over the past couple of years.

2 Yield Curve Pricing In Rebound to 3–4% GDP Growth

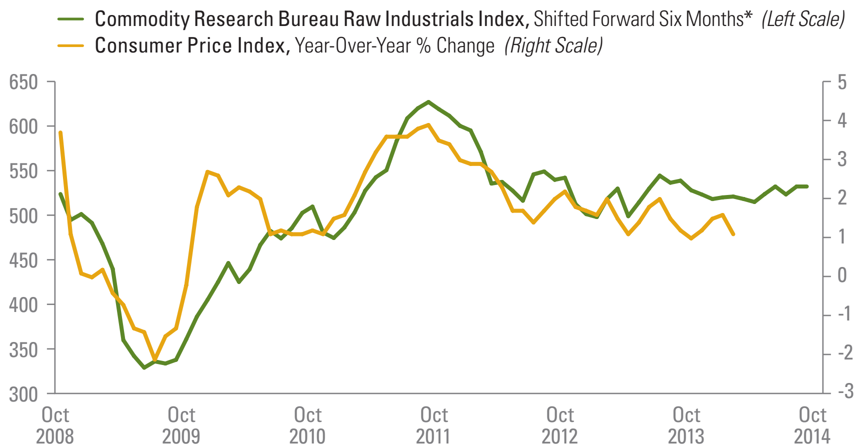


Source: LPL Financial Research, Bloomberg data 03/24/14

*Given that the bond market as measured by the yield curve is a discounting mechanism that anticipates economic events in advance, we have shifted forward the slope of the yield curve by two years to show this implied economic relationship.

Past performance is no guarantee of future results.

3 Commodities Pricing In Inflation Rising Back to 2%



Source: LPL Financial Research, Bloomberg data 03/24/14

*Given that commodity prices as measured by the CRB Raw Industrials index are a discounting mechanism that anticipates economic events in advance, we have shifted forward the CRB Index by six months to show this implied economic relationship.

All indices are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment.

Past performance is no guarantee of future results.

Commodities Pricing In Return to 2% Inflation

Commodity prices tend to lead trends in inflation since they respond quickly to increases in demand and to weather-related impacts on supply, which are subsequently passed through to overall prices. The 13 commodities measured by the Commodity Research Bureau Raw Industrials Index include raw materials or early manufacturing stage products such as copper scrap, rubber, and cotton. These commodity prices have historically tended to lead inflation, measured by the Consumer Price Index, by about six months, as you can see in Figure 3. This would mark a reversal in the downtrend in inflation, known as disinflation, seen for the past couple of years and may support the move by the Fed to end stimulus and eventually raise interest rates.

The stock, bond, and commodities markets appear to have priced in a return to a positive environment for investors consisting of stronger economic and job growth accompanied by a return of some mild inflation. In order to preserve the gains in the stock market, steepness of the yield curve, and commodity prices, market participants need to see the economy progress towards these outcomes. The first quarter took a stumble towards those ends with economic data showing signs of weakness. The markets have generally paused over the past few months, waiting to see if the extreme weather or other temporary factors were the cause or if the economy has veered from the course market participants had been expecting.

The gains we expect for 2014 are dependent upon future economic data supporting the views already largely embedded in the markets. We look forward to economic data points rebounding and are encouraged by the recent trend in weekly data (such as initial claims for unemployment benefits, commercial and industrial loans, and shipping traffic) as the weather has become less severe. However, any faltering in the economy, even if accompanied by a shift by the Fed to continue or accelerate their bond-buying program, would likely lead to markets disappointing as they move to price in a different, and weaker, economic outlook. ■

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. 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.

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.

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 Commodity Research Bureau (CRB) Index is an index that measures the overall direction of commodity sectors. The CRB was designed to isolate and reveal the directional movement of prices in overall commodity trades.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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