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A SENTIMENT CHECK

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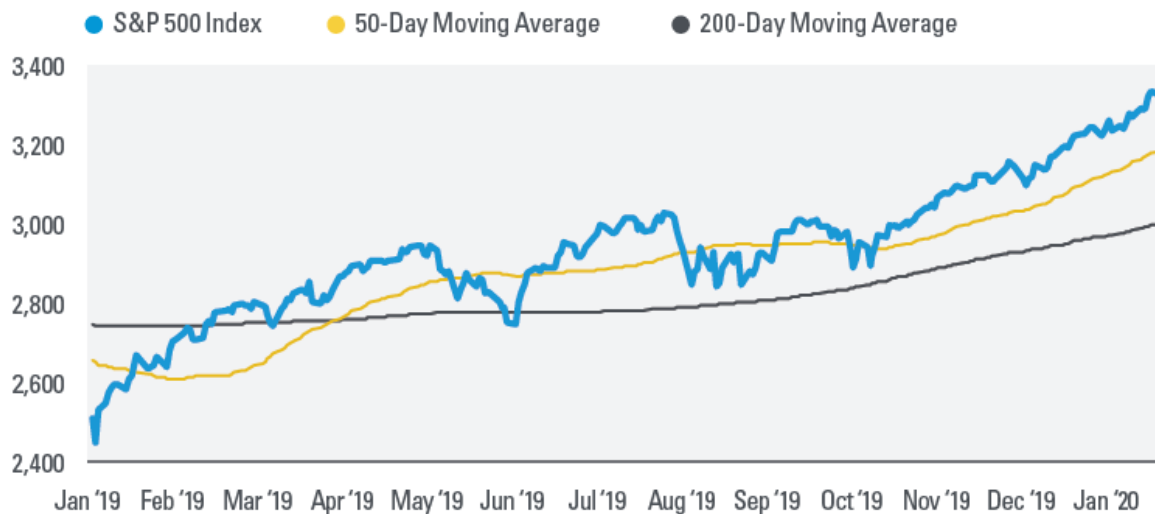
U.S. stocks have staged an impressive rally over the past few months. While we like seeing stocks rise, we're starting to see signs of overbought conditions and stretched sentiment in market indicators we watch. We still believe in long-term fundamentals, but we think a modest pullback may be looking increasingly probable.

CHARGING FORWARD

Wall Street has often called this the most hated bull market in history, and for good reason. Even though this bull market is the longest on record, it has been the third-slowest expansion since 1950 based on annualized growth. While slow and steady price appreciation has been frustrating at times, stocks' gradual ascent has helped sustain consistent gains for 129 months and kept sentiment in check.

The S&P 500 Index's latest rally has been anything but gradual, though, and the bull market has charged past our expectations for this year so far. The S&P 500 has climbed as high as 3,330 in January, breaking the upper end of our 2020 estimated fair value range of 3,250 to 3,300 [Figure 1].

1 SENTIMENT HEATS UP WITH IMPRESSIVE S&P 500 INDEX RALLY



Source: LPL Research, Bloomberg 01/17/20

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

SENTIMENT CHECK

In turn, investor sentiment has climbed to concerning levels. We think excessive sentiment shows stocks could be especially vulnerable to weakness if the optimism fades.

We're watching these market indicators for sentiment:

- **Stocks' momentum has been unusually strong.** The S&P 500 has climbed 15% since October 2, 2019, in what has felt like a straight line up. The biggest decline over that period has been a two-day drop of only 2% through October 8, 2019. As a result, the S&P 500 is sitting about 10% above its 200-day moving average, and the index's stocks are the most overbought they've been in two years (according to the Relative Strength Index).
- **Portfolio hedge purchases have dwindled.** On January 17, 2020, the 10-day average of the Chicago Board Options Exchange's (CBOE) put-volume-to-call-volume ratio fell to the lowest level since January 2011. This is important because fewer put options changing hands shows investors may be overly relaxed about the near-term market outlook, as puts typically have been bought to protect against market declines.
- **Cash balances have fallen.** Fund managers' cash balances are at a six-year low, showing investors have bought into other assets instead of using cash as a safe haven (according to data from Bank of America-Merrill Lynch). A significant reduction in cash suggests investors may be overwhelmingly on one side of market positioning.
- **Investors are historically optimistic.** The number of individual investors who feel bullish about the next six months (relative to those who feel bearish or neutral) rose to a 15-month high, according to American Association of Individual Investors (AAII) survey data released January 22, 2020. We view the AAII survey as a contrarian indicator, so this historic optimism bolsters our case for stocks' near-term vulnerability.

NO ALARMS YET

Sentiment is worth watching, as excessive optimism has doomed market rallies in the past. However, we're still not seeing alarming excesses, leading us to believe a pullback at this time would most likely be a temporary pause in the bull market. Broad participation and cyclical stocks' leadership in the latest climb may show that U.S. stocks have a good base from which to build. About 25% of S&P 500 stocks made new 52-week highs on January 17, the best participation on a record-high day since January 2018.

Other financial markets have also appeared solid, as global stock indexes like the Japanese Nikkei, the European Stoxx 600 Index, and the German DAX Index have joined the S&P 500 in breaking out to new highs this month. U.S. corporate credit spreads have pushed down to multi-year lows, and economic data has improved globally. Historically, sentiment has become more of a worry when fundamentals haven't supported market strength.

If stocks sell off, we'd expect the solid backdrop for equities to entice buyers back into the market before too long. We'd encourage suitable investors to view volatility here as an opportunity to possibly rebalance positions or add to current positions at a discount.

WHAT'S NEXT?

We still see the potential for a rebound in earnings growth to send stocks higher in 2020, even if the path isn't straight. We expect profits to recover as U.S. businesses welcome clarity from the U.S.-China phase-one trade deal. We could even envision modest upside to our earnings forecast in the event of further progress on trade and the possibility of additional tariff relief.

There are risks on the horizon, including still present geopolitical issues, impeachment hearings, and the upcoming election. With the S&P 500 charging past our fair value estimate, we expect more volatility in the near-term as momentum fades. When, and not if, this occurs, we'll look to the fundamentals supporting gross domestic product, inflation, employment, interest rates, and profits before making investment decisions. Considering these fundamentals, we'd likely position portfolios to benefit from any sentiment-related weakness and for leadership from large caps, value, international markets, and cyclical sector exposure.

OUTLOOK 2020

For more investment insights, check out our [*Outlook 2020: Bringing Markets Into Focus*](#).

WEEKLY MARKET PERFORMANCE REPORT

Please see our new [*Weekly Market Performance*](#) report with insights on major asset classes.

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