LPL RESEARCH

WEEKLY MARKET COMMENTARY

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MORE ON FED RATE CUT IMPLICATIONS

John Lynch *Chief Investment Strategist, LPL Financial*
Jeffrey Buchbinder, CFA *Equity Strategist, LPL Financial*

KEY TAKEAWAYS

We would recommend tilting equity allocations slightly toward value because of the duration and magnitude of the growth rally, but we recognize growth may get a boost from the Fed.

Small cap underperformance experienced over the past year may continue as the Fed's rate-cutting campaign gets underway.

Industrials, emerging markets, and gold may be among the beneficiaries of a more accommodative Fed, which could potentially contribute to a weaker U.S. dollar.

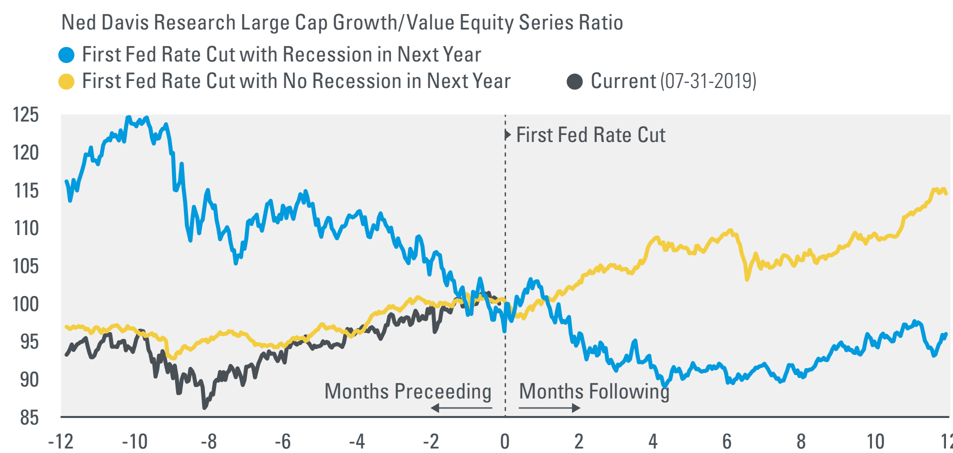
The Federal Reserve (Fed) is likely to start an easing cycle this week, which has several investment implications. We have written a fair amount about the Fed's U-turn in policy stance this year, including last week's *Weekly Market Commentary*. That reversal from raising rates to presumably lowering them will become a reality if the Fed cuts rates at this week's policy meeting, which concludes on Wednesday, July 31. Here we look at some potential asset allocation implications from this monetary policy transition.

GROWTH VS. VALUE

First, let's look at what initial Fed rate cuts might mean for growth stocks. This 10-year-old bull market has been powered by growth stocks. Much of that bull market has been accompanied by abnormally low interest rates and Fed bond purchases, also known as quantitative easing. Does that mean Fed rate cuts will fuel more gains for growth stocks?

To help answer that question we looked at a study from our friends at Ned Davis Research. The study looked at past initial Fed rate cuts to see how the relationship between growth and value stocks changed before and after those transitions. As you can see in Figure 1, in the absence of a subsequent recession within one year, growth stocks have done quite well relative to value after initial Fed rate cuts. If a

1 FEDERAL RESERVE MAY DELAY TRANSITION TO VALUE LEADERSHIP



Source: LPL Research, S&P Dow Jones Indexes, Ned Davis Research 07/28/19

Index performance normalized to 100 at first Fed rate cut. An upward sloping line indicates growth stocks outperforming value stocks.

Past performance is no guarantee of future results.

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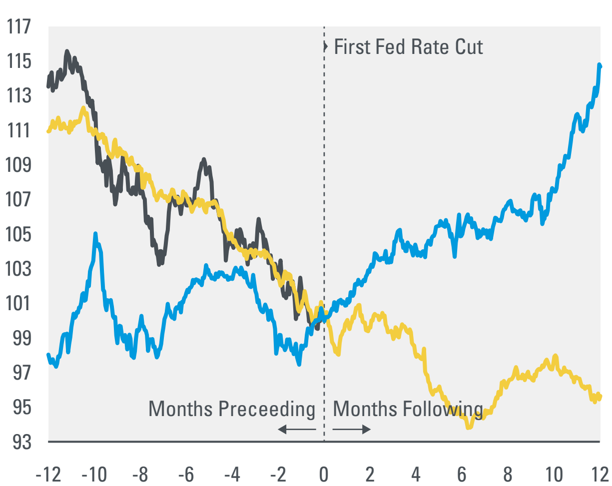
recession occurred within one year of the initial rate cut (not our expectation at this time), the growth-value relationship was a pitched battle. (Note that these studies are based on Ned Davis' classifications of growth and value stocks, which differ from the Russell indexes we normally use.)

The chart also shows that in the historical non-recession scenarios, growth stocks started to outperform about nine months on average before the rate cuts. In the past year, growth stocks started a run of outperformance November 19, 2018, a little more than eight months ago. This growth outperformance may signal continued economic growth and no recession over the next year, matching our view.

We would still recommend tilting equity allocations slightly toward the value style because of the duration and magnitude of the growth rally, which has left value stocks attractively valued in our view. Our positive financials sector view also points to a potential reversal of the growth rally. However,

2 LARGE CAPS MAY GET A FED BOOST IF NO RECESSION

Russell 2000 Index/Russell 1000 Index
- First Fed Rate Cut with Recession in Next Year
- First Fed Rate Cut with No Recession in Next Year
- Current (07-31-2019)



Source: LPL Research, FTSE Russell, Ned Davis Research 07/28/19

Index performance normalized to 100 at first Fed rate cut. An downward sloping line indicates small cap stocks underperforming large cap stocks.

Past performance is no guarantee of future results.

we recognize the counter arguments. Growth may get a boost from the anticipated Fed rate cut and is enjoying strong momentum from a technical analysis perspective. As a result, we suggest keeping any value tilts small.

SMALL CAPS VS. LARGE

Turning to market capitalization, let's look at what a Fed rate-cutting campaign may mean for small cap stocks relative to their larger counterparts. Again, we refer to analysis by Ned Davis Research that reveals some interesting trends [Figure 2]. First, we see that over the past year the relationship between small caps and larger cap stocks has generally followed the no-recession path with small cap stocks underperforming large caps. If this relationship were signaling recession, small and large cap stocks would have produced more similar returns over the past year.

Based on historical performance after initial Fed rate cuts, the chart shows a big divergence between small and large cap performance, particularly when breaking out recessionary and non-recessionary periods. Small cap stocks historically have done better after initial Fed rate cuts that occurred during recessions [Figure 2]. That may seem counter-intuitive, but the best time to invest in small caps historically has been during an economic contraction when markets began to sniff recovery. That doesn't mean small caps can't do well any other time, but they typically have performed best early in economic cycles. As the economy has slowed and the Fed has begun to lower rates, large caps typically have performed better.

If we assume we are in the non-recession scenario—our base case—then small cap underperformance experienced over the past year, as shown in Figure 2, may continue. That is consistent with our existing tactical view, in which we have favored large caps over small because of the aging economic cycle. In addition, we see a potential trade agreement with China later this year as a possible positive catalyst for the largest and most global companies. We continue to recommend suitable investors consider maintaining only very modest exposure to small caps, with much larger large-cap allocations at or above benchmark levels.

SECTOR IMPLICATIONS

The most obvious sector impacted by the Fed is financials, although Ned Davis Research has pegged financials as a market performer after initial rate cuts historically. Still, we believe attractive valuations, increasing dividend payouts, a continued favorable regulatory environment, and the potential re-steepening of the yield curve (meaning short-term rates would potentially fall back below long-term interest rates) could benefit the big banks, which generally posted good earnings over the past couple of weeks.

The best performing sectors after initial Fed rate cuts have historically been consumer staples, healthcare, and industrials. We prefer industrials from this group. Again, large cap stocks have tended to do better as economic cycles aged, and more defensive sectors generally fared well too. We continue to wait for healthcare valuations to fall further amid election-related policy risks before considering a more positive stance toward that sector. We do not believe the cycle is close enough to its end to recommend one of the most defensive sectors—consumer staples. Finally, technology's track record around initial rate cuts has been mixed, but we like the sector's growth opportunities enough to maintain our positive view.

Though it's not a sector, also consider that Fed rate cuts may take some wind out of the U.S. dollar's sails, which could support currency-sensitive assets such as emerging markets (equities and bonds) and gold. We have a positive view of emerging market equities, and we're warming up to gold.

CONCLUSION

The Fed will almost certainly cut rates this week—which will have implications for equity markets. As we explained last week, our bias is for stocks to go higher over the balance of the year, supported by Fed rate cuts and potentially more U.S.-China trade progress. However, gains from current levels of the S&P 500 Index may be modest and could come with more volatility.

The start of a Fed rate-cutting cycle could prolong the period of growth leadership and delay a potential value rebound. Large cap stocks may also enjoy tailwinds from a more accommodating Fed. Finally, we continue to favor financials, industrials, and technology among the equity sectors while emerging markets and gold may be a beneficiary of a more accommodative Fed. ■

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 and are subject to change at any time based on market and other conditions. 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.

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Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

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.

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 payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

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.

All information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

DEFINITIONS

Price to Forward Earnings is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation.

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.

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