Weekly Market Commentary

Your weekly update on risks and opportunities in the financial markets.

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Is it Late Enough to Be Early?

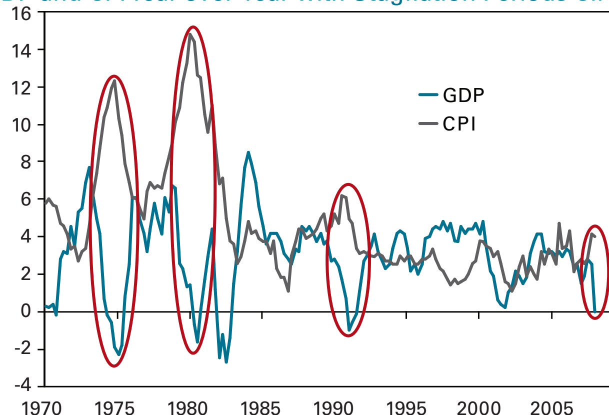
- Historically, stock market behavior shifts from late cycle to early cycle with sudden and definitive action. The late cycle environment has often been termed "stagflation".
- Currently, the stock market is exhibiting classic stagflation behavior: falling P/Es, leadership by the Materials and Energy sectors, and rising volatility.
- One of the key drivers of the current mild stagflation environment is the rise in energy prices. A break in oil prices and respite in the dollar decline may be the trigger for the decisive shift in the stock market from late cycle to early cycle environment fostering rising P/Es, a shift to Consumer Discretionary and Information Technology leadership, and subsiding (though still elevated) volatility.

When is it late enough in the business cycle to be the beginning of the next one? From an economic perspective, this question is often answered by economists a year or more after the time has passed and is subject to a wide degree of subjectivity. Alternatively, the stock market makes that determination in real time as behavior shifts from late cycle to early cycle with sudden and definitive action.

The late cycle environment is often termed "stagflation". This label refers to a period of stagnant (or contracting) economic growth with a rising pace of inflation. Last week's economic data pointed to a stagnant economy with a weak retail sales report and rising inflation with CPI data reflecting an ongoing rise in CPI since early 2007.

Late Cycle Periods of Rising Inflation and Falling Growth

GDP and CPI Year-over-Year with Stagflation Periods Circled



Source: Bloomberg, LPL Financial

It is important to note that this environment does not compare to the stagflation seen in the 1970s, when pay increases were rising at about 10% a year while corporate payrolls were shrinking. This level of stagflation took place in 1974-75 and again in 1979-1980. Later, from 1989-90, pay increases surged to 6% as payroll growth slowed. In contrast, current pay increases are close to 40 year lows. Unlike when inflation found its way into wages, it is now difficult for companies to pass on higher commodity prices to consumers – especially as demand slows. This limitation has kept inflation, while elevated relative to the past 10 years, relatively tame compared to the late cycle environments of the 1970s and 1980s.

Today's environment is a much milder form of stagflation. Notably, the current mild stagflation is not affecting the bond market in the usual way, with interest rates remaining low rather than surging to cycle highs. However, the stock market is exhibiting classic stagflation behavior: falling P/Es, leadership coming largely from the Materials and Energy sectors, and rising volatility.

Sector Ranking From S&P 500 Peak on October 9, 2007 to March 14, 2008

Sector	Total Return
Consumer Staples	-3.68
Energy	-3.75
Materials	-5.67
Utilities	-9.02
Industrials	-14.80
Health Care	-15.59
Information Technology	-19.58
Consumer Discretionary	-21.12
Telecommunications Services	-25.68
Financials	-33.91

Source: Bloomberg, LPL Financial

Previous periods of stagflation were ended by a peak in inflation and improvement in economic indicators. The end of stagflation was preceded by a shift in market behavior – P/Es rising, Materials and Energy leadership shifting to Consumer Discretionary and Technology, volatility subsiding (although remaining somewhat elevated). Also, bond yields typically began to fall – but in this case they are more likely to rise as sentiment on growth improves and because they have behaved differently than in prior episodes of stagflation.

Historically, the yield curve (the difference between yields on long and short term debt) steepens about six months before the turn in the cycle. The yield curve began to steepen at the end of August, about six months ago. If the turning point is near, then what might be a near-term catalyst to shift the market from late to early cycle? One of the key drivers of the current mild stagflation environment is the rise in energy prices, and the sharp rise in oil prices in recent months to $110 per barrel is starting to be felt in gasoline prices, slowing the economy and pushing up inflation. A break in oil prices (and respite in the dollar decline) may be the trigger for the decisive shift in the stock market from late cycle to early cycle environment.

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INDEX DESCRIPTIONS

Dow Jones Average - 30 Industrial

Prepared and published by Dow Jones & Co. It's one of the oldest and most-widely quoted of all the market indicators. The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries, and widely held by individuals and institutional investors. These 30 stocks represent about a fifth of the $8 trillion-plus market value of all U.S. stocks and about a fourth of the value of stocks listed on the New York Stock Exchange.

NASDAQ Composite Index

The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S. based common stocks listed on The Nasdaq Stock Market. The Index is market-value weighted. This means that each company's security affects the Index in proportion to its market value. 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

S&P 500 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. The index was developed with a base level of 10 for the 1941-43 base period.

Russell 3000 Index

Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. As of the latest reconstitution, the average market capitalization was approximately $4.8 billion; the median market capitalization was approximately $944.7 million. The index had a total market capitalization range of approximately $386.9 billion to $182.6 million.

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