LPL RESEARCH

GLOBAL PORTFOLIO STRATEGY

February 2021

UPGRADING ECONOMIC AND MARKET FORECASTS

LPL Research's Monthly Market Outlook

We have raised our year-end S&P 500 Index fair value target range to 4,050–4,100 from 3,850–3,900 due to our increasingly optimistic expectations for US economic growth and corporate profits. Prospects for additional fiscal stimulus, recent progress in reducing COVID-19 cases, and the ramping up of vaccine distribution underpin our increased optimism. More economic growth potential in our view and a surprisingly strong fourth quarter earnings season have led us to increase our forecast for S&P 500 earnings per share in 2021 to $170 from $165. A strong earnings rebound may enable stocks to grow into somewhat elevated valuations. Our S&P 500 target is based on a price-to-earnings (PE) multiple of 21 and our still-preliminary but raised 2022 earnings forecast of $195. There is no change to our 10-year Treasury yield forecast range for 2021 of 1.25–1.75%.

KEY CHANGES FROM JANUARY'S REPORT:

- Upgraded value and energy views to neutral
- Downgraded growth and healthcare views to neutral
- In fixed income, upgraded bank loan view to neutral

INVESTMENT TAKEAWAYS

- Our equities recommendation remains overweight. We continue to favor stocks over bonds based on our expectation for a strong economic and earnings recovery in 2021, supported by prospects for additional fiscal stimulus, continued progress in combatting COVID-19, and the likely continuation of the low-rate environment.
- Key near-term risks include potential delays in the COVID-19 vaccine rollout and possible variant viruses, potential tax increases (unlikely until 2022), and tougher regulations under a Democratic-controlled Congress.
- We have upgraded our view of value-style stocks to neutral as the economic rebound potentially picks up speed, supporting cyclical value stocks.
- As the economic recovery progresses in 2021, we would expect cyclical value stocks to get a boost. We took a step toward balanced growth-value views last month with our financials upgrade and take another step this month in upgrading energy.
- We expect solid economic growth across Asia to support continued outperformance by stocks in emerging markets (EM). EM may garner additional support from potential easing of US-China trade tensions, although ongoing geopolitical and regulatory threats may lead to bouts of volatility.
- We continue to recommend remaining underweight fixed income. While Federal Reserve (Fed) policy and manageable inflation may limit the risk of a large rate move, rising rates may still put some pressure on bond returns while economic improvement may help support equities going out a full year.
- We favor a blend of high-quality intermediate bonds that is underweight US Treasuries with an emphasis on short-to-intermediate maturities and sector weightings tilted toward mortgage-backed securities (MBS).

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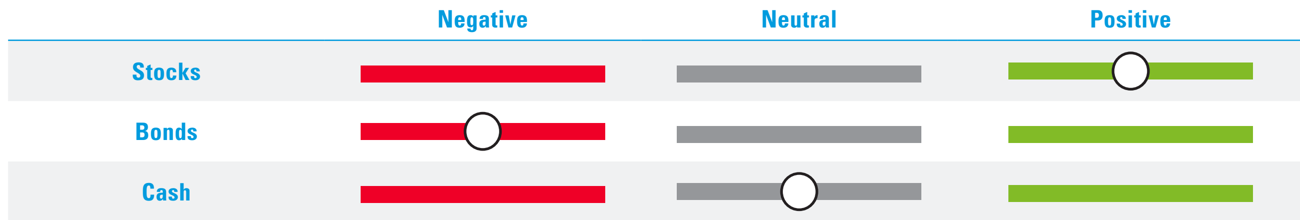
BROAD ASSET CLASS VIEWS

LPL Research's Views on Stocks, Bonds, and Cash



OUR ASSET CLASS & SECTOR CHOICES

Equity Asset Classes	Equity Sectors	Fixed Income	Alternative Asset Classes
▪ Emerging Markets Equities	▪ Materials ▪ Technology	▪ Mortgage-Backed Securities	▪ Event Driven

2021 MARKET FORECASTS

Raising Earnings and S&P 500 Forecasts

	Previous	New
10-Year US Treasury Yield	1.25–1.75%	1.25–1.75%
S&P 500 Earnings per Share	$165	$170
S&P 500 Fair Value	3,850–3,900	4,050-4,100*

Source: LPL Research

All indexes are unmanaged and cannot be invested into directly. The economic forecasts may not develop as predicted.

*As noted in our *Weekly Market Commentary* dated 02/8/2021, our year-end 2021 fair-value target range for the S&P 500 of 4,050–4,100 is based on a price-to-earnings ratio (PE) of 21 and our revised preliminary S&P 500 earnings per share (EPS) forecast of $195 in 2022.

2021 ECONOMIC FORECASTS

End of Pandemic to Usher in Strong Recovery

	Previous	New
United States	4% to 4.5%	5% to 5.5%
Developed ex-US	3.75% to 4.25%	3.75% to 4.25%
Emerging Markets	5% to 5.5%	5.25% to 5.75%
Global	4.5% to 5%	5% to 5.5%

Source: LPL Research

The economic forecasts may not develop as predicted.

All data, views, and forecasts herein are as of 02/05/21.

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EQUITY ASSET CLASSES

Squaring up Growth and Value as Recovery Gains Steam

We favor stocks over bonds in 2021 based on our expectation for a strong economic and earnings recovery, supported by additional fiscal stimulus, continued progress combating COVID-19, and still-low interest rates. We expect the strong rebound in economic growth as progress toward ending the pandemic continues to help cyclical value stocks keep up with their growth counterparts. We expect solid economic growth across Asia to support continued outperformance by stocks in emerging markets over their developed international markets counterparts.

	Sector	Overall View	Relative Trend	Rationale
Market Capitalization	Large Caps			The relatively greater financial strength enjoyed by most **large cap** companies has helped during the pandemic. But smaller market cap companies tend to perform better early in economic expansions and during the early stages of bull markets, which has caused market participation to broaden out.
	Mid Caps			**Mid caps** enjoy some of the early cycle characteristics of small caps, and therefore, should perform well as a more durable recovery develops. We believe mid cap stock valuations are more attractive than those of small caps in general.
	Small Caps			We maintain our neutral view of **small caps** with a positive bias. The early-stage bull market and beginning of the new economic expansion provide tailwinds for small cap stock relative performance. Although we see valuations as reasonable and justified by earnings, a pause or pullback may be warranted with the Russell 2000 Index up more than 120% since its March 18, 2020 lows.
Style	Growth			We have moved to a balanced style view of growth and value. We believe **growth stocks** will continue to be bolstered by strong earnings trends and favorable positioning for the pandemic in the near term. But as the threat of COVID-19 subsides and the economic recovery potentially picks up steam in the spring, cyclical value stocks may get a boost.
	Value			If a strong and durable economic recovery emerges in the coming months as we expect, we would expect cyclical value stocks to perform well. **Value stocks** remain attractively valued relative to their growth counterparts and tend to perform relatively well when economic growth accelerates. Our financials upgrade in January and this month's upgrade of energy are steps toward value.
Region	United States			Among developed markets, we remain US-focused, but international developed equities have become more interesting as the world moves closer to the end of the pandemic and the case for a weaker US dollar builds. We see solid gains for US stocks in 2021, but the gap between US and developed international stocks has started to narrow.
	Developed International			As a more durable economic expansion materializes and the US dollar potentially weakens further, performance for European and Japanese markets may improve. We give the edge to Japan over Europe based on the country's massive stimulus efforts and relative success containing COVID-19.
	Emerging Markets			We expect solid economic growth across Asia to support outperformance by emerging market equities over developed markets in 2021. China has led the way out of the global health crisis and is the only major economy in the world that grew in 2020. US-China tensions may calm some under a Biden administration, though political instability in certain emerging countries carries risk.

Trend is measured by relative performance of the index for the past 12 months, minus the most recent month, compared to the other indexes in a particular sector or asset class grouping.

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EQUITY SECTORS

Upgrading Energy, Downgrading Healthcare

We continue to favor cyclical sectors in general for 2021 based on the early cycle stage of the economic expansion and bull market and improving prospects for a strong economic rebound in 2021. Our sector preferences have shifted more toward cyclical value with our upgraded energy view (to neutral) and downgraded healthcare view (also to neutral), which followed January's upgrade of financials to neutral. We continue to like materials and technology, which have both generated stellar mid-teens year-over-year earnings growth during fourth quarter earnings season.

	Sector	Overall View	Relative Trend	S&P Wgt	Rationale
Cyclical	Materials			2.6	As China's economy outpaces the rest of the world, metal and agriculture prices have firmed. Beneficiary of weak US dollar and strong housing market. Additional fiscal stimulus passed in December 2020 and more is on the way.
	Energy			2.5	Demand outlook has improved and technical analysis signals are more positive, driving our upgraded view. Still, supply overhang may limit oil price upside as production has become more profitable.
	Industrials			8.1	Expected to be among the biggest beneficiaries of an eventual durable economic recovery. Support from strong Chinese economy and potential weak US dollar. Earnings poised to rebound strongly in 2021.
	Communication Services			10.9	Beneficiary of the stay-at-home environment. Risk of rotation toward cyclicals as economy reopens is a concern, and regulatory environment may toughen. Valuations are reasonable.
	Consumer Discretionary			13.0	Historically a strong early-cycle performer. E-commerce and housing are booming, supporting our neutral view despite rich valuations and likely long wait for hospitality, travel, and leisure industries to fully recover.
	Technology			28.0	Among the best Q4 2020 earnings performers. Benefiting from work-from-home environment and some powerful secular mobile and cloud computing trends. Valuations are still reasonable overall, in our view.
	Financials			10.6	Recently upgraded view driven by steeper yield curve, rising interest rates, improving economic outlook, and higher shareholder payouts. Low interest rates and tepid business loan demand remain challenges.
Defensive	Utilities			2.7	Valuations are reasonable, and more green energy spending may help boost growth, but we still expect interest rates to rise and prefer healthcare among defensives.
	Healthcare			13.3	The healthcare spending outlook, demographics, and valuations are still supportive, and policy clarity may help performance at some point, but economic cycle considerations, relative earnings growth, and our technical analysis assessment temper enthusiasm.
	Consumer Staples			6.1	Historically a poor relative performer early in economic cycles. Defensive sector may have to wait for a market correction to outperform, as it did early in the pandemic.
	Real Estate			2.4	Like consumer staples, likely underperformer early in economic cycles. Mixed fundamentals and interest rate sensitivity suggest caution, though technology and industrial segments are strong.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

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.

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FIXED INCOME

Limit Rate Sensitivity With Intermediate Focus

We suggest a blend of high-quality short-to-intermediate bonds in tactical portfolios. We expect the 10-year Treasury yield to climb to 1.25–1.75% in 2021 as economic activity continues to recover. Compensation for longer-maturity, rate-sensitive bonds remains unattractive, in our view, supporting our positive view of MBS. We still see incremental value in corporate bonds over Treasuries, but credit spreads have little room for further tightening. We favor municipal bonds as a high-quality option for taxable accounts, although valuations relative to Treasuries have normalized.

		Low / Medium / High	Rationale
Positioning	Credit Quality	Medium	Credit spreads have tightened significantly, but the economic outlook may be supportive.
		Short / Int. / Long	
	Duration	Short–Int.	Concerns over rising interest rates with the prospects of economic acceleration increase interest-rate risk.
		Neg. / Neutral / Pos.	Rationale
Sectors	US Treasuries	Neg.	Yield spreads to international sovereigns remain attractive. Yields still low versus history after COVID-19-related demand. Inflation breakeven rates leave TIPS fairly valued.
	MBS	Pos.	Fed buying is supportive and refinancing and prepayment slowing. MBS may provide some resilience if rates rise. Diversifying source of yield among high-quality options.
	Investment-Grade Corporates	Neutral	Risks tempered as economy improves and vaccine distribution progresses. Leverage metrics have increased, but cash levels are high. Interest-rate sensitivity has increased but shorter maturity options exist. Tight credit spreads limit attractiveness.
	Preferred Stocks	Neutral	Higher credit quality among the riskier fixed income options. Bank fundamentals sound overall. Can be rate sensitive but may be able to tolerate gradual increases.
	High-Yield Corporates	Neg.	Valuations have grown rich but economic environment may become more supportive. Distressed high-yield bond levels are back to pre-COVID-19 levels and defaults have slowed. More attractive for income-oriented investors. We believe equities have more upside and high-quality options may be better diversifiers.
	Bank Loans	Neutral	Economic environment supportive and better sector mix than high yield. Economic acceleration may support demand. Floating rate structures becoming more attractive as rates rise. Fewer investor protections, below-historical credit ratings and illiquidity of individual loans remain concerns..
	Foreign Bonds	Neg.	Rich valuations, interest-rate risk, and potential currency volatility are among the negatives.
	EM Debt	Neutral	Dovish central banks improve the valuation picture. Stronger global growth and commodity prices could be supportive, but spreads no longer attractive. Liquidity can be an added risk during periods of stress.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk. **Bank loans** are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk. For the purposes of this publication, **intermediate-term bonds** have maturities between 3 and 10 years, and short-term bonds are those with maturities of less than 3 years.

All bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. **Corporate bonds** are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. Investing in **foreign and emerging market debt (EMD)** securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. **High-yield/junk bonds** are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors. **Municipal bonds** are subject to availability, price, and market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply. **Mortgage-backed securities (MBS)** are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

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COMMODITIES

Favor Industrial Metals

Our view of **industrial metals** is positive, reflecting China's strong economic growth outlook, an improving outlook for growth in the United States, and the strong technical momentum of copper. A potentially weaker US dollar could provide a boost to industrial metals and the broader commodities complex.

Our **precious metals** view is neutral. Our December downgrade of this asset class was driven primarily by our technical analysis work that suggested less upside potential in the near term. The attractiveness of precious metals is further reduced by the improving economic outlook and rising interest rates, although the potential for additional US dollar weakness may help attract some interest in the gold commodity and support the price.

Our **crude oil** outlook is positive primarily due to improving signals from our technical analysis work. At the same time, the global demand outlook has improved recently as the end of the pandemic comes into view, and higher oil prices have increased the amount of profitable available production. Our concerns remain the US supply overhang that may limit further upside potential for prices, the potential for more production internationally as prices rise, and the likely slow recovery in travel-related demand, particularly air travel.

ALTERNATIVE INVESTMENTS

Event-Driven Outperforms

Alternative investment strategy performance was more range bound than usual during January as turbulence within the long/short industry led to manager specific declines due to short positioning. However, **event driven strategies**, which remain our preferred implementation solution, were able to deliver positive returns with the HFRX Event Driven Index gaining .7%. The merger and acquisition environment continues to be supported by access to cheap funding, private equity dry powder, and the ability to use all-time high share prices for share transactions. While this environment has been healthy for transactions, it's unfortunately led to the average deal spread tightening to roughly 5%, which is in-line with the historical average and something we are closely considering. At this point, we believe the sheer number of investment opportunities across the event driven space compensates for the average deal spread and we believe skilled active managers will continue to add value. While the strategy continues to feature a conservative risk profile, if spreads continue to decline and if merger announcements were to taper off, we would consider revising event driven strategies as our top alternative investment pick.

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IMPORTANT DISCLOSURES

This material has been prepared for informational purposes only, and is not intended as specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors and they do not take into account the particular needs, investment objectives, tax and financial condition of any specific person. To determine which investment(s) may be appropriate for you, please consult your financial professional prior to investing. Any economic forecasts set forth may not develop as predicted and are subject to change.

Stock investing involves risk including loss of principal. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies. Value investments can perform differently from the market as a whole and can remain undervalued by the market for long periods of time. The prices of small and mid-cap stocks are generally more volatile than large cap stocks. Bonds are subject to market and interest rate risk if sold prior to maturity.

Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Corporate bonds are considered higher risk than government bonds. Municipal bonds are subject to availability and change in price. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply. U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. It is expressed as a number of years.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments. The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

All index data from FactSet.

For a list of descriptions of the indexes referenced in this publication, please visit our website at lplresearch.com/definitions.

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