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# THE DOW JOINS THE PARTY

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## KEY TAKEAWAYS

When the Dow hits a fresh record high after a long drought, as it did last week, it tends to be followed by above-average performance.

We believe the continued strength of the U.S. economy and corporate profits are the biggest reasons stocks have been resilient in the face of the ongoing trade dispute with China.

The market's resilience in the face of rising interest rates is encouraging but not surprising based on history.

**The Dow joined the S&P 500 in reaching fresh new highs last week.** The record came after a drought lasting nearly eight months. The blue chip index has lagged the S&P 500 Index and Nasdaq Composite this year amid escalating trade tensions, which have weighed on the larger multinational U.S. companies that make up most of the 30-stock Dow Jones Industrial Average (Dow). This week, we'll discuss the impact of the Dow's new high and whether stocks have enough support from economic growth and corporate profits to build on recent gains.

## NEW HIGHS TEND TO PRECEDE MORE NEW HIGHS

When the Dow reaches a new high, more new highs and above-average performance tend to follow. When there is a lot of time between record highs, the gains tend to be larger and more frequent. In fact, when a record high is the first in more than seven months, the average gain for the Dow in the following six months was 6.3%, with gains occurring 87% of the time (over 15 instances since 1950). Both of those measures are better than the historical performance for the Dow over all six-month periods, as shown in [Figure 1](#). Performance under those circumstances was even better over longer periods (e.g., 12 months), though it was similar over three-month periods. Of course, history doesn't always repeat, but we think the Dow has more new highs to make over the rest of 2018 and into 2019.

### 1 DOW INDUSTRIALS PERFORMANCE FOLLOWING ITS FIRST RECORD HIGH IN 7+ MONTHS

#### Dow Industrials Following First Record High in 7+ Months\*

	3 Months	6 Months	12 Months
Average Performance	2.3%	6.3%	13.7%
Percent Positive	53%	87%	80%

#### Dow Industrials Historical Performance (Over All Periods)

	3 Months	6 Months	12 Months
Average Performance	2.1%	4.1%	8.4%
Percent Positive	65%	69%	72%

Source: LPL Research, FactSet 09/21/18

\*Data back to 1950, covering 15 observations.

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.

A new high for the Dow also may be a positive economic signal. Based on data back to 1950, within six months of a Dow record high, a U.S. recession occurred less than 1% of the time. Over the subsequent year, the occurrences haven't been much higher, at 2.2%, compared with about 13% during any time in the period covered.

## SUPPORTIVE DATA

Some investors may be perplexed by the stock market's recent strength amid the ongoing trade dispute with China. The latest headlines—including news over the weekend that China had canceled trade talks slated for this week—have provided little cause for optimism. United States and Canadian trade officials have struggled to get NAFTA 2.0 over the finish line, and there is still work to be done with Europe. China is the primary target, but not the only source of trade-related angst.

So why have stocks done so well? We think the continued strength of the U.S. economy is the biggest reason. Some of the highlights:

- After a very strong second quarter, gross domestic product (GDP) is expected to grow roughly 3% in the second half, per Bloomberg consensus. Consumers are in great shape and business spending is picking up.
- The job market remains strong. Jobless claims reported last week fell to the lowest level since 1969. Income growth is starting to pick up, but is well below levels that have historically been worrisome for the Federal Reserve (Fed).
- Business and consumer confidence measures are quite high. The Institute for Supply Management (ISM) manufacturing survey is at its highest level of the economic expansion. Bloomberg's and

the University of Michigan's current conditions consumer confidence readings both are at or near the highest levels since the dot-com bubble. The University of Michigan consumer expectations index just surpassed its highs of the current economic expansion, while the National Federation of Independent Business (NFIB) Small Business Optimism Index hit an all-time high last week.

- The leading economic index (LEI) gained or was flat for the twenty-seventh straight month in August, rising 6.4% year over year and signaling more economic growth ahead. This is the longest streak without a negative LEI since the mid-1980s.

Some segments of the U.S. economy are cooling, including housing and autos, and we acknowledge the risk associated with further escalation of trade tensions. However, we expect the positive impact of fiscal stimulus, including tax reform and increased government spending, to more than offset these potential drags on growth and help support continued gains in stocks.

## MORE STRONG PROFIT GROWTH AHEAD

Strong profit growth has also helped buoy the stock market in recent months. After two quarters of annual S&P 500 earnings growth over 25%, a 22% increase is expected in the third quarter (which ends this week), followed by an expected 20% increase in the fourth (according to Thomson Reuters). Although the earnings growth rate may slow a bit in the second half, the strong economic backdrop—notably high manufacturing and business confidence—is likely to support continued solid earnings gains through year-end and into 2019. We plan to preview earnings season here within the next two weeks.

## 10-YEAR YIELD BREAKS 3%

Recent gains in the stock market are also encouraging given rising interest rates. Since August 24, the 10-year yield has moved from 2.81% to 3.06% while the S&P 500 is up about 3%. So should investors be worried about a further rise in rates? As long as the potential move is fairly gradual, as we expect, we don't think so. Historically, as shown in [Figure 2](#), stocks have done quite well when rates rise—particularly over the past three decades. In fact, since 1996, stocks have risen with

higher rates every single time (12 out of 12 times). Since 1962, the S&P 500 has gained an average of 6.1% during the rising rate periods, with gains in 83% of those periods (average increase in yield of 2.2%, average length of time of 13 months).

Bottom line, we do not see rising interest rates as a reason to sell stocks, particularly in the absence of runaway inflation. The market is interpreting higher rates as a response to better growth, not as a reason to fear a policy mistake, which we find encouraging. Find more details on the upcoming Fed meeting in this week's [Weekly Economic Commentary](#).

### 2 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%
07/08/16	03/13/17	8	1.2%	11.4%
09/07/17	05/17/18	8	1.0%	10.3%
05/29/18	09/20/18*	4	0.3%	9.0%
All Periods Since 1962: 24 Instances (Not All Shown)	Average	13	2.2%	6.1%
	Median	8	1.5%	4.5%
	Percent Positive			83.3%
Post 1996: 12 Instances	Average	7	1.4%	9.6%
	Median	5	1.3%	6.0%
	Percent Positive			100%

Source: LPL Research, FactSet 09/21/18

\*Note that the current period of higher interest rates is still active and not included in the aggregated calculations.

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

## CONCLUSION

Last week the Dow Industrials joined the S&P 500 and Nasdaq at fresh record highs, supported by a favorable outlook for the U.S. economy and corporate profits. Even though the S&P 500 is within the range of our year-end forecast (2,900-3,000)\*, we still believe the economic and profit backdrop is strong enough to support further gains. We could see more volatility around trade policy, midterm elections, higher inflation, or pockets

of stress in emerging markets. This bull market is already the longest ever, and the economic expansion may likely become the longest ever this spring. The so-called “wall of worry” that stocks are climbing is high, in our view.

Based on our forecast for a favorable economic and corporate profit environment over the balance of 2018 and into 2019, we are sticking with our positive stock market view. We continue to forecast stronger returns for stocks than bonds over the short-to-intermediate term. ■

\*Additional descriptions and disclosures are available in the [Midyear Outlook 2018: The Plot Thickens](#) publication

### IMPORTANT DISCLOSURES

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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.

Treasuries are a marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semiannually and the income that holders receive is taxed only at the federal level.

### INDEX DESCRIPTIONS

Dow Jones Industrial Average (DJIA), or DOW, is the most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. The 30 stocks are chosen by the editors of the Wall Street Journal. The Dow is computed using a price-weighted indexing system, rather than the more common market cap-weighted indexing system.

The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S. based common stocks listed on the Nasdaq Stock Market. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the Index.

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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