



Weekly Market Commentary



September 12, 2011

Beyond the Near-Term Clouds the Outlook May be Brightening for Long-Term Investors

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

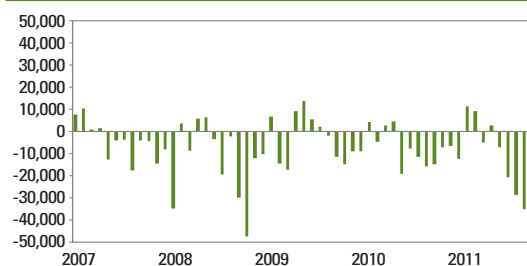
Highlights

We believe that the most consistently accurate predictor of long-term stock market returns is the S&P 500 Index price-to-earnings ratio (P/E). The P/E has demonstrated consistent success predicting long-term returns going all the way back to the 1930s.

Focusing on the short-term can be paralyzing for many investors. Long-term investors can take heart since the P/E predicts that this is the best time in 20 years to consider buying, not selling, stocks.

History shows us that what really matters is the price we pay, not so much what happens along the way.

1 Monthly Inflows/Outflows to Long-Term Domestic Equity Funds in \$Millions



Source: LPL Financial/The Investment Company Institute (ICI) 09/2/11

Friday's (September 9, 2011) stock market loss erased last week's gain. The S&P 500 ended the week at 1154, down 1.7%, near the middle of the range of about 1120 to 1200 that has prevailed since early August 2011. The near-term outlook remains clouded and uncertain. The main issue keeping the market in this volatile range is coming from overseas.

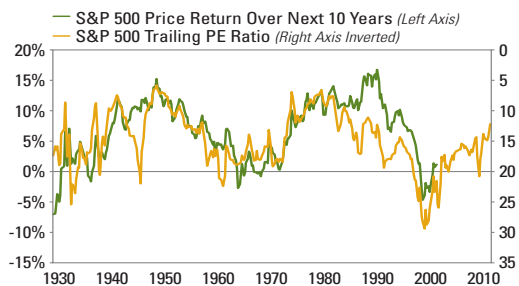
The sovereign debt problems in the eurozone require policy actions to get peripheral countries on the right fiscal path and ensure their funding until the European banks are sufficiently insulated and a partial default for Greece can take place. We assessed this situation in detail earlier this year in a *Weekly Market Commentary*, entitled "Greece Fire", published on June 20, 2011. In that publication, we noted that European banks have taken actions to reduce their exposure; in total, German banks exposure to Greek debt is about 1.2% of consolidated cross-border debt holdings and for France it is 1.8%. But the question of whether or not Greece's default can be orderly is complex. The fear among some market participants is that the default or restructuring of Greece's debt will trigger a series of financial institution defaults and a financial crisis throughout Europe and beyond similar to what happened in the fall of 2008 after Lehman Brothers unexpectedly declared bankruptcy. While our analysis suggests this is not likely to be the case, no one knows for sure unless it happens.

The near-term uncertainty over the outcome of the European debt problem, and the fragile state of the U.S. economy, has kept individual investors scared and prompted them to sell their holdings of stocks at the fastest pace since the peak of the financial crisis in 2008. We can see this in the monthly money outflows from U.S. stock mutual funds totaling \$35 billion in August [Chart 1].

Fortunately, the long-term outlook offers a clearer picture for investors.

Though past performance is not an indicator of future results, we believe that history has made it clear that the most consistently accurate predictor of long-term stock market returns is the S&P 500 Index price-to-earnings ratio (P/E). The P/E is obtained by taking the price level of the Index and dividing it by the earnings per share over the past four quarters. Essentially, the P/E is how many dollars investors are currently willing to pay per dollar of earnings. It makes sense that the price you pay when you buy a stock can have a big impact on your return. The level of the P/E and the annualized return on stocks over the next 10 years has a very close relationship, as you can see in Chart 2. In essence, the lower the P/E, the higher the return over the next 10 years. Currently, this relationship predicts that high single-digit gains are likely, on average per year, for the stock market over the next 10 years.

2 80-year Long-Term History: P/E Predicts Gains for Stocks-S&P 500 Price-to-Earnings Ratio and Next 10 Years Annualized Price Return



Source: LPL Financial/Thomson Financial/Bloomberg Data 09/2/11

Based on this relationship between future returns and P/E, the stock market's lowest valuations in 20 years suggests this the best time in 20 years for long-term investors to consider buying, not selling, stocks.

Despite the fact that the P/E has a nearly perfect track record of forecasting long-term performance, many investors have been selling and believe that it is different this time given the troubled banks, European credit problems, geopolitical tensions, concerns over both inflation and deflation, the U.S. budget deficit, threat of rising tax rates, and uneven economic data, among other concerns. We do not dismiss these issues. However, the P/E has demonstrated consistent success predicting long-term returns over the entire history of the S&P 500 Index—going all the way back to the 1930s.

Investors have always faced challenges. Since 1928, the S&P 500 has weathered massive bank failures, a dozen European countries defaulting, a world war, double-digit inflation, top marginal income and dividend tax rates of about 90 percent, the percentage of U.S. government debt-to-GDP at double the current level, not to mention the Great Depression. And yet, through all of these unprecedented events the P/E remained a consistently accurate forecaster of future long-term returns.

The annualized loss for stock market investors during decade of the 2000s was the result of the record high 30 P/E 10 years ago in early 2000. However, we believe the current P/E of about 12 forecasts a better decade for performance ahead. The current P/E of around 12 suggests a 7–8% price return for the S&P 500. The addition of a 2% dividend yield may result in a total return of 9–10% [Chart 2].

Based on this relationship between future returns and P/E, the stock market's lowest valuations in 20 years suggests this the best time in 20 years for long-term investors to consider buying, not selling, stocks.

Often, investing can be emotional, and the near-term clouds of uncertainty too often obscure what we may feel more certain of over the long term. This simple predictive relationship between P/E and future returns gives us hope that it is not different this time. It is easy to focus on all that could go wrong and assume it is insurmountable, but history shows us that what really matters is the price we pay and not so much what happens along the way.



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 reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of \$11.18 trillion and serve nearly 90 million shareholders.

The P/E 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 P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

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.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit