

December 4 2017

2018 STOCK MARKET OUTLOOK

DOUBLE-DIGIT RETURNS?

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KEY TAKEAWAYS

We forecast 8–10% returns for the S&P 500 in 2018.

The S&P 500 is well positioned to generate strong earnings, in our view, thanks to better global growth and potentially lower corporate tax rates.

Back to business: fundamentals to drive stock market gains in 2018. With a focus on business fundamentals and the impact of fiscal policy, the return of the business cycle means that earnings growth may have to shoulder most, if not all, of the load if stocks are going to produce attractive returns in 2018.

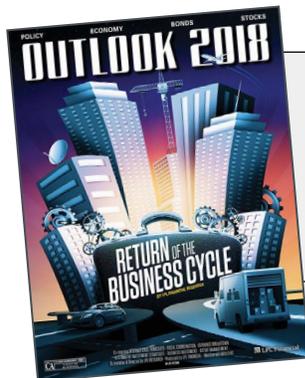
The good news is the S&P 500 Index may be well positioned to generate earnings growth at or near double-digits in 2018 thanks to a combination of better economic growth and potentially lower corporate tax rates, despite some possible downward pressure on profit margins from higher wages.

We also expect the stock market’s price-to-earnings (PE) multiple, at 19.5 times trailing earnings, to hold steady (or drop slightly) in 2018, as the economic cycle ages, inflation picks up modestly, and central bank policy tightens further*.

Risks to our stock market forecast include Congress failing to pass a tax agreement (a low risk after Senate passage over the weekend), a potential policy mistake by a central bank, and political uncertainty around the midterm elections.

EARNINGS COULD BE STRONGER THAN EVER

After three straight years (2014–2016) of basically flat S&P 500 operating earnings, at around \$118 per share, consensus estimates project \$131 earnings per share (EPS)



Please see our [Outlook 2018: Return of the Business Cycle](#) 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.

* 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 a lower PE ratio.

for 2017 and \$146 per share for 2018. Earnings are supported by better global economic growth, including a pickup in business spending and robust manufacturing activity, normalized inflation (near 2%), and stable operating margins, even with some modest wage and other input cost pressures.

Should tax reform, or even just a lowered corporate tax rate, be achieved, earnings may get another 5–6% boost on top of that, putting numbers above the consensus \$146 per share potentially in play. To break that down, a favorable macroeconomic backdrop supports mid- to high-single-digit earnings gains in the next year, consistent with long-term trends, resulting in our forecast of 8–10% growth, or roughly \$142–143 for S&P 500 EPS for 2018 [Figure 1]. Our forecast does not include any direct impact from the tax bill because passage is not assured at this time (although likely) and final details remain unclear. We would identify earnings growth in the 13–16% range as the upside potential we may see from tax reform.

SOME OTHER LEADERS TO TURN TO

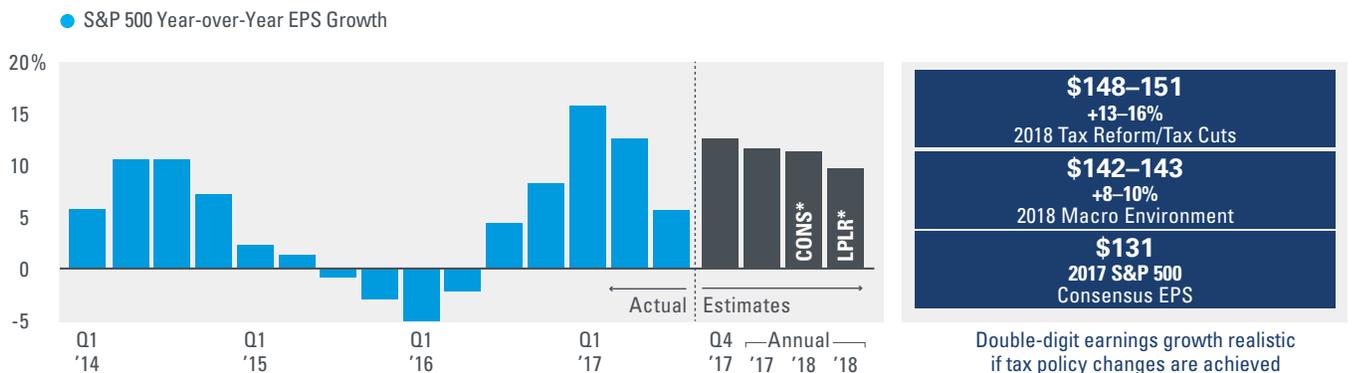
A focus on business fundamentals and the impact of fiscal policy will have implications for equity leadership across size, style, sectors, and geography.

Small Cap Opportunity

Since the initial post-election rally late in 2016, small caps have had a difficult time keeping up with the strong performance of large caps, at least until September 2017 when prospects for tax reform began to improve. Small caps generally pay higher tax rates than large caps—we estimate 5% higher on average—so any potential tax reform would benefit this group significantly [Figure 2].

As the monetary policy ball is handed off to fiscal policy and a more typical business cycle emerges, small cap performance may improve. That hinges on the White House and Republicans reaching a tax deal that can get passed through Congress. Small cap, which are more domestically oriented

1 STRONG EARNINGS GROWTH EXPECTED TO CONTINUE



Source: LPL Research, Thomson Reuters 10/31/17

*CONS = Consensus estimate; LPLR = LPL Research forecast. Estimates may not develop as predicted.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. EPS is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the PE valuation ratio.

companies, are also in a better position to weather a potentially stronger dollar due to their higher proportion of domestic revenue.

Technicals are also supportive of small cap. The trend for small cap performance relative to large caps is favorable, suggesting small caps may be poised to outperform large caps in 2018.

We see the risk to small caps related to the age of the business cycle as manageable at this stage, but small caps may underperform should a potential stock market correction materialize. It is also important to keep in mind, the prices of small cap stocks are generally more volatile than large cap stocks.

Style

Growth has been on a roll, outperforming value significantly so far in 2017. That leadership is nothing new, as growth has outpaced value consistently for a decade in what has been one of the longest periods of growth outperformance in history [Figure 3].

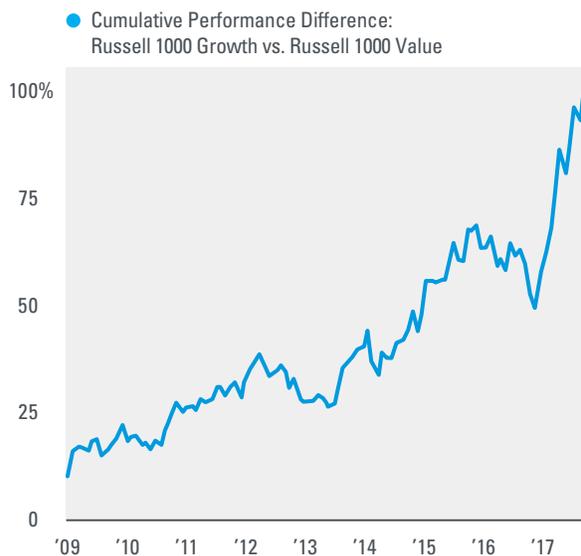
As markets return to more traditional business cycle drivers, several dynamics may contribute to a better environment for value stocks. The value style tends to perform better when economic growth accelerates, which we expect to see in 2018, especially if fiscal stimulus is put in place and corporate tax rates are lowered. The gradual acceleration since the first quarter of 2017 has not benefited value, suggesting that benefit could still be forthcoming. Higher interest rates as growth and inflation pick up, and a potentially steeper yield curve, may also support better value performance in traditional value plays such as financials; while strength in technology, the biggest growth sector, may moderate even if the sector outperforms as we expect.

2 MORE FAVORABLE FACTORS FOR SMALL CAPS THAN LARGE

	Small Cap	Large Cap
Tax Policy	✓	
Lower Corporate Tax Rate	✓	
Repatriation		✓
Stock Market Sensitivity	✓	
Cyclical Sector Leadership	✓	
Rising Interest Rates		✓
U.S. Dollar	✓	
Valuations		✓

Source: LPL Research 10/31/17

3 HAS THE GROWTH RUN BECOME OVEREXTENDED?



Source: LPL Research, Bloomberg 10/31/17

The referenced indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

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

Sectors

We expect cyclical sectors to outperform their defensive counterparts as the economic expansion continues. Our favored sectors include:

- **Financials.** May benefit from an acceleration in loan growth, deregulation, and a steeper yield curve as monetary policy stimulus is removed.
- **Industrials.** May benefit from stronger global economic growth, a pickup in business spending, and increasing government defense budgets.
- **Technology.** May benefit from a pickup in business spending, product innovation, and the sector's role as a productivity enabler.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Regions

From a regional perspective, we favor the U.S. and emerging markets (EM) over developed foreign markets broadly, although the improving outlook in Japan is noteworthy. When looking at a combination of economic growth (favors U.S. and EM), earnings growth (favors U.S. and EM), relative political stability (favors U.S., Japan, and China over Europe), and valuations (favors EM), we see the U.S. and EM having the most favorable risk-reward profiles.

When possible, we suggest hedging currency exposure in developed markets, which would make these markets more attractive to us given our expectation that the U.S. dollar will rise. ■

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

HOW TO INVEST

Our expectations for equity market leadership in 2018 are based on our forecast for stronger global economic growth, continued strong earnings gains, tighter monetary policy, and a gradual rise in interest rates.

U.S. Stocks



A slight pickup in economic growth and fiscal stimulus are supportive of a continuation of the bull market.

Cyclical Stocks



Improving economic environment is supportive of more economically sensitive investments.

Small Caps



A reduction in the corporate tax rate and potential gains in the U.S. dollar favor small caps.

Value



Rising interest rates to help biggest value sector (financials); relative valuations increasingly attractive.

Emerging Markets (EM)



Strong economic growth and attractive valuations help EM offset tighter global monetary policy.

U.S. Defensive Stocks



Improving economic environment favors more economically sensitive investments.

Growth



Better overall economic and profit growth may cause growth to lag value in 2018, while outsized gains for technology, the biggest growth sector, are unlikely to be repeated.

Developed International



European growth may have peaked while structural concerns remain, although outlook in Japan is positive.

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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 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.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Currency risk is a form of risk that 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.

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.

Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000® Value Index measures the performance of those Russell 1000 companies considered undervalued relative to comparable companies.

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